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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 90/142

10:00 a.m., September 14, 1990

M. Camdessus, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
M. Al-Jasser	
G. K. Arora	L. E. N. Fernando
	D. Powell, Temporary
	Zhang Z.
	Wang J., Temporary
T. C. Dawson	
	J. Prader
	L. B. Monyake
E. A. Evans	S.-W. Kwon
E. V. Feldman	
L. Filardo	M. A. Fernández Ordóñez
R. Filosa	
	M. A. Ahmed, Temporary
M. Fogelholm	I. H. Thorláksson
	S. Rouai, Temporary
G. Grosche	B. Goos
J. E. Ismael	
A. Kafka	
J.-P. Landau	J.-F. Cirelli
	C. V. Santos
D. Peretz	
G. A. Posthumus	G. P. J. Hogeweg
K. Yamazaki	S. Yoshikuni

C. Brachet, Acting Secretary
S. W. Tenney, Assistant

Also Present

African Department: M. Lazare. Asian Department: J. R. Marquez-Ruarte. European Department: M. Russo, Director. Exchange and Trade Relations Department: T. Leddy, Deputy Director; M. G. Gilman, M. R. Kelly. External Relations Department: J. C. Roushdy. Fiscal Affairs Department: M. S. Lutz. Legal Department: E. Aguirre-Carrillo. Middle Eastern Department: P. Chabrier, Deputy Director; J. Hicklin, S. H. Hitti, M. Zavadjil. Research Department: J. A. Frenkel, Economic Counsellor and Director; B. Chadha, J. E. Greene, E. Hernández-Catá, P. R. Masson. Western Hemisphere Department: S. T. Beza, Counsellor and Director; M. Caiola, Deputy Director; J. Ferrán, Deputy Director; K. N.-O. Andersson, S. A. Coorey, L. P. Ebrill, O. J. Evans, S. M. Fries, Y. Horiguchi, C. M. Loser, M. Mered, E. M. Nedde. Personal Assistant to the Managing Director: B. P. A. Andrews. Advisors to Executive Directors: M. B. Chatah, A. Gronn, Z. Iqbal, A. R. Ismael, J.-L. Menda, P. O. Montórfano, B. S. Newman, Y. Patel, F. A. Quirós, S. P. Shrestha. Assistants to Executive Directors: H. Brohs, Chen M., S. B. Creane, E. C. Demaestri, S. K. Fayyad, S. Gurumurthi, M. E. Hansen, A. Hashim, O. A. Himani, Hon C.-W., P. Kapetanovic, C. J. Jarvis, M. Mrakovcic, H.-J. Scheid, M. J. Shaffrey, C. M. Towe, S. von Stenglin, J. C. Westerweel.

1. SUDAN - OVERDUE FINANCIAL OBLIGATIONS - DECLARATION OF NONCOOPERATION

The Chairman recalled that Directors had agreed at EBM/90/120 (7/23/90) to publish a declaration of noncooperation regarding Sudan by September 14, 1990 unless by that time, following discussions with the Sudanese authorities, he had, in light of actions taken by Sudan in the meantime regarding settlement of its arrears to the Fund and the formulation and implementation of a comprehensive adjustment program, brought the matter for consideration by the Executive Board.

Following a mission to Sudan in August 1990, the staff had concluded that the policy initiatives envisaged by the Sudanese authorities were not sufficient to warrant a postponement of the declaration of noncooperation, the Chairman said. In addition, on August 25, 1990, he had received from the Minister of Finance and Economic Planning of Sudan a letter, reiterating the authorities' current economic policy stance. Therefore, the Fund had no alternative but to issue the declaration of noncooperation in accordance with the decision taken during EBM/90/120 (7/23/90).

Nevertheless, the Chairman concluded, the Fund would continue its efforts to convince the Sudanese authorities of the urgent need for appropriate economic adjustment efforts.

2. UNITED STATES - 1990 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1990 Article IV consultation with the United States (SM/90/155, 8/3/90; Sup. 1, 8/13/90; and Sup. 2, 9/7/90), together with a background paper on recent economic developments in the United States (SM/90/159, 8/10/90; Sup. 1, 8/16/90; and Sup. 2, 8/16/90). They also had before them a staff memorandum relating to the regulations of the U.S. Government blocking Iraqi government property and prohibiting transactions with Iraq (EBD/90/252, 8/17/90), a memorandum related to regulations of the U.S. Government blocking Kuwaiti government property and prohibiting transactions with Kuwait (EBD/90/253, 8/17/90), and a memorandum relating to the lifting of restrictions imposed by the United States on certain transactions with Panama (EBD/90/263, 8/21/90).

Mr. Dawson made the following statement:

> As usual, the 1990 Article IV consultation with the United States provides an invaluable opportunity for a full and frank exchange of views on the U.S. economic situation, outlook, and policies. My authorities consider that an effective Fund surveillance process requires that Article IV consultations provide a critical assessment of national policies and produce a creative tension between the staff and the authorities that may result in

considerable debate, but hopefully also shed some light on the implications of alternative policy options. I am sure that the staff will agree that the 1990 Article IV consultation with the United States had the intended effect, and that, while there may be differences of view on certain issues, both parties found the discussions worthwhile.

Economic situation and prospects

The long period of economic expansion enjoyed by the United States slowed markedly in mid-1989, as the tighter monetary policies that had previously been implemented began to have their intended impact, especially on residential construction activity and spending on durable goods. The pace of economic activity continued to slow in 1990, as other forms of consumer spending and nonresidential business investment also began to weaken. Recent data, including that on the most recent increase in the level of unemployment, suggest that the slowdown is continuing and that the recovery, which had been expected in the second half of 1990, will be postponed. Prospects for 1991 are, of course, clouded by recent oil market developments and the uncertainties arising from events in the Middle East. However, the downside risks have clearly increased significantly and the outlook is for very modest growth at best.

Inflation rates increased early in 1990, largely owing to temporary factors that had begun to pass before the most recent rise in oil prices. The increase in oil prices is currently expected to push the inflation rate up to about 5 percent in 1990 and 1991. However, we do not consider that this signals renewed inflationary pressures or a situation of stagflation, as in the 1970s. Increases in wage rates have been surprisingly moderate during the current expansion. Moreover, the increase in unit labor costs over the past year has reflected primarily the lower productivity that accompanies slower output growth and higher nonwage benefit costs, especially rapidly rising health benefit costs. With the economy slowing markedly and unemployment rising, the increase in oil prices is unlikely to spill over into increased wage demands and a sustained higher level of inflation. Moreover, the problem of rising benefits costs are addressed better through targeted structural reforms than through macroeconomic policies.

With domestic demand slowing and strong growth abroad, the improvement of the external sector provided an important contribution to overall growth over the past year. The rapid rise in export volume, together with the moderate growth of imports, resulted in a substantial reduction in the trade deficit and, combined with a rise in net service receipts, a significant improvement in the current account deficit. Some further modest improvement in the current account should occur in 1991, as the effects of the slower growth rate and the depreciation of the dollar since mid-1989 more than offset the impact of higher oil import costs. However, it is clear that the adjustment process is slowing and the external deficit will remain large in absolute terms and still significant relative to GNP.

Monetary policy and exchange rates

Monetary policy has been directed at achieving price stability over the medium term, defined as a change in the average price level that is low enough not to influence materially the private sector's financial decisions. For this purpose, the Federal Reserve gradually has sought to lower its targets for monetary growth consistent with maintaining adequate growth in the economy. In this context, the Federal Reserve began to ease its policy in the middle of 1989 in response to growing signs of a weakening economy. As a result, the federal funds rate has declined by nearly 2 percentage points from its peak, although growth of measures of the money supply remain below the midpoints of their target ranges.

The increase in oil prices at a time of a further weakening of the economy and strain in the financial system has complicated the Federal Reserve's task. However, in view of the limited prospects for serious spillover effects given current economic conditions, we do not believe that a tightening of monetary conditions as suggested by the staff would be appropriate. Rather, the policy stance that was appropriate in light of conditions prior to the recent events in the Middle East continue to apply.

The depreciation of the dollar since mid-1989 has reflected the movement of interest differentials and the change in cyclical conditions in the United States and other major industrial countries. The depreciation has been most pronounced against the European currencies as higher German interest rates in response to the mounting cost of unification have resulted in an increase in real interest rates. More recently, the dollar has depreciated against the yen, as Japanese interest rates have begun to catch up with earlier European rises, although the exchange rate of the dollar is only slightly lower against the yen compared with levels reached earlier in the year. On the whole, the movements in exchange rates have been orderly, and they are facilitating external adjustment.

Fiscal policy and the budget deficit

The budget deficit in the fiscal year ending in September 1990 will reach about $165 billion, some $65 billion larger than provided for in the Gramm-Rudman-Hollings (GRH) legislation. Inclusion of the rising savings and loan costs would bring the deficit to roughly $220 billion.

Slower economic growth, higher interest rates, and the increasing cost of the savings and loan crisis were the principal factors in the larger deficit. The midyear projections for the fiscal year beginning on October 1, 1990, were for a deficit of about $230 billion, including the cost of the savings and loan crisis, with the increase reflecting slower economic growth and downward revisions in estimates of the tax yield from a given level of GNP. However, the rising defense expenditures and slower growth due to recent events in the Middle East are likely to cause the deficit to increase further on a current policy basis.

The United States recognizes that it has the primary responsibility for dealing with the budget situation. Negotiations between the Administration and the Congress have resumed with the aim of achieving $500 billion in deficit reduction over the next five years, including $50 billion in fiscal year 1991. In addition, proposals have been made to improve the budget process, including many of the ideas advocated by the Fund staff. The participants are acutely aware that failure to succeed will have serious consequences in the form of slower growth, higher inflation and interest rates, and financial market instability.

Recent events will clearly make it more difficult to reach agreement, although they in no way reduce the urgency of prompt and credible action. The increase in defense costs associated with recent events in the Middle East will add about $1 billion a month to expenditures. Moreover, concerns about the impact of large deficit reduction on an already weakening economy will need to be taken into account. In these circumstances, proposals for a large front-loading of deficit reduction, amounting to $100 billion or more as the staff implies, are neither credible nor desirable. Indeed, such action could prove counterproductive to efforts to increase national saving and strengthen the budget process.

First, a deficit reduction package that triggered a recession could not be sustained, as higher unemployment costs and revenue losses associated with slower growth would offset a substantial portion of the initial deficit reduction. Moreover, under the GRH legislation, even a mild recession would almost certainly trigger suspension of the budget ceilings and irresistible political pressures for fiscal stimulus.

Second, the slow recovery in private saving that has occurred over the past year could be jeopardized as households sought to preserve consumption levels in the face of declining income.

Third, a budget package that triggered recession would further undermine an already weakened financial system and substantially increase the costs associated with the savings and loan situation. Moreover, the danger that financial pressures could extend to the banking system could force the Federal Reserve to provide more liquidity than economic conditions alone would warrant.

Fourth, and possibly most important, a budget package proposal as large as the staff suggests simply will not be adopted by the Congress.

In these circumstances, we do not believe that a budget package as large as the staff suggests would result in the credibility effects assumed in its model and could have serious downside risks for the U.S. and world economies. A budget package that takes into account current economic conditions while putting in place a multiyear program of substantial deficit reduction and process reforms to improve implementation remains the most credible and effective means of bringing the budget under control.

Global savings and the balance of payments adjustment process

Despite the progress that has been achieved in reducing the U.S. external deficits, we remain concerned about the prospect of continuing deficits in the $100 billion range in the near term. We do not agree with the staff that the reduction in global imbalances that has been achieved in recent years has significantly eased adjustment requirements with respect to the balance of payments. Indeed, we find most disturbing the staff's medium-term projections of continued U.S. and Japanese imbalances in the range of 2 percent of GDP and even larger in a united Germany, despite the assumptions of higher growth in surplus countries and improved U.S. savings. Imbalances of these magnitudes, while smaller than in the recent past, still represent a significant threat to the stability of the international financial system and our ability to restrain protectionist pressures that could damage the open trading system and the maintenance of a growing world economy.

The prospect of higher resource demands for the reform of Eastern Europe and the continuing financing needs of developing countries has led to concerns about higher real interest rates and fears of a "global savings shortage." This has led the staff and others to suggest that efforts to increase global savings would best be achieved through a balance of payments adjustment process that relies disproportionately on measures by deficit countries to increase national savings by reducing fiscal deficits. The rationale for such an approach is that in some sense the external surpluses are benign, because they contribute to global savings, while the deficits are malign, because they utilize scarce savings in a manner that does not increase global welfare.

In the context of the discussion on the world economic outlook (EBM/90/56 and EBM/90/57, 4/11/90 and EBM/90/58, 4/13/90), I suggested that this approach to balance of payments adjustment issues reflected specific assumptions about capacity constraints in individual countries and the world in general. Even under the constraint of global full employment, it would be possible to develop an alternative expenditure pattern that reduced external imbalances while leaving global savings unchanged. Moreover, if less than full employment anywhere in the world were assumed, it would be possible to increase global savings and reduce external imbalances.

For the current discussion, I would like to focus on a somewhat different, but related, issue that can also affect judgments on the appropriate approach to balance of payments adjustment in the context of concerns about global savings. An assumption underlying the staff's approach is that the use of global savings to finance investment in Eastern Europe and developing countries would result in higher rates of return than would use of those resources to finance expenditures in deficit countries. Even if we accept that assumption--which is suspect given past experience--it does not follow that the level and pattern of public expenditures and taxes in surplus countries are more welfare maximizing from a global perspective than those in deficit countries. Recent events, in particular, highlight this point most graphically.

At present, the United States has a small surplus in its primary budget, with the overall federal budget deficit, of roughly 4 percent of GDP, reflecting interest payments on the accumulated deficits and debt of the 1980s. As is well known, I do not place much stock in the Fund's use of the primary balance as a measure of a country's fiscal position, since interest obligations must also be met and financed. However, it does highlight the fact that current U.S. expenditures are covered by current income.

The increased deficits and debt in the early 1980s reflected a sharp increase in expenditures, including defense spending, and the impact of the steep recession in 1981-82. The defense expenditures have many of the characteristics of an investment in a public good in which the benefits extend beyond the United States. The benefits can be seen, for example, in the transformation now taking place in Eastern Europe, including German unification and the opening up of Eastern Europe, as well as in the current U.S. effort to deter aggression in the Middle East and implement UN sanctions.

The United States has borne virtually the full cost of these defense expenditures, although an important share of the benefits have accrued to others. Thus, U.S. defense expenditures as a share of GDP in the 1980s have been nearly double that of other major industrial countries, and even higher compared with a number of surplus countries. The willingness of the United States to bear these costs has contributed importantly to the stronger fiscal position of other industrial countries and higher levels of national savings than would have been possible with a more balanced sharing of the burden.

In these circumstances, serious questions of equity and efficiency arise from the staff's proposal that the United States bear a disproportionate share of the adjustment responsibility by further reducing expenditures and raising taxes, possibly at the risk of a recession. It is difficult to accept that U.S. taxpayers should in effect pay twice for benefits that accrue to other countries so that those countries can continue to maintain larger public expenditures, lower taxes, and higher savings than would be possible with a more balanced sharing of the collective responsibility for global security. Similarly, global savings could increase if these countries, particularly those in surplus, were to undertake a larger share of the defense burden commensurate with the benefits they receive. A useful first step in this respect would be a substantial contribution to the sharing of the direct and indirect cost of international efforts to deter aggression and implement UN sanctions.

U.S. trade policy and aid

In recent years, there has been growing concern that large trade deficits would lead the United States to abandon its traditional support for an open multilateral trading system. Protectionist sentiment has increased, in particular in the sectors that have been under severe strain. There is also clearly a danger that protectionist pressures could intensify further as the pace of economic activity slows, especially if a serious recession were to emerge. However, the most recent presidential election demonstrated that broad support remains for maintaining and extending the open trade and investment system that has served the U.S. and world economy so well over the past 45 years. This remains a fundamental tenet of U.S. trade policy.

There is broad recognition that U.S. trade deficits have their roots in macroeconomic and structural policies in the United States and abroad and that the cure is changing those policies in a coordinated manner with other trading countries rather than imposing barriers. It is for these reasons that the United States is firmly committed to an effective economic policy coordination process and considers the successful conclusion of the Uruguay Round of multilateral trade negotiations the overriding objective of trade policy at present. Nevertheless, there are certain trade practices that extend beyond the purview of current trade rules and serve as a serious barrier to the flow of goods and services. In these circumstances, bilateral negotiations may be the only effective means of addressing these problems.

The authority provided by the Super 301 legislation has been implemented prudently and in a manner aimed at reducing trade barriers through negotiations rather than as a justification for retaliation and increased restrictions. The successful conclusion of negotiations with several countries on specific priority issues has resulted in significant new trading opportunities that are open to all countries, not just U.S. producers.

The U.S.-Japan Structural Impediments Initiative (SII) represents a path-breaking effort that goes well beyond traditional trade issues to examine policies and practices in both countries that hamper trade and effective balance of payments adjustment. The progress being made in dismantling and reducing these impediments will benefit all countries.

With respect to U.S. official assistance to developing countries, current budget constraints make it extremely unlikely that the United States will be in a position to raise the level of foreign assistance in relation to GNP and, quite frankly, we would be doing well to even maintain present absolute levels in real terms.

However, the United States is exploring other ways to help developing countries. For example, in recent years, the United States has been the principal market for manufactured exports from developing countries. We are pursuing policies that should further open the U.S. market to developing country exports; pushing for substantial trade liberalization through the Uruguay Round; offering the possibility of U.S. trade liberalization as an incentive for trade and investment liberalization in Latin America; and we expect to enter negotiations with Mexico for a free trade agreement. In addition, we have made permanent our unilateral trade preference under the Caribbean Basin Initiative and are proposing to create a similar program for Andean countries. Furthermore, the United States has agreed to waive up to $1 billion in official debt owed by African countries, proposed official debt reduction for other Latin American countries as part of economic reform programs, and announced its intention to waive nearly $7 billion in debt owed by Egypt.

Conclusion

The coming year will be difficult for the U.S. economy. Growth will slow to a crawl. Inflation will be at levels that are undesirable over the medium term. A painful correction of the fiscal deficit will be initiated. However, the United States recognizes that it must get its house in order and that the success of this adjustment effort will provide substantial benefits for both the U.S. and the world economy.

Ms. Powell made the following statement:

In many respects, the recent performance of the U.S. economy has been commendable; output growth has been sustained for an unprecedented eight years; the federal fiscal deficit, on a public accounts basis, has been reduced from its 1986 peak of 5.3 percent of GNP, to approximately 3.1 percent of GNP in 1990, excluding the purchase of assets of failed savings and loans, while the current account deficit fell from 3.2 percent of GNP in 1987 to an estimated 1 3/4 percent of GNP in 1990.

Despite these successes, the imbalances facing the United States remain serious. More disturbing is the sense that the adjustment seems to have virtually halted. Indeed, the fiscal deficit has exhibited a remarkable resilience to further reduction efforts, and the staff estimates that the 1991 budget deficit--in the absence of additional measures--will be on the order of $190 billion, or well over 3 percent of GNP. Earlier progress on inflation has been reversed; since 1986, the average annual rate of inflation has more than doubled, from 1.9 percent to 4.8 percent. The staff estimates on the external front are also discouraging, as the current account deficit is not expected to show any further improvement over the medium term.

Nevertheless, the most frustrating realization is that an opportunity to resolve these issues during a period of protracted economic and political calm seems to have been forgone. Since the previous Article IV consultation with the United States (EBM/89/116, 9/1/89), new and serious economic challenges have arisen. In particular, recent increases in the consumer price index and in the index of employment costs, of well over 5 percent, signal growing inflationary pressures. Moreover, events in the Middle East have worsened the outlook for both prices and output, which, as Mr. Dawson's opening statement notes, will increase pressures on the fiscal accounts.

These trends argue for greater urgency in addressing the domestic imbalances of the U.S. economy. Therefore, we agree with the staff that the U.S. authorities should be encouraged to establish a credible commitment to a front-loaded fiscal deficit-reduction package, and to return the focus of monetary policy to achieving price stability. We note the authorities' concerns about a recession. However, the events of the past two decades have convincingly demonstrated the futility of attempting to exploit a trade-off between inflation and output growth, as well as the substantial real economic costs of protracted inflation. We consider that the long-term risks of delaying the adjustment should be given the highest priority.

I will elaborate on this theme in the context of fiscal policy, monetary policy, and the external balance.

The reduction of the U.S. fiscal deficit remains of paramount importance to the achievement of sustained noninflationary growth. Its costs include continued pressures on prices and the current account, growing international indebtedness, and high real rates of interest. In addition to its domestic impact, the U.S. deficit also places an unfortunate burden on the global economy, raising real interest rates and reducing capital accumulation and growth.

Higher world petroleum prices only increase the importance of the prompt achievement of a sustainable fiscal balance. It is instructive to recall that the most successful adjustment--defined as the change in the sum of inflation and unemployment rates--to the 1979-80 oil price shock was achieved by Japan, despite its comparative disadvantage as a major importer of energy products. This success has been ascribed, in large part, to the process of fiscal consolidation that began at that time.

A front-loaded adjustment is suggested for several reasons. First, a delayed adjustment will contribute to inflationary pressures, as a result of the impact on aggregate demand, and on expectations of an eventual monetization of the growing national debt. Second, a delayed adjustment will also compound the impact of the deficit on real interest rates and capital accumulation, and diminish the long-term growth prospects of the U.S. economy.

Third, and perhaps most important, a front-loaded adjustment would also help re-establish the credibility of the fiscal authorities. The staff scenarios illustrate the importance of fiscal credibility in minimizing the output consequences of a fiscal adjustment. A multiyear adjustment program that does not significantly reduce the deficit in the very near term would be received with skepticism, magnifying any temporary output effects.

Moreover, any further erosion of private sector confidence in the commitment to fiscal adjustment could lead to self-fulfilling expectations of larger deficits. For example, without a meaningful adjustment in the near term, the private sector may be unwilling to place a high degree of credence on any promise of future adjustment. As a result, pressure on real interest rates and any output loss would be increased. We worry that this could strain the authorities' resolve in continuing the course of adjustment and result in a self-fulfilling prophecy of excessive fiscal deficits, inflation, and weak output growth.

While the arguments for a front-loaded adjustment are persuasive, Mr. Dawson's opening statement very candidly indicates that political and other constraints will probably limit new measures to no more than $50 billion in 1991. We acknowledge that this would represent a significant effort. However, we are concerned that anything less than this amount will not alleviate doubts about the authorities' commitment to the longer-term goal of deficit reduction, especially in light of fiscal pressures arising from recent events in the Middle East. The credibility of the commitment to deficit reduction has been severely strained in recent years, owing to the deviations from both the original and the revised versions of the GRH legislation; the adoption of overly optimistic fiscal objectives and forecasts; and the manipulation of budget accounting methodologies. Therefore, we strongly urge the authorities to combine any fiscal package for 1991 with a substantial reform of the budget process. In particular, we recall the suggestions made during the 1989 Article IV consultation with the United States on reforms to the GRH process, including proposals for midyear corrections.

While Mr. Dawson's opening statement indicates an encouraging willingness to consider tax increases, the authorities also seem to be considering tax incentives to enhance private savings. We strongly urge the authorities against this course of action, as such measures would result in an additional budgetary burden, with only a negligible impact on private savings. Tax incentives are a second-best solution to the problem of deficient national savings. The more effective approach would be to correct those aspects of the tax system that create incentives to consume. Therefore, we endorse the adoption of consumption taxes as a means of achieving increased public and private sector savings.

As to monetary policy, the United States is a principal partner in the collective responsibility to provide a nominal anchor to the international monetary system. Therefore, it is a cause for concern that the monetary authorities appear to have diluted their commitment to achieving a containment of inflation in favor of other considerations, including short-term real growth and the fragility of the financial system. The appropriate target of monetary policy is price stability, not the short-run stabilization of real variables.

Moreover, as I have indicated previously, we consider the experience of the past two decades to be strong evidence of the futility of attempting to exploit a trade-off between inflation and growth. Any success in this respect would be short lived, and would be very quickly outweighed by the output cost associated with having to address much higher, and more entrenched, rates of inflation. Moreover, the adoption of a real output target, even in the short run, puts at jeopardy the credibility of the authorities' commitment to stable prices and could fuel self-fulfilling inflationary expectations. The recent events in the Middle East only imply the need for a reinforced commitment to contain inflation and establish the basis for steady progress toward price stability. The experience of the mid-1970s suggests that attempting to offset higher oil prices by easing monetary policy only compounds the risk of inflation.

Finally, we consider the authorities' concerns about recession to be premature. While we recognize that demand growth has slowed significantly in the United States, we are not convinced that, as yet, the output gaps have emerged that would contain, much less reduce, inflation.

Against this background, the staff report calls for perseverance with monetary policy restraint, while its scenarios seemed to concede the possibility of a more relaxed policy stance in the event of a strong fiscal adjustment. We wonder whether the staff could elaborate on its prescription for monetary policy with respect to the Federal Reserve's target range of money growth and the current prospects for a budget package.

On the external front, it is encouraging to note the continued improvement in the U.S. trade and current accounts. However, the staff analysis suggests that on the basis of unchanged policies, further improvement is unlikely. We agree with the staff and the authorities that a sustained improvement in the current account will require a lower fiscal deficit and higher national savings. Therefore, it is disconcerting to note that the U.S. authorities "regret" the recent emphasis placed by surplus countries on combating inflation, rather than reducing external imbalances.

Again, we consider that macroeconomic policy should be targeted toward price stability and the achievement of sustainable growth. A focus on the achievement of a particular current account balance is analogous to treating a symptom and not the disease, and is likely to be just as effective. Therefore, we view the renewed focus on reducing inflation among many of the G-7 countries as entirely appropriate. This strategy has a greater potential for achieving sustainable growth and alleviating external imbalances than does a concern with short-run stabilization goals.

Mr. Peretz made the following statement:

The world's major industrial countries, especially those responsible for managing the main reserve currencies, share a responsibility to safeguard the integrity of the international financial system. This means a responsibility to keep rates of inflation low and maintain the value of money.

The United States is the world's dominant economic and financial power, just as the United Kingdom was a century ago. International dominance brings benefits to the country, but it also brings costs and responsibilities.

There are clear risks to price stability in the current situation, which is characterized, on the one hand, by an apparent loosening of the fiscal position in some major countries, and on the other hand, by the rise in oil prices, which may or may not turn out to be sustained.

Therefore, the original cause of the inflation of the 1970s and the breakdown of the Bretton Woods system should be borne in mind. It was not only the 1973 oil shock that brought on those problems, but also the way in which many countries, including the United States, managed their economies in the late 1960s and 1970s. Faced with a difficult fiscal position, the legacy of the immense demands of the Vietnam War, and the unexpected costs of the Johnson Administration's domestic programs, the U.S. authorities failed to keep monetary policy sufficiently tight to prevent a rapid rise in the rate of inflation. In describing Board discussions in 1969, <u>The History of the International Monetary Fund</u> notes, "...Directors criticized the United States for putting undue weight on monetary policy instead of on fiscal policy." However, the United States was not alone in making that mistake;

the U.K. authorities, as well as some others, had done the same. Nevertheless, experience shows how quickly rates of inflation can rise--from 5 percent to 10 percent or higher in a year or more.

It is important to remember this experience and not repeat the same mistakes. The oil price rise has thus far, of course, been much less significant than either of the two oil shocks of the 1970s. However, at present, the availability of international savings to finance the U.S. deficit may well diminish as the costs and consequences of German unification and events in Eastern Europe become apparent. As the U.S. President pointed out in his recent address to Congress, the economic vulnerability of the United States makes immediate action to address the budget deficit necessary. Without such action, the strain put on monetary policy to combat inflation could become intense. In addition, of course, there is always the risk that--rather than face that strain--the authorities will choose to accommodate inflation instead.

All this may be too gloomy, and the judgment of what precise combination of budget deficit and interest rates is sufficiently tight in the face of shifting expectations, is always very hard to make. However, I do consider that inflationary risks are present and that we would be wise not to ignore the lessons of the past 20 years.

My comments for the current discussion will first address U.S. fiscal policy and then monetary policy.

With respect to fiscal policy, Mr. Dawson's opening statement suggests that his authorities are concerned that too much fiscal retrenchment would increase the risk of a recession. However, the staff has correctly pointed out that if a credible fiscal package can be worked out, it should permit some loosening of monetary policy and that the combination may actually lead to faster, not slower, growth. This was the experience of the United Kingdom in the 1980s. In 1981, fiscal policy was tightened substantially, though a combination of broadening the tax base and controlling expenditures, at a time of severe recession. Despite a public letter to a newspaper from 364 eminent economists prophesying disaster, this action paved the way--partly through the loosening of monetary policy that it permitted--to seven years of sustained and above average growth, at a rate that was faster than most other European countries at the time.

In any case, the risk of recession is clearly even greater if a credible fiscal policy cannot be agreed. If inflationary expectations become entrenched, it will certainly in the end take a bigger contraction in output to dislodge them, and there is always the danger of a collapse in investor confidence at some point if inflation begins to accelerate too quickly.

Moreover, the staff report contains plentiful evidence of the difficulties and constraints caused by the authorities' fiscal problems. While I have mentioned the constraints on monetary policy, the problem of the deficit has come to dominate, and perhaps distort, the policy agenda in other areas.

While I hesitate to prescribe specific remedies, as a general principle, it seems that the authorities should look to broaden the tax base and cut spending, rather than raising tax rates. I think they agree with this principle in general terms. I also think that the appropriate way to broaden the tax base would be to increase energy taxes, which would also be justified on global environmental grounds. The price of energy, and especially gasoline, is significantly lower in the United States than in other major industrial countries, and consumption of energy as a percentage of GDP is significantly higher. I am sure these two facts are related. It is time for the world's largest energy consumer to join other industrial countries in using the price mechanism to encourage energy conservation and greater efficiency in energy use.

From my previous comments, it is obvious that I would urge the use of extreme caution with respect to monetary policy. The first priority must be to contain inflation and to adopt a non-accommodating response to the oil price increase. Mr. Dawson's opening statement put forward many seductive arguments. One argument is that, as the oil price rise is only temporary, it can safely be ignored in the operation of policy. Alternatively, it is sometimes argued that the increase in the price of oil will raise prices, but reduce output by the same amount, so that if nominal GDP is the target, there is no need for action. Others argue that the events in the Middle East have raised the demand for liquidity, thereby tightening policy for a given level of interest rates. Mr. Dawson's opening statement in effect argues that the low value of the dollar can safely be ignored; it is mainly due to high interest rates overseas, and that the depreciation so far as in fact been an orderly one.

I have reservations about all these arguments. The important point about the oil price rise is not whether it is temporary, but whether it is perceived to be temporary. If the average expectation is that it will last, at least for a period--and I believe that is the popular perception--then there is a risk that the rise in short-term inflationary expectations will lead to a longer-term increase in the rate of inflation. For example, it will get built into wage negotiations. It certainly implies a cut in real short-term interest rates unless there is an increase in nominal rates, owing to short-term inflationary expectations.

Cutting interest rates to allow for a shift in liquidity preferences is a mistake that most of the major countries made in 1987 after the fall in equity prices. It seems a bit premature to be making the same mistake again.

A sustained decline in the exchange rate, whatever its cause, adds to inflationary pressures. The exchange rate of the dollar against the other major currencies, both in nominal and real terms, is currently at the bottom--or perhaps below the bottom--of the range in which it has fluctuated for the past 20 years. This is a further signal of the need for domestic action.

With respect to structural policy, as most Directors commented during the 1990 Article IV consultation with France (EBM/90/140, 9/12/90), and as is commonly the Fund's advice to other countries, the way to improve output growth is to improve the supply side. Most countries, certainly including my own, look to the U.S. economy as a paradigm in this respect. However, that does not mean there is no room for improvement. For example, many of the difficulties that some U.S. financial institutions are experiencing are the result of legal restrictions that prevent them from diversifying regionally or functionally. There may be some merit, as the staff indicated, to a reconsideration of the Glass-Steagal laws to allow banks to avoid this overdependence on single regions or sectoral bases.

Another example of where structural action could be desirable is the health care system. The United States spends more on health care as a percentage of GNP than any other industrial country, and both total spending and the Federal Government's share of this spending is rising. Working Paper 90/1 (1/16/90) on the U.S. health care industry pointed out considerable distortions in the health sector. The insurance-based nature of the system encourages overconsumption of medical services, which is exacerbated by tax deductions on employer contributions to medical insurance. There are other significant distortions arising from the legal and insurance treatment of medical malpractice. The staff has suggested some interesting proposals for reform in this area, and it would be easy to think of others.

As to macroeconomic policy, the worst outcome at present, not only for the United States, but for the whole world, would be another trend of rapid dollar, and hence world, inflation, and a repeat of the situation that prevailed in the 1970s and early 1980s.

Mr. Fogelholm made the following statement:

Both the staff and the U.S. Administration expect economic growth to continue in the near term, but at a slower pace. But even a growth rate equivalent to a crawl may turn out to be optimistic in light of current circumstances and the many recent signs of a significant slowdown. Economic indicators show sluggish consumer spending, weak income growth and a low level of residential construction starts, as well as the oil price increase with its attendant negative impact on domestic demand and output. On a more positive note, exports and fixed investment have developed favorably. The growth in exports indicates that the loss of market shares might be less than projected. The strong growth in productive investment will eventually ease pressure on production capacity. Nevertheless, the underlying economic trend is weak, presenting some danger of sliding into recession.

For some time the international economic community has been concerned about the twin deficits that threaten the economic progress in the United States. The staff report analyzes both the federal budget deficit and the current account in depth; the Nordic countries have concluded that these imbalances must be addressed even at the cost of a temporary deterioration of the general economic conditions in the United States.

The federal deficit peaked in 1986, reaching a cyclically adjusted 4 1/4 percent of GNP, but fell to 3 1/2 percent of GDP in 1987, and has since stayed at that level. This modest improvement reflects the Federal Government's efforts to curb the deficit in stages in accordance with the targets in the GRH legislation and the amendments to it. Recently, however, the gap between the actual deficit and the amended targets has had a tendency to widen even excluding the cost of the resolution of the insolvent thrifts.

The figures in the staff report show that the federal budget deficit has been reduced mainly through a relative decline in expenditures rather than through increased revenues. Undoubtedly, there is still substantial leeway for further cuts in government expenditures. However, the ability to balance the budget over the medium term would be greatly improved if also revenue-enhancing measures could also be introduced. We, therefore, welcome the fact that in the ongoing budget negotiations new revenues are being contemplated. In the present situation, a tax on oil products, for instance, could be particularly suitable, as it would simultaneously enhance government revenues and induce a more efficient use of energy.

Anyway, the central question is whether the $50 billion deficit reduction the Administration is seeking for the coming fiscal year is sufficient. The staff concludes, using medium-term scenario calculations as a basis, that the more front-loaded approach would be preferable. As in most cases, when adjustment is overdue, the situation does not improve if correction is postponed--the same problems lie ahead but more severe. Not surprisingly, Mr. Dawson strongly disagrees. However, his case basically rests on one crucial assumption: that the Congress is willing to irrevocably decide on an enforceable five-year, $500 billion deficit reduction plan. If that were the case, credibility in fiscal policy would most likely be restored and the markets would probably accept a slower pace of adjustment. But, if only a one-year, $50 billion reduction is approved, downward pressures on the dollar exchange rate will probably continue and the prospects for growth, inflation curtailment, and favorable interest rate developments would be impaired. So much is at stake in the coming days and weeks; the fourth point made by Mr. Dawson is the most convincing, namely, that the Congress will not approve a larger deficit reduction proposal.

The staff report points out that outstanding federal debt held by the public has stabilized at about 43 percent of GNP. Excluding net interest payments, government spending as a percent of GNP was the same in 1989 as on average in the 1970s, when the fiscal deficits were considerably smaller. This illustrates clearly that accumulation of public debt has become a burden on fiscal policy and will hamper its flexibility at times when the economy might be in need of fiscal stimulus.

Persistent current account deficits have placed the United States in a net external liability position. The Nordic countries share the staff's concern about the continuing buildup of external debt, and believe that the fundamental solution to this problem can only be reached through actions that improve the national savings performance.

The slow productivity growth further underlines the need to increase savings rather than to decrease investment. The staff report notes that the U.S. national saving rate declined sharply in the mid-1980s and recovered only slightly by the end of the decade. The Government has taken some measures that hopefully will provide incentives to increase private savings. Nonetheless, national saving at present is at a very low level, 3.1 percent of GNP in 1989 compared with an average of 8.2 percent in the period 1950-79, and it cannot be expected to reach a more healthy level unless government savings are increased considerably.

A substantial part of the government deficit is financed by foreign savings. So far, the United States has not had any problem financing the deficit, but a large fall in the value of the dollar--a fall that does not seem desirable, particularly in the absence of policy action--could erode confidence in the U.S. economy and the willingness of international investors to direct funds to the United States in the necessary amounts and at current interest rate levels.

This possibility adds impetus to the need for strengthened cooperation between the major countries in order to preserve stability in the foreign exchange markets.

A substantial rise in unit labor costs in 1989 and 1990 has increased the concerns about inflation in a time of sluggish economic growth. The recent increase in oil prices gives a stagflationary impulse to the economy. This has, indeed, made the conduct of monetary policy a delicate matter, requiring a balancing act of restricting inflation without hampering growth. But as already noted by previous speakers, the emphasis of monetary policy should squarely lie on fighting inflation. Thus, it is important that the U.S. authorities continue to stress their commitment to price stability.

The Nordic countries strongly support the extension of excise duties and other economic instruments to obtain simultaneously more efficient energy utilization and reduced pollution levels. The proposed revision of the Clean Air Act, which incorporates a proposal to issue tradable pollution permits that would encourage industry to reduce the emission of sulfur dioxide, is appreciated by the Nordic countries. Although we consider that the revisions do not cut the emission of sulfur dioxide to desired levels, they increase the economic incentives to improve production techniques and should ensure that environmental gains are made at least cost.

My authorities welcome the efforts that the Government of the United States has made to find solutions to the debt problems of the highly indebted developing countries. However, these efforts would be considerably strengthened if they were accompanied by actions promoting growth in international trade. In this connection, we commend the efforts of the U.S. Government to pursue trade liberalization within the framework of the Uruguay Round. As noted by Mr. Dawson, the results to date of U.S. bilateral trade negotiations with individual countries have been beneficial for third countries, allaying the fears expressed to the contrary by this chair among others. Nevertheless, it should be clear that trade liberalization within a multilateral framework is preferable.

Finally, the Nordic countries note with regret that U.S. official development assistance has fallen by over 20 percent from 1988 to 1989. We strongly encourage the Government to reverse this development.

Mr. Al-Jasser made the following statement:

The U.S. economy has recently been characterized by some important positive developments. The external current account deficit has declined, while improvements in economic growth and the level of unemployment have been realized. The rate of inflation has also remained generally low. More important, gross national savings, after being on a declining trend for several years, have started to increase, albeit slowly, after 1987.

However, over the past year or so, perceptible economic slackening has set in, the savings ratio has started to decline, and unemployment rose in August 1990. At the same time, the rate of inflation has started to edge up, while industrial production has remained sluggish. I agree with the staff that, under the unchanged policy stance, the economic slowdown will persist in the near term. However, it should be noted that there are no visible signs of a recession.

Clearly, this evolution has highlighted some important dilemmas in the U.S. economy. At the heart of these dilemmas is the low level of domestic savings and limited investment. It goes without saying that a reduction in the current account deficit without a better national savings effort would simply reduce investment and, hence, growth capacity. Moreover, the prevailing structural rigidities and low growth of labor productivity, combined with high domestic demand, have underpinned the inflationary bias. These dilemmas can substantially be traced to the burgeoning budget deficits.

In the short term, the main challenge is to contain inflationary pressures without aggravating an economic slowdown. However, in the medium term, the objective should be to raise the levels of savings and investment and improve their interrelationship, so as to strengthen the basis for noninflationary growth without large external current account deficits. In the process, the U.S. economy would help in attenuating the global slowdown in the short term, and in strengthening the longer-term growth prospects for the world economy. Since both the short- and long-term objectives are mutually consistent, they can be pursued simultaneously. However, caution would be needed in an environment of rising inflation rates and a weakening exchange rate, especially while the economy is slowing down. Moreover, there are signs of global shifts in capital toward Europe in the wake of German unification which would entail difficulties in sustaining investment growth in the United States.

With respect to the short-run objectives, it should be noted that, while domestic demand needs to be contained, a precipitated contraction in the budget deficit would be counterproductive. Instead, as part of the Government's medium-term strategy to achieve a rough budgetary balance by 1995, in 1991, the authorities should aim at reducing the budget deficit by the $50 billion mentioned. Steps to achieve such a cut should be substantive and should be viewed by the market as credible. I agree with Mr. Dawson that a purely expenditure-induced reduction in the budget deficit could contract the economy which, in turn, may worsen the deficit. At the present juncture, it appears that an adjustment in tax rates, along with a curtailment of expenditures, may have a less deflationary impact on growth. As a matter of fact, it may be easier for the business sector to accept higher taxes rather than the consequences of an uncertain business climate that may emerge from an enlarged budget deficit. However, it is essential that any additional revenues be directed at trimming the deficit rather than meeting additional expenditures.

On the monetary front, the Federal Reserve should continue to follow its present policy stance to contain inflationary pressures. While there has been an autonomous tightening of credit, the Federal Reserve should not ease monetary restraint in order to offset its effects. However, if need be, minor adjustments may be helpful to forestall any perceptibly large credit crunch and the consequent higher interest rates, which would also have adverse international implications. Alternatively, a further monetary tightening to contain the inflation rate substantially below the currently prevailing rate could trigger an unacceptable further economic slowdown. Clearly, a decisive and credible fiscal response that will avoid upward pressures on interest rates is essential for easing the burden on monetary policy.

On the global level, the systemically important economies should continue collaborating in order to ease the process of adjustment in the U.S. economy and to handle the nonrecurring exigencies. At a minimum, other industrial countries, in particular those with current account surpluses, should not unduly contain domestic demand. This will also permit the exchange rate to play its role in substituting foreign demand for domestic demand. The fact that the major industrial countries are at different cyclical positions should facilitate the pursuit of convergent adjustment policies in these countries, including the United States.

As to the medium-term objectives, a comprehensive restructuring seems to be called for. At the heart of such a transformation would be a basic reform of the budget, aimed at achieving the objective of a budget balance by 1995 and modest surpluses thereafter to repay the Social Security Fund. It would have to be supported by corrections of internal rigidities, including financial sector weaknesses, tax disincentives to savings, protection of specific industries, and the relatively slow growth of labor productivity. This is a time-consuming process and will require a steady and persistent effort.

It is heartening to note that the U.S. authorities are fully cognizant of the need for an orderly and full correction of the budget deficit. What is needed is restructured revenue and expenditure patterns that would eliminate the budget deficit and provide incentives for private savings and investment. For example, a shift toward consumption and/or expenditure taxes, such as value-added taxes, combined with cuts in entitlement programs and some other headings would be worth exploring. Such a tax structure may reduce the bias against savings. It is also highly desirable to redirect government expenditures toward encouraging development of skills and enhancing productivity growth, which eventually would help in promoting private investment. Combined with a prudent monetary policy, such a budgetary stance would reduce interest rates, which would, in turn, encourage investment and growth. This will also reduce the cost of debt servicing of developing countries.

These fiscal and monetary policy reforms would have to be complemented by structural reforms. An immediate need is for a restructuring of the U.S. banking sector, so that it can provide efficient intermediation and compete internationally without taxpayer support. This may entail, as the Chairman of the Federal Reserve recently said, the weaning of some institutions from the unintended benefits that accompany the safety net. Higher capital requirements would be desirable as they would call for more efficiency and increased aversion toward risk. Macroeconomic stability will clearly have to be ensured while such reforms are under way.

Further structural reforms will require policy coordination among the G-7 countries and the world community at large. The United States can take a leading role in this process by institutionalizing its commitment to structural changes. In this context, a beginning has to be made through trade liberalization. The United States should take a lead in implementing such reforms and, in order to accord a global impetus to this process, the U.S. authorities should do their utmost to successfully conclude the Uruguay Round.

I welcome the U.S. initiative on Latin America and the Caribbean to ease the debt problems of the regional developing countries. However, what is needed is a better trading environment for all developing countries, which would be beneficial for the global economy.

Mr. Yamazaki made the following statement:

As usual, the Article IV consultation with the United States provides thought-provoking and in-depth studies that attest to the expertise of the Fund in Article IV surveillance. The importance of the U.S. economy, particularly at the current juncture of the precarious international economic situation, fully justifies the large volume of documents under consideration.

The current discussion takes place at a time when the world economy is faced with new challenges, such as the dramatic change in Eastern European economies, including the unification of the German economies, and the recent crisis in the Middle East. Furthermore, as I noted during the recent discussion on the world economic outlook (EBM/90/56 and EBM/90/57, 4/11/90 and EBM/90/58, 4/13/90), the U.S. economy was in a difficult situation before the onset of the Middle East crisis, and the effect of the oil price increases, although small relative to previous oil shocks, will further exacerbate the problem. Recent revisions of the staff projections suggest that in 1990 the real growth rate will decline to 1.3 percent, while the inflation rate, as measured by the consumer price index, will increase to 5.1 percent. These figures point to the fact that the U.S. economy is on the verge of serious economic difficulty, that is to say, between the Scylla of inflation and the Charybdis of recession. However, the staff also envisages some improvement in both the growth rate and the inflation rate in 1991 and stresses that the recent increase in oil prices does not alter the basic thrust of the original staff report, which notes that the U.S. economy can avoid a recession.

While I generally agree with the optimistic view presented by the staff, I also agree with Mr. Dawson that the downside risks have increased significantly and the room for maneuver in macroeconomic management is more limited than ever.

I am in general agreement with the staff appraisal and would like to limit my intervention to a few policy issues.

Let me begin by addressing the most important issue, fiscal policy. Needless to say, it is of paramount importance not only for the U.S. economy, but also for the world economy as a whole, that a credible multiyear fiscal deficit plan be worked out immediately with a view to avoiding the overheating of the economy, thereby reducing the external imbalances while increasing global saving. In the light of this consideration, I have a serious concern about the recent developments pertaining to the budget, which point to a larger deficit than provided for in the GRH legislation. Under these circumstances, we urge the authorities to explore every avenue to get the fiscal position back on track as envisaged by the GRH legislation as soon as possible; otherwise, the credibility of U.S. fiscal policy will be lost, which will have a serious impact on the international financial markets. In his opening statement, Mr. Dawson noted that a deficit reduction package that triggered a recession could not be sustained. While I recognize this point, I consider that a recession cannot be avoided without a credible deficit reduction package. In any case, there is an urgent need for renewed efforts on the fiscal front in order to underpin the credibility of U.S. fiscal policy. In this connection, we strongly support the statement made by the U.S. President, on June 26, 1990, which clearly indicated that the United States would take all necessary measures, including, inter alia, tax revenue increases to ensure that the deficit problem is brought under reasonable control. Furthermore, the U.S. authorities are working out various initiatives to vigorously tackle the fiscal deficit, such as the strengthening of the GRH law, and the possible establishment of the Social Security Integrity and Debt Reduction Fund (SSIDRF). I strongly hope that the authorities work out a credible deficit reduction package in the not too distant future.

In the light of the extremely limited room for maneuver, the cautious and skillful conduct of monetary policy by the Federal Reserve, which has so far avoided both a severe economic downturn and an acceleration in the inflation rate, is commendable. I fully agree with the concerns expressed by the staff about the current rate of inflation, which is not consistent with the long-term objectives of the central bank--all the more so given the recent increase in oil prices. Under these circumstances, neither outright relaxation of monetary conditions nor abrupt credit tightening is desirable. Hence, I generally agree with Mr. Dawson that the policy stance that was appropriate prior to the recent developments in the Middle East continues to apply. At the same time, however, Directors agreed during the recent discussion on the world economic outlook (EBM/90/56, EBM/90/57, and EBM/90/58), that it is evident that an accommodative monetary policy such as the one taken in response to the first oil shock was not appropriate. Therefore, Mr. Dawson's remarks should be interpreted as advocating a nonaccommodating policy stance, although I recognize that the conduct of monetary policy should vary depending on the specific situation of the country. In any event, in order to forestall a negative impact on the economy from the monetary side, the importance of a credible multiyear fiscal deficit plan should be stressed.

However, it should be borne in mind that the root cause of the savings and loan crisis is the overall vulnerability of the U.S. financial system. In the long run the authorities should make every effort to improve the profitability of financial institutions, including the abolition or modification of Glass-Steagall Regulations and interstate banking regulations, while paying due attention to the possible risks to the deposit insurance system. As the stability of the U.S. financial and payments system is the basis of stable international financial transactions, we strongly urge the authorities to strike a balance between the efficiency and prudentiality of the financial system in addressing this issue.

As to external adjustment, I will reiterate a few points I have put forward on many previous occasions. First, we agree with the staff that there is an urgent need to increase global saving, given the rapid change in the world economy, including the restructuring of the Eastern European economies. Second, in this connection, we attach particular importance to the reduction of the current account deficit of the United States through an increase in national savings. Third, my authorities continue to strive to reduce Japan's external imbalance, as evidenced by the substantial reduction in the current account surplus. Japan's current account surplus declined sharply from 4.5 percent of GNP in 1986 to 1.9 percent in 1989. Furthermore, during the first seven months of 1990, the current account surplus declined by 37 percent compared with the same period of the previous year. Also, we do not consider that the external imbalance will increase over the medium term. Fourth, with respect to the U.S. current account, in addition to the efforts on the fiscal front, there is an urgent need to improve the savings and investment relationship in the private sector. In this connection, my authorities strongly welcome the U.S. authorities' initiatives--which were presented to Congress as a group, including the Savings and Economic Growth Act (SEGA). However, these initiatives represent only the first step in the right direction, and we urge the authorities to put these measures into practice as soon as possible.

I agree with the staff and other speakers that the essential role of the United States in promoting a free trade system should be emphasized. In this connection, I agree with the staff that the United States should not depend on a bilateral approach, such as the one based on Super 301. The issue of external imbalance should be addressed in a multilateral setting and should not be predicated by a specific bilateral relationship.

Finally, on the exchange rate, given the growing uncertainties arising from events in the Middle East, the role of close policy coordination among major industrial countries is all the more important. Therefore, I urge the U.S. authorities to persevere with the policy coordination process, including cooperation on exchange markets.

Mr. Fernández Ordóñez made the following statement:

We endorse the basic thrust of the staff appraisal and its main conclusion, namely, that the requirements for policy action in the United States have not changed since the previous Article IV consultation.

The U.S. authorities have been able to sustain an economic expansion for eight years and have shown a remarkable ability to cope with the severe crises that have emerged over that period--including, for instance, the stock market crash of October 1987. The skillful handling of policy by the Federal Reserve has helped the economy to avoid a significant acceleration of inflation and a recession. It is undeniable that the U.S. economy has shown a great deal of resilience during the second half of the 1980s. In this connection, it is noteworthy that in spite of the major shocks confronted by the economy, including the current developments in the Middle East, neither the U.S. authorities nor the staff are forecasting a recession. Indeed, the staff envisages a pickup in the growth rate of real GNP from 1.25 percent in 1990 to 2 percent 1991, while Mr. Dawson is less optimistic and recognizes that the downside risks have increased significantly and projects, at best, very modest growth. Perhaps the staff could elaborate on the forces behind the projected pickup in economic growth during 1991.

The key issue in the current discussion is related to the relative ranking of economic goals, in particular the perceived trade-off between short-run growth and inflation. It is evident from the staff report that the Federal Reserve considers price stability a long-term goal and that the best way to move toward that goal is by striking a delicate balance between short-run political considerations that are heavily dependent on the strength of economic activity and the capacity of the Federal Reserve to influence such developments. This type of monetary policy, which could be described as period-by-period policy, unfortunately does not provide an adequate framework for monetary stability.

The experience of the 1970s shows that there is no successful means to sustain an artificial growth rate through the use of monetary policy. It shows that the policymaker has no choice between inflation and unemployment. It also demonstrates the harmful effect on incentives and structural policies this course of action leads to. Perhaps the low private saving rate and the fiscal problems faced by the U.S. economy are part of a legacy from that period.

Against this background, and stressing the importance my authorities attach to price stability, I consider that the policy recommendations for the United States should follow the same basic principles that are embedded in growth-oriented adjustment programs. As is well known, the centerpiece of such programs is always fiscal consolidation. In the short term, the main concerns are the fiscal impact of the savings and loan crisis and the estimated costs of that crisis, which continue to rise; the defense expenditures related to recent events in the Middle East; and the overshooting of the targets set under the GRH legislation.

We welcome the initiatives for deficit reduction over the medium term contained in the Administration's January 1990 budget. However, it is evident that the fiscal projections have worsened since that budget was announced, leading to the "budget summit" deliberations. We sincerely hope that the outcome of the summit is a deficit reduction package that is very much along the lines of the January 1990 budget.

The favorable impact that a credible U.S. deficit reduction package would have both domestically and internationally cannot be overemphasized. Domestically, it would reduce the burden on monetary policy for demand management policies and would allow adoption of easier monetary conditions. However, we must stress that until a sufficient deficit reduction package is in place and working, monetary policy will need to remain tight if the Federal Reserve wishes to maintain inflation under control, particularly given the rising trend in the consumer price index that measures underlying inflation in recent months. Other favorable effects of deficit reducing measures would be through its impact on domestic private demand and net exports. In addition, by relieving the upward pressure on real interest rates, it would greatly reduce the danger of a recession.

Internationally, by making an important contribution in the effort to raise savings, a credible deficit reduction package would relieve pressure on the so-called global savings shortage, and by allowing real interest rates to be lower than would otherwise be the case, it would contribute to reducing the debt burden of heavily indebted countries.

With respect to the external sector and exchange rate policy, the dramatic movement in the real effective exchange rate of the dollar is a matter for serious concern. Given the current level of capacity utilization in the United States and the degree of resource use in the major surplus countries, it seems that the recent depreciation of the dollar will mainly exert inflationary pressures and contribute little to a further narrowing of the external imbalance of the United States. Therefore, we are encouraged that the U.S. authorities recognize the fact that the current account deficit is a manifestation of the persistently low level of national savings. Hopefully, this recognition will lead to actions to stabilize the value of the dollar.

We agree with the staff that the reduction in the current account deficit should not be made at the expense of reducing domestic investment. Table 2f of the staff report shows that gross private investment in the United States was 6 percentage points of GNP lower than the average of other G-7 countries. Probably the productivity of investment has been higher in the United States than in other G-7 countries. Nevertheless, the investment trend is disturbing, because, if it continues, it will have adverse effects on the growth potential of the U.S. economy. The current account deficit would be less a matter of concern if it was attributable to strong investment activity rather than to the strength of consumption.

With respect to trade policy, we encourage the Administration to further its goal of achieving freer world trade based on a multilateral system of clear and enforceable rules for every participant. We welcome the Administration's reaffirmation that the highest priority should be placed on the Uruguay Round, and, accordingly, we hope that it will play a leadership role in those negotiations.

The relationship between the U.S. economy and developing countries takes multiple forms; one of the most important is its contribution to a stable and orderly economic and financial world environment. Nonetheless, the recently announced initiative for the Americas, through its three-pronged approach to trade, investment, and debt reduction is indeed very welcome. Any initiative that promotes trade, economic cooperation, and investment flows--even if it is targeted to a specific region--has a potential welfare enhancing role for the world economy. The experience of the European Community shows that the world economy benefits from a healthy region more than the possible trade diversion effects regional arrangements can entail. We hope that the operational details of the initiative for the Americas will soon be finalized and that its impact is fully felt in the Latin American region.

We urge the United States to raise its official development assistance from the current low levels.

Mr. Ismael made the following statement:

I will begin by commenting on the macroeconomic aspects of the U.S. economy and then turn to trade policy and aid. In doing so, I will start with the most recent developments in the employment sector as a basis for my other comments.

The increase in employment in August 1990 was significantly lower than the increases reported earlier in the year, but it was still positive. Moreover, the very sharp decline in employment initially reported for July 1990 was revised substantially downward. Therefore, the most recent data are consistent with the picture suggested by other economic indicators, namely that the pre-oil shock economy was weak--as evidenced by the rise in the unemployment rate--but it was certainly not in recession.

Higher oil prices will weaken the economy further, once they have had time to have an effect. I agree with other speakers that this effect is not likely to be nearly as significant as in previous oil price shocks. If the oil price remains at about $25 per barrel, the loss in terms of purchasing power would, according to experts' estimates, be about $25 billion, or 0.5 percent of GNP. That is about half the size of the $50 billion deficit reduction package for 1991, which, up until August 1990, many observers believed the U.S. economy was strong enough to withstand.

Against this background, there will clearly be significant pressures on the Federal Reserve to ease interest rates. However, I hope that the Federal Reserve will feel constrained in doing so by the outlook for inflation. The prospects for inflation were fairly poor even before oil prices rose, with consumer prices increasing by 4.8 percent in the year to July, and the exfood and energy rate rising to above 5 percent. Higher oil prices could, therefore, push the headline consumer price inflation rate to about 5.5 percent and possibly higher in the coming months. This is a very high rate by U.S. standards, but it could well prove to be the peak.

If oil prices rise no further, and if earnings do not respond to higher prices, the impact of higher oil prices on inflation will be of a one-off nature. Indeed, the weakness in economic activity is likely to lead to some downward pressure on prices in time, but probably not until 1991. To reduce interest rates at the present stage could lead to an additional deterioration in the bond market, which could offset any stimulus to economic activity associated with lower short-term rates. Moreover, such a step would likely push the U.S. currency further down in the short term.

Negotiations between the Administration and Congress have resumed, and I agree with Mr. Dawson that "recent events will clearly make it more difficult to reach agreement, although they in no way reduce the urgency of prompt and credible action." Indeed, one further implication of recent developments is that the prospects for a significant deficit reduction package emerging from Congress have declined. There is currently less scope to implement an energy tax, which was likely to have been one of the main sources of new revenue, and Congress might well not wish to force through a significant fiscal tightening at a time of weak economic growth. This--apart from the inflation problem and higher interest rates abroad--is likely to limit the scope which the Federal Reserve has to ease monetary policy.

With respect to trade policy, it is important to note Mr. Dawson's statement that the United States considers the successful conclusion of the Uruguay Round the overriding objective of trade policy at present, and that the United States is pushing for substantial trade liberalization through the Uruguay Round. There is one issue, which is vital for most of the members of my constituency, that the United States could help to solve. A U.S. proposal, which met virtually unanimous opposition from other GATT members, is for a ten-year phase-out of the Multifiber Trade Agreement on world textile trade to be replaced by "global quotas" for textiles established under the auspices of the GATT. Textiles would then be back within the GATT by the end of 2001. The period for the phase-out is considerably longer than that suggested by other countries, because the United States will need ten years to phase out its current bilateral and multilateral commitments. Developing countries, while reserving their final positions, have been trying to eliminate such bilateral agreements in the Uruguay Round. One possible compromise would be to couple the phase-out suggested by the United States with a general liberalization of textiles trade in order to avoid unduly disturbing world trade as suggested by Japan.

Finally, with respect to Mr. Dawson's comments on aid: the trade, investment, and debt proposal made by the U.S. President in June 1990 to assist Latin America is admirable, particularly in its focus on bilateral debt reduction. Hopefully, if the United States substantially reduces the $12 billion in official debt, of which $7 billion is from concessional loans through such programs as Food for Peace, the principle will be extended to obligations in other regions. It is of utmost importance--when we speak of international assistance--not to see that assistance as being circumscribed by local or regional affinities.

Mr. Grosche made the following statement:

I agree with the staff's analysis and endorse the thrust of its recommendations.

Since the previous Article IV consultation with the United States, the policy requirements have not changed much. However, the economic environment has become more difficult. I fully agree with Mr. Dawson that a recession at the present stage would be inconvenient, to say the least; it would make the pressing task of cutting the federal budget deficit much harder. Moreover, there is a danger that shaky banks and debt-laden firms could turn a recession into a crash.

The question is how a recession should be avoided. It certainly would not be wise to push up the economy to high speed, at all cost. The long-term costs of an excessive monetary expansion would mean disaster--if indeed monetary expansion can accelerate activity, which is doubtful. Fiscal consolidation is the key to keeping the economy on a path of growth.

The U.S. economy has reached a slow path of growth, but this has advantages in that it allows the economy to recover from a long-lasting race at full speed. Much progress has been made already over the past two and a half years: the current account improved markedly, and its deficit--measured as a percentage of GNP--is expected in 1990 to be half the size of the 1987 peak. The total for 1990 is expected to drop below $100 billion for the first time since 1984. The improvement in the trade account is even more impressive. The federal budget deficit has halved as a share of GNP. Gross personal saving went up from 2 percent in 1987 to 3.3 percent in 1989.

This is not good enough, yet, but it seems that the U.S. economy achieved the soft landing that was hoped for. The dollar depreciated without the long-feared dollar crash, and interest rates are relatively moderate and are not conducive to a shrinkage in output. The economy is ticking along and unemployment remains close to the low level of the 1960s.

Indeed, this is no small achievement. Policies have to be directed to sustaining this soft landing scenario for some time to come, allowing the economy to correct further the excesses of the past. Higher growth rates will anyway be difficult to maintain, given the slow growth in the capital stock over the 1980s; a growth substantially below the figures achieved in the 1970s and particularly in the 1960s, as can be seen from Table 2 of the first supplement to the staff report. The slump in net business fixed investment has reduced America's long-term, sustainable, noninflationary rate of growth below that of some other G-7 countries.

That is the main reason for cutting the budget deficit: only by saving more can America invest more and enjoy higher living standards. As a recent article in the Economist pointed out: "Americans could hardly expect to get their economy in shape without a stint of dieting."

I agree with the staff that recent developments complicate the task of fiscal correction, but they do not fundamentally alter the need for a credible multiyear fiscal deficit reduction plan. Early and substantial action is required. However, I was impressed by some of Mr. Dawson's arguments on whether the plan needs to be heavily front-loaded. I agree with him that a substantial total amount of cuts to be implemented in a credible way over a fixed period is more important than the size of the first installment.

I wonder whether the staff could comment on how it would interpret the advice for "early and substantial action" in light of the most recent developments. Which cuts in expenditure would they expect to be made, or which would they like to see?

Aside from cuts, public expenditure has to be shifted, mainly into higher investment in infrastructure. Over the past two decades, this kind of investment has been slowing, thereby also contributing to slow productivity growth, higher imports of finished goods, and a widening current account deficit.

As to the revenue side, some room of maneuver exists without harming economic incentives--in particular, by cutting tax expenditures. Unfortunately, a rise in energy taxes might be difficult to engineer at the present stage, but remains an important task for the reasons explained by Mr. Peretz.

I hope that the participants in the "Budget Summit" will reach a satisfying compromise, the sooner the better. I agree with Ms. Powell that budgetary procedures need to be improved. The GRH legislation should provide for corrections that can be enforced over the course of the fiscal year in order to achieve the deficit targets as prescribed in the legislation.

With respect to monetary policy, the Federal Reserve has been steering a difficult, but quite successful, course. The staff was correct to describe the Federal Reserve's policy as focusing more on keeping inflation from rising rather than lowering it convincingly. We welcome the Federal Reserve's commitment to the goal of long-term price stability, which is the best monetary policy can do to foster the maximum sustainable rate of economic growth. But, in order to be more successful, the Federal Reserve should demonstrate its commitment more often: it is worrisome to note that the 12-month rate of increase in the consumer price index--less food and energy--was above 5 percent in July 1990. Nevertheless, any appreciable progress in reducing inflation has to wait for significant and convincing fiscal action, which, in contrast to a tightening of the monetary stance, would help to reduce resource pressures without pushing up interest rates.

As to the external side, I have indicated that the cuts that were made in the current account deficit are welcome. However, further progress is expected to be slow, if significant at all. The momentum needs to be maintained, despite the rise in oil prices. Higher domestic saving is the key. It is worrisome to note from the first supplement to the staff report that the national saving rate has declined somewhat from 1988 to 1989. This trend seems to continue in 1990. In order to improve saving, the staff correctly suggests a strengthening of the fiscal position and steps to eliminate distortions affecting private saving and portfolio decisions.

In the context of correcting the external imbalances, we welcome the Administration's willingness to achieve a more open trade system through a successful conclusion of the Uruguay Round, and not to rely on Super 301 and other unilateral and bilateral approaches. We endorse the recently announced initiative for Latin America and the Caribbean, but we hope that it does not run counter to the basic goal of free trade on a multilateral basis.

The savings and loan crisis has revealed a strong need for deep and confidence-creating reform in the financial sector as a whole. I fully agree with the point made by Mr. Peretz on this subject.

The Director of the Western Hemisphere Department noted that Mr. Grosche and a number of other Directors had asked whether a front-loaded adjustment effort would be appropriate at the present stage; several Directors had commented that if the adjustment effort was not front loaded, it would be crucial for the adjustment effort to be carefully spelled out in a way that would ensure its implementation; and some Directors had emphasized the need for a reform of the budget process in that respect.

It would have been best to have started the process of making cuts in the fiscal deficit when the rates of growth and capacity utilization were higher, but that opportunity had been lost, the Director of the Western Hemisphere Department commented. It did not mean, however, that the resolution of fiscal, or national saving, problems had become less urgent. There clearly were benefits that could be derived from a front-loaded adjustment effort even at the present stage. Also, there was danger in taking a gradual approach in making the necessary adjustments in that it could risk the achievement of longer-term objectives, owing to unforeseen circumstances that could require changes in the planned adjustment. The experience of the GRH legislation illustrated that danger.

Although the U.S. economy was currently weak in terms of the rate of growth, it was not weak in terms of the level of economic activity, the Director of the Western Hemisphere Department emphasized. The levels of unemployment and capacity utilization were only slightly lower than they had been in the recent past.

In the current circumstances, it was important to stress the benefits that could be derived from cutting the fiscal budget deficit, the Director of the Western Hemisphere Department said. Any credible adjustment effort, whether achieved as a result of increased revenues or decreased expenditures, would help to ease credit market conditions and crowd in expenditures that had previously been crowded out, namely, private investment and net exports.

Commenting on questions related to tax increases as a way to cut deficits, the Director of the Western Hemisphere Department said that any significantly front-loaded adjustment effort would have to include increases in taxation. Tax increases already formed a significant part of most of the alternative deficit-cutting packages currently under consideration. Additional attention could be paid to the great deal of room that existed for cutting tax expenditures. While it might be difficult to obtain popular support for cuts in some areas, there was a long list of tax expenditures that could be reduced with a view to raising revenue without adverse effects on economic efficiency.

The staff representative from the Western Hemisphere Department said, in response to a question raised by Mr. Fernández Ordóñez, that the projected increase in the rate of growth, from 1 1/4 percent in 1990 to 2 percent in 1991, was rather modest and that the 2 percent growth envisaged was not large compared with the potential growth rate, which was estimated to be about 2 1/2 percent by the staff and about 3 percent by the authorities.

One factor underlying the staff's projection of the pickup in growth was the expected halt in the decline of some demand components, particularly in the areas of housing and construction and durable goods, the staff representative stated. A leveling-out of demand in those areas would in itself lend some impetus to growth. Another factor was that interest rates had already declined by 2 percentage points over the course of the past year. In time that reduction in interest rates would help to stimulate demand, thereby contributing to a resumption of growth.

In addition, the projections contained in the most recent World Economic Outlook assumed that the price of oil would decrease from the level of $26 per barrel in the fourth quarter of 1990 to $21 per barrel--the reference price of the Organization of Petroleum Exporting Countries--in the fourth quarter of 1991, the staff representative continued. A decrease in the price of oil would help to stimulate production.

Moreover, the recent depreciation of the dollar was expected to add some stimulus to net exports, which would also help to bring about some increase in the rate of growth over the course of 1991, the staff representative added.

The question raised by Ms. Powell on how monetary policy should be conducted in the light of the currently envisaged deficit reduction package was difficult to address, because there was no reliable monetary aggregate the Federal Reserve could target as a guideline, the staff representative went on. Without such aggregates, it was not possible precisely to gauge the stance of monetary policy and changes thereof.

If there had been a reliable aggregate, possible monetary policy responses to fiscal adjustment could have been discussed more easily, the staff representative noted. For M2, for example, the Federal Reserve had established an annual growth target band of 3 percent to 7 percent for 1991. If there was a significant reduction of the fiscal deficit over the coming year, the Federal Reserve could afford to allow that monetary aggregate to run in the upper half of the targeted range, rather than in the lower half, without deviating from the longer-term objective of achieving price stability.

In the absence of reliable monetary aggregates, one indicator that could be used to guide monetary policy was the behavior of long-term interest rates, the staff representative stated. For example, a substantial decline in long-term interest rates in response to a fiscal package would suggest that there was some scope for allowing short-term interest rates to decline.

In any event, the staff representative from the Western Hemisphere Department concluded, one of the most important benefits of the fiscal deficit reduction effort would be a reduction in pressures on interest rates, and there ought to be a compelling reason if monetary policy were to prevent any decline in interest rates in the face of such efforts. Of course, the authorities needed to bear in mind that the existing rate of price increase was not satisfactory and ensure that the interest rate reduction occasioned by the fiscal adjustment effort would not put at risk the long-term objective of achieving price stability.

Mr. Evans said that it was not surprising that the requirements for policy had not changed since the previous Article IV consultation with the United States; the policies pursued by the authorities had not changed since that time. While many speakers had expressed concern about the lack of progress in the context of the current discussion, he considered that the policies had not changed sufficiently because the Administration had not accepted the fact that there was a need for change in its approach to the fiscal deficit.

Several years had passed since former U.S. President Reagan had named a reduction in the deficit the first priority of policy, and yet the deficit remained large, and inadequate efforts were being made to reduce it, Mr. Evans noted. The arguments presented in Mr. Dawson's opening statement against the staff's recommendations were unconvincing, if familiar. Indeed, similar arguments had been put forward on many previous occasions by a number of countries, including his own--although fortunately not in the past decade--and they were not difficult to dismiss.

The most disappointing argument presented by Mr. Dawson, however, reflected the familiar dictum that Fund programs must be politically acceptable, Mr. Evans considered. It would be wrong for the Fund to accept that argument. During the previous Article IV consultation with the United States (EBM/89/116, 9/1/89), he had said, "In the United States, as in every other country, the ability to remove political constraints to appropriate policies lies in the ability to create a proper understanding within the general electorate, and there lies the nub of current U.S. problems." It seemed that that was still the problem, and it was fortunate that a so-called Budget Summit was needed to address the deficit problem. Such a summit would not be needed if there were a proper understanding of the problems related to the fiscal deficit among the general electorate.

Although he had agreed with Mr. Dawson on previous occasions that simplistic ideas of one-to-one relationships between budget deficits and external deficits could be misleading, the need to reduce the U.S. fiscal deficit was not a "twin deficit" problem, Mr. Evans continued. As Mr. Peretz and the staff had pointed out, the United States had a responsibility, as the senior member of the Fund, not to force the rest of the world to bear the burden of its current policies in terms of interest rates. In that respect, it was up to the United States to increase savings and to correct the investment shortfall of the 1980s.

Those considerations gave rise to questions concerning the effectiveness of Fund surveillance, Mr. Evans went on. While he agreed with Mr. Yamazaki that the Article IV consultation with the United States provided thought-provoking and in-depth studies that attested to the expertise of the Fund, the effectiveness of surveillance, in terms of policy results, in the case of the United States was negligible. Although he was not in a position to offer a solution to that problem at the present stage, it merited the Board's attention.

He fully supported the staff's recommendations, Mr. Evans concluded. Indeed, it was unfortunate that its recommendations concerning fiscal policy had been characterized as "front loaded," given that stronger action should have been taken to reduce the fiscal deficit in previous years. In the current circumstances, there was a prospect that a small recession could occur in the United States as a response to the needed fiscal adjustment. However, the previous experience of the United Kingdom, as described by Mr. Peretz, as well as that of several other European countries and Australia indicated that recession was not a likely response to credible fiscal adjustment action.

Mr. Kafka noted that the U.S. authorities might be facing a dilemma: whether to guard more against inflation or more against the risk of recession. The safest course was to go further on the fiscal front. In addition to possible expenditure cuts, it would be necessary to adopt revenue measures, including tax measures that did not impair savings efforts. In that connection, he fully supported Mr. Peretz's call for much higher energy taxes. Nevertheless, if clear signs of recession appeared to intensify and endure, monetary policy might need to be adapted.

With respect to the external sector, the reduction of the current account disequilibrium achieved over the past two years was welcome, Mr. Kafka commented. However, like the staff he was concerned about an improvement in the current account that was not coupled with a larger increase in the rate of national savings, since that would imply a narrowing of domestic investment. Indeed, the rate of gross national savings had worsened somewhat over the past year.

He supported the U.S. position in favor of a more open trading system, including agricultural goods and textiles, Mr. Kafka stated. While he welcomed the idea of greater relief for outstanding official debt, it should apply to middle-income countries, as well as to lower and lower-middle income countries.

The various scenarios presented by the staff confirmed that the U.S. economy was at a critical juncture, aggravated--at least in the short run--by the third oil crisis, Mr. Kafka concluded. Therefore, in the interest of the entire international community, he wished the U.S. authorities the best of luck in their difficult endeavors.

Mr. Cirelli made the following statement:

> Given the fact that other Directors have thoroughly analyzed the fiscal policy, and that I agree with most of the views expressed, in particular by Mr. Evans, I can be brief. Like other speakers, I agree with the staff's analysis and recommendation, in particular, that fiscal policy credibility is currently essential to the whole reform process and that the best way to avoid a recession is to implement the fiscal corrections as soon

as possible, and to the largest extent feasible. Therefore, I also agree with the staff that any further destabilization of the GRH legislation would be highly detrimental.

Against that background, I will concentrate my remarks on the extent of the inflationary threat, and the objectives of monetary policy in the current circumstances.

I have some reservations about the view expressed in Mr. Dawson's opening statement that the increase in the rate of inflation in 1990 was in large part due to temporary factors. Indeed, there might be some renewal of the inflationary pressures in the period ahead. The second supplement to the staff report shows that the consumer price index, less food and energy, has been on a steady upward trend since the beginning of 1990 and shows no signs of abating.

Tight labor market conditions have induced increases in hourly wages over the past year, at a pace significantly above that experienced in 1986-88. Over the past year, total compensation has grown by more than 5 percent. A large part of that increase has come from rising benefits costs. Structural reforms are certainly welcome with respect to benefits, but there is no guarantee that reforms in that field will lead to a decrease of costs.

The recent rise in the level of unemployment might ease labor market conditions, but, as the U.S. economy is still working at full capacity utilization, it cannot be totally taken for granted that there will be no spillover of inflation into higher wage demands.

Moreover, the fall in the dollar could also add, at least in the short term, to inflationary pressures, and a greater depreciation would certainly not be desirable. Finally, the recent rise in oil prices and the potential uncertainties in the conduct of fiscal policy might add to these factors.

Some of the elements I have mentioned could be of a temporary nature, for instance, the oil price effect. But others are sources of concern and I wonder to what extent we are witnessing in the U.S. economy the beginning of a process of cost-push inflation building itself in the expectations of positive agents.

In this uncertain context, what should be the authorities' objective, in particular with respect to monetary policy? Undoubtedly, the handling of monetary policy by the Federal Reserve has been very skillful so far and sharp increases in the acceleration of inflation have been avoided. According to the staff, the U.S. authorities have developed "a flexible approach to monetary targeting;" the strategy is to restrain growth in aggregate demand enough to establish a clear downward path for inflation and inflationary expectations, but not so severely as to cause a recession. This might be the best definition available of fine-tuning. Indeed, U.S. monetary policy during recent years has been mostly a work of fine-tuning. Thus, the real issue is whether such an approach can be adapted to the present environment.

A monetary policy aimed at short-term demand management might miss its more important function in an unstable inflationary environment: to set inflationary expectations at a stable and low level. While the fine-tuning approach was acceptable as long as there were no cost-inflation pressures in the economy, that may no longer be the case. From the staff report, it seems that the long-term perspective in monetary policy has been subdued. The objective of achieving price stability, which is still a priority, seems to have been sidestepped in the short run, and therefore, has become more elusive, thereby running the risk of lowering the credibility of the authorities.

According to the authorities, the price stability goal is defined as "a change"--or as the Chairman of the Federal Reserve termed it, an "expected change"--in the average price level that is low enough not to influence materially the private sector's financial decisions.

Taking this definition into consideration in a period marked by both the uncertainty caused by the increase in oil prices and the risk of a building cost-push inflation, it seems indispensable that the markets do not expect too large a change in the average price level, which might lead to the development of inflationary expectations. The building up of such a process would certainly be detrimental and, in the end, could lead to stagflation, such as in the 1970s. Therefore, as the staff indicated during the recent discussion on the world economic outlook (EBM/90/56, EBM/90/57, and EBM/90/58), a policy directed toward achieving approximately the same rate of expansion of nominal GDP that was envisaged earlier seems to be an appropriate answer in view of the need to calm down the potential changes in expectations.

While such a policy could clearly mean temporarily somewhat lower output growth, this should be balanced against the risks of a more prolonged recession. An inappropriate response, aimed at coping with the present inflationary trend, would certainly lead to losses in confidence, and, as the staff indicated, would leave the authorities with little choice but to provoke a sharp economic contraction in the event of large external or internal shocks.

I wonder whether, in the present situation, a greater respect for long-term objectives would not be more appropriate than a fine-tuning of the demand and supply of money aimed at short-term stabilization. This does not mean that there is no chance of lowering the interest rate in the foreseeable future. Indeed, substantial progress in lowering the fiscal deficit and continued coordination among industrial countries will help reduce external imbalances and raise savings, which would certainly provide scope for a future interest rate decline.

Mr. Posthumus made the following statement:

Even before the recent international political crisis, the development of the U.S. fiscal deficit was disappointing. The staff recommendation for a further deficit reduction than the planned $50 billion has our support. Since the fiscal position has deteriorated further because of increasing military and interest expenditures, an additional effort is warranted. The concerns about recession should not prevent the authorities from taking measures that have already been postponed too long and that are structurally necessary. Bold fiscal action remains necessary to increase national savings, to adjust the external deficit, and to moderate interest rate increases. The staff's suggestion to increase excise taxes and to consider the introduction of a value-added tax should be seriously considered.

Therefore, I support the staff's appraisal of fiscal policy. It is substantially in line with the general approach of the Fund, which states that a deterioration of the fiscal situation requires more fiscal adjustment. In his opening statement, Mr. Dawson indicated that he does not completely agree, which gives rise to some questions. It is my understanding that the GRH approach was that the fiscal deficit would follow a certain path. Thus, the size of fiscal measures would have to be larger if it appeared that the size of the fiscal problem was larger. Only if a recession occurred would the intended deficit ceiling be suspended. The current approach, on the contrary, is that the size of the fiscal deficit reduction will be fixed, at $50 billion for 1991, and at $500 billion over five years, and that the resulting fiscal deficit will be accepted whatever its size. Although growth is weakening, it is still projected to be 2 percent of GDP in 1991, yet a package of substantially more than $50 billion is feared to trigger a recession. Thus, the likelihood of larger debt-reduction measures after 1991 seems to be limited, because the recession-triggering argument currently accepted by the authorities will probably continue to be used. The fiscal deficit may therefore decrease only slowly if at all in the coming years. I wonder what this would mean for the health of the U.S. economy.

Under these circumstances the monetary authorities are faced with a difficult task. The rate of inflation is already at almost 5 percent, and the dollar depreciation and the oil price increase have yet to make themselves felt. The Federal Reserve, which has already moderated its interest rate policy, seems reluctant to strengthen its anti-inflationary stance in view of the tensions on the financial markets, and because of the fear that it will trigger a recession. However, I assume--and hope--that the Federal Reserve will at a certain point decide to give preference to anti-inflation policy. Also, both the increasing global demand for capital and the increasing deficit-financing requirements of the United States may force an interest rate increase. This leads to the conclusion that a $50 billion debt reduction package in 1991 should not lead the Federal Reserve to decrease interest rates. Moreover, it is clear that monetary policy has become overburdened, and that too much is being expected from the Federal Reserve.

Mr. Feldman made the following statement:

We are in broad agreement with the appraisal contained in the staff report, which clearly describes recent developments and policy options.

The good news is that neither the U.S. authorities nor the staff forecasts a recession. The bad news is that neither the authorities nor the staff foresees an improvement in inflation and the external current account. The old news is that the fiscal deficit continues to be of serious concern, and a substantial deficit reduction is far from concrete.

In addition, both the staff and Mr. Dawson recognize that economic activity is decelerating, and that prospects for the coming year are not any better. In fact, as Mr. Dawson states, these prospects are further clouded by recent oil market developments and the recent events in the Middle East.

Rather than reiterate the comments that have already been put forward by previous speakers, I will emphasize the need for fiscal adjustment and briefly touch on three points: growth and productivity, the savings and loan crisis, and the U.S. effort to aid developing countries.

The long-standing and very large fiscal deficit is putting a severe strain on available resources and has been negatively affecting both domestic and external imbalances. From Mr. Dawson's opening statement, it is clear that the prospects for reducing or eliminating the fiscal deficit are not encouraging.

The budget deficit for the current fiscal year is substantially larger than provided for in the GRH legislation, and when the rising costs of the savings and loan crisis are considered, the deficit increases substantially. According to Mr. Dawson, the rise in defense expenditure and slower growth due to the recent events in the Middle East are further increasing the fiscal deficit based on current policies. However, the most discouraging point raised in Mr. Dawson's opening statement is that a sizable and substantial reduction of the deficit will lack the necessary political support and, in his view, it will trigger a too costly and intolerable recession.

The United States has not made the necessary fiscal adjustments in recent years, when the economy was experiencing an unprecedented long and sustained expansionary cycle. Consequently, the country is currently facing the need for this adjustment. Regrettably, this adjustment will have to be tackled under the more painful context of very slow growth or a recession and the negative consequences of developments in the Middle East. This means that the United States and perhaps some other countries, particularly heavily indebted countries, may need to face the higher costs associated with the adoption of necessary measures to curb domestic imbalances. I agree with Mr. Dawson that failure to succeed in reducing the fiscal deficit will result in slower growth, higher inflation and interest rates, and financial market instability. I also agree with him that a credible multiyear program of substantial deficit reduction is required. However, I also agree with the staff that a substantial front-loaded adjustment is required. This adjustment could bring about a fast reduction in domestic imbalances, and it is precisely the front-loading that is needed to make a multiyear program credible. The program's credibility strongly depends on the size of the first settlement.

As to structural difficulties, in particular the slow growth in labor productivity, the slowing down of growth and productivity could in part be explained by the disproportionate growth and employment absorption by low productivity activities, mainly services during the 1980s. Both the large fiscal deficit and a relatively appreciated currency have conspired against increases in employment oriented to the production of export goods, which might have, in turn, resulted in higher gains in labor productivity. Reduction in the current account deficit and larger public sector savings could go hand in hand with increases in productive investment, labor productivity, and economic growth. A reduced fiscal deficit could be compatible with an easing of monetary policy that would, in turn, lead to a more competitive exchange rate, a reduction in domestic real interest rates, and hence to more investment and growth.

The savings and loan crisis is exerting additional pressure on the fiscal deficit, and its solution will require the adoption of structural reforms in the financial system. The advantages associated with the implementation of a risk-based deposit insurance are clear, although the implementation of this measure could be complex. Apart from the fact that it is very difficult to evaluate the risks associated with the operations of different financial institutions, there are problems related to the market perception of those risks. If differential fees were adopted, and if they were known by the market participants, this could dangerously add to the potential instability of the banking system, because the knowledge of these differential fees might precipitate shifts of financial resources among institutions. In other words, such knowledge could influence economic agents to withdraw from the less secure institutions and lead to a redistribution of resources, which would perhaps lead to a situation more unbalanced than the one existing before the introduction of that measure. I wonder whether the staff could comment on this point.

Finally, we welcome Mr. Dawson's comments on the United States' interest in exploring ways to help developing countries, in particular policies to further open the U.S. market to developing countries' exports and to push for substantial trade liberalization through the Uruguay Round. During the most recent discussion on the world economic outlook, we emphasized the advantages of trade liberalization. The U.S. proposal on debt reduction for the Latin American countries implementing economic reform programs is welcome. We had hoped this subject would have received more detailed treatment in Mr. Dawson's opening statement, and we wonder whether Mr. Dawson or the staff could comment on it. My authorities welcome the proposal made by the U.S. President in June 1990, as a useful complement to the Brady Plan. We wonder whether the staff or Mr. Dawson could comment on how these two initiatives could work in conjunction. As the more recent proposal requires Congressional approval, we wonder whether there are any preliminary indications concerning the timing of its approval and implementation.

Mr. Monyake made the following statement:

The importance of international coordination on macroeconomic policies for the promotion of world economic growth has been emphasized on many previous occasions in this Board.

At the same time as vigorous, and sometimes painful, adjustment processes take place in the developing world, the industrial countries should be contributing to a sustained effort to adjust their financial policies as a measure to reduce the global imbalances.

According to the staff report, the requirements for fiscal, monetary, and structural policies remain unchanged since the previous Article IV consultation with the United States. We fully agree with that conclusion.

Despite the expansion of the American economy over previous years, albeit at a slow pace, the persistence of large fiscal and current account deficits continues to be a matter of major concern to the world economy. Moreover, the revised projections of the short- and medium-term outlook show an even slower pace of economic growth during 1990 and 1991 and, although with a declining trend up to 1995, higher levels of interest and inflation rates than those projected earlier this year. We agree with the staff that stronger macroeconomic policies as well as structural reforms will be required to achieve sustained growth, low inflation rates, and reduced fiscal and external imbalances.

The staff recommendation that further fiscal corrections than those proposed by the Administration are necessary to reduce the deficit to a sustainable level becomes even more pertinent when viewed within the context of the large increase expected on the expenditure side, in view of the deployment of U.S. forces in the Middle East. This emphasizes the need for further adjustments on the tax system in order to increase the national savings, with a consequent positive impact on the reduction of the current account deficit.

As to monetary policy, we note the cautious actions taken by the Federal Reserve to control the inflationary pressures through restraining domestic demand.

We welcome the commitment of the U.S. authorities toward a successful conclusion of the Uruguay Round and a dismantling of trade barriers. Again, coordination among the major industrial countries, to ensure symmetry in the implementation of this policy, will play a key role in the progress and conclusion of these negotiations. The developing countries are hopeful that these commitments will be translated into practice in the near future.

The debt strategies launched by the U.S. Administration over the past year, particularly the one recently proposed for the Latin American and Caribbean regions, raise some doubts about their successful implementation, in light of the conditionalities surrounding them. Most of the potential beneficiary debtor countries are already implementing profound adjustment programs, and we wonder whether additional policy demands can be borne by these countries without creating counterproductive effects.

It is disappointing to note that the rate of official development assistance has fallen to such a low level during 1989. Regrettably, the level of the U.S. development assistance, in relation to GNP, is not only far behind the UN target, it is also the lowest of the Development Assistance Committee members. A very disturbing feature is the prospect of a declining trend for future years. Finally, in view of the important role that the United States plays in the balancing of the world economy, its Administration should be responsive to the concerns of the rest of the world as expressed through this Board.

Mr. Prader made the following statement:

Since the Plaza agreement started the policy coordination process among the large industrial countries, substantial progress has been made in moving the world toward adjustment in a context of overall high economic growth. However, the progress that has been achieved should not induce complacency, because the results have been suboptimal. This is clearly illustrated in the case currently under consideration. In concert with supporting actions undertaken by partner countries, the U.S. authorities succeeded in reducing the magnitude of their macroeconomic disequilibria. This result was partly aided by the impetus supplied by continued strong economic growth, which at the same time lessened the urgency of the effort by masking the underlying disequilibria. The slowing of the economic expansion in 1989 and 1990 has brought these disequilibria to the fore, and the recent movements in the price of oil are likely to aggravate the problems already facing the U.S. economy, deepening any recession and intensifying the upward pressure on prices.

To a certain extent, the situation of the U.S. economy is like a man riding a tiger. Should efforts to reduce the fiscal deficit and lower the inflation rate be temporarily slackened or interrupted to prolong the economic expansion, or does prolonging the ride only promise greater problems later on?

From the perspective of achieving a certain growth momentum, it should be noted that the center of growth among the industrial countries shifted in 1989 and early 1990 from the U.S. economy to continental Europe and to Japan, which continued its already strong economic activity. Despite this reduction in the rate of expansion, the U.S. economy began to face very high rates of capacity utilization and a firming of labor market conditions. It is significant that despite this slowdown, the U.S. economy has created an impressive number of new jobs, bringing the unemployment rate to a new low for this decade. But shortages in skilled labor have been building and wage pressures have intensified with the acceleration over time of the rate of increase in unit labor costs in the private nonfarm sector, which is currently close to 5 percent. These developments presage further inflationary pressures. Moreover, the nonaccelerating wage rate of unemployment (NAWRU) has probably been increasing in parallel with the past decade's continuous reduction of the unemployment rate. If the estimates are correct, the current rate of unemployment in the U.S. economy is close to or even below the NAWRU. This points once more to the recent rise in wage and price inflation and may be another indication of the difficulty of reversing or at least containing further cost pressures while at the same time maintaining strong economic activity.

The above-mentioned considerations call for a cautious approach in U.S. policy management. This conclusion, based on the domestic economy, is corroborated by developments in the external accounts. The U.S. current account deficit has considerably narrowed during the past two years and this process should be continued for the current year. The adjustment, particularly in the trade account, resulted from the combined effects of two factors. The first was an improvement in external competitiveness, as reflected in real effective exchange rates. Since the trade volume effects of changes in competitiveness lag by about one or two years, the dollar's earlier decline was still helping the current account. However, by 1989 this continued adjustment already showed less strength than during earlier periods when measured as an adjustment in real terms, i.e., by the difference between the volume growth of imports and exports. If the adjustment process is to be continued, as it should be, it will have to be supported not only by the real effective exchange rate, but also by movement in the correct direction of relative domestic demand, which is the second traditional factor influencing the trade account: since 1985, U.S. final domestic demand growth has been below the average domestic demand growth of the OECD countries. Continuation of the external adjustment process calls for maintaining these relative final demand growth patterns for some time.

External current account disequilibria reflect imbalances between domestic production and domestic absorption. To view these imbalances in a longer-term perspective, it is useful to refer to savings and investment patterns. From this perspective, it is well known that the 1980s was a decade in which savings became increasingly scarce. By comparison with the surplus industrial countries, the U.S. economy has both very low gross savings and a low gross fixed capital formation rate. The adjustment process in the United States has been hindered by the very small rise in the national savings rate, which still remains well below the depressed levels prevailing earlier in the decade. What is needed to bring the United States back into the mainstream of the Group of Seven is a substantial increase in both the investment and the savings rates. Of course this cannot be achieved at once but will require the structural corrections contemplated by the U.S. Administration. Meanwhile it is clear that the adjustment process must involve a rise in domestic savings and no falling off of investment, because only such a rise in domestic savings allows for the increased domestic investment that is ultimately needed to bring production capacity into better balance with domestic absorption in the medium term.

The changes in the financial sectors of industrial economies have tended to weaken the short-run relationships between monetary and other economic variables, but extensive research on longer-run relationships between monetary aggregates and the price level has made it possible to derive the potential level of prices over the medium term. Many technical difficulties still exist, but the results of those investigations are nonetheless relevant in assessing the future course of monetary policy. In the case of the United States, they indicate that the recent slowdown in monetary growth may well not suffice to prevent inflation from accelerating, because the liquidity overhang created in the first years after the stock market crash has not yet been reabsorbed.

The degree of utilization of aggregate production capacity, the state of the current account adjustment process, and the inflation outlook all clearly indicate that the national savings rate has to be increased, and that this can best be done by continuing and strengthening the fiscal adjustment. They also indicate that monetary policy should not be relaxed prematurely if abrupt policy changes aimed at reining in a rising inflation rate are to be avoided later.

The recent acknowledgment by the U.S. President of the need to include tax revenue measures in the budget correction package augurs well for the future, as an official recognition of the earlier judgmental errors that led to belief in the long-term existence of a free lunch. Let us hope this correction will not be nullified by a new error denying the existence of a real resource transfer connected with the oil price increase, which might lead to a postponement of the needed fiscal adjustment. Recent events in the oil market have strengthened my interest in a proposal to double the price of oil to the U.S. consumer, which would only adjust the oil price to approximately the levels prevailing in the other industrial countries. The price would be raised gradually through incremental increases in the tax on oil. Such a preannounced scheme of tax increases would give time for rational decision making on the part of both consumers and companies. It would not immediately make large parts of the capital stock obsolete. It would have extremely beneficial effects on the environment and national security, and it would greatly enhance public earnings and aid the correction of the budget deficit. This proposal, therefore, deserves close attention. Its only drawback is that its narrow focus on the oil commodity might introduce distortions into the decision-making process. A way around this drawback, which would strengthen all the benefits I have enumerated thus far, would be to levy the tax not only on oil, but also on energy in general. This broadening would avoid merely shifting the demand for energy to energy sources less costly than oil: it would tend to reduce the global demand for energy and thereby lead to resumption of the effort, interrupted in the late 1980s, to reduce the energy dependence of aggregate production.

I basically agree with the authorities that the external adjustment is a two-way process. The recent shift of growth momentum from the United States to the European and Japanese economies is most welcome, since it contributes positively to the external adjustment. But if domestic demand in surplus countries has increased compared with domestic production and if this can be expected to continue for the short term at least, adjustment in the U.S. external accounts can occur only if the U.S. economy is in a position to respond to the increased external demand. Given the existing capacity constraints and degree of capacity utilization, this means U.S. domestic absorption will have to grow more slowly than domestic production. Hence the need to keep internal demand under control, which means continuing the fiscal adjustment. Such a course of action would truly make the external adjustment process a two-way street.

Mr. Filosa made the following statement:

The range of issues facing the economy has not changed since the previous Article IV consultation with the United States. Against a continuously good performance of the economy in terms of growth and employment creation, the large fiscal and external imbalances remain. Similarly, various structural problems continue to affect the American economy. The passing of time has only added to the urgency of addressing the two main macroeconomic issues, the fiscal and trade deficits, and of reinvigorating policies in the structural area. This is the basic message of the staff report.

However, the most recent developments in the American economy and in the Middle East have led the economic debate to be increasingly focused on both the feasibility and desirability of a strong fiscal adjustment. Many, at this juncture, believe that the implementation of a strong fiscal adjustment is not only difficult, but also inappropriate. Others, instead, continue to believe that a sizable fiscal adjustment remains desirable as a matter of principle and feasible as a matter of practice and that the recent events, while imposing new policy constraints, do not eliminate the need for a decisive fiscal adjustment effort.

I am inclined to agree that a sizable fiscal adjustment remains both necessary and feasible, in light of three major factors: the possible path of the fiscal adjustment, the role of monetary policy in implementing global macroeconomic adjustment, and the composition of a package aimed at reducing the large fiscal deficit. As I broadly agree with the views expressed by the staff, I will not comment specifically on structural issues.

There are many different factors that should be reconciled in setting the path of fiscal adjustment. First, it should be noted that, while the risks of a recession should not be exaggerated, they should not be overlooked. In fact, the present slowdown in growth appears to have begun earlier and to be more pronounced than previously expected, and the revised staff projections indicate that growth in 1990 will be in the range of only 1 percent. Moreover, a fiscal adjustment path should be set at realistic levels in order to appear credible to financial markets. Nevertheless, it is clear that too cautious an approach to fiscal adjustment for fear of a recession could be interpreted as a lack of determination in pursuing the objective of fiscal adjustment in general, given that even during years of robust growth, fiscal adjustment has not been forcefully pursued. If financial markets perceive deficit reduction as too cautious, they would expect further interest rate increases and, in turn, would aggravate the increases in interest rates recorded since the outbreak of the crisis in the Middle East.

Therefore, I tend to agree that a deficit reduction plan aimed at strengthening the fiscal position along the lines envisaged in the January 1990 budget, but that limits the deficit reduction for 1991 to only $50 billion, can hardly be considered a strong fiscal adjustment. A more front-loaded approach to fiscal adjustment would have, as indicated by the staff in its medium-term scenario, a more favorable effect on interest rates and on the rate of growth in the medium term. An adjustment of $50 billion in 1991, given the goal of achieving a cumulative reduction cut of $500 billion over five years, would imply further discretionary measures to cut the deficit in the future and, presumably, very large additional cuts from 1992 onward. In fact, I am not confident that automatic stabilizers would provide, by themselves, enough resources to limit to a minimum new measures to achieve the fiscal consolidation targets. As a consequence, a $50 billion deficit reduction in 1991 would imply that the potential deflationary pressures of strong deficit-cutting measures would have to be squarely faced in the years ahead. Therefore, a limited adjustment in 1991 remains only a postponement of important decisions that could be taken immediately.

With respect to the role of monetary policy in determining global macroeconomic adjustment, it is clear that monetary policy could play a useful role in keeping growth on track and avoiding the emergence of a recession in the United States. In this connection, the recent statement made by the Chairman of the Federal Reserve that, "concerns that the Federal Reserve would be unable to offset undesirable macroeconomic effects of a budget pact are, largely unfounded" is reassuring. However, the staff's analysis makes it clear that an accommodating monetary policy can be adopted only to the extent that a credible and strong fiscal adjustment process is undertaken in the United States. In the absence of a strong fiscal adjustment, an accommodating monetary policy could simply lead to lower short-term interest rates, without significant effects on long-term interest rates, which might well increase as a result of higher inflationary expectations. A monetary expansion would, therefore, result in a further depreciation of the dollar and a higher rate of inflation and would require, sooner or later, a period of strong monetary restraint to reverse inflationary expectations. All this would not be conducive to a stable domestic economic environment and could cause unwanted short-term capital movements, without improving the trade deficit in the medium term. In this respect, a monetary expansion in the absence of fiscal adjustment could be seen as a de facto contradiction to the principle that monetary policy must be devoted to the goal of price stability, rather than to other objectives, such as external equilibrium. This principle has been very firmly held by the U.S. authorities and was reiterated in Mr. Dawson's opening statement.

It is clear that the fiscal deficit reduction package will embrace both expenditure cuts and tax increases. However, the problem of deciding the relative size of expenditure cuts and tax increases, as well as whether direct or indirect taxes should be increased, remains. On the expenditure side, I differ with Ms. Powell in that I agree with the authorities that it is difficult to envisage extremely large cuts in major expenditure items. In fact, Federal Government spending, excluding net interest payments, was the same in 1989 in terms of GDP as the average of the 1970s. Furthermore, the reduction in military expenditure will probably be smaller than previously envisaged. On the revenue side, the introduction of an energy tax would certainly serve the objective of raising federal revenues, while, at the same time, contributing to energy conservation and the reduction of pollution. In light of the recent oil price increase and the inevitable inflationary consequences of higher indirect taxation, I wonder whether the contribution of energy taxation to deficit reduction would be significant. Furthermore, an increase in indirect taxation would drastically rein in the progressiveness of the whole tax system. As a consequence, the package should include not only indirect, but also some direct tax increases mainly through a broadening of the tax base. In this case, the increase in income tax would not have to be very large, and, therefore, would not reduce incentives.

In conclusion, recent developments have certainly complicated the task of implementing a fiscal adjustment strategy. At the same time, such developments have highlighted the need to pursue the adjustment effort forcefully and durably. In view of the prominent role of the United States in the world economy, I hope that an agreement will be found to achieve that goal.

Mr. Rouai made the following statement:

We generally agree with the staff's analysis of the current economic situation in the United States.

Like many previous speakers, we agree with the staff's recommendations on the appropriate stance of policies in the United States, compatible with the objective of achieving strong growth over the medium term coupled with progress toward lower rates of inflation and a reduced current account deficit. However, there are two specific issues that are particularly important and deserve emphasis.

First, the consolidation of national savings should remain very high on the authorities' agenda for the coming years for both external and internal reasons. From an international perspective, it can hardly be denied that the fall in the national saving rate in the United States during the 1980s contributed largely to the parallel deterioration in the balance of payments and to the buildup of external debt. The persistence of large external imbalances clearly constitutes a major source of vulnerability for the international monetary system and contributes to the pressures on world savings and the level of interest rates. From an internal perspective, the issue of saving in the United States highlights the importance and the urgency of tackling decisively the fiscal deficit in the context of a multiyear plan, encompassing both expenditure restraint and measures to raise revenues. Concomitantly, further emphasis should be devoted to the promotion of private savings. On a related matter, the savings and loan crisis highlights the urgency of reforming the deposit insurance system. This system, which has been helpful in preventing any spillover effect of the crisis and in preserving--for the time being--confidence in the financial system, is nevertheless very costly and appears to be inadequately funded.

The second issue that should be emphasized deals with U.S. economic relations with developing countries. Despite the severe budgetary constraints, we encourage the U.S. authorities to consolidate their overall support to developing countries and particularly their participation in the debt strategy. This support could materialize in an increase in official development assistance to a level commensurate with the size of the U.S. economy. It could also include initiatives in debt relief and forgiveness similar to that taken recently by the Administration and linked to the adherence to adjustment programs. Finally, the authorities are encouraged to enlarge access to the U.S. market for exports from developing countries, in particular for products such as textiles and clothing, for which developing countries have gained comparative advantage. On the latter point, we are assured by the authorities' commitment to a more open trading system and we encourage them to reinforce their stance against protectionist pressures. However, the need to adhere to multilateralism in the area of trade policy should be emphasized. The staff was correct to urge the authorities to ensure that regional free trade agreements will not run counter to the basic goal of a free trade on a multilateral basis.

Mr. Arora made the following statement:

The United States occupies such a dominant position that any adverse development in its economy has far-reaching implications for the world economy generally and the developing countries in particular. In this context, recent developments in the U.S. economy are not satisfactory; in fact, they are cause for serious concern. The second supplement to the staff report indicates that the situation is even worse than previously reported. Thus, it appears that the slowdown began earlier and is more pronounced than previously reported, the level of consumer spending is flat, the inflation rate continues to drift upward, the unemployment rate is edging up, the gross private and national savings rates actually declined in 1989, monthly housing starts in July 1990 fell to their lowest level in eight years, sales of new automobiles are down, profits are sagging, business confidence is weak, the level of industrial production is flat, and net exports actually fell in the second quarter of 1990. These developments represent the situation before the eruption of the current oil crisis. How the oil market will behave in the short run is not known. However, even with Saudi Arabia pumping more crude, the market remains hard with prices remaining above $30 per barrel. Therefore, the staff assumption that world oil prices will average $26 per barrel for the remainder of 1990 and then slide down to the reference level of the Organization of Petroleum Exporting Countries of $21 per barrel by the last quarter of 1991 appears somewhat optimistic. But even on that assumption, output growth in the United States may not exceed 1.3 percent in 1990 and only fractionally more in 1991; the inflation rate will exceed 5 percent; and the current account deficit is projected to remain close to $100 billion. Although short-term interest rates have eased somewhat, they remain high. Interest rates at the longer end of maturity continue to inch upward, indicating that the market is discounting the Federal Reserve's ability to control inflation.

These are of course short-term developments; the longer-term trends in the U.S. economy are equally disturbing. The rate of growth of labor, which is also a factor of productivity, has declined over time. The average rate of increase in labor productivity in the nonfarm business sector, which was about 2.5 percent during the 1950s and 1960s, declined to 1.3 percent in the 1980s, and it was estimated to be only 0.9 percent in 1989. The rate of increase in total factor productivity declined from 2.7 percent in the 1950s to 0.4 percent in the 1980s. There has also been a marked decline in the rate of growth of capital stock during this period. Moreover, while the rate of increase in output per hour is decelerating, hourly compensation is increasing at an accelerated rate; there has thus been considerable increase in unit labor costs. This has affected U.S. competitiveness in the international market. The rise in unit labor cost has also affected the profit margins. The adjusted after-tax profit rate in the nonfinancial corporate sector declined from 8.4 percent of GDP in 1986 to 6.6 percent in 1989; it is estimated to be only 6.2 percent in the first quarter of 1990. Rising labor costs and sagging profit margins have affected investment decisions. In addition, real investment in residential construction fell by 7 percent in 1989--this was the second decline in three years; there has also been a marked decline in the rate of growth of real nonresidential investment. The fall in net fixed investment has reduced the long-term, sustainable, noninflationary rate of growth--some estimate to under 2.5 percent. These trends need to be reversed. To the extent that these developments point to major structural deficiencies in the U.S. economy, there is an urgent need for reform. Delays in undertaking such reforms or any attempt to tackle the problem through the adoption of inward-looking policies will only aggravate the problem.

One major problem is the meager and falling rate of savings. National savings declined from 16.7 percent of GNP in the 1970s to

14.1 percent in the 1980s; it was 13.3 percent in 1989. The corresponding gross personal savings rates were 5.6 percent, 3.8 percent, and 3.3 percent, respectively. The hope of some recovery in the savings rate during 1989 has turned out to be false. In fact, as the staff has indicated, the gross private and national savings rates are estimated to have declined in 1989 instead of rising slightly as previously projected. The United States has for a long time lived on the savings of other nations, creating problems for itself as well as for others. We fear that the United States will never be in a position to work its way out of its competitive problems unless it saves more and devotes the increased savings to productive investment. The best way to increase the savings pool is to balance the federal budget. Unfortunately, present indications show that the possibility of cutting down the fiscal deficit--let alone, balancing the budget--is thin.

Acceleration in the rate of inflation is speeding up. Price rises during 1990 to date have been considerably above the corresponding level of previous years. The recent rise in prices is not an isolated incident. Although prices are under control, the undertone has been firm for quite some time. The price rise has been fed, inter alia, by the depreciation of the dollar; the value of the dollar recently reached a record low against the deutsche mark. With oil prices shooting up, prices in the United States may go up further. However, the economy has been slowing down. With real personal consumption expenditure and real gross fixed private domestic investment subdued, the price of housing fell in July 1990 for the sixth straight month, representing the longest string of monthly declines during the current upswing. These developments coupled with interest rates that remain high mean that the possibility of a mild recession cannot be ruled out. Thus, the Federal Reserve is faced with the difficult dilemma of whether to ease monetary policy and thus help the economy to grow, even at the cost of pushing prices further up, or to tighten monetary policy and thus help contain price rises, but at the risk of further weakening economic activity. The testimony of the Federal Reserve Board Chairman to Congress in late July 1990 indicated that his preference was for the latter course of action. While the Chairman of the Federal Reserve is in a better position and more competent to assess the emerging situation, it seems that the basic duty of the monetary authorities is to keep prices stable, thereby creating a climate for healthy growth; monetary policy should not be used to target real GNP. Therefore, I strongly consider that--following the loosening of recent months--the Federal Reserve should continue with a tight monetary policy. This would raise interest rates and could also weaken the economy, thus, creating further problems for the developing countries. However, to the extent it would help weed out inefficient units, thereby helping to improve efficiency and competitiveness, it may be the better course of action in the long run. Another problem with easing monetary controls is that it may send the market a misleading signal that the Federal Reserve is abandoning its fight against inflation. In that event, long-term interest rates may go up, thus defeating the very purpose for which monetary policy was eased in the first place. Therefore, on balance, the Federal Reserve should opt for a tight monetary policy and an increase in interest rates to make a credible stand against inflation. The growth aspect should be taken care of through structural adjustments, in particular sharp reductions in the fiscal deficit. A meaningful exchange rate policy may also prove helpful. The value of the dollar is already sliding down. Rising interest rates in Japan and Germany and the belief that the Federal Reserve may ease the brake somewhat would depress the value of the dollar further. This may work against recession by improving exports.

It is unfortunate that political compulsions rather than economic realities have been given greater weight in framing fiscal policy. Therefore, I am not surprised that every year fiscal deficits have been larger than projected; they have also been significantly larger than provided for in the GRH legislation. 1990 is no exception. This is one major problem with the U.S. economy. As Mr. Dawson pointed out, failure to succeed in this respect will have serious consequences in the form of slower growth, higher inflation and interest rates, and financial market instability. I agree with Mr. Dawson that it is the responsibility of the United States to correct the situation. Nevertheless, in his opening statement Mr. Dawson indicated that the proposals for a large front-loading of the deficit reduction effort are neither credible nor desirable. Moreover, the arguments he put forward to justify a continued large fiscal deficit are disturbing.

Although negotiations are under way to reduce the deficit substantially over five years, according to recent press reports, the negotiators have apparently reached an impasse and they may fail to produce a credible multiyear deficit reduction package. This has serious medium-term implications for growth performance and inflation, as well as for interest rates and the external value of the dollar. As the staff indicated, this may cause a loss of business confidence and a sharp decline in the exchange rate of the dollar with attendant upward pressure on U.S. interest rates and inflation and a significant erosion of the competitive edge. The current account may improve, but only at the cost of domestic investment and weaker growth performance. This would also adversely affect the growth prospects of net debtor developing countries, but these countries are projected to suffer under the other alternative scenarios as well.

It is unfortunate that the flow of official development assistance from the United States dropped sharply from $10.1 billion in 1988 to $7.7 billion in 1989; as a percentage of GNP, the decline was from 0.21 percent to 0.15 percent. In his opening statement, Mr. Dawson was candid in making it clear that there is no hope for any increase in such assistance. Although the United States never accepted the UN target of official development assistance equivalent to 0.7 percent of GNP, I am sure that, financial constraints notwithstanding, a $1 trillion budget can always afford to provide some additional development assistance. I urge the Administration to reconsider its approach to official development assistance.

Mr. Santos made the following statement:

While welcoming the continued expansion of the U.S. economy, which is in its eighth year, like other speakers, we note the general weakness that pervades the economy and that has increased its vulnerability to exogenous shocks. The staff has clearly highlighted the problems facing the economy and made policy recommendations that we can support. In this respect, we note that many of the recommendations made by the Board during the previous Article IV consultation with the United States remain not only valid, but also have taken on added importance with recent developments. Indeed, as Mr. Grosche pointed out, while policy recommendations have not changed, the economic environment has deteriorated.

Previous speakers have addressed the difficult choices that are facing the U.S. authorities with respect to policies and measures to reduce the fiscal and external imbalances, and we have little to add to their analysis and recommendations with which we broadly concur. However, we have serious concerns with respect to developments in the fiscal and external sectors.

On the fiscal side, the importance we attach to the enactment of a credible fiscal package should be stressed. In this respect we welcome the discussions between the Administration and the Congress aimed at achieving a deficit reduction of $500 billion over five years. However, we note from Mr. Dawson's opening statement that the aim for 1991 might be a reduction of only $50 billion. Such a reduction is inadequate and might lead to a credibility problem, the more so since it is less than required to meet the GRH deficit target and would involve another revision of the GRH legislation. Therefore, we agree with the staff that front-loaded actions are needed to reduce the fiscal deficit. Such a reduction would be more credible to the financial and business community, as it would reduce the risks and uncertainties that could stand in the way of the process of implementing a medium-term fiscal plan.

As to the external sector, despite some improvements in the current account, further progress to reduce the current account deficit is likely to be slow, unless domestic demand is reduced and the national saving rate is increased. Again, this calls for progress on the fiscal front, as well as for the introduction of measures that will remove the structural impediments to private savings decisions. The effect of any measures to reduce the current account deficit will surely be helped by the sustained higher level of growth in Western Europe and Japan, as well as by the recent depreciation of the dollar. In any event, the continued weakness of the external position raises concerns about the threat of protectionism. Therefore, the priority the authorities attach to achieving a more open trading system through a successful conclusion of the Uruguay Round is welcome. We encourage them to stand firm against protectionist pressures and to take steps to eliminate existing trade barriers, especially with respect to textiles, clothing, and sugar. While we welcome the recent trade initiative on Latin America and the Caribbean, we agree with the staff that this arrangement should be framed in a way that will not run against the basic goal of free trade on a multilateral basis.

Finally, we note the active role the United States is playing to find solutions to the debt problem of developing countries and create the conditions necessary to ensure sustained growth, particularly in the Western Hemisphere. We also welcome the initiatives that the U.S. Administration has taken to waive the official debt of African countries. However, we must express our disappointment and concern about the declining trend in U.S. official development assistance in relation to GDP. While recognizing the current budgetary constraints the authorities face, we urge them to reverse this decline.

Mr. Wang made the following statement:

The updated information contained in the second supplement to the staff report clearly indicates that the downturn of the U.S. economy began before the recent developments in the Middle East. Indeed, the economy has been running at full capacity utilization, yet much below its potential growth rate, for quite some time. The oil price increase resulting from recent events in the Middle East has clearly aggravated inflationary pressures and added to the uncertainties of the economic outlook. However, recent developments, grave as they are, should not divert attention from economic fundamentals, nor should the reaction to them be inconsistent with the medium-term macroeconomic policy objectives. Against this background, my comments will focus on the theme of policy reaction and on U.S. trade policy.

First, I agree with the staff that, in order to minimize the loss of confidence in economic prospects as well as the overt reaction of the financial markets to uncertainties, the authorities have no time to waste in giving clear signals of their policy intentions. The risk premium already built into U.S. long-term interest rates reveals that the markets are uneasy about the prospects for the economy and point irrevocably to the need for quick action and policy transparency. In the current uncertain circumstances, when weekly events overtake economic information and projections, the slightest sign of policy paralysis or, worse still, wrong signals, would give rise to serious consequences. Clearly, the ideal policy mix would be for the U.S. authorities to drastically and credibly reduce the fiscal deficit so as to provide some leeway for monetary policy to be more responsive to weakening economic activities. Such a combination of policies would certainly relieve resource pressures without pushing up interest rates. Unfortunately, under the circumstances of imminent recession and rising prices, such an ideal pattern seems more elusive than ever.

Obviously, the slowdown in economic growth, together with the rise in oil prices, has made it even more difficult to cut the budget deficit as required under the GRH targets, because of both the reduced revenue, resulting from lower GNP growth, and the narrow room for maneuver in raising taxes--not to mention vanishing peace dividends in light of the massive military expenditures in the Middle East. Moreover, the indication contained in Mr. Dawson's opening statement that, if the readings on the growth figures should fall below 1 percent in late 1990 or early 1991--which is probable in spite of the optimistic staff projection for a higher growth rate--the GRH targets would be suspended is cause for concern. Given this probability, I agree with the staff's implicit recommendation that action needs to be taken as soon as possible in reaching a credible and drastic deficit reduction package in order to pre-empt likely future increases in expenditures, on top of stabilizing expectations.

Second, monetary policy should not be blamed solely for the economic downturn, nor for any future sluggishness in the economy. Fiscal and structural policies should be held responsible. This does not mean that monetary policy should not be sensitive to GNP growth, but there should be no doubt that the best contribution monetary policy can make to sustained growth is through maintaining price stability over the medium term. Nevertheless, the benefits of controlling inflation should be weighed carefully against the cost of a recession with its resultant painful dislocation of resources, plus the even more serious consequences if the world economy is dragged into a recession with it. All of this points to the need for the Federal Reserve to remain firm in its fight against inflation over the medium term and to stand ready to respond swiftly to weakening economic activities. These objectives should not be seen as opposing each other.

Essentially, the continued lack of progress in making the necessary economic policy changes, such as in the fiscal area, is not due so much to a need for sound recommendations, but rather to a lack of consensus and implementation. Despite their validity, the staff recommendations have become platitudes, owing to their recurrence every year, which indicates that there must be something seriously amiss within the system itself. It also reveals that the Fund's surveillance policy over major members leaves something to be desired.

Finally, my authorities are concerned about the continued protectionist sentiment in the United States. The U.S. obsession with the trade practices of its partners and its inclination toward retaliatory action are indeed disturbing. On this point, a French economist once observed that the fact that other countries had rocks in their harbors was no reason to throw rocks in your own. In other words, the fact that other countries distort their production with protectionism and subsidies is no reason for the United States to do so. Not to mention that the United States is looked up to as the leader of the multilateral trade system.

Mr. Ahmed made the following statement:

As I am in broad agreement with the staff analysis and policy recommendations, I will limit my comments to a few observations.

With respect to the overall growth and inflation prospects, provided the right mix of fiscal, monetary, and structural policies are put in place, the U.S. economy has the resilience to absorb the recent oil price increase without significant adverse effects and to sustain positive rates of economic growth while moving toward price stability and external adjustment.

Central to such an outcome, however, will be the success of present efforts to bring about a significant strengthening of the federal fiscal position. This constitutes the greatest challenge to policymaking presently facing the authorities. While U.S. involvement in the Middle East has complicated the fiscal outlook, it does not fundamentally alter the urgent need for bringing about a decisive improvement in the fiscal position. As the various scenarios presented by the staff have demonstrated, a credible agreement on the fiscal front would have a number of favorable effects on market confidence, domestic private demand, and net exports, in addition to addressing the world savings shortage, a key concern of the international community. On the other hand, failure to secure a meaningful agreement on the fiscal situation could lead to serious consequences for the U.S. and global economies.

With respect to monetary management, which is obviously an immediate policy concern, the staff was correct to advise steadiness in the course of monetary policy, but this caution should not result in an overreaction, which could trigger a further slowdown in economic activity. However, an overt easing of monetary policy as a means of accommodating the increase in oil prices would also be undesirable. It would risk a significant acceleration of inflation and reduce the credibility of the authorities' long-term strategy of moving toward price stability. The important point is that the task of monetary policy--where the room for maneuver that existed before recent developments was already limited--would be greatly eased by substantial progress in lowering the fiscal deficit, since that would reduce resource pressures without pushing up interest rates.

With respect to trade policy, we were encouraged by the indication contained in the staff report that the Super 301 provision of the 1988 Trade Act would not be extended beyond 1990 and that the United States would give the highest priority to achieving a more open trade system through bringing about a successful conclusion of the Uruguay Round. However, we were concerned about a recent report that quotes the U.S. Coordinator for the Uruguay Round as saying that, irrespective of the results of the ongoing multinational trade talks, the Super 301 trade bill will continue to apply. I wonder whether the staff or Mr. Dawson could comment on this point.

The Executive Directors then agreed to continue their consideration of the staff report for the 1990 Article IV consultation with the United States in the afternoon.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/90/141 (9/12/90) and EBM/90/142 (9/14/90).

3. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors and by an Advisor to Executive Director as set forth in EBAP/90/239 (9/11/90) is approved.

4. TRAVEL BY MANAGING DIRECTOR

Travel by the Managing Director as set forth in EBAP/90/238, Supplement 1 (9/12/90) is approved.

APPROVED: August 20, 1991

JOSEPH W. LANG, JR.
Acting Secretary