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0404

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 90/134

10:00 a.m., September 5, 1990

M. Camdessus, Chairman

Executive Directors	Alternate Executive Directors
M. Al-Jasser	
G. K. Arora	L. E. N. Fernando
C. S. Clark	
Dai Q.	Zhang Z.
T. C. Dawson	
J. de Groote	
	Y. Patel, Temporary
	S.-W. Kwon
E. V. Feldman	R. J. Lombardo
L. Filardo	M. A. Fernández Ordóñez
R. Filosa	
M. Finaish	A. M. Othman
M. Fogelholm	
M. R. Ghasimi	O. Kabbaj
G. Grosche	
J. E. Ismael	T. Sirivedhin
A. Kafka	L. M. Piantini
J.-P. Landau	J.-F. Cirelli
	J.-C. Obame, Temporary
D. Peretz	P. Wright
G. A. Posthumus	G. P. J. Hogeweg
K. Yamazaki	S. Yoshikuni

L. Van Houtven, Secretary and Counsellor
M. J. Primorac, Assistant

Also Present:
African Department: M. Touré, Counsellor and Director; J. Artus, P. Dhonte. Asian Department: D. A. Citrin, R. J. Corker, Y. Harada. European Department: M. Guitián, Deputy Director; M. C. Deppler. Exchange and Trade Relations Department: J. T. Boorman, Director; T. Leddy, Deputy Director. External Relations Department: D. D. Driscoll, A. Mountford. Fiscal Affairs Department: M. S. Lutz. IMF Institute: O. B. Makalou. Legal Department: F. P. Gianviti, General Counsel; W. E. Holder, Deputy General Counsel; R. H. Munzberg, Deputy General Counsel. Middle Eastern Department: S. von Post. Research Department: J. A. Frenkel, Economic Counsellor and Director; M. Goldstein, Deputy Director; P. B. Clark, D. T. Coe, P. Gajdeczka, S. J. A. Gorne, J. E. Greene, G. Hacche, E. Hernández-Catá, T. Krueger, P. R. Masson, M. Schulze-Ghattas, S. A. Symansky, M. A. Wattleworth, P. Wickham. Secretary's Department: C. Brachet, Deputy Secretary; J. W. Lang, Jr., Deputy Secretary; R. S. Franklin. Treasurer's Department: G. Laske, Treasurer; D. Williams, Deputy Treasurer; G. S. Tavlas. Western Hemisphere Department: S. T. Beza, Counsellor and Director; J. Ferrán, Deputy Director; Y. Horiguchi. Office in Geneva: H. B. Junz, Special Trade Representative and Director. Personal Representative of the Managing Director for the Study of the Soviet Union Economy: L. A. Whittome. Personal Assistant to the Managing Director: B. P. A. Andrews. Advisors to Executive Directors: J. O. Aderibigbe, M. A. Ahmed, M. B. Chatah, A. Gronn, Z. Iqbal, J.-L. Menda, M. J. Mojarrad, P. O. Montórfano, B. S. Newman, D. Powell, A. Raza, S. P. Shrestha, A. M. Tanase. Assistants to Executive Directors: T. S. Allouba, J. R. N. Almeida, T. Berrihun, H. S. Binay, C. J. Björklund, B. Bossone, H. Brohs, Chen M., S. B. Creane, E. C. Demaestri, T. T. Do, A. Fanna, S. K. Fayyad, B. R. Fuleihan, M. E. Hansen, M. Hepp, L. Hubloue, A. Iljas, M. E. F. Jones, R. Marino, M. Mrakovcic, M. Nakagawa, S. Rouai, D. Saha, H.-J. Scheid, C. Schioppa, Shao Z., Wang J.

1. <u>1990 ANNUAL MEETINGS - SPECIAL INVITEES</u>

The Chairman said that the authorities of the Union of Soviet Socialist Republics had indicated a desire to attend the Annual Meetings. Staff work on the study of the Soviet economy as requested at the Houston Summit was proceeding well with the full cooperation of the Soviet authorities, and it would be desirable to meet the authorities' request. Accordingly, he would suggest that he and the President of the World Bank jointly invite the Soviet representatives to attend as Special Invitees. In that manner, the request would be dealt with sui generis and connotations of observer status or special guest status could be avoided. The Soviet representatives would have access to the plenary sessions of the Annual Meetings but not to the restricted meetings, such as those of the Development and Interim Committees. They would be provided with office space as needed. Was that agreeable to Directors?

Mr. Dawson said that he considered the Chairman's suggestion to be appropriate, particularly given the high degree of Soviet cooperation on the study of the Soviet economy. He welcomed the fact that no precedent would be set for treatment of other countries or institutions with which the Fund currently had relations.

2. <u>NINTH GENERAL REVIEW OF QUOTAS AND THIRD AMENDMENT - REPORT BY MANAGING DIRECTOR</u>

The Managing Director made the following statement:

> I would like to reflect with you on the work that is now proceeding in member countries' capitals toward consenting to the increase in quotas under the Ninth General Review and toward acceptance of the Third Amendment of the Articles. More specifically, I wish to explore with you what we--Executive Directors, management, and staff--can do to assist and speed up the steps that are required in our capitals.
>
> I submit that it is our responsibility to demonstrate clearly and unequivocally the support of the membership at large for the institution through a speedy consent to the quota increase and acceptance of the Third Amendment. Events of recent weeks have dramatically demonstrated, once again, how unforeseen circumstances and events can fundamentally affect the world economy and monetary system. The Fund should stand ready, and be seen to be ready, to assist its member countries. Of course we all hope that tensions in the Middle East will soon lessen and that the number of severely affected countries will remain limited, but we cannot be sure. There always is a danger that we may still have to face a worse-case scenario for a number of members and for the world

economy as a whole. In short, we must be in a position to give confidence to our members regarding the Fund's ability to assist them when necessary.

Therefore, I believe that we should set ourselves as a firm objective to achieve the necessary participation requirement and acceptance of the Third Amendment by the time of the spring 1991 meeting of the Interim Committee. A firm date for that meeting has not yet been set, but you have just received a memorandum from the Secretary suggesting that Committee members accept April 29, 1991 as the date for the next spring meeting. We are of course all aware that the participation requirement for consent to the quota increase is very high, namely, 85 percent until the end of 1991. However, this should not lead us to an attitude of looking over our shoulder and waiting for the example to be given by the largest shareholders. All of us must proceed because the consent of all is the objective. Similarly, we all are aware that approximately one third of the membership, accounting for somewhat over 20 percent of total voting power, either voted against the resolution on the Third Amendment, or formally recorded an abstention, or did not participate in the voting. We all respect the reticence that a number of you continue to have vis-à-vis the Third Amendment. Those sentiments have been duly recorded in our discussions and again in the voting by Governors. However, what is now at stake is the life and future and the credibility of the institution and, to that effect, we may need to set aside our reticence vis-à-vis the Amendment in order to achieve the quota increase, which the institution and its membership needs. I will be talking to the Executive Directors who have in their constituencies members that did not reply positively to the resolution on the Third Amendment.

In order to give specific content to the objective of speeding up the quota increase and the Third Amendment, the staff will contact all delegations at the time of the Annual Meeting in order to obtain a full update regarding:

(a) The legislative and other steps that are required in each country in order to consent to the quota increase and to accept the Third Amendment;

(b) What steps have already been undertaken and what remains to be done; and

(c) What the likely timing is for these procedures to be completed.

I would appreciate it if the authorities of your member countries would stand ready to provide us with all the necessary information, including their timetables, at the time of the Annual Meetings. I realize that a number of questions have already been addressed to the staff regarding some procedural issues. Accordingly, we intend soon to issue appropriate material that may help member countries in completing the necessary procedural steps.

May I go one step further. I would not like to wait another four weeks or so before knowing where we stand. I really need to have a view now. To that effect, I would very much appreciate it if Executive Directors could ask of their main countries--I have in mind a total number of about the 35 to 40 largest member countries of the institution--what progress is being made toward consent to the quota increase and acceptance of the Third Amendment; whether all work can be finalized before the end of April next year; and, if necessary, what steps would be needed to accelerate the existing timetable. Could you please channel that information to the Secretary.

Mr. Dawson said that he appreciated the need to have the quota increase and the Third Amendment adopted in a timely fashion, and indicated that he would pass the Managing Director's request on to his authorities. They expected to introduce the necessary legislation in January, although they had an open mind on that date. It would be difficult to have the legislation adopted by April, given the normal legislative process, but that concern could be dealt with later.

While he did not deny the need to work on the quota increase, Mr. Dawson continued, the Fund's liquidity ratio was at a historically high level of over 100 percent and rising. Accordingly, the Fund should not delay any response to member countries' needs arising out of the present international situation because of a sense that Fund resources were currently inadequate.

The Managing Director commented that the Fund would respond to the needs of the membership in any emergency situation to the best of its ability. However, in order for it to respond quickly and effectively to the current situation, a quota increase was necessary.

Mr. Grosche said that he welcomed the Managing Director's timely statement, and agreed that Directors should do all they could to have the quota increase implemented. However, one could not ignore the risk that the increase would not be successful because of the related requirement that there be 85 percent majority support for the Third Amendment to the Articles of Agreement.

Mr. Yamazaki agreed that the comments of the Managing Director were timely and appropriate. The current crisis required action by the Fund, and the institution needed to be financially sound to take such action. Therefore, it was very important that the quota increase be implemented together with the Third Amendment to the Articles. Since that would require the parliamentary approval of many member countries, which was far from certain, it was incumbent on Directors to do all they could to facilitate advance preparation in their capitals. He would convey the message to his authorities that they should make every effort to accelerate their deliberations and to approve both the quota increase and the Amendment of the Articles; he urged his colleagues to do likewise.

3. WORLD ECONOMIC OUTLOOK

The Executive Directors considered a staff paper on prospects and policy issues related to the world economic outlook (EBS/90/147, 8/15/90; Sup. 1, 8/21/90; and Sup. 2, 8/30/90; and Cor. 1, 9/4/90). They also had before them a statistical appendix (SM/90/164, 8/16/90) and supplementary notes on the world economic outlook (SM/90/170, 8/17/90), and a paper on recent exchange and financial market developments (EBD/90/282, 9/4/90).

The Chairman noted that Directors had agreed first to address the current situation and short-term prospects, including the review of recent exchange rate developments. He suggested that the staff be given the opportunity at the end of the current meeting to answer any questions on short-term developments, thus leaving the afternoon free for the discussion of medium-term prospects and policy issues, including any remarks on reforms toward market-oriented economic systems, which was the third substantive item of the Interim Committee agenda.

The Economic Counsellor and Director of the Research Department remarked that including the discussion of exchange market developments in the current meeting would facilitate interpretation of recent developments as covered in Supplement 2 to the main paper (EBS/90/147, Sup. 2, 8/30/90). Such discussion might include the implications of steepening yield curves and the roles of increased uncertainty and inflation expectations in interest rate changes. There were several possible sources of increased uncertainty: the nature of the shock--triggering the crisis in the Middle East--itself; the nature of the economic response to that shock, which depended on the structure and flexibility of the economic system; and perhaps most important, the uncertainty associated with the policy response. The staff considered that much of what was referred to as excess volatility in financial markets--namely, large changes in financial market prices that did not fully mirror changes in fundamentals--could in fact be explained to a large extent by those various sources of uncertainty.

The Economic Counsellor then made the following statement:

> The projections contained in the staff paper on the world economic outlook (EBS/90/147, 8/15/90) were prepared before the sharp increase in oil prices in the first days of August. An illustrative, model-based scenario was circulated to the Board

as Supplement 2 to the world economic outlook paper, providing an indication of the possible effects on the world economy of a sustained increase in oil prices. That scenario assumed average world oil prices of $25 per barrel from August 1990 onward, which implied an increase in oil prices of about 17 1/2 percent in 1990 and 41 percent in 1991 compared with the oil price assumption in the Board paper.

Recently, the staff has had the opportunity to make a more comprehensive reassessment of the economic outlook. These revised projections, which will be presented to the Interim Committee and then published in late September, are based on the assumption that world oil prices will average $26 per barrel for the remainder of 1990 and then come down gradually to the new OPEC target reference price of $21 per barrel by the fourth quarter of 1991. Thereafter, the oil price is assumed to remain constant in real terms, that is, to rise at the same rate as the price of manufactures exported by the industrial countries. These assumptions imply an increase of 20 percent in the annual average oil price for 1990 (to $20.60 per barrel) and a further increase of 10 1/2 percent for 1991 (to $22.75 per barrel). For 1991, this would mean a rise of 28 percent relative to the oil price assumption used in the world economic outlook paper.

The revised projections also incorporate new assumptions for exchange rates, nonfuel commodity prices, and interest rates. Exchange rates are now assumed to remain constant in real terms at their levels in August 1990; the main differences compared with the world economic outlook paper are a real effective depreciation of the U.S. dollar of about 4 1/4 percent and a real effective appreciation of the pound of about 8 3/4 percent. Non-fuel commodity prices are now assumed to decline slightly in 1991, compared with the previous assumption of a small increase. Finally, the U.S. dollar LIBOR (London inter-bank borrowing rate) is now assumed to remain constant at 8 percent, 1/4 of a percentage point lower than previously assumed, reflecting the offsetting influence of weaker U.S. growth in 1991 and higher oil prices.

On the basis of these assumptions, and also taking into account a more general reassessment of economic developments in the various countries as well as recent data, the revised projections point to a somewhat weaker outlook for global economic activity and to somewhat higher inflation in 1990-91 (Tables 1 and 2 of Annex).

For the major industrial countries as a group, output growth in 1990 is now projected to be marginally lower than in the world economic outlook paper. Slower growth in Canada, Japan, and France would be partly offset by higher growth in the United Kingdom. In 1991, growth is now expected to be almost 1/2 of a percentage point lower on average for the major industrial countries, with particularly large downward revisions for Japan, the United Kingdom, and Canada. Although growth in Japan has been revised downward--reflecting the recent rise in domestic real interest rates, the decline in equity prices, and the increase in oil prices--it is still expected to remain relatively strong in both 1990 and 1991. In the United Kingdom, growth is expected to be 1/2 of a percentage point higher than previously envisaged in 1990 and 3/4 of a percentage point lower in 1991 as stronger-than-expected growth in the first half of 1990 has led to a reassessment of the timing of the slowdown that was projected in the world economic outlook paper.

Consumer price inflation in the major industrial countries is now expected to be about 1/4 and 1/2 of a percentage point higher in 1990 and 1991, respectively, reflecting primarily the assumption of higher oil prices. The upward revision to the inflation projections is highest for Japan, Italy, and Canada where the level of consumer prices is now expected to be about 1 percent higher in 1991.

The external current account deficit of the United States is now expected to be $97 billion in 1990 reflecting the net impact of the increase in the cost of oil imports, slower growth during 1990, and a weaker dollar. In 1991, however, the U.S. current account deficit is projected to be just under $100 billion, about $7 billion lower than previously expected, as the impact of higher oil prices would be more than offset by slower growth and the depreciation of the dollar. The external surplus of Japan has been revised downward by $2 1/4 billion in 1990 and by $9 1/2 billion in 1991, owing primarily to the rise in oil prices. For the same reason, the projected surplus for Germany has been lowered by about $3 billion in both years.

For the developing countries, the staff has made a highly tentative assessment of the likely impact of the rise in oil prices as well as the changes in inflation and growth in the industrial countries. The preliminary results suggest that growth may be marginally higher (by 1/4 of a percentage point) in 1990 but lower in 1991 (by 1/4 of a percentage point) compared with the projections in the Board paper. This aggregate result, of course, masks offsetting revisions to the projections for the fuel exporting countries and for the fuel importing countries. Growth in the fuel exporting countries is now expected to be somewhat higher in both 1990 and 1991 (by about 1 percentage point and 1/2 of a percentage point, respectively), although this assessment must be considered particularly tentative in light of the ongoing developments in the Middle East. In the group of countries classified as nonfuel exporters, output growth is now expected to be somewhat lower in

> 1990-91. This result also conceals offsetting revisions as a number of countries that are not classified as predominantly fuel exporters are nevertheless net exporters of fuel and hence benefit from the increased price of oil.

Mr. Al-Jasser noted that Table 2 of the Economic Counsellor's statement indicated that industrial countries' real GDP growth would decrease in 1990 by 0.1 percent, while the supplement suggested that it would fall by 0.2 percent.

The staff representative from the Research Department indicated that the world economic outlook paper contained the usual set of comprehensive projections for all countries, which were based on oil price assumptions that were valid before the crisis in the Middle East developed. In reaction to events in the Middle East, Supplement 2 had been issued; it provided an illustrative scenario of the implications on the industrial countries of a world oil price of $25 per barrel. That was not meant to be a projection, but simply a scenario, which could be adjusted if and when the oil price changed. Subsequently, as was always done in preparation for the Interim Committee meeting and for the Board discussion of the world economic outlook, the staff in charge of the large industrial countries had been asked to revise their projections on the basis of new information, including assumptions for oil prices and exchange rates as well as new data on the domestic economy. The statement of the Economic Counsellor summarized the results of that exercise, which in effect involved a rather full revision of the world economic outlook projections. The projected fall in real GDP growth in the industrial countries for 1990 as set out in the main paper was lower than that set out in Supplement 2 because the oil price was assumed to fall from $26 in the fourth quarter of 1990 to $21 in the fourth quarter of 1991.

Mr. Dawson observed that Supplement 2 had assumed a 1991 oil price of $25, while the revised projections assumed a price of $21, which was the OPEC reference price. However, the revised projections also took into account other changes, such as an expected depreciation of the U.S. dollar by about 4 1/4 percent.

Mr. de Groote made the following statement:

> The recent oil price rise should not obscure the fact that the major determinants of short- and medium-term prospects for the world economy will remain the reactions of the three superpowers to recent changes in their domestic policy outlooks: to the risk of a recession in the United States; to the financial implications of unification in Germany; and to the effects of inflationary pressures on Japan's policy mix. Until recently, a medium-term perspective seemed the most appropriate for evaluating these issues,

but the suddenly changed oil outlook gives them all a new urgency requiring immediate preparation of suitable policy responses.

I share the staff's general conclusion on page 43 of the world economic outlook paper that a further reinforcement of monetary policy to reduce inflation and a further reduction of budget imbalances to improve savings are the best options for safeguarding the full benefit of the structural changes, especially those in Europe, that will support output in the medium term. However, I submit that it will require policy actions more flexible than the staff suggests, stronger policy coordination among the largest countries, and a more active role for the Fund, to protect the prospective expansion of supply against excessively high or unstable interest rates.

More specifically, I recommend: a reasonable time extension of the budget correction process in the United States to protect that country's medium-term stabilization objectives against a serious slowdown in activity; more intense balance of payments coordination to improve the international distribution of savings in favor of Europe and to alleviate tensions in the U.S./Japanese trade outlook; and a more active role for the Fund in the exchange rate management of the three key currencies of the system, and in the solution of the additional liquidity needs arising from reform and adjustment under less favorable economic conditions.

On the current situation and short-term prospects for the industrial countries, on page 11 of the paper the staff submits that the world economy is now much better placed to resist a major slowdown in any single country than it was some years ago. This is highly relevant to the current situation: it confirms the general view held in Europe and Japan that a U.S. recession would inflict only limited output losses on most countries other than a few U.S. neighbors. The adjustment strategies pursued in Europe and Japan during the 1980s have greatly boosted confidence of both business sectors and policymakers. The expansion in these regions is moving on a structural investment path, anticipating the positive consequences of reform and integration, and is resistant to external shocks. For the same reason, I also expect that for these regions the impact of higher oil prices could well be limited to the mechanical effects simulated by the staff in Supplement 2. While substantial, these effects are not serious enough to require a shift in domestic policy. In the United States, however, the situation is different: there, even a negative impact smaller than that projected for Europe and Japan may now be strong enough to precipitate the mild recession that is already taking shape.

We do not contest the validity of the foregoing analysis, but we feel concern that it does not cover the whole issue: we believe that a U.S. recession would have destabilizing policy effects with serious negative repercussions for the rest of the world. First, a recession would virtually ensure temporary abandonment of the budget correction. The seriousness of this possibility is already foreshadowed by the failure of Administration and Congress to get the budget correction back onto the path mandated by the Gramm Rudman Hollings Act. This legislation is now more likely to be implemented by reliance on the clause which suspends automatic sequestration in case of recessionary developments.

Second, a recession will make it much harder for the Federal Reserve to resist Administration pressures to relax monetary policy. These pressures are now reinforced by the risk of crisis developments in the banking sector: the buildup of household and corporate indebtedness during the 1980s has made the banking sector extremely vulnerable to default risks which at some stage only a radical easing of credit could help to avert. In short, the risk that monetary policy will be relaxed before inflation is fully controlled is greater now than at any moment since the present expansion began. Chairman Greenspan's legitimate strategy consisting of maintaining growth conditions just sufficient to offset that risk, will now come under increased pressure due to failure of the other sectors of the economy to adjust in time.

International market instability is bound to increase as a result of such a policy scenario. U.S. reliance on external savings will continue for many years, and as long as the internal adjustment is postponed, U.S. external financing needs will be associated with the public sector's imbalance. But from now on the United States will no longer be able to pay a sufficiently high interest rate to meet its persistent financing needs under stable exchange rate conditions. The financial markets are already anticipating this prospect: incoming news about the slowdown in activity instantly produces downward adjustments in the dollar exchange rate and is offsetting the upward pressures that normally affect U.S. currency during periods of international political crisis.

In the short run, other countries may benefit from this situation, since a lower dollar eases the effects of higher oil prices on their imports and inflation rates. In the longer run, however, excessive depreciation of the dollar now will bring an overcorrection in the opposite direction later on: this could well occur when the Federal Reserve is forced to raise sharply interest rates in order to eradicate the inflationary pressures first induced by the dollar's depreciation. This policy correction could precipitate the recession if it should occur while the business cycle is still on a downward path.

The inescapable policy conclusion of the foregoing analysis is that the further domestic and international adjustment of the U.S. economy has to be seen in the context of a slowdown of activity induced by sufficiently tight monetary and fiscal policies. Such a slowdown would be the natural outcome of the adjustment so far, and would create room for investment and exports once the budget deficit and inflation have been sufficiently reduced. Because this option was not implemented at a more favorable stage of the present expansion, we now have to consider the risk that it will be abandoned under the pressure of an impending reversal of the business cycle. Increased dollar instability and intensification of domestic price pressures would be the direct results of such an abandonment.

Moderate expansion of U.S. output to avert such a risk therefore remains the preferred strategy, even though this may now imply a reasonable extension of the timing of the budget correction. Such an extension would be justified by the need to maintain output at a level sufficiently high to protect monetary policy against undue relaxation. Because the extension of the budget correction would limit the slowdown in activity, especially employment activity, it would also increase the credibility of the fiscal stabilization as a medium-term objective by allowing the authorities to reaffirm, to the markets and public opinion, the priority of the fiscal stabilization. Finally, in the area of exchange rate management, I find it interesting to note the divergent market reactions to the oil crisis. Where credible arrangements are not in place, currency relationships have been destabilized, but in the European Monetary System (EMS), relative currency positions are adjusting toward a renormalization reflecting the economic performance and resistance to external shocks of each participant.

The oil price increase hits the Eastern European countries just when their reforms are about to be fully deployed. It will not only aggravate their immediate balance of payments needs, already expected to rise in order to support the liberalization of their economic systems, but also worsen the precarious state of their industries. Failure to modernize in time makes their industrial apparatus much more vulnerable to environmental limitations and energy shocks than the countries with which they now must start competing for a fair share of world trade. The hesitation of the German banks to shoulder their expected share of Germany's unification suggests that private investment capital alone will probably never be able to accommodate reconversion needs of such a magnitude. We therefore propose inviting the participants at the upcoming meetings to begin reflecting seriously on the choice to be made between preparing for an increase in official capital flows to accelerate the reconversion of Eastern Europe, or accepting a transition that will take more time and be more costly.

The staff's simulations show that the impact of higher oil prices on the indebted developing countries is less uniform than for the industrial countries, and may on the whole even be positive. Those who have been most successful in applying the present debt strategy are particularly likely to find their situation improved under the changed outlook. This apparent success should not divert attention from the fundamental flaws we still discern in that strategy: in point of fact, the majority of countries will now find the strategy even harder to implement.

Because the oil price increase damages the terms of trade of the indebted developing countries, they will be forced to divert scarce resources to their suddenly increased balance of payments needs instead of using them for debt reduction. Stronger Fund support cannot, in the present circumstances, solve this problem, since the Fund's own general resources will probably undergo a similar shift, from the support of debt reduction to the support of more immediate payments needs.

In sum, before the debt-reduction strategy can be more widely applied, its liquidity aspects need to be improved: additional resources need to be made available in order to support collateralization on a wider scale, especially with a view to alleviating interest charges in case of adverse shocks. Until the liquidity of the Fund has been accordingly reinforced, the creditor governments will find themselves called upon to keep the strategy alive by canceling, at high budgetary costs, their own claims on a growing number of countries, or by providing budgetary resources of their own as a substitute for the Fund's liquidity.

The countries that are successfully growing out of debt deserve special attention at this point in time. Their strategy for regaining creditworthiness by prudent market borrowing is now at risk, owing to the additional needs resulting from the oil shock. A return to official borrowing entails equal risks in most cases because this kind of assistance is now almost exclusively associated with cases where growing out of debt is no longer considered feasible. For most countries growing out of debt, vigorous trade liberalization opening more markets to their exports would be the most appropriate solution, but until now this particular link between the debt strategy and the industrial countries' policies has not received much systematic attention.

Turning to medium-term issues, on page 47 of the world economic outlook paper the staff joins other economic agencies that interpret the German unification as an aggregate demand shock that will increase global investment relative to world savings. In recent months, this interpretation has focused international attention almost exclusively on what savings measures Germany should take to restore an appropriate balance. Let me make two comments that throw a somewhat different light on this interpretation.

First, from the international adjustment standpoint, we should not worry unduly over the possibility that Germany will take the expected measures, because its fundamentally sound economy can absorb a shock as large as unification provided that appropriate policy adjustments are considered in time. Now that the initial social and reconversion costs look higher than originally, a consensus is emerging in favor of a tax contingency plan to avoid excessive public borrowing. This is wholly consistent with our recommendations for fiscal flexibility during the April world economic outlook discussion. The most relevant lesson from the perspective of international adjustment is that Germany is now uniquely positioned to implement such a fiscal corrective without upsetting its long-term consolidation strategy because it has steadfastly pursued that strategy over the last decade. The stabilization of Germany's long-term rates in the weeks preceding the Middle East crisis suggests that the markets share this basic confidence.

My second comment is that even the initial market reaction to unification would have been less violent if other countries, including the United States, had been in a better position to release savings to the new investment opportunities emerging in Europe. Shocks like unification and East European reform are bound to have disproportionate effects on interest rates as long as the U.S. imbalances continue to distort world financial flows. In short, interest rate stability still depends at least as much on improving the international distribution of savings as it does on raising the savings level. Here we find an answer to the important question the staff raises on page 46: should surplus countries contribute to the international adjustment by supplying savings, or by actions aimed at promoting the absorption of their surpluses? Let me just reinforce the staff's view on the issue by submitting that, at least in Germany's case, absorption would now be the normal course of action, but that more active coordination among the largest countries is needed to prevent the absorption from taking place under conditions of structurally higher interest rates and lower growth in the deficit countries. This coordination should aim at promoting policies for an orderly redistribution of international savings away from the United States and toward Europe as the most appropriate solution to the current tensions.

The foregoing considerations imply that the external adjustment of the large industrial countries cannot stop where it is now. Policies for gradually reducing the current account imbalances should remain at the center of international coordination. Active balance of payments coordination is for the United States the most effective medium for helping to alleviate savings and inflation tensions in the international context by further correcting its internal imbalances. It is also the only effective way to prevent settlement of international trade tensions, especially U.S.-Japanese tensions, on a purely bilateral basis. In this connection, I note that the staff expects Japan's current account surplus to rise again in the future. The bilateral tensions implied by this prospect will be intensified if Japan has to consider offsetting its high energy dependency with measures to increase its trade surpluses in other sectors. In sum, intensified policy coordination is a precondition to the successful outcome of trade liberalization discussions: it is even essential to ensure that these discussions take place with a view to improving resource allocation for all, and especially for the developing countries.

I have three brief comments on the role of the Fund, which reinforce the arguments I set out in my statement at Seminar/90/1 (6/5/90) on the evolution of the international monetary system. The first concerns the need to begin serious reflections on the role of the Fund in a tripolar exchange rate system. The present world economic outlook highlights the need to anticipate the merits of such a system more actively from now on. First, it shows that the markets' reaction to the oil shock has been stabilizing for EMS participants, but potentially quite destabilizing for dollar-yen-mark relationships. Second, it leads to the conclusion that even a purely internal shock like the German unification calls for more active coordination--in particular, balance of payments coordination--among the economic superpowers. The case for joint leadership based on a new set of exchange rate rules is considerably strengthened, because without it the markets will once again become more likely to impose an unstable adjustment.

My second comment concerns Eastern European reform. I suggest that we expedite our work on the financial implications of the dismantling of trade patterns among the CMEA countries. This dismantling now seems likely to be accelerated by developments in the U.S.S.R., and its consequences will be all the more intense unless the oil price increase is soon reversed. Professor Kenen's forthcoming working paper on the transitional arrangements for trade and payments among the CMEA countries would be an excellent basis for starting this work, and I would like to suggest inviting him to a Board seminar discussion on the subject soon after the Annual Meetings.

Third, we should prepare for the possibility that implementation of our debt strategy may suffer from a new deterioration in many countries' terms of trade, which could even coincide, for the first time since 1982, with a serious slowdown of activity in their principal export markets. The implications of this prospect bring to the forefront the need to organize the Fund's role in a system characterized by the periodic emergence of exceptional liquidity needs that are unrelated to Fund quotas.

Mrs. Filardo made the following statement:

I would like to commend the staff for the excellent, comprehensive papers, especially those portions on structural reform and growth in developing countries and on the sustainability of fiscal policy in the major industrial countries. The papers emphasize the major issues to be assessed by the Board regarding present and future developments in the world economy. While the main paper is well balanced between industrial and developing countries, Supplement 2--on developments in oil markets--seems to assume rational behavior in the face of an imminent external shock.

The staff has made its projections using a benchmark oil spot price of $25 per barrel, based on the evolution of prices during a few days in the month of August. Chart 15 of the main paper and Chart 1 of Supplement 2 reflect the volatility of oil prices, which have been on a downward trend since 1981--with an increase in 1989, but a subsequent decline since March 1990.

The staff has indicated that while the evolution of oil prices will very much depend on developments in the Middle East and the level of oil production by OPEC members, there are plausible scenarios that would result in a decline of oil prices from current levels. Inventories remain high, strategic reserves are at approximately 1 billion barrels, and owing to the slowing down of the world economy, consumption of oil is expected to moderate.

I do not deny that we are facing a difficult situation in the oil market and that we should consider the worse possible outcome, but as the staff has rightly indicated, the course of oil prices is highly uncertain. In view of the recent decision of the OPEC nations to increase oil production to supplement the lack of the oil supply from Iraq and Kuwait, given that other non-oil producers could also increase production--which has not been envisaged by the staff in its projections, and since oil demand could be reduced before a recession occurs and the crisis in the Middle East could end as quickly as it started, I question the appropriateness of using only one benchmark price in the world economic outlook. Perhaps the staff should present a number of scenarios, taking into account the fact that increased production and lower demand could imply a reduction of prices. If the crisis in the Middle East ends suddenly, there could be an excess supply of oil and prices could fall just as suddenly as they rose.

Given the Fund's conservative approach in making projections, basing those projections on an extreme case of higher oil prices could further exacerbate the negative effects of the Middle East crisis on financial markets, and could have an adverse impact on the management of Fund programs both for oil importing countries and for net debtor oil exporting countries. We should not forget that the world economic outlook is the basis on which Fund programs' baseline scenarios are determined. Therefore, a projection of very high oil prices will affect program design and policy implementation as well as negotiations of financing packages with commercial banks. The banks' perception of the risk involved in such packages will of course be influenced by the projected oil price for better or for worse, depending on whether the country is an oil importer or an oil exporter. If oil prices reverse and do not settle at the high level projected by the staff, the net debtor oil exporting countries would face another adverse shock, together with its negative consequences for program implementation.

The staff fails to assess the impact on the U.S. budget of the military cost of troop and armament mobilization in the Middle East, at a time when the fiscal deficit has deteriorated dramatically and there is still no agreement in Congress on how to solve the fiscal deficit for 1990/91. While it seems to be possible that this expenditure will be shared by the superpowers, it is still unclear how they will proceed. In any event, the fiscal situation of the superpowers, except for Japan and the United Kingdom, is rather tight. The problem of increased oil prices will be fairly manageable, absent the extreme case of oil field destruction, but the impact of military expenditures on the budgets of the industrial countries will be more serious. If the worst possible scenario of high oil prices and substantial military expenditures in the industrial world develops, we will probably face one of the most serious recessions ever experienced. The staff should try to evaluate this situation and its possible outcome and also should include alternative scenarios for oil prices. We must monitor the situation continuously. Both management and staff should also be very cautious with regard to the projections that they make for the Interim Committee and the Annual Meetings regarding oil prices and developments in the Middle East.

Monetary policy has been overburdened by a lack of fiscal discipline, which has been relaxed in major industrial countries. In addition, in these countries, manufacturing capacity utilization is at the highest level, unemployment has declined, and consumer prices and interest rates have increased. The possibility of increased pressure on the fiscal deficits of industrial countries, through either increased military spending or higher oil prices, will have an adverse impact on inflation. There is therefore no other way to tighten monetary policy but to contain price increases. The question is whether this additional burden on monetary policy is sustainable or whether there will not be additional pressure on the Federal Reserve to ease interest rates, given the expectation of a recession as reported in yesterday's press. It would be preferable if the industrial countries allow their growth to slow but fight hard to control inflation.

In Eastern Europe and the U.S.S.R., output is expected to contract in 1990 and remain stagnant in 1991, owing to the short-term impact of stabilization policies and structural reforms. Given the present difficult situation of those countries and their lack of experience with Fund stabilization programs, there is no doubt that there will be a contraction in their economic activity. Nevertheless, the lack of reliable information, adequate institutional frameworks, and instruments to implement a program seem to indicate that there could be policy slippages or that the expected results may not materialize. Therefore, we should be extremely cautious in our projections, given our experience with other countries that have implemented structural policies simultaneously with a stabilization program. Eastern Europe and especially the U.S.S.R. are new territory for the Fund and, given the deep-seated structural problems they are experiencing, it is very difficult to make any precise projections. In our discussion of the world economic outlook this spring, I emphasized the importance of taking into consideration our experience in Latin America. Even though that continent has been under a capitalistic system, it has taken a long time for its countries to adjust and to restructure their economies. We must therefore be realistic about the difficulties that the Eastern European countries will face in overcoming their complex problems.

The staff representative from the Research Department, in response to a question from Mr. Al-Jasser, indicated that the staff would prepare a brief note for the Interim Committee on the world economic outlook, which would not contain any scenarios. The projections that would be used in the text and in the tables will be based on the new price assumption as presented by the Economic Counsellor in his statement--that the price of oil would decline from $26 in the fourth quarter of 1990 to $21 in the fourth quarter of 1991.

In response to Mrs. Filardo's point that increased production by certain countries could influence the world oil price, the staff representative noted that the projection of $21 a barrel by the end of 1991 indeed took that possibility into account. The staff was assuming that the oil market would remain relatively tight, in part because of seasonal demand in the fourth quarter of 1990 and in the first quarter of 1991, with the price staying at $26 in the fourth quarter of 1990 and falling to $25 in the first quarter of 1991. Based on the assumption that the rest of OPEC would increase supplies by about 4 million barrels a day, thus making up most of the shortfall from Kuwait and Iraq, and given the seasonal reduction in demand that would come with springtime, the price was projected to fall progressively to $21 per barrel by the fourth quarter of 1991. That projection did not allow for any interruption of oil supply owing to industrial accidents, nor did it allow for the possibility of a decline in production by the largest oil producer in the world--the U.S.S.R. There was currently little unused capacity from oil producing countries other than OPEC members--perhaps on the order of 1/2-1 million barrels per day. Therefore, the staff was assuming that most of the increase in supply would come from OPEC members. Specifically, more than one half of the increase would probably come from Saudi Arabia, with the rest coming primarily from the United Arab Emirates and Venezuela.

Mr. Al-Jasser made the following statement:

As the short-term projections indicate that the world economy will continue to grow, albeit at a slower pace, it is worth remembering that this slowdown in growth comes on the heels of seven and a half years of economic expansion, which only recently began to cause high-capacity utilization and upward-cost pressures. In addition, as the staff indicates, the major industrial countries have been at different cyclical positions over the past few years, thus leading to varying adjustment policies in different countries at different times. Therefore, it seems that present divergences would reduce the chances of a sharp, generalized slowdown or a major recession in any one country.

Clearly, recent developments in the Middle East have heightened the level of uncertainty about the price of oil. However, I firmly believe that the above assessment of the world economy remains valid. Indeed, the effect of the recent changes in the international oil market appears to be relatively small and, consequently, the short-term outlook should not change substantially. Therefore, the current policy stance remains both valid and appropriate. In this context, it is reassuring to note from the staff scenario that inflation and growth performance of the global economy would not be dramatically affected.

My authorities have always believed that stable oil markets and prices are in the best interest of all members of the global economy. Motivated by this belief, my authorities have striven to bring about an agreement within OPEC to increase production, so as to reassure the market that sufficient oil supplies are available. This assurance on the supply side, coupled with the adequate levels of strategic reserves and oil stocks, should ensure that supplies will be adequate and therefore should stabilize prices closer to the OPEC reference price of $21 per barrel.

I would point out that OPEC members, even in their recent emergency meeting, have not hinted in any way that they would be changing that reference price in the near future. The OPEC reference price is still the price that OPEC is committed to, and until there are indications that it will be changed, it would be helpful if that scenario is examined by the staff. In my view, there is no economic reason for the price to gyrate to the level of $26 per barrel, which is only a result of speculation about military and political uncertainties.

The economic determinants of prices are clearly pointing toward a lower price than the $25 assumed in the staff scenario. Clearly, very short-term gyrations in the price are not caused by changes in economic fundamentals, and, therefore, should not be given undue weight. I believe that a price between OPEC's reference price and the staff assumption of $25 is more likely in the near future. Later, the price should oscillate back to OPEC'S reference price.

It is encouraging to observe that even in the very pessimistic staff scenario, which assumes a price of $30 a barrel, no systemic dislocations are expected. However, my authorities remain very concerned with the burden on heavily indebted and poor oil importing countries, with which the Fund is deeply involved. This concern was very much in their minds when they undertook to restore stability to the world supplies of oil.

This being said, I believe that it is important to maintain the current monetary, fiscal, and structural policy mix, on which I will elaborate further in the afternoon. At this stage, suffice it to say that I agree with the staff that an easing of monetary policy would be inappropriate, since it would threaten the strength and credibility of the anti-inflationary stance.

Moreover, despite the large fluctuations witnessed in equity markets before and after the oil market developments, exchange markets have exhibited reasonable stability, which can be considered as a positive indication of the consistency in the exchange rate policies of major countries. This, in turn, reflects these countries' responsible monetary policies, which further highlights the importance of staying the course with respect to monetary policy.

The Fund has been playing a constructive role in helping developing countries to adjust and embark on sustained noninflationary growth, as well as in helping industrial countries to coordinate their macroeconomic policies. Continued leadership in this area is critical to enhancing the multilateral nature of policy advice and coordination, which should strengthen the membership's ability to adapt to unforeseen developments.

Mr. Landau made the following statement:

Obviously, this year's world economic outlook discussion is of special importance. Uncertainties as to the final outcome of the present crisis make any assessment tentative and provisional. But the staff's studies and recent supplement provide us with very important material and fruitful analysis, which our authorities can use for the design of policies.

One main lesson is apparent from the staff paper: if the oil situation stays stable, about \$25-\$26 per barrel, its direct macroeconomic consequences for industrial countries should stay manageable. But there are, of course, two caveats: first, will the oil market stabilize? Second, what are the indirect consequences of the present crisis?

On the first point, there are some elements of optimism, namely, the recent OPEC decision to increase output, making up for a significant part of the loss in Iraqi and Kuwaiti production; and the high level of stocks, including an exceptionally high level of strategic stocks.

Nevertheless, there is still much uncertainty in the immediate future. Of course, the risk of war and/or major disruption in the oil production fields cannot be discounted. But pre-emptive storage and speculation might also cause wide fluctuations in the oil prices. There are signs that this was the case in previous weeks, when the prices went up \$30 per barrel. This might make a good case for some strengthened international cooperation in monitoring and regulating the oil market.

But what makes this increase in the oil prices especially difficult to deal with is that it comes at a time of increasing vulnerability of the world economy. I would stress, inter alia, the following factors. First, growth is now unequally distributed among countries. A significant slowdown in the United States, with the possibility of a recession in the future, contrasts with sustained, although weakened, growth in Europe and Japan.

Second, the financial sector displays some signs of fragility, as illustrated, inter alia, by the collapse of the junk bond market, difficulties in real estate financing, and the downgrading of many major banks. Although microeconomic in nature, these events could have a major macroeconomic impact if they lead to a spontaneous credit contraction or widespread financial disruption affecting real economic growth.

Third, there remain many uncertainties as to the timing and extent of fiscal measures, which have to be implemented in some major deficit countries. All these factors might have contributed to the strong and brutal correction that has occurred in stock markets during the month of August. It is difficult to isolate a specific cause of that correction, and, in particular, to determine whether it was a reaction to the oil price increase, a consequence of underlying weaknesses in the growth process, or the result of uncertainty about the future course of economic policy.

Last but not least, many developing countries find themselves in a situation of increased vulnerability to the consequences of the oil price increase. Many of those indebted countries no longer have access to international borrowing to deal with their external financial situation. I will return to this issue later.

From all this, it is clear the economic policy response to the present situation, provided it stabilizes, should be to address both the direct consequences of the oil crisis and the underlying vulnerability and weaknesses that exist.

Turning to policy issues, I shall present some general reflections before making specific remarks. What we face today is essentially a supply shock at a time when all industrial economies are operating at full capacity. So it seems clear that the temptation of demand stimulation should, in the present circumstances, be resisted. Furthermore, we know from previous oil shocks that even partial accommodation of inflationary pressures in order to preserve growth in the short run is bound to be detrimental to longer-run prospects. Markets and economic agents are no longer fooled by monetary illusion, and the real effects of monetary expansion are thus minimal. At the very least, this means that economic policy should not be guided by the exclusive and overriding preoccupation of avoiding, in any one country, a short-term and short-lived slowing of growth.

We may not have control over oil price developments, but we can and must aim at controlling the financial markets' reaction to external shocks. The overall objective in the present circumstances should be, in the short run, to prevent financial volatility and uncertainty from adding to the disruptive consequences of the international events in the Middle East.

There is a need for a concerted and cooperative response to present events. This has generally been the case up to now, but particularly difficult challenges lie ahead in the formulation and implementation of economic policy. The markets are looking for coherent and cohesive measures to be implemented and taken. I was especially struck by the analysis of the staff paper on how markets had reacted differently on interest rates according to the diverging perceptions on national economic policies. This had no major consequences up to now, but might be detrimental to overall economic stability in the future.

There should be no relaxation of monetary policy. Attempts to lower interest rates through monetary expansion would be both counterproductive and unsuccessful; they would only fuel inflationary expectations, as witnessed by recent steepening of the yield curves. On the contrary, consistent and broadly restrictive monetary policies would help to stabilize market expectations and maintain pressures in favor of fiscal consolidation wherever it is needed. I thus fully concur with the staff's recommendation that monetary policy aim at maintaining the present rate of nominal GNP expansion, even if it means, reduced or negative real growth and higher interest rates for some of us.

There should be no benign neglect as far as exchange rates are concerned. This, as you know, has been a constant position of my country and we certainly continue to favor a strengthening of international coordination in that field. Several considerations show that benign neglect would be especially dangerous in the present situation. In the staff paper, some international imbalances are projected to increase, especially as far as the Japanese current account is concerned. The U.S. dollar has now reached approximately the real level that prevailed at the end of 1989, when there was general agreement that no further decline was warranted, and it is at the lowest level in nominal effective terms for the last 30 years. We might not be far from the outer limits of the range warranted by economic fundamentals. Needless to say, exchange rate volatility between the main currencies would contribute heavily to a general climate of uncertainty.

On the desirable nature and degree of the Fund's involvement in the present circumstances, the paper states that on the whole, developing countries will benefit from current events, since some of them are net oil exporters. However, this has to be balanced against two other considerations: first, a significant number of individual countries will be heavily penalized, whether or not they are directly affected by the conflict, by the increase in their oil costs, the loss of workers' remittances, and the reduction of services receipts. Second, these countries will be even more vulnerable than they had been during previous shocks, since they no longer enjoy easy or spontaneous access to international financial markets. For all practical purposes, the whole recycling mechanism based on bank lending is dead. The worsening of these countries' situation will thus have to be counteracted by a mix of internal adjustment and official financing. That is exactly what the Fund is good at providing and organizing. My authorities foresee a central role in the period to come in this regard for both the Fund and the World Bank.

The modalities of the Fund's intervention would have to be carefully assessed in the light of the evolving situation. No options should be excluded a priori. All deserve full study, and in particular, the following possibilities. A revival of the oil facility, which was implemented in previous crises, should be considered if the evolution of the oil market takes a more dramatic turn; the Fund should stand ready, in such a case, with the necessary mechanism. There might be room for simplifying and making more flexible access under the CCFF, in order to increase or accelerate the facility's contribution to compensating for the effect of oil prices on those countries mostly affected. Finally, a flexible approach to access policy, which could incorporate the recourse to exceptional circumstances clauses (leading to some waiver of the access limits), should not be excluded for those countries which have financial arrangements with the Fund and whose program implementation warrant continued support.

Mr. Al-Jasser remarked that it was perhaps not appropriate to term the recent developments as an oil supply shock; it was important that the Fund choose its words with care so as to avoid disrupting the financial markets. There had been a decline in exports by Iraq and Kuwait, but the first half of 1990 had seen excess supply in the market, resulting in an unusual increase in the stock buildup of oil. The current oil situation was not a crisis; if it were, the strategic reserves of the major countries would have been used.

Mr. Finaish made the following statement:

The staff presents a useful and interesting assessment of the implications of recent developments in the international oil market. But as the staff paper clearly recognizes, this assessment is only illustrative, since there is a high degree of uncertainty about the course that oil prices are likely to take in the future, including the very immediate future. While one cannot exclude the possibility that oil prices may rise significantly above their current levels, it is also conceivable that the opposite will take place, given the level of excess capacity in oil exporting countries and the recent decision by a number of them to increase production as a compensating measure, in addition to the large inventories of crude oil in industrial countries. Clearly, however, the current nervousness of the market is not related so much to whether current supplies will be sufficient, or to the impact of an oil price of $25 per barrel--which in the aggregate is not so extreme, particularly when compared to the experiences of the 1970s and early 1980s--but more to the threat of a sharp curtailment of supplies, which could result from an outbreak of military hostilities. It may also reflect fear of much wider political instability in the Middle East in the aftermath of the present crisis, particularly in the event of an actual war.

The major issue facing the international financial community today is not only how best to respond to the implications of an increase of a certain magnitude in oil price levels, but also how to respond to the general environment of acute uncertainty to which I have just referred.

Monetary management is obviously an immediate policy concern. This is so not only because monetary policy is more amenable to short-term policy decision making, but also because the monetary authorities in the major industrial countries were already strained in trying to maintain a delicate balance among the various, and often conflicting, domestic and external objectives. The very limited room for maneuver that existed before recent developments has become even smaller. On the whole, I believe the staff is right in advising steadiness in the course of monetary policy. Past experiences with oil price increases would certainly call for cautiousness on the part of monetary authorities, who need to dispel any impression or expectation on the part of economic agents of an accommodating monetary policy.

At the same time, it is important that caution not be translated into an overreaction in the opposite direction. Monetary tightening is not without cost. Indeed, for many oil importing developing countries, the implications of a sharp increase in interest rates can be even more significant than the direct effect of the rise in oil prices. Another consideration that this delicate balancing act has to take into account is the possibility of renewed downward pressures on equity markets. If such pressures were to materialize, the cost of excessive tightening will be even greater. To recap, while the message to economic agents should be one of steadiness in monetary policy, erring in either direction would entail substantial costs.

Perhaps one silver lining in the way that markets have reacted to recent developments is the relative stability of exchange markets, notwithstanding some downward pressure on the U.S. dollar. This seems to be at odds with past episodes of comparable international crises, which have usually led to upward pressures on the dollar. In the paper on exchange rate developments, the staff provides one explanation for the recent behavior of the dollar. Another explanation could be the changes in the structure of the international economy that occurred in recent years. Yet another possible, and perhaps complementary, explanation is the fact that in this particular case, the United States is directly involved. It is not inconceivable that the usual flight to the dollar may have been offset by perceived costs to the U.S. economy, particularly in case of an outbreak of military hostilities. In any event, further staff elaboration on exchange markets behavior in recent weeks would be useful.

Although fiscal policy is not usually considered an ideal instrument for responding to sudden changes in the economic environment or for crisis management, in our view recent developments have made the need for action on the fiscal front, particularly in the United States, much more urgent. The increased burden on monetary policy and the risk of a significant rise in interest rates make it an absolute necessity that public sector demand for credit and the pressure that this puts on global savings be eased. This was a major concern even before recent developments, given the increasing demands on global savings associated with developments in Europe. The costs of insufficient fiscal action have now become much higher. What is important at this juncture is to send a clear and decisive message to economic agents about the course of fiscal policy. This can be done only through a credible multiyear fiscal plan that has the support of the U.S. Executive Branch and Congress.

Clearly, the U.S. fiscal position is not the only important issue for the world economy, and other major industrial countries can do a lot to help ensure a stable noninflationary growth over the medium term. But given the scope of the discussion this morning I have limited myself to issues that are, in my view, of more immediate concern.

Drawing on previous experience with sharp increases in oil prices, the staff cautions against limiting the pass-through to domestic energy prices. The staff also argues that any attempt to offset a full pass-through by imposing higher taxes on other sectors would not be desirable since it would lead to price distortions. This is of course correct in cases where domestic energy prices are subsidized or where a limitation on a full pass-through would result in a subsidy. However, in those countries where domestic energy prices incorporate a heavy tax, as is the case in many industrial countries, the argument for a full pass-through cannot in our view be based on efficiency considerations. The case for maintaining domestic prices at levels that are significantly above international prices is usually based on other objectives, such as reducing dependence on imported oil or subsidizing domestic energy sectors such as coal, which is often incompatible with pricing efficiency.

With regard to the appropriate policy response in the oil importing developing countries, I agree that attempts to insulate the domestic market through such expedients as subsidies or price controls, or for that matter through an easing of domestic financial policies, may bring some short-term relief but would merely compound the problem and pose yet greater difficulties for the authorities in the future. However, while it is difficult to question the staff's advice, let us not think that implementing yet more stringent adjustment measures will be easy. The risks of policy slippages, in the absence of countervailing action through an appropriate blend of adjustment and financing, will now be much greater.

Obviously, the impact of the current situation in the Middle East on individual developing countries will vary substantially, as illustrated in Supplement 2. Even for oil importing countries outside the region, the potential impact ranges from relatively small to quite substantial. In some cases, the loss of workers' remittances, earnings from construction contracts, and special trading arrangements could place additional strains even if the price of oil were to stabilize at a relatively low level.

In my region, although the narrow effect of higher oil prices would be beneficial to the oil exporting countries, this has to be weighed against the many negative implications of perceptions of prolonged instability in the region. The adverse effect on investment and private capital movements may well be substantial. In any event, it is crucial that oil exporting countries adopt cautious policies in response to an increase in their oil revenue. The experience of previous increases in oil prices provides important policy lessons, which in the current uncertain environment are particularly relevant.

For some of the other countries in my region, developments in the international oil markets aside, the adverse consequences of recent events, including those associated with compliance with the UN-mandated sanctions and the loss of income from workers' remittances and tourism, are certain to be staggering. This is indicated even by the preliminary assessments of those consequences, which, by focusing mainly on the primary channels of influence, clearly understate the real magnitude of the damage and dislocations which the countries in question stand to sustain. For example, the massive influx of refugees and returning expatriates would place an enormous burden on government services, which would also have to cope with the further rise of unemployment associated, at least in the short run, with the loss of export markets. Furthermore, the conduct of monetary policy has already been further complicated in those countries by the challenges posed by the weakened confidence in national currencies which had been precipitated by the present situation.

Clearly, the current circumstances in the countries in question call for immediate and adequate external support of a form that would not further exacerbate their debt-servicing difficulties. In this connection, the authorities concerned welcome the increased recognition on the part of the international community of their special needs, and the steps being considered by some major creditors. It should also be stressed that the current situation in this group of countries will inevitably require short-run measures in order to deal effectively with the economic and social dislocations brought about by the crisis. While adherence of those countries to the overall objectives of their adjustment and reform strategies will be essential, a reassessment of the adjustment and financing mixes in the light of the changed circumstances and the short-term emergency needs will be equally necessary.

As far as the Fund is concerned, I agree with the staff on the need to make a careful evaluation of the implications of recent developments on external viability and to assess adjustment and financing needs based on the particular circumstances of each country. Depending on the course of events in the period ahead this may entail larger demands on Fund resources. Indeed, unlike the situation in the 1970s, where commercial banks played a major role in meeting financing needs associated with oil price developments, it is the official sector--including the Fund, the Bank, and bilateral creditors--that is likely to play the central role. It is therefore crucial that the official creditor community respond in a timely manner where necessary.

The Fund's ability to respond will no doubt be enhanced by the increase in its quota resources; hopefully, this increase will become effective sooner rather than later. In the meantime, however, the Fund should stand ready to respond quickly and adequately within its current means if the need arises. Moreover, as I stated in the discussion on debt last week, it is now even more urgent, given the high degree of uncertainty, to explore new ways of making adjustment programs and Fund arrangements more robust and better able to withstand sharp changes in the general economic environment, including in particular possible shifts in oil prices.

Mr. Kafka made the following statement:

The most important aspect of the short-term situation is the quite unusual degree of uncertainty that the developed as well as the developing world face. It would be a mistake to look with equanimity on the effects of these uncertainties and allow them to work themselves out. At the time of the first oil shock, the perceived creditworthiness of the oil importing countries was still entirely intact. At the time of the second oil shock, their perceived creditworthiness was, to some extent, intact. There was, therefore, leeway to offset some of the immediate effects of the oil shocks by mobilizing capital inflows. That the countries concerned did not always use this leeway in the best way, particularly after the second oil shock, is a different matter. The absence of practically any immediately available external leeway at this time for most of the oil importing net debtor countries must concern us. It must do so particularly because of the uncertainties attached to the underlying assumption of Chapter I of the main paper, that all the adjustment and restructuring programs of the Bank and the Fund will be carried out by the member countries concerned as intended and lead to a strong 1991 recovery in developing countries.

I am grateful to the staff that it has, in Chapter III of the paper, formulated two medium-term scenarios, of which one is based on less unrealistic underlying assumptions than the Chapter I projections. The effects on the potential growth performance, in particular of countries with recent debt-servicing difficulties, are quite dramatic. It would have been helpful if an alternative pessimistic scenario had been given prominence already in Chapter I. By comparison with a pessimistic scenario, the potential effects of the present uncertainties are dangerous, both economically and politically, both in the short and in the medium term.

I strongly support the staff's insistence that the most recent oil market developments should not be hidden nor should any attempt be made to neutralize them as was done previously. But that is not the same thing as saying that no assistance is needed to help countries overcome the effects of these developments if they last for any length of time. It is incumbent on the international financial community to start providing for the appropriate type of offsetting assistance, if it should be needed. This assistance would be addressed not to hiding the price effects of the oil market developments but to helping the countries affected to adopt measures that reduce their dependence on oil. The Fund's oil facility was not addressed to that purpose. The extended Fund facility was the more appropriate type of reaction. I think that the excellent analyses provided by the staff should be supplemented very soon by a staff paper designed to define the appropriate action that the Fund should devise, unless there is a very sudden and very complete rolling back of the oil price. Where a given problem faces many, we should not abandon our case-by-case approach, which will have to be appropriately applied on grounds of being seen not as prudent flexibility but as simple differentiation.

While the present outlook must on the whole be pessimistic, one should not overlook those elements of hope that are inherent in the present situation. Among these is the fact that several industrial countries find themselves at the moment at different stages of their economic cycle. This is likely to offset to some extent the recessionary influences that are likely to emanate from the countries of this group.

Among the developing countries, there are some extremely encouraging developments, although their effects will not at once be visible. These are a result of the new attitude toward inflation and economic efficiency that is becoming prominent, inter alia, in the Western Hemisphere, where such a new departure has been most necessary.

Mr. Clark made the following statement:

We are having our discussion today at a time of considerable uncertainty about the course of developments in the Middle East, uncertainty about the impacts of higher oil prices on industrial and developing countries, and uncertainty concerning rapid changes taking place in Eastern Europe and the U.S.S.R. Obviously, these developments, and the uncertainty that surrounds them, have important implications for the global economy and the appropriate macroeconomic policy stance for both industrial and developing countries. The staff has endeavored to take account of these developments in its analysis, including the very interesting supplement on the effects of higher oil prices, but it nevertheless remains the case that the outlook is clouded by greater uncertainty, and the risks to sustained growth are considerably greater, than was the case only a few months ago.

Looking first at the economic conjuncture in the industrial countries prior to the upsurge in oil prices, I am in broad agreement with the staff's projections and its assessment of the situation. This assessment points to the fact that fundamental policy issues have remained essentially unchanged since last May, a point that I will be coming back to this afternoon when we discuss the medium-term prospects and policy issues. However, this does not mean that the balance of risks associated with policy action, or inaction, has not shifted. In our discussion of the world economic outlook in the spring, it was the view of this chair that the greatest risk was for increasing inflationary pressures. This still remains our view; indeed, our concerns have deepened, given trends in the first half of this year and recent developments in world oil markets.

It is well to keep in mind that, over the past four years, consumer price inflation in the industrial countries has been moving up, rising from about 3 percent in 1987-88, into the 4 percent to 5 percent range during the past year. Even more worrisome, there is little evidence that this upward trend has been contained.

In the United States, consumer prices, excluding food and energy, rose at an annual rate of about 5.5 percent in the first six months of this year. Employment costs in the United States in the first six months of this year increased by 5.2 percent, compared with 4.8 percent in 1989. In Canada, wage settlements were about 6 percent in the first quarter of this year, compared with 5 percent last year. In Germany and Japan, spring wage negotiations led to wage increases of nearly 6 percent, compared with hourly earning increases of just over 4 percent and 5 percent, respectively in 1989. Capacity utilization rates in Japan, Germany, and the other major continental European countries, are at the highest levels since the peak in 1980-81. In North America and the United Kingdom, capacity utilization has declined a little with the slowing in demand, but it nevertheless remains at very high levels. Long-term interest rates rose significantly in late 1989 and the early months of this year, reflecting partly potential credit demands from Eastern Europe, but also rising inflationary expectations. At the end of April, long-term rates stood 100, 125, and 184 basis points above their year-end levels in the United States, Germany, and Japan, respectively. Since the outbreak of the Middle East crisis, bond yields in Germany, the United States, and the United Kingdom have risen by 50 basis points, and by nearly 80 basis points in Japan.

I recognize that demand growth has slowed in the United States, but it is by no means clear yet that capacity gaps have emerged that would even ensure the containment of inflation, let alone a reduction in inflation.

In the case of Canada, where monetary policy has been very tight for more than two years, growth of GDP was negative in the second quarter, and will, we hope, remain very weak over the balance of the year. This opening in output gaps will exert downward pressure on costs and prices in the near term. But even here, given the uncertainty with respect to oil prices, the authorities will have to exercise caution, as monetary conditions ease, to ensure that these hard-earned gains are not lost.

Growth in Germany and Japan this year is clearly stronger than had been predicted at the beginning of the year. Indeed, the extremely strong pace of expansion in the first half of the year suggests an intensification of underlying inflationary pressures.

Demand conditions are also strong in a number of other continental European countries, while in the United Kingdom, preliminary data for the second quarter also suggest that excess demand may not have been eliminated.

In light of these developments, it is my view that the balance of risks remains tilted more toward higher inflation, or at least to no appreciable progress in reducing inflation, than the staff's original assessment suggested. This view seems to be reflected in the staff's new forecast presented this morning.

There is clearly a great deal of uncertainty about the future course of oil prices. In these circumstances, the oil price assumption set out by the staff this morning appears reasonable, although, as noted, it is subject to considerable risks. I strongly agree with the staff that, as past experience has shown, efforts to mitigate the adverse short-run effects of higher oil prices risk not only being counterproductive, but may also lead to stronger price pressures.

In the current situation, where cost/price pressures have been evident for some time and long-term bond prices provide evidence of an escalation in inflationary expectations, an easing in monetary policy would clearly be inappropriate. I agree that the appropriate response would be to direct policy at achieving the same rate of expansion of nominal GNP, as had been envisaged prior to the rise in oil prices. While arguments could be made for accommodating the first round price effects, provided there is no accommodation of any second round effects, I wonder about the practicality of implementing such a policy. It may be better to err on the side of caution, particularly as there is some question as to whether policy should be tightened somewhat in a number of countries.

I would now like to touch very briefly on the short-term prospects for developing countries. Ignoring for the moment the impact of higher oil prices on these countries, I find it difficult to share the staff's optimism regarding short-term growth and inflation prospects. Even though the staff has scaled down its estimates of economic activity for 1990, they may have to be scaled down even further. However, it is mainly the projection of a strong recovery next year, primarily reflecting a projected marked upturn in the Western Hemisphere and Eastern European countries, that seems most questionable. Even if one accepts the staff's possibly optimistic assumption on policy implementation, I question whether the projections adequately take into account the impact of a significant slowing in industrial country growth, coupled with continuing high international interest rates and weak non-oil commodity prices.

Although higher oil prices will have a beneficial effect on a few developing countries, for many it will clearly make a recovery in growth more difficult. I agree with the staff that, equally with industrial countries, the appropriate short-term response is not to attempt to insulate domestic markets, or ease the stance of macroeconomic policies.

Mr. Fogelholm made the following statement:

Let me first say that this chair is in broad agreement with the staff's analysis of the current situation in the world economy. With regard to the short-term global economic prospects, we believe that they are marred by downside risks evident in both industrialized and developing countries.

First, the U.S. economy gives strong indications of weakening, but despite this development, inflationary pressures persist. Moreover, both the large and growing U.S. external debt and the budget deficit are still causes for concern.

Second, the cost of German reunification and the need for resource transfers have apparently been underestimated. Similarly, the costs of general systemic changes in Eastern Europe now appear to be higher than previously assessed. It is to be hoped that this development will not slow or halt the reforms; if so, the risk of political unrest and resistance to change will undoubtedly increase. There are also significant uncertainties associated with economic policy reforms and developments in the U.S.S.R., where the role of central planning has been reduced but where wide-ranging market mechanisms have not yet been introduced.

Third, despite the strong, and so far rather successful, policy tightening implemented to reduce inflation rates in Brazil and Argentina, the average annual inflation rate in Latin America is expected to rise in 1990, before being drastically reduced in 1991. Economic growth is expected to gain momentum due to the stabilization of these economies and as a result of structural changes. However, despite the fact that there are encouraging signs in certain countries where stabilization programs have yielded positive results, this chair feels that the staff's scenario for Latin America is overly optimistic, even though we of course hope that does not turn out to be the case. But considering earlier experiences of unsuccessful economic stabilization programs, caution is needed when assessing the outlook for the Latin American economies.

With regard to the crisis in the Middle East, the increase in the price of oil will obviously have a negative impact on economic growth, on inflation in the world economy, and on the terms of trade of the oil importing countries. However, as the staff points out, the oil price rise is of quite another order than the price increases that occurred in the 1970s. Moreover, today many countries are less dependent on oil, and are more flexible in their energy requirements. In addition, many countries have significant stocks of oil. Therefore, the negative effects of the recent oil price rise will naturally be less traumatic than during the two previous oil shocks in 1973/74 and 1979/80.

The Nordic countries concur with the staff's conclusion that uncertainties regarding the direction of economic policies could cause more harm than the actual and direct repercussions of the oil price increases themselves. Therefore, it is important, not least in order to stabilize developments in financial markets, that the markets be given clear and unambiguous signals that the higher oil prices are not going to result in accommodating policies. It is essential that monetary policies remain tight and that efforts to reduce fiscal imbalances in several countries are not disrupted. This being said, my authorities are concerned about the fact that it is mainly the oil importing developing countries and the countries in Eastern Europe--all of whom are facing huge adjustment needs--that will be the hardest hit by the increases in oil prices.

In the present circumstances, the international financial institutions have an important task, and that is to attempt--in a coordinated fashion--to even out the burden and cushion the effects of the turmoil in the oil markets, particularly for those countries facing a fundamental and far-reaching restructuring of their economies. As stated by Mr. Finaish, these economies should be strengthened, especially with a view to improving resistance to external shocks. Assistance in this process should be provided basically by offering the expertise of these institutions, and by catalyzing financing on reasonable terms.

To conclude my remarks this morning, I will just say that my authorities agree fully with the staff that all attempts to isolate domestic oil markets in order to alleviate the price effects will only create more problems for the future.

Mr. Yamazaki made the following statement:

Today's discussion of the world economic outlook takes place against a backdrop of growing uncertainty surrounding the world economy. When we discussed the effect of "peace dividends" in the Board just three months ago, how many Directors imagined that we would be talking about the possible widening of the U.S. budget deficit as a result of the military conflict in the Middle East?

Looking back further, how many Directors could have imagined at the discussion of the world economic outlook last September such developments as the dramatic changes in the Eastern European economies, the reunification of Germany, and the initiative of the Fund in the research project on the economy of the U.S.S.R.? The comprehensive staff paper before us, including the timely supplements, rightly addresses those problems facing the world economy. Nonetheless, given the extremely uncertain situation, particularly with regard to oil prices, we should bear in mind the limitation of the analyses in interpreting the figures in those reports.

With this in mind, let me start by touching upon the short-term prospects. I am in broad agreement with the staff's overview based on the assumptions made before the crisis in the Middle East. I will therefore concentrate on the issue of the macroeconomic effects and implications of recent oil market developments, which were addressed in Supplement 2 to the staff paper.

As regards the industrial countries, I generally think that an oil price increase of the magnitude assumed by the staff would not seriously undermine the noninflationary sustainable growth. Compared with the previous oil shocks, not only is the magnitude of the price increase smaller, but also the economies of the major industrial countries have become less dependent on oil imports, as evidenced by Table 1 of the Supplement. As a matter of fact, the staff's analysis in Table 2 clearly shows that the direct impact of oil price increases on growth and inflation is relatively small. Nonetheless, there may be a number of caveats to this rather optimistic prospect.

First, oil prices may rise further in the event of a delayed solution to the Middle East problem, particularly toward winter when the demand for oil is seasonally high. There are, however, encouraging factors that indicate that such an outcome can be avoided, namely, the existence of sufficient oil reserves in the industrial countries and the willingness of many oil producing countries to make up for the loss of production caused by Iraq's invasion of Kuwait. On this latter point, we appreciate the cooperative efforts of many OPEC and non-OPEC countries. That being said, we should nevertheless be prepared for the worst case in which military conflict pushes the oil price substantially higher while at the same time reducing the supply of oil. In this connection, I would appreciate the staff's comment on the sensitivity of the analysis to varied oil price assumptions.

Another caveat concerns the possibility that for some industrial countries that are already suffering from economic imbalances, the marginal effect of oil price increases could be the last straw in precipitating a serious economic crisis. In this connection I would attach particular importance to the U.S. economy. While I will reserve my full statement on the U.S. economy for the Article IV discussion on that country next week, I would stress that the adverse effects of an oil price increase on growth, inflation, and external imbalances would further reduce the room for maneuver of macroeconomic policy management, which was already small before the oil crisis.

Furthermore, in addition to the direct impact of an oil price increase, the possible upward pressure on fiscal expenditure owing to the military buildup in the Middle East would undermine the U.S. fiscal position, which was already eroded before the oil crisis.

This brings me to the next most important issue, namely the appropriate macroeconomic policy response of industrial countries to the new environment. Fortunately, we have had the experience of two oil shocks in the past from which we learned several important lessons. An increase in oil prices, or in commodity prices in general, would have both an inflationary and a deflationary effect on importing countries by transferring real income to exporting countries. Since this income transfer effect is inevitable, importing countries should not attempt to offset it through nominal adjustment, namely, through direct price controls and outright relaxation of financial policies. Instead, the appropriate policy response to such external supply shocks is to let market forces absorb the cost of higher oil prices while at the same time avoiding homemade inflation through cautious monetary policy. On the other hand, since higher oil prices would aggravate the external balance of oil importing countries, the role of fiscal policy in fostering national savings should be emphasized. All in all, I fully endorse the staff's observation on pages 13 and 14 of Supplement 2. In these circumstances, policy coordination among major industrial countries needs to be maintained in order to secure the stability of prices and exchange markets.

Let me now say a few words about the current Japanese economy. Despite the recent oil price increases, we do not see any need to change the basic conclusion reached at the Article IV discussion last July that the Japanese economy will maintain sustainable noninflationary growth led by domestic demand. In this connection, I would like to draw your attention to the remarkable changes in the Japanese economy since the first oil shock. As can be seen in Table A on page 5 of Supplement 2, although Japan continues to be dependent on imported oil, the impact of oil price increases as measured by the import of oil as a percentage of nominal GNP has declined dramatically in the past two decades. For example, in 1972-74, the impact on Japan was more than four times greater than the impact on the United States, whereas in 1990-91, it is almost the same as in the other major industrial countries. Furthermore, the state of the current Japanese economy is generally better than that of the other industrial countries.

Accordingly, it would be fair to say that the negative effect of oil price increases on the Japanese economy would be small compared with that on other industrial countries and with previous oil shocks. Nevertheless, since Japan imports most of the oil from the Middle East countries, a further substantial decline in oil production in that area would be detrimental to the economy. In my view, the recent volatility in the Japanese financial markets reflect investors' fears about such an abrupt scenario and the markets will restore stability unless the situation in the Middle East deteriorates further.

Meanwhile, taking into account the recent monetary and economic developments, including the change in the oil situation, the Bank of Japan raised the official discount rate last week. Given the favorable economic situation in Japan, we do not think that this measure will have an adverse impact on the economy. Rather, it will help to sustain domestic demand-led growth by forestalling inflation, thereby contributing to stability in the financial markets.

I would like to make a few brief comments on the staff's short-term outlook for the Japanese economy. First, for 1990, my authorities envisage a somewhat slower growth rate than the 5.3 percent envisaged by the staff, given the official forecast of 4.0 percent for the fiscal year. Second, my authorities expect the current account surplus to decline further in 1991. Third, on inflation, although there is some sign of tightening in factor input markets, it has not exerted inflationary pressure at this stage. On the other hand, while the staff envisages a reduction in the consumer price index as a result of the revision of the general consumption tax, no schedule has been settled regarding such revision.

I will now turn to the short-term prospects for the developing countries. As the staff paper rightly states, the oil price increase will have a much larger impact on the economies of non-oil producing developing countries, including the Eastern European economies. In particular, for those countries that are in the process of transformation from centralized to market-oriented economies, the adverse impact of an oil price increase would undermine the adjustment process. We are very concerned about the possible deterioration in the external balances of these countries. In these circumstances, there is a need to underpin the momentum for economic restructuring of the non-oil developing countries by consolidating the cooperative efforts of the industrial countries, oil producing countries, and international institutions.

Mr. Peretz remarked that he would like to have some time to reflect on the new staff projections as presented by the Economic Counsellor at the current meeting. He assumed that the quite dramatic change in the projected U.K. growth for 1990 and 1991 largely reflected information about what had actually already happened rather than any new thinking about the future. Indeed, all the recent evidence he had seen about the United Kingdom confirmed that inflationary pressures were beginning to come under control as the economy slowed, partly as a result of the rise in the exchange rate in recent months. For example, the growth in the target monetary aggregate M_0 had fallen to within its target range in August for the first time in a long time.

Turning to the world economic outlook, Mr. Peretz remarked that there were two main issues: first, the likely effects of the increase in oil prices, if it was sustained, coming on top of inflationary pressures that were already strong; and second, the greater demands that were likely to be made on world savings as a result of investment in the united Germany and elsewhere, in Eastern Europe in particular.

Taking the oil price situation first, Mr. Peretz welcomed the emphasis in the staff paper on the contrast between the current rise in oil prices, if it turned out to be sustained, and the rises in the 1970s. But given the uncertainty in the current situation, it would be wise to consider what the implications would be were oil prices to remain at a high level or even rise further. Even at its current level, however, the real oil price was only half that of 1980, and the percentage increase had been much less than in earlier episodes. Furthermore, the capacity of the industrial economies to absorb increases in the oil price was also much greater than it had been. That emerged clearly from Table 1 of Supplement 2, which also demonstrated the continued overdependence of the North American economies on oil. The case for encouraging greater energy efficiency, in particular through taxation in the United States, remained as strong as ever, if not stronger.

It was also important, Mr. Peretz stressed, that oil prices be passed through to domestic markets in all countries. Where domestic prices had been held artificially low, the opportunity should be taken to raise them to world levels so that the price mechanism could do its work. Attempts to insulate domestic prices from developments in world markets could only result in distortions, inefficiency in use of energy, and substantial fiscal costs to the countries concerned.

While the increase in oil prices so far had been much smaller than those in 1973 and 1979, and the circumstances in which it was taking place were very different, Mr. Peretz said, there were nevertheless important lessons to be learned from different countries' responses to previous oil price rises--for the conduct of policy in industrial countries, for the conduct of policy in oil importing developing countries, and for the conduct of policy in oil exporting countries.

Insofar as the industrial countries were concerned, the lesson was that policy should be nonaccommodating, with the first priority being to bear down on inflation with a view to achieving price stability, Mr. Peretz continued. Attempts to boost demand would not succeed and, except possibly in the very short run, would simply lead to faster inflation, not higher output. The outlook for both output and inflation had, however, altered materially. Even before the oil price increase, inflation had already been too high, with growth in a number of industrial countries set to continue at rates similar to that of productive capacity. He agreed that the balance of risk remained that more rather than less action would need to be taken to contain and reduce inflationary pressures. He certainly concurred with the staff that any easing of policy at the current stage would run the risk of embedding inflationary pressures and expectations. But should a tightening of policy, fiscal or monetary, be needed in any industrial countries to control inflation, those countries should not flinch from that.

A lesson of history for oil importing developing countries was equally clear, Mr. Peretz went on. Higher oil prices would tend to aggravate existing balance of payments problems. But that made adjustment in the sense of adopting sound macroeconomic policies and structural reforms an even higher priority. Even where countries were creditworthy, they would do well to resist the temptation to increase borrowing.

As for oil exporters, the lesson from the past was that they should be very cautious about committing or borrowing against higher oil revenues, particularly so given the very great uncertainty about the future course of oil prices, Mr. Peretz stated.

It went along with those remarks, Mr. Peretz commented, as well as with the great uncertainties in the current situation, that he would advocate great care in considering calls for generalized debt-creating support from the Fund or from other international financial institutions for countries that were adversely affected by the economic consequences of events in the Middle East.

The final lesson of history for all countries was that the right way to sustain growth was not by accommodating macroeconomic policy, but through structural reform, Mr. Peretz said. Domestically, that meant greater and quicker efforts to increase efficiency through structural improvements. Internationally, it meant that efforts to liberalize trade should be intensified. The rise in oil prices reinforced the importance of a successful resolution of the Uruguay Round.

Provided that appropriate measures were taken in the three main groups of countries along the lines he had suggested, Mr. Peretz said, the adjustment to higher oil prices would be eased and world savings should not fall. Indeed, aggregate savings might even rise somewhat. That was particularly significant as the rise in oil prices was occurring at a time when claims on world savings were likely to remain extremely high. Investment in most industrial countries was projected to be somewhat below the truly exceptional rates of recent years, but still high by historical standards, and particularly so in Europe, where it was likely to be underpinned by the prospects for the single market. Set alongside that would be the reconstruction taking place in eastern Germany and in Eastern Europe, generally, as well as in the U.S.S.R. In addition, there was the continuing need for financing the developing countries.

All that pointed to the need to continue to provide savings in the industrial economies, Mr. Peretz continued. A continuation of tight monetary policies with substantially positive real interest rates clearly helped in that respect. Other national measures to promote private sector savings, if only by removing antisaving tax distortions, were also welcome. But he agreed with the staff that there was currently a greater need than ever for public sector savings through fiscal consolidation. That was a particularly high priority in those countries that were running substantial deficits on both their fiscal and external accounts.

Above all, the need for fiscal adjustment remained particularly pressing in the United States, Mr. Peretz noted. A tightening of fiscal policy achieved through adjustments on both revenue and expenditure sides in the United States would make an important contribution to world saving. It would also be an absolutely essential requirement before any easing of monetary policy should also be contemplated in the United States. Indeed, if there was inadequate progress on the budget, an increase in U.S. interest rates might need to be considered, given the extent of inflationary pressures. The weakness of the dollar was a further sign of possible policy looseness in the United States. The dollar effective rate was as low as it had ever been, though not in fact very different from the level it had reached at the end of 1987. While it was not yet a matter for major international concern or major policy concern in the United States, and certainly not something that indicated the need for a rise in U.S. interest rates, it was a strong argument against a further reduction in interest rates.

Mr. de Groote questioned the legitimacy of passing fully on to the consumer any changes in the oil price. When the price of oil eventually fell, it seemed reasonable to recommend to some countries--especially to the United States, but also to some other countries--to recapture part of the decline by taxation, for instance, of oil imports, which would have the advantage of promoting local production and savings in the consumption of energy. That did not go radically against the rules of the market.

Mr. Peretz indicated that he had been advocating a full pass-through of any increase in oil prices, but would certainly agree with Mr. de Groote's suggestion in the event of a fall in oil prices.

Mr. Al-Jasser said that he opposed any use of the Middle East crisis as an excuse to dismiss the liberalization of trade and to reintroduce biases against certain commodities by imposing good-specific taxes.

Mr. Ismael made the following statement:

The crisis in the Middle East has undoubtedly clouded the outlook of the world economy, and its full impact is very difficult to gauge at this stage. On the assumption that oil prices remain about $25 per barrel, the impact of higher oil prices on the major economies is likely to be significant but less than at the times of previous jumps in the oil price, because of the energy conservation measures implemented in the past ten years. A global recession is therefore not a probable development.

In terms of currency movements, higher oil prices are significant to the extent that the major economies are affected in different ways. In many respects, the macroeconomic impact on them is likely to be broadly similar, particularly in comparison with the two previous oil price shocks. From this perspective, the likelihood of sharp currency movements occurring is only limited.

Having said this, let me now deal specifically with the policy responses in the three major industrial countries and their impact on the developing countries. The inflationary impetus associated with recent oil market developments has come at a particularly unfavorable time for Japan. Economic growth has remained strong and the incipient inflationary pressures associated with a tight labor market and capacity constraints were becoming increasingly evident. On the other hand, the very substantial weakness in the Japanese stock market and the yen remaining at its higher level are factors suggesting that further increase in market interest rates is not necessary. In the end, higher oil prices acted as the catalyst for higher interest rates, with the decision last week to increase the official discount rate by 0.75 percent to 6 percent, the fifth increase since May 1989, and the first change in monetary stance among the major economies since the Middle East crisis. The associated rise in short-term market interest rates to above 8 percent (and to approximate parity with short-term U.S. rates) was one factor causing a significant appreciation in the yen recently.

The cyclical position of the German economy is fairly similar to that of Japan. There are a number of reasons why higher interest rates might not be deemed necessary: money supply growth has been well behaved; the inflation performance in the first half of the year was surprisingly good; the deutsche mark's strength against the U.S. dollar could offset all of the inflationary impact of higher oil prices; and East German industry would be hit even harder were monetary policy to be tightened. On the other hand, the money supply position is less favorable if the growth in German companies' offshore deposits is included in the calculation; the good inflation performance up to July was partly the result of the weakness in oil prices; labor market developments have been less favorable; currency strength could prove to be more short-lived than higher oil prices; and East German industry is now in such a difficult position that a slightly higher level of interest rates is likely to have only a very marginal adverse impact on it.

The possibility of German official interest rates falling is therefore negligible, and a rise is a distinct possibility. However, the implementation of this increase might be delayed until the end of the year after the December elections are over, unless the recent rise in the deutsche mark appears likely to be reversed.

The policy response in the United States is likely to be different. Concern over the extent of the slowdown in economic growth has increased significantly in recent months, and the sharp decline in employment and rise in the unemployment rate in July have exacerbated these concerns. With the Federal Reserve under significant pressure to resist recessionary forces, U.S. interest rates are most unlikely to rise, despite the more adverse inflation outlook. Although a full recession will not likely emerge in the coming months, nevertheless, the rate of growth is likely to be sufficiently slow to induce the Federal Reserve to reduce interest rates in the coming months. This development is likely to push the U.S. currency down in the short term.

I do not wish to go into further detail on policy measures at this stage, except to say that too early a relaxation of monetary policy could undermine its role and credibility in achieving price stability over the medium term. Appropriate and well-coordinated policy responses are clearly called for, and the Fund can and should play an important role in this matter.

In any event, the countries that are likely to suffer most from any increase in oil prices are the heavily indebted oil importing developing countries, especially those that are also heavily dependent on workers' remittances from the Middle East and/or those who are badly affected by the trade embargo through significant loss of export outlets. These countries certainly need special assistance from the international community, and I welcome the Japanese initiative in this area. Moreover, commodity prices and exports of developing countries could suffer from slower demand in industrial countries. As for the indebted oil exporting countries, it is very important that they use the additional revenues to strengthen their adjustment efforts and reduce their external debt.

The crisis in the Middle East--with all of its consequences and ramifications--is, of course, only part of the global problem and issues that need to be addressed. We are now also observing a number of history-making events unfolding: the process toward an integration of EC economies, economic reforms in Eastern Europe and the Union of Soviet Socialist Republics, and the unification of Germany. I welcome the staff analyses on these matters, but it seems to me that more attention could be given to potential benefits and costs of all these developments on non-European developing countries. Already, for example, there has been a rise in global investment relative to world savings, thereby pressing interest rates upward. I would like to stress, in this regard, that with all of the excitement in response to changes taking place in Europe, one should continue to keep in mind the plight of millions of people in many developing countries who are still striving to live at subsistence levels. I will come back to this issue in my afternoon intervention.

Mr. Feldman made the following statement:

The current situation and short-term prospects of the world economy are not encouraging, even before considering the impact of the oil crisis. We would like to underscore two major concerns: one relates to the increasing difficulties that the present situation would impose to narrow down the existing imbalances in industrial countries, particularly to deal with the U.S. federal fiscal deficit; the second relates to the impact on the developing world of a new adverse external shock. In addition, it seems now that the contrast between rapid growth rates observed in Asian developing countries and the tendency for output to decline, or in the best of cases to stagnate, in the developing countries of Europe and the Western Hemisphere is becoming a perpetual, gloomy feature of the world economic outlook.

We are still not approaching a global recession and, hopefully, with the help of sound policies in industrial countries and policy coordination, this recession will be altogether avoided. However, the years of high growth seem to be over and we shall witness a significant deceleration in GNP growth in industrial countries: from 3 3/4 percent for 1987/89 to 2 1/4 percent in 1990/91, even before taking into account the still uncertain effects of the oil shock. When this shock is taken into account, the result is a deeper deceleration of economic activity, higher prices, and higher interest rates.

Chart 21 on page 42a of the staff paper clearly illustrates the absence of a lasting trade-off between inflation and growth. It also shows that the present expansionary cycle is taking place under very high real interest rates and that it will be accentuated by the present oil shock, with an obvious adverse impact on highly indebted countries. It is in this adverse and worsened framework that many developing countries will have to either consolidate or start over once again and persevere in their adjustment efforts in order to achieve macroeconomic stability and external viability. Their prospects for growth will be grim. Given the present short-term prospects, demand for these countries' exports and higher interest rates will probably result, which will in turn overburden their debt problems.

It is therefore of the utmost importance and priority to strengthen the debt strategy and to speed up the completion of the Uruguay Round in order to encourage more competitive trade between developing and industrial countries. The strengthening of the debt strategy will require increased coordination between debtors and creditors, a workable solution to overcome banks' reluctance to participate in debt-reduction schemes, and a stronger role for the Fund. Mr. de Groote has stressed the need to rethink that role in order to deal with periodic emergence of exceptional liquidity requirements.

The staff paper contends that less developed countries will need to stick to fiscal adjustment and macroeconomic stabilization and that the most promising, if not the only, avenue to growth must be sought in the implementation of outward-looking policies. I agree with the staff arguments, but this strategy could face a severe setback in the near future unless more impetus is given to the process of trade liberalization. Trade liberalization will be crucial in forthcoming years to offset the negative impact on the less developed countries of slower growth and higher interest rates in the industrial world. The staff paper clearly underscores the reasons to conclude the Uruguay Round; this is the only way to give a fair chance to those developing countries that are adopting export-oriented policies, given the gloomy current situation, which is now aggravated by the crisis in the Middle East. The other way to countervail high interest rates is to put more emphasis in fiscal consolidation in the industrial countries, particularly in the United States.

My second point relates to exchange rate policy in European countries and, in a certain important way, it also relates to my preceding point on the need to speed up the dismantling of protectionist policies. Exchange rate realignment is mentioned at least twice in the staff paper, once in the context of the implications of German unification, and once in connection with the transitional issues related to the European integration. Although these issues might belong to the analysis of medium-term prospects, the possible one-shot realignment vis-à-vis the deutsche mark by some exchange rate mechanism (ERM) countries as a substitute for a further tightening of monetary conditions and to avoid the deflationary effects that might result from unification could take place before 1992.

The second implicit reference to exchange rate realignment is reflected in the proposal to start the european monetary union (EMU) with a core group of countries with a good record of monetary and price stability, and have other countries joining at a later stage.

The staff's positions against the one-shot realignment and the two-stage EMU approach are clearly expressed in the paper. The staff is basically concerned about a possible loss of credibility in the commitment to price stability and to the hard currency option of those countries, which in turn could magnify the inflationary impact and lead to destabilizing speculation against the currencies that were depreciated. I understand the staff's position in this regard but am concerned about the costs of a premature untimely adoption of the hard currency option. I expressed my views in this connection when the possibilities were raised of one-shot realignments of the peseta and the pound sterling on the occasion of the Article IV consultations with Spain and the United Kingdom. I continue to see high costs resulting from the large accumulation of imbalances and from the loss of efficiency in both resource allocation and external competitiveness. This, of course, relates to my first point, on the need to speed up the completion of the Uruguay Round, as any delay in correcting present exchange rate misalignments will increase the reluctance of countries with appreciated currencies to give the necessary impetus to trade liberalization.

Mr. Dawson made the following statement:

Had our world economic outlook discussion taken place in late July rather than early September, the Executive Board might have concluded that the economic situation and short-term prospects were broadly satisfactory. Conditions in the Middle East and the resulting imposition of UN sanctions clearly have clouded the outlook and increased the risks for the world economy. However, the disruption to the international trade and financial system should be manageable and the dislocation to the world economy minimized with the continued cooperation of the international community.

We agree with the staff that the initial reaction of financial markets reflects the considerable uncertainties that still exist. Fears of renewed inflationary pressures undoubtedly have played a role in the increase in interest rates, particularly in bond markets, and in movements in exchange rates. However, other factors, which may be at least as significant, are also at work, many predating recent developments. Thus, the increased slope of the yield curve which has emerged is a natural reaction by investors to move toward more liquid assets at a time of political uncertainty and concerns about the security situation, independent of any inflation fears. Moreover, recent movements need to be seen in the context of trends emerging prior to the crisis, including higher German interest rates as markets respond to the mounting cost of unification and the prospect of much larger German borrowing requirements. Finally, the recent increase in the Japanese discount rate can be seen as a continuing catch-up of yen rates, which have lagged behind earlier interest rate rises in Europe, although there may also be some elements of a pre-emptive effort to minimize possible oil price induced inflation. It would be unfortunate, however, if this action were to trigger a further increase in interest rates in circumstances where it is not altogether clear that increased inflation pressures are emerging but global growth is slowing.

The depreciation of the dollar since the beginning of August also needs to be viewed in the context of trends that began in mid-1989. The shift in interest differentials against dollar assets and the slowing of U.S. economic activity relative to other industrial countries has resulted in a marked dollar depreciation, which offset the earlier dollar rise as U.S. monetary policy tightened in 1988-89. Such an orderly adjustment of exchange rates should contribute to a further reduction of external imbalances, while helping to reduce latent price pressures in surplus countries that may face greater capacity constraints than in the U.S. case.

There is a natural tendency to draw parallels between the current situation and the oil shocks of the 1970s. The experience of the 1973 and 1979 oil price increases provide important lessons--in particular, the need to avoid using controls to prevent price rises and to adjust promptly to large, sustained changes in the terms of trade. However, crucial differences exist between then and now, which also need to be taken into account in assessing the impact of the current supply disruption and in developing appropriate policy responses.

There is relatively little variation in the results between countries in the group owing to the size of the increase and the reduced role of oil in national output that has resulted from conservation efforts since the 1970s. The conventional response to such a price shock would be to tighten monetary policy and to ease fiscal policy. In practice, and given current economic conditions, such an approach may not be feasible or desirable.

The staff's proposed monetary policy response--to maintain the rate of expansion of nominal income that was targeted prior to the oil price increase--would in effect represent a slight tightening in order to facilitate some reduction in output and thus prevent the oil price increase from spilling over into wages and permanently higher inflation. Such an approach would be consistent with the lessons of the 1970s, and the staff's view that there is a general shortage of capacity and growing inflation pressures in industrial countries as a group. However, such a general approach could require greater restraint in monetary policy than current conditions may warrant, especially if the increase in oil prices is more temporary and economic conditions are such as to make it unlikely that the oil price effects would trigger higher general inflation.

Several factors suggest that the supply disruption will in fact be temporary and that a modest price rise is unlikely to spill over to higher wage settlements and a more general increase in inflationary pressures. First, the very constructive and welcomed decision by OPEC to suspend production quotas and raise output will largely offset the supply lost from Kuwait and Iraq. Moreover, there is scope for additional production from non-OPEC sources, and substantial stocks are available in private and official reserves if unforeseen shortages do emerge. In these circumstances, the supply dislocation and the price increase could be more modest and temporary than the staff assumes in its simulations.

Second, recent data confirm that economic activity was already slowing significantly prior to the crisis and that the outlook for growth is much weaker than earlier projections indicate. With demand pressures weakening considerably and unemployment likely to rise, the danger that higher oil prices would trigger increased wage and price pressures on an economy-wide basis are greatly diminished.

In these circumstances, a more differentiated approach which takes account of economic conditions in individual countries might be more appropriate. Thus, in the United States, where demand pressures and growth have weakened considerably, an easing of monetary policy would still be appropriate, particularly in connection with a reduction of the fiscal deficit. In Germany, a further increase in interest rates may not be necessary since rates were already rising as a result of the growing cost of unification, and inflation remains moderate, particularly if the cost of unification were spread more evenly through additional fiscal measures, in particular, subsidy reduction, and some exchange rate adjustment. A similar argument could be made for Japan, which has already increased interest rates despite the absence of serious inflationary pressures.

With regard to U.S. fiscal policy in particular, we would certainly agree with the staff that recent events do not alter the need for the United States to implement a credible plan to lower its budget deficit. Slower growth in the economy and the increased defense costs associated with implementation of UN sanctions will make the task more difficult. However, as President Bush indicated last week, the Administration is committed to reaching agreement with the Congress on a credible budget package that will result in significant deficit reduction and improvements in the budget process. At the same time, however, the ability of the Administration to mobilize support for budget deficit reduction will depend importantly on the willingness of other countries to undertake their fair share of the cost associated with the situation in the Middle East. We will have more to say on this matter during the U.S. Article IV consultation next week.

With regard to the impact of recent events on developing countries, it is clear from the staff paper that even a modest oil price increase and temporary supply dislocation will have serious consequences, especially for those countries already faced with substantial adjustment requirements and severe financial constraints. In contrast with the 1970s, private markets are unlikely to play as large a role in meeting increased financing needs, and official sources, including the Fund and other international financial institutions, will need to be in a position to provide an appropriate response. A number of countries whose transactions with Kuwait and Iraq were especially large, are bearing a significant part of the burden of sanctions and higher oil prices and extraordinary efforts are likely to be required to assist them.

The United States is consulting with a wide range of countries to coordinate efforts to deal with the economic and financial consequences of the crisis in the Middle East. The Fund, as the central monetary institution for the world economy, will have a critical role to play in such an international effort. In this connection, we believe that the Executive Board should give urgent consideration to appropriate modifications in the Fund's lending policies to help deal with current conditions.

Mr. Landau asked whether the fact that the steepening of the yield curve varied between countries indicated that the steepening was due in some cases to changes in inflationary expectations and in others to shifts in liquidity preferences.

Mr. Obame made the following statement:

The year 1989 has been a year of historical changes: we have seen in Eastern Europe a shift from centrally planned to market-oriented economies. In Western Europe, we have witnessed the prospects of reunification of the two postwar German economies, the acceleration of the edification of the single European market and throughout the world, the process of economic liberalization and economic reforms was taking hold. However, for 1990, the most unexpected current tensions in the Middle East, which have led to a sharp increase in oil prices, have created uncertainties in the world economic environment. Without contradicting the well-known economic cycles, these events are illustrative of the fact that economic forecasts will never be as precise as one can expect them to be, and that human behavior will always challenge the outcome of our best sophisticated econometric models.

With this thought in mind, I will turn briefly to the topics for discussion as suggested by the staff. First, on the risks to the short-term projections, I note that the staff projects global economic growth to moderate to about 2 percent in 1990 from 3 percent in 1989, before rebounding somewhat again in 1991. The question one can raise is how realistic these projections are. But, this is not the issue: there will always be risks of errors or misjudgment when making economic forecasts. Rather, the real issues to be discussed are on what set of assumptions are the projections based and how realistic are those assumptions. In the present case, the assumption is made that real domestic demand in the developed countries will fall, mainly as a result of the substantial decline in 1990 of business investment in three major industrial countries (Canada, the United States, and the United Kingdom). Given the impact of these countries on the world economy, we can therefore go along with the staff's projections for a moderate global economic growth in 1990.

This moderation of global economic growth is expected to be more pronounced as a result of the recent surge in oil prices. Indeed, under the staff's assumption that oil prices would stabilize this year at about $25 or $26 per barrel before going down to $21 per barrel in 1991 as can be seen in the latest staff projections, the level of real GNP in the industrial countries would fall by an appreciable margin below the baseline, particularly in 1991. However, it is reassuring to learn from the staff that the effects of the oil shock on the industrial economies will not be devastating because industrial countries have adjusted to previous increases in the relative price of oil. In this connection, I agree with and support the staff observation that "the authorities in the developed countries should provide clear signals to the public that economic policies will not be derailed by the ongoing events and that the mistakes made in similar circumstances in the past will not be repeated."

With regard to the developing countries, I note that the staff is forecasting for 1990 a slowdown in economic activity as a result of several factors, including slower growth of export markets, declining prices for nonfuel primary commodities, and higher interest rates in international markets. I also note that for 1991, the staff has projected a substantial increase in output growth in the order of 4 1/4 percent on the assumption that sustained stabilization efforts would contribute to this outcome.

I wonder whether this latter projection is not subject to considerable risk. As stated earlier, the realism of forecasts depends on the associated assumptions. I have serious difficulties in accepting the staff's projection, since the sustainability of stabilization efforts would contribute to a rebound of economic activity in developing countries. The staff seems to have placed too much emphasis on adjustment efforts alone, and underestimated the impact of some other key parameters that could improve the prospects of developing countries. Thus, if access to export markets do not improve, if the decline in prices for nonfuel primary commodities is not reversed, and if a significant alleviation of developing countries' debt burden is not achieved, one cannot be so optimistic about the economic recovery in most of these countries.

For the same reasons, I cannot agree with the staff's projection of a recovery of GDP growth in Africa in 1991 for the same reasons mentioned above. Even if I wanted to be optimistic, Chart 12 on page 22a indicates that real GDP per capita in Africa as a whole has been stagnant over the past two decades. Therefore, more coordinated actions are needed for these projections to materialize. In this context, alleviation of debt burdens, higher investments, positive capital inflows at concessional terms to strengthen adjustment efforts, and improved prices for raw materials are some of the factors that could improve prospects for African countries. This also underscores the need for the African countries themselves and the international financial community to combine their efforts to improve growth and reduce poverty during this decade in that region. I can endorse the proposals made by previous Directors for new initiatives by the Fund--including the revival of the oil facility--to help the developing countries that will be affected by the consequences of this oil crisis if it lasts any longer.

On the projections of growth for Eastern Europe and the U.S.S.R., I note that the staff is projecting a decline in economic activity in 1990 in most of these countries, and particularly in those implementing the most far-reaching reforms. Since the establishment of indirect macroeconomic instruments is still at an early stage, I feel that more time is necessary to assess economic developments in these countries and make reliable forecasts. Here, I share the views expressed by Mrs. Filardo that we should be more cautious in our projections.

Second, on inflation and monetary policy, I continue to believe that we must strike an appropriate balance between controlling inflation through monetary restraint and ensuring a sustainable level of economic growth. Moreover, in light of the adverse consequences of a policy of continued monetary restraint alone--in particular, its impact on interest rate volatility in international markets, I advocate that monetary policy be coupled with fiscal adjustment in those countries where budget deficits remain high. The present situation in the Middle East should not constitute an excuse for postponing the implementation of a credible plan to lower fiscal deficits in industrial countries. An easing of monetary policy in response to the rise in oil prices would be inappropriate as it could amplify price pressures. A combination of monetary restraint and fiscal measures would have the merit of lowering inflationary expectations and thereby, contributing to lowering long-term interest rates. Here, the advisory role of the Fund would need to be more active, in particular with regard to those countries whose economies have greater impact on the global economy.

Mr. Ghasimi made the following statement:

The analysis of current economic developments indicates that 1990 is likely to mark the second consecutive year of slow growth for the global economy. While the growth of world output was originally projected to recover in 1991, the outlook in both industrial and developing countries is subject to considerable risks, associated with uncertainties on future economic and political developments in Eastern Europe, and recent developments in world oil markets.

For the industrial countries as a group, growth is expected to slow further in both 1990 and 1991. Needless to say, in light of recent developments in the oil market and in view of the climate of uncertainty, any projections are highly tentative. In the present circumstances, I remain cautiously optimistic about the economic prospects for the industrial countries in the short term. Since growth performance is likely to differ significantly across industrial countries, the chance of a sharp and generalized slowdown or a major recession in the industrial countries is most likely slim.

Over the past year, non-oil commodity prices have declined sharply and it is anticipated that a further decline will be witnessed during the current year. Non-oil commodity prices relative to the export price of manufactured goods have dropped by 40 percent over the last decade. This unfavorable external condition, together with slower growth of exports and continuing high real interest rates and external financing constraints, have largely damaged the growth performance of the developing countries. In these circumstances, it is rather optimistic to expect that output growth would rebound to 4 1/4 percent in developing countries in 1991, especially if one takes into consideration the adverse impact of the recent surge in oil prices on the oil importing developing countries.

Inflation for the developing countries as a group is expected to remain very high in 1990, but it is projected to decline significantly to 15.5 percent in 1991 if the stabilization efforts that are being implemented in a number of countries that have experienced high inflation prove to be successful. This outlook appears somewhat optimistic in view of the unfavorable external environment, in particular, continued high international interest rates in the face of the recent surge in world oil prices. In addition, given the high rate of capacity utilization in the industrial countries, the emerging need for imports in Eastern Europe could increase import prices and thus aggravate inflationary pressures in the developing countries.

If the current development in oil markets leads to a sustainable increase in oil prices, the results would clearly be higher inflation and less economic growth for industrial countries. It is rather disappointing to note that this is happening at a time when long-term interest rates have already been rising in response to the financial needs of the reconstruction of Eastern Europe and stabilization efforts in many developing countries. The rise in interest rates also reflects inflationary expectations. Although there is little chance of recession, the risk of acceleration of inflation is higher. In such a circumstance, easing monetary policy could give rise to stronger inflationary pressures that would have to be controlled. Nonetheless, fiscal consolidation should continue to prevent overreliance on monetary policy in coping with the possible negative impact of reduced economic activity and the higher interest rates resulting from higher oil prices.

The Executive Directors agreed to continue their discussion of the world economic outlook in the afternoon.

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/90/133 (8/31/90) and EBM/90/134 (9/5/90).

4. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors and by Advisors to Executive Directors as set forth in EBAP/90/233 (8/31/90) is approved.

APPROVED: August 13, 1991

JOSEPH W. LANG, JR.
Acting Secretary

Table 1. Revised Projections for the Industrial Countries

(In percent, unless otherwise noted)

	Real GNP/GDP Growth		Consumer Price Inflation		Current Account Balance 1/		Current Account Balance 2/	
	1990	1991	1990	1991	1990	1991	1990	1991
Industrial countries	2.7	2.4	4.8	4.3	-95.0	-100.3	-0.6	-0.6
United States	1.3	1.7	5.1	4.5	-97.0	-99.7	-1.8	-1.7
Japan	5.1	3.7	2.8	2.3	47.5	55.8	1.7	1.8
Germany	3.9	3.3	2.8	3.7	48.9	38.4	3.3	2.3
France	3.1	3.0	3.2	3.0	-4.6	-4.9	-0.4	-0.4
United Kingdom	1.4	1.3	9.3	6.6	-26.6	-21.6	-2.8	-2.0
Italy	2.7	2.7	6.4	5.6	-11.3	-11.7	-1.1	-1.0
Canada	1.1	1.1	4.9	6.1	-15.7	-16.9	-2.7	-2.7
Seven major countries	2.7	2.4	4.6	4.1	-58.8	-60.6	-0.4	-0.4
Other industrial countries	2.5	2.3	6.3	5.4	-36.2	-39.7	-1.6	-1.6

1/ In billions of U.S. dollars.
2/ As percentage of GNP.

Table 2. Revised Projections for the Industrial Countries:
Differences from Board Paper

(In percent, unless otherwise noted)

	Real GNP/GDP Growth		Consumer Price Inflation		Current Account Balance 1/		Current Account Balance 2/	
	1990	1991	1990	1991	1990	1991	1990	1991
Industrial countries	-0.1	-0.4	0.3	0.4	-8.5	-9.8	--	-0.1
United States	--	-0.3	0.3	0.2	-1.8	7.1	-0.1	0.1
Japan	-0.2	-0.6	0.2	0.7	-2.3	-9.4	-0.1	-0.4
Germany	-0.1	-0.2	--	0.3	-2.7	-3.0	-0.2	-0.3
France	-0.2	-0.1	0.2	0.3	-0.7	-1.2	-0.1	-0.1
United Kingdom	0.4	-0.8	0.2	0.4	0.2	0.8	0.2	0.4
Italy	-0.1	-0.1	0.6	0.6	-2.3	-3.2	-0.2	-0.3
Canada	-0.7	-0.8	0.1	0.9	1.3	0.6	0.2	0.1
Seven major countries	-0.1	-0.4	0.3	0.4	-8.2	-8.3	--	--
Other industrial countries	-0.2	-0.2	0.4	0.4	-0.3	-1.5	-0.1	-0.1

1/ In billions of U.S. dollars.
2/ As percentage of GNP.