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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 92/110

10:00 a.m., September 2, 1992

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

Executive Directors	Alternate Executive Directors
M. Al-Jasser	A. A. Al-Tuwaijri
G. K. Arora	L. E. N. Fernando
	Wei B.
	G. C. Noonan
	J. Jamnik, Temporary
T. C. Dawson	Q. M. Krosby
	J. Prader
E. A. Evans	
R. Filosa	J. Papadakis
	A. F. Mohammed
I. Fridriksson	J. A. Solheim
H. Fukui	N. Tabata
	B. Esdar
J. E. Ismael	T. Sirivedhin
A. Kafka	J. C. Jaramillo
J.-P. Landau	I. Martel
A. Mirakhor	O. Kabbaj
	L. J. Mwananshiku
D. Peretz	J. Dorrington
G. A. Posthumus	
C. V. Santos	Y.-M. T. Koissy
A. Torres	R. Marino
A. Végh	A. G. Zoccali

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

Also Present

African Department: M. Touré, Counsellor and Director; J. A. Clement. Central Asia Department: B. B. Aghevli, U. Baumgartner, C. Sumi. European I Department: G. Bélanger, S. Oberg. External Relations Department: S. J. Anjaria, Director; A. Mountford. Fiscal Affairs Department: F. C. Ribe. IMF Institute: P. B. de Fontenay, Director. Legal Department: K. Sono. Policy Development and Review Department: J. Boorman, Director; J. Ferrán, Deputy Director; R. Danielsen. Research Department: M. Mussa, Economic Counsellor and Director; M. Goldstein, Deputy Director; D. T. Coe, R. A. Feldman, R. P. Ford, S. J. A. Gorne, G. Hacche, 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: D. Williams, Treasurer; L. Duke, S. M. Thakur, M. A. Wattleworth. Western Hemisphere Department: S. T. Beza, Counsellor and Director; E. M. Nedde. Office in Geneva, H. B. Junz, Director. Special Advisor to the Managing Director: P. R. Narvekar. Personal Assistants to the Managing Director: B. P. A. Andrews, R. Saunders. Advisors to Executive Directors: J. M. Abbott, P. Bonzom, M. B. Chatah, C. D. Cuong, L. Dicks-Mireaux, B. R. Fuleihan, Y.-H. Lee, R. Meron, M. J. Mojarrad, A. Raza, B. A. Sarr, A. Törnqvist, S. von Stenglin. Assistants to Executive Directors: S. Al-Huseini, B. Bossone, J. H. Brits, Chen M., J. A. Costa, A. Giustiniani, M. A. Hammoudi, M. E. Hansen, O. A. Himani, J. Jonas, V. Kural, K. J. Langdon, W. Laux, G. J. Matthews, F. Moss, L. F. Ochoa, E. H. Pedersen, N. Shimizu, F. A. Sorokos, N. Sulaiman, L. Tase, Tin Win, T. P. Thomas, R. Thorne.

1. INTERIM COMMITTEE - PROVISIONAL AGENDA

The Executive Directors continued from a previous meeting (EBM/92/108, 8/31/92) their consideration of a draft provisional agenda for the Thirty-Ninth Meeting of the Interim Committee (EBD/92/180, 8/19/92).

After a brief discussion, Directors agreed that the Russian delegation should be invited to participate in the afternoon discussion on structural change and economic stabilization policies in Eastern Europe and the states of the former Soviet Union.

2. WORLD ECONOMIC OUTLOOK

The Executive Directors considered 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).

The Economic Counsellor and Director of the Research Department made the following statement:

> In my introductory remarks, I shall comment first on the main developments in foreign exchange and financial markets in the period since the most recent Board discussion on exchange market developments on August 5 (IS/92/4, 8/5/92). I shall then comment on revisions to the world economic outlook and conclude with a few brief remarks on very current and immediate policy concerns in the international financial arena.
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> With respect to the first point, as the Chinese sometimes say, we live in interesting times. August again lived up to its reputation of being an interesting and eventful month in financial markets. This year, there were no disturbances to match the attempted Soviet coup of August 1991 or the Iraqi invasion of Kuwait in August 1990; nevertheless, there were some striking developments in both foreign exchange markets and equity markets in the past month.
>
> In foreign exchange markets, the U.S. dollar has fallen to historic lows, both against the deutsche mark and in effective terms, despite several rounds of concerted intervention. There has also been a notable increase in tensions in the European Monetary System (EMS). In equity markets, stock prices in Tokyo fell to six-and-one-half-year lows two weeks ago but, following measures by Japan's Ministry of Finance, have rebounded to their levels of early June 1992.

Before examining these developments in detail, however, I shall first summarize recent movements in interest rates. Following the proliferation of monetary policy actions in July 1992 to which I referred at the previous discussion, there were no adjustments of key official interest rates in the major industrial countries during the past month. Meanwhile, movements in short-term market rates have been mixed. In the United States and Germany, they are virtually unchanged from four weeks ago; however, in both Japan and Canada, the monetary authorities have allowed short-term rates to ease by a further 25 basis points. In Europe, currency pressures in the EMS have led to significant further increases in short-term market rates outside Germany--increases of about 25 basis points in France and the United Kingdom, and of up to 200 basis points as of today in Italy. Outside the group of major industrial countries, currency pressures in Europe have led to increases in official interest rates amounting to 400 basis points in Sweden and 150 basis points in Finland, and to slight upward movements in central bank dealing rates in Belgium and the Netherlands.

Movements in government bond yields have broadly paralleled movements in short-term interest rates over the past month, but a couple of developments are particularly noteworthy. First, in the United States, long-term rates fell to their lowest levels in five-and-one-half years about two weeks ago before rising back last week to where they stood at the time of the most recent Board meeting. The decline in yields in the first part of the period seems attributable mainly to growing doubts about the strength of the economic recovery, while the subsequent reversal may have stemmed partly from increased concerns about the fiscal deficit--associated, perhaps, with talk about tax cuts or other measures that might enlarge the deficit, and partly from the weakness of the dollar.

The second notable development in bond markets is that yields in Germany have declined by about 25 basis points during the past month while short-term rates have barely changed. Thus, the yield curve in Germany has become even more steeply inverted, as illustrated in Chart 8, and it is now the most steeply inverted among the major industrial countries. This may be viewed as an indication of the tightness of the stance of monetary policy in Germany; it contrasts with, however, the continuing relatively rapid growth of the targeted monetary aggregate, M3, in Germany.

The most notable development in equity markets in the past month has been the continued decline and subsequent rebound of stock prices in Tokyo. Two weeks ago yesterday, the Nikkei index fell to a six-and-one-half-year low, 63 percent below its end-1989 peak. Since then, it has jumped by 23 percent to levels most recently seen three months ago; it now stands 10 percent higher than at the time of the previous Board meeting. The turnaround began immediately after the announcement by the Japanese authorities on August 18, 1992 of measures to support the stock market. The recovery gathered strength in the past week as expectations of the scale of the package of fiscal measures announced on Friday of that week were revised upward. It appears that those revised expectations were not disappointed.

In the other major industrial countries, stock market prices have weakened over the past month--by 8 percent in Italy, where interest rates have risen the most; by 6 percent in Germany, perhaps owing partly to the appreciation of the deutsche mark and its impact on profit expectations; and by 4 percent or less elsewhere in Europe.

In the past four weeks, the U.S. dollar has depreciated by 6 percent against the deutsche mark, by about 5 percent against the other major European currencies, and by 3 1/2 percent against the yen. Meanwhile, the U.S. dollar has depreciated by 6 percent against the Canadian dollar. In nominal effective terms, the U.S. dollar has fallen by 3 1/2 percent since August 5, 1992, and by 10 1/2 percent from its local peak reached in March 1992. Ten days ago, as shown in Chart 2, the U.S. dollar dropped below its previous historic lows of February 1991, both against the deutsche mark and in nominal effective terms. After stabilizing briefly at the end of the past week, the dollar weakened again yesterday, and it is trading this morning at a new low of DM 1.3870=US$1.

Concerted intervention by a large number of central banks in support of the dollar was reported on three days in the past month, and there may have been other episodes as well. The amounts reportedly involved were moderate by most past standards. The intervention clearly did not succeed in preventing the dollar from dropping below its previous trough, but it may have moderated the pace and extent of the dollar decline.

As to the sources of the downward pressure on the dollar, particularly against the deutsche mark, during the past month, at least part of the answer clearly lies in interest differentials. Here, Directors may wish to turn to Chart 11 of the Annex providing supplementary background material. The second pair of panels in this chart shows the extraordinary shift--and it is really remarkable--in interest differentials in favor of mark-denominated assets vis-à-vis the dollar that has occurred over the past three-and-one-half years. Since early 1989, interest rate differentials have shifted in favor of the deutsche mark against the dollar by more than 10 percentage points at short maturities, and by about 4 percentage points at longer maturities. Thus, interest rates on mark-denominated assets are now up to 7 percentage points higher then on dollar-denominated assets.

In the face of these adverse changes in relative interest rates, the dollar has, in fact, been quite buoyant over most of the past two years or so; and, even in the most recent episode, its value has dropped only marginally below its trough of early 1991, when interest differentials were significantly more favorable to the dollar. In this sense, the dollar's recent weakness is hardly surprising; however, changes in interest rate differentials do not explain the timing of the dollar's recent decline, which is probably related to several factors. First, expectations of an eventual tightening action by the Federal Reserve may have been put back somewhat by further evidence of a weak and uneven recovery in the United States. Second, expectations of easing action by the Bundesbank may have been set back by the continued rapid growth of M3. Third, with monetary policy in both the United States and Germany thus apparently unavailable to provide support for the dollar, the markets may have been less inclined to be impressed by official intervention. Finally, political uncertainties in the United States may have increased concerns about, inter alia, the federal budget deficit and its possible influence on both monetary policy and the credibility of government policy generally.

Associated with the upward pressure on the deutsche mark vis-à-vis the dollar over the past month has been upward pressure on the deutsche mark and the currencies closely tied to it--the Belgian franc and Netherlands guilder most especially--in relation to other currencies participating in the exchange rate mechanism (ERM) of the EMS. This is illustrated in Charts 4 and 5. Chart 5 shows that the wide band has been virtually fully stretched since late July 1992, with the Portuguese escudo at the top and the pound sterling at the bottom. It also shows the narrow-band currencies, effectively led by the deutsche mark, climbing sharply within the wide band, with the result that the pound has got much closer to its floor against the mark. These charts had to be drawn before the data for the past ten days were available; these data would show the mark even closer to the top of the wide band. Inclusion of the past ten days' data in Chart 4 would have an even more dramatic impact, because they would show the narrow band also almost fully stretched since the past week, with the mark at or near the top and the lira at the bottom. We have not really seen this phenomenon of the mark being at or very near the top of the narrow band since the previous period of great tension in the EMS.

These increased tensions in the EMS may be attributed partly to the familiar tendency for pressure on the mark vis-à-vis the dollar to be associated with pressure on the mark in the same direction inside the EMS. However, two other factors also seem to have been important in the recent episode. First, doubts about the ratification of the Maastricht Treaty and the associated process of convergence toward European economic and monetary union

(EMU), having increased following the Danish referendum in early June 1992, have not been allayed in the buildup to the French referendum due on September 20, 1992. Second, the particular strains on the pound and the lira have probably also reflected important concerns about domestic economic developments and reactions to public comments about a possible realignment of EMS currencies.

Pressures within the EMS have been absorbed not only by exchange rate movements, but also by the movements in interest rates referred to earlier, and by official intervention. In particular, the U.K. authorities are reported to have engaged a week ago in the largest support operation for sterling in the past six years. It is also notable that Italy's foreign exchange reserves shrank by more than $8 billion during July 1992 to only $24 billion, compared with $60 billion of reserves at the end of 1990.

Also, on Friday, August 28, 1992, European Community (EC) finance ministers issued a statement that ruled out a realignment: they stated that "a change in the present structure of central rates would not be the appropriate response to the current tensions" in the EMS. Nevertheless, I expect that speculation about this issue will continue in the press.

Turning now to the world economic outlook, I will review the revisions before discussing the very current policy issues. The staff has updated its assessment of the outlook presented in the staff paper to take account of recent data and information. The revised projections will be presented to the Interim Committee later this month and will then appear in the published version of the World Economic Outlook.

The major changes to global assumptions involve exchange rates, interest rates, and petroleum prices. Compared with the assumptions underlying the projections in the staff paper, the nominal effective exchange rate of the U.S. dollar is now 5 percent lower, and the yen and the Canadian dollar about 1 percent lower. The nominal effective exchange rates of continental European currencies are assumed to be 2 1/2-3 1/2 percent higher, while sterling is unchanged in nominal effective terms. As a result of the decline in U.S. interest rates through June-July 1992, the six-month U.S. dollar London interbank offered rate (LIBOR) for the revised world economic outlook is now assumed to be about 100 basis points lower than what was assumed earlier. The new oil price assumption is based on future quotations through August 10, 1992; for 1993, the price of oil is assumed to be $18.21 per barrel, or about 7 percent below the earlier assumption.

In light of these changed assumptions, and of other recent information, the staff has reassessed the economic prospects of the seven major industrial countries. Projected output growth in these countries, taken together, has been revised downward only marginally for 1992 as a whole, although growth for the United Kingdom has been revised down by a full percentage point into negative territory. For 1993, however, the staff has revised projected growth for the major industrial countries downward by about 1/4 of 1 percentage point--from 3.2 percent to 3 percent. This reflects downward revisions to growth forecast in the United States from 3.4 percent to 3.1 percent; in the United Kingdom, from 3 percent to 2.1 percent; and, in Canada, from 4.8 percent to 4.4 percent. For Japan, the staff's revised projections take into account the economic stimulus package announced on Friday, August 28, 1992, although it should be borne in mind that information about its implementation is as yet incomplete. The impact of the package is expected to slightly more than offset the greater than expected weakness of the economy seen since July 1992. Thus, without the package, the staff's projections of growth would have been lowered somewhat; with the package, they have been revised upward--only slightly for 1992, but by 1/4 of 1 percentage point for 1993. Growth projections for the major industrial countries in 1994 remain unchanged. Inflation projections for 1993 have been revised downward for the United Kingdom and Canada by 1/4 of 1 percent, reflecting, respectively, greater slack in 1992 and 1993, and better than expected performance in 1992. Inflation projections remain essentially unchanged for the other major industrial countries.

The outlook for growth in developing countries is largely unchanged, with the beneficial effects of lower oil prices and interest rates roughly offset by the somewhat slower growth now projected in the industrial countries. Recent developments in the Russian Federation suggest that the decline in output in 1992 will be about 3 percentage points larger than the 14 percent reported in the staff paper.

Finally, I want to turn briefly to what I would call current policy considerations in financial and exchange markets. As I emphasized at the previous Board discussion, financial markets generally--and foreign exchange markets, in particular--are being affected by an unusual and impressive array of doubts, fears, and uncertainties concerning economic and political developments. This will continue to be the case in the weeks immediately ahead.

In the United States, negative economic news that suggests increased likelihood of further easing by the Federal Reserve will tend to depress the dollar and have other disturbing effects on stock and bond markets. Of course, we do not know what that news will be, but, if it is negative, it will have that direction of effect. The shifting fortunes of the contending presidential candidates and possibly their statements on important economic policy issues will undoubtedly contribute to the general air of uncertainty.

In Japan, recently announced policy measures have clearly provided meaningful reassurance to jittery financial markets. However, with continuing worries about the economy, financial institutions, and corporate earnings, the risk of further turbulence cannot be entirely ruled out.

In Germany, monetary policy appears sufficiently tight to sustain progress in reducing inflation, and I do not expect a further rise in the Lombard rate within coming weeks. The prospects for an early easing of official interest rates, however, are not yet apparent, and worries about a further tightening seem a possible contributor or likely to contribute to the continued strength of the deutsche mark.

In France, doubts about the outcome of the referendum on EMU, fueled by swings in the opinion polls, will contribute to tensions in the EMS until the outcome is known on September 20, 1992. Personally, I expect a positive if somewhat narrow victory. A negative outcome, however, cannot be excluded and would almost surely trigger a crisis in the EMS--and probably more broadly in European economic and political relations.

In Italy, a substantial package of specific measures to reduce the fiscal deficit is urgently required to underpin official commitments on the exchange rate, and to the Maastricht convergency process; even with such a package, pressures on the lira may well continue.

In the United Kingdom, substantial further intervention and, at some point, an increase in official interest rates may well be required to defend the position of sterling within the EMS. The consequences of an interest rate rise for an economy still struggling to begin recovery would be unfortunate, and the political consequences for parliamentary consideration of EMU ratification later this year or in 1993 could be--what should I say--interesting.

In Canada, important progress has recently been made in resolving long-standing constitutional controversies. Perhaps the resolution of these uncertainties will simultaneously allow a further lowering of Canadian interest rates and provide an independent stimulus to confidence, investment, and growth.

In many other places, however, immediate economic prospects are more bleak. Sweden, which is still in deep recession, recently had to raise official interest rates by 400 basis points to defend the peg of its currency. Finland, which is experiencing an even deeper downturn, recently raised official interest rates by 150 basis points. Among the industrial countries, nowhere do there appear to be particularly bright prospects for really buoyant growth in the period immediately ahead. Among the developing countries, recent economic performance has been remarkably strong, especially in view of the sluggish growth in the industrial countries. This has been reflected in strong gains in equity prices, and in expanding markets for the exports of industrial countries. At some point, however, gloom and turmoil in world financial markets will spill over to affect developing countries and thereby further blunt prospects for growth in the world economy.

In their comments on the world economic outlook, I know that Directors will focus attention on the policy measures that are necessary and appropriate to strengthen prospects for sustainable, noninflationary growth--especially in the medium term, for their own economies and, more generally, for the world economy. At present, however, it may be of some use to offer four brief observations on what might be done in the very near term to contain risks of financial and exchange market turmoil.

First, as a practical matter, very little can be done during the next few months to alter in a positive direction the economic fundamentals that underlie financial market developments by changing the main elements of the economic policies of the largest countries. Therefore, some of the sources of turmoil and uncertainties are just going to have to be lived with.

Second, it should be possible, however, to avoid policy actions that would contribute to financial market turbulence for no good reason. Unless there is sufficiently bad news about the U.S. economy that induces declines in short-term market interest rates in and of themselves, the Federal Reserve will probably not feel compelled to ease official rates further. In Germany, monetary policy is sufficiently tight to combat inflation, and further rises in the Lombard rate can probably be avoided. In Japan, there remains flexibility to respond to financial market turmoil if that should become a problem.

Third, it is essential to avoid discord and disarray among important governments and policymakers that would needlessly contribute to financial market turmoil. The public bickering that immediately preceded the stock market crash of October 1987 was probably not the major cause of that debacle, but it surely was not helpful and should not be repeated. What would be helpful is a clear demonstration of cooperation and solidarity among the major economic powers. The Uruguay Round provides a particular opportunity in this regard.

Fourth, and finally, given the constraints on monetary policies, if something is to be done to avoid destabilizing movements of exchange rates among the three major currency areas, official intervention remains as the only real option in the near term. Normally, I do not think that intervention is very effective, especially when it is widely perceived that intervention will not be backed up, if necessary, by early adjustments of monetary policy. Therefore, in the present situation, official intervention would need to be visibly massive as a threat--and probably as a reality--in order to resist major pressures affecting exchange rates among the largest countries. The authorities would need to show that they have a very big stick and are prepared to wield it very aggressively, and this stance would need to be backed by serious commitments for adjustments of policies in the medium term to validate the exchange rates that are being defended.

Mr. Torres suggested that it might be useful to circulate the Economic Counsellor's statement to Board members.

The Chairman recalled that the discussions on exchange market developments had formerly been held in restricted session. It would be difficult to maintain the lively spirit of give-and-take that had characterized those meetings if the practice of circulating the Economic Counsellor's remarks were to be initiated.

Mr. Prader made the following statement:

One year ago, Mr. de Groote's statement on the world economic outlook (delivered at EBM/91/129, 9/23/91) started off with the following paragraph:

> At this point in time, it is not yet clear whether the policies undertaken in the three largest industrial countries will succeed in achieving their objectives: instigating a decisive and sustained upswing in the United States and accommodating a soft landing, followed by a renewed noninflationary takeoff next year, in Japan and Germany. If the U.S. economic recovery remains sluggish, and if, at the same time, growth continues to decelerate rapidly in Germany and Japan, the scenario for the industrial countries next year, namely, 1992 in the direction of a 3 percent annual growth rate of output might not be so easily achieved. The question of timing is highly important, but policymakers seem to be lacking the necessary instruments to influence the timing pattern.

By the time of the Thirty-Eighth Meeting of the Interim Committee on April 27-28, 1992, the staff had already tuned down its earlier optimism with some notes of caution, highlighting the downside risks of its projections, which, for growth in the industrial countries as a whole, had themselves been revised downward by 1 full percentage point from 2.8 percent to 1.8 percent. We remained of the view, however, that the staff continued to underestimate the sluggishness in the pace of recovery.

The projections contained in the circulated draft of the World Economic Outlook retain the 1.8 percent output growth forecast for 1992; however, this is the result of a further downward revision in the growth prospects for Japan and the EC being compensated by an upward revision in the outlook for the United States. During Monday's discussion on the U.S. Article IV consultation (EBM/92/108 and 92/109, 8/31/92), many Directors expressed their skepticism over the ability of the U.S. economy to register a 2.1 percent output growth rate this year. Likewise, we continue to have doubts on the feasibility for the industrial countries as a whole to register output growth in excess of 3 percent in 1993, if growth in 1992 were to be near the 2 percent figure projected by the staff.

Instead, we would lend more weight to the factors that have thus far caused the economic recovery to be more subdued than projected, and that continue to present downside risks to the buoyancy of the cyclical upturn. The most important factors in this respect are the ongoing balance sheet adjustments in the financial and nonfinancial sectors of the economy, especially in the United States, the persistent high real interest on both long- and short-term maturities in Europe, the continued weak levels of business--and, in particular, consumer--confidence, and the financial fragility in Japan. These factors are mainly the symptoms of unsolved long-term and, therefore, structural problems of the previous growth cycles--basically from the 1980s--that are now hampering a normal cyclical upturn. Two such problems stand out: first, the asymmetry in the pace between, on the one hand, the liberalization of financial markets and, on the other, the liberalization of goods and factor markets--more specifically, the international trade and labor markets--in the industrial world; and, second, the continuing high level of budget deficits in most countries, which is preventing inflationary expectations from coming down as one would expect in the wake of increasing signs of disinflation, and which, therefore, is keeping real interest rates at a high level.

The obvious way to address these longer-term problems is to redouble efforts to try to attain the objectives set out in the medium-term policy strategy to which the major industrial countries claim adherence. Unfortunately, rigid adherence to that strategy at this point in the economic cycle would only delay the recovery further. This is why some short-term departure from the medium-term strategy might be the most realistic option. Seen from this angle, we want to advocate a more outspoken anticyclical strategy for the immediate future. We had already proposed such a stance at the spring Interim Committee meeting. Today, in view of the weaker outlook for the major economies compared with six months ago, we cannot but reiterate our earlier position. Let it be clearly understood, however, that we are suggesting some short-term policy action to assist the recovery, especially in the United States, on the understanding that the resumption of a faster and more even pace of economic growth will make it easier to resume the pursuit of the medium-term policy strategy immediately afterward.

For the United States, we would, therefore, accept a temporary increase in the budget deficit--not by reducing taxes, but one that is geared toward stimulating investment demand. The negative interest rate and confidence effects of the increased deficit can be contained by a simultaneous announcement of a credible multiyear deficit reduction package, comprising both revenue-raising and expenditure-reducing measures, which will be put into effect once the economic recovery has gained strength. Obviously, such a package could enter into effect only after the presidential elections. If the inflation rate were to rise as a result of the fiscal stimulus--that is, if the slack in the economy were overestimated--monetary policy restraint should be envisaged.

For Japan, we had warned at the time of the Article IV consultation discussion (EBM/92/88 and 92/89, 7/15/92) against the risk of a temporary slowdown being aggravated by financial fragility. We are happy to see that the Japanese Finance Minister has since expressed his concern over the health of the banking system, and that he has presented a number of measures in the context of a large emergency economic package, announced at the end of the past week. Given the monetary easing by the Bank of Japan and the fiscal stimulus attached to the supplementary budget, Japan seems to be perfectly in line with our view on the value of pursuing a short-term anticyclical strategy in the context of the medium-term framework. The country's enviable macroeconomic position has allowed it to act immediately.

For Germany, we would advocate a change in the policy mix, with some monetary policy easing in the wake of signs of receding inflationary pressures--which, we believe, will occur early next year--and a rigorous fiscal policy stance designed to allow long-term real interest rates to come down. Germany will thus become the fiscal policy anchor for the other European countries putting their fiscal houses in order so as to comply with the convergence criteria of the Maastricht Treaty. Rather than being deflationary, the EMU-induced fiscal retrenchment in Germany and its EC partner countries will lead to a double gain in lower interest rates for the latter group, as both interest rate differentials vis-à-vis the deutsche mark and the interest rate on the deutsche mark itself will decline. This is an additional reason for contesting the view that the EMU process will be deflationary for some time. The staff is right in stressing that declining interest rate differentials in the EMS presuppose that markets believe that currencies will no longer be devalued in terms of the deutsche mark. The example of Belgium stands to show that, if governments declare that they are forgoing the exchange rate instrument and adopt policies aimed at achieving convergence in the monetary and fiscal domains, they will gain credibility in the market and be rewarded by declining interest rate differentials vis-à-vis the anchor currency.

Once growth has resumed a faster and more even pace, it will be important for the industrial countries to refocus on their medium-term objectives, in particular, the fiscal and structural policy components, in which areas, as the world economic outlook documents indicate, much remains to be done.

We welcome the evidence that stabilization and reform efforts are beginning to bear fruit in an increasing number of developing countries in all regions of the world. We fully endorse the staff's view that sustained adjustment is crucial to the rewarding performance of the developing world in the face of sluggish world demand. We particularly like the approach that the staff has followed in focusing on one key component of successful adjustment in an annex to the spring 1992 world economic outlook document (SM/92/58, 3/17/92), namely, fiscal consolidation, and in highlighting another core element this time, namely, structural reform. It is to be hoped that the experience with respect to structural reform described in the document will hold valuable lessons not only for developing countries, but also for former centrally planned economies trying to establish a market economy. In this respect, the chapter on structural reform is perhaps too rigidly tied to the heading of developing countries' experience.

One region continues to lag in economic performance and is projected in the medium-term scenario to continue to do so: Africa. There exist obvious explanations for this outcome, such as the fact that adjustment started later in this continent than in Asia, and that, contrary to Latin America, Africa is more dependent on the export of primary commodities and thus more prone to climatic developments, such as the recent drought. Another explanation seems to be that sub-Saharan Africa, consisting mostly of low-income countries, has failed to make progress in resolving its external debt problems, contrary to the experience of middle-income countries.

It is a well-established fact by now that highly uncertain prospects for external viability can undermine countries' adjustment efforts and pose important questions regarding Fund support to such low-income countries, in view of their limited capacity to repay. It is no coincidence that, excluding Nigeria, more than 50 percent of the total debt of the 28 low-income countries engaged in debt rescheduling through the Paris Club is held by 5 countries that were in arrears to the Fund--Honduras, Nicaragua, Sudan, Zaire, and Zambia. Three of these countries, all African, still have to settle their arrears. It seems appropriate, therefore, to, first, try not just to halt the pace of deterioration of the debt situation in the low-income countries, but to actually improve it; and, second, do this by means of a combined effort of the multilateral institutions and the bilateral official creditors, to whom just over 80 percent of the external debt of the low-income countries is owed. We will return to this issue during the Board discussion scheduled for Friday, September 4, 1992 on the debt situation of developing countries.

With respect to the transformation process in the former centrally planned economies, another quotation--this time from Mr. de Groote's statement at the spring 1992 world economic outlook discussion (EBM/92/46, 4/6/92)--is relevant:

> Can the further demand adjustment needed before the supply response takes hold be dampened somewhat? Maybe yes, if further macroeconomic stabilization is sufficiently counterbalanced by a rapid pace of structural and institution-building reforms. If not, further harsh demand adjustment would be to little avail, except to increase the likelihood of wearing out the resolve of the population and its policymakers to continue with the transformation process. Indeed, one of the major reasons why the transition costs in terms of output loss and the persistence of inflation have proved higher than anticipated has to do with the fact that a large number of systemic reforms still remain to be defined or implemented.

In the world economic outlook document under discussion today, as well as in the papers prepared for the Board seminar scheduled for September 9, 1992 on the experience with programs in Eastern Europe and the reform strategy in the former Soviet Union, similar lines have been written concerning the interdependence of macroeconomic stabilization and structural reform. This may require some flexibility in the pace of macroeconomic stabilization in certain countries, but we want to make it clear that this in no way entails a preference for a gradualist strategy vis-à-vis shock therapy. Speedy reforms will necessarily diminish the total cost of the transition process. However, the emphasis must remain on the mutual consistency and support of the individual reform measures in the macroeconomic and structural areas, rather than on radicalism and speed in the macroeconomic area alone. In the case of asymmetric implementation of reforms, radicalism could even be detrimental and lead to rollbacks in the whole reform process.

Indeed, adjusting prices in the direction of world market levels and embarking on restrictive fiscal and monetary policies while delaying the needed supportive institutional changes would only produce an unsustainable system, as no supply response could materialize. In fact, perverse developments might occur. Financial stability would soon be undermined again, owing to re-emerging macroeconomic imbalances in the wake of lacking competitive behavior, and further progress in structural adjustment would be jeopardized. Russia is perhaps coming dangerously close to such an outcome, and the accumulation of interenterprise arrears might be the symptom. However, it would be all too easy to interpret this reasoning as an argument against a vigorous pursuit of macroeconomic stabilization. Current circumstances in the former Soviet Union demonstrate, just like prior evidence from Eastern Europe, that there is hardly anything more obstructive to a successful transformation than a situation of real economic instability and financial chaos. The goal of macroeconomic stability is not something on which the authorities should be ready to compromise.

It would be counterproductive for the Fund to try to invent a strategy for reforming the economies of the former Soviet Union that would differ fundamentally from the strategy that is proving its viability in the Central and Eastern European countries. It is true, of course, that the scope and scale of the problems facing the economies of Russia and many other states of the former Soviet Union are unique. However, it could be a dangerous illusion to assume that more deep-rooted inefficiencies and misallocations could be corrected or removed with less stringent stabilization, less widespread liberalization, or less comprehensive structural reform than in Eastern Europe. If anything, the payoff of the economic reforms will take longer to materialize, in view of the minimal experience of these countries with the functioning of market institutions, the creation of an appropriate legislative framework, and the implementation of market-based macroeconomic policies.

Mr. Al-Jasser made the following statement:

The projected, albeit gradual, recovery in world economic activity has once again proven to be more uneven and hesitant than initially expected. Nevertheless, there is room for cautious optimism. The protracted weakness of growth in the industrial countries suggests that negative cyclical influences and balance sheet adjustments have had time to play themselves out, thereby giving greater confidence for a recovery. Moreover, the widening of output gaps and the moderation in inflationary pressures have made possible a further easing of monetary conditions. All in all, it would appear that the scene is set for the projected modest recovery in output to take place.

However, in several respects, such a conclusion strongly resembles the global scenario presented at the most recent world economic outlook exercise, which has not fully materialized. This cautionary reminder reinforces my belief that there remains a considerable downside risk to the outlook that deserves the attention of policymakers. In particular, it is not yet clear that business and consumer confidence is about to revive in any great strength, nor can we confidently assume that the adjustment of balance sheets and restructuring is complete. Indeed, even in countries where appropriate stimulative macroeconomic measures are being taken, the restructuring activities of the private sector still impart uncertainty to economic forecasts.

The economic record in the developing countries presents a somewhat different picture. For many areas of the world, the world economic outlook exudes a refreshing air of confidence--one that I share--that real progress toward stronger sustainable growth has been achieved. Here, much credit should be given to the policy efforts of the developing countries themselves. Nevertheless, in Africa, economic and social conditions continue to be difficult and, indeed, critical in some countries--which is a timely reminder that our efforts to assist this continent must not be allowed to slacken. In the former centrally planned economies, the near-term situation remains difficult, and the medium-term outlook is colored by unusually large, although understandable, uncertainties.

The staff's short-term policy outlook for most industrial countries can be characterized as follows: the scope for further monetary policy easing is in large measure exhausted while, with the exception of Japan, the underlying fiscal situation does not allow for any significant budgetary stimulus. Accordingly, watchful patience is the order of the day, as we await the positive effects of the earlier easing of monetary policy and a cyclical reversal in private sector behavior. However, in view of the downside risks, more should be done. Here, I have in mind what the staff characterizes as impediments to a more satisfactory economic performance over the medium term, namely, large structural fiscal deficits, labor market distortions, and sizable government subsidies. Indeed, credible policies to overcome these impediments could contribute much to short-term prospects by instilling confidence and removing uncertainty in the private sector's perception of the future.

In this regard, a revitalization of the fiscal consolidation process, in particular in the United States and Germany, would contribute to lower real long-term interest rates and thereby enhance investment and output. I will not dwell on the situation in the United States, which we discussed at the Board on Monday. In Europe, the discipline imposed by the EMU timetable underscores the importance of strengthening the fiscal consolidation process in Germany. Without such a strengthening, the cost of convergence for the EC as a whole will be larger and may be associated with unhelpful tensions in the ERM, such as those experienced during the past week.

The removal of barriers to the efficient use of resources would also facilitate the process of convergence, as well as ensure that the full economic rewards of a single European market would be realized. In this regard, the 1980s provide overwhelming evidence of the need to correct existing labor market rigidities with renewed vigor. In part, this will need to be done through a restructuring of benefits, but, in view of the steady rise in the level of long-term unemployment, attention also should be given to retraining schemes. Such schemes could be financed easily by the cessation of pervasive industrial and agricultural subsidies that harm economic prospects, both within Europe and in the rest of the world. Of course, the need to reduce these wasteful subsidies applies to all industrial countries.

There is one major structural reform that could be achieved virtually overnight and at almost no cost, and that would also benefit all of the world's economies and inject a healthy dose of confidence into private sector activities. I am, of course, talking about the need to conclude the Uruguay Round. It is regrettable that we have had to return to this subject so many times in the past two years. The major industrial countries have a critical role in bringing this episode to a swift and successful conclusion, and I urge them to exercise this special and important responsibility.

This brings me to the developing world. Here, I welcome the staff's useful condensation of the experience of successfully adjusting countries. It is a heartening illustration of what can be achieved through the steadfast application of sound economic policies. This success also is evidence of the valuable contribution that this institution plays in the reform efforts of the developing countries. Of course, neither this institution nor the authorities in the developing countries should rest on their laurels. The foundation for sustained growth in those countries that have successfully adjusted must be preserved and built upon. A striking element in the improved performance of successful adjustors is the way in which countries, such as those in Asia and Latin America, have benefited from partner countries' efforts to liberalize their own domestic economies and trade regimes through a sizable growth in regional trade. This is a timely reminder of the power of trade liberalization when undertaken on a global basis.

While the number of successful adjustors has increased, there are still a significant number of developing countries where much remains to be done. The need for sound policies in these countries remains critical, but we must also look closely at how their domestic efforts might be supported more effectively. Needless to say, conclusion of the Uruguay Round would provide an important impetus to these economies. In addition, we must continue to explore ways in which the catalytic role of the Fund can be enhanced through both its surveillance and program activities. Specifically, can the Fund play a more effective role in reviving developing countries' access to commercial bank credit and capital markets? In addition, it is imperative that the flow of official development assistance to low-income countries, which have few alternative sources of external financial support, be sustained and strengthened to support their development efforts. For these countries, we shall need to consider carefully the catalytic, and more general, role of the Fund after the completion of the arrangements under the enhanced structural adjustment facility (ESAF).

Turning to developments in the former centrally planned economies, the strong interdependence between stabilization and structural policies has become increasingly evident. The conclusion to be drawn from this interdependence is that both sets of policies should be given priority from the very outset of the transformation process. However, few of these economies have the capacity to address the full range of policy issues that deserve attention. In these circumstances, policymakers and the Fund must strive to identify the highest priority areas, especially with respect to structural reforms. Also, more speedy reform mechanisms must be developed, so that as much progress as possible can be made with the financial, human, and institutional resources at hand. In this way, the painful costs of transformation, which, through their potentially intolerable social consequences, may place the restructuring process at risk, can be offset by some early gains. Moreover, the importance of developing new institutions and entrepreneurial skills underscores the need for external technical assistance, which all the major international organizations must strive to meet. However, I would be remiss if I did not add that such needs are present throughout the developing world.

I would like to offer some possibly provocative and--it is to be hoped--constructive remarks on Fund surveillance. In reading the world economic outlook documents, I was struck by the rather different direction in which the industrial and developing economies moved in the latter part of the 1980s. In collaboration with the Fund, many developing countries turned a corner toward a future that promises greater productivity and prosperity. By contrast, while the industrial countries were enjoying strong growth, the seeds for the present protracted recession were being unwittingly sown. In retrospect, it appears that the easing of monetary conditions, which began after the Plaza Accord and continued in the wake of the 1987 stock market crash, went too far. As noted on page 29 of the staff paper, "monetary policy inadvertently permitted an overly rapid expansion of credit in some countries." In part, this reflected a perhaps understandable lack of appreciation of the consequences of financial deregulation, as well as inadequate attention to asset prices and the structure of balance sheets. The cost of these "mistakes" has been a more prolonged recession and a weakened ability of monetary policy to revive economic activity. On the fiscal stage, the story is well known: an inadequate adjustment of large structural deficits has acted as a drag on growth prospects and severely limited the ability of policymakers to respond to conjunctural developments.

These issues beg the question: Where was the Fund? That is perhaps an unfair question as it is asked with the benefit of hindsight; nevertheless, I believe that the developments that I have described should prompt us to reconsider the effectiveness of Fund surveillance, which depends greatly on how we conduct our business in the Board and the credence given to it by our national authorities. Here, I have three remarks. First, the Fund has consistently and correctly called for fiscal consolidation to sustainable levels. Second, on monetary policy, the Fund, like national policymakers, did not appreciate at an early enough stage the interaction of financial deregulation and monetary policy and did not give sufficient weight to asset market developments. For that reason, I welcome the staff's suggestion that price movements over a broad range of assets now be followed with greater scrutiny. This has implications for the coverage and analysis provided in our annual capital markets paper. Third, as we haul ourselves out of recession, we should not simply breathe a sigh of relief. Instead, in recognition of the global challenges that lie ahead, we should endeavor to make our surveillance role more effective and credible.

Finally, I warmly welcome the forthcoming formal publication of the Arabic edition of the World Economic Outlook, which not only will promote a better understanding of the Fund's policy advice in the Arab and Islamic worlds, but also will provide a significant contribution to economic analysis and policymaking in the region.

Mr. Dawson made the following statement:

My Government traditionally has placed a great deal of importance on the World Economic Outlook. It is the central document in the Fund's global surveillance effort. It is the principal reference book for discussions of economic policy that we routinely have with other major industrialized countries. We look to the World Economic Outlook for professional, independent, and disinterested analysis of economic trends and economic policies. Unfortunately, we are reluctantly coming to the view that the usefulness of the World Economic Outlook has deteriorated over the past few years. Forecasts have been wide of the mark, consistently overestimating growth and underestimating progress against inflation. The industrial countries are going through a major economic slowdown that the staff has been reluctant to recognize and--even after the fact--has inadequately analyzed. Reiteration of the verities of medium-term fiscal and monetary orthodoxy has been substituted for a balanced and judicious assessment of both trends and policy. By and large, policy advice is limited to "stand pat" or "squeeze harder."

This latest World Economic Outlook does nothing to enhance our confidence in its usefulness. In our view, growth prospects in the industrialized countries are again being overestimated, unemployment problems ignored, inflation risks exaggerated, and policy rigidity encouraged.

For the G-7 countries, we believe that the growth forecasts prepared for us remain overly optimistic. The new revisions discussed this morning only confirm our impression that the staff has been slow to recognize the underlying trends.

Right at the start, the staff analysis seems to go astray. The first sentence of the summary on page 1 of the staff paper states that "world economic activity showed signs of revival in the first half of 1992 as some major economies began to emerge from the cyclical slowdowns of 1990-91." In fact, the only thing that the first half statistics really showed was the effect of the Gregorian calendar. An extra day for leap year and a late Easter put a bulge in the first quarter numbers for several countries, part of which was clawed back in the second quarter of the year. I also note in passing a report out of Germany indicating that the warm winter also had an effect in the first half of the year; perhaps, therefore, we should add global warming to the list of causes. Accumulating evidence makes it pretty clear that there is little vitality in countries that seemed to be improving earlier in the year. Others are being caught in the undertow of weak activity in the major countries.

As the U.S. economy was thoroughly reviewed during the Board discussion on Monday, I would only note that today's downward revision of 1993 growth forecasts to 3.1 percent brings staff estimates into line with the mainstream estimates that have been prevalent in the United States for several months.

Our neighbor to the north, Canada, is finally poised for some strong growth in 1993 after its long slump. We are not quite as bullish as the staff, which now expects growth next year to reach 4.4 percent. We think that the result is more likely to be in the upper end of the 3 percent range. Even this, however, is likely to produce a hat trick for Canada in the G-7 competition: highest growth, lowest inflation, and highest unemployment.

Growth in Japan next year is projected to be 3.5 percent. This may turn out to be accurate. But if it does, it will only be because the Japanese authorities have had the good sense to disregard staff and Board policy advice and adopt forceful fiscal measures to support wilting economic activity. In the staff's analysis, however, we were asked to believe that Japanese growth in 1993 would have snapped back to 3.5 percent on the basis of anticipated policies and a projected upturn in business investment. As we indicated at the most recent Article IV consultation discussion on Japan--and, indeed, as we had indicated during the previous year's discussion (EBM/91/93 and 91/94, 7/17/91)--an expectation that Japanese growth would continue to be led by business investment was implausible on its face. The bulge in the share of investment in GDP was already large enough to cause suspicion that a further expansion in the investment share was unlikely. Over and above this, the rising costs of capital and excess capacity were increasingly evident. We were not surprised that investment went flat in 1992 and, prior to the past week's announcements, had little confidence in the upturn projected for 1993.

Given the pattern of activity, the swelling of the Japanese current account that has taken place was to be expected, although the actual magnitude has only slowly been incorporated into the staff's projections. We believe that the $100 billion estimate for this year, which itself represents an upward revision of $10 billion in the few weeks since the completion of the 1992 Article IV consultation, is still too low; we would note that, according to the background material on exchange rate developments circulated earlier, the surplus could run to about $114 billion in 1992. There is going to have to be a substantial downward adjustment in the second half of this year. We believe, however, that there will be a further increase in the current account surplus for Japan rather than the small decline anticipated by the staff.

In our view, neither Japan nor the Fund membership has been well served by recent staff and Board analyses of the Japanese economy. The authorities faced a delicate task in trying to unwind the distortions of the bubble economy without damaging its underlying dynamism, but unfolding developments indicate that the Japanese authorities overstayed their earlier monetary squeeze. Fund endorsement of fiscal inflexibility over the past two years seemed to us like bad policy advice, as we indicated on several occasions. An earlier and more forthright recognition by the staff and the Board of the deteriorating economic prospects could reasonably have been expected. In any event, we are pleased that the Japanese authorities have now taken the bull by the horns and adopted decisive policy actions that hold out the prospect for stronger and better-balanced economic activity in a noninflationary environment.

The staff says that the reasons for the EC's lackluster growth and high unemployment rates are complex. We are not sure that the reasons are all that complex, although we do agree that the details would be a lot clearer if the Board had had the benefit of a timely completion of an Article IV consultation with Germany. ERM-linked policies have been austere for some time and have grown more so recently, as European countries try to outdo each other in their commitment to anchored exchange rates and unchanged price levels.

Unemployment is treated more or less as a policy stepchild, a problem that apparently is expected to solve itself whenever the elusive goal of policy credibility is achieved. That solution is not expected soon. In July 1992, EC Commissioner Papandreou, on releasing the Commission's annual labor report--which projects an average EC unemployment rate of 9.7 percent in 1993--commented that high unemployment levels could become the central problem for EC countries in the late 1990s. Some might view that it already is.

As for more immediate prospects, the Bank of England put it quite succinctly in its latest Bulletin: "The outlook for Europe for the rest of this year is still fairly bleak." In its original draft of the World Economic Outlook, the staff was not expecting much in the way of European growth this year--1 1/2 percent--or next--2 1/2 percent. From the update provided this morning by the Economic Counsellor, it would appear that even these weak numbers will need to be scaled back because of downward revisions in the forecast for Germany and the United Kingdom.

Germany is the acknowledged pivot point for European economic prospects. Unfortunately, without a recent Article IV consultation discussion, we are left without much structured analysis of what is actually going on in Germany. The scattered comments in the world economic outlook documents are not always consistent and are occasionally inexplicable.

The original documentation showed German growth coming in at a 1.9 percent rate in 1992, followed by a 2.8 percent growth rate in 1993. Some of this has been lost in the latest revisions, which bring the forecasts more in line with the increasingly pessimistic estimates now emerging from Germany. We expect that the update is more correct, even if it is inconsistent with the narrative on page 4 and on page 13 of the staff paper, which cited evidence of firming activity and expectations of continuing strong domestic demand.

Inflation suppression is the avowed aim of the tough monetary policy that the Bundesbank has implemented, but the world economic outlook papers do not provide much insight into any progress that Germany might be making. The consumer price index projections reported in Table A9 of the statistical appendix--5 percent for 1992 and 4.4 percent for 1993--seem high in light of recent reports that the year-on-year inflation in west Germany has recently dropped to 3.4 percent. Without a current Article IV consultation, we are left adrift in trying to puzzle out both the inflation trend and the appropriateness of the current German monetary stance.

In fact, had we had a German Article IV consultation discussion, there are a number of questions that we would have liked to have asked. What, for example, is going on with German growth? Press reports now give us about a dozen versions of what German growth is--depending on whether it refers to west Germany, east Germany, all of Germany, GDP or GNP, seasonally adjusted, or unadjusted. Just this morning, it was reported that, for west Germany, GDP grew by a seasonally adjusted 2 percent in the first quarter, up 3.1 percent from the same period in 1991. GNP for the same period for west Germany was up 2 percent, seasonally adjusted, but up only 1.8 percent from the same period a year earlier. Growth apparently was either accelerating or decelerating in the first quarter.

However, economic commentators say that, if proper account were taken of an unseasonably mild winter, real first quarter growth was probably flat in 1992. Presumably, the Gregorian calendar compounded the first quarter measurement problems. Now, for the second quarter, the press is saying that statistics for west Germany that are to be released soon will show that the year-on-year change for GNP was flat, but that GDP growth was 0.4 percent higher.

So much for one part of the country. Separate GNP/GDP figures for east Germany will come out only in September 1992. All-German GNP/GDP data are not expected to be released until 1995. Meanwhile, how are we expected to reconcile these GNP/GDP differences for the two halves of the united Germany? Presumably, the net factor income difference that accounts for the difference between GNP and GDP reflects a lot of intra-Germany transactions that will drop out when the numbers are consolidated; however, the proliferation of numbers seems to be producing more riddles than answers.

Also, we would have asked, "What is inflation really doing?" The latest inflation figure for west Germany shows a year-over-year increase in the consumer price index of 3.4 percent. When all-German numbers are reported, however, the numbers always seem to be a full percentage point higher. Now, if this pattern is true, it would seem to require that inflation in east Germany, which accounts for only 10 percent of the composite economy, adds a third to the overall inflation rate. Clearly, east German inflation is off on a separate track from that in west Germany. For a monetary union, this is an odd development that cries out for clarification. The projections for 1993 that are carried in the world economic outlook documents are about 1 percentage point higher than current levels. Presumably, planned excise tax increases account for much of this; what, however, are we to make of all this when we try to figure out German inflation trends and Germany's monetary policy?

Germany certainly has some serious economic management problems. It may or may not have its domestic policy on track. We will have to return to that subject when we finally do discuss the German Article IV consultation. Meanwhile, however, it is starkly clear that the German economy is malfunctioning, and that the spillover of German policy, as transmitted through the ERM arrangements, is damaging growth prospects throughout Europe. In the spring 1992 world economic outlook discussion, we had some debate about whether neighboring countries might be gaining more from increased sales to Germany than they were losing from imported tight money. Whatever the merits of that debate with respect to the events of 1991, it is a moot point this year, as German growth has dwindled and high interest rates have remained.

The tortured position of the U.K. economy is a particularly sad reflection of the damaging effects of importing an inappropriate monetary policy. With the downward revisions reported earlier by the Economic Counsellor, the staff has now caught up with prevailing private forecasts that 1992 will again see a drop in real GDP in the United Kingdom. Hopes for 1993 have also been scaled back.

On page 28 of the staff paper, there is just a hint that imported monetary rigor may really be a blessing in disguise for the United Kingdom since it still has some inflationary pressures that need to be crushed. This may be the politically correct viewpoint, given the sanctity of the deutsche mark peg--to say nothing of the macho requirements of "maintaining credibility"--but we doubt that it is optimal policy. Given the freedom to choose, there is no doubt whatsoever in our mind that the U.K. authorities would aim to hit the same inflation target with a less damaging monetary policy and a more disciplined fiscal policy.

France seems to be marking time in the shadow of German monetary discipline, growing slowly, but not quite fast enough to avoid a gradual increase in unemployment. French inflation sets the standard for major European countries, and its budget position is well controlled, being just slightly over 2 percent of GDP. A small growth improvement is still expected next year. Recently, however, there has been increased nervousness that France's European markets will be too weak to support such an improvement. In these circumstances, we found the cautionary commentary on French fiscal policy that appears on page 33 of the staff paper rather surrealistic. It is said there that "a further... deterioration would jeopardize the credibility of policy." In the pantheon of the Fund, the gods of "credibility" are hard to appease!

Italy is a case apart. It has major restructuring problems that are now being addressed with impressive determination by the new Amato-led Government. We wish the Italians well in this endeavor.

Elsewhere in Europe, there are few bright spots. The torpor that has radiated from Frankfurt has ensnared most of the smaller economies, as well as the larger ones. Scandinavia seems to be thoroughly tangled in its anchor line, but we will have to come back to that subject on another day. In that respect, I would add that I look forward to the return of a number of the Scandinavian countries to Article IV consultations on the standard 12-month cycle.

The bright spot in a generally dismal world economic outlook is the greatly improved performance of many developing countries. Average growth is expected to jump to about 6 percent this year and continue at that level next year. This would be far and away the best performance in over a decade. Much of this growth would appear to be self-initiated by countries that have restructured themselves and shed restrictive policies. But, as always, trade is the engine that propels prosperity forward.

A striking feature of this world economic outlook exercise is the forecast that, in 1993, world trade will grow by 7 percent in volume terms. Expanding trade on this scale would sustain strong growth in many countries. We are skeptical, however, that such strong trade projections are consistent with the sluggish recovery expected in most industrial countries. In fact, one of the more worrisome aspects of recent months has been the extent to which exporters in the major countries are scaling back their export expectations because of weakening demand in trading partner countries. Certainly, this is true here in the United States. Press reports indicate that export forecasts are also being downgraded in Germany, the United Kingdom, France, and many of the smaller countries in Europe.

Sustaining growth with open markets is the best thing that the industrialized countries can do for themselves and the best thing that they can do to ensure that the opportunities that have opened up for developing countries can be fulfilled. On current prospects, it looks like the industrialized countries are falling down on their responsibility to keep the world economy humming.

The major industrial countries are performing poorly at low levels of inflation. Adjustments need to be made, and not all of the needed adjustments will improve near-term growth and employment. In this environment, we believe that wisdom lies on the side of trying to find policies that will support better activity while minimizing the unavoidable costs of adjustment. As I have tried to make clear, we found the staff analysis long on doctrine and short on the needed pragmatism.

Identification and correction of policy lapses are essential. However, policy excesses and misapplication also need closer scrutiny. We thought that the staff might be on to something when, on page 29 of the paper, it discussed the possibility that monetary policy had inadvertently been too loose in the late 1980s. The behavior of nominal income, asset prices, and general inflation in several countries would certainly support such an interpretation. In the slippery world of financial deregulation, this is an issue that certainly needs to be examined in more depth. It also needs to be examined symmetrically. Trends in several countries suggest that, more recently, monetary policy has inadvertently been too tight for too long. There is not much doubt in our mind that the depth and persistence of the cyclical slowdown in many of the industrialized countries has been aggravated by excessive monetary tightness. The sad thing about developments in Europe is that excessively tight monetary policy is being applied with policymakers' eyes wide open, not through inadvertence.

Before closing, I would like to request that a couple of especially egregious comments about the United States be corrected in the published World Economic Outlook. On page 4 of the paper, in the last sentence of the second paragraph, it is stated, with reference to the U.S. budget deficit, that "it is a major reason for the persistent weakness of the U.S. external position, and it remains a potential source of tension in financial and foreign exchange markets." Whatever the sins attributable to the U.S. budget deficit, persistent weakness of the external position of the United States is not one of them. The past six years have seen a persistent strengthening of the U.S. external position. This point was acknowledged in Monday's Article IV consultation discussion on the United States.

On page 3 of the paper, the final sentence of the middle paragraph discusses the U.S. economy in the following terms.

> These problems, in turn, reflect the absence of meaningful progress in reducing the structural budget deficit in the United States, the heritage of relatively high inflation in North America for most of the past two decades, and the need to correct the financial imbalances that have resulted from the borrowing binges and speculative excess of the 1980s.

The tone of this comment is what we might expect to hear on the presidential campaign trail rather that in a document prepared by the staff. Tone aside, the statement about inflation is misconceived. Table 4 on page 18 of the paper recounts the inflation experience of developed countries since the 1960s. During the 1970s, the U.S. inflation rate was the second best among the industrialized countries. In the 1980s, U.S. performance was squarely in the middle of the experience of all industrialized countries. Either the characterization of U.S. inflation should be withdrawn, or it should be incorporated into the commentary on most of the other industrialized countries.

Mr. Landau noted that Mr. Dawson had referred many times to the slow growth in both Europe and France. However, that remark should be put in proper perspective. The projections for growth in France in 1992 were higher than in the United States. The impression should not be transmitted that the slow growth in Europe was policy induced. Over the past five years--during which time there had been no realignment in the EMS--the overall growth performance in Europe had been better than in the United States. In that context, a line of reasoning that attempted to establish a correlation between exchange rate policy and growth performance might not be totally valid.

Mr. Dawson said that he had not been attempting to establish an argument along those lines.

Mr. Fukui made the following statement:

> At the outset, I would like to express my appreciation to the staff for preparing these high-quality documents. I agree with the main thrust of the papers.
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> The real GDP of industrial countries is expected to pick up rather sharply, to about 3.1 percent in 1993 from 1.8 percent in 1992. It is, therefore, worthwhile to examine whether this is plausible or not. In the United States, housing construction is losing its momentum mainly because of high long-term interest rates, and personal consumption is erratic as a result of income stagnation. As for the prospects for 1993, a continuation of the large fiscal deficit will force long-term rates to remain high, and progress in restructuring the balance sheet of the corporate, financial, and household sectors will be slow. Against this background, it is likely that the recovery of the U.S. economy will be moderate in 1993.
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> In Germany, given the large fiscal deficit and the persistent inflation, the current tight monetary stance will not be eased in the near future. In addition, high interest rates in Germany are forcing the ERM countries to maintain higher interest rates, which has an adverse effect on the recovery of their economies. At the same time, the ability of the ERM countries to use fiscal stimuli is limited because of their large government deficits. Against this background, the economic recovery in EC countries is projected to be slow.
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> In this context, Japan can now provide a different touch to the picture. Measures were taken to have public works expenditures front-loaded, and the official discount rate was further reduced by 0.5 percent to 3.25 percent in July 1992. As recently as August 28, 1992, the Comprehensive Economic Measures were announced. These included an additional increase in public works expenditure of ¥ 8.6 trillion for a total of ¥ 10.7 trillion, or approximately $85 billion. These measures will strengthen substantially the confidence of the business, financial, and household sectors and have a significant impact on economic activities. In fact, stock prices responded quickly, rising by 23 percent to ¥ 18,000 on August 31, 1992. This is a more than 20 percent jump from the bottom. At the same time, it should be noted that the price of stocks showed bullish signs immediately after the announcement of the policy guidelines for financial

stability which, having been made on August 18, 1992, preceded the Comprehensive Economic Measures. These decisive and consecutive actions will be effective enough to reverse the present economic trend in Japan.

The economic recovery of North America, Europe, and Japan as a whole, however, will be slow and, therefore, some downside risk seems to exist in the staff's outlook for 1993. Consequently, timely, adequate, and viable policy measures need to be taken, similar to those taken in Japan, in order to keep the projected 3 percent growth in industrial countries in 1993 attainable. At the same time, we should keep in mind that our target is sustainable growth in the medium term; for this purpose, policies must be well coordinated among the major industrial countries.

I would like to issue a reminder that unemployment rates are continuing to rise in the United States and Europe. In particular, according to the staff's analysis, the unemployment rate in the EC will climb to over 10 percent this year. Needless to say, this will create downward pressure on personal consumption, as well as on other final demand components. I believe that this is one of the major structural problems in this area, and it is urgent to take needed measures, such as a reduction of the minimum wage, an improvement in the methods of wage determination, and the establishment of job-training systems.

As for price developments, I appreciate the fact that prices in the industrial countries have been stable, and that inflationary pressure has been calmed, reflecting the slow recovery of the economy and the stable conditions affecting energy prices and commodity markets.

As for the sluggishness of activity and the weakness of business and consumer confidence in industrial countries as a whole, I agree with the analysis contained in the staff paper. The main reasons for the sluggishness are the continuation of high long-term interest rates stemming from the large government deficits, the persistence of inflationary expectations, the delay in the restructuring of the balance sheet of the business and household sectors after the decline in asset prices, and the reluctant lending policies on the part of banks, which reflects the accumulation of nonperforming assets.

Regarding the aftereffects of the decline in assets prices, the ratio of stocks vis-à-vis total financial assets of the household sector is about 10 percent in Japan, and the land held by this sector is used mainly for residential purposes. Therefore, the soundness of the balance sheet of the household sector has not been undermined. It is intended to introduce measures to liquidate collateralized land held by the financial institutions through the Comprehensive Economic Measures mentioned earlier, and, with the positive effect of this sizable package, the balance sheets of the financial and business sectors are expected to improve in due course.

In assessing current monetary and fiscal policies, it should be noted that, in Japan and the United States, interest rates were reduced substantially in line with the slow recovery, as well as with the stagnancy of business activity. The United States has been hampered by a large government deficit, and Japan needs to continue along the basic line of fiscal consolidation. Thus, the fiscal stimulus measures that can be used are extremely limited. Moreover, inflation rates have been kept low in both countries. Taking these situations into account, the monetary policies of both countries, which have been implemented flexibly, are to be commended.

Regarding monetary policy in Europe, the German authorities, as I already mentioned, should be cautious about the effects of their tight monetary stance on the economic development of the ERM members.

As for current fiscal policy, there is no need to repeat the crucial and urgent need for the major industrial countries to take deficit reduction measures. In particular, in view of the significance of the U.S. economy, the size and persistence of the U.S. deficit is such that I fully support the analysis on page 4 of the staff paper that "the large structural deficit of the United States constitutes an impediment to growth domestically and globally. It is a major reason for the persistent weakness of the U.S. external position, and it remains a potential source of tension in financial and foreign exchange markets." In EC countries, budget consolidation is not a sweet medicine, but, if the consolidation brings about a successful ERM mechanism, we expect that it might eventually have a positive effect on the economy.

With respect to the fiscal structure of Japan, I think that it should be viewed on a central government basis. The outstanding balance of central government bonds at the end of fiscal year 1992/93 is projected to be ¥ 174 trillion. The related interest payments are equivalent to 16.8 percent of general account expenditures, which is the highest figure among the major industrial countries. Our authorities intend to pursue a course of fiscal reform and rehabilitation, with a thorough reassessment of existing policies. We do not share the view that Japan has attained a favorable result in fiscal consolidation. Regarding the medium-term projection of the fiscal position of individual countries, we believe that it is desirable to delete these figures when the World Economic Outlook is published, because, depending on the assumptions, the projections differ and are thus misleading.

We agree with the staff that one of the main reasons for the increase in asset prices in the second half of the 1980s was that, with the progress of financial liberalization, competition among financial institutions became extremely severe, and, at the same time, business and household sectors were able to obtain new funding and investment measures. Against this background, financial institutions increased credit to risky areas, and business and household sectors tended to invest in high-risk, high-return assets. The Japanese experience was more or less similar.

We believe that another important factor in the increase in asset prices in Japan was the excess liquidity that financial institutions began to provide in 1985. This liquidity was generated by the relaxation of fiscal and monetary conditions to cope with the recession caused by the severe appreciation of the yen after the Plaza Accord. Although the side effects of the excess liquidity became clear in the middle of 1987, the relaxed stance could not be changed until mid-1989 because of the suspicion that the adverse effects of Black Monday would dampen the economy.

The lesson to be drawn from these experiences of the effect of financial liberalization is the necessity of strengthening bank supervision and increasing the capital of financial institutions. These experiences also teach us of the need to work out an effective method to use asset prices as one of the indicators to judge economic developments and formulate policy.

As I have already stated, we take the strong position that most of the industrial countries definitely need to reduce their fiscal deficits, and that this effort will contribute to sustainable medium-term growth. Delays will result in higher costs in the long run.

On the revenue side, the urgency of raising taxes or introducing new taxes needs to be generally acknowledged; at the same time, due consideration needs to be paid to domestic business conditions so as not to provoke any unduly adverse effects on economic activity--in particular, personal consumption--as a result of these tax measures.

On the expenditure side, it is crucial to take some effective measures to restrain mandatory outlays, and, at the same time, to implement a thorough streamlining of discretionary expenditures. At this juncture, priority should be given to the elimination of agricultural and industrial subsidies. A further reduction of military expenditures should also be considered. We believe that the Fund should take more initiative in the field of reducing or eliminating unproductive expenditures.

It is encouraging to note that, even though the world economic environment remains difficult, the real GDP of developing countries is expected to grow by 6 percent in 1992-93, which is much higher than during the 1980s. In particular, it is worth noting that in Asia, especially in the newly industrializing economies (NIEs) and China, economic activity continues to be robust. However, it should also be noted that economic growth varies among areas. It is a matter of regret that, in Africa, projected economic growth continues to be modest, and that per capita income is expected to be stagnant. Furthermore, as already noted, there is a downside risk in the economic environment, namely, that economic growth in industrial countries may not be so strong as expected. It is hoped, therefore, that developing countries, especially in Africa, will strengthen their adjustment efforts. The international financial community, however, needs to take into account the serious commitments made by countries undertaking adjustment.

The experience of successfully adjusting developing countries shows the importance of adjustment policies. The staff paper clearly indicates that sound economic policies have stimulated economic activities and reduced the rate of inflation in all regions. In addition, the establishment of credibility with respect to governments' adjustment policies is an important factor of success.

In light of the importance of adjustment policies in improving economic performance, it is worthwhile to analyze what successful countries have done, and to use the results as guidelines for countries about to embark on adjustment policies. In this sense, I welcome the staff's efforts in Chapter IV of the paper, which is quite useful in analyzing successfully implemented policies, such as sound financial and structural reform policies. The staff could make a further contribution in this regard by making an analysis based on regions or stages of development, or by making a case study of one successful country in particular.

Turning to the debt issue, I would underscore that the main objective of the debt strategy is for debtor countries to regain spontaneous access to financial markets and thus external viability. In this process, the importance of debtor countries' adjustment efforts cannot be overemphasized.

With respect to commercial debt, I welcome the fact that there has been progress--for example, Argentina's agreement with commercial banks. I hope that further progress will be made on commercial debt restructuring.

On official debt, it should be recognized that its reduction has a detrimental effect on new money and will cause a moral hazard to those countries that have served their debt faithfully despite a difficult balance of payments situation. With respect to low-income countries, I welcome the fact that the new Toronto scheme has already been applied to eight countries in that category. The problems of the lower-middle-income countries should be dealt with through extended rescheduling, as agreed in September 1990.

In assessing the progress of economic reforms in Eastern Europe, it seems a bit optimistic to say that the output contraction in Hungary, Czechoslovakia, and Poland may have ended. Money and credit have not been controlled effectively in these countries, and their inflation rates are projected to be in the 15-50 percent range in 1992. These difficult situations are likely to continue, particularly in Poland.

As for the countries of the former Soviet Union, the reforms have just begun and are thus in the very early stages. It is likely to take a long time for their reforms to bear fruit. In the Russian Federation, although price reform has made some progress, measures in other areas, including, inter alia, fiscal consolidation, privatization, financial reform, the introduction of a modern accounting system, and the arrangement of the ruble area, have all been delayed longer than envisaged. This gives us great concern; we would appreciate the demonstration of a firmer commitment by the Russian Federation.

The reasons for the large output contraction in the former Soviet Union and the Eastern European countries are the decline in exports due to the dissolution of the Council of Mutual Economic Assistance (CMEA), the reduction of purchasing power, which was influenced by the severe inflation, and political reasons, such as internal war and political instability.

An additional and far more critical point is that the abrupt price liberalization, the so-called "shock therapy," has not yet provoked the expected reaction from the supply side because of that sector's inefficient and monopolistic or oligopolistic production system. In other words, it is now clear to us that, although price liberation is a necessity, it alone is not enough to make the price mechanism work. It must be supported by the elimination of impediments on the supply side. Both sets of reforms must go hand in hand. In this sense, we do not want to rule out the practical importance of such measures as the application of credit rationing or concessional interest rates to small- and medium-sized businesses, or the assignation of hard currencies to the export industries. The reform effort must be supported by supplementary measures to cope with actual problems stemming from the failure of the market mechanism.

Mr. Landau made the following statement:

As evidenced by the situation in the financial markets, these are difficult and uncertain times for the world economy. The world economic outlook papers provide a clear and accurate framework for an analysis of the situation, although, of course, the formulation of policy prescriptions might be more difficult in the present environment.

As I very much agree with most of the staff paper, I will limit myself to some remarks and questions on industrial countries, Europe, the developing economies, and, finally, the former centrally planned countries of Eastern Europe and the USSR.

As concerns industrial countries, several main conclusions can be drawn from the staff paper. The present recovery is unusually weak and uneven, which is disturbing, especially with regard to the level of available capacity in most industrialized countries. As is well documented in the paper, this situation results from an unprecedented mix of low business and consumer confidence, combined with strong balance sheet constraints due to a high level of indebtedness.

This situation has two additional consequences. First, we do not know enough yet about the mechanisms through which balance sheet constraints translate into spending and investment decisions. This might account for the frequent overestimation of growth prospects in the past two years. I wonder whether econometric and modeling investigations and studies have been attempted--either within or outside this institution--to improve our knowledge in this regard.

Second, contrary to the experience of previous decades, it might be impossible to grow out of the present situation of "debt deflation" by accepting a temporary increase in inflation. The mechanism through which this worked in the past, namely, negative real interest rates imposed on owners of financial assets, no longer operates. The development and liberalization of financial markets do not allow for any monetary illusion imposed on lenders. This, in my view, is the main reason why the temptation of growing out of the present crisis through inflation should be resisted. There might be no other alternative than sustained and progressive balance sheet consolidations, both inside and outside the financial sector.

A second characteristic feature of the present situation is the difficulty experienced by policymakers in calibrating and operating monetary policy. The staff paper, as well as Annex I, presents this very clearly. Monetary aggregates cannot be relied upon as indicators and guides of monetary policy to the same extent as before. Their definition is increasingly blurred by financial deregulation and disintermediation; their evolution may be influenced by the term structure of interest rates. However, there are considerable uncertainties as to the quantitative impact of interest rates on growth and economic activity. The effect of the reduction implemented in most countries--notably, the United States--in the past two years has been overestimated. Finally, and above all, monetary policy seems to operate increasingly through wealth and portfolio effects transmitted by the evolution of financial asset prices. This poses a double challenge to policymakers. First, as stated on page 2 of Annex I, "to the extent that asset prices and their movements are not captured by consumer price...indices,...monetary authorities may have ignored important information about the short-term and medium-term effects of their policies" and thus have difficulties in calibrating their policy stance. Second, financial asset prices have been affected by speculative movements that have either contradicted or overamplified the effect of autonomous monetary policy changes.

In most industrial countries, there is not much room left for fiscal policy moves. In this regard, it is welcome that this world economic outlook exercise avoids the somehow complacent tone that characterized the previous one. Nevertheless, I tend to think that the fiscal situation in my own country has perhaps been overdramatized. There is in most industrialized countries a need for fiscal consolidation. Its contractionary impact should not be overestimated, as is sometimes done--I shall come back to this point when discussing the situation in Europe--as experience shows that financial market reactions to credible and sustained fiscal consolidation can lead to overall beneficial effects on growth, which compensate for--or even overcompensate for--the negative initial impact of fiscal contraction.

It is in this context very much welcome that the only country with significant room for maneuver, namely, Japan, has recently announced--against advice previously given by the staff--a significant package of fiscal stimulation. The financial market reaction shows that it was the right step to take. The question is: Is this not too little too late? I would certainly appreciate comments by the staff on the overall impact of the package, both for Japan--which, according to some estimates, will be less than 1 percent of GDP--and the rest of the world.

With respect to Annex III--the effects of convergence in the framework of the EMU--the staff has presented very interesting scenarios and remarks. We certainly look forward to examining them in our future seminar discussion on this topic. At this stage, I shall present four preliminary remarks. First, with respect to the baseline scenario, it basically assumes that, in the absence of the Maastricht Treaty, and even when deficits are unsustainable, no policy change would take place. Clearly, this is an unrealistic assumption: in those circumstances, a deficit reduction would have to occur whether or not the Maastricht Treaty had been implemented, as all policy actions cannot be considered as resulting from the Treaty.

Second, our experts have some difficulty with Scenario II. In this scenario of "noncredibility," interest rates stay high, but inflation nevertheless recedes significantly in high inflation countries--such as Italy--and, although markets strongly expect realignment, nothing of the sort occurs before 1996. This seems to be an unsustainable and mutually incompatible set of conditions. If inflation is reduced, market expectations should change; if not, there might be a realignment. In our view, this consideration casts some doubt on the overall significance of this scenario, which is the one that yields the most negative convergence results.

Our experts have run MULTIMOD--although perhaps not as expertly as the staff can--and they see the main deviations of the parameters as displaying strong cyclical features around a zero trend. The final judgment is, therefore, highly dependent on the period of observation, and most of the conclusions in this annex might in this regard be open to criticism.

My third remark is more of a question: How, and to what extent, has the effect of external real exchange rate changes been taken into account? Fiscal consolidation inside the EC should normally be associated with a real depreciation of European currencies vis-à-vis other currencies. I would like to make sure that this effect has been incorporated into the simulations.

Finally, in the present circumstances, it might be wiser to delete Annex III from the published World Economic Outlook. We would also wish to wait until our discussion on this topic has been concluded before making any mention of these scenarios and their conclusions--including any contractionary impact of convergence--in the main text.

With respect to developing countries, I have only two brief remarks to make about the very interesting developments reported in the staff paper. First, I tend to find the judgment on the role of wage controls a bit too negative. The staff is right to emphasize that wage controls, if not supported by very strong monetary and fiscal policies, will be powerless to reduce inflation and will only perpetuate labor market distortions. However, when a genuinely strong macroeconomic policy is in place, temporary wage controls might offer some benefits. First, they could reduce the delay involved in the adjustment of inflationary expectations to the target incorporated in the program--although this, naturally, is contingent on the credibility of the overall strategy. Second, by doing so, wage controls might minimize the loss of output associated with a stabilization program. I would note, in this regard, that they have been used and implemented with some success in most Eastern European countries. While wage controls cannot form the cornerstone of the anti-inflation strategy, they might usefully complement other measures in appropriate circumstances.

Second, the staff paper could have been clearer about the need for the appropriate sequencing of financial sector reforms in developing countries. The paper recognizes that internal reform must precede external liberalization; however, the suppression of direct credit control without the replacement of appropriate market mechanisms for determining interest rates might lead to a loss of monetary control. By the same token, liberalizing monetary policy without establishing an appropriate overall macroeconomic framework could lead to capital flight. The paper might have been clearer in that regard.

On developments in Eastern Europe, I will only say a few words as I fully concur with the thrust of the staff paper. With respect to the contraction in output, it is certainly true that the CMEA collapse played a major role. It might also be that too restrictive a demand management policy, as well as a kind of credit crunch, can explain the phenomenon. However, the core of the matter is that we do not know much about the dynamics of supply during the transition from a centrally planned to a market economy. The changes in behavior, the relation between enterprises and banks, the transformation from an ad hoc to a modern tax system, all concur to inflict major shocks to the supply system, the results of which are highly unpredictable. We should recognize this more clearly and allow for more caution and diversity in some of our policy recommendations.

In this respect, the case against gradualism that is presented in the report might be better substantiated. As regards the past, the shock therapy strategies that were implemented had, in my view, two main justifications: first, without any ambiguity, all of the governments involved wanted it; and, second, as documented in other parts of the staff paper, macroeconomic stabilization and structural reform must be implemented simultaneously if they are to succeed. However, we might gain from an analysis of the success met by countries that have adopted a more progressive or gradual approach, especially China, on the one hand, which has recorded an impressive growth performance, and Hungary, on the other, which has suffered relatively smaller output losses. For the future, some lessons might be drawn as to the appropriate pace and modalities of reform in certain areas; here, I am thinking especially of the trade sector.

Mr. Filosa made the following statement:

This world economic outlook exercise is taking place at a difficult moment. The recession that in the past two years has hit the industrial world has proved to be longer and more intense than expected, and, in those countries affected most by the downturn, no convincing signs of recovery have yet taken hold to an extent to encourage particularly optimistic expectations. Moreover, the economies of Japan and Germany, which at first appeared less disturbed by the negative cyclical phase, have also shown symptoms of fatigue, and their output growth has started to decline. The Japanese authorities, however, have passed a fiscal package to counteract the slowdown, and we support this initiative. At this time, however, the situation is being complicated even further by the pronounced and persistent volatility spanning the exchange markets.

Despite widespread uncertainties, however, the world economic outlook papers indicate that the world-leading economies are now about to approach the end of the tunnel, and that the next 12 months will likely witness a progressive resumption of activity and a shrinking of cyclical differences. Although Mr. Dawson has provided us with an impressive set of indicators that illustrates the still existing divergent cyclical positions of the major industrial countries, it is difficult to challenge the world economic outlook projections with comparable forecasts for the world economy, primarily because we trust that the world economic outlook simulations internalize all the best information available for forecast uses. However, one cannot fail to recognize that, in the recent past, the expectations of economic revival in the industrialized countries, claimed both within and outside of our institution, have consistently been baffled by subsequent events. Today, the economic agents' uncertainty as to the future course of economic policy in major countries would appear not to grant us enough reasons for optimism. Thus, for policymaking purposes, we should at this point regard projections--including even the revisions that the Economic Counsellor has provided--with rather great caution.

Besides, enough evidence has accumulated during the course of the recession--and from the ways that countries have reacted to it--to discourage policymakers from pursuing policy choices exclusively on the basis of short-term preoccupations while overlooking the much more important need to address the fundamental weaknesses of their economies within a longer-term perspective.

Thus, even if correct, the expectations of more favorable cyclical developments over the next few months, such as those contained in the world economic outlook papers, should not obscure the need for the authorities of the major industrial economies to work together, firmly keeping in mind that, in the given circumstances and within the scope of their actions, there is no substitute for the enactment of strong domestic medium-term policies, unequivocally aimed at restoring financial equilibrium within a specific time frame, and at designing a better-balanced domestic policy mix, with a view to avoiding the overburdening of monetary policy that is now being experienced in the majority of the large industrial countries.

At the same time--but for the very same reason--the consideration of downside risks to the world economic outlook projections should not induce policymakers to resort to short-term measures to revive the economy. These would only compound the existing financial imbalances because, in a number of large industrial countries, the major impediments to a stronger cyclical rebound are structural in nature, including, inter alia, the unaccomplished balance sheet adjustments in the financial and nonfinancial sectors of the economy--especially in the United States--the large fiscal deficits, the financial fragility in Japan, and the continued weak levels of business and consumer confidence. The delay in concluding the Uruguay Round is also one of the major reasons why the investment and consumption decisions of the private sector have been discouraging.

Furthermore, if the turbulence currently upsetting the foreign exchange markets can be of any use to policymakers, it should be taken as pointing to the apparent divergence between the policy stance of the major countries, as epitomized by the wide short-term interest rate differentials between Europe and the United States, and to the markets' concern about the structural financial imbalances still unaddressed in major countries, in particular, Italy and the United States. As it happens, the aim of generating conditions for a medium-term, sustainable, noninflationary growth in the industrial countries is consistent with the urgent need to regain calm in the foreign exchange markets. Moreover, if the policymakers in the countries concerned credibly show their determination in addressing the fundamental domestic financial imbalances, market confidence can soon be restored and speculative attacks avoided.

Thus, it seems to me that one priority objective is to create expectations of stabilizing the U.S. dollar and, ultimately, of reversing its course. This would require the U.S. authorities to pursue financial stability through the reduction of the excessive fiscal deficit, and to prevent a further easing of their monetary policy. At the same time, expectations of currency stabilization would be more easily created if monetary conditions were to be relaxed in Europe as well. For this to be possible, however, additional steps would necessarily have to be taken in Germany to reduce the public deficit. In both countries, taking a tighter fiscal attitude would amount to freeing monetary policy from the extra burden that the inadequate fiscal stance has so far imposed upon it. In that respect, I agree with the list of actions proposed by the Economic Counsellor, in particular, his suggestion that the authorities of the major industrial countries should not feel compelled to take initiatives leading to a further widening of interest rate differentials.

The urgent need to reaffirm the objectives set forth in the medium-term strategy led me to consider the analysis presented by the staff in assessing the macroeconomic effects of the measures aimed at achieving the required convergence criteria set forth in the new European Economic Community (EEC) Treaty. The results of the simulations are highly questionable on technical grounds; more important, they would be potentially damaging if published at the very moment in which far-reaching economic and political decisions are about to be taken in Europe. My authorities, therefore, have requested me to ask that Annex III be discarded from the World Economic Outlook to be published. It was expected that the conclusions of these simulations were to be discussed; it was also expected that the discussion would take place in the form of a seminar; however, the discussion has not yet taken place. Therefore, I was surprised and disappointed to see that such a sensitive issue would be included in the World Economic Outlook without prior Board examination.

I would elaborate on the reason for my request by noting, first, that, in the baseline scenario, a nonconverging path of the European economies is envisaged for the 1993-96 period, in particular, Italy's, which in many respects is unrealistic and misleading. According to this scenario, with no adjustment taken to counteract the underlying fiscal deficit, Italy would experience over the next five years a path of satisfactory growth, at an annual rate of 2.5 percent per year. However, the public deficit would reach 12 percent of GDP in 1996; the inflation rate would be 5 percent; and the exchange rate and the interest rate differentials would remain stable.

Such a baseline scenario, which is not consistent with recent developments in the financial and exchange markets, invalidates most of the forecast results. As the staff emphasizes on page 41 of the main document, if strong fiscal action is not undertaken, it is highly unlikely that growth could be maintained at a satisfactory pace, as markets would likely request growing interest rate differentials. Therefore, because of the resulting overestimation of real GDP growth assumed in the baseline scenario, the convergence scenarios show strong recessionary effects. This, incidentally, is true not only for Italy.

In addition, it is assumed exogenously in Scenario 2 that fiscal and inflation convergence will not be necessarily accompanied by interest rate convergence because the loss of competitiveness occurring prior to the adjustment would create expectations in the market of a "final realignment." As a consequence of the exogenously assumed failure to comply with the interest rate criterion of convergence, Italy--and other EEC countries as well--would be excluded from Stage Three of the EMU.

As I indicated, these assumptions seem to be inconsistent with market behavior. In fact, in Scenario 2, markets are assumed to stubbornly refuse to acknowledge throughout the entire five-year period that, in determining interest rates, financial imbalances, both domestic and external, are being reduced steadily, and that gains in competitiveness are progressively emerging. The exercise, therefore, lends support to and validates the exclusion from Stage Three of the EMU of Italy on the basis of assumptions that are not only extremely unlikely, but would also be extremely damaging if they were to be incorporated into market expectations.

There are other weaknesses in the simulations of a more technical nature. It is doubtful that, as indicated in the baseline scenario, the debt/GDP ratio would be equal to only 115 percent in 1996 in Italy if the fiscal stance were not corrected. More realistically, this ratio would reach at least 125 percent of GDP, thus making it even more difficult to believe that the interest rate differentials and exchange rates would remain constant.

The simulations also show that the crowding-in effects on consumption and investment that the fiscal adjustment could induce by improving expectations are rather modest. It is useful to call to mind that, during the 1980s, the exceptional fiscal adjustment of Denmark and Ireland was accompanied by a rate of growth of about 4 percent. In addition, one has to note that countries having already achieved full nominal convergence, like France, have little or nothing to gain in the process.

Lastly, there is little justification for the assumed need of a final realignment in the case of Italy. In fact, if a correct indicator of the real exchange rate is used in place of labor costs, namely, prices of tradable goods, the cumulative deterioration of competitiveness vis-à-vis EEC countries since 1987 would be seen to have been minor, being equal to 2 percent at the end of July 1992. The reduction of inflation, if fiscal convergence and appropriate income policies are undertaken, will tend in the near future to absorb the limited deterioration that now exists.

From these remarks of a technical nature follow considerations of political relevance. The entire exercise lends strong support to the conclusion that not attaining nominal convergence through fiscal consolidation is a superior strategy to the alternative option of complying with the Maastricht criteria. I am firmly convinced that our World Economic Outlook should not give this damaging message. For this reason, I believe that the request of my Italian authorities not to publish Annex III is fully justified.

The elimination of Annex III will also require appropriate and consistent modifications of the text of the main document. In particular, on pages 39-41, in the discussion on fiscal policy and convergence in the EC, the singling out of Italy should be avoided by deleting the relevant part of the first full paragraph on page 41. I am also inclined to believe that significant redrafting of the second full paragraph on page 41 is necessary, in particular, to dispel doubts that, despite fiscal adjustment, the narrowing of interest rate differentials may not occur. I would be grateful, given the sensitivity of the issue, if the staff could consult with me and other interested Directors on the proposed final version of the text.

Precisely to ensure fiscal sustainability and restore confidence in the financial and exchange rate markets, the Italian government has introduced a fiscal package to prevent the deficit from continuing to rise in 1992. Subsequently, it adopted a 1993-95 fiscal plan that provides for a reduction of the deficit to 5 percent by 1995. The Government has achieved the objective of discontinuing the indexation of wages in the private and public sectors. It is estimated that inflation will be reduced to 2 percent by 1995, and it is the explicit intention of the Italian government to carry out this program regardless of the circumstances--including both domestic and international--that will prevail in the foreseeable future. Both actions are intended to validate the exchange rate policy that has consistently been followed in the past decade, which remains the central pillar of Italy's economic policy. In that context, I am encouraged by Mr. Dawson's full endorsement of Mr. Amato's initiative to reverse past fiscal policy and wage behavior.

Much more encouraging news comes from the developing countries, in which the recent economic performance, as well as the short- and medium-term outlook, sounds a promising note and reveals some crucial lessons. In this connection, I would like to emphasize the interest with which I read the well-drafted chapter devoted to the experience of successfully adjusting developing countries. This chapter--Chapter IV--offers a very insightful and comprehensive review of the major factors underlying the success of the adjustment strategy in a significant number of countries. Also, it may well serve as an important reference study for those countries that have so far been unable to undertake the necessary adjustments. Indeed, I would take this opportunity to ask the staff to persevere in this kind of investigation and, perhaps, to include in one of the next world economic outlook papers a study of those developing countries that have been adjusting less successfully, for the purpose of identifying the reasons that have impeded or interrupted adjustment.

Without pretense of being exhaustive in my comments on this section of the world economic outlook documents, which would certainly deserve much more specific and in-depth consideration, I would briefly note some important lessons that can be drawn from them. Essentially, the analysis shows that there are four crucial ingredients for a successful adjustment strategy. First, the national authorities must make a credible commitment to implement policies aimed at reasserting control over the financial variables. Second, domestic prices must be set correctly through market-oriented reforms, as a way to achieve a correct allocation of resources, which, in turn, will lead to appropriate investment. Third, institutional reforms aimed at making the domestic tax structure equitable and effective, and at rendering the national monetary authority independent from political pressure, should be undertaken. Finally, support from the international financial community in the form of concessional assistance or debt relief measures is needed. I would add to these four a fifth ingredient identifiable in the supportive and monitoring role played by the Bretton Woods institutions in helping the countries concerned to put the first four ingredients together coherently, as well as in assisting their governments to sustain the adjustment efforts for the period necessary, and in supervising their progress in policy implementation.

The positive results attained by the countries assessed in Chapter IV are proof of the validity of the strategy that they have pursued. These results also serve as a reassurance to the Fund of the merits of its conditional lending for adjustment-cum-growth programs and point to the general success of the debt strategy promoted by creditor countries. Certainly, we should not use these results for indulging in self-complacent exercises; however, we should be constantly working to refine where feasible and improve where necessary the instruments used by all parties concerned in the adjustment program. To this purpose, the study that I have requested on the causes of adjustment failures should, to the extent possible, include an assessment of the role and responsibilities of the multilateral financial institutions and the donor community.

The process of transition to a market economy in the Central and Eastern European countries has endured despite the fact that the costs of macroeconomic stabilization have turned out to be higher than expected. These high costs have cast some doubts on the appropriateness of the strategy adopted so far by the Fund in

Eastern Europe, and on the desirability of applying it to the states of the former U.S.S.R. I do not share these doubts. Without entering into the debate on gradualism versus the "big bang" approach, as my views are well known to the Board, I will state simply that a gradualist approach might have had the benefit of phasing the output losses--at the cost, however, of prolonging resource misallocations, goods shortages, and hidden or explicit inflationary pressures. Eventually, gradualism would jeopardize reforms. Furthermore, the first signs of economic recovery are now visible precisely in those countries in which the governments have decided to cut rather than untie the Gordian knot that bound their economies. Therefore, I certainly agree with Mr. Prader that "it could be a dangerous illusion" to believe that more critical situations, like those characterizing the states of the former Soviet Union, could be addressed with less stringent and less pervasive policies. I would also add that it remains crucial for the countries that have already embarked on the reform process to maintain stable macroeconomic conditions.

What the experience gathered so far has shown us is the crucial link between macroeconomic stabilization and structural reforms. These two elements are clearly interdependent, and neither can succeed without the other. In fact, the impact of appropriate macroeconomic policies--appropriate, that is, for market economy standards--may give rise to perverse results if the economic fabric is not adequately receptive. For instance, in almost all the relevant countries, the combination of tight monetary conditions, which are necessary to curb inflationary pressures, and weak financial discipline in enterprises has led to the problem of a rapid buildup of interenterprise payments arrears, which, in conjunction with the already existing problem of bad loans, has made financial institutions more fragile. Where to put the blame? Were monetary conditions too tight, or were the incentives for the enterprises to become profitable too weak? Even though such an issue deserves further analysis--and the seminar scheduled for next week on the programs in Eastern Europe and the reform strategy in the former U.S.S.R. may be the occasion to discuss such dilemmas--I would support the second key of interpretation. I think that softer credit conditions would have had the effect only of perpetuating under different forms the pervasive subsidization of unprofitable economic activities, and of increasing the risk of exacerbating inflationary pressures and the gravity of the problem of bad loans.

If, on the one hand, I do not think that there is sufficient evidence to support the hypothesis of a too tight domestic monetary condition, on the other hand, I believe that the external financing constraint has been too severe for these economies. This has forced many of them to compress imports in order to maintain external viability, resulting in only modest increases in their stocks of international reserves, but with significant adverse consequences for economic activity. Therefore, I would like to reiterate my support for a mechanism of allocation and redistribution of SDRs that would have beneficial effects for the world economy.

The Chairman said that he could support the suggestions made by Mr. Landau and Mr. Filosa to exclude from the published version of the World Economic Outlook the section on the macroeconomic effects of convergence. The Board seminar on policy issues and implications for Fund surveillance of the EMU in Europe, which would have provided an excellent forum to discuss the ideas contained in Annex III, and which had originally been scheduled for discussion on July 28, 1992, had been postponed until after the Annual Meeting. After the seminar, the Board could decide whether and in what form to publish Annex III.

Mr. Abbott commented that, although he could sympathize with Directors' requests to delete Annex III from the published World Economic Outlook, it should be remembered that a similar situation had arisen earlier in the week in connection with the staff paper prepared for the Board's Article IV consultation discussion on the United States. On that occasion, his chair had asked that references to unfavorable side effects of certain policy options should be deleted because they might discourage the U.S. authorities from taking the actions needed to improve their fiscal position.

With respect to the results of the simulations in Annex III, Mr. Abbott remarked, the adverse side effects--which would probably have only a marginal impact--did not lessen the need to make the fiscal corrections. The authorities could easily neutralize those side effects by taking appropriate compensatory actions. In those circumstances, it was somewhat disturbing to consider that the Board seemed to prefer to proceed on faith rather than accept the evidence contained in Annex III, which was based on well-established economic propositions.

The Chairman said that, in the upcoming seminar on the EMU, the considerations and requests of the concerned member countries would be dealt with according to the same principles that had been applied during the U.S. Article IV consultation discussion.

Mr. Filosa noted that there was a big difference between the audiences of the two publications referred to by Mr. Abbott. The annexes to the World Economic Outlook would be distributed to the general public while the staff paper for the U.S. Article IV consultation was for internal Fund use only.

Mr. Peretz made the following statement:

I thought that this was a very good and thought-provoking world economic outlook document. I do not think that it is thought provoking only because we live in interesting times, although that is part of the story, but also because of the skill of those responsible for preparing the document. I will try in one way or another to answer the questions set out on page 9 of the staff paper, which seem to me to set a good agenda for discussion.

It has been a theme for over a year now in these discussions that recovery in the industrial countries is taking longer than expected, just as the previous period of rapid growth lasted longer than expected. I agree with the overall assessment that the recovery in industrial countries over the next 18 months is likely to continue to be slow. The staff paper acknowledges that most of the risks to the forecast are downside risks. My own judgment, like that of many previous speakers, is that the balance of short-term risks is such that a central-case forecast would be more pessimistic than that contained in the document, and probably even more pessimistic than the revisions that the Economic Counsellor gave earlier. I do not think that overoptimism in Fund forecasts is of much help to policymakers, and--in this respect, at least--I agree with Mr. Dawson. Recent data show that activity is slowing rapidly in Japan and Germany. High real interest rates and low consumer confidence in Germany, and falling asset prices and continued stock adjustment in Japan may postpone recovery in these countries until 1993--even allowing for the measures recently announced in Japan. Meanwhile, the recovery in the United States remains slow.

As to the outlook for inflation, it is interesting that, despite the much slower than expected recovery and the persistence of a large negative output gap in most industrialized countries, the staff is not forecasting any significant further fall in inflation. On the one hand, one can take comfort from the fact that industrialized countries' inflation levels are now approaching levels last seen in the late 1960s. On the other hand, while I think that the forecast is probably a reasonable and realistic one, I think that it is disappointing that further progress cannot be made at this stage. This certainly suggests that we cannot yet regard the battle for price stability as a battle that has been won.

As to the reasons for this very slow recovery, and the policy lessons to be learned from the experience of the 1980s, I would say that the analysis in the world economic outlook document is broadly right: the loosening of monetary policy in many countries in the wake of the 1987 stock market crash was not reversed quickly enough. Or to put the point another way, not enough account was taken in setting monetary policy of the prolonged boom in asset and property prices that both preceded and, in many countries, followed the 1987 collapse. Perhaps partly as a result of the financial liberalization, the boom of the late 1980s was strengthened and lengthened as individuals and companies took advantage of new borrowing opportunities. Confidence, in a sense, was too high. A quicker tightening of monetary policy would have been the appropriate policy response.

Now, we are faced with the consequences of this history. Confidence is low. In many countries, asset prices are falling. Individuals and business are very naturally seeking to reduce the debts that they incurred in the late 1980s. This is leading to a longer than normal period of slow growth.

I would draw several lessons for policymaking. First, confidence is immensely important. One thing that we could well do without in this respect is serious exchange market turbulence. I have little to add here to what the Economic Counsellor had to say, except to stress that, in the current circumstances, what is said by policymakers--which can have a very big impact on expectations--is just as important as what is done. As to what could be done positively to build confidence, not only in exchange markets but also more generally, one important step, as several previous speakers have emphasized, would be to reach an early and successful conclusion to the Uruguay Round. It is difficult to overstate how important this achievement would be.

Second, the lesson of the 1980s is that setting monetary policy correctly is an art, not a science. It is important to take proper account of a wide range of indicators in deciding the appropriate level of short-term interest rates. Here, I agree very much with the staff's view that monetary aggregates may be unreliable indicators at present in the United States, Japan, and Germany. In Germany, the inverted yield curve is making the M3 assets attractive and leading to an unusually fast rate of growth of broad money. This point, which I made at our most recent informal discussion on exchange market developments, is well borne out by the analysis in the paper. Accordingly, I agree with Mr. Landau's comments on this subject. Indeed, I would question the staff's apparently firm judgment that inflationary pressures in Germany remain sufficiently strong to warrant the present exceptionally high level of real interest rates. In Germany, the recent falls in consumer and producer price inflation rates, the strength of the deutsche mark, and weakening activity--and, indeed, the weak activity and declining inflation rates in many other closely linked European economies--all argue otherwise.

Third, medium-term fiscal consolidation is more important than ever in those countries where it is needed. In Italy and the United States, and to some degree also in Germany, it is a key to improved confidence and lower long-term interest rates. As we discussed the United States at some length on Monday, I would merely like to add the following quotation:

> It is almost universally agreed that the federal deficit should be reduced. But our political system has demonstrated a consistent bias towards short-term political convenience. ...We are borrowing from the future--not in order to invest, but to pay for the consumption of the present....The interests of future generation are not being adequately protected by the representatives of current voters....The public itself is now clearly fed up.

That quotation was from a statement on May 6, 1992 by Mr. Richard Darman, the Budget Director of the United States. Like Mr. Fukui and other speakers, I agree with the staff that the persistence of the U.S. deficit is a factor, both actual and potential, that is affecting the value of the U.S. dollar.

Of course, action to improve the structural functioning of our economies remains the key to improving the underlying rate of growth. In Europe, high unemployment levels reflect to a large degree the poor functioning of European labor markets. In that respect, the comparisons that have been made between Europe and the United States largely reflect the difference between a well-functioning labor market in the United States and poorly functioning labor markets throughout most of Europe. In the United Kingdom, it is disappointing that earnings growth did not slow faster than it did; this has certainly contributed to a sharper rise in unemployment than was expected. Throughout Europe, the process of convergence under the EMU and the ERM discipline is increasing the need for flexibility in domestic prices and costs. The United Kingdom has consistently opposed EC proposals that would have the reverse result in labor markets, and I hope that our partners will join us on this point.

Turning briefly to the staff's forecast for the United Kingdom, I agree with its assessment that the strengthening of balance sheets and the sharp fall in inflation have laid the basis for recovery starting in the second half of 1992. Further falls in the U. K. inflation rate can be expected, and downward pressure on inflation will be sustained as economic activity recovers.

The only major difference that I have with the staff, as I said at the time of the most recent Article IV discussion on the United Kingdom (EBM/92/23 and 92/24, 2/26/92), is that my authorities do not accept that there has been an expansionary fiscal impulse in the United Kingdom other than through the effects of automatic stabilizers. I will not dwell on this point now but will send a separate note to the staff about it. In any event, the staff paper confirms that the United Kingdom is expected to satisfy the Maastricht fiscal criteria without major changes in its underlying fiscal policy.

As for Mr. Dawson's comments on the United Kingdom, I have very little to say other than that I disagree with them on almost every count. A country like the United Kingdom cannot simply ignore the level of its exchange rate vis-à-vis its major trading partners, whether it is participating in the ERM or not. If the United Kingdom were not a member of the ERM, or if it were to leave that mechanism or devalue the pound, short- and long-term interest rates would have to be higher, not lower. The result would be lower growth, not higher. Worse, still, talk about devaluation or leaving the ERM is actually making it more likely, as the Economic Counsellor said earlier, that interest rates would have to be raised, at least for a short while, to confirm the authorities' commitment to the discipline, and to prevent the even more substantial rise in rates that would be needed if that discipline were seen to be lost.

I would add that I have a good deal of sympathy with Mr. Landau's and Mr. Filosa's comments about the simulation of the macroeconomic effects of achieving the convergence criteria of the Maastricht Treaty, as detailed in Annex III of the world economic outlook documents. These comments to some degree echo the points that some of us made in Monday's discussion about the simulation of the impact of fiscal consolidation on the United States. I suspect that the difficulty in both cases is that the baseline scenarios, which assume no action, are probably overoptimistic.

On developing countries, I welcome the forthright acknowledgment of the uncertainties in forecasts for growth and inflation. One particular problem in the world economic outlook forecast is the conventional assumption of adherence to Fund-supported programs by member countries. Although any other practice would clearly pose problems of moral hazard, the present convention risks misleading policymakers by being overly optimistic. I wonder, therefore, whether we might not in future show also a second-case aggregate forecast for developing countries, adjusted for likely slippage in implementing Fund-supported programs. As the pessimistic version would show less adjustment, larger fiscal deficits, faster inflation, and lower growth, the comparison might also be quite educational.

I certainly welcome the prominence given in the text to the well-established benefits of adjustment and, in particular, the staff research illustrating the beneficial impact of positive real interest rates and a high degree of trade openness. I also strongly endorse the need--mentioned on page 58 of the staff paper--to assess military expenditures in adjustment programs, given the trade-off with social spending.

Finally, turning to Eastern Europe and the states of the former Soviet Union, I, like other Directors, strongly agree with the conclusion that there really is no feasible alternative to rapid reform in most of these countries. It is now crucial that the authorities build quickly on the initial reforms that have been instituted by taking decisive steps to implement measures of monetary control, including those aimed at limiting credit growth and moving toward positive real interest rates. In addition, rapid action should be taken on wide-ranging privatization and institutional reform.

I have only two comments on the staff's analysis and conclusions. First, I would question how far, in practice, recovery in Eastern Europe has been delayed by the difficulty of finding new export markets following the demise of the CMEA. I would like to see Western countries doing even more than they have done to open their markets. However, I believe that the EC accounts for 35-60 percent of the exports of Eastern European countries, indicating that trade has already been diverted quite substantially.

Second, I believe that there is one important factor that has been left out of the analysis. The output of the former Soviet Union was highly concentrated in the military sector. This means that the end of the Cold War has had a disproportionately large economic impact on the successor states. This is a large and additional economic shock, which would have been hard to handle even if it had occurred in well-functioning economies. I suggest that this is a particular issue to which it might be worthwhile to give further thought.

Mr. Posthumus made the following statement:

The Board discusses the world economic outlook documents not only to indicate in which areas it supports the analysis and policy advice, and in which it does not; our intention is also to suggest to the Interim Committee what it can say and do in the present situation of the world economy. Looking at the industrialized world, we are witnessing a fast-developing situation of uncertainty and hesitation, which is a cause for concern. Major countries seem to have discontinued active policy coordination efforts; blaming others is now the game. The Economic Counsellor's comments on this point are well placed. The U.S. dollar, the most important currency in the world, has been depreciating quickly; the only instrument to prevent a continuing fall, however, cannot be used because it seems to be required to support economic growth. A reduction of interest rates in Germany should not be expected--rightly so, in view of the inflationary pressures that are still present. The EC, which thought that it was on the verge of taking a big step forward with the adoption of the Maastricht Treaty, is suddenly confronted with the possibility of taking two or more steps backward. In addition, there is tension in the EMS. Japan, for years a pillar of economic growth, has decided all at once to stimulate its economy with a fiscal impulse that, in my view, contains the classic elements of overreaction: although the announcement is welcome and has a positive impact, the implementation may be slow, and its effects may be felt only when the cycle has turned again.

This, then, is the situation with which the members of the Interim Committee are confronted. The message of the world economic outlook papers is that the prospects for recovery are not that bad and, in fact, are quite good. Inflation has been substantially reduced, which means that one of the conditions for economic growth has been improved. Nevertheless, I assume that the forecast in the staff paper, namely, that growth in the industrialized countries, after increasing by 2 percent in 1992, will rise by 3.5 percent in 1993, will not be deemed a great consolation. There may well be some skepticism about these estimates--a skepticism that becomes partly visible when the news is not the numbers themselves, but the downward revision compared with the previous estimates.

The staff makes clear in the main paper what policies should be followed, and I essentially support its recommendations. What can the Board do in its presentation to the Interim Committee? The Board should, in my view, stress that this is the time to implement structural measures, particularly in the field of international trade. Trade opportunities are the engine of growth of market economies. The United States, Canada, and Mexico took an important step with the ratification of the North American Free Trade Association (NAFTA), which should be supported. As Mr. Peretz has emphasized, the Uruguay Round should be completed; instead, however, it is fading away. Europe could also take measures to open its markets to the Eastern European countries; in that respect, the EC's current large share of the exports of the Eastern European countries, which Mr. Peretz alluded to, should be seen in the context of the latter group's low export levels. The strategy to stimulate growth by lowering interest rates has perhaps become too popular, while the strategy to stimulate growth by increasing fiscal deficits is no longer credible because the markets know that the room for maneuver in this area has been exhausted, and that the risks for the authorities are too great. Along these lines, I wonder whether the staff has not perhaps taken too big a risk in making its estimates of global growth, which are based on the assumption of a substantial acceleration of output in the industrialized countries.

Finally, one of the annexes to the staff paper examines the macroeconomic effects of the efforts required of ERM members to achieve the Maastricht convergence criteria by 1996. I have serious reservations about the presentation of these scenarios in staff papers. At the Board discussion on the Article IV consultation with the United States on Monday, the staff's replies to Mr. Dawson's critical remarks about the inclusion of such scenarios were, in my opinion, unconvincing. In this instance, I agree with Mr. Filosa and Mr. Peretz that the convergence scenarios presented in Annex III should, as a minimum, be discussed more thoroughly before publication. To publish the scenarios in their present form would be counterproductive, as they would give the impression that ERM members could avoid the negative short-term consequences of budget deficit reduction by opting to maintain the status quo--as represented by the baseline scenario--rather than comply with the Maastricht Treaty criteria. However, this assumption ignores the fact that, if budget deficit corrections are not made, participating countries will feel the negative growth consequences in the medium term. The text of the World Economic Outlook should contain some references to the EMU, but these references should be more objective and less MULTIMOD-inspired.

In conclusion, I can support the approach that the staff has taken in preparing the world economic outlook documents, which I see as essentially espousing the medium-term strategy of economic policy implementation. I do not consider that this approach should be applied as an automatic rule but, rather, as more of a rough guideline. For example, although economic policymakers should in theory aim for a balanced budget, they should, in practice, keep fiscal balances within a band of plus or minus 2 percent of GDP, depending on the phase of the economic cycle. A comparable guideline could be formulated so as to contain the inflation rate--the main monetary policy target--to 0-3 percent. Needless to say, however, it is much more difficult to contain inflation and implement monetary policy than to manage fiscal policy.

Mr. Esdar made the following statement:.

At the outset, I would like to commend the staff and management for the excellent material presented for this discussion. In my view--and contrary to Mr. Dawson's--the present world economic outlook exercise again underscores the reputation of this institution for both sound economic analysis and prudential policy advice.

The central policy recommendation, namely, to pursue a medium-term-oriented growth strategy based on price stability, fiscal consolidation, and structural reform, deserves our full support. We very much welcome and endorse the clear focus on the medium-term orientation of policy and the strong discouragement of any policies of fine-tuning. In our view, these world economic outlook documents confirm the proven approach of the past years.

In this regard, the spring discussions had given rise to some doubts.

Notwithstanding the considerable uncertainties, I broadly agree with the staff's assessment of the global economic situation. However, like others, I feel that there is some doubt as to whether the projected recovery in 1993 will materialize, given the considerable risks. Perhaps the staff could explain what, in its view, will be the main driving force for the revitalization of growth. Despite these doubts, I agree with the staff that there is little scope for further action to stimulate activities in the short run; the objective has to be to improve confidence and strengthen the prospects for sustained growth over the medium term through a credible policy approach.

On price stability, I share the view that considerable progress has been achieved. Inflation rates in some industrial countries have reached historic lows. However, inflation is still very high in other countries. Even in my country, exceptional inflation rates give cause for concern. Therefore, there is no room for complacency. I very much welcome the clear statement in the paper with regard to price stability as a prerequisite for sustainable economic growth. I support the staff's finding on page 3 of the text that "improved adherence to the objective of seeking reasonable price stability was generally rewarded not only by lower inflation but also by smaller fluctuations in output and employment." It would be a critical misjudgment to expect that there might be a trade-off between inflation and growth.

I was somewhat surprised that the staff paper gives only little room to the discussion on balance of payments developments. I note that, in general, the balance of payments situation is more settled than in earlier years; however, I had expected to get more information about the medium-term perspective. For example, when we discussed the situation in the United States recently, different views had been expressed as to whether the balance of payments adjustment in that country was more related to temporary factors, or whether a lasting consolidation could be expected. In addition, it would be helpful to hear the staff's view on the expected developments with respect to the Japanese current account surplus, given the policy package that was announced in the previous week. It would also be helpful to hear the staff's assessment of the impact of this announcement on the overall balance of payments situation.

Turning to the policy recommendations, I, as already mentioned, strongly support the staff's recommendation to pursue a medium-term-oriented growth strategy. The paper correctly states that the shortfalls in implementing this strategy in the past have been the main contributors to the sluggishness of recovery in industrial countries that can presently be observed. It is, therefore, a logical conclusion that the most appropriate response needed to overcome existing problems would be a strong effort to correct these deviations. The staff identifies unsolved budgetary problems and the lack of structural reform in many countries as the main areas in which corrective actions are needed.

Against this background, we have no problem with endorsing the policy recommendations, which reflect the attempt to apply this strategy to the particular conditions of each country. To keep its own house in order is certainly the most effective contribution that every single country can make to sustain economic growth and reduce international imbalances in a consistent and sustainable manner.

As the situation in the United States was discussed two days ago, I can, therefore, be very brief on this topic. Fiscal consolidation and an improvement in private saving are of the utmost importance, and, although some improvement has been reached with respect to the latter, the prospect for fiscal developments remains a matter of concern.

With regard to monetary policy in the United States, I share the staff's view that there is no scope for monetary stimulus without risking the credibility of the policy's overall course. The quite steep yield curve and the remaining high long-term interest rates, which discourage investment, indicate that uncertainties persist, which can be overcome only by a credible course of fiscal consolidation, combined with a strong commitment on the part of the authorities to maintaining price stability.

A reduction of the fiscal deficit is also a most important task in Germany. Although the deficit is caused by the transitory effects of German unification--and, therefore, not as much by structural factors, such as in the United States and many other countries--my authorities are fully aware of the risks that would arise if these deficits persist. The Government has announced the target of reducing the federal government deficit to 1/2 of 1 percentage point of GNP by 1996, and, at the same time, of reducing the general government deficit to 2 percent. To achieve these targets, tight limits on expenditure growth are being implemented. For the federal budget, it is intended to keep the average annual growth rate of expenditures to 2.3 percent, which is less than half of the projected growth rate of nominal GNP. The fiscal impact of the dissolution of the Treuhand and the inherited east German debt is included in these figures.

There is, however, one point that I should like to emphasize. Those factors that have led to larger deficits in Germany have, at the same time, had a substantially positive impact on growth for its European partner countries. According to the recent annual economic report of the Commission of the European Communities, the impact on growth of the German unification process amounted to 1/2 of 1 percentage point in each of 1990 and 1991, thereby accounting for more than 90 percent of the total growth of Germany's EC partner countries in 1991.

The improvements in the fiscal area in Germany, as described, should help to ease the burden on monetary policy. Given the very high price increases--by German standards--the staff has correctly pointed out that, for the time being, any easing of monetary policy should be precluded, as it would not only undermine the medium-term growth effects in Germany, but also weaken the important role of the deutsche mark as the anchor of the EMS. The development of long-term interest rates, which are today clearly below the end-1991 levels, reflects the fact that capital markets are giving credit to the anti-inflationary stance of monetary policy. This, in my view, is especially important, as long-term interest rates have a major impact on investment decisions. With regard to Mr. Landau's comment on a possible shift in the monetary aggregates in Germany, our finding seems to indicate that shifts are not taking place between the different aggregates, but within the M3 framework; the upcoming Article IV consultation will give us an opportunity to discuss this in detail. With regard to Mr. Peretz's comment on the possibility of an easing in the price situation in Germany, our latest August 1992 figures show an increase in consumer prices of about 3 1/2 percent, which would seem to indicate that, for the time being, there is no room for maneuver. On this point, I agree very much with the view expressed by Mr. Posthumus.

It is difficult to say too much at present about the prospects for prices in Germany in 1993, partly because of statistical problems arising from base effects--which are described in the staff paper--relating to unification. Given that, as Mr. Dawson indicated, there are many different short-term estimates of German inflation in circulation, it is probably better to focus on medium-term developments and not attach too much emphasis to small changes in monthly inflation rates. Based on the medium-term projections, we can say--without being able to be too specific at present--that the overall inflation rate is likely to subside somewhat in 1993.

The office of the Executive Director for Germany will be happy to provide Mr. Dawson with help in interpreting the statistics on inflation, which, admittedly, are somewhat confusing. In that respect, the situation is similar to the expectations surrounding growth and inflationary developments in the United States, where it seems that two or three new--and sometimes conflicting--figures are quoted daily in the newspapers. In both countries, it is essential to resist the temptation to fine-tune policies in response to the latest developments.

As far as budget consolidation in other EC member countries is concerned, the Maastricht agreement on economic and monetary union provides a most important framework for major improvement in the budgetary positions for those EC countries in which fiscal adjustment has not progressed sufficiently. The staff has correctly pointed out that countries with excessive fiscal deficits are in need of strong fiscal action to allow room for growth. In this respect, the Maastricht agreement should help to facilitate the conduct of more responsible fiscal policies, as the agreed fiscal objectives provide a clear yardstick for domestic policymakers and should facilitate the task of overcoming the obstacles that until now have slowed down the implementation of the necessary adjustment measures.

With regard to the economic effects of improving convergence, I am very skeptical as to whether the MULTIMOD stimulations discussed in Annex III provide a realistic picture. I made a similar point already when we discussed the U.S. situation. We will discuss this issue further on the occasion of our seminar on policy issues and implications for Fund surveillance of the EMU in Europe. I strongly support Mr. Filosa's request not to publish Annex III of the paper dealing with the macroeconomic effects of convergence in the EC.

Turning to the exchange market, I would observe, first of all, that the current U.S. dollar exchange rate does not reflect the fundamentals adequately. While the drastic devaluation of the dollar, if limited to a short period of time, might be no cause for concern, it could cause problems if it were to persist for a longer period.

Exchange rates are influenced by many different elements, and single-cause explanations usually do not contribute to finding adequate solutions. There is no doubt that interest rate differentials have a significant influence on exchange rates. In this regard, I very much agree with the Economic Counsellor. The relatively high short-term interest rates in Germany reflect adequately the inflationary developments and the buoyant growth of monetary aggregates; I have addressed already the ways in which we want to react to this situation in Germany, namely, by providing more room to monetary policy by following an appropriate fiscal consolidation course.

However, the exchange rate also reflects very much the assessments and expectations of market participants. Therefore, reiterated public discussions on the adequacy of monetary policy would certainly not be very helpful. Uncertainties with regard to the future monetary course in the United States, the unsolved issue of the budget consolidation, and general uncertainties with regard to economic development in this country have certainly had a very important influence on the expectations concerning the dollar. Taken all together, a clear signal to the market in the form of a commitment to a consolidation course, as recommended by the staff, would certainly contribute to stabilizing expectations and increasing the confidence of market participants.

The outlook for the developing countries will be discussed in more detail when we address the financing and debt situation of these countries in a Board meeting scheduled for this Friday, September 4, 1992. In addition, the Fund's experiences with Eastern European countries and the states of the former Soviet Union are subject to a special seminar envisaged for next week. Therefore, I would prefer to address those issues at that time.

Mr. Kafka made the following statement:

In industrial countries as a group, a substantial recovery is foreseen by the staff for 1993, even after the most recent revisions, but the arguments supporting the forecast are not overwhelming. In other words, much as I admire the analysis performed by the staff for us today, I must agree more with Mr. Dawson's pessimism than with the staff's relative optimism. Strong growth among developing countries in both 1992 and 1993 is expected by the staff. The arguments supporting this expectation also raise doubts, and a 6 percent growth rate sustained for two years, as predicted by the staff, has not been registered for many years--if not decades--by the developing countries as a group, which is, therefore, relevant even if there are some unusual circumstances. Among the former centrally planned economies, a hesitant recovery is foreseen by the staff for Eastern European countries. How much, if any, progress can be made in the short term among the republics of the former Soviet Union--including Russia--seems altogether uncertain. The answer to these concerns, of course, is not fine-tuning, and, on this point, I agree fully with Mr. Esdar.

As for the medium-term outlook, the scope for monetary stimuli has been exhausted in most industrial countries; for the United States, this fact is being demonstrated by developments in the exchange markets. How soon the opportunity for monetary stimuli will reappear is quite uncertain. There is also at this time little or no room in the major industrial countries for fiscal stimuli, not only in view of the widespread desire to move firmly in the direction of fiscal consolidation, but also--and more important--because, during the recent economic downturn, budget deficits increased in some countries beyond what cyclical developments would have warranted. The one exception where there is scope for fiscal stimulus is Japan; the Government has announced ambitious programs of fiscal expansion and bank salvage, on which it is to be congratulated. The extent to which, and the speed with which, these programs can be carried out will be eagerly watched.

Among developing countries, those in the Middle East should be able to resume, and those in Asia to continue, their rapid growth rates, while, in Africa, well-known obstacles will continue to hamper growth. Latin American countries will not be in a position to grow very fast as a group, as they are still in the process of fiscal consolidation and inflation reduction. However, balance of payments constraints on growth have been greatly eased in several Latin American countries. For this reason, some optimism can be justified.

The discussion in the staff paper brings together interesting aspects of the factors that have contributed to the resumption of growth in developing countries. The analysis of factors that have hindered the adoption of growth-promoting policies in developing countries is something to which the Fund should perhaps pay increased attention; these factors include, in particular, inadequate safety nets. Economic growth, like improved income distribution--which is also a necessary policy objective in developing countries--is not a purely economic problem.

In this connection, it should be noted that capital flows toward developing countries can be a mixed blessing. Where they represent the counterpart of real foreign investment, their effects on recipient countries are favorable; however, the benefits of short-term capital inflows with no immediate real counterparts are dubious, as they frequently force currency revaluations and raise the need for sterilized intervention, usually accompanied by increased quasi-fiscal deficits. Moreover, as recent experience has shown, on many occasions, they cannot be effectively sterilized. In such cases, it may be in the best interest of the recipients' long-term prospects to restrict short-term capital inflows, be it through administrative measures or mechanisms, such as taxes, to affect their relative attractiveness. This conclusion seems to be supported to an extent by comments made in the main staff paper on the lessons derived from the experience of financial sector reforms in developing countries.

The former centrally planned economies need advice, technical assistance, financial support, and access to the world market. Among Eastern European countries, substantial progress has been made in establishing market economies. In most of the republics of the former Soviet Union, the situation is less clear.

Although the debt problem of the developing countries is sometimes being written off, this assessment seems to be premature. The net debt relief on commercial bank debt, as well as other debt obtained so far, deserves to be noted. The financial institutions involved may have saved themselves by their own and others' exertions. Even if they have done so, to restore growth rates that are sustainable and acceptable over the long run in the debtor countries will require important additional efforts. Support for the early conclusion of the Uruguay Round is an essential aspect. An intensification of official development assistance, as well as a careful review of the regulatory approach to private capital flows, is also important. The situation is undoubtedly much better than it has been at any time in the past ten years. However, the participants in the debt problem are by no means out of the woods.

With respect to the economic policies in the countries of the former Soviet Union, we wholeheartedly agree with the notion of allowing market forces to determine the distribution and allocation of resources. However, as has been mentioned by Mr. Fukui, this requires that markets exist. When, as is the case with many former centrally planned economies, such markets do not exist, a certain degree of governmental guidance is not only a possibility, but also a prerequisite to halt the continued output decline. In this context, the Japanese postwar economic revival, as well as the Chinese revival in more recent years, may provide useful lessons for these countries.

What does all this mean? At the very least, one must assume that a period of slow growth can be expected. The future does not look inviting unless the world can greatly accelerate its adjustment, not only to bring or continue to maintain--as the case may be--inflation under control, but also to step up saving and direct it--if I may use such a word--toward productive investment in both the private and public sectors, and among countries capable of taking advantage of it. There is, after all, no point in preaching optimism.

Mr. Jamnik made the following statement:

Once again, the staff has provided a useful overview of recent world economic developments. I must say, however, that we found the paper somewhat anodyne, particularly with respect to developments in the industrial countries. While we agree with the Fund prescription for the medium term, we believe that in some countries there may be, or there may soon be, scope for further policy easing. However, in countries like the United States, where there may be a need for further balance sheet adjustment, additional measures taken to boost growth in the short term may only jeopardize medium-term objectives. Moreover, given the long and variable lags associated with monetary policy, and the uncertainties with respect to the duration of balance sheet effects--and their impact on aggregate demand--further easing of monetary policy may be unnecessary.

With respect to recent developments in developing countries, the staff paper is quite upbeat, noting the resilience of growth in developing countries as a group despite the economic slowdown in industrial countries. That the international debt strategy, in general, and structural adjustment efforts, in particular, are bearing fruit is, indeed, an important message to get out. The paper may, however, be somewhat too self-congratulatory. The sharp decline in global interest rates and the resulting fall in debt-service costs are also major factors behind better performance.

Unfortunately, most of sub-Saharan Africa is not sharing in this success. It is regrettable that there was no discussion of what should be done in these countries or what industrial countries could do to assist. I will return to this issue shortly.

With respect to the former centrally planned economies, we found the paper to be perhaps too optimistic with respect to some countries. While we would concur that there have been some signs of a bottoming out in Poland, Hungary, and Czechoslovakia, we--like Mr. Fukui--would hesitate to say that the contraction of output has ended or is about to end. Elsewhere, we agree that prospects are less favorable. In the former Soviet Union, we expect economic conditions to continue to deteriorate.

Given Monday's discussion on the United States and previous statements today, I would like to make only a few observations on the industrial countries, largely focusing my remarks on the developing countries. On balance, we support the thrust of the staff's analysis of the economic outlook for the industrial countries and the policies recommended. We agree that countries must keep their eyes fixed firmly on medium-term objectives--in particular, fiscal consolidation, structural reforms, including a successful conclusion to the Uruguay Round, and further progress toward price stability. In this regard, we would also agree with the staff that a failure to implement fully this medium-term strategy has contributed to the difficulties facing many industrial countries today. In particular, had fiscal policy been tighter in the past in certain countries, their governments today would have more room to maneuver and greater credibility. Enhanced credibility and a smaller outstanding stock of debts would have contributed to lower long-term interest rates.

Regarding the short-run outlook, our view, in general, is similar to that of the staff; however, we would inject a note of caution. In the recent past, real growth in the major industrial countries as a group has been sustained by Japan and Germany. Many had expected that a slowing of growth in these countries would be mitigated by recovery elsewhere. However, with the recovery slowed or delayed in North America and the United Kingdom, economic activity in the G-7 countries seems to have become more synchronized. Should this pattern continue, growth in the Group of Seven as a whole might still be weaker than expected in the immediate period ahead.

At this stage, we see this only as a risk. We still anticipate that real activity in North America will strengthen through the remainder of this year and 1993, and at a faster pace than expected by the staff. However, we are becoming increasingly concerned about prospects in Europe and Japan. High interest rates and currency appreciation have significantly tightened monetary conditions throughout Europe in recent weeks. While this partly reflects a restrictive monetary policy in Germany aimed at reducing inflationary pressures in that country, rising uncertainty about the EMU and the commitment of weaker European countries to economic convergence have also been factors. These factors may increase in influence in the days leading up to the French referendum on Maastricht and will certainly increase if the "non" forces prevail. In Japan, financial fragility, weak investment, and reports that private consumption may be slowing point to weaker growth. However, the recently announced package of fiscal measures should support growth, especially in the early part of next year, although we wonder how much effect such measures will have on the demand for goods and services.

With respect to the near-term projections for inflation and output, we continue to have problems reconciling the large output gaps prevailing in certain countries, the expected growth during the period to end-1993, and the projected profiles of inflation. For example, despite a large output gap in the United States, inflation is expected by both the U.S. authorities and the staff to hold steady at best or rise. Unless other forces are at play, we would argue that inflation ought to continue to subside.

Turning to the developing countries, we note that a prominent feature of recent global economic developments is the resilience of the developing countries in the face of a slowdown of economic activity in industrial countries. Undoubtedly, this resilience reflects in large measure the stabilization and reform policies--some of which were implemented in the context of the international debt strategy--pursued by many developing countries in recent years. Such policies have contributed to a significant reduction of macroeconomic imbalances, a marked deceleration of the inflation rate, and improved resource allocation and efficiency. In some countries, there has been an improvement in international confidence, a reversal of flight capital, and increased net inflows of foreign investment.

While these welcome developments justify a certain optimism, we view the situation as still being fragile and generally remain more cautious than the staff in our assessment of the outlook for developing countries. There are several reasons for this. Without minimizing the contribution of domestic adjustment and reform initiatives--and, more broadly, the international debt strategy--in enhancing the ability of many developing economies to withstand adverse shocks, lower international short-term interest rates have also played an important role in supporting growth in developing countries. However, the high long-term international interest rates can be expected to continue if global economic conditions remain sluggish. There is also the additional risk that the reform process in some countries will lose momentum.

In this context, and as I have indicated in my opening remarks, we are particularly concerned about the outlook for Africa. Despite recent efforts by some African countries to strengthen fiscal discipline and implement much-needed structural reforms, progress has been slow, in part reflecting setbacks related to civil strife and natural disasters, particularly drought, but also unfavorable external developments and heavy external debt burdens--especially in sub-Saharan countries.

While we agree with the staff that sustainable noninflationary growth depends crucially on the implementation of prudent domestic adjustment policies, we must also recognize that a country's resolve will be seriously tested if the external environment remains unfavorable. Pressures to ease policies may intensify if industrial country demand and world commodity prices remain weak. Further delays in concluding multilateral negotiations to liberalize world trade represent another potential threat to sustained adjustment efforts. Indeed, lack of progress in this area could force the authorities of traditionally inward-oriented developing countries that have only recently embraced open markets to rethink their policies, with unfortunate consequences.

We would urge the successful and speedy conclusion of the Uruguay Round. In so doing, trade in areas hitherto outside of the General Agreement on Tariffs and Trade would be encouraged to the benefit of all. In many countries, agreement would also head off rising protectionist pressures, which have been fueled by weak growth or recession and trade imbalances.

The debt crisis may not be over yet either, although the systemic risk it posed for the international banking sector has passed. The observed reduction in debt burdens under the international debt strategy has taken place primarily in the highly indebted middle-income countries. Other countries, especially those in which debts are owed largely to official creditors, have not benefited commensurately. The debt problem of small, low-income countries, notably in sub-Saharan Africa, remains unresolved.

I would venture to say that, in some cases, the current level of concessionality extended in the rescheduling of these countries' official debts is not sufficient to eliminate their debt overhang problems. Moreover, while the Paris Club has agreed to consider in three or four years' time the possibility of reducing the stock of debt of the poorest countries, it might be appropriate to consider accelerating such a move for countries that have already demonstrated progress under their Fund-supported programs and honored the terms of their rescheduling agreements.

In light of the sizable private capital inflows experienced by certain Latin American countries in recent years, it is appropriate that the staff consider the causes of such inflows and discuss policy options to cope with the "unfamiliar" monetary and exchange rate implications thereof. With regard to the causes for these inflows, we have a few comments. Even though lower U.S. interest rates may have contributed to greater attention paid by investors to Latin America, reduced uncertainty with respect to the prospects of these countries since 1989 has been, in our view, the major factor.

As a result of sustained prudent policies, diminished political uncertainty and an improvement in the macroeconomic environment have been decisive factors behind increased investor confidence in Mexico and Chile since 1989. The elimination of restrictions on foreign ownership in some Latin American countries and--in the particular case of Mexico--both the privatization of the banking sector and the prospects for the NAFTA have also been important elements.

Somewhat oddly, there was comparatively little discussion of the NIEs in Asia. This may just be a reflection of a "prodigal son" syndrome, with more attention being paid to reforming developing countries than to those that never needed Fund support. However, given the increasing importance of these economies, we would hope that the Fund would devote more time to them in future world economic outlook documents.

As a final observation in this area, like other speakers, we would note that the staff review in Chapter IV of the paper of the experience of successfully adjusting developing countries, and of the key lessons to be drawn from such experience, was very useful.

These lessons could be especially relevant to other countries, including those of Eastern Europe and the former Soviet Union, that have recently embarked on or are about to adopt similar stabilization and adjustment programs.

With respect to the former centrally planned economies, which have been commented on extensively in recent months, short-term growth projections for Eastern Europe and the former Soviet Union have been revised downward by considerable margins. The revisions are in the direction that we suggested in our comments during the most recent world economic outlook exercise. Still, in the case of the former Soviet Union in particular, output losses could be significantly greater than projected.

On the question of the speed and sequencing of reforms, the staff favors a rapid, as opposed to a more gradual, process--an approach with which we have considerable sympathy. The staff points out that, even though less restrictive macroeconomic policies or a slower pace of reform might have resulted in a smaller contraction of output in the short run in Eastern Europe, this would have been at the expense of higher inflation. All this may be particularly relevant for the states of the former Soviet Union, where differing views regarding the appropriate pace of reforms have already resulted in some unfortunate backtracking.

The Executive Directors agreed to continue their discussion in the afternoon.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/92/109 (8/31/92) and EBM/92/110 (9/2/92).

3. OPERATIONAL BUDGET FOR SEPTEMBER-NOVEMBER 1992

The Executive Board approves the list of members considered sufficiently strong as set out in EBS/92/135, page 2, footnote 1 and the operational budget for the quarterly period beginning September 1, 1992 as set out in EBS/92/135 (8/19/92).

Decision No. 10120-(92/110), adopted
September 1, 1992

4. SDR DEPARTMENT - DESIGNATION PLAN FOR SEPTEMBER-NOVEMBER 1992

The Executive Board approves the designation plan for the quarterly period beginning September 1, 1992 as set out in EBS/92/136 (8/19/92).

Decision No. 10121-(92/110), S, adopted
September 1, 1992

5. COMMISSION OF THE EUROPEAN COMMUNITIES - RELEASE OF INFORMATION

The Executive Board approves the transmittal of documents pertaining to Estonia and Latvia to the Commission of the European Communities, as set forth in EBD/92/185 (8/28/92).

Adopted September 1, 1992

6. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director and by Advisors to Executive Directors as set forth in EBAM/92/72 (8/28/92) is approved.

APPROVED: April 5, 1993

LEO VAN HOUTVEN
Secretary