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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/54

3:00 p.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	
M. Finaish	T. Alhaimus
H. Fujino	M. Sugita
G. Grosche	
	Jaafar A.
R. K. Joyce	L. Leonard
	J. Hospedales, Temporary
H. Lundstrom	H. Fugmann
E. I. M. Mtei	
	B. Jensen
Y. A. Nimatallah	J. E. Suraisry
	G. Ortiz
J. J. Polak	J. de Beaufort Wijnholds
	A. V. Romuáldez
	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, H. Vittas. Exchange and Trade Relations Department: E. H. Brau, M. R. Kelly, C. M. Watson. External Relations Department: A. F. Mohammed, Director; N. K. Humphreys. Fiscal Affairs Department: M. I. Blejer, A. Feltenstein. IMF Institute: O. B. Makalou. Legal Department: G. P. Nicoletopoulos, Director. Middle Eastern Department: J. G. Borpujari, S. von Post. Research Department: W. C. Hood, Economic Counsellor and Director; A. D. Crockett, Deputy Director; R. R. Rhomberg, Deputy Director; F. C. Adams, C. P. Blackwell, J. M. Boughton, M. C. Deppler, D. Folkerts-Landau, M. D. Knight, A. Lanyi, P. R. Masson, 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, S. M. Hassan, G. E. L. Nguyen, J.-C. Obame, G. W. K. Pickering, M. Z. M. Qureshi, T. Sirivedhin, E. M. Taha, D. C. Templeman, A. Vasudevan. Assistants to Executive Directors: H. Alaoui-Abdallaoui, I. Angeloni, G. Biron, M. B. Chatah, Chen J., J. J. Dreizzen, G. Ercel, V. Govindarajan, N. Haque, Z. b. Ismail, 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, L. Tornetta, A. H. van Ee, E. L. Walker, B. D. White, A. Yasseri.

1. WORLD ECONOMIC OUTLOOK

The Executive Directors continued from the previous meeting (EBM/85/53, 4/3/85) 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 Deputy Director of the Research Department recalled a speaker had asked whether an appreciation of non-dollar currencies would have symmetrical consequences for the United States and other countries, and whether the appreciation would not adversely affect output and demand outside the United States. Answers to those questions were of course speculative. The price effect of the appreciation of the non-dollar currencies would increase real incomes and wealth outside the United States, thereby positively affecting domestic demand. The strengthening of the currencies might increase consumer and business confidence in the non-dollar countries; that pattern had recently been observed in the United States.

There was no way of predicting in absolute terms the effects on interest rates of a decline in the dollar and an appreciation of other currencies, the Deputy Director continued. In hazarding a guess, he would wish to make particular assumptions about the cause of the exchange rate adjustment. Presumably Mr. Kafka, in raising the question about the effects of an appreciation of non-dollar currencies, had assumed that the exchange rate changes were due to changes in interest rates and a reassessment by the market of the external value of the currencies concerned. If the exchange rate adjustments did not affect the world weighted average stock of money, real investment, and real savings, there was no reason to expect that the adjustments would affect world average interest rates. Of course, the exchange rate adjustments could have some effect on relative interest rates among countries, depending to a considerable extent on whether the adjustments were thought to constitute a movement toward a new sustainable level or a movement that would probably be reversed. Each possibility had different likely consequences for interest rates.

If the decline in the dollar were perceived to be the start of a series of steps in the same direction, a market equilibrium would not be established unless an interest rate differential were created between dollar assets and non-dollar assets sufficient to compensate for the expected future depreciation of the dollar, the Deputy Director went on. If the decline in the dollar reflected merely the market's reassessment of the medium-term equilibrium value of the dollar, there would probably be only one downward adjustment of the rate in proportion to the market's expectation of the medium-term equilibrium rate; there would be no reason to expect any further change in interest rate differentials, and the effect on current interest rates would be neutral. However, if the change in the spot exchange rate occurred in the absence of the market's perception of a new medium-term equilibrium rate resulting from, say, spot market transactions or intervention, interest rates on dollar-denominated assets could be expected to fall relative to interest rates on other assets, as the premium on dollar-denominated assets needed to compensate for the expected decline in the dollar as it moved from its spot rate to its future rate would have been reduced. The question had also been raised whether a decline in the exchange rate for the dollar would affect the willingness of foreigners to hold dollars in their portfolios. The reduced exchange rate for the dollar, ceteris paribus, would increase the incentive to hold that asset, as its price would in effect have been reduced, thereby making it more attractive.

The role of the exchange rate regime in the adjustment process depended upon the nature of the regime, the Deputy Director commented. Under a fixed regime, intervention provided a short-term barrier to depreciation, and policy reactions to a loss of, or gain in, reserves provided the medium-term support for the short-term intervention. Under a pure gold exchange standard in particular, a loss of reserves signaled an automatic decline in the domestic money supply that had a contractionary effect, which restored balance. Under a managed or adjustable peg system, a change in reserves led the authorities concerned to take deliberate policy actions designed to validate the existing exchange rate.

Under a flexible exchange rate regime, there was no automatic policy response to a change in reserves, and the role of the exchange rate in limiting a depreciation depended to a considerable extent on the expectations by market participants about the likely new equilibrium exchange rate, the Deputy Director went on. Presumably, those expectations were based on an assessment of government policies and recent economic developments. Moreover, the authorities concerned would probably hope that, if domestic policy reactions were reasonably constant, a change in external circumstances or a reassessment by some market participants of the medium-term equilibrium exchange rate would encounter resistance in the form of offsetting actions by other market participants that would stabilize the exchange rate after a relatively minor movement in it. An initial movement in the exchange rate could set in motion exchange rate actions by market participants if, for example, the authorities gave the market reason to believe that they would respond to a depreciation by implementing a more expansionary monetary policy.

Accordingly, the essential difference between the two exchange rate regimes was that a fixed exchange rate regime provided for a fairly clearly identified and nearly automatic mechanism for limiting exchange rate movements in the short and medium term, while the movement of the rate under a flexible regime depended upon the constancy of policymakers, the Deputy Director of the Research Department concluded. That conclusion suggested to many the need for firmer rules governing the responses of governments and central banks to exchange rate movements. For example, it had been suggested that there should be agreement in advance that an exchange rate movement beyond a certain threshold would trigger a certain monetary policy response designed to increase interest rates in the country whose currency was depreciating and to lower interest rates in the country whose currency was appreciating. In general, the role of an exchange rate regime depended upon domestic policies and participants' confidence in the resilience of those policies in the face of an exchange rate movement.

Mr. Zecchini commented that, under a freely floating exchange rate system, the exchange rate could be a driving force in restoring balance to the external current account over the long run. In the short run, however, undershooting, overshooting, and bandwagon effects could cause the exchange rate to deviate substantially from its equilibrium level. The authorities concerned should respond to such a deviation by introducing appropriate policies.

The Fund could play one of several different roles in the exchange rate area, Mr. Zecchini remarked. It could encourage member countries to return to a system of more stable exchange rates, or it could establish criteria governing intervention and the conduct of monetary policy in response to exchange rate developments. In his view, surveillance should be designed to encourage member countries to implement monetary and fiscal policies designed to reduce short-term deviations of exchange rates from their medium-term equilibrium levels. At the same time, demand management should play a more fundamental role in restoring balance to a member country's external current account. If the exchange rate mechanism could not restore balance to the external current account, measures designed to restrain domestic absorption must be implemented.

The staff representative from the Western Hemisphere Department commented that if the decline in the real value of the dollar were triggered by a reappraisal of the long-term outlook for the U.S. economy and if there were no change in the U.S. fiscal position, the U.S. external current account position would improve, and some other variable in the system would have to adjust to restore the balance between total U.S. savings and investment. Presumably the adjustment would take the form of crowding out investment in the United States through an increase in U.S. interest rates. The improvement in the external current account position and the reduction in the reliance on foreign savings need not be accompanied by a precisely corresponding amount of crowding out; domestic savings in the United States could conceivably increase as a result of the higher interest rates. However, experience suggested that savings were not particularly responsive to changes in real interest rates; therefore, it was unlikely that the reduced absorption of foreign savings would be accompanied by a significant rise in domestic savings in the United States, and it was probable that some crowding out of investment in the United States would occur.

A substantial cut in the U.S. fiscal deficit probably would cause U.S. interest rates to fall and the value of the dollar to decline, the staff representative noted. Those developments should lead to an improvement in the external current account position and a reduction in the reliance of the United States on foreign capital inflows. At the same time, the improvement in the fiscal position would probably boost private investment and other interest-sensitive components of expenditure in relation to GNP.

He did not mean to suggest that confidence factors and changes in the fiscal position in the United States were never interrelated, the staff representative from the Western Hemisphere Department concluded. It was conceivable that the U.S. authorities could contain inflation and significantly reduce the budget deficit without impairing investment incentives. In those circumstances, foreign investors probably would feel that the attractiveness of investment in the United States had increased, and the effect of that additional confidence might offset the decline in interest rates stemming from the adjustment in the fiscal position. In that event, the dollar might not decline, the external current account might not adjust, and the United States might continue to experience a substantial inflow of capital. That possibility raised a question whether the United States could continue to issue liabilities to foreigners that yielded a fairly high real rate of return. The answer to that question hinged on the counterpart of those liabilities: if the foreign borrowing were used to finance productive investment in the United States, the capacity of the economy to repay a stream of foreign debt would increase; if the inflow were used to finance private or public consumption, the situation was likely to be unsustainable. Thus, there was a clear need to improve the U.S. fiscal position, whether or not the effort would result in a decline in the exchange rate for the dollar.

Mr. Dallara said that he was not as confident as the staff about the existence of the relationship the staff had described between investment, interest rates, the external current account, and the dollar. A reduction in the U.S. budget deficit would substantially reduce the external current account deficit only if the staff's particular assumptions about the relationship between budget deficits, interest rates, the U.S. dollar, and the current account were accurate. In fact, there was considerable uncertainty about the interrelationship of those factors.

Since 1950, there had been a remarkably close relationship between investment and the real after-tax rate of return in the United States, Mr. Dallara continued. The closeness of the correlation suggested that the effect of the recent tax changes in the United States might well be lasting rather than temporary. The staff apparently had assumed that the U.S. fiscal deficit affected interest rates in the United States largely through borrowing by the Government in the capital markets. In fact, however, public sector and private sector borrowing as a percent of GDP was about the same at present as in 1970-79, namely, 17 percent. There was no particular reason why government borrowing should have had a greater effect than private sector borrowing on interest rates. The mix of borrowing had changed in favor of the public sector, but total borrowing relative to national savings and GDP had not changed significantly. The shift in the shares of public and private borrowing in total borrowing in favor of public borrowing in the early 1980s was admittedly a cause for concern.

On a number of occasions during the previous four years, the dollar had strengthened even though nominal U.S. interest rates, nominal interest rate differentials, real interest rates, and real interest rate differentials had moved in ways that could not have contributed to the strengthening of the dollar, Mr. Dallara commented. Since August 1983, the dollar had appreciated against the deutsche mark by more than 9 percent even though the nominal interest rate differential had moved against the dollar by 2.9 percentage points. On a trade-weighted basis, the dollar had appreciated against the deutsche mark by 20 percent during the first three quarters of 1982 while nominal interest rates had moved against the dollar by 3 percentage points. Real interest rate differentials and real interest rates in absolute terms had tended to show the same inconsistent relationship over longer periods. In 1981-84 the dollar had appreciated in real trade-weighted terms by some 40 percent despite the decline in the real interest rate differential against the dollar of about 4 percentage points.

In explaining the movement in the value of the dollar, the staff had concentrated on developments in the United States, Mr. Dallara remarked. It was also important to bear in mind factors outside the United States. For example, one of the main causes of the appreciation of the dollar in late 1984 and early 1985 had been the weakening of the pound sterling by 7.5 percent against all currencies on a trade-weighted basis. The coal strike in the United Kingdom, oil market developments, and the perceived loosening of U.K. monetary policy in the final quarter of 1984 had affected the exchange rate between the pound sterling and the dollar. Moreover, the structural rigidities in Europe had become increasingly clear causes of movements in exchange rates. In any event, in assessing the effect of a decline in the U.S. fiscal deficit on the external current account position, Executive Directors should note that roughly half of the external current account deficit was explained by the growth differential between the United States on the one hand, and European and developing countries on the other. Since 1982, the U.S. economy had grown at an annual rate of 5.3 percent while the other industrial economies had grown at an annual rate of 2.7 percent. In the 1970s, the annual rate of economic growth in the United States had been about 3 percent, compared with 3.8 percent in the other major industrial countries, and the difference had been even more marked in the 1960s. Similarly, industrial production in the United States in 1984 had been roughly 13 percent greater than in 1980, while the level in Europe had remained roughly unchanged over the same period. It might be true that, as the staff had suggested, cyclical changes did not play a substantial role in reducing the U.S. external current account deficit; however, changes in underlying policies might be needed before it could be determined whether cyclical differences played such a role.

The comments of Mr. Fujino on the relationship between trade and macroeconomic developments were particularly interesting, Mr. Dallara said. Japan's growth performance during the previous four years had been excellent: GNP had grown by 16 percent. The question naturally arose why the vigorous growth in Japan had not been reflected to a greater extent in the U.S. trade and current accounts. In that connection, the exchange rate had played a role, but it was also important to note that only 9 percent of U.S. exports had been directed to Japan, suggesting that the Japanese economy would have to become more open if the evolution of the U.S. and Japanese external current account positions over the coming several years were to be satisfactory. Mr. Fujino had noted the developments in 1984 suggesting that the Japanese external current account had begun to contribute to overall balance of payments adjustment in Japan. However, Japan's trade surplus with the European Communities had grown from $4.8 billion in 1983 to $6.6 billion in 1984, even though the rate of economic growth in Japan had substantially exceeded that of the EC countries and their currencies had been depreciating. In addition, in 1981-83, Japan's trade surplus with developing countries had fallen from $12 billion to $7 billion, a surprising outcome that boded well for the future.

Nonetheless, in the coming period, attention should be focused on ways of reducing the substantial U.S. and Japanese external current account imbalances, Mr. Dallara continued. Mr. Fujino had usefully noted that the demand for high-quality consumer goods in Japan was perceived outside the country as a form of nontariff barrier; a detailed examination of Japan's trading policies and practices suggested that significant nontrade barriers still existed. For example, the Japanese Tobacco and Salt Corporation, a government monopoly, had established various tests of foreign brands of tobacco that were clearly more restrictive than tests of Japanese tobacco. There were also restrictions on advertising expenditure that discriminated against brands of tobacco that were not well known in Japan. Thought was being given in Japan to legislation that would shift the tobacco industry to the private sector. That shift might well have a positive effect on trade, depending on how the relevant legislation was implemented.

The relationship between changes in macroeconomic conditions and policies outside the United States and the desired adjustment of the U.S. external current account had been usefully commented on by Mr. Zecchini, Mr. Dallara recalled. European countries seemed to have little scope for altering their basic anti-inflationary fiscal and monetary policy stance. However, while the large share of expenditures in GDP--ranging from 40 percent to 50 percent--seemed likely to persist in European countries, some structural changes might be possible in the fairly short run. For example, attention should be paid to the scope for reducing unemployment compensation. Such structural measures had generally been outside the scope of the traditional concerns of the Fund as well as many finance ministries and central banks, but they might well play an important role in solving global payments problems in the coming period. In the United States and Japan, unemployment compensation as a proportion of past wages was substantially reduced after six months of unemployment, from 55 percent to 27 percent in the United States and from 65 percent to 50 percent in Japan. In the United Kingdom, the compensation actually increased marginally after six months; in Germany, it remained essentially unchanged. While his authorities harbored some serious doubts about the links seen by the staff between the U.S. fiscal and current account deficits, they strongly agreed with the staff that reducing the U.S. budget deficit was essential not only for the United States but also for the world economy. His authorities were determined to reduce the deficit, and they hoped that the authorities in other countries were equally determined to move quickly and forcefully to take steps to reduce the imbalances in their external current accounts.

Mr. Grosche remarked that the main question at hand was the appropriate course of action for the United States and other industrial countries in the coming period. The discussion had underscored the urgent need for actions by the United States and other countries to prevent a sudden break in the financing of the U.S. current account deficit and a hard landing by the dollar. Interest rates in Europe ideally should be lower, but a reduction was difficult to achieve given the present pattern of exchange rates. There was a clear relationship between interest rates in the United States and Germany, and there was room for maneuver in that area. However, he doubted whether there was room for maneuver in the form of somewhat more expansionary demand management policies in countries like Germany, where the balance of payments was strong and the rate of inflation very low.

A number of Executive Directors had suggested that Germany was one of the members that might be in a position to adopt somewhat more expansionary demand management policies, Mr. Grosche went on. In assessing that possibility, Directors should bear in mind that the situation in European countries was not comparable with that of the United States, where a fiscal stimulus had contributed to the growth performance. The flexibility of the U.S. economy in response to changing circumstances had been a major factor in the country's growth performance. That flexibility was lacking in Europe. Nor did Europe have the ability of the United States to attract the substantial foreign savings that had enabled that country to enjoy a boom in investment and to run a growing fiscal deficit. Moreover, the U.S. fiscal deficit in the 1970s had been much smaller than the deficit in Germany and other industrial countries. Hence, the U.S. authorities had had more room in recent years to use fiscal policy to stimulate the economy. At present, Germany still had a substantial fiscal deficit and did not have the same room for maneuver as the United States. Similarly, the share of government in GNP was substantially smaller in the United States than in Germany. Accordingly, his authorities were convinced that they should maintain their medium-term financial strategy, which was aimed at restoring and maintaining financial stability. Shifting away from that policy stance would involve the considerable risk of seriously impairing the confidence that had been restored over the previous several years.

In any event, his authorities were skeptical about the usefulness of an expansionary demand management policy in Germany, mainly for three reasons, Mr. Grosche went on. First, Germany's anticyclical policies of the 1970s had had short-lived effects, had delayed needed adjustment, and had created a substantial volume of debt. The present calls for an expansionary fiscal policy in Germany were similar to those made in 1978, when the authorities' response to requests to alter their policy stance had created the conditions that had led to many of the present problems facing the economy. The expansionary policy shift in 1978 had been one of the factors in the large current account deficit recorded in 1980 and in the weakening of the deutsche mark. Those developments had underscored the difference between the reserve currency roles of the dollar and the deutsche mark, the latter having been vulnerable to even small shifts in the external current account.

Second, excluding the trend in unemployment, the economic situation in Germany was satisfactory, Mr. Grosche continued. The economy had achieved positive real growth for two consecutive years--the present rate was 3 percent--and any anticyclical demand push was therefore difficult to justify. The rate of unemployment had remained high despite the prolonged growth, a feature suggesting that the economy had structural imbalances that could not be eliminated by an increase in public demand.

Third, the room for maneuver in Germany was limited, Mr. Grosche said. The authorities' progress in reducing the fiscal deficit since 1982 had often been overstated by observers. The progress had differed from one sector of the Government to the next, the Central Government having achieved the least consolidation; furthermore, the pace of the reduction in the fiscal deficit had been slowing. In any event, the authorities would be using whatever margin for maneuver was available to them. They had already taken steps to reduce income taxes in 1986 and 1988, and corporate taxes had already been cut. As shown in Table 1 of Supplementary Note 1 (SM/85/70, 3/11/85), the contractionary fiscal impulse of the Central Government had been slightly negative in recent years and was expected to be zero in 1986.

Mr. Polak considered that international policy coordination through the Fund, the OECD, and summit meetings was not meant to lead to agreement among the main industrial countries on their individual or combined economic growth rates. Those rates were mainly domestic objectives that were to be weighed against other domestic objectives such as inflation control and restructuring of the fiscal system. The subject of countries' pressuring one another with respect to economic growth was a new one; it had arisen mainly because the United States and the other industrial countries had each been able to maintain their preferred policies without encountering significant roadblocks. The European countries had been able to make needed fiscal adjustments, which were inherently contractionary in the short run, without impeding reasonable economic growth. The political leaders who had advocated those adjustments had been able to avoid considerable domestic criticism because actual rates of economic growth had often exceeded the planned rates. Moreover, the level of aggregate world demand had not posed any difficulties and the debt problem had been dealt with reasonably well.

The main question at hand was the likely course of events when the U.S. fiscal deficit was cut or the dollar depreciated, Mr. Polak continued. The extreme imbalances between the United States and the other industrial countries would inevitably disappear. The staff had usefully noted the uncertainty about the likely effects of a reduction in the imbalances on exchange rates, the real money supply, and other variables. The overall outcome after adjustments in the U.S. current account deficit and the exchange rate could conceivably be satisfactory, in which event Germany, for example, need not be encouraged to adopt fiscal measures that the authorities were reluctant to implement. In any event, the pace at which the European economies made needed structural adjustments was of only minor interest in the context of overall international adjustment. Those structural adjustments were being made too slowly in the context of the objectives of individual European countries, where the pace of adjustment could affect real income, unemployment, and other variables in those countries.

However, the Interim Committee should consider the appropriate steps to take if the adjustment process were to produce conflicting trends among countries, Mr. Polak went on. It was conceivable that the slack in U.S. economic activity would not be sufficiently offset by further expansion in Europe and Japan. In that event, the Interim Committee should expect the United States, European countries, and Japan to take a step they had refused to take thus far, namely, to give up some of their preferred policy packages for the good of the international monetary and financial system. Indeed, encouraging member countries to take that step was the main purpose of surveillance. Mr. Grosche's position that fiscal adjustment in Germany should not be slowed was appropriate in present conditions. However, if the overall debt situation in the developing countries were to become particularly difficult because the industrial countries had been unable to achieve a desirable pattern of exchange rates, then the major industrial countries would have to reconsider their priorities with a view to bolstering the international financial system. Accordingly, Germany and Japan--and perhaps some other countries as well--might have to loosen somewhat their fiscal or monetary policy stance while the United States might have to give up some of its particular adjustment policy preferences, for example, by adopting certain tax measures. Participants in the coming Interim Committee and economic summit meetings should be willing to agree--for the benefit of the overall system--to subordinate their preferred first solutions to policies that might be slightly less preferable in the context of the goals of each country concerned.

Mr. Lundstrom remarked that, while the present strategy of the major industrial countries had produced positive results on the inflation front and on the external side, employment had remained unacceptably high, especially in Europe. He was particularly worried about likely future developments. The fiscal and external imbalances in the United States were obviously unsustainable, and the only question was how and when they would be reduced. Other industrial countries would have to take up the slack. Developing countries could not be expected to increase their external current account deficits further in order to offset the reduction in the U.S. deficit. Instead, the world community had to look mainly to Japan and a few European countries to take offsetting steps. In that context, the baseline scenario was worrying: developments in Europe and Japan were not expected to be sufficient to take up the slack resulting from the decline in the rate of U.S. economic growth. The necessary and unavoidable further adjustment in many developed and developing countries must take place in the context of a sufficiently strong expansion in world trade that would ease the adjustment process.

That was not to say that certain member countries should adopt strongly expansionary policies or resort to fine tuning; rather, the member countries concerned should take a somewhat more relaxed attitude toward their medium-term policies to reduce fiscal deficits, Mr. Lundstrom went on. Minor changes making those policies somewhat less restrictive would not undermine confidence; moreover, if undertaken simultaneously in a number of different countries, they would be mutually reinforcing. At the same time, there should be a much stronger attack on the structural rigidities in the European economies, particularly in labor markets, although structural measures alone would not be sufficient, given the expected merely moderate increases in economic growth in the European economies even on the assumption that appropriate policies would be implemented. Recent experience, together with the baseline and so-called better policies scenarios, suggested that low inflation rates alone were not sufficient to generate adequate economic growth. Selected countries would have to exploit their room for maneuver, and he had taken Mr. Grosche to mean that there might be at least a little such room in Germany. That approach would have to be taken if the United States were to reduce the imbalances in its economy and if a further improvement in the external position of developing countries were to be achieved. Countries should be expected to adopt more expansionary policies if they had a strong or at least a balanced external current account position, a low or declining rate of inflation, and underutilized productive resources as reflected in particularly high unemployment or a relatively low rate of economic growth. An important Asian country, two large European countries, and at least one smaller European country met those criteria.

The Director of the European Department, responding to a question by Mr. de Maulde, said that a significant appreciation of the European currencies against the dollar would probably affect the growth of European exports. The increase in those exports to the United States during the previous 12 months had been remarkable. Indeed, the full effect on trade flows of the appreciation of the dollar against European currencies probably had not yet been fully felt. Accordingly, a sudden depreciation of the dollar by, say, 15 percent, would probably be followed eventually by a decline in the rate of growth of European exports to the United States, but the rate would probably remain high for some time. However, there was some evidence that exporters in the main European industrial countries did not believe that the present exchange rate relationships were durable and had therefore held back from increasing their productive capacity and setting up service activities in the United States. A deceleration in the rate of growth of exports of European countries would have significant consequences for economic growth in those countries. The staff projections for growth in the main European countries were reasonable by historical standards, but domestic demand in some of those countries was expected to weaken significantly, and a weakening of export growth as well would of course raise questions about the appropriate domestic demand policies for those countries.

Mr. Fujino remarked that he continued to feel that Japan was not in a position to adopt expansionary policies. The Japanese economy already enjoyed positive economic growth sustained by domestic demand. The country's growth rates in the previous and present fiscal years were 5.4 percent and 4.6 percent, respectively, and a reasonable growth rate--4 percent--was expected in the medium term.

The Japanese authorities had been introducing budgetary reforms for six years, Mr. Fujino noted. There had been slightly negative growth in budgetary expenditure in recent years as a result of the authorities' firm fiscal policy, and administrative reforms were being made, such as the organization of the tobacco companies and the Japan Telephone and Telegraph Corporation into private companies. As a result of the authorities' efforts, the fiscal climate in Japan had changed markedly: the heavy political pressure for rapid increases in budgetary expenditure had given way to a more cautious approach that was helping to create a better climate for private initiative. Indeed, private investment had increased by 5.4 percent in 1983 and 10 percent in 1984; it was expected to increase by a further 8.5 percent in 1985. Moreover, the share of investment in GNP had risen from 17.4 percent in 1983 to 18.2 percent in 1984 and was projected at 18.9 percent in 1985, owing mainly to strong growth in private investment. Accordingly, the authorities expected that the main support for economic growth would continue to be provided by domestic demand.

The differentiated demand management policy--the so-called locomotive policy--promoted by the OECD in 1978 had created considerable difficulties for Japan, Mr. Fujino recalled. Similar policies at the present stage would undermine private initiative in Japan. An increase in the budget deficit would certainly cause interest rates to rise. Macroeconomic policies in Japan should not be assessed merely in the light of the need to balance investment and savings. The mechanism for financing government operations depended upon the working of the financial market. In any event, an increase in public sector activity would have only a relatively small effect on other variables. For instance, a 15 percent increase in spending on public works would induce an increase in imports of only $1.3 billion, an amount that would not significantly reduce the trade imbalance but that would seriously undermine domestic investment.

Mr. Jaafar considered that industrial countries should use whatever room for maneuver existed to maintain a more flexible approach to demand management policies. The need to stimulate and support underlying growth in many European countries and Japan should be recognized. Of course, those countries should not be encouraged to stimulate growth in excess of their long-term growth potential, but industrial countries with low rates of inflation should provide some stimulation in order to strengthen imports. The Japanese authorities had contained inflation despite the weakness of the yen, and the danger of renewed inflation in Japan and other industrial countries from some stimulus to their economies was perhaps being overemphasized.

The European countries should make a forceful and determined effort to eliminate the structural rigidities in their economies, particularly in view of the continued high rate of unemployment in those countries, Mr. Jaafar said. That approach had already begun to pay dividends in the United Kingdom, where special attention had been paid to removing the rigidities in the labor market. There were no shortcuts to eliminating the rigidities in the European economies. Wage rates in those countries were excessive and were not contributing to long-term economic adjustment. Significant progress in containing wages probably could not be made, even in the medium term, in the absence of more vigorous economic growth; after all, unemployment rates in European countries were already unacceptably high.

Part of the reason why economic growth in Europe had been inadequate was that a sizable portion of investable funds had been directed to the United States; the remaining funds in Europe had not been sufficient to finance a level of investment that could significantly reduce unemployment, Mr. Jaafar went on. An immediate and decisive policy initiative was needed. Demand management policy action might well be required in the short run. If the U.S. budget deficit were reduced, as the U.S. authorities intended, the European countries and Japan would have to take up the slack if the U.S. authorities did not also succeed in bolstering the economy by making more capital available to the private sector.

The Deputy Director of the Research Department, responding to a question by the Chairman, explained that an underlying assumption of the baseline scenario was that the U.S. budget deficit, excluding interest payments, would be cut by the equivalent of 1 percent of GDP as a result of measures implemented gradually in 1986-88. Accordingly, the budget deficit would be reduced by approximately $60 billion, including $50 billion resulting from direct measures and $10 billion resulting from reduced interest payments. If the U.S. authorities made all the planned budget cuts, economic growth in the first year of the baseline scenario period would decline somewhat, slow less rapidly in the second year, stop declining in the third year, and accelerate in the fourth year as a result of the interest rate effect on investment.

The Chairman said that he was concerned by the comments of some speakers to the effect that the outlook for the world economy was gloomy because of the likely decline in the immediate future of the U.S. economic growth rate and the need for other countries to take up the slack. It was more helpful to note that the U.S. external current account deficits seemed unsustainable over the longer run because of their likely snowball effects. The U.S. external imbalance obviously would have to be gradually reduced. To that end, the U.S. authorities must make an effort to reduce significantly the fiscal deficit along the lines that the U.S. Administration had suggested. The negative effects of the adjustment on growth in the first two years of the adjustment effort would be offset thereafter by the positive effects of the adjustment.

At the same time, the other industrial countries should introduce into their economies as quickly as possible the kind of flexibility that already existed in the U.S. economy, the Chairman continued. Efforts to reduce the rigidities in the European economies were overdue, and the sooner they were undertaken the better, as they would have a significant psychological effect and would help to bolster investment and a more appropriate pattern of exchange rates. Policies aimed at reducing the rigidities in Europe could not be expected to show results in the immediate future, but that was no reason to delay their implementation. The introduction of policies of fiscal restraint in the United States might well run the risk of slowing world economic activity over the coming two years, but in the longer run the policies would help to achieve sustainable and more evenly spread growth. The baseline scenario should not include a repetition of the skewed growth of 1983-84. Accordingly, in the coming period the United States should not accumulate substantial and growing balance of payments deficits, and the European countries should tackle the structural rigidities in their economies to avoid a repetition of low rates of economic growth and unacceptably high unemployment. There might well be some negative effects on general economic activity as a result of efforts to avoid a repetition of the pattern of developments in 1983-84, but industrial countries should maintain their basic anti-inflationary stance. As Mr. Polak had stressed, the situation in developing countries might well become more difficult in 1986-87, and international cooperation within the Fund and other institutions would be needed to assist those countries.

Mr. Zecchini noted that some major industrial countries had not yet brought inflationary pressures fully under control: they had had to support a more rapid increase in domestic demand than some other industrial countries but had reduced or eliminated their external current account deficit. Those countries, which included Italy, could not continue to support world demand to the extent that they had in 1984. Hence, there was an even stronger need for countries with relatively good overall economic positions to take on their full share of the responsibility for sustaining world economic activity.

The huge costs of eliminating rigidities in the European economies were perhaps one of the main reasons why some European countries had been slow to make the effort, Mr. Zecchini said. Yet there was no reason to believe that structural rigidities could be tackled more effectively when economic activity was stagnant than when an economy was expanding. That conclusion underscored the importance of maintaining economic expansion in the industrial world as well as in developing countries.

He did not agree that sizable public expenditure in relation to GDP necessarily constituted a structural rigidity, Mr. Zecchini commented. Automatic increases in public expenditure could be seen to constitute a rigidity, but the size of such expenditure in relation to GDP did not. The structure and quality of public expenditure could also be seen to constitute structural problems. There had been long discussions in the EC on possible improvements in the quality of public expenditures, and in general they were much more fruitful than discussions merely on the volume of such expenditure. In sum, the dynamics of an economic situation, rather than the magnitudes of certain variables, were of paramount importance.

Mr. Grosche said that he agreed with the Chairman's comments on the performance of the U.S. and European economies and on their relative responsibilities for supporting world economic activity. However, the ability of European countries to take up the slack--particularly by increasing imports from developing countries--resulting from a slowdown in U.S. economic activity should not be overstated. For example, 8 percent of Germany's exports in 1984 were directed to developing countries, and only 10 percent of Germany's imports originated in those countries. Of the DM 434 billion in total German imports in 1984, only some DM 13 billion had come from Latin America. Hence, even if the rate of economic growth in Germany increased by 1 or 2 percentage points as a result of the introduction of expansionary measures--and despite all the risks involved for the German economy--the benefit for Latin America, including the most highly indebted countries, would not be substantial.

Mr. Sengupta commented that he was worried that there seemed to be little appreciation of the fact that a substantial transfer of resources to the developing countries could not occur in the absence of a change in the pattern of growth and balance of payments positions among the developed countries. The present substantial external current account deficit of the United States was absorbing most of available world savings, leaving little to meet the needs of developing countries. As a result, the chances for developing countries to record relatively rapid rates of economic growth were slim.

Industrial countries should be able to coordinate their macroeconomic policies, thereby increasing the chances for developing countries to achieve reasonable economic growth, Mr. Sengupta went on. Such coordination could ensure that there would be no slack in world economic activity if the United States were to reduce the imbalances in its economy. Substantial policy coordination would be needed to ensure that the industrial countries as a group could record an overall external surplus that would make resources available to developing countries. Floating exchange rates had not enabled member countries to adjust sufficiently, and they clearly must be supported by complementary policy efforts, particularly policy coordination to ensure an orderly international trade and payments system while encompassing fiscal and monetary policy.

Whether individual industrial countries wished to stress demand management policies or supply-side policies, their goals--including economic growth rates--should be coordinated, Mr. Sengupta considered. It was no longer valid to assume that individual countries could attempt to maintain their own economic growth path without considering the consequences for the international community. In that connection, the Fund could play a useful role by providing various scenarios based on different assumptions concerning the macroeconomic policies of individual major countries. He was worried because comments by Executive Directors suggested that individual industrial countries were unwilling to accept the need to move away somewhat from their preferred policy approaches in order to make a contribution to maintaining adequate world economic activity. If world economic conditions were to improve, the Fund must play a greater role in encouraging policy coordination among the major industrial countries.

Some of the conclusions in the various staff papers and the assumptions underlying them seemed akin to immutable theological principles, Mr. Sengupta remarked. For example, the staff apparently felt that the public sector had no important role to play in member countries' economies. It was true that each member country should strive for the proper alignment of relative prices to relative resource scarcity, but it was not up to the private sector alone to achieve that balance. Indeed, in some cases, the necessary flexibility in an economy could not be introduced in the absence of public sector intervention. Action by the public sector-rather than the play of normal market forces--might be the most direct means of eliminating a distortion in an economy. Of course, as Mr. Zecchini had stressed, a government that was willing to act to remove rigidities could always do so most efficiently and with the least human and social cost when an economy was expanding than when it was contracting. That conclusion was particularly applicable to developing countries, including those where government intervention played an especially important role in making needed adjustments in the economy.

The Chairman noted that the baseline scenario deliberately included acceptable economic growth rates, especially for developing countries. The policy recommendations for developing and industrial countries under that scenario were designed to achieve acceptable growth rates. Moreover, the remaining scenarios were designed to underscore the consequences for growth rates of the implementation of ideal or inappropriate policies. Member countries were likely to encounter significant problems if, at the least, the pattern of developments described in the baseline scenario were not achieved. It was true that the rigidities in an economy were easier to eliminate in a period of expansion than during a recession. However, experience showed that rigidities tended to accumulate during expansionary periods and that contractionary periods, as they left no margin for maneuver, provided the opportunity to overhaul and reduce rigidities. As to the role of the public sector, the staff had not meant that it had in mind a precise criterion for suggesting whether or not the role of the public sector in any given economy was excessive. The staff had meant to suggest that an excessive volume of nonproductive current expenditure in relation to GDP could create rigidities.

Mr. Ortiz commented that, in principle, greater fiscal discipline, better management, restructuring of public enterprises, and adequate monetary and interest rate policies would help to enhance domestic savings, increase investment, and accelerate growth in developing countries. In fact, in the past there had not been a strong relation between income levels and savings ratios in developing countries; total savings had tended to increase gradually up to a certain threshold level and to decrease gradually thereafter. In the present circumstances, however, including the substantial declines in incomes and living standards in a large number of developing countries, it was difficult to increase the volume of domestic savings, although there seemed to be considerable scope for increasing the efficiency of the use of those savings.

The staff had mentioned that there was room in developing countries to increase government savings at the central government level by improving the management of public enterprises, Mr. Ortiz continued. However, experience suggested that eliminating the fiscal deficit of a central government and increasing the level of central government savings might involve a fall in private sector savings at any given level of foreign savings. Assuming that foreign savings remained constant, the closing of the fiscal gap of a central government through taxation decreased disposable income, thereby reducing total savings. Eliminating the fiscal gap by decreasing the deficit of public enterprises through adequate pricing policies, as the Fund often recommended, also decreased the disposable income of the private sector, thereby reducing savings in that sector.

It was often argued that an increase in real interest rates would enhance savings, Mr. Ortiz noted. In fact, however, such a rise usually caused an increase in financial intermediation. He wondered whether there was strong evidence that real interest rates could increase overall savings in an economy. Adequate interest rates helped to ensure the efficient use of savings, but he doubted whether they could encourage an increase in total savings during difficult periods, particularly when incomes were depressed. In assessing the role of real interest rates in developing countries, Directors should remember that high rates could greatly complicate the adjustment process: countries with a large volume of external debt often also had sizable internal debts that were difficult to service when real domestic interest rates were high. In some of the major Latin American debtor countries, public sector interest payments exceeded the public sector deficit.

The Deputy Director of the Research Department remarked that the evidence suggested that, within the closed-economy framework mentioned by Mr. Ortiz, national savings consisted of public and private sector savings. While those elements of savings were interrelated, there was not an offsetting, one-for-one relationship. Accordingly, a reduction in public sector dissaving would not necessarily be fully offset by a decline in private sector savings. The World Economic Outlook data showed that a decline in a country's public sector deficit in 1984 had typically been associated with an increase in overall national savings; it had not been fully offset by a fall in private sector savings. Accordingly, the evidence suggested that fiscal policy measures could influence the level of national savings.

He was inclined to agree with Mr. Ortiz that real interest rates had an ambiguous effect on aggregate savings, the Deputy Director said. It seemed safe to conclude that they affected the direction of savings. Moreover, real interest rates had the beneficial effect of channeling savings into the financial sector, thereby reducing the amount of savings that leaked out into inflation hedges and through capital flight. In his comments, Mr. Ortiz had deliberately restricted his analysis to the closed-economy context, but one of the main features of highly indebted countries was the loss of savings through capital flight and exports of capital, partly because of inadequate incentives for investment in the domestic economy. The staff had recently noted that the favorable shift in the current account position of developing countries over the previous two years had been helped by the repatriation of flight capital.

He agreed with Mr. Ortiz that a multifaceted strategy was required to combat very high rates of domestic inflation, the Deputy Director of the Research Department remarked. In many countries, the efforts to reduce the fiscal imbalance were merely the first step, particularly where there were institutional mechanisms, such as indexation, which could perpetuate inflationary pressures. If anti-inflationary policies were to succeed, they would have to include not only conventional fiscal and monetary measures but also steps to reduce institutional rigidities that added to the difficulty in successfully implementing demand management policies.

Mr. de Maulde considered that it was important to examine the institutional aspect of savings in developing countries, a matter that seemed to fall more within the purview of the World Bank than the Fund. A number of Fund staff reports had noted the inadequacy of savings mechanisms and institutions in developing countries. It was hardly coincidental that the development of the major countries had been associated with the creation of effective savings institutions and that such institutions were clearly lacking in many developing countries.

Mr. Mtei said that domestic savings had a significant role to play in developing economies. However, in countries where incomes were very low, measures designed to enhance domestic savings would have only limited success. Increases in savings were likely to come primarily from improved management and restructuring of public enterprises. Exchange rate and interest rate policies would probably have no significant effect on an economy in the short run because of structural rigidities that constrained supply responses, and improvements in the institutional framework could be made only in the medium and longer run. In promoting adjustment in developing countries, the Fund should give more weight to measures designed to eliminate supply rigidities, particularly to steps to increase both the supply of inputs and technical assistance in production and marketing. As supply-side policies could not be expected to show positive results in the short term, the design and implementation of adjustment programs should be set in a medium-term framework. Program design should be balanced to ensure that adjustment would take place within the context of economic growth, thereby reducing the cost of adjustment and ensuring that Fund-supported programs would receive popular support in the member countries making needed adjustments.

Mr. Zecchini remarked that developing countries clearly needed to strengthen their productive capacity. Therefore, they must channel that increasing volume of resources to fixed investment. In those circumstances, investment was likely to exceed savings, and, until they completed the development stage, the countries concerned would have to run external current account deficits in order to draw on real resources of the industrial world. That pattern of development did not imply that domestic sources of savings in developing countries were unimportant. Indeed, those sources of savings were crucial when external savings were not available at a cost consistent with the marginal efficiency of capital in developing countries. The main task of domestic savings policy was to create the conditions for the optimal use of savings in the country concerned with a view to enhancing capital accumulation. In that connection, the role of interest rates was to demonstrate clearly the opportunity costs of alternative uses of resources under the strategy aimed at enhancing capital accumulation in developing countries. That strategy was not appropriate for all developing countries. Countries with relatively low per capita incomes had little room to compress consumption expenditure further; indeed, such expenditure in those countries had not reached the level required to ensure an acceptable standard of living. The strategy was applicable to developing countries that had exceeded that income threshold. Those countries should maintain an appropriate interest rate policy as well as other policies that created the conditions for the optimal use of available savings from internal sources and for attracting foreign direct investment.

Inflation was a complex phenomenon that was significantly affected by factors besides the rate of monetary expansion, Mr. Zecchini said. To keep inflation under control at a time of external adjustment, members had to depreciate their exchange rates and maintain appropriate monetary and fiscal policies. Even major developing countries had not consistently supported an exchange rate depreciation with stringent monetary and fiscal policies. An exchange rate depreciation designed to restore competitiveness and external equilibrium must always be supported by appropriate monetary and fiscal policies.

Mr. de Maulde remarked that Mr. Zecchini's conclusions were fully applicable to developing countries that were not suffering from hyperinflation. Experience suggested that only broad-ranging monetary reform could succeed in controlling hyperinflation.

Mr. Leonard considered that further thought should be given to the causes--and particularly the common causes--of very high rates of inflation in member countries. In Brazil, for example, a tightening of monetary policy had seemed to be essential to contain the rapid inflation in that country; in fact, however, a tighter monetary policy had not contained the inflation. Moreover, there had then been a widespread call for a reduction in indexation in Brazil, but there had been some uncertainty about which aspects of the indexation had been significant factors in the inflation. Apparently, there were some causal factors in countries with very high rates of inflation that had yet to be addressed.

Mr. Zecchini commented that excessive growth of the money supply had been an essential cause of rapid inflation in countries, including the European countries that had experienced hyperinflation. In his earlier comments, he had meant to include money supply targets among the inconsistent monetary and fiscal policies that contributed to very high rates of inflation. Brazil had recently faced a steep increase in the money supply owing to the improvement in the external current account. Brazil's failure to remain within the monetary targets had been a root cause of the surge in inflation in that country.

Mr. Suraisry considered that, in assessing the sustainability of the growth of the industrial economies and the appropriate policies to consolidate adjustments in developing countries, Directors should remember that conditions varied significantly among members. Accordingly, such assessments should be made on a country-by-country basis. Policy recommendations for a member country should be based on the particular circumstances of that country.

Some economic policy tools, particularly interest rates, could not be expected to work as efficiently in low-income countries as in highly industrial countries, Mr. Suraisry said. Policy recommendations for developing countries should stress the need to maintain confidence and stability through the persistent application of appropriate policies. No economic tool could be used effectively in industrial or developing countries in the absence of stability and confidence.

He agreed with Mr. Leonard that further study was needed to gain a better understanding of the causes of and solutions to hyperinflation in member countries, Mr. Suraisry remarked. A country should tackle its inflation problem while implementing a strong Fund-supported adjustment program, and Fund surveillance should be used to keep careful track of a country's efforts to combat inflation in the period after the completion of its Fund-supported program, when the authorities would have room in which to tackle the inflation problem but might well feel less pressure to do so.

Mr. Ortiz recalled that it had been mentioned that one of the main sources of inflation in some countries was the authorities' failure to complement an exchange rate depreciation with a sufficiently stringent monetary policy. The course of inflation differed from one country to the next, depending upon the particular conditions in a country. However, a member that eventually introduced a Fund-supported adjustment program typically had experienced some repressed inflation: it had kept constant the prices of goods and services produced by public sector enterprises while subsidizing basic foodstuffs and other items. The subsidies had been reflected in a growing public sector deficit financed mainly through the accumulation of foreign debt or arrears. At the start of its Fund-supported stabilization program, such a member typically depreciated the exchange rate but faced a financial constraint in the form of a limited volume of available foreign savings.

Distorted relative prices were also typical of the first stage of a Fund-supported program, Mr. Ortiz went on, and the authorities' initial efforts to correct relative prices usually introduced some distortions into the country's price mechanism: sudden large jumps in the prices of energy and basic goods and services, in interest rates, and in exchange rates as a part of the desired realignment of prices in the economy made it difficult for participants in economic activities to know what the correct prices actually were. In those conditions of leads and lags in the pricing of goods, the authorities usually introduced a stringent monetary policy with a view to limiting the money supply in order to reduce the rate of inflation. The abrupt decline in the rate of increase in money often seriously disrupted economic activity, and individuals and businesses that lagged in adjusting prices and had difficult liquidity positions often faced serious problems. Anti-inflation policies buttressed by a Fund-supported program were particularly successful in small, open economies where the domestic price level was similar to the external price level, GNP could be adjusted quickly, and price stabilization was achieved fairly rapidly after the source of inflation in the country had been tackled. Inflation was much more difficult to tackle in large, complex economies that had a long history of distorted prices and protected markets. The role of protection in inflation had not been underscored during the present discussion; the contribution of liberalization to anti-inflation efforts should be emphasized.

Mr. Zecchini considered that Mr. Ortiz's conclusions were applicable only to a member that was undertaking adjustment with Fund support for the first time, in which event the existence of rigidities in relative prices was understandable. Those conclusions did not apply to a developing country that had implemented a series of Fund-supported programs over a long period. In the transitory adjustment phase described by Mr. Ortiz, a member would gain a greater advantage from strong, one-time-only measures designed to change expectations dramatically than from piecemeal measures introduced over the longer run that did not change expectations or eliminate serious distortions.

The Chairman said that he sympathized with Mr. Ortiz and Mr. Zecchini. One of the dangers of the situation in a member as described by Mr. Ortiz was the pressure that the authorities would feel to introduce indexation mechanisms in the course of correcting relative prices. Elaborate and sometimes imperfect indexation mechanisms tended to offset efforts to improve relative price relationships. The countries concerned often created serious problems by trying to improve relative price relationships in an increasingly inflationary environment.

Mr. Ortiz said that he fully agreed with the Chairman. A policy of immediately establishing high positive real interest rates was tantamount to maintaining a scheme of partial indexation, in which event the brunt of a country's adjustment effort fell on the sectors not protected by indexation. That was not to say that member countries should avoid establishing positive real interest rates as soon as possible. However, raising those rates complicated the adjustment effort by making sectors unprotected by inflation bear the brunt of adjustment. Moreover, a government's efforts to reduce the fiscal imbalance could be complicated by the increased difficulty in servicing its internal debt because of the rise in real interest rates. In those circumstances, the effort to improve the fiscal balance had to do less with a reduction in the public sector deficit than with the speed at which the private sector was willing to absorb the real amortization of debt by the public sector. In sum, the role of positive real interest rates in adjustment was a complex matter.

The Associate Director of the Western Hemisphere Department remarked that, in a number of cases, the staff had encouraged authorities to permit interest rates and exchange rates to be determined by market forces, but the authorities had felt that such an approach would be inappropriate, and the staff and the authorities had had to reach understandings on how those variables would be managed. It would have been unusual--and in all likelihood inappropriate--for such understandings to include negative real interest rates or exchange rates that continually lagged behind the rate of inflation.

He agreed with Mr. Ortiz on the conditions that typically prevailed in a member country implementing a Fund-supported program for the first time, the Associate Director said. Mr. Ortiz's description was also applicable to a number of countries where the initial stabilization effort had failed and the rigidities and distortions described by Mr. Ortiz still remained. In member countries that had faced a high rate of inflation for a long period and where formal or informal systems of indexation had developed, Fund-supported programs usually were designed to reduce the rate of inflation gradually; it was often assumed that further reductions in the rate of inflation would be made after the completion of the program. It was important to bear in mind the considerable difficulty in implementing such programs and in following them up with appropriate additional measures. The gradual approach suggested that the authorities would be able to spread out the cost of adjustment over time, thereby making adjustment more feasible. In fact, such an approach involved a firm policy commitment over an extended period, and programs were subject to risk from exogenous factors and the wearing out of the patience of the general public. Thus, the magnitude of the adjustment task in such cases should not be underestimated.

When a member implementing a Fund-supported adjustment program had indexation mechanisms, the staff encouraged the authorities to support the adjustment effort through a strong and forward-looking incomes policy designed to lower the rate of inflation, the Associate Director went on. Of course, that effort had to be complemented by monetary and fiscal policies designed to slow the growth of nominal demand. While monetary restraint had a significant role to play, it needed to be adequately supported by fiscal policy. In instances where monetary policy alone had been tightened, the repercussions on interest rates had led in due course to pressures to relax monetary policy. That experience underscored the need to maintain a fiscal policy that provided the monetary authorities with room for maneuver by limiting pressure on interest rates.

There were three basic points to emphasize from the experience of countries undergoing Fund-supported adjustment, the Associate Director noted. First, a member country should go as far as possible on the incomes policy side to complement other adjustment measures; that strategy was the best way to limit the adverse effects on employment of a stabilization effort. Second, the authorities should make an ambitious effort to use fiscal policy to support monetary and credit policy in seeking a reduction in the rate of inflation. Third, even if the authorities maintained a firm incomes policy, there should be no illusions about the strain that the anti-inflation effort would entail, particularly because of the probable effects on unemployment in the short run. For that reason, the staff encouraged a member undertaking a multiyear stabilization effort to front-load its measures in order to put the most painful period of the adjustment effort behind it as soon as possible, rather than extend the discomfort over some years.

There remained the question, the Associate Director of the Western Hemisphere Department remarked, whether the gradual approach to anti-inflation programs was in fact less harsh than a shock treatment, given the relatively long period over which a gradual approach would need to be maintained.

Mr. Sengupta commented that Mr. Ortiz had usefully raised the issue of the quality of Fund-supported adjustment programs. He agreed with Mr. Zecchini that monetary restraint was needed to control hyperinflation or to reduce lower rates of inflation, but, in most cases, Fund-supported adjustment programs should include structural adjustment policies. The kind of shock treatment that Mr. Zecchini had mentioned was applicable only to countries with hyperinflation, in which event strong measures were needed to eliminate the expectation of rapidly rising prices. For countries with lower rates of inflation, however, the way in which the authorities chose to move from the existing set of prices to the equilibrium set of prices might well affect the prices that were finally established. In those cases, the main objective under an adjustment program should be to ensure that prices were moving in the right direction, thereby ensuring that the inflation would not become explosive. To that end, adjustment programs should be spread out over a number of years rather than confined to one or two years, and countries' sources of financial assistance should be prepared to provide relatively large amounts over the longer period, so that the economic system could make a smooth adjustment to the desired set of prices. There should also be constant surveillance of the member's policy stance in order to ensure that the required restraint--particularly in monetary policy--would be maintained.

Fund-supported adjustment efforts should include sectoral programming as well as targets for macroeconomic aggregates in order to ensure that adjustment would be accompanied by economic growth, Mr. Sengupta continued. Accordingly, the adjustment should be designed both to contain nominal demand and to increase aggregate supply by protecting the rate of investment. Under most Fund-supported programs in recent years, adjustment had been achieved at the cost of a sharp fall in the rate of investment. In striving for investment members should bear in mind the particular needs of certain sectors as well as the desirability of maintaining an adequate rate of investment. That conclusion should help to shape policy on subsidies. While some subsidies--for example, a subsidy on fertilizer--should eventually be eliminated, the process should be gradual, as a sudden removal of a subsidy would directly affect agricultural production and could affect the general equilibrium of the whole economy.

In the circumstances that he had described, the extended Fund facility could play an important role in helping members, Mr. Sengupta said. The Fund should continue to work with the international banking community to catalyze resources to assist members in crisis. In that connection, the Fund could continue to play a crucial role in helping the members concerned to introduce and maintain appropriate adjustment policies. In many cases, the Fund's own financial assistance would play a crucial role, particularly in helping countries to keep their payments problems from reaching the crisis stage. The Fund's recent assistance to Brazil had been given only after the economic situation--particularly the rate of inflation--had become critical. A number of other Latin American countries had high rates of inflation but did not yet have an extremely difficult overall economic situation. The Fund could usefully provide contingency planning assistance for those countries within the context of an extended arrangement.

Mr. Dallara remarked that he had noted with concern that, in many countries, the ratio of government savings to GDP had generally been reduced in the period after the implementation of a Fund-supported program. However, nongovernment savings and investment as a percentage of GDP had tended to increase while Fund-supported programs were being implemented. He wondered what scope existed for the Fund to encourage additional reductions in consumption in order to make more room for investment. It was his impression that the Fund had generally encouraged reductions in consumption, but that members had often resisted making such cuts and had had to reduce investment expenditure in order to achieve a satisfactory overall fiscal stance. Further thought should be given to designing programs that would not hinder investment.

Countries with high rates of inflation might make considerable progress in bringing the inflation under control by substantially liberalizing their trade regimes in a fairly short period, Mr. Dallara commented. A kind of shock approach to trade liberalization might help to bring inflation under control if it were complemented by the appropriate monetary, fiscal, and wage policies described by the staff. Major changes in their financial systems might also help members to reduce a high rate of inflation. For example, some countries could sharply reduce their controls on the direction of bank credit within the economy.

The Associate Director of the Western Hemisphere Department noted that the ratio of investment to GDP had been reduced in a number of countries that had implemented Fund-supported stabilization programs, but many of those countries had experienced a sharp decline in available foreign savings from unsustainable levels; in such circumstances, investment inevitably had to bear some of the adjustment burden. At the same time, however, a number of countries had made large adjustments in their fiscal positions in attempting to shield domestic investment from the effects of a reduction in available foreign credits. In discussions between members and the staff, considerable attention was given to means of curbing current outlays.

The staff assigned an important role to trade liberalization in Fund-supported stabilization programs, and many countries were convinced of the benefits of that approach, the Associate Director said. However, there was no certainty that trade liberalization would bring with it a significant decline in the rate of inflation in a member, particularly when the country was unable to afford to increase imports to any great extent. Still, the staff attached considerable importance to encouraging members to permit the price mechanism to determine the flow of imports, thereby establishing the basis for improving efficiency over the longer run. Trade liberalization might well help to prevent very high rates of price increase in various sectors, but it alone was not a major anti-inflation instrument.

Mr. Finaish recalled that most Executive Directors had made the case for an increase in concessional aid to the low-income countries because of their lack of access to other sources of finance and because of their need for financial flows that would not complicate their future debt service obligations. One of the main questions was the possible sources of an increase in concessional assistance. The World Bank had made some initiatives in that area. Some Executive Directors had said that their authorities faced budgetary constraints and could not be expected to make a significant contribution to concessional aid, and some others had stated that, despite budgetary constraints, their authorities planned to maintain relatively high ratios of official development assistance to GNP. He was confident that, at least for humanitarian reasons, all the participants in the coming Interim Committee would address the issue of concessional assistance. Of course, concessional aid donors would expect their assistance to be used as effectively as possible, but that particular issue was best dealt with by other international organizations.

The role of the Fund vis-à-vis low-income countries should be seen in the context of access policy and the nature of the adjustment the Fund encouraged member countries to undertake, Mr. Finaish continued. An important factor in determining access to Fund resources by low-income countries was their ability to repay the Fund, and, in that context, many

Executive Directors had concluded that the role of the Fund in helping low-income countries would have to be limited to that of a catalyst of resources. If that conclusion were correct, the least that should be expected was that the Fund would play its role as a catalyst as effectively as possible. Low-income countries that approached the Fund for assistance in the coming period would generally have already made substantial adjustment efforts, would have little room for additional measures to cut demand further, and might well have income and consumption levels below subsistence. Accordingly, adjustment programs for those countries should stress supply-oriented policies. A further comment on the Fund's role in assisting low-income countries would be helpful.

Foreign direct investment should not be a substitute for other kinds of financial flows, Mr. Finaish considered. Such investment was useful for host countries, as it did not add to their debt service burden and could involve a transfer of technology and managerial resources. There were also potential disadvantages, such as a loss of control of domestic economic activities and the inappropriate exploitation of natural and human resources. Of course, foreign direct investment was not available to all countries; some low-income countries could not hope to attract foreign direct investment even after making a considerable effort to do so, as they lacked the necessary infrastructure or were unattractive for noneconomic reasons.

It was difficult to draw general conclusions about foreign direct investment, Mr. Finaish continued. The appropriateness of such investment for member countries should be considered on a case-by-case basis. Some developing countries were apprehensive about such investment for historical reasons. The same apprehensions were evident in many industrial countries: oil exporting countries that had explored investment possibilities in industrial countries had found that some of those countries were fearful of such investment and not very open to it. The investment needs of each potential host country should be carefully considered. The emphasis on joint ventures and equity participation by host countries should be increased.

The Chairman considered that low-income countries should not be excluded from receiving Fund assistance in the coming period. They would clearly need relatively substantial official development assistance--preferably on concessional terms--for a long time to provide the savings needed to expand their economic base. That was not the proper task of the Fund; increasing member countries' access to Fund resources would not meet low-income countries' need to expand their economic base. The other relevant international institutions and bilateral donors should transfer real resources to those countries for a considerable period through either grants or long-term concessional loans. At the same time, the low-income countries should manage their domestic economy in an appropriate manner. Current account deficits were sometimes reversible through the adoption of appropriate domestic policies. The Fund could provide policy advice and financial assistance to help member countries to maintain appropriate policies designed to eliminate imbalances in their economy, provided that the basic inflow of capital needed to expand the economic base was maintained.

The Fund could continue to step in to help a low-income country to meet external challenges and to reverse domestic imbalances, the Chairman went on. Of course, it was often difficult to tell whether problems facing an economy could be reversed in the short run or were structural. The Fund had to be cautious lest it be seen as a country's main source of financial assistance in tackling structural problems. The Fund was not designed to tackle such problems and did not have the resources to do so. Indeed, the Fund would lose its credibility if it were to pretend to have the resources and tools to solve members' structural problems. Accordingly, the Fund would have to be cautious in the way in which it assisted low-income countries; it could provide relatively modest amounts of financial assistance and help the authorities to improve the domestic situation, thereby encouraging other donors to participate in concerted action to assist the member in solving its structural and other economic problems. If that approach were used effectively, the Fund could conceivably remain involved in an individual member for some time; however, it could not do so merely by increasing access, which would create lumps in countries' debt profiles, thereby increasing the difficulty that they would have in making timely repayments. The Fund would have to approach low-income countries cautiously, working in close collaboration with other international institutions, particularly the World Bank.

As Mr. Finaish had stressed, some developing countries did not have access to foreign direct investment, the Chairman said. In assessing the attractiveness of countries to investors abroad, he himself would also emphasize the importance of the quality of the host's domestic policies. Members maintaining policies that made investments profitable and furthered a climate of confidence were more likely to attract investment from abroad.

Mr. Leonard considered that sufficient attention should be paid to the potential benefits of foreign direct investment, which could make a significant contribution to a country's development. A number of low-income countries were not in a position to make the optimal use of such investment. Direct investment not only immediately benefited the sector in which the investment occurred, but also provided broader benefits in the form of improved managerial and technical expertise that could positively affect domestic suppliers. Host countries should have a clear idea of what they wished to achieve from foreign investment. Some of them might wish to use the receipts from industries supported by foreign investment to finance programs of education and training, including, for example, scholarships. The Fund, working with the World Bank, could provide the expertise that would enable host countries to make the best possible use of investment from abroad.

Mr. Finaish said that he fully agreed that the host countries should encourage foreign direct investment by maintaining appropriate policies and a stable environment. The Fund recommended those policies during

Article IV consultations, and it was in that connection that the Fund had an important role to play in encouraging foreign direct investment. The Fund should not attempt to influence the specific terms or kinds of direct investment; that role could be better played by the World Bank and the International Finance Corporation. In addition, host countries should clearly stress their needs and concerns with respect to foreign investment, for instance, the sectors requiring such investment and the projects that would be appropriate; it was in those areas that problems might well arise.

Mr. Ortiz commented that debtor countries could significantly reduce current expenditures if interest rates were to decline. A drop of 2 percentage points in international interest rates reduced the public sector deficit of debtor countries by the equivalent of 1 percent of GDP. However, he agreed with the staff that current expenditures could also be reduced by cutting employment in the many debtor countries where public sector overstaffing was evident.

The Chairman said that he would sum up the discussion on April 5, 1985. 1/

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/85/53 (4/3/85) and EBM/85/54 (4/3/85).

2. KENYA - EXCHANGE SYSTEM

The approval of Kenya's exchange restrictions arising from limitations on foreign exchange made available for certain imports, and for dividend and rental income remittances under Decision No. 7701-(84/78), adopted May 16, 1984, is extended until October 31, 1985, or the completion of the 1985 Article IV consultation with Kenya, whichever is the earlier.

Decision No. 7944-(85/54), adopted
April 3, 1985

1/ The Chairman's summing up was made at EBM/85/55 (4/5/85) and was circulated in SUR/85/37 (4/5/85).

3. SOCIALIST PEOPLE'S LIBYAN ARAB JAMAHIRIYA - EXCHANGE SYSTEM

The approval of the Socialist People's Libyan Arab Jamahiriya's restrictions arising from limits on the access to foreign exchange for certain travel abroad under Decision No. 7817-(84/146), adopted October 3, 1984, is extended until June 30, 1985 or the completion of the 1985 Article IV consultation with the Socialist People's Libyan Arab Jamahiriya, whichever is the earlier.

Decision No. 7945-(85/54), adopted
April 3, 1985

APPROVED: February 3, 1986

LEO VAN HOUTVEN
Secretary