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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/121

3:00 p.m., August 5, 1985

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

Executive Directors	Alternate Executive Directors
	K. Yao, Temporary
C. H. Dallara	M. K. Bush
	S. Kolb, Temporary
B. de Maulde	
	M. Z. M. Qureshi, Temporary
H. Fujino	M. Sugita
G. Grosche	B. Goos
J. E. Ismael	Jaafar A.
R. K. Joyce	
A. Kafka	
H. Lundstrom	
	A. Abdallah
F. L. Nebbia	B. Jensen
	J. E. Suraisry
	G. Ortiz
J. J. Polak	J. de Beaufort Wijnholds
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: P. Dhonte, G. Szapary. Exchange and Trade Relations Department: C. D. Finch, Counsellor and Director; S. J. Anjaria, J. T. Boorman, A. B. Petersen, R. L. Sheehy. External Relations Department: A. F. Mohammed, Director. Fiscal Affairs Department: V. Tanzi, Director; G. Blondal, M. Katz. 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, F. B. Larsen. 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, T. Sirivedhin, E. M. Taha, D. C. Templeman, A. Vasudevan. Assistants to Executive Directors: Bo T., Chen J., S. de Forges, J. de la Herrán, G. Ercel, V. Govindarajan, G. D. Hodgson, O. Isleifsson, Z. b. Ismail, M. Lundsager, J. A. K. Munhali, 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. UNITED STATES - 1985 ARTICLE IV CONSULTATION

The Executive Directors continued from their previous meeting (EBM/85/120, 8/5/85) their consideration of 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).

Mr. Wang said that he was in broad agreement with the staff's appraisal. During the Board discussion on the 1984 Article IV consultation with the United States (EBM/84/120 and EBM/84/121, 8/3/84), Directors had expressed concern about the serious imbalances in the U.S. economy and the unsustainability of the high fiscal and current account deficits. Those concerns still remained. Moreover, the factors contributing to the recent deceleration of economic growth were unchanged. The persistence of the federal deficit remained at the heart of the economy's imbalances, having increased from 4.2 percent of GNP in 1982--a recession year--to 5.25 percent of GNP in 1984. Although the deficit reduction program recently adopted by Congress was welcome, substantial federal deficits would continue to 1990, and huge deficit financing would then be occurring at a time when the economy was operating at a high degree of resource utilization.

In the recent past, large deficit spending in most countries during periods of economic upswing had halted the upward momentum by a crowding out private investment and accelerating inflation, Mr. Wang observed. In the United States, however, deficit spending had led to the external sector incurring an ever-widening current account deficit that had in turn depressed domestic economic activity. According to the staff's medium-term scenario, given the present overvalued dollar, the current account deficit would continue to grow, given the present overvalued dollar, reaching $271 million by 1990; and, assuming even a 5 percent annual depreciation of the dollar, the net external debt would still rise at an average annual rate of 57 percent, reaching $646 billion by 1990--although the current account deficit would begin to decline after 1987. Clearly, further substantial reduction of the federal deficit was needed.

He noted with concern the rising trend of protectionism in the United States, Mr. Wang continued. Against a background of decelerated growth and an overvalued dollar, increased protectionism could have serious consequences for U.S. trading partners as well as the world trade system. The Textile and Apparel Trade Enforcement Act, which was pending in Congress, singled out textiles and apparel for trade protection and thus was of particular concern to a large number of developing countries. By exempting the European Communities and a number of other industrial countries from its coverage, the Act intentionally targeted the exports of developing countries, clearly contravening the principles of the General System of Preferences. He therefore welcomed the authorities' reaffirmation of their commitment to market liberalization.

The flow of U.S. financial resources, in particular official development assistance (ODA), to developing countries had either stagnated or declined over the past few years, Mr. Wang noted. The decline of ODA as a share of GNP was particularly disturbing because it had occurred at a time when the United States had been experiencing the most vigorous recovery in the postwar period compared with recoveries in other industrial countries. The authorities should therefore consider increasing the proportion of national income devoted to foreign economic assistance.

The U.S. economy had become further integrated and had interacted more closely with other national economies over the past few years, Mr. Wang observed. Large-scale movements in international capital markets and fluctuations among the major currencies had demonstrated the increased impact of U.S. economic behavior on the world economy. The absorption of foreign savings by the U.S. economy in the past year and a half was of such a magnitude as to bring about great dislocations in the current account balances of major countries as well as misalignments between major currencies. Also, high U.S. real interest rates and the overvalued dollar had had wide and adverse repercussions abroad. The indebted developing countries in particular had suffered financial and economic hardships on account of those unforeseen developments. Therefore, in making economic decisions, the U.S. authorities should pay more attention to the global impact of their policies, especially taking into consideration the interests of the developing countries. Stronger surveillance of U.S. economic policies by the Fund as well as a more positive response to Fund surveillance on the part of the authorities was also needed. In that regard, he suggested that future consultation reports include a section analyzing the global impact of U.S. economic conditions and policies.

Mr. Zecchini noted that the U.S. authorities had successfully maintained the employment of domestic resources at a comparatively high level without jeopardizing price stability. The United States also had made a fundamental contribution to boosting the world economy out of an alarming recession. Moreover, although sizable deficits continued to characterize the economy, the Administration had made persistent efforts to achieve the congressional consensus necessary for major policy adjustments.

Several recent developments in the real economy were perplexing, Mr. Zecchini continued. The current slowdown of economic growth and the associated tendency of unit labor costs to accelerate in the private nonfarm sector were not totally attributable to falling productivity. At the same time slower growth had not given rise to initial signs of a reduction in the external deficit, notwithstanding the contemporaneous fall in the dollar exchange rate. Those developments, coupled with the absence of significant adjustments in the current policy mix had made it more difficult than expected to correct the fundamental disequilibria in the economy.

Perhaps the American people did not consider those disequilibria to be fundamental or crucial, Mr. Zecchini suggested. Perhaps the authorities still believed strongly in their strategy of tax reduction to generate an increase in output and incomes such that all public budget revenues would be offset. In any event, Mr. Dallara's description of the Administration's overall economic strategy and priorities had omitted any reference to the need to correct the federal and external deficits; in his view, those were the central problems facing the U.S. economy to which priority should now be given. The deficits were unsustainable and threatened to have damaging consequences both for the domestic and global economies in the longer run.

The present trends indicated that the growth of public debt was on an unsustainable and explosive course, Mr. Zecchini continued. If one considered the change in the debt/GNP ratio as equal to the sum of the nonfinancial part of the deficit--as a ratio of GDP--and the difference between the rate of net interest cost of existing debt and real growth rate of GNP, where the difference is multiplied by the existing debt/GNP ratio, at present the deficit in the nonfinancial budget and the net interest rate continued to exceed the rate of GNP expansion, resulting in a rising trend in the public debt vis-à-vis GNP. Assuming that the ratio of public wealth to GNP was limited, the larger the public deficit, the smaller gross private investment would be, since a higher proportion of domestic savings would be absorbed by the deficit.

That conclusion assumed a given inflow of foreign savings, Mr. Zecchini added. If that assumption was relaxed, clearly higher interest rates and expectations for a continuous appreciation of the dollar would be required to make more room for dollar-denominated assets in the portfolios of foreign investors. Those conditions would, in turn, lead to a slowdown in economic expansion. Thus a vicious circle of cumulative negative effects emerged over the longer run that could only be prevented by tackling the deficit problem.

The correction of the imbalances had to be gradual and did not necessarily imply the elimination of both deficits, Mr. Zecchini observed. An effort to eliminate the budget deficit in a relatively short time would result in a shortfall in aggregate demand of more than 5 percent. An early elimination of the external current deficit, together with a rise in domestic production of 3 percent would still result in a shortfall in aggregate demand, although reduced to 2 percent. Therefore, in the present circumstances, the objective should be to reach a sustainable position in both accounts rather than a zero balance.

Large imbalances seldom called for correction on one side alone, Mr. Zecchini noted. Reducing the budget deficit would require a larger contribution from the taxpayer than that in the past. While reducing the external deficit would require the cooperation of other industrial countries to reduce the gaps in relative growth of domestic demand.

The two deficits stemmed from a combination of fiscal and monetary policy that was self-defeating over the long run, Mr. Zecchini remarked. The ability of a rising fiscal deficit to push an economy toward full employment of resources in a context of price stability would eventually be limited by higher interest rates and monetary stringency. That would hold true, of course, until the long-awaited supply-side effects in terms of higher personal and domestic saving ratios materialized.

The policy mix had changed recently, as monetary policy had become more accommodating, leading to a decline in interest rates as well as to a fall in the favorable interest differential vis-à-vis assets denominated in major reserve currencies, Mr. Zecchini continued. That development had been associated with a depreciation of the nominal exchange rate. Nevertheless, he doubted that a depreciating trend for the dollar would be sufficient to balance the current external account unless there was a significant reduction in the budget deficit. Indeed, a monetary stance that accommodated the increasing financing needs of both the Treasury and the business sector at declining interest cost would most likely involve higher inflation and no depreciation of the real effective exchange rate, which meant no lasting gains in competitiveness. Likewise, a firm monetary stance would result in higher interest rates with either a crowding out of private demand for credit or large net inflows of foreign savings, which meant a current account deficit.

The central issue was therefore to correct significantly the budget deficit in order to leave room for some easing of monetary policy, Mr. Zecchini added. In that regard, the 1986 budget recently approved by Congress appeared unambitious and fell somewhat short of expectations. Under the more realistic economic assumptions of the Congressional Budget Office, the deficit reduction was estimated to be $39 billion in 1986 and to total $199 billion for the next three years. He invited the staff to comment on the extent to which the budget package together with the recent fall of the dollar and the slowdown in growth would alter the scenario envisaged for the world economy in the most recent world economic outlook exercise.

The budget package highlighted the difficulties in cutting expenditures, Mr. Zecchini observed. Although the authorities considered that soaring spending had prevented a balanced budget, between 1982 and 1984 total federal expenditure actually had fallen as a share of GNP while the deficit had not. Also, the composition of the expenditure reductions recently approved by Congress was not neutral with respect to their implications for economic growth. He invited the staff to comment on that point, particularly with reference to the projection of a larger share of military expenditure in total spending. If expenditures could not be curtailed further, some measures had to be taken to raise revenues while preserving incentives to save and invest. Moreover, it seemed inappropriate to introduce the proposed tax reform before undertaking changes to guarantee that there would be no revenue losses.

Given the limited reduction in the budget deficit approved for 1986, the room for further easing of monetary policy without endangering price stability was extremely limited, Mr. Zecchini noted. In that context and in light of external pressure on prices resulting from the dollar depreciation, the monetary stance could not but remain cautious. In assessing monetary targeting, due attention should be paid to the fact that most of the lagged effects of recent regulatory changes and financial innovations had already materialized. Therefore, past differences in money velocities as measured by M-1, M-2, and M-3 tended to shrink, and M-1 velocity tended to move toward a more stable pattern.

The Administration's strong commitment to the principle of free trade and its efforts to resist strong internal pressure for more protection were commendable, Mr. Zecchini concluded. The authorities should persevere with strong determination in their efforts to keep the domestic market open to external competition. He did not agree with Mr. Dallara that the resolution of present pressures did not lie solely in trade policies and world economic developments; equally important would be the ability of the United States to deal effectively with its budget deficit, thereby restoring conditions on domestic demand, interest rates, and the exchange rate that were conducive to external balance.

Mr. Clark noted that judged in terms of output, prices, and the labor market, the period 1982-84 was an outstandingly successful one for the U.S. economy. GNP had grown by over 10 percent; the rate of inflation had remained around 4-5 percent; and employment had risen by over 5 percent while unemployment had fallen sharply. Those developments had underpinned the world economic recovery over the same period, and they had also contributed to easing pressures on debtor countries; for example, the value of Latin American exports to the United States had increased by nearly one fourth between 1982-84, while the value of Latin American exports to the rest of the world had actually fallen by about 5 percent.

It was disappointing that so little progress had been made in response to concerns that Executive Directors and their authorities had expressed in recent years concerning U.S. economic policy, Mr. Clark continued. His authorities were also seeking to limit the role of the public sector in the economy and strengthen incentives through changes in taxation. In pursuing those objectives, some regard had to be paid to shorter-term tactics and constraints. Unfortunately, although rapid growth had certainly been achieved by the United States in recent years, it had been at the cost of large, growing, and unsustainable financial imbalances. To put the U.S. current account deficit in perspective: the U.S. absorption of real resources from the rest of the world was at present running at a rate roughly equivalent to the entire GNP of Australia.

Imbalances of such magnitude were having damaging effects both internally and externally, Mr. Clark added. The most important immediate factor contributing to the U.S. current account deficit had been the

appreciation of the dollar and the associated deterioration of U.S. trade competitiveness. According to staff estimates, the appreciation of the dollar represented an increase in the trade deficit of some $75 billion in 1984 and an increase in the cumulative deficit of some $185 billion since 1981. The loss of competitiveness had put heavy pressure on many sectors of the economy in terms of both market shares and profitability. To some extent, those effects had been offset by the rapid growth of the domestic market. But if, as seemed likely, growth in that market slowed, there was the risk that profits would be compressed severely, damaging the cash position of companies and their capacity to undertake new investments.

The impact of the current account deficit on the corporate sector was naturally reflected in the present U.S. external position, Mr. Clark observed. Growing competitive pressures had led to increasingly strident demands for protectionism, as evidenced by the number of protectionist trade bills introduced recently in Congress. The authorities were to be commended for their generally staunch opposition to those demands, and in particular for their rejection of proposals to introduce restrictions on copper imports. The authorities should continue to resist trade restrictions, whether for individual commodities, individual sectors, or more generally. Moreover, although the recent fall in nominal U.S. interest rates had somewhat alleviated cash payments on debts for many countries, real interest rates remained high, which clearly was not helpful from the point of view of the ultimate resource cost of servicing external borrowing. In addition, the United States had recently been absorbing a significant part of world savings. Although it had been argued that that development merely reflected the attractive returns to be earned on investments in the United States, the argument was perhaps not entirely convincing, as much of the inflow seemed to have been attracted into government debt. In any event, if global needs for capital formation were to be met over the medium to longer term, clearly a substantial shift in the U.S. position would be required.

The staff's medium-term projections clearly indicated that the U.S. current account position was unsustainable, implying that a substantial depreciation of the dollar would be needed if there was to be any prospect of restoring the current account position to balance by 1990, Mr. Clark noted. Such a depreciation, in combination with the likely associated changes in interest rates, would itself have important and partially offsetting effects on current account flows for developing countries, depending, for example, on the proportion of debt and exports denominated in dollars, and on the proportion of exports directed to the United States. That issue might provide the basis for an appendix in a future staff report on the world economic outlook.

As his chair had stated during the 1984 Article IV consultation with the United States, his authorities believed that the basis for an elimination of the imbalances in the U.S. economy, for a reduction in interest rates, and for a substantial but orderly depreciation of the dollar could only be a sharp cut in government borrowing, Mr. Clark remarked. Although

it was difficult to prove conclusively that high fiscal deficits caused high interest rates, his authorities believed that the balance of evidence pointed in that direction. Nonetheless, if the current account deficit was to fall, and unless saving increased dramatically, either investment or the fiscal deficit must be reduced in the medium term. Clearly the latter would be greatly preferable. In that regard, the budget agreement reached in Congress recently was welcome, but much more needed to be done. He agreed with the staff that further revenue measures might be necessary, but, at the very least, tax reform should be no worse than revenue neutral.

Although it had been argued that the dollar exchange rate was determined by the market and was therefore an equilibrium rate, one element in that equilibrium was an apparent willingness of the U.S. authorities to supply assets yielding extremely high real interest rates, Mr. Clark observed. A question for the U.S. authorities must be whether it was in the interest of the United States to incur new debt on the present terms in the face of growth prospects that the staff suggested might be no better than 3 percent a year for some time. He invited Mr. Dallara to comment on that point.

Mr. Polak observed that in consultations with the United States in recent years, the substantive discussion of events, measures, and prospects had been hampered by the lack of a common basis in economics. He fully accepted the staff's theoretical framework for the present consultation, which was supported by the serious econometric analyses presented in the supplement to the paper on recent economic developments. He also accepted the staff's medium-term outlook for growth in the United States, which seemed to be based on sound analyses compared with the authorities' estimates, which seemed to be at least partially inspired by the desire to make fiscal forecasts look comfortable some years ahead. On that basis, he generally agreed with the views expressed in the staff appraisal.

At the time of the last Article IV consultation, the United States had just pulled the world economy out of the most severe recession since the end of World War II, Mr. Polak recalled. However, it was recognized that the prevailing combination of a huge current account deficit and matching net capital inflows was unlikely to prove sustainable over the medium term and required adjustment. To understand how the inevitable adjustment would occur, it was necessary to go to the roots of the present imbalance. The central factor had been the extraordinary growth of domestic demand, which had increased 18 percent in the period 1983-85. Even with the best supply-side policies, that increase could not have been matched by output growth. As a result of strict U.S. monetary policy, that boom had not ended in inflation but in a strong appreciation of the dollar that had made it possible to satisfy the excess demand by additional imports.

To correct the external imbalance, U.S. domestic demand would have to grow more slowly than output in the medium term, while in the rest of

the world, domestic demand would have to grow faster than output, Mr. Polak continued. The distinction between the performance of output and the performance of domestic demand, or absorption, was crucial. In cataloging the various ways to correct the current account deficit, Mr. Dallara had referred only to relative growth rates and not to relative rates of absorption between the United States and the rest of the world; consequently, the fiscal deficit, an important component of absorption, had been dealt out of the equation. To apply the advice that the Fund gave to other countries with a large budget deficit, a large current account deficit, and an overvalued currency: to correct the imbalances would require both fiscal restraint and a depreciation of the currency. Adherence to appropriately restrictive monetary policies could ensure that the necessary exchange rate correction would not produce undue inflationary effects.

Some important steps in the direction of adjustment had been taken over the past year, Mr. Polak noted. A tightening of U.S. monetary policy in the first half of 1984 had prevented the U.S. boom from ending in inflationary disarray. However, an inflation rate stalled at 4 percent with the benefit of an appreciating currency could not be considered an unqualified success. And after the initial overshooting, the dollar exchange rate had come down when the monetary tightening could be reversed. If domestic demand were to be brought below growth of output, it would be desirable that that be done without reducing the rate of output growth below capacity growth. However, he agreed with the staff that it was unlikely that GNP growth could average above 3 percent. Thus, the expansion of domestic demand would have to be reduced so as to curtail the level of excess demand. The challenge would be to limit the negative effect that curtailment could have on both domestic and global output growth. Part of the answer would have to come from abroad. In any event, the present U.S. payments position would become untenable in a few years. It was therefore necessary to consider measures that could contribute to an orderly slowing down of the growth of domestic demand, which could allow the necessary correction to take place in an orderly manner. The respective roles of monetary and fiscal policies were crucial in that connection.

The stance of monetary policy had shifted over the past year from heavy emphasis on breaking the current surge in domestic demand to an unconventional effort to reduce the current account deficit by bringing interest rates down in order to stimulate growth in output, Mr. Polak observed. At present, further efforts in that direction were likely to prove counterproductive. It was notable that since mid-June, when the prospects for decisive action on the budget waned, long-term interest rates had risen again by 3/4 of 1 percent. It seemed essential that monetary growth be brought down into the new target range. Confidence in the Federal Reserve, which had been restored at such great cost, should not be put in jeopardy. That was not to suggest, however, that monetary policy should be the main instrument to slow the rate of domestic absorption; that process would make the objective of limiting the effects on

output more difficult to achieve and higher interest rates would also worsen the debt problems of developing countries as well as the position of the U.S. banking sector.

Deficits of the magnitude presently prevailing not only resulted in external imbalances but also reduced growth prospects, Mr. Polak remarked. Therefore, the need for a sustained decline in the federal deficit was unquestionable. However, the deficit, instead of declining, would increase again in FY 1985 to new heights, following the reduction in FY 1984. It was disappointing that prospects for decisive action for 1986 and beyond had dimmed over the past months. The recently agreed expenditure reductions could not be accepted at face value and were of a temporary character. Added to that the effects of slower than assumed growth on the deficit for the further out years and the need for additional measures, the deficit continued to be a problem of the greatest concern. In more difficult deficit situations the Fund urged other countries to avoid a crisis by striking some acceptable balance between cutting expenditures and raising taxes; that advice was equally appropriate in the present case.

The external imbalance had increased the pressure for protectionist measures, Mr. Polak noted. The authorities should adhere to their commitment to resist such demands, which were mainly triggered by developments in macroeconomic factors. He also shared the staff's concern about the dangers of increased bilateralism in U.S. trade policy. The United States and the European Communities had a special responsibility for the preservation of a multilateral framework.

Finally, he welcomed the participation of the Secretary of the Treasury and the Managing Director in the consultation discussions, Mr. Polak remarked. He hoped that such high-level involvement in the consultation process would help steer U.S. economic policy toward a less ominous course.

Mr. Lundstrom said that developments in the U.S. economy over the past few years had not only led to strong growth and a higher level of employment in the United States but had also contributed decisively to world economic growth. The impressive achievements, particularly in inflation and job creation, were commendable. The forecasts for the next few years in those areas were also positive. Nevertheless, large imbalances were building up and posed a threat to the stability of the world economy.

The overriding problem facing the U.S. economy was the need to reduce the fiscal deficit, Mr. Lundstrom continued. The recently approved congressional resolution to reduce federal spending was clearly insufficient, particularly as the final outcome appeared uncertain, and demonstrated the virtual impossibility of achieving a sufficient reduction of the deficit without addressing the revenue side of the budget. Action to increase federal revenues by expanding the tax base was necessary. With respect to the objectives of the proposed tax reform he

agreed with the staff that further emphasis should be placed on eliminating tax preferences and regulations that were producing distortions in the economy. The reform provided an excellent opportunity to increase federal revenue. The general view held by the Board and by his chair during the previous Article IV consultation with the United States had been that taxes would have to be raised to curb the increasing budget deficit in a way that would not unfavorably affect the already low propensity to save. The recent economic slowdown underscored the conclusion that a sufficiently improved fiscal balance was not likely to be attained as long as tax increases were excluded.

If no comprehensive solution were found to the budget problem, real interest rates may have to rise again in order to attract enough foreign saving to finance the deficit, Mr. Lundstrom added. The major industrial countries whose economies had benefited from the U.S. expansion had in many cases used the increased room for maneuver to consolidate public finances by curbing domestic demand and thus improving their current external accounts. In the present circumstances, continued growth in those countries should to a larger extent be based on increased domestic activity, especially with respect to investment. If U.S. real interest rates resumed their rise, those investment prospects would be seriously hampered. It would be paradoxical if the U.S. economy were to impede such a development by becoming a major net importer of capital on a more permanent basis, which would have discouraging implications for the U.S. current account and debt accumulation as had been pointed out in the staff's medium-term scenarios.

The appreciation of the dollar had adversely affected the U.S. manufacturing industry and had increased the pressure for protectionist measures, Mr. Lundstrom observed. In the wake of the increase in the budget deficit, the current account deficit had deteriorated further, and the forecast was clearly alarming. His authorities considered that reversing that deterioration would prove impossible without a more substantial reduction of the budget deficit than that agreed in Congress the previous week. Although the dollar had recently depreciated somewhat, it was unclear whether that trend would continue so as to contribute to a marked improvement in the external account. His authorities were therefore concerned that protectionist pressure would continue and be intensified. A significant reduction of the fiscal imbalance would help the Administration to abide by its resolve to promote a free trade system. Moreover, a reduction of the fiscal deficit combined with a gradual depreciation of the dollar would improve the climate for a correction of the external balance. His authorities welcomed the United States' support of the multilateral trading system and the proposal to initiate a new round of GATT negotiations. However, they were concerned about the strong protectionist sentiment in the United States and the inherent dangers of a growing emphasis on bilateral trade arrangements.

The economies of developing nations had benefited from the fall in U.S. interest rates and the recent depreciation of the dollar, Mr. Lundstrom noted. Liberal access to the U.S. market had been of

tremendous importance to debtor countries in their endeavors to redress their external position. At present, exports by those countries risked being dampened by declining U.S. growth rates. At the same time, the problem was exacerbated by protectionist currents in the United States. Also, the continued need of the U.S. economy for large imports of capital would exert an upward pressure on interest rates, thereby increasing debtor countries' already heavy debt service burden. Therefore, improved growth outside the United States was urgently needed, particularly in industrial countries with a comfortable balance of payments position and a good inflation performance.

His authorities agreed that the flow of private capital to developing countries needed to be increased, and the U.S. authorities should be commended for the initiatives they had taken to promote such a development, Mr. Lundstrom remarked. However, the weak--or nonexistent--creditworthiness of many debtor nations strongly limited what could be achieved through direct investment, making official development assistance all the more important. Thus, U.S. official development assistance should be increased considerably. If that assistance were to attain only the average OECD level as a share of GDP, or about half the 0.7 percent target, total ODA of industrial countries would be increased by about $4.5 billion, or 16 percent.

Mr. Abdallah remarked that the U.S. economy had performed well and retained reasonable prospects for continued expansion in the near and immediate future. The authorities were to be commended for their impressive achievements. Also, he was in broad agreement with the staff appraisal.

The federal budget deficit had been rising since 1981, complicating economic management both for the U.S. authorities and for the world at large, Mr. Abdallah noted. Through the absorption of a tremendous portion of international saving attracted by relatively high real interest rates and other factors, the U.S. fiscal deficit had not only pre-empted resources from the rest of the world but had also increased the debt service burden of developing countries. There was an urgent need to bring the deficit under control. Although the budget resolution recently adopted was a positive step, the actual reduction to be achieved was likely to be much lower than that estimated by the authorities. Since fiscal adjustment was crucial to the continued growth of the U.S. economy under stable conditions, the authorities should adopt a more pragmatic approach and consider revenue-raising measures as an essential element of deficit reduction.

Monetary policy had played an important role in fighting inflation for some time, Mr. Abdallah remarked. Until recently, monetary targeting had worked relatively well, although deregulation of the banking system and recent innovations in banking practices were making the conduct of monetary policy somewhat difficult. In the circumstances, he supported the more judgmental approach that had been adopted by the Federal Reserve Board.

The growing current account deficit and the behavior of the dollar had had mixed repercussions on the rest of the world, particularly on

developing countries, Mr. Abdallah observed. For example, because of the relatively strong growth of the domestic economy, coupled with the strong dollar, the U.S. market had absorbed exports from many countries, including developing countries, although African participation in the induced trade expansion had been smaller than that of other regions. However, the sustainability of the balance of payments over time was worrisome. Thus far the situation had been ameliorated by autonomous capital inflows, but they could not be assumed to continue indefinitely. Although a sudden reversal of those capital flows was not expected, it was not prudent for the world's largest economy to rely, as a permanent objective of policy, on external resources to finance its fiscal and balance of payments deficits. A reduction in the fiscal deficit would undoubtedly have a positive impact on the external sector.

Despite growing current account deficits, the United States remained broadly committed to the principles of a free and open trade system, Mr. Abdallah noted. That commitment must be maintained, and he urged the authorities to implement in full the recommendations of the Tokyo Round and to resist protectionist pressures at home. In that connection, the recent adoption of an export support program for agricultural commodities was regrettable and likely to have adverse effects on the exports of developing countries. He would appreciate some indication from Mr. Dallara or the staff of how permanent the program was intended to be and whether or not it had been utilized.

The U.S. authorities' contribution to international cooperation and development was commendable, Mr. Abdallah remarked. The developing world urgently needed increased capital flows, both private and official. Regrettably, ODA from the United States was lower as a share of GDP than that for all members of the Group of Ten. The U.S. authorities should raise their ODA to a level commensurate with the country's position in the world economy. He also urged the authorities to make a direct contribution to the Special Facility for Sub-Saharan Africa and to increase their support for multilateral financial institutions.

Mr. Qureshi said that he was in broad agreement with the staff appraisal. The key policy question was the reduction of the large federal deficit. While the recently approved congressional budget resolution contained several measures to reduce the deficit, it appeared to fall well short of achieving the magnitude of reduction needed or even envisaged. According to some assessments, the economic and legislative assumptions underlying the package were doubtful. If the economy grew at an average annual rate of about 3 percent during 1986-90 as projected by the staff rather than at 4 percent as projected by the Administration, the deficit would be significantly larger. Staff analysis of the sources and disposition of funds available to the U.S. economy indicated that the expectation of a 4 percent annual growth rate would be unrealistic, not only because it would require an unusually high rate of investment but also because, given the likely outcome for the federal deficit, it would require an inflow of foreign savings at a rate that appeared to be unsustainable. Although the Administration was counting on more rapid growth

to help reduce the deficit, the achievement of that growth rate could be rendered difficult or infeasible by lack of prior action to reduce the large absorption of investable funds by the deficit. Consequently, deficit reduction would have to rely more on discretionary action and less on the automatic effects of growth.

Significant further action was therefore needed to reduce the fiscal deficit, Mr. Qureshi continued. Also, to reduce it adequately within a reasonable length of time, expenditure-cutting measures would need to be supplemented by measures to raise revenues. The structural deficit that remained to be tackled was large in magnitude, and total spending relative to GNP had not fallen despite the concentration of deficit reduction efforts on expenditure cuts so far. In fact, the reduction achieved in domestic spending relative to GNP had been more than offset by increases in other expenditure categories such as defense and interest payments. Moreover, the protracted and difficult debate in Congress before agreement was reached on the recently announced budget package suggested that it would become increasingly difficult to secure further cuts in domestic spending as its share in total spending declined.

The increase in the federal deficit relative to GNP between 1981 and 1984 had occurred primarily on account of a decline in the ratio of revenues to GNP, largely owing to tax reductions initiated in 1981-83, Mr. Qureshi noted. Indeed, in structural, cyclically adjusted terms, the decline in the revenue ratio exceeded the increase in the deficit ratio. Revenue losses resulting from tax reductions were estimated to have contributed as much as $120 billion to the current federal deficit. The prediction, based on supply-side theory, that revenue losses from lower tax rates would be fully recovered, or more than offset, through more rapid growth, had not been borne out thus far. Moreover, empirical evidence presented in Appendices I and II of the paper on recent economic developments did not support the predictions that tax reductions would induce significant increases in savings and investment through improving incentives. Although the difficulties in estimating such relationships should not be underestimated, the results called for careful scrutiny of proposals for substantial, supply-side motivated tax reductions. Proponents of supply-side policies had recommended such reductions for many other countries, including developing countries. Particular caution should be exercised in proposing large supply-side motivated tax reductions for developing countries in view of the different character of their economies.

In opposing tax increases as a means of reducing the deficit, the Administration had argued that higher taxes would have an adverse effect on incentives and that it was desirable to deal with the deficit by reducing the size of the Government, Mr. Qureshi recalled. As the staff had pointed out, it should be possible to raise revenues in ways that would avoid or limit adverse incentive effects. The reduction or elimination of certain tax deductions or preferences might not only serve to broaden the revenue base but also might reduce the distortions in the tax system. Moreover, the scope of the Administration's tax reform proposals

could be broadened to include measures that served to raise revenue. The suggestions that import tariffs be utilized to raise revenue while also providing additional protection to domestic industries should, however, be firmly resisted. Also, where reducing the size of the Government was an objective, the timing of tax cuts relative to expenditure cuts was important. Recent experience showed that precipitate tax reductions that were not coordinated with expenditure reductions would only raise the fiscal deficit.

The Administration had shown appreciable resolve in resisting protectionist pressures in some areas, Mr. Qureshi observed. It was regrettable, however, that in other areas access to the U.S. market had been reduced. Since protectionist pressures were likely to remain strong for some time, firmness and steadfastness in resisting those pressures would be needed. Making those pressures recede would depend fundamentally on policy corrections--notably reducing the federal deficit--to deal with the underlying factors that had contributed to the rise in protectionist sentiment. In the coming months, the Administration's resolve would be tested in respect of some exports of particular importance to developing countries--textiles and apparel, and footwear. Although some of the recent restrictive trade measures taken by the United States had been justified as countering interventions in trade flows on the part of other countries, such measures ran the risk of a universal escalation of trade barriers. Given the key position of the United States in world trade, a clear demonstration of its commitment to free trade was particularly important to check the spread of such barriers. The move toward a bilateral approach to trade negotiations and its inherent risks also gave rise to concern.

The staff had reported that the Administration had taken some positive actions in the trade area, deciding not to seek renewal of voluntary restraints on Japanese auto exports and not to grant the request for protection from the domestic copper industry, Mr. Qureshi pointed out. That the test of good or liberal commercial policy had been effectively diluted to the avoidance of additional protectionist barriers was regrettable. Nonetheless, he recognized that even holding the line at a time when protectionist sentiment was rising was not a small achievement.

The ratio of U.S. ODA to GNP had continued to fall and in recent years had been one of the lowest among the main donor countries, Mr. Qureshi remarked. While he agreed with the Administration on the need to promote direct investment flows to developing countries, some factors limited the extent to which they could substitute for other types of flows, including ODA. The increased emphasis on raising the effectiveness of aid was well taken. However, the effectiveness of aid was also partly a function of the policies of donors themselves. Thus, the effectiveness of U.S. aid flows could be enhanced by reversing the large decline in the share of official development assistance relative to security assistance in total U.S. official flows, by restoring the share of funds channeled through multilateral institutions, and by reducing the

presently highly skewed distribution of aid flows and relating them more to the economic needs of recipients and to their productive utilization.

Mr. Sengupta noted that the U.S. economy accounted for 20 percent of world GNP and about 15 percent of world trade, and that the dollar played a dominant role in international markets. As the policies pursued by the U.S. authorities had a substantial impact on the world economy, they should be judged not merely by domestic criteria but in the context of their international implications.

The recent slackening of the rate of growth in the United States was extremely worrisome, Mr. Sengupta continued. The pace of deceleration was far too steep and, if it was indicative of the excessive imbalances in the economy, threatened the prospects for medium-term growth both in the United States and abroad. According to the U.S. authorities, a real rate of growth of about 3 percent was expected for 1985, mainly as a result of the restoration of inventories to normal levels, the beneficial impact of lower interest rates, strong domestic demand, and the recent, somewhat high rate of growth in M-1. According to the staff, "the conditions for the achievement of such a rate of growth are unlikely to be met." He invited the staff to elaborate on the attainability of the projected growth rate in the second half of 1985 and on those variables mentioned by Mr. Dallara that were not considered likely to have their desired effect.

The medium-term outlook was far from reassuring, Mr. Sengupta added. The rise in private domestic saving had not matched the growth of domestic investment, and financing growth through inflows of foreign savings had resulted in increases in the current account deficit in recent years. The United States--once a net supplier of savings to the rest of the world--had recently become a net borrower, absorbing an enormous magnitude of foreign savings. Although that development had helped promote world recovery and had facilitated the adjustment efforts of developing countries, its sustainability was doubtful. He wondered whether a stronger world recovery would not have occurred if the United States had generated more domestic savings, thereby allowing a major part of external savings to be absorbed by developing countries.

A reasonable outturn in the medium term depended crucially on reducing the budget deficit, along with other complementary measures, Mr. Sengupta remarked. The Administration's recent proposals presented for reducing the budget deficit relied primarily on expenditure cuts. He agreed with the staff that it might not be possible to deal with the fiscal problem by action on the expenditure front alone. Moreover, the tax reform proposals would not contribute to deficit reduction. In fact, it was improbable that substantial deficit reductions could be achieved without resorting to additional taxation. In an economy where the capacity to pay was large, there was no reason why taxes could not be raised without impairing incentives to save and invest. In any event, the budget deficit had to be reduced to ensure the health of the U.S. economy as well as continued world economic recovery and growth.

A recent OECD study stated that based on three major linkage models--the Japanese EPA, the Federal Reserve System multicountry model, and the OECD Secretariat's Interlink model--a sustained reduction of the U.S. budget deficit, achieved through fiscal contraction, would of itself reduce U.S. GNP in the short- to medium-term, Mr. Sengupta commented. Also, if the federal deficit and interest rates were clearly related, a reduction in the deficit could induce lower U.S. interest rates, which could lower the value of the dollar. He recognized that the empirical relations between deficits and interest rates were not clear and that the causes for the high value of the dollar were controversial. However, if voluntary, noninterest-induced, safe-haven-attracted capital flows were not the main cause of the dollar appreciation, lower interest rates would lower the exchange value of the dollar. Nonetheless, a lower level of economic activity in the United States, resulting in reduced demand for imports, would also reduce growth abroad.

The rapid growth of the U.S. economy had been a major impetus to world trade and thereby to the growth of exports and GNP globally, Mr. Sengupta said. A continuation of U.S. import growth was vital to the developing countries; 58 percent of developing countries' exports of manufactures had been absorbed by the United States, and even in sensitive trade areas such as textile and apparel imports, the U.S. performance was far better than that of most other countries. Clearly, deficit reduction in the United States could not be considered in isolation from policy measures in other major OECD countries. Coordination was particularly needed regarding exchange rate movements; to ensure a soft or step-wise landing of the dollar, the appreciation of other currencies as well as a significant improvement in foreign growth relative to U.S. growth would be needed. If the slack in U.S. economic growth was not picked up by other major industrial countries, the whole process of global recovery might be jeopardized. The main issue was policy coordination among industrial countries and the surveillance function of the Fund in that context, Mr. Sengupta considered. It would be desirable for the Executive Board to discuss at one time the international impact of the macroeconomic policies of major industrial countries in order to provide scope for a more coordinated Board discussion and for improved Fund surveillance.

In recent years protectionism had grown in the United States despite some efforts to reduce trade barriers, such as removing restraints on automobile imports, Mr. Sengupta noted. Protectionist pressures were clearly related to the high value of the dollar, which had weakened the competitiveness of domestic products. However, the imposition of trade barriers would only impede internal adjustment and would be counterproductive. Further steps to restore the value of the dollar to a sustainable level and to remove trade restrictions, especially on imports from developing countries, were needed.

It was regrettable that U.S. ODA had declined as a share of GNP, Mr. Sengupta remarked. The authorities should be urged to participate generously in such aid programs.

He considered that Mr. Dallara's comprehensive buff statement should be publicized, even if the staff report and summing up were not, because it fully brought out the rationale of U.S. policy, Mr. Sengupta concluded.

Mr. Rye remarked that he supported the conclusions of the staff paper. He also expressed his strong support, and that of his authorities, for the basic policy strategy of the U.S. Administration. In addition, he associated himself with the comments of previous speakers, particularly Mr. Joyce, Mr. de Maulde, Mr. Schneider, and Mr. Clark, on the issue of the budget deficit and fiscal policy.

The Administration's economic projections for the rest of the decade were doubtful and seemed to be internally inconsistent, which would carry sharply adverse implications for fiscal predictions, Mr. Rye added. If indeed growth were to exceed longer-term potential over the period, with unemployment falling, it was unlikely that inflation would continue to decline since unemployment might already be close to the natural rate. Consequently, the possibility of a recrudescence of inflation in the United States could not be dismissed.

One element underlying such a possibility was the recent fall in the value of the dollar, Mr. Rye continued. While that adjustment was welcome, not least for the beneficial effects on the debt burden of developing countries, it was a potentially inflationary development. For example, pressures on the traded goods sector to restrain prices might ease somewhat. Moreover, the U.S. economy had shown a most enviable flexibility with regard to wage policies fostered by Administration policies. However, despite the impressive stability in real hourly wages in the recent period of strong economic growth, it was doubtful that that stability could persist. The recent figures on productivity and unit labor costs were far from reassuring. Indeed, productivity had actually declined over the past year, and unit labor costs had risen in the first two quarters of 1985 at an annual rate of almost 6 percent, a sharp acceleration over 1984.

There had also been an easing of U.S. monetary policy, with all monetary aggregates running either near or above the upper end of their target ranges, Mr. Rye observed. It appeared that the actual targets being aimed at were closer to the top of the announced target ranges than to their midpoints. For example, the authorities had indicated that they would be quite content if the growth of M-1--at present increasing at about 10 percent annually--fell to under 8 percent, which suggested a target range of around 6 percent to 10 percent rather than the announced target of 3 percent to 8 percent. Other indicators of monetary conditions were likewise pointing to a relaxed monetary policy. Although there were no doubt beneficial consequences from the judgmental approach adopted by the Federal Reserve so far, such rates of monetary growth could not continue for long without running inflationary risks. The authorities should begin to adopt a more cautious approach to monetary policy, particularly if evidence of acceleration in inflation should begin to emerge.

The authorities had expressed their willingness to publish the staff report and summing up from the 1985 Article IV consultation with the United States if other member countries were prepared to agree to do so as well, Mr. Rye concluded. His authorities would not regard such publicity as appropriate or helpful.

The staff representative from the Western Hemisphere Department noted that the staff's downward revision in its growth projections for 1985 had been stronger than the Administration's. Both revisions had been prompted by the disappointing results for real GNP in the first half of 1985--particularly the first quarter--as indicated by the revised national income accounts data. The Administration had revised its forecast for the growth of real GNP during 1985--from the fourth quarter of 1984 to the fourth quarter of 1985--from 4 percent to 3 percent, which implied a year-over-year increase of 2.7 percent from 1984 to 1985. The staff had revised its forecast for growth during 1985 downward from 2.9 percent to 2.6 percent, implying a year-on-year growth of 2.6 percent in 1985. The Administration's projection implied that real GNP would grow at about 4 1/4 percent a year in the second half of 1985, while the staff's projection implied growth of about 3 1/2 percent in the second half.

Both projections implied a significant acceleration in economic activity in the second half of 1985, which was not overly optimistic, the staff representative added. Interest rates had dropped substantially over the past year and were expected to lead to a pickup in the interest-sensitive components of demand, particularly consumer durables and construction. Also, the recent rapid growth of M-1 suggested that output was not likely to be squeezed in the period ahead by an overly restrictive monetary policy. Moreover, the disappointing performance in the first quarter had been influenced by a number of special factors, including a delay in shipments and new orders of mainframe computers following the announcement by a major U.S. producer of the introduction of a new model later in the year. That factor, together with other temporary factors, was expected to be partially offset in the second half of 1985. Also, as a result of the depreciation of the dollar in recent months, the negative effect of the expected deterioration in the current account on real GNP should be less than had been anticipated earlier, although the favorable effects of the depreciated dollar would probably be felt more strongly in 1986.

Economic indicators did not point to a recession in the near term, the staff representative continued. Inventory/sales ratios appeared to be fairly low by historical standards, inflation remained moderate, and interest rates had been declining until recently. The usual warning signs of a cyclical downturn did not seem to be present. Private balance sheets indicated that consumer installment debt had been rising rapidly in recent quarters and that corporate debt had been increasing rapidly owing to a large volume of takeovers and equity buyouts. Although those trends indicated potential vulnerability, particularly in the event of a sharp upturn in interest rates, they did not signal any immediate danger.

There was no qualitative difference between the staff's projections and those of the Administration regarding the strength of the economy in the remainder of 1985; however, the pickup envisaged in the staff forecast was more modest. There was a greater divergence between Administration and staff forecasts for the medium term, which were fully documented in Appendix X to the paper on recent economic developments.

During the present cyclical upswing, labor productivity--measured in terms of real GNP per employee--had been relatively weak, the staff representative noted. In the two and one half years ended in the second half of 1985, real GNP per employee had risen less than 5 percent compared with an increase of almost 6 1/2 percent during the typical postwar recovery. During the 1980s productivity had increased by about 3/4 of 1 percent annually, a rate equivalent to that in the 1970s but down from an annual average increase of 2 1/4 percent during the 1960s. The assumption made in Appendix X was that the growth of multifactor productivity--which represented what remained from the growth of output after growth in capital stock and employment had been taken into account--would pick up gradually over the period 1985 to 1990 from about 1/4 of 1 percent in 1985 to 1 percent in 1990. Although that rate of growth was lower than the 1.7 percent annual average increase during 1948-73, it would represent a favorable performance compared with that for 1973-83, when there had been essentially no growth in multifactor productivity.

In interpreting recent developments in the U.S. economy, the Administration emphasized improvements in technology and the climate for investment in the United States, while the staff had emphasized the role of financial policies, the staff representative remarked. That difference, however, should not be overstated. The staff did not dispute that certain factors that were not directly related to macroeconomic policies had played an important role in explaining the strong rise in private investment in the face of historically high interest rates and also in explaining the strength of the dollar. In Appendices I and IX of the paper on recent economic developments, the staff had emphasized the remarkable growth of high technology investment in recent years, notably in the computer area, and the likely role of exogenous factors--such as "safe haven" effects--in explaining the appreciation of the dollar since mid-1980. Nevertheless, the staff remained convinced that financial policies, and fiscal policy in particular, had affected macroeconomic developments in recent years, including the course of real interest rates and exchange rates.

The fiscal measures recently approved by Congress, if effectively implemented, could be expected to lower U.S. interest rates, the staff representative commented. If the interest rate decline was not offset by comparable declines in foreign interest rates, a decline in the value of the dollar could also be expected, with a favorable effect on the current account balance over time. Any confidence effect that might initially bolster the dollar would probably be short run. Inasmuch as the value of the dollar had been boosted in the past by rising fiscal deficits, a reversal of those fiscal trends should tend to lower the dollar and hence

to reduce the external imbalance by reducing aggregate expenditure in relation to aggregate output. It would be difficult to quantify the relationship between a decline in interest rates and the associated decline in the value of the currency. Some econometric models suggested that a $50 billion reduction in federal expenditures might be accompanied by a drop in short-term U.S. interest rates of about 1 percentage point. Thus the spending cuts envisaged in the congressional resolution, which by FY 1988 would total more than $100 billion--excluding savings on interest payments--might result in lowering short-term U.S. interest rates by perhaps 2 percentage points over the medium term. As to the effects of changes in exchange rates on the current account, the results of simulations had been summarized in Table 2 of Appendix VI of the paper on recent economic developments, which illustrated the sensitivity of the current account to a variety of assumptions regarding real exchange rates.

The economic assumptions underlying the recent congressional resolution were those provided by the Administration in February 1985 in the context of the budget for FY 1986, the staff representative remarked. Those assumptions were based on an average annual growth of 4 percent in the period 1986-88. Interest rates were assumed to average 7.9 percent in 1986, 7.2 percent in 1987, and 5.9 percent in 1988. Those interest rate assumptions had subsequently been revised downward by the Administration--to 7.5 percent for 1986 and 7 percent for 1987--to take into account the recent decline in interest rates. The Senate estimates of the congressional budget package had, however, been based on the earlier estimates of the Administration.

By comparison, the staff's forecast envisaged growth of real GNP of 3.3 percent in 1986, 2.7 percent in 1987, and 2.7 percent in 1988, the staff representative added. These projections implied an average annual growth rate of 2.9 percent for the period 1986-88, which was more than 1 percentage point below the Administration's forecast. The staff's assumption for the short-term treasury bill rate--at 7.5 percent for 1986, 7.2 percent for 1987, and 7 percent for 1988--was a bit more conservative than that of the Administration. Consequently, the staff's projections for revenues would be lower than those of the Administration because of lower economic growth, and the staff's projections for expenditures would be higher because of lower economic growth, and higher interest rates would yield higher estimates for unemployment compensation and, particularly in FY 1988, for interest on the debt.

The staff forecasts had been based on policy assumptions that differed from those recently included in the Senate forecasts, the staff representative pointed out. The staff had assumed that the federal deficit would be reduced relative to the current services estimate by $40 billion in 1986, by $55 billion in 1987, and by $65 billion in 1988. The Congress had assumed a reduction of the federal deficit by $56 billion in FY 1986, $90 billion in 1987, and $132 billion in 1988. Consequently, whereas the differences in the first year were not large, by FY 1988 the saving assumed by Congress was more than double that assumed by the staff. It was not likely that the fiscal assumptions underlying the

staff's macroeconomic forecasts would be revised to reflect the Senate's estimates, because it was highly uncertain whether all the cuts envisaged would be implemented. If the staff's assumptions were revised, growth would be lower in the short run, but in the longer run the rate of capital formation, and hence the rate of economic growth, would be higher.

The reductions in defense spending relative to the Administration's current services estimate as envisaged in the budget resolution would amount to only $10 billion in FY 1986 but grow rapidly and reach $45 billion in FY 1987 and $65 billion in FY 1988, accounting for virtually half of the cuts envisaged, the staff representative continued. It had not been exactly determined what areas of the defense budget would be affected by those cuts. Moreover, defense spending had already been running well below appropriations so that the expected cuts to some extent implied the rubberstamping of spending reductions that would have taken place in any event.

An Executive Director had said that the staff's concern about the risk of a resumption of inflation as a result of relaxed monetary policy was baseless and inappropriate, the staff representative recalled. However, the history of past expansions suggested that inflationary pressures could emerge rather suddenly, even when capacity utilization, unemployment, and other economic indicators suggested the existence of a considerable degree of slack. The behavior of commodity prices and the persistence of wage concessions more than two years into the recovery suggested that expectations and labor market conditions might have been altered in a fundamental way. That did not however mean that the risk of a return of inflation had disappeared or that vigilance could be abandoned; the staff believed that there was no basic difference of view between Federal Reserve officials and the staff on that issue.

The staff's concern that the judgmental approach to monetary policy might have unfortunate consequences on inflation was not meant to suggest that monetary policy could be conducted by adhering rigidly to monetary targets, particularly at a time when the interpretation of the monetary aggregates was difficult, the staff representative pointed out. The staff agreed with the need to look at other economic and financial indicators but also considered that the movement from a more or less automatic procedure to one in which discretion played a major role entailed the risks of cumulative departures in the monetary aggregates that might later imply the risk of resumption of inflation. He considered that Federal Reserve officials would agree that such a risk existed.

The Chairman of the Federal Reserve Board had indicated that the decision to rebase the target range for M-1 growth in 1985 had been made because of a change in the trend of velocity and to allow for the return of interest rates to more normal levels in recent months, the staff representative noted. The more widespread payment of interest on transaction accounts was expected to reduce the trend in velocity over time. Moreover, the possibility of earning interest on checking accounts

and the fact that the rates paid on such accounts changed more sluggishly than market rates had probably increased the interest responsiveness of the demand for money.

The decision to widen the target range for M-1 presumably reflected the Federal Reserve's continued uncertainty about the behavior of that aggregate, the staff representative observed. The Chairman of the Federal Reserve had emphasized in his testimony before Congress that there was yet insufficient experience following the regulatory changes introduced in recent years to specify with any precision the relationship between money, income, and interest rates. The revision of the target range for M-1 apparently was not intended to mark a fundamental departure from the Federal Reserve's medium-term objectives. Moreover, in the view of the Federal Reserve Chairman, the monetary targets were consistent with sustained growth in the economy, provided that inflationary pressures could be contained. The Chairman had also noted that the Federal Open Market Committee had decided not to take decisive actions to curtail the recent surge in M-1 growth in view of the high value of the dollar, the sluggishness of manufacturing output, relatively well contained price pressures, and the fact that broader monetary aggregates--particularly M-2 and M-3--had remained generally within or close to their target ranges.

Technical discussions with the Treasury Department concerning the tax reform package were continuing, the staff representative reported. The staff was concerned that the tax package might not be revenue-neutral in view of the plan's dual objectives of reducing the effective marginal tax rate on corporations while raising corporate revenue to compensate for the expected fall in personal revenue that would result from the proposed cuts in personal income tax rates. Nevertheless, the Secretary of the Treasury had offered assurances that the tax reform would, indeed, be revenue neutral.

If the measures contemplated in the tax reform plan to modify depreciation allowances and the investment credit tax led to a reduction in the average effective tax rate on corporations, the pretax real interest rate might be lower, the staff representative continued. For similar reasons, by lowering the effective tax rate on corporations and raising the real after-tax rate on return on capital, the depreciation allowances introduced by the Accelerated Cost Recovery System in 1981, and later revised in 1982, might have led to an increase in market interest rates, although such an increase would not discourage investment. The impact on investment of the present tax proposals was not clear. The Administration had estimated that the overall effective corporate tax rate would decline because the fall in the effective rates for inventories and for structures would more than compensate for the rise in effective corporate rates for equipment that would stem largely from the elimination of the investment tax credit. The staff's tentative calculations suggested that the overall fall in the effective corporate tax rate as a result of those proposals, if any, would be small, and hence any effect on the interest rate was also likely to be small.

The staff considered that the large current account projection shown in the medium-term scenarios presented in Appendix IV were unsustainable because they depended on continuing large capital inflows, the staff representative from the Western Hemisphere Department said. According to another view recently presented in a Fund staff study, there might have been a fundamental change in the desired proportion of net U.S. assets that world investors desired to hold as part of their net wealth. The study assumed that the portfolio shift had meant that the proportion of U.S. assets to world net wealth had moved from roughly zero a few years ago to perhaps 10 percent at present. On that basis, the United States could possibly experience fairly large current account deficits and capital inflows for a prolonged period, and a gradual and relatively small depreciation of the dollar could restore long-term equilibrium in the current account over the long run. The staff did not share that view because although it was probably true that there had been a shift in the desired proportion of U.S. assets to world net worth, the magnitude of that shift was extremely difficult to determine. Moreover, it was unlikely that the large U.S. current account deficits that were in prospect could be financed by ongoing flows of foreign savings in the absence of changes in interest rates and exchange rates.

The Director of the Exchange and Trade Relations Department noted that because of the present circumstances of world trade policy, the staff intended to pay particular attention to protectionism. In that regard, while U.S. trade policy was more transparent than that of some other member countries, the staff was striving to assure that the subject of protection was fully covered in consultation discussions and in staff reports. The trade information notices that the staff was developing should be helpful in addressing the problem of protectionism and trade policy.

The farm export program involving in-kind payment bonuses did not have multiple currency practice implications and therefore was not subject to Fund jurisdiction, the Director of the Exchange and Trade Relations Department explained. To the staff's knowledge, there had been discussions with some countries concerning purchases under the scheme, but as of yet no transactions had taken place.

Mr. Dallara observed that most Executive Directors had welcomed the recent congressional budget resolution but felt that it was only a first, and perhaps insufficient, step toward improving the U.S. fiscal position. His authorities recognized that if appropriation acts emerged that were inconsistent with the budget resolution, difficult decisions would have to be made to ensure that the resolution became a reality. Despite the different assumptions made by the staff and the U.S. authorities, both agreed that if the deficit reduction plan were implemented, in FY 1986 alone the deficit would be cut by 1-1.5 percent, depending upon the evolution of economic activity. In FY 1988, the Administration expected the deficit to be cut to 2.3 percent of GDP, putting the debt to GDP ratio on a declining trend, which--at less than 40 percent of GDP--would approximate the level that prevailed in the mid-1960s. At the same time,

state and local government surpluses could be expected to offset more than half of that deficit. Nonetheless, his authorities recognized that the deficit clearly had implications for the economy of the United States as well as the world's economy, and they intended to pursue further expenditure cuts. Obviously, the underlying economic assumptions were central to the outcome of the U.S. fiscal position, and the differences of view between the staff and his authorities reflected the difficulties inherent in forecasting.

His authorities were confident that an average annual growth rate of about 4 percent could be achieved in the medium term, Mr. Dallara continued. The staff study of the medium-term relationship between fiscal deficits, the current account, and the saving/investment imbalances in Appendix X of the paper on recent economic developments posed difficult questions regarding the medium-term outlook, with regard to both the fiscal and external positions. His authorities did not share the staff view that the Administration's projected economic growth rate might not be attainable over the medium term. Most important, his authorities considered that capital inflows would continue and that, as the recent investment boom matured and investment stock and capital stock increased, the marginal rate of return on capital would gradually decline, leading to a reduction in the rate of investment to a level that could, nonetheless, continue to support growth in the range of 4 percent.

Growing revenues did play a significant part in the projected reduction in the deficit during the period ahead, Mr. Dallara said. According to projections for 1986-88, revenues were to grow about 9 percent, whereas expenditures were to grow by about 4-4 1/2 percent. A significant part of the revenue increase related to the growth assumptions embodied in the forecasts, although changes in the social security tax structure over the past few years also played a role. Moreover, his authorities believed that it would be economically and politically unwise to resort to additional revenue measures. Indeed, expenditures as a percent of GNP had increased from about 20 percent to about 24 percent in less than five fiscal years. Over the recent history of the U.S. economy, expenditure had been closer to 20 percent, and for the period 1964-79, it had been 24 percent. However, by 1988 receipts would be very close to the historical average of about 19 percent of GDP. Therefore, his authorities did not consider that expenditures were too high or that revenues were too low. In their view, revenue measures would have an adverse effect on investment and growth in the United States and elsewhere because investment was driven by the real rate of return on capital and not by financial markets' real interest rates.

Studies undertaken by the Treasury and by others had raised serious questions as to whether or not revenue measures would indeed reduce the federal deficit, Mr. Dallara added. An empirical study of 12 cases in the period 1920-82 found that there was one-way causality in 7 out of 12 cases, which suggested that tax increases might lead to increases in expenditures. In 5 of the 12 studies, two-way causality had been found,

suggesting that there might be both increases in expenditure and a reduction in the deficit. Moreover, after reviewing the experience of other industrial countries in recent years, it appeared that the application of additional taxes did not necessarily lead to deficit reduction. The increase in government expenditure in relation to GDP following the application of a value-added tax--which in some cases had produced significant revenue--was also cause for concern. In the United Kingdom, for example, government expenditure in relation to GDP had risen from 26 percent to 38 percent following the implementation of the value-added tax. In France, the comparable figures were 28 percent and 30 percent.

The proposed tax reform was expected to generate increased saving and productivity, by lowering tax rates and increasing tax simplicity and equity, Mr. Dallara indicated. The new depreciation system should also reduce overall effective tax rates on equity capital of 20 percent or more and promote more efficient use of capital stock.

There were no differences of view between his authorities and the staff with regard to the risks involved in current monetary policy, Mr. Dallara acknowledged. Indeed, those risks had been set out recently in a statement by the Chairman of the Federal Reserve Board. His authorities considered the adjustment of the base and the target ranges for the monetary aggregates to be appropriate in the present circumstances. The risks involved would be carefully borne in mind as they continued to implement monetary policy. As to whether or not further efforts to increase output and bring down interest rates through monetary policy might be counterproductive, he could only indicate that a reduction in the rate of growth of M-1 during the period ahead was seen to be appropriate.

His authorities were concerned about the size of the external deficit and about its projected size in the coming years, Mr. Dallara noted. There were however some differences of view about what had been the primary factors contributing to the current account deficit and, more important, to the capital inflows which had been the counterpart of that deficit. His authorities' concern reflected serious problems in certain sectors of the U.S. economy that were increasing protectionist pressures, which had become increasingly difficult to contain. In that connection, he questioned the view that had been expressed that it was fundamentally inappropriate for the United States to be absorbing a significant part of world saving. The implication was that over the past few years the United States should have been running a current account surplus. Had that happened, it was difficult to envisage that the world economy would have been in an improved position. For example, had the United States been running a current account balance, the Mexican trade balance would have been reduced by about $17 billion, and a halving of the effective variable interest rate on Mexico's debts would have been required to offset that loss. Consequently, even with substantial reduction in the U.S. fiscal position, it was difficult to envisage--given the interest rate structure of Mexico's external debt--that a current account balance would have been particularly beneficial to Mexico. Indeed, that might have been the case for many developing countries over the past few years.

He welcomed the strong support the Directors had evidenced for his authorities' efforts to resist protectionist pressures, Mr. Dallara remarked. Although some of the steps taken might not appear to have gone in the direction of free trade, they had in the circumstances at least resisted protectionism. The United States remained fundamentally committed to multilateral, most-favored-nation trade principles, and its first priority was a new round of trade negotiations. However, progress on that new round had been slow, and his authorities therefore intended to take advantage of opportunities for more limited trade liberalization as they arose.

The volume of U.S. assistance flows was substantial, with official development assistance exceeding twice that of the second largest donor, Mr. Dallara pointed out. Admittedly, the amount of ODA as a percent of GDP was not large, but the U.S. contribution to developing countries' growth through trade and through the current account deficit had been important. His authorities fully agreed that the effectiveness of U.S. aid flows should be improved and strengthened. In fact, they had made constant efforts in that direction in multilateral institutions.

His authorities considered the surveillance process to be particularly important, and he regretted the reluctance of the authorities of other member countries to accept the proposal to publicize the outcome of consultations with economically important industrial and developing countries, Mr. Dallara said. The recent consultations with the United States demonstrated that although the staff and the U.S. authorities might have differing analyses of economic developments, those differences did not in all cases lead to differing policy recommendations or positions. Those dissimilarities and coincidences should not be overlooked because they represented not only the outcome of an ongoing process but also the seriousness with which his authorities viewed that process.

The Chairman made the following summing up:

> Executive Directors agreed with the general thrust of the staff appraisal in the report for the 1985 Article IV consultation with the United States. They noted that the growth in real GNP had been very strong in the initial phase of the current recovery, owing in part to an exceptionally rapid expansion in business fixed investment. The increase in output during that period had been accompanied by a sizable drop in the unemployment rate and in the rate of inflation. Directors commended the United States' authorities on these achievements, the more so, since the growth of demand in the United States had helped to promote world recovery and had facilitated to a large extent the adjustment efforts of developing countries.
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> Directors noted that in recent quarters the growth of output had declined notably and the unemployment rate had remained in the range of 7 percent to 7 1/2 percent. The achievement of the U.S. Administration's forecast for GNP growth in 1985 as a whole

implied a marked strengthening of output in the second half of the year, and there were some questions as to the feasibility of that forecast.

Directors expressed considerable concern about major imbalances in the economy, which in their view posed a threat to the prospects for continued economic growth in the United States and abroad. In particular, the federal deficit and the external current account deficit had grown to magnitudes that were large by historical standards and had become sources of vulnerability to the U.S. economy and to the rest of the world.

It was the unequivocal view of Directors that the large current and prospective federal deficits constituted the most pressing economic policy issue at this time. They observed that in the past several years the increase in the federal deficit and the growth of domestic investment had not been matched by a rise in domestic savings. Instead, the pressures stemming from the rising domestic credit demands had contributed to a sharp widening of the U.S. current account deficit. Directors felt that the continuation of those trends was likely to give rise to an unsustainable situation, as the rising capital inflows needed to finance the external deficit would imply that an increasing share of foreign savings would have to be invested in U.S. assets. In their view, this would constitute a questionable use of world savings and a worrisome development in the external debt position of the United States. They cautioned that in the absence of action to redress the fiscal imbalance, there was a greater probability of a shift by investors from U.S. assets that would trigger a sharp decline in the value of the dollar and a rise of interest rates. Directors emphasized that the result could be a crowding out of domestic investment, with serious consequences for economic growth in the United States, and the intensification of the debt-servicing difficulties faced by developing countries.

Directors agreed that the best way to alleviate the pressures generated by the large disparity between domestic savings and investment in the United States would be to reduce the absorption of savings by the Federal Government. Such a reduction should lead to a lasting decline in U.S. interest rates, thereby improving prospects for capital formation in the United States and abroad. Directors stressed that an early and substantial cut in the federal deficit also would create the conditions for an orderly adjustment in the value of the dollar and in the U.S. current account imbalance. This would help alleviate the competitive pressures that have affected the output of export and import-competing industries in the United States and have contributed to an escalation of protectionist pressures.

Directors welcomed as a step in the right direction the budget resolution adopted recently by the Congress that aimed at achieving a substantial improvement in the federal fiscal position. They emphasized, however, that this action could only be viewed as the beginning of the process of bringing the budget under control. They noted that many of the spending cuts called for in the resolution had yet to be translated into specific appropriation bills, and they stressed the importance of avoiding slippages in the implementation of the budget resolution. Moreover, a number of Directors observed that even if the congressional plan were implemented in full, future deficits would probably be considerably larger than projected by the Congress because in their view economic growth would tend to be lower than had been envisaged in the Administration's medium-term forecast on which the congressional estimates were based. Therefore, Directors felt that additional budgetary measures would be required over and above those included in the resolution adopted by the Congress.

Directors agreed with the emphasis placed by the Administration on expenditure restraint as the means of redressing the fiscal imbalance. However, many Directors noted that so far the efforts to reduce spending in relation to GNP had not succeeded, and they doubted whether the task of bringing down the federal deficit could be accomplished solely by cutting expenditure. In that context, several Directors noted that, leaving aside the expenditure categories of defense and social security, the remaining scope for spending cuts, in their view, was becoming limited. Thus, while Directors encouraged the intensification of efforts to curb spending, they generally believed that it would be necessary to consider for implementation measures to increase federal revenue so as to avoid the unfavorable consequences of continuing large deficits on investment in the United States and elsewhere. A number of Directors felt that revenues could be raised without harming economic incentives, and referred in this connection to the possibility of eliminating certain tax preferences.

Directors generally welcomed the Administration's tax reform proposals as a step to increasing the fairness and simplicity of the tax system while improving the allocation of resources. A number of them questioned, however, whether the plan would be revenue neutral as intended by the Administration. In view of the magnitude of the fiscal problem, it was important that tax reform not result in higher federal deficits.

Directors agreed that the monetary policy pursued by the Federal Reserve had been instrumental in bringing down inflation from the high levels of the early 1980s.

Many Directors believed that in view of the sluggishness of output and employment in recent quarters and of the continued moderation of inflation, the recent stance of monetary policy had indeed been appropriate. They noted that the rapid rise in M-1 had been associated with a substantial decline in U.S. interest rates which would help alleviate the debt-servicing difficulties of developing countries. Several Directors stressed, however, that in the current circumstances, there was now no room for a further easing of monetary policy without risk to relative price stability, and they believed that it would be prudent that monetary growth be kept within the new target range.

Directors agreed with the emphasis that the Administration has placed on the role of market forces in the design of economic policies. In the area of agriculture, however, it was noted that the scheme introduced recently to subsidize certain agricultural exports seemed to be at variance with the general thrust of the Administration's plan for agricultural reform.

Directors welcomed a number of positive actions in the trade area that had been taken during the past year by the United States. In particular, they welcomed the Administration's decision not to seek renewal of voluntary restraints on Japanese auto exports to the United States and the decision not to grant protection to the domestic copper industry. Directors also were encouraged by the Administration's firm opposition to proposals calling for an import surcharge.

Directors generally noted that demands for protection were likely to remain strong as long as the competitive position of U.S. producers continued to be affected by the high value of the dollar. They stressed that, to the extent that the exchange rate reflects the fiscal situation, the most appropriate way to alleviate the causes of the difficulties faced by U.S. producers of traded goods would be to correct the fiscal imbalance. Yet, they recognized that the appreciation of the dollar in the past several years also had reflected other factors, such as the favorable climate for investment in the United States and safe-haven effects. Insofar as these factors play a role, the appropriate response would be to allow adjustment to take place and not to impose trade barriers. Therefore, Directors urged the Administration to stand fast in its resolve to resist protectionist pressures, and particularly to maintain its opposition to the variety of protectionist measures advanced in Congress, including the proposed legislation that would severely restrict textile imports.

Directors acknowledged the leading role of the United States in promoting a new round of multilateral trade negotiations. At the same time, it was observed that the United States was pursuing

bilateral arrangements as well. Clearly, caution should be exercised in negotiating such arrangements lest they lead to increased restrictions on trade.

Directors recognized the important role of the United States in dealing with the debt problems of developing countries. Several Directors were encouraged by initiatives to maintain access to the U.S. market, but were concerned that certain current and proposed restrictive trade measures may hamper the exports of developing countries. Specifically, Directors urged the United States to give considerable weight to the interests of the developing countries in trade policy considerations regarding footwear and textiles in particular. Furthermore, in light of the adjustment difficulties of many developing countries, a number of Directors observed that it would be particularly desirable at the present time for the United States to raise the share of its national income devoted to foreign economic assistance, which is presently the lowest among the member countries of the Group of Ten.

Finally, several Directors underlined that the successful resolution of the imbalances in the U.S. economy and the preservation of a liberal trade stance will crucially require improved growth performance outside the United States, particularly in other industrial countries with a comfortable external position and a good price record, as well as the resolve of Fund members generally to resist protectionism.

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

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/85/120 (8/5/85) and EBM/85/121 (8/5/85).

2. ANNUAL REPORT ON EXCHANGE ARRANGEMENTS AND EXCHANGE RESTRICTIONS, 1985 - PART ONE

The Executive Board approves Part One of the 1985 Annual Report on Exchange Arrangements and Exchange Restrictions, together with a letter transmitting the Report to the Board of Governors and the members of the Fund. (SM/85/171, Rev. 1, 7/26/85)

Adopted August 5, 1985

APPROVED: May 5, 1986

LEO VAN HOUTVEN
Secretary