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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 88/131

3:15 p.m., August 29, 1988

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

Executive Directors	Alternate Executive Directors
	P. E. Archibong, Temporary
	R. Comotto, Temporary
Dai Q.	
C. H. Dallara	C. S. Warner
J. de Groote	
A. Donoso	
	A. M. Othman
G. Grosche	
J. E. Ismael	J. Reddy
A. Kafka	
M. Massé	
	C. V. Santos
	M. Al-Jasser, Temporary
G. Ortiz	
J. Ovi	
H. Ploix	
G. A. Posthumus	
C. R. Rye	
	S. Rouai, Temporary
A. K. Sengupta	
K. Yamazaki	S. Yoshikuni
S. Zecchini	

L. Van Houtven, Secretary and Counsellor
D. J. de Vos, Assistant

Also Present

Asian Department: R. J. Corker. European Department: P. B. de Fontenay, Deputy Director; L. J. Lipschitz. Exchange and Trade Relations Department: H. B. Junz, Deputy Director; M. R. Kelly, N. Kirmani. Fiscal Affairs Department: A. L. Bovenberg. IMF Institute: O. B. Makalou. Legal Department: A. O. Liuksila, J. K. Oh. Research Department: A. D. Crockett, Deputy Director; M. Goldstein, Deputy Director; F. C. Adams, J. M. Boughton, E. Hernández-Catá, S. A. Symansky, M. A. Wattleworth. Western Hemisphere Department: S. T. Beza, Director; K. B. Bercuson, D. A. Citrin, S. A. Coorey, S. Dunaway, L. P. Ebrill, O. J. Evans, S. M. Fries, Y. Horiguchi, M. Mered. Personal Assistant to the Managing Director: H. G. O. Simpson. Advisors to Executive Directors: N. Adachi, W. N. Engert, A. G. A. Faria, M. Pétursson, J. E. Zeas. Assistants to Executive Directors: H. S. Binay, S. K. Fayyad, L. Hubloue, C. Y. Legg, V. K. Malhotra, C. Noriega, J. K. Orleans-Lindsay, L. M. Piantini, A. Rieffel, E. L. Walker, R. Wenzel, C. C. A. van den Berg.

1. UNITED STATES - 1988 ARTICLE IV CONSULTATION

The Executive Directors continued from the previous meeting (EBM/88/130, 8/29/88) their consideration of the staff report for the 1988 Article IV consultation with the United States (SM/88/160, 7/26/88; and Sup. 1, 8/25/88). They also had before them a background paper on recent economic developments in the United States (SM/88/162, 7/29/88; Sup. 1, 8/2/88; Sup. 2, 8/4/88; Sup. 2, Cor. 1, 8/8/88; and Sup. 3, 8/10/88).

The Director of the Western Hemisphere Department said that the substantial deterioration of the private savings and investment balance, shown in the staff's medium-term baseline projection, was related to the assumptions used by the staff in such projections and in short-term forecasts that real effective exchange rates would remain constant and that interest rates would stay broadly unchanged. In effect, through these assumptions, inherently endogenous variables were being treated as if they were exogenous, with various consequences resulting. For example, the baseline projection in the current exercise postulated a reduction in the public sector deficit from 1988 to 1993 of about 1 3/4 percent of GNP, but without any effects on interest and exchange rates. To validate that assumption, the staff had implicitly assumed that, as fiscal stimulus was withdrawn, business fixed investment would take up the slack. The treatment of endogenous variables as exogenous had been an issue in past world economic outlook exercises.

The medium-term scenarios in Table 5 and Table 8 of SM/88/162, Supplement 1 had been cited in support of the proposition that expenditure cuts would have a more substantial effect on national savings than tax increases, the Director noted. The staff had pointed out in the same section of Supplement 1 (Appendix IV) that the model underlying those scenarios assumed that Ricardian Equivalence held in the long run, which had thus influenced the results. In Appendix XIV, the staff had looked at the evidence from another angle, and had concluded that spending cuts and tax increases were broadly equivalent in terms of their likely impact on national savings.

The staff comment in Appendix VIII that "it is not desirable for public policy to aim at reversing most of the forces that have contributed to a declining private savings rate over the past decade if it can raise national savings by reducing public dissaving," should perhaps have been phrased differently, the Director considered. In any event, it should be seen in the context of the general issue of that appendix, which was the comparative efficiency of various policy instruments for raising national savings. The rationale behind that sentence was that most of the forces behind the declining trend of the private saving rate that the staff had been referring to, such as demographic factors, the growth of private insurance, and increased ease of capital market borrowing, could perhaps be reversed only at a substantial cost in terms of efficiency. A more complex issue concerned the consequences of failure to reduce public dissaving, while not having efficient means of raising private savings;

the authorities would then face the dilemma of either living with insufficient private savings, or of doing something about it even at the aforementioned cost.

It was a mistake to view the scenarios as failing to postulate a high degree of linkage between fiscal and current account adjustment, the Director remarked. Tables 5, 9, and 11 of Appendix V in SM/88/162, Supplement 1 showed a significant linkage, although it was not dollar for dollar, and was, of course, affected by the size of the U.S. economy. In the latter connection, U.S. fiscal action could alter the real interest rates facing the United States and other economies, which would affect U.S. domestic private investment and domestic saving; in other words, the linkage was not influenced in a simple manner by, inter alia, an externally set price, but was affected by the size of the U.S. economy. At any rate, what needed to be emphasized was that all the scenarios included the common theme that improved performance of the U.S. economy depended on U.S. fiscal adjustment; more specifically, the existing high levels of employment and capacity utilization required that public dissavings be reduced to make resources available for net exports.

The scenario results obviously depended on the assumptions of the underlying models, and one therefore had to be careful in specifying the key premises, the Director continued. In that connection, he did not consider that the staff's model gave real effective exchange rate changes excessive influence over the balance of payments, and price changes too little influence. The coefficients that the staff had used were estimated from actual data and were thus consistent with historical experience. Moreover, the estimates of other observers were very similar to those of the staff. The magnitude of the effects of real exchange rate changes depended on the source of those changes, namely, whether they came from fiscal tightening, monetary easing, or portfolio shifts. The price changes were perhaps not so small if one looked at such changes in other countries as well as in the United States.

The assumption of rationality did not greatly affect the long-run properties of the simulations, but tended to bring forward the long-term results of the simulated policy shocks, the Director said. Moreover, as they were based on a multicountry model, the staff's simulations did incorporate interactions, with indirect effects via third countries or regions being taken into account. In that respect, the scenario results for the United States were fairly similar to those in earlier world economic outlook exercises.

Inflation did tend to constrain output in the staff's model because the monetary framework would rein in domestic demand, the Director commented; but the model did not include the micro effects of high inflation rates on production and, in that sense, it perhaps understated the negative consequences of inflation. Nevertheless, the staff report had not played down the risk of renewed inflation. Owing to the high capacity utilization and the relatively low unemployment rate, the inflationary risk was certainly more intense than a year ago. Indeed, the staff had emphasized that point during the recent consultation discussions.

The possible effects of the proposed increases in the minimum wage had not been discussed in great detail during the consultation, the Director noted. Since the previous adjustment of the minimum wage, it had declined in real terms by over 20 percent. Given the recent pace of inflation and the fact that the proposals under consideration suggested adjustments of roughly 10 percent a year over the next three years, the real minimum wage would still remain below its level at the time it was previously adjusted. Nevertheless, as the increases would apply to about 10-15 percent of the labor force, the adjustments would not be inconsequential under current conditions. They would not only hamper labor market flexibility and employment, but also have consequences for the rate of inflation.

The staff was opposed to monetary easing at a time when the dollar was appreciating, but he would not characterize its position as favoring exchange market intervention, the Director stated. In its report, the staff had said that intervention might be tried if it was thought that the recent appreciation was temporary, but the primary means of tackling that rise would have to be through fiscal deficit reductions and the resulting increase in resource availability. Some had argued that resource pressures and interest rate differentials had made the dollar appreciate, but it was doubtful whether the latter was changing in favor of the United States during the months in question. Also, in connection with exchange market policy, he did not believe that the authorities were contemplating borrowing in foreign currencies.

It would not be correct to characterize the staff as viewing a further depreciation of the dollar as undesirable, the Director said. What the staff had tried to emphasize was the need for the increases in saving that would raise the availability of resources for the correction of the external imbalance, if there was a relative price change, through, for instance, a depreciation.

It was obvious that the larger the stock of foreign dollar holdings grew relative to other variables, the more difficult it would become, ceteris paribus, to maintain a particular rate of increase in those holdings without changes in interest rates and/or exchange rates, the Director commented. It was very difficult to know what the limit to such holdings would be, but there were risks in the current situation.

The shift of dollar assets by official agencies between extraterritorial and domestic financial markets, as appeared to have happened during the first quarter of 1988, would not necessarily affect exchange rates or interest rates, but would be reflected in the balance of payments accounts as a shift between official and private dollar holdings, the Director pointed out. The impact of capital flows on the exchange and interest rates depended on the movements of funds between the dollar and other currencies. In any event, available information from foreign official agencies on changes in their dollar reserves indicated that exchange market intervention during the first quarter had been quite limited. And, indeed, somewhat of an opposite shift in official and private dollar asset holdings had occurred in 1987; foreign official financing, as recorded in the U.S. balance of payments accounts in 1987, had understated the change in foreign official holdings of dollars, as a substantial portion of the proceeds from intervention was invested in the Eurodollar market.

It was correct that there had been very little change in total developing country exports to the United States from 1981 to 1986, but a large increase had occurred in 1987, the Director observed. However, the overall figure had been affected considerably by the reduction in U.S. imports from oil exporting countries by approximately one half during that period, while imports from the non-oil developing countries increased substantially, by about 80 percent. Some of those exports were obviously from the newly industrializing economies, but there had been substantial increases from others as well.

Productivity growth had not been a contentious issue in the consultation discussions, the Director of the Western Hemisphere Department concluded. The staff considered it important, however, that the assumptions with respect to productivity, or of the potential growth of the economy, should be realistic in setting policies. In the final analysis, the key requirement for adjustment and greater investment remained increased savings.

Mr. Dallara said that the quality and volume of the staff papers were gratifying and necessary in view of the importance of the United States in the world economy. It might be helpful if, in the future, the staff issued the appendices of the papers over several months to help Directors absorb the material more easily, and, indeed, to allow his authorities to benefit at the time of the consultation discussion--such was the cogency of the staff's analysis.

He fully agreed with Directors who viewed policy coordination as a useful adjunct to domestic policy efforts, but certainly not as a substitute for those efforts, Mr. Dallara continued. Policy coordination was an important framework for "putting one's own house in order," or, in other words, for assuming responsibility for dealing with one's own problems, while being mindful of how domestic efforts fitted in with the actions of other authorities. In that connection, he recalled comments made by his authorities earlier in the decade when many Directors were dissatisfied with the view that international imbalances might be dealt with solely by authorities paying attention to domestic problems. Domestic adjustment efforts were obviously welcome, yet it remained true that other countries needed to be assured that such efforts did not result in damaging externalities.

The strength and direction of Directors' views on fiscal policy would be conveyed to his authorities, Mr. Dallara remarked. He had noted that the Gramm-Rudman-Hollings fiscal deficit targets were viewed as a minimum requirement, not as a ceiling, and that many Directors had agreed with the staff's front-loaded scenarios. In raising the question that the degree of adjustment effort implied by the front-loaded scenarios was perhaps greater for his authorities than for those in Europe and Japan, he had not meant to suggest that any country could approach the global adjustment problem in a negative-sum fashion.

His authorities continued to have a somewhat different view from the staff on the linkage between the fiscal and current accounts, Mr. Dallara observed. Whereas the Director of the Western Hemisphere Department had pointed to Table 5 of SM/88/162, Supplement 1, as indicating the linkage that existed, he might equally mention Table 6, in which the envisaged current account adjustment over the period 1988-93 was only 0.6 percent of GNP compared with a fiscal deficit reduction of 2.2 percent of GNP. A variety of factors were involved; for instance, the reaction of the monetary authorities to cuts in the fiscal deficit would obviously influence the extent of current account adjustment, and the quite puzzling problem of the low private sector savings rate was also relevant and still very much in need of further analysis. In the latter connection, his authorities clearly had different views from the staff; it would be unfortunate if successful fiscal adjustment over the next few years was offset by greater private sector dissaving. That risk underscored the importance of looking very carefully at the techniques that would be used to reduce the fiscal deficit.

As his authorities agreed with virtually all the staff's specific recommendations with respect to tax expenditures, the subject should be pursued more intensely during the next consultation discussions, Mr. Dallara suggested. Given the political realities in the United States during the current year, it was understandable that actions to deal with tax expenditures had not been proposed. Nevertheless, at the next consultation, the exclusion from personal income of employer contributions for medical insurance premiums and health care, the deductibility from personal income of state and local taxes other than such taxes on owner-occupied housing, and other items that were mentioned by the staff could be usefully examined.

He did not have much to add to the comments by the Director of the Western Hemisphere Department on shifts in the composition of capital flows financing the current account deficit, Mr. Dallara stated. Data clearly indicated that monetary authorities in other countries had initially placed much of their increased dollar holdings resulting from official intervention during the course of 1987 in liquid bank holdings. It was also apparent that some of those holdings had been shifted into U.S. securities during the first quarter of 1988, when the interest rate differential in favor of dollar deposits was declining. In any event, preliminary data for the second quarter of 1988 showed a return to a more positive balance on private savings inflows into U.S. banks. It was important to note the Director's point that some of those shifts might not affect the exchange rate, but obviously influenced the balance of payments quite dramatically in relatively brief periods of time. Moreover, in connection with financing the current account, the United States had used its SDR holdings as a means of acquiring foreign exchange during the recent past, but had no intention of borrowing foreign currencies or of selling gold.

He understood Directors' concern that the United States was using an excessive amount of world capital, Mr. Dallara remarked. Nevertheless, he believed that, in addition to considering the interest rate differentials and other factors that were driving capital flows, one should not minimize the effect of the openness, depth, and liquidity of U.S. capital markets in that process. Moreover, the United States' substantial imports from the rest of the world did make its use of global savings less of a negative influence than it would otherwise be. The figures for U.S. imports from non-oil developing countries, in contrast with the data including imports from oil exporting developing countries, gave quite an impressive indication of the amount of U.S. imports from the developing world.

The Administration certainly had neither any sense of complacency about the risks of renewed inflation, nor any difference of view with the monetary authorities, Mr. Dallara emphasized. Perhaps the introductory section of his opening statement had created a somewhat misleading impression, as it had covered developments on the inflation rate front for the first six months of 1988 with reference to price indices alone, whereas the subsequent discussion of inflation also focused on some of the other empirical indicators, such as capacity utilization rates, which, while not necessarily having been fully reflected in price indices, were a cause for some concern to his authorities. In any event, he had never spoken or written on monetary policy without carefully reviewing the material with his monetary authorities, who were entirely comfortable with the comments made in his opening statement.

It was understandable that Mr. Grosche viewed the recent interest rate actions by the U.S. authorities as unfortunate, although one should note that exchange rate pressure in 1988 had not been entirely balanced, Mr. Dallara added. The upward pressure on the dollar against the deutsche mark had been much greater than against the yen, with the dollar appreciating by about 14-15 percent against the deutsche mark and other European currencies during the first half of the year, while rising only 5 1/2 percent against the yen over the same period. Therefore, there were other factors, relating to those economies, that were affecting the exchange rate, in addition to the variables directly affecting the dollar itself.

With respect to the proposed minimum wage legislation, Data Resources International had studied several of the bills under consideration in the House and Senate, and had concluded that some of them could add as much as a full percentage point to the inflation rate by the early 1990s, Mr. Dallara said.

The question of productivity trends had been a source of debate with the staff for some years, and he judged that further intense dialogue on that issue at the next consultation discussions would remain very useful, Mr. Dallara observed. A variety of factors might be pointing to increased productivity growth: the aging of the so-called "baby boom" generation implied a more experienced and more educated work force; while the increasing ratio of the stock of physical capital to labor was another consideration. Not much would be gained by debating those points at the current juncture, for the staff's position was indeed cogent and persuasive in many respects.

It was gratifying to note that although several concerns were expressed with respect to trade policy, none were voiced about the United States-Canada Free Trade Agreement, which his authorities continued to regard as a very important step forward for the United States, Canada, and the rest of the world, Mr. Dallara remarked. Perhaps that omission suggested that the Canadian and U.S. authorities had successfully persuaded Directors that the legislation was in the global interest, or it might simply imply that the staff's attention was captured by the most recent trade legislation just signed into law by President Reagan. It was important to recognize that many of the draft legislation's more objectionable provisions had been removed; the proposed inclusion of the Gephardt Amendment and the Bryant Amendment--which did not receive as much press attention, but which would have required disclosure of investments or acquisitions by foreign investors--was successfully resisted by his authorities. Indeed, as some Directors had noted, there were several positive provisions in the legislation enabling the authorities to pursue various trade negotiations and to harmonize the tariff nomenclature system. The latter was a very modest technical consideration but, nevertheless, something that was very important in the long run for promoting trade. Directors' concern that the legislation might be implemented in a protectionist manner was understandable, but it should be clearly understood that the legislation did not require the authorities to pursue protectionist policies, as it contained many provisions with adequate flexibility for allowing the authorities to handle individual trade problems. Indeed, his authorities had certainly no intention of implementing the legislation in a restrictive fashion. Yet, it should be borne in mind that, in the cases in which there clearly were unfair trade practices, the authorities' potential scope for action was not insignificant. Many lawyers would be studying the legislation's consistency with the General Agreement on Tariffs and Trade (GATT), on which a few questions might arise. His authorities largely felt that the questions that existed for earlier drafts of the legislation had been dealt with adequately, but that, ultimately, some of those issues might not be fully resolved until they had been pursued, if necessary, in the GATT framework.

He would convey the concerns that Directors had roundly expressed about the decline in the level of U.S. official development assistance, Mr. Dallara indicated. He assured Directors that, as continued fiscal deficit reduction was pursued, a strong case would be made for foreign assistance from virtually all quarters of the Administration. The authorities intended to continue making it a matter of priority, while recognizing that at a time of broadly based budget cuts, all expenditure areas would eventually come under strain.

The Chairman said that whether or not the recent trade legislation was implemented in a protectionist manner would depend greatly on the Administration. He believed that the authorities did intend to pre-empt the buildup of protectionist pressure. He had paused over Mr. Dallara's comment, repeated a few times in his opening statement, that growth was occurring without significant inflationary pressure. Irrespective of the drought, the U.S. inflation rate was much higher than the average rate in the G-7 countries and, furthermore, capacity utilization was at a high level. He agreed with the authorities' response to the problem, but had hoped that it would have been possible to agree with them on the analysis of its underlying nature. He would be somewhat more pessimistic about the prospects for renewed inflation in the summing up than Mr. Dallara might consider warranted. There were no reasons to panic, but, as the authorities indeed understood, there certainly were reasons to act before inflation began to spiral.

The Chairman made the following summing up:

> Executive Directors agreed with the general thrust of the staff appraisal in the report for the 1988 Article IV consultation with the United States.
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> Directors commended the authorities for the continued growth performance of the U.S. economy. They expressed satisfaction at the shift in the composition of demand during the past year with investment showing particular strength and net exports recovering markedly. Directors emphasized, however, that the risk of a pickup in inflation had increased given, inter alia, the high level of resource utilization that the economy had reached. Directors, therefore, were of the view that policy action to raise national savings from the low levels registered in recent years was needed to ensure that net exports improved further and capital formation continued strong without an upturn in inflation.
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> In this respect, Directors emphasized the role of decisive fiscal action. While commending the U.S. authorities for the progress made in cutting the fiscal deficit in fiscal year 1987, they expressed concern that a further substantial reduction in the imbalance was not likely to be forthcoming soon. Directors stressed the importance of further urgent action on the fiscal front, and a number of Directors urged that upon taking office early next year, the next Administration use the window of opportunity, then open to it, to act quickly and forcefully. In

the view of many Directors, there was a strong case for front-loaded fiscal adjustment. Several emphasized that the revised Gramm-Rudman-Hollings fiscal targets should be regarded as a minimum requirement.

Directors agreed with the Administration's view that, in addressing the fiscal problem, emphasis should be placed on expenditure restraint. A number of Directors noted, however, that, given the size of the task at hand and the need to move quickly, measures to raise revenue also should be considered. They emphasized that it should be possible to raise revenue without significant adverse effects on economic efficiency, for example, by eliminating certain tax preferences.

Directors praised the Federal Reserve's pragmatic implementation of monetary policy, including its prompt and forceful reaction to the October stock market crisis. They also expressed strong support for the Federal Reserve's emphasis on controlling inflation since in their view sustained growth depended on a satisfactory performance of costs and prices. Directors noted that, given the unfortunate consequences of any revival of rapid inflation and the risks of this occurring under present circumstances, the Federal Reserve at this juncture would be well advised to err on the side of restraint. At the same time, many Directors expressed their concern about the recent trend in interest rates in the United States and elsewhere. They stressed that strong fiscal action would facilitate the task of monetary policy and would help reduce upward pressures on interest rates, which posed a serious threat to highly indebted developing countries. In general, Directors felt that it was unwise, for the United States and other countries, to put too large a burden on monetary policy.

Directors cautioned that notwithstanding the recent improvement, external imbalances remained large and constituted a major element of vulnerability to the U.S. and world economies. It was observed that policies in the industrial countries needed to aim at achieving relative growth rates of domestic demand and output that were conducive to the correction of imbalances in the context of relative price stability. Directors emphasized that the best contribution the United States could make in this respect would be to secure substantial further progress in reducing the federal fiscal deficit, thereby making room for external adjustment without inflation or the crowding out of investment. Directors also emphasized their full support for policy coordination, while agreeing with the U.S. authorities that it was not a substitute for domestic and external adjustment efforts.

On exchange rates, it was observed, on the one hand, that further appreciation of the U.S. dollar along the path that began in late May might seriously complicate adjustment efforts. On the other hand, a sharp depreciation of the dollar in the present situation of high resource use in the United States could be counterproductive. Looking beyond the short run, several Directors drew attention to projections on the basis of present exchange rates which suggest that very little progress would be made in reducing the U.S. current account deficit over the medium term. Given the rapid buildup of net U.S. external debt that was implied, they questioned whether a current account deficit of the size envisaged could continue to be financed at prevailing interest rates and exchange rates. In that context, many Directors maintained that there was a strong linkage between fiscal and external current account deficits and that this reinforced the case for early and major fiscal action.

In the area of trade policy, Directors were pleased to note that the authorities had successfully prevented inclusion of overtly protectionist measures in the new trade act and they agreed with the U.S. authorities' view that protectionism was not a viable means of correcting the U.S. external imbalance--this indeed can be extended to any external imbalance in the world. At the same time, they expressed concern that protectionist pressures remained strong in the United States and they strongly urged that the provisions of the trade act not be applied in a protectionist manner. Directors urged the U.S. authorities to resist protectionist pressures and to play a leadership role in international efforts toward trade liberalization. Directors noted that a freer trading environment was essential in dealing with the external imbalances among major countries and in resolving the debt problems of developing countries. In this regard, they stressed the importance of the current round of multilateral trade negotiations.

Several Directors also urged the United States to reduce protection in the steel and textile sectors. A number of Directors emphasized the need for fundamental reform in international trade in agricultural products through the elimination of the distorting domestic farm policies followed by many countries. While multilateral discussions provided a promising avenue for such reform, they believed that major countries should take the lead in reducing distortions.

Directors noted that there were several features of the current tax system that distorted private saving and portfolio decisions. Given the large saving/investment imbalance in the United States, they felt that close attention should be given to these features. They noted that, while there was some uncertainty about the effect of the removal of these distortions on the overall level of private savings, their elimination should lead to a more efficient allocation, with favorable effects on the saving/investment balance.

Noting the role played by the United States in international efforts to deal with the debt problems of developing countries, many Directors emphasized the importance of maintaining and expanding the access of developing countries to the markets of the United States and other industrial countries. With regard to development assistance, while recognizing the seriousness of the U.S. fiscal problem, Directors urged the U.S. authorities to make every effort to assure an adequate level of aid flows to the developing countries directly as well as through multilateral organizations.

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

The Chairman, continuing his remarks, added that he was sure that Mr. Dallara would convey to his authorities the Directors' desire to see the enhanced structural adjustment facility reinforced, although he did not want to give the impression that the institution was self-serving in that respect.

APPROVED: February 27, 1989

LEO VAN HOUTVEN
Secretary