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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/120

10:00 a.m., August 3, 1984

J. de Larosière, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
A. Alfidja	W. B. Tshishimbi
	H. G. Schneider
B. de Maulde	
A. Donoso	
	M. K. Bush
M. Finaish	T. Alhaimus
H. Fujino	T. Yamashita
	I. R. Panday, Temporary
R. K. Joyce	L. Leonard
A. Kafka	
G. Laske	G. Grosche
G. Lovato	N. Coumbis
R. N. Malhotra	A. S. Jayawardena
Y. A. Nimatallah	
J. J. Polak	T. de Vries
A. R. G. Prowse	
	O. Kabbaj
F. Sangare	E. I. M. Mtei
M. A. Senior	J. L. Feito
J. Tvedt	A. Lindø
N. Wicks	T. A. Clark
	Wang E.

J. W. Lang, Jr., Acting Secretary
C. Fairbairn, Assistant

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Also Present

R. S. Callis, Assistant Secretary, IBRD. C. F. Schwartz, Consultant. Administration Department: H. J. O. Struckmeyer, Deputy Director; T. Cole. African Department: J. B. Zulu, Director. Asian Department: A. Ariyoshi, G. Szapary. European Department: P. Dhonte, D. Gros, H. B. Junz, M. Xafa. Exchange and Trade Relations Department: C. D. Finch, Director; S. J. Anjaria, N. Kirmani, R. Pownall. External Relations Department: H. P. G. Handy, H. O. Hartmann. Fiscal Affairs Department: V. Tanzi, Director; P. S. Heller, P. R. Rado. Legal Department: G. P. Nicoletopoulos, Director; A. O. Liuksila. Research Department: W. C. Hood, Economic Counsellor and Director; A. D. Crockett, Deputy Director; J. Artus, C. P. Blackwell, R. D. Haas, M. D. Knight, P. R. Masson. Secretary's Department: A. Wright, Deputy Secretary; A. P. Bhagwat, E. Friis, B. R. Hughes. Treasurer's Department: W. O. Habermeier, Counsellor and Treasurer. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; K. B. Bercuson, C. V. A. Collyns, S. V. Dunaway, E. Hernandez-Cata, L. R. Kenward, G. L. Terrier. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: H. A. Arias, S. El-Khouri, H.-S. Lee, W. Moerke, G. E. L. Nguyen, J.-C. Obame, P. Péterfalvy, M. Z. M. Qureshi, A. Steinberg, D. C. Templeman, A. Vasudevan. Assistants to Executive Directors: H. Alaoui-Abdallaoui, I. Angeloni, R. L. Bernardo, M. B. Chatah, Chen J., C. Flamant, V. Govindarajan, D. Hammann, L. Ionescu, H. Kobayashi, S. Kolb, E. Landis, M. Lundsager, K. Murakami, E. Olsen, G. W. K. Pickering, E. Portas, T. Ramtoolah, M. Rasyid, J. Reddy, D. J. Robinson, Shao Z., S. Sornyanyontr, A. J. Tregilgas, Wang C. Y.

1. EXECUTIVE DIRECTOR

The Chairman welcomed Mr. Sangare, Executive Director, on his return to the Board following his enforced absence (EBM/84/59, 4/18/84; EBM/84/89, 6/8/84; EBM/84/107, 7/16/84; and EBM/84/116, 7/30/84).

2. FORTHCOMING ANNUAL MEETINGS - REPORT AND PROPOSED RESOLUTION

The Executive Directors considered a staff paper on forthcoming Annual Meetings of the Boards of Governors, together with a draft Report and proposed Resolution to be submitted to Governors for a vote by mail (EBD/84/203, 7/20/84), relating to the invitation from the Federal Republic of Germany and the Senat to hold the 1988 Annual Meetings in Berlin (West) and the 1989 and 1990 Annual Meetings in Washington, D.C.

The Acting Secretary said that on August 2, 1984 the Executive Board of the World Bank had approved a parallel Report to its Board of Governors.

Mr. Laske noted that the Governor for the Fund of the Federal Republic of Germany, on behalf of the Federal Government and the Senat, had extended an invitation to the Managing Director to hold the Annual Meetings in West Berlin in 1988.

The Federal Republic of Germany had been a member of the International Monetary Fund for more than 30 years, Mr. Laske continued, during which time the German authorities had kept in mind their wish to host an annual meeting of the two Bretton Woods institutions, to which they felt very closely attached. His authorities appreciated in particular the Fund's efforts to maintain a smoothly functioning monetary system on which the well-being of the world depended, and their invitation was therefore meant as a sign of recognition of the Fund's valuable work.

Berlin had a well-established reputation as a host for international meetings, Mr. Laske commented; several such meetings had been held there in recent years. Recently a staff mission had visited Berlin, and had found that the city's facilities were at least adequate for the Annual Meetings of the World Bank and the Fund. He hoped that the Executive Board would approve the draft Resolution before them and recommend to the Governors that they accept the invitation from the German authorities for 1988.

Mr. Nimatallah thanked the Government of the Federal Republic of Germany and the Senat for the invitation to the Bank and the Fund to meet in West Berlin in 1988, and said that he supported the proposed Resolution. He asked about the availability of office space, noting, for example, that at the Interim Committee meeting held in Helsinki in the spring of 1982 there had been inadequate space for Executive Directors.

The Acting Secretary said that the meeting site in Berlin contained abundant office space; there would be no inadequacies for anyone concerned.

The Executive Directors unanimously accepted the invitation, with Mr. Malhotra, Mr. Donoso, Mr. Kafka, Mr. Prowse, and Mr. Panday noting that, although they had not yet received instructions from their authorities, they also could accept the invitation from the Government of the Federal Republic of Germany and the Senat to hold the 1988 Annual Meetings in West Berlin.

The Executive Directors adopted the following Report and proposed Resolution for submission to the Board of Governors for a vote by mail, and authorized the Secretary to take such further action as he deemed necessary or appropriate to conduct the vote.

> The Governor for the Federal Republic of Germany, on behalf of the Government and the Senat, has invited the International Monetary Fund and the International Bank for Reconstruction and Development and its Affiliates to hold the Annual Meetings of the Boards of Governors in Berlin (West) during the period September 27-September 30, 1988. The Executive Board has considered the assurances given by the Government of the Federal Republic of Germany, has reviewed the proposed arrangements in Berlin (West), and has noted that acceptance of the invitation would be in accordance with the traditional practice of meeting elsewhere than in Washington, D.C. every third year. In this connection, it will be recalled that the Boards of Governors had previously decided that the 1985 Annual Meetings would be held in Seoul, Korea, and that the 1986 and 1987 Annual Meetings would take place in Washington, D.C.
>
> Acceptance of the German invitation would also permit related decisions to be taken that the Annual Meetings should be convened in Washington, D.C. in 1989 and 1990. Accordingly, the Executive Board recommends that the Board of Governors adopt the following Resolution:
>
> RESOLVED:
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> THAT the invitation of the Government of the Federal Republic of Germany and of the Senat to hold the Annual Meetings in Berlin (West) in 1988 be accepted;
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> THAT the 1988 Annual Meetings be convened on Tuesday, September 27, 1988; and
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> THAT the 1989 and 1990 Annual Meetings be convened, respectively, on Tuesday, September 26 and September 25, in Washington, D.C. 1/

Adopted August 3, 1984

1/ Resolution No. 39-3 adopted, effective September 11, 1984.

3. UNITED STATES - 1984 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1984 Article IV consultation with the United States (SM/84/162, 7/6/84; and Sup. 1, 8/1/84). They also had before them a report on recent economic developments in the United States (SM/84/178, 7/20/84; and Sup. 1, 7/20/84).

Ms. Bush made the following statement:

In recent discussions of the world economic outlook and the Annual Report, we have expressed dissatisfaction with the view that there is a clear cause-and-effect relationship between the U.S. fiscal deficit, high real interest rates, and the strength of the dollar. While the staff papers for this consultation present a more comprehensive description of complex relationships, we do not share some of the staff's views and conclusions. My authorities would still re-emphasize their view that there are not clear and well-defined causal relationships between fiscal deficits, interest rates, and exchange rates; and that sound analysis of economic behavior dictates that all variables be properly evaluated. In addition, may I also stress that the U.S. authorities are fully aware of the impact that the U.S. economy has on the rest of the world. We believe that recent developments in the U.S. economy are having a very favorable overall effect, both in the revival of economic activity and world trade and in the alleviation of debt problems of developing countries, which are benefiting substantially from growing U.S. markets for their goods. Over the longer term, the establishment of noninflationary and sustainable economic growth in the United States will also contribute importantly to a similarly strengthened environment for economic growth, rising employment, price stability, and sustainable balance of payments positions in the rest of the world.

The following specific comments will focus on four general areas: (1) the current nature and near-term prospects for economic recovery; (2) the balance of payments; (3) fiscal and monetary issues; and (4) trade policy.

1. The current nature and near-term prospects for economic recovery

Over the past year, further progress has been made in achieving the Administration's broad policy objectives, which focused on creating an economic environment that is more conducive to economic growth in the private sector, and on lowering inflation and thereafter maintaining a stable price environment. Growth rates have exceeded expectations, as real GNP increased by 6.3 percent in 1983, by 10.1 percent in the first quarter of 1984, and by 7.5 percent in the second quarter, based on preliminary data. Concurrent with the return to strong growth, inflation has dropped from a high 10.2 percent in 1980 as measured by the GNP deflator to 3.8 percent in 1983, and has held at relatively low levels--4.4 percent and 3.2 percent in the first and second quarters of 1984, respectively. Looking more specifically at the nature and character of the recovery, which began early in 1983, it is clear that this has been a balanced and broad-based recovery. Strong contributions to growth were made by consumer spending, particularly for durables, a reversal of the declines in residential fixed investment that had occurred between 1979 and 1982, a reversal of inventory liquidation, and very substantial growth in business fixed investment.

In addition to being broad-based, the recovery is particularly striking in several respects:

(i) Interest-sensitive sectors of the economy, such as consumer durables, residential investment, and business investment have made greater than average contributions to economic growth when compared with previous postwar recoveries. Improvement in real business fixed investment is reflected by the unusual strength of its growth rate of 16.3 percent a year over the first six quarters of this recovery, compared with an average of 8.4 percent over the same period in previous postwar recoveries.

(ii) Inventory investment has also contributed more to growth on average than in previous postwar recoveries and has continued to contribute to growth even beyond the early months of the recovery.

(iii) Despite the strength of the present expansion, it has not been accompanied by a return to high inflation. For example, preliminary data for the second quarter show a GNP deflator rise of only 3.2 percent. Also, the ratcheting upward of inflation with each cycle has now been broken.

Several elements of the U.S. economic strategy have been important in transforming the economy from the previous recessionary, high inflation environment toward one of noninflationary real economic growth. An important element of that strategy was a reduction of the tax burden through implementation of the Economic Recovery Tax Act of 1981. The lower tax load on business, which has reduced the cost of capital, has been an important factor in stimulating the growth of business investment: the rate of growth of business fixed investment has been almost twice the average of that of previous recoveries.

There are other beneficial effects that can be traced to the tax reductions, the growth of business investment, and in general to the strength of the recovery. First, growth in employment has been substantial. Civilian employment has risen by 6.7 million since the trough of the recession in November 1982. The civilian unemployment rate had reached 10.7 percent of the labor force in 1982, but fell to 7.1 percent in June 1984. Increases in employment materialized in manufacturing, in construction, and in the private market services sector. In previous recoveries, the inrovement in the rate of unemployment was less dramatic. For example, during the first 19 months following the trough of the recession for the previous six business cycles, the unemployment rate declined 1.8 percentage points on average. The decline during the first 19 months of this recovery was 3.6 percentage points. Second, trends in wage rates and in labor contract negotiations have been characterized by moderation. Average hourly earnings in the nonfarm sector increased at only a 2.7 percent annual rate during the first six months of this year; and on a year-over-year basis, recent monthly increases have been the smallest since 1965. Major collective bargaining settlements reached in the first half of the year called or average wage increases of 2.6 percent in the first year and 2.8 percent annually over the life of the contract. These results are in line with those for 1983 which were the lowest for any year in the 16-year history of the survey. Unionized workers have set the trend in decelerating wage adjustments. Some of this has been due to competitive market conditions; some to labor responsiveness to declining inlfation and to the recognized need to continue to contain inflationary pressures in order to preserve jobs; and some to the benefits to after-tax income brought about by the personal tax rate reduction of the Economic Recovery Tax Act.

The moderate drop in the second quarter preliminary growth rate from the first quarter rate suggests that growth is slowing to more sustainable levels. The authorities project that growth rates for the remainder of 1984 will slow further to the 4-4.5 percent range, resulting in a growth rate of about 6.5 percent from fourth quarter 1983 to fourth quarter 1984. The authorities expect the rate of growth will stabilize thereafter at about 4 percent.

Several underlying factors suggest a continued positive outlook for the economy.

(i) Although interest rates remain high in relation to inflation, and although there has been some increase in rates since the first half of 1983, rates have receded to generally lower levels than those that prevailed roughly in the 1980-82 period. The overall cost of capital has declined, partly owing to tax cuts. And as stated earlier, the interest-sensitive components of growth have continued to perform well in this recovery, notwithstanding high interest rates. That was influenced, to some extent, by the promising outlook for unit labor costs based on moderation in wage adjustments and on improved productivity.

(ii) Capacity utlization is still relatively low. Manufacturing capacity utilization has peaked on average at 87.9 percent in previous recoveries. In the second quarter of 1984--or the sixth quarter following the trough of the recession--manufacturing capacity utilization was 81.7 percent, not very different from the 82.6 percent average for the sixth quarter of previous recoveries.

(iii) There is still substantial slack in the labor markets. Although the unemployment rate fell to 7.1 percent by June 1984, the rate was as low as 4.6 percent on average at the peak of previous recoveries. Slack in labor markets is further indicated by the fact that the average duration of unemployment, 18 1/2 weeks in June 1984, is still well above the 10 1/4 week figure that prevailed in mid-1979.

In sum, the continued slack in the economy, generally lower costs of labor and capital inputs, and improvements in profitability and productivity, are all positive signs for a continuation of the recovery, albeit at more moderate rates of growth.

2. The balance of payments

The dramatic shift in the U.S. trade deficit has been influenced by three major factors--the strength and timing of the U.S. recovery; declines in exports, largely to developing countries; and the overall effect of the appreciation of the dollar. Real GNP growth in the United States has been both stronger and more timely than that of other industrial countries. The strong and early recovery in the United States has led to significant increases in U.S. imports over the 1982 level. As for exports, slower recovery in other industrial countries, economic and financial problems in some non-oil developing countries, and the reduced income of oil exporters have negatively influenced U.S. exports. Some of these negative factors can be expected to reverse themselves as world recovery expands and LDC debtors resume more normal import levels. In the meantime, it is important to note the positive effects of the U.S. recovery on other economies. For example, U.S. imports from non-OPEC developing countries in the first five months of 1984 were up by $9 billion, or more than 30 percent over the same period of 1983. The rate of growth of imports from Latin America alone was almost 18 percent.

The appreciation and continued strength of the U.S. dollar has also influenced the widening U.S. trade deficit. However, the strength of the dollar has been accentuated by very positive developments such as the strength of the U.S. economy--evaluated both independently and relative to other countries, and reflected in high growth and low inflation rates--and the demand for U.S. dollar-denominated assets, as investors in other countries seek the "safe haven" environment of the United States as well as relatively high after-tax rates of return on U.S. dollar investments.

With regard to the capital account, there seems to be some concern that the U.S. current account deficit is causing a "drain" of capital away from other countries. Considering the relative attractiveness of investing in the United States compared with many industrial and developing countries, the tendency for the United States to attract capital is not surprising. However, as world recovery spreads, other markets are expected to become more attractive for capital investment. Moreover, the capital drain theory is not borne out by the numbers. The change from $24 billion of net capital outflow in 1982 to $32 billion of net capital inflow in 1983 resulted largely from a substantial drop in the ouflow of capital from the United States, with the bulk of the drop accounted for by declines in U.S. bank lending abroad. The latter decline reflected a drop from unsustainably high levels and the successful adjustment efforts of developing countries in reducing their need for foreign financing. Moreover, capital inflows were actually smaller in 1983 than in 1982 and the positive statistical discrepancy declined sharply. The latter is believed to be strongly influenced by unrecorded capital flows and may reflect a drop in capital flight to the United States.

3. Fiscal and monetary issues

The guiding factor in the fiscal area for this Administration is to decrease the absorption of resources by the Government and to shift those resources toward the private sector. The fiscal policy emphasis for accomplishing this shift consisted of income tax cuts and the reduction in government expenditures, as expenditures had increased from approximately 20 percent of GNP in the early 1970s to 25 percent in 1983. My authorities are determined to reduce the fiscal deficit, giving emphasis to expenditure reduction. A step in that direction has just been taken through enactment of legislation that includes both revenue and expenditure measures that constitute the initial "downpayment" toward a lower deficit. The initial deficit downpayment and other recent measures will cut about $70 billion from the deficit over the four-year period 1984-87. These revisions, coupled with expected growth in GNP, should lower the deficit/GNP ratio continuously through fiscal years 1985-87 to about 3.5 percent by fiscal year 1987. Additional spending cuts are included in a second phase of the downpayment, which is expected to be enacted soon.

While we think it important to reduce resource absorption by the Government and the size of the deficit over time, we do not agree with the view that there is a clear link between the sizable fiscal deficits and high real interest rates. Empirical evidence is not entirely inconclusive on this issue, but the weight of evidence suggests that there is no relationship between U.S. fiscal deficits and real interest rates. Interest rates are influenced by many factors, one being expected inflation, the reduction of which tends to lag declines in current inflation as the marketplace adjusts over time to the fact that inflation has abated and will remain at low levels.

My authorities also see no evidence that financing required for the U.S. fiscal deficit is inhibiting capital formation, either domestically or in other countries. As noted earlier, business fixed investment in the United States is stronger than in any previous recovery; and flows from other countries are attracted to the safety of and returns to capital, and to the open nature and stability of U.S. capital markets. Also, as mentioned earlier, capital flows into the United States declined last year. Moreover, domestic funding potential for private capital formation and government requirements has grown as gross private savings in the United States have increased from 16.9 percent of GNP in the 1970s to 17.3 percent in 1983 and 18.4 percent in the first half of 1984. As to the personal savings rate, it is worth noting, as discussed in Appendix III to the supplement to the report on recent economic developments, that the rate in the national income accounts may well understate the actual rate. Also, the decline in the rate last year may reflect the positive wealth effect of recovery in the securities markets and in other assets.

With regard to monetary policy, the overall objective is to achieve sustained economic growth while making continued progress toward price stability. Consistent with this objective, the Federal Reserve has recently announced a continuation of money growth targets in the same ranges as announced in February. Also, some deceleration of money growth over time is implied by the recent tentative decision to reduce slightly for 1985 the target ranges for M-1 and M-2. In addition, the Federal Reserve announced its intention to assess the behavior of each of the monetary aggregates in implementing monetary policy. Implicit in this decision is the assumption that the aberrant behavior of velocity in 1982 and early 1983 was the product of cyclical influences and the introduction of new types of depository accounts. Therefore, in the future M-1 velocity might be expected to behave more typically based on historical experience.

4. Trade policy

The United States believes that market forces should be allowed to allocate resources both within the economy and in our economic relations with other countries. We encourage international efforts, such as those undertaken in the OECD and the GATT, to reduce trade barriers. The United States has now taken a leading role in building up an international consensus in favor of a new round of multilateral trade negotiations. Such a round is needed to reverse the drift toward protectionism that is becoming apparent worldwide. Although the United States has, in some cases, increased barriers to its own trade, we have been able to resist large-scale resort to trade restrictions. Also, we have generally followed GATT rules and, for the most part, our restrictive trade actions have been taken in response to unfair practices, such as subsidization, by our trading partners. Such actions have been aimed at preventing viable domestic industries from suffering as a result of the trade-distorting practices of other countries. However, this does not mean that it is easy for U.S. firms to obtain import relief; the recent rejection of petitions for relief from the tuna, footwear, and stainless steel industries demonstrates not only the transparency of U.S. institutional arrangements, but also the fact that their decision are based on objective, economic criteria.

In sum, my authorities are committed to maintaining an economic environment that is conducive to both real economic growth and price stability. The United States values the opportunity that this consultation has presented for an exchange of views with the staff, and welcomes the expression of views of Directors. We believe that careful analysis and a frank exchange of views during this kind of exercise is entirely in keeping with the Fund's efforts to improve the surveillance process.

Mr. Lovato said that the economic situation and policies of the United States, and more particularly their repercussions on the world economy, had frequently been mentioned during recent discussions in the Board. In the past three years, the United States had made a substantial contribution to the stability of the world economy by initiating a severe and steady course of anti-inflationary policies, which had been pursued to varying degrees by many industrialized countries. Those policies underlay the remarkable adjustment process that had taken place in all market economies at the beginning of the decade, creating the conditions for a restoration of balanced growth. Moreover, the American economy was now providing a powerful stimulus to the long-awaited recovery.

It had become increasingly apparent that some important corrections to macroeconomic policies were urgently needed, especially in the field of public finance, if recent achievements were to be consolidated, Mr. Lovato continued. The medium-term credibility of an anti-inflationary monetary policy ultimately depended on its compatibility with fiscal policy, a criterion that was not wholly met in the current U.S. economy. Furthermore, the United States could not continue to rely on external financing of both its public sector and external deficits without risking serious repercussions in international financial markets.

Some of the recent developments in the U.S. economy were typical of previous postwar cyclical upturns, although more pronounced in their intensity and persistence, Mr. Lovato said, while others were atypical. Typical aspects included the recovery in economic activity and the evolution of prices and incomes, while the structural imbalances in the fiscal position and weaknesses in the financial structure were clearly atypical. Concerning the economic recovery, he noted from Appendix I of the supplement to the report on recent economic developments that GNP growth had been comparable to other recent upswings, apart from the past few months, when it appeared to have been stronger. Fixed investment, both residential and nonresidential, had recovered relatively quickly after the trough, remaining buoyant throughout the second quarter of 1984. The strength of recovery of those two components of aggregate demand reflected the depth of the previous trough, although the unexpectedly strong growth of GNP had been a powerful stimulus. The Economic Recovery Tax Act had also provided an incentive to invest by reducing the after-tax cost of capital.

The reduction of inflation had been one of the most remarkable policy successes of recent years, Mr. Lovato remarked, the main causes having been the length of the recessionary period and the appreciation of the U.S. dollar. The recession had been crucial in reducing inflationary pressures originating in labor costs as wage negotiations took into account the slack in the labor market. It was perhaps not surprising that inflation was still low during the early months of the economic recovery, given the built in sluggishness in the wage-price determination mechanism, due in part to the influence of expectations on labor contracts, and to the fact that many sectors were still operating with unused capacity. In addition, the appreciation of the U.S. dollar and the slow rate of growth in many developed countries in 1983 had ensured an adequate supply of goods at low cost, thereby preventing a resurgence of inflation.

The most obvious atypical aspect of the current recovery had been the dramatic widening of the structural deficit of the Federal Government, Mr. Lovato continued. The increase in the public sector borrowing requirement had not been matched by a significant rise in the savings propensity of the household sector, which had remained low. Moreover, private credit demand had increased markedly, largely due to the buoyancy of demand for investment goods and consumer durables. As a result, the credit markets were facing unusually strong pressures, particularly in the short-term sector, since the growth of the domestic debt of the nonfinancial sector had exceeded the target and interest rates had risen. The increase in credit demand had been partially accommodated through capital inflows as U.S. banks had reduced their exposure abroad and lent instead to the domestic market at high interest rates, thereby reducing the amount of credit available to foreign borrowers.

The appearance of signs of stress in the financial markets, both in the financial intermediaries and in the nonfinancial business sector, was a second disturbing element characterizing the current recovery, Mr. Lovato remarked. The loss of confidence in some segments of the banking system during the spring of 1984 had damaged the system of financial intermediation, although the intervention of the monetary authorities had successfully limited the crisis to one isolated case, which nonetheless indicated that serious signs of instability could re-emerge. In addition, the nonfinancial business sector had recently shown signs of weakness in its financial structure, as indicated by the increasing number of mergers and acquisitions that had considerably reduced the equity component in the balance sheets of the merged companies; it was a worrying development, since corporations had traditionally consolidated their financial structures during previous cyclical upswings. The reasons behind the reduction in the equity ratios of the corporate sector should be carefully scrutinized.

The U.S. economy apparently embodied a combination of positive and negative elements, Mr. Lovato said. The record economic recovery appeared to be a positive element, although the size of recent economic fluctuations raised doubts about the future of the economy, unless it was stabilized by appropriate policies. In addition, the large budget and current account deficits, which had intensified the dependence of the U.S. economy on foreign capital, cast doubt on the sustainability of the recovery, expecially as the financial system had also shown signs of potential instability. Monetary policy should therefore remain tight to prevent a resurgence of inflation, while the upward trend in the public deficit should be reversed.

Finally, he noted that the staff report argued convincingly that U.S. trade practices had been significantly restrictive for a number of manufactured goods, Mr. Lovato commented. Although he acknowledged Ms. Bush's remarks concerning the intentions of the U.S. authorities to reverse the protectionist trend, free trade was most effectively promoted by policies to ensure the international competitiveness of domestic goods. Clearly, the current overappreciation of the U.S. dollar created a strong incentive to impose trade restrictions; policies to induce a depreciation therefore appeared to be an important precondition for trade liberalization. Given the dominance of the United States in the world economy, the authorities should take the lead in dismantling the country's protectionist measures.

Mr. de Maulde said that, as in previous years, he was participating in the discussions of the Article IV consultation with the United States with a mixture of deep interest and intense frustration. The discussion was frustrating because the U.S. Administration appeared to pay no attention to the recommendations of the Board. In 1982, the Board had strongly backed the statement in the appraisal in the staff report that "action to repair the fiscal position is undoubtedly the single most important task to be addressed by economic policy in the United States at the present time." In 1983, the Board had unequivocally endorsed the staff's recommendation that "decisive steps must be taken without delay to bring down the deficit," and in 1984, the staff report stated that "priority needs to be given to a large and rapid cutback in the budget deficit." The lack of response by the U.S. authorities to those recommendations led him to the conclusion that surveillance was a mockery, and consequently that the United States lacked credibility in propounding the idea that the exercise of surveillance by the Fund was the cornerstone of the smooth functioning of the international monetary system. That being said, he would continue to participate in the discussions in the hope that the recommendations would eventually be heeded.

He intended to concentrate his comments on the account contained in the staff report of the discussions between the staff team and the U.S. authorities, Mr. de Maulde continued, since it appeared that the staff had not always obtained satisfactory answers to its questions to the authorities. The discussion of the so-called soft landing in 1985 and beyond had raised the question whether the U.S. economy would experience a smooth transition from the current economic upswing to a more moderate but sustained growth path, with low inflation. Not surprisingly, the U.S. representatives had been optimistic concerning that possibility, and had referred to projections of an average growth of GNP of about 4 percent a year from 1985 to 1989, accompanied by a fall in inflation to 3.5 percent in 1989.

The reasoning behind that optimism was that, whereas previous recoveries in the postwar era had been halted by accelerating inflation induced by a rapid increase in the money supply, the authorities were now seeking a deceleration of monetary growth over time that would dampen inflationary expectations and bring down interest rates, Mr. de Maulde said. That major policy action would be supported by measures to curb government spending, encourage investment, and reduce regulation. However, the credibility of the soft landing process, which was based on the assumption of declining interest rates, was being undermined by the neglect of the overall fiscal stance. Once the slack in the economy generated by the previous recession had been taken up, it would not be possible to maintain strong GNP growth, a powerful fiscal stimulus, and a restrictive monetary stance all at the same time: either growth or price stability or both would have to be sacrificed. The current recovery of the U.S. economy depended heavily upon two nonrenewable assets--the excess capacity created by the previous recession and large capital inflows from abroad. Unless there was a significant shift in policies, the soft landing forecast appeared to be wishful thinking.

The present and projected fiscal deficits remained extremely large, in spite of the recent "downpayment" of measures aimed at reducing them, Mr. de Maulde went on. Moreover, the official projection was based upon assumptions about the economic situation and interest rates that were too optimistic to be entirely convincing. He congratulated the staff for presenting its own estimate of the size of federal deficit that could be financed by domestic savings without compromising the growth of the economy. The staff suggested a figure of 1.5 percent of GNP, which was less than half of the projection of the U.S. authorities. Contrary to the view of the U.S. authorities, he concurred with the staff that U.S. policies were inhibiting the recovery and growth of the rest of the world, for the reasons given in the staff appraisal. The fiscal policy of the United States, through its consequences on interest and exchange rates, was jeopardizing the stability and growth of both the world economy and of the U.S. economy itself.

U.S. monetary policy had met with general approval during the consultation discussions, Mr. de Maulde noted. The Federal Reserve had continued to perform the difficult task of presenting the only real barrier against inflation. The Treasury's criticism of its operating procedures might have some validity, but he was no expert in that field. He congratulated the Federal Reserve for providing assistance to commercial banks experiencing difficulties.

It was the shared view of the Fund staff and the U.S. authorities that the current account deficit would rise to $80 billion in 1984, and possibly to $100 billion in 1985, Mr. de Maulde remarked, and that it would have to be financed by capital inflows. When the staff had observed that such large capital inflows were unlikely to be forthcoming without an increase in interest rates or a depreciation of the exchange rate, the authorities had replied that the U.S. dollar might drift downward in the near future, but that they did not foresee an abrupt fall. He found that view implausible, since foreign investors would be unlikely to invest in the United States if the dollar were gradually to depreciate. Artificial measures to attract capital from abroad, such as the elimination of withholding taxes, the issuance of bonds and bills, or even the opening of unnumbered accounts, would not solve the fundamental problem of excessive expenditure. He feared that new market disturbances would arise before the current account position of the United States could be adjusted, a fear that was exacerbated by the restrictive policy stance of the U.S. authorities with respect to exchange rate intervention.

The U.S. authorities were not playing by the rules of the game in pressing for a new round of GATT negotiations while simultaneously imposing official and unofficial protectionist measures, Mr. de Maulde considered. The arguments of the U.S. representatives on that issue on pages 18 and 19 of the staff report were too poor to merit comment.

He noted with sadness that official development assistance provided by the United States had declined during 1983, not only as a percentage of GDP, but in nominal terms, Mr. de Maulde continued. The negative attitude of the United States toward foreign aid had already diminished the volume of assistance to the poorest countries, as evidenced in the IDA negotiations, during which all other donors had agreed to give $12 billion, but had reduced that figure to $9 billion in the face of U.S. intransigence. He hoped that the United States would soon revert to its traditional attitude of support for development assistance.

In conclusion, Mr. de Maulde noted from the staff report that the U.S. authorities believed that a factor contributing to the recent recovery was the greater flexibility of labor, goods, and capital markets in the United States. He hoped that that flexibility would also be extended to economic policymaking, and that the authorities would take the steps necessary to avoid a crash landing of their economy that would damage both their own country and the rest of the world.

Mr. Tshishimbi recalled that, when the Executive Board had discussed the staff report on the 1983 Article IV consultation with the United States (EBM/83/106 and EBM/83/107, 7/20/83), many Executive Directors had agreed that the U.S. economy had definitely emerged from the recession, although questions remained as to the pace and extent of the recovery, and whether it would be sustained over the medium term. It was now clear that there had been a quick, balanced, and broad-based economic recovery in 1983. Real GNP had been growing at an annual rate of more than 7 percent from the end of 1982 to the first quarter of 1984, and had been accompanied by declining unemployment and inflation. The authorities had estimated that the unemployment rate was close to the natural rate. Labor/management relations were considered to be harmonious and demands for wage increases remained moderate. Inflation, as measured by the GNP deflator and by the consumer price index, had declined considerably. The only apparently diverging indicator in the U.S. economy appeared to be the widening deficit of the current account of the balance of payments. In sum, the recovery seemed to have exceeded all expectations and forecasts, and to have been stronger than similar recoveries in the postwar period. He commended the U.S. authorities for that performance and for having fostered a favorable environment for economic recovery in the rest of the world.

With respect to the durability of the recovery and in particular to the outlook for capital formation in the United States and in the world at large, Mr. Tshishimbi noted, a widely shared view was that continuing large fiscal deficits limited capital formation and productivity growth. The deficits absorbed domestic as well as foreign private savings, exerted upward pressure on the level of interest rates, would continue in the long run to constitute an obstacle to sustained recovery, and would have adverse repercussions on the economies of other countries, particularly developing countries. The U.S. response to that view had been less satisfactory than its economic performance and the matter remained highly controversial. In 1983, the U.S. federal deficit had reached almost $200 billion, or twice the 1982 deficit and more than three times the 1981 deficit. According to the four-year projection for 1984-87, and assuming no substantial reduction in expenditure or tax increase, it seemed that the federal deficit would stabilize around $180 billion. The U.S. authorities, as well as independent observers, agreed that such deficits were inconsistent with sustained growth in the medium and long term. However, views diverged greatly on how a reduction in the deficit could be achieved. The authorities did not favor an increase in taxes, as they considered that taxes distorted economic decisions and led to a misallocation of resources. They also believed that increased revenue could all too easily induce Congress to increase spending. They therefore contemplated only a reduction in federal spending.

Unfortunately that strategy had not yet yielded the desired results, as noted in the staff report, Mr. Tshishimbi commented. Although the ratio of spending on nondefense programs to GNP had declined significantly during recent years, the reduction had been more than offset by increases in defense spending and interest payments, so that overall federal spending had increased substantially in relation to GNP. He therefore agreed with the suggestion on page 22 of the staff report that given the size of the federal deficit and the difficulty of reducing expenditure, further action to increase federal revenue might be unavoidable in the future.

The effects of large fiscal deficits on interest rates and on capital formation was another source of controversy, Mr. Tshishimbi said. Most observers of the U.S. economy, including many Executive Directors, believed that the public debt, both external and domestic, required to finance the large fiscal deficit put upward pressure on interest rates, crowding out the U.S. private sector and private and public borrowers in smaller and less developed countries from the financial markets. The U.S. authorities had adopted a different position, believing that there was no relationship between the U.S. fiscal deficit and real interest rates. They saw instead a direct causal relationship between inflation and interest rates, and had therefore concentrated their strategy on reducing inflation, with some success. However, interest rates remained high, partially as a result of restrictive monetary policies, but also as a reflection of the fears aroused by the high federal deficits.

Although the evidence for a causal relationship between deficits and interest rates was not conclusive, financial operators on Wall Street and elsewhere might conclude that such a relationship did exist, Mr. Tshishimbi commented. The high interest rates had placed an intolerable burden on developing countries with substantial external debt. The U.S. officials had pointed out that the high interest payments made by less developed countries might be offset by a rise in their export earnings as the volume of U.S. imports increased, but he was not certain that those developing countries which had also been affected by natural disasters, such as droughts and cyclones, would experience a significant increase in export earnings.

He shared the view that monetary policy in the United States had to bear a greater burden than in most other countries owing to the constraints on fiscal policy, Mr. Tshishimbi continued. It was therefore imperative that the growth rate of monetary aggregates should remain within the target. He therefore welcomed the lower taret rates set for the growth of M-1, M-2, and M-3 in 1984 compared with 1983, particularly given the unexpectedly strong recovery and the continued uncertainty surrounding the behavior of M-1 and the consequences of certain institutional changes.

Concerning external policy, Mr. Tshishimbi said that developments in the United States continued to have a considerable impact on the rest of the world, as stated during the 1983 Article IV consultation with the United States. The rapid appreciation of the dollar, which had begun in 1980, was currently continuing, due partly to rising confidence in the U.S. economy, but also to the fiscal policies of the authorities. The main objective of U.S. trade policies, as stated by the authorities, was the preservation of open markets within and outside the United States, as well as the expansion of free and fair world trade, in keeping with the U.S. role as the major industrial and economic power. However, some international trade measures had been inconsistent with that free market concept. The authorities themselves admitted that protectionist measures had intensified in the United States, and he understood that restrictions on imports were under consideration, even on primary products such as copper. He strongly endorsed the staff view that the United States should not only avoid new trade restrictions, but should also roll back existing barriers to international trade.

He had also noted the view of the U.S. authorities that official assistance had not been the most effective means of helping developing countries to achieve their development objectives, Mr. Tshishimbi said, and that they instead preferred direct investment. The Executive Board had recently discussed the question of foreign direct investment in the developing countries, and had noted that non-oil less developed countries could not expect a substantial increase in foreign direct investment in the near future. Furthermore, foreign direct investment tended to be inversely correlated with the degree of indebtedness of a given country, and remained concentrated in a few areas. Also, since foreign direct investment was mostly supply- rather than demand-determined, less developed countries had only marginal influence in attempting to attract it. Therefore, although the role of foreign investment should not be underestimated, development assistance should be encouraged in favor of the most needy developing countries, and he urged the United States to adopt a more positive attitude toward contributions to IDA.

Mr. Kafka said that he agreed with the general thrust of the staff report. U.S. policies in the past 18 months had achieved remarkable successes, as summarized in Section I of the staff report. There had also been some surprising features, one of which had been the recovery of interest-sensitive components of demand, for which the staff offered a series of sensible reasons. It did not, however, mention that the effect of high interest rates in the United States was to an exceptional extent moderated by the tax treatment of interest payments, even for consumer loans, thereby reducing domestic pressure for policies conducive to interest rate reduction. A second interesting feature was the relatively rapid growth in employment and the decline in unemployment, which contrasted with the experience of other industrial countries, and was due largely to developments in the service sector and to the moderation of wage demands. It had been associated with a modest cyclical rise in productivity growth, as also noted by the staff. The latest OECD economic survey suggested some of the reasons for the divergent behavior of productivity in the United States compared with the rest of the OECD membership.

Wisely, the staff did not conclude that the experience of the past 18 months had validated the arguments of the supply-siders, Mr. Kafka said. However, U.S. policy, at least at first sight, appeared to support the suggestions of Professor Robert Mundell, a former staff member, that a country facing unemployment and a potentially or actually weak balance of payments should use fiscal policy to stimulate the economy and monetary policy to attract capital and thereby external balance. Fortunately, few countries were in a position to follow such a prescription for any length of time, but the United States appeared to be among them.

The discussion between the staff and the U.S. representatives recorded in Section II of the staff report had been unusually interesting because there had been as much discussion between them as amongst the U.S. representatives themselves, Mr. Kafka added. Concerning the discussions on fiscal policy, he only partially sympathized with the U.S. Administration's position that the solution to the fiscal problem was to be sought in expenditure reduction rather than tax increases. After all, financing expenditure by taxation rather than by bond issues had a different impact on saving and on other elements of economic behavior, including interest rates and the balance of payments. A lower fiscal deficit, by whichever method it was achieved, might temporarily reduce growth, as correctly noted by the U.S. representatives; moreover, lower interest rates and the depreciation of the dollar would reduce the U.S. current account deficit and imports, including those from developing countries. The loss was likely to be offset to the extent of the reduced interest burden and, in addition, by the increased expansion which lower interest rates would permit in other industrial countries. It would be interesting if the staff would discuss the type of taxes that would be implemented if expenditure reductions alone could not reduce the deficits, as he was convinced they would not.

The discussions on monetary policy seemed to reflect a belief by the staff that signs of a substantial change in inflationary expectations, such as the weakness of commodity spot prices, should not be given much weight, Mr. Kafka noted. He wondered whether that judgment was still justified. He would also welcome comment on the difficulties faced by U.S. savings and loan institutions as a result of rising interest rates.

During the discussions of the balance of payments and exchange rate, it had been suggested that, even without major policy changes, the rate of deterioration of the current account deficit was likely to slow somewhat during 1985, and would be associated with some decrease in the rate of absorption of world savings by the United States, Mr. Kafka continued. The prediction that the U.S. dollar would have a soft landing even if efforts to curb the fiscal deficit were not wholly successful might indeed be true, although he hoped that a significant decline in the fiscal deficit would make it unnecessary to test that theory. The potential effects of a hard landing were indeed frightening.

He was grateful to the staff for their insistence on a careful discussion with the U.S. representatives of the issue of protection, Mr. Kafka added, although the results were not comforting. Urgent attempts should be made by the United States as the world economic leader to promote special arrangements to benefit the developing countries that had been damaged by recent world events, such as the present combination of high interest rates and falling commodity prices. That being said, the importance to trade of the Caribbean Basin Initiative by the United States should be recognized. He agreed with the U.S. representatives that developing countries should make full use of the advantages to be derived from flows of foreign private direct investment, although he agreed with Mr. Tshishimbi that such investment could not replace bilateral and multilateral grants and loans by official entities. He hoped that the United States would soon find it possible to increase its official development assistance.

Mr. Joyce said that he broadly agreed with the staff report. The U.S. economy was currently enjoying a strong recovery from the deep recession of 1980-82, as evident from the recent improvement in many of the indicators of aggregate economic activity, such as employment and inflation. Discussion had now shifted to a consideration of the nature of the recovery and its sustainability. The large budget and current account deficits, which had put upward pressure on interest rates and the U.S. exchange rate, constituted major threats to the recovery in the United States and in the rest of the world. Those concerns remained despite the renewed strength of the U.S. economy. Although it might be difficult for the United States to move promptly toward resolution of those problems, given the forthcoming elections, the need for action was indeed urgent.

The staff's revised economic outlook for the U.S. economy was close to the projections of his Canadian authorities, Mr. Joyce continued. Nevertheless, both projections contained substantial risks; in particular, if interest rates were to rise significantly, a more abrupt and pronounced slowdown than expected was likely. The Chairman of the Federal Reserve Board had recently mentioned before the U.S. Senate Committee on Banking, Housing and Urban Affairs that there were a number of areas in which the U.S. economy was especially vulnerable to high interest rates. For example, many corporations in the United States carried substantial levels of debt incurred in part from leveraged buyouts which had resulted in a net retirement of equity; a proportion of that debt was short term and had been contracted on a floating rate basis. Some productive sectors in the U.S. economy, such as agriculture, and thrift institutions, were also particularly exposed. In addition, the increased use of adjustable rate mortgages meant that the consumer goods sector was also more interest-rate sensitive than it might have been in the past. For those reasons, high interest rates might be a more significant danger to the U.S. recovery than the Administration appeared to believe.

The staff expressed concern about the policy mix that the U.S. authorities were implementing, Mr. Joyce said. While the staff did not make explicit its interest rate assumptions, it appeared to feel that if rates did rise further, the consequences would not greatly affect the economy before the end of 1985. Indeed, in the last paragraph of Appendix I of SM/84/162, the staff appeared to support the view of the Administration that, although the size of the fiscal deficit was a major problem, in the medium term the domestic consequences were sufficiently distant to allow for its gradual reduction.

His authorities also saw risks with respect to how close to capacity the U.S. economy was currently operating, Mr. Joyce noted. The staff view was that the rate of unemployment was approaching the estimated natural rate of 7.5 percent of the labor force. However, it could be argued that structural changes in the United States over the past several years, including deregulation and social security cutbacks, had reduced the natural rate below the staff estimates, and that there might be more slack in the labor market than the staff believed. On the other hand, the Administration appeared to be more optimistic than was justified by recent evidence concerning productivity growth. He asked the staff or Ms. Bush to comment on those points.

On fiscal policy, Mr. Joyce said he shared the staff's view that the magnitude of prospective budget deficits suggested the need for cuts in expenditure and increases in taxes. The so-called downpayment package was welcome, but probably insufficient, implying that the U.S. authorities should adopt more substantive measures if there was to be a meaningful reduction in the fiscal deficit. The staff shared the view of the Administration that the emphasis should be on expenditure reduction. However, it was unlikely that measures to achieve the necessary reductions in spending would find favor with Congress in either the short or medium term. Moreover, if it was assumed that defense spending was to remain largely untouched, the overall effort to achieve expenditure reductions would be further constrained. Therefore, since the level of the deficit and the implications of its financing were of urgent concern, there was a strong case for increasing taxation in order to reduce the borrowing needs of the U.S. authorities, irrespective of any expenditure reduction the Administration was likely to achieve. To continue the present large deficits for a number of years would inevitably increase debt servicing costs, making the ultimate elimination of the deficit far more difficult.

The staff reports provided a good review of developments in United States monetary policy, and in particular of the impact of financial innovations on the monetary aggregates, Mr. Joyce commented. As in Canada, the effect of recent innovations in financial markets underscored the need to maintain a flexible and pragmatic approach to the conduct of monetary policy. He also endorsed the staff view that a cautious monetary policy was needed, for two reasons. First, the reduction in inflation in recent months had been due to special factors such as lower food costs and energy prices, and lower prices of imported goods, reflecting the strength of the dollar. Second, despite the consensus that wage increases would remain moderate, recent studies by the Brookings Institution suggested that, as in past recoveries, unions might adopt an increasingly tough bargaining stance in an attempt to catch up on earlier wage concessions. Such a development was imminent in the automotive sector. However, the indications that real growth would slow in 1985 suggested that there should not be an excessive tightening of monetary policy at the current time, but that a more coordinated and balanced approach to monetary and fiscal policy was required.

Two irreconcilable views were held of the balance of payments and the strength of the U.S. dollar, Mr. Joyce noted. The view of the staff and many observers was that the capital inflow, the resulting strength of the dollar, and the current account deficit were largely endogenous, caused by the strength of the U.S. economy and the current policy mix being pursued by the authorities. In contrast, the Administration placed more emphasis on exogenous factors, such as the loss of export markets in developing countries, the greater profitability of investment in the United States compared with other industrial countries, and the so-called safe haven argument. On balance, the staff's views were more defensible. The U.S. Administration had not provided sufficient evidence in support of its contentions, which, however, had some merit; moreover, the U.S. view suggested a real risk of sudden changes in the value of the U.S. dollar if there were to be, for example, a reversal of safe haven flows, or changes in expectations concerning the continuing strength of the U.S. economy and the profitability of U.S. investment.

The strength of the U.S. dollar, which was at least partially attributable to high U.S. interest rates, was an important factor in the loss of competitiveness of some key sectors of U.S. industry, and had already intensified pressures for increased protection, Mr. Joyce commented. Those pressures had not eased despite the strong growth of the U.S. economy, making them a matter of considerable concern despite the authorities' commitment to resist them.

Developments in the U.S. economy and in the policy stance of the U.S. Administration were clearly among the most important factors determining the world economic environment and the prospects for progress or stagnation in many countries, Mr. Joyce remarked. He shared Mr. de Maulde's concern that the U.S. authorities appeared to ignore all advice, a situation which he hoped would change in the future. However, the recent rapid recovery of the U.S. economy had benefited other countries; without the deficits and the significant fiscal stimulus provided by the tax cuts, the world recovery would have been weaker. Nevertheless, the current policy mix, with its undue reliance on monetary policy to control inflation, had international ramifications that were a matter for increasing concern.

In conclusion, his authorities did not share the view of the U.S. Administration that U.S. policy was not having negative effects on the rest of the world, Mr. Joyce continued. The recent upward movement in real interest rates in the United States and the continued strength of the U.S. dollar were forcing a policy stance on many countries that might be inappropriate, particularly for those countries whose economies were more sensitive to high real rates of interest than the United States. As recently stated by the Governor of the Bank of Canada, the effects of U.S. policy in Canada had been to raise interest rates above the levels appropriate for the domestic economy, even allowing for the significant depreciation of the Canadian dollar. For heavily indebted developing countries, the increase in interest rates had significantly increased their debt service burden and inhibited their recovery. He recognized that the strong growth of the U.S. economy had stimulated export growth prospects in many developing countries, but he suspected that if they had to choose, they would prefer a U.S. policy stance more conducive to interest rate reduction.

On behalf of the Caribbean members of his constituency, Mr. Joyce expressed his thanks to the United States for the Caribbean Basin Initiative, and also for U.S. aid policies in support of their economies.

Mr. Wicks commented that the United States accounted for about one fifth of world GNP and 15 percent of world trade, and that the dollar played a dominant role in international markets. Because of the global impact of U.S. policies, they had to be judged not just against domestic criteria but also against the wider international background, and he would therefore concentrate on their international implications.

The continuing growth in the U.S. economy had been remarkable, Mr. Wicks noted. Preliminary second quarter data indicated that the recovery compared favorably with others in the postwar period, and had been associated with a rapid improvement in labor market conditions. Unemployment had fallen sharply and nearly seven million jobs had been created since the and of 1982, indicating the innate flexibility and responsiveness of the economy. As the U.S. authorities rightly argued, the relatively low level of state intervention in economic affairs was in part responsible for the successful economic recovery. In those respects, although perhaps not in others, the U.S. economy provided valuable lessons for both developed and developing countries.

In spite of the high level of interest rates, the current economic results were satisfactory from a domestic point of view, Mr. Wicks continued, and the U.S. authorities were right to emphasize the benefits of their recovery for the exports of the rest of the world. However, the effect of high and rising U.S. interest rates both on borrowing countries and on the nascent recoveries in industrial countries was a cause for concern. A second worry was the question of how long the U.S. recovery could be sustained given the imbalances accompanying it, and how the United States could best achieve an orderly adjustment to a more sustainable position without causing an overshooting of exchange rates and interest rates and a disruption of existing balances--the so-called soft landing which had been mentioned by other Executive Directors.

Those questions inevitably led to a consideration of the relationship between the U.S. fiscal deficit, interest rates, the current account, and the exchange rate, Mr. Wicks said. His authorities shared the conventional wisdom of the staff that the underlying problem in the U.S. economy was the size of the fiscal deficit. The U.S. authorities did not agree with that assessment, and he would have welcomed a fuller analysis by the staff of their arguments, which were repeated many times in the staff report.

He agreed with the U.S. authorities that it was necessary to examine the deficit of the entire public sector and not just that of the Federal Government, Mr. Wicks remarked. However, it was surprising to read on page 11 of the staff report that the overall deficit of the U.S. public sector had been estimated at only three and a quarter percent of GNP. The U.K. authorities' calculation of the U.S. public sector borrowing requirement, which was a more realistic measure of the public sector's demand for credit, although not identical to the federal deficit, suggested that it was higher than the crude federal deficit. State and local government surpluses were more than offset by other items such as borrowing by federally sponsored enterprises and expenditures on off-budget items, while the inclusion of federally guaranteed expenditures would, of course, increase the figures still further. He asked the staff to comment on what they believed to be the most appropriate measure of the public sector demand for credit, and to indicate its size as a percentage of GDP. He would add that, although the U.S. deficit, however defined, was lower than that of a number of other major countries, the sheer size of the United States meant that it had a substantial effect on the demand for world savings. It was therefore important to consider the external effects of the U.S. economy in terms of absolute quantities, not merely in percentage terms.

He agreed with the staff that the empirical evidence concerning the relationship between fiscal deficits and interest rates was not conclusive, Mr. Wicks continued, but the same applied to most propositions in macroeconomic theory. He did, however, note that the balance of evidence presented in Appendix XI of the supplement to the report on recent economic developments, entitled "Fiscal Deficits, Interest Rates, and Capital Formation," did tend to support such a connection. He was not convinced by the authorities' explanation that high inflationary expectations had been the main cause of high interest rates, for two main reasons: first, it could not account for the high short-term interest rates, since inflation was not expected to rise in the short term. Second, although the upward-sloping yield curve could be explained by inflationary expectations, those might in turn be the result of fears concerning the current fiscal stance and the potential pressure on future monetary growth. Indeed, that was the impression given by the behavior of financiers on Wall Street.

He agreed with the authorities that the crucial domestic issue was the relationship between the fiscal position and capital formation, Mr. Wicks commented. The staff's demonstration of the historical relationship between the capital stock and the level of debt was interesting, in that the medium-term fiscal scenario presented in Appendix XI indicated that, even under optimistic economic assumptions, current projections of the federal deficit were not consistent with both a gradual reduction in the current account deficit and the generation of investment sufficient to maintain steady growth, a situation that gave cause for concern, since one objective would have to be sacrificed. If the deficit was to be reduced, domestic savings would have to do very well indeed, although it was not clear how that could be achieved if interest rates were to fall, as predicted by the Administration. A reduction in investment would have serious consequences for growth and recovery, both in the United States and elsewhere. Increased reliance on foreign savings would probably be associated with a further appreciation of the dollar, together with continually rising interest rates to induce foreigners to increase the share of dollar assets in their portfolios. The latter situation would ultimately be unsustainable, at which point a sharp adjustment in the external account and in the value of the dollar might prove unavoidable.

There was therefore an urgent need to reduce the fiscal deficit, Mr. Wicks stated. The U.S. authorities' commitment to a downpayment was an encouraging first step, although only part of the downpayment had so far become law, and he hoped that the rest would be shortly. A potential problem was that the growth of public debt through the accumulation of interest payments would exceed the rate of growth of GDP. He therefore hoped that the United States would take comprehensive action to deal with those problems before the 1985 Article IV consultation.

He welcomed the renewed commitment by the Chairman of the Federal Reserve Board to firm monetary policies, as expressed in his recent statements before Congress, Mr. Wicks continued. Those policies would remain essential to maintain low inflation and it was encouraging that M-1 and M-2 remained within their target ranges, although M-3 was slightly above the upper limit.

He wished to emphasize the importance of the U.S. espousal of free trade policies, Mr. Wicks said. The recent imposition of protectionist measures was a cause for concern, particularly since it came at a time when unemployment had fallen sharply and profit margins had increased. Such measures imposed costs on the U.S. economy and on the rest of the world; he therefore urged the U.S. authorities to rely on the proficiency of U.S. labor markets to create new jobs and to resist protectionist pressures. The imposition of copper quotas would be a particularly unfortunate development at the present time.

A salient feature of the staff reports was that the United States had resolved the problem of financing its domestic resource gap in an unprecedented manner during the recent period of expansion, Mr. Wicks observed. It had grown dependent on a heavy net inflow of capital from abroad, at the rate of two percent of GNP, which had supplemented net domestic savings by about one quarter. The U.S. authorities appeared to recognize the fundamental instability of their financial position, and he hoped that they would soon be able to bring themselves to deal with it.

Mr. Prowse said that he broadly endorsed the staff appraisal. He agreed with the emphasis placed by the staff on the longer-term outlook, particularly the fiscal policy of the U.S. authorities. The Executive Board had frequently advised members to pursue a balanced mix of fiscal and monetary policies, advice that also applied to the United States unless there were some factors unique to the U.S. economy, which might partly be the case. However, an improvement in the fiscal situation was required, in part to ensure the freeing of capital resources for investment, since low productivity in the United States had tended to diminish the value of employment growth. It was also important to avoid upward pressure on interest rates, which harmed the debtor countries. It appeared that increases in taxation were inevitable, since as yet there had been little progress in reducing the deficit. Also, the authorities' projections for the deficit were crucially dependent on interest rate assumptions that could prove erroneous, particularly since the total demand for funds in the United States was likely to continue to increase. He therefore supported, as an intermediate objective, the staff proposal that the deficit should be reduced quickly to the point at which the federal debt ceased to grow as a proportion of GDP.

The U.S. authorities believed that all taxes tended to distort decision making by the private sector, Mr. Prowse continued, while at the same time they argued that the overall public sector deficit was the relevant measure to consider. In that context, he asked whether the U.S. authorities believed that taxes levied by the states were less distorting than taxes levied by the Federal Government since there had been a clear tendency for the states to increase taxation as the Federal Government reduced its taxes. A significant factor in the financing of the deficit was the Treasury's intention to sell securities overseas, with the likely impact of strengthening the dollar. The Treasury would have to capture either funds that were shifted out of non-dollar assets into dollars, or dollars invested abroad. To the extent that funds were shifted out of non-dollar assets, the dollar would strengthen, although if it appreciated as a result of a shift out of dollars invested abroad, it would be at the expense of private sector borrowers.

The U.S. view concerning the effects of the deficit on interest rates, as Ms. Bush had stated, asserted that a thorough review of the empirical studies revealed no consensus on the relationship between real interest rates and deficits, Mr. Prowse added. Appendix XI of the supplement to the report on recent economic developments, indicated that the body of empirical evidence surveyed by the staff clearly indicated that U.S. fiscal deficits had at the very least contributed to the high level of interest rates. It appeared that the U.S. analysis had taken less account than usual of market opinion. In fact, financial markets were evidently convinced that a relationship between deficits and interest rates existed--whatever the conclusions of the econometric studies--and that it clearly contributed to the maintenance of high interest rates. In addition, markets seemed convinced of the medium-term relationship between deficits and inflation.

The starting point for that debate had been the Williamsburg Summit in May 1983, at which the United States had been urged to reduce its budget deficit, Mr. Prowse recalled. The authorities' replies at that time had been based on the conclusions of a U.S. Treasury paper, entitled "Government Deficit Spending and its Effects on Prices of Financial Assets," which had asserted that the impact of budget deficits on interest rates could vary from crucial to nonexistent. The actual outcome depended upon the assumptions made about the savings behavior of the private sector, about which the paper made two postulations. First, it was possible that the extra personal income generated from a tax cut would be saved, creating an increase in the supply of loanable funds equal to the increase in government borrowing, with no impact on interest rates irrespective of whether government spending was financed by borrowing or by taxes. The total amount of the tax cut would then be used by the recipients to purchase bonds because they perceived that the interest earned would be sufficient to pay future taxes required by the Government to service the debt, while the return of principle would be used to retire the bond. The second theoretical position was that there was no substitution between taxes and government borrowing, so that the increase in personal income following a tax cut would be entirely consumed, generating no increase in loanable funds, and thereby placing upward pressure on interest rates.

The U.S. Treasury analysis had not conclusively supported either position, but had noted that other factors could exert a crucial influence on the outcome, such as whether deficits were caused by spending increases or tax cuts, the extent to which the deficit was financed by monetization of the debt or by the sale of debt to the public, and the extent to which tax cuts reduced marginal tax rates, Mr. Prowse continued. It was therefore not surprising that the econometric studies failed to establish a clear, direct causal link between deficits and interest rates. The Treasury paper had argued that the Keynesian model, which implied that an increase in borrowing would lead to an increase in interest rates, was incorrect because of its treatment of wealth. The paper's main theoretical argument was that bonds did not constitute wealth and that tax cuts were wholly saved, a very weak pillar on which to dispute the deficit-interest rate relationship, since it was assumed that individuals would discount the future imperfectly and irrationally. The Treasury had then argued that a reduction of inflationary expectations would lower interest rates; in fact, the more likely result was that the expectations generated by large deficits would result in higher nominal and real interest rates than would otherwise be the case. The high deficits also had supply-side effects, which, the Treasury paper had concluded, could either raise or reduce interest rates depending on the assumptions made; it had not said that the supply-side effects would inevitably reduce interest rates. In sum, he supported the staff analysis that increasing deficits had led to upward pressure on interest rates.

The future formulation of monetary policies was unclear because of the recent growth of the monetary aggregates, with M-1 expanding at a rate at the top of its range, and M-3 above its range, Mr. Prowse commented. Attempts to minimize the impact of the interest rate on the U.S. economy and on the developing economies would conflict with the objective of controlling inflationary pressures.

He endorsed the staff's recommendation that the tendency toward greater protection should be resisted, Mr. Prowse said. Ms. Bush had cited the GATT rules and the transparency of U.S. protectionist measures. Certainly, the 1955 waiver authorizing the United States to apply trade restrictions to a wide range of agricultural products was transparent, but it was nonetheless notorious, in the history of the GATT, for its undesirable effects. The variety of means by which domestic industries could obtain import relief under U.S. trade law was impressive; in that context, Appendix VII of the supplement to the report on recent economic developments was interesting. The European Communities (EC) had also imposed flexible instruments of protection, creating the curious situation in which protection was escalating in one country simply to counteract increasing protection in another country. It was a problem of enormous magnitude. For example, in 1984, the EC was planning to spend about $16 billion, and the EC Governments themselves would spend at least as much again, on 8 million farmers. However, the United States spent even more money on even fewer farmers; according to the Chemical Bank of the United States, the Federal Government in 1983 had donated $22 billion to 2 million farmers, totaling $60 billion or $30,000 per farmer. The distortionary effects of that expenditure were very large, and were unconnected with taxation, although it had to be acknowledged that a large proportion of the costs had been incurred under programs such as the Payments-in-Kind (PIK) program, which had withheld land from production, thereby reducing production rather than flooding the market. An advantage of American farm support was that most farmers received world market prices for their produce, whereas EC farmers were paid on average 50 percent above world prices. It was important to understand the nature of those distortions, which were caused by direct intervention. Given the increasing trend toward protectionism, he wondered whether it was realistic to push for a new multilateral round of trade negotiations, and whether any concrete progress was being made in that direction.

He asked the staff whether the concept of external debt was different for the United States than for other countries, since the United States borrowed overseas in its own currency, suggesting that it could repay its external debt by printing currency, Mr. Prowse remarked. If not, he would like to learn from the staff what the U.S. external debt ratio was.

Mr. Finaish noted that some important gains had been made in improving the performance of the U.S. economy since 1982. Inflation had slowed considerably, while output growth had recovered at a faster pace than expected following the deep and protracted recession. The fall in unemployment had also exceeded expectations. However, despite those positive developments, the performance of the economy in other areas had been less satisfactory. The problem of large fiscal deficits had worsened, and the current account had moved into a substantial deficit that was projected to increase during 1984 and 1985. Although they had declined during 1982 and 1983, interest rates remained at a high level, and had, in recent months, shown a tendency to inch up again. The weaker aspects of economic performance had adverse implications for the medium- and long-term prospects for both the U.S. economy and other countries.

The staff report provided a useful discussion of the policy adjustments required to ensure that the recent hard-won achievement of noninflationary growth was not short-lived, and to promote greater harmony between developments in the United States and abroad, Mr. Finaish observed. Recently, the Wall Street Journal had carried an interesting article with the provocative title--"Just Imagine an IMF Plan for America: Lower wages, higher taxes, spending cuts."

The policy discussion in the staff report correctly focused on the need for a reduction in fiscal deficits, which, despite the recovery, constituted a serious threat to the sustainability of noninflationary growth over the medium term, Mr. Finaish continued. Domestically, the threat arose from upward pressure on interest rates caused by the persistence of the deficits, the large absorption of private savings required for their financing, their implications for capital formation, and the great difficulties they created for monetary policy needed to control inflation. Externally, the adverse implications came from the higher interest rates and the absorption of foreign savings by the United States; both developments were particularly worrying given the current debt servicing difficulties of many developing countries and the sharp contraction in international flows. The high U.S. interest rates and exchange rate might not be wholly attributable to the fiscal deficits, which were however undeniably an important factor. The increase in the U.S. current account deficit had resulted in a stimulus to economic activity in other countries and an increase in their exports, although that effect should be offset against the negative implications previously noted, and also against the intensification of protectionism stemming from the appreciation of the exchange rate. Also, the contribution that the U.S. economy could make to promoting exports and economic activity in other countries in the medium to long run depended on stable and sustainable growth in the U.S. economy that was jeopardized by the persistence of large fiscal deficits. The high interest rates and an appreciating dollar had other positive effects on the external receipts of some countries, depending on the composition of their foreign asset portfolios and trade, the implications of which should again be weighed against the more global effects noted above.

A sizable and early reduction of U.S. fiscal deficits therefore deserved high priority, Mr. Finaish added, and should be pursued more resolutely than had thus far been the case. Measures passed in the recent Deficit Reduction Act of 1984 fell short of the desired degree of adjustment. The medium-term scenario of the sources and uses of savings presented in Appendix XI of the supplement to the report on recent economic developments was instructive in showing that, in the absence of substantial further action to reduce the deficit, the financing of prospective deficits would either require substantial continued inflows of foreign savings of as much as 4 3/4 percent of GNP in 1988 if interest rates failed to fall, which would be a highly anomalous situation for the world's richest economy, or it would result in substantial crowding out of private investment, causing the rate of investment to drop far below the level necessary for the maintenance of satisfactory growth rates.

The authorities' medium-term projections for the fiscal deficits were fairly sensitive to the assumption of a gradual decline in interest rates, Mr. Finaish observed. However, the persistence of large deficits could itself serve to negate that assumption. The staff had noted the authorities' skepticism regarding the role of fiscal deficits in influencing interest rates, claiming that the empirical evidence was not wholly conclusive. Although that was true, a growing body of evidence and the weight of professional and international opinion seemed to support the link between federal debt accumulation, interest rates, and capital formation. The material presented in Appendix XI was useful in that respect. Fully conclusive evidence was elusive in economics, and insistence upon finding it as a basis for policy formulation could lead to inadequate action where firm action was in fact required. In developing countries, the potential for policy inaction would increase, since empirical evidence was scarce, including evidence for several policies that were frequently recommended to them with almost single-minded zeal.

The authorities' efforts to cut expenditure to reduce the fiscal deficits had so far yielded unsatisfactory results, Mr. Finaish said. Indeed, federal spending had risen significantly relative to GNP in the recent past, even when allowance was made for cyclical factors. Given the scale of fiscal adjustment needed, substantial efforts to raise revenues appeared to be necessary to supplement expenditure restraint. As argued by the staff, tax revenue could be increased in ways that would not distort the incentives for capital formation. The authorities should also consider the effects on the composition of expenditures in formulating policies for reducing the level of government expenditures.

It was a cause for concern that, despite the authorities' stated objective of countering protectionist pressures and the rapid recovery of output and unemployment, several restrictive actions had recently been taken, Mr. Finaish commented, some of which had affected important exports from developing countries, including heavily indebted countries. Some trade restrictions had been justified on the grounds of countering protectionism by other countries. That policy risked stimulating a universal escalation of trade barriers. Considering the key position of the United States in world trade, a clear demonstration of its commitment to free trade was important in checking the spread of such barriers. The suggestion by the staff that some reform of the institutional trade arrangements in the United States might be necessary also deserved attention.

He wondered whether it would have been possible for the staff to assess in broad quantitative terms the impact of the U.S. trade restrictions on the exports of trading partners, particularly the developing countries, Mr. Finaish said. He recalled that in the report on the Annual Review of the Implementation of Surveillance in February 1984 (SM/84/44, 2/15/84; and Sup. 1, 2/16/84; EBM/84/39 and EBM/84/40, 3/12/84), the staff had said that the impact of protectionist measures on countries' trading partners would be given greater emphasis in Article IV consultations in 1984. The Chairman's summing up of that discussion had also noted that the economic costs of protectionist measures should be quantified.

Concerning agricultural policy, Mr. Finaish commented that the staff had noted that the high target and support prices for several farm products had resulted in large supply and demand imbalances and had increased the budgetary costs of farm support programs. It would have been useful if some estimates on the current budgetary outlays on those programs had been included. As already noted by Mr. Prowse, Chemical Bank had estimated that the farm support to the agricultural sector in one form or another amounted to $30,000 per farmer. The basic solution to the problem of large budgetary outlays on farm programs lay in reduction or elimination of farm support. It would be interesting to know, however, what effects that would have on the global cost and availability of foodgrains, given the important role of the United States as a foodgrain producer.

The ratio of official development assistance to GNP in the United States had for many years been among the lowest for industrial donor countries, Mr. Finaish observed, giving cause for concern. Although the authorities considered foreign direct investment to be a more effective means of channeling resources to developing countries, the extent to which that type of resource flow could be substituted for other flows, including official development assistance, was limited. Besides, the effectiveness of aid flows was partly a function of aid policies themselves. The effectiveness of U.S. aid flows could be enhanced by a reversal of the sharp decline in the share of flows channeled through multilateral institutions, and through an improved distribution of aid flows among recipient countries by reducing the present highly skewed distribution and by relating such flows more closely to the economic needs of recipients and the prospects for their productive utilization. Some of the proposals made by the Commission on Security and Economic Assistance, which had been appointed in 1983 to review U.S. foreign assistance programs, would further undermine the quality of aid flows to recipients as a result of the recommendations to integrate economic and military assistance programs more closely, and to make greater use of tied aid to protect U.S. commercial and investment interests.

Concerning the multilateral aspects of surveillance, Mr. Finaish said that the greater attention devoted in the staff reports for the 1984 Article IV consultation to the international repercussions of the U.S. deficits was appropriate and consistent with views expressed in recent discussions of the problem of Fund surveillance of countries with a large weight in the world economy. However, there was scope for further improvement in surveillance, particularly of the world's largest economy. In addition to providing a fuller identification of the channels through which domestic policies could affect the international economy, the value of the analysis could be enhanced by attempting--where possible--an assessment of the magnitude of the international impact of the more important domestic policies, especially those of particular international interest. Although a precise assessment would clearly be impossible, even an indication of the broad orders of magnitude would be helpful. He asked the staff to comment on that suggestion.

Mr. Schneider said that he was in broad agreement with the analysis of the staff report. He would comment on the impact of U.S. policy choices on the sustainability of the recovery both inside and outside the United States. The recovery of economic activity since the trough of the recession in the fourth quarter of 1982 was more robust than had been expected on the basis of the policy stance of the present Administration, while the growth of real GNP over the first three quarters of the recovery had been stronger than the average of previous postwar recoveries. The magnitude of the recovery seemed consistent with the strength of the impetus given to the economy by the income tax reductions, intended as the motor of the recovery, that were only part of a broader expansionary program, consisting of a sharp increase in the budget deficit and a more accommodating monetary policy. The present U.S. recovery had therefore been regarded as the normal outcome of a traditional policy of Keynesian demand management, while the absence of a stronger recovery in the other OECD countries had been seen as the predictable result of opposite policies.

Two aspects of the present U.S. recovery stood in sharp contrast to historical experience, Mr. Schneider continued. First, in spite of high real interest rates, all interest-sensitive components of private demand had increased at a faster rate than during the corresponding stages of previous cycles. Second, contrary to what would be expected during a supply-side recovery, the U.S. recovery continued to display structural deficiencies in its pronounced orientation toward consumption and debt instead of toward savings and investment. That analysis suggested that there had been no fundamental changes in the U.S. economy, so that the persistently strong growth, with capacity utilization already at 81 percent, could lead to inflation and even higher interest rates, which would require a tightening of policies that would inevitably abort the present recovery at a later stage. He therefore agreed with the staff that, unless the fiscal position were considerably strengthened to liberate resources for capital formation and to reduce the current account deficit, the current recovery could not be sustained.

However, the present Administration was unlikely to change its policies, Mr. Schneider remarked, since it did not share the view that the persistence of high deficits might threaten the recovery. In particular, it rejected the existence of a direct link between budget deficits, interest rates, and the dollar exchange rate. That opinion was even more striking given that a recent economic report of the Council of Economic Advisors had explicitly stated that real interest rates were jointly determined by the supply of funds in terms of savings and net foreign capital on the one hand, and demand flows consisting of the government deficit and private sector real investment on the other hand. As a result, the interest rate performed a rationing function to equate supply and demand.

It was the view of the Administration that the short-run aspects of its policy posed no serious threats, Mr. Schneider continued. However, the longer-run implications of a permanently large deficit would raise the proportion of real debt to real income and the proportion of real interest payments to real income, increasing the likelihood of monetary expansion to avert protracted periods of slow economic activity. The deficit would therefore contribute to the maintenance of, or even an increase in, inflationary expectations and a higher inflation premium. It was not only the present fiscal deficit, but the prospect of continuing large deficits accompanied by a fixed supply of savings, that was responsible for the high level of interest rates. If the impact of the federal deficit on interest rates was indeed negligible, then the Administration failed to explain why real interest rates were at such high levels. High interest rates had not aborted the recovery, but they would have to continue to rise in order to continue to attract net capital inflows to finance the budget deficit in the face of a deteriorating external balance, which could choke off the recovery. Since capacity utilization was approaching its limits, the business sector might become a net absorber of funds to finance capacity extension. Only the prospect of rapidly declining fiscal deficits would permit the maintenance of a healthy and more moderate recovery.

The budget proposals of the U.S. Administration predicted a gradual decline in fiscal deficits from 6 percent of GNP in 1983 to 3 percent of GNP in 1987, Mr. Schneider observed. The projections, which included the effects of the 1985 proposals and the so-called downpayment plan adopted in July 1984, were being viewed with skepticism, since they were based on optimistic economic assumptions, such as a decline in the Treasury bill rate from 10 percent to about 6 percent in 1987. If, however, interest rates were to remain at their present level, interest payments would offset all existing achievements in budget reduction, and would leave fiscal deficits in 1987 at over 4 percent of GNP. Moreover, the Administration's budgetary forecast assumed substantial cuts in nondefense spending, which had declined somewhat in relation to GNP under the present Administration, but far less than originally planned, and the cuts had been more than offset by increases in defense spending and interest payments. The prospects for a positive improvement in the fiscal position were therefore no more than modest.

The persistence of large fiscal deficits and high real interest rates had attracted foreign capital flows, Mr. Schneider remarked, so that capital formation worldwide had been adversely affected and other countries had been forced to maintain real interest rates at levels higher than those warranted by conditions in their own domestic economies. The impact of U.S. interest rates had been much stronger outside the United States, since only the U.S. taxpayer benefited from the fiscal treatment of interest income that reduced the net after-tax cost. Also, there was a broad but clear link between real interest rates and the exchange rate over the longer term, indicating that a decline in the dollar exchange rate could be expected if there were a downward trend in real interest rates. It should also be noted that, as shown by the analysis presented in the Annual Report of the Bank for International Settlements, long-term interest rates in the major European countries and Japan were higher than was warranted either by their domestic economic situations or by historical standards.

Recent economic developments in the United States had tended to inhibit economic activity in the other industrial countries, Mr. Schneider said. The negative effects of high U.S. interest rates had more than offset any positive effects of the large U.S. current account deficit. Large outflows of capital had been attached from other industrial countries, exerting upward pressure on their domestic interest rates and preventing the adoption of more expansionary monetary policies. Since those other industrial countries had not abandoned their commitment to a reduction of budget deficits over the medium term, in spite of lower economic activity, they had little scope to expand their economies by monetary or fiscal means. However, the negative effects of the large U.S. public deficit were most burdensome for the developing countries, who were obliged to service substantial external debts, even though they had benefited from the increased demand for their exports.

In conclusion, Mr. Schneider said that he believed that there was a clear link between the U.S. fiscal deficit, high real interest rates, and the high dollar exchange rate, which in the long run would jeopardize the recovery of both the United States and the rest of the world. Although it was an election year, it was advisable for the U.S. authorities to indicate clearly their policy choices to avoid an exacerbation of the imbalances, since a failure to do so could create the impression that U.S. economic policy was inconsistent, with harmful implications for the U.S. economy and elsewhere.

Mr. Laske said that, although developments in the U.S. economy over the past 18 months had been gratifying, they had also been surprising and even inconsistent in several respects. First, the economic recovery had been impressively strong. In the Board's discussion of the 1983 Article IV consultation with the United States, he had suggested that too strong a recovery would be unsustainable, and might endanger price stability. In fact, the recovery had been unexpectedly vigorous, while inflation had continued to decline. He therefore congratulated the U.S. authorities on their remarkable achievements. The recovery had had beneficial effects on the rest of the world, boosting the incipient signs of recovery in other industrial countries, and had lent support to the adjustment efforts of developing countries.

A second surprise was the simultaneous occurrence of a rising current account deficit and a strengthening dollar, Mr. Laske observed. Five or six years ago, a much smaller current account deficit had caused a rapid depreciation of the dollar. Moreover, the federal budget deficit was at an unprecedented level, and monetary policy was being used to contain the effects on demand. It was clear that concern expressed at the time of the 1983 Article IV consultation that the continuation of large fiscal deficits would prevent a reduction in inflation, had been exaggerated. However, although developments in the U.S. economy had contributed to the global economic recovery, they had produced unwelcome side effects, which could cause the recovery to peter out.

The strength of the U.S. dollar could not be attributed to any single factor, although the improvement in the business climate and in expectations had undoubtedly made the dollar more attractive for overseas investors, Mr. Laske added. In addition, the historically high level of real interest rates was acting as a powerful magnet for foreign funds. In its medium-term scenario, the staff concluded that the current account deficits projected for 1984/85 were unlikely to be financed by capital flows at current exchange rates, suggesting that the current structure of exchange rates might be fragile. A weakening of the dollar was distinctly possible, carrying with it the risk of an overshooting of the exchange rate. However, recent experience had demonstrated that speculation on the prospective developments of the U.S. dollar was futile.

The high dollar exchange rate had engendered intensified protectionist pressures, Mr. Laske observed; he therefore welcomed the authorities' intentions to resist them. Unfortunately, action had been taken to shield certain sectors whose international competitiveness had suffered as a result of the strength of the dollar. He hoped that the U.S. Administration would not accede to the growing demand for relief from imports, since the maintenance of an open trading system was too important to the world economy to be sacrificed to small sectors of the domestic economy.

Another aspect of the exchange rate phenomenon had been the heavy flows of foreign savings into the United States, Mr. Laske said. Between 1982 and 1983, the capital account had moved from deficit to surplus as a result of capital inflows of about $56 billion; one, although probably the most important factor, had been the retrenchment by American banks with respect to overseas loans. The position of the United States as a net importer of capital was difficult to reconcile with its role as a highly industrialized country. A Governor of the Federal Reserve had recently expressed his concern that a continuation of the observed trend might soon turn the United States into a net debtor with respect to the rest of the world, a position it last held in the early stages of the twentieth century.

Concerning fiscal policy, Mr. Laske noted that the 1984 federal budget deficit would not be significantly smaller than that recorded for 1983, while projections for the next three years indicated further increases in absolute terms and only a minimum decline in the ratio of the deficit to GNP, which was a cause for serious concern. The implications of those fiscal deficits for capital formation, the current account, and capital movements were analyzed clearly in the staff report, which concluded that, until 1988, the federal deficits should average no more than 1.5 percent of GNP if sufficient domestic savings were to be provided for the capital formation necessary to produce satisfactory growth. However, in spite of the recent downpayment package, the pursuit of present policies indicated that the deficits would decline by no more than 1 percentage point, and remain as high as 4 percent in 1988. In the report on recent economic developments, the staff concluded that fiscal deficits of that size would be possible only if fixed investment were reduced, thus compromising U.S. growth prospects, or if inflows of foreign savings were much larger, thereby increasing the current account deficit to as much as $235 billion by 1988. Either of those prospects, or a combination of the two, was wholly unsatisfactory.

Large fiscal deficits were an important determinant of the currently high nominal and real interest rates, and if they persisted, they would crowd out productive investment and threaten the long-term performance of the economy, Mr. Laske stated. The authorities' arguments, which questioned the validity of the causal relationship between fiscal deficits and interest rates, were an interesting confirmation of his suspicion that it was permissible in economics to make the argument fit the desired theoretical proof. He had never doubted that the combined financing needs of public deficits and private investment would put upward pressure on interest rates when the volume of private savings could not satisfy both, and until more convincing evidence was forthcoming, he preferred to share the staff's analysis. He did not dispute that, relative to other industrial countries, the public sector deficit in the United States was not excessively large, but in some other countries, the public deficit absorbed considerably smaller shares of private domestic savings. It was the high rate of absorption of domestic savings in the United States that had put upward pressure on U.S. interest rates for all maturities and had induced large capital inflows. Even the increase in private domestic savings in 1983 and the first half of 1984, as mentioned by Ms. Bush, did not alter that fact. Although the U.S. authorities shared the Fund's concern about the potentially adverse effects of continued large fiscal deficits, they did not appear to know how to reduce them, creating uncertainty both for the U.S. economy and for the growth and balance of payments prospects in other countries.

The recently completed downpayment package might alleviate to some degree the present fiscal problem, but more decisive amendments to fiscal policy were clearly necessary, Mr. Laske continued. Given the magnitude of the problem, the political complexity of reducing expenditure, and the lack of success of earlier attempts to do so, it was unlikely that spending cuts alone could achieve the desired results. As to which categories of spending should be reduced, the authorities should determine their priorities as soon as possible. Additional action to increase federal revenues might become inevitable, although he agreed with the staff that any revenue-raising measures should not impair incentives to save and invest. The staff had mentioned consumption taxes and the withdrawal of certain tax exemptions as possibilities for raising revenue, but a recent article in the Washington Post had questioned the feasibility of a consumption tax, since it would not find sufficient political support, and would be too difficult to administer. In general, indirect taxation was within the competence of the states. He therefore wondered what kind of federal consumption tax the staff had in mind.

The provision in the U.S. tax code for the full deductibility of interest on private debt was almost unique among industrial countries, Mr. Laske remarked. Not only did it deprive the U.S. Treasury of sizable revenue, but it encouraged consumption at a time when more savings were required. In the past, when real interest rates had been negative, that consumption incentive and deterrent to savings had been more powerful still. In sum, spending cuts and the closure of tax loopholes might offer only a partial solution to the problem, suggesting that additional revenues from tax increases or from a consumption tax would be required to reduce the deficits. Lower deficits and a consequently lower government borrowing need would ease the pressure on interest rates and their damaging effects on the longer-term prospects for the U.S. economy and the rest of the world.

He congratulated the Federal Reserve for an impressive reduction in the rate of monetary expansion, Mr. Laske continued. It had successfully convinced financial markets that it would not accommodate inflationary pressures, an intention that was reinforced by the setting of the upper limits for the expansion of the monetary aggregates in 1985 at lower rates than those established for 1984. Unfortunately, the continuation of that combination of fiscal and monetary policies would ensure the maintenance, if not further strengthening, of the high interest rates, although he hoped that the recent expectation of the New York Stock Market of declining interest rates would be fulfilled. The Administration was attempting to introduce a degree of fiscal contraction through the recent Deficit Reduction Act, although the three pieces of legislation involved were not impressive. The effect for 1984 would be marginal, while over the next three years only a very small reduction in the projected fiscal deficits would be achieved. It appeared that financial stability in the United States would depend exclusively on monetary policy, involving a continuation of high interest rates and a massive absorption of foreign savings. Under those circumstances, other industrial countries would be forced to continue the struggle to maintain growth, while the heavily indebted developing countries would continue to face difficult problems of adjustment given the scarcity and high cost of credit.

The international repercussions of the U.S. Administration's fiscal policies were burdensome for the rest of the world, Mr. Laske stated, and were tarnishing the benefits of America's economic recovery. The burden should be alleviated by an early reorientation of fiscal policy. As noted by the staff, "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."

Finally, Mr. Laske asked for an explanation of the rationale for the recent legislation to repeal the withholding of tax on interest on U.S. Treasury bonds held by nonresidents, and of the possible effects on budgetary revenue and on international capital flows.

Executive Directors agreed to resume their discussion in the afternoon.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/84/119 (8/1/84) and EBM/84/120 (8/3/84).

~~3.~~ 4. SYRIAN ARAB REPUBLIC - 1984 ARTICLE IV CONSULTATION - POSTPONEMENT

Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, the Executive Board agrees to extend the period for completing the 1984 Article IV consultation with the Syrian Arab Republic to not later than September 10, 1984. (EBD/84/208, 7/31/84)

Decision No. 7774-(84/120), adopted
August 2, 1984

5. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 84/22 through 84/25 are approved. (EBD/84/206, 7/26/84)

Adopted August 1, 1984

6. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/84/162 (7/31/84) and EBAP/84/164 (8/1/84) is approved.

APPROVED: May 21, 1985

JOSEPH W. LANG, JR.
Acting Secretary