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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/120

10:00 a.m., August 5, 1985

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

| Executive Directors | Alternate Executive Directors |
|---|---|
| A. Alfidja | |
| C. H. Dallara | M. K. Bush |
| | H. G. Schneider |
| B. de Maulde | |
| | T. Alhaimus |
| H. Fujino | M. Sugita |
| G. Grosche | |
| J. E. Ismael | Jaafar A. |
| R. K. Joyce | |
| A. Kafka | H. A. Arias |
| H. Lundstrom | |
| | A. Abdallah |
| F. L. Nebbia | B. Jensen |
| Y. A. Nimatallah | J. E. Suraisry |
| P. Pérez | G. Ortiz |
| J. J. Polak | |
| C. R. Rye | |
| | R. Msadek, Temporary |
| A. K. Sengupta | A. S. Jayawardena |
| | T. A. Clark |
| S. Zecchini | N. Coumbis |
| | Wang E. |

L. Van Houtven, Secretary
S. L. Yeager, Assistant

Also Present

African Department: A. D. Ouattara, Director. Asian Department: U. Baumgartner. Central Banking Department: E. Bertero. European Department: B. Christensen, P. Dhonte, M. Z. Khan, M. Mentini, G. Szapary. Exchange and Trade Relations Department: C. D. Finch, Counsellor and Director; S. J. Anjaria, G. Belanger, J. T. Boorman, A. B. Petersen, R. L. Sheehy. External Relations Department: A. F. Mohammed, Director. Fiscal Affairs Department: V. Tanzi, Director; G. Blöndal. IMF Institute: O. B. Makalou. Legal Department: W. E. Holder. Research Department: W. C. Hood, Economic Counsellor and Director; A. D. Crockett, Deputy Director; R. R. Rhomberg, Deputy Director; C. P. Blackwell, M. C. Deppler, M. D. Knight, F. B. Larsen, P. R. Masson. Treasurer's Department: T. Leddy, Deputy Treasurer. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; P. B. Clark, C. V. A. Collyns, R. J. Corker, L. E. DeMilner, S. V. Dunaway, E. Hernández-Catá, L. R. Kenward, F. Pham. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: P. E. Archibong, D. Hammann, K. A. Hansen, J. Hospedales, P. Péterfalvy, G. W. K. Pickering, M. Z. M. Qureshi, T. Sirivedhin, E. M. Taha, D. C. Templeman, N. Toé, A. Vasudevan, K. Yao. Assistants to Executive Directors: I. Angeloni, Bo T., M. B. Chatah, Chen J., S. de Forges, J. de la Herrán, G. Ercel, C. Flamant, V. Govindarajan, G. D. Hodgson, O. Isleifsson, Z. b. Ismail, H. Kobayashi, S. Kolb, M. Lundsager, J. A. K. Munthali, A. H. Mustafa, M. Rasyid, J. Reddy, D. J. Robinson, J. E. Rodríguez, C. A. Salinas, M. Sarenac, A. A. Scholten, L. Tornetta, E. L. Walker, B. D. White.

## 1. REPORT BY DEPUTY MANAGING DIRECTOR

The Deputy Managing Director remarked that he had recently attended a meeting of representatives from 14 major banks in Japan, the United States, and a number of European countries that played a leading role in various advisory committees. The group, known as the Committee of Fourteen, was an informal one that met in various countries at different times of the year. The representatives had spoken from the perspective of their respective institutions, not as a collective entity. The Paris meeting had been hosted by the Banque Nationale de Paris and the Crédit Lyonnais. The Executive Vice President of the Inter-American Development Bank, the Senior Vice President of the World Bank, and the Secretary General of the Paris Club had also participated in the meeting.

His discussions with the bank representatives had focused mainly on the Fund's policy of enhanced surveillance, the Deputy Managing Director indicated. In outlining some of the concerns recently expressed by the Executive Board, he had emphasized that enhanced surveillance should not be interpreted as implying a commitment or guarantee by the Fund and that the banks were expected to assume full responsibility for their own economic monitoring arrangements and credit-risk assessments; that the Fund wished to avoid providing "on/off" signals for creditors' decisions; that enhanced surveillance in the context of a multiyear restructuring arrangement (MYRA) was seen as a way to restore normal market relations between debtor countries and the banks; and that questions remained about the length of Fund involvement in such arrangements. He had also noted that the Fund's enhanced surveillance policy and procedures were evolving and would be the subject of Executive Board discussion in the future.

For their part, the commercial bank representatives who had spoken had noted that their own monitoring procedures were also evolving and that they viewed enhanced surveillance by the Fund--which was still in its earliest stages, with no Article IV report under enhanced surveillance having been received by banks--as a means of improving the quality of their information, the Deputy Managing Director added. They considered some of the mistakes made in bank lending in the late 1970s and early 1980s to have been the result of decisions based on untimely or inadequate information from borrowing countries. Some representatives had expressed the view that enhanced surveillance should not provide on/off signals, since such signals could lead commercial bank supervisors to make the wrong decisions. Moreover, MYRAs were viewed as a means of enabling countries to return to normal market relations and thus would be appropriate when considerable adjustment had been achieved. Some representatives had commented that MYRAs could reduce the time and cost associated with annual debt rescheduling negotiations, and, for that reason, might also be appropriate for countries where strong adjustment efforts were under way. Whereas in 1982-83 banks had been focusing on what they considered an emergency, they were currently looking ahead for a period of about 16 years and were at the same time seeking ways to persuade major banks involved in the advisory committees and, more important, the small and medium-sized banks that were participants in various financing arrangements to resume normal market lending to debtor countries.

Great interest had been expressed in the evolving role of the World Bank, the Deputy Managing Director commented. The financial arrangement for Chile was viewed as an example of the important link between Fund-supported adjustment programs and World Bank adjustment programs. Such Fund-Bank collaboration was considered important because countries facing severe debt problems needed not only financial assistance but also assistance in making the structural changes that would improve their prospects for economic growth and thereby enable them to remain current on debt servicing and eventually to repay their debts.

## 2. *UNITED STATES - 1985 ARTICLE IV CONSULTATION*

The Executive Directors considered the staff report for the 1985 Article IV consultation with the United States (SM/85/199, 7/8/85; and Sup. 1, 8/1/85). They also had before them a report on recent economic developments in the United States (SM/85/209, 7/22/85; Cor. 1, 7/24/85; Cor. 2, 8/2/85; Sup. 1, 7/22/85; and Sup. 1, Cor. 1, 8/2/85).

The staff representative from the Western Hemisphere Department made the following statement:

> Late last week, Congress approved a resolution that envisaged a reduction in the growth of federal spending. The resolution included savings in the Medicaid and Medicare programs, a reduction in farm price-support outlays, termination of general revenue sharing with the state and local governments after FY 1986, and reductions in the size of other domestic programs. In addition, the growth of defense outlays would be held to an average annual rate of 6 3/4 percent from FY 1985 to FY 1988, compared with an average increase of 13 1/2 percent envisaged in the current services estimate. The congressional resolution did not include tax increases or measures to reduce the cost of living adjustments in social security benefits. Relative to the current services estimates, implementation of the budget resolution was expected to result in budget savings of approximately $56 billion in FY 1986, $90 billion in FY 1987, and $132 billion in FY 1988.
>
> On the basis of the measures contained in the budget resolution and the Administration's assumptions for economic growth, prices, and interest rates, the Congress projected that the federal deficit would decline from $210 billion in FY 1985 to $172 billion in FY 1986, $154 billion in FY 1987, and $112 billion in FY 1988. In relation to GNP, the federal deficit would fall from 5 1/2 percent in FY 1985 to about 2 1/4 percent in FY 1988.

It should be emphasized that considerable work remains to be done by the relevant congressional committees in order to achieve these budget savings. Most of the spending cuts for FY 1986 implied by the resolution still need to be translated into specific appropriation bills. Moreover, because these proposals include few program terminations, the spending cuts that are envisaged for FY 1987 and FY 1988 will need to go through the appropriations process in each of those years. Thus, there is considerable danger of slippage in the implementation of the congressional proposals.

It should also be emphasized that the congressional estimates of budget savings are based on the Administration's economic assumptions as presented in February 1985 in the context of the budget for FY 1986. The Administration's forecast envisages growth of 4 percent each year in 1986-88. As was indicated in the consultation reports, the staff considers that the conditions for the achievement of such a rate of growth are unlikely to be met, and the staff's projection is for the growth of real GNP to average a little less than 3 percent each year over this period.

In the staff's forecast, the federal deficit would be considerably higher than projected by the Congress, even if the congressional plan were implemented in full. Using the staff's economic assumptions, the federal deficit would remain as high as 4 1/2 percent of GNP in FY 1986 and would be nearly 3 3/4 percent of GNP in FY 1988. On this basis, the federal debt would rise in relation to GNP from a little less than 40 percent in 1985 to 44 percent in 1988, whereas the congressional estimates imply that the debt-to-GNP ratio would peak at about 41 percent in 1987 before declining to a little less than 40 percent in 1988.

Mr. Dallara made the following statement:

The staff has provided us with comprehensive and current material on recent economic developments, policies, and prospects. In my comments, therefore, I will concentrate on aspects of these which I consider of particular importance.

Overall economic strategy

I will briefly review its principal elements.

In light of the importance of assessing developments and decisions in the context of the overall economic strategy of the United States, this strategy has consisted of:

- a fundamental belief in the central importance of market forces in guiding decision making within the economy, allowing maximum freedom for individual choice and maximum opportunity for growth, employment, and the creation of wealth;

- reducing the role of government in the economy in order that the private sector can prosper, with particular emphasis on deregulation and restraint in government expenditure;

- bringing inflation under control; and

- an international economic policy that reflects these same tenets, emphasizing market forces, free trade, and international economic cooperation, with strong support for the international institutions, including centrally the Fund, which provide the framework for such cooperation.

The overall aim of this strategy is to restore incentives for productivity and growth that will increase economic opportunity for all.

Recent economic developments and short- and medium-term prospects

The impressive record of the U.S. economy since 1982 has been comprehensively documented in the staff papers and discussed in the Executive Board on numerous occasions. I will therefore focus on more recent economic developments and short- and medium-term prospects.

Following the exceptionally rapid expansion during the early phases of the recovery--with real GNP growing at 7.1 percent during the first six quarters of the expansion--the U.S. economy has slowed. Real GNP growth in 1984 was 5.7 percent (fourth quarter to fourth quarter), and during the last four quarters just under 2 percent. Inflation has continued to improve, with the 12-month increase in the consumer price index falling to 3.75 percent through June 1985; and interest rates have declined significantly, with average short-term rates in June 1985 almost 4 percent below average levels a year earlier, and average long-term rates down 3.4 percent over the same period.

The outlook for the rest of 1985 is for an increase in economic activity, with real growth of 3 percent projected from the fourth quarter of 1984 through the fourth quarter of 1985. Inflation is expected to remain below a 4 percent annual rate. Following the creation of more than 7.3 million jobs since the 1982 trough, employment is expected to continue to grow, with the unemployment rate projected to decline gradually from a 1984 annual average of 7.4 percent to a 1985 average of 7.1 percent.

Among the factors which may be particularly relevant in considering recent developments and short-term prospects are the following:

-- the significant decline in the rate of growth during the first half of 1985 was associated with a sizable reduction in the rate of inventory investment, with inventories accumulating at an annual rate of only \$12.5 billion during the first half of 1985 compared with a rate of \$27 billion during the first half of 1984. With the inventory-sales ratio now at relatively low levels, particularly among manufacturing industries, a resumption of normal growth in inventories can be expected to contribute to second half FY 1985 production;

-- the significant decline in interest rates over the past year should enhance the prospects for an increase in activity, particularly in the most interest-sensitive sectors, such as housing;

-- domestic demand for goods and services remains robust. Real final sales, for example, continued to grow at a strong pace during the second quarter of 1985, increasing at an annual rate of 5.1 percent. The lower GNP growth during this period reflects the important role of imports in meeting U.S. demand;

-- the annual rate of growth of M-1 of 10.1 percent during the first two quarters should also facilitate an increase in economic activity; and

-- the most recent developments in leading economic indicators also point toward more activity in the second semester, with the 1 percent increase in June--the largest since January 1985--presenting an upward trend since December 1984.

The medium-term outlook for the U.S. economy is one of continued economic expansion with declining inflation. Expansion at an annual rate of 4 percent is forecast during 1986 through 1988, slowing to 3.9 percent in 1989 and 3.6 percent in 1990, and is expected to be associated with a continued gradual decline in the annual rate of inflation to about 3 percent.

This is not to imply, however, that there are not areas of concern in the medium-term outlook. Although gross private savings were at historically high levels in 1984, the personal savings rate has not yet recovered from the sharp decline during the mid-1970s and early 1980s. And the manufacturing sector appears to continue to be sluggish, in the face of the continued expansion of imports and virtual stagnation of exports. 1/ This, of course, is reflected in the growing current account imbalance, now expected to be above 3.0 percent of GNP in 1985 and near 3.5 percent of GNP in 1986.

But the largest concern about the medium-term outlook has been the federal budget deficit. Achievement of the favorable medium-term outlook outlined above is critically dependent upon implementation of sound U.S. policies--and that must include reducing significantly the budget deficit.

U.S. fiscal policy and prospects

Among the areas in which the staff and my authorities are in complete agreement is the critical importance of reducing the U.S. fiscal deficit. As President Reagan has stated, "had spending not soared out of control, today we would have nearly a balanced budget, far less national debt, and no threat to our current prosperity."

Growing fiscal deficits could pose a threat to the long-run economic health of the United States and the world. Accordingly, reducing the deficit has been a top economic priority of the Administration. The Administration's proposed FY 1986 budget put forward a plan to reduce the deficit substantially over the next few years. The deficit reduction plan was based firmly on the proposition that the most effective, economically sound, and lasting way to reduce the deficit is through expenditure restraint.

My authorities are pleased with the recent agreement in Congress on a budget resolution providing for a reduction in the deficit of $55 billion in FY 1986 and a total of $277 billion over the three-year period FY 1986-88. That meets the Administration targets on both a one- and three-year basis without increasing individual or corporate tax burdens or energy import fees.

The agreement provides for a reduction of the deficit of more than 1 percent of GNP in FY 1986 from the FY 1985 level of 5.7 percent of GNP, and for a progressive reduction to

1/ Recent revisions in the index of industrial production, however, cast some doubt on the apparent sluggishness of manufacturing. The revised index shows that manufacturing output at the intermediate and final stages of production has risen at an annual rate of 3.6 percent in 1985, compared with the 0.6 percent annual rise reflected in the old industrial production series.

2.3 percent of GNP by FY 1988. That would put the federal debt on a declining path relative to GDP, a critically important objective for the long-term health of the U.S. economy.

Monetary developments and policy

The Federal Reserve has recently announced that the target range for M-1 growth during 1985 has been rebased to the second quarter of 1985 and widened from 4 percent to 7 percent to 3 percent to 8 percent. That change reflects a number of considerations, but it does not reflect a change in the Federal Reserve's or Administration's fundamental stance toward monetary policy: that is, providing a financial environment conducive to sustained growth and continued progress toward price stability.

Among the considerations which underlay the decision of the Federal Open Market Committee to rebase and alter the targets were:

-- the continued softness in prices, with certain agricultural and industrial prices even declining recently, and wholesale prices almost flat;

-- continued moderation in wage increases, with the rise in nonfarm hourly compensation only 4 percent in the year ended March 1985;

-- the high level of the dollar and the U.S. current account deficit, and the related weakness in the manufacturing sector;

-- analysis which suggests that the rapid growth in M-1 this spring was a reflection in part of greater willingness of economic agents to hold cash balances in an environment of significant interest rate declines, as well as possibly a reflection of the inclusion in M-1 of interest-bearing accounts which may have altered the relationship between M-1 growth and nominal spending;

-- a view that the sharp decline in velocity during the first half of 1985 may not be fully reversed, but could presage a secular move toward lower velocity; and

-- the broader measures of monetary growth--M-2 and M-3--have remained generally within the target ranges established for the year.

It is worth noting that M-1 is currently high relative to the rebased range, and the Federal Reserve contemplates a return to M-1 within the new range gradually as the year progresses.

Tax reform

A major initiative of my authorities has been the proposal for a comprehensive reform of the tax system, which is designed to reduce tax rates, increase the simplicity and fairness of the tax system, and foster growth by increasing incentives for work, saving, investment, risk-taking, and innovation. Key elements of the proposal include:

-- the replacement of a schedule of 14 marginal tax rates ranging from 11 percent to 50 percent, with a simple three-bracket system having rates of 15 percent, 25 percent, and 35 percent;

-- reform and simplification of a complex system of itemized deductions, exclusions, and special credits, eliminating or curtailing more than 65 categories of preferential tax treatment; and

-- the reduction of corporate tax rates with a balanced set of investment incentives.

I would like to assure Directors that the Administration remains completely committed to passing a tax reform bill that is revenue neutral. That commitment has been recently reaffirmed by the Secretary of the Treasury, as well as by the leaders of the Congressional Committees with responsibility for tax matters. The Administration will work closely with Congress in order that revenue-neutral tax reform can be implemented at an early date.

The balance of payments and the exchange rate

The two predominant, related features of the U.S. economy's interaction with the rest of the world have been the large and growing U.S. trade and current account deficits, with the latter forecast to increase from $102 billion in 1984 to $125 billion in 1985 and to $150 billion in 1986; and the strength of the dollar, which appreciated a further 15.6 percent on a trade-weighted basis between January 1984 and February 26, 1985 before declining 9.1 percent thereafter.

The factors underlying the U.S. current account deficits are generally well-known (and are discussed in detail in Appendix V of SM/85/209, Sup. 1). The factors underlying the strength of the dollar are also generally not in dispute, although differences do exist over the relative importance of these factors. In particular, my authorities do not believe that interest rate differentials have been a consistently important factor in the dollar's appreciation. Neither the movement of nominal nor real interest rates appears to go very far in explaining exchange rate developments since 1981;

this is particularly the case in 1983 and 1984, when real interest rate differentials moved against the dollar by 1.6 percent while the dollar appreciated 12.8 percent on a trade-weighted basis.

While the U.S. current account deficit has provided a major stimulus to world economic growth, it also reflects serious problems for the competitiveness of U.S. industry and has intensified protectionist pressures. The recent depreciation of the dollar has been welcomed by my authorities, and it should, over time, help ease these difficulties. But the depreciation to date will obviously not solve either of these problems.

The staff raises the question of whether there could be a *sudden shift in investors' preferences away from U.S. assets*, triggering a sharp decline in the value of the dollar. We do not consider that likely, since we do not foresee any event that could trigger a sudden loss of confidence in U.S. economic policy and prospects. Directors may, however, wish to consider this important issue. But I would also posit the following as a basis of possible discussion:

> Capital flows to the United States have been voluntary and have, in fact, contributed to the appreciation of the dollar and, therefore, to the growing current account deficit. The fundamental question is not so much whether *the capital flows will continue*, but whether circumstances will develop to reduce significantly the U.S. current account deficit during the period ahead. Three ways, *inter alia*, that this could in theory be accomplished present themselves: protectionist measures by the United States; an appreciation of other currencies relative to the dollar; or a significant improvement in foreign growth relative to U.S. growth.

The first is obviously an undesirable course, while the second and third depend importantly on actions by other countries. This is not in any way to minimize the central responsibility of the United States to address its own economic problems. But the means by which the United States could bring about a sharp decline in the dollar, in the absence of relative improvement in the attractiveness of other currencies, or bring about a significant shift in relative growth away from the United States, are clearly at least as undesirable as protectionism: reinflation that could destroy confidence in the U.S. economy and the dollar; and extremely low or negative U.S. growth. (In this regard, I would call Directors' attention to Appendix VI in SM/85/209, Sup. 1.) It could be argued that if the U.S. current account deficit is to be reduced significantly in the period ahead through internationally acceptable policies, this will have to depend significantly on increased relative attractiveness of foreign currencies and improved growth in other industrial and developing countries.

International trade policy

There are three main elements to the Administration's international trade policy: the maintenance of a free and open trading system that can promote continued expansion of international trade and world economic growth; a trade system which limits the distortions to trade, particularly those due to nontariff barriers or interference by governments in trade flows; and the principles of overall reciprocity and equity.

The openness of the U.S. economy has been clearly borne out by developments of the last few years. In 1984 the United States absorbed 58 percent of LDC exports of manufactured goods to industrial countries, although the U.S. GNP is only approximately one third of total industrial country GNP. And, even growth of U.S. imports in sensitive sectors has been substantial--textile and apparel imports increased 41 percent in 1984 and automobile imports increased 27 percent.

The United States has taken certain restrictive steps over the last few years, as outlined in Appendix 7 of SM/85/209, Sup. 1. However, the United States has on the whole developed an impressive record of resistance to trade restrictions, in spite of the recession of the early 1980s and the pressures brought about by the strong dollar and the U.S. trade and current account deficits.

Two things are, however, clear: first, protectionist pressures in the United States continue to grow; and second, the resolution of current protectionist pressures does not lie solely within the realm of trade policies narrowly defined, but will depend importantly on exchange rate and macroeconomic developments in the world economy. The last point reinforces, in my view, the importance of improved economic performance outside the United States, not only to provide support for global economic expansion, but to avoid protectionist policies which can multiply and do serious damage to the world economy.

The United States remains committed to liberalization of markets and is looking to the achievement of this goal through a new round of trade negotiations within the GATT. We will continue to fight protectionism in the United States, but our task will be easier if a new round can be launched and if other countries act to reduce their use of unfair trade practices.

Conclusion

The importance of Fund surveillance has been particularly evident during the Executive Board discussions of the past week. During this brief period, Article IV consultations have been concluded with three of the four largest economies in the Fund, representing more than 28.2 percent of global GNP.

My authorities strongly support effective Fund surveillance and have put forward a number of proposals designed to strengthen surveillance as a means of encouraging the adoption and implementation of sound economic policies in member countries. It was within this context that my authorities have found the discussions with the staff during these Article IV consultations to be most useful. Secretary Baker's commitment to this process was reflected in his decision to meet with the Managing Director and staff in a concluding discussion on U.S. policy and prospects. My authorities also look forward with interest to hearing the views of the Board from today's discussion.

During the June 1985 meeting of the Group of Ten Finance Ministers and Central Bank Governors, Secretary Baker stated his interest in strengthening the effectiveness of Fund surveillance by enhancing public awareness of the international implications of policies. He urged other Ministers to give further consideration to the concept of increased publicity of Fund Article IV documentation. Following up on that statement, my authorities have expressed a willingness to publish the staff report and summing up from this year's Article IV consultation with the United States if others, particularly the economically most important industrial and developing countries, are prepared to agree to do so as well.

Mr. Joyce observed that the staff analyses provided in the appendices to the paper on recent economic developments (SM/85/209, Sup. 1, 7/22/85; and Sup. 1, Cor. 1, 8/2/85)--particularly those on wage concessions, movements in the exchange value of the dollar, and the relationship between fiscal deficits, the current account, and the saving-investment balance--made a useful contribution to the surveillance process.

During the discussion on the 1984 Article IV consultation with the United States (EBM/84/120 and EBM/84/121, 8/3/84), many Directors had been encouraged by the strength of the recovery in the U.S. economy, the moderation in the rate of inflation, and the positive impact on growth in other countries, Mr. Joyce recalled. However, concern had been expressed about the durability of that recovery. The large fiscal imbalance was exerting upward pressure on interest rates, on the exchange rate, and ultimately on the size of the current account deficit; many Directors had expressed concern that it was not being addressed adequately by either the Administration or Congress.

Those concerns continued to exist, Mr. Joyce added. Interest rates and the dollar exchange rate had declined recently in nominal terms, but real interest rates and the real value of the dollar remained at historically high levels. The rate of growth of output had fallen sharply in recent months, with GDP performance in both the first and the second quarters considerably lower than expected. While slower growth might not be wholly unexpected or undesirable at the present point in the recovery cycle, it nevertheless added to uncertainties. More important, the authorities seemed unable to deal adequately with the underlying imbalances in the economy. The fiscal deficit was undoubtedly the most crucial and troubling imbalance. Others, such as the current account deficit and the saving-investment imbalance, were important, but their resolution depended largely on fiscal adjustment. The recent congressional agreement to cut expenditures by $55 billion in FY 1986 was a major accomplishment, but could only be a starting point in bringing the deficit under control.

Some rebound in growth in the second half of 1985 was expected, based in particular upon the continued strength of consumer spending, Mr. Joyce continued. At the same time, however, special factors that had worked to advantage in the past, such as tax concessions for investment, were likely to have a diminishing impact on growth. The projections made both by the staff and by the Administration concerning growth in 1986 appeared too optimistic, and it was therefore important that other industrial countries--to the extent that they could do so, help pick up the slack as the U.S. economy slowed. Such international cooperation could be important in ensuring a smooth transition of the world economy to fiscal adjustment in the United States.

The authorities' medium-term projection of an average growth rate of 4 percent through 1990 was far too high, Mr. Joyce considered. The increase in the capital stock needed to reach that target was unrealistic, particularly in light of the outlook for domestic and foreign saving. In addition, if annual growth were significantly lower than 4 percent over the medium term, the fiscal deficit would be significantly higher, perhaps even exceeding staff projections.

He shared the staff view that a substantial reduction in the federal fiscal deficit was essential if orderly adjustment in interest rates and foreign exchange markets were to take place, Mr. Joyce remarked. The continued large fiscal imbalance, coupled with a large current account deficit, had resulted in major problems not only for the United States but also for the global economy. In his view, neither deficit was sustainable. Moreover, while the fiscally induced expansion had initially had a beneficial impact on world trade and growth, it also had entailed costs to many economies in the form of misaligned and volatile exchange rates and high real rates of interest. Those costs were mounting rapidly and were becoming more evident as growth in the United States moderated.

The understandings on expenditure reduction recently agreed by Congress were a step forward, but, even if they came to fruition, deficits would remain large in the future, Mr. Joyce commented. Additional measures would be needed, including further efforts to contain expenditures and the exploration of revenue-raising options, if the deficit were to be cut sufficiently, especially if no cuts were made in social security expenditures and if defense expenditures increased in real terms in FY 1987. Congress might repeal certain tax deductions--while preserving incentives to save and invest--but that action alone would not be sufficient. The proposed tax reform was to be revenue neutral; at present, it might make more sense in economic terms to use tax reform to increase revenues.

The Administration had argued that there was no link between high fiscal deficits and interest rates and that empirical evidence on that score was ambiguous, Mr. Joyce observed. He did not share that view. If dollar claims continued to build outside the United States at the record rate implied by the projected U.S. current account deficit, market forces would ensure that foreign savings were made available to the United States only at progressively higher costs. If the Government's demand for funds were not reduced, pressures on domestic credit markets could also be expected to push domestic interest rates up, slowing growth and exacerbating the problem of financing the deficit. The end result would be either fewer jobs or faster inflation, or both, in the United States and inevitably in other countries as well.

The staff viewed with concern the Federal Reserve's adoption of a more judgmental approach to monetary policy, with less reliance on monetary aggregate targets, Mr. Joyce noted. The adoption of a more pragmatic approach was understandable, as innovations in financial markets had made it difficult to interpret monetary aggregates and had necessitated placing greater reliance on a range of economic indicators in setting policies. Therefore, he did not consider current U.S. monetary policy to be overly expansionary: M-2 was only slightly above target, M-3 was within the target range, and real interest rates remained high. However, he welcomed the Federal Reserve Chairman's comment that further easing of credit conditions would depend on the monetary aggregates' conforming more closely to target and on developments in the exchange value of the dollar. Moreover, a successful resolution of the fiscal problem would make the Federal Reserve's task less complex.

The exchange rate and the current account position had also come under considerable pressure because of the large fiscal imbalance, Mr. Joyce stated. Appendix IX of the paper on recent economic developments showed that while real interest rate differentials and perceived sovereign risk explained much of the increase in the dollar's value, a large part of the real appreciation--especially since mid-1984--could not be explained in terms of standard economic theories. If some of the deviation since mid-1984 between predicted values in the theoretical model and actual values had been attributable not so much to "safe-haven" judgments but rather to a lemming-like rush by foreign investors, a sudden shift in their asset preferences could lead to abrupt, large changes in exchange rates, with serious adverse effects on inflation. He agreed with the staff that the way to create conditions permitting an orderly adjustment in the value of the dollar and a correction of the current account imbalance was better control over the fiscal deficit.

The loss of trade competitiveness had increased pressures for protection, Mr. Joyce observed. Although the Administration had pledged to resist protectionism and in some areas had taken specific steps to support that pledge, the longer the present situation existed, the more likely it was that the Administration and Congress would be unable to resist growing domestic pressures for further protectionist measures. Such measures would not only adversely affect the growth of world trade but also damage the U.S. economy as well as the growth prospects of other countries. In those circumstances, many debtor countries might be unable to continue to meet their obligations to external creditors.

Canadian-U.S. trade represented the largest trade flow between any two countries in the world, Mr. Joyce noted. While he appreciated the staff's concern that new bilateral trading arrangements needed to be approached cautiously, the negotiation of any such arrangement between the United States and Canada would proceed solely because both countries considered that the arrangement would not only benefit their respective peoples but, by promoting growth in the North American economies, also improve the prospects for economic growth globally. In any event, the Government of Canada remained committed to pursuing freer multilateral trade arrangements.

His Caribbean constituents wished to express their thanks to the United States for the continuing support that it had provided to the Caribbean Basin Initiative, Mr. Joyce concluded.

Mr. Ismael remarked that the uncertain outlook for the U.S. economy was worrisome. The improvement in the growth rate of GNP in the second quarter of 1985 by nearly 2 percent over the first quarter was encouraging, as was the sharp upturn in exports in 1984 following two years of decline, much of the growth having been the result of economic expansion abroad. Nonetheless, the lack of real progress in fiscal policy, monetary policy, and the balance of payments remained a serious concern.

The apparent failure to narrow substantially the large federal budget deficit was distressing, as was the lack of agreement regarding the best measures for cutting the deficit, Mr. Ismael added. The latest budget package offered no assurance that the deficit would be reduced to sustainable levels in the medium term; the expected reduction of the deficit by about $276 billion over the next three years would have little impact on the pattern of $150 billion deficits annually in the foreseeable future. The lack of progress in addressing the structural rigidities in federal expenditures was even more disappointing. Nevertheless, a large federal deficit--exceeding $220 billion in 1984--could not be sufficiently narrowed through expenditure retrenchment alone. While he supported the authorities' commitment to diminishing the share of government in the economy in the long run, in the short and medium term, the Administration's commitment to resisting any measures to increase taxes was not understandable. Moreover, the authorities' failure to undertake a comprehensive tax reform was disappointing. He invited staff comment on the possibility that the proposed tax simplification would not be revenue neutral but would reduce revenue further.

Not only would the large federal deficit be injurious to the U.S. economy, but it could also limit the expansion of the world economy, Mr. Ismael went on. Large inflows of foreign savings to finance the deficit had retarded the consolidation of the economic recovery abroad. Because policies in the United States could have serious consequences elsewhere, the authorities should pursue policies that took greater account of the impact of the U.S. economy on the functioning of the international monetary and trade system. In that regard, the Fund's current surveillance arrangements were sorely lacking in effectiveness.

The Federal Reserve had given priority to keeping business expansion on track while maintaining its commitment to keeping inflation in check, Mr. Ismael observed. Such a monetary policy was correct because the economy appeared to be in danger of faltering; despite robust consumer spending, industrial activity was not picking up rapidly. Inflation appeared to be under control, and inflationary pressures were also absent, owing largely to recent developments in the world oil market. Moreover, unit labor costs had risen by only 3 percent in the second quarter of 1985, a reflection of rising productivity. As labor constituted two thirds of all production costs, which were eventually reflected in prices, that moderate increase was significant. Those indicators had led the Federal Reserve to widen the money supply (M-1) target from a range of 4 percent to 7 percent to a range of 3 percent to 8 percent. As he considered that development to be entirely appropriate, the staff's apprehension that a more relaxed monetary stance might trigger a resurgence of inflation appeared to be baseless.

The outlook for the balance of payments, with current and trade deficits projected to reach about $150 billion in 1986, was cause for serious concern, Mr. Ismael remarked. Despite a slight downward revision of projections, mainly on account of the recent dollar exchange rate correction and the revival of imports, the deficits had reached a record figure, requiring external financing and raising a host of other related problems.

The prospect of a $1 trillion external debt--an amount exceeding the entire external debt of developing countries--could pose a threat to global market stability, Mr. Ismael went on. Financing that deficit through net capital inflows also had wide, grave implications for the stability of exchange rates and the level of interest rates globally. The explanation offered by the U.S. authorities--that the strong capital inflows were the result of a more attractive investment climate in the United States than abroad--did not, in his view, represent a constructive approach to tackling the serious deficit problem.

The strong, persistent dependence on imports owing to the high value of the dollar had offset any gains in productivity, had made U.S. exports less competitive, and would harm domestic industries in the long run, Mr. Ismael commented. Although exports had revived in 1984, the quarterly rates of growth among industries showed a dynamic retail sector but sagging industrial output. Employment had remained stagnant, with the jobless rate leveling off at 7-7.5 percent since the second half of 1984. The pattern of business activity indicated more problems ahead; therefore, efforts should be made to encourage manufacturing activities that would make U.S. exports more competitive.

The decline in the exchange rate for the dollar should be greeted with caution, as any sharp decline could prove destabilizing to the world economy Mr. Ismael observed. The deterioration in the U.S. trade balance in almost all categories of manufactures posed a special problem for global trade relations. Protectionist pressures as a result of the loss of domestic market shares had remained strong and were likely to remain so as long as external competitiveness continued to be adversely affected by the dollar's strength. Protectionism was a questionable remedy for narrowing the overall trade deficit. Moreover, trade deficits of the present magnitude could not be sustained indefinitely and depended on foreign financing, which could eventually undermine confidence in the dollar. The external deficits, combined with the large budget deficits, dimmed the prospects for significantly lowering interest rates.

The U.S. authorities were to be congratulated for maintaining official development assistance (ODA), Mr. Ismael remarked. Nevertheless, U.S. ODA as a share of GNP was low compared with that of other countries, and he urged the authorities to raise their ODA commitment and channel more aid through multilateral agencies rather than through bilaterally. Finally, the authorities should eliminate programs that subsidized exports without delay.

Mr. Grosche remarked that the U.S. authorities had recorded a number of remarkable achievements in the past year, most importantly in consolidating the gains in employment and in keeping inflationary pressures down. At the same time, however, economic and financial imbalances had increased further and posed an even greater threat to the national and international economy than they had a year previously. The tremendous deficits in the federal budget and in the external accounts were a problem not only for the United States but for the world economy as well. While the upturn in the U.S. economy had undeniably had positive effects globally, particularly on the demand for the exports of indebted developing countries, those short-term successes would exact a heavy price in the future.

The mix of expansionary fiscal and restrictive monetary policies and the ensuing overvaluation of the dollar had had an undesirable structural impact on the domestic economy, boosting the services sector while placing a heavy burden on manufacturing, Mr. Grosche observed. Internationally, the overvaluation and high volatility of the dollar were bound to strain the functioning of the international monetary system, had increased protectionist pressures, and had tended to enlarge an export sector in partner countries that might be unsustainable over time. The risks of past and present policies, especially in the budget field, could not be underestimated. A "soft landing" for the dollar was at present not at all secured. The recent congressional agreement on deficit reduction, while welcome, was still surrounded by considerable uncertainty. Moreover, the proposed reduction was smaller than expected.

Budgetary and external disequilibria were likely to persist in the future and would increase the risks for growth, employment, and prices, Mr. Grosche commented. Although it was difficult to assess the extent to which the slowdown at the beginning of the year had been the result of a particular policy mix, the slowdown raised doubts about whether even the revised official growth forecast for 1985 of 3 percent could be attained. The lower growth rate forecast by the staff, at 2.6 percent, also presupposed a sizable pickup in economic activity during the remainder of the year. However, the recent drop in consumer demand, which was to be one of the cornerstones of the upturn in the second half of 1985, raised doubts about both forecasts. Despite the resumption of growth in inventories, the authorities' medium-term forecasts of an annual expansion of 4 percent might be too optimistic, as they were clearly based on a significant reduction in the budget deficit that was not yet assured.

Federal Reserve policy had reduced pressures on prices and had maintained growth without rekindling inflation, Mr. Grosche noted. The recent slowdown in economic activity had rendered the task of monetary policy even more difficult, and continuing high deficits were likely to push interest rates higher, accelerating the onset of a new recession. The Federal Reserve faced the dilemma of maintaining a monetary policy stance that was not too tight while refraining from reigniting inflationary pressures. With the recent surge in M-1, it appeared that the Federal Reserve preferred to err on the expansionary side. That policy could also be interpreted as an attempt to encourage a further downward movement of the exchange value of the dollar, which the authorities might however offset by raising interest rates. He would appreciate any additional comments by either the staff or Mr. Dallara on the considerations that had led to rebasing and widening the monetary targets and whether those measures represented a departure from the medium-term orientation of monetary policy.

The monetary policy stance was extremely worrying, because when a new recession began, it would be more difficult to boost demand through standard fiscal policy measures, thereby putting the entire burden on a loose monetary policy, Mr. Grosche commented. The threat to monetary policy could be alleviated only by drastic action to reduce the budget deficit during an upswing. However, observing the decision-making process between the Administration and Congress, he had the impression that federal deficits had developed a life of their own, independent of urgent economic necessities. If any tax increase and any cuts in social security or in the defense budget were regarded as taboo, then the room for maneuver was virtually nil. Although he favored a comprehensive tax reform that would improve incentives and increase the fairness and simplicity of the system, he agreed with the staff that the proposed tax reform might not be revenue neutral. Such an outcome would be particularly undesirable given the present size of the federal deficit.

Recent official estimates indicated that the trade deficit would be even higher than previously expected, further underlining the need to correct the fiscal imbalance, Mr. Grosche observed. The alternatives were not at all desirable. One imminent risk was that, without a convincing move on the budgetary front, the trade deficit might be financeable only through higher interest rates, which might be reduced by a steep fall in the exchange rate for the dollar. In turn, such a steep fall would adversely affect the domestic price level and would confront the authorities with even more difficult policy choices, particularly as, in the short run, a depreciation and the concomitant J-curve effect would worsen the trade deficit. The magnitude of that effect depended, of course, on the currencies in which exports and imports were denominated. Thus a further, but slow, decline of the dollar was desirable.

The German authorities aimed at an appreciation of the deutsche mark against the dollar and would do their best to improve its attractiveness, Mr. Grosche indicated. They believed, however, that a simple reflation of the German economy, including lower interest rates, would only push the deutsche mark lower, not least because interest rate differentials might become too wide. Recently, Germany had experienced stability in the exchange market, even an appreciating deutsche mark, together with widening interest rate differentials. In the past, Germany had found that those differentials were often unsustainable either because they became too large or because other factors came into play; once capital started to flow out of Germany--resulting in a high value for the dollar--the German authorities could limit it only by reducing substantially the interest rate differentials through increasing domestic interest rates. Thus, the deutsche mark had depreciated as real interest rate differentials had moved against the dollar, but, narrowing interest rate differentials markedly, the German authorities had prevented larger depreciations of the deutsche mark. At present, they were about to push domestic interest rates down further to support domestic economic recovery. A widening of differentials, however, as a result of rising U.S. interest rates, carried the danger that the process could not continue or had even to be reversed. Thus, the right policy mix in the United States was also of utmost importance for Germany's economic performance.

Regrettably, the U.S. external imbalance was stimulating protectionist pressures in Congress, Mr. Grosche remarked. The authorities' efforts to withstand those pressures were commendable, in particular their resistance to the introduction of a 20 percent surcharge on all U.S. imports. The authorities should maintain their liberal attitude and resist the temptation to give in on particular industries--such as shoes, steel, textiles, or telecommunications--in the hope that that would ease the pressure emanating from Congress. Such measures clouded prospects for a successful new round of GATT negotiations. All countries should remain committed to resisting and rolling back protectionist measures. Open markets in the United States as well as in other industrial countries continued to be a basic requirement for an orderly adjustment in the developing world. Open markets were also needed for internal reasons, since they would enhance overall economic efficiency.

The U.S. authorities' constructive role in tackling the debt crisis was commendable, Mr. Grosche commented. His authorities fully shared the view that the problems associated with external indebtedness could be overcome only if a flexible case-by-case approach continued to be applied with determination.

Mr. de Maulde observed that a statement made by the Chairman of the Board of Governors of the Federal Reserve System before a congressional committee three weeks previously had highlighted the main policy issues facing the U.S. Administration. Domestically, a marked slowdown in the rate of growth had begun in the fall of 1984 and had continued in the first two quarters of 1985. Current administration forecasts projected a steady rate of growth of 4 percent annually, while the Fund staff projected an annual growth rate of 3.5 percent. Although some pickup in activity for the rest of the year was expected at present, predictions of an endless, rapid expansion of output should be avoided in present circumstances.

The increasingly unbalanced character of U.S. economic activity was worrisome, Mr. de Maulde continued. Manufacturing activity had remained flat since the fall of 1984, while activity in the agricultural and mining sectors was declining. At the same time, total consumption--both public and private--had continued to rise strongly, supported by large increases in public and private debt. Overall domestic final sales had been increasing at an annual average rate of more than 4 percent, while domestic output was rising at a rate of only 1.5 percent or less. The difference had been made up by the widening trade deficit, which was expected to reach some $134 billion in 1985.

Inflation performance remained good, owing largely to continued moderation in wage and salary increases, Mr. de Maulde noted. The employment picture also remained satisfactory, but it was noteworthy that the bulk of new jobs created had been in the services and trade sectors; an expansion of the industrial sector was needed to restore the external position.

The basic imbalance that triggered all others was the shortage of domestic savings to finance domestic borrowing needs, Mr. de Maulde observed. An oversized tax cut had been initiated in 1981 as part of a strategy aimed at increasing saving, productivity, and output. But the expected additional saving by the private sector had not materialized, and the massively increased borrowing requirements of the Federal Government had had to be met by unprecedented borrowing abroad. The staff had clearly explained the resulting dilemma: if the inflow of foreign savings into the United States were to continue, external debt service payments would increase rapidly and could give rise to an unstable situation; conversely, if such inflows were suddenly to decline, the subsequent rise in real interest rates would crowd out domestic investment, with grave consequences for economic growth in the United States and for the debt servicing burden of developing countries. On the other hand, a decisive improvement in the fiscal position would result in an orderly decrease of domestic interest rates, and of the exchange rate of the dollar; a progressive restoration of the trade balance; and the stimulation of economic activity on a more balanced basis. Chart 1 of Appendix VI of the paper on recent economic developments gave some measure of such a process. The problem was an elementary one, with only one solution: as the staff appraisal for the 1982 Article IV consultation (SM/82/141, 7/16/82) had pointed out, "action to repair the fiscal position is undoubtedly the single most important task to be addressed by economic policy in the United States at the present time."

He invited the staff to provide further clarification concerning the congressional deficit reduction package agreed the previous week, particularly regarding the assumptions underlying the figures concerning interest rates, Mr. de Maulde added. Clearly, the assumptions underlying the Administration's forecast were overoptimistic, and the corresponding figures provided by the staff appeared to presuppose a major adjustment. What major assumptions underlay the staff's projections of a steady growth rate of 3 percent annually, leading to a reduced fiscal deficit equivalent to 3.75 percent of GNP in FY 1988? What should be done to achieve that growth rate, and what should be assumed with regard to the deficit?

The basic supply-side strategy aimed at boosting productivity, savings, and investment, Mr. de Maulde recalled. Success had been achieved in promoting investment, but the strategy had failed to increase domestic savings. As for productivity, what had been the record over the past three to four years, what was the record for the latest period, and what was currently forecast? Mr. Dallara had suggested that the inclusion of interest-bearing accounts in M-1 might have altered the relationship between M-1 growth and nominal spending. He recalled that the inclusion had been made some time previously and that due allowance had been made in the targets at that time. He invited comment on that point.

The continued growth of protectionist pressures in the United States was amply confirmed by daily press reports, Mr. de Maulde noted. An orderly adjustment of the basic imbalances in the U.S. economy, leading to the progressive restoration of the current account, would be the most logical way to alleviate that problem.

He took note of Mr. Dallara's suggestion regarding the publication of the staff report for the 1985 Article IV consultation with the United States and the summing up of the Executive Board discussion, and he would convey that suggestion to his authorities for their consideration, Mr. de Maulde stated. That suggestion, along with other minor proposals emerging from the Report of the Group of Ten, would be considered by the Interim Committee during its forthcoming meeting in Seoul.

Mr. Pérez stated that he broadly agreed with the staff analysis and interpretation of recent developments in the U.S. economy. The strength of the recovery had been greater than many observers had expected owing to the exceptional strength in the growth of domestic demand. A salient feature of the recovery was the unusual dynamism of gross fixed business investment in the face of extremely high real interest rates. Although the investment surge had often been attributed principally to supply-side measures such as changes in tax legislation introduced in 1981 and 1982, it was noteworthy that the staff had concluded that since the changes in tax legislation appeared to have contributed significantly only to investment in nonresidential structures--a relatively small component of business fixed investment--so that the overall contribution of such legislation to the rise in investment seemed to have been small.

The recovery had been launched with a large dose of fiscal stimulus, while a restrictive monetary policy--through its effect on real interest rates--had been used to attract capital from abroad, Mr. Pérez added. The impact of restrictive monetary policies in the face of the growing fiscal deficit had raised nominal interest rates and, aided by the appreciation of the dollar, had effectively contained, first, inflationary pressures and later inflationary expectations.

The substantial differences between the U.S. authorities' and the staff's interpretation of the causality of economic events led to contrasting views on the assessment of current events and on the consequences of policy prescriptions, Mr. Pérez observed. The staff maintained that the fiscal and monetary policy mix had led to high real interest rates, larger capital inflows, and the appreciation of the dollar, and that the trade deficits had, in turn, resulted from the saving-investment gap. The authorities maintained that other factors, such as the strength and dynamism of the U.S. economy, were the main forces behind the appreciation of the dollar, as evidenced by the continued rise in the value of the dollar during the last half of 1984 when interest rates were declining. Yet there appeared to be a broad consensus in the Executive Board and among economists in academic and other circles in support of the causality advanced by the staff.

The repercussions of the U.S. fiscal imbalance were not disputed, Mr. Pérez noted. The overvalued dollar and high U.S. interest rates were impediments to an improved economic performance in Europe and had led to an unbalanced and fragile world recovery which, in turn, had contributed to depressing commodity prices further and to weakening the terms of trade of developing countries. Also, the extremely high real interest rates had contributed to the debt crisis and had complicated the process of adjustment undertaken by debtor nations.

The mounting pressures for protection were one of the most important consequences of the U.S. internal and external imbalances and threatened the recovery prospects for the world economy and developing country economies in particular, Mr. Pérez observed. The Administration had been only partially successful in resisting increased calls for protection. In areas such as steel, textiles, and footwear, those calls had been particularly strong, and a number of protectionist measures had already been implemented. The outlook for resisting further protectionism in the United States was not encouraging, given the imbalances envisaged in the near future.

Although the expenditure cuts recently proposed by Congress for the coming three years were by no means insignificant, they might not be sufficient to reduce the fiscal imbalances to the degree necessary to forestall the negative consequences envisaged by the staff, Mr. Pérez remarked. The compromise reached between the House and Senate contemplated cuts that were substantially lower than those originally envisaged both by Congress and by the Administration. He would be interested to hear the staff's assessment of the impact of those measures and the medium-term forecast for the trade deficit and external debt accumulation. Although the reluctance of the Administration to implement revenue-increasing measures was understandable, the contention that higher taxes would discourage private saving was not well founded, theoretically or empirically. The effects on private investment would depend to a large degree on the structure of the tax increase or other revenue-raising measures. If it was not possible to implement a decisive budget cut through expenditure cuts alone, revenue-raising measures would have to be considered.

The Administration had lowered its growth forecast for 1985 from 4 percent to 3 percent, Mr. Pérez observed. The staff had also revised downward--albeit by a smaller magnitude--its own forecasts. But even the revised staff forecast implied a vigorous rate of growth during the second half of 1985, which would probably require a continued downward trend of the real interest rate. Nevertheless, given current budgetary prospects, it was difficult to see how interest rates could continue to decline substantially. Consequently, the real interest rate outlook, combined with the substantial deficit contemplated for 1986, cast more doubt on the Administration's medium-term growth forecast. Moreover, if the economy grew at a lower rate than expected, the deficit might be considerably larger, which posed the danger of an economic recession starting earlier and running deeper than a "normal" cyclical pattern would indicate.

Had a more stringent fiscal policy stance been adopted, a decline in economic activity in the short term would probably have occurred, owing to the contractionary effects on domestic demand and the time lag between those effects and the positive stimulus that would result from lower interest rates and a more competitive dollar, Mr. Pérez considered. However, by choosing a more relaxed fiscal stance, the danger of events damaging to the world economy, such as a deep recession, were magnified. It was well known that countries maintaining large fiscal and current account deficits for prolonged periods, overvalued exchange rates, and an unstable rate of debt accumulation eventually would have to face the consequences of overconsumption.

Prompt and sufficient action was urgently needed to reduce the fiscal deficit, Mr. Pérez emphasized. That disequilibrium had been the dominant influence on the world economy over the past two years and, in his view, had been the primary cause of high real interest rates and consequently of the rising value of the dollar. The poor performance of European investment, employment, and growth, on the one hand, and the delicate situation of indebted countries despite the efforts they had made on the other, were due in no small part to the effect of the budget deficit in the United States. For that reason, the Fund should convey to the U.S. Government its strong hope of seeing prompt and sufficient action geared to reaching a solution to the problem of the fiscal deficit.

The trade deficit was also fostering the adoption of protectionist measures that would be harmful both to the United States and to the world economy, Mr. Pérez added. The United States should therefore resume its leading position in the fight against protectionism. It was of paramount importance to resist measures that engendered the risk of a trade war, which could result in the collapse of the already deteriorated world trading system and a worldwide economic downturn.

The U.S. authorities had argued that the external deficit had had a beneficial effect on the world economy by supporting external demand and growth, Mr. Pérez continued. But it had also coexisted with high real interest rates, a high absorption of capital flows, and a huge and growing external current account deficit. Clearly, an economic scenario characterized by low interest rates, a trend to a balanced external position, and capital flows from the United States to the rest of the world would have been preferable.

In the report of the Deputies of the Group of Ten on the functioning of the international monetary system, the U.S. representatives had supported the general strengthening of the Fund's surveillance role as a useful tool for improving the functioning of the international monetary system, Mr. Pérez continued. He hoped to see, in the coming months, positive signals from the U.S. Government that it was heeding the recommendations of the Fund.

Mr. Fujino stated that the U.S. economy had recently shown signs of a sharp deceleration in growth following two years of strong expansion that had contributed significantly to world economic recovery and the alleviation of the debt problem. The deceleration itself was not worrisome, since the extremely rapid growth in the first half of 1984, had it continued, would have involved the risk of increasing inflationary pressures. He broadly agreed with the U.S. authorities that a recession was not likely to occur in the near term in view of stable prices and declining interest rates. Special factors that had contributed to the slowdown in the economy in the first half of the year would disappear, and the expected resumption of normal growth in inventories, the significant decline in interest rates, and other factors would cause the economy to pick up in the second half. However, to attain the official growth projection for the year as a whole, growth at an annual rate of 5 percent or more would be needed in the second half. He would appreciate a more detailed assessment from the staff or Mr. Dallara concerning the attainability of that growth rate. In his view, even if the recovery in the second half fell slightly short of present expectations, the scope for macroeconomic fine tuning was very limited.

Monetary policy was heavily constrained as was fiscal stimulus, given the increasingly strong role played by market expectations, Mr. Fujino continued. Monetary expansion, if perceived by the market as being excessive enough to risk rekindling inflation, could be self-defeating and bring about a rise in interest rates. Somewhat paradoxically, a significant cut in the federal deficit might lead, over the medium term, to a higher economic growth path through improved business confidence and lower interest rates. With respect to the role of market expectations, he noted that flash estimates of GNP were released toward the end of each quarter and were subject to revision with considerable margin for error. Quick release of the figures could be double-edged; it provided a useful, rough indication of economic trends at an early stage but, because of the margin for error, it tended to have a destabilizing effect on the economy rather than providing a reliable signal to market participants. He invited staff comment on the timing of release of flash estimates.

The federal and external deficits had been the focus of Article IV consultation discussions with the United States in recent years, and the lack of significant progress on those fronts was regrettable, Mr. Fujino commented. The two deficits had increased in size and posed a serious threat to the prospects for balanced growth of the world economy. The U.S. authorities should demonstrate their responsiveness to international concern about the consequences of their policy mix, and, to dispel any skepticism concerning the effectiveness of Fund surveillance over major industrial countries, they should take concrete steps to reduce the budget deficit. The recent congressional agreement on the reduction of the deficit was a step in the right direction, but further action would be needed.

While continuous capital inflows might be expected for some time in view of the strength of the U.S. economy and the low inflation rate, it was not appropriate from an international point of view for the U.S. economy to absorb a large portion of world savings, Mr. Fujino added. The reduction of the large fiscal deficit was the most essential step in redressing that imbalance. More convergence of growth and the realignment of the exchange rate for the dollar, together with positive fiscal measures by the authorities, would also contribute to the reduction of external imbalances.

The U.S. authorities' first priority was to reduce substantially the fiscal deficit through a rapid and appreciable cut in public expenditures, Mr. Fujino recalled. The recent congressional compromise met the Administration's target for the 1986 budget and for the three-year program. However, the compromise had failed to tackle some important structural problems whose correction would be important for lasting and decisive improvements in the federal deficit. Moreover, the deficit reduction might be smaller than expected if tax revenues fell short of the estimate owing to slower than anticipated growth. The proposed tax reform, which was intended to reduce tax rates, simplify the tax system, and remove distortions, was also a step in the right direction. The possibility of revenue-increasing measures could not be totally excluded, particularly if efforts to cut expenditures proved insufficient to bring about the necessary reduction in the deficit. The staff analysis contained in Appendix I of the report on recent economic developments provided empirical evidence that the tax measures that had been introduced to stimulate capital investment had had little effect on investment in durable goods, but had affected substantially investment in nonresidential structures. At the same time, however, such measures as the investment tax credit and the accelerated cost recovery system had raised the expected after-tax rate of return on investment and thus might have contributed to higher real interest rates, which he considered to be one of the main factors behind the appreciation of the dollar. The proposed tax reform, which would reduce incentives for investment, was therefore welcome. He invited the staff and Mr. Dallara to comment on the extent to which the change in the investment tax would contribute to reducing interest rates.

The room for monetary expansion was very limited, and the strong commitment of the monetary authorities to reducing inflation was welcome, Mr. Fujino remarked. As he had some reservations about an excessively mechanical pursuit of monetary targets, he supported the present stance of monetary policy, which paid due regard to such factors as short-term interest rates, exchange rates, economic activity, inflation, and financial innovation, as well as to monetary aggregates.

He generally supported the staff appraisal of external developments and the exchange rate, Mr. Fujino commented. It was difficult to deny the strong relationship between the federal deficit, the interest rate, and the exchange rate over the medium term. The recent fall of the dollar vis-à-vis major currencies was welcome and would have to be consolidated by concrete action on the federal deficit and by a sustainable decline in interest rates. Capital flows to the United States had been voluntary and had been attracted by high interest rates and the market perception of the stability of the dollar, which constituted an important factor behind the higher value of the dollar. Maintenance of an overvalued exchange rate over a protracted period could result in a precipitous fall of the dollar, which would involve the risk of rekindling inflation and raising interest rates.

Increasing protectionist pressures reflected to a large extent the weakening competitiveness of U.S. industry as a result of the high value of the dollar and were a source of great concern, Mr. Fujino observed. Particularly worrisome was the proposal to introduce an import surcharge, which was not only an inferior substitute for a proper exchange rate but would also have undesirable international consequences that would be harmful to the United States, including the distortion of the structure of domestic industry. The efforts of the Administration to resist protectionist pressures as well as its renewed commitment to free trade were therefore welcome.

The staff report had referred to access to the Japanese market, Mr. Fujino noted. While the Japanese market was open by international standards, his authorities were aware of the concerns expressed by outside observers. Measures had been taken to further facilitate access to the Japanese domestic market, including the action program announced the previous week.

Mr. Nimatallah said that the U.S. authorities' economic policies were commendable. The authorities had come to grips with most of the long-term problems that had arisen since the late 1970s, instead of resorting to short-term quick fixes. Inflation had been controlled, labor market rigidities were being reduced, productivity had been raised, and taxes had been lowered. All those developments had created more incentives and had made it more profitable for the private sector to take the initiative and increase production. As a result, unemployment had been reduced and the rate of economic growth had increased. The steps taken had laid the foundation for sustainable growth, which he expected to continue, albeit at lower rates, throughout 1985 and 1986. In that regard, he agreed with the present staff forecast of growth rates for 1985 and 1986.

Over the past three years the real interest rate had been kept relatively high in order to mobilize domestic and foreign savings for financing the recovery, Mr. Nimatallah noted. It was time to reduce the real interest rate in order to enhance capital formation and to encourage interest-rate-sensitive sectors, such as housing, to catch up with the recovery.

The authorities were following the right fiscal and monetary policy mix for that purpose, Mr. Nimatallah continued. The latest deficit-reduction package announced by Congress was a step in the right direction. A gradual reduction in the fiscal deficit would give the U.S. economy time to adjust, particularly until the private sector could benefit from the incentives in the proposed tax reform package. Moreover, the course of monetary policy appeared appropriate at present, especially since the rate of inflation remained low.

For the medium term, the authorities might have to find more ways and means to encourage savings--one of the more fundamental, long-range problems that had not yet been addressed effectively, Mr. Nimatallah suggested. Capital remained a scarce domestic factor of production that could make it very difficult to sustain growth over the medium term. The United States could not sustain the present economic situation if it became more profitable for foreign savers to invest more in Europe and other areas of the world. The proposed tax reform package should restructure part of the tax system to provide new incentives that would encourage higher rates of saving, since the interest rate could play only a limited role in that process.

The large current account deficit could be expected to be reversed gradually over the next few years, given the declining value of the dollar and steadily increasing demand for U.S. goods in Europe and elsewhere, Mr. Nimatallah considered. The dollar appeared to be on the right course for a soft landing, which, in turn, should improve the performance of domestic export industries and help reduce the current account deficit over time. Until that process was completed, the U.S. authorities should continue to resist protectionism.

Mr. Schneider stated that he was in broad agreement with the staff appraisal. Despite the growing uncertainties about the future course of the U.S. economy, the fundamental imbalances as well as the recommendations for dealing with them had generally remained the same since the 1984 Article IV consultation with the United States and the Board's discussion on the world economic outlook (EBM/85/51 and EBM/85/52, 4/1/85; EBM/85/53 and EBM/85/54, 4/3/85; and EBM/85/55, 4/5/85). Nevertheless, one important difference was the strong perception that decisive action was urgently needed to ward off events that could be harmful to the global economy. Over the past two years the U.S. economy had realized notable achievements in the areas of growth, inflation, and employment but at the cost of huge and seemingly persistent budget and current account deficits. There was a danger that the desired soft adjustment of the U.S. economy would not occur unless convincing actions were taken to eliminate the basic disequilibria. In the past, fiscal policy had probably been the most important instrument to induce recovery by spurring both supply and demand through substantial tax reform, while monetary policy had been instrumental in reducing inflation. At present, monetary policy appeared to share the tasks of shoring up economic activity while keeping inflation under control.

In setting monetary goals, especially the wider targets for M-1, the Federal Reserve had recently shifted from a longer-term strategy toward fine tuning, Mr. Schneider continued. That policy should not be criticized so long as the two conflicting goals of stimulating economic activity while containing inflation were reasonably reconciled. However, inflationary pressures might easily become more pronounced in the medium term if public expectations were influenced by the perception of a strong relation between the magnitude of the fiscal deficit and the risk of inflation. Furthermore, the declining value of the dollar could lead to an increase in import prices. If the dollar fell abruptly as a result of sudden shifts in the portfolio preferences of investors, interest rates could rise dramatically, thus negating efforts to maintain economic activity. Consequently, the danger of relying primarily on monetary action to redress imbalances should not be underestimated.

The solution to the disequilibria in the U.S. economy lay in consistent and substantial action in the fiscal area, Mr. Schneider considered. Monetary and fiscal actions should be complementary during the phase of decelerating activity. In that regard, the congressional compromise proposals for reducing the budget deficit was disappointing. The intended cut for FY 1986 was not only smaller than had previously been deemed necessary for tackling the fiscal imbalance, but was based on optimistic assumptions regarding future growth. Moreover, the congressional debate on the budget demonstrated that the Administration's efforts had reached their limits. He was not convinced that it would be feasible to continue cutting expenditures and avoiding any tax increase. A point could be reached where the Government would be unable to guarantee an adequate supply of needed public services that could not be provided by the private sector. If U.S. society showed a preference for fewer public services, then, according to the Council of Economic Advisors, federal expenditures could be cut from 24 percent of GDP to about 20 percent without any tax increase. However, if the preference was for a higher level of public services, tax receipts would have to be increased substantially. Some action to increase federal revenues might be required in the future to attack the deficit problem more vigorously, and it should be possible to devise a tax system that would not discourage saving and investment.

The other fundamental imbalance was the current account deficit, Mr. Schneider noted. Its magnitude and persistence adversely affected domestic activities, while positively affecting other countries' economies, especially those of developing countries. Nevertheless, the gradual elimination of that imbalance could be achieved only through a correction of the exchange value of the dollar, which should be a smooth one to avoid the risks associated with a precipitous plunge, including sharp pressures on interest and inflation rates. To secure a soft landing for the dollar, the cooperation of all Fund members would be needed to counter a possible slackening of U.S. economic activity. Moreover, cooperation among the major central banks should also be improved. Sporadic, uncoordinated foreign exchange interventions could produce no meaningful results. However, actions taken by foreign central banks in tandem with the U.S. authorities could affect the evolution of the dollar especially by discouraging speculation.

The Administration's efforts to resist increasing demands for protectionist measures were commendable, Mr. Schneider remarked. It was however worrisome that Congress was not taking a similar stance with the same determination. Unrestricted access to markets should remain the governing principle, not only for the United States but for all its trading partners as well.

Mr. Kafka remarked that the recent congressional budget compromise was welcome, but that additional, more difficult measures would have to be taken to reduce the fiscal deficit. The present discussion provided an excellent opportunity not only to assess the transmission effects of U.S. policies on the world economy but also to judge the effectiveness of Fund surveillance over creditor members whose policy deficiencies could not, and must not, be cured through publicity, but through enhanced peer pressure and other means.

The emergence of the United States from the recessions of the 1980s was impressive and had been beneficial to the world economy, Mr. Kafka continued. Particularly noteworthy were the pronounced rise in jobs and fall in unemployment, in unusual combination with the sharp decline and subsequent moderation in inflation, as well as numerous structural improvements, among them a new pattern of wage negotiations and, hence, persistent wage moderation. The flexibility of the U.S. economy was exemplary, but the present outlook was very uncertain. The optimism of the U.S. authorities concerning growth in 1985 had already been toned down considerably. The Fund staff had always forecast a lower growth rate, and the differential between its projection and the U.S. projection had been maintained. The medium-term growth outlook was also likely to be less favorable than the authorities believed, even if they were to accomplish all their goals.

The United States could minimize the effect of a lower growth rate on other countries, particularly with regard to increasing calls for protectionism, which was no solution to the present U.S. balance of payments problem, Mr. Kafka considered. The Administration's relatively liberal attitude, however, was coming under increasing domestic pressure. Because of the size of the U.S. economy, any increase in American protectionism was deeply worrisome, particularly in the context of the profound development crisis and debt problems faced by most developing countries for the rest of the decade and probably beyond.

The causal chain traced by the staff between the federal fiscal deficit and various developments that raised concern for the future--including real interest rates that were still high, the absorption of world savings by a rich country, volatile exchange rate patterns, and protectionist measures--could not be demonstrated beyond doubt by a perfect correlation and was certainly not the only explanation for those developments, Mr. Kafka observed. It was however the central one, without prejudice to the numerous attractions which the United States offered to investment.

The budget compromise might lessen concern that the dollar was going to have a hard landing rather than a soft one, Mr. Kafka commented, although even a hard landing need not be disruptive. It was possible, for instance, that a quick decline of the dollar to a level at which confidence in exchange rate stability reappeared--or a series of step declines with a restoration of confidence following each step--would not require a rise in interest rates to maintain the necessary flow of foreign savings, pending reduction of the deficit. But the eventual effects of depreciation on the current account, like the slowdown in U.S. growth since the second quarter of 1984, and the effects of a reduced fiscal deficit itself, would confront other countries with a challenge to which they should respond if they were in a position to do so. If countries had made progress against inflation and disposed of ample reserves, they should initiate a degree of careful stimulation of their economy. Problems of low growth outside the United States were not purely structural, and inflation was not the only conjunctural danger.

While he agreed with the staff's comments on fiscal policy, especially tax policy, he did not share its apprehension concerning the more judgmental approach recently adopted by the Federal Reserve toward monetary policy, Mr. Kafka remarked. Monetary policy must be multifaceted; so far any excesses due to the judgmental approach had been avoided and should be avoidable also in the future. What was more worrying, although understandable, was the tightening in regulatory policies over banks' lending abroad. That matter should be pursued with extreme delicacy so as to avoid aggravating the debt problem by interrupting financial flows that might otherwise become available.

The views of the U.S. authorities on the UN target ratio for ODA were well known, Mr. Kafka observed. But ODA had assumed increasing importance for the adjustment efforts of the poorer developing countries, and as the major donor, the United States should consider raising its contribution as a share of GNP. Although direct investment was not a panacea, he agreed with the Administration that all countries should attempt to take appropriate steps to enable them to take advantage of other foreign capital flows, including direct investment.

The members of his constituency wished to thank the U.S. authorities for the understanding which they had traditionally shown for the problems faced by their countries, Mr. Kafka concluded.

Mr. Nebbia stated that his chair fully endorsed the general thrust of the staff report and its conclusions. Some recent developments in the U.S. economy continued to be encouraging. The economic recovery was remarkable, in view of recent concerns that too strong a recovery would be unsustainable and might endanger price stability. Instead, the recovery was continuing, with a persistent, above-normal rise in output accompanied by continued moderate inflation and a nearly natural rate of unemployment. The recovery had had beneficial effects on the rest of the world, boosting recovery in other industrial countries, and lending support to the adjustment efforts of developing countries. The U.S. authorities had attributed those achievements in part to the relatively low degree of state intervention in economic affairs.

Nevertheless, several aspects of U.S. economic policy that affected the world economy in general and developing countries in particular were worrisome, Mr. Nebbia continued. Action on the fiscal deficit over the past year suggested a lack of response to the Board's recommendation on concluding the 1984 Article IV consultation with the United States: if the U.S. authorities wished to give credibility to their statement that "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 federal debt to GNP could not be tolerated indefinitely," then more resolute and decisive action was needed than had been taken so far.

Although the relationship between the fiscal deficit, interest rates, and the exchange rate remained a subject of debate, there was agreement on the effects of certain macroeconomic variables, Mr. Nebbia noted. Clearly, the size of the U.S. public sector had to be reduced. Federal government expenditures were nearing 25 percent of GDP, and state and local government expenditures accounted for another 12 percent of GDP. Like the staff, he considered that the federal deficit was the key variable in assessing the impact of U.S. macroeconomic policies with regard to saving and investment flows in the economy; however, state and local governments also influenced the performance of the national economy. For a country that emphasized the important role played by private initiative, market forces, and deregulation in the economy, the public sector share of total output--at 37 percent--was on the high side. In any event, the fiscal deficit was sizable, exceeding the GDP of all Latin American countries taken as a whole.

The fiscal deficit absorbed domestic as well as foreign private savings, exerting upward pressure on interest rates, and in the long run, constituted an obstacle to sustained recovery with adverse repercussions on other economies, particularly those of developing countries, Mr. Nebbia remarked. In the long term, the fiscal deficit would slow economic growth. A lower deficit would result in more savings for private sector use, less need for foreign borrowing, and more market-oriented use of resources--all of which would inevitably induce lasting declines in real interest rates and exchange rates that were closer to equilibrium. Those developments would improve prospects for long-term growth in the United States and abroad, and would thereby reduce the debt service burden of the developing countries. Moreover, adjustment of the current account imbalance would reduce the protectionist pressures that had arisen in certain sectors of the U.S. economy.

The various means by which domestic industries could obtain import relief under U.S. trade law was impressive, Mr. Nebbia observed. Appendix VI of the report on recent economic developments dealing with international trade and investment policies indicated that, despite the Administration's efforts to resist numerous calls to protect certain sectors from further loss of competitiveness, there had been disappointing setbacks. Although an effort to grant protection to the U.S. copper industry in the form of quotas and/or an increase in tariffs had been vetoed by the President--despite the International Trade Commission's affirmative determination of substantial injury to the industry by imports--the imposition of further restrictions in the textile and steel industries and nontariff proposals for the footwear industry were particularly worrisome. Imposing obstacles to free trade clearly had a negative effect on the efforts of developing countries to increase and diversify their exports. The U.S. authorities should take the lead in dismantling the country's protectionist regime, particularly as most of the existing protectionist pressures stemmed from internal policy choices in other sectors of the economy and because of the clear dominance of the United States in the world economy.

A recent scheme to subsidize agricultural exports provided for in-kind bonus payments by the Commodity Credit Corporation to exporters who exported to markets receiving allegedly subsidized imports from third world countries, Mr. Nebbia noted. He wondered whether that export incentive scheme represented a multiple currency practice. In any event, such an agricultural export policy was detrimental to developing countries that were seeking markets for their agricultural exports.

The level of U.S. official development assistance, both in absolute and relative terms, gave rise to concern, Mr. Nebbia remarked. Although the preliminary estimates for 1984 showed some increase in absolute terms, ODA had declined slightly in relation to GNP. The authorities still did not appear prepared to recognize the role of ODA as a separate, important contribution that richer countries could make to the development of less-developed countries. Although direct investment had an important role to play in development, its objectives were different from those of development assistance.

The members of his constituency recognized and appreciated the role of the U.S. authorities in dealing with the debt problems of many developing countries, Mr. Nebbia concluded. In expressing their concern about U.S. economic policy, they sought to promote even-handedness in surveillance and global economic adjustment.

Mr. Alfidja stated that following two years of strong economic recovery, the growth of the U.S. economy had slowed considerably during the first two quarters of 1985. While the rate of inflation had remained relatively low and interest rates had declined, real interest rates were high; on the other hand, the unemployment rate had improved but remained worrisome. U.S. economic performance was further clouded by sizable internal and external imbalances: the budget deficit continued to widen, and the current account deficit had deteriorated further.

He was in broad agreement with the staff appraisal, Mr. Alfidja remarked. The U.S. economy had become dependent upon the inflow of foreign savings, which in relation to GNP had risen to 2.6 percent in 1984. The combined effects of the present fiscal and monetary policies had contributed to the appreciation of the dollar and a high real rate of interest, which in turn had exacerbated the debt service problems of developing countries and had spurred inflows of capital to the United States, thereby dampening investment in other countries. In light of the adverse effects of the U.S. budget deficit on the world economy, and the prospects for ever larger deficits, he strongly endorsed the staff's view that urgent and decisive actions to improve the fiscal position of the Federal Government were called for. The U.S. authorities were understood to share that view, and in that context, the budget resolution recently approved was a first step in the right direction. The emphasis placed in the proposal on expenditure cuts was fully justified. However, further measures were likely to be needed, and he shared the staff's view that "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." The authorities' comprehensive tax reform aimed at simplifying the tax system and making it more equitable was also welcome. Nevertheless, more than a revenue-neutral tax reform was needed.

The faster pace of economic activity in the United States coupled with the strong dollar had led to the deterioration of the external current account, Mr. Alfidja observed. While that development had contributed positively to growth in many economies, it had also awakened protectionist sentiment in the import-competing sector of the U.S. economy. The Administration was to be commended for resisting that growing pressure. The decision to eliminate the restraints on cars imported from Japan was testimony to its commitment to rely mainly upon the private sector for the allocation of resources, both domestically and internationally, and the decision not to support the recommended restraint on copper imports was welcome. Nevertheless, the signs of growing protectionist pressures were alarming. Even though the Administration had at times resorted to trade restrictions to protect some industries, its efforts to foster an environment conducive to free trade were encouraging, as was its decision not to resort to protectionist measures as a means of reducing the external current account deficit.

The authorities' continued maintenance of official development assistance at a relatively low level as a share of national income was regrettable, particularly at a time when an increase in such assistance was needed to help many developing countries implement strenuous adjustment measures, Mr. Alfidja concluded.

The Executive Directors agreed to continue their discussion in the afternoon.

## DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/85/119 (8/2/85) and EBM/85/120 (8/5/85).

### 3. 1985 ANNUAL MEETINGS - OBSERVERS

The Executive Board approves the proposal to invite Switzerland to attend the 1985 Annual Meetings of the Boards of Governors as an observer, as set forth in EBD/85/183, Supplement 1 (7/23/85).

Decision No. 8042-(85/120), adopted
August 2, 1985

### 4. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director and by Advisors to Executive Directors as set forth in EBAP/85/202 (8/1/85) is approved.

APPROVED: May 5, 1986

LEO VAN HOUTVEN
Secretary