FOR AGENDA

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July 8, 1985

To: Members of the Executive Board

From: The Secretary

Subject: United States - Staff Report for the 1985 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1985 Article IV consultation with the United States, which has been tentatively scheduled for discussion on Monday, August 5, 1985.

Mr. Hernández-Catá (ext. 8486) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

UNITED STATES

Staff Report for the 1985 Article IV Consultation

Prepared by the Staff Representatives for the 1985 Consultation with the United States

Approved by E. Wiesner and C. David Finch

July 8, 1985

Article IV consultation discussions with the United States were held in Washington, D.C. in the period from May 20 to June 28, 1985. The discussions were concluded on June 28 in a meeting with Mr. James Baker III, Secretary of the Treasury, in which the Managing Director participated, and a meeting with Mr. Paul A. Volcker, Chairman of the Federal Reserve Board. During the earlier discussions, the U.S. Government was represented by Mr. Beryl Sprinkel, Chairman of the Council of Economic Advisers, and officials of the Department of the Treasury; the Council of Economic Advisers; the Office of Management and Budget; the Federal Reserve Board; the Departments of Agriculture, Commerce, Energy, and State; and the Office of the U.S. Trade Representative. The staff team consisted of S. T. Beza, K. Bercuson, P. Clark, C. Collyns, R. Corker, S. Dunaway, E. Hernandez-Cata, and L. Kenward (all WHD); S. Anjaria (ETR) and M. Wattleworth (FAD) participated in the meetings on trade and fiscal policies, respectively. Mr. C. Dallara, Executive Director for the United States and Ms. M. Bush, Alternate Executive Director for the United States, participated in the discussions. The United States has accepted the obligations of Article VIII, Sections 2, 3, and 4.

This paper is organized as follows: Section I reviews recent economic developments; Section II covers the policy discussions with the U.S. representatives; and Section III contains the staff appraisal. Appendix I summarizes the staff's view on the economic outlook, Appendix II describes Fund relations with the United States, Appendix III provides basic data, and Appendix IV deals with statistical issues. The charts referred to in the text appear at the end of the paper.

I. Recent Economic Developments

After a period of economic stagnation and rising unemployment, the U.S. economy began to recover in late 1982 (Chart 1). Following a large drop in inflation and interest rates, economic activity increased at an average annual rate of just over 7 percent during the six quarters ended in the second quarter of 1984. The recovery of output stemmed initially from a turnaround in inventory investment and substantial increases in expenditures on consumer durables and residential investment. From mid-1983 onward, the expansion was supported by a very rapid increase in business fixed investment. The pace of the expansion slowed considerably in the second half of 1984 and the first quarter of 1985; during this period real GNP increased at an annual rate of 2 percent, with all major components of demand contributing to the slowdown.1/

The growth of real GNP during the first nine quarters of the recovery was a little above the average of previous postwar recoveries (Chart 2) owing to an exceptionally rapid expansion in domestic demand. Despite historically high real interest rates, all interest-sensitive components of domestic expenditure (stockbuilding, residential and business fixed investment, and spending on consumer durables) increased faster than the average of previous cyclical upswings. As a result of the real appreciation of the U.S. dollar since mid-1980, an unusually large portion of the growth in domestic demand was met by imports and the growth of exports was well below the average of past cyclical expansions. The following tabulation compares the key elements of the recent recovery with previous recoveries in the postwar period.

(Percentage changes at annual rates)

	Nominal		Real			
	GNP	Domestic Demand	GNP	Domestic Demand	Business Fixed Investment	Net Exports 2/
Typical recovery 3/	8.7	8.8	5.2	5.2	7.0	--
1975:I to 1977:II	11.6	12.5	5.7	6.2	6.4	-0.4
1982:IV to 1985:I	9.4	10.5	5.4	6.9	13.1	-1.6

After declining during the period 1980-82, real nonresidential fixed investment grew rapidly during the current recovery. This strong growth reflected in part the decline in the cost of capital that occurred in 1982-83 as well as the rapid growth of aggregate demand during the recovery. The decline in the cost of capital resulted from a large drop in interest rates in the second half of 1982 and the associated reduction in the cost of equity financing; the decline in inflation, which raised the expected value of depreciation allowances for tax purposes measured at historical cost, also played a role. Moreover, measures to liberalize depreciation allowances (introduced by the Administration in 1981

1/ Preliminary data indicate that output rose at an annual rate of a little more than 3 percent in the second quarter of 1985.
2/ Contribution to the growth of real GNP during the period.
3/ First nine quarters of a typical recovery in the postwar period.

and modified in 1982) resulted in a substantial reduction in the cost of capital for investment in structures. In the case of investment in producers' durable equipment, however, the measures affecting depreciation allowances appear to have had little net effect on the cost of capital. The exceptionally strong increase in this category of investment in 1983-84 seems to have reflected in large measure technological developments, including a sharp reduction in the cost of data processing equipment. High technology investment--including office machinery, and scientific, engineering, and communications equipment--has increased very rapidly in recent years, and during the current recovery it has accounted for almost half of the growth in producers' durable equipment.1/

Employment increased at a fast pace in the first six quarters of the recovery, and by June 1984 the civilian unemployment rate was down to 7 1/4 percent, a drop of 3 1/2 percentage points from its cyclical peak in late 1982 (Chart 3). Since mid-1984 the rate of growth of employment has declined, while the labor force has continued to increase rapidly; the unemployment rate has fluctuated between 7 and 7 1/2 percent, not far from the range of current estimates for the natural rate of unemployment. (As a result of changes in demographic factors, the natural rate of unemployment is expected to decline somewhat over the medium term.)

The rise in labor costs has moderated considerably in the past few years. The 12-month increase in the index of hourly earnings in the private nonfarm sector came down from nearly 10 percent in early 1981 to 3 percent in June 1985 (Chart 4). Hourly compensation in the nonfarm business sector rose by 4 percent during the year ended in the first quarter of 1985, down from an increase of 10 3/4 percent during 1980. The rate of increase in unit labor costs fell from 10 1/2 percent during 1980 to zero during 1983; however, with productivity slowing as the expansion matured, unit labor costs rose by 3 percent during the year ended in the first quarter of 1985.

The rate of price increase also has come down substantially in the past few years. The GNP deflator rose by 3 3/4 percent during the year ended the first quarter of 1985, down from more than 10 percent during 1980. The 12-month rate of increase of the consumer price index came down from almost 12 1/2 percent in December 1980 to about 2 1/2 percent around the middle of 1983 (Chart 5). Consumer prices accelerated somewhat in the period from mid-1983 to March 1984, but they have slowed

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1/ A more detailed analysis of the factors that have contributed to the recent growth of business fixed investment is contained in Appendix I to the recent economic developments paper. This appendix also provides a discussion of various measures of the cost of capital, including an analysis of the effect of changes in the tax treatment of depreciation allowances. As is explained more fully in Appendix I, the growth of investment in the past several years probably is underestimated by the national accounts data owing to difficulties in estimating an appropriate price deflator for computers.

since then, and in the 12-month period ended May 1985 consumer prices rose by 3 3/4 percent.

The deficit in the current account of the balance of payments widened from $8 billion in 1982 to $41 billion in 1983 and to $102 billion, or 2 3/4 percent of GNP, in 1984 (see tabulation below and Chart 6). The merchandise trade deficit rose from $36 billion in 1982 to $62 billion in 1983 and reached $108 billion in 1984. Imports increased sharply from 1982 to 1984, reflecting the strong expansion of economic activity in the United States and the real effective appreciation of the dollar since mid-1980 (Chart 7). The rise in the dollar, coupled with relatively weak foreign demand, also contributed to the drop in the value of exports in 1982 and 1983. Exports picked up in 1984 owing mainly to the recovery of economic activity abroad.1/ The surplus on U.S. trade in invisibles declined substantially from 1982 to 1984 as net investment income receipts dropped sharply while net payments for travel and transportation increased. In the first quarter of 1985, the current account deficit widened to an annual rate of $120 billion; the trade deficit rose to an annual rate of $118 billion and net invisibles registered a small deficit.

(In billions of dollars)

	1980	1981	1982	1983	1984
Trade balance	-25.5	-28.0	-36.4	-62.0	-108.3
Services, net	34.4	41.2	36.5	30.1	18.2
Investment income	30.4	34.1	29.5	25.4	19.1
Travel and transportation	-1.0	0.1	-1.0	-4.7	-9.0
Other services	5.0	6.9	8.0	9.4	8.0
Transfers, net	-7.1	-6.8	-8.1	-8.9	-11.4
Current account balance	1.9	6.3	-8.0	-40.8	-101.5

The effective value of the U.S. dollar (MERM weights) rose by 57 percent from its low point in July 1980 to December 1984 (Chart 8). The dollar appreciated by a further 10 percent from December 1984 to its peak at the end of February 1985; the dollar subsequently declined, and in June its value was 7 1/2 percent below its February peak. In real terms, from the third quarter of 1980 to the fourth quarter of 1984 the value of the dollar increased by 56 percent on the basis of relative unit labor costs in manufacturing and by 44 percent on the basis of relative value-added deflators in manufacturing (Chart 9).

1/ Appendix V to the recent economic developments paper contains a detailed analysis of the factors that have contributed to the deterioration of the U.S. trade balance in recent years.

The appreciation of the dollar since mid-1980 cannot be fully explained by historical relationships. Movements in inflation-adjusted interest rate differentials between assets denominated in U.S. dollars and in other currencies help to explain a part of the rise in the dollar (Charts 10 and 11). However, other factors appear to have contributed to the inflow of capital into the United States and to the strength of the dollar, particularly in the period since mid-1982. These factors include a relatively favorable climate for investment in the United States, the major reduction in U.S. inflation, and inflows of capital seeking a safe haven.

II. U.S. Economic Policies and Prospects

1. Introduction

In concluding the discussions on the 1984 Article IV consultations with the United States in August 1984, Executive Directors welcomed the improvement that had taken place in the U.S. economic situation, including the strong recovery of output since late 1982--which had had positive effects on other countries--and the continued moderation of inflation. At the same time, Directors were concerned about the medium-term outlook for growth and capital formation in the United States and the rest of the world. In that connection, they noted the prospect of continuing large federal deficits, and they stressed the urgent need for a major improvement in the federal fiscal position. Regarding monetary policy, Directors emphasized the importance of continued vigilance in order to avoid the resurgence of inflation that had been characteristic of the expansion phases of previous cycles. In the area of foreign trade, Directors acknowledged the Administration's commitment to maintaining open markets in the United States in the face of a large and growing trade deficit, but they expressed concern about the apparent intensification of protectionist pressures and called on the United States to resist requests for import protection.

Since last August, the rate of growth in output has declined markedly from the extraordinarily rapid pace registered in the earlier phase of the recovery; the rate of inflation has remained relatively low and interest rates generally have declined, although in real terms they are still high by historical standards. At the same time, the external current account deficit has continued to widen and pressures for import relief have remained strong; in certain important areas, these pressures have been effectively resisted by official actions. In the fiscal area, federal deficits have remained very large and the need to redress the fiscal imbalance continues to be the key economic problem faced by the U.S. authorities.

2. Economic situation and outlook

In commenting on economic developments during the current expansion, the U.S. representatives noted that the rise in output and employment and the exceptional growth of investment had reflected high real after-tax rates of return on capital. U.S. officials emphasized that restraint in the growth of the monetary aggregates had been the key factor in keeping inflation at relatively low levels during the current expansion. The appreciation of the U.S. dollar had brought about a drop in the relative price of imports and the resulting competitive pressures appeared to have forced many U.S. producers to contain their costs. However, the U.S. representatives thought that the appreciation of the dollar had been largel ' the result, rather than the cause, of the abatement of inflation and inflationary expectations.

The achievement of strong employment growth with moderate inflation during the current recovery contrasted with the experience of the 1970s, the U.S. representatives said, and reflected increased flexibility in the wage bargaining process in the United States. This had been particularly evident with regard to wage concessions by labor unions; such concessions had occurred not only during the recession but had continued more than two years into the recovery. The flexibility of labor markets in the United States stood in contrast with the situation in certain other industrial countries, where the functioning of these markets was affected by a number of rigidities.

With regard to the prospects for the U.S. economy, the Administration's forecast, as revised in April 1985, envisaged increases in real GNP of 3.8 percent in 1985 and just over 4 percent in 1986; this would be followed by growth of real GNP averaging 3.8 percent a year in the period 1987-90. Thus, on the basis of this forecast, the growth of output during the entire period 1985-90 would exceed the rate of increase in potential GNP, estimated by the Administration at about 3 1/2 percent. According to this forecast, the unemployment rate would fall from an average of approximately 7 percent in 1985-86 to 5 3/4 percent at the end of 1990. The forecast also assumed that interest rates would decline substantially, with the three-month Treasury bill rate falling from about 8 percent in 1985 to 5 percent by the end of the decade. The rate of increase in the GNP deflator would remain in the neighborhood of 4 percent through 1987 before declining to about 3 1/4 percent by 1990. However, the U.S representatives thought that inflation might well drop more rapidly than was envisaged in this projection, and they emphasized that the ultimate objective of the Administration continued to be the achievement of price stability.

The U.S. representatives said that a revision of the official forecast was underway as part of the preparation for the midyear review of the budget. On the basis of the information that had become available since April, it appeared that the projection for economic growth during 1985 probably would be subject to a downward revision. In particular, the growth of GNP in the first quarter of 1985 (0.7 percent at an annual rate) had been considerably lower than expected.1/ However, the outcome for the first quarter had been influenced by a number of special factors,

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1/ Growth of real GNP in the first quarter was subsequently revised downward to an annual rate of 0.3 percent.

the effects of which were expected to be largely reversed in the remaining quarters of 1985. Furthermore, the recent declines in interest rates would boost residential construction and other interest-sensitive components of demand. The monetary aggregates (particularly M-1) had been rising rapidly since late 1984; with inflation remaining under control--and barring a sharp drop in monetary growth or an unexpected decline in velocity--this pointed to a significant pickup in the growth of output.

The U.S. representatives said there were no indications that a recession was likely to occur in the near term: stock to sales ratios were not out of balance; inflation was not accelerating; and interest rates (which usually rise in the late phase of expansions) were declining. The growing trade deficit and the rising proportion of total demand that was satisfied by imports were a source of concern, but the growth of imports was expected to decline in the period ahead as the impact of past increases in the value of the dollar tapered off. All in all, the U.S. representatives were not inclined to revise their medium-term forecast in a significant way.

The staff noted that the Administration's medium-term projection of growth in real GNP of close to 4 percent appeared to be rather optimistic in that it would require growth in the capital stock that was unusually rapid by historical standards. More specifically, the staff observed that the investment needed to achieve the Administration's growth projection would require more saving than probably would be available, given the prospects for the federal deficit and the likelihood that the external current account would undergo adjustment.1/

3. Fiscal policy

The economic program introduced by the Administration in early 1981 envisaged that the federal budget would be in balance in FY 1984. In the event, the federal deficit as a ratio to GNP rose from 2 3/4 percent in FY 1981 to 6 1/2 percent in FY 1983 and, despite the vigorous expansion in economic activity, declined only to 5 1/4 percent in FY 1984.2/ In relation to GNP, federal receipts fell from 20 3/4 percent in FY 1981 to 18 1/2 percent in FY 1984, whereas federal outlays in FY 1984, at 23 3/4 percent of GNP, were a little higher than in FY 1981. The difference between the fiscal outcome and the Administration's projection was partly due to slower growth than the Administration had expected, but it also reflected slippages in the implementation of proposed cuts in federal spending and the costs of servicing the rising federal debt at higher interest rates than had been anticipated in 1981.

1/ The implications of alternative growth scenarios for investment, the federal deficit, and the external current account are discussed in Appendix X of the recent economic developments paper.

2/ Fiscal data in this section are on a unified budget basis and refer to fiscal years ending on September 30. On a national income accounts basis, the federal budget deficit rose from $64 billion (2 1/4 percent of GNP) in 1981 to $176 billion (4 3/4 percent of GNP) in 1984 (Chart 12).

In preparing the FY 1986 budget proposals (presented to Congress in February 1985), the Administration was faced with the prospect of sizable and persistent budget deficits. On a current services basis, 1/ the Administration projected that the federal deficit would remain in the range of $220 billion to $250 billion in the period from FY 1985 to FY 1990; in relation to GNP the deficit would decline from 5 3/4 percent in FY 1985 to 5 percent in FY 1988 and to 4 percent in FY 1990, when the economy would be operating at high levels of resource utilization. After increasing from about 28 percent in FY 1980 to almost 37 percent in FY 1984, the ratio of federal debt to GNP would rise to almost 48 percent in FY 1990 (Chart 13).

The Administration's budget for FY 1986 proposed substantial cuts in domestic spending 2/ other than social security. The measures proposed included a restructuring of the medicare and medicaid programs; reform of certain income security programs; a major reform of the farm income stabilization program (mainly a reduction in price supports for farm products); and termination of general revenue sharing with the state and local governments. In addition, the budget proposals called for cuts in defense spending relative to current services levels, although sizable real increases in defense expenditure were maintained. The budget did not include measures designed to raise revenue or to reduce the cost of living adjustments in social security benefits. On the basis of these proposed measures, the budget envisaged that the federal deficit would decline in relation to GNP from 5 3/4 percent in FY 1985 to just under 3 percent in FY 1988 and to 1 1/2 percent in FY 1990. The federal debt would rise to nearly 41 percent of GNP in FY 1987 before declining to about 38 percent in FY 1990.

Fiscal Position of the Federal Government 3/

(In percent of GNP)

	Actual				Projections 4/			
	1981	1982	1983	1984	1985	1986	1987	1988
Outlays	23.5	24.5	25.1	23.8	24.6	23.4	22.5	22.2
Receipts	20.7	20.3	18.6	18.6	18.9	18.9	18.9	19.3
Deficit	2.7	4.2	6.5	5.2	5.7	4.3	3.6	2.9
(Billions of dollars)	(79)	(128)	(208)	(185)	(222)	(180)	(165)	(144)

1/ On the basis of the current tax system and spending programs.
2/ Expenditure other than defense and net interest payments.
3/ Fiscal years. Outlays include off-budget items under current law that the Administration has proposed be classified as on-budget.
4/ Administration's projections as presented in the FY 1986 budget.

The Administration's budget proposals met with strong congressional opposition. However, after a period of intense negotiation, in early May the Senate passed a budget resolution that was acceptable to the Administration and that would imply somewhat larger expenditure cuts over the next three fiscal years than the February budget proposals. The Senate plan would eliminate cost of living adjustments for social security for FY 1986 and would hold the growth of defense spending in FY 1986 to the rate of inflation, but it would increase spending on other programs relative to the budget proposals. In late May, the House of Representatives passed a budget resolution calling for spending cuts that would reduce the federal deficit in FY 1986 by about the same amount as the Senate plan.1/ However, the House plan would freeze defense appropriations in nominal terms, would maintain the cost of living adjustment for social security, and would keep spending on social programs at a significantly higher level than the Senate plan.

In the discussions, the staff noted that whereas the deficit reductions sought by both Houses of Congress were of the same order of magnitude, the two plans were quite different as regards the composition of expenditure cuts and the number of program terminations. The U.S. representatives said that the Senate plan was preferable from their perspective because it provided for higher levels of defense spending and because it proposed the termination of a large number of domestic programs, thus achieving higher savings than the House plan over the longer term. They recognized that the reconciliation process in Congress would be a difficult one, but they were confident that a compromise resulting in substantial reductions in expenditure--probably $40 billion or more--would be worked out for FY 1986.

The U.S. representatives said that, in the absence of reductions in spending, the prospects for economic growth and inflation would be less favorable; interest rates would be higher, and savings, investment, productivity, and employment would be lower. The goal of reducing the federal deficit could not be achieved by relying on rapid economic growth; it required decisive action to reduce the growth of spending, for example, along the lines of the Senate plan. Such action would improve the prospects for economic growth by making resources available to the private sector. It also would avoid a continued rise in the federal debt in relation to GNP, and thus could have a favorable effect on expectations about inflation by reducing fears that the debt would be monetized.

As regards the short-run effects of the deficit-reduction package, the U.S. representatives thought they probably would not be very large. Certain macroeconomic models suggested that the impact on GNP of a

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1/ Relative to the current services estimate, the Senate plan envisages spending reductions of $56 billion in FY 1986, $100 billion in FY 1987, and $139 billion in FY 1988. The House plan would cut spending by the same amount as the Senate plan in FY 1986, by $83 billion in FY 1987 and by $120 billion in FY 1988.

reduction in government spending was negative in the short run (perhaps one year) but positive after several years. They noted that the shift of resources from the Government to the private sector would lead to efficiency gains that were not captured by such models. U.S. officials acknowledged that the process through which this shift of resources would take place might involve a decline in real interest rates, but they added that the spending reductions incorporated in the budget proposals might already have been reflected in the recent decline in interest rates.

The U.S. representatives observed that, while there was a link between government spending and interest rates, they had found no consensus in the empirical literature as to the direction--let alone the size or the statistical significance--of the relationship between federal budget deficits and real interest rates. The results of the Treasury Department's econometric studies indicated that large federal deficits had virtually no relationship with high interest rates during the period 1965-83. The lack of consensus in this area was not surprising in view of the technical problems involved in the analysis of this relationship, including the difficulties in measuring the expected rate of inflation and hence the real interest rate.

The U.S. representatives acknowledged that real interest rates over the past few years had been high, even though their precise level could not be measured with confidence. In their view, the initial rise in real rates in 1980 had been associated with the change toward a more restrictive monetary policy in late 1979. The increased volatility in money growth that followed this policy shift had resulted in greater volatility in bond prices, which appeared to have added a substantial risk premium to inflation-adjusted interest rates. In addition, the ratio of the federal debt to GNP had increased rapidly since 1981. However, these factors could not be accepted as a full explanation for the high level of interest rates in the past two years, given the strength of business investment during the current recovery. The surge of investment suggested that the high level of real interest rates reflected a substantial increase in the real after-tax rate of return on capital stemming from technological developments, measures to liberalize depreciation allowances, and the decline in inflation.

The staff commented that, while empirical studies on the link between interest rates and federal deficits were by no means conclusive, there was a growing body of evidence suggesting the existence of a statistically significant relationship between the real interest rate and the ratio of the federal debt to GNP.1/ With regard to the measurement problem, there was no doubt that the widespread use of the actual rate of inflation in defining the real interest rate was inappropriate in certain respects. It was important to note, however, that the use of

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1/ Surveys of the empirical literature in this area were provided in Appendix XI to last year's recent economic developments paper (SM/84/178, Supplement 1) and in Supplementary Note VII to the World Economic Outlook papers circulated in March 1985 (SM/85/76).

expected inflation variables based on survey information also suggested that real interest rates had remained quite high by historical standards.1/

In discussing the fiscal outlook, the staff noted that while the budget resolutions approved by Congress called for a sizable adjustment in the fiscal position, the federal budget would nevertheless remain in deficit over the medium term. On the basis of the economic assumptions presented in the FY 1986 budget and assuming that the spending cuts proposed in the Senate plan were adopted in full, the deficit would be around 2 percent of GNP in FY 1988, and over 1 percent of GNP by FY 1990, when the economy would be operating at a high degree of resource utilization. The staff noted, moreover, that the Administration's fiscal projections were based on optimistic assumptions for economic growth over the medium term, as was discussed above. In particular, the Administration was projecting output growth averaging close to 4 percent a year from 1985 to 1990. It would seem more prudent to base the budget projections on growth of real GNP of 3 percent a year, approximately the average for the postwar period. Under this assumption, the deficit would still be some 2 3/4 percent of GNP in FY 1988 and over 2 percent of GNP in FY 1990.2/

These projections suggested that further action to reduce the federal deficit might well be needed, the staff observed, even if there were a successful resolution to the current budget debate. In seeking a reduction of the deficit, emphasis should be placed on expenditure restraint, since this would be the most effective way to make room for the private sector and increase economic efficiency. However, the staff noted that it probably would become increasingly difficult to reduce expenditure relative to GNP as the share of domestic programs in total spending declined. Thus, action to increase federal revenue might be needed to cope with the fiscal problem.

1/ As explained more fully in the recent economic developments paper, calculations based on a ten-year ahead expected inflation variable derived from survey data suggest that the real interest rate on ten-year U.S. Treasury securities rose from an average of 2 1/4 percent in 1978-80 to an average of more than 6 percent in 1981-82. On this basis, the real rate fell to about 4 1/2 percent in 1983, moved back to the neighborhood of 6 percent in 1984, and has declined to around 5 percent in mid-1985.

2/ The following examples may serve to illustrate the sensitivity of fiscal projections to assumptions about underlying economic conditions. A sustained reduction of 1 percentage point in the annual rate of growth of real GNP would increase the deficit by about \$5 billion in the first year, \$17 billion in the second year, and over \$50 billion in the fifth year. A sustained 1 pecentage point increase in interest rates would increase the deficit by about \$3 billion in the first year, \$8 billion in the second year, and about \$17 billion in the fifth year.

The U.S. representatives stressed that the Administration opposed tax increases as a way to reduce the fiscal deficit. They felt strongly that, in present circumstances, a tax increase would erode the political will that was necessary to cut spending. Furthermore, they were convinced that higher taxes would have adverse incentive effects on the supply of labor and capital. Specifically, an increase in taxes would reduce the expected real after-tax rate of return on capital, and although interest rates might be lower, so would the growth of the capital stock and productivity. In their view, tax financing was not a satisfactory alternative to debt financing; what was important was to deal with the deficit by reducing the size of the Government.

The staff agreed that tax increases could have adverse effects on incentives to save and invest. However, it should be possible to increase revenue while limiting or avoiding those effects, for example, by reducing certain tax preferences. Furthermore, the staff could not accept the suggestion that there was virtually no difference between debt financing and tax financing. Debt financing was unlikely to be matched by an increase in private saving and would therefore lead to the crowding out of investment. This effect on capital formation could be alleviated for some time by relying on inflows of foreign savings, as the U.S. experience of the past several years had demonstrated. But the accumulation of external debt resulting from such inflows could not continue indefinitely and at some point the crowding out of investment would become inevitable.

The staff noted that the dangers related to the fiscal problem could also be seen by focusing on the outlook for the federal debt in the long run. Without measures to correct the fiscal imbalance, the federal debt would rise substantially in relation to GNP, even on the basis of the Administration's rather optimistic assumptions with regard to economic growth. This would have adverse effects on capital formation in the United States and the rest of the world. Moreover, if economic growth were to be substantially lower, there would be a danger that a spiral of mounting federal debt and rising interest payments could give rise to an unsustainable situation and to a serious erosion of confidence in government policies.

The U.S. representatives said they fully recognized the dangers posed by the continuation of large fiscal deficits; in particular, there was no doubt that increases in the ratio of the federal debt to GNP could not be tolerated indefinitely. It was precisely in order to avoid these dangers that the Administration had proposed, and continued to support, substantial deficit reduction measures. They emphasized that their aim was the elimination of the structural deficit of the Federal Government which they presently estimated at around 4 percent of GNP.

On May 28, the President announced a proposal to reform the tax system with a view to increasing its fairness and simplicity and improving the allocation of resources in the economy, while leaving revenues approximately unchanged.1/ In the area of personal taxation, the proposal would reduce the number of tax brackets from 14 to 3, with the top marginal tax rate being reduced to 35 percent from 50 percent under the present system. The plan also proposed the elimination and curtailment of many deductions, including the deduction for state and local taxes; the mortgage interest deduction for principal residences would remain, but the deduction for other interest expenses would be limited. The net effect of the proposed measures would be to lower personal tax payments relative to current services estimates by an average of about $26 billion a year in the period FY 1986-90.

As regards business taxation, the plan would reduce the maximum corporate tax rate from 46 percent to 33 percent, allow corporations to deduct 10 percent of dividend payments, eliminate the investment tax credit, and revise the accelerated depreciation system that was introduced in 1981. These changes would lower the effective corporate tax rate on structures and inventories while raising it for equipment. The net effect of the tax proposals would be to increase taxation on corporations by about $25 billion a year in the period FY 1986-90 relative to current services estimates.

In the discussion, the staff welcomed the tax reform proposal inasmuch as it would simplify the tax system and remove distortions in the economy stemming from the current tax structure. The staff expressed concern, however, that the proposal would not be revenue neutral, especially in the long run. U.S. officials assured the staff that tax reform would not be allowed to lead to a reduction in revenues; they emphasized that the President would not sign a tax reform bill that was not revenue neutral.

4. Monetary policy

During 1984, M-1 and M-2 moved in line with historical relationships with income and interest rates and were well within their respective target ranges (see tabulation below and Chart 14). In contrast, M-3 and the credit aggregate were well above their respective target ranges during most of 1984. In the view of the Federal Reserve, the unusually rapid expansion of these broader aggregates reflected the unprecedented scale of merger and takeover activity, the continued large federal deficit, and the exceptional strength of business fixed investment.

1/ A more detailed description of these proposals is contained in Appendix XI to the recent economic developments paper.

(Percentage change at annual rate)

	1984		1985	
	Target 1/	Actual 1/	Target 1/	Actual 2/
M-1	4-8	5.2	4-7	10.4
M-2	6-9	7.7	6-9	8.6
M-3	6-9	10.5	6-9 1/2	8.1
Domestic nonfinancial sector debt	8-11	13.4	9-12	13.3

After rising during the first half of 1984, interest rates have declined substantially. In the latter half of 1984, the Federal Reserve moved to ease reserve provision in the context of a marked slowing in the pace of economic activity, relatively favorable developments in wages and prices, and the strength of the dollar. Declines in short-term interest rates were also fostered by reductions in the discount rate toward the end of 1984; the discount rate was further reduced (to 7 1/2 percent) in May of this year. Yields on three-month Treasury bills declined from a recent peak of 10 1/2 percent in August 1984 to around 7 percent in June 1985, and yields on long-term Treasury securities declined by more than 3 percentage points from June 1984 to about 10 percent in June 1985 (Chart 15).

In February 1985, the Federal Reserve announced its target ranges for growth in the monetary aggregates this year, which were designed to be consistent with sustainable economic growth and progress toward reasonable price stability over time. The upper bound of the range for M-1 growth during 1985 was lowered by 1 percentage point relative to the previous year, while the growth range for M-2 was left unchanged. The ranges for M-3 and the credit aggregate were raised somewhat in reflection of the Federal Reserve's view that the factors which had boosted growth of these aggregates in 1984 would continue to play a role in 1985. In formulating these objectives, the Federal Reserve assumed that trends in velocity of M-1 and M-2 would be returning to a more normal and predictable pattern, following a period in 1981-83 when there had been significant departures from historical relationships between the monetary aggregates and such economic variables as income and interest rates. Nevertheless, the Federal Reserve officials stated that considerable uncertainty still existed regarding the behavior of the monetary aggregates.

In view of this uncertainty, and given the prevailing imbalances in the economy and the progress that has been made in reducing inflation, since late 1982 the Federal Reserve has adopted a new approach to monetary management. This approach places less emphasis on achieving

1/ Growth during year ended in the fourth quarter.
2/ Growth from fourth quarter of 1984 to May 1985 (April 1985 in case of debt aggregate).

targets for the aggregates and provides more room for discretion in setting the stance of policy than did the procedures in use from late 1979 to late 1982.1/ Federal Reserve officials explained that, in forming judgments about the appropriate course of monetary policy, movements in the monetary aggregates were assessed in conjunction with developments in economic activity, prices, financial market conditions, and exchange rates.

The staff noted that a more judgmental approach to monetary policy risked an excessive delay in responding to rapid growth in the aggregates and thus reduced the protection against rising inflation. Federal Reserve representatives agreed that the current procedures involved some risk. However, they stressed that the Federal Reserve was still required by law to have monetary targets and that the onus was on the Federal Reserve to justify monetary growth outside the target ranges. They added that the members of the Federal Open Market Committee fully recognized the dangers involved in a more discretionary approach to policy and were very sensitive to indications of inflationary pressures.

The representatives of the Administration said that they fully supported the Federal Reserve's stated policy of providing monetary expansion that was consistent with sustainable economic growth and continued progress toward price stability. Their concerns with the conduct of monetary policy related to short-run fluctuations in monetary growth which they believed were detrimental to the economy. In their view, sharp swings in money growth lasting five or six months had a significant impact on the growth of output and resulted in increased uncertainty about future money growth and inflation, thereby raising interest rates by increasing the risk premium. The representatives of the Administration noted that the growth of M-1 in recent months had been well above the target range, and expressed concern that this development might be followed by a sharp deceleration in M-1, which would portend a slowdown in economic activity.

For their part, the Federal Reserve representatives indicated that the fact that M-1 was currently above its target range was not all that worrisome. They viewed the recent rapid growth in M-1 as a response to the decline in interest rates, and they noted that both M-2 and M-3 were inside their target ranges. Furthermore, given the relatively low level of inflation and the spare capacity available at present, they felt that the Federal Reserve would have sufficient time to adjust monetary policy if it were necessary. Federal Reserve officials noted that world demand continued to be relatively weak, commodity prices were still falling, the U.S. dollar remained strong, and the U.S. goods-producing sector was stagnating. In this context, they stressed that the potential costs of

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1/ Appendix XII to the report on recent economic developments provides a description of the approach to monetary control used by the Federal Reserve since the fall of 1982, and contrasts this approach to the procedures in effect prior to 1979 and between 1979 and 1982.

moving to tighten credit conditions and slow M-1 growth exceeded the dangers of a resurgence of inflation.

When asked how monetary policy would respond if substantial action were taken to correct the fiscal imbalance, Federal Reserve officials replied that even without changes in the monetary targets there would be an automatic decline in interest rates that would tend to offset the effect of the withdrawal of fiscal stimulus. Moreover, in view of the interest-sensitivity of the demand for M-1, the drop in interest rates would tend to reduce velocity. If this decline in velocity proved to be permanent, the Federal Reserve would need to reconsider the appropriate rates of growth of the aggregates, and might allow growth at the upper end of the ranges or even shift the ranges themselves.

Federal Reserve officials commented on the recent difficulties experienced by certain banks and thrift institutions in the United States and the implications of such problems for the conduct of monetary policy. They noted that the Federal Reserve had responded to liquidity problems of depository institutions by acting as lender of last resort, thereby safeguarding the economy's payments system. At the same time, the Federal Reserve had conducted open market operations so as to avoid any unintended easing of the overall pressure on banks' reserve positions.

The number of problem banks had increased considerably, but Federal Reserve officials observed that such banks represented only 6 percent of all commercial banks. Moreover, despite pressures on earnings and asset quality experienced in recent years, U.S. banks in general--and the largest banking organizations in particular--had raised record amounts of capital, significantly increasing their capital ratios. In the view of the Federal Reserve, there was an adequate buffer in the banking system to cope with a deterioration in the quality of bank assets; in addition to capital, bank customers were protected by the federal safety net comprised of federal deposit insurance, the Federal Reserve discount window, and a supervisory and regulatory framework designed to assure the safety and soundness of financial institutions.

With regard to the supervison of the international lending of U.S. banks, the three Federal bank regulatory agencies have adopted new bank examination procedures designed to improve the identification of problem credits, integrate country risk considerations more effectively into the examiners' overall rating of the condition of a bank, and emphasize to bank management the concerns of regulators regarding country risk. Also, the International Lending Supervision Act, passed by Congress in 1983, contained regulations regarding the collection of information on international lending, the accounting for fees on international loans, and the establishment of reserves against international loans when their quality had been impaired by the borrower's protracted inability to repay.

5. The balance of payments and the exchange rate

In the view of U.S. officials, the sharp widening of the trade and current account deficits in 1984 had reflected primarily the very strong growth of economic activity in the United States relative to other industrial countries and the cumulative effects of the appreciation of the dollar since 1980. They thought that as much as half of the U.S. trade deficit in 1984 could be attributed to the loss of competitiveness associated with the high value of the dollar. Continuing financial constraints among certain developing countries (stemming from debt servicing problems or from declining oil export revenues) also had held back the growth of U.S. exports, even though shipments to Mexico and Venezuela had increased sharply in 1984, partially reversing two years of steep declines. They also noted that the surplus on invisibles had fallen to less than $6 billion in 1984 owing partly to a drop in net investment income.

On the assumption that the world price of oil would remain constant through the end of 1986 and that the average value of the dollar would remain unchanged at its April 1985 level, U.S. officials were projecting that the U.S. current account deficit would widen from a little more than $100 billion in 1984 to $120 billion in 1985 and to about $150 billion in 1986. This deterioration would be attributable in large measure to an increase in the trade deficit from $108 billion in 1984 to $125 billion in 1985 and to $150 billion in 1986. This rise would reflect the combination of approximately equal growth rates in exports and imports and a large initial trade imbalance; the adverse effects of the appreciation of the dollar in 1983 and 1984 would continue to be felt, but the rates of growth of economic activity in the United States and in other major countries would tend to converge. With regard to invisibles, there would be a decline in net portfolio investment income reflecting the deterioration in the U.S. net international investment position.

The Administration's current account projections for 1985-86 do not differ greatly from those prepared by the staff and described in Appendix I to this report. Looking beyond 1986, the staff has prepared several medium-term scenarios for the U.S. current account on the basis of a variety of growth and exchange rate assumptions.1/ In one of these scenarios, it is assumed that the value of the dollar will remain constant in real terms and that economic activity will grow at about the same rate in the United States and in other industrial countries. On this basis, the U.S. current account deficit would rise to about $275 billion in 1990, and the net external debt of the United States would increase from approximately zero at present to almost $1 trillion at the end of 1990; this would represent nearly 20 percent of U.S. GNP and more than 150 percent of U.S. exports of goods and services.

1/ These scenarios are presented in Appendix VI to the recent economic developments paper.

The staff asked whether the United States would be able to finance growing current account deficits without major changes in interest rates or exchange rates. The U.S. representatives observed that over the past few years, the current account deficit had been financed by persistent inflows of private capital, often at times when interest rate differentials were moving against dollar-denominated assets. Moreover, while the net inflow of capital in 1983 had reflected mainly a cutback in U.S. bank lending abroad, net capital inflows in 1984 had been registered in virtually every major category of the private capital account, including, in particular, purchases of U.S. Treasury securities by private foreigners and net direct investment.

The U.S. representatives interpreted these developments as suggesting that the inflow of foreign capital--and the strength of the dollar--reflected mainly a broadly based view that U.S. assets had become relatively more attractive. This had been largely associated with factors such as the relatively strong economic performance of the United States, the stable and generally favorable climate for investment in the United States, and the decline in U.S. inflation--rather than with movements in interest rate differentials. The proposition that the high value of the dollar resulted from the effects of large fiscal deficits on interest rates was inconsistent with the recent movements in these variables. The staff acknowledged that the appreciation of the dollar over the past two years (and particularly since mid-1984) could not be explained on the basis of historical relationships. However, the staff pointed out that, over the period of generalized floating, there had been a significant relationship between the real value of the dollar and the inflation-adjusted interest rate differential (see Chart 11).

On the basis of their interpretation of events, the U.S. representatives did not see any reason for a sudden shift in investor preferences against U.S. assets as long as moderate growth with low inflation could be sustained in the United States. Accordingly, they did not foresee major problems in the financing of prospective U.S. current account deficits over the near term, nor did they anticipate any abrupt decline in the value of the dollar. To be sure, if the situation in Europe were to improve as a result of measures to deal with structural rigidiies in labor markets or to improve the climate for investment, the net outflow of saving from these countries would be reduced and the value of the dollar would tend to decline.

The U.S. representatives said that the effects of a substantial reduction in the federal deficit on the exchange value of the dollar were very difficult to predict. It was possible that such a reduction would lead to lower interest rates and to a decline in the dollar. It could also be argued, however, that an improvement in the U.S. fiscal position might enhance confidence in the sustainability of noninflationary growth in the United States, and thereby strengthen the value of the dollar.

In response to a question about the volatility of the exchange value of the dollar in recent months, the U.S. representatives said that uncertainty about the near-term outlook for the U.S. economy and concern about the problems of thrift institutions in the United States might have contributed to the drop in the dollar during March and April 1985. More recently, these concerns appeared to have faded and the dollar had tended to stabilize. Exchange market volatility in the recent past also appeared to have reflected the legacy of substantial intervention in the period from late January to early March. This experience had confirmed the view of the U.S. Administration that intervention cannot alter underlying exchange market trends. Nevertheless, the United States remained prepared to intervene when necessary to counter disorderly market conditions.

6. Trade policy and other foreign economic issues

The U.S. representatives said that the major goal of U.S. trade policy continued to be the maintenance of a free and open trading system based on principles of reciprocity and equity. The United States also sought to limit existing distortions to trade, particularly those due to nontariff barriers, and to deal with the problems associated with increased intervention by governments in the trade area. To attain these objectives, the Administration would continue its efforts to resist protectionist pressures at home and to move toward negotiated trade liberalization with other countries.

Pressures for protection had increased since the conclusion of the last round of trade negotiations. In the view of the U.S. representatives, these pressures had been fueled by the recession in the United States in the early 1980s and subsequently by rapidly rising import penetration in certain sectors. The pressures arising from import competition had been particularly severe in sectors--such as textiles and apparel, footwear, steel, and automobiles--that faced the need for structural adjustment. However, even some of the strongest U.S. industries (including computers, electrical machinery, and telecommunications) had experienced a sharp decline in competitiveness over the past several years as a result of the rise in the value of the dollar. Moreover, the restrictions placed on U.S. exports by certain countries had weakened the domestic constituency for free trade, thereby making it more difficult to cope with pressures for import protection. Nevertheless, the U.S. representatives felt that they had so far been relatively successful in resisting such pressures.

A number of important actions were taken in the trade area in 1984 and the first half of 1985.1/ The U.S. International Trade Commission (ITC) ruled on several escape clause petitions. In the case of copper, in May 1984 the ITC found that the domestic industry had been seriously injured by imports, but the President subsequently decided against granting import relief. With regard to carbon steel, the ITC ruled that the

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1/ These measures are described in Appendix VII to the recent economic developments paper.

industry had been injured, and in September 1984 the President proposed a plan which would grant temporary import relief while fostering adjustment efforts by the domestic industry. As part of this plan, the United States has reached voluntary export restraint agreements with a number of major foreign suppliers. In June 1985, the ITC proposed the introduction of quotas on imports of nonrubber footwear; a final decision by the President is expected by September.

In March 1985, the President announced that the United States would not ask Japan to extend its restraints on exports of automobiles beyond their scheduled termination at the end of March. Subsequently, the Japanese Government decided to continue to restrict car shipments to the United States, although the limit on such shipments was raised by nearly 25 percent. In May, the Administration announced a $2 billion program designed to improve the competitive position of U.S. agricultural exports and to counter the "unfair" trade practices of other countries. Under this plan, surplus farm commodities in U.S. Government stocks would be given to U.S. exporters to subsidize foreign sales to selected markets over the next three years.

The U.S. representatives noted that several bills challenging the open trade posture of the United States had been introduced in Congress; they were particularly concerned about a bill that would severely restrict imports of textiles and which had considerable support in Congress. Moreover, in recent months there had been interest in Congress regarding measures to deal with the U.S. external imbalance by imposing a 20 percent surcharge on all U.S. imports. The Administration had voiced strong opposition to the proposal of an import surcharge. Such a surcharge would raise prices; it would invite retaliation by other countries; and, to the extent that it curtailed U.S. imports, it would cause the dollar to strengthen and would therefore hurt U.S. exports. The U.S. representatives were confident that import surcharge legislation would not be enacted.

Regarding U.S. trade relations with Japan, the U.S. representatives said that the main issues involved limitations on access to the Japanese market for competitive U.S. products. The large U.S. bilateral trade deficit with Japan had served to heighten the sense of dissatisfaction with the lack of openness of Japanese markets. From the perspective of the United States, effective trade liberalization in Japan was desirable; however, it would not necessarily imply a major reduction in the bilateral deficit with Japan or in the overall U.S. trade deficit, since these imbalances were more closely associated with macroeconomic conditions and policies than with trade practices.

The U.S. representatives emphasized that the Administration was fully committed to trade liberalization through multilateral negotiations. Such negotiations would help deter mounting protectionism and provide new opportunities for trade. The specific objectives of the United States in a new round of multilateral negotiations included reducing tariffs and quantitative restrictions and improving the working of the trading system in the areas of safeguards, agriculture, nontariff barrier codes, and dispute settlements. In addition, the United States sought to extend the coverage of the GATT to areas of international trade that were crucial to the future economic growth of the United States, such as services, high technology, intellectual property, and investment.

In view of the difficulties encountered in starting a new round of multilateral trade talks, the United States was willing to explore bilateral means of reducing both tariff and nontariff barriers in the pursuit of an open, multilateral trading system; they regarded the bilateral approach as complementary to multilateral trade liberalization. The United States had negotiated a reciprocal free trade area agreement with Israel and had held discussions with the Canadian Government to explore possible bilateral liberalization agreements. The Administration hoped that the benefits provided in arrangements of this kind would exert pressure on other countries to liberalize their own trade policies in order to take advantage of similar benefits.

In the discussion of U.S. economic relations with developing countries, the U.S. representatives noted the role played by the United States in dealing with the debt problems of those countries. They stated that the United States would continue to use a case-by-case approach in helping to resolve the problems of individual countries. The strategy pursued by the United States in this area emphasized the need for effective adjustment programs in developing countries, continued flows of credit from official sources and commercial banks, and a reduction in the role of the government sector in the economies of these countries. U.S. officials also emphasized the need for efforts to improve the climate for private investment (including foreign direct investment) in developing countries.

U.S. officials stated that providing liberal access to a growing U.S. market was an important contribution in easing the debt burden of developing countries. They pointed out that a substantial portion of the increase in the exports of developing countries in 1984 had come to the United States. In addition, access to U.S. markets had been improved by the Caribbean Basin Initiative and continued preferential access guaranteed by the extension of the General System of Preferences (GSP). In extending the GSP, changes had been made to increase the proportion of benefits accruing to the most needy countries, while flexibility in the GSP graduation procedure had been retained in order to ease the impact of withdrawal of GSP benefits on the more advanced developing countries and to encourage them to liberalize access to their own domestic markets.

The U.S. representatives recognized the importance of official development assistance, but they emphasized that such assistance could have a lasting, favorable impact only in the context of sound economic policies in recipient countries. They noted that the United States did not accept the validity of a target ratio for official development assistance in relation to GNP. The U.S. representatives added that the United States intended to fulfill all existing commitments to multilateral development banks, but that the Administration had not budgeted at this time for future replenishments for these institutions. Decisions on levels of U.S. participation in funding for the development banks would be made in the course of future negotiations and in light of U.S. budget priorities.

III. Staff Appraisal

The economic situation in the United States has improved in many respects since 1982. The growth of real GNP has been strong and there has been an exceptionally rapid expansion in business fixed investment, albeit from a relatively low level. The increase in output has been accompanied by a large rise in employment, and the unemployment rate has dropped sharply from its cyclical peak. The rate of inflation has come down substantially from the high levels registered in the late 1970s and early 1980s, although it remains high by the standards of previous decades.

In recent quarters, the rate of growth in output has declined sharply from the very rapid pace registered during the earlier phase of the recovery. In itself, this deceleration is not particularly disturbing; a slowdown in the rate of expansion from the extremely rapid pace in the first half of 1984 was needed in order to avoid the danger of upward pressures on inflation. What is worrisome is that certain imbalances have developed in the economy which threaten the prospects for continued economic growth. In particular, the federal deficit and the external current account imbalance have grown to magnitudes that are outside the range of the relevant historical experience and have become sources of vulnerability.

In the past several years, the increase in the federal deficit and the growth of domestic investment have not been matched by a rise in private domestic saving. In a situation in which the demand for credit in other countries has been relatively weak and U.S. monetary policy has followed an anti-inflationary course, the pressures stemming from rising credit demands in the United States have been reflected in a widening of the U.S. current account deficit. This development has had its positive aspects, as it has helped to promote the world recovery and has facilitated the adjustment efforts of developing countries. However, this process has had adverse effects on the output of U.S. export and import-competing industries, and this has contributed to an escalation of protectionist pressures.

Looking ahead, both the Administration and the staff expect the current account deficit to widen to around $150 billion in 1986. Over the medium term, the current account balance probably would deteriorate further if the real value of the dollar were to remain unchanged. Yet, it cannot be taken for granted that rising capital inflows will continue for an extended period at prevailing interest and exchange rates because this would imply that an increasing share of foreign saving would need to be invested in U.S. assets. Indeed, it would not be prudent to rule out the possibility of a sudden shift in investors' preferences away from U.S. assets that would trigger a sharp decline in the value of the dollar; in the absence of fiscal adjustment, such a decline would lead to a rise in real interest rates that would crowd out domestic investment, with serious consequences for economic growth in the United States and for the debt-servicing burden of developing countries. Furthermore, even if the inflow of foreign saving continued to make up for the diversion of domestic saving into deficit financing, external debt service payments would increase rapidly and could give rise to an unstable situation.

A reduction in the absorption of saving by the Federal Government would provide the best way to alleviate the domestic and international pressures generated by the large disparity between domestic saving and investment in the United States. Such a reduction should lead to a lasting decline in U.S. interest rates, which would improve the prospects for capital formation and long-term growth in the United States and abroad, and would reduce the debt-servicing burden of developing countries. An early and substantial cut in the federal deficit also would create the conditions under which an orderly adjustment in the value of the dollar and in the U.S. current account imbalance could take place, thus alleviating the competitive pressures that have affected certain sectors of the U.S. economy.

The budget proposals presented by the Administration earlier this year aimed at a substantial improvement in the federal fiscal position. Since then, both Houses of Congress have approved budget resolutions that seek sizable reductions in the federal deficit through expenditure cuts. However, there are substantial differences between the two plans, and numerous difficulties will need to be overcome in order to bring about a reduction of the size that was envisaged.

Even on the basis of the Administration's relatively favorable economic projections and assuming a successful resolution to the current budget debate, the federal budget would remain in deficit through the end of this decade, when the economy would be operating at a high degree of resource utilization. If the trend rate of growth should turn out to be closer to the postwar average, the deficit would be significantly larger. The elimination of the structural deficit, which the Administration supports, can therefore only be achieved if the fiscal measures now contemplated are carried through and are followed by additional budgetary action in the following years. The staff agrees with the Administration that further efforts to reduce the deficit would be best achieved through expenditure restraint, since this would be the most effective way to relieve pressures on resources while limiting adverse effects on incentives. However, the experience of recent years (in particular, the rise in the ratio of federal expenditure to GNP from FY 1981 to FY 1985) suggests that it may not be possible to deal with the fiscal problem solely by restraining expenditures. Accordingly, action to increase federal revenue may well be needed to avoid the unfavorable consequences of continued large deficits on investment in the United States and elsewhere.

It should be possible to raise revenue while preserving incentives to save and invest, for example, through reductions in tax expenditures. In this regard, the staff welcomes the repeal of certain tax deductions contained in the tax reform proposals presented recently by the President. The staff believes that these proposals are a step toward reducing the distortions created by the present tax system. Yet, it would seem desirable to make further progress in this direction while expanding the revenue base through the elimination of tax preferences that have been retained in the President's proposals.

There is no doubt that the monetary policy pursued by the Federal Reserve has been instrumental in bringing down inflation from the high levels reached in the early 1980s. As regards the current approach to monetary policy, there is a question whether the reduced emphasis on achieving the monetary targets does not increase the risk of an acceleration of the aggregates that may eventually trigger a resurgence of inflation. In this connection, the continued growth of M-1 this year above its target range is a source of concern, given that the target range seemed to provide scope for adequate real growth and protection against rising inflation. The staff recognizes that the Federal Reserve is committed to reducing the rate of inflation and is aware of the dangers of "fine-tuning". It would seem that this commitment should involve a determination to resist pressures to stimulate the economy in order to achieve short-run objectives for employment and output. More generally, it should be emphasized that the goal of achieving price stability requires that both monetary and fiscal policies be consistent with a progressive reduction in the rate of expansion of nominal demand toward the growth rate of potential output.

The staff supports the emphasis that the Administration has placed on the role of market forces in the design of economic policies. In the area of agriculture, the Administration's proposals for major reforms in farm programs represent a welcome step toward a long-term solution to the problems of this sector; the staff hopes that reforms along the lines of these proposals will be adopted by Congress. However, the scheme introduced recently to subsidize certain agricultural exports would seem to be at variance with the general thrust of the Administration's plan for agricultural reform. This scheme does not appear to improve materially the domestic agricultural situation and threatens to create instability in world markets.

During the past year, the United States has taken a number of positive actions in the trade area. In particular, the staff welcomes the Administration's decision not to seek renewal of voluntary restraints on Japanese auto exports to the United States. The staff is also encouraged by the decision not to grant protection to the domestic copper industry and by the Administration's strongly voiced opposition to proposals calling for an import surcharge. However, in other areas (notably steel) pressures have not been resisted as effectively, and access to the U.S. market has been reduced.

In the period ahead, demands for protection are likely to remain strong as long as the competitive position of U.S. producers continues to be affected by the high value of the dollar. The staff would stress that, to the extent that the exchange rate reflects the fiscal situation, the most appropriate way to alleviate the difficulties faced by U.S. producers of traded goods would be to correct the fiscal imbalance. Insofar as the appreciation of the dollar has reflected other factors, such as the climate for investment in the United States and safe-haven effects, the appropriate response would be to allow adjustment to take place and not to impose trade barriers. Therefore, the staff urges the Administration to stand fast in its resolve to resist protectionist pressures. In this regard, the staff welcomes the recent efforts of the Administration to discourage the enactment of legislation that would severely restrict textile imports. The staff also would urge the United States to resolve disputes with its trading partners without resorting to trade restrictions.

The United States has played a leading role in promoting a new round of multilateral trade negotiations. At the same time, however, the U.S. representatives have indicated that they intend to pursue bilateral arrangements, which in their view would not be inconsistent with a move toward freer trade and would not undermine a new round of multilateral trade negotiations. In the view of the staff, considerable caution should be exercised in negotiating such arrangements because of the danger that they could divide the world into blocs of trading countries and could lead to increased restrictions on trade.

The United States has continued to play an important and constructive role in dealing with the debt problems of developing countries. Open access to the U.S. market and to the markets of other industrial countries is important in helping developing countries to deal with the problems of adjustment and growth they face. The staff is encouraged by initiatives to maintain access to the U.S. market, but it is also concerned that current and proposed restrictive trade measures may hamper the exports of developing countries. Specifically, the staff urges the United States to give considerable weight to the interests of the developing countries in reaching a decision on protection in the safeguard case on footwear and in formulating its position on the Multifiber Arrangement.

Official development assistance as a proportion of GNP is low in the United States in comparison with a number of other countries that are members of the Development Assistance Committee. The staff feels that it would be desirable for the United States to raise the proportion of its national income devoted to foreign economic assistance. At the same time, the staff agrees with the view expressed by the U.S. authorities that more open access to foreign direct investment in developing countries would improve the efficiency of resource allocation worldwide and could help in resolving the international debt problem.

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

Outlook

The staff's projections through the end of 1986, prepared in the context of the current World Economic Outlook exercise, are based on the assumption that the Federal Reserve will achieve growth in the monetary aggregates consistent with an expansion of nominal GNP of around 7 percent during 1985 (from the fourth quarter of 1984 to the fourth quarter of 1985), and of 6 1/2 percent during 1986. As regards fiscal policy, it is assumed that Congress will adopt cuts in federal spending sufficient to reduce the federal deficit in FY 1986 by at least $40 billion relative to the current services level. In addition, the projections assume that real interest rates will decline somewhat from 1985 to 1986, reflecting in part progress in reducing the federal deficit.

On the basis of the above assumptions, the staff envisages that during 1985 real GNP would grow by nearly 3 percent. This would imply that the sluggishness in economic activity in the first half of the year would be followed by a more robust expansion of output in the second half. Government purchases of goods and services and gross fixed investment, which had been held down by temporary factors in the first quarter, are projected to recover in the latter half of 1985; in particular, residential investment would pick up in response to the substantial decline in interest rates since mid-1984. In addition, the negative contributions to GNP growth of inventory investment and net exports of goods and services are projected to be much smaller in the second half of 1985 than in the first part of the year.

The growth of real GNP is projected to be 2 3/4 percent during 1986. Lower growth in consumption and a decline in the rate of inventory investment would dampen the expansion of economic activity. However, the rise of output during 1986 would be sustained by the growth in government purchases of goods and services and gross fixed investment, although such growth would come down from the first to the second half of the year. On a year-over-year basis, real GNP would grow by 2 3/4 percent in 1985 and by 3 1/4 percent in 1986 (Table 1); the faster growth next year reflects the pickup in the second half of 1985.

In line with the expansion in output, employment would grow on average around 1 1/2 percent during this year and 1986. With comparable growth in the labor force expected over this period, the unemployment rate is projected to remain roughly unchanged at around 7 1/4 percent through the end of 1986. The GNP deflator is forecast to increase by 4 percent during 1985 and by about the same amount during 1986. Hourly compensation in manufacturing would rise by about 5 percent during both years, but unit labor costs would accelerate a little owing to a cyclical slowdown in the growth of productivity.

The deficit in the current account of the balance of payments is projected to widen to $125 billion (3 1/4 percent of GNP) in 1985 and to $159 billion (3 3/4 percent of GNP) in 1986. The deficit on merchandise trade would increase to $129 billion this year and to $159 billion in 1986. These projections assume that the price of U.S. oil imports will decline by nearly 5 percent during 1985 and remain unchanged during 1986, and that the value of the dollar will remain fixed at its May 1985 value. Non-oil imports would increase quite rapidly this year, reflecting the lagged effects of the past appreciation of the dollar, but would rise at a much slower pace in 1986. In contrast, petroleum imports would decline in both value and volume terms in 1985, largely reflecting inventory drawdowns in the first part of the year, before increasing in 1986. After registering a sizable increase in 1984, exports are projected to expand more slowly this year and next as a result of less rapid growth of industrial production abroad. The surplus on services transactions would continue to decline, reflecting a drop in net income on portfolio investment stemming from the deterioration in the international investment position of the United States.

It should be emphasized that, as indicated above, this forecast is based on the assumption of a substantial effort to correct the fiscal situation. If this effort does not succeed, economic events could unfold less favorably than envisaged in these projections; real interest rates would likely be higher than assumed because of a larger imbalance between domestic saving and investment.

Table 1. United States: Selected Economic Indicators

(Percentage changes from preceding year, except as indicated)

	1981	1982	1983	1984	Proj. 1985	Proj. 1986
Gross national product						
(in constant prices)	2.5	-2.1	3.7	6.8	2.8	3.3
Consumer expenditure	2.0	1.4	4.8	5.3	4.0	3.5
Government expenditure	0.9	2.0	0.3	3.5	4.4	3.9
Residential construction	-5.5	-14.8	41.7	12.1	1.0	2.5
Nonresidential fixed investment	5.5	-4.6	2.5	19.8	5.8	4.3
Final domestic demand	2.0	0.3	4.4	6.8	4.2	3.7
Stockbuilding 1/	1.1	-1.4	0.5	1.9	-0.5	-0.3
Total domestic demand	3.1	-1.2	4.9	8.7	3.7	3.4
Foreign balance 1/	-0.4	-0.9	-1.2	-1.8	-0.9	-0.2
Output, employment, and costs						
Industrial production	2.6	-8.1	6.4	10.7	2.3	3.4
Employment	1.1	-0.9	1.3	4.1	2.2	1.4
Unemployment rate, civilian 2/	7.6	9.7	9.6	7.5	7.3	7.2
Hourly compensation in the manufacturing sector	9.4	8.8	3.4	3.6	4.8	5.0
Prices						
GNP deflator	9.6	6.0	3.8	3.8	3.8	3.8
Consumer price index	10.4	6.2	3.2	4.3	3.7	4.3
Foreign trade						
Export unit value	9.2	1.1	1.0	1.4	0.8	3.8
Import unit value	5.5	-1.6	-4.1	1.8	-3.6	0.1
Terms of trade	3.5	2.8	5.5	-0.5	4.6	3.6
Volume of exports	-3.2	-11.9	-5.9	8.3	1.2	2.8
Volume of imports	0.6	-5.0	10.7	22.8	11.7	12.4
Current external transactions (in billions of dollars)						
Trade balance	-28.0	-36.4	-62.0	-108.3	-128.9	-158.6
Balance on services and private transfers	38.8	33.9	27.5	15.3	10.8	6.7
Current balance, excluding official transfers	10.8	-2.6	-34.5	-93.0	-118.2	-151.9
Current balance, including official transfers	6.3	-8.1	-40.8	-101.5	-125.0	-158.5

1/ Change as a percentage of GNP in the previous year.
2/ Annual averages, in percent.

United States - Fund Relations

(Position as of May 31, 1985 except where otherwise indicated)

I. Membership Status

The United States became a member of the Fund on December 27, 1945. The United States has accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Fund agreement.

A. Financial Relations

II. General Department

(a) Quota: SDR 17,918.3 million

(b) Total Fund holdings of U.S. dollars:
SDR 7,728.4 million (43.13 percent of quota)

(c) Fund credit: None

(d) Reserve tranche position: SDR 10,194.2 million

(e) Current operational budget (June-August):
Purchases: SDR 250.0 million
Repurchases: SDR 500.0 million

(f) Lending to the Fund (in millions of SDRs):

	Limits	Outstanding	Uncalled
GAB	4,250	--	4,250
SFF	1,450	1,256.5	--
Enlarged access	--	--	--
Total	5,700	1,256.5	4,250

III. Current Stand-By or Extended Arrangement and Special Facilities

No use of Fund credit during the last ten years.

IV. SDR Department

(a) Net cumulative allocation: SDR 4,899.5 million

(b) Holdings: SDR 6,206.8 million (126.7 percent of net cumulative allocation)

(c) Current designation plan: The United States is included in the designation plan for June-August 1985 but it has not been assigned a designation amount because its excess holding ratio is above the projected common ratio of 0.30 percent used in calculating this designation plan.

V. Administered Accounts

Not applicable.

VI. Overdue Obligations to the Fund

None.

VII. The United States has not used Fund credit to date

However, the United States made two reserve tranche purchases totaling SDR 2,275.08 million in November 1978 as part of a package of measures undertaken by the U.S. Government to strengthen the position of the U.S. dollar.

B. Nonfinancial Relations

VIII. Exchange Rate Arrangements

The U.S. authorities do not maintain margins in respect of exchange transactions, and spot and forward exchange rates are determined on the basis of demand and supply conditions in the exchange markets. However, the authorities intervene when necessary to counter disorderly conditions in the exchange markets. There are no taxes or subsidies on purchases or sales of foreign exchange. On July 2, 1985 the exchange rate of the dollar, as determined by the Fund under Rule O-2(a), was SDR 1.00057 per U.S. dollar.

IX. Last Article IV Consultation

The staff report for the 1984 consultation with the United States (SM/84/162 and Supplement 1) was considered by the Executive Board at EBM/84/120 and 121 (August 3, 1984). The United States is on a 12-month consultation cycle.

X. Technical Assistance

None.

XI. Resident Representative/Advisor

None.

United States - Basic Data

Area and population			
Area	3,615,000 sq. miles (9,363,000 sq. kilometers)		
Population (mid-1984)	236.7 million		
Annual rate of population increase (1976-84)	1 percent		
Unemployment rate (June 1985)	7.3 percent		
GNP per capita (1984)	US$15,476		
Origin of national income (1984)	(percent)		
Agriculture	2.6		
Manufacturing	22.3		
Construction and mining	5.9		
Transportation and communications	5.6		
Government and public utilities	16.7		
Wholesale and retail trade	14.7		
Finance, insurance, and real estate	14.8		
Other services	16.1		
Rest of the world	1.5		
Ratios to GNP (1984)			
Exports of goods and services	9.9		
Imports of goods and services	11.7		
Federal government revenues	19.2		
Federal government expenditures	24.0		
Domestic saving (private)	18.4		
Domestic investment (private)	17.4		
Money and quasi-money (December)	62.2		

Annual changes in selected economic indicators (annual averages)	1982	1983	1984
		(percent)	
Real GNP per capita	-3.1	2.7	5.8
Real GNP	-2.1	3.7	6.8
GNP at current prices	3.8	7.7	10.8
Domestic expenditure (at current prices)	4.1	8.6	12.5
Investment (private)	-14.3	13.7	35.2
Consumption (private)	7.3	8.6	8.6
GNP deflator	6.0	3.8	3.8
Producer prices (finished goods)	4.0	1.7	2.1
Consumer prices	6.2	3.2	4.3
Federal government revenues 1/	-1.3	3.9	9.9
Federal government expenditures 1/	11.0	7.2	7.4
Money and quasi-money (M-2)	9.3	12.5	7.9
Money (M-1)	6.6	11.2	6.9
Quasi-money	10.3	13.0	8.3

Outstanding debt of nonfinancial sectors	9.2	10.1	12.8
Merchandise exports (f.a.s.)	-10.9	-4.9	9.7
Merchandise imports (f.a.s.)	-6.6	6.1	25.1
Federal government finances (fiscal years) 2/	1982	1983	1984
	(billions of U.S. dollars)		
Revenues	617.8	600.6	666.5
Expenditures	728.4	796.0	841.8
Overall surplus or deficit (-)	-110.6	-195.4	-175.4
Balance of payments			
Merchandise exports (f.a.s.)	211.2	200.7	220.3
Merchandise imports (f.a.s.)	-247.6	-262.8	-328.6
Investment income (net)	29.5	25.4	19.1
Other services and transfers (net)	-1.1	-4.2	-12.4
Balance on current account 3/	-8.1	-40.8	-101.5
Official reserve assets, net (increase -)	-5.0	-1.2	-3.1
Official reserve liabilities	3.0	5.2	3.0
Other capital transactions (net)	-22.8	25.2	77.0
SDR allocation	--	--	--
Errors and omissions	32.8	11.5	24.7
International reserve position	Dec. 31 1983	Dec. 31 1984	May 31 1985
	(billions of SDRs)		
Gross official international reserve assets	30.8	33.5	34.1

1/ National income accounts basis.
2/ Unified budget basis; fiscal years end September 30.
3/ Including official transfers.

United States - Statistical Issues

1. Outstanding statistical issues

a. Government finance

The 1984 Government Finance Statistics Yearbook contains data in the statistical tables through 1983 for the consolidated central government and through 1982 for state and local governments. The 1983 data for state and local governments were received in May 1985 and it is expected that the 1984 data for the consolidated central government will be received by August 1985.

IFS includes data through December 1984 except for financing data which extend only through 1980; these data have been extracted from the *Treasury Bulletin and differ from those of the GFS Yearbook. The* Treasury Department is presently studying the possibility of providing monthly and quarterly data for IFS that will be consistent with the annual data in the GFS Yearbook.

b. Monetary accounts

In the January 1985 issue of IFS, revisions were introduced to the presentation on the page for the United States expanding the coverage of the Deposit Money Banks' section and the Monetary Survey by the inclusion of nonbank deposit-taking institutions.

2. Coverage, currentness, and reporting of data in IFS

The table below shows the currentness and coverage of data published in the country page for the United States in the June 1985 issue of IFS. The data are based on reports sent to the Fund's Bureau of Statistics by the Federal Reserve Board and other U.S. government agencies, which during the past year have been provided on a timely basis.

Status of IFS Data

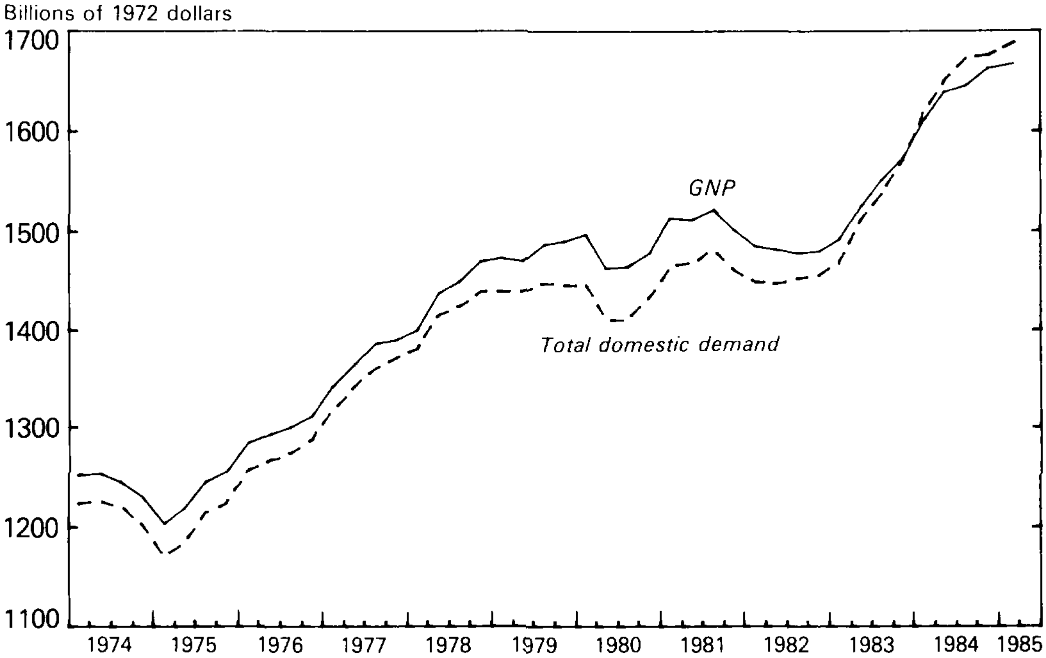
		Latest Data in June 1985 IFS
Real sector:	National accounts	QI 1985
	Prices	April 1985
	Production	April 1985
	Employment	April 1985
	Earnings	March 1985
Government finance:	Deficit/surplus	December 1984
	Financing	1980
	Debt	December 1984

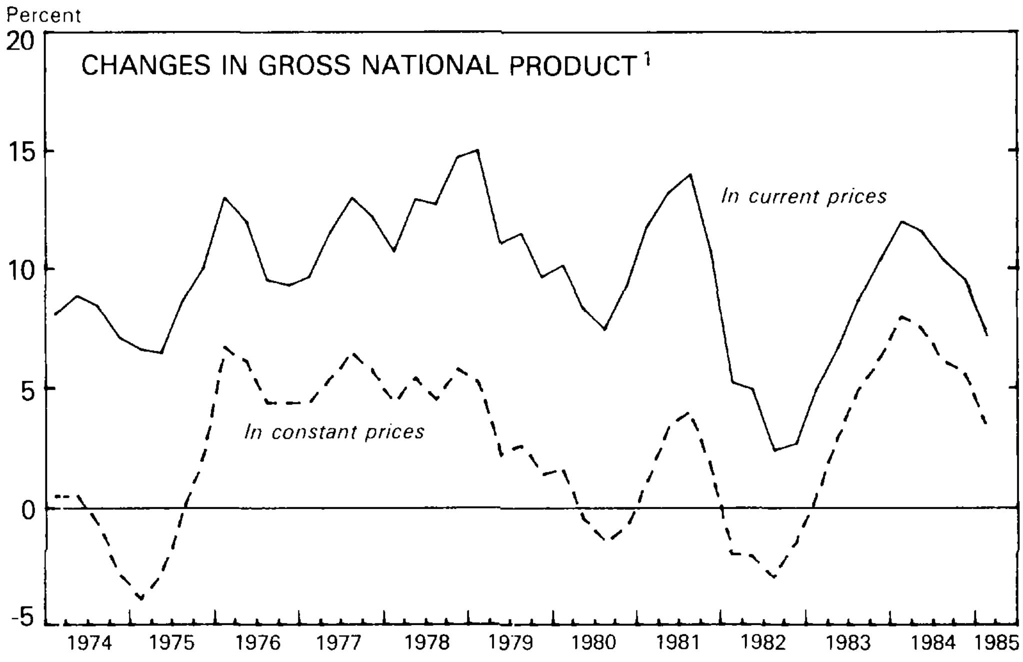
Monetary accounts:	Monetary authorities	March 1985
	Deposit money banks	March 1985
	Other financial institutions	March 1985
	Interest rates	April 1985
External sector:	Merchandise trade: Value	March 1985
	Prices	March 1985
	Balance of payments	QIV 1984
	International reserves	April 1985
	Exchange rates	April 1985

CHART 1

UNITED STATES

GROSS NATIONAL PRODUCT





[1]Percentage changes over 4 quarters

CHART 2

UNITED STATES

CYCLICAL COMPARISONS: REAL GNP, INVESTMENT AND NET EXPORTS

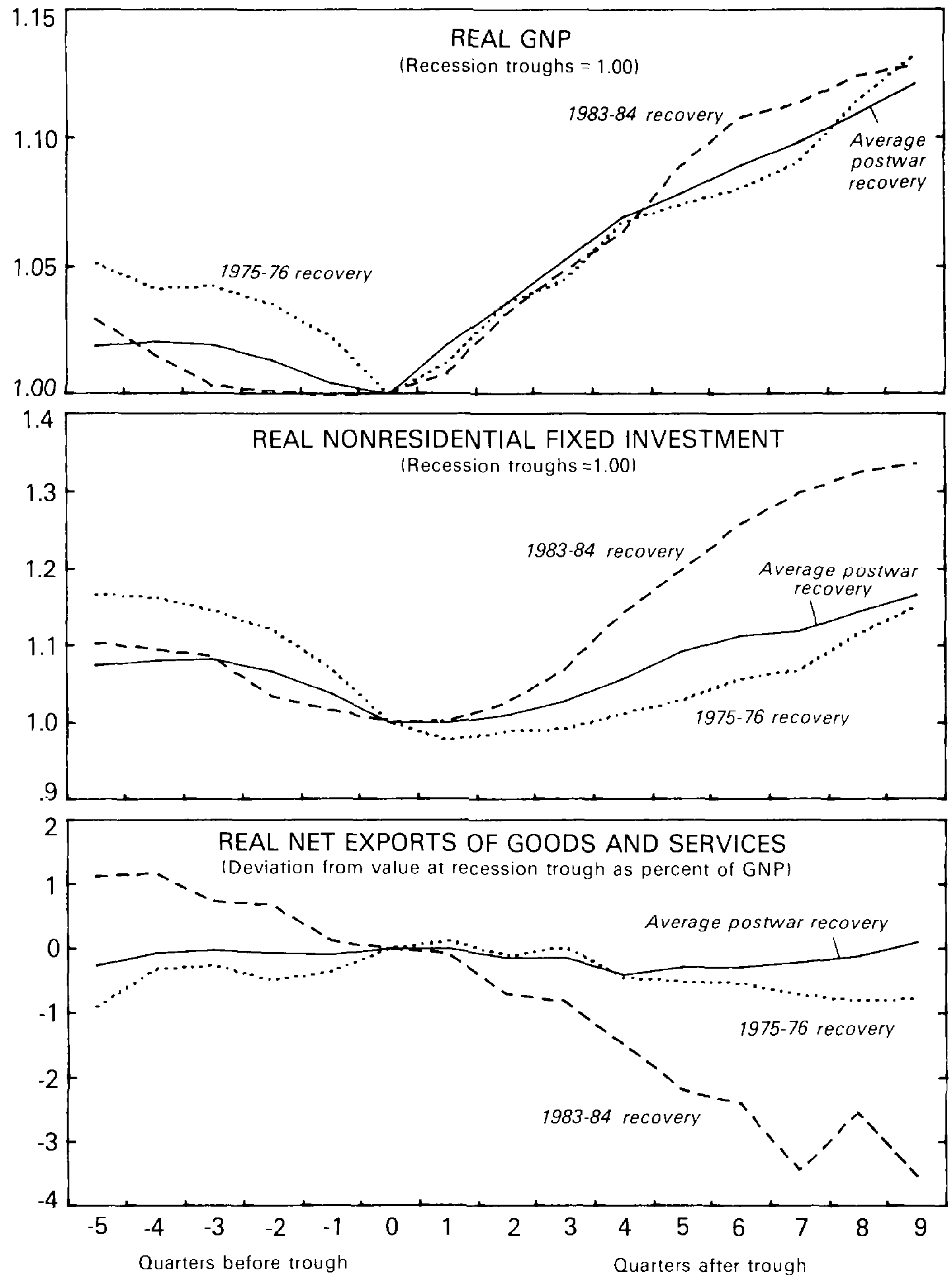
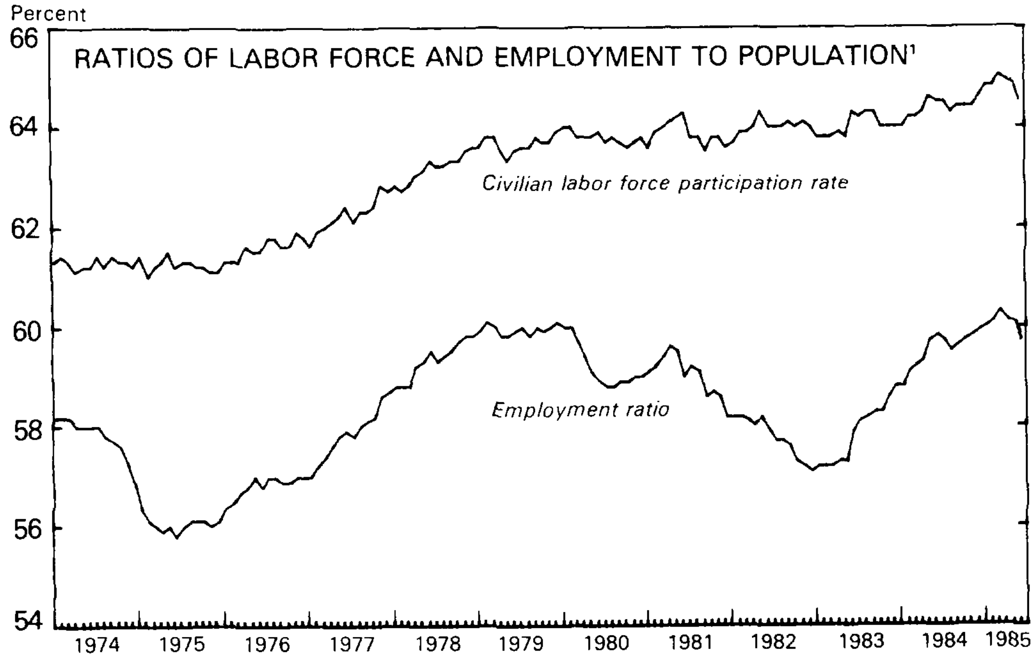


CHART 3

UNITED STATES

LABOR FORCE, EMPLOYMENT, AND UNEMPLOYMENT

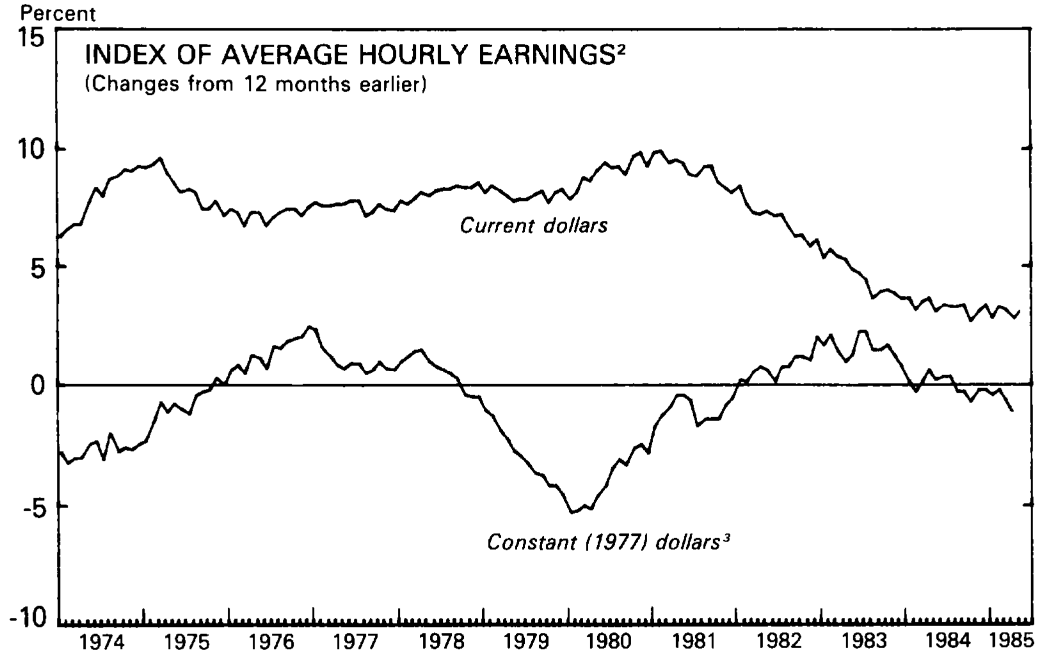


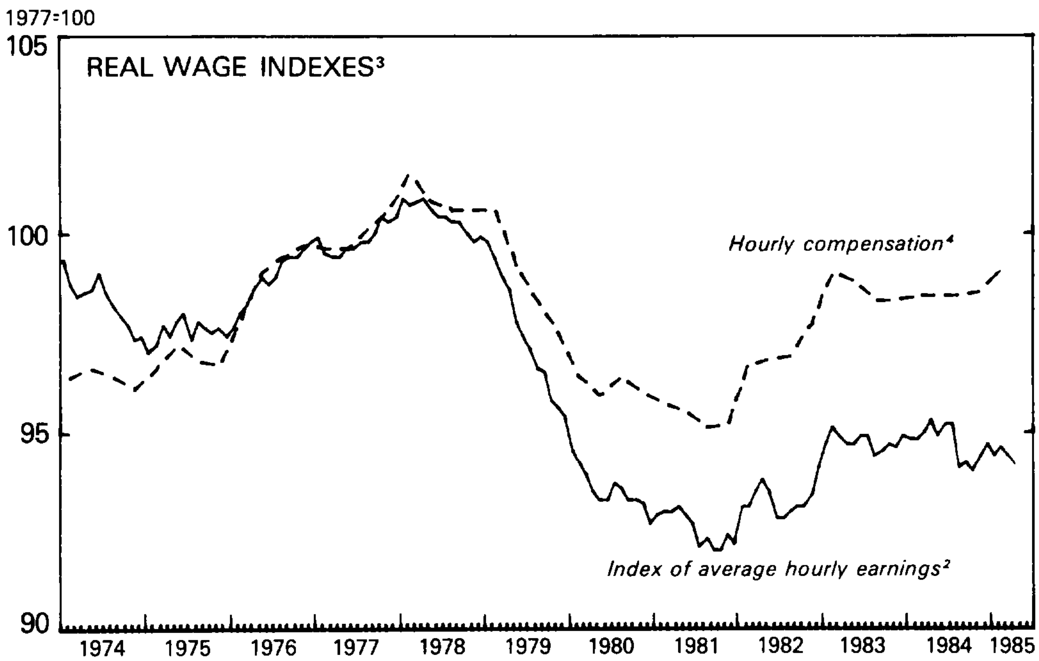
[1]Civilian noninstitutional population, 16 years and over.

CHART 4

UNITED STATES

WAGES IN THE PRIVATE NONFARM ECONOMY[1]



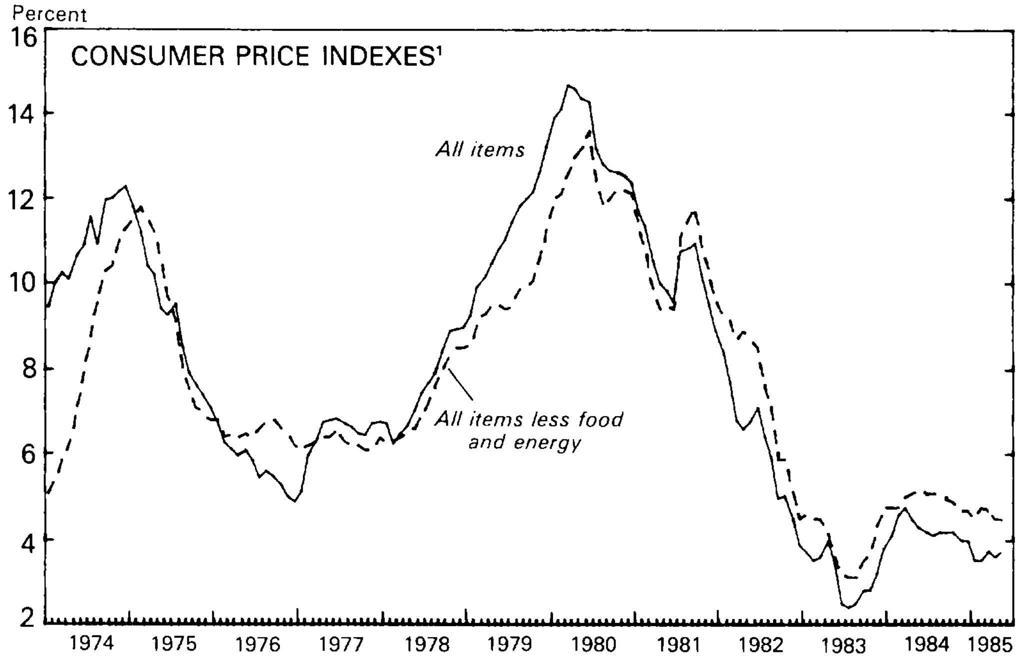


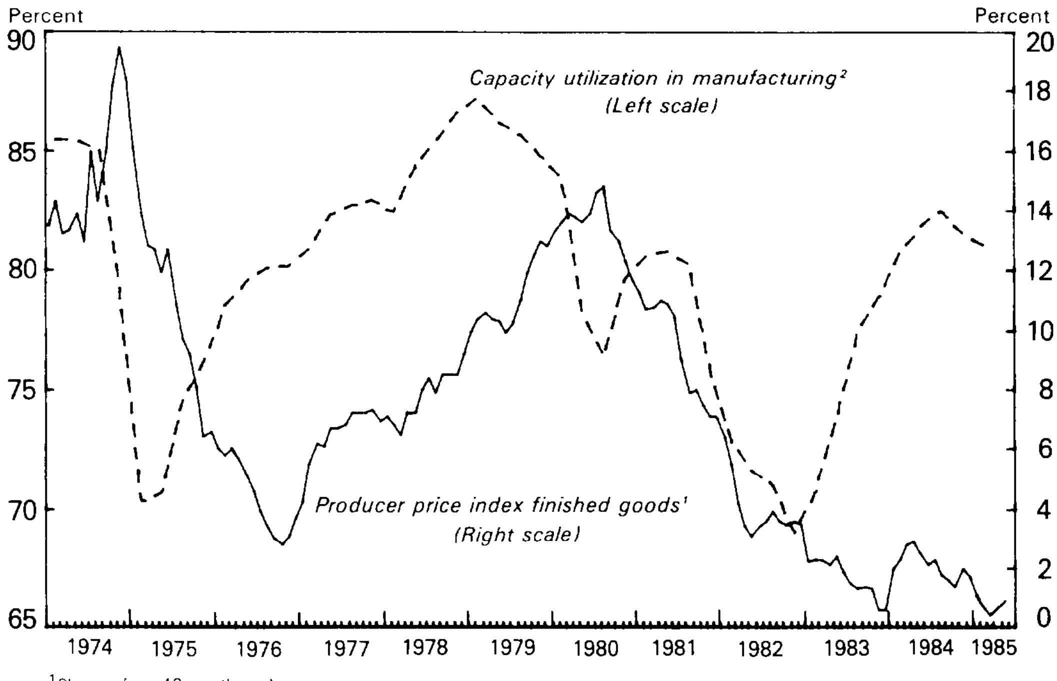
[1] For production and nonsupervisory workers.
[2] Adjusted for overtime in manufacturing and interindustry employment shifts.
[3] Deflated by the consumer price index for all urban consumers.
[4] Nonfarm business sector.

CHART 5

UNITED STATES

CONSUMER PRICES, PRODUCER PRICES AND CAPACITY UTILIZATION





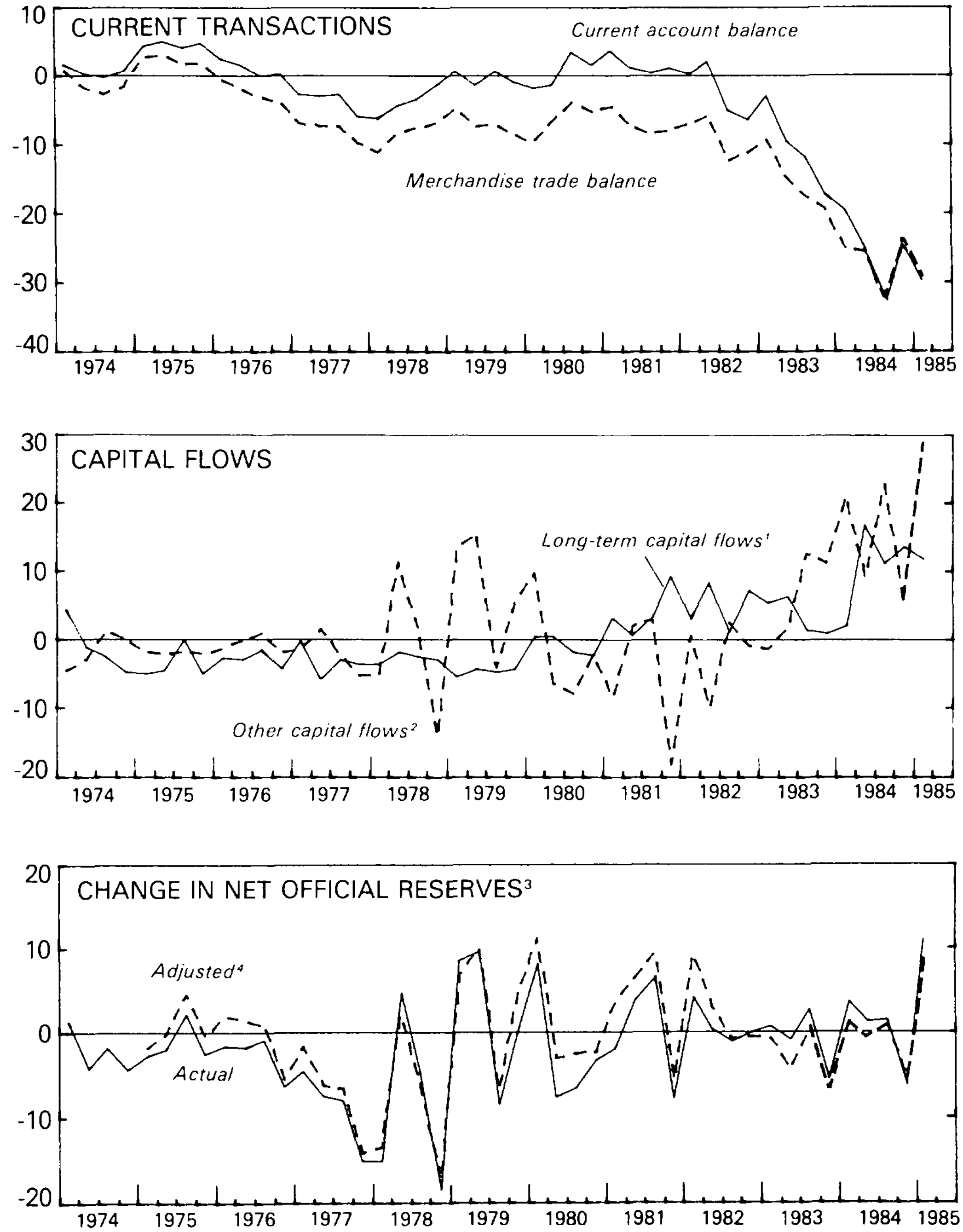
[1]Changes from 12 months earlier.
[2]As calculated by the Federal Reserve Board.

CHART 6

UNITED STATES

BALANCE OF PAYMENTS DEVELOPMENTS

(In billions of dollars; seasonally adjusted at quarterly rates)



[1] Includes direct investment, securities, and other U.S. Government assets and liabilities. Excludes net issues of U.S. Treasury securities in the German and Swiss capital markets.

[2] Including the statistical discrepancy.

[3] U.S. official reserve assets minus liabilities to foreign official agencies less net issues of U.S. Treasury securities in the German and Swiss capital markets.

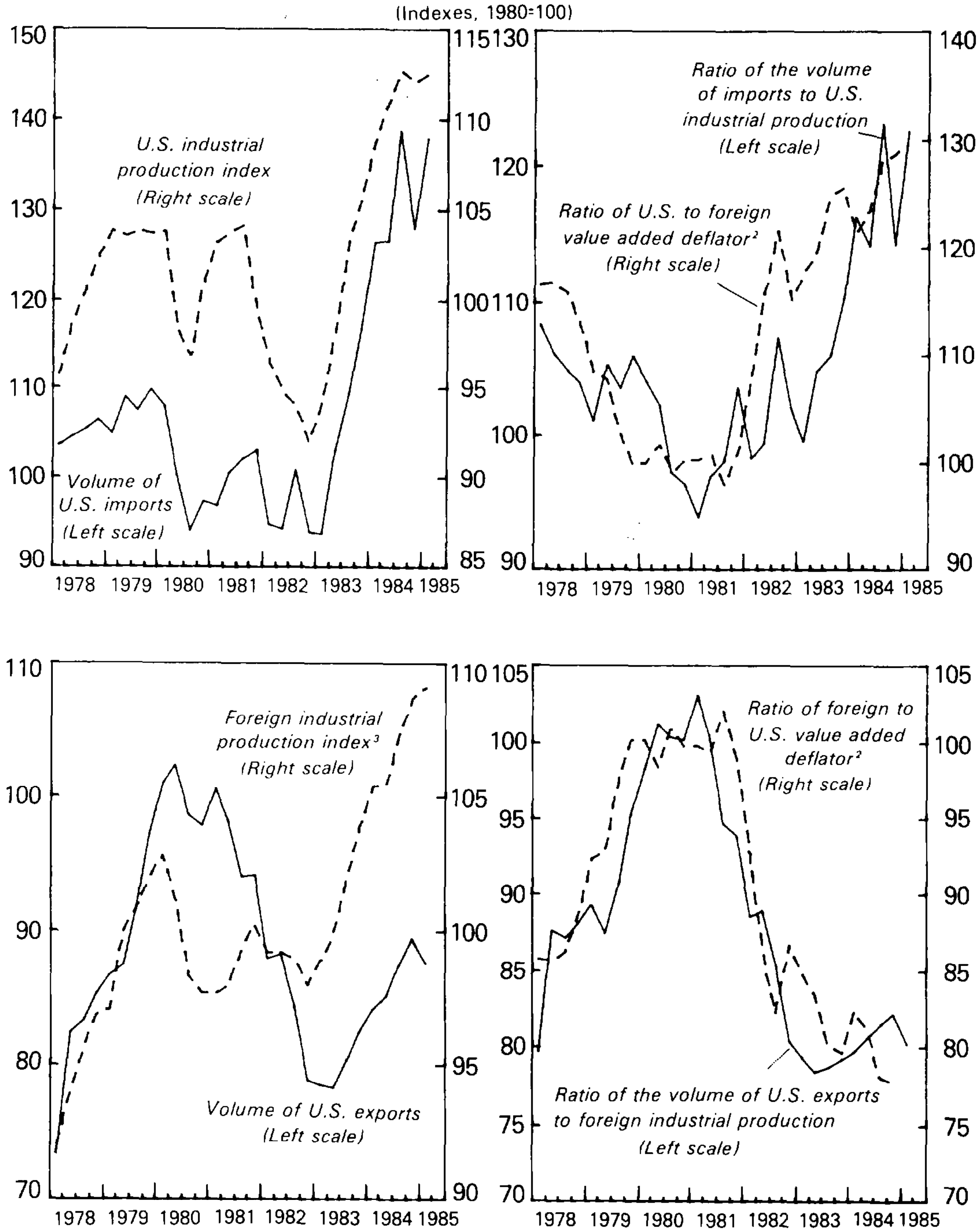
[4] Excludes transactions with official agencies of OPEC members.

CHART 7

UNITED STATES

MERCHANDISE TRADE DEVELOPMENTS[1]

(Indexes, 1980=100)



[1]Imports and exports are at 1977 prices.

[2]Adjusted for exchange rate changes (lagged 4 quarters).

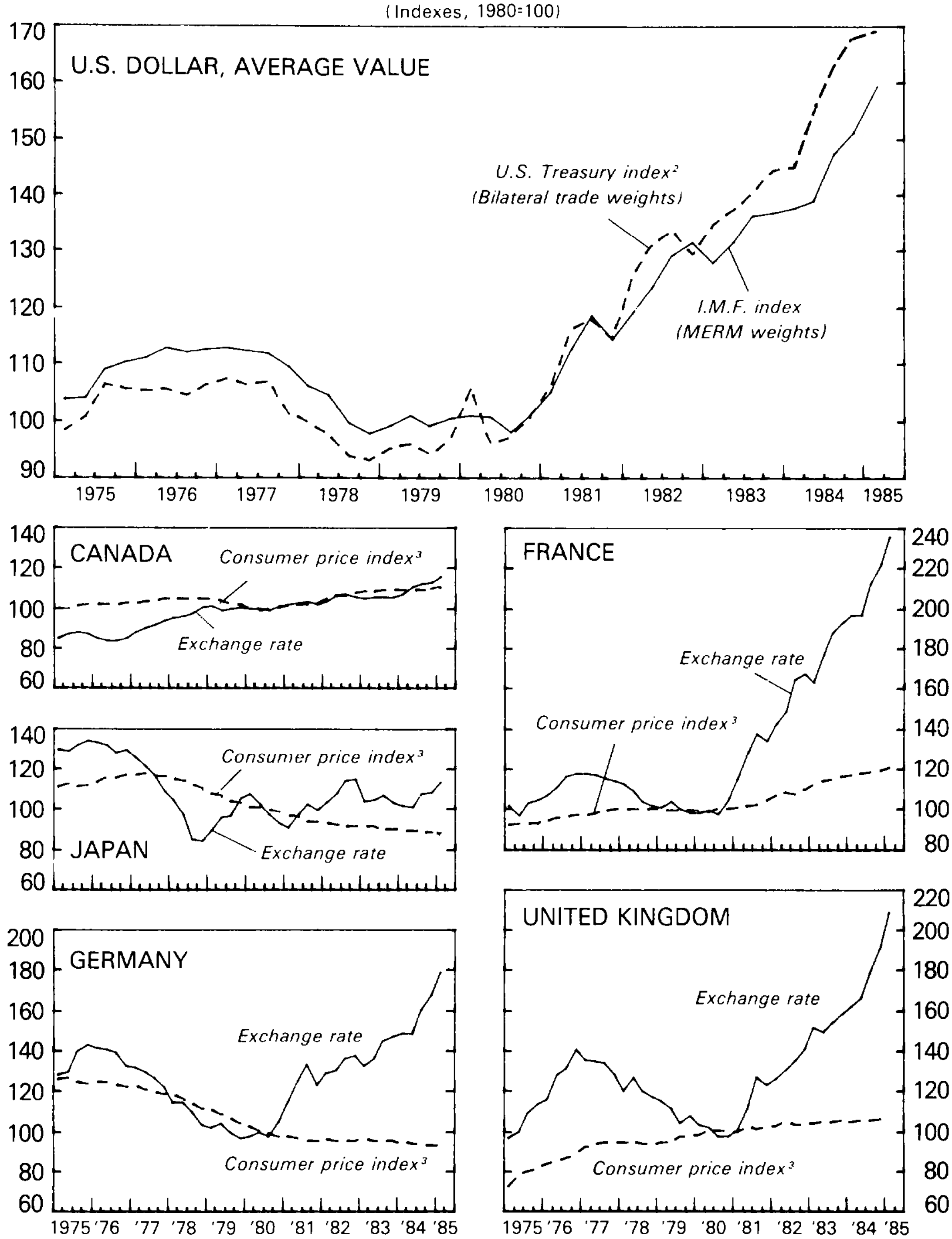
[3]Trade weighted average of industrial production indexes for France, Germany, Italy, Japan and the United Kingdom.

CHART 8

UNITED STATES

VALUE OF THE U.S. DOLLAR IN TERMS OF MAJOR CURRENCIES[1]

(Indexes, 1980=100)



[1]Exchange rate indexes are based on quarterly averages of daily rates, and are defined in terms of local currency per U.S dollar.

[2]Based on OECD countries end of period.

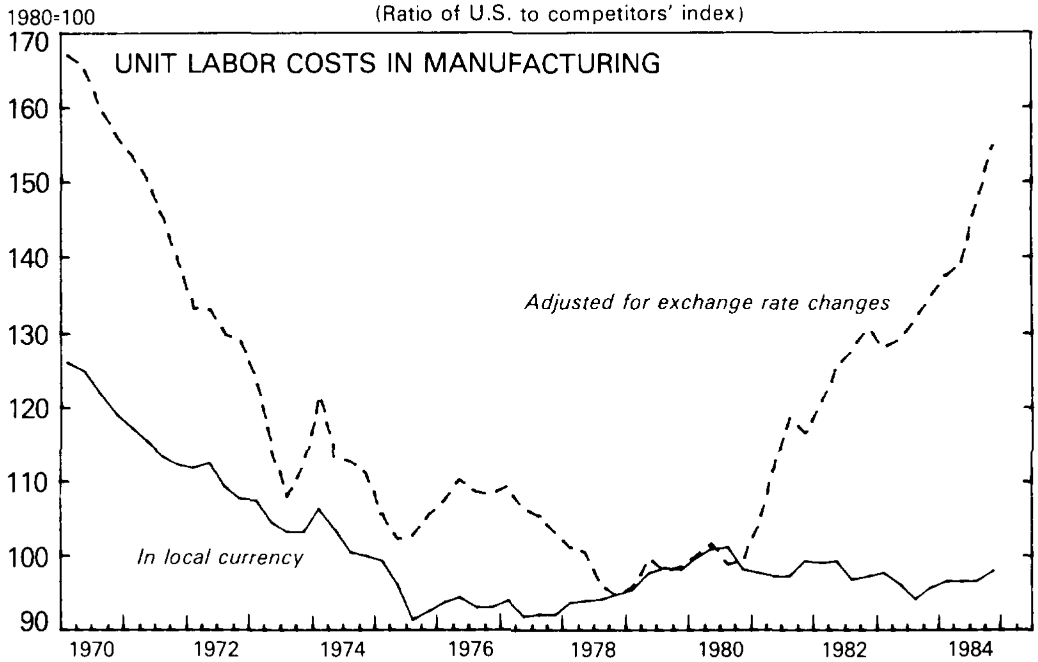
[3]Ratio of foreign consumer price index to U.S consumer price index.

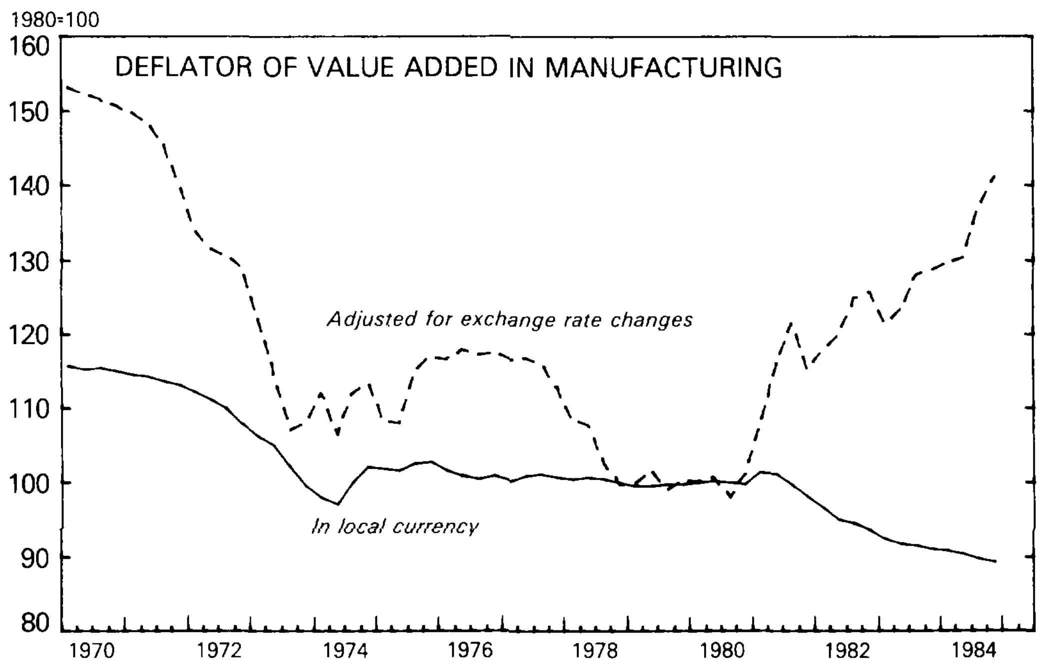
CHART 9

UNITED STATES

COSTS AND PRICES IN MANUFACTURING RELATIVE TO OTHER INDUSTRIAL COUNTRIES

(Ratio of U.S. to competitors' index)



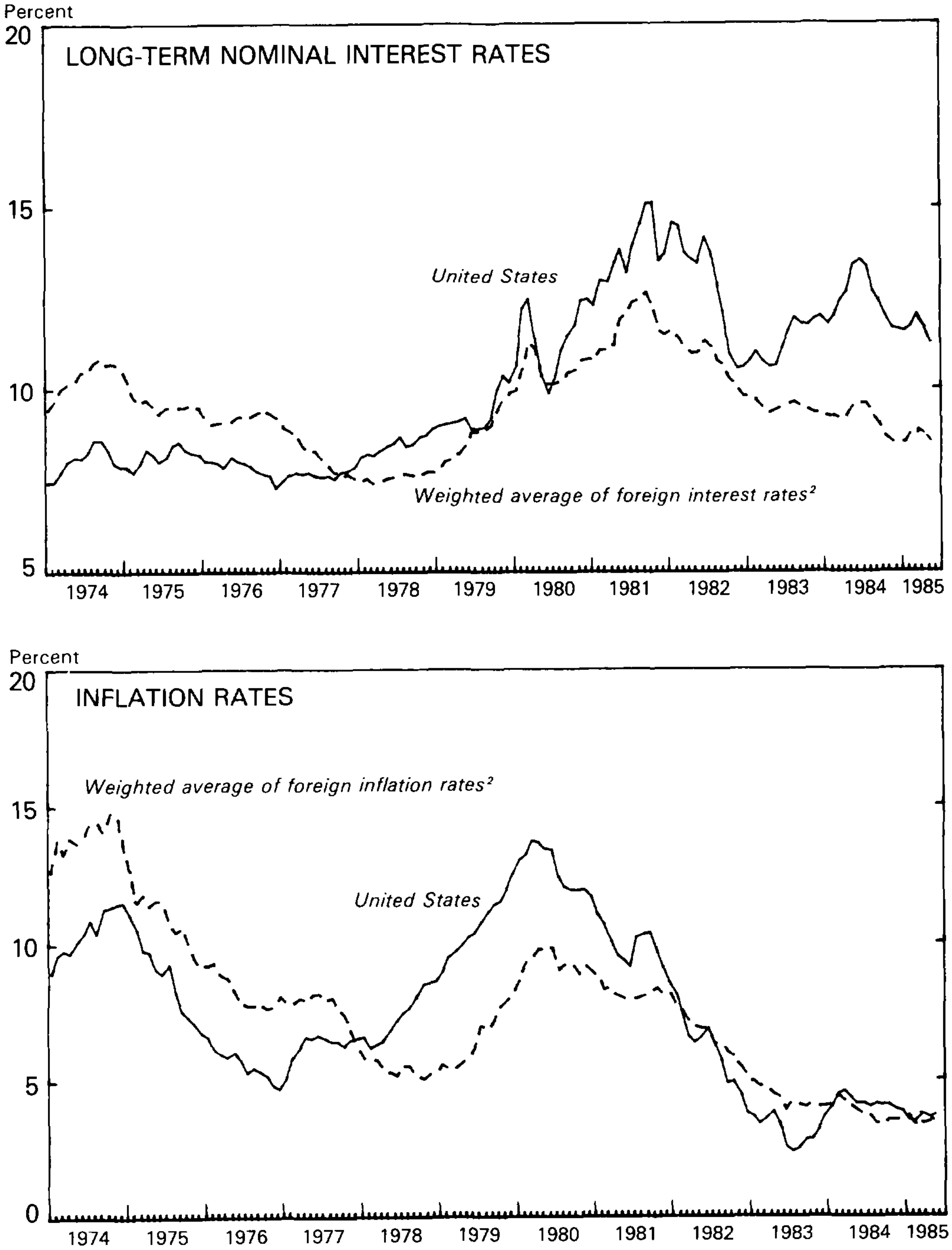


[1]Competitors indexes are weighted averages of the corresponding data for 13 major industrial countries. The weights, which are based on 1975 trade in manufactures take account of both bilateral and third market effects.

CHART 10

UNITED STATES

RELATIVE INTEREST RATES AND INFLATION RATES[1]



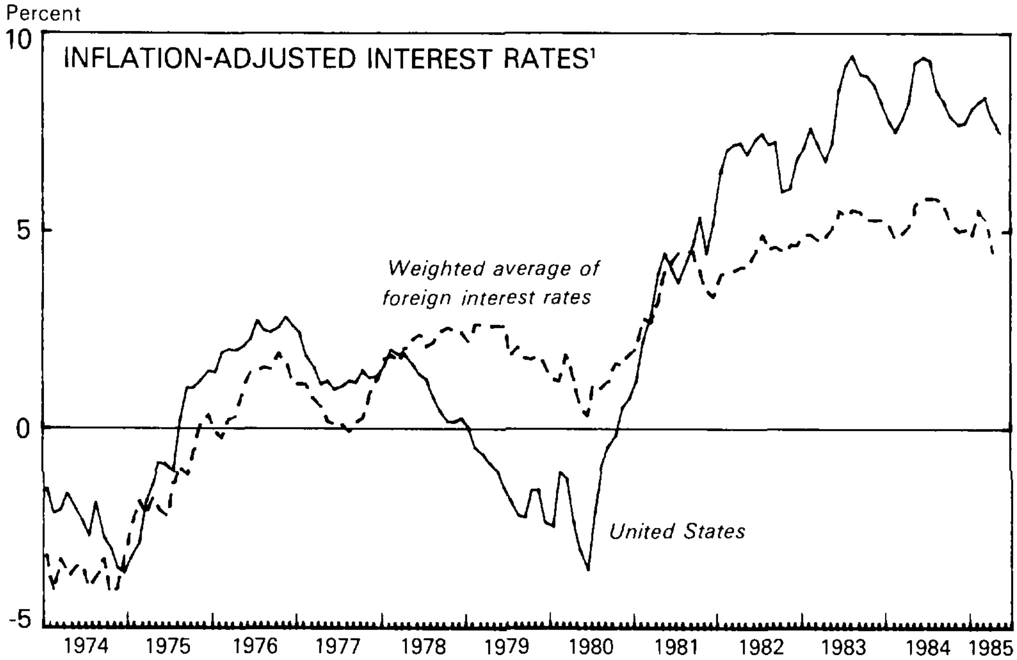
[1] Interest rates are medium to long term yields on government bonds. Inflation rates are measured as 12 month rates of change in consumer prices.

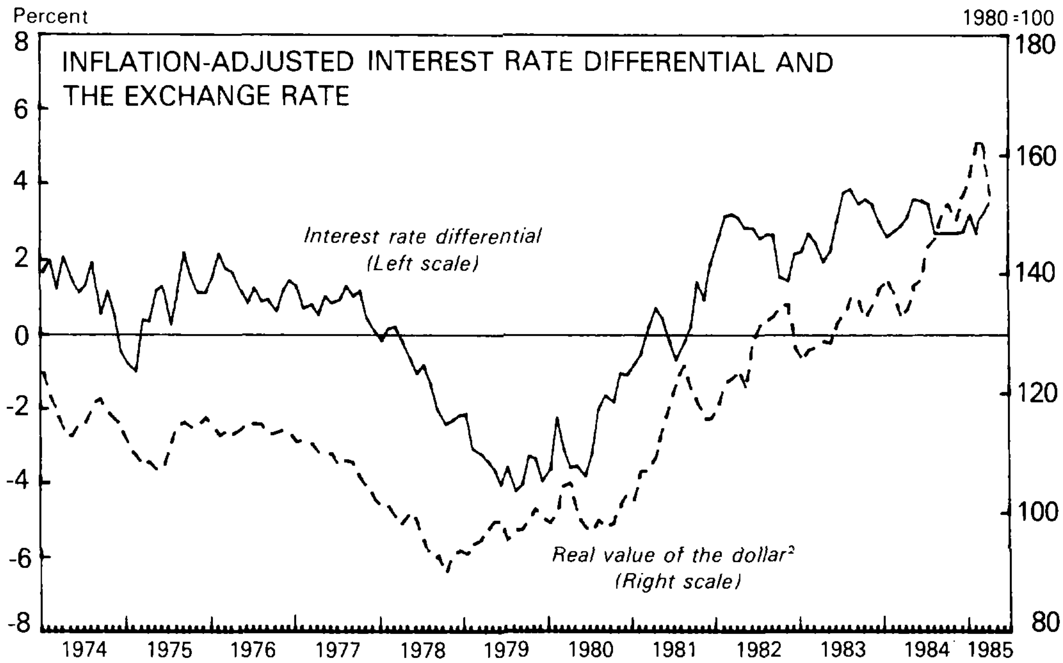
[2] Data for Canada, France, Germany, Japan, Switzerland, and the United Kingdom, weighted by 1976 GNP levels.

CHART 11

UNITED STATES

INFLATION ADJUSTED LONG-TERM INTEREST RATES AND THE EXCHANGE RATE





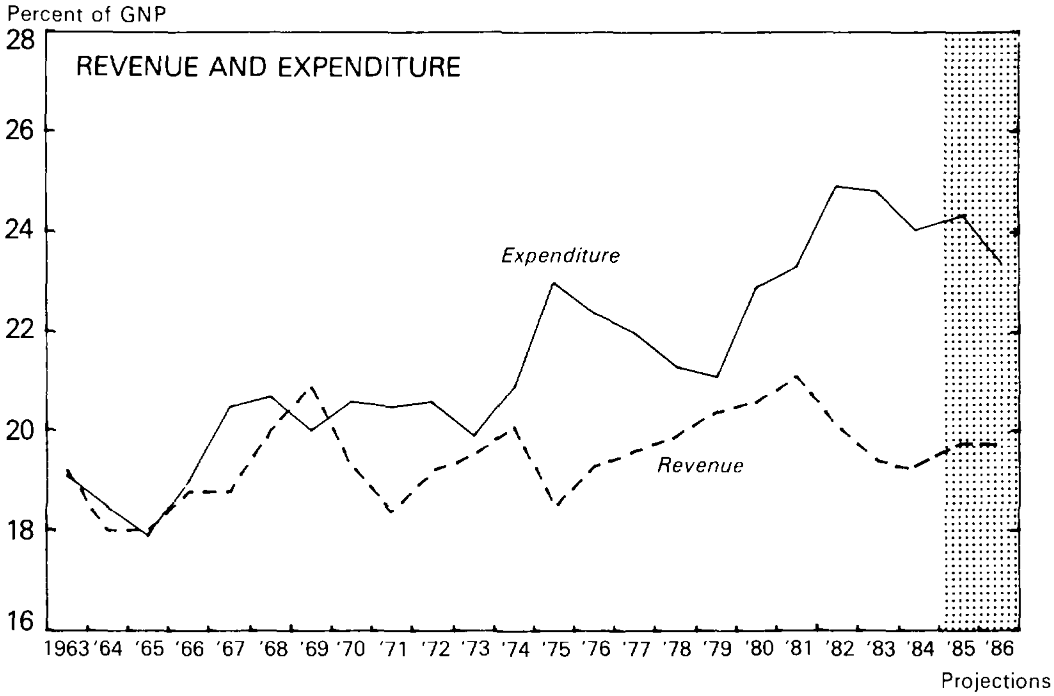
[1] Inflation-adjusted interest rates are defined as nominal rates on medium-to-long term government bonds less 12-month rates of change in consumer prices. Foreign real interest rates are measured as weighted averages (1976 GNP weights) of real rates in Canada, France, Germany, Japan, Switzerland, and the United Kingdom.

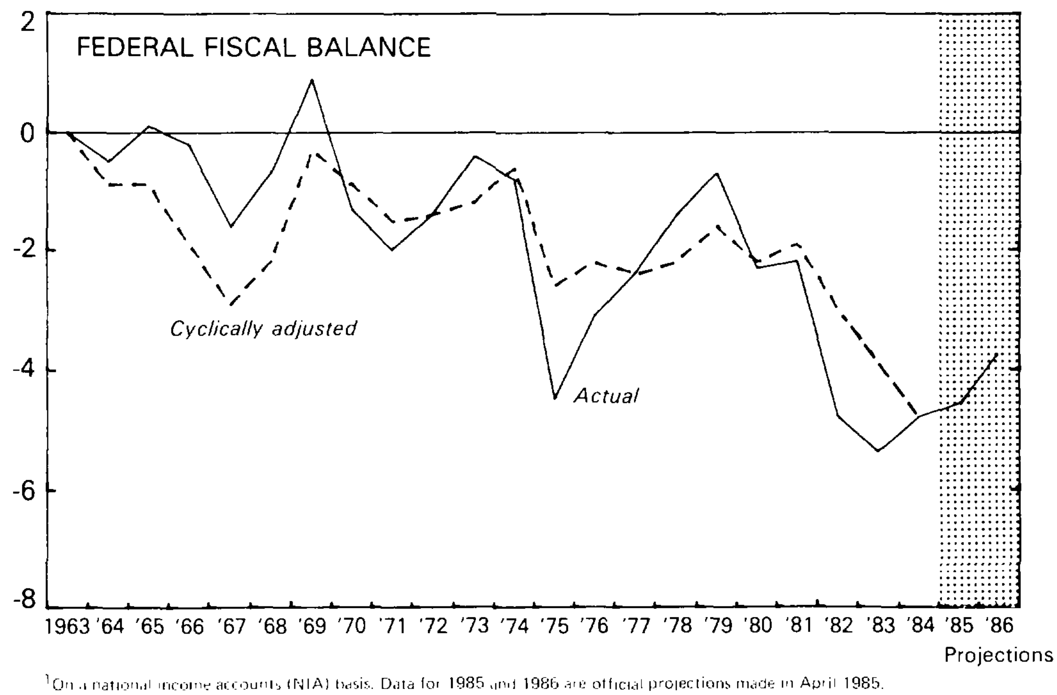
[2] Defined as a weighted average (1976 GNP weights) of the nominal value of the dollar vis a vis the currencies of the countries listed in footnote 1, adjusted for relative consumer prices

CHART 12

UNITED STATES

FISCAL TRANSACTIONS OF THE FEDERAL GOVERNMENT[1]





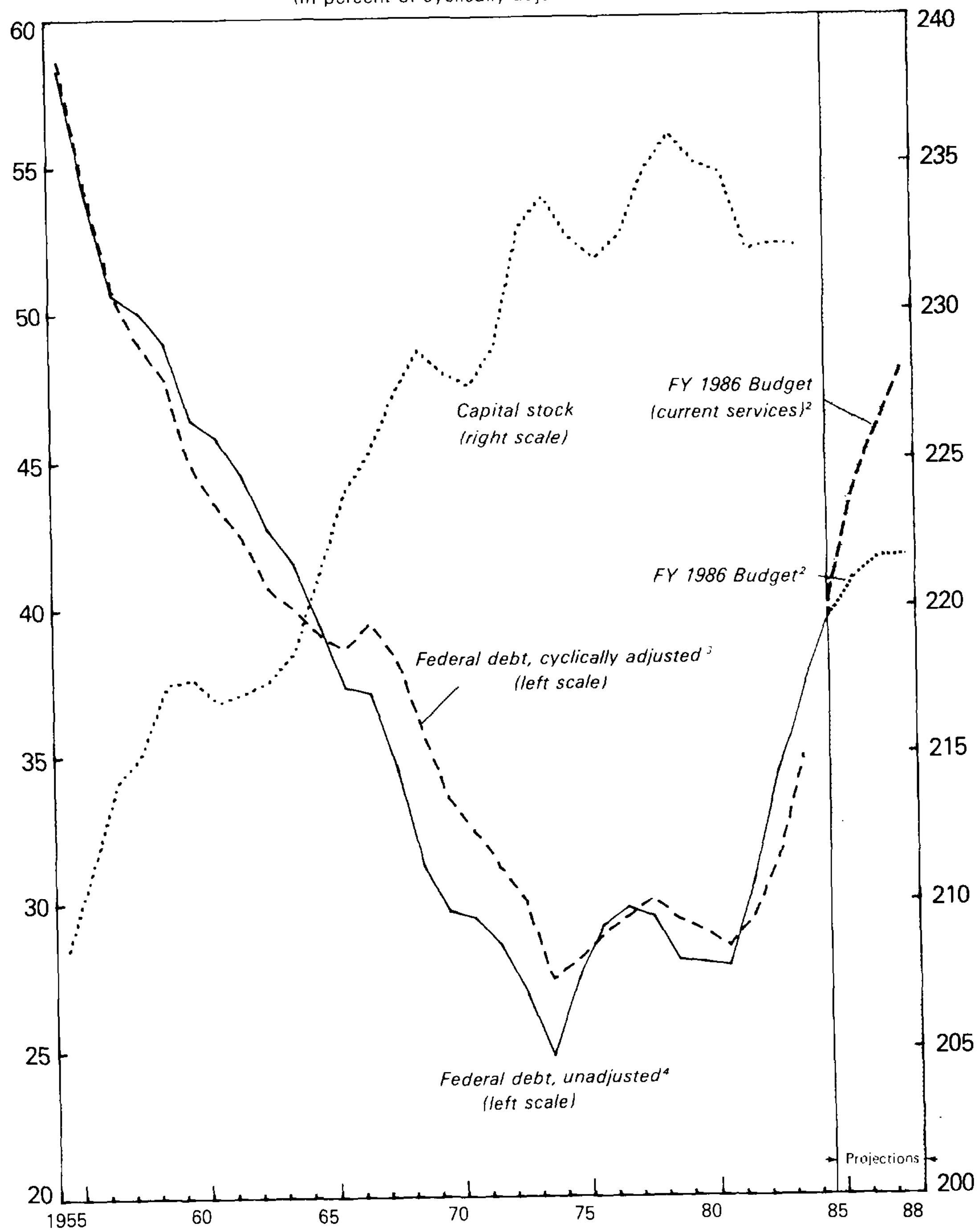
[1] On a national income accounts (NIA) basis. Data for 1985 and 1986 are official projections made in April 1985. Estimates for 1986 refer to the first three quarters of the year, at annual rate.

CHART 13

UNITED STATES

CAPITAL STOCK AND FEDERAL DEBT

(In percent of cyclically adjusted GNP[1])



[1] Based on the U.S. Department of Commerce concept of middle expansion trend of GNP

[2] Staff estimates based on the April 1985 update of the fiscal year 1986 budget proposals.

[3] As estimated by the U.S. Department of Commerce.

[4] At par value. Excludes Federal debt held by government agencies.

CHART 14

UNITED STATES

MONETARY TARGETS AND PERFORMANCE

(In billions of dollars)

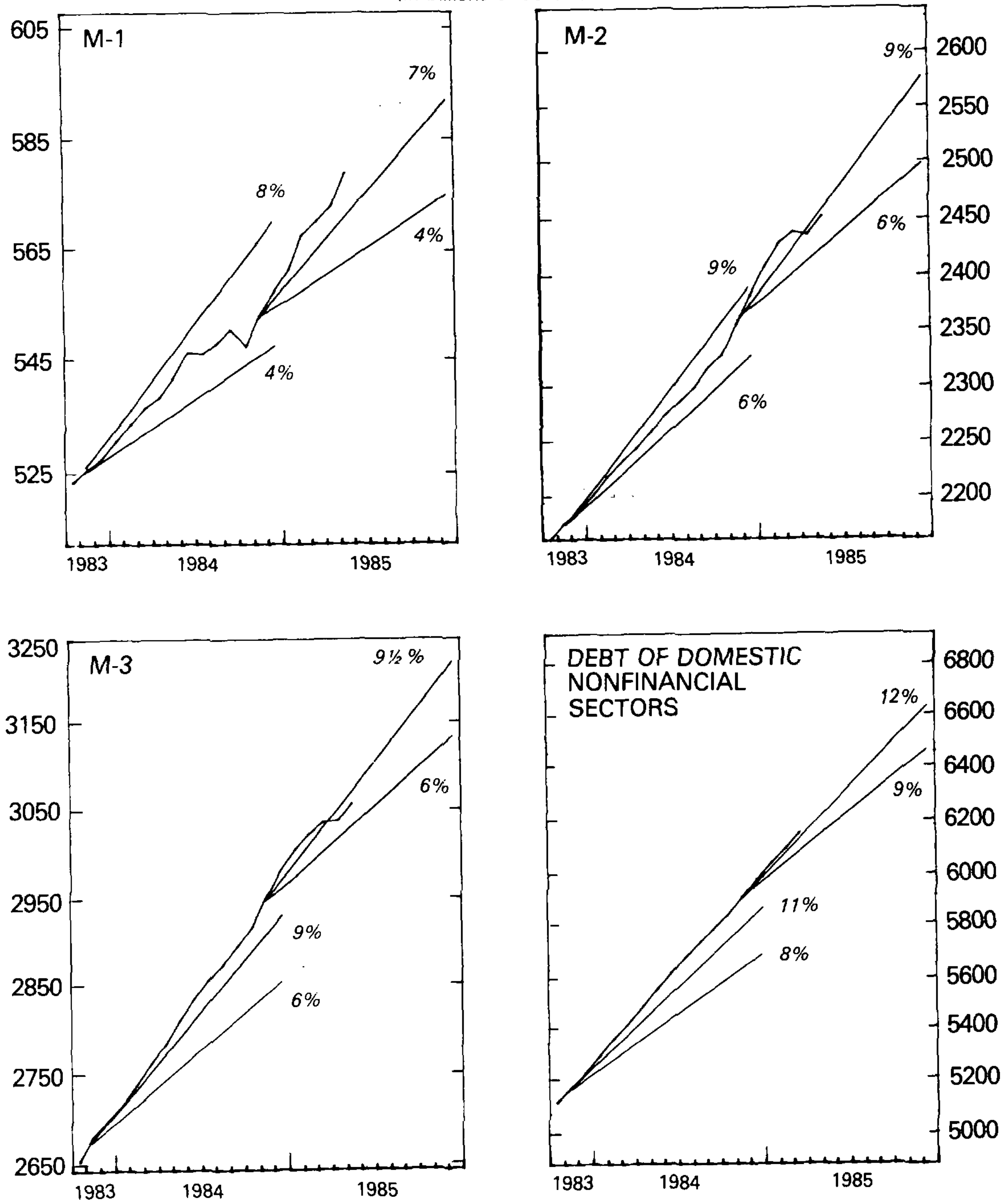


CHART 15

UNITED STATES

INTEREST RATES