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Seeking Symmetry: Article IV and the Largest Industrial Countries

. . . WE, AS AN INSTITUTION, HAVE, I THINK, FAILED IN our task of industrial country surveillance. . . . we have to do a better job—if I may put it this way—of warning our authorities about the errors of their ways.

Thomas C. Dawson, II
U.S. Executive Director[1]

Nowhere is the difficulty of conducting surveillance more apparent than in the relations between the IMF and the major industrial countries. Effective oversight over the policies of the largest countries is obviously essential if surveillance is to be uniform and symmetric across the membership, but progress in achieving that goal has been slow and hesitant. The structure that evolved in the 1980s, though a bit jerry-built and complex, had three basic elements. First, the Fund conducted surveillance with[2] each country individually through the consultations required under Article IV of the Articles of Agreement and—both in the consultation itself and again in the World Economic Outlook exercise—proffered advice on the multilateral effects of each country's policies. Second, the major industrial countries held frequent meetings to discuss among themselves the policies that each country was pursuing, to convey any concerns about each other's policies, and to try to formulate joint policies on matters of mutual concern. Third, the Fund both participated in some of these multilateral meetings and, more generally, analyzed and evaluated the exercise for the membership at large.

The practice of bilateral surveillance with the five largest industrial countries is the subject of this chapter. The multilateral dimension (including the next two largest countries, Italy and Canada) is examined in Chapter 4. Broadly, this review

[1]Farewell remarks, EBM/93/123 (September 3, 1993).

[2]The phrase "surveillance with" is intended to express the idea that the Fund and the authorities of a country are jointly engaged in surveillance over the country's economic performance. Article IV enjoins the Fund to "exercise firm surveillance *over* the exchange rate policies of members," but it also obligates member countries "to collaborate *with* the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates" (emphasis added). As used here, "surveillance with" stresses both the collaborative aspects of the process and the Fund's limited powers of enforcement.

suggests that the lack of symmetry in the effectiveness of surveillance (that is, the very limited influence over the policies of the largest countries) is attributable primarily to differences between countries in the demand for the Fund's advice, and not to differences in the effort devoted to the task by the Fund. In some instances discussed below, effectiveness was also limited by the staff's deference to the authorities and by its reluctance to question the existing course of economic policy. Overall, however, this review of bilateral surveillance showcases the Fund's continuous but evolving efforts to warn governments of "the errors of their ways."

Surveillance, as practiced by the IMF with the major industrial countries in the late 1970s and 1980s, had two principal goals. The first was to identify and discuss differences in interests and perspectives between the country (i.e., the authorities in charge) and the international community (i.e., the Fund's membership at large). Such differences typically arose from several sources:

- Conflicts in goals between countries; for example, with respect to their tolerance for inflation or unemployment or to the importance attached to external balance. Governments of large countries often assigned a lower priority to the implications of external imbalances than did their smaller trading partners.
- Conflicts in economic models between countries, for example with respect to the effects of fiscal or monetary policies on aggregate demand or supply. These differences in turn arose because of the differing credence given to Keynesian, neoclassical, or structural (supply-side) explanations of economic behavior.
- The possibility that exchange rate policy could be manipulated for domestic purposes, either to encourage depreciation to gain a competitive advantage or to encourage appreciation to fight inflation or foster an image of economic strength. In practice, however, manipulation is difficult to identify and was seldom a serious issue in the Fund's consultations with the major countries.

The second goal was for the Fund staff to examine economic developments and prospects objectively, abstracting as much as possible from political goals and constraints. The point about abstraction from politics is crucial for an understanding of the surveillance process. The staff were not necessarily better informed or more analytical than their counterparts across the table, but they were more likely to bring an objective viewpoint into the room. Owing to that difference, a comparison of staff and official analyses and forecasts often provided insights into the political constraints that inhibit effective economic policymaking.

From the beginning, Article IV consultations were conducted annually with each of the seven largest industrial countries. To the extent possible, these consultations were grouped in the periods before the semiannual World Economic Outlook (WEO) exercise. Thus, the Executive Board would usually discuss the United States, Germany, France, and Italy in July–August; and Japan, the United Kingdom, and Canada in January–March. To ensure that the WEO discussions were fully informed with the latest data, smaller staff visits were often held in the interval between consultations. The missions were headed by a senior officer of the relevant area department. In a few cases, as discussed below, the Managing Director

joined the staff for the concluding meetings with the finance minister and other senior officials.

The preparation for and conduct of the annual consultations with the largest countries followed the same general procedures described in Chapter 2 for all member countries. The themes and objectives of each consultation were established in broad outline through a briefing paper, which was circulated and commented upon throughout the Fund and then cleared by management before the mission's departure for the country. In addition, the staff prepared for the mission by drafting a background paper that would later be revised and updated and then circulated under the heading of "Recent Economic Developments" (the RED) in the country being examined. The background paper assembled a detailed statistical base from published and internal sources, and often included research on topics of particular relevance to the forthcoming discussions. After the on-site discussions, the staff would return to headquarters to spend six to eight weeks preparing the staff report, the RED, and any special background or research papers required for circulation as supplements or annexes to the RED. The main staff report always included a brief summary of the major economic developments, an overview of the policy discussions, and a "staff appraisal" based primarily on the conclusions presented at the final meeting with the authorities.[3]

Within three months of the conclusion of the discussions with the authorities and about one month after circulation of the staff report, the Executive Board met and devoted all or most of a day (more, on rare occasions) to discussing the report. Two major themes dominated these discussions: exchange rate policies per se, and the conduct of macroeconomic policies. The first theme, however, was seldom of primary importance. As described below, the staff and the Executive Board occasionally examined the appropriateness of the authorities' exchange rate objectives (or, more often, the lack of objectives), and they frequently examined the appropriateness of official intervention practices. However, the exchange rate policies of the largest countries, which are inherently difficult to consider in isolation and apart from the actions of other major countries, were taken up more comprehensively in multilateral contexts: the WEO exercise, the Group of Seven (G-7) surveillance exercise, and general policy discussions. Even in those forums, exchange rate policies were treated as gingerly as those of smaller countries, owing to political sensitivities and concerns not to destabilize market activity.

Article IV discussions with the major countries therefore focused primarily on the conduct of fiscal and monetary policies, and in particular on the question of whether the country's policies were appropriate and sustainable over the medium term (generally meaning the course of three to five years). The difficulty with that approach was the lack of a real definition and of clear quantitative guidance for assessing appropriateness or sustainability. The goal was to assess simultaneously the country's internal and external balance, where internal balance refers to the

[3]Staff appraisals also took into account the responses of management and other staff to the mission's preliminary conclusions.

achievement of the maximum growth of output and the highest employment level consistent with (reasonable) price stability, and external balance refers variously to some combination of exchange rate stability and an appropriate and sustainable balance on current transactions in goods and services. Each of these concepts contains enough meat to serve as the basis for a serious discussion of the issues, but each also contains enough gristle to make the discussion difficult to digest.[4]

United States

A good place to begin this story is on November 1, 1978, seven months to the day after the amended Article IV came into effect. For most of that interval, the U.S. dollar had been depreciating against all of the other major currencies; in a year, the dollar had lost about 12 percent of its effective value. During the spring and summer of 1978, the U.S. monetary authorities attempted to counter the decline by tightening credit conditions by enough to raise short-term interest rates by about two percentage points, but that strategy produced little effect. The situation then became serious enough that the Fund's management and senior staff began exploring the possibility of an upper-tranche stand-by arrangement with the United States. Discussions to that effect were held in October between the Managing Director and the Secretary of the Treasury.[5] In late October, President Jimmy Carter announced new price and wage "standards," coupled with a tightening of fiscal policy. Those measures also failed to impress the exchange markets, and the downward spiral of the dollar was unabated.

Finally, on November 1, the Federal Reserve further tightened monetary policy, and the government announced a set of measures aimed directly at assuring the exchange markets that the dollar would be defended against further attack. These measures included a $7.5 billion increase in swap lines with the Deutsche Bundesbank, the Bank of Japan, and the Swiss National Bank;[6] plans to issue $10 billion in U.S. treasury securities denominated in foreign currencies; drawing down the U.S. reserve tranche in the Fund (SDR 2.3 billion, equivalent to $3 billion); and selling about half the country's holdings of SDRs, worth close to $2 billion. (Also see de Vries, 1985, pp. 858–66.) Mobilizing these resources in support of the dollar was described by the U.S. authorities as a "more vigorous" application of the existing policy of "intervening to counter disorderly conditions" in exchange mar-

[4]For a more detailed discussion of the issues and the difficulties, see Artus and Knight (1984) and Boughton (1989).

[5]Memorandum from the Managing Director to the U.S. Secretary of the Treasury (October 6, 1978); in IMF/CF (C/United States/820). Also see memorandum from the Deputy Managing Director to department heads (August 18, 1978); in IMF/RD Deputy Managing Director file "United States—1978" (Accession 82/22, Box 4, Section 139).

[6]A swap line is an agreement between central banks or national treasuries to permit either party to borrow the other's currency, up to the specified amount, for the purpose of reselling it in the foreign exchange market. It is, in effect, an overdraft facility to support official intervention.

kets,[7] but it was widely seen as a reversal of an attitude of indifference with respect to the level of the exchange rate.

The Managing Director responded to the U.S. announcement by calling for a "special consultation" under the new Article IV, the first such action with respect to a major country. In concluding the annual consultation, in July 1978, Executive Directors had judged that the depreciation and volatility of the dollar were attributable both to a failure to control U.S. inflation and to insufficient official intervention.[8] The Fund's goal now was to determine whether the new measures were an adequate response to those problems and to assess their consequences for the international monetary system. A staff team set out immediately to hold discussions with Treasury and Federal Reserve officials over the next few weeks, and a report was issued to Executive Directors on December 1.

The staff report unreservedly endorsed the U.S. effort to rescue the dollar. The "sharp depreciation of the U.S. dollar during October [had posed] a danger to the functioning of the international monetary system"; the November 1 policy package "was a welcome response in a situation in which exchange markets had become very disorderly and shifts in currency values were exaggerated in terms of both magnitude and speed." But the report also noted that solving the underlying inflation problem would require longer-term measures; the staff urged greater control of aggregate demand, notably through fiscal policy. The Executive Board, meeting two weeks later to discuss the report, supported those views and recommendations.[9]

The mission chief for that special consultation was the Deputy Director of the Western Hemisphere Department, Sterie T. Beza. Known universally as "Ted," Beza had participated in the U.S. consultations since 1969,[10] and had been leading those missions since 1973. He would continue to lead the U.S. consultations throughout the 1980s and right up to his retirement (as Counsellor, and Director of the Department) in 1994. His presence gave an unparalleled continuity to the discussions with the Fund's largest and predominant member country throughout the period of this History.

No more formal special consultations were held with the United States, but the handling of the 1978 episode set the tone for surveillance with this country over the next decade: the Fund, representing the interests of the international community, stressed the importance of implementing stable macroeconomic policies *and* of implementing exchange rate policies aimed at preventing misalignments. To illustrate further the application of Fund surveillance to the United States in the 1980s, two major themes will be examined here in some detail: the push by the Fund for greater fiscal discipline, and the treatment of exchange rate policy in re-

[7]"United States—Recent Economic Developments and Policy Actions," EBS/78/657 (December 1, 1978), p. 12.

[8]Minutes of EBM/78/106 (July 10, 1978), pp. 18–19.

[9]"United States—Recent Economic Developments and Policy Actions," EBS/78/657 (December 1, 1978), pp. 15 and 17; and minutes of EBM/78/197–198 (December 13, 1978).

[10]Consultations with the United States were held annually, beginning in 1962. For the background to the evolution of Fund consultations, see the introduction to Chapter 2.

sponse to the wide cycles in the value of the U.S. dollar. These debates show, sometimes almost painfully, how difficult surveillance can be when domestic political interests conflict with the economic interests of other countries.

Fiscal Deficit

The IMF took a remarkably strong and consistent stand in favor of fiscal moderation throughout the late 1970s and the 1980s, against the consistent and sometimes strong opposition of the U.S. authorities. Over time, the authorities gradually softened their own views, though the extent of the Fund's influence in that process is very difficult to judge and should not be exaggerated.[11]

As the United States struggled to recover from the 1974–75 recession, the fiscal deficit grew sharply, from less than $5 billion in 1974 to $75 billion (5 percent of GNP) two years later. By 1979, the Fund staff had identified deficit reduction as the key issue facing the U.S. government, and the issue remained at the top of the agenda throughout the 1980s. The Fund's focus, however, shifted during this period, as the perceived adverse effects of the deficit ranged from inflation to external imbalance to the crowding out of domestic investment and finally to the saddling of future generations with a mountain of debt. The authorities generally agreed that the deficit was a problem, but they consistently rejected the Fund's recommendations to take more aggressive action to reduce it; their reasoning also evolved markedly over time.

In the 1979 discussions, held just four months after the special consultation described above, the staff argued that cutting the fiscal deficit was a key requirement for reducing inflation, which was then running at about 13 percent a year, the highest rate experienced in the United States since the postwar release of pent-up demand pressures in 1947. Carter administration officials[12] agreed with the staff that deficit reduction was desirable, but they believed that they lacked the flexibility to take action before the next fiscal year. More fundamentally, they argued that inflation was largely a structural problem in the United States, and their strategy for reducing it was based primarily on supply-side measures such as deregulation of industry, simplification of government controls, and incomes policies.

Meeting in June 1979, the Executive Board was split almost evenly on this issue, between Directors who were satisfied that U.S. policy was on course and those

[11]Research for this chapter included interviews with senior officials from each country. (For a list, see the Preface.) Asked to recall an instance when a policy decision had been influenced by advice from the Fund, none of these officials admitted to being able to do so. To determine whether those negative responses reflected personal pride or a more general indifference to the surveillance process would require a much more detailed investigation than was possible here.

[12]The team of officials from the U.S. Treasury involved in the consultations was normally headed either by the Deputy Secretary (the number two official, after the Secretary) or, more commonly, the Under Secretary for International Monetary Affairs (directly below the Deputy Secretary on the organizational chart). Officials from other agencies, including the President's Council of Economic Advisers and the Office of Management and Budget, participated in some meetings. In addition to meeting with representatives of the administration, the Fund staff met regularly with officials from the independent Federal Reserve System.

who thought that more fiscal restriction was warranted. The summing up concluded, "Directors agreed that demand policy had a central role to play in the anti-inflationary strategy, and that *as a minimum* there needed to be firm adherence to the present stance of moderate demand restraint" (emphasis added).[13]

By 1980, finding the right course for U.S. fiscal policy had become even more difficult, as the economy had slipped into recession while inflation continued unabated. In part, this conjuncture was a coincidental result of the second oil shock, and in part it was an inevitable result of the Federal Reserve's October 1979 shift toward much stricter control over monetary growth; but it also showed that the potential for stagflation was greater than had seemed possible. Despite the recession, the staff argued against using either fiscal or monetary policy for countercyclical purposes and urged the authorities to stick to an anti-inflationary policy. This advice—which reflected a growing consensus among economists against attempting to "fine tune" macroeconomic policies—was in line with Carter administration and Federal Reserve thinking, and it generated little controversy when discussed by the Executive Board.[14]

The landscape changed dramatically in 1981, as the new administration of President Ronald Reagan proposed a bold strategy to stimulate output by cutting personal income tax rates and to stimulate investment by introducing an accelerated-recovery system for depreciating capital expenditures. Although similar proposals had previously been billed as stimulants to demand (notably in the Kennedy administration of the early 1960s), they now were repackaged as supply-side measures with the additional claim that the direct revenue losses to the government would be more than compensated by the effect of induced economic growth on revenues and on welfare and other spending programs (see Chapter 1, pp. 32–33). On that optimistic basis, President Reagan set a goal of balancing the federal budget by fiscal year (FY) 1984.[15]

The staff report rejected the administration's rosy growth projections and concluded that "relatively large fiscal deficits . . . are in the offing for the period ahead."[16] Executive Directors as well as the staff found the reasoning behind the U.S. shift toward fiscal expansion to be puzzling, and in July the unusual step was taken of inviting the newly appointed Under Secretary of the U.S. Treasury for International Monetary Affairs, Beryl Sprinkel, for a lunch with Executive Directors at the Fund. On that occasion, Sprinkel played down the significance of the deficit and asserted that monetary restraint would produce expectations of stable prices and so would lower interest rates, whatever the fiscal position. Neither the staff nor the Board accepted this line of reasoning: as Jacques J. Polak (Netherlands) noted,

[13]Minutes of EBM/79/93 (June 18, 1979), p. 22.

[14]See "United States—Staff Report for the 1980 Article IV Consultation," SM/80/144 (June 17, 1980) and the minutes of EBM/80/103–104 (July 11, 1980).

[15]Since 1977, the fiscal year for the federal government in the United States has ended on September 30. The goal of balancing the budget in four years was incorporated in President Reagan's initial budget, as submitted to the U.S. Congress in February 1981.

[16]"United States—Staff Report for the 1981 Article IV Consultation," SM/81/157 (7/14/81), p. 18.

the proposition could not possibly hold except in the very long run.[17] The stage was thus set for a clash of economic models that would dominate the discussions throughout the rest of the decade.

The case for supply-side economics was cogently argued by the U.S. Executive Director, Richard D. Erb, at the Board meeting that concluded the 1981 consultation. Erb rejected the staff's mainstream view that inflation reduction required "restraints on effective demand"; in the U.S. administration's view, that approach would discourage investment and limit growth. Instead, he argued that tax cuts aimed at stimulating investment were needed. Nonetheless, he averred, "I can assure you that the United States is determined to reduce the budget deficit and takes the goal of a balanced budget by 1984 very seriously." The Board, however, rebuffed this argument, and the summing up of the meeting noted that it was the "general view" of Directors that U.S. fiscal policy was too loose and would continue to produce large deficits and high real interest rates.[18]

In October 1981, trying to move beyond stalemate on this critical issue, the Managing Director, Jacques de Larosière, sent the U.S. Treasury a note via Erb, asking for a further exchange of views (in effect, an informal supplemental consultation, though without a meeting of the Executive Board) on the need for additional fiscal restraint, including "strengthening revenue." In response, at a series of meetings held around the beginning of December, Sprinkel argued that inflation control was a monetary problem that was essentially independent from fiscal actions. He also informed the Managing Director that the administration did not intend to introduce any revenue-raising measures until after spending had been effectively reduced.[19]

By the time of the 1982 consultation, the Reagan administration was backing away from promises to balance the budget by 1984, owing to recession, high interest rates, and the difficulty of cutting spending. The staff report (issued in July) again called for greater fiscal restraint, in spite of the recession, which had become the worst U.S. downturn since before World War II.[20] A few weeks later, as the Mexican debt crisis was approaching the bursting point, the Managing Director met with the Secretary of the U.S. Treasury, Donald T. Regan, both to discuss that crisis and to express his "very deep concern" about the growing U.S. fiscal deficit.[21] That concern was echoed at the Executive Board meeting that concluded the consultation, which was also notable for the strength of the view that counter cyclical policy no longer had any place in the strategy. The recession in the U.S. economy was attributed to the adverse effects of inflation rather than to a weakening of de-

[17]Minutes of EBM/81/110 (July 31, 1981), p. 9.

[18]Minutes of EBM/81/111 (August 3, 1981), p. 15.

[19]File memorandums by Beza (December 2 and 8, 1981); in IMF/RD Western Hemisphere Department file, "United States—1981" (Accession 84/70, Box 2, Section 74).

[20]"United States—Staff Report for the 1982 Article IV Consultation," SM/82/141 (July 16, 1982), pp. 1–2 and 16.

[21]File memorandum (August 12, 1982) by William B. Dale (Deputy Managing Director); in IMF/RD Deputy Managing Director file "United States—1982" (Accession 88/285, Box 5, Section 250).

mand, and the Board recommended steady policies as the cure for both inflation and recession.[22] The size and growth of the fiscal deficit were viewed as having severely limited the authorities' room for maneuver, and the Keynesian policies that were the most visible legacy of the Fund's most famous founding father were apparently orphaned and disowned. (See, however, the recounting below of the treatment of fiscal policy in the consultations with Japan.)

In 1983, the U.S. administration's viewpoint again shifted slightly. Tax increases were still rejected, but no longer because tax cuts were supposed to produce revenue increases via the Laffer curve. The argument now was that a tax increase would encourage the U.S. Congress to approve commensurately higher spending and therefore would do little to reduce the deficit. The staff rejoined that the deficit could not be reduced by enough through spending cuts alone and argued that the problem would have to be tackled comprehensively.[23] At the Executive Board meeting, Erb agreed with the staff that the deficit was having adverse effects, including appreciation of the dollar and a weakening current account position, but he was not able to offer any new initiatives to reduce it.[24]

By 1984, the Fund surveillance process was beginning to have an impact on the domestic debate in the United States, as critics of administration policy cited the Fund's views to buttress their arguments. For example, Senator William Proxmire of Wisconsin, questioning Assistant Treasury Secretary David C. Mulford during a Senate committee hearing on Argentina, cited a speech by the Managing Director noting the importance of reducing the federal deficit. Proxmire then asked Mulford whether he agreed that the deficit was the number one obstacle to a healthy world economy. Mulford replied that it was an issue, but that "up until now" it had not had an evident negative effect. Later in the hearing, Anthony Solomon, the President of the Federal Reserve Bank of New York, supported the Fund's view that reducing the deficit was important.[25]

The split between the U.S. administration and the Federal Reserve on this issue was noted by the Fund staff during the 1984 consultation. Sensing that the administration's indifference to the deficit was not widely shared even among U.S. officials, the staff drew a more specific and stronger conclusion than before, that "priority needs to be given to a large and rapid cutback of the federal deficit."[26]

[22]The Managing Director summarized this argument as follows: "Most Directors agreed that sustained growth of output and employment would require a lasting reduction of inflation, and they cautioned against a shift to expansionary policies, a shift that would likely cause a setback in the fight against inflation." Minutes of EBM/82/108 (August 16, 1982), p. 29.

[23]"United States—Staff Report for the 1983 Article IV Consultation," SM/83/135 (June 20, 1983), pp. 13 and 21.

[24]Minutes of EBM/83/106 (July 20, 1983), p. 5.

[25]Testimony before the Subcommittee on International Finance and Monetary Policy of the Committee on Banking, Housing, and Urban Affairs, United States Senate (S. Hrg. 98-782, *The Argentinean Debt*; hearings on "Details and Implications of U.S. Government Involvement in both the Argentinean and the Larger Latin American Debt Crises"), May 3, 1984; pp. 40 (Mulford) and 63 (Solomon).

[26]"United States—Staff Report for the 1984 Article IV Consultation," SM/84/162 (July 6, 1984), p. 21.

Perhaps also sensing its isolation on this major issue, the administration began to display what many in the Fund interpreted as an antipathy toward the whole consultation process.

By the time of the Executive Board meeting, on August 3, 1984, the U.S. administration's apparent attitude was producing a palpable frustration and disillusionment of Directors whose economies were being adversely affected by the persistence of the U.S. deficit.[27] The French Executive Director, Bruno de Maulde, led the attack on the United States, expressing his "intense frustration . . . because the U.S. administration appeared to pay no attention to the recommendations of the Board." He concluded that surveillance with the United States had become a "mockery, and consequently that the United States lacked credibility in propounding the idea that the exercise of surveillance by the Fund was the cornerstone of the smooth functioning of the international monetary system."

De Maulde's position, though a rare display of intemperance in these meetings, was supported by several other chairs. For example, R.N. Malhotra (India) observed that "unless the major economies of the world were prepared to play by the rules of the game, he did not see how the surveillance function of the Fund could be effectively discharged." Mary Bush, then the Acting Executive Director for the United States, reportedly remained stoic throughout this discussion, without even taking notes. When it was over, she responded only with a brief assertion that U.S. officials did pay attention to "constructive criticism from abroad" and that they did value the surveillance process. More substantively, however, Bush's opening statement at the meeting revealed a hardening attitude by the Reagan administration against pressures to reduce the deficit: "the weight of evidence," she argued, "suggests that there is no relationship between U.S. fiscal deficits and real interest rates" and that the deficit was not "inhibiting capital formation."

The American arguments on this point were soundly rejected and even mocked around the table. Gerhard Laske (Germany) concluded that the U.S. "authorities' arguments, which questioned the validity of the causal relationship between fiscal deficits and interest rates, were an interesting confirmation of his suspicion that it was permissible in economics to make the argument fit the desired theoretical proof." As the meeting progressed, Polak was concerned enough about the widening gulf between the United States and the rest of the world that he called for a supplemental consultation discussion to take place within six months.[28]

In December 1984, the Managing Director followed up on Polak's suggestion by meeting again with Secretary Regan. The administration, just reelected, was in the midst of preparing the budget for the next fiscal year, and the Managing Director

[27]The Managing Director's summing up of the discussion emphasized that the concern was that the surveillance process was being subverted, not just that there was a disagreement over policies: "Several Executive Directors were concerned that the recommendations of the Executive Board, which were part of the surveillance process and its effectiveness, did not seem to be reflected in U.S. economic policy in the fiscal area."

[28]On the last three paragraphs, see minutes of EBM/84/120 (August 3, 1984), pp. 9–10 (Bush), 13 (de Maulde), and 35 (Laske); and EBM/84/121 (same date), pp. 5 (Polak), 14 (Malhotra), 28 (Bush), and 30 (summing up).

again took the occasion to make the case for strong action. He conveyed to Regan the Fund's view that the current account deficit was unsustainable and that it should be reduced in an orderly fashion through fiscal action; the alternative, he argued, would be a disruptive depreciation of the dollar that would be difficult to control.[29]

The U.S. position began to shift in 1985, following a shuffling of key personnel in which James A. Baker III replaced Regan as Secretary of the Treasury and Richard G. Darman took over as Deputy Secretary.[30] That spring, however, witnessed a last and most difficult manifestation of the strains that had developed between the U.S. administration and the international community.

In response to the U.S. arguments during the 1984 consultation that there was no relationship between the fiscal deficit and real interest rates, the Research Department in the Fund had undertaken an extensive study of the issue as part of the regular WEO exercise. The results of the study were circulated to the Executive Board in March 1985 as part of the standard documentation for the WEO (under the modest heading of "Supplementary Note 7," belying its length of 140 single-spaced pages: a paper that covered all of the major channels by which shifts in fiscal policy might affect both the domestic and international economies and that included five detailed appendixes on empirical tests). The paper concluded, on the basis of an extensive examination of the empirical literature, that the conventional wisdom was correct: a cut in the U.S. fiscal deficit, whether from spending cuts or tax increases, would be expected to lead to a predictable decline in real interest rates.[31]

When the WEO was published in April, Executive Directors were surprised, and several expressed disappointment, to discover that Supplementary Note 7 had not been included. Nigel Wicks (United Kingdom) and Bruno de Maulde (France), after determining that the deletion had been made at the request of the U.S. authorities, called for an exceptional discussion in the Board, which was held on May 3.[32] Most speakers at the meeting supported their call for publication; they and the Managing Director noted that it could be published separately as an Occasional Paper or as an article in the IMF's academic journal, *Staff Papers*. But Bush—supported by four other Directors—was adamant, claiming that the study was "an outgrowth" of the U.S. consultation, objecting to publication on the

[29]Based on the Managing Director's draft notes for the meeting; in his file, "EXR 1985–1986" (IMF/RD, Accession 88/18, Box 6, Section 485).

[30]At the Treasury, Darman replaced Richard T. McNamar as Deputy Secretary, but he also assumed many of the international responsibilities formerly taken on by the former Under Secretary, Beryl Sprinkel; see footnote 12, p, 140.

[31]The essential point demonstrated in the paper was that most of the studies purporting to show weak or absent effects had failed to control adequately for the sources of the shift in the deficit, so that they treated changes arising endogenously from the business cycle as if they were similar to changes arising from direct policy actions. "World Economic Outlook: Supplementary Note 7—Domestic and International Effects of the U.S. Fiscal Position," SM/85/76 (March 11, 1985); the conclusion is stated on p. 36.

[32]Memorandum to the Managing Director (May 1, 1985); in IMF/RD (Historian's files).

grounds that it dealt with "a sensitive policy issue," and asserting that the United States would nonetheless have been willing to see it published if other Directors had supported a recent U.S. request for giving greater publicity to consultation reports. Publication was thus blocked, despite a further plea from the Managing Director for reconsideration.[33]

Relations improved markedly after that episode, but the fiscal deficit continued to be a major source of dispute between the Fund and its largest member country. At the conclusion of the 1985 consultation discussions in late June, the Managing Director met with both Baker and the Chairman of the Federal Reserve System, Paul A. Volcker, to discuss the Fund's main policy recommendations and to stress again the importance of taking wide-ranging measures to reduce the deficit. This appears to have been the first time since 1971 that the U.S. consultation had concluded with a ministerial-level meeting, which then became standard practice. In welcoming this development, Polak hoped that it would "help steer U.S. economic policy toward a less ominous course."[34]

The ominousness of that course was not easy to determine. Far from being balanced by FY 1984 as originally targeted by the president four years earlier, the fiscal deficit had risen from 2¾ percent of GNP in FY 1981 to 6½ percent in FY 1983 before dropping back to 5¼ percent. In the judgment of the Fund staff and the Managing Director, even if the deficit had peaked in relation to output, it remained extraordinarily high and was still the main policy problem facing the United States. Furthermore, the administration continued to insist that no causal link existed between high deficits and high real interest rates, and that debt and tax financing were essentially equivalent ("Ricardian equivalence"; see Chapter 1), a view that the staff "could not accept."[35] At the Executive Board meeting in early August 1985, the United States remained isolated in its expressed indifference to the consequences of the deficit, as Directors "unequivocally" agreed that deficit reduction should be the top priority for the U.S. administration.[36]

Between the 1985 and 1986 consultations, the U.S. Congress passed the Gramm-Rudman-Hollings (generally known more simply as Gramm-Rudman) legislation, mandating a gradual reduction in the fiscal deficit until it was balanced in FY 1991. The actual deficit, however, rose in FY 1986, owing to rising military spending and the passage of additional tax cuts. The administration nonetheless projected that its FY 1987 budget would be consistent with the Gramm-Rudman target, and it presented a plan to balance the budget by FY 1991.

[33]Minutes of EBM/85/69 (May 3, 1985). Also see memorandum from Kafka to the Managing Director (May 2, 1985); in IMF/CF, "WEO, Fund Reviews—March 21, 1985–December 1985" (S 321).

[34]Minutes of EBM/85/121, p. 9. As Director of the Research Department, Polak had been the mission chief for several U.S. consultations in the 1960s and early 1970s. He thus had first-hand experience of the significance of the willingness of the Secretary of the Treasury to meet with the mission.

[35]"United States—Staff Report for the 1985 Article IV Consultation," SM/85/199 (July 8, 1985), p. 12. The staff also examined this issue in Appendix I of the WEO document cited in footnote 31, above.

[36]Chairman's summing up, minutes of EBM/85/121 (August 5, 1985), p. 29.

In the consultation discussions in the spring of 1986, the staff argued that the FY 1987 budget would not meet the target, because it was predicated on an unrealistically optimistic growth forecast. They also noted that to balance the budget by FY 1991 would require up to $150 billion in additional spending cuts that had not yet been identified.[37] When the Managing Director met with Secretary Baker on June 24 to conclude the discussions, he again stressed that revenue measures would have to be taken: measures that, as Baker reminded him, the president opposed on a deep philosophical level.[38]

At the 1986 Board meeting on the United States, the usual differences of view on fiscal issues persisted (focusing now on the optimistic growth forecasts that the administration obviously was adopting only to meet the Gramm-Rudman targets ex ante).[39] Even so, the tension that had characterized the previous two meetings was now gone. As the Managing Director summarized the meeting, "Directors warmly commended the U.S. authorities for the open and thorough dialogue that had marked the 1986 consultation discussions . . . [and] welcomed the significant improvements in policy formulation and performance since the last consultation."[40]

Although the Gramm-Rudman law had little if any discernible impact on the deficit, it did serve to make the surveillance process more transparent and objective. Beginning in 1986, the staff made its own medium-term projections of the deficit, based on the assumption that current policies would continue and on what the staff regarded as a more realistic forecast of GNP growth. As shown in Figure 3.1, each year the U.S. administration presented a deficit-reduction plan that closely paralleled the Gramm-Rudman path;[41] each year the staff countered with a projection showing that unless further policy measures were specified and carried out and unless the administration's optimistic assumptions for economic growth were realized, the deficit would not fall significantly at all; and the outcome turned out to be consistently worse even than the staff projections.

In the 1987 consultations, treasury officials shared the staff's disappointment and acknowledged that Gramm-Rudman had led to an increased reliance on what commentators were calling "smoke and mirrors": accounting gimmicks and temporary actions such as asset sales.[42] To conclude the discussions, the new Manag-

[37]"United States—Staff Report for the 1986 Article IV Consultation," SM/86/167 (July 7, 1986), pp. 7–13.

[38]Background note sent to Secretary Baker in advance of the meeting, and minutes of the meeting; in IMF/RD Western Hemisphere Department file "United States: 1987 Article IV Consultation" (Accession 1996-0012, Box 4, Section 408).

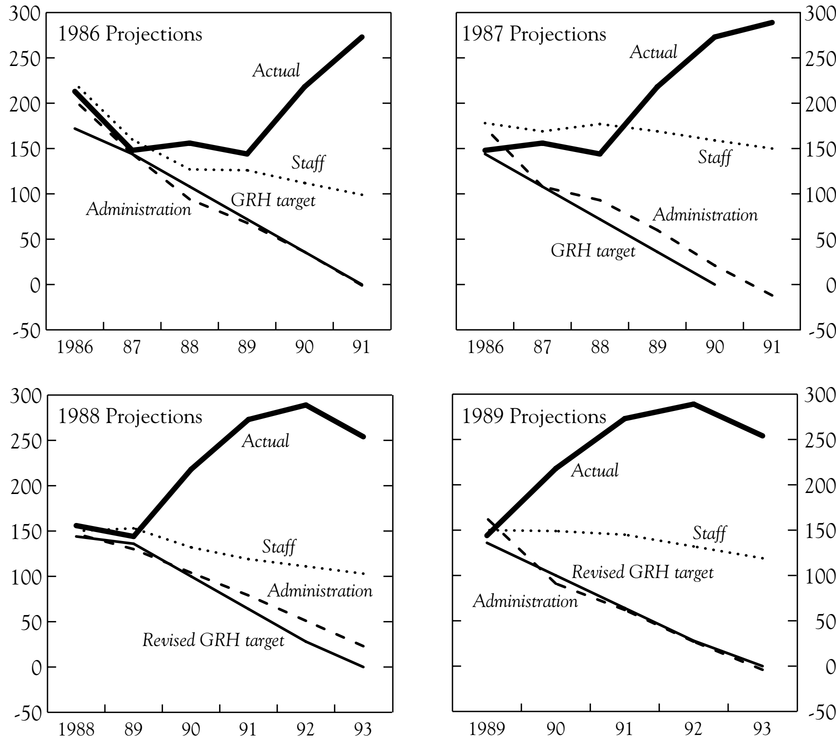
[39]The legislation required the administration to submit a budget with a deficit no higher than the specified ceiling, based on the administration's economic assumptions; no ceiling was imposed on the outcome. If economic growth fell short of the assumptions, then the deficit would exceed the target for that fiscal year, and the ex ante reduction required in the following year would be that much larger.

[40]Minutes of EBM/86/132 (August 6, 1986), p. 59.

[41]By 1988, the Gramm-Rudman legislation had been amended so as to postpone the day of reckoning to FY 1993 and to raise the intervening ceilings commensurately.

[42]"United States—Staff Report for the 1987 Article IV Consultation," SM/87/179 (July 23, 1987), p. 11.

Figure 3.1. United States: Projections of the Fiscal Deficit
(In billions of U.S. dollars)



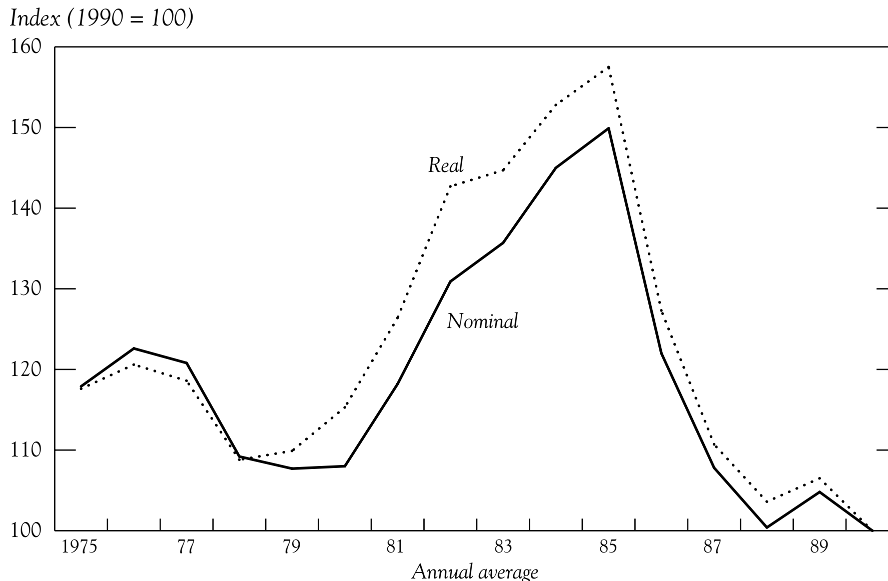
Note: GRH target = Gramm-Rudman-Hollings target.

ing Director, Michel Camdessus, met with Baker on June 3 and took up where his predecessor had left off in calling for tough additional measures to meet the Gramm-Rudman targets.

In 1988, the staff gave another turn of the screw to their perennial call for fiscal discipline by raising concerns over the prospect that the social security trust fund would shift into deficit after the year 2010. The staff report argued that the U.S. administration should prepare now to avoid major financial strains in the next century, and it even took the position—rejected as unrealistic by the administration—that the non–social security portion of the budget should be balanced and that the social security budget should show a surplus sufficient to fund the anticipated post-2010 deficits. In other words, in the staff's view, balancing the budget was not enough; the unified budget should show a substantial surplus. Executive Directors were more cautious on this score, but the Board did note that fiscal adjustment should be "front-loaded" and that the Gramm-Rudman targets "should be regarded as a minimal requirement."[43]

[43]Chairman's summing up; minutes of EBM/88/131 (August 29, 1988), p. 11.

Figure 3.2. U.S. Effective Exchange Rate, 1975–90



The final consultation of the decade found these same themes still being debated. By this time, several Directors were getting concerned that the staff might be overstating the case by calling for a substantial fiscal surplus at a time when getting the deficit under control would be a major achievement. What brought everyone together was agreement that the Gramm-Rudman legislation had perverted the budget process in the United States and that a lasting solution would require a new and more serious approach in the years to come.

Exchange Rate Policy

A second overriding theme in the U.S. consultations during the 1980s was the desirability of stabilizing the exchange rate of the dollar.[44] From the low point in November 1978 that triggered the events described at the beginning of this section, the dollar strengthened through 1979 and then weakened in 1980 before beginning a four-year sustained appreciation against all other major currencies (Figure 3.2). Although the appreciation was substantially reversed in 1985 and 1986, concerns continued to be raised about the appropriateness of the level and about

[44]See Destler and Henning (1989), Frankel (1994), and Henning (1994), Chapter 6, for overviews of U.S. exchange rate policy in the 1980s. For the sake of exposition, the phrase "the exchange rate of the dollar" is used here to refer to the general tendency regarding exchange rates between the U.S. dollar and other major currencies. During the major 1980–87 cycle of the dollar, rates against the major European currencies and the Japanese yen tended to move in the same direction most of the time, and the nominal and real changes in the effective (weighted-average) rates tended to be quite similar.

whether more systemic measures should be taken to stabilize the rate. Nonetheless, differences between the U.S. authorities and the Fund were surprisingly mild, especially compared with the debates that raged over the fiscal policies that had largely produced the major swings in the dollar's exchange value.

Shortly before the 1981 consultations, Beryl Sprinkel announced that the United States would no longer intervene in foreign exchange markets except "when necessary to counter conditions of disorder in the market" (Sprinkel, 1981, p. 18). Although this position was nominally the same as that of the preceding administration, Sprinkel made it clear that it was an almost total pullback from the activist intervention policy of 1979–80 (see above, p. 139).[45] The staff report on the consultation discussions supported this position: "It is readily apparent that a substantial degree of exchange rate flexibility needs to be maintained in present circumstances . . . and the staff agrees with the U.S. authorities that the information obtained from exchange markets should be used as a guide to [domestic] policy."[46]

The Executive Directors from Germany and Japan attacked the nonintervention policy at the Board meeting at the end of July. In Gerhard Laske's view, "the notion of 'disorderly markets' should . . . not be interpreted too narrowly. . . . Experience has shown that markets are frequently motivated by unrealistic expectations, and that in such circumstances intervention in close coordination with the authorities of the [other] major countries is not out of place."[47] Speaking for the staff, however, C. David Finch (Director of the Exchange and Trade Relations Department, ETR) justified the staff support of nonintervention on three grounds: judging the equilibrium level of the exchange rate was hard, intervention often failed to work because it was not backed up by appropriate domestic policies, and in any event the U.S. administration's intention to pursue stable domestic policies might well suffice to stabilize the dollar. The Chairman's summing up of the discussion noted the concerns expressed by "some Directors," but it avoided drawing a general conclusion on behalf of the Board.[48]

By 1982, the appreciation of the dollar was beginning to be the focus of attention, but the staff continued to accept the U.S. administration's laissez-faire policy. In the staff's view, the appreciation—which was not yet generating a current account deficit—resulted partly from anticipated lower inflation and partly from safe-haven effects. At the Executive Board meeting, Jacques Polak characterized

[45]As reported in U.S. Council of Economic Advisers (1982), p. 190, the U.S. authorities sold $2.6 billion (net) in foreign exchange to support the value of the dollar from September 1977 to March 1978 and purchased $2.1 billion net over the next six months. Then, in the space of 28 months after the announcement of the dollar support package in November 1978, they purchased $11.9 billion net. The shift in strategy in 1981 was seen as a reaction to that large net purchase, which was viewed by the new administration as of "massive proportions by historical U.S. standards (although not by the more activist standards of many foreign governments)." The Council report (p. 173) clarified the meaning of the policy shift by adding "severe" before "disorder" in describing conditions that might be countered by intervention.

[46]"United States—Staff Report for the 1981 Article IV Consultation," SM/81/157 (July 14, 1981), p. 19.

[47]Minutes of EBM/81/109 (7/31/81), p. 19.

[48]Minutes of EBM/81/111 (August 3, 1981), pp. 9 (Finch) and 16 (summing up).

the official view as "the market can do no wrong." He rejected that view, criticized the staff for accepting it, and asked that the staff be more explicit in assessing the level of the exchange rate.[49] The summing up of the meeting was again cautious about drawing a general conclusion, except to note that "Directors were encouraged by the decision of the major industrial countries to conduct a study of the effects of intervention . . . to clarify some of the difficult issues. . . ."[50]

The staff position on U.S. exchange rate policy shifted in 1983, as the dollar's unabated appreciation began to look less benign. As one argument for deficit reduction, the staff report suggested that fiscal contraction would be "conducive to an orderly correction in the exchange value of the U.S. dollar." The staff also urged the authorities to participate in coordinated intervention, but only to counter "disorderly market conditions," not to try to influence the level.[51] Similarly, the summing up of the meeting reflected the growing consensus "that participation by the United States in coordinated intervention with other countries could, under appropriate circumstances, serve a useful purpose."[52] U.S. treasury officials, however, believed that the rising value of the dollar reflected a growing worldwide confidence in the strength of the U.S. economy, and that any feasible level of intervention would be swamped by the vastly larger resources of the financial markets.

The following year, the staff raised the specter of nonsustainability of the current account deficit that had now emerged. It could not be financed over the medium term, the report concluded, without either higher interest rates or a dollar depreciation. Executive Directors generally agreed with that assessment, but the U.S. authorities expressed indifference to the problem.[53] The discussion on this issue at the Board meeting was nonetheless muted, as the staff acknowledged that empirical models (including their own) provided no convincing explanation for why the dollar was continuing to appreciate.[54]

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[49]Minutes of EBM/82/107 (August 16, 1982), p. 15.

[50]Minutes of EBM/82/108 (August 16, 1982), p. 30. The G-7 intervention study led to the 1983 Jurgensen Report (see Chapter 4, p. 197), which concluded that official intervention can have beneficial effects in the short run but that longer-run stability hinges on more fundamental policies.

[51]The U.S. authorities did intervene on three occasions in 1983, coordinated with Germany and Japan, but this practice remained exceptional. See Dominguez and Frankel (1993). The staff appraisal is in "United States—Staff Report for the 1983 Article IV Consultation," SM/83/135 (June 20, 1983), pp. 21–22. Intervention in 1983 is described in "United States—Staff Report for the 1984 Article IV Consultation," SM/84/162 (July 6, 1984), p. 17.

[52]Minutes of EBM/83/107 (July 20, 1983), p. 25.

[53]See "United States—Staff Report for the 1984 Article IV Consultation," SM/84/162 (July 6, 1984), and the minutes of EBM/84/120–121 (August 3, 1984).

[54]The then-prevailing empirical model for the expected path of the exchange rate hypothesized that the rate would move away from the long-run equilibrium level only in response to unanticipated changes in relative conditions such as interest rate differentials (see Chapter 1, section on "unstable exchange rates"). By mid-1984, these "fundamentals" were moving against the dollar and theoretically should have brought on a depreciation. Although portfolio balance models with more realistic and flexible expectations mechanisms, such as Boughton (1984), generated predictions consistent with a continued appreciation of the dollar at least through the third quarter of 1984, those models had little impact on the internal debate at the time.

By the time of the 1985 consultation, the dollar was beginning to depreciate, at least partly because of a return to more active and coordinated official intervention. Although the Executive Board meeting was held just six weeks before the Plaza meeting (see Chapter 4)—at a time when the Group of Five (G-5) countries were already planning a major initiative to ensure that the depreciation would be sustained—no serious concerns about the dollar were expressed, except indirectly through the continuing call for fiscal deficit reduction.[55]

The cautious and tentative approach to exchange rate policy continued through 1986, as the analysis of the persistent external deficit of the United States was hampered by the lack of a clear theoretical and empirical model of the relationship between exchange rates and current account positions. A staff study for the WEO prepared around that time (Boughton and others, 1986) argued that because these two variables were both endogenous, a depreciation might or might not be accompanied by a strengthening of the current account position. Nonetheless, the 1986 staff report, issued in early July, concluded that "a further downward adjustment in the value of the dollar may well be needed in order to achieve a sustainable current account position."[56]

In February 1987, officials from the major industrial countries, gathered at the Louvre in Paris, agreed that exchange rates between the dollar and other key currencies were at appropriate levels and that they would aim to maintain those rates (see Chapter 4). Within a few months, however, doubts were being raised by outside analysts about the appropriateness of the Louvre-agreed exchange rates. In that view, a further depreciation was needed to keep the improvement in the U.S. current account balance from stalling.[57] The staff report on the 1987 U.S. consultations supported both the Louvre process and the outcome, despite some skepticism by the staff as to whether the current account deficit could be reduced sufficiently without further depreciation. The report concluded that the U.S. authorities were correct in arguing that "in present circumstances a further substantial depreciation of the dollar could be counterproductive as it could retard the correction of external imbalances by depressing economic growth abroad."[58]

At the Executive Board meeting concluding the consultations in August, all the other industrial countries urged the U.S. authorities to maintain the pattern of exchange rates established at the Louvre. Guenter Grosche, in a statement that was notable because Germany had not been the biggest supporter of the Louvre process, declared that his authorities were "deeply satisfied" with the accord and the resulting pattern of exchange rates. Directors from developing countries, however, were more worried; although in principle exchange rates could be stabilized by coordinating interest rates at low levels, in practice they were being stabilized

[55]Minutes of EBM/85/120–121 (August 5, 1985).

[56]"United States—Staff Report for the 1986 Article IV Consultation," SM/86/167 (July 7, 1986), p. 27.

[57]Martin Feldstein and Paul Krugman were leading proponents of this view; see Feldstein (1988) and Krugman (1988).

[58]"United States—Staff Report for the 1987 Article IV Consultation," SM/87/179 (July 23, 1987), p. 19; on the staff's skepticism, see pp. 24–25.

by keeping rates high. Alvaro Donoso (Chile) pointed out that the Federal Reserve was tightening U.S. monetary policy to keep the dollar from depreciating, and the consequent high level of interest rates was depressing world growth. He, Arjun K. Sengupta (India), and others accordingly called for a further depreciation of the dollar against other key currencies.[59]

During the 1988 consultation, the U.S. authorities signaled a further shift in their policy regarding official intervention, stating that the Louvre experience had shown "that in suitable circumstances it could be more helpful than they had previously thought."[60] Furthermore, attitudes had shifted all around toward more sympathy for allowing the dollar to depreciate, partly because the exchange rate had appreciated in recent months in response to the government's inability to reduce the fiscal deficit sufficiently, and partly because the dangers identified in 1987 appeared more serious now. The summing up for the Executive Board meeting in late August concluded, with subtle asymmetry, that it would be undesirable to see a "further appreciation" or a "sharp depreciation" (implying that either the continuation of the present rate or an orderly depreciation would be acceptable outcomes).[61]

Finally, in 1989, while there was little overt discussion of the exchange rate, the related issue concerned whether the United States or "the surplus countries" should bear the primary burden of adjustment. The U.S. position was that those countries (a euphemism for Germany and Japan, in particular) should take measures to stimulate their economies in the interest of reducing global payments imbalances and strengthening world growth. At the Executive Board meeting, most Directors were critical of that view and argued (along with the staff) that deficit reduction in the United States was still the top priority.

Special Studies

Although macroeconomic and exchange rate policies were the natural focus of all of the consultation discussions in the 1980s, international interest in structural issues affecting the U.S. economy was also widespread. Accordingly, the staff devoted substantial and increasing effort to special studies undertaken as part of the consultation process. The number of studies circulated as background papers for the staff report on the United States more than doubled, from 8 in 1979 to 17 a decade later. The 1989 collection, which totaled 350 single-spaced pages, covered topics ranging from macroeconomic issues such as the outlook for the current account balance and the operation of the Gramm-Rudman legislation to microeconomic issues such as the crisis in the savings and loan industry and the performance of the U.S. health care industry.[62] Although many of the special studies were

[59]See minutes of EBM/87/124 (August 28, 1987), pp. 39 (Grosche) and 51–52 (Donoso); and EBM/87/125, pp. 3–4 (Sengupta).

[60]"United States—Staff Report for the 1988 Article IV Consultation," SM/88/160 (July 26, 1988), p. 14.

[61]Minutes of EBM/88/131 (August 29, 1988), p. 12.

[62]"United States—Recent Economic Developments," SM/89/176, Sups. 1 and 2 (August 18, 1989).

compilations of existing technical and factual material, many others were innovative theoretical and empirical analyses. Several staff studies were published separately as individual articles, and a selected collection was later published by the Fund.[63]

Japan

The IMF's consultations with Japan—the world's second-largest economy—were framed by strong expressions of admiration and support for the authorities' conduct of growth-oriented and financially stable policies. The staff report for the 1982 consultations, for example, paid "high tribute . . . to the skill and success that are evident in the management of the economy."[64] The 1985 report paid similar homage and commended "the willingness of the Japanese authorities to take account of views expressed in international fora."[65] Two years later, when the Managing Director met with the minister of finance to conclude the 1987 consultation discussions, his main recommendation was that the authorities should continue on their present course. Nonetheless, the French Executive Director in 1985, Bruno de Maulde, may have best captured the spirit of the Fund's position in stating that "Japan's performance and economic policies deserve admiration, but they also create an enormous problem for the rest of the world."[66] The challenge for the Fund in conducting surveillance with Japan throughout the 1980s was to strike the right balance between tribute and tribulation.

During the second round of major oil price increases, in 1979–80, Japan experienced two years of current account deficits; but as the 1980s unfolded, Japan became the world's largest creditor country, partly by conserving on fuel imports but more importantly through a remarkable growth in manufactured exports.[67] As Japan's major trading partners, especially in North America and western Europe, became increasingly edgy about the effects of imports from Japan on their economies, a key issue in the annual consultations became the extent to which the Fund should encourage the authorities to stimulate the economy to moderate the external imbalance. Related to this issue were concerns over Japan's slowness to open its trade and financial systems fully.

[63]See the papers in Horiguchi and others (1992), such as the studies by Krister Andersson on the effects of tax policy on housing investment, by Charles Adams and David Coe on measurement of potential output and the natural rate of unemployment, by Sharmini Coorey on the determinants of real interest rates, and by Ellen Nedde on modeling the external current account. Beginning in 1995, the Fund began publishing background papers in full and as a matter of course.

[64]"Japan—Staff Report for the 1982 Article IV Consultation," SM/83/36 (February 18, 1983), p. 23.

[65]"Japan—Staff Report for the 1985 Article IV Consultation," SM/86/24 (February 10, 1986), p. 29.

[66]Minutes of EBM/85/33 (March 4, 1985), p. 29.

[67]Japan had one of the highest national saving rates in the world at that time, but the saving rate did not increase during the 1980s and thus did not contribute to the shift toward external surplus. See Aghevli and others (1990).

The mission chief for the first few years of Article IV consultations with Japan was W. John R. Woodley (Deputy Director of the Asian Department), who retired in 1980. Tun Thin (Director of the Department) took over for the mission of November 1980, after which the consultations were headed by his Deputy, Prabhakar R. Narvekar. Narvekar succeeded Tun Thin as Director in 1986 and continued to lead the missions to Tokyo until his retirement from the staff in 1991. On the Japanese side, the discussion team was normally headed by the Vice Minister of Finance for International Affairs and by the Governor of the Bank of Japan. In December 1987, the Managing Director (Camdessus) and his Economic Counsellor (Jacob A. Frenkel) joined the mission in its closing days for meetings with the minister of finance (Noboru Takeshita) and the governor (Satoshi Sumita). That was the first such high-level visit in the context of the Article IV consultations with Japan, but—in contrast to the U.S. discussions—it did not become standard practice.[68]

Fiscal Policy

Throughout much of the period of this History, the IMF staff and the Japanese authorities took markedly different views on how fiscal policy should be conducted. They did learn from each other, and they gradually moved toward more central positions. Even so, the debates over Japanese fiscal policy in the late 1970s and 1980s would resurface in similar form after the financial crisis of the late 1990s.

By 1979 Japan had accumulated a substantial stock of public sector debt from the large fiscal (and external) deficits experienced throughout the 1970s. In view of the economic growth that Japan had achieved by that time, the authorities' top priority was to establish a greater degree of fiscal discipline. Accordingly, the government made a commitment in 1980 to reduce borrowing gradually and attain a zero deficit for current (i.e., noninvestment) spending by FY 1985 (ending March 31, 1985).

The staff agreed with the general goal of reducing the fiscal deficit. Nevertheless, they believed that it was being pursued too vigorously (i.e., that the authorities were trying to get there too fast) and with insufficient flexibility (i.e., that there was also a need for occasional recourse to expansion to counter weakness in domestic demand). Part of the basis for this argument was the belief that reducing the U.S. fiscal deficit was a much higher priority objective, from any perspective. If both countries attempted to balance their budgets simultaneously, world economic demand would contract dramatically. Moreover, if Japan acted aggressively to reduce its deficit while the U.S. government failed to control its own budget, the current account balances of Japan and the United States would become un-

[68]An additional purpose of the Managing Director's participation was to reach agreement on Japan's contribution to the Enhanced Structural Adjustment Facility; see Chapter 14. Apart from the U.S. consultations, this appears to have been the only instance in the 1980s in which the Managing Director participated in an Article IV consultation with the authorities.

sustainably large. In addition, the staff regarded Japan's fiscal deficit (6 percent of GNP in 1979) as sustainable as long as it was gradually reduced, since it was offset by a very high rate of household saving.[69]

On at least two occasions in the first quarter of 1979, Japanese officials—including the Vice Minister of Finance, Takehiro Sagami, and the governor of the Bank of Japan, Teiichiro Morinaga—visited the Fund to meet with the Managing Director. On both occasions, and again on a visit to Tokyo in early May, de Larosière suggested to them that they could be more open to the idea of fiscal stimulus. Taking a line similar to the one then being pushed to Japan by the U.S. government, he noted that a strong effort to balance the budget was likely to lead to slow growth and a persistent current account surplus, both of which would be difficult to sustain. The Japanese authorities were troubled by this criticism, but the differences in view were soon overshadowed by the sharp rise in oil prices that began around the middle of the year. Faced with a potentially large depressing effect on output, the authorities then had little choice but to allow the expansionary fiscal policy to continue.[70]

When Woodley's mission arrived in Tokyo in November 1979, the fiscal expansion was taking hold, and the authorities were preparing to pull back sharply. The staff supported that general policy, but they urged the authorities to be prepared again to take countercyclical action if necessary. At the Executive Board meeting that concluded the consultation, most Directors who addressed the fiscal issue sided with the staff, except for Robert J. Whitelaw (Australia), who criticized the staff position and urged the authorities to aim for a rapid restoration of fiscal discipline.[71]

A comparison of the Fund's advice on fiscal policy to the United States and to Japan at the end of the 1970s reveals an interesting contrast and suggests a lack of analytical consistency. Both countries were trying to reduce their fiscal deficits, and both were trying to establish and adhere to a medium-term goal and to reduce the use of tax and spending policies for countercyclical stabilization. In discussions with the United States, the Fund strongly endorsed those goals and pushed the authorities to pursue them more vigorously. For Japan, the Fund's advice was tilted more toward moderation and flexibility. On the question of how aggressively to pursue deficit reduction, the contrast reflected a judgment that the U.S. fiscal problem was far more severe than Japan's, both from a global vantage point and in relation to the aggregate level of national saving. The contrast in advice on the use of fiscal policy for countercyclical purposes is more difficult to explain, especially since the Japanese economy had shown a much greater intrinsic resilience in the face of negative shocks than had the United States. It may be noted, however, that

[69]Statement by Woodley at EBM/80/26 (February 20, 1980), p. 7.

[70]See memorandum from Woodley to management (January 15, 1979) and file memorandum by Woodley (March 12); in IMF/RD Asian Department Immediate Office file "Japan Correspondence, January–June 1979" (Accession 82/37, Box 3, Section 139). Additional information is from background interviews with participants.

[71]Minutes of EBM/80/25 (February 20, 1980), pp. 22–23.

the wisdom of fiscal stabilization was being hotly debated throughout the economics profession at the time, and both views were well within the broad mainstream of the day.

In 1980, the Japanese economy did weaken as expected, though output growth was still high by international standards (3½ percent, down from 5½ percent in 1979), as a sharp growth in real exports compensated for the withdrawal of fiscal stimulus. The staff continued to urge the authorities to be prepared to ease up on fiscal restraint if necessary for countercyclical purposes. At the Executive Board meeting in February 1981, Tun Thin made a twofold case. First, if output growth did weaken further, fiscal stimulus could be introduced without sacrificing the medium-term goal, by "front-loading" planned investment expenditures. Second, fiscal discipline was less of a priority in Japan than in other countries because of the high level of private sector saving. What mattered was the overall saving rate, not that of any particular sector.[72] The Japanese authorities did not strongly dispute the first point, but—as noted by their Executive Director, Teruo Hirao—they did not accept that high private saving justified high public dissaving.[73]

By late 1981, when the next consultation discussions took place, the staff was more convinced than ever that the authorities were being too optimistic about output growth and that they should be prepared to ease up on fiscal adjustment if necessary. Their case was now a little stronger, as growth had weakened during the year (see Figure 3.3), so Narvekar (who had taken over from Tun Thin in heading this mission) suggested that the authorities delay their timetable for eliminating deficit-financing bonds by 1985. More generally, the staff called for Japan to strengthen domestic investment, so as not to have to curtail national saving as the means of reducing the external surplus. At the Executive Board meeting, in February 1982, the Managing Director lent his voice to this theme, arguing that fiscal expansion was the right policy for domestic reasons (with high overall saving, Japan need not worry about "crowding out" private investment) as well as international (since it would raise interest rates and thereby strengthen the yen). Although most Executive Directors broadly agreed with that line of reasoning, Richard Erb (speaking for the United States) leaned more toward the Japanese position.[74]

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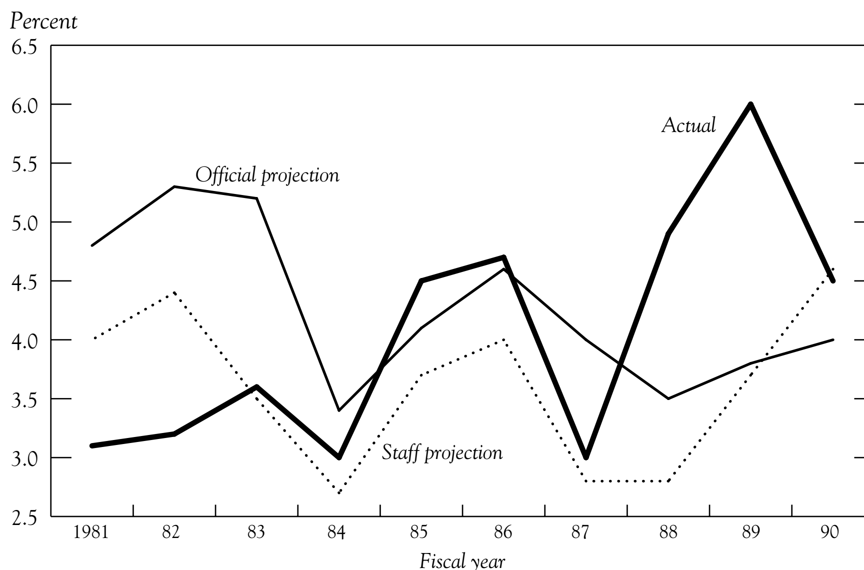
[72]Minutes of EBM/81/20 (February 11, 1981), p. 35.

[73]Minutes of EBM/81/21 (February 11, 1981), p. 5.

[74]Minutes of EBM/82/18 (February 17, 1982), pp. 4 (Narvekar) and 18 (Erb). The summing up of the discussion (pp. 19–20) sought to reflect carefully the balance of opinion on the Board as well as the sensitivities of the national authorities:

> While Directors were sympathetic to the effort to curtail the budget deficit in the medium term, many Directors wondered whether this objective would be appropriate if the expected autonomous recovery of domestic demand did not occur and if further relaxation of monetary conditions continued to be constrained by high interest rates abroad. Most Directors, thus, advocated some shift in the mix of monetary and fiscal policies, but a number of Directors added that the feasibility of such a shift would depend in part on the implementation of a more appropriate policy mix in other countries. The view was also expressed in the Board that it would be appropriate to maintain the firm commitment to a rapid reduction of the budget deficit as a medium-term objective.

Figure 3.3. Japan: Actual and Projected GNP Growth, 1981–90
(Fiscal years ending March 31)



Note: Forecasts were made 3–4 months before the start of the fiscal year.

The landscape shifted just as the 1982 consultations were getting under way in Tokyo, when Yasuhiro Nakasone succeeded Zenko Suzuki as prime minister. Before that, fiscal policy had been eased following (though not necessarily in response to) the Fund's recommendations, but Nakasone shifted quickly to what the staff report called a "striking" austerity program. The goal of balancing the current budget by the mid-1980s was, however, dropped, as the earlier optimism in the official forecasts was replaced by a new realism.[75] The staff welcomed that development and again called for continued flexibility. They got European support at the Executive Board (from Gerhard Laske of Germany, Jacques Polak of the Netherlands, John Tvedt of Norway, and others), while the two North American Directors (Erb plus George W.K. Pickering, Temporary Alternate from Canada) continued to warn of the dangers of deviating from longer-term goals. Tse Chun Chang (China) worried that the staff was erring by, in effect, advising countries to adopt the U.S. policy mix (loose fiscal and tight monetary policy); he called for a more multilateral approach to surveillance that would take international interactions more heavily into account.[76]

[75]See Figure 3.3, noting that the forecast made at the time of the 1982 consultation was for FY 1984, the fiscal year starting a few months after the discussions.

[76]Minutes of EBM/83/48 and 49 (March 18, 1983).

Staff and official views came closer together in 1983. The authorities acknowledged that balancing the current budget by 1985 was no longer a realistic goal, and they set a new target, which the staff readily supported: to balance the current budget by FY 1991 (a goal that they did meet). On the Fund side, Narvekar acknowledged that the staff had "gained a better understanding" of the authorities' perspective on fiscal policy, though they continued to believe that the optimum strategy was to approach the medium-term goal flexibly. Most Executive Directors, however, continued to call explicitly for a more expansionary fiscal policy.[77]

The theoretical dimension of the debate over fiscal policy was made more explicit in 1984, as the staff drew a clear causal linkage from fiscal tightening to the ongoing rise in the current account surplus. The authorities rejected that argument, asserting that the national accounts identity had no causal implications and that a relaxation of fiscal policy would mainly crowd out private sector investment.[78] In the authorities' view, the external surplus resulted from "stable or falling commodity prices, rapid growth in the United States, and the strength of the dollar."[79] At the Executive Board meeting in March 1985, the United States—which at the time was still pointedly rejecting the Fund's advice regarding its own fiscal policy (see above, especially pp. 144–46)—continued to side with Japan on this issue. The dilemma felt by many other Executive Directors in discussing this issue was well captured by the remark by Bruno de Maulde, made at this meeting and quoted above on p. 154; no matter how much one admired Japan's economic performance and policies, the problem remained of how to get to a stable pattern of global output and demand.

The debate continued along similar lines in 1986, as the staff concluded that the appreciation of the yen was likely to depress output growth and that the case for fiscal expansion was therefore stronger than ever. The following year, the government did implement a fiscal stimulus package to counter the effects of the appreciation, and both the staff and the Executive Board welcomed the shift in policy priorities. Subsequently (in the final consultation of the decade, in February 1989), the staff broadly endorsed the conduct of fiscal policy in Japan. Not everyone on the Executive Board was completely comfortable in accepting what was still a very high rate of national saving. Dai Qianding (China), for example, wondered "whether a reduction in personal income . . . tax rates would increase the in-

[77]Minutes of EBM/84/33, pp. 14 (Narvekar) and 20–21 (summing up).

[78]By definition, a decline in the fiscal deficit must be matched by an increase in the excess of private saving over private domestic investment, by a strengthening of the external current account balance, or by some combination of the two. The staff position was based on the idea (supported by most macroeconomic models) that, for an economy operating near its capacity, net private saving will be relatively unaffected and the bulk of the adjustment will fall on the external balance. The authorities' argument that the offsetting changes would fall mainly on domestic saving and investment was based primarily on the idea that the effects of deficit reduction could vary substantially, depending on the specific policy actions that brought it about.

[79]"Japan—Staff Report for the 1984 Article IV Consultation," SM/85/33 (January 31, 1985), p. 10.

clination to consume" in Japan. Overall, though, the decade ended with a strong endorsement from the international community.[80]

Exchange Rate Policy

The behavior of the yen and the need for policy changes aimed at influencing the exchange rate were central topics for discussion in the Article IV consultations with Japan, especially during the first few years of Fund surveillance.

At the time of the 1979 consultation, the yen had been depreciating against other major currencies for about a year, partly in reflection of the recovery in the dollar after the 1978 crisis but also because Japan was pursuing a policy mix based on using easy money and credit conditions to offset the contractionary effects of fiscal adjustment. That combination was causing interest rates in Japan to fall while they were rising in the United States. In addition, the yen was being negatively affected by rising oil prices, since Japan was more heavily dependent on imported oil than the other leading industrial countries. Both Fund staff and the authorities saw the weakness of the yen as a problem, but they differed in their assessments of the causes.

Analyzing the relationship between a country's policies and its exchange rate contains an inherent ambiguity, because the rate reflects conditions in other countries as well. In 1979 and early 1980, the recovery of the U.S. dollar from the historic lows of October 1978 was the major story in the exchange markets. From the Fund's perspective, however, the key point was that the dollar was gaining far more against the yen than against European currencies. The yen dropped in value from 176 per dollar at the end of October 1978 to an average of 252 in April 1980, or by 43 percent. In contrast, the deutsche mark weakened by just 8 percent over the same period, and the pound sterling *strengthened* by 5 percent.

With that perspective in mind, the staff set out to assess the appropriateness of the Japanese policy regime, taking U.S. policy as given. Not only was the answer not obvious, it also was not clear that this was the right way to frame the question. In the WEO exercise, the staff could examine the policies of the major countries jointly, but that multilateral approach was not feasible in the Article IV consultations. Given that constraint, the staff report for 1979 concluded that "a stronger yen" would be appropriate and implied that the authorities should either engineer a rise in domestic interest rates or discourage (perhaps through official intervention) market speculation against the yen.[81] The Executive Board

[80]The 1986 debate is discussed in "Japan—Staff Report for the 1986 Article IV Consultation," SM/87/33 (February 6, 1987), esp. pp. 24–26. For the staff endorsement of the 1987 stimulus, see "Japan—Staff Report for the 1987 Article IV Consultation," SM/88/44 (February 18, 1988), p. 19. The 1989 report is "Japan—Staff Report for the 1989 Article IV Consultation," SM/89/75 (April 26, 1989), and the quote from Dai is from the minutes of EBM/89/70 (June 7, 1989), p. 57.

[81]"Japan—Staff Report for the 1979 Article IV Consultation," SM/79/295 (December 28, 1979), pp. 16–17.

focused particularly on the latter aspect and attributed the problem to the market, not to the mix of policies in Japan. As the Managing Director summarized the discussion in February 1980, "The view was expressed by many Executive Directors that the market had probably gone too far now in depreciating the yen."[82]

Two weeks after that Board meeting, the Japanese authorities announced a package of liberalization measures and an intensification of official intervention (coordinated with the U.S., German, and Swiss monetary authorities) aimed at supporting the yen, which was still hovering around the level of 250 per dollar. The mid-March announcement by the U.S. authorities of additional measures to control inflation then produced a temporary strengthening of the dollar that put substantial additional pressure on the Japanese authorities to prevent a commensurate weakening of the yen. Within days, the Bank of Japan raised both its discount rate and bank reserve requirements, and the government announced a fiscal tightening and other anti-inflationary measures.

Meanwhile, the Fund's informal Surveillance Committee (see Chapter 2) recommended on March 6 that the Fund undertake a special ad hoc consultation with Japan to discuss policies related to the exchange rate. The Managing Director agreed, and while the policy tightening was taking place on both sides of the Pacific, he approved a proposal to initiate a consultation aimed at encouraging Japan to take additional measures to push the yen into the range of 220–230 yen per dollar.[83] The Japanese authorities, however, agreed only to an informal staff visit, which was led by John Woodley in mid-May.

By the time Woodley arrived in Tokyo, the dollar's general appreciation was being reversed and the yen had strengthened to around 230, the weak end of the range at which the Fund had been aiming. De Larosière, however, instructed Woodley to push for a "further strengthening" beyond that level; without additional measures, the Managing Director was convinced, Japan's external deficit would rapidly vanish and turn into a surplus that other major countries would not readily accept.[84]

Woodley met with general agreement by the authorities that a strengthening beyond 230 would be desirable, and he concluded that a formal special consultation was unnecessary. Nonetheless, and despite an appreciation to 220 by the end of May, the Managing Director expressed to the Executive Director his concern that the authorities were continuing to intervene in large amounts and suggested that further strengthening was still needed. Though no formal discussion of the

[82]Minutes of EBM/80/26 (February 20, 1980), p. 13.

[83]Memorandum from Woodley to the Managing Director (March 18, 1980) in IMF/CF (C/Japan/810 "Mission, Woodley and Otani, May 1980").

[84]The May 5 briefing paper, approved by management the following day, included the phrase, "further strengthening beyond the current rate of ¥240 appears consistent with the medium-term underlying trends" (p. 8). On May 9, following a meeting with the Managing Director, Tun Thin cabled Woodley (at his stopover in Honolulu): "Terms of reference . . . remain valid if 230 is substituted for 240 on line 3, page 8."

matter was to be held by the Board, de Larosière informed Executive Directors on June 11, 1980, that informal discussions had taken place and that he found the results to be "encouraging."[85] That statement concluded the matter for the time being.

Throughout the next two years, the Fund staff and management continued to express concerns quietly over the weakness of the yen. While the authorities also would have liked to see an appreciation, they were reluctant either to set a target for the yen or to redirect monetary or fiscal policies toward influencing the exchange rate. These differences in view were particularly acute during the 1982 consultations, held in Tokyo around the end of November. For most of the year, the yen had been weakening sharply against the ascendant U.S. dollar, bottoming out around 280 yen per dollar in early November. Although the rate recovered strongly over the next few months, the staff report, reviewing developments in Japan, concluded that the renewed weakening of the yen had been "the most troubling development during 1982."[86]

The Japanese authorities, who had spent some $8 billion in 1982 defending the yen against downward pressures, agreed that the weak yen was a problem, but again they differed with the staff assessment on the root causes. They had taken several measures to enhance the attractiveness of the yen as an asset and liberalize the market for capital inflows; but it did not make sense, in their view, to loosen fiscal policy or tighten monetary policy to counteract the exchange rate effects of a similar shift in the policy mix in the United States. Nor did they believe that official intervention could be expected to have a stronger influence on exchange markets until the United States was ready to join in a coordinated effort. When Hirao presented these arguments at the Executive Board meeting in March 1983, he was supported by several other Directors, notably Heinrich G. Schneider (Alternate—Austria) on the need for coordinated intervention and by Chang on the dangers of implicitly expecting other countries to adopt the U.S. policy mix in order to stabilize exchange rates. The sense of the meeting was that a stronger yen would be beneficial but it was up to the markets rather than the policymakers to bring it about.[87]

After 1982, the level of the exchange rate effectively ceased to be a major issue between the authorities and the Fund for the rest of the decade. The yen remained weak against the dollar through 1983 and 1984, but it then began to appreciate against the other major currencies and in effective terms. After the Plaza meeting of the G-5 in September 1985, the yen's appreciation accelerated, and it continued to strengthen even after the Louvre agreement in February 1987. Throughout that period, both the staff and the Executive Board generally accepted that Japan's macroeconomic policies were consistent with an orderly appreciation of the currency.

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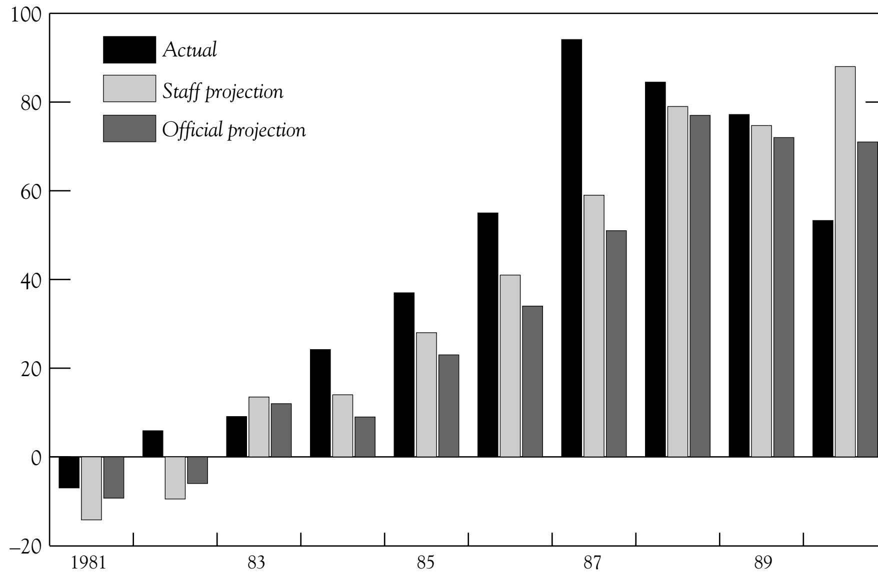
[85]Minutes of EBM/80/89 (June 11, 1980), p. 3.

[86]"Japan—Staff Report for the 1982 Article IV Consultation," SM/83/36 (February 18, 1983), p. 6.

[87]Minutes of EBM/83/48 (March 18, 1983), pp. 8 (Hirao), 12 (Schneider), and 15 (Chang); and EBM/83/49, p. 4 (summing up).

Figure 3.4. Japan: Actual and Projected Current Account Balances, 1981–90
(Fiscal years ending March 31)



Note: Forecasts were made 3–4 months before the start of the fiscal year.

Monetary policy was eased in 1986 (notably after the Baker-Miyazawa agreement)[88] and remained "relaxed" through 1989, as the mounting evidence of asset price inflation (land and equities) was offset by stable consumer prices. Throughout this period, which came to be known as that of the "bubble economy" in Japan, the Fund supported the policy stance and failed to foresee the emerging imbalances. As the decade ended, inflation began to creep up and the yen began to weaken again, but the staff regarded those problems as minor: inflation in Japan was not "a matter of concern" in 1989, and therefore "no compelling reason" could be found to tighten monetary policy.[89]

Liberalization of Trade and Finance

A third major issue in the consultations with Japan, especially in the early 1980s, concerned the pace of liberalization of international trade and finance. Until the late 1970s, Japan maintained high barriers, both against many imports and against

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[88]On the Plaza and Louvre accords, as well as the Baker-Miyazawa agreement, see Chapter 4.

[89]"Japan—Staff Report for the 1979 Article IV Consultation," SM/79/295 (December 28, 1979), pp. 13 and 17; and "Japan—Staff Report for the 1989 Article IV Consultation," SM/89/75 (April 26, 1989), p. 20 ("no compelling reason"); statement by Narvekar at EBM/89/71 (June 7, 1989), p. 3 ("matter of concern").

capital flows. Through a series of legislative and regulatory actions, Japan gradually lowered those barriers, but the extent and importance of the remaining restrictions were a source of continuing friction with the international community.

The focus of the discussions on trade was the effect of restrictions on the external current account imbalance, which shifted from deficit to surplus in 1982, reached a peak of $94 billion in FY 1987, and remained large throughout the rest of the decade. In projecting the external balance (see Figure 3.4), few significant differences arose between the staff and the authorities. Both forecasts missed the initial shift to surplus, both underpredicted the extent of the growth in the surplus from 1984 through 1987, and both failed to foresee the sharp drop that occurred in 1990. In most years, however, the direction of change and the general order of magnitude of the problem were clearly understood and agreed upon.

Throughout the decade, the position of staff and management was to commend the steps toward liberalization taken each year, to call attention to remaining problems while pointing out the ambiguities and uncertainties in assessing the picture, and generally to deal gingerly with this politically explosive subject. The Fund did, however, consistently object to reliance on restrictions rather than price and income adjustments for moderating trade imbalances. Notably, when the Fund began leaning on Japan in 1979 to allow the yen to appreciate to prevent a disruptively rapid growth in exports, the authorities responded that they expected "voluntary self-restraint" by exporters to prevent too rapid a buildup. The staff criticized that approach. Two years later, after Japan introduced (in May 1981) a formal system of voluntary export restraints on automobile exports to the United States, the staff expressed their "regrets" that the authorities were relying on such measures rather than tackling the underlying imbalance between saving and investment.[90]

From 1982 onward, the staff's consultation reports welcomed the measures that were being taken to liberalize imports but called for bolder actions to be taken to reduce administrative hurdles and open the distribution system. That issue was on the table for several years, especially during the discussions by the Executive Board. In the view of many Directors, the issue was not so much the existence of formal regulations as it was the perception of an invisible barrier against foreign penetration of Japanese markets. In March 1985, for example, the Japanese Executive Director, Hirotake Fujino, claimed that "the Japanese [goods] market has now become one of the most open markets among industrial countries"; to which Nigel Wicks (the United Kingdom) responded that "Japan's close-knit industrial structure inhibited imports." The Executive Board, noting that "access to the Japanese market remained difficult" and was producing "protectionist sentiment against Japan's exports," "urged the authorities to act resolutely to reduce remaining import restrictions and to open markets to imports."[91]

[90]"Japan—Staff Report for the 1979 Article IV Consultation," SM/79/295 (December 28, 1979), pp. 13 and 17; and "Japan—Staff Report for the 1981 Article IV Consultation," SM/82/13 (January 18, 1982), p. 19.

[91]Minutes of EBM/85/33 (March 4, 1985), pp. 16 (Wicks) and 11 (Fujino); and EBM/85/34, p. 20 (summing up).

Germany

Germany's[92] macroeconomic policies came under fire in 1978, as world leaders sought a means of escaping stagflation and getting their economies back onto a path of sustainable growth. In Germany, the growth of domestic demand had been unusually slow for a year or more, principally because of an unintended contractionary impulse from fiscal actions.[93] Output, instead of growing at the 4–5 percent rate that the government had targeted a year earlier, had grown "only" by 2½ percent. When analysts would look back at that growth rate a decade or two later, it would look like a reasonably successful outcome and about all that one could have hoped to sustain under the circumstances. In 1978, however, it looked like a serious shortfall from the potential inherent in the German economy.

The primary forum for trying to remedy the situation was the summit meeting of the G-7 heads of state and government, which fortuitously was held in Bonn on July 16–17, 1978. Chancellor Helmut Schmidt was under heavy pressure from his peers in the G-7 who wanted Germany to be a "locomotive" for the world economy, and he was eager to get a deal in which the United States would promise to take measures to curb its massive consumption of petroleum. At the summit, Schmidt agreed to quickly implement a stimulus package equivalent to 1 percent of GNP. Less than two weeks later, the German parliament enacted the package, including additional domestic spending, tax cuts, and—in a gesture of solidarity with other oil-importing economies—financing for programs to help poorer countries develop renewable energy sources.[94]

Two months before the Bonn summit, a staff team headed by the Director of the European Department, L. Alan Whittome, tackled these same issues with the authorities in the 1978 Article IV consultations in Bonn and Frankfurt.[95] Whittome and his team viewed Germany's slow growth rate as "of concern both from a domestic and an international point of view." Their report noted that the government had begun 1978 aiming to achieve a growth rate of 3½ percent (already scaled down from earlier projections), but neither the staff nor the authorities now thought that the goal was achievable. Unemployment was holding steady around 4 percent, while inflation was falling to around 3 percent, but in the staff view, the sizeable gap between actual and potential output was not being closed. Most wor-

[92]All references to Germany are to the Federal Republic of Germany, which was vernacularly known as West Germany during the period of this History. The German Democratic Republic (East Germany), which was not a member of the IMF, merged with the Federal Republic in October 1990.

[93]The contraction resulted from a combination of factors that had not been fully anticipated. States (länder) and municipalities curtailed spending to control their deficits, environmental objections delayed federal investment projects, and tax revenues were higher than had been projected. Consequently, the general government deficit fell from 3½ percent of GNP in 1976 to 2½ percent in 1977.

[94]For the background to the Bonn summit, see Putnam and Henning (1989) and Putnam and Bayne (1987), Chapter 4.

[95]For a broad summary of the 1978 consultation, see de Vries (1985), p. 916.

ryingly, "there appeared to be a protracted weakness of business investment," implying that the slowdown was not likely to end soon and that stimulus was needed for long-term growth as well as cyclical recovery.[96]

On the other side of the table, the authorities saw matters differently. In their view, the initial output gap was not that large, the potential growth rate was not that high, unemployment was almost entirely structural or frictional, and fiscal stimulus would not promote—and could well discourage—investment. The minister of finance, Hans Matthöffer, expressed strong skepticism about the rationale for changing the course of fiscal policy, but other officials—including Hans Tietmeyer, then Head of the Division of General Economic Policy in the Ministry of Economics—indicated that the government had not yet formulated a common position on the issue.[97]

The Fund staff was unconvinced by the authorities' arguments, and the report concluded that policies should be redirected:

> The staff would hope that fiscal and monetary policies designed to secure sustainable increases in domestic demand and in GNP—for the time being somewhat in excess of the growth of potential GNP—would, in conjunction with appropriate exchange rate policies, lead to a further contribution from Germany in the form of a significantly smaller current account surplus. . . . The danger of renewed pressure on prices . . . need [not] be a constraint on policy in the near future.[98]

By the time the Executive Board met at the end of July to discuss the staff report, the G-7 summit had already resolved the issue. It was understood, however, that the German authorities were less than enthusiastic about their own stimulus package and had implemented it only because of international pressure.[99] The Executive Director for Germany, Eckard Pieske, devoted most of his remarks to an explanation of why fiscal stimulus was unlikely to benefit the economy. Furthermore, the other G-7 countries presented less than a united front on the issue. Denis Samuel-Lajeunesse (Alternate—France) suggested that the German economy was already extremely well managed and concluded that the authorities were right to question what had become known as the "locomotive theory." William S. Ryrie (United Kingdom) noted that the international interest did not really concern the growth rate of output in Germany, but only the size of its current account surplus.[100] Over-

[96]"Federal Republic of Germany—Staff Report for the 1978 Article IV Consultation," SM/78/180 (July 5, 1978), pp. 4 and 16.

[97]Minutes of meetings held on May 17 and 18, 1978, in IMF/CF (C/Germany/420.3, "Article IV Consultations—1978, Minutes of Meetings").

[98]"Federal Republic of Germany—Staff Report for the 1978 Article IV Consultation," SM/78/180 (July 5, 1978), p. 17. Whittome later explained that the phrase "for the time being" meant two to three years; minutes of EBM/78/120 (July 28, 1978), p. 16. The reference to "appropriate exchange rate policies" meant that the deutsche mark should be allowed to appreciate.

[99]This conclusion applies only to the financial authorities dealing directly with the Fund. Chancellor Schmidt had been reelected in 1976 on a pro-growth platform and appears to have been personally more enthusiastic than his economic advisors. See Putnam and Bayne (1987), pp. 79–82.

[100]Minutes of EBM/78/120 (July 28, 1978), pp. 25–26 (Samuel-Lajeunesse) and 28 (Ryrie).

all, however, the Board concluded that the post-summit stimulus package was a minimum requirement for growth that might well turn out to be inadequate.

For the next ten years, the consultations with Germany were handled by senior officials just below the Director of the European Department. Brian E. Rose (Deputy Director) headed the 1979–82 and 1985–87 missions, after which he retired from the staff. The 1983 and 1984 missions were led by Hans O. Schmitt (Senior Advisor), and Manuel Guitián (Deputy Director) headed the 1988 mission. In 1989 the Director of the Department—by then it was Massimo Russo—again led the annual consultation mission. On the German side, the level of representation also varied. In that critical 1978 consultation, both the minister of finance (Matthöffer) and the president of the Deutsche Bundesbank (Otmar Emminger) met with the mission team. For the next two years, Emminger and then his successor, Karl Otto Pöhl, continued to participate, but the minister did not. There followed a drought of five years (through 1985), after which the finance minister and Bundesbank president began again to receive the Fund missions regularly.

Richesse Oblige: The Burdens of Economic Power

The Fund staff's analysis of German macroeconomic policies underwent both cyclical and more sustained evolution from 1979 through 1989. The cyclical fluctuations—essentially between recommending fiscal stimulus and endorsing the status quo—reflected both the actual business cycle and shifts in view about how much growth could reasonably be expected under prevailing circumstances. In addition, staff priorities trended away from cyclical concerns and toward the requirements for longer-term growth. Throughout this period and into the 1990s, the dominant underlying theme for the discussions between Germany and the Fund was the same as it had been in 1978: the responsibilities of surplus countries to contribute to the global adjustment process. As de Larosière put it in concluding the 1978 discussion by the Executive Board: Germany, "with its low rate of inflation and its strong balance of payments, is especially well placed to make a strong contribution to the recovery of the world economy and the alleviation of the balance of payments problems of other countries."[101]

The 1979 consultation took place just two months after the establishment of the European Monetary System (EMS), which heightened Germany's obligations to maintain fixed exchange rates with the other participating countries.[102] However, the factor that most affected the discussions was that the economy was growing with unanticipated robustness, and it was already apparent that the "locomotive" package had been ill-advised: the seeds of renewed growth had already been planted, and with a little patience the desired recovery would have occurred with no further feeding. Nonetheless, and despite this surprise growth, the current ac-

[101]Minutes of EBM/78/122 (July 31, 1978), p. 4.

[102]For simplicity of exposition, references here to the EMS generally refer to the currencies participating in the exchange rate mechanism (ERM) of the EMS. See the discussion of the system in Chapter 2.

count surplus was also larger than anticipated. Accordingly, the staff could focus on the requirements for moderating the surplus as the central policy issue.

The staff held that the external surplus could be kept under control if the authorities (1) remained ready to implement countercyclical fiscal policies if domestic demand appeared to be weakening, and (2) stopped intervening against the tendency for the mark to appreciate against the U.S. dollar. In practice, the German economy was better able to absorb the consequences of an appreciating currency than were some other members of the EMS, so occasionally realigning EMS rates would be better than trying to depress the value of the mark artificially.

The authorities, in contrast, believed that the main task of macroeconomic policy was to prevent inflationary pressures from arising, not to push for stronger growth. They also argued that it was important to maintain stability within the EMS, which was still a young and fragile mechanism. Throughout the first five months of 1979, the authorities had engaged in "massive" intervention vis-à-vis the dollar. They disclaimed having a specific target for the rate against the dollar, but their intervention policy suggested that they viewed the degree of market pressures as "disorderly."

The Executive Board was sharply divided in 1979 on the question of whether further stimulus was desirable. The U.S. chair (represented by Donald E. Syvrud—Alternate) put the case for growth in terms of the global effects of the second oil shock: "As we start a new round of major OPEC surpluses," Syvrud concluded, "there are only a limited number of countries that are in a position to accept a share of the burden. In this regard, few countries are better placed than Germany." On the other side, Masanao Matsunaga (Japan) empathized more with the Germans' desire for stable prices. He "fully endorsed" the recent tightening of German macroeconomic policies and concluded that there was "no case at the moment for additional stimulus from the fiscal front."[103]

By 1980, the staff had come around more closely to the views of the German authorities. Since the last consultation was completed, the economy had grown strongly, inflation had accelerated, and the current account had shifted into deficit. Consequently, the staff acknowledged that the authorities' earlier concerns about overheating had been "fully justified by events although some of them, such as the large increase in the price of oil in 1979, could not have been foreseen at the time." The main issue on the table now was whether the time was ripe to ease up. The staff report essentially endorsed existing policies and concluded that there was "no need for any drastic change in the direction of monetary and fiscal policy."[104] At the Executive Board meeting, although some chairs still would have preferred somewhat more expansionary policies, the controversy had largely died down.[105]

Staff views shifted further in 1981. Although the economy had weakened again, this time the mission chief (Brian Rose) did not attempt to persuade the authori-

[103]Minutes of EBM/79/135 (August 2, 1979), pp. 11 (Syvrud) and 14 (Matsunaga).

[104]"Federal Republic of Germany—Staff Report for the 1980 Article IV Consultation," SM/80/163 (July 3, 1980), pp. 3 ("fully justified") and 15 ("no need for change").

[105]Minutes of EBM/80/108–109 (July 23, 1980).

ties to use macroeconomic policies for countercyclical purposes. Instead, the staff report focused on the need for structural adjustment aimed at strengthening the economy's potential for growth and job creation. Most of the measures identified by the staff were similar to those already identified by the authorities as necessary or desirable and were as much macroeconomic as structural: further energy conservation, "cautious financial policies" that would discourage high wage demands, and maintenance of a competitive exchange rate (for which the staff judged the prevailing level to be about right).

A nuance of dispute nonetheless remained over the focus of macroeconomic policies. While acknowledging that the 1978–80 overheating of the German economy had demonstrated the "failure of the locomotive theory," Rose argued at the Board meeting that the avoidance of excessive slack in economic activity was still important. Directors generally agreed that the immediate priority was to restrain domestic demand, though not everyone was prepared to endorse the degree of restriction implicit in the current policy stance.[106]

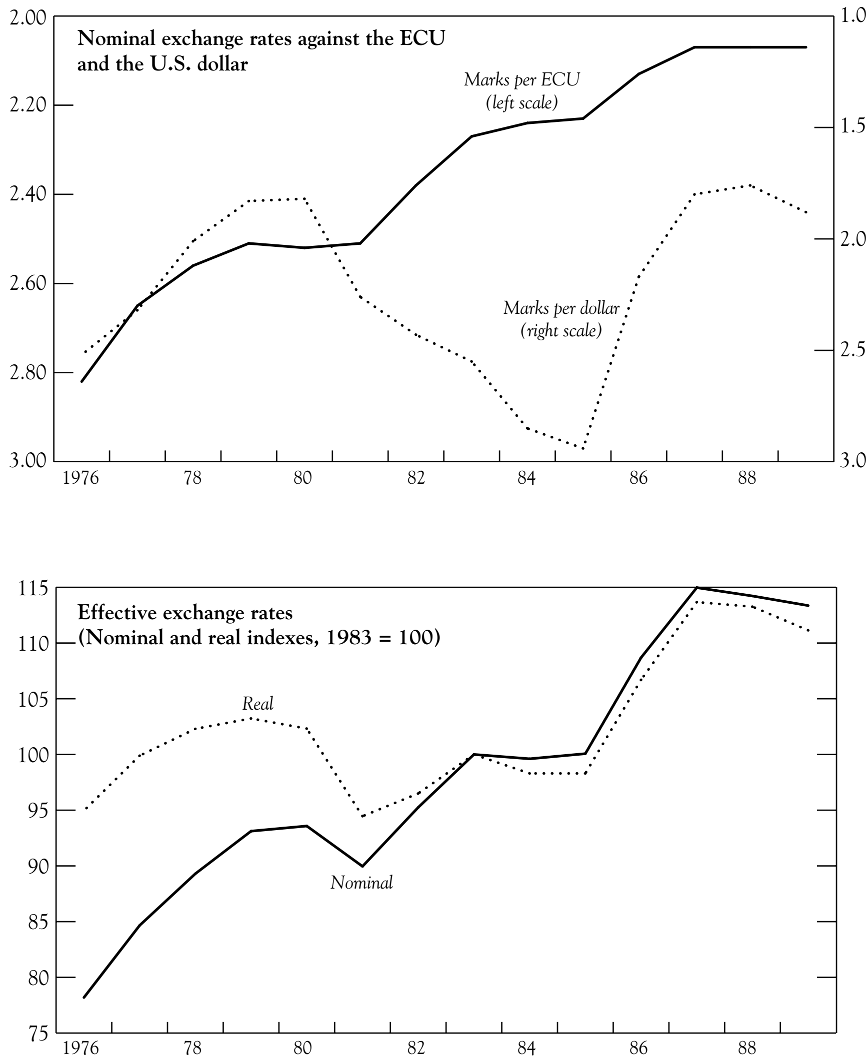
Between the 1981 and 1982 consultations, the question of whether to ease up on fiscal restraint to combat the recession became a major issue in the German political debate. In October 1981, as the appreciation of the U.S. dollar began to impose inflationary pressures on Europe, Germany agreed to a 5½ percent upward revaluation of the deutsche mark within the EMS, a move that reinforced the position of the mark as the dominant currency in Europe (Figure 3.5). That move forestalled the importation of inflation, but it also weakened the demand for German exports and thus helped prolong the recession into 1982. Chancellor Schmidt and his Social Democratic Party then advocated tilting fiscal policy toward expansion, but they were opposed by some other parties in the ruling coalition (notably by the Free Democrats led by the Economics Minister, Otto Lambsdorff) as well as by the opposition coalition headed by Helmut Kohl.[107]

In the midst of this debate, the German authorities asked the Fund to hold a "special consultation" on fiscal policy, in conjunction with the normally scheduled staff visit for the WEO exercise, in January 1982. By asking for such a review, it appears that the advocates of stability and restraint were hoping that the staff had come far enough around from the locomotive days that the Fund would lend its intellectual prestige to their side. In the event, that is precisely what happened. Whittome, who led the mission, obtained the support of the Managing Director for a recommendation of continued restraint. Then, at the concluding session, with the authorities represented by a team headed by Klemens Wesselcock (Director of the International Affairs Department in the Ministry of Finance), Whittome argued that "What is now required is an effort to restore public confidence in the ability of the authorities to control the budget and to

[106]Minutes of EBM/81/113 (August 5, 1981). The quotation is from p. 38.

[107]Lambsdorff, who shifted to support for a tax cut (but not a spending increase) later in 1982, retained his position as Economics Minister under Kohl.

Figure 3.5. Germany: Exchange Rates, 1976–89



Source: IMF, *IFS*.

maintain a course of policy that promises a satisfactory rate of growth in the medium term. . . ."[108]

This cautious approach toward fiscal policy was repeated in the staff report on the regular 1982 consultations, held in May. That report focused more on ex-

[108]Concluding statement presented on January 16, 1982. Also see memorandums from Whittome to the Managing Director dated December 31, 1981 (with annotations by the Managing Director in response) and January 19, 1982. All in IMF/RD Managing Director file "Germany 1981" (Accession 83/89, Box 1, Section 378).

change rate policy, and in particular on the tendency for the EMS member countries to wait until crises developed in exchange markets before realigning rates. (The sixth realignment in less than three years, in which the central parity of the mark was revalued by 4¼ percent, took place on June 14: after the discussions but before the issuance of the staff report.) Consistent with the general support of policies of restraint, the report advised Germany to resist further depreciation of the mark against the U.S. dollar; until U.S. interest rates came down from their extraordinarily high levels, the authorities would have little choice but to keep their own rates higher than they would like. On this issue at least, the staff turned out to be *plus royalist que le roi*. As Gerhard Laske pointed out at the Executive Board meeting in mid-August—responding to a request for further tightening from the U.S. Director, Richard Erb—his authorities' ability to push interest rates up to calm the exchange markets was limited by the need to sustain demand in the face of still-weakening economic activity.[109]

In an election that hinged on the government's perceived inability to rein in the fiscal deficit (which had risen from 2½ percent of GNP in 1978 to 3¾ percent in 1981), Kohl's more conservative coalition, led by the Christian Democratic Union, defeated Schmidt in October 1982. Five months later, the deutsche mark was again revalued, rising by 5½ percent against all other currencies in the EMS. Even so, because of the continuing rise of the U.S. dollar and an easing of monetary conditions in Germany, the mark depreciated by 6½ percent against the dollar during the first half of 1983, and its real effective value showed virtually no change (see Figure 3.5). By the time the 1983 consultations took place, a modest economic recovery was under way in Germany, led by an unexpected rise in consumer spending.

The 1983 consultation (headed by Hans Schmitt) tilted back slightly toward recommending an easier fiscal policy. The new wrinkle on this occasion was an effort to place that recommendation firmly within a broader policy of fiscal consolidation. The staff report welcomed "the present policy of expenditure restraint," noting that it was aimed at freeing up resources for the private sector. "The positive effects of expenditure cuts," however, "may . . . be delayed, unless the authorities are prepared to shift their emphasis from reductions in the deficit to reductions in taxes that will raise private spending by raising disposable incomes."[110] In other words (as Schmitt explained the matter to the Executive Board), the spending cuts that had already been made had, in the staff view, created room in the budget for a cut in taxes aimed at "crowding in" private spending directly rather than indirectly through interest rate cuts. That view was shared by several Executive Directors who were skeptical that the incipient recovery could be sustained

[109]The Board meeting took place on Wednesday, August 18, 1982, just five days after the initial eruption of the debt crisis in Mexico. In Laske's view, that development, far more than events in Europe, was currently controlling the exchange markets. Minutes of EBM/82/110 (August 18, 1982), pp. 4 (Erb) and 6 (Laske).

[110]"Federal Republic of Germany—Staff Report for the 1983 Article IV Consultation," SM/83/153 (July 5, 1983), p. 16.

without some new stimulus, while others felt that German policies in 1983 were pitched about right.[111]

The 1984 report saw no immediate problem in the stance of fiscal policy. The deficit had been reduced from 4 percent to 2 percent of GNP, largely by cutting expenditure from 50 percent of GNP to 48 percent. Despite this withdrawal of direct stimulus, output growth had recovered to 2¾ percent in 1983 before dropping off in the first few months of 1984. Reviewing these developments, the staff attributed the improved performance of the German economy to a combination of factors: a strong private sector, growing confidence from the reduced deficit, shifts in the structure of spending toward boosting investment, and an easing of monetary conditions.[112]

On the negative side, the staff for the first time emphasized the theme that would take on increasing importance over the next several years: the resumption of economic growth had not brought any job creation in its wake. Indeed, no net job creation had been recorded for a decade, despite a fair record of output growth. The culprit, Schmitt argued, was "excessive labor costs," including not only wages but also social security, employee subsidies, generous paid leave, and other benefits. While widespread agreement existed both in Germany and elsewhere that these costs were a serious issue, the political reality was that there was little immediate prospect of seeing any real reforms.[113]

The emphasis on structural labor market reforms did not completely replace the more traditional view of fiscal policy as a means of sustaining aggregate demand. Economic growth continued at a modest rate in the months between the 1984 and 1985 consultations, but that growth derived more from exports than from domestic demand. Moreover, the prognosis in 1985 was that this situation would continue and would further enlarge the surplus in the current account. When the authorities argued that demand stimulus would do little to alter that outlook, the staff (led by Brian Rose) disagreed cautiously and concluded as follows:

> From an international perspective, it is essential that the major industrial countries achieve the maximum rate of growth that is sustainable over the medium term and is consistent with strict control of inflation. In the medium run, . . . a rate of growth sufficient to lower unemployment will depend upon a strengthening of domestic demand. . . . These considerations should not suggest that the appropriate policy response to the present situation is a *pronounced* shift to more stimulatory short-term demand management. . . . But changes in taxation can resolve the dilemma by raising disposable incomes without increasing labor costs.[114]

[111]Minutes of EBM/83/114 (July 29, 1983). Schmitt's views are stated on pp. 44–46.

[112]"Federal Republic of Germany—Staff Report for the 1984 Article IV Consultation," SM/84/142 (June 22, 1984); and remarks by Schmitt at EBM/84/113 (July 20, 1984), p. 4.

[113]Minutes of EBM/84/113 (July 20, 1984), p. 5; emphasis added. Also see "Federal Republic of Germany—Staff Report for the 1984 Article IV Consultation," SM/84/142 (June 22, 1984), pp. 15–17.

[114]"Federal Republic of Germany—Staff Report for the 1985 Article IV Consultation," SM/85/194 (July 5, 1985), pp. 17–19.

This highly nuanced statement attempted to carve out a tenable foothold between Keynesian and neoclassical or supply-side extremes. Tax cuts, in this view, would properly stimulate demand and would produce maximum benefit if they were structured to shift part of the burden of taxation away from labor costs.

Germany was being pressured along similar lines in multilateral meetings in 1985. The G-7 summit meeting had come around again to Bonn, for the first time since the debacle of 1978. This time the Economic Declaration stressed the importance of addressing structural rigidities, including those in Germany, and played down the role of demand management. Similarly, the G-5 ministerial meeting at the Plaza Hotel in September 1985 produced a communiqué (see Funabashi, 1988, pp. 264–65) in which Germany asserted its desire to generate a "steady economic recovery based increasingly on internally generated growth," while indicating its intention to aim policies at fiscal consolidation rather than stimulus, at removing "rigidities inhibiting the efficient functioning of markets," and at promoting "a stable environment" for domestic economic activity. The public defense of that approach, of course, reflected the presence of quiet diplomatic suggestions for a more active policy stance (Funabashi, 1988, esp. p. 41).

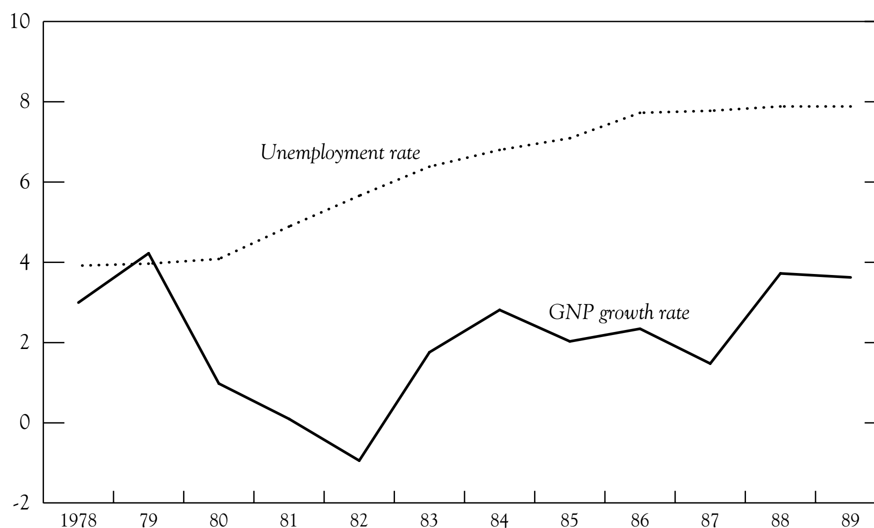
Partly in response to international pressures, the German parliament agreed in June 1985 to reduce taxes in two stages—in January 1986 and again two years later—by a total that was approximately equivalent to 1 percent of GNP. At the time, neither the government nor the staff regarded this reduction as a substantial stimulus, because it was designed merely to offset the effects of "fiscal drag" since the last major change in tax rates, in 1981.[115] Eventually, however, the staff recognized it as a shift in policy emphasis, "from reducing the deficit to reducing the tax burden."[116]

In 1986, the Fund staff and the authorities substantially agreed. The economy was doing well, and what few problems existed were mostly expected to be alleviated without any shift in policy. The staff suggested that the tax cut scheduled for January 1988 could be brought forward, as unemployment was sitting stubbornly around 8 percent of the labor force (Figure 3.6) and the economy was "still capable of accommodating a further growth of demand." Overall, however, the staff endorsed the existing macroeconomic policy stance and focused more on the requirements for achieving a sustained reduction in the persistent and growing current account surplus (Figure 3.7). To that end, the 1986 report concluded that "much more must be done to try to loosen constraints on supply, in particular by breaking down rigidities in the labor market." The suggestion was unexception-

[115]Because the progressive brackets for tax rates were fixed in nominal terms, the average tax rate rose automatically along with nominal incomes. This phenomenon was known variously as "fiscal drag" or "bracket creep." Only through a periodic lowering of the nominal brackets could tax policy be kept neutral in its effects on aggregate demand.

[116]For the initial interpretation, see "Federal Republic of Germany—Staff Report for the 1985 Article IV Consultation," SM/85/194 (July 5, 1985), p. 8. For the quoted later view, and for the conclusion that the action had been taken partly in response to international pressures, see "Federal Republic of Germany—Staff Report for the 1988 Article IV Consultation," SM/88/136 (June 24, 1988), p. 7.

Figure 3.6. Germany: GNP Growth and Unemployment, 1978–89
(In percent, and percent of labor force, respectively)



Source: *World Economic Outlook*.

able, and the only objection raised by the authorities was that "political sensitivities" made those rigidities difficult to supple.[117]

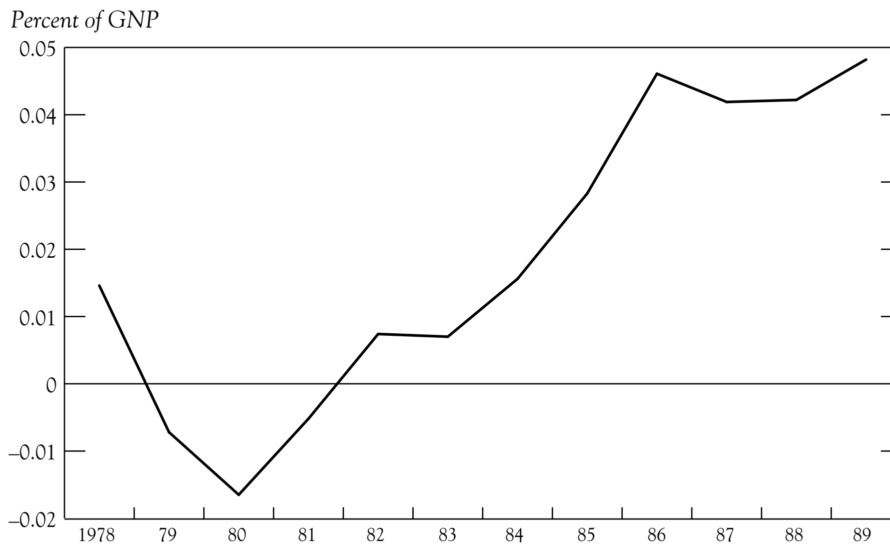
In January 1987, Kohl was reelected chancellor, following an election campaign in which he pointed to his government's success in reducing both government spending (from 50 percent of GNP to 47 percent) and the fiscal deficit (from 3¾ percent of GNP to 1¼ percent). A month later, to carry out a commitment made at the February 22 meeting of major industrial countries at the Louvre, the government agreed to grant tax relief amounting approximately to 2 percent of GNP over the period 1988–90. When Rose and his team arrived in Bonn at the end of April to conduct the 1987 consultation discussions, both output and domestic demand were growing reasonably well, and prices were essentially stable. The major strain was that the current account surplus had ballooned in 1986 to more than 4½ percent of GNP.

To buttress the argument that stimulus was needed to reduce the external surplus, the staff team presented the authorities with a detailed set of medium-term "scenarios" generated by econometric macro models estimated by the staff.[118] The

[117]"Federal Republic of Germany—Staff Report for the 1986 Article IV Consultation," SM/86/160 (July 2, 1986), pp. 2 and 21; and statement by Guenter Grosche at EBM/86/127 (August 1, 1986), p. 14.

[118]For a summary, see "Federal Republic of Germany—Staff Report for the 1987 Article IV Consultation," SM/87/144 (June 26, 1987), p. 14. The models and the detailed simulation results are in Appendixes I through IV of "Federal Republic of Germany—Recent Economic Developments," SM/87/156 (July 10, 1987), pp. 103–144.

Figure 3.7. Germany: Current Account Balance, 1978–89



Source: IMF, *IFS*.

baseline scenario, with no change from current policies, suggested that by 1991 the current account surplus would fall gradually but would still be around 2 percent of GNP by 1991. Because the fiscal deficit was small enough in view of the high level of private saving in Germany, the staff report concluded that there was room for some fiscal easing and that, over the medium term, fiscal policy should be aimed more at sustaining demand and less at containing the deficit. Moreover, "little progress" had been made in reducing labor market rigidities.[119]

German economic growth slowed again in 1988, unemployment remained near 8 percent, and the current account surplus held stubbornly above 4 percent of GNP. All of that contributed to a general "uneasiness," a feeling "that there was something that Germany could do but was not doing to help international adjustment."[120] The Fund staff had now come around to the view (shared by the authorities) that the growth "problem" in Germany was almost entirely structural in nature, and the 1988 report on this issue was innovative in two respects.[121] First, as a supplement to the usual macroeconomic forecasts and scenarios, the report

[119]"Federal Republic of Germany—Staff Report for the 1987 Article IV Consultation," SM/87/144 (June 26, 1987), pp. 11 (labor market rigidities) and 16–18 (fiscal policy).

[120]Statement by the mission chief, Manuel Guitián; minutes of EBM/88/112 (July 22, 1988), p. 3.

[121]In addition to the problem of rigidities, the 1988 staff report called attention to Germany's relatively low rate of population growth. Although aggregate GNP had grown relatively slowly during the 1980s, growth in GNP per capita had been near the average for the major industrial countries. "Federal Republic of Germany—Staff Report for the 1988 Article IV Consultation," SM/88/136 (June 24, 1988); on the issue of population growth, see p. 2 and Chart 1.

presented detailed structural simulations derived from a four-sector computable general-equilibrium (CGE) model.[122] Those simulations showed that reducing rigidities could significantly strengthen economic growth. Second, the report delved into the structural problems in much more detail than before. Specifically, it stressed the need for further progress in reducing subsidies (especially those that protected industries against foreign competition); for reducing nontariff barriers (especially in iron and steel, textiles, and clothing); for easing sectoral regulations that prevented the supply of goods from responding to shifting conditions; and for easing labor market regulations that raised overhead costs, limited flexibility in hiring and firing, and reduced wage differentials across sectors.

This advice met with two types of resistance. First, as the staff acknowledged, the German authorities viewed many of the specific recommendations as "somewhat remote from the realities of the German situation" (i.e., as politically unrealistic).[123] Second, at the Executive Board, several Directors—from a diverse group of countries, including Denmark, India, Indonesia, Italy, Mexico, and Tanzania—expressed skepticism that Germany's large current account surplus could be effectively reduced by structural reforms alone. In their view, some fiscal easing was also required. As recorded in the summing up of the meeting, those Directors "took issue with the [government's] decision to reduce the budget deficit at a time when . . . growth would be below potential."[124]

The 1989 mission stuck to the structural position even more firmly than before. Although output growth had accelerated since the previous consultation, the external surplus had remained at 4 percent of GNP. The staff mission (in which both Russo and Guitián participated) concluded that the medium-term outlook was for a larger stream of surpluses than had previously been projected, and it called for a very specific set of reforms aimed at stimulating productive investment. These reforms included moving away from price-support programs such as the Common Agricultural Policy of the European Communities; reducing subsidies to coal and other energy sources; reducing protection of iron, steel, and other heavy industries; reducing labor market rigidities; and concomitant changes in the tax system. Fiscal expansion, however, was seen as having only temporary benefits that would be ineffective in reducing the surplus.[125]

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[122]The parameters of macroeconomic models such as the Fund's MULTIMOD are estimated primarily by econometric regressions on time-series data. Parameters for CGE models are derived primarily by reference to the structure of the economy and may be estimated by a variety of techniques external to the model, including cross-sectional studies, or may be assigned by the model-builder for consistency or stability. The German model, the simulations, and the analysis of structural issues were published in Lipschitz and others (1989). That publication of a study undertaken for an Article IV consultation—an innovation in itself—was hailed in the financial press as a symbol of "glasnost at the IMF"; see Norman (1989).

[123]"Federal Republic of Germany—Staff Report for the 1988 Article IV Consultation," SM/88/136 (June 24, 1988), p. 17.

[124]Minutes of EBM/88/111–112 (July 22, 1988); the quotation is from meeting 88/112, p. 8.

[125]"Federal Republic of Germany—Staff Report for the 1989 Article IV Consultation," SM/89/126 (June 27, 1989), pp. 15–23.

At the Board meeting in July, several Executive Directors took quite strong exception to the staff position. Charles S. Warner (Alternate—United States) averred that he was "rather disturbed by the overall theme" of the staff report. The Interim Committee, the G-7 leaders, and the Executive Board in its WEO discussions had all "agreed that all countries—surplus and deficit alike—share responsibility for reducing external imbalances," and he was concerned that the staff was not holding Germany up to that standard. Hélène Ploix (France) and Yusuf A. Nimatallah (Saudi Arabia) both noted the need to reduce "excess savings" in the German economy. And Gustavo García (Temporary Alternate—Venezuela) and Renato Filosa (Italy) focused directly on the need for a more "active" fiscal policy "directed to increase domestic demand." Reflecting those views, the Managing Director summed up the meeting by noting that "no major country could be exempted from contributing to the adjustment process." Many other Directors, however, accepted that Germany in 1989 had (as Japan's Koji Yamazaki phrased it) "little room for expansionary . . . policies" before inflationary pressures would reappear.[126] As the decade drew to a close and the sledgehammers drew close to the Berlin wall, the international community still had not formed a consensus on what advice to give to the world's third largest economy.

France

Article IV consultations with France were largely routine affairs during this first decade, except in the period of economic crisis in 1982–83. The words "commended" and "congratulated" reached cliché status in summing up the views of both the staff and Executive Directors, and references were made to the "skill and determination" of the authorities in implementing "courageous" reforms in economic policy. Criticisms centered on the panoply of structural rigidities that distorted economic incentives and kept both inflation and unemployment higher than the average for industrial countries. Those rigidities included the de facto full indexation of wages to past inflation (until 1982), reliance on quantitative credit ceilings to keep monetary growth under control (until 1985), exchange controls to limit speculative pressures on the French franc (1981–84), controls over labor market practices (until 1986), and resort to protectionist trade policies (until 1988).[127]

The French authorities generally welcomed the Fund's advice on these issues. Most of the missions in the 1980s were led by the Director of the European Department (Alan Whittome through 1987 and then Massimo Russo), who—from 1985 on—usually concluded his visit with meetings with the minister of finance, the governor of the Bank of France, and the director of the treasury.

[126]Minutes of EBM/89/96–97 (July 24, 1989). The quotations are from meetings 86/96, pp. 14 (Ploix), 86/19 (Yamazaki), 86/20–21 (Warner), and 86/44 (Filosa); and meetings 86/97, pp. 7 (García) and 86/19 (summing up).

[127]The dates indicate when the effects of the policies had diminished by enough to defuse the issue in the consultations.

In the initial Article IV consultation, in December 1978, the Fund welcomed France's decision to join the exchange arrangements of the EMS when it commenced the following March. The staff, however, was mindful that success was hardly assured. France had a troubled history in its attempts to participate in the European currency "snake" over the preceding six years,[128] but the staff decided that the strengthening of the balance of payments in 1978 "now makes participation in the EMS technically feasible for France."[129] Although the franc was devalued three times in EMS realignments over 18 months through March 1983 (by a total of more than 16 percent), the staff did not seriously question either the exchange rate policy or the stance of macroeconomic policy.

The economic crisis of 1982–83 was a defining moment in the early days of the presidency of François Mitterrand, who led the Socialist Party to victory over the Gaullists of his predecessor, Valéry Giscard d'Estaing, in May 1981. Mitterrand swept aside the gradualist policies under which Giscard and Prime Minister Raymond Barre had attempted to restrict demand and liberalize the economy in order to reduce inflation while promoting investment. The new regime aimed instead to reduce France's extremely high unemployment rate (more than two million unemployed in 1982, or 8½ percent of the labor force) while avoiding an *acceleration* of inflation (close to 10 percent in 1982, compared with an average of 7½ in the G-7 and less than 6 in the EMS).

The staff initially took a wait-and-see attitude on the shift in policies. The mission that conducted the Article IV consultations in February 1982, led by Whittome, declared itself to be "sympathetic" to the government's goals, though it warned of "serious and unresolved questions" on how those goals were to be achieved. Even on the dramatic nationalization of several key industries and most of the banking system that was announced during the consultations, Whittome's report concluded that it was "too early to come to any judgment." Executive Directors focused more on the "serious risks" in the new strategy than on the opportunities for resolving the unemployment problem, but the tone of the Board meeting in May was still soft.[130]

By the time of the next consultation mission, in March 1983, the French franc had been devalued twice more, each time under heavy speculative selling pressure.

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[128]France joined the snake when it was formed in March 1972, agreeing to maintain its exchange rate within margins of ±2¼ percent against the other participating currencies. However, when French inflation persisted at above-average levels, the authorities were forced to suspend the margins from January 1974 through July 1975 and again from March 1976 until the arrangements were replaced by the EMS in March 1979.

[129]"France—Staff Report for the 1978 Article IV Consultation," SM/79/35 (February 1, 1979), p. 14.

[130]"France—Staff Report for the 1982 Article IV Consultation," SM/82/63 (April 5, 1982), pp. 12–13; and the minutes of EBM/82/63–64. "Serious risks" is from the Chairman's summing up at meeting 82/64, p. 13. Jacques Polak (Netherlands) gave particular stress to the risks (meeting 82/63, pp. 13–16). In his view, French macroeconomic policy in 1982 "recalled the anticyclical policies applied in the industrial countries in the 1960s, policies that . . . had come to be acknowledged as not very effective in the short run and as counterproductive in the long run. . . . It seemed likely that in France, as in other countries, mastering inflation would prove to be the precondition for an effective reflationary policy."

The current account of the balance of payments had shifted into a substantial deficit, and the whole policy approach of the previous two years had clearly become unsustainable. The staff finally acknowledged that the policies of 1981–82 had been seriously misplaced and that substantial policy changes would be needed to overcome the "deeper weaknesses in the economy." The fiscal deficit should be cut, the nascent shift toward delinking wage increases from past inflation should be strengthened, quantitative ceilings on bank lending should be scrapped and interest rates allowed to rise, and so forth.

The Fund's advice to the French authorities was uncharacteristically belated. Two days into the mission, on March 25, the government announced a radical policy reversal that included deep cuts in spending, increases in public utility charges, a variety of tax increases, new exchange restrictions to protect the franc, and a cut in targeted money growth.[131] It was not exactly what the doctor had ordered—the exchange restrictions were unwelcome, and monetary restriction would still be engineered through credit ceilings—but it was an extraordinarily bold move in the right direction, especially by a government thought to be firmly in the traditional French socialist mold.[132]

When the Board met in June to conclude the consultation, the main lesson that it drew was not whether expansion or contraction of demand was the more prudent course for a country suffering from stagflation. The lesson was that in the modern global economy, no country could successfully pursue economic policies that were sharply at variance with those of its main trading partners. With the United States, Germany, the United Kingdom, and much of the rest of western Europe striving to restore price stability, France could not hope to restore high employment unless it first joined the club of low-inflation countries. That the French authorities now seemed determined to do so was "courageous," and the main task was to carry out the newly announced policies.[133] The unstated implication was that periodic devaluation of the exchange rate could not substitute for a convergence of domestic policies, because it would lead inevitably to new crises until the inflation gap was cut to a manageable level.

For the rest of the decade, the consultations raised few major issues. Despite a succession of shifts in government, French economic policies remained on the course

[131]Much of the package was designed by Finance Minister Jacques Delors and his deputy, Michel Camdessus, in mid-February, while they were stranded at the French consulate in New York trying to get home after the blizzard-bound meeting of the Interim Committee in Washington.

[132]The new exchange restrictions, which limited the acquisition of foreign currency by French residents for foreign travel, were under the jurisdiction of the Fund under the provisions of Article VIII. (France had accepted the obligations of Article VIII in 1961.) On May 17, the authorities informed the Fund that they intended to remove the restrictions by the end of the year. On that understanding, the Executive Board granted its approval of the restrictions until December 31, 1983, with only one Director—A.R.G. Prowse (Australia)—objecting. The controls were substantially eliminated on December 20. See "France—Exchange System," SM/83/69, Sup. 1 (5/23/83); and the minutes of EBM/83/81 (6/3/81), pp. 31, 38, and 39. The elimination of restrictions is described in "France—Exchange System," EBD/83/335 (December 27, 1983).

[133]Chairman's summing up, minutes of EBM/83/81 (June 3, 1983), p. 37.

set in 1983.[134] The last EMS realignment in which the franc was significantly devalued took place in April 1986, after which the French authorities made the strength of the currency a central pillar of their economic strategy (an approach that became known as the "hard currency" or "franc fort" policy). The Fund firmly endorsed that strategy, most clearly in the 1989 consultations, when the Executive Board praised "the primacy attached to maintaining the parity of the franc vis-à-vis the deutsche mark," which "constituted a strong anchor for the economy and a powerful device for conditioning domestic policies and the behavior of the private sector."[135] France's central role in the EMS and in the European economy had become not just "technically feasible," as it had been in 1979, but an undisputed reality.

United Kingdom

Of all the countries reviewed in this chapter, the United Kingdom was the one for which both the staff of the Fund and the Executive Board examined the exchange rate most openly and frankly. The exchange value of the pound sterling rose relentlessly throughout 1979 and 1980, in response to both the tightening of monetary policy by the fledgling government of Prime Minister Margaret Thatcher and the development of the North Sea oil fields at a time of sharply rising petroleum prices. Sterling then depreciated in spurts for the next five years and by the middle of the decade was subjected to occasional bouts of heavy selling pressure. It underwent a new, smaller cycle in the late 1980s (Figure 3.8).

When the Fund began holding consultations under Article IV in 1978, the United Kingdom had just borrowed SDR 2.25 billion (approximately $2.7 billion) under the stand-by arrangement of 1977.[136] That was the eleventh lending arrangement between the Fund and the United Kingdom, dating from the Suez crisis of 1956, but it would also be the last with the United Kingdom and one of the last with any industrial country. By the time the consultation mission arrived in London in May 1978—by happenstance, the first Article IV mission to a major industrial country—the economy was already on a path toward financial stability. Although the economy became "severely depressed" in 1980 and 1981 (in the words of the January 1982 staff report)[137] and inflation was all but intractable

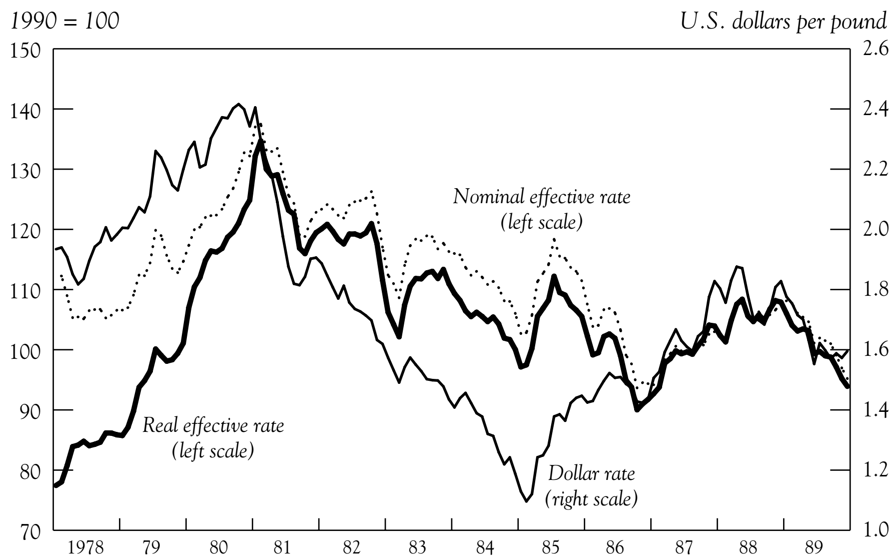
[134]Mitterrand engineered a major cabinet reshuffle in July 1984 in which Prime Minister Pierre Mauroy resigned and was replaced by Laurent Fabius, and Pierre Bérégovoy replaced Jacques Delors as minister of finance. In March 1986, the Socialist Party lost control of parliament in general elections, after which Jacques Chirac became prime minister and named Eduard Balladur as minister with responsibility for finance. The Socialists regained power in June 1988 and returned the finance portfolio to Bérégovoy.

[135]Chairman's summing up, minutes of EBM/89/103 (July 28, 1989), p. 6.

[136]The approved amount of the arrangement—the largest in Fund history up to that time—was originally SDR 3.36 billion in January 1977, augmented to SDR 3.97 billion in June. The United Kingdom drew 1 billion in January and another 1.25 billion in three installments through August. For the full story, see de Vries (1985), Chapter 24; and James (1996), pp. 279–82.

[137]"United Kingdom—Staff Report for the 1981 Article IV Consultation," SM/82/19 (January 28, 1982), p. 1.

Figure 3.8. United Kingdom: Exchange Rates, 1979–89



throughout the decade, a succession of Fund missions under shifting leadership gave consistently good marks to the authorities for their handling of both macroeconomic and more structural policies.[138] During the 1980–82 recession, the staff consistently encouraged the government to persist with its "medium-term financial strategy"—which aimed to reduce both monetary growth rates and public sector deficits steadily over a period of years—despite the high and rising levels of unemployment. After real growth resumed and inflation remained disturbingly high, the staff regularly urged more "caution" (i.e., restriction) in fiscal policy to take the burden off monetary policy and interest rates, but the reports raised few other concerns about the stance of domestic financial policy. Toward the end of the decade, when the current account shifted into deficit, the staff accepted the authorities' argument that became known as the "Lawson doctrine": that the deficit was benign and would likely be self-correcting, because it resulted from a drop in private sector saving rather than government saving (see Chapter 1).

[138]The 1978 mission was led by Azizali Mohammed (Senior Advisor in the European Department). In 1979, David Finch (Deputy Director of ETR)—one of the chief negotiators of the 1977 stand-by arrangement—took over for one year. Then Hans Schmitt (Senior Advisor in the European Department) and Patrick de Fontenay (Deputy Director) took turns leading the missions from 1980 through 1986. Through that period, the Director of the European Department, Alan Whittome, avoided leading missions to the United Kingdom because of a general preference in the Fund for not having missions headed by a national of the country being reviewed. The 1987 and 1988 missions were led by Whittome's successor, Massimo Russo, and the 1989 mission was headed by Manuel Guitián (Deputy Director). In most years the mission chief—and occasionally other team members as well—met at the conclusion of the mission with the Chancellor of the Exchequer and the governor of the Bank of England.

With all this harmony on domestic policies, much of the focus of the consultations was on the exchange rate. The staff frequently took exception to the prevailing exchange rate policy, though it is difficult to discern a consistent philosophy or strategy on either side of the debate. In the 1978 consultation, the staff worried that the authorities were engaging in the sort of "protracted large-scale intervention in one direction" that the 1977 surveillance guidelines decried. In response to the tightening of financial policies under the stand-by arrangement with the Fund, the exchange rate had begun to strengthen in 1977; the Bank of England had then intervened heavily to limit the appreciation. At the Board meeting, the U.K. Executive Director, William Ryrie, complained that the staff seemed to be "interpreting Article IV as a gospel of free floating." The Managing Director, however, insisted that the staff's judgment was "very balanced," and most of the Board agreed.[139]

When the Conservative party assumed power under Prime Minister Thatcher, the government initially embraced the "gospel" and decided to let the exchange rate seek its own level. The 1979 staff report noted that the recent appreciation of sterling was "excessive by conventional standards" and was squeezing business profits. Even so, the staff accepted that the authorities had little choice if they hoped to get inflation under control after the "winter of discontent" that had disrupted economic activity in 1978 and had led to extraordinarily large wage settlements.[140] Some Executive Directors grumbled that the pendulum had swung too far, but the Board as a whole endorsed the new policy stance. A year later, the continuing appreciation of the currency had become a major economic problem for Britain, as by any standard the loss of international competitiveness was unprecedented among the large industrial countries. The staff again concluded that the very tight stance of monetary policy that had contributed to the problem was needed for domestic price and wage control.

By the time of the 1981 consultation, the U.K. economy was really being wrung out. The staff now concluded that it had become important not to let the appreciation go any further and if possible to let the currency fall a bit. In a subtle effort at asymmetry, the report concluded that economic stability would be threatened either by "an appreciation" of the exchange rate or by "too rapid a depreciation." The Executive Board was split on this issue, as several Directors argued that sterling was now "overvalued" and in need of "substantial depreciation."[141] At the same time, the staff began quietly suggesting that the United Kingdom might benefit by joining the exchange rate mechanism (ERM) of the EMS once the overvaluation was corrected. In part, that view reflected a belief that massive swings in

[139]Minutes of EBM/78/100 (July 5, 1978), p. 7 (Ryrie); and EBM/78/101, p. 9 (de Larosière).

[140]"United Kingdom—Staff Report for 1979 Article IV Consultation," SM/79/211 (August 9, 1979); the quotation is from p. 18.

[141]"United Kingdom—Staff Report for the 1981 Article IV Consultation," SM/82/19 (January 28, 1982), p. 17 (staff view); and the minutes of EBM/82/20 (February 19, 1982), remarks by Giovanni Lovato (Italy) on pp. 8–9 ("overvalued") and Teruo Hirao (Japan) on p. 25 (on the need for depreciation).

the exchange rate were severely damaging the economy; in part, that the British financial system was now so open and complex that something other than money growth was needed to measure the stance of monetary policy. Officially, the staff position was that the authorities should make more use of the exchange rate as an indicator. In context, that position implied that the exchange rate should be deliberately stabilized. Ryrie's feared "gospel of free floating" was no longer an option.

For the next few years, the staff continued to push gently for consideration of ERM participation as a means of stabilizing the exchange rate, while simultaneously calling for further depreciation. The authorities continued to resist the former but at least implicitly revealed a willingness to let sterling float gradually downward. They largely abandoned the attempt to target the growth rate of money, in favor of a monetary policy based on a variety of indicative targets that included both nominal income and the exchange rate. For about a year starting in March 1987, they experimented with a policy of "shadowing" the deutsche mark, as a sort of preview of what life might be like inside the ERM. As the U.K. Executive Director, Timothy P. Lankester, noted at the time, "the arguments against [ERM] membership are certainly not as strong as they had been in the past," owing to the depreciation that had already occurred and to the commitments toward stability that the United Kingdom had made as its part in the Louvre accord.[142] That experiment, however, ended badly, as the Bank of England was forced to provide excessive liquidity to keep the rate from appreciating.

From March 1988 until the United Kingdom finally joined the ERM in October 1990, the authorities let the rate appreciate and then depreciate again. When the latter phase began, the staff urged firm resistance, arguing that "a strong pound is an essential ingredient in the strategy to lower inflation."[143] No longer, however, did the staff push for ERM participation. The view now was that inflation had first to be brought down close to the level prevailing in Germany.[144]

To sum up, the consultations with the United Kingdom witnessed and encouraged a decade of bold but not wholly successful experiments in exchange rate policy. Because British economic policy was in poorly charted waters, inconsistencies and shifts in course should not be surprising and may have been inevitable—both for the authorities and for the Fund's advice. Whatever the successes and failures, the history of the process illustrates the difficulties of achieving macroeconomic and financial stability in a country where both had long been absent and of defining a clear policy strategy for the transition.

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[142]Minutes of EBM/87/32 (February 24, 1987), p. 11.

[143]"United Kingdom—Staff Report for the 1989 Article IV Consultation," SM/90/33 (February 2, 1990), p. 23.

[144]The authorities were split on this issue. Both Lawson and his predecessor, Geoffrey Howe (by then the foreign minister), sought bitterly and unsuccessfully to convince Thatcher to anchor the pound in the ERM. Thatcher eventually replaced Howe with John Major, largely over this issue. When Lawson resigned a few months later, also over the ERM, Thatcher moved Major to the treasury. Ironically, these moves led to her downfall, as Major finally did persuade her to join the ERM and was promptly rewarded by the Conservative party with the prime ministership. For two sides of the story, see Lawson (1992), Chapters 73–77; and Thatcher (1993), Chapter 24.

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