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Chairman of the Executive Board and
Managing Director of the International Monetary Fund
to
the Board of Governors of the Fund

Mr. Chairman, it is a great pleasure to join you and the Governor for the United States in welcoming everyone to this year's Annual Meetings. I want to thank the President of Colombia for his thoughtful and statesmanlike remarks, which have made an impression upon us all. We are deeply honored by President Reagan's participation in these meetings and look forward with interest to his address. A special welcome is due to the representatives of our two newest member countries, Kiribati and Poland. May I also add a personal greeting to Barber Conable. He can be assured that the Fund, at all levels, is committed to the further development of the fruitful collaboration between our two institutions.

Since we met last year in Seoul, the world economic situation has been profoundly affected by several major developments: the sharp fall in energy prices, the further erosion in the prices of a wide range of primary commodities, the decline in international interest rates, and the substantial shift in currency relationships among the largest economies. Every country has experienced a change in its economic prospects. For some, the net effect has been an improvement in the medium-term outlook for growth and price stability. For others, particularly for the fuel exporting developing countries, the net impact has been adverse. In some cases, the loss of export earnings and of budget revenues has been of such magnitude as to require a major change in adjustment and financing plans.

In my remarks today I want to focus on the implications of changes in the international economic environment for three key issues of policy: sustaining noninflationary expansion in the industrial world; restoring growth with financial stability in developing countries; and strengthening the cooperative management of the international economic system.

Before taking up these issues of policy, let me make a general point about economic management. There is always the temptation to respond to unexpected short-term changes with short-term policy adjustments. In some cases, these adjustments are necessary. But we must not forget that the attempt to "fine tune" economic management is fraught with difficulty. As we saw in the 1960s and 1970s, excessive preoccupation with the short term can sometimes undermine stability in the medium term. There will invariably be bumps on the road to sustainable growth. A steady course of policy is necessary to achieve fundamental economic objectives.

I. Strengthening Economic Recovery

1. The past year has seen economic output in the major industrial countries grow at a moderate pace--slightly less than 3 percent. As a result, the growth of world trade has been subdued, adding to the underlying weakness in commodity prices. Earlier in 1986, some expected that declining interest rates would soon stimulate demand, and that falling prices for oil and primary commodities would quickly lead to higher domestic demand in countries benefiting from terms of trade gains.

With the aid of hindsight, it is now apparent that such expectations were premature. There are signs that lower oil prices and lower interest rates are beginning to boost economic activity in industrial countries. But the main impact is yet to be felt. In the short run, there are negative effects on spending in countries and regions that are net producers of oil and other primary commodities. Moreover, lower interest rates spread to final expenditure only with a lag. Much of the unexpected weakness of economic activity in early 1986 was attributable to these initial effects. As we move into 1987, the positive stimulus to final demand provided by lower oil prices and lower interest rates should become increasingly evident.

It is said by some that an economic downturn in the industrial countries is overdue after three and a half years of expansion. Without underestimating the risks associated with the current situation, I believe it would be a mistake to be pessimistic. In the past, downturns have typically occurred because inflationary pressures have built up and provoked a shift to monetary restraint. The present recovery is different in this respect. Expansion has been at a moderate pace, inflation has been kept under control, and monetary policy has been able to accommodate a reasonable growth in nominal demand. There is thus little inherent in the present business cycle to suggest that a downturn is imminent. Our projections indicate that real output should rise by about 3 percent next year in industrial countries.

2. In my view, the broad thrust of the economic strategy of the industrial countries remains appropriate. This strategy has focused on establishing the underlying conditions needed to achieve sustained growth over the medium term. It has involved three main elements: improved price stability through disinflationary monetary policy; limiting the share of real and financial resources absorbed by government spending and deficits; and strengthening market processes so as to enhance the private sector's capacity to use resources productively.

A great deal has already been achieved under this strategy. Inflation rates in the industrial world are now lower than at any time in the past twenty years. International interest rates--which are so important for the debt service burdens of the developing countries--have fallen by more than 6 percentage points from their level in 1982. Expectations about inflation, wage costs, and business profitability have been turned around. Finally, for the seven major industrial countries taken together, the steady upward drift of central government fiscal deficits--which so characterized the 1972-80 period--has been checked.

But progress has been uneven. After 1982 fiscal deficits in the Federal Republic of Germany and Japan declined, while the deficit in the United States widened substantially--thereby contributing to a sharp divergence in balance of payments positions. By the same token, European countries have had only partial success in removing structural rigidities--and this has made it that much harder for them to achieve a significant reduction in unemployment. In the case of Japan, a large external surplus has been allowed to develop.

3. Now, however, the prospects for more convergent financial policies seem to have improved. The United States has put forward plans for a major fiscal correction. This is a very positive development--not only for the United States but for the world economy as a whole. It is important that this plan be fully translated into action. In conjunction with the exchange rate changes that have already occurred, this would contribute to a more sustainable pattern of payments positions and to a more stable exchange rate environment.

Still, unwinding the imbalances that have been allowed to build up in the world economy will not be an easy task. It will require cooperative efforts. As the U.S. fiscal deficit declines, the resources released by reduced government spending will have to be reabsorbed into private expenditure and net exports. For those net exports to materialize, domestic demand growth in countries with large balance of payments surpluses will have to be sustained at an adequate pace. Toward this end, flexibility is, of course, desirable in the implementation of financial policies in those countries where inflation is under control, the private savings rate is high, and private sector demand is relatively weak. In this connection, the recently announced package of increases in public expenditures and related measures to support stronger growth in domestic demand in Japan is a welcome move. Flexibility in the implementation of financial policies must be compatible with the medium term objectives of durable growth and financial stability. It should be tailored to the circumstances of each country and should build on the room for maneuver created by earlier successes. The lower level of interest rates that accompanies a sound combination of fiscal and monetary policies will, in turn, help to "crowd in" private sector spending as budget deficits are cut, while the recent fall in the U.S. dollar will help to reduce the worrisome divergence in balance of payments positions among the major economies. With profits having risen in all major industrial countries and with more moderate rates of increase for real wages, the incentives for investment should be improved. Finally, continuing efforts are needed to deal with structural rigidities. Further actions to increase the flexibility of labor markets and to improve vocational training can only aid the absorption of redundant workers into new activities. Capital market deregulation can assist in making financial resources previously absorbed by the government promptly available to the private sector. And deregulation of goods and service markets can promote competition, improve resource allocation, and stimulate investment.

In sum, a delicate but decisive transition is under way. It is a transition from stop-go policies and inflationary expansion to a program of monetary and fiscal stability aimed at sustained growth. A good start has been made. But persistence and international cooperation are now required to ensure that the needed growth occurs, while further progress is made in removing imbalances.

II. Growth and Adjustment in Developing Countries

1. It is now four years since we met in Toronto at the outbreak of the debt crisis. The fact that the debt problem is still with us should not obscure the very considerable achievements that have been registered. The indebted countries have scaled back their current account deficits from an average of 18 percent of their exports in 1981-82 to only about 5 percent in 1985-86. Underpinning this impressive turnaround in the external accounts were firm adjustment measures. Fiscal deficits were cut, exchange rates were managed to secure needed gains in competitiveness, and domestic interest rates were in many cases increased to more realistic levels. Some large debtors who had long been "living with inflation"--Argentina and Brazil are prime examples--took bold corrective actions: they dismantled indexation, initiated currency reforms, and launched wide-ranging programs to fight inflation. Meanwhile, the international banking system has been strengthened, as commercial banks have added to their capital base and made increased provision for loan losses.

Yet there have also been disappointments, particularly during the past year. Many indebted countries are still far away from normal access to capital markets. Reflecting the export price declines of the past two years, ratios of debt to exports have tended to rise, and are now higher than in 1982. Some policy slippages--especially in the fiscal area--have taken place during the past year. And as necessary as adjustment was--and still is--to set the stage for sustained growth, we should not overlook the costs involved in the adjustment process itself. Echoing the abrupt decline in the availability of external financing, imports and investment in indebted countries fell sharply and there was a slowdown in their growth rates. It is worrisome that real per capita gross domestic product (GDP) in the developing world, which rose at an average rate of more than 3 percent a year in the 1960s and 1970s, is now virtually no higher than it was in 1980.

These aggregate figures of course conceal wide disparities among groups of developing countries. Whereas real per capita GDP in Asia has risen by almost a fifth since 1980, large declines have been pervasive in Africa, in the Middle East, and in Latin America. Similarly, exporters of primary commodities have been harder hit than exporters of manufactures.

2. The challenge we face is clear. It is to bring about a substantial recovery in economic growth in developing countries, while continuing to make progress toward a sustainable external position.

For their part, the developing countries can best improve their growth performance and their access to credit markets by their choice of macroeconomic and structural policies. While the substantial differences across developing countries dictate that each country's economic program be designed for its specific needs and circumstances, there are some common prerequisites for success.

In the first place, the policy strategy must be grounded in a realistic appraisal of external prospects. Real non-oil commodity prices, after falling by an estimated 17 percent this year, are at a record low for the postwar period. Although these prices are not expected to fall further over the medium term, the outlook for export prices of developing countries is still relatively weak. Similarly, the moderate growth rate projected for industrial countries implies that the major market for developing country exports is likely to be less buoyant than in the past. This subdued growth of export earnings cannot realistically be compensated by large increases in external borrowing. The upshot is that a return to the situation of the 1960s and 1970s, when growth was fueled by borrowing and imports, is not a feasible option for the foreseeable future. Economic growth needs to become more dependent on domestically financed investment and domestically generated improvements in resource allocation.

But the weaker prospects for developing country exports in the near term should not be allowed to become an argument for reversing the progress made toward more outward-looking policies. A realistic exchange rate is crucial to make the most of the growth in export markets that does take place, to provide an incentive for the development of new activities in which countries could establish a comparative advantage, and to guide the efficient use of scarce foreign exchange. Efforts to maintain an adequate level of external competitiveness are therefore as essential as ever. A liberalization of trade and exchange restrictions, by providing competitive discipline for domestic producers, can only pay handsome dividends. In addition, foreign direct investment can play an important role in the growth process. We should not lose sight of the lesson that countries that have consistently maintained outward-looking policies and have fostered strong private sectors have grown faster and have adjusted better to external shocks than those that have not. Retreating from excessive foreign borrowing is one thing. Retreating from integration with the world economy--and the gains in efficiency that go with it--would be quite another.

This brings me to the second element of a successful policy strategy. If developing countries are to rely more heavily for growth on the efficient mobilization and use of domestic resources, they will need to implement the policies that pave the way for it. This means maintaining real interest rates at levels that encourage private saving; making sure that government deficits do not absorb an unduly high share of private savings; keeping wage movements in line with labor productivity; orienting the tax system to reward work, saving, and investing; streamlining public enterprises; and--perhaps most of all--creating and preserving an environment of overall financial stability.

If developing countries consistently pursue these policies, they will find an added benefit: the constraint imposed by external financing will itself become looser. The confidence that makes domestic residents want to save more and invest at home will also contribute to the repatriation of flight capital. Likewise, measures directed toward the development of a strong private sector will make foreign creditors more willing to participate in the conversion of existing debt into equity. A number of indebted countries have already engaged in such conversions with creditors and some others are actively considering their introduction. The welcome initiative just taken by the International Finance Corporation should give further impetus to this promising avenue.

A final remark on a successful policy strategy. It is important that adjustment also pay attention to the health, nutritional, and educational requirements of the most vulnerable groups. This means that the authorities will have to be concerned not only with the <u>size</u> of the fiscal deficit but also with <u>how</u> they reduce it. For example, safeguarding human needs may imply that employment in overstaffed and loss-making public enterprises or defense spending be reduced in preference to cutting an accelerated immunization and health care program for children. The expertise of the Fund and the World Bank is available to help members make more informed choices about the growth and income-distribution implications of alternative forms of adjustment. The final choices, however, must rest with the country itself.

But policy reform in debtor countries--no matter how well conceived--cannot do the job alone. The reinforced debt strategy has other elements. What is needed is international cooperation conducive to a favorable external environment. Let me now turn to that point.

III. International Cooperation and the Role of the Fund

1. The whole range of issues confronting the international economy can be constructively handled only in the framework of international cooperation. Let me discuss the role that the Fund is playing in promoting international cooperation in four important areas: economic policy coordination, the debt strategy, international liquidity, and trade liberalization.

2. As I noted earlier, changes are taking place in the pattern of resource use within and across countries that call for compatible movements in such variables as exchange rates, interest rates, and fiscal positions. These changes can be facilitated by enhanced coordination of economic policies. The Fund can, I believe, play an essential role in this endeavor. Our reviews of the world economic situation have been adapted to highlight the interactions of economic policies and the potential sources of economic incompatibilities and tensions among countries. We are also working on the formulation of a set of economic indicators. The use of such indicators should help to guide governments' policies into consistent and mutually beneficial directions. But indicators can only be effective if there is the political will to frame domestic policies in light of international considerations.

Some may ask: Are these efforts at improving policy coordination and surveillance really necessary? Does not the existence of flexible exchange rates remove the need for deliberate policy coordination? The answer, I think, is to be found in the experience of the past six years when the variability and misalignments of major currency exchange rates created such difficulties for the functioning of the international monetary system. A stable system of exchange rates is simply unobtainable--under either fixed or flexible exchange rates--unless countries, especially the largest ones, adopt sound policies and coordinate them by taking into account the international repercussions of their own actions.

3. I come now to the debt strategy. As I suggested a minute ago, the recent fall in export earnings of indebted countries has, if anything, made the debt problem more pressing. It is now one year since Secretary Baker launched his constructive initiative. Where do we stand?

More than two thirds of the 15 heavily indebted countries mentioned in the U.S. initiative have in place, or are now initiating, policies supported by the Fund, with close World Bank involvement. Genuine progress has been made. Let me just cite a few significant cases. Mexico provided a key test for the strategy. Within a six-month period, it had suffered a sudden fall of more than 60 percent in the price of the one commodity that made up two thirds of its export earnings. After careful deliberation, the Mexican authorities decided upon a comprehensive program of macroeconomic and structural policies. The Fund has agreed to assist this courageous effort--and in a way that responds to the especially difficult circumstances of the case. The World Bank is also providing important support for the program, and the Paris Club has just decided to add its help. Official financing is thus in place. I am also happy to announce that Nigeria has reached initial agreement with the Fund and the World Bank on a far-reaching set of policy reforms, and discussions on commercial bank financing are now in hand. In the case of the Philippines, the Executive Board of the Fund will shortly review the economic program of the new Government; this, together with a strong World Bank involvement, should help lead to an early agreement on debt restructuring. All told, the Fund is currently supporting the growth-oriented adjustment programs of 25 developing countries. The amounts committed under these arrangements plus Fund credit outstanding total SDR 35 billion; the recently endorsed program of the Mexican authorities will add another SDR 1.4 billion to that figure. Moreover, discussions are currently under way with 20 other countries with a view toward arranging Fund support of their adjustment policies.

If the Fund is to continue to play a central role in the handling of the debt strategy, it must be able to intervene--on a case-by-case basis--with flexibility and as a direct agent of financing where adjustment efforts warrant it. It is in this light that I welcome the initiative announced by the Governor for Japan in the meeting of the Interim Committee to lend SDR 3 billion to the Fund. I also welcome the decision by the Interim Committee to leave unchanged for 1987 the enlarged access limits. This means that in the period ahead the Fund will not only be capable of acting as a financial catalyst, but will also be able, at this critical juncture, to provide significant financial support for the strong adjustment efforts of its members. In this connection, I should emphasize that the Fund continues to be very prudent in its lending activities and in the management of its own financial position. It has acted decisively to deal with arrears on payments to it. While these are relatively small in amount and involve few members, they cannot be accepted by a cooperative monetary institution such as the Fund.

Another key element of the debt initiative is the broad and active participation of commercial banks. This has been an area of some disappointment. Although final figures are not yet available, it appears that new net lending to the 15 major debtors in the first part of 1986 will fall substantially short of the amounts implied by the debt initiative. If the strategy of co-responsibility is to work, it is essential that commercial banks resume lending in adequate amounts and on appropriate terms in support of sound macroeconomic policies and growth-oriented structural reforms in debtor countries.

No discussion of financing problems would be complete without addressing the special plight of the low-income countries. These countries not only have serious debt and balance of payments problems, they are also less integrated into the world economy than other developing countries. They are more dependent on primary commodities in their exports and are less able to obtain commercial financing to cover their current account deficits. Also, some low-income countries in Africa are still feeling the devastating effects of repeated and severe drought. These countries sorely need concessional assistance. One of the hallmarks of last year's Annual Meetings was the agreement reached to establish in the Fund an SDR 2.7 billion Structural Adjustment Facility (SAF). Since the inception of this facility in March of this year, the Fund and the World Bank have been assisting low-income countries to design medium-term, growth-oriented economic programs that will give them access to resources under this facility. SAF loans have already been approved for Burundi, The Gambia, and Mauritania. Several other cases are due for Executive Board consideration after these Annual Meetings. SAF resources committed--and those currently under consideration--amount to nearly a half of the total resources available under the facility.

It is regrettable that over the past year flows of official lending to developing countries have actually declined. We face a test of economic cooperation and solidarity. Even in this time of budgetary stringency, the richer countries must adapt their efforts in the field of official development assistance to the pressing needs of recipient countries. In this respect, broad support for a general capital increase and for a strong eighth replenishment for the International Development Association are crucial to ensure that the increased role for the World Bank in the reinforced debt strategy continues.

4. I turn next to the role of the Fund in providing international liquidity to the system. Here, the international community has at its disposal a useful tool of cooperation, namely, the ability to allocate SDRs when it can be agreed that there exists a long-term global need to supplement reserves. Over the past few years, however, we have seen a strong--and I regret to say--hardening division of views among the membership on this issue. In the interests of supporting the momentum toward greater international cooperation, is it not now time for both sides to take a fresh look at their existing positions? In so doing, attention should be drawn to several salient aspects of the current world economic situation. A large number of developing countries experiencing debt-servicing problems no longer have access to financial markets, and this even while strong adjustment programs are under way. With a weakening of export earnings, there is a risk that these countries will unduly compress imports to obtain the reserves they need, which would have a negative influence on world trade and growth. But we also need to meet the legitimate concern that there has been a strong tendency for some countries to use SDRs before other reserve assets and to continue this use on a permanent basis. This is contrary to the intended monetary character of the SDR. I hope that an open reflection on these issues can facilitate the emergence of a consensus.

5. To this point, I have concentrated on recent advances in international cooperation. But I would be remiss in my duties if I did not speak out against what is probably the single greatest threat to the international economic and financial system. I refer here, of course, to protectionist pressures. The record is clear enough. In industrial countries we have seen over the past few years a proliferation of voluntary export restraints, market-sharing arrangements, quotas, and subsidies. In the meantime, the developing countries have made only limited progress in dismantling their own array of trade restrictions.

There is never a good time for protectionism. Still, as I pointed out in my recent statement to the GATT ministerial meeting in Punta del Este, the present state of the world economy is such that the risks posed by protectionism are now particularly serious. At a time when the developing countries are struggling with enormous debt-servicing problems, and when both industrial and developing countries are counting on the private sector to become a mainspring of growth, we simply cannot afford to be complacent about the drift toward protectionism.

It is for this reason that we in the Fund are most gratified that the recent ministerial meeting of GATT Contracting Parties in Punta del Este agreed on a Declaration that launches the Uruguay Round of multilateral trade negotiations. The international consensus that was achieved on such an important undertaking, encompassing such difficult issues as agriculture and services, is very heartening indeed. We especially welcome the standstill and rollback commitment by each participant. As a result of the Punta del Este meeting, an international framework and commitment now exist to pursue trade liberalization in the interest of all countries. Every country has a part to play in the achievement of this objective, and the major trading nations have a special responsibility to lead the way.

The Fund has intensified its collaboration with the GATT as well as its own efforts in behalf of maintaining an open trading system. Since 1983, the coverage and analysis of trade policy matters in the Fund's Article IV consultations with members have been expanded. Under Fund-supported adjustment programs, members agree to refrain from imposing new--or intensifying existing--import restrictions for balance of payments purposes. Where member countries are placing undue reliance on trade restrictions, the Fund--working closely with the World Bank--encourages liberalization. In some cases, the results achieved in this field have been most promising.

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Allow me to offer some concluding remarks. Significant progress has been made over the past few years. Economic policies are now better attuned to economic realities, and inflation--which had been poisoning the financial system for fifteen years--has finally been brought under control in the industrial world.

But much remains to be done. External payments imbalances among the larger industrial countries are a disturbing source of instability and tensions. The erosion of commodity prices has adversely affected the developing countries at the very time when they more than ever need increased export earnings to grow and to service their debts.

In a world that is increasingly interdependent, it is proving more complex than ever to cope with these problems. A satisfactory solution requires not only an understanding of the interaction among national economic policies but also firm adherence to the fundamental principle of monetary stability and strengthened commitment to international cooperation.

Economic policy coordination among industrial countries is no longer a matter of theoretical preference. It is instead a prerequisite for growth with stability. Industrial countries must work together to complete the process of disinflation, to maximize the sources of economic growth, and to assure an open international trading system.

Yet such a program, as ambitious as it is, is not sufficient. The international economic system will also have to encourage the developing countries to tackle the formidable structural problems that confront them. Let us not forget that foreign aid--if well directed and efficiently used--is--like international cooperation as a whole--in the enlightened self-interest of the world community. The recent massive resource transfer from the Third World to the industrial countries associated with the decline in raw material prices should facilitate the participation of the industrial world in this worthwhile endeavor. It would be in the interest of neither international trade, nor of the health of the international system, nor of peace, to see developing countries--for lack of markets or external support--be obliged to turn inward and curtail their imports, their growth and, ultimately their hopes. Such a development would be fraught with dangers and political instability. The general interest calls for a revival of sustained growth in these countries through the pursuit of structural reforms which are, in the last analysis, the key to their development. But these reforms will take time and therefore will require understanding, financial support, and cooperation.

It is my hope that the community of nations, which had the wisdom to create the Bretton Woods institutions, will face these challenges, which are at least as formidable as those of the immediate postwar period, with renewed dedication and generosity. There is no time to waste.

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A final word of a personal nature. As I indicated to the Executive Board ten days ago, this is the last time that I will be attending the Annual Meetings as Managing Director of the International Monetary Fund. Indeed, I have decided to leave my position by the end of 1986.

You are aware of the reasons for my departure. They are both personal and professional. I wanted indeed to choose a time consistent with the best interests of the Fund. We are on the eve of difficult negotiations to increase Fund quotas--negotiations that by their nature are unavoidably lengthy. It is also a time when the debt strategy must be adapted to the achievements of the last four years, and when the exercise of multilateral surveillance must be strengthened and reformulated in light of the concept of objective indicators. I think the Fund will be better served if the change in management takes place now, rather than in 18 months' time. It is this consideration, together with a wish to keep the period of transition as short as possible, that has led me to announce my decision on the eve of these Annual Meetings.

It has been a great honor to serve this institution. The eight years that I have devoted to the Fund have also been uplifting ones. They have been so because the circumstances have been exceptionally challenging; because the Fund, without losing its monetary character or becoming oversized, has demonstrated a truly remarkable vitality and ability to react; and finally, because I have been able to put a lot of myself into it all.

I want to take this opportunity to thank you for the confidence you have always placed in me and for the support you have given me, especially at the most decisive moments. The strengthening of the Fund's financial resources, the enlarged access policy, and the cooperative approach to the debt strategy have all received your support. Without your confidence and the wise counsel expressed at the Annual Meetings, at the Interim Committee, and in the Executive Board, these initiatives and adaptations could not have taken place.

Yet none of this would have been possible without the unflagging support of what is, to me, the base of the Fund, namely, its staff. I am in a better position than anyone else to measure its devotion, its hard work, its competence, its intelligence, and its selflessness. Let us never forget that an institution ultimately draws its value from the men and women who make it up. Let us find the way to motivate them, to show them our esteem, and to assure them of our commitment to a truly international and high-quality staff. It is to them that I direct my last words: thank you from the bottom of my heart for the loyal, untiring assistance that you have given me throughout my time at the Fund.