INTERNATIONAL MONETARY FUND

2009 Article IV Consultation with the United States of America

Concluding Statement of the IMF Mission

June 10, 2009

Context

1. **The U.S. financial and economic crisis has had severe global repercussions.** The run-up to the crisis involved a substantial and widespread underestimation of risks—especially in housing—and growing leverage and liquidity mismatches, in particular through off-balance-sheet vehicles and non-bank entities in less-regulated areas. Against a backdrop of easy global financial conditions, this dynamic fed an unsustainable buildup of financial imbalances, above all in housing markets. The sharp decline in housing prices that started in 2007 weakened several systemically important financial institutions, culminating in the collapse of Lehman Brothers, and revealing major weaknesses in the U.S. regulatory and resolution frameworks. This was followed by the worst global financial panic since the Great Depression, with extreme strains in a broad range of markets, volatility in capital flows and exchange rates, and a cascade of systemic events. Economic activity collapsed globally, with trade contracting sharply and advanced economies as a group registering the steepest decline in production in the postwar period. Emerging markets economies also experienced intense pressure, amid retrenching trade and tighter international financing conditions.

2. **Post-Lehman, the U.S. authorities' policy response has become increasingly strong and comprehensive.** It has included large monetary and fiscal stimulus, the latter consistent with the targets agreed by the G-20; action to mitigate strains on housing markets; and a wide range of measures to restore financial stability. The response has also been transparent, with the authorities disseminating considerable information about their initiatives, which—as seen most recently with the Supervisory Capital Assessment Program (SCAP)—has played an important role in thawing frozen markets. The U.S. has also largely avoided protectionist measures in the heat of the crisis—although the "Buy American" provisions in the stimulus bill have raised concerns among trading partners—and proposes to put foreign aid on a path to double (though it would remain modest relative to UN targets).

Outlook and Risks

3. **Recent data suggest that the sharp fall in output may now be ending, although economic activity remains weak.** Economic indicators point to a decelerating rate of deterioration, particularly in labor and housing markets, both of which are key to economic recovery and financial stability. In tandem, financial conditions have noticeably improved, with narrowing interest-rate spreads and growing confidence in financial stability in the wake of measures deployed by the Administration, the Federal Deposit Insurance Corporation

(FDIC), and the Federal Reserve. That said, both financial and economic indicators remain at stressed or weak levels by historical standards.

4. **The staff's outlook remains for a gradual recovery, consistent with past international experience of financial and housing market crises.** The combination of financial strains and ongoing adjustments in the housing and labor markets is expected to restrain growth for some time, with a solid recovery projected to emerge only in mid-2010. Against this background, GDP is expected to contract by 2½ percent in 2009, followed by a modest ¾ percent expansion in 2010 on a year-average basis (on a Q4-over-Q4 basis, -1 ½ percent in 2009 and 1 ¾ percent in 2010). Meanwhile, growing economic slack—with unemployment peaking at close to 10 percent in 2010—would push core inflation to very low levels, with the headline CPI expected to decrease by ½ percent in 2009 and increase by 1 percent in 2010.

5. **The near-term outlook is marked by an unusual level of uncertainty, with the balance of risks still tilted to the downside.** It is possible, as some of our interlocutors have suggested, that the strong policy response could lead to a more typical rapid recovery, with an emerging virtuous circle of rising confidence and strengthening financial conditions. However, there are also significant downside risks, including foreclosures and further house price declines, which along with rising unemployment would put additional pressure on households, and on domestic and foreign financial balance sheets and raise deflationary risks; the deterioration in the commercial real estate market, which may have considerably further to run; upward pressure on interest rates, on concerns about fiscal sustainability; and rising corporate distress. Much will also depend on developments abroad, including progress made in strengthening financial institutions and markets.

Policies Going Forward: From Recovery to Stability

6. **At the current juncture, the U.S. authorities face three interdependent challenges:**

- Completing near-term economic and financial stabilization to set the stage for sustained recovery;
- developing strategies for unwinding massive public interventions, coordinating with other countries; and
- addressing the longer term legacies of the crisis— a reshaped financial system, worsened fiscal imbalances, and damaged household balance sheets.

While stabilization has the greatest priority, it depends importantly on the other objectives—notably, monetary and fiscal stimulus may stoke concerns about inflation and rising debt, exerting upward pressure on interest rates. This dynamic interaction among near-term and longer-term challenges underscores the need to develop and communicate strategies for exiting extraordinary support and for dealing with long-term challenges, and implement them rigorously, to underpin confidence. Moreover, all these challenges are heightened by the likelihood that potential growth will be weak by historical standards for a considerable period, a typical legacy of financial crises.

Near-term stabilization

7. **Macroeconomic policies are providing welcome support to demand.** The fiscal stimulus—well targeted, timely, diversified, and sizeable—is projected to boost annual GDP growth by 1 percent in 2009 and ¼ percent in 2010. This is being appropriately complemented by a highly expansionary monetary stance and “credit easing” measures that are also relieving financial strains. Continued clear communication on the near-term outlook will be essential to anchor inflation expectations, given the prevailing uncertainty. If activity proves weaker than expected, the Fed could undertake additional credit easing, and further strengthen its commitment to maintain a highly accommodative stance. If necessary, additional fiscal stimulus could also be considered, focused on fast-acting measures, although this would need to be complemented by a concomitantly stronger medium-term adjustment.

8. **Steps to stabilize financial and housing markets are having noticeable effects on financial conditions.** Measures taken under the Financial Stability Plan, along with the FDIC’s and Federal Reserve’s initiatives, have done much to stabilize financial conditions. Among such measures, the SCAP, the Temporary Liquidity Guarantee Program, and bank capital injections have contributed to a substantial improvement in confidence in the stability of major financial institutions. Going forward, the Public Private Investment Program (PPIP) will provide a tool for cleaning bank balance sheets. However, it remains to be seen whether the facility will be extensively used, as banks may have to book significant losses on loans sold and investors may fear restrictions on (for example) compensation. On housing markets, purchases of mortgage-backed securities have brought down mortgage rates, although they have been volatile recently. One important uncertainty is the extent to which efforts to encourage mortgage modifications will stem the flood of foreclosures that is pushing down housing prices, particularly in light of the many households with negative equity in their homes, which may require further measures, such as subsidized writedowns, to ameliorate.

9. **The immediate priority is to complete the strengthening of banks’ capital positions, while continuing to guard against downside risks.** A scenario of sustained subpar growth—below the IMF’s baseline—would depress earnings and amplify credit losses, bringing capital below the levels targeted in the SCAP (which are low by historical standards). This calls for continued close monitoring of the financial system, along with regular stress tests to evaluate vulnerabilities; moreover, until a durable recovery is achieved, it would be prudent to retain the Administration’s proposed budgetary reserve for financial stabilization funds. It will also be essential to expeditiously implement the proposed resolution framework for nonbank financial institutions to avoid another Lehman experience, by increasing the predictability of the resolution process for large and complex financial institutions and thereby reduce moral hazard.

Exit strategy

10. **The policy response to the crisis has inevitably entailed a massive increase in the public role in the economy.** Sizeable interventions have been necessary to stabilize financial conditions and dampen the macro-financial feedback loop that threatened a downward economic spiral. Going forward, unwinding interventions will pose major challenges, and—given the high level of cross-border competition in the financial sector—will need to be coordinated internationally to facilitate a smooth exit.

11. **A key issue is to develop and communicate an exit strategy to withdraw monetary stimulus once a sustainable recovery is underway.** Some short-term facilities are now naturally unwinding, as terms are now less favorable than market rates. However, the ramping up of the Term Asset-Backed Securities Loan Facility (TALF) and ongoing purchases of Treasury debt and mortgage-backed securities (MBS) could inflate the balance sheet substantially, largely with long duration assets which—depending on future financial market conditions—may take time to unwind to avoid market disruption. Against this background, a broad-based approach will be needed to afford maximum flexibility and reassure markets that the Fed can withdraw liquidity as and when needed. In this connection, existing instruments—including remuneration on excess reserves, and traditional reverse repo operations—can usefully be supplemented by reverse repo operations in agency and mortgage-backed securities, use of the Supplementary Financing Program (which may require a corresponding adjustment of the federal debt ceiling) or, if necessary, issuance of Fed paper (which will require Congressional authorization). In addition, and as anticipated in the March joint statement with Treasury, it would be desirable to transfer the Maiden Lane facilities to the Treasury at an early stage, to reduce the Fed's exposure to credit risk.

12. **A smooth unwinding of government support for the financial sector as conditions normalize will be important to avoid distortions, fiscal risks, and governance issues.** The pace of withdrawal will need to be calibrated to future improvements in financial conditions, but in general should seek to gradually reduce subsidies and tighten access terms for any facilities that may need to be extended, both to minimize risks and to differentiate stronger institutions from chronically weak ones. Healthy firms should be encouraged to repay capital injections and issue nonguaranteed debt to signal their viability. Clear communication of the government's strategy, particularly on the conditions for unwinding (linked to the objectives of the programs), would help secure market confidence.

Long-term legacies

13. **A central lesson from the crisis is the need for major reform of financial crisis prevention and resolution frameworks.** In this connection, we welcome the Administration's proposal for a systemic risk regulator, which should be given an explicit mandate and accountability for systemic stability, and armed with the information and powers necessary to manage macro-prudential risks. The regulator could also publish regular

reviews of systemic stability, highlighting risks and vulnerabilities. Systemic institutions should be subject to a more rigorous regulatory, supervisory and resolution regime, to discourage size, complexity and interconnectedness. As suggested by Secretary Geithner, stabilization costs could be pre-funded by levies on institutions (preferably in proportion to their contribution to systemic risk). More generally, consolidation in the regulatory structure could speed decision making, clarify responsibilities, facilitate interactions with international fora, and avoid the reemergence of gaps that have allowed the buildup of systemic risks. Measures to address procyclicality and other issues thrown up by the crisis, as relevant recommendations emerge from the G-20 and other international fora, would further underpin financial stability.

14. **Restarting private securitization markets while promoting their resilience will be critical to restoring a healthy pace of credit flow.** While the TALF is an important intermediate step, regulators and private market participants need to work together to address weaknesses in the existing securitization model, including by improving disclosure about the ratings process and the underlying credits, and differentiating ratings for securitized products; strengthening the liability of bundlers to improve their accountability; and encouraging more standardized and simpler securitizations through market codes of conduct. An appropriate role for Fannie Mae and Freddie Mac will need to be formulated as well, once the future shape of the financial system becomes clearer. Regardless of the model chosen, it should be made clear whether the housing agencies' liabilities are explicitly guaranteed or not, and the agencies should be subject to strict oversight and regulation.

15. **As in other countries, the financial crisis will also result in a serious and enduring deterioration in public finances, exacerbating the already large challenges of swelling entitlement costs.** Over 2009−11, the staff projects that federal deficits will average 9 percent of GDP, and that debt held by the public will nearly double to 75 percent of GDP; with debt maturities having shortened, gross financing requirements are projected at 30 percent of GDP, about double pre-crisis levels. Looking forward, such a rise in debt may put significant pressure on Treasury bond rates, which—along with lower potential growth—will add to fiscal challenges. In addition, the fiscal outlook is subject to other risks, ranging from possible calls to support private pensions and state finances, to further financial sector spending (including losses on interventions and funds for the FDIC and housing agencies).

16. **The Administration's FY 2010 budget sets out appropriate medium-term fiscal objectives, but further measures will be required to achieve its goals.** We welcome the increased transparency of the budget document, including presenting ten-year forecasts and making more realistic assumptions about defense spending and tax policy, as well as the proposal for statutory pay-as-you-go rules; and fully support the underlying objective of an early stabilization of public debt. That said, as also noted by the Congressional Budget Office, the long run economic assumptions on which the budget is based are relatively optimistic; under the staff's economic assumptions, a significantly greater fiscal effort—on the order of 3½ percent of GDP through 2019—would be needed to achieve the medium-term debt path set out in the budget. With discretionary spending already low by historical

perspective, revenues will need to rise. Steps could include base broadening (including reducing the deductibility of corporate debt and household mortgage interest), introducing a federal consumption tax, hiking energy taxes, and strengthening compliance (the latter is being examined by the President's task force on tax reform).

17. **In addition, substantial further measures will be needed to rein in soaring entitlement costs over the longer term.** In this connection, the Administration's focus on health care reform—the key long term risk—is especially welcome, including the goals of achieving fully-funded universal health care and reducing the annual growth rate of costs by 1.5 percentage points, notably by improving the cost-effectiveness of treatments. However, the impact of measures to reduce costs—which will be essential to stabilizing Medicare/Medicaid finances—is very difficult to assess, as they rely on strengthening incentives for patients and private providers to economize. Correspondingly, health costs will need to be closely monitored and additional measures taken promptly if improvements fail to materialize. We welcome the Administration's intention to work toward developing a political consensus on social security reform once health care reforms are complete.

18. **The financial crisis will also have important implications for the U.S. external accounts, and—more broadly—the U.S. role in the global economy.** Looking forward, household savings are expected to continue to rise as households rebuild balance sheets, which—along with some fiscal consolidation and tighter financial conditions—would cement the recent reduction in the current account deficit and bring it to a more sustainable level over the medium term. Taking account of the recent depreciation, the staff assesses that the U.S. dollar is presently only modestly above the level implied by medium-term fundamentals; that said, much will also depend on the evolution of foreign demand for U.S. assets, underscoring the importance of fiscal and financial market reforms. More generally, for the foreseeable future the U.S. consumer is unlikely to play the role of global "buyer of last resort"—suggesting that other regions will need to play an increased role in supporting global growth and adjustment.