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# INTERNATIONAL MONETARY FUND

## Secretary's Journal of Executive Board
## Informal Session No. 71/1

10:00 a.m., February 1, 1971

P.-P. Schweitzer, Chairman
F. A. Southard, Deputy Managing Director

| Executive Directors | Alternate Executive Directors |
|---|---|
| L. B. Brand | G. P. C. de Kock |
| | S. Jónsson |
| W. B. Dale | C. R. Harley |
| N. A. Deif | M. Al-Atrash |
| P. Y. Hsu | |
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| | R. H. Gilchrist |
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| G. Schleiminger | L. Fuenfgelt |
| H. Suzuki | K. Satow |
| L. Ugueto | G. González |
| A. van Campenhout | H. G. Schneider |
| | C. Beaurain |
| | L. M. Rajaobelina |

W. L. Hebbard, Secretary
A. R. Helm, Assistant

Also Present

African Department: M. Touré, Director; C. L. Merwin, Deputy Director; R. J. Bhatia. Asian Department: W. J. R. Woodley, Deputy Director. Central Banking Service: M. Wyczalkowski. European Department: L. A. Whittome, Director; P. Høst-Madsen, Deputy Director; B. S. Karlstroem, H. Ungerer, L. Van Houtven, A. C. Woodward. Exchange and Trade Relations Department: E. Sturc, Director; C. D. Finch, Deputy Director; S. Mookerjee, T. Sweeney. Fiscal Affairs Department: R. Goode, Director; J. Saper, Deputy Director. Legal Department: J. Gold, General Counsel and Director; A. S. Gerstein, Deputy General Counsel; J. G. Evans. Research Department: J. J. Polak, Economic Counsellor and Director; C. F. Schwartz, Deputy Director; V. Argy, J. Chan-Lee, T. W. Eckersley, S. J. A. Gorne, F. Hirsch, O. K. H. Juusela, R. R. Rhomberg. Secretary's Department: R. V. Anderson, Deputy Secretary and Chief Editor; P. F. Gourley. Treasurer's Department: W. O. Habermeier, Treasurer; D. Williams. Western Hemisphere Department: J. Del Canto, Director; S. T. Beza, J. W. Crow. Personal Assistant to the Managing Director: L. F. T. Smith. Technical Assistants to Executive Directors: J. M. Chona, P. M. de Raet, A. M. Dierick, A. Doizé, P. C. Hayward, F. K. Hussein, K. Kjaer, E. Leung, R. W. Ley, A. Pipino, M. M. Plummer, H. Rudloff, J. A. Sogo, N. Tsukagoshi, J. R. Vallet, B. F. van Ittersum, J. C. C. Yuan.

1. WORLD ECONOMIC OUTLOOK

The Executive Board met in informal session for a general discussion of the outlook for the world economy. It had before it ID/71/1 (1/12/71).

Mr. Jónsson made the following statement on behalf of Mr. Brofoss:

I do hope that the staff paper signals the inauguration of a new order of our activities, and that such papers and the ensuing Board discussions will become part of the regular routine of the Fund. It would serve the dual purpose of being a supplement to and a follow-up of the Annual Report. In an intervention on the paper on the future work of the Fund, I submitted that periodic reviews should form the background of the global strategy that should guide our activities. The Chairman's reply was that the influence that the Fund could exert on economic policy formation was mainly through bilateral exchanges of views. I agree, but I believe one can find evidence in ID/71/1 that it is important that such consultations take place in the light of an overall appraisal by the Board of the world economic situation, and in accordance with broad lines of action adopted to promote the interests of the international community of which the IMF is a servant.

In the discussion of the U.S. consultation report, I voiced some doubts about whether it would be in the interest of the international community for the United States to pursue the balance of payments strategy indicated in SM/70/255 and SM/70/258; specifically, whether the existing gap on the overall account ought to be closed by increasing surpluses on the current account. One is left to wonder whether the staff would have unreservedly endorsed this policy line if the information on global developments, which we now have before us, had been available at the time of the consultation.

Another merit of such papers and discussions will prove to be that they bring to light particular problems which deserve special attention, and which can be examined separately. For example, the problems of capital transactions are indicated on page 34 of ID/71/1. The staff stops short of discussing how harmonization can be brought about. But it raises the very interesting question concerning what kind of institutions are needed to achieve this end. In this context, I miss a reference to the existence of the Euro-dollar market with its possible blessings, but also with all the problems it has created for monetary management in many countries. In pointing to these shortcomings, I am not criticizing the staff. One could not possibly expect a general paper to cover all fields, but I do hope that at a later stage we shall be provided with special studies on the problems of capital transactions, including the effects of interest rate differentials, and on the Euro-dollar market. Today, I only want to reiterate my own views, which seem to be shared by the staff on page 34, when it says: "...balance of payments problems are perhaps more likely to arise from shifts in international capital flows than from immediately prospective changes in trade balances." Periodic reviews will serve to secure global consistency in analyses and in policy recommendations, and to avoid the risk of a compartmentalization of views in the country-by-country "micro-approach" to annual consultations.

I do not feel quite reassured that in all respects ID/71/1 will pass the consistency test. In a fragmented analysis--imports discussed in one section and exports in another--one might easily lose sight of the fact that exports and imports are merely two sides of foreign trade and that in a global context they have, by definition, to equate. We do well in reminding ourselves that foreign trade is the vehicle for establishing a rational international division of labor. When the report says on page 14 that "the domestic price inflation of recent years has increasingly spilled over into external transactions," it only proves that after all there is one blessing that can be credited to universal inflation: it promotes an improved division of labor. Inconsistencies can inadvertently creep into the analysis because of the use of qualitative judgments coached in "mercantilistic" terminology--increased exports = gain, increased imports = loss.

I want to challenge the notion that it is in the interest of the international community that among other large industrial countries, the Federal Republic of Germany goes on "improving" in the sense that its reserves or surpluses are increasing. Neither can I endorse the implications of the following statement on page 28: "Similarly, maintenance of the German and Japanese trade surpluses at or above the high levels of 1970 seems dependent on success of domestic stabilization programs." If current account surpluses tend to increase, they might--without any compensating movements on capital account and/or revaluation--create new problems for the functioning of the international payments system. This is also one of the reasons why I cannot subscribe to the statement found on the same page, regarding developments on the service balances of those two countries: "Further increases in the adverse service balances are projected for both Germany and Japan in 1971". But, "adverse" to whom? In my opinion it is all to the good of the international community if German and Japanese people travel abroad more and thereby add to the tourist receipts of other countries.

As I said in my statement on the U.S. consultation report, the industrialized countries should run a surplus on current account in order to provide in real terms, i.e., in goods and services, the basis for increased aid to the developing countries. ID/71/1 shows that more real resources have been at the disposal of the developing countries; net imports have increased by an estimated amount of $1.3 billion. At the same time this has taken place in a period when the reserves of these countries have been increasing. But the disturbing fact is that by implication it means that the external debt of these countries has correspondingly increased. When servicing external debts is taken into account, it might, to some extent, change the rather rosy picture which is drawn of the developments in the less advanced countries.

Turning now to the problems of inflation, we should be careful to present a balanced case for vigorous action against a process that has eroded the value of money in real terms. One of the credos of many statements is that if we do not succeed in combating inflation, we shall end up with world-wide depression and mass unemployment. This theory of the inevitable catastrophe is widely held, but facts do not substantiate it. One can, of course, argue that flows of goods and services would have been even larger if inflation had not occurred. This contention does not square with the experience of earlier periods. I am saying this because among those whom we shall try to convert to a faith in the soundness of monetary stability, there are very few who believe that there is an inevitable day of reckoning when judgment will be passed on the infidels. We should do well, also, in turning against the notion that we want decreasing prices. Today, I gather that most representatives of the developing countries are concerned about declining export prices, which might break the backbone of their economies. Personally, I do not feel reassured when a slowing down of the rate of increase in the cost of living indices in industrialized countries is caused by reduced import prices, which in turn means smaller incomes for the producing countries. The distributional effects of inflation are well known, but here again we should be careful not to carry the argument too far. Workers are safeguarded in wage contracts by index clauses, social security systems provide for automatic adjustments to price increases, and the farmers' bloc will always be so powerful that parity levels of income are maintained in real terms. We are on much safer ground if we submit that an unequal distribution of income will be the inseparable companion to inflation,and that this in turn will lead to a misallocation of resources. Too many luxury houses and inadequate housing for the less privileged is a visible illustration of this point.

In the discussions of the instruments of policy, there seems to be a general consensus of opinion, based on the experience of the 1960s, that fiscal and monetary policies cannot alone prevent or stop inflation. However, they were not properly used, either in timing or in dosage, to eliminate excess demand as an inflationary factor. In the United States, there was, I believe, too much delay in applying proper fiscal policies in the initial phases of the last boom. This, too, can be said of some of the countries that elected me. But even if tightening of fiscal policies has a restraining impact on disposable income, there might be unwanted price effects, as was the case in 1969 when there was a fundamental shift in the system of taxation in Norway. There is evidence of such price-push effects in Denmark, too, and to a lesser extent in Sweden. One particular problem in using financial policies at a particular time is the tradition of the annual fiscal budget, which in the course of a current year can be changed only after prolonged and cumbersome parliamentary procedure. This is one reason why monetary policy has been resorted to; moreover, politically, action in this field is less likely to arouse public reaction. But it is more important to bring home to political bodies that the determined use of fiscal policies is indispensable in the fight against inflation.

Looking back now over the 1960s, what can be said of the inadequacy of fiscal policies is equally true of monetary policies in many countries. It is very important that aims of monetary policy should be defined in quantitative terms; but I very much doubt the validity of the black magic formula of increasing the money supply by pre-fixed percentages. The prevailing atmosphere of expectations is very important. As recent U.S. experience has shown, money supply has to grow faster to counter a general expectation of a downturn, but carrying with it the danger of the spillover into short-term investments abroad. Conversely, the increase in money supply has to be smaller when boom conditions are expected. Moreover, we should look more closely into the problems of what kinds of instruments can be usefully applied in the many countries with primitive and more often widely differing institutional structures. The strong faith in higher interest rates has not stood the test of experience. If a country is alone in manipulating the interest rate, it can obtain the desired results, in particular if it wants to attract short-term funds. But all countries cannot do so by acting in the same way at the same time. What we have been witnessing is a merry-go-round of funds hardly beneficial to the international monetary system. What stands out most clearly as one of the main general problems of monetary policy is how to integrate capital movements in credit policy management.

As for the guiding principles in the use of fiscal and monetary policies, it is a matter of greatest importance to observe that there is no uniform relationship between slack in the economy and the degree of inflation. The experience of the 1960s has demonstrated that stringent fiscal and monetary policies are most likely to severely hit economic growth and employment without having the desired effects upon prices. If slack is larger in one economy than in others, the effect is that imports tend to decline relatively. Thus the individual country can improve its external position. But we cannot all achieve the same result by applying the same policies at the same time. The history of the 1920s and 1930s should have taught us that a uniform policy aiming at a contraction of the economy may have harmful effects in the context of the international community.

The idea of the need for slack has led to some discussion of how much unemployment is to be endured to secure stability of prices. I said in the discussion on the U.S. economy: "The countries that elected me are firmly opposed to the idea of using human beings as pawns in the game of policy making," and also, because Norway is poor in real resources it "can simply not afford the luxury of foregoing the production that can be had with full employment and a maximum utilization of productive capacity." Instead of discussing in abstract the need for a varying degree of unemployment and slack, we should concede failure so far in designing policies that can reconcile economic growth and full employment, and also admit that old prescriptions will not cure the twin ills of pertinacious unemployment and persistent inflation.

We take actions, sometimes unconsciously, based on the validity of the assumptions of the 19th century economists of "market forces" which operate through an atomistic adjustment process. These assumptions have no place in modern society. We live in a world where the big industrial corporations and multinational concerns play a decisive role in price determination in many sectors. The trade unions wield enormous power. In all fields pressure groups are organized, with the farming community the most powerful. It is in recognition of these structural and institutional changes that we have to try a new tack in economic policy. I believe we have to resort to an active incomes policy. Short-term successes can be reported. But generally, we all have to contribute with stories of nonsuccess. It is easy to understand why the incomes policy has fallen into discredit. But, nevertheless, I am convinced we have to seek a solution along such lines. The wage element is probably the most important one of aggregate volume of income. But there are others too: a particularly important area where governments in all countries have had to intervene, is in the settlement of incomes of the farming community; contributions to social security systems and payments to the nonactive part of the population are also part of incomes policy; schedules of taxation will have redistributive effects on incomes; the treatment of windfall profits for tax purposes is equally important; and the position of government on price fixing practices by corporations in situations of oligopoly is also relevant. My personal opinion is that the government of today has to have a say in all these fields, which does not mean that every form of intervention is advisable. At one extreme, one might find that many countries have resorted to statutory law. Price and wage freezes or ceilings belong to this category. But what is acceptable in an emergency might not be tolerated in what one can call normal times. Also in this respect the feeling of justice and fairness is very important. Four of the countries which elected me have recently introduced laws for freezing wages, but at the same time a similar law has been adopted to provide authority for a price-freeze. Such measures, however, can only be temporary palliatives until other measures take hold. At the other end of the range of possible instruments of intervention, one finds that governments resort to exhortations. The success of such an approach will depend on the authority of the government and even more, I believe, on the general atmosphere prevailing. There is, however, a danger that exhortations become an "openmouth policy." We have to base our initiatives and actions more upon sober reasoning.

In our search for new avenues, we should look into the question of institutions. In our modern society of powerful organizations, inflation has become "institutionalized," and we need to supplement the traditional political bodies and the system of wage settlements. I believe that we have to find new institutions which can serve as a forum for confrontation between conflicting interests. We need to have the choices clearly presented to the political organs, to the bargaining parties, and in particular, to the public. In Norway the Committee for Income Settlements has been established with the participation of professional economists representing the Ministry of Finance, the Trade Unions, the Employers Association, and the Association of Fishermen and Farmers. This group has constructed a Price-Income-Model (PRIM) which describes fairly accurately the mechanism which determines price and income distribution. The model is cost-push in that it explains prices entirely in terms of cost, but it can be used to study the price propagation process through an input-output technique. The findings disclosed that there is a fundamental difference between two categories of industries, those which have to compete in the world market and those which are sheltered, either by government action or by such factors as distance (perishables) and cost of transportation. These studies have firmly established that productivity increases are much larger in the exposed than in the sheltered industries. Now, if wages were to follow the pattern of productivity gains in the sheltered industries, profits in the exposed industries would be swelled. One might say that the consequence would be that more resources would be diverted into such industries. However, the fact is that we need the products, and in particular, the services from the sheltered industries. The conflict between the productivity point of view and the problem of income distribution means that the productivity formula can only be applied with a good deal of qualification. In order to show how the price propagation process works, the group has selected a number of alternatives within the range of conceivable income settlements without expressing any preference for any of them itself, but leaving that issue to the interested parties.

The findings of the Committee are made public and presented to Parliament in a White Paper. The government appointed mediator will have this document before him when he tries to reach a settlement acceptable to the bargaining parties in wages disputes. No strike or lockout can legally be called before the mediator has announced that no settlement has been reached. In the end, of course, there might be a give-and-take situation, but each party has to be conscious of the consequences of its own action. I do feel, myself, that this is a significant step forward in establishing the new framework that the changed institutional situation in our societies requires. What is needed now, is a public awareness of the implications of the various alternatives. I believe that in these endeavors one should try to work with and through the existing influential organizations and not in conflict with them. Here, imponderable psychological factors are at work. In this respect, it is important not to affront public opinion by talking about the need for having so-and-so-many per cent unemployed. Furthermore, one can well understand the reactions of the trade union leaders, who feel that they always are regarded as Public Enemy No. 1, especially when they notice that leaders of industrial corporations are almost invariably praised for the successful management that can provide increased profits and dividends by price manipulation. In this field of "administered prices," price supervisory boards can perform a useful service by showing the red flag, even if they have no statutory power. Consumers' advisory boards can supplement that function. Such institutions may be indispensable when courts of inquiries are established to report on wage issues. In the field being discussed today, we have to have government by public consent. We have to seek institutional innovations, new auxiliary instruments, and above all, to try to create an atmosphere which is conducive to our aim of maintaining stability. It is, in my view, imperative that governments provide active and constructive leadership, more in this field than in many minor budgetary and legislative matters for which governments by constitutional law carry the responsibility of initiating action.

It is in particular with a view to creating a better atmosphere that I am very much in doubt about the wisdom of the secrecy we have been asked to observe in respect to ID/71/1. I venture to submit that the paper should have wide circulation, not only to Governors and their Alternates, but also to members' high-level policymakers, who could greatly benefit from the groundwork laid by the staff. I believe that one could even discuss going a step further and let a condensed version of the paper go to the financial press. I do not feel satisfied that in this context there are more grounds for secrecy in the IMF than there are in the OECD. In principle, the IMF is a world organization with a responsibility of its own and with a statutory obligation laid down in Article I(i) of the Fund Agreement to promote international monetary cooperation. One very important step in discharging that duty is to let not only member countries but also the public know what the strategy of the Fund is and which policies it stands for.

Mr. Dale said that the comments which he would make were related to the three tables entitled, "Two Growth Paths Consistent with the Economic Report," "Comparison of Staff Estimates with U.S. Estimates," and "Price Indicators."1/ To a considerable extent, those three tables had been based on the _Economic Report of the President_, which would be made public at 12 noon that very day.

Turning to the table entitled, "Two Growth Paths Consistent with the Economic Report," Mr. Dale indicated that the official projection of GNP for the calendar year 1971 was $1,065 billion. In order for that figure to be achieved, there were two possibilities described in the table as "A" and "B". If approach "A" were followed, there would have to be a 12 per cent growth rate between the fourth quarter of 1970 and the fourth quarter of 1971, which would reflect reports which the newspapers had given. He pointed out that the quarterly figures shown in the table had been the result of his own work and did not appear in the _Economic Report of the President_. The difference between approaches "A" and "B" was the result of the latter's accommodating the special problem concerning the reducing effect of the automobile strike on the GNP in the fourth quarter of 1970. The _Economic Report of the President_ made it clear that in the absence of that automobile strike the level of GNP at the end of the period would have been about $1,005 billion; in other words, the adverse effects of the automobile strike had been about $14 billion.

With respect to the table entitled, "Comparison of Staff Estimates with U.S. Estimates," Mr. Dale observed that with a projected 9 per cent annual growth in GNP, it could be envisaged that there would be a higher rate of growth in real GNP and a similar value for the increase in the GNP deflator. Items 1 and 2A in that table compared staff estimates with his own estimates for GNP and GNP deflator values, respectively, for 1971. While the _Economic Report of the President_ did not divide the projected growth in GNP into real and price components, his own figures were fairly consistent with the predictions of that Report.

1/ See Appendix I.

Regarding the table entitled, "Price Indicators," Mr. Dale explained that the source material had been obtained from the <u>Economic Report of the President</u>, although the form was not precisely the same. In one or two cases adjustments had been made because later official price indicators had been made available since the Report had gone to the printers. The trend in the movements of price indicators was cited in the Report as evidence for the U.S. view that the rate of increase in prices was beginning to move downwards; he himself thought that the information given in the table provided additional weight to the U.S. argument.

Mr. Dale said that he would read a few excerpts from Chapter 2 of the Report because Executive Directors might be interested in the ideas that were presented. On page 78, under the heading "The Goals of Policy," the following words occurred: "The general goal, which is more important than the precise numbers, is that the rate of unemployment should decline as fast as is consistent with a reasonably steady and durable decline in the rate of inflation. We believe that the numbers we have proposed--an unemployment rate in the 4.5 per cent zone and an inflation rate declining to approach the 3 per cent range by mid-1972--are feasible representations of that goal. But the numbers are themselves not the fundamental goal."

The section entitled "Improving the Unemployment-Inflation Choice," Mr. Dale observed, said that "It is the general policy of this Administration that where it has a legitimate role the Government should act to correct market conditions that prolong inflation, or whose correction can have a favorable effect on the price level. In line with this policy the Administration last fall took two steps to restrain increases of crude oil prices. It relaxed limitations on the importation of oil from Canada and permitted production of oil on Federal offshore leases without restriction by State regulatory commissions." On the following page of the same section the following sentence appeared: "By a decision taken in January the Council of Economic Advisers will report immediately to the Cabinet Committee on Economic Policy on any exceptionally inflationary wage or price development so that the Committee can consider appropriate Federal action."

Turning to the section entitled, "The Path of the Economy in 1971," which discussed in general terms what was expected to happen during 1971, Mr. Dale reiterated that the Report did not specifically include numerical quarterly growth indicators as he himself had done. Nevertheless, some interesting points were brought out. For example, a sentence on page 84 read as follows: "As a basis for considering what the outcome for the year would be with a specific combination of policies, it is convenient to assume that the money stock will continue to grow at about the rate that has prevailed since the turn early last year." Furthermore, four consecutive paragraphs on pages 84 and 85 read as follows:

> There is a considerable body of opinion that expects the gross national product for 1971 to be in the range between $1,045 billion

and $1,050 billion, which would be an increase of 7 to 7.5 per cent above that for 1970. This is a possible outcome. However, it seems more likely that with present policies the outcome would be higher than that and could be as high as $1,065 billion.

A $1,065 billion GNP for 1971 would be consistent with satisfactory progress toward the feasible targets suggested above--that is, toward an unemployment rate in the 4.5 per cent zone and an inflation rate approaching the 3 per cent range by mid-1972. This calculation involves estimates of the rates of increase of productivity and the labor force, which may in fact turn out differently, so that the connection between the unemployment-inflation targets and the 1971 GNP is not a rigid one. Nevertheless, although emerging information may later suggest a different view, the figure of $1,065 billion for the GNP in 1971 is an appropriate intermediate target of a policy whose ultimate goal is not a dollar total but a desired behavior of prices, unemployment, and real output. It is reasonable to expect that with an increase of the GNP to $1,065 billion in 1971, the rate of price increase would be declining through the year, the unemployment rate would also end the year significantly lower than at the end of 1970, and real output would show a strong gain.

For the GNP to reach $1,065 billion in 1971 would require an increase comparable to the increases after the low points of the economy in 1954, 1958, and 1961. If the rise in the money stock were to continue at the 1970 rate, the ratio of money to the GNP would then decline at about the average rate of the period 1952-70. Although this is a possible development, it is not a certainty. In the earlier recoveries cited, a major stimulus to the sharp rise of demand and output was a change from running down inventories to building them up. This is less likely in 1971 than after the earlier adjustments, which were much more severe.

A GNP in the neighborhood of $1,065 billion in 1971 is a good present estimate of the figure consistent with the targets for unemployment and inflation. It is feasible, and its realization with the proposed budget and complementary monetary policy is a reasonable expectation.

Those quotations from the Report, Mr. Dale thought, might be of particular interest to Executive Directors because they indicated what the U.S. authorities felt was likely to happen to the U.S. economy.

In addition, Mr. Dale said that in the table entitled "Comparison of Staff Estimates with U.S. Estimates," the letters "N.A." in the final column indicated that he himself had no firm projections for imports, exports, and the current account balance. Columns 1 and 2 of that table showed that U.S. estimates of the foreign sector magnitudes had been less favorable than those of the staff, whose figures had been based upon earlier estimating procedures. The outlook for 1971 might also be somewhat less favorable than the position indicated by the staff, numerically represented in column 3. However, at the present time he was unable to be specific on that point.

Mr. Ugueto said that ID/71/1 was impressive because it had attempted to put the economic issues of the world economy into perspective. It was perhaps the desire to focus upon the broad trends of economic activity that had caused a basic imbalance in the document. The title of ID/71/1 would possibly reflect the contents better if it were called "Economic Outlook of the Industrial World." From the point of view of financial aspects, as well as production figures, the relative importance of the issues were well set forth. He was disturbed, however, that the whole of Latin America and the Caribbean, Africa, and Asia, except Japan, seemed to rate rather low in the paper's economic evaluation of the world. The figures which were set out in that paper tended to increase his difficulty; it was evident that the international trade growth rates of developing countries were significantly lower than those of all industrial countries. The paper also indicated that the economic disequilibria between the developed and the developing countries was in no way diminishing. It was evident that in an increasingly "smaller" world such a situation would result in continued frictions and social tensions.

Turning to the broader issues raised by the paper, Mr. Ugueto felt that it might be opportune to explore the possible use of the paper. On the one hand, it could serve to improve the Fund's knowledge of the world economy and provide perspective to the discussion of particular issues which would doubtless occur during 1971. On the other hand, the present discussion could result in a consensus concerning the role that the Fund ought to play in its particular sphere of activity within the world economy. In that way, Fund influence during bilateral consultations concerning the major centers of economic power might be possible. That procedure might be particularly relevant with respect to the problems of inflation. There were two main types of inflation. A high rate of price increases in developing countries characterized one type of inflation, and considerable progress had been made in reducing such high rates. For instance, Indonesia had brought its own inflation under control and Brazil had found a method of achieving economic growth with stabilized prices. Elsewhere in the world the problem of high rates of inflation had diminished in importance. The other type of inflation was characterized by price increases in industrial countries; correction measures lay within the jurisdiction of each individual country. He believed that the Fund should look into other possibilities of how it could help in the solution of problems which were of a fundamental international nature.

There seemed to be two broad areas of economic or financial activity which had no well-defined center of control and which the staff had properly pointed out as a source of considerable worry, Mr. Ugueto remarked. On page 34 of ID/71/1 the staff said that "...balance of payments problems are perhaps more likely to arise from shifts in international capital flows than from immediately prospective changes in trade balances." Moreover, on page 35 there was part of a sentence which read as follows: "...the rapid reflux of funds drawn into the American banking system from abroad in 1969 caused a huge U.S. payments deficit and was one of the most unsettling factors in the international financial situation; prevention of a reoccurence of large, destabilizing capital outflows from the United States is imperative." The existence of a large pool of funds, subject to little or no central control, should perhaps be an area worth Fund investigation. The Fund might see if it could provide guidance to financial markets; some mechanism of sterilization or redirection of those funds could perhaps be devised and, if such a scheme was thought acceptable, the Fund could implement it. Trade was another sector of international activity which was not subject to any apparent multinational supervision. While he himself believed that trade did not really come under the Fund's jurisdiction, there was no clearly established body that could intervene in any effective way in that fundamental economic activity and produce harmonization.

Turning to two specific points, Mr. Ugueto said that in the first place, and connected with the broad treatment of global trade, the Common Market countries ought to be dealt with as one economic unit in which flows of economic activity between the member countries should not be isolated. Only the trade and financial activities of the Common Market as a whole with the rest of the world ought to be taken into account in the discussion of world economic issues. There were so many factors contributing to inter-country trade in the Common Market that did not apply to the rest of the world, and a better sense of proportion could be given to economic issues if the special factors which applied to the Common Market were not included in the general discussion. In the second place, a minor point had arisen with respect to Table 7 on page 43 of ID/71/1. Table 7 included a rather peculiar classification of major countries in the Western Hemisphere; for reasons which were unclear and which could be explained perhaps by the staff, the Netherlands Antilles were included in the major countries.

Mr. Schleiminger raised a procedural point. He suggested that instead of launching themselves into an uncoordinated discussion, Executive Directors should split their "tour d'horizon" into two stages. They should start by filling in any blank spots concerning the important consultation discussions at the beginning of the year on the United States, the United Kingdom, and Japan. After that, they could review the positions of other countries. Then they should try to use the information given in the first stage of the discussion in an attempt to discover what might be the general economic situation for 1971. At the same time, probable future problem areas might be pinpointed: some had already been mentioned in ID/71/1. For his own part, he had some advance information on the outcome of the 1970 German balance of payments position. He would provide Executive Directors with it if they so desired.

The Executive Directors agreed to Mr. Schleiminger's proposal.

Mr. Schleiminger said that he was somewhat surprised and a little disappointed by the meagerness of the U.S. projections, because, if he had understood Mr. Dale correctly, all that the Economic Report of the President, as well as the budget, indicated was that there would be a possible nominal increase of 9 per cent in GNP; even the GNP price deflator had been calculated by Mr. Dale and was not in the Report itself. Also, there did not appear to be a breakdown of demand into consumption and investment components, showing how the increase in GNP would occur. Apart from that, there did not seem to be any projections whatsoever for the total balance of payments or for individual items such as exports and imports.

Regarding the authorities' policy strategy, Mr. Schleiminger thought that the money supply would be increased at about 5.5 per cent. Turning to the budget, it had been learned recently that certain assumptions and projections had been made with respect to how the economy would finally swing on to a growth path. He asked Mr. Dale whether the Economic Report of the President would clarify the position.

The Economic Counsellor remarked that Executive Directors would recall that in the staff report (SM/70/255, 12/21/70) on the U.S. consultation the staff had discussed a 6 per cent to 7 per cent increase in money GNP as the outside limit which was thought likely to be compatible with substantial progress in reducing the rate of inflation. Of course, that percentage was not a forecast. It would be useful perhaps if he put that figure in some perspective in relation to Mr. Dale's table entitled, "Two Growth Paths Consistent with the Economic Report." The 6-7 per cent figure had not been meant to represent an increase from one time period to another; rather, it had been meant to reflect an underlying rate of increase. Looking at the prevailing situation, allowance had to be made for the fact that in the fourth quarter of 1970 the nominal growth rate had been 1.5 per cent below the trend. By adding 1.5 per cent to 6.5 per cent, which was the average of the figures given by the staff for the growth in money GNP, a figure of 8 per cent increase from the fourth quarter of 1970 to the fourth quarter of 1971 was arrived at, and that would be equivalent to the percentage which the staff had fixed on in SM/70/255. The 8 per cent figure could be compared with the figures of 12.0 per cent and 10.6 per cent which appeared in Mr. Dale's table.

Mr. Dale said in reply to Mr. Schleiminger's inquiry that the Economic Report of the President did not include quarterly figures. In the table entitled, "Two Growth Paths Consistent with the Economic Report," he himself had tried to construct quarter-to-quarter figures. There were, however, some indicators in the Report of a qualitative nature which tended to show that there would be some "make-up" in GNP in the early part of 1971 compared with the artificially low GNP in the final quarter of 1970. Assumption "B" in his own table was an approximation of those indicators, but he stressed that it was in no way intended to represent precisely what the Report was saying. The following three paragraphs from pages 82 and 83 of the Report gave such qualitative information:

> Some of the factors that will determine the course of the economy in 1971 are present and visible, others may be present but not now clearly seen, and still others are, from the standpoint of the Federal Government, matters of policy still to be decided or at least subject to revision.
>
> The most obvious of the present conditions is that the year 1970 ended with unemployment in the neighborhood of 6 per cent and output in the fourth quarter about 6.5 per cent below its potential. As explained in Chapter 1, the fourth quarter was significantly depressed by the automobile strike. This carries with it the probability of a large rise in output in early 1971 to rebuild inventories and meet customers' demands for motor vehicles. Also, apprehension that there may be a steel strike after midyear is likely to cause some larger than usual additions to steel inventories in advance. These two factors will provide a special boost to total output in the first half of the year but they also involve the danger of a subsequent letdown. The assurance of a reasonably smooth and even expansion throughout the year must be a special concern of economic policy in 1971.
>
> Aside from these transitory influences, there are several conditions that promise a strong rise of output during the year. The sharp rise in housing starts which occurred in the second half of 1970, the large inflows of savings into thrift institutions in the same period, and the beginning of a decline in mortgage interest rates all point to a much increased rate of residential construction in 1971 as compared with 1970. How fully these promising developments translate into more housing and more jobs will depend heavily on progress in stabilizing labor and other costs in the industry.

The Report continued by discussing business expenditures for plant and equipment, Mr. Dale noted. Of course, the projections for 1971 in that sector were not particularly strong. The Report showed that the results of a survey which had been carried out in November and December 1970 indicated that those expenditures would increase by about 1.5 per cent from 1970 to 1971. The Report also pointed out that the recent liberalization of depreciation allowances would possibly add about $2.6 billion to the after-tax cash flow of businesses in 1971. Of course, such a flow should stimulate, at least during part of the year, expenditures on plant and equipment. In addition, the Report also indicated that the budget proposed by the President implied an increase of $17.0 billion in federal expenditures on the national income accounts basis from calandar year 1970 to calendar year 1971. By adding up the increased direct expenditures of the Federal Government, the expenditures that were being proposed to be passed on to state and local governments under the revenue-sharing proposal, and the projected impact of the liberalization of depreciation allowances on business, a 9 per cent increase in total expenditures would result from the fiscal sector in 1971 compared with 1970. Therefore, the total impact of fiscal operations would give a 9 per cent increase, which was comparable to the 9 per cent projected growth of GNP.

The Chairman asked Mr. Dale whether he had any information concerning the U.S. balance of payments.

Mr. Dale replied that unfortunately there were no numerical estimates for the balance of payments in the Report.

Mr. Kafka wondered whether Mr. Dale could speculate about the manner in which the new budget might affect the balance of payments, not only its effect on the current account but also its effect on the overall account. It was a fact that at certain periods when there had been a combination of inflation and relatively low interest rates in the United States, the effect on short-term flows had often been offset by inflows of equity capital. It was conceivable that the U.S. Government might decide to experiment again with the so-called "twist."

At the same time, Mr. Kafka felt concerned about whether the increased money supply that the U.S. authorities had proposed would still be compatible not only with the growth of nominal GNP which was foreseen in the Report, but also with a suitable interest rate level. In fact, the proposed increase in money supply was not too different from the maximum figure compatible with the deceleration of price increases previously set forth by the staff. He wondered whether the policy of increasing money supply while accelerating the growth of nominal GNP would cause a liquidity squeeze in the United States.

Finally, Mr. Kafka said that he welcomed ID/71/1 and liked the staff's attitude of skepticism toward projections. In that connection, he recalled that it had been said that the Brazilian economy had only variables and no parameters and that made predictions very difficult. A similar point could be made about the United States and world economies.

Mr. Johnstone said that the U.S. authorities had presented certain numbers concerning the outlook for the U.S. economy in 1971. While he had found it difficult to interpret those numbers, Mr. Dale's table regarding alternative growth paths had interested him. Assumption "A" in the table entitled, "Two Growth Paths Consistent with the Economic Report," was similar to his own projection which he had made after hearing the U.S. budget news on January 29, 1971. The news that the nominal growth rate in 1971, even after adjusting for the General Motors strike in the last quarter of 1970, was projected at 10 per cent or 11 per cent, was very disturbing. It was difficult to see how such a growth path could be consistent with the policy objectives which Mr. Dale had just referred to. The difficulty centered on two types of questions. In the first place, was it possible for the authorities to stimulate the U.S. economy to such an extent as to increase nominal growth at a 10 per cent pace with the main policy levers set as Mr. Dale had suggested they would be? If such a growth rate were possible, was it likely that the rate of increase in output could be stepped up to Mr. Dale's suggested level, without a deterioration in the present price performance? He himself had doubts. The figure of $1,065 billion for GNP in 1971 did not seem to be a very realistic forecast.

In the second place, Mr. Johnstone observed that there was a much more worrying question to be asked. If it were assumed that the Administration would continue to attempt to control inflation, and taking account of the fact that policy adjustments might be necessary, had it selected a difficult set of targets? Fiscal policy was given, with the exception that the Congress might choose to spend more than the President had suggested and the President might be rather more reluctant to veto such increases than he had been in 1970. Adjustment of monetary policy would be the only tool left for the attainment of the Administration's growth objectives. Given the lags and so forth in the system, he wondered what form monetary policy would have to take in order for the $1,065 billion target to be achieved. He himself doubted whether the use of monetary policy could give the results that the authorities hoped for. If his assumptions were correct, extremely worrying strains would emerge both in the U.S. economy itself and in its economic and financial relationships with the rest of the world.

Reiterating his previous questions, Mr. Johnstone said that Mr. Dale's assumption "B" offered the Executive Directors an alternative way of looking at the possible growth path in 1971. Before accepting the quarterly increase figures for 1971--$45 billion, $20 billion, $20 billion, and $20 billion respectively--he himself would have to be provided with a lot more information about the expected spending patterns of particular sectors of the economy. In his readings from the Economic Report of the President, Mr. Dale had quoted a sentence which referred to the desirability of obtaining a relatively smooth growth path for the economy during 1971. The growth path as seen in assumption "B" certainly did not follow a smooth path.

Mr. Kharmawan said that he did not envy Mr. Dale's position because questions were being asked about the U.S. economy by Executive Directors who were concerned about repercussions of U.S. policy on other economies. Mr. Dale himself must be concerned about the state of the U.S. economy. Nevertheless, the fact of the matter was that the United States was so large that speakers were naturally interested in its health.

Continuing, Mr. Kharmawan noted that Mr. Johnstone had discussed certain issues which he himself had been going to raise. However, there was one specific point which he wished to discuss. Mr. Dale had envisaged that the U.S. economy would grow to $1,065 billion in 1971; other figures had also been mentioned. If that growth target were attained, unemployment would be reduced to about 4.5 per cent by mid-1972. At the same time, the rate of inflation was expected to decrease to about 3 per cent by the same date. He himself was concerned about that 3 per cent figure: did the authorities hope or expect that that percentage would occur? On the one hand, if the 3 per cent figure were based on a hope, it was rather meaningless. On the other hand, if it were based upon an expectation or an estimate which itself was based on certain calculations, he wondered whether those calculations, if they existed, could be made available. If not, perhaps Mr. Dale could explain how that figure had been arrived at. To be specific, how was it possible to increase GNP to $1,065 billion if unemployment were to be reduced to 4.5 per cent and inflation were to be reduced to 3 per cent per annum? While growth of the U.S. economy was welcome because it was in the interest of the United States and the rest of the world, he was concerned that growth might be accompanied by inflation, and that would not benefit either the U.S. economy or the rest of the world. With past experience in mind, the solution to the problem of growth without inflation would not be easy. Past experience had shown that when there had been slack in the economy and unemployment had been growing, inflation had persisted. Of course, it could be argued that past inflation was attributable to wage claims. It seemed as though the U.S. authorities were going to tackle the problem from the point of view of demand management; by expanding demand the economy would grow and unemployment would be reduced, but there would still be the problem of inflation. How would the expansion of aggregate demand be reflected in the price level? Furthermore, he wondered how the price of labor would react under those circumstances. The footnote on page 9 of ID/71/1 said that in the early stages of a renewed business upswing, according to historical precedent, output was likely to be expanded without proportionate additions to payroll employment; thus, by making use of unutilized capacity, increased production could outpace any wage claims. He himself was not so sure about that analysis.

Finally, Mr. Dale had referred to the quick reporting of wage and price developments which the Federal authorities were contemplating. He inquired about the kind of Federal action that was being contemplated by the Administration.

Mr. Dale remarked that he would be quite frank in his responses to the questions that he had been asked. On monetary policy, recent newspaper articles had assumed that the rates of expansion that were implicit in the 1971 projected GNP figure seemed to rely heavily on an extremely expansionary monetary policy. The Annual Report of the Council of Economic Advisers had made it very clear that they had been assuming that the rate of increase in the money stock would continue to grow at about 5.5 per cent. Of course, the institutional arrangements concerning monetary policy had not been changed, and the Federal Reserve Board and its Chairman continued to function, as did the Open Market Committee. Monetary policy was based on facts, as those bodies saw them at the time of making policy. He himself thought that there was no reason to assume that monetary aggregates would be expanded at a greatly increased rate compared to that of 1970.

With respect to the figures that he himself had provided in the tables, Mr. Dale explained that he had attempted to execute an arithmetic exercise which was consistent with the figure of $1,065 billion. Of course, assumption "B" would rely heavily on a "make-up" from the automobile strike and also, to some extent, from the anticipated steel purchases in the first quarter of 1971. The numerical procedure undertaken to arrive at those figures had been as follows: it had been assumed that the minimum estimated adverse effect of the General Motors strike on the GNP for the fourth quarter of 1970 of $14.0 billion (annual rate) would be made up in the first quarter of 1971, and in addition there would be a further growth of $30.0 billion in that same quarter; and also the growth of GNP for the remaining three quarters of 1971 would be at $20.0 billion per quarter. Assumption "B", like Assumption "A", was one way of obtaining estimated quarterly GNP figures which would be consistent with an average GNP figure of $1,065 billion. Finally, with respect to growth figures, he referred Executive Directors back to the first paragraph which he had quoted from page 84 of the Report. His own interpretation of that paragraph would be that the Council was saying that $1,065 billion was the upper range, not the mid-point, of their projections.

Regarding prices, Mr. Dale observed that his table entitled, "Price Indicators" provided some of the information which was in the Report about the trend of prices through the second half of 1970. In the case of the consumer price figures for "All Items" and for "Items other than food," he had updated the prices found in the Report in order to include recently available December figures. While he was confident that the 4.8 per cent increase figure for the second half of 1970 was accurate, he had some slight reservations about the 4.6 per cent increase figure. The Council had emphasized that the GNP deflator normally included automobile output, which had been greatly reduced in the fourth quarter. There was a technical argument why the weighting involved in the total GNP deflator might not be a very good indicator of the underlying trend recently, which the Council felt was better indicated by the data showing GNP excluding automobiles. The series of indicators which had been used showed the trend of price increases was distinctly in a downward direction and also that there was some confidence that it would continue in that direction. Under the heading "The Goals of Policy" on page 77 of the Report, the Council said the following:

> There are several reasons for believing that from this point forward a further reduction of the inflation rate will be consistent with reduction of the unemployment rate:
>
> 1. A reduction of the inflation rate has already begun. This is reflected in most broad measures of the price level.
>
> 2. There is a lag between the emergence of slack in the economy and its effect on the inflation rate so that the full effects on prices of the sluggish economy in 1970 have yet to be felt.
>
> 3. If, as expected, employment rises at a moderate rate during 1971, sufficient slack will still remain in the economy to exert downward pressure on the rate of inflation.
>
> 4. With output rising fast enough to cut into the unemployment rate, a high rate of productivity growth should continue through 1971. Stern cost-cutting measures in 1970 have put businesses in a position to achieve more favorable trends in costs per unit of output as operating rates improve. This will help to limit the pressures of these costs on prices.

Continuing, Mr. Dale commented that there had been a question concerning what would happen to future wage rates, apart from the fact that productivity was expected to increase in 1971. Table 21 on page 58 of the Report showed wage increase figures for the period 1965-70. The table showed that for all union and nonunion establishments combined the rate of increase in wages in manufacturing had been 6.2 per cent in 1969 and 7.0 per cent on a preliminary basis for 1970. The union versus nonunion establishments breakdown, however, was more interesting. For union establishments, the rate of increase had been 6.9 per cent in 1969 and 7.7 per cent in 1970. But for nonunion establishments, it had been 6.0 per cent in 1969 and 5.5 per cent in 1970. On the same page, the following passage described recent trends: "Although the collective bargaining calendar was heavy in 1970, only about 6 per cent of the civilian labor force was involved in major collective bargaining settlements during 1970, that is, settlements involving one thousand or more employees. Furthermore, the size of settlements and pattern of increases during the past few years have varied widely among industries." That passage provided some indication of the view which the Council took of probable developments in the wage field in 1971.

With respect to Mr. Kafka's request for further information on the balance of payments, Mr. Dale regretted that he could say very little. Referring to his own table entitled, "Comparison of Staff Estimates with U.S. Estimates," he observed that the trade balance for 1970 might be somewhat below the $2.7 billion figure, which had been given as the U.S. indication, because developments in the final few months of 1970 had been rather less favorable than had been anticipated earlier. At the present time, the 1971 U.S. projection would seem to be less favorable than the staff's projection. A similar comment might possibly be made about the current account balance, although perhaps to a lesser degree because the preliminary indicators confirmed that in 1970 the earnings of U.S. investments abroad had risen quite appreciably, thus offsetting some of the less favorable developments on the trade side. He himself would expect a similar trend to materialize in 1971.

Finally, Mr. Dale noted that Mr. Johnstone had indicated that it was possible that fiscal policy in 1971 might be more expansionary than had been projected. He felt that there were two possible reasons for Mr. Johnstone's remark: one, the GNP forecast might prove to be on the high side; and two, there might be some slippage in fiscal policy because of the tendency of Congress to provide larger appropriations than had been anticipated. On the latter point, he himself was not sure that under the circumstances Congress would act in such a way. If Congress proved to be uncooperative as far as the revenue-sharing idea was concerned, as early indications seemed to suggest, it might provide additional appropriations for sundry purposes, and thus slippage might occur on that score. However, it should not be forgotten that the President's budget proposals anticipated that there would be an additional $6 billion on the expenditure side attributable to revenue-sharing which might not appear in the final budget if Congress opposed revenue-sharing in general. In the coming months, therefore, fiscal policy might at least not be more expansionary than had been projected, and could prove to be less expansionary.

The Economic Counsellor said that with respect to the balance of payments the staff had been given certain information at the time of the consultation discussions with the U.S. authorities concerning the difference in the trade balance which would result from a higher GNP. The U.S. authorities had said that a $10 billion increase in GNP would produce about a $0.6 billion deterioration in the trade balance. Given that GNP would increase to $1,065 billion in 1971, or by about $15 billion over the figures as set forth in ID/71/1, the difference in the trade balance would be in the order of $1.0 billion. It had to be remembered, however, that U.S. imports had tended to behave in a far from linear manner when there had been a rapid expansion of GNP. Therefore, he himself felt that a $1.0 billion deterioration might be a low estimate. As regards the balance of payments as a whole, as some Executive Directors had already mentioned, the capital movements situation might become similar to that of 1969 if all the things which Mr. Dale had cited actually happened. In other words, if the money supply increased at 5-6 per cent and GNP increased at 9 per cent, the ratio of money to GNP would again begin to decline sharply, and that would presumably produce a considerable increase in interest rates, the outflow of money to the Euro-dollar market would be arrested, and perhaps an inflow would be produced. Thus, the question which had to be asked was whether, on the assumption that both the fiscal and monetary instruments behaved as the authorities wished, a $1,065 billion GNP figure would be reached. He himself, like other speakers, had doubts about it.

Mr. Schleiminger felt that the growth figure of $1,065 billion would remain a problem for the whole of 1971, particularly because it was unlikely to be achieved. Of course, the Executive Board was mainly interested in what would be the effects on the balance of payments position. A problem of international disequilibrium might occur, and if so it would take the form of an imbalance between the United States and the rest of the world, especially the rest of the developed world. Mr. Dale would understand, therefore, the preoccupations of Executive Directors with respect to policy instruments used and targets aimed at. Moreover, while a nominal GNP figure of $1,065 was certainly achievable, it was doubtful whether such a figure could be achieved in real terms. The effects on the rest of the world would be very detrimental to the global balance of payments structure if the projected GNP figure were obtained only in nominal terms. He himself would be interested in learning about the expected size of the gap between potential and actual output growth which would result from the proposed policies of the authorities during 1971. In 1970 that gap had been about 6.5 per cent. At the present time, however, it would perhaps be appropriate to digest the available information on the proposed U.S. policies. Finally, he stressed that the balance of payments situation was the most important aspect of U.S. policy to be borne in mind.

Mr. Dale, referring to the balance of payments, said that to the extent that $1,065 billion was not achieved and to the extent that the assumptions about monetary policy in particular were adhered to, there would be a lagged improvement in the balance of payments. He himself had no clear ideas about the effects on either the capital account or on the current account as compared with the deterioration which the Economic Counsellor had referred to. That deterioration might stem from income effects on imports, and maybe exports. Thus, if it were assumed that the GNP target of $1,065 billion was not achieved, the obvious consequence would be that the balance of payments position ought not to be of too much concern.

Mr. Schleiminger observed that a general problem had arisen both in the U.S. consultation discussion and in Mr. Brofoss's statement. The problem was as follows: should necessary economic adjustments fall mainly on the current or the capital account of the balance of payments. Perhaps that was one of the more general problems that could be discussed in stage two of the informal session on world economic outlook.

Mr. Gilchrist said that there was very little which could be added to the U.K. position because there had been an exhaustive discussion on it only on January 18.

Mr. Schleiminger said that Germany's internal and external economic position had received few headlines since the revaluation of the deutsche mark. As the regular Article VIII consultation would take place in the second half of April 1971, an Executive Board discussion could not be scheduled before some time in late spring or early summer. Therefore, it might be useful if he offered some interim information both on the external and on the internal situation. As far as the external account was concerned, the December balance of payments figure, although not yet published, had been completed. He could provide, therefore, figures for the whole of 1970. He thought that it would be useful to indicate some of the results of revaluation by providing the figures for both 1969 and 1970; thus, a comparison could be made. He would limit himself to the aggregates of all the main items of the balance of payments.1/

Mr. Schleiminger felt that there were some conclusions to be drawn from those figures, particularly with respect to revaluation. While the nominal figure for the trade balance had remained roughly unchanged, he stressed that there had been a reduction in the real trade balance by about 12 per cent because of increased export prices and decreased import values. The German authorities thought that the reduction of the trade balance in real terms had been mainly the result of revaluation. In addition, his authorities did not think that the effects of revaluation had fully worked themselves out. In the case of the U.K. devaluation, as well as of other countries where the exchange rate had been altered, initially the terms of trade had changed, and then later on the volume of imports and exports had reacted once the elasticities took effect. Nevertheless, as far as the trade balance was concerned, a more drastic impact of revaluation had been expected. After taking stock of the economic situation, the Chancellor, in a recent speech, had come to the conclusion that while the amount of revaluation had seemed to be sufficient at the time of its inception, possibly it had been too much on the low side. If the German authorities had known about the future trends in the world economy, particularly about the level of inflation abroad, as well as the fact that German exporters had been able to pass on increased costs

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1/ See Appendix II.

to foreign customers despite the increase in the value of the deutsche mark, they might perhaps have acted differently. At the time of the revaluation of the deutsche mark, the Executive Directors had discussed what the level should be, and at the time opinions had been divided. But in retrospect, the degree of revaluation had turned out to be modest; not modest in itself, but modest because of the results of inflationary tendencies both inside and outside Germany.

Turning to the services item in the account, Mr. Schleiminger commented that the effect of revaluation could be more clearly seen; there had been a marked deterioration. The main element in the services item was, of course, tourism. He himself had discussed with the German authorities how much of that deterioration was due to revaluation and how much it was due to the effect of the increased personal income of the German people. His authorities were inclined to regard the income effect as even more important than the price effect, although the greater deficit in the services account, at least as far as tourism was concerned, reflected revaluation to a greater extent than did the trade account.

With respect to unilateral transfers, Mr. Schleiminger noted that they had increased. Remittances of foreign workers had increased between 1969 and 1970 from DM 3.0 billion to DM 4.6 billion. Normally, there was no breakdown of remittances to individual countries. However, as remittances had been often discussed in the Fund's consultations with Mediterranean countries, he would give a country breakdown of the DM 4.6 billion deficit in 1970 as follows: DM 1.2 billion to Italy, DM 1.0 billion to Yugoslavia, DM 1.0 billion to Turkey, DM 0.6 billion to Greece, DM 0.5 billion to Spain, and DM 0.3 billion to other countries. Those figures indicated that a great part of the German trade balance had been achieved with the help of foreign workers, but they also reduced the surplus of the current balance.

The surplus on current account had been reduced from DM 6.2 billion to DM 2.7 billion, Mr. Schleiminger remarked. The figure of DM 2.7 billion was valued at between $700 million and $800 million, and was thus rather modest by international comparisons. The German authorities felt that it did not create problems either for Germany or for other countries, particularly so as it had been more than compensated for by long-term capital outflows.

Turning specifically to long-term capital, Mr. Schleiminger said that outflows had been drastically reduced from the figure of DM 23 billion in 1969 to the figure of DM 4-5 billion in 1970. The 1969 figure had been the result of the Bundesbank's easy monetary policy which had been implemented for external reasons in the pre-revaluation period, and also of the determination of the German authorities to encourage long-term capital outflows in order to defend the par value. The Executive Board had felt at the time that such long-term capital outflows were not sustainable and that there were indications that a fundamental disequilibrium existed. After revaluation, when monetary policy had been able to adapt itself to cyclical requirements, the outflow had been reduced. The 1970 volume seemed to be both sustainable and realistic. Of course, long-term capital outflows might increase if the global interest rate structure changed. But for the time being, the authorities regarded a DM 3 billion current balance, together with a long-term capital export of DM 4-5 billion, which would still mean a deficit in the basic balance of payments, as a reasonable figure to work with in the future.

With respect to short-term capital, Mr. Schleiminger remarked that the 1970 inflow of DM 14 billion was indicative of what had happened to international monetary flows in past years. That figure had been the result of a deterioration in the position of the banks, especially increased bank liabilities, and of heavy borrowing by German corporations on the Euro-dollar market. The German authorities felt that the short-term capital figure had been the result of a particular structure of short-term interest rates. They did not expect it to continue at that level. The figure of DM 4 billion for 1969 was, of course, rather misleading because before revaluation there had been a huge inflow of short-term funds and after revaluation there had been a reversal of that trend. The DM 4 billion figure was, therefore, the net effect of those two large flows of funds. The year 1969 could be contrasted with the year 1970: in 1969, short-term capital inflows had been the result of speculation; but in 1970, short-term capital inflows had been mainly the result of the effects of interest rates. The German authorities did not expect any drastic or sudden reversal in the flows of those funds. Some of those funds were the result of loan contracts of German corporations maturing over time. Thus, even if there was a restructuring of international interest rate differentials, there would probably be a slow shift into deutsche mark because of internal reappraisals.

It was interesting to note that if the DM 14 billion short-term capital inflow were added to the errors and omissions item for 1970, the resulting value would be more or less equal to the increase in official net reserves, Mr. Schleiminger observed. That exercise indicated that a greater part, if not the whole part, of increased German reserves had been due to money borrowed from abroad. Of course, sooner or later reserves would be subject to a decline once the heavy reliance on foreign funds was reversed.

Total German reserves were about the same level, $49 billion, that they had been at the prerevaluation time, Mr. Schleiminger noted. At that time, and in a similar vein to his previous remarks, that figure had been inflated by speculative inflows of capital. At the present time, total reserves had been inflated by inflows of capital which had been the result of interest rate motivations. Taking the trade balance and services together, i.e., total current balance minus transfers, they amounted to 1.7 per cent of GNP in 1970. The German authorities did not think that a figure less than 2 per cent was a particularly striking one, and developments during 1971 would determine whether it would further decrease.

Regarding the economic outlook for Germany during 1971, Mr. Schleiminger said that it was difficult to offer any comments. In ID/71/1, the staff expected an increase in the trade account, and thus the current account. Of course, the staff might well be correct; but his authorities believed that the effects of revaluation had not fully worked themselves out, and that there might thus be further results on the import side of the German trade balance. As a result of the present wage explosion, the high increase in disposable personal income, and the rise in consumption, the import bill might increase, and that increase might be much greater than the rise in exports. Therefore, the trade balance in 1971 could be the same as it had been in 1970 or even slightly less. However, cyclical conditions could cause the trade balance to increase lightly. In any case, his authorities did not expect any major movements in one direction or the other. The DM 4.5 billion long-term capital outflow which had occurred in 1970 was probably likely to continue. With respect to short-term capital movements, the German authorities hoped that in the future there would be some reversal of the inflows; such a reversal would have a net effect on reserves, which, if it occurred, would not cause them any concern. On the contrary, his authorities would very much welcome any such development. Of course, short-term capital movements were dependent on both interest rate and aggregate monetary policies of the United States.

Turning to the internal situation, Mr. Schleiminger remarked that the economy was in a transitional phase. After the latest boom had reached its peak in the spring of 1970, the economy had experienced some gradual cooling off. The volume of orders from businesses had been high, and that would act as a buffer against any sudden decline in demand. Thus, there was no doubt that total demand had both declined in rate of expansion and had changed its composition. With respect to the last point, private consumption had been replacing investment as the major demand factor. Similar to many other countries, the demand-pull forces in Germany had been substituted by strong cost-push forces. On wage rates in particular, the figures for the year ending October 1970 indicated that the average hourly earnings in Germany had increased by 15.5 per cent. Productivity, however, had increased more slowly at a 1 per cent rate. Thus, during that period, the increase in wage costs per unit had amounted to 14 per cent. The high increase in wage costs had resulted in a substantial squeeze of profits, which, of course, might cause certain problems for the future. Somewhat in contrast to Mr. Brofoss's view, he himself felt that after a period of economic overbuoyancy, a period of slow growth was probably unavoidable. But the German authorities were ready to prevent any spiraling down of demand with its consequences of developing slack in the economy. With respect to prices, performance during 1970 had not been too discouraging by international standards; but by German standards it had been relatively disturbing. On a December-to-December basis, 1970 figures recorded that the cost of living increase had been about 4.1 per cent.

Regarding government policies, Mr. Schleiminger said that they had been restrictive throughout 1970. There had been a mild restrictionist policy on the fiscal side, and perhaps a stronger restrictionist policy on the monetary side. It seemed as though part of the effect of monetary policy had been compensated for by inflows of short-term capital. The present rate of growth of the German economy was about 4 per cent annum. In 1970, real GNP had increased by about 4.9 per cent, which corresponded to the original projection of a real rate of about 4-5 per cent. In nominal terms, the increase had been more than 12.0 per cent, which had to be compared with the original estimate of about 9-10 per cent. Those last percentages indicated that the GNP deflator had been much greater than 4 per cent, the increase that had been originally expected. It had to be remembered however, that the GNP deflator would be distorted in a country which had experienced revaluation; it could not be taken at its face value because of terms of trade effects.

Turning to aggregate demand, Mr. Schleiminger said that strong demand forces had persisted during the first half of 1970. For the year as a whole there had been an increase in gross fixed investment, both public and private, of 22 per cent. According to the unofficial estimates of his authorities, that figure would decrease during 1971 to about 7-8 per cent. The expected change in the volume of gross fixed investment between 1970 and 1971 illustrated that there was some adjustment of the German economy taking place. There was a shift from heavy investment to more moderate investment; that trend was quite normal in the later stages of the cyclical process. Private consumption was now showing itself as a major factor in aggregate demand.

Continuing, Mr. Schleiminger remarked that economic policies were mainly concerned with reducing to a more tolerable level widespread wage increases. His authorities had also adopted the policy of following decreases in interest rates in the United States by decreasing Germany's own bank rate, but with the longest possible lag. The German economy was not in the same cyclical position as that of the United States; Germany's real rate of growth was still 4 per cent per annum. Perhaps Germany's position in the cycle could be compared to the U.S. position eighteen months ago.

Turning to the future course of wage movements, Mr. Schleiminger thought that it would be possible to check increases. There were indications in Germany that labor wage demands were still sensitive to occurrences in the labor market. Clearly, there was certainly some easing of conditions in the labor market in Germany, although they were not particularly strong. The Government had issued orientation data both for businesses and for the unions. Those data limited wage increases to 8 per cent during 1971. Whether the respective sides of the bargaining table accepted that percentage had still to be seen, but the authorities were moderately optimistic that they could achieve a more tolerable rate of wage increases. While the Government was continuing its policy of mild restraint via the German type of incomes policy, as applied through the use of orientation data, it was aware of the danger that the German economy might develop a certain amount of slack during the coming year. His authorities were ready to act, and had already undertaken contingency planning, consisting of methods to counteract greater-than-expected sluggishness of the economy. Policies aimed at stimulating the growth rate would, if applied, be helped by the accumulated cash reserves which had been sterilized with the Bundesbank. Those sterilized cash reserves had been the result of tax revenues in excess of the revenues which would have been collected under a kind of full employment budget. If economic activity necessitated it, pump priming could be carried out via additional expenditure programs financed from those sterilized reserves.

Finally, Mr. Schleiminger said that the German authorities were confident about both the balance of payments performance and their ability to contain cost inflation, while, at the same time, avoiding slack in the economy.

Mr. Kafka observed that while Mr. Schleiminger stressed that Germany had not been in the world headlines very much, he himself felt that it should have been. Of particular interest was the fact that there had been a staggering inflow of short-term capital, as well as a large, but less staggering, reduction in the outflow of long-term capital. Perhaps the world situation would be pleasanter, for both the world and Germany, if the German Government had relied more on fiscal and less on monetary policy. In that case, their restricted monetary policy might not have been offset by an inflow of short-term foreign capital.

Turning to the sharp rise in unit labor costs which had been mentioned by Mr. Schleiminger, Mr. Kafka wondered whether there were any data which showed how those costs had been distributed between the export industries and the branches of industries working mainly for the domestic market. He himself thought that there had been a tendency in the past for unit costs to rise less in the export industries than in the branches of industries which worked mainly for the domestic market. In addition, Mr. Schleiminger seemed to have indicated that the authorities' restrictive policy, as long as it lasted during 1971, would center on interest rate reductions lagged to the declines in the U.S. interest rate rather than on fiscal policy. He wondered whether Mr. Schleiminger could confirm whether or not that was so.

Finally, Mr. Kafka suggested that when stage two of the informal session was reached, Executive Directors ought to pay special attention to coordination of interest rates.

Mr. Dale said that he was interested, as Mr. Kafka had been, in the apparent difference between the behavior of unit labor costs in manufacturing in general and export unit values of manufactured goods, both of which were illustrated on page 10b of ID/71/1. He himself wondered why export unit values seemed to have behaved rather worse than the unit labor costs in manufacturing in the United States, while the opposite appeared to have been the case in Germany. It was also interesting to note that there was apparently a large difference in the GNP deflator compared with the cost of living index in Germany for 1970: the cost of living index had increased by about 4 per cent, but the GNP deflator seemed to have increased by roughly 8 per cent, which was based on the figures for both real and nominal GNP that Mr. Schleiminger had provided. He himself questioned whether such a difference was really the result of technical problems associated with revaluation. Perhaps there were some other explanations.

Noting Mr. Schleiminger's interesting balance of payments presentation, Mr. Dale observed that taken together the trade balance plus the services item amounted to just under 2 per cent of GNP. Such a percentage did not seem to offer the world any particular problems. But he himself felt that by totaling certain current account items and expressing the results as a percentage of GNP in order to indicate the appropriateness of a country's policies was not always valuable. Perhaps other kinds of international standards or criteria ought to be looked at in that connection. It might be worth discussing the issue during stage two.

Mr. Schleiminger agreed with Mr. Kafka's comments regarding the fiscal policy of Germany. While German economic policy had not meant to be one of gradualism the authorities had underestimated the strength of the boom and as a result fiscal policies had taken on a gradual effect. Again agreeing with Mr. Kafka's view, a greater share of overall policy should have been allocated to fiscal restraint, thus monetary policy would have been relieved. But it had to be remembered that the Government was intending to use fiscal policy if countercyclical action was made necessary. At the present time, fiscal policy was well suited to such action because of the measures which the authorities had already taken. The 1971 budget would cater for an increase in expenditure of 12 per cent, which was greater than the expected increase in both real and nominal GNP. Therefore, some stimulation of aggregate demand would come from the budget for the coming year.

With respect to unit costs, Mr. Schleiminger remarked that it was not possible to provide a breakdown on the lines that had been requested. Regarding the external field, in the investment goods industries, as well as in the consumer goods industries, the increase in unit costs had been steep. In all parts of industry productivity had been quite low and wage claims had tended to reflect one another.

Turning to the trade and services relationship to GNP as a standard for measurement of the balance of payments, Mr. Schleiminger said that in normal times trade and services were the contribution of the foreign sector to total GNP. He himself had merely mentioned the figure of about 2 per cent because in the past a figure of 3.5 per cent had been recorded and some Executive Directors had critically commented upon that figure. By attaining less than a 2 per cent level, the German authorities had tried to meet some of the criticisms that had been made in the past.

Turning to interest rate coordination, Mr. Schleiminger concurred with Mr. Kafka's view. It was a topic that ought to be discussed by the Executive Board, and could be taken up in stage two.

Mr. Kafka believed that Mr. Schleiminger had indicated that the 1971 budget would be expansionary. At the same time however, Mr. Schleiminger also foresaw that there would be a need to contain aggregate demand, in particular in order to discourage excessive wage increases. The consequence of that policy would mean that a large burden would fall on monetary policy because not only would it have to offset some of the strong expansionary tendencies in the German economy, but also counterbalance fiscal stimulation.

Mr. Schleiminger remarked that economic policy always included some qualitative psychological elements. The German authorities believed that a budget expansion of 12 per cent was not only tolerable but, under the existing circumstances of the transitional phase, it was probably the correct role to be played by the public sector. If the Bundesbank followed a cautious and restrictive line, it would mainly be for psychological reasons. The central bank did not wish to give the impression either to the unions or to business that there were no longer any reasons why restraint should be exercised with respect to wage claims.

With respect to the GNP deflator, Mr. Schleiminger agreed with Mr. Dale that it had been very high, perhaps 7-8 per cent. Conversely, the rise in the cost of living index had been much lower. He believed that a major reason for the apparent discrepancy could be explained by the very high increase in building costs. Those costs had been included only to a moderate extent in the current cost of living index. In fact, the building industry's prices had increased 20 per cent, and even more during the boom period. With respect to the effect of revaluation on the GNP deflator, according to the results of the 1961 revaluation there seemed to be a particular relationship between revaluation and the deflator. As far as he could recall, at least 1 per cent of the GNP deflator increase had been due to the revaluation and the improvement in the terms of trade. Revaluation was, therefore, an important factor to be taken into account when explaining the apparent discrepancy.

Mr. Johnstone said that the exchange between Mr. Schleiminger and Mr. Kafka concerning Germany's economic policy mix had raised a question in his own mind. While perhaps it was a more general question and should be discussed in stage two when Executive Directors examined the problems of harmonization of monetary policies, it was worth voicing at the present time. He wondered to what extent the German authorities felt themselves able to deal with the domestic effects of capital inflows. He stressed that his question did not concern the warding off of capital inflows. He recalled that from certain sources, particularly the comments in the Bundesbank report which had followed revaluation, there had been a feeling that prior to revaluation all the efforts which had been made to neutralize the domestic effects of capital inflows had not been very successful. He himself would be interested in any comments which Mr. Schleiminger might wish to make concerning the degree of confidence which the German authorities had with respect to mitigating the domestic effects of capital inflows.

Turning to the Canadian situation, Mr. Johnstone explained that he intended to comment briefly on the outlook as it was seen by Canadian forecasters. That outlook did not represent an official forecast. He intended to describe the areas of common agreement among officials and to indicate any differences between those views and the comments set forth in ID/71/1. He stressed that differences of opinion did not necessarily reflect on the judgment or forecasting of those who had prepared the paper but reflected the updating of views of the Canadian officials. For example, in Table 1 on page 37 of ID/71/1, the staff projected that the growth of real output of Canada during 1971 would be 3.2 per cent, but that projection had come from an earlier forecast made by the Canadian officials. At the present time, a growth of 5 per cent or as much as 6 per cent was the consensus forecast discussed in Canada with private forecasts clustering at the upper end. The difference between 3.2 per cent and 5-6 per cent was largely the result of higher growth prospects expected for the first half of 1971. One reason for the changed prospects was the change in the stance of economic policy due to the effects of both the December 3, 1970 budget and the relative easiness of monetary policy. With respect to specific categories where expenditure was likely to increase, housing was expected to be fairly strong. Expenditure in the housing sector had increased from the low reached about one year ago. Furthermore, government spending would provide some stimulus to the economy.

With respect to the external sector, Mr. Johnstone said that the 1970 outcome of the trade and current accounts had been higher than anticipated earlier. While Table 9 on page 45 of ID/71/1 gave an estimated value of $900 million for the 1970 Canadian current account, more recent estimates indicated that a value in excess of $1.0 billion was more likely.

One of the main uncertainties in the Canadian outlook was private investment, Mr. Johnstone noted. There were many technical forecasting difficulties with respect to investment. The main indicator for business plant and equipment expenditures was the Investment Intentions Survey, which in the last couple of years had not proved very reliable. Therefore, the forecasters were in considerable doubt as to how to read the prospects for private investment in the course of 1971. One factor which might lead to the discounting of some rather bullish views about private expenditure was the fact that the corporate sector had been experiencing a considerable profit squeeze, and that tended to provide the basis for certain skepticism about the investment situation. Referring back to the 5-6 per cent forecast of the growth of real output during 1971, the difference between 5 per cent and 6 per cent could largely be explained by the views that different forecasters held about the level of investment spending.

The current account ended 1970 in a strong position, Mr. Johnstone observed. The trade balance for the four quarters of 1970 had produced the following results (at annual rates): first quarter $2.7 billion, second quarter $2.7 billion, third quarter $2.4 billion, and fourth quarter $4.0 billion. A substantial part of the increase in the fourth quarter had been the result of the strike at General Motors, which had had the effect of increasing the net balance on automobile trade between Canada and the United States, and thus had improved the trade account as a whole. In 1971 the surplus on trade and current accounts was expected to become smaller. It was, however, extremely difficult to assign any value to that surplus because of the reasons related to the uncertainties about the Canadian economic outlook and also because of the uncertainties concerning the external situation. Comparing 1971 with 1970, the increase of imports into Canada might prove to be in excess of the 9.5 per cent which had been projected by the staff in Table 3 on page 39 of ID/71/1. That higher estimate would, of course, be consistent with a growth of GNP in excess of 3.2 per cent. The expansion in imports in 1971 might be 10.5 per cent or even 11.5 per cent. As far as exports were concerned, and with the rider that there were significant uncertainties about the world outlook, he himself would not argue too strongly with the 8 per cent forecast which had been given by the staff in Table 4 on page 40 of ID/71/1.

Regarding wages and prices, Mr. Johnstone said that Canada had had an extremely good price performance in 1970. That performance had been true of most of the main price categories, including wholesale and industrial selling prices and final prices, as measured by the consumer price index. In 1970, declining food prices had influenced overall price trends. Unfortunately, he did not anticipate that the 1971 aggregate price performance would be influenced by declines in the prices of food. Thus, there might well be a slightly more rapid increase in the consumer price index and in final prices in general during 1971 compared with 1970. But it was generally believed that the good price would be at risk, unless cost increases moderated. In fact, the cost structure had to be viewed very seriously. It was for that reason that the Canadian authorities had been trying extremely hard to encourage a moderate recovery of growth to gradually absorb the high level of slack in the economy because they were extremely anxious to guard against a resurgence of inflation.

Finally, Mr. Johnstone commented that he had assumed in his review of the Canadian outlook that developments in the United States would not be significantly different from those which the staff had mentioned in ID/71/1. The future of the Canadian economy had to be viewed in two ways. In the first place, the behavior of the domestic economy was important. In the second place, the external sector perhaps played a very important role. It was the latter, of course, which made any assessment of the Canadian outlook dependent upon the outlook for the United States. Therefore, it seemed fair to say that whatever uncertainties might have existed about the future of the Canadian external position, they would have been greatly increased by the most recent developments with respect to the outlook and the policy of the United States.

Mr. Gilchrist said that he expected world output to rise faster in 1971 than it had done in 1970. At the same time, he foresaw that prices would rise a little more slowly in 1971 than in 1970. Unfortunately, price trends were more complex than that because, as ID/71/1 pointed out, it was clear that the increase in prices in 1971 would be greater than the average price rise for the 1960's. In addition, the price increase which the staff had forecast for 1971 might turn out to be on the low side because the outcome of the various wage settlements which had been made during 1970 had not yet been fully reflected in final prices.

With respect to trade, Mr. Gilchrist observed that import propensities of the industrial countries had tended to rise in recent years. He questioned whether the decline in imports for 1971 would be of the projected order. It might be wise to cast doubt upon the aggregate effect of individual forecasts, merely because of the manner in which import propensities had behaved in the recent past. Thus, the developing countries might receive some comfort from that fact. The projections for exports of primary producing countries during 1971 seemed to be rather unrealistic. The staff had presented the rather high figures of 11.2 per cent in 1970 as against 9.3 per cent in 1971 for increases in the value of exports of developing countries to industrial countries.

With respect to the U.S. budget, Mr. Gilchrist thought that a battle might occur because some U.S. authorities might urge for rather an undue monetary expansion. If, in fact, that occurred, it would be difficult to see what would happen to the current and capital accounts. But as there would anyway be a worsening in the U.S. trade or current account balance, there could be no prospect of improvement in 1971.

Recent events had cast a shadow on the whole spectrum of forecasts for 1971, Mr. Gilchrist believed. It was difficult to see what would happen to the rest of the world. In any case, the whole problem of short-term capital movements and interest rate policies would be more difficult to solve than had earlier been hoped.

He had been thinking of pointing to both Germany and Japan as examples of countries which could slow down a little in the progress they had been making on the price stability problem, Mr. Gilchrist said. It could be argued that those countries should err on the side of too little rather than too much restraint because all other countries would benefit from such policies. Such thinking would be sympathetic to Mr. Brofoss's thesis that an improvement was not necessarily an improvement; the concept of "improvement" depended upon the point of view being expressed. But it seemed to him that U.S. policy had recently become more important. As a result, he could no longer suggest that a country, for instance Germany, should slow down on its price stability policy for the benefit of the rest of the world. The only thing that could be recommended would be for countries to adopt a "self-preservation" policy. The coming year would be an extremely difficult one, and he himself would not blame a country which decided that a "self-preservation" policy was the most appropriate one. In a similar vein, the same remarks applied to Canada in its attempt to fix a new par value as they had done for Germany. It would be difficult to blame the Canadian authorities for putting off any decision about fixing a new par value.

The staff paper set forth various trends, Mr. Gilchrist observed. There were many lessons to be learned about recent events concerning the timing of policy measures and the introduction of inadequate policy measures, when measures were eventually taken. There seemed to be an enormous problem associated with the knitting together of readjustment policies, and at the present time, few countries seemed to be able to discover a satisfactory solution.

A big problem which had to be faced in the future concerned the obtaining of an appropriate monetary and fiscal policy mix, Mr. Gilchrist believed. The problems of interest rates and capital movements and global coordination of their solution were important, but not so much as the monetary-fiscal mix issue, which was an old problem. The heart of the matter was that monetary policy could not distinguish clearly between internal and external considerations, and that was so because fiscal policy was not always appropriate.

Finally, Mr. Gilchrist felt that there would be no great advance in 1971 because too many countries would take up the posture of self-preservation.

Mr. Kafka wondered what were the staff's views about the expected growth path of the developing countries in 1971. He well understood why the staff had not discussed the matter at length; certain difficulties were involved. However, it might have been useful if the staff had made some comment because then it could have been compared to the OECD's forecast. Although there were some UN reports which were quite interesting, they did not cover the ground he was interested in. His own prediction was that the internal forces of expansion would continue to be as strong as they had been in 1970, and that growth would not be hampered by any lack of reserves. There was, however, the question about the slowdown in the expansion of exports. His own feeling was that such a slowdown would not be sufficient to have significant effects. But in any case, he wondered whether the staff would give its own opinion.

The Economic Counsellor concurred with Mr. Kafka's appraisal. The staff had not made any specific statement concerning the growth prospects for the developing countries because it would have been extremely difficult.

Mr. Kharmawan said that he wished to make some remarks about the problems of the developing countries. He shared Mr. Gilchrist's gloom regarding the development prospects for 1971. Because developing countries were dependent on the economic situation of the industrialized countries, they were naturally concerned about the problems of developed countries. Developing countries hoped that the industrial countries would grow but under stable conditions. Stability was, in fact, a major problem which concerned them. He himself wished for two things: first, that the developed countries would be more cautious when trying to expand, particularly with respect to price stability; and second, that if the developed countries were determined to pursue expansionary policies, there would be a lengthy lag before the effects of those policies would materialize.

Turning to the point that the reserves of the developing world had been increasing, Mr. Kharmawan wondered whether it would be possible for the staff to indicate which countries had gained the most reserves and which countries had not gained any. He himself felt that rather a small number of countries had experienced increasing reserves. In addition, increased reserves seemed to have occurred in countries with relatively small populations. If that were the case, a few of the developing countries which had small populations and high reserves would not be very concerned about global developments in 1971. But he wondered what would happen to the rest of the developing world during 1971. Mr. Brofoss had mentioned that the increase in reserves of the developing world pointed to the fact that massive financial assistance had taken place. He himself believed Mr. Brofoss to be correct. He inquired how were the developing countries with few reserves expected to continue their development effort in the face of present world difficulties. Furthermore, he believed that countries did not like to ask for financial assistance; they preferred to be self-sufficient. In that respect, there were some ominous signs on the horizon. For example, there was a tendency in some countries to restrict imports. The staff indicated that the countries which comprised the Far East, excluding Japan, depended to a large extent on the export of manufactured goods for their livelihood. He wondered what would happen to the export earnings of those developing countries if industrial countries restricted imports. As far as the primary producing, developing countries were concerned, there were still the tariff problems of the Common Market and the problem of stockpile releases. Those additional problems would also affect the export earnings of developing countries. It was because he believed that the developing world wished to be more dependent on its own export earnings rather than on aid that he drew the attention of the developed countries to the trade difficulty, especially as the future was so uncertain.

The Economic Counsellor answered Mr. Kharmawan by reviewing what had happened during 1970. He himself did not believe that the improvement in the reserves of developing countries had been highly concentrated and had only affected a few countries with high incomes. It should come as no surprise that in a year when the United States had had a deficit of about $10.0 billion on the official settlements basis, the countries of the rest of the world, taken together, had had a surplus. In fact, 75 per cent of the countries in the rest of the world had experienced increasing reserves; conversely only 25 per cent had had decreasing reserves. As far as numbers were concerned, and looking at the distribution on a regional basis, Latin America, the Middle East, Asia, and Africa had all increased their reserves during 1970. The total increase in reserves had amounted to $2.6 billion through September 1970. That increase must have been one of the highest in any postwar period. In addition, SDR 1.7 billion had also been allocated to those regions. Moreover, all those regions had reduced their indebtedness to the Fund; taken together, repurchases had amounted to nearly $500 million in 1970. Furthermore, there had been practically no compensatory financing drawings during that period. The most recent list of countries that would on the basis of their export earnings be entitled to make compensatory financing drawings from the Fund had been less than 10. Of course, few of the countries that were theoretically entitled to make such drawings actually did so. Finally, with respect to the size of countries which had had increases in reserves, there had been the oil-producing countries, India, and Brazil.

Mr. Kharmawan said that while he had not commented upon the difference in reserves between developed and developing countries, he had remarked upon the reserve position of developing countries. In that respect, he had not challenged the fact that there had been an overall increase in reserves. The point at issue concerned the reserve position of developing countries per se. He felt that the total reserves of the developing world were concentrated in a few countries. Thus, with respect to import needs, the majority of those countries did not have adequate reserves for development efforts. He reiterated that developing countries were concerned about their exports. Finally, there was a tendency for developed countries to improve their balance of payments positions. But he was concerned that the developed world might improve its external position at the expense of the rest of the world.

The Executive Directors agreed to continue their discussion of the world economic outlook at a later date.

W. LAWRENCE HEBBARD
Secretary

APPENDIX I

## APPENDIX TO MR. DALE'S STATEMENT

### Two Growth Paths Consistent with the Economic Report

GNP in Current Prices
(Annual rate, billions of U.S. dollars)

| | 1970 | | | Year | | | | |
|---|---|---|---|---|---|---|---|---|
| | III | IV | Year | I | II | III | IV | Year |
| A. | 985.5 | 990.9 | 976.8 | 1,020 | 1,050 | 1,080 | 1,110 | 1,065 |
| B. | 985.5 | 990.9 | 976.8 | 1,035 | 1,055 | 1,075 | 1,095 | 1,065 |

Percentage Growth

| | 1970-1971 | 1970 III - 1971 III | 1970 IV - 1971 IV |
|---|---|---|---|
| A. | 9.0% | 9.6% | 12.0% |
| B. | 9.0% | 9.1% | 10.6% |

NOTE: A - Assumes about equal quarterly growth from 1970 IV level of GNP.

B - Assumes minimum estimated adverse effect of General Motors strike on 1970 IV GNP ($14 billion annual Rate) is made up in 1971 I, that 1971 I has further growth of $30 billion, and that quarterly growth thereafter is equal to $20 billion per quarter.

APPENDIX I

Comparison of Staff Estimates with U.S. Estimates

(Percentage rates of growth)

| | 1970 | | 1971 | |
|---|---|---|---|---|
| | Staff | U.S. | Staff | U.S. |
| 1. GNP | -0.4 | -0.4 | 3.5 | 4.5-5.0* |
| 2A GNP deflator | 5.3 | 5.3 | 3.9 | 4.0* |
| 3. Imports | 10.1 | 10.9 | 8.4 | N.A. |
| 4. Exports | 16.5 | 14.3 | 6.0 | N.A. |
| 8. Trade balance | 3.0 | 2.7 | 2.3 | N.A. |
| 9. Current account balance | 3.7 | N.A. | 3.6 | N.A. |

* Council of Economic Advisers' Report contains no explicit estimate, but these magnitudes appear broadly consistent with Council's Report.

APPENDIX I

Price Indicators

(Annual rates of increase, seasonally adjusted)

| | 1969 | | 1970 | |
|---|---|---|---|---|
| | 1st half | 2nd half | 1st half | 2nd half |
| **GNP Deflator** | | | | |
| Total GNP | 4.9 | 5.3 | 5.4 | 5.2 |
| GNP, ex autos | 4.9 | 5.4 | 5.6 | 4.2 |
| **Consumer Prices** | | | | |
| All items | 6.4 | 5.9 | 6.0 | 4.8 |
| Items other than food | 5.3 | 3.5 | 4.6 | 4.6 |
| **Wholesale Prices** | | | | |
| All commodities | 5.3 | 4.2 | 2.6 | 2.1 |
| Industrials | 3.6 | 4.2 | 3.8 | 3.4 |

APPENDIX II

APPENDIX TO MR. SCHLEIMINGER'S STATEMENT

Changes in German Balance of Payments in 1969 and 1970

(In billions of deutsche mark)

| | 1969 | 1970 |
|---|---|---|
| Exports (f.o.b.) | 113.5 | 125.3 |
| Imports (c.i.f.) | 98.0 | 109.6 |
| Trade balance | +15.5 | +15.7 |
| Services | -1.0 | -3.6 |
| Unilateral transfers | -8.4 | -9.5 |
| Current balance | +6.2 | +2.7 |
| Long-term capital | | |
| Banks | -10.8 | +1.0 |
| Corporations | -10.2 | -3.1 |
| Public authorities | -1.9 | -2.5 |
| Total | -22.9 | -4.6 |
| Short-term capital | | |
| Banks | +4.3 | +7.9 |
| Corporations | -0.3 | +6.5 |
| Public authorities | 0 | -0.4 |
| Total | +4.0 | +14.0 |
| Total capital transactions | -18.9 | +9.4 |
| Errors and omissions | +2.3 | +9.9 |
| Net official reserves | -14.4 | +22.7 |

| | | |
|---|---|---|
| Total net official reserves: | End September 1969 | 48.2 |
| | End 1969 | 26.3 |
| | End 1970 | 49.1 |