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June 20, 1983

To: Members of the Executive Board

From: The Secretary

Subject: United States - Staff Report for the 1983 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1983 Article IV consultation with the United States, which has been tentatively scheduled for discussion on Wednesday, July 20, 1983.

If Executive Directors have technical or factual questions relating to this subject prior to the Board discussion, they should contact Mr. Ferrán, ext. 73295.

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INTERNATIONAL MONETARY FUND

UNITED STATES

Staff Report for the 1983 Article IV Consultation

Prepared by the Staff Representatives for the 1983 Consultation with the United States

Approved by E. Wiesner and C. David Finch

June 17, 1983

Article IV consultation discussions with the United States were held in Washington, D.C., in the period April 13-May 19, 1983; the United States has accepted the obligations of Article VIII, Sections 2, 3, and 4. The U.S. Government was represented by officials of the Department of the Treasury; the Council of Economic Advisers; the Office of Management and Budget; the Federal Reserve Board; the Departments of Agriculture, Commerce, Energy, and State; and the Office of the U.S. Trade Representative. The staff team consisted of S.T. Beza (WHD), S. Anjaria (ETR), K. Bercuson, C. Collyns, J. Ferran, E. Hernandez-Cata, Y. Horiguchi, L. Kenward, and L. Mendras (all WHD). Mr. R.D. Erb, Executive Director for the United States, participated in the discussions.

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

I. Recent Economic Developments

In comparison with the previous two decades, the performance of the U.S. economy since 1973 has been characterized by a slowdown in the growth of output, productivity and capital formation; a ratcheting upward of unemployment; and, until recently, a strong inflationary momentum. Following a fairly vigorous recovery from the 1974-75 recession, inflationary pressures reemerged in 1977-78--as the economy moved toward a high rate of resource utilization--and were magnified in 1979 by the second round of oil price increases. Since late 1979, the Federal Reserve has pursued a policy of monetary restraint aimed at slowing inflation. Given the entrenchment of inflationary expectations, this policy resulted in a weakening of economic activity. From late 1979 to end 1982 there was a small decline in real GNP, and late last year the rate of unemployment reached its highest level in the postwar period. The emergence of a large degree of slack contributed to a sharp deceleration of prices and wages.

Within the general pattern of sluggish economic activity since late 1979, there have been large fluctuations in the growth of output. After a sharp decline in the spring of 1980, real GNP rebounded through mid-1981 before falling in the second half of that year and in early 1982 (Chart 1). Output registered a modest increase in the middle quarters of 1982 but turned down again in the fourth quarter. Real GNP declined by almost 1 per cent during 1982 (from the fourth quarter of 1981 to the fourth quarter of 1982), reflecting reductions in certain interest sensitive components of demand (business fixed investment and stockbuilding) and a weakening of the foreign balance. In the first quarter of 1983, real GNP increased at an annual rate of 2-1/2 per cent, as the pace of inventory liquidation slowed and housing starts surged. Several indicators (including industrial production and retail sales) suggest that the growth of output in the second quarter of 1983 may be fairly strong.

Following large increases for several years through 1979, employment has fluctuated within a relatively narrow range, and in May 1983 it was at about the same level as in late 1979. The civilian unemployment rate stayed around 6 per cent in 1978-79, but it rose by more than 4-1/2 percentage points during the following three years. After peaking at 10-3/4 per cent in December 1982, the civilian unemployment rate declined to just over 10 per cent in May 1983 (Chart 2).

The rate of increase in wages has moderated substantially during the past three years. The 12-month rate of increase in the index of hourly earnings in the nonfarm sector came down from 10 per cent in early 1981 to 5 per cent in May 1983 (Chart 3). The deceleration in wages also has been evident in new multiyear labor contracts; average annual increases over the life of contracts without cost of living adjustment clauses declined from 10-1/4 per cent in 1980 to 8-3/4 per cent in 1981 and to 6-1/2 per cent in 1982. Hourly compensation in the nonfarm business sector rose by 6 per cent from the first quarter of 1982 to the first quarter of 1983, compared with 8 per cent during the previous four quarters; the slowdown in the rise of unit labor costs was more pronounced (from 9 per cent to 3-1/2 per cent), as productivity picked up.

There was a marked slowing in price inflation during 1982 which continued into 1983. The rate of increase of the GNP deflator fell to 4-3/4 per cent during the year ended in the first quarter of 1983 from 7-1/4 per cent during the preceding year and 10-1/4 per cent during the year ended the first quarter of 1981. Producer prices of finished goods rose 2-1/4 per cent from May 1982 to May 1983, compared with a peak rate of increase of almost 15 per cent during the year through August 1980. Also, the 12-month rate of increase in the consumer price index came down to 4 per cent in April 1983, from 6-1/2 per cent in April 1982 and a peak of 14-1/2 per cent in April 1980 (Chart 4). The performance of prices has been even more favorable in the very recent past; both the index of producer prices of finished goods and the consumer price index have changed very little over the past six months.

The current account of the balance of payments moved from small surpluses in 1980-81 to a deficit of $8 billion in 1982.1/ The current account balance deteriorated during the course of 1982, with a surplus of $6 billion (annual rate) in the first half giving way to a deficit of almost $23 billion in the second half (Chart 5). The merchandise trade deficit, which had increased slightly to $28 billion in 1981, widened to more than $36 billion in 1982. There was a $17 billion decline in the value of imports, as domestic demand weakened and the price of imported oil fell. However, the value of exports dropped even more ($25 billion), reflecting the appreciation of the dollar since the summer of 1980 and the weakness of demand abroad (Chart 6). The merchandise trade deficit increased sharply during the course of 1982, but narrowed in the first quarter of 1983 as the value of oil imports dropped further.2/

The effective external value of the U.S. dollar (MERM weights) increased by 36 per cent from September 1980 to November 1982. It fell in late 1982 and the early weeks of 1983, but it has risen somewhat since then; by May, the effective value of the dollar was about 2 per cent below its November 1982 level (Chart 7). The real exchange value of the U.S. dollar, measured in terms of relative value-added deflators in manufacturing, rose by 28 per cent over the two years ended in the fourth quarter of 1982; in terms of relative unit labor costs in manufacturing, the real value of the dollar increased by 34 per cent (Chart 8). On the latter basis, the dollar depreciated in real terms by about 1 per cent from the time of the previous Article IV consultation (August 1982) to March 1983.

The appreciation of the U.S. dollar in recent years--which was preceded by a large depreciation in 1977-78--cannot be fully explained. It may be noted, however, that the recent appreciation followed a substantial strengthening in the U.S. current account position relative to that of other major countries as a group. In addition, it appears to have reflected the improved outlook for inflation in the United States and other factors that induced capital inflows, including unsettled economic and political conditions abroad. The average nominal interest rate differential between assets denominated in U.S. dollars and in other major currencies fluctuated without any clear trend during the past three years (Chart 9); but inflation declined more rapidly in the United States than in other major countries taken together, and the average real interest rate differential between U.S. and foreign long-term assets rose substantially from mid-1980 to mid-1982. In the second half of 1982, the average real interest rate differential and the exchange rate moved in opposite directions, as they had during much of 1978-79 (Chart 10).

1/ Balance of payments data in this paper do not incorporate revisions issued on June 16, 1983. As a result of such revisions, the current account deficit for 1982 is now estimated at $11.2 billion.

2/ Balance of payments developments are discussed in detail in Section III of the recent economic developments paper.

II. U.S. Economic Policies and Prospects

1. Overall strategy and aims

The U.S. representatives said that, upon assuming office in early 1981, the Administration had announced a program designed to reverse the drift toward stagnation that had marked the performance of the economy over the previous one and a half decades. In their view, such a deterioration in economic performance could be traced largely to: (i) a diminution of incentives for risk-taking, saving, investment, and work effort, which to a considerable extent resulted from the combination of inflation, a progressive tax structure, and legal requirements for historical cost accounting of depreciable assets; (ii) the rising share of Federal outlays in total economic activity; (iii) an ever-mounting regulatory burden; and (iv) a failure to keep the growth of the monetary aggregates under control. Accordingly, the Administration's program included a restructuring of the tax system to restore incentives, a paring of the rate of growth of Federal outlays in real terms and achievement in time of a balanced budget, regulatory reform, and support for a policy of monetary restraint by the Federal Reserve.

The U.S. representatives said that the Administration had achieved a major success in the area of taxation. After the implementation of the third phase of the individual income tax cuts in July 1983, marginal tax rates would have been reduced by 23 per cent, and tax relief given to business would serve to offset the effects of the combination of inflation and historical cost accounting. Also important had been the deregulation of financial markets (which had given the average household access to market rates of return on savings and had increased efficiency in the allocation of financial resources), the removal of anti-competitive regulations in air and surface transportation, and the liberalization of the energy sector.1/ Moreover, monetary growth had been reduced, and inflation had been brought down sharply. A major disappointment had been the difficulty encountered in curbing the growth of government spending; recent projections suggested that by FY 1985 federal spending would be about 24 per cent of GNP, well above the 19 per cent the Administration originally had hoped to achieve by that time.

The U.S. representatives went on to say that the adjustment in the policy framework and in the underlying economic structure sought by the Administration had been a painful process, whereas--except for the reduction of inflation--the positive effects the program was expected to have on economic performance were not yet visible. In general, it was too early to sort out the effects of the program from cyclical changes taking place in the economy. However, it was worth noting that the decline in capital spending in the past two years had been less steep

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1/ Recently, the Administration has proposed certain measures to facilitate deregulation of natural gas prices. This proposal is reviewed in Appendix VI to the recent economic developments paper.

than might have been expected on the basis of the prevailing economic situation, a result that might be attributable to the tax incentives of the program.

The basic policy goal, the U.S. representatives said, continued to be the attainment of a steady, long-lasting expansion. They stressed that it was of the utmost importance to avoid steps that would provide excessive stimulus to demand and might reignite inflationary pressures which later would cause the recovery to be aborted. Provided that monetary growth were held to a moderate rate, the prospects for extending the progress against inflation appeared to be favorable. The major potential roadblock to sustained expansion would be a failure to restrain federal spending, which would result in excessive government demands on productive resources and would hinder capital formation. In this respect, it was noted in the Annual Report of the Council of Economic Advisers that controlling the federal deficit was now the single most important way of encouraging investment and growth over the long run.

2. Economic situation and prospects

In the budget documents issued in January 1983, the Administration projected that real GNP would rise by a little more than 3 per cent during 1983 and by 4 per cent during 1984, compared with a decline of about 1 per cent during 1982. The GNP deflator was expected to rise by 5-1/2 per cent during 1983 and 5 per cent during 1984, up from 4-1/2 per cent during 1982. For the period 1985-88,1/ the assumptions underlying the budget projections were that the annual rate of inflation would tend to stabilize at about 4-1/2 per cent, while output growth would stay at 4 per cent a year. The unemployment rate was expected to be 10-1/2 per cent in the fourth quarter of 1983--approximately the same as in the fourth quarter of 1982--and to decline to 6-1/4 per cent by the end of 1988.2/

The U.S. representatives said that the official forecast just referred to had been prepared before it had become clear when the recovery would start. By the time the discussions began, there was strong evidence that recovery was underway, the trough of the recession probably having occurred in December 1982. This, together with the decline in international oil prices in the early part of this year, had made it necessary to revise the official forecast. In an update of the budget estimates issued in mid-April, the projection for real GNP growth during 1983 was raised to 4-3/4 per cent, while the increase in the GNP deflator was lowered to 4-1/2 per cent. According to the revised forecast, the unemployment rate would be down to 9-3/4 per cent by the final quarter of 1983. The rates of change of real GNP and the GNP deflator for future years were left unchanged.

1/ Since 1970, budget documents have included five-year economic and fiscal projections.

2/ As was noted above, the staff forecast for the U.S. economy through 1984 is provided in Appendix I to this report.

In the early stages of the recovery, the U.S. representatives said, output would be boosted by a turnaround in inventory behavior. Moreover, defense spending, housebuilding, and purchases of consumer durables would all show substantial strength. Consumer demand would pick up markedly with the increase in incomes that would result from the third phase of the individual tax cut, the rise in household financial assets stemming from the appreciation of bonds and stocks since mid-1982, and the sharp decline in consumer debt in relation to both income and wealth. In contrast, the weakness of foreign demand and the lagged effect of the appreciation of the dollar would curtail the growth of exports, and nondefense government purchases also would be weak. Business fixed investment was expected to lag in the first half of 1983 before beginning to recover in the second half; low capacity utilization rates and the need to rebuild corporate liquidity would restrain capital spending for a while, but these constraints would diminish with the expanding economy and an expected recovery in profits. It was noted that while real long-term interest rates might remain high, their level reflected in part an upward shift in the investment demand schedule resulting from the measures taken to boost investment incentives.

Signs that economic activity was picking up became stronger as the discussions progressed, and the U.S. representatives said that growth during 1983 might well exceed their latest forecast. In this connection, it was noted that the forecast had assumed a gradual decline in money growth. However, it was possible that the distortions in the monetary aggregates in recent quarters (discussed below) had been overestimated, and that the effective rate of monetary expansion had been fairly high. It was also possible that the forecast had made insufficient allowance for the stimulative effects of the recent oil price declines.

As regards inflation, the U.S. representatives said their forecast envisaged large increases in cyclically-sensitive commodity prices and some recovery in food prices during 1983, but most other prices would decelerate further or would continue to rise at moderate rates. While the projected rate of increase in prices during the year was higher than that indicated by recent movements in some price indices, it was noted that these movements were heavily influenced by special factors. Thus, the price forecast did not imply a rise in the underlying rate of inflation. They added that the rate of wage increase would tend to stabilize, or perhaps fall a little further, as old wage contracts were replaced by new ones negotiated in a less inflationary environment. Notwithstanding the considerable slack in labor markets, significant reductions in wage inflation were not expected, partly because wages seemed to respond not only to the level but also to the rate of change of unemployment.1/ With an expected improvement in the performance of productivity, the rise in unit labor costs would slow, and there would be a rebound in profits.

1/ The recent behavior of inflation in relation to unemployment and other variables is analyzed in Appendix II to the recent economic developments paper.

As for the outlook beyond 1983, the U.S. representatives emphasized that the reforms implemented by the Administration would increase saving, investment, and work effort. In that light, the rates of output growth through 1988 indicated in the budget documents appeared quite modest. However, large federal deficits might preempt the savings necessary for the recovery of investment, thereby impairing economic growth. The U.S. representatives added that the price assumptions for the period through 1988 that were included in the budget documents should not be taken as indicative of their objective as regards inflation. They stressed that they attached more importance to setting policies on the right course than to any particular set of projections, and that in fact they expected to do better on inflation than was indicated in their medium-term scenario.

3. Monetary policy

In early 1982 the Federal Reserve established target ranges for the growth of the monetary aggregates during the year believed to be consistent with the resumption of economic growth together with continued progress toward price stability. As it turned out, the growth of the aggregates during 1982 exceeded those ranges, by a sizable margin in the case of M-1.1/ Federal Reserve officials noted that income velocities of the aggregates declined by appreciably more than had been typical of earlier recessions, and by more than would have been suggested by their historical relationships with interest rates. They believed that the behavior of velocity reflected unusually large precautionary demands for highly liquid assets, and explained that the provision of reserves to depository institutions had accommodated these demands in order to keep monetary policy from being tighter than intended. In evaluating the strength of the aggregates and in arriving at decisions regarding reserve provision, the Federal Reserve had taken account of the weakness of the economy and the liquidity strains that had developed in financial markets, both at home and abroad.

The Federal Reserve representatives also called attention to institutional developments--largely associated with the ongoing process of financial deregulation--which had tended to raise the growth of the aggregates and had further complicated the interpretation of their behavior. Early in the fall of 1982, the Federal Reserve expected M-1 to be affected by the maturing of a large volume of all-savers certificates in October and the introduction of money market deposit accounts (MMDAs) late in the year and Super-NOW accounts early in 1983; since the effect of these developments could not be predicted with any reasonable degree of confidence, beginning in October 1982 the Federal Reserve deemphasized targeting on M-1. In the final weeks of 1982 and the early months of 1983, there was a surge in M-2 as a result of shifts into MMDAs from sources outside M-2. It appeared that the introduction of the new accounts had little net effect on M-1, but the rate of growth of this aggregate in early 1983 remained high.

1/ Recent movements in the monetary aggregates, in comparison with the target ranges, are illustrated in Chart 11.

In the Monetary Policy Report presented to the Congress in mid-February 1983, the Federal Reserve confirmed that the role of M-1 as a guide for policy was being reduced, and that increasing weight was being placed on M-2 and M-3; it seemed that, after the stock adjustments associated with ongoing institutional changes had been completed, the behavior of these aggregates in relation to income would be more predictable than that of M-1. The growth range for M-3 was left unchanged from 1982 to 1983 at 6-1/2 to 9-1/2 per cent; in the view of the Federal Reserve, this aggregate was not affected much by the introduction of new types of accounts. The growth range for M-2 was raised to 7-10 per cent during 1983 (compared with 6-9 per cent during 1982), to allow for continuing (though diminishing) shifts into MMDAs; the base for that range was set at the average level of M-2 in February-March 1983, as it was expected that the bulk of these shifts would have been completed by that time. Federal Reserve officials noted that, abstracting from shifts among financial instruments, the target ranges for the broad aggregates were consistent with some deceleration in actual monetary growth from 1982 to 1983.

The Federal Reserve representatives acknowledged that the broad aggregates were not exempt from problems of interpretation. In addition, they said that these aggregates were less amenable to control than M-1, particularly in the short run. They explained that the precision of direct control over these aggregates through the reserve base was limited because for the most part they were not subject to reserve requirements. Moreover, while the growth of M-2 was influenced significantly in the past by changes in the differential between market interest rates and deposit rate ceilings, short-run control over this aggregate through policy influences on interest rates had been lessened by the increase in the proportion of M-2 having market-determined yields.

As regards the role of narrow money in the conduct of policy, the Federal Reserve representatives noted that while a target range of 4 to 8 per cent had been set for monitoring M-1 growth during 1983 (compared with a range of 2-1/2 to 5-1/2 per cent during 1982), the degree of emphasis placed on M-1 would depend on judgments whether its velocity was becoming more predictable. In assessing the behavior of M-1 in the period ahead, it should be borne in mind that velocity normally increases in the early stages of a recovery. Moreover, if (as suggested above) the exceptional weakness of M-1 velocity since late 1981 had been a reflection of extraordinary demands for liquidity related to economic uncertainties, velocity might increase strongly for some time. However, it was also possible that a basic shift in the demand for M-1 had been taking place as a result of the growing importance of interest-bearing accounts within that aggregate.

The Federal Reserve representatives said that they remained skeptical about the possibility of using alternative intermediate targets for the conduct of monetary policy. They noted that the Federal Open Market Committee had announced an expected growth range for total domestic debt of nonfinancial sectors; however, the behavioral connection

between total credit and nominal demand was not well established, and the degree of controllability of that aggregate was uncertain. The monetary base or some measure of bank reserves also had been suggested, but the relationship of these variables to aggregate demand was not very reliable and, moreover, the demand for reserves also was influenced by the regulatory changes and market innovations that were affecting the demand for money. On the possible use of interest rates, they said that the economic implications of given nominal interest rate levels were difficult to determine, and that holding an incorrect nominal rate target for any span of time would carry serious risks. Real interest rates, though conceptually more appealing, were not amenable to measurement and were not free from the problem of determining their appropriate level.

The mission asked how monetary policy was in fact conducted at present. Federal Reserve officials recalled that the Chairman of the Federal Reserve Board had referred to the highly judgmental nature of monetary policy in present circumstances, and had stressed the need for flexible and pragmatic responses to emerging events. The Federal Reserve continued to look at the aggregates as guides for arriving at the appropriate level of interest rates, but the uncertainty surrounding the interpretation of the aggregates meant that in assessing their movements the Federal Reserve had to give substantial weight to broad economic and financial developments. Given the weakness of the economy until recently and the progress that had been made in reducing inflation, reserve provision had been fairly accommodative for a while, and there had been considerable stability in interest rates.

While supporting the Federal Reserve's broad policy goals, Administration officials saw dangers in the way monetary policy has been handled. They expressed concern about the rapid growth of the aggregates (particularly M-1) in the past several months, as they were skeptical about the explanations concerning permanent shifts in the demand for money. While admitting that the recent decline in M-1 velocity might signal a fundamental change in the relationship between money and economic activity, they were not persuaded by the evidence available thus far. If M-1 were to continue growing at the rate of the recent past, there would be a clear risk that inflation would be rekindled. To prevent that from happening, the Federal Reserve might at some point feel forced to put on the brakes suddenly, an action which would almost certainly choke off the recovery. The course preferred by Administration officials was a steady, moderate growth of M-1, since in their view this would be the best way to reduce inflation and interest rates permanently and thus to facilitate a sustained economic expansion.

As regards the factors behind the present level of interest rates and the prospects for rates in the period ahead, there was a variety of views among U.S. officials.1/ Those officials who emphasized the need for a steadier monetary path saw the cause of high interest rates

1/ Recent interest rate movements are shown in Chart 12.

primarily in the broad swings in monetary growth that had occurred in recent years; in their view, these swings had had adverse effects on the credibility of monetary policy and on inflationary expectations. They acknowledged that action to restrain reserve provision in order to rein in monetary growth might imply higher interest rates for a time, but this would not be a lasting phenomenon.

Other officials emphasized the effect on interest rates of large federal deficits and the concern that these deficits would exert substantial pressure on the financial markets in the future, when private demand for credit expanded. However, it was possible that interest rates already were at the level required to avoid a resurgence of demand pressures, even after allowing for the effects coming from fiscal policy. While continuing progress on inflation and lowered inflationary expectations might make it possible to achieve further reductions in nominal interest rates even as the recovery took hold, an appreciable decline in real interest rates would require a substantial improvement in the federal fiscal position. Some officials noted, however, that while real interest rates were high by historical standards, they were probably not as high as would be suggested by calculations based on the recent trend of inflation, partly because the prospect of large fiscal deficits had kept inflationary expectations higher than they would otherwise be.

4. Fiscal policy

The U.S. representatives said that the reduction in the federal deficit that had been expected in the Administration's original program had not materialized, mainly because the recession had been much more severe than had been expected but also because of the unexpectedly large increases in interest payments and in spending under entitlement programs. In fact, the fiscal deficit (unified budget basis) increased from $58 billion in FY 1981 to $111 billion in FY 1982, and was expected to rise to $210 billion in FY 1983.1/ While large deficits would persist much longer than had been projected in early 1981, the U.S. representatives said that restoration of budgetary balance remained an objective of policy.

In the FY 1984 budget (submitted to the Congress in January 1983), it was estimated that the current services deficit--that is, the deficit projected under the present tax system and existing spending programs--would be equivalent to more than 6 per cent of GNP through FY 1988, even as the economy returned to a high level of resource utilization. For the purpose of this calculation, it was assumed that existing spending programs included an adequate defense effort defined in terms of the Administration's plans, which involve an increase in defense spending to about 8 per cent of GNP in FY 1988 from 5-1/2 per cent in FY 1981.

1/ Data on federal fiscal transactions are presented in Chart 13.

In an attempt to illustrate the factors behind the fiscal imbalance, the budget documents presented a comparison of revenue and main expenditure components in FY 1970 (when the deficit was equivalent to 1/2 per cent of GNP) and FY 1988 (when the deficit on a current services basis would be 6-1/4 per cent of GNP). The ratio of revenue to GNP would be 19 per cent in 1988, about 1 percentage point less than in 1970. On the expenditure side, while the ratio of defense spending to GNP would come down slightly from 1970 to 1988, net interest payments would rise from 1-1/2 per cent to nearly 3-1/2 per cent of GNP and other nondefense spending would rise from 10-1/2 per cent to 13-1/2 per cent of GNP.

The Annual Report of the Council of Economic Advisers noted that a succession of deficits of more than 6 per cent of GNP (as those projected on a current services basis) would absorb the bulk of net saving of households and businesses, which in the past two decades had averaged about 7 per cent of GNP. Even though there might be some offsets in the form of borrowing from abroad and higher private savings, the reduction in the rate of net business fixed investment would likely be large enough to preclude any increase in the amount of capital per worker, with adverse consequences for productivity and real income growth. To put the size of the problem in perspective, it was recalled that net private investment in plant and equipment had averaged only about 3 per cent of GNP since 1960; this performance compared unfavorably with that in most other industrial countries, and was thought to have been a factor behind the relatively slow growth of U.S. productivity over the years.

The adverse effects of large budget deficits, the Council's Report noted, would not be limited to the distant future; rather, the expectation of large deficits for years to come would keep real long-term interest rates in 1983 higher than they would otherwise be, crowding out interest-sensitive components of private spending in the upturn that was just starting. The Report also noted that large deficits would raise the exchange value of the U.S. dollar by attracting foreign capital; this would weaken the competitive position of U.S. exporters and hurt domestic industries that compete with imports. These influences would make for an unbalanced recovery and would likely give rise to stronger inflationary pressures, for any given level of total output and employment, than would a broad-based upturn. Convincing evidence that the Government was dealing with the fiscal deficit in the medium term would play an important part in ensuring a healthy and balanced recovery in the immediate future.

In the discussions, the U.S. representatives stressed that the dominant concern of the Administration in the fiscal policy area was the level and rate of growth of government spending. In the final analysis, the only effective way to free resources for use by the private sector would be a reduction of public expenditure. They noted that in the past two years the Administration had concentrated on reducing the growth of nondefense discretionary outlays, with substantial success in

obtaining congressional approval for this effort. Although thus far total spending had continued to rise in relation to GNP, the measures that had been adopted had put nondefense discretionary spending on a lower growth path, and the dividends of that policy would become increasingly apparent in future years.

The U.S. representatives noted that the Administration's budget for FY 1984 continued to emphasize expenditure restraint. Important features of the FY 1984 budget proposals were an aggregate freeze on nondefense discretionary programs, including a one-year freeze on pay and retirement benefits for all federal workers; reform of the social security and health care systems; and cutbacks in other entitlement programs and some restraint in the growth of defense spending.1/ They said that implementation of these proposals, together with the economic expansion that was expected by the Administration, would reduce the deficit substantially in the coming years. However, the uncertain nature of budgetary projections had led the Administration to propose certain standby tax measures to raise revenue by about 1 per cent of GNP, should the estimate of the FY 1986 deficit made in mid-1985 turn out to exceed 2-1/2 per cent of GNP.2/ These measures, which would be in effect for a period of three years beginning in October 1985, would consist of a surcharge on income taxes equivalent to approximately 1 per cent of taxable income and an excise tax on both domestic and imported oil.

In all, the proposals contained in the FY 1984 budget were estimated to reduce the deficit below the current services estimate by $42 billion in FY 1984, and by larger amounts in succeeding years. As a result, the ratio of the federal deficit to GNP was projected to narrow from an estimated 6-1/2 per cent in FY 1983 to a little less than 5-1/2 per cent in FY 1984 and to about 2-1/2 per cent in FY 1988. In relation to GNP, the deficit in FY 1988 would be 3-3/4 percentage points lower than the current services estimate for that year, with proposed measures on the expenditure side accounting for 2 percentage points and the temporary standby taxes for most of the remainder. On that basis, the ratio of federal debt to GNP would rise from 30 per cent in FY 1982 to more than 40 per cent in FY 1988. The budget estimates were updated in April 1983 to allow for the revised economic forecast as well as other factors (including the effects of congressional actions in the intervening period);3/ the update did not materially change the fiscal

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1/ The budgetary proposals submitted in January 1983 are described in Section IV of the recent economic developments paper, which also reviews the fiscal estimates contained in the FY 1984 budget as well as the updated estimates presented in April 1983.

2/ Implementation of these taxes would also be contingent on the economy showing positive growth at the time and on the adoption by the Congress of the other deficit reducing measures proposed by the Administration in the FY 1984 budget.

3/ These actions (namely, the jobs bill and the social security amendments passed in March and April 1983, respectively) are described in Section IV of the recent economic developments paper. The restructuring of the social security system is discussed in detail in Appendix IV to that paper.

picture for FY 1983 and FY 1984, but the estimate of the deficit for future years was scaled down somewhat.

The U.S. representatives noted that the Administration's proposals were facing strong opposition in the Congress. The Congress was seeking a slowdown in the defense buildup but any reduction in that area might be more than offset by higher nondefense expenditure. There was a question whether any compromise would entail overall spending cuts as large as those envisaged in the Administration's program. More generally, given the inherent momentum in four main categories of expenditure (defense, social security, health care, and interest payments), the ratio of federal outlays to GNP might well stay in the 23-25 per cent range for the foreseeable future. At the same time, allowing for the effect of the indexation of the individual income tax that is scheduled to start in 1985 and excluding the temporary taxes planned for the period 1985-88, the ratio of revenue to GNP would probably settle at around 19 per cent. On this basis, the underlying budgetary gap could be estimated at about 5 per cent of GNP.

The U.S. representatives observed that economic growth in the next several years could be stronger than had been assumed by the Administration for the purpose of the fiscal projections and, as a consequence, the deficit might be reduced more rapidly than projected in the April 1983 update. For example, an average annual growth of real GNP of 5-1/3 per cent instead of the 4 per cent used in the fiscal estimates would serve to eliminate the deficit by 1988, provided that the Administration's program were implemented. The mission remarked that it would not seem appropriate to count on faster growth to reduce the deficit, particularly since official projections suggested that by 1988 the economy would be operating in the high employment zone. Moreover, it was agreed that if the inflation assumptions underlying the budget estimates were to include continuing progress toward price stability, the fiscal deficit would be even larger.

In view of the difficulties in reducing spending, the mission asked whether substantial action on the revenue side was not needed to deal with the fiscal problem; it was noted that it should be possible to design such measures in a way that would avoid impairing incentives for saving and investment, for example, by resorting to consumption taxes or reducing tax expenditures (such as the tax deductibility of interest payments by households). The U.S. representatives replied that the Administration's fiscal plan already contained some proposals to raise taxes, including the standby tax measures. They were opposed to further tax increases at this time, however, since they feared that additional revenue would only make for higher government spending, with little impact on the deficit. They felt that the experience of 1982, when the passage of a tax package had lessened the pressure for spending cuts, was very telling. In answer to a question on the possibility of raising energy taxation in response to declines in international oil prices, they said it would be preferable for any drop in oil prices to be passed on to businesses and consumers.

The U.S. representatives called attention to the substantial credit activities of the Federal Government that are not included in the budget--mainly off-budget outlays and loan operations of government-sponsored agencies. They noted that borrowings to finance these activities absorb savings that could be used more efficiently by unsubsidized private borrowers. They said that the Administration was strongly committed to reducing off-budget outlays and, more generally, to controlling federal credit assistance. Off-budget outlays were projected to be reduced by about one half, to less than $10 billion, from FY 1982 to FY 1986. Credit budget outlays (which include on- and off-budget loan programs as well as lending activities of government-sponsored agencies) were estimated to decline somewhat in FY 1984 and then roughly to stabilize in nominal terms through FY 1988.

As regards the finances of the state and local governments, the U.S. representatives said that the recession had given rise to heavy strains on their revenue base, partly because property values in many areas had stopped rising or had even declined; in addition, the state and local governments were faced with the lingering effects of the tax revolt of the late 1970s and with reductions in federal grants-in-aid enacted in 1981-82. Notwithstanding the expected pickup in economic activity and a projected increase in federal grants-in-aid, the overall financial position of this sector would deteriorate further in 1983. The deficit excluding social insurance funds would rise from about $4 billion in 1982 to nearly $13 billion in 1983; including social insurance funds, the overall balance would worsen somewhat but would still show a surplus of about $20 billion in 1983.

5. Balance of payments and the exchange rate

The Administration's forecast is for a widening in the current account deficit from $8 billion in 1982 to around $30 billion in 1983; under the working assumption that the exchange rate would remain unchanged, in 1984 the deficit would increase further, perhaps to more than $50 billion. The U.S. representatives said that this deterioration would reflect the lagged effects of the real appreciation of the dollar since late 1980 as well as a stronger recovery of economic activity in the United States than in its main trading partners. In addition, exports to developing countries would be adversely affected by the reduced income of oil exporters and by the impact of adjustment policies on aggregate demand in the countries that were facing debt service problems. Partial offsets would come from lower oil import prices and from a rebound in agricultural export prices.

The U.S. representatives said that a current account shift of the size being projected for the next two years could be expected to bring about a depreciation of the dollar. They noted, however, that a worsening in the current account had been widely expected since late 1981, and that a shift from surplus to deficit actually had taken place around mid-1982, without noticeable effects on the exchange value of the dollar. It was possible that because expectations of a depreciation had

been repeatedly frustrated, investors had become wary of taking positions against the dollar. While there was little doubt that movements in the current account had implications for the exchange rate, it seemed that the effects might come with lags that were fairly long and difficult to predict.

The U.S. representatives went on to say that no single variable could explain the strength of the dollar in the past two years; rather, different factors appeared to have predominated at various times. Probably the most important factor influencing demand for dollars in this period had been the U.S. success in reducing inflation. Indeed, largely because inflation had declined more rapidly in the United States than in other major countries, real interest rate differentials appeared to have moved substantially in favor of U.S. assets during this period. Moreover, the relative improvement in the U.S. current account from 1978 to 1980 had boosted the demand for dollars at least through mid-1981. Political developments in many parts of the world appeared to have prompted safe-haven demand for U.S. assets during much of 1981-82, and measures adopted in recent years by the United States had raised the real rate of return to capital. Concern and uncertainty over the soundness of individual financial institutions and several sovereign borrowers may have contributed to the demand for dollars after mid-1982, and strains in the EMS at times may have added to this demand.

The mission asked about the likely effect on the exchange rate of changes in the U.S. monetary-fiscal policy mix along lines suggested by other countries. A lengthy debate on this issue brought out a variety of views among U.S. officials. In general, they thought that the initial impact of a tightening of fiscal policy (without changing monetary policy) would be a depreciation of the U.S. dollar. Some officials felt that this effect would not be long lasting, as the deterioration in the capital account resulting from lower U.S. real interest rates would tend to be offset by an improvement in the current account. Others put the accent on the expectational and inflation-reducing effects of the strengthening in the fiscal position, and concluded that any depreciation probably would be quite small and short lived; in fact, it was quite possible that the dollar would become stronger if the tightening of fiscal policy reinforced the expectation that inflation would be kept under control. Still others, though agreeing that the initial impact would be reversed in time, thought that the process would be a fairly long one and, therefore, they considered that for all practical purposes the result of such a change in the U.S. policy mix would be a weaker dollar.

The mission asked about the meaning of the conclusion of the April 29, 1983 statement by the seven major industrial countries that "the path to greater exchange rate stability must lie in the direction of compatible mixes of policies supporting sustainable noninflationary growth." The U.S. representatives replied that they had not entertained the possibility of a change in the mix through easing monetary policy.

What they were seeking was a strengthening of fiscal policy without an offsetting change in monetary policy, as this would be the best way to promote sustainable, noninflationary growth.

Stable economic and financial conditions in major countries, the U.S. representatives continued, clearly were a precondition for greater exchange rate stability. However, even if a substantial degree of convergence in economic policies and performance were achieved--as now seemed to be happening among most of the major industrial countries--there remained factors that would continue to result in exchange rate movements. In any event, they would not consider fluctuations or short-term volatility of the kind that had occurred in recent years as symptoms of improper functioning of foreign exchange markets. The fact that a price fluctuated did not imply that it was not serving its proper function; indeed, price movements were a basic feature of free markets. In their view, in recent years the exchange markets had performed well on balance in the face of a wide divergence in economic policy approaches and unusually large political and economic uncertainties.

The U.S. representatives said that the findings of the intervention study conducted by the major industrial countries 1/ lent support to the approach to intervention followed by the United States. There was general agreement that the effects of intervention would be short lived unless intervention were accompanied by changes in basic financial policies; thus, while intervention could play a role as a complement to necessary policy measures, it could not be a substitute for them. A key point was that intervention could not achieve exchange rate objectives inconsistent with underlying economic policies and world economic conditions.

The U.S. representatives noted that the statement of the major countries on the intervention study had recognized that in present circumstances the role of intervention could only be limited. One possible use of intervention would be to counter disorder in markets. In this respect, the study had found that intervention--even if sterilized--could have a modest, short-term impact on exchange rates. Coordinated intervention by two or more countries could have a greater impact than the same amount of intervention by a single country, owing to the effect on market psychology. They said that the United States would be prepared to participate in joint intervention if it were agreed among the countries concerned that the market situation was disorderly; however, they felt such occasions were not likely to come frequently, as the conditions for successful coordination (including agreed objectives) were not easily achieved. They added that no understanding had been reached on the definition of disorder, and that the existence of a disorderly market would have to be determined on a case-by-case basis.

1/ Circulated to the Executive Directors as EBD/83/125.

6. Other foreign economic issues

The U.S. representatives said that a combination of cyclical and accumulating structural factors had increased protectionist pressures around the world. The aim of the United States remained the preservation and extension of an open trading system. To achieve this goal, the U.S. authorities followed a three-pronged approach, involving negotiations with trading partners on the removal of trade barriers, effective enforcement of mutually agreed trade laws, and pursuit of domestic economic policies aimed at creating a favorable environment for growth. U.S. policy objectives included more open markets and elimination of subsidies for agricultural products, greater adherence to GATT rules by the developing countries, and the development of international discipline regarding trade in services and trade-distorting measures associated with foreign direct investment policies.

The U.S. representatives felt that the Administration had been fairly successful in avoiding protectionist measures, notwithstanding the erosion of confidence in an open, multilateral trading system in the United States, which was partly due to the restrictive practices of other countries. Still, some protectionist measures had been introduced since the last consultation. These included two escape clause cases (motorcycles and specialty steels), extension of the Japanese export restraints on automobiles, renegotiation of restrictive bilateral agreements with a number of suppliers of textiles and clothing among the developing countries, and new agreements limiting imports of steel from the European Community.1/ However, they noted that the agreements on steel came only after findings of material injury to U.S. producers and a final determination of subsidy and dumping margins; in such a situation, E.C. producers had preferred bilateral restraint arrangements to the application of dumping and countervailing duties.

The U.S. representatives acknowledged that in the last year there had been a heavy load of antidumping and countervailing duty cases. While the imposition of duties led to a reduction in the openness of the U.S. market, it did not have a protectionist intent; rather, it was needed to counter unfair trade practices by other countries. Moreover, such actions were compatible with accepted international rules, had a specified time limit, and did not involve a serious risk of retaliation.

The U.S. representatives recalled that the United States had dismantled some restrictive measures in 1981-82, by allowing bilateral agreements on footwear and television sets to lapse. They also referred to the recent understanding reached with Japan on trade in high technology products, which was designed to secure the benefits of open trading conditions in this rapidly growing sector. Finally, they noted that the Administration had thus far successfully withstood pressures for domestic content legislation in the automobile sector.

1/ These and other measures in the foreign trade and investment areas are described in Appendix VII to the recent economic developments paper.

As regards the agricultural sector, the U.S. representatives acknowledged that the supply-demand imbalance that had developed in grain markets (and the attendant large budgetary costs) had been due in part to high domestic target and support prices. However, the problem had been exacerbated by the policies of other countries which had less comparative advantage in grain production. They noted that the Administration recently had taken actions--notably the payment-in-kind program 1/--aimed at reducing excessive stocks of the principal grains; moreover, the FY 1984 budget had proposed a freeze on target and support prices through 1985. In the cases of dairy products, meat, and sugar, trade and domestic support measures were designed to safeguard farm incomes and, admittedly, resulted in distortions.

The U.S. representatives remarked that the United States remained committed to liberalization of agricultural trade, but that this could only be achieved effectively if its main trading partners, in particular the European Community and Japan, also worked toward reducing their own domestic farm support prices and opening their markets to foreign farm products. In this context, the U.S. representatives welcomed the recent decision in the GATT Committee on Trade in Agriculture to carry out a comprehensive work program with a view to making recommendations aimed at liberalizing trade in agricultural products. Greater international discipline in the use of agricultural export subsidies would, in their view, be an essential element in encouraging the development of agricultural trade on the basis of comparative cost.

The U.S. representatives hoped that the economic recovery that was underway would help reduce protectionism, and said that the U.S. authorities would use all avenues to pursue the objective of free trade. Even though they realized that export subsidies and import barriers were detrimental to the countries adopting them as well as to other countries, they had come to the view that recourse by the United States to selective, temporary measures of that kind may be necessary as part of a strategy to induce other countries to reduce trade-distorting measures. In this respect, they mentioned the recent sale of subsidized U.S. wheat flour to Egypt and the establishment of the reserve fund of the Export-Import Bank. The U.S. authorities were fully aware that this policy entailed the risk of escalating and entrenching protectionist measures. Nonetheless, they had concluded that continuing efforts to promote freer trade, while holding open the possibility of direct action if other countries failed to respond, was the best way to accomplish U.S. trade liberalization objectives. Reference was made in this context to the reciprocity bill, now being considered by the Congress with support from the Administration, which would broaden the President's authority to deal with unfair practices by other countries.

1/ Under this program, U.S. farmers are offered the option of reducing the acreage of certain crops, against payments in the form of deliveries of farm commodities from government stocks. The main features of this program, as well as other recent measures in the agricultural policy area, are described in Appendix VIII to the recent economic developments paper.

Concerning U.S. economic relations with developing countries, the U.S. representatives emphasized that official aid was not necessarily the most effective way of helping those countries to develop.1/ They said that it was preferable to achieve transfers of resources through private channels, including direct investment. In addition, the Administration viewed the relatively free access to the U.S. market for products from developing countries as a major contribution to their development efforts. They added that in some cases it might be appropriate to rely on integrated approaches to the development of a whole area, such as the Caribbean Basin Initiative, which includes measures in the aid, trade, and investment fields.

The U.S. representatives said that keeping the markets of industrial countries open for developing countries was particularly important at this time, when many of these countries were faced with heavy debt service burdens. In dealing with debt problems, the U.S. representatives favored a case-by-case approach such as that followed thus far; they did not see the merits of large-scale, generalized rescue packages. Financing would have to come from the Fund and other sources, including the commercial banks. In this regard, they noted that the Administration was going along with proposals to regulate foreign lending by U.S. banks but would seek to ensure that such legislation did not compromise appropriate financing of adjustment programs. While return to stronger economic growth in the world economy would greatly help debtor countries, U.S. officials cautioned against any suggestion that this dictated the adoption of highly expansionary demand policies by industrial countries; worldwide inflation might provide temporary relief to debtor countries, but in the end it would be counterproductive.

III. Staff Appraisal

The policies pursued in recent years by the United States have brought inflation down to relatively low levels and, after a period of stagnation and a large increase in unemployment, economic recovery has begun. Output and employment have picked up thus far in 1983, and it is generally expected that economic activity will continue to increase. The staff has projected a recovery that is fairly modest by historical standards, but it cannot be ruled out that demand will rebound strongly--particularly if monetary policy does not adequately contain the pressures coming from fiscal policy--with the consequence that inflation might gather new momentum. The experience of the past decade points to the danger that inflation can make a comeback even as available information indicates the existence of substantial slack in goods and labor markets.

1/ Recent trends in U.S. official development assistance are discussed in Appendix IX to the recent economic developments paper.

The key economic policy issue confronting the United States at this juncture is how to ensure a lasting economic expansion without reigniting inflationary pressures. In the view of the staff, this broad objective requires a monetary policy aimed at restraining the growth of nominal demand, together with a major change in the fiscal position to dispel doubts concerning the feasibility of pursuing an anti-inflationary monetary policy and to avoid choking off the growth of the capital stock. Such policies, together with the measures to improve the environment for private enterprise and to increase incentives for saving and investment that have been adopted in recent years, would create the basis for a strong and durable expansion.

The staff understands that the U.S. authorities generally agree with this assessment of policy requirements. They have stressed the need to pursue steady policies geared to long-term objectives and to avoid excessive stimulus, lest inflationary pressures be rekindled. What is necessary is that the Administration's aims be translated into specific measures. The staff is concerned that in key areas there may be departures from a path consistent with the Administration's broad objectives. In particular, the inadequacy of existing plans to deal with the fiscal problem is extremely worrisome, as is the uncertainty about the stance of monetary policy caused by the problems of interpretation of the monetary aggregates.

To begin with monetary policy, the staff agrees with the U.S. authorities on the need for a policy aimed at ensuring moderate growth in the monetary aggregates. However, because of the lack of indicators that can be used reliably to monitor developments in the monetary field, it is difficult to assess whether policy is in fact on the intended track. The staff would hope that it would soon be possible to resume targeting on a monetary aggregate based on transactions balances. In the meantime, the lack of a suitable guide for policy gives rise to the risk that policy may turn out to be easier than would be consistent with moderate growth in nominal demand. The rapid increase in M-1 in recent months--which apparently is not explained by shifts between different types of accounts--suggests that this risk is very real.

Given the recent behavior of the aggregates and the need to provide protection against a rekindling of inflation, the Federal Reserve will have to be cautious in providing bank reserves. Moreover, it should stand ready to tighten reserve provision and to take the interest rate consequences of such an action, should the indications that nominal demand was gathering substantial momentum become firmer; in such a situation, an increase in interest rates in the short run would work to obviate the need for larger, longer lasting increases at a later date. Interest rates currently appear to be high when viewed against the rate of inflation and the cyclical situation, and it is therefore not surprising that there are pressures to lower them in order to encourage the growth of private activity. However, it must be borne in mind that, given the present fiscal policy stance, interest rates that seem relatively high by historical standards may be needed to prevent an excessive growth in aggregate demand.

Turning to fiscal policy issues, there is little doubt that existing deficits, and the prospect of continuing large deficits even as the economy returns to high employment, are the main obstacles to a satisfactory economic performance in the United States. As was pointed out in the Annual Report of the Council of Economic Advisers, persistence of large deficits is bound to limit capital formation and productivity growth over the medium to longer run; the adverse effects of large deficits are not limited to some distant future but will be felt in the upturn that has just started, as certain components of private spending (particularly fixed investment) are crowded out. The rapid increase in government debt and the large absorption of net private savings implied by the prospective deficits could well lead to a situation in which achievement of the joint objectives of low inflation and sustained growth will not be feasible. For these reasons, decisive steps must be taken without delay to bring down the deficit, thereby demonstrating the Government's commitment to the elimination of the fiscal problem and instilling confidence that the process will be carried to a successful conclusion.

Dealing with a fiscal problem as large as that confronted by the United States will require both great restraint on expenditure and substantial efforts to raise revenue. Curbing spending would be the most direct way to reduce pressure on resources and to make room for private spending, and it is rightly emphasized by the Administration; however, it may be noted that notwithstanding this emphasis the ratio of federal outlays to GNP has increased in the past two years, even allowing for cyclical influences. As for the means of raising revenue, it should be possible to do it in ways consistent with the preservation of incentives for capital formation, for example, by focusing on consumption taxes or the reduction of tax expenditures that have adverse effects on private savings and on resource allocation; in contrast, bond financing would surely squeeze investment by exerting upward pressure on real interest rates.

A tightening of U.S. fiscal policy is required not only for domestic considerations but also from an international standpoint. How a tightening of fiscal policy, without changes in monetary policy, would affect the U.S. dollar in exchange markets is subject to debate; it should be noted in this connection that it is not clear to what extent the large real appreciation of the U.S. dollar from 1980 to 1982, and its maintenance since the time of the last consultation, has reflected the effects of pressures coming from the U.S. fiscal deficit or other factors that may have raised the relative attractiveness of investment in the United States. Nevertheless, the indications for policies are clear. As has been already discussed, a tightening of fiscal policy would produce a more stable U.S. economic and financial situation and reduce credit market pressures, and thus should contribute to the stability and growth of the world economy. Such action also would help to create conditions conducive to an orderly correction in the exchange value of the U.S. dollar, to the extent that it has been boosted temporarily by pressures from the fiscal side.

Participation by the United States in coordinated intervention with other countries can serve to counter disorderly market conditions. As has been concluded by the study conducted by the seven major industrial countries, intervention has no lasting effects unless it is supported by policy changes. Beyond the short term, the exchange rate will reflect the basic policies and the fundamental economic situations of the countries concerned, and thus greater exchange rate stability requires convergence of policies and performance among major countries.

The staff agrees with the importance attached by the Administration to reducing the scope of government regulations that restrict competition and hamper adjustment in markets. In this respect, action on the proposal to facilitate the deregulation of natural gas prices would be a useful step, but more scope for market forces continues to be necessary in this field. In some areas, government policies often have not been in line with free market principles; this is particularly the case as regards farm policy and protection from foreign competition. In the agricultural area, high target and support prices have given rise to a large demand-supply imbalance and to growing budgetary outlays. Recent initiatives taken by the Administration, including the payment-in-kind program, do not go to the core of the problem and adjustment to market realities is still needed.

As regards foreign trade policy, the U.S. authorities have stressed their objective of countering protectionist pressures in the United States and abroad. But recent actions by the United States, though at times presented as having been in response to unfair competition by other countries, have contributed to a continuing drift away from open markets and are a cause for concern. The staff would note that, even when such actions are in accordance with established rules, the limitation of competition from foreign producers undermines the efficiency of resource use both at home and internationally and has undesirable effects on the stabilization effort.

The staff believes that unless the United States gives clear evidence of support for free trade through its policy actions, there is great danger that protectionism will continue to spread around the world. The staff is concerned that the use of trade measures by the United States to induce other countries to open their markets in the present world situation would lead to an escalation of trade barriers rather than to their reduction. Because of the dangers posed by the intensification of protectionism, it would be very desirable that the major industrial countries demonstrate their commitment to free trade by taking bold action to roll back the measures that have restricted international competition; the United States would need to play a central role in this undertaking.

In the area of U.S. relations with developing countries, the United States has had a poor record as an aid donor for many years; the recent trend of U.S. official development assistance in relation to GNP has contrasted with that in most other donor countries, and the staff would

urge the U.S. authorities to start reversing that trend. There is an important role for official aid, particularly for the low-income countries, even though aid is only one facet of the contribution that can be made by industrial countries to the development effort of the developing world. In this regard, the staff welcomes the constructive role the United States has been playing in dealing with debt problems of developing countries. It is important to note that another way to assist developing countries in their development efforts would be to improve access to the markets of industrial countries for their products.

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

Outlook

The staff's projections through the end of 1984, prepared in the context of the latest World Economic Outlook exercise, are based on the assumption that monetary policy will be consistent with nominal GNP growth during 1983 in the range of 8-9 per cent, and that there will be a modest reduction in monetary growth during the following year. Furthermore, it is assumed that the Congress will enact budgetary measures that will have similar overall effects to those proposed by the Administration. The projections assume that real interest rates will remain relatively high because of the large current and prospective deficits of the Federal Government.

On the basis of the above assumptions and the underlying trend of private demand, the staff estimates that during 1983 real GNP will grow by 4 per cent, with nearly one half of the increase resulting from a turnaround in the behavior of inventories (from a large liquidation in the last quarter of 1982 to a modest accumulation in the latter part of 1983). Final domestic demand in real terms is projected to rise by 2-1/2 per cent during 1983. Personal consumption expenditure (which will be affected by the personal tax cut scheduled for July 1983) and residential construction would show considerable strength, but there would be a small decline in government purchases and a drop in nonresidential fixed investment. Growth of real GNP is projected to slow during 1984 (to 3-1/2 per cent) as the inventory cycle runs its course. The growth of final domestic demand in real terms would pick up in 1984, with personal consumption expenditure continuing to increase and nonresidential fixed investment beginning to recover from its depressed 1983 level. On a year-over-year basis, real GNP would grow by 2-1/2 per cent in 1983 and by 3-1/2 per cent in 1984.

The growth in output in 1983-84 would be accompanied by a gradual rise in employment, and the unemployment rate would fall below 9-1/2 per cent by the end of the period. An improvement in productivity performance, coupled with a further decline in the rate of wage increase, is expected to result in a continued deceleration in unit labor costs. The GNP deflator is forecast to increase by 4 per cent during both 1983 and 1984; these increases would be consistent with an improvement in profit margins.

The deficit in the current account of the balance of payments is projected to widen to $25 billion (just below 1 per cent of GNP) in 1983 and to $45 billion (nearly 1-1/2 per cent of GNP) in 1984. It is envisaged that the deficit on merchandise trade will increase to $56 billion in 1983 and to $80 billion in 1984. The value of oil imports would decline in 1983 because of the drop in world prices, but the oil import bill would rise substantially in 1984 as a result of a sizable increase in volume; it is assumed that international oil prices will not change in U.S. dollar terms through the end of the forecast period. Non-oil imports would increase rapidly in 1983 and at an even faster pace in 1984, reflecting the growth of domestic demand. Owing largely to the

lagged effects of the appreciation of the dollar in 1981-82, the volume of exports would decline substantially in 1983 before leveling off in 1984. The surplus on service transactions would rise moderately in both 1983 and 1984. It may be noted that these projections are based on the average rate of the dollar in the last ten days of March 1983. However, a deterioration in the current account as large as that projected may result in downward pressures on the exchange value of the U.S. dollar, and the resulting depreciation would work, with a lag, to cushion the worsening in the current account position.

While the staff envisages a recovery of economic activity in 1983-84, there are questions about the outlook for growth beyond the short run. In the absence of additional fiscal action, the prospect of large federal deficits even after the economy emerges from the current recession does not augur well for an enduring expansion of economic activity. Official estimates imply that the federal debt held by the public would almost double from the end of 1982 to the end of 1986, while the ratio of debt to GNP would rise from 30 per cent to 40 per cent. Large fiscal deficits and the attendant increase in government debt would tend to preempt savings and keep real interest rates high, with adverse effects on capital formation and productivity growth, and could generate uncertainty about the Government's commitment to anti-inflationary policies. Action to reduce budget deficits would likely dampen economic activity in the short run, but such action is essential to enhance the prospect of a lasting economic expansion.

United States: Projections of Selected Economic Indicators

(Percentage changes from preceding year, except as indicated)

	1979	1980	1981	1982	Proj. 1983	Proj. 1984
Gross national product (in constant prices)	2.8	-0.4	1.9	-1.7	2.4	3.6
Consumer expenditure	2.7	0.3	1.8	1.0	3.1	3.7
Government expenditure	1.3	2.3	0.9	1.4	1.6	2.0
Residential construction	-5.3	-20.2	-4.8	-10.2	24.3	18.8
Business fixed investment	7.3	-2.2	3.5	-3.6	-6.3	1.8
Final domestic demand	2.6	-0.5	1.6	0.2	2.3	3.7
Stockbuilding 1/	-0.6	-0.8	0.9	-1.2	0.8	0.3
Total domestic demand	1.9	-1.3	2.5	-1.0	3.2	3.9
Foreign balance 1/	0.9	0.9	-0.6	-0.7	-0.8	-0.3
Output, employment, and costs						
Industrial production	4.4	-3.6	2.7	-8.2	3.4	5.7
Employment	2.9	0.5	1.1	-0.9	0.2	2.2
Hourly compensation in the manufacturing sector	9.8	11.8	10.1	8.5	5.7	5.3
Prices						
GNP deflator	8.6	9.3	9.4	6.0	4.1	4.0
Consumer price index	11.3	13.5	10.4	6.1	3.0	3.6
Foreign trade						
Export unit value	16.1	10.5	9.2	1.5	2.0	7.4
Import unit value	17.3	27.4	5.3	-2.0	-0.1	4.0
Terms of trade	-1.0	-13.2	3.7	3.7	2.1	3.3
Volume of exports	11.9	10.0	-3.5	-12.0	-7.2	-0.3
Volume of imports	2.7	-7.5	0.5	-4.4	3.7	10.2
Current external transactions (in billions of dollars)						
Trade balance	-27.4	-25.3	-27.9	-36.3	-56.2	-79.8
Balance on services and private transfers	30.4	31.5	36.9	33.6	36.1	40.5
Current balance, excluding official transfers	3.1	6.2	9.0	-2.7	-20.0	-39.3
Current balance, including official transfers	-0.5	1.5	4.5	-8.1	-25.0	-45.0

1/ Change as a percentage of GNP in the previous year.

Fund Relations with the United States
(Position as of May 31, 1983)

Date of membership:	December 27, 1945.
Status:	Article VIII.
Quota:	SDR 12,607.5 million.
Fund holdings of U.S. dollars:	42.11 per cent of quota.
General Arrangements to Borrow:	The maximum commitment of the United States is $2 billion; the full amount was available.
Supplementary Financing Facility:	The maximum commitment of the United States is SDR 1,450 million; the full amount has been drawn.
SDR Department:	U.S. holdings of SDRs amounted to SDR 5,128.0 million, representing 104.7 per cent of the net cumulative allocation of the United States.
Gold distribution:	5.7 million ounces.
Exchange system:	The U.S. authorities do not maintain margins in respect of exchange transactions, and spot and forward exchange rates are determined on the basis of demand and supply conditions in the exchange markets. However, the authorities intervene when necessary to counter disorderly conditions in the exchange markets. There are no taxes or subsidies on purchases or sales of foreign exchange. On May 31, 1983, the exchange rate of the dollar, as determined by the Fund under Rule O-2(a), was SDR 0.928216 per U.S. dollar.
Last consultation:	The staff report for the 1982 Article IV consultation with the United States (SM/82/141, 7/16/82 and Supplement 1, 8/9/82) was considered by the Executive Board at EBM/82/107 and 108 (August 16, 1982).

UNITED STATES

Area and population	
Area	3,615,000 sq. miles (9,363,000 sq. kilometers)
Population (mid-1981)	231.9 million
Annual rate of population increase (1975-81)	1 per cent
Unemployment rate (May 1983)	10.1 per cent
GNP per capita (1982)	US$13,192

Origin of national income (1982)	(per cent)
Agriculture	2.7
Manufacturing	22.3
Construction and mining	6.3
Transportation and communications	5.9
Government and public utilities	16.7
Other	46.1

Ratios to GNP (1982)	
Exports of goods and services	11.5
Imports of goods and services	10.8
Federal government revenues	20.1
Federal government expenditures	25.0
Domestic saving (private)	17.4
Domestic investment (private)	14.5
Money and quasi-money (December)	73.1

Annual changes in selected economic indicators (annual averages)	1980	1981	1982
	(per cent)		
Real GNP per capita	-1.1	1.1	-2.7
Real GNP	-0.4	1.9	-1.7
GNP at current prices	8.9	11.6	4.1
Domestic expenditure (at current prices)	8.4	11.6	4.4
Investment (private)	-4.9	17.2	-10.9
Consumption (private)	10.6	10.6	6.9
GNP deflator	9.3	9.4	6.0
Producer prices	13.5	9.2	4.0
Consumer prices	13.5	10.4	6.1
Federal government revenues 1/	9.5	16.2	-2.3
Federal government expenditures 1/	18.1	14.3	10.9
Money and quasi-money (M-2)	7.7	9.0	8.8
Money (M1)	6.2	7.2	6.5
Quasi-money	8.1	9.5	9.4
Total loans and investments of commercial banks	2.7	5.3	7.5
Merchandise exports (f.a.s.)	21.6	5.4	-10.7
Merchandise imports (f.a.s.)	17.8	5.8	-6.4

Federal government finances (fiscal years)2/	1980	1981	1982
	(billions of U.S. dollars)		
Revenues	517.1	599.3	617.8
Expenditures	576.7	657.2	728.4
Overall surplus or deficit (-)	-59.6	-57.9	-110.6
Balance of payments			
Merchandise exports (f.a.s.)	224.2	236.3	211.0
Merchandise imports (f.a.s.)	-249.6	-264.1	-247.3
Investment income (net)	29.9	33.0	28.7
Other services and transfers (net)	-3.0	-0.7	0.5
Balance on current account 3/	1.5	4.5	-8.1
Official reserve assets, net (increase -)	-7.0	-7.1	-6.7
Official reserve liabilities	14.9	4.8	3.1
Other capital transactions (net)	-39.4	-29.2	-30.1
SDR allocation	1.2	1.1	--
Errors and omissions	28.9	25.8	41.9

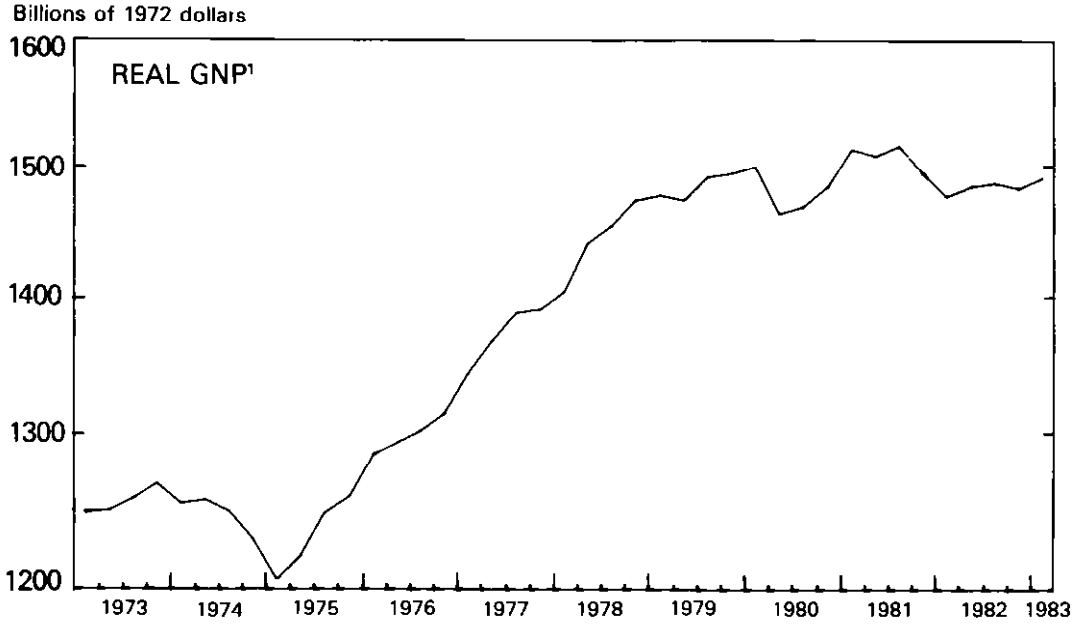
International reserve position	Dec. 31 1981	Dec. 31 1982	April 30 1983
	(billions of SDRs)		
Gross official international reserve assets	25.5	29.9	30.5

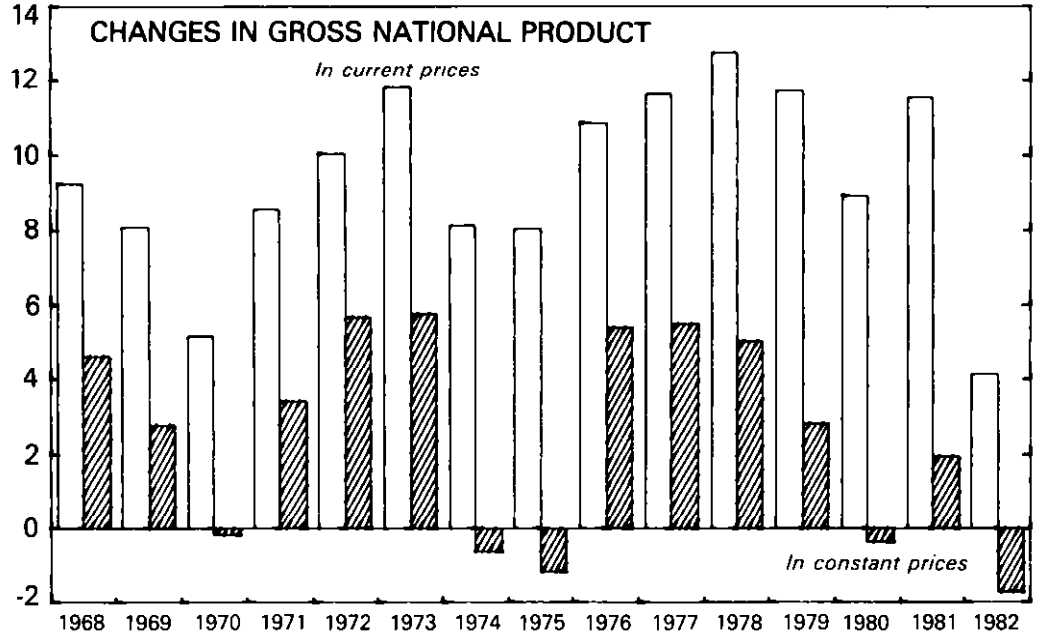
1/ National income accounts basis.
2/ Unified budget basis; fiscal years end September 30.
3/ Including official transfers.

CHART 1

UNITED STATES

GROSS NATIONAL PRODUCT



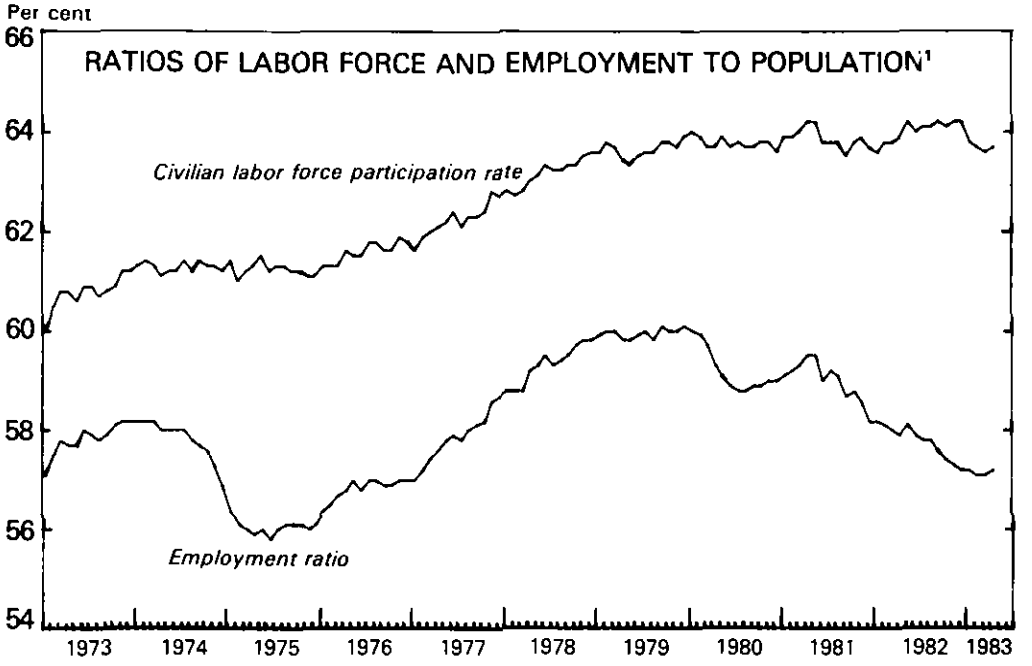


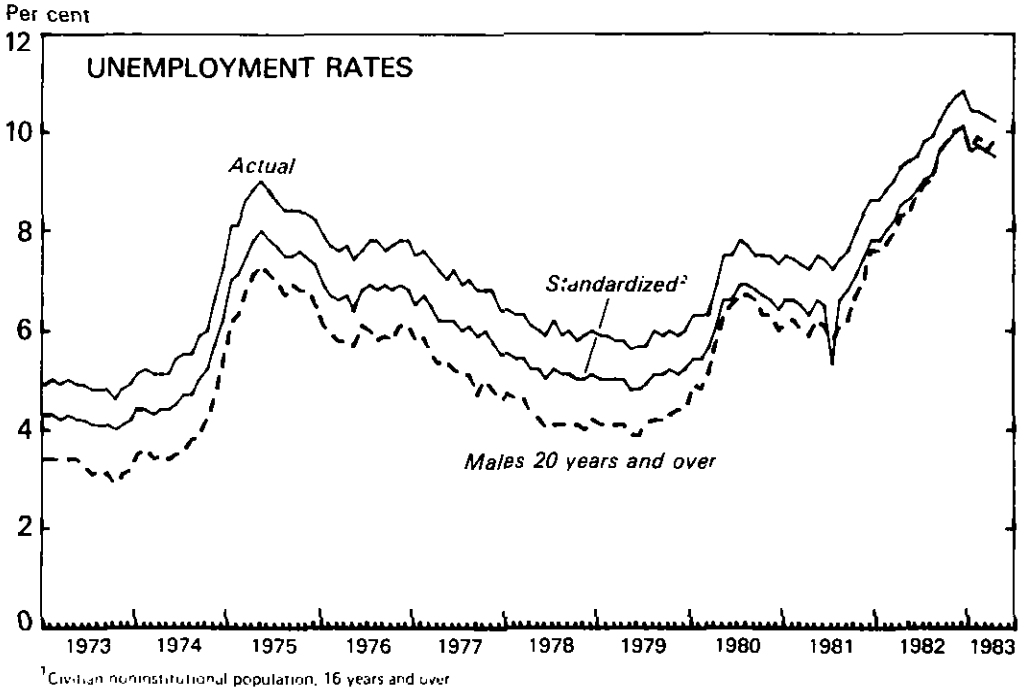
[1]Quarterly data seasonally adjusted at annual rates

CHART 2

UNITED STATES

LABOR FORCE, EMPLOYMENT, AND UNEMPLOYMENT





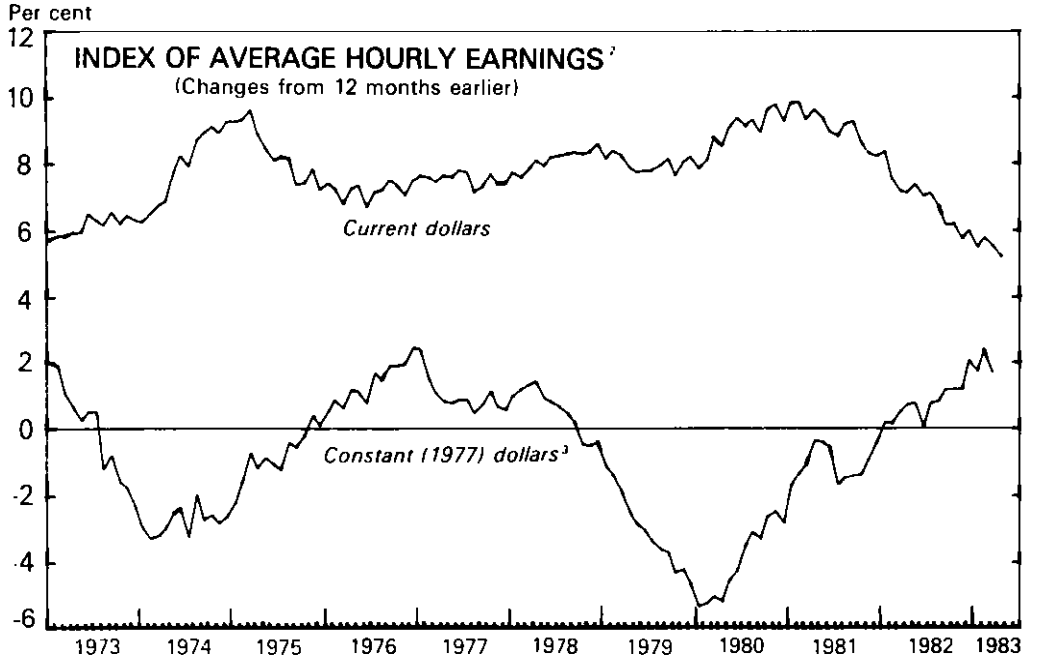
[1] Civilian noninstitutional population, 16 years and over

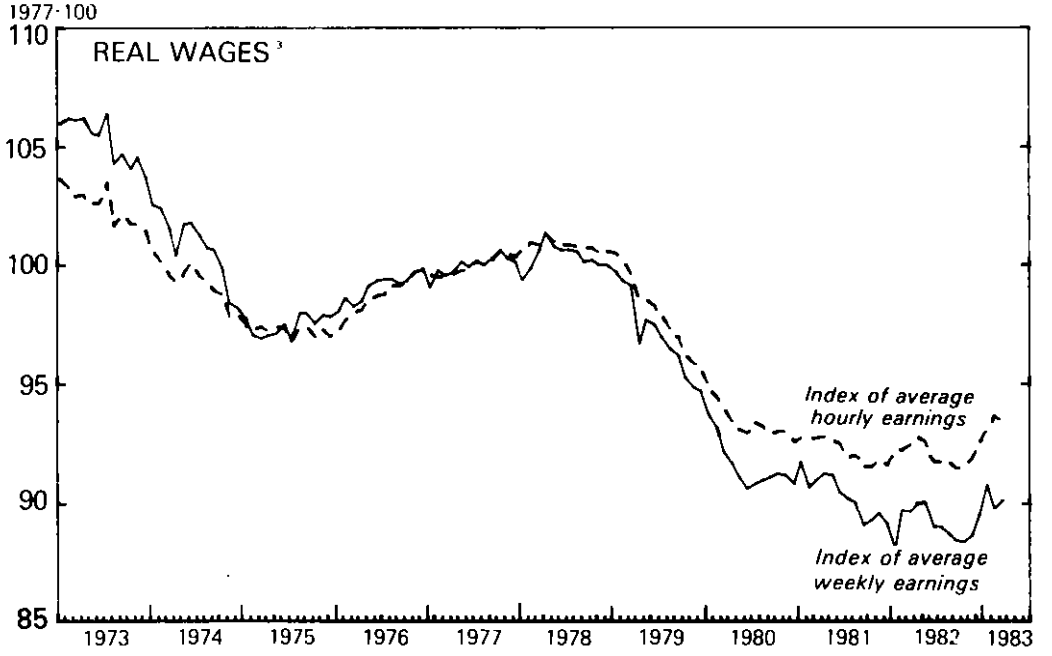
[2] The standardized rate is computed by holding the age-sex composition of the civilian labor force constant at the 1956 pattern

CHART 3

UNITED STATES

WAGES IN THE PRIVATE NONFARM ECONOMY[1]





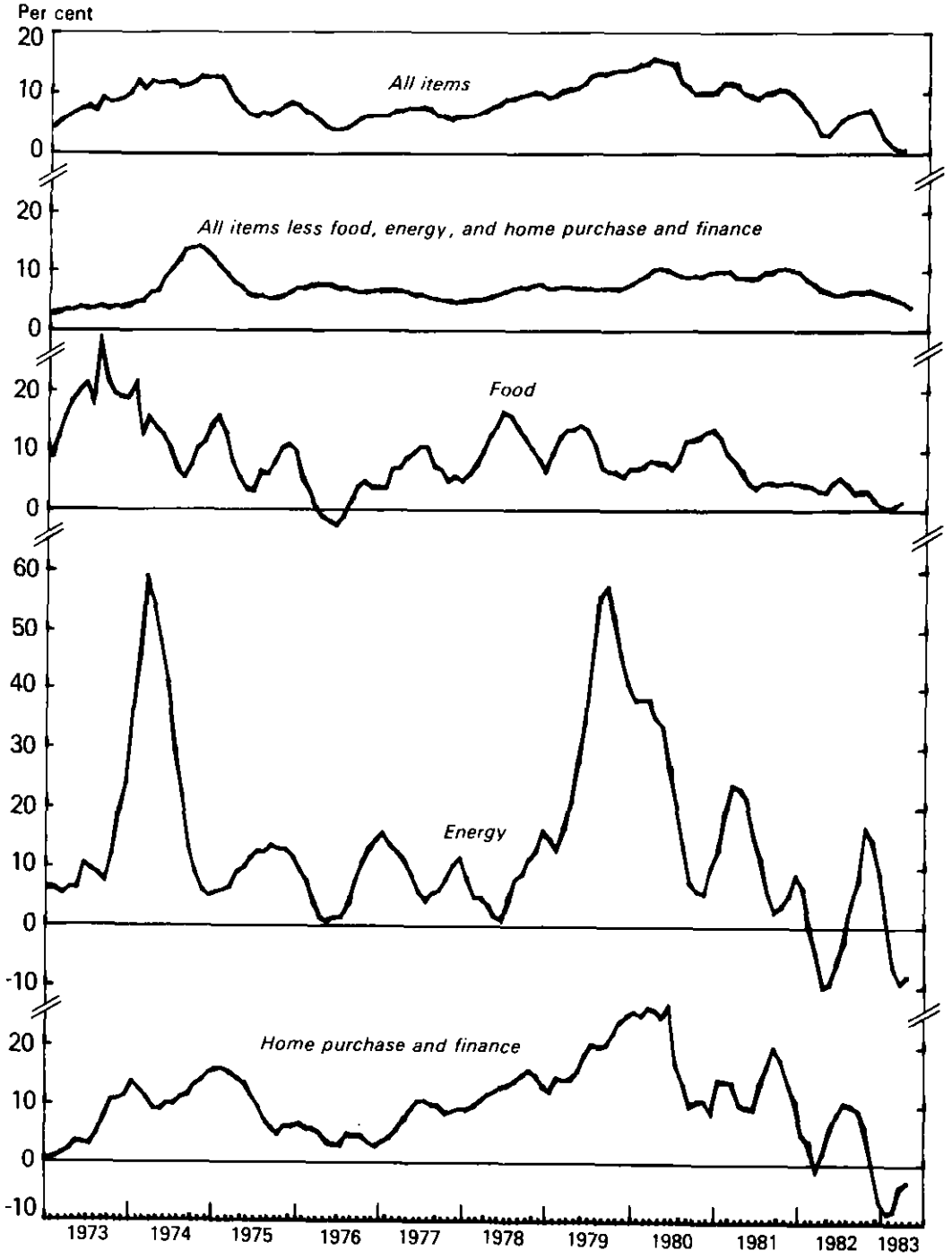
[1]For production and nonsupervisory workers
[2]Adjusted for overtime in manufacturing and interindustry employment shifts
[3]Deflated by the consumer price index for urban wage earners and clerical workers

CHART 4

UNITED STATES

CONSUMER PRICES[1]

(Per cent changes over 6-month spans, seasonally adjusted at annual rates)



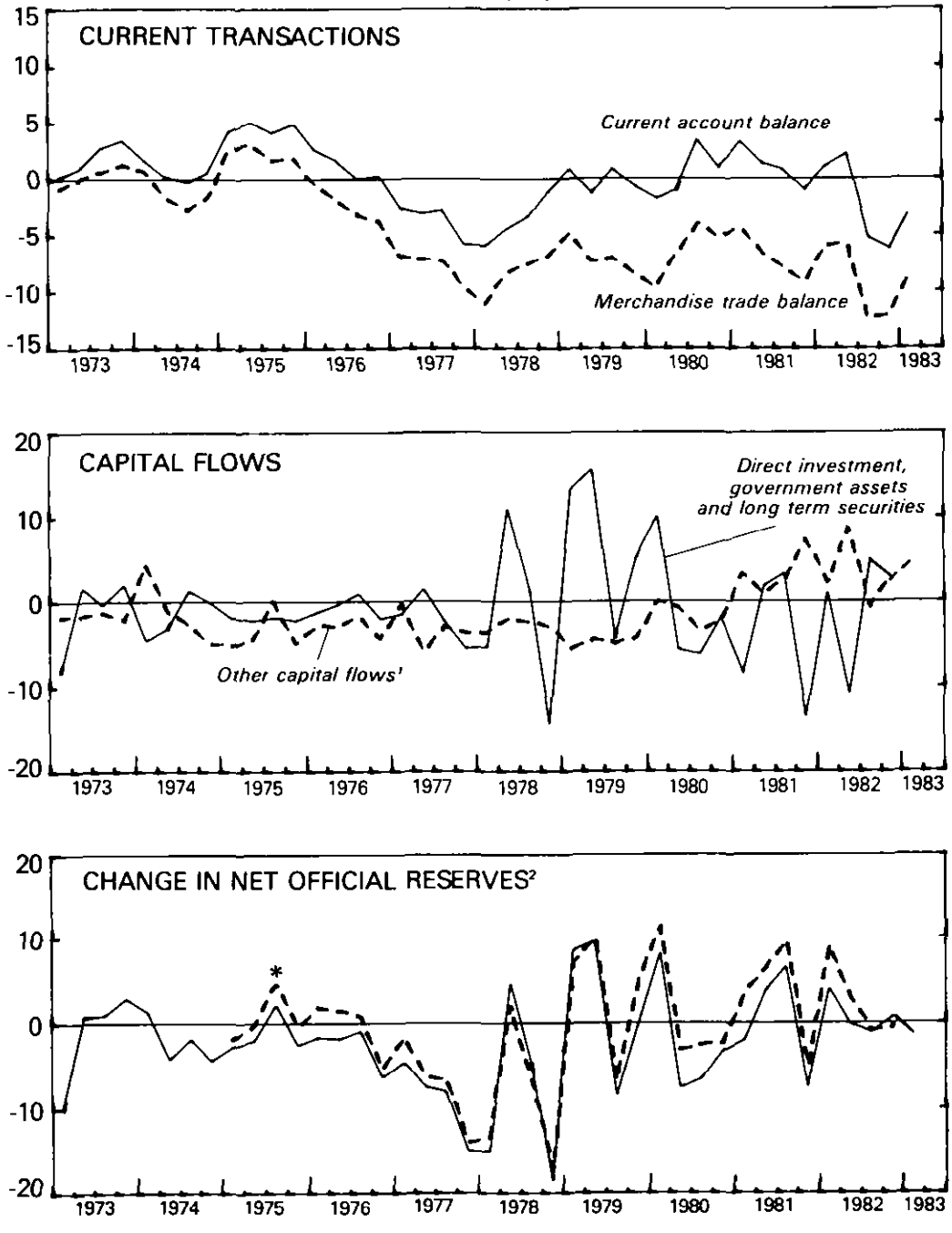
[1]Data correspond to the Consumer Price Index for all urban consumers.

CHART 5

UNITED STATES

BALANCE OF PAYMENTS DEVELOPMENTS

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



*Excluding transactions with OPEC

[1]Including the statistical discrepancy and excluding net issues of U.S. Treasury securities in the German and Swiss capital markets.

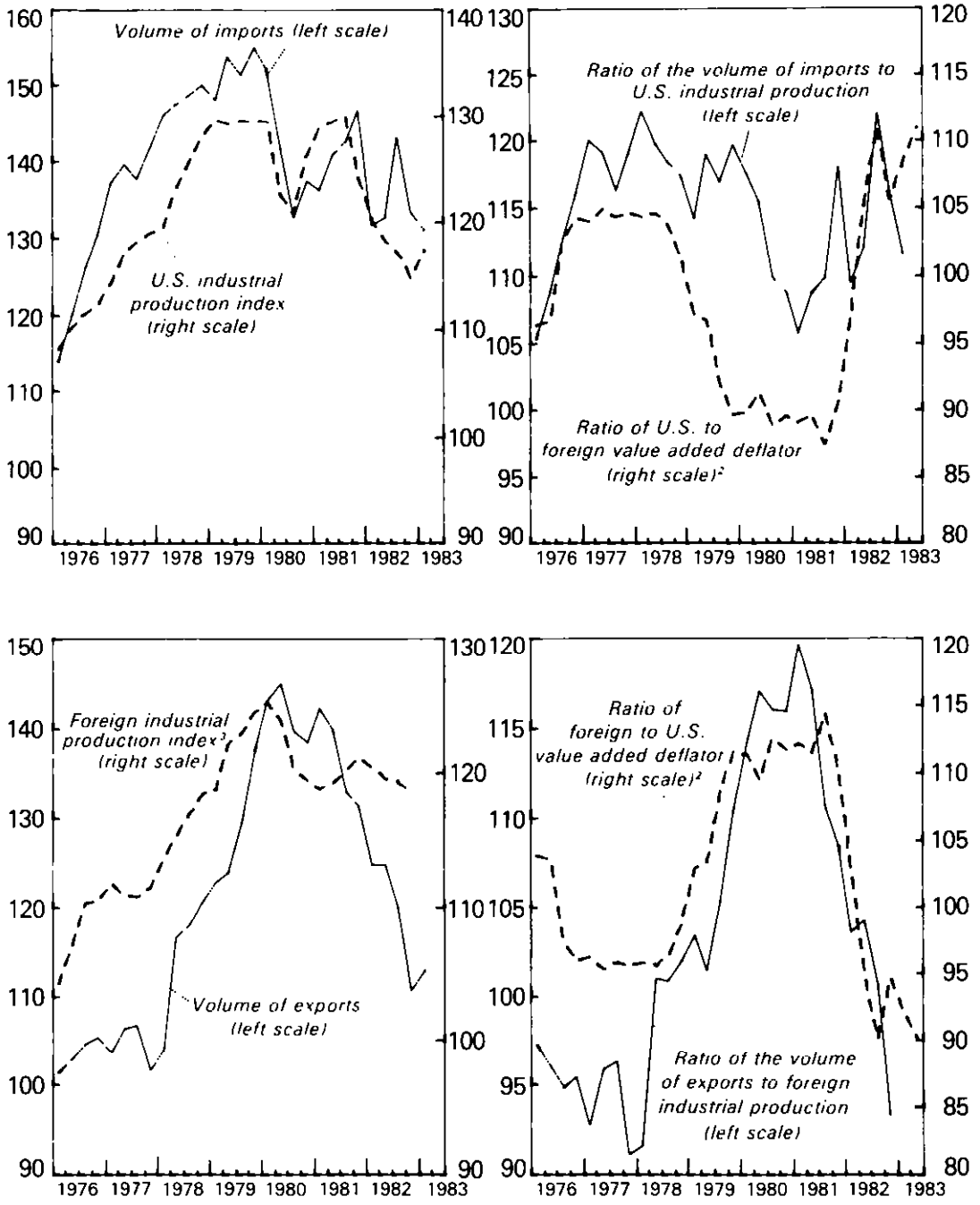
[2]U.S. official reserve assets minus liabilities to foreign official agencies less net issues of U.S. Treasury securities in the German and Swiss capital markets.

CHART 6

UNITED STATES

MERCHANDISE TRADE DEVELOPMENTS[1]

(Indices, 1975 = 100)



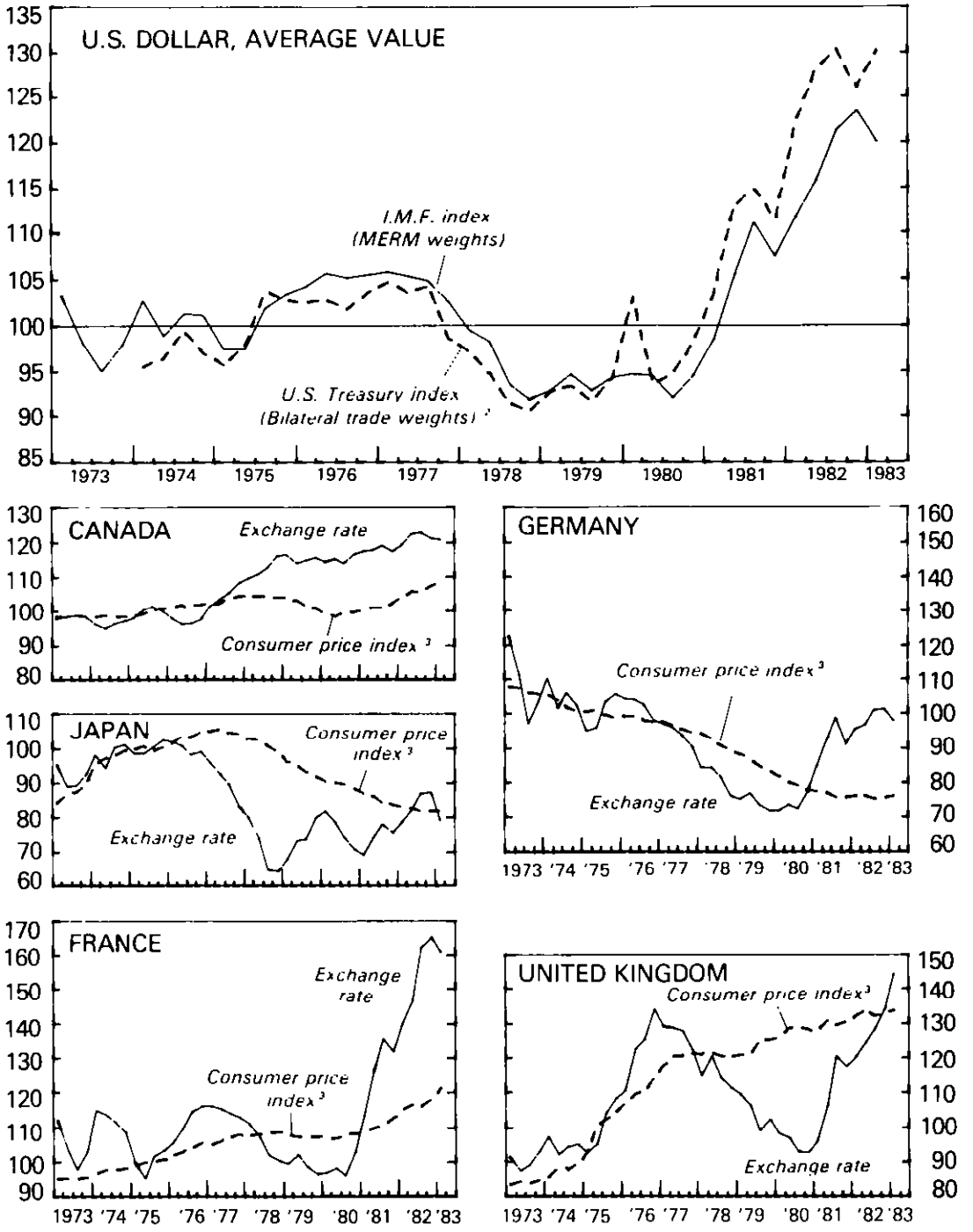
[1]Imports and exports are at 1977 prices.
[2]Adjusted for exchange rate changes (lagged 4 quarters).
[3]Trade weighted average of industrial indices for France, Germany, Italy, Japan and the United Kingdom.

CHART 7

UNITED STATES

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

(Indices, 1975=100)



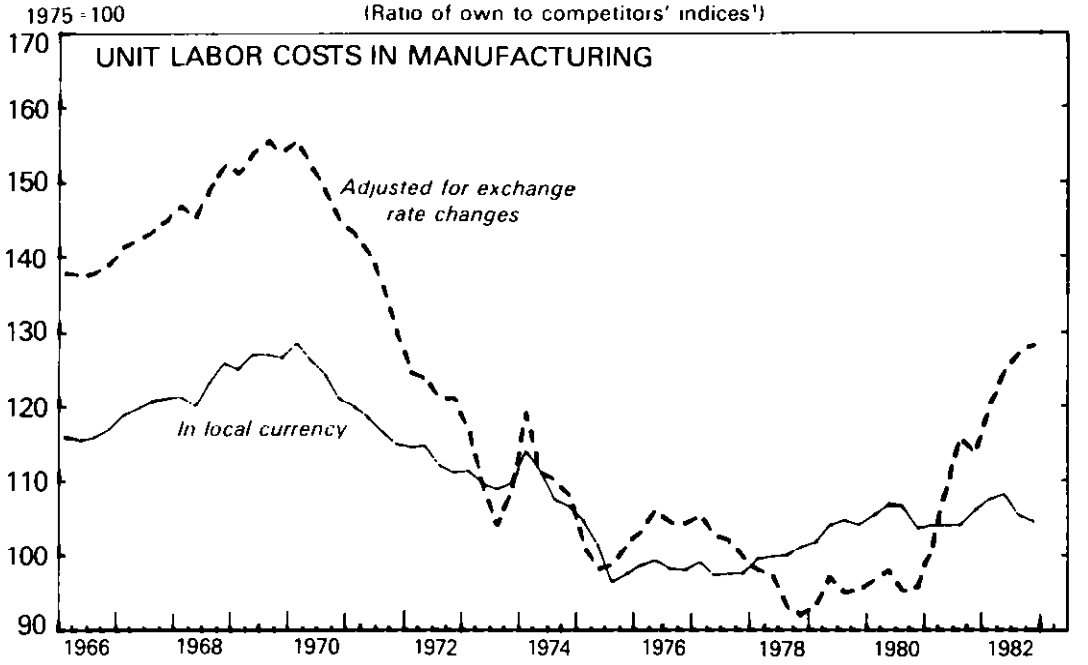
[1]Indices of monthly averages of daily rates
[2]Based on OECD countries' end of period
[3]Ratio of foreign consumer price index to U.S. consumer price index

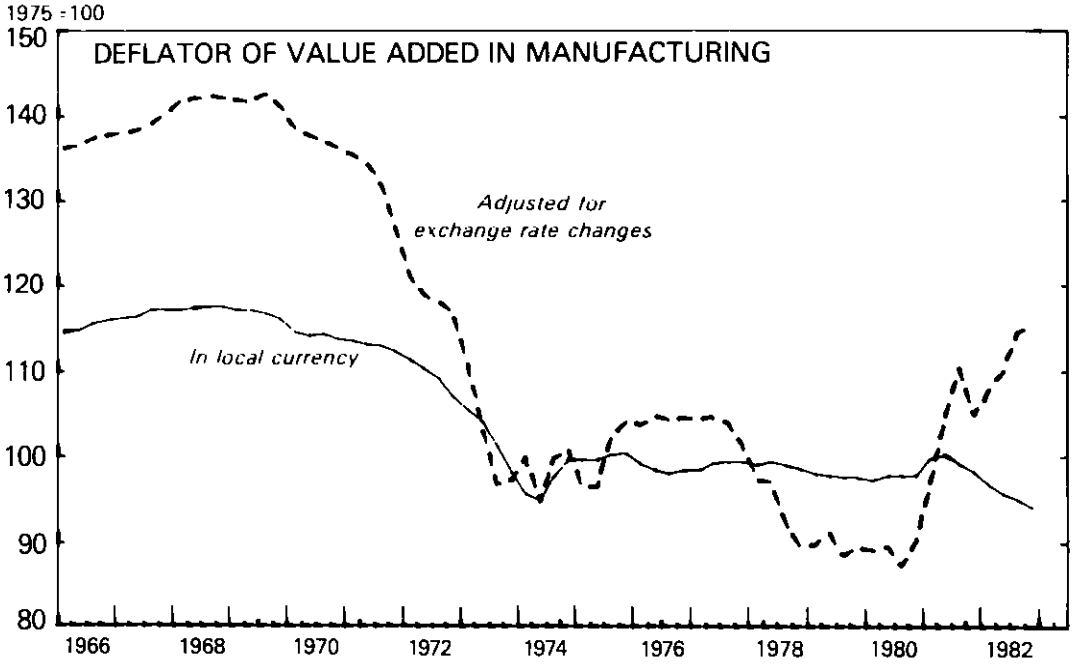
CHART 8

UNITED STATES

COSTS AND PRICES IN MANUFACTURING RELATIVE TO OTHER INDUSTRIAL COUNTRIES

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



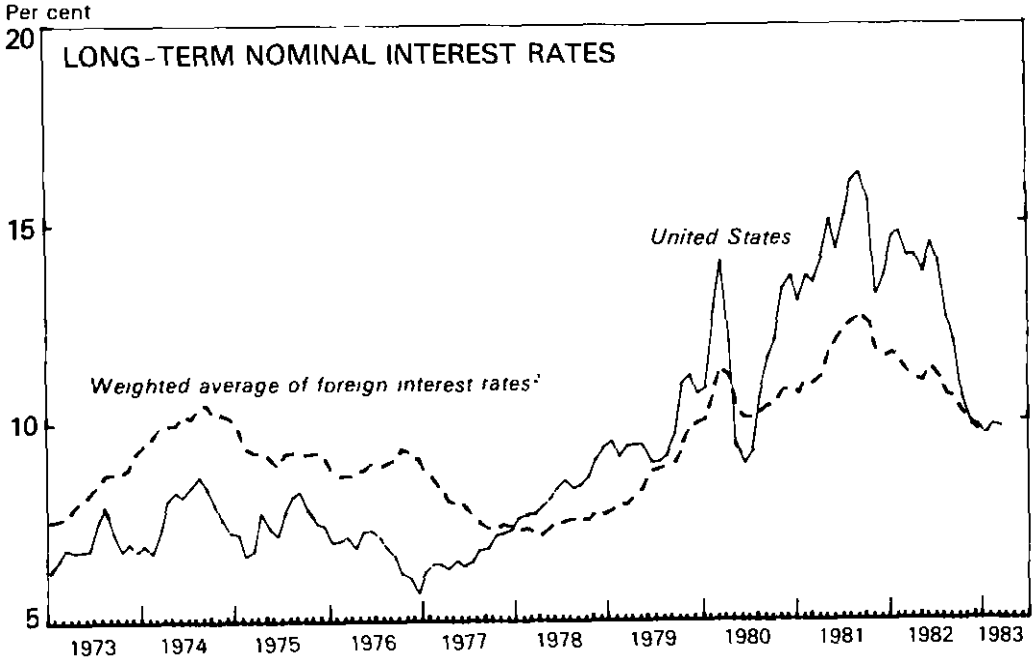


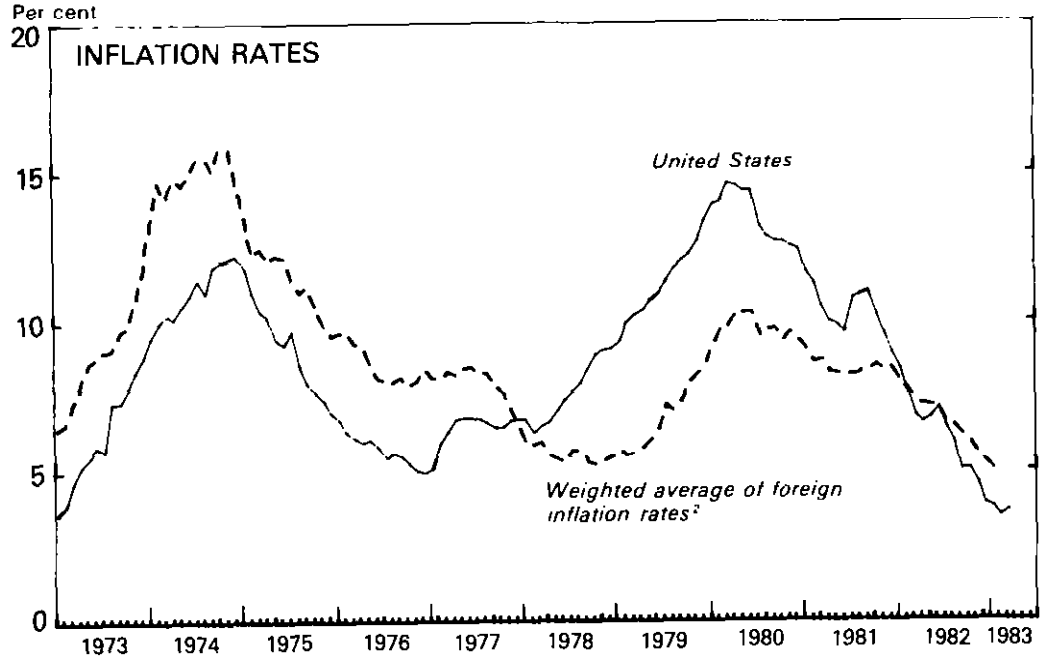
[1] Competitors' indices are weighted averages of the corresponding data for the other industrial countries. The weights, which are based on 1975 trade in manufactures, take account of both bilateral and third market effects.

CHART 9

UNITED STATES

RELATIVE INTEREST RATES AND INFLATION RATES[1]





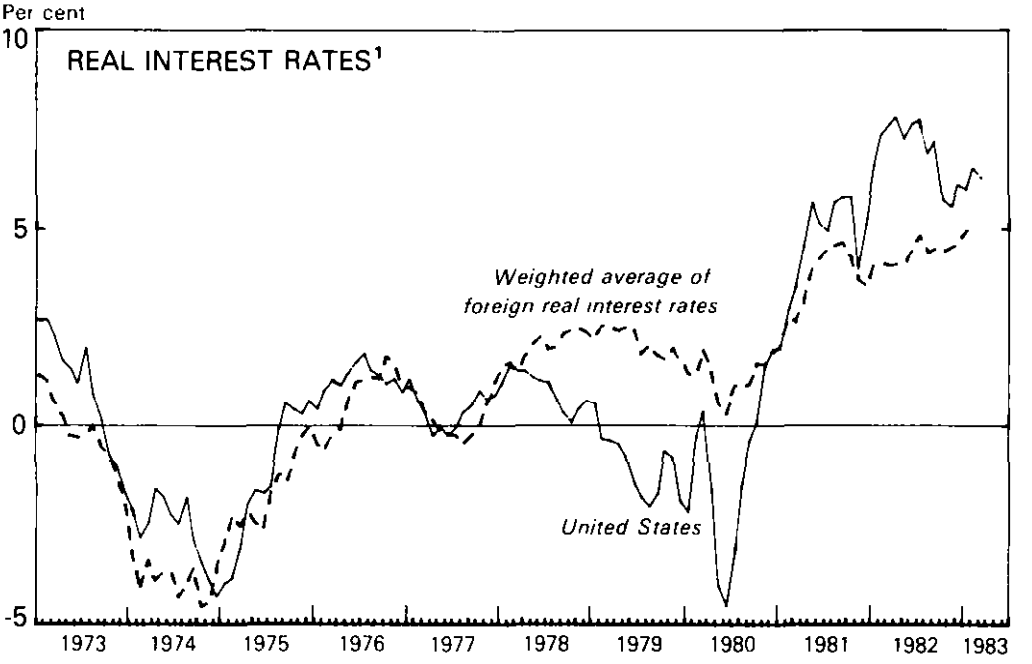
[1]Interest rates are medium to long term yields on government bonds. Inflation rates are measured as 12 month rates of change in consumer prices

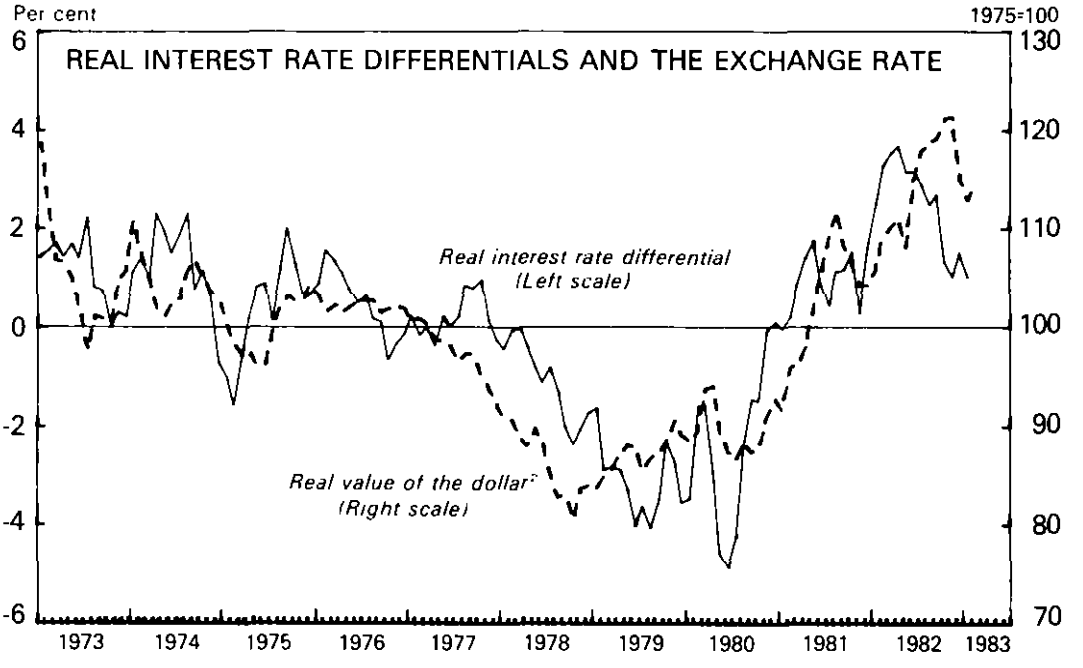
[2]Data for Canada, France, Germany, Japan, Switzerland, and the United Kingdom, weighted by 1976 GNP levels

CHART 10

UNITED STATES

LONG-TERM REAL INTEREST RATES AND THE EXCHANGE RATE





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

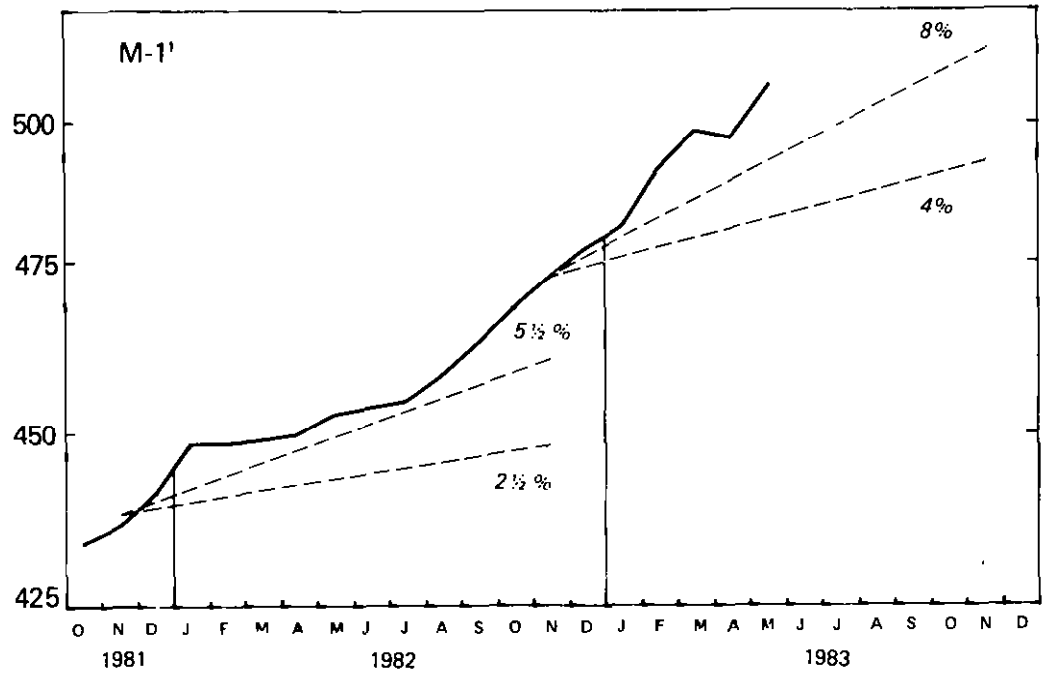
[2]Defined as a weighted average (1976 GNP weights) of the nominal value of the dollar vis a vis the currencies of the countries listed in footnote 1, adjusted for relative consumer prices.

CHART 11

UNITED STATES

M-1 AND M-2: TARGETS AND PERFORMANCE

(In billions of dollars)



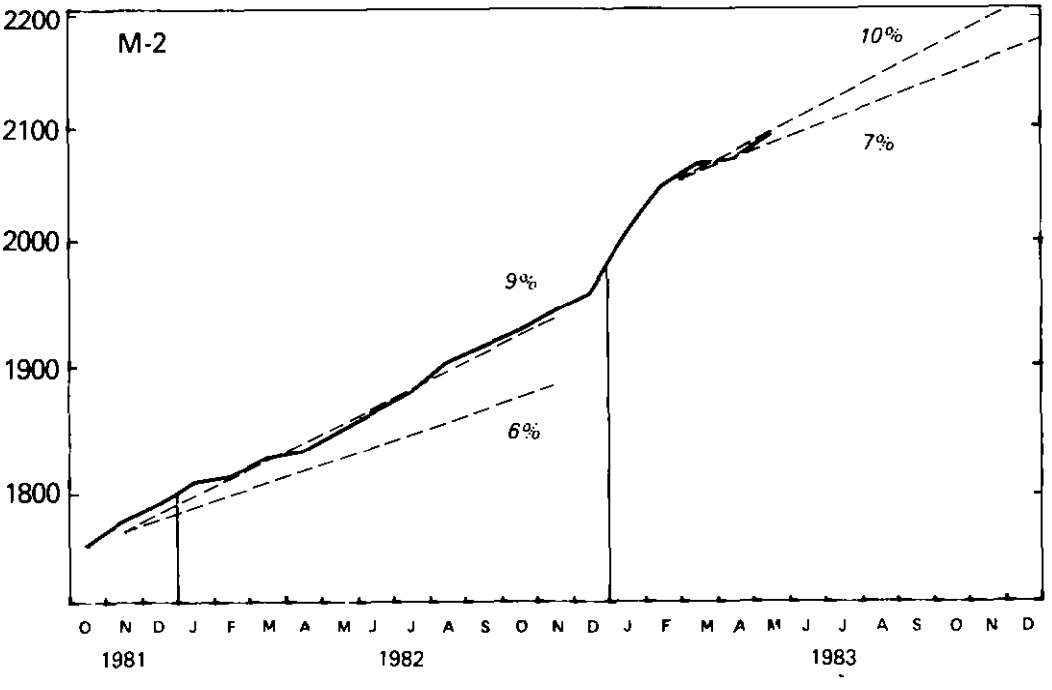
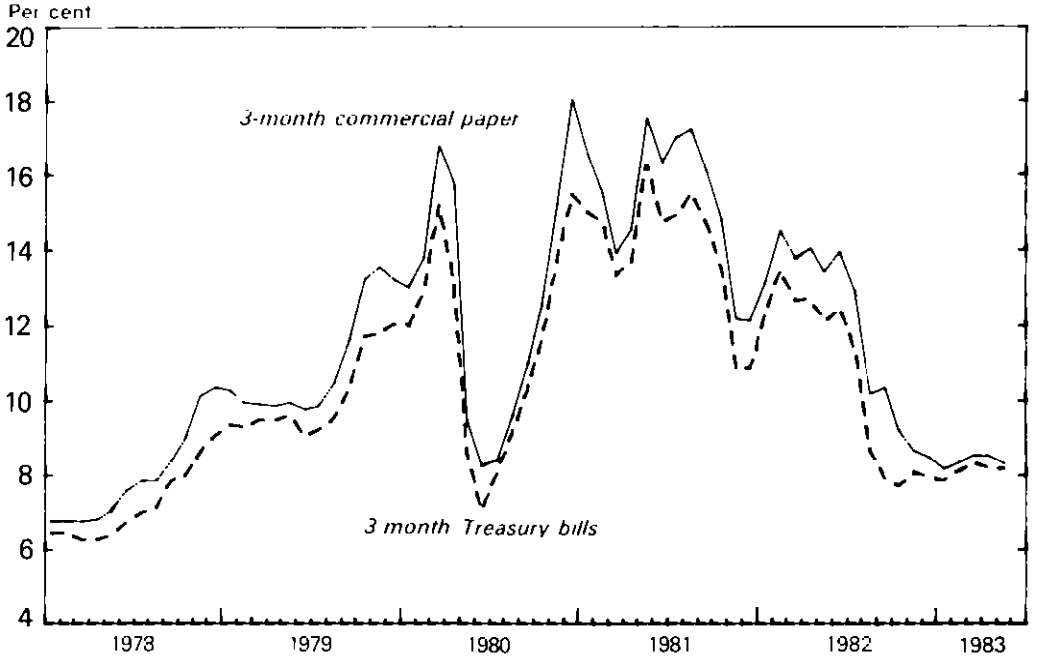


CHART 12

UNITED STATES

INTEREST RATES



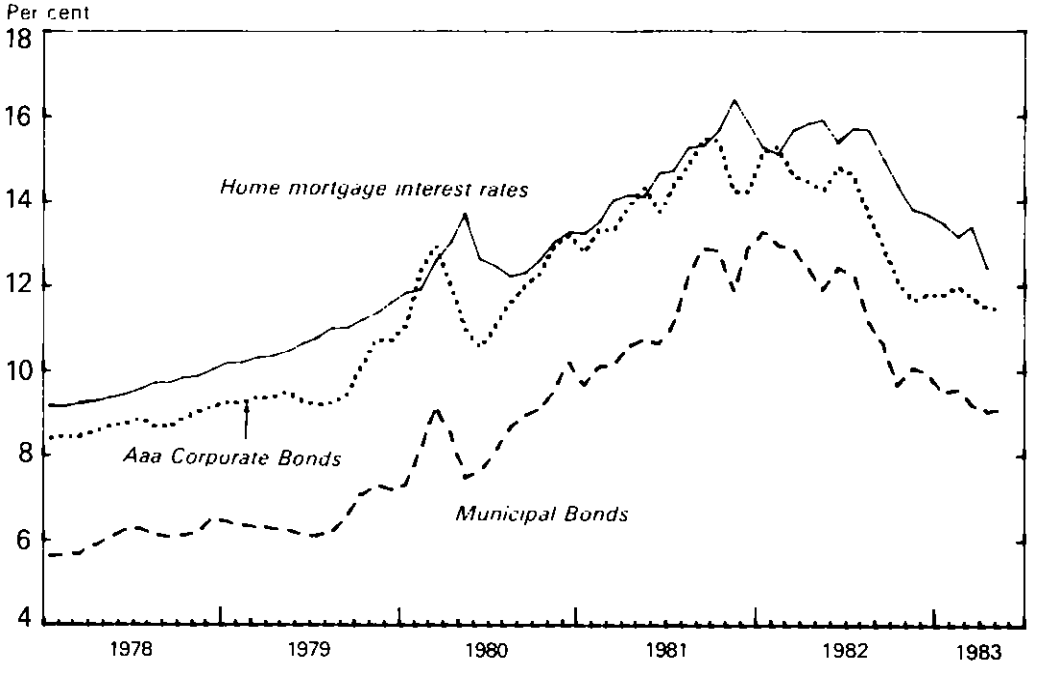
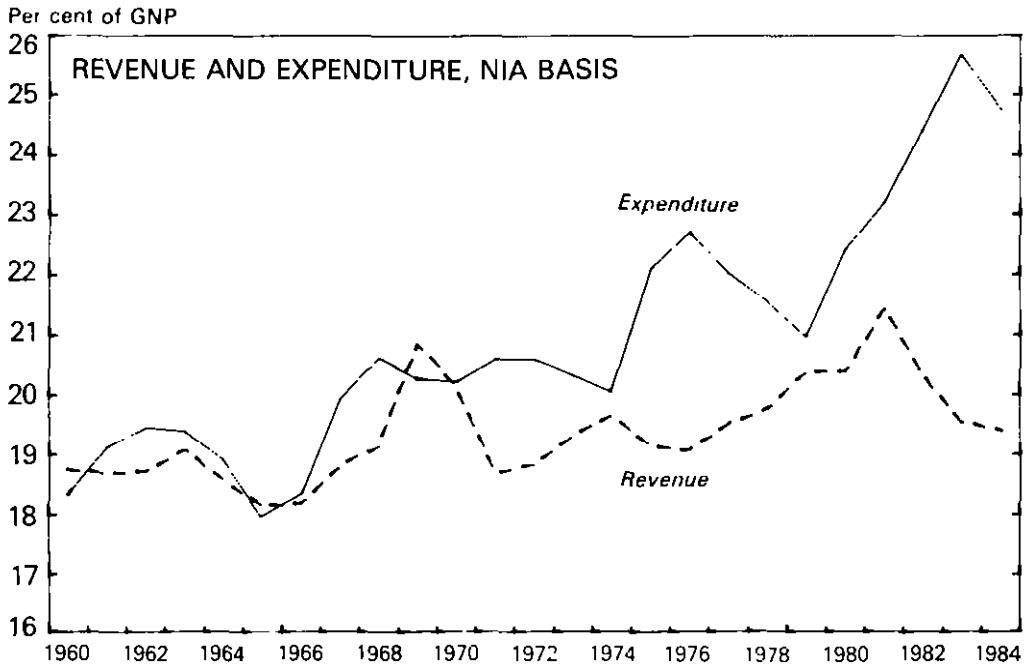
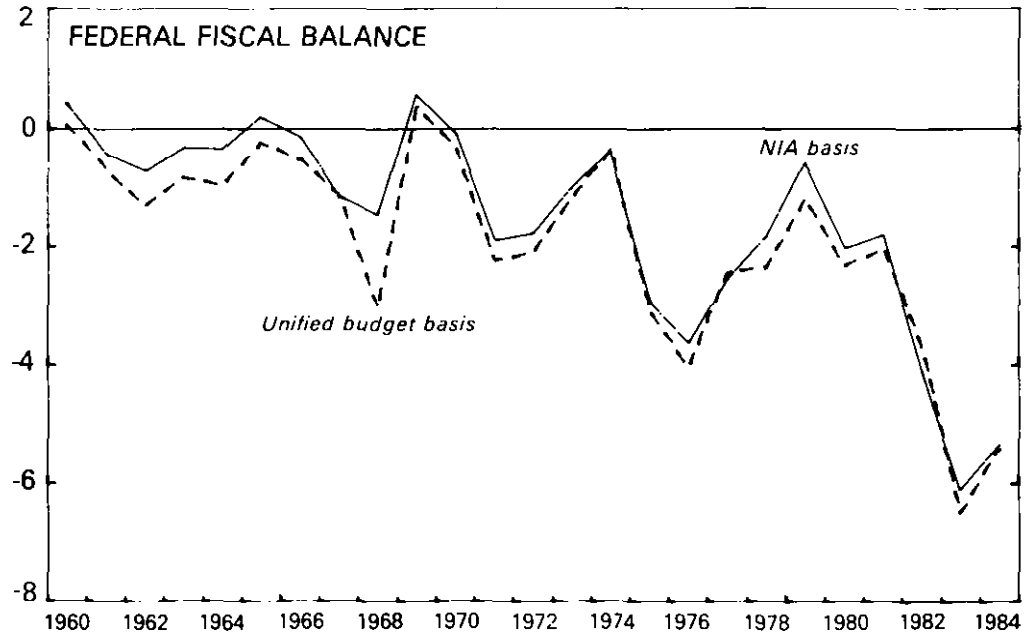


CHART 13

UNITED STATES

FISCAL TRANSACTIONS OF THE FEDERAL GOVERNMENT[1]





[1] Fiscal years, on a national income accounts (NIA) basis. Data for 1983 and 1984 are official projections made in April 1983.