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THE WHITE HOUSE
WASHINGTON

CABINET AFFAIRS STAFFING MEMORANDUM

Date: 1/24/84 **Number:** 168892CA **Due By:** ____________

Subject: CCEA meeting on Thursday, January 26, 1984 at 2:00 p.m.

TOPIC: International Trade (CM#409)

	Action	FYI
ALL CABINET MEMBERS	☐	☐
Vice President	☑	☐
State	☑	☐
Treasury	☑	☐
Defense	☑	☐
Attorney General	☐	☑
Interior	☐	☑
Agriculture	☑	☐
Commerce	☑	☐
Labor	☑	☐
HHS	☐	☑
HUD	☑	☐
Transportation	☑	☐
Energy	☐	☑
Education	☐	☑
Counsellor	☑	☐
OMB	☑	■
CIA	☐	☑
UN	☐	☑
USTR	☑	■
GSA	☐	■
EPA	☐	■
OPM	☐	☐
VA	☐	☐
SBA	☐	☐

	Action	FYI
CEA	☑	☐
CEQ	☐	☐
OSTP	☐	☐
____________	☐	☐
____________	☐	☐
____________	☐	☐
Baker	☑	☐
Deaver	☐	☑
Darman *(For WH Staffing)*	☑	☐
Jenkins	☐	☑
Mc Farlane	☐	☑
Svahn	☑	☐
____________	☐	☐
____________	☐	■
____________	☐	■
____________	☐	■
____________	☐	■
CCCT/Gunn	☐	■
CCEA/Porter	☑	☐
CCFA/	☐	■
CCHR/Simmons	☐	■
CCLP/Uhlmann	☐	■
CCMA/Bledsoe	☐	■
CCNRE/	☐	☐

REMARKS:

The Cabinet Council on Economic Affairs will meet on Thursday, January 26, 1984 at 2:00 p.m. in the Roosevelt Room.

The revised agenda will address the Economic Impact of International Trade. (Discussion on the topic of the Underground Economy is postponed until further notice.)

The briefing paper for Thursday's meeting is attached.

dollar vs. for currencies
37% nominal terms
if adjusted for inflation, etc., incr'd 45-50%

Crit: who gp pts out terrible prob, but hasn't rec'd a solution.
what happens if mkt for value of dollar down? infl, int rates incr

even w/ dollar down 10%, trade deficit will reach $125B in 1985.

high dollar is single greatest cause of the high int rates

RETURN TO:

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THE WHITE HOUSE

WASHINGTON

January 24, 1984

MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

FROM: ROGER B. PORTER RBP

SUBJECT: Agenda and Paper for the January 26 Meeting

The agenda and paper for the January 26 meeting of the Cabinet Council on Economic Affairs are attached. The meeting is scheduled for 2:00 p.m. in the Roosevelt Room.

The Council will consider the report of the Working Group on the Economic Impact of International Trade. At its October 4 meeting on the causes, consequences, and prospects for the U.S. trade deficit, the Council asked the Working Group to examine both macro and micro economic policy actions that could be taken to reduce the U.S. trade and current account deficits.

Sidney Jones of the Department of Commerce has coordinated the preparation of a paper examining the U.S. merchandise trade and current account deficits, the prospects for those accounts, and possible macroeconomic policy responses. A copy of the paper is attached.

Deputy U.S. Trade Representative Robert Lighthizer is coordinating the preparation of a paper examining possible microeconomic policy actions the Administration might take and will present his group's findings at a subsequent meeting.

Attachments

THE WHITE HOUSE

WASHINGTON

CABINET COUNCIL ON ECONOMIC AFFAIRS

January 26, 1984

2:00 p.m.

Roosevelt Room

AGENDA

1. Report of the Working Group on the Economic Impact of International Trade
(CM # 409)

UNITED STATES DEPARTMENT OF COMMERCE
The Under Secretary for Economic Affairs
Washington, D.C. 20230

CM #409

January 24, 1984

MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

FROM: Sidney L. Jones
Under Secretary for Economic Affairs-designate

SUBJECT: Report of the CCEA Working Group on the Economic Impact of International Trade: Macro Economic Policy Options.

I. International accounts respond to various factors: (1) growth trends, consumption and investment decisions, relative prices, the availability and cost of capital and raw materials, and the relative productivity of labor and capital; (2) foreign trade and investment incentives and disincentives; and (3) the effects of fiscal and monetary policies. This analysis reviews possible macro policy actions to reduce the large merchandise trade and current account deficits. Micro issues are discussed in a separate paper.

II. The Working Group report to the CCEA on October 4, 1983 concentrated on five topics: (1) the seriousness and possible causes of merchandise trade and current account deficits; (2) the marginal effects of foreign capital flows into the United States; (3) the importance of agricultural exports; (4) concerns about the adequacy of international transaction statistics; and (5) the general erosion of exports as a share of domestic output and increasing import penetration ratios in selected manufacturing industries.

III. The U.S. merchandise trade and current account deficits have increased rapidly to record levels and are now expected to be even larger in 1984. During the January to November 1983 period, merchandise exports totaled $184 billion (f.a.s. value, seasonally adjusted), a decline of 6.3 percent from the comparable 1982 period. Imports totaled $247 billion (c.i.f. value, seasonally adjusted), an increase of 5.0 percent. The cumulative merchandise trade deficit for the first 11 months of 1983 totaled $63 billion, including a record shortfall of $8.97 billion in October and a slightly smaller deficit of $7.40 billion in

November. The December deficit will likely raise the total to about $70 billion for the entire year. The combination of declining exports and rising imports has created large bilateral deficits with Canada and several developing countries and dissipated our traditional surplus with Europe. A large bilateral deficit with Japan persists. A merchandise trade surplus of $17.4 billion was reported for exchanges with the European Economic Community in 1980; during the first 11 months of 1983 a deficit of $1.2 billion was reported.

The U.S. current account deficit is also rising as income from foreign investments and services is no longer adequate to offset our chronic merchandise trade gap. During the first three quarters of 1983, the cumulative deficit totaled $25.2 billion, including a $12.0 billion shortfall during the third quarter. The anticipated 1983 current deficit of about $40 billion will be almost four times the size of the $11.2 billion deficit reported for 1982.

A. The slowdown of U.S. exports and continued import penetration into our markets have created serious problems. First, the sustained deterioration has reduced the overall performance of the U.S. economy. In 1982, the output of goods and services, measured in constant dollars, declined $28.4 billion, or 1.9 percent. The deterioration in the net exports of goods and services was a major negative factor.

CHANGES IN GNP ACCOUNTS FOR 1982; CONSTANT 1972 DOLLARS
(billions of dollars)

Gains		Losses	
Personal consumption expenditures	13.4	Change in business inventories	- 17.9
Government purchases of goods and services	5.3	Net exports of goods and services	- 14.1
		Nonresidential fixed investment	- 8.3
		Residential fixed investment	- 6.9
Sub-totals	18.7		- 47.2
Difference			- 28.4

During 1983, a strong cyclical expansion occurred in the U.S. economy, as the real output of goods and services increased $49.4 billion, or 3.3 percent, despite further erosion in the net exports of goods and services of $17.2 billion.

CHANGES IN GNP ACCOUNTS FOR 1983; CONSTANT 1972 DOLLARS
(billions of dollars)

Gains		Losses	
Personal consumption expenditures	41.2	Net exports of goods and services	-17.2
Nonresidential fixed investment	1.9		
Residential fixed investment	14.9		
Change in business inventories	7.0		
Government purchases of goods and services	1.5		
Sub-totals	66.5		-17.2
Difference	49.4		

The current economic expansion is expected to continue throughout 1984 despite the continued negative impact of the net exports account. It is apparent, however, that a sustained and balanced growth beyond 1984 will require a resumption of export growth and improved response to import competition. Continued U.S. economic growth will be a crucial factor in restoring and preserving a healthy international economy.

B. Second, the erosion of exports and increase of imports have increased protectionist pressures to restrict imports. Explicit actions have been limited to a relatively few important sectors of the economy and a pervasive trade war has fortunately been avoided, but the risks of economic and political conflicts have escalated.

C. Third, the historical U.S. net investment position in the international economy is rapidly eroding. At the end of 1982, U.S. foreign investment totaled $834 billion and foreign claims against us amounted to $666 billion, leaving a positive balance of $168 billion. That surplus is expected to decline about $40 billion when the 1983 figures are reported. Continuation of current trends would eliminate the remaining surplus within a few years making the United States a debtor nation in the international economy. As a net borrower, continuing to experience chronic merchandise trade and current account deficits, the United States would have to issue additional financial obligations requiring foreign payments or transfer real assets to foreign private and public creditors.

D. From a different viewpoint, these trends have also created some benefits. First, the acceleration of exports to the United States has contributed to the economic recovey of other nations. This improvement is expected to continue in 1984. Increased export earnings are particularly important to many developing nations required to service large external debt burdens. Second, the large flows of foreign funds into the United States have helped finance our Federal budget deficits and partially alleviated upward pressures on domestic interest rates. Third, the strong appreciation of the dollar since mid-1980 has been an important factor in reducing our domestic inflation rate, from double-digit rates to the current 5 percent zone, by pushing down the cost of imports and increasing price competition among domestic suppliers of goods and services. If this trend is reversed, domestic inflation pressures would increase. Fourth, the intensity of international competition has forced many American companies to emphasize productivity improvements, cost reduction programs, research and development efforts, and the promotion of trade.

In summary, the United States has experienced a chronic merchandise trade deficit since 1976 and the shortfall increased sharply in 1983 to about $70 billion. The current account moved into deficit in 1982 and also deteriorated rapidly in 1983 to a negative level of about $40 billion. These developments have had a significant impact on the domestic economy and will directly influence the economic expansion during 1984.

IV. Prospects for merchandise trade and current account balances.

The near-term prospects are for continued deterioration in our merchandise trade and current account deficits. The most recent OECD projections published in December indicate significant changes are expected in the current account balances of major industrial nations, particularly a large increase in the U.S. deficit.

CURRENT ACCOUNT
(billions of dollars)

	1982	1983	1984
United States	-11.2	-43	-82
Japan	6.9	23	31
West Germany	3.5	5	5
OECD Europe	-17.9	-0.5	11.5
Total OECD	-29.8	-24	-42

Source: OECD, Economic Outlook, December 1983.

Recent internal forecasts prepared by the Commerce Department's Bureau of Economic Analysis (BEA), agree that significant deterioration will occur in both accounts. The other side of this forecast is that large flows of foreign capital into the United States will continue, at least through the first half of 1984. Looking futher into the future, these forecasts question the sustainability of these inflows, suggesting exchange rate, interest rate, and domestic growth rate reactions may develop. The BEA forecasts are based on several assumptions: (1) continued real growth gains, at a decelerating rate, through 1985; (2) only a small acceleration in the pace of inflation; (3) improved economic conditions among foreign nations; (4) some moderation in the external debt servicing problems of developing nation borrowers, but continued internal adjustment policies designed to restrict imports; and (5) some decline in the value of the U.S. dollar from its very high current level (measured fourth quarter to fourth quarter, an appreciation of 10 percent in 1983, followed by annual 10 percent declines in 1984 and 1985).

International Transactions Balances
(billions of dollars)

	1983	1984	1985
Merchandise trade (balance of payments basis)	-63	-110	-125
Current account	-40	-85	-95

Source: Bureau of Economic Analysis, Department of Commerce, internal forecast, January 16, 1984.

The BEA forecast projects an increase in merchandise exports of $14 billion, or about 7 percent, in 1984, following a 5 percent drop in 1983 exports from the 1982 level. Progress on exports is expected to continue in 1985, with a further gain of $23 billion, or about 11 percent. The net services surplus is also expected to rise from $30 billion to $33 billion in 1984 and to $39 billion in 1985. These favorable developments are not adequate, however, to match the surge of imports of $61 billion, about 23 percent, in 1984 and $38 billion in 1985, a gain of about 12 percent. This pattern of change is based on assumptions calling for some slowdown in the U.S. growth rate and some erosion of the dollar in 1985, causing the pace of exports to increase relative to 1984 and the growth of imports to decelerate. The fundamental message of both reports is that the anticipated growth of merchandise trade deficits will drive the record 1983 current account deficit to a much higher level in 1984 before the rapid deterioration begins to moderate in 1985.

V. In evaluating the possible causes of the merchandise trade and current account deficit trends, the beginning point is to recognize the diversity of factors involved.

A. The most frequently mentioned variable is the rapid appreciation of the U.S. dollar. It is often argued that the sharp appreciation of our national currency in recent years has made it more difficult to export goods and services subject to price competition while making it easier for imports to penetrate our markets at more attractive prices. Following this logic further, it is claimed that a lower exchange rate for the U.S. dollar would improve the competitive status of our exports and discourage imports. The erratic pattern of exchange rate movements can be tracked using a trade-weighted average value for the U.S. dollar relative to other OECD currencies. Following the Smithsonian agreement to devalue the U.S. dollar in December 1971 and the February 1973 realignment of international exchange rates, the U.S. dollar floated downward throughout the early-1970s, rallied strongly during the middle years, and then sunk to a low point in October 1978, 24 percent below its value on May 29, 1970, when the Canadian dollar was floated. By January 3, 1984, the U.S. dollar had more than reversed the earlier erosion by appreciating to a level 20 percent above the May 1970 benchmark. Between July 22, 1980 and January 3, 1984, the U.S. dollar appreciated 37.4 percent relative to other OECD currencies. The general appreciation of the dollar against European currencies continued along an erratic path during 1983, but the Japanese yen experienced some strengthening against the U.S. dollar, which has resulted in a leveling off of the overall average value since August 11, 1983.

Trade-Weighted Value Changes in the U.S. Dollar As of January 3, 1984; Depreciation (-) or Appreciation (+); Percent Change

	Change Since July 22, 1980	Change Since August 11, 1983
U.S. Dollar vs. OECD	+37.4	+0.7
U.S. Dollar vs.:		
German Mark	+61.7	+2.4
Japanese Yen	+5.7	-5.7
Sterling	+69.3	+4.8
French Franc	+111.4	+3.4
Canadian Dollar	+8.5	+1.0
Italian Lira	+105.7	+4.8
Swiss Franc	+ 40.4	+1.6

Source: Treasury Department report, January 6, 1984.

B. A second explanation for the acceleration of U.S. merchandise trade and current account deficits concentrates on the cyclical disparity between economic growth rates in various nations. A strong economic recovery began in the United States by November 1982 and has now moved into the expansion phase. Other industrial nations have experienced a slower and less robust recovery pattern. The gaps created in national growth rates have tended to increase imports into the United States, to supply production needs and consumer spending, but our exports have remained sluggish because of the lagging recovery pattern in most industrial nations.

C. A closely related argument involves the difficult economic circumstances in many developing countries caused by large external debt service burdens. Many of the LDCs have had to sharply restrict their imports from the United States while striving to increase their exports to generate the income and foreign exchange reserves needed to remain current on external debt service obligations. Since approximately 40 percent of U.S. exports go to the LDCs, including about 20 percent to Latin America, the general economic difficulties and specific debt problems have seriously restricted our foreign sales. The sharp decline of U.S. exports to Mexico and the swing from a large trade surplus to deficit in late-1982 and 1983 is an example.

D. A fourth argument focuses on specific trade problems involving discriminatory practices such as tariffs, nontariff barriers, credit subsidies, and domestic purchasing requirements. This argument does not explain the massive shift in the reported figures, but specific trade barriers do have an important impact on specific economic sectors and geographical areas. Foreign government production and credit subsidies for exporters are frequently cited as a specific problem.

E. Finally, it is often claimed that American companies have lost their competitive edge because of obsolete technology, high labor costs, and a casual approach to developing foreign markets. Foreign companies are generally considered to be more aggressive. Once again, the evidence on this point is largely anecdotal.

F. To the degree that the high value of the dollar is considered to be an important factor, there is also disagreement about the reasons for its persistent strength. One factor frequently referred to involves the impact of high real interest rates in the United States as an attraction to large flows of foreign capital into dollar assets. Real interest rates in this country are higher than in most other nations and the gap has tended to increase as inflation rates in the United States have decelerated. Some analysts

argue that the high real interest rates in the United States reflect the relatively low level of savings available to finance private investment and the large Federal budget deficits. Others emphasize the effects on interest rates of the anticipated improvement in investment opportunities in the United States resulting from the important incentives created by changes in the tax laws in 1981. Another important variable involves the slowdown of inflation rates in the United States, particularly relative to experiences in other nations, as a factor strengthening the value of the U.S. dollar. Finally, it is frequently claimed that the value of the dollar has been pushed higher by large flows of foreign capital into dollar assets in response to the perceived "safe harbor" advantages of economic and political security provided by investments in the United States.

G. The Working Group is still unable to develop a consensus about the ranking and relative importance to be assigned to each of these explanations for the sharp increase in the size of deficits and the factors influencing the exchange rate of the U.S. dollar. All of the factors referred to probably have some significance, but the relative priorities cannot be identified and their status probably changes as domestic and international economic adjustments occur. Recognizing that agreement within the Working Group is impossible, this paper will conclude with a brief review of possible macro policy options.

VI. Review of Macro Economic Policy Options.

A. <u>Do not change existing policies and wait for anticipated cyclical adjustments to reverse the recent rapid increases in the merchandise trade and current account deficits</u>. It can be argued that these two fundamental deficits will soon begin to gradually recede, despite the conclusions of the OECD and BEA forecasts summarized above, and that specific macro fiscal and monetary policy changes are not required for this purpose, although such adjustments may be made to achieve other goals. The arguments for this position include:

1. The rapid appreciation of the U.S. dollar since mid-1980 has probably been exaggerated and a major downward correction is widely anticipated. Erosion of the current U.S. dollar valuation would assist our exports and discourage imports of goods and services affecting both the merchandise trade and current account deficits. It should be noted, however, that any reduction in the value of the U.S. dollar would initially cause even larger deficits because imports would cost more during a transition period until the volume of exchanges could be adjusted to reflect the devaluation (referred to as the J-curve effect).

2. The cyclical recovery in the United States appears to be following the traditional pattern of gradually moderating as it moves into the expansion phase during its second year. Following the rapid growth pace of the second quarter of 1983, the rate of real output gains decelerated as expected during the third and fourth quarters. The Reagan Administration and most private economic forecasters expect the 1984 real growth rate to slow down from the normal pattern of sharp increases during the first year of a cyclical expansion. The Administration forecast anticipates real growth of 4.5 percent in 1984, measured fourth quarter to fourth quarter, a reasonable deceleration from the 6.1 percent pace in 1983. As this normal cyclical deceleration occurs, the demand for imports of goods and services should also moderate. (Measured on a year over year basis, the Administration forecasts real growth of 5.3 percent in 1984. The consensus "Blue Chip" forecast of 47 private economists for 1984 is also 5.3 percent).

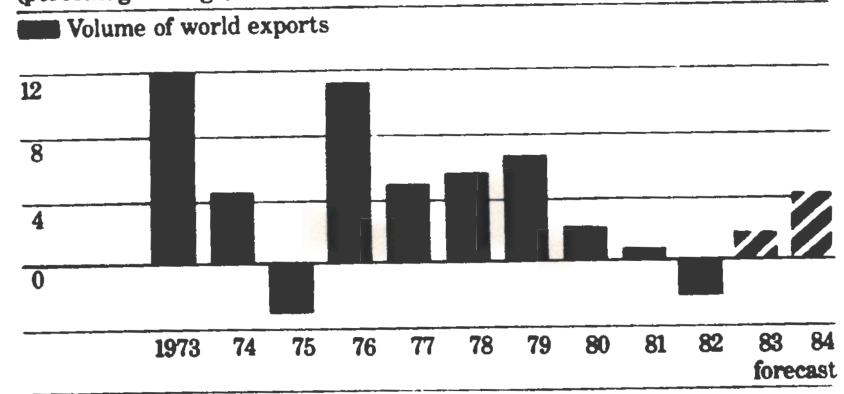
3. Our exports of goods and services should benefit from the international economic revival that appears to be gaining strength. According to the OECD projections published in December, the industrial nations appear to be breaking out of the stagnant economic conditions of recent years. Some improvement is also expected among developing nations.

Real GNP
(Percentage change from previous period)

	1982	1983	1984
United States	-1.9	3.5	5
Japan	3	3	4
West Germany	-1.1	1.5	2
OECD Europe	0.6	1	1.5
Total OECD	-0.3	2.25	3.5

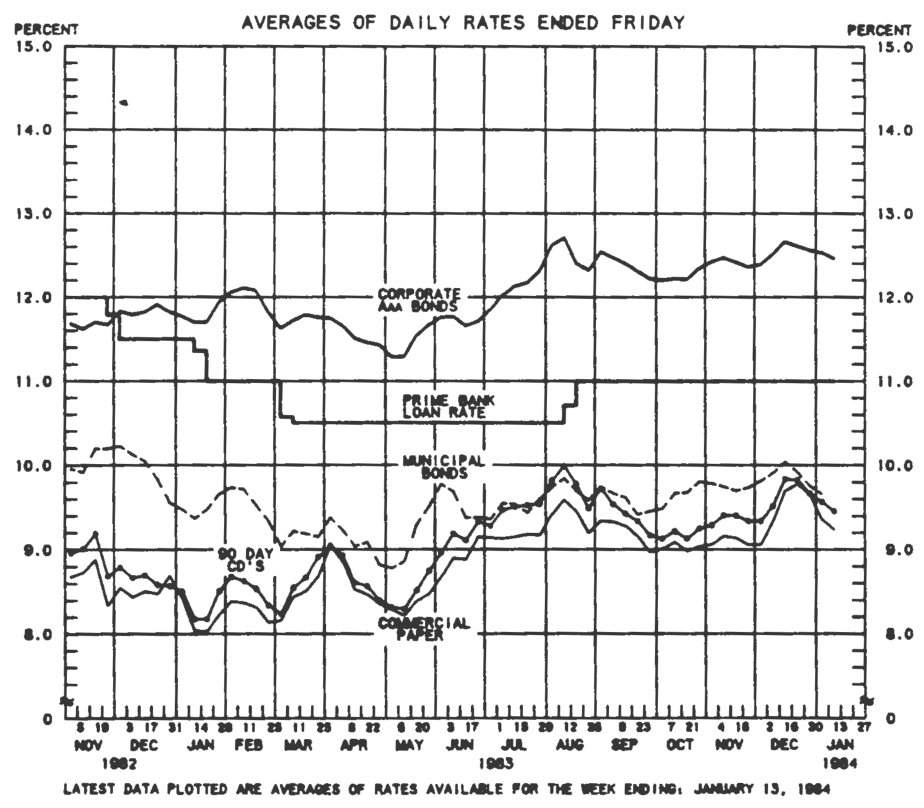
This international cyclical improvement is expected to stimulate a resumption of world export growth in 1984, following a sluggish performance in 1980 and 1981 and an actual decline in the volume of exports in 1982 (only the third decline during the entire postwar era). The United States will share in the benefits of overall trade recovery, particularly if the restrictive effects of the high value of the dollar can be overcome.

rebound for world-trade growth



4. The effects of decelerating inflation rates in the United States, acting to strengthen the value of the dollar, have probably ended for this cycle. If inflation accelerates, the dollar will come under downward pressure in 1984 unless other nations experience similar problems.

5. The outlook for interest rates is a crucial element in evaluating prospects for the international accounts because of the impact of borrowing costs and investment yields on foreign trade and investment and the valuation of national currencies in response to capital flows. Interest rates in the United States have declined sharply from the peak rates reported in 1981, but most of the downward adjustments occurred in 1982. Interest rates have tended to vacillate within a narrow range throughout 1983, as summarized in the chart prepared by the Federal Reserve Bank of St. Louis.



Source: Federal Reserve Bank of St. Louis, U.S. Financial Data, January 13, 1984, p. 6.

The consensus view of private forecasters, as reported in the latest "Blue Chip" financial forecast published January 1, 1984, anticipates continued "small up and down changes during 1984 but sees a significant uptilt for short-term rates by first quarter 1985." The summary of specific rates indicates little change over the entire year despite some declines early in the year and increases later in 1984.

Summary of "Blue Chip" Interest Rate Forecasts
(percent)

Rate	12/16/83	1984.1	1985.1
1. Prime rate	11.0	11.0	11.6
2. T-bills, 3-month	9.1	9.0	9.6
3. T-bonds, 30 year	12.0	11.7	11.9
4. Corporate Aaa bonds (seas.)	12.6	12.5	12.7
5. Aa utilities (seas.)	13.2	12.9	13.0

Finally, the drop in interest rates from their peak levels in 1981 also occurred in other major industrial nations. These shifts have narrowed the gap that existed with Japan, but U.S. rates are still higher than in the other three nations as of December 1983. The disparity becomes even larger when these nominal interest rates are adjusted to real levels by deleting the effects of anticipated inflation. In fact, the gap between real interest rates in the United States, compared to other major industrial nations, has tended to increase because of our favorable deceleration of inflation since 1981 relative to the others. In summary, the gap in nominal and real interest rates continues and is likely to persist in 1984 as rates vacillate within the narrow range summarized above.

Representative[1] Short-term Money-market Rates
(3-month maturity, end of month data)

Country	Peak 1981	December 1983	Difference
United States	17.48 (Aug)	9.75	-7.73
West Germany	14.50 (Feb)	6.30	-8.20
Japan	8.46 (Feb)	6.45	-2.01
United Kingdom	16.81 (Sept)	9.31	-7.50

Corporate Bond Yields
(more than 5 years maturity, end of month data)

Country	Peak 1981	December 1983	Difference
United States	16.63 (Sept)	12.63	-4.00
West Germany	11.90 (Sept)	8.30	-3.60
Japan	8.49 (Jan)	7.09	-1.40
United Kingdom	17.23 (Sept)	11.57	-5.66

1/ Prime industrial paper (U.S.), interbank deposits (UK & WG) and repurchase agreements (Japan)

SOURCE: Morgan Guaranty

B. Institute general government intervention in the markets to improve the merchandise trade and current account deficits. The Working Group is critical of suggestions that the U.S. Government should make more extensive use of restrictive trade practices involving import quotas, nontariff barriers, orderly marketing agreements, voluntary restraint programs, and domestic purchasing standards. It also rejects recommendations that large-scale intervention in foreign exchange markets should be used on a sustained basis to manipulate the exchange rate of the U.S. dollar as a means of reducing the deficits. This criticism does not include government efforts to revise GATT rules to promote a more open and competitive trading system, particularly for agricultural products and services, or the promotion of long-term structural adjustments to improve the competitive position of U.S. economic interests through public policies designed to improve capital investment, development of research and experimentation, productivity gains, and human resource development.

C. Restrain Federal budget outlays to reduce prospective deficits. The reduction of Federal budget deficits would create many important economic benefits, including potential merchandise trade and current account gains, by contributing to the correction of competitive disadvantages linked to interest rates and the high value of the U.S. dollar in foreign exchange markets. Recent priority decisions during the preparation of the FY 1985 budget indicate that large budget deficits will unfortunately continue to be reported in future years, even if strong and sustained economic growth occurs. Policy actions designed to reduce budget outlays will help reduce

the size of future deficits and it is possible that economic growth will turn out to be even stronger than projected, providing more favorable budget outlay and revenue results, but such optimistic assumptions must recognize the political and economic uncertainties and pressures for increased government spending. The large majority of prospective outlays are already concentrated in three sensitive categories: national defense, income security, and health programs. When net interest obligations are added to the spending estimates for these three programs, it is obvious that overall budgetary restraint will be difficult to achieve given existing priorities. Considerable success has already been reported in reducing the baseline growth of domestic spending programs (adjusted to remove social insurance and retirement programs). This part of the budget is relatively small and additional reductions in future spending will be difficult to implement, particularly given the political sensitivity of many of the programs. Similar comments apply to efforts to further reduce off-budget outlays following the successful efforts of the Reagan Administration to reverse the accelerating trend of such spending throughout the 1970s. Efforts to control Federal credit and loan-guarantee programs also need to be emphasized. Despite the familiar difficulties in trying to reduce budget outlays, off-budget spending, and the growth of Federal credit and loan guarantee programs, it is important to keep trying and it may be possible to make substantial changes in some entitlement programs given the increasing awareness of Congress and the general public of the need to slow down the growth of government spending. In particular, the imminent depletion of the Hospital Insurance Trust Fund could become a catalyst for encouraging some spending restraint.

Given the dominant influence of defense spending, income security outlays, and health program spending, plus net interest obligations, it will be difficult to achieve the necessary restraint needed to reduce the out-year deficits. Nevertheless, serious efforts should be made to control the future growth of spending as the beginning point in reversing the unfavorable budget deficit problems that have contributed to the large merchandise trade and current account deficits.

D. Increase prospective revenues. Given the recent FY 1985 budget decisions concerning proposals to increase prospective tax revenues, the Working Group does not have any policy recommendations to suggest. The continuation of strong domestic economic growth is the most important factor in projecting future revenue gains and it is necessary to recognize that tax policy decisions should focus on broad goals rather than concentrating on the merchandise trade and current account deficits. If it is decided in the future to consider tax policy changes to raise additional revenues to reduce the large prospective revenues, it should be recognized that different kinds of taxes will have varying effects on the merchandise trade and current account deficits even though domestic economic and political factors will remain the dominant factors in making such decisions.

E. Change monetary policies to encourage exports and discourage imports. The Working Group did not identify any monetary policy adjustments to influence directly the international transactions accounts even if domestic policy goals are subordinated to specific trade interests. It might be possible to depress temporarily the value of the U.S. dollar by rapidly increasing the money supply, but such actions would have negative long-term inflation results. The opposite extreme of restricting the growth of money and credit to slow down domestic growth to restrain the expansion of imports was also rejected.

VII. Summary.

This review of macro economic policy options did not identify proposals that can be used to alleviate directly the large merchandise trade and current account deficits. Government protectionist trade practices and sustained intervention in foreign currency markets to manipulate the value of the U.S. dollar were rejected as being ineffective and inconsistent with our overall national goals. The Working Group unanimously endorsed the need to reduce the prospective budget deficits, but was unable to agree on any policy recommendations given the existing fiscal priorities identified during the recent completion of the FY 1985 budget. Major changes in monetary policies to influence the exchange rate of the dollar would likely be counter-productive and such adjustments are the responsibility of the Federal Reserve System.

The immediate outlook for the merchandise trade and current account deficits is for continued deterioration in 1984 and into 1985, although the growth of the deficits is expected to decelerate. The anticipated slowdown in the pace of cyclical expansion in the United States should discourage further rapid increases of imports and improving economic conditions in other nations should encourage our exports. Exports to developing nations will continue to be restricted, however, because of their serious problems in servicing their external debts and internal adjustment problems. It is generally assumed that the rapid appreciation of the U.S. dollar since mid-1980 will end and that some downward adjustment will occur in response to the slower pace of economic expansion and the negative impact of the large merchandise trade and current account deficits. Therefore, the policy options will continue to be dominated by domestic fiscal and monetary priorities.