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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 88/6

3:00 p.m., January 13, 1988

M. Camdessus, Chairman

Executive Directors	Alternate Executive Directors
	A. G. A. Faria, Temporary
Dai Q.	
	D. C. Templeman, Temporary
J. de Groote	
A. Donoso	
M. Finaish	
G. Grosche	
J. E. Ismael	J. Reddy
	J. Hospedales
T. P. Lankester	
M. Massé	D. McCormack
Mawakani Samba	
	I. A. Al-Assaf
	L. Filardo
J. Ovi	M. Fogelholm
	G. Pineau, Temporary
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

1. World Economic Outlook - Prospects and Policy Issues - Preliminary Assessment . . . . Page 3

Also Present
African Department: R. C. Williams. Asian Department: B. B. Aghevli, D. A. Lipton. 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: C. S. Gardner, Deputy Director; P. C. Hole, J. M. Landell-Mills. Fiscal Affairs Department: G. M. Bartoli. IMF Institute: O. B. Makalou. Legal Department: J. M. Ogoola, J. K. Oh. 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, J. H. Feldman, D. Folkerts-Landau, E. Hernández-Catá, P. Isard, F. Larsen, B. E. Rourke, M. Schulze-Ghattas, M. A. Wattleworth. Treasurer's Department: D. Williams, Deputy Treasurer; G. Wittich. 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, G. D Hodgson, Khong K. N., P. D. Péroz, P. Péterfalvy, Song G., A. Vasudevan, J. E. Zeas. Assistants to Executive Directors: N. Adachi, E. C. Demaestri, F. El Fiky, W. N. Engert, V. J. Fernández, M. A. Hammoudi, C. L. Haynes, L. Hubloue, A. Iljas, S. King, K. Kpetigo, V. K. Malhotra, C. Noriega, L. M. Piantini, S. Rebecchini, G. Schurr, R. Wenzel, Yang W.

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

The Executive Directors continued from the previous meeting (EBM/88/5, 1/6/88) their consideration of 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. Donoso made the following statement:

We agree with the diagnosis presented by the staff in this updating of the world economic outlook. In spite of progress in the fiscal management of the U.S. economy and the most recent agreement between Congress and the Administration to have the deficit reduced, and in spite of the large devaluation of the U.S. dollar, external imbalances of a worrisome magnitude persist in the U.S. economy. At some point, the markets could decide not to finance the U.S. deficit, and that could result in a drastic depreciation of the U.S. dollar, an increase in the rate of inflation, and high interest rates in the United States. These developments would negatively affect the growth performance of the rest of the world. It is therefore too risky to rely on continuous external financing of the present magnitude to ensure that no drastic and disrupting adjustment occurs.

We agree with the central part of the staff's recommendations on dealing with the U.S. imbalances. The United States should adjust its fiscal situation, thus reducing overall demand and, therefore, the present level of excess demand. We consider such an adjustment crucial to a reasonable functioning of the world economy in the near future.

The appropriateness of the staff recommendations affecting the newly industrializing economies among the surplus economies is less clear to us. The staff indicates that these economies should adjust their own situations by expanding demand so as to facilitate the adjustment of the U.S. economy and to avoid excessive reduction in overall demand at the world level, as well as to achieve adjustment in the United States in the context of better terms of trade, presumably with less exchange rate adjustment. This part of the recommendation seems contradictory to the notion that the main risk in the world economy today is a possible abrupt lack of external financing for the United States. If that notion is valid, should we encourage surplus countries to reorient their savings before the United States has adjusted its demand? Might we not create the problem we want to avoid through such a strategy?

I understand that it is feared that containment of demand in the United States, without compensatory expansion in other economies, could make the overall level of economic activity in the world more difficult to preserve. I would not exaggerate the relevance of this point. If the United States frees some resources, world interest rates should go down, inducing more expenditure in the other economies, unless monetary policies are used in such a manner that they offset these tendencies, as has happened recently. Nevertheless, if the concern over the lack of financing for the U.S. economy is valid, is the appropriate response not to concentrate on using economic instruments to avoid such an event? I would appreciate comments by the staff on this point.

I have no difficulties with the concrete proposals for the so-called major surplus countries, although I have difficulty in accepting the implicit notion that a positive contribution by a surplus country to international adjustment has to consist of more expenditure and less savings.

Little has been said about the indebted developing countries and their position in the present circumstances. Basically, they are advised to continue adjusting until they regain creditworthiness, then to contribute to the international well-being by once again running current account deficits and absorbing exports from the industrial countries. The debt problem affecting many developing countries should be looked at as a major structural problem that is constraining growth in those countries. Perhaps the most productive structural reform today would be in the field of international indebtedness, but the staff did not enter into this, probably because it has produced other work on the subject.

So far I have referred to the staff recommendations dealing with demand management: less expenditure in the United States and in the indebted countries; maintenance of the present demand policy stance in the large industrial surplus economies, and expansion in the newly industrializing economies. The staff has also placed much importance on the role of changes in relative prices in facilitating the adjustment of imbalances that could result from such demand management, and we fully agree with the staff on this. Cooperation on exchange matters should concentrate on underlying policies, rather than on a particular pattern of rates. Little can be accomplished by introducing rigidity in exchange rates, which instead would create the need to rely even more on demand compression to achieve the same adjustment.

Perhaps exchange rate stability is possible in the context of stable and predictable fiscal policies, but given the fiscal difficulties in the world today, the burden of the exchange rate stability would be placed on monetary policy, with negative consequences. If the U.S. fiscal deficit is going to be further compressed, more reduction in the demand for U.S. resources will occur. To avoid unemployment, foreign demand or U.S. private demand will have to substitute for fiscal demand. For this to happen, relative prices might have to adjust further; in other words, the dollar might have to depreciate more.

Nevertheless, all the international agreements made in the past year have been oriented toward pegged exchange rates, making world adjustment more difficult. Only recently has the real value of the dollar returned to the levels before the explosion of the U.S. fiscal deficit. What were the arguments in 1987 for defending the high value of the dollar? And even now, how do we know that it is appropriate to stop the dollar's depreciation when U.S. fiscal adjustment is incomplete and external imbalances remain?

Recent attempts to drastically alter exchange rates, as if to punish those who do not believe in central banks' ability to maintain an exchange rate structure, concern me and seem to anticipate unstable times ahead.

The staff is projecting excessively large current account imbalances on the assumption of constant exchange rates. While I realize that the staff would not support attempts to freeze exchange rates at present levels, this position should be more clearly presented and promoted in all instances of international policy coordination.

I regret the lack of a deeper analysis of last October's financial crisis. In the section dealing with policy issues the staff simply stated that it is "inclined to view the stock market drop as a symptom of the deep-seated imbalances which for several years have plagued the world economy." It would have been interesting to have a more complete comment on what specifically triggered the October problems after several years of the same imbalances. There is ample agreement on the seriousness of imbalances, but there is disagreement on how to move toward balanced external accounts. Some believe that part of the reason for the stock market drop was an excessive reliance on monetary policy to keep the value of the dollar at a level which the market would not sustain, thus pushing up interest rates. Others, however, feel that the fundamental reason for the financial difficulties was the rapid depreciation recently experienced by the dollar. I would appreciate comment by the staff on this matter.

Mr. Sengupta made the following statement:

I shall organize my intervention today according to the broad topics presented for discussion at the end of the staff paper.

Despite the announced stance of fiscal policies and stronger than expected economic activity in the second half of 1987, the staff's growth projections for output and employment in the major industrial countries appear to be extremely vulnerable. In the circumstances, it is perhaps prudent to be cautious in working out these projections. The output projections for the second half of 1987 are not perhaps as important as are the financial market uncertainties. Would the projected growth rates be realizable if there were further shocks in the stock and foreign exchange markets? The confidence effect of a further crash in stock prices could well impact on consumer and business spending, and lead to recession. It is for this reason that market perceptions about the policy stance of industrial countries would need to be strengthened by some evidence of commitment to the stated policies as well as progress in policy coordination.

The December 1987 statement of the Group of Seven provides a reconfirmation of such commitment, but further disturbances in the New York stock market and foreign exchange markets since its release leave the impression that markets are perhaps still uncertain of policymakers' ability or willingness to realize their stated objectives. It would be risky to explain these disturbances as problems of overcomputerization or as temporary aberrations.

From the medium-term point of view, a number of questions are left unanswered. While real domestic demand in the United States is expected to decrease in 1988, there is no evidence that external competitiveness has improved. There are obviously time lags in the response of trade flows to changes in price competitiveness. If the staff's point that developments in nonprice competitiveness in the United States are unfavorable is correct, the growth stimulus in the United States may be very uncertain. On the other hand, even if Japan succeeded in strengthening its domestic demand, Japanese current account surpluses would remain large in spite of the large appreciation of the yen, partly because of nonprice competitiveness and partly because of the slow transmitttal of exchange rate effects to export prices.

On exchange rates, the G-7 statement argues that "either excessive fluctuation of exchange rates, a further decline of the dollar, or a rise in the dollar to an extent that becomes destabilizing to the adjustment process could be counterproductive by damaging growth prospects in the world economy." It appears that the G-7 countries have accepted implicitly a zone within which the exchange rates are to move. I have to call this a "target zone" as we know it, unless we qualify it and call it a "dirty" target zone. I hope that Chancellor Lawson would not mind this description. A strong intervention was made recently to stem the fall in the value of the U.S. dollar. The major industrial countries obviously do not think that there is any scope for further dollar depreciation. Does this imply that they do not see much scope for reducing the projected payments imbalances? Or do they believe that other policy measures would redress these imbalances? If so, what are those policies? If they are the same as before, there has to be a pattern of exchange rates different from the present one that corresponds to desirable and sustainable payments positions. The Fund has a critical role to play in working out such consistency exercises as a part of its surveillance and consultation mechanisms. If the Group of Seven is keen on following target zones, let the Fund staff work out the desirable pattern of exchange rates and the policies required to sustain them.

On the policy requirements in industrial countries, the need for an appropriate monetary and fiscal policy mix is recognized by everybody. But it is often not clearly recognized that the market perception of the policy mix that the industrial countries actually pursue may be quite different from those countries' pronounced intentions. With regard to fiscal policy, while considerable adjustment was made among the industrial countries in 1987, it is not clear whether the projected fiscal balance estimates are realistic, given the positions of the major players. Table 2 in the staff paper shows that while the U.S. fiscal deficit to GDP ratio would decline from 2.1 percent to 0.9 percent between 1987 and 1991, the ratio for Japan would almost double over the same period. The deficit to GNP ratio for Germany is estimated to increase from 1.6 percent to 2.8 percent between 1987 and 1991. While these results seem to emanate from internal consistency estimation, one wonders whether they would eventually be acceptable as goals to the countries themselves. The staff has advised Germany to give up industrial subsidies and labor market rigidities, and Japan to reform land-use regulations. Even if Germany and Japan followed this advice, it is doubtful that the picture would change much by 1991.

One problem with the staff exercises is that imbalances in the industrial countries are to be resolved within the industrial countries themselves; the efforts to resolve the imbalances are not globalized by involving the developing countries. We have talked about the possibility of recycling surpluses through the developing countries. It then might not be necessary for Japan and other surplus countries to raise their domestic demand to the extent implied in the staff exercises, and U.S. net exports might still rise significantly. I am not saying that this would solve all the problems, but it might make a significant difference, and from the international point of view may be highly desirable. I thought that the staff had promised us that it would perform such exercises and I would very much like to see the results. I have seen the numbers given by Jeffrey Sachs, and they are quite impressive. More important, however, the results would give us a sounder basis on which to discuss the policies of the developing countries and the international environment of interdependency rather than make bold recommendations that the newly industrializing economies should appreciate their currencies and the developing countries should open up their markets.

The payments position of developing countries is said to have improved in that the current account deficits declined in 1987 from $20 billion, as estimated in October, to $6 billion estimated now, because of greater than expected improvement in the payments positions of the countries in the Middle East and Asia. In this context, the staff consultant's study on forecasting accuracy acknowledged weakness in the balance of payments forecasts as well as evidence of bias in the Asia grouping. One is therefore not sure how accurate these forecasts are. In any event, we must guard against interpreting such data as meaning that the need for capital flows to developing countries is no longer as urgent, and that there is not much scope for recycling the external surpluses of surplus industrial countries to the deficit developing countries. The staff predictably talks about the need to improve the policies in the developing countries, without spelling out the impact of the growth, exchange rate, and interest rate outcomes in industrial countries on the developing countries' ability to pursue the right policies. There is a curious sentence in the staff paper which states that the heavy debt load of most developing countries may not allow a significant increase in their current account deficit. If this is true, the implications are serious. If the staff expects a continuation of substantial reverse resource transfers or outflows from the developing countries, that will do irreparable damage to growth prospects of these countries. It is important that enough attention be given to redressing the debt problem in the interest of the world economy.

I will describe an illustrative scheme to deal with this problem through the recycling of the surplus of the industrial countries, suggested in a paper jointly authored by Saburo Okita of Japan, Lal Jayawardena of the World Institute of Development in Helsinki, and myself. The paper was presented in Tokyo in the context of recycling the Japanese surplus, but it covers surpluses of all industrial countries and it mentions using zero-coupon bonds, which have suddenly become popular with their recent use in Mexico. We talked about establishing a debt reconstruction facility in an international institution--with the Fund in mind--with small paid-in contributions by the surplus countries to be used to provide long-term bonds, including zero-coupon bonds, that could be exchanged for sovereign developing country debts held by commercial banks at a substantial discount. Having assumed these debts from the commercial banks, this facility then could negotiate with the debtor countries to pass on the discounts by converting them into long-term and lower face value loans on the condition that adequate policy reform packages are adopted by the debtor countries. I am mentioning this as an example of how surpluses of industrial countries can be used to increase the absorptive capacity of the indebted developing countries, thereby improving their credit-worthiness and allowing, as the staff says, "an efficient allocation of global savings." I would like the staff to consider this suggestion.

Finally, I wholeheartedly support Mr. Posthumus's point on reviewing the working of the international monetary system. I do not think that anybody would deny that our international monetary system is not working well, and that exchange rates are not working in a desirable fashion. While I agree with Mr. de Groote about the attractiveness of target zones, there are problems which will have to be solved before that and alternatives could be explored. While everybody pays lip service to the desirability of policy coordination, mechanisms are obviously lacking to effect such coordination. Interdependence has to be extended beyond the industrial countries to incorporate the developing countries. There are unsettled questions on how to do this, as well as on what should be done to solve the debt problem and how the developing countries can adjust with reasonable growth. These are major issues confronting the world today. We may not have reached the stage at which to negotiate any specific proposal about these issues, but Mr. Posthumus is suggesting that we should think about it. A consensus on our approach to these problems must be developed before actual attempts are made to solve them. This requires systematic thinking and examination of the problems and proposed solutions, and we should begin these exercises as early as possible.

Mr. Mawakani made the following statement:

I welcome today's discussion. It provides us with an initial opportunity to consider the larger industrial countries' recent policies and economic performance, which have become a cause for great international concern. That concern has deepened largely because of the lack of an adequate consensus among these countries on how individual countries should share the burden of the required adjustment. This lack of consensus largely reflects the different views of the kinds of policy measures that are needed to establish international economic and financial stability. I share the view expressed in the staff paper that "...unless the problems confronting the world economy are tackled convincingly, the risk is that tensions in financial markets will persist and could, sooner or later, lead to a significant slowdown in growth." Therefore, this chair strongly urges the major industrial countries to address the problems confronting the global economy in a decisive way.

I now turn to the topics that have been suggested for today's discussion. First, on the realism of the projections, while the broad lines of the medium-term projections are acceptable, they appear to be on the conservative side, given that economic activity in the industrial countries was firmer in the latter half of 1987 than had been anticipated; this would suggest that the pace of economic expansion has been underestimated and is still being underestimated for the medium term. Furthermore, confidence of businesses and consumers does not appear to have been significantly affected as was expected after the October 1987 stock market crash, suggesting that businesses, in particular, are prepared to increase their spending based on a more optimistic outlook.

Second, since we expect policy improvements to have a favorable impact on medium-term growth prospects, the greatest responsibility for policy initiatives lies with the three major industrial countries. In the United States, the major policy challenge is in the fiscal area, where the large federal deficit is assessed as being the principal factor behind the persistent external deficit. Efforts recently made to reduce the deficit are commendable. However, since the U.S. dollar has substantially depreciated since 1985 and the economy is performing near capacity, it would seem appropriate for the United States to reduce further the budget deficit and to bring about the required improvement in the external trade balance, thereby reducing protectionist pressures.

I will now turn to the policy responsibilities of the other industrial countries in bringing about international adjustment. It has been recognized that the major surplus countries--Japan and Germany--could adapt their macroeconomic policies in such a way as to speed up the rate of growth of domestic demand and provide stronger markets for exports from other countries. Commendable efforts in this direction have been initiated, and I agree with Mr. Posthumus and the staff that there is a limit to what can be expected from Germany and Japan in the fiscal area. However, greater determination in removing the structural obstacles to output growth--in particular, subsidies, labor market rigidities, and excessive administrative regulations in Germany, and expansion of investment opportunities, and rationalization of the internal distribution system in Japan--would go a long way toward absorbing the slack.

On the question of exchange rate management, it has been recognized that large fluctuations in exchange rates are undesirable. Among the mechanisms that have been suggested for achieving a more stable relationship in exchange rates among the major countries is the establishment of target zones. As demonstrated recently in a study by Mr. Frenkel and Mr. Goldstein, this would, inter alia, have the advantage of improving the international consistency of policies and strengthening the discipline of macroeconomic policies, thus helping to exercise surveillance over the major countries.

It is clear that the developing countries have done their part in the international adjustment process. The staff has recognized that the aggregate fiscal deficit of developing countries is estimated to have declined in 1987. However, if the staff's claim of a relaxation of adjustment efforts in several important countries is true, the explanation is that the adjustment efforts in those countries have not attracted the necessary external finance to support their growth objectives and improving the living standards of their people. Indeed, with the difficult external financing situation, domestic pressures for easier policies have built up. Furthermore, adverse terms of trade have worsened the debt situation of most developing countries. Developing countries thus expect that improved policies in the major industrial countries would lead to growth in output in a noninflationary environment. Coupled with stable terms of trade, this could be reflected in the expansion of output in the developing world over the medium term.

Mr. Dai made the following statement:

I welcome this opportunity for a preliminary assessment of the world economic outlook after the stock market plunge of October 1987. Given that the markets have delivered the strongest possible message, it is our responsibility not only to interpret it correctly, but also to react to it appropriately.

The root cause of the recent turbulence in the financial markets, in my view, lies in the enormous imbalances in the world economy. As the staff has projected, these imbalances, and particularly the external imbalances among the three largest industrial countries, will persist for a fairly long time. For this reason, I am not certain that the growth of the major industrial countries can be well maintained without assurance that further market disturbances will be avoided. The stock market crash has left a legacy of uncertainty and impaired net worth that is likely to have an adverse impact on consumption and investment. If we take into account the fact that the current economic expansion has been ongoing for more than five years, the downside risks in the staff projection are indeed tremendous. There seems to be a great possibility that economic growth in the major industrial countries will slow down significantly in 1988, accompanied by continuing unrest in the financial markets.

Some progress has been made in correcting the fiscal and external imbalances of the major industrial countries, but the slowness of the adjustments should be neither a surprise nor a mystery. The principal obstacle is that the basic demand-management policies of the major industrial countries have not yet been adjusted adequately. Moreover, a lack of strong will on the part of major industrial countries to adjust domestic policies for global needs has further complicated the situation.

In such circumstances, a major concern is the U.S. foreign debt buildup. The United States has been consuming more than it produces, covering the difference with imports and financing these imports with foreign debt. However, U.S. foreign debt cannot continue to increase indefinitely without augmenting the danger of inflation, climbing interest rates, and more troubled financial markets.

The policy dilemma in dealing with the instability of exchange rates among the major currencies is also disquieting. While defending a specific pattern of rates against the market trend may prove to be ineffectual, a free fall of the U.S. dollar could lead to inflation in the United States and weaker economic activity elsewhere.

With a further slowdown of the world economy and rising interest rates, the international debt situation is certainly another major concern.

In tackling the current world economic problems, one necessary policy measure is a further, significant reduction in the fiscal deficit of the United States. As a complement, there is a clear need for Japan and Germany to strengthen the momentum of economic growth. With respect to the role of policy coordination in stabilizing exchange rates among major currencies, a consistent and firm policy stance seems to be most important. As recent experience shows, inconsistent policy actions and conflicting policy statements can only intensify market fluctuations and aggravate market speculation.

In addition to the continued adjustment efforts on the part of developing countries, the recycling of the trade surplus of the major industrial countries is worth our serious consideration in our search for a solution to the economic problems of the developing countries.

In a world of increasing integration of national economies, the elimination of global imbalances and promotion of economic growth demand an international approach. No national economy can isolate itself from the international environment. Therefore, it is in our common interest to strengthen multilateral surveillance in order to make policy coordination more effective. I hope that today's discussion will be beneficial to this end.

Mr. Salehkhou made the following statement:

While I fully appreciate the difficulties the staff is most likely to have encountered in preparing the paper before us--for example, the unavailability of comprehensive data for all country groupings--I have the impression that the approach to developing countries has shifted back to considering them only as a residue of industrial countries' economic activities or, at best, as a debt burden. During our previous world economic outlook discussion, I praised the more candid and realistic approach the staff had adopted on these questions. Although I recognize the necessarily less comprehensive character of the paper before us, the approach this time is, much to my regret, completely different and is more in line with the way developing countries have been treated in the past. It remains to be seen whether the staff will make good on its promise by giving in-depth coverage to the developing country membership in the forthcoming World Economic Outlook.

It is of the utmost concern to me that developing countries continue to muddle through their problems while the international community seems rather pleased with the situation of quasi-equilibrium in its current account balances. Apart from the assessment in the paper that this situation is the result of large surpluses for a few countries and still very large deficits for the majority of them, I do not see how developing countries, especially the highly indebted among them, can continue in the present circumstances, with the evolution of the economy of industrial countries at best uncertain and the risks, as the staff points out, all on the downside. Moreover, commodity prices continue to be depressed, and I frankly do not understand the indices which are provided in the paper, sometimes in SDRs and at other times in U.S. dollars. Clearly, however, the improvement, if any, is less than the fall in the U.S. dollar, which means that the purchasing power of developing countries has in no way improved.

On the question of commodity prices, I wish to point out once again that a large part of the reduction in industrial countries' imbalances is due to the sharp fall in commodity prices including oil, and I regret that the paper before us does not draw more attention to this aspect. In this regard, I wish to recall from last spring's world economic outlook discussions that terms of trade losses suffered by developing countries, in contrast to the gains by industrial countries, amounted to the equivalent of some 3 1/2 percent of GDP of industrial countries in 1986. This is based on the fact that in recent years, international trade, much like international finance, has been a zero-sum game. Fuel exporters have been the hardest hit--their terms of trade declined by 46 percent--and given recent indications in the press on oil prices, it appears that these countries are to remain in solidarity with other commodity producers for some time to come. My figures and assessment are obviously old, and accordingly I would associate myself with Mr. Finaish's request to the staff for a broad assessment of the consequences of recent developments in oil prices on the economic and financial situation of the oil producing countries. It is highly questionable that developing countries would be in a position to continue giving as high a priority to debt service as the approach of the staff in this paper suggests.

If the Fund is to play an effective role in the world economy, perhaps it should embark on a different course. Clearly, the major industrial countries are not willing to help the Fund in exercising its surveillance function over their policies, let alone to pay heed to its advice on those policies. The Fund, however, could seriously consider the possibilities of more meaningful cooperation between groupings of countries. What is needed is an approach which would suggest an acceptable mix of adjustment, growth, and financing requirements in order to make the adjustment more palatable. Otherwise we may end up with a growing number of debtor countries being unable to service their debts, which in the end could result in a dislocation of the world economy.

On a lighter note, while I do not question the usefulness of more frequent meetings of the kind we are attending today, as I have consistently advocated them, I question the timing of the suggestion. I recall that the mid-October stock market crash took place only shortly after many of our colleagues expressed unwarranted optimism in their short- and medium-term projections during our "postmortem" to the 1987 Annual Meetings. The last thing this Board can afford is to be regarded as jinxed by those who insist on blaming the crash on technical problems.

Finally, I wish to associate myself with the remarks of Mr. Posthumus on the reform of the international monetary system, and of Mr. de Groote on SDR allocation.

Mr. Templeman made the following statement:

While I welcome this opportunity to hold a preliminary discussion of the world economic outlook in the wake of the disturbances in financial markets last October, we need to be careful not to rush to judgment about the effects of those events on the world economic outlook. The sharp drop in stock markets last October needs to be kept in perspective. For example, in the United States the stock market actually rose by slightly over 2 percent from the beginning of 1987 until the end of the year, notwithstanding the October decline. Also, preliminary indications of consumer behavior in this country tend to suggest that the impact of the decline on consumer behavior may not be as large as originally feared. In any event, Executive Directors will have a better opportunity to reassess the situation at the end of March, during the full-scale discussion of the world economic outlook.

Before turning to developments and prospects in the industrial countries, I would like to stress the importance which my authorities attach to the continuation and strengthening of international economic policy coordination as evidenced by the G-7 communiqué of December 22, 1987. The Ministers: reasserted these countries' concerns about external imbalances, while citing the shift already underway in real balances; noted recent monetary policy decisions and reductions of interest rates in some countries as a contribution toward restoration of stability to financial markets; rejected protectionist measures as a means of dealing with present imbalances; expressed their common interest in more stable exchange rates; and agreed to continue to cooperate closely in monitoring and implementing policies to strengthen the underlying economic fundamentals. Very important, specific new policy commitments were made, as outlined in the annex to the communiqué, including for example, some revenue measures by the United States as part of its new fiscal package. It is worth noting that the Ministers specifically envisaged the monitoring and implementing of policies to strengthen underlying economic fundamentals as a way of fostering stability of exchange rates. In addition, they agreed to cooperate closely on exchange markets, as has been occurring in the past weeks. The latest actions by the Group of Seven reflect experience gained since the Louvre Accord and represent some evolution in the approach taken to these issues. We believe that the seriousness of purpose behind these efforts is now becoming more widely appreciated. I believe that the joint statement by President Reagan and Prime Minister Takeshita (EBD/88/13, 1/13/88), which has just been circulated to the Board, is further evidence of this fact.

Turning to specific developments and prospects, we are inclined to concur with the staff assessment that the overall revisions of industrial country growth prospects need not be very large as a result of the earlier disturbances in financial markets. In fact, growth in the latter part of 1987 was substantially higher than originally expected for the industrial countries, including an underestimation of about 1/2 percentage points each for the United States and Japan. For 1988, staff estimates show an anticipated higher growth rate of over 1/4 percentage point for Japan, but a growth rate for Germany of about 1/2 percentage point lower this year than earlier expected. Our own view is that growth in Japan and Canada in 1988 may be somewhat stronger than the staff visualizes. On the other hand, we must acknowledge that U.S. growth this year is likely to be somewhat lower than anticipated before the decline in the stock market. This shows up more clearly in estimates for the growth rate between the fourth quarters of 1987 and 1988--the decline could be 1 percentage point or so.

The inflation outlook for the industrial countries seems, if anything, somewhat better than at the October world economic outlook discussions; this includes the United States, despite fears of the effects of a declining dollar on U.S. prices. Admittedly, the decline in oil prices may be helping to contain inflation.

While we remain concerned about the persistence of external imbalances in the industrial countries, including the large U.S. current account deficit, the staff paper shows that adjustment *in real terms is already under way to a substantial extent and* should continue. For example, domestic demand grew at a slower rate than GNP in the United States, and at a faster rate than GNP in the other G-7 countries last year, except the United Kingdom. This pattern is expected to persist this year and next. In short, the transfer of real resources to the external sector is well under way in the United States and a corresponding adjustment in the opposite direction is taking place in the other G-7 countries. The decline in the dollar since the staff's projections were made should have some additional positive effect on adjustment in real terms--perhaps more quickly than did the earlier dollar depreciation, because it should be harder for foreign exporters to avoid the pass-through of the price effect to U.S. consumers. On the other hand, a new J-curve effect will be occurring, which could initially tend to obscure additional real adjustment.

In the developing countries, growth in 1987 and the current outlook for 1988 appear somewhat less favorable. The decline in oil prices may have a depressing effect on the oil producers, chronic problems in Africa continue, and slippages in adjustment and economic reform policies, especially in Latin America, would be major factors. On the other hand, we believe that progress is being made in a number of countries toward the achievement of more stable growth based on macroeconomic adjustment and structural reform efforts. In that connection, we believe that the staff analysis pays too little attention to the importance for growth of strong policy formulation and implementation efforts by the developing countries; that it is a bit too pessimistic in its overall assessment of the effects of the rise in some commodity prices; and that it tends to see only the negative effects on the oil producers from world oil price declines instead of also recognizing some positive effects on oil importers.

A point of continuing disappointment is the acceleration of inflation in the developing countries, especially in the high inflation countries of Latin America.

Concerning external adjustment in the developing countries, we note that the aggregate current account deficit last year and the expected deficit for 1988 are both significantly smaller than at the time of the October world economic outlook discussions, by a total amount of $26 billion. This reflects, to a significant extent, the large and growing surpluses of some Asian economies. The staff paper does to some extent recognize the growing importance of this development, not just within the developing country group, but in terms of its impact on world payments and adjustment. I would recall the serious concern expressed by my authorities and their colleagues in the Group of Seven about inadequate action to deal with large and growing trade surpluses in those economies, which are exacerbating global imbalances and fostering protectionist pressures. We would underline the importance of implementing, without delay, trade and exchange rate policies that will facilitate the reduction of excessive trade surpluses and allow currencies to fully reflect the strong competitive position of those economies. I would like to suggest specifically that the April World Economic Outlook give more explicit attention to the role of these economies in the adjustment process, and that the Managing Director include a reference to the Board's discussion of this matter in his report to the Interim Committee meeting in April.

I would voice a word of warning about the potential for growing protectionism. With the continued growth of real exports and slower import growth in the United States, it may be slightly easier to resist protectionist pressures, but the dangers remain strong. Furthermore, in particular in European countries with weakening external balances, high and generally rising unemployment, and rather weak growth prospects, it may become even harder politically to cope with pressures to limit the growth of imports--not only from the United States, but also from the developing world.

Turning to the medium-term outlook for growth in the industrial countries, we are inclined to think that staff estimates are somewhat on the low side for the United States. On the other hand, we believe that the staff is too optimistic in its prediction of continental European growth, given current policies, which for 1990-92 assumes actual growth at full potential. Furthermore, we recognize that there is a downside risk to world growth, should U.S. external adjustment continue as expected. It remains unclear to us that offsetting growth in the other major industrial countries will materialize on the required scale. This brings us to policy issues.

First, we agree that there are no grounds for complacency. Second, we agree that additional policy measures will be needed over the medium term in the industrial countries. Third, we also agree that both the U.S. current account deficit and the

U.S. federal fiscal deficit need to come down further. However, we believe that the extent of progress made to date and the prospects for further reduction in the U.S. fiscal deficit have been underrated. It is worth recalling the $73 billion decline in the deficit between FY 1986 and FY 1987, representing a decline in the ratio of the deficit to GNP from 5.3 percent to 3.4 percent. Even at the time of the U.S. Article IV consultation last August, the decline in the deficit was underestimated by $10 billion. The other point to bear firmly in mind, especially in reference to Table 1 in the staff paper, is that, for FY 1990 onward, the staff estimates do not assume any additional policy action to reduce the U.S. deficit. I can assure you that, notwithstanding the recent agreement to reduce the FY 1988 and FY 1989 federal deficits by a total of $79 billion, my authorities do not think that their work is done. However, in response to Mr. de Groote's question, I must say that political and budget procedure realities make major new fiscal action later this year quite unlikely. However, the specifics of the FY 1987 budget do offer some qualitative opportunities. Also, a special budget commission, which will submit its report in early 1989, has already been created.

I would also call your attention to the fiscal situation in the United States as measured by the general government deficit, which takes into account surpluses outside the federal government. For example, Table 2 in the staff paper shows a general government deficit ratio for the United States this year of 2.1 percent of GNP. This would be the third lowest among the G-7 countries. We would expect that ratio to continue falling, along with the expected decline in the federal deficit in line with the amended Gramm-Rudman-Hollings Act.

As regards future policy actions in the other major industrial countries, we concur that some combination of fiscal and structural policy actions will be desirable over the medium term. In Japan, should there be a slowdown of the recent acceleration in domestic demand this year, consideration may need to be given to supplementary measures. For example, consideration of tax reform should include the anticipated effects of such reforms on economic growth prospects. In Germany, more needs to be done, particularly in the structural area. We understand that plans are being considered to cut subsidies, raise some indirect taxes, and reduce tax preferences. It would be helpful to have an estimate of how this group of measures might affect German growth.

We tend to concur with the staff on the types of structural policies listed in the staff paper that are generally appropriate for these countries, but we believe that the staff may be overly relaxed about the prospects for structural reforms and about the linkages between fiscal and structural policies. For example, the staff paper notes that more structural adjustment in Germany would allow for faster growth of demand over the medium term. However, there has been only limited progress in reducing structural impediments to growth. At the same time, relatively weak growth and high unemployment may, in themselves, create obstacles to structural change. On the other hand, faster demand growth might facilitate structural adjustment by reducing perceived losses from structural change. I concur with the staff that, with regard to exchange rate matters, the Fund needs to focus on the underlying policies, while not denying that exchange market intervention can play a useful role in appropriate instances.

Let me turn now to the specific topics for discussion listed at the end of the staff paper. As I have already indicated, we agree with the broad lines of the staff's projections, subject to a few caveats.

On the medium-term policy responsibilities of the industrial countries, I have already stressed both the determination of my authorities to continue to reduce the U.S. federal budget deficit and the need for other industrial countries to use whatever fiscal leeway they have to foster stronger growth, supported by structural adjustments.

The staff raises a number of difficult questions related to the achievement of reasonably stable exchange market conditions. These include: the criteria for judging whether rates are at a level that warrants coordinated defense; the role to be played by intervention and how it should be financed; the cost and the benefits of using monetary policy to support rates; and the role of the Fund in all of this. Frankly, I believe that these questions are very ambitious and go well beyond our ability to deal with today. I have already cited the importance of working on the fundamentals and the utility of exchange market intervention as a modest supplementary tool. Monetary policy will have to be conducted with an unusual degree of flexibility. My authorities are still assessing the impact of disturbances in the financial markets; they will review decisions about monetary targets for 1988 in February. They continue to believe that the primary responsibility of monetary policy is to achieve sustainable, noninflationary growth. Exchange rates play a major role in influencing the attainment of this objective. However, only the appropriate utilization of all policy instruments in all our countries can, in the end, produce the kind of fundamental conditions that are consistent with exchange rate stability.

Finally, the staff poses some questions concerning the situation of developing countries with regard to: how they are likely to be affected by developments in the industrial countries; how they weigh the benefits of greater exchange rate stability as against possibly higher interest rates; and what the appropriate current account position should be for different developing country groups and how such positions should be achieved. It seems to me that the background analysis for answering these questions has not been provided in the rest of the staff paper and that such issues might better be addressed at a later time. On the other hand, there might very well have been some specific questions posed to the authorities of the developing countries as to their own policy plans for strengthening their adjustment and reform efforts in the context of the world economic outlook.

Mr. Yamazaki said that he joined Mr. Templeman in calling the Board's attention to that day's joint statement by Prime Minister Takeshita and President Reagan. He expressed his sincere wish that their firm affirmation of close coordination in economic policies and exchange markets would help further the stabilization of exchange rates.

Mr. Templeman, in response to a question by Mr. Sengupta, noted that the last sentence of the joint statement read: "... developed arrangements to assure the adequacy of resources for their cooperative efforts." The United States would be selling SDRs to Japan for yen in amounts as appropriate and necessary. The current U.S. holdings of SDRs were on the order of $10 billion equivalent.

Mr. Yamazaki indicated that a press conference would soon be held by the two heads of states; after that press conference, he could further discuss the arrangements that Mr. Templeman had mentioned.

The Director of the Research Department reminded Directors that while they had had only seven days to read the staff paper, the staff had written the paper in six working days during the Christmas period. As a result, the paper necessarily fell short in certain areas which would have been covered more comprehensively in a full world economic outlook exercise. The omission of a discussion on the developing countries was an obvious case in point, but the staff had emphasized in the opening paragraph of the paper that it would address only an important subset of countries making up the world economy.

In response to a point raised by Mr. Posthumus, cooperation was indeed reflected in countries' behavior--behavior that was different from what would have taken place in the absence of cooperation--the Director agreed. The rationale for cooperation was that what one country did had effects not only on its own economy, but also on the rest of the world, and vice versa. Therefore, the optimal results from a global perspective required that the externalities be recognized and influence behavior, and consequently be internalized. However, one could not expect a country to do something that it perceived was not in its own interests. The role of the Fund was to convince countries that if they did something for the good of the system, then they also did something good for themselves.

Some of the simulations which Jeffrey Sachs had undertaken on the negative effects of coordination highlighted the fact that one needed to distinguish between good and bad coordination, the Director went on. If the policies that countries coordinated were bad, a bad outcome would result; conversely, coordination with good policies would result in a positive outcome.

The staff's view had been that cooperation on exchange rate matters should focus on underlying policies, rather than on a particular pattern of exchange rates, the Director indicated, and two Executive Directors had noted that view, and had suggested that they would have preferred a more symmetrical treatment of both of those aspects of cooperation. It certainly would be attractive to have a framework that embraced both aspects of cooperation on exchange rate matters, and the aim was to formulate a system that could be characterized as possessing symmetry. The key to such a system was confidence and consistency, which could be restored only by making multiyear fiscal commitments.

On the question of whether the stock market plunge was a necessary correction to earlier excessive increases or whether it reflected a more fundamental problem of unsustainable fiscal and current account positions in the major countries and the continued debt difficulties facing the developing world, both viewpoints were tenable, the Director commented. While correction had been necessary, the fundamental inappropriateness of policies had triggered the plunge. Certainly, the U.S. stock market had rebounded to a position 2 percentage points above that of a year earlier, but that did not eliminate the negative effects of the stock market plunge. Indeed, the downward revision of the U.S. growth projection had been rationalized in terms of the negative effects of the stock market plunge and declines in other indicators of confidence.

On the relationship between the exchange rate, the trade balance, and fiscal imbalances, he had a few general points to make, the Director said. Current exchange rates between the currencies of the major industrial countries were similar to those prevailing in 1980--an important benchmark--and in terms of purchasing power parities the yen and the deutsche mark were even stronger than in 1980. However, in 1980 the United States had been an important creditor, while it now had a large debt that had to be serviced. Thus, it was not necessarily sufficient for the maintenance of current currency relationships for the United States to generate the same trade balance that it had in 1980. Also, secular productivity changes had occurred, as well as changes in the economic structure. Therefore, it was difficult to compare the current pattern of exchange rates with that of 1980. Certainly, large trade imbalances that were not sustainable prevailed, and it was necessary to take policy measures. If a change were to take place in exchange rates, one Executive Director had raised the question whether that should be a discrete change or a gradual change, indicating that a one-time adjustment was preferable in order to avoid J-curve effects, fatigue, and other undesirable effects. But the question that had to be asked was whether exchange rate changes had already done their share in the adjustment process. Were fiscal and exchange rate policies to be regarded as complements or substitutes?

Whenever a large fiscal correction took place, large amounts of resources were released, and a mechanism had to be found to divert them to the foreign sector; here relative prices came into play, the Director noted. On the other hand, given the tremendous exchange rate changes that had already taken place, it was time to release the resources necessary to validate that change. The two processes were complementary. Symmetry between fiscal correction and exchange rate adjustment was an indication that coordination was providing confidence that the system was working.

An important question was whether or not there had been enough adjustment, the Director said. While trade volumes had shown extraordinarily large adjustments and were therefore moving in the right direction, too much emphasis should not be placed on a comparison of real imbalances. Such a comparison could be greatly affected by the choice of period for the comparison. In addition, nominal imbalances were observed by the general public and became a basis for the formulation of expectations. Nevertheless, it was clear that significant real changes--i.e., in trade volumes--had taken place.

One Executive Director had expressed concern that the staff had "devalued" the role of monetary policy, the Director recalled. First, in the present circumstances, fiscal policy was, and should be, the center of attention. Second, he felt that the staff had paid sufficient attention to monetary policy. Indeed, the solutions to many problems in the current economic system--inflation, growth, exchange rates--were placed on the shoulders of monetary policy. In the medium term, monetary policy should focus on one or two policy objectives--perhaps, control of inflation. In the short term, however, there were also transitional roles for monetary policy.

The role of the international monetary system had been raised by several Directors, and the staff intended to fully investigate that issue under the guidance of the Board, the Director of the Research Department concluded.

Mr. Templeman said that he wished to clarify his previous reference to the stock market. At the time of the stock market plunge, the press had predicted a serious impact on consumer behavior. In fact, the change in consumer behavior as a result of the decrease in wealth had been very short lived. Also for the year as a whole, there had actually been some increase in the stock market index. That was not to imply, however, that the decline in the stock market late in the year was of no importance; it obviously was.

The adjustments in the U.S. current account and fiscal deficits did not have a one-to-one relationship, Mr. Templeman continued. For example, there had been a very large decline in the fiscal deficit in 1987, while the current account deficit had actually risen. While the fiscal deficit was an important factor, other factors were clearly contributing to the current account deficit.

Mr. Faria said that the staff paper had not so much devalued the importance of monetary policy as it had not made monetary targets explicitly clear. It seemed that the staff had envisaged a somewhat accommodative role for monetary policy, but the tables gave no indication of monetary targets for the overall scenario.

The Deputy Director of the Research Department noted that the staff's projections--which some Executive Directors had considered somewhat optimistic--were not forecasts, but conditional projections. One of the assumptions made in arriving at those projections was no change in policies; in the realm of monetary policy, that was an assumption that monetary policy would aim at accommodating a moderate increase in real output while maintaining downward pressure on inflation. That was the general underlying basis of monetary policy in the major industrial countries. There was also an assumption of no change in exchange rates and interest rates. In a situation of uncertainty, that assumption led to the potential for disturbances that would create downside risks. The staff generally felt that the best way of dealing with tensions in the projections was to spell out the consequences of alternative economic developments in the world through the use of scenarios. In the paper currently under discussion, however, the use of scenarios was limited, owing to the short time in which it had been prepared. However, in the course of preparing normal world economic outlook papers, the staff did try to outline possibilities of deviation from the conditions underlying the projections.

In response to a question by Mr. Lankester on why the outturn for growth in the second half of 1987 had been stronger than projected in the October World Economic Outlook, the benefits from changes in the terms of trade and exchange rates in 1986 had come through more slowly than expected, while the negative effects had had an impact sooner than expected, the Deputy Director explained. Therefore, the 1986 outturn was weaker than originally forecast, and the delayed beneficial effects caused the 1987 outturn to be more positive than predicted. It did seem that the underlying pace of economic activity in the industrial countries had been stronger in the second half of 1987 than originally expected, and that would have to be taken into account when the staff made its projections for 1988 and 1989. On the one hand, projections had to take account of the stronger underlying trend in economic activity, while on the other hand, they had to include the negative effect of the stock market decline.

The staff's forecasts seemed to be stronger than those of certain other agencies, to some degree because the Fund staff perceived the effects of the stock market developments as coming through somewhat more rapidly than did the OECD and the EEC. That was partly because the Fund staff saw the primary effects as being relatively stronger than the secondary effects. The OECD forecasts expected the impact of the stock market crash to be greatest in the second part of 1988, tailing off relatively slowly in 1989. In addition, the Fund staff's projections had been made approximately two months after those of the OECD and the EEC, which meant that they had had the benefit of later information concerning the course of the industrial economies in 1987.

It had been questioned whether it was appropriate for the Fund to ask surplus countries to expand in circumstances in which the main problem was financing the continuing deficit of the United States, the Deputy Director recalled. The problem of financing the large deficit would be considerably relieved if the markets that were being called on to finance that deficit could have confidence in the fact that measures were being taken to reduce, and eventually to eliminate, that deficit. The staff endorsed an appropriately symmetrical approach in which countries bore their share of the burden. That meant that domestic demand had to grow more slowly than output in the United States and other deficit countries, and faster than output in the surplus countries. There was therefore a role for appropriate actions to sustain domestic demand in the surplus countries; whether that was done simply through fiscal policy or, as the staff had suggested, by an appropriate mixture of structural and demand-management policies was another question.

The staff paper might have given the inaccurate impression that the staff was advocating faster growth in the United Kingdom, where growth was already quite rapid, the Deputy Director said. In fact, it had intended to suggest that the United Kingdom should sustain the relatively satisfactory pace of demand growth that it had experienced, while other countries that had room to absorb part of the U.S. deficit's counterpart should perhaps increase their rate of domestic demand growth.

There was a wide range of areas where structural reform could be helpful in Germany; several had been mentioned, including industrial subsidies, labor market rigidities, and the regulatory environment, the Deputy Director indicated. That subject would likely be discussed in more detail in the course of the Article IV consultation with Germany later in the year.

The staff recognized the short shrift that the paper had given to the developing countries, but given its time constraint, the staff had been unable to collect a sufficiently broad set of basic data to enable it to make more confident and more comprehensive recommendations, the Deputy Director explained. The staff hoped to rectify that in the next World Economic Outlook. In general, the staff intended to use the technique of scenario analysis to analyze a number of the interesting questions raised at the current meeting which had not been dealt with in sufficient depth in the present paper.

The staff representative from the Research Department said that the fiscal projections for the United States were based on the most recent estimate of the "current services estimate" of the budget deficit, which measured what the deficit would be on the basis of the current tax system and current spending programs. That estimate of the current services estimate also took into account the most recent package of measures adopted just before Christmas 1987. In addition to the current services estimate, the fiscal projections were predicated on a set of economic assumptions for growth and inflation, as presented in the paper. To the extent that other institutions might have prepared a forecast of the budget deficit on the basis of different assumptions, then their forecast naturally would also differ. More specifically, if one was more pessimistic about the outlook for U.S. growth, then one's deficit projection would also tend to be higher.

The impact of the decline in oil prices was complex and could not be addressed adequately in the course of the current discussion, the staff representative commented. Perhaps the staff could discuss that issue bilaterally with those Executive Directors who were interested, and then the topic could be addressed in the full-scale world economic outlook paper.

On the implications of the downward revision of the growth projections for the Western Hemisphere countries, the staff was still in the process of collecting more complete data for those countries and analyzing the reasons for the downward revision to the growth estimate for 1988, the staff representative said. It would perhaps be premature to defend the 1989 estimate until the staff received a clearer picture of the reasons for the revision to the 1988 projection. It was unlikely that the Western Hemisphere countries would experience a sharp upturn in growth for 1989, since the uncertainties with respect to the external environment and commodity prices would have a bearing on the outlook. However, there were also some more positive aspects which could help raise the growth projection, particularly the sharp improvement in the competitive position of many of those countries, and the possibility that the implementation of policies might have a positive impact on growth.

The policy assumptions for the developing countries, as in the case of the industrial countries, were to some extent based on policy intentions, and, therefore, those projections were also to some extent conditional, the staff representative from the Research Department concluded.

Mr. Sengupta said that since the Group of Seven had come to an understanding that current exchange rates were more or less appropriate and should be defended--and indeed arrangements had been made to do so--that question should have been covered in the staff paper. Exchange rate policy and structure were mutually dependent, and one could not discuss one without considering the other. Perhaps it would have been helpful to announce target zones for exchange rates. If the staff felt that the current account balances projected up to 1992 were not sustainable, either something had to be done about the exchange rates, or policy actions had to be taken. The staff should face that question and try to answer it.

The Director of the Research Department replied that, as indicated in the staff paper, the projections for external balances, based on existing policy measures, were very large and arguably unsustainable. That was well recognized by the G-7 policymakers, among others, who were consequently making policy commitments for the future. Additional measures would have to be taken on all fronts, including changes in fiscal, monetary, structural, and trade policies, with the necessary outcome that deficit countries' demand growth would be slower than output growth, while the opposite would hold true for surplus countries. In order to effect such a result, one should not only focus on the external imbalances but must also consider other objectives, with the ultimate medium-term goal of fiscal consolidation. Structural policies must always be included in such a plan, in order to use resources as effectively as possible. It was the task of policymakers to resist the pressure of interest groups in working toward longer-term objectives.

The Deputy Director of the Research Department, in response to the question whether the staff believed that the current exchange rate pattern was sustainable given the U.S. fiscal deficit projections made by the staff, said that it would be misleading to indicate a particular exchange rate that was necessary to achieve a sustainable outcome. In the first place, there were two aspects to correcting a balance of payments deficit. One was to create the scope within domestic demand to permit resources to be channeled into the balance of payments--a question of demand management--and the other was the creation of the appropriate incentives, including price incentives through exchange rates, to ensure that resources moved in the appropriate direction. There was general agreement that imbalances in domestic demand growth and output had to be corrected, but less agreement on how much exchange rate adjustment, if any, would be necessary along with those domestic demand changes to ensure that the resources flowed in the desired direction.

In addition, it was clear that if, as projected by the staff, a deficit for the United States of over 2 percent of GNP resulted, with corresponding surpluses for Japan and Germany, that was unlikely to be indefinitely sustainable, and, therefore, at some stage, there would be an implication for exchange rates, the Deputy Director said. Nevertheless, two factors had to be emphasized. It was not clear that moving to the ultimate stage of full equilibrium was necessarily the best thing to do immediately in an uncontrolled fashion. Also, fiscal policies were not currently in a sustainable alignment--another reason for not pressing further on policies that would add to demand in countries where demand was already high and reduce demand in countries where it was perhaps already low. Therefore, one could not simply calculate the long-term equilibrium position and then enact the policies to achieve that equilibrium.

Second, the staff's forecast of the 1992 U.S. deficit--2.3 percent of GNP--was a central estimate with a relatively wide range, the Deputy Director continued. It was by no means clear that the sustainable equilibrium was zero. Therefore, it would be irresponsible to indicate an optimal exchange rate. Balance of payments projections suggested that, based on present policies and at present exchange rates, payments imbalances among the three largest countries would continue to be very large, probably unsustainably so. That implied very directly that if present policies were not changed, then eventually exchange rates would in fact adjust. But that did not mean that the staff felt that exchange rates could be said to be in a disequilibrium relationship, irrespective of the assumptions that were made about policies.

The Chairman made the following summing up:

This exchange of views has demonstrated the usefulness of an interim review of the world economic situation in circumstances where conditions are changing rapidly. Two important themes running through the interventions of Directors have been the scope of the uncertainties in the present situation and, reflecting this, the importance of policy coordination. In summarizing the views you have expressed, I will follow the order of topics suggested for our discussion in the staff paper.

1. Realism of the projections

In commenting on prospects for economic activity in industrial countries, Directors noted the staff's assessment that short-term prospects now appeared somewhat more favorable than in the initial aftermath of the October stock market decline. Several Directors, including most of those from the larger industrial countries, endorsed this view. They also felt that recent moves to strengthen policy coordination were a positive element in the picture. Barring unforeseen financial market disturbances, these Directors felt that economic growth was likely to be reasonably well maintained.

A number of other Directors, however, were less sanguine. This group of speakers, which included Directors from both industrial and developing countries, emphasized that the situation of the world economy remained fragile, and that the danger of an economic slowdown could not be dismissed. They pointed out that fiscal and current account imbalances remained an important source of concern, and that relatively little progress had been made toward a satisfactory solution to debt difficulties. They noted, in particular, that economic prospects for developing countries had been revised downward in the period since the previous World Economic Outlook exercise.

2. Policy requirements in industrial countries

There was widespread agreement that policy actions in industrial countries needed to focus on two main requirements: first, strengthening progress in tackling fiscal deficits in countries where the public sector was absorbing too large a share of private savings; and second, sustaining adequate growth of domestic demand and fostering structural adjustment in countries with large payments surpluses. Directors welcomed the progress made by the United States in FY 1987 in bringing about a substantial reduction in the federal fiscal deficit. However, they were concerned that according to the staff's projections, there would be very little further progress in FY 1988 and FY 1989. The view was widely expressed that a more ambitious approach to deficit cutting was essential if the desired improvement in the external payments position was to be brought about without crowding out domestic productive investment. The high degree of capacity utilization in the United States, and the risk of reigniting inflation were also cited as arguments for stronger efforts to cut the federal deficit and encourage private savings. As far as the other industrial countries with troublesome fiscal deficits were concerned, Directors felt that they too needed to adopt a more ambitious program for strengthening public finances.

Concerning countries in balance of payments surplus, it was noted that some of these countries--in particular, Japan--were experiencing relatively strong domestic demand growth. Nevertheless, there was wide support for the proposition that surplus countries needed to do more to tackle structural rigidities and to ensure the maintenance of adequate domestic demand growth. Some Directors felt that the stance of demand-mangement policies was unnecessarily restrictive in certain surplus countries. A number of Directors also commented on the situation of smaller surplus countries, both in Europe and among the newly industrializing economies. They believed that these countries should be urged to contribute more to global adjustment. In discussing policy requirements, several speakers mentioned the usefulness of alternative scenarios, which the staff intended to include in the more detailed documentation that was being prepared for the regular world economic outlook discussion in March.

3. Exchange rate management

There was wide agreement on the desirability of stable exchange market conditions as a basic requirement for steady economic growth. Most Directors felt that the performance of the international monetary system over the past few years had fallen short of what could be desired in this respect. There was a widespread feeling that, by the end of 1987, the U.S. dollar had fallen enough and that a further decline would be counterproductive. Most Directors holding this view felt that monetary authorities had to give a decisive lead to markets. It was felt that monetary policy could have a role in defending the desired pattern of exchange rates. The continued use of intervention was also favored. However, a number of Directors cautioned against overburdening monetary policy, and several of them were reluctant to see any interest rate developments that might intensify the danger of recession and worsen the plight of the heavily indebted countries. A theme in the interventions of many Directors was that the Fund itself could play a greater role in monitoring developments in the policies of major member countries, and more specifically in tracking developments in exchange markets. I will have more to say in a moment on how we can discharge this role.

4. Situation of developing countries

As I noted at the beginning of this summing up, a number of Directors expressed concern that the estimated growth rate of many developing countries in 1987 and 1988 has been revised downward. This was seen as disturbing, not just for its direct welfare consequences, but because it made even more difficult the task of managing the debt situation. We shall be discussing the debt situation soon, and I shall, therefore, defer further comment on this subject.

What I believe was plain from today's meeting is that the economic prospects of developing countries depend fundamentally both on their own economic policies and on the nature of the global environment. In a situation of exchange rate instability, uncertainty about growth prospects, high real interest rates, rising protectionism, and major external financing constraints, it is very difficult for developing countries to durably strengthen their economic performance or to plan the economic restructuring needed to strengthen domestic economic performance.

Today's discussion has revealed a wide measure of agreement on economic objectives and the general strategy that is required to pursue them. What has not always been present in the actions that have been taken so far is the required degree of commitment, consistency, comprehensiveness, and cooperation. If these four "Cs" can be brought to bear, then the two other "Cs"--credibility and confidence--will be easier to restore and the prospect for improved economic performance will be brighter.

5. Role of the Fund

A first contribution of the Fund would be analytical, and today's discussion was an important part of this process. Directors have suggested ways in which the staff's analytical approach can be further strengthened in the future.

A second contribution would be through policy advice, which can be rendered through Article IV consultations, world economic outlook discussions, my own contribution to G-7 discussion, etc. We have to be as pragmatic as possible in this respect.

Third, peer pressure can bear heavily in bringing home to countries some of the consequences of their policies for trading investment partners. Reference was made by speakers to our responsibility to keep the working of the international monetary system under continuous review, and we will take appropriate steps to that end.

Several of you have invited me to send strong signals to the G-7 countries, and that indeed is one of our responsibilities. One way of doing so could be to conduct a "Special G-7 Updating" before each World Economic Outlook. The Article IV consultations for Germany, the United States, and France take place in July, August, September, and those of Canada, Italy, the United Kingdom, and Japan in March. Perhaps an update of the information available for those countries for which the Article IV consultation took place last summer could be made in the context of the March world economic outlook. We could proceed in the same way in September. Then, twice a year for these seven countries the most accurate data would be available as is indeed desirable for countries with very special systemic responsibilities. We would devote part of the first day of the next world economic outlook to discussing the conclusions that emerged from this work. This should not take away from our attention to other important country groupings, such as the surplus countries in Europe, which as a group have a significant impact on the global imbalances of the world economy, the newly industrializing economies, the heavily indebted countries, etc. Then, at the end of this world economic outlook exercise, we would have a somewhat deeper understanding of the world economic situation and would be able to offer the Interim Commmittee the documentation it deserves.

I think this could be a constructive way for us to discharge our responsibility as staff, management, and Executive Board while being totally in line with, and supportive of, the economic policy coordination policy process adopted in Tokyo and Venice, to which the document we have circulated today--Joint Statement on Economic Issues - United States and Japan (EBD/88/13, 1/13/88)--refers. Of course these suggestions will have to be discussed with G-7 Executive Directors and the heads of Departments. Our objective should be to continue to improve the pragmatic and informal liaison between our work with the world economic outlook and the multilateral surveillance that G-7 countries consider necessary to the smooth working of the world economic system.

APPROVED: September 6, 1988

LEO VAN HOUTVEN
Secretary

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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 88/7

10:00 a.m., January 15, 1988

M. Camdessus, Chairman

Executive Directors	Alternate Executive Directors
	A. G. A. Faria, Temporary
Dai Q.	Jiang H.
C. H. Dallara	D. C. Templeman, Temporary
	E. L. Walker, Temporary
J. de Groote	J. Prader
A. Donoso	
M. Finaish	
G. Grosche	B. Goos
J. E. Ismael	J. Reddy
	J. R. N. Almeida, Temporary
	C. Enoch
	R. Comotto, Temporary
	D. McCormack
Mawakani Samba	
Y. A. Nimatallah	I. A. Al-Assaf
	L. Filardo
J. Ovi	M. Fogelholm
	G. Pineau, Temporary
G. A. Posthumus	G. P. J. Hogeweg
C. R. Rye	
G. Salehkhou	O. Kabbaj
	A. Vasudevan, Temporary
K. Yamazaki	S. Yoshikuni
	F. Di Mauro, Temporary

L. Van Houtven, Secretary and Counsellor
K. S. Friedman, Assistant
D. de Vos, Assistant

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Also Present

African Department: S. E. Cronquist, R. E. Daumont, M. De Zamaroczy, P. H. Matthieu, S. M. Nsouli. European Department: J. R. Klein. Exchange and Trade Relations Department: S. J. Anjaria, S. Kanesa-Thasan, L. M. Valdivieso. External Relations Department: R. J. Bhatia, Director, Fund Office in the United Nations and Special Representative to the United Nations; N. Worth. IMF Institute: O. B. Makalou. Legal Department: H. Elizalde, J. V. Surr. Middle Eastern Department: A. S. Shaalan, Director; P. Chabrier, Deputy Director; M. Bell, J. G. Borpujari, H. P. G. Handy, D. B. Noursi, B. K. Short. Research Department: J. A. Frenkel, Counsellor and Director; A. D. Crockett, Deputy Director; M. Goldstein, Deputy Director; J. M. Boughton, R. P. Flood, N. M. Kaibni, F. Larsen, A. Muttardy, B. E. Rourke, J. J. Soladay. Bureau of Statistics: A. K. Patel. Personal Assistant to the Managing Director: H. G. O. Simpson. Advisors to Executive Directors: A. A. Agah, M. B. Chatah, A. Ouanes, N. Toé, J. E. Zeas. Assistants to Executive Directors: N. Adachi, F. E. R. Alfiler, S. K. Fayyad, V. J. Fernández, S. Guribye, C. L. Haynes, M. Hepp, G. K. Hodges, A. Iljas, S. King, K. Kpetigo, V. K. Malhotra, T. Morita, D. V. Nhien, J. K. Orleans-Lindsay, G. Schurr, C. Sel, C. C. A. van den Berg, R. Wenzel, Yang W., I. Zaidi.

1. SURVEILLANCE - INDICATORS - COMMODITY PRICE BASKETS

The Executive Directors continued from the previous meeting (EBM/88/4, 1/11/88) their consideration of a staff paper on commodity price baskets as possible indicators of future price developments (SM/87/291, 12/11/87).

Mr. Mawakani made the following statement:

I welcome the staff's ongoing efforts to strengthen the process of multilateral surveillance through the use of economic indicators. This discussion is part of the search for an additional variable for monitoring the economic performance of industrial countries. Every effort to predict the outcome of economic and financial developments in those countries and to help create a stable international economic environment should be encouraged. The staff paper provides useful background information on the potential ability of a commodity price index to foretell price developments in industrial countries. In addition, it highlights the complexity of the use of this index as an early warning indicator of economic developments.

I support the use of leading indicators, including commodity price indices, provided that there is sufficient evidence to show that the new indices send a reliable early warning signal of price developments and that the ensuing policy responses by industrial countries do not adversely affect the economic performance of developing countries. Charts 1, 2, and 4 show that there is little relationship between the movements in the consumer price indices in the major industrial countries and the movements of the existing commodity price indices surveyed by the staff. The conclusion to be drawn from the charts is clearly stated on page 17: "All of the commodity price indices...show essentially zero inflation through 1972, a very rapid increase from 1973 through 1974, and high volatility but again no inflation during the remainder of the 1970s and into the 1980s. Whatever the merits of these indices might be, it is clear that this long-run pattern is very different from that of the consumer price indices of the large industrial countries." In fact, Chart 1 shows that there is a stronger correlation between consumer price indices and normalized unit labor costs; this might be a promising avenue, and the staff should concentrate its efforts in this direction.

The econometric approach to constructing a commodity price index seems impressive, but considerable caution should be exercised in estimating the weights and interpreting the close fit between commodity price indices and the consumer price indices. The staff should explain why the weights derived econometrically are so different from those based on consumption and trade patterns and the conclusions that can be drawn from these divergences. Assuming that the commodity price index proves to be a reliable indicator of price developments in industrial countries, I wonder what the policy implications for the industrial countries would be. If the message conveyed by the movements in the commodity price index triggers measures aimed at depressing commodity prices, I would strongly oppose the use of this index as a supplementary leading indicator. If anything, the industrial countries should endeavor at least to stabilize commodity prices. The staff should comment on the relationship of international commodity agreements to movements in commodity prices.

Since many questions remain unanswered, it would be premature to conclude on the basis of the present paper that commodity price indices could be used to predict future price movements in industrial countries. An important lesson that can be drawn from the staff paper is that developed countries' policies have a negative impact on commodity prices. Future discussion on this subject would be enriched by an analysis of the predictive ability of normalized unit labor costs and other leading indicators, as well as by an examination of the stability of the relationship between manufactured goods prices and commodity prices.

Mr. Donoso made the following statement:

I welcome the initiative on additional indicators to anticipate inflationary pressures. The staff has made a significant effort to study this matter and has found that there appears to be a basis for considering the prices of commodities to be a useful indicator of potential inflationary pressures. However, it is clear that the conclusions are still tentative and that much work is still needed to select the one or several indices that appear to be most useful and to link the indications they provide with concrete policies to avoid inflation. It is important to analyze further the causal relationship between prices of commodities and future inflation before indices of commodity prices are included among the Fund's indicators.

The Fund has conducted research on commodity prices for a long time and has contributed to a better understanding of the behavior of those prices. Studies presented during earlier world economic outlook exercises indicate that the dollar prices of commodities have moved with contemporaneous inflation and have increased in real terms along with any depreciation of the dollar, acceleration of growth in industrial countries, and reductions in interest rates.

In the past, fluctuations in commodity prices have been explained mainly by changes in demand conditions. Recently, however, the staff included a supply element in explaining the depression of commodity prices in 1984-86, when the dollar was depreciating, GDP in industrial countries was recovering, and interest rate increases had moderated; in those circumstances, the staff suggested explanations of commodity price behavior based on demand conditions alone were insufficient. The staff found that increases in supply in response to previous increases in prices explained the low commodity prices in 1984-86. These findings should be considered when work is undertaken to define indices of commodity prices to be used in anticipating inflationary pressures.

It is conceivable that, in any given period, the factors leading to an increase in commodity prices might also have the potential of inducing an increase in the rate of inflation, thus supporting the notion that, in general, increases in commodity prices anticipate increases in the consumer price index. However, some of the studies mentioned by the staff indicate that the prices of commodities increase for reasons that are not directly related to future inflation. For example, if commodity prices increase because of a rise in the rate of growth in industrial countries, there need not necessarily be reason to expect an increase in the rate of inflation. One should not expect an acceleration of inflation in a situation in which commodity prices are rising but there is no increase in monetary stimulus. However, an index of commodity prices measured in SDRs would appear to be increasing in those circumstances and would lead one to predict an increase in the rate of inflation. Therefore, an attempt should be made to differentiate among the reasons for increases in commodity prices in order to isolate those that account for inflation. There are good reasons to expect that developments leading to accelerated inflation will be reflected first in commodity prices. However, hitherto, excessive confidence has been placed in statistical findings that might be hiding a more complex causal relationship between commodity prices and the rate of inflation.

The staff's work is a good start, but we still do not have an *indicator of inflation that is a useful instrument for* orienting macroeconomic policies. Much work remains to be done, and the staff should undertake it and report on its progress.

The choice of the particular index to use should be based on which index is easiest to interpret and which one does the most to improve our understanding of the relationship between variations in the prices in the index and in the rate of inflation. An index that is built mainly with the particular weights of its components in mind would not be significantly useful in anticipating inflation.

Mr. Almeida said that, as a rule, the approach of this chair to the Fund's operations and procedures was based on the principle that things should be kept as simple as possible. Consequently, only indices that were clearly of economic significance should be used. The Fund should not try to devise indices based on models that were so complex and cumbersome that they could be understood essentially only by the model builders themselves.

The staff paper clearly lacked key information on when the proposed indices could be made available for detailed analysis, Mr. Almeida remarked. The purpose of the indices was to improve surveillance, policy coordination, and the world economic outlook exercise, and, to those ends, timing was crucial. The staff paper could have usefully indicated how the data in the proposed commodity indices would be and how the actual indices would differ from preliminary indices based on incomplete information. Moreover, the staff could have usefully noted previous cases in which the proposed indices have given wrong signals about the prospects of an economy.

As to the questions posed by the staff on page 29, it was still too early to conclude that commodity price indices might be useful indicators of inflationary pressures, Mr. Almeida commented. All indicators should include gold and petroleum for the practical reason that those commodities were important. Since it was difficult to define "a reasonable pattern of weights," as mentioned on page 29, that should not be the criterion used to choose an index. Instead, the choice should be based on an index's record of ability to predict inflation. The Fund should never use indices that had failed to foresee significant changes in inflationary trends in the past.

Like Mr. Enoch, he wished to see more work done in the area of commodity price indices, including statistical series and comparisons between expected inflation, as measured by the proposed indices, and actual inflation, Mr. Almeida said. There should also be some work on the form of presentation of indices--for example, how and when indices would be published.

Mr. Dai made the following statement:

> The list of indicators can and should be flexible, reflecting on actual conditions and the purposes of the indicator analysis. Hence, I would have no difficulty in accepting commodity price indices as an adjunct to other indicators, if the commodity price indices helped to strengthen multilateral surveillance and promote policy coordination among the major industrial countries.
>
> Nevertheless, I am somewhat skeptical about the reliability of commodity price indices as a useful indicator of future price developments. As the staff has indicated, commodity price movements have reflected largely shifts in relative, rather than

absolute, prices, and there is no stable long-term relationship between commodity and consumer prices. The staff paper gives the impression that, even after some econometric manipulation, the correlation between commodity and consumer prices is weak. Second, while financial variables do have a sizable effect on commodity prices, supply-induced changes in commodity prices may not be closely related to the general trend of inflation. Experience has shown that commodity prices can be influenced by the decisions of producers or by holders of some particularly important commodities. In such cases, the link between the inflationary trend and commodity prices could be greatly obscured. Consequently, we cannot always be certain whether major movements in commodity prices are caused by changes in supply or by changes in demand. In addition, in responding to changing circumstances, commodity prices often tend to overshoot substantially for extended periods.

Therefore, we must be very careful in interpreting the relationship between movements in commodity prices and changes in inflationary conditions. Other, more relevant factors are worth emphasizing in the effort to find an early signal of inflationary trends. It is true that the inappropriate economic policies, especially fiscal and monetary policies, of major industrial countries used to be the main cause of global inflation. As the staff has suggested factors that are related directly to the general inflationary trend, such as money balances and unit labor costs in industrial countries, appear to be especially viable candidates as indicators of future price movements. It is well known that there is a lag between monetary expansion and the associated acceleration in the rate of inflation, and that an increase in monetary aggregates tends to lead major swings in consumer prices. Therefore, it may be worthwhile to study further the predictability of changes in monetary aggregates in relation to inflationary trends.

I agree with Mr. Posthumus that it is not the lack or weakness of the available indicators that hampers coordinated policymaking. The real difficulty is the lack of effective action in response to the indicators that are already available. The indicator exercise is widely recognized to be an important instrument in strengthening multilateral surveillance and in promoting policy coordination among the major industrial countries, and I hope that our future efforts in this area will lead to some concrete results in curbing the turbulence in the current financial markets and in eliminating the enormous imbalances in the world economy.

Mrs. Filardo made the following statement:

It is unfortunate that the two advocates of this proposal have not guided the staff adequately in this matter or set the tone of the debate. It is likely that the existence of different explanations of this subject and the lack of direction by the United States and the United Kingdom led the staff to try in the present paper to develop diverse commodity price indices as indicators of future inflation in order to encourage central banks to monitor exchange and monetary policies, thereby helping in the effort at policy coordination among the G-7 countries.

The staff paper correctly notes that in examining whether an index of commodity prices might be a helpful addition to the list of existing indicators, one of the most important criteria is whether the index provides information at an early stage in the process of the intensification of inflationary pressure.

On the basis of its empirical analysis of the relationship between commodity prices and general inflation, the staff concludes that there is a link in both directions, but also that the commodity price indices show great variability one time and tend to overshoot substantially and for long periods in response to changes in circumstances. Another finding is that when movements of commodity and consumer price indices do not coincide, a shift in the supply of and demand for individual commodities has probably taken place. It is clear that, as Mr. Nimatallah stated, a commodity price index is characterized not only by sharp fluctuations in supply and demand, but also by the fact that those fluctuations are a reaction to changes in demand and consumer price indices and are generally influenced by the stance of financial policies in industrial countries themselves. Rather than construct an artificial index that would send the wrong signals, it would be appropriate, as Mr. Enoch stressed, to analyze how commodity prices are influenced by policies in the industrial countries.

Notwithstanding the objections that I have mentioned, the staff has made a good start in constructing different indices, although it is clear that none of them can serve individually the ideal purpose of promoting policy coordination among the G-7 countries; each can serve only as an additional indicator. However, as we have seen during recent world economic outlook discussions, rather than looking for a scapegoat, industrial countries should tackle their structural problems more decisively than hitherto.

I agree with Mr. Posthumus that, in our effort to obtain a useful index, we might well end up with an arsenal of indices that are an enormous burden on the limited staff resources. Therefore, if the objective of this discussion is to select an index or indices that bear a close relationship to price movements in industrial countries, the most appropriate ones that could be added to the existing list are those that take into account imports and consumption patterns in the G-7 and other large countries. The inclusion of oil in these additional indicators appears to be particularly significant, especially because by itself oil constitutes half the total consumption of all the commodities included in the suggested indices.

Mr. Dallara made the following statement:

We welcome this opportunity to discuss the use of a commodity price index as an economic indicator in the Fund's work and in the context of international economic policy coordination, particularly among the major industrial countries. At the 1987 Annual Meetings, Secretary Baker stated that the United States was prepared to consider utilizing, as an additional indicator in the coordination process, a commodity index that would better help us to understand the relationship between currencies and a basket of commodities, including gold. This approach was seen by Secretary Baker as being potentially helpful as an early warning signal of potential global price trends. As Secretary Baker noted in his statement at the 1987 Annual Meetings, it would be unfortunate if efforts to foster exchange rate stability among currencies led eventually to stable currency relationships but in a context of overall global inflationary or deflationary policies that affected the real value of those currencies. It is obviously not inconceivable that there could be a circumstance in which one could achieve some significant degree of relative price stability among major industrial countries and, therefore, perhaps some relative stability in their currencies, while the underlying price trends suggested a potentially counterproductive inflationary or deflationary bias. In this context, my authorities continue to view a proposed indicator of this nature as an analytical tool to be used in conjunction with other measures of economic performance in reaching judgments about policies and performance.

In the light of comments by previous speakers, it is clear that there may have been some misunderstanding about the nature or thrust of Secretary Baker's proposal. Mrs. Filardo is perhaps correct in suggesting that it would have been helpful for this chair to set the tone for this discussion, although I am not confident that, having done so, we would have been fully aware at the outset of the discussion of the misunderstandings that might have existed. At this point, I certainly am aware of them, and I hope that my comments can dispel some of them.

There have been some references to, and criticisms of, the possible use of a commodities indicator as a direct and almost sole guide to exchange rate or monetary policy. I wish to assure Executive Directors that my authorities' interest in this area is focused on the much more modest and limited objectives that I have mentioned and not on far-reaching notions involving a major change in the role of gold in the monetary system or the use of a formal "anchor" around a commodity index for exchange rate movements, or the use of a commodity index as a direct basis for the management of monetary policy. A commodity indicator would only be a supplement to existing indicators; it would by no means be a replacement for national indicators, and it should not distract us from the ongoing effort to strengthen the use of national indicators and, more generally, the indicator exercise. Indeed, the focus of our efforts should be on the strengthening of the indicator exercise based on national indicators, but this indicator could provide an important supplementary source of information.

It is true that the list of indicators being used in the Fund and by industrial countries already includes industrial country price indices, and that policymakers must of course focus to a large extent on inflationary conditions in their economies in making policy decisions. However, there is a potential need for a usable measure--if one can be found--of global inflationary or deflationary trends that goes beyond the strictly national indicators already available. There is a solid conceptual basis for believing that sensitive commodity prices may help to meet this requirement, as the staff has demonstrated.

Work by the staff on a commodity indicator of this sort could be a natural outgrowth of ongoing work by the Fund to compile and analyze commodity price movements in connection with the world economic outlook, the operation of the compensatory financing facility, and assessments by the staff of the export prospects of individual countries in connection with the Fund's surveillance. The staff has already done extensive work on the subject. It is clear that the staff did not discover the subject of commodity indices following the speeches at the 1987 Annual Meetings by Chancellor Lawson and Secretary Baker. A wealth of information was already available. In fact, when I began to improve my own personal knowledge of this issue in the period preceding Secretary Baker's speech, I was somewhat surprised at how much analytical work there already was. Therefore, it is not clear to me that further development of this effort is necessarily going to involve a tremendous additional amount of staff work, as some Directors have cautioned against.

Many of the technical questions concerning possible use of commodities as an indicator are questions which I believe were directed more to the staff than to those of us who represent the authorities who made proposals. I would, therefore, only make one or two points on technical issues. There is no doubt that interrelationships between commodity price movements and consumer price inflation are complex and work in many directions. However, to a considerable extent, some of these deficiencies could be dealt with through the careful selection of the specific commodities chosen for the index and careful selection of the weights used. It is also clear that considerable judgment would be needed in assessing the implications for global price trends of the latest data from any commodity index or indices.

Since inflationary expectations are such an important factor in actual inflation, commodities that traditionally serve as a hedge against inflation, particularly gold, would be natural candidates for inclusion in any such commodity index. Gold prices admittedly can be affected by other factors, such as supply shocks, but this possibility does not disqualify gold in any way from inclusion in a commodity index; nor should the special historical aura associated with the role of gold distract us from gold's potentially technically sound use. The staff paper suggests that the weight given to gold in consumption in industrial countries may understate its importance as a possible indicator of global inflation, and the correlation tests in the staff paper tend to support this conclusion. Therefore, it would be desirable to consider weights for gold that take into account not only gold's role in consumption in the major industrial countries, but also its ability to predict inflation as suggested by the staff's analysis.

The question whether to include oil prices in the commodity index is difficult to answer. My position is close to that of Mr. Ovi. There is no question of oil's importance as a commodity either in trade or consumption among the major industrial countries, and it would be a serious analytical mistake to ignore that role. At the same time, oil could have a large, perhaps dominant, influence on any index. In addition, I recognize that there are interactions between oil prices and consumer price indices, but my authorities in no way have in mind the possible inclusion of oil in a commodities index as an effort to demonstrate any causal relationship between oil prices and price trends in industrial countries; that would not be the purpose of a commodities index with or without oil. Rather, the role of oil in the index would be the same as that of other commodities included, namely, as one component signaling potential shifts in global price trends. On balance, I am inclined to think that we should keep a foot in both camps, by constructing an index that excludes oil--perhaps focusing our attention primarily on that index--while either also developing an index that includes oil, or tracking oil separately, as previous speakers have suggested.

I attach a high priority to the predictive ability of an index. At the same time, the index should be on solid ground in terms of economic theory. A better understanding of the process that links commodity and consumer prices would facilitate the selection of both the commodities to be included in an index and the relative weights for each commodity selected. In particular, the extensive focus on econometric weights in the staff paper should not lead us into what is referred to on page 14 of the paper as the "Hall trap."

Of course, as many speakers have stressed, further work will need to be done before any decisions can be made on which index or indices to focus on. For example, there should be further work on how best to accommodate different lags and on how to select appropriate weights. We would welcome a fuller discussion of an index providing broad coverage based on consumption weights for commodities other than gold as an alternative to an index based on regression weights, which was the main focus of the staff paper.

It is interesting to note that the correlation between the indices in the staff paper and world inflation in 1979-87 is somewhat evident, even though commodity prices were on a downward trend in that period while global inflation was rising and falling. That finding raises the important question of the appropriate base period to be used. In that context, apparently neither the 1960s nor the 1970s are very relevant to the situation in the 1980s. We wonder whether a midpoint of the high and low periods of the 1980s could be examined as a possible benchmark.

As to the question of how many commodities to include in the basket, the three indices of 40, 22, and 8 commodities developed by the staff present a number of alternatives. None of those indices seems to offer a clear-cut advantage--perhaps appropriately so, at this stage although they could provide useful information. The 8-commodity index seems to predict the best, but its volatility and the limited scope of coverage--it excludes many of the commodities that some Executive Directors feel should be included a priori--are negative factors. The 22-commodity index may be a sensible compromise. Careful analysis of this issue is needed.

In sum, a commodity price index could serve as a useful supplementary indicator of aggregate inflationary or deflationary conditions. Gold clearly should be included in such an index, with its weight reflecting not only its consumption, but also its predictive possibilities. The issue of the inclusion of oil should be examined further, and there should perhaps be two indices, one with oil and one without. As to the question of weighting, strong emphasis should be given to predictability, but emphasis also needs to be given to the reasonableness of the pattern of weights and the general composition of the index. Further work in this area should be undertaken. We do not have definite views on the best format or particular procedures for that further work. We hope that future world economic outlook exercises can include some of the products of the further analysis by the staff; if the staff and other Executive Directors thought that it would be useful, the staff could attach to the fall 1988 world economic outlook paper a technical paper as an appendix that would reflect some of the further work done by the staff on some of these difficult technical issues.

As Mr. Posthumus and Mr. Ovi said, it is clearly not the absence of a commodity price indicator that is at the heart of the surveillance and policy coordination problems facing the major industrial countries. However, I hope that they would agree that, while the Executive Directors should not delude themselves into thinking that this is a potentially major answer to the problems of coordination, we also owe it to our authorities not to simply say that there are no deficiencies in our indicator analysis and that all the problems concerning coordination are traceable to the authorities' ability to produce adequate policies. The Fund must continue its efforts to improve the technical framework within which members have committed themselves to work. Certainly no one would feel comfortable in claiming that the technically optimal state of indicator analysis has been achieved. Indeed, we are far from that state. Further work in this area is entirely justified.

Mr. Enoch commented that a position in favor of a commodity price index did not imply that there was necessarily a causal relationship between movements in commodity prices and the behavior of inflation in industrial countries. As some speakers had suggested, exogenous shocks, such as an increase in the fiscal deficits of the industrial countries, might well play a role in inflation. At the same time, since commodity prices moved in a much more flexible manner than, say, the prices of manufactures, movements in commodity prices might give a forewarning of movements in the prices of manufactures without the one causing the other. At the same time, there were clearly cases of price movements in which some degree of causality exists.

The function of commodity price indicators was to provide information in addition to that which was already available, Mr. Enoch said. None of the indicators--including commodity price indices--should be interpreted mechanistically. Some indicators, such as monetary growth, were frequently thought to be more useful than commodity price indices, especially for individual industrial countries, but the issue became more complex when the objective was to have an index that was an aggregate. One approach to monitoring policies in the industrial countries as a group was to aggregate preferred noncommodity indicators of the different countries concerned. However, looking at, say, monetary aggregates involved difficulties of aggregation that were at least as challenging as the problems that previous speakers had noted in connection with the broad commodity price aggregations that had been discussed at the present meeting. Even if aggregation of monetary indicators from individual countries could be accomplished, there would be no clear theoretical rationale for selecting the resulting aggregate as the preferred index. Some countries had narrow indicators, while others had broad ones, but some kind of aggregate was common to most countries.

It was against that background that Chancellor Lawson's idea should be seen, Mr. Enoch remarked. Although there were some difficulties in developing a commodity price basket, the idea of such a basket was relatively simple and the rationale for it was relatively clear.

The point made by several Executive Directors that the relationship between commodity and consumer prices was not always clear was well taken, Mr. Enoch said. However, under his authorities' proposal, commodity prices would be assessed in a judgmental manner. Moreover, the process of examining commodity prices would include broad, as well as narrow, indices; no single index could provide the full information that was desired. While he recognized that, in some circumstances, the Fund would be able to draw only a little additional information from commodity price developments, it was likely that a sharp rise in a commodity price index at a time of rapid monetary growth in industrial countries would be an important signal.

Considerable doubt had obviously been expressed by a number of Executive Directors about the proposed indicators, and some Executive Directors remained unconvinced that such indicators would be useful, Mr. Enoch remarked. The further work on commodity price indices could be carried out in the context of the world economic outlook exercise; as Mr. Dallara suggested, that effort probably would not involve much extra work for the staff, as there was already a considerable body of relevant analytical material. Perhaps the technical paper that Mr. Dallara had suggested attaching to the paper would be an appropriate way forward.

Mr. Posthumus said that he fully agreed with Mr. Dallara that the Fund had clearly not gained a perfect understanding of the extent to which commodity price indicators could be useful. However, the main point at the present stage was that the Executive Board would have to decide whether it wished to continue to devote resources to the search for appropriate commodity price indicators. That decision need not be made immediately, but it would have to be taken sooner or later.

Mr. Yamazaki commented that the relationship that one might perceive between consumer and commodity prices depended upon the time period that was chosen. Commodity price indicators warranted further examination, although he agreed with Mr. Dallara that such indicators should not be either a formal anchor of the international monetary system, or the direct basis on which monetary policy was formulated.

The Director of the Research Department noted that the staff paper was designed to focus attention on the technical issues in the design of possible indicators of future price developments; it was not meant to be a part of an examination of possible new foundations for the international monetary system. It was, of course, always helpful to bear in mind possible improvements in that system, but the proper way to do so was to deal with systemic issues rather than a particular mechanism for predicting the trend rate of inflation in industrial countries. The staff paper was intended to raise issues concerning the possible role of a commodity price indicator, including the potential implications for policymakers, importers and exporters, and others. At the same time, it was important to consider whether the information provided by commodity price indices would be useful. In that connection, an important criterion was whether such information enhanced the process of policy coordination. Another possible area of investigation was how policy actions over the previous ten years might have been different if a commodity price indicator had been used. A difficulty with that approach was that, as some Executive Directors had stressed, the relationship between general price movements and commodity price movements changed over time and the relevant data could be interpreted in several ways, thereby yielding different conclusions. Further study was clearly needed, and the stage had not yet arrived at which strong inferences from commodity price indices could be drawn.

One of the questions that had been raised was whether the existing indices of inflation were adequate, the Director recalled. As Mr. Faria had suggested, any increase in the information available to policymakers should be encouraged. A balance should be reached between the need to provide adequate information and the possibility that an excessive amount of information would be made available; in that context, the financial and nonfinancial costs and benefits of work on indices needed to be taken into account. As Mr. Dallara and Mr. Enoch had indicated, it was important to recognize that a given pattern of exchange rates might be consistent with both rising prices around the world or falling prices. If one had in mind not only exchange market stability, but also some consideration of the value of money in general, then an additional kind of indicator might be required.

Naturally, the next question to consider was what should be done when the chosen indicator showed an upward trend in world prices in a period of exchange market stability, the Director continued. In that context, and in the absence of any other information, one might conclude that the effort to maintain exchange market stability should not be based on expansionary policies. However, the policy alternatives would not be straightforward if there were also high rates of unemployment around the world. As a number of speakers had stressed, there would clearly be a need for judgment in using new indices. It would, of course, be desirable to avoid having to deal with conflicting signals that were sent because too many indices were being used.

Executive Directors had naturally stressed that the weights assigned to the commodities in a commodity price basket should be reasonable, the Director remarked. However, the purpose of an index had to be established before "reasonable" weights could be assigned to the commodities in the basket. Moreover, while, as Mr. Almeida suggested, the commodity price index should not be excessively complex in relation to what the index was meant to achieve, some optimal amount of complexity would be needed in order to ensure good forecasts. At the same time, the complexity of the index must reflect a good understanding of how individual commodity prices were eventually translated into general price developments.

As a number of speakers had also stressed, it was important to remember that commodity price data that were used as an indicator of future inflation were also used in making inferences about other important policy variables, such as the terms of trade of developing countries, the Director remarked. Those uses of the same database were not mutually exclusive and work on both should proceed.

In the coming period, the staff would wish to continue with ongoing work on commodity prices and inflation, the Director of the Research Department commented. The staff would undertake some of that work in the context of the world economic outlook, but it was important to bear in mind that the staff was still at the stage of in effect establishing the infrastructure of its work on commodity price indices.

Mr. Donoso said that he wondered whether it was not more important to try to anticipate inflation in certain individual countries rather than to seek to anticipate global inflationary pressures through the use of selected indices.

The Director of the Research Department considered that it was helpful to try to understand the relationship between the pattern of exchange rates and the inflationary or deflationary tendency in the global economy. Policy changes made by any particular major country would of course have an impact on the world economy. Therefore, it was important to have an understanding of the global inflationary or deflationary trend. The present discussion had strongly suggested that no single indicator would be able to identify the trend, and that any particular indicator must be supplemented by others. Having indicators of global inflationary or deflationary trends seemed to be particularly important in periods in which policymakers received conflicting signals from national price and unemployment data.

The staff representative from the Research Department said that the staff would wish to answer some of the technical questions on a bilateral basis. One of the general issues was the extent to which there was a stable relationship between commodity and consumer prices. The discussion had clearly shown that commodity prices behaved very differently from consumer prices in both the short and the long run, and, therefore, each set of prices yielded very different information. At the same time, there was a statistically significant relationship between the two; indeed, the relationship had proved to be much stronger than the staff had expected.

An important question was whether the relationship was sufficiently stable to be relied upon by policymakers, the staff representative continued. The staff had recently looked at turning points of inflation over the past 20 years. There had been six such turning points as shown by the aggregate consumer price index for the G-7 countries, including three peaks and troughs, the most recent of which was a peak of around 12 percent followed by a trough of a little more than 1 percent near the end of 1986. Of these turning points, five had been clearly revealed by turning points in the commodity price index that the staff had used--an export-weighted index that included gold and oil and which had a particularly strong statistical relationship with consumer prices. The sixth turning point, in 1978, had been contemporaneous with the turning point in commodity prices. The examination of turning points clearly showed that, over the 20-year period in question, there had been a tendency for commodity prices to lead consumer prices, at least in terms of the turning point in the movement of the aggregate consumer price index of the G-7 countries. Although the staff had noted in its paper a two-way causal relationship between long-term movements in consumer and commodity prices--in some periods, consumer prices had moved ahead of commodity prices, while in other periods commodity prices had moved ahead of consumer prices--there was a clear leader/follower relationship between the two sets of prices in terms of turning points in inflation. The staff's latest research had not shown a significant relationship between turning points in inflation and either money growth or unit labor cost growth.

One of the main issues at hand was the need to interpret the information provided by movements in commodity prices, the staff representative remarked. Commodity prices were known to change for a number of different reasons, ranging from the specific conditions in one or a few markets, to changes in the overall environment. The fact that commodity prices changed for a number of different reasons was a major problem in using the information provided by such changes. It was much easier to establish a relationship between commodity and consumer prices in retrospect over a 20-year period than it was to know how precisely to respond to a current change in commodity prices. The difficulty in interpreting commodity price information probably would always remain, but in all likelihood was no more serious than the difficulty in interpreting current data on monetary growth, unit labor cost growth, or other indicators.

In considering which indicators the Fund should look at in the future, the staff would certainly agree with Executive Directors who had stressed that the new indices that the staff had estimated in its paper were very preliminary in nature, the staff representative commented. The staff had been encouraged by the results of its inquiry in the sense that the new indices provided some additional understanding of the behavior of prices. At the same time, the staff fully agreed with Executive Directors who had emphasized that much more work was needed before any of the indices on commodity prices could replace or even supplement the present indices that were used as indicators. The staff would wish to examine further the question whether a commodity whose prices tend to be dominated by supply shocks should be excluded from a commodity price index; thus far, the evidence suggested that such an exclusion would probably prove to be unnecessary. Even such commodities as oil, coffee, and tea, whose prices changed frequently because of market conditions, seemed to be useful additions to commodity price indices. In addition, the staff would wish to explore Mr. Dallara's suggestion that the weight given to gold in a commodity price basket should be relatively large; under that approach, the weight would reflect gold's significant role in expectations rather than gold's small role in total trade and consumption.

In measuring inflation in the commodity price indicator exercise, the staff had chosen for the sake of convenience to convert all the price indices for both commodity prices and consumer prices into SDRs, the staff representative explained. The staff had recently come to have second thoughts about that approach. There appeared to be no ideal way in which to measure aggregate inflation in a group of countries where exchange rates moved relative to one another. At present, the staff was working on a method of measuring the exchange rate that was based on an aggregate exchange rate basket for the G-7 countries; that basket seemed to reflect the relative weights of the different countries in currencies more accurately than the SDR. The staff would wish to continue its work in that area in the coming period.

The staff had compared the usefulness of commodity price indices with the usefulness of other kinds of indices, such as indices of manufactured goods and monetary growth, the staff representative from the Research Department said. During its examination of normalized unit labor cost, the staff had felt that it was also examining the behavior of prices of manufactured goods as had been suggested by Mr. Salehkhou; the staff had felt that normalized unit labor costs tended to lead manufactured goods prices. At present, however, the staff felt that it would have been better to incorporate manufactured goods prices as a separate possible leading indicator, and the staff would study that possibility more closely in the coming period. The staff had been surprised to see that there had been no tendency for an aggregate monetary index for the G-7 countries to lead consumer prices. Mr. Enoch had usefully suggested that that outcome was possibly due to the fact that the various monetary aggregates were affected by exchange rate movements and by the differences in the kinds of monetary aggregates that were considered for individual countries. The timing of the availability of various kinds of data clearly worked much in the favor of commodity price indices. The indices of commodity prices discussed in the staff paper were available on a monthly basis, soon after the end of the month to which they applied.

Mrs. Filardo considered that the discussion had clearly shown that a commodity price index that was used as an indicator for policy coordination must be clear and simple. However, as the staff's explanations had suggested, each commodity price index would likely have to be interpreted differently and could send different signals. It might well be difficult for the staff to base its future work on commodity price indices on the varying signals that had been sent by the present discussion.

Mr. Nimatallah commented that the discussion had suggested that the Fund was concentrating more on statistical relationships than on economic relationships in the area of commodity price indicators; the Fund's work was concentrated on the technical and statistical level and could therefore be helpful, but perhaps also misleading. The statistical skeleton that had been developed should be fleshed out with meaningful economic implications. It was useful to note that, in the area of consumer and commodity price movements, certain two-way causal relationships were statistically significant, but it was also useful to consider the causes of the price movements themselves. For example, one cause could be the result of encouragement by certain factors, the reaction to which might well be excessive. It was important to consider the economic meaning of the conclusion that rates of change in commodity prices seemed to lead changes in consumer prices. Was such a conclusion helpful for the design and implementation of economic policy? At the same time, it was important to note the distinction between dynamic and static analysis based on commodity price indices. It was one thing to note the level of commodity and consumer prices in one year compared with another, but it was another thing to draw conclusions from that information on which policy decisions--for example, decisions aimed at stabilizing consumer prices in a coming period--were based. Great care had to be taken in moving from static analysis to dynamic analysis.

Even if a statistically significant relationship between commodity and consumer prices was evident, something that was certainly not obvious, the relationship that had been shown was a static one; commodity prices had to be seen in a medium-term or longer-term perspective, Mr. Nimatallah continued. A decision by an individual firm to purchase commodities might well be seen to be based on current market conditions, but such an analysis was less helpful in assessing the behavior of a large number of commodity prices in a single basket; after all, the price of each commodity would be affected by different supply and demand conditions. Industrial countries had been making a commendable effort to reduce their demand for oil and other commodities by making more efficient use of the commodities, and those efforts affected the prices of the commodities. It was on the demand for commodities that the Fund should concentrate its attention, and Mr. Enoch had usefully referred to the possible use of a broad index to detect changes in demand. Consumer prices provided a good indication of the behavior of demand, partly because they included the prices of manufactured goods. Each element of a broad index would have to be examined carefully and separately. Such basic matters would have to be fully examined before commodity prices could be relied upon to provide an early warning signal of inflation. He doubted whether such an early warning signal could be given, since commodity prices did not lead consumer prices.

The Chairman made the following summing up:

> Our discussion was useful, I think, in identifying both the advantages and pitfalls of employing a commodity price index as

an additional indicator for predicting aggregate inflationary developments in the large industrial countries.

A number of Directors felt that commodity price indices could play a helpful role in this context, as an adjunct to other indicators, and that their use could enhance the effectiveness of surveillance over the policies and performance of the larger industrial countries that have a major influence on global economic and financial developments. They pointed in particular to the property of commodity prices to lead movements in consumer prices. Such an early-warning signal could complement more traditional indicators of inflationary pressures by providing timely information that could help to foretell shifts in global inflationary pressures by providing timely information that could help to foretell shifts in global inflationary tendencies.

At the same time, I heard concerns expressed by many Directors regarding the possibility of relying too heavily on this type of indicator. These Directors emphasized that the relationship between commodity prices and consumer prices could not be deemed to be reliable enough to serve as the basis for guiding monetary policy in individual countries, that there have been periods when changes in consumer prices have lead changes in commodity prices--rather than the reverse--and that the long-run response of consumer prices to commodity prices could depart markedly from the short-run response. Some even questioned whether additional indicators of inflationary pressures were needed and, if so, whether an index of commodity prices would be the best choice.

As demonstrated in the staff paper, commodity prices have at times fluctuated greatly, while inflation of consumer prices has been much less volatile. This relationship points to the danger of assuming that stability of consumer prices would require stability of commodity prices. Furthermore, attention was drawn to the fact that the present level of commodity prices is quite depressed in real terms, even in relation to the long-run downward trend in the ratio of commodity to manufactured prices. Some Directors cautioned that if economic policies were, for example, to stabilize real commodity prices at the currently depressed level, serious adverse consequences for many developing countries would result. More broadly, these Directors also argued that the interpretation of commodity prices as indicators of future inflation should not lead us to neglect the role of these prices as indicators of conditions affecting developing countries that rely heavily on exports of primary commodities.

Various views were expressed on the question of whether the prices of petroleum and gold should be included in a commodity price index intended to serve as an indicator of inflationary developments. Because of the special nature of the oil market, the Fund's commodity price indices have, until now, excluded petroleum; oil prices have been extensively analyzed separately from those of non-oil commodities. Some Directors noted that the price of petroleum reflects conditions that are particular to that market, and that it therefore moves very differently from other commodity prices. Other Directors, however, observed that there appears to be a strong improvement in the predictive powers of the commodity price indices discussed in the staff paper when the price of petroleum was added to them, and they felt that it would be useful for the staff to monitor developments in these price indices.

The Fund has also always closely followed the market price of gold. Some Directors expressed the view that the price of gold is a sensitive barometer of changes in inflationary expectations and, as such, could make a useful contribution to a broadly based index of commodity prices. Other Directors argued that gold plays a relatively minor quantitative role in world trade and in consumption in industrial countries, and that its price is often dominated by supply developments. They felt that the addition of gold to a conventional index of commodity prices would therefore be of limited value, and could even be misunderstood as presaging a return to gold in the international monetary system. Of course, this difficulty could easily be diminished by providing appropriate information alongside the new index itself.

Many Directors noted that it was important to ensure that commodity price indices cover a broad range of commodities and that the weights be sensible from an economic perspective. Some Directors considered that the indices newly estimated by the staff, in which the weights assigned to each commodity are selected so as to give the best overall predictions of aggregate inflation, looked reasonable from this perspective. Some other Directors, however, questioned whether the weights in these indices could be interpreted as clearly as those in the more conventional indices in which the weights are based on the importance of each commodity in international trade or in consumption. These Directors also noted that the trade- or consumption-weighted indices that include the prices of gold and petroleum seem to predict inflation about as well as the newly estimated indices.

To conclude, I would judge that most Directors would support further work by the staff toward adding--perhaps on a trial basis--an index of commodity prices to the list of indicators that currently figure in the process of multilateral surveillance. As emphasized by most Directors, care would need to be taken to exercise judgment in the interpretation of such an index or indices--indeed, this goes without saying--in order both to extract the "signal" rather than the "noise" from commodity prices for future price developments, and to give commodity prices an appropriate weight as one among many indicators that correctly assist the surveillance process. I would propose that the staff continue to investigate this issue, with an eye toward resolving, if possible, the questions raised by many Directors during this day's discussion. As this work evolves and if the track record of commodity price baskets becomes better established, the staff could also consider giving somewhat more prominence to developments related to commodity price indices in the World Economic Outlook and in other Fund publications.

2. QATAR - 1987 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1987 Article IV consultation with Qatar (SM/87/286, 12/3/87). They also had before them a background paper on recent economic developments in Qatar (SM/87/292, 12/16/87).

Mr. Finaish made the following statement:

Over the past few years, the primary focus of economic policy in Qatar has been, as it has in many other oil exporting countries, on the need to adjust to the substantial contraction of oil export revenues. This contraction was brought about by a slackening in the international demand for oil and the output restraint induced not only by that slackening, but also by an increase in the exports of non-OPEC oil producers. The repercussions of the sharply reduced oil export receipts were deeply felt throughout the economy as, closely parallel to changes in the oil sector's value added, economic growth declined in all but on year over the period 1981-86. Indeed, in 1986 alone, notwithstanding a 9 percent increase in oil production, the near halving of world market prices for oil precipitated a 21 percent decline in overall economic activity. In addition, largely due to the expenditure restraint necessitated by the decline in government oil revenues, but also due to the adjustment to more normal circumstances following the rapid growth and diversification in the decade up to the early 1980s, economic activity in the non-oil sector weakened. Reflecting this general economic slowdown, the demand for expatriate workers eased considerably, the domestic pressure on wages was sharply reduced, and rises in the cost of living index were limited to less than 2 percent annually over the past three years. As for 1987, the indications are that following the partial recovery of world oil prices, the oil sector recovered mildly while, reflecting the continued policy of fiscal restraint, the non-oil sector experienced a further, though moderate, contraction.

With government revenues in Qatar heavily dependent on income from oil and gas and with government domestic expenditures accounting for nearly 40-50 percent of GDP in recent years, the task of adjustment to the substantial decline in the country's oil export earnings in the 1980s was quite challenging. The authorities sought to strike an appropriate balance between the need, on the one hand, to limit international reserve losses and, on the other, to mitigate the contractionary impact on the economy of the fiscal restraint in the wake of the decline in government oil revenues.

As regards the fiscal restraint, total government expenditures were reduced throughout the period 1982-86, kept at approximately their 1985/86 level in 1986/87, and are expected to remain near that level in 1987/88, despite the projected recovery of oil revenue during the year. While this reduction in outlays was achieved by reducing, over most of the period of adjustment, both current and capital outlays, the relative contribution of the latter was much higher than that of the former, reflecting the completion of most of the necessary infrastructure by the early 1980s and the limited scope for further efficient diversification, as well as the need to meet the necessary spending requirements of essential social services and for the maintenance of capital projects. It is noteworthy that, in this environment of fiscal austerity, the authorities' recent decision to go ahead with the implementation of the highly needed first phase of the enormous offshore North Field gas project will have very limited budgetary implications. Also noteworthy in this regard is the authorities' intention to continue their external assistance program, albeit at a reduced level in comparison with their aid flows during periods of stronger fiscal and external payments positions.

Even though reductions in government expenditures have been substantial, they were not sufficient to offset the more rapid declines in government revenues in the 1980s. As a consequence, though government outlays were about 15 percent lower in 1986/87 than their already reduced level in 1984/85, the much sharper contraction of government revenues over that period moved the budget from a surplus to a large deficit in 1986/87. The budget deficit is expected, on account of the projected recovery of oil revenues during the year, to decline somewhat in 1987/88, with the needed financing expected to be secured by a drawdown of the Government's domestic and foreign assets. It is to be noted in this regard that in the event of future declines in government oil revenues, the authorities are prepared to give consideration to alternative revenue measures, such as the introduction and extension of user fees for government services. As for tax initiatives, the authorities consider that the scope for such initiatives is currently limited by administrative difficulties, as well as social and economic constraints. Additionally, consideration of potential revenue-broadening measures in Qatar need to take into account regional revenue arrangements and the free factor mobility within the Gulf Cooperation Council (GCC) region.

As regards recent policies and developments in the monetary field, notwithstanding their finding that none of the commercial banks faced any major risks, the authorities implemented a number of measures aimed at strengthening bank supervision and preserving the soundness of the banking system. These measures included the introduction of reserve and capital requirements and proposals by the Qatar Monetary Agency (QMA) calling on banks to provide for doubtful loans and improve the quality of their portfolios. In addition, the QMA also introduced a new discount facility with the aim of enhancing its role as a lender of last resort. The rate of monetary growth of about 10 percent in 1985-86 represented a marked decrease from the 22 percent rate in 1984, and prevented a loss of foreign reserves beyond a level regarded as acceptable by the authorities. The monetary growth rate is projected to decline further to 7 percent in 1987. Also, following two years of rapid expansion, the growth of credit to the private sector slowed down considerably in the first half of 1987.

Developments in Qatar's external position during the period 1984-86 largely reflected the adverse impact of the sharp decline in oil export receipts. These developments also reflected the impact of a number of mitigating factors, such as a reduction in private capital outflow, an improvement in investment income, and a contraction of imports. Balance of payments estimates for 1987 envisage a recovery of exports, as well as a further contraction of imports. The Qatari riyal has depreciated in line with the U.S. dollar since early 1985, and Qatar's trade system has continued to be liberal, with import duties at the lower end of the agreed GCC range, which itself is relatively low.

The medium-term projections for Qatar's balance of payments are, as illustrated by the alternative scenario reported on page 13 of the staff report, highly sensitive to developments in world oil markets. However, even under the pessimistic assumptions underlying that scenario, it appears that Qatar's international reserves are sufficiently large to afford the authorities considerable room for maneuver. In any event, the authorities fully intend to continue to be responsive to developments in the oil market while maintaining an environment conducive to the resumption of normal growth.

Mr. Al-Assaf made the following statement:

In the two years since the previous consultation with Qatar, the authorities have continued to implement their policy of economic and financial adjustment. The fall in export receipts from their 1981 peak made this adjustment unavoidable, as Mr. Finaish explained in his opening statement. Although the adjustment has been made easier by the sound initial financial position of the country, it would be incorrect to assume that this adjustment has been painless.

The authorities should be commended for their prudent management of the economy. Government spending, in particular, has been kept at a level that strikes the right balance between two main considerations: on the one hand, that government expenditure should be adequately supportive of economic activity; on the other hand, that expenditure should remain consistent with a sustainable rate of reserve use. The comfortable level of reserves demonstrates the prudence of the authorities' management of the economy. However, the income generated by these external assets will not be sufficient to prevent their drawdown, even at present levels of reduced expenditure. This clearly illustrates the limitations of foreign investment as an alternative to the diversification of the domestic economy.

In this context, the authorities have already made some decisive moves to broaden the productive base, particularly, the cement, steel, and petrochemicals industries--most of them government owned. The broadening of the productive base is the basis for the future development of other downstream industries which are essential to economic development. In view of the significant competitive advantage enjoyed by Qatar in these industries, such efforts should be encouraged.

A key to the success of such diversification is free access to external markets. In this respect, the experience of the Gulf Cooperation Council (GCC) countries, including Qatar, has not been very positive so far. The GCC countries will continue to address this issue in the context of their negotiations with their economic partners, especially countries that were members of the European Communities (EC).

On the whole, the staff report provides a fair assessment of the adjustment process being implemented by the authorities. It also recognizes their efforts to continue their program of external assistance, despite the weakness of the external position. On both counts, the authorities deserve the commendation of the Board.

Mr. Comotto made the following statement:

I endorse the staff's appraisal.

In considering Qatari economic policies, it is of course important to bear in mind the considerable flexibility afforded by Qatar's substantial reserves, which is highlighted by the medium-term projections in the staff report. I am sure, however, that the authorities are not seriously considering actually using up the room for maneuver available to them. Therefore, the need identified during the previous Article IV consultation to continue adjusting to sharply reduced oil export earnings, by enhancing non-oil revenue over the medium term and containing expenditure, particularly on subsidies, still holds true. This point must be emphasized, as the scope for further significant cuts in government expenditure is felt to be limited by social and economic objectives. I welcome the fact that the authorities have taken further action to control expenditure in some areas, by reducing the number of subsidized products and through the planned rationalization of incentives and services provided to agriculture. On the revenue side, their willingness to consider charging for government services is a sensible precaution, and they should perhaps examine the scope for increasing import tariffs. Prudent external borrowing may be helpful. Ultimately, however, the sustainability of the authorities' current decision not to undertake any "major initiatives" on the revenue side will clearly depend on external developments. In the longer term, there are also cogent structural reasons for phasing out subsidies and applying economic charges to services.

In a longer-term perspective, it is clear that Qatar, in common with its GCC partners, faces important developmental challenges. There appear to be inherent limits on agriculture and on oil and gas-related manufacturing activities. It is not clear where Qatar's comparative advantages lie outside the energy sector and related industries. The suggestion that comparative advantage lies in small and medium-term projects in the private sector that are aimed at the GCC market seems reasonable, although it would be interesting to know precisely what sort of activities are envisaged. Another area may be regional commerce. The Gulf Cooperation Council should provide an important framework within which Qatar and its Gulf partners can mutually foster their development and diversification. Perhaps, Article IV consultations for countries in this region could explore this perspective in the future; such an approach might usefully flesh out a report that is rather thin, particularly as it is produced only biennially.

As to more immediate issues, I especially welcome the authorities' actions to strengthen banking supervision, including the introduction of reserve requirements for bank deposits and minimum capital/asset ratios. I also endorse the staff's call for early adoption of a policy on provisioning for bad or doubtful debts. The development of the Qatar Monetary Agency's role as lender of last resort is sensible, but the effectiveness of its discount window as an instrument in extending crucial liquidity to the financial system appears to require some development of the market in eligible securities. Indeed, there appears to be scope for more general development of the financial system in order to improve the intermediation of Qatar's financial resources; in this respect, Qatar might find it worthwhile emulating some of its GCC partners in establishing a treasury bill market. Such a step could also be helpful in facilitating public sector financing.

I strongly urge Qatar to attack the serious deficiencies in its statistical base. This problem is unfortunately all too common for the Fund. Still, Qatar has an admirable record of cooperation in other areas--most commendably, it has maintained an open exchange and trade system despite the volatility of its external economic environment. I hope that the authorities will seek to address the statistical problems very soon.

Mr. Kabbaj made the following statement:

I broadly agree with the staff appraisal. During the previous consultation with Qatar, the Board commended the authorities for following appropriate policies to adjust the economy to the sharp drop in earnings from oil exports. It is heartening to note that the recommendations of the Board regarding budgetary and monetary policies were largely taken into account by the authorities in managing their economy.

Qatar, like other oil producing countries, has indeed suffered during recent years from the downturn in the oil markets. Given the preponderance of oil and gas in the Qatari economy--they account for 85 percent of export receipts and more than one half of government revenues in 1986--the effects on the economy of the oil market downturn could have been much greater; indeed, as pointed out in Mr. Finaish's opening statement, economic growth declined in all but one year over the period 1981-86. Oil export earnings declined sharply over the period and, consequently, the external current account turned negative in 1986, while the overall balance of payments, which recovered somewhat in 1984 and 1985, also turned negative, by about $500 million, in 1986.

Fortunately, the small size of Qatar and of its population, as well as the comfortable level of reserves and the conservative budgetary policies implemented in reaction to the downturn in oil prices, mitigated the adverse effects of the oil price situation. The non-oil sector was affected by oil sector developments and the budgetary restraint that accompanied it. I basically agree with the authorities that the situation in the non-oil sector reflects the adjustment of the economy to more normal circumstances--including lower oil prices--especially as the bulk of the infrastructure, except for the energy and water sectors, has been completed.

On the medium-term prospects, the authorities do not feel that they should embark on any major initiative at this time, but I encourage them to consider the staff recommendations--as they seem to do--as a precautionary set of measures that they can usefully implement should any adverse development warrant it. In this connection, I note Mr. Finaish's assurances that "in any event, the authorities fully intended to be responsive to developments in the oil market while maintaining an environment conducive to the resumption of normal growth."

Given the size of the Qatari economy and population, and the more than comfortable level of reserves and the strong adjustment policies that have already been implemented, there are no foreseeable problems with the reserves. Moreover, as the simulation by the staff shows, even if oil prices were below their projected level by $5 per barrel and capital outflows were much higher, the level of reserves would be sufficient to cushion Qatar until the end of 1990.

I commend the authorities for maintaining an open trade system and for the level of their official development assistance.

Mr. Templeman made the following statement:

Despite the very important external developments that have occurred in the two years since the Board last reviewed economic developments in Qatar, the nature of the economic adjustment problem facing the authorities has not changed. The need to diversify the economy in order to reduce the country's vulnerability to the vicissitudes of the world oil market and to create alternative sources of growth remains the principal issue. The sharp drop in oil prices in mid-1986 and in late 1987 has underlined the importance of this objective. While these developments have added a degree of urgency to the need for policy measures, the authorities have been making quite good progress in their adjustment and reform efforts.

The brunt of the adjustment effort has fallen on the fiscal accounts and, importantly, on a scaling back of expenditures--by an impressive 16 percent in nominal terms between 1983/84 and 1987/88. The staff report notes that subsidies have been reduced and that further cuts in subsidies will be contemplated if the budget situation deteriorates. However, I wonder why action in this area should not be taken in any case. On the revenue side, petroleum revenues have declined by nearly 50 percent between 1983/84 and 1987/88. It is therefore surprising that, while recognizing the utility of broadening the revenue base, the authorities do not plan any major initiatives in that area in the foreseeable future. Although Mr. Finaish touches on this question in his opening statement, I would welcome further comment on it.

Good progress has also been made in adjusting the external accounts to the lower oil receipts. The current account balance worsened between 1982 and 1987 by only about $1.2 billion, in the face of a decline in oil exports of $2.4 billion. While much of the correction has taken the form of a compression of imports, this does not seem to pose a threat to real economic growth, since the completion of infrastructural projects has reduced the need to maintain a high import level. The other major factor in protecting the balance of payments position has been the sharp drop in private capital outflows, by more than $1 billion between 1982 and 1986, including errors and omissions. No doubt this reflects, in part, relative interest rate changes in Qatar and abroad. Over the medium term, it appears that there is little likelihood of serious problems arising in the external accounts, because of the large cushion of reserves.

While the staff report stresses the importance of the fiscal accounts in the adjustment effort and notes the relatively limited role of monetary policy, it does alert us to the potential for some shift in the relative importance of these tools of economic management.

For example, the leveling off of fiscal expenditures, the potential effects on capital flows arising from the spread between interest rates in Qatar and abroad, and the need to preserve the soundness of financial institutions, all suggest that some more attention should be paid to monetary policy. In this connection, I welcome innovations in the form of reserve requirements, capital and reserve ratios, and the new discount facility. I also endorse the cautionary note about the possible need to use interest rate policy more actively, should international interest rates rise so as to create an incentive for capital outflows.

Like Mr. Comotto, I wish to underscore the inadequacy of Qatar's statistics and the need to improve them. For example, except for the medium-term balance of payments outlook, there are no data for 1988, and, even for 1987, the data are limited to the balance of payments and 1987/88 budget figures. I wonder if it would not have been possible to present at least a few more up-to-date estimates of additional variables.

Mr. de Groote said that he agreed with the staff's assessment of the situation in Qatar and noted that the staff's views were similar to those of Mr. Finaish. The discussion of the exchange rate system was somewhat confusing in the staff report, and was especially so in the background paper, where, in the first paragraph on page 41, the Qatar riyal was said to be pegged to the SDR, but in the following paragraph was said to be pegged to the dollar. Given those statements, and Mr. Finaish's comment that the Qatar riyal had depreciated in line with the dollar, it seemed that the peg to the SDR was only a formal peg, and that the Qatar riyal was actually pegged to the dollar. Was the actual peg of the Qatar riyal to the dollar advantageous or not? It appeared that the present sharp depreciation of the exchange rate, in line with the fall in the dollar might retard the further development of the country, because imported inputs were badly needed. As more than half of GDP did not result from oil production, it might be advantageous for the authorities to, in practice, peg the exchange rate to the SDR instead of the dollar.

Chart 2 of SM/87/292, indicated that interest rates in Qatar had remained unchanged, while the LIBOR rate had fluctuated greatly, Mr. de Groote observed. The staff papers noted that the constraints of the sharia principles explained the static interest rates. However, he wondered whether the staff was sure of its judgment on the interest rate situation; as he understood it, the rate on foreign exchange deposits was completely flexible and followed the LIBOR. Anyone in Qatar who was interested in exporting or importing capital was probably sophisticated enough to maintain deposits denominated in foreign exchange, in order to have the full benefit of the fluctuation in the relevant interest rate, but the flexibility of the deposit rate probably affected only those segments of the population that were relying on more traditional banking forms. If so, the staff's strong recommendation for important changes in the interest rate system in Qatar was inappropriate. The present situation was acceptable because the capital movements that could affect the balance of payments were already subject to fluctuating interest rates, while the fixed rates generally did not affect capital outflows.

Improvements in the statistical base were needed, and the Qatari authorities' official development assistance was commendable, Mr. de Groote concluded.

The staff representative from the Middle Eastern Department said that the staff was not well equipped to take an in-depth look at individual industries and sectors to examine the potential for diversification. Such studies were normally undertaken by the World Bank. While the Fund staff did not have the benefit of recent reports or studies by the World Bank on

Qatar, studies were available from the Bank on sectors in neighboring countries in similar situations to Qatar's; accordingly, it was thought that Qatar's comparative advantage would be in small-scale, capital-intensive industries. However, one should not become too optimistic; in the view of the staff, Qatar, like other countries in the region, had distinctly limited scope for further diversification.

As to what one speaker had called the thinness of the staff report, the staff representative said that the shortage of statistics had posed a major constraint on the preparation of the report. Moreover, since Qatar faced few problems it was felt that a succinct report was warranted.

The potential for expanding the budgetary revenue base had been discussed with the authorities, the staff representative noted, but it was not felt that any decisive steps toward revenue diversification were imminent, although the authorities were giving thought to introducing charges for some public services as a contingency. The authorities, like those in neighboring countries, faced a dilemma, because current recessionary conditions made it politically difficult to launch revenue initiatives. On the other hand, when economic conditions had been more favorable, including higher oil prices, there might have been enough political leeway to introduce revenue diversification measures, but the economic need for such steps was not pressing. Perhaps for that reason, Qatar, like other countries in the region, had tended to miss the opportunity for expanding revenues. The staff had, however, encouraged the authorities to look closely at their options in that area, particularly as the authorities saw the scope for further cuts in government expenditures as quite limited.

The exchange rate peg to the SDR was, as Mr. de Groote had observed, purely formal and had no practical significance, the staff representative said. The Qatar riyal had, in practice, been pegged to the dollar for about seven years; a number of the countries in the region had found it to be a convenient arrangement. Certainly the peg to the dollar over the past few years had not been in conflict with the weaker external position associated with the decline in oil prices and the greater emphasis on diversification; indeed, the incentive for the production of domestic goods had been rising sharply. Of course, import prices had risen, but the rise was consistent with the authorities' desire to restrain imports and to meet their reserve target.

The scope for interest rate policy was limited, the staff representative from the Middle Eastern Department remarked. Nevertheless, interest rates could play a supplementary role in the general stabilization effort. Although it was true that foreign currency deposits were free of interest rate ceilings, the authorities were apprehensive about the possible re-emergence of interest differentials in favor of world capital markets and the possibility that it would promote capital outflows. While the staff did not wish to overplay that issue, it was believed that a more flexible interest rate policy could be helpful, considering both the openness of Qatar's capital market and the desire to achieve a specific reserve target with a given budget posture.

Mr. de Groote remarked that, while the depreciating dollar might have benefited Qatar, by protecting manufacturing industries, and might not have harmed the country through a rise in the cost of imports--conclusions that he did not necessarily accept--he wondered whether Qatar enjoyed any advantages from a strong appreciation of the dollar.

The staff representative from the Middle Eastern Department said that it was likely that, when the dollar had appreciated, domestic industries had been hurt. But the appreciation had occurred largely prior to the time when oil revenues had begun to decline and, therefore, at a time when the economy could better withstand it. An important question was whether a continued link to the dollar into the future would be beneficial. In that connection, the authorities--conscious of the need to ensure domestic competitiveness and to promote whatever further efficient diversification was possible--should keep their options open. A recent proposal to introduce a common pegging arrangement in the Gulf Cooperation Council had been shelved for the time being, the staff representative noted, and the exchange rate question might well become an issue in the period ahead.

Mr. Finaish remarked that Qatar's situation was clearly similar to that of other countries in the region that had been affected by the drop in oil prices. Over the period 1982-86, oil and gas production accounted for 44 percent of Qatar's GDP, 90 percent of merchandise exports, and 83 percent of government revenues; therefore, the sharp decline in the country's oil export receipts--brought about mainly by a weakening in the international demand for oil--had serious implications for the balance of payments and the government budget. Moreover, in the case of Qatar, there was an additional, highly significant dimension to the adverse impact on the country of the weakened international demand for oil and the output restraint induced by the weakened demand, as well as the increase in the exports of non-OPEC oil producers. Nearly all of Qatar's infrastructure depended importantly on associated gas, as did the various petrochemical plants that had contributed significantly to the diversification away from simple crude oil production and export--about 40 percent of Qatar's total gas supply of approximately 600 million cubic feet per day in 1986 comprised associated gas. On the other hand, domestic demand for gas had risen by about 10 percent annually over recent years. The decline in the supply of associated gas--because of falling oil production--together with the decline in the flow of nonassociated gas--because of falling pressure in the Khuff reservoir--led to frequent power interruptions, which turned out to be costly to some of Qatar's major manufacturing plants. The country's fertilizer and petrochemical industries were especially adversely affected by the decline in gas supply, as they relied on gas not only for fuel, but also for feedstock.

It was fair to say that Qatar had managed the adjustment well, Mr. Finaish added. Over the period since the previous Article IV consultation discussions with Qatar, oil receipts declined by about QR 5 billion, while the overall balance of payments deteriorated by only QR 3 billion, moving from a surplus of QR 1.2 billion in 1984 to a deficit of QR 1.8 billion in 1986. The thrust of the adjustment came from cuts in government expenditures which, albeit substantial, were not sufficient to offset a much sharper decline in government oil revenue. As might be expected, activity in the non-oil sector, which depended heavily on domestic government expenditures, was seriously affected. Nevertheless, adjustment had been achieved without resort to restrictions or artificial support of the domestic economy and, despite the difficulties it experienced over recent years, Qatar continued to be a source of sizable foreign assistance. Furthermore, workers' remittances from Qatar continued to contribute significantly to the foreign exchange earnings of a number of countries in the region.

The authorities recognized that more attention should be paid to the statistical data base, Mr. Finaish said. As to interest rate policy, the Qatar Monetary Agency's banking control department was in the process of preparing a study on the domestic interest rate structure. He did not believe that interest rates could play a major role in adjustment, given the circumstances and constraints in the region, as had been observed by Mr. de Groote. Whether it was the interest rate differentials which played the major role in the capital outflow of foreign deposits, as Mr. de Groote had mentioned, was not clear, although the authorities were certainly studying the matter. One reason why the authorities were thinking about the issue was that, given the openness of Qatar's capital market and a reserve target, an unfavorable interest rate differential could impose a need for greater restrictiveness in fiscal policy.

The questions of the benefits of pegging the Qatar riyal to the dollar and the extent to which the exchange rate was an important factor for diversification were relevant, Mr. Finaish considered. However, the peg to the dollar over recent years had not been counterproductive, as the incentive for the production of domestic goods had risen sharply and the contraction of imports was in line with the authorities' desire to prevent a rapid drawdown of foreign reserves. Whether the peg to the dollar would continue to be beneficial in the future was a matter that should be considered in light of developments in the exchange rates of major currencies, as well as the exchange rate arrangements in the region.

As to the question of broadening domestic revenues, the staff was correct in noting that there was a cyclical dilemma, because the politically feasible time for increasing and broadening domestic revenues--when the economy was strong--did not coincide with the need for increased revenue, Mr. Finaish agreed. Although it was currently politically difficult to broaden revenues, the authorities were prepared to consider adopting user charges on government services in the event of future declines in oil revenues, but they were justifiably more hesitant about taxing income, considering that their neighbors had not done so. It would be difficult to consider tax initiatives in Qatar without taking into account the regional revenue arrangements and the free factor mobility within the GCC region. However, Directors had emphasized that it was important for the authorities to make a start on the issue of broadening revenues, particularly in view of the administrative delays involved in the implementation of new tax measures.

As to the most appropriate path to follow in the future, Qatar had built a sophisticated infrastructure and had established some oil-based industries along the lines of its comparative advantage, Mr. Finaish remarked, but he wondered whether there was an adequate market for its non-oil exports. It was useful for the staff to address this issue in a regional context, meaning within and beyond the Gulf Cooperation Council.

The Chairman made the following summing up:

> Executive Directors concurred with the conclusions and policy recommendations in the staff report for the 1987 Article IV consultation with Qatar. Directors commended the Qatari authorities for their continued sound management of the economy. Sustained adjustment to lower oil revenues has been achieved primarily through restraint in budgetary expenditures, with the result that the deterioration in the external position has been contained and official reserves have remained at a very comfortable level. Directors also welcomed the steps taken in the monetary and regulatory fields, mainly with a view to preserving the soundness of the banking system. Despite the persistence of recessionary conditions and falling employment in the non-oil sector, the authorities have wisely avoided recourse to increases in subsidies or protectionist measures.
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> Qatar's strong external reserve position, in the opinion of Directors, put the country in a good position to cope with the continued uncertainties in the world oil market. Nevertheless, in view of the stated goals of the authorities, namely, to avoid both large reserve drawdowns and further major cuts in government spending, Directors agreed that it was timely for the authorities to consider new measures to broaden the fiscal revenue base. They also endorsed the continuing efforts of the authorities to broaden the economy's productive base in collaboration with their Gulf Cooperation Council partners and, in that connection, the need for adequate access to foreign markets was emphasized. The Qatari authorities were also encouraged to keep under review the appropriateness of their exchange rate regime. Directors commended the authorities for continuing their external assistance program in spite of the weakening of the external position. They urged the authorities to press on with their efforts to strengthen the data base, as some deficiencies have been observed in it.
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> It is expected that the next Article IV consultation with Qatar will be held on the 24-month cycle.

3. BURKINA FASO - 1987 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1987 Article IV consultation with Burkina Faso (SM/87/295, 12/16/87). They also had before them a statistical annex (SM/87/299, 12/31/87) updating the previous year's background paper on recent economic developments in Burkina Faso (SM/86/168, 7/9/86).

Mr. Mawakani made the following statement:

The staff report for the 1987 Article IV consultation with Burkina Faso provides a fairly accurate description of economic and financial developments in 1986. It also gives a good indication of the trend in major economic indicators in 1987. However, the paper does not give adequate credit to the authorities' resolute efforts to reduce the financial imbalances confronting the Burkinabè economy and to move it to a sustainable growth path. It should be mentioned that since 1984, the authorities have been implementing strong austerity measures, including measures aimed at raising government revenues in order to restore viability in government finances. Moreover, as described below, these policies have yielded positive results on many fronts. While economic and financial developments, as reported by the staff, were influenced by improved weather conditions in 1986, it is fair to recognize that the policies pursued by the authorities also contributed to these developments.

The strong economic growth recorded in 1985 was sustained in 1986, with real GDP estimated to have grown by 10 percent. Inflation, as measured by the consumer price index, turned negative, and the operations of the Treasury on a commitment basis, after virtual equilibrium in 1985, registered a surplus representing 1.7 percent of GDP. Moreover, the external current account deficit, including official grants, was reduced to 3.4 percent of GDP, and the overall balance of payments recorded a substantial surplus allowing for a reserve buildup representing five and a half months of imports of goods and services.

Available data for 1987 point to a continued upward trend in real GDP growth, a downward trend in prices, and a further strengthening of the external position--with gross official reserves at the end of 1987 estimated at 6.4 months of imports of goods and services. However, because of a doubling of domestically financed investment outlays and a less buoyant revenue performance than in the previous fiscal year, the government budget is expected to shift from the surplus recorded in 1986 to a deficit amounting to CFAF 6.5 billion, or 1.3 percent of GDP. All in all, despite unfavorable developments in some of the financial indicators, Burkina Faso's economic performance in 1987 is estimated to have been satisfactory.

Instrumental in bringing about the results of the last two years was a series of measures, most of which go in the direction recommended by the Executive Board at the conclusion of the 1985 Article IV consultation.

In their efforts to move the economy toward a sustainable growth path in the medium term, the Burkinabè authorities in August 1986 launched a Five-Year Development Plan covering the period 1986-90. Among other objectives, the Plan seeks to achieve self-sufficiency in food over the medium term, protect the environment, provide adequate social services, and improve the basic infrastructure. To facilitate the implementation of the Plan, the authorities initiated steps to strengthen the planning, execution, and monitoring of public investment projects. In this vein, a unit vested with the task of establishing a data bank to standardize and centralize information to assist in project implementation was created. In addition, they are seeking World Bank assistance in the formulation of ta three-year rolling investment plan. The authorities hope that these actions will address some of the problems identified in this area.

With regard to pricing and marketing policies, and as was made clear to the staff mission, the authorities' main concern is to protect the purchasing power of the population and ensure the availability of basic consumer goods. It should be stressed that the system of price controls in place is being implemented flexibly, allowing for timely price adjustments. An example of this type of flexibility is the halving of the producer prices for cereals during the 1986/87 crop season when the bumper crops harvested led to a significant drop in cereal prices. This courageous action was taken to alleviate the financial burden experienced by the cereal marketing agency, OFNACER. In order to encourage domestic production and reduce the import bill, the authorities have stipulated that cereals should be used increasingly as inputs in the production of some domestic goods. Although this requirement is seen by the staff as a means of reinforcing marketing control, it should be pointed out that the authorities view this measure as a means of promoting consumption of local raw materials. It should also be noted that the ban on imports of fruits referred to in the staff paper was lifted in early November 1987. The authorities are satisfied with the pricing and marketing arrangements in place, but are keeping them under close scrutiny to make them more flexible, if warranted.

In the fiscal sector, the improvement in the budgetary position in 1986 is attributable to the sharp increase in government revenue, resulting from the introduction of taxes on petroleum imports and on rental income, the strengthening of the customs administration, and a better collection of income taxes.

More importantly, as a general policy, the civic duty of paying taxes was promoted and efforts were made to collect tax arrears. On the expenditure side, measures to restrain current expenditure growth and to enhance expenditure control were maintained.

Regarding the public enterprise sector, the authorities are aware of the difficulties facing this sector and are determined to tackle them. As indicated in the staff report, actions were taken in 1986 and 1987 to that effect. The fares of the bus company were increased, and private sector participation in the capital of some enterprises was encouraged, leading to a change in the status of four enterprises from public to mixed. Additional measures taken include the establishment of a management reporting system--with World Bank assistance--to provide clear and timely information on the overall performance of the public sector, and the introduction of a new wage scale that will significantly cut the wage bill of public enterprises. Higher salaries will be awarded only by enterprises that perform well.

In the external sector, in spite of the substantial deterioration of the terms of trade in 1986, the current account position showed an improvement. This was due to the authorities' efforts to expand activities in the mining sector--gold exports nearly doubled--broaden the export base of the economy, and promote the consumption of local raw materials and locally produced goods. Indeed, total exports increased by about 11 percent while total imports in CFAF terms decreased slightly. Despite these favorable developments, the Government's ability to service its external debt was constrained by the unavailability of timely budget revenues and by weaknesses in the management of the external debt. The authorities are still considering the creation of an autonomous sinking fund, a move that will help resolve some of the difficulties being encountered in this field.

To conclude, it should be recognized that over the past several years, the Burkinabè authorities have made strenuous efforts to come to grips with the financial difficulties confronting their country. They feel that their adjustment efforts did not always attract the external financial support they deserve. In any event, they are aware that the progress achieved over the last two years remains fragile, and are conscious of the need to develop a full-fledged adjustment program to put the economy back on a sustainable noninflationary growth path. They look forward to working with the Bretton Woods institutions and the international financial community to help them achieve their goals.

Mr. Rousset made the following statement:

Despite the weakness of the available statistics, the staff report contains enough information to point out the perceptible deterioration of the financial situation--mainly in the budgetary sector--which occurred in 1987. The deterioration took place despite the implementation of several courageous measures by the authorities over the past two years. I fully agree with Mr. Mawakani's opening statement: credit must be given to the authorities for the efforts they have made in such areas as the enhancement of budgetary revenues and the control of the wage bill. The progress made in the cotton sector is also worth mentioning. It is interesting to note that Burkina Faso is the only country that has made the difficult decision to reduce the producer price of cotton. Some progress has also been made in the preparation of a public investment program for 1988, and the design of a management reporting system for the public enterprise sector seems well under way.

While I recognize the seriousness and courage of the authorities in implementing these measures, it is worrisome that they did not achieve better results. The gap between these efforts and their effects may stem largely from the lack of a general strategy, which would have ensured overall consistency between objectives and constraints. The weakness of the statistics and the lack of coordination between ministries also had a significant effect on this outcome.

However, given the recent change in government, I will focus more on future prospects than on analyzing last year's events. The authorities' determination to strengthen their dialogue with the Bretton Woods institutions, as Mr. Mawakani stated in his opening statement, was very encouraging. Indeed, these institutions could provide valuable assistance to the authorities in their task of elaborating general, medium-term strategies.

The medium-term framework is clearly a prerequisite for designing an adequate public investment program, and for evaluating the role of public enterprises and the authorities' choices in trade and pricing policies. I am pleased with the attention the authorities are giving to the medium-term framework issue; I encourage them to go ahead, with the support of the Fund and the World Bank. Clearly, attention to the medium-term framework is the role assigned to the policy framework paper exercise--namely, to draw up a strategy and to design measures and a time schedule consistent with the strategy.

In addition, Burkina Faso will require increased amounts of external assistance. The conclusion of an arrangement under the structural adjustment facility will certainly play a crucial role in the mobilization of additional assistance, including that of the World Bank.

The World Bank should be able to provide some helpful support. In contrast to 1986 and 1987, 1988 should witness the approval by the Bank of several important projects. In this respect, I note the significant projects related to the transport sector, agricultural research, agricultural extension services, the urban sector, and several other areas which could be approved in 1988.

Moreover, a World Bank mission, aimed at deepening the policy dialogue with the Government, is scheduled for next February or March. In order to initiate studies for a policy framework paper, it would certainly be useful if the Fund could participate in the mission.

Mrs. Walker made the following statement:

My comments on the Article IV consultation with Burkina Faso can be brief for two reasons: the report may not reflect the economic policy plans of the new Government; and, more important, there is little statistical information on actual developments in the economy in 1987. As Mr. Rousset indicated, it is clear from examining the general trends in the data in the report that certain areas in the economy need immediate attention.

The first and foremost area requiring attention was the statistical one. It appears that Burkina Faso has a very weak statistical base. Not having much data on developments in the past year, it is difficult for us to make any accurate determination or analysis of economic developments, or to estimate future trends. The authorities should request statistical technical assistance from whatever sources might be available, including the Fund.

Second, I see several major problems in the fiscal sector. The extrabudgetary outlays need to be incorporated into the budgetary process. I urge the authorities to adopt a consolidated government budget and to include the deposits of the government and the public sector agencies in the budgetary control process.

Another problem is the weak financial position of the public sector enterprises. I welcome the establishment of a management reporting system with the World Bank and the introduction of a new wage scale. In addition, a medium-term plan for the rehabilitation of public enterprises should be developed, particularly in light of these enterprises' apparent drain on the fiscal sector.

The authorities should also develop, in conjunction with the World Bank, a realistic investment program--one that takes into account its effect on the fiscal and the balance of payments positions. In my view, only viable and essential projects should be undertaken, particularly in light of the need to curb the deficit by greater amounts than are currently projected, and to avoid a financing gap and a possible further accumulation of arrears.

Monetary policy should complement the tighter fiscal policy. I welcome the authorities' commitment in this regard, but I am unsure whether the measures taken thus far are the most efficient means of implementing a tighter monetary policy.

The present system of price and marketing controls is not as efficient and flexible as a free-market system could be. I would not be surprised if rigidity in pricing and marketing policies did contribute to the weak performance of the secondary sector of the economy, as well as of the public sector enterprises, and I urge the authorities to consider liberalization in this area.

Improvements in the statistical base of Burkina Faso are needed so that consultations as well as economic planning, could be based on at least a minimal level of knowledge about economic performance. Such a statistical base is required to develop a more comprehensive economic package that could help the authorities to obtain needed financial support. I encourage the authorities to take this opportunity to create such a program.

Mr. Goos said that he also found it difficult to comment on economic developments in Burkina Faso in the absence of information on the policy intentions of the new Government. Nevertheless, the staff report revealed several weaknesses in the economy that warranted attention and prompt action, despite the emergence of several encouraging trends in the economy, which were described in Mr. Mawakani's opening statement and which no doubt could be attributed largely to the adjustment efforts of the authorities.

The continued accumulation of external arrears and the rather bleak outlook for the external current account were clear causes for concern, Mr. Goos considered. As the staff suggested, the authorities should try to raise domestic savings by strengthening the fiscal position, and they should include in that effort the rehabilitation of the public enterprise sector. The staff's advice to liberalize the pricing and marketing system, in order to improve the efficiency of resource use, was also appropriate. The existing, rather favorable external environment provided a good opportunity to make relatively easy progress in the fiscal and public enterprise areas.

The staff's recommendations to improve the statistical data base for the planning, implementation, and monitoring capacities of the Government were correct, Mr. Goos observed. Serious shortcomings in those areas went a long way toward explaining the existing economic problems, notably the continued worrisome accumulation of external arrears. Substantial progress in improving the statistical data base was also a prerequisite for the successful implementation of any Fund-supported adjustment program. As Mrs. Walker had suggested, Burkina Faso should make greater use of the technical assistance provided by the Fund and by other institutions, although given the experience with such assistance in the recent past, it would only be useful if it coincided with a willingness by the authorities to implement the recommendations made. He supported the staff appraisal.

Mr. Comotto agreed with the other speakers that the weak statistical base was a cause for increasing concern, and that a solution to the problem was a prerequisite for the approval of a Fund-supported program.

Mr. Hogeweg made the following statement:

The staff analysis is clear, and the recommendations are entirely appropriate. It is my impression that the authorities have insufficient statistical information on their economy to enable them to formulate a comprehensive policy package. I note especially the footnote on page 2 of the staff report that says that the quantification of economic variables is only indicative of underlying trends. Indeed, there might be a link between the unavailability of economic statistics and the fact that the authorities tend to resort to administrative measures rather than market-oriented policies--there is indeed a greater chance to encounter surprises when the authorities have no accurate information on what is going on.

There have been large swings in the Central Government's finances. Apparently, these swings are due partly to the statistical treatment of some budgetary items. On page 4 of the staff report, it is mentioned that the 1985 wage bill was lower because one month's pay was withheld to finance public investments. In 1986, the wage bill was also inflated by the inclusion of salaries withheld for the financing of investments, but in that case the investment was extrabudgetary. It indeed seems necessary to broaden the scope of budgetary control, including all public investments, especially those by public enterprises. I note especially the coexistence of emerging budget deficits and the special funds, which continue to increase their net creditor position with the banking system.

The staff notes that the pricing mechanisms may have contributed to the weak performance of the economy, and that an increasing share of locally produced goods might have been channeled through the parallel market. Mr. Mawakani, on the other hand, stresses the flexible manner in which these mechanisms are applied. There seems to be a contradiction here: the more flexibly these mechanisms are applied, the more market forces are allowed to play their allocative role; but the idea behind the mechanisms is, I suppose, that market forces may lead to socially or politically undesirable outcomes. A flexible application of pricing and marketing mechanisms may thus leave both goals unattained. With this in mind, I urge the authorities to take bolder steps to liberalize the economy.

On the external side, I am concerned about the buildup of arrears. On page 10, the staff notes that debt service has increased rapidly due to the substantial disbursements of highly concessional aid. These must have been large disbursements indeed. This is especially worrisome because, as Mr. Mawakani notes, weaknesses in the management of the external debt contributed to the Government's inability to service it.

On monetary policy, I wish to stress the importance of a point made by the staff on the last page of the report--namely, that selective credit policies, based on obligatory credit ratios, may run counter to the objective of promoting sound economic growth. Selective credit policies may hinder sound economic growth not only because they may encourage banks to be less stringent in their assessment of project viability--in order to avoid penalties for not having observed the credit ratios--but also because the credit ratios themselves may not adequately reflect an optimal allocation of resources.

Mr. Finaish made the following statement:

I agree with Mr. Mawakani that the authorities should be given credit for their adjustment efforts over the past three years, which have contributed to the generally improved economic performance. Having said that, however, I believe that the authorities would also agree that the effectiveness of their ongoing efforts could be increased if they adopted a clearer and more comprehensive adjustment framework that tackles the remaining imbalances in a broader and more mutually reinforcing manner. Clearly, such an approach would require some improvement in the information base, which is presumably part of the preparatory work for the formulation of a Fund-supported adjustment program, which is referred to on page 5 of the staff report. In this regard, it would be useful if the staff could comment on the preliminary timetable which has already been prepared by the staff of the Fund and the World Bank for that purpose.

To comment on a few policy questions, I do not disagree with the staff that it is desirable to reassess the pricing arrangements. On the other hand, there are indications that the current pricing policies have a significant measure of flexibility, as indicated by Mr. Mawakani. In any event, any reassessment of pricing policies should take into account the degree of competition, or lack of it, in the Burkinabè economy, so that the elimination of price controls in particular industries would not lead to even less efficient pricing.

Burkina Faso has had a public investment plan only since 1984 and, therefore, it is understandable that there are certain problems with it. However, in light of the debt-servicing situation and the crucial importance of ensuring that investment spending is on productive and financially sound projects, I welcome the authorities' efforts to improve the investment plan. In particular, I note that the authorities are collaborating with the World Bank on the formulation of a three-year rolling investment plan.

While the authorities should continue following a restrained fiscal policy, it is of course important to be able to interpret the fiscal data meaningfully. The figures provided by the staff cover treasury operations only, and, therefore, the figures on the deficit are not necessarily consistent with the monetary data on the position of the Government vis-à-vis the banking system. It would be useful if the staff could comment on how it sees the recent fiscal developments in light of the increase in the Government's net creditor position.

The increase in reserves is of course a welcome development, but there has also been an increase in external arrears. Clearly, the accumulation of external arrears can be detrimental to a country like Burkina Faso, which will inevitably continue to rely on foreign flows for some time. Therefore, I welcome the authorities' recognition of the need to improve debt management in general, and I encourage the authorities to try to maintain constructive relations with their creditors and donors.

The staff representative from the African Department remarked that although information on the 1987 budgetary outcome was not yet available, the staff presumed that the substantial financing gap had been covered by a further increase in payments arrears. Indeed, part of the financing gap had already been foreseen in the authorities' budget proposal for 1987. Although the staff had only examined the narrow area of the treasury accounts, it was justifiable to assume that arrears had also been accumulated in public entities outside the Treasury. The staff hoped that there would be an opportunity to obtain an overall picture of the fiscal situation. During the 1987 Annual Meetings, at the authorities' request, a list of requisite preparatory measures had been drawn up, along with a preliminary timetable for their implementation. With a view to preparing eventually a policy framework paper, the World Bank staff had recently indicated that a mission would be in Burkina Faso in February or March 1988 to assess the current situation, and to ascertain whether the authorities continued to express interest in pursuing discussions on an adjustment program.

Mr. Mawakani pointed out that some progress had been made in the fiscal area over the previous two years, particularly because of the reductions in salaries and wages. That self-imposed discipline in Burkina Faso--one of the poorest countries in Africa--was especially significant. Even the Fund would not have recommended such severe measures, the result of which had been a budget surplus, on a commitment basis, in 1986.

In 1987, as several Directors had observed, the situation had been different and the information available on it was incomplete, Mr. Mawakani continued. Weak economic management, as evidenced by the accumulation of arrears, was compounded by the lack of statistics. The arrears were not the result of a decision by the Government but a reflection of its inability to accurately assess the amounts currently due to creditors; hence, achieving a reduction in the arrears would require action not only by the authorities, but also an increased willingness by creditors to engage in dialogue.

Some progress had been made on pricing policy, with the system becoming more flexible, Mr. Mawakani noted. For example, before 1986, producer prices for cereals had been administered inflexibly, but after the official marketing agency was severely pressured by the substantial excess of the official prices over those negotiated by private traders, the authorities lowered official prices of cereals.

The Government was determined to hold a dialogue with international institutions, including the Fund and the World Bank, Mr. Mawakani indicated. A mission from the Bank was expected soon. As the staff representative had pointed out, discussions had also been held with the authorities during the 1987 Annual Meetings.

Although he agreed that there was a regrettable paucity of statistics, Mr. Mawakani said some progress had been made in other areas. Although it was perhaps difficult to evaluate the situation because of the shortage of information, clearly, in social and political terms, there had been some progress. The authorities were determined to address the problems facing the economy; they were open to technical assistance from the Fund. Assistance from the international community was certainly welcome.

The staff representative from the African Department commented that the staff had in no way meant to detract from the efforts that had been made by the authorities--particularly on the fiscal front in 1985 and 1986--which were reflected in the staff report. But it was also important to plan ahead, even though the available statistical information on the fiscal situation needed to be improved. It would be important to attempt to formulate a comprehensive view of the fiscal situation from 1987 onward--one that was more comprehensive than that provided by the Treasury's accounts. Presently, it was difficult to say whether the accumulation of arrears was due to lack of statistics, or to a need to improve financial management on the part of the authorities. However, credit should be given to the authorities for the progress made in 1985 and 1986.

Mr. Mawakani said that he agreed that there was a need to improve statistics. The authorities were prepared to take the required action, but more time was needed because the situation was complicated by the current move to a more flexible price system.

The Chairman made the following summing up:

> Executive Directors generally agreed with the staff's appraisal in the report for the 1987 Article IV consultation with Burkina Faso.
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> Directors welcomed the substantial expansion of output in the past three years as well as the authorities' efforts to correct the fiscal imbalances, which had been reflected in an improvement in the Treasury's balance. Directors expressed concern that, in spite of these efforts, the budgetary and external sector positions remained difficult, as evidenced by the continued accumulation of payments arrears.
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> Against this background and the projected deterioration in the external sector over the medium term, Directors urged the authorities to adopt and implement a comprehensive set of adjustment policies aimed at achieving a sustainable rate of economic growth consonant with a viable external sector position.
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> With regard to the budget, Directors urged the authorities to reduce the fiscal imbalances, to eliminate the payments arrears, and to foster an increased flow of external assistance.
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> Directors encouraged the authorities to formulate a public investment program, and to strengthen the development strategy in close collaboration with the World Bank. Directors also encouraged the authorities to formulate a medium-term reform program for the public enterprise sector and considered it essential that the authorities adopt more market-oriented pricing and related policies.

Directors noted that substantial improvements are required in the statistical data base. They encouraged the authorities to continue their efforts to improve the availability and timeliness of statistical information, with the assistance of the Fund and other institutions.

It is expected that the next Article IV consultation with Burkina Faso will be held on the standard 12-month cycle.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/88/6 (1/13/88) and EBM/88/7 (1/15/88).

4. HAITI - 1987 ARTICLE IV CONSULTATION - POSTPONEMENT

Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, as amended, the Executive Board agrees to extend the period for completing the 1987 Article IV consultation with Haiti to not later than March 18, 1988. (EBD/88/10, 1/12/88)

Decision No. 8773-(88/7), adopted
January 14, 1988

5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/88/10 (1/13/88), by Advisors to Executive Directors as set forth in EBAP/88/7 (1/12/88), and by an Assistant to Executive Director as set for in EBAP/88/6 (1/12/88) is approved.

6. TRAVEL BY MANAGING DIRECTOR

Travel by the Managing Director as set forth in EBAP/88/8 (1/13/88) is approved.

APPROVED: September 13, 1988

C. BRACHET
Acting Secretary