INTERNATIONAL MONETARY FUND
Concluding Statement of the 2011 Article IV Mission to
The United States of America
June 20, 2011

Policies must strike the right balance between exiting from extraordinary support and sustaining the recovery amid renewed headwinds. Fiscal policy consolidation needs to proceed as debt dynamics are unsustainable and losing fiscal credibility would be extremely damaging. However, the pace and composition of adjustment should be attuned to the cycle, within a politically-backed strategy that raises medium-term revenues and addresses long-term expenditure pressures. The deficit reduction proposed in the February budget could be too front-loaded given the cyclical weakness and, at the same time, insufficient to stabilize the debt by mid-decade. Current monetary policy accommodation, including through Fed asset holdings, will likely remain appropriate for quite some time, unless inflation prospects change significantly, in either direction. Timely and thorough financial reform implementation should continue.

1. **The recovery has proceeded at a relatively slow pace, as in the aftermath of other severe financial crises, and has recently weakened**. Monetary and fiscal policies have continued to support demand in the last two years, but the ongoing repair of household balance sheets amidst declining house prices and high unemployment have weighed on private consumption, while construction activity has remained depressed. On the positive side, exports have recovered markedly and financial conditions have improved, bolstered by unprecedented liquidity support. Core inflation has started to firm from historic lows. Recent indicators point to a growth slowdown in the first half of 2011, which appears related to increases in world oil prices, as well as to transient factors such as the disruptions to global supply chains from the Japanese earthquake.

2. **Looking ahead, we expect growth to remain relatively modest, as private demand recovers only slowly and fiscal policy support is withdrawn**. We project GDP growth of 2½ percent in 2011 and 2¾ percent in 2012, with a slow decline in unemployment. With sizeable slack, core inflation should remain subdued, despite recent commodity price increases. Household deleveraging is apt to weigh on private consumption in the coming years and fiscal adjustment would hold back domestic demand. Investment rates are forecast to recover towards more normal levels, and global growth and the recent dollar depreciation should support net exports.

United States: Medium-Term Outlook
(Percent change, unless otherwise noted)

	2010	2011	2012	2013	2014	2015	2016
Real GDP	2.9	2.5	2.7	2.7	2.9	2.9	2.8
Consumer prices	1.6	2.8	1.6	1.5	1.7	1.8	1.9
Unemployment rate 1/	9.6	8.9	8.4	7.7	6.9	6.2	5.6
Current account 2/	-3.2	-3.2	-2.6	-2.3	-2.4	-2.6	-3.0

Source: Fund staff estimates.
1/ Percent of labor force.
2/ Percent of GDP.

3. **Downside risks to the outlook have increased**. These include:

(i) *Continued housing market weakness*, with the possibility of further house price declines reducing household wealth and, thus, weighing on private consumption.

(ii) *Unfavorable fiscal outcomes*. These could take the form of a sudden increase in interest rates and/or a sovereign downgrade if an agreement on consolidation does not materialize or the debt ceiling is not raised soon enough. These risks would also have significant global repercussions, given the central role of U.S. Treasury bonds in world financial markets. At the opposite extreme, an excessively large upfront fiscal adjustment could also significantly weaken domestic demand.

(iii) *Further commodity price shocks*, which could impact both growth and inflation.

(iv) *Tight credit supply conditions—with weak securitization markets and tight loan standards for most sectors*—which may become more binding as credit demand recovers.

(v) *Challenging conditions for some European sovereigns* that might trigger new global financial shocks.

On the positive side, the recovery could surprise on the upside if confidence improves and pent-up demand for consumer durables materializes more quickly, or if hiring picks up faster than expected, given healthy corporate balance sheets.

4. **The main policy challenge is to implement a substantial and durable fiscal consolidation effort while ensuring that the still-fragile recovery remains on track**. With public debt on an unsustainable trajectory, the priority is to stabilize the debt ratio by mid-decade and gradually reduce it afterwards, consistent with the administration's objectives. In this context, we see early political agreement on a comprehensive medium-term consolidation plan based on realistic macroeconomic assumptions as a cornerstone of a credible and cyclically appropriate fiscal adjustment strategy. Indeed, with a well-defined multi-year plan in place, the pace of deficit reduction in the short run could be more attuned

to cyclical conditions without jeopardizing credibility. And of course, the federal debt ceiling should be raised expeditiously to avoid a severe shock to the economy and world financial markets.

5. **Our preferred adjustment strategy entails a reduction of the federal structural primary deficit at a uniform pace over the next five years, within a fully-specified and politically-backed consolidation plan**. Fiscal adjustment should start in FY2012 to guard against the risk of a disruptive loss in fiscal credibility. Under our macroeconomic assumptions, a cumulative structural primary adjustment of 7½ percentage points of GDP (about 1½ p.p. per year until FY2016) would achieve the objective of stabilizing the debt ratio around mid-decade, and then gradually reducing it. To prevent the debt ratio from rising again during the following decade, further measures will be needed to cope with pressures from population aging and rising health care costs. The overall fiscal effort should include additional cuts in mandatory spending, including through entitlement reforms, as well as revenue increases, including through reducing tax expenditures, given the relatively limited size of non-security discretionary spending and the large cuts already envisaged in this area. Consideration could also be given to a national VAT or sales tax and carbon taxes, consistent with past advice by Fund staff.

6. **The February budget proposal envisages a front-loaded fiscal adjustment and the President's April speech proposes additional medium-term savings, but these plans may not be sufficient to stabilize the debt ratio**. Under current plans, the FY2013 federal deficit would be reduced to 4.6 percent (Table). We project a less front-loaded adjustment, more attuned to cyclical conditions, assuming the extension of some stimulus measures by Congress (Table). However, under our growth and interest rate assumptions, stabilizing the debt ratio by mid-decade and then gradually reducing it would require an additional primary adjustment of 2 percent of GDP or more in the outer years, in both adjustment scenarios.

Staff Fiscal Projections for Federal Government 1/
(Percent of GDP, Fiscal Years)

	2010	2011	2012	2013	2014	2015	2016
Federal budget balance 2/	-9.6	-9.3	-7.6	-5.6	-4.7	-4.8	-5.3
Federal primary balance 3/	-8.2	-7.9	-6.2	-3.9	-2.5	-2.0	-1.9
Structural primary balance 4/	-6.4	-6.5	-5.1	-3.1	-2.0	-1.6	-1.7
Federal debt held by public	62.1	70.2	74.6	78.3	80.7	82.7	85.0
Memorandum items							
Federal budget balance (authorities) 5/	-8.9	-10.9	-7.0	-4.6	-3.6	-3.2	-3.3
Federal budget balance (CBO) 6/	-8.9	-9.5	-7.4	-5.5	-4.4	-4.1	-4.4

Sources: IMF staff estimates; OMB; and CBO.

1/ Projections using the IMF macroeconomic assumptions. Relative to the President's February budget proposal, staff assumes further temporary extensions of emergency unemployment benefits and the payroll tax cut, some delay in implementing revenue-raising measures, and a more front-loaded spending restraint.

2/ Includes staff's adjustments for one-off items such as TARP valuation changes.

3/ Excludes net interest.

4/ Excludes net interest, effects of economic cycle, and costs of financial sector support. In percent of potential nominal GDP.

5/ President's budget proposal, February 14, 2011.

6/ CBO analysis of the President's budget proposal, April 15, 2011.

7. **The fiscal framework should be made more supportive of consolidation efforts, with an explicit Congressional endorsement of the main medium-term fiscal objectives**. Multi-year expenditure caps on non-security discretionary spending would help keep the consolidation on track across annual budget cycles, while a "failsafe" mechanism for the debt ratio along the lines recently suggested by the President could, if robustly formulated, protect against deficit overruns and other contingencies. It would also be helpful to prepare the administration's budgets using conservative economic assumptions.

8. **With subdued inflation prospects and ample resource underutilization, the extraordinary monetary policy accommodation will likely remain appropriate for quite some time**. The Federal Reserve has provided needed support to the recovery while keeping inflation expectations well anchored. The strategy has included near-zero policy rates, clear communication of the intention to keep them low for an extended period, and a second round of unconventional easing beginning in the Fall of 2010, in response to weakening inflation and growth. Going forward, the Fed should remain vigilant to the risk of an unmooring of long-term inflation expectations, and respond decisively should the risk materialize in either direction. More generally, the speed and timing of future actions should depend on incoming data on core inflation, long-term inflation expectations, and growth, with scope for cushioning the effect of fiscal consolidation on demand through a more back-loaded withdrawal of monetary stimulus.

9. **When appropriate, a gradual unwinding of the Fed's balance sheet by ceasing the reinvestment of maturing securities seems to be a reasonable first step in normalizing monetary conditions**. Against the backdrop of a passive unwinding of the Fed's securities holdings, short-term policy interest rates would serve as the main active tool to fine tune the adjustment of monetary conditions. Reducing excess reserves by ceasing reinvestments, as well as other reserve-draining operations including the use of reverse repos and term deposits, would also help tighten the link between the federal funds target rate and the interest rate on reserves. A clearly communicated and gradual path of asset sales would be an additional step in the exit process.

10. **We see merit in further policy efforts to ease housing market adjustment**. Although policy design is complicated by operational capacity constraints and the risk of inducing moral hazard, we think that housing difficulties merit more policy attention since they are central to the slow recovery and pose a critical risk. Allowing for the terms of residential mortgages to be changed in courts ("cramdowns") would create incentives for voluntary modifications. In addition, parametric changes to federal mortgage modification programs (e.g., bringing the loan-to-value ratios below 100 percent and lowering the back-end debt-to-income ratios in programs like HAMP-PRA) and expanding state programs that assist unemployed homeowners could usefully foster more participation (even if they lead to modifications of mortgages that would not default under the current parameters). Importantly, encouraging the GSEs to participate in principal write-downs could significantly increase the scope for modifications.

11. **Similarly, protracted high unemployment and underemployment call for a re-examination of existing job-training programs**. Persistently high unemployment rates, with more than 40 percent of the unemployed out of work for six months or more, may result in permanent loss of work skills. At the same time, diverging recovery prospects across sectors may require significant job reallocation going forward. The federal government has nearly 50 different programs dispersed across nine federal departments geared toward helping the unemployed, but the cumulative budget is only 0.1 percent of GDP. Moreover, a large part of this budget is transferred to states, which have many programs of their own. It would be important to assess whether a more consolidated system—with better funding—could be more effective in facilitating labor market adjustment.

12. **The U.S. financial system continues to heal, but remains vulnerable**. Bank profitability has recovered, especially for larger institutions, and increases in bank capital have lowered risks of a negative feedback loop with the still-fragile real economy. But the healing process is incomplete. Underlying profits are weak, and the rise in capital ratios also reflects a shift towards less risky assets. Mortgage markets remain largely government dependent. Turmoil in European financial markets could impact both liquidity and credit provision. Even more significantly, the tail risk of a U.S. sovereign rating downgrade and sharply higher interest rates on federal debt more generally could trigger renewed turbulence in global financial markets.

13. **A sustainable rebound in private securitization, driven by reforms to avoid the past excesses, would help meet credit demand as the recovery takes hold**. The reforms underway—in particular, steps to increase disclosure and risk retention—will strengthen incentives for sound underwriting, and should help revive investor demand. On the supply side, clarity on the final scope of the new rules would help the market recovery. Looking forward, reforms to streamline the role of GSEs (preferably, confining their activities to providing credit guarantees for high-quality mortgages under tail risks) would encourage a gradual shift in the mortgage market towards private institutions.

14. **Progress in implementing the Dodd-Frank Act is encouraging, with nearly all U.S. FSAP recommendations being addressed, but headwinds to implementation are of concern**. Appropriate budgetary resources to fund improvements in supervision and regulation should be promptly allocated, and efforts to delay or water down the legislation should be resisted. Prolonged delays or outright failures in addressing the regulatory gaps revealed by the crisis, in an environment of plentiful liquidity and increased financial concentration, could feed another very dangerous buildup in systemic risks**.**

15. **Strengthening the domestic and international crisis-prevention architecture for financial institutions should be a priority**. Key is promptly and comprehensively identifying systemic institutions to be subject to heightened supervisory scrutiny, regulatory standards, and capital surcharges. These should include investment banks operating in the United States not registered as bank holding companies, which provide significant cross-border dollar funding and can hence have significant spillover effects. Authorities are also encouraged to continue their work on improving resolvability of systemically important institutions, especially those with significant cross-border operations. Systemic issues and risks to financial stability are central to the FSOC mandate, and we look forward to their discussion in the FSOC first annual report. The authorities also need to be alert to potential new risks arising from changes in the regulatory framework that could contribute to shifts in financial stability risks across borders and will require broadening of the supervisory perimeter. International collaboration will be critical for progress in this area, and the U.S. authorities should continue exercising leadership on these matters.

16. **A multilateral approach to economic policy management remains critical**. This is particularly important in systemic countries like the United States, whose policy actions have significant cross-border effects, as discussed in the forthcoming spillovers report. We welcome the authorities' leading role in multilateral fora and their efforts to promote international stability. For the medium term, the key contributions that the United States can make to global growth and stability, consistent with the G-20 Mutual Assessment Process and spillovers analysis, are (i) raising domestic savings, particularly through fiscal consolidation, to ensure that the current account deficit remains within bounds and to forestall potentially destabilizing increases in public indebtedness; and (ii) strengthening its financial sector through enhanced regulation and supervision. The United States can no longer play the role of global consumer of last resort, underscoring the importance of

measures to boost demand in current account surplus countries to sustain world growth. The U.S. dollar depreciation over the past year would help increase demand for U.S. exports and contribute to global rebalancing.

17. **We welcome the limited recourse to protectionist measures**, and encourage the authorities, together with other countries, to redouble their efforts to secure the future of multilateral trade negotiations, especially if the Doha Round is not concluded by year-end. Increased and more secure market access would promote U.S. and global exports.