

September 10, 1987 - 87/3

Statement by Mr. Foot on the World Economic Outlook
(Preliminary)
Executive Board Meeting 87/134
September 11, 1987

The Short-Term Outlook

I found little to quarrel with in the staff's forecasts. But, if anything, I think the outlook could be viewed in a somewhat more favourable light than the staff do at times in the paper. Thus even though the recovery in the world economy has now run for longer than nearly all its predecessors, steady growth looks likely to continue in the industrialised countries; inflation remains at a comparatively low level; and the conditions for a substantial reduction in the imbalances among the largest countries are better than they were a year ago. I would also have thought that the staff projections for non-oil commodity prices in 1987 look low in the light of the developments of recent months and, consequently, understate the prospects for many LDCs.

2. Of course, as always, there are uncertainties some of which are touched on below. But I take some comfort from the review of the staff's forecasting record carried out by an external consultant recently which basically found that although the forecasts in some areas were subject to large margins of error they were not subject to systematic upward bias as has sometimes been argued.

The Medium-Term Outlook

3. Turning to the medium run, I again have little difficulty with the staff's projections (although assumptions might perhaps be a better word). I believe that we should however be careful before putting too much weight on the staff's estimates of productive potential. It has generally been difficult to identify sea-changes in trend productive potential until well after they have occurred. Certainly in the case of the UK economy there is cause for hope that the very considerable structural adjustment of the 1980s is bearing fruit in a faster rate of growth of productive potential; and the same may well be true in certain other industrial countries.

4. More generally, while the staff's alternative scenarios provided an interesting illustration of the key policy issues and strains in the

present situation, we should be cautious in our conclusions. In particular, it is easier to indicate the general direction of policy changes that we might find desirable than to quantify what should be done or specify the likely results over any given time period. There are several reasons for this. First, although the work the staff have put into the development of MINIMOD is very welcome, the model remains highly aggregated in nature. It is also important to note that the staff have used parameter estimates developed by others and I would welcome their (non-technical!) comments on the risk this approach brings, particularly on the argument that parameter estimates partly depend upon the structure in which they are estimated. Finally, the shadow of the Lucas critique inevitably looms large over any work of this nature. In light of these factors I believe that we are best to view the staff's work as illustrative. It certainly should not be regarded as providing the basis for setting quantitative policy targets or indicators.

Policy Issues

5. Turning to policy issues in the major countries, the main priority remains the need to reduce the external imbalances. Although the realignment of the major currencies that we have seen in the past 18 months or so has undoubtedly been helpful, the prospective imbalances remain large and further policy measures will undoubtedly be required. In particular the major countries need to implement the commitments of the Louvre Accord, if further significant exchange rate changes are to be avoided.

6. This chair had the opportunity recently to set out its views on the importance of further action on the fiscal front in the US in keeping with the Accord and I will not repeat them here. Germany and Japan also committed themselves to pursue policies to strengthen domestic demand and to be prepared to re-examine their policies if the intended strengthening does not materialise. As the staff note some additional measures are being put in place. Of particular importance here is the staff estimate that the recent package of Japanese measures will add 1½ per cent to the growth of domestic demand next year. I would welcome further staff elaboration, however, on how they reached this conclusion.

Promoting Growth in the Developing Countries

7. Particularly striking here were the staff's quantitative comparisons of economic performance between what they describe as the problem and non-problem countries. Most noteworthy, perhaps, was the difference in the effectiveness with which the two groups have utilised foreign savings. I would strongly endorse their conclusion that a more aggressive and outward looking approach to economic policy would be appropriate in many of the problem cases.

8. The staff are also right to stress that where appropriate policies are in place in the developing countries they will need to be supported by adequate financing. The Board discussed the related issues last week and again yesterday and will return to the particular question of enhancing the SAF next week. I will not, therefore, dwell on these issues again today.

9. I would, however, note some reservations about the way in which the staff present their estimates (on page 48 of EBS/87/182) of the possible effects of an increased financing flow on growth in the heavily indebted countries. We can probably all agree that such estimates are inevitably subject to enormously wide margins of error; but it is important to note also that, in a very real sense, they assume away the key issue by being based on the proposition that ideal policies are in place.

Statistical Problems

10. Finally, my authorities would like to record their continuing view that the world current account discrepancy needs to be analysed further. In this context, could the staff please say whether any attempt has been made to allocate to individual countries the aggregate \$65 billion share for 1986 in Table A30?