INTERNATIONAL MONETARY FUND

2007 Article IV Consultation with the United States of America

Concluding Statement of the IMF Mission

(June 22, 2007)

BACKDROP

1. ***Fortunately for the global economy, the recent cooling of U.S. activity from the robust pace of recent years has coincided with a pick up in growth elsewhere***. The U.S. slowdown has mainly reflected a drag from residential investment due to the ongoing housing market correction. Consumption, by contrast, has remained strong, supported by solid employment and wage growth. This resilience reflects the benefits of flexible markets backed by stable monetary policies and an improving fiscal position. Benign U.S. financial conditions have minimized spillovers elsewhere and, with global activity supported by faster growth in the Euro area and Asia, the U.S. current account deficit has stabilized, albeit at high levels.

2. ***Against this background, we see four main macroeconomic challenges***:

- Facilitating a soft landing for the economy;
- Maintaining a sound and innovative financial sector;
- Raising domestic savings and lowering the current account deficit, while resisting protectionism; and
- Tackling the key longer-term fiscal challenge of rising entitlement spending.

FACILITATING A SOFT LANDING

3. ***We share the U.S. authorities' view that the most likely scenario is a soft landing as growth recovers and inflation falls, although both are subject to risks*****:**

- Activity should pick up as the drag from housing dissipates, business investment recovers, and higher foreign growth supports net exports. This yields a baseline of 2 percent annual GDP growth in 2007, rising to 2¾ percent in 2008. Slack and the abatement of temporary price pressures brings core inflation below 2 percent.
- However, growth is uncomfortably close to the 2 percent "stall speed" associated with past recessions, even if other accompanying factors—rising unemployment and high real interest rates—are not evident. Consumption could weaken, given the ongoing housing market slowdown, while benign financial market conditions could tighten.
- At a time of low unemployment, cost pressures, including from rising oil and commodity prices, could feed through to prices despite the cushion provided by wide profit margins. This would be a particular concern if slowing productivity has a larger structural element than generally assumed, suggesting a need for vigilance on the price front.

4. ***Current monetary policy settings are consistent with a soft landing and can be adjusted flexibly in response to emerging macroeconomic developments***. The Federal Reserve stopped its most recent tightening cycle a year ago on signs that growth was

weakening and the federal funds rate of 5¼ percent appears consistent with a soft landing—a view supported by market expectations. However, given that labor market conditions remain tight and that there is still some risk that inflation will fail to moderate as expected, the Federal Open Market Committee has rightly emphasized maintaining well-anchored inflation expectations. At the same time, policymakers will need to be alert to the speed with which employment and activity can weaken in a downturn.

Ensuring a Robust Financial System

5. ***Financial innovation and stability have underpinned U.S. economic success and funding of the current account deficit***. The system has been highly resilient, including to recent difficulties in the subprime mortgage market, spreads and market volatility are near historical lows, and profits and capital adequacy are strong. Innovation has helped disperse risk, as the core players of the system—the large commercial and investment banks—have embraced an "originate to distribute" model in which they bundle loans into securities with varying risk characteristics for sale to investors; derivative markets too have increased the liquidity of securitization. Overall, innovation has been instrumental in attracting capital inflows, with foreigners increasingly buying U.S. private debt instruments.

6. ***However, rapid innovation has also created new regulatory challenges***. We agree that prudential oversight should focus on core commercial and investment banks, while relying on market discipline to limit risk elsewhere. However, even as new instruments have made it more difficult to asses vulnerabilities, benign market conditions have encouraged risk-taking, which can lower lending standards, as occurred with subprime mortgages:

- We are concerned that the same could be happening in other market segments, such as leveraged loans, and that tightening financial conditions could expose unanticipated risk concentrations and links across markets.
- This places a higher premium on supervisory systems geared to careful risk management, particularly for exposures of the core to hedge funds and other private pools of capital.
- Problems with subprime mortgages also raise the challenge of ensuring consistent consumer protection through federal rules without unduly constraining innovation.

7. ***With several federal and many more state regulators overseeing this evolving system, we welcome the current emphasis on improving regulatory effectiveness***. Shared responsibility can encourage informed debate, but it can also slow responses to pressing issues (e.g., to issuing guidance on hybrid subprime loans). Therefore, we support:

- ***Increasing the use of general principles as a guide to rule making***. Such principles can ease interagency coordination and shorten reaction times to developments. The scope for rationalizing the regulatory structure could also be explored, including by building on the options discussed by the report of the Government Accountability Office.
- ***Other measures to improve regulatory effectiveness***. Taking forward several proposals would help, notably instituting a national insurance charter (to reduce compliance costs with state-by-state norms); reforming oversight of government-sponsored housing enterprises (to limit risks from their portfolios); and modifying the industrial loan company charter (to avoid deposit-taking without consolidated supervision).

8. ***Competition from foreign financial markets has helped spur other initiatives to lower the costs of regulation***. We welcome new guidance reducing the compliance burden of parts of the Sarbanes-Oxley Act and rules making it easier for foreign companies to delist from U.S. markets. We also support moves by the Securities and Exchange Commission to consider recognizing International Financial Reporting Standards for foreign companies and to allow for mutual recognition of comparable regulatory regimes.

SUPPORTING EXTERNAL ADJUSTMENT

9. ***The large current account deficit remains easily funded through debt markets***. The recent fall in the nonoil trade deficit is encouraging but, at present exchange rates, the current account is projected to narrow only modestly to around 6 percent of GDP, implying rapidly rising net external debt. Nonetheless, financing has remained low cost, with long-term interest rate differentials suggesting that markets are discounting the need for real dollar depreciation to rebalance U.S. demand and reduce the current account deficit. While the innovativeness and depth of U.S. fixed-income markets may help explain the continuing attraction of foreign capital, the size of financing needs and the absence of a dollar risk premium underline potential vulnerabilities.

10. ***A disorderly resolution of global imbalances remains a low probability—but high cost—risk***. The rebalancing of U.S. demand from foreign to domestic goods, and associated real depreciation of the dollar and reduction in the current account deficit, will likely occur gradually. However, shocks could provoke a more abrupt adjustment. A flight from dollar assets would risk disrupting U.S. financial markets, thus lowering domestic demand and—given the evidence that U.S. financial market conditions are the main conduit for spillovers abroad—foreign demand as well. This highlights the importance of:

- Ensuring that U.S. financial markets remain sound and innovative; and
- Raising U.S. saving in order to lower the current account deficit. In reducing its fiscal deficit faster than anticipated, the United States is making commendable progress on the policies agreed in the Fund’s Multilateral Consultation as part of a shared responsibility of key member countries to address global imbalances.

11. ***We welcome the U.S. authorities’ sustained commitment to free trade, despite initiatives to erect trade barriers***. A more ambitious agenda for liberalizing agriculture could support a positive outcome to the Doha round of multilateral trade talks. In addition, it is worth considering a greater cushion to those temporarily dislocated by rising imports, which could also help resist pressure for higher tariffs to ameliorate the impact of trade on workers.

MEETING THE FISCAL CHALLENGES AHEAD

12. ***We also welcome recent fiscal performance and the Administration’s medium-term goal of budget balance by FY 2012, which is garnering broad support***. The FY 2007 deficit will likely fall below 1½ percent of GDP in FY 2007, again outperforming expectations on the back of revenue buoyancy from robust profit growth and tight expenditure control. Congress has also adopted this time frame for budget balance and passed supporting pay-as-you-go rules. However, achieving broad consensus on the means to achieve budgetary balance remains a major challenge, especially given the uncertainties attached to war funding and the cost of temporary fixes to the Alternative Minimum Tax.

13. ***The Administration has rightly identified the key long-term fiscal challenge: reforming unsustainable entitlement programs***. Rising health costs and aging imply huge spending increases in Medicare, Medicaid, and, to a lesser extent, Social Security:

- The Administration has appropriately proposed to strengthen the link between premiums and income so as to limit the growth in Medicare spending.
- Regarding the relatively high cost of the U.S. health care system, current proposals such as removing the tax bias for employer-sponsored health coverage may help. However, we agree with the authorities that more fundamental reform is necessary. More work is urgently needed on underlying medical cost drivers, so as to help crystallize the policy debate on alternative policy options.
- For Social Security, where the underlying costs and reform options are well understood, the priority is developing a broad consensus on reforms to make the program sustainable. We would agree that limiting the growth of benefits through progressive indexation appears to be a promising approach to Social Security reform.

14. ***A more stringent medium-term target, such as balancing the budget excluding the Social Security surplus, would better prepare for these long-term spending pressures***. By placing government debt and associated interest costs on a clear downward trajectory, a more ambitious medium-term deficit target would offer greater room for maneuver in addressing future fiscal pressures on entitlement spending.

15. ***The reform of entitlement spending should be complemented with tax reform***. Depending on the progress that can be made in controlling spending, revenue increases may also be needed. An overhaul of the complex tax system is in any case overdue. With tax expenditures a substantial portion of income tax revenues, the priorities lie in widening the tax base so as to maintain low marginal tax rates and to reform the Alternative Minimum Tax. Proposals contained in the President's Commission on Tax Reform to reduce and better target write-offs while further shielding saving from income taxes are an excellent starting point. This could be augmented by other options, such as in the area of energy taxes, which would also support environmental objectives.

In Conclusion

16. ***The U.S. economy continues to show remarkable dynamism and resilience, but important challenges lie ahead***. This performance reflects important strengths, including high levels of flexibility and innovation in markets for goods, labor, and financial assets, as well as monetary stability and a strong recent fiscal performance. The commitment of policymakers to embrace globalization has ensured that these benefits are shared with the rest of the world. Even so, policymakers will need to come to grips with the need to maintain a robust financial system, eliminate the fiscal deficit, reform the tax system and, most importantly, make entitlement programs sustainable.