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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 88/144

10:00 a.m., September 9, 1988

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

Executive Directors	Alternate Executive Directors
	E. T. El Kogali
F. Cassell	C. Enoch
	Zhang Z.
	C. S. Warner
J. de Groote	
	E. C. Demaestri, Temporary
M. Finaish	
G. Grosche	B. Goos
J. E. Ismael	J. Reddy
A. Kafka	
M. Massé	D. McCormack
Mawakani Samba	
Y. A. Nimatallah	
G. Ortiz	L. Filardo
J. Ovi	M. Fogelholm
H. Ploix	D. Marcel
G. A. Posthumus	
C. R. Rye	
G. Salehkhou	O. Kabbaj
	L. E. N. Fernando
K. Yamazaki	S. Yoshikuni
S. Zecchini	

L. Van Houtven, Secretary and Counsellor
M. J. Miller, Assistant
R. Gaster, Assistant

Also Present

Asian Department: R. J. Corker. European Department: P. B. de Fontenay, Deputy Director; P. E. Guidotti, J. Saito. Exchange and Trade Relations Department: J. T. Boorman, Deputy Director; P. A. Acquah, R. A. Feldman. External Relations Department: A. F. Mohammed, Director; D. D. Driscoll, P. C. Hole, I. S. McDonald. Fiscal Affairs Department: V. Tanzi, Director; T. M. Ter-Minassian, Deputy Director; A. H. Mansur. IMF Institute: O. B. Makalou. Legal Department: W. E. Holder, Deputy General Counsel. Middle Eastern Department: S. von Post. Research Department: J. A. Frenkel, Economic Counsellor and Director; A. D. Crockett, Deputy Director; M. Goldstein, Deputy Director; F. C. Adams, N. R. Chrimes, R. A. Feldman, R. P. Flood, S. J. A. Gorne, J. H. Green, R. D. Haas, Y. Harada, E. Hernández-Catá, M. S. Khan, F. Larsen, P. R. Masson, P. J. Montiel, B. E. Rourke, M. Schulze-Ghattas, S. A. Symansky, E. Y. P. Tung, M. A. Wattleworth. Secretary's Department: C. Brachet, Deputy Secretary. Treasurer's Department: S. I. Fawzi, Y. Ozeki. Western Hemisphere Department: S. T. Beza, Director; J. Ferrán, Deputy Director; Y. Horiguchi. Personal Assistant to the Managing Director: H. G. O. Simpson. Advisors to Executive Directors: N. Adachi, M. Al-Jasser, P. E. Archibong, M. B. Chatah, W. N. Engert, M. Eran, A. G. A. Faria, K.-H. Kleine, P. D. Péroz, P. Péterfalvy, M. Pétursson, G. Pineau, A. Vasudevan. Assistants to Executive Directors: F. E. R. Alfiler, S. Appetiti, H. S. Binay, V. J. Fernández, B. R. Fuleihan, C. L. Haynes, J. Heywood, A. Iljas, J. M. Jones, C. Y. Legg, V. K. Malhotra, D. V. Nhien, C. Noriega, L. M. Piantini, S. Rebecchini, S. Rouai, C. C. A. van den Berg, E. L. Walker, R. Wenzel, Yang J.

1. WORLD ECONOMIC OUTLOOK

The Executive Directors continued from the previous meeting their discussion of the staff paper on the world economic outlook (EBS/88/167, 8/15/88). They also had before them a background paper with annexes (SM/88/181, 8/16/88) and a statistical appendix (SM/88/180, 8/16/88 and Cor. 1, 8/19/88).

The Economic Counsellor observed that one of the major issues that had arisen in the discussion was the fear that many Directors had expressed of overburdening monetary policy. Behind that fear lay the implicit assumption that recourse to other policy instruments would not be forthcoming. Such a presumption carried the danger that, since the economic authorities seemed reluctant or unable to use other policy instruments, only monetary policy could be applied. He believed that, even though the effects of fiscal and structural policies were slow to be seen, those policies were, nevertheless, complementary to monetary policy. Also, the fact that the effects of those policies were seen only slowly militated in favor of their early adoption.

Many Executive Directors, including Mr. Ovi, Mr. Rye, and Mr. Zecchini, had drawn attention to the dangers of expecting monetary policy to bear too much of the burden of adjustment, the Economic Counsellor continued. Some Directors had also observed that complementarity among policy instruments could not be safely assumed, in that inadequate adjustment on the structural and fiscal side could not necessarily be compensated for by a more intensive application of monetary policies. Of course, perhaps the costs of adjustment could be lowered by strengthening fiscal and structural policies while moderating monetary policy, but the one could not compensate fully for the other.

Concern about interest rates had also been evident in the remarks of Directors, the Economic Counsellor went on. Two key questions arose in that regard: the first was assessing the danger of the recent upward movement in interest rates; the second was identifying the mechanism that was creating the changes in interest rates. An interesting point made in the discussion was that a given change in the interest rate might have a fundamentally different effect on the economic system, depending upon whether it was an isolated or a concerted interest rate movement, and whether or not it represented a break in communication, or the culmination of communication, between the authorities. Consequently, investigating the change in interest rates needed to be accompanied by an investigation of the reason for the change. Several Directors, including Mr. Ismael and Mr. de Groote, had made the point that increases in interest rates bore with them significant costs for the debt of developing countries, and that a change in interest rates altered not only the outlook for inflation, but also the outlook for growth and economic performance of countries in general. He further recalled that Mr. Zecchini had emphasized that the direction of interest rates had a significant impact on expectations, and that the output effects of a tightened monetary policy depended very much on the signals that were thereby sent to the markets about the credibility and seriousness of the monetary authorities in their attempts to deal with inflation. Consequently, he interpreted Mr. Zecchini's intervention to suggest that although higher interest rates carried with them an unavoidable cost, they also carried some advantage, in the sense that the seriousness of the monetary authorities in fighting inflation was thereby demonstrated.

There had been an interesting change in the mood of the Board with respect to inflation fears, the Economic Counsellor noted. Two months previously, during the discussion of exchange rate developments, he had believed that the Board felt that the fears of inflation were not as well grounded as the staff had portrayed. In the current discussion, in contradistinction, it appeared that Directors now believed that the inflation concerns were more grounded in fact than before, even though inflation had not currently manifested itself fully. The tenor of the discussion was that inflation should be accorded a high priority. He recalled that Mr. Rye had said that the dangers of inflation were more imminent than the staff had indicated when they had spoken about the possible re-emergence of inflation. Also, Mr. Massé had noted that in his view a more acceptable assumption about the inflation target in the medium-term scenarios would be zero inflation, thereby signaling that a given positive rate of inflation would not be considered acceptable. Finally, he remembered that Mr. Yamazaki had stressed the need to resist inflation before it became manifest, and to address inflation with preemptive measures before such measures became actually unavoidable.

From the operational viewpoint, the Economic Counsellor commented, the big question was what indicators of inflation needed to be heeded, at a time when there was as yet no firm evidence that inflation was indeed increasing. It had become clear that there was no single leading indicator of inflation. The commodity price indicator, as Mr. Salehkhou had remarked, had many limitations. Monetary aggregates could be used as an indicator of inflation, but as many central bankers knew, the link between monetary aggregates and prices was not as rigid or direct as it once seemed. In consequence, it was probably more useful to look at a broad spectrum of economic indicators, rather than to search for, and heed without exception, a single indicator. Even though Mr. Templeman had mentioned that an acceleration of inflation was unlikely, it was fair to say that the Board was generally seriously concerned about it. Perhaps like Mr. Nimatallah, Mr. Templeman was optimistic that the serious problems that had arisen from past inflation had convinced policymakers of the need to resist it at all costs in the future. The degree of rigidity of exchange rates had profound implications for the impact of monetary and other policies on inflation. In that respect, the focus on inflation served as background for a more general discussion of the international monetary system.

The need to address fiscal policy in a medium-term perspective was stressed by many Directors, the Economic Counsellor recalled. Mr. Ismael had mentioned that a too abrupt correction of fiscal imbalances was imprudent, an assessment with which it was difficult to disagree. That did not mean, however, that the authorities were absolved from trying to correct such imbalances. Mr. Ovi had mentioned that the United States should undertake prompt, but not too prompt, correction of the fiscal deficit. The assessment of the proper pace at which such imbalances should be corrected needed to be made with a knowledge of the international context, however. Mr. Nimatallah had remarked that the international environment was currently in favor of greater stability of exchange rates, and there were signs that some correction to external imbalances was being effected, and that the atmosphere of crisis had lessened somewhat. Those developments indicated that the time was now ripe to accelerate fiscal consolidation. An acceleration of fiscal consolidation, in the right environment, need not be too abrupt, as long as it was seen as an indication that policies were moving in the right direction. There appeared to be a general fear of moving too slowly or too quickly even though the adjustment might be in the right direction. In his view, the reality was that policymakers often went in the wrong direction, so that if they found the right direction, moving a bit too quickly was not so important, because the effects of their adjustment on expectations and on their credibility would be entirely felicitous. It was necessary to build up a good track record with actual deeds.

The correction of the fiscal imbalances needed to be seen as part of a broader spectrum, as Mr. Ovi had observed, and, if the imbalances were not dealt with in a coordinated manner, exchange market pressures might emerge relatively quickly, the Economic Counsellor continued. The question therefore arose as to the optimal mix of the various policy instruments. With respect to the domestic policy mix, the staff still believed that monetary policy should focus primarily on price developments, and that structural and fiscal policies should deal with other aspects of adjustment. With respect to the international policy mix, much time had been spent discussing the matter of symmetry, and whether it was desirable that surplus countries move in the opposite direction from deficit countries on an almost one-to-one basis. He recalled from previous discussions that Mr. Grosche and Mr. Posthumus had had difficulties with the symmetry argument. Much less had been said on that matter in the current discussion. It therefore appeared that it was generally recognized that the world was currently faced with a high level of aggregate demand. The fears were not so much on the recession side, but rather on the growth side, even though growth was admittedly not evenly distributed--Mr. Zecchini had pointed to the problem that the burden of adjustment was not shared equally among the European economies. The question was how should a situation be handled that was characterized by a high level of economic activity--perhaps a too-high level--in concert with evidence that an adjustment of external imbalances was beginning.

On the part of the surplus countries, the Economic Counsellor went on, as Mr. Ismael and Mr. Ovi had mentioned, it was important not to resist the appreciation of the U.S. dollar by the implementation of contractionary policies, and not to overreact to the effects of that appreciation. Otherwise, expectations would be upset. Although he recognized the dilemma of internal balance within a country and external balance on the international level, it was important to focus on what was desired in the long run. The current state of the world economy suggested that the proper course would be a correction of the large external imbalances which existed between countries, and a correction of the large fiscal imbalances within certain countries. He noted that Mr. Templeman had drawn attention to the fact that a large reduction in the fiscal deficit in the United States had not had a one-for-one correspondence with the amount of the reduction in the current account deficit of the balance of payments. That was true, but he hoped that that observation would not lead to an acceptance of the old fallacy that if A did not have a one-to-one correspondence with B, then A had no effect on B. To his mind, there was no question that the current account and fiscal deficits in the United States were linked, although he also agreed that the link was not necessarily on a one-for-one basis. Nevertheless, the policy direction that would be necessary to resolve those imbalances was clear.

Given that adjustments would be made in fiscal and structural policies, the Economic Counsellor continued, the question arose as to what should be done on the monetary side, and in particular, whether governments should intervene in the foreign exchange markets. Mr. Ovi had said that significant changes in exchange rates would not be helpful, and therefore that current exchange rates should be supported by a policy of vigorous intervention. That was correct, provided, in his view, that the governments which intervened expected that the intervention would be temporary. As both Mr. Grosche and Mr. Posthumus had pointed out, whether or not intervention was effective depended on how sustainable that intervention was perceived to be by the markets. If the intervention was not accompanied by changes in the fundamentals, it would not be effective. Conversely, if there were changes in the fundamentals, even to a small degree, and especially if those changes were concerted, exchange market intervention could have significant effects.

In that connection, the Economic Counsellor went on, the U.S. dollar had appreciated over the last several quarters. Although Mr. Templeman had commented that the appreciation was a complicated issue with complicated effects which could not be entirely discussed at present, it was his own view that the effects of an additional appreciation on the long-term outlook were obvious. It could be argued that under present circumstances a further appreciation of the dollar represented a wrong policy direction. Mr. de Groote had cautioned that additional appreciation might be dangerous if it were to mean larger depreciation subsequently.

Several Directors had inquired into the nature of the collaboration between the Fund and the OECD on structural indicators, the Economic Counsellor recalled. That collaboration was in the formative stage, generally guided by the principles of comparative advantage and common sense. The OECD had made significant efforts in investigating structural policies, which had been successful. Those efforts also demonstrated that a large amount of resources would be needed if studies on specific indicators were to be initiated. He agreed with Mr. Zecchini that it would be unreasonable to suggest either that the area of structural policies belonged entirely to the Fund, or not at all. It was difficult to address macroeconomic subjects while being limited to a subset of the available instruments, namely, fiscal and monetary policy, especially when structural policies could be seen to be an integral part of any policy package. As Mr. Zecchini had suggested, perhaps the OECD could focus more on the labor market, while the Fund could focus on finance and trade. The paper on structural policies that the staff was in the process of preparing had benefited from the input of the OECD. In any case, it would probably be impossible to arrive at an ironclad division of responsibilities with respect to structural indicators. Collaboration with the OECD was expanding relatively rapidly, including exchanges of staff between the Fund and the OECD. The Fund was also represented in some of the OECD's working parties by an observer.

The staff would address the question of the studies that the Board had suggested, the Economic Counsellor concluded. One study in particular, proposed by Mr. Ismael, was especially intriguing, on investment and expectations in developing countries given their high external debt levels and significant inflation expectations.

A Deputy Director of the Research Department recalled that Mr. Ortiz had suggested that the staff was prone to overestimate systematically the growth prospects of less developed countries. He had also stated that the staff had paid inadequate attention to debt as a factor inhibiting growth in those countries, and he believed that debt was one reason explaining the overestimates. The role of debt and growth had also been mentioned by Mr. de Groote, Mr. Ismael, Mr. Kafka, and Mr. Salehkhou. The staff did not believe that it systematically overestimated the growth prospects of less developed countries, in the sense that those prospects were usually revised downward after the event. In fact, there were some cases where the estimates were revised downward, and in other cases upward, but in fact, the staff's revisions had been generally upward with respect to most groups of developing countries over the past few years. However, Mr. Ortiz was correct that at present the staff had revised the figures downward for important groups of developing countries, particularly for the heavily indebted middle-income countries and the African countries. The fact that those revisions had been necessary raised some important issues.

One of the reasons why the staff's initial estimates might have turned out to be optimistic, the Deputy Director noted, was the fact that the Fund's area departments made their growth projections on the basis of the policies that had been agreed in the context of Fund-supported programs. Often, however, difficulties arose in the implementation of those policies. Unfortunately, slippages were more frequent than overattainment of a program. In consequence, as a statistical matter, overestimation could arise from the fact that the staff employed the latest program estimates when preparing the world economic outlook papers.

In addition, however, there was also a more fundamental problem, the Deputy Director went on. The growth prospects, as well as the growth performance, of the heavily indebted countries had been systematically weaker over the past few years than they had been for countries that had avoided debt problems. That difference in performance could not be regarded as simply a coincidence. There was a causal link between growth performance and indebtedness. The link, however, was not a simple one. The relationship between indebtedness, the constraints--of both an economic and political nature--that applied to policy, and economic performance, needed to be investigated, and the study that the Economic Counsellor had referred to was one aspect of it. Nevertheless, he agreed with Mr. Ortiz that the matter was complex, and said that the staff would give more attention to it in the future.

He had noted that Mr. Posthumus was not persuaded that it was necessarily appropriate for a country in fiscal surplus to consider further fiscal restraint, the Deputy Director continued. He had cited the United Kingdom as an example. The issue of what should be the appropriate long-term fiscal stance was very important, and one that was very difficult to analyze. Yet it was becoming a more relevant problem as countries made progress in fiscal consolidation, and it became less clear that additional fiscal restraint was necessarily the most appropriate course to follow.

There was a multiplicity of possible criteria for determining the fiscal stance, the Deputy Director observed. Should the fiscal stance be used to stabilize the debt to GDP ratio, to stabilize the real value of government debt; or to stabilize the nominal value of government debt? Those were just some of the difficult questions that would arise. Should asset sales and revenues from depletable natural resources be included in receipts? That was a relevant question both for the United Kingdom and the Netherlands. Should provision be made for future expenditures, for example, social security expenditures resulting from the aging of the population structure? Those considerations might imply that a zero balance would not always be an appropriate target. More generally, if economic policy was seeking multiple objectives--for example, external and internal balance--it might not be possible to have a set fiscal policy and to rely on changes in monetary policy alone to achieve the objectives. He did not wish to suggest that the staff had a simple answer to the question, but only that the question of the appropriate fiscal position could not be easily answered. It was perhaps a matter to which the staff should return, possibly in the context of a more in-depth staff study.

The reason that, in the staff's medium-term scenario, a constant monetary target appeared to be compatible with a fairly lasting increase in inflation, was because of the influence of the behavior of velocity, and the responsiveness of velocity to interest rates, which, in turn, tended to respond to expectations of inflation, the Deputy Director commented. An inflation shock could cause interest rates to increase, which would lower the demand for money, consequently making a given rate of monetary growth consistent with higher inflation. On a more technical level, the staff's model allowed for some departures from monetary targets in the short run in order to prevent excessive increases in interest rates. The main point, however, was that simply holding monetary growth constant might not be a sufficient response on the part of the authorities if the factors causing an initial inflationary shock were also contributing to changes in velocity. Over the preceding few years, velocity shifts had been beneficial, as the velocity of money had been falling, and monetary growth had fallen by less than inflation. Conversely, the effects could be adverse if expectations of an acceleration of inflation were to develop.

Another Director had wondered what the staff's view of off-market financing techniques was, and whether such techniques would be a positive factor in helping to finance the U.S. balance of payments deficit, or whether they would get in the way of adjustment, the Deputy Director stated. If the correct policy fundamentals were in place, and the difficulty facing the authorities was the financing of a transitional deficit, then the use of off-market financing techniques could help to smooth market expectations and stabilize exchange rates. If those off-market financing techniques had the effect of reducing the pressure on the authorities to follow appropriate policies, then they could be harmful. The fact that the staff's current projection envisaged that substantial deficits and surpluses would continue, with present policies and at present exchange rates, implied that the staff believed that further policy steps needed to be taken, so that a fully sustainable position into the medium term could be assured.

As to why inflation should be significantly affected by commodity prices, the Deputy Director remarked, it was not the direct contribution of commodity prices that explained the use of commodity prices as an indicator of inflation, but rather the fact that commodities tended to be traded in markets that were sensitive to inflationary factors. Therefore, if inflation appeared in commodity markets, that might be a prior indication of inflation that would appear shortly in other markets. If those signals of inflation were properly interpreted and responded to in a timely fashion, that surge of inflation in other markets might not occur. However, he agreed with Mr. Salehkhou that in practice the predictive power of commodity prices on future inflation was limited. The staff was not suggesting that rises in commodity prices should be followed by policies designed to drive down commodity prices. The staff's chief concern was that signals of inflation resulting from changes in commodity prices should be responded to appropriately. Obviously, necessary relative price changes would have to be permitted, which might well mean a strengthening of commodity prices relative to prices of manufactures. However, relative price adjustments would have to be prevented from feeding through into a general increase in inflation.

The staff representative from the Research Department recalled that Mr. Enoch had raised the question of why there was an apparent discrepancy in the staff's projections between the assumptions for primary commodity prices and the evolution of the terms of trade for primary product exporting countries. It was puzzling at first that such a discrepancy should exist between the terms of trade of those countries, which were projected to improve only marginally over the forecast period, and the significant increases projected for commodity prices. There were a number of explanations for that discrepancy, however. First, export prices were usually much less volatile than spot commodity prices, mainly owing to the existence of contracts. Second, the prices of some commodities that were particularly important for many developing countries, most notably the prices for tropical beverages, had been relatively weak. Third, although some of those countries were classified as primary commodity exporting countries, they were also exporters of oil, which in the current situation contributed negatively to the terms of trade. Finally, a large number of the commodity exporting countries had allowed their currencies to depreciate substantially over the past years, which had helped them to improve their competitive position. However, the impact of the currency depreciation on the terms of trade was negative. Consequently, the lack of any significant improvement in the terms of trade for commodity exporting countries could be explained not so much because commodity price increases had not been taken into account, but by a number of offsetting factors. The staff would continue to examine that question in revising the projections for the Interim Committee.

Both Mr. Enoch and Mr. Templeman had raised the issue of the apparent lack of any counterpart to the projected widening of the U.S. current account deficit over the medium term, the staff representative continued. That question essentially concerned the extent to which it was appropriate in a medium-term forecast to project a widening of the discrepancy in world current account balances. In the staff's judgment, the projection of such a widening seemed appropriate in the current situation. Simply maintaining the discrepancy constant in terms of its percentage of world trade would automatically generate a widening of the discrepancy over the medium term. Furthermore, since it appeared that an important part of the discrepancy could be explained by unrecorded interest receipts, the recent increase in interest rates, along with the projected persistence of large international imbalances, could conceivably suggest that the discrepancy would widen over the medium term. Nevertheless, the staff would continue to examine that question.

Mr. Nimatallah stated that it was important that the Fund, as well as the OECD, address the matter of structural adjustment and structural reforms, because the Fund's membership was broader than that of the OECD, and included many developing countries that were heavily involved in the process of structural adjustment. He also had heard that both the Fund and the OECD performed the same type of economic exercises in the form of multicountry models. In his view, such duplication was occasionally beneficial. Consequently, some duplication of the work on structural adjustment might not be inappropriate.

The Chairman commented that the question as he saw it was who duplicated the work of whom. The Fund conducted almost yearly consultations with all its member countries, and was noted for the high quality and systematic nature of its approach. In his view, other organizations were duplicating the work of the Fund.

Mr. Nimatallah agreed that other organizations, including national forecasting agencies, often duplicated the Fund's work.

In his view, countries in fiscal surplus should attempt to reduce their debt levels, Mr. Nimatallah went on. In the United Kingdom, the fiscal surplus provided the Government with the opportunity not only to reduce its debt burden, but also to enhance its savings ratio. He believed that that prescription would be useful for other countries in the same situation as well. When the appropriate policy mix required further fiscal efforts to reduce expenditure, even when the country was in fiscal surplus, fiscal as well as monetary measures should be resorted to.

He agreed with the point made by the Deputy Director of the Research Department that commodity prices were scrutinized because they reacted more quickly than other prices to changes in demand, and that the staff's intent was not to design policies to reduce, necessarily, commodity prices, Mr. Nimatallah remarked. He would like to reiterate that increases in commodity prices, and particularly in oil prices, had not led to inflation, but had rather been a response to greater demand. Consequently, commodity prices should not be blamed for creating inflation.

Mr. Posthumus observed that he agreed with Mr. Dallara's chair that the link between the fiscal deficit and the balance of payments deficit was not always clear. In the Netherlands, a huge fiscal deficit in concert with a current account surplus had been sustained for a period of more than ten years; in that particular example, he believed that the major explanation lay in the level of national savings.

Mr. Ortiz commented that he agreed with the Deputy Director of the Research Department that when looked at as a whole, the systematic overestimation of the performance of the developing countries was not as apparent. However, for specific subgroups of developing countries, the projections of growth had been revised downward, especially if more than one indicator of performance were considered. The actual performance of the heavily indebted countries and of African countries had been less satisfactory than what had been projected in the world economic outlook studies. He recognized that the Deputy Director had pointed as a source of that problem to the fact that, in making its projections, the staff assumed that programs as agreed with the Fund would be in place, and that they would attain their targets. If policy slippages occurred, performance would not be as strong as had been anticipated. To his mind, however, the question was whether the targets themselves that were formulated under those programs, as well as the economic prospects, were realistic to begin with. Another question concerned the effects of very large debts on adjustment possibilities. High levels of indebtedness had a direct impact on growth through investment, but there was also the indirect link from debt to adjustment to growth and performance in other areas. He noted that, as had been reported in the Financial Times and in the Washington Post, a group of commercial and investment bankers had concluded that the debt overhang was strangling economic growth and performance in the indebted countries. That conclusion, it appeared to him, went a bit farther even than the Fund had gone, and perhaps the Board should consider it seriously in its future deliberations.

The Chairman inquired whether the group of banks Mr. Ortiz had referred to had available to it as useful an instrument as the papers on the world economic outlook from which to draw its conclusions. He also wondered whether the banks' pessimism about the effects of the debt overhang could be attributed to more accurate data. If so, he would like to know what that data consisted of. He would appreciate knowing whether the banks were now willing to be more generous with their own money, or with the money of others.

Mr. Ortiz replied that the banks had stated that banks would benefit from granting voluntary debt relief to debtor countries. They had also mentioned that it would be important to have stronger initiatives from governments in the design of debt relief mechanisms. His interpretation of the banks' report was that both the banks themselves and governments would have to participate if the debt crisis were to be resolved.

The Chairman stated that he was delighted to note that the banks were repeating a point which the Fund had been repeating endlessly, that all parties involved in the debt strategy needed to do more and to do better.

Mr. Nimatallah remarked that the unusual amount of resources that had once been available because of the boom in oil exports from countries like Saudi Arabia was no longer available. Consequently, those resources could not be used to resolve the debt problem, or contribute to growth. The amount of those past resources could only be considered as an abnormality. The world had to adapt to a more normal situation, and that adaptation would necessarily be at the expense of growth. Countries such as Saudi Arabia and Mexico had had to bear a large burden of the adjustment already, in terms of declining rates of economic growth. Further adjustment would necessarily reduce growth rates below those that would be necessary if the debt problem were to be resolved.

The Chairman then made the following summing up:

This discussion has covered a wide range of issues. In summarizing it I will deal first with comments that were made on the realism of the staff projections, then touch on the principal topics for discussion suggested in the final section of the main paper.

1. Realism of the projections

Most Directors agreed with the staff that the pace of economic expansion in the industrial countries, which has been very strong over the past 18 months, is likely to moderate in the remainder of 1988 and in 1989 to a rate that is more in line with the expansion of economic capacity. They felt that the major factors underlying the recent acceleration in growth were mostly temporary in nature. Some Directors thought that the staff's short-term inflation projections were on the low side and that monetary conditions might eventually have to be tightened by more than was allowed for in our projections. Others, however, cautioned against overreaction.

Several Directors noted the limited impact that the favorable external environment seems to have had on current and projected growth in many developing countries. Some felt that the staff was being optimistic in projecting a strengthening of growth in the period ahead. In their view, what they termed the "debt overhang" would continue to exert a depressing effect on growth. Many Directors interpreted recent trends in developing countries as evidence that all three elements of the debt strategy, namely, better domestic policies, increased external capital flows, and a favorable external environment, are necessary conditions for growth to improve, particularly in the low-income and heavily indebted countries.

2. <u>Policies for a stable expansion in industrial countries</u>

Directors observed that there had been a fundamental shift in the pattern of industrial countries' demand over the past two years. In general, domestic demand had grown more slowly than output in deficit countries and more rapidly than output in surplus countries. It was emphasized by a broad spectrum of speakers that this shift, as well as the exchange rate realignment that it reinforced, had been facilitated by the improvements in the process of policy coordination that had taken place among the major industrial countries over the past three years.

Looking ahead to the medium term, however, many Directors expressed concern that the current expansion remained vulnerable to disturbances arising either from the persistence of external imbalances or from a revival of inflationary pressures and fears. In this regard, they thought that the staff's analysis of alternative medium-term scenarios had demonstrated clearly the benefits of addressing the inflation risk early with tighter financial policies. I was impressed to note that that point was not challenged. Directors noted with approval that recent moves by several central banks had been aimed at dealing pre-emptively with inflation. At the same time, they cautioned that monetary policy in some countries could be overburdened if it had to resist inflation without assistance from fiscal and structural policies. They noted that the staff's medium-term analysis had shown that an improved mix of monetary and fiscal policies could curb inflationary pressures more effectively while limiting the rise in world interest rates and avoiding undesirable movements in exchange rates. Inclusion of more ambitious fiscal measures in the United States, for example, could substantially reduce the cost to that country, as well as to other countries--both developing and industrial--of addressing the inflation risk.

In addition to the risk of inflation, many Directors saw the continuing large current account imbalances among industrial countries as the greatest potential threat to world economic prospects. Despite the considerable progress that had been made in reducing these imbalances, most speakers (though not all) felt that the policy measures currently in the pipeline would be inadequate to bring about a sustainable pattern of global payments. A key question in this regard was whether private markets would continue to finance the U.S. external deficit on a large scale without substantial pressures on U.S. interest rates or further exchange market disturbances.

Concerning the relative responsibilities of surplus and deficit countries, most Directors observed that the sharp imbalance between saving and investment in the United States had to be addressed more urgently and effectively. A more ambitious reduction in the federal budget deficit would reduce inflationary pressures and make room for the required strengthening in the external position.

In the surplus countries, Directors said that efforts should be directed to ensure that domestic demand remains strong. As several speakers noted, most surplus countries have growth rates that are satisfactory, or are at least picking up. It was also noted that some of the newly industrializing economies in Asia had scope to liberalize imports, to rationalize their internal distribution systems, or to allow their currencies to appreciate.

3. Implementing and monitoring structural policies

In discussing policy requirements in the current situation, many speakers put great emphasis on the fact that strong and durable growth depends not only on stable demand policies, but also on improvements in the supply side of the economy. The growth of capacity in a number of countries is inhibited by rigidities and distortions in markets for goods and factor services. Their removal could open the way for stronger growth of aggregate demand without leading to inflationary pressures. The reforms with the most important macroeconomic implications appear to be those that would improve the functioning of labor markets--particularly in Europe, which suffers from persistently high unemployment rates--as well as those designed to rationalize industrial policies. As several speakers noted, however, there is no reason to limit structural reforms to surplus countries--there are many structural reforms that could benefit deficit countries as well, such as measures to raise domestic savings, to eliminate subsidies to consumers and enterprises, and to eliminate trade restrictions. At this juncture, I should underline the unanimous view of the Board that protectionism in any form, whether from border or nonborder measures, was a destructive, and ultimately a self-defeating way of tackling economic problems.

Concerning the Fund's ability to monitor structural reforms with indicators, many Directors agreed that there are many difficulties in this area and that we should proceed cautiously. Nevertheless, it was felt that the staff papers had clarified the issues in this area, and that this work could usefully be extended. In this context, most Directors thought that Fund Article IV consultations should properly focus on analysis of structural issues, including such experimentation with quantitative indicators that might be appropriate. Indeed, they thought that this analysis should form a central part of the Fund's contribution to the member country in the consultation, and pointed to the recent consultations with the Federal Republic of Germany and the United States as models. On the question of whether the multilateral system of macroeconomic indicators should be extended to the structural area in the world economic outlook exercise, almost all Directors were of the view that this would be premature.

4. Strengthening growth in developing countries

Many Directors noted the striking contrast in the extent to which different groups of developing countries had benefited from the strong growth of world trade and of commodity prices over the past year. Countries that have avoided debt-servicing problems had gained most; in contrast, growth in the heavily indebted and low-income countries appeared to have responded relatively little to the improved external environment.

A distinguishing feature of those countries that have avoided debt-servicing problems is that they have maintained the quantity and quality of investment through the 1980s, while those with debt-servicing problems have not. Thus, for the countries with debt problems, many speakers stressed the importance of policies that would restore financial stability and raise the level and quality of investment. The actions necessary to accomplish these goals would include both macroeconomic policies to mobilize national savings and control inflation, and structural policies to improve the efficiency with which existing resources are used. Still, a number of Directors underlined the role that existing debt burdens appeared to play in explaining weak policy implementation and weak performance. Several speakers expressed the view that debt burdens would have to be reduced before adequate and sustainable levels of growth could be secured.

Many Directors pointed out that policy reforms in the developing countries would be more effective if the industrial countries would maintain an external environment characterized by sustained noninflationary growth, stable interest rates, and open markets. In this latter regard, some speakers stressed the importance of reforms of industrial policies and of liberalization of trade in agricultural products by the industrial countries. Other speakers emphasized the self-reinforcing nature of the reform-and-growth cycle, as they found a clear association between the success of domestic adjustment policies and the availability of external financing to supplement higher domestic savings.

Despite the similar necessity for domestic policy reform in the small, low-income countries, there was general agreement among Directors that domestic reform alone would not be sufficient. These countries need additional external resource flows on concessional terms, on a sustained basis, if they are to raise living standards at a rate sufficient to keep them from falling ever further behind those in the rest of the world. The best way to achieve both objectives, Directors argued, was to strengthen mechanisms that link policy reforms to external inflows--such as the Fund's structural adjustment facility and enhanced structural adjustment facility schemes--and to implement the debt reduction initiatives taken at the Toronto summit; I felt a special sense of urgency in the statements of several speakers in that regard.

5. Fostering stability of the international monetary system--the role of the Fund

A number of Directors noted also that the multilateral surveillance we undertake in our world economic outlook discussions is an integral part of the Fund's duty to monitor the functioning of the international monetary system. In this connection, Directors were in agreement that substantial short-run exchange rate volatility is not conducive to the smooth working of international monetary arrangements, although some long-term flexibility is essential. Several speakers stressed that the system should evolve in ways that would help avoid the large swings in exchange rates that we have experienced in the 1980s. To accomplish this goal, most Directors favored an intensification of policy coordination among the major industrial countries, guided by the procedures that are in the process of being developed, including the work which will be undertaken in the following weeks and months in the Executive Board.

Several speakers considered that the recent appreciation of the U.S. dollar raised questions about the medium-term sustainability of the current pattern of exchange rates, and that this episode served to reinforce the case for closer cooperation on economic fundamentals. It was felt that policy coordination should actively utilize the indicator approach, comparing actual developments in macroeconomic indicators to a projection of such indicators considered to be both desirable and sustainable over the medium term. However, most Directors thought that those comparisons should not, for the present, trigger automatic policy responses. Similarly, most speakers did not favor extending the indicator approach to the structural area at this time. Directors did express strong support for the continuing development of the medium-term scenario analysis incorporated in the staff papers, noting that it provides a valuable way to analyze and understand the implications of different policy stances among countries.

6. Publication of the World Economic Outlook documents

It is agreed that we should avoid publishing material that might be misinterpreted by market participants or that might complicate the process of reaching consensus on policy reforms. However, I believe that it is also generally agreed that we should provide the press and public at large with an accurate picture of the projections and analysis on which Fund policies are based. This can contribute to the stability of exchange markets which we are looking for.

In the past, the staff has been directed to edit the text carefully to take into account views expressed at the Board and to ensure that market-sensitive projections were removed. In practice, this procedure meant that the medium-term scenarios for industrial countries have been presented in the main text in qualitative terms only, although corresponding quantitative estimates for developing countries were published in the April 1988 World Economic Outlook. At some stage, I believe we need to address the issue of publishing at least some quantitative estimates for industrial, as well as for developing, countries. I would propose that the staff undertake a judicious extension of the degree of quantification that was included in the last published World Economic Outlook, in consultation with the offices of the Executive Directors most closely concerned. However, the detailed scenario results in Annex IV would not be published, nor would the detailed baseline projection for individual countries. The annex on structural indicators would not be published now, but following our discussion in depth in November on the larger staff paper on structural issues we may wish to re-examine the question. The two short annexes covering the current expansion in historical perspective, and potential output and capacity utilization in the major industrial countries, would be published.

May I also remind Directors that it is the intention to make minor changes to the projections in the light of recent data, and that 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 in Berlin. The printed World Economic Outlook is expected to be available by mid-October.

The Chairman, in response to questions raised by some Directors, said that the problem of countries in fiscal surplus had not been debated adequately. If the Board was to address that issue--and he hoped that it would--it would be necessary to recognize that countries in fiscal surplus constituted a very varied group. As had been mentioned, the United Kingdom had a budget surplus, but so had many highly indebted countries and their situation needed to be viewed in a different context. It was important not to discourage countries with budget surpluses from being, perhaps, overvirtuous.

The Executive Directors then concluded their discussion of the world economic outlook.

2. INTERNATIONAL ECONOMIC COORDINATION

The Executive Directors considered a staff paper on international coordination of economic policies (SM/88/183, 8/12/88).

Mr. Nimatallah made the following statement:

The purpose of today's discussion is not to debate whether or not coordination is useful for improving global economic performance. That discussion is behind us, and coordination and cooperation have proved helpful, both in improving the quality of domestic policies and in taking into consideration international policies when designing such domestic policies.

Member countries are so interdependent today that countries cannot afford to go back to the noncoordination era. It is true that some obstacles exist, like differences on objectives, or on the problems that countries face, or on the short-term costs of coordinating policies. There is also mistrust of the United States as the biggest country, one that can bully other countries when it wants something, but cannot be bullied itself. All these obstacles can be minimized if there is enough recognition that coordination will result in a better economic outcome for all.

Today's discussion should focus on means of sharpening the tools of coordination to make that benefit even larger. I know that this is difficult for some industrial country representatives, but their policies and the implementation of those policies are not purely their business alone. The impact of those policies is so large on everybody else that others have the right to ask for more coordination. We can now see the benefits of coordination even more clearly than in the past, and hence I appeal to industrial countries to be more amenable in accepting additional ways and means of strengthening coordination.

One of the more important areas concerns possible additional technical assistance from the Fund to the Group of Seven for improving the coordination process. What is pertinent here is that countries other than the G-7 members have the right to use the Fund as a forum to express their views and concerns, so that those views can be taken into consideration in formulating and implementing policies in the Group of Seven. The Fund has done a good job in improving economic indicators to help G-7 policymakers to produce better policy forecasts. The Fund staff and the Managing Director are moving in the right direction, and they have won the trust of all sides in the process of coordination. This process should continue. However, the time has come for the tools of monitoring the performance of economic indicators to be sharpened, for greater efficiency and better outcomes.

I can, with confidence, say that setting ranges in managing and coordinating on exchange rates has worked well. Therefore, the idea of setting ranges could usefully be extended gradually to cover other indicators, and I nominate inflation rates as a prime candidate for monitoring within ranges. Of course, as usual, that should be done with great flexibility, and with an eye to medium-term performance. In the medium term, another nominee for monitoring could be an external balance range, as related to GDP.

These two areas should constitute another experiment with ranges which will help to identify more criteria for assessing the evolution of economic variables, and thus perhaps assist in indicating desirable or sustainable levels of performance for the major countries. However, the criteria for determining desirable or sustainable levels are yet to be developed.

I invite the staff to devote some time to this area, because I suspect that honest disagreements might appear on medium-term sustainability or on certain performance characteristics of certain countries. I understand, for example, that honest disagreements exist on the size of a sustainable external deficit for the United States. Many would like the United States to continue to be in external deficit, to play the role of a locomotive for global growth. The difference in views might be related to the magnitude of this external deficit. One criterion that could be examined for determining the sustainability of external imbalances among major countries, for example, could be the extent of voluntary private sector capital flows. This involves, of course, investment and savings ratios, which are also relevant. In any event, the staff can explore this area further.

The next area that is logically connected with the identification of desirable and sustainable ranges is the necessary triggering of special consultations when actual outcomes appear to diverge markedly from desirable levels. Here again, it may sound startling to certain industrial countries in the Group of Seven for them to be subjected to special consultations, particularly if they are not sure that this process can be applied to all members. This reminds me of the feelings of the developing countries vis-à-vis industrial countries as a group. I agree, however, that if the principle of uniform treatment among the Group of Seven is adhered to, and if coordination means taking matters in medium-term perspective, there can always be plenty of flexibility in triggering policy modifications.

In conclusion, the world needs more confidence that it will benefit further from the improvement in global economic management through coordination. The Group of Seven has to take into consideration not only its own members, but also the rest of the world. The Fund can play a helpful and effective role in improving economic indicators and in conveying the concerns of countries outside of the Group of Seven. Maybe some day the Fund will, at some point, construct economic indicators for those other countries.

I should not miss this opportunity to say that structural adjustment indicators should also be constructed and improved within the Fund. I cannot accept the view of the few who claim that the Fund staff is already overburdened, and therefore that the OECD can do the job better. I did not hear them say that when it came to the world economic outlook exercise; the Fund is already involved in structural adjustment with its developing country members, and it should extend this in every way possible to other countries.

Mr. Ismael made the following statement:

I share many of the staff's views on the international coordination of economic policies. These views are succinctly summarized in the first paragraph of Section V of the staff paper. I support the principles that the staff suggests should underlie the ongoing coordination exercise to sustain growth with moderate inflation in the industrial countries, reduce existing external imbalances among the largest countries, and ensure better spillover effects to developing countries.

In particular, I welcome two conclusions--namely, that coordination does not reduce the need for sound macroeconomic policies, or the urgency of eliminating structural weaknesses at the national level, and that coordination must take into account the global consequences of policies, especially the impact on developing countries. The latter point is a timely reminder that stable noninflationary growth with desirable spillover effects is an international concern, as well as a global endeavor. There are several implications here, which I shall address in my comments below.

Let me now go on to the three key issues raised in the staff paper. The Fund can only play as large a role in international coordination of economic policies as the members want to give it. There is room for the Fund to increase its technical inputs into the G-7 policymaking process. In particular, the Group of Seven can usefully consider coordination on the basis of papers prepared by the Fund, and agreed to by the Board, on the desirable direction of policies in the major industrial countries. These papers would incorporate the Board's conclusions as reflected in the summings up of its discussion of Article IV consultation reports on individual countries. This would be similar to the technical backing provided by the Fund for meetings of the Interim Committee, where the Fund identifies potential problem areas and suggests solutions for various issues. In this manner, the Fund can present a more global perspective than would be possible if the major countries themselves examined issues on coordination from the viewpoint of the Group of Seven alone. In particular, coordination of policies to preserve stability in the international monetary system, to maintain an open world trading system, to deal with the debt problem, and to work toward a more sustainable pattern of exchange rates would benefit from the truly global perspective presented by the collective Fund membership.

I agree with the staff that it would be useful to quantify the ranges of values of key indicators that are sustainable or desirable. Otherwise, there would be too much room to rationalize inaction. Such quantification should aim to provide broad targets to reduce, as fast as feasible without disruption to growth or market stability, the sources of "tensions" in the medium-term outlook. For example, the coordination process could have achieved more if ranges had been set for the U.S. fiscal and external deficits, as well as for these indicators for the major surplus countries, and greater efforts had been made to achieve the objectives. If this had been the case, the sustainability of financing for the U.S. external deficit would be posing much less of a risk for the medium-term world economic outlook. Such broad targets can strengthen the hands of the authorities considerably in promoting adjustment in the face of domestic opposition. They also unambiguously signal new policy directions to markets, thereby enhancing the likelihood of stability.

Movements in indicators should not be used as a trigger for automatic policy responses. No matter how good the model used in the analytical framework for indicators, it cannot capture the complexities of economic, political, and social forces in the real world. Hence, monitoring should, at most, only trigger special consultations to examine the causes for deviation and possible further actions.

Mr. Rye made the following statement:

International economic coordination has become something of a catch word in recent times. There is a tendency to assert that the failures of the past reflect a lack of coordination, and that more and more coordination is the answer to every prospective economic problem. Of course, on a broad definition, no one would quarrel with the need for more and better coordination. In a sense, that is what we are doing sitting around this table--internationally coordinating--and I certainly would not wish to be taken, even playing a devil's advocate role, as arguing for winding up the Fund. This assertion is rather overblown--the real failures are in underlying economic policies.

But today we are discussing coordination in the narrow sense that has gained currency in recent years. The case that there can be too much of a good thing can be made for issues of both principle and practice. In principle, international coordination might be said to involve the formation of a cartel. Cartels are of course essentially inward looking, with the interests of outsiders taking a back seat, at best. Markets do have a role, even in the interplay between national economies. Coordination involves--indeed is aimed at--overriding the market. Even when we acknowledge the many faults of markets, especially perhaps at the level that concerns us here, we need to be sure that better results can be produced by the designs of fallible men--a point that is relevant to the more grandiose schemes for guiding exchange rates.

At the practical level, the various examples described on pages 3 and 4 of the staff paper, the possibilities for, or instances of, coordination all seem to raise some questions, at least, while some examples have an otherworldly aura about them. The paper suggests that unfavorable current account consequences can be avoided if all countries undertake fiscal expansion together, a possibility that is remote in the extreme.

On page 4 there is a reference to "public 'bads' such as...protectionism." While I certainly agree that international agreements would be helpful in the fight against protectionism, a large part of the difficulty is that policymakers lack an appreciation not so much of the international costs of their actions as of the domestic costs. That point is, of course, recognized later in the paper, but only in the context of agricultural protectionism, but it applies more generally. Further down the page, it is asserted that "it seems likely... that coordination among the Group of Seven has helped neutralize protectionist pressures"--a conclusion which, I must say, is not blindingly obvious to the outside observer.

To be fair, the paper certainly does go on to present a list of practical drawbacks or obstacles to successful coordination. There is very much a real world flavor here. Indeed, even more might have been said on this subject.

To date, coordination has been most successful when dealing with specific--and usually short-run--issues such as debt rescheduling, exchange rate crises, and indeed the aftermath of the October stock market crash--a successful essay in crisis management. In such circumstances, the short-run benefits of coordination are seen by each country to outweigh the short-run costs of giving up some autonomy in setting macroeconomic policies. There is little incentive for any country to free-ride on an agreement, because the costs of a breakdown can be clearly perceived.

General economic coordination over the longer term is another matter. Here, the immediate gains are much less visible, and differing political agendas, economic structures, and trade patterns complicate the coordination process and can lead to undesirable delays in the implementation of policy.

So much for my role as devil's advocate. I would not like to leave the impression that we are at odds with the basic thrust of this paper. In fact, we very much agree with the staff: first, that it is the quality of policies rather than the quantity of coordination that determines results; second, that experience shows that policies set in a medium-term context, paying due attention to fundamentals, not relying too heavily on a single policy instrument, and implemented judgmentally rather than mechanically, will provide the best results; third, that there is nothing in the coordination process itself that in any way reduces the need for sound macroeconomic policies and for determined efforts to eliminate structural weaknesses at the national level; and fourth, that "one of the most important benefits of economic cooperation and policy coordination" may be the support provided to governments in implementing policies which, while in their country's best interests, might otherwise draw domestic resistance.

The question is how to go about securing better, if not more international, coordination. While we could fully support efforts to strengthen surveillance of international economic developments, we are not convinced that much is to be gained by the use of targets, triggers, and the like. Such devices certainly cannot replace the exercise of judgment. Also, it would be unrealistic to expect countries to abide by targets for key variables for the sake of international economic cooperation if those countries are unwilling to tie themselves to such targets for their own national interests.

Indicators can indeed be useful in bringing international pressure to bear on individual countries, and there is ample scope for improving our understanding of the ways in which economies function and interact. But the basic directions for policy are already well established. The more pressing structural rigidities are equally apparent.

In our view, the major shortcoming of current coordination efforts stems not from difficulties in identifying the directions in which policy should move, but from the failure of countries to implement the required policy adjustments. More sophisticated indicators would do little to address this problem. However, I note that the summing up of our meeting on this subject in July 1987 suggested an experimental approach to monitoring procedures, whereby the Managing Director would bring to the Board's attention observed departures in the indicators away from the medium-term course projected in the 1987 World Economic Outlook. The lessons of this experiment--if indeed it was pursued--are not clear, and would need to be assessed before one was in a position to make a judgment on other actions. But I wonder whether we yet have a sufficiently precise and rigorous understanding of the concept of sustainability on which to construct a range of sustainable outcomes. The staff may wish to comment on that point.

Finally, we agree with the staff that the Fund in its surveillance function has an established role in encouraging the implementation of sound policies by all countries. However, political will, not further economic research, is the key to progress in the coordination exercise, and the Fund's direct political role is essentially limited to that of honest broker--representing the views and interests of countries not directly involved in, but intimately affected by, the decisions on policy coordination. The Fund might also, from time to time, play the useful role of nagging conscience. Of course, if policy coordination did eventually move in the direction of joint policymaking, the role of the Fund in speaking for the systemic interests of the world economy would become even more important.

Mr. Nimatallah said that floating exchange rates were expected to do miracles, and they did not. After the Plaza meeting, it had been clear that managed floating was a better idea. Managed floating was working, and the designated ranges were helping it to do so. When Mr. Rye had said that ranges might not be useful because they might reduce the use of judgment, that was not an either/or proposition: ranges and judgment were mutually reinforcing.

Mr. Rye said that Mr. Nimatallah's points were all well taken, but his concern was not that there was too much coordination, but that there was too much focus on coordination at the expense of focusing on the underlying weaknesses of economic policy.

Mr. Nimatallah observed that the term "automatically" was clearly not acceptable in the Board. The point at issue rather concerned the triggering of discussions at everybody's convenience.

The Chairman noted that no national authority responsible for the policy of a country could accept an automatic necessity to act in a specific circumstance. That was totally contrary to the principles of national sovereignty.

Mr. Massé made the following statement:

We welcome the staff's informative paper on policy coordination, and particularly the emphasis on the need to consider the implications of policy coordination among the major industrial countries for the less developed countries.

In general, the staff paper presents a balanced perspective on policy coordination issues. Our judgment is also that the policy coordination process is beneficial, and is clearly worth developing further. At the same time, my authorities would like to caution against overenthusiasm, particularly since a substantial portion of the existing literature suggests that the potential benefits from coordination are not necessarily large. However, we must acknowledge the points raised on page 16 of the staff paper, that such studies do not fully take into account all of the relevant considerations, which may suggest larger gains from policy coordination than present empirical evaluations of coordination usually indicate.

It is also worth noting, and I am sure that our technical experts in the Fund staff will agree, that these studies may not take into account some possible negative considerations. For example, in some cases, policy coordination may be counter-productive if some country or countries see it as an incentive to delay necessary domestic policy adjustments, perhaps as part of a negotiating strategy designed to shift adjustment costs to others--a not unlikely possibility if we look at the experience of the recent past. In addition, as the paper correctly notes, some work has suggested that in the present state of economic knowledge, policy coordination could diminish welfare, ex post. Here, I recognize the arguments that this critique is largely an indictment of activist or fine-tuning policies when the effects of these policies are incompletely known, and that the presence of model uncertainty should still lead us to expect some ex ante gain from policy coordination.

My conclusion is that we are justified in encouraging the international interaction of policymakers, although there is also reason to be cautious about the potential gains to be made from coordination, and about the resulting policy choices. In addition, these considerations lend support to the emphasis on medium-term issues in international policy discussion, and to the supplementation of analysis with comparable cross-national indicators and multicountry simulations--as the Fund is indeed developing in Article IV consultations, the world economic outlook exercise, and the G-7 framework. The essential point is to enhance the degree of multilateral surveillance and exchange of information in order to lead to better policy decisions for the global economy, and to decrease the possibility of sharp shocks induced for narrow, purely domestic--especially short-term--interests. The point is that the prospects of achieving this are obviously greater in the context of a process of policy coordination.

It follows that my authorities agree with the characterization that the environment most favorable for policy coordination would include a focus on the fundamentals in a medium-term framework, the use of a relatively broad set of policy targets and instruments, and the judgmental implementation of policy. Any movement toward the establishment of monitoring zones should be done only carefully and gradually. Also, automatic triggers have always given us considerable difficulty, and I note Mr. Nimatallah's comment in this respect. The tone of our intervention is quite careful, and the point is not that we do not support coordination, as indeed we do, but that the studies that have been done, including those of the staff, indicate that we have to be quite careful and cautious in our expectations of the conclusions to be drawn from them. Hence, the process is much more subtle than would be indicated by a naked enthusiasm for policy coordination. Although, in principle, one might argue that the establishment of reference ranges may well, in specific cases, lead to a review, we would not like to see the possible evolution of reference zones lead to any automatic action, or preset policy adjustment on the part of participants. In this connection, my authorities would have some concerns if the coordination process were to be viewed as a vehicle for the introduction of a more rigid or binding system, which might run the risk of focusing too narrowly on particular variables, and therefore of failing to respond to broader policy issues.

Until further agreement and a more solid analytical foundation have been developed, the Fund could most productively use its resources, skills, and expertise to assess the risks and tensions in the global economy which follow from the configuration of policies. The Fund could then provide advice, on a basis that would represent a continuation or extension of the approach that has been developed in recent Article IV consultations, the world economic outlook exercise, and the G-7 framework.

In view of the data limitations and technical difficulties associated with the construction and use of structural indicators, it could be useful to supplement the Fund's advice on structural reform with detailed studies which could include, to the extent possible, quantified illustrative simulations. This work could be developed in connection with Article IV consultations, and could be used in the preparation of the world economic outlook analysis.

The global implications of policy coordination among major industrial countries are, as they should be, increasingly recognized. We welcome the development and use of the staff's MULTIMOD model in attempting to illustrate in a quantified manner some of the implications of policy measures of the major industrial countries for the rest of the world. The model is a useful addition to the analytical framework that the staff has built up in recent years to address issues of policy coordination. However, the model's development is fairly recent, and experimentation with the model along with peer review will undoubtedly stimulate improvements to strengthen our confidence in the reliability of the model's scenarios.

Mr. Ovi made the following statement:

I must confess that I am somewhat puzzled as to why we are discussing this particular paper at exactly this point in time. I see a need to develop some sort of overall framework before turning to the three specific questions at the end of the paper.

There is a clear need for economic coordination owing both to increasing interdependence between countries and groups of countries, and the fact that the widespread existence of trade barriers and other restrictions do not clearly spell out to the authorities the full effects of their own economic policies on the world economy, as well as the costs to themselves in a longer perspective.

The two main ways to come to grips with the situation seem to be, first, through voluntary agreements between the authorities in countries which realize that they have a common interest in cooperation and are able to agree on objectives for their actions, as well as measures to achieve those aims. Work along this line has advanced quite far within the Group of Seven. Second, by voluntary actions of individual countries in the realization that it is in their own interest to internalize both the effects--particularly for major countries--of their own policies on the rest of the international community, and to take into account information on measures which will be undertaken by other countries. The latter point is true for all countries, but is particularly important for smaller countries. Work along these lines is carried out under the auspices of both the Fund and the OECD.

From the Fund's point of view, the link to the work of the Group of Seven is provided by the Managing Director's participation in the G-7 meetings--albeit still in his personal capacity--together with the secretariat functions provided by the staff. With regard to the work done by the OECD, the industrial country members of the Fund have direct access to its results, which can also be easily noted by others, since all OECD reports are published.

This chair has repeatedly spoken in favor of coordination in whatever form, and under whichever auspices it takes place. Consequently, we support an intensification of the coordination process within the Group of Seven, and are willing to stand aside while the Group of Seven is developing and gaining experience with new forms of coordination. Nonetheless, the Fund should represent the interests of the rest of the membership in this process. Further, it is our expectation that, over time, G-7 coordination will be extended and integrated into the ordinary surveillance procedures of the Fund.

Enhanced exchange of information between the Fund and the Group of Seven is now warranted, in order to facilitate future efforts and to increase the total effect of economic policy coordination. Over time, we should aim to use the same indicators in both the Group of Seven and the Fund coordination efforts, together with the same set of projections. At this stage, however, it seems that the Group of Seven relates its work basically to national projections, while the Fund, naturally, uses the framework of the World Economic Outlook and the staff projections in connection with consultations.

We agree with the staff that at this point, a further strengthening of the coordination process is warranted simply in order to sustain the process. Without considerable political will, however, this is unlikely to be achieved.

In order to incorporate the coordination aspect more effectively into the Fund's ordinary surveillance procedures, supplementary work has to be done. We welcome the increased emphasis on putting measures into a medium-term framework in the world economic outlook exercise. These scenarios could, in our view, be developed even further to reflect the effects of different combinations of measures, or the lack of measures. And, as this chair has suggested on several occasions, supplementary consultations might be used more frequently--and in cases other than those of Sweden and Korea.

In general, I stress our view that a judgmental approach has to be taken in all coordination efforts in the Fund, with the help of indicators as appropriate. Indicators can be looked upon and used in at least two different ways: they can trigger a coordination action directly, like the move in an exchange rate indicator, which causes an intervention in the exchange market or makes the Managing Director decide on the need for a supplementary consultation. Indicators can also be used as information in the deliberations to persuade individual countries to coordinate their policy actions with other countries.

It follows naturally that the first type of indicators should be easy to define and to measure and, not least, must be expected to provide some certainty as to likely effects. Such indicators should be central, and should be sufficiently indisputable to open the possibility of being commonly agreed upon. It follows also that only a small number of indicators can be used to trigger actions. The other type of indicator does not necessarily need to be as well defined, and might even be expressed only in qualitative terms. Most of the indicators already in use in Fund surveillance basically serve this purpose. Only if there is no indicator which can measure a particular aspect of policy is there a need to develop a new indicator.

It is in this light that the proposals on a commodity price indicator and new structural indicators should be seen. The commodity price indicator will measure price developments for which there already exist a whole series of indicators. The main rationale for introducing such an indicator in lieu of existing ones would have to be that it would be easier to reach general agreement on this specific indicator than on the traditional measures. Turning briefly to structural indicators, it is certainly true that the enhanced interdependence of the world economy has pointed toward the growing importance not only of coordinating macroeconomic policies but also of coordinating structural policies. More stress on these questions could easily be incorporated into the Fund's ordinary surveillance process.

Finally, let me now deal briefly with the staff's three questions. First, there are two points at which coordination can be improved between the Group of Seven and the rest of the world. The more important point concerns the G-7 discussions, and we should like to see Fund participation in these discussions increased. In particular, the Fund should be dealing with the third-party aspect, and part of the discussion at least should be conveyed to us here in the Board. Monitoring zones and the triggering of special consultations should basically be applied within a framework such as that being established among G-7 countries, as there are numerous difficulties with such an approach within the Fund. One way of moving ahead might be to base the starting point in our world economic outlook exercises. We are having regular discussions about exchange rate developments, but although they can be quite entertaining, they need some footing in our general surveillance work. One way to implement target zones would be for the staff to apply informal zones around various world economic outlook forecasts, and to use those zones as triggers for inclusion in our exchange rate discussions.

Second, the trigger of special consultations must remain a matter of judgment. There is nothing which prevents, for instance, informal staff work on zones being used as a trigger for an intervention by the Managing Director.

Mr. Cassell made the following statement:

I join Mr. Rye in noting that it is important to get the underlying policies right. While the coordination of good policies would have excellent results for the whole world, the coordination of bad policies could lead to serious problems. However, I accept the general proposition in the staff paper that coordination is a good thing. Nevertheless, I think that the paper may exaggerate the potential benefits and underestimate the practical difficulties of extending further the coordination effort and formalizing its implementation.

In particular, I am not convinced of the practicality of coordinating structural policies on a broad front, or of the need to devise corresponding structural indicators. This is in no way to belittle the importance of structural reform--for industrial and developing countries alike. We in the United Kingdom, as you know, lay tremendous emphasis on it. The real question is whether the complex task of agreeing empirically robust and internationally comparable structural indicators, and then coordinating integrated reform packages based on these indicators, would in practice aid the process of adjustment. In my view, given the technical complexities and the divergent distributional and political implications of similar policies in different countries, attempts to coordinate structural reforms might sometimes retard the process of adjustment. Nor is there much evidence of significant incompatibilities in current structural reform programs. In sum, I would argue for a pragmatic approach to structural policy coordination.

Similarly, I believe that the paper is rather ambitious in its discussion of the scope for institutionalizing or formalizing the implementation of coordination. As the staff says, it would be unrealistic and inappropriate to shift the emphasis away from judgmental analysis toward a greater automaticity of response to movements in indicators. However, unlike the staff, I believe that these same cautions should also apply to a general move toward monitoring zones. The paper almost certainly underestimates the potential technical problems inherent in such a regime, in particular the difficulty of quantifying with any confidence compatible, desirable, and sustainable paths for a range of target variables, and the difficulty of interpreting divergences from a monitoring zone in a world of random shocks and structural adjustments.

The present round of industrial country meetings, the annual cycle of Article IV consultations, and the world economic outlook discussions have in combination proved extremely effective instruments of surveillance. We should build on existing judgmental and qualitative assessments of the economic environment rather than attempting to construct more mechanistic and institutionalized procedures that might be unworkable. This, of course, is not to deny the central role that indicators play as an analytical tool, by providing a common focus for discussions. That is an important role, but it is a rather different one from that envisaged in the paper.

As to whether coordination takes due account of the repercussions of policies on the developing countries, there could certainly be a danger of the G-7 countries focusing too much on their own concerns. However, it is not clear that the interests of the Group of Seven diverge significantly from those of other countries. Indeed, all the G-7 countries have close regional or historic ties with other groups of countries. Moreover, sustainable growth rates, reduced trade imbalances, lower inflation, and trade liberalization in the major industrial countries create the best possible economic environment for the rest of the world. As the staff paper points out, policy coordination is not a zero-sum game, but one that offers significant public goods or positive externalities.

Despite this essential community of interest, the recent development of aggregate indicators--including commodity price indicators--has been useful, and should make it easier to discern the impact of G-7 policies on other countries. These indicators will prove a worthwhile addition to the existing arrangements for considering multilateral and regional issues, namely, the regular Article IV consultations and the world economic outlook exercises.

Mr. Nimatallah commented that Mr. Cassell's arguments referred to discussions that were already in the past--such as the problem of a mechanistic approach. He was intrigued by Mr. Cassell's resistance to coordination on structural adjustment, and wondered whether negotiations within the Uruguay Round were part of coordinated structural adjustment.

It was important to realize that structural adjustment had spillover effects, favorable or unfavorable, on macroeconomic policies and on economic outcomes, Mr. Nimatallah continued. It is useful to take those outcomes into consideration in forecasting and monitoring economic performance. For instance, coordinated structural adjustment could not be ignored when discussing policies--as in the context of liberalizing capital markets.

Mr. Cassell remarked that his warnings had referred to the mechanizing, institutionalizing, and formalizing of economic coordination through the development of a whole set of quantitative indicators for structural adjustment. In the long run those might be very useful tools, but they would not be ready within the next two years or so, during which time the whole process of coordination would have to continue. That was only a pragmatic approach, and he certainly had not wanted to delay progress in the Uruguay Round.

Mr. Marcel made the following statement:

Let me stress, at the outset, the great importance that this chair attaches to this discussion. Indeed, intensifying coordination policies is of the utmost importance for my authorities. I see at least three reasons for the need for enhanced international coordination: the results achieved so far in this area among the larger industrial countries are very encouraging, but still insufficient; the interdependence of national economies has increased significantly in recent years; and the unprecedented amplitude of internal and external imbalances has deep-seated consequences for the world economy, and their reduction therefore requires a cooperative approach in order to avoid too disruptive an effect. I will direct my comments toward the following two questions: why is coordination largely beneficial? How could we make it more effective?

The economic literature appears to offer a somewhat mixed judgment on the desirability of coordination; many authors assert that there is clear theoretical evidence that coordination may improve global welfare. I will not dwell on the specifics of this line of reasoning. I would like to stress that the benefits of coordination are not always easily quantifiable, but they are certainly present in many areas. Coordination prevents countries from undesirably affecting other countries through independent and self-interested action; it introduces discipline--each government needs direction together with protection against complacency. Indeed, it is very useful in improving the relations of each government with domestic opinion as well as other countries. As was rightly stressed by the staff, international coordination, by mobilizing peer pressure, helps to provide governments with the political will to make difficult choices in the face of opposition arising from domestic pressure. Such discipline can only make the implementation of strong adjustment policies easier.

Coordination is likely to make each economic policy in itself more efficient, and therefore reinforce the credibility of these policies; it also gives a strong signal to the markets. The markets, as well as governments, need to understand the policy objectives and orientations of the major countries clearly in a more medium-term perspective. Recent experience has shown that the interaction between policymakers and market participants is deepening. More generally, coordination favorably influences business and consumer confidence; as was pointed out in the last world economic outlook, coordination among the Group of Seven may have significantly helped to enhance private sector economic activity.

My authorities are of the view that policy coordination among major industrial countries has recently proved its worth and has yielded some positive results, such as progress toward reducing external imbalances and stabilization of exchange rates. In any event, they consider that coordination is an impressive achievement when compared with the situation prevailing in the middle of the 1980s. However, we must stress that progress remains to be made in order to improve the functioning of the coordination process. For instance, we must achieve better coordination in the field of interest rate policy; the improvement of international economic policy coordination rests primarily on the willingness of the participating countries to play the game.

The use of indicators is of paramount importance, since they are an indispensable basis for identifying potential inconsistencies and conflicts, together with the various policy options that might help resolve them; the recent use of aggregate indicators has been very useful, but further improvement is needed in this area.

One shortcoming of the present approach is the emphasis put on short-term developments; therefore, in order to be in a better position to detect potential strains by improving consistency at an early stage, it would be advisable to frame the exercise in the medium term. That would help us to formulate our policies in a medium-term framework.

In that sense, economic coordination is different from developing medium-term scenarios which are not designed to set policy objectives but to illustrate alternative developments in the world economy. We also strongly support intensified use of medium-term scenarios to enhance policymakers' awareness of the potential threats of inconsistent policies to the world economy.

We must also strive to improve the integration of structural policy into our economic coordination process. Indeed, it is widely acknowledged that there is a pressing need for structural reforms with a view to promoting sustainable growth, and it is therefore appropriate that the coordination process encompass this new dimension of economic policies.

Better monitoring would be instrumental in strengthening the coordination process. This means that when deviations are observed, some conclusions have to be drawn; in particular, they should give rise to intensified collaboration between countries, with, however, an adequate degree of flexibility.

It is in the very nature of the Fund to fully participate in this process. It has a key role to play in the ongoing G-7 coordination exercise, and we strongly believe that it must be closely associated with the preparation and working of G-7 meetings. Further analysis should be carried out by the Fund in two areas: it should assist participating countries in formulating more precisely their medium-term objectives; and it could facilitate improved harmonization of national definitions.

In conclusion, we are convinced that deepening the coordination strategy is a first significant step, within a pragmatic approach, in improving the functioning of the international monetary system. By building on this continuing progress, we will be able to move toward an improved international monetary system, and thus promote a more stable world economy.

Mr. Yamazaki made the following statement:

We welcome this opportunity to discuss the international coordination of economic policies. Under a floating exchange rate system, exchange rate stability cannot be achieved unless all countries try to adopt sound economic policies aimed at sustainable growth without inflation. In the present interdependent world, mutually consistent policy management is particularly important for promoting greater convergence of economic performance, and thereby exchange rate stability. We strongly support intensified policy coordination.

Against this background, I would like to center my statement on three major topics in the context of Fund surveillance: the role of the Fund, the use of indicators, and the strengthening of monitoring.

Multilateral surveillance has an important role to play in assuring the smooth functioning of the international monetary system, and we have supported strengthened Fund surveillance in order to improve the convergence of economic performances.

So far, the Fund has played a useful role in surveillance on both policy actions taken by countries, and on the interactions of policy actions, through Article IV consultations and the world economic outlook discussions. We strongly support continued Fund efforts along those lines. We have also paid careful attention to the topics of discussion raised by the staff in considering the role of Fund surveillance.

The staff paper suggests the use of indicators as a trigger for special consultations. We strongly believe that indicators cannot substitute for judgmental analysis, and that indicators should not be used as an automatic trigger device.

I would assume that the staff is referring to supplemental consultations when discussing "special" consultations, because a special consultation is supposed to be conducted only in the context of the world economic outlook exercise, according to Executive Board Decision No. 5392-(77/163). Although a supplemental consultation is only a procedure to conduct a surveillance on policy actions, we have difficulties in endorsing the staff proposal. We believe that judgmental analysis should be essential for activating supplemental consultations, because such an exercise would no doubt impose a heavy burden on a member. Moreover, since the Fund has been prudent in using supplemental consultations so far, we are concerned that their increased use could lead to pre-emptive assessments on the inappropriateness of a member's policy actions. Therefore, we think it adequate to maintain the present procedure, whereby the Managing Director decides whether to implement a supplemental consultation, based on his judgment.

As the staff paper points out, structural indicators are inherently difficult to exploit. Although structural policies should play an important role in the international policy coordination process, structural issues should be addressed on a case-by-case basis, with historical and social backgrounds being seriously considered. It would, therefore, not be appropriate to tackle structural issues with a generalized approach, such as the use of objective indicators. The Fund should also address structural issues in the context of its own responsibilities, such as the promotion of exchange stability and the reduction of international balance of payments disequilibria.

Although the proposal on monitoring zones merits careful consideration, we are not convinced of the need to introduce such a procedure. We are not in favor of any triggering mechanisms. We would be concerned that monitoring zones would add an excessive rigidity to the Fund's surveillance procedure, since judgmental analysis would be replaced by the triggering mechanism. We firmly believe that Fund surveillance has been pursued in an appropriate and balanced way, based on candid discussions in the Board. We would be concerned, therefore, that monitoring zones could undermine an effective and useful element of Board discussions. We would also be concerned about the technical difficulties of setting up such zones. Moreover, even if we set up the zones, such predetermined zones could cause speculation in the market, which could increase unstable market movements.

In conclusion, we concur with the staff on the need to continue international policy coordination. Moreover, we also appreciate the significant progress made under intensified policy coordinations. Therefore, we believe that the international coordination process should evolve along the extensive path followed so far.

The Executive Directors agreed to continue their discussion 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/88/143 (9/8/88) and EBM/88/144 (9/9/88).

3. ASSISTANT TO EXECUTIVE DIRECTOR

The Executive Board approves the appointment of an Assistant to Executive Director as set forth in EBAP/88/220 (9/6/88).

Adopted September 8, 1988

4. EXECUTIVE BOARD TRAVEL

Travel by an Advisor to Executive Director as set forth in EBAP/88/223 (9/7/88) is approved.

5. TRAVEL BY MANAGING DIRECTOR

Travel by the Managing Director as set forth in EBAP/88/224 (9/8/88) is approved.

APPROVED: March 16, 1989

LEO VAN HOUTVEN
Secretary