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Minutes of Executive Board Meeting 85/144

3:00 p.m., September 16, 1985

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

Executive Directors	Alternate Executive Directors
	Mawakani Samba
C. H. Dallara	
J. de Groote	
B. de Maulde	S. de Forges
M. Finaish	T. Alhaimus
H. Fujino	M. Sugita
G. Grosche	
	Jaafar A.
R. K. Joyce	
A. Kafka	
T. P. Lankester	
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
V. Wall, Assistant

Also Present

African Department: D. E. Syvrud. Asian Department: A. Ariyoshi. European Department: L. J. Lipschitz, G. Szapary. Exchange and Trade Relations Department: C. D. Finch, Counsellor and Director; G. Belanger, C. M. Watson. External Relations Department: A. F. Mohammed, Director; N. K. Humphreys, I. S. McDonald. Fiscal Affairs Department: V. Tanzi, Director; A. H. Mansur. Legal Department: G. P. Nicoletopoulos, Director. Middle Eastern Department: 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, S. J. A. Gorne, P. Gotur, O. E. G. Johnson, A. Lanyi, F. B. Larson, D. J. Mathieson, P. J. Montiel, B. E. Rourke, M. C. Williamson. Western Hemisphere Department: S. T. Beza, Associate Director; P. B. Clark. Bureau of Statistics: C. A. Patel. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: A. A. Agah, P. E. Archibong, J. Hospedales, G. Nguyen, G. W. K. Pickering, M. Z. M. Qureshi, T. Sirivedhin, E. M. Taha, A. Vasudevan. Assistants to Executive Directors: J. R. N. Almeida, W.-R. Bengs, J. J. Dreizzen, V. Govindarajan, Z. b. Ismail, S. King, S. Kolb, J. A. K. Munthali, E. Olsen, M. Rasyid, A. A. Scholten, B. Tamami, A. J. Tregilgas, E. L. Walker, B. D. White, Yang W.

1. WORLD ECONOMIC OUTLOOK - GENERAL SURVEY

The Executive Directors resumed their discussion of the staff paper for 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. Lundstrom said there had been some favorable developments in the world economy since the last World Economic Outlook discussion in March--namely, the decline of the U.S. dollar and somewhat lower interest and inflation rates, the latter having been caused by the decline in prices of primary commodities. While that development had been beneficial to industrial countries, it had hurt the balance of payments of developing countries. However, on balance, the world economy was in a less satisfactory state currently than it had been in March. The U.S. growth rate had decelerated more than expected during 1985, which had led to somewhat slower growth in other industrial countries, as domestic demand in those countries had not been strong enough to compensate for weakening U.S. demand. Because no policies had emerged from industrial countries in response to those developments, there had resulted increasingly large payments imbalances, accelerating protectionism, and deteriorating external debt situations in many developing countries, including some of the major debtors.

The downside risks in the projections had substantially increased, and there was increasing evidence that the projections themselves were on the optimistic side, Mr. Lundstrom noted. How much did the various data and indicators have to change and how great must the uncertainties become in order to compel the staff to revise its forecast significantly? He hoped that the Fund was not developing a new type of structural rigidity. The staff apparently had adopted the following philosophy: "to the extent that the present strategy is working, stick to it; to the extent that it is not, stick to it even more." The staff argued against "any immediate change in economic strategy"; surely that was not something that anybody would recommend. Rather, a modified strategy should gradually evolve, based on developments as they unfolded. Nevertheless, there were some individual countries' domestic economies in which drastic changes might be more effective than gradual ones. However, when dealing with the complex nexus of forces, causalities, and interrelationships that made up the world economy, sudden changes were not possible. Like a supertanker, it took a long time to change the speed or course of an economy. Nevertheless, if one waited too long to adjust an economy, it could run aground. Then there was no benefit in observing that the economy had at some point been a good one and never required any immediate change.

The staff had made valid points in the revised forecast that the weakening of growth in the first half of 1985 would be temporary, Mr. Lundstrom remarked. However, were the inventory adjustments that had taken place in the United States really temporary? They could well be cyclical, pointing to a protracted slowdown in economic activity.

Developments would have to be monitored closely in the period ahead. For example, a somewhat higher flash estimate for the third quarter, confirming some positive production data earlier last week, was not sufficient evidence one way or the other. Furthermore, recent figures indicated a reduction in business spending plans. After an unexpectedly long period of strong growth, it would not be surprising to see a sluggish performance in the U.S. economy. The case was becoming stronger for policy adjustment in some of the larger countries in order to avoid further deterioration of the world economic situation.

The paramount importance of a reduction in the large U.S. imbalances was no longer seriously questioned, Mr. Lundstrom stated. A substantial reduction in the fiscal deficit was the only way to lower the interest rate and induce a further decline in the U.S. dollar and, thereby, in the external deficit. His authorities doubted that the budget deficit reduction agreed to in Congress would prove sufficient. A more restrictive fiscal policy would have a more favorable effect on the balance of payments. The exchange rate movement that had taken place thus far was insufficient to correct a major external imbalance, as the change in real effective terms had not been particularly large. In the short run, the appropriate policy change in the United States would reduce its growth impulses. In the event, other major countries must take up the slack. He urged countries that were in a favorable economic position, such as Germany and Japan, to help avoid a deterioration in the world economic situation.

There was still a need for fiscal action in Germany, Mr. Lundstrom commented--for instance, advancing the date of the second stage of the tax reform. The current World Economic Outlook report did not adequately reflect the summing up of the recent Article IV consultation with Germany, which included the words "even within this medium-term framework, there was both scope and need for directing policies toward a strengthening of domestic demand." However, no one had suggested a shift to more stimulatory short-term demand management. As for reducing income taxes, Directors had thought that "more could be done, for example, through an accelerated schedule, in order to strengthen domestic demand and to broaden the base of the economic expansion."

In western Europe generally there was still a need for supply-side measures, Mr. Lundstrom stated. Unemployment in Europe was twice as high as ten years earlier and was still persistently rising. That fact indicated that the present strategy was not succeeding and neither would modifications of it.

In Japan, where projections of growth of domestic demand had been revised downward, there should be room for some fiscal stimulus, Mr. Lundstrom continued. However, an easing of monetary policy might be inappropriate in view of the need for strengthening the yen vis-à-vis the dollar.

His authorities did not consider the baseline scenario acceptable, since it had not provided for a reduction of unemployment, Mr. Lundstrom considered. Currently, it was not certain that even that unsatisfactory scenario would materialize. The implications of the scenario were particularly worrying for the developing countries. At present, the debt situation might appear manageable in most countries, but would that fact hold true for 1986 and 1987? Recent unfavorable developments in large debtor countries were evidence of the fragility of the situation.

One might question to what extent adjustment in developing countries could be sustained without larger export revenues and increased financial flows, Mr. Lundstrom went on. How realistic was the staff's view that the overall financing requirements of market borrowers in the short run could be reduced even more than indicated in the March World Economic Outlook paper? One wondered what kind of effects the import compression phase, which apparently had not passed, might have on the developing countries' production potential and hence on their adjustment in the long term. The effects of depressed imports in developing countries on production and employment in industrial countries should also be observed. Generally speaking, too little attention had been paid to the financing problems raised by the long-term character of the structural adjustment policies of developing countries.

Protectionism would soon increase, Mr. Lundstrom said, and it was of particular concern that developing countries would bear the brunt of the burden. It was vital to repel protectionist tendencies. In that connection, a reduction of the U.S. external imbalance was obviously important. Containment of the increasing demand by U.S. industry for protection would be facilitated by stronger growth outside the United States. The dismantling of nontariff barriers must occur. A further opening up of the Japanese market would be particularly helpful.

Advantage had been taken of the present support for a new round of GATT negotiations, and multilateral trade negotiations would commence as soon as possible, Mr. Lundstrom added. In order to increase confidence and improve conditions for the negotiations, industrial countries must live up to their commitments to freeze and remove import restrictions. Then, with sustained economic growth in industrial countries, it would be easier for developing countries to eliminate their own protectionism.

His views were dictated by his authorities' concern for the international financial and trading system if the increased downside risks materialized, Mr. Lundstrom stated. While the main responsibility for avoiding that development obviously rested with sovereign governments, the Fund nevertheless had an increasingly important role to play. It was uniquely equipped to monitor and coordinate economic policies of its members, and its role might be further enhanced by strengthening those surveillance activities. In that context his constituency attached great importance to the World Economic Outlook discussions and to their potential effects on the consistency of policies, particularly those of the major industrial countries.

He agreed that not publishing the report at present could have undesirable effects, Mr. Lundstrom continued; indeed, he could think of no context in which not publishing it would be recommendable. Continuity was essential. After all, it was a staff report, which could be repudiated by governments and authorities who did not agree with it. Of course, corrections suggested by members of the Board should be placed in the final version. The final version might also include opinions expressed by the Board, but only to the extent that the staff had been convinced by them and had adopted them. Otherwise, Directors should not claim any influence on the contents of the report.

Mr. Jaafar said that the staff paper was broadly in line with his expectations. The subtantial amount of uncertainty in the forecast favored recommending more cautious policies for the industrial countries. That caution also should be applied to policies recommended to ensure that the present recovery was on a firmer footing than before. Failure to resume growth would cost far too much to leave the adoption of policies to chance. However, in spite of uncertainties that had developed, the staff was still making the same policy recommendations it had made six months earlier.

Global recovery from the deep recession of 1982 had never been strong, Mr. Jaafar noted. Downside risks for the recovery to falter had already been discussed in the Board on several occasions. The only bright spot was the vigorous recovery in the U.S. economy, where strong demand for imports had pulled up the rest, particularly some of the European economies, Japan, and the newly industrialized countries. The European economy, beset by structural rigidities and high unemployment, had not been strong recently, and Japan's domestic demand had also remained weak. Since the strong stimulus from the U.S. fiscal deficit had for the most part already disappeared, the correct priority was for the United States to reduce its deficits. For the remainder of the industrial countries, the current strategy of budgetary consolidation in pursuit of medium-term objectives appeared incongruent with the problems. On the contrary, discretionary fiscal stimulus appeared appropriate. Japan had made significant progress in fiscal consolidation and in containing inflation. Therefore, Japan had more room for maneuver than most countries, and a more flexible fiscal policy to strengthen domestic demand was in order.

A similar situation existed in the Federal Republic of Germany, where past growth performances had been more from external sources, Mr. Jaafar commented. He agreed with the plan to cut taxes in Germany in 1986 and beyond but felt that the country could do more to encourage growth. Indeed, there appeared to be a larger scope for growth in the major European economies in general than had so far been achieved. In spite of recent recovery, excess capacity remained in the United Kingdom and Germany, yet unemployment persisted at a high level. The issue was whether Europe should try to achieve its high growth potential at present or to remain with its present policy strategy. Because there was a danger associated with a forced pace of activity, discretionary stimulus was appropriate in the face of present uncertainties--the unemployment situation and excess capacity but good inflation records.

The revival of the less developed countries' economies had never been strong, at least compared with the 1970s, Mr. Jaafar went on. Currently, recovery was uneven, and the global recovery had not touched some at all. For the less developed countries as a whole, the recommendation for no departure from current policies by the major industrial countries was inappropriate. It did not take into account the difficult prospects for the less developed countries. It was certainly not acceptable if the objective was promotion of a more orderly and less painful adjustment, particularly among the highly indebted developing countries.

The revival of world trade was the most important concern for the less developed countries, Mr. Jaafar continued. However, it could only materialize within the context of a sufficiently growing world economy. At present, world trade was expected to expand by some 4 percent, down 1 1/2 percent from the spring forecast and 4 1/2 percent from 1984. Equally disappointing was the prospect for trade for 1986, in which only a small gain of 3 1/4 percent was expected over the 1985 estimate. A similarly bleak picture had been painted for commodities. The commodity price index had fared worse in 1985 than in 1984, with a large 9 percent decline in growth. Those developments translated into a substantial reduction in export receipts for the less developed countries.

A related issue was the growing threat of protectionism, Mr. Jaafar remarked. The growing trade imbalances in favor of Japan had intensified the lobby in the United States for more protection for domestic industries. That development was of concern to the less developed countries not only because it added a larger element of uncertainty but because it involved protection against exports of both primary and manufactured commodities. The appearance of bilateral trade arrangement and quotas was undesirable, as those were trade practices that were inefficient and grossly unfair to all.

The global debt problem was far from over, Mr. Jaafar went on. Admittedly, satisfactory progress had been made since the initial crisis in 1982, when hope had existed for orderly adjustment to achieve global economic recovery. However, the recent slowing of growth in the major economies had emphasized how fragile the situation was. A less painful adjustment could not take place without assurance of external financing and improvements in the standard of living. Successful rehabilitation of the debtor economies could only come in the medium and long term. Import compression and other short-term sacrifices should be followed up by long-term measures on the supply side. However, strong export performance would ease that situation.

He was surprised that despite substantial uncertainties attached to the scenarios of the spring World Economic Outlook, little adjustment had been made in the current projections, especially in view of the significant changes expected for the key assumptions, Mr. Jaafar continued. Nonetheless, Supplement 2 of the report (EBS/85/201) had emphasized the point that the risk of a substantial decline in oil prices and the exchange value of the dollar should not be measured in terms of the magnitude of the fall, but of the suddenness of the change. For example, a small decline in oil prices, even for a relatively short period, threatened the financial stability of the international monetary system to a degree that far outweighed any benefits. The same was true of a precipitous fall in the dollar. Every country had an interest in promoting an orderly market for oil and a fundamental resolution of the problems relating to the overrated dollar.

He was glad the staff had highlighted policy interactions, because policies of major industrial countries regarding capital mobility and flexible exchange rates had repercussions in other countries, Mr. Jaafar noted. Although the need for harmony in policies of major countries was generally accepted, it had not been achieved. The reports from the G-10 and G-24 on that subject would receive significant attention from the Ministers at the forthcoming Interim Committee meeting. Two issues deserved emphasis--the inherent instability of the present exchange rate regime and the effectiveness of Fund surveillance. The first issue was the search for an institutional arrangement to regain stability, and the second was for appropriate measures to make Fund surveillance of the major industrial countries more effective.

He was in favor of publicizing, Mr. Jaafar stated. Indeed, publicity on a selected basis could lead to speculation or give the wrong signal to the public. He disagreed that the paper was the staff's paper and that its publication should be made in the name of the staff. He felt that it should reflect also the opinions of the Executive Board. Therefore, he was pleased to hear that the staff "was not operating in a vacuum" and that if a different view was expressed by the Board, it would be reflected in the edited version of the publication. Therefore, he was in favor of publishing both texts, including the statistical tables and the sensitivity analysis in Supplement 2.

Mr. Mtei indicated that his impression of the World Economic Outlook was that of apprehension about the future pace of global economic activity. The world economy was again delicately poised between recovery and recession. World economic expansion was slowing down and uncertainties prevailed. In a number of cases previous forecasts of strong recovery had been revised downward. Thus, the world economic recovery, which had been robust barely a year earlier, currently appeared anemic and fragile. Despite an increasingly firm implementation of adjustment policies, economic prospects for the developing countries in general and Africa in particular were grim, as continued weaknesses in export receipts affected domestic incomes and retarded the growth of domestic demand and output.

Exchange rate variability was a great concern to developing countries, Mr. Mtei continued, because in the absence of well-developed financial markets, exporters and importers in those countries had been exposed to high risks from the exchange rate. A Fund study had shown that "a one percentage point appreciation of the U.S. dollar vis-à-vis the currencies of other industrial countries typically led to a one fourth percent decline in the dollar price of nonfuel primary commodities." Given the significant effective appreciation of the U.S. dollar in recent years, a sizable decline in commodity prices had thus occurred.

His authorities were worried that real interest rates would remain at historically high levels, Mr. Mtei went on. That phenomenon had had important effects on debt, growth, and commodity exports in developing countries. For example, the rise in interest rates had led to a significant increase in the developing countries' debt service payments. As shown in another Fund study, "each percentage point increase in Eurodollar interest rates represents a rise of over $2 billion in the developing countries' interest payments." Interest rates were higher than inflation rates, which meant that the real debt service burden rose commensurately. Moreover, by raising the cost of commodity inputs, the increase in real interest rates caused the demand for primary commodities to decline. Under those circumstances, the low-income, commodity producing countries faced serious pressure to finance their balance of payments because they were also handicapped by fluctuations in their export receipts. Indeed, it was difficult to consider the economic growth of developing countries without contending with the fundamental issue of the impact of rising interest rates. Apart from the higher debt servicing costs and the worse outlook for export earnings, the rise in real interest rates had resulted in the decline of profitability of investments, leading to curtailment of commercial lending to developing countries since 1982, which, in turn, had forced them to compress imports, resulting in an adverse effect on growth.

Because of the deceleration in export growth, the developing countries' economies had deteriorated, Mr. Mtei remarked, the sub-Saharan African countries' economies growing at an estimated average rate of only 1 percent during 1983-84. Therefore, he did not share the optimism of the staff's projection of an annual output growth rate for that region of 3 1/2 percent in 1985/86. To achieve that rate of growth would require a significant increase in the rate of growth of foreign exchange earnings to support the growth of domestic output. However, the region was currently characterized by bleak economic prospects--new inflows of external finance were rare, terms of trade had failed to recover, genuine adjustment efforts had in a number of cases been constrained by inadequate resources, and their debt service burden had been aggravated by high real interest rates and protectionist barriers. Given the well-known special problems of that group of ¿7untries, which were complicated frequently by exogenous factors, he would like the staff to explain the assumptions underlying its optimistic growth projections. In the absence of firm and reliable statistics, care should be taken not to give wrong signals to both the donors and the receivers of the Special Facility for Sub-Saharan Africa.

He found no convincing evidence in support of the appropriateness of the overall medium-term policy strategy in industrial countries, Mr. Mtei went on. The medium-term stance should be considered against the background of large shifts in world savings and investment. On the one hand, the U.S. budget deficit had increased to such an extent that it could not be financed fully from domestic savings, resulting in continued upward pressure on interest rates. Thus, with present policies, the United States would have a budget deficit of $200 billion or more. Because of high U.S. interest rates, the deficit would bring about capital inflows, an overvalued dollar, and a widening current account deficit. On the other hand, the OPEC surplus and the "savings" it represented had disappeared, because governments in many industrial countries had increased their claims on available net savings. The resulting scarcity of savings had kept real interest rates at historic levels.

It was clear that there was a real need to take strong action immediately to reduce budget deficits. The emphasis should fall on reducing spending rather than raising taxes, because in most industrial countries government spending as a proportion of national income had been rising at an unacceptable rate. Increases in real wages should be kept below increases in productivity. Currently, there was a strong tendency toward labor-saving investment. However, capital was scarce and labor was more abundant. Given the unemployment problem, was it an appropriate policy to be substituting capital for labor to the extent that it was being done in Europe? Modifications were required not only in implementation but in some of the policies themselves.

The major countries should set a cooperative framework of policies in which the policies of each country would be deemed appropriate in an international context, Mr. Mtei remarked. Such a framework of policy cooperation was a prerequisite to reducing protectionist measures and insuring better management of exchange rates. The monetary authorities of the major industrial countries could act together to counter exchange rate swings that were clearly out of line and that threatened the preservation of the liberal trade and payments system. Lacking such cooperation, the world economy currently straddled the line between recovery and recession, which resulted in uncertainties and concern. There was a need for increased firmness in the implementation of existing policies. In addition, some policy modifications and a more effective use of Fund surveillance were required. Again, countries should give greater weight to external considerations in the formulation of domestic monetary and economic policies.

The developing countries had made extremely painful adjustment efforts that had been largely successful, Mr. Mtei indicated. However, the success of adjustment programs depended crucially on the strength of world recovery. The more the demand in industrial countries recovered, the more debtor countries could expand their exports and production instead of cutting back on imports and employment. For that reason, policies coordinated to strengthen the recovery were decisive for the resolution of developing countries' debt problems. Furthermore, the resolution of that debt problem was necessary for the sustained recovery of the world economy. Seldom had the interdependence of industrial and developing countries for policymaking been more important.

The present weak recovery and uncertainty called for more determined policy action in some countries in the short run in order to stimulate world demand, Mr. Mtei noted. The success in many industrial countries in reducing inflation at the cost of high unemployment had brought about a set of circumstances in which such a stimulus was desirable. Although some countries still had to reduce their inflation rates, there was no immediate danger of a general revival of worldwide inflation. With falling oil prices, high unemployment, and low capacity utilization, no strong upward pressure on wages and prices was to be expected in the near future.

Currently, the central difficulty of economic policymaking arose from tension between the need to reduce structural budget deficits and the short-term desirability of stimulating world demand, Mr. Mtei continued. Designing policies that could be helpful in both directions was the crucial task facing governments. In that connection, Fund staff assistance would be appropriate. Meanwhile, he would like to see a more immediate stimulus given to those countries with very low rates of inflation and a large or growing current account surplus. Unfortunately, some of those countries had been tightening their fiscal policies so that even the automatic stabilizing effect on the budget had been offset.

Given the precarious economic environment for the low-income countries--many of which were in Africa--global recovery had had a minimal effect on their economies, Mr. Mtei went on. Although there had been successful adjustment efforts in Africa, not much could be achieved in the short run because of the largely structural nature of the problems. The economies were vulnerable to exogenous shocks, which posed difficulties for economic management in general, and for the management of the balance of payments in particular. The solution to those problems required the understanding and full cooperation of the international community. Perhaps the disappointing performance of the world economy would lead to a revival of the discussion of issues relating to the functioning of the international monetary system.

There was merit in publishing the paper with all the appendices after the Annual Meetings, Mr. Mtei stated. It was important to maintain continuity with the international financial community as well as with academic circles, which had previously found the publication authoritative and useful.

Mr. Zhang said that the paper presented a consistent, if somewhat optimistic, view of the current world economic situation. The industrial countries faced growing pressure for protection, severe and mounting trade imbalances, persistent internal disequilibrium, and high unemployment, which were symptomatic of the failure of the economic system to work properly under the existing system of flexible exchange rates and the policies of major countries. Was the Board satisfied with the staff recommendation for the continuance and reinforcement of present policies?

The paper called for more vigorous implementation of existing medium-term policies--specifically, to reduce the U.S. budget and current account deficits and the Japanese current account surplus, Mr. Zhang continued. It called for easing monetary policy and for determined implementation of supply-side policies in Europe, particularly those aimed at reducing structural rigidities in the labor market. He had two questions about the paper: was the Board convinced that the recommended policies would prevent a severe slowdown of growth in the industrial world? and had sufficient attention been given to the possibility that the recommended policies might not be implemented in some countries? What if the policy strategy in a major country should suddenly precipitate sharp changes in real exchange rates or liquidity? How would that development affect another country's policy strategies? If some governments did not--or for political reasons, could not--effectively pursue their declared medium-term goals, would other countries avoid adjusting their policies?

Which of the industrial economies would be expected to expand in response to a cut in the U.S. fiscal deficit? Mr. Zhang asked. The cut would affect the United States' trading partners differently. Could the staff pinpoint the countries that were likely to be adversely affected by a U.S. economic slowdown and their likely policy reaction? Japan and Canada had been the principal beneficiaries of U.S. expansion, increasing net exports with relatively small changes in their currencies vis-à-vis the U.S. dollar. In contrast, the European countries, which had been more adversely affected by high interest rates than favorably affected by expanded U.S. demand, would need to separate their interest rates from those in the United States, thereby inducing substantial changes in their exchange rates vis-à-vis the U.S. dollar, which in turn would increase their exports. Therefore, if the United States were to cut its fiscal deficit, Europe would be able to reduce interest rates, thereby making larger gains in domestic investment and consumption than it would lose in net exports to the United States; Canada and Japan would experience a reduction in aggregate demand.

The current slowdown in industrial countries was indeed of concern, Mr. Zhang remarked. The pace of activity might slow even further in the face of the U.S. fiscal cuts. The staff's response to that was to reject fiscal expansion in other industrial countries, pointing to the danger of "trying to force the pace of mounting easing." He wondered whether the staff also would reject a one-time monetary expansion in those countries that would permit real and nominal interest rates to fall, with a subsequent return to the current monetary targets. Were the present high levels of unemployment to be regarded as the minimum? Surely an incomes policy would reduce the danger of inflation from monetary expansion. There was a role for incomes policy to play in some of the industrial countries, such as the United Kingdom, in facilitating noninflationary expansion.

The paper stated that the key issue facing the Japanese authorities "is not so much to stimulate the growth of GNP but to make it less dependent on foreign demand," Mr. Zhang continued. The staff had suggested that changes in the structure of revenues and expenditures might help to foster the growth of domestic demand. What actual measures did the staff have in mind? Could such changes produce the desired effect in a reasonably short period? Continued application of the Japanese Government's present monetary strategy apparently was not producing the desired appreciation of the exchange rate. Moreover, what if exchange rate appreciation reduced the stimulus to export expansion and strengthened the competitiveness of imports in the Japanese market? In that case, what would prevent a general decline due to lower open sector income? and would not subsequent monetary stringency cause a current account imbalance due to a decline in imports?

The paper's short discussion of the appropriate response to an unforeseen change in an industrial country's exchange rate suggested the need for closer consideration of the issue, taking the workings of the industrial countries as a realistic model, Mr. Zhang stated. The paper pointed out that if the authorities of member countries were simply tightening monetary policy--irrespective of whether their currencies were appreciating or depreciating--there would be a systematic deflationary impact on the world economy. Conversely, that implied that there would not be a deflationary impact if the existing monetary policies remained unchanged. Was that the staff's view? For one country depreciation would represent an external inflationary shock that was not accommodated by the existing monetary policy. The consequent rise in prices would cause a reduction in aggregate domestic demand. The effects on economic activity and employment, however, would be mitigated by the increased share of domestic and foreign demand met by domestic output. For the country with an appreciating currency, also pursuing a strict monetary policy, the reduction in inflation would cause an unintended stimulus to domestic demand, which would be accompanied by a sharp deflationary shock to the open sector of the economy because real wages and costs had increased at the new exchange rate. There was no inherent reason why the opposite effect in those two should be symmetrical and offsetting. On the one hand, the marked shifts in the composition of output would increase the uncertainty as to whether increased export profitability would be eroded in the country with a depreciating currency, and on the other hand, the uncertainties associated with rising unemployment and declining activity in the appreciating countries seemed likely to promote a general decline in investment and economic activity.

What reforms in the wage bargaining system did the staff believe would ensure that real wages would change in line with the marginal product of labor, since the level of real wages was not actually determined in the labor market? Mr. Zhang asked. Furthermore, he wondered if action to reduce rigidities in the labor market in Europe could prevent a rise in unemployment and a reduction in investment if exchange rates appreciated sharply against the dollar. In those circumstances, would governments be politically able to maintain the existing policy stance? and would not confidence be undermined? He wondered if promoting a wage setting procedure that would ensure greater flexibility of real wages was a sufficient response to the growing uncertainty. What was urgently needed currently was closer collaboration between major industrial countries to stabilize the absolute purchasing power of their currencies.

Mr. Rye said that overall the paper depicted a stronger performance in 1984 than had been earlier envisioned, a downward revision of expectations for 1985, and a return to an improved but still modest rate of growth in 1986, perhaps commencing in the second half of 1985. Those developments had been produced by special short-term factors in North America and Europe in the first half of 1985. The strong upswing in investment in the industrial countries in 1984--nearly 10 percent overall, 18 percent in the United States alone--was partly cyclical, reflecting the need to expand production to satisfy the higher demand in those countries since 1983. If that investment pattern were cyclical, then more subdued growth in 1985 and 1986 should not come as a surprise. Indeed, temporary slowdowns had been regular features of the upward stages of business cycles in the United States particularly. Consequently, he saw little reason to conclude that the present tendency in the world economy was toward recession, and he thought the staff correct to project the modest growth rate for 1986.

However, such an outcome was certainly not inevitable, Mr. Rye continued. The uncertainties were indeed greater than they had been a year earlier. It appeared that the short-term assessment in the spring had been too optimistic. Thus, a certain atmosphere of pessimism in the discussion so far was natural enough. In the long-term perspective, there had been much uncertainty about the economic future for many years--and it would not be hard to remember when those uncertainties were greater than they were currently. Too much pessimism could be as dangerous as complacency, and he felt that the staff had got the balance about right.

The medium-term policies pursued over the past several years were appropriate, Mr. Rye considered. The increased uncertainties in the present outlook stemmed from the failure to adequately implement announced policy intentions. Key uncertainties were the fiscal and external imbalances of the United States and, closely connected with that, international interest rates and exchange rates. For example, one scenario that would cause concern would be a smaller reduction in the deficit than envisioned in the U.S. congressional plan and a less significant downward adjustment to U.S. interest rates and the dollar. Lower interest rates and a declining dollar were crucial to a resolution of the debt problem in the medium term. While there had been some positive developments, it was uncertain whether those could be sustained without decisive action on the fiscal front, including tax increases if necessary. It would be dangerous for the U.S. authorities to force interest and exchange rate adjustments through expansionary monetary policies.

In Europe and Japan, the outlook was rather encouraging, Mr. Rye remarked. Japan and some of the European countries were better placed than in a long time to liberalize their economies and accommodate higher domestic demand. Of course, there had already been moves in that direction. Japan had taken some useful initiatives in finance and trade, and Germany, in addition to ongoing efforts in structural reform and market liberalization, had planned tax cuts for 1986 and 1988. As opportunity arose, those countries should push ahead. A more expansionary economic strategy, perhaps involving tax cuts, had been discussed in Japan for some time. It would be unfortunate if the full-scale review of the Japanese tax system, to be undertaken over the next 12 months, unduly delayed such a policy shift.

The question of policy interactions among the major economies was a complex one, Mr. Rye continued. That such interactions existed was undeniable--and it was also undeniable that countries should take those interactions into account when formulating policy. But, ultimately, how policymakers weighed the international against the domestic ramifications of their actions was up to them. Hope for more than influential guidance by institutions such as the Fund would be in vain. In that regard, he had reservations about the possibilities held out for the "new look" surveillance.

Exchange rate variability was an important aspect of policy interaction, Mr. Rye stated. To some extent, such variability was inevitable in a multireserve currency system and increasingly deregulated capital markets. While exchange rate variability might increase cost and uncertainty, there were increasingly sophisticated means of dealing with it. The present variability owed much to differences in policy stance and performance in the major countries, implying that at least some of the answer to the problem lay in redressing those differences.

The recent slowdown in industrial countries' growth had had adverse effects on the developing countries through trade linkages, Mr. Rye went on. However, had the impact of that development not been overstated? After all, non-oil imports of industrial countries were still projected to grow in dollar terms by a moderate 6.2 percent in 1985 and by a rather strong 11.9 percent in 1986. Furthermore, he noted that the latter figure had been revised upward since the spring World Economic Outlook. In particular, exports of non-oil developing countries, projected to grow by only 1.5 percent in 1985, would rapidly accelerate to 11.2 percent in 1986. If those projections were realized and if developing countries maintained competitiveness through appropriate domestic policies, then for the next year or two trade with industrial countries would be a platform for growth in developing countries.

However, some groups of developing countries faced less encouraging prospects than they did 6 or 12 months earlier, Mr. Rye noted. Two such groups stood out--oil exporters and agricultural commodity exporters. The oil exporters' less favorable outlook had to do with reactions to the earlier pricing policies for oil. The changed prospect for some agricultural exporters was connected with the downturn in industrial countries, because world trade in such commodities had always been sensitive to world aggregate demand. Trade protectionism and subsidized overproduction had also hurt agricultural commodity exporters. Those problems had not eased in recent years and had undoubtedly contributed to the downturn in prices. Accordingly, long-term growth by agricultural exporters would depend as much on the adoption of more rational and internationally responsible agricultural policies in industrial countries as on appropriate economic policies in the exporter country. That point warranted particular emphasis, given the importance of agricultural trade to a number of major debtor countries, some of which--Argentina in particular--had taken bold and courageous steps to solve their problems. Those countries were entitled to better access to industrial country markets unconstricted by protectionist measures. However, agricultural protectionism was only one side of a problem that needed to be tackled on all fronts with a much greater sense of urgency than was evident currently.

Table 44 of the statistical appendix (EBS/85/201, Sup. 1, 8/26/85) should convince anyone that the debt problem was far from solved, Mr. Rye said. For capital importing countries as a whole, the ratio of debt to exports of goods and services in 1985 was shown as 155.5 percent, less than 3 percentage points below its 1983 peak. The debt service ratio, 25.3 percent, was actually higher than the previous peak in 1984.

The main requirement in the period ahead was to contain the new money requirements of already heavily indebted countries to amounts that could be readily financed, Mr. Rye noted. It was encouraging that sources other than private creditors appeared capable of meeting anticipated financing requirements. Even so, there were some countries facing more difficult circumstances--although there was no alternative but to approach their financing needs on a case-by-case basis. Therein, the Fund must continue to play a key role, directly and as a catalyst for mobilizing other sources of finance.

After reflecting on several points that had been made, he would raise no further objection to publication of the document, Mr. Rye said in closing.

Mr. Nebbia remarked that developments in the first nine months of 1985 had indicated a slowdown in the pace of world economic expansion. The growth of world output, which had been 4.5 percent in 1984, was estimated to be 3.1 percent in 1985. That deceleration was due to two main factors--the sharp decrease projected in the U.S. growth from 6.8 percent in 1984 to 2.6 percent in 1985 and the slower growth in primary product exporters resulting in part from weaker world demand.

He was uncomfortable with the staff assessment of "broadly appropriate" for the policy strategies being pursued in those countries, Mr. Nebbia continued. There were many reasons for major concerns: the slowdown in growth during 1985, particularly in the United States; the high and increasing unemployment rates in Europe; the volatility and misalignment of exchange rates; the current account imbalances in the industrial countries; and the fiscal deficits in the United States, which had caused real interest rates to rise and produce harsh effects on the economies of indebted developing countries.

His position stated at the time of the Article IV consultations for the United States, Germany, and Japan was still valid, Mr. Nebbia commented. Nevertheless, in light of gloomier prospects and greater uncertainties in the current World Economic Outlook, Germany and Japan should be urged to assume a respective responsible role toward the international community, since the lead of the United States was fading. Because of those uncertainties and the interactions of policies, there was the risk of a further slowdown in economic activity or a jump in interest rates. Either of those developments would have dramatic effects on the debt crisis for some debtors facing a situation that would be unsustainable. The appreciation of the dollar had increased the debt service burden of developing countries, and the volatility of exchange rates made it difficult for them to manage their external sectors.

The drop in the world demand for exports from developing countries was worrying, Mr. Nebbia went on. That decline in demand, together with the deterioration of the terms of trade and the lack of external financing, would compress developing countries' imports. The low level of imports in most developing countries undermined prospects for growth. Unless they could establish clear signs of economic progress, the governments of debtor countries would be faced with political and social pressures that would make it difficult to reconcile the objectives of restoring growth and meeting debt service payments.

The staff said that it might be necessary to "ensure that appropriate forms and amounts of finance were available to enable heavily indebted countries to adopt their adjustment programs to the new realities without undue disruption," Mr. Nebbia continued. Similarly, the Group of Twenty-Four had proposed in its report, "The Functioning and Improvement of the International Monetary System," the creation of a new facility in the Fund to provide indebted developing countries with financing for interest rate increases.

Referring to industrial countries, the report said that "the removal of rigidities is likely to be easier in a situation of expanding output and employment," Mr. Nebbia added. He hoped that that useful statement would be carefully considered when the Fund discussed adjustment programs in developing countries. In those countries the rigidities were much deeper, and the difficulties for their removal were multiplied.

The concept of net transfer of real resources, or net resource flows, associated with long-term lending, would be useful to include in the Board's discussions. The World Bank data indicated that net transfers--disbursements less debt service--had declined from $33 billion in 1978 to a negative $7 billion in 1984. For major borrowers, the amount had changed from $18 billion in 1978 to a negative $15 billion in 1984. He would like some comments from the staff on those figures as well as on the future prospects of the issue. Why was the useful concept of net resource transfer not discussed in the World Economic Outlook paper?

External debt was a major concern for most developing countries not only because of its economic effects but also because of its social and political implications, Mr. Nebbia stated. Developing countries continued to undertake strenuous adjustment efforts that often caused lower growth rates, reduced living standards, and eroded the social fabric. The reduction of external deficits had been impressive in particular for market borrowers. Current account deficits of that group of countries had fallen from $75 billion in 1982 to $7 billion in 1984, and were expected to decline even more in 1985-86.

The combination of a decline in capital inflows and continuing high interest rates had resulted in a massive negative transfer of resources in the developing countries, Mr. Nebbia remarked. Net borrowing by capital importing countries was projected at under 4 percent a year in 1985-86, much lower than the envisaged rate of interest. Therefore, the negative transfer of resources would continue and increase, which, in turn, would undermine the efforts of developing countries to expand investment and export-oriented sectors. Thus, if exports did not increase sufficiently, debt service difficulties would increase.

Most adjustment efforts had followed the path of "negative adjustment," which was characterized by lower economic activity--lower imports, higher unemployment, and undesirable changes in the income structure, Mr. Nebbia went on. That process of adjustment failed to tackle the rigidities that made it difficult to increase domestic savings in a recession. Alternative approaches should be followed, especially a "positive adjustment," which would be based on strong export growth and which would leave a sufficient margin for the growth of imports and debt service payments. That alternative approach could sustain investment and output growth.

A number of debtor countries had lately reached agreements with the international financial community to restructure their debts, Mr. Nebbia said. Although those arrangements might prevent a bunching of maturities in the short term, they would not solve the debt problem, because the country was left with a major resource transfer problem due to debt servicing. Solution of the debt problem transcended market mechanisms. The debt problem required the cooperation of debtor and industrial countries, as well as commercial banks and international financial institutions. It also required that debtors and creditors assume a joint responsibility for cooperative efforts, so that through programs of adjustment a durable solution to the debt problem could be achieved worldwide. However, the immediate need was for a significant increase in the transfer of real resources to developing countries. For that purpose, the resources of international financial institutions should be increased to enable them to play a more effective role.

He would like to quote a paragraph from the staff paper, Mr. Nebbia commented. "Protectionism is not confined to the industrial countries; indeed many developing countries have even more restrictive trade systems, whole liberalization should be an important objective of policy. However, protectionism in industrial countries is of central concern because of the threat it poses to the fabric of international collaboration and to the satisfactory resolution of the international debt situation." In his opinion, the order of those sentences should be reversed in order to emphasize the global problems of protectionism in industrial countries.

He commended the stance of President Reagan for not approving the imposition of quotas for shoe importers, Mr. Nebbia commented. Nevertheless, it was only one positive note in the face of increasing pressure for higher protectionism. The shelter that many European countries enjoyed in the European Economic Communities was well known. The Japanese were as bad and in some cases worse.

The paper had not mentioned the efforts that many developing countries were undertaking in liberalizing their imports--namely, Argentina would eliminate all its prohibitions by March 1986, and Mexico and Brazil had already liberalized more than 70 percent of their trade restrictions, Mr. Nebbia continued. In recognition of the interdependence of money, finance, and trade, it was important to emphasize once again the close relationship between an expanding world trade and a solution of the balance of payments problems, including the indebtedness of developing countries. The misalignment of exchange rates was a major reason for stronger protectionist pressures in industrial countries; furthermore, the malfunctioning of that system undermined the strong adjustment efforts that were taking place in developing countries.

The basic trends he had discussed were unstable and in some cases unsustainable, Mr. Nebbia stated. The key features of the world situation were the high degree of uncertainty in general and the possibility of deterioration in the economic environment faced by developing countries. Further slowdown in growth, an increase in interest rates, and increasing protectionism in industrial countries were not impossible developments in the near future. Therefore, it was crucial that the major industrial countries attain a set of mutually consistent objectives and policies that would bring about symmetrical international adjustment, facilitate expansion of world output and trade, and give priority to real resource transfers and sustained growth in developing countries.

He agreed with Mr. Kafka on the representation of developing countries, Mr. Nebbia said in concluding, and he felt that it would be desirable to have the report published in full.

Mr. Sengupta remarked that the Board had had a lively discussion on the World Economic Outlook, ranging from pessimism, to concern, to caution, to cautious optimism, to optimism tinged with complacency. One Executive Director had said that the situation could be summed up in two sentences: "There was no cause for alarm. The adverse factors were temporary." However, the charm that some people found in the international economic situation eluded those in the developing countries. How could they be charmed by the projection that the slowdown in output of industrial countries would be reversed in the second half of 1985 and be higher than projected in 1986, while the growth of developing countries was expected to be significantly lower than earlier projections not only in 1985 but also in 1986? He was not questioning the staff's projections, but it would be useful if more explanations had been provided for the unhappy state of affairs in the developing countries.

A few of the fuel exporters' problems were understandable, but he wondered why they were not foreseen in March, Mr. Sengupta continued. Perhaps the staff should look into the demand supply balance and not just the terms of trade effects of a fall in the price of oil. Then it might be possible to project the oil price movements, which would help the rest of the world plan production programs. More important, however, was the question of why primary product exports were slowing down when the industrial countries' growth was reviving. Primary product prices had deteriorated sharply, and projections had shown no improvement. He would like the staff to point out the policy implications of that development. There would possibly be an excess of primary products even as the industrial countries' output expanded. What should be done to correct that situation--buffer stocking, supply management, international intervention in the world market?

What would have happened to inflation in industrial countries if commodity prices had not been depressed? Mr. Sengupta asked. The staff mentioned that the inflation of 1980-83 "appears to have largely run its course." However, currently, unit labor costs were expected to rise. The staff recommendation for easing monetary policy to allow lowering interest rates was based on projections of no increase in the inflation rate, the 4 percent rate in 1984 to remain slightly below 4 percent in 1985-86. Was that predication assumed on a continuation of depressed commodity prices? If commodity prices recovered, would that reverse inflation projections? He questioned the assumption that everything would be all right in the medium term after 1987. However, capital importing countries would grow at 4 1/2 to 5 percent. If some of the assumptions of the baseline scenario for 1985-86 were not going to hold, what policies would enable the developing countries to grow as projected?

The outlook for output and trade for 1985-86 both for industrial countries and developing countries was a cause for concern, Mr. Sengupta went on. In fact, 1984 had been the only year of satisfactory growth since 1980. Positive and concerted actions were immediately necessary by industrial countries to reverse that trend of weak growth. It was threatening the international economic stability with the re-emergence of international debt problems. Whereas the inflation rate for industrial countries had steadily dropped to below 4 percent from 9 percent in 1980, the unemployment rate was more than 9 percent. With inflation finally under control, the appropriate strategy to prevent another recession was for the industrial countries to raise output and volume of trade.

Extremely high confidence in the dollar had added a new dimension to the specter of recession, Mr. Sengupta continued. In view of the accumulation of dollars held by the rest of the world, loss of confidence might lead to a worldwide collapse. That uncertainty demanded an appropriate realignment of exchange rates of major international currencies. Furthermore, stabilizing those rates would bring down international interest rates and promote output growth. In order to improve trade and ease the international debt problem, the major industrial countries needed to roll back protectionism and to evolve a joint strategy to achieve significantly higher output in trade growth.

If a protracted slowdown in industrial countries made policy modifications necessary, the Fund's role would become more central, both in consulting with members about policy measures and in providing financial support, Mr. Sengupta remarked. However, such consultations and support were desirable even if there were no protracted slowdown. Recently, the Group of Twenty-Four had called for the Fund to conduct a system of multilateral surveillance. The staff had also called for increased surveillance, but the G-24 report detailed how it should be accomplished. It would be necessary for the major industrial countries to consult each other and agree on the policies and the indicators that would be monitored during bilateral surveillance. Because surveillance was not possible if policy objectives were uncertain, a concertation of policies was absolutely necessary.

Any attempt to reduce the budget deficit in the United States--by lowering the interest rate, capital inflows, the value of the dollar, or the current account deficit--must be matched by reflationary policies in the OECD countries if the world economy was to be prevented from stagnating, Mr. Sengupta continued. For example, Japan's dependence on net exports for growth should be reduced. There was a capital outflow problem in Japan that more than compensated for the current account surplus. Japan's currency could not appreciate in the way recommended by the staff; its capital outflow problem could not be solved without international policy interaction.

A number of developing countries suffering from financial shortages for productive investment would welcome external resources on reasonable terms and conditions, Mr. Sengupta noted. The current high levels of nominal and real interest rates in international markets had prevailed for too long and needed to be brought down to achieve sustained reasonable growth in the world economy. Higher growth would improve trade prospects and weaken protectionist pressures. In addition, the availability of resources to low-income countries needed to be improved, and rescheduling the developing countries' external debt would improve economic prospects.

He would like to restate a few sentences made by the staff regarding the indebted countries, Mr. Sengupta went on.

> This might include insuring that appropriate forms and amounts of finance were available to enable heavily indebted countries to adapt their adjustment programs to the new realities without undue disruption.... It is important, therefore, that appropriate financial support be available for policy programs that offer realistic prospects for effective adjustment.... A

related need is for an increased flow of official development assistance, particularly to low-income countries facing high debt servicing burdens. Although much of these countries' existing debt bears concessional interest rates, they had not benefited from recent interest rate declines to nearly the same extent as countries that borrow predominantly from private sources. The debt service ratio in Africa, for example, is projected to rise from 26 1/2 percent in 1984 to 32 1/4 percent in 1985, the largest increase in any region. Many developing countries will require substantial continuing flows of concessional foreign assistance if they are to overcome the structural obstacles to growth that they face.

That material indicated that most of the problems of the developing countries were well appreciated by the staff. They had been spelled out not only in the World Economic Outlook but in earlier reports as well, Mr. Sengupta continued. The question was what action the international community would take. The World Economic Outlook was considered by the Group of Ten as the principal forum for policy discussions. Unfortunately, that Group's policy prescriptions were not monitored and implemented. The problems were known; the solutions had been spelled out. Only the will of the international community to implement them was lacking.

Mr. Lankester said that he agreed with the broad outline of the World Economic Outlook paper. Despite some faltering in world economic activity in the first part of 1985, growth would be about 3 percent in 1985 and 1986, accompanied by only moderate inflation, some further progress in reducing unemployment, and a better balance of growth among the major economies. Although not quite as good a picture as six months earlier, it was by no means a bad one for the third and fourth years of a cyclical recovery. The respective authorities could take credit for the fact that through continued efforts at adjustment, the prospect remained reasonably encouraging.

However, a reasonable forecast was no grounds for complacency, Mr. Lankester noted. The forecast had yet to be achieved, and there were some significant downside risks in 1986 and beyond, the most important of which was the continuing imbalance in the U.S. economy. The prospective budget and trade deficits did not appear sustainable. Although those imbalances might have helped the world economy to come out of recession, they currently constituted a major threat to continued recovery. Unfortunately, the U.S. fiscal budget for 1986 made little progress in tackling problems. Indeed, estimates showed the federal deficit falling only slightly from 5 percent of GNP in 1985 to 4 3/4 percent in 1988. The U.S. authorities should not rule out tax increases if further expenditure cuts proved impossible. The reality was that sooner or later there would have to be a reduction in domestic absorption and an increase in national savings in the United States. If the authorities did not take action on the budget, an increase in private savings was likely to be forced on the United States by a fall in the dollar and a rise in interest rates. The effect of such spontaneous action would cause a crisis of confidence that could send the world economy into recession.

Real interest rates remained high in many countries, Mr. Lankester remarked. Again, that was mainly due to the U.S. budget deficit. However, deficit reduction was also needed by several other countries. Because of the deflationary effect of the national coal strike, his authorities had allowed the public sector borrowing requirement to exceed its target in 1984. Nonetheless, they had no intention of permitting a similar slippage in 1985.

Protectionism constituted a threat to the recovery, and all countries should resist it, Mr. Lankester stated. Indeed, it would have been helpful if the staff had considered the effects of protectionism in slowing the growth in world trade. In some cases, misaligned exchange rates and resulting large current account deficits were adding to the demands for greater protectionism. In that case, policies were needed to put current accounts on a sustainable basis. However, the responsibility for adjustment did not rest just with the deficit countries. The large and growing surpluses in Japan and, to a lesser degree, in Germany, were also important. Those governments had a responsibility to pursue policies that allowed domestic demand to make a full contribution to growth.

The international currency markets were turbulent, Mr. Lankester went on; for example, there was a possibility of a sharp realignment of the dollar. The principal solution remained the adoption of more convergent policies, not just convergence of performance. On the inflation front, convergence had occurred, and in former times many would have thought that sufficient to prevent major currency misalignments. However, that was no longer true. Convergent policies were also required that would, in particular, balance the fiscal policies of the major economies. In that connection, intensified surveillance was needed in order to achieve more consistent policies. Whether "increased firmness in the implementation of current policy intentions" was needed was not as clear. That depended on what those intentions were.

The major policy objective for the U.S. authorities should be to contain the budget deficit, Mr. Lankester continued. In addition, he hoped that they would resist the protectionist pressures that were building up. Of course, those two issues were related. If an orderly reduction in the value of the dollar could be achieved by dealing with the deficit, a lowering of protectionist pressures would follow.

The key issue facing the Japanese authorities was how to make growth less dependent on foreign demand, Mr. Lankester said. The low level of the yen and the large and rising current account surplus was increasing protectionist pressures not only in the United States but elsewhere. The authorities should promote faster growth in domestic demand, in order to achieve their fiscal objectives. Japan's general government financial deficit had already been reduced by 2 1/2 percent of GNP since 1980, and the budget plans included further sharp cuts in 1985 and 1986. The progress made in fiscal consolidation, together with a large pool of domestic savings, should allow the authorities to moderate the withdrawal of fiscal stimulus. In addition to faster domestic demand growth, a significant appreciation of the yen would also be required to reduce external imbalances. Monetary policy should be directed toward achieving a stronger exchange rate. In the longer term, financial liberalization would also help to strengthen the yen. Unfortunately, the liberalization undertaken thus far encouraged outflows and might actually have depressed the yen. He would be interested in the staff's assessment of the import promotion package that had been announced in July.

Despite significant progress in reducing inflation and the budget deficit, the short-term prospects in Germany looked a little disappointing, Mr. Lankester commented. Domestic demand appeared likely to continue to lag behind GNP growth. Therefore, the forthcoming personal tax cuts should support activity and also improve incentives. Nevertheless, those reductions would do little more than offset the fiscal drag that had occurred since 1982. Therefore, he wondered whether the progress that had already been achieved in fiscal consolidation might not give the authorities more room on the taxation side even within their current medium-term plans.

The U.K. economy was entering the fifth year of recovery, Mr. Lankester noted. During that period, growth had averaged 3 percent a year. Growth of about 3 1/2 percent was expected in 1985, although some 3/4 of 1 percent of that reflected the recovery from the miners strike, which had depressed activity in 1984. There had been some acceleration in inflation in the United Kingdom recently. He was confident that that increase would prove to be only temporary. The rate of inflation was projected to be 5 percent later in 1985 and below 5 percent in 1986. In macroeconomic terms, the United Kingdom was just about on track. The authorities were helping to make up for the slowing of U.S. activity while not renewing the risk of inflation. In fact, he felt that the staff projection for U.K. growth was slightly on the low side. In addition, without going into details of the United Kingdom's fiscal stance, he did not understand the staff's assertion that on a cyclically adjusted basis the Central Government's cash deficit was set to expand in 1985.

In all the European economies, including the United Kingdom, structural reform remained a key priority if faster growth and lower unemployment were to be realized, Mr. Lankester added. However, that was not an easy subject to cover in the World Economic Outlook report. Nevertheless, if that issue had been given further treatment, it could be seen where progress had been made and where greater efforts were required.

Considerable steps had been taken to adjust the economies of the developing countries in the wake of the second oil price hike and the debt crisis, Mr. Lankester remarked. The improved growth in the previous two years, which was forecast to continue to 1986, was one result. However, those countries' difficulties and needs remained formidable, and the debt problem would not disappear. It was projected over the medium term that a growth rate of 4 1/2 to 5 percent was feasible for those countries, along with a one-fourth to one-third reduction in external debt ratios. However, in order to achieve that, a further intensification of adjustment efforts was required. In particular, they must improve the productive performance of their economies by restraining their public sectors and making them more efficient. They should also shift more resources into their external sectors, preferably by appropriate pricing rather than by compressing demand.

Official assistance and revival of spontaneous lending were crucial, Mr. Lankester commented. In the short run, financing prospects did not look promising, which would make adjustment efforts all the more difficult and necessary. The best help industrial countries could give the indebted countries was continued progress in their own economies.

He thought that the World Economic Outlook report should be published in its entirety, subject to correction, Mr. Lankester stated. However, it should be made clear that it was a staff paper.

Mr. Dallara said that in the World Economic Outlook report a distinction had been made between domestic demand and GNP regarding the decline in the rate of growth of output in the United States during the first half of 1985. During that time, final domestic demand had grown at a respectable pace of 2 3/4 percent. However, 40 percent of demand had been supplied from abroad, which had caused a significant increase in the U.S. current account deficit because the figure had only been 20 percent in the first six quarters of the recovery. Thus, the decline in the rate of growth of output during the first half of 1985 was not fully matched by a weakening of demand, a fact which from one perspective could be a source of concern because it implied continued consumption at strong levels in the U.S. economy. On the other hand, it also suggested that the U.S. economy would continue to play an important role in sustaining world economic activity, particularly if demand could be shifted from external to domestic goods and services, it was hoped, in connection with appropriate exchange rate changes and improved growth prospects overseas. Notwithstanding developments over the previous ten days to two weeks, exchange rate movements in the previous few months had provided encouraging signs in that direction.

His authorities still looked for a rebound in U.S. output for the second half of 1985 in the range of 3 percent, somewhat higher than forecast, Mr. Dallara commented. Indeed, recent developments in the United States pointed toward a significant pickup in economic activity in the second half of 1985: the monetary growth; the sharp fall in both short- and long-term rates over the past year; the recent decline in the rate of unemployment; and the statistics from the automotive, construction, and agricultural sectors. In addition, the U.S. output would increase at a more rapid pace in 1986; he felt at a rate higher than projected by the staff.

There had been extensive discussions of the U.S. current account deficit during the Article IV consultation and the World Economic Outlook discussions in the spring of 1985, Mr. Dallara remarked. Many comments had been made today regarding the potential unsustainability of this deficit. His authorities recognized the need to reduce the deficit, but they did not yet see the route by which this would be reached. In addition, developments in other industrial countries would play a critical role in the reduction of the United States current account deficit. Currently, developments in the industrial world outside the United States were going in the right direction, although unemployment remained a serious and persistent problem, particularly in Europe. The low rate of economic activity early in 1985 in other important industrial countries--particularly Germany and Japan--had been temporary, a fact supported by developments within both countries in the previous six to eight weeks.

The outlook for Europe in 1986 was more positive than the staff had projected, Mr. Dallara continued. While the extent to which this outlook could be realized would depend substantially on policies in these countries, improved growth in Europe was likely to be lower than the U.S. output. This underscored the need for stronger policies to support expanded domestic demand and output in those countries. However, among the main industrial countries the recent evolution of GNP had a particularly positive aspect. Because of the convergence of performance, growth had been more balanced, which implied a sustainable low inflation, an element not fully reflected in the World Economic Outlook report. Additional progress toward convergence was important, but the current evenness in the output of major industrial countries should help to correct the existing external financial imbalances.

In spite of lower than envisaged growth for the industrial countries in 1985, the capital importing, developing countries were expected in the medium-term scenario to grow at a rate of 4.5 to 5 percent in 1986-90, Mr. Dallara said. There had been substantial efforts in many of those countries to bring about needed changes in their economic policies and conditions--many with Fund-supported programs. In addition, the sharp reduction in interest rates and the continued moderate expansion in the industrial countries had contributed to promising prospects for the developing countries. The most notable policies of the developing countries pointed to increasing supply; in particular, more effective and efficient exchange rate policies had helped recent performance and could have an increasingly important effect on medium-term growth.

He noted with concern the reduction in the expected rate of growth of exports and imports of both the major borrowers and the low-income countries of sub-Saharan Africa, Mr. Dallara continued. He had been heartened by the initial response of the latter group to an appropriate approach that he had suggested would help medium-term growth in those countries.

Following a period of substantial progress in sustained growth and viable external positions, there had been serious slippages in adjustment efforts in a number of key debtor countries, and this can be a source of concern for their long-term growth prospects, Mr. Dallara went on. However, in many cases the slippages were already being corrected. The difficulties some developing countries had in obtaining needed financing and support for comprehensive adjustment efforts was a cause for concern, particularly regarding certain changes not altogether clear from the data in the financing arrangements for those countries. It would be disconcerting if those changes persisted.

His authorities remained committed to a steady reduction in the fiscal deficit, Mr. Dallara commented. While some of the spending cuts in the budget compromise of early August were subject to congressional approval, President Reagan intended to veto any appropriation bills which might not be consistent with a deficit reduction package. While that budget resolution would not solve all the problems, it was nevertheless important for a number of reasons. First, the deficit in fiscal 1986 was expected to be in the range of $177 billion, approximately 4.3 percent of GDP, down more than 1 percent from 5.5 percent expected in fiscal 1985. That reduction was not insignificant. Furthermore, those administration projections were almost identical to those of the U.S. Congressional Budget Office, a source which many Executive Directors relied upon. The Congressional Budget Office currently estimated the deficit in the fiscal year 1986 at $175 billion, only $1 billion less than the Administration estimated and not significantly different from staff estimates. Second, that would put the United States on a path toward progressively lower deficits in the coming years. Whereas the achievement of that goal would depend on the evolution of the economy, by 1988 the debt to GNP ratio in the United States should no longer be rising, and the deficit should be moving toward a surplus.

His authorities thought that a revenue neutral tax reform package was the best means of increasing incentives for growth in the economy, Mr. Dallara said. He was puzzled by the staff's response to U.S. tax reform initiatives. Those initiatives had been noted by the staff as an example of supply-side fiscal policies intended to improve economic efficiency; however, the tax reform proposals also had been singled out as a particular source of uncertainty not only regarding its neutrality but also its "implications for the level and structure of demand." Certainly, there were uncertainties as to how the plan would eventually affect the economy. However, his authorities were committed to revenue neutral tax reform. Furthermore, there were sound reasons for believing that implications for the level and structure of demand were positive, which, indeed, was implied by the discussion on page 25 of the World Economic Outlook paper. Whereas there were tax reform initiatives under way in other important industrial countries, the ultimate effect of such tax reform effort was always uncertain. Therefore, he would have thought that a more positive view of the overall thrust of the tax reform efforts in the United States would have been more appropriate.

He agreed with the staff appraisal concerning recent developments in the U.S. monetary aggregates and monetary policy, Mr. Dallara stated. Furthermore, he assured Directors that his authorities' success in establishing anti-inflation policies had not led to complacency with regard to the need to pursue policies that were mindful of market sensitivities regarding inflationary expectations, even though they supported continued economic expansion.

His authorities were committed to resisting protectionism, Mr. Dallara went on, and he would inform them of the numerous positive comments Executive Directors had made concerning the recent decision not to impose restrictions on footwear imports into the United States. Nevertheless, one could not help but be concerned about rising protectionist actions in the United States, many of which emanated from Congress. His authorities would not be able to resist those pressures independently. Resistance to protectionism must be a cooperative effort. Other countries must not only resist further protectionist measures but must pursue fair trade policies and achieve adequate growth rates that could, along with other measures, increase the attractiveness of their currencies.

As the rate of growth in the United States became moderate and the stimulus provided by the earlier depreciation of U.S. currency receded, it would be essential that domestic demand and output in other industrial countries took up the slack, Mr. Dallara continued. That need was driven home by the many comments concerning the unsustainability of the U.S. current account deficit and the need for continued expansion of markets for developing countries' exports--an objective made more urgent by the downward revision of projections for export growth in many developing countries. The question was not whether more robust activity outside the United States was needed, but how it was to be achieved. It was not that Germany or Japan needed to depart from their fundamental paths of fiscal consolidation--paths down which both had made considerable progress in recent years--rather, those countries as well as others needed policies that would promote domestic demand and output as well as raise employment. Tax reform would be a key element in such policies and, because government expenditures in those countries was still at a rather high ratio to GDP, tax policy in the fiscal area were important. Germany had plans for tax changes that would have an important effect, Mr. Dallara said. However, it was uncertain whether the pace or scope of those changes was sufficient from either a national or an international perspective. Preliminary discussions were also under way in Japan regarding tax reform. That reform should reduce artificial incentives for savings and encourage domestic consumption and demand. The policies associated with savings had been developed at a time when substantial domestic savings had been needed to support high rates of domestic-investment associated savings with high rates of growth in output. However, Japan no longer had that problem, as rates of growth of about 8-10 percent were in the past. Currently, Japan had the opportunity to reshape tax and associated savings policies in a way more consistent with international considerations and with current and prospective realities in its own economy.

Those were not the only countries that had moved forward with tax reform, Mr. Dallara noted. France had reduced from 50 to 45 percent the tax rate on reinvested profits of businesses. That would make the tax treatment of reinvestment the same as for capital gains, and it would help the profitability of private sector investment. Additional steps in that direction should be encouraged.

Numerous steps had been taken to correct widely acknowledged rigidities in labor and capital markets in Europe and Japan, Mr. Dallara added. A flexibility had been introduced into German labor markets by extending from 6 months to 18 months the period a worker could be determined to be temporary. Similar actions had been taken in Belgium, the United Kingdom, the Netherlands, and other European countries. Nevertheless, there remained a need for a more aggressive and comprehensive reduction of rigidities. Whereas the fiscal year required governments to formulate policies once a year, a similar institution did not exist for redressing structural rigidities in the economies of the industrial countries. Perhaps that lack of institutional framework had led to the sensitivity toward the actions that had been taken. Therefore, governments should develop and project a more comprehensive approach into the market in order to make it clear that positive steps were being taken.

Monetary policy in other industrial countries would play a role, Mr. Dallara continued. While continuing prudent anti-inflationary monetary policy, there was still scope for expanding demand and output in Europe, Japan, and Canada by making changes in market conditions that had earlier been resisted, in part because of exchange rate concerns. Furthermore, the argument that interest rates in industrial countries outside the United States should not decline had clearly weakened, because U.S. exchange rates had weakened substantially, and other currencies had strengthened relative to the dollar in the previous six months. Indeed, interest rates in a number of important industrial countries outside the United States had been declining and would continue to do so.

There was a need for open market policies, particularly in Japan, Mr. Dallara went on. If one essential ingredient to a resolution of current difficulties in the world economy was a reduction in the U.S. fiscal deficit, then another essential ingredient was a more open Japanese economy.

He applauded the widespread and impressive successes in external adjustments in the developing countries, Mr. Dallara continued. There had been some significant reductions in fiscal and monetary imbalances, and exchange rate policies had become more realistic and effective. Those developments had been supported in many cases by other supply-side measures, including trade liberalization, but additional reforms were critical to continued progress. The problem of high rates of inflation in developing countries needed to be dealt with more firmly, particularly in Western Hemisphere countries. The dilemmas that were brought on by enforcing anti-inflationary policies in developing countries stressed the need for structural changes--changes that would not only make anti-inflationary policies more effective but more politically and socially tolerable.

The financing prospects for a number of key developing countries whose adjustment efforts were slipping was more uncertain at present than ever before, Mr. Dallara said. The international community could not be complacent about those financing prospects. If financing was to materialize, comprehensive adjustment policies should be pursued persistently. For the Fund to play its important catalytic role, it must continue to recommend the strong adjustment program that in the 1980s produced the confidence to bring together the needed financing. Such efforts were not only needed to promote external financing but also to support the investment required for growth in developing countries. There had been a steady decline in the ratio to GDP of capital formation in developing countries in the previous four years. Regardless of what happened on the external financing front, a turnaround of that deterioration was essential if either the baseline or a more positive growth scenario was to be realized.

In the coming years the Fund would continue to play a critical role in the adjustment process by supporting appropriate policies in the world economy in industrial and developing countries alike, Mr. Dallara stated. However, there was a cyclical aspect to the Fund's financial activity, which was to say that surveillance activities and policy guidance would inevitably take on an increasingly important role. He had noted the skepticism concerning what could be effectively accomplished through strengthened surveillance, but he was not clear whether the skepticism was based on the notion that surveillance measures would not be implemented or whether they would not have much effect in any case. His authorities thought that the Fund should take the first step by implementing measures to strengthen surveillance. At that point, one could better judge the effectiveness of surveillance.

He joined his colleagues in feeling that there was a value in publishing the Fund's analyses in that they would enhance the understanding in the international community about developments in the world economy, Mr. Dallara remarked. A broad understanding was a first step toward more effective cooperation. He hoped that the willingness to publicize Fund analyses would extend to Article IV consultations.

He was disappointed that there was no discussion in the World Economic Outlook paper on the policies, problems, or prospects of specific developing countries, Mr. Dallara commented. The exercise had to focus on policies and prospects of a number of key individual industrial countries; however, attention to developments in some particular individual developing economies would have lent a better sense to the document. Furthermore, attention should be given to selected items of policies and prospects of smaller industrial countries. Some of those countries were forging ahead in their efforts to establish and maintain sound policies, and they could provide useful examples for other industrial countries as well as for the world economy at large.

Mr. Salehkhou said that, like most previous speakers, he had noticed that today the staff's revised analysis and projections of the March 1985

World Economic Outlook had reflected a more disturbing state of imbalances and uncertainties in the global economy. Not only had the economic recovery failed to spread to the developing countries, it was uneven and halting even among the industrial countries. Waves of uncertainty had been caused by decreases in output in the United States, and the pace of growth had slowed down in general in other industrial countries.

Prospects for the world economy continued to be impaired by persisting financial and structural disequilibria in the major industrial countries, mainly resulting from their incongruent and problematic policies, Mr. Salehkhou continued. For example, despite relative improvement in a few industrial countries, the problems of unemployment were endemic and intractable. Indeed, the sustainability of the economic outturn would fall short of its real possibilities because of a number of precarious and uncoordinated economic and financial policies marked by volatile exchange rates, high real interest rates, rising protectionism, and instability in the international capital markets. Despite a relaxation of monetary policy, the industrial countries' relative achievement in the rate of inflation was probably due to reductions in commodity prices. That may indicate a trend that under the present assumptions for short- and medium-term scenarios, economic recovery in the industrial countries was being accomplished at the expense of the developing countries. Given the present uncertainties regarding the slowing of growth in several of the major industrial countries early in 1985, he could not agree with the staff that "analysis of development in individual countries suggests that part of this weakness can be attributed to factors that are expected to subside and be reversed in the second half of the year."

The economic problems of the industrial countries constituted unwarranted exogenous effects upon the developing countries and made their current economic situation and prospects look even gloomier than six months earlier, Mr. Salehkhou noted. Under the continuing external as well as internal problems, the majority of the developing countries--especially exporters of primary products--were currently facing weak export receipts and the absence of effective recycling of surplus funds. Those adverse developments further hampered economic adjustment programs and austerity measures, which were being carried out at high social and political cost.

In addition to the above-mentioned problems, the extraordinary difficulties faced by two groups of the developing countries needed particular and immediate attention, Mr. Salehkhou stated. The sub-Saharan African nations faced devastating problems of famine and drought, which were intensified by existing poverty, malnutrition, desease, and illiteracy. In addition, essential imports and exports were declining; commodity prices were falling; interest rates were still high; debt payments were anticipated to increase; and protectionist pressures by the industrial countries were continuing. Recent UNCTAD studies revealed "virtual stagnation or decline" of economic growth in 36 less developed countries whose already ailing economies were being stricken by environmental disasters and external imbalances.

The other group facing extraordinary difficulties was the heavily indebted countries, whose enormous debt servicing, intensified by volatile exchange rates and high real interest rates, had provoked international embitterment, Mr. Salehkhou commented. Meanwhile, the role of the international financial institutions to harmonize world economic activities and modify global imbalances was either being curtailed or redirected toward the national policies of certain members. Adjustment policies and programs, made more difficult by additional conditionalities and cross conditionalities, were prescribed without providing adequate financing. Prolonged use of Fund resources was no longer available to the needy countries. Few industrial countries had not yet approved new allocations of SDRs, despite repeated justification by the staff and the majority of Directors. While the global surveillance of industrial members' policy interactions was almost nonexistant, various surveillances and their enhanced versions were being intensified upon developing member countries.

Supplement 2 of the World Economic Outlook mentioned there had been a reduction in demand for oil from OPEC six months earlier, Mr. Salehkhou stated. Fairness dictated that the demand for oil from other oil exporting countries also be mentioned in the staff report. That issue raised the question as to what extent the aggregate demand for crude oil could be allocated to OPEC and whether similar declines in oil prices had been registered for non-OPEC producers. The issue was influenced by major oil importers' intentions to force further price declines in the future. The staff analysis had attempted to assess the effects of a 20 percent decline in the price of oil on short-term economic prospects, but the method used was simply speculation. Projection of such an arbitrary figure should be avoided in the World Economic Outlook. The assumption might be indirectly harmful because it gave an illusory expectation for further oil price declines that was obviously prejudicial to OPEC members. For example, the report implied that, in the absence of offsetting factors, a 20 percent drop in oil prices would result in increased demand and reduced supply. However, there were very important factors that could offset oil price declines. On the demand side, the price paid by end users of oil could remain relatively high because of ever-increasing taxation and dealer distributor costs. According to statistics provided in a 1984 OPEC study, the decline in the average final price of petroleum products in the OECD area since 1982--about 7 percent in nominal terms--was smaller than the decline in the average export price in the major oil exporting countries--about 17 percent--because the tax component had risen in absolute terms and had reduced the crude oil producers' share of the final price, from 62 percent in 1981 to less than 54 percent in 1984. On the supply side, rather than curtailing imports as foreseen by the staff, the oil exporting countries were likely to increase the volume of exports to offset the price decline in order to meet balance of payments needs and fulfill their medium-term development plans. The World Economic Outlook report and the sensitivity projection scenario, which were both based on speculation, gave direction to the oil and commodity producing countries to lower prices further. Although that might help industrial countries' sagging economies, it would clearly be detrimental to the interest of oil and commodity producer members. For that reason, his authorities were reluctant to see the document publicized.

In the context of the above-mentioned problems of imbalances and uncertainties, he would briefly and generally comment on issues for discussion, Mr. Salehkhou said. Instead of commenting on each issue separately, he would discuss his views on the issues collectively as they were all interrelated and as the very same or similar issues had been addressed by his chair in discussions on previous World Economic Outlook or other policy issue discussions.

It was the Fund's purpose in the World Economic Outlook report to present the most appropriate policy framework in accordance with the Articles of Agreement, Mr. Salehkhou continued. However, that the Fund might have indeed devised a framework to coordinate effectively even the most complex interactions of policies and conditions did not necessarily guarantee the implementation of such policies. Rather it was the responsibility of the individual member country to consider and implement its own policies according to the interrelated economic conditions of all the Fund's members. To disregard the interaction of economic policies, especially by principal members, would significantly increase the uncertainties attached to any of the issues of fiscal and monetary policies, interest rate developments, the evolution of the debt problem, or the growth of protectionist pressures. Thus, to ensure the appropriate implementation of the Fund's suggested policies for eliminating imbalances and uncertainties, the full cooperation and interdependence of all members was a prerequisite. It was in that context that issues such as the management of the debt problem or protectionism should be discussed.

He did not agree that the handling of the debt problem continued to be broadly on course, Mr. Salehkhou noted. Based on the principal of interdependence, the management of the debt problem required the industrial countries to correct financial imbalances and reduce protectionism and the developing countries to adopt domestic adjustment programs aimed at self-sufficiency. The first group of countries had not done its fair share. Finally, the staff's recommendation with regard to a multifaceted approach to dealing with the protectionist threat was indeed a manifestation of the kind of interaction that required the interdependent cooperation of all participants involved in order to eliminate the present disequilibrium in the world economy.

The role of the Fund should be manifested through surveillance more than by any other function, especially when the global economic outlook was uncertain, Mr. Salehkhou said. Without the implementation of Fund surveillance under its Articles of Agreement, inappropriate and inconsistent policies would continue to hamper healthy interdependent economic activities in both developed and developing countries.

Mr. de Maulde remarked that the main policy objective was to maintain a sufficient growth rate in industrial countries in the medium term, and the most important factor in achieving that goal was the evolution of the U.S. economy. That economy affected developing countries as well as industrial ones.

As Mr. de Groote had noted, the scenario for a deep recession in the United States that would be spread throughout the world by high interest rates and protectionist measures was feasible, Mr. de Maulde commented. Further, he shared other Directors' sense of the urgency of decisive budgetary action in the United States.

However, even if a recession could be avoided, it did not follow that the developments forecast in the base scenario would unfold automatically and that the industrial countries would adhere to the medium-term policies recommended by the staff, Mr. de Maulde stated. Three types of action were needed--on the speed and timetable of events, on the structures of the economies of one productive sector in industrial countries, and on the level of activity and demand in the poorest countries. For example, regarding the U.S. budget deficit and the related issue of the exchange rate of the U.S. dollar, it was evident that both needed sufficient time to be decisively corrected. A brutal elimination of the current fiscal stimulus would plunge the U.S. economy into a deep recession. By the same token, a drastic drop in the value of the dollar would have catastrophic effects on the financial markets, the U.S. inflation rate, and activity abroad. The problems of the fiscal deficit and the value of the dollar had to be carefully solved in order to maximize benefits and minimize downside risks. Adjustment in either area was not fine tuning, it was crisis avoidance.

Major industrial countries needed active structural adjustment policies, Mr. de Maulde added. If the path to growth in developing countries lay in export-oriented economies, then industrial countries would have to adapt their production to the fast-changing pattern of the international division of labor. They would have to close down the industries that had lost their competitive advantages and develop new technologies, new products, and new skills to fill a new demand domestically and abroad. In the presence of high rates of unemployment, an active structural adjustment policy in industrial countries was the only substitute for protectionist measures both intellectually and politically.

Contrary to the other developing countries, the poorest countries of sub-Saharan Africa would benefit little from active structural adjustment policies because their exports consisted mostly of foodstuffs and raw materials, the demand for which was quite inelastic, Mr. de Maulde commented. In addition, they benefited little from lower international interest rates, because most of their debt was not owed to commercial banks with floating rates. Indeed, year after year since the end of the 1970s, they had entered a deep and continued recession at a rate that in certain countries appeared to be accelerating. To help those countries with sufficient concessional assistance, coupled with intelligent economic conditionality, was in the best interest of the rest of the world. In a time of slack demand, the world economy could not very well accommodate a further decline in the imports from those countries. He had no quarrel with the prescription to adhere to stable medium-term financial policies while removing the so-called structural rigidities in members' economies.

He had no problems with the publication of the World Economic Outlook report under the conditions mentioned by Mr. Lankester, Mr. de Maulde said, in closing.

Mr. Fujino remarked that the many references to the need for stimulation of domestic demand in Japan sounded as if the problem was one of a weak or unsatisfactory demand. However, although the growth rate for the first quarter of 1985 was a very low 0.2 percent, domestic private demand had increased by 0.6 percent. Furthermore, judging from the indicators, the present trend of domestic private demand should continue and increase, because the low figure of the first quarter came from a negative contribution of the foreign balance.

Mr. Dallara said that he was uncomfortable with the idea of making many changes to the text of the World Economic Outlook document. There had been an allusion earlier to changing some items in light of the Board discussion, and comments by some other Directors implied perhaps even more extensive changes. Whereas the document was always subject to particular criticism and comments and updating, it was nevertheless a sound one and for a number of reasons should stand intact.

Mr. Grosche said that, while he would like to see his country achieving similar rates of growth, productivity, and unemployment as Japan, he was concerned that a number of Executive Directors thought that Germany had already either achieved those rates or the same margin of maneuver when it came to boosting domestic demand. This was obviously not the case, but Germany would avoid overconsolidation and would aim at supporting domestic demand by tax reductions. Germany was using any margin of maneuver that the policy of expenditure constraint offered, and the country was about to implement step by step its program of tax reform. The reduction for 1986 was only the first step, and there were others planned that might be needed in the years ahead. Moreover, in comparing Germany with Japan, one should bear in mind that Germany's current account surplus was only a fraction of Japan's, particularly if official transfers were included.

The Economic Counsellor stated that the main message that the staff had sought to convey in the World Economic Outlook report was that there were reasons to revise downward the short-run forecast, particularly regarding outputs and certain other measures. Furthermore, developments had occurred that had considerably increased the uncertainty of the medium-term outlook.

Although it was important to convey that message, there were some limitations to the degree to which the staff should sound alarms, the Economic Counsellor continued, especially since there was a likelihood that the document would be published. It was necessary to choose language that was moderate but which nonetheless conveyed the message, and he felt that the staff had succeeded in that.

In dealing with the medium term in particular, the alternative was to write the numbers down or discuss the increased downside risks in some detail, the Economic Counsellor said. At the present juncture, the staff felt that it was best to emphasize the downside risks, and whereas the performance figures for the medium term were lower than they had been in April 1985, the staff had chosen not to include figures but to stress the increased downside risks. In the spring of 1986--when the matter would be reviewed again--it would be possible to determine whether issues that had been thought temporary had remained that way.

He was intrigued by the remarks of Mr. Polak on the consistency of policy and the role of surveillance, the Economic Counsellor noted. Those issues were quite rightly attracting increasing attention not only among practitioners but among theoreticians as well. In the highly interdependent economy in the world at present, where the moves of individual countries subsequently affected the moves of others, there was a need to promote consistent and mutually supporting policies. He would make two remarks at this juncture. First, the consistency of the moves of the players was in some degree affected by the rules of play. For example, if there was a commitment to free trade or fixed rates of exchange or the absence of restrictions on capital movements, then the moves of the players were conditioned by those commitments. Consequently, it was appropriate from time to time to review whether the rules contributed appropriately to policy consistency.

All countries were mutually interdependent but in a way competing with each other too, the Economic Counsellor continued. Therefore, it was important that their objectives be studied. There were circumstances in which cooperation in the orientation of policies or setting of objectives was warranted, and such circumstances could best be explored and discussed in the context of surveillance.

The staff had found the concept of net transfer of resources to be unhelpful, because the measure of the net transfer of resources into or out of a country was the current account position, the Economic Counsellor noted. If one meant by the net transfer of resources the combination of capital inflows and outflows and the payment of interest on borrowed capital, then that appeared to be adding together a component from the current account and one from the capital account. If one did that, he would not have a clear result that could be interpreted. There was no more reason to add to the net capital flow that particular component of the current account that is called payment of interest than payment for machinery or anything else that was imported. It simply did not fit. Rather, the net transfer of resources was measured by the current account position, and that was the concept of net transfer of resources that the staff would stay with.

A number of Directors had noted that the broad policy view was that the economic strategy that countries had been pursuing in the previous two or three years had been appropriate except that in certain cases it should be strengthened, the Economic Counsellor said. A number of Directors had agreed with the position, and a number had hesitated. He remained convinced that it was the correct position for the moment. Furthermore, there was no basic change in policy that he would recommend to the Board that would alter the character of the current strategy. For example, the staff understood the importance of reducing the fiscal deficit in the United States. To emphasize that in the World Economic Outlook document was nothing more than asking that the strategy be followed. In fact, there was not a current policy recommendation that should be viewed as anything other than tightening the application of the strategy.

The Deputy Director of the Research Department commented that at the Board's discussion on the Article IV consultation with Germany there had been a widespread view that fiscal policy should be eased, and Directors had wondered why that had not been reflected in the World Economic Outlook. In addition, a number of Directors had stressed the room for maneuver or the possibility of a slower pace of fiscal consolidation in Japan. One Director had asked which countries would offset the projected fiscal restraint in the United States. One or two Directors had criticized the staff for not modifying or changing its suggestions regarding fiscal policy for simply advocating reliance on automatic stabilizers.

The staff position was not simply one of no change in the existing policies, the Deputy Director noted. For example, a number of Directors had suggested that a less restrictive stance on fiscal policy in Germany would be appropriate. In fact, looking ahead to 1986, the projected stance of fiscal policy in Germany was moderately stimulative. As a result of the tax cuts, fiscal policy was expected to impart a slight expansionary impulse to the German economy in 1986, a thrust that was broadly appropriate in light of the relatively moderate growth of domestic demand and the recent improvements that had taken place in the underlying fiscal position. The overall fiscal stance of the largest industrial countries other than the United States was somewhat more expansionary, thus tending to offset the expected tightening of fiscal policy in the United States.

It was not the position of the staff regarding Japan to advocate no change in current policy, the Deputy Director stated. In fact, the staff's position was that the success achieved to date in reducing the Japanese fiscal deficit provided increased scope to pursue those objectives of fiscal consolidation flexibly, taking account of the need to sustain Japan's contribution to aggregate demand growth in the world economy. Consequently, part of the answer to the question of which countries would offset U.S. fiscal restraint was that policy changes in the previous six months had already been in the direction of more stimulative policies. In addition, certain countries, within the strategy of fiscal consolidation, had taken a more flexible approach that would provide for offsets.

There was some confusion about the staff's appraisal of the appropriate monetary policy for Japan, the Deputy Director remarked. One Director had thought that the staff was suggesting restraint, and another considered that the staff was advocating that monetary policy should become more expansionary. The staff's position was that, with output growth reasonably close to potential in Japan, there was no scope for a significant expansion in overall demand growth--i.e., net exports plus domestic demand. If, therefore, the acceleration of domestic demand that was both expected and hoped for was to materialize, external demand would have to be more subdued. That requirement would place a constraint on the ability of the Japanese authorities to match declines in U.S. interest rates with declines in Japanese rates. Thus, the idea was not so much that there should be a tightening of Japanese policy but that the effects of a reduction in interest rates in the United States should be felt more in the exchange rate than in domestic interest rates in Japan.

One Director had questioned the responses of monetary policy in different countries to an exogenous shock that would cause an unforeseen change in exchange rates, the Deputy Director commented. Although analyzed in a somewhat oblique manner in the staff paper, the principal point was that if policies were not carefully managed there was a possibility of asymmetrical responses. Because authorities in different countries could view the consequences of exchange rate appreciation or depreciation differently, they might react in asymmetrical ways that would impart either an expansionary or a deflationary bias to the response. There were offsetting effects from an exchange rate depreciation. On the one hand, a depreciation would tend to strengthen the net foreign balance that would support demand; on the other hand, the depreciation would make a given rate of expansion of the money supply less accommodative because it would tend to raise domestic prices and, therefore, reduce the stock of money relative to the level of GNP. In the staff's view, estimates of the relative strength of those effects were not established firmly enough to say that one would be stronger than the other. In such circumstances, the prudent course of policy would be for monetary targets in countries to remain broadly unchanged in the light of exchange rate movements. However, that conclusion might have to be modified in circumstances where the exchange rate movement in question was in an undesirable direction from the point of view of international adjustment.

There had been a request for a comment on the prospects for the oil market in the medium term if a 20 percent fall ocurred in the short term, the Deputy Director noted. Of course, the more the price fell in the short term, the more forces would be called into play that would tend to push prices up in the medium term. At any rate, the 20 percent fall had been selected for illustrative purposes and was in no way a forecast. Nevertheless, the implications of that 20 percent reduction were that the nominal price would be 20 percent less than in the baseline scenario in 1985 and 1986. Thereafter, the price would rise in nominal terms by 7 1/2 percent per annum, which was the rate of rise in the baseline scenario. Consequently, there was already built into that scenario allowance for a strengthening in the oil market in the medium term. The staff had not taken account of possible changes in aid flows from OPEC countries that could follow a reduction in the price of oil.

An interesting and important question had been raised as to whether the elasticity of demand for imports with respect to real GNP in developing countries had become lower than it had been in the past, the Deputy Director commented. The question was interesting because it raised the possibility of developing countries' economic performance being somewhat more independent of international economic developments than had previously been thought. In 1982-83, there had been a fairly general reduction in imports relative to GDP in the aftermath of the debt crisis. Imports had fallen in developing countries by 5 percent a year even though output had continued to grow by almost 2 percent a year. It had been assumed that part of that adjustment would be reversed in subsequent years because it represented a stock adjustment phenomenon that could not be sustained. What was expected was a reversion to the experience of the 15 years leading up to the debt crisis, when the elasticity of increases in imports with respect to growth was about one and one third. Such an expectation had been built into the 1984 forecast. As it turned out, the elasticity had been considerably less than that, about five sixths the rate of growth of GDP, and that was projected for 1985 as well. However, it was too early to say whether that rate constituted a fundamental change in the relationship that would be carried into the future. If it turned out to be true, the implications were encouraging for the medium-term forecast, but it was too early to tell. At any rate, it was a point that had been analyzed in the September 1984 World Economic Outlook. Chart 9 of that report demonstrated the relationship between imports and GDP over a number of years for developing countries as a whole, as well as for individual groups of developing countries.

The recent Japanese import package was a highly desirable development in that it increased the access of foreign suppliers to Japanese markets, the Deputy Director noted. However, the thrust of the staff analysis was that the basic cause for imbalances in trade and current account positions was to be found in savings and investment imbalances among countries rather than in specific incidence of market measures. Therefore, the impact of the import package on the balance of payments on current account of Japan relative to the size of that imbalance would be relatively small.

In concluding, the Deputy Director of the Research Department noted that the numbers included in the statistical tables and the description of those numbers in the World Economic Outlook report would be brought up to date before publication. In the course of doing this, the staff would determine whether the tone of the language was appropriate in light of comments Executive Directors had made.

The staff representative from the Research Department said that the reason for the roughly $10 billion upward revision of the Japanese current account surplus for 1986 was due partly to an upward revision to exports.

However, the main reason for the revision to the Japanese current account was that imports had been much weaker than the staff had expected earlier. The recent trends were quite flat.

The growth projections for the sub-Saharan African countries for 1985 and 1986 were in the 3 to 4 percent range and quite buoyant in relation to past experience, the staff representative continued. The buoyancy of the figures largely reflected the pronounced adjustment under way in the countries. It should be noted, however, that the estimates also assumed an absence of adverse shocks, and, in particular, the weather was assumed to return to normal.

Like other forecasters, he had been surprised by the weakness of commodity prices over the past year, the staff representative added. They were weaker than anyone had thought likely on the basis of cyclical developments. The most viable explanation pointed to supply factors with harvests being thought to have been unusually ample in 1984 and 1985. In this respect it was noteworthy that the downward revisions to the commodity price projections had been greatest in the agricultural area, where the success of a harvest made a big difference to the price. Metal prices, on the other hand, were much stronger in relative terms than those of agriculture. Therefore, successful harvests appeared to be a major factor accounting for the underlying weakness of commodity prices.

The growth projections for export earnings of nonfuel exporting developing countries were estimated to rise from about 1 to 2 percent in 1985 to about 10 percent in 1986, a quite different pattern from that envisaged six months earlier, the staff representative from the Research Department said. The main reason for the revision was not volumes, which were currently projected to increase by somewhat less than had been projected six months earlier--6 percent in both 1985 and 1986, as opposed to 7 to 8 percent six months earlier. Rather, the main source of the revision to the growth profile of export earnings was the different evolution of prices expressed in terms of U.S. dollars. A first factor was the weakness of commodity prices, which had depressed earnings in 1985. A second factor was the change in the assumption on the exchange rate of the U.S. dollar. In the latest staff estimates, the dollar appreciated year on year from 1984 to 1985 but depreciated from 1985 to 1986, the result of which was to depress world trade prices and developing country export earnings in 1985 and boost them in 1986 when expressed in terms of U.S. dollars.

Mr. Ortiz remarked that, although Mr. Nebbia was not present to respond to the criticism of his use of the concept of resource transfer, he would like to say that it did not violate any sacrosanct rule to add concepts that belonged in the current and capital account, particularly if the result was economically meaningful. The concept of resource transfer was economically meaningful to the extent that it represented the portion of factor payments abroad that were not being financed through capital transfers. It was obvious that the higher the amount of factor payments abroad the smaller the resources for domestic investment. Thus, it had a direct bearing on the prospects of economic growth. In addition, it was not comparable in economic terms to treat interest payments as payments for importation--for example, for machinery. Payments for machinery and imports in general were items that could be adjusted in the short term if required in order to return to an equilibrated balance of payments position. Where there were higher interest rate payments in the current account, the more rigid the situation became.

Mr. Sengupta said that the term "resource transfer" was applicable if one compared the total current account deficit or surplus--the total trade flows plus nonfactor payments--with the interest payments and if one saw that such a current account position was balanced against the total interest payments. If total interest payments took away a substantial part of resources, then there was a resource transfer. Whether or not the resource transfer was the result of some remuneration or not was immaterial. Resource transfer could be defined as something used for further investment and growth in the country.

Mr. de Groote stated that the issue of resource transfer needed the word "net" added to it--that was to say, the term was simply used to indicate whether a country was a net lender or borrower vis-à-vis the financial market, including its interest payments. It had no pretention to national income considerations. Rather it defined whether a country was the receiver of a net flow of financial funds or not.

The Executive Directors agreed to continue their discussion at their next meeting.

APPROVED: May 28, 1986

LEO VAN HOUTVEN
Secretary