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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 88/49

3:00 p.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	
A. Kafka	J. Hospedales
	D. McCormack
	K. Yao, Temporary
	P. D. Péroz, Temporary
	L. Filardo
J. Ovi	
	D. Marcel
G. A. Posthumus	
	I. Sliper, Temporary
	A. A. Agah, Temporary
A. K. Sengupta	
K. Yamazaki	
S. Zecchini	

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

Also Present
African Department: A. T. B. Taylor. Asian Department: P. R. Narvekar, Director; R. J. Corker. European Department: J. J. M. Kremers. Exchange and Trade Relations Department: L. A. Whittome, Counsellor and Director; P. A. Acquah, D. Burton, J. H. Felman, G. R. Kincaid, J. P. Pujol. External Relations Department: J. M. Landell-Mills. Fiscal Affairs Department: A. H. Mansur. IMF Institute: O. B. Makalou. Legal Department: T. M. C. Asser. Research Department: J. A. Frenkel, Economic Counsellor and Director; A. D. Crockett, Deputy Director; N. R. Chrimes, D. A. DeRosa, M. P. Dooley, S. J. A. Gorne, R. D. Haas, F. Larsen, M. Mecagni, B. E. Rourke, M. Schulze-Ghattas, S. A. Symanski, E. Y. P. Tung, M. A. Wattleworth. Treasurer's Department: M. P. Blackwell. Western Hemisphere Department: S. T. Beza, Director. Bureau of Statistics: S. P. Quin. Personal Assistant to the Managing Director: H. G. O. Simpson. Advisors to Executive Directors: M. B. Chatah, W. N. Engert, A. G. A. Faria, Khong K. N., P. Péterfalvy, D. C. Templeman, A. Vasudevan, J. E. Zeas. Assistants to Executive Directors: N. Adachi, J. R. N. Almeida, V. J. Fernández, B. Fuleihan, S. Guribye, M. A. Hammoudi, G. K. Hodges, L. Hubloue, S. King, C. Noriega, S. Rebecchini, A. Rieffel, C. C. A. van den Berg, R. Wenzel.

1. WORLD ECONOMIC OUTLOOK

The Executive Directors continued from the previous meeting (EBM/88/48, 3/25/88), their consideration of 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 various aspects of the world economic outlook (SM/88/50, 3/3/88), a statistical appendix (SM/88/51, 3/4/88), and staff papers on medium-term scenarios (SM/88/52, 3/4/88; and Cor. 1, 3/7/88), and on the accuracy of world economic outlook and short-term forecasting (SM/87/297, 12/23/87).

Mr. Sliper made the following statement:

> The staff papers show that the world economy's recent performance and short-term outlook, at least with respect to industrial countries, is likely to be somewhat better than had first been expected after the October 1987 stock market crash. The follow-on effects of the crash are likely to be muted and transitory: in particular, the underlying strength of the U.S. economy, the low inflation rates in industrial and many developing countries, the rise in commodity prices, the interest rate declines, and the reduction in debt to export ratios, can all be regarded as favorable developments--the latter three particularly for developing countries.
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> However, at the same time, the tensions associated with the persistent large imbalances in the world economy remain largely unresolved; as a result, the risks to the outlook are on the downside. While the staff's scenarios are necessarily stylized, they elaborate some plausible broad choices about policy directions. As the staff's "reference" scenario is neither desirable nor sustainable, some adjustment is inevitable. The preferred course would be the adoption of policy measures similar to those outlined in the staff's "policy adjustment" scenario to ensure a sustainable correction of these imbalances.
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> At this stage, and however desirable it might be, the "policy adjustment" scenario does not seem to be the most likely outcome, nor does a "market enforced" adjustment similar to that outlined in the staff's "financial tensions" scenario seem highly probable at this time. Current conditions are quite different from those prevailing during 1987 when an overvalued equity market and an obvious lack of progress in correcting the large external imbalances, compounded by a deterioration in the normally constructive policy dialogue between the major countries, combined to quickly undermine market confidence. Serious imbalances certainly remain, but equity prices are presently more in line with market fundamentals, and particularly with the fiscal and external developments since October 1987, which have helped to restore near-term market confidence.

Perhaps a more likely outcome is some combination of these two scenarios--what could perhaps best be called a "muddling-through" scenario--that is, some further policy adjustments, but not enough to generate confidence that substantial further progress will be made in reducing domestic and external imbalances, and insufficient to dispel doubts over whether the authorities can implement successfully the required policy adjustments. The use of the term "muddling-through" is certainly not intended to carry with it the very serious connotations expressed by some Directors.

The "policy" doubts are fuelled by a number of factors. In the United States there seems to be a conflict between what the authorities wish to accomplish and what they are prepared to do: there is a firm desire to reduce the trade deficit and an acknowledgment that this will require further reduction in the fiscal deficit, but there seems to be little prospect of significant reductions in the budget deficit in 1988 and there are doubts over whether expenditure measures alone can achieve the desired result. As a consequence, the efforts by the United States and other countries to reduce the U.S. trade deficit have spilled over into the dangerous policy area of seeking bilateral solutions. It is also unclear whether the apparent desire to stabilize the dollar is or should be matched by a willingness to tighten U.S. monetary policy, or to loosen it elsewhere. In Japan and Germany, where the policy emphasis should be more on structural measures, the authorities' preparedness to override strong vested interest groups to address the sectoral and market inefficiencies that restrict productive potential remains doubtful.

A more general underlying concern is the risk that policymakers are concentrating more on the symptoms of the imbalances than on their causes. While the recent emphasis on stabilizing exchange rates is welcome, given the magnitude of exchange rate adjustment over recent years and the lags that are involved, market intervention can provide only a short breathing space from pressures whose origins lie elsewhere. In the absence of further policy actions, pressures are likely to mount on either exchange rates or monetary policy. While these outcomes will probably bring some further correction of external imbalances, an additional depreciation in the U.S. dollar is likely to be at the cost of mounting inflationary and interest rate pressures in the United States and lower growth outside the United States. And a tightening of U.S. monetary policy and an easing in Europe and Japan--to prevent any further fall in the dollar--would probably slow investment and growth in the United States and damage seriously the growth prospects of many developing countries.

Both of these outcomes and the staff's more serious "financial tensions" scenario are clearly unsatisfactory, and demonstrate the need for more vigorous adjustment along the lines of the staff's "policy adjustment" scenario.

As for the policy requirements of the industrial countries, I agree largely with the staff's analysis on pages 35 and 38 of the main staff paper: the key policy areas remain the fiscal and structural ones. A steady and sizable reduction in the U.S. budget deficit remains a central objective. While that reduction may entail some short-term costs in terms of reduced output--although, if the staff is right, these may not be substantial--such costs have to be measured against the price of not pursuing fiscal adjustment in the United States, and the consideration that the longer the delay, the greater the costs. It is doubtful whether the U.S. Administration can achieve the desired reduction in the deficit through expenditure cuts alone: even modest tax measures could convey a message of the Government's credibility and commitment to fiscal reduction efforts. In Europe and Japan, the emphasis is rightly put on structural policies as the means for raising potential output growth and--particularly in Europe--lowering the very high and entrenched levels of unemployment. The Board's recent discussion of the U.K. economy brought home the benefits that accrue when a government embarks on a coherent structural reform program. The individual measures may not do much in the short term, but collectively, they can contribute significantly to medium-term growth performance. Mr. de Groote suggested that the beneficial effects of a structural reform program are likely to be confined mainly to Europe; I have some doubts about this point, especially, if it was intended to apply to meaningful reform of the European Communities' agricultural policy. There is a widespread expectation that meaningful European agricultural reforms would benefit efficient agricultural producers in both developing and industrial countries.

In Germany, the implementation of structural measures is clearly needed to accelerate the pace of domestic demand growth: these measures would include the removal of labor market rigidities, a reduction in subsidies to inefficient industrial and agricultural sectors, and deregulation of goods and financial markets. The staff, and others, seem to suggest that the lack of growth of German domestic demand has been a key factor behind the stagnant growth in a number of other European countries, limiting the scope to stimulate demand in those other countries. It seems that where one stands on this issue depends on where one sits. I was very interested in the remarks on this point of Mr. Ovi, who certainly felt that Germany's modest growth was not helpful.

In the recent Article IV consultation with Japan, many Directors are looking forward in the forthcoming Japanese five-year plan to a more concrete plan for implementing many of the reform proposals that have been recognized and discussed by the authorities. The publication of a timetable for implementing the measures would do much to boost international confidence. I acknowledge the leadership role that Japan has taken in 1987, especially in promoting domestic demand, but many Directors cannot help asking for further action, particularly steps to open the Japanese market to imports.

One point that comes out very clearly in the staff's scenario analysis in SM/88/52 is that there are no winners under the protectionism scenario--certainly not when the full effects of protectionism are carried through. This point is linked closely to the overall strategy of promoting structural reforms in both industrial and developing countries, including market-opening measures and the reduction of subsidies. Our authorities should keep the dangers associated with the protectionism scenario in the forefront of their minds when the Uruguay Round discussions continue.

The staff highlights a number of important issues with respect to the role of exchange rates. First, there seems to be a clear recognition that exchange rate adjustments alone have only a limited capacity to correct external imbalances--other supporting policy measures are required. Second, while the recent emphasis on stabilizing exchange rates is welcome, we should avoid treating the symptoms rather than the causes of recent instability. Moreover, as Annex IV notes, the likelihood of a trade-off between greater exchange rate stability and interest rate and monetary stability could have particular implications for developing countries and the debt strategy. Another theme that seems to emerge on page 38 of the main staff paper is that, at least in the European context, more flexibility in exchange rates may be desirable. It is still an open question whether a more managed exchange rate regime would impose greater discipline on domestic policies.

Directors will be aware that my Korean authorities have serious reservations about the inclusion in the World Economic Outlook of the section that analyzes the newly industrializing economies as a group. The reservations are twofold: first, the different status of the economies with respect to Fund membership might focus attention on those countries that are members of the Fund; second, there are major differences between these countries in such basic characteristics as, inter alia, per capita income, net debt and reserves position, the openness of their economies, and the level and type of protection. The lumping of these economies in such a grouping as the Asian newly industrialized countries tends to obscure their differences and the quite distinct paths that are required to deal with the problems and opportunities facing them. All of my authorities agree that increased attention on the newly industrializing economies should not be allowed to divert attention from the adjustment task of the major industrial countries.

Different perceptions appear to be emerging of the risks in the current debt strategy and the Fund's appropriate role in it. It is hoped that there will be some converging of these perceptions over the coming weeks.

The recent financial innovations that have been introduced in debt rescheduling exercises do help to broaden the available options. However, ultimately, the key to continued financing for developing countries rests on the twin prongs of reducing the imbalances in the major industrial countries and a sustained commitment to adjustment policies in the developing countries; admittedly, with respect to the latter, major adjustments have occurred already over recent years.

We should be very careful about drawing conclusions from comparisons of the quantity of investment. I agree with one of the themes that the Director of the Fiscal Affairs Department has often espoused, namely, that it is the quality of investment that is the fundamental issue. Of related and vital importance is the need to have a proper pricing framework--including exchange and interest rates--which would ensure that investments will yield a good rate of return based on underlying economics, rather than on a mismatch of subsidies and conflicting price signals.

I support the idea of publishing the details of structural reforms. There are many different perceptions about what is meant by the term structural reform, and the World Economic Outlook would be weakened greatly if the Fund's detailed recommendations on structural policies were not included.

Mr. Dallara made the following statement:

By and large, we do not have fundamental differences with the staff on the short-term outlook; we have modest differences, as is often the case, with respect to certain short-term projections for the U.S. economy, but they are not worth belaboring at this point.

The staff's medium-term scenarios are welcome, and we can generally go along with the basic scenario, although it may not come as a surprise to Directors that I cannot fully associate myself with the basic scenario with respect to fiscal adjustment in the United States. As the staff states on page 25 of the main paper: "For the United States...no allowance is made for possible fiscal measures over and above those that have already been enacted. For other countries...the staff has assumed that there will be a gradual move toward medium-term fiscal objectives...."

Admittedly, the staff has every right to express skepticism about the exact course of fiscal adjustment in the United States over the years ahead, as it does in other cases as well. At the same time, I repeat a point that I made at the previous world economic outlook: we are really bothered by the difference in methodology, assumed in the "baseline" scenario that, in effect, no further progress will be made in the United States beyond the current policies in place. My authorities may not fully achieve their medium-term fiscal objectives in exactly the path that they currently would hope. Nevertheless, there is no clear reason for assuming that, contrary to every other major industrial country, no further progress will be made in policy changes in the fiscal area.

Both the nominal and real projections for the medium-term external positions of the United States, Germany, and Japan, are revealing, especially as we contemplate the possibility of inconsistencies between current policies and medium-term objectives of the major industrial countries. For example, the prospect of a $128 billion current account deficit in 1992 for the United States, or 2.1 percent of GNP, certainly would represent a further decline of the deficit in real terms, but, in both nominal and real terms, this would still be viewed by my authorities as unsustainable and undesirable. Similarly, we believe that the surpluses in Germany and Japan in 1992 of approximately 3 percent and 2 percent of GNP, respectively, would also be undesirable and unsustainable. There should be a clear objective on the U.S. part of reducing the current account deficit below the $100 billion level by 1992. An important test of the ability of the major industrial countries to coordinate effectively will be whether their policies can collectively put them on a path where the U.S., German, and Japanese current account positions are more sustainable.

The staff explores one scenario of what might happen in the event of a prolonged extension of a period of roughly unchanged payments imbalances--at least in nominal terms. Of course, in light of the exchange and other market behavior over the past year or so, one cannot exclude the prospect of further market tensions arising. Indeed, in spite of the substantial progress that has been made in policy coordination and in dealing with basic domestic and external imbalances, there is no room for complacency in 1988. There may be an ironic danger that what some might consider to be too easy financing of the U.S. current account deficit could reduce the pressure on the major industrial countries to continue needed adjustment.

The U.S. authorities certainly recognize the need for further steady progress on the fiscal front, and remain firmly committed to a steady continued reduction in the budget deficit. We are hopeful that the so-called "withdrawal of fiscal stimulus" can be accomplished without a sharp reduction in the levels of economic activity in the U.S. economy; the evidence to date in that respect has been somewhat encouraging. Indeed, one would have to say, as Mr. de Groote implied in his opening statement, that the prospects that the current strategy for correcting imbalances will get countries through the next few years without a global recession have improved somewhat over the past 6-12 months. This is a fundamental difference, perhaps, between the previous outlook and this one, and it may have, in part, and ironically, been made possible by the market disruptions of the fall of 1987.

The reduction in the negative savings rate of government that will accompany further fiscal adjustment should make an important contribution to restoring better overall balance between the excess of U.S. domestic investment over domestic savings. There is no doubt that the process of reducing absorption in the U.S. economy must continue. It is worth noting that as U.S. government dissavings are reduced, there is apt to be some offsetting decrease in private savings. Here, the mix of U.S. fiscal adjustment is particularly important: if we pursue fiscal adjustment that includes a substantial component of revenue increases it is all the more likely that there will be offsetting and negating reductions in the private savings performance of the U.S. economy.

I join other Directors and the staff in taking the basic view that further depreciation of the dollar in the near term could be counterproductive for the global adjustment process. The United States intends to continue to cooperate closely with other major industrial countries with respect to basic underlying policies and exchange market policies, in an effort to pursue adjustment with exchange rate stability. It is clear that over the medium term, continued policy efforts will be needed by my authorities and others if pressures for further substantial moves in the dollar's exchange rate are to be avoided, which underscores the need for a medium-term policy horizon in formulating near term policies.

I would have welcomed more emphasis on the unsustainability of the Japanese and German medium-term current account positions, which has an important bearing on the need for structural and macroeconomic policy action. The increasing acknowledgement from many quarters of the need for important advances in structural policy change in Europe, and indeed in all industrial countries, is striking. Despite the fact that there are some forces at work already that should help to strengthen private savings in the United States, further study and efforts in this area may well be needed. Developments that should serve to help to correct the low U.S. savings rate are: the phase out of tax deductibility of interest on consumer credit, the impact of the decline of financial asset values in 1987 and over the longer term, and the effect of the aging of the baby boom generation.

I agree with those Directors, including Mr. Ovi, who have stressed the need for a rather detailed consideration of the structural policy changes that are needed in European economies, and I join Mr. de Groote and other Directors in the view that inadequate emphasis has been given to the need for a complementary adjustment strategy in Europe, in the sense of having structural policy changes that complement--not replace--further macroeconomic policy actions. I cannot accept fully the implication that comes across in the staff's analysis that the scope for action in either of these policy areas is very limited. While there is, perhaps, more willingness and scope to look seriously at structural change in Europe and Japan than to look at additional changes in macroeconomic policy, we should not discount the important role that macroeconomic policy may in some cases make to the prospects for growth and correction of external imbalances in these countries. For example, we believe that the tendency of the German general government deficit to rise is, in part, due to the rather low level of economic growth; here, Mr. de Groote's analysis was particularly to the point.

If structural policy change is to have the intended effect over a medium-term horizon, it must be done in a rather bold and comprehensive way, and not in a piecemeal fashion. I would welcome staff analysis in staff reports for individual Article IV consultations, as well as in the next world economic outlook, of how possible strategies of structural change could be approached in a more comprehensive fashion, and one in which a high political priority is assigned. It is our impression that the same policy changes done in a piecemeal, step-by-step fashion over a number of years will produce much less adjustment than if approached more comprehensively and boldly supported strongly by political leadership.

Contrary to what may be a popular impression, we continue to believe that a combination of measures is required to bring about the needed adjustment in the newly industrializing economies. The measures should include domestic structural changes to shift these economies away from excessive dependence on exports and on a particular market, trade liberalization--embodying not just tariff reduction, but also reduction in nontariff barriers--and exchange rate change. The call for gradualism in the main staff paper was somewhat of a cause for concern. If the present Japanese external position is viewed as unjustifiable--and there would probably not be much disagreement with that--it seems that the Korean surplus, which is almost three times as large as a percent of GDP, is in need of urgent action also.

I tend to agree with Mr. Cassell and others that the world economic outlook discussion may not be the best place to consider possible precise adaptations in the international monetary system itself. However, I would welcome further analysis and study in this direction if it is focused on building on the current process of economic policy coordination--for example, the need to look at the further use of indicators in policy coordination. There is ample scope for us to move ahead both in the Board and in other fora to strengthen policy coordination as a means of buttressing the functioning of the monetary system. Healthy and critical analysis of the successes and shortcomings of the major industrial countries is important; it is interesting to listen to the criticisms and comments on the Louvre Accord and the ensuing efforts. Indeed, despite the substantial progress that has been achieved as a result of those policy coordination efforts, there is still much to be learned; in fact, I am struck by the vast terrain that remains largely unexplored in the area of more effective coordination.

Yesterday, during the Board's discussion of the extended Fund facility, Mr. Grosche expressed some understandable concern and sensitivity about the use of the word "flexibility," but, on other occasions, he and his authorities have somewhat paradoxically expressed sensitivity and concern about the use of the word "automaticity." It seems that in the policy coordination process, the major industrial countries, including my own, will have to accept ultimately the need for somewhat clearer parameters for their actions and policies if there is to be a more effective framework for policy coordination. In my view, the staff papers under consideration have provided a basis for another modest but important advancement in policy coordination and in the use of indicators. In particular, I welcome the tables on medium-term scenarios. It may not come as any surprise to the staff, but I think that there is still some further scope for clarity and detail in articulating the inconsistencies between current policies and medium-term objectives. My disagreement with the staff over what might be considered it methodological cynicism about U. S. fiscal policy should not obscure the fact that we have made a very important advance in the coordination process with this set of staff papers.

Mr. de Groote said that he hoped that the staff could later comment on Mr. Dallara's proposition that an increase in government revenue would decrease the savings rate, a proposition that reminded him of the Ricardian argument--from the perspective of comparative statistics--that if available income decreased so would savings. Both the type of taxation had to be considered--because the kind that the Chairman of the Federal Reserve Board had recommended recently would probably have quite different effects on the savings ratio than direct taxation of personal income--and also the public's perceptions of the fiscal deficit's effects on the rates of inflation and income growth. If the public believed that the deficit threatened to raise the inflation rate and slow income growth, then it was quite possible that deficit reduction financed by an appropriate type of taxation might induce a higher personal savings rate--owing to the changed expectations of higher income and more stable prices. The relationship between the personal savings rate and taxation should be discussed, because it was extremely important: Mr. Dallara had stressed it, and the Chairman of the Federal Reserve Board had spoken out in favor of a certain type of taxation in the expectation that it would increase savings.

Mr. Sengupta made the following statement:

I commend the staff for an excellent set of papers on the world economic outlook, which discuss policy issues in a medium-term context and center on achieving desirable and sustainable balances among the major industrial countries. The discussion is designed to model the transmission of policy changes among the industrial countries and to examine how changes in the economic environment affect developing countries as a whole.

The short-run economic prospects for industrial countries seem to be generally promising, notwithstanding the large payments imbalances, the stock market crash of October 1987, and the unstable conditions in the foreign exchange markets over recent months. In the developing countries, the staff expects that there will be some recovery of growth in the short run deriving from benefits that have arisen from the recent improvement in commodity prices; however, current account positions will become weaker--especially in countries in the Western Hemisphere, the Middle East, and Africa. External financing--at least for 1988 and 1989--will be stagnant, although short-run industrial country performance is expected to improve. This implies that some developing countries may have to run down their reserves to meet their payments deficits. Where reserves are not available, imports will be compressed with all the inevitable unfavorable effects.

With respect to the mutual consistency of the assumptions behind the "reference" or "baseline" scenario, the buildup of net external asset and liability positions among the major industrial countries will be large and will raise questions about the appropriate allocation of world savings. However, what is more important, the impact of this buildup on the confidence of asset holders may subject the financial system to shocks and make its present course unsustainable. Indeed, one could say that with the assumption of unchanged policies, the "baseline" scenario will evolve into the "financial tensions" scenario, which is not only unsustainable, but is also undesirable. The "policy adjustment" scenario should actually be compared with the "financial tensions" scenario to bring out more clearly the positive effects of policy changes; after all, even if the "financial tensions" scenario is more speculative, it is also more realistic than the "baseline" scenario.

The staff's "policy adjustment" scenario is only one of a spectrum of possibilities for aiming to achieve, by 1992, a balanced U.S. fiscal position and improved external account positions among the major industrial countries through further exchange rate adjustments and through the implementation of structural measures in Japan and Europe. The "policy adjustment" scenario is, as the staff state, "clearly much closer than the 'reference' scenario to meeting the test of 'sustainability.'" However, the key point is how realistic the scenario is: can fiscal corrections in the United States be so large as to deviate from the "reference" scenario by 0.9 percent of reference GNP each year from 1988 to 1992, meaning that deficits would become approximately zero by 1992? The U.S. current accounts deficits will still be very large--about 2 percent of GNP in 1989. What if the markets are reluctant to accumulate dollar claims in view of the continued tensions and costs of further exchange rate depreciation? If wealth holders do not want to hold the existing stock of financial assets at current yields, will there not be some type of repetition of the turbulence that the stock markets faced in October 1987?

The problem with the "policy adjustment" scenario is that the perceptions of economic units are assumed to respond precisely to the desired outcomes throughout the medium-term period, yet, can one assume that perceptions can be so formed? For instance, under the "policy adjustment" scenario, the slowdown in the real GNP growth rate over 1988-89 in the United States owing--to strong fiscal actions--could easily lead to a different market response if it is perceived that the sharp reduction in U.S. domestic demand will not be matched by a pickup in demand for U.S. exports from other industrial countries that are in surplus positions. Policy coordination among major countries is desirable, but considering the means by which these countries have gone about it, it would be difficult to blame the market if their perceptions are different from that of the Fund's Research Department. The medium-term scenarios paper gives the outcome of a situation in which the United States reduces its fiscal deficits significantly, while other countries continue with their current policy stances: the results are so depressing that one should not be surprised if the markets do not seem to be overly optimistic.

As a logical implication of treating the world economic outlook exercises as a part of multilateral surveillance, can the Fund work out--at a practical level--how to ensure that appropriate policy actions are taken in the major countries on the basis of the staff's, or some other mutually accepted policy adjustment scenario? Should a deviation from the scenario outcomes trigger a policy action, and if so, what could be the threshold point for such a trigger? Could it be automatic or discretionary? What should be the size and depth of the policy actions that need to be taken to ensure that the outcomes will be eventually along the envisaged lines? These important questions should be taken up as follow-up steps in which the Fund could use its expertise to foster improved international adjustment.

What results does the staff's Econometric Model, "Multimod," give relative to the "baseline" scenario if the Japanese policy reaction is--instead of raising domestic investment--to transfer about $10 billion to the developing countries. Moreover, what happens to Japanese and other countries' growth rates, and what happens to the volume of U.S. exports? I suspect that U.S. exports will be significantly higher than if these amounts were used only to raise Japanese domestic investment. A similar exercise could be done for Germany also, if its current account balance was kept at recent levels, but a part of it--say, about $10 billion--is transferred to developing countries as capital flows. I suspect that in both cases, the outcomes would be better than even in the "policy adjustment" scenario. However, if they are not, we should be able to tackle the issues globally by adjusting the imbalances not just among the industrial countries, but also taking into account the developing countries so that world output growth and trade are maximized. It is important to recognize that the policy responses of the major countries should not be guided by considerations relating only to their own economies or group of countries. As the medium-term scenarios paper shows, the policy actions of major countries have substantial effects on the rest of the world, as seen in the impact on the real GDP of developing countries when government spending is increased by 1 percent of GNP in the major economies; or when there is an increase in financing flows--of $20 billion each year--to developing countries; or when the money supply is increased by 5 percent in the major countries. This shows that adjustment should not be confined merely to surplus and deficit industrial countries, but should include surplus and deficit economies throughout the world.

It should be recognized that the required increase in developing countries' investment rates cannot be based wholly on domestic savings, which would in any event be low in view of the low income levels of those economies. External financing flows will be essential, a point that should be underscored because we know from the history of industrialization that the role of foreign savings has often been critical. This point should be highlighted in the staff's analysis because it places emphasis on raising domestic savings "in the absence of additional foreign financing." Furthermore, where private enterprise and initiatives are limited and not forthcoming, public sectors have to play an important role in providing an impetus to the process of development. As this should not be taken to imply a crowding out of the private sector, cuts to the size of the public sector should not be taken to the extreme. In this connection, the staff has commented that where fiscal deficits are high, they need to be reduced, but without "cutting those public investments that are complementary to private sector activity." While this is a reasonable suggestion, it may not be good enough in the many cases where the public sector has to be a forerunner and an innovator: it is difficult to imagine how enterprises in hitherto unknown areas of business in many developing countries could be started purely on private initiative given the unknown potential domestic demand for their products and the risks associated with them.

I fully support the Chairman's initiative at the past Annual Meeting with respect to the international monetary system and the role of the Fund. I have already referred to the potential role of the Fund in promoting policy adjustment and coordination. The Fund could help to develop such a process by participating in the determination of the technical exercise concerning target exchange rate movements. The Fund could also help to improve the stability of the international monetary system by proposing measures to enhance international liquidity, especially as there are a number of countries in serious payments difficulties. On numerous occasions, this chair has emphasized the Fund's critical role in evolving programs to enable countries to adopt growth-oriented adjustment strategies and in providing adequate finance with concessional elements in support of such programs. If the Fund gave strong signals to member countries about its willingness to play an active role in promoting adjustment among the developing countries by improving its access policies and by evolving appropriate conditionality, it would induce members to address their problems at an early stage and to remain committed to their policies.

Mr. Zecchini made the following statement:

In 1987, it was encouraging that despite the several exchange and stock market disturbances that led to increasingly unstable--if not volatile--expectations, the world economy has progressed in several important areas. Output growth was higher than expected, and the negative impact of the market crisis on world economic expansion in 1988 appears to have been quite modest. In the industrial countries, inflation rates have remained low, and some correction in the current account imbalances has occurred finally, while the aggregate current account position of developing countries has strengthened markedly, although at the expense of weakened economic activity.

It is also encouraging to see that the staff's projections for output growth for the period 1988-89--albeit revised downward--are not negative, as the present growth trend is forecast to continue on a quite stable path against a backdrop of increasing world trade and gradually declining external and fiscal imbalances. The buoyant growth of international trade is a welcome development that is not fully explained in the world economic outlook papers, but it seems to be based not only on the continuous expansion of domestic demand in major economies, but also on the stability of the terms of trade at about present levels and on the defeat of current protectionist pressures.

These positive developments should not make members excessively optimistic, or cause them to underrate the need for persevering in their efforts to put their economies on a sounder basis; in fact, large external imbalances are expected to remain in both the industrial and developing countries. The stimulative impact of domestic demand expansion in the major industrial countries is projected to slow markedly despite the gradualism of the fiscal consolidation. Unemployment is likely to continue to increase in Europe as a consequence of a slowdown in GDP growth and because of structural rigidities. In the developing world, mounting adjustment fatigue makes debt servicing and the restoration of higher growth rates appear to be just as difficult as they were before.

The foregoing causes for concern are well captured in the "reference" scenario and imply that current policies are likely to produce undesirable and unsustainable external payments positions and far-reaching market tensions. This conclusion is realistic, as is the staff's assessment of the alternative courses of action that are required to reduce the inherent risks resulting from the imbalances.

One cause of uncertainty that has been brought to my attention by the useful analysis provided in the annexes is the negative impact that the rise in net income flows in the balance of payments will have on the correction of external current account imbalances. As Annex IV shows, among industrial countries, the responsiveness of external imbalances to exchange rate and relative demand changes has been weakened by the growing size of net income flows--which are moving in the opposite direction to that needed for restoring external equilibrium. For instance, for the United States, the accumulation of a stock of net external liabilities of about $700 billion by the end of 1989 will imply an outflow of interest payments of about $56 billion--assuming an average interest rate of 8 percent. In view of this additional constraint, a more sustained correction of domestic absorption in deficit and surplus countries seems necessary to offset the impact of the expected rigidity of these flows over a number of years.

In this connection, Table 3 of the main staff paper was intriguing, as it shed some light on trends in the savings propensities--and implicitly, the consumption propensities--of household sectors in a number of countries: the household sector generally bears the brunt of adjustment in domestic absorption, particularly on the side of consumption. In all G-7 countries, according to this table, the propensity to save has declined steadily from 1981 to 1987. Has this trend been a major driving force behind the revival and the persistence of growth over the present business cycle, and have the differences in the rate of decline of the savings propensities across the G-7 countries been a major factor behind the apparent sluggishness in the correction of the current account external imbalances? Is the expected rise in the propensity to save in the period 1988-89 the inevitable condition for restoring external balance among the G-7 countries? Moreover, what policy instruments does the staff believe will induce this result; are the structural reforms under consideration presently in these countries sufficient to raise the propensity to save, or alternatively can macroeconomic stabilization of the business cycle reverse the expected decline in propensity to consume?

Any answers should not be framed in terms of testing Ricardian equivalence as the economic literature has shown that there is still no firm evidence for this effect in industrial countries--which is consistent with one's first impressions of Table 3, where the rise in U.S. deficit was accompanied by a decline in the savings ratio.

The "policy adjustment" scenario provides an appropriate framework in which demand-management and structural policies could complement each other to induce growth-oriented external adjustment and to avoid the potential risks of a market-determined correction. To this end, three components of the policy package carry wide implications and seem to be fully warranted: a more ambitious U.S. fiscal correction; a strengthening of structural adjustment measures in Europe and Japan; and a further opening of markets to foreign competition, particularly in Japan and the newly industrialized economies. As the medium-term simulations indicate, the implementation of each of these components alone can have limited impact only, or even result in some negative effects and high adjustment costs. However, a timely coordination of these three groups of measures could allow the attainment of sustained growth and the reabsorption of the world economy's domestic and external imbalances. Better policy coordination is also desirable among the major industrial and developing economies. The use of macroeconomic indicators is making the coordination exercise more sharply focused and might provide increasingly effective signals for policy changes the longer policymakers are induced to take account of the empirical evidence derived from movements in these indicators. At this stage, it would be much wiser to concentrate on the existing set of indicators, rather than to continue to enlarge their number.

In industrial countries that are in external deficit, proper domestic demand management, fiscal consolidation, and the implementation of structural reforms should be emphasized. In this respect, the recent successful fiscal stimulus package in Japan is commendable, while the expected re-emergence of excess domestic demand in the United States in 1989 as compared with Germany is not satisfactory. At the same time, there does not seem to be ample margin for a further substantial depreciation of the U.S. dollar. The real effective exchange rate of the dollar has already returned to the very low level of 1987: a further depreciation to the even lower levels of the early 1970s is hardly conceivable without serious distortions and disruptions in the pattern of trade flows among all groups of countries. As for monetary policy, the fine tuning of interest rate differentials to stabilize exchange rates should not be at the expense of price stability; this also applies to the European Monetary System, provided that the pivotal country in the system does not impart--through its passivity--a deflationary bias to the region. In the latter case, the entire spectrum of policies and policy mix of the pivot country will be called into question. There is no fundamental difference between the macroeconomic policy prescriptions for developing and industrial countries: the differences lie instead in the intensity of the required measures and in the approach to servicing the external debt. It is clear that, for deficit countries, stop-and-go policies are more painful and require longer-term austerity than a coherent implementation of corrective measures over the medium term. At the center of these corrections are fiscal consolidation, monetary discipline, and the implementation of structural reforms to create a more favorable environment for enhancing domestic savings and investment. After the first phase of stabilizing the business cycle, the time has come for several deficit countries to expedite structural changes to raise the frontiers of sustainable economic growth. External trade liberalization should be included among these changes, although the pace of liberalization might be more gradual than what is required for the newly industrialized countries. A more rapid opening of the latter group's markets should be expected, given its strong collective balance of payments position.

After stressing the predominant impact that long-standing weaknesses in economic management have had in generating the present difficulties for most of the developing countries, we cannot overlook the amplification of these difficulties deriving from the current heavy debt burden and the resulting tightening of external financing. The seriousness of this aspect of developing countries' problems is highlighted by the fact that, in 1987, for the second year in a row, the net resources provided by the banking community to these countries have not increased--despite a few notable exceptions. At the same time, official creditors have been called to share an increasing part of the burden of providing external financing, although they are not in a position to provide all of the financing necessary for a smoother development of these economies. Additions and changes to the menu of feasible approaches to this problem are advisable.

Mr. Donoso said that some progress had been made toward attaining more balanced fiscal and external positions in developed countries. The reduction of the U.S. fiscal deficit and the adoption of more expansionary policies in surplus countries had improved real trade positions, while the growth rate of industrial countries of 2.9 percent in 1987 was a good result after the fears that had been raised by the financial problems during the last quarter of 1987; furthermore, inflation remained under control.

However, it was clear that the risks remained enormous, and much adjustment was still needed, Mr. Donoso continued. There was a widespread perception of instability, and drastic market fluctuations could occur if the efforts to correct the remaining imbalances were not maintained until a sustainable position was assured.

The staff's use of alternative scenarios clarified the impact of using specific policy instruments, Mr. Donoso noted, and showed that renewed efforts were required to avoid a disorderly elimination of financial market tensions. In that connection, the staff was correct in opposing additional fiscal stimulus in the major surplus economies, because increased fiscal deficits would be contrary to those countries' long-term interests. To force additional absorption in surplus countries through fiscal expansion would risk creating additional demand for the resources being presently used by deficit countries--even if the latter resources had still not been freed--which would make the overall financial situation in the industrial countries even more volatile and keep upward pressure on interest rates. Instead, if adjustment in surplus countries was achieved through the effects of interest and exchange rate policy on private spending, the latter would better match the availability of savings freed by adjustment in deficit countries, which would in turn depend primarily on the continued reduction of the U.S fiscal deficit.

He hoped that the role envisaged by the staff for structural reform in surplus country adjustment over the short term did, in fact, exist, Mr. Donoso remarked. The staff's recommendations for structural reform were entirely appropriate, because increased market flexibility would always induce growth and employment. More specifically, it was important that European agricultural competitiveness be improved. However, it was unlikely that structural reforms could be implemented and bear results early enough to serve as a reliable instrument for coping with the present difficulties; and, in any event, although some of the structural reforms that were being discussed would most likely raise income, they would not necessarily reduce the excess of income over expenditure. In that sense, the implementation of structural reforms would not necessarily induce the required type of short-term adjustment--despite the fact that some of the measures went strongly in the right direction, such as the aggressive opening of trade barriers in surplus economies.

It was clear from the staff's analysis that the present policy stance of industrial countries involved serious risks that should be avoided, Mr. Donoso observed, and that improved adjustment would require further exchange rate change. The stronger the U.S. fiscal adjustment the more likely further exchange rate changes would be needed to substitute private and foreign demand for U.S. resources in place of reduced public sector demand. Therefore, despite the importance of structural reforms, a combination of fiscal adjustment in the United States and exchange rate change among all industrial countries over the short term was needed to move those economies toward a more sustainable position.

Continuous progress toward eliminating industrial countries' imbalances was important given the developing countries' situation, particularly the middle-income economies, Mr. Donoso added. Coordinated action to keep exchange rates in a narrow range--despite the underlying imbalances--had had costs for the developing countries: the staff papers indicated clearly the persistent relation between dollar exchange rate stability and the higher interest rates on dollar-denominated assets needed to induce capital movements. The higher interest rates--resulting from the reliance on monetary policy and ultimately from the instability of exchange rate adjustments--might have slowed industrial countries' growth and therefore the demand for developing countries' exports. High interest rates had also worsened indebted countries' current accounts, and depressed their commodity prices, while the dollar depreciation and the resulting positive impact on commodity prices had been postponed. The necessary improvement in indebted countries' positions was another reason why industrial countries should maintain exchange rate flexibility and why the United States should further reduce its fiscal deficit.

A continuation of the "current reference" scenario would result in the worst possible situation for some of the highly indebted countries, whereas improved adjustment would enhance those economies' outlook, Mr. Donoso pointed out. The "financial tensions" scenario would favor some indebted countries' prospects, because, despite the lower growth in the industrial countries in that scenario, exchange rate adjustments would increase commodity prices. The staff's projections indicated that the heavily indebted countries would be better off in a recessionary environment with low interest rates and a depreciating dollar than in the present situation.

More important than any one of those particular medium-term scenarios for heavily indebted countries, Mr. Donoso considered, was a set of circumstances that would provide incentives for those economies to adjust and therefore to surmount their debt problems. As the staff had indicated, the successful management of the debt problem required an improving world economic environment. The improved coordination among industrial countries had not facilitated the resolution of the debt problem, and had even had negative effects.

The adjustment programs supported by the Fund should reflect the fact that excessive short-run adjustment was impossible to sustain, Mr. Donoso suggested, and, therefore, the aim had to be to reach lower and reasonable debt levels by maintaining acceptable rates of consumption and investment. An approach that spread adjustment over a longer period required more financing, and for the middle-income indebted countries, that financing would have to come from commercial creditors. However, because it was not in the creditors' interests to provide more financing, it was important for the Fund to complement the menu approach with additional mechanisms to accommodate some of the banks' legitimate demands and to press them to increase their lending.

He supported the staff view that the debt strategy would have to be managed carefully to facilitate the different forms of debt reduction, such as the transformation of debt into investment--which had enabled countries to benefit from the depressed secondary market prices of their debt, Mr. Donoso said. The Research Department had done commendable work in clarifying the possibilities in that area.

Low-income countries should be treated with a full appreciation of the limitations that they faced, Mr. Donoso concluded, and in that respect, the enhancement of the structural adjustment facility and the actions undertaken by the Paris Club were welcome. He shared the staff's view on the importance of expanded official development assistance and the inclusion of elements of debt forgiveness among other forms of relief when debtors could not meet their obligations.

Mr. Abdallah made the following statement:

> The annexes and medium-term scenarios include welcome analytical innovations.
>
> It is clear that since the previous world economic outlook in September 1987, there has been some amelioration--albeit in degree rather than in kind--in the seriousness of the overall outlook. The increase in payments imbalances has slowed somewhat, reflecting the beneficial effects of domestic policy adjustment--particularly in the United States, Japan, and Germany--and also the concerted efforts to foster international policy coordination. However, there is little cause for relaxing coordination efforts, because large cumulated imbalances still persist, posing a continuing threat to growth and financial

stability in the world economy. The stock market collapse of 1987 provides one indication of the possible consequences of such imbalances, although it appears to have had less severe consequences than were feared initially; another is the greatly increased reliance on official intervention in exchange markets to finance payments imbalances, as nonofficial agents grow reluctant to hold dollar-denominated assets.

The forecast in Annex VII was quite revealing: based on present policies, external imbalances will widen markedly--albeit at a decreasing rate--so that by 1989, net asset to GNP ratios will be minus 13.9 percent in the United States, and 15.7 percent and 19.4 percent in Japan and Germany, respectively. This suggests that reducing imbalances to acceptable levels requires sustained corrective action in the industrial countries, which has implications for the process of adjustment in developing countries and for the Fund's role in facilitating smoother global adjustment. In this context, the "policy adjustment" scenario's objective seems to be relatively modest; what is really needed is a reversal of the existing trend of rising imbalances by 1992, not just mere restraint. The staff should in the future work to impose this condition on the model and thereby analyze more fully the nature and intensity of the policy mix that will be required.

The staff is correct in emphasizing that market-imposed exchange rate changes, unaccompanied by changes in domestic policies, are not an efficient way of reducing imbalances, because of their adverse consequences for the attainment of other objectives. The challenge remains that of sharing the responsibility for the phased adjustment of domestic absorption between surplus and deficit countries using an appropriate mix of macroeconomic and structural policies. Clearly, the United States, with its economy operating at near capacity levels and as the major deficit country, needs to sustain the momentum of growth by implementing fiscal measures aimed at facilitating the substitution of foreign demand for domestic demand. For Japan and Germany, the challenge is the reverse one of promoting domestic demand in place of export-led growth by reducing structural rigidities--including the consumption/saving pattern--which will also have the beneficial effect of accelerating the growth of potential output. More is required at this stage from Germany, the United States, and Japan, in that order. Furthermore, with current account surpluses totaling some $30 billion, the four newly industrialized economies should be taken into account in resolving global payments imbalances, but like Mr. Ismael and Mr. Salehkhou, I feel that their role should not be overemphasized.

In any event, as a comparison of Tables 8 and 9 in the main staff paper shows, failure by the various groups of countries to take sustained policy adjustments will provoke a substantial further realignment of exchange rates leading to significant output losses and the rekindling of inflationary pressures in the industrial countries, as well as an attendant contraction of growth among the developing countries. One particular concern is that this difficult situation does not provoke an intensification of protectionist pressures among the industrialized countries; as Section VI of the medium-term scenarios paper illustrates clearly, protectionism among the industrial countries becomes a negative sum game in which everyone loses, especially the developing countries as a group.

Section IV of the main staff paper was somewhat less specific in its treatment of sub-Saharan Africa than for other areas. Despite some recovery in the terms of trade in the second half of 1987 and the maintenance of adjustment programs for several years, growth has remained modest, investment has not revived, the restoration of creditworthiness is a long way off, inflation has accelerated, and overall adjustment fatigue seems to be taking hold. If anything, prospective trends for developing countries as a group are less promising than before. It was a particular cause for concern to note from Table 4 that the net exports of industrial countries, after having been negative over 1983-87, are likely to disappear: this has serious implications for developing countries--especially those that are debt distressed--as they struggle to grow out of their weak positions in conditions of diminishing flows of external assistance. In sub-Saharan Africa, real per capita growth is likely to stagnate, if not decline. Moreover, the exercise in Table 12 shows that Africa has the double burden of raising the general level of domestic investment as well as reversing the trend toward declining total factor productivity of such investment. The design of adjustment programs must therefore clearly take fuller account of this structural aspect, particularly by making the fiscal budget a more effective tool for directing scarce resources to productive investment, supporting investment, and promoting the development of human capital.

Over the short term, it is evident that the growth of national income in sub-Saharan Africa can be ensured only if forgiveness of existing debt is undertaken by official creditors and a "critical mass" of new longer-term financing on concessional terms is made available by both bilateral and multilateral donors. The staff makes the same point in stating that "in much of Africa, the situation has reached the point where a quantum increase in the level of official assistance is viewed now as essential to permit a resumption of growth." The implication is that multilateral institutions, including the Fund, must increase substantially the assistance they extend to the low-income countries. It is in this connection that I have noted with great interest the staff's view that, with the setting up in December 1987 of the enhanced structural adjustment facility, $5 billion in disbursements--rather than commitments--will be forthcoming over 1988 and 1989. However, considering the delays that are being experienced already, this assumed level of disbursements will call for generous access limits and a greatly stepped-up schedule of program negotiations and approvals if general disenchantment is to be avoided.

The conclusions emerging from the somewhat more wide-ranging financial simulations made in Section V of the medium-term scenarios paper are significant. The simulation assumed outright transfers from industrial countries to capital importing developing countries of $20 billion a year over the next five years. The percentage deviations from the "baseline" scenario--which assumes no worsening in the world economy--show that over the five-year period, while real import levels in these developing countries grow at between 2 percent and 3 percent a year initially, and the debt service ratio stabilizes, real output increases by only 1/10 of 1 percent a year. Equally important, such increases in the imports of developing countries are accommodated with only a small increase in the real user cost of capital in industrial countries. These forecast outcomes lead to two tentative conclusions of some significance: first, developing countries will need to be assisted by much higher and more sustained levels of concessional lending before the momentum of growth will gain sufficient strength; and second, such concessional transfers have unambiguously positive qualitative effects on industrial countries and can thus be justified on grounds of their self-interest and of the improvement in the world economy as a whole. I hope that over the coming months, we can convey this message to the industrial countries.

Mr. Posthumus said that he had no fundamental difficulties with the staff's projections. The initial size and character of the unsustainable payments positions had a significant bearing on the relative adjustment responsibilities of surplus and deficit countries. European structural rigidities were having an increasingly negative effect on the adjustment process; for instance, while the somewhat faster European growth of the mid-1980s had been export led and related to the unsustainably high level of U.S. imports, at present, the U.S. external position was adjusting and therefore slowing European export growth and further highlighting the unsolved problem of structural rigidities. In such a situation, expansionary fiscal policies might not be effective over the short term, and hence the sharing of adjustment responsibility between surplus and deficit countries was not an easy task that could be guided by macroeconomic indicators alone. The adjustment process could lead to a slowing of world economic growth even if the United States managed to switch from domestic demand to export-led growth, although Europe's performance might still be surprising; the Netherlands had recently made a big effort to contribute to such a surprise.

The European Monetary System had been largely successful in checking its members' domestic inflation rates, Mr. Posthumus observed; currency realignment would endanger that result unnecessarily. If some members were unable to reduce their domestic inflation rates below the German level, devaluation might exacerbate that problem by putting inflationary pressure on the devaluing countries while retarding revaluing economies' growth rates. As the staff had pointed out elsewhere, devaluation should be accompanied by fiscal, monetary, and other measures, which would also diminish the need to devalue, and, if taken promptly enough, even make devaluation unnecessary. European Monetary System exchange rate changes--which were usually small--had been made only if internal measures alone could no longer compensate for declining competitiveness. It was doubtful whether loosening the system's disciplinary function would reverse the lagging competitiveness of some countries, which should be improved rather through measures to increase labor productivity--the very thing that a commitment to stable exchange rates supported and which had happened in a few European countries. Therefore, he did not share the staff's view that the management of European currency arrangements should take greater account of member's growth potential.

Interest in greater exchange rate stability had certainly increased, as seen in the G-7 intentions to stabilize the G-3 exchange rates, Mr. Posthumus noted. However, the apparent realization that manipulating exchange rates was not sufficient to improve competitive positions was the reason behind the desire for exchange rate stability, not an understanding that the latter could be an important disciplinary element for national policies. The raising by the staff of the issue on page 57 of the main paper of the role of the exchange rate in adjustment and the possible usefulness of containing exchange rate fluctuations was gratifying, especially in view of the fact that on page 7, exchange rate pegging was viewed as a heterodox measure--which was surprising in a staff paper of a Bretton Woods institution.

The present working of the international monetary system should be further studied, including the functioning of its constituent elements, such as the role of the Fund and the European Monetary System, Mr. Posthumus concluded. In that respect, a very important and difficult question to answer was whether floating exchange rates had perhaps exacerbated maladjustments and delayed the implementation of needed adjustment measures. The Fund should play a central role in identifying and clarifying such issues as there was no other institution that had the same experience with individual countries as the Fund had. The Board should ask management to identify a few of the issues, get the staff to start work on it, and let management decide when it was appropriate to bring the findings to the Board. The work should not be postponed any longer.

Mr. Othman made the following statement:

> In reviewing the recent performance of the global economy it is possible to point to a number of positive developments. As the information provided in the staff papers indicates, the

external imbalances among the major industrial countries have begun to narrow, while noninflationary growth has been maintained at a reasonable pace. Moreover, the process of coordination among these countries has continued to strengthen, not only in the exchange rate area, but also, and what is more important, in the broader aspects of economic policy. The fact that price inflation has continued to be moderate adds an important element of policy flexibility that can contribute to further coordination of global adjustment over the period ahead.

The positive developments, however, do not mask the serious problems that underlie the present state of the world economy and the risks for the period ahead. Despite the fact that the external imbalances of major industrial countries have begun to decline, the pace of adjustment continues to be too slow. It is not clear whether financial markets will be patient enough to accept such a slow adjustment; therefore, the downside risks for the period ahead continue to be high. This is particularly so given the expectation of little further adjustment in the U.S. fiscal deficit over 1988-89. For the developing countries, it is rather discouraging that even with optimistic assumptions about the external environment, they will continue to face a very difficult situation. Of course, any downturn in the world economy will exacerbate the problem further, both for the indebted middle-income countries and the low-income countries; the implications of such a development for the debt strategy and for growth-oriented adjustment would be quite serious.

With respect to the industrial countries, I am in broad agreement with the staff's analysis of the tensions associated with the "reference" scenario's projections. As the staff recognizes, it is very difficult to predict exactly when and how these tensions may manifest themselves in the financial markets. One element of uncertainty in this respect is the way financial markets form their expectations and interpret economic performance. It is not clear, for example, whether continued good growth performance in the near future, following the recent upward revision in the fourth-quarter U.S. growth figures, will offset, or at least postpone, the markets' reaction to the slow adjustment in the external position. If markets do attach great weight to growth developments then the question arises whether faster financial adjustment in the United States, along the lines suggested in the staff's "policy adjustment" scenario may--through its effect on output growth--reduce the favorable impact on market expectations of faster fiscal adjustment.

This notwithstanding, there is obviously basic agreement on the direction of the required policy changes in the major industrial countries. The exchange rate adjustment over the past three years has been quite substantial, and it has become clear that without the support of domestic policy changes, further adjustments in exchange rates would not be a feasible or desirable way of accelerating the correction of external imbalances. Indeed, one could argue that although the credibility of the purchasing power parity principle has been strained severely over recent years, further adjustments in exchange rates may lead--if they have not already led--to an undervalued dollar given the current trends of price inflation; this would not be consistent with the objective of relative stability of the exchange markets over the medium term. Seen in this light, the recent coordinated interventions in the exchange market are quite understandable.

As to the role of structural versus macro policy in the process of adjustment, it is clear that in the United States--where the economy is operating close to capacity--the most pressing problem is to reduce domestic absorption through fiscal tightening. In most other industrial countries, the emphasis should be on structural policies, although in some of them, financial management should continue to play a role--at least over the short term. In this respect, I have noted and welcome Japan's efforts over the past year to combine demand management policy with accelerated structural reform. The responsiveness of the Japanese authorities should certainly be commended, including their efforts to direct more financial flows to developing countries. While it is clear that further increases in domestic absorption in Japan would be helpful to global adjustment, one should note the already high rate of private investment relative to GDP: as shown in the staff papers, gross private investment is about 30 percent of GDP compared with 17-18 percent in other major industrial countries. Perhaps the emphasis of policy should be directed more toward increasing private consumption.

Turning to the developing countries, the two main questions that have to be faced over the period ahead are: first, how to enhance growth performance despite the uncertainties about the external environment; and second, how to achieve further progress in dealing with the debt problem at a time when these countries' borrowing requirements are again rising and the financing constraint is getting tighter.

The staff has provided a useful analysis of the growth performance of developing countries over recent years and has attempted to draw lessons from that experience. In particular, I share the staff's emphasis on the need to increase the level and efficiency of investment to raise the medium-term growth potential of developing countries; with the lack of external financing, however, this will clearly be a very difficult task. There is no doubt that developing countries should aim at increasing their domestic savings and thereby allocate more resources for domestic investment. However, in many of these countries, the process of adjustment over recent years has involved not only cutbacks in investment, but also reductions in per capita private consumption; further reductions in consumption will therefore not be easy, especially in the lower-income countries where the standard of living has been declining from an already very low level. In these countries, the use of domestic resources for investment has to compete with pressing consumption needs, as well as debt-servicing obligations. The difficulty in choosing between short-term and long-term objectives is therefore quite understandable, particularly when political considerations force policymakers to discount the future at a high rate. Of course, while recognizing these difficulties, the fact remains that if growth is a central objective of the adjustment process, the investment performance of developing countries has to improve. In fact, the magnitude of the additional investment needed will be even higher if these economies are to generate enough employment for their growing labor forces and tackle the substantial unemployment problem that exists in many of them. This is perhaps one area that could have been emphasized more by the staff, the data problems notwithstanding.

While I agree broadly with the staff's conclusion with respect to the policies that developing countries need to follow over the period ahead, I am rather pessimistic about their growth outlook if the financing constraints continue to tighten. For the same reason, the prospects for a significant easing of the debt problem do not seem to be very promising. In fact, as the staff projections indicate, the debt situation of developing countries will remain quite serious over the medium term, even under optimistic assumptions. It would, of course, become even more serious if the assumptions underlying the "reference" scenario did not materialize, either because of financial tensions in industrial countries, or a rise in protectionism in the major export markets. For the oil exporting countries, a major cause of uncertainty is the outlook of the oil market. Relative stability in the oil market will depend clearly on coordination between oil exporters; recent developments provide a positive indication that the cooperation of some non-OPEC oil producers will support the common objective of a relatively stable market. In the long run, this will be beneficial to both consumers and producers, but it will be particularly important for the heavily indebted oil exporting countries that experienced a serious setback to their adjustment efforts over the last few years.

More generally, it has become clear that there is no single or simple solution to the debt problem of developing countries. One hopes, of course, that the sum total of innovations and modifications to the present approach will chip away at the debt problem gradually. The danger, however, is reaching a point where one will have to move faster and faster simply to stand still. To avoid reaching such a situation, all of the parties involved in the debt problem should seek every avenue for strengthening their role. The Fund, on its part, has taken a number of welcome steps over the recent past to strengthen its contribution to this process, including the enhancement of the structural adjustment facility and the ongoing efforts to adapt Fund facilities and policies to fit the growth-oriented approach of the current debt and adjustment strategy.

It would be useful to begin the process of considering reforms in the international monetary system. Progress in this area will, of course, depend on the political will of the members of the system.

Mrs. Filardo made the following statement:

Having weathered a stock market crisis and increased exchange market volatility since the previous full-fledged world economic outlook exercise, we may look ahead more confidently to the medium-term prospects and reflect on the most appropriate policies to pursue. From a longer-term vantage point, one may note that over recent years the major industrial countries have succeeded in abating inflation and in restoring growth; but the success has come at the expense of generating unsustainable external and internal disequilibria. Today, these latter phenomena endanger the previous accomplishments, and there is a not unnegligible probability that a new stage of world inflation cum recession might emerge.

With respect to the realism of the projections, I have stated previously that the "reference" scenario is not only useful, but also a prerequisite for gauging the tensions that will arise from maintaining the current policies; but, for this same reason, it is perhaps the least likely outcome. In consequence, the discussion should place more emphasis on the alternative scenarios--although the relative probabilities of each of them occurring is a matter of subjective judgment. However, as the staff points out correctly, based on these two scenarios, the near-term prospects are more gloomy than before, especially if we believe that governments tend to act only when a crisis is inevitable, or has occurred already. Today, we may be more optimistic: disequilibria in the major industrial countries are on a downtrend in real terms, and their policies--even if accompanied by some hitches--are more coordinated. Hence, an outcome somewhere in between the two latter scenarios might be more probable and serve as reference for the discussion of the scenarios developed in the corresponding Appendix.

How sensitive are the projected results to the two important assumptions made in the Multimod--namely, the forward-looking nature of expectations, and the proposition that the flow of credit from industrial to developing countries depends on the latter's creditworthiness?

The first assumption leads to positive short-term results from the implementation of structural measures. However, when discussing the causes for the better than expected results in 1987, the staff states that the benefits from lower raw material prices, and adjustments in the exchange rates, took time to manifest themselves. It thus seems that the first Multimod assumption is at odds with past experience, and that if history repeats itself in this respect, the "policy adjustment" scenario would yield less encouraging results over coming years. In other words, with the assumption of forward-looking expectations we would be introducing an optimistic bias to the "policy adjustment" scenario.

I wonder if the second Multimod assumption works in one direction only, and therefore whether it limits the usefulness of the model for analyzing a more active resource transfer policy. If the assumption is working the way I understand it to, then would the staff say whether the "additional financing" simulation could be superimposed on the "policy adjustment" scenario? If the results could be superimposed, one could conclude that by adopting those measures envisaged in the "policy adjustment" scenario, as well as providing grants to developing countries, output in the industrial countries would be virtually unaffected in 1988, and start growing by 1989. It would also be desirable to have a more comprehensive set of indicators for the medium-term impact of an increase in financing to be able to compare the effects of lending as opposed to providing grants. This type of analysis would give more objective grounds to the request by developing countries for stepped-up concessional assistance.

With respect to policies for external adjustment, exchange rate adjustments have a limited effect only for correcting external disequilibria if they are not supported by appropriate internal measures; hence my concern about the difficulties the United States is having to reduce substantially its fiscal deficit over the coming years.

An issue that merits further attention in this context, is the relationship between stock and flow adjustments, and its consequences for policy coordination.

The very acute debt problem affecting most developing countries has given rise to a skewed pattern of world trade. The staff recognizes that although world trade expanded by 4 3/4 percent in 1987, and will likely continue at the same rate during 1988, trade between developed countries is more active than between developed and developing economies. Furthermore, among the latter, adjustment has been effected mainly through a significant compression of imports, whereas the share of indebted countries' exports in total world trade is rather stagnant; it is, thus, not a positive achievement that for the first time in 20 years nonfuel exporting countries have recorded a current account surplus. The adjustment has translated not only into slower growth and a higher inflation rate, but signs of fatigue are also becoming apparent. These problems also seem to be taking hold of developed countries as well; for example, the annex on the net external asset position of the G-7 members shows that despite the flow adjustment that is taking place, the stocks as a percentage of GNP will continue to deteriorate over the next years--with the exception of the United Kingdom. Only under the third scenario do the relative positions of countries tend to stabilize.

From this perspective, the instability of the exchange and stock markets is more understandable, although it remains difficult to provide constructive criticism on policy coordination. Mr. de Groote's comments on exchange and interest rate coordination seem to be particularly relevant, and I endorse them fully: as stocks become progressively more important, and with a rising volume of capital flows, interest rate coordination becomes crucial. However, an element that should not be ignored is the connection between the performance of developing countries and the level of interest rates in developed economies; hence, interest rate coordination should take special consideration of the debt problem.

The emphasis on reviving growth in developing countries is commendable, although I have some reservations about the assumptions in the "reference" scenario that later serve as a basis for comparing different policy stances. With a given amount of foreign savings and--in the short term--of domestic income, the increase in investment can occur only at the expense of reducing consumption, and yet under the current already depressed levels of consumption this is an unlikely event. On the other hand, even if resources were available, it is not clear whether the resulting investment would be profitable.

The staff emphasizes that "while an improved financing situation may lead to higher investment that raises the growth of the domestic product, it will lead to higher growth of GNP only if the rate of return exceeds the interest cost of product borrowing." However, we should not forget that the cost of raising resources in the international markets depends on the monetary and exchange rate policies implemented by industrial countries.

The change in the course of U.S. interest rate policy during the 1980s and the strong depreciation of the U.S. dollar since 1985 have had serious effects on debt servicing in developing countries.

The staff recognizes rightly that under the most optimistic scenario the debt problem is a cause for serious concern. At this juncture, it is clear that multilateral institutions have to play an important catalytic role. Nevertheless, from the course of our discussions over the past few weeks, it appears that we are making little progress on what to offer the Governors at the Interim Committee meeting on the role of the Fund in the context of the negative financial flows to developing countries. The situation could result obviously in serious tensions between creditor and debtor countries that might undermine the spirit of cooperation that has prevailed since 1982.

In relation to the international monetary system and the role of the Fund, I associate myself with Mr. Kafka's view that apparently the Fund is the only place where the possible reform of the international monetary system is not discussed, and with Mr. Posthumus's point that the Fund should work in the direction of identifying problems and making recommendations. I wonder how we could proceed, whether the initiative should come from the Group of Five or the Group of Seven, the whole Board, the management, or the staff?

The Executive Directors agreed to continue their discussion on Monday, March 28, 1988.

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/88/48 (3/25/88) and EBM/88/49 (3/25/88).

2. ASSISTANT TO EXECUTIVE DIRECTOR

The Executive Board approves the appointment of an Assistant to Executive Director as set forth in EBAP/88/74 (3/22/88).

Adopted March 25, 1988

APPROVED: November 16, 1988

LEO VAN HOUTVEN
Secretary