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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/49

10:00 a.m., March 21, 1986

J. de Larosière, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	Mawakani Samba
C. H. Dallara	M. K. Bush
J. de Groote	H. G. Schneider
M. Finaish	T. Alhaimus
H. Fujino	M. Sugita
G. Grosche	
Huang F.	
	Jaafar A.
A. Kafka	
T. P. Lankester	
	H. Fugmann
M. Massé	
	A. Abdallah
F. L. Nebbia	
Y. A. Nimatallah	J. E. Suraisry
	G. Ortiz
H. Ploix	
J. J. Polak	J. de Beaufort Wijnholds
C. R. Rye	
G. Salehkhou	O. Kabbaj
A. K. Sengupta	A. S. Jayawardena
	N. Coumbis

L. Van Houtven, Secretary
L. Collier, Assistant

Also Present

African Department: R. J. Bhatia, Deputy Director; G. E. Gondwe, Deputy Director. Asian Department: P. R. Narvekar, Deputy Director; U. Baumgartner. European Department: R. de Fontenay, Deputy Director; R. A. Feldman. Exchange and Trade Relations Department: C. D. Finch, Counsellor and Director; M. Guitián, Deputy Director; G. Belanger, E. H. Brau, S. Kanesa-Thasan. External Relations Department: J. M. Landell-Mills, I. S. McDonald. Fiscal Affairs Department: V. Tanzi, Director; A. H. Mansur. IMF Institute: O. B. Makalou. Legal Department: J. G. Evans, Jr., Deputy General Counsel; R. Munzberg. Middle Eastern Department: J. G. Borpujari, S. von Post. Research Department: W. C. Hood, Economic Counsellor and Director; A. D. Crockett, Deputy Director; R. R. Rhomberg, Deputy Director; F. C. Adams, E. R. Borensztein, J. M. Boughton, M. C. Deppler, M. P. Dooley, P. R. Fenton, M. Goldstein, S. J. A. Gorne, P. Gotur, J. P. Horne, O. E. G. Johnson, S. K. Jones, N. M. Kaibni, A. Lanyi, F. Larsen, D. J. Mathieson, S. Takagi, M. C. Williamson. Secretary's Department: A. P. Bhagwat. Treasurer's Department: W. O. Habermeier, Counsellor and Treasurer. Western Hemisphere Department: S. T. Beza, Associate Director; M. Caiola, J. Ferrán. Bureau of Statistics: A. K. M. Siddique. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: A. A. Agah, M. B. Chatah, S. M. Hassan, J. Hospedales, H.-S. Lee, G. Nguyen, P. Péterfalvy, G. W. K. Pickering, I. Puro, A. Steinberg, D. C. Templeman, A. Vasudevan, K. Yao. Assistants to Executive Directors: A. Bertuch-Samuels, B. Bogdanovic, J. de la Herrán, F. Di Mauro, G. Ercel, V. Govindarajan, G. D. Hodgson, S. King, H. Kobayashi, R. Msadek, K. Murakami, J. Reddy, J. E. Rodríguez, C. A. Salinas, L. Tornetta, A. J. Tregilgas, H. van der Burg, E. L. Walker, Wang X.

1. WORLD ECONOMIC OUTLOOK

The Executive Directors considered a staff paper presenting a general survey of the world economy to 1991 (EBS/86/42, 2/28/86) and supplementary information, 1/ as well as papers dealing with recent developments and short-term prospects in the world economy (SM/86/45, 2/28/86; and Cor. 1, 3/19/86), policy interactions in industrial countries (SM/86/46, 2/28/86), and topics of special interest underlying the analysis in the general survey (SM/86/49, 3/5/86; Sup. 1, 3/5/86 and Sup. 1, Cor. 1, 3/19/86; Sup. 2, 3/5/86; Sup. 3, 3/6/86; Sup. 4, 3/6/86; and Sup. 5, 3/7/86). They also had before them background material in a statistical appendix (SM/86/47, 2/28/86; and Cor. 1, 3/13/86) and six supplementary notes (SM/86/48, 3/3/86; and Cor. 1, 3/19/86).

Mr. Sengupta remarked that because of the wealth of material provided to Directors on the world economic outlook, one day's discussion might not do justice to the numerous issues. The papers on policy interactions in industrial countries and on the transmission of economic influences from industrial to developing countries formed the basis for discussion of all the issues related to surveillance; perhaps it would be feasible to set aside another day for consideration of those two papers, preferably before the meeting of the Interim Committee in April.

The Secretary observed that the only available date would be during the first week of April. If that was acceptable to Directors, a discussion could be scheduled at that time.

Mr. Grosche, Mr. Polak, and Ms. Bush considered that, whether or not a further discussion was scheduled, the Board should attempt at the present meeting to consider all the main issues relating to the world economic outlook so that the Managing Director could draft a comprehensive report to the Interim Committee on the Board's deliberations.

Mr. Grosche, noting that rapid changes in major variables had taken place in recent months, commended the staff for incorporating them promptly into the world economic outlook papers. However, he doubted whether the Board could do justice to the volume of material produced, and consideration should be given to reducing it in future.

He was in broad agreement with the staff's analysis of developments in 1985 and of the mixed picture of the current world economic situation, Mr. Grosche continued. On the one hand, the expansion of output and world trade had fallen short of expectations, making the management of the debt situation more difficult. On the other hand, an important foundation for continuing progress and more balanced expansion had been laid in the industrial countries and, to a lesser extent, in the developing world,

1/ Subsequently issued as EBS/86/42, Supplement 1, 7/29/86.

which should improve the medium-term prospects for a sustainable global expansion. For the short and medium term, his authorities held somewhat optimistic expectations, a position that had been confirmed by the staff.

Three major factors enhanced the prospects for higher growth, Mr. Grosche stated. First, the sharp fall in oil prices should provide further stimulus to growth in the industrial countries as a group, which could in turn have a positive influence on the developing countries. Second, given the recent trend in monetary conditions--which had also benefited from oil price developments--interest rates could remain lower than expected earlier. In that connection, he had noted in the paper on policy interactions the staff prediction that real short-term interest rates in the United States would be significantly higher over the medium term than assumed by the U.S. Administration; he would appreciate further comment by the staff and Ms. Bush on the assumptions behind those projections. Third, the further depreciation of the U.S. dollar since January should contribute to growth in the United States while at the same time exerting a positive influence on debt ratios and on the debt service burden of developing countries.

Despite the elements he had mentioned, Mr. Grosche went on, the outlook was subject to a number of uncertainties--including the path of fiscal retrenchment in the United States; the pace of structural reform in the industrial countries; the future pattern of exchange rates; the impact of the fall in oil prices on the petroleum exporting, highly indebted countries; and the pace of macroeconomic and structural adjustment in indebted developing countries. On that latter point, he was particularly concerned about the weakening of resolve to implement the necessary adjustment measures in a number of cases in 1985, as well as the mounting protectionist pressures witnessed throughout that year.

Lower oil prices, declining interest rates, and a weakened U.S. dollar offered the opportunity for improved growth, Mr. Grosche commented. But those elements would yield positive results only if the industrial and developing countries pursued sound economic, financial, and trade policies and if all parties concerned continued to cooperate. In that regard, the U.S. debt initiative put forward by Secretary Baker in Seoul was a welcome and significant step that gave renewed emphasis to the most important elements of the debt strategy followed thus far. While he would comment in greater detail on the debt situation during the meeting scheduled for March 24, he did wish to stress that all parties must demonstrate their willingness to play a role in translating the debt initiative into concrete action.

He shared the staff's assessment that progress in reducing financial imbalances in the industrial countries had been uneven, Mr. Grosche said. The persistence of large fiscal deficits had been a major destabilizing factor during 1985; in particular, the large U.S. budget deficit had continued to affect adversely the financial markets and the external balance. In Europe, the stubbornly high level of unemployment continued to be a major source of concern, especially as a large part was structural in nature and, therefore, could not be alleviated through economic expansion. It was obvious that Europe had made only limited progress in reducing labor market rigidities. In Japan, the large current account surplus reflected imbalances between domestic savings and investment, mainly because of the low propensity to import. The Japanese surplus had widened considerably and was contributing to rising protectionist pressures on a global level. Against that background, his authorities welcomed the initiatives taken in recent months to enhance the compatibility of policies in major industrial countries with a view to reducing instabilities in exchange markets, opening markets, and strengthening the prospects for sustainable, noninflationary growth. In particular, his authorities welcomed the adoption of a medium-term fiscal strategy in the United States. While constitutional questions made it uncertain whether the new legislation would be fully implemented, he was nonetheless confident that a significant reduction of the U.S. fiscal deficit would be undertaken over the next few years and would contribute to a strengthening of confidence in the private sector, lower interest rates, and an improvement in the external accounts.

With regard to monetary policy in the United States, Mr. Grosche continued, he agreed with the staff that prudence was called for in adapting monetary conditions to the more restrictive fiscal stance. The experience in Germany showed that a cautious monetary policy combined with a reduction in fiscal deficits did not preclude a decline in market interest rates, a development that in turn could lead to a crowding of private demand for credit. Similarly, the central bank was more likely to follow suit if market interest rates tended to decline owing to a sustained reduction in the rate of inflation. As he saw it, the Federal Reserve would be able to reduce interest rates and keep them down only if the markets were impressed by developments in the major economic variables. Hence, he supported the staff's assessment that the credibility of the anti-inflationary stance must be maintained and that the scope for judgmental flexibility in monetary policy was limited.

One of the key issues raised in the staff papers concerned the question of whether industrial countries other than the United States should move toward more expansionary fiscal policies in response to the withdrawal of stimulus expected to result from a sharp reduction in the U.S. budget deficit, Mr. Grosche recalled. His authorities agreed with the staff that fiscal restraint continued to be appropriate in the medium term, advice which he felt applied to Germany as well as to other countries. The staff had recommended a more expansionary stance for Germany in 1987, particularly if the pace of output growth tended to slow and if the U.S. budget cuts were implemented as planned. However, he would argue against such advice on the following grounds. First, it was by no means certain that the expenditure cuts in the United States would in fact have a contractionary impact on the U.S. economy. The experience in Germany was that a reduction in the deficit laid the foundation for an improved growth performance rather than for a slowdown of economic activity. Even in the short run, negative effects could be offset by the reduction in interest rates and by improved confidence. The strong performance of the U.S. stock market would seem to confirm such an assessment. Moreover, he did not see any indication that would support the staff's assessment that the pace of output in Germany was tending to slow during the current year. On the contrary, growth seemed to be gaining momentum.

The staff was currently projecting growth in Germany to exceed 3.5 percent in 1986, and he expected additional stimulus to domestic demand from passing on the benefits of the lower oil prices to households and enterprises, Mr. Grosche remarked. That pass-through, together with substantial wage increases and the virtual abatement of inflation, should raise incomes markedly in real terms. However, those developments that would continue to influence economic activity throughout much of 1987 also involved certain risks. Even at present, actual growth was exceeding potential output growth by a sizable margin, and a rising number of enterprises in the manufacturing sector were reaching their capacity limits. Additional fiscal stimulus would thus not be prudent. In passing, he noted that it was not at all certain that the moderately expansionary fiscal stance in 1986 would become restrictive in 1987, as the staff expected, since the local authorities had begun to spend larger amounts than they had in the recent past.

With respect to monetary policy in Germany, the scope for judgmental flexibility and a planned easing of monetary conditions tended to be more limited than suggested by the staff, Mr. Grosche commented. The Bundesbank had already provided sufficient room for strong output growth and had shown flexibility in adjusting a changing environment in its recent decision to lower the discount rate. As was the case with fiscal policy, monetary policy must remain credible and must continue to be geared toward ensuring a sound and stable financial environment in which productive forces could unfold.

As he had already noted, unemployment continued to be one of the most pressing problems in Europe, and he agreed with the staff that structural problems and rigidities in the labor market had tended to limit the absorption of unemployed labor, Mr. Grosche continued. Clearly, more labor flexibility and mobility, as well as greater wage differentiation, were needed. His authorities had already taken a number of steps to enhance flexibility and mobility in the labor market, including legislative action to expand the potential for fixed-term employment and part-time work, to improve training and raise qualification standards, and to remove outdated regulations that hampered the hiring of new personnel.

It must be recognized that economic prospects for developing countries as a group were strongly affected by the difficult situation of the oil exporters among them, Mr. Grosche said. In fact, the revised baseline projections showed a further deterioration in the balance of payments of oil exporters in 1986 and 1987 and a decline in economic growth for 1986 followed by only a modest increase in 1987. For the non-fuel exporters, the outlook was more favorable; nevertheless, the serious problems facing many of those countries could not be ignored, particularly given the constraints on external financing and the limited prospects for increasing export prices. In the circumstances, capital-importing developing countries, oil exporters, and oil importers alike needed to implement the policy measures necessary to make the transition to sustainable growth. As the Managing Director had remarked in a recent speech in Los Angeles, realistic exchange and interest rates and wages, prudent monetary and fiscal policies, a liberalization of trade and exchange restrictions, and a greater receptivity to foreign direct investment all had roles to play in that transition. The staff had noted that domestic and foreign resources must be freed for investment through appropriate incentives and sound financial policies. Realistic exchange rates were not only a precondition for the full utilization of countries' export potential; together with appropriate real interest rates, they should also contribute importantly to a reversal of capital flight. From the point of view of structural policy, there was a clear need to make investment plans more flexible and to curtail nonproductive investments.

In the context of the general policy framework he had outlined, due attention needed to be given to individual circumstances, Mr. Grosche observed. As an example, while there might be a sufficient basis for developing and expanding an internationally competitive manufacturing sector in some countries, other countries might see their future in developing a thriving agricultural sector that would generally be less import intensive. Such structural changes required a longer time horizon as well as appropriate international financial and technical assistance; in that regard, the World Bank would have to play an increasingly important role.

Although sufficient financial support was important, it should not be regarded as an alternative to necessary adjustment, Mr. Grosche considered. Industrial countries must, of course, assume their share of responsibility for financial support, and commercial banks needed to resume new lending at a reasonable pace. At the same time, it was clear that additional financing could be utilized appropriately only if effective policies were implemented. The situation of the highly indebted oil exporting countries posed a particularly difficult challenge. However, the instruments available and the flexibility embedded in the Baker initiative should provide sufficient scope for dealing with the problems, provided all parties participated fully.

On the nature of policy coordination required to bring about a more stable and reliable pattern of exchange rates, Mr. Grosche agreed with the staff that economic policies in individual countries must take greater account of exchange rate considerations, which required a combination of monetary and fiscal policies that were internally coherent and internationally consistent. Recent events and developments showed that a great deal of progress toward that end had already been made, but there were clear limitations to focusing policy attention on specific exchange rates or exchange rate patterns. As noted in the Chairman's concluding remarks following the discussion on the system of floating exchange rates and target zones (EBM/86/25 and EBM/86/26, 2/12/86), "concentrating on one indicator, the exchange rate, as a guide for policy adjustments, and using only monetary policy--the most flexible instrument--to maintain a predetermined pattern of exchange rates, could together result in inappropriate policy responses in some circumstances; monetary policy could become excessively subservient to the attainment of external policy objectives, and the system could then encourage inflation or deflation." Moreover, mechanically imposed external constraints, such as target zones, not only entailed the risk of being disregarded, they also could send the wrong signals about the need for adjustment; and defending a given exchange rate pattern against underlying market forces through intervention could result in an inappropriate distribution of the adjustment burden among participants.

In the circumstances, he could only underline the fundamental conclusion of the G-10 report that continuing cooperation among countries and a strengthening of international surveillance to improve the compatibility of policies among countries and the convergence of economic performance around sustainable noninflationary growth were the best means to achieve greater exchange rate stability, Mr. Grosche concluded. The Fund had a major role to play in the achievement of that objective.

Mr. Polak observed that recent developments, particularly the fall in oil prices and the reductions in interest rates, had clearly improved the overall outlook for the world economy. The fall in the value of the dollar was also contributing to an easing of tension and a lowering of inflation outside the United States. However, uncertainties remained; the international debt situation was still fragile, and the progress in implementing initiatives in that area had been slower than hoped. The staff had projected GNP growth in the industrial countries on the basis of an oil price of $15 per barrel at 3 percent for 1986 and 3.2 percent for 1987, or on average just slightly above the 3 percent informal benchmark that separated satisfactory from less than satisfactory growth. He had also noted that the expected growth rate for 1986 for all industrial countries was the same as that projected for the United States, Europe, and Japan. Inflation in the industrial countries was projected to fall to 3.1 percent in 1986 and even lower in 1987, although the figure would be higher in the United States--at 3.8 percent--and equivalent to zero or less in the most stable European countries, owing in part to the sharp drop in the value of the U.S. dollar. Inflation might also fall in developing countries aided by lower oil prices and interest rates and by increased adjustment. Argentina, Brazil, and Israel could be seen as three recent striking examples.

Remarking on the expected effects of the decline in oil prices, Mr. Polak recalled the depressing effects of the increases in oil prices in the 1970s and wondered whether the tendency was not perhaps to overestimate the lasting positive effects of the recent oil price decline on world activity as a whole. As the staff had rightly observed, the direct demand effects depended on the difference in the marginal savings rate between oil exporters and oil importers, a difference that had been strikingly large in the 1970s but might not necessarily be large or even significant at present, especially if major importing countries used the occasion to consolidate government finance positions by raising gasoline taxes. Also, while some oil exporters might be able to delay import adjustments, others might well have to make such adjustments with a short lag. In that regard, the staff's attention should be drawn to the offsetting effects--in trade, services, emigrant remittances, and aid--that ran directly from the oil exporting countries to the oil importing developing countries. The effect on inflation, of course, was a one-time occurrence: a given fall in the oil price would lower the consumer price index when the fall occurred; however, with indexation at present much weaker than it had been ten years previously, no lasting effect on inflation could be expected. In sum, he wondered whether the major effect of an oil price decline on world income might not come through the easing of monetary conditions and lower interest rates that would occur if the growth of monetary aggregates was kept unchanged, while the growth of money GNP became smaller. Even that "Pigou" effect would be qualified if the rules for setting monetary targets in some countries induced the authorities to adjust their targets downward because of lower expected inflation. However, the general improvement in inflationary expectations would certainly induce monetary authorities to take a somewhat more relaxed attitude than would otherwise be considered prudent.

Noting his agreement with the staff's views on fiscal policy, Mr. Polak commented that a few countries with overly large budget deficits--Canada, Italy, and the United States--should give priority to reducing the deficits. In Japan, however, further withdrawal of stimulus through the budget would be undesirable, a point that had been agreed in the recent Article IV consultation discussion on Japan (EBM/86/42 and EBM/86/43, 3/10/86). The staff was much more cautious with respect to Germany, where fiscal policy had been moderately expansionary thus far in 1986. The staff had gone only so far as to suggest that if output were to slow during the year, there would be a case for offsetting the contractionary fiscal stance foreseen for 1987, a view he could support.

The staff was circumspect in its treatment of monetary policy, Mr. Polak considered. It did not provide a general assessment of monetary conditions in industrial countries but rather observed that announced monetary targets for 1986 in a few large industrial countries "seem to be consistent with some further easing of financial market conditions." As he saw it, monetary policy had been accommodating in a number of countries--Australia, Canada, the Netherlands, the United Kingdom, and a few small industrial countries--and in the United States it did not appear to be exerting a contractionary influence. With a continued withdrawal of fiscal stimulus on average for the industrial countries in 1986, it was desirable that monetary policy should not be too tight. On the basis of available evidence, that seemed to have been the case.

He would have welcomed somewhat more attention by the staff to specific policy responses to lower oil prices, particularly in industrial countries, Mr. Polak said. Where budget deficits remained too large, lower oil prices could offer an opportunity for increasing taxes on energy without imparting a deflationary impulse or increasing prices. Efforts to offset the effects of lower oil prices were under consideration in a number of countries. The advantages of such action would be lower budget deficits and, hence, lower interest rates, and the authorities would be able to avoid too rapid an erosion of the gains made in recent years in energy conservation. Those positive effects would seem to outweigh the drawback of an incomplete pass-through of lower oil prices in terms of less buoyant demand, certainly in the United States, where the need for a lower budget deficit was not disputed.

He hoped that the paper on policy interactions in the industrial countries would become a permanent feature of world economic outlook exercises, Mr. Polak continued. The present version of the paper explored the need for possible policy reactions in other industrial countries to the effects of fiscal retrenchment in the United States. As he saw it, while the conclusions of the paper were mostly negative, the discussion did not fully reflect the extent to which economic policy in most of the major industrial countries at present was set in a medium-term framework, with fiscal policy often aimed at reducing both the share of government expenditure in GNP and the budget deficit. Those two objectives were being pursued on a trend basis, without much regard for the cyclical position; the aim was not to raise or lower aggregate demand but to improve the structure of GNP at the attainable level of full employment.

The paper began with the proposition that a restoration of the U.S. fiscal balance would in the short run reduce activity in the United States but raise it over the longer term, Mr. Polak noted. That proposition had been based on the staff's MINIMOD model, and he presumed that other available models would yield similar results, although that did not necessarily make those results true. Underlying the findings were the lags that ran, first, from fiscal restraint to easier monetary conditions, and, second, from those conditions to larger private spending. There seemed to be some evidence at present that the lag pattern was, if anything, reversed. While the Gramm-Rudman-Hollings legislation in the United States had only just been approved, interest rates were tumbling, investment responses were lining up, and the effect of stock market profits on consumption was showing up in unusually low U.S. savings rates out of income. Perhaps in future the paper on industrial countries might be given a focus other than the one adopted on the present occasion. One question of enduring concern would be the consistency of the policy approaches followed in the main industrial countries, even though the record on that score recently had improved, leading to a more compatible outturn in some of the main domestic variables--such as growth and inflation--although not in all of them, as could be seen from the employment figures.

Beyond the area of domestic performance, where interests often ran parallel, the paper should concentrate far more attention on the balance of payments of the main industrial countries, Mr. Polak considered. Directors should not be misled by the harmonious experience of 1985--and especially the success of the Plaza Hotel meeting--which had brought the dollar down from a peak unrelated to underlying economic factors. To achieve that fall in the dollar, together with lower interest rates globally, even after the temporary increase in interest rates in Japan, had been a masterpiece of economic coordination--and probably some luck--on an issue where the national interests of all countries had coincided. The more difficult problems had yet to be faced. The U.S. current account deficit remained at a high level, and there was some question about how far it could be expected to fall with current exchange rates. It was also worth asking how much further the dollar would have to fall in the next few years to establish a sustainable balance of payments in the United States. Economic experts had estimated dollar/yen rates ranging from ¥ 130 to ¥ 100, as against the current rate of ¥ 175 per dollar. He had not found such figures in the staff paper--which was appropriate--but the paper should have included an analysis of the underlying payments situation from which such numbers, or different numbers, could be derived.

If Fund surveillance was to have any real meaning and if the role of the Managing Director in the discussions among the major industrial countries was to be as positive as all hoped it would be, Fund surveillance must contribute to the resolution of the problem, Mr. Polak remarked. And if the world economic outlook exercise was to be relevant to the surveillance effort, it must contain the data and analysis bearing on that topic. What he had in mind was not so much a new departure as a return to the sort of work done in the context of the world economic outlook exercise in the late 1970s, when the exchange rate issue had also been acute. In November 1977 and twice in 1978, the Executive Board had held restricted exchange rate seminars in which Executive Directors had discussed the sustainability of the then prevailing exchange rates on the basis of presentations made by the staff. He would encourage management to consider the resumption of such seminars.

The volume of material that the staff had produced for the world economic outlook exercise was impressive, but he hoped that a way could be found to make the data more digestible, Mr. Polak commented. Specifically, the valuable analytical studies circulated to Directors as part of the world economic outlook data might receive more attention by Board members if they were issued throughout the year--perhaps in the Departmental Memorandum series--and might receive more attention outside the Fund if they were published under individual names in Staff Papers or in the Occasional Paper series so that important staff studies could be more accessible to the world as a whole.

Mr. Ortiz observed that following the excessively optimistic view of the global economy presented in the April 1985 world economic outlook exercise--on the basis of a better than expected performance of the world economy during 1984--the staff had been forced to undertake substantial modifications to the growth prospects of the world economy in the September 1985 review. The current exercise reflected those modifications and presented a more realistic assessment of the short-term and medium-term outlook for the world economy. In fact, it might be argued that the staff had overtempered the excessive optimism of the April 1985 exercise and that the current short-term growth projections might be even on the conservative side for the group of industrial countries.

With regard to the current situation and short-term prospects, Mr. Ortiz noted, first, that the steep fall in commodity prices observed since the beginning of the current decade implied an important transfer of resources from the developing to the industrial countries. The recent drastic fall in the price of oil had exacerbated the situation. It was clear that although a significant group of developing countries would benefit from lower oil prices, the major gains would be experienced by the industrial countries, which would save about 3.5 times as much as the oil importing developing countries. In addition to that transfer related to the terms of trade, the high real interest rates observed since the late 1970s had led to an enormous resource transfer from debtors to creditors, which had more than offset the gains experienced by the developing countries in the early 1970s because of low or negative real interest rates then prevailing that had, among other factors, stimulated excessive debt accumulation.

Second, Mr. Ortiz continued, most observers would agree that the enormous resource transfer had allowed industrial countries simultaneously to sustain an economic recovery while reducing inflation. Contrary to historical experience, however, the benefits of the current recovery had spilled over to developing countries as a whole only in a limited sense. Indeed, important groups among them had received no such benefits, and some had seen their economic situation deteriorate. Moreover, the gap between industrial and all but a handful of developing countries had widened considerably during the past few years, with many of the developing countries having been set back at least a decade in terms of development and growth potential.

Having taken those developments into account, his authorities were deeply worried by the trends stemming from the world economic prospects and policy prescriptions endorsed by the staff in the latest world economic outlook exercise, Mr. Ortiz commented. Perhaps their main preoccupation was with the fact that the industrial countries had not taken full advantage of the favorable conditions they had enjoyed over the past few years to stimulate economic growth. Nor had they created the conditions for extending the recovery to the developing world. It had been repeatedly mentioned that one of the pillars of the debt strategy followed thus far was that the industrial countries must remain responsible for providing a growth-oriented and stable economic environment that would allow developing countries to grow out of debt and to regain export-led creditworthiness. However, the performance of the world economy in 1985 indicated that the industrial countries had not fulfilled the part of the strategy that they had proposed. Economic expansion of the industrial countries had been only slightly more than one half of that recorded in the previous year, while the corresponding expansion of world trade had been precisely one half of that envisaged by the staff in the projections contained in the April 1985 world economic outlook exercise.

While there existed grounds for a less pessimistic view about the sustainability of the recovery over the next one or two years--based on a reduction in the downside risks in the outlook for the industrial countries--the growth prospects of the industrial countries remained clearly insufficient to provide both an adequate lift to the developing world and a long-term solution to the debt problem, Mr. Ortiz remarked. In that respect, he could not support the tone of complacency that appeared in the staff papers. While the staff had pointed out that 1985 had been a "somewhat disappointing" year from the point of view of economic growth, it had noted with satisfaction that "policies and performances are beginning to converge" and that "a more sustainable pattern of growth seems to have emerged." While welcoming the positive developments reflected in those statements, he found it difficult to understand the tone of satisfaction shown in the reports following the poor performance in economic activity and world trade than had occurred in 1985.

The recent oil price fall had had a devastating effect on two countries in his constituency, Mr. Ortiz observed. Naturally, his authorities were deeply worried about that impact, but they were also concerned that, once again, the industrial countries would fail to take advantage of the opportunities afforded by lower oil prices to stimulate their economies and open their markets and would thus miss a chance to promote economic growth and adequate export performance in the developing world. In that respect, he was dismayed at the staff's forecast of the "realistic" economic prospects that developing countries were likely to face over the next few years. According to EBS/86/42, "it would not be prudent to expect any substantial further reduction in real interest rates, nor any greatly increased willingness of creditors to lend....It is also unrealistic to expect a substantial strengthening of export prices or a rapid growth in the volume of trade." If that description constituted a realistic scenario, one must conclude that the continuation of the current debt strategy as implicitly envisaged by the staff in the papers analyzing the debt situation was unrealistic.

With regard to economic policies in the industrial countries, Mr. Ortiz considered that a strong case had been made for a monetary-fiscal policy mix involving a medium-term fiscal retrenchment in the United States, accompanied by a temporary fiscal expansion in Europe and Japan and a more accommodating monetary policy. Such a strategy would minimize the downside risks of aborting the economic recovery of the industrial countries while alleviating some of the debt pressures of the developing countries through the reduction in real interest rates that would result. The obvious risk of that strategy was that the reduction of interest rates in the United States could precipitate a fall in the dollar that, together with an accommodating monetary policy, might fuel inflationary pressures. In that respect, his authorities were encouraged by recent developments. The budget guidelines adopted by Congress in 1985 to reduce the 1986 budget deficit, the subsequent adoption of the Gramm-Rudman-Hollings balanced budget legislation, and the recent reduction in the discount rate engineered by the central banks of Japan, Germany, and the United States all constituted appropriate steps. His authorities were also encouraged by actions on the budget undertaken by the U.S. Senate in recent days that seemed to indicate the formation of a political consensus for tackling the budget problem. The U.S. fiscal stance had been perhaps the greatest source of concern for most observers during the past few years. One of the most obvious links between the U.S. fiscal deficit and the world economy was the effect on the real level of interest rates produced by the large utilization of foreign savings by the U.S. economy. Not surprisingly, attention had been almost unanimously focused on the urgency of reducing the U.S. budget deficit. In his view, although a credible commitment to reduce the budget deficit substantially over the next few years was an essential ingredient in the preservation of the momentum of the recovery and the stabilization of financial and exchange markets, that reduction alone would not solve the problems of the rest of the world.

The staff had warned against the conclusion that fiscal retrenchment in the United States should be offset by more expansionary policies elsewhere, Mr. Ortiz noted. While it would perhaps be imprudent to recommend a generalized fiscal expansion in all industrial countries other than the United States, a clear case could be made for the application of some fiscal stimulus in selective countries, such as Germany and Japan. In present circumstances, an even stronger case could be made for an easing of monetary conditions, which would have important beneficial effects for the world economy at large, especially at a time when the fall in oil prices was allowing more room for maneuver by reducing the inflationary risks of a more accommodating monetary policy. At present, European countries had a unique opportunity to reduce the very high level of unemployment that continued to prevail in most of them. A situation such as that envisaged by the staff of no change in the unemployment situation should be unacceptable. That comment was not meant to be a criticism of the staff's forecast but only an observation that the time seemed ripe for introducing measures aimed at improving the flexibility of labor markets and stimulating the pace of economic activity and job creation.

On the question of policy and performance in developing countries, Mr. Ortiz recalled from the previous year's world economic outlook discussion the indication of his chair that, despite the magnitude of adjustment undertaken in the developing countries, the picture had been bleak, with a drastic fall in real incomes, output, and wages suffered in the majority of those countries, particularly those in Africa and Latin America. His chair had mentioned that, except for an occasional reference to the drop in living standards, the documents for the April 1985 world economic outlook exercise had failed to examine the costs of the adjustment in terms of per capita consumption and real wage behavior. For 1986, Supplementary Note 2 dealing with the problems of labor markets and employment in developing countries, addressed some of those issues and represented an important step toward an understanding of the impact of the current crisis on the employment situation of developing countries.

The staff had pointed out that while substantial progress had been made in improving current account positions, external creditworthiness remained fragile and growth had been only moderate, Mr. Ortiz commented. The factors accounting for those developments were the inhospitable international economic environment and the insufficient implementation of corrective policies. While agreeing with the staff that there had been slippages in policy implementation, he noted that most countries had made strenuous adjustment efforts, reflected not only in the improvement of their current account positions but also in the drastic deterioration in their living standards. As evidence of the insufficient application of corrective measures, the staff had noted the rise in fiscal deficits in the capital importing and fuel exporting countries from less than 4 percent in 1984 to 5 percent in 1985. Non-fuel exporting countries, however, had failed to reduce their fiscal deficits from the levels reached in the previous year, although the staff had later recognized that external factors had had an important impact on the stabilization of fiscal deficits of developing countries in 1985. The downturn in commodity prices in 1985 had hurt fiscal revenues in those countries where commodity export earnings were a major source of government receipts.

The staff had also mentioned that interest payments on outstanding government debts had been among the main factors pressing government deficits in developing countries, Mr. Ortiz continued. In fact, in the period 1980-84, interest payments on government debt had more than doubled as a proportion of total expenditure for countries in the Western Hemisphere. The impact of interest payments on the budget position of developing countries had been emphasized by his chair on several occasions in the past. As was well known, the inflation-induced rise in nominal interest rates contained an important element of accelerated amortization of the principal of debt, which tended to distort the measurement of such deficits. In that respect, the staff had recently circulated an interesting paper dealing with inflation and the measurement of fiscal deficits (SM/86/53, 3/3/86), which covered different aspects of the problem. He hoped that a Board discussion on that paper could be held some time after the April meetings of the Interim and Development Committees.

With respect to the staff's view that developing countries needed to reduce the "import intensity of the growth process," Mr. Ortiz wondered whether the suggestion had been raised after the staff realized that the slower import growth projections would entail a downward revision of growth prospects of the developing countries, a sensitive subject at present when growth seemed to be so much in vogue. Instead of reducing growth projections, the staff had concluded that countries needed to learn to grow more with fewer imports. Curiously, that was to be accomplished through the intensification of adjustment efforts and increased trade liberalization. Such advice gave him the impression that countries were being asked to solve a puzzle with pieces that did not fit.

On the issue of international cooperation, Mr. Ortiz said that his authorities had been encouraged by the recent signs of improved policy coordination among the industrial countries. The September 1985 meeting of the Group of Five had engineered a successful and orderly depreciation of the U.S. dollar and had avoided, at least for the time being, the much feared "hard landing." Another instance of policy coordination had been the reduction in the discount rate recently announced by the central banks of the three Western countries, that would encourage a much-needed further reduction in interest rates. Despite the downward trend in nominal interest rates, they remained high by historical standards and presented an important problem to both industrial and developing countries alike. His authorities considered that a drastic reduction in interest rates could be among the most fruitful products of international policy cooperation in the short term. Such an action would entail a "virtuous circle" for the world economy at large: economic activity would be stimulated, the debt burden would be eased, unemployment would be reduced, and the budget situations of governments would improve, through a reduction in both the interest bill and in welfare payments associated with the level of unemployment. Another area ripe for international cooperation was protectionism. Many developing countries had been encouraged to take steps toward liberalizing their own trade practices, and it was important that the determination to avoid protectionism that had been expressed by the leaders of the major industrial countries be reflected in concrete steps and strategies. Finally, international cooperation was needed to solve the debt problem. His authorities had a number of suggestions to make on that issue, but he would leave them for the later discussion on the debt situation and strategy.

Mr. Fujino noted his appreciation for the extensive and comprehensive papers prepared by the staff on important areas of the world economy; however, like Mr. Polak he believed that the staff's revised and updated projections might have been more carefully examined by the Board if more time had been allowed for their analysis. Since the Board's discussion of the Article IV consultation with Japan the previous week, he had been concerned about the extent to which the pessimistic revised projections provided by the staff had influenced that discussion. While there had been a slowdown in economic growth in 1985, remarkable progress had been made in promoting policy coordination among major countries since the September 1985 world economic outlook discussion. Closer policy coordination was bearing fruit in the form of more convergence in the performance of major economies, which was essential to address the misalignment of exchange rates, large external imbalances, and high interest rates. Following the agreement among some of the major industrial countries at the Plaza Hotel, coordinated intervention and supporting monetary policy had helped the realignment of exchange rates, which at present reflected more appropriately the fundamentals of each economy than they had in the past. That favorable development in the exchange markets, together with falling inflation rates, created an environment in which easier monetary policy could be pursued without causing financial instability. Indeed, there had been a significant fall in interest rates, as well as a coordinated reduction in discount rates among some of the major countries in March 1986--developments that would gradually exert a favorable influence on the growth rate of both industrial and developing countries, on the external balance, and on the debt problem. The most noteworthy developments behind the recent policy coordination of major countries were the common recognition of economic problems and the political willingness to tackle them.

As one of the major industrial countries, Japan had played an active role in securing and implementing policy coordination, Mr. Fujino continued. Japan's policies were directed toward regaining world economic growth and stability, as had been demonstrated by the appreciation of the yen, a reduction in the general level of interest rates, the flexible management of fiscal policy within a medium-term framework, and wide-ranging market-opening measures. Those favorable developments over the past six months in the world economy seemed not to have been sufficiently highlighted in the general survey paper; the staff was perhaps taking too pessimistic a view in formulating its projections.

Of course, many uncertainties remained, including the size and pace of fiscal consolidation in the United States, Mr. Fujino commented. The adoption of medium-term fiscal objectives in the United States was a welcome forward step, because the U.S. fiscal deficit had contributed to distorting effects on global savings and investment relationships, interest rates, and exchange rates. It was essential that steady progress be made toward reducing that deficit by 1991. On page 18 of the general survey, the staff had cited the U.S. fiscal deficit and the Japanese ex post oversaving as examples of such weaknesses. In his view, those were not separate phenomena; indeed, there was a causal relationship between the U.S. fiscal deficit and the Japanese current account surplus and the associated ex post oversavings. High U.S. interest rates arising from a large fiscal deficit and the accompanying strength of the U.S. dollar had led to a considerable weakening of competitiveness of U.S. exports. The same exchange rate relationship had substantially strengthened the competitiveness of Japanese exports, which had responded strongly to changes in the external environment and had resulted in a large current account surplus and corresponding excess savings. In passing, he noted that, contrary to some observations, in the period 1983-85, when the current account surplus had increased, Japan's household savings ratio had not increased; indeed, the propensity of households to save had declined.

The Japanese economy was showing a trend of strong growth supported by domestic demand, Mr. Fujino went on. According to latest figures, growth in the final quarter of 1985 had been 1.7 percent--translated into 7.2 percent on an annual basis--of which foreign demand had accounted for only 0.2 percent. As a result, the rate of GNP growth for 1985 had reached 4.6 percent rather than the 4.2 percent estimated in the staff paper. The staff had focused its attention on the strong growth rate of output, whereas previously it had been on the weakness of domestic demand. Staff arguments had been directed to the heavy dependence on external demand to attain overall output growth, and the logic currently in use seemed to be inconsistent with the arguments and criticisms prevailing thus far. It was natural that the appreciation of the exchange rate, a desirable outcome from a global point of view, had resulted in some reduction in external demand. In the revised staff projections, the negative contribution of the foreign balance to Japan's growth was as large as 1.2 percent, which was a problem Japan had been forced to endure during the period of adjustment. That negative external demand was evidence of the effectiveness of the exchange rate adjustment. At the same time, it was making a positive contribution to Japan's trading partners. Withdrawal of stimulus by the external sector in Japan meant an improvement in external demand for Japan's trading partners and additional global stimulus outside Japan. Focusing on domestic demand growth at one time and shifting attention to overall output growth at another did not provide viable grounds for policy recommendations to a member country.

Japan's growth prospects had been discussed extensively on the occasion of the latest Article IV consultation, and little elaboration was necessary, Mr. Fujino remarked. His authorities firmly believed that the policy package for domestic demand growth, considerable improvement in the terms of trade, and a substantial reduction in interest rates worked toward the expansion of personal consumption and housing and business investment and toward the attainment of the official forecast of 4 percent growth in GNP for FY 1986/87. Robust growth in the final quarter of 1985 at an annual rate of 7.2 percent had strengthened their conviction.

Fiscal consolidation must be pursued with determination, Mr. Fujino considered. A number of slippages observed in many member countries attested to the difficulty of the task. The increasing amount of public debt and debt service payments in Japan and the prospect of a rapid aging of the population did not provide scope for an early relaxation in the fiscal consolidation effort. Moreover, any delay in that effort could result in an offsetting rise in private savings through the expectation of increased taxes in future. It was always tempting to relax the fiscal stance, and that temptation was felt in his country as well as in others. The Japanese fiscal authorities had barely succeeded in beginning to consolidate the fiscal position, following a long campaign to convince people of the necessity of doing so. However, once the effort was relaxed, it would be difficult to continue work toward fiscal consolidation in the medium term.

Within the constraint of the basic policy stance, as much flexibility as possible had been incorporated in the budget for the next fiscal year, and Japan had a good track record of flexible management of fiscal policy, Mr. Fujino remarked. In that connection, he noted two policy suggestions in the staff paper that in his view would be counterproductive to the forward-looking approach adopted in Japan. On page 31 of the general survey, the staff had suggested that "there is scope for the fiscal consolidation in Japan to proceed at a somewhat more moderate pace than planned," advice that seemed to oppose the consensus to maintain fiscal consolidation over the medium term. That statement by the staff could have a negative impact on the shape of Japan's basic fiscal stance for the medium term. Statements on pages 20 and 21 of the same paper aroused similar concerns, while on page 20 of the paper on policy interactions, it was noted that "greater flexibility at the central government level also deserves consideration." As the staff had admitted, the fiscal deficit and the interest burden were already quite large, and the fiscal role at the central government level, if any, was limited. It should be noted in that regard that, at a recent briefing session, the Institute of International Finance had cautioned against relaxing the fiscal stance in Japan and Germany, in view of the high level of interest rates.

On the exchange rate, the staff had underlined the importance of internally coherent and internationally consistent management of intervention and monetary and fiscal policies, Mr. Fujino observed. That approach should be followed with caution, lest it be seen as advocating a fine-tuning of fiscal policy. Fiscal policy could be effective in bringing about desirable exchange rates only when it was managed in line with medium-term objectives. Frequent shifts in the fiscal stance corresponding to variations in exchange rates would only undermine financial stability and market confidence.

The problems facing the developing countries would no doubt be discussed in greater detail in the March 24 discussion on the debt situation and strategy, Mr. Fujino said. Nevertheless, the importance of a steady implementation of growth-oriented adjustment, which included structural reforms, mobilization of domestic resources, countering of capital flight, and closer cooperation between the Fund and the World Bank, must be underscored.

The 1986 world economic outlook exercise was subject to a number of uncertainties in the areas of exchange rates, oil prices, and fiscal consolidation in the United States, Mr. Fujino commented. As the outlook was occasionally taken as predictive--rather than projective--based on certain assumptions of important economic variables that were subject to considerable uncertainty, special care must be exercised in the publication of the world economic outlook papers. Moreover, as he had noted earlier, the papers did not appear to take full account of favorable developments in policy coordination among major countries, as well as of exchange rate alignments and interest rate reductions. As a result, the world economic outlook papers tended to paint a rather pessimistic picture of the world economy and should perhaps be touched up. Finally, on policy recommendations, his authorities could not go along with some of the advice provided by the staff on Japan's fiscal stance. As the world economic outlook exercise was an important element in multilateral surveillance, he would welcome further discussion with the staff to ensure that views and appraisals were presented in a way that would help policymakers achieve a common objective.

Mr. Finaish indicated that he would concentrate his remarks on recent and prospective developments in the international oil market--developments that had the potential for influencing significantly the outlook for the world economy in the coming period and that represented the most important factor in the economic outlook for a large proportion of the Fund's membership. To members of his constituency, both oil exporters and otherwise, that question was of special importance. Recent developments in the international oil market had clearly accentuated the uncertainties associated with the world economic outlook exercise, given that projections and even working assumptions about oil prices had become much more difficult to make. Moreover, those developments had been subject to many different interpretations, which in turn had led to various conclusions about the course that the market was likely to follow in the coming period and the manner in which the international community, and individual countries, should react to the dramatic turnaround in oil prices and to the apparent shift in the structure of the oil market itself.

One basic question that was being widely debated was whether the recent sharp decline in prices would prove temporary or would be reversed at some time in the foreseeable future, Mr. Finaish continued. For the short term, it was difficult to answer the question for two reasons. First, the sharp drop in the price of oil had been due in part to a change in the volume of production in a few oil exporting countries. A reversal of that production policy could thus put upward pressure on prices. It should also be kept in mind that, as stated, the decision to raise production and exports had been intended by those countries as a means to facilitate the reaching of an agreement among oil exporters that would stabilize the market, in terms of both prices and export volumes of various oil producers. To the extent that such an agreement was attained, at least a partial reversal of the price decline would take place. Second, recent price movements had also been significantly influenced by market speculation. Indeed, a comparison of the timing and pattern of price and production movements over the recent period would lead to the conclusion that, even if production were not rolled back significantly, a change in expectations could in itself lead to upward speculative pressures on prices. In sum, therefore, a reversal of the recent price movement was certainly possible, even in the short term, although it was difficult to predict the timing and extent of that reversal.

Another question was whether oil prices would stabilize at a particular level or trend, or whether as a result of changes in the market structure they would fluctuate within wide margins, Mr. Finaish commented. The answer depended on a number of factors, one of which was whether the recent shift to market pricing would persist or whether some type of administered price system would emerge. In that regard, one should not assume that price setting by exporters was the only way in which price stability could be achieved. Given the relative stability of the demand for oil because of low elasticity--at least in the short term--stable supply would to a large extent prevent erratic movements in the price. Of course, market speculation would continue to influence prices, not only because of the excess capacity that would probably persist for some time but also because of perceptions about possible supply risks associated with political and security developments in the major oil exporting regions. The extent of market speculation, however, would be greatly reduced if an agreement were to be reached to stabilize supplies and if such an agreement were perceived by the market as being sustainable. Nevertheless, there was a strong likelihood that without some coordinated action on the supply side, prices might experience wide swings in both directions, with substantial short-term fluctuations along that trend.

A third question related to the longer-term outlook for the oil market, Mr. Finaish continued. Few would argue that the recent sharp drop in prices could be sustained over the long term. Indeed, most analysts believed that the oil market would firm up significantly during the coming decade. Some would even argue that the oil reserve situation, the production costs in different regions, and the likely trend of demand could lead to a sharp increase in prices during the 1990s. While it was admittedly difficult to make long-term projections, there were a number of factors that seemed to support the projection for a significant firming up of the market over the longer term. First, the slowdown in the demand for oil by industrial countries owing to conservation was probably reaching its practical limit, if it had not already done so. Second, demand by developing countries was likely to increase, particularly in those countries where comparative advantage in industries with high energy content was beginning to emerge. Third, the current production pattern and distribution of oil reserves made it likely that the supply of oil would be concentrated more and more in a smaller number of countries, which would reduce the likelihood of overproduction and downward pressures on prices. Clearly, the extent to which prices could increase in the next decade--and the pace of such an increase--would depend, inter alia, on what happened in the interim period. The longer the period for which prices were kept at levels that were incompatible with long-term supply and demand trends and with the global energy outlook in general, the larger and sharper the price correction was likely to be in future. The price corrections of the mid-1970s, following a prolonged period of suppressed prices, were illustrative in that regard. Surely, all remembered the price increases of 1973 and 1979; however, in 1973 no one had referred to the fact that the price of oil had been kept below $2 a barrel for the previous 25 years.

Without a coordinated effort to stabilize oil production and exports, market forces were not likely to result in prices that were stable or compatible with the long-term trend, Mr. Finaish considered. While the oil situation was clearly not the only one in which market forces did not turn out to be infallible--and the analogy with the foreign exchange market was not unreasonable--there was another factor in the case of the oil market that added to the need for a stabilizing mechanism on the supply side. The fact that oil was a depletable asset meant that production and export decisions were very much linked to the time preference and discounting horizons of individual oil exporting countries. Such variables were also tied to social and political considerations and were subject to substantial change, both across countries and within individual countries over time. If one accepted the premise that some mechanism of stabilizing supplies at a reasonable price--a mechanism broadly consistent with longer-term market forces--was desirable, one had to ask what was the most feasible way of achieving that result. Until recently, the burden of stabilizing the market had fallen on members of OPEC. As a result, OPEC exports had continued to decline, in some cases to only a small fraction of their exports in the early 1980s when a number of those countries had helped to mitigate the enormous upward pressures on prices by producing at or near capacity.

The position of OPEC as a residual producer had proved untenable over time, as some other exporters had continued to produce close to capacity, even when market demand had slowed, Mr. Finaish stated. Those other exporters included countries such as the United Kingdom, where oil reserves were relatively limited. With intensive discussions currently taking place to find a new workable formula to stabilize the market, it would be premature to predict the type of agreement that might eventually emerge. However, it was clear that some agreement on production and exports was needed. One question being debated was whether OPEC could do it alone. In principle, and given that OPEC still accounted for nearly two thirds of the world's oil exports, a significant reduction in OPEC output could reverse the recent decline in prices, given the short-term inelasticity of demand. As was well known, there were different views within OPEC about whether such a course of action was the most appropriate. Clearly, however, an agreement on production and exports--whether explicit or implicit--that included OPEC and non-OPEC members would have the advantage of avoiding further reductions in the market share of one group of exporters and would be viewed by the market as a more sustainable arrangement.

Remarking on the impact of the sharp decline in oil prices on the world economy and on various country groupings, Mr. Finaish said that there was little doubt that in the absence of at least a partial reversal of recent price developments in the near future, the economic impact on oil exporting countries would be substantial indeed. The impact on oil importing countries was less clear. It was true that any reduction in the import bills resulting from lower prices would have direct positive effects on importing countries. As Supplementary Note 6 in SM/86/48 indicated, however, those beneficial effects could be smaller and could disappear altogether if the price change were perceived to be transitory. Similarly, the short-term benefits to an oil importing country could be reduced if the opportunity of lower oil prices were taken to raise fiscal revenues by taxing oil or its products.

One important aspect of the effect of lower oil prices on various country groupings was the asymmetry associated with the thinly distributed beneficial effects on oil importers and the concentrated impact on a relatively smaller number of exporters, Mr. Finaish observed. In the case of some heavily indebted oil exporting countries, the implication was for an income loss so large that the present framework for dealing with the debt problem--including the recent initiatives to strengthen that framework--might prove inadequate. Moreover, and depending on the magnitude and persistence of the income loss, it was not inconceivable that some of the indebted oil countries that had thus far managed to maintain their creditworthiness and service their debts might find themselves in an untenable financial position. Although the international banking system might be better placed at present than in the past to deal with such shocks, it would be prudent if the global community were better prepared for possible disruptions. As the staff had noted, "the risks and costs of oil-related disturbances in financial markets could not be dismissed and probably increased disproportionately with each further decrease in the price of oil."

In describing the impact on different countries of sharply lower oil prices, an important fact that should be taken into account was the significant number of oil importers whose economies tended to lose on balance from a slowdown in oil exporting economies, Mr. Finaish remarked. In those countries, the positive effects of a lower import bill would be more than offset by reduced financial flows from oil exporters. Those flows included direct financial assistance, workers' remittances, imports, and direct investment by oil exporting countries. In fact, given the magnitude of those flows over the past decade, and particularly since 1979, it was surprising that the relevant staff note did not seem to take into consideration the impact of a possible significant reduction in such flows. According to a study in the March 1986 issue of the Fund and World Bank's publication Finance & Development, direct external aid alone from OPEC members had amounted to $74 billion in the decade up to 1984, an amount equivalent to 22 percent of the aid provided by all major donors during the period. Total financial flows from OPEC to developing countries had amounted to $350 billion during the period 1973-83 and had included, inter alia, $165 billion in imports and $70 billion in workers' remittances. While some of the financial flows from oil exporting countries might drop only gradually in response to the sharp decline in oil prices, the impact of the reduced financial flows on a number of oil importers could be substantial, as Mr. Polak had observed. Staff comment on that point would be helpful.

The question arose of whether the Fund had a role to play in helping members deal with the effects of sharply reduced oil prices, Mr. Finaish noted. As he saw it, the Fund could indeed be helpful in several ways. First, as a central player in the evolving approach to managing and containing the global debt situation, the Fund was expected to play an even greater role as the drop in oil revenues of indebted oil exporting countries placed additional pressure on an already precarious debt situation. Also, some of the countries that had relied on aid and remittances from neighboring oil producers might well have need of the Fund in the near future. Second, an important avenue for providing financial assistance to countries that experienced shortfalls in their export revenues was the compensatory financing facility. Depending on price movements in the coming period, some oil exporting countries could be expected to request drawings under that facility. Staff comment on that likelihood would be helpful. One limitation on assistance through the compensatory financing facility pertained, of course, to quotas. The question of whether access limits under the compensatory financing facility should be related to quota or to the magnitude of the shortfall had been the subject of debate in the past, and he expected the question to be raised again if the magnitude of oil-related export shortfalls happened to exceed substantially the quota limits of the affected countries.

Another limitation on assistance through the compensatory financing facility was the condition that the shortfall must be reversible, Mr. Finaish continued. In the case of oil, much would depend on developments and expectations regarding the future course of the market, which raised the question of whether, in the event that a reversal was not expected within the time frame of the compensatory financing facility, the Fund should consider new avenues of assisting members that experienced large drops in their export incomes. As all would remember, the Fund had been forthcoming in the mid-1970s when the oil facility had been established to help members experiencing increases in their oil import bills. Of course, that facility had been made possible only through the cooperation of the membership in providing the necessary financing. The fact that oil exporting and industrial countries had shared--in a two-thirds to one-third proportion--the financing burden and that a wide range of countries, both industrial and developing, had benefited from the facility illustrated the kind of response and cooperation that one might expect when circumstances were reversed. Finally, after 1973, the Fund and other institutions had begun to pay attention to the question of oil and had attempted to give policy advice to oil exporters and oil consumers that had been thought at the time to be helpful to international adjustment. Certain country classifications had been introduced--including oil producers and non-oil producers--as well as the concepts of low absorptive capacity, recycling, and so on. At present, a new and different situation was facing the world economy, and he looked forward to the response that would be made by the Fund.

Mr. Kafka indicated that he was in general agreement with the approach taken by the staff in the world economic outlook papers. He welcomed three innovative elements: the attention paid by the staff to the unemployment problem in developing countries; the paper on policy interactions; and the paper on the transmission of economic influences. The staff's baseline scenario presented a picture that was less optimistic than had been presented at the time of the world economic outlook exercise in the autumn of 1985. A particularly important change for the worse concerned the outlook in the baseline scenario for a reduced improvement in prospective debt ratios of debtor countries, and there were greater uncertainties facing the world than had been the case before the Annual Meetings in Seoul. The risks in 1985 had been essentially downside. While positive possibilities were conceivable in the latest outlook, one should not exaggerate them. Their realization required appropriate policies.

The factors determining present prospects were clear, Mr. Kafka continued. They included the fiscal outlook in the United States, the behavior of oil and other commodity prices, the reaction of interest and exchange rates, and possible changes triggered by all those factors in government policies in industrial countries, which were seen as the motor of the world economy. The prospects the staff derived from those factors, depressing as they might be, were certainly not exaggeratedly pessimistic. More deserving of criticism were the staff's recommendations for acting on the present environment and the future scenario.

The growth rate of the industrial countries was projected to be approximately 3 percent through 1991, Mr. Kafka observed. That rate was lower than that prevailing even in the 1968-77 period, which had already been affected by the first oil shock; and it was more than 40 percent lower than the rate that had prevailed in the ten years prior to the first oil shock. He was curious about the reasons for, though not surprised by, the reduction currently projected in the rate of actual and, presumably, potential output growth by comparison with the two earlier periods. One factor might be lower investment; a related factor could be lower productivity growth in manufacturing. Table 10 of the statistical appendix showed that in the ten years prior to 1977, productivity growth had been one fourth higher on average than it had been since that time; and the average was projected to fall in future. Among the many other possible reasons for the change were the structure of demand, labor force composition, and, possibly, macroeconomic policies. His own guesses had not explained the situation, and a comprehensive analysis of the reasons why potential output growth was not expected to rise at a faster rate in future would be most helpful.

The staff had suggested that offsetting fiscal restraint in the United States by fiscal relaxation in other industrial countries would postpone the attainment in the longer term of gains deriving from a stronger fiscal position, while an easing of monetary conditions would risk an acceleration of inflation, Mr. Kafka noted. It was difficult to estimate the risks of a reasonable relaxation of monetary policies; but to claim that a stronger fiscal position by itself was likely to produce long-term output growth--starting eventually if not immediately--seemed to treat indiscriminately a deficit reduction and a reduction in public sector expenditure. Even nonbelievers in the Ricardian paradigm need not go that far. In other words, there were many assumptions needed to conclude that reducing deficits by raising taxes would have the same effect as reducing them by lowering expenditure. For example, to what extent would people react to higher taxes by reducing private consumption? Of course, he strongly agreed with the staff's distinction between eventual equilibrium position--the sustainable or desirable medium-term or long-term fiscal stance--and the time path by which that sustainable position was to be reached. The staff's recommendation to some countries to temporarily reduce the speed with which they approached a decrease in the size of the public sector was welcome but far too hesitant. One could not sacrifice everything to avoid even the slightest risk of inflation or of crowding out of the private sector.

The staff's new and reduced estimate of import intensity of output apparently led it to project unchanged growth in output and lower import growth in developing countries in comparison with the 1985 world economic outlook projections, Mr. Kafka observed. Of course, there would be years in which import intensity would fall, particularly when a country was recovering from a recession or when important new import-substituting capacity was coming on line, and sometimes surprising behavior of imports occurred, particularly that associated with the recovery of growth in 1984 and in 1985. He wondered how far one could project such relationships into the future.

On policy coordination among industrial countries, Mr. Kafka agreed with the staff that exchange rate policies in the face of sudden exchange rate movements must be consistent with medium-term economic objectives.

Unfortunately, the problem was perhaps only the tip of the iceberg. The present exchange rate pattern was questionable, and suggestions were currently being made that the U.S. dollar might have depreciated enough, even though it had declined far less than many would have thought sufficient a year or even six months previously. He wondered how long the world could live with the balance of payments situation that the present exchange rate structure was likely to produce and what additional policies would be necessary to enable the world to live with the present exchange rate pattern. It could not all be done by occasional and limited concerted interest rate reductions alone. Given progress on the U.S. deficit, one had to ask what price--perhaps in terms of an increased capital expenditure budget in certain countries--some major countries with balance of payments surpluses must pay if they did not want their currencies to appreciate further, even if their growth rate might recently have improved.

The staff's comments on policy problems in developing countries were well taken, Mr. Kafka continued. However, bearing in mind the sensitivity stressed by the staff of developing countries' output growth in relation to that of industrial countries, one was left with the disconcerting but hardly surprising impression that, however hard developing countries worked to adjust, they were unlikely to be successful unless the industrial countries did their fair share.

The section of the general survey dealing with international cooperation and the role of the Fund was deserving of comment, Mr. Kafka considered. The G-5 meetings in New York and London had dealt with a wide range of important problems. It was certainly a desirable objective that Fund surveillance--surveillance by the entire financial community--would be brought to bear on the mutual adjustment of major industrial country policies. The discussion of that matter in the Interim Committee should deal with the objectives and mechanisms of surveillance to be applied to strong economies that had no need for access to Fund resources. The responsibility that such surveillance placed on the Fund was great and demanded not only good analysis but also insistence, particularly by the Managing Director, that the results should be given due weight by the authorities of the countries analyzed. The Fund must not be encouraged to use publicity to exert its influence, but there was nothing to stop it from prodding its principal member countries when they did not seem to be listening to Fund advice, although a positive response could not be guaranteed. In speaking of surveillance, he did not, of course, wish to neglect the issue of more far-reaching reforms of the international monetary system that must continue to be discussed in the appropriate forums.

In the forthcoming discussion on the debt situation and strategy, he would have more to say on the Baker initiative, Mr. Kafka commented. At present, it was sufficient to stress that projected low growth and limited improvement in debt ratios defined the extreme difficulties involved in the present debt strategy. Thus far that strategy had promised at best increased liquidity relief at the expense of further increases in indebtedness and without the reduction in debt ratios that would be necessary to return to spontaneous lending in the near term. All the problems could be relieved if, in addition to the adjustment measures undertaken by member countries--and more specifically by the developing countries--the industrial countries were to place greater emphasis on the attainment of higher growth rates and would avoid excessive emphasis on the reduction of inflation, an area where remarkable progress had already been made. Accelerated growth in the industrial countries would in itself imply a reduction in the danger of protectionism, which remained a matter for concern, despite what the staff had called the "heartening reaffirmation by the leaders of the major countries of the joint determination to avoid protectionism." Prodding by the Managing Director was also needed on the matter of protectionism.

While the world might well have an opportunity, because of a change in certain parameters, to achieve a better growth rate for the time being than had thus far seemed likely, it would be tragic if the opportunity were missed through hesitant policies, Mr. Kafka said. Finally, he could endorse Mr. Fujino's remarks on the problems of publishing the world economic outlook papers. Before publication could be undertaken, the Executive Board must be given ample time to examine all 700 pages.

Mr. Nimatallah noted that he was grateful for the volume of quality work prepared for the world economic outlook discussion and that he was in general agreement with the baseline scenario assumptions and prospects. However, he agreed with Mr. Polak and Mr. Finaish that the staff had not considered adequately all the possible negative aspects of the decline in oil prices and had thus tended to exaggerate some of the benefits in certain areas. Current macroeconomic policies in industrial countries formulated in a medium-term context were broadly appropriate. Of course, it was difficult to gauge the likely short-term and medium-term global impact of fiscal consolidation in those countries. The success of policies in achieving sustainable noninflationary world growth hinged on the ability of the major industrial countries to prepare their private sectors to absorb the resources released by budgetary restraints. In the circumstances, sufficient emphasis must be placed on efforts to provide more incentives to encourage the private sector to expand investment expenditure. It was equally important that governments attempt to further reduce uncertainties faced by their private sectors and their trading partners, especially in the developing world, with a view to improving economic performance and prospects. While global uncertainties had been reduced over the years, a number of uncertainties remained. The staff had identified seven such uncertainties, although he would focus on only three of them--namely, exchange rates, oil prices, and prospects for tax reform.

The meeting at the Plaza Hotel and subsequent developments had made it clear that exchange rates could not be left only to market forces all the time, Mr. Nimatallah continued. However, the recent speed of the depreciation of the dollar brought back familiar memories of uncertainty about exchange rates. The phenomenon of wide exchange rate fluctuations was difficult to explain, in light of the progress made toward better convergence of macroeconomic policies in key currency countries and, particularly, the coordinated reduction in interest rates. If changes in interest rate differentials had been used as a partial explanation for exchange rate fluctuations in the past, he could not accept such reasoning at present. Downward pressure had brought interest rates uniformly in industrial countries to lower levels, where they might remain for a while owing to lower inflation rates and more appropriate monetary policies, as well as efforts to consolidate fiscal positions. Hence, he was more convinced at present that the adoption of appropriate fiscal and monetary policies in the major industrial countries and a better convergence of such policies were not sufficient to reduce wide fluctuations in exchange rates. In other words, while appropriate policies and better convergence were necessary, they had not been sufficient. One more element was also needed: official guidance from time to time to participants in foreign exchange markets. Those participants seeking to minimize losses and maximize profits suffered from a lack of good information about the direction of exchange rates and had no credible way of knowing where and when to stop in their speculation. It was therefore important that those participants be guided from time to time by subtle signals from the authorities of member governments. To provide reliable and credible guidance, the authorities would need basically three tools: Fund surveillance to help identify the degree of appropriateness of the policies behind exchange rate behavior; defined bans as a yardstick for delineating "safe zones" within which exchange rates could fluctuate without requiring correcting action; and intervention to be used only when necessary to prevent unduly large exchange rate fluctuations.

With respect to uncertainties surrounding developments in oil prices, Mr. Nimatallah remarked that the staff had done well in analyzing the short-term and medium-term aspects behind those developments. As he saw it, while prices would stay on the lower side for a while, short-term fluctuations in oil prices during 1986 and perhaps the major part of 1987 were likely to be within a band defined at the upper limit by the average cost of competitive fuels--such as gas and coal--of about $18 per barrel and on the lower limit by the median average variable cost of producing oil in the North Sea, the United States, Latin America, Canada, and Asia, which was about $8 per barrel. Variable or direct oil production cost, as some called it, did not include depletion, depreciation, amortization, interest, and profits.

Beyond 1987, long-term total average costs were more relevant, and uncertainties about oil prices were likely to emanate more from the supply side, Mr. Nimatallah considered. Under the present world oil market conditions, oil companies would be reluctant to invest in exploration for, and development of, new oil reserves, which meant that unstable prices would unfortunately continue, probably throughout the current year. It was not clear whether future price stabilization would be left totally to market forces, to collective efforts by all producers--assuming they found a way to stabilize prices--or to a combination of market forces and declared bands within which oil prices might fluctuate. Saudi Arabia's objective remained to ensure that the world economy received adequate supplies of oil at relatively stable prices. The difference at present was that Saudi Arabia could not secure price stability alone.

Given the uncertainties he had mentioned, the benefits of lower oil prices should be passed on fully to private sectors for the following reasons, Mr. Nimatallah said. First, because of the already large size of governments, fiscal consolidation should be accomplished over time through a smooth retrenchment in government expenditure and not through additional taxes. Second, a decline in fiscal stimulus in the industrial countries could be compensated for by a combination of lower interest rates, lower inflation rates, and lower commodity prices, including prices for oil. Recent developments in oil prices provided the world economy with a good opportunity to partly compensate for the withdrawal of fiscal stimulus. After all, what was perceived to be the "full" benefit was not that in reality when one considered the impact, with a multiplier effect, on incomes and employment in the industrial countries of the sharp decline in the oil exporting countries' imports. For example, the combined size of only OPEC imports had averaged in recent years some $150 billion a year, a fact that he believed the staff had not taken fully into account. The third reason why benefits should be passed on fully to the private sector was related to the expected fluctuations in oil prices, which would make it difficult to administer and rely on a tax on imported oil for fiscal consolidation. Finally, it was clear that not all industrial countries would favor an import tax on crude oil, and imposing such a tax by some would alter the competitiveness in a climate already threatened by protectionist pressures.

The private sectors of industrial countries were anxious to know about the extent of incentives they might receive through the proposed tax reforms, Mr. Nimatallah observed. That was especially true in the United States. If the reforms took too long to adopt and implement, uncertainties about corporate and personal income tax could inhibit the private sector from carrying out plans to save and invest. In the United States, for example, the structure of the current tax system did not encourage domestic savings, and the gap had to be covered by foreign savings. As such coverage became increasingly unsustainable because of interest rate and exchange rate factors, the adoption of tax reforms aimed at encouraging the private sector became all the more urgent. He encouraged member country authorities, particularly those in the United States, to enact legislation for a reformed tax system directed toward encouraging private sector savings and capital formation. In passing, he noted that the matter of tax reform was another area on which the staff had not adequately focused.

He assumed efforts would be made to reduce domestic and global uncertainties along the lines he had mentioned, Mr. Nimatallah said. He could thus appreciate the conclusion of the staff that, as the United States reduced its fiscal deficit along the lines established by the Gramm-Rudman-Hollings Act, and assuming that the private sectors in Europe and Japan were not yet fully prepared to absorb the savings passed on to them by their governments, it would be tempting to say that "a case can be made for moderating the pace of progress toward medium-term fiscal objectives, particularly in countries where output is below potential and domestic private investment falls short of savings." His preference would be for speeding up the strengthening of private sectors in Europe and Japan instead of disrupting the medium-term commitment of fiscal consolidation. Germany, for example, had adopted a tax cut in January, and it was to be hoped that the full benefit of the interest rate cuts and lower oil prices would work themselves through the economy to increase margins in Germany. Similar efforts in other industrial countries were also being undertaken. However, if it became clear in some of those countries that the expenditure of the private sector on investment would fall short of savings in 1986, he would reluctantly agree that governments could moderate the pace of fiscal retrenchment temporarily. He had long maintained the view that fiscal retrenchment should be accomplished in a consistent and gradual way, and despite the calls of some for a speed-up of fiscal retrenchment, it was important to maintain a consistent and gradual approach toward reducing the fiscal deficits in the industrial countries.

For the developing countries, the uncertainty lay in their ability to strengthen export growth and service their external debt, Mr. Nimatallah remarked. To reduce those uncertainties, developing countries should follow policies aimed at mobilizing domestic resources for investment and export, discouraging the outflow of domestic savings, and creating a stable financial environment conducive to enhanced private sector participation in economic activity. While such policies were necessary, they were by no means sufficient; also required were efforts aimed at reducing protectionism in the industrial countries and a clear debt strategy that would enable all parties concerned to contribute to the reduction of the uncertainties he had mentioned. In sum, the world economic prospects could be improved if domestic and global uncertainties were reduced. Domestic uncertainties could be alleviated if efforts to reduce the size of governments and strengthen private sectors were continued in both the industrial and the developing world. Global uncertainties could be reduced if coordination among industrial countries were applied to all policies, particularly exchange rate and interest rate policies, and if the Fund continued to play its effective role of surveillance and to extend help to members.

Mr. Rye stated that because he had no significant disagreements with the staff prescriptions for developing countries set out on pages 26-29 of the general survey, and since some of the problems of developing countries would be discussed in greater detail during the discussion on the debt situation and strategy on March 24, he would concentrate his remarks on the prospects and policies for industrial countries. A measure of satisfaction at what had been achieved in recent months to deal with the recognized weaknesses in implementing the economic strategy of the industrial countries was appropriate. In particular, the G-5 agreement of September 1985 had played a part in the subsequent and much needed realignment of exchange rates, the recent reductions in official interest rates, and the improved prospects for addressing the U.S. budget deficit. In the meantime, sharply lower oil prices--while a mixed blessing for some countries--were on the whole likely to make a welcome contribution to lower inflation and enhanced growth. Of course, that was assuming that oil prices stabilized at a lower level; continuing wide fluctuations would be detrimental to confidence, investment, and overall stability.

Despite the positive elements he had mentioned, many familiar problems remained, Mr. Rye commented. In particular, the debt problem continued to cloud economic prospects, more needed to be done to improve the structural aspects of industrial and developing economies, and little or no progress had been made--beyond expressions of good intention--in the effort to roll back protectionism. For the future, the appropriate attitude should perhaps be one of cautious optimism, particularly as the prospects for medium-term sustainability of the recovery seemed better than they had been one year previously. However, it was important to focus carefully on the uncertainties, including those relating to the oil market, to the appropriate responses--both internal and external--to U.S. budgetary restraint, and to the realignment of exchange rates.

Uncertainties in the oil sector covered more than the magnitude and duration of the price decline itself, Mr. Rye considered. The economic consequences of that decline--a subject to which the staff had devoted much attention--were not clear cut, in part because the nature and extent of the responses to the fall in prices remained clouded. The improvement in the terms of trade of oil importing countries would increase their real incomes, but institutional and policy-related factors would determine how the higher incomes were shared among the household, business, and government sectors. If lower fuel prices were passed on to consumers, household incomes would be the main short-term beneficiary. In some countries, governments might raise energy taxes so as to channel part of the terms of trade gain to the public sector. Also, the corporate sector might not fully pass on its lower costs to prices but might seek to raise profit margins instead.

As for the prospects for the price of oil in the medium term, some analysts had made the case that the effects of depressed crude oil prices would retard exploration and development, which, in combination with the boost in demand from lower prices to consumers, could expose the world to a third oil shock in the 1990s, Mr. Rye commented. That risk would be lessened if enough of the substantial reduction in energy usage relative to output induced by earlier price rises turned out to be irreversible and continuing. Unfortunately, experience was probably not a good guide in such matters. In particular, there must exist great uncertainty regarding behavioral reactions to large negative price shocks. In the circumstances, he saw risks in taking too seriously the quantified assessments of the impact of lower oil prices on the real output and prices of industrial countries. Effects on consumer and business confidence were particularly difficult to assess. The two oil shocks of the 1970s and the costly adjustments they had entailed had dampened the spirits of businessmen and consumers in industrial countries for a prolonged period; if one were to take an optimistic view of the current situation, one might argue that a sustained slump in oil prices could have the reverse effect.

In assessing the global effects of lower oil prices, it was important to take into account the likely behavior of oil producing countries, Mr. Rye said. Taking one view of the matter, it could be said that the earlier oil shocks had seen the sudden transfer of incomes from one group of countries--oil importers--to another--oil exporters. Since it is necessary to adjust faster to an income loss than to an income gain, there had been adverse effects on the world economy. One might say that the same thing had happened in present circumstances, with the difference that the "winners" and "losers" had been reversed. The losers in present circumstances--the exporters--could be constrained to make downward spending adjustments more quickly than the winners adjusted their spending upward, especially as some exporters already had large external deficits and were experiencing financing difficulties. He had understood Mr. Finaish to be making the point that the net effect of the differential speed of adjustment on world economic activity could be depressing, a possibility that should not be dismissed out of hand, although he did not believe that it was likely.

In any event, Mr. Rye continued, sufficient uncertainties existed to make it unwise to be dogmatic about the appropriate policy response of governments to the fall in oil prices. Circumstances altered cases, and the domestic situations facing governments were quite diverse. There was at least a case for caution in those countries where public revenues from the domestic production of oil or related products were substantial or where fiscal consolidation still had a long way to go. His own country fell into both categories, and the Australian Government had already implemented increases in indirect taxes on petroleum consumption so that consumers would gain only half the benefits of lower oil prices. On that point, he could not agree with Mr. Nimatallah's remarks for two reasons. First, the size of governments was not measured appropriately so much by their revenues as by their outlays. Second, adverse effects of instabilities in oil prices seemed to make a case for government efforts to smooth out those instabilities for the consumers.

Remarking on the implications of U.S. budget policies, Mr. Rye observed that there appeared to be general agreement about the desirability of stronger growth in industrial countries, especially in Europe and Japan. At the same time, it was less clear how that stronger growth could be achieved in the face of the withdrawal of demand as the U.S. budget deficit was decreased. He had taken note of the staff's view that fiscal policies in countries outside the United States should be assigned a role--albeit a modest one--in compensating for any temporary weakness of activity caused by U.S. budget cuts. Like a number of earlier speakers, he tended to approach the subject with considerable caution. As Mr. Grosche had noted, compensation might well be unnecessary. In any case, there were dangers in active attempts to ease fiscal policy at present. The ratios of debt to GNP in most industrial countries were still high and, in many cases, were rising in circumstances in which they would normally be expected to stabilize or to fall. It remained urgent to begin reducing those ratios, particularly where future demographic trends were likely to be unfavorable for public finances. Real interest rates, which were quite high, would also benefit from a reduction in the ratio of debt to GNP. Taken in conjunction with efforts on the budgetary side to reduce the public sector's demand on resources, appropriate conduct of monetary policy would offer the means of achieving lower interest rates. Monetary growth rates seemed broadly appropriate in the major industrial countries, and stability in nominal income growth would leave room for faster growth of real activity as inflation declined.

The outlook for interest rates would also depend importantly on developments in the foreign exchange markets, Mr. Rye considered, and he agreed with the staff's assessment that "there may be scope for some additional relaxation of monetary policy in circumstances where policy had previously been kept very tight because of exchange rate constraints, and where these constraints are seen to have eased." However, he also believed that monetary authorities would need to proceed with some caution so as not to jeopardize the hard-won credibility of their anti-inflation stance.

The central development in the exchange markets had been the sharp depreciation of the U.S. dollar, Mr. Rye noted. One question might be whether that depreciation had gone too far or too fast. The answer to the first part of the question was clear: further adjustment would in fact be necessary. But one must also consider the desirable pace of realignment. An excessively rapid decline of the dollar risked disorderly and perhaps disruptive adjustments in world financial markets and economies. It could give rise to an upsurge in inflation in the United States that might spread abroad or lead to renewed upward pressure on interest rates. There was also risk of a too swift deterioration in the competitiveness of export sectors in appreciating countries, as well as a risk that a continued rapid fall in the dollar would at some stage trigger a reversal of market sentiment, with a volatility that could reflect adversely on confidence in exchange markets and on international economic stability. However, those risks were far less than those that had faced the world one year or even six months previously, thanks largely to successful efforts at international cooperation and to the improved flexibility in most economies that lower inflation had brought in its wake.

In the circumstances, a "new" approach to policies affecting exchange rates was not called for, Mr. Rye commented; rather, more of the current approach was needed. He agreed with the staff that efforts to achieve a more reliable pattern of exchange rates must be based on a set of intervention, monetary, and fiscal policies that was internally coherent and internationally consistent. Intervention would be of limited value unless supported by monetary policy; and adaptations of monetary policy would be counterproductive unless buttressed by a shift in the fiscal stance. Also necessary would be policies to achieve structural adjustment and measures to open markets. In seeking the necessary degree of coordination, neither fine-tuning nor joint formulation of policy seemed called for. Rather, what was needed was continued sensitivity to policy interactions--a matter in which the Fund had a key role to play--with a view to achieving mutually compatible medium-term strategies and internationally consistent responses to short-term divergences. Finally, while joining those who had commended the Fund staff for the volume and quality of the work produced for the world economic outlook discussions, he wondered whether too much of the Fund's resources had not been tied up in an endeavor that, while central to the work of the institution, was nonetheless rather ephemeral and liable to be rendered obsolete by the rapid march of events. Having said that, however, he could note that much of the documentation prepared for the current meetings would form a useful source of reference for some time to come.

Mr. Massé remarked that the latest baseline scenario provided by the staff had given Directors a valuable alternative group scenario taking account of changing circumstances. The paper on policy interactions in the industrial countries was also a worthwhile addition to the world economic outlook exercise and should contribute to a better understanding of those interactions. Like others, he would focus his remarks on the policies in the industrial countries at the present meeting and concentrate on the developing countries to a greater extent during the March 24 discussion on the debt situation and strategy.

The results achieved in the industrial countries in 1985 were both encouraging and disappointing, Mr. Massé continued. He welcomed the progress that had been made toward re-establishing solid growth in the industrial countries generally but was concerned by the slowdown of growth in the United States and the continuation of a number of major imbalances, including those relating to international debt and the large balance of payments surpluses and deficits. The staff's projections for 1986 and 1987 suggested that average growth of about 3 percent in the industrial countries was the minimum needed to prevent a worsening of the debt problem. While the outlook appeared basically favorable, it contained a number of uncertainties, including those relating to international oil prices and the pace at which the imbalances in the major industrial countries would be addressed. The Gramm-Rudman-Hollings Act in the United States had been a positive signal that the U.S. deficit would be dealt with, but there remained uncertainty about the magnitude, timing, and impact of a reduction in that deficit. Experience in Canada showed how politically difficult it could be to reduce the deficit and how political will could waver over time, even though decision makers had a basic understanding of the problems posed by the deficit. One element of hope was the fact that international markets were at present a more powerful force in inducing policymakers to make the appropriate decisions.

There seemed to be room for greater optimism about developments in 1986 and 1987, Mr. Massé added. Lower oil prices, changes in exchange rates among major currencies, and reductions in interest rates could all have significant and positive effects on global output while contributing to stable or even reduced inflation. Although the effects of the exchange rate realignment would be lagged because of the J-curve effects in Japan and in the United States, there were good reasons to expect some correction in the large external imbalances of major industrial countries. Moreover, while the growth and trade prospects for fuel-exporting developing countries would clearly be impaired by a reduction in the world oil price, prospects for other developing countries might have improved, at least modestly.

His optimism was based on what he perceived as the increased recognition among industrial countries of the problems created by large imbalances and the need to better coordinate policy among themselves, Mr. Massé remarked. One of the advantages of the staff papers was that they permitted greater quantification of the relationships between the various imbalances and facilitated the reaching of conclusions that were more than subjective intangible judgments about what was going on. The September 1985 G-5 agreement had been a clear statement that the large external and internal imbalances that had been allowed to develop could no longer be tolerated and that concrete measures would be taken to address those imbalances. However, since the large external imbalances, in particular, would diminish only slowly, the cooperative approach among major industrial countries must continue. In that regard, he was rather more optimistic than Mr. Polak had been when he had mentioned that concerted efforts were easier to make when the interests of all parties were in the same direction. Obviously, policy coordination and cooperation would be more difficult to achieve when international rather than purely domestic interests were at stake, but the actors must continue to play out the drama on which the curtain had been opened.

Industrial countries must tackle structural problems in labor, financial, and other markets within their economies, Mr. Massé stated. Stronger Fund surveillance, such as that through the world economic outlook, could contribute to the process, and he hoped that the behavior of his Canadian authorities both during and after the recent budget exercise would provide an example to others. It should be recalled, for example, that his Canadian authorities had not only taken into account the discussion of their economy that had taken place in the Executive Board, after the budget had been passed, they had asked him to make a written statement to the Board correlating the remarks of Directors with the direction in which the budget had gone. Furthermore, the Managing Director had been invited within ten days after the adoption of the budget to talk to Ministry of Finance officials and the Prime Minister about the various actions that had been taken in the budget. Those moves by the Canadian authorities were, he believed, in the spirit of surveillance.

The effect of fiscal retrenchment in the United States in the coming years would be a critical factor in shaping the medium-term global outlook, Mr. Massé considered. At various points in the world economic outlook papers, the staff had placed the U.S. deficit reduction effort in the context of a short-term versus medium-term trade-off. If strong, bold steps were taken early to reduce the deficit in a credible manner, beneficial effects on financial markets could accrue very quickly, so that the short-term cost in terms of lost output would be minimized. However, if actual cuts in expenditures or revenue measures were not quickly implemented, it might be more difficult to achieve a reliable investment and the orderly re-establishment of external competitiveness. In that regard, he had taken note of Mr. Nimatallah's comment that a gradual approach to deficit reduction was preferable. However, he had seen the effects of a gradual reduction approach on political will in Canada, and that experience led him to conclude that it was better to muster the political courage and deal with an unsustainable deficit immediately.

In general, Mr. Massé continued, he agreed with the trade-off scenario put forward by the staff, although the progressive reduction in U.S. deficits might have a more negative influence than assumed by the staff. In the short term, a large and continuous withdrawal of fiscal stimulus could well result in lower growth over the medium term, with a consequent rise in the unemployment rate. Also, he had some concerns about the extent and timing of the beneficial effects operating through interest rates and confidence. Interest rates in the United States, while high in real terms, had already fallen significantly in nominal terms, but without any notable effect on output growth in the United States. Of course, he was not fully apprised of the precise lags that might be operating in the United States, but he joined his Canadian authorities in wondering to what extent the results presented by the staff reflected the characteristics of the MINIMOD macroeconomic model used by the staff. It was his understanding that the model had tended to exhibit one of the smaller multiplier effects compared with other models relating to fiscal reductions, and he was thus somewhat hesitant about fully accepting the results presented in the staff paper on that question.

Although growth in the United States might be more adversely affected by cuts in the fiscal deficit than was foreseen by the staff, clearly a program of fiscal consolidation must be undertaken, Mr. Massé said. Lower oil prices and the expectation of lower inflation through the medium term should dampen the negative effects on output of reduced deficits, and that opportunity should not be missed. There might also be room for a more flexible approach to monetary policy in the United States and in other countries, although monetary policy in the United States must continue to be directed toward price stability. The deceleration of inflation in the wake of lower oil prices might provide scope for some monetary easing, to be achieved through the maintenance of the current path of monetary policy. He agreed with Mr. Polak that, in cases where inflation was being reduced, if the current path of monetary policy was maintained, the equivalent of monetary expansion was produced at that point. Before the recent sharp oil price decline, he had considered that an easing of monetary policy in the United States would have been appropriate. At present, he believed the current path of monetary expansion should be maintained, notwithstanding reduced inflation and lower oil prices.

Among other industrial countries, short-run growth prospects for Japan had become less favorable as a result of the recent appreciation of the yen and the slowing of export demand, Mr. Massé observed. As he had noted during the recent Article IV consultation with Japan, the dilemma faced by the authorities of concurrently ensuring adequate growth in the economy while reducing the current account surplus and consolidating the fiscal balance had been sharpened. He encouraged the Japanese authorities to exhibit flexibility in the setting of monetary and fiscal policies in order to ensure adequate growth of domestic demand. In that regard, he had been interested in Mr. Fujino's indication that the Japanese authorities had announced they were on a path toward greater fiscal stability. The problem that he saw not only in the Canadian economy but in other industrial economies as well was the existence of a large surplus that must be reduced. And if it was not reduced by an increase in domestic demand through some increase in the fiscal stimulus, then some other means must be created, and it was obviously proper to indicate that, for the Japanese authorities, a fiscal stimulus by the Central Government might not be the appropriate path, although that did not detract from the fact that there was a major imbalance for which some solution must be found. In particular, room for fiscal stimulus might exist in the local and municipal sectors and, at the minimum, there should be no withdrawal of net fiscal stimulus in 1986.

In Germany, indications were that real growth would be quite strong in 1986, Mr. Massé said. At present, there did not appear to be a need for added stimulus to the German economy; but if domestic demand began to falter, the authorities might use the flexibility provided by their small fiscal deficit to advance the tax cut planned for 1988.

As for other industrial countries, Mr. Massé noted, there remained a pressing need for further fiscal consolidation or a further reduction in inflationary expectations. Hence, he saw little scope for easier monetary or fiscal policies. A number of countries, including his own, needed to press ahead with fiscal consolidation. In that regard, the negative impact on real growth in Canada of the U.S. balanced budget scenario might have been slightly overestimated by the staff. Fiscal consolidation in the United States might well have a relatively modest impact on Canada, in part because the potential negative impact on the external sector might be offset to a considerable degree by a strong response within Canada to lower interest rates.

The staff had also provided a useful overview of the progress made in addressing structural rigidities, particularly in Europe, Mr. Massé remarked. The staff's analysis tended to be classical in nature, but there was strong backing for the conclusion that the high level of unemployment in Europe might have been caused in large part by the fact that real wages had grown much more rapidly in Europe the past 15 years than in the United States and had significantly outstripped increases in productivity. The recent Article IV consultation with the United Kingdom provided one example of the problem of excessive growth in real wages. To reduce the unemployment rate in Europe, it would be necessary to enhance the function of labor markets and moderate the growth of real labor costs, even if those were not sufficient conditions. It would be unfortunate if improved growth rates in those countries were to lead to a reduction in the pace at which structural reforms were being implemented. Indeed, the continuing unacceptably high rates of unemployment suggested that structural reform should be accelerated so as to reduce the risk that stronger growth would ultimately encourage more aggressive wage bargaining and might lead to higher inflation without sufficient reduction in unemployment.

With regard to the economic performance and prospects of developing countries, the situation was mixed and remained fragile, Mr. Massé observed. Developments in the past year had been generally disquieting, as economic growth had decelerated, inflation had remained generally high, and the external creditworthiness of many countries had shown no signs of improvement. The economic outlook for developing countries was dominated by the continuation of high levels of external debt, an issue that would be dealt with in greater depth during the March 24 discussion of the debt situation and strategy. For the present meeting, it was important to note that part of the weakness in the performance of developing countries as a group could be linked to the slowdown in industrial countries and the demand by those countries for the imports of developing countries. It was therefore crucial for the industrial countries to sustain and encourage economic growth. However, there had been some slippages in developing countries' policies. Budget deficits in 1985 as a whole had remained high by comparison with deficits in earlier periods, and fiscal retrenchment had tended to concentrate on lower investment spending rather than increases in revenues or reductions in current expenditures. Moreover, the decline in the rate of domestic credit expansion had tended to fall upon the private sector all too often, and domestic savings had remained inadequate in most cases.

As a group, the developing countries would need to continue their efforts to strengthen their internal economic balances and to encourage a transfer of resources into the traded goods sector of the economy, Mr. Massé considered. Fiscal and monetary policies designed to manage domestic absorption and increase domestic savings must be followed, and they would need to be supplemented by structural reforms, including the pursuit of appropriate exchange rates, flexible domestic pricing policies, and measures to improve the quality of domestic investment. Of course, developing countries' efforts toward adjustment must be aided to the fullest by adequate flows of external financing.

The view of the global economy provided by the staff was rather guarded, Mr. Massé noted. His own feeling was that there was room for optimism, particularly with respect to the medium term. Discussions among the major industrial countries had already helped to improve policy coordination. Moreover, all countries must use every opportunity to encourage one another at a time when the need for policy coordination was only beginning to be recognized as important not only to the industrial countries but also to the rest of the world to which those countries were linked. The Fund also had an essential role to play in the effort, since rules and criteria common to individual countries would have to be developed and eventually put into place. In that regard, the staff papers indicated that a methodology was being developed that would reveal the interrelationships between the policies of various groups of countries and the results in other groups of countries. While every set of results would be transitory, their reproduction year after year would confirm the links between countries and would allow reference to those relationships in more quantifiable terms. During the next few weeks, Executive Directors would have an opportunity to take decisions on providing resources to developing countries under the structural adjustment facility and on improving the overall management of international liquidity. He was looking forward to those discussions and decisions as part of the long road toward adapting international institutions to deal with the changing environment.

The Executive Directors agreed to resume their discussion in the afternoon.

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/86/48 (3/20/86) and EBM/86/49 (3/21/86).

2. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 85/85 and 85/86 are approved. (EBD/86/73, 3/14/86)

Adopted March 20, 1986

APPROVED: November 26, 1986

LEO VAN HOUTVEN
Secretary