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SM/85/199
Supplement 1

CONTAINS CONFIDENTIAL INFORMATION

August 1, 1985

To: Members of the Executive Board

From: The Secretary

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

The attached supplement to the staff report for the 1985 Article IV consultation with the United States has been prepared on the basis of additional information.

Mr. Hernández-Catá (ext. 8486) or Mr. P. Clark (ext. 8493) are available to answer technical or factual questions relating to this paper prior to the Board discussion scheduled for Monday, August 5, 1985.

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INTERNATIONAL MONETARY FUND

UNITED STATES

Staff Report for the 1985 Article IV Consultation
Supplementary Material

Prepared by the Western Hemisphere Department

Approved by E. Wiesner and C. David Finch

August 1, 1985

This note summarizes information that has become available since the staff papers for the 1985 Article IV consultation with the United States were issued.

1. Recent developments

According to preliminary national accounts data released on July 18, real GNP rose at an annual rate of 1 3/4 percent in the second quarter of 1985 after increasing by only 1/4 percent in the first quarter. During the year ended the second quarter of 1985, real GNP rose by less than 2 percent, down from 7 1/2 percent during the preceding four-quarter period.

The rise in real GNP in the second quarter of 1985 was more than explained by the rapid increase in final domestic demand (at an annual rate of 6 1/4 percent compared with 3 1/2 percent in the first quarter and 6 percent during 1984). All major components contributed to the strength of final domestic demand in the second quarter; in particular, nonresidential fixed investment rose at an annual rate of 13 1/2 percent following a decline of 1 1/2 percent in the first quarter. However, in the second quarter there was a marked slowdown in inventory accumulation and net exports of goods and services continued to decline.

In both May and June of 1985, the index of industrial production rose by only 0.1 percent, down slightly from the average increase in the first four months of the year. With the exception of defense, most major components of the index have shown weakness in the last several months. During the 12 months ended in June 1985, industrial production rose by 1.8 percent compared with more than 13 percent during the previous year.

The consumer price index for all urban consumers rose by 0.2 percent in both May and June of 1985, down from an average increase of 0.4 percent in the first four months of the year. The 12-month rate of increase in consumer prices was 3 3/4 percent in June 1985, roughly unchanged from May, and down from a recent peak of 4 3/4 percent in March 1984. The implicit price deflator for GNP rose at an annual rate of 2 3/4 percent in the second quarter, down from 5 1/2 percent in the first quarter and 3 1/2 percent during 1984. It should be noted that quarterly movements in the GNP deflator have been relatively volatile recently owing to changes in the composition of real GNP. The GNP fixed-weighted price index, which is unaffected by such compositional changes, rose at an annual rate of 3 3/4 percent in the second quarter of 1985 compared with 4 1/4 percent in the previous quarter and just over 4 percent during 1984.

Wage settlements remained moderate in the first half of 1985. Contracts without cost of living adjustment clauses signed during the first and second quarters of 1985 provided for annual wage increases averaging about 3 percent during the first year of the contract, compared with just over 2 percent in 1984. Following a drop of more than 3 percent at an annual rate in the first quarter of 1985, productivity in the nonfarm business sector rose at an annual rate of 1/2 percent in the second quarter. Since the second quarter of 1984 productivity has declined by roughly 1/2 percent. Reflecting the turnaround in productivity growth in the second quarter of 1985, unit labor costs rose at an annual rate of just under 3 percent, compared with an unusually rapid increase of 8 1/2 percent in the first quarter; unit labor costs had risen by 2 percent during 1984.

After appreciating by nearly 10 percent from December 1984 to late February 1985, the effective value of the dollar (MERM weights) has declined substantially. In June, the dollar was 7 1/2 percent below its February peak, but about 1 percent above its December level. During July, the value of the dollar fell sharply, and by the end of the month it was 6 percent below its level in June. On the basis of the monthly estimates of relative normalized unit labor costs in manufacturing used in the information notice system, it would appear that the weakening of the dollar that began in March 1985 has reversed most of the real effective appreciation from August 1984 to February 1985; that appreciation was brought to the attention of Directors through an information notice in March 1985.

2. Outlook

As part of the mid-session budget review--which is expected to be released in late August--the Administration has lowered its forecast for the growth of real GNP during 1985 from 3.9 percent to 3 percent. Continued rapid growth in final sales and a pickup in inventory investment are expected to boost the economy in the second half of 1985 following weaker than expected output growth during the first two quarters. For the period after 1985, the forecast for economic growth is unchanged at an annual average of a little less than 4 percent.

The Administration's near-term forecast for inflation was lowered slightly; the implicit price deflator for GNP is projected to rise by 4 percent during 1985, compared with a previous forecast of 4 1/4 percent. Over the period 1986-90 the GNP deflator would rise by an average of 3 3/4 percent a year--the same rate of increase as envisaged in the previous forecast. The forecast for short-term interest rates was lowered by about 1/2 percentage point in 1985 and 1986, and by 1/4 percentage point in 1987, to reflect the decline in interest rates that occurred in the first half of 1985. According to the revised projection, the 91-day Treasury bill rate would average 7 1/2 percent in 1985-86 before declining to 7 percent in 1987.

The staff is presently updating its projections for the U.S. economy in the context of the current round of the World Economic Outlook exercise. On the basis of the latest developments, the forecast for the growth of real GNP during 1985 has been revised to 2.6 percent, from 2.9 percent envisaged at the time the staff report was issued.1/ Real GNP is expected to increase by 2.8 percent during 1986, a slight upward revision from the previous forecast. On a year-over-year basis, real GNP in 1985 is projected to rise 2.6 percent compared with 2.8 percent in the previous forecast; for 1986, the expected increase in real GNP remains unchanged at 3.3 percent. The projections for inflation have not been modified significantly; the GNP deflator is expected to rise by just under 4 percent during both 1985 and 1986.

The staff has recently revised its forecast for the current account of the U.S. balance of payments on the basis of revised assumptions for the real effective value of the dollar, preliminary data for U.S. merchandise trade in the second quarter of 1985, and small revisions to the forecasts of economic activity in the United States and in other countries. The staff is projecting that the current account deficit will widen from $102 billion in 1984 to $130 billion in 1985 and to $148 billion in 1986; the previous forecast envisaged deficits of $125 billion in 1985 and of $159 billion in 1986. The merchandise trade deficit would rise from $108 billion in 1984 to $134 billion in 1985 and to $148 billion in 1986. 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.

3. Monetary policy

In its midyear report to Congress issued on July 16, the Federal Reserve announced that the target range for the growth of M-1 during 1985 was being rebased to the second quarter of 1985 (from the previous base in the fourth quarter of 1984) and that the range would be widened from 4-7 percent to 3-8 percent (annual rates). The ranges for the other aggregates were confirmed at the levels set in February (see following tabulation). Tentative ranges were set for growth of the aggregates during 1986. The range for M-1 would be 4-7 percent, the same as the range for 1985 that had been set in February. The range for M-2 during 1986 would be left unchanged at 6-9 percent. The upper bound

1/ See SM/85/199, p. 26.

of the range for M-3 would be lowered by 1/2 percentage point, giving a range of 6-9 percent during 1986. The range for growth of the credit aggregate was lowered by 1 percentage point to 8-11 percent.

Federal Reserve Objectives and Actual
Monetary Growth

(Percent change at annual rate)

	1985		1986
	Target 1/	Actual 2/	Target 3/
M-1	3-8 4/	11.9	4-7
M-2	6-9	9.5	6-9
M-3	6-9 1/2	8.5	6-9
Domestic nonfinancial sector debt	9-12	13.1	8-11

In announcing the new target ranges to Congress, the Chairman of the Federal Reserve indicated that the monetary targets would be consistent with sustained growth in the economy provided inflationary pressures were contained. The Chairman observed that a surge in M-1 during May and June had carried that aggregate well above the target range for 1985 that had been set in February. In part, this surge in M-1 could be related to the sizable decline in interest rates that had taken place since mid-1984. The Chairman noted, however, that the payment of interest on certain types of checking accounts might tend to increase holdings of M-1 relative to GNP. He emphasized that there was as yet insufficient experience to specify with any precision the relationship between money, income, and interest rates following the regulatory changes introduced in recent years.

The Chairman said that, in these circumstances, the Federal Reserve had decided to rebase the target for the growth of M-1 to the second quarter of 1985 and to widen the range for the remainder of the year. The decision to rebase the M-1 target range reflected the view that it was appropriate to take account of both the return of interest rates toward historically more normal levels and the possibility of some change in the trend of velocity growth. In this connection, the Chairman noted that M-1 stood above the revised range in early July, but he believed that this aggregate would return gradually to within its range in the course of the year.

1/ Ranges set in February 1985 and confirmed in July 1985, except in the case of M-1. The range for M-1 was set at 4-7 percent in February and revised to 3-8 percent in July.
2/ Growth from fourth quarter of 1984 to June 1985 (May 1985 in the case of the debt aggregate).
3/ Tentative ranges set in July 1985.
4/ To apply from the second quarter to the fourth quarter.