INTERNATIONAL MONETARY FUND

2001 Article IV Consultation with the United States of America

Statement of the Fund Mission

June 26, 2001

1. ***Sound fiscal and monetary policies over the past decade have provided a strong foundation for the longest U.S. economic expansion on record.*** Determined policy efforts led to a dramatic improvement in the federal fiscal balance since 1992, resulting in large and growing fiscal surpluses in the last three years. The sure-handed implementation of monetary policy allowed the economy to expand strongly, and unemployment fell to levels not seen in more than three decades, without igniting inflationary pressures. With concerns rising that the strong pace of growth in 1999 and early 2000 might push output past even what appeared to be the economy's rapidly expanding productive capacity, the Federal Reserve moved during this period to tighten monetary policy to guard against overheating of the economy and the emergence of inflationary pressures. Signs of slower growth did not appear until mid-2000, but then the economy slowed much more rapidly than expected.

2. ***The sharp slowdown in economic growth reflected a number of mutually reinforcing developments that weighed heavily on economic activity in the second half of 2000 and into early 2001.*** Higher interest rates, rising energy prices, falling stock prices, and wider credit spreads contributed to reducing investment and dampening consumer spending. Lagging sales and a buildup in inventories triggered sharp cutbacks in production in some sectors of the economy and clouded corporate earnings and employment prospects, creating considerable uncertainty regarding the future course and strength of economic activity. At this juncture, whether economic activity recovers soon or remains sluggish for a protracted period depends on how consumer and business confidence evolve and influence consumption and investment decisions; whether households and businesses encounter balance-sheet problems that spill over on to the banking system; and whether the stronger productivity growth of recent years is sustained. The recent slowdown in a number of major economic partners is likely to have some dampening effect on U.S. growth.

3. ***In these circumstances, the IMF staff believes that the principal policy priority for the United States in the near term is to revive economic growth.*** While the new tax reduction act will provide some stimulus to domestic demand, monetary policy should be the primary instrument for stimulating economic activity. The Federal Reserve's substantial easing of monetary policy since early 2001 has been appropriate. Whether further easing will be needed will depend on the economy's response to past interest rate cuts. If economic and financial indicators remain weak, additional cuts in interest rates may be necessary. Provided that underlying productivity growth continues at a reasonable pace, inflationary pressures are expected to remain generally well contained owing to an easing in labor market tightness and strong competition in product markets, thereby providing room for a forward-looking monetary policy to support the economy in the event of persistent weakness.

4. ***In recent years, the stronger pace of U.S. growth relative to major trading partners and the real effective appreciation of the dollar—largely driven by capital inflows seeking a higher relative rate of return from investments in the United States—contributed to a large widening in the U.S. external current account deficit. The size of that deficit—now over 4½ percent of GDP—is not sustainable in the longer term, and has raised concerns that the dollar might be at risk for a sharp depreciation. Nevertheless, with the right policies in the United States and other major countries, adjustment in the current account should occur in an orderly manner.*** In the period ahead, as world demand growth is rebalanced and the cyclical positions of the United States and other major countries converge, demand for U.S. net exports should increase and U.S. net capital inflows should moderate, leading to a gradual depreciation in the dollar and a narrowing in the U.S. current account deficit. Disciplined macroeconomic policies in the United States—including the continuation of fiscal surpluses which will contribute to maintaining national saving—will facilitate, although not guarantee, an orderly adjustment. Further reforms in Europe and Japan that enhance the prospects for profitable domestic investment in these areas would also help to ensure that the adjustment of external balances takes place in a manner conducive to strong global growth.

5. ***Although evidence suggests a reasonably favorable outlook for underlying productivity growth—reflecting continued gains in technological innovation and in the adoption and diffusion of technology—less optimistic productivity prospects could trigger a downward revision in expected earnings growth and lead to a significant rebalancing of domestic and international portfolios.*** This might involve a sharp adjustment in the value of the dollar. In that event, monetary policy should remain focused on ensuring sustained low-inflationary economic growth. The main challenge for U.S. policy would be to determine whether underlying productivity growth had actually slowed down.

6. ***Given the current weakness in economic activity, some short-term fiscal stimulus along the lines of the recently enacted tax cut will help to insure against a sharper slowdown. More generally, fiscal policy should remain focused on medium-term issues, with tax policy driven mainly by structural considerations.*** The IMF staff welcomes the emphasis that has been placed on cutting all marginal personal income tax rates—rather than using the tax system to provide incentives for particular activities—and on simplifying the structure of the tax system by removing the phaseout provisions for personal exemptions and itemized deductions. These efforts are likely to yield better incentives to work and invest, to improve transparency, and to lower compliance costs. However, the scheduled expirations of some of the tax cuts, which were used as budget accounting devices to keep the estimated cost of the package within agreed limits, will increase uncertainty and complicate tax planning; it also means that parts of the tax package will need to be revisited.

7. ***In the end, the total cost of the tax cuts is likely to be significantly higher than current estimates suggest, unless offsetting actions are taken.*** The tax reductions that expire in 2010 and the relief from the impact of the alternative minimum tax that lapses in 2004 can be expected to be extended beyond these expiration dates, adding significantly to the cost of

tax reductions. Moreover, various "temporary" tax credits are likely to be renewed, as they have been in the past, entailing further budgetary costs.

8. ***Potential expenditure slippages are also a risk to the medium-term budget outlook.*** With budget surpluses in the last three fiscal years, discretionary spending has risen more rapidly than the mandated spending limits. The IMF staff welcomes the Administration's efforts to keep discretionary spending in check and its proposal to extend the use of the PAYGO requirement and discretionary spending caps (with an appropriate adjustment in their levels) beyond their expiration in FY 2002. Strong prospective spending pressures will test this resolve. The Administration, itself, has indicated a few priority areas for increasing expenditures, suggesting that this additional spending will be funded out of the "reserve" in the FY 2002 Budget or by implementing offsetting spending cuts in nonpriority items. The Budget reserve, however, may be smaller than anticipated (particularly if the cost of the tax cuts is higher than envisaged), and a substantial portion of the reserve is likely to be required to pay for the Administration's education initiatives and its plans for defense. While there is scope for cuts in other discretionary spending, limiting total discretionary spending to the modest increases planned is likely to prove to be very difficult.

9. ***In view of the uncertainties in the final cost of tax cuts, in the ability to hold down increases in discretionary spending, and in the accuracy of fiscal forecasts in the out years (when the cost of the tax cuts would be greatest), the IMF staff takes the view that both spending increases and multi-year tax cuts need to be implemented flexibly with an eye toward ensuring that sufficient resources will be available to finance these measures over the budget horizon.*** To firmly lock in place both tax reductions and new expenditure initiatives would substantially increase the risk that the budget position could deteriorate sharply in the longer term, with the possibility that the Administration's objective of preserving the Social Security surplus might not be achieved.

10. ***The Budget recognizes the need for additional measures to put the Medicare and Social Security programs on a sound long-term financial footing.*** With respect to Medicare, the Administration has chosen to focus on the finances of the program as a whole, instead of separately dealing with its two components—Hospital Insurance (HI) and Supplementary Medical Insurance (SMI). The Budget proposes effectively to spend all of the $525 billion surplus which will accrue to the Medicare HI trust fund over the next ten years in part to pay for the costs of the whole Medicare program and to expand Medicare benefits by introducing a modest prescription drug benefit for low-income seniors, pending consideration of a comprehensive Medicare reform. At the same time, the Budget commits the Administration to preserving the Social Security surplus and using it for debt reduction and Social Security reform. However, it acknowledges the need for further actions to adequately meet the program's future obligations, and a new commission has been formed to study Social Security reform.

11. ***In the IMF staff's view, a reasonable fiscal target over the medium term would be to set aside sufficient resources to put Social Security and the whole Medicare program on a financially viable basis over the longer term and keep the rest of the budget in balance***

over the economic cycle. Priority needs to be given to solving the financing problems of Social Security and Medicare, and at present there are sufficient resources available to solve these problems. In the period immediately ahead, preserving the surpluses in the Social Security and Medicare HI trust funds and balancing the rest of the budget would make a meaningful down payment toward this fiscal target. The trust funds for Social Security and Medicare HI were established originally as part of reform plans to partially pre-fund these largely pay-as-you-go programs to allow them to meet their long-term obligations without the need for sharp future increases in tax rates or cuts in benefits. To achieve this purpose, the surpluses in these trust funds have actually to be saved in order to put aside real resources to meet the programs' future liabilities. While the Administration does not find it useful to distinguish between the HI and the SMI components of Medicare, the IMF staff views some pre-funding of the entire program—which saving the Medicare HI surplus would accomplish pending the enactment of a comprehensive Medicare reform—as advantageous for tax-smoothing purposes. For Social Security, its long-term financing problems are not large, especially in comparison with those faced by many other industrial countries, and could be solved by making some moderate adjustments now to the program's parameters.

12. ***Finding a permanent long-term solution for the financing of Medicare will present a significant challenge given the difficulties associated with predicting the program's costs.*** Periodic adjustments to the program are likely to be needed, and a mechanism for making such adjustments on a regular basis should be established. A comprehensive solution to Medicare's financial problems is likely to involve a menu of choices that would include changing benefits, raising co-payments and deductibles, and increasing contribution rates. Timely adoption of a comprehensive reform package to improve the program's longer-term financial viability would avoid the need for more drastic measures if such reforms were unduly delayed.

13. ***Prospects for a significant pay down in U.S. government debt have improved dramatically from only a few years ago. In the period ahead, saving by the federal government will result in overall budget surpluses that are likely to exceed the government's redeemable marketable debt. If this money is to be saved, which it should be to deal with future liabilities, there is no choice but to invest such excess cash balances in private assets.*** The challenge will be to ensure that such investments are managed in a manner that will minimize any risk that there would be undue political interference in investment decisions and adverse effects on economic efficiency and long-term growth prospects. This could be accomplished by establishing individually controlled voluntary personal retirement accounts within the Social Security system, as the Administration suggests, or by investing these balances through the Social Security trust fund. There are important tradeoffs to be considered in adopting either of these approaches, but regardless of the means chosen, the IMF staff believes that the ultimate objective has to be to ensure that sufficient resources are set aside to meet the future needs of Social Security and Medicare.

14. ***Although U.S. banks experienced some moderate deterioration in commercial loan quality in 2000 and early 2001, the overall condition of the banking sector remains healthy.*** The deterioration in loan quality reflected higher interest rates through mid-2000,

slowing corporate profit growth, and weakness in certain sectors (particularly telecommunications). The slowdown in economic growth during 2001 is likely to result in some further deterioration in credit quality that will have a negative impact on bank profitability. However, current profit and capitalization levels are relatively high, putting banks in a strong position to weather the impact of these effects.

15. ***In late 1999, passage of the Gramm-Leach-Bliley (GLB) Act introduced a comprehensive overhaul of the outdated laws regulating the financial sector in the United States.*** The Act repealed the restrictions on affiliation between banks, securities firms, insurance companies, and other financial service providers. It empowered the Federal Reserve as the "umbrella" supervisor for the newly created financial holding companies, but limited its supervisory authority over the operating units of these companies that are regulated by other banking agencies and the nonbank functional regulators. Since the passage of the GLB Act, progress has been achieved in making this new supervisory framework operational, as the regulatory agencies have worked to enhance interagency cooperation and information sharing. These efforts are especially important in view of the wide distribution of various responsibilities among different agencies. In particular, the continued emphasis on refining the program for the supervision of large complex banking organizations, with the focus on evaluating and reviewing internal systems and controls for risk management, is welcome.

16. The United States should continue to be a major force for further liberalization of trade on a multilateral basis, and efforts to initiate a new round of multilateral trade negotiations should remain the key priority. At the same time, the IMF staff notes recent progress with free trade initiatives on a regional and bilateral basis and recognizes the beneficial effects that such negotiations may yield for global trade liberalization. The IMF staff also welcomes the renewed efforts by the Administration to obtain Trade Promotion Authority because of the important role it could play in securing commitments from other countries to conclude trade liberalization agreements. Improvements in market access provided in the African Growth and Opportunity Act and the Caribbean Basin Enhanced Initiative are useful steps in enhancing growth prospects for countries in these regions, and the IMF staff encourages the authorities to take additional needed steps to provide duty- and quota-free access to the U.S. market for all least-developed countries.

17. The slowdown in U.S. economic activity and the continued strength in the dollar may give rise to increased demands for import protection, as suggested by the recent initiation of a safeguard investigation of the steel industry. Such protectionist pressures need to be strongly resisted. To enhance market competition with substantial benefits to the economy overall, the IMF staff believes that a change in the administration of antidumping and countervailing duty procedures is needed. Such import protection should be provided only in those cases where foreign producers are found to be engaged in anticompetitive behavior.

18. ***While U.S. agricultural policy involves lower levels of overall support than in many OECD countries, supplemental actions taken in recent years to alleviate financial***

difficulties faced by U.S. farmers in the context of declining world commodity prices have created perverse incentives in the U.S. farm sector and have had an adverse impact on producers in other countries. Reforms implemented in 1996 under the Federal Agriculture Improvement and Reform (FAIR) Act sought to move government assistance to the sector away from price supports and toward income support. The recent practice of providing supplemental assistance appears to have impeded and prolonged adjustment in the farm sector. In formulating the new farm act this year, the IMF staff recommends that the authorities return to the original goals of the FAIR Act and significantly reduce income support payments and resist pressures to extend support to a wider range of crops. Also, steps need to be taken to eliminate, or at least to substantially scale back, the crop loan program, which continues to distort production decisions.

19. ***ODA in recent years has remained at historically low levels of around 0.1 percent of GNP, compared to an average of 0.2 percent during the 1980s and early 1990s, and the FY2002 Budget does not envisage an increase.*** The IMF staff encourages the authorities to make further efforts to raise foreign assistance. At the same time, the IMF staff welcomes the support for the enhanced HIPC initiative, with U.S. commitments to the HIPC trust fund and bilateral debt-reduction initiatives likely to be in place in FY 2002.