WORLD ECONOMIC AND FINANCIAL SURVEYS

April 1987

WORLD ECONOMIC OUTLOOK

A Survey by the Staff of the International Monetary Fund

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INTERNATIONAL MONETARY FUND • WASHINGTON, D.C.

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Conventions and Symbols

A number of standard conventions have been employed in arriving at the projections in the report. It has been assumed that the average real exchange rates for the major currencies of a recent period (February 23–27, 1987) will prevail through the end of 1988; that "present" policies of national authorities will be maintained; and that the average price of oil will be $15 a barrel in 1987 and remain unchanged in real terms in 1988. These are, of course, working assumptions rather than forecasts, and the uncertainties surrounding them add to the margins of error that would in any event be involved in the report's projections. The estimates and projections themselves are based on statistical information available on or before March 19, 1987.

The following symbols have been used throughout this report:

- . . . to indicate that data are not available;
- — to indicate that the figure is zero or less than half the final digit shown, or that the item does not exist;
- – between years or months (e.g., 1984–85 or January–June) to indicate the years or months covered, including the beginning and ending years or months;
- / between years (e.g., 1984/85) to indicate a crop or fiscal (financial) year.

"Billion" means a thousand million.

Minor discrepancies between constituent figures and totals are due to rounding.

* * *

It should be noted that the term "country" used in this report does not in all cases refer to a territorial entity that is a state as understood by international law and practice. The term also covers some territorial entities that are not states but for which statistical data are maintained and provided internationally on a separate and independent basis.

Preface

The projections and analysis contained in the *World Economic Outlook* are the product of a comprehensive interdepartmental review of world economic developments by the staff of the International Monetary Fund. This review is carried out annually and draws on the information the Fund staff gathers through its regular and special consultations with member countries as well as through its econometric modeling techniques. The project is coordinated in the Research Department and draws on the specialized contributions of staff members in the Fund's five Area Departments, together with those of staff in the Exchange and Trade Relations and Fiscal Affairs Departments.

An earlier version of the material in this report was the basis for a discussion of the world economic outlook by the Fund's Executive Board on March 16–17, 1987, and the present version has benefited from comments made by Executive Directors during this discussion. However, the descriptions of developments and policies that the report contains, as well as the projections for individual countries and the contents of supplementary notes, are those of the Fund staff and should not necessarily be attributed to Executive Directors or their national authorities.

The *World Economic Outlook* has been published by the Fund since 1980, initially on an annual basis, and, since 1984, semi-annually.

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Chapter I

World Economic Outlook: Prospects and Issues

The year 1986 was one of substantial changes in the international economic environment. There was a sharp drop in the price of oil, a further weakening in non-oil commodity prices, and a continuation of the decline of the dollar against other major currencies. Not surprisingly, these developments have had a mixture of positive and negative effects.

While lower oil and commodity prices contributed to a significant further improvement in inflation performance, output growth decelerated further in industrial countries. Meanwhile, lower export earnings imposed severe hardships on many developing countries, and led to a further rise in their external debt ratios. The exchange rate realignment among the major currencies, together with the increased emphasis on international policy coordination that led to the Louvre Accord among major industrial countries of February 22, 1987, has significantly improved the prospect for restoring a better pattern of payments balances. Initially, however, imbalances have widened sharply in dollar terms, reaching record levels among the three largest countries. It is clear that changes in price competitiveness are far more effective in reducing external deficits and surpluses when they are supported by appropriate macroeconomic and structural policies.

If one looks ahead to 1987 and beyond, a number of uncertainties cloud the economic outlook. One such uncertainty concerns how quickly financial imbalances in the industrial countries—fiscal deficits and payments disequilibria—can be reduced, and whether their persistence increases the risk of disruptive market developments. A second question is whether world demand growth will be resilient as individual countries pursue their stated policy priorities. And a third centers on the vital issue of how to reinvigorate growth in the developing world while dealing effectively with the debt issue.

The remainder of this chapter explores these issues in more detail. It begins with a discussion of recent developments and short-term prospects and goes on to present a scenario for possible developments over the medium term. The third section provides an analysis of possible tensions in this medium-term scenario and reviews the policy issues to which they give rise. The analysis here makes use of the "indicator" approach discussed in earlier reports.

The staff's projections are based on the conventional working assumptions of "unchanged policies" and constant real exchange rates and oil prices. Oil export prices have been assumed to average $15 a barrel in 1987 and to be constant in real terms thereafter, while real exchange rates are assumed to remain constant at the pattern prevailing in the last week of February 1987.

Recent Developments and Short-Term Prospects

Demand and Output

World output growth weakened in 1986, in part reflecting strains stemming from the large shifts in the terms of trade and the growing payments imbalances among industrial countries. The large fall in the prices of primary commodities, especially oil, had been expected to boost demand in the industrial countries and depress it in the developing countries, as indeed it did. More unexpected, however, was the rapidity with which that terms of trade shift engendered the corresponding real resource transfer. Such transfers are usually viewed as difficult to effect and likely to be phased over several years. In the event, partly because of financing constraints and partly because a number of developing countries preferred to limit the growth in their debt, much of the adjustment was carried out in 1986. As a result, industrial countries faced a sharp decline in their real net exports and, despite a strengthening of domestic demand, their output growth slowed from 3 percent in 1985 to under 2½ percent in 1986.

The other side of this coin, of course, was an increase in the volume of developing countries' exports relative to their imports. Partly because of the strength of industrial country demand and partly because developing country products were attractively priced for consumers, much of the adjustment in the developing world took the form of increased exports rather than reduced imports. Consequently, GNP growth in the non-fuel exporting group of developing countries accelerated from 4½ percent in 1985 to almost 5½ percent in 1986. For the world as a whole, output growth in 1986 is estimated to have been 2.9 percent, marginally less than in the previous year (Table 1).

Looking ahead, the question is whether the forces set in motion in 1986 will lead to an improvement in this situation or a slipping back. Will the slowing of industrial country output growth persist as economic agents face the consequences of recent large changes in competitive positions? Or will output growth recover now that exchange rates are better aligned and developing countries have largely completed their balance of payments adjustment to terms of trade losses? Answers to these questions are far from clear cut. Moreover, they cannot be resolved from the perspective of the dynamics between industrial and developing countries alone. Interactions within and among industrial countries are also significant as potential sources of strain on growth.

The slowing of output growth in industrial countries is especially disappointing in relation to the optimistic views that prevailed about a year ago. At that time, the fall in the price of oil was seen as likely to lead to strong growth in domestic demand in industrial countries, and the April 1986 *World Economic Outlook* projected increases in output of about 3¼ percent per annum from the fourth quarter of 1985 onward. In the event, growth during 1986 (fourth quarter over fourth quarter) is now estimated at only 2 percent (Chart 1). The impact on demand of the improvement in the terms of trade was relatively small in some countries. A principal reason seems to be that a considerable part of the terms of trade gain did not reach final consumers but went instead into profit margins or government revenues, possibly reflecting a sentiment that at least part of the oil price decline might prove to be transitory. Consumer prices of energy products in Japan, for example, reflected only part of the drop in import prices. The same is true in Europe, albeit to a lesser extent. Accordingly, the demand-expanding effects of the terms of trade gain have been somewhat limited, at least so far.

Table 1. World Demand and Output, 1985–87

(Annual changes, in percent, except where otherwise noted)

	Current Estimates			Revision to October 1986 Estimates[1]	
	1985	1986	1987	1986	1987
World output	3.1	2.9	2.7	0.1	−0.4
Industrial countries					
Terms of trade gain[2]	0.1	1.5	0.1	0.3	−0.1
Total domestic demand	3.1	3.5	2.4	−0.1	−1.0
Foreign balance[3]	−0.1	−1.1	−0.1	−0.2	0.2
GNP/GDP	3.0	2.4	2.3	−0.3	−0.8
Developing countries					
Terms of trade gain[2]	−0.3	−3.3	−0.5	−0.2	—
Total domestic demand	2.6	0.1	2.2	0.2	0.5
Foreign balance[3]	0.7	3.4	0.6	0.6	−0.4
GDP	3.2	3.5	3.0	0.8	0.1
Other countries' output[4]	3.5	4.3	3.8	0.9	0.3

[1] *World Economic Outlook*, October 1986; in percentage points.
[2] In percent of GNP/GDP.
[3] Contribution to growth of GNP/GDP.
[4] Net material product for the U.S.S.R. and other Eastern European countries that are not Fund members.

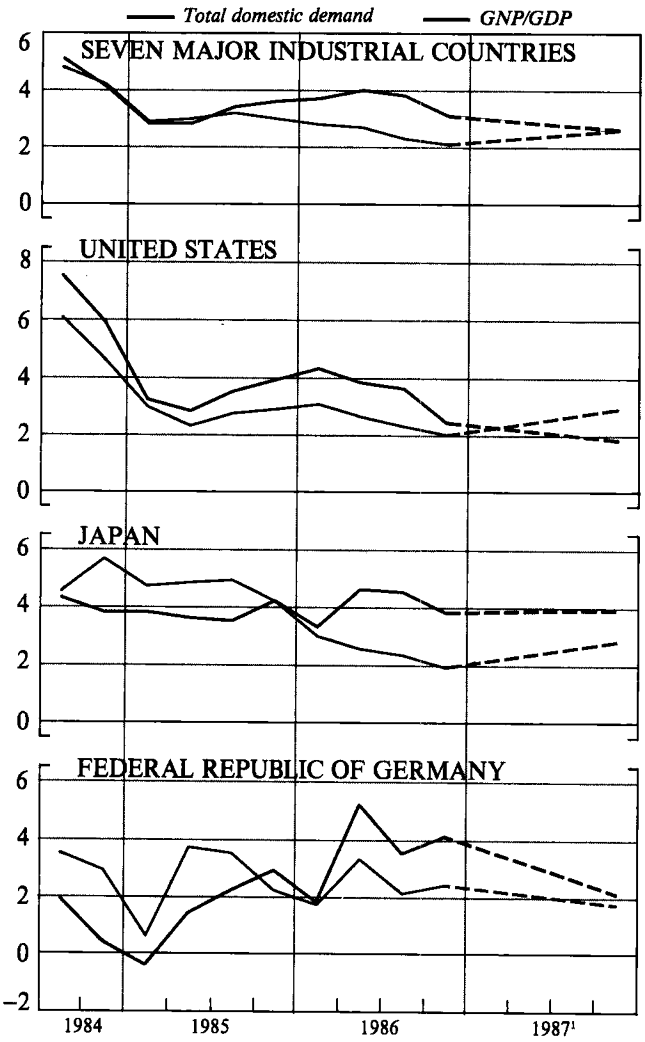
The output-contracting effects on industrial countries of the declines in oil and commodity prices, on the other hand, have been greater than expected. The oil exporting countries had, of course, been expected to curtail imports and boost exports so as to bring about the real adjustment required to restore their current accounts to a more sustainable position. This adjustment, however, took place much more rapidly than originally envisaged.

A number of other factors also served to temper the growth of demand and output in the industrial countries in 1986. Investment spending was especially hard hit, rising by only 3¼ percent last year, and by only 2¼ percent on a through-the-year basis. This is an unusually slow pace given the maturity of the current upswing. One reason was the decline in oil prices, which drastically reduced investment spending in the oil sector in the United States and Canada. But, in addition, business fixed investment in the United States seems to have been adversely affected by the curtailment of tax incentives, especially the repeal of the investment tax credit with retroactive effect to the beginning of 1986. A more pervasive factor has been the depreciation of the U.S. dollar, which appears to have reduced demand and output growth in countries with appreciating currencies, especially Japan, much more rapidly than it has boosted them in the United States.

Abstracting from the policy changes that may have triggered a movement in exchange rates, an exchange-rate-induced redistribution of output among industrial countries ought to have relatively little effect on their combined growth rate. Any loss of output of countries with appreciating currencies should normally be offset

Chart 1. Major Industrial Countries: Real Output and Domestic Demand, 1984–87

(Changes over four quarters, in percent)



[1] Fund staff projections for changes from fourth quarter of 1986 to fourth quarter of 1987.

by the gain of countries with depreciating currencies. The adjustment process is unlikely to be so smooth or rapid in practice, however. Investment plans in the tradable goods sector in Japan and the Federal Republic of Germany, for instance, were scaled back quite promptly in response to the significant appreciation of their currencies, but have yet to show any buoyancy in the United States. Such asymmetries presumably reflect the greater ease of deciding against investment projects than of initiating them. The weakness of investment spending may also reflect general uncertainty about future exchange rates and competitive positions, as well as the fact that rates of capacity utilization in the tradable goods sector have been lower in the United States than in Japan and Germany. This factor would tend to limit the immediate impetus to expand capacity, and could continue to operate for some time.

Turning to short-term prospects, there are conflicting considerations. On the positive side, the fact that external adjustment in developing countries was so rapid in 1986 may mean that less adjustment will be needed in 1987. This would tend to improve the prospects for industrial countries' net exports in volume terms. Moreover, to the extent that industrial country consumers did not receive the full benefit of terms of trade gains in 1986, lagged effects may help support demand in 1987.

Several considerations, however, suggest that any strengthening of growth in the industrial countries is likely to be modest. First, financial policies, as announced by national authorities, are somewhat more restrictive in 1987–88 than they were in 1986. Fiscal policy is likely to supply less stimulus, especially at the central government level, largely because of a projected substantial reduction in the U.S. federal deficit. And the easing of monetary conditions that occurred during 1986 is not expected to be repeated in 1987. Second, while an improvement in the real foreign balance should help sustain growth in the United States, demand in that country may be dampened by continuing sluggishness in investment spending and a rise in the personal saving rate from the very low levels of the second half of 1986 (2¾ percent of disposable income). For the rest of the industrial world, the gradual waning of favorable terms of trade effects on consumption, together with continuing sluggishness in the pace of output and investment because of negative net exports, is likely to engender a slowing of domestic demand from its recent relatively strong pace.

Consequently, the staff foresees some moderation in the overall pace of domestic demand expansion in the industrial countries in 1987. Weaker domestic demand, however, should be counterbalanced by a much smaller negative impulse from net foreign demand, as real import growth resumes in developing countries. For the industrial countries as a whole, output growth is expected to average 2¼ percent in 1987, slightly less than in 1986.

Turning to the developing countries, the terms of trade loss of $100 billion or so in 1986 did not have as large an impact on output as expected because of the unanticipated strength of these countries' exports to industrial countries. In fact, output growth even firmed slightly, from 3¼ percent in 1985 to 3½ percent in 1986. The staff is, however, less sanguine about prospects for 1987. While the deterioration in the terms of trade is expected to be much smaller than in 1986, some adjustment to past losses still remains to be carried out. Moreover, given the projected slowing of domestic demand growth in industrial countries from 3½ percent to 2½ percent, prospects for exports are more subdued. Consequently, the staff foresees output growth in the developing countries slowing to about 3 percent in 1987 (Chart 2).

These aggregate figures conceal a considerable diversity in the situations facing individual countries and groups of countries. The fuel exporters were most adversely affected by recent developments, suffering terms of trade losses equivalent to some 13–15 percent of national income. Although this loss was partly made up in higher export volumes, and partly financed by running down foreign assets, strong adjustment measures were still needed to curb spending and imports. Consequently, the real output of the fuel exporters, as a group, declined in 1986. Moreover, because of a continuing need to bring current account balances back to sustainable levels, output in these countries is expected to grow little in 1987.

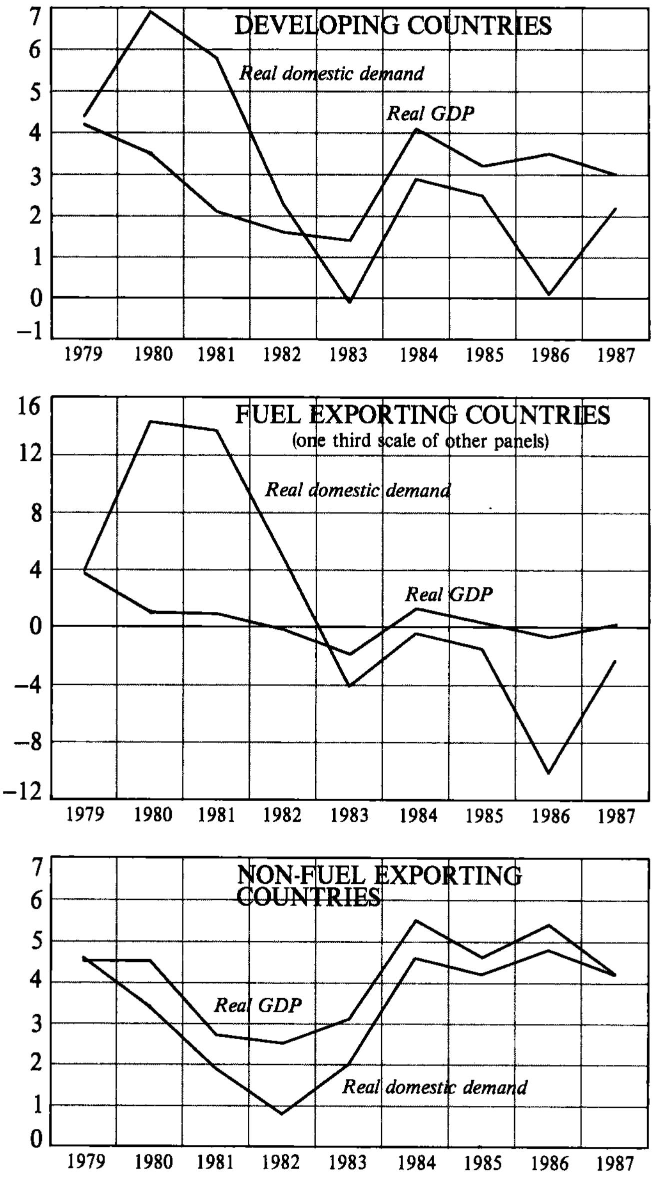
The non-fuel exporters, by contrast, fared considerably better, at least when seen as a group. Declining commodity prices were largely made up by savings in oil import payments and the decline in interest rates on external debt. Moreover, the surge in industrial country demand in 1986 boosted the exports of the non-fuel exporting countries by 7¾ percent. As a result, output growth in these countries, taken together, accelerated from 4½ percent in 1985 to almost 5½ percent in 1986.

Perhaps less appreciated, however, is the very uneven impact that external circumstances had on individual non-fuel exporting developing countries. For instance, for over half of the 110 countries in this group, the configuration of commodity price and interest rate changes last year had a negative impact on their external balances. Moreover, half of these countries experienced losses equivalent to 10 percent or more of exports of goods and services. Not surprisingly, growth in these typically smaller, more vulnerable, primary product exporters (many of which are in sub-Saharan Africa) slowed in 1986 and is expected to improve little if at all in 1987. At the other end of the spectrum, those countries that import a lot of oil, that have a high proportion of their debt at floating rates, and that export a lot of manufactures have done rather well.

Financial policies also played a role in determining the pace of output achieved in individual developing countries. In some countries where external developments were favorable in 1986, relaxation of the external constraints was promptly used to initiate or foster consumption-led recoveries, in some cases at the expense of exports. In other countries, on the other hand, much greater emphasis was placed on spurring exports and enhancing creditworthiness through the accumulation of reserves and the repayment of debt. Growth prospects for the latter countries are quite buoyant, in part because of the prospective firming of investment spending in these countries.

Chart 2. Developing Countries, by Predominant Export: Real Output and Domestic Demand, 1979–87

(Annual changes, in percent)



Employment and Capacity Utilization

Despite the moderate pace of economic activity, the growth of employment in the industrial countries strengthened further last year. The pickup was especially marked in Europe where employment grew by ¾ of 1 percent, over one and a half times the rate of 1985 and in sharp contrast to the declines in 1981–84. This shift seems to have reflected the end of the phase of large-scale labor shedding that characterized the first half of the 1980s. This, in turn, may owe something to the achievement of a better balance between real wages and the marginal product of labor.

The employment gains of 1986 did not, however, make any significant dent in unemployment rates, since the improved employment prospects attracted new entrants to the labor markets. Unemployment rates in Europe thus remained unchanged at 10¾ percent on average. Unemployment in Japan was also little changed, reflecting the steady growth of employment as well as the emphasis placed on continuity of employment.

The continuing high level of unemployment in industrial countries has prompted questions about the scope that exists to absorb unused resources (both capital and labor) and thus to accelerate growth. These questions are considered in more detail in a staff study, "Potential Output in the Major Industrial Countries," to be published later this year. This study finds that, if potential is defined as the ceiling path of output that can be achieved without an acceleration in inflation over the medium term, the amount of slack may be rather less than would be suggested by the high unemployment rates in many countries. Nevertheless, the scope for noninflationary growth in the industrial countries may have been enlarged somewhat by the recent decline in oil prices. This effect is not expected to be large enough to allow a return to the high growth rates of the 1950s and 1960s, mainly because the slowdown in growth in the 1970s was primarily attributable to factors other than oil prices.

In the developing countries, the very low rates of increase in per capita income in 1986 probably led to a further worsening of the employment situation, even though recorded unemployment declined in some of the more rapidly growing economies. This situation of deteriorating labor markets is rendered even more acute by the prospect that the capital stock seems increasingly likely to act as a constraint on growth in many developing economies long before reasonably high employment conditions are reached. Investment rates in many developing countries have fallen dramatically since the onset of the debt crisis, but a downward trend was in evidence prior to that time as well. Moreover, the efficiency of those investments does not appear to have always been very high. (This issue is examined in more detail in Chapter III.)

Inflation

One of the most positive aspects of the current economic situation in the industrial countries is the continued deceleration of inflation—a deceleration that clearly sets the present upswing apart from earlier recoveries. Consumer prices in the industrial countries as a group rose by only 2.3 percent in 1986, the lowest rate since the early 1960s. Although last year's price performance benefited considerably from the sharp decline in oil prices and the weakness of non-oil commodity prices, there also appears to have been some further progress in reducing domestic price pressures.

The favorable inflation performance in industrial countries is projected to continue through the forecast period. In the near term, the lagged effects of last year's substantial terms of trade gains should continue to be felt, particularly in countries whose currencies appreciated over the past year. Inflation is expected to pick up somewhat in the United States during 1987, to about 3½ percent. For the industrial countries as a group, inflation is projected to return to its "underlying" rate, which seems to be in the 3–3½ percent range, corresponding to the average inflation rate in the 1960s.

Although the staff's projections suggest that inflation in most of the industrial countries will remain under control, the risk of a resurgence of inflationary pressures is by no means completely absent. This risk is related to the difficulties monetary authorities face in implementing monetary policy in an environment in which changes in the demand for money are hard to predict. In recognition of these difficulties, central banks have exercised considerable discretion in responding to signals from monetary aggregates. Such a judgmental approach appears to have been appropriate under the circumstances—an absence of cost and aggregate demand pressures and an apparent rise in demand for money associated with the reduction in inflationary expectations and financial deregulation. However, there would be a substantial risk of renewed inflation if, as a result of increased discretion in monetary management, interest rates became unduly politicized, thereby making it difficult for monetary authorities to raise rates when the need to do so arose. The outlook for oil and commodity prices is an additional source of uncertainty. These prices have fluctuated significantly in the past, and there is a possibility that the sharp price declines of 1986 may be at least partially reversed over the medium term.

Developing countries as a group experienced a sharp reduction in inflation in 1986 owing in large part to price stabilization programs instituted in a number of high-inflation countries, most notably Argentina, Bolivia, Brazil, and Israel. As a result, the average rate of inflation, after reaching 40 percent in 1985, slowed to 29 percent in 1986. At the same time, the median inflation rate receded from 9 percent to 8 percent. The downward trend in inflation may be harder to sustain this year, however. In fact, prices have begun to accelerate in several countries in recent months as a result of policy slippages. Also, in some other countries, exchange rate corrections undertaken in support of external adjustment needs are likely to result in higher rates of price increase and may give rise to additional inflationary pressures unless they are adequately buttressed by firm financial policies.

Stance of Policies

The mix of financial policies in the industrial countries has changed noticeably over the past 18 months, with monetary conditions continuing to ease and fiscal policy becoming more cautious, at least in countries with large deficits. At the same time the geographical configuration of policies among countries has become somewhat better balanced. For the most part, these changes in the mix and configuration of policies among countries, which received new impetus from the Louvre Accord of February 22, 1987, have supported an orderly realignment of key exchange rates, thereby helping to promote a more sustainable pattern of growth among countries.

The changed thrust of fiscal policy in the United States since late 1985—following a four-year period of substantial injection of fiscal stimulus—is the most important aspect of the new policy situation. It must be recognized, of course, that the improved fiscal outlook in the United States has yet to show up in a major reduction in the recorded deficit. Canada, Italy, and some smaller countries with large imbalances (Belgium, for example) have also made progress in improving their budgetary outlook. Meanwhile, the pace of fiscal consolidation has moderated in several countries that have been steadily reducing their budget deficits, including the Federal Republic of Germany, Japan, and—to a lesser extent—France and the United Kingdom. The initiation of these policy shifts can be detected in the fiscal indicators for 1986; in general, they are expected to become more apparent in 1987.

The fiscal situation in 1988 and beyond is more uncertain, particularly in the United States. The U.S. Administration's budget proposal for fiscal year 1988 implies a reduction in the federal budget deficit to $108 billion in FY 1988, as compared with an estimated deficit of $173 billion in FY 1987. Although the deficit implied by the budget proposal is in line with the target stipulated by the Gramm-Rudman-Hollings Balanced Budget Act, there is a substantial risk that the actual deficit will be significantly larger, since many of the proposed expenditure reductions have been rejected previously by Congress, and a key element of the sequestration process of the Balanced Budget Act has been ruled unconstitutional. Given the uncertainties, the staff has chosen to use a "current services" path of fiscal deficits as its working assumption. (This path traces the deficits that would obtain if current policies for spending programs and taxes remained in force.) On this basis, federal budget deficits of $182 billion in FY 1987 and $166 billion in FY 1988 are projected. For the other industrial countries, the assumed stance of fiscal policies in 1987 and 1988 reflects current expenditure plans and legislated tax rates, modified in some cases for planned changes whose implementation can be foreseen with reasonable confidence. As a result, fiscal policy in the major industrial countries outside the United States is expected to be slightly restrictive in both 1987 and 1988.

Monetary developments in the major industrial countries have been guided by the objective of maintaining downward pressure on inflation while permitting an adequate growth of output. The better fiscal outlook and the continuing improvement in price performance have provided monetary authorities with scope for some discretion in pursuing announced monetary growth targets. In particular, the instability of the velocity of key monetary aggregates has entailed a broadening of the focus of concern to include also growth and exchange rates. These concerns were reflected in a series of discount rate reductions over the past year in several of the major countries.

Monetary authorities have accommodated substantial declines in interest rates since mid-1984. Despite temporary increases in some countries owing to exchange rate tensions, short-term interest rates are now at their lowest level since 1978, with rates on U.S. dollar-denominated instruments having experienced a particularly sharp reduction. The 3-month London interbank offered rate (LIBOR) fell from 8¼ percent in late 1985 to about 6¼ percent in early 1987. The decline in long-term interest rates has been even more pronounced. The resultant flattening of the yield curve in most countries seems to indicate a marked reduction in inflationary expectations. Short-term interest rates firmed slightly toward the end of 1986 and early in 1987, possibly because of exchange rate tensions, but subsequently eased again. Provided fiscal consolidation plans are implemented, particularly in the United States, monetary authorities appear prepared to continue to support sustained growth in economic activity over the forecast period.

Efforts to enhance the functioning of markets with a view to improving resource allocation continue to receive high priority in all the industrial countries. In addition to the deregulation of financial markets, programs of privatization of public sector enterprises have been implemented or announced in several countries. Governments have also turned their attention to the distortions created by tax systems, and major tax reforms have been implemented or are planned in several countries. However, despite the growing list of achievements in the area of structural reform, much remains to be done, both to reduce labor market rigidities—particularly in Europe—and to dismantle trade barriers—in all countries. In this context, large subsidies to agriculture and to structurally depressed industrial sectors remain major impediments to an efficient allocation of resources, both within individual industrial countries and on a global scale. The slow pass-through of recent terms of trade gains to consumers in Japan also suggests there may be scope for structural changes to enhance competition in that country's distribution system.

Among the developing countries, financial performance in 1986 largely reflected the external forces to which they were exposed. For most countries, these forces led to a deterioration in the fiscal situation. In the fuel exporting countries, the loss of revenues as a result of the sharp decline in international oil prices more than offset lower debt-servicing costs from the fall in international interest rates. In response, adjustment efforts were intensified, triggering substantial cuts in public expenditure. However, despite reductions in outlays, the fiscal deficit of the fuel exporting countries deteriorated sharply, from 6 percent of GDP in 1985 to over 10 percent in 1986. In contrast, fiscal policy was eased somewhat in several of the countries that are exporters of manufactures. These countries benefited both from the weakness of oil and commodity prices and from the decline in interest rates; in general, they also enjoyed strong growth of exports. Exporters of primary products also experienced a rise in their fiscal deficits, either as a result of stagnating export revenue, or because of domestic policy initiatives.

Monetary and credit policies in the developing countries have in general remained cautious, as they continued to be directed at dampening inflationary pressures. A further deceleration in the growth of money and total domestic credit was particularly pronounced in a small group of high-inflation countries following the introduction of wide-ranging anti-inflationary measures.

The year 1986 also witnessed considerable use of exchange rate policy as a means for achieving external adjustment. Exchange rate adjustments were prevalent among those developing countries that suffered large terms of trade losses. The currencies of these countries, as well as of others, were often depreciated vis-à-vis the U.S. dollar in an effort to spur the growth of nontraditional exports. While a number of such adjustments were made among primary product exporters, the largest ones were made in countries that export oil, especially those with relatively diversified economies. Also, a number of countries that were not nearly so hard pressed experienced large real depreciations in 1986, with the adjustment often occurring through the fixed relationship of their currencies to the depreciating U.S. dollar. Some of these countries, notably the exporters of manufactures of Southeast Asia, were able to translate gains in competitiveness into sizable increases in market share.

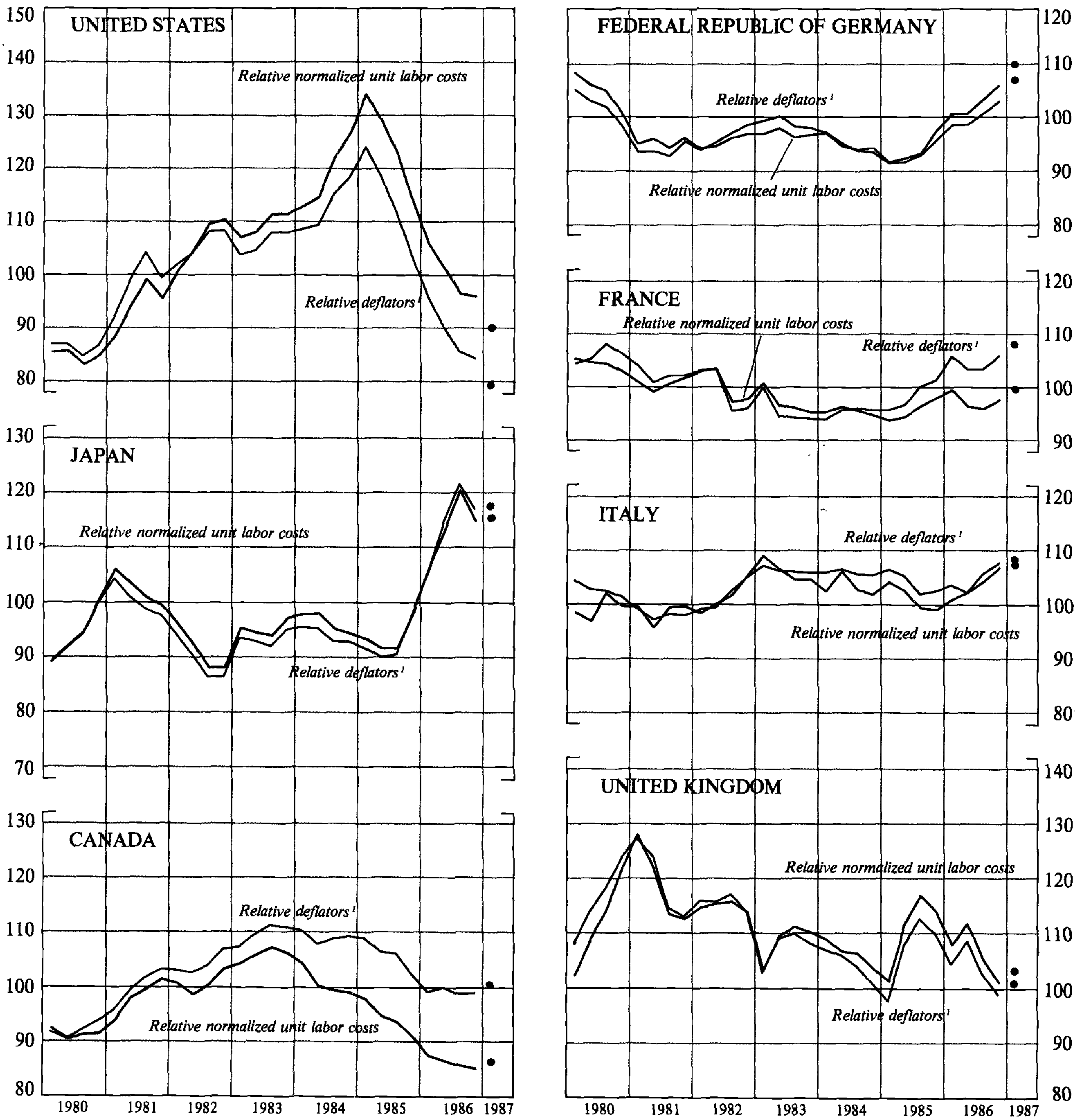
Exchange Rates and Payments Balances

The U.S. dollar fell sharply against other major currencies in early 1987. Added to the changes that had taken place since March 1985 (Chart 3), the cumulative decline represents a major realignment in the pattern of exchange rates. From its peak in the first quarter of 1985 to late February 1987, the U.S. dollar depreciated by 31 percent in nominal effective terms, and by about the same amount in real terms. The decline in the value of the dollar has reversed about five sixths of its appreciation from 1980 to the first quarter of 1985.[1] Conversely, the yen and the deutsche mark have appreciated by 23 percent and 20 percent, respectively, in real effective terms since early 1985. The yen's slightly greater real effective appreciation is due to the large weight of Japan's trade with countries with dollar or dollar-linked currencies.

This large correction in exchange rates has begun to affect real trade flows. As is evident from the shifting relationships between domestic demand and output shown in Chart 1, U.S. net exports have started to increase in real terms, and those of the Federal Republic of Germany and Japan have weakened appreciably. Nonetheless, despite these sizable real adjustments, current account imbalances among the major industrial countries widened in 1986. The U.S. current account deficit rose from \$118 billion in 1985 to \$141 billion in 1986, while the Japanese surplus rose from \$49 billion to \$86 billion, and the German surplus from \$13 billion to \$36 billion (Statistical Appendix Table A30). Although these increases reflect in part the use of a depreciating currency as the standard of measurement, there has also been a widening of the imbalances in relative terms. The U.S. deficit rose from the equivalent of 2.9 percent of GNP in 1985 to

[1] The calculations presented here use weights derived from the Fund's Multilateral Exchange Rate Model (MERM). Calculations using a broader currency basket generally show a smaller appreciation in the early 1980s, offset by a smaller subsequent depreciation.

Chart 3. Major Industrial Countries: Indicators of Real Effective Exchange Rates, 1980–87
(Indices, 1976–85 = 100)



Note: Bullets (•) denote estimates based on exchange rates prevailing during last week of February 1987.

[1] Annual deflators for GDP originating in manufacturing with quarterly interpolations and extrapolations (beyond the latest available data) based on wholesale price data for manufactures.

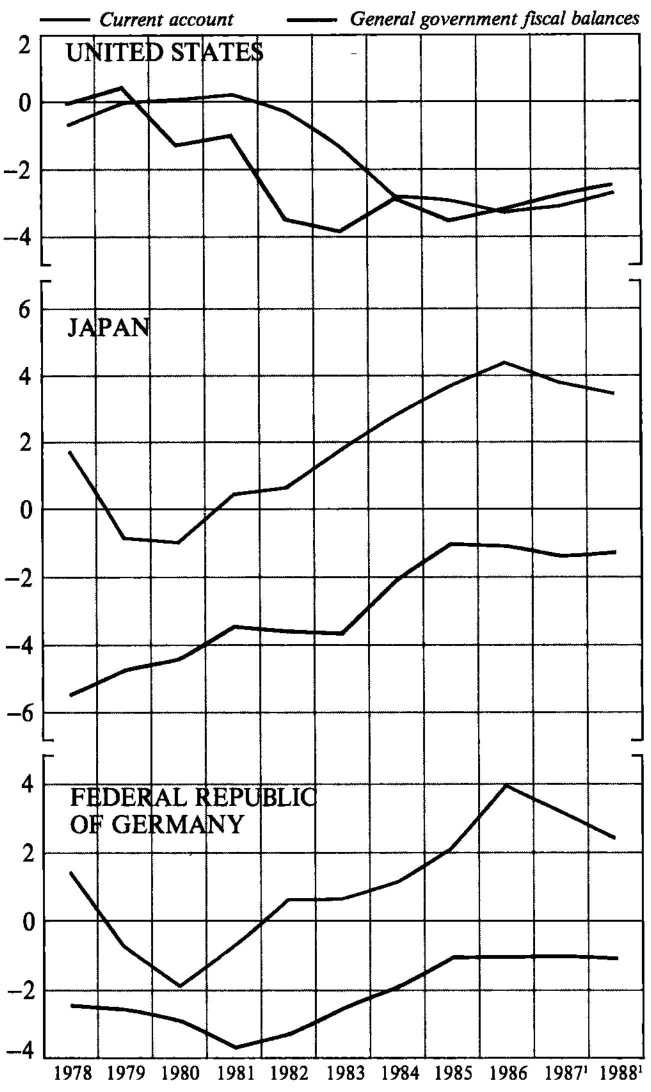
3.3 percent in 1986, while the Japanese surplus went from 3.7 percent to 4.4 percent, and the German surplus almost doubled as a share of GNP, to 4.0 percent.

These growing imbalances, occurring in the face of large exchange rate movements and slower growth in the United States, have prompted questions about what it will take to correct them. In this connection, it has to be recognized that exchange rate adjustments take time to work through to payments flows—probably at least three years to get a reasonably complete effect. The adjustments may take even more time on this occasion. Partly because of increased competition from developing countries, exporters to the U.S. market have cut their profit margins substantially. Prices of U.S. imports other than oil increased by 5½ percent from the first quarter of 1985 to the fourth quarter of 1986, that is, by only about a fifth of the depreciation in the exchange rate over this period. There has thus been a much smaller induced shift in demand than might have been expected. By the same token, however, the profitability of exporting to the United States or into third markets must have been substantially reduced, a development which in time should have substantial effects on the volume of sales.

External adjustment has also been slowed by income effects. Reflecting largely the stance of U.S. fiscal policy, absorption in the United States increased faster than potential output in each year from 1983 through 1986. Conversely, because of generally opposite fiscal developments among U.S. trading partners, demand in these countries grew at a rate well below that of the United States from 1983 to 1985 and only just in line with it in 1986. Neither of these developments was conducive to external adjustment (Chart 4).

Chart 4. United States, Japan, and the Federal Republic of Germany: Current Account and General Government Fiscal Balances, 1978–88

(In percentage of GNP)



¹ Fund staff estimates and projections.

From now on, some improvement in this situation is expected, albeit not sufficient to eliminate the large existing imbalances. The shift in real foreign balances that began in 1986 is likely to become stronger in 1987, partly because of price effects and partly because of a more appropriate configuration of aggregate demand growth. In relation to GNP, current account imbalances are expected to decline by over ½ of 1 percentage point for the United States, 1 percentage point for Japan, and 1½ percentage points for the Federal Republic of Germany from 1986 to 1988. Nonetheless, the remaining imbalances are large. Moreover, when expressed in U.S. dollar terms, the apparent correction is smaller because of valuation effects.

Shifts in current account balances among industrial countries tend to cancel out when aggregated across countries. Developments for the industrial countries as a group are dominated by the effects of the decline in the price of oil and other primary commodities relative to that for manufactures. Reflecting this development, the trade balance of industrial countries improved and that of developing countries deteriorated by some $40 billion from 1984 to 1986. The bulk of these shifts occurred in 1986, and reflected essentially a deterioration in the trade position of the fuel exporting countries.

The shift in the aggregate payments position of developing countries, although large, is considerably smaller than it would have been were it not for pronounced adjustments in import and export volumes made in response to terms of trade losses. Adjustment