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Minutes of Executive Board Meeting 87/47

3:00 p.m., March 16, 1987

M. Camdessus, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
A. Abdallah	
Dai Q.	
C. H. Dallara	
J. de Groote	
A. Donoso	E. V. Feldman
M. Finaish	
G. Grosche	
	J. Reddy
	J. R. N. Almeida, Temporary
	M. Foot
H. Lundstrom	
M. Massé	
	C. V. Santos
Y. A. Nimatallah	I. A. Al-Assaf
	L. Filardo
H. Ploix	
G. A. Posthumus	J. de Beaufort Wijnholds
C. R. Rye	C.-Y. Lim
G. Salehkhou	O. Kabbaj
A. K. Sengupta	
K. Yamazaki	M. Sugita
S. Zecchini	

L. Van Houtven, Secretary
L. Collier, Assistant

Also Present

African Department: A. D. Ouattara, Director; M. E. Edo. Asian Department: V. Mendras, A. K. McGuirk, B. J. Smith. European Department: B. E. Rose, Deputy Director; K.-W. Riechel. Exchange and Trade Relations Department: C. D. Finch, Counsellor and Director; M. Guitián, Deputy Director; S. J. Anjaria, G. Bélanger, C. M. Watson, M. Xafa. External Relations Department: H. O. Hartmann, J. M. Landell-Mills. Fiscal Affairs Department: V. Tanzi, Director; A. H. Mansur. IMF Institute: O. B. Makalou. Legal Department: J. V. Surr. Middle Eastern Department: S. Von Post. Research Department: J. A. Frenkel, Economic Counsellor and Director; A. D. Crockett, Deputy Director; F. C. Adams, J. M. Boughton, M. C. Deppler, P. R. Fenton, R. D. Haas, N. M. Kaibni, M. D. Knight, F. Larsen, P. R. Masson, E. A. Milne, A. Mirakhor, P. E. Rourke, E. Y. P. Tung, M. A. Wattleworth. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; E. Hernández-Catá, Y. Horiguchi. Bureau of Statistics: A. K. M. Siddique. Personal Assistant to the Managing Director: R. M. G. Brown; Advisors to Executive Directors: P. E. Archibong, A. Bertuch-Samuels, L. P. Ebrill, G. D. Hodgson, J.-C. Obame, P. Péterfalvy, Song G., D. C. Templeman, A. Vasudevan. Assistants to Executive Directors: A. R. Al-Abdullatif, H. S. Binay, F. Di Mauro, V. J. Fernández, M. Hepp, G. K. Hodges, J. M. Jones, S. King, M. A. Kyhlberg, V. K. Malhotra, D. V. Nhien, L. M. Piantini, S. Rebecchini, G. Seyler, H. van der Burg, E. L. Walker, Yang W., I. Zaidi.

1. WORLD ECONOMIC OUTLOOK - PROSPECTS AND ISSUES

The Executive Directors resumed from the previous meeting (EBM/87/46, 3/16/87) their consideration of a staff paper on prospects and issues relating to the world economic outlook (EBS/87/39, 2/24/87; Cor. 1, 3/10/87; and Cor. 2, 3/12/87), together with background material on recent developments and short-term prospects (SM/87/54, 2/25/87) and a statistical appendix (SM/87/55, 2/25/87). They also had before them a staff study, prepared in response to requests by some Directors at earlier discussions of the world economic outlook, on potential output in the major industrial countries (SM/87/40, 2/12/87).

Mr. Abdallah made the following statement:

The apprehension expressed by some of us in September 1986 about the pace of global economic activity has been borne out by the current world economic outlook exercise. While it is apparent that many countries, both developed and developing, have succeeded in minimizing the threat of inflation, uncertainties abound as to whether the recovery that began a few years ago can indeed usher in a period of sustained economic growth for the international community. The optimism of the year before concerning the performance of industrial economies has not been borne out by reality, owing largely to the slow pace of investment spending, which at this point of the recovery reflects the persistence of uncertainty among industrialists and businessmen.

The pace of economic growth slowed in 1986; and most worrisome is the fact that the outlook for the near future is also not encouraging. Moreover, the developing world--particularly the low-income countries--is likely to continue experiencing grave hardships. The African economic scene, in particular, remains grim as many sub-Saharan countries have been severely affected by the decline in commodity prices, leading to a drop in the median growth rate in 1986. This contrasts markedly with the robust growth performance recorded in the aggregate by primary product exporting countries--a picture which itself is highly skewed because of the exceptionally high growth experienced by two large countries included in that category.

The poor performance of African countries with respect to aggregate output has led to an uninterrupted decline in per capita income since 1981, with no significant reversal of the trend in sight for the next few years. This is a disquieting prospect, given the low absolute level of per capita income in the region. In this connection, I welcome the attempt by the staff to discuss, in the paper on recent developments and short-term prospects (SM/87/54), the welfare implications of the economic slowdown and adjustment process in developing countries. Behind the numbers lies a tragic story: the lowering of nutrition standards, falling incomes, less access to basic health care, declining educational opportunities, rising unemployment, and so on. These are the consequences of adjusting in a deteriorating economic environment. Adjustment is not a neutral process; it involves serious distributional and welfare consequences that must be taken into account in the design of adjustment programs. All the countries in my constituency face serious adjustment problems. We therefore cannot emphasize strongly enough the need for strong cooperative efforts to revive those economies that are at the bottom of the development ladder. It would thus have been helpful if the main paper on prospects and issues (EBS/87/39) had included a more pointed discussion of the welfare issues arising from the continuing economic decline of the low-income countries. Such an exercise would reveal more clearly the human dimension of economic adjustment and convey some understanding of the agonies facing policymakers of many countries where absolute poverty is spreading among growing segments of their population.

An international economic system that gives rise to hardship and deprivation of the present scale and intensity is definitely out of joint. It is in need of fundamental reform, and the Fund staff must never tire of drawing attention to what a conservative British leader, who felt that the free market system could do better--as many of us agree--called "the ugly face of capitalism."

Having said this, let me now turn to the various policy issues to which we are invited to pay attention in Section V of the main paper.

The two overriding questions for the major industrial countries that have implications for the rest of the world are the need for them to ensure coordination of economic policy among themselves in order to inject momentum into the global economy and to pursue an orderly reduction in current account imbalances among themselves. It is crucial to note in this connection the role that the United States has to play in moving quickly to consolidate its policy of fiscal restraint. There have been indications of the U.S. Government's intention along those lines, but as the report shows, absorption in the United States, reflecting largely the stance of fiscal policy, increased at a faster rate than potential output in each year from 1983 through 1986. In the words of the staff, "the improved fiscal outlook in the United States has yet to show up in a major reduction in the recorded deficit." With regard to the other two major industrial countries, Japan and Germany, their relatively strong fiscal positions provide some room for a less restrictive fiscal stance to supplement investment in the private sector. However, the large increase in investment projected under the medium-term scenario leaves a great deal of uncertainty as to the extent to which aggregate demand in these two countries can become the engine of growth for the international economy. In any event, it is significant that no major change is expected in the aggregate current account position of the major industrial countries vis-à-vis the rest of the world, implying that no significant change in the transfer of resources to developing countries is expected. This scenario has serious implications for the adjustment process since inadequate flows of external resources to developing countries is one of the major factors inhibiting the evolution of the adjustment process in a symmetrical and harmonious manner.

This brings me to the outlook for developing countries. My general reaction to the staff's assessment is to caution against being too optimistic about the waning of the debt crisis and the prospect of achieving adjustment with "reasonable" rates of growth. It should be noted that the rate of growth projected for developing countries in the staff's scenario assumes a substantial increase in domestic investment, which will entail a massive effort to limit consumption and increase saving and to expand the export sector in order to earn sufficient foreign exchange to finance the import component of investment. The probability of these assumptions being realized is not high considering the declines in living standards that have already occurred.

In attempting to cope with their problems, it is essential that developing countries remain committed to the policy of orderly adjustment. But the complexity of the situation is such that for many developing countries, especially low-income countries burdened by debt, the international community must go beyond financial stabilization to the much broader issue of economic development with all its implications. The structural adjustment facility could be a most useful mechanism to this end since the limitations inherent in the traditional policy of stabilization are now so well known.

It follows therefore that progress toward adjustment with growth in all indebted countries depends to a large extent on how the debt problem is handled. The staff makes a useful distinction between countries that have a liquidity problem, namely, an inability over the short run to meet their debt-servicing obligations, and countries that appear incapable for the foreseeable future of meeting these obligations. (Some observers have referred to this as the liquidity problem versus the solvency problem.) The latter group of countries is made up largely of low-income countries that have accumulated external payments arrears far in excess of even total annual export earnings. What is to be done about these countries is best left to the Board's forthcoming discussion on the debt strategy.

Finally, there is the question of international cooperation in which the Fund has an essential role to play through multilateral surveillance. It is imperative that multilateral surveillance be universalized and strengthened so that a representative group such as this Board has a direct role in the process and is not left on the sidelines as at present. This development need not exclude useful contributions from other forums either before or after consideration by our Executive Board. Current procedures are eroding the authority of the Fund, something we cannot accept.

Mr. Feldman made the following statement:

We would like to commend the staff for the comprehensive work it carried out in analyzing the world economic outlook; the analysis of economic interactions and policy issues involved in this work undoubtedly has great relevance for predicting economic performance in industrial and developing countries. Let me stress from the start, however, that we feel that some crucial aspects that are strongly associated with the central issues of external balance and maintenance of noninflationary growth in industrial countries and of strengthening investment and growth in indebted countries would have deserved, in some cases, more emphasis and stronger recommendations from the staff, and, in other cases, a more symmetrical treatment. In saying that we are basically referring to such questions as structural reform in industrial and developing countries, the increasing reluctance of commercial banks to lend either on a concerted or voluntary basis to indebted nations, and the difficulties of increasing investment in heavily indebted countries as well as the adjustment lags involved in the investment decisions.

The world economic performance for 1986--characterized by a deceleration of growth in industrial countries, despite the steep gains in their terms of trade, and by strong difficulties for developing countries, which faced sharp commodity price declines and severe limitations on the availability of external finance--has been disappointing. What is worse, the prospects for 1987 and following years are clouded by a number of uncertainties related to the persistence of financial imbalances and structural factors that may hinder growth in industrial countries, as well as to the challenge facing the developing world, especially the heavily indebted countries, of recovering the per capita income levels that had been attained prior to the 1982 crisis.

Most of these uncertainties are well analyzed and documented in the staff papers and have been discussed by other Executive Directors; I shall therefore concentrate my comments on two basic issues. The first relates to the question of structural reform in industrial countries and its implications for these nations as well as for developing nations' prospective growth. The second issue relates specifically to the investment-saving process in developing countries, especially in heavily indebted countries. In many senses, both questions are interrelated and both may, in my consideration, become critical obstacles to a better performance of the world economy.

On the question of structural reforms in industrial countries, a principal reason for the disappointing growth performance in these countries seems to be related to the fact that a considerable part of the terms of trade gain did not reach final consumers. In the recent Board discussion of the Article IV consultation with Japan we had the opportunity to comment on the slow pass-through of recent terms of trade gains to consumers as reflected by the wide gap between wholesale and retail prices. The explanation lay precisely in structural rigidities and lack of competition, features which seem to be present in several other countries' distribution systems. Terms of trade gains also appear to have resulted in higher profit margins, which so far, however, have not given any greater impetus to spending decisions. The staff conclusion was that the propensity to spend of those who gained from the terms of trade changes appear to have been significantly lower than that of those who lost. This conclusion is a matter of great concern as we feel that the structural problems involved constitute a major deterrent to growth prospects. Exchange and interest rate realignments in industrial countries do not seem by themselves to provide sufficient macroeconomic adjustment to consolidate a steady growth rate.

The other important question pertaining to the question of structural reform in industrial countries is protectionism. Large subsidies to agriculture and the maintenance of trade barriers to protect several manufacturing sectors in the developed countries remain a major obstacle to reinvigorating trade flows between industrial and developing countries. Although this has been recognized again and again, it is hard to understand, at least on technical grounds, why the dismantlement of trade restrictions--especially in agriculture--is not seen as an appropriate way to allow highly indebted countries to expand exports and consequently to be in a better position to pursue with a greater chance of success a strategy of growth with adjustment. But perhaps more important from the perspective of industrial nations, it is also difficult to understand why the rolling back of protectionist practices, by inducing larger volumes of commodity imports from developing countries, is not seen as simultaneously allowing more industrial exports to these countries, this way contributing to an abatement of the current unacceptable rates of unemployment in Europe. It is true that most industrial countries need structural measures to reduce labor market rigidities; but is it not worth promoting trade liberalization, bringing about in this way a better economic situation for all nations and allowing many industrial countries to leave behind the current two-digit rates of unemployment?

Perhaps the staff could comment further on these issues, especially as on page 23 of the main paper it is stated that "there are no clear reasons to expect further major changes in...the ease of access to industrial country markets."

On the question of investment and growth in developing countries, I would like to draw attention to Table 4 in EBS/87/39 on the medium-term scenario for capital importing developing countries. One could consider the category of countries with recent debt-servicing problems, although it is perhaps more convenient for analytical purposes to concentrate on the group of 15 heavily indebted countries, whose investment ratio for the period 1988-91 will be 4 percentage points higher than in 1986, increasing from 16.8 percent to 20.8 percent. This recovery in the investment ratio would allow these countries to accelerate their real GDP growth from about 3.5 percent in 1986 to 4.7 percent during the years 1988-91. I agree with the staff that this would obviously imply a drastic improvement in the quality and efficiency of investment projects carried out in developing countries; there is certainly room to move away from the very high incremental capital output ratios of the 1970s.

In other words, there is no doubt that the productivity of investment and the overall efficiency of the economies will have to rise a great deal. But this is not the issue. The issue is that a rise of 4 percentage points in investment ratios in the forthcoming years--a rise which is moreover supposed to come basically from private investment--is unthinkable and unrealistic, given the basic features of the medium-term scenario depicted in the staff documents. By 1984, heavily indebted countries had achieved a dramatic improvement in their external accounts at the expense of costly reductions in output, employment, and wages. Servicing the debt implied a sizable transfer of resources abroad, which is reflected in the drastic fall in investment ratios of about 7 percentage points, comparing present levels with those prevailing before the 1982 debt crisis. Unfortunately, this unprecedented adjustment effort suffered a serious setback in 1986, partly as a result of slippages in some developing countries' macroeconomic policies, but mainly owing to further declines in the prices of basic commodities. As is shown in the Statistical Appendix, export unit value for the 15 heavily indebted countries dropped by more than 25 percent during the period 1982-86. Debt ratios are much worse now than they were four or five years ago, implying the need to prolong adjustment. Given the prevailing uncertainties, prolonging adjustment may be viewed in indebted countries as the need to perpetuate adjustment; if so, it is hard to foresee a recovery in private investment.

But there are other factors to consider in the medium-term scenario proposed by the staff. First, the staff's projections indicate that real commodity prices will not have recovered by 1991 to their 1986 level and will be some 30 percent below the level prevailing in 1980. Second, as stated before, there are no reasons to expect an attitude in favor of rolling back protectionism in industrial nations. These two factors seem, in principle, to run counter to any incentive for capital accumulation in export-led activities in developing countries, a circumstance that cannot be offset irregardless of what appropriate exchange rate policies are implemented. This situation contrasts sharply with the historical opportunity enjoyed during the 1960s and early 1970s by several countries--notably in Southeast Asia--which at present can be treated separately from the developing world and have been labeled "exporters of manufactures."

Third, there is the matter of limiting consumption in favor of savings and of generating the foreign exchange needed to finance the import component of the projected increase in investment. It is worth noting that living standards in most developing countries are today well below their levels at the end of the 1970s. Moreover, to achieve an increase in savings would require further financial liberalization, which in turn would likely imply, at least in the first stages, much higher real interest rates than those that prevailed before financial deepening. It is apparent, however, that the faster fiscal consolidation is achieved, the greater the chances of shortening the transitional period of high interest rates. In the meantime, doubts may arise about a rapid response from private investors in developing countries, especially if they have been used to subsidize credits for long periods. Moreover, if fiscal discipline requires further adjustments in the level of public investment, this will also add uncertainty to private investment decisions, as in most developing countries experience indicates that public investment has traditionally led private investment.

The fourth and last factor to be considered is the bleak picture for external financing flows to developing countries, given the present reluctance of commercial banks to engage not only in voluntary lending but also in concerted lending--a question to be discussed in the meeting on the implementation of the debt strategy. It is difficult to imagine that domestic entrepreneurs in developing countries will commit themselves to investment projects when they perceive that external creditors are becoming increasingly reluctant to lend, or are only prepared to make concerted lending involving more and more conditionality. Furthermore, if no financial support is available from external sources, developing nations' efforts to increase savings will have to be applied to service the debt and, what is worse, part of these savings may again be lost in a further wave of capital flight.

It is worth noting the asymmetric treatment by the staff of the investment process in industrial and developing nations. In the interesting and illuminating analysis of the "tensions" in sectoral balances, the staff casts some doubts on the relationship between fiscal adjustment and the speed at which private investment will react in industrial nations. Questions arise whether the beneficial effects of a stronger fiscal position on the growth of private sector activity will be felt rapidly enough to avoid a short-term slowing of economic activity as government spending is cut back. This typical Keynesian approach to the possible effect on expectations of uncertainty derived from quantity adjustment and hence on investment decisions is absent from the staff's consideration of the same process for developing countries. To put it in an extreme way, it appears as if a new level of investment and output can be achieved automatically, not to say instantaneously for these countries, even without giving much consideration to the adverse effects I have mentioned.

The staff paper states that the sluggish growth of world trade in recent years and the price performance of many primary commodities have led to a certain degree of "export pessimism." This is a somewhat optimistic view, because instead of export pessimism one should perhaps talk of "growth pessimism," given the scenario depicted in the papers we are discussing. Unless we can imagine an alternative scenario, involving drastic changes in protectionist practices, coupled with other structural reforms by industrial countries, as well as in the availability of external financial resources to developing countries, the prospects for world economic performance will remain gloomy, and the social and political stability of many developing countries will be at stake.

Mrs. Ploix made the following statement:

Before tackling the general issues raised in the interesting set of papers before us today, I will devote some comments to methodological points.

The presentation and the staff's use of indicators, in particular the emphasis placed on the savings-investment balance, are helpful in supporting the analysis and focusing the readers' attention. The indicators are particularly helpful in the section devoted to "tensions" in the projections, an approach that merits enhancement in future. In our opinion, further research should try to quantify the implications of the tensions analysis more fully as well as provide a more in-depth discussion of the effects of fundamental assumptions, for instance, those on oil prices or exchange rates.

I shall begin by commenting on the lessons of the past before addressing the flexibility needed for the future if we wish to improve the present outlook.

As clearly recognized by the staff, 1986 was special from an analytical point of view. Two main changes--the sharp lowering in the prices of oil and other commodities, and drastic movements in exchange rates--did not bring the forecast results. To gain a better forecasting capacity, it is necessary to spend some time on the reasons for last year's excessive optimism. In our opinion, the disappointing performance in 1986 derives in part from the rapid adjustment to these changes made in most countries.

First, industrial countries generaly focused their efforts on the reduction of domestic imbalances, particularly fiscal deficits, and used the margin given by the decrease in oil prices for increasing imports and for maintaining shares in world trade. Otherwise, these shares would have been threatened by changes in exchange rates. Second, oil exporting developing countries adjusted their imports far more rapidly than expected. Third, other developing countries generally preferred to limit the growth of their debt, compensating for the lowering of their export prices by an increase in volume. On the whole, they maintained their adjustment stance.

In sum, 1986 has shown, rather than an asymmetry in reactions, a noticeable synchronism in the implementation of adjustment policies geared at lowering either external--developing countries--or domestic imbalances--industrial countries--in conjunction with a slow reduction of the U.S. imbalances.

It is thus not surprising if the expected growth resumption did not materialize, since this expectation was based on the assumptions of lags in adjustment rhythms and of a sharp increase in private demand in the industrial countries.

These unexpected developments are worrisome because they do not seem to be of a transitory nature. Considering also that the brunt of the adjustment was borne by investment in almost all countries, the risk of a widespread economic downswing cannot be brushed aside altogether.

In contrast with last year's forecasts, the staff's projections for the short- and medium-term future look rather gloomy.

As far as the industrial countries are concerned, the unsustainability of balance of payments positions remains at the heart of the staff analysis. The persistence of current account imbalances hovering around 3 percent of GDP in the United States and Japan can hardly be seen as satisfactory. Likewise, the resulting buildup of net external positions can only act as a brake on growth in the medium term and undermine the orderly functioning of financial markets in the short run. One element that appears particularly worrisome relates to the absence of leeway in terms of growth differentials between the major economies. This means that the only way of redressing external imbalances would rest on exchange rate changes.

Nonetheless, it should be recalled that the present levels are widely viewed as adequate and that, unfortunately, the impact of recent realignments on external adjustment remains to be seen. Consequently, every effort designed to widen growth differentials between surplus and deficit countries must be used more systematically. The staff admits that its estimate of output potential is partly judgmental; thus it appears difficult for surplus countries to justify too cautious a demand-management policy on the grounds that growth differentials cannot be exploited.

The importance of securing as strong a growth rate as possible is also reinforced by the potential consequences of an economic slowdown for the employment situation. Surprisingly enough, this aspect is hardly mentioned in the staff paper; however, the European countries, and to a lesser extent Japan, should pay due heed to this sensitive problem.

Another noticeable constraint that hinders an effective coordination of economic policies is to be found in the "crowding in" process. The staff rightly stresses the detrimental effects which would result from the withdrawal of fiscal stimulus that would not be fully counterbalanced by increased investment in the private sector. To forestall such a risk, the right approach for the surplus countries is to steer toward a flexible fiscal policy. In this respect, a parallel could be drawn with monetary policy, which has been conducted in a pragmatic way for some time now and is still significantly contributing to the disinflationary process. The substantial gains in terms of trade experienced by industrial countries have obviously helped keep inflation under control. However, at the present juncture any future loosening of monetary policies for growth's sake does not appear advisable. Fiscal policy should thus be called upon to play a greater role. The United States clearly remains the exception, and a steady phasing out of the fiscal deficit must be kept high on the agenda.

More generally, with a view to fostering the propensity to invest among all the industrial countries, the staff is right in emphasizing the role of structural reforms and the opening up of international markets. This latter point is crucial; our hopes of restoring a better balanced world economy without jeopardizing long-term growth will be safeguarded as long as protectionist pressures are kept at bay. It should also be noted that the lasting stabilization of exchange rates appears to be an increasingly necessary component of a climate conducive to sustaining private investment.

As a last comment on the industrial countries, I would like to state that my authorities consider that the staff forecast for growth should serve as a foil. Indeed, it is the Fund staff's role to stress the limits on action, to make constraints clear, and to bring tensions out into the open. Nevertheless, the worst is not always sure; I would like to recall the commitment made in Paris three weeks ago: "The Ministers and Governors agreed to intensify their economic policy coordination efforts in order to promote more balanced global growth and to reduce existing imbalances." The terms of this communiqué clearly demonstrate that our authorities are committed to seizing any opportunity in a coordinated way to foster an open, growing world economy, or in other words, to demonstrate that the rigidity stressed by the staff is not such as to rule out more favorable achievements than it forecasts. I would also like to add that we very much welcomed the presence of the Managing Director at the Paris meeting.

I will not dwell too long on the prospects for developing countries, since the Board will soon review the debt strategy. As a whole, the developing countries achieved a remarkable adjustment in 1986. It is, however, highly contestable that such a stringent policy stance can be maintained without strain in the medium term. It would imply no new net financial contribution from the private sector, whereas the official creditors' exposure to low- and middle-income countries would continue to increase. Such a financing scheme is unacceptable, as the various creditors must remain mutually responsible. In this connection, the substantial net repurchases from the Fund which are projected for this year are also a matter of serious concern: such a withdrawal by the Fund can only aggravate the mounting tensions that weaken the cohesion of the major creditors. There is no use arguing about the necessary efforts to be made by the developing countries to mobilize and retain their domestic savings. But I would have liked the staff to present more clearly the impact of such a strenuous adjustment process on per capita GDP, and perhaps more important on the shrinking domestic absorption in these countries, as the share of resources channeled to the external sector will remain very high.

Mr. Posthumus made the following statement:

The analytical approach and the use of indicators in the staff paper on prospects and issues relating to the world economic outlook have my explicit support, as do the issues identified as important and the policy conclusions implicit in the paper. This implies that my contribution is mainly one of suggesting the need for somewhat more emphasis on subjects that I think deserve more attention. I note that the policy conclusions do not include fiscal expansion as an instrument to increase macroeconomic demand and growth. Moreover, it is made clear that exchange rate measures or changes lead to unsustainable situations if not supported by other measures. I also note, finally, that monetary policy is being viewed as supporting rather than as stimulating. Some of the relatively attractive instruments of macroeconomic policy indeed hardly seem usable at this juncture, a sobering but realistic thought leading to the conclusion that the world economic outlook is not very positive, though by no means unmanageable. What is even more sobering is that those countries that indeed could manage their own household better with positive effects for the world seem to be making little progress in doing so.

Table 5 in EBS/87/39, which gives the net foreign debt position of some major industrial countries that had current account deficits over a number of years, indicates that the balance of payments trends of some of these countries are unsustainable, because it cannot be expected that investors would be willing to invest permanently on a net basis. One other way of indicating the unsustainability of debt positions is to calculate the interest payments on the debt and compare these with either export proceeds--the debt service ratio--government income, or national income. Perhaps some figures would be illustrative. An increase in those ratios is unsustainable; the uncertainty is only one of duration. However, unsustainability cannot be related only to the willingness of investors to invest, important though this may be in a market economy. A better distribution of growth in the world requires a better distribution of savings and investment. The U.S. balance of payments position is apparently a problem for the United States because the country imports so much more than it exports, which gives rise to protectionist pressures; it is a problem for the rest of the world because the United States imports savings, thus crowding out investment elsewhere.

The wording of the topics for discussion, in particular that of maintaining noninflationary growth, made me somewhat uncertain about the analytical approach of the staff or about my understanding of it. Action to ensure that growth is maintained seems to be equated with relaxation on the fiscal front. And moderation of the fiscal stance seems to be an instrument that might enable European countries, especially those without serious budgetary imbalances, to aim for faster growth. This wording cannot be reconciled with an analysis in which a decreasing fiscal deficit means that resources are released for private investment. Reconciliation, however, is possible if two very important elements are added. First, medium-term fiscal strengthening should remain the objective. Second, structural policies are required to enable the private sector to absorb the released resources--to crowd in--with as little friction as possible. With regard to fiscal policy, the staff suggests that a slower pace of fiscal restraint would be appropriate in Japan and Germany. In the case of Japan, this was the consensus of the recent Article IV discussions. In the case of Germany, it should be pointed out that the figures indicate little change in the fiscal deficit for the next two years, and apparently even less of a change if the announced tax cuts are taken into account. The intended reduction of subsidies may indeed be one of the structural measures required to improve the functioning of markets in Germany.

There is also a suggestion that a few other industrial countries may have scope henceforth for a more moderate pace of fiscal consolidation. Since two countries from this group--Belgium and the staff reports bear out, few countries for which the recommendation holds remain in this group. I am a little sensitive to suggestions that European countries resort to fiscal stimulation or let up on their efforts to keep their budgets under control. The European experience of the 1970s was disastrous, and other countries should not try to push Europe in that direction again. As to the treatment of the smaller industrial countries, there is a reference to them here and there in the world economic outlook. However, their collective GNP is equal to that of France and the United Kingdom together. In future exercises they might perhaps merit more attention, and splitting this group into surplus and deficit countries might then indeed add to the analysis.

My conclusion with regard to the second topic for discussion is that I would suggest that more attention be given in the world ecomomic outlook to the necessity of strong and active structural policies. We have no indicators for the rigidity of markets, although like the elephant, it is easy to recognize but difficult to describe. Decreasing rigidity is not a very exciting policy recommendation for macroeconomists. Yet it may be one of the most effective instruments at the moment. A specific recommendation might be directed, for instance, to the European Communities in this respect, to clear up as soon as possible the remaining barriers to internal trade and therefore to European growth.

The prospects for developing countries are much less clear to me than a number of speakers today have indicated. Certainly, it is worrisome that the prospects for large net capital flows to the developing countries as a group are not very positive. However, if one looks at the major Asian countries--only 20 years ago the subject of Myrdal's Asian drama, now hardly discussed in the world economic outlook--it appears that adjustment and growth policies are possible indeed, and that debt problems can be prevented, not only solved. My only remark then in this regard is that the world economic outlook should pay more attention to the economic situation and prospects of Asian countries, because their steady, large, and growing economies may be important.

Finally, a few remarks on international cooperation and the role of the Fund. The debt strategy and protectionism will be discussed by the Board separately. Policy coordination among the major countries is the third key area identified at the moment.

Analyses like those of the world economic outlook are an important contribution of the Fund to this coordination among the Group of Seven. But the precise content of that coordination remains vague. In Europe and in the OECD, for many years the call for international coordination was really only a call on other countries to stimulate their economies fiscally. It is disconcerting that quite a few countries seem unable to take the required, generally not popular, measures and prefer to look abroad for solutions. However, international cooperation does not mean that putting one's own house in order is not so urgent anymore; in fact, the national level is still the only one where decisions can be made.

International cooperation is perhaps most important in identifying and analyzing incompatibilities and unsustainable situations. A surplus situation is usually sustainable for the long term, while the logical counterpart, a negative current account, is not. A very flexible exchange rate policy may shift the burden of adjustment to other countries, at least for a short period of time. International cooperation is required to strike a balance between too much flexibility and too much rigidity. Perhaps some of these issues could be dealt with somewhat more extensively in the forthcoming world economic outlook exercise than in the papers before us.

Mr. Salehkhou made the following statement:

In spite of the substantial changes that have marked the international economic environment in 1986, and in contrast with the optimism with which the industrial countries greeted last year's sharp decline in oil prices, there has been little progress in dealing with the major difficulties and uncertainties affecting the world economy. Although industrial countries' domestic demand was boosted by the large terms of trade gains resulting from the decline in oil and other commodity prices, their overall growth performance was significantly below last year's projections. The parallel hardship in developing countries also led to a curtailment in industrial countries' net exports, the extent of which had been largely underestimated and which more than offset the impact on domestic demand. Moreover, while the deliberate depreciation of the U.S. dollar and the major industrial countries' commitment to greater policy coordination have permitted the trade protection threat to be held off temporarily, uncertainties about the effective convergence and sustainability of their policies and about financial imbalances within and among their economies continue to be major concerns for the international community. Finally, in spite of continued strong adjustment and some improvement in their overall growth performance, the economic and financial difficulties facing the group of developing countries continue to be very severe. The fuel exporting countries are experiencing a major domestic and external deterioration; the excessive debt overhang and the continued lack of external financing are exacerbating the adverse impact on developing countries of declining primary commodity prices, sluggish growth, and the protectionism in their export markets; and these adverse exogenous factors are generally offsetting the beneficial impact of lower nominal international interest rates.

Last year's sharp movements in international oil prices have revived the 1970s debate about the contribution of higher energy prices to the general slowing down of economic growth in the industrial economies as compared with their strong postwar performance. The staff analysis in SM/87/40 on potential output in the major industrial countries is an important contribution to such a debate, even though the analysis of the role of higher energy prices in the slowdown in industrial countries' growth in the 1970s could have been complemented by an assessment of the role of artificially low energy and other commodity prices in those countries' strong economic growth and modernization in earlier decades. At any rate, the staff papers do adequately put in perspective the adverse impact of higher energy prices by analyzing the deep-seated factors responsible for the slowdown, including in particular the completion of the process of catching up with the best technology in Europe and Japan, the accumulation of unattended inflationary pressures during the years of strong economic growth, the increasing share of services in these countries' GNP, and the expansion of government services and regulations. Moreover, while the need for adjustment was highlighted by the advent of higher energy and commodity prices, and while a major technological adjustment did take place, there has been insufficient correction in labor markets and in intervention by governments. In fact, nominal wage increases accelerated sharply in the face of rising energy prices in the 1970s. Correction of labor and other structural rigidities in these economies still continues at a relatively slow pace, contributing significantly to the developing countries' sluggish economic growth even though energy prices declined markedly.

While slow economic growth creates uncertainty about the prospects for narrowing external imbalances among the industrial countries and about developing countries' expansion and adjustment performance, concern in this regard is only partly relieved by the major industrial countries' agreement to coordinate their policies after a long period of exchange market instability and public bickering. This is the more so as the factors underlying such imbalances are not yet being addressed decisively, including those with respect to the fiscal deficit in the United States and the extent to which private investment could be expected to rise to offset the impact of the projected fiscal consolidation on interest rates, exchange rates, and overall economic growth. Similar uncertainties are linked to the willingness of other industrial countries, particularly Japan and Germany, to implement more growth-oriented policies so as to compensate for the U.S. withdrawal of stimulus. Such policies should obviously include less fiscal consolidation and a more accommodating monetary stance now that the risk of rekindling inflation has largely subsided. It would also be necessary to accelerate the implementation of structural adjustment policies to ensure that the private sector is in a position to absorb the resources released by the public sector.

Whatever policy corrections are effectively implemented, it should be stressed that any improvement in reducing imbalances among the industrial countries will be limited in 1987-88 and will depend as much on these countries' resistance to the impatient pressures for trade protection in their political systems. Far from restoring an adequate pace of economic growth, succumbing to such pressures would complicate the ongoing, envisaged restructuring of the concerned economies and upset their efforts to strengthen their potential output.

With regard to the objective of strengthening industrial countries' potential output, it should be noted that the staff's definition of potential output--namely, the level of output that can be sustained without risking an acceleration of inflation--is adequate only to the extent that the objective of price stability would remain the overriding consideration or concern of economic policy. Such an assumption is, however, confronted not only with the existence of excessively high rates of unemployment in the industrial countries, which are already being translated into political and social strains, but with the implications of low growth for the prospects of dealing effectively with the developing countries' considerable difficulties.

The staff papers trace much of the improvement in the economic conditions of the industrial countries to the substantial decrease in oil prices and to further reductions in non-fuel commodity prices. In its first-year effects only, the reduction in oil prices has brought about a terms of trade gain of some $118 billion in 1986 to the economies of the industrial world. For three of these countries--the United States, Japan, and Germany--the reduction in their oil import bill totaled $52 billion, with Japan enjoying the largest drop--$29 billion--which accounts for some 80 percent of its current account improvement.

Even though the total benefits of the reduction in oil and non-fuel commodity prices have not fully materialized, as they have been only partly passed through to the final consumer in many industrial countries and went partly into profit margins and government revenues, their positive impact on saving, consumption, profit margins, prices, employment, and the balance of payments of these countries is already substantial. The impact on inflation was obviously the most important. While anti-inflationary and low growth policies had significantly curtailed inflation in the period 1980-85, the additional sharp decline in price pressures in industrial countries in 1986 mainly reflected the effects of declining import prices, especially oil.

Terms of trade gains have allowed the industrial countries to further consolidate their fiscal positions and have led to a strengthening of the aggregate current account of these countries amounting to $46 billion in 1986. More than ever, however, the spring 1987 world economic outlook is testimony to what many observers had suspected, that international trade in recent years has been a zero-sum game, much like the international finance experience of the same period. The terms of trade losses suffered by the developing countries, counterposed to the gains made by the industrial countries, amounted to the equivalent of some 3 1/2 percent of industrial countries' GDP. The fuel exporters were the hardest hit, suffering an average 46 percent decline in their terms of trade in 1986.

At the time of the oil price increases, many voices, mostly from the industrial countries, were heard demanding and obtaining massive recycling of the "petrodollars." Now, however, there is no similar initiative to recycle the substantial windfall gains of the industrial countries or perhaps to share them with the developing countries. The self-interest myopia of the industrial countries is so strong that none of them has even attempted to offer concessional export credit to the developing countries even though their own export revenues could well benefit by such arrangements.

Not only have the terms of trade of developing countries worsened in 1986, there is no evidence of relief in sight despite the assertion in the staff papers that the staff expects developing countries' terms of trade to stabilize during 1987-88. The staff gives no indication of what it means by stabilization. It is not clear how, considering the trends in the underlying factors, the staff reaches this optimistic expectation. Presumably, since the terms of trade continuously worsened in the past few years, by stabilization the staff implies that for the developing countries, either prices of exports or prices of imports or both will improve. But the world economic outlook papers give evidence to the contrary. There is no reason to assume that import prices will improve for the developing countries.

At the same time, the staff papers suggest that prospects for developing countries' export prices are uncertain, and prospects for prices of non-fuel commodities are weaker than for oil or manufactures; commodity prices in 1987 are expected to firm only gradually and for the year as a whole to average some 3 percent lower than in 1986.

Moreover, there is also no room for optimism about export revenues because for them to increase, either developing countries' export prices must improve or their export volume should increase. Since there is no reason to assume prices will improve, is there any hope for an increase in the volume of exports? Again, the staff papers give evidence to the contrary; they assert that the technological shifts toward less raw-material intensive production in the industrial countries continued in 1986. Is there any evidence that this technological shift will either slow or reverse itself in 1987-88? Moreover, the papers state that on the demand side, output growth in industrial countries, which is a major determinant of their demand for primary commodities, slowed from 3 percent in 1985 to 2 1/2 percent in 1986. Is there any evidence to assume that this trend is about to reverse itself in 1987-88? Again, the evidence provided is to the contrary since the staff papers do not expect an increase in output in the industrial countries of any significant magnitude; rather, there is a large overhang of stocks, which will probably take time to work off owing to the projected slow growth of output in industrial countries. The facts, therefore, are that there is no room for optimism either for terms of trade improvement--even their stabilization is in doubt--or for recovery of export earnings of the developing countries. The staff is much closer to the mark when it says that the projected moderate growth in domestic demand in the industrial world is expected to contribute to a slowing of the growth of international trade in 1987.

Worse yet is the prospect for the purchasing power of exports of developing countries which determines their import capacity. Prospects here are so discouraging as to worry the staff since the growth of the purchasing power of exports was a negative 10 percent in 1986. Once more, the fuel exporters were hit hardest since the purchasing power of their exports declined by 40 percent in 1986. These prospects are indeed worrisome for imports, investment, capital accumulation, and the economic growth of developing countries.

Nor are the prospects very encouraging for the debt situation, official capital flows, or commercial lending. The staff papers make much of a possible reduction in international interest rates, asserting that every 1 percent reduction in the London interbank offered rate (LIBOR) will release $3 billion for imports or "other uses." The papers state that the 4 1/2 percentage point reduction in the annual average level of LIBOR between 1984 and 1986 therefore freed $12-15 billion for additional imports, or other uses, in 1986. It is clear that, since massive import compressions continued unabated in 1986, the $12-15 billion "freed" as a result of reductions in LIBOR did not go to increased imports but indeed to other uses. Although the staff papers are discreet on what these other uses were, it is obvious that with a debt servicing cost of 34 percent in 1986, they could go nowhere else but to the commercial banking cartels in the industrial countries rather than to increased imports.

While I will deal with the debt issue in more detail in the Board's discussion of the debt strategy, I wish to express here my concern with regard to some of the relevant data reported by the staff. Although adequate external financing was made the cornerstone of such strategy, together with strong domestic reforms by the heavily indebted countries, I note that these countries made net repayments of debt of about $8 billion in 1985 and $12.5 billion in 1986. At the same time their ratio of debt to total exports deteriorated further, reflecting the sharp loss in their terms of trade. Furthermore, the debt overhang is also affecting these countries' efforts to mobilize domestic savings and restore an adequate level of domestic investment.

Given the dismal prospects for international trade, the terms of trade, the purchasing power of exports, and the debt situation, it is clear that the developing countries are in for a long period of more and very difficult adjustments. Since 1982 most developing countries have had to face wrenching economic conditions and continuous retrenchments in their economies, and it is becoming apparent that unless and until acceptable international arrangements are made to stabilize export prices and volumes in the world market, most developing countries will be faced with the choice between a continued path to impoverishment and the temptation of unilateral solutions.

The well-worn formulas passed on to the developing countries in the form of rhetorical advice to "correct price distortions" will do little to solve their massive, and for the most part externally generated, economic problems. The factors of key importance to the success of their adjustment efforts, as enumerated by the staff, are all of an exogenous nature and include prominently the growth of export markets, access to such markets, the terms of trade, external financing, and real interest rates. How can a country try to correct price distortions domestically if it constantly has to adjust to external shocks? It is very little help to suggest that developing countries should diversify their export production toward manufactures when there really is no guarantee that if and when they do so and become competitive, walls of protection will not be erected against their exports by the industrial countries. After all, so long as the industrial countries had no real effective competition in agricultural commodities, they vehemently argued for free trade, but as soon as the developing countries became sufficiently efficient in the production of food and agricultural commodities to compete with industrial countries, protective barriers began to be erected by these countries to protect their domestic agriculture. What is there to guarantee that the same scenario will not be followed in the case of manufacturers' exports? On this issue, I would like to associate myself with the concerns so eloquently expressed by Mr. Rye.

I wish to conclude with a proposal regarding the publication of the world economic outlook document. As observed today, and on similar past occasions, the diversity of views expressed by individual Directors covers a rather wide spectrum that enriches and enhances the staff's observations on the world economic outlook. I would therefore like to propose that effective this year, publication of the World Economic Outlook be more in the form of a collection of essays, incorporating separately the edited version of the original papers and the views of individual Directors. Should this proposal not gain unanimous support of the Board, I would then suggest that Directors' interventions be included in the publication on a voluntary basis. It goes without saying that the editorial procedures would be the same as in the past, and the edited version of Directors' interventions already available in written form would be subject to their own final approval. Such publication would go a long way toward giving the public a flavor of the extent of the diversity of views prevailing in the international community on economic matters, as expressed in this organization. The readers would also be in a better position to reach their own judgment and even their own conclusions based on firsthand individual observations.

Mr. Sengupta made the following statement:

The staff's latest assessment of the world economic outlook is marked by considerable caution in contrast to a somewhat over-enthusiastic presentation in 1986. This is understandable in view of the general sluggishness in economic activity during the past year, in particular in the United States, Japan, and the United Kingdom, and the many uncertainties surrounding short-term and medium-term prospects.

It appears as though the current expansionary phase has lost much of its momentum and has tended to settle down at a moderate pace, fortunately characterized so far by a reasonable degree of price stability and a stabilized rate of unemployment. However, there has been a marked geographical differential in domestic demand and fiscal positions and historically unprecedented external imbalances. The crucial question is whether these external imbalances might ultimately lead to a growth recession in the industrial world. Correction of these imbalances will call for considerable policy adjustments based on policy coordination among the major industrial countries so as to reduce the "tensions" in policy developments.

The staff has given a good account of the reasons for the limited response so far of current account positions to the exchange rate changes that have taken place since early 1985. Exchange rate adjustments take, according to the staff, probably at least three years to work through to payments flows, and in the current environment, they may take more time because of "the apparent willingness of non-U.S. producers to cut their profit margins substantially so as to maintain market share" (EBS/87/39). The staff quantify the lagged effects of exchange rates, but despite these effects, it appears that the imbalances, in actual dollar terms, will remain large in 1988-91.

According to the medium-term scenarios, and assuming unchanged real exchange rates and unchanged policies, the staff expects that in the medium term up to 1991, under the baseline scenario, the U.S. deficit would be just under 3 percent of GDP while the Japanese surplus will be of a similar relative size and the German surplus just over 1 percent of GNP. It is somewhat surprising that the U.S. current account deficits remain unchanged relative to GNP after 1988, even though there would be substantial reductions in fiscal deficits and changes in saving-investment positions during the period 1988-91. It is not clear why this should be so; is the implication that U.S. competitiveness will not improve after 1988 unless there is a further depreciation of the dollar accompanied by adjustments in monetary and fiscal policies? On the other hand, staff projections show sharp reductions in the current account surpluses of Japan and Germany between 1988 and 1991 and relative changes in their fiscal and saving-investment balances. The staff has stated that even after projecting the U.S. fiscal deficit on the basis of current spending plans and tax laws, the implied increase in the investment ratio by 1.4 percentage points over the medium term is large by "historical standards" and "must therefore be considered subject to considerable uncertainty." Any failure of investment to grow at the rate implied in the staff projections will put downward pressure on interest and exchange rates and could result in lower potential output growth in the medium term. If the reduction in the fiscal deficit was in line with the projections in the Gramm-Rudman-Hollings Act or the U.S. Administration's fiscal year 1988 budget, the problem would be even more serious. A higher investment ratio would be required, implying, according to the logic of the staff, increased uncertainty and a large probability of a fall in potential growth.

I wish to raise a few points that I hope the staff will carefully consider. I agree that an increase in the U.S. rate of investment by 1.4 percentage points from 16.3 percent to 17.7 percent between 1986 and 1991 is not very likely. In fact, according to the staff's baseline scenario, private saving, which in 1975-84 averaged 17.8 percent, is supposed to come down to about 16.4-16.5 percent by 1988-91--which is even more unlikely.

But why do we need these assumptions? If gross private investment did not increase beyond the 1975-86 average of about 16.4 percent, if private savings did not fall below an average of about 17 percent, and if the budget deficit fell according to the staff projections, the current account imbalances would have fallen. For example, the average 1975-84 figures were 17.8 percent for the private savings rate, 16.3 percent for the private investment rate, and 1.9 percent of GDP for the budget deificit, while the current account deficit was only 0.4 percent. Since then, the increase in the budget deficit has moved in parallel with the increase in the current account deficit--substantiating the point that U.S. budget deficits have been financed by the rest of the world, through capital inflows that sustained the current account deficit. In fact, in 1986 the current account deficit is almost equal in amount to the budget deficit. Why cannot this trend be reversed? Why cannot the U.S. budget deficit be reduced? This should be done in any case in the interest of the U.S. economy itself, and policies should be adopted to reduce the current account deficit, without trying to reduce the rate of saving. Should there be further depreciation of the dollar or would a policy to reduce the budget deficit be sufficient?

There seems to be a reluctance on the part of the staff to allow the U.S. current account deficit to fall very much. The implicit theorization behind this reluctance should be clearly brought out. The staff notes on page 32 of EBS/87/39 that if interest rates declined in the United States, as a result of a fall in the budget deficit, the U.S. dollar might depreciate, reducing the current account deficit relative to the staff projection. But the staff goes on to say that "at the same time... it would imply a weakening in the net exports of other industrial countries," which may create a problem "of maintaining output growth in these countries." Yet that was not necessarily so. The existing pattern of current account balances among the industrial countries might be such that the U.S. deficit has been met by net exports of other OECD countries, so that its reduction has adverse effects on these countries. But the rest of the world can still absorb the net exports not only of the other OECD countries but also of the United States or there could be a pattern of growth of output and demand in the world economy that could sustain a lower current account deficit or even a U.S. surplus without a corresponding decline in the surpluses of other OECD countries. There should of course be corresponding deficits in the rest of the world.

I would like the staff to examine what policies should be adopted to get back to the historical pattern of developing countries running deficits, with industrial countries running surpluses that facilitated the corresponding resource transfer. The pattern of current account balances in the medium-term scenarios in Table 5 (EBS/87/39) is not particularly sustainable as it is dependent upon assumptions of investment behavior that are not very likely to be realized or of a possible slowdown of growth. But the result for major industrial countries as a whole would be a combined current account position that would imply very little change in the transfer of resources to developing countries. This is not a viable situation for the international economy. We should be in a position to talk about scenarios and policies that change this pattern fundamentally.

The medium-term scenarios for developing countries showed that current account deficits as a percentage of exports--the current account ratio--for capital importing countries will decline from 4.7 percent in 1986 to 1.5 percent in 1991. For the same period, the current ratio for countries with recent debt-servicing problems was projected to decline from 10.3 percent to 3.9 percent and that for the 15 heavily indebted countries from 9.2 percent to 2.3 percent. The realism in these projections depends on not only the growth of the export markets but also the behavior of the terms of trade and interest rates. The staff believes that there are no "clear reasons to expect further major changes" in these variables. But considerable caution should be exercised in making these assumptions, for the simple reason that current account ratios for capital importing countries have not fallen below 4 percent in the past ten years.

The projections for heavily indebted countries show that the investment required to obtain the postulated GDP growth rate is so high that it is difficult to expect its realization through additional domestic savings. The staff does not seem to regard it as a problem, and considers that the policy improvements required to mobilize the needed domestic savings are feasible and will have relatively quick effects on economic performance.

How can this be realistic? When real per capita incomes are low or have declined, it will be difficult to expect the implied expansion in investment ratios to take place wholly on the basis of additional domestic savings. It is not that the developing countries do not recognize the need to raise their saving ratios. In fact, in the 1970s, the saving ratios of capital importing developing countries were as high as 24 percent; in the case of 15 heavily indebted countries, they were about 22-23 percent. But because there is a large net transfer of resources from these countries, it has become difficult to raise investments through additional domestic savings and maintain growth. The efforts of the indebted countries would need to be supported by substantial external resources on appropriate terms from multilateral financial institutions, official creditors, and private sources. The reluctance of private lenders to take part in this effort would have to be made good by large support by multilateral institutions and official creditors. It is in this manner that the constraint imposed by the debt overhang on effective adjustment in these countries could be overcome.

Even if developing countries do everything to strengthen their fiscal positions and increase their private savings by adopting appropriate interest rate and exchange rate policies and by taking sound measures of demand management, it would be impossible for them to raise their rates of saving to finance an increase in their investment ratio from 17.6 percent in 1987 to 20.8 percent in 1988-91 without a transfer of resources from the industrial countries. This is the central problem of the issue of international cooperation. Policy coordination among the major industrial countries would be necessary not only from the short-run point of view of reconciling their current account imbalances but also from the medium-term perspective of sustaining the growth of the entire world economy. While policy coordination should be promoted in order to strengthen noninflationary growth forces, it is becoming increasingly clear that consideration should be focused not only on the interests of the industrial countries but on those of developing countries as well. Indeed, a realistic reading of the staff's medium-term scenarios shows that the sustainability of world growth depends on a pattern of current account balances and the institution of mechanisms that would allow industrial countries to run current account surpluses which can be absorbed by developing countries. I hope that the staff will try to focus on international policies that lead to a truly interdependent synchronization of economic policies.

Mr. Zecchini made the following statement:

It is not a source of personal satisfaction to see that the notes of caution and doubt we expressed in last year's Board discussion of the world economic outlook are fully justified by recent economic developments. Last year, we expressed doubts on the realism of the staff hypothesis that the increase in real disposable income in industrial countries stemming from an improvement in the terms of trade would be sufficient to propel the world economy into a new upswing. Now, it is disappointing to realize that in 1986 the world economy has continued to be characterized by sluggish growth with output expansion decelerating in industrial areas and rising only modestly in the developing area.

The asymmetrical impact that the shift in the terms of trade has had on demand expansion in industrial and developing countries is one of the many reasons for this unsatisfactory evolution of the world economy. But in addition, two other factors have played an important role: the recent shocks to the system of relative prices; and the credit rationing that has been enforced on most developing countries. On the one hand, repeated shocks to the price structure cannot induce rapid reversals of expenditure patterns in the desired direction. To the extent that these changes are abrupt, they increase uncertainty in the private sector about decisions to spend, thereby negatively affecting fixed investment demand in particular. On the other hand, the reduced flow of external financing to several developing countries with debt difficulties was not offset by larger export earnings with the result that import compression was the only alternative left to these countries.

For the current year, can we expect that improvements in growth and adjustment will occur more or less automatically because of the temporary nature of the above-mentioned factors? Undoubtedly, the demand effects of recent changes in the terms of trade and exchange rates, as well as in relative prices, will be felt this year more than in 1987. But the outcome also depends on the stability of these changes since any volatility in these relationships would induce increasing caution on the part of both the private sector and the policymakers. At the same time, financial shortages are likely to continue to hamper the strong recovery of economic activity in the developing world, and consequently the recent net transfer of real resources toward creditor countries is not likely to be brought to a halt.

Another factor has to be added to this picture of unsatisfactory growth and adjustment. While the largest economy has to continue withdrawing the fiscal stimulus to recovery, in the two other major economies, the structural conditions for an offsetting, inwardlooking growth process do not appear to be present. The implications of these structural rigidities are compounded by the present course of economic policies in these countries. As the staff correctly points out in its baseline scenario for the medium term, under current policies, the external current account imbalances of the United States, Japan, and Germany will persist until 1991, albeit to a lesser extent, in the context moreover of an unsatisfactory expansion of their economies. Specifically, in the period 1989-91, the U.S. deficit will be at its 1985 ratio to GDP while the surpluses of Japan and Germany will be only 0.8 percent of GDP less than in 1985. In the same period, GDP growth will be basically at the level of 1985 and inflation will slow down further.

In this respect, it is encouraging to see that it is possible for the major economies to maintain the present pace of economic expansion with less inflation and lower external disequilibrium. It is also encouraging to see that in this environment, by 1991 all developing economies, whether capital importing or not, with or without debt-servicing problems, heavily or moderately indebted, can achieve the high growth rate of 1985 and at the same time bring their external current account deficit to the lowest level, as a percentage of exports, since 1976. Nevertheless, the mechanism by which these results can be brought about seems to rely on a departure from an established pattern of saving/investment imbalances which, as such, appears rather uncertain. The likelihood of the staff's scenario is in fact based on the crowding in of private investment at a rate higher than the rate of private saving in the major economies. While the expansion of investment in the United States may be justified by increased export opportunities owing to the recent gains in external competitiveness, in Japan and Germany it is not clear what should trigger the rise in private investment, given that the export markets of Japan and Germany are supposed to shrink and that both countries have enough excess capacity for production at present.

As to the developing countries, we tend to believe that the baseline scenario is on the optimistic side to the extent that it considers it feasible to combine satisfactory growth with adjustment in spite of the increasing stringency of the constraint related to the availability of external financing. There is not enough evidence to contend that many major developing countries can pursue a growth strategy based on domestic resources and can also compress domestic absorption further in order to service the accumulated external debt. This combination of results will depend crucially on the expansion of demand in industrial countries and on the stability of the terms of trade of developing countries.

So far we have focused on the uncertainties surrounding the baseline scenario, but even if this scenario were to materialize, it would imply a measure of unsustainability of balance of payments positions in the industrial area over the longer term and, consequently, a fallout of tensions into the world economy as well as into money and financial markets.

According to the staff's estimates, the U.S. net debtor position would attain $950 billion in 1991 while Japan's net creditor position would be on the order of $650 billion. Such magnitudes have two main implications: first, it must be assumed that investors' willingness to add significant amounts of U.S. dollar-denominated assets or assets in the United States would rise. But this would require either a risk-adjusted rate of return on real capital that is more attractive than in the competing economies, or a favorable interest rate differential that could involve a rise in real interest rates and deleterious consequences for economic activity and the servicing of debt in other countries. Second, the developing countries will find it even harder to compete with the United States in attracting the resources necessary for their development and to reverse the present net transfer of resources abroad. Furthermore, any weakening of market sentiment vis-à-vis the U.S. economy may create major disruptions in the financial and currency markets.

From the uncertainties and tensions inherent in the present course of policies, we draw the conclusion that at the present economic juncture we have to solve two major issues: first, how to accomplish adjustment in the U.S. economy, as well as in those developing economies which have been wavering in their adjustment efforts in the past five years; second, how to create the conditions for a return to higher growth in industrial and developing countries.

On the first issue, there is not enough room left to correct the U.S. current account deficit through further depreciation of the real exchange rate of the dollar. Given the expected stability of the U.S. inflation rate compared with that of trading partners, such a gain in competitiveness implies a depreciation of the nominal rate that has several negative repercussions. Specifically, this would rekindle inflation and prompt a tightening of monetary policy, with the result of an upward pressure on real interest rates and a consequent worsening of the terms for servicing external debt of many indebted countries. At the same time, this would reinvigorate protectionist reactions in the world economy. The dollar depreciation that has occurred between February 1985 and February 1987 in our opinion represents the maximum contribution that the exchange rate mechanism can make toward correcting the U.S. external deficit. Additional significant depreciation of the nominal rate in the near future would constitute a phenomenon of overshooting, in contrast to the principles that regulate our international monetary system.

Now the relative pace of expansion of domestic demand in the United States and abroad has to provide the long-awaited contribution to the external adjustment of the U.S. balance of payments. A confirmation of the appropriateness of this approach is given by the consideration that the income elasticity of U.S. imports is higher than the income elasticity of exports, and that at present the flow of U.S. imports is 50 percent higher than the flow of exports. To restore a more balanced pattern of domestic demand growth between the United States and the other major economies, it is necessary, on the one hand, for the United States to show more determination in accelerating the process of fiscal consolidation. On the other hand, other industrial countries and developing countries as well need to proceed toward an expansion of demand that must be focused on fixed investment. For Japan and Germany, it is not certain whether investment-led growth is feasible, given the bleak prospects for demand and profitability. If the margins for maneuver are narrow on this front, these countries can still operate in the sense of reducing the overall excess savings. To this end, fiscal policy and structural reforms should be the main instruments since monetary policy has already been used extensively to accommodate demand expansion.

As to fiscal policy, a temporary deceleration in the pace of fiscal consolidation should be recommended in order to offset a possible short-term slack in demand. It is equally important to introduce a tax reform that can revive economic initiative to improve the flexibility of the labor market. The recommendation of structural improvements and reforms applies also to Italy. On the fiscal front, however, it is necessary to proceed toward a more rapid fiscal consolidation, and my authorities are making plans in this direction.

In the industrial area, we must also stress that the possibility of reviving fixed investment is closely linked to the stability of the pattern of relative prices that has emerged in the last few years. It is, therefore, the responsibility of both industrial countries and producers of primary products to cooperate in order to create the conditions for less variability in relative prices. Furthermore, last year's recommendations to the developing countries to promote fixed investment, maximize domestic sources of savings, improve the allocation of resources, and enhance external competitiveness still apply. Nevertheless, it is evident that the external debt overhang is becoming a structural hindrance to their efforts to restore balanced growth. Hence, no viable growth strategy can be recommended to these countries if it does not come to grips with the debt problem. On this disquieting aspect of the economic situation, we will comment in the Board's forthcoming discussion.

Mr. Lundstrom made the following statement:

It is particularly gratifying that the indicator approach has been so successfully applied to the medium-term scenarios in the staff papers on the world economic outlook. The clarity of the analysis of economic interactions and "tensions" is also a matter of satisfaction. Let me add in passing that I share the views of Mr. Posthumus on how smaller industrial countries could be better covered in the world economic outlook exercise.

Despite stimulus from a lower oil price and falling interest rates, the world economy weakened in 1986. There were no clear indications that the large external imbalances among the major industrial countries were starting to decrease in spite of very substantial adjustments in exchange rates. Moreover, unemployment remained at an unacceptably high level.

This situation underlines the need for increased international cooperation with a view to strengthening economic performance and adjusting financial imbalances. Such a cooperative effort would be of crucial importance in resisting protectionist pressures and in managing the debt situation. What is needed in particular is a more determined coordination of economic policies in the major countries. In some of them, developments are still weaker than expected according to the latest figures.

A reduction of the large external imbalances is needed if sustained growth of output and world trade is to be reached. Clearly, there is a need for further adjustment beyond what would result from a continuation of present exchange rate relationships and the present policy stance. In the current situation, such adjustment should be brought about primarily by changes in domestic economic policies. In this respect, it is of the utmost importance that the U.S. fiscal deficit be decisively reduced. A correction of external imbalances should take place along a high rather than a low growth path. In other words, changes in domestic economic policies should aim at faster growth outside the United States rather than slower growth in the United States.

Provided there are sufficient changes in domestic economic policies, a further depreciation of the U.S. dollar does not seem appropriate. It could involve a risk of overshooting and even of renewed protracted misalignments between major currencies. Such misalignments would have negative effects on investment decisions and would increase the threat of protectionism.

Lower oil prices and falling interest rates in connection with adjustments in exchange rates have considerably improved the situation in many oil importing industrial countries. It is highly desirable that domestic demand in these countries be stimulated to contribute to a reduction of the external imbalances. Monetary policy in the industrial countries has been given a more expansionary role during the last year but there are limits to how far monetary expansion can be used to provide stimulus to growth in the period ahead. Fiscal policy can and should be used to a greater extent to shift the distribution of demand in order to help reduce external imbalances.

Like all previous speakers, I have stressed the importance of a vigorous reduction of the U.S. fiscal deficit. Prompt and determined action to that effect would lessen uncertainty in the currency markets and lead to a long-awaited improvement in the climate for business investment. Based on the "current services" assumption used by the staff, the fiscal deficit in the United States will reach $180 billion in fiscal year (FY) 1987, and will only be reduced to $164 billion in FY 1988. This illustrates the need for further measures if the fiscal deficit is to be reduced at an acceptable pace. Failing such a reduction, confidence in U.S. economic policies could falter with continued pressure on the U.S. dollar as a likely result. In such a situation, a tightening of monetary policy would seem probable, leading to higher interest rates with deflationary effects inside as well as outside the United States.

A more restrictive fiscal policy in the United States must be accompanied by measures aimed at stimulating demand outside the United States. Even if this results in only a relatively modest contribution toward a reduction of the U.S. current account deficit, it is important that surplus countries demonstrate their willingness to contribute to a lessening of global disequilibria. For Japan and Germany, currency appreciation has resulted in a weakening of exports; the improvement in domestic demand resulting from lower oil prices has not been large enough to offset the reduction in economic growth stemming from the declining export sector. As the staff points out, a principal reason for the limited impact of terms of trade gains on demand is that a considerable part of these gains never reached final consumers. This is particularly true for Japan, where lower world energy prices did not lead to a proportionate drop in end-users' prices of energy products. The staff proposes structural reforms that encourage private investment and action to offset the withdrawal of stimulus to economic growth stemming from the proposed budget for 1987/88. We concur with the staff in these recommendations, but at the same time we want to underline the desirability of a more expansionary fiscal policy in Japan as a contribution to the stabilization of the world economy. Taking into account the savings surplus in the private sector, the general government financial balance should be maintained at a deficit corresponding to about 2 percent of GNP throughout the medium-term period.

As for Germany, recent indications point in the direction of slow growth. Against this background, the German authorities would seem to be overly hesitant in using fiscal policy to stimulate domestic demand. Germany, with a fiscal deficit of just above 1 percent of GNP and an unemployment rate of almost 8 percent in 1986, should be in a position to adopt a less restrictive fiscal policy in 1987. Furthermore, the possibility of an earlier implementation of the tax reform planned for 1990 should be kept open. Over the medium-term period to 1991, a deficit corresponding to approximately 1 percent of GNP should be maintained to facilitate a necessary balance of payments adjustment.

Despite a long period of steadily declining inflation, unemployment is still at unacceptably high levels, mainly because growth--albeit relatively stable--has been subdued. In its interesting study on potential output in the major industrial countries, the staff concludes that the possibility of reducing these high unemployment rates without risking an acceleration of inflation over the medium term is limited. In this respect we take a less negative view. In effect, some countries would seem to be in a position to reduce unemployment through a more stimulative fiscal policy without risking cost increases.

Turning now to the developing countries, their prospects as portrayed by the staff are generally bleak. It needs to be re-emphasized that the aggregate figures conceal a considerable diversity in the situations facing individual countries or groups of countries. This diversity seems to have increased in 1986 not only between fuel and non-fuel exporters but also within the latter group. The newly industrializing countries in Southeast Asia have during recent years run large current account surpluses, thereby contributing to balance of payments strain and protectionist pressures. These countries have an important role to play in the adjustment process, particularly by appreciating the exchange rate of their currencies.

The major share of the deterioration in external balances has fallen on developing countries with serious debt problems. The difficulties of many of these countries are further exacerbated by the significant terms of trade losses also expected for 1987. With these prospects in mind, we are not fully convinced that the medium-term scenario presented by the staff implies a reasonable balance between adjustment and financing.

This conclusion does not mean that we question the staff's general policy recommendations. Obviously, in order to avoid serious adverse consequences for economic development and to allow for rising investment, developing countries have to adopt policies aimed at mobilizing domestic savings. But the increasing magnitude of the debt burden has to be borne in mind, and, as pointed out by the staff, the debt overhang negatively affects incentives to invest both by contributing to lower growth prospects and by creating expectations of higher future taxes and interest rates. The staff also points to the resource transfer from developing to industrial countries and raises the question of the effects of "these changes in the location of savings and investment." This is an issue one would like to see pursued further. Mr. Sengupta did so by implication in a central part of his intervention. It would be interesting to have a staff response to his questioning of some implicit assumptions underlying the medium-term scenarios.

Taking into account the difficulty of achieving sufficiently high and sustainable domestic savings and low external financing, the increases in investment indicated in the scenario seem optimistic. It follows that, in our view, a GNP growth rate of 4.5-5 percent a year hardly seems realistic without a much larger than expected net capital inflow from abroad or a much better external environment than assumed in the baseline scenario.

Against this background our conclusion is that determined adjustment efforts by the debtor countries must be supplemented by additional external financing. The very bleak prospects in this regard must be viewed with great concern. All parties involved must cooperate in implementing a coherent debt strategy and in arresting the decline in financial flows. The commercial banks have to play their part. It is, as the staff puts it, a question of the proper allocation of the costs of paying for past financing mistakes, which are reflected in the substantial discount at which the liabilities of indebted countries are trading. Obviously, commercial bank lending cannot be replaced by other forms of financing. A reasonable increase in the banks' lending should be in their own interest.

As regards the poorest countries--mainly those in the sub-Saharan region--I want to emphasize the paramount importance of additional official development assistance in support of medium-term adjustment programs. Further measures may also be necessary to reduce the debt overhang. The seriousness of the situation is underlined in a 1986 World Bank report: for about a dozen countries, rescheduling alone would imply little possibility of a return to normal debt servicing or growth by the end of the decade. Even with very determined adjustment efforts, those countries would seem unable to meet their debt-servicing obligations without external assistance. But this is a question we shall deal with more fully during the Board's upcoming discussion of the debt strategy.

In concluding, I fully agree that the efforts to strengthen international cooperation should concentrate on fostering policy coordination, managing the debt crisis, and resisting protectionist pressures. In this context, we welcome the indications provided at the recent meeting of major industrial countries with regard to the priority they accord to intensified economic policy coordination. As for the part to be played by the Fund in this field, like Mr. Rye, I share the views expressed by Mr. de Groote on the importance of a closer association of the Fund with the deliberations of the major industrial countries, even by way of providing a secretariat function. As noted on earlier occasions, we also attach great importance to the presence of the Managing Director at major industrial countries' economic coordination meetings. The analytical framework and the procedural mechanism for enhanced policy coordination are being progressively developed. It is to be hoped that these improved premises are matched by the necessary political will.

Mr. Yamazaki made the following statement:

The world economy is in a difficult transitional phase as it adapts to a large shift in the pattern of exchange rates and a sharp decline in oil and other commodity prices. These changes have both positive and negative effects, depending upon the trade pattern of a particular country and the exchange rate development of a particular currency. Strengthened policy coordination among industrial countries since the 1985 Plaza agreement, however, has contributed to reducing major uncertainties in the world economy. In particular, the expressed intention by the U.S. authorities to reduce the fiscal deficit and the reduction in the level of interest rates have considerably brightened the prospects for private demand expansion.

It is, therefore, somewhat disappointing that the positive effects of these changes in relative prices and in policies have not been fully reflected in the economic growth of industrial countries in 1986. The staff lists a number of factors behind this outcome and I am in broad agreement with its analysis. Of particular relevance at this juncture is the asymmetry of investment response to exchange rate movements. While investment plans in the tradable goods sector in Japan and Germany have been scaled back, they have not shown strong buoyancy in the United States. Such an asymmetry seems to suggest the importance of exchange rate stability for global stabilization at this time. The Louvre agreement in February was a significant step in this context, and it is essential that the policy commitment made in that meeting be carried out.

The U.S. fiscal position remains the focus of attention, and while welcoming the renewed commitment by the U.S. authorities at the Paris meeting to reduce the U.S. fiscal deficit, I would like to emphasize the need for a steady reduction and ultimately its elimination by 1991.

With respect to the immediate prospects for economic activities in industrial countries, I am somewhat more optimistic than the staff, based on such favorable factors as intensified policy coordination among industrial countries, the delayed effect of terms of trade gains, and the investment response to exchange rate changes in a country with a depreciated currency and low interest rates. As far as the economy of my own country, Japan, is concerned, as was extensively discussed about a week ago, my authorities project a steady growth rate for 1987. Continued expansion in private consumption and residential construction, as well as capital investment in the nonmanufacturing sector is expected to sustain private domestic demand. Maximum efforts were made, in the initial budget presented to the Diet, to incorporate measures to support the expansion of domestic demand, but they will be complemented by a comprehensive economic program, which will be prepared after the approval of the 1987 budget by the Diet, duly taking into account the prevailing economic situation.

Incidentally, I am somewhat disturbed by a reference on page 10 of EBS/87/39, where it is said that the budget deficit of Japan as well as that of other countries has already been reduced. This chair has repeatedly contended that the fiscal position of each country should be assessed taking into account all the relevant factors. In the case of Japan, because of the immaturity of social security funds whose financial balance is at present in surplus but is expected to deteriorate rapidly in coming years, strong attention needs to be paid to the central government deficit, particularly the General Account of the Central Government which indicates the underlying budgetary trend situation rather than the general government fiscal deficit. The central government debt of my country will reach ¥ 153 trillion, equivalent to 43.5 percent of GNP, more than ¥ 10 trillion having been added annually. Debt servicing will account for more than 20 percent of total government expenditures in FY 1987/88. I cannot see how the staff can conclude that Japan has already reduced its fiscal deficit. Fiscal consolidation needs to be pursued further, and this will be done in coming years.

With respect to the prospects for inflation, my authorities do not see an immediate risk of rekindling inflation as far as Japan is concerned, where the wholesale price index remains 10 percent below that of the previous year. Monetary policy will continue to be conducted appropriately with due regard to the development of domestic and external economic conditions as well as international monetary conditions.

I find the general assessment of the balance of payments, on page 13 (EBS/87/39) rather unsatisfactory. By saying that "despite this large correction in exchange rates, current account imbalances among the major industrial countries have widened," the staff fails to appreciate the progress in external adjustment that has been taking place in real terms in some countries including Japan. I do not think that this is a trivial definitional matter, but I believe that it relates to the basic perception of whether the external adjustment has started or not. By focusing attention on external balances in U.S. dollar terms, the general public has tended to have misperceptions of external adjustment in response to recent exchange rate changes. And it is highly undesirable for the Fund, as an organization specializing in external adjustment, to magnify such misperceptions. The extent to which there has been a certain degree of difference in external adjustment in real terms among countries, may also be an interesting subject for further analysis. Nevertheless, it is not appropriate to ignore important progress toward the correction of external imbalances in certain countries. I might also mention that under present circumstances, with import prices of most industrial countries having fallen significantly owing to a decline in oil and other commodity prices, even the ratio of the current account balance to GNP may not be a good indicator of the progress of external adjustment in response to exchange rates. My authorities believe that our current account surplus, even in dollar terms, will tend to decline in 1987 and will continue its declining trend in coming years. My authorities are, therefore, puzzled by the staff estimates for 1988 and would like a detailed explanation for this forecast.

The medium-term outlook is an interesting exercise, but given the uncertainties surrounding forecasts for the relatively long run, it would not be prudent for the Fund to publish projections for individual countries. The need for such prudence can easily be understood, if one looks back and asks who could have predicted the present economic environment five years ago. My authorities, therefore, request the deletion of medium-term forecasts for individual countries, as in the previous World Economic Outlook publication.

As regards the methodology used for projecting medium-term developments of current account balances, it is not clear what is meant by "trend factors" and how they are defined. Moreover, the staff makes an important and untenable assumption on these trend factors by saying that they will operate in the same way as in the past. Rapid structural changes are taking place in the Japanese economy in response to recent exchange rate changes, and they will lead to a substantial transformation of trade patterns and to a change in export and import elasticities in a few years. My authorities are, therefore, very much disturbed by the staff's use of these trend factors and cannot associate themselves with the conclusion reached on that assumption.

The chapter entitled "Economic Interactions and Policy Issues" in the main paper incorporates a response to the request of the Interim Committee to develop further the application of indicators in the context of the world economic outlook. The staff analysis in this regard, however, is basically an extension of that in the previous World Economic Outlook, and several issues raised by this chair at the time of that discussion remain relevant. For exmple, while accepting the importance of an analysis of the balance of payments, my authorities would have preferred a more balanced analysis using a wider range of indicators rather than concentrating on the balance of payments alone. Also, in analyzing savings and investment balances, the staff has tended to focus on fiscal positions and to overlook the dynamic relationship between public and private sectors and the vitality of the private sector itself, thereby falling into the pitfall of advocating fiscal expansion elsewhere in response to U.S. fiscal consolidation. In my authorities' view, such an analysis is tantamount to linking the fiscal position directly to the balance of payments position and does not represent a useful application of the savings and investment relationship. I will come back to this point in a moment.

With respect to the balance of payments prospects for my own country, on the occasion of the 1987 Article IV consultation, I elaborated in depth on the rapid changes in the industrial structure that are taking place in response to the recent exchange rate changes. I particularly emphasized the progress in shifting productive capacity abroad in the manufacturing sector and an increase in domestic investment in the nonmanufacturing sector. Such a change, together with sustained domestic demand and improved access to the Japanese market, should contribute to reducing the current account surplus to a much lower level than that forecast by the staff in the medium term.

The magnitude of the exchange rate changes since the Plaza agreement has been unusually large and perhaps unprecedented. Given the uncertainties involved with respect to the size and the pace of adjustment associated with such large exchange rate changes, any projection of the future pattern of external balances will remain highly conjectural. Moreover, a judgment on the sustainability of cumulative external positions is extremely difficult. The magnitudes of the creditor and debtor positions of Canada and the United Kingdom testify to that difficulty. It should also be noted that the external position of a country is only a statistical concept and that creditors and debtors are indeed quite diversified. The depth and breadth of financial markets, which function as an intermediary between creditors and debtors, may have been considerably expanded as a result of the global integration and liberalization of financial markets. For these various reasons, my authorities have strong reservations about the staff analysis and assessment of the medium-term balance of payments prospects and related policy recommendations. I do not believe that publication of this section would serve any constructive purpose, although I do not deny the usefulness of an exchange of views in the Board as part of the surveillance exercise. The possibility that projections by a responsible institution like the Fund could become a self-fulfilling prophecy also argues for caution in publication.

With respect to the implication of the staff projections on exchange rates, I would merely add that the exchange rate as well as the external balances are determined as a result of complex interactions among output growth, interest rates, and other factors, including structural ones, and narrowly focused attention on external balances and exchange rates would not be justified.

Based on a sectoral analysis of savings and investment, the staff has drawn a rather pessimistic conclusion on the prospects for private investment growth, which has led the staff to suggest a relaxation of the fiscal stance in some countries other than the United States. But no detailed analysis of the strengths and/or weaknesses of investment or the factors behind them are given in the staff paper. Is there not a possibility of medium-term growth of private investment in response to technological progress? Might not the high level of fiscal deficits be curbing private investment because of the expectation of a more stringent fiscal stance in the future? These are the questions that warrant more detailed analysis. Particularly relevant is the latter question, since, if the answer to that question is affirmative, the possibility exists that the short-term relaxation of the fiscal stance may not lead to medium-term growth of private investment or total demand. This point should be pursued further in the studies for the next world economic outlook exercise.

With respect to the fiscal stance of Japan, I have already touched upon the need for focusing on central government rather than general government expenditure. I also explained in detail, on the occasion of the 1987 Article IV consultation, the reasons why we did not agree to the staff calculations, which put the withdrawal of fiscal stimulus for 1987/88 at 3/4 of 1 percent of GNP. I believe that the points I made on that occasion remain valid.

I understand that that part of the staff paper relating to policy recommendations for each country will not be published, and I would like to have confirmation from the staff on this point.

Mr. Dai made the following statement:

I am in general agreement with a number of the main points in the analysis of the world economic outlook and the topics suggested for discussion by the staff. The issues put before us are major causes of concern in today's world economy, and they are closely interrelated. I shall concentrate my intervention on a few points arising from these issues.

My general view on the world economy for the foreseeable future is that the growth of industrial countries will continue at a relatively slow pace. The developing countries as a whole will continue to face a difficult external environment without signs of fundamental improvement in the terms of trade, in access markets in the industrial world, in rolling back protectionism, and in net capital outflows. The debt problem in many debt-laden developing countries will remain acute. The tensions among the major industrial countries and between the creditor and debtor countries will emerge from time to time, sometimes intensified, as a result of the bleak situation of world growth and trade, the lack of effective policy coordination among the largest industrial countries, and the uneasy path of adjustment in many developing countries.

On some specific points, first, the current account imbalances among the largest industrial countries will, in my view, remain sizable and a source of instability in the international monetary system and the world economy. There are two reasons for this view. The first is that the payments imbalances among the largest industrial countries, which have been aggravated in recent years since the recovery from the last recession, are not a temporary cyclical phenomenon but are rather of a structural nature with deep-rooted indigenous and exogenous causes. For this reason the sharp depreciation of the U.S. dollar has not brought about a reversal of the continuing trade deficit trend after two years of a weakening dollar. Recently, it has again been reported that the U.S. trade deficit rose to a record $38.4 billion in the fourth quarter in 1986 from $37.1 billion in the third quarter, raising the whole year's deficit to $147.7 billion from $123.4 billion in 1985. The stubbornness of the trade imbalance fully reflects the structural distortion in the deep-rooted deficit and surplus countries. Without courageous and effective structural reform in their economies, it would be very difficult to solve the imbalance problem in a short period. This requires not only an appropriate adjustment policy but, more important, farsighted determination on the part of policymakers.

The second reason is that so far, the economic policies of these industrial countries are not sufficient to carry out the necessary adjustment in their economies. Since the imbalances are of a structural nature, the realignment of the major currencies did not and will not bring about a smooth and rapid adjustment process. The structural nature of the imbalances limits the effectiveness of the exchange rate adjustment. Moreover, the inconsistency of national interests has made policy coordination among the major industrial countries more difficult. The clouds of increasing protectionist pressures have always drifted above the negotiation table. For different political reasons, however, it is easier for the policymakers to pursue a strategy of applying protectionist pressures rather than undergoing internal structural reform.

Economic developments and growth in indebted countries are greatly hampered by pressures stemming from terms of trade deterioration, balance of payments difficulty, curtailment of external financing, and the heavy burden of debt service since strong adjustments by many countries in recent years were carried out mainly through a "belt-tightening" approach. In other words, external and fiscal imbalances have been reduced at the expense of investment and growth. In turn, a sharp cutback of imports by indebted developing countries has been a major factor adversely affecting the growth of world trade and resulting in sluggish economic activity in both the industrial and developing countries.

It has been widely recognized that the solution to debt problems depends on the effectiveness of a growth-oriented adjustment policy, which requires concerted action by all the parties concerned. The experience of the past few years has not been satisfactory, however, partly because of the reluctance of the commercial banks to provide new financing to indebted countries, which has resulted in the decline of the financial flows that are necessary to revive the economic growth of these countries. One contributing factor could be that the weak economic performance of indebted countries in the past failed to provide assurances to commercial banks. However, the inability of the international financial markets to meet these countries' needs for financing undoubtedly also resulted from such factors as the sharp fluctuations of major currencies, a slowdown in world economic growth, and uncertainty in the international financial system. Past experience also shows that commercial lending was not a stable source of financing. Therefore, we cannot place too much hope in a change of attitude among commercial banks for an improvement in the debt situation. Against this background, the governments of creditor countries and international financial institutions should bear the major responsibility for revitalizing the debt strategy. I will elaborate on this matter in more detail in our upcoming Board meeting.

As regards international cooperation, I agree with the three key areas pointed out in the paper. Policy coordination among major industrial countries is the core issue. In today's world, the macroeconomic policy of the major industrial countries has a significant impact on economic developments in the developing countries and the stability of the world economy. In addition, external imbalances and budgetary constraints resulting from policy failures of major creditor countries would prevent them from increasing their financial support to the international community. It is therefore of paramount importance that the major industrial countries coordinate their macroeconomic policies in a context of international stability in order to create a sound environment for sustained growth of the world economy and the management of the debt situation. Any negative measures, such as protectionist measures, will lead to nothing more than a vicious cycle of domestic and external difficulties. It is still the responsibility of the international community to call repeatedly for the political will on the part of the governments of major industrial countries to roll back protectionist pressures, strengthen policy coordination, and speed up structural reform.

In this regard, one point I would like to emphasize is that action is much more important than words. I welcome the fact that a few donor countries have committed themselves to contributing funds to the international financial institutions which, I believe, will lead to more lively growth in the world economy and help to solve the world debt problem. As I see it, one of the central factors in further invigorating today's world economy is to revitalize the recycling of capital flows from the surplus countries to the developing countries, especially indebted countries. There are bottlenecks in the recycling of the flow of funds which obstruct the smooth operation of the world economy. In this circumstance, any action by the international community to remove the bottlenecks or promote the recycling is very much needed.

With regard to policy coordination, we are more concerned with actual action than with communiqués. True cooperation and coordination should be based upon the principle of equality and mutual benefit. Each party concerned must not only fully realize the responsibility of the impact of its policies on the world economy, but must also take fully into account the interests of other parties. Otherwise, there is no way to achieve true coordination. The use of the indicators approach could serve as a complement to multilateral surveillance. But, if it could not bring about any action in practice, then the role of indicators would be nothing more than "to indicate."

It has always been our view that the Fund's role should and could be enhanced. It is hoped that the Fund will be more active and effective in multilateral surveillance. Its capital base should be increased if it is to play a larger and more significant role in financing, adjustment, and tackling the debt problem in the developing world. The design of adjustment programs should be further improved on the basis of recent years' experience. The Fund's programs should not be aimed only at balance of payments problems in the short run, which usually call for a demand-management approach. More emphasis should be placed on structural problems, especially those of medium-term strategic significance, to ensure sustained development in these countries. However, this strategy should be carried out in a pragmatic manner and on the basis of full consultation and mutual understanding between member countries and the Fund.

Mr. Santos made the following statement:

Although industrial countries have entered their fifth year of uninterrupted economic growth following the 1980-82 recession, I note with great concern that in these countries the year 1986 was characterized by a continued high level of unemployment, by skewed external imbalances, and by a lower level of economic growth than expected. This performance is all the more disturbing because the price of oil fell sharply and prices of non-fuel primary commodities weakened further. However, benefiting largely from the lower prices of primary commodities, the rate of inflation continued to decline. The economic situation of developing countries was marked by a deterioration in the terms of trade that led to a widening of their external current account deficits, even though their export volume grew faster than envisaged. Nevertheless, with the adjustment efforts that most of them implemented, their economies continued to expand while the rate of inflation dropped significantly.

I will continue my remarks by commenting on the economic and financial developments in the major industrial countries and then examine their impact on the growth prospects of developing economies in general, and of sub-Saharan African countries in particular.

The large domestic and external imbalances of industrial countries are a source of increasing concern for a number of reasons. First, they have led to an increase in protectionist pressures. Second, a large misalignment of exchange rates has developed with some implications for competitiveness. The long lag between changes in exchange rates and the desired changes in external current accounts has had some destabilizing effects on the foreign exchange markets, given that exchange rates have a strong tendency to overshoot. It is, therefore, unfortunate that major industrial countries have continued to rely essentially on exchange rates to resolve the problem of external imbalances. Besides the fact that the rapid depreciation of the U.S. dollar has been harmful to many developing countries, in particular to those in my constituency, I also doubt whether a continued depreciation of the U.S. dollar would make a significant contribution to the reduction of the current account deficit of the United States. Furthermore, if, as stated by the staff, the exchange rate realignment has contributed to the weakness in investment spending, then continued exchange rate volatility will undermine the growth prospects of many countries.

In light of this assessment, the persistence of large imbalances represents a threat not only to the international monetary system but also to world economic growth. It is therefore urgent for major industrial countries to address this fundamental problem. Encouraging steps have already been taken to coordinate the economic policies of the major industrial countries, and I will urge the authorities to intensify their efforts. In this respect, I associate myself with the call that has been made for appropriate policy changes, especially in the United States, Germany, and Japan. The extensive reliance of the United States on the exchange rate to correct the large external imbalance has proved somewhat ineffective, and other approaches need to be considered. Since the major cause of the external deficit seems to be the excessive deficit of the Federal Government, steps to address this seemingly intractable problem should be taken. Until this problem is addressed, the current account deficit will persist. Efforts already started in that direction should be strengthened. While reductions in expenditures seem appropriate, the U.S. authorities should consider measures for raising revenue, as suggested by some Directors. In Germany and Japan, emphasis needs to be placed on fiscal stimulus to increase domestic demand. It is apparent from the staff analysis that the persistence of the internal and external imbalances, if not corrected, will become unsustainable and will lead to an intensification of protectionist pressures, thus adversely affecting the growth prospects of the world economy and developing countries in particular.

This leads me to developments and prospects facing developing countries, which were confronted with an unfavorable economic environment owing to the sharp deterioration of their terms of trade. The relief from external pressures that was expected because of the sharp drop in oil prices did not materialize. The prices of their primary commodities, the main source of foreign exchange, remained very weak; as a result, export earnings fell and government revenue was adversely affected. These developments also had an unfavorable impact on their ability to service their external debt.

Of grave concern to my authorities is the staff's assessment of the continuation of a slow pace of domestic demand in major developed countries, which does not give us much hope for future economic growth. For sub-Saharan African countries in particular, the deterioration of the terms of trade is expected to continue in 1987 and 1988. Furthermore, their export markets are not expected to expand significantly. The adverse economic impact of these factors will contribute further to a worsening of the debt situation. In light of this consideration, I find the staff projection of growth for the developing countries rather optimistic, especially since I expect investment in relation to GDP to fall in 1987 and 1988 because of the reduced inflow of foreign capital and the low level of domestic savings.

The staff's call on developing countries to rely more on themselves in order to improve their growth prospects has some merit. In particular, I share the view that a higher proportion of domestic production should be allocated to investment and that the efficiency of investment also needs to be increased. However, we should guard against generalizing this concept of self-reliance. In fact, the economy of many of these countries is influenced largely by external factors such as the terms of trade and the availability of external financing.

As the staff mentioned, the past year has seen a significant reduction in the exposure of commercial financial institutions in developing countries. This has made it all the more difficult for those countries to increase the level of investment and lay the basis for future economic growth. A more active participation by both official and private creditors through an increase in concessional loans will help to revive the growth process of developing countries.

In sum, the medium-term prospects of the world economy are not encouraging. Like other Directors, this chair is concerned about the situation. I hope that industrial countries whose economic policies have such important implications for the rest of the world will take the necessary measures to ensure a stable international environment conducive to noninflationary growth.

Mr. Dallara made the following statement:

Reviews of the world economy are welcome--particularly this one--as they are taking on increasing importance as part of the exercise of our responsibilities for Fund surveillance.

I will concentrate my remarks on the interactions of industrial country performance and policies, touching only briefly on developments in developing countries in light of the Board's upcoming concentrated discussion on prospects and policies in those countries.

Looking back on the performance of the world economy during the past year, we share the sense of disappointment that has been expressed today that the developments in oil prices, interest rates, and exchange rates have not had the positive effects on growth in the industrial countries, or on reductions in imbalances among those countries, on a scale or with the promptness that had been anticipated earlier. Clearly, policy reactions in key countries have not always been as helpful as possible, such as with respect to the pass-through of oil price changes. Yet the important point is not to reflect on what could have been done differently or better but to recognize that the policy and performance slippages of 1986 place a greater burden on corrective policy measures in 1987 and 1988, if an acceptable medium-term outlook for the world economy is to be achieved.

I enjoyed very much the agricultural analogies which were done this morning and, in reflecting on this past year, I hope you might indulge me if I make a sailing analogy. We could have allowed the current of interest rates and oil price declines, coupled with the breeze of exchange movements, to move us downstream this past year. But I am afraid we did not do much to allow that to happen. As a result, we will have to rely on our own skill in sailing and our own inboard or outboard engines to avoid going aground.

There have been numerous positive developments, and there are positive aspects of the outlook. I will not concentrate on those today--Mr. Nimatallah, as well as others, has done a good job in focusing on these more positive features--but I would make three brief points. First, U.S. external trade developments are perhaps a bit more positive than suggested by the staff analysis. To give one example, there was a rise in nonagricultural export volume on the order of 13.5 percent when measured from the fourth quarter of 1985 to the fourth quarter of 1986. Second, some of the impediments to external adjustment which appeared last year can be expected to recede in 1987, such as the scope for further reduction in profit margins in surplus countries. Third, concerns about the U.S. fiscal position in FY 1988, the fiscal year now under discussion in our Congress, should not obscure the fact that we are in the middle of a fiscal year that will produce a major reduction in the U.S. fiscal deficit. I think the Fund staff estimates this to be something on the order of more than 1 percent of GDP, from 5.3 percent to about 4 percent. This is a significant reduction.

These and other developments notwithstanding, important questions remain about the medium-term outlook.

Before turning to the policies of the industrial countries, let me say a few brief words on developing countries' policies. First, we were somewhat disappointed that so little attention was given to the effect of developing country policies and performance on the rest of the world, both on industrial countries and on other developing countries. We and other Directors have suggested on a number of occasions that it may be helpful to give more attention to this question, and we cannot help but feel that that continues to be justified.

One group of developing economies, perhaps, merits particular attention at this time, the so-called newly industrializing economies of Asia. A number of these economies have taken advantage of the U.S. dollar depreciation against other industrial country currencies to enhance their own competitiveness. While the U.S. dollar depreciated in nominal terms by some 41 percent against the yen and 46 percent against the deutsche mark since February 1985, the dollar has depreciated by no more than 12 percent against any of the currencies of these economies during that period. This has contributed to the large external imbalances which have grown in the past few years. For example, two key economies in the region--Korea and Taiwan--had trade surpluses as a percent of GDP which were higher than those of Japan and Germany, even though this was Korea's first year in current account surplus. Both the size and rapid growth of these surpluses call for urgent action. We strongly believe that the newly industrializing economies should assume greater responsibility for preserving an open world trading system by reducing trade barriers and pursuing policies that allow their currencies to reflect more fully underlying economic fundamentals.

With regard to other issues concerning the developing countries, I would only make one further point. We were a bit concerned to see the repeated use of the term "debt overhang" in the staff paper. We recognize that adequate levels and forms of external financing for both middle-income and low-income debtors are critical to sustaining investment and growth in these countries, but we found the concept of a debt overhang to be somewhat unhelpful and potentially misleading. It could, in fact, divert attention not only from the need for sound policies but also from the need to mobilize and catalyze new financing. In addition, prices determined in the secondary markets for debt reflect numerous operating imperfections and a lack of market depth, and we are not at all convinced that this secondary market currently is a reliable indicator of the underlying value of the debt. Accordingly, we found the emphasis on page 92 of SM/87/54 on "the lack of an appropriate international mechanism for writing down the book value of debt to a level more reflective of its market value" to be inappropriate.

On the medium-term outlook for the industrial countries, we found the use of indicators to be an important step foward in our surveillance activities. In addition, we found the analysis of potential savings and investment balances helpful. However, we would express caution about undue reliance on this particular framework, and about confusing statistical identities with cause-and-effect relationships. I must say that, in this particular case, we felt that the staff did a good job of steering clear of both of those potential pitfalls.

Nevertheless, we were disappointed that only one scenario was presented in any quantitative fashion. There was clearly a sense in the mid-January discussion on indicators that we would move in the direction of the use of alternative scenarios. We recognize that there may be good logistical and timing reasons why this was not easy to do on this occasion. We also recognize that the use of alternative scenarios could expose the staff to criticism for getting into forecasts that are not appropriate, or for using rigid models that may not reflect the variety of factors and variables that operate in reality. These difficulties notwithstanding, we would reiterate the desirability of their use in the context of the Fund's multilateral surveillance. I would add that we hope that the Fund could advance the use of indicators also by working toward establishing a framework for developing performance norms, or benchmarks. When viewed against medium-term objectives, these norms could be a basis for judging the appropriateness or inappropriateness of short-term external policies. These objectives could perhaps be hypothesized, if they are not available in a form agreed to by country authorities.

It should be recalled that one particular emphasis of the Tokyo summit agreement in May 1986 was the need for authorities to consider taking remedial action, when appropriate. Yet we are still a long way from developing the analytical process which would bring to the attention of the authorities at any early stage the need to consider such actions. I am not suggesting that the Fund develop with detailed precision fine-tuned recommendations for those actions. But certainly there is a job for the Fund in developing an analytical framework that could help authorities to better understand the medium-term implications of their policy options and to recognize circumstances that may call for remedial action.

With regard to the outlook for external imbalances among the industrial countries, there is little need to debate the view that the estimated current account positions of the United States, Japan, and Germany in 1991, based on the staff's medium-term analysis, are unlikely to be sustainable. When considering these outcomes in nominal, and not just in percentage-of-GDP terms, one gains an even clearer view that these outcomes are not sustainable, either politically or economically. A 2.9 percent of GDP current account deficit for the United States would, in 1991, involve a deficit of approximately $165 billion. That alone suggests the unsustainability of that particular scenario.

Of course, since the scenario was developed, it is fair to say that there have been some economic developments, modest exchange rate changes, and, perhaps more important, a meeting in Paris involving important cooperative commitments. At that meeting, the authorities of major industrial countries underscored the high priority that they attach to reducing these imbalances and committed themselves to measures toward that end. Whether the measures taken and currently envisaged are fully sufficient is a question that remains unanswered.

For the United States, the current staff forecast, when compared with the world economic outlook forecast last fall, involves a deterioration in the projected deficit from 2.1 percent to 2.9 percent of GDP in 1991. This rests partly on a pessimistic assumption regarding adjustment in the private savings ratio. Net private savings, while still negative, would be a somewhat smaller negative. However, such a private savings position would nevertheless be historically rare and undesirable. Moreover, my authorities clearly believe the scenario to be too pessimistic with regard to U.S. fiscal adjustment over that period. Nevertheless, it is clear that full achievement of the Gramm-Rudman-Hollings deficit targets may be difficult. Indeed, the fiscal year currently under consideration in our Congress, FY 1988, will be a key year for testing the efficiency of U.S. corrective fiscal action. Furthermore, although the historical evidence suggests that we should be able to increase our level of private savings above 17 percent, an increase from 16.4 percent to the 17.8 percent average of 1975-84 may well not be an easy accomplishment. Thus, even with appropriate action on the fiscal front, it is not entirely clear from this scenario that appropriate external adjustment can be accomplished without some further exchange rate change, in addition to the assumption of active policy steps by other countries.

Japan's current account surplus of 2.9 percent projected for 1991 is also, in the view of my authorities, an unsustainable prospect. There are, perhaps, some factors already in train which operate to mitigate the size of that surplus, such as demographic developments. But my authorities are of the view that it will take substantial additional policy action by the Japanese authorities to support a significantly larger reduction in Japan's external surplus. Thus, we welcome the commitment of the authorities in the recent Paris communiqué to prepare a comprehensive economic program to support and stimulate domestic demand in the Japanese economy. As I indicated last week during our discussion of the Japanese economy, we hope that this would involve a supplemental budget.

With regard to the Japanese fiscal position, I was somewhat puzzled by, and would be interested in a clarification of, the point made earlier by my Japanese colleague that his authorities took exception to a statement in EBS/87/39 that there had been a reduction in the fiscal deficit. Perhaps I misunderstood the point, but I thought that the data clearly indicated that, measured on either a general government or a central government basis, the deficit has been reduced--from about 5.4 percent to 3.7 percent of GDP for the Central Government, and more substantially for the General Government. However, if that particular statement bothered my Japanese colleague, my view of the statement on page 35 may, unfortunately, bother him somewhat more. The staff indicates that the "scope for easing fiscal policy is limited if, as the staff believes appropriate, the goal of medium-term budgetary strengthening is to be adhered to." This is a statement which I believe reflects staff views regarding both Germany and Japan, perhaps in a general way.

I must say that I wonder whether the time has come to ask ourselves just what we mean by medium-term budgetary strengthening for Germany and Japan today. If the implication is that there needs to be a continued effort and continued progress by both authorities in reducing the oveall size of government in the economy and the level of expenditure, then I have no problem. But if the notion of fiscal consolidation involves further reductions in the net fiscal position, then it is not entirely clear to me that any further net reduction in fiscal deficits, in either case, over the medium term is appropriate. Indeed, I would think that the medium-term analysis prepared by the staff argues rather forcefully for some modest increases in the size of the fiscal deficits of Germany and Japan in the short term, not through additional expenditure, but through a combination of further cuts in expenditure and aggressive tax reform.

With regard to the other aspects of Japanese policy that may be relevant for successful accomplishment of medium-term objectives, we would cite the need for housing, and other Mayekawa-type structural policies, to receive considerably more attention than currently. We find the savings and investment framework used by the staff at times a bit bothersome, but with regard to both the United States and Japan, it can sometimes bring home some basic truths. One of those truths may be that the savings-investment imbalance that exists in Japan may not be easily correctable without some fundamental changes with regard to a whole range of policies, including zoning, taxes, and housing. A function of the kind of analysis we have today is that it can bring such matters more to the forefront.

In the case of Germany, we recognize that a current account surplus of about 1.3 percent of GDP in 1991 may appear to approximate sustainability much more than the projected surplus of Japan and the projected deficit of the United States do. But there are reasons to be concerned. Our information suggests that since the world economic outlook forecasts were made--and Mr. Grosche's comments earlier today tended to confirm this--there have been some more troublesome signs in the German economy than had been forecast this past fall. While we recognize the tremendous effort that goes into the staff papers on the world economic outlook, and the difficulties of timeliness, it might have been helpful if we had been provided with an update of recent economic developments in Germany for today's discussion. For example, for the six months through January 1987, industrial production fell 4 percent, while building permits and industrial orders are down. The German economy was flat in the fourth quarter, and there appears to be a fair question as to whether it may again be nearly flat, if not flat, in the first quarter of 1987.

Two consecutive quarters of stagnation would have to be a matter of the utmost concern not only to the German authorities but to all of us. And it is in that light that we not only welcome the commitments made by the authorities in Paris but see the need for an aggressive implementation and follow-through on those commitments. We certainly welcome the tax reduction that now has been enlarged and is to be implemented in early January 1988. But if recent developments are validated with further data in the first and second quarters of 1987, a question must arise once again about whether there is a case for accelerating that tax reduction. The German authorities have rejected that measure on a number of other occasions, but it may nevertheless be fair to raise the question once again.

In addition, and consistent with my earlier view concerning the appropriate medium-term stance, one wonders whether there might be a case for a larger total net reduction in taxes through the medium-term tax reform package that has just been announced. Let me make clear that we welcome the authorities' tax reform plans, but one does have to wonder about its size and, perhaps, its timing. Most of the tax reform is envisaged to enter into effect in the 1990 time frame. In light of the lags involved, and in light of the potential difficulties of achieving a sustainable payments position in the early 1990s, again a question can be raised about whether or not an earlier implementation, or an earlier phasing, of that basic package might be helpful.

We believe that the major industrial countries, and indeed the entire world economy, now face a challenge. This challenge was clearly recognized in the Louvre agreement and was, in effect, put to themselves by the authorities participating in that agreement: it concerns the best way to accomplish an orderly reduction in external imbalances while sustaining world economic growth. These officials indicated in their communiqué that the reduction in these imbalances would be a matter of high priority. They even suggested that the policy emphasis in accomplishing that reduction should not be on further exchange rate changes. Yet it is difficult to escape the implications of the staff's analysis here today. Based on current exchange rates, and current policies, the imbalances may not be reduced in an orderly fashion.

Let us hope, therefore, that the authorities understand the seriousness of the challenge that they face and, in the case not only of my own authorities but of other key countries, that actions are taken in 1987 that are necessary to make 1989, 1990, and 1991 prosperous years for the world economy. As Mr. Dai very bluntly but eloquently stated, most countries are not so much interested in communiqués as in policy actions. It is our obligation to follow through.

I would hope that the Fund could, through the Managing Director, bring home clearly to the Ministers and Governors participating in the Interim Committee meeting the need for clear and decisive action if an orderly evolution of events is to follow. I would also add that the Governors and Ministers participating in the Louvre Accord acknowledge another challenge, one that Mr. de Groote cited earlier. This is the challenge to move the process of cooperation and coordination away from ad hoc meetings and ad hoc efforts toward a more systematic improvement.

I would, perhaps, not fully associate myself with some of Mr. de Groote's assessment of the earlier G-5 and, as he refers to it, G-2 efforts; I would also put somewhat more hope than he does in indicators to strengthen the system. Nevertheless, I would fully associate myself with the thrust of his analysis that it is important, in the current effort to improve coordination, not only that immediate difficulties--such as payments imbalances and growth difficulties be addressed but that the needed systemic discipline be achieved to ensure more effective coordination over the medium term. Again, the Interim Committee discussion might provide an opportunity for the Fund to further that objective as well.

Mr. Yamazaki, in response to Mr. Dallara's comments, remarked that the change in Japan's fiscal balance from minus 6.2 percent to minus 4.3 percent of GDP was not necessarily large. Furthermore, he was not aware that the Japanese Government had indicated any changes in medium-term policies to which Mr. Dallara had alluded.

Mr. Grosche noted that Mr. Dallara was correct in stating that Germany's "Law on Growth and Stability" facilitated the parliamentary procedures for changes of up to 10 percent--in either direction--of income tax obligations depending on the economic situation. Therefore, a broadly based legal framework existed, should it become necessary to help to sustain domestic demand, that would facilitate a speedy implementation of tax cuts.

The Executive Directors agreed to resume their discussion the following day.

APPROVED: October 16, 1987

LEO VAN HOUTVEN
Secretary