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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 88/5

10:00 a.m., January 13, 1988

M. Camdessus, Chairman

Executive Directors	Alternate Executive Directors
A. Abdallah	E. T. El Kogali
Dai Q.	
	D. C. Templeman, Temporary
J. de Groote	J. Prader
A. Donoso	
M. Finaish	
G. Grosche	B. Goos
J. E. Ismael	J. Reddy
	J. Hospedales
T. P. Lankester	
M. Massé	D. McCormack
Mawakani Samba	
Y. A. Nimatallah	I. A. Al-Assaf
	L. Filardo
J. Ovi	M. Fogelholm
H. Ploix	D. Marcel
G. A. Posthumus	G. P. J. Hogeweg
C. R. Rye	C.-Y. Lim
G. Salehkhou	O. Kabbaj
A. K. Sengupta	L. E. N. Fernando
K. Yamazaki	S. Yoshikuni
S. Zecchini	

L. Van Houtven, Secretary and Counsellor
M. Primorac, Assistant

Also Present

African Department: R. C. Williams. Asian Department: D. A. Lipton, J. R. Márquez-Ruarte. European Department: M. Russo, Director; M. Guitián, Deputy Director. Exchange and Trade Relations Department: L. A. Whittome, Counsellor and Director; G. Bélanger. External Relations Department: P. C. Hole, J. M. Landell-Mills. Fiscal Affairs Department: V. Tanzi, Director; G. M. Bartoli. IMF Institute: O. B. Makalou. Legal Department: T. M. C. Asser, J. V. Surr. Middle Eastern Department: S. von Post. Research Department: J. A. Frenkel, Economic Counsellor and Director; A. D. Crockett, Deputy Director; M. Goldstein, Deputy Director; F. C. Adams, J. M. Boughton, N. R. Chrimes, M. P. Dooley, J. H. Feldman, E. Hernández-Catá, F. Larsen, P. R. Masson, D. J. Mathieson, B. E. Rourke, M. Schulze-Ghattas, M. A. Wattleworth. Secretary's Department: C. Brachet, Deputy Secretary. Treasurer's Department: M. N. Bhuiyan, P. B. Clark. Western Hemisphere Department: S. T. Beza, Director; Y. Horiguchi. Personal Assistant to the Managing Director: H. G. O. Simpson. Advisors to Executive Directors: A. A. Agah, M. B. Chatah, A. G. A. Faria, G. D. Hodgson, Khong K. N., J.-C. Obame, A. Ouanes, P. Péroz, P. Péterfalvy, A. Vasudevan, J. E. Zeas. Assistants to Executive Directors: N. Adachi, J. R. N. Almeida, E. C. Demaestri, F. El Fiky, W. N. Engert, S. K. Fayyad, V. J. Fernández, P. Gorjestani, M. A. Hammoudi, C. L. Haynes, L. Hubloue, A. Iljas, S. King, K. Kpetigo, V. K. Malhotra, C. Noriega, L. M. Piantini, S. Rebecchini, A. Rieffel, G. Schurr, Yang W., I. Zaidi.

1. WORLD ECONOMIC OUTLOOK - PROSPECTS AND POLICY ISSUES - PRELIMINARY ASSESSMENT

The Executive Directors considered a staff paper on the preliminary assessment of economic prospects and policy issues related to the world economic outlook (EBS/88/1, 1/6/88).

Mr. Posthumus made the following statement:

Today's discussion on the world economic outlook should be welcomed because the Fund should continue to be the forum in which members try to indicate the significance for the world economy of individual countries' policies, whether taken in cooperation with each other or not. Such discussions should also serve to continue to review the functioning of the international monetary system, and to detect and analyze emerging ideas on amendments or changes in its functioning. There is a growing realization that international financial flows increasingly influence exchange rates. While financial flows will never be totally out of touch with economic realities in countries, sectors, and industries, it is quite possible that the connection may be very thin and that, in fact, changes in exchange rates brought about by financial flows may influence export and import flows. The Annual Meeting of September 1987 produced a strong impression that there is now much more interest in stabilization of exchange rates. Since then, we witnessed a spectacular and continuing soft landing of the dollar, but this event may stimulate such interest even more. A recent OECD report which tried to analyze the circumstances under which policy changes are brought about said that in almost all the episodes considered it was exchange rate pressure that brought matters to a head and determined the timing of the introduction of comprehensive policy measures. So perhaps we are approaching that stage now.

This introduction leads me to the topics which the staff has suggested as a focus for interventions. A first issue is the realism of the projections. I can accept the broad lines of the projections, because I realize that it is not possible to make projections any other way or, as the OECD report notes "...it is anyway rare for a forecast to depict a disastrously worsening outcome." The factors that will bring about a change in the outcome in reality are considered constant in the projection, and, therefore, I think the projections are not realistic. The issue, however, is whether the projections can be made realistic by policy changes and how these policy changes can be brought about.

The second topic is policy requirements in industrial countries. Here the discussion can take place on two levels. One level is the discussion about policy requirements in individual countries; I reread the summings up of the Article IV consultations with the major industrial countries in 1987, and I think that those consultations indicate in a balanced way what should be done by the countries concerned. It is noteworthy that this Board in general supports a medium-term orientation of fiscal and financial policies, though short-term oriented fiscal policy advice was not absent in some consultations.

The other level of policy discussion is the level of cooperative policymaking. I assume that cooperating countries would not carry out such policies to the same extent or in the same way if they were not cooperating; that such policies are not actually detrimental to the individual countries (which means that there is a limit to the extent to which it is reasonable or desirable to ask them to postpone pursuit of their medium-term fiscal objectives, as the staff puts it); and that cooperation does not mean substitution of policies to put your own house in order by policies to push other countries into unsustainable policies. Thus, cooperation is mainly, and this is important enough, an effort to harmonize policy action, to speed up international adjustment.

As regards fiscal policy, it is realistic to assume that U.S. policy will not change substantially in this election year, and probably not much next year either. I assume that the same holds for Europe, Germany in particular, but because of economic not political reasons. In my opinion the room for maneuver which Germany had in fiscal policy is certainly now depleted. And for Europe in general, I think that larger fiscal deficits tend to lead to price increases more than to production increases, considering the substantial rigidities in most markets. There is a further specific reason to caution against undue international pressure for fiscal and for monetary stimulation in Germany, and that is the role of the deutsche mark in the European Monetary System (EMS). The EMS is an effort to achieve exchange-rate, and, therefore, macroeconomic, stabilization in Europe which has as its anchor the deutsche mark. A drifting anchor would put the system in jeopardy. Continued success of the EMS is a necessary condition for further cooperation in Europe, in particular for efforts to increase intra-European trade and investment and thus growth.

U.S. fiscal and economic policies over the past couple of years have, directly or indirectly, supported exports from Europe and from the developing countries. European countries have not sufficiently used this demand support to diminish rigidities in markets, regulations of economic activity, or subsidies to uneconomic activities. The developing countries seem also not to have used this opportunity for growth sufficiently. This is deplorable because it is to be expected that adjustment in the United States will lead to at least some slowdown of growth.

On exchange rate management I can be brief. Stable exchange rates, once established, give guidance to macroeconomic policy, which then is again the basic policy to maintain the stable exchange rate. Monetary policy, including interest rate policy, as well as fiscal policy are the main elements of this macroeconomic policy. In the absence of stable exchange rates, in other words in the present reality, the focus should probably be on macroeconomic adjustment policies until external disequilibria have decreased substantially. Still, efforts might be made to slow down the depreciation of the dollar through both intervention and interest rate increases in the United States and decreases in Europe. Thus, the interest rate differentials would increase. The Netherlands has over the past few months repeatedly, and again last week, decreased its official rates; it was able to do so because of the strong position of the guilder. In the EMS last year, interest policy cooperation also helped to maintain stability in the system. While intervention can only be very temporary, and should not be sterilized, interest rate differentials can be of a longer-term character. It cannot be true that an increase of short-term interest rates in the United States would necessarily and unavoidably lead to a recession. As the experience in the EMS shows, monetary policy, which means also interest rate policy, is one, but not the only, instrument to support exchange rate stability.

What can the Fund do, and what role can it play? There are several possible contributions. First is analysis. It is extremely useful to try, through broader discussions, to widen the scope of debates, which tend to become narrower as they progress. One sometimes gets the impression that the world will be saved by either a substantial decrease of the U.S. fiscal deficit, or a substantial increase of the German fiscal deficit (Japan has already done this, it seems). Furthermore, an increase of interest rates to help defend the stabilization of the exchange rate--but of course not only that--is perceived as a recipe for recession by some, rather than as a means to stabilize the value of the currency, both internal and external. All policy instruments should, within limits, continue to be available. I would urge Executive Directors from G-7 countries to join in these discussions, because their contribution cannot be missed in this institution and it may even be helpful for G-7 cooperation.

A second possible contribution is advice, through Article IV consultations, but also through special consultations, if they are considered desirable from an international point of view.

Third would be peer pressure from the international community, pressure which can only be directed at the larger economies whose behaviour matters to the international community. This will not be particularly attractive for the countries concerned, but it is clearly one of the purposes of international cooperation.

Finally, permanent review of the working of the international monetary system would be a useful contribution, as I indicated before. In fact, it might be useful if the Board could consider asking the staff to start work on possible stable exchange rate mechanisms. For example: would the introduction of several regional stabilization schemes like the EMS be compatible? What are the financial and economic conditions in which a decision to stabilize and support exchange rates can be made? Is it desirable to peg the exchange rates of countries or groups of countries to the SDR? Have international disequilibria been worse during the period of floating rates than during the fixed exchange rate regime? We should not create the impression that we decide and act first, and think later. This institution can help further thinking on the international monetary system; it can also prepare the ground if groups like the G-10 and the G-24 countries decide to review the monetary system again; whether and where decisions are made comes later.

Extending his remarks, Mr. Posthumus said that, in making his fourth suggestion--that a permanent review of the working of the international monetary system take place--he was not proposing a major undertaking. Rather, the Board should discuss, on a regular basis, the working of that system, creating the groundwork necessary if it were decided to move closer toward stable exchange rates.

The Chairman recalled that he had made suggestions to that end at the 1987 Annual Meetings, and intended to pursue some of those ideas in the near future.

Mr. Nimatallah made the following statement:

The reasons we are holding this mini-world economic outlook discussion is to assess the causes and impact of the October stock market crash. Apparently, the causes are complex, with some related to the need for correcting an exaggerated buoyancy in the market, others to a lack of action and coordination by the Governments of the G-7 countries to reduce fiscal and payments imbalances, and yet others to the technical functioning of the markets, its computer networks, and regulations.

It appears that some correction has been made in the stock prices, but perhaps not all that is necessary, and it seems that the G-7 authorities have been prompted, for the time being, to take more action on adjustment and avoidance of a recession. Moreover, there is a movement toward improving the technical functioning of the stock and other financial markets.

The question of the impact of this crisis has been addressed by the staff in EBS/88/1, in assessing whether the crash will lead to a recession or just to a slowdown in growth. The staff avoided the discussion of the causes of the October crisis, but maybe it could address the topic briefly at the end of today's meeting. I will now give my views on the topics highlighted by the staff.

I am in general agreement with the staff projections on growth. In the United States, the stock market crash may have convinced a certain segment of consumers to spend less. However, in light of the new tax system, expenditure by business might tend to increase the need to strengthen the export sector and expand productive capacity, in general. On the other hand, in the other industrial countries, Japan and Germany in particular, it is expected that consumption expenditure will increase as a result of the authorities' efforts to accelerate aggregate demand there. The authorities in those countries also expect that the overall impact of the October stock market developments on investment expenditure will be minimal, possibly even leading to an increase in investment expenditure.

I also agree with the staff projections on the developing countries, although I am probably more optimistic, as I expect a growth rate of up to 4 percent. I think that adjustment is taking hold now in several countries in Asia, the Middle East, and certain countries in the Western Hemisphere and Africa. Some of the oil producing countries, like Saudi Arabia, are already experiencing some growth after a few years of negative growth. Furthermore, China is expected to grow at a rate of 10 percent in 1988, as it did in 1987. I also think that the highly indebted countries have a chance to improve the quality of their adjustment and experience more growth. I can only encourage developing countries to sustain their adjustment efforts without interruption, and to increase their trade among each other.

There is no doubt that payments imbalances will linger on for several years to come. I am convinced, however, that a number of effective measures have already been put in place to bring those imbalances down to manageable and sustainable levels. The important thing is that these efforts be sustained. I would even caution against possible overshooting.

The major policy emphasis should be on structural adjustment. The United States, in my judgment, should not do more for the time being, except to maintain credibility and momentum in its efforts to bring the fiscal deficit down gradually. The value of the dollar has been reduced enough, and time is needed for the impact of that depreciation to be felt. Expansion of exports cannot take place overnight. Just finding customers, negotiating deals, opening letters of credit, shipping goods, mailing the documents, and so on, would take months under normal circumstances. It is even more difficult to expand output capacity and divert needed resources to the export sector. All this will take time.

Given the decline in oil prices and the fact that the stock market shock reduced inflationary pressures, as well as possibly reducing consumer demand in the United States, the United States should not raise its interest rates at this point, nor should the other industrial countries reduce their interest rates further. What has happened so far in that area is appropriate. There are apprehensions, however, that unless the United States raises its interest rates, it will not find enough capital inflows to finance its deficit. I am not sure this argument is very strong, as it takes usually more than just the interest rate to encourage investors to buy dollar-denominated instruments.

I do not think that Germany and Japan need to do more on the fiscal and monetary fronts either; but there certainly is a need to accelerate structural adjustment as fast as possible in countries like Germany, France, and others in which the government is too strong, labor markets are too rigid, and pressure groups are too powerful. Structural adjustment is needed, not only to strengthen domestic demand, but also to remove rigidities hindering expansion in those countries' growth potential. Progress on that front seems to have been slow, and more needs to be done. In the meantime, I encourage both the current account deficit and surplus countries to do more to reduce differentials in rates of savings, and, most of all, to accelerate their efforts to remove trade barriers.

Goods, capital, and other factors of production cross borders, and payments cross in the opposite direction, to form a connection among countries. Without this crossing of borders, life would have been a lot easier for economic managers of each country. Because each country has its own national currency, the exchange rate system became the major way to effect payments among countries. With the fixed exchange rate system, when economic fluctuations took place, it was necessary for national economies to be adjusted in order to maintain the fixed exchange rate for each currency. It soon came to be realized that it might be necessary for economies in a certain group to coordinate the movement of their exchange rates so that they could avoid harming not only themselves, but also each other. In other words, the floating exchange rate system has gradually been giving in to a managed or, "dirty," floating system.

The staff asks "what is the best way to bring about stability in exchange rate markets?" First, one must recognize that drastic technological developments and liberalization in the international financial markets have resulted in capital movements having much greater impact on exchange rates than does the movement of goods--a fact that increases fluctuations in exchange rates. Second, the best way to bring about stability depends on whether the rates are at a level of misalignment, or at a level closer to equilibrium.

Given the increased liberalization in the capital markets, more guidance and supervision will be needed to prevent excessive fluctuation caused not necessarily by economic fundamentals, but at times by currency dealers' and speculators' short-term exaggerations. Between 1983 and 1985, for example, the dollar rose by about 35 percent, and since 1985 the dollar has declined by about 45 percent. It is evident to me that after 1983 there was a misalignment in exchange rates. However, today's exchange rates are closer to the 1980 levels, which indicates that real exchange rates may not be far from equilibrium. If there were still a serious misalignment in exchange rates, I would agree wholeheartedly that it would be foolish for the central banks of the Group of Seven to try to stabilize rates without removing first the large payments imbalances. But the large exchange rate misalignments are now behind us. In the meantime, effective measures have been implemented to accelerate exports in the deficit countries, and imports in the surplus countries. Also, the tax reform that has been implemented in the United States should raise the rate of savings, and fiscal measures have been taken to reduce the fiscal deficit.

The trouble with the large payments and fiscal imbalances is that it will take many years to bring them down to sustainable levels. I cannot be convinced that the world should have to wait and suffer until that happens. What is more important is that credible adjustment measures and reforms be put into place and sustained. In the meantime, there should be coordination of monetary policies and of occasional interventions to defend exchange rates within certain limits for certain periods, after which those limits may be changed. This is the essence of managed floating rates.

At this stage it makes more sense to sustain adjustment measures and at the same time manage the floating rates near moving equilibrium positions by monetary policy and coordinated intervention. The difficult question is how to finance intervention and sustain its impact on the members of the Group of Seven. I invite the staff to give us its views, drawing on the experience of the European Monetary System, among others.

The world is becoming increasingly integrated, and there has to be more cooperation and coordination among countries. The existing problems and imbalances have definitely been one factor in the disruption of financial markets. Governments of the Group of Seven have started to act, and it is only fair for other countries to ask these governments to sustain and accelerate its efforts in reducing those problems and imbalances.

The Fund can also help in accelerating cooperation and coordination, technically, by helping to polish the economic indicators that are used for that purpose, and morally, by using its moral suasion to put pressure on the G-7 countries, in addition to the pressure that the financial markets are putting on them. It is incumbent on the Fund to emphasize, through its Article IV consultations with the G-7 members, that they must accelerate structural adjustment, remove trade barriers, and improve supervision over financial markets. I do not think the countries in the Group or the Fund really have a choice; they must promote the acceleration of adjustment through cooperation and coordination. The alternative might well be further chaos in the international financial and economic systems, with great potential material losses in terms of income and employment.

On Mr. Posthumus's suggestion, the members of this organization that are not part of the Group of Seven are harmed by the occasional lack of action by the authorities of those who are, and they have the right to be heard. One way in which they can be heard is through this organization. I would like the Managing Director to inform the finance ministers of the G-7 countries each time the Board discusses the desirability of stable exchange rates. They must hear what Board members outside the Group have to say. I also suggest that when there is a G-7 meeting he be invited as an effective participant to express his views. If my colleagues agree, perhaps the Chairman of the Interim Committee could also be invited when it is necessary that he convey the concerns of Interim Committee members. I would like to hear some response to this suggestion, because it might help the Fund to convey the views of the non-G-7 countries, which are being harmed by the Group's policies or lack of them.

Mr. Abdallah made the following statement:

It is useful to recall that the principal objective of this world economic outlook exercise was presumably to obtain a better early understanding of the evolving consequences for the world economy of the widespread stock market downturn in mid-October of last year. The staff is to be commended for producing this quite readable paper at such short notice. I must confess, though, that I was somewhat disappointed that the staff did not use this unique occasion to shake off the trappings of a standard world economic outlook exercise in favor of a closer examination of the nature and consequences for the world economy of the stock market downturn. We can all agree that, contrary to Keynes's view, stock market changes are likely to have delayed effects on the real economy, particularly if the underlying malaise is deep-seated and widespread, as the staff says.

Against this background, I will attempt to respond to the staff's listed topics for discussion. The first concerns the realism of the projections. I have some reservations about the implicit assumption made by the staff that large historical imbalances can persist without further provoking financial market disturbances in the major industrial countries and the consequent danger of a recession for the world economy. This is especially true since the recent second U.S. stock market drop of 132 points--the third largest single day decline in history--is likely, as noted presciently on page 17 of the staff paper, "to have proportionately larger effects on consumer and business spending, significantly increasing the risk of recession." A recent analysis by the Institute for International Economics suggests that the November 1987 U.S. budget agreement was grossly inadequate and that the agreed 'cuts' would reduce the structural budget deficit--a concept which the Institute prefers to the current service estimates deficit used by Fund staff and the U.S. authorities--for FY 1988 to $160 billion, while that for FY 1989 would be $150 billion (or $30 billion below required levels). I would welcome the staff's views on the implied scenario for this crucial indicator of adjustment with reference to its own substantially downward revisions proposed in the December estimates (Table 1 of the staff paper).

In light of these observations, I have reservations about how the substantial deficit reduction envisaged for the United States in Table 2 will occur--especially with 1988 being an election year. In addition, I would question the pattern of consistently increasing fiscal deficits in Japan and Germany in the later years, given that Japan's May 1987 package is unlikely to be improved upon and that there is no indication that the German authorities are likely to bring forward the tax cut package for 1990, but are talking rather of tax increases. Nor am I convinced that holding down the growth of domestic demand in the United States in 1988 and 1989 by a mere 0.8 percentage point below that of output growth, as shown in Table 3, would secure the necessary improvement in the trade balance in volume terms. Finally, I find it odd that there is no explicit mention of the role for monetary policy; perhaps the staff could explain *their reasons for devaluing monetary policy to this extent.*

As regards the second question posed by the staff--that of policy adaptation to maintain medium-term sustainability--I think that there is already broad agreement on this. The central problem is that of dealing with existing major imbalances, be they the twin deficits in the United States, the large current account surpluses of Japan, Germany and the Asian newly industrializing economies, the high unemployment in Europe, or the heavy indebtedness and stagnation in the developing countries. There is nothing particularly new in Sections 3 and 4 of the staff paper in this respect. There has clearly been some movement in the right direction; for example, the leveling-off of trade balances in U.S. dollar terms is already taking place, and the shift in the volume of trade flows will reduce this further. But inasmuch as today's imbalances emerged over a period of five years, they will probably take at least as long to be corrected. The essential problem therefore is to convince the markets that there is a seriousness of purpose about the industrial countries' adjustment efforts, so that markets do not help to trigger off a recession by acting independently of country authorities. Indeed, the markets have already sent two strong signals that something is very wrong with the world economy. I am referring to the plunges of about 30 percent in the U.S. bond market in early 1987 and of 20-30 percent in the stock markets of the money center countries in late 1987.

These imbalances, which are closely interrelated, must be corrected through constructive adjustment that does not fritter away the hard-won gains in the fight against inflation during the first half of the 1980s and does not enable the major debtor countries to inflate their way out of a debt problem. Moreover, adjustment policies must be designed to eventually reduce long-term real interest rates so as to foster investment and growth. Over the next four to five years, external current account imbalances will have to be corrected by up to \$100-150 billion if the United States is to re-establish its traditional current account surplus; such a reduction can only come through corresponding reductions in the surpluses of Japan by \$50-75 billion, of Germany by \$30-50 billion, and of the Asian newly industrializing economies by \$20-25 billion. This outcome would have to be obtained, as pointed out on pages 19-20 of the staff paper, through domestic demand management and reductions in domestic market rigidities and other structural barriers to entry. Of course, as we pointed out in our intervention last October, the more it proves possible for surplus countries to channel additional funds to debtor developing countries, the less they will have to do to reduce their surpluses directly. In the U.S. case, because debt service will amount to an estimated \$30-40 billion, the improvement in the trade balance will have to be proportionately greater.

The country-specific solutions are different but complementary. For the United States, steady reduction in the rate of growth of domestic demand relative to domestic output is the crucial policy objective, and reduction of the fiscal deficit is the key instrument. For Japan, the challenge is to transform an export-driven economy to one that is driven more by domestic demand. In Europe, low growth and high unemployment create an argument for faster growth of domestic expenditure, particularly in Germany because of its likely locomotive effects on other major industrial European countries. For the Asian newly industrializing economies, a combination of trade liberalization, increased domestic investment and demand, and further currency appreciation would be warranted.

Regarding the staff's third question on exchange rate management, we agree that the key consideration should be to foster consistent national policies so that a sustainable market-validated range can be established. Real rate alignment has taken place, even beyond the 1980 levels. It may well be that, on a trade-weighted basis, an index level of between 90 and 100 (1980=100) constitutes an appropriate range, but for this to hold, markets must be convinced of the strength of various authorities' commitment to adjustment. The Fund could help, less through an examination of valid criteria for the defense of an existing pattern of rates or through its financing than through the promotion among policymakers in these countries of greater convergence in their economic management and by a more ambitious role for the Fund's surveillance and consultation mechanism.

The fourth and, to this chair, most important concern is the consequences for developing countries, particularly the low-income African countries, of the recent industrial market developments. As a preliminary but important point, I would note that, while such countries as a group are probably unable to contribute directly to the alleviation of global imbalances, they quickly become vulnerable, in terms of their economic management, to any policy failures on the part of the industrial countries. Clearly, the data and conclusion derived from this world economic outlook exercise must be regarded as highly tentative for the developing countries. However, we note from Table 3 that, although growth in these countries in 1988 and 1989 is expected to rise substantially over the 1985 level, growth projections have been revised downward and per capita income will continue to stagnate or even decline. We question the reliability of the forecast of stable real commodity prices, even as we note that there has been a reduction of over one third in their levels since 1984. Moreover, the marked improvement in external competitiveness noted by the staff has been secured at the cost of reduced real import and growth levels. Inflation rates are expected to come down marginally, to 11 percent, in 1989 according to Table 5; this apparently high annual rate should be viewed against the background of supply-induced constraints--including transportation bottlenecks--faced by our countries. The observation on page 13 of the staff paper that small, low-income countries in Africa are likely to experience little, if any, improvement in their debt positions and that this is likely to be exacerbated by the downside risk of higher interest rates is disturbing to us. Nothing short of forgiveness of past debts, concessional resource transfers, and greater access to developed country markets will hold out much hope for our countries. In this respect, the Fund can take the lead by ensuring that its concessional resources, in particular those under the enhanced structural adjustment facility, are not so heavily conditioned--to satisfy lenders' requirements--as to make eligible countries hesitate unduly to use those resources. If this were to happen, then all the resources and time that were invested last year in mobilizing support for the enhanced structural adjustment facility will not have been justified.

Mr. Ismael made the following statement:

I welcome the preliminary staff assessment of the prospects for the world economy. I believe that the primary objective of this discussion is to assess the implications of the stock market crash for growth in industrial countries and to review the progress in the coordination of economic policies among the major industrial countries.

I am happy to note from the staff paper that the stock market crash is likely to have only a modest impact on growth prospects for 1988. The growth projection for the major industrial countries has now been revised downward to 2.5 percent of GDP, and for developing countries to 3.5 percent. I believe that these projected growth rates can be achieved, although they do appear to be somewhat optimistic and there are considerable downside risks associated with the projections.

As noted in the previous discussion of the world economic outlook, the current account imbalances among the major industrial countries continue to be large and unsustainable. While the responsibility for reducing the imbalances lies with surplus as well as deficit countries, there is clearly a greater sense of urgency for the major deficit country--namely, the United States--to reduce its current account deficit, because there is a risk that foreign savers might not be willing to continue to finance the U.S. external deficit at current interest rates for long. Despite the large exchange rate correction, the U.S. current account deficit remains extremely large, owing primarily to the huge budgetary imbalance. Recent attempts to reduce the budget deficit have done little to improve market perceptions regarding the eventual elimination of the fiscal deficit. There are indications that unless bold new measures are introduced, the budget deficit will turn out to be much larger in FY 1989 than envisaged under the Gramm-Rudman-Hollings Act.

As far as Germany and Japan are concerned, they have taken measures to stimulate domestic demand. The staff seems to suggest that the stimulus provided so far by Germany and Japan remains inadequate--perhaps more so in the case of Germany--and that more needs to be done. I broadly share this assessment. I note from the staff paper that both Germany and Japan face serious structural impediments to output growth. In the case of Germany, the impediments include industrial subsidies, labor market rigidities, and regulations; in Japan, they include land use regulations, restrictions on agricultural imports, and the inefficient distribution system. In the absence of substantial progress in dealing with some of these structural problems, expansionary macroeconomic policies could lead to higher inflation rather than higher output. Therefore, it is important that priority be given to dealing with these structural problems in Germany and Japan to avoid inflationary consequences from the pursuit of more expansionary macroeconomic policies. It remains unclear to me the extent to which domestic objectives can be sacrificed in Germany and Japan for the sake of international policy coordination. This is a political question as much as it is an economic question. I raise this because, according to press reports, there is some hesitancy in Germany, in particular, to expand the economy through expansionary fiscal policies even though Germany is in an extremely strong external position, having registered a record trade surplus in 1987.

As far as other industrial countries are concerned, there is a case for reducing fiscal imbalances in Canada, Italy, Australia, and the Scandinavian countries. At the same time, there are countries in Europe with a strong external position, which provides considerable scope for pursuing more expansionary policies. I would hope that in future world economic outlook papers, the staff would examine this subject more closely and make more specific recommendations with regard to the role which some of these countries can play in the international adjustment process.

Turning now to the developing countries, it appears to me that the growth projections for these countries may be somewhat optimistic. Considerable uncertainties remain with regard to the outlook for commodity prices, protectionist measures in industrial countries, the demand for developing countries' exports, and the ability of developing countries to deal with their enormous debt problem. Therefore, I attach particular importance to the maintenance of a free and open trading system, an effective debt strategy, and better coordination of macroeconomic policies.

Progress has been achieved in the coordination of fiscal and monetary policies among the major industrial countries, but it is viewed in the financial markets as being too little and too late. If we believe that significant progress has been achieved in the coordination process, then we have to ask ourselves why it has led to less rather than more stability in the financial markets. The events of recent weeks suggest that there might be some merit in the view that the determination of certain important prices, such as exchange rates, cannot be left to the markets alone. Therefore, it seems that there is now a strong case for intervention by central banks in order to restore stability and order to the exchange markets. Coordination of macroeconomic policies has a useful role in bringing about exchange rate stability, but it may not be sufficient to produce the desired results.

Mr. Ovi made the following statement:

I very much welcome today's discussion. It is most appropriate that we go beyond the traditional format of our quarterly meetings on exchange market developments, and we probably should do so more often.

The growth forecasts presented in the staff paper are among the most optimistic in the world, as almost everybody outside this institution is emphasizing the risk of recession. We do hope that these projections will be fulfilled, even though the continued external imbalances between the major countries give rise to serious doubts about the sustainability of the present situation. Further adverse interest rate and exchange rate changes might substantially affect current growth prospects.

We agree with the staff that the fall in stock market prices, as well as the unstable, and until very recently, steadily depreciating dollar, basically have to be seen as indications of the market's perception of past and present economic policy measures as being insufficient to secure an orderly reduction of global imbalances.

We recognize that the staff makes several qualifications to its analysis--most important, that market participants be willing to finance the resultant budget and external imbalances at prevailing exchange rates and interest rates. This assumption is particularly hard to accept at face value. Last year, the huge U.S. current account deficit was financed basically by central banks of other industrial countries through their interventions in exchange markets. It is hardly plausible that this development could continue for another year. Thus, there is a serious need for more extensive adjustment of domestic economic policies in a number of countries, and, at the same time, international coordination of such measures.

A major responsibility for ensuring more sustainable developments rests on the United States, where there is a considerable need to increase total savings. We do appreciate the measures already undertaken to reduce the federal budget deficit, but at the same time we agree with the staff that a precondition for safeguarding a reduction in the current account deficit and achieving greater stability in financial markets is that additional action be taken to further reduce that deficit. This is all the more important as the U.S. economy seems to be in a state of almost full capacity utilization. Resources now employed for domestic purposes need to be freed if enhanced international competitiveness is to radically improve the trade balance.

In Europe, there is a great risk that external constraints will be increasingly felt by a majority of countries, with the result that overall economic policies will become unduly tight. Unless those countries that have room for maneuver stimulate domestic demand, there is a danger of renewed financial instability. In this connection, it is difficult to escape the particular responsibility of the Federal Republic of Germany, and the need for fiscal stimulus, given that country's considerable and lasting external surplus, high level of unemployment, and the prospects for continuing weak demand development. Recent developments in Japan demonstrate what can be brought about by fiscal policy in a situation of slim growth expectations.

Against this background, my constituency is deeply worried that Germany now seems to be considering seriously a tightening of fiscal policy for 1989, particularly as the impetus for this move seems to be the decrease in profit transfers from the Bundesbank to the Government, a change which in itself is of little economic significance.

The Asian newly industrializing economies should increase their contribution to international adjustment. Among other things, there is a need for a further appreciation of the exchange rates of these countries. The role of structural policies should be neither underestimated nor overestimated. It is of the utmost importance that protectionist tendencies be stalled. In this connection, Japan and a number of the newly industrializing economies have a particular responsibility to open up their markets.

Furthermore, there seems to be no doubt that, particularly in Europe, there is a need for many reforms in the area of industrial relations and labor markets. The staff paper again refers to Germany, but only in very general terms. In order to carry the discussion further, I would encourage the staff to be more specific. More important, one cannot but stress the need for reversal of the trend of steadily increasing subsidies in Germany to both industry and agriculture. Action in this area would greatly increase the scope for fiscal action. In general, however, in the present economic situation, more traditional macroeconomic policy measures will have to play a major role.

The Nordic countries have welcomed the intensified cooperation between the G-7 countries in the area of foreign exchange policy, because these countries announced their willingness to execute specific economic policy actions. At the same time, this chair has expressed doubts as to whether such announcements are sufficient to ensure a steady elimination of global imbalances, and developments since October have confirmed this skepticism. There is, therefore, now more than ever, a need for governments to turn their words into actions.

Foreign exchange rate stability should be promoted first and foremost by underlying confidence-inducing economic policies. If the underlying policies do not sufficiently support such stability, intervention and monetary policy action have to be used to avoid foreign exchange rate developments which would cause new distortions in the exchange rates. If intervention is undertaken, this burden should be shared as much as possible. There is a clear risk that monetary policy is currently being asked to do too much. Thus, it will not be possible to use monetary policy to stabilize exchange rates, stimulate growth, and control inflation simultaneously.

The downward revisions in the projections for growth in developing countries are a cause for considerable concern, particularly since the forecasts are connected with further downside risks. Developments in a number of African and Latin American countries are especially alarming. This seriously underlines, inter alia, the need for industrial countries to support developing countries' adjustment by opening their own markets, aiming at a stable and reasonably high domestic demand, and increasing financial transfers to the developing countries. If the debt problems are not to worsen, however, those increased capital transfers will have to be used in a way which would support future repayments of foreign debt. Also, it would have to be established that economic policies in the receiving countries clearly are compatible with such development. It is important that countries give priority to investments relating to the open sector of the economy. In this context, I wish to reiterate the Nordic chair's concern that in several cases the Board has approved programs which do not meet these requirements.

What should be the role of the Fund? It should increase the membership's understanding of the need to adjust through changes in underlying economic policies. The Fund should continuously assess whether foreign exchange rate corrections go beyond what seems feasible. Exchange rate developments should be a central indicator in the Fund's assessments. In the present situation there might be a need to go beyond this. An innovation took place toward the end of last year when the Managing Director took part in the Article IV consultations with Japan. I am sure that both parties benefited from this initiative. Indeed, perhaps the time has come for the Managing Director to take similar initiatives in relation to the United States and Germany in the near future. It would be most useful if high level policy discussions were held with all three countries as part of the preparation of material for our world economic outlook discussion at end-March.

I would very much like to support Mr. Posthumus's comments on the urgent need to keep the working of the international monetary system under permanent review. Also, I can fully associate myself with what Mr. Nimatallah has said on the need to secure the effective participation of the Managing Director in G-7 meetings.

Mr. Zecchini made the following statement:

Today's preliminary discussion of the world economic outlook is an interesting and fruitful innovation, which we welcome and which we would like to see established as a permanent feature of the process for the formulation of the April report on the status of the world economy. What makes today's innovation especially interesting is the staff paper, which has two distinctive qualities: a concise and neat analysis of the major trends; and a challenging presentation of the main policy issues. I will focus my remarks on trends and issues, following the outline proposed by the staff.

As regards recent economic developments and the projections, the 1987 level of economic activity was a major surprise, being stronger in industrial countries than originally anticipated. The staff paper does not delve into detail in analyzing the causes of this outcome, nor does it establish a link between this result and the policy stance in the monetary and fiscal areas. Therefore, it is extremely important that the April report examine the different causes of the continued high growth of output and, in particular, the roles played by the easing of fiscal and/or monetary policies as well as by the expansion of world trade. This part of the analysis would provide us with useful hints on the relative importance to be attached to the various policy instruments in order to foster output growth in the current year. Furthermore, this analysis would clarify the extent to which external trade could continue to be considered as an engine of economic expansion for several groups of countries, in a period when some major industrial countries are pursuing external adjustment while other major economies are lagging behind in the expansion of their domestic demand.

The new projections for 1989 show a modest increase of output for the industrial countries that is largely a result of the continued expansion of GNP in the United States and possibly Japan. These projections are different from the indications provided by the recent OECD economic outlook as well as by the European Economic Community. According to the OECD, in 1989, the real GNP increase for the OECD countries should decline significantly, from 2 1/4 percent to 1 3/4 percent, and this applies particularly to the United States, with a projected decline from 2 1/2 percent to 1 3/4 percent. A substantial difference also arises with respect to world trade expansion, projected to rise by about 4-4 1/2 percent by the Fund staff and by only 3 3/4 percent by the OECD; the European Economic Community also forecast a much lower expansion of GNP for both 1988 and 1989. A comment by the staff on how to reconcile these divergent predictions would be appreciated.

We strongly agree with the staff that the risks associated with the projections for 1988-89 seem to be concentrated on the downside. We view the developments in foreign exchange markets as a major potential source of instability and uncertainty in the outlook for growth. As in the case of the October 19 stock market collapse, changes in expectations concerning exchange rate behavior can have large destabilizing effects on domestic financial markets as well as on spending decisions. The source of risk lies not so much in the stock or exchange markets per se, but rather in exogenous tensions that could affect these markets, thereby producing amplified effects. Moreover, the increased integration of the U.S. financial markets with foreign markets, owing to the expansion of the amount of U.S. assets held by foreigners, has made the U.S. financial markets more sensitive to exchange rate developments.

Another striking feature of the preliminary projections is that, in spite of the severe worldwide stock market collapse and exchange rate turbulence, the projections for 1988 show a limited reduction of output growth for the industrial countries as a group, and the United States in particular. This is a positive, and somewhat unexpected, result. In this respect, it would be important to analyze in more detail the reasons why the impact of the recent market turbulence on growth will be less negative than originally forecast.

On policy requirements for the industrial countries, one of the most significant lessons of the recent market crisis is that the internationalization of national financial markets makes the strengthening of policy coordination all the more urgent. The choice facing those countries now is between a market-determined adjustment, with serious implications for output growth, or a policy-induced adjustment. Therefore, the main objective of the coordination exercise should continue to be to identify policy measures that can support the correction of external imbalances and at the same time reduce the risk of a slowdown in growth. These indications should be at the core of the forthcoming world economic outlook.

As to the evolution of U.S. economic policies, we notice with some concern the increasing burden being placed on monetary policy since the fall in the stock market. Monetary authorities are now faced with the need to provide sufficient liquidity to ease the recent market shocks, while stabilizing exchange rates and checking inflationary pressures. While these objectives may be reconciled somehow in the short run, in the medium term they are bound to be in conflict among themselves. In this respect, the objective of price and exchange rate stability should be given top priority sooner rather than later.

As for the reduction of the U.S. external imbalance, the exchange rate adjustment has gone as far as is reasonable, and emphasis should now be placed on adjusting relative domestic demand growth rates and domestic imbalances. To allow a benign neglect vis-à-vis further depreciation of the dollar in order to compensate for lack of action in redressing domestic imbalances in the saving-investment process would amount to following "beggar-my-neighbor" policies, which are outlawed even under the present regime of floating currencies. In this respect, we share the staff's opinion that further reductions of the federal fiscal deficit are a necessary, though not sufficient, condition for improving the foreign balance without unwarranted tensions on interest rates and inflation.

The emphasis on domestic demand adjustment is justified by three considerations. First, the cumulative domestic demand imbalances of the United States relative to surplus countries since the early 1980s remain large and are still a powerful driving force behind the sustained level of imports, which increased 4 percent in volume in 1987. Second, U.S. trade flows have proved to be less sensitive to price competitiveness factors than to expenditure factors. Third, the expansionary effects of further dollar depreciations might run against supply capacity constraints and could not be accommodated without inflationary pressure unless domestic demand is reduced.

As for Germany, we notice with disappointment the projections of a decline in domestic demand in 1988 and a further reduction in 1989. This development will slow the correction of the country's external imbalance. Moreover, it might affect indirectly the adjustment of the U.S. external imbalance and growth prospects in Europe. This issue needs to be further explored in the next world economic outlook. Overall, if the German authorities have already reached the limit of what can be considered a reasonable and desirable delay in pursuing their medium-term objectives, then it is imperative for them to strongly intervene in order to overcome the structural constraints to the expansion of German potential output. These interventions should be aimed particularly at reducing industrial subsidies, labor market rigidities, and regulations that are an impediment to growth. This applies to Japan as well, which also has an apparently intractable external current account surplus. Without such actions, these countries are not fulfilling their responsibilities in the current adjustment process.

As for Italy, we agree with the staff's stress on the need to correct the fiscal imbalance. Italy has already done its part in the international adjustment process and now needs to concentrate its efforts on redressing the public finances and easing structural rigidities, not so much for cyclical reasons, but mainly for the structural implications in terms of enhancement of efficiency in economic mechanisms.

An appropriate setting of domestic policy stances is the only effective prescription to ensure stability of exchange rates in the long run. In this respect, in view of the most recent G-7 agreement, the policy of market intervention can come to play a useful role, but its importance should not be overemphasized. Interventions can help to counter temporary market disturbances, gain some time to implement appropriate policies, or provide an anchor for market expectations about the effectiveness of a current policy stance. However, we know all too well that interventions cannot correct policy deficiencies over a long period. Therefore, on the basis of the experience gained in the aftermath of the Louvre agreement, the Fund should come to consider prolonged one-way interventions as a clear indication of the need to modify the stance of domestic policies. In this context, the Fund should be called upon to send strong signals of the necessity for action by national authorities.

As for developing countries, in spite of the downward revision of their 1988 output expansion, growth in the developing countries as a group should increase in 1988 and beyond. The pickup of output growth in Africa is particularly welcome. Now, the major impediment to balanced and sustained growth in these countries comes from unsatisfactory growth prospects in the industrial world and from the handling of the debt crisis; action on both fronts is required. Moreover, the role of major surplus developing countries in contributing to the reduction of external imbalances of other countries, and thus to more favorable growth perspectives for the world economy, should also be emphasized.

Finally, we noticed that the staff has revised downward significantly the 1988 projections for growth in the developing countries of the Western Hemisphere from 4.7 percent to 2.2 percent. For 1989, however, growth is expected to resume again at a rate of 4.1 percent. We wonder how these two indications can be reconciled, since the factors named by the staff as having caused the 1988 revision--namely, difficulties in the process of financial stabilization and the curtailment of fixed investment--are unlikely to be reversed in the very near future.

Mr. Grosche made the following statement:

I accept the broad lines of the staff's analysis and projections. The dollar's renewed weakness has left its mark on Germany's economic prospects. Although there is no threat of recession in 1988, the likely real growth of 1 1/2 percent, according to staff estimates, is clearly unsatisfactory. Germany is currently in the process of making its own official annual forecasts. There is some reason to believe that growth will be somewhat higher in 1988, of the order of 1 1/2-2 percent. But clearly, this year and the next will probably be fraught with considerable risks. We therefore believe that economic policy must be geared to strengthening the domestic forces of expansion. Together with other members of the Fund, we are resolved to work toward a reduction of the international imbalances while maintaining growth and stability.

Over the past two years, Germany's domestic demand has advanced more strongly than aggregate production. As Chart 3 in the staff paper shows, the real foreign balance has contributed negatively to real GNP/GDP growth and continues to do so. In real terms, Germany's external surpluses are being reduced markedly, even though in nominal terms they continue to be large, owing to the solid improvement in the country's terms of trade as the dollar has slipped and commodity prices have remained low. The dollar figures in the staff paper understate the improvement that is taking place, and it would be helpful if, in future, papers' balances were expressed in real terms and in local currencies as well. For example, in 1987 Germany's real trade surplus decreased from DM 53 billion to DM 43.6 billion.

The staff's suggestion that the recent turbulence in the financial markets had no marked impact on 1987 overall results also holds true for Germany. It was because of the slack in production at the start of the year that Germany registered growth of only 1.7 percent in 1987, despite the pickup in activity since last spring. Although capital spending on construction was disappointing--largely on account of noncyclical factors--investment in machinery and equipment proved quite buoyant and underlined the economy's basic strength.

Growth should improve somewhat in 1988. Exports should pick up again, although if the dollar stays as low as it is now, the increase will be rather small. For the domestic economy, the firmness of the deutsche mark does have advantages, namely, cheaper materials from abroad, lower inflation rates, and potentially lower interest rates.

Private consumption continues to be the economy's mainstay, due not least to the tax relief measures amounting to about DM 14 billion. In addition, on the initiative of the Federal Government, the state-owned Kreditanstalt (Reconstruction Loan Corporation) will make additional resources available, at subsidized interest rates, totaling DM 21 billion over three years. These funds are to be used to promote additional investment, particularly on the state and muncipality level, to which DM 15 billion is allocated as opposed to DM 6 billion for investment by small and medium-sized business.

Most important, all revenue losses that arise in the 1988 federal budget as a result of the most recent developments will be accepted without compensation, and these losses will be quite large. The federal deficit is expected to shoot up from a planned DM 29 billion to about DM 40 billion. In the spirit of international economic cooperation, this figure will be accepted for the time being. However, we fully share the staff's assessment that fiscal policies in major countries should continue to be directed toward reducing both the size of government and the absorption of private savings by government deficits. We believe, therefore, that measures will have to be taken in the next year to reduce the German federal deficit by at least DM 10 billion. To this effect, subsidies will be cut further, certain taxes for consumer goods--although not the VAT--will be raised, and expenditure will be kept under strict control.

We agree with the staff that industrial subsidies, labor market rigidities, and regulations governing other aspects of economic activity appear to constrain the growth of potential output. We are striving for more progress in these areas. In the context of the major tax reform, which is now being pushed through parliament and will be implemented on January 1, 1990, a number of subsidies will be removed or reduced. Additional structural measures will be initiated--among others, a further sale of state-owned shares in enterprises and an opening up of the communications sector.

I would like to reiterate our conviction that the strategy being embraced by major industrial countries remains valid. We remain committed to the coordination efforts undertaken, and we expect that the policy commitments as laid out in the G-7 communiqué of late December will provide for a positive development of the world economy.

The world economy, however, does not consist only of the G-7 countries, and that cannot be stressed enough, particularly in this institution. I welcome the emphasis given in the staff paper to the role in and responsibility for the international adjustment process that other countries will have to assume--not only the smaller industrial countries, but also the newly industrializing countries with large surpluses and large developing countries with a potential systemic impact.

Mrs. Ploix made the following statement:

Last September, most of us emphasized at the world economic outlook discussion that, despite some positive achievements, the outlook was very uncertain, due to the persistence of considerable internal and external imbalances, which jeopardized in particular the stability of exchange markets and, more generally, the confidence of investors.

This diagnosis was subsequently confirmed by the stock market crash and the sharp drop of the dollar. Certainly, the market crash can be ascribed to reasons related to the modalities of the market itself, such as excessive increases in recent years or rapid innovations. It was equally induced by the rise in interest rates. Overall, it was a clear sign of investors' lack of confidence vis-à-vis the world economy.

The staff paper before us suggests that in the short term the implications of the recent turbulences of markets should not be very significant for the major industrial countries, even though the prospects for developing countries seem somewhat less satisfactory than last September. Nevertheless, we note that other institutions, such as the OECD and the European Economic Community, see more serious consequences, especially for economic activity. In this regard, we note some decrease in domestic demand in the United States. Might this not be a result of the "Pigou effect"? We would appreciate the staff's comments on this point.

The French Government, for its part, considers that the impact on the French economy will probably be very limited. It also anticipates that growth will be greater than the staff's predictions.

Turning now to the medium term, the staff recognizes that its baseline scenario contains a number of elements that must be considered potential sources of tension, especially the persistence of disquieting imbalances. In this respect, we would have welcomed more precise information from the staff concerning the consequences of these tensions in terms of developments in, inter alia, imbalances, growth, interest rates, and inflation.

In fact, the outlook appears worrisome, as recent events show clearly that the "finance-constrained scenario" examined last September, based on the reluctance of markets to finance external deficits, is more likely to happen in the near future. A further depreciation of the dollar would be particularly dangerous, and it is improbable that it would help reduce the U.S. trade deficit. It is even likely that it would induce an increase in the value of the deficit. Therefore, we fear that the markets will continue to overshoot by bringing about further depreciation.

There would then be a vicious circle which would be difficult to control and which could expand to include all markets. In this context, the only likely response would be an overall increase of interest rates with very damaging consequences for growth in the United States and abroad. Such an increase would significantly affect stock markets, which in turn would have substantial effects on consumer and business spending, thus augmenting the risk of recession. In addition, such a scenario could certainly jeopardize the efforts of developing countries to address the debt problem.

Given this perspective, it is essential that we reinforce mutual cooperation. Given recent events, there is a greater need than ever before to take the necessary steps to prevent these projections from occurring. In this regard, let me recall that in its December 1987 statement the Group of Seven clearly re-emphasized that the major external imbalances must be corrected and that economic policy coordination must be intensified. Indeed, stabilizing the exchange rates is of great importance; it is especially needed to break anticipations. However, the defense of any particular pattern of rates can be meaningful only if at the same time each country shows a strong willingness to reduce internal and external imbalances.

It is clear that this course of action is not an easy one, since it implies both slowing domestic demand in the United States and boosting growth in the surplus countries. To achieve this goal, several measures must be implemented: further reductions of the U.S. deficit are required, but it is also necessary to tackle another crucial problem--the weakness of private savings, a leading cause of the balance of payments deficit. We agree with the staff that priority must be given to structural reforms to allow major surplus countries to foster an increase in domestic demand over the medium term. However, fiscal measures are still of great necessity. Finally, better coordination of interest rate policies is also needed.

We would like to stress that the staff should have included in its paper a more detailed and concrete assessment of the policy requirements and consequences of various policy scenarios for the worldwide economy. Only in these circumstances can the Fund play a more significant role in the surveillance process.

Mr. Lankester said that the staff had presented a measured and wise assessment of the prospects, and he broadly agreed with the staff's projections. The forecasts for output, if achieved, would represent an encouraging outcome.

Activity seemed to have been stronger than expected in the second half of 1987, and it was not entirely clear why, Mr. Lankester indicated. It would be interesting to see a fuller discussion of that subject in the full world economic outlook documents for the March discussion. Perhaps the faster growth reflected a delayed response to the fall in oil prices in 1986.

He also agreed with the staff that the effect of the stock market crash in October appeared to be smaller than some of the dire predictions at that time had suggested, Mr. Lankester continued. He was not entirely convinced that the falls in the stock markets were, as the staff suggested, primarily a symptom of the underlying imbalances in the world economy. Although that was clearly an important factor, greater weight should perhaps be given to the fact that the fall reflected a correction of price/earnings ratios which had reached an extremely high level in some markets. There was no denying, however, that further policy adjustments were required or might be required if the significant downside risks to the forecasts were to be reduced. Spending might, despite the evidence to date, be significantly reduced as a result of the stock market fall with a time lag or, indeed, because of a further plunge in the markets. If that were to happen, the authorities would need to stand ready to act quickly in order to maintain a reasonable level of nominal demand in their economies. Speed of action was often as important as the direction of action, particularly if nominal demand in the world suddenly fell, although the global pace of demand expansion currently seemed reasonable.

The other main risk was that the large projected payments imbalances would prove unsustainable, leading to financial and exchange rate turbulence and other problems, including slower world growth, Mr. Lankester noted. That risk needed to be reduced, if possible, by further early action to reduce those imbalances. In order to achieve faster reductions in payments imbalances, an even larger divergence than currently seemed in prospect between demand growth in the surplus and deficit countries was necessary--i.e., a better balance of demand growth. It was important for political and economic reasons that that be achieved on a symmetrical basis. Slower demand growth in the deficit countries--the United States in particular--without compensating demand expansion in the surplus countries, would risk further slowdown in growth for the world as a whole. Faster expansion of demand in the surplus countries without compensating action by the United States would risk refueling of inflation. Symmetrical action was also likely to produce stronger results for the payments position of the deficit countries, and was politically the more feasible option.

One possible way to achieve a better balance of demand, Mr. Lankester said, would be to sanction a further fall in the dollar. In that event, the transmission mechanism would be higher inflation in the United States, following the further dollar depreciation, and slower real demand expansion in the United States, and vice versa in the surplus countries. That would be a dangerous path to follow. The risks of inflation being reignited in the United States and further financial turbulence for the world as a whole were simply too great. Increased inflation soon got one into trouble that was hard to escape.

Fiscal policy would be the best route, Mr. Lankester declared. There was scope for stronger fiscal action in Japan and Germany. Despite Mr. Grosche's comments on the German fiscal position, he himself was still not entirely convinced that--at least on technical grounds--there was not scope for further fiscal expansion in that country. From a technical point of view there was clearly scope for further fiscal retrenchment in the United States as well. To the extent that political considerations made it difficult to act on the fiscal side, the burden would have to fall more on monetary policy--a second best solution.

Tighter monetary policy in the United States would have two disadvantages, Mr. Lankester went on: it would not be good for the balance between consumption and investment in the United States, and it would not be good for the middle-income debtor countries because of the higher dollar interest rates they would have to pay on their debt. An easing of monetary policy in the surplus countries might not necessarily achieve the desired effect. Monetary policy would have to play a significant part in achieving a better balance of demand if further fiscal action were ruled out. That would also be consistent with the need for preventing any further depreciation of the dollar, which would be counterproductive for the world economy. A readiness on the part of the U.S. authorities to tighten, and of the surplus countries to further ease monetary policy in those circumstances would help to underpin the dollar. Intervention also could, and did, have a role. Intervention by the central banks over the past year, and indeed over the past week, had proved that it could be more effective--even when the intervention had been sterilized--than had been thought a few years earlier.

On the question of exchange rates, he was not entirely persuaded by the staff's view that "cooperation on exchange rate matters should focus on underlying policies rather than on a particular pattern of rates," Mr. Lankester indicated. Exchange rate fluctuations could and did impose significant costs, and even with reasonably specific and appropriate policy understandings there could still be a wide range of possible exchange rates. Furthermore, reaching broad agreement on exchange rate patterns could exert substantial pressure on policymakers to pursue cooperative policies.

He wished to make three additional points, Mr. Lankester said. First, the improvement of structural policies had an important role to play, particularly in Europe, in enabling member countries to pursue faster growth and faster demand growth; that would also contribute to correcting the payments imbalances. Second, he was struck by the enormous continuing trade imbalance and payments surpluses of some of the newly industrializing economies. The surplus that Taiwan had achieved in 1987 was truly staggering, and the staff had been a bit light in its criticism of the policies of that economy and at least one of its neighbors. Third, he was puzzled by the call for faster expansion in his own country. The United Kingdom, according to the staff, was likely to achieve 4 percent growth in 1987, and although it was likely to slow a little in the course of 1988, the U.K. economy was still growing quite briskly. Furthermore, the country currently had a small current account deficit. The staff reasoned that a stronger expansion by the United Kingdom was justified on the grounds that that country had a very strong overseas asset position. That was certainly the case, but the United Kingdom would need those assets as its oil ran down in the 1990s, and given the rapid growth of demand and of the economy as a whole, the asset position was not an adequate justification for faster expansion at the present stage.

Mr. Hospedales made the following statement:

We welcome this preliminary discussion of the world economic outlook, and we hope that it will not be made particularly timely by another major drop in the dollar on foreign exchange markets or by a major decline in the stock markets. We regret that somewhat more detailed analysis could not have been provided in the discussion on the outlook for developing, and in particular, indebted countries, but we realize that this may not have been compatible with the timing of the exercise. In particular, we are concerned about a relapse into the excessive optimism which has characterized our world economic outlook exercises in the past, with the possible exception of the October 1987 exercise.

It is the Fund's obligation to make evenhanded forecasts, and they therefore should not be subject to either a predominantly downside or a predominantly upside risk. The present forecasts by the staff show a clear downside risk.

Regarding the short run, the staff's fiscal projections show clearly that whatever may happen in 1988, projections for the U.S. fiscal deficit will vastly exceed those foreseen in the Gramm-Rudman-Hollings Act for the 1989-91 period. In these circumstances, it is doubtful at best that other major countries will maintain their monetary and fiscal cooperation. In particular, one must ask whether the remaining very large financial and current account imbalances can be smoothly financed in such circumstances.

If output and employment in these circumstances falter in the industrial countries, the effect on output and employment in the developing countries, and particularly in the indebted countries, could be extremely severe. Moreover, the expected growth rate for these countries in 1988--at 3.6 percent--is quite low and would certainly not contribute much, if anything, to the absorption of the unemployment created since the inception of the debt crisis.

We agree with the staff that prices of developing countries' commodity exports in 1988 will decline in real terms, and that if expected growth in the industrial countries is even less than foreseen by the staff, the price decline in real terms could be larger and that there could even be a decline in nominal terms.

The staff's projection in Table 7 of an improvement in the combined balance of payments deficit of the developing countries may seem encouraging, but in reality it is uncertain and continues to be based on extremely low growth rates in 1988; the prediction of a major recovery in growth rates in 1989 does not seem to be based on specific assumptions.

As for the medium term, projections of economic performance for industrial countries are marginally lower than in October, as can be delineated from a comparison of Table 9 of the staff paper with Table A53 of the October World Economic Outlook. For developing countries, on the other hand, the decline is more pronounced.

In these circumstances, one must agree with the staff regarding the "tensions" that surround industrial countries and which could express themselves in a major recession, possibly combined with strong inflationary pressures, at least in the United States. The effects on the debt situation are also obvious. We are particularly concerned by the staff's comments regarding the possibility of a renewed rise in interest rates.

The staff agrees with what it perceives to be the policy objective of the major industrial countries: fiscal policy should promote smaller government. Whether or not small deficits are also appropriate for countries running large balance of payments surpluses would seem to be a more complicated question, the answer to which must depend on the expected growth rate of the economy after the deficits are cut. The staff also seems to subscribe to the idea that the only purpose of monetary policy must be the avoidance of inflation--a questionable recommendation. On the other hand, one can wholeheartedly agree with the staff's suggestion that European countries in particular should make structural improvements in their economies so that they may be able to raise their growth rates without danger of inflation.

Among the major deficit countries, it is clear that the United States needs to raise exports and, therefore, should further lower its fiscal deficit. Yet, the staff still seems to be too cautious in its position on the appropriate policy stance for industrial surplus countries. Would the industrial surplus countries really give up growth if the choice were between stagnating and stimulating, or are they still relying on growth in the United States to pull along their own economies?

The staff does not have much to say about the desirable policy stance of developing countries. It almost seems that it sees these countries as a source for the potential collective current account surpluses of the industrial countries, rather than being concerned with the need for developing countries to resume and accelerate their growth. Such acceleration may not be feasible until developing countries in general have re-established creditworthiness, which in present circumstances seems difficult. Only the Asian countries have done so. As 1988 goes on, the Fund cannot and must not hesitate to promote national and international action that permits a recovery of developing countries' crediworthiness and growth. This recovery does not depend only on the developing countries themselves alone.

Regarding the systemic considerations mentioned by the staff, we agree that cooperation should focus on underlying policies of the major industrial countries, as well as on coordination of monetary policies. A reasonable degree of cooperation, even in monetary affairs, should not jeopardize the medium-term credibility of inflationary objectives, and intervention--presumably unsterilized intervention--has an important role to play in mitigating disorderly movements in exchange rates. In fact, we are not convinced that an absolutely clear distinction can be drawn between a disorderly movement and a disruptive trend.

Mr. Yamazaki made the following statement:

It has been of great concern to the Fund to have had to witness the recent turbulence in the international financial market. I would like to thank the management and staff for their timely initiative in preparing the preliminary world economic outlook paper at this stage. At the same time, I have to add that, since my authorities did not have enough time to explore issues raised by the paper, my comments today will be of a preliminary nature.

The G-7 statement issued last month reaffirmed the strong commitment of major industrial countries to the Louvre Accord. In accordance with that statement, the policy coordination agreed to under the Accord has been intensified to reduce external imbalances among the G-7 countries. Moreover, cooperation in the exchange market has been strengthened in a drive toward exchange rate stability.

Given this enhanced policy coordination, I think that the world economy will continue to gather momentum in spite of the October stock market plunge. I also think that a clear trend of declining external imbalances will prevail, although month-to-month fluctuations will continue to be unavoidable.

I would like to elaborate on the policy measures my authorities are undertaking in line with the G-7 statement. The emergency economic package totaling ¥ 6 trillion is now being implemented. In addition, my authorities have recently filed their FY 1988 budget, which gives priority to the stimulation of domestic demand within the medium-term framework of fiscal reform. For instance, in FY 1988, expenditure on general public works will be maintained at the same high level as the preceding year. With these efforts, my authorities project a 3.8 percent real growth rate as well as a $10 billion reduction in the external surplus in FY 1988. Moreover, the external surplus will decline more than the staff has projected for FY 1989, owing to further progress in structural adjustment, such as the shift of production to overseas sites and the replacement of domestically supplied intermediate goods with imported intermediate goods from the newly industrializing economies.

As the staff rightly recognizes, the Fund should pay due attention to the underlying assumptions of the medium-term projections. I broadly concur with the staff's view that potential tensions exist in the baseline scenario. I would especially support the staff's view, in accordance with the G-7 statement, that a further decline of the dollar could be counterproductive for world economic growth, although the recent movement toward stability in the exchange market seems to be a sign of mitigation of these tensions. These tensions underscore the importance of the policy coordination agreed to by the G-7 countries.

This brings me to policy issues. While, as the G-7 statement clearly states, "the measures being taken will accelerate progress toward increased, more balanced economic growth, and sustainable external positions necessary for greater exchange rate stability," I would not preclude seeking further policy improvement. It is important that policy coordination be conducted so as to make full use of the fiscal, monetary, and structural policy measures. In this respect, I especially support the staff's emphasis on structural policy, which has the ability to promote the international adjustment process without having an adverse influence on efforts to achieve medium-term fiscal objectives. Such issues as labor market rigidity should be tackled, paying due attention to the unemployment rate.

I would like to stress the important role the Fund should continue to play in working toward a stable international monetary system through multilateral and bilateral surveillance.

Mr. Rye made the following statement:

Instead of attempting to address in detail the topics for discussion suggested by the staff, I shall make a few specific points.

First, the proximate cause of this discussion is the October plunge in the stock market and the subsequent turbulence in financial markets generally. The staff has suggested that these may be interpreted either as a "necessary correction to earlier excessive increases" or as a reflection of "a deeper malaise on the part of market participants" in the face of perceived policy inadequacies. These are not necessarily competing theories, of course. The long bull market was clearly overdue for correction, and the trigger to the plunge was a realization by market participants that economic policies were inadequate--and that accordingly the record levels of stock prices were not firmly based. One can hardly quarrel with the staff observation that "unless the problems confronting the world economy are tackled convincingly, the risk is that tensions in financial markets will persist"--with potentially disastrous consequences.

Second, there plainly needs to be a restoration of confidence in the capacity of governments to manage national and international economies. We may ask what might help in that regard. A few years ago there was much stress laid upon the "3 Cs." My staff has now elaborated this into a policy equation consisting of 5 "Cs": Commitment, Consistency, and Comprehensiveness equal Credibility and Confidence. One perhaps ought to add a sixth "C" on the left hand side of the equation--Cooperation. It is not easy to find these qualities in recent policy developments. What we have seen are: failures to follow up some promising beginnings to international cooperation, whereby coordinated action has too often given way to international wars of words; deeds, where there have been deeds, that plainly fall short of what is required; short-term measures that leave fundamental problems untouched; and even efforts to represent sows' ears as silk purses, in which regard I refer to the recent headline "Reagan Says U.S. Trade Deficit Sign of Economic Strength."

Third, and related to my second point, I would stress the danger of tackling symptoms rather than causes. The staff rightly observes that "cooperation on exchange rate matters should focus on underlying policies, rather than a particular pattern of rates." Yet this is almost the opposite of what we are seeing at present. No doubt one could give a qualified "yes" to the question posed by the staff whether, while more fundamental policies are taking effect, such policy instruments as monetary policy and exchange market intervention should be employed to influence exchange market developments--obviously, for now, in the pursuit of stability. But this question could be more readily answered in the affirmative if we could be sure that adequate policies were being put in place to tackle economic problems at their source. At the moment, that would require a leap of faith greater than I can summon up.

Fourth, in regard to these more fundamental policies, I would underline the central place of structural adjustment policies for all groups of countries. We in the Fund have put much emphasis on structural adjustment for the developing countries, particularly the poorer ones, but the needs are just as great in industrial countries if sustainable growth rates are to be improved and inroads made into unemployment. I very much welcome the balance that the staff has given to this question, underlining the limits on the extent to which it is reasonable or desirable to ask these countries to postpone pursuit of their medium-term fiscal objectives for the sake of short-term demand stimulation, while noting that they have "important structural impediments to output growth which it would be desirable to remove on both international and domestic grounds." While "desirable" may be an understatement, the thrust of the comment is, I think, absolutely right.

Elsewhere, however, one might read into the staff paper something of an overemphasis on the difficulties in improving structural policies. Not all structural policies can be implemented only over the course of years; and the admitted lags with which such policies generally produce their benefits can all too often be an excuse for inaction. Here, as elsewhere, consistency and commitment are of the essence. If those qualities are present, the markets will take heart even if reform is only just beginning. The key is to get going.

Finally, with the world situation as it is, one must indeed agree that the projections which the staff have provided are full of risks on the downside. We can be sure that in fact the figures will not follow the smooth pattern that the technical projections suggest. There will be shocks as yet unforeseen and indeed unforeseeable. How successful the world economy will be in withstanding these shocks will depend predominantly on the quality of underlying policies. In this regard, the Fund does have a particular role to play, and I both welcome and support the suggestions of Mr. Posthumus to strengthen that role.

Mrs. Filardo made the following statement:

When the previous world economic outlook exercise took place, it was emphasized that there were important uncertainties in the short-term outlook, even though there was a mood of guarded optimism. The scenario presented on that occasion showed that the external imbalances among the larger industrial countries were not sustainable, and that unless concerted measures were adopted, the world economy ran the risk of correcting those imbalances through a sharp depreciation of the U.S. dollar, which would in turn bring about a significant fall in world economic activity. Shortly after that meeting, there was a major crisis in the stock markets around the world, which also ended a lull in exchange rate adjustments.

It is ironic that despite continued calls for a more coordinated policy stance among major countries, only a crisis of this magnitude could create enough momentum for policymakers to adopt a tougher attitude toward adjustment. In the United States an agreement between the executive and legislative branches of government was reached regarding deficit cuts, and later the Japanese and German authorities announced a more stimulative economic policy. The Group of Seven has issued a communiqué restating the objective of coordinating its policies to attain sustainable growth and help developing countries regain access to financial support.

Although these developments constitute a desirable step, not enough has been accomplished in terms of concrete measures to convince the public that the imbalances are being tackled. For example, the recent decision by the German authorities to raise some taxes in order to arrest the fiscal deficit is a sign of the ambiguity in their commitment to stimulate their economy. It is therefore not surprising that exchange rate instability has re-emerged, and that only last week the New York stock market experienced a further sharp drop.

The decline in the world stock markets in October prompted our request to revise the short- and medium-term forecasts. We wish to commend management and the staff for the flexibility shown in responding to this request. The papers prepared by the staff for the discussion at IS/87/5 (11/13/87) and EBM/87/158 (11/18/87) are part of this response, and they provided useful information for today's discussion. Regarding EBS/88/1, we wish to reiterate our view that the methodological approach is adequate; however, notwithstanding our support for this effort, we remain unconvinced of some of the staff's conclusions and arguments. This chair has expressed the view that the primary source of disturbances in the financial markets was the exacerbation of macroeconomic disequilibria in industrial countries by poor economic policy implementation, together with the liberalization and innovation processes in capital markets. In our opinion, the recent financial crash and the continuous price volatility of various financial instruments are the result of a market perception that economic imbalances among industrial nations cannot be sustained under current economic policies.

On the realism of the projections, the staff recognizes that a second market shock, even if smaller than the first, could have proportionately larger effects on consumer and business spending, significantly increasing the risk of recession. Although last Friday's shock was smaller in magnitude and duration than the one of October, and did not affect other stock markets, it nevertheless violated the assumption on which the projections were based--namely, that there would be no further disturbances. Thus, Friday's shock has already made the latest projections too optimistic.

Furthermore, the staff analysis does not take into account the heightened volatility of the stock market, which unavoidably will have an adverse impact on the ability of the financial system to allocate savings efficiently across sectors and countries. It is disappointing that this issue was not treated more explicitly in the staff paper, since in November the staff stated that the crisis raised questions about the stability of financial institutions and the safety of international payments mechanisms. This issue is even more relevant because until a more sustainable pattern of domestic saving/investment balance across countries takes place, world potential growth will remain subdued.

It is important to emphasize that, although the staff takes into account the substantial corrections in the exchange rates which have taken place since September, the external imbalances in the industrial countries are expected to diminish only marginally: as a percentage of GNP the current account imbalances of Germany, Japan, and the United States will decline by close to only one point in two years. This is very revealing, because it reflects the limited role which exchange rates may play in correcting external imbalances and, therefore, it underscores the need to adopt structural adjustments to regain equilibrium.

In the short run, unfortunately, despite the measures being adopted in the major industrial countries, the lack of consistency between fiscal and monetary policies will most probably result in a reversal of the decline in interest rates observed since October. An increase in this variable will have an adverse effect on growth in the countries in this group, and will further complicate the deteriorated position of debtor countries.

Current events and the comments of the staff clearly show that unless the Group of Seven undertakes more decisive steps to reduce fiscal and trade imbalances as well as to introduce structural reforms, confidence will be undermined, and renewed tensions will therefore develop in financial markets.

Regarding policy requirements in industrial countries, the staff points out that the central focus of concern within the field of policy coordination is the pattern of exchange rates among those countries. The most difficult questions, in the staff's view, are, first, how to determine a pattern of exchange rates that is both compatible with a sustainable evolution of their balance of payments positions and reasonably stable over time, and second, if the pattern is not compatible, how to make it so.

In this respect, while we would agree with the staff that the optimal policy would be a combination of fiscal and structural measures that in the medium term would rectify the actual imbalances, we are concerned that in the absence of corrections, the authorities of industrial countries will continue to rely on what the Louvre Accord has implied up to now--namely, interest rate coordination and exchange market intervention, which would produce an additional source of tension in the financial markets.

Thus, in the present circumstances, it is imperative that the industrial countries adopt structural measures, along the lines suggested in the staff paper and in the staff reports for the Article IV consultations with those countries, to liberalize, inter alia, labor markets and eliminate agricultural subsidies. Reducing the fiscal disequilibrium in countries with an external deficit is also of prime importance.

On exchange rate policies, we agree that cooperation should focus on underlying policies rather than on a particular pattern of rates; however, the monetary authorities should remain prepared to avoid unwarranted volatility. In this connection, it is interesting to note the staff's point that real exchange rates have returned roughly to 1980 levels and may therefore not be far from equilibrium. Unless variables other than the external imbalances--such as the fiscal deficit, real wages, and labor and capital productivity--are compatible with the current real exchange rates, the 1980 levels cannot be used as a criterion for defining equilibrium; one needs only to recall that in that year the United States registered an external surplus and Japan a current account deficit.

We agree with the staff's allocation of responsibilities among countries according to their external balance and would only add that we urge countries to adopt the appropriate measures at the earliest possible time in order to avoid a reduction in growth.

Concerning developing countries, it is very difficult to make general comments because of the pronounced growth and development discrepancies between continents and, within them, between countries. In this regard, in Asia, the newly industrializing economies continue to register rapid growth and have very strong external sectors, while Latin America and Africa are experiencing poor performance and excessive debt burdens. It is worthwhile noting that the staff has revised downward the projections for the Western Hemisphere countries as a result not only of policy slippages but also mainly of the deterioration in the terms of trade and a sharp reduction or curtailment of external financial revenues, not to mention the protectionism encountered by many of our countries.

Regarding the developing countries' outlook, the pickup in expected growth is supported in part by arguments that the terms of trade will remain essentially stable, competitiveness has improved, and growth in industrial countries will be reasonably well maintained. This list, however, fails to mention other elements that will continue to have the opposite effect: first, a net outflow of resources is anticipated, owing to the service of foreign debt unaccompanied by renewed lending. Second, although by the end of 1987 the index of commodity export prices of developing countries had roughly regained the average level of 1986, the price of oil has been falling relative to its average value in 1987, severely affecting fuel exporting countries. Third, the rise in interest rates in international capital markets will render foreign debt service more burdensome. Finally, despite the upward adjustment in GDP growth for industrial countries in 1987, the corresponding figure for developing countries was revised downward and, in 1988, of the seven major countries only Japan and the United States are expected to show relatively robust growth. However, protectionist pressures in these two countries may not allow developing countries to benefit from their growth. Taking into consideration all the arguments, it is difficult to be optimistic about growth prospects unless clear inroads are made toward solving the debt problem and fostering a more positive external environment.

Although the Board tends to agree on the benefits to all parties of developing the surveillance role of the Fund, and the Managing Director has received assurances at the G-7 meetings that the views expressed in the World Economic Outlook serve to guide policymakers, the facts tend to lead to contradictory conclusions. Unless the major industrial countries provide political support to the surveillance role of the Fund, the world economic outlook will become merely an academic exercise that has no fruitful results. We therefore call on the Managing Director to voice our concern in this regard during consultations with the authorities in the G-7 countries. We would also like to associate ourselves with Mr. Posthumus's comments on the role of the Fund in these matters.

Mr. Massé made the following statement:

This preliminary discussion of the world economic outlook gives us a chance to assess the impact of the October stock market plunge and subsequent exchange rate developments, as well as relevant policy issues.

The staff's analysis of the short-term outlook, in light of recent financial market developments, appears surprisingly favorable. Real growth in a number of industrial countries has indeed been stronger than forecast last fall, yielding higher aggregate growth in the Group of Seven in 1987. The direct impact on real growth of the October stock market plunge seems likely to be relatively modest--at least so far--owing in no small measure to the appropriate response of monetary authorities. However, with the present policy setting and exchange rate profile, the current account imbalances among the United States, Japan, and Germany will remain very large, although some narrowing of the imbalances is to be expected as the J-curve effect in response to the exchange rate realignment works its way through.

It is noteworthy, however, that the staff puts most, if not all, of the risks in its projections on the down side--an assessment which I share. In the immediate aftermath of the October stock market crash, most analysts focused on confidence as the critical factor in determining whether the real economy would respond negatively to the fall in equity prices. So far, investor and consumer confidence does not appear to have been badly shaken, but there is reason to question whether the effect has been fully played out. Financial markets remain unstable, as demonstrated by last Friday's second plunge on Wall Street. This instability arises from the large imbalances in the U.S. fiscal and current account positions, and from the uncertain policy response to those imbalances.

At present, risks continue to face both the equity and foreign exchange markets. Downward pressures on the dollar continue to be exhibited, making it hard for trade values to catch up despite the adjustments which are taking place in trade volume data. Without changes in fundamental policies, interest rates may well rise in the United States and elsewhere, regardless of whether the pressure on the dollar is actively resisted. That is a sobering thought, and it might be helpful to have the staff's views on what risks or costs each of the possible scenarios outlined in the staff paper might entail.

Moreover, financial markets are not independent. A further drop in the dollar could see further declines in equity markets both in the United States and elsewhere, in response to fears about both high interest rates in the United States and lower levels of economic activity generally. The possibility of further instability in equity markets thus would seem to be directly linked to existing policy shortcomings that have not been fully resolved.

In our view, the main problem facing the economic outlook is this fragility in confidence and the resulting fluctuation in currency and equity markets, which leave us with few historical guides. Confidence is a matter not only of substance, but also of rhetoric. In developing their policy positions and in making their public statements, our governments have to be fully aware that it is not solely the outcome of their policies but also the attitudes of the economic actors that are being influenced and that have to be kept under consideration.

What sort of policy prescriptions therefore emerge? First and foremost, we continue to believe that significant and continuous action is needed to reduce the fiscal deficit in the United States. Recent efforts to reduce the deficit over the next two fiscal years are very welcome. However, there is certainly no room for any faltering in this process, and the efforts already taken can only be considered as a first step. Granted, the fiscal deficit in Canada is large, but one must take into account the limited influence on the world economy of Canada's situation compared to that of the United States.

In the major surplus countries, policies that remove or reduce structural rigidities, thus raising potential output growth, need to play an increasing role. The Japanese economy is now showing robust growth, but stronger efforts on land reform, improved access for agricultural imports, and a more open domestic distribution system could encourage greater absorption of domestic savings.

With respect to Germany, we agree entirely with the staff that potential output growth is being seriously constrained by the existing system of subsidies in agricultural areas and in industry, as well as rigidities in labor markets and elsewhere in the economy. That is certainly the best form of action the German authorities could offer, but it may not be sufficient. The German authorities have so far been given the benefit of the doubt on macroeconomic policies, based on the belief that domestic demand would grow fast enough to contribute to a meaningful realignment of international imbalances. Yet, while domestic demand has strengthened, there is little reduction in the German current account surplus in sight. I take the point that Mr. Grosche made about the difference between real and nominal balances, but there is no doubt that the nominal balances by themselves have an effect on confidence in the world economy. The question that now needs to be asked is whether domestic demand growth projected at 2.6 percent in 1988--a reduction of 0.5 percent from the October estimates--is adequate. At the current juncture, and in view of the potential risks facing the system, the German authorities may need to give more weight to policies that encourage domestic demand growth, within a coordinated approach to reducing the imbalances.

The staff raises further issues with respect to exchange rate management and monetary policy. Monetary authorities responded to the decline in worldwide equity prices by increasing liquidity through lower interest rates. This was an appropriate and necessary response to the circumstances. However, over the medium term, monetary policy in all countries should continue to focus on controlling inflation and inflationary expectations. In the present unstable state of foreign exchange markets, central bank intervention might have a useful role to play in slowing movements in exchange rates and ensuring that sharp dislocations or disruptions do not take place. Yet, exchange market stabilization ultimately depends upon addressing the fundamentals. Attempts to mitigate sharp fluctuations through intervention might be appropriate in the present environment, but over a longer period intervention that is not supported by fundamental policy changes will be costly and is unlikely to maintain the existing configuration of exchange rates.

The impact of higher interest rates or slower growth in the industrial world on indebted developing countries must not be overlooked. These countries, partly as a result of their own weak economic policies, but also partly as a result of external factors, have in a number of cases not even fully recovered from the recession of the late 1970s and early 1980s. Internal policies are certainly partly to blame: there has been ample evidence recently in this Board of policy shortcomings in some major debtor countries, and the shortcomings need to be redressed. Yet the Fund must also recognize that efforts to improve domestic policy in developing countries are less likely to be sustained--and adjustment fatigue more likely to be exacerbated--when there is any significant weakening of growth prospects in the world economy. The long-term growth of developing countries and a solution to the debt question are as dependent on sound domestic policies as they are on a proper external environment, including proper policies in the industrial countries.

Mr. de Groote made the following statement:

Today's interim discussion on the world economic outlook is especially timely, if only because it teaches us that the general output and adjustment prospects have not been changed dramatically by the international stock market crisis and that no impending recession is in sight that would impose a correction of the present payments imbalances at much lower output levels. There is thus no compelling reason for giving in prematurely either to propositions for a relaxation of U.S. budget policies in order to offset the negative growth effects of the stock market plunge, or to the competing suggestion that only an immediate elimination of the U.S. budget deficit can restore stable growth prospects in the future.

The recent G-7 statements and the staff's updated projections for the industrial countries seem, on the contrary, to suggest a continuation of previously endorsed prescriptions for adjustment based on the preservation of moderate growth conditions and the acceptance of large current account imbalances at levels that can be financed in relatively stable conditions--in sum, a scenario for stable imbalance. The need for a fundamental revision of those prescriptions is today perhaps even less pressing because the staff's revised output estimates for 1987 suggest that the industrial countries' underlying capacity to achieve noninflationary growth has been greater than expected until recently, especially in the largest deficit and the largest surplus countries.

I have no fundamental objection to the validity of today's muddling-through strategy, provided we remain constantly aware of the risk that it may at any time be upset by the markets' own imposed solutions and provided that we will not hesitate to unfold the confidence building measures necessary for the continuous financing of a "stable imbalance" scenario. Most recent events have shown that the policy choices imposed by such muddling through are not necessarily less demanding than those implied by more fundamental adjustment choices, but that instead they have to be constantly assessed against the requirements imposed by the financial markets.

Let me briefly outline some of the implications of the post-October scenario for the economic outlook of the developing countries, for interest rate and budget policies in the United States, and for the cooperation among the industrial countries on exchange rate policies.

The better than expected output results for the industrial countries have not been paralleled by a similar improvement in the growth estimates for the developing countries. The staff's revised projections show a serious weakening, and even a reversal, of the commonly accepted positive relationship between the general output performance of the industrial and the developing countries. This worrisome development suggests that no recovery of world demand conditions is likely to produce a fundamental improvement of the indebted countries' output prospects unless these countries' investment and financing are restored to satisfactory levels. It follows then that not only have these countries' export markets suffered from the prolonged deflationary adjustment that has been followed in the industrial countries, but also the deterioration of their financing and investment conditions no longer allows them to produce the necessary supply responses to a recovery of demand in the industrial countries. While the elements for a detailed assessment of this situation are not present today, I would certainly recommend that the Board return to the issue at the occasion of the world economic outlook discussion and that, at that time, the Board also consider the negative implications that the stock market uncertainty may have for proposals to restore the debtor countries' investment outlook through a conversion of their debts into equity.

Recent events have shown that the reduction of the U.S fiscal deficit remains the single most important variable for adjustment in the industrial countries to take place. The alternative solution, which would impose a further depreciation of the exchange rate, carries more risks than advantages because it would result in inflationary pressures, which would soon require forceful action on interest rates and might lead to a recession at a time of upward price developments. Furthermore, recent employment figures confirm that the U.S. economy is operating at a high level of capacity utilization and suggest that further action on the budget is still needed in order to create room for the nascent recovery of the U.S. export sectors without destabilizing domestic financial conditions.

The budget prospects for the two coming years, which include only marginal nominal and relative reductions of the federal deficit, suggest that the policymakers have underestimated the importance of clearly announcing more forceful corrections at this stage. The Board therefore has to give serious consideration to the possibility that a new Congress would reach a broad consensus on the additional spending and revenue measures that will be needed to comply with the deficit reduction targets. These discussions should perhaps be backed up by the action of a special committee of senior officials that would examine how worldwide confidence in the U.S. budget process can be restored. Any comments which Mr. Templeman could make on the possibility of a midyear decision on additional measures for the current fiscal year, and on the establishment of additional spending and revenue constraints that would already commit the next Administration, would be highly relevant for the outcome of today's discussion.

In this context, the issue for policy examination remains whether the 1986 tax reforms are indeed producing their supposedly positive effects on private savings or whether, on the contrary, additional tax measures still have to be envisaged in order to discourage consumption in favor of savings. In any event, it would seem that all future budget measures will have to be considered in the context of broader action toward the restoration of the U.S. savings rate, because the deficit reductions that have so far been achieved at great effort have been offset to a large extent since 1983 by a drop in the personal savings rate of the same magnitude. Decisive action is still needed in order to correct the worldwide perception that the U.S. Government lacks the power to reduce the country's domestic imbalances, because these imbalances continued to accumulate when their correction was more easily envisaged.

Failure to address these imbalances vigorously will seriously increase the risk that any improvement in U.S. output prospects will continue to be considered by the markets as a threat to price stabilization. The most recent developments in the U.S. financial markets already suggest that the continuously favorable employment outlook is immediately associated with an increase in inflationary risks, which produces upward pressure on interest rates and related weaknesses in the stock market. This seemingly paradoxical relationship between the behavior of stock markets and the achievement of satisfactory output levels at this stage of the business cycle thus suggests that a credible policy setting is strongly needed in order to avoid positive output developments being outweighed by upward interest rate pressures. With the European model for monetary policy in mind, Mr. Posthumus questions the prevailing belief that interest rate increases are a sure recipe for recession. I am not certain I can agree with him as far as the U.S. economy is concerned. Rather, I would submit that given the structurally low liquidity and high indebtedness of the U.S. private sector, business expectations in this country are much more sensitive to interest rate developments than in most European countries. This high sensitivity is illustrated by the much greater importance that the U.S. public attaches to announcements on monetary policy changes and by the importance that the issue of interest income tax deductions has always received in the debate on fiscal policies. I was impressed by a statement made at yesterday's World Bank Board meeting by the Treasurer that the figures on improved employment performance were immediately interpreted by the market as a good reason for expecting interest rate increases because they were a sign of improved economic performance.

Efforts to offset the market-imposed relationship between improved performance and inflationary risks by a relaxation of monetary policies would probably be quickly self-defeating because they would inevitably be associated with expectations of even higher inflation and the need for an equally more forceful readjustment thereafter. Instead, monetary policy should continue to be mindful of the inflationary preoccupations that dominate market views on interest rates; conditions should thus be created under which further reductions in the U.S. budget deficit would eventually produce a structural decline of the interest rate level worldwide. It is only in those circumstances that the additional growth measures, which we recommend Europe and Japan to constantly envisage as their adjustment unfolds, will have lastingly positive effects on general world output and demand conditions.

By stressing the need for further U.S. budget actions in the near future, we do not endorse the markets' dissatisfaction with the present outlook. After all, the U.S. potential for noninflationary growth may still be largely underestimated given the greater flexibility which the United States has by now achieved compared with many European countries, owing to the elimination of structural rigidities in the economy. Rather, the recommendation for further budget measures should be considered as the necessary corollary of the present "imbalance scenario," which has to be supported constantly by confidence building measures in order to ensure the preservation of stable financing conditions.

Has the adjustment between the major industrial economies been assisted or impaired by the evolution of exchange rates since October? In this connection two additional questions have to be addressed. First, assuming that the further depreciation of the dollar rate was needed, has it been pursued by an appropriate technique, letting the rate crawl down instead of adjusting it at a discrete moment in time? Second, has the depreciation been supportive of the adjustment?

We seriously doubt the merits of an exchange rate adjustment that extends, over a period of several months, uncertainties and speculation that could be avoided if the adjustment took place at once, as is the case for the exchange rate modifications under the EEC monetary arrangements. As long as the rate is not stabilized at its new level, the possibility of favorable J-curve effects is constantly postponed; part of the disappointing performance of the U.S. current account in recent months might be due to this circumstance.

On the relevance of a depreciation in the dollar to a rate adjustment, a number of considerations have to be taken into account. The U.S. economy is edging closer to full employment, which leaves little room for the allocation of resources to the balance of payments. This also implies that the risk of a resurgence in inflation becomes greater when the rate depreciates further. Irrespective of the degree of employment of resources, depreciation of the rate has its well-known effects on prices through imports. More fundamentally, we share with the staff the widespread view that the sluggish response of U.S. trade is largely due to nonprice factors. Relying on rate adjustments when structural reform is needed entertains the illusion that the instruments for a rapid elimination of the deficit are available. Continuous recourse to rate adjustments and to protectionist policies belongs to the same family of expedients and fails to address long-term adjustment needs. Even under the most optimistic scenario, the corrections of the U.S. current account will take several years and will require, meanwhile, substantial financing. Such financing is normal, given the difference in saving ratios between the United States and other large industrial countries. Destabilizing interest rate movements can be avoided only if the market accepts the view that the trade adjustment between the United States and the rest of the world is a prolonged process.

The best way to convince the public that we are in a financing scenario, and to assist the U.S. authorities in the further adoption of corrective policies, is to adhere more explicitly to a system of stable and adjustable rates. By doing so, the authorities of the industrial countries would clearly convey the notion that the adjustment has to take place through a gradual correction of the underlying policies, while the concurrent financing of the imbalances is normal, has to be continued, and can take place at reasonable interest rates. I therefore disagree with the staff's view that cooperation on exchange rate matters should focus on underlying policies rather than on a particular pattern of rates. Causal relationships are the other way around: alignment of the policies will come as a result of exchange rate stability. Mr. Posthumus convincingly makes the same point in his statement, which has set the tone for today's discussion: the experience of the EC has shown that coordination of the underlying policies can be more easily obtained if those policies are based on a commonly accepted exchange constraint. I would therefore suggest that we give due consideration to Chancellor Lawson's proposal not only to adopt a system of more stable exchange rates, but also to announce them clearly to the public. While such an announcement would have the disadvantage of facilitating speculation at times, it would have the overwhelming merit of clearly endorsing the fact that we are in a financing scenario.

Once the public has accepted the new exchange rate relationships, the need for massive intervention will rapidly subside. Readiness to intervene in order to offset temporary exchange market disturbances must nevertheless remain an essential component of the proposed financing scenario. At the same time, one must stress that interventions cannot be effective when underlying policies are not consistent with any given exchange rate pattern. As to the staff's question on how interventions should be financed, I submit that they should be financed symmetrically between the United States and the other large industrial countries, and that for this purpose the United States, as the major reserve currency country, might consider accepting an allocation of SDRs in order to be better equipped to play its role in the present adjustment process, which is bound to remain one of prolonged financing, more stable exchange rates, and intervention.

Mr. Finaish made the following statement:

Since this is an interim discussion of the world economic outlook, with a fuller assessment to be provided by the staff in about two months, my comments will be rather selective.

An evaluation of the significance and implications of recent developments in the equity and exchange markets is, to a large extent, a matter of judgment. It is not surprising, therefore, that views have differed on the interpretation of recent events. It seems that the staff has also tried to avoid giving an explicit view on some of the questions raised. But recent developments have confirmed the notion that beneath the relatively good inflation and growth performance of industrial countries there is a high degree of instability, which could manifest itself in a disruptive manner. Whether recent developments in the financial markets are of major significance or not, to the extent that they are symptoms of a deeper and potentially more serious problem, they should be viewed with some concern.

The large degree of interdependence in international financial markets has also become more evident with the recent stock market developments. This interdependence and the increased openness of markets, which in principle is beneficial to the global allocation of financial resources, have inevitably also heightened the risk of market disruptions rather quickly becoming more generalized.

A third notion that has been supported by recent developments is that while market forces are capable of bringing about adjustment, they do not necessarily bring about a smooth adjustment. This is true for the stock market as it is for the exchange market, and probably other markets as well. If adjustment is left for market forces alone, owing to the inability of major countries to undertake the required policy changes, the cost of that adjustment could be quite high.

After these rather general remarks, I will comment briefly on the outlook of the industrial countries. First, as is always the case in the world economic outlook exercises, the baseline projections are based on working assumptions and not on those assumptions most likely to materialize. Thus, to a large extent, the potential impact on the world economic outlook of recent developments may be captured not by the baseline projections but rather in the tensions and downside risks associated with those projections. In other words, a change in the world economic prospects is reflected in a change in the degree of realism of the assumptions. If one were to look at the major assumption on which the projections are based--namely, that market participants will remain willing to finance budgetary and fiscal imbalances at prevailing exchange rates and interest rates--one would have to conclude that the projections are probably less likely to be accurate than they were last fall. To that extent, the downside risks to the baseline projections have become larger.

Second, with respect to the policy changes required to deal with payments imbalances among major industrial countries, there is more or less broad agreement. But while fiscal and structural policies in these countries have been moving in the right direction, progress has not been adequate. The pace of policy adjustments, particularly in the fiscal and structural areas, is to a large extent determined by institutional and political factors which are difficult to circumvent. The question, therefore, is whether deliberate intervention in the exchange and financial markets can be used to prevent disruptive adjustment by market forces. Most recent developments seem to indicate that coordinated intervention can play a stabilizing role, but this role is a limited one, and its limits have been tested by markets in the past rather successfully.

The above points, in addition to the fact that monetary easing outside the United States in order to relieve the pressure on the U.S. dollar also has its limit, make it unlikely that a rise in international interest rates and some slowdown in the growth of industrial countries can be completely avoided. Of course, the faster major industrial countries are able to implement the needed corrective policies, the smaller the cost of adjustment will be in terms of output and employment.

The implications of significantly higher interest rates and global economic slowdown for developing countries are obviously quite serious. There are already indications that growth in many developing countries is being constrained by capital stock as a result of the investment cutbacks in the recent years of tight financial adjustment. In such an environment, a significant increase in interest rates can have a serious effect on the payments position of many indebted countries and can put further strain on the global debt situation.

The payments position of developing countries is also not being helped by commodity price movements. Although most recent data show some improvement in prices, that improvement is small relative to the decline which occurred in the first three quarters of 1987. For 1987 as a whole, real prices of commodity exports of developing countries were 8 percent lower than in 1986. It is probably too early to tell whether the very recent upward trend will continue in 1988. Obviously, this depends at least partly on growth and demand in industrial countries.

As far as the oil exporting countries are concerned, the recent decline in prices in U.S. dollar terms, together with the continued depreciation of the dollar, have made the outlook for their real export earnings less favorable. For some of them that already face financial difficulties, a continuation of the recent trend could aggravate their external payments situation even further. In this connection, it would be useful if the staff could comment on the net effect of recent exchange rate changes on the external position of indebted oil exporting countries in light of their dollar-denominated exports and the currency denomination of their debt portfolios. Obviously, the effect on different countries may be different, but I wonder whether the staff can make a broad overall assessment of the net impact of exchange rate developments on the balance of payments of indebted oil exporting countries.

We agree with many of the comments made by previous speakers on the role of the Fund vis-à-vis exchange market developments and policies and their systemic implications. In particular, we believe that the Managing Director is uniquely placed to provide a channel between major industrial country deliberations and agreements with systemic implications on the one hand, and the international community at large as represented by the Fund on the other. We would therefore encourage management to strengthen that role to the extent possible.

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/88/4 (1/11/88) and EBM/88/5 (1/13/88).

2. MAURITIUS - TECHNICAL ASSISTANCE

In response to a request from the authorities of Mauritius for technical assistance in the fiscal field, the Executive Board approves the proposal set forth in EBD/88/3 (1/6/88).

Adopted January 12, 1988

3. SWEDEN - TECHNICAL ASSISTANCE

In response to a request from the authorities of Sweden for technical assistance in the fiscal field, the Executive Board approves the proposal set forth in EBD/88/4 (1/6/88).

Adopted January 12, 1988

4. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/88/5 (1/11/88) and Correction 1 (1/12/88) is approved.

APPROVED: September 6, 1988

LEO VAN HOUTVEN
Secretary