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July 6, 1984

To: Members of the Executive Board

From: The Acting Secretary

Subject: United States - Staff Report for the 1984 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1984 Article IV consultation with the United States, which has been tentatively scheduled for discussion on Friday, August 3, 1984.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Hernández-Catá (ext. (5)8486) or Mr. Horiguchi (ext. (5)8492).

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INTERNATIONAL MONETARY FUND

UNITED STATES

Staff Report for the 1984 Article IV Consultation

Prepared by the Staff Representatives for the 1984 Consultation with the United States

Approved by E. Wiesner and S. Mookerjee

July 5, 1984

Article IV consultation discussions with the United States were held in Washington, D.C. in two stages; the technical discussions took place in the period April 24-30, 1984 and the policy discussions in the period May 25-June 8, 1984. The United States has accepted the obligations of Article VIII, Sections 2, 3, and 4. The U.S. Government was represented by officials of the Department of the Treasury; the Council of Economic Advisers; the Office of Management and Budget; the Federal Reserve Board; the Departments of Agriculture, Commerce, Energy, and State; and the Office of the U.S. Trade Representative. The staff team consisted of S.T. Beza, K. Bercuson, C. Collyns, S. Dunaway, E. Hernandez-Cata, Y. Horiguchi, L. Kenward, and H. Zee (all WHD), and S. Anjaria (ETR). Mr. R.D. Erb, Executive Director for the United States for part of the consultation, and Ms. M. Bush, Alternate Executive Director for the United States, participated in the discussions.

This paper is organized as follows: Section I reviews recent economic developments; Section II covers the policy discussions with the U.S. representatives; and Section III contains the staff appraisal. Appendix I presents the staff's view on the economic outlook, Appendix II describes Fund relations with the United States, Appendix III provides basic data, and Appendix IV deals with statistical issues. The charts referred to in the text appear at the end of the paper.

I. Recent Economic Developments

After a period of three years characterized by the virtual stagnation of output and a steep rise in unemployment, the economic situation of the United States has improved markedly over the past year and a half. Following a large drop in inflation and interest rates, in late 1982 the economy began to recover from the recession. Since mid-1982 the rate of growth of M-1 has averaged about 10 percent a year (with growth of 13 percent in the first 12 months followed by an increase of about 7 percent in the last 12 months), and the cyclically adjusted federal deficit has risen by the equivalent of some 2 percent of GNP from FY 1982 to FY 1984. In the 18 months since the last quarter of 1982, nominal GNP has increased at a rate averaging 11 percent a year.

Real GNP rose at an annual rate of almost 7 percent from the fourth quarter of 1982 to the first quarter of 1984 (see tabulation below and Chart 1). Preliminary data indicate that output increased at an annual rate of 5 3/4 percent in the second quarter of 1984. The recovery of output stemmed initially from a slowdown in the pace of inventory liquidation and from substantial increases in certain other interest-sensitive components of demand (consumer expenditure on durables and residential investment). The base of the recovery broadened after the middle of 1983, as nonresidential fixed investment began to grow rapidly. Net exports of goods and services in real terms fell in every quarter of 1983 and in the first quarter of 1984, with the cumulative decline during the five quarters amounting to more than 2 percent of GNP.

The recovery of economic activity in the course of 1983 was much more robust than had been expected by most forecasters. The growth of real GNP from its recession trough in the fourth quarter of 1982 to the first quarter of 1984 was a little stronger than the average of previous postwar recoveries, even though the deterioration in the foreign balance was much more pronounced than in the past.1/ In spite of the historically high levels of real interest rates, the interest-sensitive components of private demand (business fixed investment, spending on consumer durables, and residential investment) have increased faster in the present recovery than in similar stages of past cycles. The strong growth of business fixed investment appears to reflect a stock adjustment process that followed a substantial decline in the cost of capital. This decline resulted from a large drop in interest rates in the second half of 1982 and the accompanying fall in the cost of equity financing.2/ The liberalization of depreciation allowances legislated in 1981 also appears to have made an important contribution to the strength of investment.3/ Furthermore, investment has been bolstered by the rapid growth of aggregate demand and output, and the expectation of further growth in the period ahead. The following tabulation compares the key elements of the current recovery with the 1975-76 recovery:

1/ A detailed comparison of the behavior of GNP and other key macroeconomic variables during the present recovery and other postwar recoveries is presented in Appendix I to the recent economic developments paper.

2/ See Section II of the recent economic developments paper for a discussion of the behavior of various measures of the cost of capital.

3/ This and other tax measures legislated in 1981 were described in detail in SM/81/158, Section IV and Appendix II.

(Percentage changes at annual rates)

Five Quarters Ended In	Nominal		Real				GNP Deflator
	GNP	Domestic Demand	GNP	Business Fixed Investment	Net Exports 1/		
1976:II	11.7	12.4	5.9	2.2	-0.4		5.4
1984:I	11.2	12.5	6.9	13.3	-1.6		4.0

Employment has increased very rapidly during the current recovery and in May 1984 the civilian unemployment rate was down to 7 1/2 percent, a drop of 3 1/4 percentage points from its cyclical peak in December 1982 (Chart 2). The decline in the rate of unemployment has been more pronounced than would have been expected on the basis of historical relationships; this has been associated with a relatively modest cyclical pickup in productivity growth and a slowdown in the growth of the labor force. The unemployment rate is presently at its lowest level since September 1981 and is not far from the range of current estimates for the natural rate of unemployment.2/

The rate of increase in wages has moderated considerably in the past few years. The 12-month increase in hourly earnings in the private nonfarm sector came down from nearly 10 percent in early 1981 to a little less than 5 percent in May 1983 and about 3 percent in May 1984 (Chart 3). Hourly compensation in the nonfarm business sector rose by 4 3/4 percent during the year ended in the first quarter of 1984 compared with 6 1/4 percent during the previous year. The deceleration was even more pronounced in the case of unit labor costs, which rose by less than 1 percent from the first quarter of 1983 to the first quarter of 1984, compared with more than 4 1/2 percent during the previous year.

Price inflation also has slowed substantially. From the last quarter of 1982 to the first quarter of 1984, the GNP deflator rose at an annual rate of 4 percent, down from 4 1/2 percent during 1982 and 8 3/4 percent during 1981. Preliminary data indicate that the rise in the GNP deflator was less than 3 percent at an annual rate during the second quarter of 1984. The 12-month rate of increase of the consumer price index came down to about 2 1/2 percent around the middle of 1983 from 4 percent in December 1982 and almost 9 percent in December 1981 (Chart 4). Since mid-1983 there has been some acceleration in consumer prices; in the 12-month period ended in May 1984, the consumer price index rose by 4 1/4 percent.

1/ Contribution to the growth of real GNP during the period.

2/ In Appendix I to last year's recent economic developments paper (SM/83/152) the natural rate of unemployment in the early 1980s was estimated to be within the range of 7 to 7 1/2 percent.

The deficit in the current account of the balance of payments widened from $9 billion in 1982 to $42 billion in 1983 (1 1/4 percent of GNP). It increased markedly in the course of 1983--from $12 billion (annual rate) in the first quarter to $69 billion in the fourth quarter (Chart 5). In the first quarter of 1984 the current account deficit rose to an annual rate of $78 billion. The merchandise trade deficit increased from $36 billion in 1982 to $61 billion in 1983 and to an annual rate of $103 billion in the first quarter of 1984. Imports declined in 1982 but rose substantially in 1983 and early 1984 with the upturn in economic activity (Chart 6). Exports fell sharply in 1982 and 1983, owing to a drop in volume that reflected the appreciation of the dollar since the third quarter of 1980, relatively weak foreign demand, and cutbacks in imports by some developing countries with debt problems (particularly in Latin America).1/

The effective external value of the U.S. dollar (MERM weights) rose by 43 percent from its low point in September 1980 to January 1984; it declined in February and March but it has risen since then and in the second half of June it was slightly above its level in January (Chart 7). In real terms, from the third quarter of 1980 to the fourth quarter of 1983 the value of the dollar rose by more than 30 percent on the basis of relative value-added deflators in manufacturing and by 38 percent on the basis of relative unit labor costs (Chart 8). Depending on the index used, the real value of the dollar is some 16 to 24 percent above the average for the whole period of managed floating. The behavior of the U.S. dollar since mid-1980 cannot be explained in full on the basis of historical relationships. The increase in the real interest rate differential between assets denominated in U.S. dollars and in other major currencies has helped to explain the real appreciation of the U.S. dollar (Charts 9 and 10). However, other factors—including unsettled economic and political conditions abroad and rising confidence in the U.S. economy—also appear to have played an important role.

II. U.S. Economic Policies and Prospects

In concluding the discussion on the 1983 Article IV consultation with the United States, Executive Directors emphasized the need to consolidate the progress that had been made in reducing inflation in order to create the basis for a strong and durable expansion. They felt that the prospect of continued large fiscal deficits as the economy recovered was the main obstacle to a satisfactory economic performance in the United States, and they also expressed concern about the repercussions of such deficits on other countries. Directors stressed the need for prompt measures to bring down the deficit, and indicated that this would

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1/ Balance of payments developments are discussed in detail in Section III of the recent economic developments paper. Appendix V to that paper contains an analysis of the factors that have contributed to the deterioration of the U.S. current account position in recent years.

require considerable restraint on the side of expenditure as well as efforts to raise revenue. Furthermore, Directors drew attention to the intensification of protectionist pressures and urged the U.S. Administration to demonstrate its commitment to free trade by rolling back the measures that have restricted international competition. The key economic problems faced by the U.S. authorities continue to center around these basic issues, which were featured in the discussions between the U.S. representatives and the staff.

1. Economic situation, outlook, and aims

In referring to economic developments since late 1982, the U.S. representatives noted that the growth of output and employment had been very strong while the increase in wages and prices had remained moderate. Given the pessimism that had prevailed during the recession, they considered the improvement in the economic situation to have been remarkable. The rapid growth of business fixed investment was heartening, they said, particularly since many had thought that such growth would not have been possible given the high level of interest rates. They observed that factors such as the rise in after-tax rates of return resulting from tax measures taken in the past few years, the decline in inflation, and the reduction in regulatory burdens had more than offset the effect of high interest rates on investment. They also felt that labor, product, and capital markets in the United States were much more flexible than in many other industrial countries, and such flexibility had been a key factor underlying the strong growth of output and employment together with the favorable evolution of wages and prices.

The U.S. representatives said that they were quite optimistic about the prospects for the economy. The forecast of the Administration, as revised in April 1984, was for an increase in real GNP of 5 percent during 1984, followed by growth in the neighborhood of 4 percent a year in the period 1985-89; on the basis of recent indicators some officials suggested that growth during 1984 might reach 5 1/2 to 6 percent. The U.S. representatives noted that their projections envisaged average growth of real GNP of 4.3 percent a year in the period 1983-89, compared with an average growth of 4 percent a year in the seven years following previous cyclical troughs in the postwar period. The rate of increase in the GNP deflator might go up a little in 1984 (from 4 percent during 1983), but they expected it to come down gradually over the following five-year period, to 3 1/2 percent in 1989. The forecast assumed that interest rates would fall significantly, with the rate on three-month Treasury bills declining steadily from about 9 percent in 1984 to 5 1/2 percent in 1989.

The staff observed that the Administration's outlook for growth and inflation implied a significant departure from the pattern experienced in recent cycles, in which the expansion of economic activity and the associated reduction in the degree of economic slack typically had been accompanied by an acceleration of wages and prices. The staff noted that the rate of capacity utilization in manufacturing had risen from less than 70 percent in the last quarter of 1982 to about 81 percent in the first quarter of 1984, and currently was a little higher than it had been at a similar stage in the 1975-76 upswing (see Chart 4). The U.S. representatives agreed with the staff's observation about past patterns; they emphasized, however, that there was no reason to believe that inflation could not come down as the expansion continued, although admittedly there was no recent historical example of such a development. They were convinced that if the appropriate policies were followed continuing growth would be compatible with further progress toward price stability.

The U.S. representatives stressed that keeping inflation under control was a prerequisite for achieving a sustained expansion of output and employment. All previous recoveries in the postwar era had come to an end because of an escalation of inflation following an acceleration of monetary growth. In contrast, the authorities were now seeking a deceleration of monetary growth over time, which should work to dampen inflationary expectations and to bring down interest rates. This policy would be complemented by measures to curb the growth of government spending, to increase rewards for capital formation and risk-taking, and to reduce the burden of regulation. Such a strategy provided the best hope for a lasting economic expansion coupled with a satisfactory price performance.

2. Fiscal policy

The federal deficit rose from 2 percent of GNP in FY 1981 to 6 percent in FY 1983 (see tabulation below).1/ On a cyclically adjusted basis, the deficit is estimated by the Council of Economic Advisers to have risen from less than 1 1/2 percent of GNP to 3 1/4 percent of GNP over this same period. The budget for FY 1985 that was submitted to the Congress in February of this year contained proposals to reduce the path of the deficit in the period from FY 1985 to FY 1987 by somewhat under 1 percent of GNP compared with the path implied by the current services estimate (the estimate of the deficit under the present tax system and existing spending programs). According to revised estimates of the budget released in April, the deficit would fall from 5 percent of GNP in FY 1984 to 4 percent in FY 1987, by which time the unemployment rate would be down to 6 1/2 percent, which may be viewed as corresponding to high employment. The budget projections were based on the assumption that the interest rate on three-month Treasury bills would decline from its current level of about 10 percent to 6 1/4 percent in 1987. At present, two alternative "downpayment" plans are being debated in the Congress; however, it appears unlikely that a compromise package would reduce the deficit in FY 1987 by more than 1 percentage point of GNP from the latest budget estimates.

1/ Fiscal figures in this section are on a unified budget basis and refer to fiscal years that end on September 30. On a national income accounts basis, the federal budget deficit rose from 2 percent of GNP in calendar year 1981 to 5 1/2 percent in 1983 (Chart 11).

With the inclusion of the downpayment plan and on the basis of the Administration's economic assumptions, the unified budget deficit would be around 3 percent of GNP in FY 1987, compared with a current services deficit of 5 percent of GNP in that year. However, if interest rates were to stay at present levels, the deficit cutting efforts contained in the FY 1985 plan would be offset to a significant extent, and the deficit in FY 1987 would be in the neighborhood of 4 percent of GNP.1/

Fiscal Position of the Federal Government 2/

(In percent of GNP)

	Actual			Projections 3/			
	1981	1982	1983	1984	1985	1986	1987
Outlays	22.8	23.9	24.7	23.6	23.8	23.5	23.3
Receipts	20.8	20.2	18.6	18.7	19.3	19.3	19.3
Deficit	2.0	3.7	6.1	4.9	4.6	4.2	4.0
(Billions of dollars)	(58)	(111)	(195)	(178)	(179)	(181)	(185)
Net interest payments	2.4	2.8	2.8	3.0	3.1	3.1	2.9

The U.S. representatives agreed that the budget projections were highly sensitive to underlying economic assumptions, but they considered that the economic assumptions underlying the budget projections were reasonable. They noted that the projections prepared by the Congressional Budget Office (CBO) pointed to much higher deficits than those projected by the Administration, owing largely to the higher interest rates assumed in the CBO projections. The representatives of the Administration viewed the current high level of interest rates as primarily reflecting expectations about inflation and expressed confidence that interest rates would come down, as they had projected, if monetary policy succeeded in achieving a lasting reduction in inflation. They remarked that there had been no extended period in history in which low inflation had been accompanied by persistently high interest rates.

1/ According to estimates contained in the budget documents, a 1 percentage point increase in interest rates beginning on January 1, 1984 would increase FY 1985 outlays by $7.1 billion.

2/ Fiscal years. If off-budget transactions were to be included, the federal deficit would be some 0.4 percentage point of GNP higher in FY 1983 and 0.2 percentage point higher in FY 1987.

3/ Administration's projections based on the April update of the FY 1985 budget. This update does not include any possible effect of a downpayment plan.

The U.S. representatives said that the elimination of the federal fiscal deficit remained a long-term goal of the Administration. They indicated, however, that they considered the large deficit as a symptom of the more basic problem of excessive government spending. They restated their view that in the final analysis it was government spending--rather than fiscal deficits--that pre-empted resources that otherwise would be available for the private sector. They noted that the present level of federal revenue in relation to GNP was not low by historical standards, notwithstanding the substantial cuts in personal and business taxes in the past three years. Thus, the solution to the deficit problem should be found in expenditure restraint rather than in tax increases. They pointed out that the ratio of public sector spending to GNP in the United States was considerably lower than in any other major industrial country (with the exception of Japan), and they believed that this was being reflected positively in the growth of output and employment in the United States. Nevertheless, they were convinced that a reduction of U.S. government expenditure in relation to GNP was essential to enhance the prospects for a lasting economic expansion.

The staff noted that the ratio of federal spending to GNP had risen in the past three years (from 22 1/2 percent in FY 1980 to 24 3/4 percent of GNP in FY 1983), instead of declining considerably as had been envisaged in the economic program announced by the Administration in early 1981. The U.S. representatives attributed this result to unexpectedly large increases in interest payments and in spending under entitlement programs (social security and medicare in particular). They stressed, however, that during the past three years there had been a significant reduction in the ratio of spending to GNP for nondefense programs other than social security and medicare. They pointed out that this ratio had risen from 6 1/2 percent in FY 1970 to 9 1/4 percent in FY 1980 before declining to less than 8 1/2 percent in FY 1983.

Looking ahead, the U.S. representatives noted that the latest budget envisaged a reduction in the ratio of federal spending other than interest payments to GNP from an estimated 21 1/2 percent in FY 1984 to about 20 percent in FY 1989, notwithstanding a further increase in the ratio of defense spending to GNP. The ratio of interest payments to GNP would decline from an estimated 3 percent in FY 1984 to 2 1/2 percent in FY 1989, as the effect of the large decline in interest rates that was assumed would outweigh the impact of a substantial rise in the ratio of debt to GNP. Since they would not like to see the ratio of revenue to GNP rise above 20 percent, a substantial reduction in spending beyond that contemplated in the FY 1985 budget would be needed to achieve the long-term goal of balancing the budget. Although they were not prepared to discuss specific areas where cuts would be proposed, the U.S. representatives indicated that all areas of nondefense spending, including social security and medicare, would come under scrutiny in the preparation of the budget for FY 1986.

The U.S. representatives were generally skeptical about an attempt to solve the fiscal problem through increases in taxes. They said that virtually all taxes distorted the environment in which private decisions were made and worsened the allocation of resources. Accordingly, the net impact on the economy of a deficit reduction achieved through tax increases was at best uncertain. Moreover, they were concerned that increases in revenue would be offset, at least in part, by congressional action on the side of spending. Thus, measures to raise revenue would be considered only if they were part of a comprehensive program that assured a substantial reduction in nondefense spending and did not interfere with incentives to save and invest. They remarked that a study group within the Treasury Department was looking into the possibility of reforming the tax system, but the purpose of a reform would be to increase the efficiency and simplicity of the tax system rather than to raise revenues.

The representatives of the Administration were not specific as to how rapidly the federal deficit would be reduced, but they indicated that they shared the staff's concerns about the adverse effects that continued large deficits were likely to entail. In this connection, they pointed out that the President had stressed the importance of completing a "downpayment" package this year as a first step toward elimination of the deficit. Although there were questions concerning the evidence of the relationship between budget deficits and interest rates, they felt that continued large deficits could pose a serious threat to the long-term performance of the economy. In particular, they agreed with the staff that such deficits would add to uncertainty in financial markets and would undermine the credibility of the authorities' commitment to an anti-inflationary monetary policy. Some U.S. representatives felt that, if monetary policy stayed on course, the large credit demands of the Federal Government would crowd out productive private investment, with serious implications for economic growth in the long run.

Looking at the issue from another angle, the staff observed that the deficits that were in prospect would result in a substantial increase in the federal debt in relation to GNP even as the economy approached high employment. With the full implementation of a downpayment package, and on the basis of the Administration's economic assumptions, the staff had estimated that the ratio of the federal debt to GNP would rise from 35 1/2 percent in FY 1983 to about 39 percent in FY 1987. If interest rates did not fall as expected by the Administration and if the growth of GNP turned out to be a little lower than projected in the budget, the federal debt could well rise to 42 percent of GNP in FY 1987. The staff observed that the federal debt competed with private debt for a share of the available stock of wealth and that, in the past, changes in the ratio of the federal debt to GNP had tended to be offset by changes in the ratio of the capital stock to GNP (Chart 12).

Historical relationships suggested that a prolonged rise in debt relative to GNP was unlikely to be offset by increases in the savings rate or in the ratio of wealth to income. The effect on the capital stock of such a rise could be cushioned for a while by external borrowing; however, significant relief from this source was unlikely to last long as the rise in liabilities to foreigners could be expected, in time, to set in motion equilibrating mechanisms. Thus, the projected rise in the ratio of federal debt to GNP implied that less room would be available for private debt and for capital formation.

Various views were expressed by the U.S. representatives regarding the relation between fiscal deficits and interest rates. Some said that the view advanced by the staff that large fiscal deficits and the consequent accumulation of federal debt would result in high real interest rates represented conventional wisdom, and they acknowledged that this argument had some intuitive appeal. However, they felt that policy advice had to be grounded in empirical evidence, and that the results of studies linking fiscal deficits to interest rates were inconclusive. The staff noted that, while the empirical results in this area were not conclusive, there was a growing body of empirical evidence linking the federal debt, the level of interest rates, and the stock of capital in the United States. Other U.S. officials felt that too much emphasis had been placed on the link between deficits and interest rates. Interest rates represented only a channel through which changes in the public debt were transmitted to variables such as the capital stock and wealth. The crucial issue, they said, was the relationship between the fiscal position and capital formation.

To illustrate the implications of continued large fiscal deficits on capital formation, the staff has prepared a medium-term scenario of sources and uses of savings which is presented in Appendix XI to the recent economic developments paper. In this scenario, it was assumed that the sum of gross private savings and the surplus of state and local governments would average about 18 1/2 percent of GNP in the period 1984-88; this would be slightly higher than the average of the past three years and about 3/4 percentage point above the average of the 1970s. It was also assumed that a satisfactory growth performance would require the achievement of a rate of net capital formation similar to that observed in the 1960s. Consistent with this assumption, the ratio of gross domestic investment to GNP would rise during this period and would average 17 percent over the five years through 1988. On the basis of these assumptions, the federal deficits that could be financed by domestic savings without compromising the long-term growth objective would need to decline over the period and to average no more than 1 1/2 percent of GNP. The gap between such deficits and the deficits that would result under the FY 1985 budget plan if interest rates stayed at their present levels, and if growth were somewhat more modest than assumed by the Administration, would average 3 1/2 percent of GNP in the period under consideration. This gap might be covered by foreign savings for a time as has been the case recently. However, the scenario assumes that the reliance on foreign savings would diminish over the period and be eliminated by 1988.

With regard to the international impact of U.S. fiscal policy, the U.S. representatives questioned the proposition advanced by the staff that large fiscal deficits and high real interest rates in the United States were causing problems for the rest of the world, in particular by absorbing savings which otherwise would have been available to finance capital formation abroad. They said that a large part of the increase in net private capital inflows in 1983 reflected the debt problems of developing countries, the high real rates of return available on investment in the United States, the bright prospects for the U.S. economy in general, and political and economic uncertainties in other countries. These same factors were responsible for the strengthening of the dollar which--in conjunction with the rapid economic expansion in the United States--had resulted in a sharp rise in U.S. imports. They stressed that the widening in the U.S. external current account deficit was providing a strong stimulus to the world economy and, in particular, was facilitating the adjustment efforts of the financially troubled developing countries. Thus, the U.S. representatives could not accept the suggestion that U.S. policies were inhibiting the recovery and growth of the rest of the world.

The U.S. representatives said that, in evaluating the effect of fiscal deficits, attention should focus on the fiscal position of the entire public sector rather than just that of the Federal Government. They pointed out that the overall deficit of the U.S. public sector was 3 1/4 percent of GNP at present and was not large when compared with most other major countries. According to preliminary projections that were currently being prepared in the context of the midyear budget review, the federal fiscal deficit would come down to a range of $75-80 billion in FY 1989 and, given the projected surplus of state and local governments, the total financing requirement of the U.S. public sector would decline to less than 1 percent of GNP in that year.

The staff replied that decisions about fiscal policy that aim at affecting the overall performance of the economy were taken only at the federal level. State and local governments were not directly concerned with influencing the performance of the national economy and focused primarily on their own economic and financial situation, in much the same way as the private sector. Of course, it was important to take into account the financial position of the state and local governments (as well as that of the private sector) in examining the availability of domestic savings to finance various forms of investment and to satisfy the credit needs of the Federal Government.1/ The point that had to be emphasized was that federal fiscal deficits reduced the funds available to finance capital formation.

1/ It should be noted that the surplus of the state and local governments is expected to decline in relation to GNP after 1984, partly as a result of the expiration of temporary tax increases adopted in the past few years. The financial position of these governments is discussed in Section IV of the recent economic developments paper.

3. Monetary policy

During 1983 M-2 and M-3 rose at rates that were broadly in line with their respective target ranges of 7 to 10 percent and 6 1/2 to 9 1/2 percent.1/ In contrast, M-1 rose at an annual rate of 12 1/2 percent during the first half of 1983 (after increasing at an annual rate of 13 percent during the second half of 1982), well above the 4 to 8 percent range established early in the year. In the view of the Federal Reserve, this surge in M-1 (which was associated with an unusual decline in its velocity) reflected portfolio adjustments in response to the pronounced drop in the opportunity cost of holding M-1 balances brought about by the sharp decline in inflation and interest rates and by the increased importance of the interest-bearing component of M-1. Toward mid-1983, however, the Federal Reserve took steps to slow the expansion of M-1, in light of growing evidence that the economic recovery was robust and that the behavior of the velocity of M-1 was returning to normal. During the second half of the year, M-1 rose at an annual rate of 7 1/2 percent, which was well within the 5 to 9 percent range specified at the time of the midyear policy review in July 1983.

In February 1984, the Federal Reserve established target ranges for the growth of the monetary and credit aggregates during the year, which were intended to be consistent with the objective of achieving a lasting economic expansion coupled with continuing control of inflationary pressures. The ranges for both M-2 and M-3 were set at 6 to 9 percent--1 percentage point and 1/2 percentage point, respectively, below the ranges for 1983. The M-1 growth range was set at 4 to 8 percent, 1 percentage point lower than the range specified for the second half of 1983. These ranges were established on the assumption that the relationships between the growth of the monetary aggregates and that of nominal GNP would be broadly in line with past trends and cyclical developments. It was noted, however, that certain legislative and regulatory proposals--such as the payment of interest on demand deposits or on required reserve balances--could have an important impact on financial behavior and might require reconsideration of the ranges, especially for M-1, if they were to be implemented in 1984.

In announcing these targets to the Congress, the Chairman of the Federal Reserve said that the battle against inflation had not yet been won. Given the experience of the past, skepticism about the durability of the progress made against inflation was likely to persist until it was demonstrated that the Federal Reserve was not prepared to accommodate a new inflationary surge as the expansion continued. Thus, the greatest contribution that the Federal Reserve could make to a sustained growth of the economy was to foster the expectation that the gains against inflation would be sustained and extended. He noted that the doubts about continued progress toward price stability were reinforced by concerns that the pressures of the large budget deficits on financial

1/ Recent movements in the monetary aggregates in comparison with their target ranges are shown in Chart 13.

markets might push the Federal Reserve in the direction of accommodation. In these circumstances, monetary policy had to carry a greater burden than usual.

In discussing the recent behavior of the monetary aggregates, the Federal Reserve representatives thought that the velocity of M-1 had shown a more normal pattern in the past few quarters. However, they did not rule out the possibility that regulatory and institutional developments in the past few years might have resulted in a permanent change in the underlying relationship of money, income, and interest rates. In particular, the growing importance of interest-bearing components in M-1 appeared to have enhanced its role as a vehicle for saving. As a result of these changes the elasticity of M-1 with respect to market interest rates would be reduced, but the demand for M-1 would probably more susceptible than in the past to savings motives and to shifting asset preferences on the part of households. Only additional experience would reveal the nature and extent of such changes. For the time being, substantial weight would continue to be placed on the broader aggregates, and the growth of M-1 would continue to be evaluated in light of movements in the other aggregates; at the same time, there was recognition of the limitations of the broader aggregates as policy guides because of problems of interpretation and controlability.1/

In these circumstances, a return to the kind of automaticity in the implementation of monetary policy observed between late 1979 and the fall of 1982 appeared unlikely, the Federal Reserve representatives said. In forming judgments about the appropriate course of monetary policy, movements in the monetary aggregates would be assessed (as had been the case in 1983) in conjunction with developments in the economy, including price developments and conditions in domestic and international financial markets. However, it had to be emphasized that the behavior of the aggregates was very important in forming those judgments. The Federal Reserve had no intention of deviating from the position of regarding the aggregates as a key determinant of policy.

The representatives of the Administration said that they fully supported the stated goal of Federal Reserve policy. In their judgment, the monetary growth targets for 1984 were broadly consistent with the achievement of that goal, although they would have preferred a somewhat narrower range for M-1. Their major concern was with the implementation of monetary policy. In their view, the Federal Reserve's operating procedures in the recent past had given too much emphasis to interest rates, thus tending to cause large fluctuations in monetary growth and instability in the economy. While it was possible that the behavioral characteristics of M-1 might have been altered permanently by recent institutional changes, they did not consider the evidence available thus far as convincing. They recognized that there were uncertainties about the relationship between M-1 and economic activity, but they emphasized that alternative relationships (such as those between interest rates and economic activity) were even less reliable as guides for policy.

1/ These issues were discussed in Appendix VIII to SM/82/152.

The Administration representatives believed that monetary growth in the second half of 1982 and the first half of 1983 had been excessive, and they expected this to be reflected in some acceleration of inflation this year. They noted, however, that monetary growth had since slowed, with M-1 growing well within its target range. They remarked that they would like to see M-1 grow at a steady pace, preferably not lower than the middle of the target range, in the remainder of this year. Looking ahead, they hoped that the Federal Reserve would aim at a gradual slow-down in M-1 growth to ensure further progress toward price stability while avoiding a recession, and indicated that a reduction of about 1/2 percentage point would be appropriate for 1985.

For their part, the Federal Reserve representatives considered the near-term outlook for inflation as relatively favorable, given the moderate behavior of wages; it was their view that the present stance of monetary policy was consistent with a substantial deceleration in aggregate demand in the period ahead. They noted that if M-1 were to rise by approximately 6 percent (the midpoint of its present range), the continuation of nominal GNP growth in the double-digit range would imply an extraordinarily large increase in velocity. Their expectation, based on the judgment that the behavior of M-1 would not deviate much from historical experience, was that M-1 growth at an annual rate of 6 percent would be accompanied by an expansion of nominal GNP of some 9 percent a year, which would be consistent with the objective of monetary policy.

In reviewing the recent rise in interest rates, the Federal Reserve representatives said that it had reflected a sharp increase in credit demands, resulting mainly from the strength of the economic expansion. The annual rate of growth of private domestic nonfinancial sector debt had picked up from 6 percent in the first quarter of 1983 to 12 percent in the first quarter of 1984. At the same time, credit demands of the Federal Government had remained strong. They observed that, in May, M-3 was above its target range and M-1 and M-2 were, respectively, at the top and around the midpoint of their ranges; thus, it did not seem that the recent increase in interest rates could be attributed to monetary restraint.

The representatives of the Federal Reserve expressed concern about the effect of the recent rise in interest rates, in particular about the increased difficulties that this rise was causing to the heavily indebted developing countries. However, they emphasized that attempts to hold down interest rates by speeding up the growth of money and credit would be a serious mistake. In the present situation in which aggregate spending was expanding strongly and credit demands were escalating, the Federal Reserve should avoid giving the impression that it was not striving to keep money and credit growth at a reasonable pace.

Federal Reserve officials commented on the recent difficulties experienced by certain banks in the United States and the implications of such problems for the conduct of monetary policy. In their view, the authorities had been successful in providing assistance to banks in trouble while keeping the growth of bank reserves under control. They noted that shifts of funds toward safer financial instruments in the wake of these incidents, and the consequent widening of risk premia, could be expected to have some impact on economic activity by raising the cost of funds to private borrowers, but thus far the Federal Reserve had not attempted to offset such effects. Looking ahead, they cautioned that providing assistance to banks without affecting the stance of monetary policy would become a formidable task if a number of large financial institutions were to suffer a loss of confidence.

4. Balance of payments and the exchange rate

U.S. officials said that the main factors behind the widening of the current account deficit in 1983 were the strength of the U.S. recovery compared with that of other industrial countries, the decline in U.S. exports to financially strained developing countries, and the effects of the real appreciation of the U.S. dollar during the past several years. They also noted that U.S. exports to OPEC had declined sharply in 1983 in reflection of a drop in the oil revenues of these countries, although this had been more than offset by a decline in the value of imported oil.

The U.S. representatives expected the current account deficit to rise to around $80 billion in 1984 and to perhaps $100 billion in 1985. The trade deficit would be on the order of $105 billion this year and would increase to about $125 billion in 1985.1/ The staff's projections, which appear in Appendix I to this report, do not differ materially from those of the Administration. U.S. officials said that the $45 billion rise in the trade deficit from 1983 to 1984 would stem largely from a sizable increase in imports reflecting the relatively strong growth in U.S. GNP that was projected. Nonagricultural exports would rise moderately (after declining for two consecutive years) as growing demand in other industrial countries would begin to outweigh the remaining effects of past increases in the value of the dollar. A further decline in exports to OPEC would be more than offset by an increase in exports to non-oil developing countries, notably in Latin America. The widening in the U.S. trade deficit would be less marked in 1985 as nonagricultural exports were expected to rebound because of the growing strength of economic activity abroad and the gradual disappearance of adverse exchange rate effects.

1/ These projections assumed that the average value of the dollar would remain constant in nominal terms at its March 1984 level; the world price of oil was assumed to remain unchanged through the end of 1985.

As regards the balance on services transactions, U.S. officials said that they were projecting a small improvement from 1983 to 1985. Net direct investment income would rise as a result of improved business conditions in other major industrial countries, but net income on portfolio investment would fall in reflection of the worsening in the net international investment position of the United States implied by recent and prospective current account deficits.

With respect to the capital account, the U.S. representatives noted that the balance on reported capital transactions had shifted from a net outflow of $24 billion in 1982 to a net inflow of $32 billion in 1983. This large shift was more than accounted for by a sharp reduction in U.S. bank lending to foreigners that was associated with a reappraisal by the banks of the risks involved in extending credit to certain developing countries. U.S. officials stressed that developments in the capital account could not be interpreted without taking into consideration movements in the statistical discrepancy of the U.S. balance of payments. They recalled that the net inflow on unrecorded transactions had dropped from $33 billion in 1982 to only $9 billion in 1983. There was no fully convincing explanation for the behavior of the statistical discrepancy. However, U.S. officials thought that the size of the recent changes in that item suggested that the statistical discrepancy largely reflected unreported private capital flows of a particularly volatile nature. The U.S. representatives indicated that a number of projects aimed at improving U.S. balance of payments statistics and reducing the size of errors and omissions were underway.1/

The U.S. representatives said that there was no clear, single explanation for the continued appreciation of the dollar during 1983. Movements in interest rate differentials had been a factor behind exchange rate movements, but only during some parts of the year. They felt that the value of the dollar also had been boosted by the indications that economic growth in the United States was more robust than had been anticipated earlier while economic performance in certain other major countries had been disappointing. Moreover, the profitability of investment in the United States had improved markedly as a result of factors such as the decline in inflation, deregulation, and the investment incentives introduced in 1981. At the same time, the investment climate in other countries had been adversely affected by concerns about economic and political prospects, giving rise to inflows of private capital seeking a "safe haven" in the United States and raising the value of the dollar.

In the discussion of the outlook for the exchange rate, the staff suggested that—barring a further rise in U.S. interest rates—the large current account deficits projected for 1984 and 1985 were not likely to be financed by capital inflows at prevailing exchange rates. The U.S.

1/ A description of these projects is provided in Appendix VI of the recent economic developments paper, which also includes an examination of the recent behavior of the statistical discrepancy.

representatives answered that they would not be surprised if the dollar were to drift down in the period ahead, particularly in relation to the Japanese yen. Indeed, they thought that such a development would be a normal manifestation of the international adjustment process in the presence of large U.S. current account deficits. In the case of the Japanese yen, it was expected that efforts to liberalize capital markets and internationalize the role of the yen in the wake of the recent agreement between Japan and the United States would allow the exchange rate to reflect more fully the underlying strength of the Japanese economy.

The U.S. representatives did not foresee an abrupt fall in the dollar. In their view, such an outcome could result only from the reemergence of inflation in the United States, which they were determined to prevent. If the dollar were to decline as a result of interest rate changes induced by actions to cut the federal fiscal deficit, the adjustment probably would be gradual. They felt that an orderly depreciation of the dollar, even if substantial, would not have major implications for the long-term performance of the U.S. economy and would not warrant significant changes in U.S. policies. In this discussion, the staff emphasized that in order to avoid a squeeze of capital formation as the current account position was adjusted, the fiscal position would have to be strengthened.

The objective of U.S. intervention policy continued to be the avoidance of disorderly market conditions. There had been periods of rapid exchange rate movements during 1983 but, in the judgment of the U.S. authorities, instances of disorderly conditions warranting intervention in foreign exchange markets had been few. On three separate occasions during 1983 the United States had purchased the equivalent of $333 million of deutsche marks and Japanese yen in coordinated operations with the German and Japanese authorities. Looking ahead, the U.S. representatives said that they would not resist a decline in the dollar through intervention. However, they would continue to consult regularly with foreign monetary authorities concerning policies and market developments, and they remained prepared to undertake coordinated intervention to counter disorderly market conditions. They anticipated greater convergence of economic policies and performance among major countries, and therefore they did not expect disorderly conditions to occur with great frequency.

5. Other foreign economic issues

The U.S. representatives said that their main objectives in the trade area remained the preservation of open world markets and the expansion of free and fair trade. The Administration was seeking to achieve these objectives in two ways: by attempting to resist pressures for import-restricting measures that had no merit under U.S. and international law, and by taking advantage of the improvement in the world economic situation to strengthen international cooperation in the trade area. The U.S. representatives stressed that U.S. trade laws were consistent with the international obligations of the United States and were designed to provide relief to U.S. industries suffering either from unfair competition from imports or from severe, import-related adjustment problems. They said that access by U.S. producers and workers to import relief under U.S. trade laws was essential to maintain public support for free trade in the United States.

The U.S. representatives expressed cautious optimism with regard to the outlook for addressing current international trade problems in a multilateral setting, particularly after 1984. They noted that international discussions concerning the possibility of a new round of trade negotiations were underway; a final decision to launch such negotiations might not be taken this year, but a thorough discussion of the issues involved in the framing of new multilateral talks should not be postponed. U.S. policy objectives in such talks would include the improvement of international discipline in a number of areas (including trade in agriculture, services, and high technology) and a comprehensive multilateral agreement on a safeguards code in the GATT.

The staff noted that protectionist pressures had intensified even as unemployment had dropped and profit margins had increased substantially. The U.S. representatives said that they were disappointed by these developments. They thought that pressures for protection reflected the intensity of import competition--stemming in part from the high value of the U.S. dollar--as well as the widespread view that other countries were not practicing fair and free trade to the same extent as the United States. Also, the demands for import relief might be related to the proximity of presidential and congressional elections in the United States. The Administration would continue to resist protectionist pressures, notably in areas such as minimum domestic content rules and legislated quotas. Notwithstanding the difficulties encountered in striving to maintain a liberal trade regime, they were not convinced that there was a need to amend U.S. trade laws or to modify institutional arrangements.

Several actions were taken in the trade area in 1983 and the first half of 1984.1/ Protection from imports was granted in two escape clause cases (motorcycles and specialty steel). Also, action was taken in a number of antidumping and countervailing duty cases, notably in the area of steel; several of these cases were resolved by the adoption of voluntary export restraints by certain foreign steel producers. In response to rising claims that textile imports were disrupting domestic markets, a significant number of calls for consultations under bilateral textile agreements were made and new quantitative criteria were adopted in December 1983 to tighten the monitoring of textile imports. In addition, the voluntary restraints on automobile exports from Japan were extended for a fourth year through April 1985, although the annual export ceiling was

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1/ These and other measures in the foreign trade and investment areas are described in Appendix VIII to the recent economic developments paper; a brief description of the main avenues for import relief under U.S. trade laws is provided in Appendix VII.

raised by 10 percent.1/ The U.S. representatives indicated that petitions for import relief were pending in a number of areas, including copper, carbon steel, and machine tools.2/

The U.S. representatives said that many of the actions taken by the United States in the past few years were in response to unfair trade practices by other countries and did not have a protectionist intent. This was particularly the case for antidumping and countervailing duty actions, which had a specified time limit and were accepted under international rules. In such cases, U.S. laws gave the Executive Branch very limited discretion to deal with petitions for import relief. In response to the staff's concern about the increasing tendency to resort to "voluntary" export restraints as a means of dealing with unfair trade practices, U.S. officials emphasized that these developments did not reflect the Administration's policy.

The U.S. representatives also made reference to actions taken by the United States to induce other countries to reduce trade-distorting measures. In this connection, they mentioned the use of subsidized blended credits for the export of certain agricultural commodities, which aimed in part at regaining markets that had been lost to subsidized sales by other countries, primarily the European Community. These blended credits were not used to displace nonsubsidized exports. With regard to "targeting"—the deliberate promotion and protection of infant industries—the U.S. representatives believed that actions of this kind by foreign governments should be dealt with through bilateral diplomacy, through the GATT, or, in the last resort, through existing U.S. trade laws. The Administration opposed legislative proposals to deal with "targeting" by the imposition of countervailing duties.

In the area of international taxation, the U.S. representatives discussed the implications of a decision by the U.S. Supreme Court allowing state governments to impose taxes on the income of multinational corporations operating within their borders using the worldwide unitary method of taxation. The U.S. representatives said that a Working Group chaired by the Secretary of the Treasury had been established to make recommendations that would reconcile the views of the business community and those of foreign governments with the interests of the individual states. In December 1983, the Working Group rejected, for the time being, resort to federal legislation to deal with the use of unitary taxation since a cooperative approach was believed to offer the best chance for resolving the problems raised by the use of this method of taxation. In May 1984, the Working Group agreed to the general principle that states should limit the taxation of corporations to income earned within the boundaries of the United States. A final report by the Working Group is currently being prepared.

1/ Appendix IX to the recent economic developments paper presents an attempt to quantify the effects of these restraints.

2/ In June 1984, the International Trade Commission (ITC) ruled that imports had been a substantial cause of injury in the cases of carbon steel and copper. The President is expected to make a determination by September whether to grant relief.

The U.S. representatives said that the most serious international problem faced by the United States in the agricultural area stemmed from unfair trading practices by other countries, although the appreciation of the U.S. dollar and the debt related problems of many developing countries had played a role in restraining U.S. exports of certain commodities. They emphasized that the United States remained committed to the liberalization of agricultural trade, but they stressed that this would require action by other countries to reduce import barriers and domestic farm support programs and to roll back the measures that were distorting international trade in farm products. U.S. officials said they were encouraged by the proposals made by the staff of the GATT to deal with the problem of agricultural export subsidies. In general, they believed that any exceptions to a prohibition of agricultural subsidies should be both temporary and limited in scope.

The reduction in world demand for U.S. agricultural products together with record crops in 1981 and 1982 had resulted in large surpluses and an escalation of the budgetary cost of farm programs. The 1983 Payments-in-Kind (PIK) program had been designed as a temporary solution to these problems;1/ by encouraging farmers to cut production in exchange for deliveries of commodities from government stocks, the program sought to reduce substantially the surplus stocks of grains and cotton, to reduce government outlays for agricultural programs, and to enhance farm income while maintaining market supplies. In the event, the combined effects of the PIK program and a severe drought led in 1983 to a sharp drop in U.S. crop production and to a significant reduction in stocks for most commodities. The Administration recently had adopted various measures (including a freeze on target prices in 1984 and beyond) to reduce budget outlays on farm programs and to bring the incentives provided by these programs more in line with market realities.

In the discussion of U.S. economic relations with developing countries, the U.S. representatives restated their view that official assistance was not the most effective way to help these countries achieve their development objectives.2/ In general, it was preferable for resource transfers to take place through private channels, particularly in the form of direct investment. A more open international investment regime would improve the allocation of world resources and could play an important role in resolving the international debt problem. Moreover, they emphasized that providing liberal access to U.S. markets was an essential ingredient of U.S. strategy in this area. In this regard, they referred to the large increase in U.S. imports in 1983, and observed that the rise in imports from a number of developing countries had been exceptionally strong. The United States also had acted to increase market access for certain developing countries. For example, in early 1984, 20 countries became eligible for one-way, duty-free access to the U.S. market for a large number of products under the Caribbean Basin Recovery Act.

1/ The main features of this program were described in Appendix VIII of last year's recent economic developments paper (SM/83/152).

2/ Recent trends in U.S. official development assistance are discussed in Appendix X of the recent economic developments paper.

III. Staff Appraisal

Following a large drop in inflation and interest rates, in late 1982 the U.S. economy began to recover from a deep and prolonged recession. Since then the growth of output and employment has been very strong, and inflation has remained relatively moderate. At the same time, however, the current account of the U.S. balance of payments has moved into a very large deficit and interest rates have come under renewed upward pressure. Thus, while important gains have been made in improving the economic performance of the United States and in helping to foster an international economic recovery, questions have arisen about the medium-term prospects of the U.S. economy and about the repercussions of U.S. policies upon other countries.

Nominal GNP has been growing very rapidly since early 1983, and monetary policy will need to help steer the economy back to a path of demand growth that avoids a revival of inflation and ensures further progress in the reduction of inflation. Attention also needs to be paid to the efficiency of resource use in the pursuit of growth and stabilization objectives, particularly by assuring an open trading system. Most importantly, the fiscal position will need to be strengthened a great deal to ensure adequate resources for capital formation and to facilitate an orderly adjustment of the external current account.

It is in this last-mentioned area that the staff continues to have its most serious reservations about U.S. economic policy. The budget for FY 1985 contained proposals to reduce the deficit, but the reduction sought was limited in size and concentrated in the out years. The downpayment package that is currently being negotiated in the Congress would provide some further assistance in reducing the deficit, but that package also is small when compared with the magnitude of the fiscal gap. Moreover, the Administration's projections of budgetary improvement rest to some extent on the assumption that interest rates will come down substantially over the next few years, but it may be questioned whether rates will in fact decline unless actions are taken to bring about a substantial reduction of the federal deficit.

Indeed, if the pressures on domestic resources in recent years had not been cushioned by the use of foreign savings, domestic interest rates would have been even higher, with negative effects on domestic investment. Relief from foreign savings cannot be expected to continue for long, however, as the imbalance in the current account will at some point have to undergo adjustment. To lessen the risk of disruptive effects stemming from this adjustment, both on the United States and other countries, budgetary plans should be based on the assumption of a reduction over time in the inflow of foreign savings.

The conclusion to be drawn is that priority needs to be given to a large and rapid cutback of the federal deficit. An immediate target might be to cut the deficit to the point where the federal debt would no longer be rising in relation to GNP, thereby lowering the danger that the domestic capital stock would decline relative to output and reducing the concern that the anti-inflationary stance of monetary policy would become untenable. Of course, such an interim step would need to be followed by further substantial reductions in the federal deficit.

As for the means of bringing down the federal deficit, the staff agrees with the emphasis placed by the U.S. authorities on expenditure restraint, since this would relieve pressures on resources while minimizing adverse effects on incentives. So far, however, this strategy has not yielded the desired results, and federal spending has risen substantially in relation to GNP in the past few years. While the ratio of spending on nondefense programs to GNP has declined somewhat since the present Administration took office, the reduction has been considerably smaller than the original goal and has been more than offset by increases in defense spending and interest payments.

In view of the size of the federal deficits that are in prospect, and given the difficulty of reducing spending, further action to increase federal revenue may well be unavoidable if the fiscal problem is to be dealt with in a satisfactory manner. It should be possible to raise revenue in a way consistent with the preservation of incentives to save and invest--for example, by focusing on consumption taxes and on the reduction of certain tax expenditures that discriminate against business capital formation. The point that needs to be emphasized is that any adverse effects of tax increases must be weighed against the unfavorable consequences of a continued high rate of debt financing.

As has already been noted, inflows of foreign savings in recent years have reduced the crowding out of private spending in the United States. These inflows probably have reflected in part an improved economic environment in the United States as well as uncertainty about economic and political prospects in other countries. At the same time, however, the pressures stemming from the financing of the U.S. fiscal deficit have induced a flow of funds to the United States and have raised the real exchange value of the U.S. dollar, which has been part of the mechanism by which the real transfer of resources has been brought about. To be sure, the resource transfers from the rest of the world to the United States have been made on the expectation of obtaining rates of return that exceed those available in the rest of the world. Also, the counterpart of the large increase in the U.S. external current account deficit has been a rise in exports (and economic activity) in other countries. However, so long as large fiscal deficits and high real interest rates persist in the United States, adverse effects on capital formation can be expected, whether in the United States or abroad, with unfavorable implications for the long-term performance of the world economy.

While these considerations are generally applicable, another aspect needs to be examined in assessing the impact of large U.S. fiscal deficits on the developing countries with substantial external debts. For these countries, additions to their debt service payments resulting from increases in U.S. interest rates represent a particularly serious burden on their economies. The higher interest payments being made by these countries are in a number of instances currently being offset by a rise in export earnings, but such offsetting movements are not universal and the situation of these countries continues to be quite vulnerable. The lasting reduction in interest rates that would result from the pursuit of a significantly more restrained fiscal policy in the United States would reduce the dangers faced by these countries and also would help to lower pressures on the international banking system, which stem in part from doubts about the capacity of the heavily indebted countries to service their debts.

In regard to monetary policy, the Federal Reserve has stated that its aim continues to be the achievement of growth in the monetary aggregates consistent with sustained economic expansion and further progress toward price stability. Given the substantial reduction in the degree of economic slack that has occurred, there is a danger that inflation could make a comeback, as has occurred in previous periods of expansion. In order to avoid this danger, the growth of the monetary aggregates will have to be brought down over time to ensure a progressive reduction in the trend rate of growth of nominal demand. There are factors that may work to slow the growth of demand in the period ahead, and there are indications that such a slowdown may have begun in the second quarter of this year. However, it cannot be ruled out that demand pressures may continue to be strong for some time, with a rapid expansion of private demand coming on top of the continuing effects of fiscal policy.

In recent months the rates of growth of M-1 and M-2 generally have been within the target ranges announced by the Federal Reserve. Relatively steady growth of these aggregates near the midpoint of their ranges, with some deceleration over time, would seem to provide protection against a rise of inflation while allowing for further progress in reducing unemployment. However, it must be recognized that institutional changes may have altered the relationship among money, income, and interest rates in a permanent way. If monetary growth rates of the order of magnitude just mentioned fail to achieve a significant deceleration of nominal demand in the coming quarters, a tightening of reserve provision would be necessary to avoid an acceleration of inflation and much larger rises in interest rates in the longer term.

The Administration has stressed the objective of reducing the burden of government regulation and, more generally, has emphasized the role of market forces in the design of economic policy. The staff fully agrees with these objectives, but it notes that the policies of the Administration in certain areas—notably agriculture and international trade—have not been entirely consistent with free market principles. With regard to agriculture, the combined effects of a severe drought and the PIK program resulted in a drop in U.S. crop production in 1983. However, this development has not altered the basic situation of excess supply (and large budget outlays) stemming from high target and support prices, and the imbalance between supply and demand still has to be addressed.

On trade policy, the U.S. authorities have emphasized that the Administration has aimed at resisting the growing protectionist pressures. However, the actions taken in a number of areas (including textiles, steel, and autos) raise the question whether these pressures have been effectively resisted. Indeed, the fact that requests for import relief have proliferated even as the economic situation has improved can be read as an indication that the institutional arrangements now in place offer too much hope of success to those who seek protection from foreign competition. The U.S. authorities have pointed out that some of their actions were adopted in response to unfair competition by other countries. However, it would seem that these actions have not had much success in eliminating unfair practices but rather have had the effect of increasing intervention in international trade.

The U.S. representatives had made reference in the discussions to the real appreciation of the U.S. dollar as a factor behind the pressures for protection. Of course, it should be understood that some decline in competitiveness inevitably must develop if capital inflows are induced by an expansionary fiscal policy, and the solution to that problem should involve adjustment of the fiscal position.

The intensification of protectionism in the present world situation carries with it particularly serious dangers. The spread of trade restrictions reduces the efficiency of resource allocation both in the United States and abroad, and interferes with the efforts of developing countries to overcome debt-related difficulties. In view of these dangers, the staff considers it essential that the United States and other major industrial countries avoid new trade-restricting measures and take action to roll back existing barriers to international trade. In particular, it would be highly desirable to terminate the restraints on exports of Japanese automobiles to the United States in view of the costs of these restraints. An early termination of these barriers to U.S. automobile imports would be an important step in promoting moderation in wage settlements and reducing inflationary expectations throughout the U.S. economy.

The United States has played an important and constructive role in dealing with the debt problems of developing countries. The U.S. authorities have emphasized the importance of providing free access to the markets of industrialized countries in helping the LDCs to achieve their development objectives and have taken initiatives to open up the U.S. market for some of the smaller developing countries. However, the staff is concerned that certain restrictive trade actions that are currently under consideration (notably in the areas of steel and copper) could damage seriously the export performance of many countries, including several of the heavily indebted developing countries. In view of the severe adjustment problems many of these countries are facing, the United States should resist the adoption of such restrictive actions and take the lead in a concerted effort to dismantle the measures that are already in place. The staff also believes that, in the present circumstances, it would be particularly desirable for the United States to increase the level of official development assistance. Finally, the staff agrees with the view expressed by the U.S. authorities that a more open international investment regime would improve the allocation of world resources and could play a role in resolving the international debt problem.

It is recommended that the next Article IV consultation with the United States be held on the standard 12-month cycle.

Outlook

The staff's tentative projections through the end of 1985, prepared in the context of the current World Economic Outlook exercise, are based on the assumption that the Federal Reserve will aim at growth in the monetary aggregates consistent with an expansion of nominal GNP during 1984 (from the fourth quarter of 1984 to the fourth quarter of 1985) in the range of 9-10 percent, and that there will be a modest reduction in monetary growth during the following year. Furthermore, it is assumed that the Congress will enact budgetary measures that will have similar overall effects to those proposed in the FY 1985 budget as supplemented by the adoption of a downpayment plan. The projections assume that real interest rates will remain relatively high because of the large current and prospective deficits of the Federal Government.

On the basis of the above assumptions and the underlying trend of private demand, the staff estimates that during 1984 real GNP will grow by nearly 6 percent. The contribution of inventory investment to the growth of output is expected to be modest, and final domestic demand in real terms is projected to rise by 6 1/2 percent during 1984. Business fixed investment and residential construction would increase less rapidly than during 1983, but would continue to show considerable strength. Personal consumption expenditure would rise a little faster than GNP, but the growth in government purchases of goods and services would be modest.

The growth of real GNP is projected to fall during 1985 (to 3 1/2 percent) reflecting a slowdown in the growth of all major components of private domestic demand. There would be a sharp drop in the growth of business fixed investment and residential construction as the stock adjustment process of 1983-84 ran its course. The interest-sensitive components of demand also would be affected by the rise in interest rates and in the cost of equity financing during 1984. On a year-over-year basis, real GNP would grow by 6 3/4 percent in 1984 and by a little less than 4 percent in 1985.

In line with the growth in output, employment would rise by 4 percent during 1984 and by 2 percent during 1985, and the unemployment rate would fall to 7 percent by the end of the period. The GNP deflator is forecast to increase by 4 percent during 1984 and by 4 1/2 percent during 1985. Hourly compensation would rise by about 5 percent a year in 1984 and 1985 but unit labor costs would accelerate a little owing to a cyclical slowdown in the growth of productivity. These developments would be consistent with a modest increase in profit margins.

The deficit in the current account of the balance of payments is projected to widen to \$90 billion (2 1/2 percent of GNP) in 1984 and to \$115 billion (nearly 3 percent of GNP) in 1985. It is envisaged that the deficit on merchandise trade will increase to \$115 billion in 1984 and to \$140 billion in 1985. The value of oil imports would rise substantially in 1984 and 1985 as a result of sizable increases in volume;

it is assumed that international oil prices will not change in U.S. dollar terms through the end of the forecast period. Non-oil imports would increase very rapidly in 1984 and at a slower pace in 1985, reflecting the course of domestic demand. After falling for two consecutive years, exports would show fairly strong increases in 1984 and 1985 as a result of the strengthening of demand abroad and the gradual disappearance of the adverse effects of the appreciation of the dollar in previous years. The surplus on services transactions would rise in 1984 owing to a pickup in direct investment income with the strengthening of the recovery abroad. However, there would be a slight decline in the surplus in 1985 as the drop in net income on portfolio investment—stemming from the deterioration in the international investment position of the United States—would offset the improvement in other services transactions.

It should be emphasized that these current account projections are based on the average exchange rate of the dollar in June 1984. However, a deterioration in the current account as large as that projected may result in downward pressures on the exchange value of the U.S. dollar, and the resulting depreciation would work, with a lag, to reverse the deterioration in the current account position.

While the staff envisages a continued expansion of economic activity in 1984-85, there are certain questions about the outlook for growth beyond this period. In the absence of further fiscal action, the prospect of large federal deficits even as the economy approaches high levels of resource utilization does not augur well for an enduring expansion of economic activity. Staff estimates imply that the ratio of the federal debt to GNP would rise from about 35 1/2 percent in FY 1983 to around 42 percent in FY 1987. Large fiscal deficits and the attendant increase in government debt would tend to pre-empt savings and keep real interest rates high, with adverse effects on capital formation and productivity growth, and could generate uncertainty about the Government's commitment to anti-inflationary policies. While action to reduce budget deficits would likely dampen economic activity in the short run, it would enhance the prospects of economic expansion over the long run.

Table 1. United States: Selected Economic Indicators

(Percentage changes from preceding year, except as indicated)

	1980	1981	1982	1983	Proj. 1984	Proj. 1985
Gross national product (in constant prices)	-0.3	2.6	-1.9	3.4	6.8	3.9
Consumer expenditure	0.5	2.7	1.4	4.2	6.4	5.0
Government expenditure	2.2	0.8	1.8	0.4	1.0	2.8
Residential construction	-20.3	-5.1	-15.4	39.4	15.0	0.6
Nonresidential fixed investment	-2.4	5.2	-4.8	1.4	15.1	6.5
Final domestic demand	-0.4	2.3	0.2	4.1	6.6	4.6
Stockbuilding 1/	-0.8	0.9	-1.2	0.5	1.7	-0.5
Total domestic demand	-1.2	3.3	-1.0	4.6	8.4	4.0
Foreign balance 1/	0.9	-0.5	-0.9	-1.2	-1.6	-0.1
Output, employment, and costs						
Industrial production	-3.6	2.6	-8.1	6.4	11.7	7.3
Employment	0.5	1.1	-0.9	1.3	4.3	2.7
Unemployment rate, civilian 2/	7.2	7.6	9.7	9.6	7.6	7.1
Hourly compensation in the manufacturing sector	11.7	9.8	8.5	5.3	4.6	5.2
Prices						
GNP deflator	9.2	9.4	6.0	4.2	3.7	4.4
Consumer price index	13.5	10.3	6.2	3.2	4.5	5.0
Foreign trade						
Export unit value	13.6	9.2	1.3	1.1	3.8	4.9
Import unit value	25.4	5.5	-1.6	-4.1	0.8	1.7
Terms of trade	-9.4	3.5	2.8	5.4	3.0	3.1
Volume of exports	7.0	-3.2	-11.9	-6.2	6.5	3.6
Volume of imports	-6.0	0.7	-5.0	10.0	27.8	11.1
Current external transactions (in billions of dollars)						
Trade balance	-25.5	-28.0	-36.5	-61.1	-115.3	-139.8
Balance on services and private transfers	32.1	38.7	32.7	25.5	31.0	30.7
Current balance, excluding official transfers	6.6	10.7	-3.8	-35.5	-84.3	-109.0
Current balance, including official transfers	1.9	6.3	-9.2	-41.6	-90.0	-115.0

1/ Change as a percentage of GNP in the previous year.
2/ Annual averages, in percent.

United States - Fund Relations

(Position as of May 31, 1984 except where otherwise indicated; in millions of SDRs)

I. Membership Status

The United States became a member of the Fund on December 27, 1945. The United States has accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Fund agreement.

A. Financial Relations

II. General Department

(a) Quota: SDR 17,918.3

(b) Total Fund holdings of U.S. dollars: SDR 8,132.7 (45.38 percent of quota)

(c) Fund credit: None

(d) Reserve tranche position: SDR 9,789.9

(e) Current operational budget:
Purchases: SDR 500.0
Repurchases: SDR 345.0

(f) Lending to the Fund:

	Limits	Outstanding	Uncalled
GAB	4,250	--	4,250
SFF	1,450	1,412.3	--
Enlarged access	--	--	--
Total	5,700	1,412.3	5,250

III. Current Stand-by or Extended Arrangement and Special Facilities

No use of Fund credit during the last ten years.

IV. SDR Department

(a) Net cumulative allocation: SDR 4,899.5

(b) Holdings: SDR 5,293.7 (108.1 percent of net cumulative allocation

(c) Current designation plan: The United States is not currently included in the designation plan.

V. Administered Accounts

Not applicable.

VI. Overdue Obligations to the Fund

None.

B. Nonfinancial Relations

VIII. Exchange Rate Arrangements

The U.S. authorities do not maintain margins in respect of exchange transactions, and spot and forward exchange rates are determined on the basis of demand and supply conditions in the exchange markets. However, the authorities intervene when necessary to counter disorderly conditions in the exchange markets. There are no taxes or subsidies on purchases or sales of foreign exchange. On July 2, 1984 the exchange rate of the dollar, as determined by the Fund under Rule O-2(a), was SDR 0.971971 per U.S. dollar.

IX. Last Article IV Consultation

The staff report for the 1983 consultation with the United States (SM/83/135 and Supplement 1) was considered by the Executive Board at EBM/83/107 (July 20, 1983). The United States is on a 12-month consultation cycle.

United States - Basic Data

Area and population	
Area	3,615,000 sq. miles (9,363,000 sq. kilometers)
Population (mid-1983)	234.2 million
Annual rate of population increase (1975-83)	1 per cent
Unemployment rate (May 1984)	7.5 per cent
GNP per capita (1983)	US$14,132
Origin of national income (1983)	(percent)
Agriculture	2.6
Manufacturing	22.3
Construction and mining	5.6
Transportation and communications	5.4
Government and public utilities	16.9
Other	47.2
Ratios to GNP (1983)	
Exports of goods and services	10.1
Imports of goods and services	10.4
Federal government revenues	19.5
Federal government expenditures	25.0
Domestic saving (private)	17.2
Domestic investment (private)	14.3
Money and quasi-money (December)	79.2

Annual changes in selected economic indicators (annual averages)	1981	1982	1983
		(percent)	
Real GNP per capita	1.7	-2.8	2.5
Real GNP	2.6	-1.9	3.4
GNP at current prices	12.2	4.0	7.7
Domestic expenditure (at current prices)	12.3	4.4	8.6
Investment (private)	18.2	-12.7	13.8
Consumption (private)	11.3	7.3	8.3
GNP deflator	9.4	6.0	4.2
Producer prices	9.2	4.0	1.6
Consumer prices	10.3	6.2	3.2
Federal government revenues 1/	15.9	-1.5	4.4
Federal government expenditures 1/	14.5	10.9	8.1
Money and quasi-money (M-2)	9.0	9.0	12.3
Money (M1)	7.1	6.6	11.0
Quasi-money	9.5	9.5	12.6
Outstanding debt of nonfinancial sectors	9.6	8.9	9.7
Merchandise exports (f.a.s.)	5.7	-10.9	-5.2
Merchandise imports (f.a.s.)	6.2	-6.6	5.5

Federal government finances (fiscal years) 2/	1981	1982	1983
	(billions of U.S. dollars)		
Revenues	599.3	617.8	600.6
Expenditures	657.2	728.4	796.0
Overall surplus or deficit (-)	-57.9	-110.6	-195.4
Balance of payments			
Merchandise exports (f.a.s.)	237.1	211.2	200.3
Merchandise imports (f.a.s.)	-265.1	-247.7	-261.3
Investment income (net)	34.0	27.8	23.5
Other services and transfers (net)	0.2	-0.5	-4.0
Balance on current account 3/	6.3	-9.2	-41.6
Official reserve assets, net (increase -)	-5.2	-5.0	-1.2
Official reserve liabilities	5.3	2.9	5.1
Other capital transactions (net)	-29.8	-21.7	28.3
SDR allocation	1.1	--	--
Errors and omissions	22.3	32.9	9.3

International reserve position	Dec. 31 1982	Dec. 31 1983	May 31 1984
	(billions of SDRs)		
Gross official international reserve assets	29.9	30.8	31.9

1/ National income accounts basis.
2/ Unified budget basis; fiscal years end September 30.
3/ Including official transfers.

United States - Statistical Issues

1. Coverage, currentness, and reporting of data in IFS

		Latest Data in July 1984 IFS
Real sector:	National accounts	QI 1984
	Prices	May 1984
	Production	May 1984
	Employment	May 1984
	Earnings	May 1984
Government finance:	Deficit/surplus	December 1983
	Financing	Q3 1981
	Debt	Q4 1983
Monetary accounts:	Central Bank	March 1984
	Deposit money banks	QI 1984
	Other financial institutions	QI 1984
External sector:	Merchandise trade: values	April 1984
	Merchandise trade: prices	April 1984
	Balance of payments	Q4 1983
	International reserves	May 1984
	Exchange rates	May 1984

During the past year, the reporting of data for inclusion in IFS has been regular.

2. Outstanding statistical issues

a. Government finance

The components of data for financing are not presently available on a comparable basis beyond the third quarter of 1981. The possibility of compiling such data is currently being discussed with the correspondent.

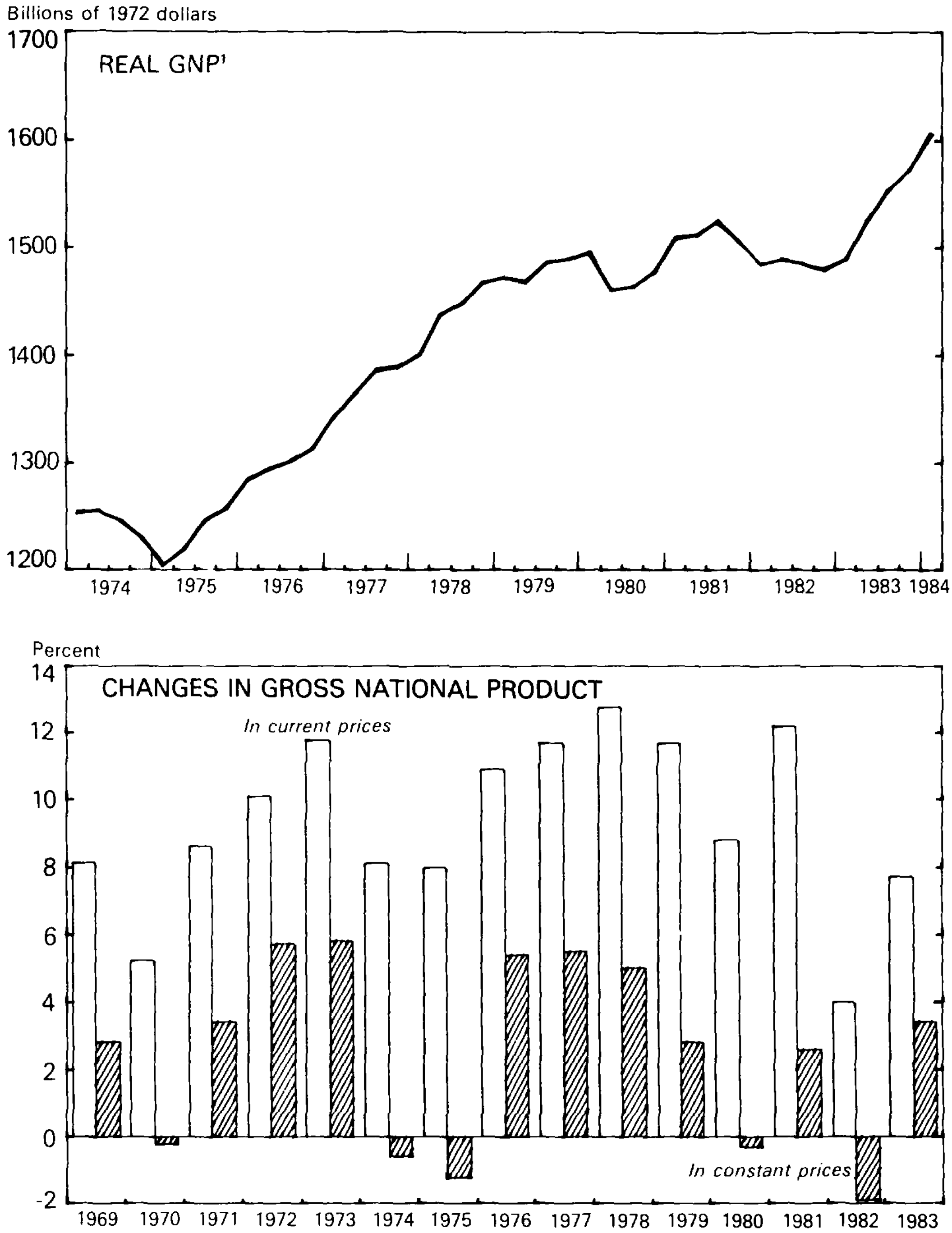
b. Monetary accounts

The Bureau of Statistics is currently working with the Federal Reserve Board on a revised presentation of money and banking data for the United States which will be published in IFS in the near future. The primary improvement will be the publication of monthly data for deposit money banks and other financial institutions.

CHART 1

UNITED STATES

GROSS NATIONAL PRODUCT

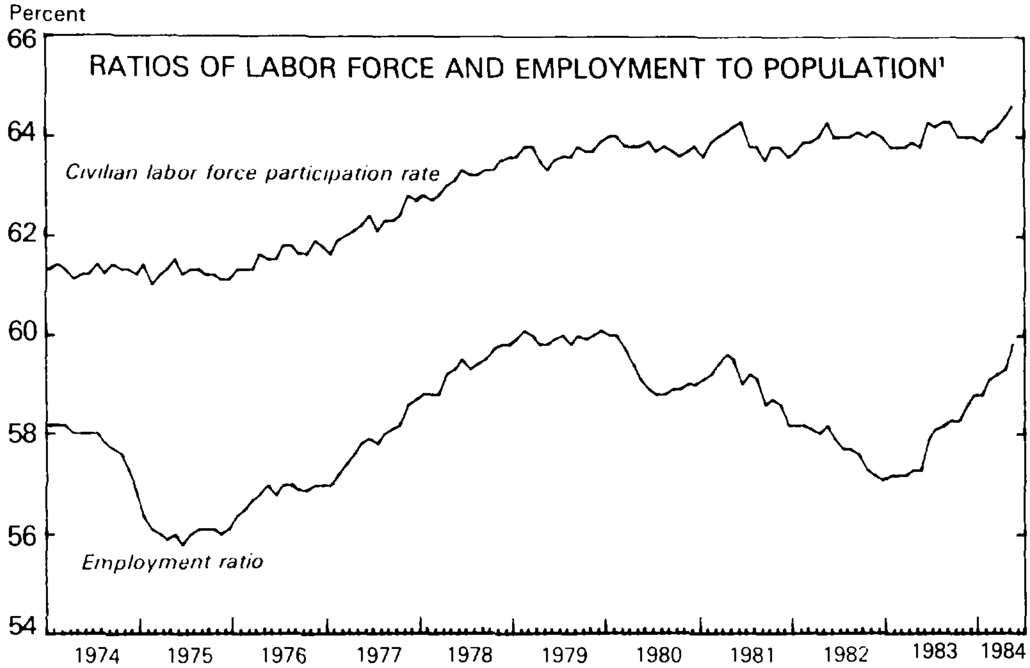


[1] Quarterly data seasonally adjusted at annual rates

CHART 2

UNITED STATES

LABOR FORCE, EMPLOYMENT, AND UNEMPLOYMENT



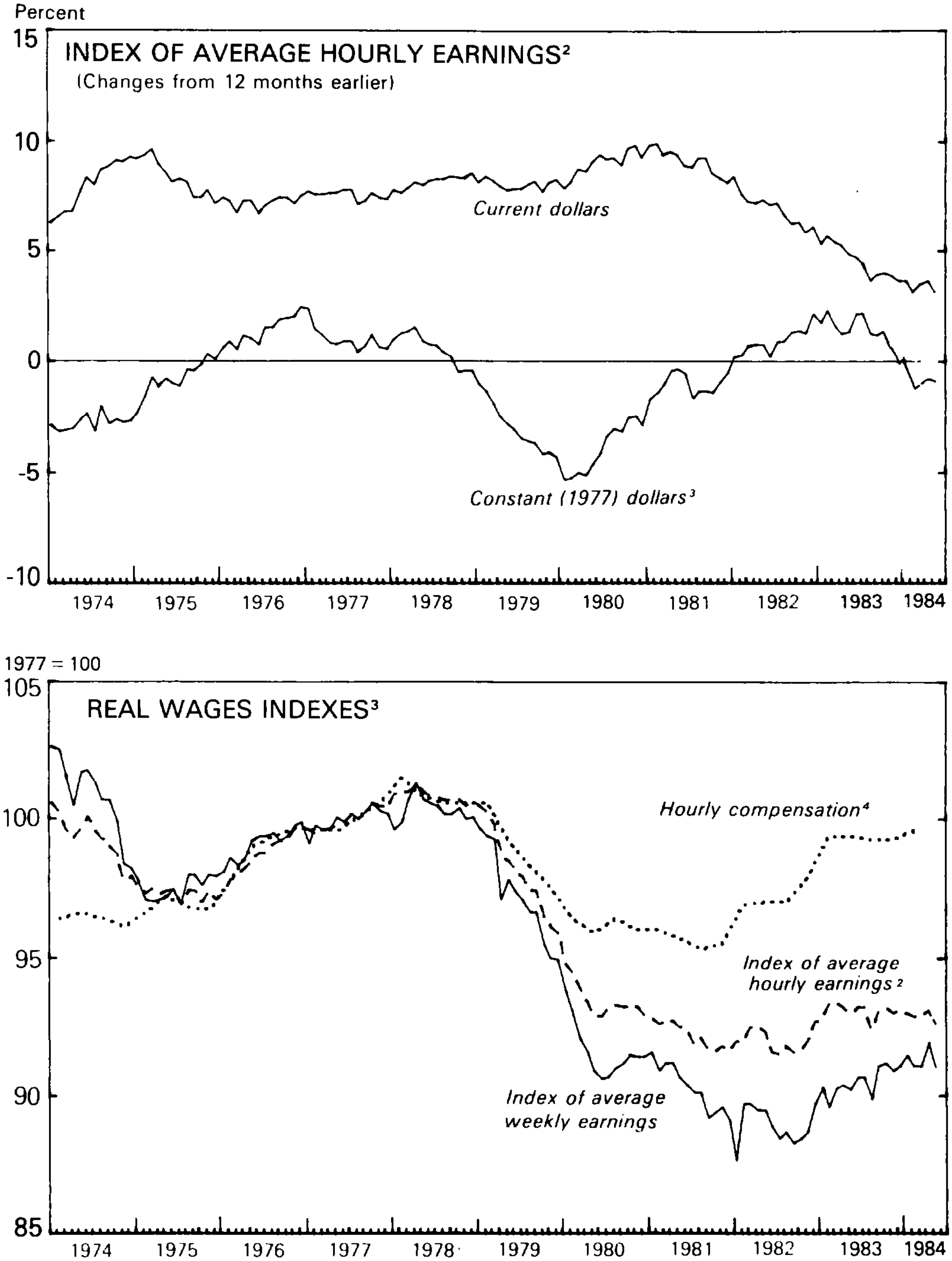
[1] Civilian noninstitutional population, 16 years and over

[2] The standardized rate is computed by holding the age-sex composition of the civilian labor force constant at the 1956 pattern

CHART 3

UNITED STATES

WAGES IN THE PRIVATE NONFARM ECONOMY[1]

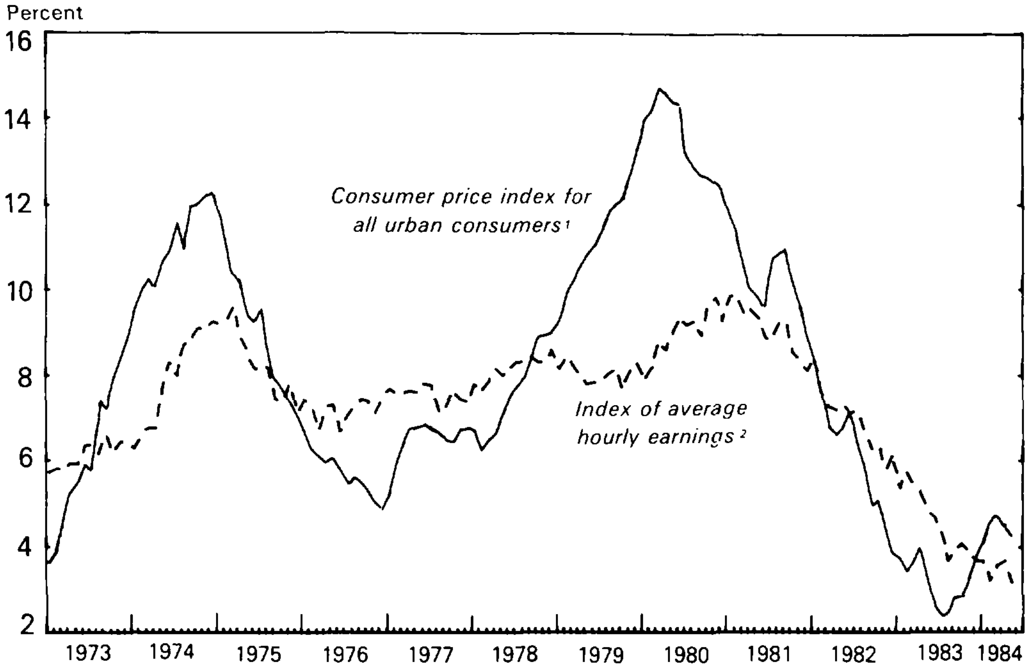


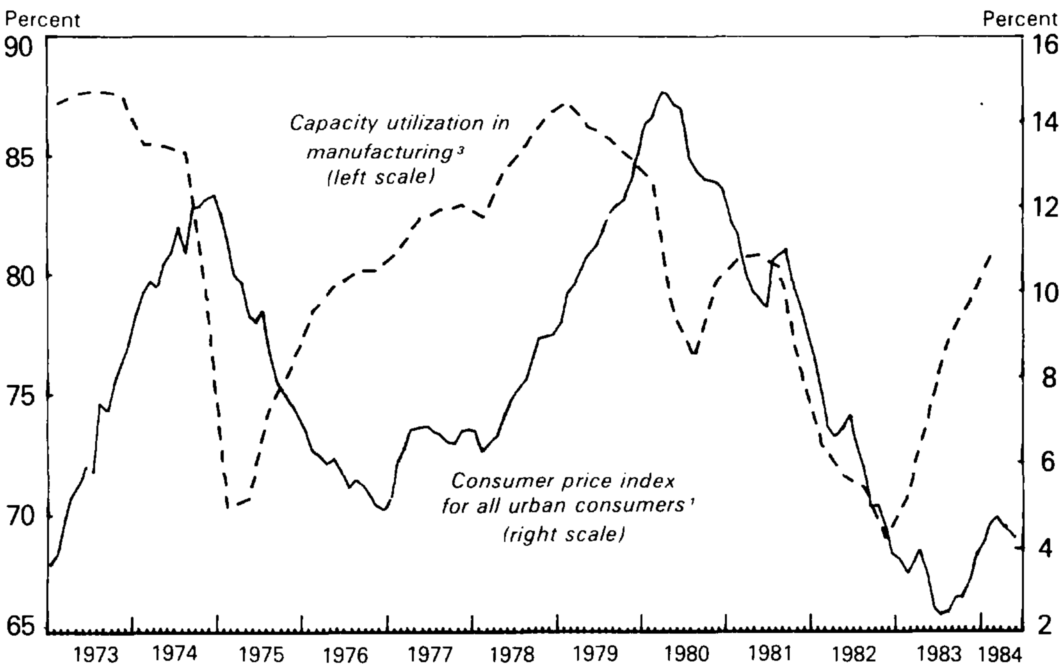
[1] For production and nonsupervisory workers.
[2] Adjusted for overtime in manufacturing and interindustry employment shifts.
[3] Deflated by the consumer price index for all urban consumers.
[4] Nonfarm business sector.

CHART 4

UNITED STATES

CONSUMER PRICES, WAGES AND CAPACITY UTILIZATION





[1] Changes from 12 months earlier.

[2] For production and nonsupervisory workers in the private nonfarm economy. Adjusted for overtime in manufacturing and inter industry employment shifts.

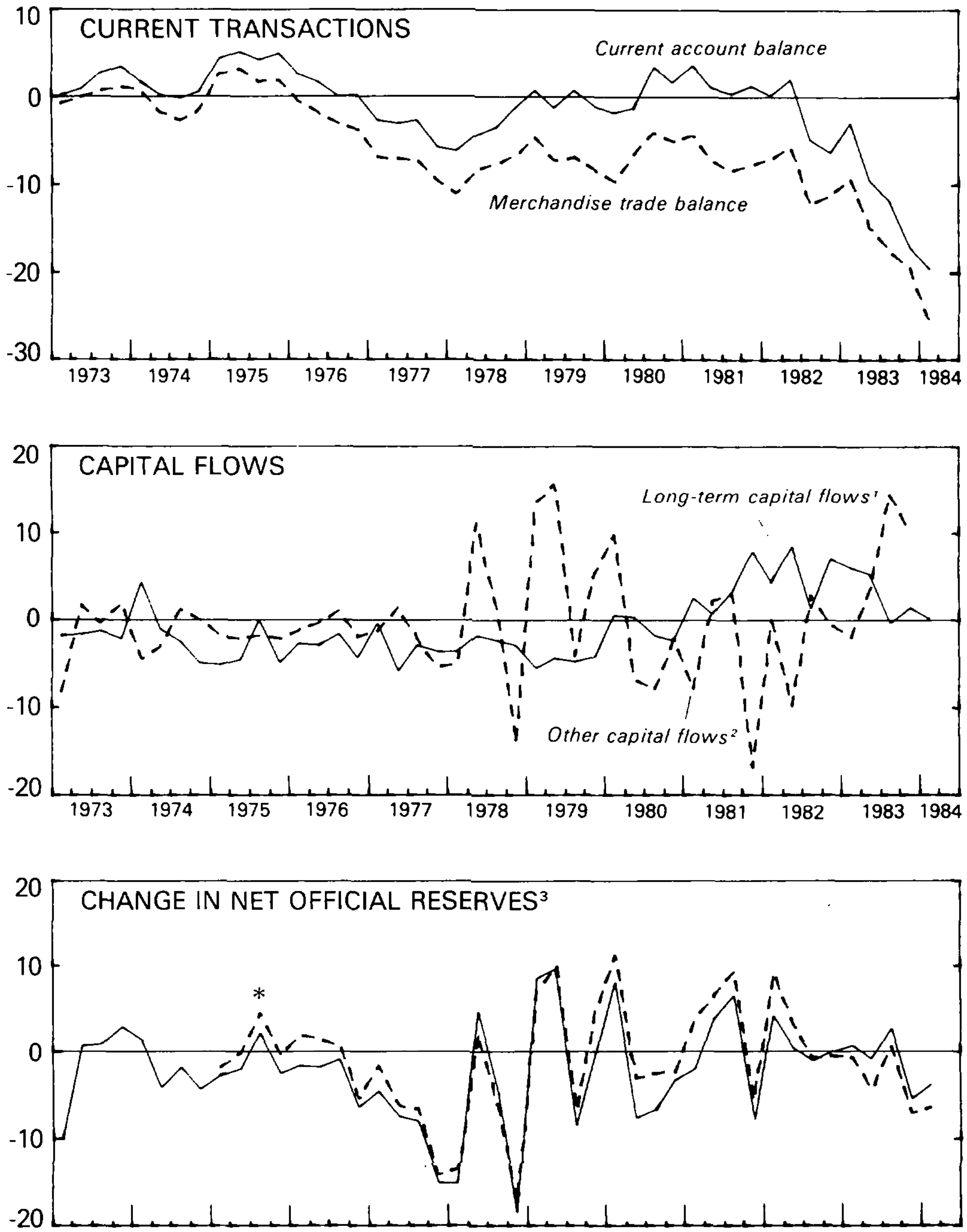
[3] As calculated by the Federal Reserve Board

CHART 5

UNITED STATES

BALANCE OF PAYMENTS DEVELOPMENTS

(In billions of dollars; seasonally adjusted at quarterly rates)



*Excluding transactions with OPEC.

1 Includes direct investment, securities, and other U.S. Government assets and liabilities. Excludes net issues of U.S. Treasury securities in the German and Swiss capital markets.

2 Including the statistical discrepancy.

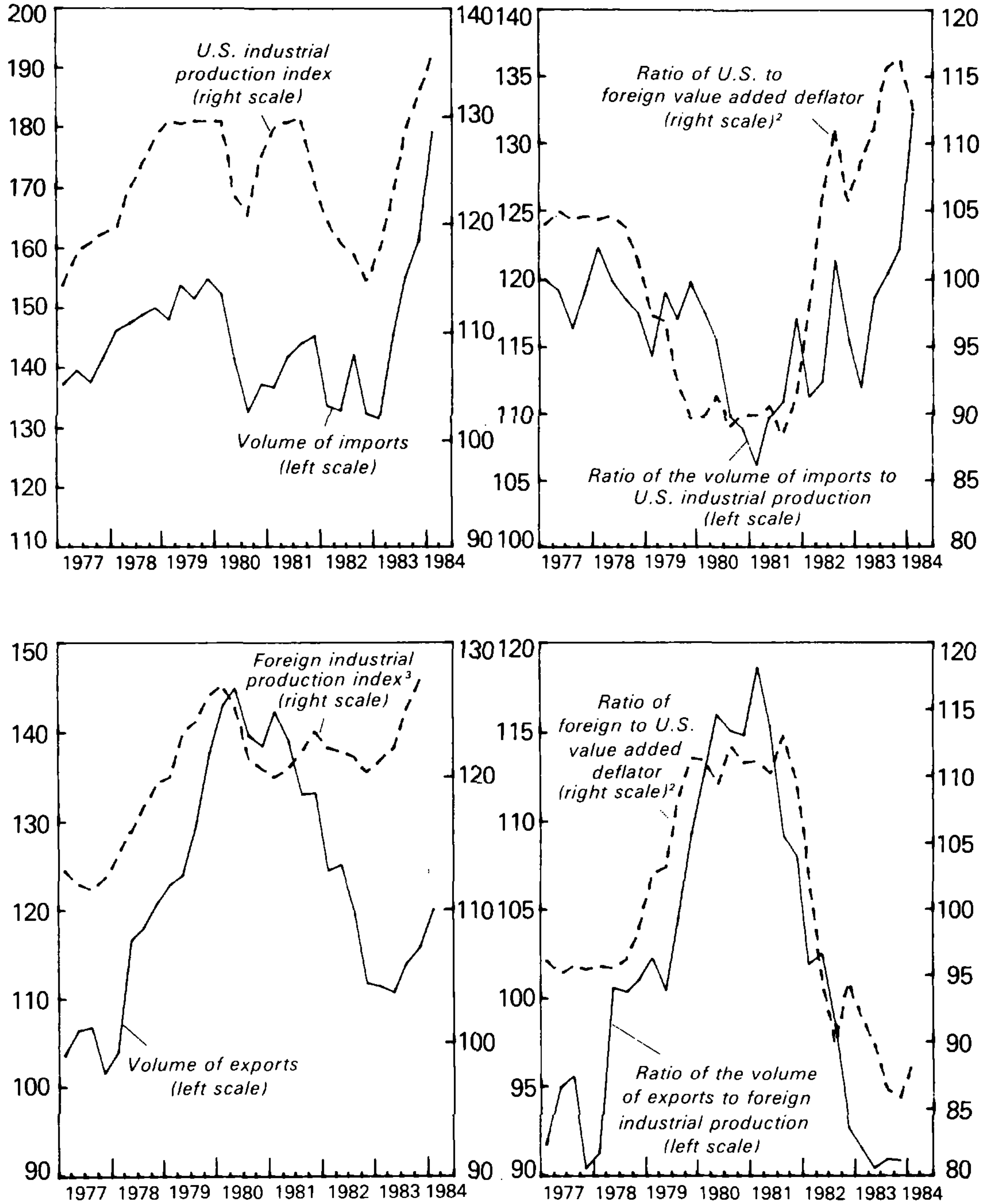
3 U.S. official reserve assets minus liabilities to foreign official agencies less net issues of U.S. Treasury securities in the German and Swiss capital markets.

CHART 6

UNITED STATES

MERCHANDISE TRADE DEVELOPMENTS[1]

(Indices, 1975 = 100)



[1] Imports and exports are at 1977 prices

[2] Adjusted for exchange rate changes (lagged 4 quarters)

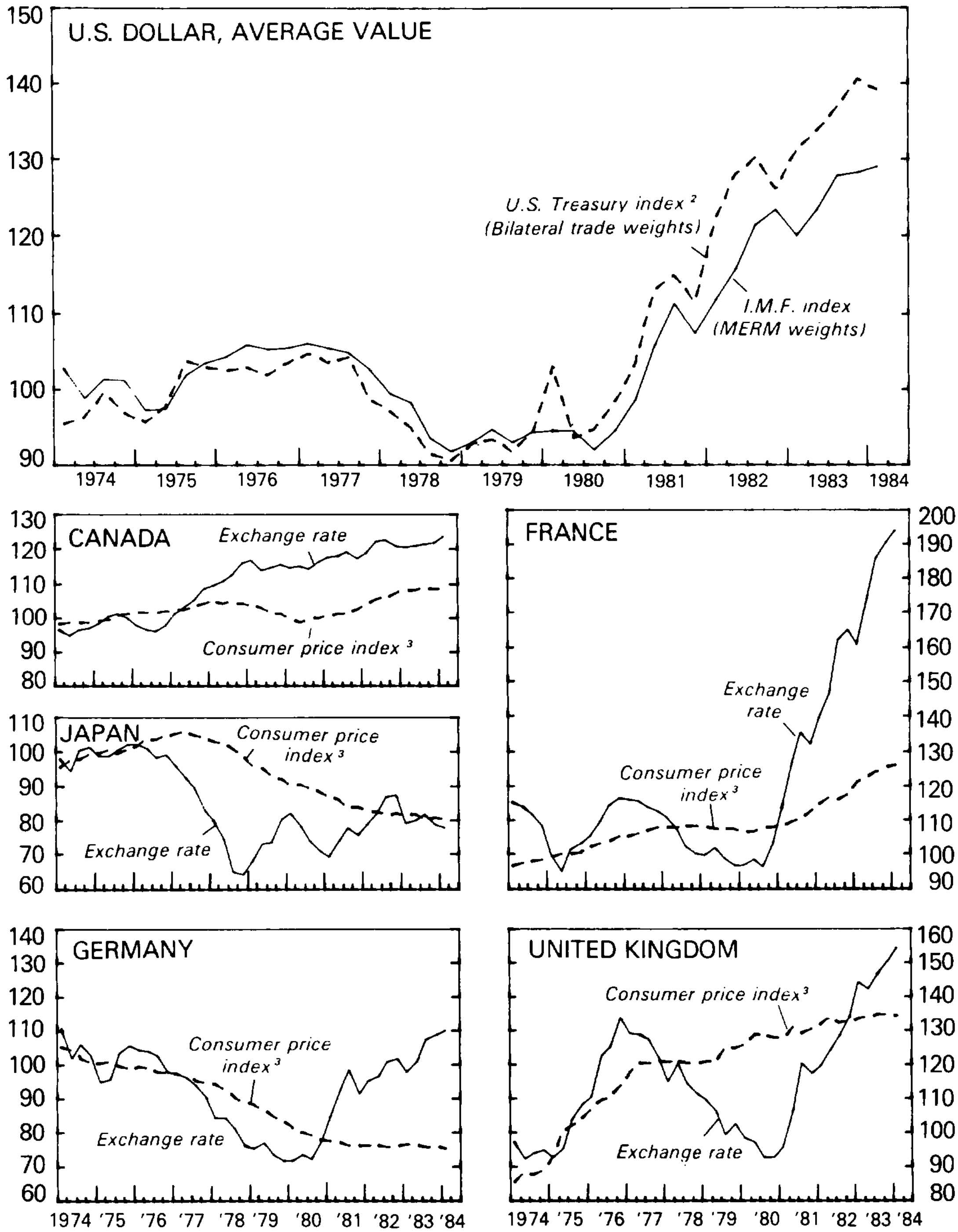
[3] Trade weighted average of industrial indices for France, Germany, Italy, Japan and the United Kingdom.

CHART 7

UNITED STATES

VALUE OF THE U.S. DOLLAR IN TERMS OF MAJOR CURRENCIES[1]

(Indices, 1975 = 100)



[1] Exchange rate indices are based on quarterly averages of daily rates, and are defined in terms of local currency per U.S. dollar.

[2] Based on OECD countries; end of period.

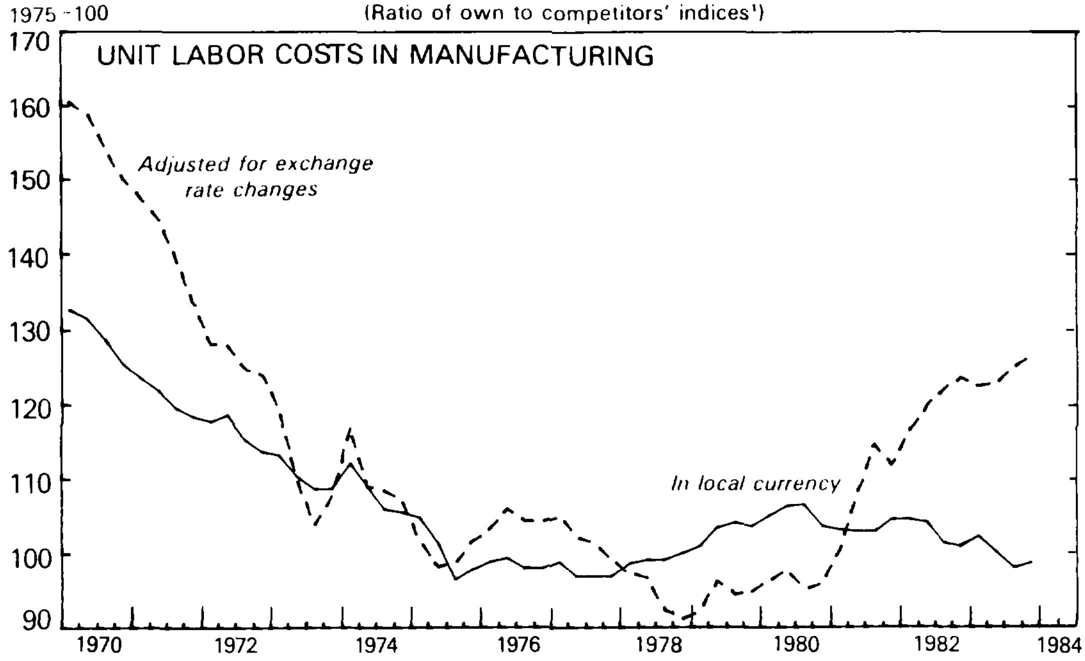
[3] Ratio of foreign consumer price index to U.S. consumer price index.

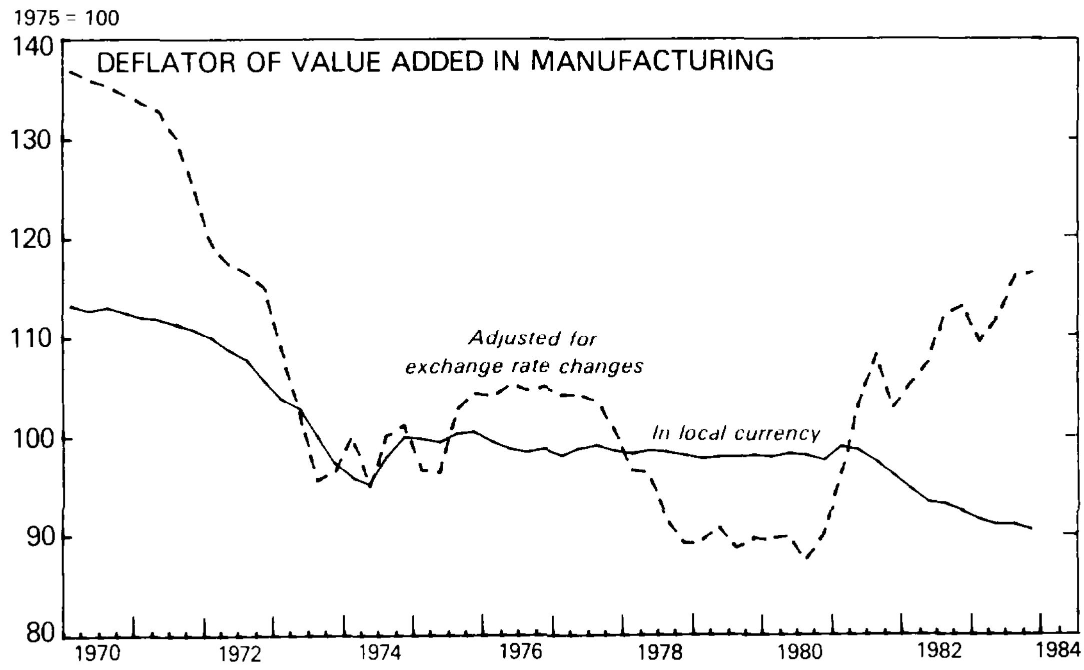
CHART 8

UNITED STATES

COSTS AND PRICES IN MANUFACTURING RELATIVE TO OTHER INDUSTRIAL COUNTRIES

(Ratio of own to competitors' indices[1])



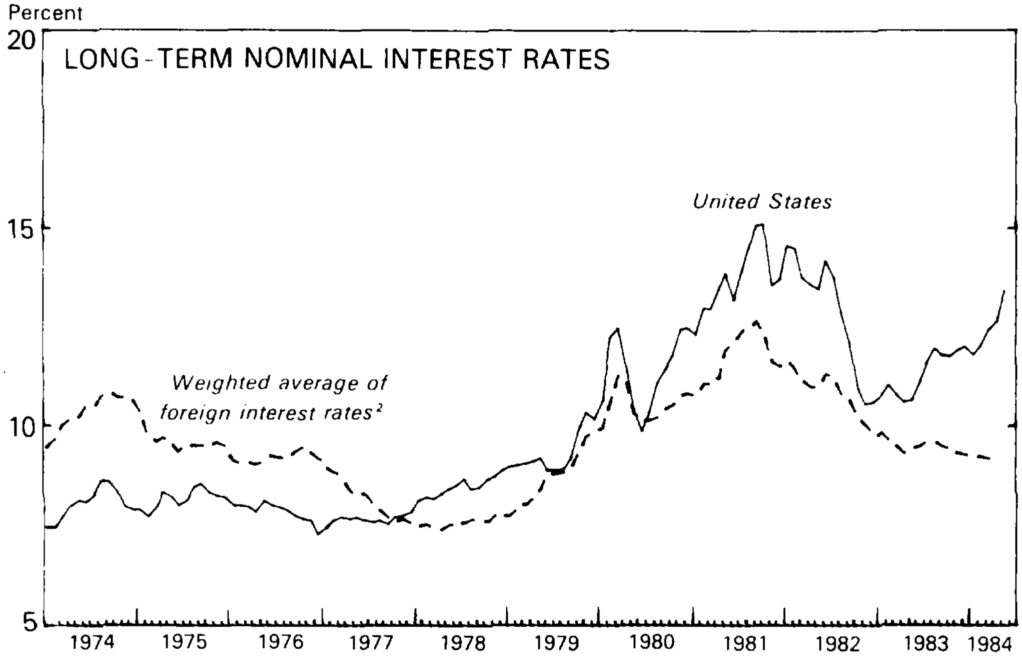


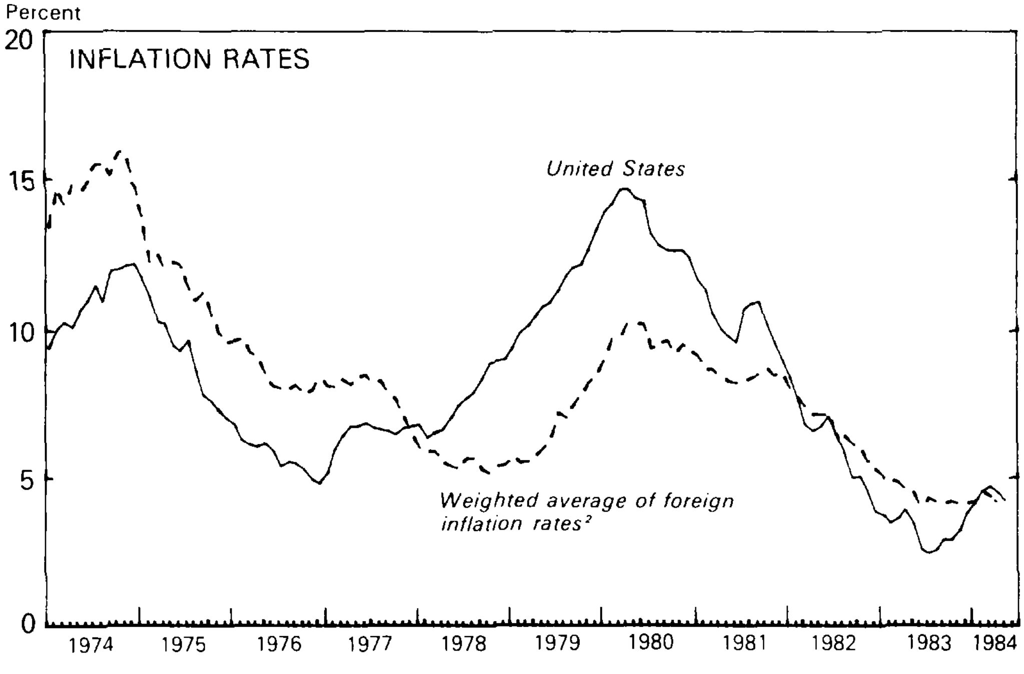
[1] Competitors' indices are weighted averages of the corresponding data for the other industrial countries. The weights, which are based on 1975 trade in manufactures, take account of both bilateral and third market effects.

CHART 9

UNITED STATES

RELATIVE INTEREST RATES AND INFLATION RATES[1]



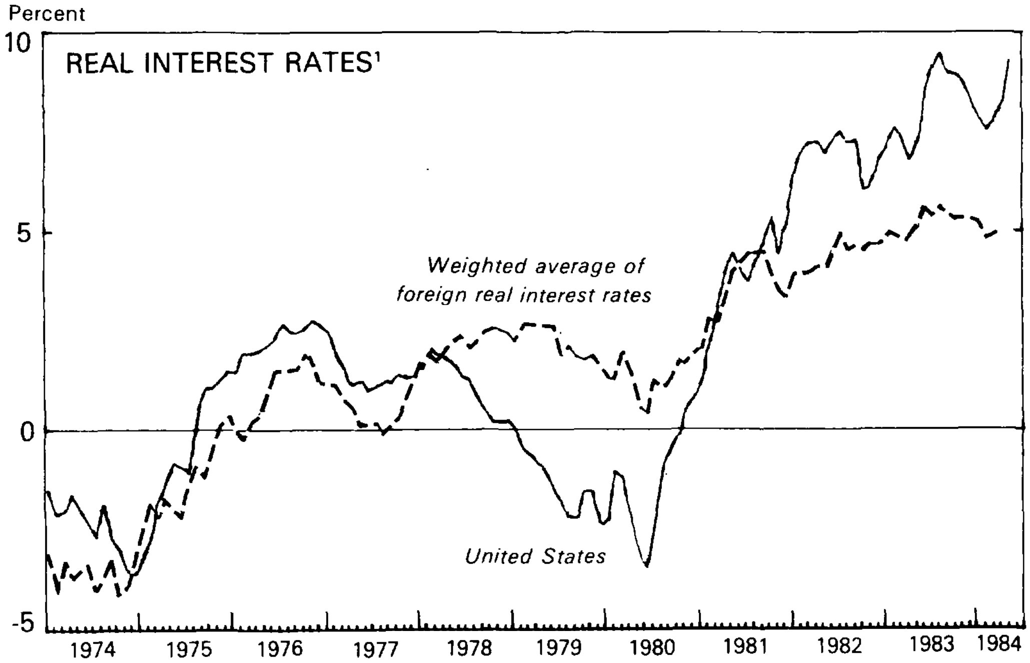


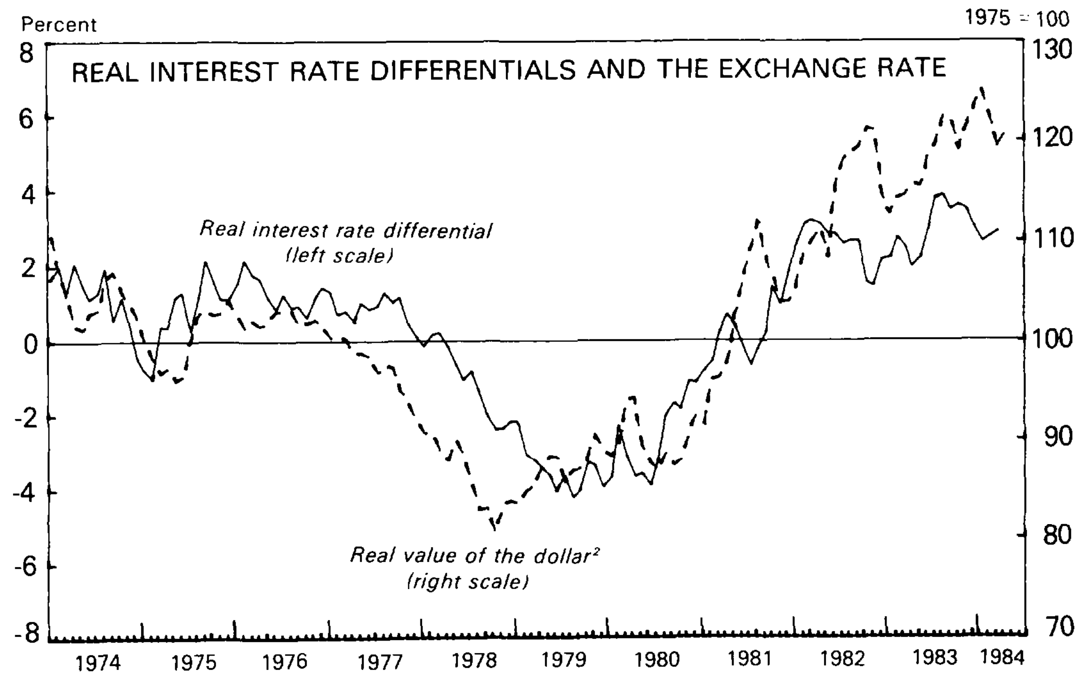
[1] Interest rates are medium to long-term yields on government bonds. Inflation rates are measured as 12-month rates of change in consumer prices.

[2] Data for Canada, France, Germany, Japan, Switzerland, and the United Kingdom, weighted by 1976 GNP levels.

CHART 10

UNITED STATES
LONG-TERM REAL INTEREST RATES AND THE EXCHANGE RATE





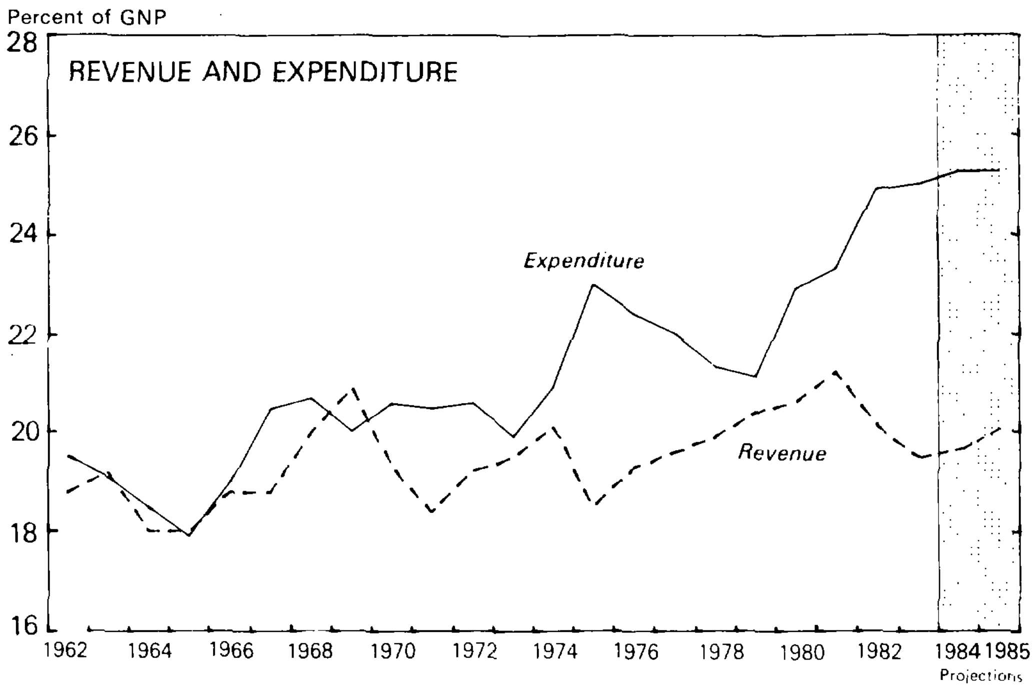
[1] Real interest rates are defined as nominal rates on medium-to-long term government bonds less 12 month rates of change in consumer prices. Foreign real interest rates are measured as weighted averages (1976 GNP weights) of real rates in Canada, France, Germany, Japan, Switzerland, and the United Kingdom.

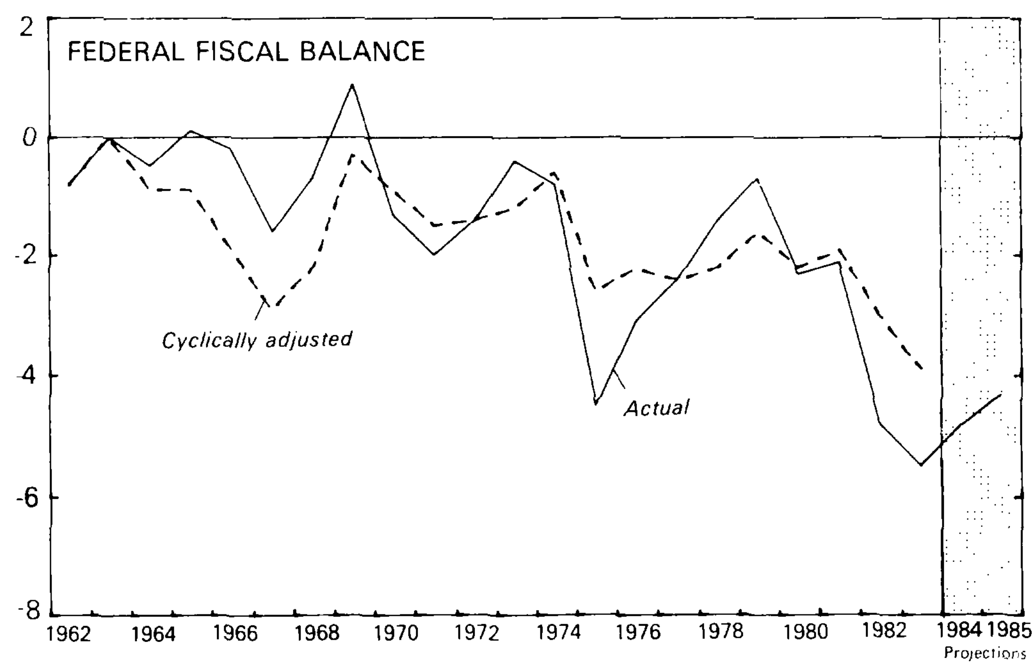
[2] Defined as a weighted average (1976 GNP weights) of the nominal value of the dollar vis-a-vis the currencies of the countries listed in footnote 1, adjusted for relative consumer prices.

CHART 11

UNITED STATES

FISCAL TRANSACTIONS OF THE FEDERAL GOVERNMENT[1]





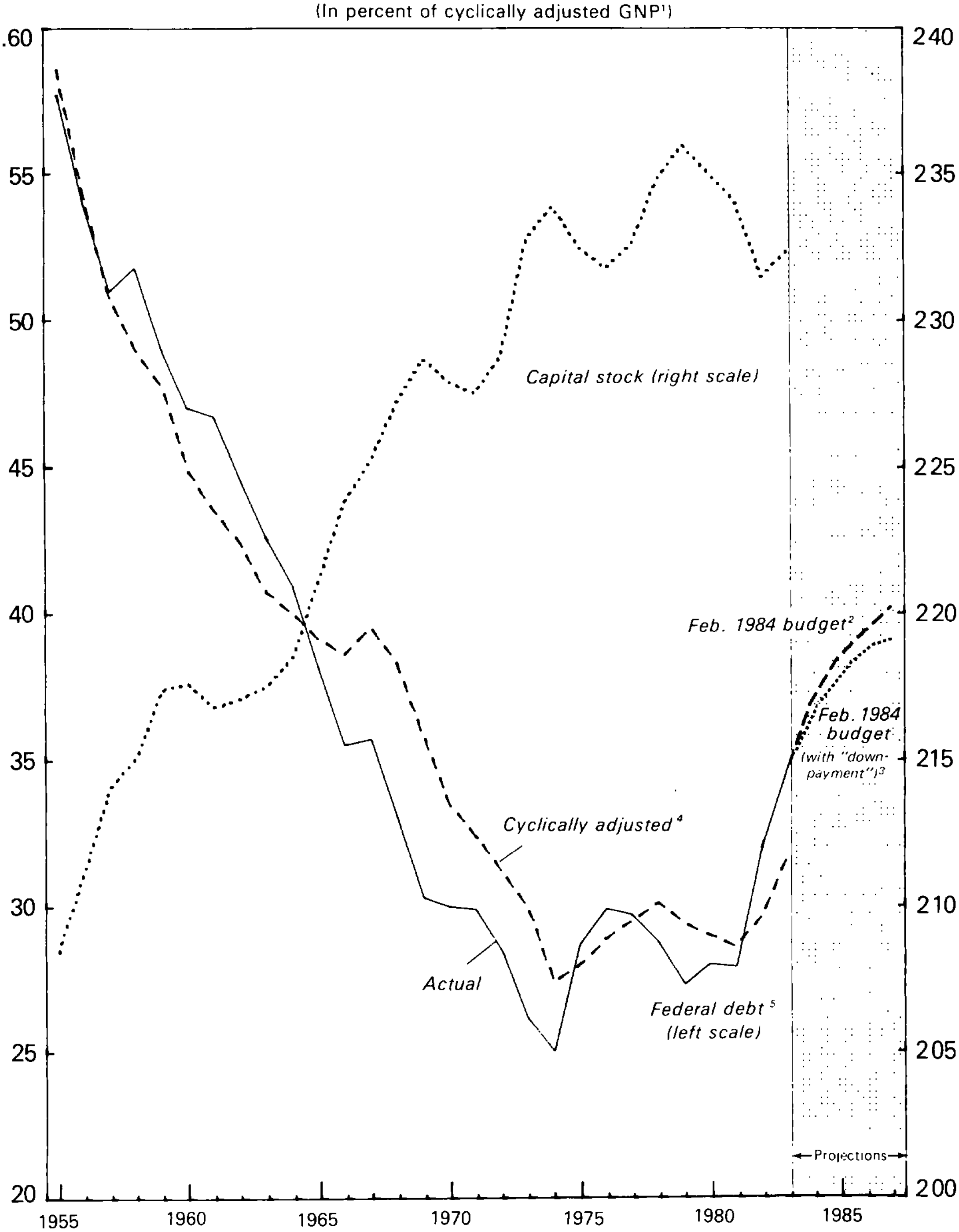
[1]On a national income accounts (NIA) basis. Data for 1984 and 1985 are official projections made in April 1984. Data for 1985 refer to the first three quarters of the year, at annual rates.

CHART 12

UNITED STATES

CAPITAL STOCK AND FEDERAL DEBT

(In percent of cyclically adjusted GNP[1])



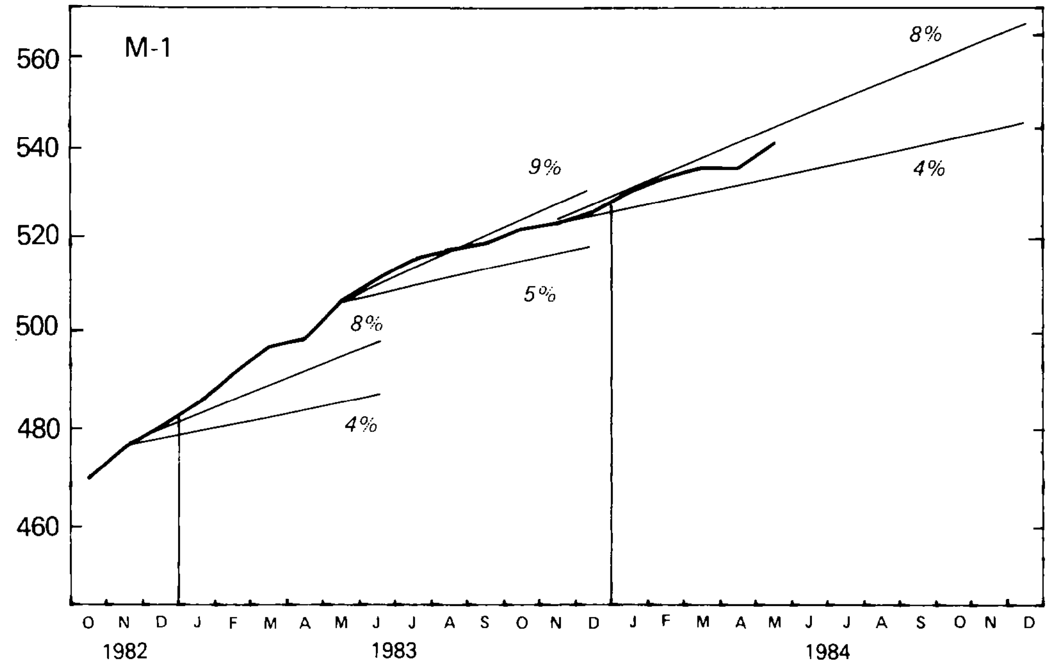
[1]Based on the U.S. Department of Commerce concept of middle expansion trend of GNP.
[2]Staff estimates based on the April 1984 update of the fiscal year 1985 budget proposals.
[3]Staff estimates based on the "downpayment" plan proposed by the Administration in March 1984.
[4]As estimated by the U.S. Department of Commerce.
[5]At par value. Excludes Federal debt held by government agencies.

CHART 13

UNITED STATES

M-1 AND M-2: TARGETS AND PERFORMANCE

(In billions of dollars)



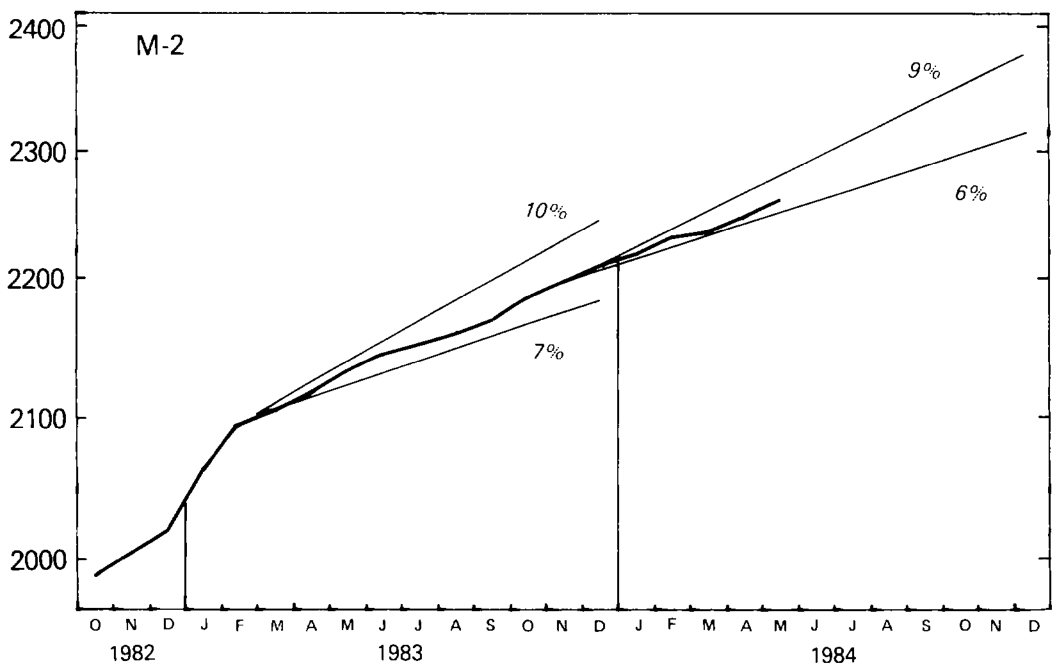


CHART 14

UNITED STATES

INTEREST RATES