PRESENTATION OF THE THIRTY-THIRD ANNUAL REPORT [1]

BY THE CHAIRMAN OF THE EXECUTIVE BOARD AND MANAGING DIRECTOR OF THE INTERNATIONAL MONETARY FUND

J. de Larosière

I join you, Mr. Chairman, in expressing sincere thanks to the Governor for the United States for his cordial welcome to our deliberations and for his kind personal words to me. I am delighted to hear that the President will be addressing us this afternoon. I wish also to extend a welcome to the Governors for Maldives, Suriname, and the Solomon Islands, which have become members since last we met. In addition, I would like to express my satisfaction with the fact that an Executive Director from Saudi Arabia—a member which has contributed substantially to Fund financing—will shortly join the Executive Board of the Fund.

I am greatly honored, Mr. Chairman, to have been entrusted with the position of Managing Director at a time when the work of the Fund is of great world importance. I count on support from the Governors and the Executive Directors in meeting my tasks. I count also on the efficiency, dedication, and superb quality of the staff of the Fund—attributes with which I have been deeply impressed since assuming office.

My remarks will be organized in three parts. First, I shall draw attention to some problems of the world economy. I shall then present my views on the economic tasks that confront us, and conclude with some observations on the role of the Fund.

I. *Some Problems of the World Economy*

Since our meeting a year ago, there have been some encouraging economic developments. A number of member countries in various parts of the world have achieved better growth and price performances or moved toward adjustment of the external position, often as a result of earlier stabilization efforts. Substantial progress has been made in overcoming the serious disturbances that struck the world economy dur-

[1] September 25, 1978.

©International Monetary Fund. Not for Redistribution

ing the years 1973–75. But despite these positive aspects of the record, I am sure that the Fund's Annual Report was right to characterize the past year as one in which developments in the world economy were again unsatisfactory in at least three important respects.

Inflation is still a problem in the great majority of countries. In the industrial world, the annual rate of price increase in the first half of 1978 was down to 1 per cent in Switzerland and 2–3 per cent in Japan and the Federal Republic of Germany. It accelerated, however, to almost 8 per cent in the United States and ranged upward to 13 per cent in Italy. In most of the industrial countries, the current rate of price increase is still much too high to be considered acceptable. The persistence of inflation generates fears and uncertainties that confuse economic decisions and hamper all aspects of policymaking.

Outside the industrial world, the inflation picture is also, on the whole, unsatisfactory. With some welcome exceptions, as in a number of Asian countries, the rates of price increase incurred by the nonindustrial countries in 1977 were about as high as in 1974. These were far above the rates that prevailed before the worldwide inflationary upsurge of a few years ago. Such high rates of inflation constitute a serious obstacle to the efficient use of savings on which more rapid economic development is crucially dependent.

In addition to inflation, a principal source of current difficulties in the world economy has been the *slow pace of recovery* from the severe international recession of 1974–75. Primarily because of this, many countries throughout the world suffer from a substantial underutilization of economic resources, including high levels of unemployment. This distressing situation prevails widely among industrial countries, with the notable exception of the United States. One of its particularly serious effects has been to depress the level of private investment. Moreover, the subdued pace of economic recovery has caused the volume of world trade to rise at a rate of only 4–5 per cent a year in the recent period. This contrasts with the average annual rate of 9 per cent that prevailed over the 1960s and early 1970s. In this unsatisfactory environment, protectionist trade practices have been spreading—a development that I find to be one of the most disturbing on the world economic scene.

Another problem of the world economy concerns the *international adjustment process*, which has not been working satisfactorily. Mainly as a result of divergent rates of growth of domestic demand among the industrial countries, balances of payments on current account have become badly out of line. Especially important and troublesome is the contrast between the deficit of the United States and the surpluses of the Federal Republic of Germany, Japan, and Switzerland. Taken

©International Monetary Fund. Not for Redistribution

together, the surpluses of the latter three countries in 1978 will substantially exceed the combined surplus of the major oil exporting countries. Now estimated at $18 billion, the oil exporters' surplus has declined by some $50 billion since 1974, when it was the major source of concern with respect to the international adjustment process.

Because of the maldistribution of current account balances among the industrial countries, and also because of concern over the policies that have led to it, foreign exchange markets for major currencies have been quite unstable during several prolonged periods in the past year. This instability—through effects on prices, confidence, and investment—has doubtless exacerbated the various economic problems confronting national authorities.

II. *The Task Before Us*

Mr. Chairman, I have called attention to a number of problems that are impairing the performance of the world economy. Taken together, they constitute a very difficult and potentially dangerous situation.

How can we tackle these economic problems? I believe that the solutions to them are closely interrelated. Undoubtedly, there is need for greater emphasis on policies to stimulate economic growth, but this need must be seen in relation to the fight against inflation. In addition, policies to stimulate growth of the world economy must be compatible with the equally pressing need to achieve a better equilibrium in international payments.

In order to promote these broad objectives simultaneously, countries should contribute to world economic growth in relation to the strength of the balance of payments and to price performance. This proposition is of particular relevance at the present time, when the diversity of economic conditions among countries is unusually great.

The problems facing the world economy are both severe and complex. It would be naive to suppose that they could be overcome in a short period. This consideration makes it all the more urgent to take steps to alleviate the problems. In the main, we need to achieve

—more convergence in growth rates around a higher average level,

—more success in the fight against inflation,

—more stability in exchange markets, and

—a strengthening of the economies of the developing countries.

Improvement and Convergence in Growth Rates

Since the divergence in rates of economic growth is one of the main causes of the present external imbalances, it is essential to achieve more coordination in this field. This is increasingly understood, and the

©International Monetary Fund. Not for Redistribution

growth rates of the major countries constituted a central topic at the July Bonn Conference.

In our recent discussions in the Fund on the world economic situation and outlook, we have paid particular attention to a medium-term strategy of coordinated growth and balance of payments adjustment for the industrial countries. Our calculations show that the very marked changes in exchange rates that have taken place over the past year and a half could yield large volume effects by 1980. These would lead to a substantial improvement in the pattern of current account balances among the industrial countries. But this finding is subject to an essential condition, namely, that adequate internal measures are taken to offset the effects of the exchange rate changes on output. It is crucial that surplus countries take the measures necessary to counteract the deflationary effects of their exchange rate appreciations. Without such measures, the effects on current account balances expected to result from these appreciations could be partly or wholly dissipated. Similarly, it is fundamental that countries incurring exchange rate depreciations, such as the United States, be ready to counteract the resulting expansionary effects.

It must be realized that the domestic effects of exchange rate changes will make it more difficult to bring about a pattern of growth rates conducive to substantial improvement in current account balances over the next few years. Still, let me stress that a pattern of growth rates differing significantly from the one we have seen in recent years is needed to make a sizable contribution to the desired evolution of current account balances. Without such an adaptation of growth rates, excessive weight would be placed on further changes in exchange rates to bring about adjustment.

Let me be a little more specific. In the case of the United States, a growth rate well below that of 4½–5 per cent experienced in recent years is clearly suitable in light of the prospects for domestic prices and the current high level of resource utilization. Moreover, it would also have the effect of constraining the size of the U.S. current account deficit. On the other hand, I believe that most industrial countries other than the United States—and especially the major surplus countries—should aim for growth rates in 1979–80 significantly higher than the actual rates for 1977 and those now seen for 1978. The pace of economic expansion in the surplus countries has not been commensurate with the strength of their economic positions. The international adjustment process has therefore functioned in an asymmetrical fashion. These countries will have to accept a lasting shift from external to domestic demand and to adopt appropriate policies—especially in the fiscal area—for the achievement of higher growth rates.

©International Monetary Fund. Not for Redistribution

More Success in the Fight Against Inflation

But to advocate a "scenario" of convergent growth rates would be a vain exercise if it consisted only of advice for expansionary measures by the countries in relatively strong positions. Lasting success can only be achieved if it is also based on strong and persistent action by the "weaker" countries to bring down their rates of inflation.

Countries with relatively high inflation rates usually have weak or vulnerable external positions. In such deficit countries, whether developed or developing, recovery of economic activity cannot be achieved merely by expanding domestic demand. The fundamental weaknesses of their economies need to be tackled first. Demand expansion in such circumstances leads rapidly to still greater inflation and to further balance of payments difficulties. It therefore makes the ultimate task of adjustment all the more difficult and painful. Instead, in order to lay the basis for sustained future growth, it is essential that deficit countries undertake corrective actions of a fundamental nature. Depending on individual situations, such actions may need to include reduction in the growth of government expenditures, moderation of rates of increase in wages and other incomes, restoration of incentives to invest, measures in the field of energy, and a turning away from devices that undermine economic efficiency, such as subsidies, artificial prices, and import restrictions. A program of corrective actions along these lines is likely to bring about a sharp improvement in a country's situation over the medium term, provided that the country has the determination to stay with the program through a difficult initial period. In this context, the Fund stands ready to provide financing needed to carry the member through this period, if it is satisfied that the member's program constitutes a constructive answer to its problems. The function of the Fund's conditionality is basically a simple, and also an indispensable, one: to make sure that the member's program meets this test.

In present circumstances, a strategy of encouraging noninflationary growth in the industrial countries would clearly require adaptations in fiscal and monetary policies. It might also require more emphasis on incomes policy, to try to affect some of the special causes of upward pressures on prices. Obviously, the broad range of approaches encompassed by the term incomes policy must be geared in each country to its own institutions, traditions, and other aspects of the social and political setting. But attempts by countries to do whatever they can in this difficult field are especially relevant because of the predominance of cost-push factors in the current inflation.

©International Monetary Fund. Not for Redistribution

More Stability in Exchange Markets

In recent discussions in the Executive Board of the Fund on the subject of exchange rates, many members have stressed the disadvantages of too great a variability in exchange rate movements. They have indicated their concern about the unsettling effects of such movements: in deficit countries, they stir up inflation through import prices; in all countries, they can discourage investment. The developing countries are particularly concerned about the implications of these phenomena on world trade, and on their problems of exchange rate management. The deep interest that has recently been expressed in the European Community in measures that could bring about greater stability of exchange rates is a manifestation of similar concerns.

It is well understood—and the Fund's new Article IV makes this understanding explicit—that greater exchange market stability has to be based primarily on the correction of imbalances in the domestic economy, and that monetary arrangements and intervention can play a useful role only if the more fundamental policies are appropriate. In this regard, it is worth noting that the surveillance principles of the Fund not only permit intervention in the exchange markets, but also obligate members to intervene in order to counter disorderly conditions. But decisions on the appropriate scale of intervention raise difficult issues of judgment. Given the overwhelming size of balances free to move, there is a danger of stimulating such movements, rather than containing them, if intervention is interpreted as reluctance to face the problems posed by underlying conditions. This is an added reason for placing emphasis on measures that will give confidence that basic factors—particularly inflation control in the United States and domestic demand expansion in the Federal Republic of Germany and Japan—are being addressed. With such confidence, only limited and occasional intervention might suffice to smooth the market satisfactorily. Without such confidence, even huge amounts of intervention would do little good. Intervention serves its purpose best in an environment of sound domestic policies in the countries concerned.

Strengthening of the Economies of the Developing Countries

Before concluding my remarks on economic conditions and policies, I should like to express particular concern for the position of the non-oil developing countries in today's troubled world economy. Within this large and heterogeneous group, many countries are encountering various difficulties. These include the inadequacy or lack of real gains in the prevailing low levels of per capita income, external financing problems and burdensome debt positions, the adverse impact on export earnings due to protectionist measures abroad, and problems of exchange rate

©International Monetary Fund. Not for Redistribution

management arising from the divergent, and sometimes rapid, movements of exchange rates for major currencies.

A number of the non-oil developing countries adjusted their economic policies to cope with the shocks to which the world economy was subjected in the period 1973–75. For others, the task of adjustment is now in process or still to be undertaken. In either case, the unsatisfactory external environment is a serious impediment to economic growth and development.

The industrial countries could make a major contribution to the economic well-being of the non-oil developing countries by undertaking the sort of coordinated strategy for growth and balance of payments adjustment that I touched on a few minutes ago. Beyond this, measures to improve market access for the exports of developing countries and to expand the flow of development assistance are clearly indicated, and their importance cannot be overstressed.

As long as the developing countries face enormous investment needs, and hence structural deficits on current account, their domestic economies are particularly vulnerable, and every effort should be made to minimize the impact of adjustment on their growth. Expanded flows of capital and aid to these countries are essential for their development, and also for the proper functioning of the whole international monetary system.

III. *The Role of the International Monetary Fund*

Mr. Chairman, in a world economy with such problems and imbalances, and marked by wide diversity of conditions among countries, the International Monetary Fund can play a very important role. I am determined to do all that I can to see that the Fund plays its role effectively for the benefit of all member countries.

The Second Amendment of the Articles provides a solid foundation on which to build the future work of the Fund. For one thing, this amendment establishes a framework within which principles and procedures can be devised to deal with international monetary problems. It is important that Article IV of the amended Articles has made it possible to address ourselves to the basic aspects of members' economic policies and to bring into force principles and procedures for firm surveillance over exchange rate policies. The apparatus for surveillance has been put in place; it is up to us to see that it is used sufficiently and well.

I believe that my remarks have shown that, despite the efforts being made to achieve greater stability at the national level, there is still a significant difference between the objectives of the amended Articles and the actual state of the world economy. One aspect of this situation has been the continued presence of large payments imbalances.

©International Monetary Fund. Not for Redistribution

It is important that the Fund should be in a position to play an active role in dealing with these imbalances, since financing by the Fund contributes to the process of international adjustment. For the Fund to be able to provide such financing on an adequate scale, and without undue recourse to borrowing, a substantial increase in Fund quotas is necessary. Indeed, such an increase is in my opinion overdue.

I am, therefore, pleased that the Interim Committee concluded yesterday in favor of a general increase in quotas of 50 per cent, which would raise the total of quotas to SDR 58.6 billion. This conclusion is of paramount importance in assuring the Fund of an appropriate capital base for the medium term. For the overwhelming majority of individual members, the increases would also be 50 per cent of their present quotas. On this occasion, special increases would be limited to a modest aggregate amount distributed among 11 developing member countries. The details of this proposal will be worked out by the Executive Board by November 1, and this should permit the Board of Governors to take its decision before the end of 1978.

I am also encouraged by the prospect that the supplementary financing facility, on which agreement was reached in the Fund over a year ago, will become effective in the near future, thus enabling the Fund to meet the immediate needs of its members. I consider this facility to be very important in the present unsettled situation of the world economy. The facility will permit the Fund—using a combination of its own resources and borrowed funds—to help members that are facing particularly large problems of adjustment in a way that only the Fund can do. This is by providing finance on a substantial scale on the basis of a program of adjustment worked out in collaboration with the Fund.

Since the First Amendment of its Articles in 1969, the Fund not only has had the task of providing conditional liquidity to its members, but also has had to play a role in the provision of reserves to its members, through the allocation of SDRs to meet a long-term global need, as and when it arises. Allocations of SDRs were made, for a total of about SDR 9.3 billion, in the three years 1970–72. No further allocations have been made since then. First, there was widespread dissatisfaction with the huge reserve increases that characterized the final years of the fixed rate system, and then came the urgent task of meeting specific financing needs that arose from a number of disturbances in international payments.

Over the last year or so, the Executive Board has given renewed attention to the question of allocations of SDRs. One has to note in this connection the important changes that have taken place in world financial markets over the past decade. With greater exchange rate flexibility, it could perhaps be expected that countries could do with much smaller reserves. Experience continues to show, however, that countries want to

©International Monetary Fund. Not for Redistribution

increase their reserves as the level of their international transactions rises. It is true that most countries can satisfy their need for reserves, in the form of reserve currencies, when international capital markets are as free, and as well supplied with funds, as they are today. But it would be difficult to argue that this is the best way for the needed reserve increases to take place. Countries that add to their gross reserves while their international debt increases are faced with the need for periodic refinancing—a difficulty that does not arise when additions to net reserves are made through SDR allocations. Moreover, to continue to place reliance on the accumulation of reserve currencies (overwhelmingly, U.S. dollars) for needed reserve increases would mean to relegate the SDR to an ever-decreasing share in international reserves. That would hardly be compatible with the objective of the amended Articles of making the SDR the principal reserve asset in the international monetary system and making further progress toward longer-term reform of the system.

These were the main considerations behind the conclusion that the resumption of SDR allocations is both appropriate and necessary. In the inflationary world of today, possible effects on expectations also need to be taken into account, and any allocation of SDRs at this time should, therefore, be relatively modest. In the light of these various considerations, the Interim Committee pronounced itself in favor of an annual allocation of SDR 4 billion for the next three years, 1979 to 1981. Further, it was agreed that various steps would be taken to improve the quality of the SDR as an international reserve asset.

Many members see a strong interconnection between the two sets of measures relating to international liquidity: quota increases and SDR allocations. I would expect, therefore, that after all the necessary details have been worked out, the decision by the Board of Governors on SDR allocations will be taken at the same time as that on quotas, toward the end of this year.

Mr. Chairman, in this, my first address to the Board of Governors, I have touched on a wide range of topics. Let me conclude by saying that I see the role of the Fund, which has been reinforced by the agreements reached yesterday in the Interim Committee, as a very broad and active one. It ranges from the provision of a worldwide forum on economic and financial matters to the provision of financial, consultative, and technical services to individual countries. In the exercise of all its functions, such as those involving the principles of conditionality or of surveillance, the Fund must act fairly and evenhandedly. It will continue to earn the respect and support of its members only if it exercises a strong moral authority. I shall make every effort to ensure that the Fund will meet this challenge.

©International Monetary Fund. Not for Redistribution