NOT FOR PUBLIC USE

MASTER FILES

ROOM C-130 04

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/132

3:00 p.m., August 6, 1986

J. de Larosière, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
A. Alfidja	
C. H. Dallara	M. K. Bush
J. de Groote	
M. Finaish	T. Alhaimus
H. Fujino	M. Sugita
G. Grosche	
Huang F.	
	Jaafar A.
	H. A. Arias
	M. Foot
H. Lundstrom	
	L. Leonard
E. I. M. Mtei	
F. L. Nebbia	
Y. A. Nimatallah	
P. Pérez	G. Ortiz
H. Ploix	S. de Forges
J. J. Polak	
C. R. Rye	A. V. Romuáldez
	R. Msadek, Temporary
A. K. Sengupta	
S. Zecchini	N. Kyriazidis

L. Van Houtven, Secretary
V. Wall, Assistant

Also Present

African Department: A. D. Ouattara, Director. Asian Department: L. Mendras, B. J. Smith. European Department: L. A. Whittome, Counsellor and Director; J. J. Hauvonen, H. B. Junz. Exchange and Trade Relations Department: C. D. Finch, Counsellor and Director; G. Belanger, J. T. Boorman, T. M. T. Paljarvi. External Relations Department: R. Varma. Fiscal Affairs Department: V. Tanzi, Director; A. H. Mansur. Legal Department: J. K. Oh. Research Department: W. C. Hood, Economic Counsellor and Director; A. D. Crockett, Deputy Director; R. R. Rhomberg, Deputy Director; J. M. Boughton, M. C. Deppler. Treasurer's Department: C. Mulder. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; K. B. Bercuson, L. E. DeMilner, S. V. Dunaway, O. J. Evans, E. Hernández-Catá, Y. Horiguchi, L. R. Kenward, M. Mered, H. J. G. Trines. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: L. P. Ebrill, J. Hospedales, H.-S. Lee, P. Péterfalvy, I. Puro, D. C. Templeman, N. Toé, R. Valladares, A. Vasudevan, M. A. Weitz. Assistants to Executive Directors: A. Bertuch-Samuels, W. N. Engert, G. Ercel, G. K. Hodges, Z. b. Ismail, J. M. Jones, M. Lundsager, L. de Montpellier, T. Morita, M. Rasyid, L. Tornetta, H. van der Burg, E. L. Walker, B. D. White.

1. UNITED STATES - 1986 ARTICLE IV CONSULTATION

The Executive Directors continued from the previous meeting (EBM/86/131, 8/6/86) their consideration of the staff report for the 1986 Article IV consultation with the United States (SM/86/167, 7/7/86; and Sup. 1, 8/1/86). They also had before them a report on recent economic developments in the United States (SM/86/180, 7/23/86; Sup. 1, 7/24/86; and Cor. 1, 8/4/86).

Mr. Dallara reported that since the previous meeting (EBM/86/131, 8/6/86) the vote had been taken in Congress on the Jenkins Bill--the protectionist textile legislation--and there had not been enough votes to override the veto. Although there had been significant support to override the veto--266 yeas and 149 nays--the effort had fallen 12 votes short--of the required two-thirds majority. While the demise of the Jenkins Bill did not signal the end of protectionist pressures generally on Congress, that particular bill would not reappear in the near future.

Mr. de Groote remarked that the vote in Congress, to which Mr. Dallara had referred, confirmed the President's stance on protectionism, which was good news for the world at large.

The strong economic recovery in the United States had been fueled by the tax cuts of 1981-83, favorable external conditions, and the adjustment in the value of the dollar, Mr. de Groote continued. However, the economy still faced the problems of fiscal and external imbalances. While there had been notable advances in economic growth, employment, and inflation, it was nonetheless likely that the budget and current account deficits would remain somewhat above acceptable levels for several years to come. He was pleased to note that there was broad agreement between the authorities and the staff on the preferred strategy for dealing with those two problems. The Administration's demonstrated intention of reducing the federal deficit over the medium term, despite uncertainties over the eventual implementation of the Gramm-Rudman-Hollings Act, was most welcome. The authorities had the full support of the Fund in their resolve to achieve a substantial reduction of the deficit by 1991. The main question that remained was how to make progress toward that goal.

The divergences of views aired in the Board's discussion of the previous Article IV consultation with the United States still existed, Mr. de Groote went on. The authorities and the staff were working with different assumptions concerning the strength of the economy and the federal fiscal position in future. Appendix VI of the supplement to the staff paper on recent economic developments indicated that the growth of capital stock required to support the output projected by the Administration would be strong by historical standards, even exceeding the unusually high rates of capital formation achieved in the 1960s. He shared the staff's skepticism concerning the growth rate assumptions on which the

Administration had based its projections, and he would welcome Mr. Dallara's comment on them because they had crucial implications for the United States and for the world economy.

Another difference of view between the staff and the authorities was the choice between spending cuts and tax increases, Mr. de Groote remarked. Since an increase in taxation had been firmly rejected by the Administration, reduction of the federal deficit would have to rely entirely on restraint in federal spending. That option should not obscure the fact that revenue increases could easily be realized by eliminating certain tax preferences. Total tax expenditures had been estimated at $84 billion in the FY 1986 budget. The Administration should consider the elimination of tax preferences as one tool for addressing the budget deficit. Another way of arriving at the same result would be to allow the consumer to benefit from only a part of the oil price decline. Was it really that difficult from an administrative or legal standpoint to tax oil imports, and would not the effects of such a measure on the deficit have been more conducive to growth than an immediate transfer of the price reductions to the consumer?

Closely related to the fiscal problems, and perhaps even more ominous, were the U.S. savings/investment position and the federal debt, Mr. de Groote commented. Despite the fact that the ratio of gross private savings and gross private investment to GNP had remained unchanged since the 1950s, total demand for savings had risen by about 3.5 percentage points between 1980 and 1985, mostly because of the federal deficit, and that increase had led to further dependence on foreign savings. Staff projections indicated that dependency on foreign savings would likely continue until 1991 in order to finance the required growth in capital stock. That imbalance should be taken seriously, since the willingness of foreign investors to increase their exposure in dollars was critical to that scenario. He agreed with the safe haven arguments, but the lower interest rates and concerns about the health of the U.S. economy might cause foreign holders of dollar-denominated assets to lose confidence. Any lessening of foreign investors' willingness to increase their holdings of U.S. debt would put sharp pressure on U.S. interest rates, threaten inflation, and have an adverse effect on demand. To guard against that scenario, the imbalance between the supply of, and demand for, funds inherent in fiscal policy must be addressed ingeniously. It was difficult to devise means for stimulating savings that did not first exert a deflationary effect on demand.

The U.S. economy was heading toward a period of stagnating domestic demand, Mr. de Groote considered, yet the response to that situation had not been clearly spelled out. In fact, there was a contradiction between the aim of sustaining expansion of output, together with the medium-term objective of achieving a better relationship between savings and investment, on the one hand, and reducing the external and fiscal deficits, on the other. For example, some policies that had been set into operation, such as the Gramm-Rudman-Hollings Act, had been explicitly predicated on assumptions that apparently would not materialize. However, he understood that the selection of many policies had been motivated by public relations and political expediency--an effect that Mr. Polak appropriately called the "vested interest in optimistic forecast." That practice would not be wise in the medium to long term, since the postponement of the additional adjustment required at present would make the adoption of the appropriate measures more difficult at a later stage, especially since some of them would have to be adopted after the unavoidable recession had begun. For example, although in the long term a reversal in the business cycle would restore the balance between the supply of and demand for funds--and hence improve the current account--such a reversal might be hard to reconcile with the additional reductions in public expenditure required by the new fiscal legislation, especially since those additional spending cuts would fall mainly on social benefits.

As he had stressed several times during the discussions of the world economic outlook and the U.S. economy, adjustment would become increasingly difficult because it had been unduly delayed, Mr. de Groote continued. However, adjustment had to come in the United States--just as it had to come in other countries--and it would take place under difficult conditions because it would coincide with a less favorable outcome than expected in the rate of output. Under such conditions, the U.S. economy would be faced with abandoning the recently adopted fiscal norms--a solution that would cripple the struggle against inflation--or further implementing fiscal measures in the midst of a recession, which would only fuel the downswing. Because that scenario was perceived by many as being politically unfeasible--the public's fear of inflation had not yet subsided--interest rates had remained higher than they would otherwise have been.

Adjustment on the U.S. economy would be greatly eased if there were a multilateral coordination of policies among industrial countries, Mr. de Groote went on. On that point, Mr. Dallara had expressed the view that the needed adjustment of policies in the United States had been hampered by external constraints. Indeed, it was difficult to challenge the opinion that there was a strong need for effective multilateral economic cooperation. However, the main burden of adjustment lay with the United States, given the fundamental imbalance in the country between the demand for and the supply of funds.

The staff's 1986 and 1987 projections for the current account deficit were more pessimistic than the previous spring's world economic outlook paper, Mr. de Groote said. The latest OECD economic outlook had also estimated higher figures than the Administration's for the current account deficit over the previous two years. The OECD Secretariat had presented a pessimistic overview of the effect of the dollar's decline on the U.S. current account balance, the main point being that there was often a large asymmetry between conditions effecting the buildup and the decline of external imbalances. Though the depreciation of the U.S. dollar was a welcome step toward elimination of the external imbalance, it appeared that the staff was somewhat dubious about the J-curve effect of the lower dollar. A comment on that effect on the U.S. economy would be helpful.

As for the relationship between the depreciation of the dollar and inflation, Mr. de Groote remarked, the Federal Reserve Board had suggested in June 1986 that although U.S. exporters passed most of the currency rate effects through to the foreign currency prices of their products, their foreign competitors absorbed a large part of the exchange rate changes in their profit margins. For that reason, the fairly large swings of the dollar exchange rate had so far had only limited effect on U.S. inflation, a fact that had been confirmed by Mr. Dallara. Therefore, it was noteworthy that recent data appeared to point toward an adjustment of prices more in line with the exchange rate movement. Given the time that had elapsed since the Plaza agreement, he doubted that the expected price effects would materialize to the required extent, partly because a large proportion of the contracts for foreign inputs to the U.S. economy, as well as contracts on goods competing with U.S. exports, were denominated in dollars.

He recognized the difficulties of conducting monetary policy on the basis of preset criteria, Mr. de Groote commented. During a period of economic and institutional transition, M1 was not a reliable measure for the guidance of monetary policy. For that reason, other indicators should be carefully assessed. Information on recent developments in setting economic indicators for the U.S. economy would be helpful.

He commended the Administration for its resistance to the increasing demand for protectionism in general, Mr. de Groote said in closing, although it was worrisome that Congress had also not taken that stance. He hoped that two enactments in May 1986, which had imposed new restrictions on imports of machine tools and certain lumber products, were not indicative of a change in U.S. trade policy.

Mr. Fujino recalled that since the previous Article IV consultation with the United States, there had been considerable progress in reducing the two major uncertainties in the economy. The enactment of the Gramm-Rudman-Hollings Act and the substantial fall in the exchange rate of the dollar had significantly improved the prospects for a reduction in the fiscal and external deficits. Coupled with the recent fall in oil prices, those achievements should provide a more reliable base for sustainable economic growth not only for the United States but also for the entire world. The improved outlook for fiscal retrenchment had already brought about a significant fall in long-term interest rates. Interest rate-sensitive spending items, including business-fixed investment, was expected eventually to respond to the decline in interest rates. The statement by the Chairman of the Council of Economic Advisors on that outlook had just been released, and he shared the view of the council, as well as that of the staff, that the oil price decline, the lower rate of inflation, the reduced interest rates, and the stronger competitive position would encourage economic activity in the period ahead. In that respect, recovery of capital investment would be the key. Also, the high rate of fixed investment that would be necessary for achieving strong economic growth, as well as increasing competitiveness, could not be attained unless confidence in business was maintained by the scheduled steady reductions in fiscal deficits.

The substantial decline in the U.S. dollar on exchange markets was having a favorable effect upon the export prospects and the external balance, which would contribute to GNP growth in the United States, Mr. Fujino considered. At the same time, a too rapid and excessive move in the exchange rate of the U.S. dollar vis-à-vis other major currencies would, as Mr. Dallara had pointed out, create uncertainties in the market about the exchange outlook, and it would exert a dampening effect on business sentiments in those countries experiencing a sharp appreciation of their own currencies. In view of the importance of market perception in determining the exchange rate, increased uncertainty would need to be avoided.

It was well known that an exchange rate adjustment took some time before it was reflected in the current account balance, Mr. Fujino said. Therefore, it would be regrettable if protectionist sentiment was fueled by the seemingly slow progress reflected in the monthly figures of trade statistics. What was important was the favorable climate for, and the clear trend toward, a better external balance. Increased public awareness of the nature and process of adjustment would help to dissipate the dissatisfaction with the inevitable time lag of the response to exchange rate changes. A prompt supply response would speed up the adjustment process, and in that light he hoped that American industries, renowned for their forward-looking entrepreneurship would respond positively and refrain from appealing for further protection.

Implementation of the Gramm-Rudman-Hollings Act would be made difficult by uncertainties related particularly to estimates of current services and future growth as well as to an automatic process of sequestration, Mr. Fujino continued. It was strongly hoped that, such uncertainties and difficulties notwithstanding, the authorities would implement the deficit reduction program as scheduled, since sustainable economic growth and a viable balance of payments position over the medium term hinged upon it. He welcomed the resolution in both Houses to contain the budget deficit in 1987 to $142.6 billion. In the short run, fiscal correction could have a more supportive than dampening effect on economic activity since by removing a major uncertainty in the world economy, the interest rate had been reduced and business confidence had been boosted. As a means of reducing the fiscal deficit, the Administration had concentrated its efforts on cutting expenditures and had tried to avoid revenue measures as much as possible, and he supported that position. At the same time, however, he noted the staff's concern that given the size of the required adjustment, a reduction in the deficit as envisaged by the Gramm-Rudman-Hollings Act might not be achievable without revenue increases. Therefore, it might be worthwhile to retain the policy option of a tax increase if planned deficit reduction proved difficult to achieve. The tax reform effort aimed at simplicity, fairness, and efficiency, was welcome. However, tax reform must not run counter to a reduction of the fiscal deficit and promotion of capital investment. In that regard, he was concerned about the statement by a member of Congress that tax reform proposals might involve an increase in the cost of capital.

There was a need to lower the underlying rate of inflation even further, Mr. Fujino went on. Once the oil price bottomed out, the inflationary outlook was likely to worsen significantly, because an unfavorable effect of currency devaluation would begin to dominate. However, mechanical reliance on monetary aggregates was not the best way to conduct monetary policy, a view that had been reinforced by the recent behavior of those aggregates. He sympathized with the Federal Reserve Board's emphasis on the need for a judgmental approach. Under the present circumstances, the exchange value of the U.S. dollar must be maintained in the conduct of monetary policy.

Continuous efforts would be required to reduce the current account deficit, Mr. Fujino maintained. It would be important to attract sufficient resources to the export sector and to strengthen the competitiveness of American industries. Consistent and coherent exchange rate and trade policies would be instrumental in fostering such a shift in resources through creating a favorable environment for fixed investment and long-term planning for the private sector. Since the previous autumn, the dollar had declined significantly vis-à-vis the deutsche mark, the Japanese yen, and other major currencies. The slower than expected response of U.S. exports to that development was disappointing. In addition, a further decline of the dollar would not only entail domestic inflation, it could also trigger excessive uncertainty and a downward spiral of the dollar on the market, which would be harmful to worldwide investment and economic growth. Therefore, a cautious exchange rate policy was essential. Contrary to the view held by the authorities, there had been several occasions when sterilized interventions had effectively turned around the expectations of the exchange markets. Various stimulative measures that had been incorporated into the FY 1986 budget in other economies, especially in Japan, together with the declines in interest rates and oil rates, should steadily increase domestic demand in those countries. However, the direct effects of the growth rates of domestic demand in other countries on the U.S. current account would be limited, as the analysis in the various scenarios in Appendix IX of the supplement to the recent economic developments paper indicated.

Increasingly strong protectionist pressures in the United States were a source of serious concern, Mr. Fujino said in closing. He appreciated the positive news in that regard made by Mr. Dallara that morning. Through the sharp decline in the exchange rate, foundations had been laid for improved competitiveness for American industries. It was strongly hoped that the authorities, while promoting industrial adjustment, resisted protectionist pressures and contributed to the expansion of global trade.

Mrs. Ploix remarked that there had been a thorough dialogue between the Administration and the staff and that there had been agreement in many areas, especially on the long-term benefits of the planned fiscal correction. Since the previous Article IV consultation with the United States, the authorities had started to tackle their major imbalances. During the year, the United States had committed itself to removing an eventual crisis scenario while strengthening the belief in international coordination, the positive outcome of which need not be argued and which she strongly advocated. Several steps that the authorities had taken were praiseworthy: a coordinated and concerted realignment of major currencies, a decrease in interest rates, and the implementation of voluntary policy to reduce the fiscal deficit. She noted, however, five areas of concern: the possibility of not achieving the expected rate of growth, the risk of not achieving the necessary cuts in expenditure, the problems inherent in the trade deficit, the consequences of tax reform, and, finally, the absence of room for maneuvering in monetary policy.

The staff report and Appendix VI of the supplement to the recent economic developments paper demonstrated a difference in point of view with the authorities in the projected rate of growth, Mrs. Ploix said. She, too, would like to know the underlying assumptions in the Administration's estimates, especially since the staff's estimates conformed more with historical experience in productivity and expansion of the capital stock. As it had been put in Appendix VI "the growth of net capital stock that would be required to sustain the growth of real GNP projected by the Administration would average about 4 1/2 percent a year during the period 1986-91....This growth would even exceed the unusually high rates of capital formation observed in the 1960s." If the Administration's projections were not realized, the current services part of the deficit would be considerably higher than envisaged, and the need for further expenditure cuts would be extreme, which was all the more worrisome because it was questionable whether even the presently planned reduction would be realized. She wondered what contingency actions the authorities would implement if the expected growth rate did not materialize.

She was pleased to see that the first stage of the Gramm-Rudman-Hollings Act was being implemented, Mrs. Ploix continued. Although the Supreme Court had invalidated the $11.7 billion in automatic spending cuts for FY 1986, Congress had passed a resolution ratifying them. However, doubts were cast on the chances of achieving the program fully when one considered the U.S. budget procedures, the share of defense in the total deficit reduction, and constraints such as the safety net programs. She agreed with the staff that it was difficult not to envisage any action on the revenue side, because what else would the authorities do if an additional cut in primary expenditure of about $60 billion were required by FY 1991? She had been impressed by the $23.8 billion outlay for farm income stabilization in 1985. Nevertheless, without the expected growth and without the forecast spending cuts, the increase in interest expenditures would have consequences that were frightening. She wondered where the financing would come from.

All countries were concerned about the trade deficit, Mrs. Ploix went on. Whereas she understood the U.S. exhortation for faster growth in the countries of their major trade partners, world economic outlook simulations were that 1 percent stimulus in Europe or Japan had an impact of 0.1 percent on the U.S. GNP. The United States first had to rely on its own efforts to correct its trade imbalance. Also, since 1983, total domestic demand had increased faster than the GNP. As previous speakers had mentioned, restraining domestic demand would have a greater impact on the trade deficit than a further increase in foreign demand. Again, expenditure cuts were the only way to achieve that goal. Yet another element of the trade deficit was productivity. Since 1950, hourly productivity had increased less rapidly in the United States than in other industrial countries. That development had not accrued because of wages, the increase in which had been well controlled, but because of a high differential in investment rate per worker in the United States as compared with the major industrial countries. She was referring to an investment rate not only in equipment but also in training. Would not tax reform hinder badly needed improvement in that area?

There were uncertainties in the consequences the authorities expected from tax reform, Mrs. Ploix commented. There were some positive points, such as taxing more people and companies and eliminating unjustified shelters. However, whereas Mr. Dallara had said that tax reform would preserve incentives for capital formation, she thought it would increase the cost of capital, thereby reducing competitiveness and endangering growth prospects and improvements in the trade deficit. She would appreciate the staff's comments on the impact tax reform would also have on domestic demand.

Monetary policy was offered no room for maneuvering, Mrs. Ploix noted; it had to strike a balance between two possible evils--being inflationary or being overly restrictive. The priority should be to support growth without inflation while avoiding a loss of confidence in the dollar which would lead to a sharp increase in interest rates. Even if real interest rates were still too high, the authorities could not lower them unilaterally for the time being. They could act only in coordination with major industrial countries.

She regretted the projected decrease in official development assistance for FY 1986, Mrs. Ploix said in closing, especially since there was also an insufficient commitment to the replenishment of IDA aid, which was compounded by the fact that net private flows had decreased substantially from $17.39 billion in 1984 to minus $9.03 billion in 1985.

Mr. Sengupta noted that economic growth and stability in the United States had wide international repercussions. Therefore, adjustment policies that the authorities pursued needed to be judged as much, if not more, from the point of view of their contribution to international economic growth as they did from the attainment of domestic economic goals.

The period from the second quarter of 1984 through the first quarter of 1986 had been characterized by a slowdown in real growth, employment, and inflation, Mr. Sengupta continued. That period had been the weaker part of the expansionary phase of the cycle that had begun with the fourth quarter of 1982. However, as a whole, it had been as good as any typical postwar expansionary phase of the cycle, having been induced by high growth rates in business-fixed investment and in residential construction. Nevertheless, that expansionary phase had coincided with disconcertingly high fiscal and external current account deficits, which had been financed mainly by large capital inflows. The large trade deficits had contributed to protectionist pressures. Because a major part of the phase had been by high interest rates and the highly appreciated exchange rate of the the dollar, the problems of adjustment for the rest of the world, in particular for the major industrial countries, had been accentuated, necessitating coordination of policy actions that addressed the debt problems of developing countries. The advent of policy coordination was a major advance in the current phase, Mr. Sengupta went on. Concerted actions by major industrial countries had reduced the exchange rate of the dollar in the final quarter of 1985 and the interest rates in early 1986. Of course, a more comprehensively articulated and coordinated policy for improving international adjustment and raising world prosperity had yet to emerge.

The developments in the first half of 1986 had not been satisfactory, Mr. Sengupta noted. Business-fixed investments, which had risen robustly in the fourth quarter of 1985, had declined in the first half of 1986. On the whole, domestic demand had expanded at a decelerated rate and inventory accumulation had occurred. Also, there was always the large trade deficit. However, the staff as well as the authorities agreed that there would be a pickup in the remainder of 1986, perhaps to an annual rate of about 4 percent, in light of the recent decline in oil prices, the fall in interest rates, and the depreciation of the dollar. While that growth might occur, the analytical and empirical basis for the projection of such a scenario for the short term had not been adequate enough to make one confident that the rebound was likely to be durable.

There was a difference in view between the staff and the authorities regarding the medium-term prospects of growth, Mr. Sengupta remarked. Even after revisions in some of the estimates, the Administration's projection of the annual growth rate was in the neighorhood of 4 percent during 1987-91. That figure was higher than the staff projection of about 3 percent and the annual average rate achieved in the 1970s or during the first half of the 1980s. The growth in capital stock that would be required to sustain the growth rate of the Administration's projections would be very high by historical standards. It appeared that the staff's estimates were more plausible.

If that projection were realized, the fiscal position in the medium term would turn out to be more difficult than was envisaged at present, Mr. Sengupta continued. The staff's estimate of the deficit in 1991 would exceed that of the Administration by almost $100 billion, reflecting different assumptions of $74 billion about economic growth and $18 billion about interest rates. That scenario implied that fiscal action would have to be stronger if the deficit was to be zero, as the Gramm-Rudman-Hollings Act envisaged by 1991. Even if the fiscal deficit turned out to be $100 billion in 1991, it would be 1.8 percent of GNP, which was much lower than the 5.4 percent of GNP in FY 1986. It had been reported that day that, in fact, the fiscal deficit would increase by about $27 billion in FY 1986. However, the Administration was committed to the Gramm-Rudman-Hollings Act target of balancing the budget by cutting spending rather than by increasing revenue over the medium term. The staff's suggestion that revenue increases should also be a part of the deficit reduction plan appeared to be most appropriate under the circumstances. The tax proposals currently being considered were all broadly revenue neutral and did not help to reduce deficits. The principle that raising revenues through taxation would hurt incentives to work and to invest was not as thoroughly tested empirically as it was generally believed. The question was not just one of expenditure cuts or revenue raising measures but was one of choosing a combination of both without harming work incentives.

He would question whether it was desirable for an economy like the United States to perfectly balance its budget at any time, Mr. Sengupta remarked. A balanced budget could well mean an absence of stimulus in the domestic economy, a vital element for growth in the United States as well for the world economy. The point had not received adequate attention in the staff report. It was possible that the current efforts to provide monetary stimulus by reductions in interest rates was a mechanism that compensated for the envisaged cuts in expenditures.

If Gramm-Rudman-Hollings targets were not adhered to and fiscal deficits turned out as projected by the staff in 1991--at $100 billion, or about 1.8 percent of GNP--there would be current account deficits of a corresponding amount unless private savings rose sharply to offset the extent of the fiscal deficit, Mr. Sengupta added. The staff did not expect gross private savings to rise very sharply. On the contrary, it expected gross private investment to increase by little more than 2 percentage points. As such, the current account deficit could well turn out to be much higher than in 1986.

The expectation that the fiscal deficit would be reduced, however, had had an impact on the exchange rates, which since March 1985 had declined in real effective terms by about 28 percent, Mr. Sengupta commented. The current account deficit or, more correctly, the trade deficit had not shown a commensurate change. Mr. Dallara believed that the effect of the depreciation would work with a lag. In Appendix IX of the supplement to the recent economic developments paper, the staff had presented a variety of scenarios that brought out the sensitivity of the current account balance to changes in assumptions of the real exchange value of the dollar and the rates of growth in the economies of the United States and its trading partners. Scenario D was particularly interesting. It assumed the real value of the dollar to fall by 15 percent in 1987 and demonstrated that the current account imbalance would be zero by 1991. The possibility of such a sharp drop was hard to believe, especially if the depreciation was against a broad range of currencies and if it was not to adversely affect confidence in capital flows. If the value of the dollar was maintained at the level of May 1986, it would imply a current account deficit of more than $100 billion over the medium term. Such a deficit would mean that the United States would have to absorb foreign savings, with unfortunate consequences for developing countries. Therefore, it was necessary to address the external deficit with strong fundamental fiscal action in the United States and, more importantly, by expansionary action from other industrial countries.

From the point of view of developing countries, it was essential that the U.S. economic growth was strong, so that it could absorb high levels of imports, Mr. Sengupta noted. If the fiscal deficit was reduced and the U.S. growth rate was higher than the one projected by the staff, the position of developing countries could be expected to improve. If there were higher growth rates in other industrial economies simultaneously, there would be more room for maneuvering the current account balance with a moderate reduction in the real exchange value of the dollar. As Mr. Dallara had pointed out, there were limits to the adjustment burden that exchange rates could carry. For international exchange rate adjustment to be smooth, major industrial countries must coordinate their policies, which in the current circumstances would imply expansionary policies by some of the major industrial countries like Germany and Japan, while the United States reduced its fiscal deficit and improved its export competitiveness, retaining the growth in its volume of imports.

However, the U.S. trade policy in 1985 had contained restrictions on imports of automobiles, machine tools, and certain lumber products, Mr. Sengupta commented. Considering the U.S. agricultural policy in 1985, the trade area had become more protectionist than before. The policies pursued had harmed the interest of developing countries in certain cases--for instance, in the sale of beef to Brazil in connection with the Dairy Termination Program. The tendency to rely on bilateral agreements had increased. Recent actions, such as the Multifibre Arrangement, had more specific restrictions than agreements with general coverage of items. The quotas of textile imports in the Multifibre Arrangement were causes for concern. He urged the authorities to expand developing countries' access to the U.S. markets, especially in view of their continuing debt problems. He also urged the authorities to raise their overseas development assistance in relation to GNP, which at 0.24 in 1985 had declined from 0.27 in 1982. Raising official development assistance would ensure that total resource flows to developing countries did not drastically decline.

Mr. Zecchini said that the Board's discussion of the Article IV consultation with the United States was important because the actions of the member with the largest economy could have a particularly determinant influence on the world economy at the present economic juncture. The United States had been the main force behind the world economic recovery that had begun in 1983. However, policies that had been followed by the United States since then had given rise to some trends that did not appear sustainable over the long run.

The authorities had recently been trying to eliminate some of the obstacles that prevented more prolonged and sustained growth, Mr. Zecchini continued. Through cooperative action with other industrial countries, the United States favored a major realignment of exchange rates to reduce existing large current account imbalances. Furthermore, jointly with other countries, the United States had fostered a decline in interest rates, thereby encouraging fixed capital formation and alleviating some of the external debt service of many indebted countries.

The authorities were to be commended for those achievements, as well as for having combined significant economic growth with low inflation and a decline in the unemployment rate, Mr. Zecchini went on. The rate of unemployment had continuously declined in the previous five years from 9.7 percent in 1982 to an estimated 7.0 percent in 1986. However, developments in other areas had not been equally favorable. Adequate measures had not yet been taken to deal effectively with the fundamental disequilibrium of the fiscal imbalance, which was a major factor in the intractability of the external current account deficit in spite of the extensive depreciation of the dollar since the beginning of 1985. The fiscal deficit as a percentage of GNP had remained approximately unchanged in the previous few years: it had risen slightly from 5 percent to 5.4 percent in FY 1985, where it was expected to remain in FY 1986.

Despite the growing political will in the Administration and in Congress to reduce the fiscal deficit, considerable uncertainties remained on the stance fiscal policy would take, Mr. Zecchini noted. The views of the Administration had not been reconciled with those of Congress concerning critical areas in making the necessary adjustments in the budget. Furthermore, the Administration's GNP growth projections that underlay the budget estimates were more optimistic than those either of the staff or private forecasting agencies. That difference in growth projections could add as much as $74 billion to the deficit by FY 1991. Moreover, owing to the fact that a key part of the Gramm-Rudman-Hollings Act had been declared unconstitutional, the automatic expenditure reducing mechanisms included in the law would no longer sufficiently guarantee that the fiscal deficit targets would be observed.

Owing to the magnitude of the targeted adjustment and to the difficulties that had already been encountered in reducing expenditures by the required amount, some consideration should be given to increasing revenues, Mr. Zecchini maintained. In that respect, federal government receipts were expected to decline as a percentage of GNP from 18.6 percent in FY 1985 to 18.2 percent in FY 1986. Revenue-raising measures should not be ruled out--for example, the possibility of taxing consumption of oil products. Furthermore, caution should be observed to make certain that the tax reform was at least revenue neutral.

A reduction in the fiscal deficit appeared necessary to reabsorb the imbalance on the external current account and to create more freedom for monetary policy, Mr. Zecchini considered. An important step had been taken regarding the current account deficit by the substantial depreciation of the dollar since the previous year. However, the dollar had depreciated markedly only against a few major currencies; its value had not fallen enough with respect to the currencies of other important trading partners such as Canada and some developing countries. Furthermore, following the debt crisis, many Latin American countries that had been large-scale importers from the United States had reduced those quantities. In addition, further dollar depreciation along the same lines would have only a limited impact on external adjustment. Exchange rate movements needed to be complemented by other appropriate macroeconomic policies both domestically and externally.

In light of the magnitude of the U.S. current account deficit and the large imbalances of the opposite sign in other major economies, he shared the U.S. authorities' view that the optimal solution to the problem was enhanced international cooperation and stronger growth of domestic demand in countries with large current account surpluses, Mr. Zecchini continued. Therefore, given the substantial realignment of exchange rates that had already taken place, the authorities should concentrate more on a major goal that was attainable--namely, the correction of the fiscal deficit, which did not deny that there was merit in either the staff's contention that a reduction in the fiscal deficit was necessary to restore greater equilibrium between domestic demand and savings or the authorities' firm belief that the current account problem might be solved only with the cooperation of the United States' trading partners. As to the staff's view, the annual increases in the fiscal deficit since 1981 had not been accompanied by compensating changes in the private sector savings/investment balance but had been financed mainly through rising inflows of foreign savings. It could be said that the public sector's excess demand for savings had at least in part added itself to the private sector's excess demand. Those trends might lead to instability in the medium term for several reasons. Even assuming that it would be possible to continue to attract savings of the appropriate magnitude from abroad, that development would force some firming up of relative interest rate levels and of the exchange rate of the dollar.

Thus far, monetary policy had played an important role in bringing about a decline in interest rates, in supporting economic growth, and in allowing a depreciation of the dollar, Mr. Zecchini went on. The authorities had been right in taking a judgmental approach to monetary policy rather than attempting to meet their initial target in a mechanical way. However, at present the mechanical path appeared justifiable since a rapid growth in M1 had accompanied a much slower growth in M2 and M3, which was attributable in part to changes in the composition of financial portfolios. Indeed, for the next year it might be difficult to judge what the most appropriate monetary policy stance should be and whether the present course of action should be pursued further. In that respect, two considerations had to be kept in mind. On the one hand, since financial markets might have already partly discounted the favorable effects that would stem from meeting the fiscal deficit reduction targets contained in the Gramm-Rudman-Hollings Act, there would be limited room for a further decrease in interest rates. Therefore, if monetary policy were to be eased, more extensive deficit cuts would be needed. On the other hand, if the expected deficit reductions were not accomplished, any attempt to accommodate the sizable demand for credit coming from either the public sector or the private sector could rekindle inflationary expectations and pressures. Indeed, those pressures had not yet been completely subdued.

Recent declines in the rate of inflation had been due to decreases in energy prices and to weak food prices, Mr. Zecchini commented. Those developments were estimated to be temporary and could be partly reversed in the medium run. Prices of products other than food and energy, which could be viewed as a better indicator of the underlying rate of inflation, had continued to increase at a rate of about 4 percent. Thus, in the face of possible inflationary pressures, any monetary accommodation would reduce the effectiveness of--and make more difficult and destabilizing for the entire monetary system--a depreciation of the real exchange rate in order to improve external competitiveness. In contrast, a cautious monetary policy stance would lead to higher interest rates with well-known repercussions on the nominal exchange rate and on economic growth.

Introducing new protectionist measures did not represent a viable solution to reduce the trade deficit as it would not eliminate the macroeconomic disequilibria at the root of the problem, Mr. Zecchini said. Furthermore, such measures tended to favor domestic price increases and to reduce the efficiency in the allocation of resources in the economy, eventually reducing its ability to compete successfully in foreign markets. Therefore, he noted with concern the increase in protectionist pressures coming from Congress and the measures designed to protect domestic producers such as, among others, the announcement of actions to restrict the imports of machine tools, lumber, and textile products. Nevertheless, he was reassured by the Administration's strong commitment to free trade and by the actions that had been taken so far to oppose protectionist legislation. He urged the authorities to continue to resist protectionist measures even more strenuously than in the past, including those that resulted in bilateral trade restriction agreements. Protectionism was not carried out exclusively with quantitative and tariff limitations of imports but also by subsidizing domestic production. The Government should be encouraged to cut those subsidies--an act that would at the same time meet the two objectives of reducing public expenditure and the fiscal deficit and of enhancing transparency in international trade.

Mr. Arias remarked that he was in agreement with the staff appraisal except for one or two areas in which he had considerable doubts. U.S. expectations for the overall outlook were more favorable than those of the staff. If the staff's projections were correct, growth would not be particularly impressive to 1991. For 1986, the deficit was not likely to rise compared to 1985. For 1987, the favorable developments noted by the staff--the dollar depreciation and the decline in interest rates and oil prices--could have a positive impact on growth. They could be effective in offsetting the short-term negative growth effects of a reduced fiscal deficit.

However, apart from the devaluation of the dollar, the effect of the favorable factors were uncertain, Mr. Arias continued. There was little assurance that the oil price decline would not be partially reversed. The interest rate decline might also be reversed, but the reason would probably be that the reduction in the deficit was smaller, or that net investment was higher, than anticipated--developments that would remove the need for lower interest rates to sustain growth. Because of the different assumptions concerning growth, the staff had considerable doubts about the medium-term fall in the deficit projected by the authorities. It was conceivable that the staff might be proved wrong, simply because the authorities could choose to pursue a more stimulatory policy than was either expected or considered wise. However, stimulating actions could lead to a resurgence of inflation and high real interest rates if a strong reversal of oil prices occurred; otherwise, increased oil prices need not prevent the growth capacity that the U.S. economy was seeking.

In the staff's view, the achievement of the Administration's deficit projections might require an increase in revenue, Mr. Arias went on. The staff's preference appeared to be a reduction in tax expenditures. The effect would depend very much on what kind of tax expenditures would be lowered. Care should be taken to avoid adverse effects on investment. It should be noted that the proposed tax reform, although neutral, would increase the tax burden on corporations and, in particular, on capital. That allocation would hardly be auspicious from the point of view of growth.

U.S. plans for monetary policy appeared sensible, Mr. Arias remarked. A judgmental approach was dangerous, but it would appear far preferable to a blind pursuit of M1 targets, particularly in the present circumstances. Apparently, the staff's primary concern was to use the present opportunity to reduce the underlying rate of inflation and thus it allocated lending monetary policy to that purpose. However, the authorities were focusing on growth, which seemed appropriate not only from the U.S. point of view but also globally. It would be different if prospects for greater growth abroad were more secure.

The authorities were rightly concerned by dangers to the financial system, which they thought could be avoided by regulatory action, Mr. Arias considered. However, care must be taken that regulatory action would not further reduce lending to the weak sectors in the United States, as well as to the heavily indebted countries, which would only promote the crisis that the authorities desired to prevent. In that connection, it was interesting to note a recent proposal to extend the provisions of delinquent agricultural loans to reduce the impact on the financial situation of banks. It was also interesting that the staff of the Joint Economic Committee had examined and apparently sympathized with a stretch-out of provisioning for banks with large exposures to countries with debt-servicing problems.

The effect of recent developments in exchange rates on the U.S. balance of payments appeared to be slower than had been generally foreseen, Mr. Arias maintained. As a result, it was likely that the external debt would rise more than had been expected, which might affect the rate of capital inflows into the United States, as well as the value of the dollar. Nevertheless, the volume of capital imports and the strength of the dollar had frequently fooled the prophets and might do so again.

It was certainly correct to say that growth abroad would have favorable impacts on the United States, Mr. Arias continued. However, the staff should be a little less concerned with constraints on growth in the rest of the Group of Three, because they probably were more subjective than objective.

From the world's point of view, the authorities had been relatively helpful in resisting protectionist tendencies, Mr. Arias went on. The maintenance and expansion of access to the U.S. markets were, of course, of critical importance to the major debtor countries. He welcomed the announcement made that morning by Mr. Dallara on the vetoed legislation that could have affected imports of textiles, footwear, and copper. However, he was concerned about continued pressure for restrictive trade legislation in the Congress, and in particular about the recent passage of the Omnibus Trade Bill in the House of Representatives and by the extension and the widened scope of the Multifibre Arrangement. He urged the Administration to intensify its efforts to resist those protectionist pressures. Also, U.S. plans for trade negotiations and for widening their scope would be received more enthusiastically by the rest of the world if priority would be given to reducing barriers of all kinds to trade in goods rather than stressing the urgency of liberalizing transactions in services. He regretted that it would apparently not be possible for the United States to raise official development assistance at the moment.

It might well be true, Mr. Arias said in concluding, that the present favorable economic environment "provides an opportunity to take substantial action to correct the fiscal imbalances without threatening a major slowdown in economic activity in the short run." However, that judgment by the staff was based on the assumption that the lags with which dollar depreciation, lower interest rates, and oil prices would affect output in the United States would be just right. Until there was more secure evidence that strong growth in the United States has returned, it would be wrong to give greater urgency to reducing the underlying rate of inflation. Certainly, lack of progress on inflation would be regrettable and could be self-defeating in terms of growth, but it was also true that risking stagnation, or even a recession, by concentrating on inflation to the exclusion of growth could be counterproductive.

Mr. Mtei remarked that recently the U.S. authorities were facing a more favorable economic environment of lower interest rates, lower energy prices, and the depreciation of the dollar. What should be stressed was that it was more of an opportunity for action than for complacency, as there was clear evidence that the economic problems of the United States remained serious. In particular, the United States continued to face fiscal and external imbalances that threatened the growth potential of its economy and that had obvious worldwide repercussions. In addition, although the United States remained a major stimulus of growth for the world economy, there was heightened concern about reaction to the fact that U.S. economic activity had slackened somewhat more than expected.

During the Board's discussion of the previous Article IV consultation with the United States, the magnitude of the fiscal deficit and the urgent need to bring it under control had elicited much concern on the part of Executive Directors, Mr. Mtei continued. Even the authorities agreed that decisive action should be taken. Regrettably, the outlook for 1986 was far from encouraging, with a deficit projected to be 5.3 percent of GNP, only one tenth of a percentage point lower than the previous year. In other words, no meaningful adjustment had been accomplished. Part of the problem was the authorities' reluctance to pursue means to raise revenue. In the circumstance, he agreed with the staff that with the difficulty of reaching a political consensus on expenditure-reducing measures, it was unlikely that the goal of achieving a balanced budget by FY 1991 would be achieved without revenue increases. On many occasions the United States had advised other countries to increase revenue when it had thought that the circumstances warranted such action, and as the staff had indicated, ways could be found in the U.S. economy to increase revenue without impairing incentives to work, save, and invest.

The current account deficit was projected to remain unchanged from its level in 1985, Mr. Mtei went on. However, he noted that the trade account would benefit from the depreciation of the dollar and the sharp decline in oil prices. Improvement in the fiscal situation would have a positive impact on the current account, which was another reason why the budget deficit should be trimmed. Not only the United States but many developing countries could make the argument that a lower budget deficit and exchange rate adjustment were not the only mechanisms for improvement in the current account. Indeed, there was merit in the authorities' view that stronger growth in Europe and Japan would speed up the adjustment in the current account imbalance.

The commitment of the authorities to the principles of free trade was welcome, Mr. Mtei remarked. However, one could not ignore the fact that protectionist pressures had grown with the widening of the trade deficit; in fact, Congress had introduced recent legislation to restrict access to the United States for a large number of products. To what extent did competition from imports reflect a loss of comparative advantage in the sectors that Congress was attempting to shield? If the issue was loss of competitiveness because of economic fundamentals, then the United States must give priority to implementing policies of structural adjustment to cope with that reality.

He would like to express his appreciation for the assistance to developing countries through the U.S. foreign aid program, Mr. Mtei said in concluding, and he hoped that efforts to correct the fiscal imbalance would not unduly curtail such aid. In fact, the authorities ought to make every effort to increase official development assistance in relation to GNP.

Mr. Rye remarked that anxiety about what might happen to the U.S. economy in the period ahead was understandable, as was disappointment that earlier hopes of a strong performance in 1986 had not so far materialized. However, one must remember that the business cycle had not been repealed. Economies did not indefinitely run a strong expansionary course. The present economic upturn in the United States had reached a mature stage; in another four months it would enter its fifth year. Growth of even 2.5-3 percent at that stage of the cycle was not to be scorned and on general grounds would be better sustainable over a longer period than the 4 percent desired by the Administration.

That the upturn was continuing at all when manufacturing, mining, and rural industries were in a slump bore testimony to the resilience and underlying strength of the U.S. economy, manifested notably in an enviable degree of labor market flexibility, Mr. Rye commented. However, the structure of the resulting growth had a less than ideal pattern. For one thing, large sectoral and regional imbalances served to promote the forces of protectionism. Despite that, the short-term outlook for the U.S. economy appeared rather promising. Much of the slowdown in the first half of 1986 was clearly attributable to short-term factors: including a temporary decline in stock levels; a surprising, and surely momentary turn for the worse in net exports; and a lag in the beneficial effects of lower oil prices whereas the adverse consequences, especially for particular industries and regions, had been quickly felt. For those and other reasons, he felt comfortable with predictions that the second half of 1986 would see a considerably improved U.S. growth rate.

Beyond that period, one could only be uncertain, Mr. Rye maintained. He noted the differences of view between the staff and the authorities on the growth prospects for 1987 and beyond, but he did not propose to take sides on that issue. Instead, he would comment on some of the elements of uncertainty which clouded the medium-term prospect and which rendered all forecasts beyond the very short term--for both the U.S. and the world economy--problematical at best.

He would confine his remarks to four areas, Mr. Rye said--the federal budget deficit, the effects of the devaluation of the dollar, the possible resurgence of inflation, and the threat--or actuality--of protectionism. The budget deficit was at the heart of U.S. economic prospects. With the passage of the Gramm-Rudman-Hollings legislation and, apparently, the emergence of a political will to deal with the deficit, prospects were better than they had been the previous year. However, the problem was far from solved because the achievement of the Gramm-Rudman-Hollings deficit reduction goals would be no easy task. The Supreme Court's decision that key provisions in the legislation were unconstitutional had not been helpful. Furthermore, another cause for concern was that the size of the spending reductions envisaged by the Administration as necessary to meet the targets of the legislation were based on optimistic growth assumptions and, thus, might be underestimated. Based on the staff's growth assumptions, the expenditure cuts needed to comply with the targets would be very large in relation to discretionary nondefense expenditure. If the staff was right, something would have to give--either defense expenditure, on which the Administration had already made some large concessions, the Administration's insistence that taxes not be increased, or the plan to reduce the deficit itself. However, if the fiscal deficit was not reduced substantially and quickly, major problems would occur.

Consequently, he endorsed the staff's view that revenue-enhancing measures should be considered if expenditure cuts appeared likely to fall short of what was required, Mr. Rye continued. The authorities had eschewed revenue measures because of the unfavorable effects they could have on incentives to work, save, and invest, and he shared that perspective in general. However, even if current tax reform proposals were enacted, certain tax preferences of dubious economic value would remain. In particular, it was difficult to justify personal interest expense deductions, which were tantamount to a fiscal incentive not to save at a time when there was a shortfall of savings in the United States.

The depreciation of the dollar could not by itself restore U.S. external balance, Mr. Rye went on. Volumes did not necessarily respond to the price changes. For example, there was the case of Japanese exports of vehicles to the U.S. market. Despite the lifting of agreed restraints, the Japanese auto exports were still controlled by a voluntary quota. Regardless of currency values, the nine Japanese passenger car producers would ship 2.3 million units in 1986. There would be no change in unit volume, but the dollar amount of Japanese cars exported to the United States would increase. The same situation was true for compact discs, video cassette recorders, and large-scale memory chips that were not made in the United States. The expensive yen thus meant higher prices in the United States and a larger deficit denominated in dollars. If depreciation effects were fully reflected in prices, which, of course, had not been updated--although, as Mr. Dallara had pointed out, more recent data suggested that current pricing more fully reflected exchange rate adjustments--Japan would have to cut shipments of those products to the United States by more than 40 percent in order for the dollar numbers just to stay at the 1985 level--a development that would not occur. Of course, there were other angles to the depreciation on both sides of the account, exports and imports, but most of them pointed in the same direction.

The requirement clearly was a depreciation that could be made to stick in real effective terms, a development that would require domestic policy action, Mr. Rye continued. Although he was not against such actions, the extent to which expansionary measures by other major economies could help was marginal. Furthermore, it would be a matter for serious concern if, in the name of convergence of policies, reflation occurred in the major economies. Economic coordination did not mean that all nations should act in unison to exacerbate the business cycle. External action would not help if the internal imbalances in the U.S. economy were not rectified, and that development would require, first and foremost, early and substantial cuts in the budget deficit. Failing that, the pressures would be toward further downward adjustment of the exchange value of the dollar--if not by design, then because external creditors would show a reduced willingness to accumulate financial claims on the United States. Even that development would not necessarily result in a further real depreciation, since it would raise the specter of an inflationary resurgence.

The staff was correct to say that inflation had been scotched, not killed, in the United States, Mr. Rye considered. The conjunction of circumstances that had led to negligible consumer price increases in recent months was not a lasting one. Also, one must be concerned that monetary expansion was beginning to take on an excessive appearance. With all due allowance of the recognized uncertainties, expansion of M1 at an annual rate of 15-20 percent was incompatible with long-term price stability. Concern would be heightened if one took the Administration's forecast of growth and employment seriously. An unemployment rate falling to 5 1/2 percent by 1991--a rate below 1978-79--would surely strain even the capacity of the U.S. labor market to deliver wage-cost stability.

The Administration deserved considerable credit for its sturdy resistance to the forces of protectionism from manufacturers, Mr. Rye noted. However, the same could not be said regarding agriculture. While he was sympathetic to U.S. complaints about the European Communities' agricultural policies, the authorities were simply fighting fire with fire. The staff's report was not critical enough of the U.S. Government's role in bringing about the "serious international problems faced by U.S. agriculture" and, indeed, agriculture worldwide. Recent U.S. trade and agricultural policy initiatives were not an effective response to the problems in the United States and only served to exacerbate the current crisis in world agricultural trade.

The 1985 Food Security Act was not promoting a more market-oriented farm sector, Mr. Rye remarked. The term market-oriented was not an apt one for a combination of high levels of domestic support and export subsidies. In practice, the effects of U.S. export subsidy programs had been felt not by the European Communities, which had the stocks, the financial resources, and the will to withstand such programs, but by more efficient nonsubsidizing, exporting countries, such as Canada, Argentina, and Australia. However, the problems were more widespread than that. Rice export subsidies in the United States were causing difficulties for Thailand, a low-cost producer among others, and cotton marketing loans were having adverse consequences for the export prospects of developing countries, such as Sudan. Therefore, it was difficult to accept the contention that the United States had made any significant attempt to prevent its policies from affecting the less developed countries. Appendix I of the supplement to the recent economic developments paper, on the U.S. farm sector, provided a comprehensive review of the U.S. agricultural sector in its many aspects. The study was most welcome, but in places it appeared to provide a rationalization for U.S. farm programs--a small flaw in what was otherwise an outstanding set of staff papers. U.S. farm programs should be seen for what they really were--measures for providing assistance to U.S. agriculture by insulating it from competition from other countries, and at considerable cost to the taxpayer. Much of the discussion in the staff paper hinged on whether loan rates or target prices were too high or too low. However, the essential point was that the loan rate and efficiency payment system operated as a subsidy that was used in the same way as any European Communities' export subsidy--namely, to provide a buffer between what domestic producers received and the prices that the United States was prepared to force producers in other countries, not having the same protective measures, to accept.

His authorities had asked him to pose a number of questions about U.S. agricultural policies, Mr. Rye continued. Three of them were key questions. Was the farm problem one of servicing debt or of earning an income that would be sufficient to allow an enterprise to remain viable after paying costs, including debt repayments, at a more traditionally acceptable level? If the latter were true, would it not be more constructive to restructure or reschedule debt burdens than meet the cost of deficiency payments, stockholding, and subsidization of exports? The second question was whether there was any analysis of the number of farmers who needed support to be assured of a reasonable income and of the proportion of total support expenditure actually received by those farmers. Third, what proportion of farmers would be competitive on the world market without the aid of subsidies, and what was their relative contribution to total U.S. farm output?

The staff papers had indicated an improved degree of surveillance in the consultation, Mr. Rye considered. However, given the uncertainties for the course of the U.S. economy and of U.S. economic policy--and their extreme significance for the world--he wondered if even further surveillance should not be considered. Even though U.S. developments were closely considered in the world economic outlook exercise, he was not sure that that was enough. Perhaps the time had come to consider six-monthly consultations--even if, because of resource constraints, the extra half-yearly discussion were conducted on a more limited basis and the papers were somewhat reduced.

Mr. Nebbia welcomed the opportunity to review the developments in the U.S. economy during the previous 12 months because of their relevance in the world economy. The staff papers constituted a useful contribution to the surveillance process, highlighting in their analyses position of agreement and disagreement with the authorities. The remarkable recovery in economic activity in the United States had been going on for a number of years; it had been accompanied by continued moderate inflation and a close to normal rate of unemployment. Indeed, it had had beneficial effects for the rest of the world, boosting the recovery in other industrial countries and had supported the adjustment effort of developing countries.

However, during 1985 in particular, growth had been slow and uneven, Mr. Nebbia continued; the hesitant growth in the second half of the year could be attributed to a further deterioration in the current account and in inventory liquidation. That picture had been reversed in the first half of 1986, though not to the expected level, under the strong influence of a substantial depreciation of the dollar, a sharp reduction of oil prices, and a falling rate of inflation that had led to a reduction in interest rates.

The authorities and the staff were confident that a rebound in economic activity would materialize in the second part of 1986, since the benefits of the improvements mentioned earlier would lag, Mr. Nebbia went on. He would remind the Board that the same expectations had been held for the second part of 1985 during the previous Article IV consultation with the United States, and, unfortunately, a slowdown had occurred in the fourth quarter. Given that the economic environment had improved in recent months, it should be possible to take measures to further correct the fiscal disequilibrium without risking a slowdown in the short run.

Fiscal imbalance continued to be a worrying feature in the U.S. economy, as the fiscal stance had continued to expand during 1985, Mr. Nebbia recalled. The further deterioration of the fiscal deficit was due to the increase in expenditures undertaken not only by the federal sector but also by the states and local sectors as well. He was encouraged that the authorities attached high priority to reducing the deficit, and he would urge them to fully implement their strategy. Some steps had been taken in the right direction--the adoption of a budget reduction in August 1985 that had significantly cut planned expenditures, especially defense expenditures and, of course, the passage of the Gramm-Rudman-Hollings Act, which had prescribed a step-by-step elimination of the fiscal deficit by FY 1991. It was not yet clear what the effect would be of the automatic clause in the Gramm-Rudman-Hollings Act after being ruled unconstitutional by the Supreme Court. That clause was at the heart of the Act and its deletion would leave the proposed adjustment in the hands of the highly politically motivated members of Congress, who could postpone or jeopardize the needed adjustment. The staff's underlying assumptions indicated that adjustment was already off track. If staff projections were correct, the fiscal deficit for FY 1991 would be in the order of $100 billion, a very significant figure. Again, he urged the authorities to offset those developments. Along those lines, he shared other speakers' comments on the benefits of fiscal restraints.

The Administration had postponed a major tax reform to simplify and increase the efficiency of the system, Mr. Nebbia noted. That initiative was welcome, but there were doubts concerning the implications of the reform. It would indeed be unfortunate if as a result of negotiations about the final format, the fiscal deficit was widened by revenue losses. Indeed, given the size of the deficit, the authorities might well consider increasing revenues in addition to reducing expenditures, but action in that area should be taken only with extreme caution to avoid damaging incentives in the economy.

Accommodative monetary policy appeared appropriate and pragmatic, given the output performance and the decline in inflation, Mr. Nebbia said. The growth of M1 should not be a cause for concern, since it was unlikely in the short run to lead to inflationary pressures. On that issue, he concurred with the authorities.

He welcomed developments in interest rates, but since the level of real interest rates was still quite high, there was still room for further reduction, which would improve the prospects of reducing the fiscal deficit, encourage growth, and help to deal with the debt-servicing problems of many developing countries, Mr. Nebbia went on.

After many years of maintaining an unsustainably overvalued exchange rate, policymakers in the United States had got together with the country's major trading partners to correct the parities of their respective currencies, Mr. Nebbia continued. That development had been long in coming and was very welcome. However, despite the sharp drop in the value of the dollar, the decline in oil prices, and the continuous fall of many commodity prices, the trade balance had not yet given signs of improvement. To comfort ourselves, as Mr. Dallara had suggested, by accepting the notion that things could have been worse was poor consolation, and further actions were needed on that front.

To maintain a relatively unchanged current account deficit in future years of about $100 billion a year would only intensify protectionist feelings in the United States and abroad, Mr. Nebbia considered. A further depreciation of the dollar might be needed in order to attain a more sustainable current account position. He was in agreement with Mr. Dallara that actions in the exchange rate alone would not be sufficient; a higher rate of growth abroad was needed. However, those countries that were able to grow had not wanted to take the risk, and the countries that were seeking to grow had not been allowed to. That paradox led him to commend the leading role that the United States had taken in helping with the debt strategy of developing countries. The Baker initiative had been a welcome one, but the proposal had to be strengthened with active and direct participation of more of the developed countries, both with direct financing and through their regulatory banking agencies.

His authorities were concerned about developments in the import stance as well as the export policies pursued by the United States, Mr. Nebbia remarked. He acknowledged that the Administration had prevented the implementation of protectionist measures, particularly with products such as footwear, textiles, and copper. He also welcomed the decision that day in the House of Representatives not to impose credit restrictions on imports of textiles; a negative resolution would have damaged the future of talks under the auspices of GATT. However, he regretted the restrictions on lumber and machine tools.

As for export policy, he shared Mr. Rye's view that the staff should have been more critical in describing the implications of U.S. agricultural policies, Mr. Nebbia said. He would comment on those policies as instructed by his Argentinian and Uruguayan authorities. Owing to the increased difficulties experienced by the agricultural sector, Congress had enacted the Food Security Act of 1985 in order to encourage a more market-oriented sector. However, again, like Mr. Rye, he felt that that Act would not lead to a more market-oriented sector. In fact, the authorities had come to realize that "the policies pursued by European Communities countries in that area were not compatible with free market-oriented policies, emphasizing that the United States could no longer tolerate the erosion in their export markets arising from European Communities policies, and are confident that the U.S. export promotion schemes could contribute to a change in European Communities policies in the long run." But the long run posed problems for a number of developing countries that heavily depended on their agricultural export proceeds--for example, Argentina. Overproduction, as well as the unfair agricultural export policies of major industrial countries--initially practical for the European Communities, but later the United States joined with strong impetus--had undermined serious efforts to overcome economic difficulties in those developing countries. Specifically, subsidies and protectionism had caused a drop in the international prices of agricultural products that had amounted to a net export loss of almost \$4 billion in the previous two years. At 1980 prices, the value of agricultural exports for those developing countries for 1986 would have been almost \$7 billion instead of the expected \$5 billion caused by the forced drop in prices.

Building on that unfair and self-defeating scenario, the United States was currently considering extending the scope of its export enhancement program, which by his estimate, would signify a further \$1 billion net export loss a year for Argentina, Mr. Nebbia continued. It was not by taking action against world markets that the difficult situation of the American farmer would be improved, nor would the worldwide protectionist climate be moderated. Times were difficult enough for debtor countries, and one should look for constructive ways to back their efforts. In that context, he would like to quote a White House and State Department bulletin that recently criticized the OPEC agreement. "We have long felt and continue to believe that the free market and the laws of supply and demand should determine oil prices and supply levels." He wondered if that should not be applied to other commodities as well.

For some time, the U.S. deficit had been at the center of discussions on the world economic situation and its prospects, Mr. Nebbia recalled. The declaration of unconstitutionality of a key element of the Gramm-Rudman-Hollings Act that had enforced automatic reductions of expenditures had renewed his concern about the feasibility of the pace of fiscal deficit correction suggested by the Administration. The information that had been provided by Mr. Dallara at the end of that morning's session had confirmed the reason for his concern. Indeed, a clear case could be made for carrying out supplemental consultations in light of the Board's discussions on enhanced surveillance, if events in the next few months did not confirm the pace of the U.S. fiscal adjustment.

Mr. Nimatallah commended the authorities on their economic achievements in the previous few years. The current expansion of the U.S. economy had been one of the longest in recent history and, more notably, had taken place in an environment of low inflation. He also commended the authorities for their awareness of potential problems. They were responding to potential future difficulties by taking medium-term measures rather than resorting to short-term expediencies: for example, the current attempt to enact a major tax reform law; the continuing commitment to reduce the fiscal deficit in an orderly fashion over a number of years; the ongoing efforts to improve the function of labor markets; the continued adherence, albeit with some slippages, to a policy of free and fair trade; and, last, but very important, the efforts to coordinate exchange rate and interest rate policies, to the extent possible, with major trading partners.

However, looking ahead at the remainder of 1986 and 1987, there was uncertainty over the growth prospects of the U.S. economy, Mr. Nimatallah continued. There were a number of factors: the delay in implementing the tax reform package had had a dampening effect on investment expenditures. He had mentioned that issue in the Board's discussion of the 1985 Article IV consultation with the United States, and the President had brought it up only recently. Also, the previous year he had hoped that the tax reform legislation would have been concluded early enough to avoid the dampening effect on investment outlays. That complex package needed time for all its implications to be evaluated and understood.

In addition, there was the fiscal deficit, Mr. Nimatallah went on. He agreed with the Administration's strategy of reducing the deficit in a steady and gradual fashion. However, particularly in light of recent court rulings, it was important for the authorities to convince the world that they remained committed to that strategy. Given projections of a possibly larger than originally anticipated deficit in 1987, there was a need for even further reassurance. More credibility and less uncertainty needed to be projected by the authorities. He welcomed Mr. Dallara's statement that "the political consensus underlying the Gramm-Rudman-Hollings Act was more important to the ultimate success of this effort than any procedure for automatic expenditure reduction." However, he would like to see that consensus be reinforced by contingency planning.

In particular, given the obvious difficulties associated with growth, it might be desirable to prepare scenarios based on two sets of assumptions--more optimistic and less optimistic--for each budget. He would prefer the authorities to envision a slightly longer, and more realistic, period beyond 1991 for eliminating the deficit, rather than to increase taxes or to reduce government expenditures beyond what was feasible at that point, Mr. Nimatallah considered. The U.S. economy was addicted to debt and fiscal deficits, and it needed some time to withdraw. The important point was to remove the uncertainty about whether deficit reduction would continue and at what rate.

The private sector had also held back on investment expenditures because of two reasons--low capacity utilization and a possible increase in inflation, Mr. Nimatallah noted. General capacity utilization in the United States was relatively low, below 80 percent, owing to the current decline in activity in the oil industry and the negative impact of the sluggish behavior of exports, both in agriculture and in manufacturing, as well as consumer retrenchment owing to a decline in real income in some midwestern and other states.

The underlying rate of inflation was no longer declining, and it seemed likely to increase, Mr. Nimatallah commented. Interest rates were likely to experience upward pressure owing to intensified difficulties over the external financing of the fiscal deficit and the current account. Nominal wages might start increasing because employment had been brought to the full level. Money supply had recently been growing at a relatively rapid rate, and the depreciation of the dollar appeared certain to force a rise in import prices as well as in those of import-competing production. What would be the net effect of those considerations?

As far as the tax reform package was concerned, it would be some time before it was finalized and even longer before it was smoothly implemented, Mr. Nimatallah considered. It would not disappoint him if it turned out to be revenue neutral or even reduce revenue because he favored a gradual reduction in the size of government over time. The important point was that the tax reform legislation should be speeded up to eliminate one of the important sources of uncertainty. Indeed, he expected it to have a generally favorable impact on growth.

He was encouraged by the commitment of all relevant parties to the deficit reduction and hoped that all of the issues would soon be resolved, Mr. Nimatallah said. As for the oil industry and agriculture, neither would help growth over the near term. In addition, the positive impact of the dollar depreciation on exports of manufactured goods would eventually arrive and, combined with improved domestic demand, would also help growth. As for the impact of potential inflation on growth, much would depend on the reaction of the Federal Reserve Board. Therefore, on balance for 1986, he was closer to the staff's growth projections. For 1987, he was closer to the more optimistic Administration forecast. The combination of the lower oil prices and the beneficial impact of the tax reform, together with the working through of the dollar depreciation on exports and a general improvement in domestic demand, would have a beneficial impact on growth in 1987.

As for the longer-run considerations of the economy, the combination of a low domestic savings rate and a rapid rate of debt accumulation, both internal and external, would eventually impose major costs and compromise the freedom of the authorities to act, Mr. Nimatallah remarked. The current level of borrowing could not be sustained for long, and even if it could, it would be too costly. Interest rates would have to creep steadily upward, which would further reduce the flexibility of monetary policy. In addition, it would increase capital outflows and debt servicing would continue to rise. Thus, foreign debt was not healthy and might eventually compromise the ability of the economy to increase its capital stock to sustain its growth. The best answer to that problem was for the United States to increase the rate of savings. The economy had been geared more toward consumption expenditures and less toward savings and it was time to gradually reverse that process.

In closing, Mr. Nimatallah said that he encouraged the authorities to continue to resist protectionist pressures and to resist attempts to reduce official development assistance.

Mr. Jaafar said that the high degree of competence demonstrated in the staff papers for the 1986 U.S. Article IV consultation was consistent with the Fund's aim of enhanced surveillance of an economy that was so important to the rest of the world. He also welcomed Mr. Dallara's comment on the need to take a broader, multilateral approach, to correct U.S. imbalances. However, such cooperation, as attractive as the idea was, did not diminish the share of the adjustment burden that the United States would have to shoulder. The priority remained to achieve a real and substantial reduction in the U.S. budget deficit because it was at the heart of current economic problems both in the United States and abroad.

Trade liberalization was another major issue, Mr. Jaafar continued, and he was pleased to hear the reaffirmation of the authorities' commitment to free trade. However, there remained some problem areas--particularly in terms of trade barriers to exports of less developed countries, such as quotas on textiles and restrictions on vegetable oil imports and export subsidies extended to certain agricultural products. He agreed with Mr. Rye and Mr. Nebbia on the issue of foodgrains, especially the subsidy on rice. A number of his constituency, whose major export was foodgrains, had already been affected by the export subsidies to rice farmers. Therefore, like other speakers, he had to express concern over restrictive trade practices of the United States.

To an extent, the current slowdown, which had come as early as the second quarter of 1984, should be expected after the vigorous upturn during the first phase of the recovery, Mr. Jaafar went on. In fact, the current expansion was already among the longest in the postwar period.

It was disappointing that unlike the pattern of previous upturns of the business cycle, commodity prices had failed to benefit from the upswing. Instead, there existed the prospect for a further commodity deflation.

The sluggish second quarter growth of only slightly more than 1 percent gave further cause for concerns on the likely overall performance for 1986, because at present the fiscal stimulus had begun to diminish, Mr. Jaafar noted. He was surprised that the positive developments in the oil market and the sharp fall in the dollar had not yet translated into a better performance for 1986. Consumer spending had directly benefited from the fall in oil prices, but the lower cost of capital stemming from the falling interest rates had not revived business spending sufficiently to contribute much to growth. That element was important for future prospects of the economy, as capital formation formed an essential ingredient for sustaining expansion. Indeed, the statement by the Chairman of the Council of Economic Advisors, which had been circulated by Mr. Dallara that morning, did not allay doubts on the downside risks attached to the forecast for capital formation. However, several factors could have contributed to a lackluster performance in business-fixed investment. Tax reform had yet to take a definite shape in either side of Congress. Until the various components of the bill were known to the business community with some degree of certainty, it was not likely that that sector would make firm commitments to expand. Furthermore, manufacturing capacity had not reached the 85 percent point, which by historical standards was still low. In addition, the Supreme Court's decision that certain provisions in the Gramm-Rudman-Hollings Act were unconstitutional had changed the high expectations for the eventual resolution of large federal deficits. The fallback provisions of the Act had not indicated completely that the deficit targets would be met in the medium term. The sentiment of business reflected that uncertainty.

Downward corrections in the real exchange rate since March 1985 had reached 30 percent, but the trade account had worsened, Mr. Jaafar commented. Unless improvements were made on the external sector, it would act as a drag to overall performance and, consequently, on prospective improvement of manufacturing productivity. Nevertheless, it was equally important to realize that supportive policies in other major countries were needed in order to narrow those gaps. In fact, some members of his constituency felt that the dollar had basically made the needed correction. To expect more on that front would carry more risks than warranted. Again, it was still too soon to see the benefit of the cheaper dollar on trade.

Meanwhile, the danger behind the growing deficit was the mounting pressure for protection of domestic industries in the United States, Mr. Jaafar maintained. He urged the authorities to stand firm against protectionism and to roll back the already existing barriers to trade. The beneficial impacts of the sharp drop in oil prices had already been realized, but the extent to which such factors influenced trends was hard to say at the moment because of the uncertain economic environment. He was not as optimistic as the Administration on its projections, but he was even less certain that he could embrace the staff's projections. The outcome would depend on the right policy being pursued in the period ahead.

Monetary policy would play an important role during the recovery, Mr. Jaafar continued. The continued commitment to growth could be observed with the accommodative stances taken in recent months. Meanwhile, much room for maneuver had been gained with the fall in oil prices and the continued low inflation. Monetary policy, coupled with an improved public expectation of real progress on the budget front, had led to the welcomed drop in both the long- and short-term interest rates. The need for those rates to keep falling should be underscored, however, because in real terms they continued to remain at a high level by historical standards. In 1986, three discount rate cuts had been made almost successively by the Federal Reserve Board. His constituency enthusiastically supported those moves because they helped to improve the climate for investment as well as to ease debt-servicing burdens. The Board might recall that the first two cuts in the discount rate had been taken in coordination with major trading partners. That development was in the interest of avoiding any sharp fluctuations in the exchange market, the need for which had not diminished, even with a significant drop in the dollar exchange rates. It should not be forgotten that the trade and current account deficits remained as large as the previous year, and the margin in terms of interest rate differentials had also narrowed considerably. Although progress had been seen on the fiscal front, the deficits would continue to call for external financing on a substantial scale. Under the circumstances, a cut taken unilaterally, such as the one taken the previous month, could not be viewed otherwise but with serious concern over what that move could entail in terms of exchange rate stability globally. Therefore, he urged that future actions in that direction be taken with that perspective in mind and, therefore, in concert with major countries.

The downside risks attached to the U.S. official projections were firmly established, especially in view of the recent sharp revisions by the Federal Reserve Board, Mr. Jaafar went on. Those new statistics had lent more credibility to the staff's estimates. The revised outlook constituted a crucial element in the deficit projections of the federal budget. The figures in the staff report represented a difference of $60 billion between the fiscal projections of the authorities and the staff on the basis of three fourths of a percentage point in the projected annual average GNP growth rate over the period 1986-91. Supplement 1 to the recent economic developments paper had revised those figures upward by another $14 billion, to $74 billion. If that scenario was played out during the period to 1991, substantial additional cuts in the budget would be required if the Gramm-Rudman-Hollings Act deficit targets were to be achieved. The point also underscored the importance of making real progress on the fiscal front. The magnitude of the needed additional cuts required that the authorities take a less rigid stance on means to narrow the deficit gap. For example, the tax reform currently under consideration could be used to supplement the expenditure retrenchment program with some revenue-side measures.

There were crucial implications in the fact that the capital stock growth rates assumed by the Administration were different from those used by the staff in projecting GNP growth, Mr. Jaafar noted. An annual net capital stock growth rate of 4 1/2 percent would be high by historical standards. On the contrary, the average rate of only 2 1/2 percent in the staff's projection looked a little pessimistic in view of past performance and the present confluence of several positive factors--namely, the substantial cut in oil prices, the strong external adjustments, and the lower cost of capital.

The adverse consequences of the current account deficit exceeding $100 billion during the decade on the basis of the present exchange rates had received due emphasis, particularly as presented in the alternative scenario for the current account balance as summarized in Chart 1, Appendix IX, of Supplement 1 to the recent economic developments paper, Mr. Jaafar commented. The beneficial impact of further depreciation of the dollar on both the current and external debt had also been noted. However, it was puzzling that Scenario E of Appendix IX presented a seemingly better outturn on the current account and debt when assuming a lower GNP growth rate than projected for 1988-91. Such an outcome, which would call for subdued economic activity in the United States, was contrary to the Fund's aim of a more sustained growth globally. In that analysis, it was important not to overlook the implications that such a low growth rate had on the fiscal deficit and, therefore, on the current account.

Mr. Finaish said that the present situation of the U.S. economy presented a mixed picture. On the one hand, there had been some changes in the overall economic environment, supported by some overdue adjustments in policy that should improve the prospects for stable and sustained growth. Those positive developments included the current more serious approach to reduce the fiscal deficit, the sizable correction in the dollar exchange rate, and the significant decline in interest rates. On the other hand, projections showed that the imbalances created by past policy weaknesses could be expected to diminish only over time. Thus, on reasonable assumptions, fiscal deficits were projected to remain substantial for several years. The external deficit, and the associated absorption of global savings, was also projected to remain large well into the medium term. Moreover, there had recently been signs of increasing sluggishness in economic activity that called into question the previously forecast GNP growth rates.

The staff had correctly focused on three main elements of policy strategy that needed to be followed in the period ahead, Mr. Finaish continued. First, the objective of reducing the fiscal deficit should be pursued decisively. In that respect, measures both to reduce spending and raise revenues should be considered. Second, monetary policy should continue to aim at sustaining the progress against inflation. Third, the mounting protectionist pressures should be firmly resisted and efforts initiated to roll back the existing and recently intensified trade barriers, some of which seriously constrained the exports of developing countries, including the major debtors.

An orderly reduction of the large U.S. external deficit, consistent with the preservation of an open trading system, would require effective cooperation and policy coordination among the major countries with respect to the exchange rate and the conduct of macroeconomic and trade policies, Mr. Finaish went on. In that context, Mr. Dallara had made a strong plea for increased and more effective multilateral economic cooperation. The recently increased U.S. interest in multilateral policy coordination represented a welcome shift from the "go-it-alone" approach of previous years. It was to be hoped that the movement toward greater international cooperation and coordination on the part of the United States would be sustained when the perception of an immediate self-interest in it began to weaken and also that it would be extended to other areas of international economic relations.

A point of interest in the growth projections of the U.S. economy was the contribution of the sharp fall in oil prices, Mr. Finaish considered. The authorities expected significant beneficial effects that would raise the level of real GNP in 1986-87 by an estimated 1-1.5 percent more than what it otherwise would have been, which amounted to a large proportion of the projected GNP growth rate for those years. He would be interested in the staff's assessment of the expected contribution to growth of the oil price fall, especially in light of the staff's lower projections for GNP growth rates compared to those of the authorities. Doubts about the magnitude of a positive contribution arose particularly when one considered the severe negative regional effect in several states and in the U.S. oil industry as a whole. Manifestations of difficulties included falling revenues, rising unemployment, and bank failures. He noted that Mr. Dallara had acknowledged that the fall in oil prices had been an important factor in the slowdown in the first half of 1986. From a medium-term perspective, falling oil prices had an important effect on oil production capacity, which had been more pronounced in the United States than in many other countries. The Petroleum Intelligence Weekly service had recently reported that lower worldwide exploration and development activity had already caused irremedial damage to reserve replacement and that "U.S. production will be hurt the most." It also reported that whereas worldwide exploration and development cuts had averaged about 30 percent, "outlays have been slashed by 40 percent in the United States." As mentioned in the staff report, the U.S. authorities had indicated that "it was important that the declines in oil prices be passed through to final users." That policy was appropriate considering its implications for the level of economic activity and inflation. The basic point he was raising about the oil price decline was that it was a development that had both positive and negative effects of a short- and long-term nature. Perhaps the staff could supply some further information and assessment on the issue.

He had a point on restrictions that he would like to make, Mr. Finaish noted. He would like to convey to the Board the grave concern of his Libyan authorities about the continuation of the blockage of Libyan assets and the restrictions on various trade transactions with

Libya that had been imposed by the United States in January of 1986. Those restrictions on payments and transfers involving Libya, which were mentioned on page 59 of Supplement 1 of the recent economic developments paper, had currently been in force for many months. The Libyan authorities reiterated their demand for the immediate withdrawal of those restrictions, which for reasons that had been given in detail in the meeting on the subject (EBM/86/17, 1/31/86), they considered to be in violation of both the letter and the spirit of U.S. obligations under the Fund's Articles. The serious international implications of the U.S. action had also been emphasized at that meeting. Executive Board Decision No. 144-(52/51), which had been invoked by the United States for the restrictions in question, stated that the Fund "reserves the right to modify or revoke, at any time, the decision or the effect of the decision on any restrictions that may have been imposed pursuant to it." Moreover, Rule H-1 of the Fund's Rules and Regulations stated that "the Fund shall keep all exchange controls under review and shall consult with members with a view to the progressive removal of exchange restrictions in accordance with the Fund Agreement." He trusted that the staff had continued to follow the issue of U.S. restrictions against Libya and had raised it with the authorities at the recent consultations. Finally, he recalled that several Directors at the January meeting had called upon management to use its good offices to continue its efforts to find an early resolution of the matter. He would appreciate any comments from the staff on that matter in the light of the Article IV consultation with the U.S. authorities.

Mr. Alfidja remarked that following almost three and a half years of strong expansion, the growth of the U.S. economy had, since mid-1984, slowed at a sharper pace than had been anticipated. That sluggish growth had increased both domestic and international concerns about the uncertain prospects for the world economy. The current account deficit had widened, reflecting a rapidly growing domestic demand that had not been satisfied by output growth but that had required yet more imports; in the meantime, exports had stagnated. However, inflation had been kept at relatively low levels; the employment situation had moderately improved with the unemployment rate stabilizing at about 7 percent.

He shared the concerns that had been expressed about the large financial imbalances in the U.S. economy, which constituted a threat to the long-term stability of the world economy, Mr. Alfidja continued. In that context, he would mention in particular the adverse impact of the U.S. fiscal imbalances on the adjustment efforts of many developing countries. It was generally agreed, but needed to be re-emphasized, that the recent drop in oil prices, lower interest rates, and the depreciation of the dollar were factors that favored an environment in which the conditions for sustained economic growth and further price stability could take place in the United States. Therefore, under those propitious circumstances, decisive measures must be taken to correct the fiscal and external imbalances. In addition to the two major areas where policy actions were needed, there was a third--international trade--in which policies were needed to resist growing protectionist pressures and to move to a more open trading system that would benefit both developed and developing countries. In that respect, he was encouraged to note that the Administration had remained firmly committed to free and fair trade and was making every effort to resist protectionist pressures. He hoped that the interest of the international trading community would prevail and that the Administration's efforts would be successful. He was also encouraged that the authorities considered the three policy areas that he had mentioned as crucial in their overall policy strategy for tackling the current financial imbalances.

He welcomed the medium-term policy framework that had been established under the balanced budget and emergency deficit control act, the Gramm-Rudman-Hollings Act, for dealing with the fiscal problem, Mr. Alfidja went on. That significant step had greatly improved the fiscal outlook and had raised expectations that the federal deficit might be progressively curtailed and even eliminated by 1991. The emphasis that the Administration currently placed on expenditure reduction rather than on revenue increases as the appropriate means to reduce the federal deficit was understandable. Nevertheless, the overall assumptions underlying the Administration's medium-term fiscal estimates and economic projections appeared to be optimistic. The staff had pointed out that on the basis of their flow of funds analysis for 1986-91, it was most unlikely that the expected expansion of capital stock would materialize; and given the uncertainties about the outcome of the federal deficit, large inflows of foreign savings might not materialize. Under those circumstances and given the difficulties in reaching a compromise on the quality and quantity of the reductions in federal spending, it was encouraging to note that the authorities had at present revised their economic forecast. At any rate, the Administration should seriously consider raising revenues in addition to the expenditure-reducing measures. He hoped that an appropriate plan could be formulated that would be acceptable to all parties, bearing in mind the need to maintain incentives and fiscal discipline.

He welcomed the tax reforms efforts under way to simplify the tax system and make it more equitable, Mr. Alfidja said. Since uncertainties appeared to have developed in some business circles regarding the impact of the tax reform on investment decisions, perhaps the timetable for concluding deliberations on the reforms could be accelerated. However, more than a revenue-neutral tax reform was needed if the medium-term fiscal deficit reduction target was to be achieved.

He welcomed the active role that the United States had continued to play in dealing with the debt problems of many developing countries, Mr. Alfidja considered. The support the Administration had provided to sustain the adjustment efforts of heavily indebted developing countries was commendable. The need to create the necessary climate for attracting foreign direct investment flows to those indebted countries and the possibility of converting debt to equity had been well noted. Also, it had been recognized that the Administration placed emphasis on the promotion of trade and private investment as an effective means of promoting economic development. However, regarding foreign economic aid, it was more than disappointing that the U.S. contribution, which had considerably decreased over the previous few years, would be further affected by the Gramm-Rudman-Hollings Act budget-reducing measures. The reduction of U.S. foreign assistance, particularly to African countries, appeared to ignore the serious efforts of those countries that had initiated comprehensive economic reforms that needed the support of the large industrial countries. Perhaps in the course of approving the budget resolutions, the appropriations for foreign assistance could be re-examined and the cuts reinstated in the light of the promise made to some of those countries during the consultations that had led to the creation of the Special Facility for Sub-Saharan Africa.

Mr. Lundstrom remarked that since the previous Article IV consultation with the United States, there had been some important positive developments. The Administration's commitment to reduce internal imbalances had been strengthened, the risks associated with an excessive dollar rate had been addressed, and important initiatives had been taken in order to help solve the debt problems of developing countries. He welcomed those developments, and he would particularly commend the authorities on their achievements during the recent economic upturn, which had been an important stimulus to the expansion of world trade and economic growth.

However, the problems facing the U.S. economy remained essentially unchanged, Mr. Lundstrom continued: the need to reduce the federal budget deficit; the need to correct the external imbalance; the need to consolidate achievements with respect to growth, employment, and inflation; and the need to resist protectionist pressures. In that day's discussion, those problems had been dealt with extensively, and a broad consensus had emerged on the action that needed to be taken, and not only by the United States. Therefore, he would only underline briefly a few points of particular importance. Concern had already been expressed a year earlier about the short- and medium-term prospects for the U.S. economy. Those prospects could hardly be said to have improved since then. As a matter of fact, the situation would appear more precarious than before. The staff was of the opinion that the favorable impact of the decline in interest rates and oil prices, together with the depreciated dollar, would be sufficient to offset the negative effects of the intended budget cut next year. However, that assessment was highly sensitive to assumptions on both the strength of the economic expansion and the related size of the budget deficit. Although lower oil prices would have beneficial effects on the economy, certain important sectors had been negatively affected. At the same time, expansionary effects had materialized slower than expected in other countries as well as in the United States. Also, the positive effects of the dollar depreciation had been slow in materializing.

Consequently, the present prospects for the U.S. economy and the rest of the world raised doubts about the possibility to reduce the fiscal deficit as planned, Mr. Lundstrom went on. The problem was even more alarming since the current economic environment was favorable to only a gradual reduction of the deficit. However, a decrease in the deficit appeared necessary in order to correct the external imbalance. To successfully deal with the fiscal deficit would demonstrate that the United States had taken its responsibility for correcting the global imbalance. It would also make it easier for other countries to stimulate their economic activity. Obviously, the reverse was equally true.

The fiscal deficit had currently reached such a magnitude that in order to correct it, all types of expenditures had to be taken into account, Mr. Lundstrom considered. Even if fiscal action should primarily take the form of expenditure cuts, the revenue side should also be considered. It was possible to find solutions that would not harm incentives to work, save, or invest. Limitations in the fiscal area made monetary flexibility even more important, but there were obvious constraints there as well. For example, interest rates had to be high enough to secure sufficient capital inflows to finance the current account deficit.

There was always the danger that short-term developments in the real economy would have an overly strong influence on monetary policy at the expense of medium-term objectives, Mr. Lundstrom noted. The significance of the M1 aggregate was doubtful, but as long as disorderly exchange rate developments could be avoided, he did not regard developments thus far as an indication of a need to tighten monetary policy. Lower interest rates would have positive effects on growth, both in the United States and in the rest of the world, thereby partly offsetting the negative demand effects of U.S. fiscal restraint. The obvious conclusion was that concerted international action was necessary if global economic growth was to be maintained. In the medium-term perspective, a monetary policy aimed at keeping interest rates low would also help U.S. competitiveness through its effects on the effective exchange rate.

He was in broad agreement with the staff report, but he would have welcomed a comprehensive assessment of structural changes in economic development in other areas than the agricultural sector, Mr. Lundstrom noted. In that connection, the following issues would be of particular interest. Savings and investment behavior had been the prime target for most economic policy reforms of the present Administration. The staff had pointed to the fact that a large increase in the fiscal deficit had not been accompanied by any significant change in the private sector savings/investment balance. He would have also been interested in a discussion on the possible impact of such factors as a reduction of taxes and inflation on private sector savings and investment behavior. In addition, the present upswing had been accompanied by a rapid change in the structure of demand and production that had accentuated regional problems. Such problems had recently been a considerable focal point in the discussion of macroeconomic issues such as tax reform and trade policy and therefore merited further analysis. The change in demand had also been reflected in the labor market, where employment in the service sector had increased rapidly, while job opportunities in the industrial sector had decreased. In view of those shifts in employment, a discussion on labor market flexibility in the United States and the employment situation would have been valuable, especially for those whose unemployment rate was above average.

He welcomed the authorities' basic attitude on trade policy, Mr. Lundstrom remarked. However, like other speakers, he was concerned about protectionist currents, which had not been as strong since the 1930s. A main feature of the trade policy debate was the alleged need to strengthen U.S. trade laws. The recent Omnibus Trade Bill, designed to cope with unfair trade practices, constituted a deviation from earlier principles. On the contrary, it was gratifying to learn about that day's vote on the Jenkins Bill. Furthermore, the United States was actively working to launch a new trade round within GATT. Preparations for the GATT Ministerial Meeting in Uruguay were currently under way. He hoped that the United States recognized the need for a balanced agenda for the new GATT round, which was attractive to all participants, including the developing countries. The outcome would be determined to a large extent by the performance of the United States, not only in the preparatory process but also in its actual policy. It was crucially important that the Administration resisted domestic protectionist pressures.

In contrast to his usual practice in Article IV consultation discussions, he would refrain from making a comment on official development assistance performance, Mr. Lundstrom said. He simply would note that he fully shared the views expressed by Mr. Leonard and many others on the subject. In closing, he would echo a few points made in Mr. Dallara's earlier statement. The mixed outlook--which was an understatement--for the world economy demonstrated the importance of U.S. policies and performance on world economic progress and also suggested that their effectiveness depended upon the willingness of other countries to follow policies aimed in part at addressing global concerns. In current circumstances, the pressing need for effective multilateral economic cooperation was clearly evident. For example, the federal fiscal deficit was a potential threat not only to the health of the U.S. economy but also to the world economy as a whole. He hoped that the authorities would not allow the staff's projections of a $100 billion fiscal deficit in FY 1991 to materialize but remained fully committed to the objectives of the Gramm-Rudman-Hollings Act. Clearly, there was a real prospect of a major setback for the free trading system. That prospect could be avoided only by cooperative multilateral action, including direct action in trade policy. He agreed with Mr. Dallara that "the course that can lead to a correction of U.S. economic difficulties in a manner consistent with world economic prosperity has become a rather narrow and perhaps treacherous one. This course can only be successfully navigated if the United States is joined by other major industrial and developing countries in tackling global imbalances." It was comforting to note from that day's discussion that there was broad agreement on what that course should be.

Mr. Huang recalled that 1985 had been a year of slow growth for the United States, with large imbalances being registered both in its domestic and external economies. GNP had grown at 2.2 percent in 1985 compared with an annual rate of almost 7 percent during the first phase of the recovery. To a considerable extent, that slowdown had reflected both a reduction in the growth of business investment and residential construction, as well as a deterioration in the current account. However, there had been improvements in inflation, which had slowed during 1985 because the effects from the weaker dollar had been more than offset by the drop in oil prices. The consumer price index for December 1985 was only 3.8 percent higher than the previous year; the unemployment rate, also by the end of the year, was below 7 percent. In addition, problems of an overvalued dollar had been corrected to a great extent by a sustained drop in the dollar from its peak of March 1985. Unfortunately, in spite of those events, the U.S. economy had continued to face enormous imbalances on the domestic and international fronts, which had resulted in huge fiscal and trade deficits the previous year. Both the budget and the trade performance had further deteriorated since the beginning of 1986.

The huge federal deficit had expanded rapidly during the early part of the 1980s and had created enormous money demand that resulted in unusually high interest rates, an overvalued dollar, and tremendous capital inflows, Mr. Huang continued. Consequently, not only the U.S. economy but the world economy suffered from those adverse impacts. In 1985, it appeared that the Administration's fiscal stance had remained expansionary. The federal budget deficit had increased from $185 billion in 1984 to $212 billion in 1985, bringing the ratio of the federal deficit to GNP from 5 percent to nearly 5.5 percent and the ratio of the federal debt to GNP from 35.5 percent to 38.5 percent. Since mid-1985, the authorities had been trying to find ways to reduce the fiscal deficit, and their efforts had led in December 1985 to the passing of the Gramm-Rudman-Hollings Act. Even though there had been many different assessments, both positive and negative, on the fiscal correction plans contained in that Act and even though the legality of a key provision was subject to examination by the Supreme Court, he felt that the authorities' determination and efforts in trying to reduce the fiscal deficit were commendable.

He agreed with the staff that the best way to reduce the deficit from the standpoint of overall economic efficiency was to restrain federal spending, and revenue increases might have to be considered as well, Mr. Huang went on. Some analysts had also suggested that recent drops in oil prices provided a good opportunity for the Administration to raise revenues by increasing taxes on oil consumption so that part of that price reduction could narrow the fiscal gap and part could subsidize domestic oil production. That suggestion had merit provided that economic growth picked up in the second half of 1986.

Efforts to reduce the fiscal deficit should not slacken, Mr. Huang remarked. In recent years, the authorities had been lulled into a false sense of security by the lower inflation level and had taken on huge debt.

Moreover, the Administration might be shifting away from focusing on the fiscal deficit as its main concern and placing more emphasis on the trade deficit. That development would be dangerous and erroneous because huge fiscal deficits might trigger rampant inflation at any moment.

The trade deficit had widened to $148 billion in 1985, and several factors had played a part, Mr. Huang noted. For instance, a number of U.S. products were unable to compete in the world market or the domestic market because of an overvalued dollar, one of the major causes for the huge U.S. trade deficit. In order to reduce the deficit, the Administration had depreciated the dollar; however, 18 months had already passed, and at present the trade performance had worsened rather than improved, even though by April 1986 the dollar had depreciated against the yen and the deutsche mark by about 30 percent. Currently, the trade deficit was running at an annual rate of nearly $170 billion. Many analysts were puzzled by that situation since the adverse consequences of the currency depreciation had existed longer than the J-curve would indicate.

There had been many explanations as to why the sharp depreciation of the U.S. dollar had failed to improve trade performance, Mr. Huang commented. It had been argued that one of the major points that needed to be stressed was that, to date, the dollar had depreciated sharply only against a few major currencies. If the dollar's trade-weighted decline was calculated against a select 25 currencies--many of which were tied closely to U.S. dollar, it would probably be found that the dollar had only slipped about 5 percent. In light of that, attempts to drive the dollar further downward would not be helpful because the dollar-linked currencies would simply keep pace. The fundamental cause of the bad trade performance lay in the fact that U.S. productivity growth had lagged far behind that of other major industrial countries. For example, U.S. manufacturers had increased the rate of productivity growth from 0 percent to 3 percent during the previous three years, while Japan had registered an 8 percent annual rate over a longer period. Some analysts had pointed out that they doubted that U.S. manufacturers could sustain even the present 3 percent rate of productivity growth because the proposed tax reform legislation was likely to retard capital formation and further slow U.S. progress in that area. He was pleased to learn from Mr. Dallara that the tax reform would preserve incentives for capital formation. At any rate, the productivity issue was a long-term problem and one that should be given clear priority.

As for short-term policies, the crux of improving the trade performance lay in expanding exports not in protectionist measures that limited imports, Mr. Huang considered. If it was difficult for U.S. companies to increase their exports to Japan or other major industrial countries, they always had a ready and potentially huge market in the developing countries. Unfortunately, those countries were short of the foreign exchange needed to pay for those imports, even though the products were often in short supply and greatly needed. In that context, any protectionist measures taken by the Administration such as restrictions against textiles and other products from those countries were bound to ultimately affect and damage U.S. exports and were not in the best interest of the U.S. economy. Also, of course, protectionist measures and trade restrictions were not in line with the policies of free trade proclaimed by the U.S. authorities. He supported the staff's stance to urge the United States to reaffirm its resolve to resist protectionism.

Recently, the Administration had appealed to Japan and the Federal Republic of Germany to stimulate their economies in order to provide a bigger market for U.S. products and to prevent a severe economic world recession, Mr. Huang said. Working out a program of acceptable trading practices by and among the three major industrial countries was a very important issue. The United States, Japan, and West Germany must play a significant role in assuming responsibility for maintaining world economic stability. It should not be ignored that somber clouds were gathering over the U.S. economy. For example, the Administration's earlier forecast that the economy would grow at a rate of 4 percent that year had already been revised downward. The growth rate for the second quarter had unexpectedly dropped to 1.1 percent annual rate, retail sales had been sluggish, housing investment had slipped, industries' utilization of capacity had dropped to 75 percent, and corporate and personal bankruptcies were up 62.5 percent over the previous year. All those factors indicated that the U.S. economy might need stronger stimulus in order to avoid a new slump if there was no firm increase in the growth rate for the second half of 1986.

The staff representative from the Western Hemisphere Department remarked that there had been several questions about the staff's forecast for a 4 percent annualized growth of real GNP in the second half of 1986, a figure that was close to that of the Administration. Total domestic demand and final domestic demand had been considerably stronger than GNP for some time; for example, final domestic demand had been rising at an annual rate of 3 1/2 percent or more. Even in the second quarter of 1986, when real GNP had slowed to a little more than 1 percent, final domestic demand had risen by approximately 3 3/4 percent, if adjustments were made for certain erratic movements related to transactions by the Commodity Credit Corporation. Thus, the domestic components of final demand had been fairly strong, particularly personal consumption and residential investment. The weakness in the second quarter had come largely from inventory investment and the foreign sector.

Inventory investment was unlikely to continue to be weak in the second half of 1986, the staff representative continued. Furthermore, on the basis of the exchange rate developments since early 1985, the foreign balance should strengthen in real terms--at least, that development was suggested by historical relationships between trade flows and exchange rates. However, it was true that such an improvement was not yet visible in a dramatic way in current indicators. Indeed, economic activity might continue to be sluggish in the second half of 1986 for two reasons. The lags in the response of consumption to the decline in oil prices and of the real trade balance to the real exchange rate depreciation might take longer than suggested by historical relationships, which would postpone the strength until early 1987. Also, strong growth simply might not occur; however, economists would then have to explain why declines in oil prices and interest rates and the depreciation of the dollar were not having the effects that they had had historically.

In sum, current economic indicators did not point to a substantial pickup, the staff representative went on. Nevertheless, the staff's forecast was based on the fundamentals--the pattern of interest rates, of oil prices, and exchange rates--and those indicators led the staff to believe that in the near term there would be an improvement, if not in the second half of 1986, at least in early 1987.

A question about the contribution of the oil price decline to economic growth in the United States had been asked by Mr. Finaish, the staff representative recalled. The staff's interpretation was close to that of the Administration. The oil price decline initially had had an adverse impact on certain areas of the economy; however, after negative effects in Texas and Oklahoma, at some point positive developments would presumably occur in New York and New England. Indeed, some of these positive effects might already have come through. Real disposable income had already risen, and as noted earlier, personal consumption expenditure had been fairly strong. The Administration had estimated that the drop in oil prices would raise the level of real GNP in 1986-87 by 1-1 1/2 percentage points compared to what it otherwise would have been, and the staff agreed with that estimate.

Several speakers had noted that the staff had a significantly weaker medium-term outlook than the Administration, the staff representative commented. Mr. Arias had observed that the staff might be wrong because the authorities might be able to pursue more expansionary policies than the staff had been projecting. However, it was not a matter of pursuing expansionary monetary or fiscal policies. Such policies would help only to increase the degree of capacity utilization--a source of growth for which the staff had made generous allowance in the simulation presented in Appendix VI of Supplement 1 to the recent economic developments paper. Expansionary demand policies would not yield more capacity output. More capacity output would come only out of higher productivity, labor force growth or capital formation. Those were the issues on which Appendix VI had concentrated.

Questions had been raised about the possible macroeconomic effects of tax reform, the staff representative recalled. There were two aspects to the question, and one was a timing problem. The tax proposals envisaged that cuts in personal tax rates would be phased in over a period of approximately two years, whereas preferential tax treatment would be eliminated early in 1987. That difference in phasing would produce an initial increase in net revenue, and, hence, presumably a decline in personal disposable income. However, the initial increase in revenue would be offset later on by an approximately equal decline in net revenue. The Congress was aware of the issue, and presumably it would act to modify the timing of the implementation of the measures in order to avoid that particular problem. Also, there was the question of the effects of tax reform on the economy independent of the issue of timing, in which case it was necessary to distinguish between consumption and investment. It was clear that consumption would rise in response to the decline in marginal tax rates on personal income, a development that was likely to offset the effects on personal disposable income and consumption of elimination of certain personal tax preferences.

The effect of tax reform on investment was more difficult to predict, the staff representative said. First, there would be an increase in efficiency in general, as the elimination of tax preferences would level the playing field by equalizing effective real rates of return among different types of investments. That increase in efficiency might not be strong in the short term, but would become more important over the medium term. Second, there was the issue of what might happen to the cost of capital on the average. There was not enough information at this point to answer that question with certainty. However, on the basis of the numbers indicated in the proposals, the cost of capital probably would drop in the case of structures because of lower corporate tax rates and because of somewhat generous depreciation allowances. But the cost of capital would likely rise in the case of equipment because the elimination of the investment tax credit would more than offset the cuts in statutory corporate tax rates. It was a good guess that the cost of capital on average would rise somewhat, particularly under the House proposal. Overall, the near-term impact of tax reform in the economy was likely to be rather modest. Once the final plan emerged from Congressional evaluation and more complete data were available, it might be possible to say something more definite about its effects. Nevertheless, it was a difficult area from the standpoint of empirical analysis, because the estimates of the effects of tax changes on various categories of investment were extremely sensitive to the specific type of investment equation used in the model. Consequently, even after all the numbers were known, it was likely that one would find a variety of estimates with a fairly wide range.

Whether it was appropriate for the United States to have a balanced budget at each period of time was a point that had been raised by Mr. Sengupta, the staff representative continued. There was not a consensus in the economic profession as to precisely what should be the path of the deficit over time, because there was not a consensus as to what should be the optimal level of the government debt in relation to GNP. Undoubtedly, there were considerations that went beyond economic analysis, which had to do with value judgments about what the size of the government and the degree of government action in the economy should be. What could be said with some confidence was the following: if a country needed more capital formation and if at the same time it wished to reduce its absorption of savings from abroad and if it did not have an extraordinarily high private savings rate, then there was little doubt that the government deficit had to be reduced substantially. Over the long term, there was virtue in the notion of a budget balanced across the cycle, with periods of fiscal deficits and economic sluggishness giving way to fiscal surpluses and above-average growth. Thus, a balanced budget would provide a degree of automatic macroeconomic stabilization. However, for many years, the picture in the United States had been of high deficits giving way to even higher deficits regardless of the state of the economy.

A question had been asked by Mr. Leonard about the limited impact of the growing net external debt of the United States on investment income after 1988 in the context of the simulation presented in Appendix IX to Supplement 1 of the recent economic developments paper, the staff representative went on. It was true that the external debt of the United States rose significantly in all of those scenarios. However, U.S. investment income was influenced not only by the size of the external debt but also by a number of other factors peculiar to the specific financial structure of the U.S. balance of payments. First, it had to be noted that there was a spread between the interest rate paid on U.S. portfolio claims and the interest rate paid by the United States on its portfolio liabilities. Specifically, U.S. portfolio assets were typically bank loans, advances, and acceptances; and, hence, carried a significantly higher interest rate than U.S. liabilities, which were predominantly in the form of treasury bills and securities, certificates of deposit, and other bank deposits. Furthermore, even though the external debt was expected to rise in the projected horizon, the United States would continue to have a sizable credit position with regard to direct investment as opposed to portfolio investment; and the rate of return on direct investment was considerably higher than the interest rate on either portfolio assets or liabilities.

In addition, when exchange rates were projected to change in a simulation, it was particularly important to distinguish between portfolio investment income and direct investment, the staff representative noted. In the context of the simulations in Appendix IX, the accumulation of foreign debt led to a deterioration in the portfolio income account in all simulations. To give an example that was not included in the Appendix: in the context of Scenario A, the deficit on portfolio investment income would widen from $7 billion in 1986 to $21 billion in 1991. However, unlike portfolio investment, direct investment income, as treated in the U.S. balance of payments, was greatly influenced by valuation changes stemming from exchange rate changes. Indeed, as indicated in the Appendix on page 72, the investment income accounts strengthened as one moved from Scenario A--constant real exchange rate--to Scenario D--15 percent real depreciation--in part because of the effect of the depreciation on direct investment income receipts. In contrast, Scenario G on page 73 of the Appendix was based on the exchange rates prevailing in early 1985, and it showed a substantial deterioration in the investment income balance. Finally, the sizable accumulation of the U.S. external debt over the forecast period in all of the simulations was partly attenuated by the underlying assumption of declining interest rates.

A question about J-curve effects on the staff's projections for the current account had been posed by Mr. de Groote, the staff representative commented. The staff did have a J-curve effect in its forecast for the trade balance, which was illustrated by the fact that the trade deficit of the United States was projected to widen from 1985 to 1986 in spite of a $20 billion reduction in oil imports. Mr. de Groote had also referred to a Federal Reserve study that suggested considerable absorption of exchange rate effects by foreign producers. The staff agreed with that finding. The limited analysis that the staff had done so far also suggested that to an unusual degree, foreign exporters had narrowed profit margins to absorb the effects that the appreciation of the currency would have had on their share in the U.S. market. There were two additional considerations, however. The numbers for April and May showed large increases in U.S. import unit values, suggesting that sizable competitive effects might still come in the period ahead. Furthermore, there were considerable problems with the monthly numbers on U.S. import unit values for a variety of technical reasons. Hence, conclusions about import prices or volumes must be made with considerable caution until the Bureau of Economic Analysis of the U.S. Department of Commerce came forth with the final revised version of the U.S. balance of payments and trade balance, in which an effort would have been made to adjust the import deflators to take account of some of those measurement problems.

A number of questions in the agricultural area had been raised by Mr. Rye, the staff representative noted. One of those was the proportion of U.S. farmers needing price support. It was difficult to provide that figure because it was impossible to categorize precisely the need for farm support. What could be said was that approximately 20 percent of U.S. farmers were facing a problem of insolvency resulting from both high debt and weak market conditions. Conversely, some 80 percent of U.S. farms were judged to be financially solvent with low debt relative to assets and positive cash flow. Mr. Rye had also asked what proportion of U.S. farmers would be competitive in the international market in the absence of government support. The answer to that question should include the absence of government support both in the United States and abroad; otherwise, a significant asymmetry would be introduced. He did not have a specific answer to the question, nor was he aware of studies by the U.S. Department of Agriculture on the issue. If all restraints were abandoned, U.S. sugar producers, for example, would have to yield to lower cost producers elsewhere. However, it was not necessary to be an expert in agriculture to understand that if all government support and subsidies were abandoned for products such as wheat, corn, barley, and soya beans, the United States would be exporting more and Europe would be exporting less.

He wanted to assure Mr. Rye that it was not the staff's intention to justify U.S. farm programs in Appendix I, the staff representative remarked. The Appendix was an attempt to put together available material on the major causes of the current difficulties faced by U.S. farmers. One of the main causes of those problems was the tendency of U.S. farm programs to create and perpetuate excess supply conditions, a fact that was brought out very clearly in the Appendix. In fact, Mr. Rye and Mr. Nebbia had said that the staff was not sufficiently critical of U.S. farm policies. He would refer them to page 25 of the staff report where the staff had pointed out that U.S. farm policies at times had had adverse effects on the interests of other countries. Specific reference had been made to the subsidies to domestic producers of ethanol from corn and to the U.S. sales of beef to Brazil in connection with the Dairy Termination Program. Indeed, discussions with the authorities on those issues had been active and critical; for example, on page 28 of the staff report, "Administration efforts to correct the problem of chronic excess supply and to control the budgetary cost of U.S. farm programs have had only limited success, and major reforms are still needed....The staff urges the United States to be cautious in the administration of its farm programs so as to minimize the risk of harming the interest of other countries."

An observation had been made by Mr. Foot that the staff papers did not pay sufficient attention to the problems facing the U.S. banking system, the staff representative stated. In fact, the staff had addressed a particular aspect of that problem, namely, the financial implications for the banking system of the difficulties faced by the U.S. farm sector--on pages 11 and 13 of Supplement 1 to the recent economic developments paper. However, according to the bank regulators, the system-wide impact of the difficulties of the farm sector--as well as those of the energy sector, incidentally--had been on the whole relatively minor. Mr. Foot had also mentioned foreign aid as an area that might have been dealt with more thoroughly. He assured Mr. Foot that in the coming year the staff report would include a more comprehensive appendix on official development assistance.

In the same vein, Mr. Lundstrom had said that he would have welcomed a discussion of structural aspects of the U.S. economy other than agriculture, in particular, savings and investment, the staff representative continued. He would refer him to two appendices to the previous year's staff report. One was on investment and dealt in particular with technological developments in the area of information processing and the impact of interest rates, the cost of capital, and changes made by the Administration to accelerated depreciation and other aspects of taxation that influence investment. Also, there had been a supplement to the previous year's recent economic developments paper that had contained an appendix on the behavior of private savings in the United States, emphasizing the estimates of the sensitivity of savings to changes in interest rates.

As for the measures adopted earlier in the year by the United States regarding trade with Libya and the blocking of Libyan assets, he would add nothing to the issue other than to refer Directors to Appendix VII of Supplement 1 to the recent economic developments paper, the staff representative from the Western Hemisphere Department said. On January 31, the Executive Board had examined the Libyan complaint (EBM/86/17) and had concluded that it did not uphold the complaint. The Board had not challenged the U.S. notification of restriction imposed for security reasons by the United States under Decision No. 144-(52/51). The staff had been in touch with the U.S. authorities to ascertain that there had been no further changes in those measures. As he understood it, therefore, the staff was under no obligation to take up the matter with the authorities during the consultation.

Mr. Dallara remarked that he had noted no reduction in the intensity of Directors' concern about the U.S. federal deficit. He also had observed that there was increased concern about U.S. agricultural and trade policies and a greater appreciation--as he had also seen with his own authorities--of the need for those problems to be solved on a multilateral basis.

His authorities were grappling in Congress with what was called the reconciliation process for the 1987 fiscal year budget, Mr. Dallara continued, an effort that would be made somewhat more difficult, although not substantially more so, by the revised economic projections that had been put forward that day. The budget resolution for FY 1987 that had been passed previously, containing a target figure of $144 billion for the deficit, was a statement of principle. It was the process of reconciling that statement of principle with the actual budget authority measures taken by individual committees that was currently under way in Congress. Considerable progress had been made, although the House had to finalize its efforts, then the focus would be on the Senate; the appropriations process would follow. In sum, the Board had discussed the broader parameters of those problems, the details of which were being addressed at the moment by his authorities.

Several speakers had mentioned the need to consider revenue increases in that connection, Mr. Dallara went on. Once the current tax reform had been accomplished and a fundamentally new approach toward revenue had been put into place, some of the measures alluded to by the staff could be brought to the notice of his authorities. One such measure, for example, concerned the tax exempt status of employer contributions to medical insurance premiums.

Consideration had been given to the possibility of an oil import fee, but it was not clear to his authorities that it would serve the interests of continued expansion in the economy, Mr. Dallara noted. An increase in prices of domestically produced petroleum products, would lead to windfall profits that would then need to be taxed away. There would be an increase in the costs of many industries--for example, petrochemical industries, whose competitiveness in international markets would be further eroded. And the effort to correct external imbalances, as well as to support continued expansion in the economy, would be undermined. Indeed, a point had been made in earlier discussions that such a measure, even if it were at the outset to produce additional revenue, would reduce the positive effects of passing through those price declines into the economy and, overall, might not produce anything like an equivalent reduction in the deficit. For example, the passage in 1982 of TEFRA and related legislation, which had increased revenues in the United States, cast some doubt on the extent to which revenue measures would lead over time to an actual reduction in the deficit. The politics were such that increased revenues reduced the pressure on some decision makers to tackle difficult areas of expenditure.

More generally, it was not at all clear that the U.S. budget deficits were out of line, Mr. Dallara said. Revenue as a percentage of GNP was not far from historical levels. In the long term, receipts were projected to average 18.9 percent of GNP between 1988-91, compared with an historical average of 18.3 percent. Clearly, it was expenditures that were out of line--in the range of 3-4 percentage points above the historic average. In some areas his authorities had emphasized expenditure reduction, but without enough success. However, some important decisions to reduce medium-term defense expenditures had been taken. In general, the approach firmly adopted by President Reagan and the U.S. authorities was more likely to force the political process to come to grips with expenditure issues than an increase in revenue would. Indeed, it had been noted by senior officials in the Treasury Department during the final meetings with the Fund staff representatives and the Managing Director that the political dynamics were such that the problem of revenue increases should not be expected to be fundamentally addressed in congressional election years. Moreover, there was the danger that the issue of revenue increases might sidetrack the developing political consensus for major expenditure reductions. In spite of the Gramm-Rudman-Hollings Act, it was not certain that that consensus was firmly and permanently established. Although considerable progress had been made in the previous year, it would be a mistake to undermine it.

Concerning tax reform, although timing considerations might affect the initial results, his authorities remained confident that the reform would have a positive effect on the economy over the medium term, Mr. Dallara commented. Indeed, it could reasonably be expected to increase the supply of labor through its direct supply-side effects. Furthermore, at present, both consumption and investment decisions were clearly not always made on the basis of economic welfare or efficiency--one example being fringe benefits, which were preferred over straight income because of their preferential tax treatment. The medium-term positive effects of tax reform were particularly important when one considered the differences between the staff and his authorities on medium-term growth prospects. Those differences perhaps merited further scrutiny in the next Article IV consultation with the United States. Indeed, he was not certain that the issue had been addressed in the detail that it fully deserved in the present consultation because it was foreign to what was considered by some to be the most effective medium-term strategy for dealing with the fiscal deficit and the external imbalances.

The staff had stressed the important relationship between potential growth and productivity on one hand and capital accumulation on the other over the medium term, Mr. Dallara recalled. However, he believed that tax reform--through the encouragement of more rational investment decisions and regulatory actions--would induce a more efficient use and creation of capital in the coming years. Furthermore, although the staff had suggested that the 4.5 percent annual rate of growth of capital stock over the medium term was high, the average growth of capital stock in the period 1948-81 was in the range of 4 percent. He mentioned those details because the question of growth in capital stock and productivity was important. In addition, whereas the methodology used by the staff in making the estimates was certainly valid, it was not entirely clear that full account had been taken of the changes that had occurred in the quality of the labor force over the years. Indeed, some very interesting analyses had been made of that particular issue--for example, the changes in the age profile. The baby boom era in the U.S. economy had passed, and it was no longer true that one skilled worker was being replaced by two unskilled teenagers. The current era was highlighted by a higher female participation in the labor force, and in general, the work force was more highly educated. It was not clear to his authorities that those factors had been taken into account by the staff. It was an issue worth further exploration in the coming months and in next year's Article IV consultation with the United States.

Several speakers had stressed the risks that were currently involved in monetary policy, Mr. Dallara went on. In the consultation discussions, his authorities had not disputed those risks; however, they existed in both directions and the Administration believed that the current approach was the most appropriate one. They had not resigned themselves to an increase in inflation. Indeed, there was a continued firm commitment to a gradual scaling down of the rate of growth of monetary aggregates. The targets for M1 understandably had been left in the 3-8 percent range, but the targets for both M2 and M3 for 1987 had been scaled down. The inflation forecast represented by the GNP deflator that was contained in the statement he had circulated that morning was further witness to the commitment of his authorities to follow policies designed to achieve a continued reduction in the rate of inflation. His authorities were well aware of the potential inflationary impact of the earlier exchange rate movement, particularly as price adjustments became more evident and as it became clear that the effects of oil price changes were only transient.

He had found the staff's medium-term scenarios for the external account in Supplement 1 to the report on recent economic developments extremely useful, Mr. Dallara continued. The absence of such scenarios from the staff reports for the 1986 Article IV consultation with Germany had been noted earlier that week (EBM/86/126 and EBM/86/127, 8/1/86). He recognized the constraints on the staff, but it was important to have as clear a view as possible of what lay ahead in the medium term on the basis of different policy assumptions. Consideration should thus be given to developing similar scenarios for Germany and Japan, and possibly other countries.

A number of speakers had asked why the external adjustment of the U.S. position had been so slow, Mr. Dallara noted. The important linkage among all economies and the difficulties that any country faced in reducing its external deficit was demonstrated by the developments vis-à-vis one of the United States' most important trading partners--Canada. Over the period 1980-85, the real exchange rate for the Canadian dollar, on a trade-weighted basis, had not changed against the U.S. dollar. Over that same period of time, however, the bilateral trade deficit between Canada and the United States had grown from $1.3 billion to $17.3 billion. He was not suggesting that the Canadian authorities had manipulated the exchange rate or taken an unfair advantage. Indeed, all evidence suggested that they had followed a rather freely floating exchange rate policy during the period. The factors underlying the relative weakness of the Canadian dollar during that period were more likely to have been a less favorable inflation performance; a large budget deficit; and some lack of confidence in the currency--in the view of his authorities as well as some segments of the market place--owing to the foreign investment policies of Canada.

However, substantial progress had been made in terms of the movement of the U.S. dollar exchange rate against a number of currencies other than the Canadian dollar, Mr. Dallara considered. It was difficult to predict future developments; many factors operated on the U.S. dollar exchange rate, as the particular case of Canada demonstrated, and many of them were beyond the control of his authorities. Furthermore, many speakers had agreed that the exchange rate could carry only so much of the burden of promoting adjustment, although somewhat paradoxically they did not believe that their economies could pursue a more rapid expansion without running substantial exchange rate risk. Indeed, there were only so many options available. He agreed with Mr. Polak that one must be cautious in making public comments about exchange rates in an effort to induce policy changes. Nevertheless, it was fair to say that his authorities had made every effort to pursue the matter through a cooperative channel, as reflected in the agreement made in Tokyo earlier in the year. Some public comments that had been made in the United States were a reflection of the frustration and of the perception that, although further substantial exchange rate changes might not be the best course, it might be the only one to follow in the absence of other policy adjustments. Officials of other countries had also been commenting publicly on the exchange rate in recent days. For instance, the German Minister of Finance had indicated that there were dangers in a further dollar decline, although he had declined to suggest a target for the dollar/deutsche mark rate. Obviously, exchange rate developments were too sensitive to be the subject of public comment, and he hoped that all countries would make use of the cooperative and more confidential channels that were being developed.

There was no notional target for the medium-term current account or view on the part of his authorities as to the sustainable level of international indebtedness, Mr. Dallara said. In fact, there were many different ways to define what might be an appropriate U.S. current account position, and unfortunately there were no empirical methods to determine balance of payments sustainability. His authorities had closely followed the shift in U.S. international indebtedness. However, even the ratios of external debt to GNP that had been incorporated into the worst case scenarios presented by the staff were considerably lower than the external debt to GNP ratio of a number of other major industrial countries, including a number of Scandinavian countries. Furthermore, the dollar was a reserve currency, and the United States did not have to earn foreign exchange to service its external debt.

Many speakers had made the comment that the authorities should resist protectionist pressures more strenuously, Mr. Dallara continued. In fact, it would have been impossible for the President and his authorities to strive any more strenuously than they had in recent days to resist congressional efforts to override the President's veto of the textile legislation. Moreover, a number of measures that had been taken were in lieu of worse alternatives. For example, the decision to sell wheat to the Soviet Union, which from some perspectives might not be particularly attractive, had been taken instead of subsidy legislation that would have had a more extensive and deleterious long-term effect on grain markets. That day's veto in the U.S. Congress of textile legislation was of fundamental importance to the world trading system, because it might be indicative of a change in direction in the political arena.

While he would convey the many comments on U.S. agricultural policy to his authorities, it was essential to recognize the adverse circumstances that had characterized the U.S. agricultural sector in recent years, Mr. Dallara stressed. While productivity per hour over the previous six-year period had increased 16 percent, farm employment had declined substantially: 400,000 jobs had been lost since 1979 in the agricultural sector, and real net farm income had been reduced by almost half since 1981. Directors from developing countries, which had experienced declines in per capita income, would appreciate what the developments in the agricultural sector of the United States had been like in recent years. At the same time, the members of the agricultural community had, in spite of extensive support programs, witnessed international bank lending flows that they believed would have been beneficial, had such flows been directed to them. It was true that the United States had many support systems in the agricultural sector, but it had been some time since a "new money" package had been raised for the U.S. agricultural community.

As to whether or not the staff had been critical enough of the agricultural sector, Mr. Dallara considered that the Appendix on U.S. agricultural policies was all the criticism that was needed. He could confirm that agricultural policy as a whole had been extensively and aggressively explored in the consultations.

It was clear that agricultural problems in the world economy must be solved multilaterally, Mr. Dallara commented. He recalled that during the Tokyo economic summit, his authorities had put forward a paragraph on agricultural policies for inclusion in the communiqué. The initial reaction of other participants at the summit had been negative. Ultimately, a paragraph had been included acknowledging both the inefficiencies and dangers of the agricultural policies of many industrial countries, and it suggested the need for action. Furthermore, his authorities had been most eager to include agriculture among the other issues to be taken up in the new GATT round. Again, that request had been met with resistance by the European Communities. None of the problems would be resolved in the absence of multilateral negotiations, and it was difficult to see how the United States could tackle its problems if there was a reluctance toward international discussion.

More generally, his authorities had placed considerable emphasis on the new GATT round, Mr. Dallara noted. Again, a number of countries, including some of the debtor countries that had a substantial interest in the United States' avoiding protectionist policies, had resisted--for understandable reasons--the inclusion of various items, particularly services, in the new GATT round. But it was unrealistic to expect the United States to come to the negotiating table, if the subjects of greatest importance to it were not to be taken up. In the interests of reinforcing the efforts of his authorities to resist protectionist pressures, he requested those involved to communicate to their authorities the concern of his authorities that the new GATT round should be broadly based.

A number of Directors considered that the staff reports and the preceding consultation discusions had left the impression of a strengthened and more effective surveillance process, Mr. Dallara noted. Indeed, the Fund's consultation with the United States had been a constructive, effective, and important dialogue. He particularly appreciated the role that the Managing Director had played in the discussions. Furthermore, he had noticed the interest expressed by Directors in having a special consultation or a semiannual surveillance of the U.S. economy. In that connection, he reiterated his suggestion, put forward at an earlier discussion on surveillance, that the major industrial countries--as many perhaps as 25--submit to the Fund a report at the midpoint of the annual consultation cycle on any actions that they had taken in response to the previous consultation. That suggestion had not met with a great deal of sympathy, but he felt that it was worth further reflection. Such special consultations should be conducted multilaterally. Certainly, his authorities looked forward to the first multilateral surveillance session with the Managing Director, following the Tokyo summit meeting, which was scheduled to take place in the coming months.

Comfort had been taken by Mr. Lundstrom in the U.S. authorities' agreement with the staff's broad strategy for addressing current U.S. economic problems, Mr. Dallara remarked. However, other key countries involved in resolving the current difficulties facing the world economy continued to see them as largely U.S. problems. For example, Mr. Grosche and Mr. Fujino, among others, had emphasized that whatever economic measures were taken by Germany and Japan in the period ahead, they would not make a substantial dent in the U.S. current account deficit. Factually speaking, he would not disagree with that statement. However, just as the reduction in the U.S. fiscal deficit might not be sufficient to resolve all existing imbalances, actions by other countries were essential even though they would not solve all problems. He hoped that by following through effectively on the commitments that they had made, his authorities would cause others to redress existing imbalances in a way that was in the interest of the world economy.

Mr. Nebbia said that he appreciated the difficulties of the agricultural sector in the United States. As both Mr. Dallara and the staff recognized, a parallel could be drawn between the situation of the U.S. agricultural sector and developing countries that were heavily indebted. Indeed, the staff's presentation of the U.S. farming sector threw new light on the problems of the debtor countries. As was stated in Appendix I on the U.S. farm sector "The crisis in agriculture, which developed rapidly over the last several years, was largely unanticipated and came on the heels of a major boom, beginning in the early 1970s, that had given rise to a substantial increase in agricultural earnings and exports." That statement was applicable in every sense to indebted countries. Moreover, the indebted countries in his constituency would have preferred to be treated like U.S. farmers--in terms of interest rates, income, and an opportunity to solve their problems--than the treatment they had received as indebted countries.

Mr. Dallara noted that while he appreciated Mr. Nebbia's position, the loss of almost half a million farming jobs in the previous six years was a development that he would not wish on any country.

Mr. Finaish said that he would like to return to the question of U.S. restrictions against Libya. The staff had said that it had ascertained that there had been no further changes in those restrictions. Therefore, the staff representatives had seen no obligation to raise the question during the consultation. It was his understanding that according to Rule H-1 of the By-Laws, Rules, and Regulations--which read, "The Fund shall keep all exchange controls under review and shall consult with members with a view to the progressive removal of exchange restrictions in accordance with the Fund Agreement"--Fund missions raised the question of restrictions--whether they were old or new, changed or unchanged, approved or not approved. Missions raised that question with the aim of the progressive removal of them according to the principles of the Fund. He was not asking the staff to insist on changing the position of the U.S. authorities but would simply like to know whether the question had been raised at all at the consultation. What was the general practice of the Fund on the issue?

The Director of the Exchange and Trade Relations Department confirmed that he was aware of the desire of the Libyan authorities to keep the issue of U.S. restrictions under review. However, the staff representative from the Western Hemisphere Department had described the position correctly. Because restrictions approved by the Executive Board under Decision No. 144-(52/51) had no time limits, the staff was circumscribed in its action. The issue was different to that of restrictions temporarily approved under the general policy on exchange restrictions. Moreover, the Executive Board had not agreed to request to keep the matter under review. Nevertheless, Mr. Finaish might have in mind another basis--that the Executive Board had expressed a hope that it would be possible for the good offices of the Fund to be used. Consequently, Mr. Finaish had been assured that that possibility would be kept in mind by the staff if a change in circumstances permitted such good offices to be used. But at the time of the consultation, the circumstances had not permitted such a staff role.

Mr. Finaish said that the question he was posing was whether it was not the normal practice that staff missions raised the question of restrictions. In the case under discussion, restrictions existed and there was a rule, which referred to all exchange controls without any exception; yet those restrictions had not been taken up at all during the consultation. When Fund missions came to any of the countries that had elected him, they always singled out restrictions, such as bilateral agreements, and demanded to know what was being done to eliminate them.

The Chairman remarked that the Executive Board had not objected to, and therefore approved, exchange measures taken by the United States involving the payments or transfers to Libya upon the invocation by the United States of Decision No. 144-(52/51), which applied to restrictions imposed for national and international security reasons. The Executive Board's approval meant that the staff could not press the issue of removing those restrictions. The approval had been granted for an indefinite period, and the provisions of Rule H-1 did not apply in that case.

Mr. Finaish commented that he was not fully satisfied with the staff's response to his question. The Fund should take a clear view on the matter, which had both legal and policy implications. Was the staff under no obligation at all to raise the question of restrictions at the consultation?

The Director of the Exchange and Trade Relations Department--in response to a comment by the Chairman that the staff could look into the legal aspects of the question--noted that he did not think there was any doubt on the legal question. The Board had considered the matter thoroughly, and it had approved the practices, without a terminal date for the approval. Therefore, it was not even appropriate for the staff to bring up the issue as if it had not been acted on by the Board. As he understood Mr. Finaish, he was saying that there was hope in the present discussion for a way to resolve the problem. The staff would certainly wish to help resolve the problem, but at the time of the consultation, it had not appeared that that was a possibility.

The Chairman then drew attention to Chart 12 of the staff report, which showed that since 1980/81, there had been a significant effort to break the tendency to increase the ratio of revenue to GNP, resulting in the downward curve alluded to by Mr. Dallara. Nevertheless, that development had not produced much restraint on the expenditure side, probably because it was politically easier to borrow than to raise taxes, and borrowing made it easier to increase expenditures. Although an increase in tax revenues might lead to an increase in expenditure, it was also possible to argue that maintaining taxes at a given level and having a somewhat relaxed attitude on the deficit eventually produced a larger tendency to increase expenditures.

Mr. Dallara commented that while the reversal of the trend toward an increase in revenues had not yet induced major reductions in expenditure, the process had begun. It was important to recall that the condition of U.S. defense at the beginning of the decade had been a matter of serious concern not only for the United States but for virtually all of its allies. Currently, the decision had been taken to eliminate for one year and to reduce over time the rate of growth in real defense spending. His authorities were faced with the choice of living with a dangerously high deficit, increasing revenues, or cutting further into defense programs. He was of the impression that the U.S. public had not yet chosen which avenue to pursue. However, there was an awareness at present that had not existed two or three years previously regarding the clear danger of deficits. Indeed, in addition to the actions of Congress and the Gramm-Rudman-Hollings Act, various surveys had demonstrated--somewhat to his surprise--that even the average U.S. citizen was concerned about the deficit. That development was reflected in the actions of Congress, and a political consensus was emerging. It was in part a political, as well as an economic and financial, issue, as to whether or not revenue actions at present might undermine the growing consensus and over time reduce the capacity to contain expenditures. There was no doubt that, as a whole, the level of expenditures was still too large for a healthy economy in the medium term. It was also possible to say that unless deficit spending was dealt with in the near future, there would be a recession. A breathing space had been provided by the favorable reactions to the Gramm-Rudman-Hollings Act, and it was clear that those expectations would be reversed if Congress failed to act.

The Chairman made the following summing up:

Executive Directors agreed with the general thrust of the staff appraisal in the report for the 1986 Article IV consultation with the United States.

Directors observed that the U.S. economy was now in the fourth year of one of the longest economic expansions in the postwar period and that this expansion had been accompanied by continued moderation of wages and prices. In certain respects, moreover, the economic environment faced by policymakers in the

United States had improved in recent months; there had been a sharp fall in inflation, owing partly to the drop in oil prices, and U.S. interest rates had declined substantially. Directors noted, however, that the imbalances that had emerged in the early stages of the recovery--in particular the large fiscal and external current account deficits--continued to be most worrisome. They emphasized that these imbalances had to be addressed squarely if sustained economic growth and further progress toward price stability were to be achieved.

Directors expressed concern about the possible implications of the recent Supreme Court decision regarding a key provision of the Gramm-Rudman-Hollings Act. The action by the Congress to ratify $11.7 billion in automatic spending reductions for FY 1986 that had been invalidated by the Supreme Court ruling was welcomed. Directors took note of the view expressed by the U.S. authorities that there was sufficient political pressure to ensure that the Congress would implement substantial expenditure cuts even in the absence of an automatic expenditure-reduction mechanism. However, the experience of the past several years suggested that the task of curbing federal spending would be a difficult one, and they urged the U.S. authorities to keep the deficit reduction plan on track. The just published upward revision of the FY 1986 federal deficit was noted with concern.

Directors believed that the long-run benefits of the fiscal correction that the U.S. authorities were planning were beyond doubt. Firm implementation of the proposed fiscal adjustments would lead to a lasting reduction in real interest rates in the United States and abroad and, consequently, to an improvement in prospects for capital formation and economic growth worldwide. It would also lead to a more sustainable pattern of saving/investment balances among major countries, which should contribute to greater stability in exchange rates. Directors generally believed that substantial action to correct the fiscal imbalance should strengthen business confidence and--given the prospective effects on economic activity of lower interest rates and oil prices and the depreciation of the dollar--improve the prospects for continued economic expansion.

Many Directors believed that the projections for economic growth underlying the U.S. Administration's medium-term fiscal estimates were on the high side because the rise in productivity and the increase in the capital stock that would be required to support the assumed path of output growth appeared to be somewhat optimistic. This ran the risk of painful correction in the course of policy. They noted that, because of the differences in economic projections, the staff's current services estimate of the fiscal deficit for 1991 was considerably higher than that of the U.S. Administration, implying that substantial additional action would be needed to meet the Gramm-Rudman-Hollings Act deficit targets.

Directors agreed with the view of the U.S. authorities that restraining expenditure was the best way to redress the fiscal imbalance from the standpoint of overall economic efficiency. However, Directors generally believed that given the magnitude of the fiscal deficit, the reluctance to cut certain major spending programs, and the rising burden of interest payments on the public debt, it appeared unlikely that the fiscal problem could be tackled over the medium term solely by acting on the side of expenditure. Thus, while urging the U.S. authorities to intensify their efforts to curb spending, Directors generally stressed that serious consideration should be given to measures to increase revenue. They emphasized, however, that such measures should be carefully chosen so as to avoid harming economic incentives to save and invest.

In light of the importance attached by the Executive Board to effective implementation of the fiscal adjustment path set by the U.S. Administration, Directors thought that fiscal developments should be monitored very closely. A few Directors suggested that, should actual developments deviate significantly from those that would seem consistent with the target for FY 1987, a supplemental consultation might be appropriate. This would have to be seen in a more general context.

Directors welcomed U.S. efforts to achieve a tax reform aimed at increased fairness, simplicity, and efficiency. Several emphasized the need to ensure that the plan finally adopted would not exacerbate the deficit problem by reducing revenue, while others stressed that tax reform should not discourage investment and increase capital costs.

Directors noted that, in light of difficulties caused by increased uncertainty about the behavior of the monetary aggregates, the Federal Reserve had developed a pragmatic and judgmental approach to monetary policy that had succeeded in keeping inflation under control, thereby helping to extend the economic expansion. A number of Directors felt that the accommodative policy recently followed by the Federal Reserve was appropriate, given the relatively sluggish growth of economic activity and the favorable performance of prices and wages. In general, Directors were not overly concerned by the signs coming from M1, which remained well above the upper end of its target range. Other Directors thought, however, that the present policy stance was not without risk and that the underlying rate of inflation in the United States remained above that of some other major economies. They observed that various factors at present were pointing to a pickup in economic growth and some upturn in inflation. In these circumstances, care would have to be taken to avoid a degree of monetary stimulus which might store up problems for the future and to ensure that policy not be overly influenced by short-term developments but rather be guided primarily by underlying trends and medium-term objectives.

Directors said that the real depreciation of the dollar since early 1985 should work to bring about a significant reduction in the U.S. current account deficit relative to what it otherwise would have been. They noted, however, that, on the basis of the present exchange rate, the current account deficit was expected to remain above $100 billion over the next several years. A number of Directors questioned whether the inflows of private capital needed to finance such deficits would be forthcoming for an extended period of time without pressures on interest rates or exchange rates; they thought that a further depreciation of the dollar might well be required in order to achieve a sustainable current account position. A number of Directors felt that exchange rate changes alone could not be relied upon to produce the adjustments that were needed and that higher growth abroad also would be desirable. Directors emphasized that correction of the fiscal deficit was important to an improvement in the current account without adverse side effects on economic activity.

On trade policy, Directors welcomed a number of positive actions taken by the United States during the past year, including the President's decision not to grant relief to the domestic footwear industry and today's action in the Congress to sustain the President's veto of legislation that would have severely restricted textile imports. They regretted, however, that the Administration had recently taken measures to restrict imports of machine tools and certain lumber products. Directors urged the United States to reaffirm its resolve to resist protectionism.

Several Directors expressed concern that U.S. actions in the agricultural area, particularly with regard to export subsidies, were having serious adverse repercussions for other producers. They urged the U.S. authorities to avoid actions in this area that could harm the interests of other countries, and they urged them to join other countries, in the context of a new round of multilateral trade negotiations, in pursuing a more market-oriented approach to trade in agriculture.

Directors welcomed the important role that the United States continued to play in dealing with the debt problems of developing countries. In this context, Directors attached great importance to the maintenance and expansion of access by developing countries to the U.S. market and encouraged the U.S. authorities to take further steps in this direction. On foreign aid, while recognizing the seriousness of the fiscal constraints faced by the United States, a number of Directors urged the authorities to give a higher priority to raising U.S. official development assistance in relation to GNP.

In sum, Directors warmly commended the U.S. authorities for the open and thorough dialogue that had marked the 1986 consultation discussions with the staff and for the participation of the principal economic policymakers in these discussions. They welcomed the significant improvements in policy formulation and performance since the last consultation and broadly agreed with the stated objectives of the U.S. policies. Directors concluded, however, that on present policies, there were real risks that reduction in the fiscal and trade deficits would not be achieved, that monetary policy would have to carry too large a burden, and that economic performance would be adversely affected. But they also concluded that the maintenance and strengthening of an economic climate in the United States and abroad that would be conducive to fiscal and external adjustment in this country would require effective multilateral economic cooperation.

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

APPROVED: April 24, 1987

J. W. LANG, JR.
Acting Secretary