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To: Members of the Executive Board

From: The Secretary

Subject: UNCTAD - Trade and Development Board - Thirty-First Session

Attached for the information of the Executive Directors is a report by the Fund observers on the thirty-first session of the UNCTAD Trade and Development Board, held in Geneva from September 16 to 27, 1985.

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INTERNATIONAL MONETARY FUND

UNCTAD--Trade and Development Board

Thirty-First Session

Report by the Fund Observers 1/

November 8, 1985

1. Introduction and summary

The Trade and Development Board (TRB) held its thirty-first session in Geneva from September 16-27, 1985 under the chairmanship of Ambassador M. Huslid of Norway. The work of the Board centered on the interdependence of problems of trade, development finance, and the international monetary system. Most participants agreed that while creditor countries should contribute actively to the search for a lasting solution to the debt problems of the Third World, it was also imperative for debtor countries to continue implementing strong adjustment programs. The fact that the Trade and Development Report 1985 prepared by the UNCTAD Secretariat 2/ included a comprehensive and balanced analysis of the current world economic problems contributed to the quality of the debate, and this was considered as an encouraging sign for the future of the organization by many speakers, especially within Group B.

The Board discussed more briefly the issue of protectionism and structural adjustment, and approved a resolution requesting the Secretariat to prepare appropriate documentation for an in-depth review of developments in the international trading system at its thirty-third session. The Board also approved a resolution regarding the particular needs and problems of land-locked developing countries and decided to forward the question of the place, date and duration of UNCTAD VII for further consideration to its thirty-second session. Finally, a highly politicized debate took place on the issue of trade relations among countries having different economic and social systems.

Messrs. Carlos Sanson and Jack Barnouin of the Geneva Office were the Fund observers.

1/ Documents referred to in this report are on file in the Secretary's Department.

2/ UNCTAD/TDR/5.

2. Interdependence of problems of trade, development finance, and the international monetary system

The Officer-in-Charge of UNCTAD recalled that in recent years the developing countries, and in particular the major debtors among them, had undertaken strenuous adjustment efforts which "in almost every case, involved cuts in living standards and retrenchment in public and private employment." These efforts, together with the economic recovery in a number of industrialized countries, had resulted in large surpluses in the current account balance of the developing countries in 1984. This had given rise to the hope that the debt problems were being progressively brought under control. Unfortunately, the foreign exchange situation of the debtor countries had deteriorated again in 1985 as export earnings had fallen significantly, partly as a result of slower growth in the United States. This made it imperative to review the strategy adopted by the international finance community to deal with the debt crisis. For those countries with debt owed mainly to official lenders, he advocated such steps as an increase in ODA flows, multi-year reschedulings, and outright cancellation of debts in the case of the poorest debtors. For commercial debts, he felt that recent proposals regarding the creation of an international interest subsidy facility and "the establishment of a direct relationship between debt service and export earnings" were worthy of consideration.

He recognized, however, that any such new international action would bear fruit only if the developing countries continued to intensify their own efforts to achieve greater efficiency and growth in their economies by the adoption of appropriate policies. As regards the industrialized countries, he urged them to adopt concerted measures to stimulate broad-based growth and to promote world trade expansion. In connection with this latter point, he stressed the need to reverse the trends towards discrimination and managed trade, to continue the momentum towards further trade liberalization in the face of protectionist pressure, and to facilitate the more effective participation of developing countries in the multilateral trading system.

Opening the general debate on this topic, the spokesman for the Group of 77 stated that the debt crisis was attributable to "numerous external shocks inflicted upon the developing countries since 1979" including, inter alia, a sharp deterioration of the terms of trade, exceedingly high levels of interest rates, and the retrenchment of new lending, particularly by banks. The developing countries had adjusted to these external shocks at a tremendous cost, including severe import retrenchment and a dramatic social and economic decline, yet the major developed countries, he argued, had done little to redress the situation. The continuation of "restrictive monetary policies in the

United States and of restrictive fiscal policies in Western Europe and Japan" had prevented a strong recovery in economic activity in the industrialized countries, which would have been necessary to significantly strengthen markets for primary commodities. Moreover, the approach to the debt crisis adopted by the creditor countries, with the support of the international financial agencies and of the banks, had been geared towards "preventing a financial crisis rather than towards strengthening the debt servicing capacity of the developing countries." The resumption of orderly debt servicing by the developing ccountries, he concluded, required a reorientation of approach toward the inter-related problems of money, trade and finance. This implied, inter alia, that debt service payment "be restricted to an appropriate percentage of export earnings compatible with the development needs of each debtor country," that the industrialized countries adopt a new strategy aimed at lowering real interest rates and at improving market access for developing countries' exports, that the resources of the multilateral financial institutions be increased, and that IMF conditionality "which was restrictive and had encouraged an asymmetrical adjustment process" be reformed.

The representative of India deplored the fact that the development consensus of the 1960s and the early 1970s was no longer in evidence. ODA flows remained woefully short of the targets, commodity negotiations had been stalled by the obstructive tactics of the importing countries, and the process of improvement of GSP schemes by preference-giving countries had stopped. All these developments, he argued, reflected a "retreat" by the developed countries from the path of international economic cooperation. Against that background, his authorities were not enthusiastic about the developed countries' proposals regarding a new round of multinational trade negotiations. In particular, they could not accept that the primary aim of the proposed new round should be to liberalize trade in the service sectors where developed countries undoubtedly had a strong comparative advantage.

The representative of Brazil said that good use had been made by the developing countries of the funds they had borrowed in the 1970s, as attested to by the high rate of investment they had achieved during this period. The debt crisis could not be attributed to over-borrowing by developing countries but to the sudden and steep rise in international interest rates which had occurred in the late 1970s and early 1980s as a result of "the inherent contradictions between the fiscal and monetary policies of the United States." The strategy adopted by the creditor countries to deal with the debt crisis aimed predominantly, if not exclusively, at the stability of the international banking system and involved a quick reduction of its exposure to heavily indebted developing countries. Its basic ingredient was a generation of substantial trade surpluses by the developing countries at the cost of severe import restrictions and a sharp curtailment in growth rates. Such an approach was bound to generate serious social tensions and dangerous political pressures in the developing countries and was not sustainable, therefore, in the long run. Moreover, at the precise moment when developing countries were requested to service in full interest payments on their external debt, they were faced with increasing and, in part, discriminatory protectionist pressures by the creditor countries, in contradiction to these countries' past commitments regarding the granting of more favorable treatment to Third World exports. With respect to the proposed new round of multilateral trade negotiations within GATT, the developed countries expected the developing countries to pay for any concessions granted on trade in goods by making reciprocal concessions on trade of services which were not covered by the General Agreement. This implied that a new world economic order was contemplated in which developing countries' exports of traditional manufactures would be allowed greater access to developed countries' markets only if developed countries were provided with a permanent, dominant position in service sectors throughout the Third World. Such an approach was totally unacceptable to his Government.

The representative of Argentina was concerned by the continuation of protectionist actions in the developed countries in spite of international undertakings not to introduce new trade restrictions and to begin to dismantle existing ones. Among these protectionist measures he mentioned "quotas, voluntary export restraints, new systems of surveillance of import licensing and the extensive use of anti-dumping measures and countervailing duties." He also deplored the introduction of concepts of reciprocity, discrimination and graduation in the GSP schemes. In this context, he recalled that the work program agreed upon at the GATT ministerial meeting in 1982 called for a full implementation of the principles of the General Agreement and especially of the obligations contained in Part IV, regarding the granting of differential and more favorable treatment to developing countries. Turning to the debt problem, he stressed that the adjustment programs adopted by developing countries to enable them to continue servicing their external debt had reduced living standards and created an explosive social situation in many countries. While his country "had launched a frontal attack on hyper-inflation and faced the immediate future with renewed confidence," it considered that the cost of economic restructuring had to be equitably distributed among creditor and debtor countries.

The representatives of several other developing countries (Algeria, Bangladesh, Bolivia, Cuba, Ecuador, Egypt, Indonesia, Jamaica, Pakistan, Peru, the Philippines, Romania, Somalia, Senegal, Tanzania, Vietnam and Yugoslavia) intervened in the debate to support the statement by the spokesman of the Group of 77 and to draw the attention of the Board on problems of specific interest to their respective countries. The representative of Tanzania stated that the debt problems in Africa had been compounded by drought and widespread famine and called for nonconventional and innovative solutions. Such solutions, he argued, could not be found in "the IMF demand-management export-oriented adjustment programs" which had "invariably floundered because they were not tailored to the local circumstances and lacked the necessary predictable external financial flows and market access." The representative of Peru said that his Government would not "compromise its domestic policies to follow the IMF adjustment programs" which, in its view, "led to economic recession and political destabilization." While his country assumed full responsibility for its debt, it had decided to limit debt service payment to 10 percent of its total export earnings and to negotiate solutions to its problems through a direct dialogue with its creditors. The search for such solutions, he went on to say, would be greatly facilitated if debtor countries in Latin America, and more generally in the Third World, agreed that the debt problem should be treated as a political problem. In this context, his country supported actively the consensus of Cartegena and the resolution on external debt adopted at the ministerial meeting of the non-aligned countries in Luanda. The representative of Cuba reiterated the call of President Fidel Castro for an outright cancellation of the debts of the developing countries, with the share of these debts owed to private banks being reimbursed by the governments of developed countries out of the saving they would realize by substantially reducing their military expenditures.

The spokesman for Group B said that while his Group could not subscribe to the most pessimistic scenario included in the Trade and Development Report 1985, it agreed that any significant improvement of the current world economic situation crucially depended on the adoption of adequate adjustment policies in both the developed and the developing countries. For their part, the members of his Group had agreed at a recent OECD ministerial meeting on a package of measures designed to improve the convergence of their macroeconomic policies. These measures related to elements such as budget deficits, deregulation of domestic financial markets and reduction of rigidities on the supply side. As regards the trading system, he noted that trade restrictive measures remained a major problem. There was, therefore, an urgent need to initiate a new round of multilateral negotiations with a view to strengthening the multilateral trading system and to adapting it to a changing world economic environment. Turning to the debt problems of developing countries, he said that the strategy adopted by the international financial community had proved effective and "that the catalytic role of the IMF had been of crucial importance." However, the short-term measures adopted within the framework of that strategy should now be supplemented by policies designed to address the long-term aspects of the debt problems. Greater use of World Bank financing and greater reliance on foreign direct investment should constitute the two major ingredients of this new approach. Finally, as regards ODA flows, he stated that, in spite of serious internal economic problems, the members of his Group intended to pursue their efforts to maintain and, where feasible, to increase their aid to developing countries, particularly to the poorer among them.

The spokesman for the European Communities stated that his authorities fully supported the strategy adopted by the international financial community to deal with the debt crisis and, in particular, recognized the positive role played by IMF stabilization programs. He considered, however, that the adjustment efforts made by a number of developing countries could be more effectively pursued "if supported by a combination of appropriate policies at a national and international level aimed at stabilizing exchange rates, reducing interest rates, and stimulating financial flows whether these were ODA flows, bank loans, private investment or export credit." There was also an urgent need to maintain a favorable environment for the further expansion of international trade by resisting protectionist pressures and rolling back protectionist measures. In this connection, the EC considered that the preparation for a new round of trade negotiations within the framework of GATT should begin as soon as possible.

The representative of the United States said that there was evidence of a widening recovery and good prospects for sustained growth with lower inflation in the industrialized countries. In this environment, a lasting solution to the restoration of growth and credit worthiness in developing countries rested chiefly on the implementation of appropriate adjustment measures by these countries rather than on global solutions which wrongly assumed that debt problems were more or less uniform across all debtors. This had been fully recognized by the major debtors which, in recent years, had undertaken economic adjustment and had seen their efforts rewarded by a significant improvement in their growth performance. The situation, however, remained very difficult in the poorest countries where economic problems were structural in nature and required a major and comprehensive reform effort extending over a number of years. For this reason, his Government strongly encouraged the World Bank and the IMF to work closely together.

As regards creditor countries, he went on to say, they had also assumed their share of responsibility. The debt service burden had been reduced by massive debt restructuring, including several multi-year reschedulings, and sizeable new credits had been provided by governments, private banks and international institutions. Dollar interest rates had dropped sharply and economic recovery had provided opportunities for developing countries to achieve exceptional increases in their exports. Nevertheless, much remained to be done to restore fully the conditions for sustainable growth in the developing countries. While the debtor countries should pursue active policies designed to promote individual initiatives as well as export growth, it was critical that developed countries maintain open markets for developing countries' exports. This, however, would be possible only if all countries, both in the North and the South, redoubled their efforts to strengthen the multilateral trading system. In this context, his Government believed that a new round of multilateral trade negotiations "should become the major vehicle for organizing trade liberalizing forces in the battle against protectionism."

In conclusion, the U.S. representative recalled that his Government had raised a series of questions concerning UNCTAD and its method of operation in the past. His authorities were encouraged by the fact that the documentation prepared by the Secretariat was now carefully reviewed for accuracy, balance and substantive worth. The Trade and Development Report 1985, in particular, was worthy of reasoned debate and discussion and had been quoted by major world newspapers and economic journals, an indication that it was being taken seriously by a significantly enlarged audience. This showed that, in contrast to the past, the North-South dialogue was now being positively influenced by UNCTAD.

The representative of Canada said that, while he cound not support all the assumptions and conclusions of the Trade and Development Report 1985, he did not question its overall quality or its serious contribution to ongoing analyses of the world economic situation. Although he found the Secretariat assessment of that situation somewhat gloomy, he recognized that there remained serious causes for concern including the narrow base of the recovery, the uneven nature of its impact on developing countries, the maintenance of high real interest rates and the persistence of large unemployment in many countries. His authorities recognized that the solution of these problems required a better convergence of the macroeconomic policies of the industrialized countries. As to the debt problems, he argued, much had been achieved over the previous two years through the case-by-case approach, but continued vigilance in the application of this current strategy was needed to restore the creditworthiness of debtor countries and to promote growth. Among the new ideas in play, he mentioned multi-year debt rescheduling arrangements, special arrangements for low-income countries which found it hard to attract commercial lending, a stronger role for the World Bank in supporting domestic adjustment and a greater cooperation between the World Bank and the IMF. Moreover, the maintenance of a stable and open multilateral trading system was of vital importance for both debtor and creditor countries. In this context, his authorities considered that a new round of multilateral negotiations in the GATT was of utmost importance.

The representative of Finland, speaking also on behalf of Norway and Sweden, generally supported the analysis and conclusions of the Trade and Development Report 1985 and, in particular, agreed that debt problems, trade policies and capital flows were all interlinked and needed an integrated approach by developed and developing countries. He shared the policy conclusions of the Trade and Development Report 1985, which included, inter alia, a call for more effective coordination of macroeconomic policies among major industrialized countries, the maintenance of open market access in a stable and predictable trade regime, and the stabilization of commodity export earnings. In connection with this latter topic, he advocated more effective implementation of the Integrated Program for Commodities (IPC) and welcomed the fact that UNCTAD was currently studying the possible establishment of a complementary compensatory financing facility.

The representative of Japan said that while the developed countries were adversely affected by high unemployment, persistent budgetary deficits, and an overvalued dollar fuelled mainly by high interest rates, the developing countries were confronting serious difficulties such as stagnating prices for commodities and debt servicing problems. As regards the latter problem, he felt that debt relief operations should be tackled on a case-by-case basis because of the need to tailor solutions to individual countries' situations. The success of such an approach, however, depended crucially on the maintenance of open-market access for the exports of debtor countries. In this context, his Government had recently adopted the outline of an action program for improved market access which intended to facilitate the early initiation of a new multilateral trade round. Moreover, despite its financial difficulties, it had decided to increase substantially its ODA flows to developing countries in the medium-term. Subject to its financial situation, Japan expected to provide over $40 billion in ODA during the period 1986-1992 compared to an amount of approximately $18 million during the period 1981-1985.

The spokesman for Group D said that despite the current economic recovery in developed market economy countries, the situation of the developing countries had not improved. As in 1984, debt service payments from these countries had exceeded the inflow of capital. The promises made at UNCTAD VI regarding the rollback of protectionist measures were not being kept by the capitalist countries which instead had introduced new protectionist and discriminatory measures against the exports of the developing countries and of the socialist countries.

Attempts were also made "to achieve political ends by completely unjustified practice of economic blackmail" such as the recent U.S. trade embargo against Nicaragua. A comprehensive settlement of current world economic problems, he argued, depended crucially on the willingness and ability of the United States to lower interest rates through a reduction of its budget deficit. However, the "U.S. policy of extending the arms race into outer space with all its budgetary consequences," he added, held out little hope in that respect. In conclusion, he called for the active participation of UNCTAD in the preparations for the International Conference on the Relationship Between Disarmament and Development scheduled to be held next year in Paris.

The representative of the U.S.S.R. regretted that the Trade and Development Report 1985 missed a very important feature of current economic development, namely, "the role of the military industrial complex in the economy of the West and the impact of military expenditure on development." The "unprecedented increase of military expenditure by some Western countries," he argued, had been the major cause of the 1980/1982 world economic crisis, "the most destructive in the post-war period." He suggested that UNCTAD should regularly review the link between disarmament and development and should, in particular, actively participate in the preparation of the proposed International Conference on the Relationship Between Disarmament and Development. Turning to the debt crisis of developing countries, he stressed that this crisis "was entirely an outcome of the relations between developing and developed market economic countries and should be solved among these countries on the basis of a radical reconstruction of international economic relations on a just and democratic basis." All recipes for relief of the debt crisis which disregarded that reality, he concluded, were "merely serving the purpose of plundering the developing countries." The representatives of Czechoslovakia and Poland supported the views expressed by the U.S.S.R. representative.

The representative of China regretted that two basic principles of the post-war trading system--nondiscrimination and most favored nation treatment--had been seriously undermined and distorted. In this connection he expressed deep concern that textile and garment exports from developing countries met "with extremely unfair and discriminatory treatment." As regards the debt crisis, he said that although it had been somewhat alleviated for the time being, the problem was still far away from an effective solution. Such a solution depended crucially on the adoption of measures by the developed countries including a substantial increase in ODA flows to the developing countries, and in particular to the poorest among them. Finally, he stated that, in view of the sharp fall of commodity prices in recent years, the IPC should be urgently implemented and, in particular, those countries which had not yet ratified the Agreement establishing the Common Fund should do so as soon as possible so as to bring about an early initiation of the Fund's operations.

The Fund observer made a statement, which is attached.

4. Other issues

The discussions on trade relations among countries having different economic and social systems revealed the existence of sharp divergencies of views among the participants with respect to the mandate of the UNCTAD Secretariat, the contents of the background documentation it had prepared for the consideration of the Board, and its future program of work. While the spokesman for Group D argued that all aspects of international trade, including East-West and East-South, were of interest to UNCTAD members and should, therefore, be studied by the Secretariat, the spokesman for Group B deplored the fact that the Secretariat wasted scarce resources to review East-West trade issues which could be better dealt with in other UN fora. In this connection, he expressed deep concern about the fact that, in spite of the objections of the Japanese Government, the Secretariat had issued a study prepared by a consultant on Japan's economic relations with the U.S.S.R. and other socialist countries of Eastern Europe. 1/ As regards the main document prepared by the Secretariat, 2/ he regretted the tendency to ascribe to market economy countries patterns of trade and debt in Eastern European countries, thereby minimizing the responsibility of the latter countries. He felt that no decision could be made regarding an expansion of the Secretariat's work program until the current weaknesses in the Secretariat documents had been corrected.

For his part, the spokesman for the Group of 77 requested the socialist countries of Eastern Europe to give due consideration to the trade interests of developing countries. After a protracted discussion, a consensus emerged on a compromise resolution which, inter alia, requested the UNCTAD Secretary General to prepare background studies on a number of specific issues related to trade among countries having different economic and social systems and to convene an ad hoc group to consider ways and means for expanding the volume of such trade. 3/

1/ UNCTAD/ST/TSC/2.
2/ TD/B/1063 and Add.1.
3/ TD/B/L.784.

As regards protectionism and structural adjustment, the spokesmen for the various groups reiterated the views they had expressed on this topic at the thirtieth session of the Board. A document prepared by the Secretariat on services in the development process 1/ was also briefly discussed, and the Board further decided to make an in-depth analysis of current developments in the world trading system at its thirty-third session, which is scheduled to be held in September 1986. 2/

The Board also adopted a resolution regarding the specific needs of land-locked developing countries. 3/

Finally, it took note that the Cuban delegation had reiterated its offer to host UNCTAD VII and decided to revert to the question of the place, date and duration of that session of the Conference at its thirty-second session scheduled to be held in April 1986. 4/

1/ TD/B/1066.
2/ TD/B(XXXI)/SC.I/L.3.
3/ TD/B(XXXI)/SC.I/L.2.
4/ TD/B/L.783.

Statement by the Fund Observer at the Thirty-First Session of the UNCTAD Trade and Development Board

Mr. Chairman:

I would like to express my appreciation for the excellent work made by the Secretariat in preparing the 1985 Trade and Development Report. This report gives a comprehensive and balanced picture of current and prospective developments in the world economy and deserves careful consideration. To assist the Board in this task, I would like to give it some current information on the economic outlook of the developing countries both in the short and medium term.

1. Short-term projects

The adjustment measures adopted by the developing countries to deal with the debt crisis began to pay off in 1984 as they enabled these countries to reap the benefits of the strong economic recovery then underway in the United States and some other industrialized countries. Growth for the developing countries as a group reached 4½ percent in 1984, compared with barely 1½ percent in 1982-83. Much of the improvement reflected an 8½ percent export volume growth which, in turn, was attributable to the resurgence of activity and imports in the industrial countries as well as to the adjustment measures being undertaken by the developing countries themselves. This surge of exports allowed the developing countries to reduce further their current account deficit while expanding their imports by 2 percent. The current account deficit for 1984 is now estimated by the Fund staff at US$42 billion, equivalent to 6¼ percent of exports of goods and services for the group, less than half its level in the peak year 1982.

This relatively strong performance has deteriorated somewhat in the first half of 1985. On the basis of developments during this period, the growth rate of developing countries as a group is now projected at 3½ percent for 1985, a one percentage point decline in relation to the previous year. The current account deficit is expected to remain stable at about its 1984 level but this picture of a stable deficit is the by-product of gross flows that give rise to somewhat more concern. Export growth is now expected to slow from 8½ percent in 1984 to 1½ percent in 1985 as a result of the slowing of the recovery in industrial countries. Moreover, this weakness of export volumes has been accompanied by a further weakening of commodity prices. As a result, the terms of trade of developing countries are now projected to deteriorate by 2 percent in 1985. Given the prevailing inability or unwillingness of these countries to increase external borrowing, the drains on real purchasing power of developing country export earnings have resulted in a scaling back of projected import growth. For the group as a whole, import volumes are now projected to increase by 1 percent instead of a 4½ percent growth projected by the staff at the beginning of the year and of an actual 2 percent increase in 1984.

This disappointing overall picture, however, conceals substantial differences in the behavior of the various groups of developing countries.

The countries most affected by recent developments have been the fuel-exporting countries whose export earnings are expected to decline by more than 9 percent in 1985 (and the achievement of even this outcome is based on the assumption that oil prices do not fall below the levels prevailing at end-July). Accordingly, fuel-exporting countries have been obliged to continue the downward adjustment of their imports which, in volume terms, are now expected to decline by 7 percent in 1985. As a result of these adverse developments in the external account, GDP in fuel-exporting countries is projected to increase by only 1 percent in 1985 as against 2 percent in 1984.

Another group of developing countries adversely affected by current changes in the world economy is the commodity exporters which have suffered from the decline in commodity prices. The weakness of export receipts in these countries has directly affected domestic incomes, which in turn has hindered the growth of domestic demand and output. The rise in real GDP for this group, therefore, is now expected to decelerate from 3½ percent in 1984 to 2¾ percent in 1985.

By contrast, the group of developing countries which export manufactures is expected to suffer only a marginal reduction in its rate of growth from 8½ percent in 1984 to 7½ percent in 1985. The growth disparities between exporters of commodities and exporters of manufactures obviously can be explained to a large extent by the weak outlook for commodity prices: whereas the terms of trade of the commodity exporters are projected to deteriorate by 3½ percent in 1985, exporters of manufactures are projected to face only a 1 percent deterioration in their terms of trade. Domestic factors, however, also account for some of the recent and projected divergencies in growth rates. Many countries among the exporters of manufactures have already undertaken substantial and successful adjustments and as a result, can now support some increases in domestic spending. On the other hand, several commodity exporting countries with high inflation are still at a much earlier stage in the process of restoring domestic financial stability. The needed adjustments require a shift in the composition of output and demand which has the natural effect of lowering growth.

2. Medium-term scenarios

Given the relatively disappointing economic performance of the developing countries in the first half of 1985, the question arises whether the medium-term scenarios presented by the staff in the March issue of the World Economic Outlook are still valid. The fact is that if the March scenarios are adjusted in the light of developments in the world economy since that date the medium-term projections are very little changed. This is because slippages from earlier projections for 1985 seem to be of a temporary nature and, therefore, the projected figures for 1986 which serve as a basis for the scenarios are much as before. Moreover, prospective policies, both in industrial countries and in developing countries are similar to how they appeared six months ago. Thus the staff continues to believe that, given the assumptions on which the baseline scenario is developed, it should be possible for capital-importing developing countries to grow at a rate of $4\frac{1}{2}$-5 percent during 1987-88, while bringing about a reduction of one-fourth to one-third in their external debt ratio.

It must be recognized, however, that even though the baseline projection has not changed much, the medium-term outlook has been rendered more uncertain than previously by recent changes in the world economy. While some of these new uncertainties imply the possibility of a more favorable outcome than was present in March, they have also increased the "downside risks," i.e. the likelihood of less favorable outcomes. Although these "downside risks" do not call for any change in basic policy stance, they underline the need for dealing firmly with the imbalances that lie behind them. This will require further efforts on the part of both the industrial and developing countries.

3. Policy requirements

The industrial countries' economic strategy for the past several years has had notable succcesses. There has been a marked reduction in inflation, output growth has picked up, and employment has begun to recover. However, a number of serious economic imbalances remain. In the United States, the Federal fiscal deficit will be in excess of 5 percent of GNP in 1985, while the deficit in the current account of the balance of payments will be over 3 percent of GNP. Elsewhere, and especially in Japan, the growth of output continues to be heavily dependent on foreign demand; and in many industrial countries, including most of those in Europe, structural rigidities have impeded employment creation and slowed recovery. The correction of these imbalances require that effective action be taken to curb the fiscal deficit in the United States and improve the quality of the fiscal and monetary policy mix in other countries in accordance with the conditions prevailing in these countries.

Beyond these requirements for suitably differentiated financial policies, there is a continuing need to implement supply-side policies that enhance the structural function of industrial countries. These policies include: reduction of distortions created by the impact of government regulations on price determination in private markets; reform of wage-setting procedures that prevent the adjustment of real wages in line with changes in the marginal product of labor; the modification of minimum wages that limit incentives to hire unskilled workers or new entrants to the labor force; the reduction of subsidies or other mechanisms for preserving uneconomic industries; action by governments to enhance the ability of workers to move between industries and geographical locations; and firm resistance to protectionist pressures, which can only benefit one group of the population at the expense of others.

In present circumstances, it is appropriate to give special emphasis to this last point. While protectionism is not confined to the industrial countries, it is of central concern in these countries because of the threat it poses to the fabric of international collaboration and to the satisfactory resolution of the international debt situation. Protectionist sentiments are exacerbated by weakness of economic activity and by imbalances in international trade. These trade imbalances give rise to shifts in employment and industrial structure that are perceived, generally erroneously, to be caused by "unfair" trade practices or inadequate "reciprocity" in trade. In dealing with protectionist sentiment, governments in industrial countries should not only resist demands for trade-distorting restrictions but also focus on actions that will help reduce the factors that give rise to such demands in the first place.

In regard to the developing countries facing debt servicing difficulties, they will have to continue to implement adjustment. Over the past three years, they have succeeded in reducing their combined current account deficit, relative to exports of goods and services, to a level that is financeable out of flows of grants, long-term official assistance, direct investment, and import-related commercial financing. Less has been achieved, however, in bringing about the internal adjustments that are needed if domestic growth is to be accelerated without the external situation deteriorating dangerously and without impeding efforts to reach a better degree of price stability.

While the policies designed to reduce the rate of growth of monetary aggregates will have to be continued and in many cases strengthened in view of the high inflation rates still prevailing in developing countries, they should be increasingly supplemented by more forceful policies on the supply side. These latter policies should have the main focus of raising the rate of growth of foreign exchange earnings and increasing the growth of domestic output that can be achieved with a given level of foreign exchange earnings. Examples of the first type of policy include ensuring that the exchange rate is at a level that provides adequate incentives for the establishment and growth of export industries; adapting the tax structure to remove unintended fiscal impediments in export activities, and providing "start-up" assistance in developing foreign markets for nontraditional exports in which the country has a potential comparative advantage. Examples of the second include measures to raise the output of domestically consumed tradable goods through pricing reforms and a more efficient allocation of public investment expenditures.

Such an "outward-looking" strategy is of crucial importance not only to encourage greater investment efficiency but also to bring about a rise in aggregate savings and investment which are fundamental to any long-term increase in the rate of economic growth. Nonetheless, there are limits to the use of such a strategy: for instance, expansion of output of certain primary products (especially if undertaken by a group of producing countries simultaneously) could have negative revenue effects. Furthermore, export prospects for some types of manufactured and agricultural products may be limited by protectionist measures in importing countries.

This shows that the success of adjustment programs in the developing countries does not depend only on the efforts of those countries but also on the contribution of the industrial countries. Obviously, the most valuable contribution that these countries could make to the adjustment process in the Third World would be to bring about a more steady noninflationary growth in their economies while maintaining an open multilateral trading system. Another important step would be for the governments and banks of the industrial countries to continue to provide restructuring and new money on realistic terms to debtor countries implementing adjustment policies and to handle debt restructuring in a longer-term context for those countries where economic performance is on track.

Finally, it should be recognized that the greater part of the financing requirements of development countries should appropriately be covered by direct investment flows--which do not give rise to debt--and by official long-term concessional financing. This implies that developing countries should do more to attract foreign capital as direct investment. It also underlines the need for industrial countries to continue to make their best effort to expand official development assistance flows to developing countries, particularly to low-income countries facing high debt servicing burdens. Although much of the latter countries' existing debt bears concessional interest rates, they have not benefitted from recent interest rate declines to nearly the same extent as countries that borrow predominantly from private sources. The debt service ratio in Africa, for example, is projected to rise from $26\frac{1}{2}$ percent in 1984 to $32\frac{1}{4}$ percent in 1985, the largest increase in any region. Obviously, low-income countries will require substantial continuing flows of concessional foreign assistance if they are to overcome the structural obstacles to growth that they face.