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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/154

10:00 a.m., September 12, 1986

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

Executive Directors

C. H. Dallara
J. de Groot

H. Fujino
G. Grosche
Huang F.
J. E. Ismael
A. Kafka
T. P. Lankester

M. Massé

F. L. Nebbia
Y. A. Nimatallah

H. Ploix
J. J. Polak
C. R. Rye
G. Salehkhoul
A. K. Sengupta
S. Zecchini

Alternate Executive Directors

Mwakani Samba
M. K. Bush
H. G. Schneider
T. Alhaimus
M. Sugita
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H. A. Arias
M. Foot
H. Fugmann
L. Leonard
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J. E. Suraisry
G. Ortiz

J. de Beaufort Wijnholds

O. Kabbaj

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

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Also Present

IBRD: A. C. Tsantis, South Asia Regional Office. African Department: D. T. S. Ballali. Asian Department: P. R. Narvekar, Director; H. Neiss, Deputy Director; A. Ariyoshi, S. Ishii, L. Mendras, D. M. Ripley, A. Salehizadeh, B. J. Smith, D. Villanueva, R. C. Williams. European Department: L. A. Whittome, Counsellor and Director; P. B. de Fontenay, Deputy Director. Exchange and Trade Relations Department: C. D. Finch, Counsellor and Director; M. Guitián, Deputy Director; E. H. Brau, S. Kanesa-Thanan. External Relations Department: C. S. Gardner, Director; M. Goldstein, J. M. Landell-Mills, I. S. McDonald. Fiscal Affairs Department: A. H. Mansur. Legal Department: W. E. Holder, R. H. Munzberg, J. K. Oh. Middle Eastern Department: J. G. Borpujari, S. von Post. Research Department: W. C. Hood, Economic Counsellor and Director; A. D. Crockett, Deputy Director; R. R. Rhomberg, Deputy Director; M. C. Deppler, M. P. Dooley, P. Isard, D. Folkerts-Landau, S. J. A. Gorne, P. Gotur, O. E. G. Johnson, M. D. Knight, A. Lanyi, F. Larsen, T. K. Morrison, R. Pownall, E. Y. P. Tung. Secretary's Department: J. W. Lang, Jr., Deputy Secretary. Treasurer's Department: T. Leddy, Deputy Treasurer; D. Williams, Deputy Treasurer; W. L. Coats, Jr., D. Gupta, F. F. J. Lin, A. F. Moustapha. Western Hemisphere Department: S. T. Beza, Associate Director; Y. Horiguchi. 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, S. Ganjarerndee, S. M. Hassan, G. D. Hodgson, J. Hospedales, G. Nguyen, A. Ouane, P. Péterfalvy, I. Puro, D. C. Templeman, R. Valladares, A. Vasudevan, M. A. Weitz. Assistants to Executive Directors: A. Bertuch-Samuels, O. S.-M. Bethel, J. de la Herrán, L. de Montpellier, F. Di Mauro, W. N. Engert, R. Fox, G. Ercel, V. Govindarajan, G. K. Hodges, Z. b. Ismail, S. King, J. K. Orleans-Lindsay, J. E. Rodríguez, S. Simonsen, G. Seyler, L. Tornetta, H. van der Burg, B. D. White, Yang W.

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

The Executive Directors continued from the previous meeting (EBM/86/153, 9/10/86) their consideration of the staff paper on developments, prospects, and policy issues related to the world economic outlook (EBS/86/196, 8/20/86; and Cor. 1, 10/4/86). They also had before them background material contained in a statistical appendix (SM/86/207, 8/20/86).

The Director of the Research Department remarked that the world economy seemed to be in a transition from less favorable conditions to somewhat more favorable conditions. Policymakers in member countries continued to face a number of difficult issues, and there was somewhat less certainty than at the time of the previous discussion on the world economic outlook that all the issues could be dealt with satisfactorily. One of the main issues was the imbalances among the industrial countries. The major country in the world economy continued to draw capital from the rest of the international economy at a fast pace. It might normally be expected that the reserve currency country in the system would run a deficit that on average would be large enough to supply the necessary increment in world currency reserves. However, the payments deficit of the United States was much larger than that and was widely acknowledged to be unsustainable. Apparently the market still expected the U.S. public sector deficit to be reduced. If the market were to lose its faith in that outcome, there might well be further developments that could adversely affect the management of other troublesome issues. Among those difficulties was the fact that many developing countries were staggering under a load of debt that seemed somewhat harder to manage at present than it had a few months previously, although conditions varied from one debtor country to another. Growth throughout the industrial world was sluggish, and although there were indications that growth would improve in some areas--especially in Europe and Japan--the staff did not expect the resumption of a vigorous expansion in the coming period. The deep and persistent problems facing the poorest countries were unlikely to be alleviated in the coming period if the difficulties facing other countries remained.

There had apparently been some loss of faith in the system, the Director continued. A sign of that development was the increase in protectionism and the emergence of what could be called economic warfare, especially with respect to agricultural subsidies, in place of healthy international competition. That situation was dangerous; uncertainty and instability tended to breed further and wider instability. However, the situation was far from hopeless for a number of reasons. First, one of the many contributions that the system required from its reserve currency countries was reasonable domestic price stability, and that stability was indeed being achieved. The rate of domestic inflation in the United States and the other major industrial countries had been contained. In addition, there was a clear determination by debtors to handle their problems. Those countries had faced frustrations and had paid a considerable price for their substantial adjustment efforts; on the whole, they

were continuing to struggle forward. Furthermore, there was a widespread appreciation of the danger facing the system. Strong efforts were being made to manage fiscal positions and to keep monetary policies under careful control. There was moreover a strong urge to sustain and defend the international system and more emphasis than ever before on the value of and a need for surveillance and economic policy coordination. In addition, there was a genuine wish to preserve an open trading system and to make the coming GATT meeting in Punta del Este fruitful.

In the circumstances, the main contribution that the Fund could make was to analyze developments, persuade authorities to adopt appropriate policies, and provide financial assistance, the Director of the Research Department said. There was a genuine need for the Fund to make those contributions. As Mr. de Groote had stressed, the Fund had a great opportunity, as well as an obligation, to assist members in formulating policy goals and measures. That assistance would have to be given by the membership, management, and the staff together. He remained optimistic about the future, despite the current difficult and dangerous conditions.

The Deputy Director of the Research Department noted that a number of Executive Directors had expressed some doubt whether the staff's projected upturn in economic growth in the second half of 1986 would materialize. When the staff had made its forecasts and analysis, some six weeks previously, it had felt somewhat hesitant about the likelihood that the projected upturn would occur; at that time, the available indicators had all been fairly unfavorable. For example, the second quarter data for the United States had included a slowdown in growth, and the first quarter data for most other countries had shown a relatively weak performance. The staff had, however, been encouraged by some developments over the several previous weeks. The second quarter growth figures for Germany, Japan, and France showed a rebound from the weak performance of the previous quarter. While one quarter's data could not be taken as strong evidence of a trend, they did confirm the staff's conclusion that there should be factors tending to lead to a recovery of demand in the second half of 1986. The benefits for the industrial countries of the decline in oil and commodity prices, and the effects on European countries and Japan of exchange rate developments had led to substantial improvements in real income in those countries. Experience suggested that the initial effect of those improvements would be reflected in an increase in savings and that the expenditure effects would be felt with a lag. The staff had not drawn that conclusion on the basis of formal econometric evidence, but a reading of past experience suggested that the conclusion was appropriate.

The downward revision in the second quarter figure for U.S. GDP growth from the initial estimate of 1.1 percent to 0.6 percent had not been taken into account by the staff in its latest estimates, the Deputy Director continued. That information had not been available at the time that the staff had made its latest forecasts, but it would be taken into account in the revised version of the world economic outlook projections. The revised figure for U.S. GDP growth was not as disturbing as it might

appear to be at first glance. The rate of growth of domestic demand in the United States had been revised upward, and the weakness of U.S. output in the second quarter was attributable partly to a turnaround in stockbuilding, which was essentially a reversible factor, and partly to the weakness in the foreign trade sector, which the staff expected to improve over the rest of 1986.

The question had been asked how the staff's short-term projections would have changed if oil and commodity prices had not fallen to the extent that they actually had, the Deputy Director recalled. The answer was that inflation rates would probably have been rather higher in the industrial countries in the absence of the oil and commodity price declines. The staff had estimated that the underlying rate of inflation in the industrial countries was still 3-4 percent. Such rates were of course not alarming, but monetary policy might well have been more cautious in the absence of the terms of trade gain, and interest rates might therefore have fallen less than they actually had. Any assessment of the impact of the absence of oil and commodity price declines on GDP must of course be highly conjectural. Demand in the industrial countries probably would have been less buoyant in the absence of the price declines; growth of demand might have been expected to be about 2 1/2 percent in the rest of 1986 and in 1987, rather than 3 percent. At the same time the slowing of growth that was partly attributable to declining oil prices in the first part of 1986 probably would not have materialized. Mr. Salehkhov had suggested that the decline in oil prices might not have had the great benefit for the world economy that was widely thought. The staff had not assessed the oil price decline in those terms. In its analysis of the impact of the fall in oil prices the staff had recognized that the price decline involved gains and losses, and that individual countries suffering lower oil export earnings would be much more greatly affected than individual countries that gained from the price decline.

In making its revised forecasts the staff's oil price assumption would be more in line with current price developments; accordingly, it would be similar to the oil price assumption for the April 1986 world economic outlook exercise, the Deputy Director went on. As to the suggestion by one speaker concerning the need to harmonize the staff's oil price assumptions, the staff would attempt to use at each point in time a similar assumption for its work on individual countries and for its work on the world economic outlook. In that connection, a problem was that forecasts and analysis were needed at different times, and over a time forecasts that had been appropriate for one purpose might no longer be realistic for another purpose. Hence, there was a tension between the wish to have similar forecasts and the effort to update forecasts; there was no clear way in which to eliminate that tension. The staff would of course continue to attempt to be as consistent as possible in its analysis.

The question had been asked whether the staff's growth projections for the second half of 1986 would likely be durable if indeed they turned out to be correct, the Deputy Director remarked. In the staff's judgment, the factors that would cause a rebound in demand and output in the second

half of 1986--especially the impact of the terms of trade gains in industrial countries--would not continue to operate with as much strength in 1987. The staff was not forecasting a reversal of the oil and commodity price trends or terms of trade gains, but those gains would not be repeated in 1987. The momentum of demand growth that was likely to be evident in the second half of 1986 would be somewhat less in 1987, although not so much less as to cause a significant reduction in the present year-on-year growth projection.

The staff's calculations were in dollar terms, and the depreciation of the dollar had led to an increase in the value in dollar terms of members' outstanding debt, the Deputy Director said. If the relevant calculation were made in the terms of another currency, the value of the outstanding debt in dollar terms would be smaller. It was for that reason that in its analysis the staff focused on developments in the ratio of debt to exports or of debt to GNP, changing both the denominator and the numerator of the ratios to the same extent. The ratios had deteriorated because although the dollar value of outstanding debt had tended to increase, export earnings of debtor countries had declined.

As one speaker had noted, the deterioration in commodity prices projected by the staff was larger than that projected by the relevant index in The Economist, the Deputy Director remarked. The difference occurred because the Fund's index was weighted by exports of developing countries while other indices were weighted by imports of developed countries. Nevertheless, the size of the divergence between the Fund and The Economist's indices was surprisingly large. However, the difference should not affect the staff's forecast, which was based on commodity-by-commodity estimates made by individual country desk officers. Accordingly, individual country desks based their import earning forecasts on price assumptions for individual commodities rather than on a weighted index.

As to the medium-term projections, Mr. Kafka had asked why potential growth in the industrial countries was assumed to be only 3 percent when as recently as the 1960s a much more rapid rate of growth was considered to be feasible and had indeed been achieved, the Deputy Director recalled. The staff was preparing a paper on the subject that it hoped to complete before the next world economic outlook exercise. At present, the staff would guess that the lower potential growth rate was due partly to the lower rate of capital accumulation in recent years compared with earlier years. Another possible explanation was that European countries and Japan had nearly reached the same level of employment of technology as the United States, so that the gains from the process of catching up were less at present than they had been in earlier years. In addition, service industries accounted for a larger proportion of output than in the past, and productivity increases were generally lower in service industries than in manufacturing.

Another issue with respect to the medium-term scenarios was how realistic it was to expect a crowding in of private sector expenditure as public sector demand declined with the correction of fiscal deficits, the

Deputy Director said. Mr. Sengupta had asked whether any measures might be needed specifically to ensure that the crowding in would actually materialize. A related, methodological question was whether it was appropriate to treat domestic demand as the residual variable in the staff's scenario for industrial countries. The medium-term scenario for the industrial countries was not meant to be a forecast of actual developments; instead, it was a device to identify areas of potential tension and incompatibility on the basis of certain assumptions. The staff had asked the question what would need to happen to net private investment relative to savings in order to achieve the rate of growth of output that could be considered to be reasonable and attainable in the light of a given pattern of exchange rates with its implications for the balance of payments positions and the fiscal objectives of the major countries. In that context, there were reasons to be cautiously optimistic about the likelihood of realizing the crowding in and the growth of private sector demand that the staff had projected. The increases in private expenditure projected by the staff were incorporated in a medium-term strategy that was announced in advance and to some extent generated its own advance response--for example, as was reflected in the lower interest rates following the previous world economic outlook discussion. The cumulative fiscal correction foreseen by the staff was not spread out over five years, and the kind of increases in private expenditure that the staff envisaged seemed to be possible. If, as one speaker suggested, there were no expenditure cuts in the United States, and if the U.S. fiscal deficit were to remain on the course that had been evident in 1982-85, the fiscal situation would become unsustainable and there would probably be a substantial increase in interest rates, together with a decline in confidence in the U.S. dollar. It would be hard to predict whether there would be a decline in exchange rates immediately or an additional strengthening of the U.S. dollar. In any event, it seemed to be clear that if the proposed pattern of fiscal strengthening in the United States were to be significantly impaired, the effect on the markets would be serious.

According to the staff's medium-term projections, the balance of payments for Germany would decline significantly by the end of 1991 while Japan would retain a relatively large external surplus, the Deputy Director said. One reason for that expected outcome was that Japan's external surplus started from a higher level relative to GDP than Germany's surplus. In addition, Germany's trade sector was significantly larger than Japan's, and the elasticities that were applicable to trade extended over a wider base; that fact tended to make the response of trade flows relative to GDP for a given exchange rate larger in Germany than in Japan. Another reason, which was difficult to quantify, was that historically Japan had enjoyed increases in nonprice competitiveness. Over time, if price competitiveness remained the same, the balance of payments of Japan would tend to strengthen. Since that factor was not quantifiable, it was of course difficult to know whether it would persist in the future in the same way as in the past. Still, it was incorporated in the staff's estimates.

The staff had taken note of the suggestions by Executive Directors for improving the presentation and analysis of policy interactions in the new chapter in the world economic outlook paper, the Deputy Director remarked. Not all of the suggestions were mutually consistent, but the staff would make every effort to use them in improving its analysis in the future. Mr. Fujino had said that he did not find the saving/investment framework to be particularly useful in discussing trends in balance of payments positions. A number of Executive Directors questioned whether the projected trends in savings and investment were plausible and implied that they felt that it was useful to look at the consequences for domestic savings and investment of projected trends in fiscal deficits and balance of payments positions. It was important to be cautious in imputing causality when dealing with identities such as the saving/investment relation and, by definition, the current account balance. Still, an identity had certain implications; any attempt to change one side of the identity must be balanced by a change in the other. The staff was careful to bear those constraints in mind. With those considerations and precautions in mind the staff felt that in the future it would have to continue to use the same broad framework that had been used for the present world economic outlook exercise.

An important question was the likely developments in the medium term in the absence of either policy changes or the more favorable assumptions that the staff had made, the Deputy Director said. In that connection, another issue was what would happen if countries were unable to sustain the rate of growth of domestic demand--particularly in the private sector--that was needed to offset the fiscal strengthening in the industrial countries and the adjustment that was needed in developing countries to adapt to terms as trade losses. Of course, saving and investment would ex post have to be made equal. Hence, the answer to the question what would happen if demand did not strengthen in the private sector as the staff expected was that the necessary equilibration of saving and investment would take place at a lower level of activity. If a significant deficit in the U.S. balance of payments position were to persist together with surpluses in the payments positions of Germany and Japan, and in the absence of other developments that would tend to reduce those imbalances, the staff would naturally expect further pressure on exchange rates at some stage, and that outcome was implied in the staff's analysis in the present world economic outlook paper.

It had been suggested by Mr. Zecchini that the staff had attempted to measure the impact on payments positions of faster growth in Germany and Japan, that perhaps the staff had not taken adequately into account the multiplier effects of faster growth in those countries, and that there would be a larger effect on the U.S. balance of payments from faster growth in Germany and Japan than the staff had expected, the Deputy Director continued. If one were to take into account only the direct effect on trade of faster growth in Germany and Japan, leaving growth in all other countries unchanged, the effect on the U.S. trade balance would be even smaller than the staff had indicated in its paper. The staff had taken into account the direct effects, plus the induced

effects, of faster growth in countries that would be affected by faster growth in Germany and Japan. Hence, in a sense the multiplier effects externally had been taken into account. However, what was not taken into account was the possibility that, as a result of such developments, the policy constraints facing other countries--countries in Europe, for example--might be relaxed in a manner that would induce them as well to stimulate economic growth. As a result, Mr. Zecchini might well be correct; there might be scope for a greater effect on the U.S. balance of payments than was described in the staff paper. However, such estimates would take the staff into the realm of estimating policy responses, which would involve considerable conjecture.

It had been suggested by one speaker that the kind of monetary policy flexibility that the staff had described could, if pushed too far, run the danger of failing to encourage the desired demand in the short term and by creating liquidity could risk an upsurge in inflation at a later stage, the Deputy Director remarked. The staff fully understood that concern, and for that reason it had said that the room for maneuver in monetary policy was the kind of cautious judgmental flexibility that some central banks had employed thus far and should not be carried to the extent of involving deliberately expansionary policies. In the staff's view, that kind of judgmental flexibility could succeed in lowering interest rates. The evidence over the previous six to nine months suggested that the skill with which central banks had managed their monetary policy had contributed to the decline in real and nominal interest rates; the staff expected that that development would have a lagged effect on real demand and output.

The question whether that outcome would run the risk of an upsurge in inflation was addressed in Section 2 of the staff paper, the Deputy Director said. In the present circumstances, it was particularly difficult to interpret the evidence provided by the monetary aggregates. It was clear that in an environment of lower rates of inflation there would be an increase in money demand; therefore, some increase in the rate of growth of the monetary aggregates could be expected, although that need not be a cause for alarm. The present inflationary expectations and inflation rates seemed to be sufficiently low to lead one to conclude that the danger of a resurgence of inflation was relatively small. However, the present phase was a transitory one, and by 1987 there was every reason to expect that the underlying inflation rate would once again equal the actual rate; by then, the danger of a resurgence of inflation would perhaps appear to be somewhat greater.

The question had been raised when the staff expected to see easier money conditions in individual industrial countries, the Deputy Director recalled. Over the previous six months, there had been a move toward lower interest rates in each of the larger industrial countries. However, the future path of interest rates was difficult to predict.

The possibility of a staff study on the role of the share economy had been mentioned by one speaker, the Deputy Director recalled. As he understood it, the term share economy referred basically to an approach to wage determination under which a significant proportion of workers' compensation was linked directly to business net revenue. It was sometimes noted that in Japan there was a significant element of such wages in the compensation of workers through the bonus system. The staff had drawn attention to that development during the previous world economic outlook exercise and had suggested that it could be a desirable means of introducing greater flexibility into wage rewards. To be successfully applied on a wider basis, however, the share economy approach would have to be adapted to the economic, political, social, and cultural circumstances, and institutional setting prevailing in each country. While it was essential for countries to seek ways in which to reduce rigidities in wage determination, the noneconomic dimensions of the share economy approach made it difficult for the staff to envisage a study that would usefully add to the present stock of knowledge.

The staff certainly had not intended to neglect in any way the need for adequate flows of finance to developing countries, as one speaker had implied, the Deputy Director commented. However, there were obvious constraints on financing. The countries that had been able to secure additional financing without great difficulty had obviously decided, given the dangers of a buildup of debt and given the rates of interest that they had to pay, to base their adjustment more on the avoidance of further debt than on borrowing to cover additional balance of payments deficits. Countries in a less favorable market position that needed substantial financing flows had to be careful that the buildup of debt was not so great as to postpone the fruits of their present adjustment efforts.

A staff study by two consultants for the Research Department had concluded that additional provisioning might reduce the willingness of commercial banks to participate in new money packages, the Deputy Director noted. The basic point that was made in the study was that, given the banks' heavy involvement in debtor countries, the survival of some banks was conditional upon the continued value of the loans that they had made. Such banks would participate in new money packages partly because they felt that they had little alternative if they were to preserve the existing value of assets on their books. Once a bank had reached a situation in which existing loans were no longer critical to the viability and survival of the bank, the bank could take a more judgmental attitude toward appraising participation in new money packages. The staff would not wish to take sides in the matter, but there had clearly been occasions on which banks had expressed greater reluctance than in the past to participate in new money packages.

In its discussion on import substitution the staff had not advocated the use of taxes and subsidies as the mechanism to encourage greater domestic production of commodities that had been imported, the Deputy Director said. However, if export earnings were rising less rapidly in

the future, economic growth would have to become less dependent upon rapid increase in imports than hitherto. That could still be accomplished by using nondistorting and nondiscriminatory market methods. In the staff's view, an appropriate exchange rate together with appropriate and nondistorting incentives in the domestic economy would enable import substitution to take place on the basis of comparative advantage; there would be no need to use distorting taxes and subsidies.

There was no inconsistency with the World Bank views in the staff discussion of domestic food production in developing countries, the Deputy Director stated. Mr. Sengupta had noted a World Bank study that suggested that developing countries should perhaps be more willing than hitherto to import food rather than to focus on domestic food production. The staff paper had focused particularly on African economies. In many of those economies there had been substantial imports of agricultural products that could well be produced domestically. The World Bank study to which Mr. Sengupta had referred was concerned primarily with a relatively small number of Asian countries where agriculture had been protected by tariffs, subsidies, and other nontariff mechanisms. Those means were clearly inappropriate in themselves, and they were clearly unnecessary and undesirable in countries such as those in Asia that had an opportunity to export other commodities. The situation was different in African economies. The World Bank staff fully agreed with the Fund staff that food imports in Africa could be reduced in line with the exploitation of the comparative advantages of the countries concerned.

One speaker had posed the question whether exchange rate recommendations made by the staff should be based on a distinction between payments problems that were generated internally and those that were generated externally, the Deputy Director recalled. The answer was that the basic and most important distinction was whether the payments problem was temporary or permanent in nature. If it was permanent, the determination whether it had been caused by domestic policy mistakes or external factors basically was not germane to the fact that the problem needed to be corrected in the most efficient manner. Exchange rate policy should be focused firmly on the need to restore a viable and sustainable payments position in the medium term and should not dwell excessively on the reasons why a payments problem had arisen.

Using national currencies instead of dollars in describing balance of payments developments in the published version of the World Economic Outlook paper would make the staff's presentation complicated, the Deputy Director said. While the staff recognized that stating values in dollars could sometimes be misleading, it preferred to use the text as the means for elucidating the trends that seemed to be important and to maintain in the tables the present approach of using dollars, which was of course the unit with which most of the users of the published version would be familiar.

It had been suggested that the published version of the World Economic Outlook paper could exclude Section 4, the Deputy Director of the Research Department noted. The staff had intended to include the present text of Section 4 in the published version but without individual country forecasts for 1991.

Mr. Fujino remarked that the balance of payments could be expressed in national currency or as a ratio of GNP. If the staff did not wish to include positions expressed in national currency, it might be helpful to include the GNP ratios.

The Director of the Research Department said that the relevant tables had always referred to absolute levels. Changing that practice at the present stage would involve a considerable alteration of the tables.

Mr. Grosche remarked that a number of Executive Directors had stressed the urgent need for a further stimulus of demand in Germany. Apparently some Executive Directors believed that the German authorities were bound to their medium-term fiscal strategy to an extent that would prevent them from reacting to a slowing of economic activity. That assumption was incorrect. The authorities had shown that they were committed to a flexible implementation of their medium-term fiscal strategy. The most recent example of that flexibility was the proposal a few days previously by the Minister of Finance of a federal budget for 1987 that envisaged for the first time in several years a slight increase in net new borrowing. That outcome was also the result of the first step in the tax reduction scheme that had taken effect in January 1986. The main question at hand was whether more in that direction should be done. There was clearly no visible danger of a downswing in economic activity in Germany. On the contrary, the data for the second quarter showed a sharp acceleration of growth, and the leading indicators pointed to a continuation of the upward trend through the remainder of 1986 and well into 1987. Executive Directors should consider carefully whether the present time was the right one at which to add further stimulus to the economy, especially as the economy was already growing at a rate above the potential growth rate.

The decline in the rate of economic growth in Germany in the fourth quarter of 1987 shown in Table A2 of SM/86/207 compared with the year-to-year growth in 1986 was taken by some as an indication of a likely sharp downturn in economic activity in Germany in 1987, Mr. Grosche remarked. The growth figure for the fourth quarter of 1987 seemed to be the result largely of developments in the fourth quarter of 1986, when a relatively rapid rate of economic growth was expected in line with the rebound in economic activity that was anticipated for the rest of 1986. Economic growth in Germany in 1987 was expected to be more balanced than in 1986. However, activity at the end of 1987 might well slow somewhat. In that event, the second step of the planned tax decrease that was to become effective in January 1988 would prove to be particularly timely.

Immediately following the general elections in January 1987, his authorities intended to intensify their work on the comprehensive tax package and hoped to have it ready for implementation in late 1987 or early 1988, Mr. Grosche continued. Whether or not that reform would be introduced in addition to the tax cuts that were already planned for the beginning of 1988 would depend upon the speed at which agreement on the reform proposals could be reached between the federal government and the states. In any event, given the present pace of economic expansion in Germany, 1988 would be a much better time in which to provide an additional boost to demand than the end of 1986 or the beginning of 1987.

Mr. Nimatallah said that he agreed with Mr. Grosche that there was no urgent need for Germany to reduce taxes in order to stimulate demand. In his own comments on the subject he had had in mind a possible fiscal stimulus in 1988 or 1989. Of course, a fiscal stimulus normally took some time to have an effect, and he was pleased that the German authorities were planning in advance to introduce any needed stimulus and that a whole package of tax reforms was being considered.

Mr. Kafka commented that he understood the staff to feel that the recent decline in real and nominal interest rates was likely to be a reliable stimulant to private demand. However, he had been struck by two recent developments. First, after the Federal Reserve had announced its cut in the discount rate from 6 percent to 5 1/2 percent, the federal funds' rate had risen rather than declined. Second, when there had been a rumor of larger August 1986 treasury bill sales, higher interest rate expectations had taken hold of the market and had led inter alia to a sharp reduction in the values of equities. Those developments suggested that, while the rate of inflation was low and could well be expected to remain low for at least a while, inflationary expectations were so volatile, as people were readily prepared to expect a resumption of high rates of inflation, that those expectations alone might interfere with the stimulative effect of lower interest rates on private demand.

Mr. Zecchini considered that the staff had not yet squarely faced the issue of the appropriate policy orientation and policy mix in industrial countries. The staff had said nothing about that issue on the ground that there was likely to be a recovery in economic activity in the second half of 1986, although at a slower pace in 1987. There was nothing in the staff's comments at the present meeting to suggest that there was any firm basis on which to believe that the experience in the coming 12-18 months would be significantly different from the experience in recent months and would warrant the scenario that the staff had described.

The staff had not fully answered the question that he had raised about the estimate of the impact of the reflation of domestic demand in Germany and Japan on the United States, Mr. Zecchini said. In his comments, he had meant to raise the issue of the policy response in an area like Europe that benefited from economic and monetary integration and an exchange system that was constrained by established rules. It was evident that when the leading member country in such a region expanded its economy,

the ability of the other countries in the region to expand increased. The staff's estimate of that phenomenon was unsatisfactory and misleading. It was incorrect to assume that monetary policy could be used to prop up demand in the second part of 1986 and in 1987; the industrial countries should reconsider their fiscal stance and perhaps their structural adjustment stance. The members of the Interim Committee must face the choice of whether to support the desired economic activity by continuing to lower interest rates or by rethinking their policy stance in the fiscal and structural adjustment areas.

Mr. Sengupta commented that it was important to consider whether, given the lack of clarity about the elasticity of expenditure and investment in industrial countries, specific policy measures should be taken to ensure the achievement of the desired crowding in of private investment. As Mr. Zecchini had usefully stressed, in the absence of a systemic effort to maximize the effect of expansionary policies and activity in major countries, their effect could be fairly limited. As the staff had mentioned, such analysis involved some conjecture, but the kind of policy thrust that he had described would be warranted.

Mr. Fugmann commented that the actual rate of economic growth in Germany did not appear to exceed the capacity growth rate. It would be useful to have a further indication of the reasons why the German authorities believed that actual growth in Germany exceeded potential growth.

Mr. Nimatallah said that it would also be useful to have a further comment on recent reports that private sector investment in the United States was declining.

Mr. Salehkhoul remarked that another fundamental issue was the rate of economic growth that would be needed to enable debtor countries to repay their external debt. In a recently published study by the Inter-American Development Bank it had been suggested that Latin American countries had made debt service payments amounting to almost \$100 billion, over \$1 billion more than they had received in foreign financing since the debt crisis had begun in 1982 and wiping out the entire net inflow of capital that had been generated in the petrodollar recycling of the 1970s.

The Director of the Research Department commented that Mr. Kafka had raised an important issue in noting the possible volatility of expectations in the market about inflation, interest rates, and exchange rates. Developments in recent years had revolved around the evolution of expectations. In earlier years, a growing concern about the U.S. fiscal position had molded expectations that had led to higher interest rates in the United States that in turn had generated capital inflows into that country, an increase in the exchange rate for the dollar, and substantial U.S. current account deficits. Following a change in expectations, interest rates had fallen in the United States and the value of the dollar had been reduced; at present, an improvement in the current account position was expected. The Fund should be alert to signals of a possible

further change in expectations. It was of course impossible to say whether the recent change in the stock market was such a signal. However, the staff kept various signals in mind in an effort to try to recognize a combination of signals that sent a convincing message of a change in expectations. It was conceivable that the delay in improving the U.S. fiscal position was affecting market expectations, thereby delaying the desired improvement in the external current account position. Such developments were of course difficult to forecast, but the staff intended to remain alert to them.

Mr. Templeman remarked that it was important to distinguish between developments in GNP growth and in final domestic demand in the United States. The difference between the two was the foreign balance in real terms and was important not only for growth in the United States, but also for investment. Capacity utilization in the United States was fairly low, mainly, many thought, because although demand had remained strong, it was being met to a larger extent by foreign suppliers. In addition, the initial effect of the decline in oil prices on the U.S. energy sector, which was an important part of the U.S. economy, had been negative. Another factor--albeit a transitory one--that should be borne in mind was the uncertainty about tax reform in the United States. There was every reason for investors to delay making investments until they knew how the tax reform was likely to take shape; as Mr. Dallara had stressed, it was clear that tax reform was going to occur in the United States.

He agreed with the Director of the Research Department that market expectations played an important role, but also that not too much should be read into a single day's activity in the stock market, Mr. Templeman continued. The recent adjustment in the stock market was unsurprising. There was still reason to be cautiously optimistic about the ability of the authorities to gain the desired outcome under the Gramm-Rudman-Hollings Act, and as much attention should be paid to that matter as to the progress of tax reform.

The Deputy Director of the Research Department remarked that Executive Directors' comments had touched on the core of the world economic situation, namely, the fear that the weakness in economic activity that was evident in the early part of 1986 might continue, so that the recovery expected by the staff would not occur; there was some concern that world economic activity would slow in 1987, and that attention should be paid forthwith to possible responses to such an outcome. At the same time, as Mr. Grosche had stressed, demand expansion in the major countries was basically on track, and a precipitate reaction to developments in one or two quarters by stimulating the industrial economies would be a mistake. Mr. Kafka had said that he wondered whether it was appropriate to be encouraged by the decline in interest rates, since higher interest rates seemed to be associated with a strengthening of economic activity. It was true that by itself a strengthening of economic activity would tend to increase demand on credit markets and push up interest rates, other things being equal. At the same time, a reduction in interest rates would tend to stimulate interest-sensitive expenditures,

other things being equal. Therefore, the question was whether the decline in interest rates in recent months was merely a reflection of economic weakness or part of an improvement in credit market conditions that would encourage expenditure. In the staff's view, both of those elements were present. Part of the decline in interest rates had clearly been encouraged by weak output, particularly in the United States; therefore, the demand for funds had been weak, and interest rates had tended to fall. By itself that decline would not be particularly encouraging, as it would be a reflection only of the weakness in economic activity. However, the monetary authorities had encouraged an easing of monetary conditions over and above what could be attributed simply to the weakness of the economy. In any event, lower interest rates tended to have a kind of automatic stabilizing effect by stimulating certain kinds of expenditure.

While the staff agreed with Mr. Zecchini that there was no hard empirical evidence for the rise in economic activity foreseen in the paper, it was reasonable to expect a positive response to such factors as the oil price decline in the second half of 1986, the Deputy Director continued. A change such as a fall in oil prices was in the first instance a transfer of resources from oil producers to oil importers. It was clear that the response of oil producers had been relatively rapid--faster than the staff had anticipated at the beginning of 1986. The response of the consuming countries and regions thus far had clearly been less rapid. The staff could not say with absolute conviction that the expected expenditure following the oil price fall would occur in the second half of 1986. However, it was plausible to expect that the increase in real incomes in industrial countries would eventually be reflected in final demand; indicators in the industrial countries were consistent with that judgment.

A related important issue was whether the staff could be confident that the strength that it expected to materialize in the second half of 1986 would endure in 1987, the Deputy Director went on. If the present fiscal goals of the major countries were achieved in 1987, and if the adjustment that would have to take place in the developing countries in response to their earlier terms of trade losses were to occur, there would have to be a substantial negative effect in the industrial countries stemming from the government and foreign sectors. That development would not necessarily provoke a slowdown, and the projected slowdown was indeed relatively modest. However, the staff was looking for crowding in to occur. Mr. Grosche had noted that his authorities believed that the crowding in of private sector expenditure was occurring and that it would be a mistake to add further to demand at the present stage. There had been considerable support among Executive Directors for that view. The staff felt that the immediate effects of the improved terms of trade in the industrial countries would reach a peak in the second half of 1986 and would tend to diminish thereafter. A key question was whether they would permit a sustainable rate of economic growth or would be unable to compensate for the fiscal retrenchment and the correction of the external position.

The shift in the terms of trade in Europe and Japan was unprecedented, the Deputy Director continued. That fact made it particularly difficult to forecast the responses of the industrial countries to the oil and commodity price declines. A case could be made for expecting a slowdown in the rate of growth of private sector demand in 1987, and the issue was whether the likely slowdown would be sufficiently large to raise questions about the sustainability of an adequate rate of expansion in 1987. The staff could not give a precise answer to that question, just as no one could say for certain why the stock market had fallen in recent days. One interpretation of that fall was that the market was afraid of a strengthening of activity that would push up interest rates, an opinion that the staff did not share. In the staff's view, there was a question mark whether aggregate private sector demand would be strong enough in 1987 to maintain a satisfactory rate of output growth given the assumption about the likely changes in fiscal positions and the likely negative effect of the foreign sector.

The decline in private sector investment in the United States was due to a number of factors, the Deputy Director commented. There had been a particularly sharp cut in oil exploration and drilling activities in the oil sector that had spread to other sectors. In addition, expenditure on computers had diminished after a substantial increase. Moreover, it was important to remember that investment growth in the United States had been very rapid in 1982-84, so that the present decline was from a high level rather than from an average level.

The question of when debtors could be expected to repay their external debt was hypothetical and in any event not relevant to the present discussion, since neither creditors nor debtors were anticipating a situation in which principal would be repaid in the near future, the Deputy Director of the Research Department said. The real issue was the circumstances in which the debt profile could be placed on a sustainable basis, so that the ratios of debt to GDP and to exports would tend to decline over time rather than to rise, as they had in recent years. The staff's scenario suggested that it should be possible for a growth rate of 4-5 percent to be maintained consistently with a reduction in the share of debt relative to exports and GDP. However, to take the question that had been posed at its face value, since debtor countries' debt was equivalent to 30 percent of their GDP, they would have to maintain a growth rate of 5 percent for 6 years to repay the debt, assuming that all of the growth in GDP would be allocated to debt retirement. Such a calculation was of course artificial, and the staff would not give much weight to it.

Mr. Zecchini remarked that one of the questions that he had raised that had not been answered was the relative importance of policy instruments in the strategy that should be pursued. That question was related to the effectiveness of monetary policy in inducing an economic upswing, together with the effect of a reduction of users' cost of capital on investment demand. Those questions need not be examined further at the present meeting, but it was important to note them at the present stage.

Mr. Kafka considered that it was interesting to note that merely a slight sign of stimulus on the monetary side--namely, the cut in the U.S. discount rate--and merely a small sign of recovery had led to what might be called an overreaction concerning inflationary expectations that was expressed in the rise in interest rates and the fall in equity prices in the United States. The conclusion to be drawn from those developments was that if any stimulation of economic activity was thought to be desirable, it might be impossible without increasing inflationary expectations to such an extent that the interest rate reaction would offset the stimulus, or it might be achieved by fiscal stimulus rather than by a loosening of monetary conditions.

The Deputy Managing Director remarked that recent developments in the U.S. economy were perhaps a reflection of a stronger recognition than hitherto that the pace of adjustment of the U.S. fiscal deficit was not likely to be as fast as had been expected at 6-12 months previously. The markets were very sensitive to developments on the fiscal side and were well aware of attitudes within the U.S. Congress as well as the slippage that seemed to be creeping into the fiscal performance for the coming year.

Mr. Salehkhrou said that the trend shown in Chart 8 cast doubt on whether it would ever be possible to achieve the growth that the staff had suggested was needed to enable developing countries to pay off their debt or even to maintain a sustainable debt service position unless the trend was to be reversed.

The Deputy Director of the Research Department responded that if interest rates on external debt exceeded the rate of growth of export earnings, the stock of debt would continue to rise faster than exports, a situation that would be unsustainable. There was no presumption that the countries concerned would necessarily keep their noninterest payment current account transactions precisely in balance. Furthermore, there was no historical evidence that a situation in which the rate of growth of export earnings was less than the interest rate would prevail for any extended period. With the present decline in real interest rates, export growth rates were likely to once more be above the interest rate. Chart 8 was not meant to suggest that the situation with respect to interest rates and the growth of export earnings was likely to be unsustainable indefinitely, but it did imply what the balance of transactions other than interest rate payments should be in the coming period; that trend was reflected in the statistics that Mr. Salehkhrou had cited concerning the excess of external payments over receipts in Latin American countries in recent years.

The staff representative from the Research Department, responding to a question, explained that the trend lines in interest rates on external debt and the growth of export earnings shown in Chart 8 would cross again over time, with the trend in export earnings exceeding the trend in interest rates. The increase in export earnings in 1987 shown by the

chart was due to the fact that export volumes were expected to overwhelm the effects of lower export prices; in 1986 in particular, the fall in prices had had the larger effect.

Mr. Sengupta commented that the staff paper unfortunately gave the impression that the staff implicitly supported policies of overall import substitution or import compression. He had assumed that, on page 41, after giving reasons for the reduced availability of foreign exchange, the staff would have mentioned that some of the factors involved--such as the slower growth of export markets and the deterioration in the terms of trade--were temporary and should be reversed, and that both developing and developed countries should contribute to the effort to make that reversal. Instead, the staff had stated that "given such an environment, the policies that developing countries pursue must be geared to maximizing the growth that can be achieved with limited availability of foreign exchange." That conclusion was in effect the first principle of import substitution. The staff had suggested that it was always possible to encourage exports in ways that would not introduce distortions into an economy, and that the main mechanism in that connection was the exchange rate. In fact, much depended upon the structure of an economy and its payments position, among other factors. A case could be made showing that, at a particular point, the second best solution would be to use import restrictions and tax subsidies rather than an exchange rate adjustment; that approach might well be particularly appropriate for African countries in place of reliance purely on the market.

On page 42, Mr. Sengupta went on, the staff had stated that "if the export earnings of these countries are to grow at a rate even approaching that achieved in the 1960s and 1970s, major progress will be necessary both on the domestic front and on global trade liberalization." That statement was certainly correct. However, the next sentence read: "Even in these circumstances, if the momentum of domestic growth is to be restored, increments to outcome will have to become relatively less dependent on imports than in the 1970s." That statement might well send the wrong signal. The staff should send a clear message like the one on page 43, namely, that "there is a danger, however, that an unfavorable economic environment, poor export duties, and inadequate external financing will induce countries to undertake a more pronounced import substitution strategy based on trade restrictions and domestic controls."

Mr. Kafka said that he agreed with Mr. Sengupta that the Fund should avoid sending signals that would encourage members to engage in import substitution. An appropriate signal that seemed to be implied by the staff paper was that growth in developing countries should become less capital intensive. That message was particularly appropriate in the light of the substantial unemployment and underemployment in developing countries.

The Deputy Director of the Research Department commented that the staff had not meant to imply that members should rely upon an import substitution strategy based on deliberate controls over imports and the

fostering of less competitive domestic industries to replace imports. The staff had noted on page 43 that "in the policy approach just outlined, the operation of market forces and the exploitation of comparative advantage can enable the growth process to become less dependent upon the rapid expansion of imports." It was important to face the likelihood, as projected by the staff, that the rate of growth of real export earnings of the developing countries as a group would be considerably less in the coming period than in the past. In addition, the rate of inflow of new capital would likely be less in the coming years than during the 1960s and 1970s. In order to reconcile the desired high rate of economic growth in developing countries with the constraints on imports, means must be sought to make the growth process less dependent on the rapid growth of borrowing and imports.

In its paper the staff had tried to say that there were two routes to take to make growth less dependent on imports, the Deputy Director of the Research Department continued. One was the strategy of import substitution, controls, and trade restrictions--a strategy that the staff had stressed was self-defeating. The other approach relied upon market mechanisms, although he agreed with Mr. Sengupta that markets were not always a fully reliable guide. Under the market-oriented approach, there would be market-type solutions involving realistic exchange rates that encouraged exports and domestic production to become more competitive. The staff felt that in a number of African countries the combination of unrealistic exchange rates and suppressed producer prices had caused inadequate production of foodstuffs and, therefore, heavy importation and sizable balance of payments problems. In those cases, the use of market forces--particularly a realistic exchange rate and realistic producer prices--could enable the countries concerned to exploit their comparative advantages and increase efficiency. The staff had meant to say that a process in which imports came to be less central to the process of growth was not inconsistent with an efficient and basically nondistorting system of prices. As Mr. Kafka had noted, in a number of countries with a planning mechanism growth was focused on the development of industries with heavy capital import requirements. That outcome was in itself a kind of distortion that could be relieved, thereby enabling the growth process to be more likely to generate domestic employment.

The Chairman made the following summing up:

Directors' comments have covered a wide range of issues. In this summing up, I will deal first with the views that were expressed about short- and medium-term economic prospects. After that, I will attempt to summarize the discussion of some of the key policy questions touched on in the staff's paper. These include: the appropriate stance of demand management and structural policies in industrial countries; how to manage policy interactions at the international level, especially among the largest countries; how to strengthen growth prospects in developing countries, while at the same time making progress toward improved creditworthiness; and how to bring about more effective

international policy coordination. In connection with policy coordination, I will review some of the comments that were made about the staff's effort to make greater use of economic indicators.

1. Economic prospects in the short and medium term

Directors agreed with the staff's assessment that economic developments in early 1986 had been disappointing. They particularly noted the weakness of world trade and the further substantial decline in commodity prices. The unexpected sluggishness in economic activity in industrial countries was generally attributed to negative initial effects from some of the major changes that had taken place in the world economy--especially the fall in oil prices and the shift in the pattern of exchange rates. The effects of weak economic activity and of the fall in commodity prices on the export earnings of developing countries were viewed with considerable concern: it was noted that developing countries had already had to cut back their imports sharply, and that a further cutback was projected by the staff. This had already led to a deceleration of growth in developing countries, and slower growth was expected to persist in 1987.

Concerning future prospects, most Directors agreed with the staff that economic activity in the industrial countries was likely to strengthen in the latter part of 1986 and in 1987, although doubts were expressed about this. Indeed, there were already signs of stronger growth in Europe. Among the reasons for expecting such an outturn were: the favorable lagged effects of oil and commodity price declines on real incomes in importing countries; the beneficial consequences of lower interest rates; and confidence effects stemming from efforts to control budget deficits and move toward a more sustainable pattern of exchange rates. Nevertheless, it was noted that recent indicators were ambiguous. Some Directors were concerned that the move toward fiscal restraint would tend to lower demand in the short run. Other Directors expressed concern that the delays in implementing fiscal correction in the United States would tend to undermine confidence and increase interest rates and inflationary expectations, thus inhibiting economic growth. Moreover, efforts by developing countries to strengthen their external position, unless offset by increased financial flows, would be exerting a negative effect on demand for industrial countries' net exports. For all these reasons, a number of Directors considered that there remained considerable downside risks in the staff's short-term projections for the industrial countries.

As far as the outlook for developing countries was concerned, Directors noted that no significant recovery in the terms of trade was expected over the forecast period, while

growth in the volume of world trade would remain subdued. Thus, export earnings, after declining sharply in 1986, were expected to rise only moderately in 1987. This prospect clouded the outlook both for economic growth and for a return to creditworthiness. Several Directors felt that it might be difficult to achieve even the relatively modest growth rates envisaged by the staff.

Looking ahead to the medium term, Directors acknowledged that the staff's projections had to be regarded as highly tentative. Several key features of the medium-term scenario were remarked upon. The continuation of growth at about 3 percent in the industrial countries was not viewed as particularly ambitious given the present high rates of unemployment and the sharp improvement in these countries' terms of trade. It was pointed out that significantly higher rates of growth had been achieved during the 1960s and 1970s. Concerning inflation, Directors noted that price increases were expected to stabilize in the 3-4 percent range. Finally, many speakers referred to the persistence of a substantial divergence in the current account positions of certain major countries, notably the United States and Japan, despite the magnitude of recent exchange rate changes.

In developing countries, many Directors expressed concern that the debt/export and debt/GDP ratios envisaged by the staff for 1991 were less favorable than in earlier projections. Several of them considered that the persistent tendency of these ratios to deteriorate (despite the staff's expectations to the contrary) indicated a bias toward optimism in the staff's assessments and underlined the difficulties in restoring creditworthiness on a durable basis. It was noted that even if the staff's projections for growth in developing countries materialized, per capita incomes would rise only slowly and little headway would be made in reducing open and disguised unemployment, which constituted a major problem for developing countries.

2. Economic policies in industrial countries

Directors generally agreed that the economic strategy that had been espoused by the main industrial countries since the early 1980s remained appropriate. The principal features of this policy are: the restoration of price stability through restraint in the growth of monetary aggregates; the gradual reduction of government expenditure and deficits; and improved functioning of markets, supported, where necessary, by structural policies. It was noted that this general strategy had so far been rather unevenly carried into effect. In particular, fiscal deficits had grown disturbingly in the United States, Canada, and Italy; structural rigidities had hindered a return to satisfactory

growth in Europe at lower levels of unemployment; and a significant part of demand growth in Japan had been accounted for by external sources.

Directors noted that the U.S. Administration and Congress were now firmly committed to a program of budgetary strengthening. This was considered a highly positive development, although it was noted that the enactment of budgetary cuts had yet to be implemented and might not be easy. A concern of a different kind was voiced by some Directors that if the cuts necessary to achieve the targets of the Gramm-Rudman-Hollings Act were made, the withdrawal of stimulus might be greater than could be offset in the short term through an expansion in private sector spending.

For countries outside the United States, some concern was expressed that the pace of domestic demand growth might not be sufficient to permit the needed reduction in balance of payments surpluses, while at the same time bringing about an expansion in employment opportunities sufficient to reduce existing rates of unemployment. Directors agreed that, in the longer term, sustainable growth had to be based on the improved functioning of national economies. This in turn would be facilitated by the removal of rigidities in the markets for goods, labor, and capital. However, a number of Directors asked the question or expressed some doubt whether one could be confident that economic activity would continue at an adequate pace in the second half of 1986 and in 1987. Thus, in a shorter-term context, a number of Directors saw scope--or perhaps a need--for policies that would help underpin a more satisfactory growth of private demand. Such policies might include, depending on the circumstances of individual countries, the bringing forward in time of desired cuts in taxation or increases in infrastructural investment, and the introduction of fiscal reforms that would help support private sector demand and output. It was noted that the countries which possessed the greatest room for maneuver in these respects were those where inflation was very low, the balance of payments was exceptionally strong, and good progress in fiscal consolidation had already been made. On monetary policy--which I did not list in the policy instruments a moment ago--several Directors felt that flexibility was also called for without abandoning the basic anti-inflationary stance of policy. Others felt that caution was needed here: inflationary expectations were volatile, and interest rates were extremely sensitive to these expectations and to perceptions of the basic anti-inflationary stance of fiscal and monetary policies and to the mix of policies. Those Directors stressed that monetary policy could not, in itself, stimulate growth without serious risks on the inflation front.

3. Policy interactions

As far as policy interactions in industrial countries are concerned, Directors noted that the correction of imbalances in the world economy will require careful coordination of policies in the major countries. Achieving effective balance of payments adjustment while maintaining the momentum of output growth would involve sizable shifts in the pattern of demand in each of the major countries. In the United States, a significant decline in the rate of growth of public spending would need to be offset by an acceleration of private domestic expenditure and a strengthening in net exports. In a number of other industrial countries, including particularly Japan and Germany, a strengthening of domestic demand was needed to provide the scope for the intended balance of payments improvement of the United States and developing countries.

Directors generally felt that the balance of payments pattern that was projected by the staff over the medium term could not be regarded as satisfactory or sustainable. A stronger growth in Europe and Japan as well as adequate financial assistance to sustain import demand in developing countries, was regarded as a helpful way of improving the balance of payments prospects of the United States. However, it was also recognized as important that U.S. competitiveness be strengthened, and that such a shift in competitiveness be underpinned by a durable improvement in the U.S. fiscal position. Directors stressed that economic policies among the larger countries, particularly monetary policies, should be carefully coordinated to avoid the risk of precipitate exchange rate adjustments.

4. Growth and adjustment in developing countries

Directors agreed with the staff that promoting faster growth in developing countries should be regarded as a key priority. They noted several developments since the early part of the year that clouded prospects for improved economic performance in developing countries. The further sharp decline in the prices of non-oil primary commodities, together with sluggish growth in the volume of exports, meant that the export earnings of these countries had been subdued. The section in the staff paper on commodity price developments was welcomed, and Directors looked forward to receiving the results of the studies that had been initiated with the World Bank. Lower commodity prices were seen as the major factor behind the downward revision of growth prospects in developing countries, and the further increase in debt to export ratios.

Directors noted that improving economic performance in developing countries would require mutually supportive efforts by all parties concerned. Developing countries themselves would

need to strengthen their efforts to improve domestic policies and pave the way for more effective resource utilization aimed at improved trade performance and faster growth. These efforts would require an international economic environment, particularly in the larger countries, in which satisfactory demand growth was matched by improved market access. Finally, adequate financial support would be needed to underpin growth-oriented adjustment efforts. All creditors had a role to play in providing such resources: multilateral institutions, official bilateral lenders, and private creditors.

Concerning policy requirements in developing countries themselves, Directors noted the importance of stable macro-economic policies. They underlined the need in several countries to strengthen efforts to bring fiscal deficits under control, to improve price stability and to increase external competitiveness. The progress that some important developing countries had made in these directions was welcomed. Improved macroeconomic policies were considered central to the process of improving economic performance. At the same time, however, Directors stressed the importance of structural improvements aimed at enhancing incentives for investment and production, which were viewed as essential if growth and living standards were to rise at a more satisfactory rate. Among the structural measures that received attention were: the removal of subsidies to inefficient industries; the reform of incentives administered through the tax or tariff structure; adjustments to administered prices to provide a better reflection of relative scarcity; more efficient priorities in the public sector investment program, etc.

While recognizing the central importance of the policies pursued by developing countries, Directors pointed out the need for a supportive international environment. Three key features of a satisfactory international environment that were cited were: stable growth in export markets; stable and adequately remunerative export prices; and fair access to international markets. In this connection, a number of Directors underlined the importance of the industrial countries cooperating successfully to achieve a better growth performance.

All speakers recognized the role to be played in the present situation by the maintenance of an adequate flow of finance. It was noted that while lending by the multilateral institutions was broadly in line with the amounts envisaged under the Baker initiative, flows of finance from commercial banks and official lending were less satisfactory. It was essential to put together financial packages in support of adjustment programs swiftly. Indeed, structural changes take time to have an impact. The global economic environment would also take time to improve. Thus, it is of the essence that the flow of lending from private and official bilateral creditors pick up in the period ahead.

5. International cooperation

As I have just noted, many Directors stressed the importance of strengthened economic cooperation and improved coordination of policies. A number of channels through which improved coordination could be achieved were cited. These included more effective multilateral surveillance of the policies of the major industrial countries, in particular through the more systematic use of indicators of economic policies and performance; the provision of financial assistance in support of growth-oriented adjustment in developing countries; and resistance to protectionism.

In commenting on the staff's efforts to make more systematic use of indicators, several points were made. First, Section IV of the staff paper was seen as a helpful first step in developing a more effective dialogue on economic interactions. The staff was encouraged to build upon it. A number of Directors offered specific suggestions for developing the staff's analysis of indicators in future WEO exercises. One Director suggested it might be helpful to consider "norms" for monetary and fiscal indicators in future WEO exercises. Second, it was agreed that the central focus of an analysis of indicators should be on the external sector, and particularly the sustainability of balance of payments positions, a notion on which further reflection and work was called for. Third, the medium-term context set forth in the staff's paper was felt to be a useful basis for discussing shorter-run policy issues. Fourth, the central role of the Fund was reaffirmed. Several Directors said that the Fund should be represented in all bodies that discussed multilateral policy interactions. We all look forward to a discussion in the Interim Committee that will focus on the substance of indicators, i.e., the economic interactions and the policy issues they elicit, thus going well beyond the more technical issues of indicators that were addressed in the staff's earlier paper.

Finally, I should note the unanimous concern that was expressed about the continued strength of protectionist pressures. Directors agreed with the staff that trade restrictions impeded efficient resource allocation and provoked retaliation. This complicated the task of resolving the debt difficulties of developing countries and tended to perpetuate economic inefficiencies in all member countries. Directors called for all countries to eschew protectionism, and for the larger countries to take the lead in this effort. Particular mention was made of the harmful consequences of agricultural subsidies in industrial countries.

After further brief remarks the Executive Directors concluded their discussion on the world economic outlook.

2. DESIGNATION PLAN AND OPERATIONAL BUDGET FOR SEPTEMBER-NOVEMBER 1986

The Executive Directors considered the designation plan (EBS/86/203, 8/29/86; and Sup. 1, 9/12/86) and the operational budget (EBS/86/204, 8/29/86) for the quarterly period from September to November 1986.

The staff representative from the Treasurer's Department noted that since the distribution of the proposed designation plan and operational budget, several expected purchases, including one large one, had failed to take place as expected. The staff had recalculated the designation plan in the light of those changes and had found that the recalculated amounts did not differ materially from the original ones. Therefore, the staff did not intend to amend the amounts in the proposed plan. The staff would issue updated tables showing the actual execution of the designation plan and the operational budget for June-August 1986.

Ms. Bush said that she looked forward to the plans that the staff would be proposing concerning the inclusion of U.S. dollars in future operational budgets. Those plans were being considered in the context of the burden sharing arrangements that the Executive Board had endorsed on the ground that some adjustment in the inclusion of the dollar would be required because of the sizable position of the United States among creditor members' positions. As she understood it, the burden sharing arrangement affecting the operational budget would begin at the time of adjustments in the rate of remuneration and the rate of charge resulting from burden sharing. If for any reason the adjustments for the U.S. dollar should lag behind the introduction of adjustments in the rate of remuneration and the rate of charge, she would expect, as was suggested during the discussions on burden sharing, that the time lag would be taken into account in future operational budgets, so that the United States would be able to recoup any losses resulting from the lag.

Mr. Nimatallah stated that the proposed decisions were acceptable. He was pleased that the new process for handling budgets that had been introduced with the first budget for 1986 seemed to be working well.

The staff representative from the Treasurer's Department remarked that the staff was studying the matter that Ms. Bush had raised with a view to the possible introduction of the new arrangement in the next quarterly period. In that connection, it might be necessary for the staff to ask the Executive Board to consider certain technical matters before the next operational budget was circulated.

The Executive Board then took the following decisions:

SDR Department - Designation Plan for September-November 1986

The Executive Board approves the designation plan for the quarterly period beginning September 12, 1986, as set out in EBS/86/203 (8/29/86).

Decision No. 8389-(86/154) S, adopted
September 12, 1986

Operational Budget for September-November 1986

The Executive Board approves the list of members considered sufficiently strong as set out in EBS/86/204, page 3, footnote 1, and the operational budget for the quarterly period beginning September 12, 1986, as set out in EBS/86/204 (8/29/86).

Decision No. 8390-(86/154), adopted
September 12, 1986

3. NEPAL - STAND-BY ARRANGEMENT - REVIEW AND MODIFICATION

The Executive Directors considered a staff paper on the review under the stand-by arrangement for Nepal approved on December 23, 1985 and requests to extend the expiration date of the stand-by arrangement for three months and to waive the application of performance criteria for July 15, 1986 (EBS/86/182, 8/11/86; and Sup. 1, 9/8/86).

The staff representative from the Asian Department said that the staff and the authorities agreed that further progress was needed in the area of timely collection and compilation of monetary and credit data in Nepal. It was expected that the authorities would be requesting further technical assistance in that area, and that the terms of reference for the assistance could be worked out during the 1986 Annual Meeting.

Mr. Ismael made the following statement:

On behalf of the Nepalese authorities, I would like to thank the staff for a very comprehensive review of the Nepalese economic program. The Nepalese authorities are in general agreement with the review and its conclusions.

The economic program for 1985/86

The adjustment program, which was introduced at the end of 1985 and supported by the Fund with a stand-by arrangement, has to date made substantial progress in achieving the program's objectives. The real GDP growth rate accelerated to an estimated

4.2 percent in 1985/86, compared with 3 percent in 1984/85. This is due mainly to improved economic activity, with notable increases in foodgrains and cash crops as well as in nonagricultural outputs. Inflation has been maintained at about 16 percent in 1985/86 after accelerating from 17 percent in November 1985 to a fiscal year peak of 34 percent in February 1986. This has been achieved despite the 14.6 percent devaluation of the Nepalese rupee prior to the implementation of the adjustment program in November 1985. Furthermore, in spite of the notable intervening deterioration in the terms of trade, there has been a substantial strengthening in Nepal's external accounts. The measured overall balance of payments deficit narrowed from SDR 53 million in 1984/85 to SDR 7 million, in spite of an unanticipated marked revaluation loss in the stock of net foreign assets.

In the fiscal sector, the authorities' tightening of the fiscal stance in the weeks prior to the devaluation in late November has led to a decline in both the overall budget deficit and in its domestic financing in relation to GDP by 1.6 percentage points, compared with the 1984/85 levels. Moreover, the overall deficit for 1985/86 was lower than that envisaged in the program by an amount equivalent to 0.2 percentage point of GDP.

With respect to the public enterprises, the planned sale to the public of government-held equity in these enterprises did not materialize during 1985/86. However, in view of their commitment to ensure that the financial position of these enterprises is not undermined and, at the same time, avoid a direct or indirect additional burden on the budget, the authorities have made periodic adjustments in the administered prices to reflect changes in import and/or domestic production costs. Important among these were increases in domestic sales prices of chemical fertilizers, cement, and sugar.

In the monetary and credit sector, the authorities have instituted measures to ensure the effectiveness of policy directives after experiencing some implementation weaknesses at the beginning of the program. These weaknesses, which were due mainly to prior commitments of commercial banks as a result of the delay in finalizing the stand-by arrangement, resulted in the nonobservance of the performance criteria on net domestic assets fixed for January, April, and July 1986. However, as a result of consistent efforts on the part of the authorities to restrain credit through monetary and fiscal measures, the expansion of domestic credit to both the public and private sectors began to decelerate in May 1986. Estimated net domestic assets for July 1986 exceeded the targeted ceiling by only 2.5 percent, compared with 5.8 percent in April 1986.

The authorities are fully aware of the need both to mobilize domestic resources for development purposes and to improve resource allocation. To this end, a sweeping reform of interest rates was put into effect on May 29, 1986. This will not only facilitate the implementation of a flexible interest rate policy, which is indispensable to mobilize domestic savings, but will also permit the authorities to conduct monetary and credit policy effectively.

In the external sector, policies on the exchange rate and commercial external borrowing conformed to the guidelines of the program. The improvement in the external competitiveness achieved by the November devaluation of the rupee has been largely maintained and has been an important factor in the significant growth in export volume.

Economic program for 1986/87

For 1986/87, the Nepalese authorities are fully committed to continue along the economic path of adjustment on which they embarked last November. The main objectives of policy will continue to be the strengthening of the balance of payments and growth prospects, while reducing inflation markedly. Based on these objectives, the adjustment efforts in 1986/87 will focus on policies to stimulate production, increase development expenditure through greater mobilization of domestic resources and better aid utilization, restrain domestic demand and wage increases, provide flexible management of the exchange rate, liberalize imports, and implement pricing and management policies by public enterprises that are more market oriented.

In order to achieve the growth objective in a framework of external account viability and reasonable price stability, the Nepalese authorities' immediate attention, however, will be focused on the need for a sizable and sustained increase in investment. Accordingly, they intend to intensify efforts to mobilize additional revenue for the budget, strictly restrain regular expenditure, and increase their capacity to utilize external development aid. To this end, a wide range of new tax measures, including most of those recommended by the recent Fund technical assistance mission, have already been introduced. Steps have also been taken to keep public sector spending under control, one of which has been the careful reviews undertaken on the level of transfers to various deficit agencies and public enterprises, with a view to markedly reducing their weight in budgetary expenditure over time. Another important step is the planned sale to the public of government-held equity in a number of enterprises, which the authorities are firmly committed to achieve in 1986/87 after implementing some internal reforms.

Monetary and credit policy for 1986/87 will be conducted in a manner consistent with the program objectives. Achievement of these objectives will be pursued by enhancing the ability of the banking system to attract deposits while keeping the level of bank credit at levels commensurate with those resource flows. To this end, the authorities have been tightening the instruments of monetary policy while increasing coordination over the credit operations of the banking system.

In the external area, the authorities believe that a continued flexible exchange rate policy would be compatible with the achievement of the balance of payments objectives of the program. In this regard, the Nepal Rastra Bank was given the authority to implement exchange rate policy within the framework of the new regime that took effect on May 31, 1986, when the authorities announced that the Nepalese rupee would be pegged to a new basket of currencies, including the Indian rupee.

Conclusion

Despite the adverse developments during the first four months of 1985/86, before the stand-by arrangement in support of the program was approved, and despite the adverse developments in the terms of trade, significant progress was achieved in Nepal's adjustment program during 1985/86. This has been due mainly to sound policy formulation as well as steady implementation of the policies by the authorities. It is my belief that the additional adjustment measures recently taken by the authorities were also timely and will lead to strengthening growth and balance of payments prospects in the period ahead. However, to fully achieve the adjustments envisaged in the original program, the Nepalese authorities believe that a lengthening of the adjustment period by three months is appropriate. The Fund staff fully concurs with this view. Accordingly, a request is being made for an extension of the program to April 22, 1987. I fully support the request of the Nepalese authorities, and I wish to ask the Board's support for the proposed decision.

Mr. Govindarajan made the following statement:

The staff has described the events that took place since the beginning of 1985/86 and the reasons for the nonobservance of ceilings on net domestic assets of the banking system and net credit to the Government in both January and April 1986, even though the balance of payments objective has nearly been achieved, as the latest estimates show. However, Nepal implemented substantial measures both as prior actions and during recent months. In looking at the slippage in performance, one can argue that it was due not only to inadequate monitoring of the credit guidelines by the Nepal Rastra Bank, but also to the

lower than expected level of disbursements of concessional foreign loans, which resulted in an increase in net domestic financing of the budget deficit to a level that exceeded the program ceiling. The authorities have taken steps to tighten the monitoring procedures and, as the staff has noted, there has been noticeable progress in this area. The actions that the authorities took included a discrete devaluation of 14.6 percent together with the introduction of a flexible exchange rate policy; a reduction in the budget deficit by nearly 1.6 percent of GDP in 1985/86, which exceeded the program target and involved an emphasis on expenditure cuts; raising of administered prices in a number of areas, including particularly substantial increases in the prices of sugar, cement, fertilizers, and chemicals; a tightening of monitoring procedures and several far-reaching reforms in the area of interest rates; and a decision to phase out the Nepal Rastra Bank's refinancing facilities to the Agricultural Development Bank of Nepal and to the Nepal Industrial Development Cooperative.

All those measures indicate a keen commitment by the authorities to pursue the adjustment in a rigorous manner. In view of these measures, and since the trends in net domestic assets and net domestic credit to the Government are converging toward the program levels, I fully support the staff recommendation of a waiver of the applicability of the quantitative performance criteria for July 15, 1986.

Before I comment on the program for 1986/87 I must note with concern one development in 1985/86, namely, the substantial retrenchment in development expenditure, which seems to have occurred not only because of domestic revenue shortfalls but also because of slower disbursements of foreign assistance. It is not clear whether the slower disbursements were due to the lack of absorptive capacity in Nepal and whether it was possible to improve the quality of the loans by making them more quick disbursing. A comment by the staff on such a possibility would be helpful.

The outline of the program for 1986/87 contained in the letter of intent is adequate, and I fully support it. In addition, I generally agree with the 1986/87 program targets and policy parameters that are outlined in Annex III, with the adjustments described by the staff.

While the freeing of interest rates, including those on government treasury bills, as the staff advocates, could be a long-term objective, I would urge caution in implementing this policy too quickly. I agree with the authorities that it is necessary to take into consideration the burden that such a policy would place on the budget in the near term.

In the fiscal policy area, I agree with the staff that there is a need to control regular expenditure in order to make available resources for development expenditure. The 1986/87 program contains a wide range of new tax measures that are expected to yield 0.7 percent of GDP. These steps should help the Government to achieve its economic growth objective under its seventh plan. I welcome the plan to increase the ratio of development expenditure to GDP by 2.5 percent over 1985/86 while reducing the domestically financed budget deficit to no more than 2 percent of GDP. This in turn should permit a reduction in government borrowing from the banking system to less than 1.4 percent of GDP. While efforts to improve domestic resource mobilization are important, it needs to be noted that the parameters agreed for 1986/87 clearly indicate the need for a substantial increase in the absorption of external aid in comparison with 1985/86 in order to achieve the targeted rate of growth. I wonder whether Nepal can be expected to absorb that level of aid and whether there would be a need to improve the timing and conditions attached to the aid from hard currency areas.

It is clearly necessary to improve the financial performance and contribution to the budget of the nonfinancial public sector enterprises. However, abrupt reductions in subsidies may not be the best course, at least in some areas of the sector. In the case of fertilizers, a budgetary expenditure in the form of a subsidy could in certain circumstances outweigh the benefits that accrue in the form of higher food production. I would suggest conducting a critical review of the existing subsidies; the costs and benefits, including social benefits, should be studied before any major reductions are undertaken.

I agree with Mr. Ismael that Nepal has been able to introduce significant measures over the previous year and that these have shown results in the form of a dramatic improvement in the balance of payments position. The performance criteria for net domestic assets and credit to the Government from the banking system have not been met, but the latest indications are that they are close to the mark. Moreover, the 1986/87 program is more than adequate. In these circumstances, I strongly support the authorities' request for a waiver of the applicability of the July 15, 1986 performance criteria and their request to extend the period of the stand-by arrangement by three months to enable them to achieve fully the objectives envisaged under the program.

Mr. Sugita made the following statement:

While a number of policy measures have been introduced in line with the adjustment program and some progress has been made in the balance of payments and in economic growth, the program

has gone off track as a result of slippages in net domestic assets of the banking sector and in net credit to the Government. The lower than expected disbursements of concessional foreign loans, together with revenue shortfalls, have led to excessive net domestic financing of the budget despite severe expenditure cuts. Inadequate control of credit to the nonfinancial public sector and the private sector has added to domestic credit expansion, which has exceeded the program target. Although the initial policy actions were somewhat delayed, the remedial actions that subsequently have been taken by the authorities have substantially reduced the gap between the program target and the actual figures and are expected to bring the program back on track shortly. The authorities have found it appropriate to lengthen the adjustment period in order to achieve fully the adjustments envisaged under the original program. In the circumstances, I have no difficulty in supporting the extension of the stand-by arrangement to April 1987 and to allowing a purchase upon the completion of this review.

I generally support the thrust of the staff appraisal. I am pleased that a relatively rapid rate of growth of export volume was achieved in 1985/86, presumably in response to the devaluation. The turnaround in the flow of short-term private capital also was reassuring. I hope that the authorities will continue their flexible exchange rate policy during the rest of the program period and beyond.

I fully recognize the difficulty in raising the savings ratio in a country with a very low per capita income, but domestic resource mobilization is essential to enhance the growth potential over the medium term. Therefore, the authorities are to be commended for their efforts to introduce in 1986/87 a wide range of new tax measures, which incorporate most of the recommendations made by the Fund's technical assistance mission. One area where further improvement seems to be needed is the accuracy of budget estimates of revenues and expenditures. The staff notes in footnote 2 on page 18 that expenditures and the availability of resources have been systematically overstated in the budget, and I have noted the disparities between the figures in the budget and those in the program. Since the slippage occurred in this area, it is essential to have more reliable budget estimates for the success of the program. I wonder whether a Fund technical assistance mission could not provide useful advice in this area; this assistance would be in addition to the planned assistance in the monetary and credit area.

In the area of administered prices and the financial position of the public enterprises, I recognize that most of the fertilizers are provided under foreign assistance with a view to stimulating the use of fertilizer in Nepal. However, the

difference between the sales prices to farmers and the landed costs represents a sizable subsidy, and more attention needs to be paid to its implications for the budget.

I welcome the liberalization of interest rates, which should be beneficial for channeling financial savings into the banking system and for a better allocation of resources. The authorities should be urged to continue their efforts, particularly in the areas of treasury bills and central bank overdrafts to the Government.

In order to achieve medium-term growth in excess of the population growth rate of 3.4 percent, it is important for the authorities to expedite structural reforms, including import liberalization. In this connection, the existing close collaboration with the World Bank is encouraging. Nepal will benefit not only from the resources that could be provided, but also from the expertise available to help design a growth-oriented strategy and select efficient investment projects.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/86/153 (9/10/86) and EBM/86/154 (9/12/86).

4. ASSISTANT TO EXECUTIVE DIRECTOR

The Executive Board approves the appointment of an Assistant to Executive Director as set forth in EBAP/86/216 (9/5/86).

Adopted September 10, 1986

5. EXECUTIVE BOARD MINUTES

The minutes of Executive Board Meetings 86/8 through 86/11 are approved. (EBD/86/240, 9/4/86)

Adopted September 10, 1986

6. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/86/217 (9/9/86) and EBAP/86/218 (9/10/86) is approved.

APPROVED: May 22, 1987

LEO VAN HOUTVEN
Secretary