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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/121

3:00 p.m., August 3, 1984

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
	W. B. Tshishimbi
	S. Kolb, Temporary
B. de Maulde	
A. Donoso	
	M. K. Bush
M. Finaish	T. Alhaimus
H. Fujino	T. Yamashita
	I. R. Panday, Temporary
R. K. Joyce	
A. Kafka	
G. Laske	
G. Lovato	
R. N. Malhotra	A. S. Jayawardena
Y. A. Nimatallah	
J. J. Polak	T. de Vries
A. R. G. Prowse	
	H. Alaoui-Abdallaoui, Temporary
	M. Camara, Temporary
M. A. Senior	
J. Tvedt	A. Lindø
N. Wicks	T. A. Clark
	Wang E.

J. W. Lang, Jr., Acting Secretary
R. S. Laurent, Assistant

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Also Present

C. F. Schwartz, Consultant. Asian Department: A. Ariyoshi. European Department: P. Dhonte, D. Gros. Exchange and Trade Relations Department: C. D. Finch, Director; S. J. Anjaria, J. A. Clement, N. Kirmani. 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. Masson. 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, H. H. Zee. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: H. A. Arias, S. El-Khouri, H.-S. Lee, W. Moerke, Nguyen, P. Péterfalvy, M. Z. M. Qureshi, A. Steinberg, D. C. Templeman, A. Vasudevan. Assistants to Executive Directors: I. Angeloni, R. L. Bernardo, M. B. Chatah, Chen J., V. Govindarajan, D. Hammann, H. Kobayashi, A. Koné, E. Landis, M. Lundsager, K. Murakami, E. Olsen, G. W. K. Pickering, J. Reddy, D. J. Robinson, J. E. Rodriguez, Shao Z., S. Sornyanyontr, Wang C. Y.

1. UNITED STATES - 1984 ARTICLE IV CONSULTATION

The Executive Directors continued from the previous meeting (EBM/84/120, 8/3/84) their consideration of 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).

Mr. Polak observed that highly positive results had recently been visible in the United States: a persistent and above-normal rise in output, including a large investment component, accompanied by continued moderate inflation--helped by an appreciating currency--and sharply falling unemployment. In a sense, the large current account deficit had a positive effect for the United States, because it helped to prevent overheating of the economy, and had a positive effect for the rest of the world as well, because the large U.S. trade deficit provided an exogenous demand stimulus that was welcome everywhere and indeed sorely needed in many countries. In addition, higher interest rates in the United States had a favorable impact on its balance of payments by attracting funds from abroad.

Nevertheless, for countries as a whole outside the United States, Mr. Polak went on, it could not be said that the drawbacks offset the improvement of their trade balances, for the deterioration in the U.S. current account had been even larger than that of the trade balance. With the U.S. international capital position rapidly declining to zero, perhaps the point had nearly been reached where the balance of payments impact of high U.S. interest rates played primarily between the other industrial countries as a group and the oil exporting countries on the one hand, and the non-oil developing countries on the other. That likelihood did not make the problem of capital flows any less serious for the latter group, and it did not absolve the United States from the responsibility of taking remedial action within its power to reduce the size of the problem.

The staff was not alone in relating its concerns primarily to the medium term, Mr. Polak noted: U.S. authorities agreed that the present combination of a large current account deficit, high interest rates, and substantial capital inflows was unlikely to prove sustainable. The question then became whether it would be possible to move toward a position that was sustainable by means of a "soft landing," and how to bring it about. The U.S. view seemed to be that the entire process could be controlled by monetary policy alone. The argument was that restrictive monetary policies would keep inflation low, reduce a possible fall in the exchange rate of the dollar, and bring interest rates down, thus reducing the fiscal deficit as well.

Although he agreed with the importance of continuing a sufficiently restrictive monetary policy, Mr. Polak remarked, the United States might soon come to know what small industrial countries had learned over many years: monetary policy by itself might be incapable of preventing overheating in the economy when the pressures of demand--private and official--were strong. Other countries had learned that the effects on demand of tightening monetary policy could be largely offset by inflows of liquidity from abroad, something that was clearly happening in the United States and might even increase if the Federal Reserve Board tried to tighten credit further. Thus, it was highly questionable whether a soft landing would occur unless fiscal action were taken to supplement monetary action. The possibility of a crisis could be foreseen when the flow of capital into the United States began to show a sharp decline, perhaps because financial circles came to the conclusion that, even after the election, fiscal policy would not improve greatly, or perhaps for no other reason than that foreigners became satisfied with the proportion of their assets invested in the United States and ceased to add to their holdings.

Given the risk of a disturbing outcome, and given the limited power of monetary policy to prevent it, the United States should look for policy measures that would provide it with additional control, Mr. Polak considered. Fiscal policy was the missing link. Without the help of fiscal adjustment, there was a risk of an old-fashioned cycle of overheating followed by a sharp downturn, with international complications superimposed. That such disconcerting results could not be foreseen with certainty was by no means a good reason not to do everything possible to prevent them, the more so since, as the staff had indicated, there were obvious long-term structural costs associated with excessive budget deficits.

As to measures to correct the budgetary position, it was a principle of the Fund, which should apply to the United States as well as to other members, that countries should follow their own preferences in curtailing excessive fiscal deficits, Mr. Polak noted. He shared the view of the U.S. authorities that it was ultimately government spending, rather than the deficits alone, that competed with private spending. However, the share of federal spending, other than defense and interest payments, had risen by 0.3 percent of GNP from 1981 to 1983. That rise made it questionable whether a substantial reduction in the deficit could be brought about by cuts in expenditure alone. He thus found it disconcerting that the U.S. authorities took such a generally negative view of fiscal remedies through tax increases. The argument that virtually all taxes had a distorting influence on private decisions struck him as particularly unconvincing. Surely the U.S. authorities were aware, as the staff had pointed out, of the distortions currently in place as a result of many negative taxes, such as exemptions for interest payments and special depreciation provisions. He found it hard to see why a general sales tax or a value-added tax at a low rate would have any significant distorting effect. The authorities must also recognize the distorting effect of the alternative adjustment mechanism, which consisted of abnormally high real interest rates.

The question of the possibility of a soft landing was of extreme importance to the United States as well as to all other countries, Mr. Polak remarked; the matter should not be allowed to rest until the 1985 Article IV consultation with the United States. The staff should prepare a thorough analysis of alternative scenarios--based on various causes that might interrupt the current rising trend of interest rates, the exchange rate, and payments imbalances--to be discussed in five or six months.

The staff had done well to devote extensive attention to trade policy, Mr. Polak went on. Incidentally, he hoped that the Fund could publish such parts of the paper as could be released. In any event, he welcomed the renewed expression by the U.S. authorities of their concern for preserving open world markets. When it came to specifics, however, the U.S. arguments were less heartening. In particular, the willingness of the United States to seek more liberal world trade by matching other countries' unfair practices with corresponding measures of its own seemed not only unlikely to bring about disarmament in the trade field but also beneath the dignity of the largest trading country in the world, which no doubt disposed of other means to persuade trading partners to stop unfair practices.

Moreover, Mr. Polak asked, was existing U.S. legislation the most effective instrument to avoid restrictive measures? After all, close to 100 requests for protection were still pending before the International Trade Commission. The process of protection was subject to rigid time limits--six months for the ITC and two more months for the President to act--which could lead to recommendations and decisions being made at highly inconvenient moments, such as those for copper and steel in the near future. A more flexible procedure would be highly desirable. More generally, he would encourage the authorities to review some of the provisions of the Trade Reform Act of 1974 that unduly encouraged industries to ask for protective measures. For instance, an earlier provision could be restored that restricted requests to cases in which the affected industry could show that the damage from imports was due to trade concessions by the United States.

Unfortunately, the United States was not prepared to recognize the role of official development assistance (ODA) as a separate important contribution that richer countries could make to the development of less developed countries, Mr. Polak remarked. Direct investment certainly had its place, but its aims were quite different from those of ODA. Liberal access to trade was important as well, but was also quite different from income transfers. He believed that it was important--a view that did not seem to be sufficiently shared by the U.S. authorities--that a large proportion of ODA be channeled through multilateral institutions.

Finally, on international investment in the United States, he remained concerned about individual states applying worldwide unitary taxation, Mr. Polak noted. He hoped that the working group on the subject would lead to the abandonment of that taxation practice by the states currently applying it. Otherwise, action by the Federal Government would be called for.

Mr. Wang observed that, following a severe and prolonged recession, the U.S. economy was experiencing a strong recovery: real GNP had increased at an annual rate of 7 percent over the past year and a half, accompanied by fairly low rates of inflation and unemployment. The resumption of economic activity had also had beneficial effects on the rest of the world. On the other hand, a number of adverse factors continued to exist: the federal deficit was historically high for the current phase of the economic cycle, interest rates had not only remained high but also shown tendencies to further increase, and the current account deficit was continuing to be large. Such serious imbalances clouded the economic prospects beyond 1984 and exerted a serious negative impact on the rest of the world.

Between 1980 and 1983, federal expenditure had risen from 22.5 percent of GNP to 24.75 percent, while the federal deficit had risen from 2 percent of GNP to 6 percent, Mr. Wang noted. Although increases of such magnitude might have had a stimulative effect at the initial stage of the recovery, the persistence of that trend into the years ahead could only have negative effects on the United States and the rest of the world. As the budget deficit soaked up domestic private savings and part of international savings as well, the continuation of large deficits would not only inhibit the growth of fixed investment in the United States but also retard recovery in other countries.

Whether the rise in interest rates since the beginning of 1984 was caused by competition for resources between federal deficit financing and private demand, or by expectations of continued high inflation in the face of such huge structural deficits, Mr. Wang remarked, high and rising real interest rates posed a serious threat to a sustained recovery in the United States and its diffusion to the rest of the world. In particular, high interest rates had imposed an increasingly unbearable burden on the debtor countries and made their adjustment unnecessarily difficult and harsh.

The huge budget deficit was also one of the reasons that the exchange rate of the U.S. dollar had remained high, Mr. Wang observed. The growing current account deficit showed that such a high exchange rate was unsustainable beyond the short term. Any abrupt change could cause havoc in international financial markets. As the U.S. authorities' policy mix, which had brought about the imbalances, was having and would continue to have detrimental effects on the rest of the world, an early readjustment of policy by the U.S. authorities was indispensable for balanced growth in the world economy as well as for the smooth functioning of the international monetary system. As a first step, he fully supported the staff's conclusion that priority should be given to a large, rapid cutback in the federal deficit.

Various protectionist measures introduced by the U.S. authorities were cause for concern, Mr. Wang went on. He found it particularly disquieting that protectionism had intensified even as unemployment had fallen with the recovery. Some of the protectionist measures had been taken in the name of combating so-called unfair trade practices of other countries, but the vicious circle of protection and retaliation was raising trade barriers higher and higher, which was not in the interest of any country. The apparent increase in trade protection in the U.S. market was particularly illogical in view of the frequent arguments that trade opportunities offered to other countries by the recovery in the United States far offset the additional burden of high interest rates. For one thing, as the staff rightly pointed out, such offsetting movements were not universal. For instance, Table 8 on page 72 of SM/84/178 showed that exports by developing countries to the United States had increased only slightly from 1982 to 1983, despite the high exchange rate for the U.S. dollar. Perhaps the staff could elaborate on that development. At any rate, the intensification of protectionism in the world's biggest market, which was currently undergoing a vigorous upturn, was an important factor behind the uneven recovery of the world economy in general and that of the developing countries in particular, that unevenness working against the adjustment efforts of debtor countries. Therefore, there was every reason to urge the U.S. authorities to take a lead in lifting trade barriers.

Flows of financial resources from the United States to developing countries, particularly official development assistance, had diminished in 1983, Mr. Wang observed. Even in nominal terms, the flow had fallen from $30 billion to about $23 billion, while ODA had fallen from $8.2 billion to $7.99 billion, or from 0.27 percent of GNP to 0.24 percent, perhaps the lowest proportion among the members of the Development Assistance Committee (DAC). It was also disturbing to note that the decline was occurring at a time when the economy was turning up. The United States could do much better. Similarly, he discerned a lack of enthusiasm by the U.S. authorities toward financing a number of important multilateral financial institutions. He hoped that the authorities would reconsider their position on such financing, and particularly on SDR allocations.

The great impact that the U.S. economy exerted on the rest of the world entailed special responsibilities for the U.S. authorities, Mr. Wang pointed out. They should pay greater attention to the adverse repercussions of their policies on other countries; benefits to one were obtained at the expense of others. Therefore, U.S. policies must be judged by their influence not only on the domestic economy but also on the economies of the rest of the world. If those policies were found deficient, as he considered them to be at present, the Fund should have a mechanism to make its surveillance of the United States as effective as its surveillance of developing countries.

The continued, vigorous expansion of the U.S. economy during the previous 18 months had not been accompanied by comparable growth in other OECD countries or by a turnaround in the developing world, Mr. Wang concluded. How did that phenomenon compare with the overall pattern of past economic cycles, and what were the factors that could explain the deviation? In Appendix I of SM/84/178, Supplement 1, the staff had drawn a good comparison between the present recovery and previous ones, but had confined its endeavors to the U.S. economy. Perhaps the staff could undertake another study on the wider issue of the relationship between recovery in the United States and recovery in the rest of the world based on previous examples.

Mr. Tvedt said that he had been encouraged that the upswing in the U.S. economy had been so strong and had shown such durability. In the short term, he shared the optimism of the authorities regarding growth prospects: growth had been continuing at a high rate, even though leading indicators pointed toward slower growth. However, the assumptions regarding inflation and interest rates were uncertain, so that he agreed with the staff that a question might be raised about developments in the medium term. The economic policy pursued in recent years had resulted in substantial and increasing deficits both in the government budget and on the external accounts. Projections indicated that fiscal deficits would decline only slowly, while it was not certain that foreign financing of the deficit could be relied on to as great a degree. In his view, financing the fiscal deficit had led to high interest rates, both domestically and internationally. He feared that persistently high interest rates in the United States would dampen investment both there and in other countries, thereby weakening the impulse toward growth in the world economy.

Therefore, the U.S. authorities should aim at sharply reducing fiscal deficits by taking measures on the revenue and the expenditure sides of the budget, Mr. Tvedt recommended. The authorities appeared to be firmly set on reducing the deficit primarily by cutting public expenditure. So far, however, their efforts had produced relatively limited results, and the prospects were not encouraging. Thus, the authorities should also consider tax increases as a means of narrowing the deficit. As private domestic savings were comparatively low, possible tax measures ought to be formulated in such a way as not to reduce the private savings ratio.

At a time of large and increasing fiscal deficits--and as long as growth remained high--a tight monetary policy had contributed to lowering inflationary pressures emanating from the demand side, Mr. Tvedt continued. Although the rate of inflation had been brought down, the risk could not be ruled out that inflationary pressures might reignite as capacity utilization rose. Given that situation, high priority must continue to be given to the fight against inflation. A tightening of fiscal policy might gradually make room for a less tight monetary policy.

As pointed out by Ms. Bush, the U.S. external deficit had been a major factor behind the improvement in the export performance of several countries in recent years, Mr. Tvedt noted. Especially for many developing and newly industrializing countries, the U.S. market seemed to have been of decisive importance. In that connection, he found it gratifying that the U.S. Administration aimed at preserving a free and fair world trading system. Domestic pressures for protectionist measures having increased substantially in recent years, he was concerned that the U.S. authorities had yielded to such pressures on several occasions. After all, "voluntary export restraints" and other "nontariff barriers," even if they did not formally violate the international rules of trade behavior, undoubtedly had the same detrimental effects as traditional restrictions.

The financing of the U.S. current account deficit had contributed to pushing up international interest rates, a development that, together with the steady strengthening in the exchange rate for the dollar, had contributed to exacerbating the debt service problems of many countries, Mr. Tvedt said. Not least for that reason, it was imperative for the authorities to bring about a better balance between fiscal and monetary policies. He agreed with the staff that, in the prevailing international debt situation, an increase in U.S. development aid would be desirable. Finally, as the economic upswing in Europe and Japan became firmer, a tightening of fiscal policy in the United States should become possible without causing a slowdown in world trade. Developments during the previous few years--a high dollar and high international interest rates--underlined the importance of better coordination of economic policy among the major industrial countries.

Mr. Fujino observed that the growth of output and employment since late 1982 had been strong, while the increases in wages and prices had remained moderate. The U.S. recovery was contributing to the growth of other economies by stimulating expansion of their exports. In the United States, the recovery had begun with a pickup in demand for consumer durables and housing, and had subsequently spread over much broader areas, especially business fixed investment. That latter development was particularly encouraging, as it contributed considerably to structural improvements in industries and laid the basis for sustained growth. Behind those achievements had been factors such as the tax measures taken by the authorities in the past few years, a reduction in regulatory burdens, and success in bringing down inflation. He would appreciate a more detailed evaluation by the staff of the effects of deregulatory measures.

Those favorable developments had occurred against a backdrop of continued high interest rates, and the authorities should keep a close watch on the long-term impact of such high rates on investment and on the economy in general, Mr. Fujino continued. He shared the staff's concern about the repercussions of the renewed upward pressure on interest rates and the shift into a huge deficit on current account. In particular, the persistence of high interest rates would entail further undermining of the fiscal balance and an exacerbation of external debt problems in many developing countries, thereby endangering the achievement of continued global economic growth.

The rate of capacity utilization in manufacturing had risen from less than 70 percent in late 1982 to about 81 percent in the first quarter of 1984, Mr. Fujino remarked. The rise could lead to renewed inflationary pressures and might eventually result in much slower growth unless correct economic policies were followed. In that respect, he found it reassuring to learn that the authorities continued to believe that keeping inflation under control would be a prerequisite for achieving a sustained expansion in output and employment.

In principle, everyone agreed, including the U.S. authorities, that efforts to reduce the present and prospective huge fiscal deficit were necessary, Mr. Fujino observed. As a first step toward that goal, the staff's suggestion to cut the deficit down to the point where federal debt would no longer be rising as a proportion of GNP seemed to be a pragmatic approach. He would tend to agree with the staff that the fiscal position of the Federal Government would be the key factor in evaluating the effects of the fiscal deficit, as decisions about fiscal policy that aimed at affecting the overall performance of the economy were taken mainly at the federal level. As to the authorities' skepticism about any attempt to resolve the fiscal problem through higher taxes, he agreed that it would be desirable if the fiscal deficit could be reduced through expenditure cuts. As a practical matter, however, the authorities seemed to be experiencing considerable difficulty in containing public expenditure, including interest payments and defense spending. Under the circumstances, he saw some grounds for the staff's suggestion that further action to increase federal revenue, perhaps by focusing on consumption taxes and the reduction of certain tax expenditures, might well be unavoidable. In that respect, although the effects of deficit reduction measures contained in recent legislation were estimated to reach $72.9 billion through fiscal year 1987, the figure fell considerably short of the total deficit reductions being debated of $176-186 billion annually through the same period.

The U.S. authorities considered that there was no empirical evidence linking fiscal deficits to interest rates, Mr. Fujino noted. That belief might have been true in the past, but a number of new factors had made the present situation different. First, the structural fiscal deficit, which continued in spite of economic recovery, was the largest by historical standards that the United States had incurred. Moreover, the stance of monetary policy, which had eventually tended to accommodate fiscal deficits in the past, remained neutral or somewhat restrictive at present. That relatively new combination of factors might be viewed as providing the link between fiscal deficits and high interest rates. Could Ms. Bush offer any further comment on how the U.S. authorities viewed the growing body of evidence presented by the Fund staff? At any rate, he would underline the staff assessment that the lasting reduction in interest rates that would result from a more restrained fiscal policy would reduce the dangers faced by developing countries with substantial external debt and would also help to diminish pressures on the international banking system.

It was encouraging that the U.S. authorities had been persistent in maintaining an anti-inflationary policy stance, which had undoubtedly contributed to the moderation in inflation and wage increases, Mr. Fujino noted. However, as the authorities had said, there was a danger that inflation could make a comeback, given the substantial reduction in the degree of economic slack. Thus, he found reassuring the authorities' continued commitment to achieving growth in monetary aggregates consistent with sustained economic expansion and further progress toward price stability. The recent rise in interest rates was a source of great concern, but he would strongly endorse the view that attempts to hold down interest rates by speeding up the growth of money and credit would be a serious mistake. He could also agree with the staff that monetary growth should continue to be closely monitored in view of developments in nominal demand.

On the external front, Mr. Fujino went on, he shared the authorities' view that there was no clear, single explanation for the continued appreciation of the dollar during the recent past. Other movements in interest rate differentials as well as the "safe haven" element might have been among the major factors affecting exchange rate movements. Perhaps an asymmetry existed between the United States and other countries in that a rise in interest rates would be accompanied by a rise in capital inflows into the United States. Such inflows might reflect a general perception that securities denominated in U.S. dollars had higher substitutability and smaller risk.

There had been some expectations that further liberalization of financial markets and greater internationalization of the yen would contribute to an immediate strengthening in the exchange value for that currency, Mr Fujino indicated. The measures decided as a result of discussions between the Japanese and U.S. authorities would contribute to the smooth functioning of markets, so that the fundamental performance of various economies could be more properly reflected in exchange rates. Recent trends, which indicated a further appreciation of the dollar, should be viewed not in connection with those measures to liberalize and internationalize the yen, but rather as reflections of other factors such as high interest rates and favorable prospects for economic growth in the United States. More generally, the U.S. authorities expected the current strength of the dollar to continue because of the attractiveness of the U.S. economy and its capital markets. Could the staff or Ms. Bush provide any further comments on how long those factors would support the present position of the dollar?

On trade policy, Mr. Fujino remarked, he agreed with the staff appraisal that the spread of trade restrictions reduced the efficiency of resource allocations, both in the United States and abroad. He welcomed the authorities' view that a thorough discussion of the issues involved and the framing of new multilateral trade talks should not be postponed. His authorities believed that the income of foreign corporations should not be subject to the unitary tax, and also that the worldwide unitary method of taxation by some U.S. states should be replaced by some other method. In addition, his authorities hoped that the United States could further strengthen its contribution to international development institutions.

Mr. Camara expressed broad agreement with the staff appraisal of the recent performance of the U.S. economy, which had performed well in a number of areas since the previous Article IV consultation. Output and employment had grown fast in an environment of relative price stability: in 1983, real GDP had risen by 7 percent, while unemployment had fallen to 7 percent and consumer prices had risen by only 4.5 percent. More comforting was the expansion in the base of the recovery, which was supported by the type of expenditure that could provide a more sustainable impetus to growth. Rapid expansion in nonresidential fixed investment indicated that the recovery might be strong and durable. Furthermore, a slowdown in rates of increase in wages and unit labor costs might reflect reduced labor market rigidities. Prospects for the future looked encouraging.

A major weakness was the growing budget deficit, which had reached 5.5 percent of GDP in 1983, Mr. Camara went on. It was a subject for concern because of its potential to keep interest rates high and to crowd out productive private investment; should those two eventualities come about, the momentum of growth might be brief, and the subsequent slowdown could set off a recession in the world economy. By contributing to higher interest rates, the U.S. fiscal deficit was helping to aggravate the debt servicing problem of developing countries, already compounded by the rise in the exchange rate for the U.S. dollar, and to make adjustment more painful for those countries.

While welcoming the intention of the United States to reduce the budget deficit, he believed that the size of the imbalance required more substantial adjustment, Mr. Camara remarked. Table 1 of Appendix XI to SM/84/178, Supplement 1, projected that, beginning in 1985, the funds available to finance the budget deficit would decline rapidly. Unless the authorities took substantial action in the near future, there was concern that public sector spending could be maintained only through progressive reductions in fixed business investment or even greater inflows of foreign savings. The staff projections showed that by 1988 the ratio of business fixed investment to GNP might have to be reduced by 4.75 percentage points, in case federal borrowing requirements had to be met from domestic resources. Otherwise, the current account deficit would reach $235 billion or 3.75 percent of GNP. A deficit of that size would have to be financed by increased flows of foreign savings; the scenario projected that more than 85 percent of such a deficit would be financed by inflows from abroad. Narrowing the deficit should receive top priority. Besides measures to reduce expenditure and adjust its composition, efforts might also be needed to increase revenue.

Another related weakness in U.S. economic performance was the rapidly expanding deficit on current account, reflecting weak export performance and increased inflows of foreign savings, Mr. Camara remarked. Continued appreciation of the dollar had adversely affected the competitiveness of U.S. exports in real terms; they had declined by more than 2 percent of GNP during 1983 and the first quarter of 1984. Rising budget deficits and widening interest rate differentials might continue to fuel the appreciation of the dollar and the inflow of foreign savings, but the need to adjust to the growing imbalances on current account could generate uncertainty about continued inflows of such savings, and the possibility of disruptive effects could not be excluded. The deepening current account deficit might also indicate more deep-rooted structural problems that would require fundamental adjustment.

While welcoming the authorities' declared commitment to promoting free trade, Mr. Camara said, some of the measures taken recently had been inconsistent with that commitment. Intensification of protectionist measures was no substitute for needed adjustment. Despite some apparent temporary gains, increased trade barriers could only lead to further loss of competitiveness and more inefficient resource allocation. Besides dismantling protectionist measures to improve economic efficiency, the authorities would have to lower interest rates and reduce the budget deficit if they were to moderate the appreciation of the dollar and make exports and import substitutes more competitive.

Without ignoring the importance of direct private investment, Mr. Camara noted that official financial assistance from the United States and other industrial countries had a special role to play in supporting adjustment efforts and promoting economic development in developing countries, particularly low-income ones. In view of its large role in the world economy, the United States would encourage other donors by increasing its own contribution. While commending the United States for dealing with its own debt problems, his authorities were disappointed by the continuous decline in U.S. development assistance and would urge them to increase their contribution substantially.

Mr. Malhotra observed that the major point made by the staff was that the mix of economic policies of the United States was inappropriate and that correction of the fiscal imbalance would have to be at the center of needed improvements. Recovery in the United States had continued to proceed strongly and had become more broadly based. So far, it had been accompanied by continued moderation in inflation and, unlike in Europe, had resulted in a substantial decline in unemployment. The U.S. authorities deserved commendation for those gains, which were having a beneficial impact not only within the United States but also outside. Robust growth in the United States had led to a change in the psychology of recession. The economy had attracted greater inflows of goods from other countries, including some developing countries. Commodity prices had also risen slightly, although they had not made good the losses incurred during previous years.

Apparently the strong restrictive monetary policies pursued by the authorities had contributed to reducing inflation, Mr. Malhotra continued; they had also contributed to one of the longest and deepest recessions since World War II, as many other countries had been simultaneously pursuing similar policies with demand going down, and prices had also declined. Further, during the past few years, the dollar had appreciated considerably, well beyond the point of equilibrium. The staff report had not indicated how much the appreciation of the dollar during the past three years had contributed to the decline in U.S. inflation. In the Federal Reserve Bulletin of June 1984, David Stockton of the Board's Division of Research and Statistics had pointed out: "All else equal, empirical estimates suggest, a 10 percent appreciation of the dollar reduces the level of consumer prices approximately 1.5 percent over two to three years. This relation implies, as a rough estimate, that the rise in the value of the dollar since mid-1980 probably has reduced inflation by 1 to 1 1/2 percentage points, on average in each of the last three years." Thus, perhaps 3 percent to 4.5 percent of the decline could be attributed to the appreciation of the dollar.

Recovery in the United States had not so far led to a rekindling of inflation, which had in fact marginally declined, Mr. Malhotra noted. The view of the U.S. authorities as set forth by Ms. Bush was that considerable slack still existed in the economy, both in manufacturing capacity and in the labor market. Nevertheless, as some Executive Directors had noted, the United States might soon reach the feasible limit of maximum capacity utilization, beyond which inflation could resurface. Capacity utilization in 1979 had reached about 87.5 percent; the present rate was about 82 percent.

He was used to differences of opinion between the Fund staff and national authorities on various issues, Mr. Malhotra continued. Nevertheless, he had yet to see greater controversy over advice given by the staff regarding a major economy on so many important aspects of policy. How was such a situation to be resolved in the context of the Fund's responsibility for surveillance? He thought that the papers were a good example of the staff's contribution to the surveillance function, in the sense that the staff had set out the issues clearly, together with the views of the U.S. authorities and its own conclusions. However, unless the major economies of the world were prepared to play by the rules of the game, he did not see how the surveillance function of the Fund could be effectively discharged.

The U.S. authorities' view was that interest rates were related neither to fiscal deficits nor perhaps, to the high value of the dollar, Mr. Malhotra observed. It was true that the budget deficits and interest and exchange rates could not be examined in isolation from other factors. When the demand for money from the private sector had been subdued--during the recession--the budget deficit's contribution to raising interest rates might not have been large. Indeed, the large fiscal deficit together with a more accommodating monetary policy in the third quarter of 1982 had stimulated the economy. Now that private demand had become buoyant, the budgetary deficit remained large, and the authorities continued to be wedded to keeping inflation down, it was difficult to argue that the deficit was unrelated to interest rate developments. Similarly, it was difficult to accept the view that exchange rates had not been influenced much by interest rates. Foreigners were investing in the U.S. economy because the overall returns there were better than those available at home. He endorsed the staff's conclusion that, in the present case, interest rates and the dollar's exchange rate were intimately connected. The "safe-haven" aspect of the U.S. economy, at least vis-à-vis the economies of Western Europe and Japan, had perhaps not increased greatly during the past few years. Lending by banks to some developing countries had declined. The dominant factor in the dollar's value was the rate of return on financial assets in the United States.

He agreed with the staff that, although the proposal to reduce the fiscal deficit in 1984 by way of a down payment was welcome, it was inadequate, Mr. Malhotra said. He appreciated the U.S. authorities' view that the first priority should go to cutting expenditure, but agreed with the staff that it was doubtful whether spending could be cut in a substantial way. Therefore, the authorities would have to raise more revenue. In an economy where the capacity to pay was large, there was no reason why more tax revenues could not be raised without inhibiting entrepreneurship or investment.

As for protectionism, Mr. Malhotra remarked, the suggestion for another multilateral round of tariff reductions under the GATT might seem attractive, but it was analagous to shifting adjustment from the current fiscal year to outer years. Another round of tariff reductions would take from five to seven years, and its implementation would take longer still. Therefore, there ought to be greater urgency and immediacy in the Fund's recommendations regarding the dismantling of protectionist barriers.

Several Executive Directors had noted that official development assistance from the United States--once the leader in the field--had declined and was perhaps the lowest for any large economy as a proportion of GDP, Mr. Malhotra concluded. He agreed with Mr. Polak that the de-emphasis on assistance channeled through multilateral institutions was a most unfortunate development. It was regrettable that one or two participants in internationally supported programs could bring down considerably the total of aid given through multilateral institutions, owing to the operation of burden-sharing mechanisms. While foreign direct investment had a role to play, it tended to be concentrated in a few countries and was not a substitute for other financial flows. Other countries, mostly low-income ones, had greater problems and were most in need of official development assistance.

Mr. Panday observed that for the past year and a half the U.S. economy had performed exceptionally well; economic growth had been strong, the rate of inflation had remained low, and unemployment had declined to a rate that might be only slightly above the natural rate of unemployment for the country. The remarkable economic recovery had occurred at a time when the dollar had been gaining strength and real interest rates in the United States had been among the highest in the world. One of the main reasons for high growth rates was the encouragement received by the private sector from supply-side tax cuts, the decline in the inflation rate, and the lightening of regulatory burdens. In addition, the U.S. economy lacked some of the structural problems faced by other countries, so that it had been more successful in ensuring flexibility of prices both in commodity markets and in the markets for factors of production. Flexibility in wages and prices, together with an improvement in business profitability, had been important elements in the present recovery, which had benefited other countries as well. At present, economic policymakers should concentrate on achieving sustainable medium-term growth by reinforcing policies that had contributed to the present recovery and by correcting the policies, particularly the fiscal deficit, that tended to reduce the chance for sustained growth in the future.

There were three avenues through which the U.S. authorities could contribute to global recovery, Mr. Panday considered. First, they must introduce measures to lower interest rates; the prevalence of high rates in the United States was attracting foreign savings and thus making the prospects for recovery in other countries more uncertain. In addition, high interest rates were compounding the difficulties of debtor countries, many of which had to set aside a large proportion of their export earnings to pay for interest charges on their debt. In order to service such debts, debtor countries had to make huge sacrifices in terms of growth and welfare. It was widely held among market participants, officials of the U.S. Federal Reserve Board, the Fund staff, and some U.S. Treasury officials, that one of the most important single factors influencing interest rates in the United States was the size of the federal deficit. Nonetheless, political realities suggested that any major initiative in an election year was unlikely; he hoped that the authorities would introduce significant measures in 1985. Although deficit reduction should ideally be achieved through expenditure cuts, political realities suggested that there might be severe constraints to such an approach. Therefore, the authorities should combine expenditure cuts with tax increases.

Second, the U.S. authorities could assist other countries' economic recovery by rolling back some of the protectionist measures already introduced and by avoiding new restrictions on imports, Mr. Panday continued. In view of its strong economic expansion, the United States was in the best position to reduce protectionism. He agreed with the conclusion of the President's Commission on Industrial Competitiveness that protection was not a suitable instrument for dealing with foreign competition and that U.S. competitiveness should be improved through better education and manpower training schemes, greater investment in research and development, wider access by new businesses to low-cost capital, and fewer administrative impediments to exports.

The advice given by the Fund to national authorities undertaking an adjustment program centered on export-led growth, Mr. Panday remarked. Fund programs were based on an assumption that a country could export as long as it had a competitive advantage, but the assumption was proving weak in a world with many forms of protectionism. He urged the U.S. authorities to adopt more liberal trade policies, thus making the United States a model for the rest of the world. Another way in which the United States could assist other countries, particularly developing countries, was by providing development assistance, both bilaterally and through multilateral organizations. It was regrettable that U.S. development assistance was showing a declining trend. He hoped that the authorities could play a more active leadership role by increasing ODA to developing countries.

Mr. Senior expressed agreement with the staff appraisal. The staff was correct in stressing the need to strengthen the U.S. fiscal position in order to buttress recovery and make it more beneficial for the world economy. Although there might be differences of view on whether the current high real interest rates and budget deficits were compatible with sustained economic growth in the United States, there was no doubt that for the world economy as a whole, uncertainties about the sustainability of a recovery led by high real interest rates and considerable budget deficits were major deterrents to economic growth. It was possible to have economic growth in the United States without significant spillovers to the rest of the world. In view of the pattern of the current recovery in the U.S. economy, it was no longer true that economic growth in the United States had to transmit its effects to the rest of the world through a growing trade deficit.

Recent increases in protectionist barriers of every kind had reduced the marginal and average propensity to import of the U.S. economy, Mr. Senior considered. Nevertheless, the United States was registering a large trade deficit: U.S. export industries had been bearing the burden of poor competitiveness due to the overvaluation of the dollar. In any event, the multiplier effects of increased U.S. income flows on the rest of the world were smaller than they would be in the absence of protectionist devices sheltering import-competing industries. As pointed out by Ms. Bush, even if the growth of U.S. markets had favorable effects on the rest of the world, those effects were nullified by the negative impact of high U.S. interest rates transmitted through capital markets. Since the United States accounted for a larger share of world capital markets than of world output, the net impact on the rest of the world of high interest rates and considerable trade deficits in the United States was negative. Therefore, while it might be arguable whether government borrowing to finance the budget deficit was crowding out the U.S. private sector, there was no question that it was crowding out private investment throughout the world, and the harmful effects were hardly offset by the overvaluation of the U.S. dollar. Producers of traded goods appeared to consider the dollar overvalued, as they refrained from making long-run investments to expand their export capacity. Thus, they viewed the current value of the dollar as unsustainable and did not plan to enlarge their export potential on the basis of differentials in competitiveness that might vanish long before such investments became operative.

Perhaps the permanence and strength of the economic recovery in the United States would lead to a review of those expectations and a reassessment of the long-term value of the dollar against other currencies, Mr. Senior suggested. If, however, expectations were proved correct and a reversal occurred of past relationships between the dollar and other major currencies, there could be major consequences for the world economy.

There was thus reason to question current macroeconomic policies in the United States from the standpoint of the international economy, Mr. Senior continued. The authorities should act to bring down the federal deficit as soon as possible in order to minimize the highly adverse effects of that deficit on capital formation in the United States and in the rest of the world.

Finally, he agreed with the staff that the protectionist attitudes in the United States entailed grave risks, Mr. Senior said. The country had a heavy responsibility in promoting an open world trading system and avoiding any intensification of protectionism. He considered it paradoxical that a country in whose currency most of the external debt of major developing countries was denominated, and whose commercial banks had the greatest exposure in debt-ridden economies, was imposing protectionist barriers to exports coming from such countries.

Mr. Nimatallah observed that the present state of the U.S. economy was encouraging, as rapid growth was occurring with low inflation. The recovery had been more soundly based than several recoveries in recent history, because it had been built on fundamental adjustments instead of short-term monetary stimulus. On the supply side, there remained capacity to be utilized; the factors of production had been structurally improved and were in a position to sustain a more lasting recovery. Labor had received a great deal of retraining and had adjusted to technological changes, so that unemployment could decline further. Productivity growth had increased; capital formation was on the rise; and the propensity to save was also increasing. On the demand side, rising personal incomes and the potential increase in the demand for U.S. exports when the dollar began to decline augured well for the sustainability of the recovery.

However, the authorities needed to stand ready, in a flexible way, to remove any potential risks to recovery that might appear, Mr. Nimatallah suggested. The recent trend toward moderation in wage settlements had been beneficial to the recovery and should continue. Future wage settlements should not be exaggerated in the light of rising profits, but should be kept to the same percentage as gains in productivity. It would be unfortunate if wage settlements exceeded productivity gains and led to inflationary pressures.

So far, the favorable effects of the fiscal deficit might well have outweighed the unfavorable effects on the economy, perhaps partly because of the availability of capital inflows from abroad, Mr. Nimatallah considered. It was not certain, however, that the favorable effects of the deficit would continue to predominate. Should capital inflows decline and the Federal Government continue to borrow heavily, credit available for the private sector would be seriously reduced. It was not a matter to be taken lightly, because private investment might then fall, reducing expenditure on investment and jeopardizing the sustainability of the recovery. If the credit available to the private sector were seriously reduced, real interest rates were apt to rise further, which, in turn, would have additional negative effects not only on the U.S. economy but on the rest of the world as well. It would be unfortunate if the increase in U.S. demand for exports from other countries were to be undone by higher interest rates.

The recent down payment intended to narrow the fiscal deficit represented an encouraging start; the authorities were moving in the right direction and in the gradual manner that was best, Mr. Nimatallah continued. There might be a need for further action, perhaps in 1985, particularly to reduce expenditure further. There was also room for legislation to increase certain kinds of taxation that should not reduce incentives for investment. To the extent that the fiscal deficit exerted an impact on interest rate levels--and there was some impact--a further reduction in the deficit could be helpful in strengthening recovery in the rest of the world. Other things being equal, lower interest rates would tend to keep more capital available for investment in other countries and would help to reduce the debt service burden borne by indebted countries. In addition, further attempts to reduce the fiscal deficit over time would ease any potential additional burden on monetary policy in achieving price stability while allowing growth to proceed smoothly.

The increasing success of the Federal Reserve Board in controlling monetary aggregates provided a welcome signal to financial markets that monetary policy was continuing on a steady course, Mr. Nimatallah remarked. He supported the Federal Reserve Board's objective of achieving a gradual reduction in the growth of monetary aggregates during 1984 and 1985, a policy that should ensure that price stability would be maintained. With a more supportive fiscal policy, the Federal Reserve Board would not, he hoped, have to resort to a more restrictive monetary policy.

Finally, he urged the U.S. authorities to continue the structural adjustment policies in the productive sectors, policies that involved taking full advantage of technological changes and moving into areas in which the United States had a comparative advantage, Mr. Nimatallah said. It was important to keep the U.S. economy open to foreign competition so as to promote a healthier productive system domestically. As the world's most important economy, the United States should take the lead in cooperating with other major industrial countries to reverse the drift toward protectionism.

Mr. Donoso noted that, after a prolonged recession, the authorities' persistence in attempting to secure noninflationary growth had produced major results. The recent recovery in output had initially been explained by higher demand for certain durable goods, residential investment, and a slowdown in the face of inventory liquidity. More recently, the impulse for growth had also come from other components of demand, such as business fixed investment, probably reflecting expectations of continued growth, and the effects of reductions in interest rates from the 1981 peak. The recovery had brought down the rate of unemployment to 7.5 percent, close to what was regarded as the natural rate--a development facilitated by a marked slowdown in the rate of increase in wages.

The GNP deflator, which in 1981 had risen at an annual rate of 8.75 percent, had recently been rising at an annual rate of only 3 percent, Mr. Donoso observed. During the 12 months ended May 1984, the increase in consumer prices had decelerated to 4.25 percent. Such slow price rises at a time when GNP was recovering rapidly indicated that monetary policy had been appropriate and seemed to establish policy guidelines for the future.

The authorities had interpreted the developments mentioned as indicators of a period of continuous improvement in the economy, but some problem areas remained, Mr. Donoso said. The federal deficit had risen from 2 percent of GNP in FY 1981 to 6.1 percent in FY 1983. For 1984, a deficit of about 5 percent of GNP was projected. Even if a significant decline in interest rates did occur, and even if the deficit did come down slightly, it would still be nearly twice as large during each of the years from 1985 to 1987 as in 1981. In the short run, the fiscal imbalance was putting pressure on the financial markets and keeping interest rates high. In net terms, the financing of the fiscal deficit derived not merely from domestic resources but also from foreign resources, thus contributing to the high interest rates behind the appreciation of the dollar that had been accommodating the inflow of foreign capital. Meanwhile, reflecting the rise in aggregate demand and the changes in relative prices brought about by an inflow of foreign capital and the accompanying appreciation of the dollar, the external accounts had deteriorated. That deterioration meant that there was an air of artificiality in the recovery: the underlying relative price structure appeared distorted, and the allocation of resources was far from the most efficient. The difficulties being experienced at present by sectors producing tradable goods were somehow the equivalent of the difficulties to be experienced later by the sectors benefiting from current distortions in relative prices.

In the medium term, the fiscal deficit projected was bound to slow economic growth, Mr. Donoso considered. The deficit required financing, which, if no longer available from abroad, would have to be provided from domestic sources, leaving fewer resources for the private sector to invest. Part of the atmosphere of prosperity being perceived might be due to the transitory well-being that normally accompanied excessive appreciation of a currency. The authorities should act decisively to bring down the fiscal deficit in order to orient the economy toward a sustainable pattern of growth and speed adjustments in interest rates, the exchange rate for the dollar, and the external accounts.

Some improvements in developing countries' terms of trade might be expected from a larger trade deficit in the United States, Mr. Donoso noted. Nonetheless, in spite of the change in relative prices of exportable and importable goods of developing countries, which was helpful to them, the appreciation of the dollar induced reductions in nominal prices of goods sold by developing countries. Such reductions would not matter if the countries did not have to service debts contracted in dollars, but they did have to service such debts. Extraordinarily high dollar interest rates in terms of other currencies, coupled with the declines in the dollar prices of tradable goods from developing countries, generated what those countries found to be exorbitant real interest rates. According to estimates in the World Economic Outlook, each 1 percent appreciation of the dollar reduced the nominal price of commodities by 1 percent.

Large debts had been contracted by developing countries in the 1970s, Mr. Donoso recalled, when a depreciating dollar had led to a high growth rate in prices for commodities, so that real interest rates had seemed negative. Those debts were being paid off at a time of high nominal interest rates and an appreciating dollar. The shift from lower nominal interest rates and rising commodity prices in the 1970s to higher nominal interest rates and decreasing commodity prices in the 1980s represented a rise in the annual real interest rates at which developing countries had been contracting debts from negative 3 percent in the 1970s to positive 20 percent from 1980 to 1983. The shift had already produced a tremendous deterioration in the standard of living in developing countries and, as it was prolonged, was creating potentially dangerous social and political circumstances. From the U.S. point of view, the worsening situation in indebted developing countries had already had the effect of impairing confidence in the U.S. financial system.

To avoid further negative developments, the authorities should take steps to reduce the fiscal deficit, thus bringing down interest rates and the value of the dollar and also promoting a better ratio of debts to exports in indebted countries, Mr. Donoso suggested. If a continuation of the crises in many indebted developing countries were to be avoided, policies designed to reduce the U.S. fiscal deficit could be postponed no longer. Such policies would also be entirely in line with the requirement of a healthy continuation of recovery in the United States. After all, uncertainties about the stability of financial institutions with high exposures abroad would diminish, because the recovery of developing economies would provide a stimulus to export growth in the United States and would orient the whole productive structure in accordance with sustainable patterns of growth.

Current distorted conditions heightened pressures for protectionism, Mr. Donoso remarked. In steel, textiles, and automobiles, to name only a few industries, concrete measures to reduce pressure from foreign competition had already been taken. They exerted a negative effect directly by inducing misallocation of resources and indirectly by setting conditions for further measures of the same type in other countries. Moreover, spreading protectionist measures limited the opportunities for developing countries to grow. To take copper as an example, in order to bring prices in the United States up to the level required to offset the effects of the appreciation of the dollar, higher interest rates, and the natural advantages enjoyed by producers abroad, measures would be required that would weaken the competitiveness of the U.S. industry manufacturing copper. Such measures would have a damaging effect on employment in the United States and would diminish efficiency in the allocation of resources. Moreover, the effects abroad would be grave. For example, 50 percent of Chile's exports consisted of copper. The mere possibility of restrictions on imports of copper into the United States had already depressed copper prices to a point that made management of Chile's debt a tremendous task. In Peru, copper represented 15 percent of exports, and a further fall in the price of copper could cause harm to that country's economy. Finally, the damage that protectionism could wreak in reducing countries' access to external financing could not be regarded lightly.

The authorities deserved commendation for restoring growth and lowering inflation, Mr. Donoso concluded, as well as for their efforts to contain protectionism. However, as the U.S. economy largely determined economic conditions in other regions of the world, the authorities should act quickly to redress the imbalances that had emerged.

The staff representative from the Western Hemisphere Department, responding to questions by Executive Directors, recalled that Mr. Joyce had said that deregulation and certain labor market developments might have moved the natural rate of unemployment below the staff's estimate of 7-7.5 percent. That estimate had been based on a methodology subject to numerous difficulties and hence should be taken merely as an indication of a rough order of magnitude. In addition, the estimate applied to the years 1980-82 and the natural rate of unemployment might have edged down since that time, as a result of changes in labor market structures and attitudes; in particular, the decline in the proportion of workers that were unionized might well have reduced the frictional component of the natural rate of unemployment. Moreover, the factors estimated to have pushed up the natural rate of unemployment during the 1970s--including the generosity of unemployment compensation and the rising share of young people in the labor force--appeared not to have been playing a significant negative role during the past two years. Thus, the natural rate of unemployment might have edged down, but probably not by a large amount.

A question had also been asked by Mr. Joyce about the interest rate assumptions underlying the staff forecast, the staff representative continued. The staff had assumed that, for the purpose of the World Economic Outlook, interest rates in the United States would remain roughly at the June 1984 levels through 1985. In other words, the secondary market rate on three-month treasury bills would stay at about 9.75 percent, and ten-year bond yields would remain at about 13 percent.

According to Mr. Kafka, the staff representative continued, the staff seemed to believe that the signs of potential decline in expected inflation should not be given much weight. He agreed that there had been some such signs--particularly in wage settlements, and the staff had incorporated them into its inflation forecast--which called for moderate rates of price rises in 1984 and 1985 by comparison with similar stages of previous recoveries. Thus, from the stance of monetary policy and from substantial changes in labor market attitudes, the staff had reason to believe that inflation would remain moderate. Nonetheless, the staff had pointed out that the unemployment rate had declined considerably and that capacity utilization in manufacturing had risen to nearly 82 percent. The staff would have to see how the situation was evolving when capacity utilization moved up to 86-87 percent, the rate at which inflationary pressures had emerged during previous cyclical upswings.

Both Mr. Laske and Mr. Kafka had said that the staff had not mentioned the deductibility of interest payments as a factor behind the strong performance of interest-sensitive components of demand, the staff representative remarked. Interest deductibility was certainly a major explanation of the composition of private net worth in the United States in terms of various assets. However, the extent of deductibility had not changed in recent years, so that that factor would not seem to explain the fall in the cost of capital during 1982 or the resulting upswing in investment. With regard to business fixed investment, deductibility of interest payments was available to businesses in many countries besides the United States.

The recent performance of savings and loan associations in the light of the difficulties experienced by certain commercial banks had been the subject of another question by Mr. Kafka, the staff representative recalled. The condition of savings and loan associations had improved significantly during 1983, as lower average interest rates had significantly reduced their operating losses. Their financial stability and flexibility had also been increased recently by the introduction of money-market deposit accounts and super-NOW accounts, which had allowed savings and loan associations to compete better for household savings. In addition, over 50 percent of recently issued mortgages in the United States were being granted at variable interest rates, a practice that reduced the exposure of the associations to possible future increases in interest rates and alleviated the severe mismatch that had arisen in the maturity structure of assets and liabilities. Nevertheless, the profit situation of savings and loan associations was far from comfortable, and they remained highly sensitive to changes in interest rates. With regard to variable-rate mortgages, there was some concern that household creditworthiness was usually assessed by using current income and current interest rates, so that financial positions of households might become overextended in the event that interest rates rose.

A question had been asked by Mr. Fujino on the effects of financial deregulation, the staff representative noted. By making a variety of new instruments available, particularly money-market accounts and super-NOW accounts, deregulation had allowed many individuals to acquire assets bearing market-related interest rates in denominations accessible to small investors. Deregulation might also have increased competition among banks and among different types of financial institutions. On the negative side, the introduction of new instruments might have complicated the task of monetary authorities by affecting the relationship between the monetary aggregates, GNP, and interest rates, a topic discussed by the staff in Appendix XII in SM/84/178, Supplement 1.

Appendix XI in the same paper, according to Mr. Prowse, had shown clear evidence of a connection between interest rates and the fiscal deficit, the staff representative observed. The staff had not made the point strongly in the staff report, because there were considerable problems with the empirical evidence assembled on the subject, in particular serious problems of stability and simultaneity in the various equations estimated. Nonetheless, some of the most careful studies, including one conducted by the staff of the U.S. Department of Commerce, pointed to a significant relationship between the size of the federal debt and the level of interest rates.

There did exist other, broader concepts of the public sector deficit than those used by the staff, as Mr. Wicks had noted, the staff representative continued. The April update of the budget for FY 1985 had put the federal deficit at $178 billion for FY 1984. To that figure perhaps $15 billion of off-budget expenditures could be added, mainly expenditures by the Federal Financing Bank, bringing the total to $183 billion for FY 1984. In addition, guaranteed loans by federal agencies could be added, amounting in FY 1984 to about $39 billion, and borrowing by government-sponsored enterprises of nearly $40 billion. Those two elements would be offset in part by an estimated surplus for state and local governments of about $54 billion for 1984. The loan guarantees, however, were contingent liabilities of the Federal Government, so that payment was required only in the event of default. Essentially, such loan guarantees could be interpreted as subsidies to private borrowers. In effect, they rechanneled funds from certain areas in the private sector to other areas in the private sector, but did not contribute to crowding out private expenditure in the aggregate.

In addition, the staff representative said, government-sponsored enterprises were private financial intermediaries established and chartered by the Federal Government to facilitate the financing of home mortgages and student loans, as well as agricultural loans. Such government-sponsored private enterprises did not contribute to crowding out private borrowing but rather rechanneled funds within the private sector. For those reasons, the staff tended not to include guaranteed loans and borrowing by government enterprises as part of the fiscal deficit of the Federal Government. Decisions about the fiscal policy affecting the performance of the entire U.S. economy were taken only at the federal level. State and local governments were not directly concerned with influencing the performance of the national economy, and focused primarily on their own economic and financial situations. The outlook for the overall deficit would not be greatly improved even if the staff had included the surplus of state and local governments, because it was projected to decline in relation to GNP during the next several years. Thus, the appropriate concept for assessing the impact of macroeconomic policies on the United States was the federal government deficit.

A question had been asked by Mr. Wang whether the staff could explain why exports from developing countries to the United States had expanded little from 1982 to 1983, the staff representative recalled. Table 8 on page 72 of SM/84/178 did show that the increase had been relatively small, although if OPEC countries were excluded, the increase would appear somewhat larger. Moreover, the year-on-year figures masked the importance of the vigorous rise in U.S. imports from developing countries during the course of 1983, a rise that had continued into the early months of 1984.

Whether the concept of external debt was relevant to the United States had been the subject of a query by Mr. Prowse, who had also asked about the ratio of external debt to GNP, the staff representive recalled. A table setting out the U.S. international investment position for 1980-83 could be found on page 37 of SM/84/178. At end-1983, foreign assets in the United States--which might be called the gross external debt of the United States--had amounted to $782 billion, or about 23.5 percent of GNP. The figure had been fully offset by U.S. assets held abroad, totaling $888 billion, or almost 27 percent of GNP. Thus, the net international investment position showed that in 1983 the United States had been a creditor by little more than $100 billion. The staff had warned that, because of the large statistical discrepancy that had emerged in recent years, data on the international investment position of the United States should be interpreted with considerable caution, particularly in view of the indirect evidence provided by the staff in Appendix VI of SM/84/178, Supplement 1, suggesting that the movements in the statistical discrepancy were linked to unreported capital flows. For that reason, the staff had included an alternative measure of the U.S. net international investment position, which included, besides recorded assets and liabilities, the cumulative statistical discrepancy. As the discrepancy amounted to over $125 billion, and as the official excess of U.S. assets abroad over foreign assets in the United States was only a little over $100 billion, the United States might already have become a net international debtor in 1983, albeit by a small amount.

The staff would have done well to quantify the effects of trade restrictions in certain sectors, according to Mr. Finaish, the staff representative observed. Appendix IX in SM/84/178, Supplement 1, dealt with the restraints imposed on Japanese automobile exports to the United States, including the effects on prices and purchases. The results obtained by the staff would have to be qualified in many respects, and they had therefore not been highlighted in the staff report. Moreover, Appendix II discussed the impact of voluntary restraint agreements on the U.S. steel industry, specifically on employment, prices, and imports.

Both Mr. Prowse and Mr. Finaish had asked about the budgetary cost of agricultural programs, the staff representative from the Western Hemisphere Department concluded. Outlays for agriculture had amounted to $22 billion in FY 1982 and were projected to decline to less than $12 billion by FY 1987 because of a freeze on target prices for major commodities that had already been decided. Of the $22 billion, nearly $19 billion had gone for commodity price supports and related programs, but the figure also included agricultural credits, crop insurance, research, and extension programs. He was unsure why the figures published by the Chemical Bank were so much higher than the estimates provided by the Office of Management and Budget. Perhaps the Chemical Bank figures included estimates of the value to the farm sector of import quotas and certain programs such as the sugar or dairy supports.

The Director of the Exchange and Trade Relations Department explained that quantification of the effects of trade measures was fraught with difficulty. The staff was continuing its work in that area, drawing upon studies by experts on the topic, and it had been in touch with GATT and other organizations. In its next trade policy paper, the staff would discuss the problems of quantification and what could be done to overcome them.

As to the issue of surveillance raised by Mr. Malhotra, the staff was actively searching for techniques to enhance the effectiveness of surveillance, the Director continued. Working with the Deputies of the Group of Ten, the staff was reviewing the ideas so far developed on the subject. It would welcome guidance from any Executive Director or the authorities of any countries, and would expect to discuss such ideas at the next general review of surveillance by the Board.

In response to Mr. Prowse's question on debt, the Director of the Exchange and Trade Relations Department said that the staff encountered difficulties in dealing with the debt service problems of industrial countries, owing to the importance of capital markets. Such difficulties were much greater for the United States, which was unique, not merely because most world trade was denominated in dollars but also because it was the center of the world's largest financial market. Thus, the issue was not so much the percentages of debt to overall GDP but rather the liquidity of those claims. Any analysis to determine whether the debt for the United States was becoming excessive would involve concerns in that area, including the consequence that, in the event of any shift in perceptions by the holder of such claims, U.S. dollar interest rates would move strongly.

The Associate Director of the Western Hemisphere Department said that Mr. Polak's suggestion of developing alternative scenarios for certain implications of policy was intriguing; the staff would look into it. Moreover, the staff would wish to look at the suggestion made by Mr. Wang that it examine the effects on other countries of the most recent recovery in the United States in comparison with the effects of previous recoveries. His suggestion had been to use the U.S. business cycle as a standard and to examine the repercussions of developments in the United States on other countries, expressed in certain variables.

In response to Mr. Prowse, the Associate Director pointed out that, should there be a sustained shift in the U.S. net external debt position, it would start to be reflected in the amount of domestic expenditure that could be sustained internally over time. Thus, the United States was no different from any other country that ran up debts, since the debt had to be serviced. Were such a shift to continue over a substantial period, the question would arise whether the increased indebtedness was being matched by, or in some sense covered by, internal investment.

Mr. Prowse observed that the table on page 37 in SM/84/178 was not comparable with what the staff normally provided for external debt analysis of member countries. The table included official assets, reserve assets, and other U.S. Government assets, as well as private assets and liabilities. For instance, the item entitled "foreign official assets," amounting to $193.9 billion at end-1983, seemed to correspond roughly to the external debt of other governments. There was a substantial U.S. overseas debt which did need to be serviced.

The Associate Director of the Western Hemisphere Department explained that what the staff called "foreign official assets" could also be called "reserve center liabilities." For other countries, the item would be called "reserve assets." For the past few years, foreign official assets had been growing only slowly.

Ms. Bush explained that, because of deregulation of financial institutions, savings and loan associations had been given the authority to expand their commercial loans. They also had acquired the possibility of obtaining new types of assets.

A number of comments had been made concerning the official development assistance provided by the United States, Ms. Bush recalled. The United States continued to be the largest provider of official development assistance, accounting for about 24 percent of the total for DAC members in 1983. Prospects for long-term economic growth in developing countries depended far more on the ability of those countries to generate domestic savings than on official assistance from abroad. Direct investment could play an important complementary role over the long term, especially because of the management skills and technology that it contributed. The full benefits of such investment had not been fully tested, especially given the variety of impediments to such flows that continued to exist. Thus, the U.S. authorities believed that both continued official development assistance and direct investment were important; the latter could encourage the development of private markets, with associated benefits for productivity and efficiency.

Many Directors had correctly observed that the United States had erected some trade barriers recently, Ms. Bush continued. Nevertheless, the Administration remained committed to resisting any generalized movement toward greater protectionism, not always an easy task. Some specific actions recently taken by the authorities showed that they were endeavoring to resist greater protectionism. For instance, they had resisted efforts to impose local content requirements for automobiles, and had rejected restrictive measures proposed for shoes, tuna, and stainless steel. Certainly, U.S. domestic producers had been exerting greater pressure for protectionism. A new round of multilateral talks would be helpful in resisting protectionist pressures, both in the United States and in other countries.

As to the status of the new round of talks on tariff reduction, it had been agreed that the United States would consult with members on the timing and coverage of a new round of trade talks, Ms. Bush pointed out. Since that time, the U.S. authorities had spoken with those of many countries regarding such a possibility and had received responses ranging from little interest to a consensus that a new round was necessary. Outside that context, the U.S. authorities would continue to resist greater protectionist measures over both the short term and the longer term. Given that multilateral talks could take a long time to come to fruition, as pointed out by one Executive Director, she would stress that the United States needed the help of some other countries in reducing protectionism.

In response to Mr. Laske's question on the recent removal of the withholding tax on financial instruments, Ms. Bush noted that the authorities had felt strongly that they should try to eliminate all impediments to free capital movements and had encouraged others to do so as well. Every effort was being made to use capital markets as efficiently as possible. The authorities also believed that they should take steps to improve the entire field of debt management. Although she was unable to provide a specific estimate of the effect that removal of the withholding tax on revenues would have, the United States did have tax treaties with many countries. Thus, even though the Government was withholding certain sums, it had to reimburse them at the end of the year, so that the Government was simply receiving the time value of money in many cases. Anyway, U.S. corporations had long been able to use the Netherlands Antilles to avoid unwanted consequences of withholding taxes. As to the effects on the international capital markets, the existence of tax treaties with many countries would tend to offset some of the effect of the removal of the withholding tax, and could result in greater capital inflows. However, good financial management dictated that the U.S. Government should be financed in the most efficient way.

The Administration had tried hard to resist unitary taxation, Ms. Bush noted. Recently, the Secretary of the Treasury, Mr. Regan, who chaired the committee established to study the issue and reach an agreement with the states, had made the proposal that unitary taxation should be limited to the water's edge or within the United States. The Treasury felt that, if it were impossible to reach agreement on that proposal, perhaps legislation should be introduced at some point to make it explicit.

Nothwithstanding the skepticism expressed by some Executive Directors, Ms. Bush went on, her authorities were well aware of the major impact on the world economy of economic developments and policies in the United States. They paid attention to constructive criticism from abroad. As they had indicated many times before, they supported the surveillance activities of the Fund through Article IV consultations.

As Mr. Lovato and Mr. Malhotra had said, there was a fair amount of disagreement in the economic debate going on in the United States about macroeconomic relationships, Ms. Bush said. Disagreement was particularly acute concerning the link between budget deficits, real interest rates, and the appreciation of the dollar. In the long run, it would be actual performance of the U.S. economy that would test those theories.

Whatever technical links might exist between budget deficits and real interest rates, the U.S. authorities also wished for a decline in real interest rates, Ms. Bush noted. Certainly, looser management of monetary aggregates was not the answer, and inflationary expectations were an important factor. The markets would become convinced that continued determination and success in containing inflation would lead to a reduction in high real interest rates.

The authorities had indicated that they would not be surprised by some eventual decline in the exchange rate for the dollar, Ms. Bush remarked. However, they knew of no convincing reason why a sharp drop should occur. Were there a gradual decline in the exchange rate for the dollar over time, which seemed more probable, the U.S. international position should respond with adjustments that would ease the deficit on current account.

The strength of the dollar had had a positive effect on U.S. exporters and firms competing with imports, in that it had made them more cost conscious, Ms. Bush pointed out. Efforts to control costs should contribute to greater competitiveness, which was one of the positive effects in both the short term and the long term of the continued appreciation. Coupled with a commensurate economic recovery in other countries, higher U.S. competitiveness should help to revive exports from the United States and cushion any fall in the exchange rate of the dollar.

The U.S. authorities held a fundamental belief that economic well-being and prosperity were best enhanced in an environment where private initiative could thrive, Ms. Bush said. They were continuing their effort to make adjustments within the economy designed to reinforce that sort of environment. In various industries, progress had been made in promoting further deregulation--or less government intervention--so that competitive market forces would be the determinant of success. In addition, as many Executive Directors had noted, the U.S. authorities had made substantial progress in reducing inflation and were endeavoring to ensure that it remained at low rates.

Despite controversy over the relationships among fiscal deficits, interest rates, and exchange rates, the U.S. authorities believed that the fiscal deficit must be reduced, Ms. Bush concluded. They were working toward that end. They believed that there should be less resource allocation to Government and a correspondingly larger allocation to the more efficient and productive private sector. That principle could work in many economies. The U.S. authorities had demonstrated their ability to take necessary measures of adjustment and had shown flexibility in responding to adverse economic conditions. The authorities were attempting to promote such features by a less regulated environment, by tax cuts that helped to promote private investment and growth, and by measures to narrow the fiscal deficit. The initial phase of the recent down payment had consisted largely of revenue measures, thus demonstrating the flexibility exercised by the authorities, in view of the Administration's strong belief that reducing expenditures was the most economically efficient means of reducing the deficit. The amount of the second phase of the down payment on the deficit should be the same as, or slightly more than, the initial phase, which had been about $70 billion. Action was expected soon, the proposal being in the final stages of congressional review. It would consist largely of spending cuts, of which a sizable proportion was to take place in defense.

The Chairman made the following summing up:

In the discussion of the staff report for the 1984 Article IV consultation with the United States, Executive Directors were in broad agreement with the views expressed in the staff appraisal. They observed that, after a deep and prolonged recession, the economic situation in the United States had improved markedly over the past year and a half. The recovery of output had been very strong by the standards of previous postwar upswings, unemployment had dropped sharply, inflation had remained moderate, and structural improvements had occurred on the supply side of the economy.

Directors welcomed these developments and noted that the recovery in the United States had had a positive effect on other countries and on world trade. However, many Directors expressed concern about certain aspects of U.S. economic policy and drew attention to the repercussions of these policies on the United States and on other countries.

In particular, they were concerned about the medium-term prospects for growth and capital formation in the United States and the rest of the world. In underscoring this point, several Directors stressed the urgent need for a major improvement in the fiscal position of the Federal Government in order to provide adequate resources for private investment and thus to foster a durable economic expansion.

Directors were of the view that the monetary policy pursued in recent years had played a major role in reducing inflation. They emphasized the importance of continued vigilance in this area because of the danger of a resurgence of inflation as the degree of resource utilization increased--a development that had been characteristic of the expansion phases of previous cycles. In the view of Directors, relatively steady growth of the monetary aggregates would seem to provide protection against a revival of inflation and would help to achieve further progress toward price stability.

In the area of fiscal policy, it was the unanimous view of Directors that the prospect of continuing large deficits was the most important economic policy issue facing the U.S. authorities at this time. Directors stressed that, without a substantial strengthening of the federal fiscal position, the availability of adequate resources for capital formation could not be assured, thereby reducing the likelihood of satisfactory growth in the period ahead. A number of Executive Directors expressed concern that the rapid increase in government debt in relation to GNP implied by the prospective federal deficits would lead to a situation in which achievement of the joint objectives of low inflation and sustained growth would be difficult to realize. Considerable attention was focused in this respect on the material contained in Appendix XI of SM/84/178, Supplement 1, on fiscal deficits, interest rates, and capital formation.

Several Executive Directors were concerned that the recommendations of the Executive Board, which were part of the surveillance process and its effectiveness, did not seem to be reflected in U.S. economic policy in the fiscal area.

Directors noted that in recent years pressure on interest rates and the potential crowding out of private spending in the United States had been alleviated by an inflow of foreign savings. They acknowledged that the resource transfers to the United States had been made at expected rates of return higher than those obtainable elsewhere. They also noted that the counterpart of the large increases in the U.S. current account deficit had been a rise in exports and economic activity in other countries. However, most Directors feared that adverse effects on capital formation in the world economy would continue as long as real interest rates remained high in the United States. In addition, a number of Directors expressed concern about the harmful consequences that a continuation of high U.S. interest rates would have for the developing countries, particularly those facing severe debt servicing difficulties.

Directors were of the view that the flow of foreign savings into the United States was not sustainable at its present rate, and they cautioned that at some point the external current account of the United States would have to undergo adjustment. Directors were concerned that this adjustment might have disruptive effects on the United States and other countries if prompt action were not taken to achieve a substantial reduction of the fiscal deficit, thus making the transition smoother.

Directors agreed with the U.S. authorities that expenditure restraint should be an important ingredient in any deficit reduction plan. They pointed out, however, that federal outlays had risen in relation to GNP in recent years, even as the economy had expanded rapidly. Because of the apparent difficulty in reducing spending, Directors felt that measures to raise revenue might be inevitable. In this regard, Directors acknowledged that certain revenue-raising measures had been enacted recently but noted that more substantial action was required in view of the size of prospective deficits. Directors said that they thought it possible to raise revenue in ways that would not seriously impair incentives for savings and capital formation, and they emphasized that any adverse effects of tax increases must be weighed against the consequences of debt financing.

Several Directors endorsed the Administration's objective of reducing the burden of government regulation and agreed with the emphasis placed on the role of market forces in the design of economic policy. They observed, however, that the policies pursued in some areas--notably agriculture and international trade--had not been entirely consistent with free-market principles. With regard to agriculture, several Directors commented on the imbalance between demand and supply and the increase in budget outlays that had occurred as a result of the high levels of target and support prices. They felt that efforts by the Administration should be directed toward finding a permanent solution to this problem by bringing the incentives provided by farm programs more nearly into line with market realities.

In the area of foreign trade policies, Directors noted the Administration's commitment to maintaining open markets in the United States and acknowledged its efforts in resisting protectionist pressures while incurring a large trade deficit. However, they expressed concern regarding actions taken by the Administration in a number of areas and about the apparent proliferation of requests for import relief. Some Directors noted that the intensification of protectionist pressures reflected in part the real appreciation of the U.S. dollar in recent years, and observed that this appreciation was related to the fiscal imbalance in the United States; thus, the problems stemming from the erosion in the competitive position of U.S. producers should be dealt with in the context of improving the fiscal position.

Directors drew attention to the dangers posed by an intensification of protectionism in the present world situation. They pointed out that trade restrictions reduced the efficiency of resource allocation both in the United States and in the rest of the world, and could hinder the adjustment efforts of debt-burdened developing countries. They called on the United States to resist new measures now pending. In this regard, a number of Directors felt that the Administration should demonstrate its commitment to free trade by rejecting in particular import protection for the copper and steel industries.

A number of Directors recognized the important role played by the United States in dealing with the debt problems of developing countries, and they acknowledged initiatives by the United States to open its markets to some of the smaller developing countries. At the same time, several Executive Directors emphasized the importance of ensuring free access to the markets of industrial countries, particularly in view of the severe adjustment problems faced by the heavily indebted developing countries. They were concerned that certain restrictive trade actions--currently under consideration by the U.S. authorities--could undermine the adjustment efforts of these countries. In this context, several Directors observed that it would be particularly desirable at the present time for the United States to increase its official development assistance, especially within a multilateral framework.

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

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Acting Secretary