INTERNATIONAL MONETARY FUND

2008 Article IV Consultation with the United States of America

Concluding Statement of the IMF Mission

(June 19, 2008)

BACKDROP

1. **The slowdown in activity in the United States has been less than feared, and recovery should begin next year as important headwinds are overcome**. Considering the severity of the shocks that have hit, the economy has held up well so far, with substantial monetary and fiscal stimulus, buoyant net exports, and healthy corporate balance sheets all providing welcome support. However, their effect is being blunted by growing strains on household and bank finances, and now also by higher commodity prices. These strains, which have yet to fully feed through to domestic demand and activity, will take time to work out. As such, we project that real GDP (Q4/Q4) will be roughly flat in 2008, and recover gradually in 2009 to around 2 percent. Although inflation expectations have ticked up on surging commodity prices, we expect that price pressures will be contained as commodity prices peak and economic slack rises.

2. **The unusual nature of the ongoing crisis in the financial and housing sectors leaves the outlook highly uncertain**. A more rapid recovery is clearly possible, given the substantial policy stimulus and proactive response of financial markets to repair balance sheets. However, the economy is facing historically unprecedented shocks, financial conditions currently presage further tightening, and there is the worrisome possibility that weakening activity will feed back into further bank losses, generating a longer slowdown.

3. **Against this uncertain background, the main policy challenges are:**

- to provide measured support to economic activity while keeping inflation expectations anchored;
- to reform financial regulation and supervision to improve liquidity management, enhance capital provisions, and reduce systemic risk;
- to implement over time the multilateral strategy, with demand rebalanced to sustain growth while reducing the external current account deficit.

MONETARY POLICY

4. **Monetary policy settings are now broadly supportive of recovery, and a risk-management approach would suggest that policy should be on hold**. The Fed has eased rapidly in response to output risks and pushed the federal funds rate to a setting in real terms that in the past has been associated with recessions. Although the impact of Fed policy on the economy will be dampened by widening spreads and tighter lending standards, this is nevertheless a robust response to downward economic pressures. At the same time, surging commodity prices have lifted headline inflation, and there are some signs from bond markets and surveys that inflation expectations are edging up. Although we anticipate a lessening of inflationary pressures, vigilance will be required, given the stimulus in the pipeline and the

imperative of keeping inflation expectations well in check. Thus, it could become necessary to withdraw stimulus quickly as the economic recovery gains traction.

FISCAL POLICY

5. **Timely fiscal stimulus, and the operation of automatic stabilizers, are providing welcome support to activity at a critical time**. Tax rebate checks have been going out to low- and middle-income individuals since late April, which will temporarily boost aggregate demand at a time when oil and food prices are weighing on consumers' purchasing power.

6. **However, medium-term pressures on the budget limit the room for further discretionary fiscal expansion**. While it is encouraging that the Administration and Congress are aiming for budget balance over the medium term, these plans do not yet provide for war-funding authority beyond FY2009 or the costs of overriding legislated actions such as hikes in the alternative minimum tax and cuts in Medicare compensation. Further fiscal effort will thus be needed in the years ahead, particularly if the medium-term balance target were made more ambitious—as we continue to favor—by excluding the social security surplus. This would complement needed reform of entitlement programs that the Administration has well recognized are unaffordable over the longer term. Reflecting these medium- and long-term budget pressures, and the experience elsewhere with repeated fiscal stimulus, if further action becomes necessary to offset much weaker activity, it could most effectively be targeted to the housing and financial sectors at the root of current problems.

POLICIES TO SUPPORT HOUSING AND FINANCIAL SECTORS

7. **Timely support has been provided to the housing and financial sectors to limit macroeconomic risks**. The Administration has supported measures encouraging lenders to avoid foreclosures by modifying loans for borrowers in difficulty. Regulators of government-sponsored enterprises have taken actions that allow for additional mortgage purchases, which could improve market liquidity (albeit at a cost of adding to concerns about the financial health of these institutions and reinforcing market perceptions of an effective government guarantee of their liabilities, thus underlining the importance of enacting proposals to strengthen oversight of these enterprises). The Federal Reserve has also contributed to market liquidity and the lowering of systemic risks by establishing several types of lending facilities, including a discount window program for major investment banks (formally, for primary securities dealers).

8. **Policies need to be mindful of moral hazard, but further action to limit avoidable foreclosures is justified by risks that house prices could fall below equilibrium**. Although policies need to be mindful of moral hazard and it is clear that house prices still need to adjust down, overshooting is a clear risk with important macroeconomic consequences. We therefore support actions in Congress to foster voluntary mortgage write-downs by allowing the Federal Housing Administration (FHA) to provide guarantees for qualifying new mortgages at a significant discount from the current appraised value, as well as to introduce long-needed regulatory reform. However, the take up of FHA guarantees may be quite limited, and stronger incentives may be needed for lenders to adopt the proposal—e.g., through issuance of negative equity warrants allowing the original lender to share any profits from future sales. In addition, consideration could be given to proposals for bankruptcy

reform. Specifically, allowing judges to write down the principal on mortgages on primary residences—as is now permitted for most other forms of debt, including mortgages on second homes—warrants consideration as it could mitigate the problem of holdouts (especially lenders with second liens). While such reforms could increase borrowing costs to homeowners, it could also encourage better risk management by lenders, and the evidence suggests that the effect on mortgage costs is likely to be small.

9. **Despite the easing in financial market conditions since the crisis last March, important risks remain**. The Fed's widening of access to its discount window following the collapse of Bear Stearns has lowered systemic risks but not eliminated them. Were the fragile conditions of last March to recur, the new facility for lending Treasury securities against asset-backed securities could be adapted with due regard to moral hazard considerations. For example, the maturity of securities loans could be lengthened significantly, as has been done with government backing in the United Kingdom. Although group-level oversight has been enhanced significantly by the inception of the consolidated supervisory program for large investment banks, further regulatory reforms, many suggested in the Treasury blueprint, would help. The agreement with over the counter derivatives dealers and other active market participants on further steps to strengthen the infrastructure of those markets is also a welcome development as it would reduce future systemic risk.

LESSONS FOR FINANCIAL REGULATION AND SUPERVISIONS

10. **A key medium-term challenge for policymakers will be to restore confidence in important segments of the U.S. financial market, most notably for securitized products**. The financial boom exposed weaknesses stemming from:

- leverage that was increasingly supported with short-term funding and thin capital bases;
- weak regulation of mortgage origination, reflecting the lack of federal oversight of this sector, difficulties in coordinating across federal and state regulators, and shortfalls in consumer protection;
- and incentive problems within the securitization chain, as mortgage originators and bundlers had few incentives to maintain loan quality even as investors became overly reliant on external ratings.

11. **The Treasury blueprint provides a sensible basis for comprehensive reform and simplification of the regulatory system**. The extension of the public safety net to primary dealers, notably the major investment banks, after the collapse of Bear Stearns has underlined the importance of effective systemic regulation. In addition to revisiting risk weights for capital (including for off-balance sheet entities), enhancing liquidity provisions, increasing transparency, and reforming governance for rating agencies—as suggested by other forums including the Financial Stability Forum and the Fund—we would add:

- stronger regulation and supervision of investment bank and thrift holding companies, as well as government-sponsored enterprises, by a single supervisor, possibly the Fed;
- closer supervision of liquidity conditions in (commercial and investment) bank-holding companies, with contingency plans that factor-in interruptions of secured financing;
- counter-cyclical capital requirements and further emphasizing the leverage ratio.

12. **Recent events have highlighted the importance of better consumer protection to realign incentives in the originate-to-distribute model**. The Fed is appropriately proposing enhanced underwriting standards for lenders of risky loans, and legislation before Congress rightly instigates federal regulation of mortgage brokers when state supervision is insufficient. The creation of a business conduct regulator, with responsibilities for mortgage consumer protection, would be an important step forward, as would greater clarity on ratings on structured credit products. Holding security bundlers partially legally liable for the quality of assets they create could also improve incentives to produce safer securities.

SUPPORTING EXTERNAL ADJUSTMENT

13. **While dollar depreciation has moved U.S. competitiveness closer to medium-term fundamentals, tensions remain given the pattern of adjustment**. Bilateral rate movements have not corresponded to the existing pattern of imbalances, with larger changes against freely-floating currencies (such as the euro) than against currencies of countries with large current account surpluses (such as the renminbi). Thus, the reduction in tensions in the international exchange rate and trade system has been more limited than suggested by the dollar's real effective rate. This underlines the importance for both the U.S. and its trade partners to make further progress in implementing the agreed multilateral strategy to reduce external imbalances, rebalancing demand in a manner that sustains growth. On the U.S. side, it is appropriate that planned fiscal consolidation is being delayed to support growth.

CONCLUSION

14. **U.S. authorities are to be congratulated on their rapid and innovative responses to a complex crisis, but significant challenges lie ahead**. The policy reactions will help minimize disruption not only in the United States but across the world. These actions will need to be supplemented by broader efforts in major countries to foster stability in international financial markets and maintain an open trading system in the period ahead.