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9

World Economic Outlook

A Survey by the Staff of the International Monetary Fund

International Monetary Fund
Washington, D.C.
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Preface

This is the latest in a series of studies on the "World Economic Outlook" that have been prepared by the staff of the International Monetary Fund since the early 1970s and published annually since 1980. The present study is published as Number 9 in the Occasional Paper series.

This year's *World Economic Outlook* retains two basic features of the 1980 and 1981 reports: (a) presentation and analysis of both short-term projections and medium-term "scenarios," and (b) discussion of key policy issues, with separate consideration of the industrial countries, the oil exporting countries, and the non-oil developing countries. The present report, however, is more comprehensive than its two predecessors, providing a greatly expanded volume of information in the form of supplementary notes (Appendix A) and of statistical tables (Appendix B).

The statistical, as well as analytical, work embodied in this report has benefited from consultations that the Fund conducted with member countries in the exercise of its responsibility for surveillance over exchange rate policies. Drawing on these consultations, as well as the Fund's extensive statistical resources, the estimates and projections for various groups of industrial and developing countries have, as usual, been built up on a country-by-country basis.

The World Economic Outlook is a large-scale project in the Fund, incorporating the specialized contributions of staff members from the five Area Departments and from several functional departments, particularly the Exchange and Trade Relations Department, the Fiscal Affairs Department, and the Research Department. The work is coordinated in the Research Department and is supervised by Charles F. Schwartz, Director of Adjustment Studies. He is assisted by many colleagues throughout the Fund, among whom special mention may be made of Carl P. Blackwell, Jacques R. Artus, Michael C. Deppler, and Stig von Post.

This report is being issued in the name of the Fund staff, and does not necessarily represent the views of the Executive Board. Further, the description of developments and policies, as well as the projections for individual countries, should not be attributed to either Executive Directors or their national authorities.

Staff studies on the World Economic Outlook have grown in their comprehensiveness and depth of analysis over the years, and have become an integral part of the work of the Fund. On behalf of our institution, I am pleased to present another such study to the public, with the hope that it may contribute to knowledge of the world economic situation and to understanding of the difficult policy issues faced by the Fund and its member countries.

/s/
J. de Larosière
Chairman of the Executive Board
and
Managing Director
International Monetary Fund

April 1982

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Chapter

I Introduction

The present report on the World Economic Outlook—like the corresponding reports published in 1980 and 1981 [1]—is the outgrowth of a comprehensive staff project involving a number of departments of the Fund. This introductory chapter briefly describes the World Economic Outlook project, outlines the contents of the report, and points out key features of the statistical projections.

Scope and nature of the project.—Staff work for this report has entailed mainly a forecasting exercise covering 1982 in depth and 1983 on a preliminary basis. The 1983 projections are not presented in tabular form but are incorporated at various points in the text to amplify the analysis.

Both the estimates and the short-term projections have been prepared on the basis of a detailed procedure involving an individual country approach. Derivation of figures for individual countries permits them to be shown separately (as in the case of the seven major industrial countries that have such a large weight in the world economy) or to be combined into meaningful subgroups (as in the case, notably, of the large and heterogeneous group of some 110 non-oil developing countries, for which economic totals or averages require disaggregation for purposes of analysis).

A special aspect of the statistical and analytical work for this report was the preparation of medium-term "scenarios" of how the world economy could evolve over the period through 1986 under alternative assumptions regarding policies and developments. The main results and policy implications of these scenarios are presented below in Chapter II. Statistical procedures and other technical matters are described in Appendix A-2.

This report has had the benefit of consultations that the Fund staff has recently conducted with a number of member countries—either in the course of its regular work or as part of the special consultations, primarily with the larger industrial countries, that are held in connection with exercises on the World Economic Outlook. These recent consultations, as usual, have proved valuable and have influenced both the statistical work and the analysis in many places, even though explicit references to them may not be made.

In the 1981 report, attention was called to the progress being made in extending the statistical coverage of the World Economic Outlook. With that report, the People's Republic of China was incorporated into the statistical series beginning with 1977. Also, work was under way to extend the coverage to nonmember Eastern European countries and the Union of Soviet Socialist Republics. As stated, the intention was to bring these latter countries more fully and explicitly within the statistical framework of the World Economic Outlook in the project scheduled for early 1982. Unfortunately, because of unexpected pressures of work, it has not been possible to carry out that intention, although it remains an objective for the future.

Content of report.—This report contains five chapters and two appendices. Chapter II, which provides a general survey, consists of four main sections: a summary of the international economic situation and outlook, focusing on recent developments and on the projections for 1982 and 1983; a discussion of key issues of policy, with separate consideration of the industrial countries, the non-oil developing countries, and the oil exporting countries; an analysis, as already mentioned, of medium-term scenarios of the world economy; and a brief account of the role of the Fund, with particular reference to the adjustment and financing of external payments imbalances incurred by member countries. Chapters III–V cover, respectively, the industrial countries, the oil exporting countries, and the non-oil developing countries. The treatment in each case is comprehensive, with discussions of both domestic and external developments and of the current stance of economic policies. Separate coverage of these main groups of countries is particularly warranted because they are in diverse and changing positions at the present time, and

[1] *World Economic Outlook: A Survey by the Staff of the International Monetary Fund* (Washington, May 1980); the June 1981 report, with the same title, was published as Occasional Paper No. 4 in the IMF Occasional Papers series. (Hereinafter these reports are referred to as *World Economic Outlook*, with the appropriate date.)

the positions of countries within the three groups vary widely.

Appendix A provides ten supplementary notes on varied aspects of the current project. Particular attention may be called to the extensive note on Country and Regional Surveys; this serves, in effect, to supplement Chapters III and V by reviewing in greater depth and detail the economic situation, prospects, and policies of the industrial countries and of the non-oil developing countries. Appendix B contains a set of some 75 tables that have emerged from the present statistical exercise and that provide quantitative frames of reference for much of the textual content.

An important aspect of this report concerns its geographical coverage as this relates both to the definition of the "world" and to the classification of the individual countries among the industrial, oil exporting, and non-oil developing groups of countries. This matter is treated in the introduction to Appendix B.

Features of statistical projections.—The projections in this report for 1982 and 1983 are based on the assumption of "present policies"; for a few countries, this has been interpreted to encompass certain policy adaptations or changes that seem likely to occur even though they have not been announced by the authorities. It was also assumed, as a working hypothesis, that the average exchange rates of a recent period (December 1981–February 1982) will prevail throughout the rest of 1982 and during 1983. Another working hypothesis for present purposes is that the average price of oil will remain constant in nominal (U.S. dollar) terms from end-March 1982 to the end of the year, and will remain constant in real terms from 1982 to 1983 (i.e., will parallel changes in import prices of the oil exporting countries).

The Fund staff projections for 1982 and 1983, particularly the latter, are subject to various caveats or limitations, which remain similar to those pointed out in the *World Economic Outlook* reports of May 1980 and June 1981. For one thing, the character of the projections is substantially affected by the working assumptions regarding present policies, exchange rates, and oil prices (which are the standard types of assumption used by the Fund and other international agencies for the purpose of making statistical projections). It will be readily evident that these assumptions are tenuous, and that they tend to become increasingly so with the lengthening of the projection period. At the same time, foresight becomes dimmer and the projections inevitably take on a somewhat "normative" character. More generally, it should also be borne in mind that the projections have been made at a time of great uncertainty and of unusual problems, with past relationships furnishing only a limited guide to probable future developments, so that the margins of error in this type of exercise are at present undoubtedly larger than customary.

Illustrative of this proposition is the range of uncertainties stemming from the prevalence of inflationary expectations. Related to this is the uncertainty surrounding the split of the projected change in nominal gross national product (GNP) into its price and volume components at a time of generally restrictive financial policies and cost/price pressures. The volume component, which is much the smaller in most countries under the current conditions of "stagflation," is particularly subject to large relative error. Powerful inflationary and deflationary forces are at work—further subject to the influence of political and other noneconomic events—and it is extremely difficult to determine with any degree of confidence where the balance between them may lie. Also noteworthy is the need to avoid attaching precision to the projections of balances on external current account, which are derived statistically as a small residual between very large flows of exports and imports and are subject to considerable error. The presence of error in the current account balances is directly evident in two respects: (a) the sharply higher "statistical asymmetry," as described in a note in Appendix B, that has emerged in the global results of estimating current account balances on an individual country basis; and (b) the sizable statistical revisions that have occurred in these balances in the course of the past year, as well as on some other occasions.

These caveats or limitations, as well as others that could be cited, emphasize the need for caution in use of the staff projections. Nevertheless, if the numbers are not taken too literally, and if the main attention is given to the directions and patterns of indicated changes, the present type of forecasting exercise can be helpful in depicting the global economic picture and in providing a basis for analyzing and deciding on the policies required to deal with both domestic and external problems.

II General Survey

Current Situation and Short-Term Prospects

This profile of the current and prospective situation of the world economy first concentrates on three basic problem areas: growth of output, inflation, and balances on external current account. It next touches on a number of consequential or associated problems. Then, a concluding part offers some further observations intended to round out the general picture. In the interest of brevity, this section deals summarily with a whole range of matters that, for the most part, are treated in more detail in subsequent sections of the report.

It may be recalled that, at a time when various forces of "stagflation" were already operative, having been built up over a long period, the authorities of the major industrial countries turned to increasingly restrictive financial policies during 1979 and 1980 in order to counter mounting inflationary pressures attributable to the second round of oil price increases and other developments. By and large, these policies have been continued despite the weakening of output growth to which they have contributed. On the external side, the increase in oil prices had large and pervasive effects on the international distribution of current account balances during 1979 and 1980; and this distribution has been substantially modified in the past year or so by two partly related developments: the progressive softening of the previously tight conditions in the world oil market, and the weakening of economic activity in the industrial world.

Growth of Output

Overall growth of real GNP in the industrial countries, after averaging 4 per cent per annum in the period 1976–79, fell off to about 1 per cent in 1980 and again in 1981 (see Table 1). Until recently, the Fund staff thought that there would be a recovery, though moderate, to about 2 per cent in 1982. But now, with the onset of another recession in the United States, coupled with weaker prospects for several other countries, the growth of output in the industrial world from 1981 to 1982 may average only ¾ of 1 per cent. This figure would comprise a small decline in the first half of the year and a modest increase in the second half. Thus, the industrial countries as a group face the prospect of a weak economic performance for the third year in a row, and the problem of low or negative growth in most of these countries appears to be even more severe and protracted than was thought likely just a few months ago. As for 1983, with all the uncertainties involved, the growth rate of real GNP is expected to show widespread improvement among industrial countries but may amount to only 2½ per cent overall.

In the United States, according to the staff projections, real GNP would decline by 1 per cent from 1981 to 1982 (Table 1) and rise by less than 2 per cent from 1982 to 1983. The projected growth performance of the United States for 1982 and 1983 is weaker than that of most other industrial countries. This reflects the current U.S. recession and the assumption of only a modest recovery in the course of the two years. Unless progress in reducing inflation turns out to be unexpectedly great, the staff is of the view that strong growth of output in 1982 and 1983 would not be compatible with the present anti-inflationary stance of monetary policy. In the absence of additional fiscal action, the prospect is for continued large federal budget deficits even after the economy emerges from the current recession, and this contributes to the unsettled conditions of financial markets. Such large deficits would not augur well for a sustained expansion of economic activity. (See the discussion of the U.S. outlook in Appendix A-1.)

For the non-oil developing group of countries, overall estimates of the growth in real GDP—based on weighted averages—should be interpreted with caution because of the wide diversity of experience among individual countries. Some have had rather high rates of growth, and some low or negative rates. This situation is analyzed in Chapter V, on the basis of "median" growth rates as well as the usual weighted averages, and with attention to the experience of both geographical areas and analytical subgroups (see Table 2). Here, two related general points should be made. First, the sluggish growth of demand and output in the industrial countries during recent years has had a widening adverse impact on the growth rates of non-oil developing countries. Second, the growth rates of the past few years have been unsatisfactory for the majority of these countries. They have been markedly below the corresponding rates of the late 1960s and early 1970s, and very modest in relation to developmental needs against a background of high population growth.

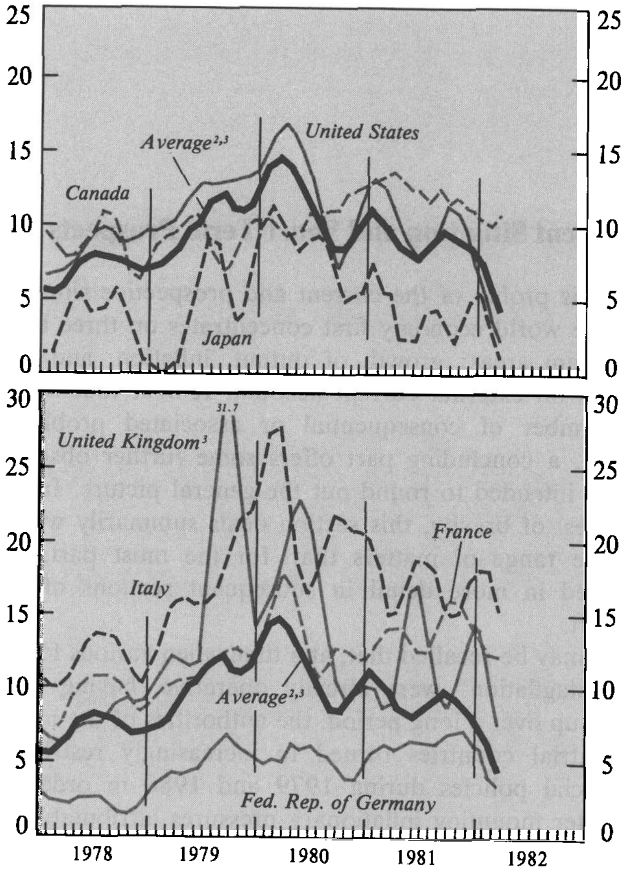
With respect to the oil exporting countries, because of the pursuit of less expansionary policies and special circumstances affecting economic conditions in a few of them, the average growth in their non-oil sectors has been more moderate in the past few years than during the mid-1970s. However, the growth in total real non-oil GDP picked up in 1980 and 1981, and is expected to remain at the 1981 rate in 1982 (see Table 2). Although total real GDP rose only moderately in 1979 and is estimated to decline markedly during 1980–82 because of the large drop in oil production, real national income of the oil exporting countries will have increased substantially from 1978 to 1982 because of the large improvement in their terms of trade (see Table 9).

Inflation

The restrictive financial policies adopted by the industrial countries during 1979–80 have been reasonably successful in limiting secondary effects of the upsurge in oil prices on increases in domestic wages and costs. This important development has been analyzed in the Fund's 1981 Annual Report (pages 6–8), which points out that by the first half of 1981 increases in cost and price indices were in general noticeably below the peak rates of 1980.

The drop in the rate of inflation that occurred in the latter part of 1980 and continued in 1981 has been extended into the current projections for 1982 and 1983. For the industrial countries as a group, the increase in consumer prices (Chart 1 and Table 7) slowed down from 12 per cent in 1980 to 10 per cent in 1981, and is expected to come down to 8 per cent in 1982 and perhaps 7 per cent in 1983. The increase in GNP deflators—a better measure of underlying inflation pressures—is also expected to moderate, but less markedly. As measured by these deflators (Table 1), the overall rate of price increase in the industrial countries averaged about 8½ per cent in the period 1977–81 and is projected to decline to 7½ per cent in 1982 and about 7 per cent in 1983. Achievement of the lower inflation rates projected for 1982–83—which are predicated on weak commodity prices, continuing restraint in financial policies, and substantial underutilization of resources—

Chart 1. Major Industrial Countries: Consumer Prices, 1978–March 1982
(Changes in per cent)[1]



[1] Three months ended in the month indicated over the preceding three months; seasonally adjusted, annual rates.
[2] Average for the seven major industrial countries.
[3] The figures plotted for the second half of 1979 are affected by the approximately 3¼ per cent increase in the United Kingdom's VAT rates, effective June 18, 1979.

would still leave the average rate of inflation in the industrial countries nearly as high as in the late 1970s and almost twice as high as in the 1960s and early 1970s.

An important feature of current inflation in the industrial world is the wide dispersion of rates among individual countries. These range (in terms of increases in GNP deflators for 1981) from about 3–4 per cent in Japan and the Federal Republic of Germany to 18 per cent in Italy among the seven major industrial countries. And rates of inflation also vary substantially within the group of 14 smaller industrial countries. Among other things, the prevailing wide dispersion in rates of inflation makes it very difficult for the national authorities to achieve a reasonable degree of stability in the exchange rates for major currencies.

In the non-oil developing countries, inflation has accelerated markedly in the past few years (as shown in Table 3) because of the prevalence of accommodating financial policies, as well as the higher cost of imported goods. Inflation may come down in 1982, but the projected change is not very large. It would still leave most countries with inflation rates higher than those in the 1976–78 period and far above those in 1968–72.

The worsening of inflation in the non-oil developing countries in 1979–81 is much more striking when measured in terms of the weighted average rates, rather than the median rates. The latter rates—representing the "middle" country in the sense that half the countries have a higher rate and half a lower rate—are more indicative of the rate of increase in consumer prices in the "typical" or "representative" country of the group than are the weighted averages, which tend to be strongly affected by developments in a relatively small number of the largest countries. Also noteworthy among the developments shown in Table 3, the median inflation rate for non-oil developing countries has regularly been at a much lower level than the weighted average rate; in 1981, for example, the figures were 14 per cent and 31 per cent, respectively.

In the oil exporting countries, the problem of inflation has in general been greatly reduced in the past few years. The overall rate of inflation is projected at about 10½ per cent for 1982, somewhat below the average for 1980 and 1981. It compares with an average annual rate of price increase of more than 17 per cent during the 1974–76 period of rapid economic expansion. However, current inflation rates for these countries are still considerably higher than in the period 1968–72.

Balances on Current Account

When attention is turned to changes in the global pattern of current account balances, it should first be noted that this area of estimation and analysis is affected by some disturbing statistical problems. The existence of these problems is signaled by a large and growing "statistical asymmetry" in the summation of estimated surpluses and deficits for all individual countries comprising the world economy. From the breakdown of this asymmetry shown in Table 23, it is clear that, in the figures for 1980–82, there has been either an overestimation of increases in payments for services, or an underestimation of increases in receipts from services, or some combination of both.

Basically, the statistical asymmetry in current account balances reflects an inadequacy of national statistical sources, and impairs the validity of the estimates and projections being made in national capitals, as well as in the Fund and other international institutions. A technical note on the asymmetry in the Fund staff's estimates of current account balances is presented in the introduction to Appendix B. In brief, this note points out that the asymmetry (a) worsens sharply in 1981 and 1982 (as well as in 1983, for which staff projections are at present very tentative); (b) is concentrated in the category of net services and private transfers, rather than merchandise trade; and (c) may be presumed to reflect, in the main, errors and inconsistencies in the accounts for the industrial and oil exporting groups of countries, where transactions in services and private transfers bulk large and have increased sharply over the past several years. This speculation about the sources of the asymmetry in an absolute sense is not meant to imply that the estimates of current account balances for the non-oil developing countries are themselves not subject to a possibly considerable margin of error. One question that is frequently asked is whether the projected deficits for the non-oil developing countries "can be financed"; on this, it should be noted that, while judgments are involved, these estimates have been built up on a country-by-country basis in a balance of payments framework that also provides for corresponding estimates of current account financing.

Even though the projections of current account balances must be viewed with reservation, it seems possible to identify four major developments.

First, the combined current account surplus of the *oil exporting countries,* after jumping from $3 billion in 1978 to $115 billion in 1980 (Table 15), has gone into a decline that is much more rapid than previously foreseen. Mainly because of the strong and sustained response by consumers to the steep rise in oil prices after 1978, and also because of the impact of sluggish economic activity in the major industrial countries, world demand for oil from the oil exporting countries fell sharply in 1980 and 1981 and is projected to decline further in 1982. Moreover, there has been some softening of oil prices. After increasing by 170 per cent from the end of 1978 to the first quarter of 1981, the average price of oil exported by the oil exporting countries (in nominal, U.S. dollar, terms) then declined by about 5 per cent in the period through March 1982. (Prices of other important oil producers—outside the group of oil exporting countries—declined even more.) Although import demand of the oil exporting countries has been more restrained than after the 1973–74 oil price increases, these developments led to a fall in the combined current account surplus of the oil exporting group to an estimated $71 billion in 1981, and a further fall to perhaps $25 billion is projected for 1982—far below the corresponding projection of $80 billion that was mentioned in the *World Economic Outlook* report of

June 1981. (The reasons for this downward revision are discussed in Chapter IV.)

Second, a strongly positive swing in the combined current account balance of the *seven major industrial countries* is in process. In the main, this is a counterpart to the fall in the oil exporters' surplus, inasmuch as the large industrial countries are the principal oil consumers. From a combined current account deficit of $16 billion in 1980, the major industrial countries are expected to shift to a current account surplus of some $24 billion in 1982. (These figures, in conformity with the definitions used in Table 15, exclude official transfers; figures including official transfers are shown for the industrial countries in Table 16.) As analyzed in Chapter III, the positive swing in the combined current account balance of the major industrial countries from 1980 to 1982 comprises markedly divergent movements among individual countries—notably, a substantial strengthening of the Japanese and German positions and some deterioration in the U.S. position.

Third, and in contrast to the substantial strengthening in the current account balances of major industrial countries, the deficits of a number of *smaller industrial countries*—the Netherlands, Norway, and Switzerland being the main exceptions—are projected to remain large in 1982 and 1983. The financing of these deficits is not expected to be a general problem, but in certain countries external debt is reaching a level where service payments absorb a sizable share of foreign exchange receipts.

Fourth, the combined current account deficit of the *non-oil developing countries* is projected to remain at a level of around $100 billion in 1982 and 1983, compared with $39 billion in 1978. Nevertheless, it seems evident that external adjustments are being widely adopted—and in many cases forced by circumstances—among these countries. This point emerges more clearly from disaggregated data for the various subgroups of non-oil developing countries than it does from the aggregate records. For the dozen members of the group of non-oil developing countries that are net exporters of oil (although not meeting the criteria for inclusion in the main oil exporting group), and thus have been generally subject to less constraint on imports, a further rise in the combined current account deficit is projected from 1981 to 1983. For the great majority of other countries in the non-oil developing group, that is, the approximately 100 countries that are net importers of oil, the combined current account deficit is projected to decline somewhat in 1982 and 1983. This decline is larger in "real" terms, that is, when account is taken of the projected further increase in exports of goods and services; the projected decline in the ratio of current account deficits to exports of goods and services from 1981 to 1983 is shared by all three subgroups of net oil importers. (See Tables 15 and 22, and Chart 11.)

In recent years, the current account positions of most non-oil developing countries have been sharply affected by external developments—notably, the 1979/80 increase in oil prices, the steep rise of interest rates in international markets, and the pervasive slowdown of economic activity in the industrial world. When account is also taken of structural problems and the inadequacy of domestic policies, it is clear that the external positions of many non-oil developing countries are fundamentally weak and require adjustment. For the most part, as explained in Chapter V, such countries fall into two categories: low-income countries and "other" net oil importers (comprising middle-income countries that, in general, export mainly primary products).

The financial market pressures of 1980 caused a noticeable shift in the pattern of financing on which the non-oil developing countries relied to cover their current account deficit. As a group, they sharply reduced their accumulation of reserves and shifted toward a substantially higher proportion of short-term financing. The share of long-term borrowing in their overall financing pattern was correspondingly reduced. Some of the short-term financing was not readily renewable, and the 1981 financing pattern showed some tendency toward renewed growth of long-term borrowing, even though interest rates in international markets remained unexpectedly high and the degree of reliance on short-term borrowing continued to be unusually great. Accumulation of reserves by the non-oil developing countries became negligible in 1981, even in nominal terms, and was again negative in real terms. The staff projections for 1982 imply a small further shift back toward a more normal financing pattern, with a moderately greater proportion of long-term borrowing and a slight pickup in nominal reserve accumulation.

Other Problem Areas

In addition to the three predominant problems—high inflation, unsatisfactory rates of economic growth, and imbalances on external current account—that have been sketched above, several other problems command attention in any current survey of the world economic situation.

—Primarily because of the weakness of economic activity in the major industrial countries, expansion of the *volume of world trade* has fallen to an extremely low level in the 1980–82 period (Table 8). This, of course, makes for a very difficult international environment for countries attempting to adjust their balance of payments positions. For many of these countries, the problem is aggravated by the weakness of commodity prices (see Appendix A-10).

—*High unemployment* is a problem of mounting economic and political significance in many of the industrial countries. Unemployment in the industrial countries (as a percentage of the labor force) was already high in 1980, roughly the same as during the international recession of 1974–75; it increased sharply in 1981 and is expected to rise further in 1982 (see Table 6).

—The conditions of weak demand and high unemployment in many of the industrial countries are bringing new threats of *protectionism* in trade policies. It would be difficult to overemphasize the importance of this area of policy. It continues to demand the utmost vigilance and prudence in government actions. So far, the industrial countries have had a generally good record in resisting protectionist pressures during the troublesome period since the mid-1970s, and across-the-board trade restrictions have been avoided. Nevertheless, the pressures are severe, and yielding to them could have very serious consequences for the growth of world trade. The present situation is analyzed in a note presented in Appendix A-9, which points out that trade frictions have intensified in the past year and goes on to discuss five key problem areas in the field of international trade policy.

—The *behavior of interest rates and exchange rates* during the past two years has posed difficult problems in the major industrial countries, with repercussions throughout the rest of the world. The interaction of monetary restraint and severe inflation has had a sharp impact on interest rates, which have become very high (in real as well as nominal terms) and very volatile. Also, in part because of interest rate variations, the exchange rates for major currencies have shown exceptionally large movements. An important element of the general picture has been the rapid rise (and sharp fluctuation) of interest rates in the United States—which, together with a markedly stronger dollar, has had the side effect of constraining the policy options of other countries.

This combination of interest rate and exchange rate developments has raised a number of policy issues. Although varied, they have focused, in essence, on a common question—namely, the scope for action in the major industrial countries, whether on the part of individual countries or of several countries jointly, to bring down the level of interest rates and to reduce the volatility of both interest rates and exchange rates, without jeopardizing the priority of national economic policies to counter inflationary pressures. These issues of policy—ranging over such questions as the appropriate mix of fiscal and monetary policies, the need for better implementation of monetary policies, the role of exchange market intervention, and the possibility of coordinating fiscal, monetary, and interest rate policies among the major industrial countries—are both difficult and controversial. They have received much attention in the Fund during its exercise of surveillance over members' exchange rate policies.

Reference may be made to the principal materials in this report that bear on the subject of interest rates and exchange rates. Chapter III analyzes developments in these areas that have taken place in the industrial countries during recent years. Appendix A-3 contains two sections that are relevant. One of them, referring to the magnitude of government expenditures and deficits as factors contributing to stagflation in the industrial world and placing excessive burdens on monetary policy in efforts to control inflation, traces the broad path by which governmental units in the major industrial countries arrived at their current high levels of spending.[1] Another section of Appendix A-3 addresses the concern that has arisen, particularly in a setting of monetary restraint in most industrial countries, that the government borrowing associated with large fiscal deficits will tend to keep real interest rates unduly high and thus to "crowd out" potential private borrowers and related investment expenditures. In this latter section, an attempt is made to draw together some rough statistics on sources and uses of national saving that will permit government borrowing requirements to be viewed in an appropriately comprehensive perspective. Appendix A-4 analyzes monetary developments in the major industrial countries over a number of years, in the context of the monetary policies being pursued. Appendix A-5 purports to provide long-range perspective on current exchange rate relationships by focusing primarily on comparative price and cost trends, with considerably less attention than would be appropriate in a shorter-term context being given to such factors as monetary conditions and interest rates, cyclical or quasi-cyclical changes in capacity utilization, and variations in current account balances. Finally, it may be noted that Appendix A-6 provides a note on the exchange rate experience of developing countries over the period since 1973.

—Another important difficulty in the industrial countries is *rigidities and structural adjustment problems,* a subject discussed in Chapter III. During the past two years, a disappointingly large proportion of the reduction in growth of aggregate nominal demand

[1] This and other aspects of fiscal disequilibrium have been covered by the Managing Director of the Fund in an address, "Restoring Fiscal Discipline: A Vital Element of a Policy for Economic Recovery," delivered to the American Enterprise Institute, Washington, D.C., on March 16, 1982; reproduced in *IMF Survey,* Vol. 11 (March 22, 1982), pp. 81–87.

engendered by the tightening of monetary policy has taken the form of shrinkage in the growth of real economic activity, rather than lower inflation. This result is attributable to various rigidities or structural imbalances that have become embedded in the economic system. Examples are to be found in wage bargaining and price setting, in government subsidization or protection of ailing industries, in various aspects of government spending and taxation, and in the governmental imposition of regulatory burdens. Because of these rigidities and structural imbalances, inflation tends to be rather sticky and economic growth to be sluggish; as long as they remain, the performance of national economies will, in varying degrees, be less than optimal.

General Picture

Taken together, the various problems discussed above add up to a very substantial package, constituting a serious situation for the authorities of many member countries. These problems depict a compelling, widespread need for policies of adjustment. This need reflects the prevalence of large imbalances in the world economy—imbalances both among groups of countries and within many individual countries. In these circumstances, the "adjustment" called for is of a broad and fundamental character—directed over the medium term to the control of inflation and the handling of structural problems and rigidities. It is adjustment with the purpose not only of correcting the balance of payments position but also of improving economic efficiency and capacity so as to strengthen the productive base and foster sustainable noninflationary growth.

Imbalances in the world economy have clearly become more intractable. One cannot expect the existing major problems to be handled quickly, easily, or painlessly. There is a clear need for patience and perseverance on the part of national authorities, as well as for public understanding of their objectives, since an approach that offers reasonable prospects of eventual success will require considerable time to achieve the desired results. In this context, it is to be emphasized that the interrelated problems of severe inflation, slow growth, and high unemployment that plague the industrial world were built up over a long period, and have deep roots in a variety of political and social factors, as well as economic causes. (See the *World Economic Outlook* report of June 1981, pp. 7–9.) Such entrenched problems of stagflation must be attacked through an integrated use of several policy instruments carefully coordinated to achieve well-defined objectives over the medium term. Similarly, the adjustment problems that face many of the developing countries include structural elements attributable to the impact of domestic and external developments since the early 1970s.

Notwithstanding these generalizations, the policies of adjustment that are called for in present circumstances differ significantly among countries. This circumstance reflects the fact that the problems discussed above are of widely varying importance on an individual country basis. In fact, conditions around the world are quite uneven, in large part because of differences in the quality of policies that have been pursued. Mention has already been made of the dispersion in inflation rates among both industrial and developing countries, and of the disparity in growth rates among countries.

In this connection, much evidence can be gleaned from the present report in support of the notion that "policies matter." Particular attention may be called (a) to Appendix A-4, which includes a comparative study of monetary policies in the major industrial countries since the mid-1970s and, perhaps not surprisingly, finds the policies of the Federal Republic of Germany and Japan to have been the most successful; and (b) to Appendix A-8, "Link Between Growth and Inflation in Non-Oil Developing Countries," which presents the interesting and significant finding that, among the large and heterogeneous group of non-oil developing countries, relatively high rates of economic growth have been associated with relatively low (or declining) inflation rates over the past decade, and vice versa. Also instructive in this regard are the strikingly different economic records of the various regional groups of non-oil developing countries (see Appendix A-1).

Thus far, this profile of the current and prospective situation of the world economy has concentrated on a variety of problems. In the interest of a balanced assessment, however, account needs to be taken of the fact that the world economic situation also contains certain positive, or encouraging, features. Two important such features are (a) the progress on the anti-inflation front that is now becoming increasingly evident in several large industrial countries, and (b) the striking improvement in the efficiency of energy use, along with the switching from oil to non-oil energy sources, that has taken place over the past few years in virtually every industrial country—a matter that is analyzed in the "World Oil Situation," Appendix A-7. A significant related development is that the recent fall in oil consumption and easing of oil prices are having beneficial effects—however slight in some cases—on growth, inflation, and current account balances in oil importing countries throughout the world.

With respect to the first positive feature just mentioned (inflation in the industrial countries), the prospects in this area are rather more hopeful than a year ago. As summarized earlier in this section, the staff projections of inflation rates in the industrial countries as a group for 1982 and 1983 would still be very high in an historical perspective. Further, no industrial country except possibly Japan can be said to have "solved" the problem of inflation and inflationary expectations. Nevertheless, the projections for 1982 and 1983 connote significant progress in the fight against inflation. Particularly noteworthy are the projections for the three largest countries; according to these projections, inflation in Japan and the Federal Republic of Germany will have settled in the 2–4 per cent range, and the rate for the United States will have dipped to about 6 per cent in 1983—down from 9¼ per cent in 1981—and to perhaps 5 per cent in the second half of that year.

It would be most unfortunate if the hard-won progress against inflation that is now under way in the three largest industrial countries were to be dissipated by a premature relaxation of restraint over the growth of aggregate nominal demand. In the other four major industrial countries, reduction of inflation must clearly remain a top-priority objective. Even if Canada and the United Kingdom were to achieve the considerable progress indicated in the staff projections, their rates of price increase in 1983 would still amount to 8 per cent; in France and Italy, the double-digit figures (Table 1) projected on the basis of "present policies" are clearly unsatisfactory. Further, inflation may prove to be quite stubborn in the group of 14 smaller industrial countries, for which an inflation rate of 8½ per cent in 1983 is being projected—about the same as in 1980. All in all, the progress against inflation that now seems to be under way in some parts of the industrial world is very welcome, and it would not be too surprising—provided that policies persevere—if the actual results in 1982 and 1983 were to be generally better than those encompassed in the staff projections (which may be subject to a certain stability bias).

With the rate of economic growth still unsatisfactory in most industrial countries, and with the rate of unemployment still high and rising, the crucial question is whether sufficient patience will be exercised to carry out the necessary policies of adjustment. As indicated in the discussion of "Key Issues of Policy" presented in the next section, the tasks that confront industrial countries in overcoming "stagflation" and developing countries in adjusting their external positions are so large and difficult as to require more time in order to yield the desired effects. "Time," in turn, will require both patience and courage on the part of the authorities.

This view, while not very comforting, is believed to be quite realistic—all the more so because there would appear to be no satisfactory alternative to the comprehensive, medium-term policy approaches outlined in "Key Issues of Policy." Both that section and the following one on "Medium-Term Scenarios" make it clear (a) that there are no quick or easy ways of achieving substantial and lasting improvement in economic performance; (b) that, despite the unsatisfactory nature of the economic situation in many countries, there is in fact little room for maneuver on the part of national authorities seeking to get their economies back on track, other than to pursue fundamental measures of adjustment aimed at reducing inflation and improving productive efficiency; and (c) that alternative approaches, notably resort to expansion of aggregate demand, would be counterproductive and, eventually, would only make the situation worse.

At the same time, despite manifold uncertainties, there is reason for hope that, with the pursuit of sound adjustment policies, the next several years could mark a transitional period of real progress in reducing inflation and improving economic efficiency, thus setting the stage for a substantially better performance of the world economy in the latter 1980s. This prospect—or possible course of developments—is analyzed in Appendix A-2, "Medium-Term Scenarios."

In sum, the Fund and its members continue to face difficult economic challenges in an environment of great uncertainty. To meet these challenges, exercise of a maximum degree of international cooperation will be required. In essence, such cooperation means that each country should take account of the interests of other countries in the formulation and conduct of its own economic policies. One extremely important form of international cooperation is the avoidance—indeed, the rescinding—of protectionist trade measures, which serve only to hinder the processes of domestic and external adjustment. Another form of international cooperation consists of member-country support for the Fund in its endeavors—described in the last section of this chapter—to play an active role in promoting and assisting adjustment in an unbalanced world economy.

Key Issues of Policy

Given the rather difficult world economic situation, it is not surprising that the policy strategies put in place over the past two or three years, in particular the policy of monetary restraint in industrial countries, are coming under question. This section reviews the effectiveness of these strategies. It concludes that, to restore a basis for sustained economic growth, it is crucial for national authorities to maintain the broad thrust of their present policy strategies, while adapting them to enhance their effectiveness.

Industrial Countries

For the past two or three years, most industrial countries have relied mainly on monetary restraint to reduce inflation and to restore a basis for sustained economic growth. Money growth rates have been reduced, often quite significantly, and real interest rates have been high (see Appendix A-4). As might have been expected, the results have been mixed. Progress has been made in the fight against inflation. In the main, industrial countries were successful in stopping the new surge of inflation that developed in 1979–80 as a result of the rise in oil prices and of the expansionary financial policies followed in 1978–79. However, by early 1982, the average rate of inflation in industrial countries, as measured by the GNP deflator, was still well above the 7½ per cent plateau of 1976–78. Furthermore, the gains against inflation have been accompanied by a sharp decline in economic growth and a large increase in unemployment. By early 1982, some 28 million workers, or 7–8 per cent of the work force, were unemployed in industrial countries. Additional millions, possibly discouraged by poor labor market conditions, had dropped from the work force altogether. The social and economic costs of such a waste of human resources are huge, and the political risks cannot be ignored.

In addition, international economic relations have been subject to growing strains. In the industrial countries, large and erratic movements in interest rate differentials, resulting mainly from movements in U.S. interest rates, have been accompanied by large and erratic movements in exchange rates. Also, there have been sustained exchange rate movements that may not be consistent with a reasonable pattern of current account balances in the medium term. In part because of interest rate differentials, the Japanese yen and the deutsche mark have been weak, while the U.S. dollar has been strong. As a result, Japan and, to a lesser extent, the Federal Republic of Germany, besides enjoying lower rates of inflation and unemployment than other industrial countries, also enjoy stronger current account balances. In such a situation, according to staff projections, economic recovery in the other industrial countries over the medium term could be adversely affected.

In part, it was to be expected that the adjustment to a low rate of money growth would be slow and painful. As discussed in the June 1981 *World Economic Outlook* (pages 7–9), the origins of stagflation in the industrial countries are both complex and deep-rooted—the result of a number of diverse developments extending over a lengthy period. The effects of these developments cannot be reversed overnight. In particular, the skepticism of private market participants as to the willingness of the authorities to persist in their policy of reducing money growth will take time to dissipate because of past disappointments in this regard. Therefore, inflationary expectations are bound to persist for some time, slowing the decrease in inflation and placing upward pressures on nominal and real interest rates and downward pressures on output and employment. In addition, the 1979–80 oil price increase has greatly complicated the task of reducing inflation.

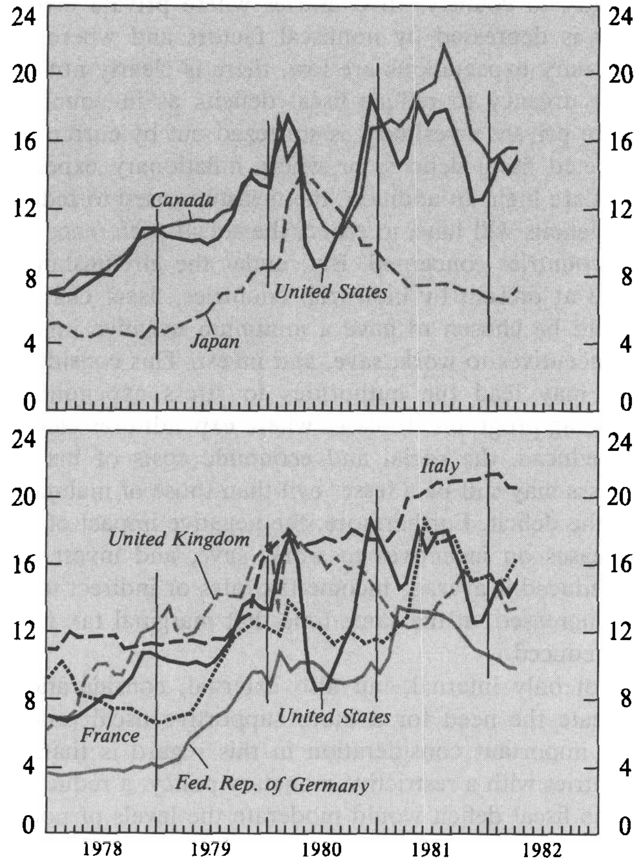
But it also seems that the adjustment has been slower and more painful than necessary in many countries because of weaknesses in the implementation of policies. These weaknesses relate to the implementation of monetary restraint per se, to the lack of an adequately supportive fiscal policy, and to the failure to tackle directly the rigidities and other structural problems that hinder economic growth and contribute to unemployment. Such weaknesses have limited the depressive effects of monetary restraint on prices and, therefore, have intensified the depressive effects on output and employment.

With respect to the implementation of monetary restraint, rates of money growth have been reduced but have continued to show wide fluctuations in many countries. These fluctuations have occurred not only over short-term periods of a week or a month—which is unavoidable and not significant—but also over longer periods (say, three to six months). While generally high, nominal interest rates have also experienced wide swings (Chart 2). Such developments may have contributed to the uncertainty of private market participants as to the longer-run commitment of the authorities to their programs of monetary restraint.

These problems have been particularly severe in the United States, where both money growth and interest rates have been highly variable over the past two and a half years. While it is difficult to explain this variability, important contributing factors probably include the following. (1) Major financial innovations, such as the growth of checkable bank deposits with a fixed rate of interest (included in M1) and of checkable money market mutual funds (included in M2), have blurred the differences among transaction balances, quasi-transaction balances, and investment accounts. (2) The new operating procedures of the Federal Reserve adopted in October 1979 have not led to a greater

Chart 2. Major Industrial Countries: Short-Term Interest Rates,[1] 1978–April 1982

(In per cent per annum)



[1] The rates shown are monthly averages of daily rates on money market instruments of about 90 days' maturity.

stability of money growth, while they may have contributed to variability of interest rates. (3) Private market participants have been uncertain about the size of federal budget deficits in 1981 and successive years and about their effects on credit markets and interest rates. Because of the role of the United States as a key financial center, the high variability of U.S. interest rates is a problem not only for the United States but also for the rest of the world. In particular, other industrial countries find themselves confronted by a difficult choice, namely, accepting a high variability of their exchange rates or a high variability of their interest rates. Both alternatives hinder the implementation of their own monetary strategy.

With respect to fiscal policy, large budget deficits have also hindered the effectiveness of the strategy of monetary restraint. It is widely recognized that a strategy of monetary restraint is not feasible when large budget deficits are monetized. What is not so widely recognized is that large budget deficits can hinder the effectiveness of monetary restraint even when, as in the past two or three years, they are not monetized. First, they may hinder the effectiveness of monetary restraint if private market participants come to believe that the deficits will be monetized sooner or later. In this case, inflationary expectations remain high, fueling the inflationary process. Nominal and real interest rates are pushed upward by inflationary expectations and by the worsening liquidity shortage, and monetary restraint leads to a decline in rates of investment and economic growth, rather than in the rate of inflation.

Second, large budget deficits may lead to a "crowding out" of private investment through high real interest rates as the government and the private sector compete for available funds. By itself, this effect may not reduce economic growth in the short run, but it will do so in the longer run because it hinders capital formation and productivity growth in the private sector. In turn, the reduction of productivity growth will make it harder to control inflation because it makes it necessary to achieve lower growth rates for nominal and real wages.

Whether a fiscal deficit contributes to inflationary expectations and a crowding out of private investments is a matter of circumstances. In the past two or three years, fiscal deficits have been a source of problems in many countries, and the same is likely to be true in 1982–83. There are strong reasons to believe that private market participants have become highly sensitive to fiscal deficits. They have come to believe that fiscal deficits lead to monetary expansion sooner or later, because the monetary authorities increasingly come under pressure to relax the liquidity squeeze that prolonged budget deficits may impose on the private sector. On the basis of the historical record, market participants can hardly be blamed for their reaction. In addition, they know that the structural adjustments needed in industrial countries and in the rest of the world during coming years will require a large flow of funds to finance private investment.

This reaction is clearly evident in the United States, where net private saving remains low. The size of the U.S. fiscal deficit—about 40 per cent of net private saving in 1981 and a similar amount in 1982 [2]—seems increasingly to be a factor contributing to longer-run inflationary expectations and high nominal and real interest rates. The concern that the deficit may not decrease substantially in the next few years is a further aggravating factor. At present, private market participants appear unconvinced that the Administration's tax reductions and other supply-side measures will lead

[2] These estimates refer only to the budget deficit. Financing of the federal "off-budget" deficit and borrowing by government-sponsored agencies account for an additional share of net private saving.