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FROM UKDEL IMF/IBRD WASHINGTON

TO ROUTINE FCO TELEGRAM NO.SAVING 401 OF 19 SEPTEMBER 1980

IMF: WORLD ECONOMIC OUTLOOK

1. On 12 September the Executive Board discussed ID/80/7.

Summary

2. Comments were generally along similar lines to those made at the corresponding discussion in April. There was broad agreement on the serious state of the world economy, and particularly on the very serious problems faced by at least some non-oil developing countries. While welcoming the indications that some reduction in inflation had been achieved, industrial country Directors were generally agreed on the need for continued top priority to further reduction, particularly given the dangers of premature relaxation of counter-inflationary policies highlighted in the "scenario" analysis in the paper; Vanhala (Finland) and Muns (Spain) were however somewhat concerned that tight financial policies in isolation might be unduly restrictive. A number of speakers suggested that, while fiscal policy as a whole should be restrained and supportive of a tight monetary policy, there was scope for fiscal incentives for productive investment and other appropriate supply responses. There was general support for a large role for the Fund in recycling. Nimatallah (Saudi Arabia) reacted sharply to recent suggestions that oil exporters should play a substantial role in directly financing developing country deficits. Several Directors thought the staff's estimates of US growth in 1981 too low.

Detail

3. Schwartz (staff) said that the forecasts in the staff paper, prepared several weeks ago, were being revised to reflect more recent developments, particularly indications that economic activity in the US was stronger than had been estimated. Provisional staff estimates were that the decline in US real GNP from peak to trough of the recession would now be 3¼%, rather than the 4% estimated in the paper, and the decline in GNP in 1981 -½% rather than -1½%. Germany's growth in 1980

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would still be 2½%, but activity now seemed likely to be stronger than earlier estimated in the first half-year, and weaker in the second, and growth in 1981 1½% rather than 2%. Total industrial country growth in 1981 would now probably be "well over" 1% rather than 0.7%. The US GNP deflator might be a little higher than in the paper, perhaps about 8.6% in 1981. Since 8 August, major industrial country effective exchange rates had generally not changed much; the yen had however appreciated 3½% up to 10 September.

Views of industrial country Directors

4. Laske (Germany) cautioned against any relaxation in counter-inflationary policies; the apparent reduction in industrial country inflation noted by the staff was only slight and might not be very significant. The increase in oil prices should be absorbed as soon as possible. While each of the three scenarios described by the staff (pages 22-23) was unpleasant, the first was certainly the least unpleasant - a point made by most speakers. In the long run, a reduction in inflation would benefit both developing and industrial countries. It was important that industrial countries did not resort to protectionism against developing countries. Staff estimates of the 1981 US current account surplus and Japanese deficit might be rather high, particularly if the US made a tax cut. It had been expected that the German economy would slow significantly during 1980 after a strong first quarter; however, while the slowdown would carry over into 1981, he could not necessarily endorse Schwartz's revised estimate of growth of 1½% compared with 2%; it was perhaps preferable not to try to "fine tune" such estimates (a similar point was made by Mentre (France)). Germany's monetary aggregates were being kept in the lower part of the target range of 5-8% for 1980. The authorities had recently made a minor adjustment to monetary policy in response to the slowdown in economic activity, but a reduction in interest rates was not advisable given inflation and the need to finance the current account deficit. Generally, very large fluctuations of exchange rates were a cause for concern. The best way to prevent them would be internationally coordinated demand management policies but, though there had been some progress in this direction, the prospects should not be over-rated. Authorities

needed to be ready to intervene to smooth exchange rate movements. Measures to improve supply conditions might in general include tax incentives, energy policies and possibly some public expenditure in support of productive investment or energy conservation. The main adjustment to higher energy prices had however to be made by the private sector. Non-oil developing countries faced very serious problems. To some extent, they could help themselves by adopting appropriate adjustment policies; it seemed that sometimes their difficulties resulted partly from inadequate policies. A large amount of the financing they needed could be provided by private capital markets, though there were an increasing number of developing countries without access to these markets. The Fund would therefore have a large role to play; while he supported lending larger amounts for longer periods, it was important that this was on the basis of appropriate adjustment - a point also stressed particularly by de Vries (Netherlands). Laske stressed that oil exporting countries should play a substantial role in financing developing country deficits, as Chancellor Schmidt had recently commented.

5. Price covered the points in your telno.197. Progress was being made in the battle against inflation, but the process was not over, and continued priority had to be given to squeezing inflation out of the world economy. While inflation seemed to have peaked in may countries, the staff's forecast decline might be a little too rapid. The importance of maintaining counter-inflation policies was illustrated by the staff's useful scenario analysis. The description of the scenarios suggested that, the staff assumed that the real price of oil depended on industrial country inflation and demand; did oil exporters themselves have no control over pricing? While industrial countries - including producers like the UK - had a clear responsibility to conserve energy and contain inflation (which they were discharging), responsibility in energy and inflation matters also fell, in an interdependent world, on oil exporters. The staff's analysis showed that the world economy would be sensitive to even a modest increase in the real price of oil. The effect on developing country inflation of increased import prices also illustrated the joint responsibility of industrial countries and

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exporters, though developing countries should also address their higher inflation with appropriate domestic policies. While data availability was clearly a problem, when would the staff be able to include the PRC in their world economic outlook exercises? Even the staff's likely revised forecast of US growth in 1981 was sluggish compared with that of most private forecasters, and stronger developments suggested by recent indicators. US growth in 1981 could easily be +1%, and aggregate industrial country growth therefore higher than the staff forecast. The US current account surplus, and the German and Japanese deficits, might thus be smaller. He made the point on exchange rate assumptions in the first part of your paragraph 10. The UK believed it important to resist pressure for a premature relaxation of its counter-inflationary policies; he spoke to your paragraphs 3,4 and 5 on monetary policy. There was little scope in the UK and in many other countries for relaxation of fiscal policy, given the problems that an increased fiscal deficit would create for monetary policy. Supply side issues were also important to ensure that sustained growth followed the reduction in worldwide inflation. The UK authorities saw promotion of supply more in terms of the creation of an appropriate environment for the efficient use of resources than of direct intervention. He cited the removal of price and exchange controls. The UK's supply side measures were however likely to have their major effect in the medium-term, with little immediate offset to the short-term adverse effects of tight financial policies. On exchange rates, he made the point in your paragraph 5(d) and added that now that the major currency countries were maintaining firm counter-inflation policies and inflation was coming under control, the need for large sudden changes in interest rates, unless there were an external shock such as a large oil price increase, was unlikely. The low-income non-oil developing countries could not continue to sustain deteriorations in their net reserve positions at the rate envisaged by the staff for 1981. The forecast 8% increase in developing country export volume in 1981 seemed optimistic at least on the staff's forecasts of industrial country growth. On measures to alleviate developing country difficulties, he spoke to your paragraph 5(e), emphasising support for an enhanced role for the international financial institutions

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in promoting supply, necessary adjustment and stability; and also the major role that oil exporters could play in assisting recycling.

6. Syvrud (US) agreed with Price that the staff's estimate of US growth in 1981 was too low. This was perhaps partly because it did not take account of the President's recent economic package. The administration now expected +1.1% growth for the US in 1981 (in line with private forecasters) and +1.7% for the seven major industrial countries as a whole. The staff's presentation of scenarios in broad qualitative form was more appropriate than a detailed quantitative analysis. The most serious problem was the financing of developing country deficits. A substantial and increasing number of countries would encounter financing difficulties. Some would need to adjust faster, supported by the Fund, perhaps on more flexible terms. The position varied however for different countries and might not be as serious as it appeared. Developing countries had been able to maintain higher growth rates than industrial countries; further, in general, a higher US growth rate (as now estimated) would have greater trade benefits for developing countries than a similar increase in European growth, reflecting the relatively greater proportion that trade with developing countries formed of total US trade. Some developing countries would benefit from improved agricultural conditions; this underlined the general need for greater efforts to raise agricultural productivity. US monetary policy was fairly restrained. Fiscal policy had loosened somewhat; the deficit now expected was about 1% of GNP, which was modest in the context of 7% unemployment. His authorities regarded the present stance as "neutral", relying on automatic stabilisers.

7. Hirao (Japan) agreed the conclusion of the staff's scenario analysis that too early a relaxation of demand management would have very adverse medium-term effects. Given recent stronger signs in US economic indicators, the staff's original growth projection certainly seemed somewhat pessimistic. The staff's estimate of 4.7% growth in Japan in 1980 seemed about right. The 1980 GNP deflator estimate of 2.5% seemed low however; his authorities' estimates of wholesale and consumer price increases for the year to March 1981, reflecting higher import prices, were 14.5% and 6.4% respectively. The staff's estimate that the positive change in the Japanese

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real foreign balance from 1979 to 1980 was about 2 3/4% of GNP was a "statistical illusion" based on an excessively high import deflator. He wondered whether the large improvement forecast for the US current balance marked the development of another disequilibrium in the world economy. Under Japan's tight monetary policy, the rate of increase of the money supply had slowed from 12.3% to 9% in recent months. While the discount rate had recently been lowered from 9% to 8.25% in response to slack personal demand, monetary policy remained prudent and counter-inflationary. Some acceleration of Japan's public works programme had recently been made. More generally, however, there was little scope for using fiscal policy to provide a stimulus; public finances in many industrialised countries, including Japan, were in need of "major restructuring". In general, supply side measures should address energy constraints, and also promote efficiency and productivity; to be effective however they needed to be complemented by demand management measures. While the main purpose of interest rate changes was domestic, external implications should be taken into account. It was true that, reflecting the relatively greater interest rate differential between the US and Japan than between the US and European countries, the dollar had depreciated faster against the yen than against European currencies over the period April-June 1980; however, this sharp appreciation of the yen against the dollar could be regarded as a reversal of earlier depreciation. The relatively adverse position forecast for developing country exporters of manufactures underlined the general need to avoid protectionist tendencies. Assistance by oil exporters to non-oil developing countries was needed since the latters' larger deficits were at least partly due to higher oil prices. An SFF interest subsidy would also help developing countries. It was desirable that countries in difficulties approach the Fund at an early stage.

8. Mentre noted that, even with the recent reduction, industrial country inflation in 1981 would still be high by historical standards. Inflationary expectations were thus deeply rooted, which made more difficult the vital task of bringing inflation under control. The determination of authorities to maintain appropriate monetary policy despite underutilised capacity was however encouraging.

The uncertainties as to further world economic developments lay perhaps more with the price and availability of oil than with industrial country policies. His authorities' forecasts of French growth, slightly different from the staff's, were for a little more than 2% in 1980, and 1.6% in 1981. France maintained a firm monetary policy. While monetary targets in 1979 had not been met, those for 1980 should be. 1981 monetary targets were not yet fixed, but would probably involve a gradual reduction in the rate of increase to between 10-11% (nearer 11%,we understand outside the meeting). In general, any fiscal stimulus to private demand in industrial countries would be inappropriate, given the need to restrain demand. There might however be some scope for fiscal incentives for productive investment and to help the adjustment to more energy-efficient capital stock, on the lines that some industrial countries had introduced. Fiscal incentives for private investment had been included in the recent French budget, which however, overall involved a reduction in the deficit as a percentage of GDP. Incomes policies could play a role in industrial countries. It would now be appropriate to consider such policies in a supply side as well (as previously) in a "demand" context. Tax-based incomes policies could perhaps play a role; it might be useful for Fund staff to study this (a suggestion also made by Muns and Kafka (Brazil)). Given the estimated distribution of current account balances, the staff were probably right that large exchange rate fluctuations were unlikely. This was though clearly also dependent on interest rate developments; he welcomed the recent halt in the decline in US interest rates. EMS had had a "beneficial effect" on European exchange markets. The Fund should continue its surveillance activities. The staff's analysis drew perhaps too sharp a distinction between the prospects for recycling through the capital markets in 1980 and those in 1981. The Fund would also have an important role. He supported further cooperation with the World Bank (as did Price and Drabble (Canada) among others), and adaptation of Fund facilities, including that of the CFF to cover food imports.

9. De Vries commented particularly on the very serious outlook for the world econom – and even that was on the perhaps optimistic assumption of no real increase in the price

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of oil. Following the first phase of the second oil shock - high inflation and a reduction in growth - the world had moved to a second phase of slow growth, and a shift in deficits from industrial to oil-importing developing countries. The position of the low income developing countries was particularly serious. It was quite inappropriate to expect industrial countries to meet with aid the financing of deficits caused entirely by the oil price increase. Financing should be provided by the oil exporters on grant terms - this was the only appropriate form of funding given developing countries' debt problems. Recycling through the capital markets would increase those debt problems without providing for the necessary adjustment. Inflation in industrial countries was primarily a political rather than an economic problem. Unlike the middle class in the nineteenth century no major group within those countries was at present strongly in favour of price stability, though in time such a group (for example, higher paid workers) might emerge. It was only through the development of such a social and political constituency that inflation was likely to be eliminated. In the meantime, cautious fiscal and monetary policies were appropriate. Depending on definition, there was some risk of over-emphasis on supply side issues. It was clearly right that governments should encourage productive investment and structural adjustment. But there were dangers if "supply side measures" were taken to include excessive direct government involvement, such as aid to ailing industries.

10. Whitelaw (Australia) agreed with others on the serious outlook and the need to continue the fight against inflation. There were perhaps however some grounds for cautious optimism. Industrial country counter-inflationary policies seemed to be having some effect. Wage settlements had been considerably more moderate over 1978-80 than 1974-75, perhaps because of higher unemployment, though possibly reflecting a greater trade union awareness of the danger of pressing for excessively high money wages at a time of worsening terms of trade. Energy conservation measures also seemed to be taking effect.

11. Drabble also thought that there was some cause for optimism from progress so far in reducing inflation, which should encourage continued efforts. Canada's delayed budget would be announced in October, when a clearer picture of fiscal policy would emerge. Generally, all of his constituents considered that there was still a need to reduce their government expenditure. On the supply side, the issue of energy pricing had been attracting considerable attention in Canada. It was important for industrial countries that wage settlements declined in line with the fall in inflation; this might be achieved by tax policy, incomes policy or informal arrangement. The large 1981 surplus forecast for the US partly reflected a strong cyclical effect, but also that, at the current level of the dollar, many sectors of the US economy were very competitive. A rise in nominal US GNP in 1981 at the higher level suggested by Syvrud and Price, coupled with present monetary policy, could result in high interest rates. The present distribution of industrial country current account deficits was more helpful than in 1974-75. For 1981, it would be helpful for a substantial part of the total deficit to be carried by the stronger countries, rather than being concentrated on the smaller weaker industrial countries. He welcomed a larger role for the Fund in recycling in broadly similar terms to the above speakers. Oil exporting countries might consider financing the deficits of middle-income, particularly newly-industrialising, developing countries; these countries were likely to have attractive economic prospects after the next few years.

12. Caranicas (Greece) spoke in broadly similar terms to the above speakers.

13. Vanhala thought it important to continue the fight against inflation; the risks involved in counter-inflationary policies should however be brought out more clearly. There were considerable short-term costs to the staff's first scenario, and it was not clear that under it there would be a permanent change in inflationary expectations; further, the real price of oil might increase for reasons unconnected with those expectations. Incomes policies could be required to counteract claims for wage increases to compensate for oil price increases. Financial policies should be framed to encourage the supply side as well as contain inflation. Less restrictive

monetary policy, coupled with tighter fiscal policy could allow for the pursuit of counter-inflationary objectives at lower interest rates, which would therefore encourage investment. Increasing industrial country unemployment would increase pressures for protectionism, which should certainly be avoided. Developing countries needed increased balance of payments financing in general; but the primary need was for an increase in trade, and in concessional aid. The tendency towards higher deficits for smaller industrial countries (a point noted by de Vries) might partly be a reflection of different countries' preferences as to the level of employment.

14. Muns spoke similarly of the need to obtain a maximum supply response within a policy of overall restraint. While at an earlier stage expansionary forces in the world economy had been strong, investment and productivity were now depressed, and unduly restrictive policies in isolation were therefore not appropriate. Firm monetary policy was important, but should be accompanied by fiscal measures (within the limits of restrain) to increase investment. Protectionist tendencies should be avoided. The recently announced Mexican/Venezuelan regional oil facility was a good example of international cooperation in energy.

Views of oil exporting Directors

15. Finaish (Libya) and Nimatallah commented that/the staff's first scenario was not pleasant, but certainly better than the others. Finaish said that the reduction of inflation was important even at the expense of growth. The analysis in the paper was right to imply that oil price increases were the result of developments in industrial countries, not the cause. Considerations relevant to the price of oil were the state of the market and of the world economy, industrial country inflation, exchange rate changes, and the need for incentives to stimulate the development of further energy resources. Considerations relevant to the level of production were conservation efforts, particularly in the US, and realistic pricing. It was also not reasonable that importers should stockpile oil (Nimatallah spoke similarly). Oil exporters were acting in the international interest by producing more oil than they need to, at considerable economic and social cost to themselves;

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it was reasonable to expect reciprocity and understanding from consumers. Oil exporters would try to assist developing countries as far as possible; but it was unfair to expect poorer countries, albeit with temporary surpluses, to remove responsibility for providing aid from the rich industrial countries. As well as reducing their inflation - the main problem in the world economy - industrial countries should maintain an open market for developing country exports.

16. Nimatallah spoke in rather aggressive terms, particularly critical of recent suggestions by Secretary Muskie at the UN and by Chancellor Schmidt that oil exporters should increase their aid. Muskie's comments had been intended to create a rift between oil exporters and other developing countries. Oil exporters were doing more for the world economy than countries who made these suggestions were willing to, both in increasing oil production and providing aid, 15(?) times larger in relation to GNP than the US or Germany. Such countries were trying to deplete oil exporters' resources, and evade their own responsibilities, while expecting the world economy to put up with their high inflation. Industrial countries should make up their minds on oil exporter lending to the Fund. Saudi Arabia had indicated willingness to do so, given the Fund's expertise, but it now seemed that some industrial countries were opposed to such lending, as they thought it would result in undue oil exporter influence.

Views of developing country Directors

17. Kafka commented that despite some reduction in industrial country inflation, it would be higher at the start of the new cyclical recovery than at the previous, albeit not as high as in 1973-74. There was some risk that the US recession might prove "double-dipped" (Syvrud thought this unlikely; the last time such a phenomenon had occurred had been in 1937). Industrial countries needed to maintain careful demand management, while using fiscal measures to stimulate investment and perhaps support incomes policy. Developing countries should take action to improve supply and liberalise prices. Developing country exporters of manufactures would be significantly affected by slower industrial country growth, though they might escape the worst effects since their exports were as yet only relatively small. There

no major difficulties for recycling through the markets in the short-term. The longer-term prospects depended partly on how industrial country authorities operated prudential controls on bank lending, and partly on how the Fund and other institutions acted as a "safety net".

18. Kharmawan (Indonesia) saw some signs for optimism, in similar terms to Whitelaw. The outlook remained serious however, particularly for low-income developing countries. His constituents maintained fiscal and monetary policies aimed at stability, though these policies also reflected the needs of development and the generally rather larger role of the public sector than that in industrial countries. A sharp distinction between demand and supply measures was not always possible. His constituents attached importance to exchange rate stability. The Fund had an important role in providing advice to all member countries conducive to the smooth functioning of the international monetary system, particularly in this era of floating rates. Low income developing countries were in particular need of more concessional resources. He was concerned by de Vries's apparent implication that industrial countries were unwilling to provide more aid; in an interdependent world, it was inappropriate to try to pass the responsibility entirely to oil producers. It did however seem that the general climate was not conducive to increased aid from industrial countries. The Brandt Commission had made a number of interesting and worthy suggestions, though their practicability needed study. While pursuing the possibility of establishing new international institutions, it seemed best for the present at least to concentrate on the Fund. He welcomedrecent moves towards greater flexibility in amount and length of lending, and towards increasing the Fund's resources, and particularly the Managing Director's personal initiatives here (a point made by a number of Directors). He believed that, generally, developing countries fully accepted that adjustment needed to be accompanied by financing.

19. Garces (Chile) thought the staff's first scenario the most appropriate. His constituents were all following prudent policies to achieve necessary adjustment, but external inflation caused them serious difficulties. The supply side was important; the main role of authorities should be to create the appropriate

environment for efficiency and production. It was very important that industrial countries avoid protectionism (a point also stressed by Deshmukh (India)). The attitudes of oil exporting countries were also of "key importance" to the international environment. He supported an increased role for the Fund together with a sufficient flow of concessional aid.

20. Mogae (Botswana) and Deshmukh expressed concern about the effect of slower industrial country growth, particularly on low-income developing countries. Mogae commented that such countries were in a very unfavourable position in being price takers. It was true that they had often exacerbated their difficulties by inappropriate policies, and he supported the role of Fund programmes in correcting these. Equally, however, inappropriate policies in developing countries generally had an adverse effect only on them, while such policies in industrial or oil-exporting countries had a much more widespread adverse effect. He believed there was scope within the Fund's terms of references for certain special measures to benefit developing countries.

Staff reply to questions & comments

21. Schwartz said that the staff were now trying not to achieve excessive "fine tuning" in their forecasts, particularly of individual countries. There was of course some margin of error associated with any forecast. The staff were likely to revise downwards the estimate of a $17bn US surplus in 1981, consequent on their now less negative provisional revised estimate of growth. While it was not possible to be categorical, he doubted whether growth would be as high as 1%, as Syvrud and Price suggested, since the growth in nominal GNP implied by it - 12% or more - seemed inconsistent with present policies. Monetary growth was due to decline in 1981, and even taking account of the Administration's recent package, the cyclically adjusted fiscal deficit would move towards restraint; and the stimulative effects of that package might not in any case show much before end-1981. A "double-dipped" US recession seemed unlikely though it could not entirely be ruled out; so far, the bulk of the decline in GNP had been concentrated just in housing and the car industry, and it was conceivably possible that other sectors might now also

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be more affected. The forecast 8% increase in non-oil developing country export volume had been constructed "country by country", taking account of the external environment of each. It might be somewhat high, but not excessively so. Non-oil developing country export volume had grown considerably faster than world trade, partly because the larger exporters of manufacturers had managed to increase their market shares (even after 1975) and in particular their exports to oil exporters, whose imports had continued to grow quite rapidly. It had not been possible to include the PRC in this WEO because of data problems, but the staff intended to do so in the next exercise. The deficits of small industrial countries had increased relative to those of the major countries probably because of a 3-6 months' lag in cyclical developments behind the major ones, generally less restrictive financial policies, and smaller gains in exports to oil exporters. It was too early to say whether pressures to compensate for oil price increases in industrial country wage settlements were being successfully resisted, but this seemed possible; settlements were certainly more moderate than in 1973-74. The increase in the industrial countries' CPI in July was less than 7%, though the US producer price increase in August was 19½% (annual rate), reflecting increases in food prices. The idea of a tax-based incomes policy seemed useful in principle, though there might be administrative problems; the staff would cover this idea in a study of supply policies for the next WEO discussion.

<u>Managing Director's concluding statement</u>

22. In this statement (to be included in the paper for the Interim Committee to be issued on 23 September), the Managing Director commented on the virtually unanimous endorsement of the top priority to reducing inflation. A number of Directors had suggested that fiscal policy should not only complement a counter-inflationary monetary policy but also encourage desirable shifts of resources towards investment and more efficient use of energy. There had been considerable support for supply side measures. Some had favoured direct government intervention, others the creation of an appropriate economic environment, but on the whole there had been agreement that measures should not support uncompetitive activity. A number of Directors had

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recommended incomes policy, and some the interesting possibility of a tax-based system. There had been agreement on the desirability for action to limit exchange rate variability. While the present problem of current balances was unlikely to put pressure on the exchange markets, pressure could arise from differentials in inflation and competitiveness. International procedures - including Fund surveillance - were very desirable. There had been widespread concern about the position of developing countries, particularly the low income, and general agreement on their need for assistance. However, while some industrial country Executive Directors had argued that much of this assistance would have to come from oil exporters, the latter had pointed that they were already providing considerably more in relative terms than industrial countries. In view of the interdependence of the world economy, it was to be hoped that all countries in a position to do so would contribute to recycling. Any increase in industrial country protectionism would cause problems for developing countries. Most Directors had considered the staff's first scenario - though far from agreeable - the least unfavourable. All had agreed that premature relaxation of counter-inflation policies should be avoided, particularly because the first signs of adjustment were beginning to show. There had been general reaffirmation of recent discussions on the role of the Fund on enlarged access to resources and on adjustment and financing.

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