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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 89/119

10:00 a.m., September 8, 1989

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

Executive Directors	Alternate Executive Directors
F. Cassell	C. Enoch
	Zhang Z.
	C. S. Warner
J. de Groote	
	L. B. Monyake
E. A. Evans	
	R. J. Lombardo
L. Filardo	
R. Filosa	
M. Finaish	
M. Fogelholm	
M. R. Ghasimi	O. Kabbaj
G. Grosche	
	S. P. Shrestha, Temporary
B. Jalan	L. E. N. Fernando
A. Kafka	
M. Massé	
Mawakani Samba	C. V. Santos
Y. A. Nimatallah	I. A. Al-Assaf
	D. Marcel
	G. P. J. Hogeweg
K. Yamazaki	S. Yoshikuni

C. Brachet, Acting Secretary
J. W. Lang, Jr., Acting Secretary
M. J. Miller, Assistant
S. W. Tenney, Assistant

Also Present

African Department: A. T. B. Taylor. Asian Department: D. A. Citrin, J. R. Marquez-Ruarte. European Department: P. B. de Fontenay, Deputy Director; M. Guitián, Deputy Director. Exchange and Trade Relations Department: J. T. Boorman, Deputy Director; T. Leddy, Deputy Director; J. P. Pujol, M. Shadman-Valavi. External Relations Department: P. E. Gleason, A. Mountford. Fiscal Affairs Department: M. S. Lutz. Legal Department: R. H. Munzberg, Deputy General Counsel; H. Elizalde. Research Department: J. A. Frenkel, Economic Counsellor and Director; M. Goldstein, Deputy Director; B. B. Aghevli, G. Calvo, N. R. Chrimes, D. T. Coe, S. J. A. Gorne, J. H. Green, G. Hacche, Y. Harada, E. Hernández-Catá, N. M. Kaibni, F. Larsen, P. R. Masson, M. Schulze-Ghattas, M. A. Wattleworth, I. Zaidi. Treasurer's Department: G. Laske, Treasurer; D. Williams, Deputy Treasurer; D. S. Batten, S. I. Fawzi, O. Roncesvalles, A. J. Tweedie, G. Wittich. Western Hemisphere Department: S. T. Beza, Counsellor and Director; F. C. Adams, Y. Horiguchi. Bureau of Statistics: J. B. McLenaghan, Director; V. Galbis. Personal Assistant to the Managing Director: H. G. O. Simpson. Advisors to Executive Directors: N. Adachi, M. Al-Jasser, J. Basiuk, M. B. Chatah, M. Eran, G. García, P. Gorjestani, A. Gronn, J. M. Jones, P. O. Montórfano, J.-C. Obame, D. Powell, P. Péterfalvy, A. Raza. Assistants to Executive Directors: J. R. N. Almeida, S. Appetiti, H. Brohs, J.-F. Cirelli, J. Gold, S. Gurumurthi, M. Hepp, J. Heywood, L. Hubloue, K. Ichikawa, M. E. F. Jones, P. Kapetanovic, K.-H. Kleine, C. Y. Legg, J. A. K. Munthali, W. K. Parmena, A. Rieffel, J.-P. Schoder, M. J. Shaffrey, Shao Z., C. C. A. van den Berg, Yang J.

1. WORLD ECONOMIC OUTLOOK

The Executive Directors continued from the previous meeting (EBM/89/118, 9/6/89) their consideration of a staff paper on prospects and policy issues with respect to the world economic outlook (EBS/89/163, 8/16/89; and Cor. 1, 9/1/89), along with a statistical appendix (SM/89/179, 8/17/89; and Cor. 1, 9/5/89). They also had before them a background paper on the role of national saving in the world economy (SM/89/172, 8/11/89; and Sup. 1, 8/14/89).

The Economic Counsellor observed that the discussion had covered the fundamental nature and determinants of the economic adjustment process, the nature of policymaking and of policy instruments (including the question of how to increase the number of policy instruments), the role of government in the economy, and the role of policy coordination.

Government absorption of resources in an economy could be financed through three mechanisms, the Economic Counsellor continued. First, the government could borrow domestically--thereby shifting the burden onto the next generation--second, it could borrow from abroad; and third, the total size of the available pool of resources from which the government had to draw in the country could be increased. Of course, the last approach would be preferable.

If the rise in government current expenditure was not offset by a corresponding decline in private sector spending, then current interest rates would be driven up, the Economic Counsellor explained. Investment would be curtailed, and the next generation would have a smaller capital stock than it would have had otherwise; that was "intertemporal confiscation." It showed the dangers of overburdening monetary policy, and had probably been at the heart of Mr. de Groote's anxiety that governments ensure the continuity of investment and investment projects, so that government borrowing would not crowd out private investment.

Intratemporal confiscation--namely, confiscation in the same time frame--also caused real interest rates to be driven up, and the country's real exchange rate to appreciate, with the result that expanding government expenditure could be financed from abroad at rates that would ensure the needed flow of resources, the Economic Counsellor went on. Concerns about that process probably lay behind the recommendation of some speakers that the Fund pay more attention to real exchange rates, as opposed to nominal rates, as the real exchange rate was the basic mechanism governing economic behavior.

The government could effectively expand the pool of resources by increasing its spending on infrastructure and on those types of investments which increased economic efficiency or stimulated economic activity, the Economic Counsellor noted. That approach was preferable, in his view.

Real variables, like real exchange rates, determined economic behavior, the Economic Counsellor continued. Although in practice policies were determined largely by, and largely affected, nominal exchange rates, not every change in nominal exchange rates would have an impact on the real exchange rate, and thus, on economic behavior. That pointed to the general fallacy of attempting to influence real economic variables through nominal instruments. Real exchange rates could only be influenced through real instruments, which lay behind the staff's emphasis on fiscal and structural policies. In that connection, Mr. de Groote had made the point about maintaining government at a size that would be sufficient to enable it to act as a countercyclical instrument. Without government revenue or government spending, there would be no fiscal policy.

Fiscal policy was a rigid instrument, the Economic Counsellor observed. Its chief drawback was that it often directed itself to "fighting the last war." Fiscal policy could be used as a countercyclical instrument, but it needed to be supported by structural policy. For example, automatic stabilizers could be created through the structure of fiscal policy and the tax system that would respond of their own accord to economic stimuli, without an administrative order on the part of the legislature or executive. In that respect, fiscal and structural policies were part and parcel of the arsenal governments had at their disposal to affect the economic situation. The use of fiscal policy as a countercyclical instrument should not be through fine-tuning, but rather through the "automatic stabilizers" feature of the tax and expenditure systems.

A number of speakers had drawn attention to the link between the various imbalances, the Economic Counsellor went on. It was pointed out that the relationship between the budget and current account deficits was not necessarily one-to-one, and that budget deficits did not inherently cause an upsurge in inflation. While that was generally true, the magnitudes of the budget deficits and other imbalances at present meant that it was almost meaningless to argue about the exact relationships; instead, it was necessary to recognize that the time had come to move toward smaller deficits and imbalances.

On the one hand, one Director had observed that, on the external side, perhaps the correction of imbalances was on track, the Economic Counsellor recalled. On the other hand, a number of speakers had stated that significant dangers confronted adjustment, and that adjustment was not on track. Adjustment could not be made to occur overnight, and the time available in which to begin the implementation of adjustment measures was not unlimited. Steps therefore needed to be taken soon in the right direction, in his view. Once markets recognized that a credible medium-term strategy had been formed to deal with the imbalances, however, they were sophisticated enough to realize that adjustment would not take place overnight, and from that perspective, there would then be enough time to implement specific policy measures. Generally speaking, the fact that changes were being made in the right direction influenced the psychology of markets far more than the magnitude of those adjustments.

In that connection, the Economic Counsellor continued, although there had been changes in exchange rates and some adjustment of current account imbalances, those were inadequate, because the markets remained unconvinced that a medium-term strategy immune from political considerations, various cycles, and the re-examination and rescindment of commitments, had been formed. It was essential that such a strategy be formed--and that it be consistent--for its own sake, and because the markets tended to assess the adequacy of the strategy on an ongoing basis.

The comment of Mr. Warner that too much emphasis should not be placed on correction in the deficit country was warranted, the Economic Counsellor agreed. Surplus countries needed to do more. Coordination was essential, and was the joint responsibility of both surplus and deficit countries. In the major surplus countries, the implementation of appropriate structural policies was needed; in the United States, the budget deficit was the primary problem. The key to coordination was joint action; otherwise, the problem of sequencing the policy responses arose, and there was nothing more dangerous, at the current juncture, than arguing about who should go first. Assuming that joint action was needed, the next question was in which spheres it should be taken. Mr. de Groote had suggested a more formal look at real exchange rates in that connection. Focus on real rates would be indeed appropriate, as long as it was borne in mind that in general, policies addressed the nominal exchange rate. Mr. Nimatallah had again suggested looking at structural indicators as well.

The remark had been made by Mr. Warner that analysis of the intra-European Community imbalances should be undertaken in the world economic outlook in light of the impact of those imbalances on the rest of the world, the Economic Counsellor recalled. The intra-European Community imbalances were indeed a systemic matter, and were thus in the Fund's purview, as Mr. Finaish had suggested, and the staff intended to examine them, accordingly.

The fact that the demographic analysis the staff had undertaken should not detract from the immediacy of the need to promote growth and adjustment had been stressed by Mr. Warner as well, the Economic Counsellor went on. The discussion of demography and the entire long-term focus in the world economic outlook had been meant to underscore the need for immediate action, because of the long-term consequences of not taking action at present.

The point had been raised by Mr. de Groote that, as the process of correcting budgetary imbalances went on, the danger should not be ignored of a recession occurring if demand in surplus countries did not expand, the Economic Counsellor continued. The staff had emphasized the need for surplus countries to stand ready to sustain growth, but that prescription needed to be put in perspective. The existence of that concern suggested that a correction of the United States' imbalances was being undertaken in a massive way, while of course at present the process of correction was going too slowly. It was certain, however, that in the context of coordination, if such an adjustment on the part of the United States were to begin, surplus countries should be prepared to step in to offset the negative effects of the adjustment.

The question had been raised by Mr. Yamazaki as to the meaning of the staff statement that a depreciation of the U.S. dollar, or a rise in foreign demand, would not improve the current account unless it were accompanied by a reduction in one of the components of domestic demand, the Economic Counsellor recalled. If only a nominal devaluation of the dollar were to be effected, it would be translated very quickly into prices. The point about trying to cause changes in real exchange rates through changes in nominal exchange rates was relevant in that regard; under current policies, changes in the nominal exchange rate alone would not be helpful. However, if the correct policies were implemented, a change in nominal exchange rates might also generate changes in real exchange rates. For example, if the public sector's absorption of private sector savings were reduced, the effect of exchange rate changes might be greater. The staff's comment had been intended not to focus so much on what should be done with the exchange rate, but rather to direct attention to the fundamentals, and the necessity of putting the appropriate policies in place.

The proposition had been put forward by Mr. Posthumus that the recent movements in exchange rates might not have been fully helpful, and Mr. Grosche had suggested that recent exchange rate movements might not have been helpful, in particular, to the inflation situation in Germany, the Economic Counsellor remarked. The heart of those observations, in his view, was the fact that the currencies of deficit countries had strengthened, while the currencies of surplus countries had weakened--surely a puzzle. Such an evolution of currency values raised questions about the consistency of exchange rates with the medium-term strategy of current account adjustment. It pointed again to the importance of returning to the fundamentals. In that connection, Mr. Finaish had raised the question of whether knowledge of macroeconomic relationships was sufficient for fine-tuning, and he agreed with Mr. Finaish's implied answer in that regard--that it was not. The fact that knowledge of those relationships was imperfect argued in favor of a steady-as-you-go approach to economic policymaking. The weakness of fine-tuning was that, even if it worked once, it seldom worked again, because the markets, like the policy makers, became immune to the effects, and responded differently. It was dangerous to try to play with economic agents through fine-tuning in that way.

The point had been made by Mr. Enoch that imbalances per se would not be a major problem if capital flowed freely and without distortions, the Economic Counsellor recalled. He agreed that budgetary and current account imbalances in themselves were not a sufficient condition for assuming that something was wrong. Nevertheless, at present, the magnitudes of those imbalances needed to be borne in mind.

In looking at capital flows, the savings-investment approach used in the world economic outlook was helpful, the Economic Counsellor pointed out. The key problem was not raising savings in one country and lowering savings in another, which implied that the level of global savings was correct--which was not so. The adjustment prescription for countries with low savings rates should be to increase their savings rates, whereas the adjustment prescription for countries with high savings would be not that they should lower their savings, but that they should ensure that the savings were allocated properly both domestically and internationally. Capital movements and capital flows therefore became an important consideration in analyzing the world economic outlook.

He agreed with Mr. de Groote that deregulation strategies, in and of themselves, might not protect countries from inflationary pressures, the Economic Counsellor continued. That was the rationale behind using them case by case, as Mr. Kafka had pointed out. Mr. Monyake had raised the question as to whether the transformation of economies from one system to another, from regulated to deregulated, from centralized to decentralized, or from high inflation to low inflation, was really understood. Indeed, the process of transformation was not fully understood. That implied, first, that more attention should be given to the process of transformation, and second, that the need for applying the case-by-case approach needed to be stressed. Miss Yang had raised the question of how the fact could be explained that, although the imbalances had not in general diminished, the situation that governments faced at present was not as bad as might have been expected. It needed to be recognized that not everything that had been done in the past had been necessarily bad; in fact, the supply-side revolution in policymaking, which had started in the United States, had borne important fruits. The long expansion of the world economy was due to a large extent to many of the actions that had been taken on the supply side. Nevertheless, the current account imbalances remained, and needed to be examined carefully, both at present, and for the future.

The staff would examine carefully the proposals for studies that Directors had put forward in the context of the work program, the Economic Counsellor concluded. The nature of the relationship between demography and savings had been raised by several Directors. The staff would pursue that topic further, not only because of its interest in demography for its own sake, but because the staff was convinced that it was essential to understand the relationship for medium-term policymaking. Several Directors had also raised the question of the nature of capital markets, and whether current capital flows were consistent with long-term rationality. In that connection, the question of whether capital flows were responding to interest rates would be pursued. Mr. Posthumus had noted that a better understanding of the functioning of international capital markets might be useful. In addition to the necessity of understanding the operations of the international capital markets, a related question was whether the staff was in possession of all the facts and had the best information and statistics. The discrepancy in world current account balances was important in that connection. All those issues in relation to capital markets and capital flows required further research.

A staff representative from the Research Department noted that the question of the realism of the staff's projections had arisen several times in the discussion, and from various directions. On the one hand, Mr. Warner believed that monetary policy should not be driven exclusively by what he referred to as the recent modest acceleration of inflation and thought the staff was too cautious in calling for greater efforts to expand domestic demand in the surplus countries. Mr. Posthumus, on the other hand, felt that the staff had not been sufficiently strong in warning about the dangers of inflation. The staff thus appeared to be on safe middle ground, but on reflection, he would be more inclined to accept Mr. Posthumus's criticism. The staff had stated quite clearly, however, that a significant relaxation of monetary policy at the present juncture would not be appropriate given that economic growth remained quite strong in several countries. The recent revisions of the data in the United States and the Federal Republic of Germany did not lead the staff to change its conclusion on that score. He would also agree with Mr. Massé that if monetary policy should err, it should err on the side of restraint at present.

In response to the remark by Mr. Warner about the staff's excessive caution in recommending measures for stimulus in the surplus countries, in the first half of 1989, real GNP in Germany had increased by 4 3/4 percent, and in the first quarter, Japan's real GNP had risen by 4 1/2 percent, with real domestic demand rising by 5.8 percent, the staff representative pointed out. He believed that those numbers were very high by any estimates of potential GNP that he was aware of. He therefore did not believe that there was great scope at present for an expansionary shift in policies in those countries. Furthermore, even if growth could be increased in the surplus countries, it was by no means clear that that would lead in the present circumstances to an improvement in the U.S. current account, for the reasons that had been mentioned by the Economic Counsellor in discussing the possible effects of a depreciation of the dollar. If the United States was operating at full employment, there was no way in which net exports could be expanded unless the U.S. fiscal position was modified, or unless some component of private demand was crowded out.

That the staff's projections and assessments were too optimistic both for the developing and the industrial countries had been the view of Mr. Kafka and Mr. Massé, the staff representative recalled. The perception that the staff had been too optimistic with respect to the developing countries was linked to the assumptions that existing Fund programs would succeed in bringing about substantial improvements in policies, and therefore in productivity and growth. Several Directors had had difficulties with that assumption. Conversely, Mr. Grosche had been disappointed that the staff had assumed changes in policy only in those countries with Fund programs. The ground rules behind the staff's projections had been explained in detail in an annex to the previous world economic outlook. The staff's projections for countries without programs, including the industrial countries, were made on the basis of unchanged policies. In developing countries with programs, the staff assumed that the targets of the program would be reached, on the grounds that it would be inappropriate for the staff to give the impression that they had doubts about the success of the program.

That being said, if Directors wished to experiment with alternative assumptions, the staff could rely on a more neutral assumption of constant unchanged policies even in those countries with Fund programs, the staff representative stated. However, certain consequences would have to be recognized. First, what the staff was attempting to do would have to be explained very carefully. Second, countries with Fund programs would have to carry two sets of forecasts--one with the assumptions of the program, and another with the assumption of unchanged policies. Third, the projections based on the latter assumptions might have some disturbing implications. For example, if no policy improvements were projected for a country where inflation was accelerating very sharply, the numbers might become quite large. If a country was an important one, the figures might be sufficiently large to influence the aggregates in the world economic outlook.

With respect to the industrial countries, he did not believe that the staff's projections had been particularly optimistic, the staff representative went on. Mr. Massé had felt that there might be some contradiction between the staff's inflation and output forecasts for North America, and that in order to attain the inflation projection, the deceleration in the expansion of demand would have to be more pronounced. The staff was not sure whether the trade-off between growth and inflation was as rigid as that, however. It was a fact that the underlying rate of inflation at the current stage of the expansion was lower than would have been expected on the basis of past cyclical experience. He agreed, however, that the trade-off might become less favorable if expectations were allowed to get out of hand.

It had been observed by Mr. Nimatallah, on the other side of the question, that the staff should have been more optimistic with regard to growth in the industrial countries, because he believed that investment would be stronger than had been anticipated, the staff representative recalled. In the medium-term baseline projections for the industrial countries, the staff had envisaged a substantial increase in the investment to GNP ratios over the medium term, particularly in the case of the United States and Canada, where the ratio rose 2 1/2 percentage points, and in the United Kingdom, where the ratio rose by 1 1/2 percentage points. Of course, investment was a fundamental determinant of growth in the medium term, but its effect on potential output in the near term was not very large, however, because the share of capital in output was relatively small.

If structural measures were to go beyond what the staff had assumed, as Mr. Nimatallah suggested might be the case, or if the impact of ongoing technological developments in sectors such as information processing and industrial materials were to be more pronounced than they were at present, it was possible that total factor productivity and potential output growth would be stronger, the staff representative commented. However, the staff's inclination at present was to be cautious and not to incorporate those assumptions into the baseline unless they appeared to be clearly visible on the basis of current policies or developments. As Mr. Enoch had mentioned, it was possible that potential GNP was higher at present than the staff estimated. The staff expected to update its estimates of the GNPs of major countries in future world economic outlook papers.

The question had been raised by Mr. Yamazaki as to why the deceleration of growth in the United States did not lead to an improvement in the current account position of the United States in the staff's projections, the staff representative recalled. In fact, the slowdown in growth, both past and prospective, did contribute to an improvement in the U.S. current account position compared to what it would have been otherwise. The problem was that other factors tended to push the deficit up. First, the United States seemed to have an income elasticity of imports significantly larger than that of its major trading partners. Second, the projection period began at a time when the United States was experiencing a large trade deficit. That meant that exports would have to rise significantly faster than imports for the trade deficit to decline, or, for that matter, to remain unchanged. Third, with continued current account deficits, whether large or small, the external debt of the United States would rise, interest payments abroad would tend to rise, and the investment income account, which used to contribute a considerable element of strength to the United States balance of payments, would turn increasingly into deficit. In that connection, Mr. Finaish had asked about the differences between the forecasts of the OECD and the Fund for the current account. Inasmuch as those differences reflected different views on the long-term effects on competitiveness associated with past exchange rate realignments, the staff continued to believe that the empirical support for those long-term effects was unconvincing. There was no compelling reason at present to doubt the usefulness of "conventional" trade models in explaining current account transactions.

It had been queried by Mr. Evans as to why the staff had given so much prominence to the view that international capital flows provided an efficient way of allocating savings among countries with different propensities to save and different rates of return on capital, the staff representative continued. That was a widespread, although not predominant, view in economic circles, and had received considerable attention in official circles in a number of countries, including the United Kingdom. The staff believed that it deserved a fair hearing. In his view, the staff had taken a critical view of those hypotheses and had concluded that the current account was a useful indicator of policy, and that external imbalances were a source of concern when they were large and persistent. If the staff had not been more ferocious in condemning those views, it was because the world was moving in the direction of more financial integration and, to that extent, those views could be helpful in understanding the direction in which the world might be evolving. That perspective was also useful in understanding the situation in some countries--in Spain, for example--where large capital inflows had less to do with inappropriate policies than with the fact that the country was perceived as having an attractive investment climate by foreign investors in countries where savings were in excess supply. Perhaps the same observation could be made about Australia.

Some doubt had been voiced by Mr. Evans about the way the staff had captured the impact of demographics on savings by introducing a dependency ratio in the consumption function, the staff representative from the Research Department went on. That approach had been followed by other authors in the past. There might be better ways of approaching that subject, and the staff would certainly appreciate any suggestions that Executive Directors might wish to make.

Also in the area of demographics, the staff representative continued, Mr. Marcel had observed that demographic prospects could not justify the current account surpluses at the levels being recorded by countries in which the effective aging of the population was expected to occur relatively early, and a similar point had been made by Mr. Warner. It was necessary to be very cautious in deriving conclusions from the demographic scenarios, as they were subject to a great deal of uncertainty, particularly, as Mr. Marcel had observed, with regard to immigration in the case of Germany, and also, to a certain extent, in the United States. The assumptions about fertility were also subject to a wide margin of error. However, in the staff's view, there was little doubt that populations would age in those countries, and that aging would be particularly rapid in the surplus countries--notably in Japan. If the implications of such aging on savings and on the decumulation of foreign assets of those countries was on the scale that was indicated by the scenarios, then those countries should strive to have a high stock of national wealth at present. Whether that wealth took the form of an accumulation of external assets or of domestic capital stock was a different question, but it did indicate that a relatively high national savings rate in those countries at present was not inappropriate.

In that connection, the staff representative concluded, Mr. Evans and Mr. Enoch pointed out that much work needed to be done in the area of demographics, regarding the effects of a decline in the labor force on capital intensity, in particular. They also pointed out that a more refined quantification of the age structure was desirable, and, perhaps most important, that the effects of aging on government spending, public pensions, and health programs must be taken into account. The staff intended to explore thoroughly all those aspects. In the current world economic outlook, the staff had intended to address the demographic issues in a preliminary way, and had decided in consequence to limit the analysis strictly to the effects of aging on private savings. However, the staff would become more deeply involved in studying demographic issues in the future.

Another staff representative from the Research Department recalled that a number of Directors had expressed particular interest in the staff's balance of payments projections. Mr. Finaish had asked for an explanation of the differences between the staff's current projections and those of the OECD Secretariat as released several months previously in the OECD Economic Outlook. The OECD's projections pointed to a somewhat more favorable evolution of current account imbalances, with smaller imbalances over the following few years than those projected by the staff. There were three basic reasons for those differences. First, the different exchange rate assumptions; the OECD Secretariat's projections had been prepared earlier in the year, and were based on an earlier cutoff date for the exchange rate assumption, which implied a lower exchange rate assumption for the U.S. dollar than in the staff's projection. Second, the OECD had allowed, on a judgmental basis, for somewhat more substantial and longer-lasting effects of the significant exchange rate realignment that had occurred since early 1985, mainly to take account of supply-side considerations. The staff certainly did not rule that out, but those effects had been extremely difficult, if not impossible, to capture empirically, and they had consequently only been incorporated to a small extent in the staff's current projections. Third, the OECD had a somewhat different view of the evolution of net invisibles, including factor income and tourism earnings--two items where the econometric evidence was less robust than for trade flows, and where there was thus a need for a more judgmental forecast. Overall, however, the differences between the projections of the staff and the OECD were not all that large, particularly when the very large margin of uncertainty associated with forecasting the balance of payments was kept in mind; the balance of payments was the net result of very large gross flows. According to the experience of both the OECD Secretariat and the Fund's staff, the differences between the two sets of forecasts were clearly well within the margin of error that had been observed in the past in balance of payments forecasts.

With respect to the current account position of Japan, the staff representative continued, the sharp decline in the current account surplus in Japan in the second quarter of 1989 appeared to have been due largely to temporary factors, including both the J-curve effects associated with the recent depreciation of the yen, and the sharp fall in the volume of exports in the second quarter after an unusual surge of exports in the first quarter. Those quarter-to-quarter movements could not be extrapolated into the future, of course. Regarding investment income, the net inflow had been flat for the previous 18 months, after having risen sharply in 1986 and 1987 in spite of the continued rapid accumulation of net foreign assets. It was important to note that investment income seemed to be subject to a number of recording problems, however, and that movements in that figure were very hard to explain. In the case of Japan, investment income was recorded on a cash basis, and excluded accrued earnings by Japanese companies that were reinvested abroad. In contrast, the data for the United States made an allowance for such reinvested earnings on an estimated basis. Net inflows for Japan were therefore very difficult to predict, since on a cash basis they might reflect shifts in portfolio preference, which behaved more like a capital flow. This problem was also related to the recent changes and shifts that had occurred in the discrepancy in the world current account balance because of the asymmetries between countries in the way in which net factor income was reported. Indeed, it might help to explain the widening of the global current account discrepancy, which was analyzed in more detail in the annex to the world economic outlook paper.

The staff had taken into account the decline in the Japanese surplus in the second quarter in revising its projections for 1989 and 1990, the staff representative pointed out. The factors that lowered the surplus in the second quarter were mainly transitory in nature. The projected widening of the current account surplus also reflected the recent depreciation in real terms of the yen, as well as an estimated increase in investment income receipts due to the further accumulation of net foreign assets.

The possibility of harmonizing the classification criteria for groups of countries used by the World Bank and the Fund had been raised by Mr. Jalan, the staff representative recalled. Such a harmonization would make it easier to resolve the analyses produced by both organizations. There was a degree of overlap already, to the extent that in the statistical appendix, the Fund included data for developing countries that were classified as low-income countries by the World Bank. However, with respect to the middle-income countries and the high-income countries, it was more difficult to reconcile the statistics, because the World Bank no longer distinguished between developing and industrial countries, and their middle-income and high-income groups included both developing and industrial countries. For analytical purposes, the staff tended to examine groups of developing countries, unlike in the World Bank, where developing countries were defined for operational purposes. That being said, the staff had not found it possible to harmonize completely the country classification. Mr. Jalan had also called for a study of the recent track record of the staff's analysis. Such a study had in fact been carried out quite recently, with statistics that had stretched back to the very first world economic outlook analyses in the late 1960s and early 1970s. That study had been published in the summer of 1988, and he believed that it might be a bit early to update it at present.

Mr. Nimatallah commented that the question of external imbalances should be discussed particularly thoroughly in the forthcoming papers on the world economic outlook. In his view, it was clear that many Directors saw risks if external imbalances were not addressed early enough, despite the fact that those problems were medium term in nature. Another interconnected issue was that of savings. Investment in the right sector and in the right direction appeared to him to be just as important as adjustment on the part of deficit and surplus countries. For example, more productive investment in the export sector in the United States would be appropriate, because there were signs that domestic demand was declining in that country, but there were no signs that the capacity of the export sector was being expanded. He believed that the staff representative from the Research Department had been correct in noting that the recommendation of short-term policies to the surplus countries to expand domestic consumption would be useless if the export sector of the United States was not to respond to the additional demand that was thus created. Thus, the

United States should be urged to take measures to encourage productive investment in order to raise the capacity of the export sector. In that respect, the links between short-term and medium-term policy recommendations should be explored further. Those links would demonstrate the complementarity between macroeconomic and microeconomic policies, and the necessity for coordination, especially in those areas where such coordination would assist the process of reducing imbalances.

Mr. Grosche commented that he agreed that symmetry in the coordination process should mean that all participants were pushed into action on all those fronts that needed to be addressed. It should not be interpreted to mean that some countries would act only if others acted. That would be a recipe for inaction, as the Economic Counsellor had remarked. In speaking about sequencing, he meant to point out that active microeconomic and structural policies were needed in order to increase efficiency in economies everywhere, including in the surplus countries. He had been satisfied by the staff representative's explanation of the basis for the staff's assumptions. He wished the staff to continue with the current practice of assuming changed policies in those developing countries with Fund-supported programs.

The Chairman commented that the first rule in the book of coordination was that inaction on the part of one side was never justification for inaction on the other side.

Mr. Kafka commented that he had been struck by the Economic Counsellor's observations on the rigidity of fiscal policy. To his mind, the real question was why those policies had to be rigid. For example, in the United Kingdom, the so-called regulator had existed for some time, and it might be useful to examine it again. Also, Directors did not appear to be prepared to face up to the fact that they would be living in a totally irrational world if they did nothing to incorporate changes in indirect taxes into price indexes, thus allowing those indexes to be the base for salary and wage adjustments. It should be possible to explain that an indirect tax need be no more harmful to given population groups than a direct tax.

With respect to the staff's optimism regarding the prospective growth rates of developing countries, Mr. Kafka continued, he agreed with Mr. Grosche that in its assumptions for the world economic outlook the staff must expect that Fund-supported programs would be successful. Nevertheless, the staff could have pointed out that when all of the factors were taken together, an obvious contradiction could be perceived between the growth rates of developed countries and what the staff foresaw for the growth rates of the developing countries. He did not wish to imply that the staff should go beyond such a comment, but such a comment was clearly in order, nevertheless.

Mr. Evans said that the paper the Economic Counsellor had referred to on structural policies in the European Community was being updated by the Exchange and Trade Relations Department. He would suggest that the

Board's discussion of that paper be brought forward, in the context of the question that had been raised earlier by Mr. Warner of intra-European Community imbalances.

The Economic Counsellor commented that the intent was not to match the past paper with an updated version. Rather, intra-European Community imbalances would be examined in a broader context, and it was his understanding that the European Department was looking into it on an ongoing basis.

Mr. Nimatallah said that there should be some flexibility in fiscal policy in the short term, especially on the expenditure side. Such flexibility would aid fiscal policy in handling unexpected upward pressures on prices. He agreed that although fiscal policy was usually rigid, it did not necessarily have to be so, and the Fund should see it in that light.

Mr. Hogeweg said that in his intervention, he had remarked that the assumption that the removal of distortions in those economies with surpluses would serve to decrease their surpluses was a rather uncertain one. He wondered what the staff's reactions to that comment were.

The Economic Counsellor said that he agreed with Mr. Grosche that the implementation of appropriate adjustment policies needed to be done at the fastest possible pace, that paralysis should not be allowed to set in, and that a situation should be avoided in which each country awaited action on the part of the others. Something else that needed to be recognized was that coordination was not a one-shot affair, but was an ongoing process. That being said, it was perfectly understandable that differences in calendar needed to be accommodated, and that policy actions could not always be perfectly synchronized. Some partners in coordination might be able to proceed at present, whereas others would have to wait until a more auspicious time. The issue of sequencing needed to be seen within the context of joint coordination on the part of all participants.

In response to Mr. Hogeweg's question, the Economic Counsellor went on, the justification for structural policies, and indeed for any policies, was not the correction of imbalances, but rather that those policies were in the interest of the country itself. Of course, each and every structural measure would not necessarily improve the current account, and there were some that might even worsen it. Nevertheless, to the extent that structural policies removed distortions and increased the flexibility of the economic system as a whole, they were conducive to current account adjustment, in the sense that exchange rate changes and other signals would be allowed to translate themselves in a better way into current account adjustments.

The Chairman made the following summing up:

> This discussion has covered a wide range of issues. In summarizing it, I will deal first with Directors' comments on

the realism of the staff's projections, and then turn to the other main issues of the discussion.

Realism of the short-term projections

Directors generally agreed with the staff that the expansion of the world economy was likely to be sustained in the second half of 1989 and in 1990, albeit at a more moderate pace than in the past two years. In the industrial countries, the projected moderation of aggregate demand growth was regarded as a positive development, and was attributed in part to the substantial tightening of monetary conditions that had taken place in the past year and a half. However, several Directors pointed out that economic activity continued to be very strong in some industrial countries, that most countries were still operating near capacity limits, and that some had experienced an intensification of underlying price pressures.

Most Directors were concerned about the outlook for inflation, and felt that the projected moderation in demand growth would be a necessary condition for achieving a reduction in inflation in 1990. Taking into consideration the potentially serious costs of a return to high inflation, Directors agreed that a relaxation of monetary policy in the industrial countries would seem to be unwarranted at present. Although several Directors were cautiously optimistic that the present degree of monetary restraint would be sufficient to bring inflation under control, some felt that the need for a further tightening of monetary conditions in certain countries could not be ruled out. However, most Directors emphasized that the risks of a further rise in interest rates--and the associated risk of a severe cyclical downturn--could be reduced significantly if monetary policy were supported more effectively by fiscal and structural policies. Several Directors felt that excessive reliance on monetary policy could result in unduly high interest rates, with adverse consequences for investment and for the debt burden of the developing countries. They thought it was important for fiscal policy to play a greater role in controlling inflation, particularly in those countries where fiscal deficits remained high. In that connection, several Directors noted that recent indications of high capacity utilization and continued buoyancy of economic activity in the United States strengthened the case for further fiscal adjustment in that country.

Directors also expressed concern over the near-term prospects for the developing countries, especially low-income countries and those with debt-servicing problems, many of which had failed to benefit fully from the generally favorable external environment during the past two years. The prospective slowdown in the expansion of world demand and trade, the expected weakness in non-oil commodity prices, and continued high world interest rates all highlighted the urgency of fundamental policy reforms in those countries, aimed at making better use of existing opportunities and resources. Several Directors felt that the projected improvement in the output performance of the debt problem countries in 1990 and beyond was optimistic and could only be achieved through a firm implementation of strong adjustment policies, in conjunction with an adequate flow of new financial resources and a sufficient reduction of those countries' debt and debt-servicing burdens.

Current account imbalances and external adjustment in industrial countries

Most Directors noted that the external adjustment process had slowed significantly during the past year, although some Directors thought that further adjustment was likely even on the basis of current policies and exchange rates. Directors agreed that the prospect of persistently large current account imbalances continued to be a major element of vulnerability for the world economy. They recognized that those imbalances reflected in part the international implications of fundamental differences among countries in the balance between private saving and investment resulting, inter alia, from different demographic trends. In a world of highly integrated financial markets, those differences could give rise to private capital movements in the direction of countries with relatively low saving rates and relatively high (risk-adjusted) rates of return on capital. However, Directors emphasized that such imbalances were a cause for serious concern--particularly if they were large and persistent--because they could result in a spiral of rising external debt and interest payments, disruptive market reactions and exchange rate swings, and protectionist reactions. Directors also stressed that in some important cases, the external imbalances reflected an excessive absorption of saving by the public sector, and therefore provided an indication of the need for changes in fiscal policy.

Directors agreed that both deficit and surplus countries should share the burden of bringing the external adjustment process back on track. Achievement of a more sustainable pattern of current accounts would diminish the risks associated with a continued buildup of external assets and liabilities, facilitate the management of the exchange rate system, and strengthen the credibility of the policy coordination process. Several speakers noted that, since most industrial countries were operating at very high levels of capacity utilization, external adjustment required a shift in the composition of aggregate demand in both deficit and surplus countries. In view of the concern about the performance of saving in industrial countries, several Directors emphasized that such a shift should be brought about primarily by raising national saving rates in deficit countries, rather than by reducing them in the surplus countries.

In the deficit countries, Directors agreed that a further consolidation of the fiscal position, with emphasis on reducing current expenditure, continued to be required. Such an improvement--together with efforts to remove structural distortions affecting private savings, particularly in the United States and in the United Kingdom--would help to contain aggregate demand, permit the continued expansion of the tradable goods sector, and reduce upward pressure on inflation and interest rates. Directors emphasized that, given the current high level of resource use, exchange rate adjustment alone would either result in higher inflation--thus progressively eroding its effects on net exports--or lead to higher interest rates and lower investment. That further underlined the need for fundamental adjustments to fiscal and structural policies.

Directors pointed to the necessity in surplus countries to promote adequate growth of domestic demand in excess of output growth, primarily by complementing fiscal and monetary policies with structural policy measures. In Japan, it would be essential to accelerate structural reform in a number of areas, including agriculture, land regulation, and those aspects of the distribution system that added to domestic prices and inhibited market access. Those reforms would not only improve domestic resource allocation and enhance consumer welfare, but also increase domestic absorption of saving, thus promoting international adjustment, and reduce protectionist pressures in other countries. In Germany, trade liberalization, decontrol, and the reduction of subsidies would facilitate the reallocation of resources from the tradable to the nontradable goods sector, enhance the economy's flexibility in adjusting to exchange rate changes, and reduce price pressures.

A number of Directors also noted that the process of external adjustment appeared to be under way in the newly industrializing economies in Asia. However, a few speakers remarked that scope remained in some of those countries to reduce import restrictions, liberalize the financial system, and allow a greater role for market forces in the determination of the exchange rate.

Restoring growth in indebted developing countries

Many Directors stressed that the medium-term outlook for indebted developing countries was subject to considerable risks. The gradual strengthening of growth projected by the staff for the net debtor countries seemed to hinge crucially on the assumption that policy reforms would be implemented in a number of countries, and would result in a marked increase in saving and investment ratios and a substantial improvement in the efficiency of investment. Policy reforms on the scale necessary to achieve the growth performance envisaged in the medium-term baseline scenario would depend critically on substantial and timely progress being made under the strengthened debt strategy, as well as on the resolve of the indebted countries themselves. In that context, Directors emphasized that the debt strategy must take appropriate account of the external financing requirements of all developing countries subject, of course, to the needs and specific circumstances of individual countries.

Directors welcomed the staff's growth accounting analysis and its illustrative analysis of the possible impact of debt reduction operations. Those scenarios highlighted the fact that debt reduction, in and of itself, was not a panacea for the economic difficulties of the indebted developing countries, and would need to be accompanied by strong adjustment measures, which remained the key to fundamental and lasting improvements in economic performance. Those measures should include macroeconomic policies designed to raise national saving, foster capital formation, lower inflation, and encourage the repatriation of flight capital, as well as vigorous structural reforms--including trade liberalization--aimed at allocating existing resources more efficiently and improving the quality of investment and the performance of productivity.

Several Directors emphasized that policy reforms in the developing countries would be more effective, and more likely to be implemented on a sufficient scale, if they were carried out in conjunction with increased flows of long-term external financing as well as debt and debt-service reduction operations. In addition, Directors stressed the importance of adequate and stable growth in the industrial economies.

Another crucial requirement was the need to move toward a more open trading system worldwide, especially in the area of agriculture and certain manufactures, including textiles. Of course, all countries stand to gain from a successful conclusion of the current round of Multilateral Trade Negotiations, but a reversal of existing protectionist tendencies would be especially important for the indebted developing countries, which must be offered as favorable an international environment for the growth and diversification of their exports as possible.

<u>The international monetary system and the role of the Fund</u>

Directors emphasized that the multilateral surveillance undertaken in the context of Article IV consultations and the world economic outlook discussions was an essential part of the Fund's responsibility to monitor the functioning of the international monetary system. Directors agreed that excessive exchange rate volatility--as in much of the 1980s--was not conducive to the smooth functioning of the system, although some degree of flexibility would be essential in order to allow exchange rates to respond to changes in fundamentals.

Directors noted that the Fund had made an important contribution to the process of policy coordination through its work on key economic indicators. A few Directors noted the need to move the Fund toward a more active role in the policy coordination process. Directors suggested that further improvements in the analytical framework underlying policy coordination might be possible through a better understanding of the determinants and macroeconomic implications of international capital flows. That important issue, which was appropriately elaborated on by one Director, could be approached again in the Board's discussion of the work program after the Annual Meeting. Directors also emphasized the need for a continued focus on structural issues in Article IV consultations. Directors expressed support for the continuing development of the medium-term scenario analysis, noting that it constituted a valuable way to analyze and understand the implications of different policy stances among countries. Several Directors welcomed the attention devoted to demographic issues in the present staff paper, which provided a useful, long-term perspective on the stance of fiscal policies and the evolution of external imbalances.

<u>Publication of the world economic outlook documents</u>

The staff will edit the main text and the two annexes of the documents carefully to ensure that market-sensitive material is removed and that analytical material is presented in a manner that takes proper account of the concerns and sensitivities of national authorities. Concerning medium-term scenarios, we would proceed as in the past, i.e., omitting quantitative details of the baseline projections for individual countries and presenting the discussion in qualitative terms. As mentioned in the summing up of the discussion on the world economic outlook of March 1989 (SUR/89/20, 3/22/89), it would be desirable at some stage to publish at least some of the quantitative material on the medium-term scenarios and projections presented in the main paper, because that would enhance the understanding of key policy issues and help to reduce the attention being given to the medium-term baseline projections. Although the alternative scenario on demographic developments has a longer-term focus than most of those included in past <u>World Economic Outlook</u> reports, its implications are highly relevant for the medium-term stance of fiscal policy and for the assessment of external imbalances, and it contains little material of a market-sensitive nature. It is therefore a good candidate for publication.

Finally, let me remind Directors that minor changes in the projections will have to be made in light of recent data. As usual, a preliminary version of the document to be published will be released to the press at the time of the meeting of the Interim Committee. The printed version will be available in mid-October 1989.

Mr. Kafka observed that in the summing up, the Chairman had said that Directors had agreed that domestic demand should be expanded faster than the growth rate of output in surplus countries, mainly by structural measures. He did not understand how demand could be expanded in excess of the expansion of output by structural measures. A related point was that one way of disposing of surpluses which were seen as embarrassing would be through an increase in capital exports--which were very necessary in themselves. Perhaps that could be worked into the Chairman's summing up.

The Chairman responded that that point had not figured very strongly in the discussion.

Mr. Nimatallah commented that the matter of external imbalances was a medium-term problem, and that it was clear that the deficit countries--in particular, the United States--needed to promote exports by investing more in the export sector and by improving the quality of exports. It needed to be borne in mind that the stimulation of the economies of surplus countries would be fruitless if the situation in the United States was such that that country could not take advantage of it.

Mr. Grosche commented that he did not really understand Mr. Kafka's point about capital exports. Although there was no direct connection between current account surpluses and capital exports, they were nevertheless linked in many ways. For example, through export credits to developing countries the financing of certain investments might contribute to increasing the surpluses of the surplus country, at the same time that capital was exported. Very often, capital export came first, and surpluses second. Therefore, it could be said that in trying to move away from surpluses, a cut in capital exports might be useful. For example, he was not sure whether the capital recycling approaches that had been taken by Japan were bound to decrease the Japanese surplus.

Mr. Kafka responded that he was not concerned about surpluses per se. Surpluses merely reflected differences in the propensity to invest and to save, and they were not embarrassing. That was especially true of surpluses which financed capital outflows, particularly to developing countries where they presumably contributed to growth.

Mr. Yamazaki stated that he had some problems about the publication of the long-term economic scenario. Naturally, the judgment of what was sensitive needed to be based upon an evaluation of what the authorities deemed sensitive. He would take up the matter bilaterally with the staff. He had been flattered by the attention that had been given in the world economic outlook to the structural policies of Germany and Japan. Perhaps an equal honor could be accorded to the major deficit country, by placing a bit more emphasis on the need for structural adjustment in that country.

The Chairman commented that he had tried to place equal emphasis on the need for structural action in both surplus and deficit countries. However, as deficit countries tended to be occupied with budgetary problems, it might be expected that emphasis would be placed on the contribution that surplus countries could make.

Mr. Warner said that he believed that the Fund's commentary on structural measures that were needed in surplus countries was fully in keeping with the Fund's role in overseeing the international coordination process. He believed that the Fund's assessment in that regard was completely balanced.

The Chairman said that the matter of the varying ways in which investment income was recorded in the balance of payments, as the staff representative from the Research Department had noted, pointed to the importance of the question of the discrepancy in world current account balances. He shared Directors' concerns over the renewed widening of that discrepancy, which reflected in part, as the staff had observed differences in the measurement of current account variables, but which also mirrored problems arising from inadequate reporting of capital flows. In that respect, he fully shared the view of Mr. Posthumus that there was a need to strengthen the monitoring of capital flows, especially given the increased liberalization of markets and the interdependence of economies that was evident from the transmission of capital market disturbances. Perhaps the time had come for the Fund to undertake a follow-up study to the report on the world current account discrepancy so as to enhance the Fund's understanding of the causes of the discrepancy in recorded international capital flows, as well as of the measurement problems related to unrecorded transactions in both the current and capital accounts of the balance of payments. He made the suggestion with some hesitation, given the heavy work load, but he would welcome Executive Directors' views on moving forward with such a study. In his view, the Fund had a responsibility for monitoring international capital flows.

2. NINTH GENERAL REVIEW OF QUOTAS - REPORT TO INTERIM COMMITTEE

The Executive Directors considered a revised draft of the Executive Board's report to the Interim Committee on the Ninth General Review of Quotas (SM/89/192, 9/5/89).

Mr. Nimatallah commented that a very evenhanded approach had been taken with respect to the draft report of the Executive Board to the Interim Committee; it seemed to impartially encompass the various positions that had been expressed by the Executive Directors. Although he would make some suggestions for minor changes to the report later in the discussion, he considered that the draft report under consideration was much better than the ones that had been presented to the Executive Board on previous occasions.

Mr. Cassell said that he wondered whether the section on access limits needed to be included in the report to the Interim Committee on the Ninth Review, as that issue had been included in other reports that would be presented to the Interim Committee during its forthcoming meetings.

The Deputy Treasurer remarked that the section on access limits had been included in the draft report on the Ninth General Review of Quotas, because that report was intended to reflect the discussions that had taken place among the Executive Directors. During those discussions, several Directors had raised the issue of access policy, because in their view it had a bearing on the size of the overall increase in quotas.

Mr. Grosche commented that the section on access limits should be retained in the report on the Ninth General Review of Quotas, because considerations related to access were closely linked to the question of appropriate Fund size.

The Chairman said that, in the light of the reasoning offered by Mr. Grosche and the staff, he agreed that the section on access limits should be included in the Board's report to the Interim Committee.

Given the nature of the revised draft report under consideration, the Chairman suggested that it might be useful for Directors to consider it on a paragraph-by-paragraph basis, offering suggestions for improvements wherever appropriate.

I. Continuation of the Ninth Review

The Executive Directors accepted paragraphs 1, 2, and 3 without change.

Mr. Warner suggested that, with respect to the first sentence in the fourth paragraph, which read, "...the Executive Directors have considered all the main elements relating to the Ninth Review...," it might be more accurate to replace the word "all" with "further," given that other issues pertaining to the Ninth Review could emerge as the discussions on that matter progressed. In addition, as a matter of consistency, the term "on these issues," appearing in the third sentence of that paragraph should be changed to "on these elements," in order to relate back to the first sentence.

Also with respect to paragraph 4, he wondered whether it would be appropriate to delete the final portion of the third sentence: "and in particular on the basic issue of the size of the overall increase in quotas," Mr. Warner continued. While Directors had certainly emphasized the issue of size as a prime, if not fundamental, issue for the Interim

Committee to consider, all of the elements on which the Committee's guidance was sought were listed in other areas of the draft report. In that connection, and to follow logically from the fourth sentence, the final sentence of paragraph 4 should be amended to exclude the phrase, "...and its endorsement of the key principles for distributing the increase..." as, again, all of the central issues related to the Ninth Review were specified elsewhere in the revised draft report.

The Chairman stated that, while he could agree with Mr. Warner's suggestion to change the first sentence of paragraph 4 and to use the word "elements" consistently throughout the paragraph, he differed with Mr. Warner's suggestion to delete parts of the text in the remainder of the paragraph. In particular, he did not consider that it would be appropriate to omit the specific references to the issues of size and distribution in the fourth and fifth sentences. Indeed, during recent discussions on the Ninth Review, Directors had agreed that guidance from the Interim Committee was urgent with respect to the central question of the appropriate size of the Fund.

Mr. Jalan said that he agreed with the Chairman's comments. Of all the issues related to the Ninth Review, the questions of size and distribution were the most central, because the final positions that would be taken with respect to other related issues were dependent on them. Therefore, some guidance from the Interim Committee on those two questions was urgently needed.

The Executive Directors agreed that the text of paragraph 4 should read:

> Since the last meeting of the Interim Committee, the Executive Directors have considered further the main elements relating to the Ninth Review: (i) the role of the Fund in the early 1990s; (ii) the size of the overall increase in quotas; (iii) the issues bearing on the distribution of the overall increase, including an examination of the position of the developing countries in the Fund and, in particular, those members with very small quotas; (iv) the question of ad hoc increases in the context of the quota review; (v) the mode of payment for the increase in quotas; and (vi) issues relating to the period of the economic data to be used in making quota calculations. The Executive Directors' discussions of these issues are reported below. The Executive Board requests guidance from the Committee on these elements, and in particular on the basic issue of the size of the overall increase in quotas. Agreement by the Committee on this issue, and its endorsement of the key principles for distributing the increase, would enable the Executive Board to make proposals to the Board of Governors in time for the Review to be completed before the end of this year.

II. Role of the Fund in the 1990s

Mr. Hogeweg noted that the text of paragraph 5 was not consistent with the wording of Article I of the Fund's Articles of Agreement, in listing the basic purposes of the Fund. While the Articles referred to the Fund's objective to encourage further liberalization of trade, they did not mention capital flows. Therefore, the wording in paragraph 5 should be changed either to reflect the basic purposes of the Fund precisely as spelled out in its Articles or to replace the term "basic purposes."

The Executive Directors agreed to amend paragraph 5 to reflect the exact wording used in the Articles to specify the basic purposes of the Fund.

Mr. Ghasimi remarked that since the last two sentences in paragraph 6 referred to the three main elements of the Fund's cooperative approach, a listing of those elements--preventive, collaborative, and remedial--should be included in the final sentence.

Mr. Warner stated that he supported the suggestion made by Mr. Ghasimi. In addition, paragraph 6 could be strengthened by changing the tense of the verb in the third sentence from "posed" to "pose," as, indeed, the overdue obligations of members continued to pose serious costs and risks to the Fund. In that connection, the word "broader" at the end of the third sentence should be changed to "broad," and the words "and which could erode support for the Fund in member countries" should be added at the end of that sentence.

The Chairman said that he agreed with the amendments suggested by Mr. Warner. With respect to the reference to potential risks to the Fund, one such risk was that of pushing the liquidity ratio down to a dangerously low level. In his recent discussions with central bankers, he had been impressed by the importance of the Fund's ability to maintain at all time members' claims on the Fund.

Mr. Grosche remarked that he agreed with the Chairman with respect to the importance of maintaining a prudent liquidity ratio. Indeed, there was a connection between the problem of arrears to the Fund and concerns about the liquidity ratio. In that connection, Directors should note that the arrears problems would become less critical in the context of a large quota increase.

The Executive Directors approved paragraph 6 as amended.

Mr. Nimatallah suggested that paragraph 7 of the draft report should be amended to read as follows:

> Directors have unanimously expressed the view that the Fund must be adequately endowed so as to maintain its presence at the center of the system. It was generally agreed that the Fund

must be in a position to assist the entire membership in all its diversity. Members need to be given confidence that sufficient resources would be available to them from the Fund, on appropriate terms and conditions, if they encounter payments difficulties so as to encourage them to take early measures of adjustment, including support for their efforts to liberalize trade and capital flows and in their pursuit of appropriate exchange rate policies, and thereby help avoid the emergence of a crisis situation. In helping to restore viability to members' payments positions over the medium term, Directors noted the importance, inter alia, of members instituting growth-oriented adjustment programs of high quality which would improve their creditworthiness. In providing general balance of payments financing to support growth-oriented adjustment, the Fund should maintain its catalytic role. Its purpose is primarily to promote adjustment, and in that context provide only a relatively small part of the gross financing requirements of members, and to induce other financial institutions to provide the bulk of the external financing needs of members. Directors agreed that the Fund must not replace private market financing with its own resources.

The Executive Directors approved paragraph 7 as amended.

Mr. Nimatallah considered that the meaning of the first sentence of paragraph 8 was not clear, in particular with respect to the term "is of enhanced significance." The meaning of that sentence could be clarified by revising the text to read: "The Fund's role as catalyst at the center of the system is significant."

The Chairman said that he differed with Mr. Nimatallah. In the context of the new debt strategy, the role of the Fund as a catalyst was in fact gaining enhanced significance. Indeed, more countries were presently entering into programs with the Fund than ever before. While that was possibly a temporary phenomenon, it would certainly have an influence on the period covered by the Ninth Review.

Mr. Nimatallah stated that he could agree with the Chairman that the catalytic role of the Fund was enhanced, in the sense that the Fund's approach to financing was becoming less restrictive; in some circumstances, the Fund was willing to accept some arrears incurred by countries to commercial banks, and it was sometimes willing to help countries in finalizing negotiations with the banks.

Also with respect to paragraph 8, the use of the term "continued access" in the second sentence could be misleading, Mr. Nimatallah noted. Therefore, that sentence should be changed to read: "Furthermore, the Fund's role in the strengthened debt strategy implies that, when appropriate, additional amounts of interest support would be provided in accordance with guidelines for use of Fund resources."

The Chairman remarked that the words "continued access" in the second sentence of paragraph 8 referred to the obligation of the Fund to be impartial in offering members, and in particular indebted countries, similar access to its resources whether they came to the Fund before or after the quota increase. Perhaps that point could be made more explicitly, but for the strengthened debt strategy to work, the Fund had to ensure that access would be broadly maintained. While he was not calling for higher access limits, he wondered how the Fund could maintain its credibility with respect to commercial creditors if it decreased the level of its own financing.

Mr. Nimatallah commented that he was not in disagreement with the argument put forward by the Chairman, but he considered that the language used in paragraph 8 could send the wrong signal to the international community.

Mr. Hogeweg considered that the term "continued access" was ambiguous in that it could be interpreted in two different ways. On the one hand, it could be taken as relating to different countries over time, and, on the other hand, it could be taken as relating to the same country over time--as if the Fund would continue granting access to the same country repeatedly.

Mr. Cassell suggested that, since the word "continued" was the source of ambiguity, that word should be changed to "maintain."

Mr. Warner remarked that he supported Mr. Cassell's suggestion to replace the word "continued" with "maintain," because such a wording would send the correct signal--that the Fund would maintain normal and uninterrupted relations with member countries. In addition, paragraph 8 could be made more neutral if the second sentence ended after the words, "guidelines for use of the Fund's resources."

Mr. Evans noted that it would be more appropriate to change the first word of the second sentence in paragraph 8 from "furthermore" to "accordingly."

Mr. Hogeweg stated that, because the Fund's role in the debt strategy did not imply that continued access was in accordance with the guidelines, the word "if" should be inserted into the final part of the second sentence in paragraph 8.

The Executive Directors agreed to amend the text of paragraph 8 to read as follows:

> The Fund's role as catalyst at the center of the system is of enhanced significance in the light of its role in the strengthened international debt strategy: the full implementation of a growth-oriented adjustment program agreed with the Fund by highly indebted members is a key element of the debt strategy upon which the successful involvement of other parties

depends, and lays the basis for such members to achieve sustainable external payments positions, renewed economic growth and price stability, and helps to restore members' creditworthiness with official and private creditors. Accordingly, the Fund's role in the strengthened debt strategy calls for access to the Fund's resources being maintained at a level that would permit the Fund to provide resources to members, including resources for debt and debt-service reduction and additional amounts of resources for interest support, in accordance with existing guidelines for use of the Fund's resources. Directors emphasized that the Fund's role in the strengthened debt strategy needs to be considered in the broader context of the Fund's basic responsibility of providing general balance of payments financing on appropriate terms and conditions in support of growth-oriented adjustment programs, taking into account the catalytic role of the Fund.

Mr. Warner proposed that the following paragraph be added to the section on the role of the Fund in the 1990s, following paragraph 8:

Despite the broad agreement reached by Directors on these aspects of the role of the IMF in the 1990s, important differences remain on a number of other aspects. To begin with, there are differences about the relationship between the monetary character of the Fund and prolonged use of IMF financing, the lengthening of the Fund's maturity structure, the large and growing arrears, and demands for net transfers from the Fund. Second, there are divergent views on the question of whether the universal character of the IMF is affected by the tendency for industrial countries and some developing countries to be seen solely as creditors or debtors. Third, different conclusions have been reached regarding the relationship between arrears to the Fund and public support for the IMF. Lastly, there remain important differences concerning the appropriate balance between adjustment and financing in IMF-supported programs, and the ensuing implications for the demand for IMF resources.

However, in light of the length of the proposed additional paragraph, Directors might require some time to consider its merits, Mr. Warner noted. Therefore, it might be useful to return to it in the afternoon session.

The Executive Directors then agreed to continue their discussion of the revised draft report of the Executive Board's report to the Interim Committee on the Ninth General Review of Quotas in the afternoon.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/89/118 (9/6/89) and EBM/89/119 (9/8/89).

3. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 89/25 through 89/27 are approved. (EBD/89/270, 8/31/89)

Adopted September 7, 1989

4. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAP/89/212 (9/5/89) is approved.

APPROVED: May 1, 1990

LEO VAN HOUTVEN
Secretary