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Date: February 19, 1997

DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
1. minutes	the Chairman's summing up at the conclusion of the 1985 Article IV consultation with US Executive Board meeting 85/121 8/5/85 (4 pp.) R 10/20/2010 F95-043/1 #46	8/8/85	P1
2. summary	of statements by Directors at US Article IV board meeting 8/5/85 (3 pp.) R 10/20/2010 F95-043/1 #47	n.d.	P1
3. minutes	the Chairman's summing up at the conclusion of the 1985 Article IV consultation with US Executive Board meeting 85/121 8/5/85 (4 pp.) R 10/20/2010 F95-043/1 #48	8/8/85	P1

RESTRICTION CODES

Presidential Records Act - [44 U.S.C. 2204(a)]

- P-1 National security classified information [(a)(1) of the PRA].
- P-2 Relating to appointment to Federal office [(a)(2) of the PRA].
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THE SECRETARY OF THE TREASURY
WASHINGTON 20220

August 15, 1985

MEMORANDUM FOR: THE HONORABLE MALCOLM BALDRIGE
SECRETARY OF COMMERCE

THE HONORABLE JAMES MILLER
DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

THE HONORABLE CLAYTON YEUTTER
UNITED STATES TRADE REPRESENTATIVE

THE HONORABLE PAUL VOLCKER
CHAIRMAN, FEDERAL RESERVE BOARD

THE HONORABLE BERYL SPRINKEL
CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS

FROM: JAMES A. BAKER, III *JAB*

SUBJECT: United States Article IV Consultation at the IMF

On Monday, August 5, 1984, The United States concluded its annual Article IV consultation with the International Monetary Fund with a discussion of the U.S. economy in the Executive Board. Although Executive Directors expressed serious concerns about our fiscal and current account imbalance, the tone of this year's discussion was somewhat less critical than last year's, with more recognition of the important role the U.S. economy has played in world economic growth in recent years.

Directors remained concerned about our fiscal deficit. While commending the recent Budget agreement as a positive step, they expressed some skepticism that our deficit reduction target would be realized, primarily due to concerns about medium-term growth prospects. Directors generally welcomed our tax reform efforts, although many voiced a fear that it would be revenue negative. There was general support for the Federal Reserve's current monetary policy stance, although several directors sounded a note of caution and laid importance in bringing M1 gradually within the new target range.

Our current account deficit was also viewed as a problem, particularly as it has generated protectionist pressures. This concern was tempered somewhat, however, by the realization of how it has contributed to world growth and by recognition of the importance of other countries stimulating growth and imports if the U.S. current account deficit is reduced.

While there was widespread support for largely successful efforts to resist protectionism thus far, several directors expressed concern over the rising protectionist pressures.

Attached are several background documents concerning the consultation which you or your staff may find of interest.

Finally, I would like to extend my appreciation for the participation of your agency in the Article IV Consultation process.

Attachments

August 2, 1985 - 85/135

Statement by Mr. Dallara on the United States
1985 Article IV Consultation
Executive Board Meeting 85/120
August 5, 1985

On behalf of my authorities, I would like to express my appreciation to the staff for the excellent documents which they have prepared for today's concluding session of the 1985 Article IV Consultations with the United States, as well as for the professionalism and thoroughness which they have exhibited throughout the consultation process. The staff has provided us with comprehensive and current material on recent economic developments, policies and prospects. In my comments, therefore, I will concentrate on aspects of these which I consider of particular importance.

Overall Economic Strategy

The overall economic strategy of the United States is familiar to Directors, but I will briefly review its principal elements in light of the importance of assessing developments and decisions in the context of this basic strategy. This strategy has consisted of:

- A fundamental belief in the central importance of market forces in guiding decision-making within the economy, allowing maximum freedom for individual choice and maximum opportunity for growth, employment and the creation of wealth;
- Reducing the role of government in the economy in order that the private sector can prosper, with a particular emphasis on deregulation and restraint in government expenditure;
- Bringing inflation under control;
- An international economic policy that reflects these same tenets, emphasizing market forces, free trade and international economic cooperation, with strong support for the international institutions, including centrally the IMF, which provide the framework for such cooperation.

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

Recent Economic Developments and Short and Medium-Term Prospects

The impressive record of the U.S. economy since 1982 has been comprehensively documented in the material before us and discussed in the Executive Board on numerous occasions. I will not, therefore, elaborate on these developments, but focus on more recent economic developments and short and medium-term prospects.

Following the exceptionally rapid expansion during the early phases of this recovery -- with real GNP growing at 7.1% during the first 6 quarters of the expansion -- the U.S. economy has slowed. Real GNP growth in 1984 was 5.7% (4th/4th), and during the last four quarters just under 2%. Inflation has continued to improve, with the 12-month increase in the consumer price index falling to 3.75% through June 1985; and interest rates have declined significantly, with average short-term rates in June 1985 almost 4% below average levels a year earlier, and average long-term rates down 3.4% over this period.

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

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

- The significant decline in the rate of growth during the first half of 1985 was associated with a sizable reduction in the rate of inventory investment, with inventories accumulating at an annual rate of only \$12.5 billion during the first half of 1985 compared to a \$27 billion rate during the first half of 1984. With the inventory-sales ratio now at relatively low levels, particularly among manufacturing industries, a resumption of normal growth in inventories can be expected to contribute to second half FY 1985 production;
- The significant decline in interest rates over the last year should enhance the prospects for an increase in activity, particularly in the most interest-sensitive sectors such as housing;
- Domestic demand for goods and services remains robust. Real final sales, for example, continued to grow at a

strong pace during the second quarter of 1985, increasing at an annual rate of 5.1%. The lower GNP growth during this period reflects the important role of imports in meeting U.S. demand;

- The annual rate of growth of M1 of 10.1% during the first two quarters should also facilitate an increase in economic activity;
- The most recent developments in leading economic indicators also point toward more activity in the second semester, with the 1% increase in June -- the largest since January 1985 -- presenting an upward trend since December 1984.

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

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

But the largest concern about the medium-term outlook has been the Federal budget deficit. Achievement of the favorable medium-term outlook outlined above is critically dependent upon implementation of sound U.S. policies -- and that must include reducing significantly the budget deficit. It is to that I will now turn my attention.

U.S. Fiscal Policy and Prospects

Among the areas in which the staff and my authorities are in complete agreement is the critical importance of reducing the U.S. fiscal deficit.

¹Recent revisions in the index of industrial production, however, cast some doubt on the apparent sluggishness of manufacturing. The revised index shows that manufacturing output at the intermediate and final stages of production have risen at an annual rate of 3.6% this year, in contrast to the 0.6% annual rise reflected in the old industrial production series.

As President Reagan has stated, "had spending not soared out of control, today we would have nearly a balanced budget, far less national debt, and no threat to our current prosperity."

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

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

The agreement provides for a reduction of the deficit of more than 1% of GNP in FY 1986 from the FY 1985 level of 5.7% of GNP, and for a progressive reduction to 2.3% of GNP by FY 1988. This would put the Federal debt on a declining path relative to GDP, a critically important objective for the long-term health of the U.S. economy.

Monetary Developments and Policy

As the supplement to the staff report indicates, the Federal Reserve has recently announced that the target range for M1 growth during 1985 has been rebased to the second quarter of 1985, and widened from 4-7% to 3-8%. This change reflects a number of considerations, but before touching upon them, let me make clear that it does not reflect a change in the Federal Reserve's or Administration's fundamental stance toward monetary policy: that is, providing a financial environment conducive to sustained growth and continued progress toward price stability.

Among the considerations which underlay the FOMC's decision to rebase and alter the targets were:

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

- continued moderation in wage increases, with the rise in non-farm hourly compensation only 4% in the year ending March 1985;
- the high level of the dollar and the U.S. current account deficit, and the related weakness in the manufacturing sector;
- analysis which suggests that the rapid growth in M1 this spring was a reflection in part of greater willingness of economic agents to hold cash balances in an environment of significant interest rate declines, as well as possibly a reflection of the inclusion in M1 of interest-bearing accounts which may have altered the relationship between M1 growth and nominal spending;
- a view that the sharp decline in velocity during the first half of this year may not be fully reversed, but could presage a secular move toward lower velocity;
- the broader measures of monetary growth -- M2 and M3 -- have remained generally within the target ranges established for the year;

It is worth noting that M1 is currently high relative to the rebased range, and the Federal Reserve contemplates a return to M1 within the new range gradually as the year progresses.

Tax Reform

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

- the replacement of a schedule of 14 marginal tax rates ranging from 11% to 50%, with a simple three bracket system having rates of 15, 25 and 35%;
- reform and simplification of a complex system of itemized deductions, exclusions and special credits, eliminating or curtailing more than 65 categories of preferential tax treatment;
- the reduction of corporate tax rates with a balanced set of investment incentives.

I would like to assure Directors that the Administration remains completely committed to passing a tax reform bill that is revenue neutral. That commitment has been recently

reaffirmed by Secretary of the Treasury Baker, as well as by the leaders of the Congressional Committees with responsibility for tax matters. The Administration will work closely with Congress in order that revenue neutral tax reform can be implemented on an early date.

The Balance of Payments and the Exchange Rate

The two predominant, related features of the U.S. economy's interaction with the rest of the world have been:

- the large and growing U.S. trade and current account deficits, with the latter forecast to increase from \$102 billion in 1984 to \$125 billion in 1985 and to \$150 billion in 1986;
- the strength of the dollar, which appreciated a further 15.6% on a trade-weighted basis between January 1984 and February 26 of this year before declining 9.1% since that time.

The factors underlying the U.S. current account deficits are generally well-known (and are discussed in detail in Appendix V of the RED, SM/85/209, Supp. 1). The factors underlying the strength of the dollar are also generally not in dispute, although differences do exist over the relative importance of these factors. In particular, my authorities do not believe that interest rate differentials have been a consistently important factor in the dollar's appreciation. Neither the movement of nominal nor real interest rates appears to go very far in explaining exchange rate developments since 1981; this is particularly the case in 1983 and 1984, when real interest rate differentials moved against the dollar by 1.6% while the dollar appreciated 12.8% on a trade-weighted basis.

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

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

The openness of the U.S. economy has been clearly borne out by developments of the last few years:

- in 1984 the U.S. absorbed 58% of LDC exports of manufactured goods to industrial countries, although the U.S. GNP is only approximately 1/3 of total industrial country GNP;
- even growth of U.S. imports in sensitive sectors has been substantial -- textile and apparel imports increased 41% in 1984 and automobile imports increased 27%.

The United States has taken certain restrictive steps over the last few years, as outlined in Appendix 7 of the RED (SM/85/209 Supp. 1). However, the U.S. has on the whole developed an impressive record of resistance to trade restrictions, in spite of the recession of the early '80s and the pressures brought about by the strong dollar and the U.S. trade and current account deficits.

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

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

Conclusion

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

My authorities strongly support effective IMF surveillance, and have put forward a number of proposals designed to strengthen Fund surveillance as a means of encouraging the adoption and implementation of sound economic policies in

Capital flows to the U.S. have been voluntary and have, in fact, contributed to the appreciation of the dollar and, therefore, to the growing current account deficit. The fundamental question isn't so much whether the capital flows will continue, but whether circumstances will develop to reduce significantly the U.S. current account deficit during the period ahead. Three ways, inter alia, that this could in theory be accomplished present themselves:

- protectionist measures by the U.S.;
- an appreciation of other currencies relative to the dollar;
- a significant improvement in foreign growth relative to U.S. growth.

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

International Trade Policy

There are three main elements to the Administration's international trade policy:

- the maintenance of a free and open trading system that can promote continued expansion of international trade and world economic growth;
- a trade system which limits the distortions to trade, particularly those due to non-tariff barriers or interference by governments in trade flows; and
- the principles of overall reciprocity and equity.

member countries. It was within this context that my authorities have found the discussions with the staff during these Article IV Consultations to be most useful. Secretary Baker's commitment to this process was reflected in his decision to meet with the Managing Director and staff in a concluding discussion of U.S. policy and prospects. My authorities also look forward with interest to hearing the views of the Board from today's discussion.

During the June 1985 meeting of the G-10 Finance Ministers and Central Bank Governors, Secretary Baker stated his interest in strengthening the effectiveness of IMF surveillance by enhancing public awareness of the international implications of policies. He urged other Ministers to give further consideration to the concept of increased publicity of IMF Article IV documentation. Following up on that statement, my authorities have expressed a willingness to publish the staff report and Summing Up from this year's Article IV Consultation with the United States if others, particularly the economically most important industrial and developing countries, are prepared to agree to do so as well.

SUR/85/89

~~CONFIDENTIAL~~

August 8, 1985

The Chairman's Summing Up at the Conclusion of the
1985 Article IV Consultation with the United States
Executive Board Meeting 85/121 - August 5, 1985

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.

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

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BY RW NARA DATE 10/20/82

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.

SUMMARY OF STATEMENTS BY DIRECTORS
AT U.S. ARTICLE IV BOARD MEETING AUGUST 5, 1985

FRANCE

- Commended inflation performance, moderation in wages.
- Fiscal deficit due to inadequate increase in savings from 1981 tax measures.
- Action to restore fiscal situation most important issue; improvement would bring orderly decrease in interest and exchange rates and progressive restoration of trade balance.
- Will convey to authorities question of publication of Article IV material.

GERMANY

- Commended employment, inflation performance but short-run successes may be paid for in future at expensive cost.
- Doubted growth rate projections for remainder '85 can be achieved.
- Concerned that shift in monetary policy could refuel inflation.
- Concerned tax reform won't be revenue neutral and could add to deficit.
- German's trying to make DM more attractive, but do not believe re-inflating economy will help.

JAPAN

- Uncertain growth projections can be obtained, particularly without significant budget cuts.
- Not appropriate for U.S. to absorb such large part of world savings.
- Disappointed budget resolution fails to tackle important structural problems, but welcome compromise.
- Sympathized with emphasis on expenditure restraint, but revenue-increasing measures can't be excluded.
- Welcomed monetary policy shift to look at other factors.
- Welcomed U.S. commitment to free trade; Japan doing all it can to open its' markets.

UNITED KINGDOM

- U.S. recovery underpinned world recovery; eased pressures on debtor countries
- Achieved at cost of large, growing, unsustainable financial imbalances.
- U.S. absorbing significant part of world savings; while partially reflecting attractive investment climate, also to service government debt. If world capital needs over medium-term are to be met, need substantial shift in U.S. position.
- Cut in fiscal deficit essential to decrease real interest rates and effect substantial and orderly depreciation of U.S. dollar.
- Budget cut first step, but may need revenue measures

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BY RW
NARA DATE 10/20/10
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BELGIUM

- Achievements in certain areas, but costs high.
- Fiscal policy most important instrument to correct imbalances; budget resolution did little to help.
- Commended resistance of protectionism.

CANADA

- Growth outlook difficult; other industrial countries must pick up slack.
- Budget resolution major accomplishment, but only starting point.
- Revenue-raising and repeal of some tax incentives should be explored.
- Monetary shift not overly expansive.
- Canada-U.S. bilateral trade benefits both countries, while they continue to pursue free trade.

ITALY

- Need to correct two unsustainable deficits.
- Contribution to deficit reduction needed on expenditure and revenue fronts.
- Without reduction in deficit, more accommodating monetary policy will fuel inflation and have no downward effect on real effective exchange rates.

NETHERLANDS

- Unlikely to achieve 3 percent growth in 1985.
- Further efforts to use monetary policy to bring down interest rates to stimulate growth in output could be counterproductive and jeopardize confidence in FED.
- Deficit problem treated as political football; need for further measures too obvious to comment.
- Fund urges most countries to avoid crisis by striking balance between cutting expenditure and/or raising taxes.
- Welcome meeting between MD and Secretary Baker.

NORDIC

- Commended achievements in inflation and job creation.
- Overriding problem need to reduce U.S. deficit.
- Need to increase taxes, eliminate tax preference, and tax regulations that distort economy.
- U.S. could hamper world growth if became major net importer of capital on a more permanent basis.
- Support new round of GATT; worried about increased protectionist sentiment and emphasis on bilateral trade
- Urgent need for growth in other Industrial countries.
- Need increase in U.S. ODA.

ARGENTINA

- Economic recovery remarkable.
- Must reduce fiscal deficit to help interest rates and LDC debt.
- U.S. must take lead in dismantling protectionism.
- Must increase ODA.
- Thanks for help with debt problems.

AUSTRALIA

- Doubtful Administration's projections could be achieved.
- Relaxed monetary policy has benefits, but rates cannot continue for long without inflationary risks.
- Australian authorities would not want publication of Article IV.

INDIA

- Need for coordination of policies with others to help pick up slack in U.S. growth; improve surveillance.
- Trade barriers hurt LDC adjustment.
- Must increase ODA.
- Taxes can be increased to help U.S. fiscal deficit without hurting incentives.

SAUDI ARABIA

- Commendable economic achievements in many areas.
- Need to bring down real interest rates to encourage capital formation and promote interest sensitive industries.
- Congressional budget action step in right direction; gradual reduction will give time for private sector to benefit from new tax reform.
- Need to find more means to increase saving, particularly to finance growth.
- Not too concerned over current account deficit; will reduce over time with gradual decline in dollar.
- U.S. doing very well in managing economy.

SPAIN

- Value of dollar, increase in real interest rates have hurt Europe, led to lopsided and fragile world economy, precipitated debt crisis, hurt recovery; must take prompt deficit action.
- Mounting protectionist pressures worrisome for steel, textiles, shoes.
- Essential to increase revenues even if against main tenet of Administration's policy.
- Required decrease in real interest rates needed to achieve Administration's growth projections difficult to see.



INTERNATIONAL MONETARY FUND
WASHINGTON, D. C. 20431

EXECUTIVE DIRECTOR
United States

CABLE ADDRESS
INTERFUND

August 16, 1985

Dear Beryl:

By now you should have received a memo from Secretary Baker providing background on the concluding session of the U.S. Article IV Consultation at the Fund. (Enclosed are copies of some of the relevant background material in case that memo has not yet arrived.)

I have also enclosed a copy of the recent supplement to the Recent Economic Developments on the U.S. economy. It contains two appendices which I thought you might find of particular interest: Appendix 6, which projects various U.S. current account scenarios over the next few years, and Appendix 10, which analyzes the relationship between fiscal deficits, the current account and the savings/investment balance. Those two appendices are not particularly long, and if you have time to glance at them I think you will find it worthwhile.

The final enclosure concerns an issue dear to your heart: fiscal deficits and interest rates. The author claims to have found a definite relationship between fiscal deficits and interest rates. I am sure there must be problems with his analysis, but I am also sure you will find them much faster than I!

I found our meeting prior to the Article IV discussion in the Board very helpful. I believe that if you glance through my buff statement for the Board discussion you may find a point or two with which you are familiar (i.e., which I stole from you!).

Best regards, and look after the ladies in your office.

Sincerely,

A handwritten signature in cursive script, appearing to read "Charles", written over a horizontal line.

Charles H. Dallara

The Honorable
Beryl W. Sprinkel
Chairman, Council of Economic
Advisors
Washington, D.C. 20506

Enclosures

August 2, 1985 - 85/135

Statement by Mr. Dallara on the United States
1985 Article IV Consultation
Executive Board Meeting 85/120
August 5, 1985

On behalf of my authorities, I would like to express my appreciation to the staff for the excellent documents which they have prepared for today's concluding session of the 1985 Article IV Consultations with the United States, as well as for the professionalism and thoroughness which they have exhibited throughout the consultation process. The staff has provided us with comprehensive and current material on recent economic developments, policies and prospects. In my comments, therefore, I will concentrate on aspects of these which I consider of particular importance.

Overall Economic Strategy

The overall economic strategy of the United States is familiar to Directors, but I will briefly review its principal elements in light of the importance of assessing developments and decisions in the context of this basic strategy. This strategy has consisted of:

- A fundamental belief in the central importance of market forces in guiding decision-making within the economy, allowing maximum freedom for individual choice and maximum opportunity for growth, employment and the creation of wealth;
- Reducing the role of government in the economy in order that the private sector can prosper, with a particular emphasis on deregulation and restraint in government expenditure;
- Bringing inflation under control;
- An international economic policy that reflects these same tenets, emphasizing market forces, free trade and international economic cooperation, with strong support for the international institutions, including centrally the IMF, which provide the framework for such cooperation.

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

Recent Economic Developments and Short and Medium-Term Prospects

The impressive record of the U.S. economy since 1982 has been comprehensively documented in the material before us and discussed in the Executive Board on numerous occasions. I will not, therefore, elaborate on these developments, but focus on more recent economic developments and short and medium-term prospects.

Following the exceptionally rapid expansion during the early phases of this recovery -- with real GNP growing at 7.1% during the first 6 quarters of the expansion -- the U.S. economy has slowed. Real GNP growth in 1984 was 5.7% (4th/4th), and during the last four quarters just under 2%. Inflation has continued to improve, with the 12-month increase in the consumer price index falling to 3.75% through June 1985; and interest rates have declined significantly, with average short-term rates in June 1985 almost 4% below average levels a year earlier, and average long-term rates down 3.4% over this period.

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

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

- The significant decline in the rate of growth during the first half of 1985 was associated with a sizable reduction in the rate of inventory investment, with inventories accumulating at an annual rate of only \$12.5 billion during the first half of 1985 compared to a \$27 billion rate during the first half of 1984. With the inventory-sales ratio now at relatively low levels, particularly among manufacturing industries, a resumption of normal growth in inventories can be expected to contribute to second half FY 1985 production;
- The significant decline in interest rates over the last year should enhance the prospects for an increase in activity, particularly in the most interest-sensitive sectors such as housing;
- Domestic demand for goods and services remains robust. Real final sales, for example, continued to grow at a

strong pace during the second quarter of 1985, increasing at an annual rate of 5.1%. The lower GNP growth during this period reflects the important role of imports in meeting U.S. demand;

- The annual rate of growth of M1 of 10.1% during the first two quarters should also facilitate an increase in economic activity;
- The most recent developments in leading economic indicators also point toward more activity in the second semester, with the 1% increase in June -- the largest since January 1985 -- presenting an upward trend since December 1984.

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

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

But the largest concern about the medium-term outlook has been the Federal budget deficit. Achievement of the favorable medium-term outlook outlined above is critically dependent upon implementation of sound U.S. policies -- and that must include reducing significantly the budget deficit. It is to that I will now turn my attention.

U.S. Fiscal Policy and Prospects

Among the areas in which the staff and my authorities are in complete agreement is the critical importance of reducing the U.S. fiscal deficit.

¹Recent revisions in the index of industrial production, however, cast some doubt on the apparent sluggishness of manufacturing. The revised index shows that manufacturing output at the intermediate and final stages of production have risen at an annual rate of 3.6% this year, in contrast to the 0.6% annual rise reflected in the old industrial production series.

As President Reagan has stated, "had spending not soared out of control, today we would have nearly a balanced budget, far less national debt, and no threat to our current prosperity."

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

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

The agreement provides for a reduction of the deficit of more than 1% of GNP in FY 1986 from the FY 1985 level of 5.7% of GNP, and for a progressive reduction to 2.3% of GNP by FY 1988. This would put the Federal debt on a declining path relative to GDP, a critically important objective for the long-term health of the U.S. economy.

Monetary Developments and Policy

As the supplement to the staff report indicates, the Federal Reserve has recently announced that the target range for M1 growth during 1985 has been rebased to the second quarter of 1985, and widened from 4-7% to 3-8%. This change reflects a number of considerations, but before touching upon them, let me make clear that it does not reflect a change in the Federal Reserve's or Administration's fundamental stance toward monetary policy: that is, providing a financial environment conducive to sustained growth and continued progress toward price stability.

Among the considerations which underlay the FOMC's decision to rebase and alter the targets were:

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

- continued moderation in wage increases, with the rise in non-farm hourly compensation only 4% in the year ending March 1985;
- the high level of the dollar and the U.S. current account deficit, and the related weakness in the manufacturing sector;
- analysis which suggests that the rapid growth in M1 this spring was a reflection in part of greater willingness of economic agents to hold cash balances in an environment of significant interest rate declines, as well as possibly a reflection of the inclusion in M1 of interest-bearing accounts which may have altered the relationship between M1 growth and nominal spending;
- a view that the sharp decline in velocity during the first half of this year may not be fully reversed, but could presage a secular move toward lower velocity;
- the broader measures of monetary growth -- M2 and M3 -- have remained generally within the target ranges established for the year;

It is worth noting that M1 is currently high relative to the rebased range, and the Federal Reserve contemplates a return to M1 within the new range gradually as the year progresses.

Tax Reform

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

- the replacement of a schedule of 14 marginal tax rates ranging from 11% to 50%, with a simple three bracket system having rates of 15, 25 and 35%;
- reform and simplification of a complex system of itemized deductions, exclusions and special credits, eliminating or curtailing more than 65 categories of preferential tax treatment;
- the reduction of corporate tax rates with a balanced set of investment incentives.

I would like to assure Directors that the Administration remains completely committed to passing a tax reform bill that is revenue neutral. That commitment has been recently

reaffirmed by Secretary of the Treasury Baker, as well as by the leaders of the Congressional Committees with responsibility for tax matters. The Administration will work closely with Congress in order that revenue neutral tax reform can be implemented on an early date.

The Balance of Payments and the Exchange Rate

The two predominant, related features of the U.S. economy's interaction with the rest of the world have been:

- the large and growing U.S. trade and current account deficits, with the latter forecast to increase from \$102 billion in 1984 to \$125 billion in 1985 and to \$150 billion in 1986;
- the strength of the dollar, which appreciated a further 15.6% on a trade-weighted basis between January 1984 and February 26 of this year before declining 9.1% since that time.

The factors underlying the U.S. current account deficits are generally well-known (and are discussed in detail in Appendix V of the RED, SM/85/209, Supp. 1). The factors underlying the strength of the dollar are also generally not in dispute, although differences do exist over the relative importance of these factors. In particular, my authorities do not believe that interest rate differentials have been a consistently important factor in the dollar's appreciation. Neither the movement of nominal nor real interest rates appears to go very far in explaining exchange rate developments since 1981; this is particularly the case in 1983 and 1984, when real interest rate differentials moved against the dollar by 1.6% while the dollar appreciated 12.8% on a trade-weighted basis.

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

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

Capital flows to the U.S. have been voluntary and have, in fact, contributed to the appreciation of the dollar and, therefore, to the growing current account deficit. The fundamental question isn't so much whether the capital flows will continue, but whether circumstances will develop to reduce significantly the U.S. current account deficit during the period ahead. Three ways, inter alia, that this could in theory be accomplished present themselves:

- protectionist measures by the U.S.;
- an appreciation of other currencies relative to the dollar;
- a significant improvement in foreign growth relative to U.S. growth.

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

International Trade Policy

There are three main elements to the Administration's international trade policy:

- the maintenance of a free and open trading system that can promote continued expansion of international trade and world economic growth;
- a trade system which limits the distortions to trade, particularly those due to non-tariff barriers or interference by governments in trade flows; and
- the principles of overall reciprocity and equity.

The openness of the U.S. economy has been clearly borne out by developments of the last few years:

- in 1984 the U.S. absorbed 58% of LDC exports of manufactured goods to industrial countries, although the U.S. GNP is only approximately 1/3 of total industrial country GNP;
- even growth of U.S. imports in sensitive sectors has been substantial -- textile and apparel imports increased 41% in 1984 and automobile imports increased 27%.

The United States has taken certain restrictive steps over the last few years, as outlined in Appendix 7 of the RED (SM/85/209 Supp. 1). However, the U.S. has on the whole developed an impressive record of resistance to trade restrictions, in spite of the recession of the early '80s and the pressures brought about by the strong dollar and the U.S. trade and current account deficits.

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

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

Conclusion

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

My authorities strongly support effective IMF surveillance, and have put forward a number of proposals designed to strengthen Fund surveillance as a means of encouraging the adoption and implementation of sound economic policies in

member countries. It was within this context that my authorities have found the discussions with the staff during these Article IV Consultations to be most useful. Secretary Baker's commitment to this process was reflected in his decision to meet with the Managing Director and staff in a concluding discussion of U.S. policy and prospects. My authorities also look forward with interest to hearing the views of the Board from today's discussion.

During the June 1985 meeting of the G-10 Finance Ministers and Central Bank Governors, Secretary Baker stated his interest in strengthening the effectiveness of IMF surveillance by enhancing public awareness of the international implications of policies. He urged other Ministers to give further consideration to the concept of increased publicity of IMF Article IV documentation. Following up on that statement, my authorities have expressed a willingness to publish the staff report and Summing Up from this year's Article IV Consultation with the United States if others, particularly the economically most important industrial and developing countries, are prepared to agree to do so as well.

SUR/85/89

~~CONFIDENTIAL~~

August 8, 1985

The Chairman's Summing Up at the Conclusion of the
1985 Article IV Consultation with the United States
Executive Board Meeting 85/121 - August 5, 1985

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.

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

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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.