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IMF: 1985 WORLD ECONOMIC OUTLOOK

On 3 April, the Executive Board held its second discussion on the World Economic Outlook (EBS/85/47 - 50 and Supplements 1 - 11). The discussion was based (loosely) on the themes identified in the Managing Director's buff statement (85/63), taking the form of a seminar with Directors making unscripted interventions and with the staff also playing an active role.

Summary of Discussion

2. An interesting and thoughtful discussion, if sometimes a little lacking in focus. Many ideas emerged but few conclusions. The MD made two general points.

3. First, he said that while recovery in the world economy was likely to continue, it was only realistic to recognise that the pace might slow this year and next and perhaps into 1987. It was certainly true that the US current account deficit was unsustainable at the present rate, and would have to be reduced. This would need to be done by a combination of US budget deficit reduction, and removal of rigidities in other industrial countries. But for the immediate future, the net effect on activity was almost certainly to be negative, in the developed countries and elsewhere. There could be "rough terrain" to traverse; but there was no avoiding it if longer-term prospects were not to be jeopardised. (Comment: effectively, the MD seemed to be saying that in aggregate the world had

been growing faster than it really should have done - and for reasons other than lower inflation and lower nominal interest rates i.e. a substantial fiscal stimulus from the US - and things would now have to slow down).

4. Second, in response to comments from a number of LDC Directors, the MD elaborated on his view of the Fund's role in low income countries. These countries were not excluded per se from Fund assistance; and they would clearly need flows of concessional assistance for a long time. The Fund's role was to help them to meet reversible external shocks, and to help countries correct their domestic policies. Often it was difficult to know whether an external problem was reversible, or whether it reflected more deep-seated structural problems which the Fund was not well-equipped to tackle. Where the latter was the case, the Fund would have to be cautious, putting in programmes for relatively modest amounts while encouraging other donors to look at the problems and to increase their assistance. The answer was certainly not increased access, which would not address the fundamental problems.

Main Points of Interest

The US

5. Directors asked how long the inflow of capital into the United States could continue. Fujino noted that the US dollar was a reserve currency, and that the depth of the US financial markets was very great. This asymmetry between the US and other countries meant that the US could continue the current policy stance longer than would be possible elsewhere. De Maulde asked how long it would be before the debt export ratio in the US exceeded the levels that had been considered worrying in Brazil and Mexico. Hernandez-Cata (Division Chief, Western Hemisphere Department) felt that it would be five years at most. De Groote and other Directors emphasised the importance of looking at the stock of dollar denominated assets abroad. A depreciation of the dollar would reduce the

ratio of dollar assets to other assets, and, all other things being equal (which they would of course not be), result in a further capital inflow into the US to restore the previous ratio. Sengupta said that the crucial assumption being made was that the rest of the world just watched the present capital inflow and did nothing. If the dollar fell, and the fiscal deficit was not reduced, he wondered whether the US could contain the rate of inflation. Harmonisation of monetary and fiscal policies between countries was the only way to achieve the staff's baseline scenario.

6. Dallara observed that the current capital inflow did not reflect use of foreign savings per se, but rather a rundown of US assets abroad. He noted too the difficulties of making any very precise analysis in the presence of large errors and omissions. Hernandez-Cata agreed that there had been a substantial rundown of US assets abroad; however, if one assumed errors and omissions to be largely short-term capital inflows, there might well also have been substantial use of foreign savings. What really mattered was the US' net external position abroad.

7 Clark noted that many Directors had questioned the continuing willingness of investors to put money in the US. But, turning the question around, he wondered whether it was wise from the US' own point of view to be absorbing funds at a real interest rate which far exceeded the probable growth potential of the economy. One way out was clearly a big depreciation to write down the accumulated stock of debt. But this was only a partial answer. In the aftermath of such a depreciation, with perhaps a serious erosion of confidence in the United States, real interest rates (and perhaps to an even greater extent, nominal interest rates) might have to go higher.

8. Hernandez-Cata added that the US current account deficit would not be removed by any likely change in the relative cyclical position of the US vis-a-vis other countries; even if US growth slowed to be roughly

comparable with that abroad, there would still be a substantial deterioration of the external position. If one assumed that market psychology and perceptions remained constant, such deficits would have to be financed from savings and not from portfolio readjustments. This would require a very large fraction of world savings.

9. Hernandez-Cata said that he knew of no model of exchange rates which explained the movement of the dollar in 1983/84 and particularly the later part of 1984.

10. Nimatallah remarked that we should not wait until capital flows to the US dropped off sharply; the proper solution was a gradual reduction in the fiscal deficit, in which case the capital which had been freed would probably be invested in Europe.

11. Crockett (Deputy Director, Research Department) noted that a fall in the dollar would tend to push up the US prices and reduce US demand with the opposite effect elsewhere. In adition, there would be an external to production in the US which would offset the effect of the fall in demand in the US to some extent. However, much would depend on the US authorities' policy response. If they tightened monetary policy to reduce the inflationary effect of a dollar fall, this would further reduce the level of demand through an increase in interest rates, which might, via the inventory cycle, send the economy into a recession.

12. Hernandez-Cata then observed that a reduction in the US fiscal deficit might, by removing what could be seen as the last obstacle to sustainable growth in the US economy, have the paradoxical effect of increasing capital inflows, and the current account deficit.

Japan

13. Fujino made a spirited defense of the Japanese surplus, very much along the lines of his comments in the recent Japanese Article IV

discussion. Most of the deterioration of the US current account over the past four years had been due to the high dollar. The Japanese were making strenuous efforts to open their markets. To take a topical example, sales of cars in Japan would be much facilitated if foreign manufacturers expanded their dealing and service networks, as German suppliers were doing. He added that his brother-in-law owned both a Pontiac and a Volkswagen (which some people felt did not entirely clinch the argument). Dallara countered that the US still believed that market opening in Japan was necessary, and pointed to the sharp increase in the EEC trade deficit with Japan at a time when Japan's growth was considerably higher than that in Europe and the yen was appreciating against European currencies.

The Scope for Fiscal Relaxation

14. Grosche argued that relaxing fiscal policies in particular economies, such as Germany, would be extremely risky. It would impair confidence without guaranteeing results; such policies had proved very ineffective in the 1970s. In any case, the economic situation in Germany was relatively satisfactory apart for unemployment, and a boost in demand would be difficult to justify. In addition, Germany's room for manoeuvre was quite small, and there was still some way to go in reducing the fiscal deficit.

15. Polak said that he did not believe that international policy coordination should be based on agreement to reach certain growth rates. Growth rates were domestic objectives which had to be weighed against other domestic objectives such as inflation. So far, fiscal adjustment in Europe had not prevented reasonable growth, largely because of the demand effects of the US deficit. Political leaders had thus been able to avoid domestic criticism. However, there were questions about what would happen when the deficit and the dollar were corrected. In that case, the slack in the US might not be sufficiently offset by further expansion in Europe and Japan. Then, countries on both sides of the Atlantic and Pacific would

have to give up some of their preferred policy package for the good of the international system as a whole.

16. Lundstrom intervened to repeat his view that there was scope for a fiscal stimulus in certain countries (which he did not name but which clearly included Japan, Germany and the UK). Fujino said that he would have to decline "with characteristic oriental modesty" (and uncharacteristic oriental humour) this invitation. As Grosche had noted previously, fiscal stimuli had not worked in 1978 and would probably not work now. Jaafar, however, felt that there was scope for Japan to expand faster than other countries, and that the Fund followed the G7's views too much on this question.

17. The MD summed up this part of the discussion with the remarks noted in the summary above. Sengupta intervened to record his dismay at the course the discussion had taken, saying that in his view policy coordination was essential.

Savings and Interest Rates

18. Ortiz emphasised the difficulty of increasing domestic savings in many developing countries. For instance, raising public savings through tax increases reduced private disposable income and thence, in turn, private savings. Price increases in public enterprises had a similar effect. As for private savings, in the very poorest countries these were largely constrained by the level of income. In a closed economy, real positive interest rates would often not increase savings significantly, although they would improve resource allocation and increase the amount of savings channelled through the financial system. He added that increases in domestic interest rates could have serious effects on internal debt service and thereby worsen the fiscal position.

19. Crockett remarked that real positive interest rates were often necessary to bolster the external position by preventing capital flight.

Indeed, the staff had pointed out in their papers that this had been an important factor in developing countries' recent current account adjustment.

20. De Maulde said that his authorities attached great importance to increasing domestic savings in developing countries. In many ways, the remedies lay more in the province of the Bank than the Fund. One important factor was often the inadequacy of the institutional framework (e.g. the lack of banking services in rural areas).

Inflation

21. Discussion then moved to the question of hyper-inflation in Western Hemisphere countries. The MD observed that it was essential to avoid putting any new indexation systems in place.

22. Ortiz remarked that the staff's prescriptions often amounted to indexing exchange and interest rates, which pushed a greater weight of adjustment onto other prices in the economy. Beza (Deputy Director, Western Hemisphere Department) said that the staff would usually have been able to accept market determination of these rates; but the authorities were often not willing to allow this. Some form of indexation was the inevitable result.

23. Sengupta said that the quality of adjustment was the essential thing. He then made an impassioned plea for slower adjustment and more finance, suggesting that most standby arrangements should in fact be EFFs. Dallara emphasised the importance of reducing public consumption rather than public investment. Inflation could be reduced by trade liberalisation, and by eliminating the use of credit ceilings as a monetary tool.

Direct Investment

24. There was a very brief discussion of the role of direct investment in developing countries, which added nothing to the discussion in the Board last year.

WICKS.

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