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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 81/109

10:00 a.m., July 31, 1981

J. de Larosière, Chairman
W. B. Dale, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	A. Yasseri, Temporary
J. Anson	L. D. D. Price
A. Buira	
J. de Groote	H. G. Schneider
R. D. Erb	D. E. Syvrud
M. Finaish	T. Alhaimus
T. Hirao	A. Nagashima
J. C. Iarezza	R. T. Salazar
	M. Casey
A. Kafka	J. R. Gabriel-Peña
B. Kharmawan	V. Supinit
S. Kiingi	F. Sangare
G. Laske	G. Winkelmann
G. Lovato	C. P. Caranicas
P. Mentré de Loye	T. Aulagnon
S. Nana-Sinkam	
	D. L. Kannangara
Y. A. Nimatallah	
J. J. Polak	
A. R. G. Prowse	
J. Sigurdsson	L. Vidvei
Zhang Z.	Tai Q.

L. Van Houtven, Secretary
K. S. Friedman, Assistant

Also Present

C. Taylor, Alternate Executive Director Designate. African Department: R. Franco. Asian Department: S. Kashiwagi, S. M. Schadler. Central Banking Department: C. Lubochinsky. European Department: S. M. Thakur, M. Xafa. Exchange and Trade Relations Department: C. D. Finch, Director; D. K. Palmer, Deputy Director; M. Guitian, Z. Iqbal, P. J. Quirk. External Relations Department: N. K. Humphreys. Fiscal Affairs Department: P. Short. Legal Department: G. P. Nicoletopoulos, Director; W. E. Holder, S. A. Silard. Research Department: W. C. Hood, Economic Counsellor and Director; C. F. Schwartz, Associate Director and Director of Adjustment Studies; R. R. Rhomberg, Deputy Director; C. P. Blackwell, J. Boughton. Treasurer's Department: J. R. Karlik. Western Hemisphere Department: E. W. Robichek, Director; S. T. Beza, Deputy Director; K. B. Bercuson, M. E. Bonangelino, E. Hernandez-Cata, Y. Horiguchi, J. R. Marquez-Ruarte, B. C. Stuart, E. C. Suss. Personal Assistant to the Managing Director: C. M. Watson. Advisors to Executive Directors: S. R. Abiad, C. J. Batliwalla, C. Bouchard, J. U. Holst, M. A. Janjua, K. V. Jännäri, G. Jauregui, F. A. Tourreilles, Wang E., F. Yeo T. Y. Assistants to Executive Directors: H. Alaoui-Abdallaoui, E. M. Ainley, A. F. P. Bakker, M. J. Callaghan, L. E. J. Coene, J. L. Feito, A. Halevi, J. M. Jones, P. Kohnert, J. S. Mair, M. Michelangeli, V. K. S. Nair, Y. Okubo, M. Z. M. Qureshi, H. Suzuki, P. S. Tjokronegoro, O. Üçer, J. F. Williams, T. H. Williams.

1. UNITED STATES - 1981 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1981 Article IV consultation with the United States (SM/81/157, 7/14/81; and Sup. 1, 7/28/81). They also had before them a report on recent economic developments in the United States (SM/81/158, 7/17/81).

Mr. Erb made the following statement:

The United States has been a leading supporter of effective Fund surveillance as an essential complement to the Fund's balance of payments financing activities. We continue to believe that surveillance should play an important role in promoting a sound, stable global economy. Consequently, I welcome the first formal Fund consultation on U.S. economic policies and performance under the Reagan Administration and hope that a full and frank discussion will allay some of the concerns that have been expressed about the impact of the new U.S. economic program on the world economy.

I would also like to take this opportunity to express my appreciation to the staff for the comprehensive and balanced report prepared for this consultation and to thank them for the very useful discussions held with the U.S. authorities in June. Many of my colleagues who had not participated in Article IV discussions before were impressed with the Fund team's knowledge of the U.S. economy and U.S. policies--current and historical.

Recent Economic Developments

The staff report describes the serious adverse developments in the U.S. economy during the past decade, including low economic growth, high unemployment, and rising inflation.

In setting the stage for the discussion of current U.S. economic policies, however, attention must also be given to broader sectoral and institutional developments over the past decade. Longer-term micro, macro, and institutional developments have had far more influence on the thinking and decisions of the Reagan Administration than macroeconomic fluctuations over the last year or so. These longer-term economic and economic policy developments have also influenced the attitudes of the American public toward the role of government and the traditional economic policies pursued by successive administrations. The public's recognition of the need for a fundamental change is reflected in the broad public support for the Reagan Administration's economic program.

A review of developments points to the follwoing central policy errors of the past which the President's economic program seeks to correct:

-- Frequent shifts in fiscal and monetary policies geared to stimulating or braking short-run demand too often behaved procyclically rather than countercyclically and curtailed longer-run growth in the economy by exacerbating uncertainties for private investors.

-- Pressures from the Congress and the Executive Branch too often induced the monetary authorities to lean against rising interest rates by printing more money. More money, however, fueled inflation and inflationary expectations, which in turn increased interest rates even further.

-- Personal and business tax policies ignored the impact of taxes ont the nature and magnitudes of saving, investment, and work effort.

-- An often capricious regulatory system failed to explicitly and adequately weigh the benefits of a regulation with the costs. In addition, regulatory policies relied primarily on administrative directive rather than price-oriented incentives for influencing undesirable social and economic behavior.

-- Selected price controls and interest rate ceilings have distorted the allocation of resources and delayed necessary adjustments in the U.S. economy. Energy producers, auto producers, banking institutions, and the savings and loans industry are examples of industries whose long-run strategic position has been hurt by such controls.

-- Foreign exchange market intervention policies (i) delayed necessary domestic policy adjustments; (ii) created uncertainty about the timing and magnitudes of intervention, which contributed to instability in the foreign exchange markets; (iii) delayed necessary exchange rate adjustments, thus precipitating market instability when the exchange rates were ultimately allowed to adjust; (iv) inhibited the development of market institutions geared to providing (directly or indirectly) stabilizing speculation.

U.S. Economic Policies and Prospects

Turning now to U.S. economic policies and prospects, the staff has done a good job of describing the economic aims and policies of the U.S. Government and the technical features of the various components of the economic program.

There has been a tendency for many commentators at home and abroad to attach labels to the economic program of the Reagan Administration. "Monetarist" and "supply side" are the terms most frequently used, but the analytical framework underlying the Administration's economic program is not captured by any one theory or school of economic thought. As Under Secretary of the

Treasury for Monetary Affairs Sprinkel explained to this group last week, the economic policies of the Administration are formed by a consensus process involving members of the Administration, the Congress, and the private sector. Although it is a diverse group, a number of central concepts emerged that have shaped the U.S. eocnomic program.

First, and reflecting a growing national mood, the economic policies of the Reagan Administration are based on a belief that economic growth is necessary for increasing social welfare, political stability, and international security. The various no-growth, zero risk arguments voiced during the last decade have not prevailed, and greater emphasis is being given to work, saving, investment, and risk taking.

Second, there exists a commonly shared view that economic decisions should be decentralized and made by the individuals and institutions that are in the best position to make the decisions affecting their economic welfare. In this regard, well-functioning markets in which prices accurately reflect demand and supply are of critical importance.

Third, given the pervasive impact of government policies on the decisions of workers, consumers, and producers, there is a strongly held belief that government has a responsibility to manage those policies in a stable and predictable manner rather than attempting to fine-tune policies. There is a high degree of respect for what is not known about the inner workings of the U.S. economy, its dynamics over time, and its interaction with other economies.

Fourth, there is a strongly held view within the Administration that the U.S. economy must once again become a source of international economic growth and stability. The dollar remains the central international currency and the U.S. economy remains the largest, most open economy in the world. Thus, price stability and stable but vigorous economic growth in the United States will benefit other countries in a variety of ways including the following:

-- Monetary and price stability on the domestic front will go a long way toward permanently restoring confidence in the dollar.

-- Monetary and price stability in the United States will contribute to stability in international as well as domestic financial markets.

-- A more stable domestic growth rate will reduce the volatility of U.S. import flows and thus contribute to economic stability in other countries, especially developing countries.

-- A higher domestic growth rate will provide larger market opportunities for foreign producers.

-- A more dynamic and innovative U.S. economy will provide more diversified market opportunities for foreign producers and better domestic job opportunities for those whose jobs are affected by foreign competition, thus easing protectionist pressures.

-- Price stability will eliminate the erosion in the real value of development assistance caused by inflation.

-- Higher domestic economic growth will increase the economic base underpinning development assistance programs.

Appraisal of U.S. Policies

Since the specific elements of the President's economic program are examined in detail in the staff's report, I will not describe them. As noted in the report, and as frequently stated by U.S. officials, all of the elements are interrelated and mutually reinforcing. This approach recognizes that the problems of inflation, unemployment, and declining productivity growth also are interrelated and mutually reinforcing.

Without tax cuts to encourage investment, without personal tax cuts to encourage total personal savings and a shift in savings from unproductive tax hedges toward productive investments, without a reduction in the relative size of government and the budget deficit over time, without regulatory reform, and without the elimination of price controls and interest rate ceilings, continued unemployment and declining productivity growth would ultimately undermine the efforts to reduce inflation. In short, the Administration's program is based on the premise that the fight against inflation not only requires a reduction in money growth but also a simultaneous increase in investment and a reallocation of resources within the economy from nonproductive to productive sectors. In this important sense, the program is a significant break from past efforts to reduce inflation and increase employment and productivity.

In the past, the usual recipe for fighting inflation called for fiscal and monetary demand restraint sufficient to induce slack in the economy to ease wage and price pressures but not so much slack as to undermine the program politically. This strategy that became known as "gradualism" required a degree of control over the level and time path of aggregate demand that eludes most governments. More importantly, by relying on reductions in aggregate demand, the "gradualist" approach discourages investment and also does nothing to encourage shifts in the allocation of labor and capital among sectors of the economy. Lower levels of investment and rigidities in the alloaciton of labor and capital among sectors of the economy in turn depress productivity growth and employment growth. The lack of productivity growth makes it more difficult to reduce inflation and the lack of employment growth. The lack of productivity growth makes it more difficult to reduce inflation and the lack of employment growth generates social and political problems.

The Fund staff report seems to be suggesting a third approach. The staff begins with the premise that "because inflationary expectations have become firmly entrenched, visible progress in reducing price and wage inflation is likely to require, for a time, a significant degree of slack in product and labor markets." While endorsing the policy of monetary restraint, and the proposals for reductions in government expenditture and tax cuts to improve incentives, the staff would like to see the budget deficit cut more rapidly, possibly by introducing a consumption tax.

The staff's concern about the size of the budget deficit apparently reflects the view that the deficit will create pressures for still higher interest rates and/or demands for an easing of monetary policy. I can assure you that the United States is determined to reduce the budget deficit and takes the goal of a balanced budget by 1984 very seriously. The Administration will not press for higher money growth.

However, we do not believe that a more rapid reduction is feasible or desirable. Experience strongly suggests that increased tax revenues (from deferring the tax cut or imposing a consumption tax) would be spent. The end result would be that we would have sacrificed the needed incentives to work, save, and invest while contributing little to reducing the deficit. Thus, a more rapid reduction in the deficit is likely to result in an even lower economic growth rate over the next year or two than the Fund staff forecasts for the Administration's program, which in turn is lower than the Administration's own real output forecast.

The Reagan Administration strategy thus differs fundamentally from the traditional "gradualist" and Fund approaches, both of which emphasize, in varying degrees, restraints on effective demand. The Reagan strategy, while limiting money growth, places equal emphasis on reallocation of resources to productive sectors to increase productivity, lower production costs, and increase factor supplies, including labor. Such shifts will augment monetary policy by contributing to a reduction in inflation.

Many foreign critics of U.S. economic policies seem to be closer to the Fund staff's policy alternative. As the staff paper notes, "the questions other countries have raised on the mix of U.S. financial policies have appropriately focused on whether fiscal policy should be tightened rather than on whether monetary policy should be eased." Underlying this view is a perception that a more rapid decline in the budget deficit would lower current and future interest rate levels, and thus reduce the exchange market pressures that allegedly force other countries to pursue higher interest rate policies.

However, suppose the U.S. budget deficit could be reduced more quickly. The effect on interest rates would depend on the impact of the deficit reduction on savings rates, the demand for credit, and inflationary expectations. If tax rate increases caused savings rates to fall, interest rates would tend to remain high. If overall credit demand and employment declined sharply, inflationary expectations and interest rates would probably remain high if it were thought that political pressures would result in a policy reversal. On the other hand, if inflationary expectations did decline and thus further contribute to a decline in interest rates, other countries would probably find little relief on the exchange market front and real interest rates would be unaffected.

In short, the relationship between the budget deficit and the level of interest rates is not straightforward. Nor is there a straightforward relation between interest rates and exchange rates--a subject I had better leave to another time. At the same time, most foreign advocates of tax increases fail to take into account the detrimental impact such increases ill have on U.S. growth and in turn the world economy.

With all the attention that has been focused on the impact of current U.S. interest rates on other countries, the advocates of a tighter fiscal policy have lost sight of the fact that other countries are linked to the U.S. economy through the flows of goods, services, and raw materials. Thus, if the budget deficit were more quickly reduced with tax increases, lower U.S. economic growth would result in lower export growth in the industrial and developing world during the near term. In such circumstances, I am sure that focus of the debate on economic policies would be quite different.

In closing, I would like to turn to the final conclusions of the staff's appraisal, which I believe best summarizes the situation all of as are in:

"It has to be recognized that pursuit by the United States of policies to cope with an inflation that has gathered great momentum inevitably will have effects--for example, on interest rates and aggregate demand--that may be regarded as undesirable by other countries. Of course, the degree to which other countries will be disturbed will vary, depending on their views about the pace at which inflation ought to be reduced and the policies best employed for that purpose. What other countries should be able to expect from the United States is a steadfast and consistent application of its anti-inflation program, which would enable them to develop their own policies with some certainty about the external environment."

Mr. Lovato said that recent developments in the U.S. economy were of paramount importance for the short- and medium-term future of the United States and had worldwide implications. The staff had reported the facts accurately but had made neither an overall judgment nor an in-depth appraisal of certain aspects of the U.S. economy; its comments on individual policies merely hinted at their international repercussions that were important to the Fund.

His authorities fully agreed with the U.S. Government's two main objectives: reducing inflation and, in the medium run, achieving economic recovery by increasing savings, investment, and productivity, Mr. Lovato continued. As the Administration's economic policy approach was based on supply-side measures, and the recovery program was to be stretched over three years, there would not likely be significant improvement in the economy for a while yet. The Administration assumed that the tax reductions that it favored would bring about the needed increase in savings, investment, and productivity, but it remained to be seen whether its basic assumptions about the working of supply-side policies were valid. The recently approved sharp tax cuts meant that during the coming several years there would be sizable budget deficits the financing of which would collide with the effort to maintain a tight money policy. In the short run, the tax reductions might well increase consumption demand.

The staff, Mr. Lovato went on, had forecast a lower rate of increase in production in 1982 than the U.S. authorities, and it favored permitting a significant degree of slack in product and labor markets to ensure the success of the fight against inflation. Presumably the budget defict would be even larger than the authorities now anticipated, the inflationary expectations would continue, and the level of interest rates would be even higher than the Government had projected. Indeed, many observers on Wall Street had no confidence in the new fiscal policy and were concerned about the short- and longer-run effects of the imminent large Treasury borrowing.

As had been the case in the past 12 months, Mr. Lovato noted, in the coming period the fight against inflation would probably rely primarily on monetary policy. However, it was widely felt that overemphasis on monetary policy could be dangerous, and that the authorities should maintain a mix of policies. Recent experience had shown that, while controlling the monetary base for short periods with a liberal fiscal policy was impossible, a tight money policy could restrain inflation only temporarily and at the high economic and social costs of a slump in economic activity and a considerable increase in unemployment. If the burden of economic adjustment was placed entirely on the private sector, a boost in investment in new plant and equipment and a consequent improvement in productivity could not reasonably be expected.

The recent slowing of the rate of inflation seemed to be the result of favorable developments with respect to nonlabor factors, Mr. Lovato remarked, but there was no reason to believe that it was due specifically to the tight money policy; a rigid commitment to a specific rate of growth of a particular measure of the money stock could not in itself cure inflation, even at an unacceptable social cost. Reducing inflation and shifting resources to savings and investment required continued monetary restraint, which naturally raised questions on the timing and magnitude of the restraint, and on the level and volatility of interest rates; in that connection, participants in the U.S. financial markets had become deeply concerned. Volatility was the inevitable result of a money supply strategy based on controlling the growth of bank reserves by focusing on short-term deviations rather than on the trend movement in the aggregates. Such a strategy encouraged the market to protect itself by building in an extra cushion in interest rates, and it created a climate of uncertainty that was not conducive to an increase in investment.

Even if the Government's supply-side policies worked, Mr. Lovato went on, the present monetary and financial situation would discourage the investment needed to restructure the production system. In addition, the high level and volatility of interest rates in the United States forced interest rates elsewhere to rise, thereby affecting at least one other component of the U.S. strategy--the exchange rate. Each economy had to maintain an economic policy stance that would enable it to fight inflation while readjusting the economic production structure, but the high level and the volatility of interest rates in such an important economy as that of the United States made it more difficult for other countries--particularly non-oil producing developing countries--to maintain stability and achieve economic recovery. One of the Fund's general guidelines was that in setting its own policies each member should take into account the effects of its policies on other members.

Labor costs and productivity should constitute important elements of a program for reducing inflation and restoring the level of production, Mr. Lovato remarked, but the Administration's supply-side strategy seemed to imply that economic expansion, smaller public deficits, and tight money could halt inflation without assistance from a wage-price policy. As labor costs accounted for the bulk of total costs and their rise had maintained the inflationary momentum, the absence of an incomes policy based on a consensus of the social parties concerned--rather than on imposed guidelines--could be a weak point in the Government's economic strategy. A less restrictive monetary policy than the authorities were now maintaining also could be helpful, as the present high interest rates could be exerting an upward pressure on wage demand by workers facing record high consumer loan costs.

The next step in the overall U.S. economic policy--introducing a certain degree of deregulation--could help to improve productivity, Mr. Lovato said; but he hoped that it would not be taken at the expense of maintaining a satisfactory quality of life in the United States. Finally, while he supported the Administration's goals, he doubted whether they could be reached with an economic policy based solely or largely on a very restrictive monetary strategy. He hoped that the authorities would be able to curb inflation and spur economic growth.

Mr. Anson stated that he basically agreed with the staff appraisal, which was realistic and identified the key issues that would have to be dealt with if the Government's policy approach was to be successful. The main problems facing the economy--inflation and low productivity growth--were interrelated, but the authorities had rightly decided to give the first policy priority to the effort to counter inflation, as success in that area would help stimulate savings and investment, thereby improving output and productivity over time; maintaining that approach was in the best interests of the world economy. The authorities had emphasized that achieving their objectives would require concerted action in the fields of monetary policy, taxes, expenditure control, and deregulation, and the staff had raised certain questions about the extent of the costs that the implementation of the Government's policies might involve, and about the speed at which the benefits could be secured.

Commenting on monetary policy, Mr. Anson said that he agreed with the staff that, given the entrenched nature of the inflationary expectations, a gradual but sustained reduction of monetary growth would be needed to achieve the inflation target without unduly wrenching the financial markets and seriously damaging the working of the economy. The authorities' decision to aim for the lower end of the M-1B target growth rate range for 1981 as a whole implied a considerable slowdown in the growth of the monetary aggregate, an exceptional increase in the velocity of money, and a cautious outlook for the growth of output in the coming year; and there seemed to be some risk that the financial markets could be upset and that the working of the economy could be seriously damaged. The staff data clearly showed that the savings and loan associations had already experienced serious outflows; it would be useful to have the staff comment further on the implications of that development.

He agreed with the U.S. authorities, Mr. Anson continued, that the function of monetary policy should be to control aggregate demand, but the timing of the effect of the policy on inflation depended in part on the policy's impact on cost and price expectations. The Administration's 1981 mid-year economic forecasts had included an increase in wages and salaries of 11.6 per cent in 1982. While the rate of increase in wages might perhaps tend to be sticky because of the existence of multiyear contracts, a rate of increase as high as 11.6 per cent might well undermine the attempt to slow the rate of inflation and to achieve the rapid rise in the rate of growth of business fixed investment that was needed to ensure the recovery of output. In the light of the most recent data, what was the staff's view on the outlook for wage costs and productivity in 1982?

Close attention should be paid to the behavior of real interest rates before and after taxes, Mr. Anson considered. Despite the high real pretax interest rates, borrowing had remained substantial, while the after-tax real return on savings by individuals had continued to be low and, in some cases, negative. As the authorities had mentioned, the problem seemed to stem in part from the high marginal rates of personal taxation, but another contributing factor might well have been the tax deductibility of interest payments, which made individuals more willing than they would be otherwise to borrow at apparently high nominal rates. Some structural change in the interest rate area might ease the problems of monetary management and help to reduce the level of credit demand and, hence, of interest rates.

The fiscal measures that would likely be taken in the coming period had nearly been finalized, Mr. Anson noted. The planned tax reduction of 25 per cent was not much larger than the 22 per cent addition to the tax burden that the authorities had estimated would result from "bracket creep" and higher social security taxes. The most interesting element of the new tax legislation was the permanent indexation of the tax brackets after 1984. Strong arguments could certainly be made in favor of such an arrangement; in particular, it would reduce the risk that the growth in tax yield due to inflation would facilitate devoting a constantly rising proportion of GDP to public spending. The price to be paid for the indexing approach was some reduction in the room for maneuver in economic management, and its introduction after 1984 would make it all the more important to hold expenditure levels down if the Government's aim of eliminating the federal budget deficit was to be achieved.

Although the federal deficit was not large by international standards, Mr. Anson went on, influencing expectations was at the core of the Government's policy approach, and maintenance of the published timetable for eliminating the deficit would be an important element in that respect. The 1981 mid-year budget review, which did not take account of the indexation proposal, projected that, after an approximate balance in the federal accounts in 1984, there would be small surpluses in 1985 and 1986, and that after a decline in federal expenditure in real terms up to 1984, there would be an increase in real terms between then and 1986. What effect would the introduction of indexation have on the Government's revenue and expenditure projections? Would the indexation offset all or part of the projected budget surplus, or perhaps even cause a return to a deficit? Expressions of concern about the federal deficit need not imply that action on the tax side should be deferred or reduced; rather, they underscored the need both to achieve the planned reduction in federal expenditures and to identify the further spending cuts required to meet the Administration's budget targets. In addition, the authorities should be ready to take corrective action if there were unexpected increases in the so-called uncontrollable expenditures, such as debt interest payments. Was the Administration prepared for such a contingency?

He wondered, Mr. Anson continued, how far the proposed spending cuts would go toward meeting the authorities' objective of freeing resources for use in the private sector. The projections in the 1981 mid-year budget review seemed to imply that over the next five years there would be an increase in the proportion of federal expenditure that would take the form of direct expenditure on goods and services, thereby reversing the general trend of the 1970s. Hence, the proportion of GNP taken by direct federal expenditure on goods and services might not fall significantly, and might even rise; and the reductions in grants to state and local governments could have a fairly limited impact on total public sector spending if the governments chose to maintain services at the cost of higher state and local taxes.

On pages 57 and 58 of SM/81/158 the staff had reported on an interesting study of the implications of tax cuts for savings, Mr. Anson noted. In view of the central place that the Administration had given to the stimulation of savings and investments through tax cuts, it would be useful to know the reaction of the authorities to the staff's analysis.

The authorities seemed to feel, Mr. Anson remarked, that the major inducement to energy conservation should come from the market pricing of energy products. He wondered what the authorities' latest intentions were with respect to natural gas prices.

During the consultation discussions, Mr. Anson said, the authorities had projected a deficit of $25 billion in 1982 while the staff, having made different assumptions about growth and the average dollar exchange rate from those of the authorities, had projected a near balance. Since then, there had been a marked increase in the exchange rate. Given the likely constraints on the growth of output in the short term, the staff might well be right in projecting a considerably lower deficit than the authorities; indeed, the Administration itself had somewhat scaled down its own initial forecast. It would be interesting to have the latest views on the likely size of the external deficit and on the implications of the deficit for the exchange rate.

Mr. Kafka commented that the United States, the world's largest economy, was engaged in a fascinating experiment to reverse a trend of low productivity growth and high inflation in a manner that was designed to be very nearly painless for it. The staff reports and Mr. Erb's statement had sketched the Government's model for achieving the desired results and should help Executive Directors to judge whether the authorities' theory was consistent and realistic in the present circumstances. In general, although the theory accepted by the authorities was correct, it might well be difficult to apply. According to the model, reductions in personal income tax rates and the assurance of future indexation of tax brackets created incentives for work and savings, while reductions in corporate taxes provided incentives for business investment and risk taking, thereby ensuring that the economy would expand. Presumably the physical capacity and human resources needed for the initial recovery already existed, and the tax base could expand, permitting tax revenues to rise in real terms even while declining somewhat in relation to GNP. It was not clear to him whether the Administration assumed, as had Professor Laffer, the originator of the model, that there would be a full recovery of tax collections as a result of growth in real output. Judgments on the advantages and the timing of the tax rate reduction strategy compared with other possible policy approaches would be affected by the rates of recovery and real growth (after allowing for cyclical factors).

At the same time, there were to be impressive expenditure reductions, Mr. Kafka went on, so that, even at the outset, and irrespective of the tax collection recovery, the budget deficit need not rise in the program period. To the extent that it did not rise, the relationship between financial savings and the budget deficit would have to improve because part of the tax rate reduction would be reflected in additional savings. In any event, the deficit would probably be relatively small, equivalent to less than 2 per cent of GNP. The proposed program would be significant even if it succeeded merely in reducing the public sector's share of GNP--thereby leaving only a relatively moderate deficit to finance--and introduced permanent indexation of personal income taxes and the so-called expensing of business investment; but, in fact, the program aimed at achieving much more.

Commenting on the policies that the authorities planned to use to reduce inflation, Mr. Kafka said that, even though the overall policy objective was to achieve growth in output and in productivity, a tight monetary policy would be essential. In the circumstances, the question naturally arose whether the desired expansion of the tax base through an increase in real output was likely to occur. If the initiation of the program caused a rapid reversal of expectations, thereby enabling interest rates and nominal wage demand to decline, the Government should have no difficulty in meeting its main objectives. However, what would happen if there was not a rapid reversal of expectations? It was no longer realistic to expect the mere announcement of a sound policy to produce rapid effects, such as had been evident after the German inflations of 1923 and 1948, and when Italy had dramatically reduced inflation in 1947. If it was true that expectations could not be easily reversed, the staff had certainly been right in concluding that a lengthy period of enforced slack in the economy would be required to reduce the rate of inflation. However, the tight monetary policy that would be needed to slow the inflation might prevent the desired expansion of the economy and of the tax base. The staff had raised an important unanswered question, namely, what would be the likely increase in the velocity of circulation as a result of the projected monetary policy?

The concern about the Government's monetary policy was traceable in part to the deductibility of interest payments from income taxes, Mr. Kafka went on. If monetary policy was to be effective in the United States, interest rates would have to be particularly high for a while compared with interest rates in countries that did not permit interest payments to be deducted from income taxes. In the circumstances of the United States, he agreed with the staff that tightening fiscal policy by raising indirect taxes could be helpful, provided that the increase in those taxes was not reflected in the indices to which wage and price adjustments were tied. That goal could be accomplished in two ways: first, the beneficiaries of indexation could be persuaded to accept an expurgated index; second, an attempt could be made to raise revenues by taxing those commodities and services that had a relatively small weight in the index and the demand for which was not excessively price elastic. Otherwise, there would be a potentially disagreeable dilemma involving the need to create confidence by maintaining the income tax cuts, and the desirability of avoiding an excessive rise in the budget deficit which, according to some observers, itself had an effect on expectations. The importance of the dilemma was seen particularly in the fact that, while specific tax reductions had been approved for the coming three years, corresponding expenditure reductions had been approved for only one year. The authorities had undoubtedly formulated contingency plans if things did not work out as was now expected.

The authorities' intention to proceed with efforts at deregulation was welcome, Mr. Kafka stated, and he was pleased that they planned to maintain their support for the program to develop synthetic fuels, as it would help both the United States and other countries. The Government's policy on synthetic fuels seemed to be consistent with the view that the World Bank should act--directly or through an affiliate, and with additional resources or through a change in the gearing ratio--to support the developing countries' search for substitutes for imported petroleum, rather than leave the effort entirely to private enterprise, which, however, certainly had an important and useful role to play.

The determination of the authorities to resist protectionist measures was encouraging, Mr. Kafka went on, but, in the eyes of those affected, the difference between voluntary export restraints and involuntary import restraints was slight. In addition, the references in the recent Ottawa communiqué to temporary protection struck an ominous note.

As for exchange rate policy, Mr. Kafka said, the authorities understandably wished to minimize intervention in the exchange markets so that their high interest rates would not lead to an undesired expansion of the monetary base. However, it might be possible to find a compromise between the rigid defense of a range of exchange rate relationships and the unhindered movement of the U.S. dollar to levels that might be difficult to sustain and which might have disagreeable consequences for the United States itself.

That the United States intended to continue devoting a relatively low proportion of its resources to official development assistance was disappointing, Mr. Kafka remarked. It would be even more disappointing if the share of U.S. assistance that was channeled through multilateral institutions was further reduced, so that the activities of multilateral institutions, including, perhaps, the Fund, had to be scaled down.

A possible substantial rise in the U.S. current account deficit in 1982 was foreseen by the authorities but not by the staff because each had made different growth forecasts, Mr. Kafka remarked. The deficit had both positive and unfavorable aspects from the point of view of various other countries. The rise in the deficit was unlikely to reflect an increase in the oil deficit, and it would therefore probably improve the current account position of the rest of the world, including the non-oil developing countries.

The Government had adopted a courageous program, Mr. Kafka considered. He hoped that the reversal of expectations would be sufficiently rapid to permit the income tax rate reductions and tax reform to reinforce monetary policy, thereby slowing inflation while encouraging an increase in output, even in the initial stages.

Mr. Laske commented that the staff reports clearly explained the risks and likely consequences of the Government's economic policies for both the United States and the world at large. The new Administration faced a wide range of economic difficulties, particularly a relatively rapid rate of inflation, modest economic growth, low productivity gains, and a high level of unemployment. The staff had correctly noted that the difficulties had their origin in developments that had taken place as early as the second half of the 1960s. Other industrial countries, including Germany, faced similar problems that could be traced to the same roots, and the economic program that had been presented by the new Administration and recently approved by Congress had been closely followed by policymakers in many countries. His authorities were particularly impressed by the persistence and skill that the authorities and the President had shown in convincing the public at large and the majority of members of Congress of the need for such far-reaching policy changes. His authorities broadly agreed with the thrust of the new program, although they had some lingering doubts about certain elements of it, were concerned about its potential repercussions on other countries, and questioned to some extent a few of the key assumptions underlying the Administration's projections. He would comment on the main elements of the new economic program: fiscal and monetary policy, and the authorities' attitude toward intervention in the foreign exchange markets.

The Government's objective of practically eliminating the fiscal deficit by FY 1984 was highly commendable, Mr. Laske considered. The Administration had been very successful in slashing expenditure programs for FY 1982 substantially below what they would have been otherwise, but cuts needed to meet the expenditure targets in subsequent years had not yet been identified, thereby causing him to harbor some doubt whether the authorities' ambitious targets were consistent with the realities of everyday politics. However, the determination with which the expenditure cutting exercise for FY 1982 had been carried out gave solid reassurance that those efforts would be continued.

The attainment of the budgetary objectives could be placed in jeopardy by risks that were being run on the revenue side, Mr. Laske went on. In its appraisal the staff had observed that the Administration might be paying inadequate attention to the federal revenue base. During the public discussion in the United States on the Administration's fiscal approach, a great deal of interest had been expressed in the likely effects on economic growth of the newly adopted tax cuts and of the liberalization of the depreciation rules for business, and there was some doubt whether the transmission mechanism assumed by the Administration would in fact operate as was expected. In any event, he wondered whether the quantitative contribution to growth that the Administration expected from the tax cut and from the improvement in the depreciation allowance was not overoptimistic. A precise answer to the question was of course difficult to find, but it was notable that both the Fund staff and the OECD had forecast substantially lower growth rates than the Administration.

The authorities' hope for relatively rapid growth as a result of their tax measures rested on the expectation that there would be a significant increase in the savings rate and in business investment, Mr. Laske went on. In that connection, the simulations presented in Appendix 1 in SM/81/158 were particularly interesting, as they indicated that, while the additional savings flowing from the reduced income tax burden would be significant, they did not necessarily justify the authorities' expectations. Another important implication of the simulations was that there would probably be diminishing returns from the tax cut over time, once consumers had adjusted their permanent expectations to their increased income; the Administration might well have underestimated the effects of the tax cut on demand and inflation, and might have overestimated the effect on supply.

The projected winding down of monetary expansion--which he fully supported--would exercise an effective check on economic growth, and there was no assurance that the authorities would be able to meet their revenue objectives, Mr. Laske said; if necessary, they would have to take remedial action to keep the budget deficits from overshooting the mark. In its appraisal the staff had noted the various negative effects that persistent large fiscal deficits would have, and he was concerned that their occurrence might be seen as evidence of failure of the Administration's new policies, thereby creating pressures for them to be reversed. In the fifth paragraph on page 18 (SM/81/157) the staff discussed possible ways of securing the envisaged reduction in the fiscal deficit. Would the authorities consider the possibility of strengthening the revenue base by increasing the reliance on consumption taxes if the reduction of the budget deficit fell short of expectations?

The stability of the U.S. dollar was of overriding importance for the world economy, Mr. Laske remarked; past experience had clearly taught, sometimes painfully, that economic developments in the United States affected all other member countries. Inflation in the United States had been persistently rising for a number of years, and the new Administration's policy stance was designed to reduce the inflation and the inflationary expectations, something that his authorities fully approved. He was very pleased that in recent months the rate of inflation had shown signs of slowing; the consumer price index appeared to have risen by less than the double digit figures that had become almost customary. He fully recognized, in part from Germany's own experience, that the fight against inflation could not succeed without a monetary policy that kept the increase in the money supply in line with the growth potential of the economy.

Such a stance, Mr. Laske went on, required positive real rates of interest, a requirement that had unfortunately often been overlooked or neglected by a number of countries. The high level of nominal and real interest rates in the United States was a direct result of the determination of the authorities to reduce the rate of inflation, although certain institutional factors might have helped to push interest rates higher than was needed to ensure a successful attack on inflation and inflationary expectations. One such factor was the mix of fiscal and monetary policies, which Executive Directors had discussed extensively during the most recent World Economic Outlook exercise and to which the Interim Committee had devoted considerable attention. Attaining their budgetary objectives would help the authorities to make the desired improvement in their policy mix. Another factor in the interest rate trend was the extensive use in the United States of consumer credit; Table 19 in SM/81/158 showed that consumer credit had been constantly rising in the period 1976-78, when inflation had clearly become entrenched. The rather negligible increase in consumer credit in 1980 was apparently due exclusively to the effect of the temporary credit restrictions that had been in effect in the second quarter. At the same time, it was noteworthy that, in the first quarter of 1981 the increase in consumer credit was larger than it had been in the same quarter of 1980, and he wondered whether the impact of the Federal Reserve's tight money policy had not yet been felt in that particular sector of the financial market. The provision permitting the full deductibility from taxable income of interest payments on personal debt had undoubtedly contributed to the upward trend in consumer credit; it clearly encouraged current consumption and discouraged saving in the form of financial assets. Such generous tax treatment of the cost of personal indebtedness was not appropriate at a time when all other economic policy efforts were being directed toward strengthening the savings effort by both the private and public sectors.

It was well known, Mr. Laske continued, that the authorities in Europe were somewhat worried about the strong volatility of interest rates in U.S. financial markets during the previous 12-15 months. His monetary authorities were aware of the need to have high interest rates when inflation was excessive, but they were concerned about the violent swings that interest rates had shown because of their harmful effects on the exchange markets and on interest rates in other countries. The Federal Reserve's own studies--such as the report presented to Congress by Chairman Volcker in February 1981--had concluded that the increase in the volatility of interest rates was at least partially attributable to the open market operating procedures that had been adopted in 1979, and the Administration's intention to consider possible modifications of the procedures in the area of reserve requirements was welcome.

The German monetary authorities had adopted certain measures that had helped them to avoid pronounced interest rate volatility, Mr. Laske said. There was of course an important difference between the U.S. and German approaches: although both central bank systems established monetary targets in the form of ranges, the Federal Reserve aimed exclusively at the level of nonborrowed reserves and left the determination of interest rates to market forces, while the Bundesbank used interest rates as a means of achieving its monetary target and as an indicator to the market of the direction in which it wished to see monetary developments move. While the overall objective was the same, the techniques used were different.

Another important, although technical, difference, Mr. Laske continued, was that while the Federal Reserve published developments in the monetary aggregates on a weekly basis, the Bundesbank published comparable figures only at monthly intervals, having discontinued weekly publication in the 1950s, feeling that such short reporting periods served no useful purpose. The publication of the movement of monetary indicators over very short periods might well invite market participants to anticipate expected actions by the monetary authorities, especially when the indicators were relatively narrow based and were therefore subject to large swings. Not surprisingly, in the United States such anticipatory, speculative actions had led to excessive movements, which in turn had apparently forced the Federal Reserve to intervene in the market. Hence, his authorities wondered whether the Federal Reserve had found the optimal means of achieving a stable money supply and of avoiding excessive interest rate fluctuations. In the past, the Federal Reserve seemed to have occasionally reacted somewhat too eagerly to swings in the monetary aggregates, which might well have been self-correcting through market forces in relatively short periods. He hesitated to agree with the staff that the credibility of the Federal Reserve policy stance required quick reaction to deviations from the desired monetary growth path. However, he did agree that the markets would gradually gain experience in interpreting the new monetary approach, something that would help to reduce the volatility of interest rates.

The fundamental change made by the Administration in the country's exchange market intervention policy was consistent with the authorities' basic view that market forces should determine the level of the exchange rate, Mr. Laske observed. However, the U.S. dollar continued to be the most important currency because of its role as a reserve instrument and as a transactions currency, and the U.S. authorities bore particular responsibility for the extent, speed, and predictability of movements in the exchange rate of the dollar. The notion of "disorderly markets" should therefore not be interpreted too narrowly, especially when movements in the rates were caused less by changes in the so-called fundamentals, than by unrealistic market expectations about future economic and political developments. Experience had shown that the markets were frequently motivated by unrealistic expectations, and that in such circumstances intervention in close coordination with the authorities of the major currencies was not out of place.

His authorities, Mr. Laske said, greatly appreciated the determination of the U.S. authorities to resist any intensification of protectionism and to reduce existing barriers to international trade. However, they were somewhat concerned about recent protection-like voluntary agreements, which might well set unfortunate examples that would make it all but impossible for other important trading countries to remain on the path of free trade.

Mr. Mentré de Loye commented that, given the large size of the U.S. economy, the Administration's strategy should be seen in the light of both its international and its internal effects. That fact had been mentioned a number of times during the most recent OECD ministerial meeting, at the Ottawa summit, and in the staff reports.

Achievement of the authorities' main policy objective of bringing inflation under control, Mr. Mentré de Loye remarked, would certainly benefit both the United States and other countries, and the authorities were to be commended for their commitment to restoring sound economic domestic conditions. A major development in recent months was the substantial slowdown in the rate of inflation: the GNP deflator in the second quarter of 1981 stood at 6 per cent, and there was widespread agreement, between the staff and the U.S. Administration especially, that the figure for the year would be about 10 per cent. However, he wondered whether the GNP deflator of 7 per cent forecast by the staff for 1982, which was close to the 7.2 per cent forecast by the Administration, might not prove to be somewhat optimistic for a number of reasons. The question in fact arose whether the deceleration of prices might not prove less rapid and pronounced than currently expected, on the basis of several considerations. First, there were few signs of moderation in wage pressures, as the compensation of employees had continued to accelerate in the first quarter of 1981; hourly earnings were now running at a rate of more than 9 per cent. Second, the downward trends of special factors--such as energy prices, retail food prices, commodity prices, and the cost of home ownership--which had helped to bring down the rate of increase in the consumer price index in recent months, might well be shortlived. Third, it remained to be seen whether gains in productivity would contribute to moderating the upward trend in unit labor costs, which had continued to advance in the first quarter of 1981, apparently largely for cyclical reasons.

There was a difference of opinion, Mr. Mentré de Loye noted, between the staff and the authorities with respect to the likely rate of economic growth in 1982, the Administration predicting 5.2 per cent, and the staff 2 per cent. That range, however, seemed consistent with the range of projections of private forecasters. The major uncertainty was the amount of time that would be needed for the new fiscal policy to cause the expected upswing in savings and investment. In all likelihood, it would probably occur no sooner than the second half of 1982, when the second planned reduction in personel income tax rates was to be implemented. The recovery from the slowdown in activity in 1981 could take place somewhat later than the Administration expected, in which event the actual rate of growth in 1982 would be comparable with the rate in 1981 and would be closer to the staff's prediction than to the Administration's.

The four interdependent parts of the Administration's program for economic recovery constituted a comprehensive new approach to the interrelated problems of high inflation, slow growth, and poor overall economic performance which had plagued the U.S. economy in recent years, Mr. Mentré de Loye said. The authorities' commitment to restoring noninflationary growth by introducing incentives for savings and investment was certainly commendable. But it raised a question that was important for the partners of the United States and for the world economy as a whole, namely, whether the kind of policy mix that was being implemented would minimize the recessionary impact on other countries of the U.S. counterinflation effort. In that context, it was important to note that each part of the overall program had been given a different weight, and that the authorities seemed to be giving far greater emphasis to controlling monetary aggregates than to their efforts to reduce the fiscal deficit and the degree of regulation.

The objective of fiscal policy--to reduce the share of GDP absorbed by the Federal Government, was unlikely to be achieved before the second half of 1982, Mr. Mentré de Loye continued. Thus, during the coming 12 months, the persistence of substantial fiscal deficits might adversely affect inflationary expectations and delay the return to lower interest rates; and the likelihood of unexpectedly large fiscal deficits would increase if the economic recovery was actually weaker than was now foreseen. Hence, he fully agreed with the staff that fiscal policy could end up being too loose, with adverse effects on interest rates.

He agreed with Mr. Anson, Mr. Mentré de Loye went on, that the deductibility of interest payments from taxable income had undesirable effects. It would be useful to receive further comments on the possible evolution of the tax system in coming years, including the treatment of capital costs as current expenses, the elimination of the double taxation of dividends, and the integration of the personal and corporate income tax systems. The decision to index personal income tax brackets after 1984 was consistent with the aim of limiting the growth of federal revenues in relation to GNP, but it would introduce a rigidity in the management of fiscal policy and reinforce the need for steady control of federal expenditure. The difficulty in maintaining such control was evidenced by the need to make additional spending cuts that had not yet been identified and that might prove difficult to get Congressional approval, solve the problems with the social security system, and by the authorities' wish to increase sharply defense expenditures. As a result, the magnitude and the timing of the new tax package was a matter of concern, as the tax reductions seemed to be preceding the needed corresponding restraint on public expenditure.

Commenting on regulatory reform, Mr. Mentré de Loye stressed the national and international importance of removing the controls on natural gas prices. The authorities apparently had not paid sufficient attention to the need for microeconomic policy measures designed to deal with some of the structural causes of inflation. For instance, recent Congressional decisions concerning agricultural prices, such as milk, sugar, cotton, corn, and wheat prices, were not consistent with the priority the authorities were giving to the fight against inflation. Insufficient attention also had probably been given to the likely effects of the recent decision increasing the legal minimum wage.

Because there was some uncertainty about the probable evolution of fiscal policy, and because the effort at deregulation would take some time to have a positive effect, Mr. Mentré de Loye continued, the authorities were relying to an important extent on monetary policy. He fully agreed with them that progressive reduction in the rate of growth of the money supply was needed to slow inflation, and that the Government's monetary objectives implied a gradual reduction of the money supply, as evidenced by the fact that, assuming the aggregates would remain close to the upper end of the ranges, the reduction in the growth of the money supply in 1981 over 1980 would not exceed half a point. But he, like Mr. Laske, wondered whether the operating procedures that were being used to implement the monetary policy were fully appropriate. In order to achieve a gradual reduction in the money supply, interest rates had reached record highs in recent months, and the question naturally arose whether the Government's goals could not be achieved through some other means. The Administration and the Federal Reserve had begun discussions on the most appropriate way in which to compute reserves, adjust the discount rate, and maintain access to the rediscount windows. As Mr. Laske had suggested, the authorities might have been relying too heavily on making rapid corrections of deviations from monetary aggregates, and the publication of weekly figures for the aggregates might well have been contributing to the instability in the markets and the considerable interest rate volatility, developments that had important consequences for domestic interest rates in other countries.

The outlook for the external current account was certainly favorable, Mr. Mentré de Loye said. As a result of the sluggish economic activity, a surplus in the range of $5-10 billion was expected in 1981 after two years of approximate balance. If the economic recovery was moderate, as the staff had implicitly assumed, the current account would probably register a deficit in the range of $5-10 billion in 1982. Accordingly, the fundamental position of the external accounts was not expected to change much during the coming two years.

The favorable current account position during the previous 18 months and the moderately favorable prospects for it in coming months had undoubtedly had an important effect on the evolution of the dollar against other major currencies, Mr. Mentré de Loye remarked. At the same time, the sharp appreciation of the dollar against some major currencies, particularly the currencies of the European Monetary System (EMS), had been closely related to the existence of large interest rate differentials and had resulted in a considerable degree of overshooting. In addition, the extreme volatility of U.S. interest rates had caused wide fluctuations in exchange rates, which had clearly not been warranted by underlying economic conditions. The overshooting and the erratic variations in exchange rates had disrupted the exchange markets. The intervention policy of the U.S. authorities together with the establishment of the

EMS had contributed to the stability of the exchange markets which had prevailed in 1979 and early 1980, but the present Administration had stated its intention of returning to the pre-1978 policy of intervening in the market only when there was a need to counter disorderly conditions. His authorities wondered whether the U.S. Government's definition of "disorderly conditions" might not be excessively narrow, and they doubted whether it was fully consistent with the Fund's exchange rate policy guidelines adopted in April 1977, which stated in part that "a member should intervene in the exchange market if necessary to counter disorderly conditions which may be characterized inter alia by disruptive short-term movements in the exchange value of its currency." In recent months, the daily variability of the U.S. dollar against European currencies had exceeded 2-3 per cent and might be seen as constituting disorderly conditions. The intervention policy of the U.S. authorities was a matter of great concern to other countries and warranted further discussion by the Fund, the United States, and its major partners.

Commenting on trade policies, Mr. Mentré de Loye said that he agreed with the staff that resistance by the United States to protectionist measures was in the best interests of the international community and of the authorities' own counterinflation program. However, his authorities felt that the trigger price mechanism for steel imports constituted a nontariff barrier to trade by preventing European exporters from selling at fair value without recourse to a clearance procedure, and by not permitting exporters to take advantage of the appreciation of the dollar. However, his authorities had noted with satisfaction the recent statement by the U.S. authorities to the effect that the trigger price mechanism would not serve as a minimum price policy.

The low and declining ratio of U.S. foreign aid to GNP and the failure of the United States to fulfill its commitments concerning the replenishment of IDA resources were regrettable, Mr. Mentré de Loye remarked. It was of course difficult to maintain aid programs at a time when cuts were being made in sensitive domestic programs, but that problem was common to other industrial countries, and the U.S. authorities might wish to consider possible ways of improving their presentation and explanation of foreign aid programs in order to gain a better balance between Congressional actions on domestic and foreign aid programs.

He appreciated the courage and determination that the U.S. authorities were showing in their efforts to restore conditions for sound economic growth through a comprehensive set of policies, the success of which would clearly benefit the world economy as a whole, Mr. Mentré de Loye concluded. However, the Government's strategy ran the potential danger of relying excessively on the control of monetary aggregates, thereby hampering for a protracted period domestic activity and investment in the United States and abroad. In addition, when the most important country refrained from intervening in the market, the effort to stabilize the exchange markets could not be successful. A country could not be expected to intervene in the market to defend its currency if there was no cooperation among all the other countries that could be involved in maintaining exchange market stability.

Mr. de Groote considered that the Administration's objectives of achieving a progressive reduction in the rate of inflation and a recovery of output, as well as maintaining a strong dollar, would benefit the U.S. economy itself and help to re-establish more favorable conditions in the world economy, especially if a strong dollar was understood to mean a stable one. The main issues on which the consultation might usefully shed some light were whether the present policies were likely to succeed, whether the same results could be achieved at a lesser cost through other policies, and the implications of the present policies for the adjustment process and the functioning of the international monetary system.

The chances of successfully implementing the policies depended on whether the assumed mechanisms and relationships would in fact work themselves out, Mr. de Groote went on. The Administration's system was based on controlling the money base and it assumed that exchange rate fluctuations ensured that the external source of the base could be controlled. Accordingly, when the demand for money increased as a result of a balance of payments surplus, the resulting appreciation of the exchange rate should have two effects: in the market for financial assets there should be an increase in the price of the domestic financial assets in relation to the price of foreign financial assets, thereby reducing the demand for domestic money; however, the appreciation should cause a reduction in internal prices and, therefore, in the transactions demand for money. The two effects together should reduce the internal demand for money and insulate the monetary base from balance of payments effects. If such a mechanism was to work, the authorities had to refrain fully from intervening on the exchange market, something that, in certain future circumstances, might be neither possible nor desirable. For instance, in the unlikely event that the present external surplus persisted, the U.S. authorities might wish, at a certain moment, to prevent the exchange rate from increasing further in order not to fall back into a period of excessive deficits and unemployment. A more realistic possibility was that, since the effects of a decrease in the exchange rate on internal prices was more pronounced than had previously been thought, the U.S. authorities might wish to intervene if, in coming years, a balance of payments deficit threatened to undermine the fight against inflation. It seemed reasonable to assume that such reactions by the authorities, including at least a limited degree of intervention in the exchange market, were to be expected, and that, accordingly, controlling the monetary base might not be as easy as was now believed.

In any event, it also seemed realistic to assume that some of the mechanisms underlying the present policies would not necessarily work as expected, Mr. de Groote continued. Internal prices would have to be sufficiently flexible to allow the transactions demand for money to fall when the exchange rate increased, and to rise when the exchange rate fell. It was true that price flexibility was greater in the United States than in most other industrial countries, but he doubted whether it was sufficient to warrant the authorities' belief in their ability to control the monetary base. The necessary adjustment in the price of domestic financial assets in relation to foreign assets was likely to have a crowding-out effect, especially in the light of the recent tax reductions. The authorities apparently believed that the crowding-out effect would be offset by a reduction in the share of the public sector in total spending. That argument, however, was valid only if both the share of public spending in total spending and the size of the deficit itself were reduced over time, as it was the latter that determined the degree of competition between public and private uses of available funds. Because defense spending was on the rise, welfare payments remained essentially unchanged, and government revenue during the coming one or two years would probably reflect the likely decline in output, there was little hope of recording a reduction in the public sector deficit; indeed, an increase in the deficit seemed to be a realistic assumption. He had difficulty in reconciling that prospect with the stress that the authorities had placed on expanding supply, especially as he was not convinced that the reduction in taxation would necessarily result in a sufficient increase in personal savings.

Ideally, Mr. de Groote went on, under the authorities' present approach, the selected monetary aggregates should be adjusted essentially in line with the medium-term evolution of physical output, and there should be no corrective action in response to short-term variations in the monetary aggregates. The authorities had the option to enhance the credibility of monetary policy by quickly reacting to variations in the monetary aggregates--an understandably attractive option, given the need to influence inflationary expectations. However, there was a real danger that, if there were frequent reactions, the medium-term monetary policy objective would be lost sight of and that the public would come to feel that actions with respect to the monetary aggregates were confusing and contributed to the volatility of both the monetary aggregates and interest rates. It was true that most of the questions that he had raised could in effect be sidestepped by suggesting, as Mr. Erb had done in his opening statement, that the present set of policies was not as systematic as was often thought. Further information was needed on the mechanisms on which the present policies were supposed to rely.

As previous speakers had mentioned, Mr. de Groote recalled, a policy mix--possibly including an incomes policy--that gave greater importance to fiscal restraint, would probably be more effective than the present set of policies in moderating inflation with a minimum of negative effects. Public expectations seemed to be determined to some extent by the size of the government deficit and its expected crowding-out effect. However, inflationary pressures were caused by factors in addition to the movement of the monetary aggregates.

Commenting on the implications of present U.S. policies for the process of adjustment and for the functioning of the international monetary system, Mr. de Groote said that he shared the concern of previous speakers that, in the near future, the United States might have to intervene in the exchange markets if the balance of payments surplus persisted and the authorities wished to avoid further appreciation of the rate in order not to be pushed at a later stage into larger deficits and into a see-saw movement of the rate; or if external deficits materialized, as many observers expected, and the authorities wished to avoid the internal price effects of exchange rate movements. Such intervention would obviously limit the scope for action through the monetary aggregates and affect the functioning of the international monetary system. In the circumstances that he had described, the U.S. authorities might find it desirable to increase the role of the SDR in the international monetary system. They could also consider a gradual formal restoration of the central role of the dollar by relating the definition of the currency to some kind of an international standard, or even by restoring some degree of convertibility and asset settlement through SDR convertibility of the dollar, so that the United States would no longer have to intervene in the market to maintain a stable exchange rate level. A consultation discussion was the appropriate occasion on which to raise such questions, and he hoped that they would be examined in due course.

Mr. Buira commented that since 1973 the performance of the U.S. economy had been characterized by lower rates of growth and higher rates of inflation and unemployment than in the preceding quarter century, together with a decline in productivity growth, reflecting inter alia low rates of savings and investment. The weak performance had naturally been a cause for concern and had led the authorities to search for a new combination of policies that would reverse the trends that some analysts thought constituted a syndrome of the advanced countries.

Between 1945 and the early 1970s, Mr. Buira went on, the United States, like most other industrial countries, had experienced unprecedented economic expansion because of a number of factors, particularly the liberalization of trade and payments, strong and widespread technological progress, and expansion of the labor force because of demographic factors and migration. There had also been high rates of capital formation, stable supplies of raw materials and energy inputs, a slight improvement in the terms of trade for manufacturers, and a general climate of confidence arising from the belief that the knowledge of economics could be used to eliminate cyclical problems and to maintain high rates of employment and capacity utilization.

In recent years, however, Mr. Buira continued, there had been a series of changes, many structural in nature, including a marked slowdown in the growth of labor productivity, a decline in profitability rates, an increase in the natural unemployment rate, a more adverse external environment in terms of both trade growth and inflation rates, and a broad loss of confidence in the ability of governments to achieve low rates of both unemployment and inflation. Perhaps the most significant change was the increase in energy prices that for decades had been kept at low levels. The increase had had an impact on price and income levels and had rendered obsolete an appreciable portion of the existing industrial plant, technology, and social infrastructure based on cheap energy, thereby contributing to low productivity growth in all countries, particularly in those that had oriented their development toward high personal consumption based on an ample supply of low-priced energy, mineral and other resources. Moreover, the heightened awareness that the supplies of nonrenewable physical resources were finite, and that access to them was subject to political and economic limits, had been accompanied by environmental movements that had led to restrictions on industry and to cost increases to regulate pollution and other external diseconomies in order to preserve some degree of ecological equilibrium.

The trends that he had described suggested that it was reasonable to expect that the United States, like other industrial countries, might well experience lower average rates of growth during the 1980s than in the past, Mr. Buira considered. The United States had begun a bold effort to overcome some of the adverse trends through a combination of fiscal and monetary policies aimed at increasing returns on savings and investment, deregulating industry, and, more generally, liberalizing the economy to give the free play of market forces a greater role than hitherto in resource allocation. The Administration's strategy for improving the economic environment was likely to have positive effects, but they were unlikely to be sufficient to solve some of the structural problems and to permit a restoration of the growth rates of the 1960s.

Commenting on specific policy issues, Mr. Buira said that monetary policy had been significantly changed since the fall of 1979: it was at present aimed at controlling the rate of growth of monetary aggregates rather than the level of interest rates, which were permitted to move wherever the market took them. As a result, there had been sharp fluctuations in interest rates, reflecting changes in expectations with respect to economic policy. In an attempt to reduce the rate of inflation and to influence inflationary expectations, the Federal Reserve aimed to achieve a gradual decline in the rate of growth of certain monetary aggregates in the coming two years. Fiscal policy had emphasized tax cuts that were meant to induce a recovery of activity. There was some risk that the reduction in taxes and public expenditure would not be immediately offset by an increase in private investment and new jobs and could lead simply to increases in both consumption and the fiscal deficit. However, if the tax policy succeeded in inducing a recovery of activity, an increase in demand for credit in 1981, together with the planned restraint on the growth of the monetary aggregates, would probably keep interest rates at high levels or even raise them further. In such circumstances, the upward movement of interest rates could cause a renewed slowdown of the economy in 1982, even though the level of economic activity now appeared to be somewhat less sensitive to interest rates than it had in the past. Hence, the test of the present mix of fiscal and monetary policies would probably come sometime during the coming year.

There was a possible conflict, Mr. Buira remarked, between the Government's monetary policy--which was aimed at lowering inflation by reducing the rapid rate of growth of monetary aggregates that had caused the very high interest rates--and its fiscal policy, which was aimed at restoring incentives to economic activity by cutting taxes. The policy conflict was likely to affect certain sectors of the economy in particular, including the savings and loan associations, housing, and small businesses.

The adverse impact of high interest rates on investment could be somewhat moderated by changing the interest payment deduction and by reducing the tax on interest income in order to maintain the net incentives for borrowers at present levels, Mr. Buira said. The tax deduction for interest payments on consumer and mortgage debt provided an incentive to spending that channeled funds away from productive investment in plant and equipment. The present system, which taxed income from savings and permitted a deduction of interest payments on loans, contributed to the unnecessarily high level of interest rates which, in turn, had resulted in massive capital inflows into the United States and the appreciation of the dollar, trends that were unlikely to contribute to boosting exports and which created pressures on the monetary policy and exchange rates of other countries.

The Administration's fiscal policy, Mr. Buira noted, was aimed at reducing the ratio of public expenditure to GNP by some 3 percentage points during the coming three years, and at shifting expenditure priorities by increasing the share of defense spending while cutting the share of social programs. While it was clear that inflation had introduced distortions, especially as a result of the progressive nature of the tax schedules, care should be taken that minorities, the young, the elderly, and other disadvantaged groups did not have to carry more than their share of the adjustment burden. That could easily happen if the lowering of income and capital gains taxes was accompanied by increases in consumption taxes and other indirect taxes, as the staff had apparently suggested. It was easy to forget that the most productive kind of investment was investment in human capital. Expenditure on health, nutrition, education, and training facilities had made the U.S. labor force one of the most productive in the world; it might cease to be so if the supporting social facilities were reduced.

It was important to recognize, Mr. Buira went on, the real danger that, if the economic recovery turned out to be slower than had been forecast, the federal deficit could be substantially larger than was projected; that possibility cast doubt on the sustainability of the counterinflation effort. The question naturally arose to what extent the tax cuts would result in larger deficits than would otherwise be the case, and to what extent the financing of the deficits would absorb the expected increase in private saving.

The test of the Government's present policy of not intervening in the exchange market would not come for some time, Mr. Buira considered; it was easier for a country to practice a policy of nonintervention when its currency was strong than when it was weak. However, if in the future the dollar came under strong downward pressure, the authorities would have to decide whether the factors causing the pressures were temporary and possibly speculative in nature, and whether intervention might not be inconsistent with the fight against inflation and the attainment of other objectives. In that event, he hoped that the authorities' approach would be pragmatic, and that they would recognize that markets often overshot the mark; they should not necessarily conclude that the developments in the market were an indication that their policies were inappropriate.

U.S. energy policy, Mr. Buira noted, had been quite successful in encouraging conservation, largely through the operation of the price system. He wondered what the authorities' policy intentions were with respect to the price of natural gas. The Administration's commitment to resist protectionist pressures and to work toward reducing barriers to trade was encouraging. The authorities should avoid voluntary restraint agreements and encourage the increase in factor mobility needed to facilitate structural adjustment. However, he was dismayed by what appeared to be the policy toward official development assistance and multilateral development institutions, as it was unduly optimistic to believe that development assistance could be replaced by private flows even to countries with a relatively favorable investment climate. Restoring the health of the U.S. economy would help the developing countries by providing them with a growing market for their products, but there was a role to be played by aid flows to low-income countries with inadequate physical and social infrastructures and insufficient human capital. The concept of official development assistance assumed that there was a moral obligation to assist less fortunate countries, and that such assistance was in addition, and complementary, to private transactions, however important they might be. Private capital tended to flow only to countries where a good return could be expected, something that was only infrequently true of the poorest countries. The reduction of the share of U.S. aid channeled through multilateral institutions was a particular cause for concern, as it would lessen the likelihood that sufficient contributions would be forthcoming from others.

Faced with a long-term trend of deterioration in the performance of the economy, Mr. Buira concluded, the new Administration had undertaken a bold program that placed considerable reliance on a number of untested policy mechanisms. Although clearly containing many positive elements, the approach ran certain risks, including that of becoming unsustainable should the results expected during the coming one or two years not be achieved. The U.S. economy accounted for a substantial part of the world's production and trade, and developments in the United States had a major influence on the economies of its main trading partners and on the evolution of the entire international economy. Accordingly, the United States had special responsibilities; given the grim outlook for the international economy, it was imperative that the United States maintain a constructive and positive attitude toward international cooperation in general, and toward assisting developing countries in particular.

Mr. Sigurdsson commented that U.S. economic developments and policies had important effects on the world economy. The economic program of the new Administration was designed to achieve a major reorientation of the economy through a policy approach with which the authorities had had little previous experience; therefore, there was more than the usual uncertainty about the economic forecasts for, and appraisals of, the

U.S. economy. In particular, there were differences of opinion whether the new policy measures could succeed in reducing inflation significantly without negatively affecting economic growth and employment in the long period of transition to greater price stability. This in turn depended on the speed at which the economy would react to the combination of gradual monetary restraint and incentives for private enterprise and capital formation. The major question was whether the GNP growth projected by the U.S. authorities for the coming several years was consistent with the target ranges for monetary expansion which had been set by the Federal Reserve; given the firmly entrenched inflationary expectations, there seemed to be some risk of a significant degree of slack in product and labor markets if monetary growth was kept within the Board's target range.

A key part of the Administration's economic program was a sizable and sustained reduction in the rate of monetary expansion, Mr. Sigurdsson noted. As the staff had concluded in its appraisal, there was some uncertainty about the ultimate effects of monetary restraint and about the mechanism of monetary control itself, including the frequent reporting of monetary developments and the reactions of the authorities to perceived deviations of the monetary aggregates from the desired path. The staff had indicated that, given the state of the art of monetary control, tight control might well involve the continuation of a high degree of variability of interest rates. Were there any indications that monetary control was improving in the sense of achieving a smoother trend of the monetary aggregates and less pronounced short-term variability of interest rates than had occurred in the past?

Bringing inflation under control in the United States, Mr. Sigurdsson remarked, would obviously have long-term beneficial effects for economic growth in the United States and would contribute to slowing the inflation in the world economy. A more restrictive fiscal policy in the United States might take some of the pressure off interest rates, thereby stimulating investments and helping to reduce inflation. The present high level of interest rates in the United States had far-reaching consequences for the world economy, and his authorities looked forward to the time when conditions would permit interest rates to fall.

The staff had raised a number of interesting questions about the possible difficulties in achieving the Government's fiscal objectives and the economic effects of the fiscal stance, Mr. Sigurdsson commented. On the expenditure side, it was noteworthy that, within the overall structure of restraint, there was to be a significant increase in defense outlays and corresponding cuts in other categories, some of which had not yet been identified for the period after FY 1982. Did not the combination of relatively certain increases in expenditures and less certain cuts in specific areas mean that there was some risk of budget overruns? In addition, did the focusing of the significant increases in federal expenditure on a relatively narrow sector of the economy not entail inflationary pressures of a sectoral or structural kind? Since the brunt of the planned expenditure cuts had fallen on grants to state and local governments and on benefits to individuals, he wondered whether the fiscal problem had not merely been shifted within the consolidated public sector, rather than fully solved.

On the revenue side, Mr. Sigurdsson went on, the crucial questions had to do with the effects of the tax cuts on the economy. The staff appraisal had brought to mind the discussion at EBM/81/62 and EBM/81/63 (4/20/81 and 4/21/81) on supply-oriented adjustment policies, particularly the following statement by the staff on page 27 of SM/81/78:

> Some have argued that cuts in marginal income-tax rates could have a significant stimulative effect on employment in industrial countries, thus increasing the overall level of production. At present, however, most of the available empirical evidence seems to suggest that, at least in the case of the United States, the total supply of labor is relatively unresponsive to increases in real after-tax wages in the relevant range. This indicates that an income tax cut that was not accompanied by spending reductions would probably enlarge the fiscal deficit, while having only a moderate effect on real aggregate supply.

The staff's analysis in Appendix I of SM/81/158 of the effects of tax changes on personal savings was particularly useful. In the United States reference had frequently been made to the positive effects on the economy of the tax cut in 1963, and he wondered whether the present circumstances and those in 1963 were comparable, and what effects the new tax cuts would have on supply and savings.

He shared the staff's concern, Mr. Sigurdsson continued, that the persistence of large fiscal deficits could cast doubt on the sustainability of the anti-inflation effort, and that fiscal policy might turn out to be excessively loose because inadequate attention had been paid to the federal revenue base. In that connection, Mr. Anson's question about the effects of indexation of income tax scales was particularly important. The staff had cautiously recommended that consideration be given to an increase in indirect taxes on consumption. Such a move might help to strengthen the fiscal balance, provided that the price effects did not call forth a very strong reaction in terms of wage demands, a matter that involved difficult political judgments and economic analysis.

Another tax issue that had monetary implications was the tax treatment of interest income and payments and the likely effects on the credit market and the tax base, Mr. Sigurdsson commented. Abolishing or reducing the personal income tax deduction for interest payments was worth considering for both monetary and fiscal policy reasons.

He was uncertain whether the strong appreciation of the U.S. dollar during the previous 12 months was a reflection of an improvement in the fundamental economic factors, Mr. Sigurdsson commented; but it was important to underscore the difficulties that had been created by the sharp fluctuations in exchange rates and the substantial fluctuations in short-term interest rates. An increase in stability in interest rates could lead to greater stability in the exchange markets. He hoped that in implementing their intervention policy the U.S. authorities would not interpret the concept of disorderly conditions too narrowly, so that they could contribute to moderating the short-term fluctuations in exchange rates. That approach would be consistent with the present guidelines for members' exchange rate policies and with the principles and procedures governing surveillance. In general, there was a continuing need for all the major currency countries to coordinate closely their interest rate and intervention policies.

On page 19 of SM/81/157, Mr. Sigurdsson noted, the staff had mentioned that "how a currency fares in the exchange market is an indicator of the adequacy of the country's economic policies, and the staff agrees with the U.S. authorities that the information obtained from exchange markets should be used as a guide to policy." That statement was presumably an indirect reference to a statement by a U.S. official, Under Secretary Sprinkel, on May 4, 1981 to the Joint Economic Committee of Congress. It was not clear to him which economic policies should be guided by information derived from the exchange markets.

As the staff had concluded, Mr. Sigurdsson continued, deregulation of natural gas prices would be an important improvement in U.S. energy policy. There was also a need to stimulate directly the development of alternative energy sources and, in that connection, the recent news on the likelihood of continued support for the development of synthetic fuels was interesting, although it probably had some unfavorable budgetary implications.

He agreed with the staff, Mr. Sigurdsson said, that a liberal trade policy could make an important contribution to reducing inflation, and his authorities hoped that the U.S. Government would actively maintain such a policy. The United States bore a particularly great responsibility in the trade area; any deviation by the United States from a liberal trade regime could establish a precedent that would have serious adverse consequences.

The staff had correctly criticized the trend in U.S. financial assistance to the developing countries, Mr. Sigurdsson remarked. His authorities were particularly worried that in coming years the United States might well reduce its support--including financial contributions--for multilateral financial institutions.

The Administration's medium-term program was aimed at creating a more dynamic and resilient economic environment than hitherto, Mr. Sigurdsson commented, and its success would depend upon policies remaining relatively fixed over an extended period. In addition, it assumed that, to some extent, there would be changing expectations and new patterns in important areas, such as the setting of wages and prices. It was particularly important to know how the Administration proposed to act if the desired drastic changes in established patterns did not occur, or if they emerged much more slowly than the authorities now assumed. How would the authorities react if, for instance, as the staff appraisal seemed to indicate, economic expansion in the coming years was significantly slower than they anticipated? The entire world had a stake in the success of the implementation of its policies by the U.S. Government.

Mr. Hirao remarked that he was encouraged by the indications that inflation in the United States had slowed during the previous several months; the rate of increase of the GNP deflator had fallen to 6 per cent in the second quarter of 1981. The figure for a single quarter should of course be interpreted with great caution, as it could be due mainly to temporary favorable factors but, if the positive trend continued in coming quarters, it might well be regarded as a result of the firm implementation of appropriate anti-inflation policies. He hoped that the recent figure on inflation meant that the rate for 1981 as a whole would be lower than had been projected, thereby helping to reduce inflationary expectations and setting the stage for a favorable outcome of the major wage negotiations that were to be initiated in the spring of 1982. At the same time, real GNP had declined in the second quarter by more than had been generally expected, Mr. Hirao observed.

It could be argued that, because of the deep-rooted inflationary expectations, progress in curbing inflation might require a considerable degree of slack in the real economy, and that the second quarter's decline in economic activity was a sign of the beginning of such a trend. He tended to agree with the staff that the growth rate predicted by the Administration for 1982--3.4 per cent in real GNP--might be somewhat optimistic, but he fully agreed with the authorities that the merits of the new policy should not be judged in terms of the short-term performance of the economy; slow growth in the period of transition would probably be unavoidable. In the circumstances, it might be appropriate for the authorities to make a rather cautious public forecast of near-term growth in order to minimize the risk of facing considerable pressure to reverse the policies if actual economic growth was slower than had been projected.

Commenting on specific policy issues, Mr. Hirao said that, because of the significant expansion of the fiscal deficit, monetary policy had had to play the leading role in the counterinflation effort, and the new Administration seemed to wish to maintain a sustained reduction in the rate of monetary expansion. The unusually high level of interest rates caused by the excessive reliance on monetary restraint had had adverse repercussions on other economies, but some time would be needed before the fiscal restraint that had been introduced by the new Administration took effect, and any relaxation of the restrictive policies in the present circumstances would undermine public confidence in the anti-inflation effort.

As for monetary policy in the medium-term perspective, Mr. Hirao went on, it was important to note that the tax deductibility of interest payments, a peculiar feature of the U.S. tax system, seemed to be one of the reasons why domestic interest policy in the United States was less effective than in many other countries in deterring individual borrowers; the high level of interest rates in other countries, where such tax treatment did not exist, had restricted the economic activities of individuals and the national economy. Although it was undoubtedly politically difficult to do so, some consideration should be given to reducing the scope of the unusual tax treatment of interest payments in the United States.

The federal funds rate and other interest rates had been fluctuating to an increasing extent since October 1979, Mr. Hirao went on. If the rate of growth of the monetary aggregates declined to a rate that was below the target ranges due to changes in economic activity and in credit demand, and if the authorities tried to adjust the reserve position quickly in response to such movements, interest rates were likely to start falling rather rapidly, as had been the case in April-July 1980. The Federal Reserve had concluded that there had been a marked increase in the week-to-week volatility of interest rates because of certain operating procedures. A sharp drop in interest rates was certainly undesirable because it would stimulate pent-up demand for credit, and highly volatile interest rates in the United States had adverse effects on interest rates abroad. In the circumstances, intervention by the authorities with a view to smoothing out the wide variability in interest rates might be desirable. In that connection, he agreed with the recent statement by the Chairman of the Federal Reserve to the effect that the rate of growth of M-1B should be near the lower end of the target range.

In the fiscal policy area, Mr. Hirao said, the authorities were to be complimented for their determined effort to slow the growth of federal spending from an average annual rate of 13 per cent over the four years through 1981 to 6 per cent in 1982 and similar rates in the subsequent several years. Thus far, the U.S. Congress had endorsed almost the entire package of spending cuts that the Administration had proposed, but further spending cuts would be needed to achieve the balanced budget that the authorities had targeted for 1984. He strongly hoped that the momentum toward reducing the size of government and revitalizing the U.S. private economy would be maintained, so that the required reduction in federal spending would be possible.

The accelerated depreciation allowance should help to increase the private investment that was vitally needed to reverse the declining trend in productivity of U.S. industry, Mr. Hirao went on. However, there was some uncertainty whether the planned reduction in marginal rates of taxation on personal income would achieve the desired results, as the outcome would depend on a number of factors. The simulation in Appendix I of SM/81/158 indicated that, in the first year of the new program, a 30 per cent cut in personal income tax rates would raise the financial investment ratio by about 2 percentage points, and that approximately half of the tax reduction benefits would go to savings in the form of financial investments. It would be useful to receive further comments on the staff's interesting study.

The staff had noted that certain countries with large fiscal deficits had done much better than the United States in containing inflation, Mr. Hirao remarked. He agreed with the authorities that fiscal deficits per se were not inflationary if they were not accommodated by monetary policy, but, in most cases, persistent fiscal deficits by themselves forced monetary policy to be accommodating. In an economy with persistent, large fiscal deficits, the anti-inflation performance could be favorable only if there were certain favorable conditions for maintaining monetary policy in such a way that it would not be forced to accommodate the fiscal deficits. One such major condition was a high savings ratio in the private sector; if private savings were sufficiently large, the public deficits could be financed without exceeding the range of the rates of growth of the monetary aggregates and without crowding out the desired private investment.

Externally, Mr. Hirao said, there was a wide difference between the projections by the staff and those of the authorities for the current account balance for 1982, and it would be useful to receive further comments on the figures. As for the exchange rate, the strong dollar had probably been caused by a combination of factors, including high interest rates, the improvement in the U.S. current account position, and the growing confidence in the policies of the U.S. Government. As for the exchange rate of the dollar vis-à-vis the yen in particular, interest rates seemed to have been the main factor behind the recent weakness of the yen.

The wide daily fluctuations in exchange rates were a reflection of the variability of interest rates and, probably, of the decline in the amount of intervention in the exchange markets, Mr. Hirao remarked. The staff agreed with the U.S. authorities that the information obtained from exchange markets should be used as a guide to economic policy. In his view, such an opinion was generally, but not always, warranted. Exchange rates sometimes fluctuated to an extent that could not reasonably be explained by the current underlying conditions, and, when overshooting in exchange markets occurred, closely coordinated intervention among authorities of major currency countries had proved to be very effective in stemming speculative forces. He strongly hoped that the recent change in U.S. intervention policy would not lead to the abandonment of the long-established close coordination in market operations among the major currency countries.

The new Administration should be commended for changing U.S. energy policy to accelerate the removal of existing controls on the pricing of energy products and to encourage competition, Mr. Hirao considered. The previous control of domestic energy prices had probably been the main factor in the delay in the structural adjustment of the U.S. economy. He was pleased that energy conservation had progressed dramatically in the United States and had contributed to the remarkable decline in oil imports.

Mr. Iarezza commented that the U.S. economic program combined a gradual application of demand restraint--mainly through control of the money supply--with incentives for capital formation. Firm implementation of the new policies should succeed in achieving a reduction in inflation and a sustainable rate of economic growth over the medium to long run. Given the firmly established inflationary expectations in the United States, the main questions were how fast the effects of the new policies would be felt, and what their internal and international costs would be during the period of adjustment.

The inflationary expectations had become deeply rooted as a result of several years of above-average inflation rates caused by, inter alia, a lack of appropriate and timely adjustment policies, Mr. Iarezza continued. The problem had been compounded by the premature relaxation in 1980 of the control of monetary aggregates which had been initiated in late 1979.

As a general rule, Mr. Iarezza went on, in a setting of inflationary expectations a government should provide clear signals to the markets of its policy intentions by setting appropriate targets for key variables. However, experience in other countries in a similar situation to that of the United States showed that there were special difficulties in setting the correct monetary targets; it was particularly difficult to forecast the velocity of money in an environment of changing financial practices. The existence of those difficulties, together with the natural lag in the response of inflationary expectations to changes in government policies, meant that, in a period of adjustment, there would be continued excess nominal demand for credit and, consequently, an increase in real interest rates and an appreciation of the exchange rate. Nevertheless, he fully agreed with the authorities' approach to controlling inflation. In particular, they were to be commended for their firm commitment to persevere in their policy stance; perseverance was the key factor in reducing inflation in an environment of inflationary expectations. He also agreed with the authorities that during the adjustment period the best policy was to let interest rates and the exchange rate find their own equilibrium levels. However, as soon as the adjustment process had been completed, a greater degree of exchange rate coordination might be advisable, and serious consideration should perhaps be given to Mr. de Groote's suggestions concerning convertibility or a similar alternative.

He agreed with the staff, Mr. Iarezza said, that, given the persistence of the inflationary expectations and the unlikelihood that the velocity of income would increase to the extent expected by the authorities, the rate of growth of GNP in 1982 would probably be lower than the authorities had projected. In that event, he, like the staff, hoped that the consequent internal political pressures would not result in a premature shift in economic policy.

The U.S. authorities, Mr. Iarezza noted, had mentioned that they had had difficulty in keeping the rate of growth of the money supply within the target ranges. He hoped that they could solve the problem;

otherwise, the money supply would fluctuate significantly in the short run, the achievement of a reduction in inflationary expectations could be delayed, interest rates would remain high, the real costs of the adjustment process would grow, and internal political pressures to change the economic policy course could become considerable.

Commenting on fiscal policy, Mr. Iarezza said that, in the light of the large size of the U.S. financial markets, it was not necessarily correct to assume that, given a correct monetary policy, there would be a positive correlation between the level of the public sector deficit and the rate of inflation. There might be a correlation if the private sector felt that the size of the fiscal deficit was a measure of the Government's resolve to combat inflation. With regard to the use of fiscal policy as an instrument to affect the composition of aggregate demand and supply, and given the important role that the private sector had traditionally played in the U.S. economy, the authorities' commitment to reducing public sector expenditure, eliminating excessive regulation, and developing a more neutral tax system was certainly welcome. As previous speakers had stressed, the authorities should examine the possibility of modifying the present tax treatment of interest payments.

He broadly agreed with the Government's present policies, Mr. Iarezza commented; in the long run, they should benefit both the United States and other countries, including developing countries. However, it was important to stress that the policies could involve a long and difficult process of adjustment with high interest rates and sluggish demand, both of which would affect other countries, particularly developing countries. The United States was capable of assisting the developing countries during the adjustment process without impairing its own economic policies; in so doing, it could make an invaluable contribution to a smooth international adjustment process. In that connection, the authorities should be urged to maintain a consistent commitment to free trade and to resist domestic political pressures to protect industries that directly competed with those in developing countries. In the near future, current account balance of payments deficits would undoubtedly persist in developing countries, and multilateral financial organizations would continue to play a fundamental role in financing and in promoting international adjustment. Accordingly, the U.S. authorities should be urged to do everything possible to fulfill and expand their support for those institutions. Finally, during the present adjustment period the low-income countries were in particular need of soft loans from multilateral institutions and of official development assistance from industrial countries; the U.S. authorities should be encouraged to increase their level of official development assistance and their financial support for the soft loan facilities of international institutions.

Mr. Nimatallah said that, while he generally agreed with the staff analysis, the tone of the report was excessively optimistic. With the rate of unemployment near 8 per cent, inflation very high, GNP growth expected to be stagnant in the remainder of 1981 and only moderately positive in 1982, and the world seriously discomforted by the high interest rates and the exchange rate instability in 1981, one would have expected the staff to have been somewhat more doubtful about the likely success of some of the Government's policies. Nevertheless, the international community, including Saudi Arabia, clearly supported the Administration's policy emphasis on reducing inflation; the good intentions of the authorities were clearly beyond doubt, their policy objectives were fully warranted, and their restrictive credit policy certainly had an important role to play. The rate of growth of the monetary aggregates was to be slowed gradually, and the Federal Reserve would have to maintain its present policies in the foreseeable future. However, monetary policy alone might not be sufficient to control aggregate demand. A prolonged period of high interest rates could depress the private sector to the extent that the outcome of the wage negotiations in 1982 would be favorable and inflation would continue to decelerate. But he was worried that that kind of scenario would not be consistent with either the official projection of GNP growth in 1982, or the approach of depending upon rising tax revenues produced by growing output to achieve an improvement in the budget position.

Unfortunately, Mr. Nimatallah continued, the rate of wage increase in 1981 had been rapid and major wage negotiations were to take place in 1982. It would be difficult to implement successfully the anti-inflation program if wage increases in the unionized sector were determined largely by past rates of inflation. The Administration's goal of reducing inflation was not compatible with its policy of nonintervention in labor decisions unless unemployment rose well above the present level.

He strongly hoped that the Government's comprehensive economic policy succeeded, Mr. Nimatallah commented, as it would be beneficial for the entire world economy. In addition, the United States represented an important and interesting case of the application of supply-side economics in an effort to ease structural problems.

The staff report, Mr. Nimatallah noted, contained a helpful section on U.S. energy policy and correctly emphasized the Government's success in limiting energy consumption. The decisions that had already been taken to relax price and other controls on petroleum were certainly welcome, and, as the staff had concluded, the controls on natural gas should be removed. Recent evidence that the demand for oil had begun to rise again might well be a ground for concern; the signals given by the price system should perhaps be reinforced as a part of the effort to achieve medium-term changes in the pattern of energy consumption.

He was pleased that protectionism was to be resisted, as had been stated in the Ottawa Declaration, Mr. Nimatallah remarked. In that connection, he hoped that in the coming period the United States would adopt more decisions like the recent one on shoe and textile imports, and would avoid additional decisions like the recent one on automobile imports.

The U.S. foreign aid program should not be curtailed, Mr. Nimatallah considered. It would be unfortunate if the United States ignored its responsibilities for assisting developing countries. Paragraph 18 of the Ottawa Declaration confirmed the trend, evident in the previous six years, of a shrinking of responsibility by the major industrial countries for assisting developing countries. Saudi Arabia had a positive and long-term outlook on the importance of assisting needy developing countries; his authorities believed that economic development and growth of developing countries contributed to world peace and prosperity. The United States had been a prominent donor to developing countries, and his authorities attached importance to having the United States continue to contribute to world peace and stability by maintaining its foreign aid programs. Helping developing countries to grow and prosper was imperative if only to achieve the long-run goal of permitting those countries to increase their imports from the industrial countries; the United States should continue to take the lead in transferring resources to less fortunate countries.

It was important to have an opportunity to discuss the policies and prospects of the member country that was at the center of the international financial system, Mr. Nimatallah commented, and the staff reports were an essential part of the process. There certainly appeared to be grounds for hope that serious attempts were being made to control inflation in the United States without excessive disturbance of world trade and payments, but it was important to bear in mind that there was much room for improvement, and that political and social fabrics in both industrial and developing countries were being sorely strained by the present economic trends. It was refreshing and helpful to world cooperation to have the United States making a positive and serious attempt to contribute to eliminating the fundamental causes of the economic problems facing the world economy, rather than having member countries merely exchange blame and accusations.

Mr. Casey said that it was his understanding that the basic strategy of the Administration was to encourage investment by altering depreciation tax rules, and to promote efficiency and savings by cutting income taxes. The increase in investment should bolster output and, given the elasticity of tax collections, the greater output should have a positive effect on the fiscal position. Increased output and productivity should help to slow inflation if certain assumptions about aggregate demand and the role of monetary policy held true. The strategy was consistent, neat, and conceptually appealing, and the main question was whether it would work in practice. The behavioral relationships underlying the Government's strategy were obviously not clear cut and could be influenced by such unpredictable factors as confidence and expectations.

The Administration's strategy probably would not work so quickly as to produce the officially projected growth rate of 5 per cent in 1982, Mr. Casey considered. Although investment had occasionally responded quickly to a reduction in the user cost of capital, there were several other important determinants of investment which would not exert much influence for some time. Therefore, he agreed with the staff that the Administration's growth forecast for 1982 was overoptimistic; indeed, the staff's own forecast might be slightly optimistic. In addition, the prospects for inflation were rather mixed. What was the likely underlying rate of inflation in 1982? Had that rate already been determined in part by the appreciation of the dollar? He agreed with the staff that, if the benefits to growth and the control of inflation did not accrue immediately, the authorities should still adhere broadly to their strategy; perseverance was undoubtedly the key to combating inflationary expectations.

The investment response was crucial to the entire program and was the essence of the supply-side approach, Mr. Casey went on. He did not doubt that the new depreciation tax rules would give investment an initial push, but inflation would have to be brought down rapidly if the investment momentum was to be maintained. Inflationary expectations had had a serious adverse effect on investment--particularly long-term investment of a capital-deepening nature--which accounted for the sluggish growth in the capital/labor ratio and for the very poor growth of productivity in recent years. High interest rates seemed to be one of the best ways of bringing inflation under control, and the present policy of high rates had to be continued even if the direct effect on investment was unfavorable. However, reducing the volatility of interest rates might be one way of at least giving the business sector more certainty about investment decisions; it would also give more order to the world economy.

The present structure of interest rates was not ideally suited to increasing household savings from the present very low level, Mr. Casey went on. The federal funds rate, the discount rate, and other important interest rates were of course significantly positive in real terms, but the average householder received only 4.25 per cent on ordinary deposits in commercial banks. There seemed to be a wide divergence of interest rates within the overall structure, and higher rates seemed to be available only to those who could make sizable deposits for considerable periods of time. If that structural aspect of interest rates did represent a problem, the expected increase in the savings ratio from its present low level might not materialize. As for lending rates, they seemed to be higher than necessary because borrowers were permitted to deduct interest payments from their tax liability. Some changes in the tax code could permit somewhat lower lending rates--without implying a relaxation of monetary policy--thereby helping the public finances, resource allocation, savings, and the international community. Had the authorities given any thought to making such changes?

Commenting on monetary policy, Mr. Casey said that the new procedure of focusing on bank reserves on a day-to-day basis clearly accounted for much of the interest rate volatility, something that had indeed been confirmed by the Federal Reserve itself in a recent study. Bank reserve accounting might soon be put on a contemporaneous basis, as opposed to the regular lag basis, and he wondered whether some averaging procedure might not be helpful in dampening interest rate volatility without undermining the broad thrust of monetary policy.

Control of some of the narrower monetary aggregates had been tightened, Mr. Casey noted, partly on the ground that there had been leakages from them into other forms of liquidity. The shiftability of assets from one aggregate to another had clearly created problems for the monetary authorities, and they were right to attempt to err on the side of caution in controlling the aggregates. The surge in the money supply in the previous two summers and the present surge in business loan demand at commercial banks were also good reasons for maintaining a cautious approach to monetary policy. What accounted for the growth in demand for business credit in the second quarter of 1981, when there had been negative GNP growth?

Monetary policy should continue to be tight in 1982, Mr. Casey considered, but it seemed likely that the targeted growth in the relevant monetary aggregates would be significantly less than the Administration's own forecast of growth in nominal GNP. How did the authorities' feel that that conflict would be resolved? Did they expect that the tightness of money would force interest rates up even higher? Was the velocity of money expected to increase, either autonomously or in response to higher interest rates, or was there perhaps an expectation that the growth of nominal GNP would be reduced below the target figure? He wished to gain a better understanding of the authorities' thinking with respect to their forecasts and targets. In practice, the conflict that he had described would probably not be very severe because the GNP forecasts seemed too optimistic. In any event, there was bound to be some tradeoff between tight credit and growth, at least in the short term.

If the 5 per cent GNP growth rate target was not in fact reached, Mr. Casey said, to what extent was the revenue performance likely to fall short of expectations? A comparison of the so-called high employment deficit with the actual deficit clearly suggested that considerable revenue could be lost if the GNP growth rate fell below target. The recent decision on tax cuts would further reduce revenues, and it was important to note that the relatively uncontrollable outlays represented 76 per cent of federal spending, so that expenditure cuts would certainly not be easy and expenditures might simply be shifted to state and local levels, as Mr. Sigurdsson had suggested. In the circumstances, how did the staff see the fiscal deficit evolving in FY 1982? Did it feel that the objective of balance in FY 1984 would be realized? He tended to agree with Mr. de Groote that it would be rather difficult to achieve that objective.

The income tax cuts would have a rather limited effect on personal disposable income, Mr. Casey commented, although he realized the situation would probably be much worse without them. The cuts probably would not have much impact either on personal savings or on the incentive to work. It could be argued, perhaps a little cynically, that taxation by stealth was one of the best ways a government had of raising revenue without many taxpayers realizing that incentives were being eroded. The staff's suggestion for increasing taxes on consumption, especially on luxury goods, might be useful; it would certainly be consistent with the objective of shifting resources from consumption into savings and investment.

He was surprised, Mr. Casey remarked, that the authorities felt that fiscal policy had only a small role to play in demand management and in combating inflation, and that fiscal deficits did not place pressure on monetary aggregates and interest rates. Such conclusions suggested that the supply-side philosophy had been taken too far. It was true that fiscal measures might boost savings, reduce interest rates, and increase investments; but those effects were fairly long run, and the short-run role of fiscal policy should not be lost sight of, otherwise an excessively large burden of adjustment would be placed on monetary policy, and interest rates would skyrocket, thereby causing, inter alia, a very difficult international situation. As was the case with most new philosophies, there had been a tendency with supply-side economics for the economic policy pendulum to swing too far initially. However, a more balanced approach would probably emerge after a while, as experience showed that rigid monetary rules were not complete substitutes for the use of judgment. The U.S. authorities had shown good judgment in the past, and he hoped that their qualities of feel and flair would not be unduly stifled by the present policy approach. He certainly agreed with Mr. Erb's opening comments on the role of fine-tuning but, while fine-tuning of either demand management or intervention policy was difficult, it should not be discarded altogether. The volatility that resulted from a lack of fine-tuning might well undermine the investment that was at the heart of the entire strategy.

Commenting on incomes policy, Mr. Casey said that great caution was needed in the light of the poor productivity growth and the recent large wage increases awarded under collective agreements. He wondered whether a shift from wages to profits was part of the plan to boost investment. With the slack in the labor market, the unionized labor force had tended to fare better than non-unionized labor, and he wondered whether that trend might accelerate the process of unionization. Was there any danger that the shift from consumption to investment might cause some friction among the social partners?

Externally, Mr. Casey commented, he understood that the differences in growth forecasts explained why the authorities' figure for the expected deterioration in the current account in 1982 was larger than the staff's figure. It was important to note, however, that the OECD had also predicted a large current account deficit even though it expected growth to be moderate. It would be useful to have further comments on the differences in the forecasts, especially in the light of the OECD figure. The authorities seemed to feel that, even with a large current account deficit in 1982, the capital account would be buoyant, thereby avoiding any downward pressure on the dollar. Did Mr. Erb and the staff feel that the dollar would remain strong merely because of sizable capital inflows even though there was a large current account deficit? Was there some feeling that interest rate differentials would not narrow as had previously been expected?

He agreed with the staff's comments on natural gas pricing, regulatory reform, and the need to reduce protectionism, Mr. Casey said. It had been argued that, as the supply-side approach began to produce results, further steps could be taken to liberalize trade. The argument could be reversed: the supply-side approach might not begin to produce results until trade was liberalized. Indeed, reducing protectionism was indispensable to the whole supply-side approach. The Administration was clearly anxious to reduce excessive bureaucracy in the public sector, and he hoped that it succeeded and that the private sector would follow suit. Finally, he also hoped that the overall strategy worked; it might well set an example for other countries and place the United States in a position to increase its international development aid.

The Executive Directors agreed to continue their discussion of the staff report for the 1981 Article IV consultation with the United States in the afternoon.

2. WORK PROGRAM

Mr. Prowse said that the tentative schedule of Executive Board meetings published on July 13, 1981 included the review of the Philippines' stand-by arrangement on August 5, 1981. That date had been set on the basis of the best information then available, which had included the likelihood that the relevant discussions and staff paper would be completed in good time. Unfortunately, the circulation of the relevant staff report had been somewhat delayed because of ongoing discussions with the Philippine authorities. The discussions had subsequently been satisfactorily completed, and the staff report had been circulated on July 30, 1981. That date, of course, did not allow the normal period for consideration of staff papers before discussion in the Executive Board. However, he hoped that the Executive Directors would agree to depart from the normal practice concerning the timetable for discussing items on the agenda, and to proceed with consideration of the staff report on the review of the stand-by arrangement for the Philippines on August 5, 1981.

The staff and the authorities had made strenuous efforts to complete the relevant paper in time for it to be discussed before the coming recess of the Executive Board, Mr. Prowse went on. The continuing discussions had been directed at clarifying as far as possible the latest situation with respect to the budget and economic conditions in the Philippines, and the delay in the completion of the discussions and of the report was therefore justified. In addition, it was important to note that, while the stand-by arrangement with the Philippines was active and the Government had been making purchases under it and wished to continue to do so, no further purchases would be in order until the Executive Board had considered the staff paper on the review and had reached a decision on it.

In normal circumstances, Mr. Prowse went on, he would have proposed a delay of a week or so, consistent with the Executive Board's general practice. However, the Executive Board recess was scheduled to begin on August 10, 1981 and, because of both the recess and staff commitments, deferring the discussion in the Executive Board would mean that the review could be conducted no earlier than September 2, 1981, a solution that had obvious disadvantages. He hoped that the Executive Directors could agree to proceed with the consideration of the staff paper as scheduled, on August 5.

The Chairman remarked that the Executive Directors seemed to be prepared to accept Mr. Prowse's proposal as an exceptional departure from the Board's normal practice.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/81/108 (7/27/81) and EBM/81/109 (7/31/81).

3. CYPRUS - EXCHANGE SYSTEM

The Fund extends approval of Cyprus' restriction on payments and transfers for current international transactions, as described in SM/80/155 (7/1/80) and SM/80/166 (7/10/80), until December 31, 1981, or the completion of the 1981 Article IV consultation with Cyprus, whichever is earlier. (EBD/81/192, 7/27/81)

Decision No. 6921-(81/109), adopted
July 30, 1981

4. PHILIPPINES - EXCHANGE SYSTEM

The approval of the Philippines' exchange restrictions under Decision No. 6586-(80/118), adopted August 4, 1980, is extended until September 30, 1981, or the completion of the next review of the stand-by program, whichever is earlier. (EBD/81/155, 7/22/81)

Decision No. 6922-(81/109), adopted
July 27, 1981

5. ASSISTANT TO EXECUTIVE DIRECTOR

The Executive Board approves the proposal set forth in EBAP/81/237 (7/23/81).

Adopted July 27, 1981

6. ASSISTANT TO EXECUTIVE DIRECTOR

The Executive Board approves the proposal set forth in EBAP/81/246 (7/27/81).

Adopted July 29, 1981

7. STAFF FOR OFFICES OF EXECUTIVE DIRECTORS

The Executive Board approves the recommendation set forth in EBAP/81/244 (7/27/81).

Adopted July 29, 1981

8. STAFF FOR OFFICE OF EXECUTIVE DIRECTOR

The Executive Board approves the recommendation set forth in EBAP/81/245 (7/27/81).

Adopted July 29, 1981

9. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 81/22 through 81/26 are approved. (EBD/81/186, 7/23/81)

Adopted July 29, 1981

10. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/81/196, Supplement 1 (7/28/81), EBAP/81/241 (7/24/81), EBAP/81/242 (7/27/81), EBAP/81/243 (7/27/81), EBAP/81/249 (7/30/81), EBAP/81/250 (7/29/81), and EBAP/81/251 (7/29/81) and by an Advisor as set forth in EBAP/81/241 (7/24/81) is approved.

11. STAFF TRAVEL

Travel by the Managing Director as set forth in EBAP/81/248 (7/29/81) is approved.

APPROVED: January 22, 1982

LEO VAN HOUTVEN
Secretary