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PART B

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PART B

Chancellor's (Lawson) Papers:

COMMUNIQUE AND SPEECHES AT THE INTERNATIONAL MONETARY FUND MEETING SEPTEMBER 1987

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PART B

pup

Chancellor

cc: Sir G. Littler
Mr Caines
Mr. Lankester
Mr. Culpin
Mr. Walsh

CONABLE ON GROWTH

In his opening address today, Conable said, in the context of middle-income debtors, "An annual growth rate of at least 2 per cent per capita should be the objective we all agree to support as a key element of every adjustment program". This line, which has not been endorsed by the (as yet unreformed) Bank Board nor agreed with the IMF, might come up at your press conference tomorrow.

Line to Take

2. Growth with adjustment remains the aim. Positive income per capita growth is a natural aspiration for all countries, indebted or not.

3. Role of governments and IFIs is to create conditions for growth. Impossible to be confident of achieving specific growth targets.

4. In particular, not prudent for World Bank to encourage aspirations which it cannot, on its own, deliver.

5. Economic policies in developing countries are key to sustainable growth.

HPE

H P EVANS
29 September, 1987

Press Release No. 2

September 29, 1987

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Tuesday, September 29, 1987

Address by Barber B. Conable
to the Board of Governors of the World Bank
and International Finance Corporation

Introduction

Mr. Chairman, Governors, ladies and gentlemen. Welcome to this annual meeting. It is an honor to share the platform with Michel Camdessus. In the short time we have worked together, I have learned to respect his judgment, candor and commitment to the great tasks our institutions jointly face. The Fund and Bank have a long history of collaboration on which to build. I am confident our productive relationship will intensify in the years ahead.

My purpose today is to outline the Bank's strategy for steady advance toward restored global economic growth, for steady progress in the fight against poverty. I offer neither instant nor easy remedies for today's grave problems. There are no such shortcuts. These twin objectives demand concerted, patient and imaginative international action, strengthening and building upon the unique relationship of cooperation and trust between the Bank and our borrowers.

Drawing on the lessons and capitalizing on the successes of the past, a renewed World Bank is ready with an agenda for the future, a realistic vision of the pressing challenges to development and of the rewards that increased and determined effort can win.

The Bank's reorganization is now completed. This change in structure was long overdue, but no undertaking of this magnitude could be accomplished without some pain. And so on this occasion I want to pay special tribute to Bank staff for the extraordinary dedication and professionalism they have shown during the difficulties of recent months. The staff has long been an outstanding collection of well motivated and highly skilled individuals. Looking ahead, I am confident that we have greatly improved our institutional ability to provide sensitive, effective and timely support to each of our borrowers and to offer intellectual leadership in the understanding of development.

The Present Situation

As we discuss the Bank's role in the future, let us look first at our present situation.

I am fundamentally an optimist, but I recognize that we meet in threatening times. I need not catalogue all the ups and downs of the world economy for this group; a few illustrations will suffice.

Prospects for continued stable growth of the leading industrial nations and hence of the world economy are uncertain. Despite some progress, for many countries the problem of debt has not abated. Several major debtors, in fact, have faltered in their efforts to resume non-inflationary growth and consequently to bear the burden of their indebtedness.

Although there have been encouraging efforts at adjustment in many countries, much of sub-Saharan Africa continues to suffer from acute economic crisis as well as from major long-term development problems. Severe environmental problems exacerbate the difficulties of the region.

Even in Asia, where most countries have continued to manage their economies to minimize the impact of the world's economic troubles, poverty remains widespread. Some countries are suffering from climatic disasters; others from a difficult period of political and economic transition.

As the world's principal development agency, the Bank must confront these harsh, diverse realities. We must ask where we can do more. We need to help member governments design and implement better programs that will contribute more strongly to the resumption of growth and development. And we must look beyond the immediate crises to our long-term, long-standing development mission.

To wait for better times is to delay their coming. To default on the obligations of leadership is to raise the cost -- in social upheaval as well as economic loss -- of remedial action. Thus, the IMF and the World Bank, our members and the leaders of the international financial community must act with resolve and a clear sense of direction.

Commitment For The Future

This is my commitment to you today -- that the World Bank is ready to play a reinvigorated role in the fundamental tasks of development: to promote economic growth and to combat poverty.

To do so, we will give strong and reliable support to the adjustment efforts of our member countries. We will work to preserve and extend the open global financial and trading system which is fundamental to growth. And we will vigorously promote the market-oriented policies and reforms which will best mobilize vital private capital flows and harness the creative energies of millions of people for efficient growth.

Restoring and strengthening growth is essential for achieving our greatest goal -- to reduce the poverty, misery and destitution which blights our world. But growth, by itself, is not enough.

The Bank will increase lending aimed directly at improving the access of the poor to better food, shelter, health care and schooling. We shall strive to protect the poor during periods of adjustment. We will support policy and institutional changes to ensure that public programs more efficiently direct their benefits to poor people. In these vital social investments we shall work more closely with the private sector and non-governmental organizations in order to multiply their effectiveness at the grassroots level.

Poverty is a major cause of environmental degradation, and so Bank-supported programs that help reduce poverty by improving incomes, introducing new skills and fostering family planning, are also effective means of environmental protection.

We will devote more of our staff resources and financial strength to helping borrowers safeguard and improve the environment -- by supporting better environmental policies and standards and by specific environmental investments.

We will emphasize the importance of protecting renewable resources to reduce their pollution and waste. Only by defending nature can we ensure the survival of man.

For the heavily indebted middle-income countries, our objectives are a return to steady, non-inflationary growth, and for many of them a return to full creditworthiness in the international capital markets within the next five to seven years.

In sub-Saharan Africa, our goals are to help meet the current crisis by organizing major programs in the severely debt-distressed countries, to see the productive capacity of African economies rebuilt, and to help ensure that the welfare and food security of Africa's millions of poor people are protected in the process of adjustment and recovery.

In Asia, we will help combat poverty directly in countries with the world's largest numbers of very poor people, and assist the efficient integration of this rapidly growing region into the world economy.

Shared Responsibilities - Need for a Collective Effort

I intend to spell out what the Bank will do -- with your support and guidance -- to help ensure that these objectives are met. But I cannot stress enough the simple fact that all members of the international community -- industrialized and developing members alike -- must make a major effort if growth and development are to be assured.

Developing countries need to sustain demanding reforms in order to make their development strategies effective. Despite the many difficulties imposed by the global environment and by domestic social and political conditions, there is no alternative to adjustment and the correction of past policy mistakes. Adjustment efforts that are half-hearted, too slowly implemented, or allowed to unravel will postpone -- perhaps indefinitely -- the resumption of growth and improvement of living standards.

But structural adjustment is not just a prescription for developing countries. The major industrial countries must address their own trade, monetary and fiscal problems so that they can resume a more adequate rate of growth. Their present slow growth severely constrains the capacity of developing countries to recover and grow, which in turn harms all nations in this interdependent global economy. Continued large trade and fiscal imbalances, and the exchange rate instability and protectionist pressures to which they give rise, hold the growth of the world economy well below desirable levels.

Commercial lenders, too, need to match the realism they have shown in provisioning against loan losses with realism about their longer-term stake in world trade, investment and economic growth. Major commercial lenders and investors, as well as the now enormous private capital markets, will have an essential role in any resolution of the debt crisis. Any debt strategy cannot succeed without their active participation, and success in overcoming the debt crisis is central to their own future strength and growth.

Increases are needed in all resource flows to support developing countries' adjustment and growth. There is a serious gap between what is needed for development and what most donors and creditors are doing.

The Bank in particular needs a stronger resource base if we are to play an enhanced role. Only our shareholders can make this a reality -- by completing the IDA-8 replenishment for the low-income countries, by making the Multilateral Investment Guarantee Agency a fully operational source of stimulation to private sector investment and, above all, by providing a substantial general capital increase for the World Bank.

I believe that Governors gathered here will agree that the alternative to this collective effort -- stultified growth, intractable debt burdens, and growing poverty for millions of additional people -- is simply unacceptable. It is unacceptable from a moral and ethical standpoint. But it is also unacceptable from the standpoint of simple self-interest. It is surely in all our interests that the developing economies prosper and grow.

Let me now turn more specifically to the role of the World Bank in three sets of countries -- the heavily indebted middle-income group, sub-Saharan Africa, and Asia.

The Bank's Role in Heavily Indebted Middle-Income Countries

The heavily indebted middle-income countries face a basic problem: how to resume growth and development while dealing with the burden of debt. They need to adopt and implement far reaching adjustment programs; they need to expand their income from trade; they need adequate supplies of net new capital from both public and private sources; and they require adjustment by the industrial countries to facilitate their return to creditworthiness.

The Bank has a central responsibility in assisting heavily indebted countries to grow out of debt and recession. We have expanded our lending to meet that responsibility. We plan to maintain our commitments, and we will play an active part in the further development of strategies to resolve the debt problem -- both at the international level and in our work with individual member countries.

A number of heavily indebted countries have been making strenuous efforts to resume growth by means of far-reaching adjustment programs. These often provide an improved policy framework for vigorous private-sector development, a more liberal environment for export growth, and public-sector management that combines greater fiscal discipline with a much sharper focus on those areas where .

public resources can and must play a central role -- for example, basic infrastructure and the provision of educational and other social services.

Experience with adjustment programs has been diverse. Much progress has been made. Indeed, in a number of countries the resumption of sustained growth seems underway.

In many other countries, however, adjustment efforts have been inadequate. In part the reason for this is that these programs have come under severe internal political and social pressures because the process was slower than anticipated. In part it is because of domestic policy mistakes -- for example, stimulating consumption to unsustainable levels, with resultant inflation.

The problems of these countries have also been greatly complicated by the global environment. Deteriorating terms of trade have reduced the value of primary commodity exports. Sluggish world markets and rising protectionism have slowed the growth rate of manufactured exports, even though a few countries have achieved some notable successes. Interest rates have remained high by historical standards and have again begun to turn upwards. Net new financial resources from abroad have often been inadequate and what funds have been available have frequently taken too long to arrange.

As a consequence, the burden of debt has risen, not declined, since the onset of the debt crisis five years ago. This has happened despite large debt service payments (amounting, in the case of Latin American debtor countries, to $130 billion since 1982, or four percent of their collective GDP). There have been major setbacks to development in many of these countries in the 1980s. While they almost doubled their per capita incomes between 1965 and 1980, incomes have fallen by about 20 percent in this decade. The consequence has been an alarming growth in absolute poverty, worsening unemployment and deteriorating social welfare.

There is no quick solution for these linked debt and development problems, but we must learn from experience and strengthen our programs. There have been a number of stages in the evolution of the crisis since 1982, and I believe we are approaching yet another turning point in the implementation of the debt strategy. The adjustment process and the resumption of sustained growth are proving more difficult than we had hoped. Greater political participation in many heavily indebted countries makes both growth and the choice of appropriate development strategies all the more important.

At the same time, it is becoming increasingly difficult for heavily indebted countries to obtain timely new financing. Following the onset of the debt crisis, commercial banks rescheduled substantial amounts of debt, made net new commitments of funds, and provided major financing to countries that had not rescheduled. But in recent years they have drawn back, and the prolonged nature of the problem is making it more difficult to arrange concerted lending packages with hundreds of partner banks. The recent provisioning decisions of large banks in the United States and elsewhere may limit still further the availability of new lending. Financing from some official sources has also dropped markedly from levels earlier in the decade.

In a period of dramatically increased global reach and financial sophistication of capital markets, the total flow of financial resources to the heavily indebted middle-income countries has been dwindling, and the need to tap market sources other than the commercial banks is growing more urgent. A determined partnership is needed between debtors, creditors and investors to devise fresh ways to harness market resources to development needs.

Resolution of debt problems is crucial if our common development objectives are to be achieved. It is also crucial to the healthy growth of the industrial countries. Economic decline in the highly indebted countries has caused a drop of over $100 billion in imports between 1980 and 1985 -- and thus meant foregone exports, jobs and profits for the industrial world.

It is urgent that non-inflationary growth be resumed in the heavily indebted middle-income countries. An annual growth rate of at least 2 percent per capita should be the objective we all agree to support as a key element of every adjustment program. Our common goal should be to restore the major debtor countries to full creditworthiness within five to seven years.

The World Bank is already an active partner of many heavily indebted countries, and we expect to play an even more vigorous role in the future. The restoration of sustained growth and creditworthiness will be major objectives of our programs for these countries. More of our financial resources and best staff skills will be devoted to help design and implement adjustment programs. Where countries are prepared to sustain adequate reforms, the Bank will support their programs with substantial new lending.

And in partnership with the Fund, we will play an active role in helping to assemble debt restructuring and financing packages, including the development of a broader range of instruments to facilitate the reduction of debt and to supplement direct new lending.

I believe we should look closely at innovative market-based approaches to the resolution of debt problems. Such techniques will only succeed if they are accepted voluntarily and at realistic prices. We will encourage the wider and more creative use of debt conversion, to turn debt into equity or working capital -- both through direct investment and through debt-equity conversion funds such as those the IFC is developing with a number of member countries. Debt conversion has proven effective in reducing debt and debt payments, and there is more demand for such schemes than present programs in the indebted countries are able to utilize. We will work with governments to expand such programs in ways consistent with prudent fiscal and monetary policies and with the encouragement of sound investment. Other approaches which reduce outstanding debt and annual interest payments -- such as exit bonds -- also warrant further development.

Increased use of more market-based instruments to help finance development in the medium and longer term requires a strong and sophisticated domestic financial structure. The Bank and IFC will help countries to strengthen their financial sectors and, particularly, their capital markets. The broader the domestic financial sector, the greater the flow of private capital can be whether through debt-equity conversions or direct investment -- without confronting the sometimes politically sensitive issue of majority foreign ownership.

One of the major problems in recent years has been the time lapse between agreement on debt restructuring and the actual provision of new funds. We are all familiar with the complexities which have led to these protracted delays. Governments and ministers commit themselves to major policy changes which are often politically difficult. Their success depends on a supply response -- increased production and employment -- which, in turn, depends on the provision of new financing. But if such financing is delayed by 6-9 months, which has not been unusual, public support for reform wanes and the pressure for alternative approaches mounts.

We will work with the commercial banks and export credit agencies to help streamline this process considerably, so that external financing is available expeditiously after agreement has been reached on a satisfactory growth-oriented adjustment program.

Export credit agencies have an important role to play. The Export-Import Bank of Japan has been authorized to provide flexible untied, quick-disbursing loans to the highly indebted countries, in association with World Bank operations. This has proved immensely helpful in Mexico, Argentina, and other countries. We welcome this initiative and urge other OECD countries to consider similar approaches.

We also intend to initiate a program of financial technical assistance, in which the highly indebted countries will have priority. The program will draw on the financial expertise of the Bank to assist countries to develop techniques to mitigate interest and currency risks in the management of their debts and foreign assets.

The solutions which we help to develop will be designed to benefit both debtors and creditors and will be consistent with the prudent management of the Bank's own financing.

For the past several years the Bank has been the leading source of net funds for the heavily indebted middle-income countries. Last year, in fact, the Bank provided the equivalent of four-fifths of total net lending to the 15 countries that are central to the debt strategy. The Bank was prepared to accept this increased exposure because it was both prudent and necessary to help ensure a resumption of growth and development in the affected countries. But we cannot stand alone.

As I have indicated, we intend to maintain our greatly expanded program of lending in support of these countries' growth-oriented programs. While we will not give comfort to risks which properly belong in the private sector, we will energetically develop our relationships with commercial banks and seek through our participation in financing packages to build confidence in these countries' prospects. We will not assume the debts of others, but we are prepared to maintain substantial disbursements and adapt our financing instruments as long as we see credible adjustment efforts and responsive actions by the governments of the debtor countries, as well as appropriate participation by other official and private creditors.

I believe that we should commit ourselves to restoring the stronger debtor countries to spontaneous access to the world's credit markets in five to seven years. This will demand sustained effort by both creditors and debtors. For such countries -- Brazil, Argentina, Mexico and Venezuela, for instance -- the right approach remains one of strong adjustment programs together with imaginative packages based on new borrowing from both private and public sources, as well as on other types of financing.

For some less resilient middle-income countries pursuing adjustment, however, there may be legitimate concerns about financing solutions which rely largely on increased indebtedness on commercial terms. Their return to normal credit status is likely to be more protracted and their growth and debt servicing capacity more limited, while commercial financing on appropriate terms is increasingly difficult to arrange. These differences -- which underline the wisdom of the case-by-case approach -- may require extension of the present range of options within the menu to provide the debtor with adequate foreign resources. These may include greater reliance on official sources of finance, and understandings between commercial banks and debtor governments on ways to avoid increasing the stock of debt on commercial terms and the unmanageable build-up of arrears. These are areas which need further exploration in the search for individually tailored arrangements to restore growth and creditworthiness as rapidly as possible.

The success of any debt work-out program in which the World Bank might participate will be heavily dependent on actions by the industrial countries. These countries, particularly those in surplus, bear a great responsibility to ensure more rapid growth in the world economy. If indebted developing countries are to meet their external obligations by expanding export revenues, developed countries will need to absorb greater amounts of their exports. This process will entail painful adjustments by industrial country producers and staunch resistance to easy but self-defeating protectionism. Actual and threatened protectionism in the industrial countries is totally counterproductive to any viable debt work-out strategy.

In these circumstances, the success of the GATT Uruguay Round is essential to the welfare of the global economy. The GATT nations should act urgently to assure a stand-still and rollback of existing protectionist measures.

In the proper global economic setting, many of the heavily indebted middle-income countries should be able to see their creditworthiness restored within five to seven years. For others, the process will take longer and may require enhancement of the existing strategies. In all cases, however, debtors and their creditors must persist with the search for negotiated, mutually accommodative solutions. And the World Bank must shoulder its share of responsibility. We cannot shirk this responsibility. We do not wish to do so. But this in turn has implications for our own resource base -- a point which I shall take up in greater detail later.

<u>The African Crisis</u>

Let me turn now to another troubled group of countries in which the Bank has been playing an extremely active role. The severity of the crisis in sub-Saharan Africa is well known to this audience -- and the response of governments and ordinary people in the developed countries has greatly strengthened African initiatives. That generous response must be translated into sustained, long-term assistance to tackle Africa's deep-seated problems -- a fragile ecology, weak institutions, underdeveloped human potential and minimal infrastructure. These problems have been exacerbated, in an extremely difficult external climate for primary producers, by policy errors and wasted resources in too many African countries. The common results have been increasing debt, foreign exchange scarcity and virtual fiscal collapse.

Long-term recovery in Africa must thus start from a determined effort to contain and manage the present crisis, and to institute sustained adjustment programs to liberate the entrepreneurial and productive potential of Africa's economies and people. Africans, as Nigeria's former Head of State, Olusegun Obasanjo, has so eloquently written, "must seriously organize and mobilize their societies for a more sustained development process, predicated on the conviction that they cannot have development without sacrifice. ... Development means hard work, sweat, forebearance and discipline."

Structural adjustment is therefore absolutely fundamental to the Bank's assistance strategy for Africa, and is not in any sense separate from our development role in the continent. Indeed, we will continue to concentrate IDA resources on the growing number of countries which are making determined and realistic adjustment efforts. They will be backed up by imaginative new programs being initiated by IFC, such as the African Management Services Company which will involve 40-50 international companies as well as governments and international organizations in assisting the African private sector.

Africa's courageous reform efforts are being hampered in many cases, however, by a shortage of financial resources exacerbated by a severe burden of debt. Urgent, determined and coordinated action is needed, as the Venice Economic Summit recognized, to relieve the debt distressed low-income countries and to mobilize the additional resources essential to economic recovery.

As a result, the Bank has proposed an ambitious but realistic international program of assistance to a group of low-income, especially debt-distressed countries undertaking significant adjustment programs. (While our proposals have focussed on Africa, there are low-income countries elsewhere which face identical problems. In Latin America, for instance, Bolivia's future development depends on official actions and financing.) For the group of about 15 highly indebted low-income African countries undertaking adjustment programs, the objective is to mobilize at least $1.5 billion in additional external resources each year in 1988-90. This would permit a modest growth of 2 percent per capita annually in GDP, some growth in consumption, and the maintenance of debt service ratios at manageable levels of about 25 percent in these countries.

The key components of this program are:

- o concessional debt relief in the Paris Club, including lowered interest rates and extended grace periods and maturities as well as continued conversion of loans to grants,
- o increased flows from IDA, together with expanded co-financing from other donors and speedier disbursement in support of adjustment operations, and
- o support for the enlargement of the Structural Adjustment Facility as proposed by the Managing Director of the Fund.

The Bank is giving very high priority to this multi-donor/creditor effort. We have been encouraged by the response of the donor community. We are now undertaking special missions to develop specific programs with donor governments, especially for expanded cofinancing of adjustment.

But there is not yet sufficient tangible progress -- especially on debt relief -- to make the program a reality. I urge the donor countries to support efforts to mobilize the resources vital to African recovery by agreeing now to these special initiatives, by completing parliamentary and other actions required to make available expeditiously the resources committed to IDA-8, by supporting an enlarged SAF, and by directing their own national assistance to these deserving programs.

Adjustment programs provide the essential basis for economic recovery. But the process of recovery will inevitably be painful and prolonged. In the meantime, Africa's 450 million people, the vast majority of them very poor, will continue to be vulnerable to austerity and to the natural calamities which have blighted the continent in recent years. They must be protected while growth gradually resumes.

In particular the availability of adequate supplies of food in all countries must be ensured, while strong efforts are made to increase food production. Sub-Saharan Africa needs to grow 4 percent more food every year to match the growing population and to reduce uneconomic food imports. Food security for all Africans will therefore be a central feature of the Bank's long-term assistance strategy in Africa, and we will work in close collaboration with other donors and with African governments to achieve it.

To do so, some important objectives must be met:

- Individual African countries need to concentrate their efforts on important food crops in which they are or can become efficient producers, rather than adopt expensive and wasteful policies of self-sufficiency in all foods.

- Specific policies must be designed to reduce fluctuations in the food supply and to increase production and purchasing power within food-deficit regions and population groups.

- Food distribution systems need to be improved both within and between countries, by encouraging smoothly functioning markets and appropriate supporting institutions.

- Environmental degradation and the loss of valuable food-producing land must be reversed.

To help meet these objectives, we are taking a number of initiatives. The Bank will expand adjustment lending in the agricultural sector to assist African governments in establishing the policies, incentives and institutional framework to encourage farmers to produce and sell more. Adjustment lending will also help governments remove inappropriate interventions in the marketing and distribution of food, which have often inhibited food production and consumption.

At the same time, we will pay careful attention to the need for safeguards for groups whose food security may be threatened during the process of adjustment--for example, urban poor people affected by the phasing out of subsidies, or state employees who lose jobs as civil services and public enterprises retrench and reform.

The production of African agriculture can be sharply increased. National programs are being developed to bring research results, technology and agricultural services to small farmers, using management and organizational techniques pioneered by the Bank which have already proven successful in some African countries. These programs will soon be underway in 14 countries. A key objective of this initiative will be to reach women farmers, who produce the bulk of the continent's food but whose role in food production has too long been ignored.

Norman Borlaug, the father of the Green Revolution, has described agriculture as "the mother of science ... the science which makes life possible." While we can do much with present technology to expand food production, Africa's farmers must also benefit from the great strides made in recent years in biology and genetics. To help adapt this knowledge to the continent's different and often very difficult terrain, we are supporting the Special Program for African Agricultural Research, which is mobilizing international efforts to develop effective technical solutions for African agriculture.

Food security will also require a major environmental rescue and development effort. Africa's rapid shift from land-abundance and labor-scarcity to a situation of closing land frontiers and increasing population pressures is turning three-quarters of a billion hectares of land to desert, while almost four million hectares of forest and woodland are disappearing annually. Poverty breeds environmental neglect and abuse, and resource degradation deepens the poverty problem. We must break this vicious circle.

The Bank will promote policy changes to reverse the incentives for environmental degradation and to bring about a synergy between food production and the renewal of Africa's natural resources. An important part of this effort will be our planned trebling of lending for forestry, much of it concentrated in those countries of sub-Saharan Africa that have policies conducive to environmental preservation. Far from competing with food production, forests preserve the rainfall and soils essential to it.

Finally, we will work closely with governments and international bodies such as the World Food Program to increase African countries' capacity to deal with food scarcity and emergencies, and to design food security packages for specially affected population groups.

Food security is central to our efforts to alleviate African poverty. Closely linked is the need to strengthen Africa's human resources. Investment in people is a fundamental requirement if these economies are to achieve sustained growth as well as to emerge from the present crisis.

Africa has made important progress in providing education for its people, but the current crisis has made that achievement vulnerable. I propose to expand the Bank's sector adjustment lending to promote reforms which will mobilize more private and community financing of education, provide better materials and equipment, and encourage cost containment and the more efficient use of schoolteachers.

We will not neglect higher education, which is vital to the development of the continent's managerial and technical capacity. Through our policy advice and adjustment lending, we will encourage governments to introduce policy, financial and institutional reforms to improve access to higher education, and to share its costs and benefits more equitably than in the past.

We will complement these efforts by continued support for safe motherhood and other programs aimed particularly at female and child welfare. Lending to sub-Saharan Africa for population, health and nutrition programs will more than double by 1990. We will support the World Health Organization's worldwide effort to combat AIDS, a disease which has potentially grave consequences for some countries in Africa. In all these efforts, we will be looking for new and more creative ways to work closely with voluntary organizations, community and church groups, and the private sector.

Too much of Africa's recent history has been written in spurts of beneficence, too little in steady attention to deep-rooted problems that preclude simple, speedy remedy. The challenge Africans face is to salvage the gains of the past in order to bolster the foundation for future recovery. The Bank will do everything possible to help Africa meet this challenge.

The Bank's Role in Asia

In its work in Africa and Latin America, the Bank is responding to deep economic crisis and dramatically interrupted growth. In Asia, by contrast, we have had enduring partnerships with countries which together comprise the most diverse, dynamic and fastest growing region on earth. With one or two exceptions this region, because of sound economic management, has been affected relatively little by recession and crisis.

As these countries continue their impressive development, our own role as development partner must change. We are placing particular emphasis, through our lending and policy advice, on facilitating the process of market-oriented reform in major Asian countries -- of which China is a complex and striking example. We are assisting our East Asian borrowers to adjust the trade, financial and industrial sectors of their increasingly sophisticated economies to changes in the global economy. And we plan to examine with them their strategic options for the next phase of growth, especially those offered by increased trade, investment and economic integration within the Asian region itself.

The private sector in Asia is vigorous but could play a larger role in promoting economic growth and technological advance, if it is given the freedom to do so. Asia's rapidly expanding capital markets have the potential to promote more rapid private sector growth, serving the needs of their countries in accumulating and allocating savings. Their development role will be more effective, as they become linked to the major capital markets of the world. The portfolio funds which IFC has been promoting foster these links, and encourage us to look forward to a time when a large number of corporations in developing countries are able to raise capital on international markets. Asia is already showing the way in this process.

The dynamism of these economies requires sustained investment for large-scale projects in infrastructure, energy and communications. In several of these countries, the external economic environment has contributed to sharply declining investment in new physical and human infrastructure and postponed maintenance and rehabilitation of existing capacity. The Bank as a long-term development institution must continue to support these countries' investment and institution building needs which are crucial for sustaining their progress in the longer-term. Investment in infrastructure and in other sectors therefore will remain the mainstay of Bank lending in this region. Bank projects and lending instruments will provide as much room as possible for associating private and official cofinancing with the Bank's funds.

Alongside these major initiatives to promote growth, I wish to highlight another major direction for the Bank.

It is a tragedy that despite the great progress which mankind has made in the last few decades, millions of people continue to live in conditions of abject poverty. Rapid economic growth or the advances of modern technology seem of little consequence if nearly a billion people do not have enough food, clean water or shelter.

Let me turn therefore to the Bank's role in combatting Asian poverty. We shall pursue poverty eradication on a global basis, but it has particular relevance to Asia, which accounts for more than 500 million of the world's absolute poor.

In the large, poor countries of Asia we wish to support government strategies to eliminate the worst aspects of absolute poverty by the year 2000. This is a bold objective, but not an impossible one. In the face of the most pessimistic predictions some 20 years ago, low-income Asia tripled its gross domestic product and almost doubled its per capita income, which now stands close to $300. In the first half of this decade these countries maintained a striking average annual growth rate of almost 8 percent, while much of the rest of the world suffered from deep recession. We believe there is every prospect that these countries can double their per capita income again by the turn of the century, placing them in the ranks of middle-income countries.

This large region, which accommodates two-thirds of the world's population, therefore stands at the threshold of transition from poverty to relative affluence. But in spite of these great achievements and bright prospects, the proportion of people living below the poverty line -- that is without the income needed to buy an adequate amount of food -- has not changed very much. Despite the continued efforts of governments, serious income disparities continue to exist within countries and extreme poverty and deprivation persist.

Of the large countries in the region, China has made the most rapid progress in alleviating poverty. It has provided an increasing range of social services consistent with efforts to more than double its per capita income by the year 2000. We will support the Chinese government's program to eliminate remaining pockets of absolute poverty. India too has consistently kept poverty alleviation at the top of its development agenda, but poverty remains pervasive despite progress in reducing its incidence over the years. We will support the commitment of the Indian government to achieve its goal of eliminating absolute poverty by the year 2000.

There is little reason to expect that future growth alone will attain the progress against poverty which it has failed to secure in the past. Nor can World Bank resources alone address these huge problems. But we can and will target an increased proportion of our IDA lending to help tackle the poverty which has remained largely impervious to the benefits of growth: among the landless and assetless rural poor, among vulnerable social groups such as rural women and children, and in distant or backward areas of the large countries.

Extreme poverty lies overwhelmingly in the countryside, and most of its solution must be found in the villages of Asia, although we will not ignore the continent's hard pressed mega-cities. Our strategy will concentrate on the delivery of basic services to ensure adequate food, shelter and health care, and on conserving the often fragile environment of rural areas.

We will support education, nutrition and family planning programs, and increased attention to rural employment and income generation for landless labor. In all our poverty alleviation programs, we will apply the lessons we have learned to design more effective, targeted approaches to eliminating the worst aspects of poverty -- malnutrition, disease and lack of employment opportunity. Our lending programs will emphasize eliminating poverty in ways conducive to economic efficiency and growth.

Many of the technologies to combat this entrenched poverty are cheap, simple and effective: village hand-pumps to draw clean and safe water, oral rehydration tablets costing a few cents which save the lives of thousands of children, contraceptives which can provide poor people with the family choice from which much of Asia already benefits.

But the institutions to deliver these services to poor people and to inaccessible areas are frequently absent or -- in the case of official programs -- are often cumbersome and ineffective. We will work with governments, therefore, to find new ways to involve voluntary, non-government organizations (NGOs) and the private sector in our poverty eradication efforts.

In many Asian countries, NGOs have devised imaginative solutions to the problems of organizing poor people and delivering services to them at low cost. By working more closely with these groups, we can strengthen development programs. But we must respect their independence and their sometimes unconventional approaches. The international community and governments should also collaborate to develop and deliver the research and technical packages -- in dry land farming, livestock, root crops and pulses, and simple replicable technologies -- which the poor can use. The Bank has acquired valuable experience in these areas, and is supporting further research. We will find fresh ways to put the results to work for the poor.

We will also work with governments to remove the barriers which inhibit the development of fair markets and better incentives. Only governments have the ability to remove some of these administrative restrictions -- restrictions which permit both bureaucratic and private exploitation of poor people -- and to provide the incentive framework within which poor producers and an efficient and competitive private sector can flourish.

In the coming months we will be developing these ideas further, in concert with our Asian partners and other experienced donors and organizations. Together we can ensure that continued rapid development is more widely and equitably shared, so that these countries enter a new century free of the terrible poverty that has stained every century before.

Resources for Development

Mr. Chairman, I have set out today a challenging agenda of action for the World Bank. I have rededicated a renewed World Bank to economic growth and the fight against poverty. In pursuit of these goals, I have pledged strong action on debt, firm support for economic reform and adjustment, new initiatives to promote the private sector, and renewed and innovative programs to safeguard the human environment.

It is an agenda which places heavy demands on our staff and which can only be achieved if we can continue to count on the moral, political and financial support of our borrowers and other partners in the international community. I referred earlier in my remarks to the demands that our development agenda would also make on our financial resources, and in concluding my address today I would like to elaborate on those.

There has been a dramatic decline in the resources flowing to developing countries in recent years -- in a period when their needs have been very pressing indeed. Total resource flows fell by 50 percent between 1981 and 1986, largely because of the virtual disappearance of net private bank lending and net export credits. Official flows and private foreign investment, which in aggregate have inched up only a little from the levels of the early 1980s, therefore account for almost four-fifths of the current reduced total.

These figures are all the more depressing in the face of the blow dealt to developing countries' efforts in the 1980s. Excluding a few major countries which managed to sustain substantial growth rates, developing countries' income and consumption actually fell, while investment and imports declined steeply and debt service rose sharply to almost one quarter of export earnings. In sub-Saharan Africa incomes declined by one quarter, investment and imports have been effectively halved, and debt service has soared from 8 to 30 percent.

None of our mutual goals for development, none of our hopes for success in the struggle against poverty, none of our investments in strengthening human resources and protecting natural resources can be realized by the World Bank acting alone. We fill but a small part of the total need. The major burden falls on the developing countries themselves. But the program I have outlined today depends not just on their efforts and on increasing the Bank's resources, but on substantially expanding the flow of all resources from the industrial nations to the developing world.

The role of the World Bank Group is nevertheless of particular significance. We have global responsibilities -- in the heavily populated giant nations of Asia, in the poorest countries, especially in sub-Saharan Africa, and in the middle-income countries.

The Bank can and does lead the way in helping borrowers address poverty and growth, not least by encouraging and mobilizing the energies and the resources of the private sector. Adjustment efforts are creating promising new climates for investment, encouraging openings for entrepreneurship. As barriers -- licensing restrictions, import and export controls -- come down, private forces should rise to the opportunity. The flow of private equity investment, stagnant at about $10 billion over the last four years, is particularly important -- and we must find new ways of increasing it. The policies of developing country governments are critical to investor confidence, and a precondition for success. But we also need new mechanisms to mobilize the trillions of investment dollars available in the markets so as to benefit the developing world -- and thereby ultimately to benefit us all.

In addition to the Bank's own work in this area, the International Finance Corporation and the Multilateral Investment Guarantee Agency (MIGA) offer vital backing to private initiative, and help in strengthening the infrastructure essential to the workings of market forces. The IFC's $800 million program of investment this year shows the range of help available and the diversity of enterprise possible. MIGA has already been ratified by the necessary number of developing countries, and by Japan and Denmark among the industrial nations. It is poised to begin valuable work through programs to help improve investment conditions, attract capital and facilitate joint ventures. I am ready to call the required conference of signatory countries in Washington to decide on any further steps needed to enable MIGA to start operating, if the MIGA convention does not enter into force by the end of next month. I am still hopeful that more industrial countries will ratify the convention soon so that MIGA can become a reality before then.

For the poorest countries, the IDA-8 replenishment is fundamental to the whole structure of international action. The ratification of IDA-8 must now be swiftly followed by governments notifying the Association of commitments and initial payments into the replenishment. I wish to thank those donor countries which have notified their contributions to IDA and thus enabled us to continue lending to our poorest member countries without interruption. In the same vein, it is critical that our efforts to mobilize resources for the most distressed debtors and the IMF's proposal for an enlarged Structural Adjustment Facility be translated into concrete action with all possible speed.

For the highly indebted middle-income countries, the Bank is currently virtually the sole source of net funds. Others must do more, and so must the Bank. I have pledged to you today that we will continue our greatly expanded support for the recovery efforts of our heavily indebted members, on the basis of thoroughgoing and sustained programs of economic and institutional reform. To achieve this while maintaining and increasing our essential commitments to the growth and poverty alleviation programs of all our borrowers, we must move forward with a substantial general capital increase for the Bank sufficient to support our expanding lending program well into the 1990s.[1] If we do not act on a general capital increase now, we simply cannot provide the resources we are being asked to provide, nor take

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1/ In this context, it is important to recall that the Executive Directors decided last October to value the Bank's capital in terms of U.S. dollars, and periodically to review the adequacy of the capital in case the U.S. dollar substantially depreciates against the SDR.

the risks we are being asked to take. I am confident that your strong support for a substantial increase in our capital can be translated into an agreement this year.

I realize that the Bank is putting a demanding load on its members. The burden of a positive response, however, is lighter than the weight history would attach to our failure. With so many lives, so much past progress and future potential at risk, the international development community must now put new effort and added resources into the work of recovery and renewed progress. With all of us working together I am confident we can succeed.

Thank you.

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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
INTERNATIONAL FINANCE CORPORATION
INTERNATIONAL DEVELOPMENT ASSOCIATION
INTERNATIONAL MONETARY FUND

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Address by M. Camdessus
Chairman of the Executive Board and
Managing Director of the International Monetary Fund
to
the Board of Governors of the Fund

It is a great honor for me to address you for the first time in my new capacity. You can, I am sure, imagine my feelings: gratitude for your trust; awe about the magnitude of the challenges we face; reassurance stemming from the caliber of the Executive Board and the staff of this institution; hope that your understanding and support will match your trust . . . . . These are my feelings as I seek to build on the exceptional achievements of my predecessor, Jacques de Larosière, who will go down in history as having preserved, at a crucial moment, the international financial system. I am well aware, in facing these challenges, that success will depend crucially on effective collaboration between the Fund and the World Bank, collaboration built on many of the shared goals so eloquently set out by Barber Conable.

I will not dwell longer on my own feelings. What matters at this moment is the fact that you, the Ministers of Finance and Governors of the member countries of our Bretton Woods institutions have come together here--at a time when one of the few things we know for certain about our future is that it will depend on the nature of your cooperation. And the Fund's ultimate raison d'être, as you well know, is to serve that cooperation.

How can we ensure that these brief meetings dispel doubts, discourage the temptation to "go it alone," and revitalize our spirit of cooperation? For this, common ground for action has to be found. And it is a task of the Fund to help find it. Allow me, therefore, to comment briefly on the world economic situation; then to elaborate on some of the key issues we face, including growth and stability in the major industrial countries, and the problems of the poorest and the most heavily indebted countries; and, finally, to say a few words on the role of the Fund today and in the future.

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What are the salient features of the current economic situation? First, two positive points: the industrial world is now completing its fifth year of continuous--albeit, in my view, insufficient--growth, and for the time being inflation in the industrial countries remains under control. But problems persist that are daunting in their complexity:

-- Economic expansion remains fragile;

-- Few inroads have been made into unemployment and poverty;

-- Domestic and external imbalances are unsustainably large;

-- The external debt burden of the developing countries stands at a record level;

-- Commodity prices have fallen to their lowest levels in real terms since the 1930s; and

-- The situation of many of the poorest countries defies description.

Fortunately, the map of the world is not uniformly gray. A good number of developing countries have been making major efforts to improve the efficiency and competitiveness of their economies, and last year the non-fuel exporters, taken together, were able to combine a further reduction in their current account deficit with a faster rate of growth. Indeed, some countries are demonstrating that, with courageous adjustment policies, dramatic reversals of trends can be achieved. Some others, meanwhile, can be proud of the results of growth-oriented adjustment efforts that have been consistently applied. Still other developing countries, let us not forget, have avoided external crises and continue to make steady progress.

But it is also true that, as an African Head of State pointed out to me recently, "no country can expect to be an oasis of prosperity in a world of crisis." In fact, developing and industrial countries alike are all affected by problems that have a common source: policies that are insufficiently strong--and insufficiently structural in content--to achieve sustained growth. We are facing an interlocking complex of problems which have their roots in the mistakes of the past. This should induce in us some feelings of humility, but it should also make us determined to be clearheaded, to see the problems for what they are, and to address them universally and not simply in countries seeking to use the Fund's resources. We need better policies to be implemented on a sustained basis, and this is clear when we look at each of the three "continents" making up the special geography of the problems that face us today.

Policies in the industrial countries

The major industrial countries had a priority task to carry out in the first half of the 1980s: to bring inflation under control. And they succeeded. Inflation has been brought to its lowest level in 20 years, and after the deep recession in 1980-82, moderate growth has resumed and been sustained. But serious imbalances emerged, and structural rigidities of all kinds are blocking the road to more rapid growth and higher employment. A reduction of imbalances and the pursuit of structural adjustment are thus the medium-term priorities for the major industrial countries.

Looking at these countries, we find four policy imperatives:

-- First, to reduce the fiscal deficit of the United States in line with the commitments made. This is crucial because of its impact on so many key areas: on interest rates in the United States and elsewhere; on the balance of payments of the United States and its take-up of external debt; on the credibility of efforts to stabilize the dollar--and, thereby, of the pattern of exchange rates as a whole; and, finally, on the allocation of savings throughout the world. Noteworthy success has been recorded during the fiscal year now ending which is very much to be welcomed. But further significant progress will be needed in 1988 and beyond. As this task will be so difficult, no approach should be ruled out.

-- Second, to channel efficiently the savings of surplus countries. This, of course, must not entail a repetition of the sometimes imprudent experience of the 1970s. The best safeguard is to be found in the quality of the economic policies pursued by the recipient countries, a subject to which I shall return later. Allow me here, however, to welcome the initiatives under way in this area by the Government of Japan. It goes without saying that if the surpluses remain as large as expected, further steps of this type will be needed.

-- Third, to implement more vigorous structural adjustment, including measures to turn the tide against protectionism. The industrial countries must attend to the rigidities that have a tendency to beset mature economies. Let me simply note in this context that efforts in many countries to reconsider the role of government and policies intended to increase economic efficiency, such as deregulation, promotion of a more competitive environment, and introduction of greater flexibility in markets--including labor markets, a particular problem in Europe--are by no means in competition with social objectives. On the contrary, it seems more and more that such policies are crucial if such goals are to be secured on a durable basis.

-- Lastly, but implicit in each of the foregoing, to achieve enhanced coordination of economic policies. This past year, with the Louvre and Venice Agreements, represents a milestone. The Fund's Executive Board has warmly welcomed these agreements--particularly the effort to achieve greater exchange rate stability, and hence better conditions for growth. It believes, however, that these goals require increased efforts by all key currency countries, and that the urgency of the matter permits no delay. The current account disequilibria must be dealt with in a way that is symmetrical. Shifts in trade flows require that domestic spending in the United States grow more slowly than domestic output for an extended period. In the surplus countries the reverse will have to continue. Japan and the Federal Republic of Germany, the major surplus countries, obviously have special responsibilities in this regard.

The role of the largest industrial countries is crucial, but they are not alone responsible for strengthening world economic growth. The smaller and medium-sized industrial countries, as well as the newly industrialized economies, must also formulate their objectives and policies with due regard to their international implications. By promoting greater structural flexibility in their economies, they, too, can play an important role.

Restoring Sustainable Growth in the Developing Countries

If growth can be strengthened and put on a sounder basis in the industrial countries, an important step will have been taken toward dealing with the problems of the developing world. Nevertheless, the task here remains immense, especially in those countries--whether among the poorest or in the middle-income category--where the debt problem is most serious.

Let me first address the particular problems of the poorest countries. I will confine my observations today to the countries that are potential beneficiaries of our Structural Adjustment Facility (SAF). This should not be construed to mean that we devote any less attention to the others. I am thinking in particular of India and China, which in 1985 so generously decided not to exercise their rights to draw on the SAF, and I am thinking of all the others as well.

Why did I ask that the Heads of State and Government meeting in Venice be asked to support a tripling of the resources available under the SAF? And why am I asking you today? Because I have become convinced that the situation of the poorest countries is such that the only way for the Fund to continue to support strong macroeconomic policies and structural reforms in these countries--in a manner consistent with safeguarding the Fund's monetary role--is to have resources available, specifically for this purpose, that are less costly and of longer maturity than its ordinary resources. This is why the Interim Committee expressed the hope last April that the SAF would make it possible to obtain the necessary additional bilateral and multilateral support.

A tripling of resources available to the SAF will still leave the facility playing only a small role in what must be accomplished in these countries. But that role is crucial; for it is imperative that international resources to these countries--in all forms--should be employed in the context of policies designed to restore economic balance, the achievement of which can draw heavily on programs of macroeconomic and structural adjustment that are backed by the Fund with the participation of the World Bank. This is why I have asked you to give us the means for the difficult task that you have asked of us. I am hopeful that all countries that can do so will indicate very soon their intention to contribute to this initiative. On our part, we are aiming to proceed as quickly as possible with further consultations with potential contributors in order to conclude these discussions within the year, in line with the wish expressed at the Venice summit.

Other initiatives in related fields are also important: the World Bank's recent initiatives for sub-Saharan Africa; the reforms under way in the Paris Club to provide for better-adapted maturities in rescheduling operations; and, as far as development finance is concerned, the implementation of the IDA-VIII replenishment and a general capital increase for the World Bank. Let it not be thought that these initiatives are alternatives to each other. They are not. They are mutually supportive. And even when you have acted on all of them to the best of your possibilities--as it is my strong hope that you will--the major part of the effort for the future of these countries will still remain to be accomplished, as it must, by the countries themselves. I shall return shortly to the nature of the policy efforts required.

Let me turn now to the third continent: the heavily indebted middle-income countries, whose problems most of you had especially in mind when you came here this morning. Where do we stand today? Five years ago, when we met in Toronto, the debt crisis had just erupted, and the outlook was bleak. It is still full of difficulty. But we have come far. The international banking system has been strengthened; economic growth has resumed; these countries as a group have reduced their external and fiscal deficits; and many of them have moved seriously to adjust their economies. Unfortunately, in several cases, the effort has been only partial or has been prematurely interrupted.

Over the same five years these countries have, however, seen a deterioration in their terms of trade that has had a negative impact far exceeding any advantage they may have derived from the decline in interest rates. Standards of living have declined. And flows of external financing to them have been considerably smaller than they could have devoted to productive investment.

At the same time, the burden of indebtedness, far from declining, as we hoped five years ago, has actually risen. The average ratio of debt to exports in the entire group of capital-importing developing countries reached 187 percent at the end of 1986, as against 156 percent at the end of 1982.

Much clearly remains to be done. Indeed, we must acknowledge that more time than anticipated will be required to emerge from the crisis. A crisis which passes quickly is one thing. Dealing with a crisis which becomes a persistent problem is quite another.

Under these circumstances, how can we fail to understand the anguish felt by the leaders of developing countries when confronting a world in which economic activity languishes, protectionism continues to spread, interest rates rise anew, and net external financing shrinks? What must we do to ensure that our strategy remains relevant?

There is in our strategy a fundamental element that must be preserved at all cost: the principle of shared responsibility and its corollary, the duty to work cooperatively. Our strategy is a cooperative one. As Barber Conable has said, the problems of these highly indebted countries can only be overcome through a determined partnership between debtor countries and their international creditors. The four groups involved--debtor governments, creditor governments, international financial institutions, and commercial banks--have recognized that there can be no durable gain for any one unless there are gains for all. It is a strategy in which each group agrees to make its greatest possible contribution and to accept as much risk as it it prudently can in order that the effort of each will be strengthened and the external creditworthiness of the indebted countries restored as rapidly as possible. This will ultimately be to the advantage of all. There is no satisfactory alternative to this approach.

What then must be done now by the various parties involved? Each must do more and must do it better.

The <u>governments of all developing countries</u> have three key responsibilities, and these are especially pressing in the case of the heavily-indebted countries. First, they have to persevere with the implementation of sound macroeconomic and structural policies for growth and external creditworthiness. This obligation is inescapable, and it is, above all, in their own interest. No country today--especially not the poorest or most indebted--can afford an economic policy that does not seek, with the greatest possible determination, to eliminate imbalances and structural rigidities. Policies which tolerate imbalances or rigidities, regardless of the reasons advanced for them, will sooner or later come back to haunt the poorest and undermine international solidarity.

The ingredients of strong reform programs are not cast in one mold. They need to be tailored carefully to the unique circumstances of each economy and to pay due regard to the country's social and political priorities. Certain basic requirements, though, are self-evident:

-- Monetary and fiscal policies must combat inflation and promote the mobilization of domestic resources for the development effort;

-- Interest rates must be maintained at positive levels in real terms so as to attract a sufficient flow of savings and ensure that they are put to productive use;

-- The price structure, including the exchange rate, must encourage the efficient use of domestic resources and investment in activities which exploit countries' comparative advantages;

-- Distorting tariffs and quotas must be removed, and outdated and inefficient structures of taxation and subsidies reformed.

Such policies, we well know, are not easy to pursue. On the contrary, it requires the greatest political courage to introduce them and to see them through to their conclusion. This courage must be acknowledged by those who are called upon to assess programs, so that they do not, through skepticism or unrealistic demands, undermine the actions that we all support. Then, policies must be sustained. Too often have we witnessed the damaging costs of pauses in program implementation--costs that become evident when a fresh start proves more difficult than the initial steps.

A second responsibility incumbent on the developing countries--especially those that are experiencing debt problems--is to open their doors further to foreign capital investors. Is it not paradoxical that while great emphasis is laid on promoting flows of financing that do not add to debt, all too frequently there are multiple barriers to such flows?

Finally, a third responsibility for the governments of these countries is that they must do everything they can to strengthen the spirit of cooperation and thus of mutual trust. However much demagogy may beset them on all sides, they must not permit ambiguous remarks or threats of unilateral action to raise doubts about the sincerity of their commitment to a common effort to restore sustainable growth and external creditworthiness.

The unflagging commitment of debtor countries to strong policy reforms will, of course, be extremely difficult if appropriate financing is not available for their productive investment and if growth is not restored. In countries with recent debt-servicing problems, investment has dropped from more than 25 percent of GNP to 19 percent over the past five years. True the earlier ratio included some expenditures which were not very productive. But, at the current pace, new investment in many of these countries is barely sufficient to keep the capital stock from falling, and good projects are left without financing.

Additional financing is thus urgently needed. In what amount? There is no simple formula, either as a proportion of debt repayments, or of GNP. But where we have strong growth-oriented adjustment programs, the aim has to be to leave no good, productive investment or import without appropriate financing. With such financing, the ratio of investment to GNP will be able to grow as warranted--at rates which will vary from one country to another, taking into account the quality of their investment programs, their economic situation and the boldness of their adjustment policies. It is in this spirit that we in the Fund analyze the financing side of programs submitted to us.

Given the need for additional external financing, how could creditors do more and better?

As for creditor country governments, it goes without saying that the four imperatives for industrial countries to which I referred a moment ago acquire even more importance in the context of debt and development. The world needs stronger growth in the creditor countries, better balance in their external current accounts, greater stability in exchange rates, policies conducive in the long run to lower real interest rates, and a rollback of protectionism. Progress in these areas has been made, but it is slow. It equally needs to be complemented by a strengthening of international financial institutions, an increase in official flows of bilateral assistance, and more determined efforts to harmonize divergent tax and regulatory policies which impede the assembly of concerted financing packages by their commercial banks. Without this, how can we hope to restore satisfactory growth in the developing world and solve the debt problem?

As for the commercial banks, their situation has significantly improved in recent years. This is welcome for them and for the world financial system. It is welcome also for the indebted countries. A sounder banking system should be able to play a more active role in supporting countries' recoveries and thus rebuilding the quality of banks' existing claims and future business. As we all know, the banks have not been inactive of late. The financing plan agreed with Argentina, for example, illustrates that cooperative action among creditors and debtors can speed up procedures and expand what has come to be known as the "menu" of options offered.

The use of such techniques is essential, but I share the view of those who doubt that they will provide a full answer. Equally, though, I remain convinced that the basic answer continues to lie in cooperative actions. And I believe that for the banks to play fully their essential role in this strategy--and in their own longer term interest--they will have to do more and do it better.

-- First, the spirit of innovation that has pervaded the international capital markets needs also to permeate the area of bank debt restructurings. I see two broad guidelines for new approaches. They should be freely negotiated between debtor and creditor, and they should be market based. Departure from these principles would only delay rather than hasten the resumption of voluntary financial flows to countries that are on their way to restoring creditworthiness. The present market in sovereign debt is segmented and imperfect: the prices quoted send unclear signals to debtor and creditor alike. I would welcome the emergence over time of a broader and more transparent market--one that would reflect the changes in the credit standing of countries and lay the basis in due course to tap a wider pool of financing. In the meantime, no approach should be struck from the "menu" as long as it results from an agreement reached freely by the parties to the contract. Consistent with this, I would hope that the nature of negotiations among banks can evolve to accommodate greater diversity and not converge on a "lowest common denominator."

-- Second, banks should be prepared to provide greater financing. The increase in banks' net exposure in developing countries since the launching of Secretary Baker's initiative in October 1985 has been very modest. While in some cases this has reflected problems of policy implementation, in others it has reflected delays or shortfalls in the provision of warranted financing. It is important that there should be no question about the willingness of the banks to respond promptly by providing the moderate amounts expected from them to support good programs.

-- Third, it would be most helpful if banks approached the problems of small countries and medium-sized countries in the same spirit and as promptly as they do those of large countries. One major negotiation should not be allowed to delay one or several other negotiations.

-- Fourth, and finally, let me urge that decision making be speeded up. The delays which we have often seen only hamper the implementation of adjustment programs and undermine progress toward the restoration of creditworthiness. It is indefensible that in some cases, while far-reaching adjustment programs have been adopted with the international community's support, inordinate delays on the part of certain smaller banks frustrate the completion of financing arrangements by governments and international financial organizations. International cooperation must not be paralyzed in this way.

<u>The role of the Fund</u>

I would like now to turn to the role of the Fund. In a sense, this has been implicit in much of what I have already said. Let me now only highlight certain areas of key importance.

First, I believe that the Fund has a crucial role to play in strengthening multilateral mechanisms of cooperation that can promote faster world economic growth and a stable international monetary system. The Louvre and Venice Agreements have opened up new areas for cooperation in which the Fund is invited to play an important part. It will do so by providing the major industrial countries with a frank evaluation of their economic policies, through the use of indicators; by drawing the attention of each of these countries to the impact of its actions on other countries; and by seeking to ensure that the interests and aspirations of the rest of the world are taken into account. We have, with the indicators, a means of giving sharper focus to the analysis, providing a benchmark against which policy recommendations can be made more persuasive, and thereby enhancing the effectiveness of multilateral surveillance, for the benefit of all.

Second, the Interim Committee in its meeting two days ago reaffirmed the Fund's central role in the debt strategy. This is a role the Fund must play, working closely with the World Bank and continuing to adapt flexibly to the changing needs of its member countries, while adhering firmly to the principles which guide its actions under its Articles of Agreement--in particular preserving its nature as a monetary institution. What does this entail?

-- That the Fund assist countries in designing economic programs, monitoring their implementation, and, if necessary, explaining them to the international community--which rightly considers there to be no finer guarantee for external financing than the appropriateness of economic policies.

-- That the Fund help mobilize financing flows from other sources, and work with the other parties to the strategy to help ensure that such flows and financial relief are adequate to sustain the resumption of growth.

-- That the Fund also stand ready to contribute financially itself. In the current economic climate, the Fund's own financial involvement in the implementation of the debt strategy has to remain sizable. It is possible, in fact, that greater use of Fund resources will be necessary than contemplated earlier. It is thus all the more essential that we fulfill our duty to be rigorous. It also goes without saying that we must continue to exert all energy to ensure that obligations to the Fund are discharged on time and in full; arrears are totally unacceptable in a cooperative monetary institution like the Fund. This does not mean, however, that when times are tough we should confine ourselves to collecting on our claims and burying the money in the strong box. We cannot be oblivious to the payments needs of countries pursuing strong policies that merit continued support. That would run counter to the intentions of our founders and the interests of all our members.

Among the Fund's basic instruments for fulfilling these three aspects of its role--helping members with the design and implementation of their adjustment programs, mobilizing financial flows from other sources, and providing its own financial contribution--are its financial facilities. For the low-income countries, the SAF has a particularly important role to play. For our membership at large, the Extended Fund Facility was designed to provide financial assistance over a longer period to members engaged in structural adjustment, but has been used little in recent years. It has, I believe, the potential to be used more, and we will need to see what can be done to revitalize it. High on the agenda also, as the Interim Committee has pointed out, is a review of the Compensatory Financing Facility.

The Fund must stand ready, in reviewing its procedures and its approach to program design, to draw on the lessons that recent experience has taught. One such lesson, perhaps, is that it often takes more time now than in earlier "traditional" balance of payments crises to achieve a lasting recovery. Another is that unexpected external developments beyond the control of the authorities can have disruptive effects on carefully elaborated and steadily implemented adjustment programs. In such cases, appropriate contingency mechanisms are worth considering. Yet another is that in certain cases our conditionality might lose nothing of its rigor, and indeed could gain in effectiveness, if it were predicated on a smaller number of essential variables with somewhat longer time frames. Ten years have passed since the Fund last reviewed in comprehensive fashion its policies on the conditional use of its resources, and it is time we reviewed them again. We will be doing so in the months ahead. The work of the Group of Ten and the Group of Twenty-Four provide an important input to this process, and the new Report of the G-24 has been received with great interest. We have recently had a preliminary discussion in the Executive Board of these reports, and the Board has committed itself to rapid study of the suggestions they contain.

At the same time that we seek to nurture the major cooperative effort required to help overcome the debt problem, we must also attend to a number of other vital tasks.

The Fund must continue to strengthen its cooperation with two organizations. The first is the World Bank. Whatever the developing country, this cooperation goes on daily at all levels. As Barber Conable said earlier, the Fund and the Bank have a long history of collaboration on which to build. In this regard, I count myself fortunate to benefit from such close and cordial relations with him, and you may be assured that we will continue to deepen the process of concertation.

The second organization is the GATT. Protectionism is a growing and progressively more harmful obstacle to growth-oriented adjustment. It is my conviction that it threatens to undermine a considerable part of the hard-won fruits of adjustment. Throughout the world it is wiping out the economic advantages of efficient resource allocation and complicating the problem of reducing payments imbalances. At another level, it is poisoning the international dialogue. We have at hand, within the framework of the Uruguay Round, the means to reverse this disturbing slide toward trade restrictions of the most varied kinds. We will do our utmost to ensure that the efforts of the Fund and the GATT are mutually reinforcing.

It would be remiss of me to speak of the Fund's support for its members in the present difficult world environment without touching on the implications for the Fund's own financing. In this regard, I am pleased that the Group of Ten has indicated its readiness to renew the General Arrangements to Borrow. This is a welcome decision, for if the Fund is to respond flexibly and imaginatively to the problems we face today, it cannot do so without the firm commitment and financial support of its member countries.

Looking ahead to the future, it is our duty, in the same context, to pursue our work on the Ninth General Review of Quotas. For anyone who believes that the early 1990s may be no less difficult than the present years, it would be imprudent not to strengthen the Fund in readiness by expanding it at least in proportion to the expansion of the world economy, and to base its financing again on quotas and not on borrowed resources. This is an issue that cannot be avoided. This is why I have proposed that a substantial increase in Fund quotas be considered. It is a matter of importance that this work proceed rapidly.

A second area of work for the future is to intensify our efforts to achieve a more efficiently functioning international monetary system. Closer policy coordination is a first step toward a better international monetary order via the best method available: pragmatism and constructive experimentation. At the same time, this should not preclude more general work on the international monetary system. While it would be unreasonable to rush ahead, it would be every bit as irresponsible not to be prepared to move forward when circumstances once again were favorable. That is why I am planning to give priority to examining the international monetary arrangements that are in the process of developing and the role that might be played in this process by the SDR--which, I remind you, our Articles of Agreement would make the principal instrument in the international monetary system. This work should enable me, at some appropriate future date, to provide the Executive Board with a number of carefully-thought-out initial considerations. Meanwhile, strengthened cooperation will, I trust, have been enhanced by further fruitful experiences.

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These are the tasks before us. I have spoken to you today about boosting growth everywhere, but on a sound basis so as not to repeat the mistakes of the past. This is surely the path we have to follow in order to surmount our difficulties, particularly those of the poorest. It will require the resolute pursuit of good economic policies, cooperation among all parties, and the sharing of risks. I have proposed none of the things that our world has seen in the past and some still demand of us today--namely, unconditional, plentiful financing; unsustainable rates of growth; and reliance on financing that was at times thought to be virtually risk free. This climate existed in the past, and at times it may seem a lost paradise. It was, though, a "paradise" with a dark side, for many of our present difficulties stem directly from that period. Let us turn our eyes to the future and look to the task before us. It is a difficult task, to be sure. But let us remember that many countries are taking steps to adapt to new times, and let us build on this. Let us also remember that no crisis fails to yield some opportunity. Indeed, let us seize the opportunity that the present situation offers: the opportunity to build a more trusting, more solid, and more active cooperation.

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Press Release No. 4

September 29, 1987

Remarks by the Hon. RONALD REAGAN,
PRESIDENT OF THE UNITED STATES, at the 1987
Annual Meetings of the Boards of Governors of
the Bank, IFC, IDA, and the Fund

I appreciate this opportunity to speak with you today. I still remember when we first met together, not that long after my arrival in Washington. Then, we talked about a revolution in economic thinking, a revolution whose ideas have proven themselves in the years since. And while progress has been made, formidable challenges remain. It is fitting then, on this occasion, that we make an assessment, and discuss our vision of the world's economic potential, as mankind, quite literally, moves toward a new millennium.

Making an assessment and setting goals are, of course, nothing more than good management. And if there is anything that the working people, whose taxes contribute to the support of our institutions, have a right to insist upon, it is just that: good management. The world looks to us for leadership, to set a standard of honesty, responsibility, and rational decision making.

You know, when I mention good management, that doesn't mean that everything always goes as expected. There is a story about a man who was invited to the opening of a new branch office of a business owned by his friend. And the man ordered some flowers sent over for the occasion, but was shocked when he arrived to see that the inscription on the floral bouquet read, "Rest in Peace." Well, on the way home, he stopped at the florist to complain. And the florist simply said, "Well, you know, don't get upset. Just look at it this way. Today someone in this city was buried beneath a floral bouquet with the inscription, 'Good luck in your new location.'"

I'd like to take this opportunity to thank each of you for the exemplary work you've been doing and to express my deep appreciation to Barber Conable and Michel Camdessus for their outstanding service.

When I first addressed these institutions 6 years ago, the United States was suffering from economic decisions that can only be described as bad management. Inflation, stagnation, and 21 percent interest rates were the order of the day.

Good management must be built on sound principle. And before our economic revolution, the decision makers increasingly put their faith in solutions that, no matter how well intended, did not work. Instead of encouraging enterprise and production, the emphasis was on bureaucratic planning and redistribution. Instead of demanding measurable results and strict accounting from public spending, the federal spigot was turned on. Resources were drained from productive, job-creating enterprise in the private sector and siphoned to questionable, ineffective, and often counterproductive government programs. Decentralized decision making in the private sector and in local and state government was supplanted by federal planning, as new power and resources were centralized in the federal bureaucracy.

But as we found out to our detriment, good management should never be mistaken with the expansion of government control and power over an economy. Good management, if it means anything, must bring a country closer to reaching its full potential and must improve the well-being of its people.

That is obviously not what was happening in the United States in the late 1970s. Policies then in place led to declining productivity, a drop in the GNP, lower real take-home pay, and a dramatic rise in poverty. In 1980, the American people called for fundamental change, reform that would put this country solidly back on the road to growth, expansion, and long-term stability.

Our goal was to increase economic activity from the bottom up. Again, good management doesn't mean amassing control and authority. It means finding ways of achieving one's objectives. In dealing with a national economy, it means opening opportunity for the people and giving them the incentive to work more efficiently and to invest in economy-building projects and job-creating businesses; it means making certain that excessive regulation doesn't strangle enterprise; it means leaving enough resources in the private sector to serve the needs of investment; it means competition, even from foreign companies; and more than anything else, it means expanding freedom and opportunity for individuals instead of increasing the power of the state.

You know, it is said that an economist is the only professional who sees something working in practice and then seriously wonders if it works in theory. Whether one agrees with the theory, the results have been undeniable. The people of the United States have now enjoyed 57 straight months of growth, which will shortly be the longest peacetime expansion in the postwar era. Inflation, which was public enemy number one in 1980, has been cut by nearly two thirds. Unemployment is down, and employment in our country is at its highest level in history. Interest rates are down. Productivity is up. Real family income is up. And we've at last reversed the rise in poverty that began in 1979.

Credit for these accomplishments belongs to the American people themselves because, as is often the case, the best thing government can do is get out of the way. And that's just what we've tried to do.

Our expanding economy has not only improved the well-being of our own citizens, but has served as an engine for progress throughout the world. The expansion of trade and international commerce during the last 6 years has helped keep our prices low, our industry and manufacturing competitive, and our economy growing. At the same time, expanding trade with the United States has helped many countries weather an economic storm. Earnings from exports to the United States, in some cases, made all the difference. The central themes of our relations, especially with developing countries, have been, and should continue to be, trade rather than aid, mutual benefit rather than charity, a hand up rather than a handout.

There is, of course, the trade deficit--something of justifiable concern both in this country and abroad. Corrections are necessary, and there are strong signs that corrections are under way. It is vital, however, that policymakers not be stampeded into self-destructive action. There has been a chorus of American politicians playing to the fears of working people, singing the song of protectionism and charging that, as a result of the trade deficit: jobs will go overseas, unemployment will rise, and the United States will be deindustrialized.

It sounds good as part of a political campaign speech, but as an old Virginia lawyer once told his hometown jury, "tain't so." Unemployment has declined in the United States by 40 percent since late 1982, even as our trade deficit has grown. In Japan and Germany, countries with large trade surpluses, unemployment has gone up. And a long-term analysis shows us holding our own in manufacturing jobs. Importantly, from the end of 1982 to the present, during a time of large trade deficits, manufacturing jobs in the United States grew by more than a million. Furthermore, real wages in manufacturing, which declined by 7 percent from 1977 to 1981, increased by 2-1/2 percent from 1981 to 1986.

The trade deficit is symptomatic of structural problems that we as managers need to address. Self-destructive protectionism, however, is definitely not the answer. I pledge to you that any protectionist legislation reaching my desk is going to be returned to the Congress with veto on the cover.

Part of the answer lies here at home. As I noted at the economic summit in Venice last June, it is imperative that the United States consistently reduce its federal deficit spending. Today, I will sign a bill that reinstates our deficit reduction targets as part of an extension of the borrowing authority of the United States Government. This was not an easy decision.

On one hand was the responsibility to preserve our 200-year history of meeting our obligations and maintaining credibility and reliability to our own citizens and to the world.

On the other hand was the political debate being waged between those who favor either raising taxes or cutting defense--or both--and those of us committed to further reductions in domestic spending, reductions that will bring down the deficit and keep our economy strong.

As I said, it was a tough decision. It should be seen as a signal that America is not backing down from its responsibilities. But having made this decision, I call on the surplus countries to do the same--to find the political gumption to stimulate their economies without reigniting the fires of inflation. It must be recognized that the health of the world economy does not hinge solely on U.S. budget policy. As U.S. budget and trade deficits decline, other countries must pick up the slack, particularly on imports from developing countries.

Our focus--and this means all of us--must be on achieving balanced growth and more open economies. Secretary Baker and finance ministers from other major countries have been working hard to devise ways to achieve these dual goals. This is a true test of our ability to manage the international economy.

Certainly we cannot succeed without an open and fair world trading system. As the pace of change picks up, it is essential that the guidelines for trade, the rules of the road for international commerce, be kept up to date and that reoccurring areas of friction be dealt with. That is why our Government is totally committed to the success of the Uruguay Round of trade negotiations. GATT has played a major role in expanding world trade and economic growth in these last four decades. Now it must address new areas, as technology and changing circumstances vastly increase the potential and scope of economic dealings between the peoples of the world. Services, investment, and intellectual property protection, formerly of only domestic concern, are now economic activities that are part of the arena of world commerce and must be included in any overall trade agreement.

The management decisions are ours to make. This is a time of tremendous opportunity to set in place a world trading structure that will carry mankind to new levels of enterprise, opportunity, and well-being. A good place to start achieving that laudable goal is with the substantive proposals the United States has set forth concerning agriculture.

For too long, our farm policies have managed us, instead of us managing them. Unless decisive and common action is taken, this growing burden could well overwhelm us. In the major western economies, farm subsidies alone have jumped from $10-$15 billion in 1970 to $100 billion in 1986. And that is just the direct costs. Billions of dollars are being spent by governments for capital investment in agriculture that would be totally unnecessary with an open trading system. Consumers in nations that limit agricultural imports are forced to pay higher prices using family resources that could be put to much better use.

The unnecessary costs, market distortions, and the inefficiencies of current agriculture policy are part of the political and economic landscape throughout much of the western world. And for that very reason, the commonality of the problem, we believe a broad-based, cooperative, international solution is the only answer.

We are asking the people of the world to consider not piecemeal reform, but revolutionary change in the production and distribution of food and fiber. We propose a total phaseout over the next 10 years of farm export subsidies, quotas, nontariff barriers, and all distortions of agricultural markets. In doing so, world food costs will be cut, government budgets spared, wasteful practices eliminated, and economic growth boosted on a broad international scale. We envision by the end of the century an open and free trading system in agricultural products throughout the vast expanses of the world: people of every land, communicating, cooperating, and competing with each other, buying and selling, producing and distributing, finding more efficient ways of meeting the universal challenge of keeping food on the table.

And what we accomplish in agriculture may some day be used as a blueprint for opening borders throughout the planet to the totality of trade and commerce of every nation--a global free and fair trading system, uniting and uplifting all mankind. And today, as we reaffirm our goals, let us underscore that, as mankind moves forward, we go together. No nation will be excluded; no people left behind.

The United States remains fully committed to doing its part in working with those developing nations that are struggling to improve the well-being of their people. Overcoming the obstacles to progress in these poorer nations is, perhaps, the greatest management challenge in the world today. A cooperative solution to the debt problem is the only real answer. It involves a partnership among developing countries, commercial banks, and international financial institutions.

The huge debt burden carried in the Third World is not just their problem; it is our problem. And today let us pledge: We will solve it together.

First and foremost, let us move forward with the understanding that there are no easy answers or quick fixes. Those who counsel otherwise are either mistaken or malicious. Now is the time for rational decision making and responsible action. Those who choose to follow false prophets, to live in an illusion instead of seeking a solution, will be left with the consequences of their actions.

What the United States has proposed is a positive program, a forward strategy, if you will, that will see debt retired not by extracting wealth from nations that are already too poor, but by increasing the level of economic activity and servicing the debt from new wealth. Last week, Secretary Baker announced added U.S. support for this program with his endorsement of expanding the resources of the World Bank. A number of proposals to strengthen the Fund's ability to promote growth-oriented reform will be advanced soon. But this alone will not be enough.

Leaders in debtor nations have tough decisions to make. Our slogan must be: It can be done.

And let no one suggest that some people are condemned by culture or race to misery and deprivation. Victor Hugo once wrote: "People do not lack strength; they lack will." And the "will" comes from a realization that one can accomplish what one sets out to do, that great deeds are possible.

What is needed is commitment and, as in all good management plans, a model that works. The world is not without such models. In the last 30 years there has been extraordinary growth and economic advancement in what were underdeveloped nations around the Pacific Rim, some of which are poor in every significant natural resource, including adequate territory. These peoples have overcome great difficulties, improved their living standards, and become a major force in the world economy. They have done so using economic concepts similar to those that helped reinvigorate America's economy these last 5 years. Tax structures and regulatory policies designed to encourage investment and enterprise are the magic behind the miracle.

And debt, coincidentally, has not been the serious roadblock to growth on the Pacific Rim that it has been elsewhere.

The success I'm talking about is in stark contrast to the misery and decline so evident in nations that have followed statist development models. In many parts of Africa, collectivism has brought decline even in countries rich in natural resources. There are, however, reasons for hope that the corner has been turned in Africa. A growing commitment to economic reform is one of the most promising developments in years. Senegal, Ghana, Cameroon, and Malawi are some of the countries where market-oriented reforms are being put in place. The World Bank and the Fund are supporting these efforts. The United States will do all we can. U.S. economic efforts in sub-Saharan Africa are aimed toward ending hunger through economic growth, policy reform, and private sector development. My hope is that cooperative support for policy reform in Africa--including the active participation of other donor countries and institutions--can eliminate hunger in Africa by the end of the century.

The promise in some African countries is in stark contrast to the continuing plight of Ethiopia. It's time to admit that in Ethiopia, statism, as well as drought, was the cause of a human tragedy that touched the hearts of people throughout the world. Yet even as food, medicine, and other humanitarian support has poured into Ethiopia--donated by caring people in western countries--the Marxist Government there, supported by the Soviet Union, has barreled down a path that obliterates hope for the future. Sadly, famine again is returning to that land, and it is becoming ever more clear that fundamental changes must occur if their 2,000-year-old society is to survive.

Ethiopia, of course, is an extreme example. Nevertheless, there is an undeniable relationship between freedom and human progress in every part of the world. The more repressive the government, the more controlled the economy, the more confiscatory the taxation, the more likely a society is to sink into poverty and despair. John Dos Passos was so right when he observed, "Marxism has not only failed to promote human freedom. It has failed to produce food."

Leaders in China understood this when they began easing their country toward a freer economic system. Reform in China is now widespread and dramatic. From 1979 to 1985 the value of agricultural output in China rose at more than double the rate of the 15 previous years. Rural per capita income more than doubled. The total grain harvest went from 300 million tons in 1978 to over 400 million tons in 1984. In fact, in 1985, for the first time in 25 years, China became a net grain exporter. Similar progress is being enjoyed in other areas of the economy where reforms have been instituted.

Throughout the world, people are realizing that moving forward will require cutting themselves free from statist controls and from the weight of heavily subsidized government enterprises. In many industrialized countries, and in Third World countries as well, deregulation is the order of the day. Instead of looking at private enterprise as the adversary, many governments now see it as their best hope for progress and development. Tax rates are being lowered from New Zealand to France, from India to England. Government corporations are being privatized, denationalized, and cut off from subsidies from Ghana to Argentina, from the Philippines to Mexico.

The impetus for privatization directly complements efforts to reduce the debt burden. Debt-equity swaps can offer a method of turning money-losing government operations into tax-paying private businesses. The debt is reduced and a budget obligation is eliminated. The government is, thereby, free to use its resources and focus its attention on other matters.

My Presidential Task Force on Project Economic Justice, headed by Ambassador William Middendorf, recommended that this method could be used not only to bring down the debt and stimulate privatization, but to expand employee ownership as well. Bold, innovative ideas like this are consistent with the overall American debt strategy and deserve to be given serious consideration. What is not needed now is business as usual. The United States will continue working with all those who are putting forth an honest effort to deal with the debt dilemma.

As vexing as our problems are, let no one doubt democracy works. The unbridled energy of free people is the most powerful, creative, and moral force on this planet. And through all the political maneuvering and public debate, through the arduous negotiations, compromises, and balloting, one cannot but feel that he or she is part of something far more grand, far more historic. There is more evidence every day that the future is on the side of the free. In the Western Hemisphere, the 1980s has seen an historic shift to democracy. Today 90 percent of the people of the hemisphere live in countries that are either democratic or in transition to democracy.

All who love liberty are heartened by the return to democracy in the Philippines and by recent events in South Korea. All this is reason for confidence that mankind is truly moving into a new era of freedom and prosperity, these two mutually reinforcing goals.

Andres Bello, intellectual giant of the last century, once wrote: "All truths touch on one another, from those that govern the path of the planets in space...to those that delineate the actions and reactions of political forces....Progress in one line attracts progress in all others, all are connected and propel one another forward."

Today we are part of that process of free men and women that is propelling mankind forward. The World Bank, the International Monetary Fund, and each of you are playing a vital role, and it has been my honor to speak with you today.

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Press Release No. 5

September 29, 1987

HOLD FOR RELEASE
UNTIL DELIVERY

Statement by the Hon. SATOSHI SUMITA,
Governor of the Bank of Japan and Alternate Governor
of the Bank and Fund for JAPAN,
at the Joint Annual Discussion

It is indeed a pleasure to have this opportunity to meet with the honorable Governors for a constructive exchange of views on the many issues of mutual concern. Before stating my own views on these issues, I would like to express my appreciation for the arrangements that the United States has made for these meetings and my high regard for the outstanding leadership that the Managing Director of the Fund, Mr. Camdessus, and the President of the World Bank, Mr. Conable, have demonstrated and the peerless support that they have received from their staffs.

1. Current Situation and Problems Ahead for the World Economy

1.1 Outlook

At our last meeting, we reaffirmed our shared concern in sustaining economic growth, stabilizing exchange rates, and reducing international imbalances. Over the last year, we have made efforts to attain these goals and thereby to achieve sustained and noninflationary world economic growth.

As a result of these efforts, the world economy has continued its gradual but steady growth, with the industrial countries in particular showing signs of economic expansion. These developments bode well for our shared future.

Much of the progress that has been achieved may be attributed to efforts that have been made for policy coordination to stabilize exchange rates. At the same time, the progress in policy coordination is contributing importantly to the alleviation of external imbalances. Adjustments in the trade flows are already under way.

1.2 The Role of the Japanese Economy

Japan has contributed to these favorable international economic developments.

As Governor Miyazawa told you when we met last year, Japan fully recognizes its international responsibilities in the management of its economy.

In 1986, the Japanese economy recorded strong 4 percent growth in domestic demand, although the negative growth in external demand that resulted from the yen's appreciation and other factors brought the overall growth rate down to 2.4 percent.

Looking at the economic situation since the beginning of this year, domestic demand has been increasing vigorously and our economy is firmly on the road to recovery. For example, individual consumption has continued steady growth and housing starts have enjoyed double-digit growth for four straight quarters beginning in the third quarter of last year. Capital investment has also picked up recently after last year's sluggishness. This expansion in domestic demand is pulling in more imports and contributing to the balanced development of the world economy.

While promoting policy coordination with the other leading countries, we announced emergency economic measures in May, despite our severe fiscal constraints, to ensure that domestic demand continues expanding and the overall economy continues growing vigorously and to reduce the international imbalances for more harmonious external economic relations.

These economic measures include unprecedented front-loading of public works, a record Y 5 trillion (about $36 billion) in additional expenditures for public works and the like, and the advanced implementation of income tax reductions. The supplementary budget for these economic measures was passed in July.

Earlier this month, a tax reform bill was passed providing for a total of Y 1.54 trillion (about $11 billion) in income tax cuts. These latest reductions have been accompanied by the reform of the tax-exempt savings system.

These are just a few examples of how we are seriously working to respond to the social and economic changes taking place in Japan and the rest of the world.

These measures are expected to ensure continued firm growth in domestic demand and steady economic recovery.

Japan is determined to achieve noninflationary economic expansion led by strong domestic demand. We believe this will contribute to enhancing the quality of life and will meet the expectations of the countries that have called upon Japan to play a greater role commensurate with its increasing importance in the world economy.

Looking at financial and capital markets, we have instituted a number of measures to deregulate interest rates, to strengthen and expand short-term financial and capital markets, to improve access to Japanese markets for foreign financial institutions, and otherwise to promote the deregulation and internationalization of the Japanese financial and capital markets.

Consistent with the progressive globalization of markets, we are working to ensure that Japanese financial and capital markets are able to play an important role in the world. In June we announced further interest deregulation, the establishment of a market for commercial paper, and other changes to further enhance short-term financial markets. I assure you that we intend to proceed apace with deregulation and internationalization.

1.3 Issues for the Future

Despite the progress that has been made, there are still a number of important issues remaining in the world economy.

The first of these is that of promoting noninflationary world economic growth and reducing the still-large external imbalances while continuing to work to reduce the massive fiscal deficits in many of our countries in light of the problems they cause. Policy coordination and exchange rate stability are both very important in this context.

Second is the need to resolve the serious problems of debt and development. This is not simply an issue facing the developing countries but is a crucial issue for all of us, for failure to achieve a satisfactory solution could easily impact adversely on the industrial countries and disrupt the entire world economy.

In seeking to resolve these problems, it should go without saying that it is imperative that we roll back the protectionist pressures emerging in some quarters and preserve and strengthen free trade arrangements. In this regard, I am most hopeful that major progress will be made in the Uruguay Round of Multilateral Trade Negotiations, and I urge all countries everywhere to make the maximum effort to ensure that these negotiations are successful.

2. International Policy Coordination and the Outlook for a Stable Monetary System

2.1 Policy Coordination and Exchange Rate Stability

The cooperative efforts that have been made since the 1985 Plaza agreement have enabled us to achieve the goal of rectifying the prolonged overvaluation of the U.S. dollar and have taken us on the first strong step toward a solution of the issues bedeviling the world economy.

Consulting closely since our last meeting, we have engaged in both macroeconomic policy coordination and exchange market cooperation. While this may lack the drama of a major institutional change in the international monetary system, I am confident that such an incremental and practical approach is the best way to achieve steady progress and evolution in the monetary system.

Our cooperation in exchange markets should be seen not simply as a means of tiding us through a time of temporary volatility in exchange rates but as a part of our international cooperation toward the longer-term goals of achieving sustained and noninflationary growth and reducing the major external imbalances.

The international consensus evolving through the process of such pragmatic efforts and cooperation offers the prospect of a stable monetary system. Japan has been, and will continue to be, an active participant in this process.

The current international monetary system was launched in 1978 when it was decided, in the Second Amendment of the Articles of Agreement of the Fund, to abolish the official price of gold and to gradually reduce gold's role. This was indicative of our determination that it should be possible to stabilize international currency values through resolute agreement even without the traditional crutch of the gold exchange standard. I am convinced that we must persevere in this direction.

Although the dollar continues to play an important role as a key reserve currency, we are encouraged to see that the Japanese yen is one of the currencies which has also been playing an increasingly important supplementary role. Consistent with this, Japan has promoted the yen's internationalization. While SDRs now serve primarily as a safety net for future contingencies, I believe it is important that we continue to re-examine their function in the international monetary system.

2.2 The Role of the Fund

I have the highest regard for the role that the Fund has played in the development of our current international monetary system. I am encouraged at the progress being made in studies on implementing multilateral surveillance consistent with increasing international policy coordination. I am confident that it will contribute to international monetary stability for the Fund to provide the *World Economic Outlook* and other materials for discussion and for the member countries to undertake their best efforts to reach understandings on the basis of free and full discussion of these materials.

Seeking to further strengthen the central role of the Fund in promoting international monetary stability, it is imperative that we enhance the Fund's financial base. This enhancement should be in the form of a quota increase, and Japan intends to contribute to the forthcoming ninth quota increase commensurate with its economic abilities.

The Fund has also played an important role for the defusing and resolution of the debt problems, and I very much hope that it will continue to play this central role. From this perspective, I am therefore appreciative of the fact that the Trust Fund established in 1976 and financed with the proceeds from the sale of the Fund's gold stock was used to assist countries facing severe balance of payments difficulties, and that the structural adjustment facility (SAF) was established last year utilizing the repayments to the Trust Fund. Regarding the enhancement of the SAF now under discussion, I hope that the negotiations between the Fund and the countries concerned will result in the creation of a framework conducive to positive cooperation, and, assuming this can be done, Japan is prepared to participate within this framework.

3. Responding to the Debt and Development Issues

3.1 The Debt Situation at Present and the Basis for a Viable Debt and Development Strategy

The developing countries still face serious debt situations. Their debt outstanding continues to rise, and, even though it is anticipated that the increase will taper off a bit, no decline appears in store.

While the developing countries' own self-help efforts are basic to any strategy to solve the debt problem, it is important that the international institutions, industrial countries, and private banks undertake cooperative actions to respond to the problem on a case-by-case basis. Japan believes it is important that the debtor countries, in keeping with their growth-oriented economic structural adjustments, adopt market-oriented debt and development strategies, including the promotion of the private sector, encouragement for the financial and capital markets, higher savings ratios, efforts to block capital flight, and the creation of a climate conducive to attracting more direct investment.

3.2 Japan's Positive Response

Over the last year, Japan has been acting to resolve these debt and development problems by seeking to recycle a total of approximately $10 billion, including the establishment of a special fund within the World Bank and increased lending to the Fund. This May, we announced that we would recycle an additional $20 billion of completely untied public and private funds to the developing countries over a three-year period. These funds will be recycled in the form of budgetary contributions to the multilateral development banks, their additional borrowing on Japan's financial and capital markets, and cofinancing with these institutions by the Export-Import Bank of Japan, the Overseas Economic Cooperation Fund, and commercial banks.

Looking at official development assistance (ODA) overall, Japan is working for the earliest possible implementation of its Third Medium-Term Target. We have thus decided to advance the original seven-year doubling target by two years and to see that our actual ODA disbursements during 1990 are in excess of $7.6 billion.

3.3 Strengthening the Role of International Financial Institutions

Understandably, there are increasing expectations of the role to be played by the international financial institutions in this international response to the debt and development problems. Japan supports the strengthening and enhancement of the international financial institutions to enable them to respond to the development challenge.

Both the Fund and the World Bank have central roles to play in the solution of the debt problems, and it is essential that the World Bank, in cooperation with the Fund, support the debtor countries' growth- and market-oriented adjustment efforts and that it step up its policy advisory capability to enable these countries to regain the financial community's trust. Likewise, every effort should be made to provide these countries with the additional resources they require as efficiently and effectively as possible, including the greater use of structural adjustment loans and sector adjustment loans. Given the size of these countries' debts, it is increasingly hoped that the World Bank's catalytic role will be successful in promoting the flow of private and official funds to them. In this sense, the World Bank is being called upon to expand cofinancing and to make active use of loan guarantees.

I very much hope that the reorganization that is nearing completion within the World Bank will enable the Bank to play the expanded and enhanced role that we and so many other people envision for it.

At the same time, there is also a clear need for strengthening the Bank's capital foundations to enable the Bank to meet these heightened expectations. A general capital increase is urgently needed. I am therefore delighted that agreement has been reached on starting negotiations for a new general capital increase, and I would like to express my respects for the constructive approach that the United States has brought to this issue.

3.4 Expanded Flow of Private Sector Capital

One of the most important factors in solving the debt and development problems is the question of how best to promote and ensure the flow of funds--particularly private sector funds--to the developing countries.

In this regard, it is imperative that the Multilateral Investment Guarantee Agency (MIGA) be established as soon as possible to promote greater direct investment. Recognizing MIGA's importance, Japan was the first industrial country to ratify the Convention establishing MIGA this June. We very much hope that other countries will follow suit and that MIGA will be up and running without delay.

It would also be useful to consider the possibilities for new multilateral frameworks and schemes to mitigate the risk of exposure in the developing countries and hence to contribute to promoting the flow of new money from private sector financial institutions to these countries.

At the same time, we also value the important work being done by the International Finance Corporation (IFC) in establishing developing country investment funds and otherwise promoting the flow of private sector capital to the developing countries in the form of equity investment, direct investment, and the like.

IFC should quite rightly play a central role in arranging debt-equity swaps in the developing countries to reduce their debt burdens and to revitalize their economies.

3.5 Responses for the Low-Income Developing Countries

In seeking to promote development in the sub-Saharan and other low-income developing countries, we must recognize the difficulty of obtaining private sector capital flows and must work to expand the availability of concessional funds.

The International Development Association (IDA) has a major role to play here. I am therefore gratified that the negotiations for IDA-VIII were concluded with agreement on a $12.4 billion scale and that this agreement is about to go into effect. For our part, Japan has already notified the Association of its commitment to participate in the Replenishment.

In addition to the recycling that I already mentioned, Japan intends to provide approximately $500 million over the next three years in nonproject grant assistance to these low-income developing countries.

4. Conclusion

The expansion of trade and capital mobility has made all of our economies highly interdependent. As a result, the need to achieve balanced development for the world economy increasingly requires that all of us promote mutual understanding and work to implement cooperative policies in our shared best interests.

I am encouraged by the fact that the Fund and the World Bank are crucial catalysts and major forums for this mutual understanding and cooperation, and I trust they will continue to play central roles as our consciences and our better selves.

Cooperating with the other member countries, Japan intends to play a leading role within the Fund/World Bank structure and to work to the benefit of the industrial countries and the developing countries alike, for we know that this is one of the crucial issues for humanity. The only future we have is a shared future. It is up to us to make it work.

BOARDS OF GOVERNORS • 1987 ANNUAL MEETINGS • WASHINGTON, D.C.

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
INTERNATIONAL FINANCE CORPORATION
INTERNATIONAL DEVELOPMENT ASSOCIATION
INTERNATIONAL MONETARY FUND

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Statement by the Hon. EDOUARD BALLADUR,
Minister of State for Economy, Finance and Privatization
and Governor of the Fund for FRANCE, at the Joint Annual Discussion

This year's Annual Meetings of the World Bank and the International Monetary Fund should, in my view, mark a special stage in international cooperation:

The strategy of cooperation instituted by the Louvre agreement represents a genuine success and, in my opinion, gives encouragement to those who, like myself, believe in the need to restore a more stable international monetary system.

The debt strategy adopted in Seoul must be pursued and adjusted. In this regard, I call upon the international community to give the multilateral institutions the means to cope with their task.

What is the state of the world economy? Inflation is again at a very low rate and seems unlikely to accelerate. We have had more than five straight years of growth, although the growth rate has fallen to a level which I deem too low. World trade is expanding, but inadequately. The trends in the developing countries are highly uneven, ranging between the two extremes of remarkable growth in the newly industrialized countries of Asia and intensifying difficulties in the poorest African countries south of the Sahara.

To help improve the world economic situation, both the industrial countries and the developing countries have a part to play.

The contribution which the major industrial countries can and must make lies first of all in consistent application of the cooperative strategy set forth at the Louvre in February and repeatedly confirmed since then. We have already seen the results in terms of exchange rate stabilization, and that is no small matter considering the risks of inflation and recession which a dollar slippage would impose on the world economy. The studies prepared by the Fund bear this out. This success, in my view, confirms our ability to organize and manage an orderly monetary system. It is necessary, of course, for the largest countries to demonstrate the will to cooperate through sound and compatible economic policies. France, which, you will recall, has always supported this view, is more convinced of it today than ever.

We must naturally continue along this path. The major industrial countries have just confirmed the Louvre agreement. This means that each of them must provide itself with the means to honor its commitments. To this end, it is necessary to continue to reduce deficits where needed and to favor high levels of growth in the surplus countries.

I would also stress the need to avoid another rise in interest rates, which would place a hurdle in the way of our hopes for growth and would severely burden the indebted countries.

These efforts are vital if we are to avoid the worst of all solutions--resorting to protectionism. The temptation is there; we must resist it. My country attaches great importance to the new round of trade negotiations launched a year ago at Punta del Este.

These negotiations will be lengthy and difficult, but they are crucial for the strengthening of the multilateral system. They will have to cover all aspects of trade, while preserving their global nature. France, which will consistently strive for this balance will contribute fully to these negotiations.

I turn now to the developing countries. As a whole, they are pursuing rigorous recovery and adjustment programs with determination. But they must persist in their efforts in order to promote an in-depth strengthening of their economies and lay the groundwork for a return to lasting, balanced growth. Let us not delude ourselves: the adjustment process will be long. But, in return, the international community must give solid backing to the recovery effort. How can we expect sacrifices of some if the rest of us are not willing to make any?

It is therefore vital that we mobilize adequate financial resources for development. This is not happening today. These resources can be provided mainly by the multilateral institutions. However great the efforts--often underestimated--made by the Paris Club and international commercial banks, however great the effort made to attract private capital, only the multilateral institutions, especially those of Bretton Woods, are in a position to make sufficiently rapid, meaningful, and large contributions. But what is actually occurring? The net contribution of the Fund is becoming negative and the lending capacity of the World Bank is approaching exhaustion.

This situation cannot go on. The international community must urgently take further steps to demonstrate its commitment. I shall limit myself at this point to stressing three areas for priority action.

In 1984 my country was the first to give vigorous support to a general capital increase for the World Bank; it is imperative that this increase take place promptly and be substantial in size. The start of the negotiations has already been too long in coming. A figure of about US$80 billion seems reasonable to me. I also think it desirable for the financial terms of the World Bank loans to be eased for the benefit of middle-income countries.

With respect to the Fund, its Articles provide that a decision on the Ninth General Review of Quotas must be made by March 31, 1988. I feel that a substantial increase is needed, one that would enable the capital of the Fund to keep pace with the world economy. Since 1965, the Fund's capital has been reduced by half in relation to world production, and by two thirds in relation to world trade. The Fund's financing must continue to be based chiefly on quotas, not on borrowing. This is necessary if its assistance is to be on more attractive terms than those offered by the market.

The Bretton Woods institutions must also adapt their activities to the needs of the poorest countries; this is a priority of the international community.

The approach most appropriate to their needs rests on a substantial increase in the long-term resources available to them on highly concessional terms.

The proposal of the Fund's Managing Director for a tripling of the structural adjustment facility is certainly the most significant initiative of those to which we must react. It meets some of the objectives of the proposals I made in April, and I regard it as a priority. My country therefore supports it fully and indeed expects to see it adopted by the end of the year. I can assure you that I shall work toward this end, and I hereby announce that France is prepared to devote at least US$500 million to it over the next three years.

My country also globally supports the suggestions of the World Bank regarding the contribution of further resources. Moreover, a significant portion of French bilateral aid is used to support the adjustment programs undertaken by developing countries. It is, of course, a priority that the Eighth Replenishment of IDA resources be implemented promptly.

The debt consolidation effort in the Paris Club must also be pursued. I am pleased to note that an extension of rescheduling periods has now been applied to the very poor, highly indebted countries which are engaged in adjustment efforts.

With respect to the objective of a reduction in interest rates on existing debt, a consensus on two steps which would have an immediate impact should not be beyond reach. First, concessional rates on rescheduled development assistance loans should be systematically applied, and, secondly, the margins charged by creditor countries over the cost of their borrowed funds should be reduced, or even eliminated, on consolidated commercial credits.

This reference to the Paris Club naturally leads me to bring up the case of the highly indebted middle-income countries. A moment ago I mentioned how important it is to strengthen the Bretton Woods institutions, whose resources are a key element in the process of balance of payments adjustment for these countries.

But efforts to mobilize commercial bank financing and to expand private investment are no less essential. Progress has been made, for example, with the idea of "menus with options," which I personally hope will be as diversified and as imaginative as possible, provided that the fundamental principle of freedom of choice for banks is upheld.

I cannot conclude without reiterating how concerned I am with the trend in commodity prices.

The drop in prices has been so sharp and persistent that it seriously jeopardizes the economic potential of many developing countries and raises doubts about whether the courageous adjustment efforts they have undertaken have any chance of success.

That is why I deem it crucial for the international community to strengthen its activities in this area. The review of the compensatory facility we have agreed to will give us an excellent opportunity for reflection.

All of us know how attached France is to the effective launching of a common fund for commodities. I hope that this fund will soon be established. It will then be necessary to look realistically at the procedures for using its resources. I also think that the World Bank must play an active role in this area.

Those, then, are the principal concerns guiding my country. I shall conclude by appealing to the imagination and generosity of the international community as a whole, so that further progress may be achieved. You may rest assured that France, for one, will continue to do its utmost to work toward this goal.

ROME, OTTAWA, PARIS, TOKYO, BONN, UKDEL OECD AND UKMIS BRUSSELS

IMF: INTERIM COMMITTEE

Summary

A relatively low-key meeting although underlying tensions were not all that far below the surface.

2. There was general agreement that moderate growth was continuing in the industrial countries. The success of the Louvre accord was welcomed. Governors stressed that the associated policy commitments needed to be fully implemented if the present unsustainably large current account imbalances among the major countries were to be reduced.

3. Governors recognised that the situation facing many of the ldcs remained difficult. There was general recognition that the broad lines of the debt strategy remained appropriate although it might need to be strengthened in certain areas. Bresser Pereira (Brasil) and Sourreille (Argentina) both emphasised the very difficult situation facing the ldcs and that substantial measures to ease the effective debt burden were required but stopped short of explicit threats or demands.

4. The discussions on SDR allocations, the Quota Review and the enhancement of the SAF revealed little new. The US attitude towards contributing to the SAF at least in the short-term has apparently hardened somewhat as a result of their decision to support an early GCI.

5. All Governors said that they were now willing to maintain current access limits in 1988 although in the US' case this was only on the understanding that the quota review would not be concluded until after March 1988.

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Detail

6. The 29th meeting of the Interim Committee was held in Washington on 27 September, 1987. The communique was released to the press on the morning of 28 September. Copies of the Chancellor's statements have already been faxed to London. A copy of the communique has been sent separately by savingram.

7. The meeting discussed the World Economic Outlook, SDR allocations and the access limits for 1988 in the morning before turning in the afternoon session to the debt situation (including the proposal to triple the size of the SAF) and the Ninth Quota Review.

World Economic Outlook (WEO)

8. There was general agreement that moderate growth was continuing in the industrial countries despite uncertainties which continued to mark the world economy. Governors from the industrialised countries saw this as being a relatively favourable outcome for this stage in the cycle and stressed that the recovery looked set to continue. They noted in particular that inflation and other imbalances which had ended past recoveries, were notable by their absence. Baker (US), Miyazawa (Japan) and Stoltenberg (Germany) all stressed that they were fulfilling their Louvre commitments. The ldcs were less sanguine however. They noted that growth in the major countries was likely to remain below 3% - a level which some had viewed as being the minimum acceptable if the debt problem was to be resolved. They also stressed that continuing budgetary and current account imbalances among the major countries posed a threat to continued growth.

9. There was a range of views on the outlook for the ldcs. At one extreme, Baker was fairly optimistic. He stressed that considerable progress had been made in recent years. Growth in the ldcs this year and next was expected to be reasonably robust. The ldcs themselves were again much more gloomy. They stressed the weakness of export earnings as a result of low commodity prices and protectionist barriers in the industrial countries. Sourrouille emphasised in particular the damaging consequences of the recent increases in interest rates.

10. Governors welcomed the evidence of improved policy coordination among the major countries. They supported the objectives of the Louvre accord and emphasised the importance of avoiding exchange rate fluctuations. Balladur (France) thought that a further significant fall in the dollar would be likely to lead to a recession. The fall in the US fiscal deficit in FY87 was recognised but Governors stressed that more would be needed in future years. The recent stimulatory measures in Japan were fairly widely welcomed. Germany was also recognised to be taking steps to implement its Louvre commitments. In both cases however, several Governors clearly thought that further stimulatory measures (perhaps particularly in Germany's case) would be required if adequate domestic demand growth was to be maintained.

11. There was general agreement on the importance of resisting protectionism. Abalkhail (Saudi Arabia) felt that the increase in protectionist pressures in the industrial countries reflected underlying structural rigidities which ought to be tackled directly. Baker and Stoltenberg among others stressed that the NICs had to play their part in reducing current account imbalances by opening their markets and allowing their currencies to reflect the strengths of their external positions.

12. There was general recognition that the indicators exercise had been valuable and that it should be further strengthend. Beyond that there were very few concrete suggestions, although Baker did promise to devote part of his speech at the annual meetings to some ideas on how the indicators exercise might be incorporated into the WEO's medium term scenarios. Miyazawa was particularly gratified that there now seemed to be general agreement that the indicators exercise should not be used to trigger automatic policy changes or even multilateral discussions and that indicators should not be used to try and fine tune economic performance. He felt that it was important to recognise that the figures in the medium term scenarios were, at best, rough approximations. Feldt (Nordics) on the other hand thought that exchange rates had to be given a central role in the indicators exercise as signals of potentially unsustainable positions.

He suggested that the Managing Director should make more use of supplemental consultations. He argued that the staff should try and construct an exchange rate indicator which could be used to trigger multilateral policy discussions.

SDR Allocations

13. Governors rehearsed the usual arguments concerning SDR allocations. There were no changes in existing positions.

Enlarged Access

14. All governors (including the Americans, Germans and Japanese who had argued for a modest reduction in access limits at the Executive Board's preliminary discussion - our savingram 334 not to all) supported maintaining existing access limits for 1988. Baker said however that he could only do so on the understanding firstly that the Fund would continue with its cautious application of the limits and secondly that it was understood that there would not be early progress on the quota increase. The ldcs argued for the maintenance of existing limits and for the Fund to give higher actual access by using more of the room within the ceilings.

15. Bresser Pereira, Tiwari (India) and other ldcs commended the recent G24 report on the role of the Fund and argued that it should be considered at the Interim Committee's next meeting.

Debt Strategy

16. The discussion of the debt strategy was divided into two sessions, the first of which dealt with the middle income debtors and the second with the low income debtors and the enhancement of the Structural Adjustment Facility (SAF).

Debt - the Middle Income Debtors

17. Baker opened this session. He emphasised the progress that had been made in tackling the debt problem during the last two years. The debt strategy had worked and its basic principles remained valid. Growth in the

ldcs had picked up and the debt stock was growing more slowly. Important progress had been made in many countries (he cited in particular Colombia, Mexico, Chile and the Philippines). The need was to persevere with the basic elements of the strategy. The MENU approach should be fully utilised. Stoltenberg shared much of Baker's analysis.

18. Bresser Pereira and Sourrouille were much more gloomy although they stopped short of making any explicit threats. Bresser Pereira felt that the debt strategy had, at best, been a temporary palliative. Ldc growth had been disappointing. The ldcs had faced further deteriorations in their terms of trade. Financial flows had proved inadequate and investment had fallen commensurately. The flow of resources out of the ldcs should be reversed. Some countries had been forced to stop paying. Despite enormous efforts, the situation remained unbearable. The main beneficiaries of the strategy had been the banks. In sum the strategy was exhausted and the discounts in the secondary debt market showed the true situation. A longer term solution was needed. The interest burden should be reduced to historical levels and longer terms granted. Debt should be restructured in line with countries' payment capacities. One possibility which should be examined was converting some debt into securities with appropriately modified terms.

19. Sourrouille echoed Bresser Pereira's remarks. Ldcs needed more resources. The debt service burden needed to be reduced. Ldcs should not be asked to adjust to external shocks which were not of their own making, rather these should be financed. The Fund should do more and the CFF should be expanded. The interest burden facing ldcs as a result of currently high real interest rates should be eased. Although some had welcomed the innovatory ideas included in the recent Argentinian financing package, it was instructive that the exit bonds option had not been very successful. Failure to act on the part of the international community was likely to lead to tension beyond that which the peoples and governments of the ldcs could bear.

Debt - Low Income Debtors

20. The discussion on the low income debtors mainly concentrated upon the various proposals currently being discussed to ease their debt burden and particularly the proposed enhancement of the SAF.

21. The Managing Director opened the session with a lengthy defence of his SAF proposal. He stressed the need for the Fund to remain involved in the poorest countries. Even tripling the available resources would only make a relatively modest contribution to the problems. He urged countries which supported the initiatve to make firm commitments without making these dependent upon the contributions of others.

22. In response, the potential donors all stressed that they warmly welcomed the initiative but few were willing to go beyond their existing positions (see our telno 235 - not to all). Indeed Greenspan (US) went rather further than the US have in the past in saying that they would not be able to contribute as the Administration had now decided to back a GCI and that this would have to be given priority. It was not clear whether the US would in due course consider a contribution.

23. Trichet (for Balladur) noted France's pledge to contribute at least $500 million. He thought that all countries should do their best but that explicit burden sharing was not appropriate. However others generally thought that some form of reasonable burden sharing would be necessary. Feldt said that the Nordic countries were considering how to participate but that reasonable burden sharing was essential. Sumita (Japan) said that Japan was willing to contribute within the context of a fair burden sharing arrangement and re-iterated the suggestion that half of the increase might be found from sales of the Fund's gold holdings. Eyskens (Belgium), Tietmeyer (Germany) and Amato (Italy) also thought the possibility of gold sales worthy of further examination. Duisenberg (Netherlands) said that the financing arrangements should be left flexible and that his authorities were attracted by making their contribution in the form of co-financing with the IBRD. Wilson (Canada) said that he would be willing to contribute SDR 200 million to a <u>tripling</u> of the SAF provided that there were widespread contributions by others.

24. The ldc's generally confined themselves to welcoming the SAF enhancement and urging potential donors to reach early agreement so that disbursements could begin in early 1988. They also hoped that these resources would be truly additional. Malhotra (India) said that the terms and conditions - including eligibility - of the enhanced SAF should be the same as those under the original SAF even if some countries decided not to draw.

25. Several governors also commented on the Chancellor's initiative. Feldt said that he believed that further consideration needed to be given to the possibility of granting concessional interest rate reductions in the Paris Club to the poorest countries. Personally he favoured this proposal although he noted that others in his constituency favoured other measures which would have a similar overall effect. Sumita noted that the Japanese government was already doing a lot for the ldcs. He thought that it would be difficult to do more on the interest rate front although other additional measures with similar overall results could be considered. Duisenberg also had doubts about interest rate concessions but thought that the idea was worthy of further study.

Ninth Quota Increase

26. Governors' comments on the Ninth Quota increase were fairly brief. There was general agreement that the Fund should primarily rely upon ordinary rather than borrowed resources. Most Governors argued that the review should be completed as soon as possible - preferably before March 1988. Mulford (US) on the other hand said that the review should be continued beyond that date. Sumita favoured a substantial increase and noted that the divergences between calculated and actual quotas remained significant and argued for a relative adjustment of individual positions. Several of the ldcs, on the other hand, noted that their relative calculated quotas had declined and argued that their share in total quotas should be at least maintained. Malhotra argued for the inclusion of a poverty index in the formulae. If that were not accepted, the quota increase should mainly take the form of a proportional rather than selective increase in order to protect the ldcs overall position.

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DEVELOPMENT COMMITTEE: 28 SEPTEMBER 1987 (30TH SESSION)

SUMMARY

1. A LOW KEY MEETING FOCUSSING MAINLY ON DEBT, AND MARKED BY THE RESTRAINT SHOWN BY DEBTORS IN PRESSING UNCONVENTIONAL APPROACHES TO THE DEBT PROBLEM. CONSIDERABLE PROMINENCE GIVEN TO THE ROLE OF PRIVATE INVESTMENT. SECRETARY BAKER'S CONVERSION TO THE NEED FOR AN EARLY GCI DEFUSED THE THIRD MAIN TOPIC ON THE AGENDA, THE WORLD BANK'S CAPITAL REQUIREMENTS, AND THERE WAS A UNANIMOUS CALL FOR AN EARLY COMPLETION OF NEGOTIATIONS.

2. IN SPITE OF CONSIDERABLE PRESSURE BY THE CHANCELLOR FOR HIS DEBT INITIATIVE, LITTLE MOVEMENT FROM MAJOR CREDITORS, WITH HARDLINE POSITIONS CONTINUING TO BE ADOPTED BY US, GERMANY, JAPAN, NETHERLANDS, AND LITTLE HELP FROM FRANCE. COMMUNIQUE WORDING REPRESENTS A SLIGHT ADVANCE OVER VENICE.

DETAIL

ACTION FOR LOW-INCOME SERIOUSLY INDEBTED COUNTRIES

3. THE SAF ENLARGEMENT, CHANCELLOR'S INITIATIVE, AND THE WORLD BANK COFINANCING PROPOSALS, WERE THE THEMES OF THE DISCUSSION. PROCEEDINGS ARE REPORTED IN MORE DETAIL IN A SEPARATE TELEGRAM TO FOLLOW. STRONG US AND SAUDI OPPOSITION TO RTA. GENERAL CALL FOR MAKING IDA 8 EFFECTIVE AS SOON AS POSSIBLE.

HEAVILY INDEBTED MIDDLE-INCOME COUNTRIES

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4. THE G24 CALLED FOR A RECASTING OF THE CURRENT DEBT STRATEGY AND AGAIN PROPOSED A DEBT TASK FORCE. LATIN AMERICAN INTERVENTIONS CONTAINED REFERENCES TO SECONDARY MARKET VALUATION OF DEBT AND IDEA OF RELATING INTEREST PAYMENTS TO IT. BAKER STRESSED POSITIVE FEATURES OF PROGRESS SO FAR AND PRODUCED NO NEW IDEAS, THOUGH HE FORECAST SOME FOR HIS ANNUAL MEETINGS SPEECH. OTHER G5 MEMBERS SUPPORTED CASE BY CASE AND MARKET-BASED APPROACHES. JAPAN FLOATED TWO LARGELY UNDEFINED PROPOSALS FOR FURTHER STUDY (SPEECH BY BAG):

(I) GUARANTEEING COMMERCIAL BANK LENDING AGAINST NON-COMMERCIAL RISKS THROUGH SOME MULTILATERAL MECHANISM, POSSIBLY LINKED WITH MIGA,

(II) A FACILITY FOR REDEMPTION OF DISCOUNTED DEBT ORGANISED BY IFC.

IBRD CAPITAL REQUIREMENTS

5. BAKER CONFIRMED THE US' RECENTLY ANNOUNCED READINESS TO PROCEED WITH EARLY SUBSTANTIVE NEGOTIATIONS ON THE GCI. THERE WAS PREDICTABLE WELCOME ACCOMPANIED BY UNANIMOUS AGREEMENT THAT MATTERS SHOULD NOW MOVE FORWARD TO ENABLE A SUBSTANTIAL GCI TO BE PUT IN PLACE AS SOON AS POSSIBLE. HOWEVER, IN THE INFORMAL SESSION, CONROW (US) INSISTED ON DELETING REFERENCES TO THE POSSIBLE TIMING OR SIZE OF THE GCI ON THE GROUNDS THAT THEY WOULD COMPLICATE THE ADMINISTRATION'S NEGOTIATIONS WITH CONGRESS.

ENVIRONMENT

6. REFERENCES WERE MADE TO THE IMPORTANCE OF THE ENVIRONMENTAL DIMENSION BY BAKER, THE CHANCELLOR, KLEIN AND RUDING. IN THE INFORMAL SESSION, CAINES (UK) SECURED A STRENGTHENING OF THE COMMUNIQUE LANGUAGE, AND A FURTHER PAPER AND DISCUSSION IS SCHEDULED FOR THE SPRING MEETINGS.

MIGA

7. THERE WAS SOME DISPUTE DURING THE INFORMAL SESSION OVER A FAIRLY BLAND PASSAGE ON MIGA IN THE COMMUNIQUE, MALAN (BRAZIL) AND BUIRA (MEXICO) POINTING OUT THAT NOT ALL MEMBERS SUPPORTED IT, OR INTENDED TO PARTICIPATE. THE CHAIRMAN SECURED A REASONABLE OUTCOME, WITH THE HELP OF THE US AND OTHERS.

ADMINISTRATIVE

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8. FORTIN (CANADA) WAS ELECTED EXECUTIVE SECRETARY IN A CLOSE RACE WITH GUE. FISCHER, THE OUTGOING SECRETARY, AGAIN MANAGED THE MEETINGS INEPTLY, AND DUE TO AN EXTENDED COMMUNIQUE DRAFTING SESSION THE MEETING CONCLUDED AT 10.30 PM.

9. FCO PLEASE PASS TO WHITE (ERD), WALSH (HMT), FROST (ODA) KENT (BANK OF ENGLAND).

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ANNUAL MEETINGS: CHANCELLOR'S INITIATIVE AND SAF ENLARGEMENT

SUMMARY

1. CHANCELLOR'S SUB-SAHARAN AFRICAN DEBT INITIATIVE ENDORSED IN INTERIM AND DEVELOPMENT COMMITTEE BY ITALIANS, NORDICS, MANY DEVELOPING COUNTRY SPEAKERS AND HELPFULLY BY CAMDESSUS. VIRTUALLY RULED OUT BY US AND JAPAN: DUTCH AND FRENCH DOUBTS. DEVELOPMENT COMMITTEE COMMUNIQUE WORDING LARGELY REPEATS VENICE SUMMIT LANGUAGE, BUT AT LEAST RECOGNISES THAT CONTINUED RELIANCE ON RESCHEDULING AT COMMERCIAL INTEREST RATES IS NO ANSWER. CHANCELLOR LINKS HIS PLAN WITH A PROPOSAL THAT ALLOCATIONS FROM AN ENLARGED SAF BE SKEWED IN FAVOUR OF POOREST AND MOST INDEBTED. FRENCH SUPPORT: CAMDESSUS HESITANT.

DETAIL

2. THE CHANCELLOR HAS PRESSED HIS PLAN, AND ESPECIALLY THE NEED FOR REDUCED INTEREST RATES, BOTH IN THE INTERIM COMMITTEE AND (TWICE) IN THE DEVELOPMENT COMMITTEE. DRAWING ON THE ARGUMENTS HE USED AT THE CFM, HE REBUTTED THE OBJECTIONS OF CONTAGION AND BUDGETARY COST, NOTED THAT VENICE SUMMIT HAD ACCEPTED THAT THE POORES
T
AND MOST INDEBTED COUNTRIES, ESPECIALLY IN SSA, WERE A SPECIAL CASE, AND ARGUED THAT CREDITORS SHOULD TACKLE THE PROBLEM HEAD-ON NOW, BEFORE IT GOT WORSE.

3. FOR COMMENTS BY OTHER INTERIM COMMITTEE CONSTITUENCIES, SEE PARA. 25 OF MY SAVINGRAM 367 OF 28 SEPTEMBER. IN THE DEVELOPMENT COMMITTEE, FINLAND FOR THE NORDICS GAVE SUPPORT, AS DID GAMBIA AND IN GENERAL TERMS CHINA. BRAZIL APPROVED BUT WANTED RELIEF FOR MIDDLE INCOME DEBTORS TOO. MEXICO NOTET THAT TWO OF ITS LATIN AMERICAN CONSTITUENTS WERE ALSO DEBT-DISTRESSED. ITALY GAVE HELPFUL BACKING AND RESISTED FRENCH AND US ATTEMPTS TO WATER DOWN FURTHER THE COMMUNIQUE. GYOHTEN (JAPAN) SAID THAT QUOTE WE ARE UNABLE TO OBTAIN SUPPORT FROM THE DIET (FOR REDUCED INTEREST RATES) FOR BUDGETARY REASONS UNQUOTE, AND RECALLED THAT JAPAN WAS INSTEAD CONTRIBUTING DOLLARS 500 MILLION IN NON-PROJECT GRANT ASSISTANCE TO SSA COUNTRIES MAKING STRUCTURAL ADJUSTMENT EFFORTS. FOR THE US, WALLIS SAID THAT TWO ELEMENTS IN THE CHANCELLOR'S INITIATIVE (RTA FOR OFFICIAL AID LOANS AND REDUCED INTEREST RATES) WERE

QUOTE NEAR-IMPOSSIBLE UNQUOTE BECAUSE THEY WOULD REQUIRE CONGRESSIONAL APPROPRIATIONS, INEVITABLY AT THE EXPENSE OF THE EXISTING AID BUDGET. AT A G6 MEETING, THE AMERICANS ALSO SHOWED CONCERN ABOUT THE DOMESTIC IMPLICATIONS (FARM CREDIT).

4. LAROSIERE (FRANCE) TOOK A MORE BALANCED LINE. THERE WERE TWO WAYS OF EFFECTIVELY LOWERING THE COST OF EXISTING DEBT, AND BOTH HAD DRAWBACKS. NEW CONSESSIONAL AID MIGHT PROVE, IN PRACTICE, TO CONTAIN NO ADDITIONALITY. AS FOR INTEREST RATE REDUCTIONS, HE WAS LESS WORRIED BY THE RISKS OF CONTAGION THAN BY THE LIKELY DRYING UP OF NEW GUARANTEED COMMERCIAL CREDITS. HE REPEATED THE QUOTE COMPROMISE UNQUOTE PARIS CLUB PROPOSAL OF AN ELIMINATION OF MARGINS ON ECA GUARANTEED CREDITS. AT AN EARLIER G6 MEETING, LAJEUNESSE SHOWED HIMSELF MORE CONCERNED

ABOUT CONTAGION, (WITH EGYPT AND MIND), AND THOUGH HE SAID THAT FRANCE WOULD JOIN A CONSENSUS, HE WAS UNHELPFUL IN SUBSEQUENT DRAFTIN G

5. CAMDESSUS TOLD THE DEVELOPMENT COMMITTEE AND SUBSEQUENTLY PLENARY THAT THE CHANCELLOR'S INITIATIVE DESERVED THEIR SUPPORT. CONABLE PREFERRED TO SPEAK OF QUOTE EQUIVALENT MEASURES UNQUOTE, IN LINE WITH THE WORLD BANK'S ADVOCACY OF A MENU APPROACH. CHIDZERO WAS HELPFUL THROUGHOUT, BUT CONSTRAINED BY BEING IN THE CHAIR. RUDING (NETHERLANDS AND INTERIM COMMITTEE CHAIRMAN) SPOKE TACTFULLY AT THE DEVELOPMENT COMMITTEE (QUOTE NEEDED CAREFUL STUDY UNQUOTE) BUT SAID BLUNTLY TO THE PRESS THAT THERE WAS NO CONSENSUS ON INTEREST RATE RELIEF.

6. IN THE DEVELOPMENT COMMITTEE DRAFTING SESSION, FRANCE AND THE US REOPENED DISCUSSION OF PARAGRAPH 7, AND TRIED HARD TO GET THE WHOLE OF THE LAST THREE SENTENCES CUT. WE OBJECTED, AND SUCCEEDED IN KEEPING THE RTEXT SUBSANTIALLY INTACT.

7. THE MAIN PROBLEMS WITH PARAGRAPH 6 (ON THE SAF) WERE US RESISTANCE TO ANY TARGET DATE FOR BRING AN ENLARGED SAF INTO OPERATION: AND JAPANESE OPPOSITION, WHICH CHIDZERO DISREGARDED, TO SUCH RESOURCES BEING ADDITIONAL. THE CHANCELLOR, FOLLOWING UP HIS REMARKS IN THE INTERIM COMMITTEE, PROPOSED THAT THE COMMUNIQUE SHOULD REQUEST THAT CONSIDERATION BE GIVEN IN THE ENLARGEMENT NEGOTIATIONS TO PROVIDING SPECIAL ACCESS TO SAF RESOURCES FOR THE POOREST AND MOST HEAVILY INDEBTED. HE RECEIVED SOME FRENCH SUPPORT BUT FOR AN APPROACH SOMEWHAT DIFFERENT FROM THE CHANCELLOR'S. CAMDESSUS SAID HE COULD ACCEPT SUCH DISCUSSIONS BUT DID NOT WANT A REFERENCE IN THE COMMUNIQUE. HE DID NOT WANT TO ESTABLISH A FAVOURED SUB-CATEGORY WITHIN SAF-ELIGIBLE COUNTRIES, WHICH WAS WHAT THE CHANCELLOR WAS IN ESSENCE SEEKING. CAMDESSUS WAS PREPARED ONLY TO GO AS FAR AS ACCEPTING THAT HEAVY INDEBTEDNESS WOULD

BE LIKELY TO BE AN IMPORTANT FACTOR IN ANY CASE-BY-CASE ASSESSMENTS: THAT WAS WHAT THE FRENCH SUPPORTED.

COMMENT

8. ONE OF THE CHANCELLOR'S MOTIVES IN ADVOCATING A SKEWING OF THE SAF WAS TO PROVIDE AN ALTERNATIVE ROUTE TO HELP THE POOREST AND MOST INDEBTED IN THE EVENT OF A CONTINUING DEADLOCK IN THE PARIS CLUB ON INTEREST RATE REDUCTIONS. CONABLE HAS URGED THE CHANCELLOR TO PRESS ON BECAUSE EVENTUALLY HE SHOULD WIN THROUGH. THAT DOES NOT (NOT) MEAN THAT THE CHANCELLOR IS ABANDONING HIS PLAN, FOR WHICH IN ANY CASE WE SHALL WANT TO OBTAIN CHOGM'S ENDORSEMENT. BUT CAREFUL THOUGHT WILL NEED TO BE GIVEN THEREAFTER TO THE EXTENT TO WHICH WE CONTINUE TO PRESS THE SCHEME WITH OTHER CREIDTORS: THE PROS AND CONS OF ACCEPTING THE FRENCH COMPROMISE (PARA 4 ABOVE) AS AN AGREED FIRST STEP: AND MORE GENERALLY WHAT NEW TIMETABLE WE SHOULD SET OURSELVES FOR DECISIONS ON THE CHANCELLOR'S INITIATIVE, AND THE LINK WITH SAF ENLARGEMENT.

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CHANCELLOR - PRESS BRIEFING ON WASHINGTON IMF/WORLD BANK MEETING

Transcript from: tape recording, Washington, 30 September 1987

CHANCELLOR: ... is in 3 parts. There is a part on the immediate Bank and Fund issues with special reference to the proposals that I and others have made in order to assist the heavily indebted very poorest countries of subSaharan Africa. I then turn to the British economy, the performance of the British economy which as you know is very good and I expect it to remain good. And then there is the main section of the speech which is an analysis of the system, or regime, of managed floating which we now have in operation among the major currencies. I trace out this, it began at really the Plaza and then was intensified at the Louvre which of course has been further re-affirmed at these meetings, and I try and set out how and why this shift in the way that we deal with exchange rates has occurred and suggest that this is not something temporary or short lived so long as we can maintain success in the battle against inflation which is a vital precondition. Then I believe that we can and should retain this system of managed floating which gives a far greater degree of stability than its predecessor of freer floating did and that this is in the interests of the world economy.

QUESTION: Sir, your final paragraph on page 6 seems to indicate that so long as the United States remains a capital importing country and the rate of saving remains too low it's going to go on having a current account deficit for ever. Is that a fair interpretation?

CHANCELLOR: I certainly believe that the Americans are right to want to see some reduction in their current deficit for the reasons I indicate in the speech. But I think that it is quite acceptable , and indeed not only inevitable but also acceptable, that this will be a slow and gradual process and that it is not necessary that this

should eventually end with current account balance. If you take the case of Japan - at least certainly for the foreseeable future - if you take the case of Japan, Japan for reasons that I think are well known to you - its very high propensity to save in particular - is likely to be a capital exporter. It is difficult to see that not being the case. And its capital exports, I would have thought some of those capital exports, will inevitably find a home in their United States, again for obvious reasons. And therefore if the United States is likely to be a capital importer of some size that obviously has to .... by the counterpart of a current account deficit.

QUESTION: Two questions: one, how close are you to James Baker in your idea of, if you like, prolonging the period of managed floating and institutionalising it and saying there's a break with the past? I see that you do mention the development of indicators but in the past you've been less enthusiastic perhaps than the Americans. And why - if you're going for much closer co-operation - do you target something that's really just an intermediate indicator, the exchange rate, rather than broader things like inflation, growth, you know, whether nominal or real?

CHANCELLOR: I think that we are all of us very close together. And I think that certainly my position and that of Jim Baker's are pretty close although they may not be identical in all respects. What I am saying here on indicators is that they're something slightly different - of course Phillip you haven't had a lot of time to read, I realise that - but something different from what you have said. What I said is the existing indicators exercise, which I welcome but I don't really think that we can usefully take it much further. What I think we should now be concentrating on is indicators for the G7 as a whole. Because of course what we have to make sure is not merely that there is exchange rate stability but that this exchange rate

stability is anchored and it isn't just, as it were, a change in the ......, a cover under which we all inflate. And therefore the anchor has got to be either, as you said, looking at the path of money GDP for the Group as a whole or the inflation rate, the average inflation rate, for the Group as a whole. You can do it either way and I think there are some advantages in doing money GDP rather than looking at inflation and real growth separately - but you could do it either way. And there are particular things too which I think it's desirable to focus on, noteably the trend of commodity prices because that gives you a very good indication of whether world conditions are inflationary or not. But within that context, as I say, I think that we should be building on what we've achieved in securing a regime of managed floating which provides the greatest practical, practicable, measure of exchange rate stability.

QUESTION: Can I just follow up on that, if you develop these indicators - to take an example, would changes in British interest rates be based on the perception of what's happening in the whole of the Group of 7 or on, as last month, purely domestic considerations or would you have a mixture of both?

CHANCELLOR: The indicators for the G7 as a whole are designed to secure that the Group as a whole is on track with particular reference to inflation. The decisions that are taken so far as interest rates are concerned will be taken by each country looking at conditions in its own country but in a way that is consistent with the exchange rate agreement.

QUESTION: When you say you want to build a more permanent regime of managed floating why in that case won't you take Sterling fully into the EMS?

CHANCELLOR: That is a matter which I believe Peter you have asked me on every single occasion whether I hold a press conference here or

anywhere else. And my answer will be the same and if you look in your notebook you will find it there.

QUESTION: Chancellor may I just have a brief follow up on interest rates: what about recent creeping up of interest rates in Germany and particularly in Japan, have you had any assurance by your Japanese counterpart that this is just a transient movement or do you believe this could seriously undermine your efforts to have a co-ordinated exchange rate policy?

CHANCELLOR: I don't believe it ... - what is happening basically in a number of countries, particularly Japan, is that the bond rates, the long rates, have been going up. And that's true to some extent in Germany as well. I don't think it follows from that - and I don't think it will - I see no immediate prospect for it happening - that short rates in Japan will go up which are of greater relevance to the exchange rate regime. What you're seeing is a slight difference in the ~~total~~ slope of the yield curve in these countries rather than any general tendency for short term rates to rise to any significant extent.

QUESTION: Chancellor, given the emphasis which you put upon containing inflation in looking at the G7 indicators as a whole do you think the obligation on deficit countries to deflate and surplus countries to reflate is as the important one or do you think there should be a bias against inflation?

CHANCELLOR: Of course there must be a bias against inflation. That is the essential underpinning of the whole regime. It is that that makes it possible and it is why it wasn't possible. As I say, it is one of the main reasons why it wsn't possible during the earlier period when inflation rates were high and volatile. If inflation rates are high and volatile there is no way that a managed exchange rate regime designed for greater stability can work. The pressures

have to be taken on the exchange rate. Once you have got - and which we all want to have and which we have got now and we want to keep for its own sake - a world which is a low inflation world where we're constantly seeking to get it lower then this system that I described here does become possible. But it is a vital pre-condition.

QUESTION: You say that there's now a general support for a general capital increase in the World Bank, I doubt whether that support is shared by the US Congress and therefore it would seem to be in doubt as to whether the United States Government would be able to deliver on that capital increase. What does that mean, how will that undermine your other initiatives within the Paris Club and particularly relating to Africa if the World Bank does not get that general capital increase and therefore is unable to play its full part in helping reduce the indebtedness of the poorest countries?

CHANCELLOR: I don't think it would undermine my quite separate initiative for assisting the subSaharan African countries with their very heavy bilateral indebtedness. But it would be a very serious matter if the Congress were not to support the Administration's request for authority to subscribe to a substantial general increase for the World Bank. And I'm quite sure that the Administration will, having declared itself very clearly and very fully, will make every effort to get this through the Congress. And I believe that it is their judgement that will be able to do so. Of course there will be a battle in Congress but I believe that it is their judgement that they will get it through.

QUESTION: How quickly will you be able to get it through the British Parliament?

CHANCELLOR: No difficulties with the British Parliament.

QUESTION: Chancellor, this commitment to a floating rate regime, does this involve an open ended commitment to intervening on the markets

if necessary to hold sterling at a particular level?

CHANCELLOR: Well clearly, as I have mentioned here, concerted intervention is one essential element of the commitment. From time to time that intervention may need to be on a substantial scale but I don't think that that presents any great problems. Those countries who were worried about the effect on their monetary policy, and that's perfectly understandable and in fact we would I think act the same way, can when the pressure is off take steps to sterilise the intervention.

QUESTION: Can I follow that up, I mean are interest rate movements designed to maintain currency levels ruled out in this broader context or not?

CHANCELLOR: No not at all, not at all. As I say in the speech, that one of the essential elements of this regime is that monetary policy, and that means to a large extent - in a free society anyway - the determination of short term interest rates is increasingly pursued with an eye to sustaining this exchange rate regime.

QUESTION: Apparently you say in the speech that you ...., can you envision a plan in the future where the so called band or both those could actually be revealed?

CHANCELLOR: I think that it is possible to envisage such a time. Once the existing regime that we have has been in place for long enough to have a degree of , a sufficient degree, of market credibility so that the publication of the bands as you call them would be helpful rather than harmful. In the early period however I believe that the publication of the bands would be harmful. Once the thing has been in place and working satisfactorily for a sufficient time to have got a real degree of market credibility then I think publication of the bands could become positively helpful. But that's some way ahead.

QUESTION: Chancellor in your speech you say in the medium term ... we should not become involved in an exercise in short term fine tuning. Is this a wholesale rejection of automaticity and if so how would you guarantee that the G7 would adhere to certain targets like inflation?

CHANCELLOR: I don't beleive in automaticity although my consistent urging that we should take amedium term view and not engage in short term fine tuning goes wider than that. As for how people operate the thing among the G7 we will operate it in the way that we have been operating it. A large part of this is an attempt to, as it were, codify and describe in a coherent way what has actually happened, what has actually emerged. That is the main part, I then suggest tentatively how it might develop. But what I think is the main part is a description and an analysis of what has actually happened and why.

QUESTION: Sir, it's reported that we're going to hear a Baker Plan 2 or at least some modification of the Baker Plan this morning. Would you like to see some changes in the system for dealing with the international debt problem?

CHANCELLOR: No, I don't think so. If you mean something like the extrordinary proposition which was put forward in the leading article in the Financial Times today certainly not, no. I think that ..., I don't beleive in a bale out of the banks by the taxpayer as the financial Times is advocating. No I don't think that's the answer. I believe that we should develop the system we have in the way that we are developing it. And I think that the so called menu approach, to use the current in-word, which means developing a whole lot of more market related mechanisms, which I've been advocating for some time, I think that is highly desirable. But this is basically the same strategy. I do think, as I have said, that there is a very, very special problem, quite separate problem, of the very heavily indebted,

very low income, countries of subSaharan Africa the vast bulk of whose debts is not owed to the commercial banks because the commercial banks has never ever thought them a bankable proposition and there is no way in which these countries in foreseeable future would get back to market credit worthiness. But that is a separate problem and I've made my proposals there. and of course we now, subsequent to mine, proposals from the IMF and from the World Bank.

QUESTION: ... there seems to be some opposition to reduction of interest rates for those particular countries for fear that a reduction might serve as a precedent for some of the middle income countries. Do you share that view or do you think they can let some of their interest rates ....?

CHANCELLOR: No I don't share that ivew. And I find that view is slightly surprising on at least wo grounds. First, that the whole essence of the structural adjustment facility, the SAF, which is being proposed should be enalrged for the poorest countries, ineherent in that is concessional interest rates. So this is accepted by the international community. And furthermore, in the communique of the Venice Summit in June of this year it was clearly stated there the view that all the 7 major nations took was that these very poor, heavily indebted subSharan African countries were a special case.

QUESTION: What you said before .... they want stable, lower interest rates and longer maturities. .... 30 year bonds with a lower rate, how are you reacting to those?

CHANCELLOR: My reaction straightfrward. This is a matter, this bond proposal that the Brazilians have, is a matter between them and their commerical bank creditors. If they can persuade their commercial bank creditors to accept their proposals after negotiations and in

some modified form no doubt if they can well that's fine. It is a matter between Brazil and their commercial bank creditors. The way in which Governments come in and the UK Government comes in is when it comes to rescheduling of Brazil's Paris Club debt. And there we have made it absolutely clear that we willn ot reschedule Brazil's Paris Club debts unless and until she has concluded an agreement with the Fund.

QUESTION: Chancellor, given the unexpected .... from tax revenue in the UK what's the likelihood that we'll see a tax cut there some time in the near future?

CHANCELLOR: You won't see one before March. Whether you see one in March you will know in March.

QUESTION: If I can get back sir to your proposal on ......, did you suggest or communicate to the Group that there's a hole, doesn't it bring up the claim that when you set up one number for everybody it becomes nobody's problem because it doesn't come specificall through that one country being a product of the problem or a part of the problem? In other words, isn't setting up indicators for a whole a way to escape pinning blame on any particular part of the Group?

CHANCELLOR: No I - let me make myself clear - we have this long standing surveillance process which is based on looking at numbers for each individual country that is a member. Whether that surveillance process will continue, I'm not suggesting that that should be scrapped, certainly not. What I'm saying is that we have I think now developed - and the indicators, the original indicators exercise grew ut of this surveillance process which has been going on at meetings of, in the old days the G5, for a very long time. What I am saying is that not that we should scrap that. I think that we have carried thatpretty well as far as it is sensible to carry it. I don't think any further refinements are going to help us much. I

think one further thing we need now is to develop indicators for the Group as a whole.

QUESTION: If I can return on the subjet of debt. Do you think there would be any logic in extending the kind of proposals you put forward for Africa to the middle income countries but with the commercial banks providing the sort of concessions you're suggesting Governments should for Africa?

CHANCELLOR: Well that would be a matter for the commercial banks. But I would not see them doing that.

QUESTION: I mean would you like to see them doing that?

INTERVIEWER: No, I think the cases are quite different. I think that these countries can turn themselves round. And I think that if you look at what is happening now for example in Mexico it is very impressive to see the waysin which the Mexican economy has been turned round and to see in which, after a period in the past when there was very considerable capital flight, capital is now being repatriated back to Mexico. And there are other countries too which have successfully, smaller countries, which have achieved a great deal in the adjustment process. And the capacity of these countries is of a totally different order from the capacity of these, as I say, very desperately poor heavily indebted countries of subSaharan Africa. It's a very clear distinction.

QUESTION: Could I also justask, I think you were saying in an interview the other day you'd like to see the British banks strengthening their balance sheets more, we've seen Deutche Bank saying this week it's had 70% provisions against Sovereign debt, would you expect to see another round, or would you like to see another round of provisioning by the British banks?

CHANCELLOR: Well there's a distinction between strengthening balance sheets and provision. Strengthening balance sheets may , can be

achieved, and indeed has been achieved by raising new capital and in ways of that sort. The provisioning came really at a later stage after they had strengthened their balance sheet very considerably. And what I was talking about is, as I say, is a further strengthening of their balance sheets so that they have better ratios and , as I say, a stronger capital base. If they decide to do further provisioning that is really more a matter between them and the supervisory authority.

QUESTION: I come back to the question of exchange rates. If the market s start testing the ranges that have been established do you think there is a need to increase the interest differentials?

CHANCELLOR: The markets have been off and on testing the ranges during the 7 months which the Louvre Agreement has been in operation. And at the beginning the Agreement was greeted with almost universal scepticism by the markets and the commentators. But it is survived triumphantly and I think it is now must be regarded as a success. There has been obviously some change in the pattern of interest rates during that period. It is quite interesting perhaps that during the period between the Plaza and the Louvre United States interest rates were steadily coming down whereas since the Louvre that has not been the case. But I think that would have been necessary on economic policy considerations anyway.

QUESTION: Chancellor, taking the process forward of managed floating, how convinced or how confident are you that you'll get support from other countries and particularly those countries whch have independent central banks where there can sometimes be a littlefriction between Finance Ministries and the central banks?

CHANCELLOR: I don't think we should get into the subject of prima donnas or anything like that. The plain fact is that those countries which have independent central banks are full hearted members of the

Louvre Agreement.

QUESTION: But do you think, to answer my first question, are you confident of getting a sort of strong support for your proposal to sort of institutionalise what's already happened?

CHANCELLOR: As I say, I'm not suggesxting the setting up of any new institution let me hasten to add - you say institutionalise, we have quite enough international instutions as it is. No, what I am largely doing here is describing what has happened, how it's happened and why, what has now emerged. It is something that all of us believe to be an improvement on the status quo ante and in broad terms how I see it developing and in particular that I believe that it is here to stay so long as we live in a non-inflationary world.

QUESTION: Is your commercial for managed floating which you've been describing to us, was it launched, to be launched today with the foreknowledge of the other members of the 7 or was it just your idea?

CHANCELLOR: Well it's my own views of course. The United Kingdom is an independent Sovereign State. But I had some bilateral discussions in which I indicated what I would be saying.

QUESTION: Going back to Phillips point, was this greeted with enthusiasm and that cast a light forward that people are going to be pleased that you said it and will say .....?

CHANCELLOR: We shall have to wait and see won't we.

QUESTION: Chancellor, I wonder if you coud give us your own assessment of where we now stand on aid to the poorest countries given US resistance to interest rate relief and some comments by the United States the surplus nations must put the money forward, where actually are we in the process?

CHANCELLOR: We're ina process of discussion and negotiation which is going to continue for a little while I think. I mean in the Venice - and that goes for my proposal, that goes for the Conte De

Susac proposal and other proposals too and the World Bank one as well. And my proposal, particularly my proposal and the Conte de Susac proposal which are very much complimentary, were linked together in the communique to the Venice summit where we gaveourselves a deadline at the end of the year to try and get proposals worked out. I hope we shall be able to meet that deadline.

QUESTION: Can you do it without US monetary support of some sort?

CHANCELLOR: No I think it's not a question of whether we can do it without it it is whether it is right that the United States should opt out. I don't think it is.

QUESTION: There's one bit of your regime for the future which I must confess I don't understand. And that's where it says if and when the time comes to adjust one of the rates that adjustment should be made by moving the mid point within the confines of the existing range. Now what does that mean, how can you move a mid point within confines of an existing range?

CHANCELLOR: Well if, let me try and make it simple - and the mumbers are purely illustrative - if the range say were between - and these as I say numbers ...... - between 0 and 10 then the mid point at the present time would be 5. Then a movement would be a new point either higher or lower than 5 but still between 0 and 10.

QUESTION: But then it's not a mid point is it?

CHANCELLOR: It would be the new mid point and then the permitted fluctuation would be about that new point right. So that the range would vary but the mid point, the important operational point, the mid point of the new range would be within the old range.

QUESTION: Do you mean that the ... cahnge ..... should never be greater than the width of existing ranges?

CHANCELLOR: How well you put it.

QUESTION: Chancellor, may I ask whether you think the differential

growth rate between the United Kingdom and other European countries is going to be narrowed in the near future and if so is it going to be narrowed by the UK slowing down or the others speeding up?

CHANCELLOR:CHANCELLOR: I think that there may well be some slight slowing down of UK growth between 1987 and 1988. But I very much hope that the others will speed up as well. I think that in the case of Germany they believe that they will.

QUESTION: Chancellor, the creeping up in long rates referred to earlier, does that in your view indicate renewed concern about inflation and if so what is the proper response between the managed system you describe?

CHANCELLOR: I think that the ... - I think it's rathre tricky to know precisely what determines long bnd rates. I think there have been two factors present. One of the matters which are specific to the long bond market in a number of countries. One I think is perhaps a mistaken tendency amongst some people to assume that because there has been a bounce back, some bounce back, of inflation between 1986 and 1987 when it was artificially low if you like in 1986 because of the collapse of the oil price then, the effect that this had and indeed it was always predicted that there would be some bounce back. Nevertheless some people don't realise that this is just one of those blips and are projecting the thing to go on going up. In other words, there may be some, as a result of this movement that I was describing between 1986 and 1987, there may be inflationary expectations generated in some markets which are not warranted.

TREASURY NEWS

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Remarks by
Secretary of the Treasury
James A. Baker, III
at the Joint Meetings of the
World Bank and the International Monetary Fund
Washington, D.C.
September 30, 1987

Chairman Abdul Karim, President Conable, Managing Director Camdessus, fellow Governors and distinguished guests:

Two hundred years ago, the representatives of the thirteen American states gathered in Philadelphia to establish a common Constitution founded on individual rights and responsibilities. In much the same vein, we, as representatives of the global community, share similar needs and responsibilities that transcend our particular borders and require a strengthened framework for cooperation for the good of us all.

Our tasks are three-fold and inter-related: to build on the progress already achieved in strengthening the process of economic policy coordination; to achieve higher, sustainable growth among the developing nations; and to improve our international financial institutions.

Strong leadership from the Fund and the Bank in accomplishing these tasks is vital. A reorganized World Bank under the able leadership of President Barber Conable stands ready to expand its role in assisting the developing nations, while in a short period Michel Camdessus has demonstrated his broad capacities in guiding the IMF as its new Managing Director.

B-1142

Improved International Policy Coordination

The current process of economic policy coordination evolved gradually over the last two years along a steady path, pointing toward greater stability and predictability in our international monetary arrangements. It had its roots in a broad consensus that volatile exchange rates were contributing to large trade imbalances, distorted investment, and a growing protectionist threat.

The September 1985 Plaza Agreement represented a major turning point in our efforts to promote a sound world economy. Too often in the past, the major industrial countries had reviewed the performance of their individual economies with little consideration of the interaction among them. At the Plaza, we revitalized the G-5 by agreeing on the direction that national policies should take, and by entering into new arrangements to facilitate exchange rate adjustments to reflect more fully underlying economic fundamentals.

The success of the new efforts created a momentum to move further along this course. At the Tokyo Summit, the Heads of State and Government agreed on a framework for a political mechanism for conducting multilateral surveillance of their economies utilizing economic indicators. Further, a new group was formed, the Group of Seven (G-7), that was symmetrical with the Summit structure. This brought to bear on the coordination process the necessary political leadership at the Heads of State and Government level. It also created a direct link between the formation of domestic policies and the international coordination process.

The Louvre Accord represented another milestone. We agreed upon a strengthened coordination process involving use of medium-term objectives and performance indicators. Furthermore, we made specific national policy commitments, and agreed to cooperate closely to foster exchange rate stability.

In April 1987, we initiated the new coordination process at a G-7 meeting in Washington, where we expanded and refined the Louvre Accord. At the Venice Summit, the Heads of State and Government endorsed these agreements, signaling full support by their governments at the highest levels. This past weekend, the G-7 reaffirmed their commitments to the policy directions set forth at the Louvre, including continued cooperation to foster stability of exchange rates.

The process is now firmly in place. Commitments are being met and progress is being achieved in addressing global economic problems.

In fiscal 1987, the U.S. budget deficit has been reduced by over $60 billion, a decline of 1.7 percent of GNP. Over the past four years, in fact, the U.S. has reduced its deficit by 2.7 percent of GNP -- the largest deficit reduction of any of the major industrial countries over a comparable period.

Our other economic signals also remain upbeat. The current expansion is on the verge of becoming the longest peacetime expansion in U.S. history -- an expansion that has taken place without a resurgence of inflation. Unemployment is down and jobs are up. Our trade deficit, although still large in nominal terms, has begun to decline in volume terms.

Other major industrial countries have also recognized their obligations. Japan is implementing a major stimulus package and domestic demand is strengthening, which should help to reduce its trade surplus. Germany has accelerated its tax reform efforts and agreed to reconsider domestic policies if growth falters.

These efforts are having their intended impact. Growth prospects are improving. Trade imbalances are showing signs of coming down, and exchange rates have been more stable.

This progress does not mean that we could or should stop seeking further improvements. Imbalances remain large and growth in Europe remains weak. We must follow through on earlier commitments and take additional steps as needed. At the recent G-7 meeting, we committed to do just that. In the United States, we recognize the need to continue our deficit reduction efforts in the U.S. in fiscal year 1988 and beyond. The President's decision this past weekend to sign the recent Gramm-Rudman-Hollings legislation will reinforce progress in reducing the budget deficit. Germany, Japan, and other surplus countries must also do their part by following policies which will enhance economic growth without inflation.

And it is critical that each of us works to preserve an open trading system. The imposition of protectionist measures at this time could undermine the progress we have made so far. The U.S. Administration remains resolute in its opposition to protectionist trade legislation. As President Reagan made absolutely clear yesterday, he will veto any protectionist legislation. Others must commit to fair trade policies that will buttress public support for an open trading system.

We have agreed that we should be concerned about the predictability and stability of exchange rates. Our coordination process utilizing indicators takes this into consideration. It is equally important that the policies resulting from the coordination process not be inflationary. It would be unfortunate if our efforts to foster exchange rate stability among currencies led to stable currency relationships -- but in a context of inflationary economic policies that reduced the real value of all currencies.

Accordingly, the United States is prepared to consider utilizing, as an additional indicator in the coordination process, the relationship among our currencies and a basket of commodities, including gold. This could be helpful as an early-warning signal of potential price trends.

We are proposing consideration of a commodity price indicator as an analytical tool and an improvement to our indicator process, to be used in conjunction with the other measures of economic performance -- such as growth, external imbalances, and exchange rates -- in reaching judgments about policies and performance.

Coordination is a step-by-step process, and we should be willing to consider additional refinements as we move forward.

The major industrial economies are not the only ones with an obligation to the world economy. It is time that South Korea, Taiwan, Hong Kong, and Singapore also help preserve the open world trading system. It is critical that they open their markets where restrictions remain and allow their currencies to reflect underlying economic fundamentals.

The International Debt Strategy

I would like to turn now to our cooperative efforts to address international debt problems. The "Program for Sustained Growth" that we have pursued since Seoul remains the only viable, mutually acceptable approach to debt problems.

Its basic principles remain as important and valid today as when initially proposed. The first is the central importance of economic growth. Second, in order to promote growth, market-oriented policy reforms within the debtor nations are critical. Third, to support these reforms, additional capital is needed in the form of equity, debt, and the repatriation of flight capital. And fourth, each case should be dealt with on its own merits.

Considerable progress has been made under this approach. The debtor nations have made substantial efforts to restructure their economies along more market-oriented lines. As a result, for the 15 major debtors as a whole, GDP growth is now in the range of 3.7 percent, the best in six years. Export earnings are projected to recover strongly in 1987-88, while imports this year are expected to be the highest since 1982. Capital flight has been reversed in several countries, and interest-to-export ratios are expected to fall to 27 percent this year compared to 31 percent in 1981.

The IMF and World Bank have provided sound policy advice, made $16 billion in new loan commitments since Seoul, and catalyzed financial support by other creditors. Over the same period, official creditors have rescheduled more than $17 billion in outstanding debt, including both principal and interest. And the commercial banks have committed nearly $10 billion in new loans, restructured approximately $110 billion in outstanding debt, reduced spreads and provided longer grace periods and maturities.

Nevertheless, problems remain. Reductions in commodity prices and export earnings in 1985-86 have worsened debt-to-export ratios for some. The recent firming of interest rates and continued strong protectionist pressures are both matters of serious concern.

The debt strategy provides a flexible, case-by-case framework for responding to individual debtor's needs and changes in the global environment. We should not be attracted by generalized debt relief schemes: They do not really offer significant short-term relief, and they pose major long-term risks to the debtors. They also ignore the reality that many debtors have inherently strong economies with unlimited potential. Their course into the 21st century must be built upon increasing their trade and financial linkages with the rest of the world, not undermining them.

We all need to do more to enhance the progress already made under the current strategy. To strengthen it further, we should further develop the "menu approach," strengthen the IMF's ability to promote growth, and initiate negotiations on a World Bank General Capital Increase (GCI).

<u>The "Menu" Approach</u>

Last spring, I suggested the development of a "menu" of financial options to facilitate commercial bank financing packages.

Permit me to elaborate today on the types of instruments that should be considered, where appropriate, for such "menus."

- <u>Trade and project loans</u> can channel more funds to the private sector, encouraging imports and providing banks with more easily identifiable returns.

- <u>On-lending</u> provisions also help to provide funds for productive use by private sector borrowers.

- <u>New money bonds</u> could have some of the characteristics of a senior claim, and therefore may be more attractive to banks in new money packages or to reduce the stock of debt.

- o Notes or bonds which are convertible into local equity can help reduce debt service burdens and provide a boost to domestic production.

- o Exit bonds can permit banks with smaller exposures to "exit" from future new money obligations, helping to streamline financing procedures.

- o Debt/equity swaps help reduce both debt and debt-service burdens, while improving the debt/equity mix in foreign obligations.

- o Conversion of debt paper to local currency for use by charitable organizations can provide some limited benefit.

- o Limited voluntary interest capitalization may also be appropriate in certain selective cases, particularly for small debtors.

- o Finally, general balance of payments loans will, of course, continue to be an essential component of virtually all new money packages.

More can be done to develop "menu" options -- by the debtors themselves, by commercial banks, by the international institutions, and by creditor governments. For example, we are now trying to identify possible regulatory impediments which might lie in the path of "menu" items. The Federal Reserve Board recently announced measures that will facilitate greater use of debt/equity swaps. Additional steps in this and possibly other areas are under consideration.

IMF Policies and Facilities

The IMF has played a central role in the debt strategy, and we must ensure that it will be able to continue this role as long as debt problems persist. In fulfilling this role, the Fund must remain faithful to its mandate as a monetary institution providing sound policy advice and temporary balance of payments financing. To do this, the Fund will need to adapt its policies to the changing circumstances and needs of its members.

In particular, the Fund must give greater attention in its programs to measures needed to promote long-run growth, as well as to correct short-run imbalances. And the Fund should work to see that comprehensive, growth-oriented programs are not blown off course by unforeseen developments beyond a country's control. Toward these ends, I propose the following package of changes in Fund facilities and policies.

First, I propose the creation of a new External Contingency Facility. It would help cushion the adverse effects on stand-by programs of external, unforeseen developments such as weaker commodity prices, lower export volumes, natural disasters, and sustained higher interest rates. Modification in economic policies will also often be required, but we hope this facility will catalyze additional lending by other creditors as well. Since such a new facility would compensate, among other things, for shortfalls in export earnings, it would of course replace the existing Compensatory Financing Facility (CFF). Like the CFF, it would be funded out of existing resources.

This new facility should be complemented by other changes which reinforce the growth orientation in Fund programs. Therefore, to help give debtors both the scope and impetus to focus on measures to promote growth and to correct payments imbalances, I propose that programs of 18 months or longer should involve semiannual -- rather than quarterly -- performance criteria and disbursements. Quarterly monitoring would still be needed to detect problems at an early stage, but debtors could avoid excessive focus on the short-run. This would be coupled with greater use of structural reforms as performance criteria in Fund programs, to complement the Fund's macroeconomic and exchange rate emphasis. Such areas as market-oriented pricing, privatization and reform of public enterprises, and trade and foreign investment liberalization would be covered, with careful coordination with the World Bank.

With the overall strengthening of performance that should result from these changes, the commercial banks should be able to rely more on overall program quality than on rigid linkages to Fund disbursements. In place of a preoccupation with mechanical formulas, the banks should focus on the appropriate policies to restore growth and creditworthiness and to maintain flexibility with regard to financing flows.

World Bank's Resources and Policies

Two years ago, I called upon the World Bank to play a greater role in the debt strategy, supporting structural reforms that are essential to achieve sustained economic growth and helping to catalyze private financing.

After carefully reviewing President Conable's plans for lending by the Bank and the need for a capital expansion in order to ensure that the Bank can fulfill this role, I believe that the time is now right to begin negotiations on a General Capital Increase.

However, I want to stress that the GCI is in no way intended to be a substitute for continued private flows. All must do their part -- the multilateral institutions, private creditors, and the developing countries themselves -- to support a return to creditworthiness and sustained growth.

I also believe the World Bank must play a more active role in the investment area. The development of loans based on investment policy reforms, for example, can provide needed encouragement to foreign direct and portfolio investment. Cofinancing of World Bank project loans can help encourage enhanced flows of foreign capital to support new production, including both commercial bank loans under the "menu" approach as well as other flows from private sector pension, insurance, or mutual funds.

The World Bank can also strengthen its advisory role in debt/equity swaps. Additional efforts to assist in the development of debtors' domestic capital markets and to provide financial advice -- for example in hedging interest and exchange rate risk -- should also be encouraged.

Low-Income Countries

Let me turn now to low-income countries. Many of these countries are now pursuing difficult economic reforms whose success requires persistent efforts at home and strong support abroad. A number of recent initiatives are designed to provide this support.

The first evolved from a U.S. initiative at Seoul two years ago. It resulted in the establishment of the IMF's Structural Adjustment Facility (SAF), and supplied a basis for enhanced cooperation between the World Bank and the IMF through the development of Policy Framework Papers.

Managing Director Camdessus has proposed expanding the SAF to provide additional funds for low-income countries with protracted payments problems. We welcome this proposal and believe that the best source of new funding for this purpose is the surplus countries.

To support these efforts, more must also be done to strengthen the effectiveness of program design and the policy coordination process. I therefore call on the Bank and the Fund to undertake joint missions, and to form a joint committee of the two Executive Boards, to review Policy Framework Papers. IDA loans should also be integrated into Policy Frameworks as closely as loans from the SAF.

The IDA VIII replenishment is another essential component. We expect Congress to take up the IDA VIII legislation in October. It has full Administration backing and we are committed to getting legislation before the end of the year.

Finally, as agreed at Venice, we continue to support on a case-by-case basis the provision of longer grace periods and maturities in official Paris Club reschedulings for the most needy low-income debtor nations.

Conclusion

We stand today at a particularly important juncture in international economic relations. We have accomplished much in recent years, but major tasks are still before us. The policy agenda remains a challenging one, and more than ever demands a unity of purpose among a diversity of interests.

The framers of the U.S. Constitution recognized 200 years ago that each state would benefit if the United States were strong and prosperous. Like them, we must put aside narrow parochial interests for the general good of the international commonwealth of nations. In so doing, we can forge a growing global economy and stable monetary system that enhances the well-being of each of us.

We have made a beginning, a good beginning. Now, we must continue our patient efforts to promote economic liberty, improve the global economy, and strengthen the framework for international cooperation. With your support, I am confident that we will be successful in this important endeavor.

Thank you.

PPS 12/2.

H. M. TREASURY

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30 September 1987

THE CHANCELLOR OF THE EXCHEQUER'S SPEECH TO THE IMF

Attached is the text of the speech delivered in Washington today by the Rt Hon Nigel Lawson MP, Chancellor of the Exchequer, at the Joint Annual Meeting of the International Monetary Fund and the International Bank for Reconstruction and Development.

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55/87

BOARD OF GOVERNORS 1987 ANNUAL MEETINGS, WASHINGTON DC
STATEMENT BY THE RT.HON. NIGEL LAWSON MP
CHANCELLOR OF THE EXCHEQUER
GOVERNOR OF THE FUND FOR THE UNITED KINGDOM
AT THE JOINT ANNUAL MEETINGS, SEPTEMBER 30, 1987

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I WELCOME THE PROGRESS THAT WE HAVE MADE AT THESE MEETINGS ON A NUMBER OF ISSUES OF GREAT IMPORTANCE. WE HAVE REAFFIRMED THE LOUVRE AGREEMENT. THERE IS NOW FULL SUPPORT FOR AN EARLY AND SUBSTANTIAL GENERAL CAPITAL INCREASE FOR THE WORLD BANK. AND THERE IS INCREASING RECOGNITION THAT WITHIN THE GENERAL DEBT STRATEGY, SPECIAL ACTION IS REQUIRED TO HELP THE VERY POOREST AND MOST HEAVILY INDEBTED COUNTRIES, PARTICULARLY IN SUB-SAHARAN AFRICA.

AT THE MEETINGS OF THE INTERIM AND DEVELOPMENT COMMITTEES THIS APRIL, I PUT FORWARD A THREE-POINT PROPOSAL FOR ASSISTING THESE COUNTRIES, PROVIDED THEY PURSUE APPROPRIATE ADJUSTMENT POLICIES: THE CONVERSION OF AID LOANS INTO OUTRIGHT GRANTS; LONGER REPAYMENT AND GRACE PERIODS ON PARIS CLUB RESCHEDULINGS; AND REDUCTIONS IN THE RATES OF INTEREST ON THOSE RESCHEDULINGS.

THE MANAGING DIRECTOR OF THE INTERNATIONAL MONETARY FUND AND THE PRESIDENT OF THE WORLD BANK HAVE PUT FORWARD COMPLEMENTARY PROPOSALS FOR HELPING THE POOREST COUNTRIES BY CONCESSIONAL INTEREST RATES, INCLUDING A SUBSTANTIAL INCREASE IN THE SIZE OF THE IMF'S STRUCTURAL ADJUSTMENT FACILITY. I SUPPORT THESE PROPOSALS, AND BELIEVE THAT HEAVY INDEBTEDNESS SHOULD BE A MAJOR FACTOR IN DETERMINING THE ALLOCATION OF FUNDS UNDER ANY ENLARGEMENT OF THE SAF.

IT IS OF THE FIRST IMPORTANCE THAT WE MAKE A REAL EFFORT TO REACH AGREEMENT ON ALL THESE PROPOSALS AT THE EARLIEST POSSIBLE DATE.

THE UK ECONOMY

I NOW TURN TO THE EXPERIENCE OF MY OWN COUNTRY DURING THE PAST YEAR. SINCE THE SHARP FALL IN THE OIL PRICE IN 1986 THE GROWTH RATE OF THE UK ECONOMY, SO FAR FROM SLOWING DOWN AS WAS EXPECTED, HAS ACTUALLY PICKED UP. AT THE SAME TIME, THE GROWTH RATE FOR THE MAJOR INDUSTRIALISED COUNTRIES AS A WHOLE HAS BEEN BELOW EXPECTATIONS. AT FIRST SIGHT THIS SEEMS PARADOXICAL. THE INDUSTRIALISED COUNTRIES IN AGGREGATE WERE SIGNIFICANT BENEFICIARIES FROM LOWER OIL PRICES WHEREAS THE UK, AS A MAJOR OIL PRODUCER AND EXPORTER, STOOD TO LOSE SIGNIFICANTLY.

WHAT HAS HAPPENED IS THAT THE UK ECONOMY HAS ADJUSTED MORE SMOOTHLY TO THE FALL IN OIL PRICES THAN MANY THOUGHT POSSIBLE. THE LATEST IMF FORECAST PUTS UK GROWTH AT 3.4 PER CENT THIS YEAR--THE FASTEST GROWTH OF ALL THE MAJOR INDUSTRIALISED COUNTRIES. AND UK MANUFACTURING PRODUCTIVITY, CURRENTLY RISING AT ABOUT 6 PER CENT, HAS CONTINUED TO EXCEED EXPECTATIONS, THUS CONTAINING THE GROWTH OF UNIT LABOUR COSTS.

THE UK'S STRONG GROWTH PERFORMANCE HAS NOT BEEN BROUGHT ABOUT BY ANY FISCAL STIMULUS. THE PUBLIC SECTOR BORROWING REQUIREMENT HAS IN FACT BEEN REDUCED TO LESS THAN 1 PER CENT OF GDP. WE HAVE BEEN ABLE TO BRING DOWN TAX RATES BY MAINTAINING A DECLINING PATH FOR PUBLIC EXPENDITURE AS A PROPORTION OF GDP. NOR HAS THERE BEEN ANY RELAXATION OF MONETARY POLICY. INTEREST RATES HAVE BEEN HELD AT LEVELS NECESSARY TO MAINTAIN SOUND ANTI-INFLATIONARY CONDITIONS. IN SHORT, IT IS THE ENTERPRISE ECONOMY THAT HAS DONE THE TRICK. ONE CONSEQUENCE OF THIS IMPROVED PERFORMANCE HAS BEEN A SIGNIFICANT DROP IN UNEMPLOYMENT, WHICH HAS FALLEN BY 400,000 OVER THE LAST 14 MONTHS.

THE STRONG GROWTH OF UK OUTPUT AND DEMAND HAS CAUSED SOME TO SUGGEST THAT THE UK ECONOMY IS IN DANGER OF OVERHEATING, WHILE OTHERS ARE FORECASTING A SLOWDOWN. SOME MANAGE TO COMBINE BOTH PREDICTIONS. BUT WHILE, AS IN MOST COUNTRIES, INFLATION IS A BIT HIGHER THAN LAST YEAR WHEN THE IMPACT OF FALLING OIL PRICES WAS GREATEST, THERE HAS BEEN NO SIGNIFICANT CHANGE IN UNDERLYING INFLATIONARY PRESSURE.

THE UK IS NOW WELL INTO ITS SEVENTH YEAR OF STEADY GROWTH AT 3 PER CENT A YEAR. DURING THAT PERIOD THERE HAVE BEEN MINOR FLUCTUATIONS, AND AFTER THE SLIGHT SPURT THIS YEAR, I WOULD EXPECT SOMETHING CLOSER TO THE 3 PER CENT AVERAGE RATE NEXT YEAR.

THE BACKGROUND TO THE LOUVRE

I NOW TURN TO THE EVOLUTION OF EXCHANGE RATE POLICY.

FOR THE FIRST 25 YEARS AFTER THE WAR, EXCHANGE RATE STABILITY WAS ACHIEVED THROUGH THE BRETTON WOODS SYSTEM. THIS FORMED A CORNERSTONE OF THE POST-WAR ECONOMIC ORDER, NOT LEAST AS A FORCE FOR FINANCIAL DISCIPLINE. BUT IT BEGAN TO BREAK DOWN IN THE LATE 1960S, AND BY THE EARLY 1970S IT HAD COLLAPSED ALTOGETHER.

THEREAFTER, WITH COUNTRIES PURSUING DIVERGENT ECONOMIC POLICIES, AND MANY SUFFERING FROM HIGH AND VOLATILE INFLATION, A SYSTEM OF FLOATING EXCHANGE RATES WAS VIRTUALLY INESCAPABLE. INDEED MANY AT THE TIME BELIEVED THIS NEW FLEXIBILITY TO BE DESIRABLE.

WITH HINDSIGHT, SOME OF THE ARGUMENTS FOR FREE FLOATING SEEM MUCH LESS COMPELLING. AND THE BELIEF THAT MARKETS WOULD PROVIDE A STABILISING INFLUENCE, THROUGH THE OPERATIONS OF MEDIUM-TERM SPECULATORS, HAS NOT BEEN BORNE OUT.

IN PARTICULAR, WE HAVE SEEN WILD GYRATIONS IN THE DOLLAR, THAT HAVE CLEARLY NOT BEEN A REFLECTION OF ECONOMIC FUNDAMENTALS, WHICH ARE ESSENTIALLY SLOW-MOVING. FEW COULD SERIOUSLY ARGUE THAT TWO DEUTSCHEMARKS TO THE DOLLAR WAS "CORRECT" IN 1979, AND AGAIN AT THE END OF 1986, AND YET THAT THREE DEUTSCHEMARKS TO THE DOLLAR WAS "CORRECT" IN 1985.

MOREOVER, THESE GYRATIONS HAVE DAMAGED GROWTH IN WORLD TRADE. BUSINESSES HAVE HAD TO DIVERT SCARCE MANAGEMENT TIME AND SKILLS TO COPING WITH CURRENCY FLUCTUATIONS, RATHER THAN IMPROVING COMPANY PERFORMANCE. AND THE MAJOR UNCERTAINTIES ABOUT EXCHANGE RATE MOVEMENTS INHIBITED RISK TAKING AND REQUIRED A SWITCHING OF RESOURCES AT A PACE THAT WAS WHOLLY UNREALISTIC.

THE EXPLANATION FOR THESE GYRATIONS IN THE DOLLAR DERIVES IN LARGE PART FROM THE NATURE OF THE FOREIGN EXCHANGE MARKETS. WE NOW HAVE GLOBAL 24-HOUR MARKETS IN WHICH TURNOVER HAS INCREASED DRAMATICALLY, WITH ONLY A SMALL PART OF THAT RELATED TO COMMERCIAL TRANSACTIONS.

THIS PRESENTS PARTICULARLY ACUTE PROBLEMS FOR THE DOLLAR, WHICH STILL DOMINATES THE WORLD'S MONEY MARKETS. IN 1986, ON THE LONDON FOREIGN EXCHANGE MARKET, 97 PER CENT OF ALL TRANSACTIONS WERE IN DOLLARS.

OF COURSE, ALL FINANCIAL MARKETS HAVE A CERTAIN AMOUNT OF SPECULATIVE FROTH. BUT TO FUNCTION WELL THEY NEED SOME PLAYERS TO TAKE A LONGER VIEW, AND SO PROVIDE A STABILISING INFLUENCE. IN FOREIGN EXCHANGE MARKETS THEY HAVE BEEN CONSPICUOUS BY THEIR ABSENCE.

THIS MEANS THAT ONCE THE DOLLAR STARTS TO MOVE IN ONE DIRECTION, IT CAN CONTINUE IN THE SAME DIRECTION FOR MONTHS AND EVEN YEARS, EVEN IF THERE IS A GENERAL CONSENSUS THAT THE RATE IS OUT OF LINE. THIS IS WHAT HAPPENED IN 1984 AND EARLY 1985. ALMOST EVERYBODY AGREED THAT THE DOLLAR WAS OVERVALUED, AND THAT, IN THE LONG RUN, IT WAS BOUND TO FALL. BUT THEY CONTINUED TO BUY DOLLARS IN THE BELIEF THAT, IN THE SHORT RUN, IT WOULD MOVE EVEN HIGHER--WHICH IS, OF COURSE, WHAT CONSEQUENTLY OCCURRED.

THE RESULT IS THAT TRENDS HAVE BEEN GREATLY MAGNIFIED. CAPITAL MOVEMENTS HAVE GENERATED FLUCTUATIONS IN THE DOLLAR; BUT EQUALLY, FLUCTUATIONS IN THE DOLLAR HAVE THEMSELVES GENERATED FURTHER CAPITAL MOVEMENTS. THIS IS HOW EXCHANGE RATES HAVE OFTEN ACQUIRED A MOMENTUM OF THEIR OWN, WHICH HAS NOT BEEN REVERSED UNTIL THEY HAVE REACHED EXTREME LEVELS OF OVER- OR UNDER-VALUATION.

BACKGROUND TO PLAZA

IT WAS A GROWING CONCERN ABOUT THIS PROCESS THAT LED TO A SMALL GROUP OF US TO MEET IN THE PLAZA HOTEL IN SEPTEMBER 1985. WE SHARED THREE PERCEPTIONS.

- FIRST, THAT THE GYRATIONS IN EXCHANGE RATES HAD PROVED DAMAGING.

- SECOND, THAT THE IMMEDIATE PROBLEM WAS THAT THE DOLLAR WAS MUCH TOO HIGH.

- AND THIRD, THAT THE TIME WAS RIGHT FOR THE AUTHORITIES OF THE MAJOR COUNTRIES TO GIVE THE MARKETS A CLEAR LEAD.

THE PLAZA AGREEMENT MARKED AN IMPORTANT STEP TOWARDS A MORE MANAGED SYSTEM. IN PRIVATE, WE DISCUSSED THE SCALE OF FALL WE SAW AS DESIRABLE, AND ALTHOUGH NO FIGURES WERE GIVEN IN PUBLIC, EVERYONE WAS AWARE THAT WE WERE LOOKING FOR SUBSTANTIAL CHANGES. WE AGREED TO COOPERATE TO BRING THAT ABOUT. AND THAT AGREEMENT PLAYED AN IMPORTANT ROLE IN SECURING A CONTINUING FALL IN THE DOLLAR OVER THE SUCCEEDING 15 MONTHS.

THE LOUVRE

THE LOUVRE ACCORD EARLIER THIS YEAR MARKED ANOTHER IMPORTANT STEP FORWARD--PLAZA II, AS I CALLED IT AT THE TIME TO EMPHASISE THE CONTINUITY. BY THEN THE BROAD OBJECTIVES AGREED AT PLAZA HAD BEEN ACHIEVED. THE YEN AND THE DEUTSCHE MARK HAD APPRECIATED BY AS MUCH AS 50 PER CENT OR SO AGAINST THE DOLLAR.

WE AGREED THAT, GIVEN THE POLICIES BEING FOLLOWED, THE DOLLAR WAS BY THEN BROADLY IN LINE WITH ECONOMIC FUNDAMENTALS AND THAT THE INTERESTS OF THE WORLD ECONOMY WOULD BEST BE SERVED BY A PERIOD OF STABILITY, TO ALLOW TIME FOR THE MAJOR ECONOMIES TO ADJUST TO THE EXCHANGE

RATE/

CHANGES THAT HAD OCCURRED. WE WERE NOT, OF COURSE, THINKING IN TERMS OF RIGID EXCHANGE RATES, BUT WE DID DISCUSS THE SCALE OF FLUCTUATION, AROUND THE THEN CURRENT LEVELS, WHICH WE WOULD NOT WISH TO SEE EXCEEDED. FIGURES WERE AGREED IN PRIVATE, BUT NOT, OF COURSE, REVEALED IN PUBLIC.

IN SPITE OF WIDESPREAD SCEPTICISM WHEN IT WAS FIRST CONCLUDED SEVEN MONTHS AGO, THE AGREEMENT HAS PROVED A SUCCESS.

MANAGED FLOATING

THE MOVE TO MANAGED FLOATING HAS BEEN MADE POSSIBLE BY TWO FUNDAMENTAL CHANGES:

- FIRST, WE HAVE AT LAST RETURNED TO A WORLD OF LOW INFLATION. THE AVERAGE INFLATION RATE FOR THE MAJOR SEVEN ECONOMIES HAS FALLEN FROM 12 PER CENT IN 1980 TO ABOUT 3 PER CENT TODAY. IN THE PROCESS INFLATION DIFFERENTIALS HAVE BEEN NARROWED CONSIDERABLY.

- SECOND, THERE IS NOW A CLEAR CONSENSUS AMONG THE MAJOR COUNTRIES ABOUT THE APPROACH TO ECONOMIC POLICY. AND WE ALL AGREE ON THE NEED FOR A GREATER RELIANCE ON MARKET MECHANISMS WITHIN THE FRAMEWORK OF A FIRM MONETARY AND FISCAL POLICY.

WE HAVE BEEN ABLE TO MAKE THIS REGIME WORK BECAUSE:

- WE HAVE CHOSEN THE RIGHT TIME TO GIVE A LEAD TO THE MARKETS. IN THIS SENSE WE HAVE BEEN WORKING WITH, RATHER THAN AGAINST, THE GRAIN OF THE MARKETS.

- WE HAVE BEEN PREPARED TO COMMIT OURSELVES PUBLICLY TO APPROPRIATE AND CONSISTENT DOMESTIC POLICIES.

- IN PARTICULAR, WE HAVE ALL BEEN PREPARED IN PRACTICE TO GIVE SIGNIFICANT WEIGHT TO EXCHANGE RATES IN THE CONDUCT OF MONETARY POLICY.

- WE HAVE BEEN PREPARED TO BACK UP OUR AGREEMENT WITH CO-ORDINATED INTERVENTION, SOMETIMES ON A SUBSTANTIAL SCALE.

- WE HAVE DELIBERATELY NOT REVEALED DETAILS OF OUR ARRANGEMENTS. AND WE HAVE WORKED WITHIN MARGINS OF A SIZE SUFFICIENT TO ALLOW US THE NECESSARY TACTICAL ROOM FOR MANOEUVRE.

A REGIME FOR THE FUTURE

I BELIEVE THAT WE CAN AND SHOULD USE THE EXPERIENCE WE HAVE GAINED TO BUILD A MORE PERMANENT REGIME OF MANAGED FLOATING. I DO NOT SEE THE PAST TWO YEARS SIMPLY AS A TEMPORARY PHASE. OUR OBJECTIVES SHOULD BE CLEAR: TO MAINTAIN THE MAXIMUM STABILITY OF KEY EXCHANGE RATES, AND TO MANAGE ANY CHANGES THAT MAY BE NECESSARY IN AN ORDERLY WAY.

LET ME MAKE IT CLEAR THAT I AM NOT SUGGESTING THAT WE CAN OR SHOULD RETURN TO BRETTON WOODS. THAT SYSTEM WAS UNDERMINED BY ITS RIGIDITY; THE MARGINS WERE TOO NARROW; IT REQUIRED A PREDICTABLE AND MECHANICAL RESPONSE FROM THE AUTHORITIES THAT MADE THEM AN EASY TARGET; NECESSARY REALIGNMENTS WERE POSTPONED TOO LONG AND CONSEQUENTLY, WHEN THEY CAME, THEY WERE INEVITABLY LARGE.

FOR THE FUTURE, IT IS IMPORTANT, THEREFORE, THAT WE CONTINUE TO KEEP AN ADEQUATE DEGREE OF FLEXIBILITY IN TERMS OF THE WIDTH OF THE BANDS WITHIN WHICH CURRENCIES ARE ABLE TO FLUCTUATE. AND, IF AND WHEN THE TIME COMES TO ADJUST ONE OF THE RATES, THAT ADJUSTMENT SHOULD BE MADE BY MOVING THE MIDPOINT WITHIN THE CONFINES OF THE EXISTING RANGE. THIS MEANS THAT THE MARKETS ARE NOT GIVEN A ONE-WAY BET, AND THE AUTHORITIES RETAIN TACTICAL FLEXIBILITY.

AS I HAVE ALREADY EMPHASISED, WHAT MADE THE PLAZA AND LOUVRE AGREEMENTS POSSIBLE WAS THAT THE COUNTRIES PARTICIPATING WERE, AND REMAIN, IN EFFECT, MEMBERS OF AN ANTI-INFLATIONARY CLUB, WITH A CLEAR COMMITMENT TO TAKING WHATEVER STEPS ARE NECESSARY TO CURB THEIR OWN INFLATION. IT IS VITAL THAT THAT COMMITMENT CONTINUES, INDIVIDUALLY AND COLLECTIVELY. A RESURGENCE OF INFLATION IN ANY INDIVIDUAL COUNTRY WOULD MAKE IT DIFFICULT FOR THAT COUNTRY TO REMAIN WITHIN THE CLUB

AT THE SAME TIME, WE MUST ALSO ENSURE THAT THERE IS NO PERSISTENT INFLATIONARY (OR FOR THAT MATTER DEFLATIONARY) BIAS FOR THE GROUP AS A WHOLE. THIS CAN BE HELPED BY:

- THE DEVELOPMENT OF INDICATORS FOR THE GROUP AS A WHOLE; THESE WILL BE MAINLY FINANCIAL BUT SPECIAL ATTENTION SHOULD ALSO BE GIVEN TO THE TREND OF WORLD COMMODITY PRICES;

- A NOMINAL FRAMEWORK FOR POLICY, IN TERMS EITHER OF A PATH FOR GDP GROWTH FOR THE GROUP AS A WHOLE, OR ONE FOR THE AVERAGE INFLATION RATE;

- AND A MEDIUM-TERM PERSPECTIVE WHEN SETTING OUT THE PATH AND IN GAUGING ACTUAL PERFORMANCE. WE SHOULD NOT BECOME INVOLVED IN AN EXERCISE IN SHORT-TERM FINE TUNING.

IN RECENT MEETINGS WE HAVE PUT A LOT OF EFFORT INTO DEVELOPING PERFORMANCE INDICATORS FOR INDIVIDUAL COUNTRIES. I HAVE TO SAY THAT I HAVE CONSIDERABLE DOUBTS WHETHER WE CAN USEFULLY TAKE THAT EXERCISE MUCH FURTHER. I BELIEVE IT WOULD BE FAR MORE USEFUL TO DEVOTE

OUR EFFORTS TO MONITORING THE PERFORMANCE OF THE GROUP AS A WHOLE, SO THAT WE CAN ENSURE THAT WE MAINTAIN THE CORRECT NON-INFLATIONARY STANCE OF POLICY.

CURRENT ACCOUNT IMBALANCES

SOME FEARS HAVE BEEN EXPRESSED THAT THE LOUVRE AGREEMENT WILL BE UNDERMINED BY THE PERSISTENCE OF CURRENT ACCOUNT IMBALANCES BETWEEN THE MAJOR COUNTRIES. I DO NOT BELIEVE THIS NEED BE SO.

WHAT WE ARE SEEING IS NOT ALTOGETHER SURPRISING. IT IS THE FAMILIAR J-CURVE EFFECT, AND ALTHOUGH THE IMBALANCES REMAIN LARGE, TRADE VOLUMES ARE ADJUSTING.

IN ANY CASE, THERE IS NO LAW THAT DICTATES THAT THE CURRENT ACCOUNTS OF THE MAJOR INDUSTRIAL COUNTRIES SHOULD ALWAYS BE IN BALANCE. WE HAVE AN INTEGRATED WORLD ECONOMY AND WE ENCOURAGE THE FREE FLOW OF CAPITAL AND GOODS. CLEARLY THERE ARE LIMITS TO THE ACCUMULATED EXTERNAL LIABILITIES OR ASSETS THAT CAN BE SUSTAINED

WITHOUT CREATING MAJOR ANXIETIES FOR CAPITAL MARKETS. BUT INVESTMENT OPPORTUNITIES AND SAVINGS PROPENSITIES INEVITABLY DIFFER FROM COUNTRY TO COUNTRY AND IT IS NATURAL FOR THIS TO PRODUCE SUBSTANTIAL, AND OFTEN SUSTAINED, CAPITAL ACCOUNT FLOWS. THESE FLOWS NECESSARILY HAVE THEIR COUNTERPARTS IN CURRENT ACCOUNT SURPLUSES AND DEFICITS.

THE PRESENT COMBINATION OF DEFICITS AND SUPLUSES HAS EMERGED OVER SEVERAL YEARS DURING WHICH THE GROWTH OF DOMESTIC DEMAND IN GERMANY AND JAPAN HAS BEEN CONSISTENTLY BELOW THE GROWTH OF OUTPUT, WHILE IN THE UNITED STATES IT HAS BEEN CONSISTENTLY ABOVE. THE PROCESS OF UNWINDING THE IMBALANCES REQUIRES A REVERSAL OF THE DIFFERENCES BETWEEN DOMESTIC DEMAND AND OUTPUT IN THOSE COUNTRIES. THIS IS BOUND TO TAKE TIME TO COMPLETE, BUT --AND THIS IS IMPORTANT--IT HAS NOW BEGUN.

IT WOULD BE A SERIOUS MISTAKE TO SEEK A SHORT CUT BY A FURTHER DOLLAR DEPRECIATION. IT WAS UNDOUBTEDLY NECESSARY TO CORRECT THE HUGE MISALIGNMENT OF THE DOLLAR IN 1985. BUT THERE IS NO CASE FOR GOING TO THE OPPOSITE EXTREME OF AN ARTIFICIALLY LOW DOLLAR. THE BENEFITS TO THE CURRENT ACCOUNT WOULD BE SMALL COMPARED TO THE DAMAGE TO US INFLATION AND THE DISLOCATION TO THE WORLD ECONOMY. THE MAIN LESSON FROM RECENT YEARS IS THAT WE SHOULD AVOID EXCHANGE RATE MISALIGNMENTS, NOT ENCOURAGE THEM.

CONCLUSION

IN CONCLUSION, I BELIEVE THAT EXTERNAL STABILITY SHOULD NOW COMPLEMENT THE INTERNAL FINANCIAL STABILITY THAT WE HAVE ALREADY ACHIEVED. IT WILL REMEDY A MAJOR WEAKNESS IN THE WORLD FINANCIAL ORDER AND PROVIDE A SOUNDER BASIS FOR THE PROSPERITY WE ALL SEEK.

TO: HM TREASURY FAX OPERATOR

FROM: UKDEL IMF/IBRD, WASHINGTON

PLEASE PASS THE FOLLOWING PAGES IMMEDIATELY * TO:

Chancellor's Secretariat
Mr. H.G. Walsh
Mr. Stephen Pickford *

and fax to:

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THANKS.

DMR
30/ix/87

cc PS/EST
Sir P. Middleton
Mr Cassell
Mr Lovelle
Mr Peretz
Mr Mountfield
Mr S W Matthews
Mr Cropper
Mr Hudson
PS/Governor (Bank)
Mr Norgrove (No 10)

BOARD OF GOVERNORS 1987 ANNUAL MEETINGS, WASHINGTON DC
STATEMENT BY THE RT.HON. NIGEL LAWSON MP
CHANCELLOR OF THE EXCHEQUER
GOVERNOR OF THE FUND FOR THE UNITED KINGDOM
AT THE JOINT ANNUAL MEETINGS, SEPTEMBER 30, 1987

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I WELCOME THE PROGRESS THAT WE HAVE MADE AT THESE MEETINGS ON A NUMBER OF ISSUES OF GREAT IMPORTANCE. WE HAVE REAFFIRMED THE LOUVRE AGREEMENT. THERE IS NOW FULL SUPPORT FOR AN EARLY AND SUBSTANTIAL GENERAL CAPITAL INCREASE FOR THE WORLD BANK. AND THERE IS INCREASING RECOGNITION THAT WITHIN THE GENERAL DEBT STRATEGY, SPECIAL ACTION IS REQUIRED TO HELP THE VERY POOREST AND MOST HEAVILY INDEBTED COUNTRIES, PARTICULARLY IN SUB-SAHARAN AFRICA.

AT THE MEETINGS OF THE INTERIM AND DEVELOPMENT COMMITTEES THIS APRIL, I PUT FORWARD A THREE-POINT PROPOSAL FOR ASSISTING THESE COUNTRIES, PROVIDED THEY PURSUE APPROPRIATE ADJUSTMENT POLICIES: THE CONVERSION OF AID LOANS INTO OUTRIGHT GRANTS; LONGER REPAYMENT AND GRACE PERIODS ON PARIS CLUB RESCHEDULINGS; AND REDUCTIONS IN THE RATES OF INTEREST ON THOSE RESCHEDULINGS

THE MANAGING DIRECTOR OF THE INTERNATIONAL MONETARY FUND AND THE PRESIDENT OF THE WORLD BANK HAVE PUT FORWARD COMPLEMENTARY PROPOSALS FOR HELPING THE POOREST COUNTRIES BY CONCESSIONAL INTEREST RATES, INCLUDING A SUBSTANTIAL INCREASE IN THE SIZE OF THE IMF'S STRUCTURAL ADJUSTMENT FACILITY. I SUPPORT THESE PROPOSALS, AND BELIEVE THAT HEAVY INDEBTEDNESS SHOULD BE A MAJOR FACTOR IN DETERMINING THE ALLOCATION OF FUNDS UNDER ANY ENLARGEMENT OF THE SAF.

IT IS OF THE FIRST IMPORTANCE THAT WE MAKE A REAL EFFORT TO REACH AGREEMENT ON ALL THESE PROPOSALS AT THE EARLIEST POSSIBLE DATE.

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I NOW TURN TO THE EXPERIENCE OF MY OWN COUNTRY DURING THE PAST YEAR. SINCE THE SHARP FALL IN THE OIL PRICE IN 1986 THE GROWTH RATE OF THE UK ECONOMY, SO FAR FROM SLOWING DOWN AS WAS EXPECTED, HAS ACTUALLY PICKED UP. AT THE SAME TIME, THE GROWTH RATE FOR THE MAJOR INDUSTRIALISED COUNTRIES AS A WHOLE HAS BEEN BELOW EXPECTATIONS. AT FIRST SIGHT THIS SEEMS PARADOXICAL. THE INDUSTRIALISED COUNTRIES IN AGGREGATE WERE SIGNIFICANT BENEFICIARIES FROM LOWER OIL PRICES WHEREAS THE UK, AS A MAJOR OIL PRODUCER AND EXPORTER, STOOD TO LOSE SIGNIFICANTLY.

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THE UK IS NOW WELL INTO ITS SEVENTH YEAR OF STEADY GROWTH AT 3 PER CENT A YEAR. DURING THAT PERIOD THERE HAVE BEEN MINOR FLUCTUATIONS, AND AFTER THE SLIGHT SPURT THIS YEAR, I WOULD EXPECT SOMETHING CLOSER TO THE 3 PER CENT AVERAGE RATE NEXT YEAR.

THE BACKGROUND TO THE LOUVRE

I NOW TURN TO THE EVOLUTION OF EXCHANGE RATE POLICY.

FOR THE FIRST 25 YEARS AFTER THE WAR, EXCHANGE RATE STABILITY WAS ACHIEVED THROUGH THE BRETTON WOODS SYSTEM. THIS FORMED A CORNERSTONE OF THE POST-WAR ECONOMIC ORDER, NOT LEAST AS A FORCE FOR FINANCIAL DISCIPLINE. BUT IT BEGAN TO BREAK DOWN IN THE LATE 1960s, AND BY THE EARLY 1970s IT HAD COLLAPSED ALTOGETHER.

THEREAFTER, WITH COUNTRIES PURSUING DIVERGENT ECONOMIC POLICIES, AND MANY SUFFERING FROM HIGH AND VOLATILE INFLATION, A SYSTEM OF FLOATING EXCHANGE RATES WAS VIRTUALLY INESCAPABLE. INDEED MANY AT THE TIME BELIEVED THIS NEW FLEXIBILITY TO BE DESIRABLE.

WITH HINDSIGHT, SOME OF THE ARGUMENTS FOR FREE FLOATING SEEM MUCH LESS COMPELLING. AND THE BELIEF THAT MARKETS WOULD PROVIDE A STABILISING INFLUENCE, THROUGH THE OPERATIONS OF MEDIUM-TERM SPECULATORS, HAS NOT BEEN BORNE OUT.

IN PARTICULAR, WE HAVE SEEN WILD GYRATIONS IN THE DOLLAR, THAT HAVE CLEARLY NOT BEEN A REFLECTION OF ECONOMIC FUNDAMENTALS, WHICH ARE ESSENTIALLY SLOW-MOVING. FEW COULD SERIOUSLY ARGUE THAT TWO DEUTSCHEMARKS TO THE DOLLAR WAS "CORRECT" IN 1979, AND AGAIN AT THE END OF 1986, AND YET THAT THREE DEUTSCHEMARKS TO THE DOLLAR WAS "CORRECT" IN 1985.

MOREOVER, THESE GYRATIONS HAVE DAMAGED GROWTH IN WORLD TRADE. BUSINESSES HAVE HAD TO DIVERT SCARCE MANAGEMENT TIME AND SKILLS TO COPING WITH CURRENCY FLUCTUATIONS, RATHER THAN IMPROVING COMPANY PERFORMANCE. AND THE MAJOR UNCERTAINTIES ABOUT EXCHANGE RATE MOVEMENTS INHIBITED RISK TAKING AND REQUIRED A SWITCHING OF RESOURCES AT A PACE THAT WAS WHOLLY UNREALISTIC.

THE EXPLANATION FOR THESE GYRATIONS IN THE DOLLAR DERIVES IN LARGE PART FROM THE NATURE OF THE FOREIGN EXCHANGE MARKETS. WE NOW HAVE GLOBAL 24-HOUR MARKETS IN WHICH TURNOVER HAS INCREASED DRAMATICALLY, WITH ONLY A SMALL PART OF THAT RELATED TO COMMERCIAL TRANSACTIONS.

THIS PRESENTS PARTICULARLY ACUTE PROBLEMS FOR THE DOLLAR, WHICH STILL DOMINATES THE WORLD'S MONEY MARKETS. IN 1986, ON THE LONDON FOREIGN EXCHANGE MARKET, 97 PER CENT OF ALL TRANSACTIONS WERE IN DOLLARS.

OF COURSE, ALL FINANCIAL MARKETS HAVE A CERTAIN AMOUNT OF SPECULATIVE FROTH. BUT TO FUNCTION WELL THEY NEED SOME PLAYERS TO TAKE A LONGER VIEW, AND SO PROVIDE A STABILISING INFLUENCE. IN FOREIGN EXCHANGE MARKETS THEY HAVE BEEN CONSPICUOUS BY THEIR ABSENCE.

THIS MEANS THAT ONCE THE DOLLAR STARTS TO MOVE IN ONE DIRECTION, IT CAN CONTINUE IN THE SAME DIRECTION FOR MONTHS AND EVEN YEARS, EVEN IF THERE IS A GENERAL CONSENSUS THAT THE RATE IS OUT OF LINE. THIS IS WHAT HAPPENED IN 1984 AND EARLY 1985. ALMOST EVERYBODY AGREED THAT THE DOLLAR WAS OVERVALUED, AND THAT, IN THE LONG RUN, IT WAS BOUND TO FALL. BUT THEY CONTINUED TO BUY DOLLARS IN THE BELIEF THAT, IN THE SHORT RUN, IT WOULD MOVE EVEN HIGHER--WHICH IS, OF COURSE, WHAT CONSEQUENTLY OCCURRED.

THE RESULT IS THAT TRENDS HAVE BEEN GREATLY MAGNIFIED. CAPITAL MOVEMENTS HAVE GENERATED FLUCTUATIONS IN THE DOLLAR; BUT EQUALLY, FLUCTUATIONS IN THE DOLLAR HAVE THEMSELVES GENERATED FURTHER CAPITAL MOVEMENTS. THIS IS HOW EXCHANGE RATES HAVE OFTEN ACQUIRED A MOMENTUM OF THEIR OWN, WHICH HAS NOT BEEN REVERSED UNTIL THEY HAVE REACHED EXTREME LEVELS OF OVER- OR UNDER-VALUATION.

BACKGROUND TO PLAZA

IT WAS A GROWING CONCERN ABOUT THIS PROCESS THAT LED TO A SMALL GROUP OF US TO MEET IN THE PLAZA HOTEL IN SEPTEMBER 1985. WE SHARED THREE PERCEPTIONS.

- FIRST, THAT THE GYRATIONS IN EXCHANGE RATES HAD PROVED DAMAGING.

- SECOND, THAT THE IMMEDIATE PROBLEM WAS THAT THE DOLLAR WAS MUCH TOO HIGH.

- AND THIRD, THAT THE TIME WAS RIGHT FOR THE AUTHORITIES OF THE MAJOR COUNTRIES TO GIVE THE MARKETS A CLEAR LEAD.

The Plaza Agreement marked an important step towards a more managed system. In private, we discussed the scale of fall we saw as desirable, and although no figures were given in public, everyone was aware that we were looking for substantial changes. We agreed to cooperate to bring that about. And that agreement played an important role in securing a continuing fall in the dollar over the succeeding 15 months.

The Louvre

The Louvre Accord earlier this year marked another important step forward--Plaza II, as I called it at the time to emphasise the continuity. By then the broad objectives agreed at Plaza had been achieved. The yen and the deutsche mark had appreciated by as much as 50 per cent or so against the dollar.

We agreed that, given the policies being followed the dollar was by then broadly in line with economic fundamentals and that the interests of the world economy would best be served by a period of stability, to allow time for the major economies to adjust to the exchange r

CHANGES THAT HAD OCCURRED. WE WERE NOT, OF COURSE, THINKING IN TERMS OF RIGID EXCHANGE RATES, BUT WE DID DISCUSS THE SCALE OF FLUCTUATION, AROUND THE THEN CURRENT LEVELS, WHICH WE WOULD NOT WISH TO SEE EXCEEDED. FIGURES WERE AGREED IN PRIVATE, BUT NOT, OF COURSE, REVEALED IN PUBLIC.

IN SPITE OF WIDESPREAD SCEPTICISM WHEN IT WAS FIRST CONCLUDED SEVEN MONTHS AGO, THE AGREEMENT HAS PROVED A SUCCESS.

MANAGED FLOATING

THE MOVE TO MANAGED FLOATING HAS BEEN MADE POSSIBLE BY TWO FUNDAMENTAL CHANGES:

- FIRST, WE HAVE AT LAST RETURNED TO A WORLD OF LOW INFLATION. THE AVERAGE INFLATION RATE FOR THE MAJOR SEVEN ECONOMIES HAS FALLEN FROM 12 PER CENT IN 1980 TO ABOUT 3 PER CENT TODAY. IN THE PROCESS INFLATION DIFFERENTIALS HAVE BEEN NARROWED CONSIDERABLY.

- SECOND, THERE IS NOW A CLEAR CONSENSUS AMONG THE MAJOR COUNTRIES ABOUT THE APPROACH TO ECONOMIC POLICY. AND WE ALL AGREE ON THE NEED FOR A GREATER RELIANCE ON MARKET MECHANISMS WITHIN THE FRAMEWORK OF A FIRM MONETARY AND FISCAL POLICY.

WE HAVE BEEN ABLE TO MAKE THIS REGIME WORK BECAUSE:

- WE HAVE CHOSEN THE RIGHT TIME TO GIVE A LEAD TO THE MARKETS. IN THIS SENSE WE HAVE BEEN WORKING WITH, RATHER THAN AGAINST, THE GRAIN OF THE MARKETS.

- WE HAVE BEEN PREPARED TO COMMIT OURSELVES PUBLICLY TO APPROPRIATE AND CONSISTENT DOMESTIC POLICIES.

- IN PARTICULAR, WE HAVE ALL BEEN PREPARED IN PRACTICE TO GIVE SIGNIFICANT WEIGHT TO EXCHANGE RATES IN THE CONDUCT OF MONETARY POLICY.

- WE HAVE BEEN PREPARED TO BACK UP OUR AGREEMENT WITH CO-ORDINATED INTERVENTION, SOMETIMES ON A SUBSTANTIAL SCALE.

- WE HAVE DELIBERATELY NOT REVEALED DETAILS OF OUR ARRANGEMENTS. AND WE HAVE WORKED WITHIN MARGINS OF A SIZE SUFFICIENT TO ALLOW US THE NECESSARY TACTICAL ROOM FOR MANOEUVRE.

A REGIME FOR THE FUTURE

I BELIEVE THAT WE CAN AND SHOULD USE THE EXPERIENCE WE HAVE GAINED TO BUILD A MORE PERMANENT REGIME OF MANAGED FLOATING. I DO NOT SEE THE PAST TWO YEARS SIMPLY AS A TEMPORARY PHASE. OUR OBJECTIVES SHOULD BE CLEAR: TO MAINTAIN THE MAXIMUM STABILITY OF KEY EXCHANGE RATES, AND TO MANAGE ANY CHANGES THAT MAY BE NECESSARY IN AN ORDERLY WAY.

Let me make it clear that I am not suggesting that we can or should return to Bretton Woods. That system was undermined by its rigidity; the margins were too narrow; it required a predictable and mechanical response from the authorities that made them an easy target; necessary realignments were postponed too long and consequently, when they came, they were inevitably large.

For the future, it is important, therefore, that we continue to keep an adequate degree of flexibility in terms of the width of the bands within which currencies are able to fluctuate. And, if and when the time comes to adjust one of the rates, that adjustment should be made by moving the midpoint within the confines of the existing range. This means that the markets are not given a one-way bet, and the authorities retain tactical flexibility.

As I have already emphasised, what made the Plaza and Louvre agreements possible was that the countries participating were, and remain, in effect, members of an anti-inflationary club, with a clear commitment to taking whatever steps are necessary to curb their own inflation. It is vital that that commitment continues, individually and collectively. A resurgence of inflation in any individual country would make it difficult for that country to remain within the club

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AT THE SAME TIME, WE MUST ALSO ENSURE THAT THERE IS NO PERSISTENT INFLATIONARY (OR FOR THAT MATTER DEFLATIONARY) BIAS FOR THE GROUP AS A WHOLE. THIS CAN BE HELPED BY:

- THE DEVELOPMENT OF INDICATORS FOR THE GROUP AS A WHOLE; THESE WILL BE MAINLY FINANCIAL BUT SPECIAL ATTENTION SHOULD ALSO BE GIVEN TO THE TREND OF WORLD COMMODITY PRICES;

- A NOMINAL FRAMEWORK FOR POLICY, IN TERMS EITHER OF A PATH FOR GDP GROWTH FOR THE GROUP AS A WHOLE, OR ONE FOR THE AVERAGE INFLATION RATE;

- AND A MEDIUM-TERM PERSPECTIVE WHEN SETTING OUT THE PATH AND IN GAUGING ACTUAL PERFORMANCE. WE SHOULD NOT BECOME INVOLVED IN AN EXERCISE IN SHORT-TERM FINE TUNING.

IN RECENT MEETINGS WE HAVE PUT A LOT OF EFFORT INTO DEVELOPING PERFORMANCE INDICATORS FOR INDIVIDUAL COUNTRIES. I HAVE TO SAY THAT I HAVE CONSIDERABLE DOUBTS WHETHER WE CAN USEFULLY TAKE THAT EXERCISE MUCH FURTHER. I BELIEVE IT WOULD BE FAR MORE USEFUL TO DEVOTE

OUR EFFORTS TO MONITORING THE PERFORMANCE OF THE GROUP AS A WHOLE, SO THAT WE CAN ENSURE THAT WE MAINTAIN THE CORRECT NON-INFLATIONARY STANCE OF POLICY.

<u>CURRENT ACCOUNT IMBALANCES</u>

SOME FEARS HAVE BEEN EXPRESSED THAT THE LOUVRE AGREEMENT WILL BE UNDERMINED BY THE PERSISTENCE OF CURRENT ACCOUNT IMBALANCES BETWEEN THE MAJOR COUNTRIES. I DO NOT BELIEVE THIS NEED BE SO.

WHAT WE ARE SEEING IS NOT ALTOGETHER SURPRISING. IT IS THE FAMILIAR J-CURVE EFFECT, AND ALTHOUGH THE IMBALANCES REMAIN LARGE, TRADE VOLUMES ARE ADJUSTING.

IN ANY CASE, THERE IS NO LAW THAT DICTATES THAT THE CURRENT ACCOUNTS OF THE MAJOR INDUSTRIAL COUNTRIES SHOULD ALWAYS BE IN BALANCE. WE HAVE AN INTEGRATED WORLD ECONOMY AND WE ENCOURAGE THE FREE FLOW OF CAPITAL AND GOODS. CLEARLY THERE ARE LIMITS TO THE ACCUMULATED EXTERNAL LIABILITIES OR ASSETS THAT CAN BE SUSTAINED

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WITHOUT CREATING MAJOR ANXIETIES FOR CAPITAL MARKETS. BUT INVESTMENT OPPORTUNITIES AND SAVINGS PROPENSITIES INEVITABLY DIFFER FROM COUNTRY TO COUNTRY AND IT IS NATURAL FOR THIS TO PRODUCE SUBSTANTIAL, AND OFTEN SUSTAINED, CAPITAL ACCOUNT FLOWS. THESE FLOWS NECESSARILY HAVE THEIR COUNTERPARTS IN CURRENT ACCOUNT SURPLUSES AND DEFICITS.

THE PRESENT COMBINATION OF DEFICITS AND SUPLUSES HAS EMERGED OVER SEVERAL YEARS DURING WHICH THE GROWTH OF DOMESTIC DEMAND IN GERMANY AND JAPAN HAS BEEN CONSISTENTLY BELOW THE GROWTH OF OUTPUT, WHILE IN THE UNITED STATES IT HAS BEEN CONSISTENTLY ABOVE. THE PROCESS OF UNWINDING THE IMBALANCES REQUIRES A REVERSAL OF THE DIFFERENCES BETWEEN DOMESTIC DEMAND AND OUTPUT IN THOSE COUNTRIES. THIS IS BOUND TO TAKE TIME TO COMPLETE, BUT --AND THIS IS IMPORTANT--IT HAS NOW BEGUN.

IT WOULD BE A SERIOUS MISTAKE TO SEEK A SHORT CUT BY A FURTHER DOLLAR DEPRECIATION. IT WAS UNDOUBTEDLY NECESSARY TO CORRECT THE HUGE MISALIGNMENT OF THE DOLLAR IN 1985. BUT THERE IS NO CASE FOR GOING TO THE OPPOSITE EXTREME OF AN ARTIFICIALLY LOW DOLLAR. THE BENEFITS TO THE CURRENT ACCOUNT WOULD BE SMALL COMPARED TO THE DAMAGE TO US INFLATION AND THE DISLOCATION TO THE WORLD ECONOMY. THE MAIN LESSON FROM RECENT YEARS IS THAT WE SHOULD AVOID EXCHANGE RATE MISALIGNMENTS, NOT ENCOURAGE THEM.

<u>CONCLUSION</u>

IN CONCLUSION, I BELIEVE THAT EXTERNAL STABILITY SHOULD NOW COMPLEMENT THE INTERNAL FINANCIAL STABILITY THAT WE HAVE ALREADY ACHIEVED. IT WILL REMEDY A MAJOR WEAKNESS IN THE WORLD FINANCIAL ORDER AND PROVIDE A SOUNDER BASIS FOR THE PROSPERITY WE ALL SEEK.

30/9/87. PWP

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The result is that trends have been greatly magnified. Capital movements have generated fluctuations in the dollar; but equally, fluctuations in the dollar have themselves generated further capital movements. This is how exchange rates have often acquired a momentum of their own, which has not been reversed until they have reached extreme levels of over- or under-valuation.

<u>Background to Plaza</u>

It was a growing concern about this process that led a small group of us to meet in the Plaza Hotel in September 1985. We shared three perceptions.

- First, that the gyrations in exchange rates had proved damaging.

- Second, that the immediate problem was that the dollar was much too high.

- And third, that the time was right for the authorities of the major countries to give the markets a clear lead.

THE PLAZA AGREEMENT MARKED AN IMPORTANT STEP TOWARDS A MORE MANAGED SYSTEM. IN PRIVATE, WE DISCUSSED THE SCALE OF FALL WE SAW AS DESIRABLE, AND ALTHOUGH NO FIGURES WERE GIVEN IN PUBLIC, EVERYONE WAS AWARE THAT WE WERE LOOKING FOR SUBSTANTIAL CHANGES. WE AGREED TO COOPERATE TO BRING THAT ABOUT. AND THAT AGREEMENT PLAYED AN IMPORTANT ROLE IN SECURING A CONTINUING FALL IN THE DOLLAR OVER THE SUCCEEDING 15 MONTHS.

THE LOUVRE

THE LOUVRE ACCORD EARLIER THIS YEAR MARKED ANOTHER IMPORTANT STEP FORWARD--PLAZA II, AS I CALLED IT AT THE TIME TO EMPHASISE THE CONTINUITY. BY THEN THE BROAD OBJECTIVES AGREED AT PLAZA HAD BEEN ACHIEVED. THE YEN AND THE DEUTSCHE MARK HAD APPRECIATED BY AS MUCH AS 50 PER CENT OR SO AGAINST THE DOLLAR.

WE AGREED THAT, GIVEN THE POLICIES BEING FOLLOWED, THE DOLLAR WAS BY THEN BROADLY IN LINE WITH ECONOMIC FUNDAMENTALS AND THAT THE INTERESTS OF THE WORLD ECONOMY WOULD BEST BE SERVED BY A PERIOD OF STABILITY, TO ALLOW TIME FOR THE MAJOR ECONOMIES TO ADJUST TO THE EXCHANGE RATE

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IN SPITE OF WIDESPREAD SCEPTICISM WHEN IT WAS FIRST CONCLUDED SEVEN MONTHS AGO, THE AGREEMENT HAS PROVED A SUCCESS.

MANAGED FLOATING

THE MOVE TO MANAGED FLOATING HAS BEEN MADE POSSIBLE BY TWO FUNDAMENTAL CHANGES:

- FIRST, WE HAVE AT LAST RETURNED TO A WORLD OF LOW INFLATION. THE AVERAGE INFLATION RATE FOR THE MAJOR SEVEN ECONOMIES HAS FALLEN FROM 12 PER CENT IN 1980 TO ABOUT 3 PER CENT TODAY. IN THE PROCESS INFLATION DIFFERENTIALS HAVE BEEN NARROWED CONSIDERABLY.

- SECOND, THERE IS NOW A CLEAR CONSENSUS AMONG THE MAJOR COUNTRIES ABOUT THE APPROACH TO ECONOMIC POLICY. AND WE ALL AGREE ON THE NEED FOR A GREATER RELIANCE ON MARKET MECHANISMS WITHIN THE FRAMEWORK OF A FIRM MONETARY AND FISCAL POLICY.

WE HAVE BEEN ABLE TO MAKE THIS REGIME WORK BECAUSE:

- WE HAVE CHOSEN THE RIGHT TIME TO GIVE A LEAD TO THE MARKETS. IN THIS SENSE WE HAVE BEEN WORKING WITH, RATHER THAN AGAINST, THE GRAIN OF THE MARKETS.

- WE HAVE BEEN PREPARED TO COMMIT OURSELVES PUBLICLY TO APPROPRIATE AND CONSISTENT DOMESTIC POLICIES.

- IN PARTICULAR, WE HAVE ALL BEEN PREPARED IN PRACTICE TO GIVE SIGNIFICANT WEIGHT TO EXCHANGE RATES IN THE CONDUCT OF MONETARY POLICY.

- WE HAVE BEEN PREPARED TO BACK UP OUR AGREEMENT WITH CO-ORDINATED INTERVENTION, SOMETIMES ON A SUBSTANTIAL SCALE.

- WE HAVE DELIBERATELY NOT REVEALED DETAILS OF OUR ARRANGEMENTS. AND WE HAVE WORKED WITHIN MARGINS OF A SIZE SUFFICIENT TO ALLOW US THE NECESSARY TACTICAL ROOM FOR MANOEUVRE.

A REGIME FOR THE FUTURE

I BELIEVE THAT WE CAN AND SHOULD USE THE EXPERIENCE WE HAVE GAINED TO BUILD A MORE PERMANENT REGIME OF MANAGED FLOATING. I DO NOT SEE THE PAST TWO YEARS SIMPLY AS A TEMPORARY PHASE. OUR OBJECTIVES SHOULD BE CLEAR: TO MAINTAIN THE MAXIMUM STABILITY OF KEY EXCHANGE RATES, AND TO MANAGE ANY CHANGES THAT MAY BE NECESSARY IN AN ORDERLY WAY.

LET ME MAKE IT CLEAR THAT I AM NOT SUGGESTING THAT WE CAN OR SHOULD RETURN TO BRETTON WOODS. THAT SYSTEM WAS UNDERMINED BY ITS RIGIDITY; THE MARGINS WERE TOO NARROW; IT REQUIRED A PREDICTABLE AND MECHANICAL RESPONSE FROM THE AUTHORITIES THAT MADE THEM AN EASY TARGET; NECESSARY REALIGNMENTS WERE POSTPONED TOO LONG AND CONSEQUENTLY, WHEN THEY CAME, THEY WERE INEVITABLY LARGE.

FOR THE FUTURE, IT IS IMPORTANT, THEREFORE, THAT WE CONTINUE TO KEEP AN ADEQUATE DEGREE OF FLEXIBILITY IN TERMS OF THE WIDTH OF THE BANDS WITHIN WHICH CURRENCIES ARE ABLE TO FLUCTUATE. AND, IF AND WHEN THE TIME COMES TO ADJUST ONE OF THE RATES, THAT ADJUSTMENT SHOULD BE MADE BY MOVING THE MIDPOINT WITHIN THE CONFINES OF THE EXISTING RANGE. THIS MEANS THAT THE MARKETS ARE NOT GIVEN A ONE-WAY BET, AND THE AUTHORITIES RETAIN TACTICAL FLEXIBILITY.

AS I HAVE ALREADY EMPHASISED, WHAT MADE THE PLAZA AND LOUVRE AGREEMENTS POSSIBLE WAS THAT THE COUNTRIES PARTICIPATING WERE, AND REMAIN, IN EFFECT, MEMBERS OF AN ANTI-INFLATIONARY CLUB, WITH A CLEAR COMMITMENT TO TAKING WHATEVER STEPS ARE NECESSARY TO CURB THEIR OWN INFLATION. IT IS VITAL THAT THAT COMMITMENT CONTINUES, INDIVIDUALLY AND COLLECTIVELY. A RESURGENCE OF INFLATION IN ANY INDIVIDUAL COUNTRY WOULD MAKE IT DIFFICULT FOR THAT COUNTRY TO REMAIN WITHIN THE CLUB.

AT THE SAME TIME, WE MUST ALSO ENSURE THAT THERE IS NO PERSISTENT INFLATIONARY (OR FOR THAT MATTER DEFLATIONARY) BIAS FOR THE GROUP AS A WHOLE. THIS CAN BE HELPED BY:

- THE DEVELOPMENT OF INDICATORS FOR THE GROUP AS A WHOLE; THESE WILL BE MAINLY FINANCIAL BUT SPECIAL ATTENTION SHOULD ALSO BE GIVEN TO THE TREND OF WORLD COMMODITY PRICES;

- A NOMINAL FRAMEWORK FOR POLICY, IN TERMS EITHER OF A PATH FOR GDP GROWTH FOR THE GROUP AS A WHOLE, OR ONE FOR THE AVERAGE INFLATION RATE;

- AND A MEDIUM-TERM PERSPECTIVE WHEN SETTING OUT THE PATH AND IN GAUGING ACTUAL PERFORMANCE. WE SHOULD NOT BECOME INVOLVED IN AN EXERCISE IN SHORT-TERM FINE TUNING.

IN RECENT MEETINGS WE HAVE PUT A LOT OF EFFORT INTO DEVELOPING PERFORMANCE INDICATORS FOR INDIVIDUAL COUNTRIES. I HAVE TO SAY THAT I HAVE CONSIDERABLE DOUBTS WHETHER WE CAN USEFULLY TAKE THAT EXERCISE MUCH FURTHER. I BELIEVE IT WOULD BE FAR MORE USEFUL TO DEVOTE

OUR EFFORTS TO MONITORING THE PERFORMANCE OF THE GROUP AS A WHOLE, SO THAT WE CAN ENSURE THAT WE MAINTAIN THE CORRECT NON-INFLATIONARY STANCE OF POLICY.

Current Account Imbalances

Some fears have been expressed that the Louvre agreement will be undermined by the persistence of current account imbalances between the major countries. I do not believe this need be so.

What we are seeing is not altogether surprising. It is the familiar J-curve effect, and although the imbalances remain large, trade volumes are adjusting.

In any case, there is no law that dictates that the current accounts of the major industrial countries should always be in balance. We have an integrated world economy and we encourage the free flow of capital and goods. Clearly there are limits to the accumulated external liabilities or assets that can be sustained

WITHOUT CREATING MAJOR ANXIETIES FOR CAPITAL MARKETS. BUT INVESTMENT OPPORTUNITIES AND SAVINGS PROPENSITIES INEVITABLY DIFFER FROM COUNTRY TO COUNTRY, AND IT IS NATURAL FOR THIS TO PRODUCE SUBSTANTIAL, AND OFTEN SUSTAINED, CAPITAL ACCOUNT FLOWS. THESE FLOWS NECESSARILY HAVE THEIR COUNTERPARTS IN CURRENT ACCOUNT SURPLUSES AND DEFICITS.

THE PRESENT COMBINATION OF DEFICITS AND SUPLUSES HAS EMERGED OVER SEVERAL YEARS DURING WHICH THE GROWTH OF DOMESTIC DEMAND IN GERMANY AND JAPAN HAS BEEN CONSISTENTLY BELOW THE GROWTH OF OUTPUT, WHILE IN THE UNITED STATES IT HAS BEEN CONSISTENTLY ABOVE. THE PROCESS OF UNWINDING THE IMBALANCES REQUIRES A REVERSAL OF THE DIFFERENCES BETWEEN DOMESTIC DEMAND AND OUTPUT IN THOSE COUNTRIES. THIS IS BOUND TO TAKE TIME TO COMPLETE, BUT ~~--AND THIS IS IMPORTANT--IT HAS NOW BEGUN.~~

IT WOULD BE A SERIOUS MISTAKE TO SEEK A SHORT CUT BY A FURTHER DOLLAR DEPRECIATION. IT WAS UNDOUBTEDLY NECESSARY TO CORRECT THE HUGE MISALIGNMENT OF THE DOLLAR IN 1985. BUT THERE IS NO CASE FOR GOING TO THE OPPOSITE EXTREME OF AN ARTIFICIALLY LOW DOLLAR. THE BENEFITS TO THE CURRENT ACCOUNT WOULD BE SMALL COMPARED TO THE DAMAGE TO US INFLATION AND THE DISLOCATION TO THE WORLD ECONOMY. THE MAIN LESSON FROM RECENT YEARS IS THAT WE SHOULD AVOID EXCHANGE RATE MISALIGNMENTS, NOT ENCOURAGE THEM.

CONCLUSION

IN CONCLUSION, I BELIEVE THAT EXTERNAL STABILITY SHOULD NOW COMPLEMENT THE INTERNAL FINANCIAL STABILITY THAT WE HAVE ALREADY ACHIEVED. IT WILL REMEDY A MAJOR WEAKNESS IN THE WORLD FINANCIAL ORDER AND PROVIDE A SOUNDER BASIS FOR THE PROSPERITY WE ALL SEEK.

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pnp

FROM: A C S ALLAN
DATE: 1 October 1987

SIR G LITTLER

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Byatt
Mr Cassell
Mr Lavelle
Mr Monck
Mr H P Evans
Mr Scholar
Mr Culpin
Mr S Matthews
Mr Cropper
Mr Tyrie
Mr Call

NEW ZEALAND SPEECH TO IMF/IBRD ANNUAL MEETINGS

... The attached speech by Roger Douglas, the New Zealand Minister of Finance, seems worth a wider circulation.

ACSA

A C S ALLAN

BOARDS OF GOVERNORS • 1987 ANNUAL MEETINGS • WASHINGTON, D.C.

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
INTERNATIONAL FINANCE CORPORATION
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Press Release No. 26

September 29, 1987

Statement by the Hon. R. O. DOUGLAS,
Minister of Finance and Governor of
the Fund for NEW ZEALAND,
at the Joint Annual Discussion

One of the catchphrases of this and most of the recent Joint Annual Meetings of the World Bank and the Fund is the need for adjustment. In New Zealand, we have in fact spent the last three years pursuing in a resolute and wide-ranging manner the kinds of adjustment reforms recommended by the Bank and the Fund. We have gone from being one of the more highly regulated economies in the OECD to one of the least regulated.

We have floated the New Zealand dollar, introduced a firm, anti-inflationary monetary policy, and removed exchange controls. In our traditional manufacturing sector, we are moving with speed to remove all import licensing at the same time as reducing tariffs across the board. In the public sector, we have established nine new government corporations with output equal to 12½ percent of GDP which were previously run as government departments in a noncommercial way. We are proceeding with a program of selling shares in a number of other government-owned enterprises. In the labor market, we have taken steps to overhaul the wage bargaining and industrial relations systems which had remained virtually unchanged since the turn of the century. Major tax reform has been undertaken with a flattening of marginal tax rates and the introduction of a broad-based consumption tax at a flat rate of 10 percent.

In our most important export industry - pastoral agriculture - we have virtually removed all government subsidies, concessional tax treatments, and soft lending. New Zealand therefore strongly endorses President Reagan's call for the removal of distortions in trade in agriculture. As President Reagan said, this would be a major step toward raising living standards, especially in developing countries, and increasing growth in world trade. Such reforms would achieve far more than any amount of concessional lending. Most delegates, I believe, recognize that agricultural reform is both desirable and necessary. The real question is whether there is sufficient political courage to introduce the required changes.

Members are generally agreed about what needs to be done to ensure higher economic growth and employment levels on a worldwide basis. The key ingredient of this process is the political will and effective management of structural adjustment.

I want to share with you some of the lessons we in New Zealand have learned in implementing our reforms. First, change must be made in quantum leaps. It must be comprehensive and wide ranging. Piecemeal reform can undermine the process of change.

Second, reforms must be implemented in the form of packages where there are offsetting costs and benefits for the community as a whole. There must be a sense of fairness, where all groups are seen to share the burden and benefits of adjustment.

At the same time, there must be careful attention to the pace of change. There are considerable lags between the implementation of policy changes and the achievement of positive outcomes. Insufficient momentum risks deferring the benefits of adjustments and thereby increasing the costs. This in turn risks eroding the constituency for the overall strategy.

Public education is important. It must be made clear why past approaches have failed, why there must be change, and what the benefits of change will be. Vested interest groups have in the past captured the policy process for their own benefit at the expense of the consumer. As we move to reverse this situation, we must learn to ignore the cries of the vested interest groups and talk directly to the general public about the benefits that will flow to them.

Fourth, change must be harmonized in different areas so that they are all mutually reinforcing. Improvements in fiscal and monetary policy, liberalization of markets, and the reduction of excessive debt levels must all be put in place at the same time.

Finally, we should all remember that the price for refusing to change will be a lot higher for all of us than the price of changing.