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Minutes of Executive Board Meeting 92/111

3:00 p.m., September 2, 1992

M. Camdessus, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	A. A. Al-Tuwaijri
G. K. Arora	
	Wei B.
	J. Jamnik, Temporary
T. C. Dawson	Q. M. Krosby
	J. Prader
E. A. Evans	
	J. Papadakis
	M. B. Chatah, Temporary
	J. A. Solheim
H. Fukui	N. Tabata
	B. Esdar
	T. Sirivedhin
	F. A. Quirós, Temporary
	P. Bonzom, Temporary
A. Mirakhor	O. Kabbaj
	L. J. Mwananshiku
D. Peretz	J. Dorrington
G. A. Posthumus	
C. V. Santos	
A. Torres	R. Marino
A. Végh	

L. Van Houtven, Secretary and Counsellor
T. S. Walter, Assistant

Also Present
Central Asia Department: U. Baumgartner. European I Department: S. Oberg. External Relations Department: S. J. Anjaria, Director; A. Mountford. Fiscal Affairs Department: F. C. Ribe. Legal Department: K. Sono. Policy Development and Review Department: J. Boorman, Director; R. Danielsen, N. Kirmani. Research Department: M. Mussa, Economic Counsellor and Director; J. Baras, D. T. Coe, R. Feldman, R. P. Ford, S. J. A. Gorne, M. D. Knight, M. S. Kumar, F. Larsen, P. R. Masson, G. J. Schinasi, S. A. Symansky. Secretary's Department: A. Jbili, A. Leipold. Southeast Asia and Pacific Department: K. Saito, Director. Treasurer's Department: L. Duke, M. A. Wattleworth. Western Hemsiphere Department: F. van Beek. Office in Geneva: H. B. Junz, Director. Office of the Managing Director: B. P. A. Andrews, R. Saunders, Personal Assistants to the Managing Director; J. Prust, Advisor to the Managing Director. Advisors to Executive Directors: J. M. Abbott, L. Dicks-Mireaux, M. J. Mojarrad, A. Raza, B. A. Sarr, A. Törnqvist, S. von Stenglin. Assistants to Executive Directors: S. E. Al-Huseini, B. Bossone, Chen M., J. A. Costa, M. A. Hammoudi, K. J. Langdon, W. Laux, G. J. Matthews, F. Moss, N. Shimizu, N. Sulaiman, T. P. Thomas, R. Thorne.

1. WORLD ECONOMIC OUTLOOK

The Executive Directors continued from the previous meeting (EBM/92/110, 9/2/92) their consideration of a staff paper on prospects and policy issues related to the world economic outlook (EBS/92/127, 8/6/92), together with a statistical appendix (SM/92/154, 8/7/92) and annexes providing supplementary background material (SM/92/156, 8/7/92). They also had before them charts and tables on exchange rate developments (EBD/92/189, 8/31/92).

Mr. Mirakhor made the following statement:

I would first like to thank the Economic Counsellor for the candid remarks that he made this morning; it is to be hoped that the remarks made by some Directors will constrain neither his candor nor his language. We also hope that the usual "sources close to the Executive Board of the Fund" will be magnanimous enough to leave his candid comments for consumption only by the Board even if they feel obliged to report on the substance of his remarks to others.

The Economic Counsellor's comments were very important, particularly those made in reference to the need for international economic coordination. Lack of this kind of coordination has dimmed the prospects for intensified international cooperation in other areas as well, and this is most unfortunate because economic cooperation is a much easier task than many others that need greater international cooperation. If an early conclusion of the Uruguay Round does not materialize soon, the expected dividends of the post-cold war period would be further diminished.

As regards the world economic outlook exercise, I agree with the comments made by other Directors on the quality of the papers, particularly the highly informative review of structural reforms in the developing countries. Here, I share Mr. Filosa's view and support his call for further analysis of countries that have not succeeded in their adjustment efforts.

I was also pleased with the technical annex relating to the assessment of the accuracy of the projections in the World Economic Outlook over the past two decades. While I welcome the inclusion in this assessment of world economic outlook projections for developing countries, it would have been more illuminating if the magnitude of the various components of the projection errors had been included. This would help in determining the extent to which policy assumptions, model design, and measurement errors, respectively, contributed to projection errors.

On the outlook for industrial countries, I wish to join other Directors in commending the Japanese authorities for their recent fiscal stance. With regard to EC policies, I have sympathy for Mr. Dawson's views on the degree of macroeconomic policy rigidities, particularly in countries that, to a large degree, meet inflationary convergence criteria. Here, I was somewhat surprised by Mr. Dawson's criticism that, in the world economic outlook papers, "policy rigidity is encouraged." He may have possibly overlooked the remarks on page 29 of the main staff paper on the existence of policy flexibility in some EC countries. These remarks, I believe, are right on target.

I made similar points at the time of the Netherlands' 1991 Article IV consultation discussions (EBM/92/25, 2/28/92), namely, that the members of the EC have greater policy flexibility than is commonly assumed. Once a member makes the commitment to join a fixed exchange rate regime and brings its inflation rate in line with the anchor, and once that commitment has gained credibility in the financial markets, constraints on policies are less binding than is commonly supposed. In fact, the "no monetization" requirement of a hard-currency policy need not be incompatible with a considerable degree of policy autonomy. This point is made succinctly and effectively in an excellent paper by Hugh Bredenkamp and Michael Deppler, "Fiscal Constraints of a Fixed Exchange Rate Regime," in a 1990 Fund publication, Choosing an Exchange Rate Regime. Concentrating on fiscal policy flexibility in a fixed exchange rate regime and assuming inflation rate convergence, they argue that policy autonomy need not be compromised by either the exchange requirements of a fixed exchange rate regime or attempts to maintain an external balance so that the country can participate in a hard-currency regime or monetary union. In fact, they argue that a wide range of deficit and debt ratios can be--and indeed have been--consistent with stable exchange rates, provided that larger deficits are not associated with increased monetary financing.

I know that Mr. J.M. Keynes is not very popular in this building; however, he once said that management of the domestic economy depends on the freedom to have the appropriate rate of interest without reference to the rates prevailing elsewhere in the world. By this account, it appears that only one country in the European Community is in a position to design its policies against the background provided by the needs of its own domestic economy. As these requirements will not necessarily be similar to those of other countries, these policies will not only have an impact on European economies directly but will also, through feedback, generate ripple effects that will be felt on the world economy. In this connection, the Economic Counsellor referred earlier to the risks to developing countries' growth prospects from the spillover effects of recent developments in Western Europe. It is to be recognized that a common currency and a common policymaking apparatus, which can design policies with reference to the economic circumstances of the Community as a whole, will help; during the transition, however, other lead economies in the Community with low and stable inflation rates, such as those mentioned on page 29 of the staff paper--France, in particular--could and must take the lead in balancing the adverse consequences of the corrective tight policies implemented in the anchor country. There is no compelling reason to believe that the degree of policy flexibility that needs to be exercised by these countries should or would compromise their commitment to a stable exchange rate.

Turning to the developing countries, I share the concerns expressed by Mr. Kafka regarding the growth rate of 6 percent projected for these countries in 1992. It is clear from Table 3 that the projected average growth rates are GDP-weighted, and that, on account of Asia's large weight, the aggregate rate converges to that of Asia's, which is 6.2 percent. However, there is considerable divergence among the projected growth rates for the different regions, and it would have been useful if the staff had discussed these in some detail. Africa's average growth rate, at 1.8 percent, and that of the Western Hemisphere, at 3 percent, are below the average for all developing countries by more than 4 percentage points and 3 percentage points, respectively. In the Middle East region, which also has a part in pulling the average growth rate up, the category labeled "other" has the largest growth rate for 1992, reflecting reconstruction efforts in the countries in the region that were most affected by the Kuwait war.

A column in Table 3 showing the 1993 forecast for developing countries would also have been helpful. Given the present stance of international oil prices and the drop in the U.S. dollar, it is difficult to see how the Middle East region will be able to meet the heavy financial requirements of reconstruction and growth in the near term, particularly if the forecasted recovery in the industrial countries fails to materialize.

Nevertheless, we agree with the staff that macroeconomic stability and structural reform bring about a flexibility in the economic structure that enable economies to absorb adverse external shocks more efficiently. However, these policy reforms take a long time to bear fruit, and, among the developing countries, there are only a few that embarked upon such reforms long enough ago to have experienced permanent effects. More important, the credibility of the reform program is crucial to the response of the private sector to these measures. Even in very successful countries, such as Mexico, it took many years before private investors began to respond positively to the new economic environment. In countries that have succeeded in achieving macroeconomic stability but have been unable to introduce key structural reforms because of social and political factors, growth has been relatively fragile.

In addition, a major risk facing the reforming developing countries is the continued protectionism in the markets of industrial countries. Most of the reformers are redirecting their resources toward the tradable goods sector and exports. If the markets of the industrial countries are not opened to the developing country exports, the latter will face lower growth prospects, which will undermine their willingness to undertake the reforms in the first place.

For these reasons, projections of investment and growth for the developing countries, to the extent that they are based on ongoing economic reforms in these countries, may be somewhat overstated. Indeed, since the mid-1970s, the year-ahead projections for developing countries, except for a couple of years, have consistently been optimistic. Regarding Africa, I share the concerns and the comment made earlier by Mr. Al-Jasser that "efforts to assist this continent must not be allowed to slacken."

As to Eastern Europe and the newly emerging states of the former Soviet Union, this region has suffered substantial output decline since 1990. In addition to the inevitable transitional disruptions associated with the dismantling of the command system, two immediate causes of the massive decline in output have been the breakdown of the Council for Mutual Economic Assistance (CMEA) trade bloc and the obsolescence of much of the capital stock in these countries. While there has been some supply response to market forces, the difficulties involved in finding new markets and developing new products have hampered this response. The limits to the pace with which structural change can be brought about and the crucial link between structural reform and financial stability, on the one hand, and uncertainties over property rights, on the other, have also adversely affected the supply response in this region. Needless to say, further development of this region will depend crucially on the level of assistance forthcoming from the industrial countries and, as Mr. Filosa suggested, the political will of the countries themselves to pursue adjustment efforts.

Mr. Solheim made the following statement:

Like many of the previous speakers, I wish to first compliment the staff for having produced a very stimulating and useful world economic outlook paper. I will organize my remarks in accordance with the issues for discussion and conclude with some observations on trade.

First, although the expansion envisaged in the world economic outlook paper for 1992 and 1993 is weak by historical standards, my authorities consider that the balance of risk is once again on the downside. Most of the recent economic indicators remain weak, which may justify an even larger downward adjustment of the forecasts than outlined by the Economic Counsellor this morning.

The problem of predicting the strength of the present recovery is related to the uncertainties concerning the timing and magnitude of balance sheet restructuring in the private sector. The reason for this is, of course, the rapid accumulation of debt during the 1980s in many countries. The experiences of some Nordic countries show that the strength and duration of the impact of financial consolidation have been underestimated. The continued fall of asset prices in many countries may increase the need for further financial consolidation and thus undermine confidence. In this connection, I am in broad agreement with the staff's interesting descriptions and assessments in Annex I, which deals with financial sector adjustments. Notwithstanding the progress made in liberalizing financial markets, further measures need to be taken by the authorities to strengthen financial inspection in order to foresee and avoid unfavorable developments.

However, there are also positive signs. The rate of inflation has decelerated, and, in the United States, this has led to some fall in long-term interest rates, even though no reduction of the budget deficit has been signaled. Lower long-term rates in the United States and Japan will improve the prospects for stronger economic growth. A possible reduction of interest rates in Europe may stimulate the upswing there, also. At the same time, the weak response to lower interest rates by the U.S. economy clearly illustrates the extent to which financial imbalances and a large federal budget deficit may reduce the impact of an expansionary monetary policy on the real economy.

Second, with regard to policy issues in industrial countries, it is crucial to reduce the structural budget deficits in order to make room for increased capital investments. In Europe, compliance with the criteria for joining the European economic and monetary union (EMU) will work in this direction, even if this temporarily may lead to a lower growth rate, as illustrated by the staff in Annex III. If the EC countries with substantial budget deficits start their budget consolidation in a convincing way, this may strengthen confidence and subsequently improve their growth prospects.

Although there is a need for decisive fiscal consolidation in most industrial countries, the United States and Germany--even if the situation in the latter is somewhat unique, owing to the German reunification--have a special responsibility, in view of the negative effects of their deficits on the world economy. However, Japan represents a positive example as regards fiscal policy. Owing to the fiscal restraint exercised by the Japanese authorities over several years, it is the only major industrial country with scope for a countercyclical fiscal policy. My authorities welcome the fiscal policy measures recently proposed by the Japanese authorities.

The present mix of fiscal and monetary policies in the major industrial countries and the differences in their policy approaches have created unrest in the international currency markets. Clearly, there is a need for much better policy coordination among the major countries to ease tensions on the exchange markets, and to help secure sustainable growth.

German short-term interest rates are now about 6 percentage points higher than the corresponding U.S. rates. This implies that there is a large potential for lower interest rates in Europe as soon as inflationary pressures in Germany abate. However, unless European budget deficits are sharply reduced, long-term interest rates may remain at a high level even if short-term rates start to decline.

Low long-term rates are not an end in themselves. An important role of real interest rates is to establish equilibrium between savings and investments. In order to achieve economic growth, both savings and investments need to increase. Thus, measures to stimulate savings ought to be given the highest priority. In addition to the reduction of budget deficits, these measures should include the elimination of disincentives to save and the promotion of investment profitability.

The moderate economic growth foreseen by the staff will not be sufficient to reduce the high unemployment. In order to alleviate this problem, an active labor market policy is necessary. This may include, inter alia, incentives to the unemployed for actively seeking jobs, the abolishment of regulations hampering employment, increased wage flexibility, and measures to sustain and upgrade the skills of the unemployed.

Third, turning to the outlook for developing countries, I wish to commend the staff for its useful and interesting review of the experience of countries that have been successful in their adjustment efforts. The analysis confirms that fiscal and monetary stabilization, combined with structural reforms aiming at increased competition and functioning markets, contributes to a positive economic development. However, the time lag of such policies may vary markedly between countries.

Furthermore, it is of crucial importance for developing countries to encourage savings. Fiscal and financial market reforms should be undertaken with this aim. Other important structural measures are the opening of foreign trade, the privatization of public enterprises, and the strengthening of the educational system. The analysis shows clearly that, of all the measures that can improve the situation of developing countries, the major part has to be undertaken by these countries themselves.

One of the most important ways in which the industrial countries can improve the outlook for the developing country group is by opening their economies for trade with that group. Debt restructuring, combined with supplementary external financing, is also essential. Although much has been achieved in this area during the past year, this will be of particular importance in the future for the low-income developing countries.

Fourth, concerning the transformation process in the former centrally planned economies, my authorities concur with the view that positive results can be achieved only by a combination of stabilizing measures and structural reforms. It is not evident that a more gradual implementation of reform policies would have resulted in a less steep fall in output in these countries. A more gradual approach could have undermined public confidence in the reform process and thus negatively influenced both production and the restructuring of the economy, especially in a long-term perspective.

Some countries have made progress in stabilizing their economies, but their experience indicates that structural reforms should have been implemented at an even faster pace. Without the appropriate incentives for entrepreneurial efforts, it will be difficult to obtain the necessary supply response to the stabilization policy measures. It is absolutely indispensable to establish the legal and institutional framework of a market economy and privatize public enterprises. In addition, my authorities wish to reiterate the importance for these countries of fully implementing their Fund-supported programs. Continued technical assistance in building structures and institutions will remain a task of high priority for the Fund in the coming years.

In order to increase trade among the former centrally planned economies, the establishment of a functioning multilateral payments system should be given the highest priority. An important step in this direction is to make the ruble convertible for current transactions. Clear and effective monetary arrangements within the ruble area are urgently needed. The coordination of monetary policies within the ruble area will necessarily be problematic. Although all parties involved have a common responsibility for solving these problems, a special responsibility falls on Russia.

Fifth, with regard to international trade, my authorities wish to express their concern about the lack of progress in completing the Uruguay Round. The major industrial countries carry a special responsibility for achieving a successful conclusion. The unclear prospects for the future of the multilateral trade system are one of the many uncertainties now facing the international economy--and one which is probably an obstacle to higher economic growth. Furthermore, a well-functioning multilateral trade system would facilitate the integration of the former centrally planned economies into the world economy and strengthen the potential for growth in the developing countries. If the Uruguay Round fails, there is a great risk for increased protectionism. The creation of regional trade blocs should not be allowed to negatively influence the efforts to conclude multilateral agreements.

To conclude, trade policy plays in many respects a crucial role for the future development of the world economy. Accordingly, my authorities feel that trade issues should have been given somewhat greater attention in the present world economic outlook paper.

The Chairman said that he agreed completely with Mr. Solheim's authorities on that final point. However, in the 12 most recent World Economic Outlooks, trade policy issues had been dealt with quite exhaustively. In particular, the October 1990 World Economic Outlook had featured an analysis--which had lost very little of its relevance--of the potential effects of the completion of the Uruguay Round on developing countries.

Mr. Végh said that all the points that he had planned to raise had been covered thoroughly by previous speakers. He wished merely to congratulate the staff for its well-prepared paper and the Economic Counsellor for his interesting presentation.

Mr. Santos made the following statement:

I will make a few general remarks on recent economic and financial developments and the short-term prospects of the world economy before addressing the issues suggested for discussion by the staff in its comprehensive and well-balanced paper.

I note from the staff's assessment that the modest recovery in world economic activity, which began earlier this year, is likely to take hold during the remainder of 1992 and 1993. Also, inflationary pressures have eased, short-term interest rates have declined, and the recovery of world trade is beginning to show some strength. This outcome was helped by the improvements recorded in private sector balance sheets and the interest-sensitive sectors, as well as the lower inflation rates, especially in North America. The recovery of domestic and external demand in the EC also contributed to this moderate growth. However, no significant reduction in unemployment was achieved, and the short-term prospects indicate that the unemployment situation might even worsen.

For developing countries as a whole, output is projected to expand by 6 percent in 1992, reflecting the ongoing reconstruction efforts in the Middle East and the sustained expansion of the fast-growing economies in Asia. The decline in interest rates, better debt-restructuring arrangements, and the significant strengthening of domestic policies have enhanced the prospects of Western Hemisphere countries' registering strong economic growth in 1992 and 1993. For sub-Saharan African countries, despite small improvements in output, real growth is projected to remain weak in 1992, reflecting largely the continued deterioration in their terms of trade and shortfalls in external financing, as well as drought in some parts of the region. These adverse factors are likely to further frustrate the determined efforts of these countries to implement adjustment programs and alleviate poverty. With regard to Eastern Europe and the former Soviet Union, it is a matter of concern to note that output loss is likely to be more prolonged than envisaged. Difficulties in bringing financial policies under control and removing structural bottlenecks could intensify, leading to further output losses, inflationary pressures, and increased unemployment, with negative social and political consequences.

Against this background, the major challenge facing the world community is to ensure that policy directions in industrial countries succeed in reviving business and consumer confidence and bringing about sustainable noninflationary growth. Policymakers in the major industrial countries are facing a complicated task in attempting to meet this challenge because of the high degree of uncertainty surrounding the conduct of monetary policies, the recent setback in medium-term fiscal consolidation, and the lack of credibility in their announced policy stances. Therefore, strong actions to regain the momentum of the fiscal consolidation efforts and lend more credibility to their policy stances are warranted. Delays in taking the appropriate measures will only slow down the economic recovery in the industrial countries and adversely affect the ongoing adjustment efforts in developing countries and the former centrally planned economies.

On the first specific issue suggested for discussion by the staff, the risks to the short-term outlook, it appears from the staff papers that 1992 could be a turning point in the cyclical downturn that started in late 1989. However, as previous speakers have mentioned, the recovery is constrained by a number of factors, including the divergent macroeconomic policy responses in the industrial countries, the potential buildup of excess liquidity associated with the easing of monetary conditions, continued depressed business and consumer confidence, and the renewed tensions in the financial and foreign exchange markets. We are concerned about the adverse impact of these diverse factors on the economic prospects of developing countries--particularly the successfully adjusting African countries, where structural reforms are taking hold, and where efforts at export diversification and expansion are being jeopardized by the weak demand in industrial countries. As the scope for further easing monetary conditions would seem to be limited in many of these industrial countries, the authorities should concentrate their efforts on fiscal consolidation; they should stand ready to tighten credit conditions as soon as inflationary pressures begin to emerge.

With respect to the second issue suggested for discussion--policy issues in industrial countries--the discrete monetary policy actions taken to stimulate activity under the present cycle have not yet achieved the desired results. It is not clear to what extent this lack of effectiveness of monetary policies could be attributed to the various changes that have occurred in financial markets. Nevertheless, the staff raises challenging questions on the profound impact that private debt accumulation, as a result of rising asset prices, could have had over the past few years on both financial and nonfinancial markets. Undoubtedly, delays in completing the balance sheet adjustments in a number of countries continue to play an important role in slowing down the recovery process. Perhaps this is an issue that could be analyzed more deeply in the next set of world economic outlook papers.

However, a preliminary conclusion to be derived from these developments is that the number of indicators needed to assess the stance of monetary policy needs to be broadened to enable asset prices to be closely monitored. This is important in view of the speed and scope of the deregulation of financial markets envisaged in Europe. This deregulatory process also has clear implications for the role that regulatory and supervisory agencies will need to play to ensure that the position of financial institutions is not weakened. Perceptions that the position of financial institutions in industrial countries is deteriorating could also jeopardize the economic recovery.

Fiscal policy seems to have been generally passive in most industrial countries. The staff's medium-term fiscal projections convey the magnitude of the required fiscal adjustment, especially in the United States, the United Kingdom, and Italy, where the prospects for attaining the medium-term fiscal objectives have deteriorated sharply during the present cyclical downturn.

In the case of the European economies, convergence as envisaged under the Maastricht agreement is especially needed on the fiscal front. A decisive deficit reduction through tax and expenditure measures would help reduce inflation differentials and improve the medium-term growth prospects of the Community.

In the case of the United States, I share the staff's view that, in order to be consistent with the goal of attaining a balanced federal budget by 1997, strong fiscal measures on the revenue and expenditure fronts are needed to bring the structural component of the federal deficit under control. From the staff's simulation, it would appear that this course of action is also in line with the need to improve consumer and business confidence. Moreover, from a more global perspective, this approach is desirable as a means to revive world demand. A positive spillover effect is projected for developing countries' output and current accounts as debt servicing and exports improve.

On the third issue suggested for discussion, namely, the outlook for developing countries, Table 11 of the staff paper illustrates the performance achieved by successfully adjusting developing countries, some of which were able to register higher growth rates and lower inflation rates, and, in general, to improve their indicators of external debt. In view of this performance, there is no doubt that the stabilization and structural reform programs under way in most developing countries should be firmly pursued. In the African countries, this commendable outcome has been facilitated by structural adjustment programs supported by the structural adjustment facility (SAF) and the enhanced structural adjustment facility (ESAF). As there is no alternative to the adjustment process, we believe that efforts to help those countries that have not yet been able to undertake comprehensive stabilization programs will need to be intensified.

Credibility in maintaining a macroeconomic adjustment program is an important requirement in re-establishing confidence and attracting capital inflows. Structural reforms instituted in order to raise potential output and provide incentives to save and invest are also crucial. The experience of successful reformers indicates the significant role that fiscal reform can play in ensuring the success rate of many programs. For example, the implementation of a simple, broad-based, distortion-free tax system with an efficient administration can enhance the revenue-raising potential of the tax system and reduce the rate of loss of revenue stemming from tax evasion. However, in the short run, when the bulk of adjustment has to fall on expenditure cuts, problems are inevitably encountered in maintaining the strength of the adjustment process. In this regard, while developing countries cannot afford to delay or relax their adjustment efforts, they will need to stand ready to take appropriate measures to deal with difficult budget conditions in an efficient manner. We believe that the quality of adjustment and its lasting effects on public sector investment--especially in the areas of education, health, and human resource development--will constantly need to be assessed to ensure that future growth is not constrained.

Also, the provision of timely and adequate financial assistance to countries, with conditions that are in line with their financial situation and their capacity to service their debts, cannot be overemphasized. In this regard, one cannot fail to observe that the African region, which experienced the lowest growth rate among developing country groups, also registered more modest net financial inflows than the other regions over the 1990-92 period--a time when the countries in that group were also experiencing sharp declines in their terms of trade. Moreover, the staff's medium-term scenario for developing countries underscores the need to stabilize the terms of trade and reverse the decline in financial flows. These conditions, together with sustained adjustment efforts, are the prerequisites for improving the per capita incomes of the African countries.

For this objective to be realized, the multilateral financial institutions must play an important part. The Fund's catalytic role of providing concessional financial assistance will continue to be crucial. Therefore, we look forward to discussing the proposals regarding the Fund's post-ESAF role in support of the adjustment efforts of these countries.

With regard to the debt situation, the continued improvement in the reduction of debt/export ratios in developing countries--a result of significant stabilization efforts, lower interest rates, and progress in managing the debt problem--has contributed to alleviating the debt burden of most developing countries. However, the debt situation in African countries remains critical and, therefore, requires more meaningful solutions that will go far beyond the current enhanced concessions in order to encourage countries to persevere in their adjustment efforts. In this regard, we support the comments made earlier by Mr. Jamnik. I would also recall Mr. Prader's call for a concerted effort by multilateral and bilateral official creditors to improve the debt situation of the low-income countries.

With respect to the fourth issue proposed for discussion, the transformation process in the former centrally planned economies, it should be noted that, although the Eastern European countries and the states of the former U.S.S.R. registered initial progress in reforming their economies, the continued fall in output and the ensuing decline in their living standards will put severe constraints on the smooth pursuit of the transformation process. The unusual circumstances in which the reform process was undertaken in these countries--in particular, the total dismantling of economic and trading systems against the background of political upheavals--may have played a major role in the decline of their output. Moreover, limited data availability and institutional bottlenecks could have complicated the task of formulating economic stabilization measures and structural reforms.

I agree with the staff that, in the present circumstances, the thrust of the reform process will have to be maintained by balancing macroeconomic stabilization measures and structural reforms, and that, at this stage, slowing the pace of adjustment will affect the credibility of the adjustment effort and increase the uncertainties in the reform process. In this context, adjustment can be accelerated by strong actions to effect much-needed legislative and regulatory changes in support of market-based institutions.

Finally, in this large-scale reform process--the outcome of which can have a beneficial effect for the global economy--diversified technical assistance and timely financial support can increase the chances of success.

Mrs. Sirivedhin made the following statement:

The scenario presented in the latest world economic outlook papers is somewhat less optimistic than the picture given in the spring of this year and much worse than the one presented a year ago, which was appropriately recognized to be fraught with downside risks. In the opinion of this chair, some downside risks remain even for the present, more conservative, projections. While indications of recovery have emerged in some countries, consumer and business confidence has yet to be established, even in the United States and Japan. Moreover, the scope for economic stimuli is very small in countries with large fiscal imbalances--which is to say, most industrial countries. Lastly, policy divergences are giving rise to large exchange rate movements, which is not a recipe guaranteed to support business confidence.

At the same time, there may be a need for more pragmatism with regard to industrial countries' concerns about the risk of a resurgence of inflation. In particular, in the present circumstances of proliferating structural rigidities in the industrial countries, it may not be realistic for them to expect a return to "stable" prices, defined as they were in the 1950s and 1960s. In other words, unless strong and realistic adjustments are made in the area of labor market and trade reforms, inflation rates lower than 1-2 percent may not be achievable without much sacrifice in the areas of growth and employment and, therefore, may not be a realistic target. This implies that, if industrial countries took the necessary structural adjustments, there might be slightly more leeway than is generally conceded for some of them to allow a modicum of stimulus to their economies, in order to elicit the confidence needed to bring about recovery without increasing the underlying rate of inflation.

This leeway, of course, varies from country to country, and we would not advocate a departure from the medium-term objective of stable growth, particularly in those countries where fiscal consolidation is still needed. Once an upturn in activity becomes established, the objectives of the medium-term strategy should be pursued with vigor. We note from the staff's analysis that final consolidation would in the longer run benefit both the countries concerned and the global economy. At the same time, we again emphasize the urgency of addressing structural rigidities, both to reduce the underlying rate of inflation and raise the level of productive capacity. This would be important not only for countries that are close to capacity, such as Japan, but for others also. Moreover, financial policies should be tightened at the first sign of a resurgence of inflationary pressures inconsistent with the underlying rigidities.

We are pleased to note that the environment facing developing countries is expected to be somewhat more conducive to growth, especially in 1993: the volume of world trade is expected to grow by 7 percent; non-fuel commodity prices will increase slightly, albeit not in real terms; and interest rates will continue to be moderate. We are also pleased to note that the number of countries undertaking adjustment programs with the Fund has increased, and that many programs have been judged to be successful. The projections for 1992-93 show an improvement in the situation of developing countries as a whole. This is heartening; however, a more disaggregated analysis shows substantial differences among the various groups of countries, and among the countries within each group, underlining the still precarious situation of many economies in Africa and the fragility of many economies in other regions. The analysis of the results of adjustment by developing countries is very useful and underscores the necessity of credible macroeconomic and structural adjustment, supported by bilateral and multilateral assistance. Even with strong adjustment programs, many lower-income countries will continue to need concessional assistance for some time to come. The Fund should consider various options for such assistance after the expiry of the ESAF.

The successful experience of the newly industrialized countries with their open economies and the difficulties of former centrally planned economies, which suffered from the collapse of CMEA trade, point to the significant role that international trade can play in economic development. Most important, however, an open world trading system would provide inestimable benefits to the global economy--industrial and developing economies alike. For industrial countries, open markets would increase the efficiency of production, boost productive capacity, and raise the well-being of consumers. Moreover, these markets would in the long run reduce the level of financial assistance needed by developing countries. At the same time, international trade is essential for developing countries to achieve external viability and reduce their reliance on external aid and debt restructuring.

We are pleased to note that the Munich communiqué of the Group of Seven gives cognizance to the importance of trade and the successful conclusion of the Uruguay Round negotiations. Nonetheless, we are very disappointed that, after so many years of acknowledgement by individual countries and various groupings of countries of its importance, success remains elusive. A more open trading system is all the more necessary in view of the need to reconstruct Eastern Europe and the states of the former Soviet Union. Failure to provide the developing and transforming countries with adequate markets would result in a number of adverse consequences: the credibility of the Fund's policy advice would be undermined, given the trade liberalization that is urged under Fund-supported programs; it would be difficult for developing countries to mobilize political support for reforms, especially in the area of trade; export earnings would be constrained; the flow of non-debt-creating capital inflows, especially foreign direct investment, would be discouraged; financing requirements would rise; and access to capital markets would become more difficult. Ultimately, these developments would exert pressure on the Fund's financial position and, in a worst-case scenario, could trigger a second debt crisis as early as the next decade.

The tendency of some industrial countries to rely on bilateral and unilateral solutions is a cause for concern, as is the increasing tendency of groups of countries to polarize into trade blocs. While regional or bilateral trade arrangements can benefit participating countries, they must not be inward looking. Moreover, a comprehensive Uruguay Round agreement is the optimal solution, as it would greatly strengthen the multilateral trading system and help to ensure that regional arrangements are outward oriented.

Mr. Mwananshiku made the following statement:

The uncertainty that was evident earlier in the year about the prospects for the world economy still features in our assessment today. Growth in the industrial countries remains slow; even the 1.8 percent projected for 1992 might be on the high side, considering that it incorporates some optimistic assumptions about the U.S. economy. Moreover, unemployment is high, and several of these countries are entering the 1990s with budgetary gaps larger than in the early 1980s. Weak consumer confidence is linked to the unemployment problem, and the large fiscal imbalances have produced an inertia with respect to inflationary expectations, which, in turn, have caused real interest rates to remain high.

With the fair success achieved on the inflation front, and given the sluggish performance of the major economies, it would seem that greater attention should be accorded to the design of policies to enhance economic growth and lead to a meaningful improvement of the employment picture. The staff paper emphasizes the role of fiscal consolidation in helping to reduce real long-term interest rates. The downside of this approach is that output and employment are likely to be adversely affected, thereby delaying the recovery. This could worsen the crisis of confidence. How to make a smooth transition from short-run-oriented to long-run-oriented policies is a conundrum, the solution of which will require imagination. An approach that relies on everything falling into place once the market perceives that balance is being restored on the fiscal front might not be enough to address the economy's immediate concerns. Consideration of more direct approaches to stimulating growth might be in order. The point of emphasis is that a vibrant global economy should not be the residual objective of economic policy; rather, it should be an explicit goal, the attainment of which is in the interest of both industrial and developing countries.

The staff paper carries an upbeat message for developing countries. As other speakers have said, this is probably true only for the countries of Southeast Asia and the Middle East, as well as those countries that have been implementing prudential policies. For a large number of countries, the reform effort is still an uphill battle. This is particularly true for Africa, as we shall shortly see. The 35 countries mentioned in the report as successful adjusters are only a minority of all developing countries; moreover, that number includes several Asian countries that have pursued not so much an adjustment strategy as a development strategy over an extended period of time. That there are important lessons for other countries is hardly the question: the point is to continue to explore ways of improving the design of Fund-supported adjustment programs on the basis of historical experience.

Efforts to control fiscal deficits and inflation and the role of market forces are cited in the staff paper as key ingredients determining the performance of the successful reformers. We also wish to emphasize the role of investment in physical and human capital, which has been one of the keys to high productivity in the successful Asian countries. It should be noted that the Asian experience has also emphasized the role of government, thus underlining the fact that a strengthened role for the market does not necessarily eliminate the government from the scene. In fact, government policies can be used to help the market to function more efficiently. There is an implicit recognition of this in the section of the staff paper dealing with financial reform, in which it is argued that supervisory practices need to be strengthened as deregulation proceeds, and that regulatory policies must play their part in preventing financial imbalances from having systemic consequences. All of this can be taken to mean that there are times when markets need to be protected from the consequences of their own actions.

Turning to Africa, one sees a continent in no less of a crisis than it was a decade ago. In 1991, the growth rate of developing countries as a group was more than twice that of the African countries; this year, it is projected to be more than three times higher. The recent drought in the southern region can only make matters worse. Real per capita GDP is expected to decline again, with a bigger drop expected for sub-Saharan countries. The data show that Africa is the only developing country region where the real per capita income is projected to fall in 1992. Africa is also the exception when it comes to projections of financial inflows: all other regions are expected to see a significant increase. Meanwhile, and despite the recent actions taken by the Paris Club, the continent remains saddled with a serious debt problem. As the staff paper notes, progress in alleviating the debt burden has been slow for the least developed countries, most of which are in Africa. Therefore, a case can be made for advancing the consideration of further actions by the Paris Club.

Africa's development prospects are also hampered by the decline in commodity prices. A recent working paper by R.C. Baban and J.E. Greene, "The Export Performance of Sub-Saharan Africa, 1970-90: A Survey" (WP/92/55, 7/20/92), states that "sub-Saharan Africa is virtually unique among groups of developing countries in having experienced an absolute decline in export earnings during the 1980s." What is more, this happened during a period of generally rising prices for imports. The secular decline in the terms of trade is a major cause of Africa's continuing external problems. Against this background, the extent to which reform programs address the problem of economic diversification remains a crucial question. The evidence suggests that not enough has been done, and it is time for the design of adjustment programs to be improved in order to correct this situation.

Summing up the African experience, we welcome the headway that is being made in some countries. The staff paper draws attention to cases in which reforms have taken place that could improve efficiency in these countries. Prudent domestic policies must remain at the center of the drive to transform African economies. However, as Mr. Jamnik reminded us this morning, the bottom line is that Africa will continue to need special attention from the international community if adjustment fatigue is not to set in. The early conclusion of the Uruguay Round negotiations would also help greatly to widen market access. The Fund has a crucial role to play not only in helping to design more suitable programs, but also in mobilizing concessional assistance to sustain the adjustment and reform effort.

Mr. Evans made the following statement:

I shall concentrate my remarks on three themes: first, the risks attaching to the short-term economic forecasts and the implications of these for economic policy; second, the conduct of economic policy in Germany and the implications of that for the rest of the world; and third, if only despairingly, international trade policies.

On the first of these issues, the risks attaching to the forecasts, the general question I am addressing could be put as follows: Would world economic growth now be stronger had we not so consistently forecast over the past two years that it would be? I think that we will find that when our ministers and governors meet again shortly in the Interim Committee, some of them will recall that when they met one year ago in Bangkok, they mentioned even then that the forecasts that the staff had put before them seemed rather familiar; all that was different from when they had last met was what had occurred in the interim. When they meet this year, they will have precisely the same feeling: the outlook seems much the same, it is just the recent past that does not look so bright. However, because many of them will have moved closer to having to face their electorates during that period, their despair at those overly optimistic forecasts will be heightened, and they will be looking for an explanation as to what went wrong.

When we look for that explanation in the world economic outlook documentation, we do not find much that is very convincing. It is notable, however, that most of the reasons that are given relate to factors that were noted in previous forecasts as representing downside risks. They have indeed proven to be that.

Today, once more, we see that the forecasts are said to be subject to downside risks, for much the same reasons as before. Two questions arise from this that I would explicitly like to address to the staff. The first is a technical issue, although it has policy implications: At what stage should a downside risk be incorporated into the forecast itself? In referring to the staff's forecast as being optimistic, several speakers today have clearly already made that adjustment. Should the staff not also do so? If it judges otherwise, what is the basis for that judgment?

The second, closely related question for the staff is: What would have been the implications for policies had the adjustment to its forecast to which I have just referred been made 12 months ago? Listening to some speakers today--I think that I could refer to them generically as European--one could gain the impression that economic policies should be oblivious to forecasts, as only the medium term matters, even if--or is it because?--the medium term is unreachable. Does the staff share that judgment, or would it agree that, had we been able to accurately forecast some 12 or 18 months ago what has now occurred, policies could and should have been adjusted? If that had been done, would the outcome now have been stronger? By extension, would a lowering of its forecasts now, in line with the acknowledged risks, lead to different policy recommendations?

My second theme, not entirely unrelated to the first, is the conduct of economic policy in Germany and the implications of that for Europe, in particular, and the international monetary system, in general. It is clear, both from the world economic outlook documentation and the comments of earlier speakers, that the conduct of economic policy in Germany--and the current level of interest rates, in particular--is of very real concern to Europe and the world. Most speakers seem prepared to accept that the present situation in Germany has been an inevitable outcome of reunification, the ensuing inflationary pressures, and the need to contain them through monetary policy. The implications of that thinking, however, are sufficiently important that we should not hesitate to look back to the basic issues raised by reunification.

Basically, reunification required--and still requires--additional access by Germany as a whole to both capital and labor resources. The attempt to meet those demands primarily from within Germany has led, as all acknowledge, to pressures on labor markets--and, hence, labor costs--and to pressures on financial markets. However, I would suggest that this has occurred because Germany has placed too much emphasis on meeting those demands primarily from within its own borders. Outside Germany, at least, it must appear ironic to many that there are such pressures on German labor markets when that country is in the midst of others with unconscionably high unemployment rates. Is there not in that observation at least the potential for easing inflationary pressures by other means, which would, in turn, permit some relaxing of the current stringent monetary policy?

Similarly, in respect of the persistent upward pressure on the deutsche mark, could not some relief be found if Germany were to draw more on external savings by importing more of the capital equipment required by reunification?

In summary, it appears to me that both Germany and the world might benefit if, in attempting to address the structural problems raised by reunification, more emphasis were placed on structural solutions and less on financial policies. There may be a role here for the Fund in explaining these issues to financial markets.

On the third theme, international trade, I wish to do little more than support previous speakers in stressing the importance of this topic to the health of the world economy. I endorse the Chairman's observation that the Fund has been continually at the forefront of this issue, but I would ask that we not desist just when the matter is in danger of flagging. Also, it is disturbing to read in the world economic outlook papers that the share of world trade covered by nontariff barriers has intensified over the past decade, particularly in Japan, the United States, and EC member countries.

Before closing, I would like to compliment the staff on its analysis of successful adjustment cases in the developing countries. There are some issues in that chapter, including, in particular, the difficulty of sterilizing capital inflows while maintaining external competitiveness, that I would like to address, but I shall do so directly to the staff. I hope that we shall see more of this kind of analysis in future editions of the World Economic Outlook. I note that one previous speaker has suggested that we might have a chapter dealing with the less successful adjustment cases, but I wonder if that would tell us any more than we can learn from reading the regular chapters on the industrial countries.

By way of footnotes, I am also pleased to see that the chapter on centrally planned economies now includes Mongolia within its purview. In addition, I join previous speakers in complimenting the Japanese authorities on their recent fiscal package, coming as it did so promptly after our Article IV consultation discussion (EBM/92/88 and 92/89, 7/15/92). Finally, I would note that the inflation estimates and forecasts for New Zealand on page 18 of the staff paper are grossly excessive, and that substituting the correct figures will show that New Zealand has the lowest inflation rate of all the industrial countries.

Mr. Wei made the following statement:

I would like to join other speakers in welcoming today's discussion on prospects and policy issues with regard to the world economic outlook, and I should like to thank the staff for the well-prepared set of documents that it has provided.

On the question of the risks to the short-term outlook, it has been well noted that, in a couple of the previous world economic outlook exercises, the staff made very important downward revisions with respect to their projections of growth of world output and growth in the industrial world for the 1992-93 period. Here, I would like to omit an analysis of the projections contained in the May 1991 and May 1992 issues of the World Economic Outlook and compare the projections contained in the October 1991 issue with those forthcoming in the October 1992 issue.

In the October 1991 World Economic Outlook, world output and industrial country growth were both projected to be 2.8 percent in 1992; current projections for the same indicators are 1.2 percent and 1.8 percent, respectively. Obviously, the year-to-year percentage change in these forecasts is very substantial. I would say that this change has nothing to do with the accuracy of the forecasts; rather, it is the outcome of different or even divergent judgments on how--and how fast--the world economy and, in particular, the industrial economies would recover from the current recession. It is evident that the difficulties involved in getting out of the present recession have been underestimated; the positive aspects of the current situation, meanwhile, seem to have been overestimated. It is true that a positive--although not fundamental--turnaround has been seen in a few major industrial economies; however, as the staff has rightly pointed out, not only has the pace of the recovery been very uneven, but the recovery has also been more sluggish than expected. It seems likely that, during the current recovery--and before the recession is over--the major industrial economies will have to suffer through repetitive ups and downs or even erratic setbacks.

As for the forecast for 1993, it appears that the staff expects its earlier forecast for 1992 to be realized in 1993, as it has made relevant downward revisions for 1992. I believe that these forecasts are still somewhat uncertain and, therefore, could be subject to further downside risks. I consider 3 percent to be a critical figure for growth in both world output and the industrial economies; however, without reassuring evidence, I would not venture to go along with such a rosy picture.

The reasons for the continued sluggish activity and weak business and consumer confidence in much of the industrial world are complex. My position remains the same as was expressed in our most recent discussion on the world economic outlook (EBM/92/47, 4/6/92). Here, I would simply re-emphasize that the sluggish activity and weak confidence are symptoms only: they are a natural reflection of a number of protracted structural problems in the industrial economies. These problems, which are fundamentally more structural than cyclical in nature, will certainly not be easy to reverse in the medium term.

It should be clear that, while some deep-rooted structural problems stem from the irrationality of economic policies in industrial countries, others derive from the workings of the market economy. Good policy is not only instrumental in solving the first type of structural problem, but also necessary to mitigate the negative impacts of the second type. The medium-term strategy is an example of the kind of sound policymaking that the industrial countries should pursue with reinforced efforts.

I am not against the intention to use monetary policy in a discretionary manner for the purpose of macroeconomic management. However, it should be done within the framework of the medium-term strategy, which, if pursued faithfully, should have a binding effect on the extent to which monetary policy can be manipulated with discretion. Therefore, I would not like to see a further significant relaxing of monetary policy in some of the major industrial countries. Although the inflation rate is still relatively low in these countries, it is apparent that the scope for continued cuts in short-term interest rates is limited; real long-term rates remain at high levels, and further monetary actions on short-term rates will not bring the long-term rates down unless government financing pressures on capital markets can be substantially curbed.

The staff has once again clearly spelled out the basic elements of the medium-term fiscal policy strategy. These elements are interconnected, and, as such, they should be looked at and implemented as integrated parts of a whole designed to tackle deep-rooted structural problems, rather than as piecemeal solutions. In this regard, I would repeat what I said during our most recent world economic outlook discussion, namely, that "some major industrial countries have long been departing from the medium-term strategy." Even worse is the situation in other major industrial countries, in which such a medium-term strategy no longer exists. The legacy of this strategy will fade away unless efforts in the right direction are sustained.

It is becoming clear that the task of fiscal consolidation in major industrial countries is so weighty that any delay in tackling it will intensify the existing protracted structural problems. Financial markets should be relieved of the responsibility of financing governments. Irrational behavior on the part of corporations and consumers could be constrained by well-executed governmental policies of self-restraint. However, a good fiscal consolidation performance by one industrial country will not of itself contribute greatly to the healthy development of the world economy; a collective effort in the fiscal area by all major industrial countries is thus all the more necessary.

It is noted that the staff has also made important revisions--mostly upward--in its developing country forecasts. Indeed, the recent performance of many developing countries from various continents has been far better than expected. These achievements have taken place against the backdrop of an economic recession that has been affecting some of the major industrial countries; however, as the staff has correctly pointed out, the achievements of these developing countries are the fruits of their long-term adjustment and reform efforts and should not be interpreted to mean that developing countries fare better when industrial countries are in recession. On the contrary, by aggravating the external environment, and, in particular, by helping to intensify protectionist sentiments aimed at the developing countries, the continued sluggish activity in major industrial countries has prevented the successfully adjusting developing countries from achieving even better results.

The experience of both the successfully adjusting and the reforming developing countries demonstrates that the authorities' determination to implement sound programs effectively and the strong support of the public are crucial elements of these countries' successes. However, this does not mean that developing countries can rely totally on their own efforts; given the nature of our interdependent world, their successes cannot be maintained without the genuine support of the international community. The efforts of this community to reduce the debt burden of the developing countries provide one obvious example of this relationship; financial assistance, in various forms, provides another. However, the most important step that industrial countries could take in this respect would be to open their markets wider to developing countries. The staff has emphasized the importance of this point in its discussion of the former centrally planned economies; however, the recommendation is equally applicable to the developing world, to which, in reality, most of the centrally planned economies belong. It is thus clear that there is still ample room for contributions from industrial countries to successful adjustment and reform efforts in the developing countries.

Among the downward revisions in the world economic outlook's growth projections, the revision for the African region is a cause for grave concern. Many developing countries in Africa are faced with great difficulties, some of which are the consequences of delays in adjustment and reforms; others are the direct results of exogenous shocks and various natural disasters. The international community should give a more generous helping hand to these countries by assisting them in implementing realistic adjustment and reform programs so that these difficulties can be surmounted.

As for the downward revision in the growth projection for the Middle East, I find this to be a more realistic forecast. The only difficulty may be the new method of categorization, which makes a comparison of the current forecast with that contained in the October 1991 World Economic Outlook somewhat confusing.

We continue to observe with interest, as well as with concern, the current transformation process in the former centrally planned economies. The continuous contraction of production in Eastern Europe and the states of the former U.S.S.R. is having serious repercussions, largely because of the approach taken to the process. The authorities should make adaptations that depend on the current circumstances. Another reason for the contraction of production may be that, as the staff has indicated, the stabilization efforts have not been fully successful in many of these countries. Financial and monetary instability still frustrate the authorities of the former centrally planned economies; therefore, it is crucial that they should redouble their efforts to achieve the goal of stability, which would enable them to carry out other reforms.

Also, in some states of the former U.S.S.R., the capacity of the authorities to fully implement sound adjustment and reform programs amid the current difficult conditions is questionable. With this in mind, I have reservations about the staff's forecast for these regions for 1993, given that the 1992-93 growth picture continues to be grim.

Mr. Chatah made the following statement:

Two main themes of the world economic outlook documents are the question of how to strengthen short-term growth performance, particularly in light of the persistent sluggishness of the recovery in most industrial countries, and the question of which policies are needed to improve the prospects for sustained growth over the medium term. While we agree with much of the staff's analysis on this issue, we remain of the view--which we also expressed in the spring 1992 world economic outlook discussion (EBM/92,46, 4/6/92)--that we are probably still underestimating the magnitude and implications of the balance sheet adjustments that have been going on since the beginning of the recent downturn. More specifically, there are indications that we may be witnessing the onset of an upward trend in private savings in some major industrial countries--in particular, the United States--

which is reversing the decline that has taken place during much of the past decade.

Although a number of factors might be contributing to such a development, the most important, in my view, is the negative wealth effect emanating from the decline in asset values over the past two years, particularly as it affects the net worth of the household sector. Such a shift in spending and savings behavior may constitute yet another source of short-term risk to recovery, notwithstanding the positive implications of greater savings over the medium term; I wonder whether the staff's assessment of policies would be different if an upward trend in private savings were indeed under way. For example, would the focus in that case shift somewhat from policies geared toward reducing public sector dissaving to policies aimed at promoting--or at least reducing disincentives to--private investment? If so, changes to the tax system might figure more prominently in the Fund's policy recommendations. It seems to me that the issue of private investment warrants more attention in the context of promoting medium-term growth, particularly if a private savings trend materializes.

Having said this, we have no doubt that a reduction in the fiscal imbalances of a number of major countries--in particular, the United States--is needed; furthermore, I tend to agree that the staff's medium-term simulations do not fully capture the effects of fiscal correction, especially in the United States. Although, in my view, the staff has done the right thing by presenting the simulation results, there is a risk that unqualified conclusions may be drawn from this exercise. It is important, therefore, to make explicit all of the model's caveats, particularly in a published version of the document.

Turning to developing countries, I would like to make four brief points. First, it is encouraging to see a marked improvement in the aggregate economic performance of developing countries. There is no doubt that corrective policies on the part of developing countries themselves have been instrumental in bringing about this improvement. This progress has occurred despite the economic slowdown in the industrial world, although the substantial decline in major international short-term interest rates has probably played a significant role. However, if the recovery in industrial countries continues to lag, developing country prospects may change unless specific offsetting initiatives are taken. For example, the pace of the reduction of nontariff barriers to developing country exports could be accelerated, and faster progress could be made in implementing the G-7 initiatives dealing with the debt of middle- and low-income countries.

Second, notwithstanding the aggregate improvement in the economic performance of developing countries, wide disparities become clearly apparent when one looks at individual countries or groups of countries. Beyond this, however, it is important to keep the indicators of performance in perspective, as they often provide only a partial picture of economic conditions. Two areas that deserve more attention are unemployment and income distribution, which are often masked--or, at least, not captured--by other indicators of economic performance.

Third, the staff has raised some interesting issues in regard to financial policies, including currency switching, in countries that have succeeded in reversing private capital flows. Given the increase in the number of such countries, we would encourage the staff to explore the policy issues involved further. It seems to me that a risk does exist of a treadmill-like monetary situation developing in some of these countries, with a policy of high interest rates generating flows that would, in turn, need to be neutralized through the maintenance of an excessively tight monetary policy.

Fourth, on structural reform, whether in developing countries or in those classified as formerly centrally planned, my feeling--and I believe that experience confirms this--is that we continue to underestimate the problems associated with systemic change, particularly in the areas of public enterprise reform and privatization. At the same time, we tend to overestimate the supply response to reform, particularly in the short term. On this issue, I share the views expressed by Mr. Landau. This does not necessarily mean that reform should be gradual; however, in my view, it does call for more caution and realism in designing and pacing the various elements of adjustment and liberalization, which should be done in such a way as to minimize avoidable costs and the problems of transition.

Mr. Arora made the following statement:

I welcome Mr. Dawson's well-considered defection from mainstream orthodoxy. Echoes of a revisionist kind may also be found in Mr. Prader's felicitous phrasing concerning the underestimation by the staff of the sluggishness in the pace of recovery, and in his open endorsement of a short-term departure from the medium-term strategy, with a view to assisting recovery. Basically, however, I think that Mr. Dawson's frontal attack on the mainstream view, which has overwhelming support in the Board, struck the right note. He characterized unemployment as the stepchild of policy and pointedly drew attention to the neglect of major issues of growth and unemployment in our discussions on the global economy. He saw little vitality in the so-called recovery process and called a spade a spade when he said that the industrial countries were performing poorly. Do I agree with him? Well, I agree with him insofar as his symptomatic diagnosis is concerned, although not with his nitpicking on certain isolated passages in the staff paper. However, I wonder whether he would carry his logic forward in search of permanent remedies for what is, after all, a serious ailment that is not susceptible to fine-tuning. I signal here my agreement with the staff and with other critics of fine-tuning.

The aspects to which Mr. Dawson has drawn attention are aspects of a fundamental crisis in the industrial economies. This crisis did not erupt yesterday; it did not even erupt in the 1980s, although some manifestations of it, such as the borrowing binges and speculative excesses, were aggravated in that decade, which--the objections of Mr. Dawson notwithstanding--the staff has rightly noted. The problem began to emerge in the mid-1960s when the bloom of the postwar boom was still very much intact. It gathered steam in the mid-1970s when exchange rate problems raised their head after the collapse of the Bretton Woods system, and when policy instruments of anticyclical stabilization began to demonstrate their ineffectiveness. Alas, the monetarist revolution was soon to claim total victory, albeit for a relatively short period in the intellectual history of western economic thought. What is important for our present purposes is that that was the time when anti-inflation strategy, in its most extreme version, came to be regarded with the veneration due in pre-Darwinian times to the secrets of evolution as revealed in Genesis.

It was ardently believed then--and it is ardently believed now--that if only we could return to the low-inflation period of the golden age of capitalism, all will be well with us and with the future generations, who are waiting to inherit the dream that they will do better than their fathers. Thus, the perennial theme of capital accumulation, which is indeed the basis of the capitalist miracle, began to take a back seat. It was conveniently forgotten that, in the last analysis, inflation is but another name for the ongoing struggle between capital and labor over shares in national output; it was also forgotten that, if there is no social compact as prevailed in the United States and some European economies between 1946/47 and 1974/75, it is not possible to ensure a stable share of profit in national output and, hence, a growing rate of capital accumulation. It is the breakdown of the social consensus on capital accumulation that accounts for the crisis today. In a fundamental sense, the fiscal deficit in the United States and other countries is only a reflection of the breakdown of this consensus.

There have been episodes in recent U.S. economic history when the fiscal deficit touched 5.5 percent of GDP without arousing the visceral anger of the untamable financial markets. However, the cold bath--or, perhaps more accurately, the Arctic freeze--was soon to arrive; for the sake of slaying the monster of inflation, it came on the scene in 1979 and persisted throughout the 1980s. During that decade, there were many occasions when victory was declared. But, sadly, even today the monster does not seem to have been finally vanquished--or so, at least, the Bundesbank believes. Mr. Dawson, however, thinks that the beast has been tamed and put in a cage. Even the world economic outlook documents suggest a qualified victory while counseling persistence on the straight and narrow path of virtue. Inflation is down, but animal spirits are down, too.

It may be useful to remind ourselves of a small but instructive piece of history of the Organization for Economic Cooperation and Development (OECD). In 1978, the OECD published an influential study, the "McCracken Report," which dealt with the subject of the slowdown in growth rates. The report analyzed the causes of the Great Inflation in the late 1960s and early 1970s and suggested a program for recovery. It blamed the oil shock, the collapse of the Bretton Woods System, and rising aspirations induced by prolonged prosperity for the acceleration of wage and price inflation.

What was the doctor's prescription? The report called for a halt to the rapid stimulation of aggregate demand and a major attack on inflationary psychology. It reflected a guarded optimism that, if an anti-inflationary policy were pursued, the OECD average unemployment rate could be reduced to 4 percent, and inflation cut to 5 percent by 1980. Economic growth would then accelerate. The anti-inflationary strategy was indeed pursued fairly strongly, but the beneficial results in terms of growth and employment did not arrive.

What are the facts in a historical perspective? The critical and relevant parameters for 15 OECD economies are as follows:

<u>Annual average unemployment</u>

1963-79	2.1 percent
1974-79	4.1 percent
1980-88	6.4 percent

<u>Inflation of consumer prices</u>

1963-1973	4.7 percent
1974-1979	9.7 percent
1980-88	6.9 percent

Misery index

1963-73	6.8 percent
1974-79	13.8 percent
1980-88	13.7 percent

These data suggest that unemployment and inflation rates and the misery index have all shown a secular trend.

With respect to trends in labor productivity, the following table documents the annual average rate of growth of real GDP for persons employed for selected OECD economies:

	U.S.	Japan	Germany
1960-68	2.6 percent	8.8 percent	4.2 percent
1968-73	1.0 percent	7.3 percent	4.1 percent
1973-79	0.0 percent	2.9 percent	2.9 percent
1979-88	0.9 percent	3.1 percent	1.9 percent

The questions to address are: Why has there been a consistent decline in labor productivity? What are the main factors? Is it due to the exhaustion of the technological innovations that buoyed up the economies in the 1960s and part of the 1970s? Is it due to the decline of manufacturing and the significant shift of resources to the services sector? Is it due to the completion of the catching-up process?

Is it possibly due to the slower growth of exports from the industrial countries? We are aware that much emphasis is being laid on trade liberalization from the point of view of contribution to growth. In particular, hopes are being fixed on the Uruguay Round. The Uruguay Round is a good thing and should by all means be pursued to a successful conclusion. Nevertheless, it would be useful to look at the historical evidence. The free trade agreement between Canada and the United States does not appear to have solved the growth problem in any significant way. In fact, the complaint in Canada is that thousands of jobs have been lost since the pact was concluded. The area of the agreement has since been enlarged by the addition of Mexico, but it remains to be seen whether this agreement will spur growth in the United States.

More generally, the possibilities for growth offered by the developing country markets will depend on the direction that the adjustment process takes and whether, as a result of adjustment policies, the developing countries build up the necessary capacity for enlarging their imports.

There has been a great deal of discussion on adjustment strategies in the developing countries, which are constantly being told to do one thing or another. The thrust of my intervention has been to examine adjustment strategies in the developed countries. The reading that I have presented of adjustment in the industrial countries does not give inspiration for the future.

To mention just one more subject, unemployment has now become an unmentionable topic in public discourse. As a social and economic problem, it is not high on the national agendas of industrial countries. The perception that there is a widespread conflict between prosperity and inflation effectively dampens any discussion of unemployment, which is seen as an awkward problem that, it is believed, will somehow go away. Structural remedies are prescribed; for example, it is suggested that labor market rigidities are responsible for unemployment. However, the United States, where structural rigidities are presumably absent, does not offer any evidence of the success of economic policy in reducing unemployment.

To my mind, it seems that the slowdown of productivity in the industrial economy and the consequent rise in inflation and unemployment are due primarily to a crisis in the process of capital accumulation. Unless this crisis is resolved, we shall continue to focus attention on short-term stabilization at the cost of the medium- and long-term growth process.

The staff is to be complimented for the analytical attention that it has devoted to developing countries. In this, if not in anything else, the North-South balance has been redressed. However, what is happening in developing countries is a minor episode in a Faustian play starring, as the tragic hero, the industrial economies. The industrial country protagonist does not seem to know where he is going or what he can do to overcome his fate.

The economies of the developing countries offer the prospects of a mutually beneficial interaction between them and the developed world, resulting in the growth of the global economy. However, there are certain preconditions: the debt burden has to be significantly reduced, and a more generous attitude to official development assistance has to come about; Fund concessional arrangements for accelerating growth-oriented adjustment have to be bolstered; the developing countries have to make a concerted effort to strengthen policies for noninflationary growth; and, finally, access to industrial country markets has to be vastly improved to enable adjustment policies in the developing countries to create a solid foundation for growth and prosperity.

In conclusion, I would suggest that we are still very far from ensuring a suitable environment for the success of adjustment policies in the developing countries.

Mr. Torres made the following statement:

The current world economic outlook, despite its characteristic air of optimism, actually paints a gloomy picture. The expansion in industrial countries continues to be slow and uneven, and downside risks persist despite the high levels of unused capacity and unemployment. Consumer and business confidence continue to be low. Moreover, structural imbalances in many industrial economies still pose serious challenges and will intensify pressures to increase government expenditure.

Developing countries that managed to attain higher growth rates in an unfavorable external environment because of stabilization and reform efforts sustained over many years are being bogged down by the slow expansion of output and trade in world markets, and by a rising wave of protectionism. In addition, instability in international financial markets, including wide swings in stock market prices, has generated greater uncertainty and complicated monetary management.

The economies of many Eastern European countries and the countries of the former Soviet Union continue to be engaged in the painful process of transforming themselves into market economies--a process characterized by a sharp contraction of output and a high degree of monetary instability.

The only bright spots on the horizon of the industrial countries seem to be the progress made in reducing inflation, the low level of short-term interest rates, particularly in the United States, the improvement in financial balance sheets, and the advances in liberalizing financial markets. In developing countries, the main strengths are the progress achieved in reducing macroeconomic imbalances, the improved efficiency derived from important structural changes, and, as the staff puts it on page 48 of the main paper, "the significant changes in economic philosophy."

Under these conditions, it seems clear that the main priority for the world economy--and especially for the industrial countries--is to seek ways to restore growth potential. However, policy measures to support a more robust recovery in industrial countries face several severe constraints: on the fiscal side of the ledger, expansionary policies in industrial countries other than Japan have been ruled out because of the prevailing large structural budget deficits; on the monetary side, meanwhile, it seems that further reductions in short-term interest rates would only increase inflationary expectations without providing a significant stimulus, given the low sensitivity observed in consumption and investment demand with respect to short-term interest rates in recent years.

In this situation, the route advocated by the staff is for industrial countries to pursue more vigorously the goals of the medium-term strategy, particularly in the area of fiscal consolidation, with the hope that this will produce a crowding in of private investment and a restoration of consumer confidence, and with the expectation that the subsequent easing of monetary conditions will finally produce the stimulus required for economic activity without rekindling inflationary pressures.

An alternative recommendation would be along the lines suggested by Mr. Prader, who advocated in his statement the objectives of the medium-term strategy while allowing for a short-term departure from it. This would provide the initial impulse that the world economy needs, but it would also make it easier to resume the pursuit of the medium-term strategy later.

Although mindful of the dangers of oversimplification, we feel that there are basically two options facing the policymakers. The first would involve slow short-term growth, fiscal adjustment, and the laying of a foundation for sustained medium-term growth. The second option calls for faster short-term growth to get the plane off the ground, a period of restrained growth while a credible multiyear deficit reduction package is implemented, and a later period of growth at potential once the objectives of the medium-term strategy have been obtained and the favorable effects of growth resumption, credibility, and confidence have kicked in.

The second option is tempting; unfortunately, experience suggests that you cannot be just "a little bit pregnant." The record shows that several industrial countries missed the opportunity to push toward the goals of the medium-term strategy during the long expansion of the 1980s. The public would be right to be skeptical about the commitment of these governments to a multiyear deficit-reduction package, and, therefore, the credibility and confidence that are required to make the plane fly would not materialize.

Alternatively, the staff's policy recommendations, which we agree with, are not exempt from risks. The greatest risk is that the rewards for virtue, as Mr. Dawson put it during the U.S. Article IV consultation discussion on Monday (EBM/92/108, 8/31/92), might take too long to materialize--after all, a mild recession feels very much the same as a mild recovery--and that might lead politicians and policymakers to reassess the merits of the strategy and switch course. Or, more dangerously, advocates of returning to the old days--I hesitate to say "the good old days" because I doubt that they were good--will win enough support from a population that has grown impatient waiting for economic growth to resurface.

However, we are optimistic that this will not be the case. We are confident that, based on the many structural strengths that Mr. Peretz and other speakers reminded us of on Monday, the economy of the United States will soon resurface, and that Japan, with its high productivity and commendable savings habits, will also recover its growth dynamics. In Europe, the push to liberalize and deregulate generated by the single market program and the challenges posed by the Maastricht agreement offer the right incentives to overcome the structural impediments to higher sustained growth.

Turning to developing countries, we note that the staff is projecting an average real growth rate of GDP of 6 percent in both 1992 and 1993. This optimistic forecast is based on stronger growth in the industrial countries, a rebound in economic activity in the Middle East, and the continued effects of improved macroeconomic policies and structural reforms.

We are less optimistic than the staff, as it seems inevitable that the protracted slowdown in industrial countries and the turmoil in the financial markets will sooner or later impinge on the performance of developing countries. This point was recognized by the Economic Counsellor in his opening statement. The initial boost received from lower international interest rates and debt-reduction operations is bound to taper off if import demand in industrial countries remains sluggish and economic activity continues to stagnate. In this regard, we share the view of Mr. Dawson that the world trade projections in the world economic outlook papers seem to be very optimistic.

The staff presents some interesting results regarding the performance of successfully adjusting countries. The main conclusion is that, as a group, adjusting countries exhibit generally higher growth rates, lower inflation rates, and lower levels of external debt. However, one other important result, implicit in Table 11, is that the process of adjustment, stabilization, and structural change is a lengthy one. One finds that countries that have sustained their adjustment effort for more than five years are the ones that show a better overall performance. This finding should serve to moderate our expectations about the short-term prospects for developing countries that are in the initial stages of the adjustment process.

Another important conclusion that can be drawn from this exercise is that, although the adoption and implementation of domestic policy reforms are critical to the realization of development objectives, success undoubtedly also requires a supportive international environment. At the very least, this means reduced levels of protectionism in the industrial countries, further progress in debt reduction and relief, and increased flows of financial resources. In this regard, the successful resolution of the Uruguay Round would be an important step toward a more favorable trade environment.

The Executive Directors agreed to continue their discussion on the world economic outlook on Friday, September 4, 1992.

APPROVED: April 6, 1993

LEO VAN HOUTVEN
Secretary