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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/55

10:00 a.m., April 5, 1985

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
A. Alfidja	
	M. K. Bush
	S. Kolb, Temporary
	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. A. Arias
H. Lundstrom	H. Fugmann
E. I. M. Mtei	A. Abdallah
	B. Jensen
Y. A. Nimatallah	J. E. Suraisry
P. Pérez	G. Ortiz
J. J. Polak	J. de Beaufort Wijnholds
	A. V. Romuáldez
G. Salehkhou	O. Kabbaj
A. K. Sengupta	A. S. Jayawardena
	T. A. Clark
S. Zecchini	N. Coumbis
	Wang E.

L. Van Houtven, Secretary
B. J. Owen, Assistant

Also Present

Administration Department: V. R. Sertic. African Department: C. V. Callender. European Department: J. K. Salop. Exchange and Trade Relations Department: C. D. Finch, Director; M. Guitián, Deputy Director; M. R. Kelly. External Relations Department: A. F. Mohammed, Director; N. K. Humphreys, H. P. G. Handy. Fiscal Affairs Department: V. Tanzi, Director. IMF Institute: O. B. Makalou. Legal Department: G. P. Nicoletopoulos, Director. Middle Eastern Department: J. G. Borpujari, S. von Post. Research Department: A. D. Crockett, Deputy Director; R. R. Rhomberg, Deputy Director; J. Artus, M. C. Deppler, S. J. A. Gorne, M. D. Knight, A. Lanyi, D. J. Mathieson, T. K. Morrison. Secretary's Department: A. P. Bhagwat. Treasurer's Department: J. E. Blalock. Western Hemisphere Department: E. Hernández-Catá. Bureau of Statistics: J. B. McLenaghan. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: J. Hospedales, G. E. L. Nguyen, J.-C. Obame, G. W. K. Pickering, T. Sirivedhin, E. M. Taha, A. Vasudevan, M. A. Weitz. Assistants to Executive Directors: E. M. Ainley, H. Alaoui-Abdallaoui, W.-R. Bengs, J. Bulloch, M. B. Chatah, Chen J., J. J. Dreizzen, V. Govindarajan, Z. b. Ismail, A. K. Juusela, H. Kobayashi, R. Msadek, K. Murakami, A. Mustafa, E. Olsen, W. K. Parmena, M. Rasyid, J. Reddy, D. J. Robinson, J. E. Rodríguez, A. A. Scholten, L. Tornetta, A. J. Tregilgas, E. L. Walker, B. D. White, A. Yasseri.

1. WORLD ECONOMIC OUTLOOK

The Executive Directors resumed from the previous meeting (EBM/85/54, 4/3/85) their review of the world economic outlook.

The Chairman made the following summing up:

In this summing up, I will deal first with the comments that were made on the staff's analysis of economic developments and prospects, then attempt to cover the main policy issues that attracted the attention of Executive Directors.

1. Recent economic developments

Directors welcomed the improvements that had taken place in the world economy during 1984, though it was agreed that there was no cause for complacency. On the positive side, output in the industrial countries had grown by almost 5 percent, the best performance in eight years, and inflation had continued to recede. While expansion had again been strongest in the United States, Directors noted that the geographical basis of recovery was broadening, with a marked acceleration of growth in Japan and a firming of output trends in Europe. A most encouraging feature of recent developments was the strength of business fixed investment.

Most Directors felt that the improved economic performance in industrial countries owed much to the firmness with which counter-inflationary monetary policies had been implemented and the improved climate of expectations for price stability to which this firmness had given rise. At the same time, it was noted that demand growth in the United States had been supported by fiscal incentives to invest, by the impact of the enlarged budget deficit, and by the generally greater flexibility with which the U.S. economy functioned. The strength of economic performance in the United States had acted as a strong stimulus to output growth in the rest of the world. The flexibility in its economy had also helped Japan to respond successfully to the growth of foreign demand, but, in Europe, rigidities had tended to limit the pace of economic recovery.

For the developing countries as a group, it was noted that a continuing improvement in the external position had been accompanied in 1984 by an encouraging increase in growth. For the nonfuel exporting developing countries, the current account deficit in relation to exports of goods and services had been reduced last year to the smallest size on record. At the same time, output had grown more rapidly than it had for several years, reaching 3 3/4 percent for developing countries as a whole, and 4 1/2 percent for the nonfuel exporting group. The reasons for this improved performance were generally felt to lie both in the better policies that had been adopted in the wake of debt servicing difficulties and in the strengthening of the external environment that had accompanied the continuing recovery in industrial countries.

While noting these various improvements in the international economy, Directors also stressed that there was a negative side to developments in 1984 that should not be forgotten. In the industrial countries, recovery had so far done little or nothing to alleviate the serious unemployment problem afflicting most European countries. Interest rates had remained high and had behaved unpredictably. Moreover, the discussion highlighted doubts about the sustainability of the prevailing pattern of exchange rates and current account balances. Directors felt that there was no single explanation for these phenomena, but the discussion generally identified several main factors contributing to the recent developments in exchange rates and balance of payments positions. These were: the persistence of high fiscal deficits in the United States; the difficulties encountered by European countries in dealing with structural rigidities; the success of the United States in stimulating strong growth in investment; and the continued high rate of domestic savings, relative to domestic investment, in Japan. I shall return to these themes in summarizing the discussion on policy issues.

In developing countries, the encouragement that could be taken from the improved performance of 1984 must be tempered by recalling that average living standards remained below those of the early 1980s; that unemployment and underemployment, though not monitored in available statistics, were worryingly high in many countries; that many countries, including some of the poorest, had failed to share fully in the average growth; and that the external position of a number of countries remained fragile. Directors from developing countries reminded us forcefully that much remained to be done if the momentum of development were to be restored to the pace considered normal in the 1960s and 1970s.

It was also pointed out that much of the improvement that had taken place in the external position over the past several years had reflected import compression in the face of extreme financial stringency. In this sense, Directors noted that the reduction in current account deficits that had taken place was not an unalloyed benefit, especially since it had been accompanied in many countries by cuts in the share of investment in GDP. Another disturbing phenomenon that a number of Directors alluded to was the persistence of worryingly high rates of inflation in a number of important countries. Thus, the success of adjustment policies would remain incomplete until growth rates and capacity utilization had been brought back on a proper track in a noninflationary climate.

2. Future prospects

While Directors for the most part accepted that the assumptions underlying the staff projections were reasonable, several Directors expressed concern that, unless the growth performance in the industrial countries outside the United States were to strengthen significantly in the near term, a period of below-trend output growth might well develop, which, in turn, would adversely affect the growth and export prospects of developing countries. In the same context, some Directors rightly noted that the staff's medium-term projections should not lead to complacency with regard to the financing role of the Fund, a matter to which I shall return later.

The key features of the baseline projections to 1990 that were singled out by Directors as particularly significant included the following: growth in the industrial countries at just over 3 percent per annum, with output in Europe and North America expanding at about the same pace and Japanese growth being somewhat more rapid; continuing moderate inflation in the industrial world, at just under 4 percent per annum; a stabilization in the current account deficit of developing countries at about 6-8 percent of exports; growth in developing countries over the medium term at about 4 3/4 percent; and a decline in the debt ratio of developing countries that would bring this ratio back to somewhat below the level prevailing in 1980.

A feature of the medium-term projection that Directors asked the staff to study in more detail was the development of unemployment in industrial and developing countries.

By and large, it was felt that the outcome of the baseline scenario could be regarded as satisfactory, though only barely so. Directors considered that the simulations presented in the staff's variant scenarios showed that there was very little room for policy slippage. A point that was made forcefully was that the prospects for African countries, entailing very little per capita income growth under the baseline scenario, would become even bleaker if the results of the "worse policies" scenario were to materialize.

A number of Directors alluded to the fact that economic performance in developing countries was relatively more susceptible to shifts in industrial country policies than to policy changes that the developing countries themselves might adopt. They considered that this aspect of the staff's scenarios underlined the responsibility that fell on the authorities of the industrial countries but, at the same time, they agreed that this finding in no way reduced the responsibility of indebted countries to follow prudent adjustment policies.

3. Policy issues in industrial countries

In discussing the overall economic strategy being pursued by industrial countries, Directors generally remained convinced that it was essential to frame policy in a medium-term context. Such a context involved: the steadfast pursuit of anti-inflationary monetary policies; fiscal policy aimed at curbing the share of output absorbed by current public outlays and steadily reducing the share of private saving pre-empted by fiscal deficits; and structural policies directed at improving the functioning of labor, financial, and goods markets, thus enhancing the flexibility of resource allocation. Better harmonization of policies was generally endorsed, although it was recognized that the recent policy divergences between the United States and other industrial countries had played a useful role in permitting the rather different policy objectives in the two regions to be achieved simultaneously.

It was felt that the best contribution to sustaining and broadening the recovery would be to strengthen the implementation of the medium-term strategy. This implied in particular a determined attack on the fiscal deficit in the United States, which, most Directors stressed, was a major priority. It was also noted that a number of other countries needed to strengthen their fiscal policies and that the composition of expenditures and revenues, as well as the size of the overall deficit, was important in determining the economic impact of a given fiscal stance. Attention was drawn to the persistence of widespread rigidities in the functioning of markets, particularly in the operation of labor markets in European countries. A determined effort to tackle these rigidities promptly would improve the prospects of more evenly distributed growth among the industrial countries. Another manifestation of inflexibilities that was mentioned was the disturbing increase in protectionism, about which I shall have more to say later.

Several Directors drew attention to the room that they considered existed in some countries for less restrictive financial policies. For those industrial countries where the balance of payments was strong, inflation low, and domestic demand growing only moderately, these speakers felt that relatively less emphasis could be placed on fiscal retrenchment. It was pointed out, for example, that growth in Japan had thus far relied to an excessive and probably unsustainable degree, in the view of those Directors, on the external sector. Many Directors, however, felt that the dangers of a relaxation in demand management outweighed any potential benefits. Directors from those countries whose room for maneuver was said by some speakers to be greatest pointed out that domestic demand had begun to grow more rapidly in the absence of fiscal stimulus, and they feared that any change in policy thrust would undermine credibility in the medium-term constancy of policy.

An issue that received particular attention was the sustainability of the domestic and external positions being projected by the staff. It was widely agreed that the strength of the dollar and the widening of the U.S. current account deficit owed much to the size of the U.S. federal government deficit and the role that fiscal measures had had in stimulating investment and pushing up interest rates. While noting Mr. Dallara's view that causality in the field of fiscal policy, interest rates, and exchange rates was a complicated phenomenon, and that many factors had combined to produce the observed trends in the U.S. external position, Directors wondered whether the possibility of financial uncertainties would tend to affect the viability of the output and balance of payments trends in the staff's scenarios. It was pointed out that existing and projected current account imbalances implied an unprecedented redirection of global savings, and a very large accumulation of claims on the United States, with the debt servicing consequences attached to such a phenomenon. If a reassessment of the external value of the dollar were to occur on the markets, Directors noted that it would have implications for exchange rates, relative inflation rates, and output trends that were hard to identify precisely in advance. A number of Directors therefore stressed the importance of policy measures that would facilitate a smooth convergence to a more sustainable pattern of exchange rates. At the same time, it was stressed that, if substantial exchange rate movements were to occur, the response of the major countries should be carefully coordinated so as to avoid unnecessarily adverse repercussions on output and inflation. Thus, the vulnerability attached to the present and projected external positions was seen as one of the important challenges to policymakers in the industrial countries and to the Fund.

4. Policy issues in developing countries

In the matter of external adjustment, there seemed to be little practical alternative for developing countries to maintaining external deficits that, in the aggregate, were close to the magnitude (relative to exports of goods and services) currently prevailing. At such a level, these deficits might well be somewhat lower than would be sustainable in the longer term. This, however, was an unavoidable consequence of the process of correcting for past overborrowing. So long as the outstanding stock of debt remained above a level that could be comfortably serviced, it would be necessary to limit further borrowing for some time.

In the field of domestic adjustment, it was acknowledged that much remained to be done. A number of Directors drew attention to the sharp cutback in investment that had accompanied the adjustment efforts, and stressed that it was in general not sustainable to base adjustment policies on the curtailment of investment expenditures. What was necessary was the firm pursuit of policies that would lead to parallel increases in domestic investment and savings, so that productive capacity would be enhanced and the hard-won improvements in the external sector safeguarded. Indeed, Directors generally stressed that the enhancement of domestic savings in developing countries was of paramount importance for the acceleration of investment and growth. A number of Directors drew attention to the hardships, in terms of domestic living standards, that had accompanied the adjustment process. They wondered whether, from a political standpoint, the policies that gave rise to such hardships could be maintained much longer and felt that both multilateral and bilateral creditors should give this consideration greater weight in their decisions about providing financial support, particularly official development assistance (ODA) to low-income countries.

In dealing with the issue of development strategy, Directors generally endorsed the pursuit of outward-looking strategies. Many Directors drew attention to the linkage between development strategy and the international trading climate. In their view, pursuit of an outward-looking development strategy in developing countries would be greatly encouraged by trade liberalization in industrial countries, and would receive a severe setback from further protectionist measures.

5. Role of the international community

In discussing the question of capital flows to developing countries, several Directors from these countries felt that the staff had given insufficient attention to the central role to be played by an adequate flow of ODA. Given unavoidable limitations on flows of commercial credit, ODA would play a key role in supporting the adjustment and development efforts of a number of countries, in particular the low-income countries of sub-Saharan Africa. Other Directors, while agreeing with the importance of adequate flows of ODA, emphasized the need for appropriate macroeconomic policies to enable concessional assistance to be more effectively used than at times in the past. The potential contribution that private direct investment could make both to the balance of payments and to the domestic development effort was stressed in a number of interventions.

Let me turn now to the issue of protectionism. The point that was made most consistently and emphatically in the entire discussion was the need to resist and, where possible, roll back protectionism. Every Director addressed this issue, and each one stressed the paramount importance of vigilance in this respect. Speakers referred to the lengthy consideration of protectionism in staff papers recently discussed by the Board. Among the key points made in this area were: the relationship between protectionist pressures and current account imbalances among the industrial countries; the linkage between resistance to protectionism and the satisfactory resolution of the debt issue; the self-defeating nature of protectionist actions undertaken to support the balance of payments or overall employment levels; the support that liberal trade offers to the adoption of outward-looking development strategies; and the potential for reciprocal action by trading partners in response to any measure (whether of restriction or of liberalization) in the trade sphere.

In dealing with the role of the Fund, I have already referred to the challenges to the international community and the Fund of facilitating a smooth transition to sustainable external positions among industrial countries and of achieving the baseline scenario while avoiding below-trend output growth in the medium term and of maximizing the chances of achieving the better scenario. As far as developing countries are concerned, Directors considered that the Fund would continue to play an important role in the period ahead and that it needed to maintain the necessary flexibility to respond appropriately to changing circumstances and to the needs of members. In sum, it was the view of the Board that the Fund should continue to assist members in the design of appropriate adjustment policies, to encourage flows of finance that would support adjustment efforts and be compatible with debt servicing capacity, and to exercise firmer surveillance over the policies of all member countries, especially those larger countries whose economic policies had major implications for the rest of the world.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/85/54 (4/3/85) and EBM/85/55 (4/5/85).

2. TRADE POLICY ISSUES AND DEVELOPMENTS - PUBLICATION

The Executive Board approves the proposal for the publication, in the series of Occasional Papers, of a staff paper entitled "Trade Policy Issues and Developments" (SM/85/60, 2/19/85; Sup. 1, 2/25/85; and Sup. 2, 2/25/85), as set forth in EBD/85/90 (4/1/85).

Adopted April 4, 1985

3. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 84/107 through 84/109 are approved. (EBD/85/86, 3/28/85)

Adopted April 3, 1985

4. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/85/87 (4/2/85) and EBAP/85/89 (4/3/85) is approved.

APPROVED: February 5, 1986

LEO VAN HOUTVEN
Secretary