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SM/88/160
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INFORMATION

August 25, 1988

To: Members of the Executive Board

From: The Secretary

Subject: United States - Staff Report for the 1988 Article IV Consultation

The attached supplement to the staff report for the 1988 Article IV consultation with the United States has been prepared on the basis of additional information.

Mr. Horiguchi (ext. 8486), Mr. Dunaway (ext. 8494), or Mr. Ebrill (ext. 8489) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

UNITED STATES OF AMERICA

Staff Report for the 1988 Article IV Consultation Supplementary Material

Approved by S. T. Beza and J. Boorman

August 25, 1988

This note summarizes information that has become available since the staff papers for the 1988 Article IV consultation with the United States were issued. The latest developments do not alter the thrust of the report on the policy discussions and the staff appraisal of SM/88/160, and indeed underscore the need to keep inflationary pressures firmly in check and to maintain progress in reducing internal and external imbalances.

1. Recent economic developments

According to national accounts data released on July 27, real GNP increased at an annual rate of 3.1 percent in the second quarter of 1988, following an increase of 3.4 percent in the first quarter, and reached a level 4.3 percent above that registered a year earlier. 1/ The main impetus to growth in the second quarter of 1988 came, as in the previous quarter, from business fixed investment and real net exports. Business fixed investment grew at an annual rate of 14 percent, reflecting a rebound in expenditures on structures as well as a continued robust rise in purchases of equipment. Real net exports of goods and services contributed 2 percentage points (annual rate) to output growth--despite a slowdown in export growth from the exceptionally rapid pace in the previous several quarters-- as imports declined at an annual rate of more than 6 percent.

Inventory investment in the second quarter of 1988, although substantial, was sharply lower than in the first quarter (and the final quarter of 1987) and subtracted 2 percentage points (annual rate) from output growth. As a result, total domestic demand rose at an annual rate of just over 1 percent despite a 3.3 percent growth in final domestic demand.

The fixed weight GNP price index increased at an annual rate of 4.7 percent in the second quarter, compared with 3.5 percent in the

1/ Table 1 provides national accounts data and staff projections. Table 2 on historical economic indicators updates, on the basis of revised national accounts data, a corresponding table contained in the staff report (SM/88/160).

first quarter. This was the sharpest increase since the third quarter of 1982. The pick-up in the rate of increase in prices was most evident in the case of personal consumption expenditures, particularly those on nondurable goods. 1/

As regards other data that have become available, industrial production rose by 0.8 percent (monthly rate) in July, compared with an average increase of 0.5 percent in the previous 12 months. Capacity utilization in manufacturing, mining, and utilities rose from 83.1 percent in June to 83.5 percent in July, the highest level since March 1980. Nonfarm payroll employment rose by 285,000 in July on the heels of an increase of 532,000 in June, bringing the cumulative job gains over the first seven months of this year to 2 3/4 million.

On the inflation side, the producer price index (PPI) excluding food and energy increased by 0.6 percent in July, twice the rise recorded in June. The consumer price index (CPI) excluding food and energy rose by 0.3 percent in July, after increasing by 0.4 percent in June. 2/ For the first seven months of 1988, the PPI excluding food and energy rose at an annual rate of 4.4 percent compared with 2.3 percent in the same period a year earlier; the CPI excluding food and energy increased at an annual rate of 4.7 percent compared with 4.3 percent in the same period a year earlier. The index of hourly earnings rose by 0.5 percent (monthly rate) in July, compared with an average increase of 0.3 percent in the previous 12 months.

The merchandise trade deficit on a Census basis for June (seasonally adjusted) was estimated at $12 1/2 billion, compared with $9 3/4 billion (revised from an initial estimate of just under $11 billion) in May. 3/ Exports declined by 2 1/2 percent in June to $26 3/4 billion while imports rose by 5 1/2 percent to $39 1/4 billion. 4/ According to data on a balance of payments basis just released, the trade deficit declined from $35 1/4 billion in the first quarter to $30 billion in the second. For the first half of 1988, the trade deficit on this basis is estimated to have been about $14 billion below the level registered in the same period in 1987.

1/ In the context of the annual revision of the national income accounts, data for the period 1985-87 were also revised on July 27. In particular, real GNP growth during 1987 (from the fourth quarter of 1986 to the fourth quarter of 1987) is now estimated to have been 5 percent compared with a previous estimate of 4 percent.

2/ Including food and energy the producer price index rose by 0.5 percent in July (0.4 percent in June) while the consumer price index increased by 0.4 percent (0.3 percent in June).

3/ Trade data on a Census basis differ from those on a balance of payments basis with respect to the coverage, timing, and valuation of transactions.

4/ It should be noted that monthly trade numbers are volatile and are often subject to large revisions.

The U.S. dollar has strengthened since late May, with its effective value (MERM weights) rising by about 7 percent by the third week of August. The real effective value of the dollar rose by 6 1/2 percent in June-July; its level in July was 38 percent below its peak in March 1985 and roughly equal to its previous low point in July 1980.

Because of the rise in the value of the dollar, staff projections now envisage somewhat higher current account deficits over the medium term than indicated in the staff papers. 1/ After declining from 3.4 percent of GNP in 1987 to 2.6 percent of GNP in 1989, the current account deficit is projected to widen again, reaching a little above 3 percent of GNP in 1993.

2. Revisions to the Administration's economic and fiscal projections

As part of the Mid-Session Review of the FY 1989 Budget released in late July 1988, the Administration revised its economic projections for 1988-93. Given the stronger than expected performance of the economy since estimates in the February 1988 budget were prepared, the forecast for GNP growth during 1988 was raised from 2 1/2 percent to 3 percent. At the same time, projected growth during 1989 was lowered by 1/4 percentage point to 3 1/4 percent because faster growth during 1988 was expected to bring the economy closer to full capacity leaving less room for growth in 1989. Growth over the period 1990-93 would average 3 1/4 percent annually, slightly less than projected in February. 2/

The unemployment rate, which has declined more quickly than previously envisaged, was projected by the Administration to average 5 1/2 percent (instead of 5 3/4 percent) in 1988. It would decline to about 5 percent in 1990 and remain at that level through 1993. The forecast for inflation (as measured by the consumer price index) was unchanged. Reflecting developments in the first half of 1988, the projected paths of interest rates for 1988 and 1989 were revised upward by around 1/2 percentage point.

On the basis of these economic projections, technical re-estimates of receipts and expenditures, and legislation enacted since the February budget, the Administration revised its fiscal estimates for the period FY 1988-93 (see tabulation below). The deficit for FY 1988 is now projected to be $152 billion, $5.5 billion larger than expected in

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1/ The projections presented here (and in the latest WEO documents) are based on a constant real value of the dollar at the level in the first half of July, which is about 5 percent above the level assumed in the staff papers for the 1988 Article IV consultation with the United States (i.e., the level in the first half of June).

2/ These revisions to economic projections are the same as those mentioned in footnotes 1 and 2 on page 7 of the staff report (SM/88/160).

February. While the estimate of FY 1988 receipts was raised owing to revisions in economic assumptions, this increase was more than offset by higher spending estimates, in part related to larger than expected expenditures to aid thrift and banking institutions.

For FY 1989, the deficit on a current services basis was reduced by $6 billion to $132 billion, mainly reflecting changes in the economic outlook. The current services deficit for FY 1990 was unchanged from the level estimated in the February budget, while those in subsequent years were raised. Measures being proposed by the Administration (yet to be enacted) would reduce the deficit in FY 1989 to $123 billion. The GRH baseline deficit for that year derived from the Administration's estimates was $140 billion, which would satisfy the GRH guidelines.

Alternative Estimates of the
Federal Fiscal Deficit 1/

Fiscal Years	Revised GRH Target (Billions)	Current Services Estimates: Billions of Dollars			Current Services Estimates: Percent of GNP			Administration's Budget Estimate	
		Admin.	Staff	CBO	Admin.	Staff	CBO	Billions of Dollars	Percent of GNP
1987	...	150	150	150	3.4	3.4	3.4	150	3.4
1988	144	152	152	155	3.2	3.2	3.2	152	3.2
1989	136	132	143	148	2.6	2.8	2.9	123	2.4
1990	100	111	129	136	2.0	2.4	2.5	102	1.9
1991	64	94	126	131	1.6	2.2	2.3	85	1.5
1992	28	80	126	126	1.3	2.0	2.0	65	1.1
1993	--	53	113	121	0.8	1.7	1.8	34	0.5

Based on the Administration's revised fiscal projections and adjusting for differences in economic assumptions, the staff has updated its current services estimates for the period FY 1988-93. It may be noted that for FY 1988 the staff assumes $4 billion in drought relief spending not included in the Administration's current services projections. This assumption is in line with the legislation enacted in August 1988. Revised budget estimates by the Congressional Budget Office show a profile for the deficit similar to the staff's.

The staff's fiscal projections continue to suggest that, in the absence of new policy measures, the year-to-year reductions in the fiscal deficit over the medium term would be rather limited. It should

1/ This tabulation updates the estimates provided on page 8 of the staff report (SM/88/160) on the basis of the Mid-Session Review of the FY 1989 Budget released July 28, 1988.

be noted that the budget estimates (of both the Administration and the staff) may understate spending, possibly by a sizable amount, because they do not allow for contingencies. In this regard, the greatest risks to the budget outlook this fiscal year and in FY 1989 are related to larger outlays by the Federal Saving and Loan Insurance Corporation than allowed for in the Mid-Session Review of the budget.

3. Monetary policy

In its monetary policy report to Congress in July 1988, the Federal Reserve reaffirmed the target ranges for 1988 for the growth of M-2 and M-3 established in February 1988 (4 to 8 percent for both aggregates) and announced tentative targets ranges for 1989. The Federal Reserve again decided not to set a target range for Ml for the second half of the year because of the continued uncertainty about the relationships between Ml, income, and interest rates.

Federal Reserve Targets and Actual Monetary Growth

(Percent changes at annual rates)

	1987		1988		1989
	Target	Actual	Target	Actual 1/	Target 2/
Ml	...	6.3	...	5.1	...
M2	5 1/2-8 1/2	4.0	4-8	7.5	3-7
M3	5 1/2-8 1/2	5.4	4-8	7.2	3 1/2-7 1/2

In his accompanying testimony to Congress, Chairman Greenspan cautioned against a growing risk of inflation stemming from greater pressure on resources, the upward movement of import prices, and recent drought-related rises in food prices. He noted that, considering the already limited slack in available labor and capital, a leveling of the unemployment and capacity utilization rates was essential if more intense inflationary pressures were to be avoided in the period ahead. He observed that the long run costs of a return to higher underlying inflation and the risk of this occurring under current circumstances were sufficiently great that Federal Reserve policy might advisedly err on the side of restrictiveness. The Chairman also emphasized the need to curb the growth of external debt and noted that the most direct and effective means to this end was to reduce substantially the federal budget deficit which remained the most important factor behind low national saving.

On August 9, 1988 the Federal Reserve raised its discount rate to 6 1/2 percent from 6 percent. In announcing the decision, the Federal

1/ Fourth quarter 1987 to second quarter 1988 at an annual rate.
2/ Tentative ranges, to be reviewed next February.

Reserve noted that this move was not only aimed at reducing inflationary pressure but was taken in light of the growing spread between market interest rates and the discount rate. The federal funds rate has risen somewhat since then, averaging a little above 8 percent in the third week of August.

4. Trade policy

On August 23, 1988, the President signed the Omnibus Trade and Competitiveness Act of 1988 passed earlier in Congress. 1/ The Act provides renewed presidential authority to enter into international trade agreements involving tariff reductions and extends the "fast-track" trade agreement authority. 2/

The legislation transfers from the President to the U.S. Trade Representative the authority to initiate expedited investigations of whether foreign trade practices violate a trade agreement or are injurious to U.S. trade, to make the final determinations in such cases, and to implement measures as appropriate. The Act also requires the U.S. Trade Representative to initiate investigations when countries are deemed to maintain pervasive unfair foreign trade practices.

The legislation revises U.S. laws regarding safeguard actions. In order to qualify for safeguard protection, industries must now demonstrate a preparedness to adjust positively to import competition in addition to showing serious injury from increased imports. Where such relief is warranted, the bill expands the range of actions that can be taken by the President; these now would include imposition of tariffs or quotas, international negotiations, and legislative proposals.

The legislation also seeks to strengthen protection of intellectual property and directs the U.S. Trade Representative to initiate expedited investigations of countries that do not afford protection of U.S. intellectual property. Among other provisions of the Act, the U.S. Trade Representative is required to negotiate with foreign countries to gain greater U.S. access to their telecommunications markets. The Federal Reserve is prohibited from designating, or permitting the continued designation of, foreign securities firms as primary dealers in U.S. goverment securities unless their governments accord reciprocal treatment

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1/ This legislation is virtually identical to the trade bill discussed on page 19 of the staff report (SM/88/160), except that it is stripped of two provisions cited in the President's veto message, one relating to mandatory advance notice of plant closings and the other relating to Alaskan oil exports.

2/ The "fast-track" authority provides for expedited consideration of trade legislation by Congress. A crucial feature of the procedure is that the legislation cannot be amended but must instead be considered as a whole.

to U.S. firms within one year. Authorization is provided for additional subsidies for U.S. agricultural exports.

While the immediate impact of the new legislation is not entirely clear, it appears to provide the potential for increased access to protection. To a large extent, however, the eventual impact of the law would seem to depend on how it is administered.

Table 1. United States: Real GNP and Components

(Percentage changes; quarterly data are seasonally adjusted at annual rates)

	Year-On-Year				Fourth Quarter On Fourth Quarter						
			Proj. 1/				Proj. 1/		1987	1988	
	1986	1987	1988	1989	1986	1987	1988	1989	IV	I	II
Real GNP	2.8	3.4	3.9	2.7	2.0	5.0	2.8	2.7	6.1	3.4	3.1
(previous estimate) 2/	(2.9)	(2.9)	(3.4)	(2.8)	(2.2)	(4.0)	(2.8)	(2.7)	(4.8)	(3.6)	(2.9)
Consumer expenditure	4.3	2.7	2.4	2.3	4.2	1.8	2.8	2.4	-2.1	4.5	2.3
Business fixed investment	-4.5	2.8	9.9	5.2	-7.3	8.8	7.6	4.6	1.7	7.6	14.0
Residential construction	11.8	0.1	-2.7	0.9	11.3	-3.5	-1.6	1.9	1.3	-6.5	2.8
Government purchases	4.0	2.6	0.6	2.7	2.9	2.3	1.0	2.0	5.0	-7.9	0.4
Final domestic demand	3.5	2.5	2.6	2.7	2.8	2.4	2.8	2.6	-0.1	1.8	3.3
Inventory investment 3/	0.2	0.5	0.2	-0.2	-0.5	2.1	-1.1	0.2	5.7	-0.1	-2.1
Total domestic demand	3.7	3.0	2.8	2.5	2.4	4.4	1.7	2.7	5.4	1.6	1.1
Net exports 3/	-0.9	0.2	1.0	0.2	-0.5	0.4	1.1	-0.1	0.5	1.8	1.9
Exports of goods and services	3.0	13.1	16.9	7.0	5.6	18.4	11.9	6.5	17.7	25.7	8.0
Imports of goods and services	9.4	7.9	6.3	4.9	7.6	10.4	2.1	6.5	9.9	6.9	-6.2
Memoranda:											
GNP deflator	2.7	3.3	3.0	4.1	2.8	3.1	3.5	4.1	2.4	1.7	4.1
CPI	1.9	3.7	4.1	4.5	1.3	4.5	4.5	4.3	3.5	3.2	4.9
Unemployment rate (percent)	7.0	6.2	5.4	5.3	...	...	...	...	5.9	5.7	5.5

1/ Staff projections in the context of the latest WEO exercise.
2/ Figures for 1986, 1987, and the first quarter of 1988 are based on estimates prior to the July 27, 1988 revisions to the national income accounts; projected data for 1988 and 1989 are as presented in SM/88/160.
3/ Contribution to the growth of real GNP.

Table 2. United States: Historical Economic Indicators

	Averages						
	1950s	1960s	1970s	1980-1987	1985	1986	1987
	(Percentage changes)						
Economic activity and prices							
Real GNP	3.9	4.1	2.8	2.4	3.4	2.8	3.4
Real net exports 1/	-0.3	-0.1	0.2	-0.5	-0.6	-0.9	0.2
Real domestic demand	4.2	4.1	2.6	2.8	3.8	3.7	3.0
Consumer spending	3.5	4.0	3.2	2.9	4.7	4.3	2.7
Business fixed investment	3.0	5.8	3.7	1.7	6.7	-4.5	2.8
Labor force	1.1	1.7	2.7	1.7	1.7	2.1	1.7
Employment	1.1	1.9	2.4	1.6	2.0	2.3	2.6
Unemployment rate (percent of labor force)	4.5	4.8	6.2	7.7	7.2	7.0	6.2
Labor productivity 2/	2.7	2.4	1.1	1.2	1.1	1.6	0.8
Total factor productivity 2/	2.1	1.7	0.4	0.3 3/	0.6	0.9	...
Capital stock 4/	3.7	4.1	3.6	2.7	3.5	2.6	2.4
GNP deflator	2.6	2.7	7.0	5.2	3.0	2.7	3.3
Fixed weight price index for GNP	...	1.9	5.6	5.3	3.3	2.8	3.6
Consumer price index	2.1	2.3	7.1	5.8	3.6	1.9	3.7
	(In percent of GNP)						
Balance of payments							
Current account	0.1	0.5	--	-1.7	-2.9	-3.3	-3.4
Trade balance	0.7	0.6	-0.5	-2.2	-3.0	-3.4	-3.5
Invisibles balance	-0.6	-0.1	0.5	0.5	0.1	0.1	0.1
Real net exports 5/	0.1	-0.5	-0.7	-1.1	-2.9	-3.7	-3.4
Savings and investment							
National saving	16.1	16.3	16.7	14.3	13.3	12.7	12.4
General government balance	-0.1	-0.3	-1.0	-2.7	-3.3	-3.4	-2.3
Of which: Federal	0.1	-0.3	-1.7	-4.0	-4.9	-4.8	-3.5
Gross private savings	16.2	16.6	17.6	17.0	16.6	16.1	14.7
Personal	4.7	4.6	5.6	3.9	3.1	2.9	2.3
Business	11.4	11.9	12.0	13.0	13.4	13.2	12.4
Gross private investment	16.2	15.5	16.4	15.9	16.0	15.7	15.7
Private savings/investment balance	--	1.0	1.2	1.1	0.6	0.4	-1.1
	(In percent)						
Monetary indicators							
Growth rate of M2 6/	...	7.0	9.8	8.7	8.9	9.4	4.0
Three-month Treasury bill interest rate	2.0	4.0	6.3	9.2	7.5	6.0	5.8
Ten-year government bond interest rate 7/	3.1	4.7	7.5	11.1	10.6	7.7	8.4

1/ Contribution to GNP growth.
2/ Nonfarm business sector.
3/ Average for 1980-86.
4/ Business sector.
5/ In percent of real GNP.
6/ Growth from fourth quarter to fourth quarter. Averages are compound growth rates.
7/ Average for 1950s is for 1953-59.