NOT FOR PUBLIC USE

MASTER FILES
ROOM C-525

0404

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 91/130

3:00 p.m., September 23, 1991

M. Camdessus, Chairman

Executive Directors	Alternate Executive Directors
M. Al-Jasser	
G. K. Arora	
	Chen M., Temporary
C. S. Clark	
	Q. M. Krosby
	J. Prader
	F. Moss, Temporary
E. A. Evans	
R. Filosa	
	M. B. Chatah, Temporary
M. Fogelholm	
H. Fukui	N. Tabata
B. Goos	B. Esdar
J. E. Ismael	T. Sirivedhin
	J. C. Jaramillo
J.-P. Landau	
	M. J. Mojarrad, Temporary
	L. J. Mwananshiku
	R. Thorne, Temporary
G. A. Posthumus	
	A. R. Ismael, Temporary
A. Torres	R. Marino
A. Végh	A. G. Zoccali

L. Van Houtven, Secretary and Counsellor
S. W. Tenney, Assistant

Also Present

African Department: M. Touré, Counsellor and Director; G. E. Gondwe, Deputy Director. Central Asia Department: D. A. Citrin, G. M. Meredith. Southeast Asia and Pacific Department: K. Saito, Director. Exchange and Trade Relations Department: J. T. Boorman, Director; S. Kanesa-Thasan, M. R. Kelly. External Relations Department: S. J. Anjaria, Director; D. M. Cheney. Fiscal Affairs Department: E. F. Offerdal. Legal Department: J. M. Ogoola. Research Department: M. Mussa, Economic Counsellor and Director; M. Goldstein, Deputy Director; E. Hernández-Catá, Deputy Director; P. B. Clark, D. T. Coe, P. Gajdeczka, S. J. R. Gorne, G. Hacche, E. Mendoza, M. Schulze-Ghattas, S. A. Symansky, K. S. Warwick, M. A. Wattleworth. Secretary's Department: A. Tahari. Treasurer's Department: M. G. Papaioannou, G. S. Tavlas. Western Hemisphere Department: D. Dwor-Frecaut, L. P. Ebrill. Office in Geneva: H. Junz, Special Trade Representative and Director. Personal Assistant to the Managing Director: B. P. A. Andrews. Advisors to Executive Directors: J. M. Abbott, B. R. Fuleihan, A. Gronn, D. Powell, A. Raza, A. M. Tanase. Assistants to Executive Directors: J. R. N. Almeida, T. Berrihun, J. A. Costa, J. Dognin, D. P. Enger, A. Giustiniani, O. A. Himani, I. Martel, P. K. Kafle, V. Kural, R. Meron, M. Mrakovcic, L. Rodríguez, S. Shimizu, C. M. Towe.

1. WORLD ECONOMIC OUTLOOK

The Executive Directors continued from the previous meeting (EBM/91/129 9/23/91) their consideration of a staff paper on prospects and policy issues related to the world economic outlook (EBS/91/146, 8/30/91; and Cor. 1, 9/18/91), together with a statistical appendix (SM/91/179, 9/3/91) and supplementary notes providing background material (SM/91/190, 9/6/91). They also had before them a staff paper on the Uruguay Round of multilateral trade negotiations (SM/91/187, 9/4/91), a staff paper on recent developments and issues in the world trade system (SM/91/196, 9/18/91), and charts on exchange rate developments (EBD/91/273, 9/20/91).

Mr. Jaramillo made the following statement:

> The staff paper provides insight to the short-term outlook of the world economy and highlights the major problems that will be faced during the present decade in a clear, straightforward, and instructive manner, emphasizing many of the topics that have most interested this Board in recent months. For the current discussion, I will comment only on the problems of Eastern Europe and the U.S.S.R. The Board will address the impact of the debt situation on the prospects of developing countries in the coming week, but it should be noted that the debt problem is still a major concern for all the countries in our constituency, including those that have been able to maintain their debt-service record intact.
>
> The 3 percent upswing projected for the world economy in 1991-92 seems sensible, although perhaps somewhat on the optimistic side. As mentioned in the staff paper, the U.S. recession has been mild, so there are no major expectations of a strong rebound, as on previous occasions. In fact, most signs already show that the trough has passed, but the speed of recovery is slow. And if inflation is to be maintained in check, monetary policy will not have much leeway toward enhancing a more rapid expansion. Moreover, given the diagnosis of a global savings shortage, the stance of fiscal policies in most industrial countries must be tightened, even in the short run, as discussed thoroughly in the staff paper. All these factors suggest that the short-term projections of developments in the industrial world may be on the optimistic side, as there does not seem to be room for any unexpected shock or policy shortcoming.
>
> With respect to the outlook for developing countries, prospects in the short run are even more pessimistic than presented in the staff paper, since in the near future the deteriorated terms of trade will strongly influence the economies of these countries. Although the direct effects of this fact have been incorporated in the staff's assumptions, it is also assumed that programs will remain on track, despite adverse terms of trade developments. As

was pointed out during the recent review of conditionality, the prospects for maintaining adjustment efforts, not surprisingly, diminish significantly when there is a deterioration of the terms of trade. Consequently, it would not be surprising to find higher than average slippages in policy areas while these circumstances persist.

The staff paper emphasizes the importance for the world economy of a significant rebound in the medium term of the savings ratio of industrial countries. The overall savings rate is expected to increase by 1.5 percentage points of GDP over 1991-96, but with expectations of a continued deterioration of private savings, this result will require an improvement of more than 2 percentage points of GDP in the overall fiscal performance of industrial countries. This amount can be compared with the sums required to meet the so called savings shortage. Including the reconstruction of east Germany, the additional demands for world savings included in the staff paper have been roughly calculated to be $100 billion per year during 1992-96. This is equivalent to about 0.6 percent of industrial countries' GDP, or about one fourth to one third of the required fiscal consolidation in industrial countries suggested by the staff for the same period.

Put in these terms, financially speaking, failure to bring about the suggested fiscal adjustment would create problems to the world economy equivalent to three or four times the size of the expected external requirements for the reconstruction of Eastern Europe, the U.S.S.R., and the Middle East combined. These figures highlight the importance of achieving fiscal consolidation in the industrial world and suggest that failure to do so will result not only in lower investment ratios, slower growth, and higher inflation in these countries, but also in a financial squeeze in the rest of the world that may not have any recent parallel. It is thus of crucial importance to maintain--and if possible strengthen--the consensus that has developed around the need for a major restrictive fiscal stance in industrial countries during the coming years.

The staff paper mentions that the recent decline in short-term interest rates in relation to long-term interest rates is in line with historical records, as financial markets will become more confident about the prospects of recovery. But this does not explain the persistence of the very high levels of long-term real interest rates during the past decade as noted by the Bank for International Settlements 1991 report. It perhaps suggests the presence of more fundamental longer-term factors, aside from the present recession and its recovery--that could be related to the long-term decline in savings. I wonder whether the staff could comment on this matter.

Although the developing countries' contribution to world growth is not overly significant, the roughly 5 percent trend for the medium term envisioned by the staff for developing countries, excluding the U.S.S.R. and Eastern Europe, is also on the high side. The expected outcome depends on the assumption of successful implementation of all Fund or World Bank-supported adjustment programs underway. During the recent review of conditionality, the staff noted that 20 of a sample of 44 Fund-supported annual programs during 1985-88 did not meet their quantitative objectives of economic growth. Also, the staff pointed out that developing countries with debt-servicing difficulties face uncertain prospects for normalizing financial relations with their creditors, and that in several of these countries new imbalances are emerging, deteriorating their macroeconomic situation. Furthermore, the staff correctly points out that in the case of the Western Hemisphere, projections are subject to large downside risks. There are also the concerns about the strength of recovery in industrial countries. These are all indications that perhaps we should be more realistic with respect to economic projections.

As in previous world economic outlook exercises, the staff paper develops alternative medium-term scenarios for developing countries. These are based on more realistic assumptions than those adopted for the baseline scenario. The medium-term scenarios assume that countries with very high inflation rates during the past two years would move toward price increases in 1993-96 similar to those that prevailed in 1983-86. This will not be an easy task, and it involves strong adjustment in these countries, as the staff recognizes. From the recent review of conditionality and ex-post results of programs, this seems to be a more probable outcome. Perhaps it would be more appropriate to use this alternative as the baseline scenario, despite the technical and political caveats involved in such an approach. The baseline scenario contained in the staff paper could be seen as a best-case or optimistic outcome. As this chair noted during the previous discussion on the world economic outlook, it would be very useful if the alternative scenarios were fully recorded in Tables A51-53 of the statistical annex to facilitate comparisons and to highlight them.

We fully agree with Mr. Posthumus and other speakers who have suggested that the Fund adopt a strong stance on the importance of a successful conclusion of the Uruguay Round of multilateral trade negotiations, by emphasizing that this issue is of direct relevance to the Fund. The credibility of Fund--and World Bank--advice can be severely eroded if, after supporting unilateral liberalization in many developing countries, some of the largest Fund members are not seen to move in the same direction. Moreover, the financial situation of the Fund could also suffer. To the extent that more programs would tend to fail, there would be an increase in the demand for Fund support and probably in the number of countries either in arrears or in situations where they could not avoid becoming prolonged users of Fund resources.

Mr. Végh made the following statement:

The comprehensive staff paper currently under consideration underlines the complexities of the simulation exercise for the world economy and the crucial linkage between its conclusions and the initial assumptions.

Basically, I agree with a clear majority of previous speakers that the staff projections for the world economy are too optimistic, because the assumptions they are based on are not likely to be realized in their entirety. In this connection, I agree with the comments put forward by Mr. Fukui for the current discussion and with the observation made by Mrs. Krosby during the 1991 Article IV consultation with the United States (EBM/91/125 and EBM/91/126, 9/18/91) on the unsatisfactory evolution of consumer confidence in the United States. Moreover, to assume that all industrial countries will fulfill their commitment to reduce fiscal deficits, that all developing countries under adjustment programs will do the same and, moreover, that they will have unimpeded access to industrial countries' markets, as the staff paper does, is too optimistic.

The Uruguay Round is proof of the reluctance to implement reasonable policy measures. Ensuring adequate market access under predictable rules is of paramount importance if the trading environment, which has been so conducive to liberalization and growth during the recent past, is to be relied upon in the future.

In this context, it should be emphasized that the definition of market access has to be sufficiently broad to encompass the trade and fiscal effects of export subsidies and domestic support schemes.

The absence of market access in the broader sense and the obvious relationship with diminished external repayment capacity is central to Fund policy advice and program design. Therefore, I support Mr. Posthumus's suggestion that an explicit and urgent appeal, calling attention to the consequences of failure in this respect, should be included in the summing up of the current discussion. At the present stage, there is reason to be less optimistic than a year ago on the likely outcome of the Uruguay Round, especially given the attitude of the German Government. When the December 1990 deadline was approaching, I thought, like many people, that the very strong attitude taken by the German authorities was attributable to the forthcoming presidential election. Indeed, at that time, the German Government had good reason to postpone taking a very strong position on this matter. However, at the present stage, we are concerned that no move has been made by Germany to take on a leadership role in the area of trade negotiations; certainly it has not come close to playing the role it has had in the area of coordinating monetary policy.

It would be an oversimplification to suggest that the most important change in the near-term prospects, since the previous world economic outlook exercise, is the greater than expected fall in output in Eastern Europe and the U.S.S.R., when Table B of the statistical annex shows that the region's share of total world GDP is 5.6 percent, and that its share of total exports of goods and services is 5.8 percent. Financial fragility in the United States and fiscal weakness in Germany are matters of more importance.

The most worrisome aspect of the current world economic analysis is that while the world economy has been slowing down since 1988, the rate of inflation has shown an increasing trend. Although global figures mask developments across countries and regions, the fact is that inflation is a serious threat for the world economy. The medium-term inflation outlook for several industrial economies is not comforting. Lack of a strong fiscal adjustment in the United States and other countries, excessive resource transfers, mostly for consumption, to east Germany, and rigidities in labor markets in many European countries are worrisome factors that may contribute to inflationary pressure as soon as a rebound of economic activity is present.

As the staff paper has presented a very clear analytical framework to address the shortage of savings, I will make only a few points on this issue. We should consider whether enough funds will be available at reasonable cost to fill the needs of these countries, or if there will be significant changes in the level of international interest rates. It is important to consider in this respect that even if an increase in the interest rate occurs out of an increased demand for funds, much of that demand may still be unmet to the extent that suppliers of credit are unwilling to take the risk even at high interest rates. This is true for private capital, and it may have a bearing on public capital flows.

I agree with Mr. Posthumus's statement that the problem of saving shortages is more political than economic. Both the reduction of public disavings and the allocation of public expenditures to alternative uses are mainly political decisions. This becomes apparent with respect to agricultural subsidies. Another area of growing concern is military expenditures, particularly now that tensions have subsided.

It is worrisome that political considerations are being presented by several industrial countries as the main reason for delaying necessary policy measures, both to reduce public expenditures and to change their composition. This is particularly unwelcome when experience has shown that fiscal adjustment helps economic growth in the medium term.

Another important concern has to do with the expenditure mix of the resources that will actually be transferred to the importing regions. One can imagine the political pressures and motivations toward using these funds to sustain a level of public and private consumption that would otherwise be unsustainable. In this respect, the experience of east Germany comes to mind. Another experience that should be kept in mind is the debt crisis of the 1980s. In Latin America, for instance, during the 1970s increased demand for funds arose from development needs. The ensuing external indebtedness, some of which was used to sustain consumption levels incompatible with the economic fundamentals of the time or for low-efficiency investments, proved to be very counterproductive, and we are paying for that at the present juncture.

It is also important to take into account that, in the case of the external debt crisis, commercial banks provided the funds, which makes it very unlikely that private capital will meet much of the present demand for savings in Central Europe and the U.S.S.R. Thus, the presence of the public sector will be required. Official financing has the advantage over private flows in that conditionality can be imposed in connection with the use of resources. However, it is cause for concern that much of the official financing may be diverted to consumption rather than to building physical and human capital, which is the only way to insure that these loans will be repaid. The financial position of official financial institutions--both bilateral and multilateral--may be at risk in the future if the use of the borrowed resources is not closely monitored.

As to the behavior of the private saving rate, which has been declining since the 1980s and is projected to decline further in the 1990s, the explanations contained in the staff paper do not provide a satisfactory solution. The impact of the wealth effect is not clear. Although it is true that consumers enjoyed substantial capital gains on housing and equity in the recent past, they have also increased their level of indebtedness, so their net wealth may not have increased that much. It appears that a better understanding of the private saving rate is needed in order to be able to implement measures to increase its level in the future.

Mr. Chen made the following statement:

Like previous speakers, I welcome the current discussion on prospects and policy issues related to the world economic outlook.

Although the staff has emphasized that the assessment of the near-term prospects for the world economy has not changed markedly from those presented in the previous world economic outlook exercise, some very important changes have been made in the previous projections. For 1991 Japan, Germany, and the United Kingdom seem to be performing somewhat better than envisaged, while the United States, France, and Italy have experienced a more serious recession than expected. Only the prospects for the other industrial countries may not have changed much. In this context, desynchronization is still working in 1991 to offset the larger than expected decline in the countries in recession. The expected moderation of economic growth in Japan and Germany is projected to be delayed by one more year, which is contrary to the view that a faster recovery in the United States and in other major industrial countries would offset the effect of the slowdown in Japan and Germany on the world economy and on the industrial countries as a whole. Nevertheless, in the context of the multipolar system, prospects for the industrial countries as well as for the world economy will still depend on how well these three economies perform. In this respect, I agree with Mr. de Groote that not only the timing but also the magnitude of relative change in these economies are highly important.

With respect to the staff's projection for the industrial countries for 1992, a 3 percent growth rate is no longer a modest pick-up, as this is almost the average level of growth between 1983 and 1991. As Mr. Posthumus stated, a much sharper upswing would be required; however, it is still not very clear whether this sharper upswing can be realized in the short run.

On the whole, I tend to agree with Mr. de Groote that the picture drawn by the staff on the world economic outlook and that for some major industrial countries, such as the United States, may be somewhat optimistic.

I agree with the staff projections on the prospects for the developing countries. The staff has made even more significant changes for the developing countries compared with the spring World Economic Outlook. We are worried that not only will many developing countries and regions continue to suffer negative growth in 1991, but also the developing countries as a whole are expected to experience negative growth for the first time over the past decade. The year 1991 is indeed extremely difficult for the developing countries. I am in broad agreement with the staff's analysis on the reasons for this gloomy picture, such as the ever-severe and devastating effects of a variety of natural disasters like floods, earthquakes, and volcanic eruptions that have taken place in quite a number of developing countries. These natural disasters not only caused heavy physical and human loss, but also resulted in policy slippages in their adjustment programs.

With respect to the principal elements of the rebound in developing countries, I would emphasize the recovery in the major industrial countries, including the rebound in world trade; progress in adjustment and reform in the developing countries; prospects for debt relief for heavily indebted lower- and middle-income countries; and the possibility for increased inflows of new money to the developing countries.

As to policy issues in the industrial countries, I agree with the staff that the current relatively lower level of inflation rates in the major industrial countries still allows them some room to maneuver interest rates in order to stimulate investment and consumption, which are requirements to pull their economies out of recession. But, as interest rates are further lowered and the room for maneuverability becomes narrower, caution should be exercised against any excessive relaxation of monetary policy. In this respect, I agree with the staff. As to monetary policy, in addition to my concern about the medium-term prospects for price stability in the industrial countries, I wonder whether the expected further slowdown in Germany would bring about some decline in interest rates, despite the still higher demand for the use of resources in Germany. Like Mr. de Groote, I wonder why the U.S. consumer reaction so far has been small to the exceptionally low interest rates and whether the decline in elasticity is a temporary phenomenon.

The adequacy of savings at the global level as well as at the national level is one of the conditions for sustainable growth in the developing countries as well as in the industrial countries. The industrial countries have an important role to play in increasing public savings by implementing sound fiscal policies. As we have expressed our view on this issue on several previous occasions, and this issue remains unchanged, we shall not repeat it for the current discussion.

It seems unnecessary to emphasize the importance of the global multilateral trading system. It is regrettable that little progress has been made since the resumption of talks in the Uruguay Round and that there is no immediate sign that it will come to a successful completion by the end of 1991. The consecutive disruption of the talks is both a reflection of the intensification of trade conflicts, in particular the rising protectionism in many industrial countries as well as the lack of sufficient political will of the parties concerned. If the Uruguay Round is to be concluded, two principles are crucial: one is heightened political will, the other is the necessary compromise. In this respect, I support the proposals contained in Mr. Posthumus's opening statement.

The trend of regional integration is still a second-best solution compared with a global multilateral trading system; as it is moving faster than expected, there is all the more need to emphasize that every effort should be made to ensure that the arrangements made in regional integration are in line with the principles of the global multilateral trading system in order to avoid any adverse impact on third parties, in particular those countries undertaking trade reform and liberalization.

Mr. Torres made the following statement:

We welcome this opportunity to review the recent developments and prospects for the world economy over the coming years. Unfortunately, the salient feature of this world economic outlook exercise is the substantial slowdown in economic activity in the world economy for the third consecutive year and the recession suffered by several industrial countries including the United States. The current world economic outlook exercise proves to be particularly relevant given the recent developments in the U.S.S.R. and the radical transformations taking place in Eastern Europe and east Germany. It also comes at a time when the major industrial countries are involved in an important exercise of multilateral trade liberalization under the Uruguay Round. Therefore, the prospects for the world economy are particularly uncertain at the present juncture, and there is an upside potential to the forecasts presented by the staff, there is also considerable downside risk.

I will comment briefly on the current developments and short-term prospects in industrial countries. Although we agree with the thrust of the staff's analysis, we are less optimistic, particularly with respect to the short-term prospects. I will concentrate my remarks on the medium-term prospects and policy issues in the developing countries, including the prospects for the pattern of international saving flows--the so-called savings shortage. I will also comment on the relationship between trade and financing, including recent developments in the Uruguay Round. Finally, I will briefly comment on the recent evolution in the debt strategy, since I will present our complete assessment of this topic during the forthcoming discussion on management of the debt situation.

The growth rate of economic activity in industrial countries is expected to decline to 1.3 percent in 1991, which would constitute the third consecutive year in which a decline is observed. This slowdown in output growth in industrial countries is attributable to the entering into recession of the United States, Canada, the United Kingdom, and four other small industrial countries--Australia, Finland, New Zealand, and Sweden. The staff is forecasting a recovery in output growth to 2.9 percent in 1992 based on the sharp fall in oil prices since the beginning of 1991, the large decline in short-term interest rates, particularly in the United States, and an expected rebound in stockbuilding and consumer and business spending. This growth rate would be roughly in line with the estimated growth of potential output. During 1992, the divergence in cyclical positions in industrial countries that characterized 1990 and the first part of 1991 is projected to come to an end. However, the timing and extent of this convergence remains highly uncertain. The recovery in the United States could be slower and weaker than projected by the staff given the low levels of consumer confidence and the sluggish demand response to lower interest rates. High interest rates in Germany would hamper growth prospects in Europe, and there are signs of weakening investment demand in Japan.

The rate of inflation is expected to decline in industrial countries from 5 percent in 1990 to 4.5 percent in 1991, and to moderate further to 3.75 percent in 1992. However, the continuation of restrictive monetary policies, particularly in Germany and Japan, where there are pressures on productive capacity, suggests that the containment of inflation remains a significant risk. In the United States, the underlying inflation rate--consumer price index excluding food and energy--of about 4 percent at the trough of the cycle is still substantially above the Federal Reserve's medium-term goal for price stability.

The rise in import volumes in industrial countries will slow in 1991 to its slowest pace since 1982, despite continued strong growth of imports in Germany. However, the staff optimistically project a rebound of export markets in 1992.

Over the medium term, real GDP growth is projected to recover from 1.25 percent in 1991 to an average of 3 percent in 1992-96, with changes in the trade and current account balance being relatively minor in relation to GDP. There will be a moderation in inflation over the medium term, given the excess capacity in recession countries. The projections for output growth over the medium term envisage a reversal of the earlier decline in the average national saving rate of the industrial countries, which fell by 4.5 percentage points of GNP from 1967-73 to 1980-90. The national savings rate is projected to rise by 1.5 percentage points from 1990 to 1996. With respect to these issues, we hope that the process of fiscal consolidation will be advanced in the main industrial countries, particularly the United States, Canada, and Italy, since they are a central element in the staff's medium-term forecast. It should be highlighted that the full implementation of existing deficit reduction plans would be a minimum requirement to ensure that the increase in investment needed to sustain growth can be financed at the projected level of interest rates.

Output growth in developing countries is projected to increase by an annual average of 4.25 percent in the period 1993-96 in the baseline scenario. This forecast is based on the combination of a favorable external economic environment and the implementation of sound economic policies in developing countries. Tight monetary and fiscal polices would lead to a reduction in inflation rates, an increase in domestic savings, and an increase in total factor productivity; all these forces combined would produce the increase in output growth. Following the continuous decline in per capita GDP in the countries of the Middle East, the Western Hemisphere, and Africa since the late 1970s, the restoration of growth in these regions is a matter of urgency. Therefore, the fulfillment of the staff's optimistic forecast would constitute an endorsement of the outward-oriented growth strategy and market-oriented reforms undertaken by many of these countries. We hope that the adjustment efforts made by many developing countries will start to bear fruit and that the 1990s will become a decade of prosperity for the developing world.

Nevertheless, many downside risks exist, and we are grateful to the staff for preparing an alternative scenario based on less optimistic assumptions about the progress of domestic policy reforms, and a less favorable external economic environment that quantifies the effects of these developments on potential output growth, inflation, investment, and total factor productivity. The comparison between alternative scenarios is useful, as it highlights which groups of developing countries are more severely affected by the downside risks that exist in the current world economic outlook. It is interesting to note that most severely affected group is the countries with adjustment programs, for which the growth of potential output declines from 3.8 percent to 2 percent. Paradoxically, the poorest countries--the least developed countries--are not affected significantly by the lower growth scenario, presumably owing to their product mix and the geographic composition of their exports.

Despite the low sensitivity of the poorest countries to the external environment, which does seem rather strange, the staff usefully highlights the importance of the external environment for developing countries. As illustrated in Table 11 of EBS/91/146, slower average growth in the industrial countries by 1 percentage point reduces GDP growth potential in developing countries by 1.2 percentage points; similarly, a 5 percent cut in manufacturing tariffs in industrial countries would increase average growth in developing countries by 1.4 percentage points. This underscores the importance for developing countries of a successful conclusion of the Uruguay Round. For many developing countries and formerly centrally planned economies that have liberalized unilaterally their trade systems and embarked on outward-looking growth strategies under Fund-supported programs and with the encouragement of the industrial countries, open access to the markets of industrial countries would boost their probability of achieving successful adjustment. In this respect, a possible failure of the Uruguay Round is a major source of trade and investment-inhibiting uncertainty.

The driving force behind the postwar expansion of world trade came from outward-looking long-term investment, made possible by the stability of the international trading system. The failure of the Uruguay Round may undermine this stability at an accelerating pace. Uncertainties surrounding future market access and the erosion of the predictability of the rules of the game impose a serious threat to the growth prospects of the world economy; in particular, to the ability of developing countries to develop in line with their own comparative advantage. The resolution of the debt problem is also linked to the problem of maintaining a relatively free and predictable trade environment in the world economy.

However, the risk of a failure does not undermine the case for unilateral trade liberalization. The ultimate purpose of trade liberalization is not to maximize a country's exports, or even world trade, but rather to bring about a more productive use of resources. I agree with the remarks made by Mr. Evans on this issue. The case for unilateral trade liberalization is independent of whether or not it is accompanied by a reduction of trade barriers in the rest of the world. However, multilateral liberalization maximizes the positive effects of opening up an economy. In its absence, the case for unilateral trade liberalization will be more difficult to sell domestically, and will lead to inefficient patterns of specialization in production and trade.

Nevertheless, the risks of a failure, as well as the benefits of success, of the Uruguay Round are well known. The most obvious conclusion to be drawn from the protracted deadlock of the negotiations concerns the limitations of economic advice, as well as of our own influence. All the major problems and difficulties involved in successfully completing the negotiations are essentially political. It is much less difficult to determine what the appropriate actions should be than to disentangle national economies from policies known to be wrong; in particular, in those of the major trading partners. On this point, I agree with the comments made by Mr. Finaish. We are left with a sense of frustration and wonder about what can be done to help break the present deadlock. We should not overestimate our influence, but we should no be content with a general call for a successful completion of the Uruguay Round, particularly at the present stage, when time was running out.

I agree with Mr. Posthumus's suggestion to include in the summing up of the current discussion an urgent appeal to the Interim Committee to call for strong support by Fund Governors for active efforts to overcome the political obstacles to a timely and comprehensive outcome of the Uruguay Round, focusing--in addition to general concerns--on the implications of a failure for the success of Fund-supported programs, financing assurances, and the financial position of the Fund. In that way the Fund would not give up its responsibility to clarify and understand, through an informed discussion, the full consequences of different lines of collective action.

On the adequacy of global savings, the staff paper contains several important conclusions and policy recommendations, some of which are clear, but others require some interpretation. I will offer our view on the topics that require interpretation.

First, additional investment demand from the different sources identified in the staff paper, but particularly from the economic transformation efforts in Eastern Europe, the unification of Germany, and the prospects of reform in the U.S.S.R. will affect only marginally the equilibrium in the private market for loanable funds. As a reflection of this, the staff projects that interest rates would increase by 50 basis points if the additional potential demand becomes effective and there is no compensating supply response. I wonder whether the staff could comment on the variables related to interest rate elasticity. They seem to be on the high side.

Second, increasing government savings in both the industrial and developing countries constitutes the best way to increase the supply of savings. Other things being equal, it would seem preferable to increase government saving and national saving by reducing government expenditures, although great care should be exercised in not reducing those types of government expenditure that promote the accumulation of human capital and foster technological innovations and traditional expenditure on infrastructure.

Third, efforts should be directed toward increasing the level of savings in industrial and developing countries, particularly in countries where a large domestic savings-investment gap exists. However, it is equally important to ensure that the existing savings are allocated to the most socially productive uses. From the figures contained in the staff paper, it would seem possible to increase official transfers to countries undergoing radical transformation of their economies without putting additional pressure on the budget and interest rates, if these transfers are offset by spending cuts in other categories, particularly military expenditures and subsidies to industry and agriculture.

With respect to military expenditures, it seems appropriate to use the so-called "peace dividend" to bolster the official pool of resources available to finance the transformation process of the U.S.S.R. and Eastern Europe. A reduction in military expenditures in both donor and recipient countries would free resources that could be applied to the pressing investment needs in health, education, and infrastructure. In addition, it would make an important contribution to industrial countries' deficit-reduction efforts.

Another area that offers great potential to rationalize government expenditure is farm subsidies. As the staff points out, the abolition of agricultural support measures in the industrial countries would reduce government outlays by more than $100 billion a year. It seems that both cutting military expenditures and the rationalization of government subsidies to domestic producers in industrial countries by freeing resources for other more productive investments, by contributing to a more efficient allocation of scarce savings, by contributing to the expansion of trade in developing countries, can make a substantial contribution to world prosperity in the coming years. We are well aware that these are very sensitive areas. However, given their great potential contribution, we believe that the Fund should make a strong call to member countries to look carefully at the structure of their government expenditures and try to reorient them into their most efficient uses.

Fourth, the challenge before the international community is finding a way to respond to the new demands for official financing from east Germany, Eastern Europe, and the U.S.S.R. without crowding out the developing countries in Africa, Asia, and the Western Hemisphere, thereby, hindering their adjustment efforts. It seems evident that the main factors limiting capital flows to developing countries are not the availability of savings; more important in many cases are political uncertainty, macroeconomic instability, and excessive caution on the part of lenders owing to the so-called contagion effects.

The international official financial community should be ready to step in under circumstances of investment externalities in developing countries. The staff correctly pointed out that private capital flows to developing countries are likely to be suboptimal, given the wedge that exists between the social rate of return and the private rate in investments in physical infrastructure and human capital.

As we have argued on previous occasions, the debt overhang represents an important obstacle to external financing and growth, since it exacerbates uncertainty about the prospects for the economy. The current debt strategy precisely seeks to reduce the obstacles to investment and private capital flows resulting from the excessive debt in developing countries. While there has been some progress by a few heavily indebted countries in regaining access to international capital markets on a voluntary basis, many highly indebted developing countries remain dependent on official sources of finance. This is related to the issue of the savings shortage, and the point made by Mr. Posthumus that in order to improve the prospects for official financing, fiscal action will need to be taken and that this process is determined by government behavior. We are all conscious that it is in the market for official funds that the potential imbalance exists, and that this market is not cleared by the workings of the price mechanism. Resources in this market are rationed on the basis of other considerations. In this connection, I agree with Mr. Landau that we need to be concerned about finding ways to improve the efficiency and the proper conditionality of official funds to developing countries--including some which go beyond the realm of the merely economic considerations. Given this situation, I urge industrial countries to focus their policy discussion on the longer-term benefits derived from a solid fiscal position, where expenditures go to their most socially productive uses, and an open trading system.

Mr. Filosa noted, with respect to recent developments in the exchange and interest rate market, that the concerted interventions in July 1991 had played an important role in stemming the surge of the dollar after the Bundesbank's decision not to change its monetary policy. Such interventions again in August 1991, had restored calm in disorderly markets. While it was clear that the behavior of the major currencies had been driven by the evolution of interest rate differentials, other factors, including the high financial requirements of the U.S. budget deficit, the uncertain prospects in the U.S.S.R., and the heavy cost of German reunification, also seemed to be at work. In that context, the EMS had reacted well to economic and political events during the summer.

Looking ahead, however, the underlying trends in the exchange rate market would require a great deal of attention in order to reach a more stable equilibrium, Mr. Filosa considered. The changing pattern of the balance of payments of Germany and the affects it had within the EC, as well as the tendency of the market to exploit any opportunity for the dollar to appreciate, required special attention by all parties. In that context, the outlook prepared by the staff was reassuring.

Although the stagnation of the world economy as a whole had protracted well into the second half of 1991, recent economic indicators suggested that a reversal of the negative cycle in the countries currently in recession was in sight for the end of the year, Mr. Filosa continued. At the same time, in the economies that had been growing at more than full capacity over the past year, namely, Germany and Japan, domestic activity was expected over the coming months to be geared toward a more sustainable pace that would avert the risk of higher inflation. In the event that such a desirable scenario materialized, the major industrial economies would achieve a degree of convergence that could set the stage for a new phase of stable and noninflationary world output growth. In fact, the elements for that kind of scenario were clearly possible, provided national authorities used the policy instruments available to them appropriately.

He agreed with Mr. de Groote that it was far from certain that the major industrial economies would converge at the same time to achieve a growth rate of 3 percent, Mr. Filosa went on. However, he differed with Mr. de Groote's indication that there was little policymakers could do to assist in achieving such an outcome, in particular that policymakers lacked the necessary instruments to influence the time pattern of the recovery. Views differed on the risks of the current policy mix and on how and when to achieve the fiscal adjustment on both sides of the Atlantic. Perhaps the difference in view between himself and Mr. de Groote was more one of degrees of optimism or pessimism rather than of concept.

For the world economy to position itself on the desired path, sufficient weight should be given by the national authorities to the pursuance of internationally consistent external objectives, Mr. Filosa considered. The effort to secure convergence among the world's leading economies would depend on the willingness of policymakers to strike an appropriate balance between domestic targets and external objectives.

Indeed, the greatest risk to the process of international economic convergence was the underestimation of the external impact of domestic policies, Mr. Filosa stated. That was typically the case when policies were formulated predominantly on the basis of domestic objectives, within a framework that took little heed of possible international repercussions.

The re-emergence of growing international financial imbalances among the industrial countries, albeit limited, underlined the need to increase the consistency at the international level of the domestic policy mix currently in place, Mr. Filosa noted. As he emphasized on previous occasions with respect to the United States and Germany, the risk was that a diverging monetary policy stance could continue to prevail in the future, thus prolonging the uncertainties in the exchange rate market.

With respect to the medium-term prospects and to the issue of saving, he agreed with other Directors that the particularly well-prepared analysis contained in the world economic outlook documents tended to be rather optimistic in that it required a timely and farsighted implementation of a wide range of macroeconomic and structural policies that might prove difficult or time consuming. First, it was critical that monetary policy be geared toward price stability, and less emphasis should be placed on fostering growth by stimulating nominal demand. Second, a satisfactory medium-term outlook was predicated on the implementation of several structural reforms that had in the past proved difficult to forcefully pursue.

However, the single most important issue at stake over the medium term was finding the means to generate sufficient saving to fill the ex ante demand for resources. In that connection, the approach followed by the staff was fairly comprehensive and balanced. Appropriately, greater attention had been given in the current world economic outlook exercise to the need to promote private saving in conjunction with the need to reduce public dissaving. Compared with previous years, when emphasis was placed almost exclusively on public dissaving, the current world economic outlook exercise had made significant progress. Nevertheless, he agreed with Mr. de Groote's comments on the need for a more in-depth analysis of potentially useful reforms in the future.

He was pleased to note the emphasis placed by the staff on sustainable growth as a source of saving, Mr. Filosa commented. Indeed, he had stressed the importance of sustainable growth during the world economic outlook exercises for previous years, when too much emphasis had been placed on expenditure cuts both in the short and in the medium term. An across-the-board reduction in public outlays could result in a permanent reduction of the growth rate; therefore, he agreed with the staff on the need to overhaul expenditure priorities in the public budget to reduce unproductive expenditures, if adequate saving flows had to be stimulated.

He agreed with Mr. Landau that further interest rate increases would only add to the present difficulties faced by many countries, Mr. Filosa continued. In that respect, he was somewhat skeptical about the staff's conclusion that the effect of high interest rates could prove to be negligible. Moreover, while the staff was correct to point out that higher interest rates could reduce output while increasing national income, there was a great deal of uncertainty about the time it would take for that outcome to emerge. In fact, although the rate of return on new investment in recipient countries could be high, it could take significant time for the new investment to start bearing fruit. Meanwhile, both output and national income could decrease, and it would require a high degree of optimism for both borrowers and lenders to stay the course.

In the context of the Fund's activities and the adjustment process under way in many developing countries, further delay in the conclusion of the Uruguay Round could pose a major obstacle to the successful achievement of structural reforms, Mr. Filosa went on. For example, a failure of the Uruguay Round could increase the risk of creating a two-speed Europe between EC and non-EC countries and severely constrain the development opportunities of the Eastern European countries.

More important, failure to successfully conclude the Uruguay Round would not only forestall new trade opportunities, but also negate a great deal of the improvements achieved during the recent years in the area of international economic relations, Mr. Filosa considered. First, protectionist measures avoided during the Uruguay Round negotiations would likely be reconsidered--and eventually adopted--by individual governments as a consequence of the uncertainty arising from the failure of the negotiations. Second, regional trade agreements, which under a successful Uruguay Round would constitute evolutionary steps toward higher degrees of world trade integration, would likely become inward-looking, thereby weakening multilateralism. Third, governments that--assuming the Uruguay Round's success--had engaged in trade liberalization with a view to becoming integrated in a more open world trade regime, might reverse their policy trend and turn to protectionist strategies.

Such events could lead to confusion in the long-term policymaking process in a number of developing countries, where policy strategies--not without serious political difficulty--have been shaped on the basis of more open world trade scenarios, Mr. Filosa said. A reversal of expectations on global trade developments would strengthen the political positions of those who still advocate a return to inward-looking practices. Indeed, in the case of many developing countries, where past financial assistance was conditional on the implementation of painful trade liberalization and reforms to enhance competitiveness on the premise that domestic producers would gain access to foreign markets, there was the possibility that a retreat from open trade commitments could be seen as deceptive.

Finally, reduced trade opportunities would reverse the progress that had been made in debt reduction efforts, as the indebted countries would find it harder to earn the foreign exchange needed to repay creditors, Mr. Filosa concluded. Also, the balance of payments scenario for many developing countries would worsen considerably, with important repercussions on Fund activities. Worse than expected external financial scenarios would imply additional requests for Fund assistance with an impact on the financial position of the institution. Moreover, with different prospective scenarios, the Fund might be called on to review its ongoing programs, the assumptions on which those programs were based, and the policy packages involved.

Mr. Arora noted that many previous speakers had expressed doubts about whether the staff projections were realistic. While the projections might seem optimistic, it was important to bear in mind that--except for the case of Japan, where unofficial quantitative analysis was available--views concerning those projections would vary according to the qualitative judgments of individual Directors.

In that connection, it should be noted that the present situation was more positive in many respects than that prevailing in the previous year, Mr. Arora commented. For example, there was a greater degree of consensus among the industrial countries on the need for fiscal consolidation than there had been in the past. While some countries had not yet been able to introduce a medium-term policy program, owing to political considerations, it was clear that industrial country authorities, particularly in the United States and Germany, were strongly committed to bringing about fiscal consolidation.

There was also clear recognition both in Europe and the United States that structural reform was needed with respect to both labor and goods markets, and some, albeit slow, progress had been made in that direction, Mr. Arora continued. Nevertheless, it was clear that a solution to the persistent problem of unemployment, particularly in Europe, would require more than adjustments in wage policy. In that respect, it would be helpful if the staff could present the model outlined in EBS/91/146 as applied to a particular country. That would enable the staff and the Board to observe over a longer period the response of employment to various policy measures and to determine whether the model could be used to explain the phenomenon of unemployment in Western Europe.

Another positive factor in the current world economic outlook was the very significant improvement in relations between the formerly centrally planned economies and the West, which would facilitate reductions in military expenditure by all affected countries, Mr. Arora went on.

The current situation of the Untied States was puzzling, Mr. Arora commented. Although the United States had been easing monetary policy over the past six to eight months, the recovery was not as strong as had originally been expected. While the continued lack of consumer confidence was clearly a factor in that outcome, it should be borne in mind that that was a symptom of the problem, not the cause. He wondered whether the reluctance of consumer confidence was a result of the policies implemented in the 1980s, when the financial markets were deregulated as an impetus to investment in both the corporate and household sectors. He also wondered whether a similar situation could evolve in Europe over the coming period in which stable growth was expected. Those considerations were not to suggest that the Federal Reserve should panic as soon as the growth rate reached 3 percent, but it was essential that economic growth should not be hindered by fundamental economic factors, such as a demand for private savings. As Mr. Landau had suggested, saving rates were an important topic for further study not only with respect to individual countries, but also for the international economy as a whole. Factor productivity in the United States also warranted further study. Although the rate of productivity had been very strong in the 1950s and 1960s, it had been declining since the 1970s. Therefore, every effort should be made to find a way to reverse that trend.

While external imbalances among the industrial countries would lessen in 1991, owing to one-time measures, such as transfers to the United States resulting from the Middle East crisis, those imbalances were likely to re-emerge in the future, especially if the U.S. economic recovery proceeded as currently anticipated, Mr. Arora considered. As the staff paper indicated, a certain level of imbalance among the industrial countries was sustainable. However, the question was not so much whether such imbalances could be sustained, but whether they should be expected from the perspective of the international economic community.

Of course, the developing countries also had a responsibility to increase saving rates, Mr. Arora continued. However that was not likely to be an easy task for a large number of developing countries, given the consistent decline in their terms of trade evidenced by the fall in real commodity prices that had severely limited not only their level of saving, but also their income.

He differed with Mr. Dawson and Mr. Goos about the need to rely on quantitative indicators in estimating the level of saving and additional demand for global savings, Mr. Arora stated. As Mr. Fukui had pointed out, the additional demand for savings in the period ahead could be much larger than projected by the staff. Moreover, as a result of increased demand, long-term interest rates could further increase, thereby placing an even heavier burden on developing countries.

While the accuracy of the staff assessment was an open question, it should be borne in mind that there would likely be additional demand for savings not only from Eastern Europe and the U.S.S.R., but also from other countries implementing programs of structural reform, Mr. Arora noted. The developing countries would need additional financing in the period ahead in order to successfully complete their programs of economic adjustment. That problem had been somewhat overlooked in the staff paper, which seemed to focus primarily on the U.S.S.R. and Eastern Europe. Nevertheless, the section of EBS/91/146 on impediments to capital flows to the developing countries highlighted the need for official capital flows to be increased during the period of adjustment.

He strongly supported Mr. de Groote's proposal on a contingency plan for a conditional allocation of SDRs, as private commercial banks would be slow to recognize that internal conditions in countries undergoing adjustment were bound to change; such recognition would likely take time, and the countries would suffer in the interim, Mr. Arora stated. There was also a need to redirect the flow of liquidity--a task that could only be accomplished by an international organization that was fully conscious of its responsibility to maintain an orderly payments system. A strong case could not be made for the proposition that the market would behave responsibly in allocating savings to the areas most in need. Indeed, it had not done so in the past.

However, the above-mentioned considerations did not minimize the responsibility of developing countries to undertake structural reforms aimed at increasing their savings, Mr. Arora commented. In that respect, the overriding message of the staff paper was not one of unconditional optimism, but a signal to the developing countries about the crucial importance of reform, as it was only under such conditions that they could be entitled to receive the support of the international community.

While there was almost unanimity among Directors on the importance of bringing the Uruguay Round to a successful conclusion, he had difficulty with Mr. Evans's suggestion that trade liberalization would solve all problems, Mr. Arora said. He agreed with Mr. Landau that trade liberalization was not a substitute for finance. Indeed, history showed that trade liberalization had not begun with the Uruguay Round, but long before among certain groups of countries, and it had been the combination of liberalization and appropriate financing that brought about the expansion of trade, economic activity, and output that characterized the 1950s and early 1960s. Many countries that would benefit from trade liberalization in the longer term would not do so immediately, even in Eastern Europe, because it would take time to build the necessary infrastructural and institutional framework. Meanwhile, a successful Uruguay Round would enable such countries to participate in trade more freely in areas where they did have a comparative advantage and to increase their tradables.

Also with respect to trade, Mr. Posthumus was correct to point out that constrained access to markets would increase pressure on Fund resources, Mr. Arora continued. That was a serious cause for concern, given the smaller than expected quota increase, which would limit the Fund's ability to help developing countries, especially in cases where questions arose concerning the capacity to repay the Fund. Based on those considerations, trade liberalization was crucial to enable structural adjustment to proceed smoothly.

Finally, it was important to stress that in the use of aggregate quantitative analysis there could be a tendency to overlook the least developed economies, Mr. Arora said. While the outlook for the developing countries as a whole was quite positive, the situation of the African countries, particularly those in sub-Saharan Africa, remained grim, and they would continue to need special assistance in the period ahead.

Mr. Goos remarked that he had reservations about whether an allocation of SDRs, which would create additional liquidity, could solve the problems related to a shortage of global savings.

Mr. Arora responded that the proposal for an allocation of SDRs was not directly related to the shortage of global savings, but to the inability of the capital markets to allocate savings to the areas where they could be used most effectively.

Mr. A. R. Ismael made the following statement:

> During the previous discussion on the world economic outlook, Directors acknowledged that the general uncertainties prevailing in the global economic environment posed serious risks to the world economy. For the current discussion, it is estimated that economic activity will slow down considerably in 1991 with the recession in some regions becoming more pronounced than previously envisaged. On the basis of recent economic developments in different regions of the world, one would expect the staff to be less sanguine about the growth prospects of world output in the near term. Yet, in the baseline scenario the staff projects a rebound in economic activity of about 3 percent in 1992. Our views on the realism of the projections are more in line with the Directors who consider that the baseline scenario may be erring on the side of optimism and may be understating current problems. Indeed, in view of the multifaceted difficulties confronting both industrial and developing economies, world output growth in the vicinity of 3 percent in 1992 may not be easily achieved.
>
> As many previous speakers have stressed, there are many downside risks to the staff projections. For example, in the industrial world, the rebound in economic activity in 1992 is predicated on a strong recovery in the United States, as economic growth in Germany and Japan is expected to slowdown somewhat. It should be noted that a number of adverse factors and weaknesses still pervade the U.S. economy. Thus, while the possibility of a "double dip" recession in the United States seems remote, a quick recovery of the magnitude contemplated by the staff is not certain.
>
> In the developing countries, a series of problems persist: the decline in the terms of trade continues; the debt overhang clouds the growth prospects of many of them; and developments in Eastern Europe, particularly in the U.S.S.R., are unsettling and constitute a serious cause for concern not only in the short-term projections but also in the medium term. These factors call for a more sobering view of the world economic situation at the present stage. For the medium term, there are too many uncertainties to feel comfortable about the projections. Despite measures already taken and the good intentions of national authorities, fiscal deficits continue to grow in some industrial countries and are not

falling fast enough in others. Moreover, monetary policy in some countries continues to carry an unduly heavy burden, affecting future growth prospects.

The lack of progress in the Uruguay Round is depriving developing countries of the potential benefits deriving from an open multilateral trade system. Except for a very few cases, not much progress has been achieved in the pursuit of the debt strategy, and a large number of heavily indebted countries still do not have access to capital markets, and there is not much hope of attaining external viability under present schemes. All these factors make us more pessimistic than the staff, despite the noticeable progress achieved in a few countries.

With respect to the policy issues in the industrial countries, we agree with the staff that the general stance of monetary policy in North America and within the European Monetary System (EMS) is appropriate at the present stage, although it could be argued that interest rates in the EMS countries are relatively high. In the light of the possibility that the U.S. recovery may be rather weak, the monetary policy stance currently pursued seems appropriate. However, the underlying rate of inflation remains relatively high and will require careful monitoring by the monetary authorities. A tightening of credit policies would probably be warranted as soon as there are strong signs of a recovery. However, as was made clear during the 1991 Article IV consultation with the United States (EBM/91/125 and EBM/91/126, 9/18/91), monetary policy should not be geared primarily toward finetuning the economy, and much help is needed from fiscal policy.

We note that, in spite of the rapid economic expansion of the 1980s and the high rate of economic growth projected over the medium term, the rate of unemployment, which is already high, is not expected to decline significantly. Developments in the labor markets in industrial countries point to the existence of deep-seated structural problems that do not lend themselves to macroeconomic solutions, but require a structural approach. In this connection, we agree with the staff's suggestions to address these problems. In this connection, the need to reassess the issue of unemployment benefits should be noted. A more appropriate unemployment benefit package, together with training programs, could help to reduce the level of unemployment in many of the industrial countries.

The baseline scenario for developing countries mirrors that of industrial countries in the sense that after a slowdown of economic activity in 1991-92, the medium-term prospects for the developing countries on the whole appear to much better, with most economic indicators pointing toward an improvement if present policies are maintained. This is quite encouraging. However, as the staff paper points out, a number of challenges lie ahead. Among these, the potential effects of the ex ante shortfall in global savings, the uncertainties regarding market access by many developing countries, and the debt overhang, are particularly important.

While we agree with the staff that, for most of the developing countries, macroeconomic stabilization and structural reforms must be maintained, it should be stressed that a major responsibility in creating the conditions for sustainable growth in these countries rests with industrial countries. As to the steps that the developing countries can take, it should be noted that most of them are already implementing Fund-supported programs of adjustment. Strict implementation of these programs is the foundation on which these countries can achieve better economic performance. But these efforts will have to be complemented by an hospitable economic environment, financial assistance on concessional terms, and access to the markets of industrial countries.

The staff's analysis clearly shows the direct link between the issue of global saving and that of fiscal consolidation. We agree with the staff's analysis and recommendations with respect to this issue. We also note that the demand for additional savings from the Middle East, Eastern Europe, and the U.S.S.R. would amount to about $100 billion annually over the next five years. Furthermore, the staff's calculations show that a 20 percent reduction in defense spending would liberate about $90 billion annually; and additional savings of $100 billion could be effected through the elimination of subsidies in industrial countries. What is interesting is that these gains would come not at the expense of growth in these countries, but--on the contrary--through rationalization of budgetary expenditures to maximize efficiency. In fact, policies that emphasize a reduction in spending in these areas would raise capital formation and potential output in the long run and lead to a further improvement in the savings picture.

We are also encouraged to note from the staff's analysis that the net adverse impact of the added demand for world savings would be small on the indebted developing countries, despite our skepticism that this will actually be the case. However, this conclusion assumes that there will be an increase in the value of exports that will offset higher interest payments stemming from the ensuing rise in world interest rates. In view of the slow progress in the Uruguay Round discussions, I wonder how realistic this assumption is. As experience shows, the developing countries stand to suffer the most when world trade slows down. Therefore, alternatives solutions are needed to ensure steady flows of resources to these countries.

Despite the many debt relief schemes developed over the past few years, which have helped to alleviate the burden to some extent, the situation remains difficult, requiring additional steps to ensure a permanent solution. Indeed, debt reschedulings in the context of the Paris Club, while providing temporary relief, have led to increases in the stock of debt and thus have not contributed to the achievement of external viability. As this chair has indicated on previous occasions, in addition to the temporary relief, a significant reduction in the stock of debt and additional financial resources are needed to help develop the economies of the indebted countries. For most of these countries, especially those in Africa, per capita income is so low--and has even been declining--that, despite every effort to increase savings, the amount will be insufficient to ensure a sound development of the economy.

Like other speakers, we regret that the Uruguay Round discussions have not been concluded on schedule and that prospects for their conclusion are still uncertain. On many previous occasions, the staff has demonstrated the benefits that the world economy would derive from an open multilateral trading system. As we are all aware, for developing countries undertaking Fund-supported adjustment programs, trade liberalization has been an important part of all policy packages. The objective of adopting such an outward-looking stance is to help them to improve their external position and reach external viability. Moreover, it should be emphasized that one of the pillars of the debt strategy rests on an expansion of trade that would contribute to an improvement in the external position, particularly to enhance debt-servicing prospects. Failure of the Uruguay Round would thus put the debt strategy in jeopardy. But the greatest danger of failure may be the start of trade wars, which would be at the expense of everyone. Therefore, we agree with the views expressed in Mr. Posthumus's opening statement on this issue and support his suggestion for an urgent appeal to the Interim Committee on the need for concluding the Uruguay Round.

Mr. Fogelholm made the following statement:

In commenting on the international economic prospects, I have structured my intervention along the lines of the staff paper by first remarking on the short-term prospects for the world economy, and then moving on to the medium-term prospects for industrial countries and developing countries, in turn.

However, let me at the outset say a few words about the issue that is of the single greatest importance for the future development of the world economy--as duly recognized in the Economic Declaration of the London Summit--the satisfactory conclusion of the Uruguay Round negotiations. This issue is also essential to the efficient execution of the Fund's responsibilities in member countries, and the facilitation of a balanced expansion of world trade.

For all to benefit, the multilateral trading regime would have to be strengthened, as failure of the trade negotiations would mark the beginning of serious negative macroeconomic consequences. These effects would be particularly devastating for countries implementing economic adjustment programs, as they would not be able to realize their growth potential and would even run the risk of having their programs failing for this reason, as convincingly argued by Mr. Posthumus in his opening statement.

It would also seem reasonable for these countries, which often as a central feature of their adjustment programs have unilaterally liberalized their own trading system, to expect an international trade environment that provides freer market access to their produce than at present.

If, indeed, multinational trade liberalization does not progress, the Fund's own efforts--conducted within the framework of Article IV consultations and in connection with program negotiations to open up member countries' economies--could eventually be hampered.

Let me now turn to the short-term economic prospects. The world economy is currently in the process of recovering from a short period of slow growth. Nevertheless, my authorities would like to point out that the renewed growth pattern is not without risks. First, there are questions related to the timing and strength of the projected pick up of activity in the United States. As already noted during the 1991 Article IV consultation with the United States, the persistence of high long-term interest rates may be an indication of an expectation that inflationary pressures will increase again when economic activity regains strength. Therefore, targeting monetary policy too much toward short-term demand stimulation at the expense of the long-term fight against inflation, could, in the end, lead to a very short-lived recovery.

Second, while welcoming the recent tightening of fiscal policy in Germany, which has resulted in a favorable shift in the policy mix, my authorities would like to point out that relying too heavily on monetary policy to restrain inflationary pressures could dampen growth prospects in Western Europe. Instead, Germany should introduce a comprehensive set of measures to reduce the general government borrowing requirements in order to contain the inflationary impulses.

With regard to the medium-term economic prospects for industrial countries, my authorities agree with the staff that for the projected growth rates to be attained, it is essential that domestic savings rates in these countries rise significantly. The staff's projections show that the falling trend in the private savings rate in industrial countries, at best, will only level off. Consequently, it is assumed that individual governments will substantially increase public savings relative to GDP. However, large budget deficits remain a serious medium-term problem in many countries. With regard to the United States, for example, while we acknowledge the consolidation efforts made in the context of last year's budget agreement, the long-term outlook for the budget deficit has worsened recently. Therefore, against the background of rising demands for savings globally, my authorities would like to emphasize strongly that the achievement of fiscal objectives in many countries, is essential to sustained growth in the industrial world.

The staff's emphasis on the need for further structural policies is welcome. Despite the favorable growth performance in the industrial countries during the 1980s, and the projected high growth in the period 1992-96, the level of unemployment will remain very high in many European countries. Therefore, we would like to stress the importance of undertaking structural measures in the labor market. Measures such as training programs and job placement services, should also be adopted more widely than is generally the case at present.

The staff's calculations on the macroeconomic consequences of new demands on world savings arising from the restructuring in Eastern Europe, the U.S.S.R., and the Middle East, suggest that a comfortable balance between demand and supply of resources can be found. But these calculations can at best only be indicative. The magnitude of resource flows needed in the Eastern European economies and in the U.S.S.R, the time profile of investments, and the rate of return of these funds, are all questions that cannot be fully answered at this juncture. Therefore, the estimation of the effects of these resource transfers on world interest rates and incomes is definitely uncertain, and I would encourage the staff to continue working to enhance our understanding of the relationships involved.

In the staff's projections, the medium-term prospects for developing countries other than the U.S.S.R. and those in Eastern

Europe, appear to be relatively favorable against the pick up of growth in industrial countries and a slight improvement in the terms of trade.

Nonetheless, there are factors that make this projection highly uncertain. First, is the assumption that all countries will be able to successfully implement domestic policy reforms, and more specifically adhere to Fund programs, where relevant. Even though, hopefully, not completely unfounded, experience from recent years makes this proposition somewhat doubtful. Second, there is the problem of access to export markets. And last, the debt situation in many countries remains an obstacle to growth. Inter alia, it should be kept in mind that, notwithstanding the higher growth expected in 1992, the poorest countries, such as those in the sub-Saharan Africa, will continue to face a falling level of per capita GDP. This development underlines the need for an agreement on rescheduling terms that go well beyond Toronto terms for this group of countries.

To conclude, my authorities view the staff's estimates of the overall external financing needs of the developing countries to be somewhat optimistic. It is questionable whether countries with debt-servicing difficulties will be able to improve their domestic savings rate to the extent that the projections indicate.

Mr. Moss said that he agreed with Mr. Goos that there was a theoretical potential for the United States to act more forcefully with respect to fiscal policy. However, in light of the recent discussion on the 1991 Article IV consultation with the United States, the use of such policy instruments over the next 18 months did not seem possible.

He also agreed with Mr. Goos that an allocation of SDRs could not substitute for savings, Mr. Moss stated. However, it could lead to higher rates of output growth in developing countries, where other funds were lacking. That higher rate of output growth could, in turn, generate the needed private savings. From an analytical perspective, there was not a significant difference between calling for further official bilateral financing to assist developing countries and providing such assistance multilaterally in the event that private capital flows were not forthcoming.

Mr. Goos noted that, based on the MULTIMODE analysis, an allocation of SDRs could create additional demand for savings, as it would lead to high interest rates, which had a negative impact on economic activity. Moreover, such an allocation would contradict the staff's recommendation to avoid the use of monetary instruments to achieve growth at the present juncture, because such artificially stimulated growth could actually reduce the amount of savings available.

Mr. Arora commented that the staff's recommendation to avoid the use of monetary instruments was well taken, but the developing countries were not working close to their potential, and they could do so if they had sufficient liquidity.

Mr. Mwananshiku made the following statement:

The staff analysis has revealed the underlying weaknesses of the global economy in 1991. Attributable largely to the poor performance of the major industrial economies, notably, the United States, the United Kingdom, and Canada, and the contraction of total output in developing countries as a group, world output growth decelerated to less than 1 percent in 1991. The expansion of world trade is also estimated to have declined sharply from 4.2 percent in 1990 to 0.9 percent in 1991. However, inflation in both the industrial and developing countries showed considerable moderation, and the high real interest rates which had always been a source of concern to most developing countries, particularly the heavily indebted countries, eased somewhat except in Germany. For sub-Saharan Africa, growth has remained low at 2.5 percent, and the decline in per capita income has persisted during 1991. In addition, the average inflation rate is expected to rise to 22 percent.

We are encouraged by the prospects for an improved outlook for 1992, as indicated in the staff's projections. However, the growth projections for 1992 appear to be too optimistic and are indeed fully supported by economic fundamentals. The prospect of early and strong recovery of the U.S. economy is fraught with great uncertainty, as the major economic indicators have not shown appreciable and sustained improvement. Also, the problems of transformation in Eastern Europe and the U.S.S.R. are likely to persist and continue to constrain output growth. In particular, the impact of the collapse of the CMEA trade arrangement on output in the region should not be underestimated. Structural factors and a hostile external environment are likely to continue to impede growth in most developing countries.

In most of the sub-Saharan African countries, as well as other countries in Latin America and Asia, adjustment efforts to bring their economies back on a track of growth and development have been constrained by the high external debt outlays and the continued deterioration of the terms of trade with the resultant decline in capital formation. The average world prices of non-oil primary commodities, particularly tropical beverages and minerals, are said to have shown considerable declines in 1990, and no improvement is expected in 1991. Even if the expected expansion of world trade is realized in 1992, it is likely to favor the industrial countries more as producers of manufactured goods, while the developing countries would at best derive marginal benefits.

Economic activity in most of the developing countries remains highly vulnerable to fluctuations in the international credit and exchange rate markets. These uncertainties are expected to be heightened by the impact of the increased investment demands on limited global savings. While the undertaking of macroeconomic policies and structural reforms is the primary responsibility of the developing countries, it is equally important that similar action be taken to address structural factors impeding growth and efficiency gains in industrial countries to facilitate the establishment of an improved external economic environment for developing countries.

The need for a substantial increase in global savings to meet worldwide increased investment demands, particularly for postwar reconstruction in the Middle East and reforms in Eastern Europe, including the U.S.S.R., calls for appropriate and urgent action. In particular, the prospect of maintaining interest rates at low levels would depend critically on the ability of industrial countries to increase global savings through fiscal consolidation in countries where budget deficits are very high. It goes without saying that domestic polices in developing countries conducive to increasing domestic savings are equally important and should be vigorously pursued. It should, however, be noted that the capacity to generate such savings, remains extremely limited, particularly for the low-income countries, the majority of which are in sub-Saharan Africa, owing to the low output income level and the heavy debt burden. This situation calls for increased channeling of world savings to these countries, if a sustained high growth rate is to be achieved, as envisaged in the staff projections. Thus, the persistent decline in per capita income, which characterized the 1980s, could be reversed and the widespread poverty that affects the citizens of these countries could be alleviated.

Substantial progress has been made under the current debt strategy, with a number of developing countries are making reasonable improvements aimed at restoring external viability. However, most of the heavily indebted countries, particularly the low-income countries, are still confronted with the difficulty of servicing their debt obligations. This calls for bolder initiatives on the part of creditors that could provide a more durable solution to the intractable debt problem. Hopefully, the low-income countries will be able to see more encouraging signs of improvement in their external accounts, if the proposals made during the most recent G-7 meeting, which included the cancellation of a significant portion of outstanding debts, are implemented.

As this chair has consistently emphasized, the prospects of growth in developing countries are largely influenced not only by the terms of trade, but also by the extent to which their products can gain access to markets in industrial countries. The removal of trade barriers in these countries would, unquestionably, bring substantial improvement to the developing countries' trade balance, in terms of increased volume of exports and of capital inflows that would help to reduce excessive reliance on external assistance. It would in fact encourage the developing countries to pursue more resolutely the path of export diversification. It is the only way by which efforts at privatization, through the participation of private domestic and foreign investors, could be given the necessary boost. This chair maintains that the current emphasis on regional trade integration should not undermine the principal goal of achieving a multilateral trade agreement. An early and successful conclusion of the Uruguay Round is therefore critical to the achievement of sustained world output growth and international trade expansion.

Mr. Posthumus noted that some Directors' comments about the possibility of reducing military expenditures could send a misleading signal that the resources that had been used to support defense could immediately be reallocated to other purposes. While articles discussing whether or not to continue the production of B-2 bombers in the United States could be seen in the press daily, it was important to bear in mind that a decision not to produce that airplane might force an entire aircraft factory into bankruptcy, and hundreds or even thousands of workers would become unemployed. New employment would have to be found. The resources diverted from military expenditure would, therefore, not likely be used for alternative purposes within individual countries at least in the short term. Therefore, such resources would not contribute to the amount of global savings available within the period covered by the current world economic outlook exercise.

The staff representative from the Research Department said that historically the staff projections for the industrial countries had not been biased. The errors that had occurred in previous world economic outlook projections for industrial countries had tended to offset each other. Based on that historical experience, there was no reason to expect the projections contained in the current world economic outlook for industrial countries to be overly optimistic.

However, the staff projections for developing countries taken as a group had shown signs of bias to the extent that they were based on the assumption of full program implementation for the countries currently implementing Fund-supported adjustment programs, the staff representative confirmed. For those countries the world economic outlook projections assumed that the targets incorporated in the programs would be attained.

While world economic outlook projections for the developing countries as a group tended to be overly optimistic, there was an historical tendency for those projections to underestimate the growth of Asian developing countries, the staff representative added. Although experience showed that projections for the developing countries with programs had a tendency to be overly optimistic, it would be difficult for both tactical and diplomatic reasons to change the basis for those projections. In those circumstances, it was important to recognize that the projected outcome was conditional on all Fund-supported programs being fully implemented as envisaged. In that respect, Mr. Arora was correct to point out that the overall message of the world economic outlook for developing countries was not one of unqualified optimism; it showed the outcome that would be possible if strong macroeconomic policies were adopted and if difficult reforms were fully implemented.

The staff's estimate of potential GNP for Japan was slightly higher than that of the authorities, the staff representative noted. However, as Chart 20 of EBS/91/146 on the evolution of medium-term output showed, the staff projections for Japan assumed a declining contribution of labor force, employment, and total factor productivity, as did those of the Japanese authorities. However, the staff had assumed a somewhat higher contribution of capital formation, which reflected the high level of investment in Japan during the 1980s, particularly toward the end of that decade. While the staff had projected a slightly stronger contribution of labor and capital than the authorities, there was little difference in the general outturn from a qualitative point of view.

With respect to the demand for savings in the coming period, a number of Directors had expressed concern that the actual demand for savings could be significantly larger than the $100 billion a year projected by the staff, the staff representative recalled. Other Directors, including Mr. Dawson and Mr. Fukui, had asked why the projected demand for east Germany was larger than that for Eastern Europe and the U.S.S.R. In addition, Mr. Goos had questioned the accuracy of the models used to derive scenario, given that the outcome was a decline in production over the medium term, even though there was a rise in world saving and investment.

It was important to bear in mind that the figure of $100 billion was little more than conjectural speculation, the staff representative commented. Nevertheless, even if the actual demand for saving was $50 billion a year more, the amount would not be large in relation to industrial country GNP, which was about $17 trillion for 1991 and was expected to increase to $20 trillion over the medium term. The significance of the model simulations was not the accuracy of the projected demand for saving, but the magnitude of fiscal consolidation called for on the part of the industrial countries, which was equivalent to approximately 2.5 percent of their GNP.

It was also important to note that the methodology applied in analyzing the case of Germany was different from that for the Eastern European countries and the U.S.S.R., the staff representative stated. As discussed at the time of the previous world economic outlook and at the 1991 Article IV consultation with Germany (EBM/91/119 and EBM/91/120, 9/11/91), the staff projections were based on the following assumptions: a target for increasing labor productivity in east Germany to 80-90 percent of that prevailing in west Germany; some gains in terms of efficiency translated into higher growth of total factor productivity; and the needed investment would be financed partly by a reallocation of west German saving from a current account surplus to east Germany, and partly by an absorption of external saving by Germany as a whole. Those assumptions were possible in the case of Germany, because data for that country were available, which was not the case for the U.S.S.R.

Nevertheless, the staff representative went on if the same kind of exercise had been applied to the case of the U.S.S.R., the resulting investment requirement would have been totally unrealistic, given the supply of funds available at the time the staff paper was prepared. Although the situation might have changed since then, it probably had not changed to an extent that would make $200 billion a year available to the U.S.S.R. In other words, while it was possible to assume movement toward the per capita income of Western Europe in east Germany, particularly in light of the political commitment of the German Government, it would not be technically feasible or realistic to do the same for Eastern Europe or the U.S.S.R., given data limitations and the likely inflows of foreign capital.

The staff projections for the Middle East aimed at achieving a realistic assessment of the amounts that would come primarily from the private sector to finance reconstruction in that region, in particular with respect to the oil facilities destroyed in the recent conflict, the staff representative said. While the exact figures projected might prove to be in error, the qualitative assessment of the overall situation was not likely to change.

While it was true that high demand for world saving would likely lead to higher interest rates, the impact on the world economy would depend on whether the lending countries would earn an adequate return on their investments and/or whether the rise in interest rates would come from a deterioration of fiscal positions, reflecting the financing of consumption through fiscal transfers, the staff representative remarked. That fact was related to the question raised by Mr. Goos on how the assertion that more saving and investment were needed to finance growth was consistent with the simulation result that an increase in the demand for savings over the medium term would lead to a decline in world GDP. As the staff paper illustrated, the countries that would benefit from increased investment and transfers would experience a high growth of potential GNP over the medium term. However, the rest of the world would likely experience a reduction in investment, as the higher interest rates would crowd out investment in other regions, leading to declines in production and output. However, it should be noted that that did not necessarily translate into reductions in income. As Mr. Filosa had pointed out, income from domestic production would decline, while income from interest and dividends on assets held abroad might increase. The final outcome, therefore, would depend on whether an adequate rate of return on capital would be realized by the lenders.

Although some of the increased saving made available in the simulation would be allocated to finance investment, some of it must be expected, realistically, to finance consumption, the staff representative noted. For example, some of the transfers from west Germany to east Germany financed investment and infrastructure building and some were used to finance consumption. While the transfers allocated to consumption might realize the greatest political dividends in history, they would not result directly in physical capital formation and increased potential GNP, as measured in the national accounts.

In the staff's simulations, the interest rate response of consumption was slightly below 1 percent, while the interest rate response to investment was between 0.8 percent and 1.4 percent, depending on the country, the staff representative continued. While the elasticities were not small, they were roughly in line with those found in other macroeconomic models.

While the staff did not have sufficient data to comment with certainty on the reason interest rates were so high in the 1980s, it seemed that one important element in that phenomenon was the substantial increase in the debt to GNP--or public debt to wealth--ratios of the industrial countries during the decade, the staff representative went on. Moreover, there had been a significant increase in the after-tax rate of return on capital in some of the industrial countries. For example, in the United States, substantial reductions in the corporate and income tax rates in the early 1980s led to increases in the after-tax rate of return on capital, which exerted upward pressure on interest rates, although not in the same way as increases in the public debt to GNP ratio.

With respect to the asymmetrical treatment of Germany and France, the staff basically agreed with Mr. Dawson's comments, the staff representative commented. Despite the progress in recent years toward alleviating rigidities and distortions in the German economy, many problems remained in the labor market as well as in the agricultural, industrial, and service sectors. The need to address those problems was more urgent in the light of the challenges posed by unification.

The staff also agreed with Mr. Dawson that in North America, the United Kingdom, and other countries that had recently experienced recession, the margin of unused resources was currently substantial, and the risk of an acceleration of price increases appeared to be minimal in the short run, the staff representative stated. Nevertheless, as the economic recovery proceeded, the monetary authorities must be prepared to tighten the policy stance. In that connection, an early tightening would be preferable to one that came too late. While the staff did not envisage that the recovery would be stronger than currently projected, the resumption of economic activity had a tendency to quicken rapidly, as was the case in 1984, when the U.S. economy grew at a much faster rate than had been expected. However, structural weaknesses in some sectors of the U.S. economy, such as the construction and financial sectors, could take time to be absorbed. Therefore, the appropriate degree of restraint with respect to monetary policy was conditional on the actual pace of recovery that would be realized.

Several questions had been raised about the staff projection that the contribution of total factor productivity to growth in the United States would be stronger in the 1990s than in the 1980s, the staff representative recalled. Total factor productivity was a residual in that it was derived by subtracting from the estimated growth of potential GNP the contributions of capital formation and potential employment. However, the expected future increase in total factor productivity was not a residual, but rather was projected on the basis of prospective changes in the composition of the work force in terms of age and sex. The expected decline in the average age of the work force in the future meant an increase in the average level of experience and, therefore, an increase in productivity. Moreover, as women's participation in the work force became an historical factor, the average level of experience of female workers would increase; hence, productivity would increase. There was also reason to believe that there might be an increase in expenditure devoted to research and development, which would also have a positive impact on total factor productivity.

Also with respect to demographic trends, private savings rates were expected to decline in most industrial countries, particularly in Japan and Europe, and later in the United States and Canada, the staff representative said. As those populations aged, the aggregate private savings rate would decline. In the case of Japan, the staff considered that the current fiscal surplus was appropriate not because it believed that any fiscal surplus, no matter how large, was good, but because the aging of the Japanese population was expected to have a particularly rapid and forceful impact, especially with respect to the decline in the private savings rate.

The staff could not accurately interpret the widening discrepancies in the balance of payments and current account statistics, because that element was essentially not known, the staff representative from the Research Department concluded. As world savings should always equal world investment, there was no reason to attach any specific meaning to the unrecorded portion of that balance. However, Robert Solomon had expressed an interesting theory that, because the staff's projections were based on an assumption of constant real interest and exchange rates, any ex ante imbalance between world saving and investment would show up in the form of a widening of the global current account imbalance. However, as the staff usually tried to adjust the data to avoid such excessive discrepancies in the world current account projections, Solomon's theory should not be fully applicable.

Another staff representative from the Research Department noted that the steepening of the yield curve in the United States could in principle reflect an increase in inflationary expectations. However, the fall in short-term interest rates had exceeded the decline in long-term interest rates by a substantial margin. Therefore, the staff considered that the steepening of the yield curve did not reflect a change in inflationary expectations.

The staff projected no growth in Germany in the second half of 1991 on the basis of recent data, which showed a decline in manufacturing production from June to July, a decline in domestic orders, and an increase in unemployment, the staff representative said. That projection also reflected other more general factors, such as weak foreign demand, the midyear increase in taxes, and the effects of the interest rate increase. However, the growth rate projected for 1991 as a whole was 3.1 percent.

The difference between the gross and net use of external savings reflected the acquisition of foreign assets by the private sector, which could be seen as capital flight, the staff representative commented. However, it also reflected an increase in claims abroad by the authorities, in particular substantial increases in official reserves.

The increase in the current account deficit in Africa in 1991 reflected the negative impact of the decline in the oil prices on African oil exporters, the staff representative noted. There had really been no change in the current account deficit of the sub-Saharan African countries from 1990 to 1991. In fact, the current account deficit for Africa as a whole had declined from $7.5 billion in 1989 to $2.75 billion in 1990, owing to the increase in the value of oil exports. However, the overall deficit had since rebounded to $8.75 billion in 1991.

There had been an increase in the average inflation rate for Africa from 15.5 percent to 18.5 percent over 1990/91, the staff representative added. Nevertheless, the median inflation rate had declined from 9.5 percent to 8 percent over the same period.

It was important to note that Tables 11 and 14 of EBS/91/146 showed how changes in the external environment facing developing countries affected their level of income, not their rate of growth, the staff representative remarked. At the same time, those tables showed the effect of external shocks on the rate of growth for industrial countries. Therefore, it would not be accurate to conclude from those tables that changes in the external environment were more likely to have an adverse impact on the growth of developing countries than changes in domestic policy assumptions.

In response to the question raised by Mr. Mojarrad on why changes in factor productivity in the policy slippage scenario were more adverse for countries in the Western Hemisphere than for other developing countries, it should be noted that that scenario was constructed by reducing in half the increase in total factor productivity, the staff representative continued. As the Western Hemisphere countries had the largest increase in total factor productivity, they had the most to lose in terms of the way in which the policy slippage scenario was designed.

As to the reason for the contrast between the sharp increase in total factor productivity for the developing countries in the Western Hemisphere shown in the baseline projection and that computed for the World Development Report, it should be noted that different methodologies had been used, the staff representative from the Research Department concluded. In addition, as the world economic outlook exercise assumed full implementation of adjustment programs, the results of structural reforms, which should contribute to higher rates of growth in total factor productivity, were reflected in the baseline projections. The rate of growth that was projected in the current world economic outlook exercise was in line with the rates that had been attained by other groups of developing countries. Nevertheless, it was important to bear in mind that the projections for total factor productivity were subject of large downside risks.

Mr. Abbott noted that the OECD had recently reviewed the effect of an aging population on anticipated saving. As a result, it had somewhat reversed its previous conclusion that aging would have a substantial effect on savings patterns in Japan. He wondered whether the staff could comment on the OECD review.

With respect to the asymmetry in the treatment of France and Germany in the staff paper, Mr. Dawson's statement was not intended to question the need for labor market reform, as his chair fully agreed with the staff's conclusions on that point, Mr. Abbott stated. However, the assessment of France had been placed in the context of actions within the exchange rate mechanism of the EMS, while that of Germany was not. In an area where monetary policy was circumscribed by the need to maintain exchange arrangements, the requirement to emphasize structural solutions to problems applied equally to all members.

As to the staff's advice on U.S. monetary policy in the event that the recovery was stronger than expected, it should be noted that the situation could also turn out to be less favorable than expected, as was the case following the 1990 Article IV consultation with the United States, when the United States fell into a unforecasted recession, Mr. Abbott considered. He wondered what advice the staff would offer if the recovery turned out to be slower than described in the baseline scenario. While Directors generally considered that the forecast for industrial countries was optimistic, it was important to bear in mind that the world economic outlook exercise should provide some idea of where the balance of policy ought to be.

The staff was correct to point out that a lot of the transfers to reconstruct formerly centrally planned economies would finance consumption, Mr. Abbott commented. However, in the framework of the analysis on the increased demand for savings, it was generally assumed that that demand would be matched by investment. In that connection, one source of confusion was the notion that the need for savings would automatically be matched by investment and capital accumulation. That was not necessarily true. He wondered whether the staff could comment on the extent to which adjustment efforts in Eastern Europe would be capital intensive, and the extent to which the projected increased use of savings would be above the average for previous years. At the present juncture, much of the adjustment effort in Eastern Europe would involve institution building and legal reform, which was not capital intensive. The sense of the current discussion seemed to imply that adjustment in Eastern Europe would be similar to reconstruction efforts following a war, which was not the case. Moreover, the case of east Germany involved incorporating one economy into another, and a rapid rise in income standards; that case would not call for the same type of adjustment efforts needed in other areas of the world.

Mr. Goos commented that it was difficult to differentiate between consumption and investment. There was need to take a longer-term perspective, as some transfers could be seen as preinvestment. Economic analysis should focus on the capital needs, both for preinvestment and investment in the traditional sense, and the expected return in determining whether such transfers were beneficial and whether they were being used efficiently. In the absence of preinvestment, there was a risk that the situation might become socially and politically unstable. It should be borne in mind that the maintenance of a socially stable climate was an essential basis on which to build new market-oriented economies.

In pointing out that the U.S.S.R. did not yet have appropriate policies in place, the staff paper could be seen to imply that, since reforms were not in place, transfers of resources to the U.S.S.R. should be avoided, Mr. Goos remarked. Such an absolutist view could be very misleading, because even in the interim before a full-fledged adjustment strategy was put in place, preinvestment was needed to form a sort of social and political safety net.

Mr. Fukui stated that the staff projections on the rate of growth of potential GNP in Japan were a cause for concern for the medium and long term. As the growth rate of potential GNP had decelerated much faster than previously envisaged, the approaches followed in the past were not necessarily applicable to the projection of potential capacity in Japan. The Japanese economy had changed from a production-oriented economy to a more service-oriented one. Therefore, the rate of growth of labor productivity would be much lower than in the past. In addition, a number of economic research institutes had published results showing that the maintenance of a potential growth rate of 3 percent in the future would be difficult. Moreover, the recently implemented action program, which required that emissions of CO_2 should be contained at the current level for the next ten years, would hinder potential capacity for growth. In the light of those considerations, it would be misleading to make projections that were overly optimistic. He wondered whether the staff would include comments on the abovementioned points or revise the projections downward in the published World Economic Outlook.

The staff representative from the Research Department said that the staff would meet with Mr. Fukui to compare the staff projections with those of the authorities.

Mr. Fogelholm remarked that the discrepancy in the current account projections was a serious cause for concern, especially given that recorded current account deficits had reached $124 billion in 1990. As that level of debt was already uncomfortably high, the discrepancy warranted further study.

Mr. Mojarrad asked whether the staff had tested the sensitivity of the estimates for total factor productivity to various assumptions or methods of calculation.

The staff representative from the Research Department responded that the staff projections on total factor productivity were based on fundamental determinants applied to the industrial countries. For the developing countries, total factor productivity was a residual.

The sensitivity of the projections to alternative assumptions about total factor productivity was one to one, the staff representative continued. Unlike capital formation and labor force growth, total factor productivity did not get multiplied by a factor share; it directly contributed to the growth of potential GNP. In other words, as the assumption about total factor productivity was increased by one, the growth of potential GNP would increase by the same amount.

Nevertheless, the staff did not have much information about the behavior of that factor in the developing countries, the staff representative said. As a residual, the interpretation of total factor productivity was subject to considerable difficulties, because the data concerning the size of the labor force and capital formation were often inaccurate, the staff representative said. There was an historical tendency for mediocre, or even negative growth of total factor productivity in the developing countries of the Western Hemisphere and Africa. That was in sharp contrast with the countries of Asia, where the growth of total factor productivity continued to be substantially positive.

While it was premature to predict whether there would be a recovery of total factor productivity over the medium term, the staff representative from the Asian Department remarked, a great deal of progress had been made in terms of ensuring a greater role for the private sector and greater openness in the economy, and those changes should have an effect on total factor productivity over time.

The Executive Directors agreed to continue their discussion on September 25, 1991.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/91/129 (9/23/91) and EBM/91/130 (9/23/91).

2. RULES AND REGULATIONS AMENDED SINCE 1990 ANNUAL MEETING

The Executive Board approves the letter to the Chairman of the Board of Governors submitting for review by the Governors the texts of amendments to the Rules and Regulations adopted since the 1990 Annual Meeting and the proposed resolution for the Board of Governors, as set forth in EBD/91/237, Revision 1 (9/18/91).

Adopted September 23, 1991

3. EXECUTIVE BOARD TRAVEL

Travel by an Assistant to Executive Director as set forth in EBAP/91/237 (9/19/91) is approved.

APPROVED: March 25, 1992

LEO VAN HOUTVEN
Secretary