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ROOM C-120 04

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/143

10:00 a.m., September 16, 1985

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

Executive Directors	Alternate Executive Directors
A. Alfidja	Mawakani Samba
C. H. Dallara	M. K. Bush
J. de Groote	
B. de Maulde	S. de Forges
M. Finaish	T. Alhaimus
H. Fujino	M. Sugita
G. Grosche	B. Goos
	Jaafar A.
R. K. Joyce	L. Leonard
A. Kafka	H. A. Arias
T. P. Lankester	T. A. Clark
H. Lundstrom	
E. I. M. Mtei	
F. L. Nebbia	
Y. A. Nimatallah	J. E. Suraisry
	G. Ortiz
J. J. Polak	J. de Beaufort Wijnholds
C. R. Rye	
G. Salehkhou	O. Kabbaj
A. K. Sengupta	A. S. Jayawardena
S. Zecchini	N. Coumbis
Zhang Z.	Jiang H.

L. Van Houtven, Secretary
R. S. Franklin, Assistant

Also Present

Administration Department: J.-P. C. Golle. African Department: D. E. Syvrud. Asian Department: A. Ariyoshi. European Department: P. Dhonte, L. J. Lipschitz, G. Szapary. Exchange and Trade Relations Department: C. D. Finch, Counsellor and Director; G. Belanger, S. Kanesa-Thasan, C. M. Watson. External Relations Department: A. F. Mohammed, Director; N. K. Humphreys, Chief Editor; I. S. McDonald. Fiscal Affairs Department: V. Tanzi, Director; A. H. Mansur. 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; J. M. Boughton, M. C. Deppler, R. A. Franks, P. Gotur, R. D. Haas, O. E. G. Johnson, A. Lanyi, F. B. Larson, P. R. Masson, D. J. Mathieson, P. J. Montiel, B. E. Rourke, M. C. Williamson. Western Hemisphere Department: S. T. Beza, Associate Director. Bureau of Statistics: J. B. McLenaghan. Advisors to Executive Directors: A. A. Agah, P. E. Archibong, D. Hammann, J. Hospedales, H.-S. Lee, G. Nguyen, P. Péterfalvy, G. W. K. Pickering, M. Z. M. Qureshi, T. Sirivedhin, E. M. Taha, A. Vasudevan. Assistants to Executive Directors: I. Angeloni, W.-R. Bengs, M. B. Chatah, A. K. Diaby, J. J. Dreizzen, G. Ercel, V. Govindarajan, N. Haque, G. D. Hodgson, Z. b. Ismail, S. King, S. Kolb, A. H. Mustafa, E. Olsen, M. Rasyid, A. A. Scholten, L. Tornetta, A. J. Tregilgas, E. L. Walker, B. D. White, Yang W., A. Yasseri.

1. WORLD ECONOMIC OUTLOOK - GENERAL SURVEY

The Executive Directors considered a general survey paper on the world economic outlook (EBS/85/201, 8/26/85; and Cor. 1, 9/9/85), together with technical notes on the sensitivity of projections to changes in certain key assumptions (EBS/85/201, Sup. 2, 8/28/85) and the statistical appendix (EBS/85/201, Sup. 1, 8/26/85; and Cor. 1, 9/9/85).

Mr. Kafka observed that the main policy problem confronting the world economy at present was derived from the increasing uncertainty about whether or not it would be possible to maintain even the low growth rates of the industrial countries forecast through the end of the decade. Moreover, the danger existed that, as a result of that uncertainty and because of intensified protectionism, the growth rate of developing countries might be much lower than currently foreseen. Against that background, the staff report was far too optimistic in tone, despite its careful qualifications. Whether, in the circumstances, the staff should speak in the published version of an expectation of an unchanged medium-term scenario with an increased downside risk, or whether it should revise its base scenario downward and speak of an increased upside hope might well be a matter of taste; but the former formulation risked encouraging all the Candide-like propensities from which too many of the world's major nations seemed to suffer, if not in a cognitive sense then at least in the sense that they were not making the efforts that they should be making to promote faster noninflationary growth.

The sensitivity of growth in the developing countries to growth and trade and other policies in the industrial countries was well known and had been clearly described in the papers for both the current and the spring 1985 World Economic Outlook exercise, Mr. Kafka continued. A favorable outcome for the present economic malaise in developing countries required action to improve medium-term growth prospects in the industrial countries and to strengthen the resistance to protectionism. The factors that were likely to impede growth in the industrial countries were well known. The absorption of an important share of the world's savings by U.S. fiscal deficits and the multifaceted other consequences of those deficits were of central importance. In Germany, there had been recent, but too hesitant, signs of a greater disposition to advance fiscal--and perhaps even monetary--stimuli. In Japan, despite the high savings ratio, the preoccupation of the authorities with the fiscal deficit would continue to predominate over other considerations. In the policy advice provided by the Fund to the industrial countries, Executive Directors had in his view been far too impressed by the undoubted dangers to medium-term growth posed by a resumption of inflation; and they had been far too little impressed by the even greater danger posed by prolonged low growth. Perhaps Directors had been too timid in considering a 3 percent industrial growth rate as respectable, although the industrial countries had shown they could do better and no longer could blame an oil shock for doing worse.

A second great danger to developing country growth was increased protectionsim, Mr. Kafka remarked. At present, the fight against protectionism was being threatened by congressional pressure in the United States, despite the more liberal attitude of the Executive Branch that deserved recognition; and that danger would continue unless the fiscal and current account deficits declined in an orderly fashion. There was also no sign of any change in the pervasive protectionsim of industrial and agricultural export subsidization policies in the European Community; and Japan appeared to be retreating only very slowly from its predilection for an undervalued currency, with the capital exports that sustained undervaluation going too often to industrial countries and too seldom to the developing world.

Even if the industrial countries were able to attain the 3 percent annual growth rate shown in the scenario and the developing countries were able to achieve the corresponding 4.5-5 percent growth rate by the end of the decade, that would not be sufficient to absorb the unemployment created in the 1980s or even to prevent its increase, Mr. Kafka commented. The consequences were obvious: since they had no social security systems, which they could ill afford, people in the poor nations of the world must have the chance to work. The alternatives were far too dangerous to be worth the risk. While capital-labor ratios were flexible in the long run, in the short and medium run lowering these ratios could not enable an economy to raise employment, despite lower growth and savings ratios, which were closely connected.

The first requirement for resolving the current global economic difficulties was that the macroeconomic policies of the industrial countries, other than the United States, should switch from an exclusively anti-inflationary stance to one that gave due weight to the most rapidly sustainable demand growth while making continued progress to remove supply rigidities. The correct prescription for the United States was not in dispute, although he was tempted to ask whether, pending further dollar depreciation, the authorities should not look again at Keynes's 1930 tax-cum-subsidy scheme. The second requirement was to resist new protectionism--industrial and agricultural--and to roll back existing protectionist measures.

Another element of the problem was the international debt crisis, Mr. Kafka observed. While the debt problem had lost some of its drama for the moment, it continued to be serious; and the drama could easily be resumed. Even assuming a continuation of the current situation in which the major debtors at heavy cost were able to pay interest on their loans, if the world entered a new recession or if protectionism intensified, the basic conditions on which their ability to pay was based would fail, with obvious consequences. Since the world would have to face the possibility of debt crises for many years to come, it was legitimate to ask whether the world economy at present was sufficiently well prepared to face them. In several respects, it appeared that the world was less well prepared than in the past. He needed only to mention the problem of bridging credits, including the Fund's own former type of bridging credit; the compensatory financing facility, which was no longer quick disbursing because of an entirely inappropriate increase in conditionality; the violent reduction in effective access to the Fund's resources under its tranche policies together with intensified conditionality; the closely related reluctance of the Fund's major members to consent either to adequate quota increases or to the growth of official borrowing; the refusal of those same members to permit Fund borrowing in the private markets and their insistence, thus far, on utilizing the General Arrangements to Borrow (GAB) for the benefit of developing countries only in the case of "systemic" crises in the international financial system.

It must be understood that the Fund was not only a financial institution, Mr. Kafka said. Its prestige placed upon it the obligation to continue to develop solutions to the evolving character of the debt problem rather than to be satisfied with past practices or strenuously to resist innovations. More insistence was necessary on the correction of levels of interest rates and fees, whose reduction should not necessarily have to be linked to multiyear reschedulings. The Fund should also explore new forms of concerted lending and shift a greater part of the burden of financing--especially where that burden arose not because of any policies of the debtor countries but because of unfavorable developments in the world economy--to official as well as to multilateral creditors, which should be provided with more access to resources. It was important to encourage new thinking on the part of bank regulatory agencies. The strengthening at a prudent rate of the capital base of commercial banks and the requirements for the establishment of loan loss reserves were welcome, but there was a danger that those prudential innovations could lead to an unintended reduction in access at a time when it was badly needed, a point elaborated upon by the Group of Ten (G-10) in its recent report on the international monetary system. Fund surveillance, even enhanced surveillance, weighed heavily on countries requiring access to the Fund's resources or the institution's "good conduct certificate" in other forms, but it was notoriously ineffective over all other countries, including the major trading countries, whose conduct determined the shape and development of the world economy; and that discrepancy could not be resolved by simplistic formulas. Those matters were the responsibility of the Fund and, therefore, the responsibility of those members holding the decisive voting power in the institution, and it was important for them to speed up discussions on reform of the international monetary system.

Finally, the developing countries themselves bore primary responsibility for their growth, Mr. Kafka said. As clearly brought out in the April 1985 World Economic Outlook exercise, the policies of the industrial countries had a disproportionately strong effect on the developing countries, stronger, in fact than those countries' own policies. Nevertheless, if the developing countries were to grow, they must rely increasingly on their own efforts, in particular on their own savings, through appropriate monetary and fiscal policies. They must also adopt proper pricing policies, including exchange rate policies, to preserve stimuli, rationalize their own protectionism and encourage capital flows, and reduce the obstacles to development of trade within their own regions. For global growth to recover, the industrial and the developing countries must carry out the appropriate policy prescriptions.

Mr. Ortiz remarked that during the spring 1985 World Economic Outlook exercise, his chair had expressed reservations about the sustainability of the 1984 recovery and about the staff's appraisal of the possible evolution of world economic activity in the short and medium term. Unfortunately, the events of the first part of 1985 had shown that the pace of economic expansion of the world economy for the year as a whole would be weaker than anticipated six months previously. That revelation, together with the steep decline experienced in commodity prices, had significantly clouded the prospects for developing countries.

In its latest reassessment of world economic prospects, the staff had revised downward by some 10 percent the growth estimates for developing countries in 1985 and 1986. It had also emphasized the uncertainties and risks surrounding the assumptions on which the projections for 1985 and the medium term were based. However, in spite of the bleaker picture for 1985 and 1986, the basic medium-term scenarios remained unchanged and, as a corollary to its unchanged perceptions for the medium term, the staff had maintained without modification its policy prescriptions. He found the approach to be odd and reiterated his doubts about the staff's appraisal of the world economic situation, particularly its assessment of the situation facing the developing countries. While the staff had considerably tempered the excessive optimism of the earlier World Economic Outlook exercise, it had still not presented an accurate picture of the current conditions and prospects facing most developing countries. Unfortunately, the situation could be considerably worse than that acknowledged by the staff; a possibility that led him to hold somewhat different views on the appropriateness of the members' policy stances, the degree of uncertainty surrounding the medium-term outlook, and the management of the debt crisis and the perceived role of the Fund in that regard.

Although some progress had been made in reducing the U.S. fiscal deficit, Mr. Ortiz said that more needed to be done. As noted in the staff paper, there was at present widespread agreement in the United States about the urgency of effective action to curb the federal deficit. Nonetheless, as experience of the past few years showed, it had often proved difficult to translate such a perception or agreement on the part of the U.S. public into concrete action. At present, when the undoubtedly beneficial stimulus that the U.S. expansionary fiscal stance had had on the world economy was wearing off, the world was left with real interest rates that, while reduced, were still quite high by historical standards and when compared with the evolution of commodity prices for developing countries. Monetary policy in the United States had played a positive role in the important reduction in nominal interest rates that had taken place during the past few months; however, it was doubtful that, even if an accommodating monetary policy were to be followed in the United States--an unlikely event in any case--interest rates would fall further or would be prevented from rising if the public was not convinced that a definite solution to the budget deficit had finally been found. In his view, the public was far from convinced that such a solution had been found; hence, high real interest rates would probably be a fact of life for years to come.

Beyond their well-known undesirable effects on economic growth in industrial and developing countries alike, high real interest rates also placed a heavy direct and indirect burden on debtor countries, Mr. Ortiz remarked. The direct effects on the servicing of external debt were obvious and deserved no further elaboration, but it might be worth clarifying the indirect effects of high interest rates on the internal debt situation of developing countries, since those were less well understood. The public sectors of most countries that had accumulated large external debts had also accumulated large debts internally; hence, in the presence of high real interest rates abroad, governments must also pay even higher real interest rates on their domestically held debt, since a substantial premium must often be paid above international interest rates if domestic savings were to be prevented from leaving the country. The implication was for enormous complications in the handling of the fiscal situation, as other types of expenditure must be further compressed to make room for increased interest payments in the event that the perceived deterioration of economic prospects gave rise to increases in the risk premium.

Elaborating on the uncertainties and risks surrounding the assumptions on which the projections for 1985 and the medium term were based, Mr. Ortiz observed from the staff report that export growth of developing countries was expected to reach 1.5 percent in 1985, compared with 8.5 percent in 1984 and a March 1985 estimate of 5.5 percent. Commodity prices were expected to decline by about 9 percent in dollar terms in 1985 in comparison with an earlier projection of a fall of only 2.5 percent. Those revised estimates had, moreover, been made without taking into account the decline in oil prices. Hence, for developing countries as a whole, the terms of trade had again deteriorated substantially. And the situation facing major borrowers was even worse: while the terms of trade were expected to decline 2 percent for developing countries as a whole, the decline for major borrowers was expected to reach 3.5 percent. Reduced export prospects implied reduced imports, slower economic growth, and a weakened capacity for indebted countries to service their foreign debt. However, in the face of those developments, the staff had concluded, first, that the medium-term scenario continued to indicate that external debt/export ratios of developing countries would be reduced by about one third, while those countries would achieve domestic growth rates of 4.5-5 percent from 1987 until 1990. The staff had also suggested that, in spite of the considerably worse outlook for 1985, the estimates for 1986 need not be greatly modified and the medium-term baseline scenario could remain unchanged. Also, in spite of the fact that some slippages had occurred in a number of adjustment programs, the staff had concluded that the handling of the debt crisis continued to be broadly on course. His own view was that both those assessments were open to question and that the policy actions emanating from them might well turn out to be less than fully adequate. If so, the financial community at large and the international organizations in particular might well be ill prepared for a second phase of the debt crisis, which could turn out to be even more profound and difficult to manage than the first.

Given the serious deterioration in the economic outlook for 1985 facing most developing countries, it was crucial that economic activity in the industrial countries should pick up for the remainder of 1985 and 1986, Mr. Ortiz continued. Although the recent behavior of economic indicators for August in the United States and the recent strength shown by some European countries were welcome developments, it was as yet too early to establish that those events had firmed up the foundation for recovery. It was moreover worrying that commodity prices--including those for oil--remained "soft," and there was no expectation that those prices might firm up even if growth resumed in the industrial world. Hence, the possibility that the world might face a scenario for 1986 characterized by a slower pace of economic activity in the industrial world, coupled with a continued downward trend of real commodity prices, seemed to have increased substantially.

Of course, Mr. Ortiz went on, he was not in disagreement with the staff's view that what was required was for "industrial countries to strengthen the sustainability of expansion through action to lessen financial imbalances and reduce protectionism, and for developing countries to intensify domestic efforts." As the staff had noted, adjustment had been very much a fact of life for the vast majority of developing countries during the past few years, and there was no doubt that their adjustment efforts must continue. However, it was difficult to imagine that it would be feasible to continue orderly adjustment in the context of a protracted recession and falling living standards.

Three years had elapsed since the onset of the debt crisis, Mr. Ortiz observed. It had repeatedly been stated that the various participants of the international financial community had shown great flexibility in dealing with the 1982 financial crisis. The leading role of the Fund in forestalling the disruption of the international financial system and establishing a viable procedure for borrowing countries to cope with the initial stages of the adjustment process could not be overemphasized. Unfortunately, despite some success in dealing with the problems posed by the increase in the debt of many developing countries, the situation of borrowing countries remained serious and precarious. His authorities were concerned that the success achieved thus far in preventing a crisis of major proportions had led to the perception that the most pressing aspects of the debt crisis had already been dealt with and that developing countries could maintain the pace of adjustment with very little additional financing. That perception by some industrial countries showed a lack of awareness of the costs incurred by borrowing countries in the adjustment efforts undertaken in the past three years. Those costs had a direct bearing on the prospects for the years ahead, since the room for maneuver had narrowed significantly. Access to financing over the medium term was essential to ensure the viability of indebted countries and thus prevent a new crisis that would have more severe repercussions than the crisis in

1982. Those concerns and their underlying implications had not been adequately transmitted in the staff's analysis of the World Economic Outlook; and the recent discussion on access to Fund resources did not reflect an awareness of the urgency of ensuring the adequacy of resources. Given the dim prospects for a resumption of bank lending to developing countries, it seemed inevitable that schemes involving substantial real resource transfers to borrowing countries would eventually have to be implemented if major disruptions of the international payments system were to be avoided. However, the longer it took to recognize the need for the establishment of such mechanisms, the more difficult the problems at hand were likely to become.

Mr. Alfidja made the following statement:

During our previous meetings on the World Economic Outlook, the most recent of which took place in spring 1985, this chair and several others stressed the need for decisive action on the part of some of the large industrial countries to reduce their fiscal imbalances. According to the staff, while action to achieve this goal has been taken in some European countries, especially in Germany, there has not yet been a conversion of the "good intentions" into specific actions. This apparent lack of resolute action to attack the structural element of the fiscal deficits of these countries is becoming increasingly worrying for several reasons:

First, the persistence of these deficits continues to feed the uncertainty in the minds of several people about future developments in such areas as capital formation, employment, economic growth, inflation, and the external position.

Second, the continued lack of conclusive and effective action on the fiscal deficits could give the wrong impression that these large imbalances are quite acceptable for industrial countries since their economies are still growing in spite of--or, I might say, because of--these deficits.

Third, as a corollary, the inaction of the authorities of these industrial countries aggravates the frustration and sense of inequity of developing countries that are constantly being called upon by them to make sacrifices in the form of cutbacks in personnel, lower wages and salaries, coupled with higher taxes. Under present circumstances, the burden of adjustment of the world economy is being disproportionately borne by countries that are least equipped to do so, namely, developing countries.

According to the staff, the overall economic strategy and policy intentions of industrial countries are appropriate. The weak point seems to be the lack of consensus on the actions to be taken. I hope that the staff is right in its judgment. I, for one, am not certain about the adequacy of some of the policy decisions that gave rise to the fiscal imbalances in some of the large industrial countries. In particular, I wonder whether the initiation of new large-scale and expensive projects in the area of defense is not likely to exacerbate the structural elements of the budget deficits in the years to come and hitherto have had serious repercussions on other sectors of the economy. In any event, the members of my constituency think that it is high time that large industrial countries convert their "good intentions" into specific actions that would have long-term beneficial effects not only on their own economies but on others as well. Still, in the fiscal area, I welcome the staff statement on page 25 that the French Government intends to reduce the burden of the employment tax on employers.

The following sentence appears on page 8 of the staff paper before us: I quote, "The sub-Saharan African countries grew at an average rate of only 1 percent during 1983-84 as a result of weak export growth, shortcomings in domestic policies, acute shortages due to import cutbacks, and prolonged drought in several countries." I wish to make the following observation about the reference to, and I quote, "shortcomings in domestic policies," in the context of this sentence as formulated and the actual economic and financial adjustment that has taken place in those countries.

One might have the impression from reading the sentence as it is that domestic policies in most, if not in all, sub-Saharan African countries have been inadequate. However, over the period 1980-84, 24 sub-Saharan African countries have adopted 59 adjustment programs supported by Fund resources. The other countries did also undertake policy reforms. Relative to 1983, the fiscal deficits of the Central Governments of sub-Saharan African countries, inclusive of Nigeria, decreased on average by nearly 3 percentage points to the equivalent of 5 percent of GDP. The rate of expansion of domestic credit fell sharply from more than 25 percent to less than 14 percent in 1984 on account of lower credit to the Government. The combined current account deficit of these countries decreased from 10.8 percent of GDP in 1983 to 5.3 percent in 1984. It is doubtful that adjustments of these magnitudes could have taken place had these countries not readapted thoroughly their domestic policies. In fact the aforementioned fiscal, monetary, and external adjustment in sub-Saharan Africa has probably contributed a great deal to the slowdown in the overall economic activity and I would prefer that the relevant passage on page 8 be recast to reflect these effects. There are certainly weaknesses in policy implementation in certain individual cases, but certainly not in most of the sub-Saharan African countries as might be implied. In order to avoid this impression, while at the same time indicating that the economic and financial adjustments have exerted a dampening effect on economic growth, I would prefer that prior to publication the sentence in the middle of paragraph 3 on page 8 be modified to read:

> The economies of the sub-Saharan African countries grew at an average rate of only 1 percent during 1983-84, <u>largely</u> as a result of weak export growth, acute shortages of <u>spare parts and inputs</u> due to import cutbacks, <u>the dampening effect of austerity measures</u>, prolonged drought in several countries, and shortcomings in domstic policies <u>in some cases</u>.
>
> (The proposed modifications have been underlined.)

The staff has correctly ascribed the slowdown in economic activity in non-oil developing countries (page 7), especially in sub-Saharan Africa (page 8), to a weak export growth. This unsatisfactory export performance reflects unfavorable price developments, the volume of commodities exported having risen. Except for the countries in the Western Hemisphere, the deterioration in the terms of trade of the developing countries is forecast to continue in 1985 and 1986 apart from a short-lived stagnation in 1984. It is the view of my authorities that these adverse effects of the evolution of the terms of trade over several years is one of the main root causes of the persistent current account deficits and the debt servicing problems confronting their countries. According to my authorities, this trend is all the more disturbing considering that they have been depreciating their currencies over the years. As stated by this chair last April, in light of the dominant role of the terms of trade in determining the performance of the economy of developing countries, more prominence should be given to this issue in an important document such as the Fund's World Economic Outlook.

Another topic that is not sufficiently highlighted in the paper before us today is the external debt problem. The limited coverage, in terms of financing, provided on page 20 on this subject, would give the impression, which I hope is wrong, that the debt problem is no longer of importance and can be dealt with appropriately within such frameworks as enhanced surveillance. Should this interpretation be correct my authorities would disassociate themselves from it. In their view, the external debt problem has not been resolved and deserves front page coverage, i.e., extensive analysis and discussion in the World Economic Outlook.

Contrary to the staff (page 49), my authorities do not think that the debt problem will be resolved only by the implementation of adjustment programs and growth in industrial countries. Several developing countries are still experiencing a debt crisis, having to devote inordinate proportions of their meager foreign exchange earnings to ever-increasing debt service payments even after rescheduling. Consequently, my authorities are still calling on the creditors to help find more imaginative, durable, and effective solutions to the debt problem.

Another area that was virtually ignored in the present paper is the cost of implementation and adjustment programs. As stated by this chair during the April discussions on the World Economic Outlook, my authorities take the view that not only should the merits and benefits associated with economic and financial adjustments be expanded upon, but the cost of these adjustments should be covered as well. These costs are not unrelated to the scope and speed of the required adjustment as embodied in the concept of conditionality. Therefore, I should like to seize this opportunity to reiterate the call of the countries represented by this chair in favor of a more flexible application of this concept.

Finally, I would like to conclude with a few words on the access limits and the enlarged access policy. The steady decrease of the current account deficit of developing countries during the past three years and the improved liquidity position of the Fund should not be considered as an easing of the external imbalances and a justification for a reduction of the access limits, a more restrictive application of these ratios, or the elimination of the enlarged access policy. My autthorities take the position that the demand for Fund assistance will remain sustained in the foreseeable future. Therefore, the Fund should be well equipped to assist effectively member countries as the need arises.

Mr. Joyce observed that the prospects for 1985 were at present somewhat less favorable than they had been during the April 1985 World Economic Outlook discussions. Growth in the industrial countries, particularly in the United States, had been lower than projected, a development that had led to a weakening of commodity prices worldwide and a generally less favorable external environment for developing countries. However, despite the adverse developments he had mentioned and the slow growth in the first half of 1985, the global recovery continued to remain more or less on track, and he generally agreed with the staff's revised projections for the year as a whole, noting that the downside risks were greater than they had been in April 1985. The persistence of major financial and current account imbalances among industrial countries, particularly in the United States, remained a matter of concern. Moreover, the adjustment process in some debtor countries had not been going as well as had been hoped, a development which posed greater risks that the debtor countries would not pursue the required adjustment and would not meet their obligations.

The staff view that the hesitant growth in industrial countries in the first half of 1985 had been due partly to temporary factors was understandable, Mr. Joyce continued. However, while the growth in the

United States and other industrial countries might again be strengthening, there was some question about how strong that growth would prove to be. He found somewhat high the U.S. administration forecast of a 5 percent growth rate in the second half of 1985 and a 4 percent rate thereafter. Moreover, as he had already noted, major imbalances among the industrial countries clouded the horizon. To a great extent, the unsustainable and threatening nature of those imbalances made the forecasts uncertain, the more so since no one seemed to have a clear view about how or when they might be resolved.

He shared the staff's assessment of the policy issues facing the major industrial countries, Mr. Joyce said. The need to pursue fiscal restraint remained a priority matter in most of them; however, from a global perspective, it was the large and growing U.S. fiscal deficit that offered the greatest threat to continued recovery. While the recent Senate-House agreement aimed at a significant reduction in federal deficits beginning in 1986, the ratio of debt to GNP was still projected to rise. Moreover, there was a definite risk of slippage as the Appropriations Committee dealt with spending requests. While the initial benefits of the fiscally induced U.S. expansion had been considerable--a point clearly brought about during the most recent U.S. Article IV consultation discussion--the increasingly large fiscal deficit involved increasing costs for the world as a whole. The strength and volatility of the U.S. dollar had contributed to a slowdown in the U.S. economy, a weakening in the current account deficit, and an upsurge in protectionist pressures. It had also limited the room for manuever in other countries. Interest rates in the United States had fallen in 1985, but they remained high in real terms and had served to keep interest rates high in other countries as well, threatening the strength and sustainability of the recovery generally, particularly in the debtor countries. Interest rates internationally would remain high unless and until the United States could reduce its deficit.

Given the planned withdrawal of fiscal stimulus by the United States, it was all the more important that other industrial countries should establish and implement appropriate policies, Mr. Joyce continued. The social strains caused by continued high unemployment, especially in Europe and the Third World, argued for aiming at faster growth, which should be possible without rekindling inflation. Achievement of that goal would require increased determination in the implementation of policy intentions, particularly if noninflationary growth was to be sustained. Europe, for example, must deal more effectively with labor market rigidities. More generally, greater flexibility must be sought in the stance of economic policy. Each country must work out sound medium-term policy strategies that would be mutually compatible; an effort must be made to ensure that the overall stance of policy in the industrial world was not tighter than needed or intended. The staff had taken note of a slight expansionary impulse in Germany; however, Directors would recall in that regard that the feeling of the Board during the 1985 Article IV consultation with Germany was that the German authorities might do more to encourage growth, a view shared by his authorities.

In Japan, the widening current account surplus had been one of the main contributors to increased pressures for protectionism in other industrial countries, Mr. Joyce noted. Japan could help combat those pressures by implementing domestic and exchange rate policies aimed at reducing imbalances and encouraging sound growth. The key to success was a continued strengthening of domestic demand. In that context, he was worried that the sharp slowdown of GNP in Japan early in 1985 had been attributable at least in part to an easing in domestic demand. Recent reports indicated that housing, construction, and smaller industries in outlying regions continued to exhibit sluggish performance. Those tendencies needed to be reversed. It was not sufficient for Japan merely to lower trade barriers; demand and domestic economic growth must also be maintained if the foreign balance were to be corrected.

Remarking on the progress and prospects for the developing countries, Mr. Joyce observed that the relatively favorable external environment and the strong adjustment measures adopted had led to a sharp reduction in the current account deficit in some of the main developing countries. The revival in exports and the new financing packages arranged for certain countries had also allowed for some growth in import volumes in 1984, as well as some improvement in reserves. At the same time, however, there had been disturbing signs even in 1984 that the policies in place in many developing countries to deal with domestic imbalances had not been as strong or as effective as would have been desirable. At present, with the growing uncertainties about the external environment, and the strength and duration of the recovery in the industrial countries, the prospects for developing countries were more difficult to assess. The trade figures for the first part of 1985 suggested that export receipts would be lower than in 1984 and much weaker than projected for 1985 only six months previously. While the impact on the current account balance might be partly offset by a decline in imports and by a possible easing of interest rates, it was likely that production would fall and unemployment would rise; and it would be more difficult to contain the fiscal deficit and the rate of inflation, all of which raised serious questions about the ability of some of the developing countries to service their debts.

He agreed with the staff that the developing countries must continue to pursue with determination policies designed to correct their domestic financial positions and to improve their external competitiveness, Mr. Joyce went on. The downward revision in prospects for export performance and the greater difficulties that the developing countries were likely to encounter in obtaining foreign financial resources in future placed an ever greater premium on using whatever resources were available for efficient investment, which required appropriate pricing policies and credit decisions, as well as effective public sector investment policies. Unfortunately, there was evidence that adjustment policies were not being implemented as planned and that the medium-term prospects of the developing countries would be weakened, no matter how positive the external environment might prove to be.

In emphasizing the risks attending its forecasts, the staff had implied that the downside scenarios were the more realistic, Mr. Joyce noted. Mr. Kafka had suggested that the staff forecasts were too optimistic; his own view was that they were just about right, although he might have been somewhat more cautious simply because he was perhaps more pessimistic than the staff about the ability of the main industrial players to achieve among themselves an appropriate mix of macroeconomic policies. He did agree with the staff that the existence of uncertainties did not justify any immediate change in economic strategy. If anything, those risks demanded firmer action to bring policies into line with the medium-term strategy. He also agreed that it would be impractical to prepare detailed policy responses to deal with all possible eventualities. Still, the uncertainties were growing, and developments over the next few months would need to be watched closely. In that regard, the role of surveillance would be particularly important, and the Fund must be prepared to speak out firmly and to entertain new initiatives if, in fact, deviations from the forecast growth path were to occur.

Mr. de Groote considered that the staff papers conveyed a certain sense of satisfaction that was misleading, given the large imbalances prevailing throughout the world economy and the lack of convergence of macroeconomic policies among major countries. Those problems were cause for greater concern than had been expressed in the staff's assessment of the current situation. While the staff had attempted to convey, between the lines of its report, a somewhat less optimistic picture than it had presented six months earlier, he would have preferred a clearer indication of the changed view.

Having successfully fueled the strong economic recovery that had taken place in the United States in 1984, the U.S. budget deficit had since that time remained unduly high, Mr. de Groote noted. It was that deficit that should be regarded as the main element on which forecasts for the future had to be based. Since the Federal Reserve Board had rightly maintained its firm anti-inflationary stance, the U.S. budget deficit had had to be financed by capturing a significant share of world savings, a fact that had exerted continuing upward pressure on real interest rates throughout most of 1984. High interest rates in the United States and the overall strength of the economy, supported by deficit financing policies, had continued to attract capital inflows, leading to a further appreciation of the U.S. dollar, which in turn had ensured a further widening of the U.S. trade deficit. The dollar's strength had damaged the competitiveness of traditional U.S. exports and had reinforced the pressure for protectionist measures. While those interrelationships were well known, those in policymaking circles had not yet fully perceived that the continued existence of such a large budget deficit would intensify the financial strains on the budget as a whole through a self-sustaining cumulative mechanism. The interest on the national debt already absorbed a large share of government spending. If the debt maintained its recent rate of increase--the debt had doubled in the past four years--interest payments on the debt would escalate, thus widening the structural deficit and placing additional upward pressure on interest rates, a most undesirable development at a time when the economy was likely to be slowing down.

Even more ominous a problem was the U.S. external trade and investment position, Mr. de Groote considered. As argued recently at the Brookings Institution in a paper by S. Marris, there was good reason to suppose that the United States faced the prospect of a recession induced by the pressures of external adjustment. Such a recession might be unduly severe because it could be accompanied by high interest rates and increasing inflation. In the initial phase of the recession, the economy would rein in considerably, as it had thus far in 1985, and interest rates would fall, narrowing the interest rate differential vis-à-vis other currencies. Lower dollar interest rates and pessimism over the health of the U.S. economy might cause foreign holders of dollar-denominated assets to become nervous. If investors' willingness to increase their exposure in dollar terms lessened faster than the economy's need for capital inflows to offset the lack of domestic savings, there could be a crunch in the financial markets that could drive U.S. interest rates up sharply. The working of market forces would then cause high interest rates to affect demand negatively, while the sharp decline of the dollar could soon create the high risk of an inflationary explosion. If that scenario were to materialize, the outcome would depend very much on how policy responded to those developments.

On the fiscal side, Mr. de Groote continued, it did not seem yet to be fully realized that investors' willingness to increase their exposure in dollar-denominated assets could soon fall to zero or even turn negative. If that occurred, "crowding out" in the U.S. financial markets would become inevitable unless the structural budget deficit had been substantially reduced or eliminated, which was unlikely. The budget compromise reached by Congress in the summer of 1985 called for the fiscal year 1986 federal deficit to be reduced by $55 billion through spending cuts. Realization of that target was uncertain, as proposals for spending cuts must still be approved by a number of House subcommittees, which would be lobbied intensely by affected special interest groups. The obvious way to reduce the deficit in the circumstances, and one that might have a chance of being considered by Congress, was an increase in taxation--an approach opposed by the Administration. That opposition should not, however, prevent Executive Directors from mentioning a tax increase as one of the clear-cut solutions to the deficit problem, at least from an analytical point of view. It seemed particularly desirable at present to consider an increase in consumer taxation, which could easily take the form of a partial transfer toward the public sector of the effects of oil price decreases that at present were exclusively benefiting the consumer. If only one third of the oil price decreases had been recaptured in taxes, the U.S. budgetary problem could have been viewed in a far more positive light.

Even if quick action were possible, Mr. de Groote continued, the proposed program might still be insufficiently comprehensive, and the room for maneuver by the monetary authorities might be further narrowed. The Federal Reserve Board might indeed confront an impossible choice, given the characteristics--namely, strong upward pressure on interest rates, accelerating inflation, and a rapidly depreciating currency--that an externally generated recession was bound to exhibit. If the Federal Reserve held fast to its monetary targets, high interest rates would push the economy into recession, with the risk of a major financial crisis that would squeeze debtors hard in the United States and in the developing world. If, on the other hand, the Federal Reserve Board were to relax its policy in order to prevent an excessive rise in interest rates, the financial and foreign exchange markets would be given the impression that the Federal Reserve Board was prepared to monetize both the budget deficit and the external deficit, and they might panic. The result could be an erosion of confidence that would greatly increase the upward pressure on interest rates and the downward pressure on the dollar. The implication seemed to be that the U.S. authorities would eventually be left with very few effective means of preventing a negative outcome, unless they succeeded in changing the course of their budgetary policies and took action in cooperation with the OECD. In any case, the reorientation of budgetary policies would come at a late stage in the business cycle and would thus produce a slowdown in activity, whether either spending cuts or tax increases were chosen. Hence, the choice was between a corrective adjustment resulting from a reduction of the budget deficit, or a more pronounced decline in activity that would be caused by the continuance of a deficit of the present magnitude, a deficit that was, moreover, gradually becoming self-sustaining.

A cooperative scenario in which the rest of the OECD area took expansionary action sufficient to offset the negative impact of declining net exports could produce substantial gains for all parties involved, Mr. de Groote observed. The benefits to the United States from faster growth abroad would come partly in the form of a smaller depreciation of the dollar--which would slow inflation--and partly in the form of a more moderate slowdown. The benefits to the other OECD countries would be in the form of lower unemployment, although their inflation gains would be somewhat less than under a "crash landing" scenario without policy changes, because the dollar would depreciate less. There would also be significant benefits for the developing countries, which could grow faster and tolerate some larger current account deficits.

Although the staff and the U.S. Administration acknowledged that it would be desirable to increase cooperation with a view to securing sustained economic growth at the global level, and although they shared a common basic approach in terms of the importance each assigned to business cycle movements, their common view about those movements in the business cycle seemed to differ from the observations he had made earlier, Mr. de Groote remarked. The U.S. Administration and the staff tended to regard some recession in economic activity as a normal event in an overall long-term process of economic growth. For them, the slowdown of economic activity likely to occur in 1985 and 1986 was merely the continuation of an ongoing adjustment process, a stage that would have necessary and beneficial effects--such as further slowing of inflation and shedding of excess production capacity--and that would improve conditions for a better allocation of resources in the longer run. If that view were correct, the appropriate policy response was to reduce the budget deficit in order to free resources for private investment and to fine tune the growth of monetary aggregates in order to lower interest rates and cool down inflation. However, that general approach did not seem to pay sufficient attention to one typical aspect of the U.S. economy, namely, the fundamental imbalance between domestic savings and investment, which had made the U.S. economy heavily dependent on the rest of the world to finance the sustained investment it needed. As long as the savings ratio in the United States remained at its current very low level, the United States would continue to depend on foreign savings, even though that dependence could be somewhat lessened by reducing the budget deficit. A recession might finally bring domestic savings into equilibrium with investments, but it could do so only by depressing the level of investments. That contradicted the long-term need for sustained investment so that, following a recession, the situation might well arise again when investment needs could only be met from foreign savings. Long-term success would in that case depend very much on the continued willingness of foreign investors to provide the necessary financing. If their willingness were to moderate, investment activity would remain low, and long-term growth of any significant magnitude would not take place. An analysis of the business cycle and the conclusions that might be drawn from it concerning the prospects of the U.S. economy suggested that the fundamental disequilibrium must be eliminated if sustainable long-term growth was to be achieved. One of the instruments for achieving that goal was a reduction in the disincentive to save by increasing real interest rates for borrowers. Borrowers at present enjoyed a variety of tax deductibility that placed interest costs for debtors much lower than the figures for nominal interest rates would seem to suggest.

Turning to the European economies, Mr. de Groote remarked that, while some aspects of economic performance had improved in 1984, thus increasing business confidence in the region, there was still little prospect that the economic growth rate would accelerate significantly in the short term. Impediments to a more dynamic expansion included the restructuring of expenditures through fiscal discipline, the cautious monetary policies prompted partly by uncertainties in international markets over interest and exchange rate movements, the persistent rigidities of some segments of the labor market, and the slow progress of industrial restructuring. Taken together, growth rates in the European economies in 1985 and 1986 would barely exceed the 2.3 percent level achieved in 1984, and unemployment rates would remain in the low double digits. Many countries in Western Europe and Japan seemed to have regained ampler room for policy maneuver because of a significant slowdown in domestic inflation, lower budget deficits, decreased interest rates in the international markets, and steady improvement in their balance of payments. However, there was no evidence at present that Japan, Germany, and the United Kingdom were prepared to take expansionary actions of a reasonable magnitude. Their reluctance probably reflected the belief of their authorities that an expansionary approach to demand management either would not work or would do more harm than good. Whatever validity those fears might have as they applied to the past or to each country in isolation, they would probably lose their force to a great extent once the slide of the dollar accelerated. As long as the dollar remained strong, the highly unbalanced U.S. fiscal and monetary policy mix stimulated external demand in the other OECD countries but, at the same time, kept their interest rates high and, through currency depreciation, boosted their inflation. A strong shift away from the dollar would reverse the situation by creating downward pressures on interest rates in the rest of the OECD area and currency depreciation would reduce inflation; however, those benefits would be offset by negative external effects on demand. Put another way, a new situation could develop that called for more expansionary, or at least less restrictive, fiscal and monetary policies. Such a situation would improve the chances that such policies would increase domestic demand and employment instead of fueling inflation and pushing up interest rates. Thus, ironically, "Reaganomics" had set the stage for an upswing in Europe and Japan like that which had occurred in the United States in 1983-84. Several important European countries, and Japan, could at present afford to give themselves a large dose of fiscal expansion to sustain a resurgence of domestic demand. Inflation would be checked by the appreciation of their currencies, and it was possible that their budget deficits might not crowd out investment because their savings would begin to flow back from the United States.

Sustained growth in the industrial countries and the stabilization of financial variables were particularly important for the developing countries, which had been especially damaged by the rapid shifts in the international economic environment, Mr. de Groote commented. At the beginning of the 1980s, sudden changes in product and capital markets had demanded rapid adjustments by national economies. While many countries had been able to react quickly to changes in international economic conditions, excessive volatility in certain key markets had adversely affected growth and development. The instability of capital flows, interest rates, and primary commodity prices continued to impede the formulation and application of outward-looking national economic strategies. It had also made private investors in developing countries reluctant to commit their funds. Recent policy shifts in many developing countries toward greater reliance on market forces, a stance generally supported by the International Monetary Fund in its programs and consultations, would work best in an environment of greater stability in key markets. In that context, the issue to be debated was how greater exchange rate stability could be enforced, and he hoped that the relevant discussions at the forthcoming Interim Committee meeting would bear fruit in that respect. He was happy to note that the conclusions of the Report of the Group of Twenty-Four on the international monetary system went one step further in the direction of advocating stability of exchange rates than did the report of the Group of Ten.

Another topic for discussion, newly revived, was the continuing debt overhang of the developing countries, Mr. de Groote observed. Recent debt reschedulings and rapid export growth had provided breathing space for import growth to a number of large debtor countries. The financial situation had also improved from the creditors' standpoint. International commercial banks had significantly increased their contingency reserves, and their profits had generally recovered. However, those improvements gave no cause for complacency. Most developing countries with relatively large debts continued to suffer from considerable balance of payments constraints, low rates of growth, high unemployment, and major obstacles to the expansion of productive investments. Indeed, the underlying financial conditions in those countries had not fundamentally changed. Many indebted developing countries--especially in Latin America--had managed through stringent adjustment measures under Fund programs to achieve considerable trade balance surpluses. However, despite the rapid increase in their exports, their debt service ratios remained virtually unchanged, and many of those countries had for two years in succession experienced negative resource transfers. Their failure to reduce the unusually high ratio of interest payments to export revenues was cause for serious concern. The average ratio for 1985 would be slightly more than 25 percent and, for countries in Africa, it would be more than 32 percent. If that trend continued, the positive results of rescheduling were likely to be only temporary. For the debtor countries, it was thus essential that the interest rate decrease of late 1984 should continue; if it did not, the slowing of international trade growth predicted for 1985 and 1986 could lead to insurmountable payments pressures in the years ahead. Those strains would, of course, delay development and could once again endanger the stability of the international financial system.

Progress toward stability was also threatened by mounting protectionist pressures throughout the world, Mr. de Groote noted. The hope that a strong recovery would eliminate the protectionist measures had not been fulfilled. In the recent past, liberalization measures had generally been offset by the introduction or intensification of nontariff barriers, which had eroded the credibility of accepted trade norms and had damaged trade-related investment. The situation was one of serious concern because sustained world economic growth and progress toward the solution of the debt problem depended crucially on the smooth expansion of international trade. The call for a new round of trade negotiations was a positive development, but it did not lessen the urgent need for more immediate action. Prompt implementation of all past agreements and elimination of those barriers that had capped the trade levels of a large number of goods were essential. He agreed with the staff that a multifaceted approach to the problem of protectionism was necessary: negotiations alone would not suffice but must be accompanied by the elimination of the major imbalances in the world economy.

Increased support for the Bretton Woods institutions and other multilateral financial institutions was critically important at present, Mr. de Groote considered. The deep world recession of the early 1980s had left many developing countries without sufficient international reserves and with unsustainable balance of payments positions. The aggregate current account deficit of the developing countries had been reduced from its 1982 peak of $100 billion by extraordinary adjustment efforts; but that deficit was estimated to have increased by $8 billion from the 1984 level to about $50 billion in 1985, and no major reduction in that global deficit was expected in the near future. Moreover, even the most extraordinary adjustment efforts would not, at an early date, give many developing countries significant access to fresh funds from private financial markets. An increased flow of official assistance to support investments, particularly in trade-related sectors, could be decisive not only for accelerating growth but also for solving the balance of payments problems in the longer term. Official credits could also be the catalyst needed by developing countries desiring to increase direct foreign investment and flows from international commercial banks. In short, the time was right for paying greater attention to development as well as to adjustment. Indeed, as a consequence of the improvement in 1984, in the world economic situation, there had been some shift of attention away from coping with immediate liquidity pressures and toward the creation of the conditions necessary for the general resumption of sustainable economic growth and development over the longer term. That shift in emphasis from crisis management to growth and adjustment over the medium and longer term would provide an opportunity for the Fund to redefine its role in meeting members' balance of payments adjustment and financing needs and to develop new areas of cooperation with the World Bank. In conclusion, changes in the thrust of policies adopted to deal with the problems he had outlined could significantly influence the course of events in the second half of the 1980s. A more stable and supportive international economic environment would ease some of the current strains and uncertainties and would allow many countries to resume growth sooner. In particular, concerted action by the large industrial countries to harmonize their macroeconomic policies, halt and dismantle protectionism, and support more decisively the multilateral financial institutions would significantly improve the international economic environment.

Mr. Finaish remarked that the faltering of growth in the industrial countries in the first half of 1985 had brought into sharper focus the uncertainties surrounding the prospects for sustained, adequate growth in the world economy in the period ahead. While the staff had made no basic revisions to its medium-term growth projections for the industrial countries, the downside risks for those projections appeared greater than they had been six months previously. Certainly the maintenance of a reasonable rate of growth in industrial countries was important for a satisfactory evolution of the world economy, particularly in present circumstances. A significant slowdown in industrial country growth in the near term could place in serious jeopardy the manageability of the international debt situation and the sustainability of orderly adjustment in developing countries in general. For the industrial countries themselves, such a slowdown could mean that the recovery would begin to ebb without having made any dent in the high unemployment in the majority of those countries; and the surge of protectionist pressures, which had not receded with the recovery, would become much more difficult to contain. In short, the world economy could ill-afford a slide into recessionary tendencies at the present juncture.

If the recent weakness in industrial country growth should persist or deteriorate, the staff's suggested response of maintaining the current stance of policies, while allowing automatic stabilizers to perform their role, might not be sufficient to bring about a rebound in economic activity and thus prevent a strengthening of recessionary tendencies, Mr. Finaish continued. Some discretionary fiscal stimulus, including a reduction of the tax burden aimed at boosting production incentives, might then be needed. In countries where inflation had been contained and where the external position was comfortable and the structural fiscal position had been improved, such an action would not amount to a departure from medium-term financial and structural objectives that could undermine market confidence in the stability of policy; rather, it would be consistent with the margin of flexibility that needed to be maintained within a medium-term framework for policymaking.

The appropriate course for fiscal policy in the United States was reasonably clear, Mr. Finaish remarked. A firm approach to reducing the fiscal deficit was required. The possibility that a moderate fiscal stimulus might be needed arose in some other industrial countries where conditions seemed to exist that would permit such an action. The need for stimulus could arise if other sources of domestic demand growth in those countries failed to compensate for the reduced stimulus from foreign demand as growth in the United States slowed down and that country began significantly to tighten its fiscal policy. However, it might be difficult for some of those countries to undertake stimulative action except in coordination with other countries able to do likewise.

The emphasis in reducing structural rigidities in the European economies should certainly continue, Mr. Finaish considered. By their nature, measures to reduce such rigidities would not have a significant effect on economic performance in the short run, but they were important for improving prospects for growth of output and employment in the medium term. The needed structural reform would be facilitated if it took place in an environment of a healthy growth in economic activity. High real wage costs in relation to productivity were an important impediment to growth of employment in many European countries. Measures to increase labor market flexibility, together with the dampening effect of high unemployment, had recently caused some decline in real wages, although the process was a slow and painful one because of the persistently high unemployment. The gap between productivity and wages could be closed more rapidly, and perhaps less painfully, if productivity were rising faster. One way to encourage a faster growth in productivity was through higher investment in plant and equipment, which in turn would require, inter alia, the establishment of conditions inducing a redirection of some of the investable funds flowing out of the United States toward investment within Europe.

The staff's emphasis on the need to make effective use of surveillance mechanisms to ensure consistency of policy responses by countries--particularly in the face of significant risks of adverse developments that existed at present--was well placed, Mr. Finaish said. That need had also been underscored by the continued, and recently increased, variability of exchange rates. The focal point of the discussions under way on increasing the effectiveness of Fund surveillance should be to put some "teeth" into Fund surveillance over the policies of major countries. The World Economic Outlook exercise was itself a useful vehicle for the conduct of multilateral surveillance. Recent reports on the functioning of the international monetary system by both the Group of Ten and the Group of Twenty-Four had emphasized the strengthening of the analyses in World Economic Outlook papers of the international repercussions of the national policies of major countries and had recommended a more effective use of the conclusions of those analyses for harmonizing policy responses.

The recent slowdown of growth in industrial countries had caused a substantial weakening of the prospects for export growth and the terms of trade of developing countries for 1985 and 1986, Mr. Finaish observed. Since the combined current account of the developing countries was assumed to remain broadly unchanged because of financing constraints, the lower growth of export earnings was reflected in the scaling back of the projected growth of imports and output. The groups most adversely affected by such developments were the fuel exporting countries and the exporters of primary products other than fuel. The first group included some major debtors, and the latter was comprised of a large number of low-income countries for which the projected outlook was already quite difficult. Growth forecast for the group of major borrowers had also been cut back. While the staff had not revised its medium-term baseline scenario--which projected, on the basis of current policies, a gradual reduction in the debt burden and a restoration of growth rates in the period up to 1990--the developments he had mentioned significantly increased the margin of uncertainty around the baseline scenario. And those uncertainties in the outlook for developing countries had implications both for adjustment and financing.

The adjustment under way in indebted developing countries should be pursued with firmness, Mr. Finaish remarked. The combined current account deficit of those countries relative to exports was at present low not only in relation to the recent peak but also to the average for many past years. External deficits, however, remained large in many individual countries. Furthermore, a lowering of the external deficit was not in itself a measure of effective adjustment. For some countries, the fall in the deficit, initially resulting from a contraction of imports necessitated by financing constraints, had been followed by substantial and successful domestic adjustment. In many others, however, less progress had been achieved in making the requisite domestic adjustments. In those countries, large underlying imbalances continued to exist. Further substantial domestic adjustment, especially structural adjustment, was needed in those countries if growth was to be accelerated without a renewed deterioration of the external position and if those countries were to benefit more fully from the export opportunities afforded by growth in the world economy. It should be noted that adjustment programs were currently under way in many of those countries. In some important debtor countries, high inflation remained a serious problem; and their recent adjustment efforts, if firmly adhered to, held the promise of a significant lowering of inflation.

Given the uncertainties that he had mentioned, contingency planning for financing was necessary, Mr. Finaish said. Because of the existing financing constraints and the need to limit additional borrowing by countries already under a heavy debt burden, the projected weakening of exports in indebted developing countries had been assumed by the staff to be absorbed mainly through fewer imports and slower growth. However, it might be unrealistic to think that if the weakening of export prospects persisted, the same assumptions could be maintained. It might be difficult in those circumstances to avoid an increase in external deficits and additional financing and debt relief in support of the greater adjustment that would be called for. While debtor countries' financing requirements could thus increase, the availability of commercial financing might tend to shrink further because of reduced confidence in the economic prospects of those countries. In the circumstances, the International Monetary Fund needed to maintain its financing capacity at a level adequate to deal with such contingencies. The Fund must play the role of a provider of direct financial assistance in support of adjustment and of an effective catalyst for other sources of financing. In the case of low-income countries, especially those in sub-Saharan Africa, what was needed was an increase in the flow of concessional assistance. The prospects for the growth of exports and output in those countries were particularly bleak and promised little if any recovery in the recent substantial per capita income losses from what had already been very low levels of income. Although a large part of the debt of those countries was in concessional financing, their debt servicing burden had shown the greatest increase in recent years. The adjustment needed was primarily structural, aimed at expanding and diversifying production and exports, and the adjustment efforts toward those ends needed to be supported by adequate and appropriate financial assistance.

On the growth in protectionism, Mr. Finaish considered that the staff was correct in advocating a multifaceted approach to the increase in protectionist pressures in industrial countries. While those pressures should be firmly resisted, a more fundamental approach would be to act on the economic and financial imbalances that lay behind them, including trade imbalances, exchange rate misalignments, and the general weakness of economic activity. An effective approach to tackling protectionism was thus intimately linked with several aspects of macroeconomic management. The roots of the array of trade barriers against developing countries, however, went far deeper than cyclical or relatively short-term factors. The barriers were concentrated in the industries that were showing a secular tendency to decline as a result of evolving comparative advantage in developing countries in those lines of production. The solution to such protectionism lay basically in a determined approach toward industrial restructuring. The opening up of industrial country markets in those particular areas of production was an important precondition for the success of the "outward looking" strategies that were being recommended to developing countries.

It was indeed a difficult task to trace the impact of a decline in oil prices on various aspects of economic performance in different country groups, Mr. Finaish noted. The difficulty arose because of the existence of a number of interrelationships among the relevant economic variables--which were not easy to model and quantify--and also because a number of assumptions had to be made about certain aspects of the impact and the policy responses of various countries that could be rather arbitrary. The methodology and assumptions used could have a significant bearing on the outcome of the analysis, and the result of the staff's analysis of that matter should be seen in that light. In his view, the presentation of the staff analysis could have been made clearer and the methodology used could have been set out in an appendix. Some of the assumptions used could also have been more explicit, and the short-term effects might have been presented in a summary tabular form, as had been done for the medium-term effects. Moreover, the clarity of exposition would have been improved if textual discussion of the medium-term analysis had followed more closely the tabular presentation. There were also certain apparent inconsistencies between the text and the figures provided in some of the tables. For example, the impact on output growth of net oil importers and small low-income countries appeared to have been overestimated when viewed against the information provided in Table 4 (EBS/85/201).

He would welcome staff comment on six general points regarding the staff's analysis of the impact of a decline in the price of oil, Mr. Finaish continued. First, with regard to the longer-term implications for the oil market itself of a sharp decline in oil prices, he noted that the staff had indicated that a 20 percent decline in the price could be expected to result in both increased demand and a reduced supply of oil, which, as a consequence, would result in tighter oil market conditions at some future date than might otherwise be the case. It was reasonable to assume, as the staff had done, that such market response would take place gradually and thus could be ignored in the short-term analysis. However, it was less clear whether it could be ignored in the medium-term sensitivity analysis covering the period up to 1990. The medium-term analysis assumed that, subsequent to a 20 percent decline, the oil price movement would parallel that assumed in the baseline scenario, i.e., oil prices would remain 20 percent below the baseline scenario throughout the projection. However, if the market response on both the demand and supply sides was significantly elastic in the medium term--and past experience suggested that it could be--then some correction to the hypothetical price decline at present could be expected later, during the period of the baseline scenario, over and above the price increase allowed for in that scenario. If so, an allowance for such an effect needed to be made in the analysis.

Second, Mr. Finaish continued, if a sharp drop in oil prices could produce a market response leading to a sharp increase in the price a few years hence, the question arose whether, from the standpoint of both producers and consumers of oil, a more stable course for the oil price might not be better over the medium term than such oscillation.

Third, Mr. Finaish said, the effects of an oil price decline examined in the staff paper were essentially the effects of a terms of trade change, or an income transfer, between oil exporting and oil importing countries. However, oil prices might not be looked at only as a determinant of terms of trade between exporters and importers of oil. They were meant to balance supply and demand conditions in the global oil market, taking into account both current conditions, as well as the prospective relative scarcity of oil. In assessing the desirable course for oil prices at present, full weight should be given to its implications for the longer-term global energy balance.

Fourth, leaving aside the broader issues he had mentioned and looking at some of the results of the staff exercise as presented, Mr. Finaish noted that the debt situation of developing countries as a group was likely to be adversely affected by the assumed oil price decline. The figures in Table 4 relating to the medium-term sensitivity analysis showed that the current account and debt ratios would worsen for all groups of capital-importing countries. The effect on growth would also be negative for most of those groups. Even for net oil importers and small, low-income countries where the effect on growth was shown to be positive, that positive effect could be significantly offset for many of those countries by a drop in the flows of aid and workers' remittances as a result of the decline in the revenues of oil exporters. He would appreciate confirmation from the staff that the possibility of a decline in aid flows and remittances from oil exporting countries had indeed not been allowed for in the analysis. Fifth, the cutback in imports by the fuel exporting countries in response to the drop in oil revenues might well exceed that assumed in the exercise. Finally, the staff paper took note of the possible serious implications of a significant oil price decline for the financial position of some large debtor countries and, in turn, for the international banking system and the overall manageability of the debt situation. Since the strains on the international financial system so generated, and the related confidence effects, were difficult to quantify, they did not show up in results quantified in the exercise. The potential significance of those effects, however, could not be minimized.

Mr. Grosche stated that, despite some disappointing new projections outlined in Table 1 on page 3 of the staff report, there was no cause for alarm: the outlook was not bad, provided that current policies were more forcefully implemented. Like the staff, he expected some of the factors adversely affecting economic expansion in the first half of 1985 to be only temporary. The underlying factors remained basically unchanged and should continue to sustain the recovery. The staff had rightly pointed out that the profit situation was broadly satisfactory, monetary conditions had eased, and inflation was subdued. Recently, moreover, some U.S. economic indicators were again pointing in an upward direction.

The medium-term prospects as presented in the Spring 1985 World Economic Outlook also remained broadly valid, Mr. Grosche continued. According to the baseline scenario, it should still be possible for capital importing developing countries to grow at a rate of 4.5-5 percent during the period 1987-90, bringing about a significant reduction in their external debt ratio. While some of the downward revisions particularly affected the developing countries as a group, it had to be noted that developments within that group varied markedly. The downward revision of output, for example, affected mainly the fuel exporters; there had indeed been upward revisions for the group of nonfuel exporters and, particularly, for exporters of manufactured goods. In addition, a pickup in output and export volumes was projected for the developing countries in 1986. Of course, there was no way to minimize the uncertainties and downside risks that had clearly increased since April 1985. Beyond the deterioration in prospects for some developing countries, it was worrying that there had been a number of slippages in the implementation of required adjustment policies that had undermined the prospects for sustained growth in the future. While the developing countries generally had succeeded in reducing their combined current account deficit by a substantial amount, it was troubling to note that less progress had been achieved in bringing about the internal adjustments necessary to sustain external performance and growth. A number of large debtor countries were currently facing problems in their efforts to correct the slippages that had led to a suspension of drawings under Fund arrangements. The increased incidence of arrears to the Fund, as well as an increasing number of prolonged users of Fund resources, added to the bleak picture.

Despite the developments he had mentioned, there was at present no need for a change in the basic stance of policies, Mr. Grosche said. It remained essential, first, to pursue or intensify, where necessary, adjustment policies in developing and developed countries alike; second, to withstand protectionist pressures; third, to deal with the debt problems of individual countries on a case-by-case basis; and, fourth, to ensure that banks maintained their lending at appropriate levels. It was clear that the new uncertainties and downside risks underlined the need to implement adjustment policies with more firmness, particularly in those developing countries where slippages in the implementation of those policies had occurred and in those industrial countries where there had been marginal or unsatisfactory progress in reducing unsustainably large fiscal imbalances or where structural impediments to growth remained. The policy conclusions of the staff paper clearly indicated that more needed to be done if the expansion of the world economy were to be placed on firmer footing.

One of the key requirements for the industrial countries was a significant reduction in the U.S. fiscal deficit, Mr. Grosche considered. During the recent Article IV consultation with the United States, his authorities had welcomed the progress made toward reaching agreement on a reduction in the fiscal deficit. However, that agreement should be viewed as only a first step; more needed to be done, particularly since the official budget projections continued to be based on very optimistic assumptions for U.S. economic growth. If those did not materialize, the deficit would be substantially larger than currently projected. Clearly, persistent deficits of a magnitude of nearly 5 percent of GNP would be unsustainable for the United States and the world economy alike. As for U.S. monetary policy, he was in full agreement with the assessment of the staff that room for maneuver in actively pursuing an expansionary monetary policy was clearly limited and that a deliberate loosening of the monetary stance would likely be counterproductive.

He was also in full agreement with the staff's assessment of the economic policy pursued in European countries, Mr. Grosche commented. The European countries had, by and large, exercised greater fiscal restraint than had the United States, but in a number of countries, the process of fiscal consolidation had encountered difficulties or had been slower than envisaged, thus underlining the need for continued efforts in that area. The staff had rightly pointed out that monetary policy in Europe had until recently been constrained by the strong U.S. dollar. The easing of monetary conditions in the United States had widely been used by European central banks to justify easing monetary conditions in Europe as well. In that regard, interest rates in Germany had been reduced markedly, although it remained questionable whether there was room for a further significant lowering of interest rates in other European countries. The renewed strength of the dollar in recent weeks showed that interest rate differentials could not be stretched deliberately without provoking a reaction in the markets. While still on the European economies, he agreed with the staff that the existing structural rigidities in Europe impeded stronger growth.

As for Japan, the prospects for a further rapidly rising external surplus and continued dependence on foreign demand for economic growth were a source of concern, since those developments were likely to intensify protectionist pressures abroad, Mr. Grosche observed. His authorities were concerned that the measures taken by the Japanese authorities thus far to reduce the imbalances had not prevented a further increase in the current account surplus. While welcoming the set of measures adopted recently to further open up the Japanese market, his authorities questioned whether that action would lead to a significant reduction in the trade surplus, since the measures taken did not contain steps to stimulate domestic demand. Fiscal and other measures seemed desirable as a way of reducing the surplus of domestic savings over domestic investments. Unless that relationship was changed, capital exports could be expected to persist, thus weakening the yen and stimulating exports. In view of the considerable progress made in strengthening the underlying fiscal position in Japan, it was appropriate for the authorities to pursue their medium-term objective of fiscal consolidation in a somewhat more flexible manner. The staff's suggestions with regard to the stance of monetary policy in Japan were somewhat less convincing. In his view, the staff had overestimated the room for maneuver by the central banks, since moves to strengthen the yen by a tightening of monetary conditions would conflict with the aim of stimulating domestic demand.

On some of the issues raised in the main paper, Mr. Grosche noted that, while the increased economic uncertainties warranted neither basic changes in the current policy stance nor the establishment of contingency plans, they did call for increased firmness in the implementation of current policy intentions, particularly in the United States and in a number of highly indebted developing countries. Still, it seemed reasonable and desirable to consider possible policy responses in advance of unexpected unfavorable developments in order to assure mutual consistency of the policy response across countries.

On the role of the Fund, his authorities believed that the institution must continue to exercise its surveillance function and to promote internationally compatible policies, Mr. Grosche commented. Also, there could be no doubt that sufficient financing would continue to be required in support of the adjustment efforts of indebted countries, and the Fund must play a crucial part in assuring that financing and adjustment went hand in hand. As the tasks ahead had not diminished, Fund management and the Executive Board would face a difficult time in making surveillance work and in ensuring that adjustment programs were supported by Fund resources only if balance of payments viability could be reasonably expected. Appropriate financial support was usually unlocked only on the basis of a strong domestic adjustment, particularly a successful fight against inflation.

Mr. Polak observed that the latest World Economic Outlook papers contained little new material to discuss, a fact that followed inevitably from the view adopted by the Fund and its major borrowers that it was better to focus on stable policies for the medium term. That approach was in sharp contrast to the stance adopted some years previously when fine tuning had been in fashion and when each half-year forecast was accompanied by new advice on policy for each member. More recently, the medium-term framework of policy pursued by the industrial countries and prescribed for the developing countries severely limited the extent to which the staff's forecasts encouraged new observations on policy. Mostly the advice was simply to implement current policy more forcefully or efficiently.

He agreed with the emphasis placed by the staff on improved fiscal performance in the United States, including the admonition that, if sufficient fiscal improvement could not be obtained by cutting expenditures, taxes would have to be raised, Mr. Polak continued. He also agreed with the staff's advice to Italy, the United Kingdom, and France to bring fiscal policy back on track. Where success had been achieved, the staff appropriately saw some room for a relaxation of fiscal policy or for some flexibility in the fiscal field, advice that applied in particular to Germany and Japan. He also shared the more general suggestion that monetary policy in Europe should allow European interest rates to fall as rates declined in the United States. However, he did not feel that that was the correct advice for Japan, given the overriding need for an appreciation of the yen.

The staff's insistence on the need to reduce rigidities was well taken, as was its argument that protectionism must at all costs be held at bay or rolled back, Mr. Polak commented. The recent decision of the U.S. authorities not to accept import restrictions on shoes deserved warm support; he hoped that they would resist with equal vigor the onslaught of protectionist proposals being brought forward in the Congress. His only concern with the staff's advice was related to the brief comment on monetary policy for the smaller industrial countries in Europe. The staff had suggested that monetary policy for those countries was constrained by links to the currencies of larger countries, but the advice was to conduct monetary policy so as to make further progress toward better price stability. That idea might have been presented by stating that the linkage of those smaller countries' currencies to the deutsche mark under the rules of the European Monetary System made an important contribution toward the desired inflation objective.

The staff had noted that the aggregate current account deficit of the developing countries, following an involuntary compression over the past three years, could be financed without the need for new net balance of payments lending by commercial banks, Mr. Polak continued. Unfortunately, that statement applied only in the aggregate. The situation of primary product exporting countries had deteriorated significantly, and that group had need for net nonofficial borrowing in 1985 of some $13.5 billion, an amount higher than that required in 1983 and 1984 and much higher than the amount forecast in the March 1985 World Economic Outlook papers. For individual countries that did not need new money, the debt problem had been reduced. The joint interests of debtor countries and banks to find ways of overcoming the repayment hump of the next few years had become increasingly evident in the course of 1985. The process could, in his view, clearly be helped along if the Fund were to provide an umbrella of enhanced surveillance. Continued adjustment by debtor countries was required to make the process feasible and to allow those countries to grow into the indebtedness that had clearly been excessive when the debt crisis had broken out. The policies needed for that adjustment had been described in earlier World Economic Outlook papers and were well summarized in the latest paper on pages 35 and 36.

Although the staff had dealt extensively with inflation in developing countries, there remained scope for a more imaginative treatment of the subject, either by itself or in future World Economic Outlook papers, Mr. Polak considered. One of the issues deserving more detailed attention was inertial inflation, or inflation that continued long after the original cause for it--usually a large government deficit--had been removed. Recent attempts to deal with that issue in Argentina and other countries deserved careful study, as did countries in Europe and elsewhere that seemed stuck in the circular process of rather high rates of inflation and exchange rate adjustment to correct the inflation. As the staff had correctly stressed, the world could not be complacent about what were currently called low rates of inflation in industrial countries. The limits of reduction in inflation that seemed to have been reached, for example, in the United States and the United Kingdom were not acceptable, and policy should not be based on the misconception that inflation had been beaten.

The staff had, in his view, appropriately concluded its World Economic Outlook analysis with a discussion of possible less favorable developments and their impact on various groups of countries, Mr. Polak observed. As the staff had noted, uncertainties in the world economic situation had increased, or at least the world was more aware of those uncertainties at present than it had been 6-12 months earlier. Despite the accurate description of the uncertainties, he was somewhat troubled about the staff's suggested policy responses to them. Of course, one could not blame the staff for not presenting ready-made answers to problems that had not been adequately studied, but it should have been possible for the staff to give specific content to the policy prescriptions put forward in general terms. For example, the staff had called a number of times for consistency in policy responses across countries or mutually compatible policies in response to developments that diverged from expectations. However, on the most important issue in that connection--namely, exchange rates--the staff found itself unable to specify what would be consistent policy responses, citing the likely existence in any particular situation of dichotomies of views. In seeking a way out of the difficulty he had described, the staff had invoked the magic word "surveillance" and had called upon the international community to help avoid inappropriate or inconsistent policies by effective use of surveillance mechanisms. While he could accept the staff's view that "there is a clear need to avoid inconsistent policies through the use of mechanisms for international consultation," he noted that neither theory nor recent practice made him particularly confident that that need could be fulfilled. Surveillance might well be the only lever by which the Fund could exert pressure on its industrial member countries, but he wondered whether more was not being claimed for the concept of surveillance than could reasonably be hoped for in reality.

Mr. Nimatallah agreed with the staff that the short-term outlook for the world economy was little different than it had been six months previously, although there were at present more uncertainties about the medium-term prospects for sustaining the world economic recovery. Those uncertainties were caused by slower growth in the industrial countries, weaker oil and primary commodity prices, and intensified protectionist pressures. In addition, some heavily indebted countries had failed to control their high rates of inflation. The useful sensitivity analysis provided by the staff clearly demonstrated the risks ahead.

He also agreed that the medium-term policies adopted by the industrial countries in recent years remained appropriate, Mr. Nimatallah continued. However, given the new uncertainties, the industrial countries must intensify their efforts to implement those policies more consistently. The main elements of the policies should include fiscal discipline to increase savings and investment, sustained pursuit of anti-inflationary monetary policies, and the restructuring of labor, commodity, and financial markets aimed at reducing rigidities and improving resource allocation. As he had mentioned on other occasions, the United States had made good progress in tackling its long-term economic problems by adopting more appropriate policies. On balance, those policies had also had a favorable impact on the world economy. In the period ahead, the U.S. authorities needed to concentrate more on reducing real interest rates, resisting protectionist pressures, and increasing domestic savings. The proposed tax reform package should include features that encouraged private sector savings. Fundamentally, however, it was important to ensure a consistent gradual reduction in the federal fiscal deficit in the years ahead.

For their part, the European countries should begin to take advantage of cheaper oil and raw materials and lower interest rates to intensify their efforts to reduce labor market rigidities and make employment practices more flexible, Mr. Nimatallah considered. Further efforts would also be needed to reduce unnecessary government expenditures and provide scope for tax cuts and further improvements in tax structure in order to improve employment opportunities and encourage investment. Germany was already making progress in reducing expenditure and improving its tax structure, but more could be done in other European countries and in Japan.

In September 1984 he had been fairly confident that the problem of international debt had been under control, Mr. Nimatallah said. Unfortunately, that confidence had waned. The highly indebted developing countries had benefited from the world recovery in the past two years and, with appropriate policies, several of them had made good progress in reducing their external payments imbalances by increasing exports. In view of the uncertainties at present, it was imperative that the highly indebted countries did not lose the momentum of adjustment. Their creditors and trading partners would feel more morally obligated to help them if they intensified their efforts to control inflation and emphasized policies that were more conducive to achieving domestic financial balance. It was certainly essential that their trading partners keep their markets open and firmly resist protectionist pressures.

Other developing countries had been, and were being, adversely affected by lower oil and commodity prices, Mr. Nimatallah observed. Those countries had to adjust to the new situation. Some had already done so successfully, but it was possible that oil and commodity prices would decline further. The oil market, for example, might well dictate a decline in oil prices. In that regard, it was most important that the decline should not take place abruptly. Saudi Arabia would like to see an orderly functioning of the oil market, and non-OPEC oil producers had a responsibility as well to help to reduce uncertainties in that market.

On the role of the Fund, Mr. Nimatallah noted that the institution had played a central part in the effort to strengthen the international financial system, and he hoped it would continue to do so. The Fund should not be discouraged by unwarranted criticism but should continue to help its members adjust and grow. He agreed with the staff that the additional uncertainties facing the world economy at present necessitated a strengthening of the Fund. One way to strengthen the institution was to preserve its financial integrity and to ensure closer cooperation among its members to make surveillance more effective. Greater coordination of policies among the industrial countries would help to reduce the current uncertainties. The reports of both the Group of Ten and the Group of Twenty-Four on the international monetary system rightly emphasized that point; he hoped that the Group of Ten members, in particular, would be able to translate their intentions to cooperate into concrete action.

Mr. Zecchini observed that developments in the world economy in the past six months had confirmed the validity of the scenarios outlined in the April 1985 papers on the World Economic Outlook, but they also suggested that new and significant areas of uncertainty had come to light. Those uncertainties related to the rapid and partly unexpected deceleration of growth in the U.S. economy in the first half of 1985, the marked reduction in the growth of exports of indebted developing countries, and the further deterioration in the terms of trade of primary product exporters. They also related to the more recent volatility in exchange rates. The surge of the dollar in the past few weeks was a symptom of the uncertainties surrounding the future course of fiscal and monetary policies in the United States and, if that surge were to be sustained, it would substantially contribute to a worsening of the economic picture.

Without implying any radical modification in the scenarios, the factors of uncertainty undoubtedly were cause for concern, Mr. Zecchini continued. They demanded that countries look at what course of policies was the best for dealing with the uncertainties and what contingent actions should be envisaged if more unfavorable developments were to materialize. In his view, the response to the new uncertainties in the world economy should be a confirmation generally of the recent course of policies, but with a greater degree of coordination in the economic policies of the major countries and greater attention to their international implications. The objectives of policy should continue to be a sustained and noninflationary growth in the industrial world, the maintenance of exchange and interest rate conditions favorable to a gradual easing of the debt service burden of developing countries, sound and realistic policies by the developing countries, and a firm rejection of protectionist measures. Increased coordination was necessary to ensure that the adjustment efforts still under way in the developing and some industrial countries would be facilitated by a stimulus from those countries that had already brought inflation under control and had achieved strong external positions.

It remained unclear how the fiscal and current account deficits in the United States would be dealt with and how strong the pickup in economic activity would be in the second half of 1985 and in 1986, Mr. Zecchini commented. It was important to ensure that the reduction in the fiscal imbalances was gradual and was not brought about by an excessive withdrawal of stimulus from the economy. On the other hand, the agreement recently reached in Congress to reduce the deficits in the medium term was not in his view sufficient, since the underlying assumptions about the growth of the U.S. economy were optimistic. Should excessive problems arise in reducing expenditures by the required amount, action on the revenue side should be considered. As for monetary policy, there had been some change in policy stance in recent months with an easing that had favored a decline in interest rates and a depreciation of the dollar. Those movements in interest and exchange rates had been partly reversed of late, reflecting conflicting impulses stemming from fiscal and monetary developments in the United States. Those developments reinforced his view that it was not possible to obtain a stable reduction in current account deficits only through exchange rate and monetary policy changes without parallel corrective action on the fiscal front.

In those large industrial countries with current account surpluses--such as Germany and Japan--economic policies had not shown a sufficient degree of flexibility, and growth had relied mainly on the contribution from foreign demand, Mr. Zecchini remarked. The dangers of such reliance had become evident in the first part of 1985, when, following the slowdown in activity in the United States, increases in world trade and economic growth had fallen considerably short of expectations. He agreed with the authorities of those countries and with the staff that fiscal and financial policies should be set in a medium-term framework; however, the staff's approach was in his view too rigid, as it called for changes in policy stances in the face of unforeseen circumstances to occur only through the working of the so-called automatic stabilizers. A more appropriate approach in his view would be for Germany and Japan to strike a balance between short-term and medium-term fiscal objectives. On the other hand, economic policies in countries like his own should be aimed primarily at further fiscal retrenchment and reductions in inflationary pressures. Continuous action would also need to be taken in European countries to reduce labor market rigidities in order to favor the reabsorption of the existing unemployed.

The global economic developments outlined in the latest World Economic Outlook papers were particularly worrying insofar as they related to the prospects for growth and adjustment in developing countries, Mr. Zecchini commented. After the favorable developments in 1984, many of the developing countries were again facing weak world demand for their primary product exports and worsening terms of trade and, consequently, more difficult conditions for their adjustment efforts. It was interesting in that regard to look closely at the figures in the statistical tables and to compare certain indicators in different years. By comparison with the figures for 1984, the estimate of growth for the indebted developing countries had been revised upward by a significant amount, and the volume of exports of those countries had also undergone an upward revision. In other words, the unexpected growth of export demand had allowed the indebted developing countries to grow faster than expected. At the same time, the estimate of import volumes had also been revised, although in a downward direction, a development he found interesting and one that might be related to the fact that many developing countries had been able to realize an improvement in the degree of their import dependence, perhaps through successful policies of import substitution. Certainly that had been the case for some countries, like Brazil, recently examined in the Executive Board. It would be interesting to hear from the staff whether the phenomenon had been so generalized as to explain the behavior of aggregate imports and growth for all indebted developing countries. If so, that would represent an encouraging signal, since policies aimed at promoting import substitution were often an integral part of Fund-supported programs.

Developments in 1985, unfortunately, were not so positive, Mr. Zecchini continued. Since the April 1985 World Economic Outlook exercise, there had been a sharp decline in export growth and an unexpected decline in export prices, both of which were particularly large for the group of primary product exporters. The declines had been partly compensated by a lower growth of import volumes, but they nevertheless reflected a significant worsening of the current account balance and gave a clear idea of the difficult external conditions that developing countries were facing in 1985. Moreover, they suggested that the worsening of the current payment flows of the developing countries was due mainly to a relaxation of adjustment efforts in those countries.

Turning specifically to the issues for discussion suggested by the staff at the end of its main paper, Mr. Zecchini said that he shared the view that the medium-term framework for policies continued to be appropriate, although it should be complemented by increased coordination of national policies, particularly among the major industrial countries. Those countries that had already brought inflation under control and were enjoying strong external positions should increase their contribution to global demand; that was particularly true for those countries that continued to suffer from a weak employment situation and for which the risks of an inflationary stimulus were lowest. On that point, in particular, the staff should perhaps have worded its views somewhat more strongly.

The emphasis placed by the staff on the uncertainties of the World Economic Outlook was appropriate, Mr. Zecchini considered. However, he had some doubts about the general strategy put forward for dealing with those uncertainties. Specifically, he doubted that, in the face of unfavorable developments relating to growth in industrial countries, the simple working of the automatic stabilizers would be sufficient to realize the baseline scenarios. In that context, consideration of some more active "contingency plans" could be useful.

On the persistent debt problem, two elements should be delineated, Mr. Zecchini said. The first had to do with the way individual cases of debtor countries were handled. In that regard, the current strategy--comprised mainly of reschedulings, adjustment programs, and "enhanced surveillance"--was appropriate and should be continued. The other element of the debt problem was related to the way in which global economic conditions affected the situation of debtor countries. On that matter, a greater degree of preoccupation was justified. In the absence of favorable conditions in the world economy, it was doubtful that either the bilateral strategy mentioned above or the current stance of policies in the industrial countries--even allowing for the favorable effects of the automatic stabilizers--constituted an adequate means of dealing with the debt problem.

Finally, protectionism was an obvious threat in the latest World Economic Outlook, Mr. Zecchini remarked. The only effective way to fend off that threat was to deal with its causes, which consisted mainly of wide divergences in competitiveness among major countries that had emerged in the current decade. As those causes were being corrected, it was essential that governments of countries in deficit, particularly the United States, should strongly resist the pressures exerted on them to increase the degree of protection of the domestic market.

Mr. Fujino observed that slower economic growth in the first half of 1985 had made short-term prospects more uncertain than during the April 1985 World Economic Outlook discussions. In particular, the economic growth of the United States had decelerated markedly during the period, mainly because of inventory investments and a deterioration in the external balance. Also, in continental Europe, similar stock adjustments and a severe winter had prevented the expected growth from materializing. In Japan, the foreign balance, which had been negative in the first quarter of the year, had offset the expansion in domestic demand. He supported the staff view that some of the factors that had brought about a deceleration in growth were temporary in nature and that the underlying factors that would support continued recovery remained in place. Indeed, reduced inflation, the improved profit situation, and eased monetary conditions in industrial countries were encouraging. The economy of Japan had been following a course of moderate expansion, and the staff projections have been revised marginally upward with respect to the growth rate of Japan for 1985, in contrast to the downward adjustment for the United States and Europe.

For the developing countries, it was encouraging to note that output growth in 1984 had been better than originally forecast and that many of the exporters of manufactures that had already undertaken substantial adjustments had relatively good prospects for continued expansion through 1986, Mr. Fujino commented. On the other hand, he noted with concern that the growth prospects of the major borrowers and of sub-Saharan African countries had deteriorated.

The staff's moderate concern about inflationary prospects for industrial countries was legitimate, Mr. Fujino considered. Continued price stability in those countries was largely attributable to weak commodity prices and, as the growth of labor productivity decelerated, renewed price pressures might increase. In that respect, prudent conduct of monetary policy and supply-side measures aimed at fostering the growth of labor productivity were essential.

Remarking on exchange rate developments, Mr. Fujino welcomed the depreciation of the U.S. dollar since March 1985, while noting that a reversal in the trend had occurred quite recently. A further decline in the U.S. dollar at a moderate pace would contribute to more convergent current account positions for industrial countries. In that regard, and in respect of the current account forecasts for Japan in 1986, it was not clear to him on what basis a revision from the spring 1985 forecasts had been made. It should be borne in mind that the new forecast was at most a tentative one and depended heavily on exchange rate assumptions.

On the stance of policies in the industrial countries, the staff had noted that the general government deficit of Japan in relation to GNP would move to the lowest among the five largest countries in 1986, although the central government deficit would remain one of the highest among major industrial countries, Mr. Fujino observed. A reduction in the deficit at the general government level might indicate that certain progress had been made in fiscal reform in Japan. However, the large central government deficit remained and continued to add to the already high central government debt currently outstanding. Further fiscal reform was imperative in order to achieve the medium-term official target of reducing dependency on deficit financing loans. Another reason why the Japanese authorities were not complacent about reducing the general government deficit was related to the rapid aging of the population. Because of that factor, social security funds--which had traditionally recorded a large surplus--would come under strong financial pressure in the coming years and, unless the central government deficit had been reduced considerably by that time, those pressures might lead to another increase in general government deficit. It should be added in that regard that, despite fiscal retrenchment, the investment activities of public corporations, financed through the Fiscal Investment and Loan Program, remained strong in Japan, providing additional fiscal stimulus to domestic demand.

On medium-term prospects, Mr. Fujino stated that he could generally support that staff view that the conclusions in the March 1985 scenarios remained valid, although increased uncertainties had to be attached to them. In view of the uncertainties, the sensitivity analyses presented in Supplement 2 to the main paper were useful. One particular analysis that had attracted his attention was the effect of the depreciation of the U.S. dollar on the U.S. current account and, more specifically, the speed with which the U.S. current account might improve with a dollar depreciation. Table 1 on page 10 of the supplement indicated that the U.S. current account would improve by $10 billion in the second half of the year after a depreciation of the U.S. dollar by 20 percent. That was an encouraging analysis and underscored the important role that exchange rates could play in causing and rectifying current account imbalances. To the extent that protectionist pressures were related to external imbalances, the results of the simulation pointed to the way in which such protectionist pressures could most effectively be dealt with.

The urgency of reducing the U.S. fiscal deficit was widely recognized, and an important step had been taken in July toward that end, Mr. Fujino said. However, further action seemed to be required if a significant reduction in the fiscal deficit was to be achieved against the background of prospects for slower economic growth. It was likely that revenue enhancing measures would have to be included among those further actions if expenditure cuts proved inadequate. It should be emphasized that the relatively low interest rates prevailing in the United States were sustainable and consistent with moderate economic growth only if considerable progress on the fiscal front was in prospect. An easing of monetary policy that was not supported by fiscal restraint would run the risk of a renewed increase in interest rates, which, in turn, could add another difficult dimension to the debt problem and the effort to roll back protectionism.

Divergent payments positions were a source of serious concern, Mr. Fujino noted. For their part, the Japanese authorities had taken a number of market-opening measures in the fields of trade and finance in the past several years. One recent measure was the "action program" on which an extensive account had been given in the information notes on trade. There was no denying the important role that the exchange rate configurations had played in producing the present current account imbalances. In the circumstances, monetary policy in Japan had been conducted cautiously and in a way that would foster an appreciation of the Japanese yen. Another important factor that should contribute to the improvement in the external balance was the expansion of domestic demand at a satisfactory pace. Within the framework of medium-term fiscal objectives, as much attention as possible had been paid to the structure of revenues and expenditures so that the maximum stimulative effect on domestic demand could be secured. Together with those efforts by the Japanese authorities, which would be continued in future, decisive action by the United States aimed at reducing the federal deficit should help to reduce both the external imbalance and the accompanying protectionist pressures.

The staff's suggested policy responses to the uncertainties he had mentioned represented a relatively cautious and prudent course of action, Mr. Fujino said. However, the situation in the coming months might become more complicated, and flexibility in policy responses should therefore not be precluded.

Finally, on a presentational matter, Mr. Fujino remarked that it might be somewhat confusing to observers to see the World Economic Outlook paper, which was somewhat different in coverage and content from the Annual Report, published immediately after the Annual Meetings. The publication of the Outlook twice a year also added to the work load and expenditures of the Fund at a time when the maintenance of efficiency and a reduction in the work load were badly needed. Too frequent publication of the World Economic Outlook, particularly if it involved politically delicate recommendations, could undermine the trust that member countries placed in the Fund; on the other hand, if the Fund attempted to be too sensitive to the interests of member countries, the result could be a World Economic Outlook of little substance. It was, therefore, his authorities' view that the published version of the World Economic Outlook should consist mainly of the tables and short comments taken from Chapters II and III; the full text of the World Economic Outlook papers should not be published.

Mr. Nimatallah said that he could not go along with the suggestion of Mr. Fujino to shorten drastically the published version of the World Economic Outlook. The paper was in his view an excellent one and should be published in full with only the usual editing.

The Chairman observed that it had become the practice of the Fund to publish at the time of the Annual Meetings an updated version of the World Economic Outlook. In 1984, the publication had been limited to the shorter-term aspects of the World Economic Outlook and had not included medium-term aspects and policy considerations. At present, however, there were many concerns about the way the medium-term prospects were shaping up, given the uncertainties that Directors had been mentioning. In that respect, the staff and management had been giving thought to a more ambitious publication in which some of the medium-term and policy aspects of the exercise might be included. In the circumstances, and in view of Mr. Fujino's remarks, he would appreciate hearing the views of other Directors on what should be included in the published version of the World Economic Outlook paper.

Mr. Kafka observed that his views on the publication of an updated version of the World Economic Outlook were well known and did not bear repeating. However, on the assumption that publication would take place, he hoped that account would be taken of the view of a number of Directors that the paper as presently formulated was somewhat optimistic in tone.

Mr. Joyce considered that the World Economic Outlook report should be published in one form or another, since failure to publish it at the present juncture would send an inappropriate signal. Also, he tended to agree with the Chairman that the time was perhaps ripe for a more extensive publication than in the past, particularly with respect to some of the medium-term prospects, as the report was increasingly becoming the basis for more informed economic discussion of the prospects for the world economy. As to the tone of the published report, he had always understood that the document was one produced by the staff and not by the Executive Board; and he hoped that the staff would not make any extensive changes for publication unless it had been intellectually convinced to do so by arguments put forward by Directors.

Mr. Rye agreed that it would be unwise to cut back on publication of the World Economic Outlook and, at a minimum, the publication should be at least as comprehensive as those in earlier years. How far the Fund should go beyond what it had done in the past was a matter open to question. He could see that a more comprehensive report might be attractive to some; on the other hand, he saw no obligation to publish any more than had been published in the past, especially if there were to be a preponderance of views among Directors that the report was deficient in some way. It might be confusing if a number of Ministers found it necessary at the Annual Meetings in Seoul to disassociate themselves in some way from what the staff had been saying.

Mr. Grosche remarked that he had great sympathy for the views of the Chairman and Mr. Nimatallah and Mr. Joyce that the published version of the World Economic Outlook should perhaps cover medium-term and policy aspects of the exercise and that it might thus be appropriate at the present juncture to go beyond what had been published in the previous year and make it clear that enhancement in the implementation of policy was needed. However, publication of the Annual Report and a second full-fledged World Economic Outlook paper at the same time might be somewhat awkward. On balance, he could support publication of the World Economic Outlook report as it stood.

The Economic Counsellor, responding to Mr. Kafka's concerns about the tone of the report, observed that the published version of the World Economic Outlook, while it was a staff report, often took into account the concerns of Directors, and the staff made an effort to be as accommodating as possible. As for the report in question, the intention of the staff at present was not to include the supplementary paper on sensitivity projections but to incorporate in the published version the tables currently embodied in the statistical appendix.

Mr. Lankester considered that the report was a useful one and expressed the hope that the staff would publish it in its current form.

Mr. Dallara said that his views on the extent of publication would be offered during his statement later in the day. However, he would appreciate hearing from the staff precisely what had been published in the past from the time when the Fund had first begun publishing the fall version.

The Economic Counsellor replied that the fall publication had first appeared in 1984. It had been the equivalent of Chapter II of the current year's report and had also included all tables except those pertaining to the medium-term scenario. In that respect, the published version had been an updated picture of the World Economic Outlook, and the current developments had been outlined in the tables.

Mr. Sengupta said that he saw no reason why the World Economic Outlook paper should not be published, although he wondered why some parts of it were held back from publication. On another matter, he took note of a recently circulated paper written by an individual staff member on the U.S. deficit and interest rates, and he asked why some papers were considered staff papers and others were viewed as papers written by individuals.

The Chairman suggested that Executive Directors continue their discussion of the World Economic Outlook in the afternoon and expressed the hope that other Directors would at that time offer their views on the desirability of publishing the World Economic Outlook report and on the extent of the material it should cover.

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/85/142 (9/13/85) and EBM/85/143 (9/16/85).

2. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/85/236 (9/12/85) and EBAP/85/237 (9/12/85) is approved.

APPROVED: May 23, 1986

LEO VAN HOUTVEN
Secretary