INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 87/135

3:00 p.m., September 11, 1987

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

Executive Directors	Alternate Executive Directors
A. Abdallah	E. T. El Kogali
	Song G., Temporary
C. H. Dallara	
J. de Groote	
	E. Feldman
	A. M. Othman
G. Grosche	
J. E. Ismael	J. Reddy
	J. E. Zeas, Temporary
T. P. Lankester	M. Foot
M. Massé	
Mawakani Samba	
Y. A. Nimatallah	
G. Ortiz	L. Filardo
J. Ovi	M. Fogelholm
H. Ploix	D. Marcel
G. A. Posthumus	G. P. J. Hogeweg
C. R. Rye	
	O. Kabbaj
A. K. Sengupta	L. E. N. Fernando
K. Yamazaki	M. Sugita
S. Zecchini	

L. Van Houtven, Secretary and Counsellor
K. S. Friedman, Assistant

Also Present

African Department: R. J. Bhatia, Deputy Director; M. G. Kuhn. Asian Department: B. B. Aghevli, D. A. Lipton. European Department: M. Russo, Director; M. Guitián, Deputy Director; R. B. Hicks. Exchange and Trade Relations Department: J. T. Boorman, Deputy Director; L. Hansen, H. B. Junz, S. Kanesa-Thasan. External Relations Department: A. F. Mohammed, Director; P. C. Hole, J. M. Landell-Mills, I. S. McDonald. Fiscal Affairs Department: V. Tanzi, Director; A. H. Mansur. IMF Institute: O. B. Makalou. Legal Department: H. Elizalde, P. L. Francotte. Middle Eastern Department: S. von Post. Research Department: J. A. Frenkel, Economic Counsellor and Director; A. D. Crockett, Deputy Director; M. Goldstein, Deputy Director; R. R. Rhomberg, Deputy Director; J. M. Boughton, M. C. Deppler, M. Dooley, R. Flood, S. J. A. Gorne, R. D. Haas, G. Hacche, J. P. Horne, N. M. Kaibni, F. Larsen, M. Mecagni, I. Otani, S. Symansky, E. Y. P. Tung, M. A. Wattleworth. Secretary's Department: C. Brachet, Deputy Secretary; J. W. Lang, Jr., Deputy Secretary. Western Hemisphere Department: S. T. Beza, Director; Y. Horiguchi. Bureau of Statistics: A. K. M. Siddique. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: A. Bertuch-Samuels, M. B. Chatah, L. P. Ebrill, A. G. A. Faria, G. D. Hodgson, D. C. Templeman, A. Vasudevan. Assistants to Executive Directors: J. R. N. Almeida, O. S.-M. Bethel, E. C. Demaestri, F. Di Mauro, W. N. Engert, G. K. Hodges, L. Hubloue, S. King, M. A. Kyhlberg, V. K. Malhotra, C. Noriega, L. M. Piantini, S. Rebecchini, H. van der Burg.

1. WORLD ECONOMIC OUTLOOK - DEVELOPMENTS, PROSPECTS, AND POLICY ISSUES

The Executive Directors continued from the previous meeting (EBM/87/134, 9/11/87) their consideration of a staff paper on prospects and policy issues related to the world economic outlook (EBS/87/182, 8/21/87). They have before them as background material a statistical appendix (SM/87/222, 8/21/87) and a staff paper on medium-term scenarios (SM/87/221, 8/21/87; and Cor. 1, 9/3/87).

Mr. Dallara made the following statement:

The Board's recent discussions of the U.S. Article IV consultation and the debt strategy have already covered much ground with regard to the role and responsibilities of the United States and of the developing countries in the world economy. Therefore, I will not repeat the points that I made on those occasions, although I certainly will touch on the U.S. fiscal issue. Instead, I will concentrate mainly on other aspects of the world economic outlook. I hope that my developing country colleagues will understand my focus on other aspects and not on developing countries' prospects on this occasion.

Concerning the current situation and short-term prospects for the world economy, in general we concur with the staff's views. I am tempted to agree with Mr. Foot that the outlook could be viewed in a somewhat more favorable light than the staff does, but recent data are cause for concern, including data in some cases released since this paper was distributed. Second quarter data in Germany, for example, although understandably portrayed by the authorities in a positive light, as we all do, did not even carry GNP above the level reached in the first quarter of 1986. This is a rather worrisome development. Without trying to put too much emphasis on developments in any one particular quarter, I note that these data, combined with the building of protectionist pressures here, lead me to a position very close to that of the staff in assessing the short-term outlook.

One short-term, as well as medium-term issue--a methodological one--concerns the staff's treatment of U.S. fiscal adjustment in FY 1988 and beyond as incorporated in the reference, or baseline, scenario. This scenario incorporates the current services budget projections for the U.S. budgetary position in the years ahead under the "no policy change" guideline that the staff applies. The staff does have a difficult judgment to make, but I would ask the staff to review the way in which it treats the U.S. fiscal posture in these exercises relative to the fiscal postures of other countries. For example, the "no policy change" scenario does incorporate planned fiscal actions by Japan and Germany. One could, of course, say that there is some logic to that, and I would have some sympathy for that view. After all, the supplementary budget of Japan has already been passed by the Diet. Much, although not all, of the

German tax reform has already been approved throughout Germany's Government, but I do not believe that all of it has. And I believe that some of it is dependent on reaching agreement on subsidy reductions, which may not be very much easier politically than reaching agreement in my own country on budgetary reductions; this is asking the staff to make a judgment call that could also be the subject of our criticism. Nevertheless, I would ask the staff to see whether it could not come up with a more realistic indication of what it believes the evolution of the U.S. fiscal posture might be in the years ahead and incorporate that in a baseline scenario. This is because I do not believe that it is the staff's judgment that the most likely outcome would be the current services deficit, although I would certainly defer from the staff's judgment on this matter.

Turning to the short-term, as well as medium-term, outlook for developing countries, we would have welcomed more analysis of developments in and prospects for some of the larger developing economies. Perhaps developments and prospects in these developing countries could be incorporated in the indicators exercise, as Mr. Grosche and others suggested. In addition, we would look for more analysis of the role of the newly industrializing economies among the larger developing economies that merit our attention.

Let me also make one point with regard to the prospects over the medium term for developing economies. I am troubled somewhat by the repeated indications by the staff which tend to lend credibility to the view that even for middle-income debtors, and even with substantial policy adjustments, there will likely need to be a substantial reduction in the nominal levels of debt before creditworthiness can be restored. Perhaps through debt/equity swaps there is a viable course involving nominal debt reduction for those countries that is consistent with the preservation of creditworthiness and enhancement of growth prospects. But it is not clear to me that there is a persuasive case to be made at this stage that creditworthiness cannot be restored for these countries without nominal reductions in the level of debt. Here I have some difference of view with the implications, if not the words, of Mr. Ortiz at EBM/87/134.

As to the medium-term outlook for industrial countries, it is clear that the challenge now facing my authorities and those of other major industrial countries is how to bring about a reduction in the current account imbalances of the United States and the major surplus countries in an orderly way, while sustaining global growth and open markets and making further progress in dealing with the international debt problems. Here I noted the well-placed, although not extensive, comments of the staff on the potential under various scenarios for protectionist pressures to grow. I fear that there is in the current policy stance of many countries a sense of complacency concerning protectionist measures which may be misplaced.

The protectionist pressures in my own country are very real, very threatening, and potentially catastrophic for the world economy. To the extent that we can give even more weight to this potentially adverse development in the documents prepared for the Interim Committee and in our subsequent world economic outlook analyses, we should do so. Perhaps one or two scenarios could be prepared that assume different degrees of protectionism globally, so that we could see the potentially adverse consequences of this threat.

We very much welcome the presentation in this exercise of a number of medium-term scenarios both those in the main paper and in the separate documents. Care must be taken to ensure that subtle distinctions between scenarios presented in the main paper and in supplementary papers do not create some confusion. Perhaps one way of doing this would be to incorporate some references to all these scenarios in the main paper. But I am not sure that we have yet found the optimum method of presenting such a wide range of scenarios. Let me be clear that I am not criticizing having such a wide range of scenarios, because I did find them very welcome, indeed.

Scenario I presents a useful baseline case. Perhaps it is the most useful case for policymakers at this stage. It suggests to us that, even taking into account the fiscal adjustments under way in Germany and Japan, there is a real possibility, one might even say a likelihood, that without additional policy actions in the industrial countries and in some developing economies, the medium-term outlook could result in further downward pressure on the dollar and/or inadequate current account adjustment, a continued unsatisfactory employment situation in many European countries, possible recurrences of financial market instability, an upward movement in interest rates, insufficient success in resisting protectionism, and slow global growth. This is a sobering possibility. Of course, there will be accommodating finance, at least for a period of time, as discussed in Scenario I. This scenario, if it evolves, would tend to resemble the scenario, referred to in Mr. de Groote's statement, under which adjustment is postponed for some time and huge imbalances continue to grow. I do not think that this scenario is highly likely. There is indeed a risk that continued efforts at collaboration may be insufficient. Yet they may, in fact, lull the markets for a long enough period, until the imbalances grow to heroic proportions.

If that happens, we could find that Scenario I turns into Scenario II sometime in the early 1990s. I do not believe that it would occur because of some absolute constraint on the willingness of foreigners to supply funds to the United States, but rather out of a willingness to supply them only at a very high price. This could, without a doubt, produce a global recession as the answer to major imbalances.

Scenario III, involving additional fiscal adjustment by the United States and a boost to demand in Germany and Japan through macroeconomic and structural methods, is clearly the most desirable of the three scenarios presented in the main paper. It would go some way toward increasing adjustment of the external imbalances of these countries and mitigating any short-term adverse effect on growth.

But we do not believe that it is necessary to assume an additional $10 billion a year in financing for developing countries in order to achieve an acceptable external environment for those countries, although we certainly accept the fact that, in some cases, additional flows would be constructive and appropriate.

We note, in particular, that Chart 10 on page 46a of the staff paper does not suggest a very close association between the amount of real resources available to developing economies and the rates of investment and growth in those countries.

The current account outcome of Scenario III does result in a reduction in the current account imbalances of the United States, Germany, and Japan by 1991 to a deficit ratio of 1.5 percent of GNP for the United States, and surplus ratios of 1.7 percent for Japan, and 1.2 percent for Germany. Of course, the remaining imbalances in dollar terms would still be rather large--according to our rough calculations, perhaps on the order of a $80-100 billion deficit for the United States and surpluses of $50-80 billion for Japan and $18-25 billion for Germany.

There is, frankly, some question in our mind whether a deficit of this magnitude at that time would necessarily be small enough to elicit the necessary accommodating financing at low interest rates, and about the viability of the implied exchange rates. We noted with interest that, while this scenario assumes only a 5 percent real depreciation of the dollar, relative differences in inflation rates in the three major industrial countries suggest considerably larger movements in nominal rates. We have made a rough calculation--which may not be particularly accurate, but which I assume is indicative--suggesting that, even if one assumes only a 5 percent real depreciation of the dollar, there will be a rate of ¥ 120 to the dollar and a rate of DM 1.60 to the dollar. It is important to recognize, therefore, that Scenario III implies greater nominal exchange rate change than is readily apparent; in the future, this trend could usefully be brought out more clearly, since it may be more helpful for policy officials to focus on nominal, rather than real, exchange rates.

These factors suggest that for Scenario III to be consistent with the current account objectives of policymakers, additional efforts will be needed in all major countries, and particularly surplus countries, to foster higher levels of domestic demand. Of course, this conclusion is not, meant to minimize the important--indeed, essential--nature of further action on the fiscal front by the United States. If there is any sense of fatigue on my part in listening to a discussion of U.S. fiscal policy, it does not relate to hearing you call attention to the importance of action on that front, but rather to the implicit corollary of minimizing the importance of action on other fronts.

Indeed, it is rather clear that, regardless of how many doubts one has about the accuracy of various scenarios, if the Louvre Accord is to be a living, breathing, functioning accord for a period of time, then, to be very explicit, countries must make additional policy efforts. I hope that the phrase "persistence and patience" used earlier by Mr. Grosche includes the concept not just of persistence with current policies in place, but also persistence, if need be, with additional policy actions. This is because without additional policy actions by all major countries, it looks very unlikely that we will be able to sit here a year from now and still, as we do today, consider the Louvre Accord a success.

The section on indicators is innovative and constructive. As a number of Directors have said, it is also indicative of further work that can be done. I will not discuss this matter in detail, in light of the attention that I have given to the various scenarios. However, our next task relating to indicators will be to make an effort to integrate the indicator analysis with the various scenarios somewhat more explicitly than has been done here. We could analyze whether the various objectives--either stated or imputed--of our authorities are mutually consistent both internally, within each country, and among the major industrial countries.

For example, are the fiscal objectives of the various governments consistent with a realistic set of sustainable payments positions in the 1991 to 1992 time frame? I believe the staff gives us an answer, but perhaps with rather less attention by the staff than I would have thought appropriate. The staff suggests on page 26 that perhaps these objectives are only mutually consistent if major structural efforts are made in other industrial countries. I believe that this does hit home the point, which we have alluded to before, that, in addition to U.S. fiscal efforts in the years ahead, one of the keys to achieving the maintenance of a stable exchange rate system, adequate levels of global growth, and open markets, as well as reduced unemployment, will be a major attack on structural inhibitions in Europe. It is troublesome that the recognition of the pressing urgency of this problem does not seem to have spread throughout the major industrial countries of Europe.

I share some of the reservations expressed earlier by Mr. Yamazaki on the full publication of all these scenarios. On balance, I am inclined to think that full publication remains appropriate and, in the long run, if not necessarily in the short run, constructive. But I would be willing to suggest that we move somewhat in the direction of Mr. Yamazaki. If there is a clear willingness on the part of his authorities, and perhaps the other key authorities involved in the indicators' exercise, to see this exercise move ahead aggressively in the Board, there is a relationship between the degree to which we are specific, aggressive, and comprehensive in our indicator efforts, and our willingness to publish. Indeed, if the price of moving ahead in a comprehensive and aggressive fashion is a willingness not to publish everything we write, I might be willing to pay some of that price.

Mrs. Ploix made the following statement:

I wish to make three main points. We must recognize two key achievements: there is a consensus on the analysis of the economic situation, and there is a consensus on the courses of action to take. Unfortunately, however, the outlook remains mediocre and is not in line with our desires for the world economy. Therefore, we must remain steadfast in our strategy of correcting imbalances and strengthening international cooperation.

I wish to stress that the commonly accepted diagnosis shows some positive achievements in industrial as well as in developing countries with respect to inflation and structural policies as well as the correction of internal and external imbalances in certain countries. The basic conditions for continued moderate growth will remain in place, at least in the short run. Furthermore, some of the policy commitments made by the industrial countries are being translated into action. These achievements are well described on page 2 of Mr. de Groote's statement; I endorse particularly the third and fourth paragraph of the section on a positive balance in 1987.

I regret that the outlook remains mediocre and is not in line with our desires for the world economy. As the staff has stated, the outlook is very uncertain, particularly because of the persistence of considerable external imbalances in the major industrial countries. These deficits jeopardize the attainment of exchange market stability, the containment of inflation and, in general, undermine the confidence of investors.

In addition, certain features of the world economy appear worrying: world economic growth remains too low to provide lasting reductions in unemployment in industrial countries; growth rates for countries experiencing large external surpluses are still too low; the increase in real interest rates could have a negative impact on growth, and particularly on the investments and debt service of developing countries; debt ratios in developing countries are at very high levels and banks are withdrawing their support; and the projected growth for some of these developing countries remains inadequate, especially in relation to the demographic growth rate. In this respect, I agree with the staff and with Mr. Foot that appropriate policies in the developing countries will need to be supported by adequate financing.

The first two scenarios presented by the staff clearly show the dangers of not adhering to the strategy of correcting imbalances in the framework of international cooperation. Although the first scenario seems more optimistic, it also seems less realistic in that it hypothesizes no reaction by markets to persistent external imbalances. In any event, the first scenario merely delays the resolution of difficulties. Scenario B would lead to results that would be even less satisfying, since it involves a negative impact on growth, inflation, and the U.S. budget deficit.

My authorities are convinced that a new and sharp depreciation of the dollar would be very dangerous for the world economy, and they agree with much of the staff's analysis in this regard, although my authorities draw more pessimistic conclusions. It is not obvious to them that a deterioration in the dollar's value would help reduce the U.S. commercial deficit. Eliminating the U.S. external deficit depends heavily on controlling domestic demand. Such a scenario is the opposite of the strategy agreed upon by the industrial countries in the Louvre Accord and later at the Venice Summit.

The third scenario, the "policy adjustment scenario," which appears to be the most desirable of the three, clearly illustrates that this strategy is the most suitable instrument for eliminating external imbalances; it demonstrates that acting on domestic demand makes sense only within the context of enhanced international cooperation. The staff's work on indicators clearly highlights this point. Like Mr. Kafka and Mr. Ortiz, I noted that even under this scenario, medium-term current account imbalances would remain fairly large. However, presumably the imbalances would be easier to finance if effective and coordinated fiscal policies are in place.

In this connection, this chair recently reiterated the need for further fiscal action in the United States and encouraged Germany and Japan to implement the policies to which they are committed and even to re-examine them if some additional efforts seemed warranted. Recent results in Germany with respect to the trade balance seem somewhat disappointing.

In sum, I recognize that adjustment takes time. It requires persistence and patience. However, as Mr. Massé said, there is still a clear need for further timely action.

Mr. Feldman made the following statement:

The declining growth performance in the industrial countries during 1986 and the first half of 1987, the considerable uncertainty about the prospects for the world economy, and the persistence of a very difficult economic situation in the developing world are the starting points for this world economic outlook exercise. From this rather gloomy reality we move to alternative scenarios that are clearly developed by the staff but which are in general biased toward the optimistic side.

I broadly agree with the staff's assessment of the current world economic situation and the short-term prospects. I share the staff's concern about the dangers of an increasing rate of inflation, lack of growth, and the uncertainties regarding the debt problem and financing for developing countries. However, I have a more pessimistic view about the prospects for 1988 and beyond. I am particularly concerned because the staff projections are based on the overoptimistic assessment of several key variables.

The methodology used by the staff in its short-term projections contributes to that tendency toward optimism. The projections for 1988 are optimistic, as they are based on unrealistic estimates for the period 1987-88 taken as an average. The staff projections seem too optimistic because the estimates for 1989-91 are calculated from an optimistic starting point, namely, the estimates for 1988.

The medium-term prospects for industrial countries are presented by the staff in the form of three scenarios. The first one, the so-called accommodating finance scenario, assumes that mainly "quantities" will be adjusted while key prices will remain unaltered. The second one, the finance-constrained scenario, assumes that price adjustments will occur and the third scenario will, the policy adjustment scenario, implies that policies are adjusted to reach a reasonable mix of quantity and price adjustments.

The staff is inclined to believe that something close to the third scenario will happen. I consider that view to be too optimistic, because the positive response to the differentiated fiscal policy adjustments that will eventually be implemented to reach quantity objectives might have been overestimated. The authorities in industrial countries may not apply, at least fully, the proposed policies, and price adjustments in addition to those considered in Scenario III will then be necessary.

Therefore, the outcome will probably be somewhere between the second and third scenarios. Such an outcome would be characterized by a further depreciation of the dollar, higher inflation rates, higher interest rates, and less growth than are estimated in Scenario III. The viability of Scenario III is limited, because current account imbalances under that scenario remain large in the medium term, and there is a possibility of an intensification of exchange market pressures. That scenario therefore implies that additional policy adaptations would be necessary to strengthen the process of external adjustment. The additional adaptations can be on either the positive or negative side. Let me clarify that point. As the staff has noted, "two developments that appear unambiguously desirable are the relaxation of import restrictions in industrial countries and the provision of additional finance in support of growth-oriented adjustment in the developing world." Among the possible negative policies are a further depreciation of the dollar and the use of monetary policy to sustain exchange rate stability. Both types of measures would worsen the economic situation in industrial and developing countries, implying less growth, more inflation, and/or higher interest rates.

Unfortunately, the present situation and past experience suggest that negative policies are being implemented and are likely to be applied in the future. Less protectionism and more financing are desirable in theory, but they are absent in fact.

The staff's medium-term scenario for developing countries contains, as the staff paper points out, a number of encouraging elements. "Output growth in the capital importing countries is projected at 4 1/2-5 percent annually, and current account deficits are seen as stabilizing at levels that permit a decline in the ratio of debt to exports. The average debt ratio, which reached 184 percent in 1986, is projected to come down to 164 percent by the end of 1988, and to fall further to 140 percent by 1991." That outcome is unlikely in the current world economic context.

Consequently, I am among the "others" mentioned by the staff who take a less sanguine view about the debt strategy and do not feel that the strategy is beginning to bear fruit, and have a pessimistic view of the current implementation of the present debt strategy. Debt ratios are increasing and have reached record highs, voluntary new financing is at a record low, commercial banks are trying to reduce their exposure in developing countries, growth prospects of industrial countries are weak, protectionism has intensified, a favorable evolution of the terms of trade for developing countries is unlikely, and some debtor countries seem to be unable to continue their adjustment efforts.

I agree that the debt strategy has been aimed at a gradual solution of debt difficulties in the context of growth. Moreover, the three premises on which the strategy is based--growth-oriented adjustment in the developing countries, sustained noninflationary expansion and liberal trading policies in the industrial world, and continued flows of financing from creditors--are essential to reaching a successful outcome. However, the debt strategy has not been successful, because while adjustment in developing countries has effectively taken place, the other two conditions--a favorable external environment, and a continuous flow of financing, have not been present.

I cannot present a new scenario based on the effects of a more realistic assessment of the situation in developing and industrial countries and the interrelations among them. I will try to sketch, however, certain qualitative effects of a more realistic scenario, which are in line with the ones presented by Mr. Ortiz. Such a scenario for industrial countries would be characterized by a larger depreciation of the dollar, higher inflation rates, higher interest rates, and a lower rate of growth than are estimated in Scenario III. This situation would certainly not favor the dismantling of the protectionism in the industrial world that undermines developing countries' export prospects. Moreover, eventual tightening of monetary policy in the United States would increase interest rates, affect export volumes, and worsen the terms of trade for developing countries. Moreover, developing countries would face a worse economic situation, and the debt strategy would be seriously threatened. These developments would in turn have a negative feedback effect on industrial countries that would reinforce the chain of negative events.

I did not find in the paper an explicit analysis of the relationship between the scenarios for industrial countries and the scenario for developing countries. Which one industrial country scenario, if any, is related to the staff's scenario of medium-term prospects for the developing countries? I encourage the staff to develop a full scenario that carefully analyzes the interrelationship between industrial and developing countries. I strongly support Mr. Dallara's suggestion to incorporate explicitly the impact of different degrees of protectionism in alternative scenarios.

Certain asymmetries are evident when the analysis of the three scenarios for industrial countries is compared with the scenario for developing countries. In this connection, there are two major questions raised in the staff paper. The first one refers to the analysis of the short-run economic prospects for the three largest countries. In this respect, the paper states that "on the basis of current policies and exchange rates the imbalances are expected to remain above sustainable levels after 1988." I wonder why this has to be so; in other words, the staff should comment on why such an "unavoidable situation" will need to hold, or why such huge and undesirable disequilibria will be allowed to persist. If these imbalances were present in developing countries, the staff would certainly expect market forces to eliminate the imbalances. Moreover, the staff paper points out that the failure to remove these imbalances could ultimately lead to a marked slowdown in growth triggered by instability in foreign exchange markets, an increase in inflationary pressures, tighter monetary conditions, and the intensification of protectionist pressures.

The second question concerns the economic indicators and the speed of internal and external adjustment in industrial countries. In this respect, the paper states that the present pace of shifts in output and demand prescribed for the three largest countries appears to be close to the maximum that can be achieved in the short run without significant transitional costs. I wonder whether the staff would have been so sensitive to the question of transitional costs if the adjustment involved developing countries. In a sense, both categories of countries face several macroeconomic imbalances that are similar in nature. One would have expected that the countries that are strong enough to afford transitional costs are the industrial economies, not the highly indebted countries. This conclusion raises the question of the speed of adjustment for developing countries--a question that we will surely tackle when analyzing the G-24 proposals on the role of the Fund.

The staff paper contains several warnings about possible risks involved in the alternative scenarios developed for the industrial countries, and it is recognized that the consequences of those risks would be very disruptive--even more disruptive than those embodied in the finance-constrained scenario. For the sake of realism, an attempt should be made to quantify these risks and to embody them in an alternative scenario. Simultaneously, a set of contingency policy measures to face these eventual risks should be designed. A set of contingency measures is, after all, what the Fund has systematically been suggesting that countries should introduce when embarking upon an adjustment program to offset possible slippages in their programs; let us be symmetric and think of a set of contingency measures to face the risks that might have been underestimated in the global scenarios presented in the paper. This could be a constructive exercise, which may contribute to avoiding or, at least, to offsetting the effects of persistent and strong macroeconomic imbalances.

Mr. Zecchini made the following statement:

As in the past, the staff has prepared a comprehensive set of papers that invite an articulate debate. These papers comprise a commendable experiment in the use of indicators in the framework of alternative scenarios. Despite some approximations in the quantification of some policy variables and in capturing the underlying reality of current trends with an econometric model, this experiment with indicators is successful, since it arrives at quantitative conclusions that are well focused, plausible, and consistent with the broad rationale of economic policymakers in the major countries under scrutiny. Therefore, I encourage the staff to deepen in the future its indicator exercise in the framework of the estimation of alternative scenarios aimed at projecting the consequences of present policies and of sensible options for corrective actions.

Nevertheless, even after such a commendable innovation, the staff outlook cannot escape the criticism that this is the fourth optimistic world economic outlook in a row. The staff's view that the momentum of output growth can easily be maintained in the near term seems to be biased on the side of optimism. In fact, the world eocnomy is still experiencing asymmetries in the impact on spending and growth of the sizable changes that occurred in exchange rates and the terms of trade in 1985-87; and over the previous two years these asymmetries have appeared to be more systemic than transitory in nature. Furthermore, the economic development of many low-income countries seems tightly constrained by the severe rationing of markets' financial resources over the previous year. Therefore, there is still a significant risk that the deflationary impulses deriving from the correction of external and fiscal deficits in the major economies will exert a predominant influence on the evolution of the entire world economy.

Optimism about the existence in the world economy of inner forces that can automatically generate adequate growth can also explain the staff's view that the three largest economies are close to the maximum that can be achieved in shifting demand and output over the short term. This absence of a call for action is regrettable, and I hope that this refers only to the current year and not to 1988.

The same optimism may also be the main reason why an analysis of the unemployment situation is missing in the main paper and why there is not even a table on the evolution of this economic condition. I hope that this deficiency can be easily overcome before the publication of the world economic outlook. In contrast, having stressed the link between a more favorable economic condition in the industrial countries and the solution of the debt problem seems fully appropriate.

After these general, inescapable impressions, I will address the short- and medium-term economic prospects and the policy requirements for the industrial and developing countries.

Despite the marginal improvements in the current outlook compared with the April world economic outlook paper, the short- and medium-term prospects remain unsatisfactory in terms of both the output expansion and the correction of external imbalances.

Output growth in the industrial countries in 1987 will be the lowest since the 1982 recession, well below the average of the 1970s, and insufficient to ease adjustment in the developing countries. Moreover, this situation is not bound to improve significantly in 1988. In the medium term, according to the staff, only under the most favorable scenario--based on current interest and exchange rates--will output expansion stabilize at a higher rate, which is around the rate of growth of productive potential.

External imbalances will remain large in spite of some correction, and the risks they pose to the international monetary system and to economic growth will not abate. As indicated in the medium-term accommodating finance scenario, the persistent U.S. current account deficit will bring the ratio of external debt to GDP to about 20 percent in 1991. Although the current ratio is half that level (about 10 percent), the fears about "sustainability" of the U.S. external imbalance are already affecting market behavior. A first symptom is the significant pressure on the dollar exchange rate that has occurred in recent months. It should be recalled that this pressure was resisted through unprecedented exchange market intervention that helped reduce the scope of interest rate changes that would otherwise have been necessary to stabilize exchange rates. A second symptom is the behavior of capital flows. According to OECD estimates, in the first four months of 1987 private capital flows to the United States have been reduced significantly and a net capital outflow might have occurred in April. Moreover, it seems that long-term outflows from Japan have been redirected from investments in the United States to investments in Canada, Australia, and the United Kingdom.

The concern over this scenario is compounded by the uncertainties that accompany the staff projections. The main factor of uncertainty pertains to the stability of real exchange rates and interest rates. In view of the persistent large imbalances in the current account of industrial countries, it is not unlikely that exchange rates--and interest rates as well--will undergo a period of renewed instability.

Turning to policy requirements for the industrial countries, a clarification on Scenario II, the so-called finance-constrained scenario, is needed regarding the role of interest rates in this adjustment model. According to the analysis on page 24 of the main paper, a shift in portfolio preferences causes a depreciation of the dollar by some 20 percent and, at the same time, a rise in U.S. interest rates. An additional increase in nominal interest rates occurs later as a result of the exchange depreciation and the inflation premium requested by holders of dollar-denominated assets. What is the mechanism that distributes the impact of the portfolio shift among major currencies partly on the exchange rate and partly on the U.S. interest rates? Is the staff implying that the interest rate on non-dollar assets will increase and, hence, that U.S. rates will also have to increase? What is the sensitivity of the exchange depreciation to a change in the U.S. interest rate differential with respect to other major currencies, so that a sizable dollar depreciation and a strong rise in U.S. interest rates can occur at the same time, as the staff implies? Since the effect on U.S. domestic demand of a fall of the dollar and a rise in interest rates go in opposite directions, the distribution of the effects of the portfolio shift between exchange rates and interest rates will significantly affect the results in terms of investment and output.

Several useful policy prescriptions can be derived from the results of the alternative policy adjustment scenarios. First, as to demand-management policies, it is clear that fiscal policy is the most effective instrument in setting an appropriate pattern of demand across industrial countries. Monetary policy should be aimed mainly at stabilizing domestic prices. Over the long run, monetary policy does appear to be neutral with respect to changes in real exchange rates, i.e., it does not seem to be able to affect the real level.

Second, the fiscal adjustment by the United States along the lines proposed by the Administration, without offsetting measures on the part of major surplus countries, would still be less than satisfactory in terms of the correction of external imbalances. In such a case, according to Scenario C1 presented in SM/87/221, the United States would continue to run a large current account deficit that would lead to a significant increase of the ratio of external debt to GDP.

Third, additional fiscal stimulus by Germany and Japan in 1988-89 could provide a significant contribution to growth. Although the effect on the U.S. current account might be modest, but still positive, the additional stimulus would contribute to mitigating the global external imbalances and market instability.

Fourth, the fiscal policy measures considered by the staff for the three major industrial countries do not exclude the need of a further dollar adjustment. As indicated in Scenarios C1 and C2, the implementation of the proposed measures is accompanied by a depreciation of the dollar by 3-5 percent. The staff seems to imply that, for a given monetary policy, the contraction of the fiscal imbalance in the United States and a more expansionary stance in Germany and Japan have to be complemented by a depreciation of the dollar. The question then arises whether an appropriate mix of fiscal and monetary policies can be devised to avoid unwarranted effects on exchange rates.

In light of the previous considerations, the set of policy adjustments envisaged in Scenario III represents an appropriate approach in order to avoid sharp exchange rate movements and output costs and, at the same time, improve the "sustainability" of external positions. In particular, differentiated fiscal policy political grounds. In this regard, I wish to recall Mr. Massé's remarks this morning on the importance of the confidence factor. Increased growth in other countries is a vital part of a credible overall adjustment picture.

If no additional economic measures are taken, in all likelihood there will be no clear reduction of current account imbalances among, in particular, the three largest countries. Even though at present inflation rates of industrial countries seem to have stabilized at a low level, there is an evident risk of a rekindling of inflation in some countries; it is most pronounced in the United States, reflecting the impact of increasing import prices. Furthermore, unemployment, especially in Europe, continues to be high, and there are no improvements in sight. The increasing protectionist trend should be viewed primarily as a symptom of these imbalances and the serious unemployment problems. Despite some bright spots, the debt problems remain very serious, and, if anything, the living standards of the population of the poorest countries seem to be deteriorating even further.

The sharp fall this year in the U.S. federal budget deficit is very welcome. However, the prospects for the coming years are worrisome. A continued substantial reduction of the U.S. budget deficit is the crucial factor for the credibility of the present strategy to correct global imbalances without inflation in the long run.

At the same time, international considerations, as well as the domestic employment situation, continue to point to the need for Germany and a number of other countries with current account surpluses and low inflation rates to complement U.S. demand restraining measures. In Japan, the introduction of the fiscal policy package, which in itself is greatly welcome, makes the assessment of the present economic situation rather difficult. The effect on imports--particularly manufactured goods--might be fairly small. Therefore, the prospective large surplus on the current account does seem to call for further demand-stimulating policies as well as measures aimed at increasing the propensity to import. Similar considerations apply to a number of newly industrialized countries.

I agree with the staff that monetary policy can only be a temporary substitute for changes in the underlying fiscal situation. Already there are signs that monetary policy has been asked to do too much in the effort to maintain exchange rate stability.

On the other hand, the staff's view on the possibilities of increasing economic growth through fiscal measures is characterized by too much complacency, given the present circumstances. Especially given the high unemployment rates in most industrial countries, not too much emphasis should be placed on estimates of potential output in considering the scope for a more expansive policy without rekindling inflation.

A turnaround in the present trend of increasing protectionism is of the utmost importance. To this end, the recommendations to supplement U.S. budget deficit cuts by demand-stimulating policies in the largest surplus countries will be very important.

If economic policy measures along these lines are not undertaken, no substantial reduction in the current account imbalances among the largest industrial economies can be expected. For a long time, there has been a virtual international consensus on the necessary ingredients of a coordinated economic policy. It is, indeed, a positive sign that economic policy cooperation has been given increasing priority internationally. So far, the actual effects flowing from this have been rather modest. At this point, however, I see no alternative but to continue to argue in favor of such a strategy. Indeed, developments call for stronger and more binding cooperation efforts.

The staff's helpful medium-term scenarios illuminate the significant risks inherent in the present situation. Of the three scenarios, the "policy adjustment scenario" clearly gives the most desirable outcome, although it requires considerable policy actions by the largest countries. But even this scenario is not fully satisfactory. On the other hand, if current policies followed by the largest countries are not changed, we will be faced only with undesirable alternatives. Even though there are analytical limitations, the staff should be encouraged to continue its work on such alternative scenarios, thereby increasing the scope for choosing among alternative economic policy strategies. The intention to disaggregate the model, with regard to the group presently representing all countries but the three largest, seems valuable.

The ongoing extension of the indicator exercise is an important step toward a more systematic and normative analysis of economic developments. However, individual indicators should, to a large extent, be viewed against broader objectives. For instance, fiscal indicators should be seen not only in the light of overall economic developments, but also, and more particularly, in the light of developments in private savings. Experience thus far shows that surveillance and coordination need to be strengthened and made more binding. The actual outcome will, of course, depend crucially on political will, but the surveillance procedures should be conducive to supporting such an outcome. One option might be that, if there is considerable deviation between the actual and desired economic developments in an individual country, special consultations and, possibly, separate Board discussions, on this matter could be considered.

Finally, I will address the special problems of the very disparate developments in developing countries. The very high growth rates in the newly industrialized countries, and in the Asian countries as a group, is a positive development. The most negative aspect is the stagnation in GNP growth per capita in the poorest, mainly African, countries. The situation of the large debtor countries seems rather difficult to assess. In general, the debt situation has not improved to the extent that was hoped for some years ago; in this connection, the negative developments of the terms of trade, particularly international commodity prices, have played an important role. This development illustrates the various downside risks shown by the present projections.

The staff study clearly demonstrates how the full implementation of the existing debt strategy might alleviate the debt situation. The analysis also shows the importance of following an adjustment policy favoring investments and exports and of undertaking the necessary adjustment at an early stage.

To strengthen the incentives for debtor countries to pursue an outward-oriented strategy, protectionist tendencies should be reversed. To maintain the commitment to continued adjustment it is in the long-term interest of creditors to increase net lending. For the poorest countries, some form of debt service alleviation might have to be considered.

Last week, this chair presented its views on the current debt strategy. In its paper on the world economic outlook the staff emphasizes that removal of import restrictions in industrial countries and a substantial increase in financial flows to developing countries would not only contribute to solving the debt problem, but also help to stimulate economic growth in industrial countries. This latter finding should not be forgotten.

Among the poorest countries, particularly in Africa, GDP per capita has dropped by about 5 percent since the beginning of the 1980s from an already low level. No significant improvement is in sight; nor has protracted stagnation been accompanied by improvement in current account developments.

Adjustment policies in the poorest countries must emphasize the dismantling of price rigidities as well as the introduction of more market-oriented exchange rates and interest rates. In order for most of these countries to be able to embark upon a path of economic growth, however, such adjustment measures must be supported by a significant increase of concessional flows.

Mr. Rye made the following statement:

I found the approach in the staff papers very interesting and the conclusions, by and large, quite convincing. I wish to make a few general comments. First, the overall picture of where we are going and what the risks are is broadly the same as in the April world economic documents; and so also, as we should expect, is the assessment of policies needed to reduce those risks and uncertainties. There is some comfort in this.

My second comment relates to the use of alternative medium-term scenarios and the quantitative indicator analysis. While the scenarios do not change the basic thrust of earlier qualitative analysis, they do lend weight to earlier conclusions as to the most desirable, or least costly, course of adjustment. But I have mixed feelings about the use of quantitative targets for indicators. The setting of quantitative ranges for variables seems to be the necessary minimum if the indicator approach to policy coordination is to have real content. Such ranges can help, no doubt, to focus views on the desired rate of adjustment and what needs to be done to achieve it. But any rigid use of indicators as targets would be dangerous; we must beware of trying to shape the world economy to some preconceived procrustean bed. I suspect that there is more flexibility out there than we sometimes allow, and too much intervention is at least as harmful as too little.

Incidentally, I note that the "policy adjustment scenario" is based on fiscal restraint in the United States applied wholly on the expenditure side. I would be interested if the staff could tell us whether restraint implemented in significant part through higher taxation would make a material difference to the outcome under this scenario.

Third, the greater emphasis on developing countries in this world economic outlook exercise is welcome. The points made on pages 42 and 43 about the different approaches taken by nonfuel exporters that have avoided debt-servicing problems and those that have not are particularly well taken.

Turning to the issues identified by the staff for discussion, I have little problem with the short-term outlook presented in the paper. Given the current stage of the economic cycle and the sharp adjustments to exchange rates, oil prices, and so on in the last year or so, the short-term prospects for output, growth, and inflation are about as satisfactory as we could expect. Although external imbalances are still large, there are signs that relative price changes over the past two years are beginning to take effect. Apart from the significant changes already evident in U.S. trade volumes, the staff is projecting considerable movement in the geographical composition of demand, which will work toward reducing external imbalances.

For the medium term, it is somewhat disconcerting that the three basic scenarios might be characterized as follows: Scenario I as highly risky; Scenario II as highly costly; and Scenario III as highly unlikely, although of course highly desirable. So any optimism must be tinged with a strong element of caution. Certainly, medium-term prospects will depend heavily on current and prospective policy decisions. We can take some comfort in the fact that policies and indicators seem to be moving slowly in the right direction. The recent fiscal measures in Japan, and to a lesser extent Germany, the large (although perhaps temporary) reduction in the U.S. fiscal deficit in FY 1987, and the signs of improvement, such as they are, in the external imbalances are all positive developments.

It is more difficult to generalize about the outlook for developing countries. Prospects remain mixed, varying region by region, and depending heavily on the composition of exports. The outlook for world trade and for commodity prices has improved since the April assessment, but the medium-term prospects for developing countries will remain heavily dependent on industrial country performance, the level of available financing, and the developing countries' own policy responses.

As regards policy requirements of industrial countries, I largely agree with the staff's comments on pages 35-38 of the policy paper. The main focus of monetary policy must be on the control of inflation. Limited and short-term use of monetary policy to help smooth exchange rate adjustments can doubtless also help. The key policy areas, however, 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 reduced output, such costs have to be measured against the costs of not pursuing fiscal reform in the United States and the fact, as Mr. de Groote has pointed out, that the longer the delay, the greater the costs. I agree with the staff that it would not necessarily be desirable for fiscal restraint in the United States and other countries where it is urgently needed to be balanced by equivalent expansionary policies where it is not. Indeed, some reduction in aggregate fiscal deficits remains necessary. I agree with Mr. Posthumus on this point.

As others have observed, there is still scope for further enhancing productive potential over the medium term through structural measures--in which regard I endorse the staff's list of areas requiring attention on pages 37 and 38 of the main paper, including labor and financial markets and, most important, reduced protection. On this general matter, I share Mr. Foot's doubts whether we have yet seen the full effects of past structural improvements in the major economies upon their productive potential.

In this connection, it is worth emphasizing the substantial costs likely to be associated with a further significant adjustment in exchange rates--costs in terms of higher inflation and interest rates and slower growth in the United States, reflective of business confidence effects and reduced investments, slower growth also in countries experiencing significant appreciation of their currency, and substantial costs to developing countries by way of reduced trading opportunities and higher debt servicing costs. As Samuel Brittain put it in yesterday's Financial Times, "most purported remedies (for the U.S. payments gap)--whether protection or further dollar devaluation--are worse than the disease!"

The staff papers seem to suggest that the reduction in the U.S. budget deficit would have a more substantial role in reducing the U.S. current account deficit than some were prepared to acknowledge during the latest Article IV consultation with the United States. I agree with this; the argument set out in the first full paragraph on page 26 seems to be particularly cogent.

Finally, there is the question of the debt strategy. I welcome Mr. de Groote's invitation to reconfirm the principles of the Baker strategy, and I endorse his emphasis on the necessity for structural adjustment in debtor countries in accordance with outward-looking principles--which, of course, requires that the industrial countries must play their part in creating and sustaining the appropriate environment for trade and output to flourish.

I like the clear elaboration on pages 49 and 50 of the main staff paper of the policy requirements for overcoming the debt problem. However, I share the doubts raised by Mr. Posthumus on the first complete paragraph of page 51. Of course, it is a basic issue "whether countries can afford additional external saving." But the case-by-case approach must be maintained and developed on an eclectic basis. There are elements in this paragraph which seem to me to be too generalized. Beyond the very short term, new lending is not the same, for most countries, as reductions in payments--just as expanding exports is not the same as constraining imports. The effects on business activity and the long-run health of the economy are likely to be quite different.

I also feel a little uneasy about the various speculations further down page 51 about attitudes or actions of commercial creditors. I am not sure how helpful all this is. Perhaps we should be concentrating more on the relationships between the Fund and its members, and on trying to disengage our own decision-making processes more from those of the commercial banks. But that is a topic for another day.

Mr. Sengupta made the following statement:

I will first deal with the three issues raised by the staff for discussion in the order in which they were presented, and then make some observations that are relevant to our examination.

On the realism of the projections, the staff does not interpret recent developments as signaling a downturn in the world economy in the short term. In fact, output growth in industrial countries in 1987-88 is projected to be close to the estimated rate of growth of potential output. The downside risks in these projections are well known--the persistence of large current account imbalances, weakness in consumer spending in the United States, and a pickup in inflation in the United States--but the staff believes that its projections for the forecast period will stand. However, given the weight of the United States in these projections and the likely evolution of variables in the United States, I tend to feel that even this guarded optimism about the United States could turn out to be somewhat misplaced. In this context, the staff notes that the U.S. fiscal deficit is "expected to decline significantly in the fiscal year 1987" but does not comment on likely developments in the subsequent year. During the latest Board discussions on the United States, many observed that the factors that contributed to a sharp decline in the U.S. fiscal deficit in FY 1987 would not be present in subsequent years. Besides, investment in fixed assets seems to be sluggish during the forecast period; in fact, a decline is projected for 1987. Growth in consumer expenditure is expected to decelerate sharply, in contrast to its robustness in 1983-86. This raises doubts whether domestic demand will grow at even the modest rates projected.

One of the reasons for the staff's revised projection is the growth expected in the United States on the basis of a stimulus from the improvement in external competitiveness. The staff expects a sizable increase in U.S. real net exports. Competitiveness has not so far been reflected in the actual trade or current account figures in 1985 and 1986, despite the sharp depreciation of the U.S. dollar. However, given the sluggishness in investment and the deceleration in private consumption, it is possible that real imports would decelerate sharply, while real exports rise; but the increase in net terms may not be as high as the data show. Such large increases in real exports could well imply a further large depreciation of the U.S. dollar, which in turn could trigger inflationary pressures, increased trade frictions, and a lowering of investor confidence.

I welcome the introduction of alternative scenarios for the first time in the world economic outlook paper and of the economic indicators in the context of the world economic outlook. Growth in the scenarios is to settle down at around the rate of growth of productive potential, which is measured by a production function approach, resembling the methodology used by the OECD. However, one could envisage a higher annual growth rate of, say, 4.3 percent, as the World Bank had assumed for 1986-95 in its World Development Report, on the assumption that a variety of medium and long-term adjustment policies would be undertaken. It would be interesting to know from the staff the differences between their third, "policy adjustment scenario" and the World Development Report's high growth scenario, especially since the scenarios can be used to affect policies of different countries.

Output growth in developing countries is linked to their export growth, which in turn is related to the output growth in industrial countries. These links show that the critical issue in world adjustment is the growth rate of industrial countries; the higher their growth rate, the higher the rate of world output expansion and the higher the growth rate of developing countries. It is interesting to note that the staff has done the minimum consistency exercises necessary to instill confidence in these figures. I am not talking about the assumptions regarding unchanged interest rates, real exchange rates or even the terms of trade. The realism of the assumptions may be questionable, but a model builder has to make such assumptions, and the quality of his model depends on the realism of these assumptions.

The point I am making here is different. According to the staff's model, 3 percent medium-term growth in industrial countries would increase exports of developing countries by 5 1/2 percent, given the elasticities estimated from the past; and that export growth would suggest annual growth of 4 1/2-5 percent of real output, presumably through a relationship between GDP and import capacity. But what about the relationship between output growth and required investment? The growth of external credit in the baseline scenario is presumably derived from the current account estimates, but are these estimates consistent with the ex ante investment-saving gap based on estimates of required investment through capital/output ratios and projections of saving rate? It is important to have these estimates, so that they can be related to saving-investment differences in the industrial countries and assure us of the global consistency of these exercises. We would then be able to judge if output growth of developing countries could be higher, as the World Development Report projection or of 5.9 percent, if their foreign capital requirements could be met by the current pattern of capital flows, and what international policies should be adjusted to make such international capital available to the developing countries.

This leads me to the main weakness of the staff model, although I hasten to add that the staff's present exercise is a remarkable improvement over the past: the model does not seem to capture the alternative possibilities of recycling the surpluses to reduce global imbalances and having overall higher growth. The staff seems to be overly preoccupied with the imbalances between only the three major countries, and with having a reduction of the U.S. deficit matched by a reduction of the surpluses of Japan and Germany. Mr. Grosche has underlined today a point that we in the developing countries have consistently maintained: the objective of international policy coordination should be to maintain a sustained growth of output and employment that permits a net current account surplus for the industrial countries as a whole, corresponding to a real transfer of capital from these countries to the developing countries. This would allow some deficits and surpluses within the industrial countries, and Mr. Grosche is right that it would require the U.S. deficit to fall more than the reduction in the surpluses of Japan and Germany. The goal is to achieve this outcome without a fall in growth. It was seen during the latest discussion on the United States that the country can reduce its deficit by reducing its output growth; but that should be avoided, and doing so may require expansion and reduction of the surpluses of Japan and Germany and other industrial countries. Mr. Grosche also agrees with this. The question is by how much, and I submit that if the global interactions were brought out in full, with feedback throughout developing countries, the extent of adjustment of Japan and Germany would have been much smaller.

Consider a global model of interaction: the U.S. budget deficit is reduced, with a corresponding reduction of the current account deficit, but while maintaining a growth of exports that provides the stimulus to its output growth; Japan and Germany reduce their surpluses only partly, to allow for a part of increased net exports of the United States, but they transfer most or a large part of their surplus to the developing countries, which absorb that surplus as capital by increasing their deficit; these developments would allow the developing countries to increase their imports, which would correspondingly increase their output, and to the extent that these imports are from the United States, they would provide a growth stimulus to the United States. In this model, Japan and Germany can maintain their surpluses but the United States would be allowed an increase in net exports to be sustained by recycling this surplus to the developing countries which would increase their imports from the United States. If Japanese and German growth is determined largely by foreign demand--and this is clearly true in the case of Japan--this model would allow them to maintain a high growth rate while allowing the developing countries and the United States to grow at a reasonable rate. The actual numbers in the model would of course depend upon the different parameters and elasticities, and given the existing policies and historical relationships--particularly the elasticity of developing country imports from the United States to developing country output growth, as well as the capital/output ratios of the developing countries--the extent of the reduction of the surpluses of Japan and Germany may turn out to be large. But there is no a priori reason for that outcome, and the numbers may give a different result and substantiate Mr. Grosche's view that a large reduction of U.S. deficit may be consistent with a small reduction of the Japanese and German surpluses and with the maintenance of reasonable overall growth of the world economy. The likelihood of this possibility improves if we bring in other blocks of countries in addition to the developing countries, such as the rest of OECD.

If the staff built up this model of interaction, it could be used to guide international policies; instead of using it as a model of projection, it could be used as a model of planning. If the foreign capital requirement for maintaining a 5 percent growth rate of developing countries could be estimated, one could derive the policy interaction in a model that incorporated that figure as a parameter for the overall net current account surplus of the industrial countries taken together. In other words, the relevant question should be how would the policies of the industrial countries adjust to alter the existing imbalances among themselves, satisfy the industrial countries' objectives of growth, employment, and inflation, and ensure that there is a net current account surplus for all of them together that is greater than or equal to the required foreign capital inflows to the developing countries. This is the task that the Research Department should undertake to make the world economic outlook exercise truly international.

I agree with Mr. Grosche that the developing countries should also adopt the right policies to attract foreign capital--private and official. An estimation of foreign capital requirements would not produce that capital for the developing countries. But at present the problem is that, to use an analogy, while the developing countries, at least a large number of them that have adopted strong adjustment policies, are willing to tango, the German and Japanese seem to be overly fascinated by the Americans, despite the steady depreciation of the dollar and the large accumulation of dollar-denominated debt. Recently, 60 percent of medium-term papers issued by the U.S. Treasury was taken up in a single day by the Japanese. That is why we have said that an appropriate international mechanism for financial intermediation should be set up to recycle these surpluses to the developing countries. Whether it is a debt reconstruction facility, the structural adjustment facility, IDA, or IFC, the international community should take upon itself this task of recycling, in the interest not only of the developing countries, but also world growth and a harmonious resolution of the imbalances within the industrial countries.

A reduction in current account imbalances is of course the urgent aim of policy in industrial countries. A primary issue is to determine the desirable and sustainable pattern of current account positions on the basis of the global model of interaction that we have talked about. The staff correctly suggests that the U.S. current account deficit is not sustainable because investment demand has exceeded its underlying trend and private saving is below its longer-term trend. This is a good reason for effecting a reduction in the current account deficit. There is yet another reason for reducing the deficit, namely, the deprivation of needed external resources for developing countries because of the United States' absorption of foreign savings to finance its deficit.

The issue of how rapidly the U.S. deficit should be reduced is pertinent. The reference scenario projects lower shifts in real external flows than are needed for a sustainable and desirable evolution of economic variables among the three largest economies.

But the sustainability and desirability are viewed not from a global viewpoint, but from the viewpoint mainly of the three largest economies, which is concentrated on the shifts in domestic demand in line with a given sustainable and desirable rate of GNP growth that is defined as "slightly above the estimated growth rate of productive potential." It is not clear how much reliance can be placed on the estimates of production potential, particularly as large technological modifications and improvements have taken place in the 1980s under the impact of computer and electronic technology.

Yet, the staff analysis is important because it indicates the directions in which the variables should move. It is in this context that policy coordination among industrial countries has a key role to play and that the role that exchange rates play in the future evolution of current account positions will be crucial. The staff's Scenarios II and III clearly indicate the help that some shifts in exchange rates would provide in reducing current account imbalances. But the staff seems to be schizophrenic on the matter of exchange rates. The staff knows that the exchange rate is the business of the Fund, and that a whole set of policy indicators can be built up around the notion of desirable exchange rates, whether they are called "target zones" or exchange rate variations that are not misaligned. How can one then say that it does not seem appropriate for the staff to attempt to define a desirable and sustainable path for exchange rate changes. The staff has said that "movements in the exchange rates may be used to signify the possibility that other variables may be departing from their intended path." I fully agree with Mr. Ortiz that this can be said about any other variable. For example, why not say that, given that the United States is unable to reduce its budget deficit below a particular level, the exchange rate has to deviate from its desirable path by a particular amount to satisfy a current account target. Even though at the Louvre meeting the industrial countries decided that the current level of exchange rates should not be allowed to vary much, the Fund cannot give up its responsibility for pronouncing on the desirability and sustainability of an exchange rate path. An exercise by the Fund may actually help the policymakers in the industrial countries in deciding the appropriate level of exchange rates.

Finally, I will make three general observations. First, I agree with Mr. Posthumus that the discussions on policy issues with respect to developing countries has focused almost entirely on the debt problem. No doubt that is a main problem now, but the problem of development goes beyond that and, in a fundamental sense, involves the global transfer of resources. Second, the paper on medium-term scenarios could be published by itself to provide a basis for wide-ranging discussions. I hope that Mr. Yamazaki might be able to withdraw his objections to publishing the medium-term scenarios, which are at the heart of the world economic outlook discussions. Third, for this exercise, a new category, the 60 SAF-eligible countries, was introduced and data are given for these countries from 1979, even though the structural adjustment facility came into being only in 1986. India and China, although eligible to use the facility, have been excluded from the new category. The decision on the facility has merely a footnote to show that these countries have "indicated that they do not intend to make use of the resources of the structural adjustment facility." But that indication has nothing to do with the statistical characteristics of the Indian economy; India is just as poor, or as qualified, to be in that group as any other SAF-eligible country. This new category should therefore be modified before the publication of the paper.

Mr. Dallara noted that Mr. Sengupta had stressed that heavy reliance should not be placed on improvements in the real net export position of the United States; recent trade figures were discouraging, and improvement in the U.S. real net export position would require a further substantial depreciation of the dollar. However, there did not seem to be a clear relationship between the movement in the nominal trade data for the United States and the U.S. real net export position. Despite the discouraging nominal trade figures, there had been a clear and substantial improvement in real net exports over the previous three consecutive quarters, amounting to $28 billion, which had accounted for approximately one third of U.S. real economic growth in that period. It was therefore important to focus on real, as well as nominal, variables.

Mr. Sengupta's point that a significant portion of the surpluses of the major industrial countries could be recycled through official channels to developing countries was well taken, Mr. Dallara said. However, the implied suggestion that had been made during the discussion thus far that capital flows should be planned was worrying, as it would involve directing international capital flows. While Japan's decision to recycle some of its surplus to developing countries was, of course, significant and welcome, it was important to bear in mind the inherent strength of open capital markets and the desirability of permitting capital to respond to the risk considerations that dominated most capital flows around the world.

It had been suggested by Mr. Sengupta and Mr. Ortiz that the staff had in effect skirted the exchange rate issue in its discussion on indicators, Mr. Dallara remarked. In fact, the staff had not skirted the issue in its various scenarios. There was probably a way forward that would not necessarily require the staff to make a pronouncement on the desirability or sustainability of a particular exchange rate path. Instead, the staff could indicate which exchange rate paths might be consistent with outcomes for other key variables--as the staff had indeed done in the scenarios. That approach could usefully be incorporated into the indicator approach, so that implications could be even more clearly drawn about the relationship between various exchange rate paths and various outcomes for economic growth and external positions.

The circulation of the statements by Mr. de Groote, Mr. Foot, and Mr. Posthumus had given Executive Directors an opportunity to examine them before the meeting, Mr. Dallara commented. He hoped that Mr. de Groote, Mr. Foot, and Mr. Posthumus would make additional comments toward the end of the meeting on the basis of the discussion itself.

The Chairman said that he agreed with Mr. Dallara that Executive Directors who circulated their statements before a meeting should always feel free to make an additional contribution to the discussion toward the end of the meeting. In addition, the staff scenarios would give the participants in the coming ministerial meetings a better opportunity than ever before to judge for themselves the appropriateness of the present exchange rate trends.

Mr. Sengupta commented that he agreed that the exchange rate assumptions had been clearly expressed in the current scenarios and during the latest discussions on the U.S. economy. He had had in mind the possible use of target zones; the staff could formulate a set of consistent policy recommendations derived from exchange rate movements. Finally, in referring to "planning" to recycle developed countries' external surpluses to developing countries, he had meant to use the term "planning" in the way in which it was used in the context of policy determination in France. He had not meant to say that there could be centrally determined direction of international capital flows.

Mr. Song made the following statement:

> If correctly interpreted, one assumption is that, although the world economic situation and prospects are uncertain, recent developments do not necessarily mean a downturn in the world economy, particularly in terms of growth.
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> On this point, I believe, there will be little argument. However, this is not the crux of the matter. What has obsessed the international community recently is that no definite progress or promising future is in sight for solving two troublesome problems, namely, protracted external imbalances between the major industrial countries, and the intricate debt problems of the developing world. On the contrary, some uneasy signs have emerged in recent weeks. Even worse, in its scenarios of medium-term prospects the staff conveys more bad than good news in these respects; for instance, with regard to imbalances, on page 2 it is stated that "...on the basis of current policies and exchange rates, the imbalances are expected to remain above sustainable levels after 1988"; and on debt, it is stated on page 41 that "as a result, the resolution of the debt crisis seems as far away as ever." Experience suggests that no progress usually means regression. This standstill has prevailed for too long and is fraught with danger, which should concern us deeply. I do not think that I am being overly pessimistic. I feel strongly that more action needs to be taken.

A question that has puzzled me for a long time is whether there is any linkage between the external imbalances in industrial countries and the debt crises in developing countries. The staff paper, unfortunately, provides no explicit answer. Apparently external imbalances in the industrial countries seriously hamper a solution to the debt crises, particularly because the United States is too dependent on savings from abroad--including those from indebted countries--to finance its deficits and to offset the adverse effects of the imbalances on exchange rates and interest rates. Similarly, debt crises in developing countries seriously hamper efforts to reduce the external imbalances, because these heavily indebted countries are unable to absorb exports from the United States, the traditional supplier.

For two reasons, I wonder whether the solution offered on page 52--namely, "...the major countries demonstrate the willingness to take the steps needed to bring about a durable reorientation of relative rates of domestic demand growth"--is sufficient and effective enough. First, even if the major countries were willing, the additional domestic demand of Japan and Germany may not necessarily be enough to absorb the reduced domestic demand in the United States. Second, reduced domestic demand in the United States may not coincide with what Japan and Germany need. For example, it is quite possible that expansion of domestic demand in these two countries may partly be for resources linked to imports that are not from the United States. Therefore, increased export earnings from, say, the developing countries, traditionally the main export markets for the United States, may have to be used in debt service to private creditors. At least this has been the experience in recent years.

If this type of situation arises, the result of such a change may, at best, be an easing in the U.S. capital account and in some invisibles items, but there will not necessarily be a reduction in the trade deficit. Substantial trade deficits in the United States may still exist, which means that trade frictions, protectionist pressures, and exchange market unrest will continue. I do not deny the necessity to reorient domestic demand growth in the major countries, but reliance solely on this approach may not achieve the intended goal of eliminating the external imbalances, even in the long run.

As to the growth-oriented debt strategy, I am pleased that the staff is aware that several measures must converge and that successful efforts to improve growth prospects in developing countries depend on a combination of growth-oriented adjustment policies in indebted countries, on adequate flows of foreign financing, and on a supportive international environment. These three factors are fundamentally interdependent and, clearly, more needs to be done in each individual area. Unfortunately, in specific analysis of the relationship among the three, it is the adjustment policies of indebted countries that have been emphasized everywhere as a prerequisite for the other two. This approach totally ignores the point that the other two factors--a favorable international environment and adequate external financing--are concurrently the precondition and the integrating parts in the design and implementation of sound and feasible adjustment policies. I welcome the staff's suggestion that financing of $10 billion a year should go to the developing countries, but I wonder whether the size is adequate and for what purposes the money will be used.

Although basically I can go along with the view on page 24 that "the fundamental basis of the debt strategy is the pursuit of effective adjustment policies in the developing countries themselves," the staff comparisons between adjustment performance of those developing countries that have debt-servicing problems and those that have not are unfair, because none of the particular conditions of those countries--such as the sociopolitical background and its limitations on economic developments, differences in the various developmental stages, the administrative capabilities of the countries concerned, and the capacity to absorb external shocks--have been considered. Obviously, these factors have had a severe impact on adjustment performance. Some of these factors are beyond the authorities' control and occur even when sound adjustment policies are in place. The best approach is still the case-by-case method that has always been advocated by the Fund; it is an appropriate way in which to make relevant decisions on an individual basis.

However, the question of how to solve the debt crisis remains. Categorizing the debt crisis cases into two subgroups, those in which solvency is at issue and those in which the problems are related to liquidity, still has merit.

For the first group, broad agreement has already been reached on solutions to the debt problem of heavily indebted low-income countries, namely, to develop and implement growth-oriented structural policies supported by increased concessional support and debt relief. The donor countries must now meet their commitments, and one of the first steps toward an effective solution of this problem is--as already requested by the Managing Director--to substantially enlarge the resource base of the structural adjustment facility.

Regarding the liquidity crisis cases, imaginative and innovative measures are needed, and it may be desirable to develop schemes, such as the 1930s New Deal of the United States, to inject the needed resources into developing countries with recent debt-servicing problems to set their economies in full motion and reverse the standstill of the world economy. Such an injection can occur either by recycling the surplus countries' liquidity, or through debt reconstruction to reverse the trend of net outflows of resources from the indebted countries concerned, or a combination of both. In this connection, it is necessary to develop various types of debt relief by such means as subordinating sovereign debt in the hands of private holders, interest capitalization, and debt-equity swaps. All these approaches are directed toward revitalizing the economic activity of the indebted countries and increasing their capacity to absorb imports from the industrial countries, especially the United States.

As to the recycling of the surplus countries' liquidity, working through the private banking community is not very promising simply because maximizing profits at minimum risk is the main consideration of this community. In order to overcome this barrier, the community's reluctance has to be eliminated by using policy instruments and financial innovations that will be in their interest and would have to be accepted to keep the banks from suffering unbearable losses. Under present circumstances, it is essential that the mandated responsibilities of the Fund and the World Bank be strengthened and, equally important, that their cooperative nature be enhanced. It is in this context that an increase in quota, an allocation of SDRs, and enlarged use of the GAB resources are not only warranted, but will also benefit both developing and industrial countries.

With respect to the use of indicators and medium-term scenarios in this world economic outlook exercise, the staff has made useful and constructive efforts. The choice and analysis of microeconomic variables will no doubt help in the recognition of specific movements in various aspects of the world economy. However, it may be desirable to integrate all specific indicator analyses through the use of one or two key points in order to show clearly the causality of the movement between and among them. Such an approach may help to avoid the bias of not being able to "see the woods for the trees." One of the merits of these medium-term scenario exercises is that they highlight the possible risk of some policy choices. If we cannot point out precisely where the right track is, these sensitivity tests can still be regarded as second best.

Mr. Abdallah made the following statement:

I commend the staff for introducing innovative features relating to the use of indicators and medium-term scenarios which, with further refinement, should significantly facilitate the Board's future assessment of the world economic outlook.

There are clearly some positive features of the current economic situation for the major industrial countries. The recovery cycle, now in its fifth year, has proved to be more durable than expected. I agree with the staff, however, that there remain substantial downside risks in the prospective evolution of macroeconomic performance in the industrial countries, associated principally with the prevalence of large external imbalances and delayed fiscal adjustment in the United States. Against this background of mixed developments, I note the staff's forecast that in 1988 the average growth rate of output for industrial countries will moderate to a level which is closer to potential output and domestic demand. I am less sanguine than the staff, however, about the likelihood of a significant reduction in the size of the large current account imbalances of the industrial countries, mainly because the full measure of expected beneficial effects arising from the exchange rate corrections and from the welcome stimulative fiscal packages announced in Japan and Germany are likely to be masked by the adverse consequences of persistently large U.S. federal budget deficits. In this context, I note with concern that, in sharp contrast to official forecasts, the staff projects the deficit to remain unchanged at 3.7 percent of GDP in 1988 and to be only marginally lower by 1990, probably reflecting the current impasse between the Administration and Congress and prospective political uncertainties associated with a presidential election year. I share the concerns expressed by Mr. de Groote about the justifications being advanced to support a delayed fiscal adjustment in the United States. Most informed observers remain concerned about the worrisome prospect that a more desirable balance between saving and investment in the United States may be pre-empted by financial markets through movements of the exchange and interest rates with, as the staff clearly recognizes, substantial potential short-term output costs in both surplus and deficit countries. Indeed, we are beginning to see rising tensions in the foreign exchange market, a tightening of monetary conditions, and the emergence of protectionist sentiment as markets react to policy slippages.

In reviewing the three medium-term scenarios for industrial countries as presented, I recognize that, rather than being forecasts, these represent only illustrative simulations designed to uncover deviations from a baseline scenario. However, the general impression one derives is that substantial fiscal adjustments in Germany and Japan are likely to lead to only a modest reduction of external imbalances in the absence of fiscal consolidation in the United States itself, and that adjustment policies for the industrial countries as a group are likely to run out of steam after 1988. I have no particular problems with the first two scenarios--indeed, some variant of Scenario II is implicit in my observations. Scenario III is clearly the preferred scenario because balanced use of policy instruments and adaptation result in a more controlled adjustment process, which will presumably be reinforced by a qualitative reduction of rigidities in the markets of European countries and Japan. However, inasmuch as the reduction of the U.S. budget deficit remains central to the reduction of external imbalances, I would welcome the staff's comments on whether the sensitivity of the U.S. current account balance to a range of assumed budget deficit reduction and associated revenue/expenditure mixes, including those proposed by the U.S. Administration through expenditure reductions, could have been simulated more straightforwardly.

The importance for industrial countries, especially the G-5 countries, of translating statements of intention to coordinate macroeconomic policies--the most recent being the Louvre Accord--into concrete action cannot be overemphasized. Although the innovative section in the staff paper on indicators of economic performance and policy is couched in nonoperational terms, it serves to emphasize that economic variables in industrial countries are interconnected and their performance can be influenced in the medium term more effectively through differentiated fiscal policy adjustment linked to structural reforms that ensure greater efficiency in the labor, goods, and financial markets. To enable the Fund to carry out its enhanced surveillance role in the context of policy coordination and review among industrial countries, it is necessary for the staff to develop and update medium-term target ranges for key macroeconomic policy variables in industrial countries.

I will now comment on the difficult situation facing the developing countries, which appears likely to be exacerbated in 1988 with the convergence of prospective reduced growth rates of output and domestic demand in the major industrial countries, resulting in diminished export growth prospects and continued stagnation in real per capita income, especially for sub-Saharan African countries. In particular, I concur with Mr. de Groote that uncertainty in industrial country macroeconomic prospects may end up by compromising progress in the prospective alleviation of the international debt situation. In this context, I find the forecast average real GDP growth rate of 3.8 percent for these countries surprisingly high and, like Mr. Sengupta, who found the projected growth rate for developing countries as a whole also to be too high, I would appreciate some comments from the staff on this matter together with an indication of the corresponding median rate. In any event, over the medium term, it is my view that per capita growth prospects are likely to be modest at best, despite continuing adjustment, leading to a growing intractability of the debt problem. In this connection, I was interested to see the conclusion, which emerged from the innovative staff analysis crystallized in Table 8 on page 43 of EBS/87/182, to the effect that the forecast error in the debt ratio was due largely to exogenous factors. This merely reinforces the strongly held view of most authorities in developing countries that growth prospects are increasingly being held hostage to the effective solution of the debt problem, which, in turn, is considered to be beyond the exclusive writ of domestic adjustment policies.

I agree with the staff about the pivotal importance of the debt strategy for medium-term prospects in developing countries and the three main factors which influence it. Clearly, the pursuit of effective adjustment policies remains the primary condition for alleviating the debt situation, although there may be genuine disagreement about the extent and pace of such adjustment, in part because of the unavoidable sociopolitical reactions it generates. However, in reviewing the wealth of insightful data presented in SM/87/222, I was struck by the extent to which, since 1981, real capital formation in per capita terms has stagnated, if not declined, because of import compression, while other indicators of adjustment--notably, domestic prices, central government budget deficits, monetary aggregates, external current account deficits, and reserves--have exhibited significant changes in the right direction. Despite these developments, the external debt situation has continued to worsen, with the total debt/export and debt service/export ratios, inclusive of the Fund, more than doubling between 1979 and 1986 to about 77 percent and 36 percent, respectively. A disturbing conclusion that may be drawn from these trends is that domestic policy adjustment has been undermined by unfavorable trade developments and the lack of adequate net external capital inflows, inducing a growing number of sub-Saharan African countries to wonder whether there is any "light at the end of the tunnel." It is imperative in designing new adjustment programs for this region that much greater weight than hitherto be explicitly given to the prospects for a favorable external environment and increased international lending in establishing the pace of adjustment.

I am much less convinced than the staff that for the rest of this decade the prospects of reduced export earnings and growth in developing countries due to a slowdown of economic activity in industrial countries are less likely, even if the relationship to business cycle trends in developed countries is less pronounced. Since I have already suggested that some version of Scenario II is more likely to be realized than Scenario III, and because of the resurgence of protectionist tendencies in industrial countries, I can foresee only a decline in the export earnings of low-income countries, despite their attempts, through regional free-trade and currency clearinghouse arrangements, to undertake outward-oriented development strategies to reduce their vulnerability to adverse exogenous developments.

While from a self-sustaining growth perspective overall buoyancy of trade may be preferred to net availability of foreign savings by developing countries, the inability of those countries to profit from the trade growth because of the commodity composition of exports and other structural trading impediments necessarily make them more dependent on the latter. In particular, experience in the last decade has shown that real resource transfer remains critical because of its implications for investment spending and growth. A recent study by the World Institute for Development Economics points up the reversal that is taking place this decade in capital flows to developing countries, from a net inflow of $30 billion in 1980/81 to a projected net outflow of $40 billion by 1990/91, despite significant import compression. There is a clear need to reverse this trend by recycling industrial country surpluses in the direction of developing countries to the eventual benefit of both groups of countries. Failure to do so will surely render sterile much of the effort associated with the costly and drawn-out adjustment strategy being undertaken by low-income, debt-burdened countries. The Fund, through enhanced resources under the structural adjustment facility and better designed adjustment programs, should play an active and larger catalytic role in ensuring that for these countries the harmful effects of a prospective stagnation or decline in export earnings do not compound the drag on their economies being exerted by existing levels of debt. While additional financing from private creditors, in part through use of innovative modalities, would be desirable, major attention must be directed at official creditors to generate increased loans and grants as well as more realistic debt packages.

In this connection, I was very encouraged by the staff's recognition on page 27 of EBS/87/182 that provision of additional finance in support of growth-oriented adjustment in the developing world would be a helpful policy adaptation in strengthening the process of external adjustment in the industrial countries, as illustrated by the discussion on the quantitative implication of official lending. There is a regrettable tendency to view such resource transfers in less than enthusiastic terms, forgetting that they are a necessary component in stabilizing global demand and fostering balanced growth. Indeed, I would encourage the staff to extend the simulation under Scenario C4 by including much higher estimates of potential private and official lending to different groups of middle- and low-income developing countries, respectively.

Mr. Mawakani made the following statement:

The world economic outlook papers show that over the past five years, major industrial countries have experienced steady economic growth, although during the more recent past the pace of the economic expansion has slowed. This expansion has been accompanied by a moderate rate of inflation. These developments are fairly satisfactory, and these gains should be consolidated. However, I am deeply concerned about the developments in the financial sector. In particular, the current account deficit of the United States and the surpluses of Japan and Germany have reached an unprecedented magnitude and cast a shadow on the prospects for the world economy.

While there has been economic expansion in industrial countries, the economic and financial situation in developing countries has remained a cause for concern. On the basis of the statistical information provided, it appears that the standard of living, as measured by per capita income, of several developing countries has deteriorated. For instance, in 1981-86, the standard of living of African countries declined by nearly 13 percent, and that of the Western Hemisphere fell by about 5 percent. The financial situation of these groups of countries has also remained precarious. The fiscal deficit of developing countries as a percentage of GDP has widened from 4.3 percent in 1981 to 6.2 percent in 1986. On a regional basis, the fiscal prospects for Africa and the Middle East are not expected to improve in 1987. Furthermore, the debt problem seems to have confounded all proposed solutions, as the debt service ratio continues to rise.

In light of these developments, it is clear that the world economy is confronted with two major issues: how to address the debt problem of the developing countries; and how to reduce the current account imbalances of major industrial countries while preserving noninflationary growth.

There is no doubt that the medium-term prospects of developing countries will continue to depend upon a durable solution of the debt problem. While I broadly support the present debt strategy--growth-oriented adjustment policies in indebted countries, adequate flows of foreign financing, and a favorable economic environment--I am concerned about the tendency to overemphasize adjustment. Experience seems to indicate that the strong adjustment measures implemented did not bear fruit. The unwillingness of major creditors to support financially these adjustment efforts, coupled with the deteriorating terms of trade, largely explain why the debt service difficulties persist.

The recent proposals to enhance financial assistance to low-income countries are steps in the right direction. Similar proposals for middle-income countries should be studied; debt relief and even securitization of a large portion of the outstanding debt should be considered on a case-by-case basis. It has been said that the discounting of the debt that would take place through the securitization would prevent many countries from having access to the capital market in the future. In my view, such fears are unfounded, because once economic performance in these countries is improved and the debt burden is reduced, market confidence will be enhanced and creditors will be more willing to lend.

Priority should be given to reducing the current account imbalances in major industrial countries. Therefore, I welcome steps taken by major industrial countries to coordinate their economic policies and stabilize the exchange market. However, I am concerned about the excessive use of monetary policy, especially in the United

States, to stabilize the exchange market. This can only lead to an increase in interest rates, thereby aggravating the debt service difficulties faced by many developing countries. To avoid such an unfavorable development, the United States, Japan, and Germany should take the necessary steps on the fiscal front to bring about the appropriate reduction in their respective current account imbalances.

Medium-term Scenarios I and II do not appear very encouraging, while Scenario III shows that, with some policy changes, we may have a better economic outlook, especially for developing countries. These scenarios also indicate that to reduce the imbalances in the economy in a smooth way, the U.S. fiscal deficit, as well as structural rigidities, especially in the labor and agricultural markets of major industrial countries, need to be reduced. There is also a need for domestic demand in some industrial countries to be increased. Obviously, exchange rates too will need to be adjusted. If industrial countries were to implement these policy changes and relax import restrictions, we could witness a higher level of trade, which will benefit both industrial and developing countries.

One encouraging element in the scenarios is that the debt service ratio of developing countries is projected to decline substantially over the medium term. However, the debt service ratio will still stand at about 140 percent. This implies that the costs of servicing the external debt will continue to be a burden on the economies of the developing countries. The transfer of such a large amount of real resources that this will entail will definitely be a drag on their development and can only adversely affect their future growth. These scenarios, more than anything else, show that a substantial increase in the amount of capital flows to developing countries will be needed in the next few years.

The Executive Directors agreed to continue their discussion on September 14, 1987.

APPROVED: April 14, 1988

LEO VAN HOUTVEN
Secretary