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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/53

10:00 a.m., April 3, 1985

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

Executive Directors	Alternate Executive Directors
	L. K. Doe, Temporary
C. H. Dallara	M. K. Bush
J. de Groote	H. G. Schneider
B. de Maulde	X. Blandin
M. Finaish	T. Alhaimus
H. Fujino	M. Sugita
G. Grosche	
J. E. Ismael	Jaafar A.
R. K. Joyce	L. Leonard
A. Kafka	
H. Lundstrom	H. Fugmann
E. I. M. Mtei	
	B. Jensen
Y. A. Nimatallah	J. E. Suraisry
P. Pérez	G. Ortiz
J. J. Polak	J. de Beaufort Wijnholds
	A. V. Romuâldez
G. Salehkhou	O. Kabbaj
A. K. Sengupta	A. S. Jayawardena
	T. A. Clark
S. Zecchini	N. Coumbis
	Wang E.

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

Also Present

African Department: C. V. Callender. Asian Department: P. R. Narvekar, Deputy Director; U. Baumgartner. European Department: L. A. Whittome, Counsellor and Director; J. K. Salop. Exchange and Trade Relations Department: M. Guitián, Deputy Director; M. R. Kelly, C. M. Watson. External Relations Department: N. K. Humphreys, P. J. Bradley. Fiscal Affairs Department: M. I. Blejer, A. Feltenstein. IMF Institute: O. B. Makalou. Legal Department: G. P. Nicoletopoulos, Director. Middle Eastern Department: J. C. Borpujari, S. von Post. Research Department: W. C. Hood, Economic Counsellor and Director; A. D. Crockett, Deputy Director; R. R. Rhomberg, Deputy Director; C. P. Blackwell, M. E. Bond, J. M. Boughton, M. C. Deppler, O. E. G. Johnson, M. D. Knight, A. Lanyi, P. J. Mathieson, T. K. Morrison, M. C. Williamson. Western Hemisphere Department: S. T. Beza, Associate Director; E. Hernández-Catá. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: A. A. Agah, G. R. Castellanos, J. Hospedales, G. E. L. Nguyen, J.-C. Obame, G. W. K. Pickering, M. Z. M. Qureshi, T. Sirivedhin, A. Steinberg, E. M. Taha, D. C. Templeman, A. Vasudevan. Assistants to Executive Directors: E. M. Ainley, H. Alaoui-Abdallaoui, W.-R. Bengs, G. Biron, Chen J., G. Ercel, V. Govindarajan, N. Haque, G. D. Hodgson, Z. b. Ismail, J. M. Jones, A. K. Juusela, H. Kobayashi, M. Lundsager, R. Msadek, K. Murakami, A. Mustafa, E. Olsen, J. Reddy, D. J. Robinson, J. E. Rodríguez, A. A. Scholten, A. J. Tregilgas, A. H. van Ee, E. L. Walker, B. D. White.

1. WORLD ECONOMIC OUTLOOK

The Executive Directors continued from the previous meeting (EBM/85/52, 4/1/85) their consideration of staff papers on prospects and issues for the world economy to 1990 (EBS/85/47, 3/11/85; and Cor. 1, 3/22/85), the current situation and short-term prospects (EBS/85/48, 3/11/85), and medium-term scenarios (EBS/85/49, 3/11/85). They also had before them a statistical appendix (EBS/85/50, 3/11/85; Cor. 1, 3/22/85; and Cor. 2, 3/29/85), together with 11 supplementary notes (SM/85/70 through SM/85/80, 3/11/85).

The Economic Counsellor said that he agreed with Mr. Sengupta that the success of a member country's adjustment effort was not reflected solely in the performance of the external current account. In assessing member countries' progress in making needed adjustments, the staff had consistently drawn attention to aspects of economic performance in addition to the current account. The staff recognized that, in a number of cases, a phase of import compression might well be inevitable in the early stages of adjustment. The staff also recognized that the resources for debt servicing must come partly from exports, and that if a country's debt had been growing more rapidly than the country's capacity to service it, the authorities must realign various items in the balance of payments, particularly those in the current account. However, that process could not be considered complete while economic growth remained slower than was warranted by the country's resources and productivity, as reflected--although not in a mechanical way--in its record of growth over the years. The staff had taken great pains to give economic growth a prominent place in the scenarios for developing debtor countries.

The staff also agreed with Mr. Pérez that import compression affected a country's ability to resume or sustain growth while making needed adjustments, the Economic Counsellor continued. The Fund's policies, practices, and objectives were based on the belief that trade and growth were mutually supportive. A member country that had an unsustainable level of capital imports and faced a possible reduction in those imports, a substantial capital outflow, or both, might have to experience some deceleration in the rate of growth of imports vital to domestic production. Ideally, of course, member countries should attempt to prevent the need for adjustment from arising and should try to smooth its effects when adjustment became inevitable. In any event, growth overall had been maintained remarkably well during the previous two or three years, even though a number of countries had experienced the adverse effects of import compression.

A question had been raised whether the staff could not provide scenarios for the near term as well as the medium term, the Economic Counsellor recalled. The effects of policy changes usually did not become evident until a year or two after the changes had been made. Accordingly, alternative scenarios based on policy shifts usually dealt with the medium term rather than the near term. In its short-term analysis, the staff took into account the effects of existing policies and of new policies in the process of being formulated or implemented. A sudden drop in the external value of the dollar was an example of an important development that could occur in the short run as a result of a shift in policy or expectations. The staff believed that forecasts of near-term changes in market variables, such as exchange rates, must be approached with great caution and should not be published.

He agreed with Mr. Polak that it would be useful to pay greater attention to business cycles in the staff scenarios and that the cycles could result from the normal working of economic forces as well as from inappropriate policies, the Economic Counsellor went on. Accordingly, there could be no guarantee that, even if an appropriate set of policies were maintained, a downturn in the business cycle could be avoided. The staff believed that near-term forecasts of changes in variables should reflect any shift in the phase of the business cycle. The staff would wish to give further thought to how the business cycle could be reflected more fully in its medium-term scenarios. The staff had described the technical aspects of preparing its medium-term scenarios in a paper prepared for the previous World Economic Outlook exercise. The techniques often changed with the benefit of experience, and the staff would keep Executive Directors informed of any changes.

Mr. Zecchini's question on the impact of differential growth rates and the strong dollar on the U.S. external accounts was hard to answer, partly because the differential growth rates and strong dollar were attributable to some of the same factors; moreover, it was difficult to distinguish the separate effects on the external accounts of the growth rates and the exchange rate, the Economic Counsellor said. The staff suspected that the external current account had adjusted to the capital inflow and that the exchange rate had had to move in order to bring the current account in line with the developments in the capital account. The staff had estimated that roughly one fourth of the increase in the U.S. current account deficit in the recent past had been due to the adjustment efforts of developing countries, and that the rest of the increase had been due to roughly an equal extent to the differential growth rates in the industrial world and the strength of the dollar. The effects of those variables on the U.S. current account were still being felt, although the effect of the differential growth rates had probably been more fully played out than the effect of the exchange rate.

The staff felt that there was considerable scope in the larger developing economies, such as those of India and China, as well as in the smaller developing countries, to maintain outward-looking policies, the Economic Counsellor concluded. The Chinese authorities were making a determined effort to modernize the economy and apparently believed that contacts with the rest of the world would play an important role in achieving that objective.

The Deputy Director of the Research Department recalled that the question had been raised whether the recent recovery in investment in the industrial countries had appeared strong because the performance in earlier months had been particularly weak. In fact, the decline in investment during the 1980-82 recession had been less steep than the decline in the previous recession, in 1974-75; the expansion in investment since 1982 had been substantial and significant in its own right. Mr. Clark had suggested that the recent strong export performance might imply that interest rates played a smaller role in investment performance than had been assumed. In fact, however, a number of factors had tended to support investment during the recent recovery in industrial countries. In the United States, where investment growth had been particularly strong, the authorities had introduced fiscal incentives. Investment in other countries had apparently benefited from the increase in confidence and the stability in the overall financial climate.

The staff had provided less information on the components and behavior of demand in developing countries than in industrial countries mainly because of the noncomparability of the data on developing countries, the Deputy Director explained. In the present papers, the staff had attempted to move in the direction that Mr. Pérez had suggested by providing, for the first time, data on investment in the developing countries as well as qualitative indications on savings and the real net foreign balance in those countries. The staff would continue to assess the data problems and wherever possible make further progress in analyzing the components of aggregate demand in the developing countries.

The staff tried to take into account the feedback effects of trends in developing countries on industrial countries, the Deputy Director said. However, scope for feedback effects was relatively limited, as exports by the industrial countries to the non-oil developing countries constituted only about 2.5 percent of the industrial countries' GDP.

The ratios of external debt to exports and GDP in developing countries shown in Table 48 in EBS/85/50 covered the short term, the Deputy Director noted. The staff had not attempted to make similar calculations for the medium term, mainly because of the conversion difficulties in so doing; the Fund's trade statistics were denominated in dollars, but trade data in member countries were usually in local currency. The difficulties were probably not insurmountable, and the staff would make every effort to respond to Mr. Finaish's proposal to include debt ratios in the medium-term projections.

A question had been raised whether a cut in the U.S. budget deficit might not be essentially offset by a decline in U.S. private savings and therefore have relatively little impact on financial conditions, the Deputy Director recalled. The available evidence suggested that a cut in the budget deficit would affect private savings, but not to the extent implied in the question.

The budget recently introduced by the U.K. authorities was more or less in line with the fiscal policy announced by the Chancellor of the Exchequer in November 1984, which was already reflected in the staff projections, the Deputy Director said. Accordingly, the staff had seen no need to change its projections for either the U.K. fiscal deficit or its implications for growth of the U.K. economy.

One speaker had raised the question of the effect of the U.S. balance of payments deficit on economic growth in the rest of the world, the Deputy Director recalled. The increase in the U.S. balance of payments deficit in absolute terms over the previous three years had amounted to approximately 1.5 percent of the rest of the world's GNP. Assuming that the U.S. deficit had a multiplier effect of two on the rest of the world's GNP, it seemed likely that the deficit had contributed 1 percentage point each year to the growth of GNP outside the United States. The danger with that sort of calculation was that it did not take into account factors that might have given rise to the U.S. balance of payments deficit. In Supplementary Note 7 (SM/85/76), the staff had described the various policies that might have caused the deficit and the consequences of the implementation of those policies. It was difficult to gauge the impact on growth in the rest of the world of the U.S. balance of payments deficit without making specific assumptions about the kinds of policies that had led to the deficit.

Member countries where services and remittances were relatively important items in the balance of payments included the Caribbean countries that had large tourist sectors and the Middle Eastern countries that relied on workers' remittances, the Deputy Director noted. The staff was examining the accounts for those countries to determine whether they warranted a separate country classification.

The staff had noted that the relationship between the debt and exports of goods and services projected for 1990 would be roughly equivalent to that of 1980, the Deputy Director remarked. The staff had chosen 1980 as the comparator year because it had been then that the trend in the debt ratio following the second oil crisis had reached its trough. The ratio of debt to exports of goods and services was projected to be 108 percent in 1990, compared with 95 percent in 1974/75 and 130 percent in 1972, the earliest year for which the relevant data were available.

It was difficult to predict when the living standards enjoyed by many countries before the oil crises would be restored, the Deputy Director of the Research Department said. There were significant differences among countries; for example, several important developing countries had experienced increases in their standard of living in recent years, while others had registered sharp declines. In addition, the concept of the standard of living was not clearly reflected in straightforward economic criteria for which data were readily available. On average, for all developing countries as a group, per capita GNP in 1985 was expected to exceed the previous peak of 1980-81. For the nonfuel exporting developing countries as a group, per capita GNP in 1984 had exceeded the previous peak for all developing countries on average. However, the need to correct large balance of payments deficits and to compensate for the substantial deterioration in the terms of trade had meant that domestic absorption had grown considerably less rapidly than domestic output since 1981. The previous peak in domestic absorption would not be attained until 1987 or 1988 on average for all developing countries; there were of course significant differences among those countries.

Mr. Kafka considered that the staff should make every effort to provide data on overt unemployment in developing countries and on the rate at which the unemployment could be reduced over coming years. Collecting the necessary data was admittedly difficult, but unemployment was an increasingly serious problem in many developing countries, particularly the newly industrializing countries.

Mr. Salehkhou invited the staff to comment on the effectiveness of previous World Economic Outlook exercises.

The Economic Counsellor responded that the staff was continually evaluating its work on previous World Economic Outlook exercises. Using statistics made available to it monthly, the staff kept track of developments in the areas covered by its forecasts, which, to a considerable extent, were based on information gathered from country desk officers in the Fund. In addition, the staff paid close attention to comparable forecasting efforts by other international organizations in order to determine possible improvements in the Fund's exercise, although no other institution was able to draw on as large a body of information. A significant element of judgment was involved in assessing the productivity of the World Economic Outlook exercise. It was not particularly useful to base that assessment on the accuracy of forecasts seen in retrospect. A better criterion was the reasonableness of the forecasts in the light of the information available when they were made. Although that kind of assessment was sensible, it was difficult to make in practice.

Mr. Sengupta asked whether the staff forecasts reflected cyclical developments in the relevant data.

The Economic Counsellor commented that the course of the business cycle was reflected more fully in the annual data for the near term than in the annual data for the medium term. Explicit reference to an adverse movement in the business cycle in the medium term had been limited to the "worst-policies" scenario. Mr. Polak had usefully suggested that the staff should bear in mind that adverse movements in the business cycle could occur for reasons in addition to inappropriate policies.

The Deputy Director of the Research Department remarked that the staff had considered whether it should include a normal business cycle in the baseline scenario. The staff's calculations had shown that including an average business cycle, which excluded the two most recent cycles, those in 1974-75 and 1980-82, would not significantly affect the main variables--average growth rates, debt ratios, and current account deficits--for 1990, the end of the medium-term scenario period. The staff had judged that including a normal business cycle would not cause the projections to show an unfinanceable external deficit for the developing countries as a group in 1990. Including an average business cycle would have caused some fluctuations in interest rates and the relative overall positions among member countries. The staff felt that, for the sake of a clear presentation in the World Economic Outlook papers, cyclical fluctuations should be taken into account only if they significantly affected the outcome at the end of the medium-term scenario period. Such an outcome would have been evident in the worst-policies scenario but not in the other scenarios. Excluding the cycles of 1974-75 and 1980-82, the cycle of the industrial countries as a group was relatively shallow. If it were assumed that the cycles of 1974-75 and 1980-82 had been caused by events that were unlikely to recur, there was no reason to build a substantial business cycle into a medium-term forecast.

The Chairman inquired whether the staff forecasts of the stock ratios--for example, the ratios of debt to GDP and exports--for the medium-term scenario period would have been significantly different if the staff had made a precise forecast of the business cycle over that period.

The Deputy Director of the Research Department replied that the answer to that question was in the negative, provided that it was assumed that 1990 would not mark the up or down phase of the business cycle. If the staff projections included a business cycle that began in 1986 and had fully run its course by 1990, the interior effects of that fluctuation would not be significant.

The Chairman commented that the staff forecasts did not exclude the effects of a normal business cycle. At the same time, the baseline scenario clearly did not include an unusual business cycle similar to the actual two previous cycles.

Mr. Polak said that he agreed with the staff that it probably would not be useful to build a hypothetical business cycle into the forecasts, especially as it would introduce considerable uncertainty about the forecasts. However, there were risks in assuming that future developments could be safely predicted merely on the basis of a straight extrapolation of recent and current developments. The main risk was that the Fund would become complacent: it might fail to make the necessary preparations to respond adequately to a serious decline in the business cycle, in which event the demand for Fund resources might considerably exceed the demand based on forecasts that were merely an extrapolation of current trends.

The Chairman remarked that it was always advantageous for the Fund to maintain flexibility in applying its various policy tools in order to be able to cope with unexpectedly difficult situations. The medium-term scenarios were not meant to encourage a complacent attitude.

Mr. Salehkhou said that he continued to attach considerable importance to the World Economic Outlook exercise, and he was pleased that the staff periodically reviewed the data provided in earlier World Economic Outlook papers. It might be helpful to have the staff share--on a quarterly or some other regular basis--the findings of those reviews with the Executive Board. In addition, the staff should always be alert to possible ways of improving its forecasting techniques. Forecasting was of course inherently difficult, but it was useful to consider why a particularly inaccurate forecast had been made. It might also be useful to compare Fund forecasts with forecasts by other institutions.

The Economic Counsellor commented that the OECD's forecasting exercise was broadly similar to the Fund's, and the Fund staff kept in close touch with the OECD staff and attended meetings of OECD working parties and forecasting experts. Fund forecasts for the industrial countries rarely differed significantly from OECD forecasts. The staff could inform the Executive Board when actual developments deviated significantly from the staff's forecasts.

The staff, like Mr. Kafka, was concerned about the lack of data on unemployment in developing countries, the Economic Counsellor said. Most developing countries lacked sufficient data to enable the staff to report to the Executive Board on unemployment in those countries. Considerable efforts had been made to provide data on unemployment in industrial countries, but even those data had to be approached with caution.

Mr. Dallara remarked that in negotiating many stand-by arrangements the staff was forced to make difficult estimates of unemployment in member countries. The staff need not make the collection of data on unemployment a leading priority, but additional technical assistance by resident representatives or staff members from headquarters could help developing countries to collect such data, thereby enabling the Fund to gain a better understanding of the effects of its programs and of basic trends in the world economy.

The World Economic Outlook papers could usefully include a fuller discussion of the analytical framework on which the staff's conclusions were based, Mr. Dallara considered. For some time, his authorities had stressed that resolving the differences of view between them and the staff on the analytical framework would help to improve the effectiveness of surveillance. For example, his authorities believed that the level of investment in the United States and many other industrial countries was determined largely by the return on capital, rather than by nominal or real interest rates in the financial markets. In its discussion on investment in industrial countries, the staff could usefully say briefly how its analysis hinged on certain assumptions regarding the relationship between interest rates and investment.

The Economic Counsellor remarked that the staff had noted that changes in U.S. tax laws had played a significant role in the strengthening of capital investment in the United States during the previous two years.

The staff representative from the Western Hemisphere Department added that the staff had concluded during the 1984 Article IV consultation with the United States that the large decline in the cost of capital in that country had also played an important role in the rapid recovery of investment.

Mr. Dallara noted that the particular method of analysis of developments in the U.S. economy significantly influenced the conclusions about the thrust of policy in the United States. There seemed to be some uncertainty about the relationship in the United States between interest rates, the budget deficit, and the external current account. A further discussion in the staff papers on the staff's analytical framework would be helpful.

The Chairman remarked that it would certainly be useful for both the staff and the U.S. authorities to gain a better understanding of their analysis of the relationship between the U.S. fiscal deficit, interest rates in the United States, the U.S. balance of payments, and exchange rate developments. The staff could usefully comment further on the analytical framework within which it had reached conclusions about those relationships.

Mr. de Groote said that he supported Mr. Dallara's request for further discussion on the staff's analytical framework. In addition, it might be helpful to use the present occasion to assess the staff's conclusions on the relationship in the United States between the fiscal deficit, interest rates, the balance of payments, and exchange rate developments. For instance, he agreed with Mr. Dallara that the strong recovery of investment in the United States had probably been due to the increase in the real return on capital, which in turn had been significantly affected by tax legislation designed to provide advantages to investors. However, the additional conclusions that he himself had drawn differed markedly from Mr. Dallara's. For instance, he himself felt that since additional fiscal incentives would increase the fiscal deficit and were therefore unlikely to be adopted, the existing fiscal deficit was likely to continue to create an upward pressure on interest rates that had already been intensified by the widespread inflationary expectations in the United States. The present high level of interest rates was due to the link between the size of the budget deficit and the perceived risks of inflation. The high interest rates were in effect supported by certain institutional developments, particularly the deregulation of the banking sector and the need for the nonbank financing sector to maintain deposits. As a result, interest rates might be becoming sufficiently high to discourage investment, and it was in that connection that Mr. Polak had usefully stressed the advisability of analyzing the business cycle. Indeed, a classical analysis of current conditions suggested that a business cycle downturn in the United States would occur in 1986 or 1987. The differences of view between the staff and Mr. Dallara were based on different analytical interpretations of the effects of certain facts, rather than on a dispute about the facts themselves.

The Chairman commented that there seemed to be different views on the impact of the U.S. fiscal deficit. External savings had helped the U.S. authorities to cover the fiscal deficit and had certainly moderated the interest rate effect of the deficit in global terms. At the same time, the deficit affected expectations in the financial markets. Hence, the staff had reason to believe that the large U.S. fiscal deficit affected interest rates and the allocation of resources between productive investment and consumption.

Mr. Sengupta noted that Supplementary Note 7 contained a number of simulations showing the likely effects on the fiscal deficit of specific changes in expenditure and revenue. The staff analysis was based on the apparently universally accepted fact that there was a relationship between the real rate of return in the United States and the amount of investment in that country. In his view, one of the main conclusions to be drawn from the staff analysis was that, because of the efforts by the U.S. authorities to avoid crowding out the private sector, the rest of the world was financing the large U.S. budget deficit; that development had affected exchange rates. The external current account deficit was permitting the United States to maintain a large fiscal deficit and to contain domestic inflation. The staff had concluded that "perhaps the most important exchange rate effect of fiscal restraint would be to reduce the likelihood of a sudden crisis of confidence in the value of the U.S. dollar on balance, because current differentials of real interest rates suggest that the U.S. dollar may well be above the level that would be sustainable. In the longer run, the main effect of a fiscal reduction program would likely be to accelerate the reduction of the real exchange rate to the longer-term sustainable level." The developments in the U.S. economy described by the staff would have important consequences for the rest of the world.

The staff representative from the Western Hemisphere Department commented that, in preparing World Economic Outlook forecasts, the Research Department collected data from individual country desks throughout the Fund. Accordingly, the forecasts were a product of both the judgments and analytical methods of individual desk officers and the Research Department. It would be impossible to reflect fully in the papers all the judgments and methodologies used without making the papers considerably longer than they already were. However, the staff had fully explained its analysis of the relationship between the U.S. fiscal position and investment and interest rates in the United States in World Economic Outlook Supplementary Note 7 and in Appendix XI to the latest staff report on recent economic developments in the United States.

Investment in the United States during the recent recovery had been remarkably vigorous, the staff representative continued. The argument by some that the recent recovery of the U.S. economy had resulted from a Keynesian fiscal stimulus was inconsistent with the fact that the recovery of investment had been particularly strong while the recovery of consumption had not been. That particular pattern had occurred partly because the weakening of the U.S. fiscal position in recent years had reflected in part a significant reduction in the effective corporate tax rate stemming from a liberalization of depreciation allowances. The tax changes had significantly affected the real user cost of capital in the United States in 1980-82 and, in turn, the performance of investment. However, the effect on investment of the tax measures was expected to be temporary: as the cost of capital declined in response to the tax measures, the stock of capital in the United States would be adjusted; the adjustment would take place within a limited period, not an indefinite one. Hence, the vigorous investment performance could be expected to taper off. Indeed, investment in the United States had slowed considerably from the very high rates in 1983 and early 1984.

It was important to note another factor underlying the strength of capital formation in the United States over the past several years, the staff representative said. Investment in high technology had been persistently strong even during the 1981-82 recession, had recovered more rapidly than aggregate investment in 1983 and 1984, and might well remain strong for some time, as its performance was not directly related to either cyclical developments or to fiscal policy.

That was not to say that the U.S. fiscal position and interest rates and investment in the United States were unrelated, the staff representative went on. Mr. Dallara had noted the distinction between the real after-tax rate of return on investment and interest rates in financial markets. Nominal interest rates were an important element in the real rate of return on capital in a given period, although admittedly not the only one. Over the longer run, a considerable increase in the ratio of the federal debt to GNP through a series of fiscal deficits would obviously affect other variables; either the ratio of capital stock to wealth would have to decline, or the ratio of net foreign borrowing to wealth would have to increase substantially. It was difficult to predict precisely how those variables would behave in the short run.

The U.S. external current account deficit had risen sharply in recent years, the staff representative from the Western Hemisphere Department noted. The increased reliance of the U.S. economy on foreign savings had permitted total domestic investment in the United States to rise in relation to GNP even in the face of a widening of the federal deficit in relation to GNP. There was no certainty that that increased reliance would continue indefinitely. After all, in recent years foreign capital inflows into the United States had totaled some $100 billion, a significant proportion of the increment in world wealth. The staff doubted whether, given present trends in exchange rates and interest rates, similar large capital inflows could be maintained over the long run.

Mr. de Maulde asked how long the present trend of capital flows into the United States could be maintained.

The staff representative from the Western Hemisphere Department said that, if real exchange rates remained constant and the rate of growth of output and demand in the United States were fairly similar to the rates in its main trading partners, the U.S. external current account deficit was likely to continue increasing and might well exceed $200 billion by 1990. It was difficult to say with any great certainty how long the trend in the current account and its financing could reasonably be expected to last. The outcome would depend partly on the extent to which the capital flows into the United States occurred in response to the relatively high U.S. interest rates or were due to unquantifiable perceptions about the relative stability of the U.S. economy and the attractiveness of investment in the United States. If the inflows were due mainly to investors' perceptions of the United States, such inflows could presumably continue for a while. At some point, however, investors could conceivably decide that the international investment position of the United States had become a source of concern. By then, the United States might have become a net international debtor--if, indeed, it had not done so already. Moreover, given the outlook for the external current account deficit, the net debtor position of the United States would likely continue to increase rapidly. The increased external debt of the United States would be reflected in a widening of the U.S. current account deficit through a substantial rise in interest payments.

The Deputy Director of the Research Department added that there was no point identifiable in advance at which the upward trend in capital inflows in the United States would definitely cease. It was interesting to consider whether the present trend might not continue until investors holding U.S. assets changed their evaluation of the investment performance outlook for the United States, thereby causing a sudden and marked decline in the value of the dollar. Another aspect of the same issue was whether the flexible exchange rate system was capable of adjusting smoothly to such a change. The recent movement in relative interest rates could be seen as an implicit projection by the market of a decline in the value of the U.S. dollar by 3-4 percent per annum.

Mr. Fujino agreed that it was difficult to say when the present trend in capital flows into the United States was likely to change, particularly in view of the considerable uncertainty about the possible behavior of the main economic variables in member countries. It was important to bear in mind that the situation in the United States was not symmetrical to that of most other countries, as the dollar, unlike most other currencies, was a reserve currency, and because of the relatively large size of the U.S. financial market. Even if foreign investors wished to withdraw their assets from the United States, they could not hope to find a comparable financial market anywhere outside the United States. The present trend in capital flows was likely to continue as long as the considerable asymmetry between the economic and financial conditions in the United States and other countries persisted.

The Chairman commented that another element that reinforced the asymmetry described by Mr. Fujino was the relatively strong containment of inflation in the United States. That achievement, together with the country's deep and growing financial markets and the market orientation of its economic management, helped to maintain the value of assets held in the United States and contributed to the asymmetry in the overall system that might make current trends last longer than the usual analytical methods suggested.

Mr. Dallara remarked that it was conceivable that the potential for the United States to become a net debtor in the coming period could have significant psychological effects on financial and exchange markets, possibly placing the value of the dollar under considerable downward pressure. However, the value of the dollar had been weak under markedly different conditions in 1978-79, when there had been a lack of confidence in U.S. economic policies and the United States had been a net creditor to the world, the capital outflow having reached some $95 billion.

The data on the U.S. balance of payments should be approached cautiously, Mr. Dallara considered. After all, the fluctuations in the statistical discrepancy item alone were nearly equivalent to the combined external current account deficit of the major debtor developing countries in 1984, $30 billion; the comparable figures in 1982 and 1983 had been $33 billion and $89 billion. The staff and Executive Directors should keep those fluctuations in mind when assessing the sustainability of the present trends in the U.S. current account and capital inflows.

In 1982 and 1983, there had been a sharp swing in capital flows, from a net outflow of $45 billion to a net inflow of $24 billion, Mr. Dallara continued. The international debt problem had made banks reluctant to channel funds directly or indirectly to the developing world. At the same time, the flow of foreign-owned assets into the United States had slowed in 1982 and 1983; accordingly, the increase in the current account deficit in that period had been financed by a substantial decline in U.S.-owned assets abroad, from $119 billion in 1982 to $50 billion in 1983. The role of U.S.-owned assets abroad in the flow of savings to the United States was important to keep in mind; the flow had not been composed entirely of savings owned by foreigners. Moreover, the flow had not been volatile and had not moved in close relation to the trend of the U.S. external current account deficit. In any event, the sustainability of the U.S. current account in coming years was perhaps an irrelevant issue. After all, the deficit was by definition always financeable. It had been noted that some 60 percent of the present U.S. current account position reflected differences in economic growth between the United States on the one hand, and other industrial countries and developing countries on the other.

Mr. Kafka said that he recognized the difficulty in reporting on unemployment in some developing countries, where sufficient data were often lacking. Still, the staff could usefully attempt to estimate the number of entrants into the labor force in developing countries, as well as the composition of the labor force, the attitudes of women and young persons, and productivity growth rates, which together could give Executive Directors some idea of the amount of unemployment and underemployment in developing countries.

Mr. de Groote commented that, in considering the sustainability of the trend of capital flows in coming years, Directors might find it useful to note the shares of different currencies in investors' portfolios. The shares were determined largely by interest rates and certain other factors; for a long time in which most portfolio assets had been denominated in dollars. It seemed likely that, in the coming period, portfolio investors would tend to increase their holdings of assets denominated in currencies other than the dollar.

Mr. Nimatallah considered that the United States should take appropriate steps to reduce the fiscal deficit before the breaking point in the current trend in capital flows to the United States was reached. That issue had been usefully analyzed in Supplementary Note 7, in which the staff said that it favored a gradual reduction in the U.S. deficit. A sudden large reduction might be harmful in the short run; it could not be easily absorbed by the rest of the world. The gradual approach to fiscal adjustment would probably result in a decline in real interest rates that would encourage domestic private investment. At the same time, the decline in the real U.S. interest rates would discourage the inflow of foreign savings, which in turn would help to increase investment abroad--in Europe, for example--thereby setting the stage for an increase in the rate of economic growth outside the United States in the medium and longer run. Those developments would encourage appropriate adjustments in exchange rates that would support a gradual decline in the U.S. external current account deficit and enable the U.S. economy to make the soft landing, an outcome that was clearly preferable to permitting present trends to reach a crisis stage.

Mr. Sengupta remarked that the large U.S. external current account deficit and sizable capital flows into the United States due to high real interest rates in that country could well continue for some time, particularly if the rest of the world did nothing to reduce the substantial portion of total savings flowing to the United States. Indeed, the response of the rest of the world to present trends was the key issue in the present discussion. The staff paper did not clearly indicate the relative shares of treasury bills, stocks, and equity holdings of investors; that information might give some indication of the relative importance of monetary and real factors in investors' decisions.

Holders of dollar-denominated assets could conceivably react adversely to changes in U.S. economic policy and lose confidence in the dollar, thereby causing the value of that currency to fall, Mr. Sengupta continued. The decline in the dollar could be precipitous if the U.S. authorities failed to reduce the fiscal deficit. Such a decline would make it particularly difficult for the U.S. authorities to maintain the low rate of inflation that was one of the main reasons for the external confidence in dollar-denominated assets. If the U.S. fiscal deficit remained large and the dollar depreciated, the authorities would have to adopt counteractive monetary measures that might raise interest rates, thereby adversely affecting the rate of domestic investment in the United States. The Japanese and European authorities should be prepared to take up the slack in the world economy as the rate of growth of the U.S. economy slowed; exchange controls and restrictions on capital movements perhaps should not be ruled out.

In addition, Mr. Sengupta concluded, the major-currency countries should harmonize their monetary and fiscal policies in order to ensure that the needed adjustments in the international monetary and financial system in the coming period could be made smoothly and gradually. The asymmetry between growth rates in the United States and the rest of the world, which had contributed to the substantial flow of savings to the United States, was the result of the passive response to that asymmetry by the rest of the world, which could conceivably decide that the lack of policy harmonization and the high rates of unemployment outside the United States were no longer tolerable.

The Chairman remarked that, as Mr. Dallara had noted, much of the capital flowing into the United States had been held abroad by U.S. citizens. However, additional large U.S. external current account imbalances would have to be financed by further capital inflows; since the United States had used a major portion of the stock of U.S. citizens' assets held abroad to finance previous deficits, the country might have to increase its reliance on foreign savings not held by U.S. citizens in the coming period.

The staff representative from the Western Hemisphere Department agreed with Mr. Dallara that U.S. balance of payments statistics in general and capital flows in particular should be interpreted with caution. That conclusion was particularly applicable to the geographic distribution of capital flows. For example, reported U.S. claims on countries like the Bahamas and the Cayman Islands amounted to billions of dollars, but most of these claims were in effect transferred to third countries.

It was true that published statistics on recorded capital flows showed that most of the capital inflow into the United States in recent years had been due to a rundown of U.S. assets abroad, the staff representative commented. However, as Mr. Dallara had noted, the errors and omissions item was a substantial part of the overall U.S. balance of payments. Presumably, a major portion of the errors and omissions consisted of unrecorded capital flows representing an increase in U.S. liabilities to foreigners. Accordingly, the significance of the rundown of U.S. assets abroad in the inflow of capital to the United States should not be overstated; that inflow might have been due to a significant extent to a substantial unrecorded accumulation of U.S. liabilities to foreigners. The composition of the capital inflow into the United States did not have particularly important implications for the current account and debt servicing; the more important factor was the total net capital inflow.

It was also true that studies had suggested that changes in relative rates of economic activity in the United States and its partner countries in 1980-84 had accounted for a significant part of the increase in the U.S. external current account deficit, the staff representative went on. That conclusion was particularly applicable to 1983-84, when the U.S. economy had been growing much more rapidly than the economies of partner countries. However, even if growth rates in the United States in the coming four to six years were roughly comparable with rates of growth abroad, the U.S. current account position was likely to continue to deteriorate for two reasons. First, there was a substantial imbalance in the U.S. trade position; therefore, similar growth rates in demand in the United States and abroad would, other things being equal, lead to a widening of the U.S. trade deficit. Second, the net international investment position of the United States would continue to deteriorate, and portfolio investment income in the United States--traditionally a positive element in the U.S. balance of payments--would become increasingly negative. As a result, net services, which had traditionally largely offset a large fraction of the trade deficit, would eventually record a deficit. Hence, even if relative cyclical positions remained unchanged in the coming period, the U.S. external current account position would likely deteriorate further in the absence of exchange rate adjustments.

In those circumstances, the best response by the United States would be to take steps to strengthen its fiscal position, the staff representative went on. That response would be the best one whether the present capital inflows and high value of the dollar reflected essentially relative interest rates or confidence in the United States as a haven for investment. Interest rate developments explained much of the appreciation of the dollar in 1982, but no econometric model could explain why the dollar had continued to appreciate in 1983 and 1984, when the interest rate differential had leveled off and, at times, moved against assets denominated in dollars. Foreign exchange market decisions conceivably were being based on factors that analysts had not recognized or could not quantify.

Looking ahead, there was no reason to believe that, if inflation continued to be contained in the United States and incentives for capital formation continued to be provided, investors' confidence in the United States and the country's attractiveness to investment would diminish significantly in the coming period, the staff representative went on. The main question was whether foreigners would be willing to continue to provide the United States with a substantial portion of their total savings. If the safe-haven and confidence effects had reached their limits, investors abroad were probably satisfied with the portion of their assets held in dollar-denominated assets, and, therefore, there was no reason to expect a further unbalancing of their portfolios through an increase in capital inflows into the United States. As Mr. Dallara had noted, the U.S. current account deficit would continue to be financed even if the psychological perceptions of investors were to change. Nonetheless, capital inflows into the United States of the order of $100 billion or more in the future would have to come from increments to wealth, and it would be imprudent to assume that a growing fraction of world savings would be provided to the United States indefinitely.

The United States and other industrial countries had introduced restrictions on foreign capital in the past, the staff representative from the Western Hemisphere Department noted. The restrictions in the

United States had been ineffective. For example, the interest equalization tax introduced in the early 1960s had reduced outflows in the form of securities but had induced flows in the form of banking capital and unreported capital movements. The voluntary foreign credit restraint program had encouraged an increase in unreported capital outflows, largely to the Eurodollar market. Hence, while restrictions might appear advantageous in theory, they usually did not work in practice in sophisticated capital markets.

The Deputy Director of the Research Department said that the first effect of a decline in the dollar exchange rate would be an increase in prices in the United States and a reduction in prices abroad. In the absence of policy changes in the United States in response to the increased prices, real incomes and wealth in that country would fall, thereby restraining demand and expenditure. At the same time, demand abroad would probably increase. However, U.S. output in traded goods would become more competitive compared with exports of other countries, thereby offsetting the restraining effect of the rise in prices. The extent to which the increased competitiveness would offset the restraint of the price rise was difficult to gauge. It was conceivable that a rapid depreciation of the dollar would cause the kind of asymmetrical policy response that Mr. Sengupta had mentioned: the U.S. authorities might respond to the increase in the rate of inflation by tightening monetary policy, while countries experiencing an exchange rate appreciation and a decline in prices might loosen their monetary policies. That outcome would have adverse consequences. An increase in prices in the United States together with unchanged U.S. financial policies would reduce domestic demand. If, in addition, the U.S. authorities adopted a contractionary monetary policy, interest rates would likely increase further, and a recession might occur. On the whole, the staff felt that the present U.S. monetary policy should broadly be maintained, even if the dollar were to depreciate fairly rapidly.

Mr. Kafka remarked that it would be helpful to have a further comment on the various conditions under which an abrupt decline in the exchange rate for the U.S. dollar might occur. He strongly doubted whether developments in the United States after a depreciation of the dollar would be precisely offset by developments abroad. In fact, as U.S. exports became increasingly competitive as a result of the depreciation, the rate of increase in protectionism in other industrial countries would probably accelerate more rapidly than the pace of protection would decline in the United States; the level of protection in that country was already relatively restrained.

The staff should also comment further on the likely effect on interest rates abroad of an abrupt decline in the real dollar exchange rate, Mr. Kafka said. If the depreciation were seen to be an overshooting, interest rates might well fall unless a quick correction of the overshooting through an increase in the rate of inflation--a development that could not be taken for granted--were anticipated. He wondered how a decline in interest rates would affect developments in the United States and abroad.

If the depreciation were seen to be an undershooting--in other words, the first in a series of steps of real depreciation--he wondered what would happen to interest rates outside the United States.

Mr. de Maulde commented that the shares of assets denominated in dollars and in other currencies in portfolios held outside the United States reflected the pattern of exchange rates. When the exchange rate for the dollar fell, the willingness of foreign savers to finance the need for savings in the United States increased. He wondered whether he was correct in concluding that a decline in the value of the dollar helped the United States to finance its external current account deficit in the short run.

Mr. Clark remarked that several speakers had questioned the continuing willingness of foreign investors to finance the U.S. external deficit. It was worth turning the question around and asking whether it was really wise for the United States to be absorbing foreign savings at a real interest rate which seemed well in excess of the economy's potential rate of growth. Even though the United States enjoyed the confidence of foreign investors, it had to pay a high real rate of interest--8 percent--on savings from abroad. If confidence weakened, an even higher real rate might be required.

Mr. Joyce said that, while the growth in the industrial economies was sustainable, the present global payments situation was not. Still, that situation was unlikely to continue: the United States would probably remain relatively attractive to investors and could probably maintain its present policies and an adequate inflow of savings from abroad, but the growing size of the external current account deficit would probably create pressure within the United States for policy changes; at the same time, other industrial countries would feel some pressure to take action before an international financial crisis developed. A soft landing of the U.S. economy was in the best interest of all countries. The question of the likely effects of an abrupt decline in the dollar exchange rate was interesting, but it was particularly helpful to consider the actions that the United States should take in response to the particular pressures in that country, and also the adequacy of the measures that were likely to be adopted.

Mr. Zecchini remarked that he continued to feel that, in assessments of appropriate adjustment mechanisms in present circumstances, further consideration should be given to the role of the different economic growth rates in the United States and other countries and greater attention should be paid to the role of the flexible exchange rate system. It was appropriate to consider the impact of an abrupt decline in the dollar exchange rate, but little mention had been made of the particular currencies that might appreciate as the dollar depreciated. Nor had mention been made of likely developments in the gold market in the event of a sharp decline in the exchange rate for the dollar.

It would also be helpful to have further comment on the likely short-term reaction in the United States to an abrupt shift of confidence in the dollar, Mr. Zecchini continued. Interest rates could conceivably increase, but the reaction might also be evident in the fiscal deficit. He also wondered whether authorities in Europe and Japan would permit their currencies to appreciate sufficiently to enable the adjustment mechanism to work. For example, would the German authorities allow the mark to appreciate, or would they instead choose to permit an increase in the money supply? The effects of a change in market sentiments depended crucially on the reaction by the monetary authorities of major countries. Experience suggested that the German authorities would not wish to exceed established monetary targets in order to avoid adversely affecting expectations in the financial markets.

Mr. Fujino said that he agreed with Mr. Joyce that the main question at hand was how to make the adjustment to a better balance in the international monetary and financial system, rather than whether the existing large imbalances were sustainable. In that connection, it was helpful to examine more closely the U.S. trade balance, which over the previous four years had deteriorated by $85 billion, of which some $60 billion was attributable to the 65 percent appreciation of the dollar. Approximately one fourth of that deterioration could be explained by the differences in the cyclical phases of the industrial countries, particularly the relatively rapid economic growth in the United States. The rest of the deterioration in the U.S. trade position was accounted for by the increase in imports from developing countries. To some extent, those factors had been offset by the $20 billion fall in the price of oil bought by the United States.

Japan's trade surplus had increased from $20 billion in 1983 to $33 billion in 1984, Mr. Fujino continued. In the same period, the surplus with the United States had risen from $18 billion to $33 billion, but the surplus with the EC countries had fallen from $10.4 billion to $10 billion, mainly as a result of a 15 percent increase in Japanese imports. Japan's trade balance with the ASEAN countries, including Indonesia, had deteriorated from negative $2.3 billion in 1983 to negative $5.7 billion in 1984, largely because of a 14 percent increase in Japanese imports. It was clear that the increase in Japan's trade surplus in 1984 had been due mainly to the rise in Japanese exports to the United States; Japan's trade balance with the rest of the world had deteriorated. The Japanese authorities were making a continuous effort to increase imports. A number of measures designed to open the Japanese markets had been introduced, and additional ones would be announced in the near future. There was a strong demand for imported cars in Japan, and German car makers had provided the strong network of dealerships, spare parts, and reliable sources of repairs required to increase rapidly their shares in Japan's market for new cars. Furthermore, a U.K. manufacturer was rebuilding its dealer network in Japan. Given Japan's relatively small land area and large population, the authorities understandably maintained strict antipollution standards for imported cars. He was pleased that the EC countries had recently agreed to the more stringent antipollution criteria favored by the Japanese authorities. Those criteria should not be seen as constituting a kind of nontariff barrier; they had led to a significant reduction in pollution in Japan. In an examination of trade policy matters, it was instructive to examine the regional pattern of trade as well as trade in particular items, rather than global data alone. Japan's trade surplus was substantial, and the authorities did not feel complacent about it, but recent developments suggested that Japan's surplus with the EC countries was declining; in that connection, the relationship between the currencies of EC countries and the yen had made a significant contribution.

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/85/52 (4/1/85) and EBM/85/53 (4/3/85).

2. SAUDI ARABIA - TECHNICAL ASSISTANCE

In response to a request from Saudi Arabia for technical assistance relating to economic development strategy, in conjunction with a World Bank and IFC study mission and the 1985 Article IV consultation, the Executive Board approves the proposal set forth in EBD/85/87 (3/28/85).

Adopted April 2, 1985

3. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/85/84 (3/29/85) is approved.

APPROVED: February 3, 1986

LEO VAN HOUTVEN
Secretary