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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 88/48

10:00 a.m., March 25, 1988

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

Executive Directors	Alternate Executive Directors
A. Abdallah	E. T. El Kogali
F. Cassell	
	Yang W., Temporary
C. H. Dallara	
J. de Groote	
A. Donoso	E. V. Feldman
	A. M. Othman
G. Grosche	
J. E. Ismael	J. Reddy
A. Kafka	J. Hospedales
	D. McCormack
	K. Yao, Temporary
	I. A. Al-Assaf
	L. Filardo
J. Ovi	
	D. Marcel
G. A. Posthumus	
	I. Sliper, Temporary
G. Salehkhou	
A. K. Sengupta	L. E. N. Fernando
K. Yamazaki	
	S. Rebecchini, Temporary

L. Van Houtven, Secretary and Counsellor
D. de Vos, Assistant

Also Present

African Department: A. T. B. Taylor. Asian Department: R. J. Corker. European Department: M. Guitián, Deputy Director; J. J. M. Kremers. Exchange and Trade Relations Department: J. T. Boorman, Deputy Director; P. A. Acquah, S. J. Anjaria, A. Basu, J. H. Felman, G. R. Kincaid, J. P. Pujol. External Relations Department: P. C. Hole, J. M. Landell-Mills. Fiscal Affairs Department: T. M. Ter-Minassian, Deputy Director; A. H. Mansur. IMF Institute: O. B. Makalou. Legal Department: J. V. Surr. Research Department: J. A. Frenkel, Economic Counsellor and Director; A. D. Crockett, Deputy Director; M. Goldstein, Deputy Director; F. C. Adams, N. R. Chrimes, M. P. Dooley, R. A. Feldman, S. J. A. Gorne, R. D. Haas, E. Hernández-Catá, N. M. Kaibni, F. Larsen, M. Mecagni, P. R. Masson, D. J. Mathieson, B. E. Rourke, M. Schulze-Ghattas, S. A. Symanski, E. Y. P. Tung, M. A. Wattleworth. Secretary's Department: A. P. Bhagwat. Treasurer's Department: M. P. Blackwell. Western Hemisphere Department: S. T. Beza, Director; Y. Horiguchi. Bureau of Statistics: S. P. Quin. Personal Assistant to the Managing Director: H. G. O. Simpson. Advisors to Executive Directors: A. A. Agah, P. E. Archibong, M. B. Chatah, W. N. Engert, A. G. A. Faria, P. Péterfalvy, G. Pineau, D. C. Templeman, A. Vasudevan, J. E. Zeas. Assistants to Executive Directors: N. Adachi, J. R. N. Almeida, A. A. Badi, H. S. Binay, E. C. Demaestri, F. El Fiky, V. J. Fernández, B. Fuleihan, J. Gold, M. A. Hammoudi, C. L. Haynes, G. K. Hodges, L. Hubloue, A. Iljas, S. King, M. A. Kyhlberg, L. M. Piantini, A. Rieffel, C. C. A. van den Berg, E. L. Walker, R. Wenzel.

1. WORLD ECONOMIC OUTLOOK

The Executive Directors considered a staff paper on prospects and policy issues related to the world economic outlook (EBS/88/44, 3/4/88). They also had before them as background material annexes on the world economic outlook (SM/88/50, 3/3/88), a statistical appendix (SM/88/51, 3/4/88), medium-term scenarios (SM/88/52, 3/4/88; and Cor. 1, 3/7/88), and on the accuracy of the world economic outlook and short-term forecasting (SM/87/297, 12/23/87).

Mr. de Groote made the following statement:

The staff's extensive experience in the simulation of the alternative adjustment scenarios has a high payoff in terms of the detection of potential policy inconsistencies and, by the same token, strikingly shows the usefulness of the world economic outlook exercise. The staff efforts deserve full support, since the World Economic Outlook remains the single most important platform from which we can discuss future Fund policies. The importance of the outlook is likely to increase further in the near future, when we will be making more use of the world economic outlook projections to detect external shortfalls in the adjustment programs of members that qualify for contingent financing.

I shall focus my remarks on five questions which are particularly relevant to the continuation of the international adjustment process: do the staff scenarios take sufficient account of the policy measures required to preserve stable external financing conditions in today's circumstances? Is further dollar depreciation desirable to accommodate the correction of the present imbalances? What are the general policy assumptions for the achievement of rates of higher structural growth in Europe? What approaches are needed to restore the investment performance of the developing countries? And are additional cooperative efforts needed in the areas of interest rate coordination and exchange rate stabilization?

While I broadly support the staff's general recommendations on these questions, I shall suggest for each of them a differently focused policy approach, which could enhance chances for an orderly continuation of the international adjustment process.

GNP growth in the industrial countries was 2.9 percent in 1987, which is 0.5 percent higher than was commonly being forecast six months ago. The present recovery of output has thus been extended for a fifth year. The validity of the current adjustment strategy is strikingly confirmed by the fact that this positive outcome resulted from marked progress in correcting economic imbalances among the major countries, including shifts in both their domestic demand levels and real trade flows.

The fact that despite this positive outcome the adjustment will still take a long time, displays the full relevance of the financing scenario that I have been urging for some time should be used to assess the medium-term policy choices of the industrial countries. Because several years will be needed to correct the present imbalances--even during the forceful implementation of generally accepted policy recommendations--the stable financing of these imbalances is essential for maintaining conditions under which the adjustment will continue to support, and not slow the present recovery.

The financing scenario I am proposing differs from the staff's standard scenarios, because it does not assume that the full implementation of structural and fiscal corrections recommended under the staff's "policy adjustment" scenario will suffice, under present circumstances, to protect the ongoing adjustment from the threat of market disturbances. The United States will continue accumulating external liabilities for many years under the most optimistic of current scenarios; thus, even if adjustment is well under way, we cannot dismiss the risk of recurrent market instability, as was demonstrated starkly by the financial turmoil of late 1987. This risk might even increase considerably if the rapid reduction of the U.S. public sector deficit considered in the staff's adjustment scenario confronts the U.S. Administration with much lower output than has been supporting the adjustment so far. The need to support the correction of the U.S. fiscal imbalance with favorable growth has been reflected faithfully in the optimistic public revenue assumptions of the Gramm-Rudman-Hollings Act and its revisions. A more rapid fiscal correction along the lines suggested by the staff might soon trigger output shortfalls serious enough to cause the Administration to abandon further adjustment in favor of a relaxation of monetary policy, thereby risking the re-emergence of pressures on the exchange rate. In other words, not only is there no guarantee that radical action on the U.S. budget will pay off in greater market stability, but there is also a good chance that it would cause serious output losses, with the postponement of further adjustment being the most likely outcome.

Both the certainty that U.S. external indebtedness will continue to increase and the likelihood that massive correction of the U.S. budget will damage growth enough to postpone further adjustment justify consideration of an alternative policy scenario. The financing scenario I propose is based on the notion that the undeniably necessary additional reductions of the U.S. budget deficit are bound to extend over a long period, and therefore require the constant support of confidence-building measures that will clearly reflect that the adjustment is taking place, and needs to be supported by stable and prolonged financing. The most obvious solution containing these prescriptions--and that currently seems to be accepted by the largest countries--is to take further steps to reinforce the present exchange rate system; this would announce clearly that the adjustment is subject to a sufficient amount of common discipline and induce the structural decline in interest rates that increased exchange rate stability should logically bring about over time.

That further action is still needed, or will be imposed, to bring about the correction of the U.S. current account deficit, is no longer doubted. There is a more intense debate over whether this correction should be sought through additional fiscal correction or additional dollar depreciation. The issue could come to a head at any time when the re-emerging impatience of foreign holders of dollar assets might force the U.S. Administration to reconsider the slow pace of budget reduction planned over the next two years.

The Fund staff has taken a nuanced approach to this issue; although it cautions against the short-lived successes of unilateral dollar depreciations--which under present conditions of high capacity utilization could threaten domestic price stability--the staff analysis is at least implicitly sympathetic to the merits of a combined approach under which a moderate dollar depreciation would promote the reallocation to the current account of the resources released by additional budgetary restraint. This preference is supported by the simulation exercises, which show how fiscal adjustment in the United States--by moderating domestic spending and interest rates--would in itself produce the additional dollar depreciation needed to bring about a swift reallocation of resources toward the U.S. trade sector. More generally, the staff's projections lead to the conclusion that no matter what policy stance is eventually adopted, additional currency corrections will always play an essential role in the adjustment process, whether they are imposed by unilateral decision through market disruptions, or by international shifts in domestic demand positions.

The conclusions from this analytical evidence invite us to consider a number of fundamental choices on how the present adjustment process might continue: is the preference for exchange rate stability--presently shared by the major countries--justified by the need for additional structural and fiscal adjustments to complete from now on the correction of the external imbalances, or can these fundamental adjustments be accomplished only if they are supported by further dollar depreciation? Alternatively, should we base our expectations of lower interest rates exclusively on further fiscal correction, or should a flexible dollar policy allow for the temporary reduction of interest rates that would facilitate the orderly solution of the U.S. budget problem? I suggest that additional fiscal adjustment by the United States will remain, under all circumstances, the single most important component of U.S. current account correction, and that the room to support this adjustment with further dollar depreciation may be narrower than some would like to believe.

The close connection that exists between the U.S. trade and fiscal imbalances should be viewed in the light of the structurally low U.S. savings rate. Since the beginning of the 1980s, U.S. personal savings as a percentage of disposable income have run at about half the average savings rates of the seven major industrial countries, while the additional 2.5 percentage drop since 1984 has more than offset the federal deficit reductions achieved over the same period. Further fiscal adjustment is needed to compensate for the structural inadequacy of savings, to restore the balance between consumption and output, and to maintain interest rate conditions that are conducive to a crowding in of the investment and trade sectors. This view seemed to be shared by the Chairman of the Federal Reserve Board, Mr. Greenspan, when he recently injected into the public debate a recommendation for an increase in gasoline taxes, thereby suggesting that requests for a relaxation of monetary policy can be considered seriously only when coupled with action on the budget deficit.

The closeness of the link between the U.S. trade and fiscal imbalances is also evidenced by the recent behavior of the U.S. financial markets. The most recent market developments suggest that the continued favorable employment outlook feeds expectations about continuous monetary tightening aimed at quelling inflationary pressures, and thus generates upward pressure on interest rates that then weaken the stock market. The seeming contradiction between the behavior of the stock markets and the achievement of satisfactory output levels at the present stage of the business cycle suggests, a fortiori, that a credible fiscal policy environment is urgently needed to prevent positive export developments from being overwhelmed by upward interest rate pressure.

In sum, the structurally low U.S. savings rate and the markets' preoccupations with high capacity utilization at the present stage of the business cycle, both indicate that further budget actions, rather than additional dollar depreciation, are the appropriate means for sustaining the U.S. adjustment. The continuous positive performance of the U.S. business sectors shows that the exchange and interest rate corrections that have been made since 1985--in anticipation of the announced restoration of the U.S. public finances--have prepared the economy to accommodate large reallocations toward the trade sector of the resources released by the budget correction process. The sufficient time must now be allowed for a durable recovery of the non-price factors affecting U.S. competitiveness. A more useful attitude toward exchange rates is to avoid speculating about the lower interest rates that additional exchange rate depreciation would bring, but to consider whether additional fiscal action could be taken in a sufficiently convincing manner to avoid triggering the higher interest rates that would result from downward exchange rate pressures at the present stage of high capacity utilization. It is in connection with this question that Mr. Greenspan's suggestion for a moderate tax increase deserves consideration as one of the confidence-building measures that might have to be taken to protect the present financing scenario from recurrent market instability.

The need for a durable recovery of European output performance from its persistent low levels should be assessed from two standpoints: making Europe's adjustment process less vulnerable to external shocks inflicted by the U.S. business cycle; and ensuring that the positive contributions Europe is called on to make to the orderly correction of world current account imbalances in fact occur.

The elimination of subsidies and structural rigidities in European markets is the Fund staff's favorite prescription for Europe's chronically slow growth rate. The new simulations of possible output effects and spillover effects from the improvement of structural policies in Europe vitiate the validity of this standard view in two ways: first of all, these simulations show--not altogether surprisingly--that it takes a long time for improved output potential to be translated into increased output performance. And second, they show that the results of European structural policies will be confined largely to Europe, both because of the importance of intra-European trade and because the downward pressure on prices exerted by improved output capacity will, at least initially, improve Europe's competitive position.

In other words, from the standpoint of the international adjustment process, structural actions in Europe will in and of themselves postpone, rather than accelerate, the absorption of the current account imbalances. This prospect alone should spur the exploration of alternative solutions. Serious consideration should be directed toward the potential merits of combined approaches in which demand-supporting policies would speed up the output effects of structural measures and contribute more positively to increased import demand from abroad.

I would therefore urge the staff to give due consideration in future world economic outlook exercises to the analysis, recently presented by the Organization for Economic Cooperation and Development (OECD), of the merits and drawbacks for Europe of such combined approaches. Generally speaking, these analyses conclude that given each individual country's openness to intra-European trade, the effect on output of an isolated fiscal stimulus would be diluted largely by import leakages in the current account, and therefore would not increase income and tax receipts enough to offset the initial cost of the stimulus to the fiscal deficit. In many European countries, fiscal constraints are still a major obstacle to more forceful measures to support demand. The long process of deflation and low growth imposed on their economies by the slow response of supply to the reduction of the public sector's role continues to push up public debt/GNP ratios, despite these countries' considerable efforts at deficit reduction. Germany's situation is typical of this problem: throughout the 1980s its growth rate has lagged behind those of the other G-7 countries, and has slowed currently to a pace that threatens to produce tax revenue shortfalls which will imperil the successes of past fiscal consolidation and narrow room for more active growth policies.

While high intra-European trade and high government indebtedness limit the possible effectiveness of selective fiscal action for individual countries, the close interconnection of the European economies can be converted into a powerful asset if fiscal actions to support structural reform can be undertaken jointly by all countries. Under this scenario, the positive spillover effects within Europe would produce mutually reinforcing demand and output results large enough to justify expectations of a structurally supported improvement of Europe's output level at a reasonable fiscal cost. The zone of financial discipline that the European Monetary System mechanism has installed gradually in Europe, the planned completion of the internal market, the restored capacity to achieve noninflationary growth, and Europe's structural unemployment problems, are all solid arguments for a more forceful utilization of these possibilities.

Since the beginning of the decade, the capital importing developing countries have achieved an adjustment of their real trade balances of over $150 billion, or 8 percent of their combined GDP. Corrections of such a large magnitude, especially when they are accomplished under conditions of volatile world demand and increasing financing strains, cannot fail to harm domestic growth. How to restore these countries' investment levels to improve their output potential should be the Fund's central concern when considering the adjustment needs of the developing countries.

Both quantitative and qualitative improvements will have to be considered in the attempt to break out of the present circular relationships between the insufficiency of investment funds, the resulting failure to increase exports and domestic revenues, and the perception--stemming from that failure--that creditworthiness cannot be restored. Structural action to mobilize and reallocate available resources and to correct the many deficiencies of the production and distribution sectors in the indebted countries is the received prescription for restoring their productivity and creating conditions which logically should lead to a resumption of external investment flows. While I fully support the validity of this prescription, I also invite consideration of the secular nature of the low productivity levels of most debtor countries, which has so far not received sufficient attention in the Fund's general adjustment recommendations.

The negative productivity patterns that dominate the growth and adjustment prospects of the indebted countries are a corollary of the overexpansive lending and borrowing patterns established in the 1970s. The secular nature of these countries' productivity shortfalls suggests strongly that their adjustment to a more balanced pattern of capital accumulation has to be seen as a process with a much longer time horizon than the current account corrections presently being imposed on them. Adjustment of their capital accumulation patterns requires changing fundamentally the long-standing production relationship by means that most countries are apparently ready to consider. The secular nature of their productivity problem also suggests that until these corrections have been completed successfully, output and investment performance will continue to be depressed by the low productivity of the capital accumulated in the 1970s.

So far, the present strategy has failed to improve investment performance in countries with recent debt problems; instead, their already negative productivity rates have fallen further. Such a trend, especially in the face of their vigorously implemented adjustment policies, is quite worrisome. It suggests that in addition to the negative effects of previously accumulated capital, the adjustment itself may have helped postpone, rather than accelerate, the recovery of investment performance. In the heavily indebted countries, the adjustment effort has focused almost exclusively on rapid correction of the current account to comply with ever tighter financing constraints. The required massive reallocation of resources to the trade sector has had powerful negative side effects on domestic activity and stabilization, as I suggested during the recent Board discussion on the Mexican program. These side effects include internal supply constraints and loss of public sector revenues from the traditional domestic tax bases, which greatly impede the elimination of inflationary mechanisms from the economy. Generally speaking, adjustment efforts have been designed and implemented in a short-term framework, which has excluded the longer-term process of creating the orderly absorption conditions needed for sound investment decisions.

The debtor countries' productivity patterns shed an especially strong light on the prescriptions and limitations of the present debt strategy; overborrowing has saddled these countries with poorly performing investments and structurally defective productivity levels. Adequate financing flows are needed urgently to preserve orderly adjustment conditions that are reasonably conducive to investment and productivity improvement. Unfortunately, access to such financing remains blocked, because of low productivity of previously accumulated capital has led to the imposition of impossibly high rates of return on additional investment.

There is thus a fundamental need for additional financing to support adjustment and to reduce the burden of nonperforming outstanding debt. Present and alternative debt strategies must all be assessed in terms of the solutions they offer for a more forceful response to this need. Greater use of the extended Fund facility, and an expansion of the World Bank's role in the rehabilitation of poorly performing production sectors, can contribute to these solutions. Together they can promote the prolonged adjustment and financing choices from which a better balance between current account correction and internal productivity improvement can logically be expected.

The dilemma that the present adjustment process poses for U.S. monetary policy is especially difficult; the use of tight money to combat recurrent dollar instability risks bringing on a recession through the negative effects of wealth of further stock market weakness. However, the only lasting result of letting the interest and exchange rates fall to protect domestic output would probably be to push interest rates to even higher levels--in response to fears about the inflationary effects of import price increases and the growing strains on domestic capacity utilization.

While the staff fully recognizes the horns of this dilemma, I would have preferred it to give more explicit consideration to the important contributions that more systematic cooperation on interest and exchange rates could make toward alleviating the downside risks this dilemma inflicts on the present adjustment process. These risks could materialize at any time when recurrent market instability increases pressures on the U.S. authorities to widen the interest differential in favor of the U.S. dollar.

For the same reasons, recommending a unilateral hike in U.S. interest rates to offset the possibility of future exchange market tensions seems to call for the greatest caution. Owing to the structurally low savings rate position of the United States, business expectations in that country seem much more sensitive to interest rate fluctuations than is the case in most European countries. This sensitivity has increased even further over recent years, owing to the memories of the prolonged recession associated with Chairman Volcker's policies in the early 1980s aimed at eliminating inflationary pressures and offsetting the relaxation of budgetary policies. In other words, comparison of the U.S. situation with experience in the European Monetary System (EMS)--where interest rates are often used to support the stability of the member currencies--does not permit us to dismiss prematurely the risk that a loss of confidence by the U.S. business sector, triggered by a tightening of monetary policy, would bring an economic slowdown with worldwide consequences. The recently demonstrated volatility of the stock markets has further increased this risk.

As has already been shown by their past coordinated interest rate actions, Europe and Japan can make an important contribution to lessening these downside risks by systematically seizing every opportunity to accommodate a structural decline in interest rates worldwide. Prospects for achieving a decline would brighten considerably if further systemic steps were taken to reinforce the stability of the present exchange rate system. The major countries have gone a long way toward accepting the fact that within the present financing scenario, stable interest rate conditions cannot be obtained through recurrent currency realignments. The effects run in the opposite direction; exchange rates need to be subjected to sufficient systemic discipline to impose mutually consistent policy choices and bring on the structural decline in interest rates that should be the logical outcome of achieving more stable financing conditions.

In other words, the scenario of prolonged financing and structural adjustment, in which we find ourselves, invites us to reconsider the relationship that is commonly assumed between the achievement of more stable exchange rates and the acceptance of the higher and more volatile interest rates needed to defend the exchange rate. Instead, I suggest that hereafter, fullest consideration be given to the alternative solution, which would consist of a more formal adoption of a system of stable exchange rates, and its clear announcement to the public. Such a step would acknowledge that we are currently in a situation of prolonged adjustment financing that has to be supported by stable interest and exchange rates, instead of regarding the need for financing as an impediment to stability.

More generally, I recommend the continuous consolidation of the important steps that the major countries have been taking for two years toward stabilizing the present system, first by accepting the need to achieve common views on desirable exchange rate directions, second, by developing an indicator framework for the multilateral assessment of the underlying policy choices, and most recently be agreeing on SDR sales to support coordinated interventions. The latter decision, which reflects nascent acceptance of the need to support the emerging system of stable exchange rates by a reserve mechanism for symmetrical intervention, is a major step toward more general willingness to consider the SDR as the natural instrument for meeting the global need to support the role of the major reserve currency in the present system, which is based on prolonged financing and adjustment. Taken together, these consecutive actions have established a beachhead from which more integrated approaches should hereafter be explored carefully.

Mr. Yamazaki made the following statement:

At the outset, I would like to commend the staff for the high quality, comprehensive coverage, and balanced analysis of the world economic outlook papers. I would like to begin by taking up recent developments and short-term prospects for the world economy, where I am in general agreement with the staff's view. It is pleasing to note that the world economy has shown a number of favorable phenomena in 1987 and will show them in 1988 and 1989 as well: steady growth, low inflation rates, stabilizing exchange markets, shrinking external imbalances among industrial countries, and declining external debt burdens in many developing countries, are all encouraging.

Just after the so-called Black Monday in October 1987, the majority of the international community shared the concern about the serious slowdown of the world economy, which turned out to be an overpessimistic view. The underlying strength of the world economy has almost offset the negative effect of the stock market decline. I expect that this strong trend in the world economy will prevail in coming years. However, we should keep in mind the lessons from "Black Monday" so that we will take advantage of that experience in future economic management. In this context, I would like to stress the importance of the firm commitment of the United States to a continued reduction of its fiscal deficit.

The current account imbalances among major industrial countries have overshadowed the positive elements in the world economy and remain a source of concern to us. However, I concur with the staff that the current account imbalances expressed in U.S. dollar terms are misleading indicators of underlying imbalances and that significant adjustment has already taken place, as is clearly illustrated by Table 5 on page 20 of the main staff paper.

I project that the emerging lagged consequence of exchange rate adjustments, coupled with continued policy coordination among major industrial countries, will no doubt bring down the external imbalances steadily, but I admit that month-to-month fluctuations will be unavoidable. In the context of materializing this projection, I would like to underscore the need for major industrial countries to continue to make efforts to stabilize exchange markets and to intensify policy coordination, as agreed under the Louvre Accord and reaffirmed by the G-7 statements in December 1987.

As the Board has fully recognized, the Japanese economy has entered into a phase of robust expansion in 1987. My authorities project that vigorous domestic demand will bring overall economic growth up to 3.8 percent in spite of the negative growth of external demand in 1988. As to the trade and payments balances, my authorities expect a further reduction of the current account surplus of $72 billion in 1988--reflecting the overseas allocation of production facilities, favorable domestic demand, and expanding imports of manufactured goods. In this respect, I fully associate myself with the staff's view that the decline in the real trade surplus has been blurred by the weakness of oil prices and by the J-curve effect.

My authorities have committed themselves to the appropriate management of fiscal and monetary policy in order to secure sustainable growth in the Japanese economy. In fiscal policy, especially, my authorities intend to give priority to continued fiscal consolidation toward the elimination of the Government's dependence on deficit financing bonds by fiscal year 1990. My authorities will also pay due regard to domestic demand conditions as well. In this context, I would like to point out the need for the staff to use a wider range of indicators on the Japanese budgetary situation--in addition to the general government deficit--so that the Board can make a more appropriate and balanced analysis of Japan's fiscal stance.

I certainly understand the usefulness of the analysis based on medium-term scenarios; however, I would like to underscore that that analysis is no more than a complement to judgmental analysis, since those scenarios are effective only under the specific assumptions on which the scenarios are based. In addition, with respect to the analysis in the scenarios, I am concerned about the technical limitation of the economic models' ability to reflect economic reality fully. I, therefore, would like to invite the staff to increase the focus on the analysis of real economic phenomena, such as the October 1987 stock market plunge.

In this respect, I am apprehensive about discussing in depth, situations that, in a sense, are hypothetical, and about making a choice from scenarios. I, therefore, only wish to seek factual clarification from the staff.

As to the "reference" scenario, I would like the staff to explain its criteria for judging the sustainability and desirability of external payments positions among the three major countries. Then, with respect to the "fiscal tensions" scenario, I would like to learn about the rationale behind the staff's assumption on the size of the possible shock.

As far as the policy adjustment scenario is concerned, I would like to have further clarification from the staff on the assumptions about Japanese policy made in that scenario. The staff assumes on page 21 of the medium-term scenarios paper that "A change in structural policies that result in...greater openness of Japanese markets to foreign goods." On this point, I would like to make clear that Japan is experiencing double digit import growth, mainly stemming from the rapid increase of manufactured goods imports. This fact clearly illustrates that a further increase in imports will be attained mainly through a change of the export-oriented Japanese economy into a domestically fueled economy.

In this context, I would like to call to the Board's attention that the discussion of individual structural reform measures in individual countries, without appropriate background data, could be misleading.

While I certainly prefer Scenario III, or the "policy adjustment" scenario, which advocates the need for further efforts by surplus countries, especially to attain higher domestic demand, I stress that the most important challenge for the Fund is not to find the desirable scenario, but to find a way to promote steady policy coordination.

With respect to the medium-term policy issues, the staff is correct to point out that it is important to note that the effects of exchange rate movements will be reduced, without adjustments in the absorption patterns among countries. Therefore, I support the staff's view that the deficit countries should increase overall output more than domestic demand, while the surplus countries should increase domestic demand more than overall output--with both sides attaining exchange market stability.

In a similar vein, I particularly concur with the staff that a reduction of the U.S. fiscal deficit would have a significant salutary effect on current account imbalances.

I also associate myself with the staff on the importance of structural reform. My authorities have made a strong commitment to structural policies to reform the Japanese economy into a domestically led economy, with the implementation of the Mayekawa Report's recommendations.

I very much welcome the staff's view that the developing countries will maintain continued growth and that the ratios of debt to export earnings will decline steadily. This encouraging prospect reflects low interest rates, the expansion of world trade, the adjustment efforts by indebted countries, and the initiative of international financial organizations.

I agree with the staff on the need to recognize the diversified problems confronting different groups of countries. Therefore, the Fund should develop its strategy based on the diversity of problems; in particular, it should follow a different approach for low-income countries and middle-income countries.

In line with this recognition, Japan has already announced its substantial contribution to the enhanced structural adjustment facility on concessional terms. Moreover, it is necessary to make serious studies on the possible contributions of international financial institutions and industrial countries to facilitate the resolution of middle-income indebted countries' problems, while recognizing the importance of the market-based approach.

It is very encouraging that we have made significant progress in the use of indicators. However, it should be noted that we are still developing surveillance procedures and have not yet reached a definitive agreement on them. I, therefore, think that it is still premature to make conclusions on surveillance principles as well as on guidelines.

I have serious concerns about the publication of any medium-term scenarios--just as I did during the previous world economic outlook--since the publication of these scenarios could undermine the stability of exchange and financial markets. I also have difficulty with identifying areas where microeconomic reform measures should be taken, since the publication of individual areas of structural reform in individual countries could overheat the political discussion of these reforms and could be counterproductive to their earliest possible implementation.

The Chairman observed that, on the question of publication, much industrial country adjustment was presently accomplished through the implementation of structural measures. If the Fund did not comment publicly on them, the international financial press would do so in its place; moreover, a prudent and delicate expression of Fund views could help governments to promote structural adjustment policies. Despite the sensitivity, some specification of structural adjustment priorities should not be ruled out.

Mr. Grosche made the following statement:

The broad outlines of the staff's "reference" scenario are realistic, although I am somewhat more optimistic than the staff is with respect to the pace of adjustment. Some recent developments justify this optimism: the U.S. economy seems to be reacting faster to improvements in price competitiveness--as evidenced by its strong export performance over recent months--and more resources seem to be devoted to export production. Nonetheless, I agree with the staff that the risks are more on the downside. The challenge we are facing is to reduce these risks as much as possible, which should be done along the lines suggested by the staff in its "policy adjustment" scenario.

With respect to the United States, I share broadly the staff's recommendations and Mr. de Groote's suggestions. The task remains one of further reducing the fiscal deficit without interrupting growth. The withdrawal of fiscal stimulus appears to have been rather modest, and is probably not sufficient to make ample room for a continued strong expansion of private sector activity, particularly in the export sector. Therefore, price developments have to be monitored closely and checked if necessary.

Nobody has better expressed this chair's concerns than Chairman Greenspan in his statement before the Joint Economic Committee of Congress on March 15, 1988, when he said that "Ideally, one can conceive of a strengthening of exports meshing neatly with a slowing of domestic spending in such a way as to maintain utilization levels for labor and capital without overheating.... Realistically, however, one has to recognize that events in the real world may not mesh as neatly as contemplated and that the adjustment may not proceed as smoothly as we would like." Against this background, monetary policy is indeed facing a difficult task. I agree with Mr. Greenspan that "Monetary policy needs to remain supportive of the expansion but also alert to the possibility of a re-emergence of inflation."

In Japan, the authorities are moving in the right direction but here, too, monetary policy has to be mindful of inflation.

In Germany, external adjustment is under way and has gathered momentum: exports of goods and services increased from 1985 to 1987 in real terms by just 0.5 percent, whereas imports increased by about 8 1/2 percent. For 1988, I expect that real imports will again grow significantly faster, probably by about 4-5 percent, as compared with 1 1/2 to 2 1/2 percent for real exports.

The adjustment in Germany is showing up presently in the nominal trade figures as the J-curve effects are tapering off. The current account surplus declined by DM 3 billion in 1987.

The picture becomes even clearer when one looks at semiannual data: the current account surplus in the first half of 1987 increased by DM 4 billion from the same period in 1986, but declined in the second half of the year by DM 7 billion.

Despite the continued drag on GNP growth caused by the foreign sector, most of the recent data suggest that economic performance could be better in 1988 than had been expected widely a few weeks ago. The business climate seems to have improved; consumer spending appears to be staying at high levels, and owing to the rather mild winter, incoming orders and production have remained large. Thus, the first quarter of 1988 should show growth in the range of 2 to 4 percent on an annual and seasonally adjusted basis. A slowdown over the course of the year is not expected. Private consumption should benefit from the tax reduction of about DM 14 billion--equivalent to about 3/4 of 1 percent of GNP--that came into effect at the beginning of 1988. Moreover, private investment activity should pick up as the appreciation of the deutsche mark appears to have fed through the system, and the uncertainties following the October 19 stock market events have subsided.

Fiscal policy is supporting domestic demand through the tax cut; meanwhile, a further and far-reaching program of tax reform is being debated in Parliament. The tax reform program will not only bring about a further tax reduction, but will also introduce structural reforms in the tax system by closing loopholes and cutting marginal tax rates. Most important, all revenue losses occurring during 1988 will be accepted without compensation. Thus, the federal deficit is expected to jump from a planned DM 29 billion to about DM 40 billion. German fiscal policy is walking a tightrope: on the one hand, fiscal policy has to react to the economic cycle and to challenges from abroad; on the other hand, if investor and consumer expectations of a stable economic environment are to be maintained, fiscal policy must continue to stick to its basic objective of medium-term consolidation.

The staff's recommendation that macroeconomic policy must be complemented by structural measures is entirely appropriate. The Federal Government has recently taken further steps in a sustained process of adapting the German economic framework to a changing environment. Further sales of state-owned shares in enterprises have been approved; the deregulation of the telecommunication sector will be another important undertaking.

However, developments in Germany will also depend on events in currency markets. With exchange rates staying at about their current levels for the rest of 1988, a growth rate at the upper end and perhaps above the official German forecast of 1 1/2-2 percent is possible.

Everybody agrees that once exchange rates have been corrected to better reflect relative competitive positions, external adjustment then has to be fostered in deficit countries by a lesser expansion of domestic demand than aggregate production, while in surplus countries, the reverse process has to take place. In that sense, there is a need for sharing the responsibility for adjustment between debtor and creditor countries, but I have doubts about the desirability of a symmetrical adjustment.

The prospective trends in external payment positions of the three major countries are described in the main staff paper as neither "desirable" nor "sustainable"--an assessment on which there is much consensus. However, this broad assessment glosses over a critical distinction between two aspects of the prevailing and prospective current account positions: first, are both the deficits and surpluses unsustainably large, or only the deficits; and second, are the current account positions compatible with an appropriate allocation of world savings?

An assessment of the adequacy of world savings seems to be a necessary condition for making a judgment on the appropriate correction of the major industrial countries' current account imbalances. The notion that such a correction calls for reductions in both deficits and surpluses implies that net savings--represented by the current account surpluses--are excessive from the world economy's standpoint. Evidence of this is not provided in the staff papers and, yet, such a judgment seems to be behind the staff's calls for an accelerated "pace of domestic demand growth" in surplus countries.

I acknowledge that this line of reasoning is not followed elsewhere in the main staff paper: in discussing the resulting stock positions, particularly that of the United States, the staff does not see these positions as "easy to relate to conventional perceptions about the appropriate allocation of world savings." This is a promising line of inquiry that, together with the need to tackle structural rigidities, should be pursued further, because it can yield important insights on the appropriate policy path. The appropriate policy path would indicate clearly that the primary responsibility for external adjustment rested with the deficit countries. To be sure, the contribution that surplus countries can make to adjustment is to accept the relative price consequences of their imbalances, which, in fact, the major surplus countries have done in accepting drastic corrections to their exchange rates; some observers would say that the corrections went too far. However, the deficit countries do not seem to have met fully their responsibilities, in the sense that they might not have reduced their domestic consumption sufficiently to provide enough resources for investment and exports, or in other words, to enable them to absorb less world savings.

An assessment of the appropriateness of the level and allocation of world savings would clearly be a useful aim for forthcoming world economic outlooks; such an assessment would also help to link the industrial countries' outlook with that of the developing or capital-importing countries, particularly the group of highly indebted developing economies. Moreover, an assessment of the long-term evolution of world savings should also take into account net savings trends in mature economies, which could become even more important providers of the capital flows that are required for growth in the rest of the world.

There was a troublesome theme running through the world economic outlook papers--the assertion that European Monetary System members are constrained by the relatively slow rate of domestic demand growth in Germany. A fundamental issue is whether such a constraint vanishes for countries outside the European Monetary System or, in other words, whether a sustainable path of domestic demand cannot accompany financial discipline. It is by no means obvious that the European Monetary System implies necessarily that demand has to be kept below sustainable levels: both the intra-system capital flows and periodic exchange rate realignments contribute to the compatibility of differential growth paths; and to the extent that considerable progress has been made toward converging to the lowest inflation rate in the European Monetary System, participation in the system should not retard growth--provided that competitiveness prevails in each economy. The challenge is well described on page 38 of the main staff paper in connection with the need to manage the European Monetary System exchange rate arrangements to "facilitate the changes in competitiveness required for members to realize their growth potential without endangering price stability." It can be argued that the operations of the European Monetary System have conformed to this description by balancing, in a manner acceptable to members, the need to allow for adaptations in relative competitive positions with that of convergence toward the lowest rate of inflation.

From Germany's standpoint, the policy stances in several areas need to be seen together to gauge adequately the country's contribution to smooth adjustment within the European Monetary System and elsewhere. Apart from the exchange rate developments mentioned above--which are clear evidence of the authorities' willingness and ability to adjust--there is a fiscal policy stance characterized by growing deficits and a monetary policy stance that is allowing the rapid growth of the money supply--particularly by Germany's standards. Both of these trends have kept, and are keeping, domestic demand growth rates above those of potential output, which again illustrates the authorities' willingness and ability to adjust.

There can be no doubt that stable exchange rates are most desirable, but the European Monetary System's achievements cannot be extended easily to other currency zones. In this connection, the conclusion of the G-10 report on the international monetary system remains very valid, that is, neither fixed exchange rates nor target zones are practical or desirable under present circumstances. The inappropriateness of fixed or targeted exchange rates should not be interpreted to mean that we ought not to work hard toward achieving more stability among major currencies; on the contrary, my authorities are deeply satisfied with the recent progress in this respect, resulting from the improved international cooperation among the major industrial countries. The only feasible means of bringing about exchange rate stability and smooth adjustment is through international cooperation, aiming at economic fundamentals and the consistency of national policies. In pursuing this path, official statements on the desired level of exchange rates at a given time can assist greatly in guiding the markets, particularly if the statements are underpinned by timely interventions. However, despite the recent progress in this respect, it is perhaps not yet time to begin considering reforms of the international monetary system.

The Fund's bilateral and multilateral surveillance role is critically important for the success of international policy coordination. The use of indicators has improved the Fund's approach, although an excessively mechanistic use of them should be avoided; they cannot replace judgment and political decision making. We will have to gain additional experience before attempting to develop more formal guidelines for the conduct of policies that influence exchange rates, but I would not object to experimenting with a commodity price index and adding it to the Fund's list of indicators.

Mr. Ismael made the following statement:

At the previous Board discussion of the world economic outlook, I said that if governments did not promote a more desirable medium-term evolution of the world economy, the financial markets would determine the outcome for them with unpleasant consequences. Despite the staff's greater optimism about the smooth financing of prospective imbalances, and the apparent stability of financial markets over recent months, my view about the significant downside risks to the "baseline" scenario has not changed. The financial markets continue to be very jittery about the course of growth, inflation, exchange and interest rates, and the fiscal and external imbalances in the major industrial countries, and they are reacting to every indication of new developments in the key economic variables. The news has been favorable thus far, but there is always a possibility that the recent tranquility could evaporate quickly, as it did on several occasions in 1987.

The realistic choice for the world economy's medium-term outlook is between the "policy adjustment" and "financial tensions" scenarios. It is not realistic to expect that countries can muddle through another five years of sustained growth close to potential output in the face of fiscal and external imbalances that continue to be unsustainably large in relation to present policies. As long as the world's largest economy depends on about $130 billion of external financing a year, the global economy and financial system will remain vulnerable to shifts in portfolio preferences. During 1987, we witnessed a drying-up of private financing, while, in supporting the dollar, foreign central banks were forced to finance the U.S. fiscal and external deficits. The key issue is whether they will remain willing to do so to the same extent in the future.

Beside the "baseline" scenario's downside risks, and despite its apparent attraction of continued moderate output growth over the medium term, it has several important undesirable aspects.

First, the U.S. current account deficit will persist at about $130 billion until 1992, despite a falling deficit to GNP ratio. External deficits of such a large magnitude will intensify pressures for trade and investment restrictions, and will increase the U.S. net external debt to about $1.1 trillion--equivalent to about 18 percent of GNP--by 1992. Apart from the issue of whether the United States should continue to pre-empt such a large share of global savings because of its own very low savings ratio, the U.S. authorities will be less able to manage the U.S. current account in the 1990s, as interest payments alone on outstanding debt will amount to about $90 billion annually.

Moreover, the continuing large U.S. financing needs will keep nominal and real interest rates on dollar assets high compared with their historical levels. The real six-month LIBOR rate of 4.3 percent over 1988-92 will be too high relative to the growth of real GDP, which averaged 4.6 percent a year for the capital-importing developing countries during the same period. For countries with recent debt-servicing problems, most of the real growth will be pre-empted by interest payments, leaving only a small growth increment to raise per capita income or to increase investment. If better fiscal adjustment in the United States could reduce dollar interest rates by only

2 percentage points, the developing countries could save at least $15 billion a year in debt-servicing costs, without there being any costs for industrial country governments.

In addition, the danger of rekindled inflation in the United States is very real over the medium term. With capacity utilization higher than at any time since the rapid inflation rates of the late 1970s, the question is whether the U.S. economy can increase exports to reduce its external imbalance and simultaneously supply domestic demand at the projected levels; hence, further fiscal consolidation is essential to "crowd in" private investment and to free resources for exports, as well as to impart greater confidence to financial markets.

Finally, European unemployment rates remain unacceptably high compared with historical levels, indicating that output can be increased--through structural adjustments that will contribute to the international adjustment process--without either rekindling inflation or compromising fiscal consolidation.

The negative aspects of the "baseline" scenario point clearly to the urgent need for international cooperation to achieve a more sustainable outcome closer to that under the "policy adjustment" scenario. After the substantial exchange rate changes that have taken place, policies to manage domestic demand and to accelerate structural reform should assume center stage in the effort to achieve a viable payments pattern, for which both surplus and deficit countries should share responsibility. The policy prescriptions in the "policy adjustment" scenario--namely, further fiscal correction in the United States, the strengthening of structural adjustment in Europe, and the reform of key sectors in Japan--address my main concerns about the "baseline" scenario. However, it is disappointing that the staff did not include the reform of European agricultural protection: the huge sums of money spent by the European Economic Community on the Common Agricultural Policy result only in the surplus production of commodities and continue to encourage a grossly inefficient use of scarce resources. The reform of European agricultural policies would help to achieve further fiscal consolidation in the United States by reducing the need for U.S. export subsidies and facilitate agricultural reform in Japan, whereas in Europe, the reduction of consumer prices would increase real income and domestic demand so that the enhanced output potential from structural adjustment measures could be realized without the need for further fiscal stimulus.

I support the staff's view that reviving growth in developing countries requires a strengthening of macroeconomic and microeconomic policies to complement the availability of increased financing. However, the real issue is not the strengthening of adjustment, but whether adequate financing will be available to increase investment from its depressed levels. The global strategy to sustain growth and promote adjustment cannot be complete without increased financial support for developing countries. Complementing the "cost-free" method to reduce dollar interest rates that I suggested earlier--namely, stronger fiscal adjustment in the United States--would be increased official development assistance.

Nevertheless, without a stronger revival of private lending, debtors will still find it difficult to grow out of debt, even under the "policy adjustment" scenario. Further private lending requires a renewed belief by investors that the future level of debt will be manageable, or in other words, that the debt "overhang" will be lower than it is at present. For this purpose, the "menu" of options enabling lenders to convert their claims could be widened significantly with an international debt adjustment facility. Once the debt overhang is reduced, the Fund could play a more important role in sustaining adjustment through a modified extended Fund facility and a contingency mechanism in its growth-oriented adjustment programs.

It would be useful to begin considering reforms to the international monetary system. The experience of the 1980s shows that the use of exchange and interest rates as substitutes for fiscal adjustment has been very costly, particularly for the developing countries. In this connection, the staff's finding that 60 percent of the increase in developing countries' debt in 1987 has been due to valuation effects associated with the dollar depreciation is significant; in addition, dollar interest rates have been much higher than they would otherwise have been, because of the large U.S. fiscal and external deficits. There ought to be a stronger adjustment mechanism in place to avoid the policy divergences of the 1980s, which led to prolonged currency overvaluation, sustained and large external imbalances, and the need for subsequent corrections.

Import growth in the newly industrializing economies has surged along with their export expansion--aiding the international adjustment process by increasing demand for raw materials and capital goods. Their increased surpluses with certain countries reflect mainly the trade restrictions that have been placed on other successful exporters. The newly industrializing economies' export of motor vehicles is a good example of their trading success. These countries can play a role in reducing external imbalances, but we should be careful not to destabilize their economies by asking them to shoulder too much of the international adjustment burden. Moreover, any trade liberalization should be promoted on a multilateral basis rather than serving the interests of any particular country.

Mr. Kafka said that the world economy's short-term growth prospects to end-1989 were at best modest and were threatened in the industrial countries by fiscal and current account imbalances, and in the less developed countries by the uncertain growth of, and financing from, the developed economies. Little consolation could be taken from the estimated decline in debtor countries' debt ratios in 1987, as the fall did not portend any new perception by lenders of those countries' increased creditworthiness.

Modest growth, at best, was expected to continue in the industrial countries over the medium term to end-1992, only four fifths over that of 1982-87, Mr. Kafka continued. In the capital-importing countries, growth in the later medium term, or during 1990-92, was expected to be better, but would still be only about four fifths of what it was before the disastrous 1980s. He agreed strongly with the staff that "to the extent that current debt service burdens inhibit a return to higher levels of investment and long-term growth, ways may need to be sought to alleviate such burdens in the long-term interest of both debtors and creditors." In many countries, these burdens do threaten, along with growth, even more basic objectives, including the stability of the social framework.

The major short-term problem in industrial countries was policy coordination, Mr. Kafka considered, as there was a need to combine U.S. fiscal deficit reduction and adequate stimulation in other countries, and to ensure that exchange rates adapted smoothly rather than explosively. Policy coordination was discussed widely and praised universally, but seemed to prove difficult to achieve, especially on fiscal policy. In that connection, serious consequences would stem from the fact that little short-term progress on U.S. fiscal deficit reduction was likely. However, as for monetary policy, coordinated intervention over the past month appeared to have been quite successful in maintaining exchange rates within a limited range, yet it might not be either possible or desirable much longer, because if the narrow exchange rate band had to be abandoned, the longer one waited, the more explosive the abandonment would be. In any event, the one bright spot in recent developments was that the past year's stock market crash seemed to have had little effect on growth.

The industrial countries' medium-term problems were the same as those in the short term, Mr. Kafka added. The staff had perhaps been too hesitant in stressing the need for the "policy adjustment" scenario and had not emphasized adequately the problems of industrial country structural change, especially agricultural protection, and, more generally, why the industrial countries had not addressed substantively the issue of adapting their economies to accommodate developing countries' increasing role in world trade. Furthermore, the industrial countries faced other major structural problems that required the implementation of structural reform measures--even in the United States, where the economy was less rigid than in Europe and Japan.

There was an urgent need to stimulate domestic savings in developing countries, Mr. Kafka stated, and although the developing countries' policies had greatly strengthened their current accounts, that had been--to an excessive extent--at the expense of more rapid inflation rates, greater import compression, and slower growth rates. However, the increasing flexibility of interest and exchange rate policies was welcome, despite the fact that the latter did make anti-inflation policies more difficult. Moreover, it was deplorable that the public sector deficits continued to be so difficult to control.

The indebted countries had not reached a comfortable external financial position, despite the strong improvements in their current accounts, Mr. Kafka pointed out. It was estimated that their debt and debt service ratios had begun to fall and would continue to do so; whereas the debt service ratios of capital-importing countries as a whole would be somewhat lower than in 1980--owing to the postponement of amortization payments--the debt ratios of countries with recent debt-servicing problems would in 1992 still be apparently 60 percent higher than in 1980.

The reduced current account deficits of indebted developing countries reflected essentially the slower growth of output and the compression of imports, Mr. Kafka explained. The traditional debt strategy that was initiated in 1982 was first questioned not by the less developed countries or the international institutions, but by Secretary Baker, who pointed out that the debt problem could be solved only if the strategy adopted envisaged a reacceleration of indebted country growth. The idea of alleviating the debt service burden by arranging additional borrowing to offset interest payments was also being questioned: accumulating more debt no longer seemed like a sensible approach to the problem. On the other hand, debt forgiveness endangered the restoration of debt countries' creditworthiness--even if it did not threaten the financial stability of the world's banks. No single instrument could deal adequately with the debt crisis, and even the menu approach left open the substantial question of deciding in what proportions the different ingredients--including debt forgiveness--were to be applied. Another aspect to the debt question was the extent to which the Fund should use its jurisdiction over exchange restrictions to provide incentives to both creditors and debtors to develop appropriate attitudes with respect to the accumulation of financial arrears.

The restoration of a satisfactory growth rate in the indebted countries required the implementation of the well-known trinity of improvements: better debtor country policies, an improved international economic environment, and increased external financing, Mr. Kafka observed. It was doubtful whether those improvements would emerge considering the relatively slow growth policies that had been adopted by the industrial countries, the increasing trend toward protectionism rather than to a standstill or rollback of recent protectionist measures, and the implausibility of replacing large flows of syndicated bank loans by other sources of funds. Moreover, contrary to what the staff seemed to be claiming, its own figures indicated that developing country growth would slow to 3.6 percent a year over 1988-89 from 3.8 percent over 1984-86. Beyond the fact that the Fund had increased the supply of concessional finance for low-income countries, the outlook was extremely somber. In 1987, the Fund had received over

$6 billion in repurchases--not including payment of charges or SDR interest--which represented a burden equivalent to more than 50 percent of less developed countries' combined deficits on goods, services, and private transfers.

The attitude of the developing and indebted countries was obviously crucial in the promotion of a successful growth strategy, Mr. Kafka noted. The staff's highly suggestive data showed that capital had played a similar role both in those countries that had no debt service problems and had grown relatively rapidly, and those that had serious debt service problems and had grown relatively slowly. The big difference between the two groups of countries was that in the former, the contribution of capital and labor to growth was reinforced by increasing factor productivity, while in the latter group of countries, the decline in factor productivity offset part of the contribution of capital and labor. As the staff had recognized, the implication for the higher indebted middle-income countries was obvious: "the scope for action in the short term is severely constrained by the debt overhang and by adjustment fatigue." The staff has also pointed to the need for "an imaginative pursuit of a menu of options," and more specifically, the need to find a means of sharing equitably discounts on debt and the benefits from successful adjustment between debtor and creditor countries. Furthermore, the issue of the extent to which creditor country governments could help by deploying their own financial resources directly, and by using their regulatory and taxing powers to encourage the private sector to resume increased resource flows, had been played down thus far.

It was good to see a reference in a staff paper to the international monetary system and the role of the Fund, although it had not been discussed much, Mr. Kafka commented. It was easier to agree that flexible exchange rates had not been helpful than to find a system to replace them with. A commodity currency would have few attractions; furthermore, it was an open question whether a composite currency could be a stable but adjustable peg for the world's principal currencies as was the issue of whether an international version of the European Monetary System could be established in the absence of a currency that was not simultaneously the most widely used and that of a country with the lowest inflation rate in the international community. As the Managing Director had suggested previously, the Board should think more about those issues and related monetary reform questions; the Fund could not be the only place where the international monetary system was not discussed.

The classification of countries exporting manufactures seemed to require a redefinition, Mr. Kafka indicated, by changing the cutoff date for inclusion from 1980 to a somewhat later date. The staff had come to realize that, in addition to Turkey, quite a number of countries had joined the manufactures exporting group in 1980.

He agreed with Mr. Yamazaki that the Fund should be extremely careful to avoid individual references in the World Economic Outlook publication, Mr. Kafka concluded.

Mr. Cassell said that he endorsed broadly the staff's forecasts for 1988, but did wonder in a couple of cases whether it had accounted fully for the most recent economic figures at the end of 1987. The results in 1987 turned out to be better than expected, and the growth rate might still be stronger than the staff predicted. The prospects for 1988 were reasonably good, but thereafter, they became increasingly uncertain. Doubtless, the Board recognized the extent to which the staff's medium-term scenarios were best regarded as giving broad indications of future trends, rather than specific forecasts, although it might be salutary in future exercises to show, alongside the results, the past forecasting record for the main variables.

The staff suggested that the major forecasting risks were on the downside, Mr. Cassell continued, but whereas the risks in the United States did seem to be in that direction, it might not be so for many European economies. More generally, the danger was that the present imbalances among the major countries might not be financeable at current interest and exchange rates, although it was very difficult to assess how large the risk was. The staff approached the question by looking at the projected net asset positions of the major countries, but one should remember that the statistics on which it rested were extremely unreliable. Nonetheless, the implication from the trends in the "reference" scenario that the United States, Germany, and Japan would have net creditor or debtor positions of between 17 and 24 percent of GNP by 1992 was certainly an arresting one.

The staff noted that despite the fact that the prospective deterioration of the external asset position of the United States was well within the balance successfully managed by other economies in the past, Mr. Cassell recalled, they doubted whether it was sustainable, both because of the absolute size of the U.S. economy and as the inflow of capital seemed to have been used mainly to finance consumption rather than investment. He agreed with the staff that borrowing to finance consumption might be undesirable, but was less sure that it was unsustainable over the medium term; indeed, the very ease with which it had been sustained during the past was the reason why there were presently such large imbalances.

The staff was certainly right to go from the "reference" scenario to explore a "financial tensions" scenario, Mr. Cassell agreed, but he had not found that part of the paper easy to follow. Simulating a stock market collapse and a dollar depreciation at the same time made it hard to disentangle what was happening; and despite the events of the autumn of 1987, it was far from clear that a combination of the two financial market disturbances would necessarily occur simultaneously in the future.

Many subjective assumptions had been made in the "financial tensions" scenario, Mr. Cassell commented; for instance, it was not obvious why a market-enforced dollar depreciation would accompany a level of U.S. interest rates that were about 1.5 percentage points lower in the latter part of the period than in the "baseline" scenario. That did not deny the clear risk that the financial markets might lose confidence and that there might be disruptive shifts in interest and exchange rates; indeed, it was those risks that prompted the strengthening of policy coordination among the major countries.

The general direction of policy adjustment implied in the main staff paper seemed to be appropriate, Mr. Cassell considered. Further reductions were required in the U.S. fiscal deficit, despite the cuts that had been made over the past few years. As the staff pointed out, additional exchange rate changes would not be useful in the current circumstances of continued high capacity utilization in the United States; instead, domestic absorption needed to be reduced, while the major surplus countries should continue to promote faster domestic demand growth. As the Board had discussed recently, the Japanese Government had made considerable progress in the latter respect; progress had been slower in Germany--although the authorities' decision to allow automatic stabilizers to work had been helpful. As many Directors had noted in the Article IV discussion on Japan, and as was true for most of the European countries, structural policies had a key role to play in promoting adjustment.

During that Article IV discussion with Japan, the staff had made the point that an excessive reduction in the Japanese current account surplus, if it stemmed from a reduction in savings, could harm the world economy as it would tend to put upward pressure on world interest rates, Mr. Cassell recalled. In the context of the indicator approach, it seemed that the Board could usefully do more in analyzing those sort of questions. The commodity price basket was a move in that direction, allowing the Board to focus on the inflation rate outlook for the major countries as a group; in that connection, Chart 4 of EBS/88/44 showing the relationship between a commodity price basket and the G-7 inflation rate was impressive. The indicator approach could be expanded to cover other aspects of the performance of the G-7 economies as a group. For example, Chart 8 of EBS/88/44 showed dramatically how the real effective exchange rates of all groups of developing countries had fallen significantly over recent years, the corollary of which was presumably that there had been a matching rise in the real effective exchange rate of the industrial countries as a group. Those exchange rate developments had clear implications for the process of external adjustment. It would be helpful in analyzing those issues if the staff in the future tried to construct a real effective exchange rate for the G-7 countries as a group.

The overall circumstances of developing countries in 1987 had some encouraging aspects, Mr. Cassell observed: growth in the non-oil developing countries was 4 1/2 percent, and there was a substantial fall in the debt service ratio for the first time since the debt problem had emerged. However, it was clear that those aggregates disguised the very different experiences of individual countries. As the situation remained very serious in many African countries, continued structural reforms supported by adequate concessional financing would be essential, and even with the prospect of additional disbursements through the international financial institutions as a result of the replenishment of the International Development Association, the World Bank's cofinancing initiative, and the enhanced structural adjustment facility, the situation was likely to remain very difficult. His authorities continued to believe that some change in the Paris Club's rescheduling terms was not only desirable, but also ultimately unavoidable.

The staff's estimate of the amount of adjustment undertaken by the indebted middle-income countries over the past few years was striking, Mr. Cassell noted. Those efforts had not resulted in greater balance of payments adjustment largely because of the very difficult external environment. It was clear from the staff's work that further measures were needed to improve resource-use efficiency, of which structural policies were an important part, but the latter would have to be supported by adequate external financing.

The newly industrialized economies (NIEs) had made impressive progress over recent years, and in some cases had generated large external surpluses, Mr. Cassell remarked. As the staff pointed out, the countries in that group were heterogeneous and they faced substantial differences in economic conditions. However, it was important for the countries that had generated substantial external surpluses to play their role in international adjustment. As had been said in the Board during the recent discussion on the Uruguay Round of the GATT (EBM/88/32 and EBM/88/33, 3/7/88), the NIEs were no longer "developing" countries in the old sense of the term. None of the foregoing implied that they should not run current account surpluses, but it did mean that they should recognize that excessive surpluses--particularly when the surpluses resulted from restrictive exchange or trade policies--were bound to increase the protectionist pressures in industrial countries and slow the pace of adjustment.

Interesting remarks on the international monetary system and the role of the Fund had been made by Mr. Grosche and Mr. Kafka, Mr. Cassell concluded, but he doubted whether the world economic outlook discussion was the best occasion for considering such an issue, which the staff could obviously only deal with in part in the background papers. He was sure that the Board could agree with the staff that there were serious costs in allowing exchange rates to bear the full brunt of adjustment; for that reason, policy coordination had been improved among the major countries and had helped to make a greater degree of exchange rate stability a feasible objective. However, the question of how to ensure that there was no inherent inflationary or deflationary bias in the international monetary system remained, which was why his authorities were among those who did see a role for a nominal anchor and had suggested that a commodity price indicator might play a useful role in that respect.

The Chairman remarked that if the world economic outlook discussion was not considered to be an appropriate occasion for an extensive discussion of international monetary reform, another opportunity would have to be found, at some point after the Interim Committee meeting, to take up that issue.

Mr. Cassell responded that he agreed that the Fund would have to take up the issue at some point.

Mr. Salehkhou made the following statement

The compounding of imbalances in the world economy finally led to the events of October 1987, following an earlier plunge in the bond markets. The sharp worldwide falls in equity and bond prices were the inevitable and dramatic manifestation of prolonged tensions in the major economies. The financial market turbulence spread to the recurrently unstable foreign exchange markets shortly thereafter--adding to the problematic tasks of already overstretched monetary policy in the industrial countries. Clearly, the sharp slide in world commodity prices, particularly oil, greatly contributed to absorbing the further negative impact of the crash on the industrial countries. On the other hand, many developing countries, including some in my own constituency, had to face huge losses due to deliberate successive depreciations of the U.S. dollar. Despite attempts to downplay its negative impact, the shock of the stock market crash continues to reverberate, and magnifies the inherent volatility in the international financial and exchange markets.

Worries are expressed by many observers with respect to the persistent global economic imbalances: this includes the staff's concern about the possible recurrence of the stock market crash in an already disconcerted and confused international environment. The overall economic outlook is, therefore, bleak, particularly because of inadequate policy responses and their implications for future investment and market confidence.

In addition to the staff's implicit but clear concerns, others--including the Brady Commission, the Organization for Economic Cooperation and Development, and the Institute for International Economics--have also warned that the piecemeal and superficial changes since October 1987 have only increased the risks in the already fragile and vulnerable financial markets. Hence, the consensus is that in the absence of quick and drastic correction of international economic and financial imbalances at their roots, the probability of a recession--possibly preceded by another acute financial market turmoil--is relatively high.

This chair has made it a policy of speaking directly about issues even though at times its position may have either been misinterpreted, misunderstood, or generally considered unpleasant. Long before the October crash, I had on several occasions warned that the existing imbalances created by the "beggar-thy-developing-neighbor" policy of industrial economies were untenable and would sooner or later lead to disaster; albeit, the warnings were not heeded. Propitiously, this year, many professional organizations and prominent analysts, including our own Chairman, have deemed it appropriate to explicitly warn the international community, and I take this opportunity to join them. No amount of tranquilizers will save the badly impaired world financial markets from another disaster. Before major economies' self-centered policies create a Sisyphus out of the Fund, the Board would be well advised to take serious steps to deal with the three major problems that are rapidly leading the rest of the world like lemmings into the sea.

The three-pronged problem of needed structural adjustments in the major economies, the crisis-ridden international monetary system, and external debt, can still be effectively tackled if the Fund is in a position to firmly assume its responsibilities to restore international economic stability. On the first issue, I have consistently raised the problem of the asymmetry of Fund surveillance. The major economies with equally major structural problems have consistently berated developing countries and utilized every opportunity to press for more structural adjustments: now the world economy is in serious danger of collapse because structural adjustments have long been neglected in the major economies themselves. When the United Kingdom chose to take its structural problems seriously enough to taste the medicine that it, as a member of the privileged class of countries, was prescribing to the developing countries, the results were so positive that even the British were impressed. Perhaps the British example could convince the rest of the club members to follow suit.

The effectiveness of world economic outlook as a minimal surveillance tool is diminished increasingly by the calls from some industrial country creditors to focus attention on the few newly industrialized economies that have managed to pull themselves up by their own bootstraps. The undue emphasis on these economies diverts attention from the real issue of the needed structural reforms in industrial countries.

On the second issue, it hardly needs to be emphasized that the international monetary system is under a great deal of stress, and that the root cause is the weakness of the international reserve currency. The compelling question remains whether a new international currency system can be adopted without a major disaster such as the Great Depression.

On the debt question, most analysts agree that this problem is nothing short of a "ticking time bomb" that must be defused urgently. Just as an expectant mother cannot willfully argue for the status quo, the Fund should not continue to remain on the sidelines or at best parrot the interests of the creditor countries.

Before turning to the topics for discussion, let me reiterate my position on the publication of the world economic outlook. Given the relative divergence of the views expressed by many Directors, which at times differ widely from those of the staff, the individual Directors' comments should somehow be incorporated in the World Economic Outlook publication at their own discretion and subject to their final approval of the edited version.

On the topics for discussion, I will refer first to the realism of the projections. While the "reference" scenario may provide a useful starting point for identifying the source and magnitude of the "tensions," the mutual consistency of its assumptions is subject to stable conditions in the financial markets. Yet, the world economic outlook itself recognizes in Annex I that the loss of confidence on the part of consumers and investors reflects a high degree of uncertainty; hence, "the possibility that the stock market decline could lead to a marked loss of consumer and business confidence...still remains real." In this respect, I appreciate the Managing Director's courageous remarks at the conclusion of the Board meeting on SDR allocation about this real danger. Given the continuing volatility of financial markets, the probability of the remaining confidence being undermined is rather high; consider, for example, as that on January 8, 1988 the Dow Jones industrial average fell by 140 points--the third largest decline in history. In this respect, the staff rightly observed, that this "incident highlighted the continuing vulnerability of the system and suggested that the October 1987 decline was not only a 'technical' market correction, but also reflected market perceptions of the relative inadequacy and slowness with which the international adjustment process was proceeding."

The vulnerability of the market and the loss of confidence on the part of consumers and investors are reinforced by the lack of political will and decisive action to correct existing imbalances at their roots; by the recurrently unstable conditions in foreign exchange markets and exchange rate instability; the overstressed international monetary system; the relative lack of progress in structural reforms; and the growing trade restrictions and rising protectionism, not to mention the huge debt overhang choking off any potential growth in developing countries.

It is perhaps the above considerations that have led the staff to recognize "that the assumption of unchanged policies is not necessarily consistent with the assumption of stable conditions in financial markets. In particular, if present policies lead to a buildup of financial imbalances, it is unlikely that exchange rates and interest rates will be unaffected. Even if policies were to remain unchanged in the short run, the possibility of eventual abrupt adjustments would clearly increase."

In that event, it seems plausible that the staff's assumptions of unchanged constant real exchange rate policies and the absence of financial market disturbances, and particularly the absence of major changes in interest rates and stock prices, are judged to be incompatible. Hence, the choice is narrowed to between the "financial tensions" and "policy adjustment" scenarios. I agree with the staff that the "financial tensions" scenario would not be useful for making economic projections owing to its speculative nature.

As for the "policy adjustment" scenario, given the prevailing skepticism owing to the persistent imbalances and confused world economy, I agree that the set of proposed actions in the areas of fiscal, monetary, and structural policies, are only "consistent with the policy intentions set forth in the Louvre communiqué." I, however, strongly believe that the communiqué essentially disregards the position of developing countries; this is hardly compatible with the spirit of international cooperation. Moreover, it is no secret that the provisions envisaged in the Louvre Accord have not been implemented by the signatories to any significant extent, as is reflected in daily press accounts and policy announcements. Incidentally, I wonder to what extent the use of indicators has been effective in policy coordination among these countries.

The realism of the medium-term projections, therefore, is more than ever constrained by continued lack of effective and willful policy coordination.

Since I agree with the thrust of the staff's analysis of the policies required for external adjustment, I will confine my remarks to emphasizing some of the main points.

First, exchange rate variations unaccompanied by changes in domestic structural policies are not efficient means of reducing imbalances, as experience has shown that they have had adverse consequences for other economic objectives.

Second, the responsibility for the adjustment of aggregate demand should be shared between surplus and deficit countries. The burden of adjustment--which has consistently been shifted to the developing countries over the past two decades in terms of, inter alia, substantial terms of trade losses, the collapse of oil and commodity prices, interest rate burdens, and exchange rate manipulation--will finally have to be carried by the industrial world as the developing countries no longer have the capacity to serve as a cushion.

Third, in view of this, it is abundantly clear that there is a need for intense efforts at structural reform in industrial countries to revitalize their economic performance, which has been retarded by structural rigidities.

Fourth, and finally, it needs to be reiterated that international policy coordination is desperately needed and that it will not come about in the absence of political will.

I broadly agree with the essence of the staff's analysis on reviving developing country growth. Aside from a few newly industrialized economies, most developing countries are oil and primary commodity producers. The staff's recommendations in terms of quality and quantity of adjustment measures, at both macroeconomic and microeconomic levels have essentially been carried out, at least in those countries having Fund-supported adjustment programs. Obviously, all these programs have involved, as their essential ingredients, the advocation of positive real interest rates, the reduction of budget deficits, the creation of a stable financial environment, and a structure of relative prices that creates the appropriate incentives for efficient resource allocation." Have the results obtained thus far been compatible with the strident and heavy-handed way in which these policies were imposed on less developed countries?

The staff's advice to commodity producers to further devalue their currencies, which will perpetuate an environment of competitive devaluation, and, their recommendation to newly industrializing economies to revalue their currencies to reduce their surpluses, reminds one of the early twentieth century robber barons who forced their competitors to price themselves out of the market and, compelled their suppliers of raw materials to lower their prices so that they could have the best of both worlds. Also this frankly reminds me of the caste system in sixth and seventh century Persia that discouraged the upward mobility of the members of the lower caste.

As for projections of oil prices, while the staff has rightly acknowledged the considerable margin of error in its assumptions, it has predicted that "the oil market is not expected to strengthen significantly in the medium term." But given the recent staff proposal regarding more use of world economic outlook projections for contingency financing and the Fund's de facto policy of excluding oil countries from compensatory financing facility drawings, I am rather doubtful about the possibility of any linkage in this respect and wonder whether the projection would not further jeopardize oil countries' entitlements to benefit from these resources.

Considering the staff's own assessment that "...the size of developing countries' debt relative to exports remains considerably higher than at the onset of the debt crisis," I wonder how long some scheme of debt forgiveness can be left out of serious consideration by creditors. As for the proposed menu of financial assets considered by the staff, I can simply comment that it would be impossible to milk an ox no matter what color gloves one wears, or how hard one tries. The task of defusing the "debt bomb" is becoming increasingly difficult while the creditors dream up various schemes for milking the ox.

My overall position on the international monetary system and the role of the Fund remains broadly in line with that of the Group of Twenty-Four. However, in light of the latest round of contentious, and--exhaustive discussions we have held over recent weeks on international quotas, SDR allocations, the compensatory financing facility, and extended Fund facility, and external contingency mechanism, regrettably, I am inclined to wonder what kind of role can be envisaged for the Fund in face of the encroachment of industrial countries on the Fund's domain of responsibility.

Mr. Yang made the following statement:

A prominent characteristic of the present world economic situation is the seeming pervasive uncertainty about the immediate future, particularly in the area of policy adjustment. In these circumstances, it is a very complicated matter to predict the staff scenario that might reflect most accurately the world economy's prospects for the next couple of years.

The world economy is presently showing several positive signs. The adjustment of the fiscal and external imbalances among the major industrial countries appears to be headed in the right direction, and the overall economic performance of these economies has been less adversely affected by the stock market crash than was expected. Policy coordination among the major industrial countries is still proceeding despite some recent deviations, while the financial markets have largely calmed down since the beginning of this year--although, perhaps, in a fragile sense only. With respect to the developing countries, despite the continued unfavorable international environment and inadequate external financing, adjustment efforts have been continuing and the current account positions of some developing economies have started to recover. Moreover, the dialogue between debtors and creditors has been largely maintained.

However, we have to be aware that the financial market turbulence of 1987 may take effect gradually: there are already signs of a slowing of consumption and investment in some industrial countries. Even though the economies of the industrial world have not yet exhibited the geriatric characteristics of the late stages of a business cycle, we still have to acknowledge that the expansion has already lasted nearly six years and that the amount of forward momentum is open to question. Furthermore, some of the developments in the world economy appear to be particularly worrisome, one of the most prominent being the gloomy prospect for additional fiscal adjustment in the United States. As predicted by the staff, little further reduction in the U.S. budget deficit is expected in 1988 and 1989 on the basis of current spending programs and the existing tax system. This prospect obviously clouds any hope of closing the unsustainable gap between savings and investment in the United States; the question then naturally arises as to how the U.S. foreign debt buildup can be reversed without sweeping changes in U.S. fiscal policy.

Another worrisome development has been sluggish growth in Europe, particularly in the Federal Republic of Germany: it is discouraging that the largest European economy has fallen significantly below its economic potential and that there seems to be little chance of preventing an already high unemployment rate from rising further. In addition to the disappointing developments in the industrial world, the persistent economic hardships of the developing countries--characterized by inadequate growth and a rising debt burden--continues to be a cause for major concern. While U.S. exports are increasing currently at a double-digit annual rate, and there is growing optimism concerning the turnaround of the U.S. trade balance, the question remains of how long a weak world economy, outside the United States, can sustain the momentum of the U.S. export boom.

In sum, I agree with the staff's view that on the basis of current policies, external imbalances among the major industrial countries will persist at an unsustainable level; therefore, there are essentially two possible alternative scenarios, namely, the "policy adjustment" scenario, or the "financial tensions" scenario. If the necessary policy adjustments are not undertaken, the world economy will fall inevitably into the "financial tensions" scenario, but on the other hand, if every effort is made to improve economic fundamentals, then the "policy adjustment" scenario will materialize. It seems hardly possible that countries can muddle through as the staff has projected in the "reference" scenario. Moreover, with respect to the staff's projection of continued moderate growth in the industrial countries in 1988 and 1989, I am less confident in accepting the projection for 1989 than for 1988.

In correcting external imbalances, excessive reliance on exchange rates without a corresponding adjustment in the economic fundamentals would be ineffectual and counterproductive. In reality, however, a further reduction in the U.S. fiscal deficit is unlikely, and demand outside the United States remains weak.

If this situation continues, exchange rates will again eventually have to bear the burden of adjusting the U.S. external imbalance: a further depreciation of the U.S. dollar will become unavoidable, and the already very nervous market psychology could be exacerbated, leading to renewed market turbulence.

To avoid renewed financial tensions, nothing is more important and more urgent than firm policy action to reduce the U.S. fiscal deficit, complemented by a strengthening of the momentum of growth in Germany and Japan; I am in broad agreement with the staff's specific recommendations with respect to policy adjustment in the three largest industrial economies.

Greater attention has been given recently to the structural policies of the major industrial countries, a stance that I fully support. While the staff appears to place more emphasis on structural reforms in the surplus countries, I do not believe that they have suggested that structural policies are less important in the United States; in fact, some of the structural issues in the U.S. economy are unresolved. In addition to the low level of savings mentioned by the staff, the erosion of U.S. competitiveness has been a cause for major concern. As recent developments indicate, U.S. firms have been so preoccupied with takeovers that they have become increasingly reluctant to make investments in research and development. As a result, foreign companies and inventors have held nearly one half of all U.S. patents over the past few years and some 50 percent of science Ph.D. graduates in the United States are foreigners. Therefore, the overall competitiveness of the U.S. economy has naturally suffered. The rise of protectionism in the United States may to some extent be seen as reflecting the economy's inability to compete internationally. To retain the long-run vitality of the U.S. economy, it may be advisable for the United States--while rightly focusing on fiscal adjustment--not to neglect its structural problems.

With respect to the Federal Republic of Germany, the implementation of structural measures is probably more important than the conduct of financial policy; I support the staff's recommendations about reducing subsidies, improving labor markets, and deregulating goods and financial markets. Even so, with its extremely low inflation rate and strong external position, the German economy should have the potential to grow faster, and a more flexible stance on demand management may be warranted.

The Japanese authorities have been commended widely for their impressive accomplishments in adjusting the economy. They should maintain the present course of economic policy with emphasis on structural reform of land use, agriculture, and market access. Japan needs to play a greater role in assisting the developing countries in view of the growing strength of its economy and its large trade surplus. That surplus should hopefully be recycled to better serve the interests of the developing countries and should also play a strengthened role in the resolution of the debt problem.

In 1987, the sharp decline of the U.S. dollar and the perceived failure to halt the plunge have generated a contentious debate on the wisdom of international policy coordination. Some commentators have asserted that the Louvre Accord may have discredited policy coordination by placing undue emphasis on exchange rate stability, while others have argued that at the time the Louvre Accord was signed, the U.S. dollar's exchange rate was too high to be stabilized. A few people have even advocated that the goal of policy coordination is unachievable and should be abandoned. We certainly cannot agree with all of these differing viewpoints, although we can learn from them and recognize that the ongoing process of international policy coordination does have some shortcomings that need to be modified. The drawback of the Louvre Accord was perhaps not so much what the signatory parties had promised, but their failure to live up to the promises they had made. As we witnessed in 1987, there was much talk but little action, causing financing markets to react strongly and with great turbulence in the latter part of the year. At present, a semblance of calm has returned to the markets, but does this calm signify any major progress in policy coordination, or does it just reflect an absence of strong views about what will happen next? This question is well worth examining: what we learnt from the experience of 1987 may be helpful in the Fund's attempts to improve international policy coordination.

With respect to the issue of reviving growth in the developing countries, the Managing Director raised the important question, in his speech in Singapore in January 1987, as to whether the Fund could do more and do it better to help promote and sustain implementation of appropriately strong programs of economic policy reform. He answered this question with great imagination, and this chair supports strongly his initiatives to enhance the Fund's role in providing financial assistance. In this connection, a topic worth the Board's attention is why many developing countries are reluctant to accept adjustment programs designed by the Fund but have frequently sought the policy advice of outside economists or even employed experts in economic management from abroad. The key issue is perhaps that available evidence has not yet convinced many developing countries that Fund-supported adjustment programs are effective in improving their basic welfare. Unfortunately, the opposite view seems to be more common, that is, Fund adjustment programs have sometimes become a synonym for "harsh conditionality." If this perception is correct, then it is essential that the Fund make every effort to improve the design of adjustment programs to make them an effective prescription for solving economic problems, instead of being seen as an instrument of coercive restraint enforced on borrowing countries. By overhauling the design of adjustment programs, not only can the perceived image of the Fund by many developing countries be improved, but also the role of the Fund in helping them can be enhanced greatly. I hope that the forthcoming Board discussion on this important subject will yield positive results.

Mr. Marcel made the following statement:

It is difficult to make an original contribution to the discussion of the world economic situation and to avoid repeating the ideas of others; therefore, there is a danger that the world economic outlook might become a rather academic or stylistic exercise, instead of one of the most important events in the life of the Fund. Indeed, the main staff paper reveals the risks threatening the stability of the world economy; and is it not the role of the Fund to contribute to stability? The outlook discussion is also an occasion to look for means of improving the coordination of all of our countries' economic policies--with cooperation not being confined simply to the major industrial countries, even if that aspect is crucial.

The "reference" scenario certainly looks familiar: it differs little from the final projections made in the autumn of 1987, except with respect to a slight slowdown in world growth. It gives little cause for enthusiasm, but neither is it catastrophic. The French Government predicts that the impact of the October crisis will be very limited; in any event, growth in 1987 was substantially faster than estimated in the September 1987 world economic outlook. The staff should comment on the impact of the withdrawal of fiscal stimulus on growth; France recorded such a withdrawal in 1986/87 without any significant impact on growth. The following features of the "reference" scenario remain worrisome: growth is still slow--especially in relation to the rate that is needed to achieve lasting reductions in unemployment--while substantial domestic and external imbalances persist. It is a particular cause for concern that little further reduction in the U.S. budget deficit is expected over 1988/89, which has implications for the extent to which the staff's "financial tensions" scenario is likely to materialize. The answer to this question is the key to determining the degree of urgency and the extent of the additional adjustment measures that are required in these countries, and while I concur with the main staff paper's view that such an exercise is extraordinarily difficult, further elucidation on this point would have been welcome.

The fact that, to some extent, the "financial tensions" scenario became a reality in October 1987 should give the Board pause. Even if the stock market crash was brought about partially by specific causes--interest rate policies and the needed correction of a market that had risen too high--it was also indisputable evidence of a crisis of confidence. Moreover, we must not forget that the stabilization of the markets was achieved mainly by the massive interventions of the central banks; such interventions were efficient, but they cannot be repeated indefinitely. The fact that coordination among the major industrial countries has functioned well, particularly during the October 1987 crisis, will go some way toward restoring market confidence. By any assumption, it would be wrong to adduce the conclusion that very limited effects of the October 1987 crisis are a pretext for relaxing vigilance; this is a temptation to which we should not succumb.

In any event, adjustment policies must be not only continued, but broadened, in the context of a needed strengthening of coordination. The question of sharing the burden of the adjustment between surplus countries and deficit countries may not be pertinent as it seems that it is clearly in everyone's interest to participate in the process. Cooperation should not be seen as a constraint, but a way to facilitate the application of domestic policies. It must be acknowledged that very significant improvements in cooperation were obtained in 1987.

The main staff paper suggests that there should be a further reduction in the U.S. budget deficit and a broadening of structural policies, particularly in Japan and Germany. This approach is entirely appropriate, but seems to be too limited. A further effort by the United States in the budget area is certainly crucial, and the results that have been obtained--without the recessionary effect that some feared--are encouraging. But it should be borne in mind that the external imbalance is also directly attributable to a very low U.S. savings rate, for which structural measures are no doubt required. The Japanese and German authorities' reluctance to turn again to demand enhancement measures is understandable, and I note that this possibility has been practically ruled out by the staff. It would nonetheless have been interesting to consider whether there was any further room for demand-management action.

The management of monetary policy is certainly not an easy task given the potentially conflicting objectives it has to meet, but it must still play a vital role in maintaining exchange rate stability and controlling inflation. I welcome the U.S. authorities' vigilance and readiness to take appropriate measures.

I concur with the staff's view that there is a need to introduce structural policies, particularly in Europe, where they will constitute the cornerstone of efforts to resume more sustained growth. However, the effects of structural policies take a long time to take effect, and the slower the rate of growth, the more difficult it is to implement the measures. We should not stake all of our hopes on structural policies and consider ourselves exonerated from examining other approaches. I noted from the staff paper on medium-term scenarios that the increase in actual output could be more clearly in line with an increase in potential output if it was accompanied by stimulation of aggregate demand. In sum, the "policy adjustment" scenario is certainly more favorable in terms of growth and the reduction of imbalances; whether it is genuinely satisfactory, and whether it would guarantee that economies would be spared a transition to the second scenario, is more debatable.

The "deterrent" scenarios confirm that protectionism has nothing to offer the world economy, particularly the developing countries. This type of exercise enables us to gain at least a clear idea of the courses we should avoid.

The main staff paper stresses the precariousness of developing countries' positions. Admittedly, there were some favorable developments in 1987, such as the improvement in their overall payments position, but it will again deteriorate slightly in 1988 and 1989. Furthermore, the overall debt has increased, although there has been a small decline in the debt-export ratio and a reduction in the amounts of debt service and arrears. These global figures mask profound differences between developing countries: the staff stresses the very disquieting situation of sub-Saharan African countries, which are still growing at well below the rate of population growth.

Despite the fact that the staff suggests that a recycling of capital from the surplus countries to the developing countries would be beneficial, we should not forget that this is something that cannot be merely decreed, for it depends first and foremost on the quality of macroeconomic policies and structural reforms implemented in these countries.

With respect to the debt strategy, we clearly cannot expect the anticipated developments in the world economy alone to resolve the problem; we must therefore continue to seek appropriate solutions.

The past 15 years have clearly shown that floating exchange rates have not equilibrated imbalances. On the contrary, J-curve effects and the expectations they induced in the markets often contributed to increased imbalances, particularly in cases where countries were not encouraged at the same time to introduce appropriate domestic policies. Recent experience has shown that stabilization of exchange rates is possible and could be beneficial, provided it is accompanied by better coordination in the spirit of the Louvre Agreements. It should lead to the consideration of possible reforms to the international monetary system. Further depreciation of the dollar would be very dangerous for the world economy. In this respect, the staff should explain what it means by a "reasonable degree of exchange rate stability in the United States."

The stabilization of exchange rates in the European Monetary System played a vital role in controlling inflation rates, in reducing imbalances, and has allowed a greater coordination of economic policies. My authorities are fully committed to the EMS and they consider that the present pattern of exchange rates is appropriate.

Mr. Al-Assaf made the following statement:

On the whole, 1987 was a reasonably good year, despite our apprehensions. While world economic growth was still not satisfactory, it did not falter, inflation remained under control, and significant progress was made in correcting severe imbalances among the major industrial countries. This better than expected outcome was no accident: with the benefit of hindsight, it appears that the strong and active policy coordination during the course of the year was one of the major factors behind this development. Enhanced policy coordination helped to promote not only the process of external adjustment among G-7 countries, but also to restore confidence in the system at the time of the October 1987 stock market crisis, thus minimizing the adverse effects on the world economy.

While significant progress has been achieved so far, it is clear from the staff's projections that external imbalances will persist at an unsustainable level in the absence of a further policy adaptation in the major industrial countries. At the same time, progress over 1988 and beyond is likely to be more difficult for a number of reasons.

First, future adjustments must involve a deepening and broadening of policy measures in the major industrial countries. The large exchange rate adjustments that have taken place since 1986 have thus far not been accompanied by sufficient adjustments in the pattern of domestic absorption among countries. Chart 10 of the main staff paper underscores the need for adjustment in the underlying economic fundamentals, including more emphasis on structural measures. These types of measures tend to be more difficult to implement, and it takes more time for their benefits to be felt.

Second, to the extent that the needed adjustment involves a reorientation of trade flows, it runs the risk of being undermined by the intensification of protectionist measures.

Third, in the years ahead, the adjustment should also be associated with a deepening and broadening of international cooperation, which may prove more difficult to achieve than is currently thought, and may test the will of authorities in G-7 countries.

In view of these vulnerabilities, the main task facing national policymakers at the international level in the months ahead will be to address the imbalances in a timely and credible manner. In this respect, the equity market disturbances that were experienced toward the end of 1987 served as a useful reminder of the essential need for a credible and durable reduction of imbalances within the context of a consistent macroeconomic framework. There is no escape from the judgment of the market: the choice is between adjustment made in an orderly and gradual way, or adjustment dictated by market pressure. The first option is far superior, but it will require the implementation of a number of steps.

The first step is to further enhance international cooperation. As I have already indicated, considerable progress has been achieved on the exchange rate front; hence, a further exchange rate realignment at this time is neither necessary nor desirable. More benefit would be derived from stabilizing exchange rates at roughly their present levels, thus allowing market and trade patterns to catch up with recent changes. Emphasis must therefore be shifted toward the coordination of policies in the fiscal, monetary, and trade areas.

The second step is to place more emphasis on structural measures in the major industrial countries if the momentum of growth is to be preserved.

The third step is to have a freer trade environment. The need for this is greater than ever as the new exchange rate relationships among major currencies imply a substantial reorientation of trade flows, which is a ready source of new trade disputes. It is essential that the highly indebted and primary producing countries do not have their current problems aggravated by the consequences of trade disputes between major industrial countries.

The emphasis in the developing world has to be on restoring a satisfactory rate of economic growth. This objective seems to be most urgent in low-income sub-Saharan countries, where arresting the fall in per capita income has to be the priority of policy. To achieve this objective, domestic policies in these countries will clearly have to be adjusted. Nevertheless, the success of their adjustment policies will be predicated on the availability of an adequate level of concessional external resources. The opportunity that is accorded to these countries with the imminent activation of the enhanced structural adjustment facility must not be missed.

While significant progress was attained in the middle-income, highly indebted countries, the increase in inflation rates was disappointing--particularly in the Western Hemisphere countries, where this constitutes a serious setback to their stabilization programs. As the economic history of that region has taught, very high inflation rates are neither conducive to investment nor favorable to much needed capital flows and financial savings. Most important, failure to contain these inflationary pressures may compromise the hard-earned gains achieved over the past several years; in the absence of a prompt reversal of these unfavorable trends, the ultimate success of the debt strategy might be compromised.

The fuel-exporting countries have been affected severely by the lower oil prices in 1986 and by the significant depreciation of the U.S. dollar: their terms-of-trade loss amounted to nearly 60 percent over the past few years. In the face of such a loss, these countries--especially those in the Middle East--have adjusted by reducing substantially their fiscal deficits, thereby reducing drastically their real economic activity. The continued uncertainty in the oil markets poses a difficult policy choice for the fuel-exporting countries and hampers their efforts to diversify their exports. However, it is important that these efforts be supported by a favorable international environment characterized by stable exchange rate markets, improved growth in the industrial countries, and more liberal access to export markets.

Mr. McCormack made the following statement:

The principal policy issue facing the industrial countries continues to be the need to reduce the fiscal and current account imbalances that threaten the sustainability of stable economic expansion over the medium term. As suggested by the staff, further policy adjustment--possibly in conjunction with additional modest adjustment of real effective exchange rates--is required to unwind the imbalances that have developed.

We agree broadly with the staff's analysis of the short-term prospects. However, real growth over the short term may be better maintained than is assumed by the staff, particularly in Japan, the United Kingdom, Canada, and the United States. Similarly, the October 1987 stock market crash might not have significant effects on growth in the industrial countries, although the lack of experience with such shocks makes this estimation difficult. However, if the check on inflationary pressures from the stock market crash is indeed less than assumed, and real growth in some major countries is stronger, then the risk of a resurgence of the inflation rate in these countries may have been somewhat understated by the staff.

The "baseline" projection provides a good reference from which to outline the tensions that develop under the standard assumptions of unchanged policy, exchange, and interest rates. I share the staff's concern that under such a scenario, the net asset and liability positions of the major industrial economies would be unsustainable over the medium term. In the "reference" scenario, the three major industrial economies attain net debtor and creditor positions ranging from 17-24 percent of GNP in the final year, and there is no indication that these ratios will stabilize over the medium term. The risks in this outlook are clearly on the downside.

The "financial tensions" scenario highlights the potential risks that might arise if market forces are left by themselves to narrow current account imbalances; the implication is that sharp adjustments in exchange rates alone can have substantial negative effects on medium-term economic growth. Clearly, a more desirable path would involve further fiscal correction in the United States and structural reforms in Europe and Japan, as is highlighted by the "policy adjustment" scenario.

Nevertheless, given the low probability of any important fiscal adjustments over the short term, the outlook should perhaps involve further exchange rate adjustment. A satisfactory medium-term resolution of the international imbalances may require a combination of more ambitious U.S. fiscal action, growth of domestic demand and structural adjustment in surplus countries, and additional, although modest, exchange rate adjustment. Therefore, a combination of the "policy adjustment" scenario and exchange rate adjustment, as in the "financial tensions" scenario, may be a promising possibility to explore further.

As was suggested in the staff's simulations, thorough and ambitious structural reforms can clearly be very important in the adjustment process; moreover, there should be continued action in all countries to improve the functioning of the supply side of the economy. This recommendation is applicable to not only the industrial countries, but also the developing and newly industrializing economies.

I agree generally with Mr. Grosche's views of the European Monetary System, but wonder whether the staff's view that "an approach to managing the exchange rate arrangements that would facilitate the changes in competitiveness required for members to realize their growth potential without endangering price stability" could be read as suggesting a depreciation of the currencies concerned vis-à-vis the deutsche mark. This raises two issues: first, the suggestions highlight the substantive question--discussed during our recent surveillance review--of the role of the exchange rate as a nominal anchor and the relative roles of domestic cost and demand restraint versus exchange rate flexibility in maintaining competitiveness. Second, if page 38 of the main staff paper could be construed as implying the need for a realignment in the European Monetary System, its presentation in the published version should be particularly sensitive so as to prevent the markets from drawing damaging conclusions.

The performance of developing countries in 1987 was mixed, and their prospects are subject to considerable uncertainty. On the positive side, the aggregate current account position strengthened and there was a decline in the debt ratios for the first time since 1980, which is expected to continue. However, there were disturbing signs in a number of countries that adjustment efforts, particularly fiscal and monetary policy, were not as strong or as effective as had been anticipated. In addition, the pace of economic growth in 1987 was disappointing, inflation rates accelerated, and the level of domestic investment remained depressed.

An important cause for concern is the slowing of potential output growth, particularly in the Western Hemisphere. Investment has fallen sharply and remains low in many developing countries, although there has been some recent improvement in a few countries; the staff's comments about the possible allocational inefficiency of investment resources in the Western Hemisphere suggest a continuing need to look at contributing factors, such as relative prices. In this connection, the "additional financing" scenario is instructive, because it indicates that additional lending leads to only modest increases in output in early years and to rising debt-service ratios. As it is largely in subsequent years that the economic benefits of investment accrue--assuming that only profitable investments are made--there is a continuing need to develop and implement macroeconomic policies that will foster a stable financial environment. Furthermore, the measures should include structural reforms to reduce the relative price distortions that impede the efficient allocation of resources, and actions to open the economy to competitive forces. Attempts to attract domestic or foreign financing that are not accompanied by an appropriate policy framework could worsen the situation.

At the same time, I am impressed by the great difficulty of trying to establish stabilization and structural reform programs while countries are confronted with large debt-service burdens. Much attention continues to be focused, justifiably, on the difficulties in obtaining appropriate amounts of financing--particularly from commercial banks. As the stock of debt might inhibit investment, debt reduction plans, like the recent Mexican scheme, can present advantages by reducing debt ratios and encouraging investment. Additional thought might be given to how financial instruments can be better designed to permit creditors and debtors to allocate risks and rewards efficiently, while maintaining a proper structure of incentives.

The more medium-term analytical orientation of this world economic outlook is commendable; the staff has also made an important contribution by focusing on the impact of structural reform, and I encourage the staff to continue its work in this area.

Mr. Yao made the following statement:

It is encouraging to note that the world economy's short-term prospects are much brighter than were anticipated initially after the equity market crash in October 1987. The Group of Seven's prompt response in restating its commitment to policy coordination is welcome, and I hope that macroeconomic coordination will be strengthened to foster a more favorable medium-term international economic environment.

In many respects, 1987 has witnessed a reversal of the divergence of major industrial countries' fiscal policies. In the United States, steps were taken to reduce the budget deficit by an amount equivalent to about 2 percent of GDP, while in Japan and Germany, more expansionary fiscal policies were implemented; efforts to curb fiscal deficits were also made with varying degrees of success in other industrial countries. It is significant that--against a background of relative price stability--monetary instruments were used appropriately to foster exchange rate stability, resulting in a widening of interest rate differentials between major industrial countries. The coordination of economic policy facilitated a stronger than expected growth of economic activity and a reduction in the external imbalances, while preserving the previous gains on the inflation rate front. However, the U.S. budget deficit remains relatively large, and the big payments imbalances of major industrial countries cast a shadow over the smooth functioning of the international monetary system increasing the system's vulnerability and the likelihood of another financial disturbance.

The economic performance of developing countries continues to be affected adversely by the uncertainty surrounding the international economic environment and the inadequacy of external financing. Economic growth in developing countries slowed to

2.8 percent in 1987 compared with 3.4 percent in 1986, reflecting the implementation of adjustment measures in the face of deteriorating terms of trade in the Middle East, sub-Saharan Africa, and the Western Hemisphere. While the economic situation of developing countries is generally difficult, it is particularly alarming in sub-Saharan Africa, where the continued sluggish economic performance over the past eight years has led to a decline in the standard of living, which is no higher than it was at the beginning of the 1970s.

The external position of developing countries has remained weak despite the improvement in their aggregate current account. The Asian countries have surpluses owing to the strong export growth of manufacturing goods, while in Africa, the Western Hemisphere, and the Middle East, the current account deficit persists, albeit at a lower level--reflecting the compression of imports. Unless the latter trend is reversed, the prospects for future growth of the countries in those regions are not good.

I agree with the staff on the debt situation in developing countries: although all the aggregate indicators point to an improvement, the financial picture of debtor countries is still precarious. For instance, the marked decline in the debt-service ratio was caused primarily by to the increasing use of debt-restructuring agreements--equivalent to about 9 percent of developing country exports. Furthermore, the secondary market valuation of developing country debt seems to have fallen, indicating declining market confidence in the ability of these countries to service their financial obligations. The weak financial situation of developing countries, together with the adjustment fatigue that is being felt in most of them, raises a number of questions about the Fund's present approach to the debt problem.

The medium-term scenarios are useful as they provide a likely time path of key economic indicators based on alternative sets of economic policies. The outlook of the world economy that they illustrate appears to be clouded by external imbalances. Further adjustment will be required in both the developed and developing countries if the world economic expansion is to continue under conditions of financial stability.

In light of the October 1987 events, the assumption of unchanged economic policy in the "reference" scenario appears to be unrealistic. Given the reluctance of major countries to take additional adjustment measures, it is most likely that the accumulating imbalances under this scenario will lead to major disturbances in financial and currency markets equivalent to the undesirable "financial tensions" scenario. To prevent a disruption of financial markets, the staff described a policy scenario based on the Louvre Accord, consisting of a strengthening of

U.S. fiscal policy and efforts by Europe and Japan to tackle structural rigidities. The implementation of such consistent cooperative policies is the most suitable strategy for creating a more stable international economic environment.

If the "policy adjustment" scenario gives the most desirable or sustainable outcome, then one should inquire what role the various policy instruments ought to play in the adjustment process, and how the burden of adjustment should be shared between deficit and surplus countries.

On several occasions, this chair has expressed its reservations about excessive reliance on the exchange rate as a means of restoring external balance. While timely and orderly developments in real effective exchange rates could contribute to the redirection of trade flows, the relation between current account balances and movements in real effective exchange rates could be weakened unless appropriate demand-management and structural policies are implemented. The lack of significant improvement in the U.S. current account position, despite the sharp depreciation of the U.S. dollar against other major currencies, corroborates this view; hence, the effective use of other policy instruments is called for. Deficit countries, particularly the United States, should adopt more restrictive fiscal policies, and surplus countries should stimulate their economies.

Reviving growth is undoubtedly the overriding priority of developing countries, and I agree broadly with the staff that this objective could be achieved by increasing the quantity and quality of investment. The staff seem to re-emphasize the need for the strengthening of adjustment policies as another condition for renewing growth; but after several years of difficult adjustment, an improved international economic environment is probably more important and for this, substantial external financing is needed. It is important to note that the required increase in investment will depend also on finding a durable solution of the debt problem, which absorbs a significant proportion of developing countries' domestic financial resources.

The Fund has a greater role to play in the shaping of the international monetary system. First, its technical and financial assistance to low-income countries through the structural and enhanced structural adjustment facilities are invaluable. The reactivation of the extended Fund facility and the incorporation of an external contingency mechanism into Fund-supported programs will help to ensure the successful implementation of these programs. Second, the Fund's role in multilateral surveillance should be strengthened to make developed countries more responsive to the effects of their policies on the world economy.

Mr. Ovi made the following statement:

The different simulations provided by the staff point to productive means by which, if further developed, the Fund's surveillance procedures could be facilitated and strengthened within the world economic outlook framework.

The staff's short-term projections have a clear downward risk attached to them. It seems that the financial system has emerged relatively unharmed from the latest turbulence, and at present, exchange and capital markets are fairly stable. However, this does not mean unequivocally that the international economy is embarked on a more durable course. In light of the developments over 1987 and so far this year, one should expect only modest production growth in industrial countries during the remainder of 1988.

In Europe particularly, where several countries are facing external constraints increasingly, there is a clear risk of a slowdown in the already low growth rate; considering the present high unemployment rate, this would be unacceptable.

For the industrial countries as a group, there are similar risks that a worse than projected outcome will emerge. The presence of continuous large external imbalances between major countries requires further policy adjustments: in both surplus and deficit countries, the greatest stress should be placed on fiscal policy adjustment. The main responsibility for creating the conditions necessary for more durable development continues to rest with the major industrial countries.

A reduction of the U.S. external deficit requires an increase in domestic savings, which has to be achieved mainly by lowering domestic demand. The low expectations about possible compliance with the Gramm-Rudman-Hollings fiscal deficit targets in the United States has, presumably, been a critical factor behind the unrest in capital and exchange markets during recent years, and there are reasons to fear a similar development in 1988. Moreover, to the extent that U.S. capacity utilization has increased recently, a further depreciation of the dollar might result in a higher inflation rate; therefore, further fiscal restraint is needed urgently.

In Germany, and some other European countries with current account surpluses, there seems to be room for more expansive policies; indeed, if such countries do not sustain domestic demand at a sufficiently high level, there is a risk of renewed instability in Europe.

With respect to the comments made by Mr. Grosche on the staff's analysis of the European Monetary System on page 38 of the main staff paper, I disagree somewhat with his view. Certainly, some European Monetary System members feel constrained, or more precisely fear that weak external demand during 1988 might make their efforts to restore external balance rather difficult. However, when discussing whether to publish this policy debate, I side with both Mr. Grosche and Mr. McCormack.

The public sector deficits in the surplus countries should be viewed in relation to the surpluses in private sector savings. If, nevertheless, targets with respect to public finances continue to be given priority, a change in, for instance, tax rules might be needed to bring about a change in private savings and investment behavior. In addition, structural measures, especially with respect to the labor market and subsidies to the private sector, are certainly needed.

In Japan, the development of domestic demand shows what can be achieved through macroeconomic measures; the Government should be encouraged to continue this course along the lines mentioned by Mr. Yamazaki, and with a strong emphasis on structural measures.

While recognizing the concerns of Mr. Yamazaki on publicly being too explicit in the structural area, I strongly support what the Managing Director said on this issue this morning that there is a clear need to go beyond merely referring to structural rigidities in general. In the recent staff reports on Germany and the Netherlands, I encouraged the staff to be more specific than just referring to such matters as "shop opening hours." Like we do in the trade area, I think it is important that we be specific on the nature of structural rigidities, trying also to evaluate the costs involved. This should be done in staff reports prepared for the Board's consideration and, to the largest extent possible, also when making material public.

In a longer-term perspective, it remains questionable, though, whether the Japanese external surplus can be brought down at an appropriate pace without further exchange rate adjustments.

Several newly industrializing economies ought to deregulate their markets further, and in some cases, allow their currencies to appreciate somewhat. However, the situations of individual countries differ substantially; and, although a few can make substantial contributions to the adjustment, it is wrong to believe that these countries could or should be the main contributors to reducing world imbalances.

The staff's medium-term scenarios provide a valuable contribution to the discussion on the design of international economic policies. The "reference" scenario is not very realistic as there is a clear risk of developments occurring similar to those outlined in the "financial tensions" scenario. Of the three main projections, the "policy adjustment" scenario shows that fairly limited policy changes only are needed to achieve a more satisfactory outcome; again, the international will to cooperate is the crucial element in global adjustment. The staff should run simulations of alternative scenarios of cooperation between individual countries. It might be interesting to demonstrate more clearly the different outcomes if, for instance, not all of the major surplus countries participate in adapting their policies; or, alternatively, to show the outcome of all surplus countries adjusting, with U.S. fiscal measures not being sufficiently far reaching to bring about the needed cut in the budget deficit.

In the staff's medium-term simulations, monetary policy is tied to keeping the inflation rate down; if this works simultaneously to stabilize real economies, as it probably does, a stimulative fiscal policy would result normally in crowding out. It would have been interesting to have the results of simulations in which more significant fiscal measures, for example, in the surplus European countries, had been combined with other assumptions for monetary policy; such analysis should aim at demonstrating the effects of symmetrical adjustments in deficit and surplus countries.

Another decisive element in adjustment is the likely impact of structural measures. The staff necessarily makes the fairly arbitrary assumption that, for Europe, potential growth can be increased by the implementation of structural measures by 1 percentage point. But it is significant that unless the structural measures are accompanied by more stimulative demand management policy, as was noted rightly in the staff paper, the effects on growth will materialize slowly.

With respect to the developing countries, recent rises in commodity prices have been reflected in some recovery of short-term growth. As an improvement in the quality of commodity price forecasts will be instrumental in enhancing the overall growth predictions for these countries--according to the staff study on the accuracy of the world economic outlook projections--I would appreciate further discussion of the staff's assumption that commodity prices will remain basically stable over the rest of the forecasting period. I wonder also how the assumptions in the world economic outlook are related to the findings in a recently distributed departmental memorandum (DM/88/2) on primary commodities that seems to offer a mixed picture of price prospects in different commodity markets.

The difficult financing situation combined with "adjustment fatigue" makes the "reference" scenario for the developing countries highly uncertain. The overriding importance of these countries pursuing appropriate domestic economic policies is highlighted by the staff's growth analysis; for middle-income countries especially, this is the crucial factor. In the poorest countries, the need for increased concessional assistance is as important. The responsibility of industrial countries for developments in the Third World is highlighted by the scenario on the devastating effects of protectionist measures and by the scenario on the derived effects of renewed financial market tensions.

Various indicators show that there has been an improvement in the debt situation of capital-importing debtor economies, but substantial differences remain between individual countries and groups of countries. The improvement in heavily indebted countries seems to be primarily the result of continued external financial constraints and the resulting deceleration in growth. The situation of the poorest countries is especially precarious, and an improvement in their debt situation will be contingent on additional efforts to provide concessional funds.

With respect to middle-income countries, the Fund should continue to play an important role through lending conditioned on strong and credible adjustment programs. The resistance of banks to increasing their exposure may be overcome successively by introducing other forms of lending--adapted to the situation in special cases. The importance of productive investments has to be emphasized: the staff's analysis of this--and especially on the distribution between internal adjustment and financing--should be further elaborated.

Exchange rate turbulence over recent years, and the growing acknowledgement of the necessity of major industrial countries pursuing policies aimed at greater exchange rate stability, seem to create a basis for beginning to extend the Fund's surveillance guidelines. The use of indicators could be part of this extension, but their exact form will have to wait until further experience is gained. As commodity price indicators have a number of problems associated with them, they should be regarded as only one among many possible types of indicators.

The Fund provides the natural forum for studies on "target ranges," and to the largest extent possible, it should be given a say on international exchange rate policy cooperation. The special role of the exchange rate should continue to be stressed in the Fund's work, especially with respect to the need for evaluating whether exchange rate shifts are excessive in relation to developments in underlying fundamentals. Furthermore, when economic prospects change substantially, the management of the

Fund should--to a greater extent than at present--feel encouraged to initiate separate discussions on the economic developments in individual countries or country groups.

The Executive Board agreed to resume the discussion in the afternoon.

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/88/47 (3/24/88) and EBM/88/48 (3/25/88).

2. EXECUTIVE BOARD TRAVEL

Travel by an Advisor to Executive Director as set forth in EBAP/88/14, Supplement 1 (3/23/88) is approved.

APPROVED: November 16, 1988

LEO VAN HOUTVEN
Secretary