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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/51

10:00 a.m., March 24, 1986

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

Executive Directors	Alternate Executive Directors
A. Alfidja	
C. H. Dallara	
J. de Groote	H. G. Schneider
M. Finaish	T. Alhaimus
H. Fujino	M. Sugita
G. Grosche	B. Goos
Huang F.	Jiang H.
J. E. Ismael	Jaafar A.
A. Kafka	
	M. Foot
H. Lundstrom	
M. Massé	L. Leonard
E. I. M. Mtei	
F. L. Nebbia	
Y. A. Nimatallah	J. E. Suraisry
	G. Ortiz
H. Ploix	
J. J. Polak	J. de Beaufort Wijnholds
C. R. Rye	
G. Salehkhou	O. Kabbaj
A. K. Sengupta	
	N. Coumbis

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

Also Present

IBRD: V. Dubey, Operations Policy Staff. African Department: T. Muzondo. Asian Department: U. Baumgartner. European Department: R. A. Feldman, H. B. Junz. Exchange and Trade Relations Department: C. D. Finch, Counsellor and Director; M. Guitián, Deputy Director; C. Atkinson, G. Belanger, J. T. Boorman, E. H. Brau, K. B. Dillon, H. Hino, S. Kanesa-Thasan, R. Kincaid, C. M. Watson, M. Xafa. External Relations Department: J. M. Landell-Mills, I. S. McDonald, B. Nowzad. Fiscal Affairs Department: V. Tanzi, Director; A. H. Mansur. IMF Institute: O. B. Makalou. Legal Department: J. G. Evans, Jr., Deputy General Counsel; W. E. Holder, A. O. Liuksila. Middle Eastern Department: J. G. Borpujari, M. A. El-Erian, S. Von Post, M. Zavadjil. Research Department: W. C. Hood, Economic Counsellor and Director; A. D. Crockett, Deputy Director; R. R. Rhomberg, Deputy Director; K.-Y. Chu, M. C. Deppler, D. Folkerts-Landau, S. J. A. Gorne, J. P. Horne, O. E. G. Johnson, N. M. Kaibni, F. Larsen, P. R. Masson, D. J. Mathieson, P. J. Montiel, S. Takagi. Secretary's Department: A. P. Bhagwat. Treasurer's Department: W. O. Habermeier, Counsellor and Treasurer; S. I. Fawzi. Western Hemisphere Department: S. T. Beza, Associate Director. Bureau of Statistics: H. Flinch. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: A. A. Agah, W.-R. Bengs, M. B. Chatah, L. P. Ebrill, J. Hospedales, P. Péterfalvy, G. W. K. Pickering, I. Puro, M. Z. M. Qureshi, D. C. Templeman, A. Vasudevan, M. A. Weitz. Assistants to Executive Directors: J. R. N. Almeida, A. Bertuch-Samuels, B. Bogdanovic, J. de la Herrán, F. Di Mauro, J. J. Dreizzen, G. Ercel, R. Fox, V. Govindarajan, G. D. Hodgson, A. R. Ismael, Z. b. Ismail, S. King, M. Lundsager, K. Murakami, J. K. Orleans-Lindsay, W. K. Parmena, J. Reddy, J. E. Rodríguez, S. Simonsen, B. Tamami, 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/86/50, 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).

The Director of the Research Department recalled that an Executive Director had asked why the staff had not assumed the full implementation of the Gramm-Rudman-Hollings Act in its baseline scenario and why it had concluded that there would be long lags between the initiation of U.S. fiscal consolidation and the improvement in the economic situation. In the staff's view, although the passage of the Act had reduced somewhat the uncertainty with respect to the fiscal outcome, it was nonetheless unclear whether the annual reductions would in fact be fully implemented over the medium term. If the legislation was implemented as planned, it would be the first time that the United States had undertaken a major deficit reduction program over a multiyear horizon. However, the Gramm-Rudman-Hollings Act was unique in that it represented a commitment to fiscal consolidation over a period of years that was reinforced by law. That kind of policy action had not occurred in recent experience. If markets increasingly anticipated the consequences of that legislation, the staff might not have made a sufficient allowance for the positive impact of that legislation in coming years. In the light of experience, however, the staff did not consider that the duration of the lags was overestimated.

The Chairman stated that the staff could have assumed either the full application of the Gramm-Rudman-Hollings Act in the baseline scenario or the reverse. The judgment it reached on the likely impact of that Act had not been arrived at lightly; as he would explain in his summing up, the assumption with respect to the implementation of the Gramm-Rudman-Hollings legislation was only an economic alternative, having no political content. There had been no intention of suggesting that the Act was not going to be fully implemented. As for the economic effects of the U.S. legislation, his summing up would allude to the view held by some Executive Directors that the staff had overstated the negative impact of the legislation on the economy and had perhaps been too mechanistic in its evaluation.

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

Mr. Dallara said that his authorities remained of the view that it would have been more appropriate to assume the complete implementation of the Gramm-Rudman-Hollings legislation in the baseline scenario. Nevertheless, he recognized that there was always a need for a healthy degree of skepticism on the part of the Fund when viewing the medium-term fiscal efforts of any country, especially of a major industrial country whose fiscal accomplishments in recent years had not been fully consistent with the fiscal objectives of the Administration. While he had no fundamental problem with the baseline scenario in an economic sense, in a political sense it might have been more appropriate to assume the full implementation of the Gramm-Rudman-Hollings legislation.

The essence of his concern, however, was the analysis underlying the interpretation of the effects of the U.S. fiscal deficit reduction, Mr. Dallara continued. In his view, that analysis had been too mechanically Keynesian. Executive Directors had given priority to reducing the U.S. fiscal deficit during past discussions of the world economic outlook and during the most recent discussion of the Article IV consultation with the United States (EBM/85/120 and EBM/85/121, 8/5/85). It was therefore difficult to understand how the present exercise could produce an overall sense that a deficit reduction in the United States would have a negative effect on the world economy for the next four and a half years. The analysis seemed to imply that the continuation of current imbalances in the U.S. fiscal position--at least on a nominal level--would continue to provide some stimulus to the world economy. Otherwise, how could one assume the withdrawal of stimulus over a period of four and a half years? Having in the past analyzed the negative effects of the U.S. deficit on interest rates, on investment opportunities both in the United States and in other countries, on external imbalances, and on other areas, he wondered where the positive effects of fiscal reduction were expected in the present scenario. Admittedly, the staff papers had referred to the uncertainties surrounding the outcome, and to the beneficial effects on financial markets, which could accrue quickly so that the short-run costs in terms of lost output might be diminished. Other references included in particular the notion that the medium-term positive effects could emerge at an earlier stage. In discussing policy interactions, the staff had indicated that over the longer run, output would be expected to rise over its baseline path. If those expectations were sufficiently positive, the long-run effects could be realized sooner. However, his authorities considered that if the deficit was reduced in the short run, the resources would not disappear but would be allocated to more efficient uses than in the past. Certainly, some transitional issues were present in such circumstances, particularly if the change in the U.S. fiscal position turned out to be as substantial as envisaged. Yet, the real and psychological effects on financial markets were likely to be positive, and as Mr. Polak had pointed out, the lags might not only be shorter, but might be reversed.

Despite the caveats concerning the overall thrust of the analysis, the suggestion that a reduction in the U.S. fiscal deficit could have a negative effect on the U.S. and world economies over the medium term was dangerous, because it could raise serious doubts in the minds of U.S.

policymakers about the propriety of reducing the deficit, Mr. Dallara considered. Politically, the effects of the analysis might be potentially negative.

He understood the wide range of uncertainties underlying the staff's analysis and the need to use models, Mr. Dallara remarked. However, neither the staff nor management nor the Board was hostage to models, and he hoped that a long, hard look would be taken at the analysis to see whether it was the most appropriate way to depict the medium- and long-term effects of a U.S. deficit reduction on the U.S. and global economies.

Mr. Nimatallah said that he tended to agree with Mr. Dallara, that the deficit reduction might have a positive impact in the not-too-distant future, but only if tax reform was speeded up. That caveat was one that needed to be added to the analysis.

Mr. Fujino noted that he had already expressed his concern that the staff projections were overly pessimistic and that perhaps one of the main causes of that pessimism was the staff's view of the U.S. economy. More promising projections for the United States would have implications not only for the global projections but also for the policy recommendations for other major industrial countries.

Mr. Grosche reiterated his belief that the Gramm-Rudman-Hollings legislation would have quick, positive results and that the staff's projections were overly pessimistic. He tended to agree with Mr. Dallara that the effect of a better balancing in the U.S. budget would also be positive in the short term. At present, the private sector reacted differently and more quickly to budget deficits than it had in the past. Therefore, he expected that a reduction in the U.S. deficit would show short-term results quite quickly.

Mr. Rye said that he supported Mr. Dallara's position and considered that he had made some telling points, particularly with respect to the lack of symmetry in the staff's arguments on the impact of the U.S. deficit before and after the enactment of the Gramm-Rudman-Hollings legislation. If prior to that Act continuing large U.S. deficits were considered a major drag on the U.S. and world economy, it could not be argued subsequent to that Act that reducing the deficit imposed an even larger burden on the economy. That overly pessimistic view lent a considerable bias to the world economic outlook and to the presumption of a risk in the upward direction.

Mr. Sengupta said that he fully agreed with the staff position. Most of the technical literature indicated that the immediate effect of reducing the U.S. deficit would be a decline of output growth in the United States and the rest of the world unless complementary actions were taken by the international community to prevent a slowdown in economic activity. The staff's medium-term scenario rightly stressed that point. To argue instead that there would immediately be an increase in output and a crowding in of the private sector would go against all of the existing literature. Nonetheless, the political consideration raised by Mr. Dallara was important. The Fund had been encouraging the U.S. authorities to reduce the deficit, and it should not now give a signal to the U.S. public or the rest of the world that such action was not desirable. The Fund's report should indicate the desirability of reducing the deficit while stressing that the reduction would have some immediate short-run costs in terms of U.S. and world output. In any event, that outcome should not be glossed over.

Mr. Foot said that he wished to support Mr. Dallara's viewpoint. Confidence effects were purely a question of judgment. Moreover, the scale of fiscal change envisaged was unprecedented, so that the margins of uncertainty in the staff's model were far larger than they would have been in the absence of the Gramm-Rudman-Hollings legislation. He doubted, however, that the adverse confidence effects resulting from partial implementation of that legislation would be greater than they would have been without it. Thus, the sense of the staff paper seemed to go against common sense.

The Director of the Research Department, responding to Mr. Sengupta, noted that the staff paper clearly indicated the unsustainability of the U.S. budget position, and the discussion of the baseline scenario had dealt explicitly with that point. Also, the staff had expressed some doubt as to the wisdom of reducing the deficit to zero as envisaged in the Gramm-Rudman-Hollings legislation. While the staff might have been too pessimistic with respect to the lags, it was realistic to ask whether reducing the deficit to zero within five years was an appropriate policy stance. It was possible that the staff had underestimated the positive effects of a clear indication by the authorities that the United States was starting to manage its budget deficit.

Mr. Kafka said that more generally, the discussion had brought out a fact that had often worried him--namely, that the staff seemed to have a pessimistic bias on certain types of policy action which was evident not only in its judgment of the Gramm-Rudman-Hollings legislation but often in the way in which it approached stand-by arrangements and their underlying policies. He hoped that the Board's discussion on the theoretical underpinnings of the Fund's adjustment programs would provide the proper occasion for discussing that predilection.

Mr. Polak noted that different models gave different answers as to the timing of the impact of policies, and that, in turn, gave rise to a greater or lesser degree of optimism or pessimism. The difficulty with the present analysis was to know whether the lags were there. The Director of the Research Department had said at the previous meeting that the lag might be zero; he himself had indicated that the lag might be negative. Of course, if the lag were zero or negative, then the basis for the present scenario disappeared, and that was too important an issue to gloss over.

The Deputy Director of the Research Department remarked that the staff had considered three scenarios: the do-nothing scenario, in which the deficit remained at 5 percent of GNP or higher; the baseline scenario in which the deficit was reduced to 2 1/2 percent of GNP; and the balanced-budget scenario, wherein the deficit was reduced to zero. The do-nothing scenario, which would allow the deficit to remain at the same level as in the past, would have serious consequences--namely, either a recession, a collapse of the dollar, or even a further strengthening of the dollar. These possibilities would presumably eventually provoke measures to reduce the deficit, quite possibly with severe effects on world economic activity. The second scenario envisaged a situation in which the deficit was brought down to 2 1/2 percent of GNP, close to the ratio at which government debt could be stabilized as a share of GNP. Such reduction would have beneficial effects on confidence and would result in an outcome far superior to that of the first scenario. While the second scenario established a credible or sustainable position, the third scenario represented the incremental effects of going further. In evaluating the third scenario, the staff had relied on some model-based estimates. The model did contain expectational effects, so that the beneficial consequences of additional deficit reduction tended to come through somewhat more rapidly than in other models.

There were essentially two kinds of lags--the lag between the effective reduction of the deficit and the fall in interest rates, and the lag between the reduction of interest rates and the strengthening in economic activity, the Deputy Director of the Research Department observed. Most models showed that the second lag was the longer and more important one. Recent evidence suggested that the first lag might become much shorter or indeed negative if interest rates were falling in anticipation of budgetary action, but previous experience still suggested that there was a significant lag before the beneficial effects came through. Although the circumstances surrounding the U.S. deficit were unique, the staff considered that additional action to reduce the deficit, beyond that assumed in the staff's baseline scenario, would by itself tend to have negative short-run effects on activity.

Mr. Dallara said that the lag issue was important, but a more basic question was whether the analytical framework was adequate and appropriate. He also wished to note that while Mr. Sengupta had continually stressed the importance of growth outside the United States, he had also consistently stressed the importance of reducing the U.S. fiscal deficit for the health of the world economy.

Mr. de Groote remarked that the imbalance in the U.S. economy reflected not only the excessive government deficit but also the imbalance between savings and investment in the United States. The latter imbalance had been made up by the supply of foreign savings and was reflected through the exchange rate in a large deficit on the current account. It was difficult to imagine a fundamental correction of the U.S. fiscal position that would not be accompanied by a correction in the savings/investment imbalance and in the current account position. Such adjustment therefore could not occur quickly. Moreover, not much had been said during the discussion about the effect of the new legislation on the savings behavior of the American public. If a positive effect could be demonstrated, he might agree that the lags would be shorter; there was however the possibility that the public would continue to react in a way that was perhaps not entirely rational. Unless there was a quick readjustment of the savings/investment imbalance, there would be some lag.

It was generally recognized that the situation resulting from the new legislation would create conditions that were definitely more favorable for the United States and for the world, at least in terms of output growth, than would be the case in the absence of such legislation, Mr. de Groote added. Indeed, the situation would have become totally unsustainable if the U.S. authorities had not acted. The question remained whether that decision--which was bound to have beneficial medium-term effects--would not in the short term be accompanied by output and income reductions; as yet, no country had engaged in an adjustment process without having to pay some costs. Political considerations called for caution in describing possible outturns. Nonetheless, the Fund had often told members that the adjustment measures they were advised to take might have temporary income effects. He had constantly defended the idea that the adjustment process in the United States would probably lead to a moderate adjustment in incomes and might indeed have a recessionary aspect, but he did not think that that outcome could simply be ignored in a report that was expected to be intellectually balanced.

Mr. Nimatallah said that he agreed with Mr. de Groote that in the short term there would be negative effects--namely, a slowdown in economic activity. At issue was the extent of such a slowdown: in his view, that it would be less severe than expected.

The Chairman noted that the models used by the staff were very sensitive to changes in fiscal policy. The changes in fiscal policy envisaged in the Gramm-Rudman-Hollings Act were substantial, and it would not be surprising if the model tended to overstate the reaction.

Mr. Polak asked whether any of the models used by the staff made allowance for developments that ran from interest rates, to stock market prices, to consumption expenditure. If not, he wished to refer them to a 1939 model on the United States that did.

Mr. Dallara, responding to Mr. de Groote's point, said that although some Executive Directors clearly considered that a temporary short-term output loss would result from the reduction of the U.S. fiscal deficit, his authorities did not share that view. In any event, the question to be applied to the medium-term scenario as well as to Fund-supported adjustment programs was what loss of output and economic activity would have occurred in the absence of fiscal adjustment? That comparison, which in many instances justified the adoption of policies involved in Fund-supported programs and which justified the need to reduce the U.S. deficit, was missing.

The Director of the Research Department said that the staff could of course make more explicit the consequences of the absence of fiscal action so that the papers sufficiently conveyed the staff's support for the U.S. Administration's seizing hold of its fiscal problem and managing it.

The Chairman remarked that it was important not to give the impression that the Gramm-Rudman-Hollings legislation was going to produce a negative impact on the world economy. Its impact would be positive--as Mr. Dallara had correctly pointed out--compared with what would have happened in the absence of such legislation.

Mr. Sengupta said that he could agree with the Chairman's view of the outcome of the Gramm-Rudman-Hollings legislation. He wished to stress that a major lesson to be learned from all of the models was the need for coordinated action, particularly among the OECD countries.

He recalled that he had asked whether it would be possible for the United States to reduce interest rates in line with a smooth fall in the dollar's exchange value without concomitant action on the part of Germany and Japan. If that was not possible, then the underlying need for coordinated action by the major currency countries had to be stressed.

Mr. Fujino noted that Directors had in the past urged the United States to reduce its fiscal deficit. It was important to stress that, as Mr. Dallara had pointed out, initiating a reduction and a time schedule for the reduction should be a positive factor.

Mr. Massé recalled that Mr. Dallara had said that the view expressed by Canada and the staff had disappointed him. In his authorities' view, the reduction of the U.S. fiscal deficit was a positive step. At the same time, while the outcome was expected to be more positive than might otherwise have been expected, it could not be concluded that the deficit reduction would have no negative effects. Canada's experience had been that reducing the deficit led to a reduction in net demand, as was to be expected because of the change in the use of resources and increased unemployment, which however would be compensated by other effects in the economy. In Canada, not all of the expected reduction in stimulus had occurred because a number of lobbyists had been able to obtain the deferral of some deficit reductions. However, it was realistic to assume that the implementation of some aspects of the Gramm-Rudman-Hollings Act might be delayed or changed, and that the Government might have to adapt the legislation. He therefore supported the staff's viewpoint. In the medium term, even if the Act was only partially applied, it would lead to a situation that would be much better than would have obtained in the absence of such legislation. He therefore welcomed the U.S. legislation and agreed with Mr. Dallara regarding its effects in the medium term.

The Chairman noted that a technical question remained. First, if the lag between the deficit reduction and the lowering of interest rates was shorter than that implied in the model--or even negative--and if the reaction of the real economy to a reduction in interest rates, with the increase in stock values associated with that process, was more rapid than that implied in the model, the outlook stemming from the assumption regarding the impact of the Gramm-Rudman-Hollings legislation would be different from that presented in the staff paper. That was not to say that the model was wrong, but that it could be constructed in a way--perhaps not based on secular experiences--that would give different results. The analysis presented in the staff papers had a rather negative overtone, voicing several questions: First, was the scenario based on a model in which the Fund had confidence? Second, was the outcome likely to be misinterpreted--especially as the Fund had preached fiscal discipline, particularly with respect to the United States, for a number of years? Was the Fund changing its stance and saying that fiscal discipline was a dangerous thing? To avoid any misunderstandings, he asked Directors for their views on the issue.

The Deputy Director of the Research Department noted that the model provided insights that were non-Keynesian: the investment functions were more sophisticated; forward-looking expectations permitted shifts in interest rates to be reflected in savings patterns; and shifts in investment income, including earnings from bonds and stocks, were allowed to have an effect on consumer spending. The basic limitation of any analysis based on models was that the behavioral relationships had to reflect historical experience. In a situation in which that experience became less relevant as a result of a basic change in the regime in which expenditure decisions were made, the model would be less satisfactory.

As to whether a different model would have produced a different result, the answer was no, the Deputy Director of the Research Department continued. In a Brookings Institution exercise conducted a few months previously, the results of a number of different models used in the United States and abroad in both the private and public sectors were compared with respect to their responsiveness to a number of items, including a reduction in the U.S. deficit. Fundamentally, the results of the models were reasonably close to each other; in particular, the model used by the Fund performed roughly in the middle. That outcome underscored that the models could only perform the limited task of taking a set of assumptions and pre-existing behavioral relationships and translating them into assumptions about the future.

Mr. Nimatallah remarked that previous behavior did not include the intention of the U.S. Government to reduce the size of government and its impact on the private sector. That factor, which he did not think had been considered in many models, was central to the present discussion.

The Director of the Research Department noted that the staff agreed with Executive Directors that it was essential that the papers indicate more clearly than they had the benefit that would derive from reducing the U.S. fiscal deficit. Moreover, Directors had expressed considerable doubt as to whether the staff had been sufficiently optimistic regarding the consequences of the U.S. authorities' commitment to managing the fiscal deficit problem. The staff would need to emphasize the uncertainty connected with that development. In that regard, Table 2 of the paper on policy interactions could perhaps be revised to be less explicit about the consequences of the full implementation of the Gramm-Rudman-Hollings legislation. While he was not suggesting that the central scenario needed to be changed, the concerns raised by Executive Directors would be reflected in the paper on the world economic outlook to be presented to the Interim Committee.

Mr. Dallara remarked that the procedure outlined by the Director of the Research Department appeared to be satisfactory. With respect to the consequences of the Gramm-Rudman-Hollings legislation, it was important to indicate not only that the U.S. fiscal effort, if accomplished, would be good for the world economy, but also that, on balance, it would have positive effects on world economic growth during the period of its implementation. It might also be useful to look closely at the term "withdrawal of stimulus," because one had to ask, withdrawal compared to what? With respect to the behavioral relationships on which the models were based, he wished to point out that the use of those models had led in the past to the judgment that a reduction in the U.S. deficit was desirable. The question remained whether those past behavioral relationships needed to be reviewed as a result of the substantial change in U.S. fiscal policy. As to the magnitude of the assumed deficit reduction, he did not have a strong view.

The Chairman recalled that when the Fund had issued its warnings concerning the size of the U.S. fiscal deficit in years past, it had been conscious of the demand effects of a deficit reduction, especially when those deficits had reached very large proportions. For that reason the Fund had been urging the authorities to adjust at an earlier stage when the reduction and thus any negative reactions would also be smaller. The staff's comments with respect to the models raised intellectually disturbing issues in that the situation in the United States at present was basically different than that assumed in the historical relationships in the models because it had been announced that a substantial reduction of the U.S. deficit would take place over a period of five years. It was necessary to look at the way the model functioned because that announcement would have favorable impacts on the economy. If the environment had continued to be more uncertain and more difficult to interpret, then reactions could have been expected to be more negative than when an announcement was made at the outset. Indeed, it might well be that the negative reactions to the deficit reduction might be less or shorter in duration as a result of the announced policy. He was not sure that the model allowed for that unique situation. The basic question was should the Fund rely on historical relationships that had little to do with new realities.

Mr. Kafka noted that even if a more optimistic assessment of U.S. policy were made in the revised paper, one fact should not be ignored--namely, that the effect of the Gramm-Rudman-Hollings legislation on the global economy would depend on the extent to which complementary action was taken by other industrial countries.

The Deputy Director of the Research Department remarked that the staff's forecast did indicate that the deficit reduction legislation would have positive effects over the medium term. The question of the speed with which those positive effects would be felt was of course an open one, but the positive medium-term effects would outweigh the short-term negative effects.

It had been pointed out that perhaps even in the shorter term those negative effects would be slight or perhaps even nonexistent, the Deputy Director of the Research Department continued. That outcome would run counter to the analysis that had been done, not only on the basis of models of past relationships, but on the basis of a priori reasoning. For example, much of the strength of the recovery--although not all of it--had been attributed to the strong stimulus that was coming from the fiscal position. Similarly, a somewhat more moderate pace of fiscal consolidation was being advocated for certain countries in the expectation that that would tend to lessen the short-term negative effects of a U.S. deficit reduction. Evidence suggested that there was a pattern of negative impact in the short term followed by positive impact thereafter. Of course, when the regime changed and expectations changed, judgment would have to be substituted for past experience. In a sense, that judgment was present in the staff papers but had not been quantified. Collateral evidence would have to be used to reach judgments about the future.

The Chairman noted that the historical bias in a way distorted the presentation because people tended to look at the tables based on quantifiable data rather than to consider the qualified judgments presented in the text.

The Deputy Director of the Research Department said that the presentation would have to be made clearer in that regard. For instance, there were effects resulting from a planned reduction of government expenditure over a future period that would be positive. There might however be negative effects over the medium term. If the Government made clear in advance that certain expenditures would be curtailed in the following two or three years, then investment decisions would be made on that basis. A fall in interest rates would be a positive factor, but it could not necessarily be assumed that there would be no offsetting negative effects even though the overall effect was positive.

Mr. Fujino said that he had a positive view with respect to the medium-term outlook for the major industrial countries, including the United States and Japan. In Japan there was clear evidence of strong growth in the last quarter of 1985 and, if additional measures were to be formulated, they should be based on actual developments. Because so many uncertainties were involved--including exchange rate and oil price changes--developments in each economy had to be watched carefully; the Fund should not press for too much expansion of a country's economy. There was a limit to a country's growth potential.

Mr. Nimatallah, returning to the question of oil prices and inflation, noted that a recent article in Fortune said that despite cheap oil and the collapsing value of the dollar, the rate of inflation in the United States depended primarily on labor cost developments. The article added that in 1985 union labor costs had increased 4.1 percent, but that wages would not accelerate much in 1986 or 1987. Thus, labor costs appeared to be the primary factor influencing the rate of inflation. Previous staff reports had identified government expenditure as a most important factor with respect to inflation. And the present staff paper identified lower oil prices as the most important factor.

The article in Fortune further stated that in 1987, even if energy costs remained low, as they seemed likely to do, the beneficial effect on the inflation rate was expected to wear off and the decline in the value of the dollar was expected to push up prices, Mr. Nimatallah continued. Thus, there were other factors besides declining oil prices that contributed importantly to lowering the rate of inflation; the fact that their impact on inflation would be positive in the short run should be specified, just to be on the safe side.

The Deputy Director of the Research Department commented that Mr. Nimatallah's remarks had already been reflected in the staff paper, which indicated that over the longer term the rate of inflation would be determined basically by government financial policies, particularly monetary policy, and that restraint in monetary policy was fundamental in bringing down inflation and keeping it down. In any particular year, against a background of constant policies, an external disturbance--whether it be an exchange rate change or a shift in imports, such as oil--would tend to bring down the price level, with an effect on inflation over the period during which that change was working its way through the economy. Thus by 1987, the benefits from lower oil prices would cease to affect the economy. One might also say that the adverse effects of a declining dollar--assuming that the dollar ceased to decline--would also cease to affect the economy.

The Chairman then made the following summing up:

> We have had a wide-ranging discussion on the world economic outlook and the policy implications that arise in the present situation. I will organize my remarks under the four general themes identified in the topics for discussion in the staff paper.

1. The general outlook

> Many Directors drew attention to the major developments in the international environment that have occurred since the Board's last consideration of the world economic outlook. These developments include the recent sharp decline in oil prices; the continued depreciation of the U.S. dollar and the corresponding appreciation

of the yen and the European currencies; the further decline in interest rates; and the increased determination of the United States to deal effectively with its fiscal deficit. As Directors have pointed out, considerable uncertainty surrounds the channels through which such developments affect economic performance as well as the question of how far recent developments can be taken as a guide to future conditions. Any assessment of short-term and medium-term prospects, therefore, has to be undertaken with considerable caution.

The recent performance of the world economy, Directors noted, had been somewhat mixed. The growth of output in the industrial countries had slowed in 1985 by more than had been expected a year ago, thereby contributing to a significant weakening of the expansion of world trade, which had increased only half as rapidly as envisaged in last April's World Economic Outlook. The terms of trade of developing countries had deteriorated sharply so that their real export earnings had been hard hit. At the same time bank financing to indebted countries had virtually dried up. Thus, economic growth in the developing world had slowed and the management of the debt situation had been made more difficult.

Nevertheless, a number of positive developments give grounds for hoping that global economic performance will improve in 1986. Directors noted that the rate of inflation had continued to fall in the industrial countries, and that several developing countries had recently taken bold measures to deal more effectively with price pressures. The fact that recovery in the industrial world had become better balanced across countries, and had now entered its fourth year, was also considered to be encouraging. Recent exchange rate movements had been in the right direction and should help reduce the threat of an unsustainable buildup of external disequilibria. Growing evidence of a determination to deal with fiscal imbalances had contributed to a general decline in interest rates, and this was helping to improve the investment climate and to ease the debt service burden of heavily indebted countries. Finally, the evidence of greater and more coordinated attention by the major countries to issues of economic management, such as exchange rates and the debt situation, was widely agreed to be a helpful development.

Against that background, Directors felt that opportunities existed to strengthen economic performance in the period ahead. I might recall three points in this connection. First, lower oil prices should make it possible to improve the outcome of the coordinated strategy in the industrial countries. Most Directors felt that lower oil prices should be passed through in full to the private sector, in particular to enterprises, if domestic circumstances permit, so as to strengthen private demand. It was recognized, however, that in some countries it might be necessary to raise energy taxes so as to strengthen fiscal positions and maintain incentives for energy conservation. Second, policy efforts should continue to focus on facilitating the strengthening of private sector activity. This would be helped by allowing lower costs to be reflected in enterprise profits, by an easing of monetary conditions (not policies) and by continued fiscal consolidation to permit the "crowding-in" of private investment. Third, it was felt desirable to further improve the functioning of the mechanisms of international cooperation. The debt strategy needs to be strengthened; the need to recycle funds to facilitate the adjustment to lower oil prices has to be recognized; active, persistent and mutually supportive measures are required to contain the threat of protectionism; and, Fund surveillance has to be strengthened along the lines recently discussed in the Board.

If the opportunities inherent in the present situation are seized, many Directors feel that the outcome in the industrial countries would be stronger than projected by the staff. There was indeed a fairly widespread view that the staff might have overestimated the negative short-term effects on output of fiscal consolidation in the United States. They might also have taken an unduly pessimistic view of the lags with which the subsequent benefits would be felt. Since the commitment of the U.S. authorities to fiscal consolidation was stronger than in the past, and since a firm medium-term plan had been adopted, it was reasonable to expect the benefits of expenditure cuts--in the form of lower interest rates and enhanced private sector confidence--to come through more quickly than past experience might suggest. Indeed, financial markets appear to have already reacted in a favorable way, and the benefits of growing confidence could soon start to show up in rising investment and output.

Some Directors, however, considered that the staff might not have taken account of certain negative factors, particularly as they affected developing countries. It was pointed out, for example, that aid flows from oil exporting countries, as well as import payments and workers' remittances, had been an important source of foreign exchange for many non-fuel exporting countries. These flows would presumably diminish if oil prices remain at their present levels and if no offsetting recycling mechanisms were found to replace them. It was also pointed out that, as a result of the decline in oil prices, some indebted, oil exporting countries now face financing gaps that are larger than anticipated.

2. Policies in industrial countries

There was wide agreement that the basic challenge facing industrial countries remained unchanged: the pursuit of sustainable growth in output through policies that promote economic and financial stability, give full encouragement to the strengthening of private sector activity, and take account of the international interactions of policies and performance. In this latter connection, it was recognized that coordination of economic policies was of the essence if the exchange rate shifts needed to correct external imbalances were to take place compatibly with sustained growth in all countries and the avoidance of inflationary pressures.

Directors generally endorsed the medium-term thrust of the fiscal policy being pursued by the major countries. All speakers stressed that bringing down the United States' federal deficit in a durable and credible manner was central to the overall strategy of establishing conditions for sustained world economic growth and international financial and exchange rate stability. They warmly welcomed the steps that have been taken by the U.S. Administration and Congress to this end. Although they noted some legal uncertainties surrounding certain features of the U.S. legislation, they recognized the broad-based commitment to the process of deficit reduction. Many Directors believed that U.S. efforts to reduce the fiscal deficit were having a favorable impact on confidence, and that this bodes well for economic growth. Among the other industrial countries, it was noted that Canada and Italy both have large deficits and could not afford any relaxation in their efforts to bring them under control.

Germany and Japan were felt by a number of speakers to have somewhat more room for maneuver. In the case of Japan, many Directors felt that the prospective weakness of output, combined with the progress already made in reducing the general government deficit and the high savings propensity of the Japanese private sector, argued for a somewhat less restrictive fiscal stance in 1986-87, particularly at the noncentral government level. This in no way implied any disagreement with the objectives of the medium-term fiscal consolidation in Japan. Mr. Fujino pointed out that the central government deficit in Japan remained high, that government spending would increase sharply in the 1990s for demoraphic reasons, and that any weakness of output was due to the adjustment of Japan's external accounts, rather than to a softening in domestic demand. Domestic demand was actually accelerating, and Mr. Fujino considered that pressure to adjust the fiscal stance in the short term could be counterproductive to the Government's medium-term objectives. For Germany, most Directors agreed with the staff's assessment that any scope for easing of the fiscal stance was prospective rather than immediate. The German authorities were nevertheless urged to keep an open mind and to assess the possibility of bringing forward the planned 1988 tax cut in the light of developments during the current year. Some other Directors felt that macroeconomic policy in Germany could play a more active role than I have just described. However, Mr. Grosche noted that output was expected to grow in Germany at a rate above that of productive potential and that his authorities therefore did not see a need for further stimulus.

Concerning monetary policy, there was a widespread view that lower real interest rates would be helpful in sustaining the growth of private sector activity as well as in easing pressures on indebted countries. Directors generally felt that the improved outlook for inflation and the increased credibility of governments' commitment to price stability broadened the scope for policy to be implemented in a flexible way, so as to facilitate a downward movement in interest rates. A number of Directors, however, cautioned against the dangers of activism in this area. Besides undermining the prospects for inflation control over the medium term, an aggressively expansionary monetary stance could fairly quickly generate a counterproductive reaction in financial markets, leading to higher, not lower, rates. Thus, monetary policy should aim at permitting an easing in monetary conditions, which could be expected as a result of keeping monetary growth rates steady in the face of a decline in inflationary expectations.

Several Directors referred to the issue of structural policies in industrial countries, agreeing with the staff that rigidities in the functioning of labor markets were an important impediment to improving the rate of employment creation in Europe. To the extent that declines in import prices--especially for energy--could be used to raise enterprise profits, this could help redress a fundamental imbalance in the European economies. Other initiatives would be necessary, however, including measures to encourage greater wage flexibility, to moderate the share of payroll taxes, to reduce artificial incentives to substitute capital for labor, and to promote occupational and geographic mobility.

3. Policies in developing countries

A number of Directors commented on the role of additional capital flows in promoting growth in indebted countries. Since we will be hearing more of these issues later today, I will reserve my summing up on this aspect of the subject until the conclusion of our discussion on the debt situation and strategy.

As far as policy requirements in developing countries are concerned, a number of Directors drew attention to the relatively weak external environment these countries would be facing over the next several years. Exports were projected to grow relatively slowly; the terms of trade were not expected to improve; little further relief on interest rates had been assumed--although a number of Directors thought that the staff might have been a little too pessimistic on the medium-term prospects for interest rates; and capital inflows would remain subdued. It was stressed that the goal of restoring satisfactory growth with external financial stability could only be achieved if the international economic environment was satisfactory. In this context, many

Directors emphasized the need for industrial countries to manage their economies so as to promote adequate growth, to ensure access for imports from the developing world, and to achieve a moderation of real interest rates.

Against that background of modest growth in export earnings, it was recognized that particular importance had to be attached to the effectiveness of domestic policies in developing countries in promoting the growth process. I may perhaps list some of the key points that were made. First, continued efforts were needed to mobilize resources for the development effort. This would require appropriately supportive monetary and fiscal policies as well as a realistic exchange rate to raise the level of national saving and to tackle the problem of capital flight. Second, domestic conditions conducive to a revival of investment had to be created. These conditions would in many cases require structural reforms in the domestic economy and changes in the structure of relative prices. Third, the process of adapting to slower growth in world markets required broadening the range of traded goods that could be produced domestically. In this connection, the setting of the exchange rate had a key role to play, although several Directors cautioned that shifts in the structure of production in developing countries could not be expected to come about quickly or easily.

4. International coordination

Directors considered that the increased commitment to international policy coordination had been a positive feature of developments in the past few months, and had, in itself, contributed to increased optimism about the economic outlook. In addition, the tangible consequences of these efforts--in the form of the resulting movements in exchange rates and interest rates--had helped reduce potential constraints on the sustainability of growth.

It was noted, however, that the coordinated actions that had taken place so far had occurred in an environment in which the interests of the countries concerned largely coincided. It would be important to sustain the momentum of coordination in an environment in which agreement might become harder to reach. In this connection, many Directors stressed the Fund's surveillance role and the importance of the Fund's participation in other forums where economic policy coordination was being discussed.

Directors welcomed the staff paper on policy interactions in industrial countries, and noted that it was a helpful innovation and one that should be continued. Several suggestions were made for developing the staff's analysis, including the suggestion that the analysis should focus more explicitly on prospective balance of payments developments of major countries over the medium term. These suggestions will be reviewed as we approach next year's exercise. We will also, as suggested by one Director, review the scope for analyzing more explicitly the international implications of the economic policies and performance of developing countries.

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I will add a word on publication, since several Directors have commented on this subject. It would be our intention to release the main forecast and analysis at the time of the Interim Committee meeting, as was done last year. The bound copy of the World Economic Outlook would be made available for distribution as soon as it is received from the printers, probably about two weeks later. It would not include the lengthy staff studies, which, as some Directors have pointed out, require adequate time for reflection. These studies would appear later in a suitable form, such as the Occasional Papers series.

The publication schedule that is envisaged will permit the staff to revise the world economic outlook papers in the light of comments received from Executive Directors during and immediately after these Board meetings. This schedule does not, however, allow for an iterative procedure of comments and responses. Such a procedure would run the risk of two disadvantages: it could delay publication of the projections to a date when they may have become less timely; and it could also perhaps compromise the status of the projections and analysis as being those of the staff. It is indeed important to make it clear--and the papers on the world economic outlook will contain a specific disclaimer, as always--that the projections and assessments are those of the staff and should not necessarily be attributed to Executive Directors or their national authorities.

2. DEBT SITUATION AND STRATEGY

The Executive Directors considered staff papers on prospects and policy issues with respect to the debt situation (EBS/86/43, 2/28/86; and Cor. 1, 3/19/86) and financing issues with respect to the implementation of the debt strategy (EBS/86/41, 2/24/86; and Sup. 1, 3/21/86). They also had before them background papers on developments in and prospects for export credits (SM/86/10, 1/14/86; and Sup. 1, 3/20/86) and developments in 1985 concerning Fund/Bank collaboration (SM/86/40, 2/25/86).

The Chairman invited Executive Directors to make a single intervention on all the issues under discussion. It was proposed that the paper on export credits should be published in a version that would omit any possibly sensitive references to individual countries and that would take into account pertinent comments made by Executive Directors during the present meeting. Any additional comments that Executive Directors might have should be conveyed to the staff by April 4, 1986.

Mr. Ortiz remarked that more than three years had passed since the beginning of the debt crisis in August 1982, when Mexico had asked the banking community for a 90-day extension on the payments of the principal of the country's public sector debt. A wide range of experience had been accumulated since then, and the present stage was a particularly appropriate one at which to evaluate the debt strategy that had been followed thus far in the light of developments in the world economy in 1985 and early 1986, especially oil price developments.

The staff papers included helpful analysis of the origins of the debt problem and a description of the debt strategy that had been followed hitherto, Mr. Ortiz continued. More important, they included a medium-term outlook of the evolution of economic activity in debtor countries that enabled Executive Directors to consider the likely debt situation toward the end of the 1980s on the basis of different sets of assumptions. He broadly agreed with the staff's analysis of the background of the current debt situation and would focus his comments on the present debt situation and the steps that should be taken in the future to deal with the debt problem.

In his speeches over the previous several years the Managing Director had been monitoring the progress that had been made in dealing with the debt problem and the recommendations that had been put forward to that end, Mr. Ortiz remarked. In the Managing Director's recent speech in Los Angeles to the World Affairs Council he had listed three main achievements of the debt strategy: the improvement in the current account position of debtor countries to an extent that, as the Managing Director had put it, few could have imagined; the fact that developing countries had introduced firm adjustment measures as was reflected in reductions in fiscal deficits and in improved competitiveness of debtors' exports; and the fact that the debt had largely been serviced and the principal had been restructured in an orderly fashion. In addition, pragmatic and cooperative steps had been taken in the initial phase of the debt crisis, thereby preventing a breakdown of the international financial system.

Despite those positive developments, the debt situation remained serious, Mr. Ortiz said. On previous occasions, he had stressed that an often neglected dimension of the adjustment that had been undertaken by industrial countries was the extent to which consumption had fallen and living standards had deteriorated in debtor countries. For example, in Latin America, real per capita GDP had fallen nearly 8 percent over the previous three years while the drop in per capita consumption had been even more substantial. In addition, real wages had fallen dramatically. According to the latest world economic outlook paper, real wages had dropped by 19 percent in Brazil, 33 percent in Chile, 26 percent in Ecuador and Mexico, and 27 percent in Venezuela in 1980-84; moreover, there had been further significant declines in 1985. Those figures clearly suggested the human costs of adjustment in debtor countries, the political costs of the adjustment efforts of the governments of debtor countries, and the limited margin for maneuver that those governments had left for future action. Executive Directors from industrial countries should consider what the political situation in their own countries would be if they had been confronted with shocks similar to those that had been experienced by debtor countries in Latin America and elsewhere.

It was important to consider the ability of debtor countries to continue to make debt service payments and to restore economic growth after three years of dramatic external current account adjustments, reductions in real wages and consumption, and generally deteriorating living standards, Mr. Ortiz remarked. Table 2 on page 21 of EBS/86/43 showed that the debt/export ratio of countries with debt problems had fallen from 252 percent in 1983 to 244 in 1984 but had increased in 1985 to a figure that was 6 percent higher than the corresponding figure in 1983. The baseline scenario suggested that that ratio would decline to 196 percent by 1991, which would still be considerably above both the 1977-81 average and the figure expected for capital-importing developing countries that had not recently experienced debt-servicing problems.

It was important to remember that the baseline scenario projections assumed that "best policies" were being maintained by developing countries, Mr. Ortiz went on. They also assumed the continuation of the current recovery--albeit at a moderate pace--of industrial economies. The baseline scenario did not assume that there would be a cyclical downturn in economic activity in industrial countries. In addition, the modest growth rates envisaged for debtor countries were based on the innovative assumption regarding the reduction of the so-called import-intensity of growth that was first suggested in the latest world economic outlook paper. He wondered how the present growth and debt/export ratio projections would be modified if the concept of import propensities had been used instead.

The most striking feature of the debt situation was the extraordinary vulnerability of debtor countries to external developments, Mr. Ortiz commented. Not long ago one of the important developments in the debt situation that had been widely noted was the apparent completion by debtor countries of the "import compression" stage of their adjustment efforts. In addition, an export-led return to creditworthiness and a reduction in the debt burden had seemed to be within sight. The world economic outlook exercise in April 1985 had projected debt/export ratios for countries facing debt problems of 186 percent by 1988, compared with 246 percent in 1986. In fact, the ratio for 1985 had been considerably higher than expected, and the ratio for 1987 was projected at 231 percent. Those drastic modifications had been the result of just one year of sluggish trade. One of the pillars of the debt strategy that the Managing Director had repeatedly stressed was the responsibility of industrial countries to provide a stable economic environment that would promote growth and open trade, thereby allowing developing countries to grow out of their debt problem. The performance of the industrial countries in 1985 indicated that they had not adequately fulfilled their responsibilities in implementing the debt strategy.

The staff projections were useful because they clearly showed the implausibility of the mainline scenario and the likely continuation of the enormous resource transfer from creditors to debtors that had taken place over the previous three years and which had been mentioned by Executive Directors on a number of previous occasions but had never been analyzed in staff papers, Mr. Ortiz remarked. That resource transfer was reflected in the difference between national and domestic savings, which in turn reflected the amount of resources that were sent abroad in the form of interest payments on the foreign debt and which were therefore not available for domestic investment. A reasonable estimate of the amount of resources transfered abroad by the heavily-indebted Latin American countries was 5 percent of GDP.

Given the magnitude of those transfers and their negative effects on welfare and living standards, Mr. Ortiz commented, and given the continued extremely weak balance of payments position of debtor countries that was reflected in the fact that debt/export ratios were higher at present than in 1983, it was not surprising that the debt issue had become the subject of intense internal debate in the debtor countries. The debt problem had acquired a new political dimension.

In considering the appropriate steps that should be taken thenceforth to deal with the debt situation Executive Directors could usefully re-examine the initiative that Secretary Baker had taken during the 1985 Annual Meeting, Mr. Ortiz commented. During the Executive Board's discussion on international capital markets in November 1985, he had mentioned that his authorities had considered that the U.S. initiative was a welcome development. At that time, creditor countries had stressed that a long-term solution to the debt problem must be based on a growth-oriented policy framework in debtor countries and that all the parties concerned should be included in the design of the debt strategy. In its meetings in Buenos Aires the Group of Twenty-Four had noted the positive elements of the U.S. initiative.

The two main aspects of the U.S. debt initiative were adjustment and finance, Mr. Ortiz noted. One of the key elements of the U.S. debt proposal was the continuation of the macroeconomic adjustment process of debtor countries with emphasis on the adoption of structural policies aimed at improving the overall microeconomic efficiency of debtors' economies. The adjustment efforts that had been made thus far were clearly reflected in the improvement in the balance of payments of debtors since 1982; that improvement had resulted from steep reductions in domestic absorption and real exchange rate depreciations, which, in turn, had been reflected in unexpectedly large declines in consumption and real wages.

The staff had noted that little progress had been made in 1985 in reducing fiscal deficits and that governments had tended to adjust those deficits mainly through cuts in investment expenditure, Mr. Ortiz commented. Despite the fall of the U.S. dollar, commodity prices in dollar terms had dropped by 12 percent, causing yet another year of declining terms of trade. In those circumstances, improvement in fiscal positions could not be expected, as commodity export earnings were a major source of government receipts in most debtor countries. In addition, the continuous rise in interest payments as a proportion of total expenditure had tended to crowd out investment. Given the high level of interest payments in national budgets, it was crucial to reduce those payments if investment were to be preserved while attempts were made to reduce the level of overall government outlays. For example, in Mexico, interest payments represented approximately 12 percent of GDP and one third of public sector expenditure.

On previous occasions, he had stressed the difficulty in implementing "orthodox" stabilization schemes in countries with large debts and high rates of inflation, Mr. Ortiz recalled. Experience over the previous several years indicated that more flexibility in the design of adjustment programs was called for. In particular, it was important to take into account the distorting effect of inflation on the measurement of fiscal deficits in order to evaluate the real magnitude of the efforts that were being made to correct public sector imbalances. Failure to consider adjustment in real terms resulted in the setting of unrealistic targets the nonachievement of which sent harmful signals to both domestic investors and the international community.

Structural measures were at the heart of Secretary Baker's debt initiative, and his authorities were convinced that those measures deserved to be emphasized, Mr. Ortiz said. Many such measures had been implemented for some time and were being reinforced in several countries in his constituency. While improving economic efficiency was essential, supply-side measures normally took a number of years to make their full effect on an economy felt. Diversification of the export base took time, and inefficiencies of public sector enterprises resulting from policies that had been maintained for long periods--often for several decades--could not be eliminated in the short run. However, Executive Board discussions and staff reports had often given the impression that the introduction of supply-side policies should yield immediate results. While it was true that, as the staff had noted, investment projects had sometimes been undertaken with little regard for economic profitability, it was important to recognize that in many instances those projects had been made unprofitable following shifts in relative prices and technology.

Another striking feature of the staff's simulation exercise was the fact that the additional debt that had been contracted on commercial terms at the interest rates that were expected to prevail over the medium term plus the new debt that was expected under the baseline scenario would raise economic growth only marginally and would result in only a slow decline in debt/export ratios, Mr. Ortiz commented. That scenario explained the reluctance of several highly indebted countries to incur additional debt to service old debt at the present high real interest rates. Given the limited prospects for export expansion and the continued high level of interest rates projected over the medium term, it was not surprising that debt/export ratios were expected to decline slowly--and the expected decline was attributable to continuously growing trade surpluses--while growth rates remained inadequate even on the basis of the questionable assumption of the reduced so-called import intensity of growth. If those conditions were to continue, the debt problem would not be solved.

It had long been recognized that the various parties in the debt problem shared the responsibility for the origination of that problem, Mr. Ortiz remarked. Countries had overborrowed, banks had overlent, and regulatory agencies and international organizations had not sent enough warning signals, probably because the rapid world economic developments had taken most observers by surprise. The recession had been longer and deeper, interest rates had risen much higher, and commodity prices had fallen much more steeply than anyone had expected. Moreover, events continued to take place rapidly. No one would have forecast five years previously that in 1986 the real price of oil would return to the level of the 1970s. Five years previously, the world economic outlook forecast--among the most conservative at the time--suggested that the price of oil would remain constant in real terms over the medium term. It was doubtful whether Mexico or other oil-producing countries would or could have accumulated as much debt as they had if the present commodity prices had been correctly forecast five years previously.

The debt strategy must be revised within a framework of coresponsibility and burden sharing, Mr. Ortiz considered. The debtor countries should maintain their adjustment efforts, industrial countries must make new efforts to improve the economic environment through policy coordination, an appropriate Fund surveillance mechanism should be introduced to ensure the implementation of policy coordination, and creditors should bear a larger share of the debt burden.

In addition to long-term rescheduling of principal and the resumption of credit flows on an adequate scale, a realistic medium-term strategy to solve permanently the debt problem must involve a substantial reduction in interest payments by debtors and a reversal of the transfer of resources that had occurred during the previous three or four years, Mr. Ortiz said. Those objectives could be accomplished in different ways. The most obvious one was concerted action by the industrial countries to cut interest rates drastically. Most observers agreed that inflationary expectations had been effectively broken, and concerted action by the main industrial countries could produce substantial results similar to those that had recently been achieved in the exchange rate area. That effort need not involve an excessive easing of monetary policy if the announcement of coordinated policy intentions was accompanied by credible signs that the fundamental causes of high interest rates--such as the U.S. budget deficit--were being tackled satisfactorily. The Fund's management could play an important role in such concerted action. In addition, the Fund could propose more flexible rules for the use of the compensatory financing facility along the line of Mr. Finaish's suggestion at EBM/86/49 (3/21/86). Commercial banks should consider immediately reducing interest spreads, and cutting interest rates on outstanding loans below market rates while capitalizing those rates on concessional terms.

A number of proposals had been made concerning the different modalities under which such schemes could be implemented, Mr. Ortiz continued. For example, the concessional elements of the schemes could be linked to the evolution of commodity prices or the terms of trade. The present occasion was not the appropriate one on which to discuss those modalities in detail. Other schemes that had already been introduced on a limited scale--such as swaping debt for equity or recycling interest payments for private sector financing in debtor countries--deserved to be encouraged. In cases--mainly involving low-income countries--in which it was clear that even under the most optimistic assumptions debt service payments would not be made, a selective scheme of partial debt cancellation might be called for; cancellation should perhaps be conditional on the members concerned maintaining their adjustment efforts. His authorities felt strongly that debt service and repayment were essential to ensuring the viability of the international financial system. However, they also felt that countries should make payments according to a realistic assessment of their capacity to pay.

To re-establish confidence--which might be the most important factor affecting investment and capital flight--debtor countries must maintain adequate policies and convince the public that such policies would produce positive results and solve the debt problem, Mr. Ortiz said. A significant reduction in the debt burden of debtor countries might have a virtuous circle effect to the extent that it could contribute to a much quicker restoration of confidence among domestic and foreign investors. At the same time, industrial countries would have to make the necessary modifications in the regulatory environment to minimize the negative effects on the income position of financial institutions of the recommended actions under the strengthened debt strategy. The industrial countries had an important role to play in facilitating more favorable arrangements by the Paris Club and in continuing to provide adequate export credit cover. The flexible attitude of some important export credit cover agencies over the previous several years was encouraging.

After three years of implementing harsh adjustment policies in a difficult external environment that had been considerably exacerbated by the recent developments in the oil market, his authorities faced a political situation that demanded greater sharing of the debt burden by creditors, Mr. Ortiz stated. Burden sharing was an essential ingredient for the continuation of debtor countries' domestic adjustment efforts. Since the beginning of the debt crisis, the authorities of the debtor countries in his constituency had maintained a responsible attitude toward the international community and they expected the community's strong support in return.

Mr. Ismael commented that the management of the debt crisis was based on a mixture of policy adjustment and new financing and had helped to alleviate the debt-servicing burden of a number of developing countries. However, recent developments, such as the slow global economic growth, inadequate bank lending to developing countries, unfavorable commodity prices and, most important, widespread protectionist measures, had threatened to undermine those hard-earned achievements. In addition, the overemphasis on demand management in debtor countries had involved enormous costs, a conclusion with which the staff seemed to agree on page 13 of EBS/86/43, where it was stated that strong initial emphasis on demand management measures, without accompanying supply-side measures of equal effectiveness, had led to a disappointing growth performance in a number of countries, despite the recovery of growth in world trade and output in 1984.

The debt outlook for the coming period was not promising, Mr. Ismael said. Despite an overoptimistic assumption about non-oil commodity prices, the baseline scenario suggested that debt-service ratios in high-debt countries would exceed 30 percent. In the circumstances, the time was ripe to seek new solutions to the debt problem. To succeed, a debt strategy must have the full support of all the parties concerned and must ensure normal access by debtor countries to the credit and capital markets. In that connection, Secretary Baker's call for increased lending by multilateral development banks and commercial banks to debtor countries that maintained appropriate economic policies was timely, and the present opportunity to discuss a modififed version of a strengthened debt strategy was welcome. Most of the elements of a new, strengthened debt strategy were contained in the staff papers.

The first major element of the debt strategy was the adjustment effort by debtor countries, Mr. Ismael remarked. It was generally recognized that the outcome of past adjustment efforts had been far from satisfactory. The strengthening of the external current accounts of debtors was attributable mainly to the compression of imports rather than to the expansion of exports. In a large number of cases, that compression had been accompanied by a stagnation in savings and a curtailment of investment that had implied a deterioration in productive capacity. Although realistic exchange rate and pricing policies had been adopted to encourage more efficient use of resources, the achievement of the objective of those policies had been undermined by the lack of open markets for debtors' export products. The primary product exports of most developing countries were obstructed by widespread protectionism in the major countries.

It was clearly necessary for debtor countries to make domestic policy adjustments, Mr. Ismael went on. However, traditional demand management was not adequate to deal with the chronic problems facing debtors. Successful adjustment would not occur unless policy packages were designed to achieving, and resulted in, the establishment of the foundation for productive capacity that would be sufficient to generate income to service debt. In addition to realistic interest rates, there was a crucial need to increase investment and, to that end, to design proper incentives to mobilize domestic savings. However, increased savings must be used for the most productive purposes, namely, to finance capital formation in export-oriented activities and in high value-added import-competing industries, something that had rarely happened in the past. Exchange rate policy had often been used to encourage efficient resource use, but the results had usually been disappointing. Additional tax and monetary incentives were called for as well as the opening of markets by developed countries; such requirements were particularly evident in countries characterized by limited factor mobility.

Past policies aimed at adjustment of public enterprises might have overemphasized pricing as an instrument to improve the enterprises' financial position, Mr. Ismael said. While appropriate pricing policies were required, additional steps could be taken to improve administrative efficiency. Emphasis on pricing might lead to politically unacceptable actions. Intensive efforts to cut costs and to increase efficiency might have more favorable results.

The debtor countries also needed to improve their external debt management, Mr. Ismael considered. The first step in that direction was to design and introduce a comprehensive information system. Information on amounts, maturities, and terms was essential for making an accurate assessment of a country's debt service situation. In addition, debtor countries should have access to information that would enable them to develop or choose suitable types of debt instruments to alleviate the adverse effects of volatility in the exchange and financial markets.

The creditor countries had an important role to play in the debt strategy, Mr. Ismael said. No attempt to solve the debt problem would succeed in the absence of the full cooperation of the major industrial countries. The staff's calculations underscored the paramount importance of industrial countries' policies: a 1 percentage point reduction in the growth of industrial countries from the baseline scenario in 1987-91 would result in a 1.5 percentage point lower growth of exports of developing countries and a sharp rise in their total external debt and debt service. A successful debt strategy depended crucially on the ability of the major industrial countries' policies to maintain sustainable and stable growth together with access to their markets. To those ends, the major industrial countries must be willing and determined to introduce a combination of fiscal and monetary policies that would reduce real interest rates. As the staff had stressed, an appropriate environment could be created only if the creditor countries were to base their policies on equity, generosity, and stability.

The recent statement by the U.S. authorities that they intended to support a general capital increase in the World Bank was welcome, Mr. Ismael remarked. That statement was a step in the direction of reinforcing the resources of multilateral development institutions so that more effective loans could be given to debtor countries facing structural problems. The Fund also could play an effective role if the Ninth General Review of Quotas were begun as soon as possible.

A satisfactory compromise could be reached on the role of bank supervisory bodies, Mr. Ismael considered. Bank supervisors and advocates of concerted financing shared the common objective of strengthening banks' financial position. The difference between them was their emphasis on the time that should be taken to achieve that goal. That difference could be resolved if a more accommodating attitude were taken by the supervisory bodies, particularly in cases in which financing arrangements were associated with adjustment policies supported by the Fund and the World Bank.

Commenting on the role of official sources of finance in the debt strategy, Mr. Ismael said that it was discouraging that both the G-24 report on the international monetary system and the staff had stressed the inadequacy of the current amounts of official assistance and had expressed their concern about the declining share of official funds in total resource transfers. The staff's conclusion concerning the role of interest rates in reducing debt service in the recovery phase should not be taken lightly. Increased development assistance and export credit cover were called for.

As to the role of commercial banks and the export credit authorities in the debt strategy, recent developments concerning Secretary Baker's initiative were welcome, although a number of issues remained unresolved, Mr. Ismael remarked. An often mentioned issue was the equitable sharing of the debt burden under concerted arrangements involving new money packages. A facility for the sale of loan claims through the issuance of "exit bonds" had some merit and was worth exploring. Another issue was the terms of financing. Those terms should be determined on a case-by-case approach, but the spread should be kept to a minimum. Commercial banks preferred to have official guarantees of their loans. In his view, in principle, such guarantees should not be provided.

Four points concerning the financing aspects of the debt strategy were worth making, Mr. Ismael considered. First, the increasing number of multiyear restructuring agreements was encouraging. Second, once a sound economic program was in place, export credit agencies should have a more flexible attitude toward the resumption and expansion of cover. Third, in the longer run, attempts should be made to develop financial instruments that could tap external resources that were relatively less dependent on the movements of interest rates. Fourth, the idea of converting debt into equity, although not yet fully developed, was promising, and the establishment of a trust fund to facilitate such a process for banks with small exposure could be an appropriate first step in that direction.

Commenting on the role of the Fund and other multilateral institutions in the debt strategy, Mr. Ismael said that the effectiveness of surveillance over members' policies was crucial to the success of any debt strategy. The recent agreement on enhanced surveillance was welcome, but there was some question whether the Fund could not play a more active and direct role in concerted efforts to arrange new money packages. He hoped that the staff would be able to explore new modalities under which the Fund could play such a role.

As to the collaboration between the Fund and the World Bank, the importance of exchanging views and information--particularly in the area of growth, savings, and investment--in order to enhance the effectiveness of Fund and World Bank-supported programs should be emphasized, Mr. Ismael remarked. In addition, commercial banks and export-credit bodies should be encouraged to make optimal use of the World Bank's expertise in project evaluation and sectoral development strategy so that rapid progress could be made in restoring normal relations between debtors and creditors.

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

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/86/50 (3/21/86) and EBM/86/51 (3/24/86).

3. STAFF TRAVEL

Travel by the Managing Director, as notified by the Secretary on March 22, 1986, is approved.

APPROVED: December 8, 1986

LEO VAN HOUTVEN
Secretary