CANADA

16 February

Mr. N.L. Wicks, CBE,
Principal Private Secretary
to the Prime Minister,
Prime Minister's Office.

Nigel

Look forward to seeing you at dinner on the 23rd, when we could discuss attached.

Jim

L. James Taylor

With the Compliments
of the
Minister (Commercial/Economic)

de la part du
ministre (affaires commerciale/économiques)

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et représentante personnelle du
Premier ministre
pour le sommet économique

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February 15, 1988

Dear Colleague:

I am forwarding to you the Issues for Discussion Paper for our second meeting at the end of the month.

I hope that at our meeting we will be able to concentrate on the questions and reach as far as possible a common approach to the issues they raise.

I look forward to seeing you in the Laurentians.

Yours sincerely,

Sylvia Ostry

Sylvia Ostry

125 promenade Sussex Drive
Ottawa, K1A 0G2

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February 15, 1988

ISSUES FOR DISCUSSION PAPER
SECOND SHERPA MEETING

I INTRODUCTION: Commitment, Credibility, Confidence

Since the Venice Summit, the world economy has been rendered vulnerable to turbulence in financial markets which could lead to a slowdown in growth. Concern centres on the sustainability of current account positions and the external debt problems of the developing countries. To minimize the risk of a downturn in world economic activity and defuse tension in the international trade and payments systems, governments must demonstrate commitment to the goals of sustainable economic performance and external positions. Government policies must be seen as credible in addressing those goals. Commitment and credibility will restore market confidence.

II DEVELOPMENTS SINCE VENICE SUMMIT

Economic activity in the Summit countries was stronger in 1987 than expected at the time of the Venice Summit, but unemployment rates declined only in North America and the United Kingdom. Inflation, which troughed in 1986 (or early 1987), remains moderate. The differential between real total domestic demand growth in the United States and the other countries as a group turned significantly negative in 1987, mostly on account of weaker US domestic demand growth. Real net exports made a positive contribution to output growth in the United States -- the first year since 1980 -- but a negative contribution in all other Summit countries except the United Kingdom. Really?

In volume terms, trade flows adjusted considerably toward more sustainable positions, although in nominal terms the imbalances of the three major economies remained persistently large. The further realignment of exchange rates in 1987 will contribute to the ongoing international adjustment process. (The recent economic performance of the Summit countries and the latest OECD and IMF projections are summarized in the appended tables.)

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On the basis of unchanged policies and exchange rates (as of the end of 1987), no further large disturbances in financial markets, and stable terms of trade, the medium term outlook is one of moderate, but lower growth in the major industrial countries, a modest increase in inflation, and continuing large external imbalances among the three largest industrial economies. There is a high degree of uncertainty about the outlook, however, and the risks are on the downside.

The fiscal stance of the Summit countries as a group, as measured by changes in general government structural balances, moved toward restriction in 1987 and is projected to move further toward restriction in 1988 and 1989. Fiscal consolidation was particularly marked in the United States, though the federal deficit remains high in absolute terms. In Japan and Germany fiscal policy was moderately expansionary. The fiscal stance of the United States and Japan is expected to be approximately neutral in 1988 before once again turning restrictive in 1989. Fiscal policy in Germany is projected to remain mildly expansionary in 1988 and approximately neutral in 1989.

Really

In the wake of the October stock-market decline interest rates fell in all major industrial countries, albeit unevenly, as central banks injected liquidity to support the financial system. US interest rates declined more than German and Japanese rates, leading to downward pressure on the dollar. In turn, the upward pressure on the Deutschmark created tensions within the EMS which were defused by reductions in German interest rates. Since October 1987, a number of coordinated interest rate reductions in Europe have largely reversed the increases earlier in the year. From about mid-November, short-term interest rates in the United States, Canada, and Japan have edged upwards as central banks withdrew much of the liquidity injected previously. Over the past year, interest rate developments, especially in the major surplus countries, have also been affected by the "trade-off" between exchange rate stabilization and domestic monetary objectives. This potential conflict remains.

Good Point

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Economic activity in the developing countries in 1987 was weaker than expected at the time of the Venice Summit. Moreover, the outlook for the next year has deteriorated. On a regional basis there are wide divergences, however. The Asian economies are continuing to grow strongly, whereas the Latin American economies have weakened considerably. Growth in Africa is weak.

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The debt situation remains a matter of serious concern in many developing countries. Even barring unfavourable developments such as a further terms-of-trade deterioration or world interest rate increases, debt-export ratios are expected to show only modest reductions.

III MACROECONOMIC POLICIES AND EXCHANGE RATES

Two crucial factors impinging on the outlook are investor and consumer confidence, and the willingness of markets to continue financing the fiscal and current account deficits at prevailing interest rates and exchange rates. A further shock in equity markets could undermine confidence, thereby reducing business and consumer spending and making a recession more likely. As well, a strongly increasing reluctance by investors to absorb dollar-denominated assets would tend to raise US interest rates and dampen economic activity in the United States and abroad. Though these potential developments cloud the economic outlook, they should be considered in light of the progress that has been made in reducing underlying international imbalances. In particular, the favourable effects of past policy actions and exchange rate changes have begun to materialize, as witnessed, for instance, by the considerable adjustment of trade volumes over the past year. Nor should it be overlooked that in recent weeks a substantial degree of calmness has been restored to foreign exchange and equity markets. The challenge is to manage the transition to a more sustainable, that is, less vulnerable, position so as to reduce the downside risks.

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> **The main issue is the adoption of macroeconomic policies that will facilitate the smooth adjustment of international current account imbalances while maintaining growth and avoiding a resurgence of excessive inflationary pressures.**

On the basis of projections by the IMF and the OECD of the US current account balance over the next couple of years, the United States at the end of 1989 will have an external debt of about $700 billion, for which annual servicing payment will be in the range of $30 to $40 billion. Under current exchange rates and policy settings, many observers project large US current account deficits for some years to come, resulting in a rapid cumulation of US external debt. For instance, the latest IMF World Economic Outlook implies a US current account

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Is it now. C.B interventions?

deficit of about $130-140 billion in 1992. Of concern is whether the projected rate of debt accumulation is sustainable, i.e., whether the current account deficits would be financed by private capital flows at prevailing interest rates and exchange rates. Official flows are not a viable long-run alternative.

Concerns by market participants about the implications of rapid accumulation of US net external debt for future exchange rates, inflation and growth, could result in a drying-up of foreign lending and, consequently, strong downward pressure on the dollar and upward pressure on US interest rates. Furthermore, there is the risk that these pressures could erupt in a sudden loss of investor confidence with ensuing turmoil in financial markets.

At some point the US trade deficit will have to shrink significantly, as will, correspondingly, the trade surpluses of other countries. What is of concern is the manner and the speed with which these changes will come about and the economies' ability to shift resources across sectors smoothly. Specifically, what will be the roles of relative prices, expenditures, and structural flexibility in bringing about the adjustment? Before turning to the issues raised by these factors, one point needs to be underlined. Evidence from a range of multicountry models[1] indicates that the rise in the US current account deficit can be broadly explained by differences in policy stance between the United States and the other major industrial countries. The deficit took several years to accumulate and will likely take several years to reverse.

1 This evidence is from the Brookings Institution conference of March 1986 and workshop of January 1987, as well as other research. Some of this evidence may be found in R. Bryant, G. Holtham, and P. Hooper, eds., *External Deficits and the Dollar: The Pit and the Pendulum*, Washington, D.C., Brookings Inst. 1987, and R. Bryant, D. Henderson, G. Holtham, P. Hooper, and S. Symansky, eds., *Empirical Macroeconomics for Interdependent Economies*, forthcoming.

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That the narrowing of international imbalances will be a slow process enhances the importance of cooperation amongst countries to ensure the adoption of policies which foster that process. The alternatives, including the prospect of an even longer period of adjustment and uncertainty, would be a disturbing signal to markets.

The Role of Expenditures and Exchange Rates in the Adjustment of International Imbalances

Expenditures

In the past five years the cumulative growth of real total domestic demand in the United States has exceeded considerably that of other industrial countries. The respective rates for the Summit countries are: United States, 25 1/2 percent; Canada, 23 3/4; Japan, 19 percent; and the four major European countries, 14 percent. This cumulative differential in domestic spending accounts for a considerable portion of the US current account deficit. Reduction of the external imbalances would require a reversal of this differential in domestic spending. US fiscal policy would have to be tightened to permit the transfer of resources from domestic absorption to net exports, whereas domestic demand in the other industrial countries (especially the external surplus countries) would have to grow more rapidly. This process is now underway and is projected to continue over the next couple of years, but, in view of the slow adjustment of external imbalances, the question remains as to whether further policy actions are necessary.

Exchange Rates

The other major proximate cause of the external imbalances of the three major economies was the large real appreciation of the US dollar between 1981 and March 1985 which eroded US international competitiveness. However, notwithstanding the sharp depreciation of the US dollar against other major currencies since March 1985, which has restored US competitiveness to 1979-1980 levels, the US current account deficit has continued to grow.

These persistently large external imbalances mask two important developments, however. First, US export volumes have risen sharply in the past year, whereas those of the two principal surplus countries have declined. Secondly, the current account imbalances in US dollar terms reflect the use of a depreciating currency as the basis of measurement. Expressed as a proportion of GNP/GDP, the current account surpluses of Japan and the Federal Republic of Germany peaked in 1986.

A number of explanations for the persistence of the US trade deficit, and the surpluses elsewhere, have been offered. In addition to the traditional J-curve phenomenon and the fact that in 1985 the value of US imports was more than double that of exports, explanations include a number of microeconomic developments and special factors which have affected exports and imports asymmetrically:

- weak prices for agricultural products have depressed a usually strong US export sector;
- credit-constrained LDCs have reduced their demand for US products;
- US price competitiveness has not followed in step with the evolution of the exchange rate. Changes in bilateral exchange rates have not been completely reflected in changes in US import prices. Exporters to the United States have absorbed part of the appreciation of their national currency by maintaining their export prices in US dollar terms and reducing their profit margins in an effort to maintain their market share. In contrast, US export prices have been determined mostly by movements in internal markets and only to a limited extent by external events;
- adjustment costs make the recapture of lost market shares by US firms a slow process; and
- new competitors have entered world markets for manufactures, in particular the Asian NICs, which have experienced large increases in competitiveness in the past two-and-one-half years.(The U.S. dollar has depreciated little against the currencies of these countries.)

The above, and perhaps other, factors help explain the persistence of the US trade deficit, but in the final analysis a reduction of the deficit requires that US output grow faster than final spending. And conversely for the countries with trade surpluses. Inasmuch as the US economy is operating near capacity -- the unemployment rate and capacity utilization in manufacturing are at their lowest and highest levels, respectively, since the end of 1979 -- further improvement in the external balance will require a reduction of US

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domestic absorption (either by reducing the fiscal deficit or through a drop in investment and consumption), thereby freeing resources for the export sector. Faster domestic demand growth in Europe and sustained growth in Japan would contribute to a narrowing of the imbalances and support world demand.

The Asian NICs also should play a role in the international adjustment process by further liberalizing trade, reorienting more of their savings toward domestic investment, and correcting exchange rate misalignments.

Conclusion and Issues for Discussion

If international payments imbalances are to be significantly reduced from present levels, the US current account balance would have to improve substantially, whereas the surpluses of Japan, Europe (largely the Federal Republic of Germany), and the NICs would have to shrink by a similar amount. The policy challenge is to correct the imbalances while avoiding a decline in world demand.

To maintain world demand any reduction in US expenditure should be offset by increases in other countries. Expenditure changes alone will likely not be sufficient to bring about the required adjustment. Even if the reduction in US expenditure is matched by an increase in spending in other countries of the same amount, the effect on trade balances would be only a small fraction of the changes in expenditures (since propensities to spend on domestic goods are much higher than propensities to spend on foreign goods.) Thus, changes in expenditures will have to be accompanied by a switch in expenditure toward US goods and services. Given the large real depreciation of the US dollar that has already occurred, any further depreciation necessary to induce the switch in expenditure is likely to be comparatively small.

What rate of reduction of international imbalances would be viewed as necessary to manage the transition to a sustainable outcome? Z

Are the differences in the projected rates of growth of domestic demand in the Summit countries concordant with the desired narrowing of international imbalances?

In view of the large cumulative domestic demand gap between Europe and the rest of the Summit countries, are there special factors which have to be considered in Europe?

What specific further fiscal and monetary policy measures by individual countries are necessary to bring about the desired adjustment of international imbalances?

How best can the NICs be integrated in the coordination process?

IV STRUCTURAL POLICIES

As trade imbalances narrow, the macroeconomic adjustments will be accompanied by structural adaptation. Regardless of how the gap between production and absorption in the deficit and surplus countries is achieved, it will involve large sectoral adjustments -- between tradables and non-tradables and within tradables -- which displace labour. The longer the trade imbalances persist, the greater will be the subsequent sectoral adjustments.

As the trade deficit and surpluses are reduced, producers in surplus countries have to shift from producing for the US market to producing for their domestic market, whereas US producers have to orient more of their production towards foreign markets. Given the structure of trade, much of the adjustment will fall on manufacturing. Agriculture might make some contribution to the improvement in the US trade balance, but in view of the excess supply of many agricultural products in world markets, any such contribution is likely to be small. Service exports cannot expand sufficiently to make a significant contribution -- the net investment income category will be in deficit, while the remaining categories are too small to make a sizeable contribution. Hence, manufacturing trade must bear the brunt of the adjustment. In this regard, the declining trend in the growth of world trade in manufactures is of concern, since adjustment is likely to be more difficult, and protectionist pressures more intense, in a climate of uncertainty and slow growth.

In view of the large adjustments required to correct existing international imbalances, and in view of the resistance that may be encountered from affected groups, there is a need for the encouragement of policies that will facilitate sectoral adjustments. This need is underlined by the fact that in the major European countries employment in manufacturing has declined throughout the 1980s despite strong exports of manufactures. Moreover, the growth of service-sector employment has not been sufficient to offset employment losses in manufacturing and absorb new entrants to the labour force. In contrast, in North America the decline in manufacturing employment in the first three years of the 1980s has since been reversed, and strong growth in service-sector employment has permitted a reduction of unemployment rates to 1979-80 levels. In Japan, employment has risen somewhat in manufacturing and more rapidly in the services sector, but not sufficiently to prevent some increase in unemployment.

What policies can countries implement or modify -- for instance, with regard to subsidies, government regulations, and taxation -- that would facilitate sectoral adjustments while contributing to demand growth?

In particular, are labour markets sufficiently flexible to allow the required sectoral adjustments to come about without undue frictions??

V MULTILATERAL SURVEILLANCE AND POLICY COORDINATION

The two major issues in this area concern the management of the transition to sustainable economic policies and performance for the Summit countries, and, once sustainability is achieved, ensuring that it is maintained. Multilateral surveillance and coordination of policies should facilitate the attainment of both these objectives.

Over the past two years the Summit countries, in conjunction with the IMF, have been formulating a surveillance mechanism based on a set of economic indicators proposed at the Tokyo Summit. Countries have also agreed to provide medium-term objectives and projections for their economies. These are now being assessed regularly in conjunction with the IMF's World Economic Outlook in order to highlight possible tensions.

At the IMF/World Bank Annual Meetings in September 1987, US Treasury Secretary Baker and UK Chancellor of the Exchequer Lawson proposed possible extensions to the use of indicators in the surveillance process. Both suggested the use of a commodity price index as a leading indicator of inflationary trends. More generally, the question is whether there is a need for global indicators to aid in monitoring the performance of the Summit countries as a group.

Work underway at the IMF, the OECD, and elsewhere suggests that a commodity price index could play a role as an indicator of inflation pressures in the Summit countries, individually and globally, complementary to that of other indicators. But given the relatively small contribution of commodity prices to the inflation forecast, their volatility and their high susceptibility to speculative forces that role would be limited. A commodity price index, however, is only one possible global indicator.

Is there a need for global indicators as:

- **an aid to discussion amongst countries on the appropriate policy stance?, and/or**
- **a guide to the policy that individual countries should adopt (i.e., who does what)?**

The rapid trend towards the global integration of securities markets and the recent turbulence of equities markets have raised the question of whether greater international cooperation in the supervision of securities markets is called for.

Is there scope for Summit consideration of how to catalyze the ongoing discussion in this area?

The scope for policy surveillance also extends to other areas. In an increasingly integrated world economy, the "spillover" of domestic microeconomic or structural policies cannot be neglected; especially as these have often been the motive force of protectionism. In the future, latent protectionist pressures may be exacerbated by the turnaround of current account positions and the

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ongoing force of structural change stemming from technological developments and shifting patterns of comparative advantage.

How can a method of domestic surveillance of micro or structural policies be developed?

VI MULTILATERAL TRADING SYSTEM

The international trading and monetary systems, national economic policies, international imbalances and developing countries' debt problems are all inter-related. Difficulties in resolving external imbalances exacerbate protectionist pressures. Also, to the extent that these difficulties adversely affect growth and the smooth functioning of financial and foreign exchange markets, they affect the ability of LDCs to service their international debt. On the other hand, further trade liberalization will contribute to international well being generally and assist in the adjustment of international imbalances and debt servicing problems of the developing countries.

Recent events - e.g. the October stock market shock - may have momentarily helped stem the forces of protectionism, but exchange rate and trade adjustments may well renew protectionist pressures.

A key issue is a credible and continuing fight against protectionism. A successful MTN, with its commitment to standstill and rollback, to improved market access, to improved rules of trade and to an expanded role for GATT, is essential.

Further, unless the GATT System itself is fundamentally strengthened, gradual erosion may over time render it obsolete. More effective multilateral surveillance of the full range of trade-related policies is imperative. At the very least, the system needs a strong vote of confidence. Substantive early progress toward a successful MTN thus remains a major goal.

How can the Summit best help prevent continuing erosion of the trading system and provide the momentum to maintain and improve the functioning of the GATT System?

In particular, how can an effective system of multilateral surveillance be implemented to facilitate the adjustment process?

A major political and institutional consideration is the future role of developing countries in the GATT System. On the one hand, some developing countries - the NICs - are able to take on greater GATT responsibilities and to be less dependent on special treatment. On the other hand, a number of developing countries should play a larger GATT role - in their own developmental interests - but lack the resources to participate fully.

The developing countries and especially the NICs should be encouraged to undertake increased commitments and obligations and a greater role in the GATT, commensurate with their place in international trade and their respective stages of development. Moreover, developed countries must consider in this context what they are prepared to do to meet the legitimate need of developing countries for greater, more secure access for their exports into developed countries.

How should the NICs be encouraged to undertake increased commitments and obligations and a greater role in the GATT?

At the Venice Summit leaders reaffirmed the OECD Ministerial Agreement on agriculture, including the principles for policy reform and undertook to refrain from adverse practices which would exacerbate market imbalances and the trade environment. They agreed on the early tabling of negotiating proposals in the MTN (which has been done by Canada, the United States and the European Community) and committed themselves to review progress in the MTN at the 1988 Summit and consider the tasks that remain. Provisional results of OECD studies suggest little progress, however.

Assuming discussions in Geneva can be sufficiently advanced, what could be the elements of a framework agreement for the negotiation of long term reform of agricultural trade and trade-distorting domestic policies? What specific commitments on such a framework could Summit leaders make?

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What undertakings could leaders make on short term measures which would: (a) lead to immediate improvements in the trade situation? (b) be consistent with longer term reform?

Ministers have also in more general terms committed themselves to further trade liberalization and the success of the MTN. It will be important to reaffirm this broad commitment particularly at a time of possible slower economic growth. The 1988 Summit will undertake the same kind of overall review of the state of play in the MTN, as in agriculture. The key issue will be to ensure that the MTN momentum is maintained. In this context the Ministerial level Mid-Term Review Conference is most important. The question of when (December) and where (Canada) has basically been settled. For the Toronto Summit the outstanding issue will be:

What is to be achieved at the Mid Term Review?

VII <u>DEVELOPING COUNTRIES AND DEBT</u>

A. MIDDLE INCOME COUNTRIES

The situation of indebted developing countries is characterised by uncertainty. There has been progress in strengthening the international financial system and commercial banks against the risks posed by the debt situation, and many indebted countries have implemented programs of macroeconomic adjustment, complemented in some cases by structural reforms. However, a generalized return of these countries to sustained economic growth and creditworthiness is proving elusive. There is a growing sense that recent developments may have marked a turning point in the international debt strategy, as the focus on "growing out of debt" begins to be complemented by techniques which actually reduce the stock of debt.

Perceptions of the middle-income debtors tend to be dominated by the three largest debtors: Brazil, Mexico and Argentina. The financial system has withstood Brazil's moratorium of 1987, and negotiations may result in a comprehensive agreement and a resumption of debt service. Mexico's situation is also encouraging, particularly since a sizeable increase in non-oil exports and a return of some flight capital have occurred. However, in Argentina's case there is a serious prospect the country will once again fall out of compliance with the IMF Standby Arrangement, possibly leading to a debt

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service moratorium. While that action would be a matter of deep concern, the international financial system and the debt strategy have already demonstrated their capacity to withstand the non-participation of one of the major debtors. While the situations of other middle-income debtors vary considerably, none can be characterized as on the brink of financial collapse. There are therefore grounds for assuming the international debt situation can be managed over the next period within the framework of the current strategy.

In addition to economic risks relating to interest rates and growth of world output and trade, there are intimately connected political and financial risks. Debtor commitment to adjustment, and new financial flows from commercial and official sources, are essential components of the strategy. The Acapulco summit, while eschewing confrontation and unilateral measures, demonstrated that regional leaders are under domestic political pressure to take action on the external front as well as on domestic policy. The pressure can only grow, as most of the countries in the region will be putting their recently recovered democracy to the test in elections in the next 12 to 18 months. Their dilemma is worsened since necessary declines in consumption have not been accompanied by the increases in investment required for an eventual growing out of the debt: recent small increases have still not made up for the precipitous declines of 1982/83, and the average growth rate of investment for the World Bank's Seventeen Highly Indebted Countries for the period 1980-87 is still -4.8 percent.

A disruption consisting of unilateral action by a debtor or debtors, therefore, cannot be ruled out in coming months. As noted above, a debt service moratorium by Argentina could be withstood by the international financial system. Were Brazil's negotiations, however, to falter badly or break down at roughly the same time, the situation could become a good deal more ominous. A coherent response could be impeded by the different levels of financial strength of various creditor banks.

The growing difficulties in assembling concerted lending packages attest to the differentiation in financial positions of creditor banks, and even more to the reluctance of private sector lenders to put up any more resources, even for countries whose adjustment records are fairly good.

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Progress in developing and implementing the "menu of options" has been mixed, both because unrealistic expectations by debtors of what lenders will find attractive, and because some of the options are less ways of mobilising new resources than they are means to allow both debtors and creditors to exit from a financial relationship that both find constraining. The recent Mexico-Morgan Guaranty bond scheme may be a successful example of the latter, with the important new element that the debtor will now capture at least some of the benefit of an effective asset write down. While the Mexican scheme is not immediately applicable to other debtors (because, inter alia, of Mexico's strong reserves and relatively good debt service record), new and similar "options" may begin to appear for other debtors. Finally, debt-equity swap programs have been successful where debtors have a good macroeconomic policy record, and a welcoming legislative and regulatory regime for foreign investment. Chile, for instance, has retired well over $2 billion in this manner, some 12 to 14 per cent of its total debt burden.

The Mexico-Morgan Guaranty scheme can also be seen as a significant step in the process of developing a second track to the debt strategy, namely that of actually reducing the stock of debt. The process has its roots in the growth of secondary markets for LDC debt, and notably in the large discounts at which these assets are traded, as well as in last year's well publicized increase in commercial banks' loan loss provisions. The latter development in particular may have had the result of increasing expectations among debtors that banks' ability to withstand losses could readily be transformed into willingness to do so.

Burden-sharing amongst creditors could come under increasing pressure in the coming months. This would seem to pose questions to creditor governments, since different bank supervisory practices and regulations have clearly played a role in promoting different levels of financial strength among national groups of banks. Even more delicate is the question of official credits: the Paris Club would be ill-placed to reject burden-sharing as new approaches and techniques are developed, after having firmly insisted on it in earlier phases.

The role of official financing is likely to grow, particularly by the World Bank. Prospects for a substantial increase in available resources are good, as

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progress toward a GCI has been encouraging. An early conclusion to these negotiations, accompanied by a suitable clarification of the Bank's role in assisting the major problem debtors, is essential to achieving a significant strengthening of the debt strategy. This contribution will be particularly welcome, given that net transfers from the World Bank to LDCs in FY 1987 were only some $2.6 billion, of which only $776 million were to major debtors. The IMF's role as a source of financing seems set to diminish. This may be inevitable given the nature of the institution as compared to the fundamentally long-term, structural problems of the debtors. On the other hand, its policy role seems more necessary than ever, given the vital link between commitment to adjustment and prospects for an eventual return to creditworthiness. Official sources of financing, especially the Paris Club, will continue to require an IMF role. Thus it is important that the current review of conditionality, with an emphasis on greater flexibility, help debtors to overcome their reluctance to seek Fund assistance.

What scope for further progress does the "menu of options" provide? Can it be expanded further, through action by creditor governments or the international financial institutions? Are there "options" which creditor governments can adopt in the Paris Club vis-à-vis their own credits in heavily indebted countries?

What are the prospects for financial flows to debtors from commercial banks, official sources (including ODA and export credits), and private sector investors (both direct investment and purchases of LDC securities)?

How likely is a disruption to the current situation and strategy in coming months? Are creditor governments and banks positioned to cope with it, or is further preparation required?

How likely is the second track to complement the current strategy in coming months? What should be the role of international financial institutions and creditor governments, and especially their bank supervisors, if its development accelerates? How could equitable burden-sharing among different creditors be maintained? Would there be a role for conditionality under such a scenario?

B. DEBT OF THE POOREST

The Venice Summit made a commitment to address the debt problems of the poorest indebted countries, mainly in sub-Saharan Africa. Progress has been encouraging:

- the Paris Club has adopted extended rescheduling terms of 15 to 20 years for these countries;

- the World Bank, in conjunction with ODA agencies, has put in place an enhanced program of co-financing aimed at the region;

- the IMF Managing Director has announced the establishment of the Enhanced Structural Adjustment Facility, at close to the target level of SDR 6 billion on highly concessional terms.

While the proposal for concessional interest rates in the Paris Club has not been implemented, it can nevertheless be argued that the Venice commitment to greater action has been met.

What is less clear is whether the action taken is sufficient to allow these countries to overcome their debt burden and resume sustained development, hopefully with the aid of market-oriented adjustment programs. A variety of analyses have shown that most of these countries must be considered insolvent, and that only a substantial increase in concessional resources, either through increased ODA or concessional debt rescheduling, will allow them to break out of their current situation

However, despite the eighth replenishment of IDA, there are still shortfalls in meeting these countries' needs for concessional resources. Notwithstanding undertakings in international meetings, the strong adjustment programs which many of these countries are at last undertaking risk failure if concessional flows are not increased from their current levels.

> Only a few years ago our populations were deeply concerned over the obvious failure of development effort in Africa. What actions can we take to ensure that this episode is not repeated? How can we ensure that strong adjustment programs in the region are successful?

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	OECD Projections				IMF Projections			
	1986	1987	1988	1989	1987	1988	1989	Average 1990-92
	Percentage changes from previous period							
Real GNP								
United States	2.90	2.75	2.50	1.75	2.8	2.6	2.8	2.8
Japan	2.40	3.50	3.50	3.00	3.8	3.7	3.6	3.6
Germany	2.50	1.50	1.50	1.25	1.6	1.6	1.7	2.3
France	2.00	1.50	1.50	1.25	2.0	1.8	1.8	2.2
United Kingdom	3.30	3.75	2.75	1.75	4.0	2.6	2.0	2.3
Italy	2.70	2.75	2.00	1.75	3.0	2.3	2.3	2.3
Canada	3.30	3.75	2.75	2.25	3.7	2.7	3.1	3.0
Summit Countries	2.80	2.75	2.50	1.75	3.0	2.6	2.7	2.8
Real Total Domestic Demand								
United States	3.90	2.00	1.00	1.00	2.3	1.6	2.2	
Japan	4.00	4.25	4.00	3.25	4.7	5.3	4.4	
Germany	3.70	2.50	2.25	2.00	2.8	2.6	2.0	
France	3.70	3.00	1.50	1.25	3.0	1.9	2.0	
United Kingdom	3.80	3.50	3.75	2.25	3.7	3.6	2.5	
Italy	3.20	4.50	2.50	2.25	4.5	2.8	2.7	
Canada	3.90	4.00	2.75	2.00	4.3	3.1	3.1	
Summit Countries	3.80	3.00	2.00	1.50	3.1	2.7	2.7	
Inflation (GNP/GDP deflator)								
United States	2.60	3.00	3.50	3.75	3.1	3.6	3.7	
Japan	1.80	-.25	1.00	1.50	-0.1	1.8	1.6	
Germany	3.10	2.50	1.75	1.75	2.1	2.0	2.0	
France	4.70	2.75	2.75	2.50	3.3	2.4	2.4	
United Kingdom	3.50	4.00	5.25	5.00	4.4	4.8	4.2	
Italy	8.00	5.75	5.00	4.25	5.4	4.8	4.6	
Canada	2.90	4.75	4.25	3.50	4.4	3.6	3.5	
Summit Countries	3.10	2.75	3.25	3.25	2.7	3.2	3.0	

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	OECD Projections				IMF Projections			
	1986	1987	1988	1989	1987	1988	1989	1992
	US $ Billion				Percent of GNP/GDP			
Current Balance								
United States	-141.3	-156.0	-134.0	-105.0	-3.5	-3.0	-2.7	-2.3
Japan	85.8	86.0	81.0	79.0	3.6	2.7	2.5	2.2
Germany	37.1	44.0	41.0	32.0	3.8	3.3	3.1	3.0
France	2.9	-3.0	-5.0	-6.0	-0.2	-0.2	-0.3	-0.2
United Kingdom	-1.5	-3.0	-6.0	-9.0	-0.6	-0.7	-1.1	-1.0
Italy	4.0	-2.0	-4.0	-4.0	--	-0.1	-0.3	-0.6
Canada	-6.7	-7.0	-7.0	-7.0	-1.7	-1.8	-1.7	-2.5
Summit Countries	-19.7	-41.0	-35.0	-21.0	-0.4	-0.4	-0.4	-0.4
Unemployment	Percent of labour force							
United States	7.0	6.25	6.00	6.50	6.2	6.1	6.1	
Japan	2.8	3.00	3.00	3.25	2.8	2.8	2.8	
Germany	8.0	8.00	8.25	8.50	7.9	8.1	8.2	
France	10.5	10.75	10.75	11.75	10.8	11.4	11.9	
United Kingdom	11.8	10.75	10.25	10.50	10.4	9.5	9.3	
Italy	10.1	10.75	11.25	11.50	11.6	11.8	12.0	
Canada	9.6	9.00	8.75	9.00	8.9	8.4	8.4	
Summit Countries	7.3	7.00	7.00	7.25	7.0	6.9	7.0	

Source: OECD Economic Outlook 42, December 1987
World Economic Outlook - Preliminary Assessment of Prospects and Policy Issues, EBS/88/1, January 6, 1988.

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