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TO DESKBY 061800Z UKDEL IMF/IBRD WASHINGTON

TELNO 156

OF 061800Z SEPTEMBER 88

IMF: WORLD ECONOMIC OUTLOOK - PROSPECTS AND POLICY ISSUES
EBS/88/167

THIS TELEGRAM AND MIFT SET OUT OUR OBJECTIVES AND OUR ASSESSMENT OF THE STAFF'S LATEST PROJECTIONS, AND GIVE POINTS TO MAKE ON THE TOPICS FOR DISCUSSION RAISED ON PP. 56-57. FURTHER POINTS ON THE MEDIUM TERM SCENARIOS FOLLOW. BRIEFING ON FORECAST FOR UK AND ON REFERENCES TO UK POLICY ISSUES IS CONTAINED IN A FURTHER TELEGRAM. ALSO RELEVANT ARE BRIEFING TELEGRAMS FOR RECENT US AND GERMAN ARTICLE IV CONSULTATIONS AND FOR BOARD DISCUSSION OF DEBT MANAGEMENT ISSUES ON 26 AUGUST.

OBJECTIVES

2. AGREE THAT MOST LIKELY OUTCOME IS THAT ECONOMIC GROWTH IN INDUSTRIAL COUNTRIES WILL MODERATE TO A RATE CLOSER TO GROWTH OF POTENTIAL, AND THAT A SERIOUS PICK-UP IN INFLATION WILL BE AVOIDED.
3. ENDORSE VIEW THAT, WITH ACTIVITY SO STRONG AND COMMODITY PRICES RISING SHARPLY EARLIER IN THE YEAR, THE RISK OF INFLATION SHOULD NOT BE UNDERESTIMATED. BUT NOTE THAT MONETARY AUTHORITIES HAVE RESPONDED TO SIGNS OF INFLATIONARY PRESSURE BY RAISING INTEREST RATES OVER THE PAST FOUR MONTHS, INCLUDING THE UK.
4. AGREE THAT A REDUCTION IN THE US BUDGET DEFICIT WOULD LIGHTEN CONSIDERABLY THE BURDEN ON MONETARY POLICY IN CONTAINING INFLATION IN THE US (WHERE PRESSURE ON CAPACITY IS PROBABLY GREATEST) AND ALLOW LOWER INTEREST RATES WORLDWIDE.
5. STRESS THAT, WHILE SOUND MACRO POLICIES ARE NEEDED TO PREVENT INFLATION, STRUCTURAL POLICIES ARE KEY TO STRENGTHENING ECONOMIC GROWTH AND REDUCING UNEMPLOYMENT. IMPROVED UK PERFORMANCE IN RECENT YEARS SHOWS THE BENEFITS OF SUCH POLICIES.
6. NOTE THAT WITH STRONG GROWTH OF WORLD TRADE AND RECOVERY IN COMODITY PRICES HAVE IMPROVED PROSPECTS IN THE DEVELOPING COUNTRIES. BUT STRESS CONTINUING NEED FOR STRUCTURAL ADJUSTMENT AMONG MIDDLE-INCOME DEBTORS, AND FOR FIRMER FISCAL AND MONETARY POLICIES IN A NUMBER

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OF COUNTRIES (PARTICULARLY IN LATIN AMERICA) WHERE INFLATION HAS ACCELERATED.

7. NOTE PROGRESS SINCE LAST WEO ON SPECIAL PROBLEMS OF LOW INCOME AFRICAN COUNTRIES AND LEADING ROLE OF UK.

8. SUPPORT PRESSURE ON TAIWAN AND KOREA TO TAKE ACTION TO REDUCE THEIR TRADE SURPLUSES AND COMPLETE THE LIBERALISATION OF THEIR TRADE. (BUT AVOID HONG KONG BEING INCLUDED IN CRITICISMS OF NIES' EXCHANGE RATE POLICIES).

9. EXPRESS CONTINUED RESERVATIONS ABOUT PUTTING TOO MUCH WEIGHT ON MEDIUM TERM PROJECTIONS.

10. DEFEND UK ECONOMIC POLICIES, IF NECESSARY.

11. QUERY WHETHER WEO DISCUSSION IS APPROPRIATE OCCASION FOR CONSIDERING REFORM OF INTERNATIONAL MONETARY SYSTEM. CURRENT SITUATION AND SHORT TERM PROSPECTS

12. BROADLY AGREE WITH THE BASIC PICTURE. BUT NOTE FOLLOWING POINTS:

I. TEXT SAYS LITTLE ABOUT LATEST DEVELOPMENTS IN INDUSTRIAL PRODUCTION AND COMMODITY PRICES. BOTH SUGGEST SOME MODERATION IN THE PACE OF ACTIVITY FOLLOWING VERY RAPID GROWTH EARLIER IN THE YEAR. WITHOUT A QUARTERLY PATH IT IS DIFFICULT TO SEE HOW FAR THIS HAS BEEN REFLECTED IN THE FORECASTS.

II. THE FORECAST OF 7 PER CENT FOR GROWTH IN WORLD TRADE IN 1988 LOOKS A LITTLE LOW - THE LAST OECD FORECAST HAD 6 AND THREE QUARTER PERCENT WITH MARKEDLY SLOWER OUTPUT GROWTH (3 PERCENT AGAINST 3.8 PER CENT FOR G7 GDP)

III. WHILE YEAR ON YEAR GROWTH RATES SHOW A SUBSTANTIAL DECELERATION BETWEEN 1988 AND 1989, FOURTH QUARTER FIGURES (TABLE A2) IMPLY A SLOWING DOWN FROM THE RAPID FIRST QUARTER RATE DURING THE REMAINDER OF 1988, FOLLOWED BY A RE-ACCELERATION DURING 1989. WHY THIS RE-ACCELERATION?

IV. AT 3.1 PER CENT FOR G7, GROWTH DURING 1989 IS ABOVE THE ESTIMATED TREND OF POTENTIAL (2.8 PER CENT). GIVEN EMERGENCE OF CAPACITY CONSTRAINTS, ESPECIALLY IN THE US, IS THIS CONSISTENT WITH ONLY A MARGINAL RISE IN INFLATION?

VI. NOTE MARKED SLOWING DOWN THAT IS EXPECTED IN RATE OF REDUCTION IN TRADE IMBALANCES IN 1989. THIS WOULD BE DISAPPOINTING GIVEN THE GOOD PROGRESS THAT HAS BEEN MADE SINCE 1986 IN REDUCING IMBALANCES

VII. THE RISK TO OIL PRICES MAY BE ON THE DOWNSIDE FOLLOWING THE SETTLEMENT OF THE GULF WAR (THOUGH ASSUMPTION OF CONSTANT REAL PRICES IS UNDERSTANDABLE).

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VIII. THE ASSUMPTION THAT NON-OIL COMMODITY PRICES WILL DECLINE SLIGHTLY NEXT YEAR IS QUESTIONABLE IN VIEW OF THE RATE OF ECONOMIC GROWTH THAT IS EXPECTED.

IX. PROJECTIONS FOR DEVELOPING COUNTRIES TERMS OF TRADE NEED EXPLANATION (TABLE A28). RISE OF ONLY 0.1 PER CENT FOR PRIMARY PRODUCT EXPORTERS IN 1988 LOOKS CURIOUS GIVEN 17.5 PER CENT RISE IN NON-OIL COMMODITY PRICES AND 11 PER CENT FALL IN OIL PRICE. ALSO LOOKS CURIOUS IN COMPARISON TO 1 PER CENT FALL IN 1989 ON BASIS OF 3 PER CENT FALL IN NON-OIL COMMODITY PRICES AND 5 PER CENT RISE IN OIL PRICES.

X. NO FORECAST IS COMPLETE WITHOUT AN INDICATION OF ERROR MARGINS. DISAPPOINTED THAT OUR SUGGESTION THAT AVERAGE ERRORS (FROM THE ARTIS EXERCISE) SHOULD BE CITED HAS NOT BEEN TAKEN UP.

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TOPICS FOR DISCUSSION: POINTS TO MAKE
FOSTERING STABLE EXPANSION

13. RENEWED INFLATION IS THE MAJOR THREAT. AGREE (P40) THAT POLICY MAKERS SHOULD NOT DELAY UNTIL INFLATION IS CLEARLY VISIBLE IN PRICE DATA. BUT ADMIT THERE ARE PROBLEMS IN INTERPRETING MONETARY CONDITIONS. THIS IS ONE REASON FOR LOOKING AT COMMODITY PRICES.

14. BUT STRESS COMMODITY PRICES ARE ONLY ONE INDICATOR USEFUL FOR JUDGING INFLATIONARY PRESSURES. NOTE:

I. BROADLY BASED INDICES OF PRICES OF PRIMARY PRODUCTS ARE RISING CONSIDERABLY MORE SLOWLY THAN EG ECONOMIST/IMF SPOT PRICE INDICES. MOREOVER OIL PRICES HAVE CHANGED LITTLE AND CONTRACT PRICES HAVE RISEN LESS THAN SPOT PRICES USED TO CONSTRUCT IMF INDICES.

II. RISE IN COMMODITY PRICES HAS TAKEN PLACE FROM AN EXCEPTIONALLY LOW LEVEL. EARLIER FALLS IN COMMODITY PRICES WERE PROBABLY NOT FULLY REFLECTED IN FINAL PRICES SO THAT PROFIT MARGINS WIDENED, AND ARE NOW LIKELY TO ABSORB TO SOME EXTENT THE CURRENT RECOVERY IN COMMODITY PRICES.

III. ON THEIR OWN, COMMODITY PRICES ARE ONLY A RELATIVELY SMALL ELEMENT IN FINAL PRICES. OTHER FACTORS POINT TO CONTINUED LOW INFLATION RATES: DOMESTIC COST PRESSURES, ALTHOUGH STRENGTHENING ARE STILL GENERALLY WEAK SEMI COLON REAL INTEREST RATES ARE SUBSTANTIALLY POSITIVE.

IV. DEMAND PRESSURES IN THE MAJOR COUNTRIES ARE NOT GENERALLY STRONG. ONLY IN THE US (AND PERHAPS JAPAN) ARE THERE SIGNS OF CAPACITY BOTTLENECKS.

INFLATION THREAT SHOULD NOT THEREFORE BE EXAGGERATED.

15. THE CURRENT ACCOUNT IMBALANCES REMAIN A POTENTIAL THREAT, BUT IT TOO SHOULD NOT BE EXAGGERATED. AS PERCENTAGES OF GDP, IMBALANCES HAVE NARROWED A GOOD DEAL SINCE 1986. BUT SMALLER IMBALANCES REMAIN DESIRABLE FOR REASONS GIVEN AT BOTTOM OF P39.

16. WITH THE US ECONOMY CLOSE TO FULL CAPACITY, US POLICY SHOULD ENSURE THAT THE ECONOMY DOES NOT OVERHEAT

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AND THAT ROOM IS AVAILABLE FOR BALANCE OF PAYMENTS TO IMPROVE. HOPE EFFECTIVE ACTION TO REDUCE US BUDGET DEFICIT IS TAKEN SOON AS POSSIBLE AFTER ELECTION. AGREE THAT STANCE OF POLICY IN JAPAN IS BROADLY APPROPRIATE (P42). STAFF MAY BE EXAGGERATING INFLATION RISKS IN JAPAN - CONSUMER PRICES ARE STABLE, LABOUR COSTS ARE FALLING. ON GERMANY: NOTE ONLY MODEST EXPECTED REDUCTION IN CURRENT ACCOUNT SURPLUS - COMFORTABLY FINANCED SO FAR THIS YEAR BUT RISKS OF DISRUPTIVE EFFECTS ON EXCHANGE RATE/MONETARY POLICY REMAIN. ERRATIC COURSE OF GERMAN FISCAL POLICY (TAX CUTS IN 1988, TAX INCREASES IN 1989, AND TAX CUTS IN 1990) LIABLE TO BE DESTABILISING.

STRUCTURAL POLICIES

17. PRIORITIES WILL VARY FROM COUNTRY TO COUNTRY. BUT THERE IS MUCH TO BE SAID FOR PURSUING REFORM ACROSS A BROAD FRONT. THIS ENABLES BETTER ACCOUNT TO BE TAKEN OF INTERRELATIONSHIPS AMONG POLICIES. IT ALSO ENBLES POLICY MAKERS TO SEIZE OPPORTUNITIES WHEN THEY ARISE.

18. REFORM CAN MAKE A MAJOR CONTRIBUTION TO INTERNATIONAL ADJUSTMENT, DIRECTLY BY REMOVING IMPEDIMENTS SUCH AS RESTRICTED MARKET ACCESS AND BARRIERS LIMITING FREE TRADE, BUT ALSO MORE WIDELY BY PROMOTING GREATER EFFICIENCY AND USE OF COMPARATIVE ADVANTAGE. FOR EXAMPLE, FURTHER IMPROVEMENTS TO MARKET ACCESS AND MORE DEREGULATED DISTRIBUTION SYSTEMS IN JAPAN, KOREA AND TAIWAN WOULD HELP TO PROMOTE IMPORTS, BENEFITTING THEIR CONSUMERS DIRECTLY, AND THE ADJUSTMENT PROCESS. REDUCTION IN AGRICULTURAL PROTECTION WOULD BENEFIT DEVELOPING COUNTRIES, AND HELP THE DEBT PROBLEM, AS WELL AS PROVIDING BENEFITS TO CONSUMERS AND TAXPAYERS IN PROTECTED INDUSTRIAL COUNTRIES.

19. THE FUND SHOULD NOT SEEK TO DUPLICATE THE WORK OF THE OECD, WHICH HAS A CONSIDERABLE COMPETENCE IN THIS FIELD. LAST OECD MINISTERIAL MEETING, COMMUNIQUE (19 MAY 1988), ENDORSED PRIORITIES FOR STRUCTURAL REFORM IDENTIFIED BY THE EPC, AND CALLED ON OECD TO 'DEVELOP FURTHER AND STRENGTHEN THE OECD'S SURVEILLANCE OF STRUCTURAL REFORM'. BUT FUND CAN CONTINUE TO PLAY A USEFUL ROLE IN DOCUMENTING AND MONITORING STRUCTURAL POLICIES IN INDIVIDUAL COUNTRIES IN THE ARTICLE IV CONSULTATIONS.

20. ANNEX III PROVIDES A USEFUL REVIEW OF LITERATURE ON STRUCTURAL INDICATORS. AGREE THAT WHILE CONCEPTUALLY POSSIBLE, IT WOULD BE IMPRACTICABLE TO DEVELOP SATISFACTORY STRUCTURAL INDICATORS BECAUSE OF DIFFICULTY OF OBTAINING RELIABLE EMPIRICAL ESTIMATES AND SEVERE DATA REQUIREMENTS.

AGREE THAT 'GENERATING AND INTERPRETING MANY STRUCTURAL INDICATORS REPRESENTS A SUBSTANTIAL AND ONGOING RESEARCH PROJECT' (P32) - REINFORCING NEED TO AVOID DUPLICATION WITH OECD.

21. AGREE THAT OPEN QUOTE SEVERE DISTORTIONS CAN USUALLY BE IDENTIFIED WITHOUT THE NEED OF SOPHISTICATED INDICATORS CLOSE QUOTE (P33). THE TECHNICAL DIFFICULTY OF DEVELOPING INDICATORS IN NO WAY REDUCES THE IMPORTANCE OR URGENCY OF REFORM. NOR SHOULD REFORMS WAIT ON REACHING INTERNATIONAL AGREEMENTS, GENERALLY IN A COUNTRY'S DIRECT SELF INTEREST. DEVELOPING COUNTRIES

22. THE CONTRASTING PERFORMANCE OF DEVELOPING COUNTRIES THAT HAVE ENCOUNTERED DEBT-SERVICING DIFFICULTIES AND THOSE THAT HAVE NOT DEMONSTRATES THE IMPORTANCE OF APPROPRIATE DOMESTIC POLICIES. IN GENERAL, THE MORE SUCCESSFUL COUNTRIES HAVE

- ADJUSTED MORE FLEXIBLY TO CHANGES IN EXTERNAL CIRCUMSTANCES
- PURSUED SOUNDER MACROECONOMIC POLICIES AND HAD LOWER INFLATION RATES
- ACHIEVED HIGHER RATES OF SAVING AND INVESTMENT
- PURSUED OUTWARD-ORIENTATED POLCIES THAT DO NOT DISCRIMINATE AGAINST EXPORTS.

23. IT IS OF COURSE IMPORTANT TO SINGLE OUT THE VERY POOR SUB-SAHARAN COUNTRIES - WHICH, EVEN WITH APPROPRIATE ADJUSTMENT POLICIES, CLEARLY COULD NOT SERVICE THEIR DEBTS IN FULL. THESE COUNTRIES WILL BENEFIT FROM THE MEASURES AGREED AT THE TORONTO SUMMIT.

24. MISLEADING TO TREAT NIES' AS A BLOC. THE LARGE COMBINED CURRENT ACCOUNT SURPLUS OF THE FOUR COUNTRIES (SHOWN IN TABLE 3) IS BEING RUN ENTIRELY BY KOREA AND PARTICULARLY TAIWAN. THE CURRENT ACCOUNTS OF SINGAPORE AND HONG KONG ARE CLOSE TO BALANCE. KOREA AND TAIWAN SHOULD CONTINUE TO REDUCE THEIR BARRIERS TO TRADE AND CAPITAL FLOWS. SINGAPORE AND HONG KONG HAVE NO TRADE OR CAPITAL RESTRICTIONS TO LIBERALISE. KOREA AND TAIWAN MAY HAVE TO REVALUE THEIR CURRENCIES FURTHER TO REDUCE THEIR SURPLUSES. HONG KONG DOES NOT HAVE A CURRENT ACCOUNT SURPLUS, AND THE FIXED LINK BETWEEN THE HONG KONG AND US DOLLAR IS IN ANY CASE CRUCIAL FOR FINANCIAL CONFIDENCE. MEDIUM TERM PROJECTIONS

25. EXPRESS CONSIDERABLE RESERVATIONS ABOUT MEDIUM TERM PROJECTIONS AND SIMULATIONS. WE AGREE WITH THE STAFF MAKING GREATER USE OF ECONOMETRIC MODELS AS AN AID IN PRODUCING THE WEO, BUT THEY NEED TO BE MORE CAREFUL

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ABOUT HOW THE RESULTING NUMBERS ARE USED AND DESCRIBED. THEY OUGHT TO BE MUCH MORE AWARE OF THE VERY LARGE ERROR MARGINS INVOLVED. (THE ONLY REFERENCE TO ERROR MARGINS IS THE UNTRUE STATEMENT ON P2 THAT THE SHOCKS ASSUMED IN THE SIMULATIONS ARE SMALL RELATIVE TO PAST FORECASTING ERRORS).

THE REFERENCE CASE HAS A NUMBER OF ODD FEATURES:

I. WHY DOES THE US CURRENT ACCOUNT DEFICIT INCREASE SIGNIFICANTLY ALTHOUGH REAL OUTPUT CONTINUES TO GROW FASTER THAN DOMESTIC DEMAND AND THERE APPEARS TO BE LITTLE CHANGE IN THE TERMS OF TRADE?

II. APART FROM THE UK WHERE ARE THE COUNTERPARTS TO THE DETERIORATION IN THE CURRENT ACCOUNTS OF THE US, JAPAN AND CANADA?

III. WHY DO FRANCE AND GERMANY GROW SIGNIFICANTLY FASTER THAN POTENTIAL OVER THE MEDIUM TERM?

IV. SEE COMMENTS IN SEPARATE TELEGRAM ON UK PROJECTIONS.

26. THE COMBINATION OF DEMAND - AND SUPPLY-SIDE SHOCKS (NAMELY AN INCREASE IN CONSUMPTION AND A REDUCTION IN US POTENTIAL OUTPUT) COMPLICATES INTERPRETATION - WHY NOT JUST THE FORMER?

RESULTS UNDER ACCOMMODATING MONETARY POLICIES WOULD HAVE BEEN USEFUL FOR COMPARISON. IN FACT THE SIMULATIONS SEEM TO IMPLY A VERY PESSIMISTIC VIEW OF ADJUSTMENT OF INFLATION UNDER MONETARY TARGETING. IN SCENARIO A, WITH UNCHANGED MONETARY TARGETS, ONE WOULD EXPECT THE INITIAL SHOCK TO LEAD TO HIGHER INFLATION AT FIRST, BUT IN THE MEDIUM TO LONGER TERM INFLATION WOULD REVERT TO WHAT IT WAS IN THE BASE. (EXCEPT IN THE US WHERE LOWER POTENTIAL GROWTH COMBINED WITH UNCHANGED MONETARY TARGETS WOULD RAISE INFLATION BY HALF A PER CENT PER ANNUM). HOWEVER, WHAT WE SEE IS INFLATION RATES STILL PICKING UP STRONGLY IN 1992: IN THE US IN 1992 THE RATE OF INFLATION IS UP BY 4 AND A HALF PER CENT, IN OTHER INDUSTRIAL COUNTRIES BETWEEN 3 AND THREE QUARTER AND 4 PER CENT. AT THE SAME TIME THERE SEEMS TO BE REMARKABLY LITTLE CROWDING OUT OF REAL GDP BY THIS COMBINATION OF UNCHANGED MONETARY TARGETS AND HIGHER INFLATION. FOR EXAMPLE GERMAN OUTPUT IS UNCHANGED FROM BASE IN 1992 IN SPITE OF A 10 PER CENT HIGHER PRICE LEVEL SEMI COLON OTHER INDUSTRIAL COUNTRIES OUTPUT IS 0.4 PER CENT LOWER IN 1992 WHILE PRICE ARE ALMOST 12 AND A HALF PERCENT HIGHER. THE MODEL APPEARS TO LACK ANY SIGNIFICANT FEEDBACK FROM REAL MONEY SUPPLY TO REAL OUTPUT.

27. IN ALL THREE SCENARIOS, THE INCREASES IN THE INFLATION

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RATE FROM THE BASE ARE FAIRLY SIMILAR FOR THE THREE MAJOR COUNTRIES. THIS IS ODD (A) BECAUSE THE US IS SUBJECTED TO A SUPPLY-SIDE AS WELL AS DEMAND-SIDE SHOCK AND (B) BECAUSE THE GNP GAP IN THE US IS ESTIMATED (PLAUSIBLY) TO BE ESPECIALLY NARROW (SEE ANNEX II, CHART II.1). IN GERMANY, WHERE THE GNP GAP IS WIDEST, THE INFLATION RATE RISES BY ONE PER CENT IN THE FIRST YEAR (IN SCENARIO A) ALTHOUGH REAL GNP RISES ONLY 0.1 PER CENT (AND THE EXCHANGE RATE IS UNCHANGED).

28. IT IS MORE APPROPRIATE TO COMPARE LEVELS OF GNP (AND POSSIBLY CUMULATIVE LEVELS) BETWEEN THE THREE SCENARIOS RATHER THAN RATES OF GROWTH. IN FACT, EVEN AT THE END OF THE PERIOD THE LEVEL OF US REAL GNP IS STILL ONE AND A HALF PER CENT LOWER IN THE EARLY MONETARY CORRECTION CASE THAN IN THE UNCHANGED MONETARY POLICY CASE. WHILE WE STRONGLY AGREE THAT EARLY MONETARY CORRECTION IS THE RIGHT POLICY THIS IS NOT CONVINCINGLY DEMONSTRATED BY THE SIMULATIONS.

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