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Statement by Mr. de Groote on World Economic Outlook
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I found the innovations in the staff's World Economic Outlook most valuable in helping us to point out, for the Interim Committee members, the clear policy choices and potential conflicts on which they may concentrate their deliberations. Of course, the study of economic indicators can be expanded still further. In the context of a medium-term analysis, more attention will perhaps have to be paid to those domestic production relationships which have structural effects on international payments and trade patterns. My remarks today are partly intended to bring some of these elements into the discussion. They will focus on the following policy questions: What adjustment strategy is to be preferred for correcting the large trade imbalances among the industrial countries? Do we accept the implications of this adjustment, or do we prefer its postponement? Are we satisfied with the present state of international policy coordination? What is our position on the continuation of the debt strategy? My general conclusions with respect to these issues can be briefly summarized as follows:

An orderly correction of the trade imbalances among the largest countries critically depends on a sizable reduction in the U. S. budget deficit. But because this reduction has been postponed too long, it will now have to take place under conditions of lower growth and will have to be supported by additional measures which at first will hit growth even harder.

The prospect of a considerable slowdown may be so unpopular that procrastination will continue, in the hope that the adjustment can later be absorbed by a return to higher growth levels. Stubborn trade imbalances, creeping protectionism, and unsettled debt problems would then continue to affect the business cycle, so that output growth would remain sluggish, with neither a severe recession nor an equally vigorous rebound following it.

Under such conditions, the present degree of policy coordination can only produce partial stabilization. Coordination needs to be reinforced by the reintroduction of a systematic cooperation which will impose a sufficient degree of discipline on the members' policy choices to ensure the alignment of their domestic adjustment processes with the prescriptions of an orderly global adjustment.

The need to reconfirm the systemic principles of the debt strategy is especially urgent in this context. There exists a clear and present danger that debtors and creditors will find the burdens of adjustment and its financing too heavy, and will be led, by financial market pressures to interact on debt solutions whose result will be an indefinite postponement of the adjustment process indefinitely. There is, therefore, a greater need than ever to reaffirm that structural adjustment, supportive financing, and higher world demand are the only avenues for achieving lasting debt solutions.

1. 1987: A POSITIVE BALANCE AFTER ALL?

1.1. The prescriptions of the international adjustment process have been clearly established for quite some time now. A forceful correction of the fiscal position of the United States is urgently needed in order to align that country's internal absorption with its output and to reduce the large trade imbalances on which the present business cycle is built. Domestic demand in Europe and Japan has to be strengthened in order to offset the withdrawal of foreign demand and to support the international adjustment with the preservation of reasonable growth conditions. Exchange rate policies have to be closely coordinated in order to strike, at each stage, an appropriate balance between the restoration of dollar competitiveness on the one hand and the capacity of real and financial sectors to absorb additional dollar depreciations on the other.

Application of these prescriptions is also essential to create conditions for a durable and unrestricted expansion of world trade, within which the developing countries can achieve the possibility of pursuing adjustment and financing paths which promise the restoration of sustained growth in the medium term.

1.2. Recommendations along these lines are now generally endorsed in the economic discourse of policy makers worldwide. Developments so far in 1987 suggest that in a number of areas, positive adjustments may now be under way which from now on will influence the international background against which future economic prospects are to be assessed. The most visible sign of a positive turnaround in the adjustment process has been the major countries' successful implementation of their Louvre Accords of last February: exchange rate decisions have again been brought under a certain degree of international discipline, and for the first time during the present recovery, fiscal policies are now working to support the needed redistribution of demand among the major countries. From now on there is hope that exchange rate decisions will better reflect generally accepted views on the capacity of business sectors worldwide to adjust to changing currency patterns, and will be buttressed by additional policies capable of allocating domestic resources in line with desirable current account adjustments.

However, the emergence of a commonly accepted diagnosis, and the first prudent steps which have so far been taken in the direction of cooperative solutions, should not be taken for granted. The risk is as great as ever that if the additional policy measures which will be needed are neglected, then even these modest gains will be lost as the adjustment continues to unfold.

1.3. Of particular concern in the context of this peril are the conditions of slow growth under which the adjustment must proceed: because the economy was permitted to run out of steam under the threat of ever growing trade imbalances, the correction of those imbalances is likely to hit growth even harder. The staff's short-term estimate of output growth in the industrial countries, at around 2.5 percent, falls short of the 3.0 percent which their earlier projections had insistently predicted, and will also fall short of bringing about the kind of vigorous expansion of world trade which would enable the developing countries to grow out of their debts. Moreover, disaggregation of current growth indicators shows that the slowdown of domestic demand in the U. S. and the slow recovery of demand in its trading partners have in turn slowed the growth of output in the industrial countries to a rate below its potential, pushing the world economy onto the downward adjustment path which we have long considered the inevitable corollary of the current account corrections.

This prospect imposes difficult choices on the policy makers of the industrial and developing countries. The Fund staff's analysis concludes that if choice is to be made between an adjustment imposed by unilateral dollar depreciation, and an adjustment directed by intensive policy cooperation, the latter is far preferable because it promises to yield the most favorable mix of growth and current account corrections. I do not disagree with this preference in the terms in which it is posed in the staff's analysis, but would ask the Board also to consider the antecedent question whether there will be an occasion to make such a choice. I shall develop the possibility that any kind of adjustment may be fundamentally delayed because unless there is a strong reversal in the pattern of international capital flows, the industrial countries will indefinitely prefer to postpone, as long as possible, the inevitable cyclic slowdown which will accompany adjustment. The central problem this possibility presents for policy consideration is to judge whether the cure of an immediate adjustment is not still preferable to the more tempting decision to postpone adjustment in the hope that the imbalances will in the course of time be absorbed naturally through the restoration of higher structural growth levels.

The policy choices imposed on the developing countries have likewise become critical, with the deterioration of general growth conditions. Because they no longer believe that debtor countries will be able to outgrow their debts, the participants in the debt strategy now propose reducing the high debt levels, instead of rescheduling. I am concerned that the solutions imposed by this new perception may turn out to be deceptive. There is a danger that such a reorientation of debt management principles will undermine the validity of the present strategy by seriously delaying the pursuit of structurally oriented adjustment, on which it is based. The Board should therefore strongly reaffirm its conviction that the Baker plan is basically sound. And because this plan will have to be implemented under conditions of lower growth, lasting debt solutions must now more than ever be built on structural adjustment and on supportive financing arrangements.

2. INTERNATIONAL ADJUSTMENT: UNDER WAY OR POSTPONED?

2.1. The Staff's Proposed Adjustment Choices

2.1.1. The staff's reference scenario for the outlook of the industrial countries expects that current fiscal policies and exchange rate configurations will only moderately reduce the external imbalances among the largest countries over the medium term. This improvement will result mostly from the effects of past currency realignments; although fiscal policies are now supporting, rather than delaying, the adjustment, their contribution will remain only marginal unless additional measures are taken. The staff's reference scenario also shows that the brunt of the adjustment, whether in terms of impending trade realignments or in terms of output performance as a function of output potential, will probably be borne by Europe. This unpleasant side effect of the present adjustment process suggests that for years to come Europe may not be able to achieve growth rates sufficient to absorb, or even to stabilize, its alarming unemployment levels.

The possibility that extrapolation from the reference scenario will translate into an unsustainable growth of the U. S. external indebtedness position was a legitimate reason for the staff to propose alternative scenarios predicting stronger balance-of-payments adjustments, whether achieved under the pressure of exchange market forces or as a result of cooperative policy efforts. Let me briefly review the conclusions of these alternative scenarios.

2.1.2. The staff's "Non-Accommodating Finance Scenario" gives a worrisome demonstration of the chain of perverse reactions which would be unleashed by a disorderly depreciation of the U. S. dollar due to a loss of confidence on the part of foreign dollar asset holders. U. S. interest rates would be driven up sharply by the combined influence of the financial markets, which would still need to finance the external deficit, and the efforts of the Federal Reserve to curb inflationary pressures stemming from the rise in import prices. Because the fiscal deficit would still be much larger than justified by the domestic savings situation, the crowding out effect on private investment would be particularly severe. The decline in aggregate demand would overshadow any gains in export performance for years to come, and the U. S. economy would be pushed onto a depressed investment path from which it could not recover until the early 1990s.

Similar regressive adjustment patterns would be imposed on Europe and Japan by the shrinkage of their export markets and the loss of confidence of their domestic business sectors. The decline of demand in these regions would spill back into the U. S. economy and increase the danger that despite a falling dollar, U. S. exports would continue to fall, driving the dollar down even further. In the end, the exchange markets would impose on the U. S. economy a current account pattern consistent with stable financial flows, but this result would bear the price tag of an overall reduction in world economic activity too great to be justified from the standpoint of global adjustment.

2.1.3. This risk is now generally well enough perceived to motivate exploring the intensification of cooperative adjustment policies recommended under the staff's preferred adjustment scenario. This scenario irrefutably concludes that no matter what mix of policies the largest countries agree on to support the twin goals of adjustment and growth, a sizable reduction of the U. S. fiscal deficit will be essential for reducing the existing trade imbalances to acceptable levels. Only forceful implementation of U. S. budget plans will suffice to retain the confidence of foreign dollar asset holders, and create the stable financial conditions needed for a durable crowding in of the productive investment and export sectors. In time, the reduction of domestic absorption would permit relaxation of monetary conditions to the point where a moderate additional dollar depreciation could complete the balance-of-payments adjustment.

The staff concludes that the positive contributions Germany and Japan together could make to support this adjustment through fiscal expansion measures would definitely be smaller than U. S. government circles want to believe. I do not contest the contention that the staff's partial conclusion probably underestimates the global benefits which could flow from a financial easing in those two countries through a positive spilling over into other, smaller economies, but I also note that the ability of the U. S. to evade the necessity of correcting its own imbalances is becoming weaker the longer the adjustment is postponed.

2.2. <u>Will the Adjustment Take Place?</u>

2.2.1. I do not contest the validity of the staff's medium-term scenarios, nor their insistence on a durable correction of the internal imbalances of the U. S. economy combined with the adoption of supportive policies elsewhere. However, I would also like to submit for consideration a totally different possibility, namely that the adjustment will not take place because U. S. policy makers will continue to prefer its postponement as long as possible. No matter how self-evident the staff's plea for a forceful and cooperative adjustment may be, it will avail little against an inertia which is likely to impose sluggish growth on the economy for years to come, with neither a real recession nor an offsetting real recovery in sight. The inability of the U. S. economy to heal its internal conflicts without accepting the risk of a recession, coupled with the continued willingness of the financial markets to absorb smaller, but still large external deficits, would provide the setting for such a scenario. The following considerations highlight the possibility that such a scenario will be played out.

Foreign asset holders' willingness to extend their dollar exposure will continue to be narrowly determined, at least through the short term, by international interest rate developments. Earlier scenarios for a disorderly adjustment of the U. S. imbalances have all been based on the assumption of an impending slowdown of economic activity in the U. S. which would be answered by a relaxation of monetary conditions adversely affecting foreign investors' confidence. These scenarios further anticipated that the unleashing of strong exchange rate market pressures and the rekindling of inflationary expectations would soon return interest rates to even higher levels, saddling the U. S. economy with a long period of low growth and high inflation. Current economic indicators and projections, however, do not contain the seeds from which such scenarios can grow: on the contrary, they suggest that following the relapse of early 1987 the U. S. could again be heading for a period of reasonable expansion supported by sustained demand and a moderate recovery of the U. S. export sectors. Under these kinds of conditions, worries about growth would not stand high on the policy agenda of the Federal Reserve Board, and monetary policy would continue to be directed at curbing the latent inflationary pressures produced by the present high degree of capacity utilization and by the risk that the dollar might depreciate too rapidly. The recent decision to increase the U. S. discount rate fully supports this view. In other words, the prospect of continuous positive growth and employment performances and the absence of any imminent policy changes could very well create a situation permitting the U. S. economy to remain afloat on a large budget deficit and high foreign indebtedness for years to come.

Paradoxically, it is precisely the government's deliberate decision to break out of the present inertia in order to meet the worldwide requirements on a U. S. budget correction, which could create the initial conditions for foreign asset holders to trigger a disorderly depreciation of the dollar, with potentially damaging consequences for everyone. Because the government's plans for eliminating the public deficit by 1991 are based on growth assumptions which are too optimistic to be true, compliance with the deficit targets will have to be achieved from now on by means of additional measures. These measures will initially damage growth without being offset in a timely manner by a crowding in of the domestic investment and export sectors. In such a situation, the maintenance of tight monetary policies in the face of lower growth prospects will be critically essential to maintaining orderly adjustment conditions in which a natural decline of interest rates can later be expected. However, the U. S. government seems to have a firmly articulated but opposite view of the issue: during the recent consultation discussions with the Fund, they reiterated that they would not use monetary policy to defend the dollar if the cost of doing so would be to plunge the economy into a recession. This stance could establish a combination of loose money and tight budgeting, the mirror image of the policy mix which produced the dollar appreciation of the early 1980s, and could trigger the unwarranted dollar decline of which a disorderly adjustment is the inevitable sequel.

2.2.2. The above analysis is not intended to replace the staff's scenarios as the most likely or desirable outcome; nor is it intended to cast doubt on the urgency of the U. S. budget correction. Its purpose is to illustrate the many uncertainties which still surround the present adjustment process. Even though, for example, rational economic thought would expect dollar asset holders to respond positively to the prospect of smaller U. S. budget deficits, the accompanying slowdown of economic activity and relaxation of monetary policy could well provoke negative reactions which are hard to predict. Even more importantly, these propositions are put forward as shedding additional light on the internal contradictions of the U. S. economy, which can probably not correct its imbalances in an orderly way without also having to swallow the bitter medicine of a recession. That is a prospect unpopular enough to make the longest possible postponement of adjustment the most likely outcome.

Uneasiness with this prospect also explains the great importance which U. S. policy makers have recently begun to attach to improving the weak competitiveness of U. S. industry, as a structural move which would help the economy outgrow its present adjustment problems. Though it should be considered neither a panacea, nor allowed to be a palliative permitting postponement of the correction of internal imbalances, this emphasis on the problematic international competitiveness of U. S. industry should be actively supported. First, it sounds a welcome new note in the internal political debate, following a period when the only way to resist protectionist pressures seemed to be to provoke additional dollar depreciation. Second, the advent of the general growth conditions which would align U. S. internal absorption with the domestic savings rate will largely depend on the ability of U. S. industry to generate additional savings through the recovery of its foreign trade segments. Third, worries over the weak competitiveness of U. S. foreign trade are a correct reflection of the structural damage that prolonged dollar appreciation may have inflicted on U. S. business by enabling foreign producers to establish beachheads in U. S. markets.

Structural preoccupations with the weakness of the U. S. current account have recently refueled interest in the long-term aspects of the present adjustment process. U. S. Treasury officials have reintroduced into the economic debate the suggestion that it was an upward shift in private investment, rather than excessive absorption produced by growing public deficits, which explains the prolonged past concurrence of dollar appreciation and rising trade deficits. 1/ In brief, they suggest that instead of loose budget policies, it is rather the combined effect of a drop in the national savings rate caused by below-trend growth in personal income, and above-average growth in private investment demand, which has created the present resource gap in the U. S. economy. These observers implicitly suggest that the present balance-of-payments configuration may be a symptom of a long-term process of adaptation to changing production relationships, from which a more balanced economy will emerge over time. Unlike many other industrial countries, the U. S. has seen its adjustment process directed from the outset by the continuous, rapid absorption of large labor supplies, made possible by the great flexibility of the nation's labor market. This successful absorption has created favorable investment conditions which continue to attract international capital flows by the promise of high output productivity of investments and the expectation of a high return on equity. Such arguments at least suggest that we should consider the possibility that the U. S. will continue to postpone budgetary deflation in the hope that adjustment can later take place painlessly through natural reabsorption following the achievement of higher growth levels.

2.2.3. To conclude this discussion of the possibility that the correction of the U. S. imbalances will be postponed, I would like to

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1/ Michael K. Darby (Assistant Secretary for Economic Policy, U. S. Treasury Department), "The Current Account Deficit, Capital Account Surplus, and National Investment and Saving": Unpublished paper, May 28, 1987.

submit the following policy implications to further consideration by the Board. The large imbalances which have appeared among major groups of countries cannot be considered as solely the result of divergent financial policies adopted by the largest members in response to the present business cycle. The likelihood that neither the reestablishment of sound currency relationships, nor the closer coordination of demand management policies, will succeed in eliminating these imbalances over the medium term, suggests that other, structural forces must also be at work. To spotlight just one aspect of these underlying forces, it will suffice to mention the fundamentally conflicting adjustment positions reflected by the high-employment/low competitiveness situation of the U. S. economy, the existence of an opposite configuration in Europe, and the outstanding performance of Japan on both counts. Reconciliation of these conflicting positions with the prescriptions of an orderly global adjustment will require major policy contributions from each partner and will require an especially high degree of international cooperation.

The magnitude of the tasks ahead, and the complexity of the policy situations which will emerge further down the road, are perhaps best illustrated by tracing the special role international capital flows have played in the present adjustment process. The total deregulation of their capital markets has recently become, for many governments of industrial countries, the focal point and chosen symbol of their policy programs for fundamental reform and liberalization of their economies. Strangely, these governments share equally strong disappointment over the adjustment pattern that these deregulated financial markets are now imposing on the world economy. They openly regret that the U. S., despite its position as the dominant economy, has been permitted to tap the international capital markets in order to finance its own domestic expansion; that Japan, despite its enormous internal growth potential, continues to export large excess savings; and that Europe, despite its unprecedented purging of structural rigidities, must still increase the structural flexibility of its labor markets in order to meet the stiff demands imposed by the financial markets on the international location of investments. They are also unanimous in condemning the unbearable adjustment burden the financial markets are now forcing on the developing countries: the structural reforms which these countries must accomplish, from now on under conditions of low world demand, are made even more difficult because the financial markets have decided no longer to support them.

In sum, it is not solely the partial tensions created by the U. S.'s external indebtedness, but rather the combined effect of all the above mentioned circumstances, which added together have led to the present unsustainability of world imbalances. Admittedly, divergent policy choices by major groups of countries go far to explain the emergence of these imbalances, but there is no doubt at all that international capital flows have amplified them and contributed to their present intractability. Moreover, because such flows generally encourage, rather than discourage, the postponement of successful adjustment, they have also fueled the recent buildup of the protectionist pressures which persistent trade imbalances invariably produce.

I am not suggesting that the rapid globalization of world financial markets should be delayed or reversed; from the present pattern of international capital flows, it can be concluded instead that globalization is capable of imposing, on countries' adjustment efforts, a structural discipline which no temporary policy coordination can easily achieve. There are no international prescriptions, nor is it likely that any economic crisis situation will teach the U. S. economy to live within its means or show Japan how to make the best possible use of its structural payments surpluses. Each country must decide for itself how best to further its own structural adjustment with internationally consistent solutions, bearing always in mind that any postponement increases the risk of squeezing the world economy, for years to come, between the strains of persistent exchange rate uncertainty, increasing protectionism, and unsettled debt problems. The need for international cooperation becomes particularly demanding in this context, and the temporary compromises the largest countries are now willing to accept in their own self-interest cannot meet it. To be successful, cooperation must grow out of the re-establishment of relationships and rules of conduct which promote economic stability by means of systemic interventions and the pursuit of global adjustment solutions. The Fund must never lose sight of these principles in its periodic deliberations, and should constantly remind its members of the benefits which systemic discipline can produce for the successful pursuit of their own structural adjustment processes. It analysis of economic indicators gives the Fund a powerful tool for promoting these ideas.

3. THE INTERNATIONAL DEBT STRATEGY UNDER SIEGE

3.1 Persistent Strains on the Developing Countries' Adjustment

The staff's medium-term scenario for the developing countries predicts that these countries' domestic growth performances and external payments positions will gradually recover from their recent lapses. But these fairly optimistic expectations give no grounds to be complacent: their fulfillment depends critically on the absence of any further deterioration in external demand and financing conditions, and will not solve the protracted problems faced by most of the low-income countries. Even with the most optimistic growth assumptions the rate of improvement in living standards in these countries remains unacceptably slow, and negative financing trends will continue to drag out their long-term development processes.

A more serious source of concern is that even the present conditions of world demand and private lending trends will already seriously hamper the debtor countries' ability to achieve structurally oriented growth. In this connection, the historical series presented on page 46a of the staff report leads to the highly relevant conclusion that during the 1970s, the growth performances of developing countries were continuously supported by favorable lending trends, while in the early 1980s, it was the recovery of real export growth which briefly enabled them to outgrow the ongoing shift to negative lending trends. The staff does not fully reflect these historical relationships in its analysis and assigns them no dominant role in the assessment of the developing countries' output prospects. Instead the staff expects that the continuation of the structural adjustment process will gradually enable these countries to reduce their dependence on large external borrowings and achieve sustained internal growth without being closely tied to the fluctuations of world demand. I do not dispute that this is the most desirable outcome of the present adjustment process, but I submit that it is a more likely outcome that no adjustment will durably succeed unless it is supported by higher world demand, larger financial resources, or a balanced combination of the two. The damage done to the adjustment process by the lack of sufficient financing is already visible in the depressed investment levels of many countries, and casts additional doubt on their capacity to achieve structural output growth on their own.

Our discussion last Friday on the most recent developments in the international capital markets suggests that the participants in the debt strategy are not yet prepared to accept this lesson. Instead of increasing their support of structural adjustment during a period of low world demand, they seem to have concluded that no structural adjustment efforts can justify forceful commercial bank support until such time as world demand conditions improve sufficiently for existing debt levels to be reabsorbed through higher exports. They insist instead that excessive debt levels must be reduced until the value of old debt is restored. I am concerned that this reorientation of debt management principles will have far-reaching implications for the continuation of the present debt strategy and will damage the fundamental principles on which that strategy is founded.

3.2. Policy Responses

Sustained demand in the industrial countries, structural adjustment in the debtor countries, and sufficient financing from the creditors have since our adoption of the Baker strategy been considered the only valid combination from which lasting debt solutions can be expected. Because the first condition has not been met, the burden has accordingly shifted to adjustment and financing, and there is now a real danger that creditors and debtors alike will be led by the pressure of market forces to reduce their respective roles in the present strategy. That this possibility cannot be disregarded is already demonstrated by nascent acceptance of the idea that the high discounts in the secondary market for sovereign debt indicate the direction of a market-imposed resolution to the debt problem and that from now on, debtors and creditors should both agree on mutually shared schemes for the reduction of excessive indebtedness levels at their present market values. The banks have clearly strengthened their balance sheets sufficiently to enter into such schemes, the indebted countries would be relieved of the high adjustment burdens which their present debt levels impose on their economies, and the general availability of a market-related debt resolution scheme would seem an attractive alternative to the present deadlock. However, these short-term benefits would still be greatly outweighed by the more fundamental disadvantages which would accompany an indefinite postponement of the structural adjustment process for years to come, if the premise of supportive financing arrangements is no longer being met.

It is with these preoccupations in mind that I invite the Board to reconfirm the following principles of the Baker strategy: strong and sustained adjustment is the only valid strategy for growing out of the present debt problem. Supportive financing arrangements must be accepted as a necessary corollary of this strategy, especially during the present conditions of low world demand. However, because sound financing decisions must also be justified by the debtor countries prospective ability to service their debts, the uncertainties which the present world imbalances impose on future world demand need to be reassessed in the light of the debt strategy. It is urgent to ease these uncertainties by the application of forceful adjustment solutions in the industrial countries in order to create trade and output conditions which will favor the indebted countries efforts to generate the payments surpluses required to service their debts and encourage them to reform their economies in accordance with outward-looking principles.

Reconfirmation of these basic principles has direct implications for the continuation of the Fund's roles in the debt strategy. Continuation of the Enlarged Access Policy at present access limits, strong support to the principle of the SAF enlargement, and thorough preparation of a substantial quota increase are the general recommendations through which the role of the Fund in the structural adjustment process is to be supported.

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