INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/50

3:00 p.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	
H. Fujino	M. Sugita
G. Grosche	
Huang F.	
	Jaafar A.
A. Kafka	
T. P. Lankester	H. Foot
	H. Fugmann
M. Massé	
	A. Abdallah
	S. M. Hassan, Temporary
F. L. Nebbia	
Y. A. Nimatallah	
	G. Ortiz
H. Ploix	
J. J. Polak	J. de Beaufort Wijnholds
C. R. Rye	A. V. Romuáldez
G. Salehkhou	O. Kabbaj
A. K. Sengupta	A. S. Jayawardena
	N. Coumbis

L. Van Houtven, Secretary
S. L. Yeager, Assistant

Also Present

Asian Department: U. Baumgartner. European Department: P. 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: W. E. Holder, R. Munzberg. Middle Eastern Department: 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, J. M. Boughton, M. C. Deppler, P. R. Fenton, S. J. A. Gorne, P. Gotur, J. P. Horne, O. E. G. Johnson, A. Lanyi, F. Larsen, D. J. Mathieson, P. R. Masson, S. Takagi, M. C. Williamson. Western Hemisphere Department: S. T. Beza, Associate Director; M. Caiola. 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, J. Hospedales, H.-S. Lee, G. Nguyen, P. Péterfalvy, I. Puro, Song G., A. Steinberg, D. C. Templeman, A. Vasudevan. Assistants to Executive Directors: H. Alaoui-Abdallaoui, J. R. N. Almeida, A. Bertuch-Samuels, B. Bogdanovic, J. de la Herrán, F. Di Mauro, V. Govindarajan, G. D. Hodgson, L. Hubloue, S. King, H. Kobayashi, M. Lundsager, K. Murakami, M. Rasyid, J. Reddy, J. E. Rodríguez, C. A. Salinas, L. Tornetta, A. J. Tregilgas, H. van der Burg, E. L. Walker.

1. WORLD ECONOMIC OUTLOOK

The Executive Directors continued from the previous meeting (EBM/86/49, 3/21/86) their consideration of 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. Lankester observed that the staff had prepared a large volume of high-quality material for the present discussion. The paper on policy interactions in the industrial economies was particularly helpful in highlighting the problems associated with current policies and identifying the pros and cons of various alternative approaches to improving multilateral surveillance.

Developments since the September 1985 world economic outlook discussions (EBM/85/143 and EBM/85/144, 9/16/85; and EBM/85/145, 9/18/85) had, on balance, been favorable, Mr. Lankester continued. Although overall growth in the industrial countries in 1985 had been somewhat disappointing, the slowdown mainly reflected a return to more sustainable rates of growth in the United States, and in that respect could be seen as inevitable. Elsewhere, growth had continued at a steady pace. His authorities could support the staff's conclusion that general prospects continued to be good for steady growth over the foreseeable future and had brightened somewhat as a result of lower oil prices. In some respects, his authorities believed that as a result of recent developments, the outlook might be slightly more favorable than the staff had suggested. Forecasts in the United Kingdom, which had been published earlier in the week, together with the U.K. budget statement, had been based on a $15 per barrel oil price and had shown a 3.5 percent rate of growth for the seven major economies with only a 2.5 percent rate of inflation in 1986.

Among the factors underlying a more optimistic outlook, the recent fall in interest rates should help to stimulate greater activity in the industrial countries while reducing the difficulties facing many of the major debtors, Mr. Lankester observed. As financial markets came to realize the extent to which the fight against inflation was being won, further declines in nominal interest rates should be possible. In that connection, the staff's assumption that interest rates in 1987 would remain unchanged from the previous forecasts, despite the recent improvement in the prospects for inflation, seemed to be rather pessimistic.

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

His authorities believed that the fall in the price of oil would also have significant overall benefits for the world economy, although it would have a negative impact on certain countries. Moreover, the realignment of the major currencies that had taken place in recent months should be of particular benefit, not least because it improved the prospects for broadly based and sustainable growth in the major industrial countries and, thus, improved the picture for exports from the less developed countries. And the fall in the value of the U.S. dollar should directly help many developing countries. For example, the depreciation of the dollar significantly reduced the debt ratio of the capital-importing developing countries. Finally, the strong performance of many of the major stock markets in recent months suggested that the overall level of confidence was fairly high. Of course, it was difficult to quantify the effects of those influences in making economic forecasts, and it was understandable that the staff should have avoided attempting to do so; but that did not reduce the potential significance of those factors.

The staff had properly recognized that there were risks to the latest scenario, including the possible resurgence of protectionist pressures and a too rapid further realignment of exchange rates, Mr. Lankester remarked. However, the staff had perhaps not sufficiently taken into account the benefits of recent developments. In general, the past year had seen some improvements in the prospects for greater policy coordination among the major countries, which had served as an important factor behind the high-level realignment of exchange rates. Also important was the strengthened commitment of the U.S. authorities to reducing their budget deficit. The process of fiscal consolidation in the United States would be difficult, and the staff had assumed that such consolidation would proceed at a slower pace than envisaged by the Gramm-Rudman-Hollings legislation. It was his hope that that assumption proved to be too pessimistic, because it was particularly important that progress be made over the coming fiscal year. The staff had argued that reducing the U.S. budget deficit might have some net adverse impact on economic activity in the short run, even allowing for some offsetting effects due to improved confidence and lower interest rates. In his view, the net impact, even in the short run, would be neutral or, as Mr. Polak had suggested, positive.

The Board had had an opportunity only recently to discuss the policies in Japan, and Mr. Fujino had provided more recent data showing strong growth in the fourth quarter of 1985, Mr. Lankester continued. However, there was some evidence of a possible temporary slowdown since that time, and his feeling was that the need for additional fiscal measures aimed at strengthening domestic demand could not be ruled out. In Germany, and in light of Mr. Grosche's relatively optimistic assessment of the German economy, he agreed with the staff that the best course of action for the authorities would be to review the stance of policy later in the year in the light of the outlook at that time for growth and activity. He agreed with Mr. Grosche that structural problems--particularly labor market rigidities--remained a major problem in Europe. Given the high unemployment rate in his own country, the U.K. authorities were particularly conscious of the problem of those rigidities and, in the budget announced earlier in the week, the Chancellor of the Exchequer had described new initiatives aimed at achieving greater wage flexibility and making wages more responsive to profitability.

The fall in the price of oil would not only improve the outlook for growth and inflation, it would also give governments room for improving the fiscal position by raising taxes on petroleum products, Mr. Lankester considered. Where fiscal deficits remained unsustainable, that opportunity would no doubt be welcomed. In other cases, however, governments might wish to allow most, if not all, of the benefits of lower oil prices to be passed on to consumers, an approach that had been adopted in the United Kingdom and announced in the latest budget. Despite the impact of lower oil prices on government revenue, the U.K. fiscal position had turned out more favorably than had been expected by many outside observers, partly as a result of buoyant non-oil revenues, which reflected continued growth in the economy and which were expected to be about 3 percent of GNP again in 1986. In the circumstances, the Chancellor of the Exchequer had been able to reduce the forecast for public sector borrowing requirements for the coming fiscal year from £7.5 billion to £7 billion while indexing personal tax allowances and reducing the basic rate of tax to 29 percent. In response to the budget, U.K. commercial bank interest rates had fallen by 1 percentage point. The benefits of lower oil prices had been passed through mainly to consumers as the duty on gasoline had been increased by only a relatively small margin above that required to keep pace with inflation. It was to be hoped that other countries with a reasonable fiscal position would follow a similar path.

While the position in the industrial countries had improved, some developing countries continued to face difficult external circumstances, although the extent and nature of those circumstances varied considerably from country to country, Mr. Lankester remarked. While the debt situation would be considered by Directors at a forthcoming meeting, the problems of the developing countries were deserving of one or two remarks at the present meeting. Recent developments would, on balance, have a positive effect on developing countries as a whole, although their overall situation would remain difficult. He agreed with Mr. Massé that prudent demand policies were nonetheless needed and should be accompanied by measures to promote growth. As Mr. Massé had observed, not enough had been done to stimulate domestic saving and productive investment over the past year in the developing debtor countries, despite the benefits that could result from such efforts. In addition, external financing was needed if debtor countries were to achieve a return to creditworthiness, combined with some improvement in per capita consumption. It was disappointing that the staff projections showed a negative net borrowing from commercial banks by the heavily indebted countries in both 1986 and 1987.

The agreement on exchange rates by the Group of Five countries and the debt initiative put forward by the U.S. Treasury Secretary both represented significant attempts to improve international policy coordination, Mr. Lankester considered. Further steps were needed to increase the degree to which the international implications of domestic policies were taken into account. In particular, in formulating budget policies, countries must take account of the global impact of those policies on real interest rates and external flows. The Fund had an important role to play in multilateral surveillance and might be called upon to play an even greater role in future.

The steady growth of the world economy was continuing, and recent developments suggested that that growth would strengthen in the coming months and should be sustainable, Mr. Lankester remarked. Furthermore, the major industrial countries seemed much closer to achieving their goal of destroying inflationary expectations than they had been only one year previously. As inflation was overcome, it was to be hoped that nominal interest rates would decline further and that real interest rates would fall toward historic levels. In general, while much remained to be done to improve economic policies, the climate for such improvement was favorable.

Mr. Dallara stated that he welcomed the additional effort that had been devoted in the staff analysis to such subjects as the interaction of policies in industrial countries and the labor market situation in both the industrial and developing countries. The bulk of the analysis was insightful and useful, although he had some serious difficulties with certain aspects of it, particularly the analysis relating to the short- and medium-term effects of reductions in the U.S. budget deficit on both the U.S. and the world economy.

The present discussion on the world economic outlook was a key element in the overall surveillance effort and, in that regard, he reiterated a suggestion made during the recent Board discussions on surveillance (EBM/86/29 and EBM/86/30, 2/19/86) that some consideration be given to devoting a full day in the Executive Board to a paper, perhaps similar to that provided for the present discussion, focusing on policy interactions among industrial countries, Mr. Dallara continued. He also recalled his earlier suggestion that a separate paper be prepared focusing on the policy interactions among the 10-15 major developing countries. He continued to believe that the idea was worth exploring, although he recognized that it might present some practical difficulties by extending to possibly three full days the period that must be devoted in the Board to the world economic outlook. He hoped that ways could be found to overcome such difficulties and that consideration would be given to implementing his suggestions.

Central to the present discussion was the persistence of external imbalances among industrial countries and the prospect of a reduction in the U.S. fiscal deficit, Mr. Dallara commented. There was a clear need for international cooperation to achieve sustainable low-inflation growth in the medium term, particularly among the major industrial countries. For 1986, the staff had projected a U.S. current account deficit equivalent to $114 billion, or approximately the same level as in 1985. For 1987, the deficit was projected to be reduced only modestly to about $110 billion. At the same time, the Japanese current account surplus was projected to increase from $48 billion to $72 billion, with only a modest decline foreseen in 1987 to $62 billion. For Germany, the staff had projected an approximate doubling of the current account surplus in 1986--from $13 billion to $26 billion--with a modest decline to $20 billion in 1987. It was clear that the surpluses for Japan and Germany were expected to be larger in 1987 than in 1985, whether based on Fund staff forecasts or those by Japan and Germany. The growth forecasts suggested that in 1986, the U.S. economy would grow at a rate of nearly 3 percent, the Japanese economy would grow at close to the same rate, and the German economy would grow at a rate of 3.7 percent. For 1987, the forecast was for a growth rate of 3.7 percent in the United States, 3.2 percent in Japan, and 2.7 percent in Germany.

Assuming that the relationship between those forecasts could be accepted, even if there might be some differences of view about the specific numbers, and if there was a sense that exchange rates might have provided the bulk of the adjustment of external imbalances that they ought to provide, at least for the time being, then one must look to differences in absorption and growth between economies to reduce imbalances further, Mr. Dallara continued. Unfortunately, the growth rates he had noted were not likely to significantly reduce imbalances much further. Indeed, U.S. Treasury forecasts suggested that the current account deficit would increase in 1988 by about $30 billion--from $100 billion to $130 billion--and while it might be possible to reduce those figures by, say, another $5 billion, that kind of reversal in the U.S. current account position in 1988 might not be in the interest of the global economy. Against that backdrop, he would make his comments on the latest world economic outlook.

Recent economic policy initiatives and two uncertainties related to the fall in oil prices and exchange rate developments and prospects were particularly deserving of attention, Mr. Dallara observed. In September 1985, the Ministers of Finance and Central Bank Governors of the Group of Five countries had reviewed the convergence of favorable economic performance under way among their economies that had been influenced by policy initiatives undertaken in their countries as well as by more favorable economic performance elsewhere. Moreover, each of the countries represented at that meeting was committed to implementing further policy measures to reinforce convergence and strengthen the sustainability of the current expansion. Among those commitments was to be a continued effort by the United States to reduce government expenditures as a share of GNP in order to reduce the fiscal deficit. In addition, multilateral commitments were made pertaining to, inter alia, the need to resist protectionist pressures.

The uncertainties relating to recent oil price and substantial exchange rates movements involved not only their direction and extent but also the nature and pace of their impact on the world economy, Mr. Dallara continued. On balance, both developments offered promising opportunities for sustainable world economic growth and for a reduction in external imbalances. While a durable downward trend in the price of oil obviously could be expected to help growth, volatile price movements resulting from abrupt policy changes by cartel members might have undesirable disruptive effects in the short run, particularly for certain exporters. In that regard, he had taken note of Mr. Finaish's earlier questions concerning oil exporters and the compensatory financing facility. Among the points mentioned by Mr. Finaish was the temporariness associated with current shortfalls. Another point to be remembered, in his view, was the test of whether any shortfall was due to circumstances largely beyond the member's control.

Remarking on U.S. policies and prospects, Mr. Dallara said that the Gramm-Rudman-Hollings Act was expected to make a major contribution to sustainable growth. That Act, which mandated that the Federal deficit be cut in specific steps toward the achievement of balance by 1991, had set specific procedures for meeting targets should the Congress and the Administration fail to agree on an alternative formula for meeting those targets. A Federal court had recently ruled that one of the Act's procedural provisions was unconstitutional, and the Supreme Court was expected to meet on the same issue in early July. Of course, specific fallback provisions had been incorporated in the Act, but it was unclear at present how significant an adverse decision by the Supreme Court would be. The point to be remembered about the Gramm-Rudman-Hollings Act was that Congress had passed it, the President had signed it, and both the Administration and the Congress were on record as intending to take action to cut the deficit on a sustained basis. Clearly, each side might have somewhat different views about precisely how the deficit reduction should be achieved, but there was a growing consensus that significant and lasting reductions must be achieved.

For FY 1986, expected spending cuts of about $12 billion, together with other developments, were expected to reduce the deficit to approximately $203 billion, which would represent an actual reduction from the level of the deficit in FY 1985, Mr. Dallara added. The term "reduction" had been interpreted in many ways in the U.S. Government in the past few years, and he was pleased to see that actual reductions in the deficit were being projected in nominal terms that were significant in terms of GNP. For FY 1987, the budget deficit must be reduced to $144 billion, or approximately 3.2 percent of GNP. There had already been a sharp downward adjustment in the current services budget projections of both the Office of Management and Budget and the Congressional Budget Office from one year previously, with both estimates leading to deficits of slightly more than $100 billion in 1991, compared with estimates 12 months earlier ranging from $200 billion to $300 billion. Those new estimates did not take account of the Gramm-Rudman-Hollings legislation but reflected a variety of factors, including prior actions by the Administration and the Congress, some definitional changes in the baseline projections for defense expenditures, and some economic developments, including interest rate declines. All of those developments and actions seemed to suggest that the outlook for reducing the fiscal deficit had clearly improved. His authorities believed that reductions along the lines projected were in the interests of the United States and other economies and were consistent with a strengthening of growth in the short and medium term. They had also thought that a general consensus existed among the international community that a reduction in the U.S. fiscal deficit was consistent in the short and medium term with sustaining and expanding world economic activity. In that respect, he had been somewhat disheartened by comments in the staff papers and from some of his colleagues, particularly Mr. Massé.

The staff papers concluded that a reduction in the U.S. deficit would result in a withdrawal of fiscal stimulus and, in the short term, would reduce domestic demand and overall growth, Mr. Dallara observed. He believed that conclusion to be basically incorrect or, at best, significantly exaggerated. Indeed, the staff seemed to be arguing that in both the short and the medium run--at least through 1991--the effects of the reduction in the U.S. budget deficit on growth in the United States and abroad would be negative. In that regard, he recalled that the staff appraisal in the report for the most recent Article IV consultation with the United States (SM/85/199, 7/8/85) stated that "A reduction in the absorption of saving by the Federal Government would provide the best way to alleviate the domestic and international pressures generated by the large disparity between domestic saving and investment in the United States. Such a reduction should lead to a lasting decline in U.S. interest rates, which would improve the prospects for capital formation and long-term growth in the United States and abroad...."Even if there were to be some short-term impact on domestic demand, he firmly believed that the flexible U.S. economy could promptly facilitate the shift in demand from the Federal Government to the private sector and that the resulting increases in efficiency could sustain overall U.S. growth. In that regard, he tended to agree with Mr. Polak's suggestion that the lags seemed to be going in the other direction and that congratulations were being handed out for the great progress made in dealing with the budget deficit that had not in fact yet occurred. Still, the markets had already begun to react in a positive way, and he recognized that the staff was dealing with a complex wealth of information and was basing projections on various models that might not always fully take into account the psychological effects of developments on market expectations. But those analytical issues had not been clearly brought out in the staff papers, and he was somewhat concerned that his authorities might gain from the papers a sense that a reduction in the U.S. budget deficit in the short and medium term might not be all that appropriate. In particular, the models underpinning the staff's analysis might not have taken fully into account the positive effects on interest rates and inflationary expectations of a reduction in the deficit as well as the effects that such a reduction might have on the environment within which investment and other business and consumption decisions were made within the U.S. economy.

Monetary policy in the United States continued to be aimed at price stability consistent with sustained growth, and monetary targets announced for 1986 were in line with that goal, Mr. Dallara said. In 1985, the broader monetary aggregates, M2 and M3, had remained generally within the ranges targeted at the beginning of the year. However, M1 had grown persistently above the established ranges, a growth that had been accompanied by a sizable decline in M1 velocity, which suggested that high M1 growth in 1985 did not imply the same inflationary potential as in the past, at least in the near term. For 1986, taking into account the greater uncertainty surrounding M1 and economic activity and prices, a relatively broad M1 target range had been established of 3 percent to 8 percent. In the meantime, the absence of perceptible price pressures, partly reflecting the effects of the drop in oil prices, had precipitated the downward movement of interest rates at the same time that the dollar value had been moving downward. That decline in interest rates clearly had favorable implications for growth in the United States and abroad, although it should not be seen as suggesting any relaxation in the authorities' determination to remain mindful of inflationary dangers in the U.S. economy.

The outlook for the U.S. economy in 1986 suggested a strengthening in the pace of economic activity, Mr. Dallara commented. Employment had risen by an average of nearly 295,000 persons per month in the past four months, compared with an average of 247,000 persons per month in the preceding ten months. Short-term interest rates were clearly lower than in 1985, and long-term rates were some 3 percentage points lower than they had been in the previous year. Those reductions in rates should help to stimulate interest-sensitive sectors of the economy. The authorities' forecast for GNP growth from the fourth quarter of 1985 to the fourth quarter of 1986 was 4 percent, notwithstanding the admittedly disappointing growth rate of less than 1 percent in the final quarter of 1985. Moreover, the authorities expected an increase in employment by 1.7 million jobs and an inflation rate close to 4 percent. It was worth noting that the slowdown in real growth in the past 18 months had been largely an inventory phenomenon, with real final sales having risen in the range of 3.5 percent to 4.5 percent during each of the 3 years of the current expansion. Although private forecasters had been estimating GNP growth in 1986 at somewhat lower than 4 percent, a number of those estimates were being revised upward, particularly in light of the more recent oil price and interest rate developments. Furthermore, the authorities expected a current account deficit in the range of $125 billion, or $20 billion lower than the estimate only a few months previously. For 1987, a further decline was expected, leaving the deficit in the range of $90 billion to $95 billion. The current account outlook was heavily dependent upon assumptions relating to growth at home and abroad as well as to exchange rate movements. In that respect, the authorities had assumed a continution of current exchange rate levels and had used their own internal growth forecasts for the United States' and other economies. Unfortunately, the implication was that the relative growth rate tendencies among the major industrial countries might at present be running counter to the desired path, if satisfactory adjustment of current account balances was to proceed successfully, since the U.S. growth rate in 1986 and 1987 might modestly exceed that in most other industrial countries. Indeed, allowing for a somewhat lower figure for growth in the United States, the growth rates of the major industrial countries were unlikely to play the role that might be hoped in reducing those imbalances. The answer clearly was not lower U.S. economic growth and absorption.

The Fund staff expected the reduction in the U.S. fiscal deficit to have the effect of reducing demand in the United States and in the world economy and had suggested that other industrial countries might need to take action to sustain demand, Mr. Dallara remarked. Staff analysis relied on the supposed link between the U.S. fiscal deficit and interest and exchange rates. As he had noted on a number of occasions, his authorities had some doubts about the firmness of that link. That having been said, he found some striking asymmetry in the analysis in the latest and earlier world economic outlook papers. In the past, the staff had advised that the rising U.S. budget deficit and current account deficits had been contributing to slower growth abroad, particularly since financing of the deficits had pre-empted an unduly large share of global savings and sound investment opportunities and had had adverse effects on interest rates abroad. That was not to imply that earlier analyses had not acknowledged the contribution to growth abroad stemming from the substantial rise in U.S. imports; but there clearly had been a sense that the budget deficit had been a real threat to growth. More recently, the staff had said that reducing the budget deficit through 1991 was likely to slow growth abroad. In addition, in connection with earlier advice that rising oil prices hurt growth and inflation, the staff was currently suggesting that while there might be a slowdown in the oil price decline, the economic effects of the slowdown were minimal. His view was that the rapid fall in local currency costs of oil in Europe and Japan, both through the oil price and exchange rate effects, offered important opportunities in terms of reducing inflation and promoting real growth. The oil price declines were enabling a major currency depreciation to be absorbed with less inflationary impact than might have otherwise been the case.

He fully agreed with the staff on the need for strong growth performance in other industrial countries, quite apart from any presumptions of a slowdown in U.S. economic activity, Mr. Dallara said. The staff had focused to some extent on fiscal policy in other countries as offering some potential for sustaining aggregate demand. A properly cautionary note had been sounded about the continued need over the medium term for industrial countries generally to release resources currently employed in the public sector for private use, to maintain fiscal flexibility in the face of high public debt, and to anticipate the effects on future fiscal accounts of demographic developments. Nonetheless, the possibility for some flexibility in fiscal policies in current circumstances had been enhanced as a result of recent developments, including the recent decline in interest rates, as well as past successes in containing inflation. The need for action to support economic growth in other industrial countries had been apparent long before the latest appreciation of several currencies against the dollar. Further declines in the oil price and in the dollar value in recent weeks had perhaps reinforced that need. As he saw it, if world economic growth was to benefit from the oil price decline, the income gains must be passed through to the private sector in order to facilitate the growth of investment and consumption, and those gains must not be pre-empted by tax increases.

He had been interested in hearing a number of Directors use the occasion of the world economic outlook discussion to make some general comments about the functioning of the international monetary system, Mr. Dallara remarked. Like others, he believed that the world economic outlook exercise was an important part of the surveillance process. Moreover, in general, there had been a direct inverse correlation between the perceived effectiveness of surveillance over the past few years and the apparent growing interest in some quarters in a more systematic form of surveillance. He presumed that those who were not enamoured of a more systematic system, might have a particular interest in ensuring that the present structure of surveillance was made more effective. In that connection, he had been concerned at the indication by Mr. Fujino that there was no scope for an early relaxation of Japan's fiscal consolidation effort. He was not of course suggesting that fiscal stimulus should be pursued by Japan through an increase in central government expenditures, but he joined Mr. Massé in noting that it should be possible for some local governments and public enterprises to increase expenditures for investment purposes; and tax cuts should also be possible in anticipation of tax reform, as should the pass through to consumers of the benefits of a lower oil price. Over the longer term, it was to be hoped that the proposed tax reform and policy action on other laws and practices that tended to foster a savings/consumption imbalance in Japan would address that issue, and he urged the Japanese authorities to consider some of the suggestions that had been raised. While he had some reservations about the proposition that Japan should continue the process of medium-term fiscal consolidation, he could support the thoughts on that matter captured in the Chairman's summing up of the recent Article IV consultation with Japan (EBM/86/43, 3/10/86). It was to be hoped that consideration would be given to other policy areas, including structural policy changes, to support expanded activity in Japan. The question of how the external imbalances between the United States and Japan would be addressed must also be answered, and he would appreciate any comment Mr. Fujino might have on that matter.

Economic growth prospects in Germany in 1986 were not expected to be tied closely to recent oil and exchange rate developments, and the margin for fiscal action beyond the tax cuts already adopted was not clear, although his authorities continued to believe that some margin for further fiscal action remained, Mr. Dallara said. In any event, the oil price decline, which coincided with signs of European economic recovery, offered a good opportunity to strengthen growth in Germany with favorable spillover effects elsewhere in Europe. In that respect, he appreciated Mr. Grosche's continued emphasis on the need for further actions in Japan and Germany to deal with labor market rigidities. He was not entirely certain how to interpret Mr. Grosche's indication that additional fiscal stimulus would not be appropriate; while he could accept that additional central government expenditures might not be appropriate, he hoped that other avenues of stimulus, including further tax cuts, were not being ruled out. The comment that there was only limited scope in Germany for monetary flexibility was an interesting one and could, as others had noted, be interpreted in two ways. One interpretation relied on the assumption that the pursuit of the present course of monetary policy in current circumstances inherently made that policy more flexible, which could imply scope for further interest rate declines. The other interpretation was that pursuit of the present monetary policy might be adjusted in light of current circumstances that might preclude further interest rate declines. He would appreciate clarification from Mr. Grosche on that matter.

The external imbalances among the industrial countries were expected to remain large in 1986 and 1987, and the extent of growth in those imbalances in Japan and Germany was perhaps not widely recognized, Mr. Dallara considered. The initial adverse J-curve effects, of course, were unavoidable. At the same time, growth in other industrial countries would be essential if a lasting reduction in the external imbalances was to be achieved. And prompt action was also essential since, in the absence of faster reductions in the external imbalances, protectionist pressures in the United States could be expected to rise and there might be a reversal in the trend toward a reduction in the U.S. current account deficit, which could pose even more serious dangers.

It was difficult to make generalizations about current developments and prospects in the developing countries at present, Mr. Dallara observed. In 1985, a moderate 3 percent growth rate for the developing countries as a whole had masked a small decline for the fuel exporters and a favorable growth rate of about 4.7 percent for other developing countries. He had not sensed in the comments of some Directors an appreciation of the fact that growth on the whole for nonfuel exporting developing countries had been substantial. Prospects for employment and unemployment in the developing countries remained unclear, and he welcomed the information contained in the staff paper on labor markets in the developing countries. However, the continued scarcity of data on labor markets must surely be an impediment to policy formulations in these countries. The rapid rate of inflation in those countries continued to be cause for concern; in an inflationary environment, it was difficult to believe that domestic savings could be mobilized adequately and that productive investment could be planned and realized. Some cause for greater optimism could be drawn from the dramatic action taken by several high-inflation countries during the past year--notably Argentina, Bolivia, Israel, and Brazil. The measures taken by those countries could be helpful in turning around inflationary expectations, and there were clear signs in each of the countries that some success toward that end had been achieved. A durable reduction in inflation would be possible only if governments retained their credibility and followed complementary actions to restrain demand and increase supply. After the sharp drop in the current account deficits of developing countries in 1983 and 1984, there had been little change in 1985, as the size of the deficit had continued to be limited generally by financing constraints. Of course, the financing constraint itself was to an extent a reflection of foreign creditors' and investors' assessments of economic policies in the debtor countries. Concentration by those countries on mobilizing domestic resources for export and investment growth mainly through private sector initiative, with the help and guidance of structural reforms, offered in his view the best assurance of economic recovery and increased access to foreign capital. Those relationships were at the heart of the debt initiative recently outlined by the U.S. Secretary of the Treasury.

The projections for the medium-term outlook might have been more realistic if the staff had taken as its baseline assumption a balanced budget in the United States by 1991, Mr. Dallara remarked. He did not believe that the reduction in the U.S. fiscal deficit would adversely affect the rate of economic growth in the United States, particularly for the longer term. Thus, the baseline scenario was far too pessimistic. While he continued to support the publication of the staff papers on the world economic outlook, he noted that because there might possibly be adverse reactions to the conclusions of the present study, its publication must be considered carefully.

Another assumption in the medium-term forecast that seemed to be rather pessimistic concerned the level of real interest rates, Mr. Dallara continued. Table 8 in the general survey paper showed a real six-month London interbank borrowing rate of 4.2 percent on average for the period 1988-91. In his view, that rate was clearly on the high side. Particularly in light of recent developments in inflation and inflationary expectations, it did not seem likely that real rates would remain at that level. Also, like Mr. Polak, he would have preferred to see a more complete forecast over the medium term of relative growth and current account balances among the industrial countries. In particular, increased attention should be given to the savings/consumption imbalance in Japan. Until Japan's high domestic savings rate was reduced, it would be difficult for the current account imbalance to fall in the context of adequate domestic growth. It was difficult to avoid the conclusion that the high savings rate in Japan had given a major impetus to capital outflows, to the weakness of the yen in recent years, and to Japan's large current account surpluses. The solution to those imbalances would certainly depend upon the adequate growth of personal income, the reduction in exceptional incentives to savings, and the removal of impediments to import growth.

For 1987 and beyond, he was concerned that an economic growth gap might persist between the United States and other industrial countries that would make further reduction of external imbalances more difficult, Mr. Dallara indicated. That gap underscored the need to address the savings and consumption imbalance as well as some of the structural rigidities in Europe, which remained in spite of the efforts under way in many countries to tackle them.

On the differences in employment behavior among industrial countries, Mr. Dallara observed that there had not been a significant break in European wage behavior recently. At the least, one could not assume that the recent slowdown in the growth of real wages would continue if unemployment were significantly reduced. If unemployment was of the classical variety, then increased demand could result in adverse inflationary and balance of payments effects rather than in job creation. Hence, a combination of measures to contain the rise in real labor costs and to improve the functioning of labor markets would appear to offer the best prospect for success. Complementary actions might be considered, including a reduction in the gap between labor costs and take-home pay of workers, a re-examination of tax and other incentives for capital-intensive investment, a reduction in replacement ratios between wage income and income-support payments to the unemployed, possible changes in labor tenure laws and practices to enhance labor mobility, some skill upgrading through training, and measures to facilitate worker relocation.

For the developing countries, economic growth in the period 1988-91 was expected to be at a fairly satisfactory level in the aggregate--at 4.8 percent--and the ratio of debt to exports and the debt service ratios would fall fairly substantially by 1991, Mr. Dallara observed. However, the medium-term outlook was not fully satisfactory; indeed, the forecasts lent credence to the need for strong actions of the sort outlined in the U.S. debt initiative. Particularly noteworthy was the likely impact on developing countries of growth changes in the industrial countries and the risks of additional borrowing by developing countries without either a more favorable global economic environment or better economic policies in the developing countries.

Notwithstanding the uncertainties and risks that lay ahead and the difficulties that all countries, including his own, would experience in pursuing sound macroeconomic policies and structural reforms, the international community had made important strides in recent months, Mr. Dallara concluded. Closer convergence of economic performance among the industrial countries and closer economic policy coordination was already under way. Members had embarked on a collaborative effort to strengthen the debt strategy and to promote higher rates of economic growth in developing countries on the basis of reinforced macroeconomic and structural policies, together with external financing. Discussions were under way to improve the functioning of the international monetary system and, in that respect, he hoped that the new facility to be financed in part by reflows from the Trust Fund would serve as an important avenue for facilitating higher and sustained levels of growth in low-income countries. Despite the persistence of strong protectionist pressures in industrial and developing countries alike, most governments seemed to be resisting those pressures; and the prospect for a new round of multilateral trade negotiations offered an opportunity to preserve and expand the system of open markets for world trade from which all countries had benefited.

Mr. Nimatallah recalled that Mr. Dallara had characterized certain oil exporting countries as members of a "cartel," a word that carried some unfortunate connotations. In particular, Mr. Dallara had indicated that abrupt policy changes by "cartel" members might have undesirable disruptive effects in the short run. It should be noted that Saudi Arabia and other OPEC members had found themselves unable to carry the burden of stabilizing prices although they had certainly attempted to do so, and it was perhaps not fair to characterize their action under pressure from others as an abrupt policy change.

Mr. Fujino observed that the latest growth figures for Japan showed that growth in the fourth quarter of 1985 had been almost entirely supported by domestic demand growth. So long as such demand growth existed, there seemed to be little scope for additional policy measures of the sort suggested by Mr. Dallara. Moreover, as he had mentioned earlier, fiscal management was already quite flexible in Japan, although it was important to maintain the basic fiscal stance over the medium term. There was already strong pressure domestically for a relaxation of the fiscal consolidation stance.

Mr. Ortiz said that he wished to make explicit the support of his authorities for the views expressed by Mr. Dallara and other speakers that the benefits of the oil price reduction should be passed through to the private sector.

Mr. Grosche, clarifying a point raised earlier, recalled that the Fund staff seemed to be saying that there was large scope for maneuver in monetary policy in Germany. As he had already noted, the central bank, in establishing the monetary target for 1986, had provided sufficient room for a strong output growth. The effects of the oil price decline on inflation should enhance the flexibility of monetary policy even further and should assist his authorities in their intention to reduce interest rates as far as possible.

Mr. Salehkhou remarked that he had long been troubled by the use of catch phrases to describe certain groups, because those phrases that gained acceptance through public use always seemed to connote a positive or negative prejudgment about the group being described. For example, at the first hint that debtor countries planned to get together as a group, the term "debt cartel" had been applied to the as yet unformed group, with all its negative connotations. But when the commercial banks decided to get together on the debt question, they had been called an advisory committee. Like Mr. Nimatallah, he found it unfortunate that OPEC was being referred to as a cartel.

Turning to the staff papers on the world economic outlook, Mr. Salehkhou remarked that realism, particularly in the context of the world economic outlook projections, was relative and subject to a set of given conditions and an assumed environment. The staff had appropriately emphasized that "private market responses to government policy initiatives can differ from those predicted by economic models..."and that changes in policies and conditions could invalidate the economic projections of a given scenario. It followed that under the scenarios provided by the staff, while the degree of realism of projections depended on the plausibility of the assumptions and the reasonableness of the underlying model, the outcome was primarily subject to the policy stance of the participants. Hence, even presuming a certain degree of plausibility and reasonableness for the staff's assumptions and models, it remained to be seen whether the domestic and external macroeconomic policy stances of industrial countries would actually lead to coordinated and sustainable international economic policies. In that regard, much had been made of the recent U.S. legislative effort aimed at reducing the federal deficit, which was supposed to improve confidence in the industrial countries and lead to an increase in the resources available to developing nations. He wondered why the reduction of capital inflows into the United States should be expected to increase lending to developing countries when there was a strong demand for increased savings in Western European economies? Moreover, a reduction in capital imports into the United States could be seen as the consequence of a lower real rate of interest and lower dollar value rather than the result of a responsible fiscal policy action. The latter reduced the rate of return, whereas the former reduced the value of dollar-denominated assets held by foreigners, thus reducing capital exports to the United States. Moreover, the lower price of oil should further strengthen reductions in capital exports to the United States. In its papers the staff had been surprisingly silent on those relationships, which could seriously threaten the objectives of a legislated mandate for deficit reduction in the United States. The staff had also been silent on the impact of reductions in capital imports to the United States on other industrial economies that could easily absorb any reduction in capital exports to the United States, thus casting doubts on the plausibility of the assumption that a reduction in capital exports would increase lending to developing countries.

Since the need for increased savings was always emphasized by the staff, it was surprising to note that the question of capital flight had not been adequately dealt with in the context of the major industrial countries' macroeconomic policies, Mr. Salehkhou remarked. Given the many studies on capital flight--including a recent article in the December 1985 edition of Staff Papers entitled "Foreign Borrowing and Capital Flight: A Formal Analysis"--and considering the magnitude of the problem, which was equivalent to more than $106 billion from only eight developing countries during the period 1974-82, it was only reasonable to expect that the world economic outlook exercise, as an instrument of multilateral surveillance, would offer a methodology and policy recommendations for dealing with the problem of capital flight in the main text rather than one of the supplements.

Remarking on U.S. economic policies, Mr. Salehkhou noted the medium-term risks of easier monetary and fiscal policies, particularly in view of the recent reduction in interest rates, the decline in the value of the dollar, expected increases in exports, and, most important, the sharp decline in the price of oil. The effects of those factors on growth and possible overheating of the U.S. economy could indeed undermine monetary and fiscal policies in the medium term. Given the staff's assumptions regarding macroeconomic policies in industrial countries in general, and the impact of lower oil and commodity prices, both in terms of reducing inflation and providing an impetus for increased aggregate demand on the economies of the industrial countries, it was ironic that lower oil and other commodity prices were expected to compensate for the dampening effects of policies aimed at reducing the deficits. The implication was, as always, that the developing countries would bear the brunt of both the recession and the recovery in the industrial countries. He asked for the staff's views on these questions.

More specifically, on policies in industrial countries, Mr. Salehkhou remarked, first, that since the actual implementation of the proposed reduction in the U.S. fiscal deficits had not been carried out and since the envisaged results were far from being realized, disruptions in the international economy would continue. In that regard, the fiscal policy stance of other industrial countries, especially those with substantial surpluses, was not clear. Moreover, the staff's cautious appraisal did not point to any particular initiatives to soften structural rigidities in most European industrial countries where, for example, persistent unemployment continued to be high. Third, by comparison with historical levels, and in view of present ratios of debt and debt service to GNP, real interest rates continued to be high. Fourth, protectionist policies continued to be pursued by industrial countries. Fifth, since the industrial countries had insisted that the gains to oil producing countries in the 1970s must be recycled through international institutions, it was only reasonable to expect that the converse must be insisted upon in present circumstances. The substantial savings currently being realized by industrial countries as a result of reduced oil prices should be recycled through the international institutions.

While appreciating the caution exercised by the staff in not projecting an unfavorable picture of the international economy in its reports, he was troubled by the fact that the policies of the major industrial countries in present circumstances were contributing to the imbalances and uncertainties in the global economy, Mr. Salehkhou said. Hence, he could not agree with the notion that the general stance of macroeconomic policy in industrial countries in 1986 was appropriate. So long as the imbalances continued to characterize industrial countries' economic policies, the appropriateness of the medium-term stance of those countries must be questioned.

During the 1985 discussion of the world economic outlook, he had outlined the difficult yet often untackled economic situation of most developing countries, and he had reiterated his view that policy recommendations to meet the developing countries' persistent problems were often unrealistically harsh or insufficient, Mr. Salehkhou recalled. As had often been stated by Directors in the Board, appropriate policies must be pursued in both industrial and developing countries alike. In the face of great internal and external obstacles, many developing countries had continuously committed themselves to either self-imposed or prescribed adjustment policies and programs. However, the character of those adjustments should be substantially modified to minimize recourse to measures that depressed the level of activity and to maximize the restructuring of the economy with a view to improving its performance within a reasonable time frame. As he saw it, the industrial countries had a vital role to play in formulating policies consistent with those objectives. The problems of developing countries could not be resolved, so long as falling commodity prices, large debt and debt servicing, high real interest rates, and stagnation or decline in exports prevail. Any realistic initiative toward long-term solutions for the problems of developing countries would require appropriate macroeconomic and open trading policies in the industrial countries that would promote a rate of growth of the value of imports from developing countries that was substantially higher than the nominal rate of interest. Conditions for adjustment policies and programs should be growth-oriented and forward-looking. It should be noted that the adverse effects of the recent significant fall in the price of oil would reach beyond fuel exporting developing countries per se. Declining oil prices were bound to adversely affect the flow of multilateral and bilateral assistance from those countries to other developing countries and could thus lead to a decline in output growth in the developing countries generally, a rise in unemployment, and a deterioration in world trade.

On the international coordination of economic policies among the major currency countries, Mr. Salehkhou considered that care should be taken to ensure that their exchange rate policies avoided volatile and unpredictable short-term exchange rate fluctuations that adversely affected developing countries. Divergent national policies among the industrial countries should be streamlined, and sound discipline and harmonious coordination in macroeconomic policies should be based on the recognition of exchange rate stability as an integral policy objective and not merely as a residual of policy formulations. Given the international character of the Fund and its surveillance function, the institution should participate actively in the determination and adoption of any exchange rate discipline and coordination among the major currency countries. In view of the most recent Board discussion on surveillance, the staff should understand that symmetrical and effective implementation of Fund surveillance did not necessarily call for the introduction of any new procedural arrangements. What was needed was political will and the commitment of major industrial countries to allow the Fund to carry out its mandate and to ensure that the principle of international policy consistency was observed at all times.

On a related matter, he could broadly support the position of the Group of Twenty-Four, which called for further study of the proposal on target zones, Mr. Salehkhou remarked. The Fund should be the primary instrument for the close monitoring and proper functioning of any exchange rate system. With regard to the functioning and improvement of the international monetary system, he associated himself with the views set forth in paragraphs 38-42 of the communiqué of the Ministers of the Group of Twenty-Four issued on March 6, 1986 at the conclusion of their meeting in Buenos Aires.

Mrs. Ploix noted the quality of the staff work on the world economic outlook exercise. However, the sheer volume of the papers had prevented her from taking full advantage of the thorough analyses contained therein, and she hoped that a way could be found in future to streamline the presentation, even if that meant greater elaboration on the papers in the course of Board meetings.

In assessing the world economic outlook, she was aware of the fragility of certain assumptions, Mrs. Ploix remarked. Since the previous discussion of the world economy, a number of international events and developments had made the present exercise more interesting and perhaps more difficult. Time would be needed to assess the implications of those developments thoroughly, although it was already clear that some of them had changed the outlook significantly. The staff had provided details on the various changes that had occurred, three of which deserved particular attention. First, the agreement reached in September 1985 among the Group of Five countries on the management of the exchange system had tended to eliminate many of the uncertainties on exchange matters. At the most recent meeting in London, the Group had reviewed exchange developments and had again emphasized the need to coordinate economic policies among the major industrial countries. In that respect, the recent and coordinated cut in discount rates was to be commended as was the expressed willingness to reduce inflation. It should be noted, however, that policy coordination and compatibility did not mean that all countries should necessarily follow the same policies.

Second, the renewed determination of the U.S. authorities to tackle their internal and external imbalances, mainly through a gradual reduction in the fiscal deficit, was welcome, Mrs. Ploix continued. The staff and the U.S. authorities differed in their projections on the final outcome of a deficit reduction, but it was clear that the United States had taken a step in the right direction. Finally, the sharp fall in oil prices had been unexpected and had occurred in the context of already depressed non-oil commodity prices. It was important that use of the surpluses created by the oil price decline did not contribute to further increasing the imbalances in the world economy.

Examining the conditions for a more balanced and sustained growth in the world economy, Mrs. Ploix observed that she would focus her comments on five points: developments in the oil markets, the management of financial surpluses, growth, employment, and the role of international organizations in current circumstances. Recent world oil price developments had had significant effects on the global economy and had created uncertainty not only for the energy sector, but also for the trading and financial sectors. In that regard, she was grateful for Mr. Finaish, Mr. Nimatallah, and others having pointed out ways of reducing that uncertainty.

The management of financial surpluses, namely, recycling, was certainly a matter for concern, Mrs. Ploix commented. An important implication of a reduction in the U.S. fiscal deficit was an increase in total domestic savings in the United States, thereby freeing financial resources for use by other countries. It was not clear whether the decline in oil prices would generate sufficient net savings in industrial countries to ease the financial constraints of the major debtor countries, or whether those savings would be directed toward countries where the situation had recently deteriorated. Even if adjustment was needed in the oil exporting countries, the availability of financing would contribute to an easing of the adjustment process. By the same token, countries that were not receiving sufficient capital inflows would have to reduce imports, which would affect export growth in the industrial countries. More generally, active consideration must be given to increasing lending flows to the developing countries, and, in that regard, the suggestions put forward by Mr. Sengupta on the occasion of the Board's discussion of the recent Article IV consultation with Japan (EBM/86/42 and EBM/86/43, 3/10/86) were worthy of further study.

Of particular importance was the need to promote growth and offer better prospects for trade, especially among the developing countries, Mrs. Ploix commented. The necessary policies aimed at tackling major imbalances in budgets and current accounts had been detailed by her colleagues. But she wondered how well oil-importing countries would use the greater room for maneuver afforded them. There was perhaps room for a voluntary release of constraints without jeopardizing the medium-term strategy, a point that had been stressed during the Board's discussion of the recent Article IV consultation with Japan and was likely to be repeated in the next discussion on Germany. Everything possible should be done to reinforce domestic demand in those countries that had adjusted their policies, particularly in view of the need to tackle the employment problem that was plaguing European economies.

Labor costs in some industrial countries were too high in relation to capital costs, and while no ready solution to the problem was available, she was somewhat uncomfortable with the staff's bias against incomes policy, particularly the statement that "on the whole, experience suggests that such social contracts are difficult to sustain," Mrs. Ploix remarked. Her authorities had been implementing such a policy over the previous few years with reasonable results, and a similar policy had met with success in Canada and, more recently, in the Netherlands. Nonetheless, she agreed that efforts should be made toward eliminating rigidities in labor markets, and she had been interested in Mr. Grosche's remarks on that matter.

The problem of unemployment in developing countries should perhaps not be dealt with in the same manner as in industrial countries, Mrs. Ploix said. The best contribution that the industrial countries could make to resolving that problem would be to resist protectionist pressures by promoting open trade, stabilizing commodity prices, and reinforcing technical and financial assistance. For their part, the developing countries should rationalize and further adjust their economies, reduce the import intensity of the growth process, and foster better conditions for the development of savings and investment. It was only in such a context that the necessary capital flows, including the repatriation of domestic savings invested abroad, could resume their natural path.

The role of the international organizations, particularly the Fund and the World Bank, in resolving the debt problem and encouraging a more dynamic world economy must be underlined, Mrs. Ploix stated. The debt problem was a central element of the world economic outlook exercise, which would be examined in the forthcoming discussion on the debt situation and strategy. At present, it was sufficient to reiterate the view of her authorities that a reinforcement of the financial resources of the Fund and World Bank was crucial if those institutions were to play a credible role in resolving the debt problem.

Mr. Huang noted that the world economic outlook papers presented short- and medium-term prospects for the world economy as well as a detailed analysis of major economic issues and their impact on global economic developments. The papers also focused on some major policy issues and on the need for improving overall global economic performance. One of the more important subjects was the short-term outlook for economic growth in the industrial and developing countries. The great divergence of views among economists on the outlook for economic growth in the industrial world in 1986 and 1987 was well known, although most observers agreed that economic performance in industrial countries would depend largely on developments in the United States. Some economists took a pessimistic view, emphasizing fiscal restraint and external deficits; while others were more optimistic, pointing to more favorable factors, such as the decline in oil prices, interest rates, and the value of the U.S. dollar. Taking both positive and negative effects into account, the Fund staff was suggesting that GNP in industrial countries would grow at a rate of 3 percent or only slightly faster in 1986 than in 1985 when GNP had grown at a rate of 2 3/4 percent. He considered that view to be cautious, but appropriate.

The recent sharp fall in oil prices and the decline in interest rates and the value of the U.S. dollar had caused some economists to expect a higher growth rate, Mr. Huang continued. In his view, those positive factors should not be exaggerated for several reasons. All of those factors could produce a stimulative effect on the economy only after time lags. In most cases, a drop in the oil price would not provide the stimulus to production and investment that a tax cut would provide because the oil price decline only transferred income from producers to consumers in the form of a transfer payment. Moreover, investment, employment, and output in the fuel sector would suffer from a sharp drop in oil prices, and a sharp drop in the value of the U.S. dollar would make all imported goods and materials in the United States more expensive, which in turn would give rise to inflationary expectations. Thus, there were no convincing reasons to expect a much greater growth rate for the industrial world in 1986.

Because the large U.S. deficit posed a major threat to international economic stability, any effort by the U.S. Congress and Administration to cut the deficit would be welcome, Mr. Huang remarked. If the U.S. authorities succeeded in considerably reducing the deficit, the initial impact on both domestic and global economic activity would be negative. In those circumstances, countries where output was below potential and where domestic investment fell short of savings could help offset that negative impact by making greater contribution toward supporting international demand through the application of expansionary policies. Japan and Germany would seem to fall into that category. In his view, the notion that Western Europe and Japan should or could assume a "locomotive" role in sustaining world economic growth warranted consideration by the governments concerned.

The economic imbalance between developing countries and the industrial countries was of greater importance than the imbalances in the industrial world, Mr. Huang considered. The oil exporting countries had been severely affected by the sharp drop in the price of oil, and the resulting savings to Western Europe amounted to approximately \$30 billion a year, with a savings of \$13.5 billion each accruing in the United States and in Japan. It was evident that such savings in the industrial countries arose at the expense of the oil exporting countries. While the oil importing developing countries would perhaps benefit somewhat from the oil price decline, they would also suffer from a fall in their exports to oil exporting countries. The rise in protectionism and the deterioration in the terms of trade had also imposed heavy losses on the developing countries. All those factors adversely affected the solvency of debtor countries and exacerbated the severe debt crisis, in spite of lower interest rates. The need for capital in the developing countries was obviously acute, and an excess of savings obviously existed in some major industrial countries. Large capital flows had been channeled into the United States but not toward countries that desperately needed them. Thus, it was reasonable to ask why the direction of capital flows was not changed through the establishment of new mechanisms and arrangements to correct the large economic imbalance between the developed and developing countries. It was regrettable that the staff had not offered any policy suggestions toward that end.

On the matter of policy coordination, particularly among the industrial countries, Mr. Huang observed that the world had been confronted with a series of problems in 1986, including the debt problem, the exchange rate issue, the fall in oil prices, and protectionism. All those problems could be dealt with only through concerted action. The exchange market intervention effected by the Group of Five major industrial countries in September 1985, and the more recent concerted action on interest rates had convinced him of the importance of policy coordination. Of course, there remained room for improvement and, in that regard, a Fund representative should be invited to participate and play a more central role in future policy coordination meetings among the major industrial countries. The participation of a Fund representative was particularly important because the Fund as an institution was responsible for dealing with international financial issues and because the Fund was working toward promoting international economic stability and growth and not the interests of any individual country. As such, the Fund was qualified to assume the role of a catalytic agent, and there was no doubt that it could make a significant contribution to the international coordination of policies, which would greatly benefit the international community. It was to be hoped, in addition, that great progress toward multilateral surveillance arrangements could be made through the concerted efforts of Fund members.

Mr. Fugmann, noting the quality of the studies provided by the Fund staff, agreed with Mr. Polak that it was difficult to put such a volume of information to productive use in a short period of time. More justice could have been done to the papers if they had come out more gradually and over a longer period.

Since the previous world economic outlook discussion in the Board, prospects for growth had improved, particularly in the short term and for the industrial countries, Mr. Fugmann continued. The world was facing at present declining inflation rates, supported by falling oil prices and weak non-oil commodity prices; and the significant decline in the U.S. dollar strengthened that trend in several major economies. For the United States, the decline in oil prices had been sufficiently large to offset the effect on import prices of the reduced value of the dollar, thus reducing the immediate risk for increased inflation in the United States. Moreover, the move toward more active policy discussions and cooperation among the industrial countries had contributed to strengthening confidence in economic developments. In particular, he welcomed the joint efforts of the Group of Five countries since September 1985 to achieve an exchange rate pattern more in line with economic fundamentals. Closer cooperation on monetary policy had also made reductions in interest rates possible. Nonetheless, the world economy continued to be faced by external imbalances between the major industrial countries, protectionist pressures, and the debt problem of the developing countries.

Even for the short term, the degree of uncertainty in the staff projections was unusually high, Mr. Fugmann observed. The uncertainties pertained in particular to the effects of lower oil prices and to the policy responses of major countries. It would have been helpful if the staff had presented the wealth of information it had gathered in alternative scenarios that would have enabled the highlighting, for example, of particular developments in the United States, including the possibility that reductions in the U.S. budget deficit would take place at a different pace than assumed by the staff. As for the European countries, he agreed with the staff that a pickup in activity seemed likely, at least in the short term, although the present stance of economic policies and the persistence of structural rigidities in many European countries lessened the likelihood of a major acceleration of output in Europe.

The external imbalances in the major industrial countries had not improved and might even increase in 1986, mainly because of J-curve effects, Mr. Fugmann noted. Even though the exchange rates movements during the past six months would in due course be helpful, they were not in and of themselves sufficient to correct the economic disequilibria. Given the present stance of macroeconomic policies in the industrial countries, large imbalances were likely to prevail throughout the forecasting period. Even by 1991, the U.S. balance of payments deficit would probably remain unacceptably high, while Japan, Germany, and some other countries would continue to run substantial surpluses. The persistence of imbalances on the expected scale could at some point cause serious problems, including increased protectionism or an excessive depreciation of the U.S. dollar, not least because of the tendencies of foreign exchange markets to produce overshooting. In that regard, he would like to see balance of payments projections for the major countries over the next five-year period in future world economic outlook papers for much the same reasons as mentioned by Mr. Polak and Mr. Dallara.

The Nordic countries believed that in order to alleviate the present balance of payments strains, supplementary adjustments in economic policies within and between major countries were needed, Mr. Fugmann said. It was to be hoped that substantial reductions in the U.S. budget deficit would be effected in the next few years, which would substantially reduce the burden carried by monetary policy in the United States. Since both Japan and Germany would be among the main beneficiaries of the fall in energy prices, and since both countries at present had an advantageous balance of payments situation, there would be scope for stronger expansion within their growth potential. Falling oil prices would, in his view, stimulate domestic demand in most industrial countries. The disturbingly large number of unemployed in many of those countries made it appropriate that, where favorable balance of payments positions existed, a large part of the fall in energy prices should be passed on to final consumers. On the other hand, it was important that the fall in the price of oil did not lead to renewed complacency with respect to energy conservation. In many countries, there might be a case for increasing energy taxes, which, at the same time, would serve to reduce budget deficits without impairing the incentives to work and invest.

Recent monetary policy developments, particularly the depreciation of the U.S. dollar, had expanded the scope for easier monetary policy in most countries, Mr. Fugmann observed. Making use of that greater flexibility, countries could support domestic demand and help to implement the necessary structural adjustments, thereby offsetting the negative effects of weaker U.S. import demand. In that context, he welcomed the recent initiatives in reducing interest rates taken by Japan and Germany. On the fiscal side, the room for maneuver had been limited during the past few years in many countries because of the accumulation of budget deficits. It would be necessary for those countries to continue restrictive fiscal policies to achieve medium-term consolidation objectives. Those countries with a structure of excess domestic savings seemed to be in a more favorable position to pursue a less restrictive fiscal policy in coming years.

Even within the restrictions set by a tight budget, however, there might be room for structural change in fiscal expenditures--changes that could be facilitated by raising real incomes. For example, more incentives to lessen the cost of labor could be undertaken. As for structural policies, he agreed with the staff that further action in many countries was needed. Reducing structural rigidities in the economy was one effective way of moving closer to a solution of the serious unemployment problems, especially over the longer term.

Remarking on the matter of international cooperation, Mr. Fugmann noted that developments in the world economy demonstrated the need to improve the functioning of the exchange rate system and the importance of strengthened multilateral surveillance in which the Fund should continue to play a central role. He shared the staff's view that in order to stabilize exchange rates, coordination of economic policies must be improved. However, coordinated intervention might make a further contribution in stabilizing exchange rates, and he noted with satisfaction the recent success of coordinated actions toward that end by the major economies. International coordination must also be supplemented by determined action to resist protectionism. The Nordic countries fully supported the efforts to move forward on a new round of trade negotiations. The only question was whether the world would be able to wait for the results of that lengthy process.

Regarding the medium-term prospects for developing countries, Mr. Fugmann remarked that the projected growth rates in the baseline scenario were highly sensitive to external developments, and the assumptions themselves were uncertain. A further compression in imports was envisaged for the developing countries, beyond what had been projected in September 1985, at which time his chair had already begun to question whether the necessary internal adjustment would be possible without larger export revenues and increased financial flows. The persistence of high debt ratios also gave rise to concern. The seriousness of the situation was underlined in the staff paper on the debt situation (EBS/86/43, 2/28/86) primarily as it related to highly indebted and sub-Saharan African countries. As pointed out in that paper, a somewhat worse outcome than projected would "have serious implications both for the state of creditor confidence and for the internal political support for needed policy reforms."

Given the great uncertainty prevailing in the assumptions, it would have been preferable if the staff had presented in a more precise way a set of alternative scenarios rather than one baseline scenario, Mr. Fugmann said. Although the staff had emphasized that the baseline scenario was not a forecast, there was the danger that the scenario would be regarded as such. The full implications of the precarious situation in many developing countries might therefore be concealed. Finally, in addition to the necessary adjustments required in debtor countries, it had been repeatedly stressed by the Nordic countries that the industrial countries had a special responsibility to adopt economic policies that could contribute to keeping the debt problem manageable. Such policies must be supplemented by measures to increase access to their markets. The sensitivity analysis undertaken by the staff again pointed to the vital importance of policies in the industrial world.

Mr. Jaafar observed that the staff's assessment of the world economy was more optimistic than it had been some six months previously. Prospects were for growth to be sustained at broadly 3 percent a year over the next two years and at approximately the same rate over the medium term. A number of developments had lent support to that forecast: sharply lower oil prices, with some indications that prices would fall even further; a record low inflation rate for the major industrial countries; and easier levels of interest rates internationally. Moreover, there were reasons to be optimistic that the policies of the major countries would create a better economic climate in future. First, real progress had been made toward reducing the U.S. budget deficit through the enactment of the Gramm-Rudman-Hollings Act. If that legislation was implemented along the assumptions of the baseline scenario, the outlook for the medium term would be greatly improved, international interest rates should fall to more acceptable levels, and financial stability should be assured. Second, the ability of the major currency countries to cooperate appeared to have been clearly demonstrated in the results of the meeting of the Group of Five in September 1985 and the latest concerted action by that Group to foster currency realignment in foreign exchange markets, which had been followed later by coordinated discount rate cuts. A clear commitment to pursue a mutually consistent and complementary strategy in the medium term should significantly improve business confidence and prospects for a more durable economic expansion.

Despite those positive signs, major elements of uncertainty remained that posed serious threats to the projections, Mr. Jaafar continued. In fact, they could threaten the very recovery and stability envisaged under the revised baseline scenario. First, excessive external imbalances had persisted, and the attending financial flows had been accumulating at record levels and had been accompanied by fluctuations in foreign exchange values. The potentially destabilizing effect of those elements could not be underestimated. In his view, the recent foreign exchange interventions were an appropriate way of emphasizing underlying trends and should, if maintained consistently, help to correct the trade imbalances. Still, more needed to be done, as the value of the dollar vis-à-vis the yen was grossly out of line and inconsistent with the pattern of trade and current account balances of both the United States and Japan. The recent sharp rise in the yen and the corresponding fall in the dollar value should help, but he was troubled that the exchange rate no longer seemed capable of playing its traditional role in correcting trade imbalances. Instead, cross-border capital movements had dominated in fixing exchange values, a phenomenon that re-emphasized the need for better coordination of policies, as intercountry interest rate differentials and other tangible factors such as inflationary expections had increasingly become the primary force behind capital flows. In that connection, the mounting external financial obligations of the United States posed a serious threat to exchange rate stability and, consequently, to world economic growth.

Another problem was the weak recovery of developing countries, an issue connected fundamentally to the resolution of the debt problem, Mr. Jaafar remarked. It was a major disappointment that the current upturn in the business cycle had not brought about the much anticipated strong recovery, particularly in world trade. Sluggish growth in the major industrial countries had instead translated into record-low commodity prices across a broad spectrum of commodities, which had adversely affected the terms of trade of developing countries. In fact, their terms of trade had, almost without exception, failed to rise since 1982, and the same trend was forecast for 1986 and 1987. That trend narrowly limited the ability of many developing countries to resolve satisfactorily the pressing debt problem. Furthermore, protectionism had been hampering the exports of the developing countries and, in Europe, the rate of unemployment continued to be high despite the signs of recovery. And he was equally concerned about the outlook for the medium term, the projections for which did not look promising, particularly for the developing countries.

On policy issues for the immediate future and the medium term, Mr. Jaafar considered that there were at least two reasons for calling for more vigor in the world economic expansion. First, although the outlook for growth in the industrial countries might appear comfortable and was broadly consistent with the long-term noninflationary growth path in those countries, it was difficult to reconcile the sluggish pace of growth with the urgent need to strengthen world trade and export prices of primary commodities. As he saw it, developing countries needed more assurances than the current economic expansion was providing if adjustment was to proceed smoothly in the context of growth. Second, although much could be done to resolve the high unemployment rate in Europe by addressing directly the structural impediments in the labor market, doing so within the context of more rapid growth would be far less painful. In the circumstances, the issue was whether growth could be strengthened. Sharply lower oil prices, the significant rise in the yen against the dollar, and the record-low inflation rates in major industrial countries seemed to provide additional room for policy maneuver. The easier monetary conditions had already led to a welcome fall in interest rates, and the question to be asked was whether the stance of monetary policy should be made more accommodating in view of reduced external constraints. Welcome moves had been made recently by the central banks of the Group of Five countries to cut their discount rates. It was important that more was done along those lines to help restore confidence and stimulate business investment. He would be interested in hearing the staff's assessment of whether further scope existed for interest rate cuts by the Group of Five countries, either individually or in concert.

While it was difficult to oppose the arguments in favor of fiscal consolidation in the medium term, it would not be altogether inappropriate to apply a judicious fiscal relaxation in the medium term, particularly in view of the recent sharp appreciation of the yen and the real prospect for a large withdrawal of fiscal stimulus from the United States, Mr. Jaafar commented. Of course, fiscal retrenchment in the

United States through 1991 was needed because of the unsustainable size of the U.S. fiscal deficit. Still, revenue measures could play an important role in reducing the deficit, and the use of monetary policy should not be precluded. The U.S. monetary aggregates had recently grown at a more rapid pace, possibly in response to flagging demand. However, he would prefer to see the scope of U.S. monetary policy conditioned by the need to prevent too sharp a devaluation of the dollar.

Japan appeared to have greater room for maneuver, Mr. Jaafar considered. Its performance had been remarkable, with strong growth, low inflation, and record trade surpluses. But a sharp appreciation of the yen had significantly shifted Japan's source of growth from the external sector, while domestic demand had remained sluggish. Moreover, fiscal policy was expected to continue to withdraw stimulus. Those factors, together with the high savings ratio in Japan, led him to believe that scope existed for Japan to relax its contractionary fiscal stance, preferably through tax measures to encourage consumption at the expense of savings. Monetary policy in Japan could play an equally important role in stimulating investment and in promoting a better international balance, especially given the continuing appreciation of the yen. To a somewhat lesser extent, conditions in West Germany also favored a more expansionary fiscal and monetary stance.

The actions he had suggested were in large part dependent upon developments in the United States, Mr. Jaafar remarked. If U.S. budget cuts were implemented as planned, a withdrawal of stimulus could perhaps ultimately affect both Japan and Germany. On the exchange market front, the sharp fall in the value of the dollar and the appreciation of the yen should not be allowed to get out of control. Thus far, an orchestrated realignment of the yen and the dollar had been smooth, but the situation could change quickly if the widely expected progress in reducing the U.S. budget deficit failed to materialize. Macroeconomic policies, both in the United States and in other key currency countries, should be made mutually consistent to cushion the expected impact of the U.S. deficit reduction. At the same time, those policy actions should not detract from the need to promote a more acceptable recovery in the developing countries. In sum, while the room for maneuver existed, it was limited in scope, although the opportunity created by lower oil prices, interest rates, a better exchange market, and record-low inflation rates must be taken quickly by those countries that could afford to expand their economies. For the medium term, insistence should be on international cooperation to secure greater policy compatibility.

On the situation and prospects of the developing countries, Mr. Jaafar observed that the growth and prosperity of those countries was crucially dependent upon their export performance. Prospects would not improve unless export demand revived strongly and prices of primary commodities took a strong upturn. On the oil situation, he would advise caution. Although sharply lower oil prices had brought a measure of relief to oil importers, the risks posed by another steep fall in prices should not be underestimated.

Weak demand for the exports of developing countries was connected mainly with the slow global recovery, particularly that in the industrial countries, Mr. Jaafar said. Despite the recent favorable developments in the world economy, the revised scenarios did not show a significantly stronger revival in world trade. Stronger world demand was urgently needed, and a revival in world trade was closely connected to a resolution of the debt problem. Of course, calls for greater demand and a resolution of the debt problem should not detract from the effort to promote appropriate supply and demand conditions in the developing countries.

According to the revised medium-term scenarios, the outlook seemed to have improved, Mr. Jaafar noted. The underlying projections might be realized, given that some of the assumptions had already materialized for oil and commodity prices; but prospects for real progress on the U.S. budget deficit remained uncertain, at least with respect to the magnitude of the cuts. From the point of view of the developing countries, it would have been helpful if the staff had conducted sensitivity analyses on the changes required in industrial countries' growth that would lead either to an upturn in the terms of trade of the non-oil developing countries or a significant strengthening of their growth rates. In conclusion, he appreciated the analyses of the policy interactions in industrial countries and was pleased that the staff had been more specific and forthcoming in its evaluations of policies and recommendations for individual countries, an approach that had made it easier for him to evaluate the alternative policies and options in the context of the surveillance process. He noted in that regard that the report of the Group of Twenty-Four on the functioning of the international monetary system had made more specific suggestions on the details of that process.

Mr. Coumbis observed that developments in the world economy since the September 1985 world economic outlook exercise had been mixed and had not diverged substantially from the path envisaged by the staff. Two important and partly unforeseen developments had, however, occurred in the past six months. First, there had been a major realignment in the exchange rates of the major industrial countries that should contribute to a reduction of the existing external imbalances. It was worth noting that the adjustment had been brought about through concerted action. Second, a sharp decline in oil prices had markedly affected in different and contrasting ways the economic outlook of various groups of countries. Uncertainties remained on the future course of exchange rates and oil prices, as could be seen from the fact that recent changes had prompted the staff to provide alternative scenarios.

The recovery in the industrial countries had continued, though at a more modest pace than had been envisaged six months previously, Mr. Coumbis commented. The most positive aspect of the recovery was its sustainability, as it was at present entering into the fourth year without showing signs of strain. Moreover, in contrast to previous recoveries, inflation was on a steadily decreasing path, and recent developments in oil prices indicated that price reductions would be more pronounced.

Output in the industrial countries was expected to grow at an annual rate of nearly 3 percent in 1986 and 1987, which appeared compatible with the growth of productive potential. In addition, room for maneuver still existed in some cases, as the factors of production were still far from full utilization. Unemployment levels were high in most countries, and rates of capacity utilization in manufacturing remained well below the peaks reached in 1979-80. Economic developments in the developing countries had been disappointing compared with those in 1984, and prospects remained a source of concern. Economic growth had decelerated and inflation remained high. For the group of capital-importing countries, fiscal deficits and current account deficits had tended to increase in 1985, indicating a worsening of savings-investment imbalances. Those developments had been due to some extent to the slowdown in industrial countries and, in individual cases, to flaws in domestic policies. However, he would not deal extensively with the problems of the developing countries at the present meeting, since those would be the focus of the Board's March 24 discussion on debt.

The paper on Policy Interactions in Industrial Countries provided more precise indications than had been previously available on the different policy options and their effects on other countries and represented the first serious attempt to implement multilateral surveillance, Mr. Coumbis said. As experience was gained, improvements in similar papers might be obtained by giving more space to an evaluation of past policies, describing the repercussions they had had on other countries, and examining the degree of compliance of policy stances with the recommendations that had emerged in previous Board discussions. It would also be useful in future discussions of the world economic outlook to have a paper containing the comments of the authorities of the main industrial countries on the various scenarios outlined by the staff as well as some indications of the policies they would follow. In that respect, he had been grateful for the comments of his colleagues from Japan, Germany, and the United States.

The policy interactions paper presented some conclusions regarding the implementation of budget deficit reduction in the United States and the policies that might modify the implications for other industrial countries of those deficit reductions, Mr. Coumbis observed. One such policy might be the easing of the fiscal stance through a more gradual consolidation of the budget for a few countries that had ample room for maneuver. He had the impression that the longer-run consequences on inflation and interest rates had been overstated and that the short-term advantages of fiscal easing in terms of output and employment outweighed the longer-term disadvantages. At the April 1985 world economic outlook discussions (EBM/85/51 and EBM/85/52, 4/1/85; EBM/85/53 and EBM/85/54, 4/3/85; and EBM/85/55, 4/5/85), his chair had remarked that the staff's view that changes in policy stances in the face of unforeseen circumstances would stem only from the working of so-called automatic stabilizers was too rigid. In the latest report, he had seen no reference to automatic stabilizers, but was pleased instead to read from that while the first task of policy must be to establish a stable environment for planning and implementing private sector decisions, that did not imply that the policy stance should remain unchanged in the face of major external disturbances. Furthermore, the staff argued that attempting to hold constant such variables as interest rates, the growth of monetary aggregates, and the level of government borrowing, at times when policy changes in other countries were generating international repercussions, might in itself be destabilizing.

The main policy issue in the United States continued to be a reduction in the fiscal deficit, Mr. Coumbis noted. The baseline scenario envisaged a more progressive reduction in the deficit--which should decline to 2.5 percent of GNP by 1991--while the balanced budget variant called for by the Gramm-Rudman-Hollings Act envisaged a much stronger process of fiscal consolidation. Those two courses of action seemed to be the minimum and maximum desirable levels of fiscal retrenchment; however, an excessively abrupt withdrawal of stimuli from the economy should be avoided. In that regard, he noted that the balanced budget variant would reduce the U.S. GNP growth figures for 1987-89 by 1 percentage point per year. Steady progress on the fiscal front was necessary to improve the savings-investment imbalance and to favor an exchange rate path consistent with a reduction of the fiscal deficit in the current account of the balance of payments. The recent sharp depreciation of the U.S. dollar had been favored by major industrial countries through concerted market intervention and a gearing of monetary policies to exchange rate considerations. However, as argued by the staff, market intervention and monetary policy might affect the exchange rate in the short run, but a more stable adjustment would call for additional action on the fiscal front. It could be argued that the decline in the U.S. dollar had been favored by increased expectations that reductions in the U.S. fiscal deficit were forthcoming--expectations that might have been partly influenced by the passage of the Gramm-Rudman-Hollings Act. A lack of adjustment on the fiscal front could therefore have destabilizing and unforeseeable effects on the dollar exchange rate.

As for other major industrial countries, Mr. Coumbis observed that the recommendations his chair had made during the Board's discussion of the recent Article IV consultation with Japan concerning the need for flexible financial policies to sustain growth remained valid as the projected 3 percent growth was considerably lower than the potential rate. Developments in Germany were more encouraging, as growth had picked up in the second half of 1985, owing to a strengthening of domestic demand. The authorities should closely monitor developments in domestic demand and should stand ready to take action to sustain domestic demand growth in the current year.

The recent oil price declines should be used by industrial countries to accommodate a stronger growth path by passing on to consumers the price decreases, Mr. Coumbis considered. Demand might also be fostered by the greater room made available by monetary policy. Specifically, in the presence of improved inflation prospects, unchanged monetary targets would allow for a greater increase in real monetary aggregates, which could accommodate a higher pace of real growth. Monetary conditions in the industrial countries had been less stringent in recent months, as shown by reductions in interest rates. Hence, some of the available room for maneuver appeared to have been used, and a further easing of monetary policies would have to be weighed in light of developments in exchange rates, progress in reducing the U.S. fiscal deficit, and price trends.

Unemployment continued to be a serious problem in the industrial countries and especially in Europe, Mr. Coumbis said. He endorsed the analysis of the staff that classical or structural factors were the main cause of high unemployment levels, and he supported the conclusions of the staff report in that regard. However, growth might have been given insufficient importance in the discussion in the staff papers. While agreeing that economic growth itself was not sufficient to guarantee lasting increases in employment, he believed that it would reinforce the positive effects of a reduction in labor market rigidities. Only a combination of the two would allow the reallocation of resources and the absorption of unemployment to take place at an adequate pace.

As he had already noted, the difficulties of the developing countries had been compounded by recent relatively unfavorable external developments, Mr. Coumbis went on. In the April 1985 world economic outlook discussion, his chair had stressed that a well-known source of economic weakness in the developing countries stemmed from the heavy dependence of the growth of their economies on the expansion of demand in the industrial countries, particularly the United States, and the movements in interest rates and relative prices of primary commodities in the world market. At present, some of those factors, such as interest and exchange rates, were working to the advantage of the developing countries; however, export growth had been sluggish in 1985, and exporters of primary products and agricultural goods had been hard hit by price and demand developments. In that respect, he wondered to what extent weaknesses in non-oil primary products prices might be considered as permanent--resulting from technical changes in production processes that required less of those inputs--and to what extent they might be due to weak demand associated with the business cycle. Similarly, he would like to know whether price weaknesses, especially for agricultural products, were associated with structural changes in demand or whether supply had increased substantially due to more intensive cultivation based on the adjustment efforts in many developing countries.

In sum, a process of fiscal consolidation in the United States remained of the essence, together with a reduction in the growing current account imbalances among major industrial countries, Mr. Coumbis remarked. Those objectives would have to be implemented through coordinated action, but care must be taken to maintain adequate levels of world demand through a flexible use of financial policies. Prospects for a reduction in external imbalances had been improved through the concerted action that had brought about a major realignment of exchange rates in the past six months. While the bulk of the adjustment had probably already taken place, medium-term projections indicated that current account imbalances were expected to remain large. In the medium term, further realignment in exchange rates, albeit at a more gradual pace, seemed called for. Adequate growth in world demand was also necessary for the developing countries. As noted by the staff, greater emphasis would have to be given in those countries to microeconomic measures supported by prudent demand measures. In that respect, particularly for the smaller- and lower-income countries, programs under the structural adjustment facility and enhanced Fund-Bank collaboration should prove useful. He would be elaborating his concerns on the problems facing the developing countries in the March 24 discussion on debt, which he viewed as a natural continuation of the more general world economic outlook discussion.

Mr. de Groote said that the staff papers were informative and well written, and carefully covered the various alternatives, given the present climate of uncertainty. The revised assumptions as a result of the recent sharp drop in oil prices helped to bring clarity to a difficult issue although further price developments would make forecasting even more uncertain. While he agreed with the staff's main conclusions, he considered the uncertainties for the medium term to be more pronounced than the staff had indicated, and therefore the need for policy coordination among industrial countries was even greater.

The staff's basic scenario was built on four main assumptions: the favorable effects on growth and interest rates of the expected reduction in the U.S. budget deficit; the positive impact on incomes and interest rates of lower oil prices; the correction of the external value of the U.S. dollar and of the trade balances among the industrial countries; and the favorable impact of higher growth in the industrial world on the expansion and adjustment prospects for developing countries, Mr. de Groote observed. In the short term all those factors, especially lower oil prices, should benefit the world economy in terms of higher output and lower inflation. However, there were three main reasons why a higher degree of uncertainty for the medium term was justified. First, the contribution of a new budgetary stance in the United States to that country's fundamental adjustment might not be as straightforward as envisaged. Second, the main exchange rate relationships might remain fundamentally unstable and thus lead to a high degree of instability in the evolution of world output. Finally, the balance of payments position of the primary exporting countries had not been re-established on a viable basis. Thus, more coordination was needed than recommended by the staff in monitoring economic policies among industrial countries, and it was essential that the response to the U.S. debt initiative should be more rapid and more explicitly directed toward producing additional financial resources to assist indebted developing countries.

That private investment would respond positively to the withdrawal of fiscal stimulus to the U.S. economy was one of the major implicit assumptions on which the staff had based its prediction of a smooth medium-term growth path, Mr. de Groote noted. Increased business confidence and the prospect of lower interest rates were traditionally thought to be the channel through which "crowding in" from the private investment sector took place. However, empirical evidence and a closer look at the spillovers caused by the U.S. fiscal deficit since 1982 suggested that that view might be too simplistic in the present circumstances. In spite of growing government deficits, private investment as a percentage of GNP in the United States had been particularly buoyant from the beginning of the present recovery, and even after the recovery began to slow down in 1985, investment remained well above the historical U.S. average and the average of the other industrial countries. There were two reasons for that development. First, the possibility for the American taxpayer to deduct borrowing costs from his taxable income and the generous tax treatment of private investments provided by the Economic Recovery Tax Act of 1981 had immunized the U.S. private sector against persistent high real interest rates. Second, because the U.S. expansion had been largely financed through capital inflows from abroad, domestic interest rates had not risen to a level that would force private investment demand to adjust to the simultaneous existence of high public sector demand and low domestic savings.

Consequently, the crowding out effect of the U.S. fiscal deficit had been exported, affecting private investment spending in the other industrial countries through persistent high interest rates worldwide, as was shown by depressed investment levels in Europe and Japan, Mr. de Groote added. The crowding out had also spilled over to the U.S. business sector, because the absorption of world savings had pushed up the external value of the dollar, squeezing U.S. exports, and causing U.S. consumers to prefer cheap imports over domestic goods. Those considerations suggested that the domestic and worldwide adjustment to the U.S. fiscal correction would have to operate through a positive response of U.S. foreign trade to the lower dollar rate and the recovery of investment demand abroad, rather than through the simple replacement of public sector spending by domestic investment demand.

The substantial correction of the dollar's value over the past six months had set the stage for improvement of U.S. trade prospects and might even go further than was desirable for the smooth adjustment of trade flows, Mr. de Groote remarked. Speculation about an appropriate equilibrium exchange rate of the dollar was a highly uncertain exercise. However, the level of US$1 = ¥ 190, reached in late January had been welcomed by many as an appropriate exchange rate. Moreover, in a recent paper on U.S.-Japan economic relations, Fred Bergstein had concluded that that rate was consistent both with the Japanese structural trade surplus in view of Japan's heavy dependence on imported primary commodities and raw materials and also with the corresponding U.S. deficit in view of that country's role as a principal reserve currency center. Observers correctly fear an exchange rate misalignment in the opposite direction as a result of an undervalued dollar because they consider that no matter what might be the optimal trade pattern between the United States and the rest of the world, the dollar would not regain market confidence until it had depreciated far enough to produce a current account surplus and reduce the U.S. external debt.

A scenario along the lines described by S. Marris was not at all impossible, Mr. de Groote commented. According to that scenario, the prospects of low inflation and declining public borrowing requirements could exert downward pressures on U.S. interest rates, in turn reducing the willingness of investors to hold dollar assets abroad. Because of the need to finance large current account deficits in the coming years, the dollar would take a new corrective plunge, seeking ground at a much lower level than was justified by trade alignments. Ultimately, U.S. inflation would be kindled, interest rates would go up, and large shares of real incomes would be absorbed by expensive imports, pushing the U.S. economy into a recession. In time, output in other industrial countries would be seriously impaired as a result of dwindling foreign demand for their exports.

He did not expect that scenario to materialize because policymakers would, he hoped, intervene in time to take corrective action, Mr. de Groote remarked. The scenario was important because it illustrated the inherent instability of the present system in which there seemed to be an implicit bias to correct misalignments in one direction by creating them in the opposite direction. The scenario also suggested that the United States would not have the possibility of taking necessary offsetting actions once the destabilizing process had begun and that therefore much closer cooperation between the industrial countries in the areas of interest and exchange rates was called for.

The U.S. authorities had, indeed, little room for maneuver to prevent a destabilizing scenario from materializing, Mr. de Groote considered. Recent debates about the desirable course of future monetary policy suggested that the Federal Reserve Board increasingly faced the dilemma of risking either too low a growth rate or too low an exchange value for the dollar. Because of the authorities' preoccupation with facilitating economic recovery and impatience with the slow response of trade flows to a lower exchange rate, they had recently modified monetary policy to allow the benefits of lower oil prices and the prospects of lower fiscal deficits to pass fully through the economy despite concern over an overcorrection of the dollar's value. Ultimately, the authorities must choose between keeping monetary conditions tight, or accepting much higher interest rates later. Instead of loosening monetary policy, they should accept the risk of some slowing of the economy, which might spur the U.S. business sector into increasing productivity. He invited the staff to comment on whether the adjustment of the financial imbalances built up in recent years in the U.S. economy might not ultimately involve exposure of the economy to a recession, which would realign domestic savings and investment, and reduce internal absorption in favor of the current account.

Japan and Europe were in a more comfortable position than ever before to offset the worldwide threat of a possible U.S. recession while at the same time setting the stage for a broader-based, domestically-oriented expansion of their economies, Mr. de Groote observed. Fiscal and monetary discipline had shaped an environment favorable for allowing the benefits of lower oil prices to operate freely throughout their economies without risk of rekindling inflationary expectations. The first step in adjusting the stance of domestic financial policies to that new environment was a decision in early March by the Japanese and a number of European central banks to lower their official discount rates. Besides the immediate effect of stimulating domestic demand, that decision had also shown that coordinated interest rate action among major industrial countries should not be ruled out as unrealistic and that with the United States at present assuming a defensive posture, it was time for Europe and Japan to act as pacesetters in international monetary matters.

It remained to be seen whether Europe and Japan would be able to go beyond the immediate need to ease monetary conditions and establish a firm basis for sustained expansion of domestic demand--a development that would offset the diminished impetus from foreign demand and the risk of a U.S. recession weakening worldwide economic activity, Mr. de Groote noted. Taught by their experiences in the 1970s, Japan and many European countries had built up a firm tradition of fiscal restraint and income moderation. So far, tight demand policies had not been rewarded by a supply-oriented response from the private sector that would support a strong, sustained expansion of domestic investment demand. Until that happened, business prospects in those countries would continue to be narrowly dictated by the vicissitudes of world demand for their exports.

Domestic demand in Japan suffered from a structurally high household savings rate and an equally low absorption capacity of consumer demand, Mr. de Groote remarked. With the growth impetus of foreign demand diminishing rapidly, the Japanese Government should be encouraged to soften, at least temporarily, its medium-term fiscal objective of eliminating bond financing for current public expenditures so as to create some room for tax incentives and public expenditures sufficient to boost residential investment and generally develop the country's social infrastructure. Indeed, there was scope for fiscal consolidation in Japan to proceed at a somewhat more moderate pace than planned.

The structural impediments hampering the European economies were of a different nature, Mr. de Groote continued. Strong labor market rigidities and high government levies on domestic resources had prevented those countries from adjusting flexibly to the oil shocks of the 1970s and had undermined their overall competitiveness. To combat those rigidities, European governments had adopted policies based on fiscal retrenchment and wage restraint, while the business sectors had achieved a dramatic increase in labor productivity, which had resulted in unsustainable unemployment levels. Several countries had already achieved considerable progress with adjustment, and reversing the deflationary bias of Europe's adjustment process would require a more supportive policy stance. Germany in particular should make use of the fiscal room for maneuver to accelerate the implementation of its tax reduction plan. In other countries where fiscal discipline had been broadly restored, similar modest steps could be considered, while the European economies as a whole would benefit from higher output and employment.

Substantial benefits could be obtained from creating more room for a modest accommodation of demand policies at the present stage of the business cycle, Mr. de Groote considered. Based on their experience with inflationary policies in the 1970s, the European countries had built up a model in which a medium-term policy stance characterized by fiscal and monetary discipline, and the continuous purging of structural rigidities in the economy were regarded as the sole and unique cornerstone on which to base expectations for sustainable growth. Without contesting the basic thrust and validity of that model, he wondered how its objectives could best be pursued at each stage of the business cycle, especially at present when the industrial countries were in a completely new situation in which higher growth could be achieved without rekindling inflationary pressures. By allowing for a modest easing of the stance of fiscal and income policies, those countries could create a climate in which higher growth and increased wage flexibility would substantially support and facilitate their medium-term efforts to reduce structural rigidities in the economy and encourage a sustained expansion of private investment. Indeed, increased wage flexibility and income growth were mutually supportive objectives.

Those countries might be able to obtain a medium-term growth path exceeding the forecast rate of 3 percent, Mr. de Groote remarked. By paving the way for a higher growth rate certain industrial countries could not only pursue their internal adjustment process in a flexible way without endangering their external competitiveness but would also benefit the adjustment prospects of the developing countries.

Mr. Sengupta remarked that the world economic exercise had acquired added significance in view of the importance that had recently been attached to it in terms of multilateral surveillance in the reports of the Group of Ten and the Group of Twenty-Four on the functioning of the international monetary system. He particularly welcomed the supplementary information on the impact of recent substantial changes in oil prices, exchange rates, and interest rates. Since it would be difficult to do justice to the extensive material that had been presented, he would limit his comments to a few central points.

He recognized that economic forecasting was not an exact science and that actual market behavior could differ substantially from that projected on the basis of models, so that only cautious conclusions could be drawn from such projections, especially when they related to medium- and longer-term forecasts, Mr. Sengupta observed. The staff projections and medium-term scenario did, however, serve as useful guideposts against which the need for coordinated policy changes could be reviewed periodically. He therefore welcomed their publication, following some further detailed scrutiny by the Board. The assumptions underlying the baseline scenario seemed quite innocuous, and it should be possible to modify the design of the models in order to forecast other possible outcomes. For example, Mr. Grosche had pointed out that the U.S. Administration had projected real short-term interest rates of 1 3/4 percent compared with the staff's projection of 3 1/2 percent to 4 percent in the medium term. The staff's projection seemed to be based on the assumption that a noninflationary monetary policy stance, together with a depreciating dollar and a reduced real money stock, would exert an upward pressure on interest rates. Given that assumption, and the staff's estimates of the effect of the dollar's depreciation on prices, he presumed there was a difference of view between the staff and the Administration on the effective price level. He wondered what changes in the U.S. monetary stance would bring about a real interest rate of 3 1/2 percent in the short term. That important question needed to be answered, especially if a lowering of the real interest rate was also regarded as a desirable aim of policy. Mr. Ortiz had indicated the desirability of lowering the rate of interest from the point of view of indebted developing countries. Mr. Grosche had also implied that possibility when speaking about the private sector crowding in as a result of fiscal retrenchment in the United States. He invited the staff to comment on what should be done to reduce the real interest rates within the framework of its model. Could the reduction be accomplished without a coordination among the key currency countries, keeping in mind also the objectives of an orderly decline in the dollar? A few weeks previously, the central banks of the United States, Japan, and Germany had made a coordinated move to lower their discount rates. While Japan had a good reason for reducing interest rates--to allow domestic demand to pick up the slack resulting from a leveling off of export volume due to the appreciation of the yen--he wondered if it could have reduced its discount rate unilaterally, without the Deutsche Bundesbank and the U.S. Federal Reserve reducing their rates simultaneously. Would a unilateral action have reversed the appreciation of the yen? If Japan and Germany had reduced their discount rate and the United States had not, would the fall in the exchange value of the dollar have been halted altogether? The Federal Reserve was understandably concerned that fiscal retrenchment and an easy monetary stance in the United States, without supportive policies of the OECD countries--especially Germany and Japan--could lead to a precipitate fall in the dollar value and a rise in the rate of inflation. Because it was generally accepted that a devaluation of the dollar was necessary and that the realignment of major currencies had to be orderly, the policy action of the major countries had to be coordinated, and one major element of that coordinated action would be a reduction in interest rates. The Group of Twenty-Four had called for coordinated action to reduce interest rates as an integral part of the program for achieving the orderly growth of the international monetary system.

Managing the depreciation of the dollar, which had become an objective of the multilateral policy action following the meeting of the Group of Five in September 1985, should have been dealt with squarely in the staff report, Mr. Sengupta considered. For instance, how much more should the dollar depreciate? And how could that be achieved in an orderly fashion? To answer the first question, one had to estimate a sustainable medium-term current account balance of the United States--and a counterpart balance of other major industrial countries--and a projection of capital flows. It would then be possible to estimate an equilibrium exchange rate for the dollar based on projections of different objective flows. To answer the second question would involve an examination of the impact of the policies of the major countries. It would then be possible to work out a program of coordinated policy intervention. In his view, answers to those questions were central to the multilateral surveillance exercise.

Such answers also represented the basic elements of the "target zone" approach, especially of the Group of Twenty-Four, which utilized objective indicators to trigger consultation among the key currency countries, Mr. Sengupta continued. Instead of debating questions such as correct equilibrium exchange rates and policy parameters, Directors should instead agree to examine exchange rate movements systematically as to how they should be guided in a particular direction in a smooth and orderly manner. During its recent meeting, the Group of Five had in a sense followed all the principles of the target zone exercise without explicitly carrying it out.

In determining the equilibrium exchange rate, a normative element could be included by introducing a desirable level of capital flows instead of a projection, Mr. Sengupta suggested. The staff had noted that an increase in capital inflows to developing countries of only $20 billion above the baseline level in 1987 and remaining at that level thereafter would raise the growth rates of those countries by some 3 percent over a period of two to three years. That amount represented a small share of total capital flows, and it would be regrettable if that level could not be achieved. He wondered if the staff could indicate the elements of policy coordination among major developed countries that would ensure such capital inflows to developing countries. In that connection, he suggested the possibility of Japan recycling its excess savings toward the developing countries.

Fiscal retrenchment in the United States was expected to affect output negatively in the short term, but initial output losses would be offset by favorable effects that built up over time, Mr. Sengupta noted. He therefore considered that the slack resulting from a deficit reduction in the United States should be taken up by other OECD countries. According to the staff paper, the impact of the U.S. action would be negative, particularly on Japan and Canada, and less negative in other industrial countries. However, Mr. Fujino had indicated that his authorities' figures showed a substantial increase in demand growth even though exports were expected to level off as a result of appreciation of the yen. If growth in Japan did not slow down and fiscal policy were not relaxed, the staff might have to revise some of its basic conclusions, including the possibility of a more rapid depreciation of the dollar vis-à-vis the yen in the near future. Moreover, it was not clear whether developing countries could be expected to improve their export growth rates even moderately in the coming period. The exports of developing countries were expected to grow in volume terms by 4.3 percent in 1986 and by 4.9 percent in 1987, compared with 0.4 percent in 1985. The staff had also indicated that commodity prices were likely to strengthen substantially in the next two years as a result of great demand and abundant supply. Therefore, if the world economy was to avoid another recession, other industrial countries, such as Japan and Germany, would have to assume their international responsibilities and increase their output so as to compensate for the loss of export markets for developing countries due to U.S. fiscal action in the immediate future. It was unlikely that they would be able to do so however without allowing any fiscal stimulus or relaxing their monetary stance.

The staff had indicated that it was difficult to predict oil price developments in the coming months, but had estimated the impact of an oil price of $15 per barrel on the output in industrial countries and on oil-importing developing countries, Mr. Sengupta noted. However, the change in oil prices had had a significant impact not only on the balance of payments but also on the domestic policies of several oil-importing developing countries, depending on the extent of their reliance on imported oil. Taxes on fuel were quite often related to international energy prices, of which oil was a major factor; similarly, if the change in world oil prices was permanent, then the price of domestic oil would need to be altered significantly as would investment priorities in the energy sector. It would therefore be useful to study the question of the impact and sustainability of oil prices further with reference to world demand-supply forecasts in the long run, which would enable a firmer trend analysis regarding likely developments.

Non-oil commodity prices, excluding coffee, were expected to rise moderately in U.S. dollar terms during 1986 and 1987, but not sufficiently to prevent a further erosion in the terms of trade of commodity-producing countries, Mr. Sengupta commented. The staff had also indicated that it would not be realistic for developing countries to expect a substantial strengthening of export prices or a rapid increase in world trade in the medium term. The general weakness of commodity prices over the past several years was a matter of concern. The relative impact of weak demand, combined with excess supply, on commodity prices was not clear. If the slackened demand was generated by structural changes resulting from technological advances in industrial countries, the shifts in demand were likely to be permanent, which would call for more fundamental structural changes in the developing countries. Until those changes occurred, the only approach to improving export performance might be supply management.

The staff had highlighted the importance of reducing the import intensity of the growth process if the momentum of development was to be restored in circumstances of relatively weak growth in world trade, Mr. Sengupta remarked. Moreover, the staff paper indicated that the ratios of the current account balance of payments to exports of goods and services of capital-importing countries for the years 1985-90 were lower than those reported six months previously. At the same time, the baseline scenario in both the earlier and present study indicated more or less the same rates of output growth during 1987-90. Those outcomes, together with the expected increase in import volume, indicated much less reliance on imports and transfers of resources to achieve the projected increase in output. Whether that was technically possible over the medium term was not clear. Unless the domestic production structure was adjusted to lower dependence on imports, the expected high output growth may not actually materialize. Such a structural change toward import substitution could hardly be achieved through exchange rate and tariff subsidy policies but would instead call for intervention in the market process.

The staff had made a good first attempt in describing the economic policy interactions among industrial countries, Mr. Sengupta considered. The objectives of economic policy coordination should not be confined merely to bringing about the better alignment of exchange rates but should encompass those three elements that were essential for the orderly functioning of the international monetary system: the promotion of greater exchange rate stability; an orderly basis for providing international liquidity; and reliable sources of nondebt-creating capital flows to developing countries. He hoped that the Board would be able to schedule another full-day discussion based on the papers on policy interactions among industrial countries and on the transmission of economic influences from industrial to developing countries.

Mr. Nebbia said that he welcomed the present discussion of the world economy to 1991 as an opportunity to reassess major trends in the medium term. The staff papers had provided a reasonable set of assumptions for the medium-term scenario, together with the most likely set of policy responses by industrial and developing countries to different domestic and external developments.

The present economic situation and the short-term outlook for the world economy remained plagued by uncertainties regarding the possible behavior of a number of key economic variables, particularly with respect to the policy actions of industrial countries and their impact on the likely evolution of interest rates and the willingness of private creditors to increase their lending to indebted developing countries, Mr. Nebbia noted. For instance, the full impact of efforts to reduce the U.S. fiscal deficit on the U.S. economy and on the economies of its trading partners was not yet clear. Nor was it clear what effect a budget deficit reduction would have on international interest rates and major exchange rate parities. Furthermore, it remained to be seen whether other industrial countries, particularly Japan or Germany, would reduce the pace of their own budgetary adjustments in the event of a slowdown of economic activity in the U.S. economy so as to provide a degree of fiscal stimulus that would allow for a reasonable level of aggregate demand in order to sustain the world economic recovery.

The recent coordinated action of the Group of Five to effect a smooth and orderly adjustment of major exchange rates was commendable, Mr. Nebbia remarked. To ensure lasting positive results of that action would require even further efforts to coordinate those countries' fiscal and monetary policies.

The current short-term outlook for developing countries remained somber, Mr. Nebbia observed. The terms of trade for most developing countries had continued to deteriorate, and that trend was expected to persist through 1986 and 1987. In addition, export markets had not been able to absorb an increased volume of developing countries' exports because world economic activity had slowed and because some countries had exerted higher levels of protectionism. The negative impact of those developments on export earnings had limited the ability of most developing countries to meet their external financial obligations and reduce their reliance on foreign borrowing, despite the considerable progress that a number of them had achieved in redressing their domestic imbalances through fiscal deficit reductions, appropriate pricing policies, and increasing the competitiveness of their external sectors. For oil-exporting developing countries, the recent sharp decline of world oil prices would certainly lead to even more severe adjustment of their economies.

With the continuation of a moderate pace of world economic growth, output prospects for developing countries remained limited in spite of the favorable impact of lower interest rates on the efficiency of resource allocation in those countries, Mr. Nebbia remarked. The increase in total output by 4 1/2 percent a year projected for nonfuel exporting developing countries during 1986-87 was far from encouraging when adjustments were made for population growth and the overall level of output. For instance, the levels of per capita income in Latin America projected for 1987 were well below those prevailing in 1980. With respect to external financing and the debt problem, the picture was also not encouraging. To the problems of reduced export earnings, deteriorating terms of trade, and increased protectionism in export markets must be added the persistent, and in some cases increasing, deterioration of the capability of some developing countries to fully honor their debt payments, and at least their debt servicing requirements. Even though a number of developing countries had become net capital exporters in the past two or three years, their economies had not improved sufficiently to reduce the stock of their external debt, but had instead been characterized by the need for further external borrowing. As a result, domestic savings were being diverted from productive uses to meet the interest payments on external debt, while the stock of debt continued to increase at rates generally exceeding the rate of growth.

For highly indebted developing countries, the prospects for the short and medium run were clearly less optimistic than the staff had indicated, Mr. Nebbia continued. In spite of full compliance with Fund-supported programs, the magnitude of the imbalances in some of those countries, particularly on the external front, remained significant. Moreover, the financial community, particularly commercial banks, had not resumed voluntary lending or even an appropriate level of financing in line with the needs of those countries and the adjustment efforts that they had already undertaken. The so-called stable sources of finance, which included nondebt-creating flows, were insufficient to offset the effect of the retrenchment of commercial bank financing. Moreover, nondebt-creating flows had not played an important role as a source of financing, particularly when compared with the levels of foreign investment in African and Latin American countries. That the growth of debt accumulation in recent years had slowed dramatically was not the result of an improved economic situation but rather the consequence of the limited availability of external financing.

Low economic rates of growth and high levels of unemployment, which reflected an economy's financial constraints, the financial constraints of an economy, were hardly indications that the developing countries no longer needed external financing, Mr. Nebbia observed. Indeed, they might also be the result of the lack of such financing and of domestic adjustment. Such adjustment had always taken place in either an orderly form--through a comprehensive economic program--or through an induced recession or hyperinflationary processes.

Medium-term prospects did not significantly change the present and short-term picture, Mr. Nebbia remarked. Though some economic growth might be expected for developing countries--assuming growth in the world economy, the stability of key exchange rate parities, and a further decline in interest rates--the level of economic growth was not sufficient when compared with the ratio of debt to GDP in highly indebted countries, population growth in most developing countries, and the economic needs facing all those countries.

Although major emphasis had been placed on structural reform in developing countries, the objectives of such reforms should be clear, Mr. Nebbia considered. If structural reform meant a reallocation of resources to the export sector, comparative advantage would tend to increase developing countries' dependency on the production of basic commodities and less sophisticated goods whose prices normally fluctuated with the level of activity in the industrial world. In addition, such specialization rarely induced the backward and forward linkages through which the benefits of a more dynamic sector could be transmitted to the rest of the economy but instead created a new dependency on imported capital goods and inputs which could not be produced efficiently given the small size of domestic markets, which did not allow for reducing the import intensity of the growth process. In addition, in the past, the shift of domestic resources--both capital and human--had tended over the short and medium term to promote an uneven income distribution, which in turn reduced the possibility for an expansion of domestic markets that could support the establishment of efficient import substitution industries at the level of capital and immediate goods. The economic history of Latin America indicated that economic growth and industrialization had been boosted during periods of weak growth in world trade, or when linkages of the region with the rest of the industrial world were weaker. If that was still true, then perhaps the structural changes that were needed were those associated with increasing regional trade, increasing the domestic absorption of economies so as to secure markets for internal production, and closing the economy somewhat to reduce the import intensity of economic growth--an idea that was not being advocated by the staff.

On the realism of the medium-term projections, he doubted that the broad assumptions regarding the effects of reducing the U.S. fiscal deficit and the effects of lower oil prices on interest and exchange rates, as well as other key variables, were theoretically acceptable, Mr. Nebbia stated. As the staff had noted, a number of uncertainties remained which made it difficult to project accurately the specific values of such variables. He agreed with the direction assumed for the principle variables, but was reluctant to assign them specific figures. Indeed, the events of the past two months had necessitated an updating of the assumptions underlying the present exercise, which indicated the certitude of the conclusions that could be drawn from the present exercise.

Mr. Mawakani said that the analytical background material prepared for the present world economic outlook exercise was welcome, and he urged the staff to continue to pursue special studies that would help to support judgments put forward in future surveys. With respect to policies in industrial countries, he wished to focus his comments on developments and prospects in the real and fiscal sectors and the labor market, and with respect to policies in developing countries, on the debt and labor market issues and the adjustment process.

The slowdown in economic activity in industrial countries that characterized the year 1985 was expected to be reversed in 1986 and 1987 on account of the sharp decline in the price of oil, a lower rate of interest, and the depreciation of the U.S. dollar, Mr. Mawakani noted. The beneficial effects of those factors were more evident in the United States, where growth was estimated to be faster than originally forecast by the staff. While output growth in Europe was expected to accelerate slightly faster than had been forecast earlier, the Japanese economy was not expected to benefit fully from the decline in oil prices because of the sharp appreciation of the yen but was expected to slow down to a rate of 3 percent as originally forecast. In the United States, economic expansion was expected to resume, with real GDP rising at a rate of 3 percent in 1986 and 3.7 percent in 1987, compared with 2.3 percent in 1985. Sustained economic growth in the United States, together with the willingness of the U.S. authorities to address the budget deficit problem, could have a favorable impact on the economy of developing countries--assuming, of course, a reversal of protectionism.

He shared the staff view that in order to stimulate growth in industrial countries, fiscal stimulus should not be withdrawn at a rapid pace in countries such as Japan and Germany where there was some room to expand absorption and imports, Mr. Mawakani continued. However, the ratio of fiscal deficit to GNP in Japan was relatively high and comparable to those in the United States and Canada. The ratio was significantly higher in Japan than in Germany, France, and the United Kingdom, leaving aside Italy, which, historically, had had a high rate of deficits. He therefore wondered whether emphasis should not be placed on directly stimulating private sector expenditure beyond the rate of 3 percent forecast for 1986-87 by implementing a more flexible monetary policy and easing further trade restrictions. For countries such as the United States, he would agree that fiscal restraint should be applied. However, consideration should be given to effecting some compositional shift away from expenditure with low job-creating incidence in favor of outlays with high job-generating potential. That strategy could contribute to lessening the impact of low fiscal stimulus on the country's economic activity. As a caveat, he emphasized the uncertainties attached to the projections.

Regarding the situation in the labor markets of industrial countries, while no spectacular gains had been achieved, no ground had been lost, Mr. Mawakani observed. Subsequent to the nearly 2 percent increase registered in 1984, the rate of expansion of employment in 1986 and 1987 was forecast to continue to hover around the 1985 rate of 1.3 percent, whereas the rate of unemployment was projected to fall only marginally. The high levels of unemployment in industrial countries reflected to a large extent rigidities in the labor market that had not been effectively addressed. Thus far, governments had chosen to maintain the rigidities by taking stronger protectionist measures. As a result, the inefficiency of the labor market in industrial countries was not only translated into higher prices for developing countries' imports but was also slowly but steadily closing the markets to their exports. In that respect, the World Bank estimated that the proportion of manufactured goods subject to nontariff barriers in major industrial countries had increased and that the restrictions on agricultural exports had been more stringent than those on manufactured goods. Serious efforts by the authorities were urgently needed to address the problem of labor market rigidities in industrial countries because of their adverse impact not only on the economy of developing countries but on the world economy as well.

With respect to developing countries, the external debt and the debt service obligations as a percentage of exports of goods and services were forecast to remain high in 1986 and 1987 and continued to be worrisome, Mr. Mawakani remarked. Unfortunately, several factors had continued to adversely affect the ability of developing countries to generate sufficient resources to service their debts. In the case of African countries, a substantial amount of borrowed resources had been invested in the agricultural sector with a view to increasing output. Producer price incentives had helped to support that objective. However, almost invariably, the reward for those endeavors had been low, or lower, export prices. The rapid and often sharp fall in export prices threw into disarray not only the income policies of national authorities but the entire spectrum of economic and financial policies of those countries. The most recent illustration of such adverse price movements was the sharp fall in the price of cotton from slightly less than CFAF 800 per kilogram to about half that amount in a short period. As a result, foreign exchange earnings and, by the same token, the debt servicing capacity of several African countries had been substantially reduced.

Other factors had also contributed to the weak financial situation in developing countries, including the deterioration of the terms of trade and the increase in nontariff barriers. Unless those and other restrictions were removed, progress toward enhancing the debt servicing capacity of developing countries in general, and African countries in particular, would be slow, and painfully so.

On the labor markets in developing countries, he agreed with the staff that the paucity of data constrained the analytical scope of the studies related to labor market issues in those countries, Mr. Mawakani commented. In the discussion of the factors that had contributed to the emergence of imbalances in labor markets, the staff had cited the high level of public sector wages relative to private sector wages. While that statement might have been correct up to the 1970s, over the past few years the wage differential had shifted in favor of workers in the private sector. The staff had also stated that "a number of countries had been able to reduce their unemployment rates by pursuing demand management, supply-side, and exchange rate policies that had contributed to sustaining high growth rates." He wondered whether among those countries there were some from Africa and especially from his constituency.

As a general observation, he would have liked to see in the paper on labor markets in developing countries a review of the employment issues in the context of Fund-supported adjustment programs, Mr. Mawakani added. In how many programs were changes in employment policy sought? What was their impact in terms of budgetary savings, social conditions, and on alternative employment opportunities in the modern private sector? Certainly, those questions were difficult to answer conclusively. However, they should not be ignored; otherwise, Fund policy recommendations could be labeled as insensitive.

The inability of developing countries to restore creditworthiness and register rapid economic expansion had been attributed to the unfavorable international economic environment and the failure of those countries to fully implement needed adjustment policies, Mr. Mawakani observed. While he agreed with the staff that the world economic environment had not been favorable in the recent past, he felt uncomfortable to say the least about the suggestion that progress toward the restoration of creditworthiness and economic growth by countries that had adopted Fund-supported programs was due to half-hearted policy implementation. Certainly, there were instances where considerations such as the necessity to preserve the stability of existing institutions or to avert events beyond the control of governments had prevented or delayed the full implementation of certain policies. Those instances would appear to be the exception, not the rule.

In many African countries with Fund-supported programs, a variety of wide-ranging policy reforms had been undertaken, Mr. Mawakani stated. Those reforms included sharp cutbacks in public sector employment and the wage bill, reduction in subsidies, the drastic curtailment of public investment, and large devaluations. Often, in the course of a program review, those policy reforms had been reinforced and had been generally maintained. Yet, a significant upturn in economic activity remained elusive. In several countries that he represented, national authorities who had been implementing stringent adjustment measures over the past several years were increasingly questioning the usefulness of undertaking such measures because they had not led to the promised economic expansion, increased export earnings, and higher government revenue. To suggest that the reason for their inability to achieve such gains resided in their failure to fully put into effect new policies, while in fact they had been doing just that for the past several years, would not only be an understatement but would also be unfair.

Mr. Hassan said that the main conclusion to be drawn from the wealth of information provided in the staff papers on the world economic outlook was that the performance of the world economy in 1985 had been disappointing and future prospects appeared to be less optimistic and more uncertain than had been earlier projected. World economic growth and expansion in trade had fallen considerably in 1985. Projections for 1986-87 were less favorable, and recent developments in the world oil market had added to the uncertainties regarding future prospects.

Developing countries had witnessed a weakening of primary commodity prices and a significant deterioration in their terms of trade, Mr. Hassan continued. Those developments had impaired their ability to import capital goods and basic inputs, with adverse implications for domestic investment and economic growth. Most observers agreed that such negative developments emanating from external shocks tended to aggravate the burden of adjustment and jeopardize efforts aimed at long-term structural change. The situation of African and Latin American countries illustrated that point, and their predicament appeared to be much worse than revealed by average indicators. The substantial deterioration in the terms of trade of those regions, coupled with the major adjustment they had had to undergo in order to service their debts had meant a continued decline in per capita incomes over the past several years for most countries and the progressive reduction in domestic consumption, and, ultimately, a decline in the standard of living.

With respect to projections, a number of forces continued to exert conflicting influences on the international economic environment, giving rise to considerable uncertainty about future prospects, Mr. Hassan observed. On the one hand, the decline in interest rates and the adjustment in the dollar exchange rate were considered to be positive developments, although it would take some time for them to influence output and employment. On the other hand, there was concern that in the absence of a more active monetary policy to counter the reduction in the U.S. fiscal deficit, output in the short term was likely to suffer not only in the United States but in its major trading partners as well. Moreover, while lower oil prices were expected to have a favorable impact on output in some countries, they had serious implications for oil-exporting countries.

For the developing countries in general, the impact of a reduction in the U.S. fiscal deficit would depend on how trade flows were influenced by that development, Mr. Hassan noted. Perhaps more important for the low-income countries, many of which were in Africa, was the extent to which budgetary policies in the United States would affect the availability of external resources needed to support their adjustment efforts. That point had not been given enough attention in the staff papers. By easing the domestic resource constraint, concessional aid and development assistance could play a significant role in improving growth prospects in low-income countries.

On the policies of industrial countries, there was some ground to justify a change in the policy mix in some of the industrial countries, Mr. Hassan considered. As most, if not all, of those countries had achieved a striking success on the inflation front, it was at present appropriate that they devise a policy mix giving greater attention to the need to sustain the expansion in output and reduce unemployment. That need became even clearer when one considered the dampening impact of the reduction in the U.S. fiscal deficit. In the United States, monetary policy might need to play a more active role to insulate the economy at least partially from the deflationary impact of fiscal contraction. Indeed, with the marked decline in oil prices, and the decline of the dollar, there appeared to be fair scope for some relaxation of monetary policy without much fear of rekindling inflation. While noting the reservations expressed by Mr. Fujino and Mr. Grosche, he agreed with the staff that a degree of moderation in fiscal policies in Japan and Germany, among other industrial countries, might be needed to help sustain global demand.

Apart from the need to change the mix of macroeconomic policies to cope with recent developments, structural rigidities appeared to be a widespread problem in a number of industrial countries, Mr. Hassan added. The prevalence of historical high levels of unemployment in most European countries reflected the existence of structural rigidities in labor markets. One could not but agree fully with the staff's diagnosis of the problem and its recommendations. Another reflection, and perhaps also a cause, of structural rigidities in the goods markets of many of the industrial countries was the intensification of protectionist pressures. To induce adjustments in those areas, protectionist barriers must be dismantled. The continued significant disequilibrium in the current account of some industrial countries, whether in the form of a persistent deficit or surplus, also indicated the existence of structural problems that called for adjustment in their external position.

In implementing domestic policies, the industrial countries needed to ensure better coordination among themselves, without which it would be nearly impossible to reduce wide fluctuations in foreign exchange markets under the present floating rate regime; enhance the flow of world trade; and sustain global economic recovery, Mr. Hassan considered. The success of the recent policy coordination among the five major industrial countries aimed at influencing exchange rates should be an incentive for widening the scope of coordination to include other countries and other policy areas. The suggestion that fiscal developments in the United States might call for some changes in the policy mix in certain other countries presented a real test for such coordination. Honoring the declared commitment by industrial countries to free trade was another area where policy coordination should make a difference in the international economy.

With respect to developing countries, there could be no doubt that domestic policies must be attuned to the objectives of structural change and sustained economic growth, Mr. Hassan remarked. He was concerned that for a number of those countries, particularly the low-income and heavily indebted countries, too much was being asked of the domestic effort if not much improvement was envisaged in the international economic environment in the form of lower interest rates, higher export prices, or increased willingness on the part of donor countries and other creditors to increase the level of financing available to developing countries. In that regard, he supported Mr. Ortiz's comments. If such improvements were not forthcoming in any significant manner, it was difficult to see how the rhetoric of adjustment with growth could become a reality for many developing countries.

He agreed that reducing the import content of domestic production was an important step in restoring the momentum of growth in view of weak world markets for developing countries' exports, Mr. Hassan commented. In that connection, he would stress two points. First, reduction in the import intensity of domestic production required changes in modes of production and adaptation in domestic products which could only be achieved over the medium to longer term. Second, the speed at which such reduction could be achieved would depend, among other things, on the nature of the products, prevailing technology, and the development stage of the country concerned.

The creation of a stable financial environment must also remain a goal of economic management in developing countries, and in that regard, the reduction of fiscal imbalances was a basic requirement, Mr. Hassan remarked. That adjustment did not necessarily mean that the public sector should play a lesser role in the development process. As for those countries in which the public sector had had to take the lead in investment in order to create basic infrastructure--without which participation of the private sector would be limited--caution should be exercised in advocating reduction in the share of resources absorbed by the public sector.

Mr. Nimatallah noted that, in discussing inflation the staff had stated that "lower oil prices are the most important reason for expecting continued progress on the price front." In his view, that sentence was not objective. He recalled that when oil prices were increasing, U.S. President Carter had said that higher oil prices were the reason for the high rate of inflation in his country. More recently, when oil prices were declining, President Reagan had said that the inappropriate fiscal policies followed by his predecessors were the main reason for inflation in the United States. Those two opposing views illustrated that there was no "most important reason." Indeed, many reasons had contributed to reducing inflation, such as the policies of the authorities and low wage rates in Europe. He would prefer that the sentence read "lower oil prices are also important in the short run."

On the need for fiscal stimulus in Europe and Japan, there appeared to be an honest disagreement among his colleagues, Mr. Nimatallah observed. Some had said that Japan and Europe should moderate the pace of fiscal retrenchment, while others had cautioned that the pace of fiscal consolidation should be maintained in the medium term. For the sake of consistency, he suggested that emphasis be placed in the report on sustainable growth without inflation. In that regard, the staff forecast of a 3 percent rate of growth seemed sound and would put the world economy on a sustainable course instead of forcing some economies into ultimately speeding up and then slowing down their rates of growth.

Mr. Sengupta remarked that the sentence to which Mr. Nimatallah had correctly referred stated the reason why, in a recovery phase, the inflation rate was going down. The statement was however disconcerting, in that it implied that lower oil prices, rather than the pursuit of prudent monetary and fiscal policies in the industrial countries, had led to improvement on the inflation front.

Mr. Grosche said that he appreciated Mr. Sengupta's remarks because they reflected his views.

The Director of the Research Department commented that the sentence did not reflect the mechanical grinding out of a model but had to be read in the context of continuing policies. Thus, although a good deal of progress had already been achieved on the inflation front, the most important reason for expecting continued progress was lower oil prices. That was not to say that other developments might not have a greater impact on rates of inflation.

Mr. Nimatallah said that he considered the most important factor influencing the price level was the policies of the authorities in the industrial countries. Suppose, for example, those countries suddenly adopted a monetary policy that triggered inflation. In fact, in the past a serious deterioration in the appropriateness of fiscal policy had led to high rates of inflation and that too could recur. He would not deny that lower oil prices could contribute to progress on the inflation front, but he did not agree that they were the most important factor.

The Director of the Research Department observed that there was a fairly widespread view among Executive Directors that the staff had not been as optimistic in its assessment of the medium-term outlook as might be warranted in the present circumstances. A number of points had been mentioned in support of that position. Some Directors considered that fiscal retrenchment might in fact be more successful in the United States than had been assumed in the staff's baseline scenario. Others had emphasized that the adjustment of expectations that had taken place, and was taking place, might generate more buoyancy in the U.S. economy than had been allowed for. He had sympathy for the view that an important change in expectations had already taken place and was being reflected in the behavior of financial markets. It was also possible that the Gramm-Rudman-Hollings Act would not be implemented in precisely the manner that was foreseen by the staff. Nonetheless, although the U.S. Congress and Administration had seized hold of the problem of the fiscal deficit, real developments did not justify a more optimistic interpretation of events than the staff had offered.

Another factor that warranted a more optimistic outlook in the view of some Executive Directors was lower interest rates, the Director continued. That factor was, of course, important and was not unrelated to the change in expectations. If the change in expectations was more important than the staff had allowed for, then the lag in the improvement of the economy following fiscal retrenchment would be shorter and there would be no negative effect on growth even in the short term in the United States. It had also been noted that improved policy coordination among industrial countries might also lead to greater economic gains than had been allowed. The staff had tried to take that factor into account and had assumed that the direction was toward improved coordination.

On publication, the staff intended to publish the supplementary studies in the Occasional Papers series, which would be issued following the publication of the World Economic Outlook, the Director noted. He agreed that the volume of material presented in the staff papers was unusually extensive. The staff had intended to circulate the papers earlier, but work on monetary reform issues had led to production delays, and thus the papers had had to be issued over a shorter period of time.

On fiscal policy in Germany and in Japan, the Director of the Research Department noted that if the reduction in growth in 1987 in Germany did not appear likely to materialize, then the staff would not offer the same policy advice. In any event, the staff considered its statement with respect to fiscal policy to be quite modest: if budget cuts were implemented in the United States as planned and the pace of output growth in Germany tended to slow down, and if signs of excess demand pressure remained absent, actions should be considered to reduce or offset the withdrawal of fiscal stimulus that was projected for 1987. He noted that there had been a certain amount of support among Executive Directors for that position.

Mr. Grosche said that his authorities did not expect output growth to slow down during the year, and to continue in 1987. Thus, there seems no need for action, particularly not for bringing forward the planned tax reductions for 1988 to the coming year. As there was almost no need for action in 1986, the sentence referred to was not relevant.

The Director of the Research Department recalled that Mr. Fujino had pointed out that his authorities were not comfortable with two sentences. With respect to the first, the staff had wished to emphasize that it remained important that the course of fiscal policy in Japan not be fundamentally changed but that "in view of the constraint on the central government budget, there is merit in making use of the scope to support demand through actions at other levels of government to the fullest extent possible." That moderate statement had received some support among Executive Directors. The second sentence, which appeared in the section "Topics for Discussion" read "against this general background, the staff believes that there is scope for the fiscal consolidation in Japan to proceed at a somewhat more rapid pace than planned." That statement was not intended for publication but had been included in that particular section specifically to put forward issues for debate and discussion.

The Chairman commented that the sentence just referred to was intended to express the notion that developments in 1986 might require a more cautious stance and that flexibility in implementing the authorities' medium-term fiscal consolidation plan was therefore called for. It did not mean that there was a need to change the consolidation plan; rather, it meant that some slowing down of the implementation of the plan was warranted at present to avoid a slowing of domestic demand through excessive fiscal restraint. The sentence was, of course, not intended for publication.

Mr. Fujino pointed out that the staff had also said that "with growth, there will also be merit in considering the medium-term fiscal stance." He was concerned that there were many places in the staff papers where doubts were raised about Japan's basic policy stance. In that regard, he felt there was a clear consensus that the medium-term fiscal stance was very much in the right direction.

The Deputy Director of the Research Department pointed out that the passage referred to by Mr. Fujino attempted to distinguish between the central government and the general government budgets. The suggestion of easing fiscal policy or consolidating less rapidly was stronger at the general government level where the deficit had already come down.

Mr. Fujino commented that perhaps the policy suggestion could be presented in somewhat more general terms and the choice of exact policy measures could be left to the authorities because there were many policy considerations to be taken into account and it would be going too far to specify each policy measure that should be taken. The major objective should be more sustained domestic demand expansion. That should be the point.

The Chairman remarked that the views of the Japanese authorities would, of course, be reflected in the published version.

Mr. Sengupta commented that, according to the staff's projections, for Germany, the rate of growth was expected to be 3.4 percent compared with 2.4 percent the previous year, whereas for Japan, the rate of growth was expected to fall, and it was in that context that the staff had made its suggestion.

Mr. Fujino recalled that he had also pointed out the shift of emphasis from domestic growth to final output in the staff's analysis. A rate of domestic demand growth of 4.2 percent or 4.4 percent was not very low and the potential was for between 4 percent to 5 percent. Because of the pattern of adjustment, the final outcome might be low, but it was important to distinguish between domestic growth and final output.

The Director of the Research Department noted that the staff had made a reference in that respect--namely, "domestic demand in Japan is expected to grow at 4 1/4-4 1/2 percent in 1985-87." That reference should perhaps be included in the published document because it made an important point.

The Deputy Director of the Research Department said that it was true, as Mr. Fujino had mentioned, that in the past the staff had pointed out that although Japanese output was growing at approximately the estimated rate of production potential of around 4 percent or 4 1/2 percent, the rate of output growth had relied to some extent on external demand and that domestic demand had been growing less rapidly. To that extent, the staff had put some emphasis on domestic demand as an indicator of some imbalance. At present, the staff considered that although domestic demand was growing at approximately the rate of productive potential, that rate of growth of domestic demand implied a rate of output growth below productive potential. Those two positions were not necessarily inconsistent. From a global standpoint and from the authorities' standpoint, there was an optimal growth rate of both domestic demand and total output. In the past, output had been growing at a satisfactory rate but domestic demand had been increasing at a rate that was, from a global perspective, less than optimal. At present, domestic demand was growing at a more satisfactory pace, but that trend needed to be seen in the context of the adjustment that taking place in Japan, which involved a negative contribution from the external sector. In the context of that adjustment--which was wholly desirable--the staff considered it would be both possible and desirable for domestic demand to grow somewhat more rapidly than productive capacity.

The Chairman noted that Mr. Fujino's point--namely, that there was not much difference between potential growth and domestic demand--should be made clear in the published version.

Mr. Dallara remarked that he had a fundamental problem with regard to the interpretation and treatment of the U.S. fiscal position in both the short and medium term in the staff papers. In particular, he was concerned about the implication that implementation of the Gramm-Rudman-Hollings Act would continue to exert negative effects on U.S. and world economic growth through 1991. While the Director of the Research Department had indicated that the models used for the baseline scenario did not take fully into account possible expectations with regard to that Act and that the outturn could be better, nonetheless the basic thrust of the baseline scenario and the revised scenario was a matter of concern.

The Director of the Research Department said that Mr. Dallara had raised an important point to which he would return.

A number of speakers had referred to the study of policy interactions in industrial countries and had made suggestions concerning future treatment of that subject, the Director continued. In that connection, it had been suggested that the staff make calculations of underlying payments imbalances, and, in fact, the staff had been tending in that direction and would be presenting more material of that sort in future papers.

On the question of the ratio of imports to growth in developing countries, the staff had assumed that imports would be growing at a rate equivalent to that of output over the coming years, the Director noted. Previous projections had assumed that imports would grow more rapidly by about 2 percentage points. The assumptions underlying the present baseline scenario reflected the judgment of the various area departments that measures to enhance the efficiency of resource allocation and investment and, above all, improved exchange rate management, would lead to more efficient use of scarce foreign exchange and to efficient import substitution.

An Executive Director had asked whether reducing the import intensity of domestic production in developing countries was in conflict with the goal of trade liberalization, the Director recalled. In the staff's view, it was not. First of all, a reduction of import restrictions and tariffs was typically accompanied by exchange rate measures to meet current account targets. Such measures would minimize the eventual impact on imports. To the extent that imports were affected, there would also be an impact on the efficiency of resource allocation and on investment as prices of different traded goods moved closer to those prevailing in world markets. Consequently, growth performance itself would be expected to improve without necessarily any effect on the import expansion associated with that growth.

A question had been raised concerning the deceleration of potential output growth in industrial countries, the Director noted. That important issue had been analyzed to some extent in the previous world economic outlook exercise which had identified the main reasons for the deceleration--namely, weaker growth of investment and in particular the slowdown in total factor productivity growth as a result of slower improvements in resource allocation because of the slowdown in the transfer of labor from agriculture to secondary and tertiary sectors; increased government regulatory requirements in areas such as environmental protection, health, safety standards; and accelerated obsolescence of capital due to sharp changes in the relative prices of energy and labor. He agreed with

Mr. Kafka that with the decline in oil prices, it would be interesting to update the staff's estimate of potential output growth for the next world economic outlook exercise.

There were arguments on both sides concerning the scope for further cuts in interest rates in the five major industrial countries, the Director of the Research Department remarked. Arguments in favor of lower interest rates included a fiscal result in the United States close to the Gramm-Rudman-Hollings target; a further fall in oil prices; and more moderate growth than had been projected. On the other side would be factors such as a reversal of the decline in oil prices; less success with fiscal policy in the United States; and stronger growth than anticipated, with more inflationary pressures. Of course, stronger growth was less likely with a reversal of the recent decline in oil prices. But those were some of the considerations that one would have to weigh in deciding whether there was scope for further interest rate cuts.

The Executive Directors agreed to resume their discussion on Monday, March 24, 1986.

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/86/49 (3/21/86) and EBM/86/50 (3/21/86).

2. CAMEROON - TECHNICAL ASSISTANCE

In response to a request from the Cameroonian authorities for technical assistance in implementing a computer system for international banking and accounting applications, the Executive Board approves the proposal set forth in EBD/86/77 (3/19/86).

Adopted March 21, 1986

APPROVED: December 8, 1986

LEO VAN HOUTVEN
Secretary