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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 92/112

10:00 a.m., September 4, 1992

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

Executive Directors	Alternate Executive Directors
	A. A. Al-Tuwaijri
G. K. Arora	L. E. N. Fernando
Che P.	Wei B.
C. S. Clark	
T. C. Dawson	Q. M. Krosby
	J. Prader
E. A. Evans	
R. Filosa	J. Papadakis
	M. B. Chatah, Temporary
	J. A. Solheim
H. Fukui	N. Tabata
	B. Esdar
J. E. Ismael	T. Sirivedhin
A. Kafka	
J.-P. Landau	I. Martel
A. Mirakhor	O. Kabbaj
	L. J. Mwananshiku
D. Peretz	
G. A. Posthumus	Z. Trbojevic
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

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Also Present

African Department: M. Touré, Counsellor and Director; J. A. Clément. Central Asia Department: H. Neiss, Director; B. B. Aghevli, Deputy Director; U. Baumgartner. European I Department: G. Bélanger, P. R. Masson, S. Oberg. European II Department: E. Brau, Deputy Director. 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. Middle Eastern Department: P. Chabrier, Director. Policy Development and Review Department: J. T. Boorman, Director; J. Ferrán, Deputy Director; H. M. Flickenchild. Research Department: M. Mussa, Economic Counsellor and Director; M. Goldstein, Deputy Director; J. Baras, J. M. Barrionuevo, D. T. Coe, R. A. Feldman, R. P. Ford, S. J. A. Gorne, G. Hacche, A. Hoffmaister, M. S. Kumar, F. Larsen, G. J. Schinasi, S. A. Symansky. Secretary's Department: J. W. Lang, Deputy Secretary; J. M. Boughton, A. Leipold. Southeast Asia and the Pacific Department: K. Saito, Director; P. J. Winglee. Treasurer's Department: D. Williams, Treasurer; 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. Office of the Managing Director: J. Prust, Advisor; B. P. A. Andrews, R. Saunders, Personal Assistants to the Managing Director. Advisors to Executive Directors: J. M. Abbott, L. Dicks-Mireaux, B. R. Fuleihan, W. Laux, M. Nakagawa, A. Raza, B. Szombati. Assistants to Executive Directors: S. E. Al-Huseini, G. Bindley-Taylor, P. Bonzom, B. Bossone, J. H. Brits, J. A. Costa, H. Deng, A. Giustiniani, H. Golriz, M. A. Hammoudi, M. E. Hansen, O. A. Himani, J. Jonas, V. Kural, K. J. Langdon, G. J. Matthews, R. Meron, F. Moss, E. H. Pedersen, E. Quattrociocche, S. Rouai, P. Rubianes, S. Shimizu, N. Sulaiman, T. P. Thomas, R. Thorne, J. W. van der Kaaij.

1. WORLD ECONOMIC OUTLOOK

The Executive Directors continued from the previous meeting (EBM/92/111, 9/2/92) their consideration of a staff paper on prospects and policy issues related to the world economic outlook (EBS/92/127, 8/6/92), together with a statistical appendix (SM/92/154, 8/7/92) and annexes providing supplementary background material (SM/92/156, 8/7/92). They also had before them charts and tables on exchange rate developments (EBD/92/189, 8/31/92).

Mr. Esdar recalled that, at the previous meeting, Mr. Evans had suggested that Germany's problems had been exacerbated by too great a reliance on its own labor and capital resources. With respect to labor resources, however, it should be noted that, particularly in the eastern part of Germany, the supply of domestic labor exceeded the demand. In the area of capital expenditures, the authorities' prudent emphasis on restraint, with a view to avoiding recourse to foreign borrowing, could be defended as being appropriate in the circumstances.

In that context, it was instructive to look at German trade developments between 1988--a good comparator year--and 1991, Mr. Esdar continued. Germany's trade balance had deteriorated by approximately DM 110 billion, as imports had risen by about DM 138 billion, or 27 percent. Imports from the European Community (EC), the United States, developing countries--excluding the Organization of the Petroleum Exporting Countries--and the former Council for Mutual Economic Assistance (CMEA) countries had increased by 29 percent, 13 percent, 20 percent, and 72 percent, respectively. However, it should be remembered that the statistics on Germany's imports from the former CMEA countries had been inflated by the inclusion of transactions with the former German Democratic Republic.

Mr. Evans said that he hoped that the Board's upcoming discussion on the 1992 Article IV consultation with Germany would provide an opportunity to look more closely at possible solutions to the country's problems. Meanwhile, the authors of the world economic outlook text might give greater consideration to his suggestion, namely, that placing greater emphasis on structural policies could ease Germany's financial pressures.

Mr. Dawson noted that, in previous years, the United States, Germany, and Japan had been listed as separate subcategories under the category of "world output, industrial countries" in Table 1 of the basic world economic outlook document. In the current version, the subcategory of "Germany" had been replaced by that of "the European Community." He had no objection to adding "the European Community" as a new subcategory; however, the subcategory of "Germany" should be restored to the table as, in his view, its omission made it more difficult to track the staff's projections over time.

Mr. Esdar said that he could accept the table either in the format proposed by Mr. Dawson or as prepared in the draft version of the World Economic Outlook.

The Economic Counsellor and Director of the Research Department said that he would like to acknowledge the essential contributions made by the staff not only of the Research Department, but also of the other departments of the Fund to what had been, was, and would continue to be the single most important and valuable international surveillance activity of the Fund. In that regard, it should be emphasized that the World Economic Outlook was not a channel for the expressions of the sometimes idiosyncratic, if stimulating, views of the Economic Counsellor; rather, it sought to provide the balanced and sober assessment of the professional staff of the Fund, based on the best knowledge of the economics profession.

As always, the world economic outlook documents covered a good deal of territory, and Directors' comments and questions had been suitably wide-ranging, the Economic Counsellor and Director of the Research Department continued. The staff's main remarks would concentrate on four general issues mentioned in the comments of several members of the Board: first, concerns about the accuracy and realism of the world economic outlook forecast; second, some brief remarks on, and responses to, the prospects and performance of developing countries, and the reform strategy in the former centrally planned economies; third, the appropriateness of the policy stance, especially in the larger economies; and, fourth, the meaning and usefulness of model-based simulations, especially those concerned with the effects of European economic and monetary union (EMU) convergence and U.S. fiscal consolidation.

A staff representative from the Research Department made the following statement:

> I would like first to address the issue of forecasting accuracy. Many Directors questioned the realism of the staff's projections for the industrial countries, suggesting that these projections are excessively optimistic. I would like to address these concerns by looking at three different dimensions of the question.
>
> The first dimension that I will touch on is that of short-term bias. If we look at the staff's forecast record in the past, is there evidence of bias in the projections? This is an issue that the staff is constantly revisiting, and we did analyze the evidence in both the May 1992 World Economic Outlook and Annex IV to the current world economic outlook paper. The evidence suggests that the industrial country projections have been unbiased, in the sense that the forecasts tend to overpredict growth no more frequently than they underpredict actual growth. I should also mention that the forecast performance has improved significantly since the mid-1980s, notwithstanding the recent mistakes.
>
> The second dimension that I will discuss is that of "long-term bias." By this, I am referring to the staff's estimates of potential, or trend, output and, more specifically, the question

of whether the staff's judgment and estimates about the medium-term evolution of aggregate supply have been excessively optimistic. Here, I would like to refer to a 1987 study of long-term growth trends in the industrial countries 1/, which contains projections of potential output over the 1986-95 period. The estimates in that study suggested a growth rate of potential output of about 2 3/4 percent per year in the seven major industrial countries from the mid-1980s to the mid-1990s. Looking at actual growth from 1986 until today, we see that this projection is almost exactly the same as the growth rate that has actually transpired, which, on average, has been about 3 percent. Since 1986, growth in the major industrial countries has been above potential in three years--1987-89--and below potential also in three years--1990-92--which, as shown in Chart 5 on page 14b of the main paper, corresponds to the recent business cycle.

The third aspect of the issue of forecast accuracy that I would like to address is the question of the appropriateness of looking at growth over the recent past as a guide for the future. Many Directors, in commenting on the staff's projections, seemed to base their pessimism in large part on the fact that growth had been overestimated in the recent past; in their view, therefore, the recent weakness of growth suggests that activity will remain weak in the future.

The evidence available does not suggest that such a forecast "model" is able to track actual developments particularly well. Michael Artis, in his 1988 study of the staff's forecast record 2/ concluded that the world economic outlook projections are considerably superior to a naive forecast based on the assumption that last year's growth will be repeated next year. This conclusion is reconfirmed in the update of Artis's work that was reported in Annex VIII of the May 1992 World Economic Outlook.

These technicalities aside, it is useful to step back for a moment and consider the information available at present and the assumptions on which the projections are predicated. Does an objective analysis of the forces presently at work in the industrial countries--and likely to be at work in the immediate future--support the projection of a moderate recovery?

1/ C. Adams, P. Fenton, and F. Larsen, "Potential Output in Major Industrial Countries," Staff Studies for the World Economic Outlook (Washington: International Monetary Fund, August 1987).

2/ "How Accurate Is the World Economic Outlook? A Postmortem on Short-Term Forecasting at the International Monetary Fund," Staff Studies for the World Economic Outlook (Washington: International Monetary Fund, July 1988).

In the staff's view, it does. To summarize some of the principal positive forces, I would first mention inflation performance, including the behavior of commodity prices: inflation rates are now at their lowest since the 1960s. Second, short-term interest rates are lower in North America and Japan. Third, the balance sheet adjustment, although it may still be ongoing, is less adverse than in 1991. In Japan, much of the adjustment may still be ahead of us, but the recent fiscal stimulus package should help support activity during the adjustment process. As the balance sheet adjustment is completed, conditions for a resumption of somewhat stronger growth than seen in the recent past will become quite favorable. Fourth, activity in developing countries has been strong; in particular, imports have been performing well and are providing some support for growth in the industrial countries as well.

Of course, there are also negative factors, such as the tight monetary conditions in Europe, the generally high level of real long-term interest rates in all countries, and the low levels of confidence, that justify the staff's projection of a relatively weak recovery, as well as the staff's assessment that the balance of risk is on the downside. Finally, it should be mentioned that the margins of slack in most of the major countries are considerably smaller than those prevailing immediately after previous recessions, which suggests that it is unrealistic to expect a particularly strong recovery.

Mr. Posthumus noted that, according to the staff, it tended neither to underpredict nor overpredict growth in its short-term projections. He wondered, however, whether there was a tendency to overpredict short-term growth following periods of recession or slow growth.

The staff representative from the Research Department said that one way of answering the question was to state that the most difficult task for all economic forecasters, including the Fund's, was to project turning points correctly. Obviously, that difficulty was related to the wide variety of shocks to which the industrial countries could be exposed. For example, the current shock was fundamentally different from those that had been experienced in the mid-1970s and early 1980s. In practice, forecasters tended to overpredict growth when industrial countries were winding down from periods of relatively rapid growth, and to underpredict growth when economic recoveries were beginning. That historical pattern provided an additional argument against undue pessimism in the current situation.

The Chairman added that he would very much like to learn of any organization or institute that specialized in correct identification of economic turning points.

Mr. Fukui said that he appreciated the staff's comments on the issue of forecasting accuracy. He wondered whether it could also comment on the point raised by Mr. Arora, namely, that, as the industrial economies became more internationalized, structural rigidities--in particular, those affecting the labor market--posed increasingly greater obstacles to growth. That longer-term perspective suggested that factors other than the business cycle had an influence on economic growth.

The staff representative from the Research Department noted that the analyses of potential output in recent staff reports prepared for Article IV consultations with the major industrial countries did not conclusively indicate that major breaks in trends would occur over the next few years; however, given the interest expressed in that issue by Directors, the staff could reassess the long-term trends in industrial countries--and, for that matter, the world at large.

Mr. Torres said that, although he did not disagree with the staff representative's remarks, he was not certain that the different perceptions of the Board and the staff on the accuracy of the world economic outlook forecasts were due only to the fact that Directors were using a more naive model. Leaving aside the latest revisions of the world economic outlook data--which he had not yet seen--he had the impression that, in certain capitals, also, the projections for at least some parts of the world--as well as for the growth of world trade in 1993--were considered to be overoptimistic.

The Chairman commented that the latest revisions to the world economic outlook, as the Economic Counsellor had summarized them in his opening remarks on the previous day (at EBM/92/110, 9/2/92), would bring the Fund's forecast more into line with the more pessimistic viewpoint referred to by Mr. Torres.

The staff representative from the Research Department said that, with a few exceptions, the staff's forecasts for the major industrial countries were somewhat more cautious than those countries' own official forecasts. Moreover, the forecasts in the May 1992 World Economic Outlook had agreed broadly with those made by the major countries and other international organizations, such as the Organization for Economic Cooperation and Development (OECD). Where deviations had occurred, the official forecasts had tended to be somewhat more upbeat than the staff's.

Another staff representative from the Research Department made the following statement:

> I will respond briefly to a number of other comments made by Directors on two closely related topics: the experience of successfully adjusting developing countries, and the realism of the projections made for developing countries and world trade.

We appreciate the positive comments on the analysis contained in Chapter IV of the main world economic outlook document. A number of Directors suggested ways that this analysis could fruitfully be extended, and we will be following up on these in our future work. The 35 countries classified as successful adjusters represent all developing country regions and account for 50 percent of output in the developing world. Most--but not all--have availed themselves of Fund resources in the past. The relatively optimistic projections for the developing countries are based largely on the recent and expected performance of this group of countries. There are, in addition, a number of other developing countries in which growth is expected to improve substantially in 1992 and 1993.

Some Directors questioned the realism of the staff's projections of a 6 percent growth in developing countries in 1992 and 1993. As we emphasize in the document, these estimates--which are almost double the 3 1/4 percent growth in 1991--reflect the sharp rebound of activity in the Middle East. Excluding the Middle East, the developing countries are projected to grow by 4 1/2 percent in 1992, and by 5 percent in 1993. These projections do not represent a notable increase from the 1991 growth of 4 1/4 percent. What is notable is that a 1 1/4 percentage point increase in growth in the developing countries, excluding the Middle East, occurred in 1991 when growth in the industrial countries was decreasing by 1 3/4 percentage points. Of course, as Mr. Wei observed, if growth in the industrial countries had not been stagnant in 1991, growth in the developing countries would have been even more robust.

In Asia, output is projected to grow by 6 1/4 percent in 1992 and 1993--1/2 of 1 percentage point more than in 1991. Given that output in China was recently reported to have expanded at an annual rate of 12 percent in the first half of 1992--which is almost double what it was in 1991 and considerably higher than expected--the distribution of risks in the staff's growth projections for Asia would appear to be, if anything, on the upside. For the Western Hemisphere, growth is expected to be 3 percent in 1992, about the same as in 1991. For 1993, we envisage a growth rate of 4 percent. This increase reflects, in addition to an improved external environment, the beneficial effects of improved policies and increased capital inflows. As Mr. Kafka noted, there are already indications of improved performance in this region.

We share the concern expressed by a number of Directors about developments and prospects in Africa, particularly in sub-Saharan Africa. It is clear that economic performance in several African countries has been restrained by policy slippages, civil disturbances, a serious drought, and debt burdens that are still heavy. For these reasons, growth in Africa in 1992 is projected to be only marginally higher than in 1991. However, as the external environment improves and the drought ends, the outlook for 1993 can reasonably be expected to improve. The data presented in Chapter IV indicate that countries in Africa that have implemented sound policies have grown by an average of 4 percent over the past five years. There is nothing intrinsic to Africa that makes low growth inevitable.

Mr. Peretz noted the absence of an alternative policy slippage scenario for the developing countries. In the past few world economic outlook exercises, we have attempted to indicate roughly what the likely impact of policy slippages would be on the outlook for the developing countries. Because we have no reliable benchmark against which to calibrate policy slippages, the analysis has been based on a variety of more or less arbitrary assumptions. The same assumptions applied to our current baseline will--not surprisingly--give the same estimates for the impact of the policy slippages. For this reason, we thought that it was not necessary to report these scenarios in every edition of the World Economic Outlook, although we did discuss them in the final paragraph of Annex II. We will again report policy slippages scenarios in future world economic outlook documents. Our hope is that this problem will become less important over time as the number of successfully adjusting developing countries increases.

Mr. Dawson and Mr. Torres were skeptical of the projections that world trade would increase by 7 percent in 1993. This projection is based on a projected increase in industrial country import volumes of 5 3/4 percent, implying an income elasticity of demand for non-oil imports of about two. An elasticity of this magnitude is by no means large. In the United States, for example, output has increased by an average of about 1 1/2 percent in the four quarters to the middle of this year, while imports have increased by an average of about 10 percent. Developing country imports are projected to rise by 9 1/2 percent in 1993, about the same rate as in 1991, and only 1 percentage point higher than what is expected in 1992. A projected growth of 7 percent for world trade in 1993, therefore, does not appear to be unusually large.

To conclude, given the pickup in growth expected in industrial countries and the continuing low international interest rates, we do not consider the projections for the developing countries to be overly optimistic. To the extent that they are optimistic, it reflects an optimism that the improved performance that has already been observed will be sustained this year and built upon in 1993. In our view, the projections do not reflect an unwarranted, overly optimistic hope that a heretofore unseen improvement will materialize. The world economic outlook message is that, regardless of the external environment, economic performance in the developing countries--and also in the former centrally planned economies--can be improved by undertaking and persevering with appropriate macroeconomic policies and structural reforms.

Mr. Mirakhor said that, given the considerable share of the Middle East region in the projections of growth for the developing countries, he wondered why the recent drop in world oil prices of nearly $1--not to mention the decline in the value of the dollar itself--had not triggered a downward revision of those projections.

The second staff representative from the Research Department replied that the developing country forecasts had been revised in light of oil prices, exchange rates, and international interest rates in effect in early August 1992, as well as of the most recent projections of growth in industrial countries, which--apart from the latest fiscal policy actions in Japan--had been based on the same cutoff dates. Those factors had tended to cancel one another out, and the growth projected for the developing countries had been revised downward by only one 1/4 of 1 percent.

Mr. Mirakhor said that he wondered whether the income elasticity of demand for non-oil imports into the United States had recently been revised, and, if so, whether it had been incorporated into the projections.

The second staff representative from the Research Department responded that the income elasticity of demand for imports had not been revised for any country, including the United States.

Mr. Peretz observed that the staff's answer to his question had confirmed that a systematically optimistic bias had been built into the developing country forecasts through the assumption of full adherence to Fund-supported programs. Although the reasons for making that assumption were perfectly understandable, the world economic outlook papers should include in the main text--rather than the closing paragraph of Annex II--forecasts adjusted more realistically for possible slippages in policy implementation.

The Economic Counsellor and Director of the Research Department said that three additional points should be considered with respect to the accuracy of the world economic outlook forecasts. First, in analyzing the error that had been made in forecasting growth in the United States, it should be remembered that, in the previous nine postwar recoveries, the average rate of growth in the first year of expansion had been almost 6 percent. The slowest growth rate in the initial year had been about 4 percent. In the summer of 1991, all the leading indicators had indicated that the recovery, although comparatively sluggish, had gotten under way. Accordingly, the world economic outlook team had forecast U.S. growth for the year to be slightly less than 3 percent--lower than any previous initial-year recovery.

Naturally, a forecast that was so far outside the sample was a cause for concern, the Economic Counsellor continued. It reminded him of one of his American Indian ancestors, who had been wandering around the plains looking for his teepee. When asked if he was lost, he had replied, "Me no lost. Teepee lost." Thus, the forecast had been right, but the economy had got it wrong.

Second, the Economic Counsellor remarked, it should be emphasized that the baseline world economic outlook forecasts necessarily abstracted from certain negative contingencies that might affect the global picture. The Fund could not publish a World Economic Outlook in which it was clearly stated that a 50 percent chance of a major financial crisis affecting countries A, B, and C had been incorporated into its baseline scenario. The usual discussion of the downside risks provided reasonable and appropriate qualifications to the baseline forecasts. The upside risks, namely, that economies could overheat, leading to a resurgence of inflation, were also mentioned when they were considered important. In general, it could be said that the policy analyses and recommendations in the world economic outlook documents--as well as in other staff papers--took into account not only the baseline forecasts, but also the perceived risks on both the downside and the upside.

Third, beginning with the informal discussion on exchange rate developments in November 1991 (IS/91/5, 11/20/91), the Research Department staff had repeatedly noted the downside risk that the growth of demand forecast for Japan might turn out to be considerably weaker than expected, the Economic Counsellor and Director of the Research Department recalled. It had been emphasized that, if that risk were to materialize, policy actions in both the fiscal and monetary areas would be appropriate to strengthen prospects for growth. That position had been taken not only by the Research Department, but also by the Fund staff at large, as the staff report for the 1992 Article IV consultation with Japan had demonstrated (SM/92/122, 6/17/92; and Sup. 1, 7/13/92). In fact, the comments made by Mr. Peretz at the Board discussion on that report (EBM/92/88 and 92/89, 7/15/92) had--if he remembered correctly--supported the thrust of the document. Furthermore, it was his understanding that the Managing Director had relayed the same message to senior Japanese policymakers during that period.

The Chairman said that he had indeed underscored that message in his discussions with the Japanese authorities. In March 1992, he had suggested to Mr. Hata, the Minister of Finance, that, if the current forecast did not materialize, it would be useful to adopt a package of stimulus measures, particularly as Japan had created for itself the required room for maneuver. Accordingly, it was somewhat surprising to hear Mr. Landau assert that the Japanese Government had adopted the stimulus package against the advice of the staff.

Mr. Dawson remarked that, as he remembered it, although the downside risk had been identified in both the staff report and the supplement for the Article IV consultation with Japan, the balance of risk had been cast clearly in favor of the existing policy stance. Moreover, as recently as July 30, 1992, the Fund staff had been behind the curve; at that time, it had indicated to him its lack of support for a cut in the discount rate as a means of stimulating growth. In contrast, his chair, as well as a number of others, had argued during the Board discussion that the balance of risk called for the consideration of a more aggressive easing of policy. Over the past couple of years, in fact, his chair and others had cautioned that the balance of risk for the Japanese economy was on the downside; they had been calling for the adoption of a stimulus package for some time before it had been adopted by the authorities at end-August 1992.

The remarks made earlier by the staff about the difficulties involved in economic forecasting were quite accurate, Mr. Dawson continued. However, the frustration--if that was the right word--expressed by Directors in their statements on the previous day (at EBM/92/110 and 92/111, 9/2/92) arose precisely because they--and their finance ministers--were looking for expert guidance from the Fund staff in identifying turning points and planning appropriate policy responses.

The recent staff paper on the economic measures taken by the Japanese Government (EBD/92/193, 9/1/92) had somewhat misleadingly quoted a sentence from the Article IV staff report on the conditions under which an easing of policy might be appropriate, Mr. Dawson added. The supplement, which gave the impression of paraphrasing the staff report's policy advice, had deleted the word "only" from the quotation, thus giving the impression that the staff report had suggested that easing should be considered "if" those conditions were met; in fact, it had said that easing should be considered "only if" those conditions were met.

The Chairman commented that the example cited by Mr. Dawson of a disagreement on the policy stance to be followed by Japan--a possible reduction of the discount rate--pertained to monetary policy. With respect to fiscal policy, the Fund had first spoken to the Japanese authorities in early 1992 about a possible turning point that it had identified; at the same time, it had begun to press the authorities to prepare a stimulus package that could be launched if the economy were to deteriorate further.

Mr. Dawson said that it was understandable that the staff and management might need to maintain some confidentiality in the policy advice that they provided to program and major industrial countries. However, recommendations contained in staff papers should not be at variance with any confidential advice given. In that respect, it was a cause for concern that the Japanese authorities had adopted a policy stance at end-August 1992--apparently at the urging of the staff and management--that had been officially disavowed by the staff as recently as end-July 1992.

Mr. Evans explained that, in the statement he had given on the world economic outlook, he had been concerned with the implications of that forecast for policymakers in the developing and smaller industrial countries. He knew from his own experience as an economic forecaster that a critical problem in that line of work was deciding when and how to announce an official forecast figure that, serious downside risks notwithstanding, was still the best possible projection that could be made at the time. That responsibility was even more serious for the world economic forecasters of the Fund and the OECD, given that the economic policymakers of the developing and smaller industrial countries had to rely very heavily on those forecasts to provide them with an exogenous model of the rest of the world. As those policymakers generally were not in a position to distinguish between, on the one hand, a forecast of world output growth of 3 percent with a downside risk and, on the other, a forecast of 2 percent growth with no downside risk, the Fund had a responsibility to make that adjustment for them. The cumulative effect of a large number of countries accepting the forecast figures at face value without understanding the caveats or risks involved could be significant.

Mr. Peretz stated that his recollection of the July 1992 Board discussion on Japan, including his own statement, was very similar to the Chairman's and the Economic Counsellor's. It had seemed to him that the language used by the staff in both the report and its remarks during the discussion, although coded to a certain extent, had sent a sufficiently clear message to the Japanese authorities. Undoubtedly, the message conveyed in private discussions with the Japanese authorities had been considerably more transparent. In his view, therefore, the stimulus package announced at end-August 1992 did not run counter to the advice that the Fund--and his chair--had given.

Mr. Dawson said that the summing up for the Board's Article IV discussion on Japan (SUR/92/56, 7/27/92) had stated that "most speakers thought that the fiscal policy envisaged for fiscal 1992 was appropriate, including the approach of waiting until the latter part of this year to determine whether further measures were necessary." Perhaps the Chairman, the Economic Counsellor, and Mr. Peretz were right to interpret the phrase "the latter part of the year" to mean four to six weeks from the day of the summing up, but it had not been clear to him at the time that that was the thrust of the message.

The Economic Counsellor and Director of the Research Department remarked that, as the downside risks had not predominated a year previously during the fall 1991 world economic outlook exercise, the staff's forecast for that time could not be called overoptimistic. In fact, his professional, independent judgment--arrived at before he had joined the Fund--was that the U. S. economy, in particular, would grow more quickly than the staff had forecast.

Over the course of that fall, the downside risks had intensified, the Economic Counsellor continued. For that reason, rather than wait until the spring 1992 world economic outlook exercise, he had taken the unusual step of informing the Board at the November 1991 informal discussion on exchange rate developments that the forecast was being revised downward significantly. The Fund, of course, was not unique in that regard; other organizations had also been revising their forecasts downward at that time.

The latest employment information released by the U.S. Government--received after the staff had locked in the official data used to make the forecast--offered further confirmation that the downside risks had to be taken more seriously, the Economic Counsellor considered. However, in order to complete the exercise on time, a cutoff date of approximately one month before the Board discussion had to be set for accepting data from the major industrial countries.

It should also be remembered that there was nothing to preclude a tilting of the balance of risk in the other--upside--direction, the Economic Counsellor and Director of the Research Department added. For whatever reason, when the staff found that its forecast was being driven off track, it could only provide a warning about the direction and, where appropriate, the magnitude of the change to the Board and its Governors.

Mr. Fukui said that, in making the decision to implement a fiscal stimulus package, his authorities had attempted to combine both a "hard" and a "soft" approach to the problem. The hard approach, of course, involved expenditure increases, which would be implemented over the remainder of the current fiscal year. The soft approach entailed the enactment of confidence-building measures to provide support to banks and prop up the stock market.

The Chairman recalled from his conversations earlier in the year with the Japanese authorities that, in order to avoid precipitating or intensifying a possible crisis of confidence, they had sought to avoid premature public discussion of a possible stimulus package.

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

> Concerning the Fund's experience with programs in Eastern Europe and the reform strategy for the formerly centrally planned economies, the Board, as Mr. Mirakhor has wisely noted, will have an opportunity to discuss this subject extensively at the seminar scheduled for Wednesday, September 9, 1992. Nevertheless, two points should perhaps be emphasized. First, Mr. Peretz has rightly pointed out that the decline of the defense industries in the republics of the former Soviet Union has been a particularly important factor in the general output decline of those republics. Second, as a number of Directors have emphasized on several occasions, the Fund staff should be studying carefully the experience of a wide number of other countries in carrying out Fund-supported programs. In fact, the staffs of both the Fund and the World Bank are looking extensively at the experience of a variety of countries with a view to designing better programs. Although there is no magic recipe, all of our experience tends to confirm one key lesson: successful growth and development cannot be built on the

foundation of massive macroeconomic instability. Hence, an emphasis on reasonable macroeconomic stability needs to be an essential part of the effort. Properly, the Fund focuses considerable attention on this important issue.

The policy stance--particularly in the largest economies--provoked much comment and discussion. Mr. Arora has made a very interesting intervention on the problem of declining long-term growth rates. This is a subject intensively researched not only here and in the World Bank, but in the academic community as well. The Deputy Director of the Research Department just attended a conference that focused exclusively on these issues. The concluding remark in his long and eloquent back-to-office report reads:

What are the main lessons for policy? Professor Mankiw provided a concise summary of the secrets to growth. There were four elements: start from behind; save and invest; educate the young; and keep population growth low. Not exactly earthshaking, but difficult to argue with. Professor Stanley Fisher remarked that, although he was no longer quartered on 19th Street in Washington, the message that seemed to come through to him was similar to what he had heard a lot around the IMF and the World Bank: keep your budget deficit and inflation rate low; avoid overvaluation of the exchange rate; integrate into the world economy; invest in human and physical capital; privatize where possible; and remove distortions in goods and factor markets.

If that is so, why do we not see more of these growth-oriented elements in place, and in more places? The answer, on which there was also wide agreement, is that postponing consumption today to invest for tomorrow involves sacrifice, and sacrifice is not always politically popular. As one speaker put it: "Blood, sweat, and tears didn't win an election for Winston Churchill after the war, and thus far hasn't won one for anyone else."

Mr. Evans has asked whether the staff's policy analysis and recommendations would have been affected if its forecast had been a little more accurate 12 months ago. This question is interesting to those who believe, as I do, that economic policy should sometimes be judiciously adjusted in the light of economic prospects and evolving circumstances. Here, I do not mean "fine-tuning," in the sense of a misguided effort to smooth out every bump and wiggle in the pattern of growth of the price level, or an insane effort to expand demand to reach an unattainable objective of very low unemployment. I do mean, however, the sensible adjustment of economic policies to influence output and employment in the direction of their sustainable paths, always with due attention paid to achieving reasonable price stability, and with due regard for the medium- and longer-term requirements of fiscal probity. In other words, I mean precisely macroeconomic policy management efforts like those recently undertaken by the Japanese authorities, which have been warmly endorsed by most members of this Board.

With respect to Japan, suppose that we had forecast a year ago that prospects for Japanese growth at present and in the near future would be as weak as now appears likely. What would have been the implications for Japanese policy? Even with such knowledge, I would not have recommended the adoption of a stimulus package for a supplemental budget in the autumn of 1991. The timing simply would have been wrong. The usefulness of any such package depends not only on what any individual or institution may forecast, but also--and very importantly--on what is generally expected. I think that Mr. Fukui was making this point in terms of the soft approach and the need to maintain confidence. The introduction of a big fiscal stimulus package a year ago would not have made any sense and might well have been counterproductive.

If I had been persuaded at the time of the spring 1992 world economic outlook exercise that the weakness in the Japanese economy would be as great as now seems to be apparent, I would have favored the implementation of part of the recently announced package. It takes time to get these things rolling, and the stimulus should be working when the economy really needs it--not, as Mr. Posthumus has reminded us, after the need has passed and it has become an inflationary embarrassment. I would have moved somewhat earlier if I had been convinced earlier that the slowdown was going to take place. However, we should remember that, in June 1992, first quarter GDP growth was being reported as higher than 3 percent at an annual rate.

As we proceeded into the summer of 1992, I became increasingly persuaded that the downside risks were growing stronger in Japan. If I had been asked at any point in the summer whether fiscal stimuli should be provided in the supplemental budget to be issued in September or October of the year, I would have answered "yes." The evidence was clear enough. However, I would not have felt compelled to act before the normal time for such action, which, given the way in which the Japanese arrange their business, would have been in late August or early September 1992.

When the financial markets in Japan sent a very powerful signal for official action, it was important that the Japanese Government was prepared to step forward and do something. This is part of the art of macroeconomic policy management. I regard it as completely consistent with the advice that we were providing to the Japanese authorities throughout this time period. With regard to future policy advice for Japan, I would not recommend further action at present. However, I would advise that risks remain, and that one needs to maintain an open mind toward the possibility of further policy action on either the monetary or fiscal front. Comparing the decline in asset values and the problems in the financial system in Japan with similar problems faced by other countries over the past two or three years, I would tend to say that the risks are on the downside. However, in the six months before the April 1993 budget needs to be determined, more information will be forthcoming, and monetary policy remains as a tool to be used in the interim.

In the United States, the Federal Reserve has cut the federal funds rate by more than 2 percentage points during the past year, and by about 5 percentage points over the past two years. One year ago, I recall, several Directors opined that, if anything, monetary easing had already gone too far, and that more emphasis should be placed on bringing about further reductions in inflation. The forecast at that time was for a sluggish U.S. recovery in 1992--with a growth rate of just under 3 percent--and for inflation at an annual rate of slightly more than 3 percent. As events developed, growth has run at about half of the forecast rate. I would guess that, without the assistance provided by further interest rate reductions, growth would have been barely positive, if not slightly negative. Accordingly, because I believe that output and employment are important concerns of economic policy, and that driving the inflation rate below 2 percent as rapidly as possible is not the only legitimate goal of monetary policy, I strongly endorse the staff's view that the Federal Reserve's actions over the past two years have been broadly appropriate in light of evolving economic conditions and prospects.

What if, one year ago, we had correctly forecast the actual sluggishness of the U.S. economy? For monetary policy, a somewhat earlier and more rapid reduction of official interest rates would probably have been appropriate. However, a monetary policy conducted through the use of an interest rate instrument cannot get too far in front of market expectations. An effort to drive short-term interest rates downward aggressively, if based solely on the idiosyncratic expectations of a very weak economy--regardless of whether those expectations are later proved correct--can easily become counterproductive when the market's expectations are for stronger growth. Thus, all things considered, I believe that the Federal Reserve made approximately the right moves at approximately the right time in order to give support to a weak economy.

It is too bad that the Federal Reserve has not provided somewhat more support, and perhaps a bit more action would have been useful if we had had a somewhat better forecast. However, as I indicated in my opening remarks, I doubt that there is much room for further easing at present. This is not because monetary policy should not be used to support a weak recovery when inflation appears to be contained--these three years will have the lowest rates that we have seen since the mid-1960s--but because of the concern that further easing could provoke counterproductive reactions in financial markets.

For U.S. fiscal policy, no alteration of the staff's recommendation would have been appropriate even if the recent sluggishness of the U.S. economy had been correctly forecast. I am not talking about the return of the Great Depression here. Concerns about medium-term objectives and the credibility of fiscal policy have removed fiscal actions from the arsenal of useful policy tools in the present economic situation. That, I think, is the heritage of a policy mistake that was made and, indeed, forecast in the mid- and late-1980s. The lesson is to consolidate fiscally while the economy is expanding reasonably rapidly; growth may be slowed somewhat, but really big problems are not created. Looking forward, the same point could be expressed in the advice to move to tighten fiscal policy, which is necessary in the medium term, as soon as the recovery seems to be more firmly established.

With respect to Canada, its authorities should be congratulated--along with those of New Zealand--for achieving such a low inflation rate. However, it might reasonably be asked whether an 11 1/2 percent unemployment rate, even if coupled with an inflation rate of 1 percent, should be an object of universal adulation. Perhaps if the Federal Reserve had held U.S. official interest rates at the levels of two years ago, or even one year ago, the United States would be in the same economic situation as Canada; that country, in turn, would probably have had an even lower inflation rate and an unemployment rate of 13-15 percent. In this situation, one might also ask how Latin America might be doing. Would not many of us share Mr. Kafka's skepticism in those circumstances about the sureness and firmness of the resolution of the debt crisis?

Turning to Europe, I would agree that, as Mr. Fukui and other Directors emphasized, the present situation is difficult, and that prospects for growth in the near term do not seem buoyant. As this situation is well described in the world economic outlook document and well understood by the Board, I need not summarize it. Except for the United Kingdom, however, the forecasts for growth in 1991/92 do not appear to be exceptionally off the mark from what was forecast one year or six months ago. Reflecting, therefore, on Mr. Evans's question, it is unclear to me that a more accurate forecast one year ago should have had a significant effect on policy recommendations. However, even with the same forecast, it probably would have been appropriate one year ago to place greater emphasis on the desirability of fiscal consolidation in Germany and, hence, on the desirability of a better balance between fiscal and monetary policies. This was done in the spring 1992 world economic outlook exercise and, as I recall, generated a good deal of controversy in the Board discussion (EBM/92/46 and 92/47, 4/6/92). Somehow, the same recommendation in the current world economic outlook document has been broadly accepted as wise policy advice; I am pleased.

If we apply Mr. Evans's question to the world economic outlook exercise of one-and-a-half years ago or, especially, that of two years ago--conveniently before my time--the answer changes. Recall, however, that the focus of attention on those occasions was, first, the effects of the Iraqi invasion of Kuwait and, subsequently, the aftermath of the Middle East war and the prospect of recovery from the recession in the United States and elsewhere. Nevertheless, the upsurge of inflation in Germany that we have recently been seeing was a forecastable consequence of the fiscal and monetary policies carried out in conjunction with the unification of that country. So, too, was the subsequent tightening of German monetary policy, the rise in German and other European interest rates, and the general appreciation of European currencies, although not the particular weakness of the U.S. dollar.

What should have been the policy recommendations one-and-a-half or two years ago? For Germany, I think, the answer would have been less fiscal expansion, more up-front paying of the cost, and a tighter stance of monetary policy. Indeed, if I were to criticize Bundesbank policy--and I understand that this was a point made by Mr. Végh in the most recent Article IV consultation discussion on Germany (EBM/91/120, 9/11/91)--it would be that it had not tightened the money supply quickly enough. An earlier strong message to private market participants might well have kept the level to which interest rates needed to be pushed significantly lower than it actually has been. Now, I might note that many economists at the time--1990 and 1991--were forecasting these difficulties, and even our somewhat maligned MULTIMOD model pointed to some of these potential difficulties. So, I think that there have been occasions on which mistakes have been made.

What about policy recommendations for other countries? For the United Kingdom and Sweden, one might reasonably ask what was the right time and the right rate at which to peg. If one knew in 1990 what one knows now, would one have made the same decision--not about whether to peg, but about the appropriate timing and rate? In this context, I want to emphasize that this is a very different question from that of what to do now, when the sterling peg is the central pillar of economic policy in the United Kingdom. I agree entirely with Mr. Peretz that the cost to credibility of altering the peg at this stage would be extremely large.

What, now, about German monetary policy? First, I agree with the comments of several Directors that a primary focus on the growth rate of M3 should not be the guiding factor behind German monetary policy. By every other standard, German monetary policy is quite tight. I have no doubt that, at the present level of the Lombard rate, the German inflation rate will be brought down over time, particularly if we focus on western Germany, and if we avoid being pushed off track by movements in indirect tax rates.

Should monetary policy be looser now? This is an issue in the art--not the science--of monetary policy management. Personally, I agree with Mr. Esdar that the time is not quite right yet. However, I think that I am somewhat more optimistic than he about when and by how much monetary policy can be relaxed. I would emphasize that, if we have a policy horizon that is a little longer than our nose, the issue is not shaving 25 or 50 basis points off the Lombard rate in the next three months; the issue is getting German interest rates down 2 or 3 percentage points. A fall in the German inflation rate to about 2 percent would allow for the reduction of nominal and real short-term interest rates to levels of 6-6.5 percent and 4 percent, respectively--which would still be fairly high. The sooner these rates can be achieved, the better.

The history of interest rate movements suggests that, once rates start to fall, they tend to come down more rapidly than expected, perhaps because the linear statistical models used to describe the behavior of the economic aggregates do not take into account phase shifts and break points. As a result, these movements are extraordinarily difficult to forecast. Nevertheless, we anticipate that the Bundesbank will be paying very careful attention to economic developments in order to determine when it can begin to ease its policies substantially.

We have indicated our policy recommendations for other countries. Unfortunately, I do not see much latitude for policy action by other European countries.

The fifth, and final, general issue raised by many members of the Board that requires some comment is the meaning and usefulness of the model-based simulations of the effects of economic policies. The staff regularly prepares these simulations, which occasionally appear in the world economic outlook documents and other papers presented in the Board. Even before the Board's comments on Annex III, "Macroeconomic Effects of Convergence in the European Community," I had suggested that the Research Department would have no problem with the idea of deferring the publication of this annex. The Board should have full opportunity to discuss and comment on the staff's professional analysis of these important issues; moreover, on politically sensitive questions, it is always prudent to be careful about publishing results that might easily be misinterpreted. As is often the case in such matters, discretion is indeed the better part of valor.

I would also emphasize that, just as a forecast is not a fact, a simulation is not always an accurate representation of a probable reality. Thus, much of the caution expressed by Directors about placing too much faith in the results of simulation exercises is justified. There are always legitimate questions about the structure and properties of the analytical model, and about the assumed baseline for a particular simulation. The latter issue, as one of my colleagues will shortly explain, is particularly difficult and troublesome with respect to the attempt to assess the effects of economic policies adopted to achieve the convergence requirements of EMU--although much less so for the case of U.S. fiscal consolidation.

In order to make a main and very important point, I want to draw on my broader academic experience, specifically, my former role as the elected spokesman for the entire faculty of the University of Chicago. In this role, I had ample opportunity to interact with my colleagues in the hard sciences, in particular, the biological sciences. In these experimental sciences, there is a standard scientific methodology that has been adopted because we have learned a fundamental lesson about what needs to be done. In any experiment involving human subjects, it is essential to employ a double-blind experimental protocol. Neither the experimenter nor the subject is told which particular subjects are receiving the treatment being tested and which are receiving an inactive placebo. Experience indicates that this double-blind procedure is essential to guard against the bias that, through whatever mechanism, generally seems to appear when either the experimenter or the subjects know who is supposed to benefit from the treatment and who is not getting the treatment. Moreover, in experiments using laboratory animals, sound experimental procedure is always single-blind. By using random assignment of treatment and placebo, the experimenter does not know until the experiment is finished which rats, cats, or monkeys received the treatment and which received the placebo. I emphasize that these safeguards against confirming one's own prejudices are rigorously and regularly employed in circumstances in which ideological commitments may be less prevalent and less strong than in issues of political economy, such as generally confront the Fund.

In order to do our work, we need to have a professional, defendable, analytical basis for the advice that we offer. We need a way of disciplining ourselves so as not to provide an unrealistic assessment. We do this in a variety of ways, including, as my colleague described, through the regular assessment of the accuracy and bias of our forecasts, as well as through the use of simulation models. The effort in these models is to capture the main macroeconomic equations that economists generally believe best characterize the behavior of economies, and to calibrate their parameters as consistently as possible with the reality that we are seeking to model.

There are many models available, of which MULTIMOD--used here at the Fund--is one of the most highly regarded. One of its special, although no longer unique, features is its inclusion of forward-looking expectations. Agents' expectations of future interest rates--and, hence, long-term interest rates today--depend not only on current government policy, but also on government policy as implemented over the next three years. As a consequence of this property, MULTIMOD has significantly smaller fiscal multipliers than most simulation models. In turn, an expansionary fiscal policy produces less of an upward bang on output for a shorter period of time in MULTIMOD than in most other models.

Similarly, in MULTIMOD, a contractionary fiscal policy results in a smaller depression of output for a shorter period of time than in virtually all other models. With a permanent tightening of fiscal policy, interest rates fall today in expectation of the policy that will be implemented tomorrow. However--and to answer a question raised by Mr. Peretz--the investors' forward-looking expectations help to limit the decline in interest rates taking place at the beginning of a fiscal contraction, as these expectations lead to an increase in investment by economic agents. In the same way, the rise in investment prevents the decline in output from being larger than it would otherwise be.

Despite these relatively small fiscal multipliers, the Research Department's MULTIMOD-based analysis of the effects of fiscal contraction in the United States shows more contraction in output than described in the staff report for the Article IV consultation with the United States (SM/92/149, 8/3/92). The confidence-building effects are already incorporated in our model through its forward-looking expectations. Indeed, it is a cause for concern whether those confidence-building effects are really going to take effect because, as the great American humorist Mark Twain observed, "it's tough to build a reputation on what you are going to do." Policies must actually be implemented for a period of time before people will be persuaded of their permanency.

The first staff representative from the Research Department made the following statement:

Many Directors were also critical of the staff's simulations of the effects of convergence in the EC. In this respect, they echoed similar concerns expressed earlier in the week regarding deficit-reducing fiscal measures in the United States (at EBM/92/108 and 92/109, 8/31/92). Somewhat simplified, Directors seem to be asking how something unfavorable could result from measures meant to correct fundamental imbalances and improve economic performance.

As stated by the staff at that time, the fiscal multiplier properties of MULTIMOD are unexceptional; if anything, the impact of a fiscal policy tightening is more favorable than in most other models because of the forward-looking character of MULTIMOD. Rather than the properties of the model, then, the main reason for Directors' concern can probably be traced to the growth path in the baseline from which the simulations are performed, which is the standard medium-term reference scenario usually presented in the world economic outlook documents. This reference scenario displays fairly stable and sustained growth over the medium term. It might be argued that such a sanguine baseline projection over the medium term is somewhat optimistic, given the persistence in some countries of large financial imbalances, which sooner or later might result in a crisis that could cause growth to falter. As should be clear from the analysis, the staff would tend to share this view.

In preparing the forecast, however, the staff assumes stable financial conditions--a convention that has always been accepted by the Board as the only feasible assumption that can be made, given the technical difficulty of forecasting financial market developments, particularly their timing, and the danger--expressed by many Directors in the past--that such projections might influence financial markets. Given these constraints, the staff interprets the simulations of fiscal consolidation--be it in the United States or Italy--in the following way. Compared with past growth trends, or with potential output, there will necessarily be some short-term pain as the large fiscal imbalances are corrected. In that sense, a temporary reduction of growth relative to potential should not be viewed as the costs of adjustment, but rather as the costs of the failure to reduce the fiscal imbalances at an earlier stage.

If, instead of a comparison of the simulations with the standard baseline, Directors have in mind a possible alternative worst-case scenario embodying the effects of a financial crisis that eventually may occur as debt continues to build up, it is indeed appropriate to argue that an adjustment scenario should show much more favorable effects. While trying to qualify such effects would be difficult and highly controversial, the staff has stated repeatedly--in the case of Italy, for example--that it would be highly unlikely that growth could be maintained at an acceptable pace in the absence of greater efforts to reduce the budget deficit and the high level of public debt. Indeed, properly interpreted, the scenarios strongly support the notion that the convergence process leading to EMU will be beneficial for Europe's economic performance--in contrast to the concern expressed by Mr. Filosa that the staff's analysis would be interpreted as evidence against convergence.

It may also seem relevant to look at the experience of those EC countries that have already made substantial progress toward convergence, such as France, Ireland, and Denmark. In all three cases, the convergence process has involved some short-term pain, which was nevertheless considered necessary and beneficial in the longer run.

Finally, in response to Mr. Torres's suggestion that the world economic outlook document gave too much prominence to the fiscal imbalances, it should be emphasized that the staff is aware that all the convergence criteria are equally important. However, the analysis draws a distinction between policy instruments and targets, and the results clearly suggest that fiscal performance is the key constraint in most cases. In the case of Spain, it is recognized that structural reforms and greater labor market flexibility will also be necessary to complement the fiscal efforts.

Structural reforms will also be important in other countries to help reduce unemployment and ensure an adequate degree of flexibility in labor markets, in accordance with the requirements of a monetary union. It is, therefore, surprising that structural issues are hardly addressed in the Maastricht Treaty. In contrast, structural issues do figure prominently in the convergence programs that are being submitted by individual countries for endorsement by the Economic and Financial Council of Ministers.

Mr. Filosa said that the effects of convergence presented in Annex III of the world economic outlook document were theoretically incorrect and politically dangerous because the baseline scenario--the assumption that the authorities could and would follow a strategy of nonadjustment--did not incorporate the concept of forward-looking expectations. As the Economic Counsellor had just explained in a somewhat different context, there was no theoretical basis--particularly in the case of Italy--for assuming that the markets would not react to the nonadjustment of government policies by raising interest rates. In reality, therefore, adoption of the baseline scenario would produce the worst possible results for an EC country, including in terms of GDP growth; understanding that situation, that country's authorities would have no choice but to follow one or another of the convergence scenarios.

Naturally, fiscal adjustment would produce a lower income path, but--among the European countries, at least--that was not perceived to be a problem, Mr. Filosa continued. Although actual GDP growth would lag behind potential GDP growth by 1-1.5 percent for a couple of years, the authorities in those countries understood that much larger benefits would be reaped in the long term. For precisely that reason, the Bank of Italy had refrained from publishing the results of a scenario incorporating the same assumptions used in the world economic outlook's baseline scenario: they realized that it would be highly misleading to publicize the macroeconomic effects produced by such an unlikely scenario.

Policymakers--not only in the EC, but in all program countries--had to ask themselves whether the costs of adjustment outweighed the costs of nonadjustment, Mr. Filosa considered. Dissemination of the results obtained under the baseline scenario in Annex III would furnish policymakers with the wrong information and serve to undermine the rationale for adjustment.

It should also be emphasized that different convergence effects would be obtained depending on which combination of measures were used to reduce the fiscal deficit, Mr. Filosa observed. If convergence were attained only through the implementation of expenditure-cutting measures, for example, the fiscal multipliers would be much larger than would result from the enactment of a policy mix including measures that also affected disposable income.

Mr. Peretz said that, like the baseline scenario used in the EC convergence simulations presented in Annex III, the baseline scenario assumed for the United States in the world economic outlook exercise was probably overoptimistic. In both cases--and contrary to the results obtained under the baseline scenarios--the markets would respond with unprecedented severity if the governments involved failed to take appropriate action to reduce their excessively large budget deficits.

In light of the decision made not to publish Annex III as part of the World Economic Outlook, Mr. Peretz considered, it would be sensible to delete all references to it in the main text.

Finally, the staff had rightly and interestingly discussed the conduct of monetary policy as an art and not a science, Mr. Peretz noted. In that context, it would be interesting to hear its assessment of the preceding meeting's discussion on the rapid growth of M3 in Germany. Perhaps the staff could also do some additional research on that issue, given its topicality.

The Chairman said that the staff was preparing an extensive analysis of the growth of M3 in conjunction with the Article IV consultation discussions with the German authorities that were taking place in Frankfurt.

The main world economic outlook text would be amended to reflect the deletion of Annex III, the Chairman added.

The Economic Counsellor and Director of the Research Department commented that, with respect to the realism of the baseline scenario used for the United States in the world economic outlook exercise, a comparison of long-term interest rates in that country with those in Germany or France did not point to the likelihood of a fiscal crisis in the short term. However, if U.S. fiscal policy were to continue unchanged into the medium term, a crisis of the proportions currently facing Italy would be certain to develop.

Mr. Végh said that the issue raised by Mr. Filosa was relevant not only to those countries in the process of converging to the Maastricht criteria, but also to every country attempting to implement an adjustment program. It was difficult for technocrats in developing countries such as himself, who believed in the necessity of adjustment, to convince politicians and the public in general of the unsustainability of nonadjustment: if the general public, knowing that adjustment would be painful, had reason to believe that the present situation was sustainable, it would naturally be reluctant to adjust. Some of his technocratic brethren had suggested that, in those circumstances, a total collapse of the economic system--which would at least enable the needed adjustment to take place--might be the best solution to the problem.

Mr. Prader noted that, in his introductory remarks on the world economic outlook, the Economic Counsellor had referred to the need for, and usefulness of, policy coordination among the major industrial countries. However, the ensuing discussion had made it worrisomely clear that the Directors representing those countries disagreed not only on the policies that should be followed, but even on the analysis of the current situation.

Mr. Evans suggested that the world economic outlook text might benefit from the inclusion of some of the Economic Counsellor's remarks, particularly those on general issues.

His reference to the low inflation rate in New Zealand, which had drawn a response from the Economic Counsellor, had not been intended as an endorsement of that country's financial policies, but merely as a factual correction, Mr. Evans added.

Mr. Filosa said that he supported Mr. Peretz's suggestion to delete from the main text of the world economic outlook all references to the macroeconomic consequences of achieving the Maastricht criteria described in Annex III.

The fundamental objective of the Maastricht process was to enable participating countries--especially those in his own constituency--to eliminate divergences in policy orientation and achieve the agreed convergence criteria by 1996, Mr. Filosa recalled. In examining the macroeconomic effects of convergence--as the Fund staff had done in Annex III--it was, therefore, particularly important that the baseline scenarios should present a plausible picture of the results of nonadjustment. However, by incorporating the same assumptions in the baseline scenario for Italy as for France and Germany, the Fund seemed to be displaying a lack of understanding of the fundamental rationale for Maastricht, fiscal convergence, and, in fact, bilateral and multilateral surveillance in those countries.

The Chairman replied that, as a matter of course, the world economic outlook documents would be revised--through either amendment or deletion, as necessary--to reflect the points made by the Executive Directors during the discussion, including on the effects of convergence on the EC countries.

Mr. Esdar emphasized that he had omitted from his statement a reference to Annex III, in accordance with the Chairman's suggestion that that issue be reserved for discussion at the upcoming seminar on policy issues and implications for Fund surveillance of the EMU in Europe. Nevertheless, he wished to go on record as strongly supporting the position taken by Mr. Filosa and Mr. Peretz. The simulation model employed in that annex was not only inaccurate but also highly sensitive politically.

Mr. Solheim said that, although the staff had convincingly defended its forecast for industrial countries, the outcome of the ongoing balance sheet restructuring was a major cause for concern. Unlike the staff papers, which had given the impression that that process was almost complete in a number of countries, he--perhaps unduly influenced by the experience of the countries in his own constituency--felt that the effects of balance sheet restructuring could still negatively influence the prospects for world economic growth.

In addition, he wondered whether the staff could comment on the need for coordinated policy action alluded to by Mr. Prader.

Mr. Arora noted that, in responding to his question about the declining trend in long-term growth rates, the Economic Counsellor had cited four key elements needed to reverse that trend. He had no disagreement with that analysis; however, he was more interested in hearing the staff's theories on the reasons for that long-term decline in growth.

The Economic Counsellor and Director of the Research Department observed that, with respect to the possibility for concerted policy action, the principal task facing the authorities at present was to conclude successfully the Uruguay Round. There seemed to be little else that could be done to coordinate macroeconomic policymaking, other than to avoid making waves unnecessarily.

The full report of the Deputy Director of the Research Department--from which he had quoted only one paragraph--would help to answer Mr. Arora's question, the Economic Counsellor and Director of the Research Department considered. The volume of literature on that topic was enormous and growing rapidly.

Mr. Posthumus commented that he agreed very much with Mr. Végh on the political dangers posed by the use of baseline and convergence scenarios, such as those described in Annex III. The effect of the presentation of those scenarios on policymaking was an issue that was relevant not only for the European countries involved in the Maastricht process, but also for the United States, as had become apparent in the Board's recent Article IV consultation discussion on that country.

The Chairman said that he agreed fully with Mr. Posthumus. It would clearly be useful if the Board could find the time to hold a seminar on that topic, in which views could be exchanged on the optimum use of simulation models. Such a seminar would enhance future Board discussions on the world economic outlook, as well as on Article IV consultations for individual countries.

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/92/111 (9/2/92) and EBM/92/112 (9/4/92).

2. GUINEA-BISSAU, MALAWI, AND MARSHALL ISLANDS - ARTICLE IV CONSULTATIONS - POSTPONEMENT

Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance Over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, as amended, the Executive Board extends the period for completing the next Article IV consultation with Guinea-Bissau, Malawi, and the Marshall Islands to the dates indicated in EBD/92/192 (8/31/92).

Decision No. 10122-(92/112), adopted
September 4, 1992

3. 1992 ANNUAL MEETINGS - OBSERVERS

The Executive Board approves the proposal to invite no observers to attend the 1992 Annual Meetings of the Boards of Governors of the Fund and the Bank, as set forth in EBD/92/188 (8/28/92).

Adopted September 3, 1992

4. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 92/18 through 92/21 are approved.

5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAM/92/74 (9/1/92) and EBAM/92/75 (9/2/92) is approved.

6. TRAVEL BY MANAGING DIRECTOR

Travel by the Managing Director as set forth in EBAP/92/137 (9/3/92) is approved.

APPROVED: May 25, 1993

LEO VAN HOUTVEN
Secretary