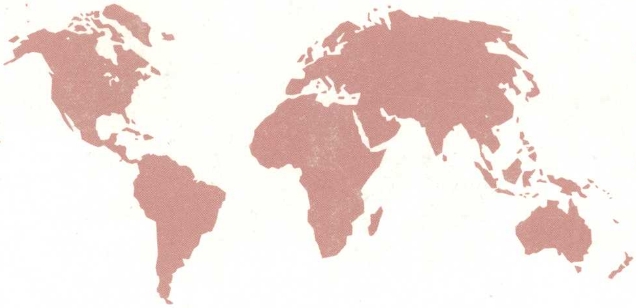

World Economic Outlook

April 1985

A Survey by the Staff of the International Monetary Fund

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 actual exchange rates of a recent period (November 1984) will prevail throughout the balance of the period to end-1986; that "present" policies of national authorities will be maintained; and that the average price of oil will remain constant in U.S. dollar terms. 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 up to and including February 22, 1985, except for some of the major industrial countries where some minor adjustments have been made to reflect information available up to March 29, 1985.

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 April 1 and April 3, 1985. The present version has benefited from comments made during those discussions by Executive Directors. 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 annually by the Fund since 1980. In 1984, a shorter, updated version of the *World Economic Outlook*, containing revised projections, was also published in the second half of the year.

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Chapter I

The World Economy to 1990: Prospects and Issues

The performance of the world economy in 1984 turned out to be considerably better than had been expected at the beginning of the year. Output grew robustly in the industrial countries, especially in the United States and Japan; inflation continued to decline; and the developing countries saw a noteworthy improvement both in their balance of payments position and in their domestic growth performance. Fears that the debt situation might deteriorate did not materialize.

All the same, many policy problems remain. Some, indeed have become more difficult for being left unattended over the past year. The imbalance in current account positions among industrial countries, for example, has intensified, and disparities in fiscal stance have continued. Unemployment in Europe has remained intractable. And living standards in developing countries, while at last rising on a weighted average basis, have a long way to go before regaining the levels of five years back.

Current Situation and Short-Term Outlook

Output and Employment

Growth of real gross national product (GNP) in industrial countries was nearly 5 percent in 1984, the best performance since 1976 (Appendix Table 1). As in 1983, the U.S. economy had the strongest gain in output, with particularly rapid growth in demand during the first half of the year. Elsewhere in the industrial world, the pace of output growth picked up in Japan, while expansion in Europe did no more than keep pace with the estimated rise in productive potential.

An encouraging feature of developments in the past year is the strengthening of investment. In the United States, business capital formation has grown even faster than might have been expected on cyclical grounds, while in the United Kingdom, Japan, and some other countries, such spending, although starting from a low base, has also shown notable increases. Less encouraging has been the persistence of a lopsided geographic pattern of demand growth, with domestic demand growing faster than output in the United States and, to a lesser extent in the United Kingdom, while most other countries received stimulus from the net foreign balance. This pattern of demand growth has helped spread the benefits of recovery, but it has been associated with a widening of current account imbalances.

For 1985 and 1986, the expansion in the industrial countries is expected to slow to about 3 percent a year, but to have a pattern that is more balanced geographically. In the United States, the continuation of cautious monetary policies, together with a lessening fiscal stimulus, is expected to hold the growth of demand well below last year's pace. However, the strength of such underlying factors as household incomes, consumer confidence, and investment intentions makes it unlikely that this moderation in demand growth would lead to any significant weakness in activity. In Japan and Europe, the strengthening of domestic demand, which was an important feature of developments in 1984, seems likely to continue in 1985 and to largely offset some slowing in export growth.

The recovery of output is gradually spreading to the developing countries. The growth of real gross domestic product (GDP) in these countries rose from 1½ percent in 1982–83, to 3¾ percent in 1984 (Appendix Table 1). While many fuel exporting countries continued to be affected by the weakness in oil demand, growth in the non-fuel exporting countries accelerated from some 2½ percent per annum in 1982–83 to 4½ percent in 1984.[1]

The improved performance in developing countries reflected the strength of exports, particularly in those countries that made progress in adjustment following the financial difficulties they had encountered in earlier years. Overall, exports grew by 8 percent in volume. Countries that rely predominantly on commercial sources for financing their current account, and which had had

[1] For a definition of the country categories used in this report, see the Introduction to the Statistical Appendix.

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the weakest performance in 1982–83, rebounded most strongly in 1984. After having declined by 0.6 percent in 1983, output in these countries grew by over 3 percent in 1984. Countries that are more reliant on official financing—often poorer countries with greater dependence on primary commodity exports—benefited less from the upturn in the world economy. Growth in sub-Saharan Africa, for example, averaged only 1.5 percent in 1984, and in the developing world at large, half of all countries had growth of 2¾ percent or less.

As to the future, a slight further acceleration in the average growth rate of developing countries is projected for both 1985 and 1986. This acceleration reflects the continued recovery in the industrial world and the beneficial effects of adjustment measures in developing countries themselves. In evaluating the rather limited increase in average growth that is projected, two considerations should be borne in mind: first, the fact that additional resources no longer have to be diverted to bring about an improvement in the balance of payments means that virtually all of the expansion in output will be available to increase domestic absorption; second, the fact that the acceleration in growth is concentrated in groups of countries with below-average rates of growth in 1984 means that the geographic basis of recovery will be widened. Thus, for the first time in several years, the economies of each major region and group of countries are projected to grow at least as fast as their populations.

The recovery in output is benefiting the employment situation, although the lack of satisfactory statistics precludes a quantitative assessment for most developing countries. In the industrial world, employment increased rapidly in the United States and Canada in 1984, and at least stopped falling in Europe. However, with continued labor force growth, unemployment rates reached record levels in several European countries, including the four largest ones. In the seven major industrial countries taken together, unemployment averaged 7.6 percent of the labor force in 1984, only 1 percentage point below the recession peak. The unemployment situation in Europe is likely to stabilize during 1985, even though some countries, including France, are expected to experience a further rise. For industrial countries as a group, joblessness is expected to stabilize at about 8¼ percent.

Unemployment in developing countries cannot be tracked by available statistics, in part because changes in employment are manifested partly in changes in the rate of rural-urban migration and in underemployment in traditional pursuits. There can be little doubt that such underemployment has increased substantially in recent years, and that the rates of output growth achieved in 1984 and projected for 1985 and 1986 will do little more than stabilize the situation.

Inflation and Interest Rates

Fears that recovery might lead to a resurgence of inflationary pressures have so far proved unfounded. For the industrial countries as a whole, the increase in the GNP deflator slowed from 4.9 percent in 1983 to 4.1 percent in 1984 (Appendix Table 7). Much of the improvement stemmed from reductions in inflation in some of the higher inflation countries, notably France and Italy. This process is expected to continue, with inflation for the group as a whole falling to below 4 percent in 1985 and to 3¾ percent in 1986.

Several factors have contributed to the improvement in inflation performance. By far the most important has been the determination of national authorities, especially in the larger countries, to re-establish a noninflationary environment. A more proximate cause has been the weakness of oil and commodity prices. At the same time, the recovery itself has contributed to a cyclical improvement in productivity that has helped restrain costs. Despite wage increases of 5–6 percent per annum, unit labor costs in manufacturing rose by only 1 percent in 1983 and were virtually unchanged in 1984. This cyclical decline in costs permitted corporate profits to recover strongly in a number of countries.

A welcome development in late 1984 and the early part of 1985 was the easing in short-term interest rates in the United States. This change reversed the rise in rates that had occurred from early in 1983 up to the middle of last year and appears to have reflected shifts in asset preferences as well as a slackening in the pace of demand growth and diminished near-term inflationary expectations. Interest rates in the other major countries (except the United Kingdom) have generally been steadier and lower in real terms than those in the United States.

Despite the downward trend in U.S. interest rates and the lower rates prevailing in other financial centers, real yields remain surprisingly high in a historical perspective. In January 1985 the average of short-term rates in the five principal financial centers, after adjustment for current inflation, was 4½ percent, while the corresponding long-term rate was over 6 percent. These yields are 3½ percentage points and 4 percentage points, respectively, above the average for 1960–80. While real interest rates are expected to fall gradually in the medium term, no decline (and even some increase) is assumed in the near-term forecast.

Inflation in developing countries (Appendix Table 7) has been reduced only to a limited extent. The median rate of inflation fell from 14.5 percent in 1980 to 10.7 percent in 1982, but progress since then has been slight. Median price increases in 1984 remained at 10 percent, considerably above the typical inflation rate among these countries in the late 1960s and early 1970s. The inflationary situation is, however, substantially more serious in several of the larger Latin American countries and in Israel, where annual rates of price increase have accelerated into triple digits. These developments are reflected in the weighted average inflation rates for the developing countries, which show a steady acceleration from about 20 percent in 1977–79 to almost 38 percent in 1984.

The policies that are being implemented in developing countries under programs of financial stabilization are expected to arrest this rise in weighted average inflation in 1985 and to bring about a significant reduction (to 22½ percent) in 1986. It needs to be remembered, however, that similar reductions have been projected by the staff in the past but have failed to materialize as a result of policy slippages in high-inflation countries.

Adjustment and Debt

The past several years have witnessed major shifts in the global pattern of current account balances: for the major oil exporting countries in the Middle East the swing from a surplus of $100 billion in 1980 to moderate deficits from 1983 onward; for other developing countries the dramatic reduction in their deficit (from $113 billion in 1981 to $38 billion in 1984); the large deterioration in the U.S. balance (from a $11 billion surplus in 1981 to a $93 billion deficit in 1984); and the partly compensating $67 billion improvement in the balances of other industrial countries over the same period (Appendix Table 29).

One encouraging feature of these developments is the strengthening in the external position of the indebted developing countries. This strengthening exceeds earlier expectations by a substantial margin and has gone a long way toward restoring a current account position that could be considered sustainable in the medium term. The degree of adjustment has, however, varied widely across countries. By far the largest adjustments, in proportionate terms, have been undertaken by the seven major borrowing countries.[2] Responding to financing constraints, the combined current account deficit of these countries fell from $40 billion in 1982 (18½ percent of their exports of goods and services) to only $1½ billion (1 percent of such earnings) in 1984. Other countries that borrow primarily from commercial creditors have also sharply adjusted their current account positions. Official financing, however, has been much better sustained in the past few years, and the current account deficits of countries relying primarily on this source of credit have changed much less.

An important factor behind the reduction in the current account deficits of indebted developing countries has been the virtual cessation of spontaneous private lending since the onset of the debt crisis in 1982. Some $130 billion of new net private funds was lent, largely spontaneously, in 1981–82, but only some $30 billion in 1983–84 (of which only $7 billion was outside the framework of restructuring arrangements). In these changed circumstances, adjustment was swift, with countries reducing their financing requirements in 1984 to amounts that, in the aggregate, were no greater than the finance available through official lending and non-debt-creating flows. In the event, developing countries were able to replenish their reserves by $22 billion in 1984.

Although the aggregate current account deficit of indebted developing countries is now unusually low in relation to exports of goods and services, little change in the deficit is foreseen for 1985 and 1986. For countries that borrow from market sources, this reflects the desire of the countries concerned and their creditors to reduce debt ratios to normal levels. Deficits of the size being projected would permit a further significant increase in reserves and require only modest borrowing from commercial bank sources.

The rapid adjustment that has been achieved by developing countries and the change in their access to private financing has brought about significant alterations in the composition and rate of growth of their external debt (Appendix Table 44). The growth of debt slowed sharply from 18 percent per annum in 1978–81 to 4½ percent in 1984. Moreover, with the resurgence of trade in 1984, ratios of debt to exports began to recede significantly from their very high levels of 1983, a trend which is projected to continue in 1985–86.

These developments do not, however, apply uniformly to all indebted countries. Countries that borrowed predominantly from official creditors did not face such a sharp curtailment of access to financing after 1982, and the shift in their current account positions has been correspondingly less. As a result, the debt-to-exports ratio of these countries continued to mount in 1983 and 1984 and is not expected to stabilize until 1986.

Debt service payments remain very high and show signs of easing only very gradually in relation to exports of goods and services, despite very large rescheduling operations. For the group of indebted developing countries as a whole, the debt service ratio in 1984 was 22½ percent, marginally higher than in the previous year. Interest rates were slightly higher, on average, than in 1983, and the relief provided by new reschedulings was largely offset by the ending of grace

[2] Argentina, Brazil, Indonesia, Korea, Mexico, the Philippines, and Venezuela.

periods on the large borrowings of a few years earlier. Little change in average debt service ratios is expected in 1985 and 1986.

Among the industrial countries, the most striking feature of the global payments situation is the large deterioration that has taken place in the U.S. current account position. This deterioration partly reflects the relative strength of the cyclical upswing in the United States in the past two years and the weakness of important export markets in Latin American and other indebted countries. However, it also owes much to the very sharp real appreciation of the U.S. dollar over the past four years. By February 1985 the dollar was over 50 percent above its level in late 1980 in real effective terms and some 10 percent higher than it had been six months previously. This prolonged appreciation reflects interest rate differentials arising from the strong demand for funds in the United States by both the Government and private sector borrowers and the attractiveness of the United States as an investment outlet for the rest of the world's savings. The continued rise of the dollar in the second half of 1984 is more difficult to explain, occurring as it did against the background of a marked narrowing in interest differentials and a further deterioration in the current account.

The counterpart to the deterioration in the U.S. balance has been an improvement in the position of every other industrial country except the United Kingdom. Japan accounts for almost half of this improvement and had a surplus in 1984 of \$36½ billion (excluding official transfers). Because of the lagged impact of past exchange rate developments, an increase in the imbalance in current account positions among industrial countries is expected for 1985–86. On the conventional assumption of unchanged nominal exchange rates (from November 1984) the current account deficit of the United States excluding official transfers is projected to reach \$117 billion in 1985, while the surplus of Japan would be about \$41 billion.

Medium-Term Prospects

To provide a background for discussion of the medium-term policy issues dealt with in the next part of this chapter, detailed scenarios for the possible course of the world economy to 1990 have been prepared. The scenario analysis involves projecting future developments on the basis of policies deemed most likely in the judgment of country specialists (the "baseline" scenario), and then analyzing the sensitivity of these developments to alternative settings of policies ("variant" scenarios).

The Baseline Scenario

The baseline scenario for industrial countries is constructed on the basis of the assumption that the U.S. Administration will achieve some success in reducing the fiscal deficit, but that not all the expenditure cuts at present under discussion will be adopted. Specifically, it is assumed that about half the cuts proposed by the Administration will be phased in during 1986–88 and will be sufficient to reduce the 1988 deficit, relative to what it would otherwise be, by just over 1 percent of GDP. Deficit reduction plans in countries other than the United States are assumed to be implemented broadly as planned, and a nonaccommodative stance of monetary policy is expected to be retained in all major industrial countries. Among developing countries, those with adjustment programs in place are assumed to implement them as planned, with some allowance for "normal" slippages. Those developing countries that do not have programs with the Fund are assumed to maintain broadly the present thrust of policies.

On the basis of these policy assumptions, an average rate of growth of slightly over 3 percent in the industrial countries is projected over the period to 1990. This results in a slight reduction in unemployment in each of the major regions of the industrial world. However, unemployment in Europe, which is considered to be at least partly attributable to structural weakness in labor markets, declines only to 9¾ percent in 1990, about 1 percentage point below the current level. Interest rates are expected to be somewhat lower by 1990, in real terms, than in early 1985, reflecting lower borrowing requirements by governments and increased confidence in medium-term price stability. It is assumed that real interest rates on short-term Eurodollar deposits would have fallen to about 3½ percent by 1990, roughly midway between the yields prevailing in 1983–84 and the average on comparable assets in the period 1960–80.

Inflation in industrial countries will of course depend on the firmness with which financial policies are pursued. There is no strong reason, however, to expect a significant acceleration from recent price trends; on the other hand, no further decline has been assumed. In commodity markets, the impact of sustained moderate growth in industrial countries is assumed to be roughly balanced by expanding supply, as producers in developing countries continue to increase output. Non-oil primary commodities prices are thus expected to rise broadly in line with prices of manufactured goods exported by industrial countries. Oil prices are a special case: it is assumed that prices will remain stable in U.S. dollar terms at their February 1985 level until the end of 1986 and thereafter will rise in line with world trade prices in general.

In appraising the implications of these trends for exchange rate and balance of payments developments, particular attention has been paid to the question of sustainability. Maintenance of the real exchange rate for the U.S. dollar at the level of November 1984 would imply an increase in the U.S. deficit on current account to the equivalent of 4½ percent of GNP by 1990. (The figure would be about 5 percent if the calculation was based on rates prevailing in January–February 1985.) Furthermore, the implications that a deficit of this size would have for interest payments abroad would make increases in the deficit self-perpetuating.

While this situation is, in the staff's judgment, unsustainable, it is much more difficult to say when, how, and by how much present trends will change. For convenience, it is assumed in the baseline scenario that the U.S. dollar will depreciate by 5 percent a year, in real terms, from 1987 onward against all other industrial country currencies, except the Canadian dollar. Since this is a rather arbitrary assumption, undue significance should not be attached to it. It implies that the underlying current account of the United States would remain in substantial deficit (of about 3 percent of GNP) in 1990. Continued improvement in the U.S. current account position after 1990 would thus be required.

These baseline developments in industrial countries form the background against which external adjustment and domestic growth prospects in developing countries can be assessed. The assumed rate of growth in industrial countries should lead to a rate of increase of developing country exports of 5–6 percent in real terms. The import capacity of developing countries will be further affected by changes in terms of trade (not expected to be significant) and by the availability of financing. Only a modest acceleration is expected in the use of private bank credit to finance developing countries' current deficits over the period to 1990. This reflects an expectation of continued caution on the part of creditors and the desire on the part of borrowers to reduce their vulnerability to future debt difficulties by scaling back their debt-export ratios.

Nevertheless, trade-related credit from both banks and nonbanks is expected to grow sufficiently to enable developing countries to increase their imports at a rate somewhat higher than the growth of their exports, permitting growth in GDP averaging about 4¾ percent per annum. This average growth rate conceals significant differences among groups of countries, however. Asian countries tend to benefit most from export growth and achieve average growth rates of GDP close to 6 percent. At the other extreme, the smaller low-income countries, dependent for the most part on primary commodity exports and slow-growing official financing, are projected to have GDP growth below the average.

Current account deficits, expressed as a ratio to exports of goods and services, are expected to remain at much the same level as in 1984. This would permit a fairly significant reduction in the ratio of external debt to exports. For all indebted developing countries taken together, the debt ratio would decline from 158 percent in 1983 to 108 percent in 1990. The decline is even more dramatic for those countries whose debt ratios had risen most before and during the debt crisis. The projected reduction in debt ratios for the seven largest borrowers, for example, is from 255 percent in 1983 to 150 percent in 1990. Countries dependent on official sources of finance, by contrast, are expected actually to experience an increase in average debt ratios, from 245 percent in 1983 to 260 percent in 1990.

For those countries that are likely to have a sizable reduction in their debt ratio, and whose economic growth over the 1980s is expected to be considerably less than in the past, the question arises whether they might not be led to relax their adjustment efforts. At least four considerations are relevant in this context. First, although the aggregate debt ratio would decline substantially from the 1983 peak, it would still be little different from the level prevailing in 1980 and would be considerably higher than the corresponding figure for 1974. Second, the debt service ratios would fall relatively less than the ratio of debt to exports, since debt service payments have been kept down in recent years by rescheduling arrangements. By 1990, the average debt service ratio of indebted developing countries in the baseline scenario is still over 20 percent—well above the ratio prevailing throughout the 1970s, when real interest rates were lower and principal repayments had not had time to build up. Third, some part of the projected decline in debt and debt service ratios is attributable to the assumed depreciation in the exchange rate for the U.S. dollar, which tends to increase the dollar value of exports by more than debt. There can be no guarantee that the exchange rate pattern assumed by the staff will actually materialize. Last, the events of the past several years have led both debtors and creditors to reappraise the sustainable equilibrium level for external debt. While such an equilibrium level is hard to quantify with any precision, it is clearly lower than the levels actually prevailing over the last few years.

Consequences of Alternative Policies

An obvious, but nevertheless important, conclusion to be drawn from the analysis of alternative scenarios is that the policies pursued by member countries can make a considerable difference to economic outcomes. This is especially important in the case of the industrial countries, since economic outcomes in the industrial world constitute the external environment within which developing countries' efforts to resume sustainable growth must take place.

As far as the industrial countries are concerned,[3] the medium-term outlook is significantly affected by the extent to which reductions in fiscal deficits are implemented. If significant slippage were to occur from the budgetary strengthening that is assumed in the baseline scenario and if such slippage were accompanied by less success in structural policies, there would be a notable worsening of economic prospects. Interest rates would be likely to rise in the short term, increasing the likelihood that an unforeseen check to demand growth would be converted into a recession. The continued buildup in both the budget deficit and the external current account deficit of the United States would give rise to additional uncertainties about the sustainability of the current exchange rate pattern. Quite apart from these enhanced risks of instability, the phenomenon of "crowding out" would reduce potential growth. Under this "worse policies" scenario, the staff would therefore expect that interest rates in industrial countries would be significantly higher than in the baseline scenario and that output growth would average only about 2 percent per annum over 1987–90 (against just over 3 percent per annum in the baseline scenario). Other consequences of worse policies in the industrial countries include a sharp, rather than a gradual, decline in the U.S. dollar, a sharp recession, and a further rise in unemployment in European countries.

Better policies are defined as a more substantial attack on the fiscal deficit in the United States (in which cuts equal in magnitude to the Administration's current request are made) and a more effective approach to structural problems in European countries. Such policies yield somewhat lower interest rates and stronger growth in private investment. It is estimated that output growth in such a scenario could reach 3½ percent in the industrial countries as a group. The outcome for exchange rates is not expected to be greatly different from that of the baseline scenario, though it is considered that the risks of volatility would be diminished.

Developing countries are affected by developments in industrial countries, as well as by the policies they themselves pursue. Given the variety of situations faced by countries in the developing world, detailed discussion of the outcomes of alternative scenarios is not feasible within the limited scope of this report. However, a few major conclusions of particular significance warrant emphasis.

First, alternative policies make a substantial difference to economic outcomes in developing countries. Better policies in industrial countries could result in an improvement in the international environment that would add more than 1½ percentage points per annum to the rate of growth attained by developing countries. Even in the absence of such policies in industrial countries, better policies in developing countries could add almost 1 percent to growth performance.

Second, risks in the downward direction are judged more significant than risks in an upward direction. Because the "most likely" policies assumed in the baseline scenario are already fairly good for most countries, the scope for slippage is greater than the scope for improvement. In particular, if "worse" industrial country policies led to the kind of outcome described above, developing country growth could be cut by some 2½ percentage points.

Third, outcomes are likely to vary most in respect of economic growth and relatively little in terms of current account developments. This is because of the primary importance of availability of financing in determining current account trends. In fact, current account deficits are rather larger under "better policies" than under "worse policies," precisely because of the reactions of external creditors to the policy stance in borrowing countries.

Fourth, economic developments in the major borrowers are relatively more sensitive to policies in industrial countries, while developments in those countries that rely on official financing are more responsive to changes in their own policies. It is estimated that better policies in the industrial countries could add as much as 1¾ percentage points per annum to the growth rate of the major borrowers, while worse policies could cut growth by over 3 percentage points. Such a cut would, of course, call into question the maintenance of the social consensus these countries require to implement domestic adjustment strategies and would adversely affect the stability of the international monetary system.

Fifth, the position of the smaller low-income countries, particularly those in sub-Saharan Africa, remains precarious. Economic growth in Africa is below the average of developing countries in all the scenario variants, despite the high rate of population growth in this region. "Worse policies," whether in the industrial or in the developing countries, lead to an outcome in which little or no growth in per capita incomes in Africa would be achieved.

[3] See Chapter III for a detailed discussion of the implications of alternative policy scenarios for both the industrial and the developing countries.

Policy Issues in Industrial Countries

For some time now, most of the major industrial countries have had a medium-term strategy for combating inflation and restoring sustainable growth. Key elements of this strategy have been the restoration of financial stability and an improvement in incentives and market efficiency. Implementation of the strategy has been recognized to require a gradual reduction in monetary expansion and firm restraint over the growth of government expenditure.

These policies have had a number of notable successes. Inflation has been brought down more rapidly than expected and has remained down even when economic recovery got under way. Growth has resumed, albeit at a fairly modest rate outside the United States and Japan. And private investment appears to be responding in some countries to better incentives and an improved climate of stability.

Nevertheless, these successes have been accompanied by a number of important failures. Unemployment in European countries remains far above levels that could be regarded as acceptable and is more than twice the rate prevailing five years ago. The large deficit in the U.S. federal budget and the growing imbalance in external payments positions raise questions about the future stability of the recovery that is now under way. A further source of uncertainty is to be found in the high and variable real rates of interest that have persisted since 1980–81.

These problems pose a number of issues for the industrial countries as they approach the task of framing economic policies for the remainder of the decade of the 1980s. A first question is whether recent shortcomings in economic performance reflect deficiencies in the economic strategy that has been espoused, or whether they can be attributed to failures in the way the strategy has been implemented. A key issue in this regard is whether demand management policies should be used more actively to stimulate economic activity in countries where recovery has been delayed.

A second set of questions concerns the structural functioning of the industrial economies, and is given added importance by the continuation of high unemployment levels in Europe. To the extent that employment and structural change are impeded by rigidities and distortions, how may government policy best approach the task of counteracting these rigidities? This general problem covers a variety of particular issues, but a more basic one is whether the focus of government efforts requires direct involvement in the process of structural change (for instance, through industrial policy), or rather policies to ensure that incentives to private initiative are adequate and operating effectively.

A third set of issues concerns the interaction of economic policies among countries. Despite a welcome convergence of inflation rates, policy stances in industrial countries have differed in certain important respects over the past several years. In such circumstances, can the mechanism of exchange rate flexibility be relied on to remove sources of tension and permit the reconciliation of individual national objectives? A particular question in this regard is whether the pattern of exchange rates and current account balances that has resulted from the current configuration of policies among the major countries is sustainable or whether it threatens difficulties that need to be addressed, both at the level of national policies and at the level of multilateral surveillance.

Fiscal and Monetary Policies in the Medium Term

Four key features of the industrial countries' economic policy strategy, at least in its design, have been (1) a gradual decline in target growth rates for monetary aggregates, consistent with bringing inflation down and keeping it down; (2) firm restraint over the aggregate level of government expenditure, in order to reduce the relative role of the public sector in the economy at large; (3) a sustained strengthening in governments' fiscal positions, in order to leave a greater share of available saving to the private sector; and (4) the avoidance of cyclical "fine-tuning" of demand management, to encourage a climate of greater certainty about the constancy of government policy.

If the first two of these features of the strategy still command widespread assent, the latter two have come in for more questioning. Specifically, it is pointed out that economic recovery has been strongest in the United States, where fiscal stimulus has been most marked. Those countries where the fiscal stance has been most restrained have, by contrast, experienced only modest recovery in domestic demand. Therefore, runs the argument, why not change the emphasis of fiscal policy in countries outside the United States?

Superficially plausible as this argument is, it overlooks a number of complexities in the situation. First, it is not the case that the whole of the difference between output growth in the United States and European countries can be attributed to conventional budgetary stimulus. In the United States, expansion has owed much to declines in inflation and in interest rates, as well as to improvements in fiscal incentives and in the flexibility with which U.S. markets have functioned. In Europe, by contrast, recovery has been retarded by structural factors, including high wage

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