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Remarks by M. Camdessus
Managing Director of the International Monetary Fund
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Challenges Currently Facing the World Economy

It is a pleasure to join you on the occasion of your Annual Meeting and to have this opportunity to share some thoughts with you on a number of challenges that we now face. I say "we," because an important focus of my remarks today will be on matters that are of concern to both of us, namely, trade and foreign financing, and obstacles to both.

These are, I think it fair to say, difficult times for the world economy. Strains are evident in various forms: in the sizable changes in exchange rates that continue to take place; in the persistence of large imbalances in the major industrial countries; in rising pressures for trade restrictions and the increasing tendency for trade disputes to flare up; and in continuing tensions between heavily indebted countries and their major creditors. The tasks that these problems pose for policymakers, as well as for you, as bankers, are pressing and complex.

It is around two of these tasks that I shall structure my remarks today. The first is how to bring external payments imbalances among the major countries into a more sustainable pattern without precipitating a recession. Robust growth of output and demand in the industrial world is fundamental. On it rest the hopes for reducing unemployment, for resisting threats to a liberal world trading order, and for creating the hospitable environment needed for export-led expansion in the debt-laden countries. The need, in current circumstances, is to guard against drifting downward--through a process in which a slowing of growth feeds pressures for protection, which in turn provokes retaliatory trade measures and unilateral action on debt and serves only to exacerbate the original deceleration in activity. The challenge is to reverse current tendencies in this direction.

Stronger growth in industrial country markets, while essential, will not, however, suffice to solve the payments difficulties of the indebted countries. The second challenge that I should like to discuss, therefore, is how to deal with the problem of foreign debt while spurring an improvement in living standards in the developing world. I shall then close with a few remarks, addressed to you as bankers, on what I see as the role of the Fund in these two important endeavors.

Let me say at the outset that the two challenges that I have identified both pose a fundamental test for the strategy of growth-oriented adjustment. If this strategy is to succeed and these challenges are to be met, declarations of support for this approach will need to be translated into policy actions in the industrial and developing economies alike. In turn, this will require an exceptional degree of cooperation by all parties in the international financial community.

Sustaining Growth in the Industrial Economies

The recovery in economic activity in the industrial countries from the 1980-82 recession is now in its fifth year. Unlike previous post-war upswings of comparable maturity, it has not so far been threatened by a buildup of inflationary pressures. On the contrary, between 1982 and 1986 there was a steady deceleration of inflation, with the rate of increase in consumer prices last year falling to its lowest level in more than 20 years. All this contrasts vividly with the stagflation that prevailed at the beginning of the decade.

There are also, however, less positive aspects. First, the rate of growth of output has been weakening. The continued deceleration last year--to 2 1/2 percent for industrial countries as a whole--was especially disappointing in circumstances in which the industrial economies reaped sizable gains in real national income from a sharp fall in commodity prices. Recent indicators, moreover, suggest that the growth of output may slacken further this year. This means that it will be more difficult to make a dent in still high levels of unemployment in many countries in the industrial world.

Second, the upswing has been accompanied by--indeed, is to some degree rooted in--large imbalances in the major industrial countries. I refer of course to the federal budget deficit of the United States, which has averaged more than 5 percent of gross national product over the past four years, and to a divergence in external payments positions which in 1986 saw the U.S. current account deficit increase to the equivalent of 3.3 percent of GNP and the current account surpluses of Japan and the Federal Republic of Germany rise to 4.4 percent and 4.0 percent of GNP, respectively.

Imbalances of this order cannot be sustained. The risks of failing to deal with them are obvious: exchange rate instability could increase; the price level and interest rates in the United States could come under upward pressure; and protectionism could intensify further--all of which would be inimical to the growth of world output, employment and trade. In recent weeks we have already begun to see some evidence of such tendencies. The task facing policymakers is thus urgent. But it is by no means straightforward. It consists not simply of reducing the imbalances and stabilizing exchange rates around current levels, but of maintaining the forward momentum of the world economy, together with relative price stability, while doing so. To the extent that past experience is any guide, indications are that this will not be easy, to say the least. In fact, we face an unprecedented challenge. But the consequences of failing to meet it are surely such as to compel us to make every effort to avoid them. And there is, I believe, an exceptional readiness emerging on the part of the major industrial countries to coordinate their policies in such an effort.

As regards the first leg of the task, the realignment of exchange rates among the major currencies that has taken place since the first quarter of 1985 has reversed a substantial part of the real appreciation of the dollar that had occurred in the five preceding years. This has significantly improved the prospect for restoring a better pattern of payments balances over time. I would, however, emphasize three points. First, exchange rate changes take time, in the best of circumstances, to work through to payments flows. Second, the existing imbalances are of such a size that, in the case of the United States for instance, sizable improvements in trade performance are now required each year simply to hold the nominal trade deficit unchanged. Third, experience suggests that changes in price competitiveness will be fully effective in reducing external surpluses and deficits only if accompanied by adequate flanking policies. If these policies are inadequate, further pressure will inevitably fall on the exchange rate. This would not only push up prices in countries whose currencies depreciated; it would also dampen activity further in countries with appreciating currencies--enlarging the adjustment task, rather than contributing to its solution.

Against this background, and focusing first on the United States, one sees the projected substantial reduction in the federal budget deficit in the current fiscal year as being of crucial importance. Indeed, the prospects for achieving a significant reduction in the U.S. external deficit will depend to a considerable extent on the speed with which the planned reduction in the fiscal deficit is implemented, both in the current fiscal year and in years beyond.

The extent to which payments imbalances are reduced will also, of course, be influenced by demand conditions in the other industrial countries. This brings me to the second leg of the adjustment task. As domestic demand is withdrawn through fiscal consolidation in the United States, it will need to be replaced elsewhere if the growth of global output is not to slacken. A collaborative understanding of this nature was at the core of the agreement reached among major industrial countries in Paris in February and was reaffirmed earlier this month in meetings in Washington. The question that now arises is where is the room for policy to maneuver.

In most countries monetary expansion has recently been relatively rapid when measured by traditional standards, and on that basis little scope might seem to exist to ease monetary policy further without jeopardizing the hard-won success achieved in reducing inflation. Interpretation of the data has, however, become much more difficult in the wake of the processes of financial deregulation and innovation that have been taking place in the industrial economies. At the same time, inflationary expectations have changed significantly in recent years. In these circumstances, the question may perhaps still exist whether a somewhat more accommodating stance of monetary policy would necessarily risk a re-emergence of inflationary pressures in some countries, particularly those where the rate of inflation is now very low. As regards fiscal policy, some countries will clearly have little scope to ease up. But, in other countries, including Germany and Japan, general government deficits are now relatively low and a more expansionary stance of fiscal policy may well be appropriate. The recently declared intention of the Japanese Government to take additional measures of fiscal stimulus is a welcome initiative in this respect. Structural policies offer a further avenue, and in my view a key one. Tax reform could be a particularly important vehicle in some countries for enhancing incentives to invest; it could also be an instrument for ensuring that savings incentives are not maintained at unduly high levels in relation to the expected level of investment. And there is much scope, in all countries, to reduce trade barriers.

In this context, I would draw your attention to the emphasis placed by the Fund's Interim Committee, during its recent meeting in Washington, on the need for all countries--including some newly industrialized countries--to exercise whatever room for maneuver they have in their economic policies with a view to supporting the global adjustment process. And I would also note that the Committee particularly stressed the need for all countries to pursue structural measures aimed at removing market rigidities and improving economic efficiency.

Clearly, a combination of policy measures will be required that will need to be fitted to the circumstances of individual countries and harmonized in order to have the desired overall impact. In this process, the consensus that emerged from the Paris and Washington meetings in favor of strengthening policy coordination among the major industrial countries is timely. To be effective, this will need to lead to important policy corrections, which will then--given the size of the task at hand--need to be pursued with firmness and consistency.

Combating Protectionism

Failure to reduce the present financial imbalances in the industrial world would, as I have said, risk a number of unwelcome consequences. One of the least desirable would be to inflame the present increase in protectionist sentiment.

Among the important achievements of international cooperation in the postwar period has been the establishment of a more liberal trading order, from which all nations have benefited. Most countries still, however, have a formidable array of barriers to trade. Worse, trade restrictions in their various guises have increased perceptibly in recent years--not only in the traditionally protected sectors of agriculture, textiles, and steel, but also in relatively new sectors. There has, at the same time, been increasing resort to special trade arrangements that undercut a multilateral trading system based on the principle of comparative advantage.

These recent tendencies are extremely worrisome. They pose a threat to the growth of world trade. They undermine the prospects of sustaining the current economic upswing. And they add a particularly unwanted burden to the already difficult task faced by developing countries.

But let me narrow the focus from global considerations and make a more parochial point. Not only is protectionism clearly not in the interest of the world trading system; infant industry considerations aside, it is generally also not in the interest of the nations resorting to it. Let me explain why.

A basic consideration is that in the process of protecting some industries, other industries in the same country will be made worse off. In the first place, industries using the protected goods as inputs will face higher costs. At the same time, the reduction in imports into the protected sectors will result in a relatively appreciated exchange rate, which will penalize _all_ import-competing and export industries in due course. Further, protection will raise the cost of living, which cannot but influence wage awards, raise labor costs, and lower the demand for labor elsewhere in the economy. Precisely where the balance between the gain for the protected sectors and the loss for the other sectors will fall--in terms of the short-run impact on output, jobs, and the trade balance--will vary from one situation to another. But it is a fallacy to believe that protectionism _must_ improve a country's balance of trade and _must_ sustain a higher level of employment than would otherwise obtain. It may well not.

Meanwhile, by favoring the less productive at the expense of the more productive sectors, protection entails a loss of national efficiency. It also biases the structure of production in favor of import substitution and away from exports. Over time, this will reduce an economy's growth potential and its adaptability to external shocks. Neither is surely a prospect that any nation can contemplate with equanimity.

One final point. Protection typically entails substantial direct costs for society as a whole. There is no shortage of studies documenting the high cost of protecting jobs through trade restrictions. This raises very basic questions about waste and whether alternative approaches would not be more effective.

There are doubtless many reasons underlying the current drift toward protectionism. One is surely the lack of a full appreciation of its costs. Another is that protectionism feeds on itself through retaliation. Viewed from an economic standpoint, this is paradoxical. The fact is that the imposition of trade restrictions by one country generally damages not just its trading partners, but also itself--and this is so whatever the reason for imposing restrictions. Conversely, countries can gain by opening up their markets, even if their actions are not matched by their partners. This said, an intensification of protectionism in one part of the world is unlikely, as a practical matter, to facilitate trade liberalization in another, particularly in the current economic climate. It is thus doubly important that countries not only resist protectionist pressures from within but also refrain from actions that would provide a pretext for protectionist measures in partner countries.

But there is a need to go further. Restrictions need to be reduced--not just by the developed countries, and not just on imports of industrial goods. At the same time, there is a need to address the issue of the competitive subsidization of agricultural exports by the industrial countries, which gives rise to considerable difficulties for other agricultural exporters at a time of weak commodity prices. An excellent opportunity to make advances in all these areas is provided by the Uruguay Round of multilateral trade negotiations. It is important that it be seized.

Managing the Debt Problem

Let me now turn to the external debt problem. The debt strategy on which the international financial community embarked in 1982 has achieved much. Substantial amounts of financing were mobilized to smooth and support the adjustment process, and widespread disruption to the world trade and financial system was averted. A resumption of normal debtor-creditor relations is, however, not yet imminent, to say the least. Indeed, the debt situation has recently been showing some signs of strain.

In part, this reflects the more difficult environment that developing countries have faced during the past two years. Last year was a difficult year by any standards, as oil and commodity prices fell very sharply in real terms. Many countries, however, responded with additional policy adjustments. As a result, the increase in the current account deficit of the group as a whole was held to one fourth of the loss of about US$100 billion in the terms of trade, and the growth of gross domestic product, in fact, quickened slightly.

Nonetheless, there are a number of aspects of recent developments and of the current situation that cast a cloud over the prospects for developing countries generally, and the heavily indebted countries in particular. First, largely as a result of the further fall in export prices, the burden of foreign debt has continued to rise, with the ratio of debt to exports of goods and services for countries with recent debt-servicing problems reaching 300 percent in 1986, against 240 percent in 1982. Second, net lending by banks to developing countries as a group has come to a halt. Countries with recent debt-servicing problems, meanwhile, have made significant net repayments to banks over the past two years. Third, investment has failed to revive. Given the need to run large trade surpluses to service debt and given the withdrawal of foreign savings, gross investment in the heavily indebted countries could average no more than an estimated 16-17 percent of GDP last year--barely enough to keep the capital stock from falling. Fourth, there have been difficulties in implementing sustained adjustment policies in some countries, including some of the larger debtors. Fifth, at least in the near term, developing countries' export markets seem likely to grow more slowly and the real purchasing power of primary commodities to remain low.

All this suggests that it will take longer to resolve the debt problem than had been hoped in the light of the progress made in 1982-84. However, while the time horizon is receding, the objective remains the same: to restore indebted countries' creditworthiness. And the key to attaining this objective will continue to rest on strengthening the ability of these countries to undertake productive investment, to realize their full economic potential, and to grow out of their currently very large debt burdens.

To this end, the collaborative debt strategy on which we are embarked remains, in my view, valid. But it needs fresh impetus. It is noteworthy that the five points of weakness in the current situation that I just mentioned are very often self-reinforcing. Thus, slippages in pursuing adjustment policies deter creditors and hamper investment; slow growth in, and restricted access to, industrial country markets depress commodity prices and contribute to rising debt ratios; and limited foreign financing holds back investment and may undermine the resolve to pursue strong adjustment policies. What is needed in the present circumstances is to generate a positive chain reaction. For this, all parties to the debt strategy must recognize their joint responsibilities and intensify their efforts.

Let me elaborate. It falls primarily to the indebted countries to recreate the conditions for attracting sustainable financing flows on normal terms. About this, there should be no illusions. They must be more steadfast and consistent than hitherto in the pursuit of policies which aim at mobilizing domestic savings, at strengthening export capacity, and at improving the efficiency with which resources are used. Re-entry to the capital markets and a repatriation of flight capital have been achieved by some countries in the past and can, with appropriate policies, be achieved by others in the period ahead.

Industrial countries must play their part, as noted earlier, by sustaining their rate of demand growth and by improving the developing countries' access to their markets. Is it not timely, in this connection, for the major trading nations to begin rolling back trade barriers and reducing agricultural export subsidization now, without waiting for the Uruguay Round?

For creditors, the key challenge is to find ways of reversing the decline in financing flows that has characterized the past few years. In this connection, a distinction needs to be drawn between two broad categories of indebted countries. One group consists of those countries with large liabilities to official creditors, low per capita incomes, limited prospects for export diversification, and limited scope in the foreseeable future for meeting their debt-service obligations. Many of these countries have recently made significant policy adjustments, which in a number of cases have been supported by the Fund with stand-by arrangements or Structural Adjustment Facility resources, or both. Despite their policy efforts, these countries continue to face a most difficult situation. The provision of finance at nonconcessional terms could very frequently aggravate an already untenable debt position. It is essential, therefore, that the international community hold out hope to these countries that exceptional efforts to strengthen their economies will be supported by increased aid and exceptional financial help on concessional terms. Proposals now being considered by the Paris Club to ease the debt burden of the most impoverished nations in sub-Saharan Africa are a most welcome move in this direction.

The second group of countries consists of middle-income economies that are unable over the short run to meet their debt-servicing obligations but have the potential to do so over the longer term. It is the financing flows to these countries that have fallen particularly sharply over the past five years. At the root of this development appear to have been a number of concerns on the part of banks: shareholder, balance sheet, and regulatory considerations; the weight of the existing debt stock, and its valuation by markets often at a considerable discount on its contractual value; and the perception that a number of adjustment programs have suffered from inadequate implementation. These I recognize and can understand. Much of the slowdown in lending from the very rapid pace of the late 1970s and early 1980s has, moreover, clearly been desirable. I am, nonetheless, troubled by the extent to which this retrenchment has now proceeded and, in particular, by the possibility that a large segment of the group of developing countries may have come to be regarded, prima facie, as a poor risk, and many countries as unacceptable risks. Developing countries can surely find extremely productive use for new capital investment. Where such opportunities exist, and where the accompanying macroeconomic policies are sound, it would be highly unfortunate if excessive caution in lending were to prevent the investment from taking place.

Things being as they are, concerted lending will continue to be needed. The challenge that we face here is to overcome the protracted delays that have attended the implementation of recent financing packages and to ease the relatively rigid stipulations--at times unduly tightly linked to the implementation of policy reforms supported by the

Fund and the World Bank--that have sometimes governed disbursements under such packages. Drawn-out negotiations of this nature on financing and disbursements are seldom in the interest of either party; indeed, they can damage both sides' credibility.

Countries pursuing strong adjustment programs have to be able again to count on the timely provision of adequate financing to underpin those programs. Arrangements that allow participating banks a wider range of financing options are clearly one avenue, and I am encouraged by a number of recent innovations in this area. These need to be built on. Such schemes as the conversion of debt to equity or domestic loan claims not only add an element of diversification to banks' financing packages. They could also send an important signal about the debtor country's willingness to welcome foreign direct investment or to promote a return of flight capital. They would also, of course, lessen the country's external debt burden in the process. I am aware that problems of comparability of treatment and of burden sharing between individual banks and among national banking systems may arise, and would regard it as important that a broadening in the range of financing instruments not lead, because of such problems, to a slowing in the assembly of financing packages. However, I have confidence in the banking community's ability to resolve these complications and sidestep delay, especially with the help and support of their tax and supervisory authorities.

At issue, fundamentally, is whether the international financial community has the will and the imagination to work collaboratively with troubled borrowers to rebuild their creditworthiness and to strengthen, rather than weaken, existing incentives for these countries to embrace strong adjustment policies. Of course, the financial community will always tend to split into two groups when facing major difficulties. One group will consist of those who would wish to concentrate their efforts on withdrawing from the situation in which they find themselves. I cannot blame them and, indeed, recognize that, for some, this can be a matter of survival. But there is another group--which I hope the great majority of you are part of--which will strive to provide the indebted countries with the means required for them to grow and recover their ability to service their debts in an orderly fashion. The efforts of this second group are needed now more than ever, and I hope that this meeting will see the approach that I have outlined as the most secure method of proceeding for all parties.

Role of the Fund

Finally, let me comment briefly on what I see as the role of the Fund in these endeavors. Two themes have permeated my remarks today: the need for closer international cooperation, and the prime importance of durable economic growth. These are also two of the considerations that motivated the founders of the Fund, who stipulated, as the first two purposes of the organization, that it should "promote international monetary cooperation" and "facilitate the expansion and balanced growth of international trade."

In the important efforts now under way among the major industrial countries to intensify the coordination of their economic policies, the Fund will have a leading role to play. One element will consist of providing for the meetings of Ministers and Central Bank Governors all the information needed to monitor and appraise their policies and economic performance. This will serve as the basis for implementing the so-called "indicators" approach. But our role will go beyond that--to focusing the attention of national policymakers on the consequences of their actions for other countries; and to serving as the instrument or locus for the critical evaluation of national policies from the standpoint of their mutual consistency with objectives endorsed by the Fund's membership as a whole. This can make a critical contribution, I hope, to meeting the challenge of reducing external payments imbalances while avoiding a recession. It is not a new role, but rather an outgrowth of our traditional Article IV consultation work and of our responsibility to exercise multilateral surveillance.

With regard to the developing countries and the debt problem, the Fund stands ready, as ever, to assist countries in the formulation of effective adjustment programs, to make available its own resources to promote those programs, and to help mobilize resources from other sources. There are three points that I would emphasize in this connection.

First, the Fund does not have a standard adjustment policy package. Sensible program design requires careful diagnosis and an approach tailored individually to the circumstances of each situation. This is how we operate now, and how we will continue to operate. Over the coming months, moreover, we will be conducting a thorough review of adjustment programs and their supporting arrangements in order to ensure that they remain appropriate in the current circumstances.

Second, the magnitude of repayments due to the Fund at the present time has led to some concern that the Fund is systematically reducing its provision of financial assistance to countries in need. The truth is that the Fund stepped in with large-scale assistance during 1982-84 at a time when many members were facing a particularly difficult balance of payments situation. The repayments now being made are in respect of those unusually heavy levels of lending and are entirely consistent with the revolving character of the Fund's resources. They replenish the Fund's usable resources and recreate for the members their drawing rights to the Fund's various facilities. The Fund is neither withdrawing nor does it intend to withdraw from its central role in promoting sound programs of adjustment with growth.

Third, the amount of financing that the Fund itself can provide is nonetheless limited. The Fund will, though, continue to be sensitive to the special circumstances of individual situations. In particular, where countries make especially important efforts, the Fund will continue to be prepared to do its utmost to assist them and will continue to look to creditors to come forward with substantial financing in response to those efforts.

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Mr. Chairman, I spoke at the beginning of these being difficult times. I also, however, see them as a time of opportunity. Indeed, if the international community can build on the new collaborative spirit that I have detected emerging in recent months and put it into action, there is every reason to believe that we can move to a sounder economic setting, with benefits for all.