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DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
1. memo	the Acting Secretary to the members of the Executive Board re attached report (1 pp.) <i>R 10/20/2010 F95-043/1 #51</i>	8/26/85	P1
2. report	re World Economic Outlook - General Survey (10 pp.) <i>R 10/20/2010 F95-043/1 #52</i>	8/23/85	P1

RESTRICTION CODES

Presidential Records Act - [44 U.S.C. 2204(a)]

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INTERNATIONAL MONETARY FUND
WASHINGTON, D.C. 20431

IMF

With the Compliments of
Charles H. Dallara
Executive Director

FOR
AGENDA

EBS/85/201

~~CONFIDENTIAL~~

August 26, 1985

To: Members of the Executive Board

From: The Acting Secretary

Subject: World Economic Outlook - General Survey

The attached paper presenting a general survey on the world economic outlook, together with a statistical appendix (EBS/85/201, Supplement 1, 8/26/85) and a technical note (EBS/85/201, Supplement 2), has been scheduled for Executive Board consideration on Monday, September 16, 1985. Issues for discussion appear on pages 48 and 49.

It is expected that parts of the material on the world economic outlook will be published shortly after the Annual Meetings. If Executive Directors have any comments regarding the text for the published version, they are requested to communicate them to Mr. Crockett (ext. 8982), who is also available to answer technical or factual questions relating to this paper prior to the Board discussion on Monday, September 16, 1985.

Att: (1)

DECLASSIFIED
NLRR F95-043/1 #51
BY RW NARA DATE 10/20/10

INTERNATIONAL MONETARY FUND

World Economic Outlook - General Survey

Prepared by the Staff 1/

Approved by Wm. C. Hood

August 23, 1985

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1/ The World Economic Outlook is a comprehensive interdepartmental project, co-ordinated in the Research Department, and drawing heavily on the specialized contribution of staff members from the five Area Departments, the Exchange and Trade Relations Department, the Fiscal Affairs Department, and the Research Department.

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NLRR F95-043/1 #52

BY RW NARA DATE 10/20/10

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WORLD ECONOMIC OUTLOOK - GENERAL SURVEY

I. Introduction

There have been increasing signs of hesitancy in the pace of world economic expansion in the first half of 1985. In the United States, output growth declined to an average of 1 percent (at an annual rate) in the first two quarters of the year; and in other industrial countries the pace of recovery was generally subdued. Commodity prices fell significantly, thus weakening growth prospects in many developing countries. These developments have not led to major revisions in the staff's view of industrial countries' economic prospects for the remainder of 1985 and 1986, in part because some of the factors affecting economic performance in the first half of 1985 are expected to be temporary. In the developing world, however, growth in 1985 and 1986 is now expected to be somewhat less than was foreseen six months ago. Moreover, the recent weakness of economic activity serves to underscore the downside risks in the staff's projections, and to focus attention on the policy issues that would arise if growth were to slow more significantly.

The present paper presents revised projections resulting from a country-by-country updating of the estimates presented in the March 1985 World Economic Outlook (WEO). ^{1/} As usual, the projections are based on the technical assumptions of: unchanged nominal exchange rates among industrial countries (at the pattern prevailing on July 22, 1985); unchanged oil prices in nominal U.S. dollar terms (at the level prevailing after the OPEC meeting in late July 1985), and "constant policies." (In some cases, constant policies have been interpreted to include policy changes that have been announced but not yet implemented.)

In present circumstances, considerable uncertainty attaches to these assumptions, as well as to the nature of the behavioral relationships by which they are linked with economic out-turns. Special attention is therefore given in later sections of this report to possible alternative paths of developments in the world economy, and to the channels by which policies and developments in major economies interact with those of their trading partners. The discussion of policy issues that concludes the present paper covers a number of questions that arise as a result of the uncertainties that are noted.

The policy conclusions that emerge from the analysis indicate that much remains to be done if expansion in the world economy is to be placed on a firmer footing, and if the prospects for combining growth with financial stability in indebted countries are to be enhanced. A key requirement is a significant reduction in the U.S. fiscal deficit. This would address one of the most troubling financial imbalances that currently cloud the outlook for sustained economic expansion. At the same time, however, it will be important for European countries to make more effective progress

^{1/} EBS/85/47-50, 3/11/85.

in tackling structural rigidities that impede economic performance, and for Japan to ensure that its output growth is based on a satisfactory rate of growth of domestic demand. In the developing world, weaker prospects for export growth make it all the more necessary for effective adjustment policies to improve the allocation of domestic resources. A particular issue in this connection is the need for countries that have not yet made adequate progress in stabilizing prices to tackle inflationary pressures more firmly.

Lastly, the report stresses the interactions of policies and developments among Fund members. These interactions are particularly evident from the way in which differences in economic policy mix have affected domestic savings and investment positions and hence interest rate differentials and trade flows. These differences are worrisome when they give rise to unsustainable imbalances, and when the means by which such imbalances are to be corrected are unclear. They are particularly troubling when, as at present, they generate demands for measures such as trade restrictions. The avoidance of recourse to such a fundamentally destructive policy response is a prime objective of international economic policy in current circumstances.

The present report contains an annex of summary statistical tables covering the main elements of the staff's projections. A comprehensive set of tables is being issued simultaneously as a statistical appendix to the present report (EBS/85/201, Supplement 1). In addition, a technical note is in preparation, dealing with some implications for the projections of possible changes in the underlying technical assumptions (EBS/85/201, Supplement 2).

II. Current Situation and Short-Term Prospects

1. Output, employment, and prices

a. Output

World output grew less rapidly in the first half of 1985 than was foreseen in the March WEO. The staff expects the pace of expansion in the industrial countries to pick up from mid-1985 onwards, although activity in developing countries would grow more slowly than in the earlier estimates. Taking all countries together, the projected rate of growth of world output is expected to be in the vicinity of 3 percent, slightly less than envisaged in March (Table 1). The projected growth rate in 1986 is unchanged at about 3 1/2 percent. The downward revision to the staff's earlier estimates for 1985 is due to two main factors: a sharper-than-expected deceleration of growth in the United States in the first half of 1985; and slower growth in primary goods exporting developing countries, resulting in part from weaker-than-expected export demand.

Table 1. Revisions to the Projections: World Output, 1984-86 ^{1/}

	Current Projections			Revisions compared with		
	1984 (Changes from preceding year, in percent)	1985	1986	March 1984	World Economic Outlook 1985	Outlook 2/ 1986
					(Percentage points)	
World	4.5	3.1	3.4	0.1	-0.3	--
Industrial countries	4.9	2.8	3.1	--	-0.3	0.1
Of which,						
United States	6.8	2.6	3.3	--	-0.8	0.3
Japan	5.8	4.4	4.3	--	0.1	--
European countries	2.3	2.3	2.4	-0.1	-0.1	--
Developing countries	4.4	3.6	4.1	0.7	-0.4	-0.4
Fuel exporters	2.2	1.0	3.0	0.2	-2.0	-0.8
Non-fuel exporters	5.6	4.8	4.6	1.2	0.4	-0.2
Primary product exporters	3.5	2.7	3.4	0.4	-0.7	-0.7
Exporters of manufactures	8.5	7.4	6.1	2.3	1.8	0.3
Service and remittance countries	3.1	3.9	4.0	-0.2	-0.2	-0.3
Other countries ^{3/}	3.1	3.6	3.5	--	--	--

^{1/} Real GDP (or GNP) for industrial and developing countries and real net material product (NMP) for other countries. Composites for the country groups are averages of percentage changes for individual countries weighted by the average U.S. dollar value of their respective GDPs (GNPs or NMPs where applicable) over the preceding three years. Because of the uncertainty surrounding the valuation of the composite NMP of the other countries, that group has been assigned--somewhat arbitrarily--a weight of 20 percent in the calculation of the growth of world output.

^{2/} The comparisons provided here are with the revised projections presented in the published version of the WEO.

^{3/} The U.S.S.R. and other countries of Eastern Europe that are not members of the Fund. The forecasts for these countries have not been updated from those given in March.

The slowing of growth in several of the major industrial countries in the early part of 1985, though not unexpected, was more abrupt and more generalized than envisaged in the March WEO. However, analysis of developments in individual countries suggests that part of this weakness can be attributed to factors that are expected to subside or be reversed in the second half of the year. With regard to the outlook for developing countries, the weakness of commodity prices appears to be related to factors, such as weak inventory demand and unusually ample supplies, that should diminish in importance with the passage of time.

The balance of forces acting on the world economy remains fundamentally unchanged and should continue to sustain the recovery, albeit at a relatively modest pace. Inflation in industrial countries has been reduced considerably and is unlikely to re-emerge as a major constraint on growth in the immediate future. The profit situation remains more satisfactory than two or three years ago, providing a basis for continued growth in business investment. Monetary conditions have eased in several major countries, including the United States. Finally, the success of adjustment policies in non-fuel exporting developing countries, in combination with lower international interest rates, implies that the financing constraint facing these countries will be less than in some recent years. These positive factors may be partly offset, in the short term, by the direct effects of fiscal retrenchment in several major countries, as well as by the continued restraining influence of structural rigidities. However, lower budget deficits in those countries with large existing imbalances should have beneficial effects on financial markets and on the climate of confidence, while actions taken by several governments to tackle structural rigidities may alleviate some of the negative effects of these rigidities on output.

The marked deceleration of output growth in the United States since last summer reflects developments in all the major components of demand. Of particular significance was the deterioration in the net foreign balance. Over the year to mid-1985, reflecting both the relative cyclical position of the United States and the strength of the dollar, more than 40 percent (net) of the growth of total domestic demand was met from foreign sources. The corresponding figure for the first six quarters of the recovery, when demand was growing more strongly, was less than 20 percent (Table 2). With the convergence of rates of demand growth in industrial countries, and on the technical assumption that the exchange rate of the dollar will be stable over the forecast period (at its value of late July 1985), the dampening influence coming from further adverse shifts in the foreign balance is projected to diminish considerably. In addition, the recent significant decline in interest rates will help to sustain the growth of demand. On this basis, the staff expects output growth to pick up to about 3 1/2 percent (annual rate) in the second half of 1985 compared with only about 1 percent during the first half.

Table 2. Stages in U.S. Recovery

(Percent change during period, in real terms at annual rate)

	Q4,1982 Q2,1984	Q2,1984 Q2,1985	Q2,1985 Q4,1986
Final domestic demand	6.7	4.2	3.6
Stockbuilding <u>1/</u>	2.0	-0.9	-0.3
Total domestic demand	8.8	3.3	3.3
Foreign balance <u>1/</u>	-1.6	-1.3	-0.2
GNP	7.1	1.9	3.2

1/ Changes expressed as percentages of GNP at the beginning of the period.

On the assumption of a moderate fiscal tightening in 1986 (see p. 26 below), output growth is expected to slow to a 2 3/4 percent rate during 1986.

In Japan, GNP growth slowed sharply in early 1985, as domestic demand weakened, and the net foreign balance deteriorated. This deterioration is likely to have been temporary, however, and the staff expects external demand to make a moderate positive contribution to output growth for 1985 as a whole, and again in 1986. Domestic demand growth in these two years is expected to be somewhat less than in 1984, mainly due to smaller multiplier effects as export growth decelerates, but also reflecting the continued withdrawal of fiscal stimulus. Overall, the growth of GDP is expected to slow from nearly 6 percent in 1984 to about 4 1/2 percent in 1985 and 1986.

The major European countries, despite their close interdependence, have exhibited uneven economic performance in early 1985, varying from relative buoyancy in the United Kingdom following the termination of the miners' strike to a decline in Germany's real GNP in the first quarter owing to an unusually harsh winter. Apart from these temporary influences, however, the underlying performance of European countries has changed little, and their average rate of growth is expected to remain at around 2 1/4 percent over the forecast period. The United Kingdom is likely to grow somewhat faster this year than the average for European countries, as a result of both the termination of the miners' strike and the transitional effects from the introduction of new, less generous, depreciation allowances for business investment. Since these effects involve a bringing forward of investment expenditures, capital formation is expected to drop back quite sharply in 1986. In Germany, growth is expected to remain fairly steady at some 2 1/2 percent in both 1985 and 1986. Investment intentions suggest that business equipment outlays will grow strongly this year, reflecting a marked improvement in the profit situation. Exports are also expected to continue to support activity. However, public consumption would grow only moderately, reflecting continuing efforts to curtail the budget deficit. In 1986, the contribution from exports is expected to decline, but the planned tax reductions and easier monetary conditions should strengthen domestic demand somewhat.

The strategy of the French authorities has been based, since 1983, on an elimination of the external deficit and a reduction in inflation. While the pursuit of these goals has been relatively successful, the immediate consequence on output has been to limit the growth rate that could be achieved. Output in 1985 is projected to rise by only 1 percent, which would be below capacity growth for the sixth consecutive year, with only a modest acceleration expected in 1986. In Italy, the relatively strong recovery of domestic demand in 1984 appears to have continued in the early part of 1985, but it has been accompanied by a sharp weakening of the net foreign balance. The July 1985 devaluation of the lira in

the EMS should help strengthen the foreign balance, but the associated measures may have an offsetting effect in reducing the growth of domestic demand.

Among other countries, Canada has been experiencing a more rapid growth in output than envisaged earlier, and the staff's estimates for GNP in 1985 have been revised upward. The smaller European countries are projected to continue to follow a pattern of recovery broadly similar to that of the major European countries, with somewhat slower export growth in 1985 and 1986 being counterbalanced by faster growth of private consumption and fixed investment.

Aggregation of these projections suggests that the expected slowing of growth in the industrial countries, from almost 5 percent in 1984 to some 3 percent in 1985 and 1986, can be traced to a deceleration in the growth of investment as well as to a turnaround in the contribution from stockbuilding. Both of these factors are almost wholly attributable to developments in the United States. Changes in the growth of the other components of demand from 1984 are of a considerably lesser magnitude, taking the industrial countries as a group.

In the developing countries, newly available data show that output grew by nearly 4 1/2 percent in 1984, rather than the 3 3/4 percent reported in the March WEO. For the non-fuel-exporting countries, growth was 5 1/2 percent, almost one and a quarter percentage points more than reported earlier. This relatively strong performance of developing countries reflected both the strength of recovery in industrial countries in 1984 and the success of their own adjustment efforts. For 1985 and 1986, however, projected growth rates for developing countries have been revised down--to about 3 1/2 percent and 4 percent, respectively (Chart 1). The downward revision is most significant for the fuel exporting and the primary-product-exporting countries, reflecting mainly weak oil and commodity markets. Lower levels of oil export receipts are expected to necessitate further reductions in government expenditure in several fuel exporting countries. Growth of non-oil GDP in these countries would therefore remain subdued while output in the oil sector is expected to decline in 1985 before recovering moderately in 1986. In other primary-product-exporting countries, weakness of export receipts is affecting domestic incomes more directly, which will tend to retard the growth of domestic demand and output. The rise in real GDP for this group of countries is now expected to decelerate from 3 1/2 percent in 1984 to 2 3/4 percent in 1985, before recovering to 3 1/2 percent in 1986.

For the exporters of manufactures, by contrast, growth reached 8 1/2 percent in 1984 and is expected to slow only gradually to 6 percent by 1986. Although partly due to the exceptional growth of output in China, the growth disparities between exporters of primary products

and exporters of manufactures can also be partly explained by the weak outlook for commodity prices: whereas the terms of trade of the primary product exporters are projected to deteriorate by 3 1/2 percent in 1985, exporters of manufactures are projected to face only a 1 percent deterioration in their terms of trade.

As mentioned above, domestic factors also account for some of the recent and projected divergences in growth rates. Many countries among the exporters of manufactures have already undertaken substantial and successful adjustments. As a result, these countries can now support some increases in domestic spending. This is reflected in the 7-8 percent contribution to output growth expected from domestic demand in 1985--an increase relative to earlier projections for 1985 as well as relative to the revised estimate for 1984. On the other hand, several primary-product exporting countries with high inflation are still at a much earlier stage in the process of restoring domestic financial stability. The needed adjustments require a shift in the composition of output and demand, which may have the initial effect of lowering growth.

Particular interest attaches to the growth prospects of two groups of countries facing difficult economic situations: the major borrowers among the heavily indebted countries, and the mostly low-income countries of sub-Saharan Africa. The recovery of output in some of the major borrowing countries has received a setback from the deceleration in growth in some of their principal export markets; adapting to lower export receipts has resulted in a downward revision to projected growth in the seven largest borrowing countries--from 4 percent and 5 percent in 1985 and 1986, respectively, in the March projections, to 3 percent and 4 percent in the present projections. The sub-Saharan African countries grew at an average rate of only 1 percent during 1983-84 as a result of weak export growth, shortcomings in domestic policies, acute shortages due to import cutbacks, and prolonged drought in several countries. Projected growth rates in the sub-Saharan African region for 1985 are now a little higher than was foreseen in the March WEO, reflecting somewhat more favorable supply conditions and the beneficial effect of adjustment policies. Nevertheless, with total output in the region expected to grow at only 3 1/2 percent annually in 1985-86, there will be little room for increases in per capita incomes.

b. Employment and unemployment

Not surprisingly, the deceleration of growth in the industrial countries has been accompanied by somewhat slower growth of employment. At the same time, the labor force has continued to expand at a relatively rapid rate, so that the average rate of unemployment has stopped declining (Chart 2). Unemployment in industrial countries, which had fallen from a peak of 8 3/4 percent of the labor force in 1983 to 8 1/4 percent in 1984,

CHART 1
DEVELOPING COUNTRIES:
REAL GDP, 1980-86
(Changes, in percent)

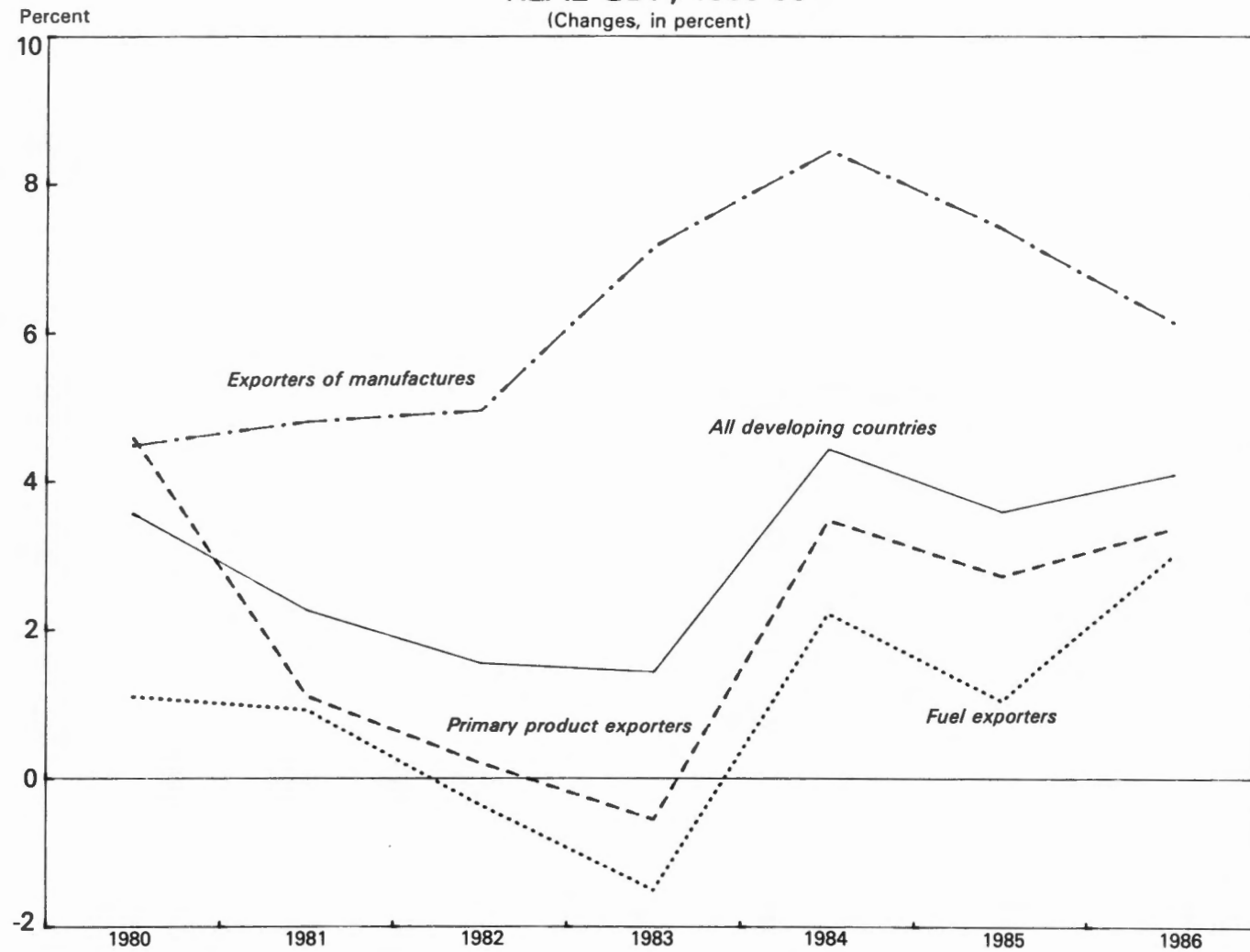
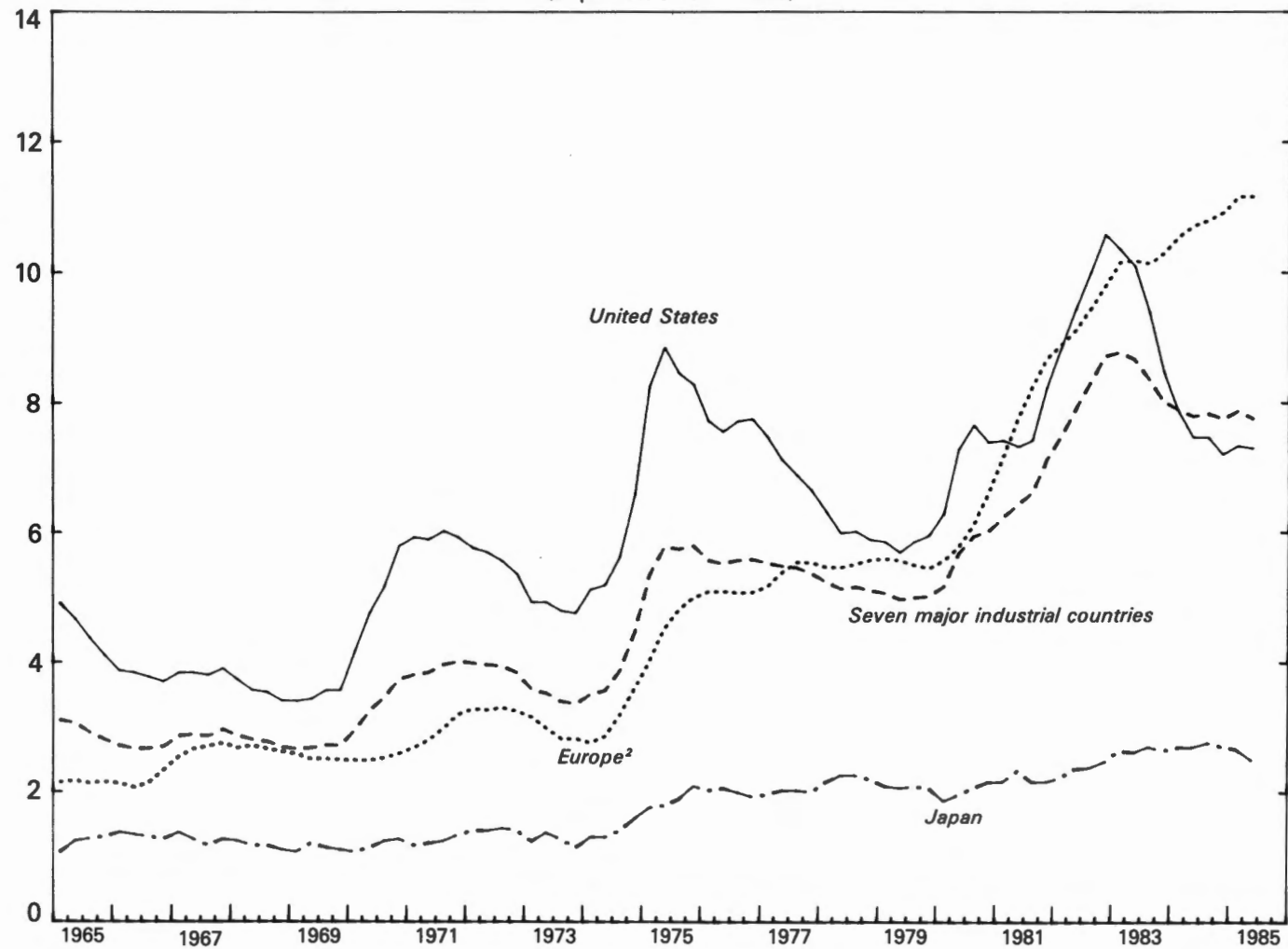


CHART 2
 MAJOR INDUSTRIAL COUNTRIES
 UNEMPLOYMENT, 1965-2ND QUARTER 1985

(In percent of labor force)¹



¹ National unemployment rates weighted by labor force in the respective countries.

² France, the Federal Republic of Germany, Italy, and the United Kingdom.

is projected to stabilize at the latter level in 1985 and decline only marginally in 1986.

The average measure of unemployment masks a continuing divergence in unemployment rates across industrial countries. In the United States, unemployment was reduced rapidly during 1983 and 1984, falling by some 3 percentage points in the first year and a half of recovery. The slower rate of growth registered since the middle of 1984 has been accompanied by a marked deceleration of productivity gains, reflecting both cyclical factors and the fact that growth has been concentrated in the service sector. As a result, even though real GNP increased by only 2 percent between mid-1984 and mid-1985, total employment rose by some 1.7 percent over the same period. Because of relatively rapid growth of labor supply, however, the rate of unemployment has been reduced only marginally since the middle of 1984 and is not expected to change much during the remainder of the forecast period.

In Europe, by contrast, the recovery was too weak in its early stages to reduce unemployment. Many countries experienced a cyclical increase in participation rates so that the growth in the labor force tended to outpace the modest increases in employment that were registered. Factor cost relationships also seem to have dampened the impact on employment of the rise in output, with enterprises apparently continuing to substitute capital for labor. However, because the gap between real wage costs and productivity that arose in the 1970s has narrowed in recent years (see below), the staff expects labor shedding gradually to taper off as the incentive to factor substitution diminishes. To the extent that this occurs, aggregate employment would increase (for the first time in several years), and labor productivity would grow somewhat less in 1985 and 1986 than over the past couple of years. This increase in employment, however, is not expected to be sufficient to prevent unemployment rates from continuing to edge up (Table 3).

In the developing countries, the recovery has barely had an impact on labor market conditions. An improvement in the employment picture is discernible in a few countries, mainly in Asia, that are predominantly exporters of manufactures and that have been well positioned to benefit from the pickup in world trade. However, in most developing countries, particularly in African and Latin American countries with high population growth, problems of unemployment and underemployment have probably increased, although available statistics do not always provide a quantitative basis for this judgment. Reflecting the particularly severe economic contraction in the Western Hemisphere, unemployment rates in 1984 in seven countries for which data are available were about 4 percentage points above their 1980 levels. Finally, in the fuel-exporting countries in the Middle East, the decline in oil revenues continues to necessitate significant reductions in the number of expatriate workers.

Table 3. Industrial Countries: Labor Force, Growth, Productivity,
Employment and Unemployment, 1967-86

(Percentage changes from preceding year, except as indicated)

	Average		From Preceding Year			
	1967-74	1975-82	1983	1984	1985	1986
United States						
Labor force	2.5	2.3	1.2	1.8	1.8	1.7
Real GNP	3.0	2.2	3.7	6.8	2.6	3.3
Productivity <u>1/</u>	0.8	0.5	2.4	2.6	0.5	1.4
Employment	2.2	1.7	1.3	4.1	2.1	1.9
Unemployment rate	4.7	7.5	9.6	7.5	7.3	7.1
Japan						
Labor force	1.0	1.1	2.0	0.7	0.8	1.0
Real GNP	8.3	4.4	3.4	5.8	4.4	4.3
Productivity <u>1/</u>	7.2	3.4	1.7	5.2	3.3	3.3
Employment	1.0	1.0	1.7	0.6	1.1	1.0
Unemployment rate	1.3	2.1	2.7	2.7	2.4	2.4
European countries						
Labor force	0.5	0.5	0.3	0.6	0.6	0.5
Real GNP	4.4	1.8	1.4	2.3	2.3	2.4
Productivity <u>1/</u>	3.8	1.9	2.2	2.4	2.0	2.0
Employment	0.6	-0.1	-0.8	-0.1	0.3	0.4
Unemployment rate	2.6	6.0	10.2	10.9	11.2	11.3

1/ Real GNP per employee.

c. Costs and prices

The decline in inflation that was a key feature of developments in industrial countries from 1980-1983 appears to have largely run its course (Chart 3 and Annex Table 2). Nevertheless, with only a few exceptions (such as the United Kingdom and New Zealand) price increases have not accelerated, and in some countries that previously had above-average inflation rates further progress has been made in stabilizing prices. For the industrial countries as a group, the average increase in the GNP deflator, which reached a peak of over 9 percent in 1980, had fallen back to about 4 percent in 1984; this measure of inflation is expected to recede slightly further to just under 4 percent annually in 1985-86.

Although there are thus no immediate signs of a revival of inflation, the risks of a renewal of price pressures appear to have increased. While the anti-inflationary policy setting, together with wage moderation and subdued commodity prices, will continue to dampen inflationary pressures in many countries, the growth of labor productivity is expected to decelerate, for cyclical reasons, as recovery matures. Thus, even though nominal wage increases are projected to remain relatively stable, the contribution of labor costs to inflation will probably pick up. In manufacturing, for example, unit labor costs in the industrial countries are expected to rise by 2 1/4 percent in 1985, after having been flat in 1984. This factor will limit the scope both for further reductions in inflation rates and for further increases in profit shares. Where monetary policy is being implemented flexibly, in order to take account of shifts in velocity, the danger exists that an overshooting of monetary targets could be interpreted as giving lower priority to inflation control, and could thus provoke cost-push pressures.

Weak commodity prices are an important element in the projected continuation of a good inflation performance in industrial countries. Commodity price estimates for 1985 and 1986 have been revised downward significantly, compared with the March WEO. During the first two years of the current recovery, the overall index of primary commodity prices rose steadily (Chart 4), reversing most of its decline since 1980 in real terms (i.e. relative to average prices of manufactured exports from industrial countries). However, since the middle of 1984, commodity prices have weakened noticeably and in the first seven months of 1985 averaged 7 1/2 percent below their year-earlier level in SDR terms. The decline was particularly pronounced for agricultural raw materials and tropical beverage crops, reflecting a combination of ample supply conditions, a slackening of growth in industrial countries, and cautious stockbuilding behavior due to continued relatively high real interest rates. Metals prices have increased slightly since the beginning of 1985 but remain extremely weak in real terms, having recovered much less than agricultural commodity prices in 1983-84. The projected strengthening of growth

in the major industrial countries in the second half of 1985, which is expected to be sustained into 1986, should help to stabilize and then increase commodity prices. Nevertheless, relative to export unit values of manufactures, these prices would be 7 percent lower in 1985 than in 1984 and would decline by a further 2 percent in 1986.

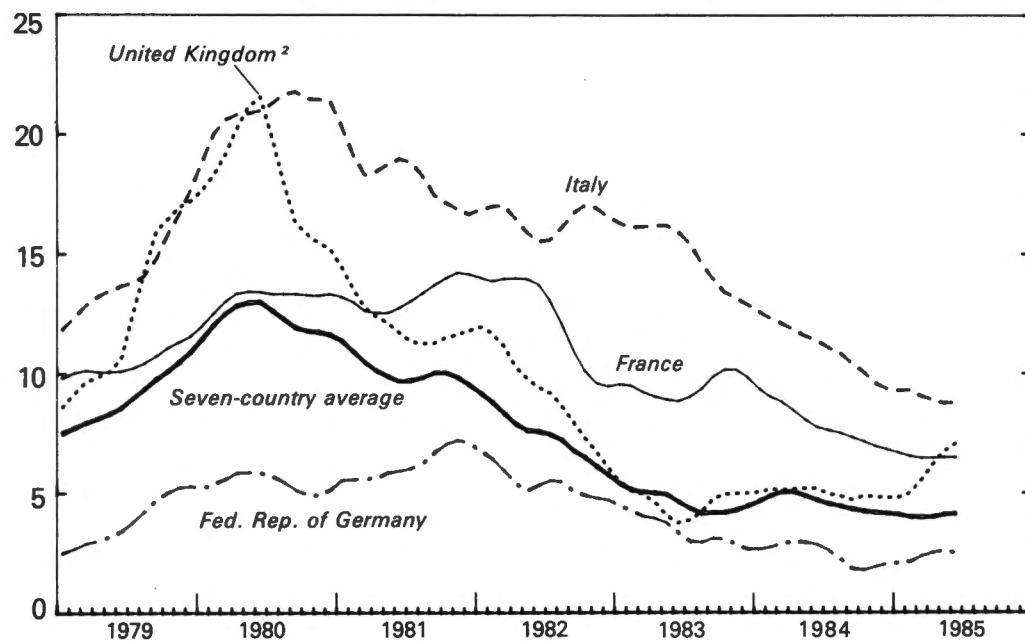
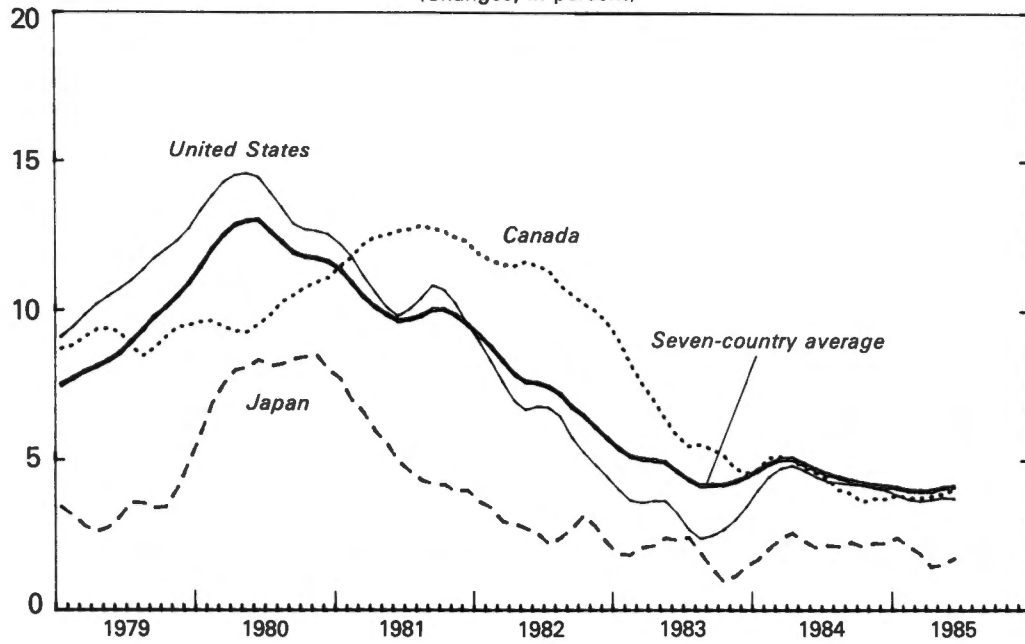
In the developing countries, inflation remains a serious problem and only modest progress is expected over the forecast period. For 1985, the weighted average inflation rate in developing countries is estimated at 39 percent, somewhat higher than in 1984 and also above the rate projected last March. It is important to note, however, that the weighted average inflation rate is strongly influenced by the situation in a small group of countries (Argentina, Bolivia, Brazil, Peru, and Israel) where inflation rates have surged to three, four, and even five digit rates. The weighted average inflation rate in these five countries, taken together, has risen from 66 percent in 1978 to some 250 percent in 1984 and is now projected to reach 280 percent in 1985. Excluding these five countries, the weighted average inflation rate is expected to decline marginally, from an average rate of 15 1/2 percent in 1984 to an estimated 15 percent in 1985. The median estimate of inflation shows a stabilization of inflation in 1985 at some 10 percent. The projections for 1986 point to a decline in the weighted average inflation rate to 28 percent (and a decline in the median rate to 8 percent). These projected improvements reflect in part the impact of intensified adjustment efforts in the context of Fund programs. Such programs are expected to contribute to sharp reductions in rates of price increase in several high-inflation countries, together with smaller declines in inflation in a wide range of other countries.

2. International payments, exchange rates, and debt

a. Overview

Reflecting the weakness of output trends in the first half of 1985, world trade is now expected to expand by some 4 percent in volume terms in the current year, compared with a growth of 5 1/2 percent forecast in the March WEO, and an increase of 8 1/2 percent recorded in 1984 (Annex Table 4). Some acceleration is expected in 1986, with trade tentatively projected to expand by about 4 3/4 percent. World trade prices are also expected to be more subdued than foreseen earlier. Prices of non-oil primary commodities, in particular, are expected to be much weaker, reflecting mainly falls that took place in the first seven months of 1985. For 1985 as a whole the index of commodity prices (in U.S. dollars) is projected to be 9 percent lower than in 1984, while manufactured prices would decline by a much lesser amount (2 percent). Oil prices fell by 2 percent in 1984, and on the assumption of no further change from early-August, would be a further 4 percent lower, on average, in 1985. The terms of trade of developing countries are projected to

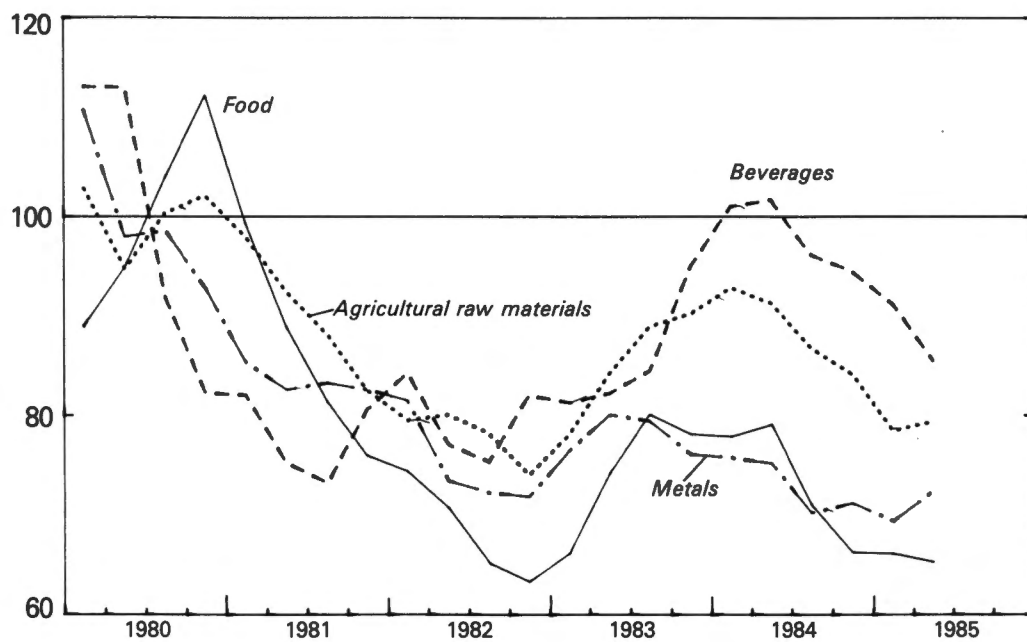
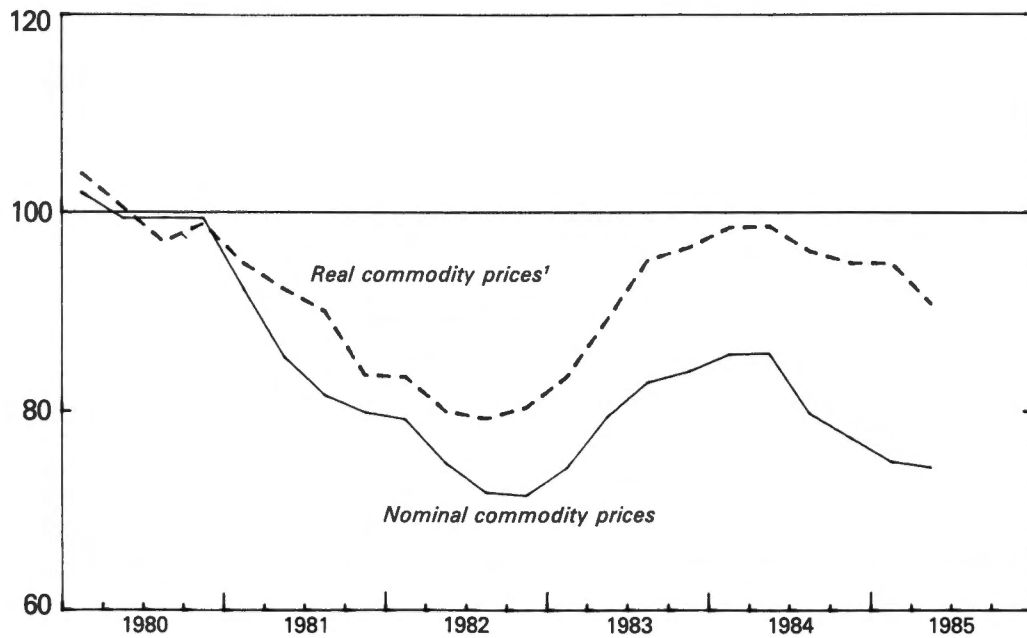
CHART 3
MAJOR INDUSTRIAL COUNTRIES:
CONSUMER PRICES, 1979-JUNE 1985
(Changes, in percent)¹



¹ Average of consumer price index for three months ended in month indicated over corresponding three months a year earlier.
² The figures for the second half of 1979 and the first half of 1980 were affected by the approximately 3 3/4 percent increase in value-added tax rates, with effect from June 18, 1979.

CHART 4
NON-OIL PRIMARY COMMODITY PRICES,
1980-2ND QUARTER 1985

(Indices, expressed in terms of U. S. dollars, 1980 = 100)



¹ Nominal commodity prices deflated by the UN index of prices of manufactured exports of developed countries.

deteriorate by about 1 1/2 percent, more than reversing the modest improvement that occurred in 1984.

While the developments just described would result in a substantial reduction in the growth of developing countries' export receipts, both from earlier projections and from the rate achieved in 1984, relatively little change is expected in the pattern of global current account balances (Annex Table 5). Largely as a result of financing constraints, developing countries are expected to scale back imports by almost as much as exports, so that their current account deficit would remain close to the relatively low level (between 6 percent and 7 percent of exports of goods and services) reached in 1984. There has also been little change in the projected current account position of industrial countries, as compared with the staff's March estimates. A widening of the industrial countries' combined deficit continues to be foreseen for 1985, with a substantial increase in the U.S. deficit outweighing a smaller rise in the combined surplus of other industrial countries. ^{1/}

b. Exchange market and current account developments
in industrial countries

The most noteworthy feature of exchange market developments for the major currencies during the first half of 1985 was the sharp appreciation and subsequent depreciation of the U.S. dollar (Chart 5). During 1984 the dollar had appreciated by 12 percent in nominal effective terms; from the end of 1984 to late February 1985 it continued to follow this pattern, rising by a further 8.5 percent. After declining sharply in March the dollar remained stable for the next three months, before sharply depreciating again in July. In the first quarter of 1985 the real effective value of the U.S. dollar--calculated on the basis of normalized unit labor costs--rose to its highest level since the Smithsonian Agreement of 1971. In real terms, the dollar was some 43 percent above its average for the decade 1974-83 and 57 percent above its trough in the third quarter of 1980.

By the end of July 1985, the U.S. dollar had returned to approximately its year-earlier levels in both real and nominal terms. The dollar's depreciation since the end of February has been associated with lower interest rates in the United States and with a decline in interest rate differentials favoring U.S. dollar-denominated assets. The decline in U.S. interest rates reflected the slowdown in the U.S. recovery and a more rapid growth of narrowly-defined money in the United States. U.S. M1 was outside the Federal Reserve's target range throughout the first seven months of 1985, while monetary growth rates in Japan and Germany were more in line with official targets or projections.

^{1/} The large increase in the projected combined deficit of industrial countries, together with a smaller shift in the same direction in the position of developing countries implies a substantial increase in the discrepancy in world current account balances.

The strengthening of sterling was a second feature of exchange market developments through the end of July. After falling in value throughout 1984, sterling began to recover late in February 1985. From February to July sterling appreciated by 26 per cent against the U.S. dollar, by 16 percent in nominal effective terms, and by about 17 percent in real effective terms. By the end of July, the real effective value of sterling was some 23 percent above its average for the period 1974-83. A sharp rise in U.K. interest rates at the end of January opened up a large interest rate differential in favor of sterling and was a significant factor in the appreciation. Resolution of the labor dispute between the National Coal Board and the miners' union, and relatively strong growth in output since the final quarter of 1984 also appear to have been contributing factors. Nevertheless, sterling remains sensitive to market expectations of oil prices, as was demonstrated in early August.

A third feature of exchange market developments for the major currencies during the first half of 1985 was a substantial increase in the variability of bilateral exchange rates relative to recent years. This variability was particularly noticeable in the U.S. dollar-sterling rate; relatively large variability in the U.S.-U.K. short-term interest rate differentials, shifting prospects for relative growth rates, and oil price uncertainty may have been contributing factors. The currencies of other industrial countries showed less movement than sterling, both against the dollar and in effective terms. The deutsche mark appreciated by 6 1/2 percent in effective terms over the first seven months of 1985. The yen appreciated by less than 3 percent in effective terms over the same period despite a short-term interest differential that moved in favor of yen and against dollar-denominated assets between March and June of 1985, and Japan's continuing current account surplus. The Canadian dollar fell by about 3 1/2 percent in both real and nominal effective terms through the end of July, but nevertheless its real value remained slightly above the average for 1974-83.

The relative absence of exchange market tensions that had characterized the European Monetary System (EMS) throughout 1984 extended into the first half of 1985. However, the lira continued to weaken over the first half of 1985 and in July the EMS currencies were realigned for the first time since March 1983. The central rate of the lira was devalued by 6 percent vis-a-vis the ECU, while the other EMS currencies were revalued by 2 percent. After the realignment, the EMS currencies remained within their margins with little sign of strain.

The major feature of the current account positions of industrial countries during early 1985 was the continued divergence between the large deficit of the United States and the large surplus of Japan (Chart 6). This divergence, which had emerged in 1982 and had increased in 1983 and 1984, continued into 1985 as the U.S. and Japanese current account

CHART 5
INDICES OF MONTHLY AVERAGE U.S. DOLLAR
AND EFFECTIVE EXCHANGE RATES

JANUARY 1980 - JULY 1985

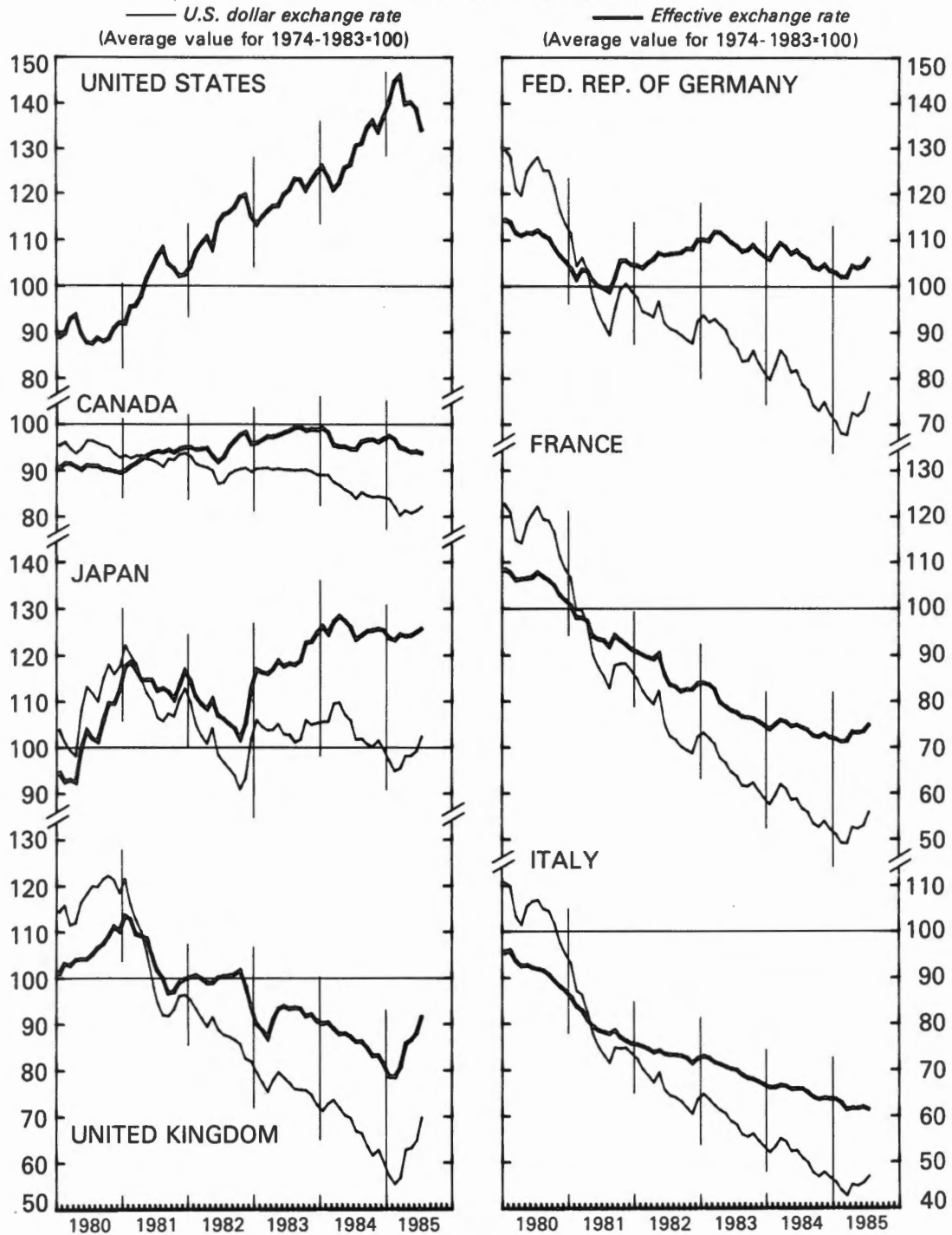
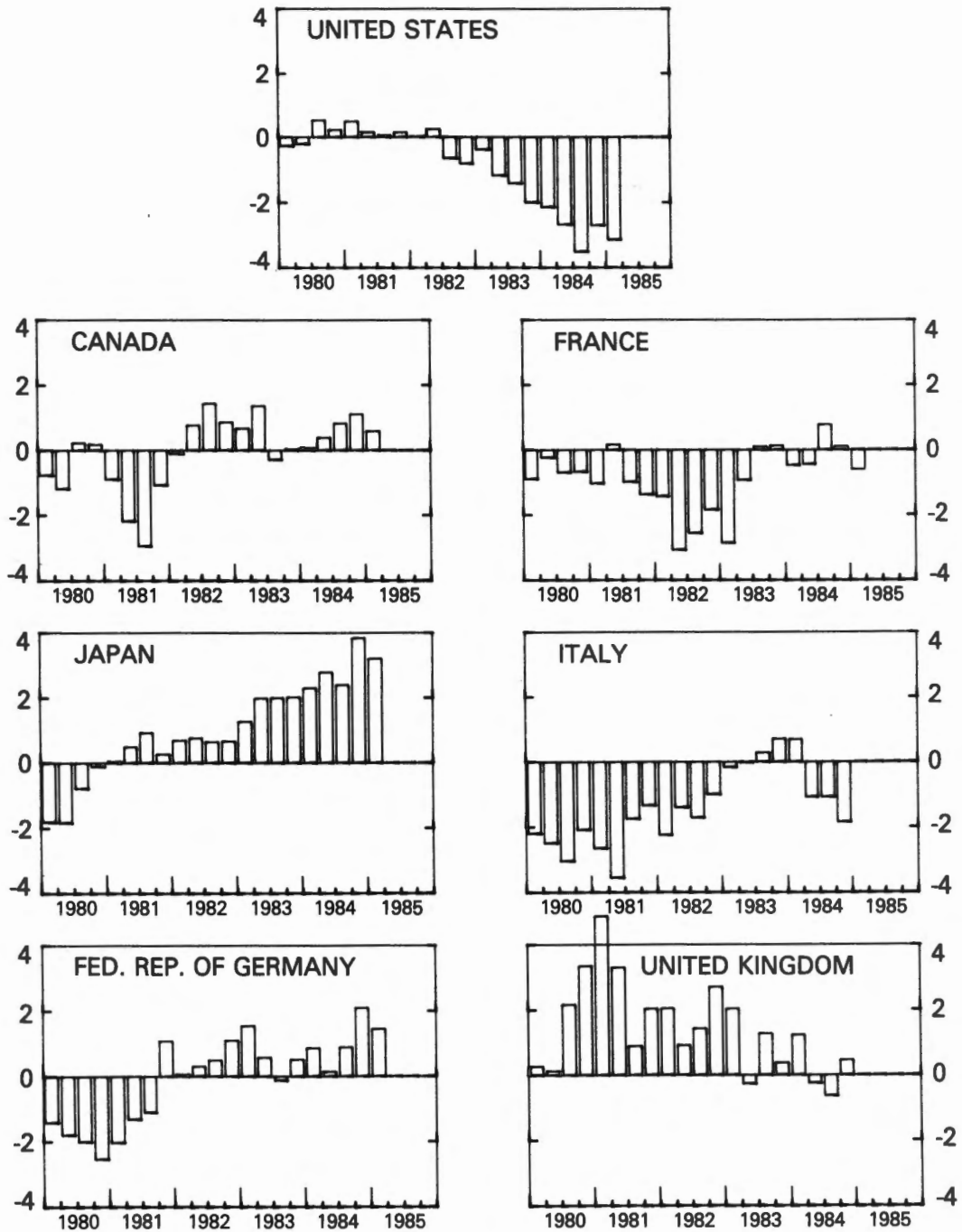


CHART 6
MAJOR INDUSTRIAL COUNTRIES:
PAYMENTS BALANCES ON CURRENT ACCOUNT,
INCLUDING OFFICIAL TRANSFERS, 1980-1ST QUARTER 1985¹
(In percent of GNP)



¹ Based on seasonally adjusted data.

imbalances widened further both in absolute terms and as proportions of GNP. Preliminary estimates show that the U.S. current account deficit (including official transfers) was 3.1 percent of GNP in the first quarter of 1985, compared with 2.8 percent during the year 1984. Japan's current account surplus in the first quarter of 1985 was 3.2 percent of GNP, against 2.8 percent during the preceding year. Within Europe, current account positions also diverged, but by smaller amounts. In Germany, the current surplus was 1.5 percent of GNP in the first quarter of 1985 (compared with 1 percent in 1984), while the Italian deficit rose to nearly 2 percent of GNP in the last quarter of 1984, and 0.8 percent for the year as a whole.

The U.S. merchandise trade deficit almost doubled in 1984 from the previous year's level. Imports increased by 25 percent in value terms, almost entirely because of strong volume growth; exports rose by almost 10 percent in value, again mainly reflecting growth in volume. Current data indicate that growth in the value of U.S. exports was modest in early 1985, while import value continued to increase at a high rate, albeit less rapidly than in 1984. The growth of final domestic demand in the United States has remained strong relative to that in other industrial countries during the last quarter of 1984 and the first quarter of 1985; this development and the appreciation of the dollar in real terms throughout 1984 and early 1985 were again the main factors accounting for the deterioration in the U.S. current account position. The effects of import compression in some heavily indebted developing countries have also played a role.

The growing U.S. current account deficit since 1982 has led to a marked change in the international investment position of the United States. Until 1985, the United States was a creditor to the rest of the world, holding net claims of some \$150 billion as recently as 1982; by early 1985, the United States is estimated to have become a net debtor in early 1985. In 1984 and early 1985, lending abroad by U.S. banks was down sharply, while both direct and portfolio financial inflows to the United States were up strongly.

The trade and current account projections for 1985 and 1986 reflect several revisions in underlying conditions from those assumed in the March WEO. The new projections are based on the working assumption that nominal exchange rates among major currencies, as well as nominal oil prices, will remain at their end-July 1985 levels during the forecast period (Table 4). This represents a depreciation of the real effective value of the U.S. dollar of 2 percent and a small reduction in the price of oil compared with that assumed in the previous WEO. In addition, non-oil commodity prices are now expected to be some 8 percent lower in 1986 than was assumed in the March WEO. This largely reflects movements in prices that have already taken place.

Table 4. Exchange Rate Assumptions--Current WEO
compared with March WEO

	Summer WEO	March WEO	Percent Change from March WEO
Bilateral Exchange Rates (Domestic currency per U.S. dollar)			
Canada	1.35	1.31	-2.6
Japan	240	243	1.4
France	8.80	9.17	4.2
Germany	2.87	2.99	4.0
Italy	1,944	1,856	-4.5
United Kingdom	0.72	0.80	11.9
Real Effective Rates (1980 = 100)			
Canada	112.7	116.8	-3.5
United States	146.9	149.8	-2.0
Japan	104.6	104.8	-0.2
France	87.6	85.4	2.6
Germany	86.1	86.2	-0.2
Italy	96.5	99.2	-2.7
United Kingdom	104.6	93.1	12.3

On the basis of these revised assumptions and projections, industrial country exports in volume terms are now expected to grow more slowly than was envisaged six months ago, while import volume growth has been revised upward. Specifically, industrial country export volumes are now projected to grow at 4 percent in 1985 and 5 percent in 1986, as compared with 5 1/4 percent and 5 percent, respectively, in the March estimates. These figures mainly reflect large downward revisions in Japanese and U.S. export growth rates. Industrial country import volumes are projected to grow by about 6 1/4 percent in 1985 and by 4 3/4 percent in 1986. The terms of trade, which had been expected to remain unchanged in 1985, are now expected to improve by 3/4 percent, reflecting weaker-than-expected commodity prices. A further improvement of almost 1 percent in the industrial countries' terms of trade is projected for 1986.

The projected current account positions of the individual countries are little changed from those envisaged six months ago. The U.S. current account deficit (including official transfers) is now projected at \$130 billion in 1985 rising to \$148 billion in 1986, while Japan's surplus is expected to increase from \$43 billion to \$58 billion during the same period. Germany's surplus would also rise significantly, reaching \$11 billion in the current year and \$16 billion in 1986. Other industrial countries have payments positions that are closer to balance and little change has been made to the staff's earlier projections. The most notable development is in the current account position of Italy, which is expected to be in deficit by about \$8 billion in 1986, despite the recent adjustment to the exchange rate for the lira.

A puzzling feature of the current account forecasts just presented is that the continued rise in the aggregate current account deficit of the industrial countries as a group (from \$60 billion in 1984 to \$78 billion in 1985) does not have a counterpart in an improved payments position for developing countries. As a result, there will be a further enlargement of the statistical discrepancy. This increase in the discrepancy is already apparent in data becoming available for the early months of 1985, and creates significant uncertainties in analyzing underlying trends. A partial reversal of this development is built into the projection for 1986.

c. Balance of payments and debt
situation in developing countries

The revised balance of payments estimates for the developing countries do not point to any major changes in the overall picture of adjustment and recovery that has been described in previous reports. The firmer estimates now available for 1984 suggest an even more pronounced adjustment effort by developing countries between 1982 and 1984, with the 1984 current account deficit now estimated to be about \$3 billion lower than

six months ago. Moreover, the projections again see a stabilization of deficits in 1985 and 1986 at about their 1984 level.

Prospects for most developing countries are somewhat obscured in the current statistics by a major revision in the projections for China. Reflecting its rapid growth of domestic demand and output, China is now expected to register a substantial (though easily financeable) current account deficit in 1985 and 1986. (Earlier estimates had been for only a gradual decline in the current account surplus.) This revision accounts for all of the widening of the combined developing country deficit in 1985 and 1986. Excluding China, the current account deficit of developing countries is still expected to remain roughly stable in 1985 and 1986, but at a level some \$4 billion lower than projected six months ago.

This broadly unchanged picture of stable and, by past standards, unusually small current account deficits in relation to export earnings is, however, the by-product of gross flows that give rise to somewhat more concern. The slowing of the recovery in industrial countries was always expected to lead to a softening in the pace of export expansion among developing countries. The export performance of the latter countries, however, is now expected to be considerably weaker than projected earlier. For the group as a whole, export growth is now expected to slow from 8 1/2 percent in 1984 to 1 1/2 percent in 1985. Moreover, this weakness of export volumes has been accompanied by a further weakening of commodity prices. As noted above, primary commodity prices other than oil are now expected to decline by 9 percent in U.S. dollar terms in 1985, compared with the 2 1/2 percent drop projected at the beginning of the year; oil prices are also somewhat weaker. As a result, the terms of trade of developing countries are projected to deteriorate by 2 percent in 1985 and by a further 1 3/4 percent in 1986. Given the prevailing inability or unwillingness of these countries to increase external borrowing, the drains on the real purchasing power of developing country export earnings have resulted in a scaling back of projected import growth. For the group as a whole, import volumes are now projected to increase by 1 percent (instead of 4 1/2 percent) in 1985 and by 3 1/2 percent (instead of 5 1/2 percent) in 1986. These disappointing overall developments conceal even less satisfactory developments for particular groups of developing countries, notably the primary product exporting countries, and especially those that export oil.

The countries most adversely affected by recent developments have been the fuel exporting countries, whose oil exports have proved to be markedly weaker than expected at the beginning of the year. Overall, these countries' export earnings, which had been expected to rise by almost 1 percent, are now projected to decline by more than 9 percent in 1985, (and the achievement of even this outcome is based on the assumption that oil prices do not fall below the levels prevailing at end-July).

Accordingly, fuel exporting countries have been obliged to continue the downward adjustment of their imports, which in volume terms are now expected to decline by 7 percent in 1985, instead of rising by 2 percent as projected earlier in the year. With import prices also being weaker than foreseen earlier, and some lowering of interest rates payable on external debt, the combined current account deficit of this group of countries in 1985-86 is now expected to be slightly smaller than projected six months ago (\$8-9 billion against \$9-11 billion).

For developing countries outside the fuel exporting group, revisions to forecasts of trade flows have also generally been in a downward direction. However, the revisions are not nearly as large, and these countries are expected, for the most part, to remain on a recovery track. The purchasing power of their exports—a measure which takes account of developments in both export volumes and terms of trade—is expected to rise by 4 percent in 1985 and by 6 percent in 1986, against increases of 7 1/4 percent in both years foreseen in the March WEO. The projected increases are expected to permit an expansion in import volumes of about 4 1/2 percent in both 1985 and 1986.

A perspective on recent trade volume developments for the non-fuel-exporting countries is provided by Chart 7, which plots rates of change in their real exports to, and imports from, industrial countries. Export volumes, which on the measure used in the chart had been rising at some 20 percent per annum in the last three quarters of 1983, slowed to about 8 percent per annum during 1984. On the other hand, import volumes, which had been curtailed sharply from mid-1981 to early 1983, firmed progressively during the balance of 1983 and in 1984 to reach increases of about 8 percent per annum. More recently, however, both exports and imports have slowed to rates of about 4 percent.

Among the non-fuel-exporting countries, those most adversely affected by the developments of the past six months have been countries that export predominantly primary products. These countries have been especially hard hit by the faltering of growth in the industrial countries in the first half of 1985. On average, export growth prospects for 1985 have been revised down by 3 percentage points and the expected deterioration of their terms of trade has been increased by over 2 percentage points. Partly as a result, imports into these countries, which had been expected to rise by an already modest 2 1/2 percent in 1985, are now projected to decline by 2 percent in real terms so as to keep the current account balance roughly unchanged at \$27 billion. This contrasts sharply with prospects for the exporters of manufactures, whose collective current account had already moved into surplus in 1984. These countries' terms of trade are projected to deteriorate by only 1 percent and their exports and imports are, in volume terms, running somewhat ahead of the staff's earlier projections.

The financing situation of capital importing developing countries 1/ is little changed from that reported six months ago. This situation remains characterized by a sharply reduced financing requirement 2/ that is almost wholly covered by financing from sources other than private creditors (Chart 8 and Annex Table 6). Moreover, the small amount of private lending that is taking place is more than offset by increases in reserves in the form of deposits in Eurobanks. However, despite the marked improvement in the overall financing situation of developing countries suggested by these developments, the situation of many countries within the group remains problematic. Many countries with unsatisfactory domestic situations are operating at the outer limits of their foreign exchange constraints and are unable to attract additional resources. A number of other countries, which used to be in this position, have adjusted to the point that they now have somewhat more room for maneuver. In some of these countries, however, the earlier inability to attract external financing has been replaced by an unwillingness to borrow from private creditors at prevailing market rates, or even a desire to reduce existing levels of indebtedness.

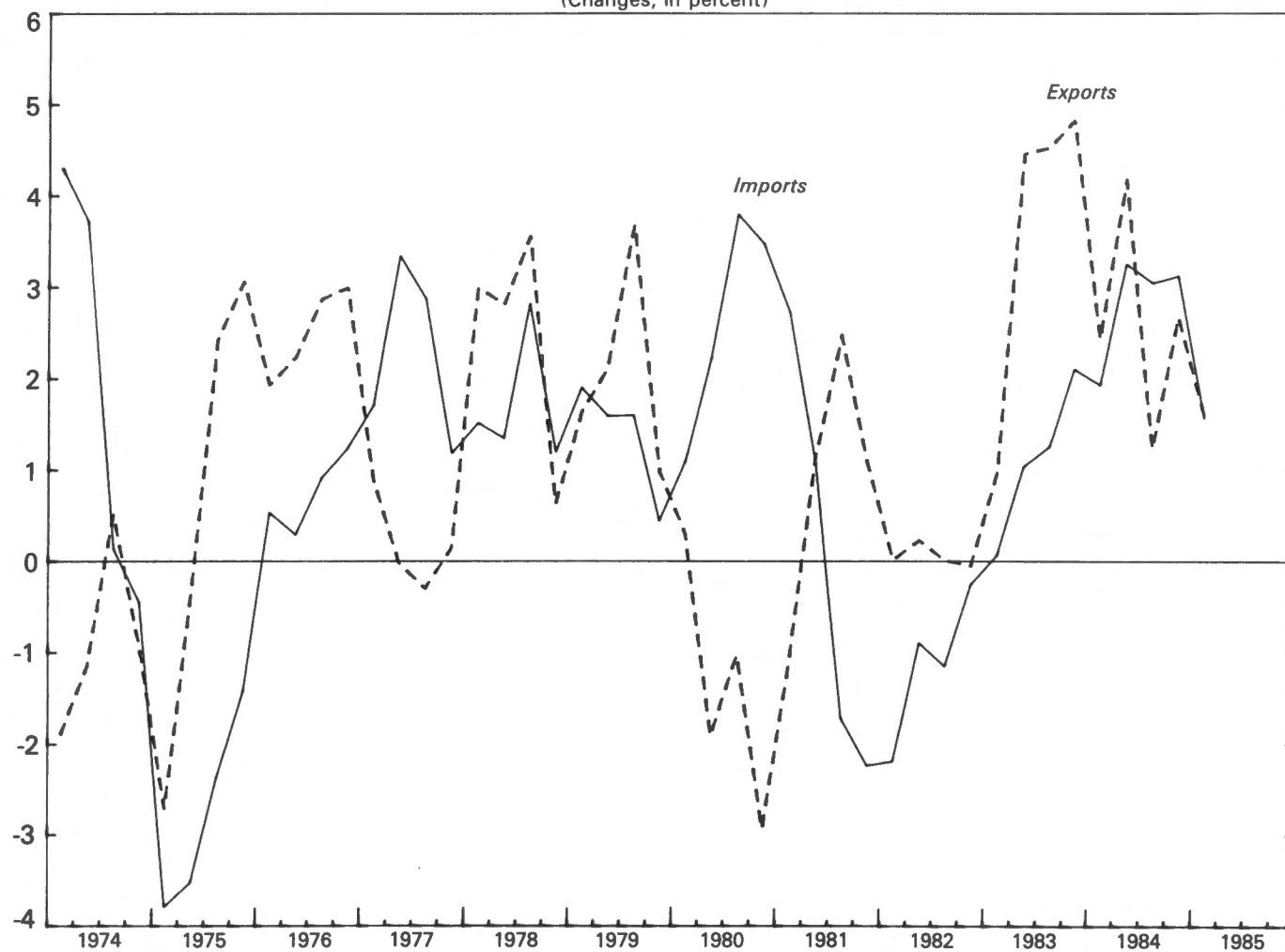
The changes in financing patterns from those shown six months ago are small and, for the most part, simply accentuate features of the situation that were highlighted at that time. The overall financing requirement of market borrowers, is projected to decline even more than expected in the March WEO, with their combined current account deficit put at \$3-4 billion annually in 1985-86. The position of the countries that rely on financing from official creditors, on the other hand, remains just as weak as in the earlier analysis.

As to the sources of finance, the main change is a downward revision of net external borrowing by about \$6 billion in 1985. Roughly half of that amount reflects the fact that some flows, notably to Israel and a number of African countries, are now expected to be disbursed on grant terms, i.e., are now classified as official transfers instead of as loans. The downward revision to the forecast for net borrowing by capital importing countries results in a small reduction in the projected growth of debt (to under 4 percent annually in 1985-86). Because of downward revisions to export earnings and GDP, this revision does not materially alter the projected improvements in the debt/export and debt/GDP ratios.

1/ All developing countries, other than the eight major oil exporting countries in the Middle Eastern region. It is recognized that this country grouping may include some countries which have positive net foreign assets.

2/ The financing requirement is defined as the need for capital inflows to cover current account deficits, capital flight, reserve accumulation, and other acquisition of external assets.

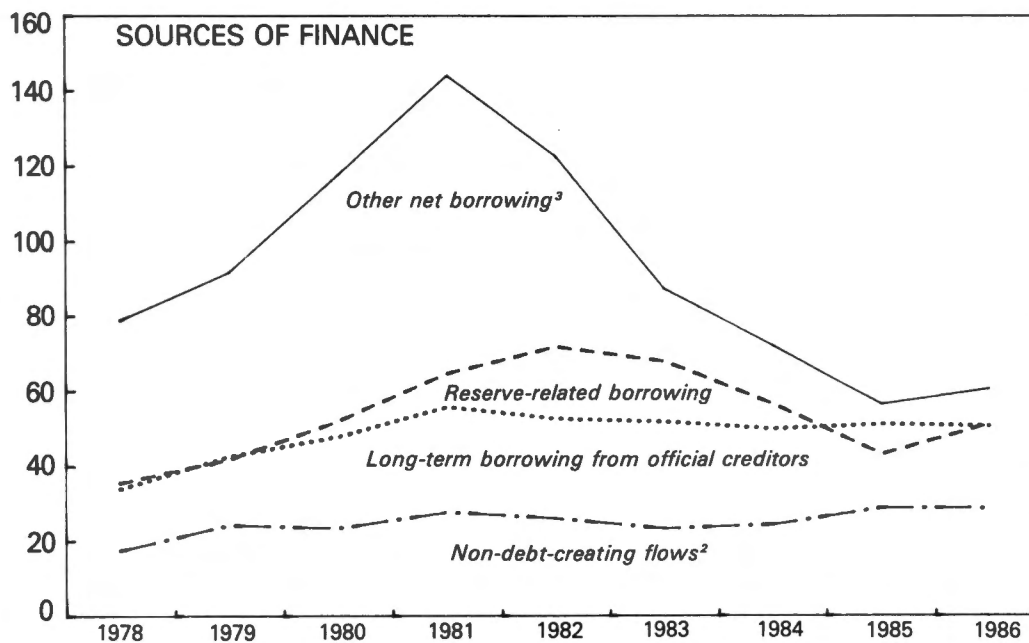
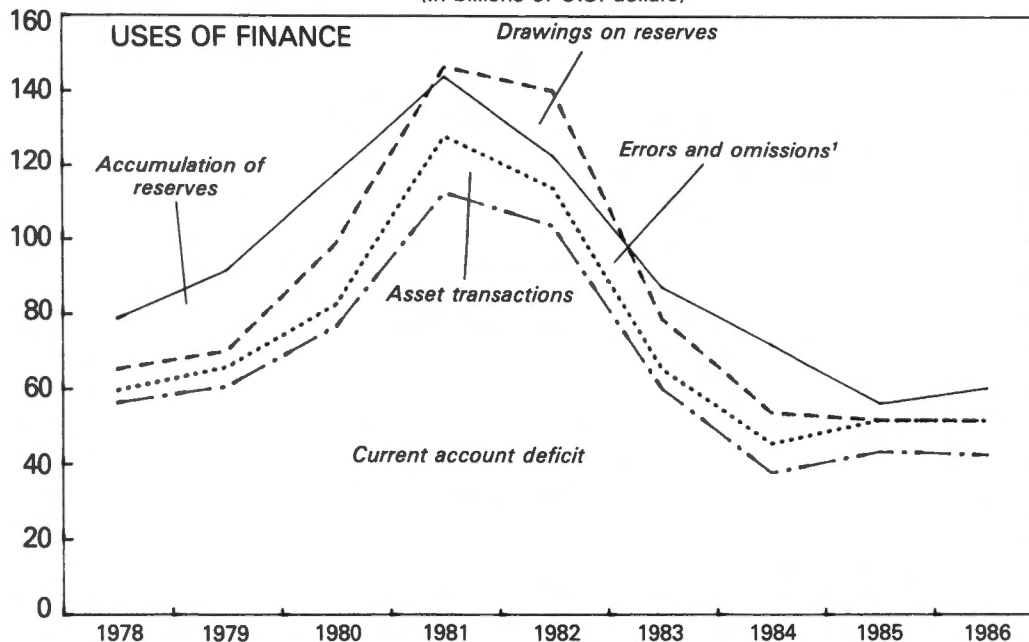
CHART 7
**TRADE VOLUMES OF NON-FUEL EXPORTING DEVELOPING COUNTRIES
 WITH INDUSTRIAL COUNTRIES, 1974-1ST QUARTER 1985¹**
 (Changes, in percent)²



¹Value data reported by industrial countries, deflated by data on export unit values of industrial and non-fuel exporting developing countries (for imports and exports, respectively).
²Of three quarter moving averages; seasonally adjusted actual rates.

CHART 8
CAPITAL-IMPORTING DEVELOPING COUNTRIES:
SOURCES AND USES OF EXTERNAL FINANCE, 1978-86

(In billions of U.S. dollars)



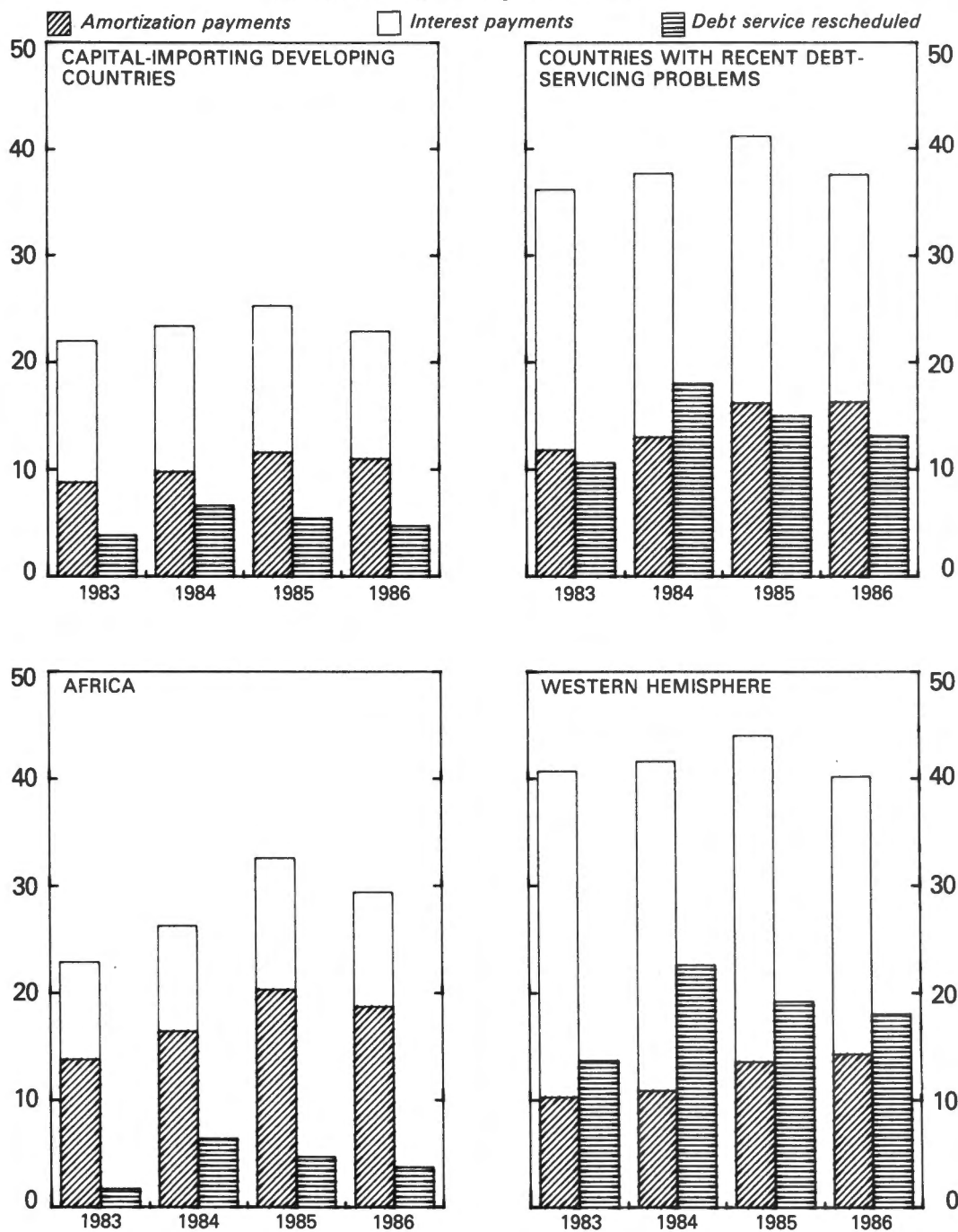
¹Presumed to be mainly capital flight.

²Official transfers, direct investment, SDR allocations, valuation adjustments and gold monetization.

³Mainly from banks.

CHART 9
CAPITAL-IMPORTING DEVELOPING COUNTRIES:
DEBT SERVICE PAYMENTS AND RESCHEDULINGS, 1983-86¹

(In percent of exports of goods and services)



¹Debt service comprises actual interest payments on all debt and actual amortization of long-term debt.

Despite reductions in international interest rates and in the growth of indebtedness, the capital-importing developing countries' debt service payments have been revised upward by \$5 1/2 billion for 1984 and by \$6 billion for 1985 (Annex Table 7). The debt service ratio has also been revised upwards, by almost one percentage point in 1984 and by 2 percentage points in 1985, when it is expected to reach 25 1/4 percent. Some of the increase in debt service payments in 1984-85 is attributable to early repayments of debt by some countries in Asia. However, a large part of the revision is on interest payments, in part reflecting the coming to light, in the context of debt restructuring negotiations, of more complete information on outstanding debt and debt service obligations. The further rise in 1985 is largely due to the weakness of export earnings.

As noted earlier, the situations of countries vary considerably, and some continue to experience severe debt-servicing problems. Debt rescheduling is expected to remain at high levels—\$30 billion in 1985 and \$28 1/2 billion in 1986—although somewhat lower than the record \$36 billion rescheduled in 1984. ^{1/} Expressed as a proportion of capital-importing developing countries' exports, debt rescheduling will decline from 6 1/2 percent in 1984 to an estimated 4 1/2 percent in 1986. This comparison, however, understates the significance of debt relief to the countries that experienced recent debt-servicing problems. For these countries, debt rescheduling amounted to the equivalent of 18 percent of exports in 1984 and, though expected to decline, will still represent 13 percent of exports in 1986 (Chart 9).

3. Stance of policies

a. Industrial countries

Economic strategy in the industrial countries continues to be based on medium-term objectives and to stress the establishment of stable underlying financial conditions, together with structural reforms aimed at improving the functioning of markets. While the avowed aims of policy are fairly uniform across countries, implementation has been subject to greater variation, whether because of domestic political constraints, policy slippages, or differences in economic circumstances.

As regards monetary policy, most major countries have sought for some years to control inflation and inflationary expectations by pursuing target growth rates for monetary aggregates that have been gradually reduced over time. While the pursuit of monetary targets continues to be an important intermediate objective, a number of central banks have stressed the need for flexibility in the face of shifts in underlying

^{1/} These large sums reflect, in large part, the impact on future debt service payments of multiyear rescheduling agreements.

velocity. As the monetary authorities in major countries have acquired greater credibility in their commitment to control inflation, they have felt more freedom to frame monetary policy in the light of developments in a range of indicators, including the behavior of interest rates and exchange rates, trends in a variety of monetary aggregates, and the rate of growth of nominal GNP.

An example of this flexibility is provided by recent developments in the United States. While both M2 and M3 were relatively close to their target ranges in the first half of 1985, the growth of M1 was allowed to exceed its target range, expanding at an annual rate of 12 percent during the first six months of 1985. The broader credit aggregate monitored by the monetary authorities (Total Domestic Nonfinancial Sector Debt) also grew above the upper limit of its target range. These developments, together with moderate growth of output, have been associated with a sharp reduction in U.S. interest rates. The Federal Reserve reduced its discount rate in May by 1/2 percent and by mid-1985, U.S. short-term rates reached their lowest levels since 1978. In mid-July, referring to distortions created by financial innovation, it announced a revised target range for M1 of 3 to 8 percent for the second half of 1985, using the higher-than-targeted second-quarter level of M1 as the base (Chart 10). Long-term interest rates have fallen by less than short-term rates but have also come down considerably over the past year. Reflecting these changes, and a relatively stable inflation performance, real interest rates have been reduced significantly, though they remain high in historical comparison (Chart 11).

In the other major countries, interest rates generally moved by less than in the United States in the first half of 1985. This resulted in a substantial movement of short-term interest rate differentials against the U.S. dollar, which contributed to the significant depreciation of the dollar from its February peak. The relatively modest initial response of interest rates outside the United States to declines in yields on dollar-denominated assets does not, however, appear to reflect a deliberate tightening of monetary policy (except perhaps in the United Kingdom). Rates of monetary growth in Europe and Japan have generally been somewhat more rapid than in 1984 and, where monetary targets are in existence, have been close to or above the upper limit of target ranges. Given that this relatively rapid rate of growth of money was not associated with any very significant decline in interest rates, despite relatively weak activity, it is possible that the targets established at the beginning of the year made insufficient allowance for underlying increases in the demand for money. Thus the targets may have implied somewhat tighter conditions than intended.

Exchange rate considerations may also have played a role in the reluctance of some countries to permit a sharp decline in interest rates. In Japan, for example, interest rates changed very little, on balance, during the first half of 1985, so that the differential with U.S. dollar interest

CHART 10
SIX MAJOR INDUSTRIAL COUNTRIES:
TARGET RANGES AND GROWTH OF TARGETED AGGREGATES
AS REPORTED AT END OF POLICY PERIOD, 1984-85

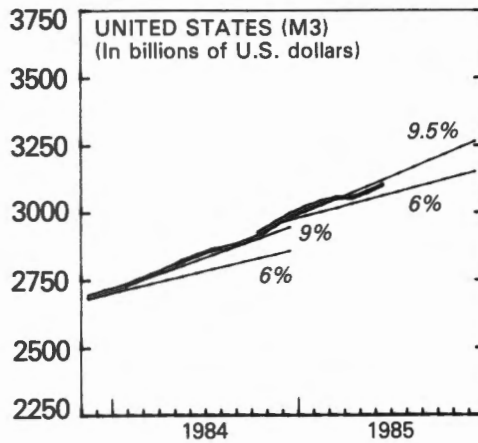
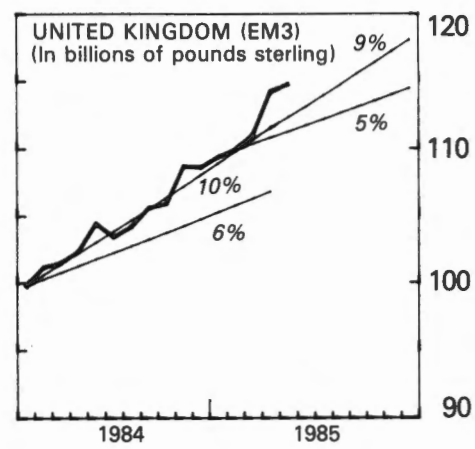
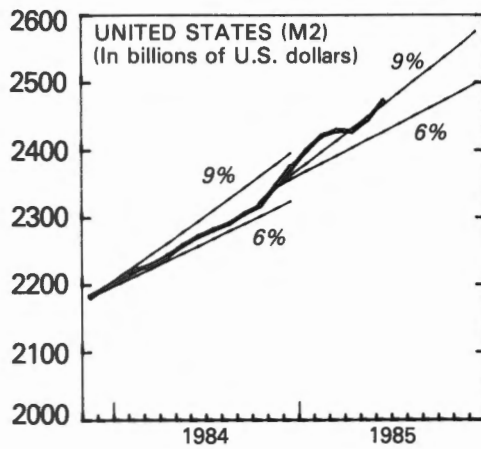
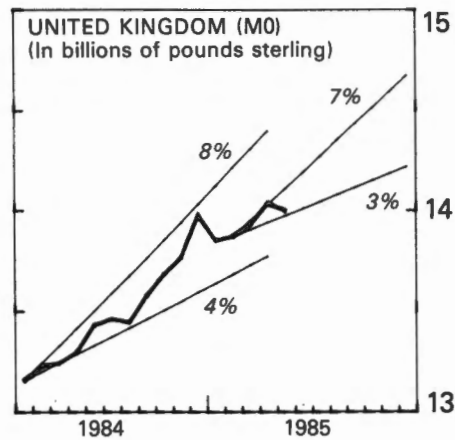
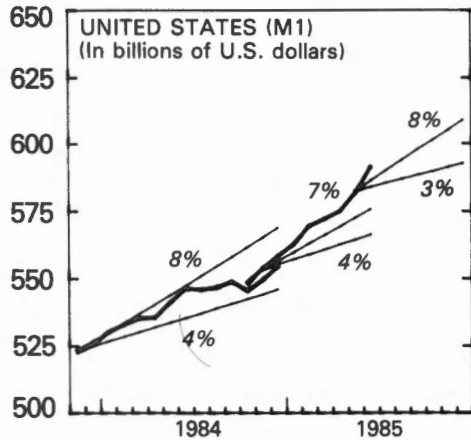


CHART 10 (Concluded)

SIX MAJOR INDUSTRIAL COUNTRIES:
TARGET RANGES AND GROWTH OF TARGETED AGGREGATES
AS REPORTED AT END OF POLICY PERIOD, 1984-85

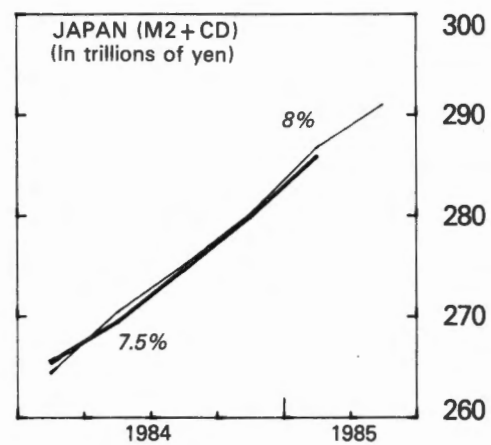
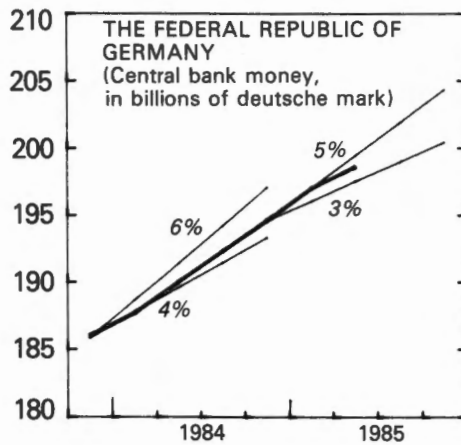
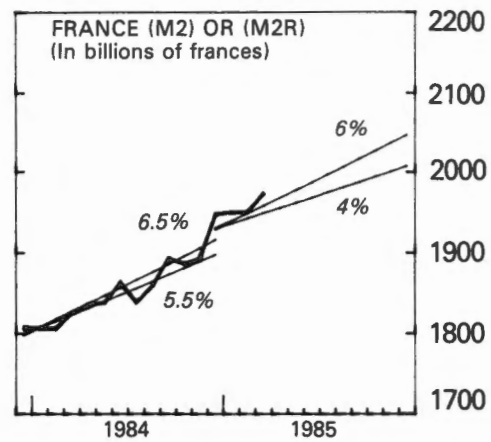
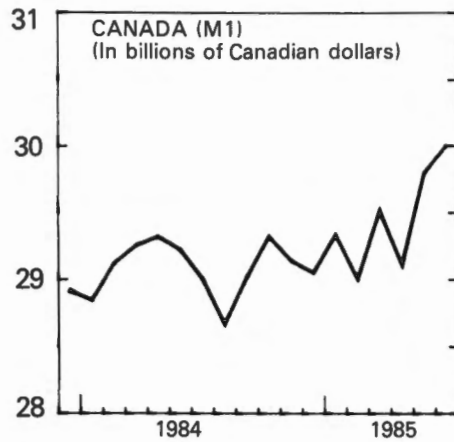
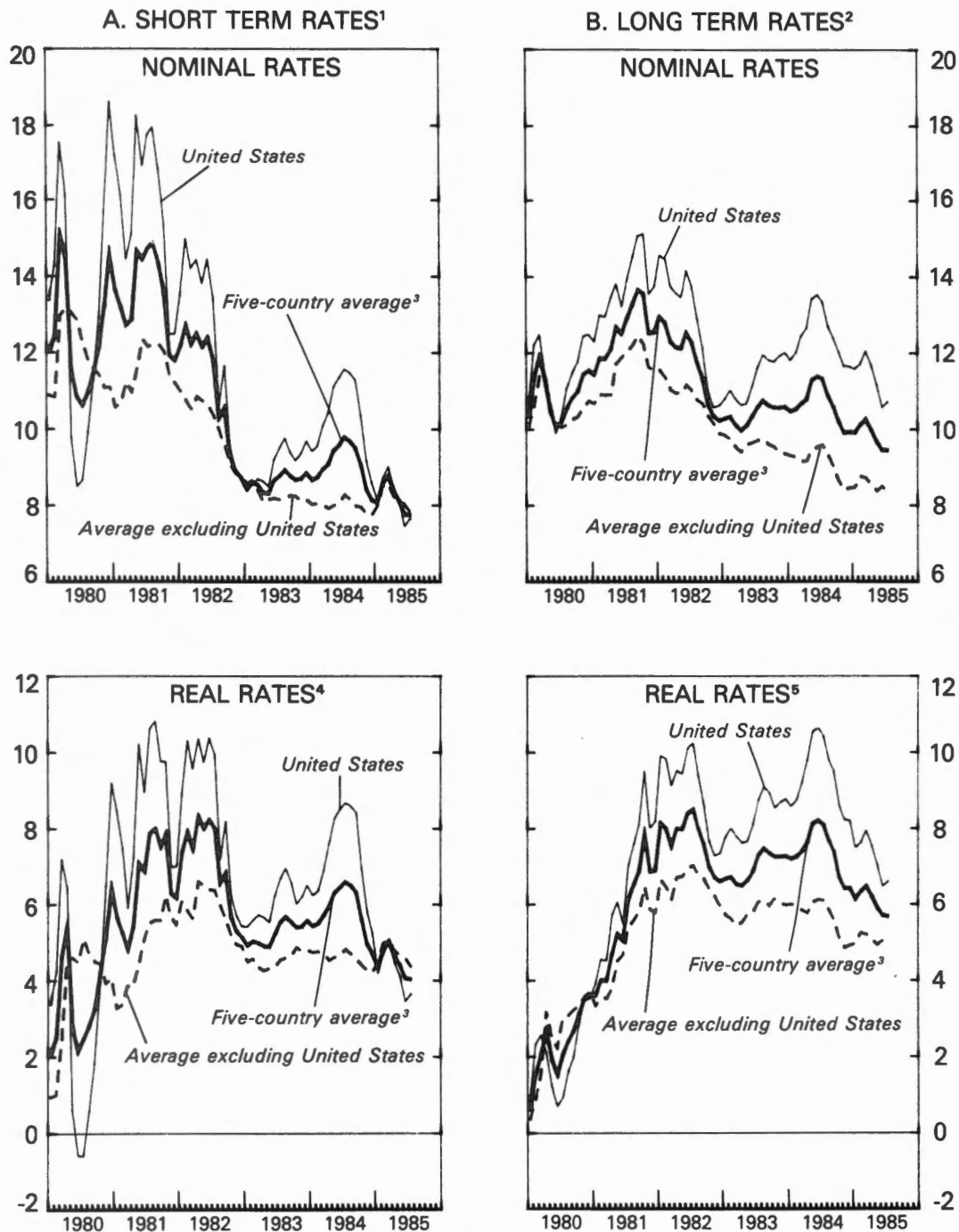


CHART 11
FIVE MAJOR INDUSTRIAL COUNTRIES
INTEREST RATES, 1980-1985
(In percent)



¹ Monthly averages of daily rates on money market instruments of about 90 days' maturity.

² Monthly averages of daily or weekly yields on government bonds, with maturities ranging from 7 years for Japan to 20 years for the United States and the United Kingdom.

³ The United States, Japan, France, the Federal Republic of Germany, and the United Kingdom.

⁴ Short-term interest rates deflated by a weighted average of the increase in the private final domestic demand deflator in the current and the following two quarters; for the most recent periods, staff projections of the deflator are used.

⁵ Long-term interest rates deflated as indicated in footnote 4.

rates narrowed significantly. In Germany the lombard rate was raised from 5 1/2 to 6 percent in February but this was a technical adjustment not intended to put upward pressure on interest rates. Short-term money market rates have declined recently, returning to levels prevailing at the beginning of the year. In France, the downward movement in both short- and long-term interest rates continued in the first half of 1985. These interest rate movements, however, broadly matched the decline in inflation so that real interest rates did not change noticeably. In January, the system of direct credit control was replaced by a more flexible system which will be enforced through non-interest-bearing reserve requirements and is regarded as a first step toward greater reliance on market forces.

Weakness of the pound led to a sharp rise in short-term interest rates in the United Kingdom in early 1985. Despite a strengthening of the currency toward the middle of the year, interest rates were allowed to ease only slightly, in part because of the rapid growth of M3, which has tended to overshoot its target range by a substantial margin for some time. An apparent revival of inflationary pressures has also militated against a reduction in rates. In Italy, whereas monetary aggregates had decelerated in 1984, the first half of 1985 has seen a re-acceleration in the growth of the money supply, largely due to the overshooting of the budget deficit. Long-term interest rates in Italy have tended to edge upwards. In Canada, interest rates have recently moved with U.S. rates, reflecting mainly exchange rate considerations. The differential between Canadian and U.S. short-term rates, which rose somewhat during 1984, remained at the higher level in the first half of 1985.

Fiscal policy in industrial countries continues to be framed in the light of medium-term objectives, and to be influenced by a variety of macroeconomic and microeconomic considerations. Governments have sought to curb the growth of aggregate public spending, to reduce budget deficits, and to restructure patterns of expenditure and taxation so as to enhance efficiency and promote growth. Success in the implementation of these broad objectives, however, has continued to be as uneven in 1985 as in earlier years.

At the macro-economic level, a feature of fiscal policy in 1985, as in the past several years, is the divergence between the expansionary thrust of policy in the United States and the average contractionary impulse in the other major countries taken together. In the United States, higher expenditures are the determining factor behind the expected rise in the deficit, as tax revenues in 1985 are expected to grow at least as fast as GDP. In Japan, France, Germany, and Canada, fiscal policy in 1985 is expected to be contractionary, reflecting mainly expenditure curbs in Germany and France, and revenue growing faster than GNP in Japan. (In Canada, the contribution comes both from the revenue and expenditure sides.)

The situation in Italy and the United Kingdom is more difficult to interpret, since sales of public sector assets, and loan transactions within the public sector, complicate assessment of the impact of fiscal developments on spending elsewhere in the economy. In both countries, however, the cyclically adjusted cash deficit of the central government is expected to widen noticeably in 1985.

Taking the seven major countries together, the thrust of fiscal policy, measured at the general government level, is expected to be roughly neutral (a slight stimulus was implied in the projections made in the March WEO). This suggests a somewhat more restrained fiscal stance than prevailed in 1984, when the expansionary impulse of fiscal policy was estimated to amount to some 1/2 percent of GNP. The combined fiscal deficit of the seven largest countries (at the general government level) would thus remain just under 4 percent of their combined GNP. ^{1/} Among smaller industrial countries, recent shifts in fiscal position have generally been in the direction of restraint. Relatively more of these countries (including Belgium, Finland, and New Zealand) have been prepared to strengthen their fiscal accounts through tax increases.

Prospects for 1986 are for somewhat more convergence in aggregate fiscal positions. In the United States, on the assumption that expenditure cuts of some \$40 billion (relative to the "current services" estimate) are implemented as a result of the recent Congressional budget resolution, the impact of fiscal policy at the central government level would become moderately contractionary after four years of strong stimulus. On the basis of the growth rate and interest rates forecast by the staff, the cash deficit of the federal government would decline by about \$20 billion. Outside the United States, the principal change foreseen for 1986 is a strong movement toward fiscal consolidation in Canada and a moderate withdrawal of stimulus in Japan. European countries would have, on balance, a mildly expansionary fiscal stance, with a positive impulse in Germany and Italy outweighing a moderate further move toward fiscal consolidation in France. Japan is expected to have a further significant strengthening of its fiscal position. Indeed, on the staff's projections, the Japanese general government deficit, relative to GNP, would have moved from being the highest among the five largest countries in 1979-80 to being the lowest in 1986. Japan has made less progress, however, in strengthening the budgetary position of the central government. At over 5 percent of GDP

^{1/} A slightly different picture is given when central government transactions are considered. The combined cash position of central governments was favorably affected in 1984 by reduced loans to other public entities in Italy and the U.K. The nonrecurrence of these items on a similar scale results in a rise in the cash deficit in 1985 and an increase in stimulus on this measure.

the central government deficit in Japan remains one of the highest among the major industrial countries.

As noted above, fiscal policies are also being directed at the objectives of reducing government spending and taxation, relative to GDP, and of restructuring government finances so as to improve incentives for the private sector. Both of these objectives are being pursued because of the contribution they are expected to make to economic efficiency, as well as on other grounds. An example of supply-oriented fiscal policies is the proposal to simplify the U.S. tax system through limitations on tax deductions, a broadening of the tax base and a lowering of tax rates. The removal of market distortions created by the existing tax system is intended to improve efficiency and thus to have a favorable impact on growth. In the United Kingdom, the authorities have sought to rectify a perceived bias in the tax system that favored the use of capital relative to labor and thus aggravated unemployment. Finally, in some other countries, for example, France, the authorities have seen employment taxes as a serious impediment to fuller utilization of available labor and have adopted the goal of reducing the relative burden of such taxes.

Besides fiscal reform, attention is also being given in industrial countries to other kinds of structural policies. These have taken a variety of forms, depending on political circumstances and institutional constraints, as well as the particular structural rigidities that are seen to have importance in individual countries. Deregulation and greater reliance on market forces has been seen as important in improving economic performance in a number of countries. Financial market deregulation, for example, is continuing in several countries, including Japan, France, Germany, and the United Kingdom. Governments have also been seeking to reduce subsidies and phase out support for declining industries, especially in Europe, while seeking to protect displaced workers through retraining schemes. The high level of minimum wages has been recognized to constitute a barrier to the employment of younger or less skilled workers, and in some countries (including Belgium, France, and Spain) the rate of increase in minimum wages has been reduced, or else devices have been sought to permit certain categories of job-seekers to obtain employment at wages below the legal minimum. Restrictions on the release of redundant labor have been relaxed in some countries as a means of increasing the willingness of employers to take on new labor. More generally, a variety of devices have been used to try and reduce the cost of labor to employers. These have ranged from incomes policy aimed at restraining wage settlements to the reduction of social and other charges levied on employers on the basis of their labor costs.

By their nature, these various structural policies are relatively specific in their incidence and do not have major effects on overall economic performance over the short term. Nevertheless, their continued implementation should, despite the many rigidities that remain, improve

prospects for growth of output and employment as their effects feed through into the general economic climate.

b. Developing Countries

In developing countries, the stance of financial policies is much as described in the March WEO. A feature highlighted there was the rather widespread reductions in central government fiscal deficits that had taken place in 1984 and were projected to continue in 1985. Updated estimates suggest that these reductions, many of which are being undertaken in the context of Fund programs, will lower the weighted average of central government deficits in developing countries from a peak level of 5 1/2 percent of GDP in 1983 to 3 1/2 percent in 1985. The corresponding reduction for the median deficit would be from 7 percent in 1983 to 5 1/2 percent in 1985. Fiscal improvements have been particularly significant in Africa, Europe, and the Western Hemisphere. (In Asian countries, deficits had generally been kept to lower levels and there was thus less need for substantial reduction.)

The improved fiscal performance has generally made possible a reduction in the growth of monetary aggregates (although the overall picture in this respect is obscured by the inclusion of certain countries that have very rapid inflation rates). Using median estimates to abstract somewhat from this problem, the median rate of money growth has been on a declining trend for some years, and is projected to fall further in 1985.

Other policies that are of key importance for economic performance in developing countries are supply-side policies and exchange rate management. Supply-side policies cannot, of course, be readily quantified and aggregated across groups of countries, but most developing countries have been making continued efforts to bring about structural reforms. Many countries, particularly those implementing programs supported by use of Fund resources, have in the past several months raised regulated domestic producer prices of export crops in real terms; raised real interest rates; restructured their tariff systems to reduce the bias in effective rates of protection; liberalized interest rate, trade, and exchange rate regimes; and relaxed price controls in retail trade.

With regard to exchange rate policies, the corrections to real exchange rates brought about in the wake of the debt crisis of 1982 have been sustained over the period to mid-1985. The staff estimates that, on a weighted average basis, real exchange rates of fuel importing developing countries declined by about 3 percent over the first five months of 1985. A noteworthy development was the decline of 7-8 percent in the real effective exchange rate of African countries, a group which in the past had experienced difficulties in adjusting exchange rates to maintain external competitiveness.

III. Medium-Term Scenarios

The staff has reviewed the medium-term scenarios presented in the March WEO, to ascertain whether the principal conclusions reached at that time remain valid. A detailed country-by-country re-evaluation of the estimates has not been undertaken; rather, the approach has been to adjust the results of the earlier analysis for certain changes in the underlying environment, and to investigate the sensitivity of the scenario outcomes to changes in the basic assumptions.

If the March scenarios are adjusted simply in the light of developments in the world economy since that date, the medium-term projections are very little changed. This is because actual developments over the past half year have not greatly changed the basis for the scenarios: the revised projections for 1986 (the "base" year from which medium-term trends start) are much as before; exchange rates and oil prices have changed only slightly from those underlying the March projections; and recent monetary developments do not call for any major change in the assumed medium-term evolution of interest rates. Moreover, prospective policies, both in industrial countries and in developing countries, are similar to how they appeared six months ago. Thus, the conclusions reached in the March WEO remain valid, and will not be repeated in detail here. In brief, the staff believes that, given the assumptions on which the baseline scenario is developed, it should be possible for capital-importing developing countries to grow at a rate of 4 1/2-5 percent during 1987-90, while bringing about a reduction of one-fourth to one-third in their external debt ratio. 1/

While the baseline projection has not changed much, it should be recognized that the medium-term outlook has been rendered more uncertain than previously by recent changes in the world economy, in particular the continued weakness of the world petroleum market, alterations in exchange rates between the U.S. dollar and other currencies, and a lower degree of optimism about medium-term growth prospects for the industrial countries. Considerable interest, therefore, is attached to the implications for the basic scenario of developments with respect to these variables, for which

1/ The key external assumptions of this scenario are: economic growth of 3 percent per annum in the industrial countries; approximate stability from 1985 onwards in the terms of trade of primary producers; stable U.S. dollar oil prices until the end of 1986, and stable real prices thereafter; a gradual decline of the dollar from 1987 onward; a stable (and, after 1988, gradually falling) level of real interest rates; no change in protectionist pressures; a modest decline (of about 2 percent per annum) in real bank exposure to developing countries; and a constant level of real foreign aid. (The deflator used to adjust nominal bank lending and foreign aid to real terms is the price of developing country imports from industrial countries.)

the staff's baseline assumptions must be regarded as particularly tentative. For example, in the absence of any straightforward alternative, the staff has continued to use the conventional assumption of unchanged oil prices (in U.S. dollar terms in the short-term, and in real terms during the medium-term scenario period). Clearly, however, there is a possibility of prices declining below the current level, and little likelihood, for the time being, of them rising above it. The staff has therefore conducted a sensitivity analysis to investigate how the scenarios would appear if oil prices were systematically 20 percent lower than in the scenario presented in March.

Significant uncertainties also apply to exchange rates, although it is less easy to be sure of the possible direction of exchange rate movements. For illustrative purposes, the staff has investigated the implications for the medium-term scenarios of a 20 percent drop in the exchange value of the U.S. dollar. Lastly, given the uncertainties that exist about the strength and sustainability of recovery in the industrial countries, the consequences were examined of a moderate recession in 1987-88, followed by recovery to no more than the trend rate of growth in 1989-90. This should not necessarily be taken to imply that there is a much stronger likelihood of growth falling short of the staff's projection than exceeding it. Realistically, however, a wide range of outcomes is possible and the issues raised by lower growth are likely to be more difficult and troublesome than those created by growth that is more rapid than expected. The implications of these various changes in underlying assumptions for short and medium-term economic prospects are discussed in some detail in a technical supplement to this paper. ^{1/} The broad conclusions, insofar as they affect the medium-term outlook for adjustment and growth in developing countries, may be briefly summarized here.

In analyzing the medium-term impact of a decline in oil prices, it is assumed that after an initial decline of 20 percent, the price of petroleum remains constant in U.S. dollar terms in 1986 and thereafter remains constant in real terms. Thus the price would be some 20 percent lower than in the staff's baseline assumption throughout the period to 1990. For the capital-importing developing countries as a group, the net impact of this assumed development would not be great, because the group contains both oil exporting and oil importing countries. For this reason, it is more significant to examine the impact on the groups of net oil importing and net oil exporting countries separately. For the net oil importers, assuming no change in the volume of external financing received, the major impact of the once-for-all change assumed in oil prices is an increase of about 1/4 of one percent in the average annual rate of growth of GDP during 1986-90, due to the greater foreign exchange available for non-oil imports. For the oil exporting countries within this group, the consequences of a decline in oil prices are considerably greater, and depend in part on

^{1/} EBS/85/201, Supplement 2, "World Economic Outlook--Technical Note on Sensitivity of Projections to Changes in Certain Key Assumptions."

whether the adverse effects on their balance of payments can be handled without an interruption in normal debt servicing. Assuming that transitional financing is available, the average reduction in growth for the fuel exporting countries (other than the major exporters in the Middle East) would be about 1 percentage point per annum.

The major effect of a dollar depreciation on the baseline scenario relates to the ratio between outstanding external debt and exports and the consequent effect on the debt service ratio. A change in currency relationships among industrial countries has relatively little direct effect on the growth of aggregate demand in the industrial world as a whole, nor would it be expected to have a major impact on developing countries' terms of trade. However, because a high percentage of external indebtedness is denominated in U.S. dollars, while a much smaller proportion of international trade is fixed in U.S. dollar terms, a depreciation of the U.S. dollar raises the U.S. dollar value of international trade by a greater amount than the U.S. dollar value of external debt. As a result, for the capital-importing developing countries as a whole, the debt-export ratio would fall to 104 percent in 1990 under the assumption of a 20 percent lower value of the U.S. dollar, instead of to 112 percent in the baseline scenario; the corresponding figures for the debt service ratio are 20 percent and 21 1/2 percent, respectively. The reduction in debt service relative to exports is also reflected in a somewhat lower current account/GDP ratio, 7 percent in 1990 (as against the baseline 8 percent).

A slowdown in economic activity in industrial countries would, not surprisingly, have major adverse implications for developing countries, even if the slowdown were not accompanied, as it well might be, by an intensification of protectionist pressures and a decline in the availability of both concessional and nonconcessional capital flows. Again for illustrative purposes, the staff has examined the consequences of a slowdown in industrial countries' growth to 1 1/2 percent per annum in 1987 and 1988 followed by a weak recovery to 3 percent growth in 1989-90. The slower growth of industrial country output would retard the growth of developing country exports, which would increase by less than 3 percent a year in 1987-88 against a growth of almost 6 percent in the baseline. Given the financial constraints facing developing countries, the latter could be expected to cut back the growth of their imports by more than half. This in turn would reduce the average growth of GDP in these countries from 4 3/4 percent to a little over 3 1/2 percent for 1987-88. Moreover, because of the lower levels of exports under this alternative assumption, the ratios of debt and debt service are higher by 1990 than under the baseline scenario: 118 percent and 22 1/2 percent, respectively, instead of 112 percent and 21 1/2 percent. Under this scenario, average per capita incomes in certain major groups of developing countries, such as the Western Hemisphere and African regions, would stagnate over the next few years, and would be no higher in 1988 than they had been a decade earlier. Such a trend would severely strain the social consensus needed for a maintenance of adjustment efforts in heavily indebted countries.

IV. Policy Considerations

The review of short- and medium-term prospects presented in Sections II and III above suggests that, despite the slowdown in activity in the first half of 1985, the overall outlook is not greatly changed from that envisaged in the March WEO. In general, therefore, the stance of policies that was recommended at that time remains appropriate in present circumstances. In the first part of this section, the main features of these policies, and the interactions among them, are recalled.

Nevertheless, it is undeniable that new uncertainties about the future course of the world economy have emerged in the past six months. While some of these imply the possibility of a more favorable outcome than was foreseen in March, the new uncertainties have also increased the "downside risks," or the likelihood of less favorable outcomes. Part 2 of this section reviews these uncertainties and risks.

Although the new uncertainties do not call for any change in basic policy stance, they do underline the need for dealing firmly with the imbalances that lie behind them. This is all the more important when international interactions are taken into account, since policy failures at one point in the system can adversely affect performance elsewhere, and may even lead to a cumulative deterioration in prospects. This is the theme of part 3 of this section. The section concludes with some brief observations about the role of the Fund in present circumstances.

1. Economic policies in the current situation

a. Industrial countries

The medium-term framework of policy that has been at the heart of the industrial countries' economic strategy for the past several years remains, in the staff's view, broadly appropriate. This strategy has had several notable successes. There has been a marked reduction in inflation, output growth has picked up, and employment has begun to recover. Investment has revived (particularly in the United States and the United Kingdom) and productivity has grown more strongly than during much of the 1970s and early 1980s. The strategy has not always been implemented as intended, however, and a number of serious economic imbalances remain. In the United States, the Federal fiscal deficit will be in excess of 5 percent of GNP in 1985, while the deficit in the current account of the balance of payments will be over 3 percent of GNP. Elsewhere, and especially in Japan, the growth of output continues to be heavily dependent on foreign demand; and in many industrial countries, including most of those in Europe, structural rigidities have impeded employment creation and slowed recovery.

Policy requirements in present circumstances flow naturally from the need to redress these imbalances. In the United States, there is now widespread agreement about the urgency of effective action to curb the Federal deficit. This deficit has major international as well as domestic implications. It is associated, in varying degrees, with the high level of international interest rates, the still-high exchange rate of the U.S. dollar, and the growing size of the U.S. current account deficit. While the fiscal deficit contributed to the initial strength of the recovery in the United States, and helped spread its benefits to other countries, it has had effects which are less desirable. Higher interest rates have retarded domestic demand growth in other industrial countries, while they have significantly increased the burden of debt service faced by heavily indebted countries. The appreciation of the U.S. dollar and associated trade developments have created uncertainties about the sustainability of the resultant patterns of exchange rates and current account balances that may have negatively influenced investment decisions, even in countries whose measured competitiveness has increased. In addition, the large U.S. foreign trade deficit has contributed to a disturbing increase in protectionist pressures from within the U.S. economy.

The U.S. Administration is firmly of the view that reduction of the fiscal deficit should be pursued through expenditure cuts, and in general the staff supports this emphasis. In a macroeconomic context, however, it needs to be recognized that reducing government expenditure and reducing government deficits, although complementary, are policies with somewhat different objectives. If insurmountable obstacles to reducing particular categories of expenditure are encountered, this cannot be regarded as a sufficient reason for abandoning or postponing attempts to bring the overall deficit back to more manageable levels. Recent moves to cut the deficit represent a welcome first step, but the process of restoring a sustainable fiscal position will require determined action over a number of years. Uncertainties about the medium-term evolution of fiscal policy could exert a potentially depressing effect on domestic investment in the United States, especially if they were accompanied by significant delays in implementing tax reform proposals.

In contrast to the difficulties that have been encountered in the implementation of fiscal policy, monetary policy in the United States has been more in accord with medium-term goals. As a result, market participants have come to have considerable confidence in the basic anti-inflationary thrust of policies. This has given the monetary authorities somewhat more room for maneuver in the short term implementation of policies. It is important to recognize, however, that this room for maneuver is not unlimited. Downward

pressure on interest rates that emerges spontaneously can be accommodated by judicious policy, and this has been skilfully achieved in the first half of 1985. However, for the authorities to attempt to create or sustain such pressures in circumstances when market sentiment became less favorable would carry considerable risks. Indeed, the sensitivity of expectations is such that an actively expansionary monetary policy would very likely be counterproductive to its intended goals. Market participants are aware that, in past cycles, monetary accommodation to sustain expansion has often contributed to a buildup of liquidity that has fueled inflationary pressures at a later date.

European countries have, by and large, exercised greater fiscal restraint than has the United States. Nevertheless, the process of fiscal consolidation has not always taken place as smoothly as could be hoped. In Italy and the United Kingdom, for example, there have been substantial, and largely unintended, swings in the thrust of fiscal policy, so that planned progress toward deficit reduction has encountered delays. In France, the budget target for the central government was exceeded in 1984, and may be exceeded again in 1985. Germany is the only major country in Europe where government expenditures have been brought sufficiently under control to permit significant tax cuts to be planned. As a result of these cuts, fiscal policy is expected to impart a slight expansionary impulse to the German economy in 1986--a thrust that seems broadly appropriate in light of the relatively moderate growth of domestic demand and the recent improvements that have taken place in the underlying fiscal position.

Monetary policy in European countries has until recently been constrained by the weakness of their currencies against the U.S. dollar. Interest rates have thus been kept higher than might have been considered desirable in a domestic perspective. With the recent easing of monetary conditions in the United States, European countries have acquired some limited freedom to choose between lower interest rates and exchange rate appreciation. The fact that exchange rates initially moved more than interest rates does not in itself mean that monetary policy was kept deliberately tight. Indeed, in Germany, France, and the United Kingdom, monetary aggregates were in the top half of, or above, their target ranges. In some cases, however, these target ranges may have been set on the low side. It would seem appropriate that, if interest rates continue to remain at lower levels in the United States, monetary policy in European countries should be such as to permit a significant decline there too.

In Japan, the key issue facing the authorities is not so much to stimulate the growth of GNP but to make it less dependent on foreign demand. The large foreign trade surplus is a problem both for Japan,

because of the danger that its access to foreign markets will be restricted, and for the world at large because of the pressures for protectionism it generates. The Japanese authorities have been very successful in stabilizing monetary growth and mastering inflation. At the same time the government has continued its program of fiscal consolidation that was made necessary by earlier rapid growth in public debt. By now, considerable progress in strengthening the underlying fiscal position has been achieved; in 1985 the general government fiscal deficit is expected to be 2 percent of GNP, lower than in any major country other than Germany and about two fifths the relative size of the deficit in 1978-80. However, the central government deficit, at over 5 percent of GDP, continues to be undesirably large, indicating that the Japanese authorities have some distance to go to achieve their structural fiscal objectives. Even so, the success achieved to date provides increased scope to pursue these objectives flexibly, taking account of the need to sustain Japan's contribution to aggregate demand growth in the world economy. In this, consideration could be given to changes in the structure of revenues and expenditures that might help foster the growth of domestic demand. A strengthening of domestic demand growth would of course have to be managed in such a way as to prevent the emergence of excess pressure of demand on resources. This becomes less of a problem the more successful policies are in reducing the contribution of net exports to the growth of total demand in Japan. In this connection, the staff believes it would be appropriate for the authorities to continue to frame monetary policy in the light of exchange rate considerations, and thus to encourage a substantial appreciation of the yen. Continued efforts are also needed to improve the effective access of foreign suppliers to Japanese markets.

In the smaller industrial countries, as in the larger ones, policy requirements have to be differentiated according to the situation of individual countries. However, fiscal retrenchment remains an important objective in many of them. Monetary policy is constrained by the formal or informal links that many of the smaller industrial currencies have with the currencies of larger countries, but should be conducted in a manner that is calculated to maintain confidence in continued progress toward better price stability.

Beyond these requirements for suitably differentiated financial policies, there is a continuing need to implement supply-side policies that enhance the structural functioning of industrial economies. This is particularly important for countries where structural rigidities, especially labor market rigidities, have impeded the restoration of satisfactory employment levels. The measures that are required have been discussed at length in earlier World Economic Outlook reports, and can therefore be summarized briefly here. They include: the

reduction of distortions created by the impact of government regulations on price determination in private markets; reform of wage-setting procedures that prevent the adjustment of real wages in line with changes in the marginal product of labor; the modification of minimum wages that limit incentives to hire unskilled workers or new entrants to the labor force; the reduction of subsidies or other mechanisms for preserving uneconomic industries; action by governments to enhance the ability of workers to move between industries and geographical locations; and firm resistance to protectionist pressures, which can only benefit one group of the population at the expense of others.

In present circumstances, it is appropriate to give special emphasis to this last point. Protectionism is not confined to the industrial countries; indeed many developing countries have even more restrictive trade systems, whose 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. Protectionist sentiments are exacerbated by weakness of economic activity and by imbalances in international trade. These trade imbalances give rise to shifts in employment and industrial structure that are perceived, generally erroneously, to be caused by "unfair" trade practices or inadequate "reciprocity" in trade. In dealing with protectionist sentiment, governments in industrial countries should not only resist demands for trade-distorting restrictions but also focus on actions that will help reduce the factors that give rise to such demands in the first place. Viewed in this light, effective action against protectionism involves effective action to deal with the whole range of economic and financial imbalances touched on above.

b. Developing countries

The staff's medium-term scenario continues to show that, on plausible assumptions, developing countries could bring about a decline of almost one third in their external debt ratios, while achieving domestic economic growth of 4 1/2-5 percent, over the period to 1990. The inevitable uncertainties in this scenario, however, leave no room for complacency, and underline the importance of an adjustment strategy geared to strengthening internal sources of growth in developing countries.

Over the past three years, developing countries have succeeded in reducing their combined current account deficit, relative to exports of goods and services, to a level that is financeable out of flows of grants, long-term official assistance, direct investment, and import-related commercial financing. Less has been achieved, however, in bringing about the internal adjustments that are needed if domestic

growth is to be accelerated without the external situation deteriorating dangerously and without impeding efforts to reach a better degree of price stability.

Given the external constraint faced by almost all developing countries, efforts to achieve higher growth on a sustainable basis need to have the twin focus of: raising the rate of growth of foreign exchange earnings; and increasing the growth of domestic output that can be achieved with a given level of foreign exchange earnings. Examples of the first type of policy include ensuring that the exchange rate is at a level that provides adequate incentives for the establishment and growth of export industries; adapting the tax structure to remove unintended fiscal impediments in export activities, and providing "start-up" assistance in developing foreign markets for nontraditional exports in which the country has a potential comparative advantage. Examples of the second include measures to raise the output of domestically consumed tradable goods--for instance, foodstuffs and import-substituting manufactures--through pricing reforms and a more efficient allocation of public investment expenditures. At the same time, policies to raise aggregate savings and investment, and to encourage greater efficiency in private investment, are fundamental to any long-term increase in the rate of economic growth.

Such an orientation of policies is often described as an "outward looking" strategy, since it gives the price mechanism a central role in determining the allocation of resources, and makes the exploitation of comparative advantage an important element in the development process. In countries with an "outward-oriented" policy stance, the centerpiece of strategy has usually been the maintenance of an appropriate exchange rate, together with a reduction of taxes and direct restrictions on international trade. Maintenance of adequate external competitiveness stimulates export growth, and thus permits over time a more rapid expansion of imports. The removal of price distortions facilitates the direction of resources to those export activities where the returns to the economy as a whole are greatest. Nonetheless, there are limits to the use of such a strategy: for instance, expansion of output of certain primary products (especially if undertaken by a group of producing countries simultaneously) could have negative revenue effects. Furthermore, export prospects for some types of manufactured and agricultural products may be limited by protectionist measures in importing countries.

Because of the importance of the government in the investment process in most developing countries, choices with regard to the share of total government expenditure channeled toward public investment, and the criteria by which public investment outlays are allocated among projects, are major determinants both of the level of aggregate investment and of its overall productivity. Nevertheless, efforts to raise

saving and investment rates through the mobilization and investment of funds by the state have at times been associated with inefficient investment choices induced by a set of prices that has become distorted through widespread price controls, high import duties, inappropriate exchange rates, and very low or negative real rates of interest. Cutting back on subsidies to inefficiently run public enterprises can encourage more realistic pricing and more cost effective operation, and can release scarce credit for financing more productive public investment, as well as capital formation in the private sector. The supply of credit for private investment can be further enhanced by an interest rate policy that promotes higher levels of domestic saving and encourages the channeling of savings through the financial system. Greater mobilization of savings through an efficiently functioning financial system can help increase the productivity of investment, which in many countries is even more fundamental to the success of the development effort than the level of investment.

In a number of developing countries, a particular impediment to domestic adjustment efforts is the persistence and, in some cases, the intensification of inflation. Out of 131 developing countries for which data are available, there were 32 countries with at least 20 percent inflation in 1984 and 22 with at least 30 percent. In the seven largest borrowing countries the weighted average inflation rate has increased in every year since 1978, and exceeded 100 percent in 1984. Little change is expected in this rate in 1985.

Views differ widely with regard to the rate of price increases at which anti-inflation policies need to become the primary focus of economic management. There are large international contrasts in this respect: rates of inflation considered high in some countries might be considered quite moderate in others. For these latter countries, it is sometimes argued that attempting to reduce inflation below a critical minimum level (that may differ among countries) will only aggravate unemployment and retard the growth of output, because of various structural rigidities and supply bottlenecks in the economy. In most member countries, however, once inflation rises beyond moderate rates, the need to achieve greater price stability is clearly perceived. Even where some of the distributional effects of inflation are mitigated through indexation and various contracting and accounting devices, substantial inflation, particularly when it is highly variable, tends to adversely affect domestic savings, investment, and growth. It does so by increasing general uncertainty, and thus the desired real return to saving and investment; by reducing the holding of financial assets; by distorting resource allocation toward assets yielding quick returns and to inflation hedges; and by diverting entrepreneurial resources from productive purposes into finding ways to cope with inflation.

A major issue arising in connection with anti-inflation policies in developing countries is how much reliance to place on financial policies (monetary and fiscal restraint) compared with other policy measures designed to increase the propensity to save, to reduce anticipated inflation, and to increase efficiency in use of resources (and hence factor productivity and exports).

There is, of course, no dispute that reducing the rate of growth of monetary aggregates is central to bringing down inflation. However, in countries with relatively undeveloped capital markets, monetary growth is strongly influenced by the state of the budget deficit. For most developing countries that have succeeded in dampening inflation in the past few years, the budget deficit has in fact been the keystone of the program, while most countries that have experienced a worsening of inflation have also allowed their budget deficits to rise in relation to GDP.

While financial restraint is an unavoidable part of an anti-inflationary strategy, it has to be recognized that if such policies give rise to sharp initial declines in output and employment, this will tend to weaken the political support for fighting inflation. For this reason, anti-inflationary financial policies usually need to be supported by structural measures that help improve the trade-off between price declines and output declines as the growth of nominal demand is cut back. In countries that have experienced several decades of high inflation, general indexation of prices, wages, interest rates, the exchange rate and taxes often become entrenched as a way of limiting the redistributive effects of inflation. Such indexation is typically backward-looking: this is notably the case for wage rates, which are adjusted at stated intervals in line with the inflation realized between adjustment dates in the past. If some degree of deindexation of wages is not carried out, real wages may tend to rise as inflation is lowered, thereby both hampering the disinflationary effort and tending to increase unemployment.

Some countries have also tried to attack inertial inflation by temporarily freezing prices and wages. Such an approach can be effective when used as a very short-term measure, and when the required monetary and fiscal policies are in place, so that it becomes obvious to workers and businesses that the authorities are taking steps to tackle the underlying causes of the inflation. Such a temporary freeze is not usually sufficient to change expectations in rapid inflations, unless accompanied by both currency reforms and fundamental changes in fiscal and credit policies.

In attempting to counteract inflationary pressures by increasing aggregate output, three types of supply-side policy measures have proved particularly useful. First, lower and more uniform import

tariffs can both lower domestic prices directly and, through easing supply constraints, contribute to improved supply and lower price increases in the medium-term. Second, the availability of imports can be increased and rationalized through liberalization of exchange control; this tends to encourage domestic production dependent on imported inputs and to reinforce the effects of any accompanying import tariff reductions. Third, improvement in the performance of public enterprises is often an important means of augmenting aggregate production and reducing budgetary deficits.

2. Uncertainties in the outlook

A number of developments in recent months have served to underline the uncertainties in the staff's projections in the present conjuncture. These uncertainties merit special attention because the balance of risks attached to alternative possible outcomes may not be symmetrical. Moreover, it may be appropriate to consider in advance the policy responses that would be required if economic conditions were different from those expected.

Questions of major concern to policy makers in present circumstances include the following: How serious is the risk that the economic slowdown of the first half of 1985 will prove more persistent than in the staff's projections? How would the projections be affected by a different evolution of the U.S. fiscal position from that assumed? How will interest rates in the United States be affected by budgetary actions, and how will these interest rate developments be reflected in exchange rate and interest rate developments more generally? Is a significant upsurge in protectionist measures a major danger, and what would be its consequences? How would the world economy be affected by a break in oil prices?

In what follows, a perspective is offered on the nature of some of these uncertainties and their interconnectedness. The issue of how policies should respond is dealt with in the next part of the paper.

a. Risks of a slowdown in industrial country growth

Assessment of this issue is not easy. On the one hand, certain factors making for lower growth are not likely to disappear. The stimulus imparted to the U.S. economy by an expansionary fiscal policy has run its course, while the indirect consequences of past stimulus (e.g., in continued high real interest rates) will limit the scope for future output increases. To the extent that fiscal policy in the major industrial countries, taken together, is likely to be more restrictive in 1986 than for some years, this could well have a dampening effect on demand growth. At the same time, structural

rigidities continue to hamper the growth of output and employment in a number of countries, while protectionist pressures and the difficulties of indebted developing countries also cloud economic prospects.

On the other hand, it can be argued that the slowdown in industrial countries in the first half of 1985 reflected a number of special factors, which are unlikely to persist with the same intensity in the second half of the year and in 1986. In the United States, a large part of the weakness in GNP is attributable to inventory adjustments, and to a deterioration in the trade balance. Final domestic demand increased at 4 3/4 percent (annual rate) during the first two quarters of 1985. Since inventories are not likely to continue to be such a negative factor as in the first half of 1985, and since the further deterioration in the trade balance will probably be smaller than in the recent past, a resumption of output growth seems likely. In continental Europe, output in the early part of the year was adversely affected by the severe winter and, partly as a result, inventories were also run down. Another unusual feature of early 1985 was a sharp increase in the intra-industrial country trade asymmetry, a statistical problem that may have depressed recorded output below actual. 1/

Looking ahead, the balance of forces acting on the world economy seems likely to sustain growth; inflation has been reduced considerably and is expected to remain subdued over the forecast period; monetary conditions have eased, especially in the United States; and the profit situation remains fairly satisfactory, providing a basis for continued increased investment. The staff is therefore inclined to view the disappointing performance of the world economy in the first half of 1985 as an interruption in a trend that is likely to be resumed, rather than as a sign of a more protracted slowdown. Nevertheless, it goes without saying that forthcoming indicators need to be monitored carefully for the light they can throw on this judgment.

b. The U.S. fiscal deficit

The agreement reached recently in the U.S. Congress provides some guidance concerning the future evolution of the fiscal stance in the

1/ The recorded deterioration in the combined overall trade balance of industrial countries in the first quarter of 1985 is considerably greater than the reported deterioration in their combined balance vis-a-vis developing countries. This suggests an over-recording of imports or an underrecording of exports, amounting to about 1/2 percent of industrial countries' combined GNP. The reasons for this are unclear, but could be associated with valuation asymmetries during a period of exceptional exchange rate volatility.

United States, but nevertheless leaves considerable uncertainties. The Congressional budget resolution would reduce the deficit (relative to the "current services" estimate) by \$56 billion in the 1986 fiscal year, \$90 billion in FY 1987, and \$132 billion in FY 1988. On this basis, and assuming output growth of 4 percent over the period 1986-88, the deficit would decline from around 5 1/2 percent of GDP in 1985 to less than 2 1/2 percent of GDP in 1988. However, most of the proposed cuts require additional legislation to take effect, and the prospects for passage of certain important measures are uncertain. Furthermore, if growth were to be lower than is anticipated by the Administration, as the staff is projecting, the deficit would be substantially larger. On the basis of slower growth and more limited deficit reduction measures--\$40 billion in FY 1986 and relatively modest additional cuts in FY 1987 and FY 1988--the staff estimates that the deficit would be about 4 3/4 percent of GDP in FY 1988.

The U.S. Administration's tax reform proposals also give rise to uncertainties. Such reforms are intended to be revenue-neutral in their impact, but this will depend upon the precise nature of the proposals that are eventually enacted into law. Even if the overall impact of the reform is neutral as far as total revenues are concerned, there could be implications for the level and structure of demand, depending on the incidence of the tax changes and the responses of economic agents.

c. Interest and exchange rates

The effect of budgetary actions on interest rates depends both on the extent to which such actions had already been discounted by market participants, and on the degree to which such actions are perceived to have consequences for other relevant variables, such as the stance of Federal Reserve policy. In present circumstances, however, budget cuts less than those expected by market opinion would be likely to bring about a rise in interest rates. If the Federal Reserve were to adopt a non-accommodative stance of monetary policy, such a rise would occur through a tightening in credit market conditions. If, instead, market opinion feared that monetary policy was likely to become more accommodative, it would come about through a revival of inflationary expectations.

Exchange rate behavior is notoriously difficult to predict, but it seems reasonable to assume that exchange rates are influenced, among other factors, by current and anticipated changes in interest rate differentials. These differentials, in turn, are affected by shifts in relative savings-investment balances among countries. The relative stance of fiscal policies is important in this connection, but does not have an unambiguous impact, nor is it the only factor of importance. A higher fiscal deficit can lead to either upward or downward pressure

on the exchange rate, depending on whether the direct effect on saving-investment balances (which would tend to push the exchange rate up in the short term) outweighs any indirect effect through a weakening of confidence in the sustainability of policy. Exchange rates will also be affected by the success of other policies in achieving satisfactory growth of output. If growth differentials among countries were to be significantly different from those envisaged by the staff, the real exchange rates of the faster-growing countries could well rise.

d. Oil prices

In the present state of the oil market, a decline in prices appears to be a significant possibility. Supply potential greatly exceeds demand at present prices, and many suppliers are in a difficult financial position. Thus far, a substantial decline in prices has been averted by the exercise of production restraint by major producers, particularly Saudi Arabia, and it cannot be ruled out that continued restraint would keep prices close to current levels. If a price decline were to occur, however, it is hard to estimate at what level prices might stabilize, given the supply and demand conditions that characterize the oil market. This in turn makes it difficult to assess the overall impact of an oil price drop, since large declines may have effects that are not simply a multiple of the effects of smaller declines. A relatively small decline in prices, that could be accommodated without causing major financial difficulties to producers, would have a number of beneficial effects. It would put downward pressure on inflation that, with unchanged financial policies, could help support real demand in oil importing countries. Lower inflation would tend to bring down nominal interest rates. Together, these effects would have positive consequences that would be larger than cutbacks in real incomes in oil exporting countries. The balance of advantage would be even more favorable if some of the decline in productivity growth associated with increases in energy prices could be recovered when prices fell.

It should be recognized, however, that a large fall in energy prices, within a relatively short period, might well have rather different consequences. It might tend to weaken the financial position of some energy exporting countries to such an extent as to call in question the manageability of their external positions. This in turn could put more widespread strains on the financing arrangements that underpin adjustment efforts in developing countries. Furthermore, a large fall might create more uncertainty about the future course of oil prices, which could tend to inhibit the growth of fixed investment.

e. Protectionism

Uncertainties concerning protectionism loom large in the current context, and are linked with uncertainties concerning growth and exchange rates. A weakening of output growth would increase the incentive for producers to seek protection from foreign competition, while the persistence of the current pattern of exchange rates and current accounts balances could provide a superficially plausible rationale for such requests. A significant move toward more protection would not only impose the economic costs involved in misallocation of resources, but also reduce global aggregate demand. There would be additional negative effects on output stemming from the fact that indebted countries adversely affected by market closures would have to adapt their adjustment programs by cutting imports. This potential chain of consequences underlines the importance of resistance to protectionism to avert a cumulative contraction of world trade and output.

f. Uncertainties and interactions

Each of these uncertainties is important not only in its own right, but also because of repercussions it might provoke. A slowing of growth in industrial countries, for example, would retard the growth of developing countries' exports, both directly and through the protectionist pressures it would encourage. A serious weakening of developing countries' external positions would in turn call in question the manageability of the international debt situation. Absence of agreement on substantial cuts in the U.S. budget deficit could well have major implications for interest rates and exchange rates, but the magnitude (and in some cases even the direction) of these effects are difficult to foretell. Whether, in such circumstances, a rise in U.S. interest rates would lead to a renewed rise in the exchange rate of the dollar, or to a further decline, is hard to determine on a priori grounds. Expectations and confidence factors play a major role in conditions in foreign exchange and credit markets, and for significant periods can swamp more direct effects on supply and demand.

It also must be recognized that uncertainties have different implications for different groups of countries. Developments may be favorable for some countries and unfavorable for others. This is particularly evident in the case of a decline in oil prices, but here too there can be secondary repercussions. Difficulties faced by oil countries can be communicated to other countries if they cause financial uncertainties that impede continued credit flows. It is therefore important to consider the incidence, as well as the overall magnitude of possible alternative developments.

3. Policy responses to uncertainty

The existence of uncertainties poses a number of issues for policy-makers, depending in part on the balance of risks involved. A first set of issues concerns whether any immediate policy changes are needed in the light of these uncertainties. For example, should increased concern about the possibility of a slowdown in industrial countries lead to offsetting policies, even though the forecasts do not envisage such a slowdown? A second set of issues concerns the question of whether contingency plans should be formulated against the possibility of unexpected adverse (or, for that matter, favorable) developments in the world economy. And a third set of issues concerns the consistency of policy responses across countries.

On the first issue, the staff does not believe that the existence of uncertainty justifies any immediate change in economic strategy. However, the increased risks that are perceived argue for firmer action to bring actual policies into line with the underlying strategy, and thus to reduce uncertainty. As has been noted above, policies in most member countries have been increasingly considered in the light of a medium-term strategy. This emphasis reflects a recognition of the fact that the lags with which policy changes affect economic conditions are uncertain. The medium-term approach is also based on the view that private markets will work more effectively, and will be better able to perform a stabilizing function, when the stance of official policy is not subject to sudden changes. While authorities must always retain a certain flexibility in the implementation of policies, present uncertainties argue for giving as clear a guidance as possible to private markets concerning the evolution of key economic variables in the medium term. In this connection, measures that would increase the confidence of market participants concerning the medium-term course of fiscal policy in the United States would be particularly helpful. It would also be desirable if several countries outside the United States were able to adhere more smoothly than in the past to their medium-term financial and structural objectives.

Concerning the second issue noted above, the need for contingency plans, it would be impracticable to prepare detailed policy responses to deal with all possible eventualities. Experience suggests that the circumstances surrounding actual developments can vary in ways that significantly affect the policy response that is called for. This does not mean, however, that policy responses should not be discussed in a general sense. Indeed, the third issue mentioned, the requirement of consistency in policy responses across countries, adds to the case for consideration of possible responses in advance. The fact that policies have implications for trading partners makes it highly important to ensure the mutual compatibility of policy actions. In what follows, possible responses to alternative developments in four key areas of uncertainty are briefly considered.

a. Growth in industrial countries

The recent weakness in economic activity in industrial countries naturally raises the question of how policies should respond if, contrary to the staff's forecasts, growth remains sluggish in the period ahead. As far as fiscal policy is concerned, a weakening of activity would lead to a widening of recorded deficits, as tax revenues fell short of projections. In the staff's view, such a widening of actual deficits should be accepted (provided, of course, that the thrust of fiscal policies is consistent with the pattern described in Section 1 above). This would constitute the working of "automatic stabilizers" which would limit the weakening of economic activity without increasing the underlying fiscal deficit. Additional discretionary fiscal action would, in general, have significant drawbacks. Discretionary (as opposed to automatic) fiscal changes would undermine confidence in stable financial policies and, given the already high level of deficits that have to be financed, might raise questions in the minds of market participants concerning whether debt could continue to be managed without recourse to inflationary finance.

As regards monetary policy, a weakening of activity with unchanged monetary growth rates would lead to an easing of monetary conditions and lower interest rates. Such a development should not be resisted, but there would be dangers, in a medium-term context, of trying to force the pace of monetary easing. The lags with which changes in monetary policy affect the real economy are in any event too uncertain for it to be used as an instrument of fine-tuning the economy.

It cannot, of course, be ruled out that growth might turn out to be higher than in the staff's forecast. If this were the case, an argument could be made for taking advantage of such a favorable development to make somewhat more rapid progress to medium-term fiscal objectives. This would apply also to structural objectives, since the removal of rigidities is likely to be easier in a situation of expanding output and employment. Stability of monetary growth targets would remain appropriate, even though more rapid growth would generate some upward pressure on interest rates. Keeping monetary policy on a steady course in such circumstances would reinforce the commitment to medium-term objectives, while not impeding progress toward a gradual further reduction in inflation.

b. Exchange market developments

As developments in the past year have shown, exchange rates can move by substantial amounts in a relatively short period, and this raises the question of whether and how monetary policies should adjust in the face of exchange market pressures. In this connection, it is

important that actions undertaken in different countries should be mutually consistent. If, for example, the authorities in a country with a depreciating currency were to respond by tightening monetary policy in order to counter inflationary pressures, while those in a country with an appreciating currency lowered monetary growth to validate the prospective decline in inflation, there would be a systematically deflationary impact on the world economy.

The risk of inconsistent policy responses arises from the fact that different countries have different objectives in the management of monetary policy, and from the uncertainties that exist concerning how, in particular circumstances, exchange rate movements affect other variables. On the one hand, an appreciation could be viewed as having an immediate deflationary impact on the foreign trade balance, which needed to be counteracted by an easing of monetary policy through higher monetary growth. On the other hand, the exchange market appreciation could be seen as causing, in itself, an easing of monetary conditions (since the initial downward pressure on prices would tend to increase the real money stock). On this view the authorities might, if they regarded monetary conditions as being initially appropriate, be tempted to tighten policy in order not to give an unintended stimulus to domestic demand. A similar dichotomy of view could arise in countries experiencing a depreciation of their currency.

Policy responses to exchange rate movements will also be affected by how desirable the movement is perceived to be. Undesired exchange rate movements can be resisted by a tightening of monetary policy in the country with a depreciating currency while easing policy in the appreciating currency. If an exchange rate movement is perceived as being in a desirable direction, however, monetary policy could be framed as to accommodate the exchange rate movement without affecting domestic monetary conditions.

c. Interest rates

The staff's projections involve relatively little change in real interest rates from the levels prevailing in mid-1985. (Some increase in short-term U.S. dollar rates is envisaged over the near term under the influence of a strengthening of economic activity, and a gradual decline is assumed from 1987 onward.) It is certainly possible, however, that the actual path of rates will be significantly higher or lower than that envisaged by the staff.

A lower path for real interest rates would generally improve the outlook for the world economy (except, of course, to the extent that it was caused by a weakness of final demand). Lower interest rates would encourage investment demand in the industrial countries, would

help strengthen fiscal positions, and would ease external debt service burdens in the developing world. In the short term, however, it would be important for policies not to overreact to any significant easing of rates on the assumption that it would be permanent. A more prudent course of action, both in industrial and developing countries, would be to make allowance for the possibility of a subsequent rise. For the industrial countries, this means maintaining broadly the same stance of monetary and fiscal policies. For developing countries, it means using a part of the savings from reduced interest payments to strengthen the external position, especially for those countries whose existing levels of debt impairs creditworthiness.

More difficult decisions would be created by a rise in rates to levels significantly above those projected. Higher rates would undermine the prospects for a sustained recovery of investment in the industrial countries, and would set back the adjustment efforts of developing countries. Nevertheless, a deliberate loosening of monetary policy, aimed at holding short-term interest rates down, would carry significant dangers. Given the sensitivity of market expectations, such a course of action might well be counterproductive to its intended effect, in anything other than the very short run. Even if interest rates were temporarily kept down, this would only be achieved by jeopardizing the credibility of medium-term policy objectives and introducing uncertainty about the future course of inflation. This uncertainty, in turn, would tend to undermine the basis of continued growth in real demand.

It follows that a rise in interest rates would call for policy actions to tackle the root cause of the higher rates (probably to be found in fears that budget deficits or incipient capital flows would be monetized), coupled with specific measures to alleviate strains that might develop in parts of the financial system. This might include ensuring 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.

d. Slippages in adjustment efforts

By and large, adjustment efforts by countries facing debt-servicing difficulties have been pursued with determination. However, slippages have occurred, due to a variety of causes, and it is possible that more serious slippages might occur in the future. In judging the appropriate policy response, it is essential to consider the nature and cause of any slippage that occurs. Where an unexpected shortfall in performance is attributable to external circumstances that are likely to be temporary, no major change in an adjustment program is called for. In such cases the international community should assist the country concerned in finding the needed liquidity to carry through a period of external stringency.

Slippages arising from developments that are not likely to be reversed pose a more serious threat. It is important to recognize that such slippages will not necessarily show up in a widening balance of payments deficit. Indeed, given the tight external constraints faced by many heavily indebted countries, they are more likely to be revealed in domestic financial imbalances--weakness in investment, accelerating inflation, a widening budget deficit, etc.

Where such developments occur it is important to deal with the basic causes of the problem, rather than focussing policy on suppressing external deficits and rationing scarce foreign exchange. Accelerating inflation requires, as discussed earlier, a combination of financial policies aimed at restraining the growth of nominal demand, coupled with structural policies that reduce inflationary expectations and limit the working of mechanisms that perpetuate inflation. Weakness of domestic savings and investment is a particularly serious early warning of future adjustment difficulties, since growth and adjustment are only sustainable on the basis of continued growth in capital formation. Incentives to productive investment can best be preserved when the aggregate price structure (including the price of foreign exchange and the price of capital) adequately reflect relative scarcities.

When countries are able to reformulate their adjustment programs to deal firmly with slippages in adjustment, there may be a need for additional financing during a transitional period. Absence of such financing could significantly increase the short-term loss of employment and output involved in reaching an equilibrium position. This, in turn, would tend to complicate the task of national authorities in mobilizing the necessary consensus for adjustment measures. 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 have 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.

4. Role of the Fund

The role of the Fund is particularly crucial when the global economic outlook is uncertain, and when there are significant risks of adverse developments. In these circumstances, the international community can help avoid inappropriate or inconsistent policies through effective use of surveillance mechanisms. In addition, the financial resources of the Fund can ease the difficult process of transition that many members face as they undertake needed adjustments in their economies.

The importance of surveillance is a reflection of the increasingly close and complex interactions that characterize economic policies and conditions among member countries. The degree of success countries have in achieving their economic objectives, and the mix of policies chosen to pursue these objectives, have major implications for the policy options and constraints facing other countries. There is a clear need to avoid inconsistent policies through the use of mechanisms for international consultation. The pursuit of mutually compatible policies does not, of course, involve detailed fine-tuning of policy in pursuit of short-term demand-management objectives. What is required is rather a common medium-term framework that includes stabilizing mechanisms that can come into play as actual developments diverge from their expected course.

The Fund's financial role (understood broadly to include both the use of the Fund's own resources, and its role as a catalyst for resources from other lenders) will remain crucial in the period ahead. The recent weakening in world economic activity--the first deceleration in growth since the beginning of the present recovery--has interrupted the strengthening that was taking place in the economies of indebted countries. This interruption does not invalidate the staff's earlier judgment that these countries can sustain a viable external position over the medium-term while restoring higher rates of growth domestically. However, it does reduce their room for maneuver. If a more protracted period of slowdown in industrial countries were to make policy modifications necessary, the Fund's role would become even more central, both in consulting with members about the policy measures that are required, and in providing financial support.

V. Issues for Discussion

The policy considerations reviewed in the preceding section raise a number of issues on which Directors may care to give their views. The following list, which is not intended to be exhaustive, is provided as a guide to Directors in structuring their interventions.

- Policies in industrial countries

The staff has argued that the medium-term framework of policies pursued over the past several years remains appropriate, despite the increase in uncertainties. Indeed, many of the uncertainties stem from failures to vigorously and consistently implement policies that are in line with the medium-term strategy. Suggestions were therefore made for modifications in the way in which policies are being implemented in several major countries (pp. 30-34 above). What are Director's views, both on the general question of the appropriateness of the overall strategy and on the particular assessments made by the staff for individual countries?

- Interactions of policies and conditions

Reference has been made at various points in the paper to the ways in which economic developments interact among member countries. These interrelationships include the complex interactions among: fiscal and monetary policies; interest rate developments; the pattern of exchange rates; current account developments; the evolution of the debt problem; and the growth of protectionist pressures. Directors may care to comment on this nexus of relationships, from the viewpoint of the countries they represent.

- Uncertainties

A key issue in present circumstances is how policies should take account of the increased level of uncertainties. The staff has argued that the appropriate response is increased firmness in the implementation of current policy intentions, coupled with a willingness to intensify surveillance consultations so as to avoid inconsistency in the response to unexpected developments. Would Directors endorse this overall view?

- Management of the debt crisis

The handling of the debt crisis continues to be broadly on course, although slippages have occurred in a number of adjustment programs. In present circumstances, the staff believes the required approach is for industrial countries to strengthen the sustainability of expansion, through action to lessen financial imbalances and reduce protectionism, and for developing countries to intensify domestic adjustment efforts, to enhance their capacity to take advantage of international economic developments. Do Directors agree with this assessment?

- Protectionism

While there is no disagreement about the need to combat protectionist pressures, Directors may care to comment on the relationship between these pressures and other manifestations of disequilibrium in the world economy. This kind of interaction points up the need for a multi-faceted approach to dealing with the protectionist threat.

Table 1. World Output, 1967-86 ^{1/}

(Changes, in percent)

	Average	From Preceding Year									
	1967-76 ^{2/}	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986
<u>World</u>	4.4	4.5	4.4	3.5	2.0	1.7	0.4	2.5	4.5	3.1	3.4
<u>Industrial countries</u>	3.7	4.0	4.0	3.5	1.3	1.7	-0.3	2.6	4.9	2.8	3.1
Canada	4.8	2.0	3.6	3.2	1.1	3.3	-4.4	3.3	5.0	4.0	2.4
United States	2.8	5.5	5.0	2.8	-0.3	2.5	-2.1	3.7	6.8	2.6	3.3
Japan	7.4	5.3	5.1	5.2	4.8	4.0	3.3	3.4	5.8	4.4	4.3
France	4.7	3.1	3.8	3.3	1.1	0.4	1.8	0.7	1.3	1.0	1.8
Germany, Fed. Rep. of	3.5	2.8	3.5	4.0	1.9	-0.2	-1.0	1.3	2.6	2.4	2.7
Italy	4.3	1.9	2.7	4.9	3.9	0.2	-0.5	-0.4	2.6	2.7	2.6
United Kingdom	2.5	2.7	3.0	2.3	-2.6	-1.4	2.1	3.0	2.7	3.2	2.2
Other industrial countries	4.2	1.7	2.0	3.2	2.1	0.6	0.3	1.8	3.1	2.6	2.5
Memorandum											
Seven major countries above	3.6	4.4	4.4	3.5	1.2	1.9	-0.4	2.8	5.2	2.8	3.2
European countries	3.9	2.5	2.9	3.4	1.6	-0.1	0.4	1.4	2.3	2.3	2.4
<u>Developing countries</u>	6.0	6.1	5.1	4.2	3.6	2.3	1.5	1.4	4.4	3.6	4.1
Median growth rate	5.2	5.5	5.6	4.9	3.7	3.2	1.5	1.5	2.9	3.0	3.3
<u>By region</u>											
Africa	4.8	4.4	1.2	2.8	4.5	1.7	0.2	-1.2	2.6	2.2	3.1
Asia	5.2	8.0	9.1	4.3	5.3	5.6	5.0	7.6	8.1	7.1	6.1
Europe	6.0	5.4	5.4	3.8	1.6	2.5	2.2	1.3	3.5	2.9	3.3
Middle East	9.0	7.0	1.7	2.3	-2.1	-1.8	-0.2	--	1.7	--	2.6
Western Hemisphere	5.9	5.3	4.1	6.1	5.3	1.0	-0.9	-3.2	3.1	2.5	3.3
<u>By analytical criteria</u>											
Fuel exporters	7.9	5.9	2.7	3.3	1.1	0.9	-0.4	-1.5	2.2	1.0	3.0
Non-fuel exporters	5.3	5.9	6.1	4.6	4.6	2.9	2.5	2.9	5.6	4.8	4.6
Market borrowers	6.2	5.7	4.6	5.9	4.7	2.3	0.3	-0.9	3.6	2.9	3.7
Official borrowers	3.5	5.8	3.8	2.1	2.9	3.3	1.9	2.3	3.2	3.5	4.0
<u>Other countries ^{3/}</u>	5.5	4.5	4.7	2.3	2.9	0.8	1.7	3.5	3.1	3.6	3.5

^{1/} Real GDP (or GNP) for industrial and developing countries and real net material product (NMP) for other countries. Composites for the country groups are averages of percentage changes for individual countries weighted by the average U.S. dollar value of their respective GDPs (GNPs or NMPs where applicable) over the preceding three years. Because of the uncertainty surrounding the valuation of the composite NMP of the other countries, they have been assigned--somewhat arbitrarily--a weight of 15 percent in the calculation of the growth of world output. For classification of countries in groups shown here, see the Introduction to "World Economic Outlook: Statistical Appendix" (EBS/85/50). Estimates do not include China for the period prior to 1978.

^{2/} Compound annual rates of change.

^{3/} The U.S.S.R. and other countries of Eastern Europe that are not members of the Fund. The forecasts for these countries have not been updated from those given in March.

Table 2. Inflation, 1967-86 ^{1/}

(In percent)

	Average 1967-76 ^{2/}	Change from Preceding Year									
		1977	1978	1979	1980	1981	1982	1983	1984	1985	1986
Industrial countries ^{3/}	6.7	7.5	7.6	7.9	9.1	8.7	7.2	4.8	4.1	3.9	3.7
Canada	6.9	7.4	6.7	10.3	11.4	10.6	10.4	5.3	2.8	3.4	4.1
United States	5.6	5.8	7.4	8.7	9.2	9.6	6.0	3.8	3.8	3.8	3.7
Japan	7.9	5.7	4.6	2.6	2.8	2.7	1.7	0.5	0.6	0.7	0.9
France	7.3	9.0	9.4	10.4	12.2	11.8	12.6	9.5	7.3	6.1	5.2
Germany, Fed. Rep. of	5.1	3.7	4.2	4.1	4.5	4.2	4.6	3.2	1.9	2.2	2.3
Italy	9.3	19.1	13.9	15.9	20.7	18.3	17.8	15.0	10.7	9.6	7.9
United Kingdom	9.9	13.9	11.1	14.4	19.9	11.7	7.2	4.2	4.6	4.9	4.2
Other industrial countries ^{3/}	8.0	9.8	9.6	7.7	9.2	9.3	9.8	7.1	6.5	5.5	5.2
Developing countries ^{4/}	13.7	24.6	18.7	21.5	26.9	25.7	24.2	32.0	36.4	39.0	28.2
Median inflation rates	7.7	11.3	9.8	11.5	14.3	13.3	10.9	9.9	10.0	10.0	8.0
<u>By region ^{4/}</u>											
Africa	8.5	18.8	16.9	16.7	16.6	21.3	13.4	18.7	19.8	20.6	24.2
Asia	9.3	7.8	4.0	8.0	13.1	10.6	6.2	6.6	7.1	8.1	6.0
Europe	9.1	15.1	19.8	25.9	37.9	24.1	23.7	23.2	28.1	27.3	18.8
Middle East	8.4	17.2	12.6	11.7	16.8	15.3	12.8	12.2	13.9	14.1	13.0
Western Hemisphere	24.5	49.9	41.9	46.5	53.7	58.2	64.6	98.6	117.0	133.0	82.4
<u>By analytical criteria ^{4/}</u>											
Fuel exporters	9.5	17.7	12.4	12.1	15.5	16.2	17.8	24.7	19.3	17.0	13.7
Non-fuel exporters	12.6	23.5	21.4	25.7	32.1	30.3	27.5	36.0	46.0	50.5	36.0
Market borrowers	18.7	32.6	28.2	31.8	36.1	38.3	37.8	54.1	64.1	68.6	46.1
Official borrowers	9.4	17.3	13.7	19.5	22.2	28.3	17.5	22.0	17.2	18.8	15.2

^{1/} As measured by changes in GNP deflators for industrial countries and changes in consumer prices for developing countries. For classification of countries in groups shown here, see the introduction to "World Economic Outlook: Statistical Appendix" (EBS/85/50).

^{2/} Compound annual rates of change.

^{3/} Averages of percentage changes in GNP deflators for individual countries weighted by the average U.S.dollar value of their respective GNPs over the preceding three years.

^{4/} Percentage changes of geometric averages of indices of consumer prices for individual countries weighted by the average U.S. dollar value of their respective GDPs over the preceding three years. Estimates exclude China prior to 1978.

Table 3. Summary Financial Indicators, 1977-86

(In percent)

	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986
<u>Major industrial countries</u>										
<u>Fiscal balances of central governments 1/</u>										
Seven major countries	-3.2	-3.4	-3.0	-3.5	-3.8	-4.7	-5.7	-5.2	-5.3	-5.1
Canada	-3.5	-4.6	-3.5	-3.5	-2.2	-5.3	-6.2	-7.0	-6.0	-4.8
United States	-2.7	-2.0	-1.2	-2.4	-2.5	-4.3	-5.8	-5.0	-5.3	-5.0
Japan	-5.1	-5.3	-6.2	-6.3	-6.0	-6.0	-5.8	-5.7	-5.4	-5.0
France	-1.0	-1.6	-1.5	-1.1	-2.6	-2.8	-3.3	-3.4	-3.2	-3.0
Germany, Fed. Rep. of	-2.2	-2.1	-1.8	-1.6	-2.1	-2.1	-2.0	-1.8	-1.5	-1.5
Italy	-9.0	-13.1	-10.8	-10.8	-12.8	-15.1	-16.4	-15.4	-16.6	-17.6
United Kingdom	-3.0	-4.9	-5.3	-4.7	-4.1	-2.8	-4.8	-3.2	-3.2	-3.2
<u>Fiscal impulses of central governments 2/</u>										
Seven major countries	--	0.5	-0.2	--	-0.2	--	0.9	0.2	0.1	-0.2
Canada	1.5	1.2	-0.5	-0.1	-1.1	0.8	0.7	1.4	-0.6	-1.1
United States	0.2	--	-0.8	0.4	--	0.4	1.7	0.5	0.4	-0.2
Japan	0.2	0.2	1.1	0.2	-0.4	-0.2	-0.4	0.5	-0.3	-0.3
France	-0.3	0.9	0.1	-0.8	1.1	--	0.1	-0.1	-0.4	-0.3
Germany, Fed. Rep. of	-0.4	0.2	0.1	-0.4	-0.7	-1.2	-0.1	0.3	-0.2	0.2
Italy	-0.8	3.8	-1.7	0.1	0.7	0.6	-0.1	-1.2	0.9	0.6
United Kingdom	-2.6	2.6	0.5	-2.4	-2.4	-1.6	2.2	-1.8	0.4	--
<u>Growth of monetary aggregates 3/</u>										
Narrow money										
Seven major countries	8.8	11.1	9.8	5.7	6.6	7.3	10.2	6.8	7.8	6.1
Canada	8.8	11.0	7.5	9.2	6.1	5.5	15.5	14.2	32.1	13.6
United States	7.6	8.2	7.7	6.3	7.1	6.6	11.2	6.9	7.5	6.0
Japan	7.0	10.1	10.7	2.6	3.3	5.8	3.6	2.8	3.0	3.0
France	7.9	11.3	13.8	6.8	12.2	13.9	9.9	7.0	5.2	5.2
Germany, Fed. Rep. of	8.3	13.4	7.5	2.4	1.1	3.6	10.3	3.3	4.1	4.8
Italy	20.3	23.6	22.3	15.9	11.2	11.6	15.3	11.7	10.0	10.0
United Kingdom	14.3	19.8	11.3	5.0	10.3	10.0	12.6	14.9	15.4	14.5
Broad money										
Seven major countries	12.2	11.0	10.7	9.5	9.9	9.6	10.5	7.5	7.9	7.0
Canada	14.3	11.1	15.7	18.9	15.1	9.4	5.7	4.4	8.7	7.7
United States	12.7	8.5	8.3	8.1	9.5	9.3	12.5	7.9	8.4	7.1
Japan	11.4	11.7	11.9	9.2	8.9	9.2	7.4	7.8	8.0	7.8
France	12.3	13.2	13.0	10.8	11.4	11.5	9.1	8.0	7.0	6.6
Germany, Fed. Rep. of	9.4	10.6	8.9	5.3	6.4	6.5	6.6	3.9	5.2	4.8
Italy	20.5	22.3	20.9	14.3	10.8	12.1	16.1	11.9	10.0	10.0
United Kingdom	8.0	15.3	13.3	16.7	15.9	11.0	10.8	9.1	11.6	9.7
<u>Interest rates 4/</u>										
Six-month Eurodollars	6.3	9.1	11.9	13.9	16.7	13.6	9.9	11.3	8.5	8.0
<u>Developing countries</u>										
<u>Fiscal balances of central governments 1/</u>										
Weighted average	-2.6	-3.4	-2.2	-1.5	-3.4	-4.8	-5.4	-4.3	-3.6	...
Median	-3.7	-3.8	-3.5	-4.6	-5.9	-6.6	-6.9	-5.3	-4.6	...
<u>Growth of monetary aggregates 5/</u>										
Weighted averages	31.9	29.0	34.0	36.1	36.0	34.7	37.5	48.0	40.0	...
Median	19.8	19.5	17.7	20.7	19.3	19.1	16.8	16.0	14.0	...

1/ In percent of GNP/GDP.

2/ For definition of fiscal impulses, see April 1985 *World Economic Outlook* report, pp. 108-110. It should be noted that estimates for the industrial and developing countries are not necessarily comparable, in part because of the exclusion of the "so-called monetary correction" from the estimates for some of the high inflation developing countries.

3/ For definitions of monetary aggregates, see "World Economic Outlook: Statistical Appendix" (EBS/85/50), Table 13, footnotes 1 and 3.

4/ London interbank offered rate on six-month U.S. dollar deposits.

5/ Money and quasi-money.

Table 4. Summary of World Trade Volumes and Prices, 1967-86 ^{1/}

(Changes, in percent)

	Average 1967-76 ^{2/}	1977	1978	1979	1980	From Preceding Year					
		1977	1978	1979	1980	1981	1982	1983	1984	1985	1986
<u>World trade ^{3/}</u>											
Volume	7.7	4.7	5.5	6.6	1.2	0.4	-2.5	2.4	8.5	4.0	4.6
Unit value (in U.S. dollar terms)	8.6	9.1	10.0	18.5	20.1	-1.0	-3.9	-4.6	-1.9	-2.1	4.9
(in SDR terms) ^{4/}	7.1	7.9	2.6	14.8	19.2	9.3	2.6	-1.5	2.3	0.2	2.5
<u>Volume of trade</u>											
<u>Exports</u>											
Industrial countries	7.9	5.0	5.8	7.1	3.7	3.4	-2.3	2.1	9.7	4.1	4.8
Developing countries	5.3	2.6	4.0	5.5	-4.4	-5.5	-8.0	2.7	8.4	1.4	4.9
Fuel exporters	4.3	1.3	-1.6	2.3	-13.7	-14.9	-16.4	-4.7	3.4	-5.4	3.1
Non-fuel exporters	6.4	3.9	9.4	8.9	8.9	6.8	0.9	8.9	12.0	5.9	6.0
<u>Imports</u>											
Industrial countries	7.5	4.2	4.9	8.5	-1.7	-2.5	-0.8	4.2	11.6	6.3	4.8
Developing countries	8.4	9.8	6.9	4.7	8.6	7.1	-3.8	-3.4	2.1	1.0	3.3
Fuel exporters	15.9	13.6	3.9	-4.8	13.3	20.1	-0.5	-12.7	-4.3	-7.3	0.1
Non-fuel exporters	6.0	7.8	8.6	9.5	6.6	1.5	-5.5	1.6	5.0	4.6	4.6
<u>Unit value of trade</u>											
(in SDR terms) ^{4/}											
<u>Exports</u>											
Industrial countries	6.2	6.9	5.6	11.9	12.5	6.0	3.0	-0.3	1.3	0.7	3.8
Developing countries	11.6	10.6	-3.9	25.3	37.7	15.6	2.2	-4.9	3.9	-1.9	0.9
Fuel exporters	19.3	8.4	-6.1	39.3	62.6	23.0	3.5	-8.6	3.4	-1.9	-1.9
Non-fuel exporters	6.4	13.0	-1.6	13.1	12.8	7.2	0.9	-1.7	4.3	-1.9	2.5
<u>Imports</u>											
Industrial countries	7.2	8.1	2.5	15.4	20.8	8.3	1.1	-2.4	1.8	--	2.8
Developing countries	6.7	6.7	3.3	13.3	17.4	12.4	3.2	-0.9	3.3	0.1	2.6
Fuel exporters	5.7	7.1	4.7	10.4	12.4	10.2	3.1	0.1	2.7	0.7	3.2
Non-fuel exporters	7.0	6.5	2.5	14.9	19.6	13.4	3.3	-1.5	3.5	--	2.4
<u>Terms of trade</u>											
Industrial countries	-0.9	-1.1	3.0	-3.1	-6.9	-2.1	1.8	2.2	-0.4	0.8	1.0
Developing countries	4.6	3.7	-6.9	10.5	17.3	2.8	-1.0	-4.0	0.7	-2.0	-1.7
Fuel exporters	12.9	1.2	-10.4	26.2	44.7	11.5	0.4	-8.7	0.7	-2.6	-5.0
Non-fuel exporters	-0.6	6.1	-4.0	-1.5	-5.7	-5.5	-2.3	-0.2	0.8	-1.8	--
<u>Memorandum</u>											
World trade prices (in U.S. dollar terms) for major commodity groups ^{5/}											
Manufactures	7.5	8.0	14.5	13.9	11.1	-6.0	-2.1	-4.3	-3.4	-2.0	6.0
Oil	21.7	9.6	0.4	45.9	63.5	9.9	-4.0	-12.2	-2.0	-4.0	-1.0
Non-oil primary commodities (market prices)	7.4	21.2	-4.1	16.3	8.3	-15.2	-12.4	7.8	2.5	-9.1	4.0

^{1/} For classification of countries in groups shown here, see the introduction to "World Economic Outlook: Statistical Appendix" (EBS/85/50). Excludes data for China prior to 1978.

^{2/} Compound annual rates of change.

^{3/} Averages based on data for the two groups of countries shown separately below and on partly estimated data for other countries (mainly the U.S.S.R. and other nonmember countries of Eastern Europe and, for years prior to 1978, China).

^{4/} For years prior to 1970, an imputed value of US\$1.00 has been assigned to the SDR.

^{5/} As represented, respectively, by (1) the United Nations export unit value index for the manufactures of the developed countries; (2) the oil export unit values of the oil exporting countries; and (3) the IFS index of market quotations for non-oil primary commodities.

Table 5. Summary of Payments Balances on Current Account, 1977-86 ^{1/}

(In billions of U.S. dollars)

	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986
<u>Industrial countries</u>	-2.4	31.9	-5.7	-38.8	3.2	2.5	2.8	-35.1	-53.6	-46.9
Canada	-4.1	-4.0	-4.2	-1.2	-5.4	1.9	1.3	2.2	0.8	-0.6
United States	-11.7	-12.3	2.6	6.6	10.8	-2.6	-34.5	-93.0	-123.2	-141.1
Japan	11.3	17.0	-7.9	-9.5	6.2	8.1	22.2	36.4	44.8	59.9
France	1.0	8.5	6.9	-2.5	-2.8	-9.5	-2.3	1.9	2.3	4.2
Germany, Fed. Rep. of	8.5	13.4	--	-8.3	1.1	10.1	10.0	13.2	19.1	24.8
Italy	3.1	7.9	6.4	-9.5	-7.5	-4.9	1.0	-2.8	-6.4	-7.6
United Kingdom	2.0	5.5	3.3	12.3	17.5	11.9	6.9	2.9	5.3	4.9
Other industrial countries	-12.5	-4.0	-12.8	-26.7	-16.7	-12.6	-1.8	4.0	3.7	8.5
<u>Developing countries</u>	-0.2	-35.8	1.0	22.8	-55.9	-99.9	-68.5	-42.1	-49.4	-48.4
<u>By region</u>										
Africa	-10.4	-15.4	-6.6	-5.3	-25.3	-25.1	-15.7	-11.6	-7.8	-7.7
Asia	-1.0	-8.9	-15.2	-21.9	-23.5	-20.2	-16.4	-7.9	-15.0	-14.6
Europe	-9.0	-7.1	-9.9	-12.3	-10.1	-6.7	-5.1	-2.7	-2.1	-2.1
Middle East	31.7	14.9	54.5	92.5	46.4	-5.7	-19.6	-14.9	-16.5	-16.0
Western Hemisphere	-11.6	-19.4	-21.7	-30.3	-43.5	-42.2	-11.6	-5.0	-8.1	-8.0
<u>By analytical criteria</u>										
Fuel exporters	24.9	-0.2	54.6	100.1	34.9	-23.2	-13.8	-3.2	-7.8	-9.1
Other developing countries	-25.1	-35.6	-53.6	-77.3	-90.8	-76.7	-54.7	-38.9	-41.6	-39.2
Market borrowers	-19.5	-32.8	-30.3	-36.5	-72.7	-74.7	-29.4	-7.2	-4.1	-3.5
Official borrowers	-8.4	-11.0	-12.1	-16.0	-19.0	-17.6	-15.7	-16.3	-16.9	-16.6
<u>Other countries ^{2/}</u>	-6.9	-3.5	-2.1	-3.0	-2.8	2.6	4.9	6.7	6.3	6.7
<u>Total ^{3/}</u>	-9.6	-7.4	-6.8	-19.0	-55.4	-94.8	-60.8	-70.6	-96.7	-88.6
Memorandum										
Total, by selected categories										
Trade balance	16.2	15.9	21.1	28.1	18.8	-2.1	11.4	22.7	-5.8	4.8
Timing asymmetry ^{4/}	5.6	13.9	23.0	7.9	-1.3	-11.8	2.0	-1.0	5.0	13.0
Residual asymmetry	10.6	2.0	-1.9	20.2	20.1	9.7	9.4	23.7	-10.8	-8.2
Services and private transfers	-25.7	-23.3	-27.9	-47.1	-74.2	-92.6	-72.2	-93.3	-90.9	-93.4
(in percent of service payments)	-7.0	-5.2	-4.9	-6.6	-9.2	-11.5	-9.7	-12.0	-11.5	-11.0

^{1/} On goods, services, and private transfers. For classification of countries in groups shown here, see the introduction to "World Economic Outlook: Statistical Appendix" (EBS/85/50).

^{2/} Covers estimated balances on current transactions only in convertible currencies of the U.S.S.R. and other nonmember countries of Eastern Europe. The forecasts for these countries have not been updated from those given in March.

^{3/} Reflects errors, omissions, and asymmetries in reported balance of payments statistics on current account, plus balance of listed groups with countries not included.

^{4/} Staff estimates of the difference between the beginning-of-year and end-of-year "float," that is, the value of those exports that have not yet been recorded as imports (usually because the goods are in transit or because of delays in the processing of the documentation). The estimates should be viewed only as rough orders of magnitude.

Table 6. Capital-Importing Developing Countries: Current Account Financing, 1977-86 ^{1/}

(In billions of U.S. dollars)

	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986
Current account deficit ^{2/}	37.0	56.4	60.7	76.8	112.5	103.5	60.1	37.9	43.6	42.7
Non-debt-creating flows	14.8	17.5	24.3	23.5	27.7	26.0	23.3	24.3	28.8	28.7
Official transfers	8.3	8.2	11.4	12.3	13.5	13.1	13.5	13.9	17.8	16.5
Direct investment flows, net	5.9	7.8	10.0	8.8	13.9	12.9	9.5	10.4	10.6	11.7
SDR allocations, valuation adjustments, and gold monetization	0.7	1.5	2.8	2.4	0.3	0.1	0.3	--	0.4	0.4
Use of reserves	-10.8	-13.6	-21.5	-18.8	2.5	17.5	-8.5	-18.2	-4.4	-7.5
Asset transactions, net ^{3/}	-6.3	-3.3	-5.2	-5.8	-15.5	-10.1	-5.3	-7.8	-8.4	-9.1
Recorded errors and omissions ^{4/}	-6.5	-5.7	-4.3	-16.3	-18.5	-26.5	-13.4	-8.2	--	--
Net external borrowing	45.7	61.4	67.4	94.3	116.3	96.6	64.0	47.8	27.6	30.7
Reserve-related liabilities	3.5	1.6	-0.8	4.2	8.9	19.3	16.1	6.6	-8.0	-0.6
Liabilities, constituting foreign authorities' reserves ^{5/}	2.0	1.4	-1.3	2.0	0.9	1.7	-2.3	-0.6	1.1	2.3
Use of Fund credit ^{6/}	-0.1	-0.3	0.2	1.4	6.0	6.8	10.6	4.6	1.0	-3.7
Arrears	1.6	0.5	0.4	0.8	2.0	10.8	7.8	2.6	-10.1	0.8
Long-term borrowing from official creditors, net ^{7/}	13.5	16.4	18.3	24.4	28.0	26.5	28.4	25.6	22.3	21.8
Other net external borrowing ^{8/}	28.8	43.4	49.9	65.7	79.4	50.8	19.4	15.6	13.3	9.4
Long-term	14.4	33.9	40.7	37.8	58.2	38.1	37.9	17.4	42.1	10.4
From banks ^{9/}	7.5	26.6	28.6	22.3	31.1	24.3	35.7	19.0	42.8	11.4
Other	6.9	7.3	12.1	15.5	27.0	13.8	2.1	-1.6	-0.6	-1.1
Short-term	14.4	9.5	9.2	27.9	21.3	12.7	-18.4	-1.8	-28.8	-0.9

Note: Except where otherwise footnoted, estimates shown here are based on national balance of payments statistics, which are not always easily reconcilable with year-to-year changes in either debtor- or creditor-reported debt statistics, mainly because the balance of payments statistics include valuation adjustments as well as changes in liabilities.

^{1/} Excluding the eight major oil exporters of the Middle East. For classification of countries in groups shown here, see the introduction to "World Economic Outlook: Statistical Appendix" (EBS/85/50).

^{2/} Net total of balances on goods, services, and private transfers, as defined in the Fund's Balance of Payments Statistics (with sign reversed).

^{3/} Pertains primarily to export credit.

^{4/} Positioned here on the presumption that estimates reflect primarily unrecorded capital outflows.

^{5/} Comprises short-term borrowing by monetary authorities from other monetary authorities.

^{6/} Projected use of Fund credit does not take into account prospective programs.

^{7/} Estimates, based on debt statistics reported in Appendix Tables 45 and 46, of net disbursements by official creditors (other than monetary institutions).

^{8/} Residually calculated. Except for minor discrepancies in coverage, amounts shown reflect almost exclusively net external borrowing from private creditors.

^{9/} Refers only to long-term lending by banks guaranteed by government of debtor country. Bank lending also accounts for large fractions of unguaranteed long-term flows (included in "other" long-term flows) and short-term flows.

Table 7. Capital-Importing Developing Countries: External Debt and Debt Service, 1977-86 ^{1/}

(In percent of exports of goods and services, except where otherwise noted)

	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986
<u>External Debt</u>										
Capital-importing countries	127.1	132.8	120.4	110.4	123.1	147.7	158.2	150.7	155.5	147.8
(in billions of U.S. dollars)	333.5	399.5	475.0	566.8	662.4	749.1	796.9	829.5	865.1	895.7
Africa	112.2	123.7	106.0	87.4	112.2	147.1	165.0	169.5	175.6	166.1
Asia	87.7	81.6	74.4	71.2	74.3	87.0	92.4	86.0	90.0	88.0
Europe	120.0	128.1	119.9	119.5	115.9	123.2	130.0	126.5	129.0	120.4
Non-oil Middle East	163.7	167.1	154.4	122.8	128.2	143.2	164.2	162.8	177.7	173.9
Western Hemisphere	192.6	215.7	196.8	181.8	207.7	264.7	288.0	271.5	282.2	268.1
Market borrowers	119.8	126.1	112.4	103.1	118.6	147.0	156.4	146.9	149.1	139.6
Official borrowers	148.1	162.1	151.9	155.6	179.6	216.4	241.3	258.6	281.2	280.8
Countries with recent debt-servicing problems	172.2	196.2	179.4	166.5	192.9	242.7	265.4	252.4	257.4	242.1
Countries without debt-servicing problems	95.7	92.2	82.4	73.6	78.3	91.4	97.9	94.0	99.2	96.4
<u>Debt service payments</u>										
Capital-importing countries	15.0	18.5	18.8	17.1	20.6	24.1	22.0	23.4	25.3	23.0
(in billions of U.S. dollars)	39.4	55.7	74.1	87.8	110.7	122.4	111.0	128.6	140.8	139.5
Africa	11.0	14.0	14.0	13.3	15.1	19.4	22.9	26.3	32.2	29.3
Asia	8.1	10.1	8.8	8.2	9.7	11.4	10.7	11.7	12.8	12.1
Europe	14.6	16.3	18.2	18.3	20.9	22.2	24.5	26.9	28.6	24.5
Non-oil Middle East	17.5	17.4	18.8	17.9	21.5	22.4	23.6	25.4	27.5	26.0
Western Hemisphere	28.2	37.1	38.8	33.0	40.6	50.4	40.7	41.6	44.0	40.3
Market borrowers	15.9	20.5	20.8	18.2	22.1	26.7	23.7	24.9	26.5	23.6
Official borrowers	12.5	13.0	12.2	13.5	14.8	15.6	17.7	21.7	25.6	26.5
Countries with recent debt-servicing problems	22.0	28.8	30.0	26.5	33.2	40.8	36.1	37.6	41.1	37.5
Countries without debt-servicing problems	10.2	11.9	11.5	10.9	12.4	14.3	14.1	15.4	16.6	15.1

^{1/} Excluding the eight major oil exporters in the Middle East. For classification of countries in groups shown here, see the introduction to "World Economic Outlook: Statistical Appendix" (EBS/85/50). Debt export ratios show the ratio of total debt at the end of a year to exports of goods and services in that year. Debt service payments and ratios refer to all interest payments plus amortization payments on long-term debt.