The Role of the IMF in a Challenging World Economy

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SUMMARY: *External imbalances among the three major countries remain a cause for concern because no improvement is in sight. Inflation poses a greater potential worry now than it has for some time. Fiscal and structural policies ought to relieve monetary policy. Cooperative action in an interdependent world is a positive-sum game. The Fund offers analysis, information and advice, especially by developing a framework of how economies interact. The Fund will assist the debt-ridden countries on the long road ahead, by helping them to formulate adjustment programs, including measures to increase responsiveness and efficiency, and by assisting them financially. Private creditors must play their part.*

The functions and activities of the International Monetary Fund, range widely. To narrow the focus, I should like to take as my basic points of reference what to my mind are the two principal challenges facing the international economy, namely

- How to sustain growth in the industrial world; how, in particular, to bring payments imbalances among the major countries into a more durable pattern without precipitating a recession or refueling inflation; and
- How to reinvigorate activity in the developing world and enable countries to grow out of their debt burdens.

And I should like to structure my remarks by addressing three questions:

- Where does the international community stand in its efforts to confront these challenges?
- What needs to be done? and
- Where does the IMF fit in?

In the process, I hope to give you some flavor of the evolving nature of the Fund's relations with various groups of its member countries.

Role in the Industrial World

First, the leading industrial countries. Robust growth in these countries is fundamental. On it rests much, not least the hopes (I) for reducing the still unacceptably high

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unemployment in much of the industrial world; (II) for resisting threats to an open world trading order; and (III) for creating a hospitable environment for export-led expansion in the debt-laden countries.

Where do we stand? We can all draw comfort from the facts that the post-1982 upswing continues; that last year growth quickened to a pace not seen for four years; and that inflation has remained in check. But we cannot be complacent:

– External imbalances among the three major countries, while they declined in absolute terms last year, remain (A) substantial and (B) a cause for concern in that, assuming the continuation of present policies and exchange rates, we see little reason for them to diminish much over the medium term.

– Inflation, meanwhile, poses a greater *potential* threat now than it has for some time. Capacity utilization rates have been rising in most industrial countries; labor market conditions are tightening in some; non-oil commodity prices are well above last year's levels; and developments in national monetary aggregates – while not always easy to interpret – surely suggest the need for vigilance in the period ahead.

We must deal with both these matters if we are to make growth in the industrial countries more durable. This will require two things: an appropriate mix of policies at the national level, and greater international coordination of such policies.

As concerns the former, there is a need at present, while maintaining a cautious monetary posture, to ensure that monetary policy is not overburdened – a need, that is, for budgetary and structural policies to assume a more important role in the process of adjustment and the support of the economic upswing. Fiscal restraint is currently called for in a number of countries, most obviously the United States. Even more important is the need to come to grips with structural impedements to output and demand growth.

Deliberate coordination is needed, meanwhile, if the pitfalls associated with incompatible policies are to be avoided *and* if the potential for mutually consistent policies to achieve shared objectives is to be realized. The specific responsibilities of deficit and surplus countries in the present situation need no rehearsal here. What I *would* emphasize and what I believe has been amply demonstrated in recent years is that, in an increasingly interdependent world, cooperative action is a positive-sum game.

Where, in all this, does the IMF fit in? The Fund was specifically established to promote international monetary cooperation; its Articles of Agreement require it to exercise firm surveillance over the exchange rate policies – and, by extension, the other relevant policies – of its members; and it has been asked by the major industrial countries to assist in various ways in the coordination of their policies. In short, the Fund has a key role to play.

The essence of this role is to offer analysis, information and advice – bringing the main issues to the surface more clearly and facilitating constructive debate. Three aspects of this work deserve particular mention: (I) examining, for each of the major economies, the consequences of its actions for the others *and* for the rest of the world; (II) reviewing the consistency of policy objectives, both within and across countries; and (III) assessing current trends and helping to determine whether there have been significant deviations from an intended course that require consideration of remedial action.

Our mechanisms for fulfilling these responsibilities are several: annual consultations with the individual countries; twice-yearly reviews of the world economic situation, prospects and policy requirements; my participation in meetings of finance ministers and central bank governors of the major industrial countries; and less formal channels, of course. Through these mechanisms, the Fund nowadays is speaking out more often and with more candor.

Now, you have heard frequent reference so far to the »major« industrial countries. But quite a lot of what I have just said applies equally to the smaller industrial countries or, at least, is directly relevant to them.

- It is an important purpose of the Fund to provide information and analysis to all member countries;
- Likewise, to offer advice and policy recommendations – advice that draws on the institution's long experience of country work; that looks beyond the expediency of the moment; that is politically detached, yet sensitive to the unique historical and social background of each member country;
- The Fund also provides a forum for all country groups, including the smaller industrial countries, to be heard on the main macroeconomic issues of the day; and
- In representing the interests of the world economy as a whole in our work with the major industrial countries, we are mindful of the interests of all parts of the world, including those of the smaller industrial economies.

Effective policy coordination among the major economies, moreover, is surely in the interests of all countries. And significant progress toward this end has been made over the past three years. Encouraging as this is though, no more than a beginning. The challenge is to continue to move the process forward – in the face, let us be candid, of not insignificant obstacles, both technical and political.

What can be done to this end? First, it seems to me, we need to press on with efforts to develop an analytical framework of how economies interact – a framework that commands broad acceptance at the technical level and yet is straghtforward and compelling enough to carry conviction at the political level. This is an area in which the Fund has a key role to play. Second, we need to continue to refine the instruments and procedures of coordination.

All this may sound rather technical when, in the final analysis, policy coordination is a matter of political will. But objective analysis and mutually agreed rules and procedures can be important in providing a structure for common thought, for peer pressure, and for action by sovereign governments.

It may never, of course, be possible to achieve total agreement among governments as to what policies should be pursued at any particular time. But is should be possible to increase the compatibility of national policies; to ensure that the major countries take the spillover effects of their policies on the rest of the world more systematically into account; and, thereby, to enhance the contribution of such policies to growth and stability generally. And those are the Fund's aims.

Over time, it should also be possible to involve countries outside the G-7 more directly in this evolving process. This points up a second facet of closer policy coordination: it represents a first, pragmatic step toward a better international order. It is by deepening and broadening this process that we will best strengthen the international adjustment mechanism, while at the same time putting in place the basic principles of a sounder monetary system.

Of course, the work of the Fund in improving the functioning of the international monetary system does not stop here. After all, the Fund was brought into being, inter alia, to provide »the« machinery for consultation and collaboration on international monetary problems. The Fund's sphere of interest is as extensive as the international monetary system, and its job is to oversee the management and adaptation of that system. In line with this, and given the reawakening of interest in systemic issues, we are examining carefully the international monetary arrangements and exchange rate mechanisms that are in the process of developing, as well as such issues as the supply and managment of international liquidity, the diversification of reserve currency assets, the role of the SDR ... The Fund thus has a continuing responsibility in this important area.

Role in the Developing World

Let me turn now to the developing world and the debt problem. Where do we stand here, more than six years after the debt crisis erupted?

- Much has been achieved in maintaining a viable international financial system and in limiting the spread of adverse effects to creditworthy countries.
- External adjustment has proceeded. Consider the large, heavily indebted, middle-income countries. Since the onset of the crisis, they have absorbed a cumulative deterioration in their terms of trade of more than 20 percent, or the equivalent of 3 percent of their GDP, and still managed to record an improvement in their combined current account of close to 5 percent of GDP.
- Over the past two years debt ratios have begun to fall.

- But growth has been slow to recover; the sheer size of debt remains above the pre-crisis level; flight capital has not been repatriated; and few countries have regained access to voluntary financing.

That there is not more to show for our efforts to cope with the debt crisis is perhaps not altogether surprising following more than a decade of inflation-generated misallocation of resources. But it is deeply disappointing. Clearly, considerably more time will be required for developing countries to emerge from the crisis than had been anticipated earlier. The objective, though, remains the same: to restore indebted countries' creditworthiness. And the key to attaining this objective continues to be the strengthening of the ability of these countries to undertake productive investment, to realize more fully their economic potential, and to grow out of their debt burden.

It has long been recognized, for this to be done, that a number of conditions need to be satisfied: effective and appropriate policies in the indebted countries; an adequate flow of foreign capital; and a supportive global economic environment. It goes without saying that we cannot be satisfied with the extent to which these conditions are currently being met. What is needed, though, is not a new approach. The answer does not lie, for example, in indiscriminate debt forgiveness. Nor in shifting risk from private to public creditors. Still less in undermining the difficult but essential reform efforts that debtor countries are making and must indeed strengthen. The answer lies, rather, in a stronger collaborative effort by all parties - debtor countries, creditor countries, banks and the multilateral institutions.

One of these parties, of course, is the IMF. Indeed, the Fund has a central role in each of the areas I just mentioned:

- First, in helping debt-burdened countries to formulate appropriately strong programs of adjustment oriented to growth;
- Second, in making available its own resources and helping to mobilize financing from other sources to support such programs - so as to facilitate their implementation and soften the »austerity« inevitably associated with adjustment; and
- Third, in seeking to ensure that countries that do not need to use the Fund's resources remain mindful of their international responsibilities.

In what ways is the Fund responding to the need for a greater collaborative effort? I have just spoken about the intensification of our work in the third area - our work with the major industrial countries. What about the two other areas of responsibility?

As concerns the design of adjustment programs, I would make four points:

(I) Adjustment is inevitable; it is an essential condition of sustainable growth. And durable growth - let there be no mistake about it - is precisely what we are seeking.

(II) Equally clearly, efforts to adjust are unlikely to be sustainable unless accompanied by growth. Over the past few years, the Fund has thus been giving increasing emphasis to supply-side and structural adjustment measures. And we are continuing to do so. Many such measures – for example price reforms and reforms of exchange systems or tax system, – fall in areas of traditional Fund competence. Where other structural weaknesses loom large, we draw heavily on help from the World Bank – an example, incidentally, of the close operational collaboration of the Fund and the Bank.

(III) The Fund has no political philosophy. In recommending structural reforms, we have but one objective in mind: to improve the efficiency with which resources are used and to promote balanced growth. For the fact is that just as structural reform will not succeed in he absence of a stable macro and financial environment, macroeconomic policies will foster growth only if structural impediments are removed.

(IV) The social aspects of adjustment *are* important. Within its mandate and its possibilites, the Fund has given steadily greater attention to this matter, too, in recent years. Again, this is a process that is continuing and needs to continue. Adjustment programs, of course, will inevitably have distributional consequences. But there is no reason why the poorest should be the ones to lose. And while decisions regarding the allocation of adjustment burdens rightly rest with sovereign governments, we have made it plain that the Fund stands ready, if requested, to assist countries in designing programs that would shelter the poorest members of society. Not, I should add, by acquiescing in a relaxation of adjustment efforts; for the failure to adjust is, to my mind, the most impoverishing approach of all. But rather by having the government in question apportion the burden of adjustment more equitably.

Adjustment, though, is never easy. And the fact is that political support for appropriately strong policy measures needs to be underpinned by the provision of adequate financing on realistic terms. Which brings me to the Fund's third area of responsibility in dealing with the debt problem. How has the Fund responded to the need for a greater collaborative effort here? What it has done is adapt to a number of considerations that have become increasingly apparent as the debt situation has unfolded:

- Greater emphasis has been given to structural policies – policies which, by their nature, typically take time to register their effects. This has implications both for the amount of assistance that is needed to smooth the adjustment process and for the period for which assistance needs to be made available.
- Greater consideration has been given to the vulnerability of adjustment efforts to

exogenous developments – terms of trade shifts, increases in interest rates on international markets, and the like.

- Greater consideration has been given to the special plight of many low-income countries – countries whose adjustment and financing needs are very great, but whose receipt of finance on nonconcessional terms would only aggravate already untenable debt position.

Over the past year, the Fund has responded to these considerations in three ways:

- By increasing the effective access of member countries to its existing medium-term credit window, the so-called extended Fund facility, and improving somewhat the terms of such access;
- By creating a contingency financing mechanism to help countries maintain the momentum of adjustment in the face of external shocks;
- And by establishing a new lending window, the enhanced structural adjustment facility, through which additional resources totaling more than $8 billion will be made available for borrowing, on concessional terms and with relatively long maturities, to the Fund's poorest members who are taking forceful steps to strengthen their economies. Let me not fail, here, to express my appreciation for the financial contribution of the Danish Government to this important effort.

These changes signal a readiness on the part of the Fund to match strengthened adjustment efforts with stronger financial support. What is important is that the indebted countries now play their part and that other creditors also take steps to move the process forward.

What is needed from the indebted countries is considerably greater resolution in adopting and implementing sound macroeconomic policies and broad-based structural reforms. It is to them, after all, that the key responsibility for growing out of debt falls. There should be no illusions about that.

Official and private creditors, though, can and indeed must also do more.

- For low-income countries, the initative launched at the Toronto summit has the potential to ease debt service burdens significantly. But grants and highly concessional loans in support of policy reforms as well as stepped-up development assistance for well-conceived investment programs are needed from official creditors.

- In the case of middle-income countries, the Government of Japan has taken an important initiative in announcing its intention to extend additional financing, in the form of untied loans, in parallel with Fund arrangements. Other countries, especially surplus countries, could follow this initiative. But it is private creditors, above all, who must play their part. By doing two things: providing the moderate amounts of new money that are vital to the working of our cooperative debt strategy; and broadening the role of debt reduction operations within the menu of financing options.

I mention debt reduction for two reasons:

- first, because of the sheer weight of existing debt in many cases. Simply adding new debt to old in some of these instances could be counterproductive.
- second, because various benefits would accrue. In particular, the medium-term growth outlook of the countries would improve as the share of resources allocated to servicing debt declined; debt ratios would fall more perceptibly, providing additional evidence to the general public that matters were moving forward; and many banks would be able, through such operations, to restructure their portfolios.

Debt reduction, of course, is only part of the solution. Indeed, the cash-flow relief that it can bring can be overstated. And it does nothing, by itself, to ensure that freed-up resources are productively invested in the indebted countries. Only sound policies can do that. Only sound policies can rectify debilitating disequilibria. Only sound policies, moreover, can generate the confidence required for a repatriation of flight capital, for inflows of direct investment, and for resumption of spontaneous bank lending. Hence the crucial importance of good program design and resolute program implementation. Hence the continued central role of the Fund in efforts to resolve the debt problem.

It is as part of a greater collaborative effort all round – and, most fundamentally, in the context of a strong adjustment program – that debt reduction can help. With such an effort – by all parties – we can, I believe, make a much more discernible dent in the debt problem in the period ahead, hastening its resolution.

Concluding Remarks

We live in a time of enormous challenges, but, by the same token, one of enormous opportunity. The IMF was brought into existence in much more turbulent times. Its creation was inspired by the recognition that world prosperity required active international monetary cooperation. We have come far since those days, but that original guiding principle remains as valid as ever. Looking to the period ahead, we have the opportunity, if we can harness the cooperative process properly, to produce a more stable environment in which the elusive goal of sustained noninflationary growth becomes a reality and the fruits of economic progress are shared more evenly among nations. Seizing that opportunity is a crucial item on the agenda of the Fund and its member contries as we move into the final decade of the century.