INTERNATIONAL MONETARY FUND
Concluding Statement of the 2013 Article IV Mission to
The United States of America
June 14, 2013

1. **The U.S. recovery has remained tepid over the past year, but underlying fundamentals have been gradually improving**. The modest growth rate of 2.2 percent in 2012 reflected legacy effects from the financial crisis, fiscal deficit reduction, a weak external environment, and temporary effects of extreme weather-related events. These headwinds notwithstanding, the nature of the recovery appears to be changing. In particular, house prices and construction activity have rebounded, household balance sheets have strengthened, labor market conditions have improved, and corporate profitability and balance sheets remain strong, especially for large firms. With the sizeable output gap and well-anchored inflation expectations keeping inflation subdued, the Fed appropriately continued to add monetary policy accommodation over the past year by increasing its asset purchases and linking the path of short-term rates to quantitative measures of economic performance, thus helping to maintain long-term rates at exceptionally low levels. Overall financial conditions have eased, as risk spreads narrowed, stock market valuations surpassed their pre-crisis peak, and bank credit conditions gradually eased.

2. **However, growth is expected to slow to 1.9 percent this year owing to an excessively rapid pace of fiscal deficit reduction, before accelerating to 2.7 percent next year**. Staff's baseline projections assume that the general government deficit will decline by over 2½ percent, subtracting between 1¼–1¾ percentage points from growth in 2013, the debt ceiling will be raised without any disruption to the U.S. and the global economy, and the Fed will continue asset purchases until the end of this year. The unemployment rate is projected to remain around 7½ percent throughout 2013. Employment growth is projected to pick up late this year and in 2014, fostered by an acceleration of output growth. With labor force participation projected to recover somewhat in 2014 as discouraged workers return to the labor force, the unemployment rate is projected to decrease (on average) to 7.2 percent next year. Given the wide output gap, inflation is expected to remain relatively subdued over this year and the next. As the legacy of the financial crisis wanes further, private domestic demand is expected to continue recovering, but weak growth in a number of trading partners is projected to weigh on export growth.

United States: Summary of Macroeconomic Projections
(Percent Change, unless otherwise noted)

	2012	2013	2014	2015	2016	2017	2018
Real GDP	2.2	1.9	2.7	3.5	3.6	3.4	2.9
CPI, Headline Inflation	2.1	1.8	1.8	1.9	2.1	2.2	2.3
Unemployment Rate (percent)	8.1	7.5	7.2	6.8	6.2	5.7	5.4
Current Account (pct. of GDP)	-3.0	-2.9	-3.1	-3.2	-3.2	-3.2	-3.2

Source: Fund staff estimates.

3. **Risks to the outlook appear modestly tilted to the downside**.

- ***A stronger impact of fiscal consolidation, a weaker external environment, and higher structural unemployment are the main downside risks***. While private consumption has so far weathered relatively well both higher tax rates and the spending cuts from the "sequester", both measures might prove to be a stronger headwind to consumer demand over the next few quarters. A slower pace of recovery may in turn delay the normalization of labor market conditions and reduce long-term growth, as more unemployed lose their skills and attachment to the labor force. On the external front, financial stress could reemerge in the euro area, affecting the United States through both trade and financial channels, including higher risk aversion and a stronger U.S. dollar amid safe-haven capital inflows. External demand may also be held back by a slower pick-up in global economic activity reflecting lower growth in a number of emerging market economies.
- ***Fiscal and monetary policy challenges also pose some downside risks to the outlook***. Failure to promptly raise the debt ceiling or—further down the road—lack of further progress on longer-term deficit reduction could eventually lead to higher sovereign risk premia, with severe repercussions for the U.S. and the global economy. The prolonged low-interest rate environment could sow the seeds of future financial vulnerabilities as investors and financial institutions aggressively search for yield—despite the increased regulatory and supervisory focus on financial stability risks. On the other hand, markets could over-react to initial steps by the Fed to normalize monetary policy conditions, leading to a sharp increase in long-term interest rates and financial market volatility, which if protracted would weigh on the recovery and have negative international spillovers.
- ***A faster-than-expected recovery of the housing sector, stronger business investment, and the unfolding energy supply boom pose upside risks to our central scenario***. In particular, a further easing of mortgage credit conditions, which remain tight, could spur a faster recovery of the housing market and jumpstart a virtuous cycle of wealth accumulation, easier financial conditions, and stronger consumer demand. Capital spending may also accelerate more than in our projections, especially if better prospects for consumer demand were to induce large firms to shift more aggressively from cash hoarding and share buy-backs to capital spending. Over the medium term, advances in the extraction of oil and gas from unconventional sources could boost growth more than anticipated, especially if lower domestic energy prices were to significantly boost the competitiveness of U.S. manufacturing.

4. **Against this background, policymakers' main challenge is to support the recovery while addressing the vulnerabilities that threaten growth, public finances, and financial stability in the medium term**. In staff's view, a desirable policy strategy to deal with this challenge includes the following ingredients:

- Repealing the sequester and adopting a more balanced and gradual pace of fiscal consolidation in the short term;
- Expeditiously raising the debt ceiling to avoid a severe shock to the U.S. and the global economy;
- Implementing a comprehensive and back-loaded set of measures to restore long-run fiscal sustainability;
- Continuing to prepare the ground for a gradual and orderly normalization of monetary policy conditions, while monitoring financial stability risks;
- Increasing the resilience of the U.S. and global financial system while reducing the risks of fragmentation of the international financial regulatory framework.

5. **On the fiscal front, the deficit reduction in 2013 has been excessively rapid and ill-designed**. In particular, the automatic spending cuts ("sequester") not only exert a heavy toll on growth in the short term, but the indiscriminate reductions in education, science, and infrastructure spending could also reduce medium-term potential growth. These cuts should be replaced with a back-loaded mix of entitlement savings and new revenues, along the lines of the Administration's budget proposal. At the same time, the expiration of the payroll tax cut and the increase in high-end marginal tax rates also imply some further drag on economic activity. A slower pace of deficit reduction would help the recovery at a time when monetary policy has limited room to support it further.

6. **Despite the substantial deficit reduction achieved over the past several years, the gradual normalization of interest rates and the impact of population aging and health care costs on spending imply that public finances remain on an unsustainable path over the longer term**. The general government deficit has more than halved from over 13 percent of GDP in 2009 to a projected 5.9 percent of GDP in 2013. In the staff's baseline scenario, the budget deficit will continue to shrink over the next few years, partly as revenues recover with faster economic growth. Gross general government debt would peak at around 110 percent of GDP and start declining in 2015 also thanks to the favorable interest rate-growth differential (reflecting still-low interest rates and the pickup in the pace of recovery). But the longer-term debt profile remains unsustainable. Despite the slowdown in growth rates over the past few years, spending on major health care programs and Social Security, absent additional reforms, is expected to increase by 2 percentage points over the next decade. Furthermore, interest outlays are projected to increase by almost 2 percentage points over the same period, as interest rates gradually return to neutral levels. These factors would cause the budget deficit to widen and put the ratio of public debt to GDP again on an upward path—and from a relatively high starting point.

7. **Together with a slower pace of deficit reduction in the short term, the authorities should promptly adopt a comprehensive and back-loaded plan entailing lower growth**

in entitlement spending and higher revenues. New revenues could be raised through a fundamental tax reform which would simplify the tax code and broaden the tax base through a reduction in exemptions and deductions, as well as through the introduction of a carbon tax and a value added tax. Spending measures would need to curb the growth in public health care and pensions outlays—and early legislative action is important in order to generate meaningful savings in these areas during the next decade, given the very gradual pace at which such savings accrue. Some measures along these lines, including health care savings and the re-indexation of public pensions to the chained CPI, are proposed in the Administration's budget for fiscal year 2014, but additional action would be needed to contain the steady growth in mandatory spending as a share of the economy. Overall, reaching over the longer term a primary surplus for the general government of about 1 percent of GDP (compared to a primary deficit of around 1 percent in staff's baseline projection) would put the debt ratio on a firmly downward path.

U.S. Government Finances: Baseline Scenario

(In percent of GDP)

	2012	2013	2014	2022	2023
IMF staff baseline projection 1/					
Federal budget balance 2/	-6.9	-4.5	-3.4	-3.8	-3.7
Federal debt held by public	72.6	75.4	76.3	74.6	75.4
General government budget balance 2/ 4/	-8.6	-5.9	-4.8	-4.9	---
General government structural primary balance 3/ 4/	-4.5	-2.0	-1.3	-0.9	---
General government debt 4/	106.5	108.8	109.6	108.5	---
Memorandum items					
Federal budget balance (authorities) 5/	-7.0	-6.0	-4.4	-2.1	-1.7

Sources: Office of Management and Budget, Congressional Budget Office, and IMF staff estimates.
1/ Projections using the IMF macroeconomic and policy assumptions.
2/ Includes staff's adjustments for one-off items, including the cost of financial sector support. Excludes the portion of payments from the GSEs related to certain accounting changes.
3/ Excludes net interest, effects of economic cycles, and costs of financial sector support. In percent of potential nominal GDP.
4/ Includes state and local governments, figures on a calendar year basis.
5/ President's FY2014 budget proposal.

8. **Implementing this fiscal strategy would help global growth in the short run and favor the rebalancing of global demand and the reduction of global imbalances over the medium term**—together with efforts to increase domestic demand in surplus countries, as highlighted in the G-20 Mutual Assessment Process. In the short run, it would partly relieve monetary policy of its burden of supporting the recovery, reducing the risks to U.S. and global financial stability from a prolonged period of low interest rates. In the medium run, it would help contain the future rise in long-term interest rates, thus promoting growth, as well as reduce the risk of turmoil in the Treasury market, which would have severe domestic and global repercussions.

9. **While the macroeconomic benefits of asset purchases continue to outweigh the costs, the Fed should continue its preparations for a smooth exit**. The highly accommodative monetary policy stance has provided important support to the U.S. and global economic recovery, and under staff's growth projections a continuation of large-scale purchases through at least end-2013 is warranted. However, a long period of exceptionally low interest rates may entail potential unintended consequences for domestic financial stability and has complicated the macro-policy environment in some emerging markets. While the Fed has a range of tools to help manage the exit from its current highly accommodative policy stance—including adjusting interest on excess reserves and conducting reserve-draining operations with an expanded list of counterparties—unwinding monetary policy accommodation is likely to present challenges. The large volume of excess reserves and the segmented nature of U.S. money markets could affect the pass-through of policy rates to short-term market rates. At the same time, effective communication on the exit strategy and a careful calibration of its timing will be critical for reducing the risk of abrupt and sustained moves in long-term interest rates and excessive interest rate volatility as the exit nears, which could have adverse global implications, including a reversal of capital flows to emerging markets and higher international financial market volatility.

10. **Despite the improvements over the last 12 months, there is still room for policies to support the housing market**. The rebound of the housing sector has benefited from government-backed programs that facilitated refinancing and modification of loans under stress. As a stronger housing market remains an essential component of the U.S. economic recovery, it would be important to maintain those programs in place and extend their reach in a few areas, including an extension of the refinancing program to loans not guaranteed by Government-Sponsored Enterprises (GSEs). Certain key regulatory rules, such as the Qualified Mortgage rule, have been issued. The finalization of remaining rules on risk retention would help to reduce uncertainty that may have hampered mortgage origination, and favor the return of private capital to the housing finance system. Moreover, as the housing market recovers, consideration should be given to the adoption of a fully articulated medium-term strategy to gradually reduce the footprint of the GSEs.

11. **Persistent weak labor force participation rates and high levels of long-term unemployment suggest there is room for active labor market policies to complement efforts to boost domestic demand**. These policies can include training and support for job search, as well as efforts to strengthen the link between the education system—particularly community colleges—and employers, including through apprenticeships. These efforts can help reduce the risk of human capital losses which would lower potential growth for the U.S. economy.

12. **U.S. banks' health has improved significantly over the past year, but there are a few signs of emerging financial sector vulnerabilities from persistently low rates**. Banks have expanded their balance sheets, increased loan books, and improved liquidity positions, while at the same time reducing the riskiness of their portfolios. The quality and quantity of

capital have been expanded, and 2013 Fed stress tests and capital planning evaluations for the largest 18 U.S. banks suggest it would be resilient to very severe shocks. That said, there are some incipient signs of rising exposure to both interest rate and credit risk in regional banks that require increased vigilance, as low interest rates squeeze interest margins. Vulnerabilities may also be building in the non-bank financial sector, with a rapid expansion of agency real estate investment trusts (REITs), weakening underwriting standards in the leveraged loan market (covenant-lite loans issuance has returned to pre-crisis levels), and higher credit and liquidity risks taken by pension funds and insurance companies. Strong macro-prudential oversight and supervision of the financial system remain essential to address these emerging vulnerabilities.

13. **The regulatory architecture has been strengthened relative to the pre-crisis period, but more remains to be done to increase the resilience of the U.S. financial system while reducing the risk of international financial regulatory fragmentation**. Key items on the agenda are finalizing the designation of systemically-important non-bank financial institutions, further strengthening of regulation of money market funds (as recently proposed by the Securities and Exchange Commission), reducing systemic risk in the tri-party repo market, and progressing with Basel III implementation. Care is also needed to ensure that the finalization and implementation of the Volcker Rule take place in a manner that minimizes the risk of a migration of systemic risk from the banking system to more lightly-regulated financial institutions and also that avoids negative spillovers to the rest of the world.[1] Notable progress has been achieved with new rules on centralized clearing of over-the-counter derivatives, in line with G-20 commitments. These will need to be implemented carefully to resolve conflicts and inconsistencies among jurisdictions given the cross-border nature of the over-the-counter (OTC) derivative markets. More generally, the bolstering of regulatory policies to support financial stability should be coordinated with the global financial reform agenda as this would reduce fragmentation of the global financial regulatory landscape and limit uncertainty and the scope for regulatory arbitrage.

14. **Over the medium term, a strengthening of the U.S. external position through some improvement in the current account deficit, which has remained around 3 percent of GDP since 2010, would be desirable**. The current account deficit is expected to remain broadly stable over the next few years as higher imports due to stronger domestic demand are offset by lower oil prices and increased domestic energy production. Still, this would imply a further—if slow—deterioration in the U.S. net international investment position, entailing over time higher interest payments overseas. The modest dollar overvaluation could be unwound and the external position strengthened through a gradual but sustained reduction in the budget deficit, accompanied by some depreciation of the dollar and adjustment in partner countries' policies geared towards global rebalancing. This would allow for a desired

[1] These issues are discussed by Viñals et al. in "Creating a Safer Financial System: Will the Volcker, Vickers, and Liikanen Structural Measures Help?" IMF Staff Discussion Notes No. 13/4 (May 2013).

strengthening of the U.S. current account balance by ½ - 1 percent of GDP in the context of full employment. The recent progress in promoting plurilateral and bilateral trade agreements should contribute to growth, as they lead to more open trade and deeper forms of integration, including by addressing non-tariff measures. This progress should complement renewed efforts to advance the multilateral trade agenda.