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Minutes of Executive Board Meeting 88/141

10:15 a.m., September 7, 1988

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

Executive Directors	Alternate Executive Directors
A. Abdallah	E. T. El Kogali
	C. Enoch
	Zhang Z.
	C. S. Warner
J. de Groote	
	E. C. Demaestri, Temporary
M. Finaish	
G. Grosche	
J. E. Ismael	J. Reddy
A. Kafka	J. Hospedales
M. Massé	
	D. Saha, Temporary
Y. A. Nimatallah	I. A. Al-Assaf
G. Ortiz	L. Filardo
J. Ovi	M. Fogelholm
H. Ploix	
G. A. Posthumus	
C. R. Rye	C.-Y. Lim
	O. Kabbaj
	L. E. N. Fernando
K. Yamazaki	S. Yoshikuni
S. Zecchini	

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

Also Present

Asian Department: B. B. Aghevli, R. J. Corker. European Department: M. Russo, Director; P. B. de Fontenay, Deputy Director; P. E. Guidotti. Exchange and Trade Relations Department: J. T. Boorman, Deputy Director; H. B. Junz, Deputy Director; R. A. Feldman, S. Watanabe. External Relations Department: A. F. Mohammed, Director; R. J. Bhatia, Special Representative to the United Nations; P. C. Hole. Fiscal Affairs Department: V. Tanzi, Director; K.-Y. Chu, A. H. Mansur. IMF Institute: O. B. Makalou. Legal Department: H. Elizalde, J. K. Oh. 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, T. Bayoumi, J. S. Bhandari, N. R. Chrimes, M. P. Dooley, R. A. Feldman, S. J. A. Gorne, J. H. Green, 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. Treasurer's Department: Y. Ozeki. Western Hemisphere Department: S. T. Beza, Director; Y. Horiguchi. Personal Assistant to the Managing Director: H. G. O. Simpson. Advisors to Executive Directors: N. Adachi, M. Al-Jasser, M. B. Chatah, W. N. Engert, A. G. A. Faria, Khong K. N., J.-C. Obame, M. Pétursson, M. A. Tareen, D. C. Templeman, A. Vasudevan, J. E. Zeas. Assistants to Executive Directors: S. Appetiti, H. S. Binay, V. J. Fernández, B. R. Fuleihan, C. L. Haynes, J. Heywood, J. M. Jones, V. K. Malhotra, D. V. Nhien, C. Noriega, W. K. Parmena, S. Rouai, G. Seyler, C. C. A. van den Berg, R. Wenzel, Yang J.

1. WORLD ECONOMIC OUTLOOK

The Executive Directors considered a 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 Correction 1, 8/19/88) and a statistical appendix (SM/88/180, 8/16/88).

Mr. Ortiz made the following statement:

There is no question that the performance of the world economy has turned out to have been substantially better than was expected following the stock market crash last October. Indeed, the current short-term projections point to a considerably higher rate of growth of the world economy than that projected in the April edition of the world economic outlook paper. World trade is also expanding at a much faster rate than envisaged earlier, and inflation remains low, although the quicker pace of economic activity and high level of capacity utilization in some key countries have recently raised some concern that inflationary pressure may increase in the near future. Another encouraging sign is that the large external imbalances among the three largest countries appear to be on a corrective path. Of course, the speed at which this correction is taking place is one of the central issues that bears on the prospects for sustaining the current phase of expansion of the world economy.

The good performance of the world economy is largely the result of the resilience shown by the U.S. economy in the wake of the stock market crash, as well as the impressive economic performance of Japan. The swift response of the U.S. monetary authorities to the fall of the stock market, as well as some action taken on the fiscal front to reassure markets, were instrumental in mitigating the effects of the market fall. In Japan, the effects of the strengthening of the yen exchange rate and the wealth effects associated with changes in the terms of trade, coupled with decisive action on the part of the authorities to stimulate domestic demand, have resulted in particularly strong output growth. In contrast, growth remains sluggish in the two largest European economies.

As the paper notes, a central feature of the growth performance in the industrial world--with the notable exception of Germany--has been the strength of investment, reflecting an improved climate of business confidence. Other aspects include positive trends in productivity in some key countries, as well as continued wage moderation. These factors have contributed to create a better climate of expectations, and justify the relatively favorable economic outlook projected by the staff for the short term. Although the extent to which the coordination of economic policies among industrial countries--a theme which has been strongly supported in summit meetings of the Group of Five major industrial countries and of the Group of Seven since the Plaza Accord--should be credited for maintaining the current momentum of economic expansion and for easing the tensions associated with the existing macroeconomic imbalances is still a matter of debate, the positive results achieved so far have strengthened considerably the case for close economic cooperation. Even skeptical market participants have been persuaded that policy coordination is indeed a workable proposition, a fact that is borne out by the increased effectiveness of coordinated exchange market intervention.

The staff points out that the two major policy challenges facing industrial countries are: how to sustain the momentum of the current expansion, and how to improve economic performance in terms of strengthening capital formation and reducing unemployment, which, in turn, should help in prolonging the current expansion in the medium term. To these challenges, I would add the revival of growth in developing countries and the resolution of the debt problem. The paper stresses two potential threats to the sustainability of the current expansion: the persistence of large external imbalances, and the risk that inflation may revive. The magnitude of the external imbalances and the speed at which their correction is proceeding have been a central issue in the Fund's analysis of world economic perspectives for quite some time. The diagnosis and prescriptions have remained largely unchanged: more decisive action on the part of the United States to correct the large fiscal deficit, accompanied by actions on the part of surplus countries toward stimulation of domestic demand. As the paper notes, Japan has largely adjusted to the drastic appreciation of the yen, and its policies have produced the desired results: the external surplus has been declining steadily in real terms, and economic growth has been particularly strong. The paper indicates that, in the case of Germany, structural actions are especially called for. While agreeing with the staff that much more needs to be done in several key structural areas, this chair is of the view that the German authorities have more room to stimulate domestic demand than they are willing to acknowledge. Action on both the macroeconomic and structural fronts is much needed to revive investment and improve growth prospects. As several Directors mentioned during the last Article IV consultation with Germany, the sluggishness of investment appeared to be largely explained by poor growth prospects, associated with the perceived policy stance of the authorities.

The risk of inflation reappearing is a newer issue, and here we find that the staff's position is less firmly established. While disclaiming, on the one hand, that "the staff is not projecting any significant pickup in inflation" and acknowledging that "consumer price inflation has remained moderate," the paper nevertheless states, on page 40, that "there are some scattered worrying signals that should [not] be ignored" We agree with the staff that the reduction of unemployment, increased capacity utilization, and rising commodity prices are elements that could indicate some emerging inflationary pressure. However, the prices of other commodities--notably oil--remain weak. In addition, the trends in productivity and continued overall wage moderation would appear to work in the direction of mitigating such pressures. In any event, concerns about inflation need to be balanced against the objective of a further correction of the external imbalances. As recent events indicate, a tightening of monetary policy in the United States that results in higher interest rates leads in the short term to pressures for an appreciation of the dollar, which acts against the further correction of the external deficit. This, of course, reinforces the case for stronger fiscal action. The recent rise in interest rates in the face of scant evidence of inflationary pressures is--for obvious reasons--a cause for concern. Although we are well aware that the consequences of allowing inflation to take hold would be even more damaging for developing countries than the effects of preventive actions--which is the justification for recent measures--one should caution against overplaying the fear of reigniting inflation. Not even the recently created compensatory and contingency financing facility will prevent a continued deterioration of debtors' economic outlook should interest rates continue their present trend.

Turning now to structural issues, we appreciate the initial efforts made by the staff to extend the system of indicators to include those for structural policies and performance, as reported in Annex III of the staff paper. From this discussion, the difficulties in developing a practical and useful system of indicators of structural policies is apparent, and although we attach considerable importance to structural issues, we agree with the staff that the development of a sophisticated system of structural indicators is not a prerequisite for addressing the most obvious problems, which are well known in any event. Thus, we are reluctant to endorse a large project, which would certainly engage a considerable amount of resources, for the development of a comprehensive set of structural indicators of dubious practical application. Instead, the staff should pursue the study of the effects of structural policies on the relevant supply-side macroeconomic variables, and include a systematic discussion of structural issues both in Article IV consultations and in the context of the world economic outlook.

In the context of the overall favorable picture presented in this exercise, one should note, however, that most developing countries have not benefited from the positive developments that are taking place in the world economy. Paradoxically, these countries have experienced the worst growth performance in decades, at a time when industrial countries are in the midst of a sustained economic expansion. Moreover, the prospects for these countries remain bleak. An examination of the current world economic outlook projections is quite revealing. While the projection for world output has been revised upward by 0.7 percent since April, this revision results entirely from a stronger than expected performance by the industrial countries. In fact, the growth projections for most developing countries have been revised downward, a fact that is not mentioned in the paper. The April projections showed a growth of 3.2 percent for Africa and 2.1 percent for the Western Hemisphere countries. The current projections anticipate growth of 2.5 percent for African countries and 1.6 percent for developing countries in the Western Hemisphere. The downward revisions imply negative per capita growth in Africa (for the eighth consecutive year) and in Latin America. The contrast in expected performance with respect to last year's projections is even sharper: for Latin America, growth forecasts have been revised downward by 3 percentage points with respect to the April 1987 forecast.

The paper mentions on page 7 that the "weakness or spillover effects [to developing countries] from the buoyancy of growth in the industrial world and the strength of commodity prices and world trade" can be explained by: (a) the weakness of oil markets (with the consequent adverse effects on oil producing countries); (b) the weakness of some other commodity prices (notably tropical beverages); (c) higher interest rates; and (d) a sharp deterioration in inflation performance in several developing countries, which has adversely affected growth prospects owing to the negative effects of inflation on investment, as well as through short-term contractionary effects of policy adjustments. On page 10 the paper asserts that the most important factor behind the acceleration of inflation in developing countries "has been lax financial policies." While it is true that these factors have restricted growth in developing countries, and that financial policies may also be responsible for the acceleration of inflation in some cases, it is surprising that, six years into the debt problem, the staff fails to mention the debt overhang as an impediment to adjustment and growth. This is all the more surprising since the evidence accumulated over the last few years has made this issue a prominent subject for reflection and research among academic circles and institutions. For example, there is a serious drawback to the argument made on page 26 that "the medium-term outlook for developing countries is essentially unchanged... [because] although the interest rate projection is now slightly higher, this is largely offset by...higher export earnings." This statement fails to recognize that the authorities are confronted by the need to raise their appropriation of foreign exchange from the private sector, and that the fiscal position is worsened by the increase in foreign interest rates, even if, for the country as a whole, net foreign exchange requirements have not varied.

The staff has emphasized the differences in performance between those countries that avoided debt-servicing difficulties--by taking appropriate actions in the face of the world recession of the early 1980s and, more generally, by pursuing more balanced and outward-oriented macroeconomic policies--and those that have experienced debt problems. Then the question is asked as to what lessons can be drawn from the experience of the former set of countries. The answer is simple: that group of countries followed "correct" policies and an overall development strategy which was based on export-led growth. But this is all well known, and there is not much debate on the appropriateness of such policies. In fact, many highly indebted countries have undertaken substantial economic reforms that signal a clear break from past policies. While these comparisons serve to highlight the payoffs of different economic strategies from a historical perspective, they are of limited use when discussing the current debt situation and growth prospects of indebted countries--except, perhaps, to point to an obvious conclusion, which, although widely noted by most observers, continues to elude inclusion in Fund documents--namely, that the debt overhang represents an insurmountable obstacle for most indebted countries for economic stabilization and the resumption of growth. It is obvious that "orthodox" adjustment measures go much further in a situation of moderate indebtedness, since the negative repercussions of interest rate and exchange rate movements on economic activity and income distribution are felt less acutely than in cases where a large debt overhang exists.

The lack of a more inquisitive search for the causes of the unsatisfactory results of the adjustment efforts of developing countries is reflected in the medium-term scenarios: although the actual outcomes for industrial countries have on average been closer to the projections, we detect an optimistic bias when focusing on the developing countries, and more particularly on highly indebted countries. In 1986, it was expected that growth in countries with debt-servicing problems would be 3.3 percent in 1987; however, it turned out to be only 2.2 percent. Last year's projection for growth in 1988 for the same group of countries was 4.3 percent, and now it is estimated at only 2.2 percent. This point is especially worrisome since these scenarios are utilized as the framework for the discussion of the debt strategy. As they are overly optimistic, it encourages the view that the debt problem will somehow sort itself out, and presents a perspective that is at odds with reality and also with economic analysis done elsewhere. In the current report, for example, too much emphasis is given to the decline in 1987 of the debt ratio; however, a closer look indicates that, even by 1992, the ratios will be substantially higher than those prevailing in the early 1980s, when spontaneous lending from commercial creditors was interrupted.

When looking back at the figures one can only deplore the fact that the principles behind the coordination of economic policy, which industrial countries have successfully applied among themselves, have not been extended to incorporate the concerns of indebted countries. Although one should recognize that positive steps have been taken for low-income countries, the debt problem of middle-income countries remains unsolved, and the growth perspectives of this group are as bleak as at the outset of the crisis. It is somewhat ironic to allude to the "cooperative" nature of the strategy when confronted with the involuntary nature of credit flows and the involuntary character of the resource transfer from indebted countries, which continue to be forced to restrict domestic demand. On this point, moreover, it is disappointing that the paper did not address more extensively the feedback effects from developing to industrial countries, an issue that is at the core of the argument in favor of coordinated initiatives to support a wide effort toward debt reconstruction.

Mr. Rye made the following statement:

The staff has done its usual highly professional job in the preparation of the papers on the world economic outlook, and for that we are grateful. If the papers contain few surprises, it is because the world economy itself has, happily, behaved in a fairly steady way over the past year or so, and because the problems and challenges facing policymakers are themselves largely familiar ones.

The world economic outlook exercise goes about as far as is useful in its consideration for developing country prospects and, more particularly, policies. This has of course been in response to pressure from the Board. Certainly it is appropriate to consider in depth the effects of policies of the major industrial countries on the rest of the world. Equally, the developments and policy approaches of certain major developing country groups, including the newly industrializing economies, have a certain world wide significance. But there are other opportunities--such as, for example, our discussion of the debt strategy--to bend our minds to developing country prospects and policies. We should not risk blurring the focus of the world economic outlook discussions, which, I suggest, should remain firmly on the driving engines of the world economy--the major industrial economies--and what needs to be done to keep them in tune.

We certainly agree that external imbalances and inflation are the major sources of concerns in the current outlook.

The inflationary threat, however, may be a little more imminent than the staff's words "possible re-emergence" might imply. The graph on page 10a of the main paper shows a distinct upward trend in manufacturing costs, at least in Canada, Germany, the United Kingdom, and the United States. And if output were extended by reference to the staff's projections for 1988, the chart in Annex II on page 4a, would show above-capacity levels for Canada, Japan, the United Kingdom, and the United States. Meanwhile, The Economist's indexes for most commodities are still showing a pronounced upward trend--in SDR terms, nearly 4 percent in August alone for all commodities, and 10 percent for metals.

These trends, if they continued or accelerated, would pose a threat to the continuance of the present long-lived expansion. For in our view, the factors contributing to the apparently more enduring nature of the current expansion, compared with previous cycles, relate largely to the greater price stability that has been its characteristic. Lower inflation has increased confidence and strengthened consumption and investment responses.

Confidence and economic performance have also been boosted by a greater willingness to set policies in a medium-term framework, with most authorities putting aside attempts at fine-tuning in favor of consolidating fiscal positions and pursuing price stability. There has also been increasing awareness of the need for structural reform. Macroeconomic policies may have been more credible in the low-inflation environment, while better structural policies have improved the efficiency and flexibility of resource use and raised potential growth rates. As the staff notes, previous expansion phases have ended with an outbreak of inflation, as demand pressures have outstripped potential supply growth.

We believe that a consolidation, and in many cases an intensification, of these general medium-term policy directions would contribute to containing inflation and would best promote sustainable growth. Moreover, such an approach would be fully consistent with promoting current account adjustement and exchange rate stability. While the current account imbalances remain a cause for concern, the signs of underlying improvement in trade flows suggest that policies have moved in the right direction. Provided the momentum is maintained, the risks associated with the imbalances should recede. That must remain an important objective.

On the macroeconomic front, the required policy changes are familiar and should be persevered with--reducing the U.S. budget deficit and general progress toward fiscal consolidation and careful demand management in all countries.

As the impact of monetary policy is difficult to gauge and as it acts with uncertain lags, the lighter the fine-tuning aspect of monetary policy and the more oriented it is to medium-term price stability, the better. Of course, this is easier said than done, given the problems of assessing monetary developments consequent on deregulation and other fundamental changes in financial systems. This adds to the case for other arms of policy taking a greater share of the burden of adjustment. Otherwise, further interest rate increases would be likely, with all their adverse implications for economic activity and the debt burden. Greater emphasis on other arms of policy would lessen the potential conflict between the need for monetary restraint as a weapon against inflation, and exchange rate consequences that may run counter to current account adjustment needs.

None of this, however, is to detract from the extreme importance of a quick response by monetary policy to any further acceleration of inflation. While I am not an enthusiast for the construction of detailed scenarios, it would be difficult to deny the cogency of the contract they show, on this occasion, between the consequences of a quick response and a delayed response to an inflationary disturbance. But here the staff paper speaks for itself. A delayed response, it is clear, might well result in an actual recession, not a mere slowdown.

Our concern, however, is to underline the part that other policies, particularly fiscal adjustment in the United States, have to play in reducing the weight placed on, and the costs of, monetary policy itself. The "disturbing features" of the early monetary correction to which staff points on page 31 (and which are, in large part, a necessary consequence of the assumptions) would be greatly mitigated, we think, if the various arms of economic policy in the major countries could be brought to bear in a properly coordinated fashion.

This of course includes structural policies. A determined and effective assault on structural rigidities in all countries (through reform of labor, capital and goods markets, and taxation systems) and at the international level (through reform of trade policies) should receive great emphasis. In this context, we believe that structural reforms contributed to the disinflationary process during the current expansion, as well as to stronger business confidence and sustained growth in output. Reform of trade and industry policies is clearly consistent with promoting international current account adjustment.

In the pursuit of structural reform, we fully support the staff's view that identifying and addressing structural problems does not require and need not be delayed by the development of sophisticated structural indicators. Nor should it be delayed by the actions, or inactivity, of other countries. The subject and urgency of the required reforms will vary from country to country, but are probably already well known. Reform of agriculture and the taxation, land tenure and distribution systems in Japan, reform of industry subsidies in Germany, and of the Common Agricultural Policy in Europe and the Export Enhancement Program in the United States are obvious examples.

The Fund could have a role in surveillance of structural reform, complementary to that of the OECD, through detailed analyses of structural problems and experiences in individual countries as part of Article IV consultations. By identifying the domestic costs of rigidities and the domestic benefits of reform, analyses of that sort may well prove more fruitful than attempts to develop refined, cross-country structural indicators. That is not to deny that cross-country comparisons can be useful in bringing international pressure to bear on those countries where reform is lagging.

The need for structural reform is common to industrial and developing countries. Reform in industrial countries would significantly improve the external environment for developing countries and their opportunities for reducing debt burdens. Thus, the World Bank has estimated that, through their effect on international markets, the industry policies of industrial countries reduce developing country national income by an amount almost twice that of official development assistance.

Finally, while the process of international coordination on interest rates and exchange rates appears to have improved, the most telling feature of the recent relative stability in the international monetary system is that it has followed a number of significant policy adjustments in the major industrial economies. This is consistent with our view that exchange rate stability will be achieved only if underlying policies move in the right directions. The recent upward movement in interest rates, triggered largely by heightened inflationary concerns, will test the degree of exchange rate coordination. The tensions involved would be considerably less if other arms of policy--notably structural reform and more action on the U.S. budget deficit--were to play a greater part in the adjustment task.

Mr. Ortiz noted that Mr. Rye had mentioned that the world economic outlook exercise went as far as it should go in treating the policies and prospects of developing countries, and that emphasis in the exercise should be placed on the industrial countries. While he generally agreed with Mr. Rye about the importance of focusing the analysis on the industrial countries, some attention should be paid to the developing countries as well, even though their economies might be shrinking, because they were also a part of the world economy that the world economic outlook aimed to address.

The current paper on the world economic outlook devoted less space to the prospects and policies of developing countries than any of the previous four exercises, Mr. Ortiz observed. By his calculations, 28.1 percent of the current paper dealt with developing countries, compared with 30 percent in the paper of April 1988, 28.3 percent in the paper of September 1987, and 32 percent in the paper of April 1986. As there had not been any noticeable increase in the number of pages devoted to developing countries in the world economic outlook, it seemed that Mr. Rye's concerns about the focus of the exercise could be allayed.

An important theme of the world economic outlook was the extent to which economic coordination had been instrumental in sustaining the current economic expansion, Mr. Ortiz went on. Even the most skeptical observers and market participants had slowly begun to realize that coordination was a workable proposition. Coordinated exchange market intervention had been much more effective, and the market appeared to have begun to believe the policy intentions of the authorities in the main industrial countries. The fact that those policy intentions had had a much greater impact on expectations and on market behavior than had been the case a few years earlier was an important development.

The staff's interpretation of the inflation signals did not exaggerate the inflation risk, but was a balanced assessment, Mr. Ortiz commented. One of the side effects of the policy response to the incipient inflationary pressures was rising interest rates, which was of great concern to all. He realized, however, that if inflationary pressures went unchecked, the policy response that would be necessary once inflation became more apparent would be much more drastic, and would have much more damaging effects on world economic prospects in general and on developing countries in particular. Therefore, to some extent, the early action of the monetary authorities to contain inflationary pressures appeared to be justified.

The problem was that only very rudimentary tools were available to deal with the problem of marginal inflation, Mr. Ortiz went on. To the extent that the major imbalances continued, and to the extent that insufficient fiscal action on the part of the United States prevented a faster pace of correction of the imbalance, a greater burden would be placed on market prices. That subject had been discussed during the latest Article IV consultations with the United States and other countries.

In the midst of the very good news about the world economy, the prospects for developing countries continued to be extremely bleak, Mr. Ortiz remarked, and it appeared that the economic situation was becoming more polarized. Some countries were doing extremely well--including the industrial countries, as well as some subgroups of the developing countries, notably, the Asian countries. Fortunately also, the two largest economies in the developing world, China and India, were doing relatively well. However, the situation in the majority of countries in Africa and the Western Hemisphere was extremely unfavorable. A redistribution of world wealth and growth prospects was creating overall polarization, a development that deserved some attention. In fact, while the growth projections in the world economic outlook had been revised upward for industrial countries and for the newly industrializing economies, they had been revised downward--he believed systematically--for the developing countries, and even then those projections had proven to be overestimations that required downward revisions consistently.

The paper did not go far enough in assessing the causes of the very poor growth prospects of Africa and Latin America, Mr. Ortiz concluded. The role of the debt overhang had not been dealt with in any depth in the exercise, and, in his view, that was an important factor in explaining the current situation of the developing countries.

Mr. Rye commented that he did not believe that his position was as far from that position of Mr. Ortiz as might appear at first sight. Both he and Mr. Ortiz had agreed that the focus should remain on the major industrial economies.

There had been two themes in his statement, Mr. Rye went on. The first placed some stress on the inflationary threat in the context of the current economic expansion. That inflation had been kept much lower than in previous cycles was an important point, and there were some emerging signs of an acceleration of inflation, as shown by a number of different indicators to which he had pointed. His second theme was to stress the need for coordination of policies, not merely across countries, but also within countries, and to note the costs of overreliance on monetary policy in combating possible emerging inflationary pressures, and the part that could be played by fiscal policies and, in the longer run, by better structural policies.

To a large extent, the recent relative stability reflected a better coordination of underlying policies, Mr. Rye concluded. That coordination might be put to the test if the upward movement in interest rates gathered strength. The tensions would be much reduced if other arms of policy, structural reform, and particularly more action on the U.S. budget deficit, were to play a greater role in the adjustment task.

Mr. Ismael made the following statement:

> We are pleased to note that the world economy has improved much more than was expected last April. Output growth has strengthened, with inflation remaining relatively subdued, while external imbalances among the largest countries are beginning to

be reduced. To no small extent, those favorable developments are the results of improved international policy coordination, especially the differentiated management of domestic demand in surplus and deficit countries, and the efforts to impart confidence, as well as greater stability, to financial markets. There are areas of disappointment, nevertheless--in particular, the continuing proliferation of trade restrictions by industrial countries, and the relatively poor performance of low-income and heavily indebted countries. In Europe, structural impediments, especially subsidies and protection in agriculture, continue to constrain medium-term output potential and growth performance. In addition, interest rates have now turned around, threatening the durability of the current expansion and the viability of the debt strategy.

The main tasks now are to sustain the current expansion and create better spillover effects to more countries in the developing world. My perception is that a dampening of re-emerging inflation and inflationary expectations may well be the key to meeting these objectives in the medium term--far more important, I think, than the readiness of financial markets to accept more claims on the United States at existing interest and exchange rates. Nevertheless, the two key questions posed by the staff are basically interrelated--policies that increase the sustainability of financing would also tend to alleviate re-emerging inflationary pressures.

With regard to appropriate policies to promote stable expansion in the industrial countries, I will make four points.

First, fiscal policies in major surplus countries are unlikely to be able to play a meaningful role in contributing directly to further differentiating the rates of growth of domestic demand across countries. But these countries should not withdraw abruptly the fiscal stimulus imparted recently, given that a sustained strong growth of domestic demand is still needed to promote adjustment and to reduce continuing large external imbalances. In other countries where demand growth is strong, the thrust of fiscal policies should now be directed again at medium-term consolidation, since limiting public sector spending and deficits would best preserve price stability by reducing monetary growth and dampening inflationary expectations.

Second, I agree with the staff that the United States needs to continue to strengthen national savings, mainly by accelerating progress in reaching the medium-term goal of fiscal consolidation. Such a policy stance would be appropriate in the context of any one of the four possible developments depicted by the staff as risks to durable growth--namely, a stronger expansion of nominal demand than currently expected, a faster growth of U.S. manufactured exports, a lower level of potential output without intensifying inflationary pressures, and a decline in financial market confidence in the sustainability of the external imbalance. Further fiscal retrenchment in the United States would free resources to alleviate price pressures and increase confidence among businesses and consumers. The system as a whole would be made more resilient to disturbances, while a better environment would be created for lower interest rates.

Third, monetary policies should continue to aim at maintaining relative price stability, even if that implies a further monetary tightening in the short term. The costs of a delayed monetary tightening are clearly shown in the staff scenarios. The earlier incipient inflationary expectations are reversed, the stronger and more durable would be growth in the medium term. In addition, coordination of monetary policies would need to ensure that recent exchange rate changes are not reversed significantly, which would derail the achievement of the goal of a more sustainable pattern of external payments balances.

Fourth, given the limited role of fiscal and monetary policies, structural policies to remove impediments to stronger output growth will have to assume center stage in the next few years. The strategy would be to let recent macroeconomic policies take effect, with appropriate changes as the situation evolved, while international coordination is focused on a concerted effort to reduce structural rigidities, with the aim of raising output potential worldwide.

At this stage of cyclical developments in the world economy, I believe that structural reforms can make a major contribution to international adjustment, dampening inflationary pressures and raising global output potential without increasing government budgetary outlays by very much. In particular, trade policies have strong links with macroeconomic imbalances and structural adjustment in industrial countries. Hence, they may be as important as the management of exchange rates and domestic demand in the coordination exercise.

With regard to the role of the Fund, I believe that the development of indicators of structural policies and performance would strengthen the process of multilateral surveillance and the coordination of policies now being overseen by the Fund. Such indicators should be monitored together with the set of indicators on macroeconomic policy and performance in the policy coordination exercise. Initially, the focus of the structural indicators could be on rigidities in labor markets, tariff protection and other restrictions on trade, and subsidies for agriculture and industrial production. To be effective, the monitoring and surveillance process would need to be pursued in both the Article IV consultations and the world economic outlook exercise. I look forward to discussing these issues when the staff study on structural policy issues is completed.

On the question of reviving growth in developing countries, there is not much that I can add to the staff views on policies to strengthen growth. The difference in growth performance between countries with and without recent debt-servicing difficulties clearly points to the critical role of appropriate macroeconomic and structural policies. I therefore agree that heavily indebted countries would need to persist with, and even strengthen, adjustment. But it should not be forgotten that ability and willingness to adjust have strong links with adequate financing to revive growth. As we concluded in the recent discussion on the debt strategy, there must be light at the end of the tunnel within a reasonable time span. But financing is not expected to be forthcoming in adequate amounts to revive the investment necessary to strengthen growth. I will not repeat my arguments here on the need to reduce, on a case-by-case basis where there are strong adjustment efforts, the debt overhang, through an international debt facility.

Without a coordinated effort in that direction, I doubt that the recent decline in debt and the debt service ratio can be durable. It is significant that, despite the expected marked improvement based on "optimistic" assumptions, the positions of countries with debt problems remain worse than they were before the debt crisis, leaving them highly vulnerable to adverse external developments. In that connection, I urge the staff to study the phenomenon of the effects of expectations on investment in highly indebted countries, particularly whether productive investment can be encouraged in an environment of expected marked depreciation of the exchange rate, expected high inflation because of the need for governments to continue debt servicing, and the expectation that resources will be commandeered, in one way or another, by the public sector. My perception is that only highly speculative investments can be justified with such risks--not investments that can increase productive capacity and exports.

On issues concerning the international monetary system, I agree with the staff on the need to ensure that the shifts in competitiveness since 1985 are not reversed significantly, given the need to continue to reduce external imbalances, which remain large. Nevertheless, given the uncertainties about the lagged effects of exchange rate adjustments, exchange rates should not be maintained rigidly. If the improvement in the U.S. current account proves to have been underestimated, the dollar should be allowed to appreciate moderately, perhaps outside the ranges set at present. It would be a mistake for countries outside the United States to attempt to stop the appreciation by tightening monetary policies further, thereby amplifying the initial "export shock" imparted by the United States, as shown in the staff's "world trade pattern" scenario. This is a particularly difficult policy dilemma, for which perhaps the only appropriate policy is flexibility.

Mr. Kafka stated that the prospects for industrial countries were certainly much better at present than in April 1988. The same was not true for developing countries in general, although there were exceptions, as had been noted. The median growth prospects of developing countries were worse than what was thought in April, and they were by no means encouraging, or even reassuring, for the medium term. The paper mentioned that the ratio of aggregate debt to exports of developing countries had finally begun to fall in 1987, but it did not mention that the debt/GDP ratio had continued to rise in 1987, even though it was expected to start falling in 1988. It was to be hoped that such a fall would in fact be realized, and that it would be maintained, despite the difficulties that were perceived in the international situation.

More importantly, Mr. Kafka observed, the paper was very optimistic regarding improved policy coordination among the major countries, even though the world had just witnessed an impressive example of the failure of policy coordination with respect to the interest rate policies of the United States, on the one hand, and several European countries, on the other. Regarding the medium-term policy problems faced by industrial countries, he fully agreed with the paper's stress on the importance of stronger fiscal policies in the United States, particularly as the need for more net exports was added to the need to restrain or prevent inflation. Given the latest data, there was no call for stronger domestic stimulation at present in the other major trading countries, but it was still important that, as the United States continued to hold domestic demand growth below capacity, those other countries would strive to do the opposite. German export growth had recently been still very strong.

He had read with great interest the analysis of structural policies in industrial countries, which could be helpful in the current situation, Mr. Kafka went on. Much of that analysis had already been discussed in the context of the recent Article IV consultation with the United States, and in the context of the trade discussion, so there was no need to go into the matter again. However, the paper's analyses and comments regarding policy issues in the developing countries required serious observation; they were important not only in themselves, but also because the developing countries constituted an important part of the world economy. One needed only to ask Senator Bradley to be informed of the impact of the debt problem on U.S. exports to those countries.

Regarding the debt strategy, the staff seemed to have underrated the difficulties faced by developing countries, Mr. Kafka commented. Thus, they believed that the very sharp changes in relative prices which the debt problem had imposed on the major debtors, and which were necessary for them to adjust their balances of payments, need not have had the inflationary consequences which they had had. While that might have been true, it was difficult to regard as other than a tautology the following sentence on page 49 of the staff paper: "If cautious financial policies are pursued, the relative price changes are unlikely to cause more than temporary pressures on inflation." That assumed the absence of any formal or informal indexation, which was of course the less likely to prevail, the sharper the relative price changes that had to be undertaken.

Regarding the problem debtor countries, Mr. Kafka continued, the staff had discussed the plight of the low-income countries and had stressed the new international initiatives that had been undertaken. Of course, much more help to those countries was required. The staff had noted realistically that no significant increase in private lending to the heavily indebted middle-income countries could be expected, although negative net flows from them to private creditors might be expected to come to a halt in the early 1990s. The staff had stressed that a significant increase in private lending would be predicated upon better policies by the borrowers, in order to create the necessary incentives for such lending. There was of course always a need for better policies, but to state that such policies were likely to succeed in promoting increased lending by private lenders seemed somewhat ingenuous as long as the debt overhang persisted. After all, there were cases in which developing debtor countries had demanded no new money, had paid amortization and interest punctually and without interruptions, and had nevertheless faced very long delays--at least--in arranging the necessary bank financing merely to meet their amortization obligations. The obvious conclusion was that the trinity of better policies, a better external environment, and better external financing, which would be required to make the so-called debt strategy work, demanded as well a financial ingredient comprised not only of new money, but also measures to reduce the debt overhang, where appropriate.

There were several points in that regard that did not seem to have been adequately stressed in the paper, Mr. Kafka noted. One was the question whether additional official resources would have to be mobilized to a major extent. In his view, it was likely that such additional resources would be required to make up for the reduction in private lending, which, one had to expect, would be reduced for a long time, not only below the abnormally high levels which prevailed in the 1970s, but also even below the levels that might otherwise be considered feasible. Those borrowing needs might require that multilateral institutions engage in innovative operations. Obviously, the Fund could not be expected to be a long-term lender to any particular country, but that did not mean that, at the least, it could not attempt to refrain from withdrawing resources from the world economy, by expanding and accelerating its operations with those countries whose debt to the Fund was modest and which requested the Fund's assistance.

The new approach to the extended Fund facility, and the compensatory and contingency financing facility as presently conceived, might not be at all adequate for that purpose, Mr. Kafka went on. It might also be necessary to expand the scope of operations of official bilateral lenders. A great deal of progress had been made recently in developing a menu to make a reduction in the debt overhang to private institutions attractive, but that was not merely a matter for the private creditors themselves, but for their governments as well. As the staff had mentioned, some of the problems that had been encountered in the menu approach included regulatory problems, such as the attitude of regulators toward the balance sheet implications of discounted assets, and the absence of a mechanism to give senior status to new loans, as well as the recent recommendations of the Cooke Committee. He agreed with the staff that new momentum was necessary in the debt strategy that had been followed so far. Perhaps it would be less misleading and simpler to refer instead to a new debt strategy.

While maintaining the need for consensual arrangements, it might prove necessary to innovate in other ways, Mr. Kafka stressed. Nothing that had been said about the need for additional external flows relieved in any way the requirement to make major improvements in the provision of domestic savings by the developing countries in general, and by the problem debtor countries, in particular.

Policy coordination was a step in the direction of international monetary reform, Mr. Kafka went on. Thus far, policy coordination was evident in institutional studies and in measures designed to provide greater exchange rate stability. The decline in inflation in the summit countries suggested that the return to a more stable system of exchange rates might be nearer, because the so-called fundamentals were evolving, or perhaps even had evolved, in the right way. Flexibility, however, would still be required as long as the major external imbalances persisted. At the same time, it would be a mistake to believe that the fundamentals could not or should not be reinforced through a further institutionalization of policy coordination beyond what was being attempted through the development and use of indicators. It was clear that policy coordination was an extremely difficult, and even dangerous, undertaking, but it was an effort that the Fund could not neglect despite the problems it might encounter.

Mr. Nimatallah made the following statement:

> I agree with the staff's general assessment of the global economic situation, and particularly with its view that the industrial countries are facing two major policy challenges: how to sustain the current expansion without the boom-recession syndrome; and second, how to improve economic performance, reduce unemployment, expand productive capacity, and accelerate the trend of productivity growth.
>
> The industrial countries generally have done well, so far, in meeting the challenge of not falling victim to the boom-recession syndrome as they sustain the current expansion. The

present performance of industrial countries, particularly the G-7 major industrial countries, seems to be appropriately geared to sustaining growth without inflation. I have reason to believe that they will continue their efforts to follow the appropriate macroeconomic policies with strengthened commitment and coordination. I am sure that the leaders of the large industrial countries, and others, are fully aware that periods of economic expansion have often ended when there was no early and effective response to inflationary pressures.

This gives me reason to believe that the potential threat of inflation will be dealt with effectively. This effectiveness hinges on three important factors. The first is the timing--the earlier the response, the better. A delay in responding will make the sacrifice larger in terms of output and employment in the short run, as indicated in Scenario C. The second factor is the mix of tools utilized in the response. Monetary correction alone would not be sufficient, simply because it means higher interest rates that could choke off the investment that is needed to enlarge productive capacity, which has now approached full utilization, and which has become one of the reasons behind today's inflationary pressures. Therefore, acceleration of fiscal retrenchment at a time when it can be afforded, and for a short period, is necessary and would be helpful. Such a mix of tools would minimize not only the need for higher interest rates, but also disruptions in exchange rates. The third factor is acceleration of structural adjustment in conjunction with the macroeconomic policy response. Structural adjustment will have to be accelerated, particularly in Germany, and, of course, in other industrial countries. I agree with the staff's statement on page 31 of EBS/88/167 that "the adverse global consequences of inflationary shocks would also be significantly reduced by structural policies that would enhance productive capacity and improve the split of nominal demand growth between output and inflation."

The Board will have further opportunities in the near future to discuss in more depth the issue of structural adjustment, and on that occasion I will suggest what the Fund could do in this area. It is important to mention the possibility that the early responses to inflationary pressures could lead to lower economic growth rates in 1989. The extent of such an effect depends a great deal on how well investor confidence is maintained, or even enhanced, not only by following the appropriate mix of monetary and fiscal policies, but also by accelerating structural adjustment. A slowdown could perhaps occur during the first two quarters of 1989, but if there is some acceleration in the removal of structural rigidities, the chances are that the slowdown would be short lived. However, the important point is that the economic expansion would be sustained on a sounder basis.

For the developing countries, the possible slowdown in growth rates in the industrial countries, together with the increase in interest rates, could have a negative impact temporarily on debt management and, more importantly, on their growth. However, that negative impact need not be deep or lasting if industrial countries accelerate their structural adjustment, particularly with respect to industrial policies.

I agree with the staff and many of my colleagues who have said on several occasions that the present strength of expansion in the large industrial countries should create an opportunity for them to look again at their domestic policies that protect certain industries from external competition. The expansion should also provide those countries with the opportunity to take the initiative, unilaterally, to bring about a favorable change in the climate of trade negotiations. Increased export revenues for developing countries, resulting from further removal of trade barriers, should help a great deal in alleviating the possible negative impact of an early response to inflationary pressures. Furthermore, it should be even more helpful if additional export revenues in developing countries were utilized for productive investment that would add to their productive capacity. That would be a sure way of reviving growth in developing countries, and of sustaining efforts to better manage the debt problem. The information in the staff papers about declining debt-export ratios is encouraging. That trend can be strengthened if heavily indebted countries adhere without interruption to sound economic policies. That action, I am sure, will automatically attract the needed financing from all possible sources.

With respect to the international monetary system and coordination efforts, the period of misalignments among the major currencies is basically over. What we see now are healthy short-term fluctuations that should be expected from time to time. I think that the G-7 major industrial countries have realized that and are following a reasonably successful strategy for maintaining exchange rate stability. Their ability to adjust the target zones flexibly from time to time attests to the success of managed floating. It is clear now that target zones do not mean fixed rates, and do not mean wild floating. The central banks of the countries concerned are doing well in coordinating intervention, thus leaving the market in no doubt as to their serious intention to sustain exchange rate stability.

However, this is an opportune time for large industrial countries to further improve their policies to reduce their external imbalances. Exchange rate adjustments alone are not enough. It is also important, for example, that the United States enhance its savings ratio by introducing additional structural measures to that end. It is still more attractive for U.S. citizens to borrow and consume than to save and invest. In addition, Japan and Germany should sustain their efforts to accelerate domestic demand. These efforts in Germany, Japan, and the United States will make coordination of policies easier, particularly policies affecting exchange rate stability.

Mr. Massé made the following statement:

A major attraction of the papers on the world economic outlook is the identification of the major tensions and risks in the global medium-term outlook it provides by analyzing the current situation and short-term prospects. In that connection, the staff argues, and we agree, that the durability of the current expansion depends on two key considerations: first, whether financial markets will be willing to finance at existing interest and exchange rates the large external imbalances that are still in prospect for the major industrial countries; and second, whether inflation is re-emerging as a significant risk that calls for policy adjustments. The world economic outlook papers clearly describe the emerging inflationary risks and its implications. In addition, the world economic outlook analysis, particularly the medium-term simulations, in conjunction with the reports for the Article IV consultations with major countries, presents a very useful means of providing guidance for policy action to secure the current expansion together with good price performance. Given the importance of the policies of the industrial countries on these considerations, and since I have already referred to the developing country outlook in our recent debt strategy discussion, I will focus my remarks on the role of industrial countries.

My authorities agree with the staff's short-term outlook of stronger growth and higher inflation in the industrial countries than was projected in April 1987. We also agree that the economies of Canada, Japan, the United Kingdom, and the United States are currently operating at very close to full capacity, and that the output gap in the other major industrial countries, while somewhat larger, is narrow by historical standards. The increasing concern about inflationary pressures has led to an upward adjustment of interest rates recently in virtually all the major industrial countries. We view this as an appropriate response to the increased risk of inflation, but, as I noted during our recent discussion of the Article IV consultation report for the United States, U.S. fiscal policy needs to play a larger role, both in the adjustment required by the external imbalances, and in order to control inflation.

Indeed, the medium-term scenarios illustrate the importance of a front-loaded and ambitious response to the emerging inflation tensions; that inflation can be addressed while simultaneously improving the U.S. fiscal deficit and global current account imbalances. We support the broad outlines of the policies suggested to achieve those ends. I will first make two points about the medium-term simulations.

In constructing the reference scenario, the staff makes the usual "unchanged policies" assumptions. In this regard, it is assumed that monetary policies are aimed at holding the growth of nominal demand in the industrial countries to rates consistent with generally stable inflation over the medium term. As a consequence, for example, inflation in the United States is projected to average 4 percent, and in Canada, 3.3 percent--results that we would view as unsatisfactory. I recognize that in making its policy assumptions, the staff did not necessarily attach normative considerations. However, my authorities feel strongly that a more desirable objective vis-à-vis inflation is stable prices, rather than stable inflation, as the staff has assumed.

The second point is related to the first, and concerns the assumed responses of the monetary authorities to the postulated inflationary shocks. We fully agree with the staff that there are substantial benefits to be had from an early response to the types of inflationary shocks presented in the paper. However, I note that even the "early monetary correction" scenario implies that the U.S. monetary authorities would be willing to accept an inflation rate of about 5.6 percent in the medium term. In Japan and Germany, the "early monetary correction" scenario implies inflation averaging over 3 percent and 4 percent, respectively, in the medium term--roughly double the inflation of the baseline scenario, and considerably higher than that recently experienced. These results raise questions about the acceptability of this kind of inflation performance, particularly in view of the experience of the 1970s, when inflation expectations ratcheted up, while price performance eroded.

However, it seems clear that the imposed inflation shocks are simply too large to permit monetary policy alone to return inflation relatively rapidly to the rates of the reference scenario without substantial short-term output costs. At the same time, if better inflation performance were to be obtained--which seems desirable--then even sharper increases in interest rates than those generated in the simulations would be necessary, with adverse consequences for growth in the short run. These considerations thus underscore the need to support monetary policy with fiscal adjustment. Even if a more moderate inflation shock had been imposed, it remains clear that the outcome would be much more favorable if monetary policy responses were supported by fiscal adjustment.

The spring paper on the world economic outlook, taken together with the current exercise and with recent Article IV consultations with the major industrial countries, suggest the appropriate policy paths to be pursued by the major industrial countries in order to address the key risks to the current expansion. These key risks are the external imbalances of the three largest industrial countries, and inflation. More ambitious U.S. fiscal adjustment is the necessary, but perhaps not sufficient, ingredient for continuation of the current expansion together with a good price performance. Fiscal adjustment in the United States should be complemented by, inter alia, a strengthening of structural adjustment measures in Europe, led by Germany, including measures to reduce structural unemployment and to enhance the efficiency of investment outlays, and structural reforms in Japan, relating, for example, to land use, agricultural protection, and the internal distribution system. Monetary policies should firmly pursue price stability, and there must be greater efforts to resist protectionism and develop more liberal trading arrangements. On pages 41-48 of the main paper, the staff presents additional policy suggestions regarding the major industrial countries which also are broadly appropriate.

It has been argued that by expanding potential output, structural reform in Europe could accommodate more expansionary demand-management policy there. However, even the broadly appropriate magnitude and timing of such an expansion, in concert with structural adjustment, is extremely difficult to establish reliably, and could carry substantial inflationary risks. In this connection, as is noted in Annex III of the most recent paper on the world economic outlook, there are no empirically estimated models that reliably forecast the macroeconomic results of most structural policies, particularly in terms of the timing of those results. We would do well to keep that in mind in our discussions of structural adjustment in developing countries as well. Nevertheless, those considerations do not diminish the importance of coming to grips with structural problems. As the Annex in the staff paper points out, severe distortions can usually be identified without sophisticated empirical analysis, and the general qualitative implications of structural reforms are relatively straightforward. Thus, measures to address structural problems need not be delayed, and I would agree that it is in the self-interest of all countries to eliminate structural rigidities, regardless of the actions of others.

I would like to make a brief comment on the role of the Fund in monitoring structural policies and fostering structural change. In view of the data limitations and technical difficulties associated with the construction and use of structural indicators--which are noted in the body of Annex III--it could be preferable to assess the need for, and consequences of, structural reform through detailed studies, rather than with a discrete list of simple, quantified cross-country structural indicators. Such studies could include, to the extent possible, quantified illustrative simulations, as in the report for the 1988 Article IV consultation with Germany, for example (SM/88/136, 6/24/88). This work could be developed in connection with Article IV consultations and could be referred to in the preparation of the world economic outlook analysis.

Mr. Posthumus made the following statement:

Growth in the industrial countries is now expected to be 1 percentage point higher than was estimated last year, which, together with low inflation and reduced balance of payments imbalances, is a very good performance. It is to a large extent also a good underlying performance, because the major element in the growth performance is the improved investment record. Over the past year, since the stock market reversal of October 1987, nobody has rocked the boat, which allows the boat to travel faster. It is still possible, of course, that some of the unsustainable elements in the picture will indeed disturb it, but that would depend to a large extent on whether progress is made to solve those problems in time.

In this connection, international coordination--in particular, coordination among the G-7 major industrial countries--may fulfill a function, presenting a balance between an approach of "putting your own house in order, the quicker the better" on the one hand, and full coordination and fine-tuning of fiscal, monetary, and exchange rate policies in the seven countries on the other hand. We may assume that there is a level of international coordination--which one may call a first step--at which unsustainable developments are being sustained a bit longer, adjustment is delayed somewhat, and balance is being sought. We may also assume that there is another level--a second step in international coordination--at which pressure is being brought to bear on countries to take national measures in order to remove imbalances.

There are a few points I would like to make. One remark is prompted by the paragraph on policy issues in individual countries, and in particular by the case that is made for exercising additional fiscal restraint in the United Kingdom. One element here is that, in the particularly difficult policy situation in the United Kingdom, and from the point of view of helping to attain exchange rate stability, the case for such a course of action may indeed be made. The overall budget, however, is already in surplus, and it seems to me that a fiscal policy that aims at reasonable balance, accepting some effects of the automatic stabilizers, if any, is much more important to keeping one's own house in order in the longer term than fiscal fine-tuning. A more long-term fiscal policy, aimed at reasonable balance, would also at least help in dealing with one of the sources of inflation in an economy. In the subparagraph on inflation on page 41, the staff states that "dealing with the problem of inflation would clearly be facilitated if fiscal instruments were more available." I think that somewhat more clarity is required in that respect; I would say that the staff's conclusion is true at least until a balanced fiscal situation is attained.

Intervention by central banks is generally regarded as a temporary phenomenon which can be used only to deal with extreme, short-term movements in the exchange rate, or to prevent such movements. Last year, official intervention was not used in such a limited way. Thus, a potential for inflation must have been built up in a number of countries, although Germany partly corrected that situation at the beginning of 1988. Some of the room for inflation that was then created may have led to the present inflationary dangers and to the general increase in interest rates that has just occurred in surplus and deficit countries alike, and which is in fact very unwelcome, albeit necessary.

In seeking as the first step of international coordination, to make unsustainable situations sustainable a bit longer, great care is required to prevent establishing a foundation for larger problems later. That is in fact the classic argument for not postponing adjustment, while at the same time preventing the market from enforcing adjustment. It is also, I think, in a larger sense, the classic argument in support of the role of the Fund in international cooperation. It not only points out the interests of that part of the world that is not represented in the coordination of policies, but also makes clear that the first step of coordination, which is to prevent a breakdown, must take into account and be succeeded by the second step, which is the necessity of putting the house in order.

I recently noted two interesting statements about international coordination. One is that "a major characteristic of the international approach to United States adjustment has been the recognition that it requires policy action by the surplus countries, as well as by the deficit country itself." Another is that "official action filled the emerging gap" in the balance of payments of the United States, when private flows faltered.

These statements represent a certain vision of the international coordination process which does not present the full picture. After all, it is possible that, if many countries follow more or less balanced fiscal and monetary policies, a large budget and balance of payments deficit in one country or group of countries will lead to surpluses in the others. If the other countries consider those surpluses to be "room for maneuver" and begin to stimulate their economies, the stage will be set for worldwide inflation. I assume that that was not the intention of these statements, which come from UNCTAD's latest Trade and Development Report.

I have read with great interest what has been written on structural policies, including the staff's observations on structural indicators. I see structural measures as being those can help to improve the functioning of markets. Governments can then make better choices as to what they leave to markets and what they want to influence or do themselves, which also makes government intervention more effective. Certainly, structural reforms can then make a major contribution to international adjustment. I hope that we will return to this subject.

Mr. Grosche made the following statement:

The world economic outlook paper provides us again with an excellent analysis of short- and medium-term prospects and the key policy issues. I agree with the thrust of the staff's analysis and conclusions. I agree, in particular, that the two main threats to a continuation of the present upswing are the persistence of large external imbalances and the risk that inflation may revive. Inflation has proved to be an immensely damaging distraction from real economic activity. Therefore, it is of paramount importance that, within a cooperative international strategy, the United States absorb less of international savings, particularly by reducing the fiscal deficit. This would reduce the burden placed on monetary policy, and could reduce interest rates and stabilize exchange rates.

The short-term prospects for a significant reduction in the fiscal deficit are not encouraging, however, and I am concerned that the most important economy will slide into a situation in which overheating and inflation force drastic actions upon us--actions that might bring the growth process to an abrupt end. The staff rightly reminds us that "previous periods of economic expansion have often come to an end when inflationary pressures were allowed to get out of hand, necessitating a sharp reversal of monetary policies which in turn provoked a slowdown of activity."

The uncertainty about fiscal and monetary developments in the United States overshadows what would otherwise appear to be, all in all, a quite encouraging picture--at least in most industrial countries and in Asian developing countries.

In Germany, growth in the first half of 1988 has been stronger than many expected--including, it appears the Fund staff. Data released by the Federal Statistical Office on September 5 indicate that real GNP grew by 3.9 percent in the first half of 1988. On a yearly basis, the German economy grew by 3.7 percent in the first half of 1988; and major shocks would have to occur in the second half to prevent attainment of the revised growth projection of 3 percent for 1988 as a whole. Many observers in Germany do not exclude an even higher growth outcome. For 1989, we expect the economy to grow by 2 percent. Even more important, real domestic demand expanded at an annual rate of 4.7 percent during the first half of the year; external adjustment is thus continuing. The data also suggest that investment performance has been better, as business investment and inventory was about 13.5 percent higher in the first half of 1988 over the second half of 1987--a growth rate substantially higher than what the staff expects in the current world economic outlook paper.

We need still more information before reaching firm conclusions about the factors driving the rapid investment in Germany's domestically oriented sectors. Expectations for high and sustained consumption certainly play a role, given that real disposable income grew by about 8 percent over the past two years in Germany. In contrast to the staff's less sanguine view, it seems that the structural change that has been under way has also contributed to a higher propensity to invest. The progress that has been achieved over the past five years in deregulating the economy has paid off. In using more, one should bear in mind that certain sectors in need of reform in other countries were liberalized in Germany quite some time ago. I assume that is why the staff did not mention Germany in its discussion on page 45 of the progress achieved in other countries in liberalizing capital markets.

I concur with the staff, however, that considerable scope for further action remains. Indeed, my authorities are contemplating further reforms, in the social security system, for example. The full integration of European markets by 1992 should add to the need for further adjustments, generating also a need for higher levels of investment.

In my view, the Fund can and should play an important role in identifying and discussing solutions to structural impediments to growth. I agree with Mr. Rye that, in order to do this, the Fund does not need sophisticated structural indicators. In the context of Article IV consultations, however, the Fund should point out to authorities the costs of delaying structural reforms. The recent Article IV consultation papers for Germany contributed significantly to the development of such approaches, and we consider that the work of the staff and the Board is very helpful for our policy formulation. I would add that cross-country comparisons can also be useful in, as Mr. Rye put it, "bringing international pressure to bear on those countries where reform is lagging."

I endorse the staff's analysis and conclusions regarding the developing countries.

Concerning developments in the international monetary system, more exchange rate stability is clearly warranted. The recent movements of the dollar exchange rate, particularly against the deutsche mark, are cause for some concern, especially as they do not seem to support the current account adjustments that are under way, and as they force interest rates up. Intervention can help to cushion movements, but cannot replace measures aimed at correcting the fundamentals. The arrangements by which major member countries cooperate to foster exchange rate stability rightly put the emphasis not on intervention, but on appropriate domestic policies. We are very satisfied with those arrangements and intend to contribute whatever we can to their improvement.

Mr. Enoch stated that he broadly endorsed the general conclusions in the staff paper, although he had a number of reservations about particular points.

It was clear that the world economy had performed significantly better in the aftermath of the substantial worldwide stock market falls of October 1987 than had been generally anticipated to be true, Mr. Enoch observed. Indeed, it seemed currently that 1988 would turn out to be a year of relatively strong growth, particularly in industrial countries. Other satisfactory developments were the strong growth in world trade and the welcome progress that had been made in reducing the substantial trade imbalances of the three largest economies.

Those developments had created a relatively favorable environment for the developing economies, Mr. Enoch remarked, and there had been some encouraging signs in that respect. Although performance had varied considerably from country to country, and substantial uncertainties remained, it seemed that both the debt/export and the debt service ratios for developing countries as a whole might have fallen significantly in 1987. Of course, Mr. Ortiz had stressed that some of the developing countries had performed much less well than the aggregate figures would suggest.

He broadly accepted the staff's prognosis that output growth in industrial countries would moderate in 1989 to a rate more in line with the growth of productive potential, Mr. Enoch stated. He was, however, slightly puzzled by the precise pattern of growth rates assumed by the staff. Table A2 of SM/88/180 seemed to suggest that, after a deceleration of growth in France, Germany, and Japan in the latter part of 1988, there would be a reacceleration in 1989. He would appreciate staff's clarification of that point.

Given the strength of economic activity in the industrial countries in 1988 and the sharp increase in non-oil commodity prices, the staff had been right to stress the inflationary risks confronting the world economy, Mr. Enoch went on. A continuing difficulty in making a definitive assessment of those risks had been the problem of interpreting data on monetary aggregates, given the effects of worldwide financial deregulation on the velocity of money. Despite that uncertainty, he accepted the staff's conclusion that the most likely outcome was that a damaging acceleration of inflation would be averted. Several considerations pointed in that direction. Most important, in recent months monetary authorities in most of the major industrial countries had responded to signs of inflationary pressures by moving swiftly to tighten monetary policies. In the United Kingdom, for example, interest rates had risen by 4 1/2 percentage points since May 1988. Signals from commodity prices were somewhat worrying, but were perhaps not unambiguous. While there had been a substantial rise in commodity prices in 1988, that rise might almost have run its course. The most recent figures, issued in the previous week in the September issue of IMF Memorandum, showed that in July there had been a significant fall in commodity prices. The fact that the recent increase in commodity prices had taken place from an exceptionally low base, which was probably not reflected fully in output prices, suggested that there might be some scope for producers to absorb the current recovery in commodity prices at the expense of their profit margins.

He concurred with the staff that there was a particular need to ensure that the growth rate of the economy of the United States returned to a more sustainable level, Mr. Enoch commented. He joined other speakers in hoping that effective action to reduce the federal deficit would be taken as soon as possible after the presidential election. Such action could also reduce the pressure on monetary policy, and could lead to lower interest rates worldwide. The stance of policy in Japan seemed broadly appropriate; he believed that, if anything, the staff might have exaggerated the inflationary risks in Japan, where prices had remained flat and unit labor cost growth was negative. The most recent figures from Japan showed a slowdown in the growth of output. The most recent figures from Germany, reported by Mr. Grosche, were welcome, particularly those pointing to a revival of domestic investment.

It was slightly disappointing to see that the staff was projecting a marked slowdown in the rate of reduction of the trade imbalances among the major economies in 1989, Mr. Enoch remarked. He would be interested to know whether the staff thought that that implied that further exchange rate adjustments were desirable.

Other Directors had already stressed the contrasting performance of developing countries that had encountered debt-servicing problems and those which had not, Mr. Enoch recalled. For a number of countries in Asia, prospects appeared to be very bright. That could be attributed in many cases to the fact that owing to sound macroeconomic policies, those countries had enjoyed considerably lower inflation rates than others and had achieved significantly higher rates of saving and investment. They had also pursued outward-oriented policies that had not discriminated against exports. In contrast, many countries that had faced debt-servicing problems were likely to continue to face adverse growth prospects in the absence of strong corrective demand management and structural policy adjustments. A particular issue that needed to be addressed urgently by the primary product exporters in the Western Hemisphere was the sharp increase in inflation in those countries from already high rates. The staff had correctly pointed to the important role financial policies had played in that deteriorating performance, with broad money growing by 150 percent on average in the Western Hemisphere countries in 1987. The staff projections suggested that a major correction would be seen over 1988 and 1989, with those countries enjoying an acceleration of growth in 1989, accompanied by a sharp reduction in inflation and a decline in the debt/export ratio. That was clearly an optimistic scenario, given that movements in the terms of trade were not expected to be particularly favorable, and that both world output and world trade growth were expected to be slower in 1989 than in the previous two years.

It was important to single out the very poor sub-Saharan African countries when looking at the developing countries, Mr. Enoch stressed. Even with the appropriate adjustment policies in place, it was unrealistic to expect those countries to fully service their debts. Those countries would benefit from the establishment of the enhanced structural adjustment facility and the measures agreed at the Toronto summit, and he hoped that those measures could be put into effect in the near future.

It was a little misleading to treat the four newly industrializing economies as a bloc, Mr. Enoch observed. The large combined current account surplus of those four economies was attributable entirely to Korea and Taiwan which should continue to reduce their barriers to trade and capital flows and contemplate further exchange rate appreciations. However, Hong Kong, in contrast, did not have a current account surplus and, like Singapore, had no trade or capital restrictions to liberalize. He had also been a little puzzled by the relationship between developing countries' terms of trade and the path of commodity prices. In particular, the 0.1 percent improvement in primary product exporters' terms of trade in 1988 sat oddly with the projected 17.5 percent increase in non-oil commodity prices and the 11 percent fall in oil prices. He would appreciate a clarification of that point by the staff.

The staff had produced a useful review of the literature on structural indicators, and had shown that it might be conceptually possible, and even desirable, to develop satisfactory and useful structural indicators, Mr. Enoch stated. However, the difficulties in obtaining reliable and agreed empirical estimates, and the stringent data requirements, made further progress in that area a heavy task. Given the other claims on the staff's time, care was needed to ensure that the staff did not duplicate the work of the OECD, which had considerable competence in the field. The Fund was well placed, however, to document, monitor, and encourage structural policies in individual countries within the framework of the Article IV consultations, and it should continue in that vein. The work undertaken for the recent Article IV consultation with Germany seemed to have set a good example in that regard.

In general, as the staff papers had recognized and as Mr. Rye, Mr. Massé, and Mr. Grosche had emphasized, sophisticated indicators were not required to know that major distortions were present in an economy. The technical difficulty of developing indicators also did not in any way reduce the importance and urgency of reform, which could make a major contribution to international adjustment, directly--by removing impediments to trade--and indirectly--by promoting greater efficiency and responsiveness. He joined other Directors in urging faster progress in structural reform and trade liberalization.

He had some reservations about the weight the staff had placed on the medium-term projections, Mr. Enoch commented. While he strongly endorsed the conclusions of the exercise that early monetary correction was the right response to an inflationary shock, and that a reduction in the U.S. budget deficit would lighten considerably the burden on monetary policy, he questioned the extent to which the staff simulations convincingly demonstrated those conclusions. The reference case had a number of odd features. First, the U.S. current account deficit was shown to increase significantly despite the fact that real output continued to grow faster than domestic demand, and there seemed to be no substantial shift in the terms of trade. Second, it was not apparent where the counterparts to the deteriorating Canadian, Japanese, and U.S. current accounts were. Third, it was not clear why France and Germany were projected to grow significantly faster than their potential long-term growth rates over the medium term.

He was surprised by the implied inefficacy over the medium term of monetary targeting, Mr. Enoch continued. Under Scenario A, with monetary targets held constant, inflation was shown to accelerate through 1993 in all the major industrial countries, whereas a gradual falling back of inflation over the medium term to the baseline rate under a nonaccommodative monetary policy might have been expected. Perhaps that was due to the apparent absence of significant crowding-out effects from the model. For example, German output was more or less unchanged from the baseline in 1982, despite the fact that monetary targets were unchanged and the price level was 10 percent higher.

The early monetary correction scenario offered clear gains over unchanged monetary targets in terms of inflation control, Mr. Enoch concluded, but it was notable that the comparative cumulative real income loss in the United States was quite substantial, and there was a significant import compression in the developing countries. In comparison, if a more modest monetary correction was accompanied by a tightening of the U.S. fiscal stance, the U.S. income loss was reduced, and the current account deficit was lower. Correspondingly, the other major industrial countries suffered significant cumulative real income losses over the medium term.

Mr. Nimatallah said that he was disappointed by Mr. Enoch's remarks on the structural adjustment efforts. He did not believe that a competent judgment could yet be made on whether or not indicators on structural adjustment policies would be helpful. The indicators were still under study.

Mr. Enoch remarked that he had meant to say that actual quantitative determination of sophisticated structural indicators was rather difficult, and that in carrying out its work on those indicators, the Fund should take care that it did not duplicate the work being done elsewhere. Also, sophisticated measurements were not necessary, in his view, to be able to perceive major imbalances, which could be identified even in the absence of such indicators. Obviously, where structural imbalances existed, countries should make haste to remedy them with structural reforms.

The Chairman remarked that in some cases, the need for structural reform was so obvious that structural indicators were not needed to arrive at that conclusion.

Mr. Nimatallah stated that the Fund staff could still coordinate its work with that of the OECD on structural indicators. It was important, in his view, that all avenues be explored to help members accelerate their efforts at structural reform.

The Chairman noted that the Fund's cooperation with the OECD on the development of structural indicators was proceeding well, and had been reinforced recently. At the same time, efforts were being made to ensure that the work involved was not duplicated. The overall intention was to use the comparative advantage of each institution to provide the best analysis, in support of promoting structural adjustment in developing countries.

Mrs. Ploix stated that the world economic outlook exercise contributed importantly to the formulation of members' economic policies, and bore upon the method of implementation of the new contingency financing mechanisms as well.

As to fostering stable expansion in the industrial countries, during the discussion in April 1988 her chair had pointed out that the reference scenario gave little cause for enthusiasm, but was not catastrophic, either, Mrs. Ploix continued. The comparison of current projections with those of April could lead to the conclusion that the overall outlook for the world economy was rather good in many respects. The growth of world output had been stronger than envisaged, world trade had been robust, and inflation rates had remained low. Such a good outcome hinged upon the unexpected growth in the industrial countries, particularly the G-7 countries. Investment had also played a key role in the recent growth. All those signs were certainly encouraging, and could be reinterpreted as reinforcing the likelihood that developments would be consistent with the reference scenario.

However, that scenario was certainly not the first best solution, and it was fraught with important uncertainties, Mrs. Ploix said. One was the persistence of substantial internal and external imbalances, which remained a serious cause for concern in spite of the progress that had been made recently. The improvements in the U.S. trade deficit still appeared fragile and could be attributed partly to favorable exogenous factors. The surpluses in Japan and Germany remained high, and the recent figures on Germany were disquieting. In that regard, it would have been interesting to have seen the effects of the financial tension scenarios.

The risk of a resurgence of inflation could not be ruled out, Mrs. Ploix continued, although she agreed with the staff that there was no reason to overestimate that risk. The significant change in price behavior that had been observed during the current expansion had been reassuring. However, the strength of economic activity, coupled with a decline in unemployment and a high degree of capacity utilization, could contribute to reversing that trend. Also, the fact that the current expansion had already endured for an unprecedented period made the continuation of the expansion and of the satisfactory inflation performance that much more uncertain.

Those uncertainties should reinforce the need for coordination and for adequate monetary and rigorous fiscal policies, Mrs. Ploix commented. The better than expected outlook should not precipitate a relaxation of adjustment efforts in the coordination process, but on the contrary, should make it possible for members to take advantage of the opportunity to accelerate those efforts, since, if growth were to slacken, the desired results would be more difficult to achieve. Furthermore, the more favorable outcome--although favorable only to a limited degree--stemmed largely from the fact that coordination among the major industrial countries had functioned well. Monetary policies had played an important role in containing the potential for inflationary pressures. The staff scenario clearly showed how crucial it was to react in a timely fashion to inflationary disturbances. However, to tie the control of inflation to monetary policy alone could undermine growth prospects and exchange market stability. A dangerous spiraling of interest rates was also to be avoided, and close coordination was required in that area as well. Those were compelling reasons to stress the necessity of not placing primary reliance on monetary policy. Fiscal policy had a crucial role to play, especially in the United States, since it entailed fewer adverse effects on growth and exchange markets and, was the most satisfactory way of achieving further external adjustment. In that context, although some reduction in the U.S. budget deficit was being accomplished, not enough was being planned at a time when the buoyancy of world economic activity could make such a reduction easier to achieve. Conversely, countries with strong external positions should continue to implement flexible fiscal policies or, at the least, avoid withdrawing stimulus.

She agreed that more emphasis should be put on structural policies, Mrs. Ploix continued. As the staff had pointed out, the successful implementation of structural reforms might have helped significantly to promote the current expansion, and might explain the paradox of improved microeconomic performance in the face of rapid money growth and large external and internal imbalances. In any event, it was clear that the removal of structural impediments could not only pave the way to enhanced growth, but also increase the efficiency of macroeconomic policies. It would be dangerous to stake all hopes on structural policies, however, since their implementation required time, the results were slow to appear, and their efficiency often depended on the socioeconomic context in which they took place. The need for further action in the area of structural policies should not exonerate countries from pursuing other approaches, such as classical macroeconomic policies.

Economic activity in developing countries appeared to have been somewhat stronger than was expected, Mrs. Ploix observed, and there were several other encouraging signs, such as the strong growth in export earnings, the improvement in overall payments positions, and the reduction in the debt/export ratios. However, several disquieting developments should be noted, such as the rise in interest rates and the renewed inflation pressures. Furthermore, the overall situation masked profound differences between countries. While the situation of commodity producers, particularly in Africa, had not improved and remained very worrisome, the newly industrializing economies had benefited from the effects of the buoyant growth in the industrial countries. The continuation of a stable expansion in the industrial countries was of the utmost importance to reviving growth in the developing countries. The staff's scenario clearly showed the adverse consequences that an increase in interest rates would entail for developing countries.

The debt strategy also played a key role in the outlook for developing countries, Mrs. Ploix went on. It was recognized that for low-income countries both significant debt relief and additional capital inflows on concessional terms were important for the revitalization of growth prospects. The availability of a 50 percent increase in financing assistance over the period 1987-89 should encourage those countries to adopt stronger adjustment programs in order to benefit from that additional financing. As for the highly indebted middle-income countries, appropriate solutions needed to be sought, bearing in mind that the quality of macroeconomic policies and of structural reforms constituted the key factors in attracting adequate financing.

With respect to the international monetary system, recent experience had shown that the stabilization of exchange rates was possible and beneficial, Mrs. Ploix concluded. It was clear that by reducing uncertainties, exchange rate stability had contributed to enhanced business and consumer confidence. The recent upward pressures on the U.S. dollar highlighted the need to further intensify policy coordination. However, it was crucial that that coordination not be limited to exchange rates, but be applied to all macroeconomic policies to reduce, as much as possible, the potential conflicts between domestic and external objectives.

Mr. Abdallah made the following statement:

The good news is that the global economy is doing better than expected. Paradoxically, the same good news also serves to highlight the difficult situation of a large number of members--the heavily indebted and low-income developing countries--and the skewed effect of the present recovery. It is true that there is some uncertainty in industrial countries about the persistence of large external and fiscal imbalances and the threat of a re-emergence of inflation, leaving the staff to conclude in page 3 of Annex I of SM/88/181 that it is still not clear whether "the resilience of the economic system has improved in any fundamental way." But the fact remains that the industrial countries have weathered the negative impact of the stock market reversal of October 1987, they are benefiting from a strong growth in international trade, and their output growth is expected to be a full percentage point higher than envisaged only last April. Meanwhile, the recovery is in its sixth year, which is exceptional by historical standards. All told, the industrial countries, though concerned about the shaky foundation of the global economy, have much to cheer about.

For the heavily indebted and low-income developing countries, the story is quite different. Times continue to be difficult, despite one of the longest periods of global recovery. Apparently, the countries that need economic progress the most have benefited the least from global growth. Should global growth falter because of tightened monetary policies as a result of resurgent inflation, austerity will intensify in the heavily indebted and low-income countries, due to higher interest rates in the industrial countries, lower import capacity, and the further depression of growth. Economic coordination among industrial countries, when viewed in that perspective, is not only desirable, but also indispensable and urgent; the interests of the "silent majority" must constantly be borne in mind.

The policy issues raised by the staff for the serious consideration of the industrial countries are not new. The staff has rightly highlighted the danger inherent in letting monetary policy carry an undue burden of economic adjustment. The staff has also stressed the need for structural adjustment in these countries. Of course, a great deal depends on the ability of the United States to curb its fiscal deficit, but the extent to which that can be achieved in the near term is open to question. The basic theme to be emphasized, evident in Occasional Paper No. 63, on Issues and Developments in International Trade Policy (December 1988), is that adjustment at both the macroeconomic and microeconomic levels must be taken seriously in industrial countries--it is not a pill to be swallowed only by the developing countries.

The staff papers have clearly shown that recovery has virtually eluded sub-Saharan Africa, and that any assumption that poorer countries stood to benefit automatically from global recovery is misplaced. Per capita income in this region fell by about 1 percent annually between 1980 and 1987, savings and investment have fallen, and the ratio of debt to exports rose to 493 percent in 1987, more than three times the average of all developing countries.

Two important questions could be raised with respect to the situation in sub-Saharan Africa. One is whether the so-called debt strategy has worked. The large debt overhang suggests that it has not. The staff paper acknowledges that action is needed to reduce the stock of debt in sub-Saharan Africa if the region is eventually to begin to normalize financial relations with the rest of the world. However, the paper stops short of endorsing a specific menu that would lead to such a reduction. Debt held by multilateral institutions has been discussed partially in the context of overdue payments to the Fund, but it should have also been considered in the context of the world economic outlook. There is clearly a case for more generous rescheduling terms, increased concessional assistance, and wider use of debt cancellation on the part of bilateral creditors.

The second question is whether the adjustment strategy being pursued in low-income countries is really appropriate. The staff has reiterated the need for countries in the region to improve their domestic policies in order to revitalize their growth prospects and to receive increased flows of concessional resources. While I agree with this assessment, it is also clear that the largely unsatisfactory record of economic performance, despite many years of adjustment, calls into question to some extent the adjustment strategy being followed. Perhaps adjustment programs, in addition to being concerned about fiscal and current account imbalances, ought to pay more attention to some of the specific development problems identified in the staff paper. Three key areas come to mind: the problem of low productivity; the low level of investment and the need to improve the quality of investment; and the narrow export base of those countries. With regard to the latter, the staff concludes that a fundamental problem of low-income African countries "has been the long-standing weakness of their export performance, which at least in part reflects the underdeveloped nature of their economies and their concentrated export structure." The result is that those countries have failed to benefit from the buoyancy in world trade.

The World Bank has an important role to play in sub-Saharan Africa, because it is the institution with both the expertise and the mandate to provide longer-term assistance to countries with the type of economic problems facing the region. Of course, programs under the structural adjustment facility and the enhanced structural adjustment facility are a step in the right direction. However, I am not so sure that they have focused enough on the questions of investment and productivity as might be required by sub-Saharan African countries. Besides, to deal with problems of that nature, it is essential that economic reform be accompanied by program lending as well as project finance, so as to increase output in tandem with the diversification of output.

The adjustment problem in low-income countries in general, and in sub-Saharan Africa in particular, cannot be resolved entirely in the short term. The Fund recognized that when it established the structural adjustment facility, but the preference for "pinpoint targetry" in the monitoring of programs, which assumes that disequilibria can be corrected in the short term, remains a problem with Fund-supported programs. Perhaps the Board and the area departments charged with developing structural adjustment programs need to reflect on what is said by the staff in the third paragraph on page 32 of Annex III in SM/88/181: "First, with the exception of major labor market reforms where there is excess capacity,...the time lags with which structural reforms yield greater output are long and highly variable. Potential output responds more slowly to structural policies than does nominal output to monetary and fiscal policies. Moreover, the existing empirical literature contains few estimates of the relevant elasticities involved. These differences imply that while it might be sensible to assess the medium-term implications of demand side policies with indicators semiannually or annually, such a frequency with structural indicators would not seem to be necessary, or even desirable, on such a frequent basis." It is time for reappraisal by both staff and management.

Mr. Yamazaki made the following statement:

I am in general agreement with the staff's analysis of the current situation and short-term prospects. The robustness of the economic expansion in the industrial countries, as evidenced by the recent GNP statistics, should be welcome.

I fully agree with the staff that the continuation of the external imbalances and the possible re-emergence of inflation are the primary sources of concern at present. Viewed in this light, the unexpectedly rapid pace of economic growth in the United States is a mixed blessing. In particular, we should not hesitate in urging the U.S. authorities to curtail the growth of domestic demand through far-reaching fiscal adjustment. I share the staff's view that inflation should be resisted before it makes its appearance in the statistics. It is not easy, however, to judge fully the extent to which inflationary pressure is emerging in individual countries. In that connection, it is not advisable to rely too much upon objective indicators, such as potential output, which is difficult to quantify and the validity of which is not firmly established.

The external imbalances of the three major industrial countries continue to be large, although they have declined remarkably in real terms. In that connection, a strong commitment of the U.S. authorities to pass on the task of fiscal consolidation to the next Administration is no doubt an essential prerequisite, as we emphasized during the Board's discussions on the staff report for the recent Article IV consultations with the United States. Also, other major industrial countries, including Japan, should continue to play their roles in harmonizing the growth pattern of domestic demand.

After registering a very rapid annual growth rate of more than 10 percent in the first quarter of 1988, the pace of economic expansion in Japan decelerated sharply in the second quarter, possibly to a negative rate, although the figure is yet to be announced. Accordingly, the staff's projection of 5.8 percent growth for 1988 might be on the high side. In view of the need to remove the inflationary pressure from the Japanese economy and to ensure the sustainability of growth in the medium term, we consider that the slowdown in the second quarter was inevitable, or even desirable. In any event, the Japanese economy continues to grow rapidly, centering on strong domestic demand. Meanwhile, we see no sign of the rekindling of inflation at this stage, in view of the stability of both the consumer price index and the wage price index. Although there have been some month-to-month fluctuations, the external current account surplus is declining not only in real terms, but also on a dollar-denominated basis, thereby reducing remarkably the external imbalance in relation to GNP. Under those circumstances, the basic stance of Japanese macroeconomic policy has not changed since the last discussion on the world economic outlook; fiscal and monetary policy continues to aim at ensuring sustainable economic growth while maintaining stability in prices as well as in foreign exchange rates. Also, we continue to proceed with structural adjustment policies with a view to establishing domestic demand-oriented economic growth. In this vein, we are drawing up a comprehensive tax reform plan that will contribute to revitalizing economic activity, as well as to stimulating domestic demand.

As this chair has reiterated on many occasions, my authorities have strong reservations about the use of the general government fiscal balances as an indicator of the fiscal situation of our country, in view of the special demographic characteristics of Japan and the resultant need for a substantial surplus in the social security fund. We believe that judgments on the fiscal policy stance should be based on a comprehensive analysis, using various data that properly reflect the current situation of the specific countries.

In that connection, I wish to raise a question concerning Table 6 on page 24 of EBS/88/167, as well as Table A17 in SM/88/180, with respect to the projections of the general government fiscal balance of Japan after 1988, about which my authorities have strong reservations. If those projections are predicated upon the large growth of tax revenues during the past several years, they would not necessarily be accurate, since the recent growth of tax revenues is due mainly to temporary factors, such as the buoyancy of asset transactions and the windfall gains from the exchange rate appreciation. In fact, the rate of growth of tax revenue has already decelerated remarkably since the beginning of the year, as evidenced by the sluggish 2.8 percent increase in January-July 1988 over the same period of last year. This compares with an increase of 11.8 percent in 1987 and 9.6 percent in 1986.

As regards the medium-term projections, the qualitative conclusion of the staff's medium-term scenario is quite interesting, and we appreciate the thought-provoking analysis of the effect of the policy responses to inflationary pressures. In particular, we are impressed by the conclusion that the quick response of the monetary policies of the industrial countries to those pressures has substantial effects on the economic adjustment process of the developing countries, as well as on the industrial countries themselves. However, let me reiterate our basic understanding that the medium-term scenario should be used to complement a judgmental analysis, taking account of various considerations. In particular, the qualitative conclusions of the scenario should not be overemphasized, since they are based on many arbitrary assumptions. By the same token, my authorities continue to have difficulty supporting the publication of medium-term scenarios.

In elaborating upon the position of my chair on the structural policy issue, I would like to touch upon the staff's very helpful analysis on structural indicators in Annex III. The analysis clearly underscores the limit to developing practical and reliable structural indicators. I fully agree with the staff's remarks on the technical and theoretical problems associated with the quantification of the impact of structural policies on conventional policy indicators. Also, I share the view that structural indicators are certainly not prerequisites for addressing structural reforms. During the Board discussions on structural issues, Directors repeatedly emphasized the importance of a case-by-case approach, with due consideration to the specific situations of the individual countries.

In sum, we strongly believe that a review of structural adjustment measures should not be predicated upon an objective and unilateral approach, such as an indicator process; rather, it should be undertaken on a case-by-case basis--a judgmental approach established through long experience.

In more general terms, my authorities are concerned about the Fund's excessive involvement in structural policies, which would result in the Fund's deviating from its original tasks, such as the stability of the international monetary system and the elimination of balance of payments disequilibria. Specifically, we believe that the involvement of the Fund should be limited to general advice on structural policies. It is not advisable for the Fund to make specific proposals addressed to specific sectors of the economy, such as the reference to the Japanese land-use problem on page 47 of the main paper, unless those proposals are based upon a detailed analysis, with due consideration of the social and political factors of the particular country. In particular, my authorities have reservations about the publication of such specific proposals. Also, due to the preliminary nature of the Annex, my authorities propose that it be deleted from the published version of the paper.

On policy issues in industrial countries, the staff suggests on page 41 of the main paper, that the countries with large external surpluses do not need any further withdrawal of stimulus in their fiscal policies, given the need to sustain the process of external adjustment. However, it is also emphasized that a medium-term goal of fiscal consolidation should be pursued to reduce the risk of inflation. Therefore, we consider that even the countries with external surpluses might need to tighten fiscal policies, depending upon the circumstances.

We welcome the staff's comment that the present stance of Japanese fiscal policy is appropriate, in view of both short-term demand-management considerations and long-term fiscal consolidation and tax reform considerations. Concerning the staff's suggestion about possible monetary restraint, it is not advisable to predicate monetary policy upon arbitrary assumptions about exchange rate movements. In addition, we are not convinced at this stage that the downward pressure on the exchange rate will automatically lead to serious inflationary pressures. Accordingly, policies to contain inflation should be formulated on a case-by-case basis, depending upon the specific circumstances, and it is not appropriate to specify in advance the direction of monetary policy based on such arbitrary assumptions.

Regarding the policy issues for developing countries, we reiterate our strong support for the ongoing case-by-case approach, based upon the cooperation of the parties concerned. Also, I join with the staff in pointing out the risk involved in not accelerating the process of seeking a sustainable solution.

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/88/140 (9/6/88) and EBM/88/141 (9/7/88).

2. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 88/3 through 88/6 are approved. (EBD/88/243, 8/30/88)

Adopted September 6, 1988

3. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors and by Advisors to Executive Directors as set forth in EBAP/88/218 (9/2/88) is approved.

APPROVED: April 4, 1989

JOSEPH W. LANG, JR.
Acting Secretary