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BUFF/ED/11/123

July 18, 2011

Statement by Ms. Lundsager and Mr. Lindquist on United States
Executive Board Meeting
July 21, 2011

Four years since the start of the financial crisis, the United States has followed its initial decisive actions to stabilize the financial system and the economy with far-reaching financial regulatory reforms, while calibrating its fiscal and monetary policies appropriately to bolster the economy as the recovery continues. The economic recovery is progressing, though the pace of growth has slowed recently and has not been sufficient to reduce unemployment levels significantly. With our authorities expecting growth to improve over the medium term, the political focus has shifted towards formulating a medium-term plan for fiscal consolidation that does not disrupt the ongoing recovery.

Overall Economic Outlook

The U.S. economic recovery continues at a moderate pace, though some temporary headwinds – including rising energy prices and supply chain disruptions – have led to a decline in the pace of growth in the first half of 2011. These transitory factors have already started to fade and we remain cautiously optimistic that economic activity will strengthen and the pace of hiring will pick up in the second half of 2011. While the economy continues to face a number of more persistent challenges, including an unacceptably high unemployment rate, weak housing and commercial real estate markets, and continued tightness in some credit markets, we still view the recovery as being well sustained. In the July Blue Chip consensus forecast, private sector analysts projected the U.S. economy to expand 2.5 percent in 2011 – in line with the staff's forecast – but also called for growth to accelerate to 3 percent in 2012 – higher than the staff's forecast of 2.7 percent.

Recoveries from financial crises tend to be more protracted, but we still do not expect that the recent recession will have a permanent effect on productivity levels or growth rates. Indeed, productivity growth rates in the aftermath of the recession have been quite robust and do not suggest a fall in potential output. Demographic trends suggest that the excess housing supply will be absorbed in the medium term, and residential investment will once again positively contribute to growth.

The U.S. external position has adjusted substantially. Since the current account deficit peaked at 6.4 percent of GDP in 2006, it has fallen to 3.2 percent of GDP in Q1 2011, a result of higher private savings and lower investment. Over the medium term, we expect investment to recover, but a substantial reduction in the fiscal deficit should offset the effect on the current account.

Financial sector health has substantially improved since the crisis. The weakest parts of the financial system are either no longer in existence or have gone through significant restructuring. In light of the improvements in financial sector health, credit conditions have eased, and banks have reported continued easing of lending standards for consumer loans and for commercial and industrial loans to large and middle market firms. Lending conditions for residential and commercial mortgages still appear to be tight, but some tightening in standards was clearly needed after the crisis.

Fiscal Policy

Even in the context of the longer-term fiscal debate, the President and Congress were able to come together in December 2010 with a fiscal package that provided further near-term support for the recovery by preventing a large tax increase and the expiration of unemployment benefits. These measures are scheduled to expire by the end of 2012 and most do not increase the deficit over the medium to long term. As the economy continues to recover and provisions of the Recovery Act and the December 2010 package expire, the deficit will narrow substantially.

Importantly, the United States remains committed to restoring its fiscal trajectory to sustainability in a manner that also avoids derailing the ongoing recovery. As a starting point, there is general consensus that deficits need to be reduced in a manner that stabilizes debt held by the public as a share of GDP by the middle of this decade and brings it down thereafter. The President and congressional leadership have both laid out plans that would achieve roughly $4 trillion in deficit reduction over the next 10-12 years. The specifics of how to achieve this are the subject of vigorous debate, centered in the near term around the need to raise the legal ceiling on U.S. federal government nominal gross debt before August 2. Both the President and the congressional leadership agree on the need to raise the ceiling, and it will be raised.

The current political debate over the specifics of a medium-term fiscal consolidation plan has touched on all elements of our long-term fiscal strategy – entitlements (both health care spending and Social Security), non-defense discretionary spending, defense spending, and revenues. The President has made clear that each of these elements is on the table, while emphasizing the importance of preserving key investments in infrastructure and education that underpin our long-run potential growth.

Monetary Policy

At its last meeting in June, the Federal Open Market Committee (FOMC) decided to maintain the target range for the federal funds rate at 0 to ¼ percent. The FOMC continues to anticipate that economic conditions – including low rates of resource utilization and a subdued outlook for inflation over the medium term – are likely to warrant exceptionally low levels for the federal funds rate for an extended period. While headline inflation has picked up in recent months, this mainly reflects higher prices for some commodities and imported goods, as well as recent supply chain disruptions. Longer-term inflation expectations have remained stable.

In November 2010, the FOMC decided to expand its holdings of securities, announcing its intent to purchase a further $600 billion of longer-term Treasury securities by the end of the second quarter of 2011. At its June meeting, the FOMC confirmed that it would complete these purchases at the end of the month and that it would maintain its existing policy of reinvesting principal payments from its securities holdings. Going forward, the FOMC will regularly review the size and composition of its securities holdings and is prepared to adjust those holdings as appropriate.

Financial Sector Repair and Reform

Repair and reform of the financial sector has made great progress in recent years. The Supervisory Capital Assessment Program (SCAP) stress tests of 2009 appear to have been a turning point. Since 2008, the 19 firms in the SCAP process have together increased common equity by more than $300 billion, with the average level of common equity to risk-weighted assets above 10 percent, much higher than before the crisis. Leverage has also fallen, and funding profiles are more conservative. The Troubled Asset Relief Program (TARP) has wound down, with the Treasury currently estimating that the bank programs within TARP will ultimately provide a lifetime positive return of approximately $20 billion.

The enactment of the Dodd-Frank Act one year ago represented a major shift in the nature of U.S. financial regulation and supervision, and regulators have made great progress in its implementation, though completing this will take more time. Importantly, implementation is either underway or completed in 32 of the 33 key recommendations from the 2010 FSAP.

One of the crucial developments over the past year is the establishment of the Financial Stability Oversight Council (FSOC). The FSOC brings together our financial regulators and other experts on a regular basis to identify – and respond to – threats to financial stability. One vital function of the FSOC is to identify non-bank financial companies and financial market utilities that could pose a threat to financial stability and designate them for heightened prudential oversight. The FSOC is currently seeking public comment on proposed rules for identifying such non-bank financial companies and approved at its July 18 meeting a final rule for designation of financial market utilities.

Our authorities recognize that the U.S. housing finance system remains overwhelmingly dependent on the government and understand the need for reform. Earlier this year, the Administration laid out a plan to transform the role of government in the housing market. Under this plan, private markets would be the primary source of mortgage credit and bear the burden for losses. The role of the government-sponsored enterprises (GSEs) would be responsibly reduced and, ultimately, Fannie Mae and Freddie Mac would be wound down. The plan presents three possible proposals for structuring the government's long-term role in the housing finance system. The Administration continues to discuss options with Congress and the public.

Financial regulatory reforms must be internationally coordinated, lest opportunities for international regulatory arbitrage allow financial institutions engaged in the riskiest activities to migrate to jurisdictions with the least oversight. To this end, our authorities are actively engaged in and, as the staff urge, leading discussions in the G-20, FSB, Basel Committee, and elsewhere to help shape the international financial regulatory environment. We strongly support Basel III, the core elements of a new global capital standard, and are committed to implementing it on schedule. We also welcome the Basel Committee's recent agreement on a capital surcharge for SIFIs.

Similarly, a global approach is needed for oversight of the over-the-counter (OTC) derivatives market, a core element of which should be the requirement that standardized derivatives are centrally cleared and traded on exchanges or electronic platforms. All OTC derivative contracts should be reported to trade repositories, and non-centrally cleared contracts should be subject to higher capital requirements. In addition, global standards should be developed for margin requirements for uncleared derivatives transactions.

Pilot Spillover Report

The United States can make its most positive contribution to the health of the global economy by: (1) supporting the long-term growth potential of the U.S. economy; (2) doing its part to foster global rebalancing, which includes a medium-term fiscal consolidation; and (3) strengthening financial sector regulation. No country would gain if the U.S. economy were to fall back into another recession.

The pilot spillover report concludes that actual purchases of securities by the Federal Reserve, as part of its large-scale asset purchase programs, did not appear to affect capital inflows to emerging markets. While these asset purchase programs are a less conventional means of conducting monetary policy than the more familiar approach of managing short-term interest rates, the goals and transmission channels are actually very similar. To the extent that these policies have affected longer-term interest rates in the United States, they have played some role in widening interest rate differentials, which may influence *cyclical* capital flows, both to advanced economies or emerging markets (EMs). But a substantial part of capital flows to EMs appears to be of a *structural* nature, reflecting the improved macroeconomic stability of EMs and their favorable long-term growth prospects. Irrespective of U.S. monetary policies, these flows are likely to persist. As the pilot spillover report points out, other countries have macroeconomic tools at their disposal to help manage inflows.

We do not see any current evidence of higher U.S. borrowing leading to "crowding out," with short- and long-term U.S. interest rates at historically low levels. If U.S. fiscal policy is not currently having a material impact on U.S. interest rates, it would be unlikely to have much impact on foreign interest rates. In the short run, U.S. fiscal consolidation would do little to lower U.S. interest rates or those in the rest of the world. To the extent that fiscal consolidation were too frontloaded and severely impacted U.S. growth, the impact on the rest of the world through both trade and financial channels could sizeable. We agree that in the long run, a lack of U.S. fiscal consolidation would likely drive up real interest rates in the United States and the rest of the world.

We agree that strong implementation of the Dodd-Frank Act – which gives U.S. regulators the authority to subject all major financial institutions operating in the United States to comprehensive, consolidated supervision – will be essential to contain negative spillovers from the U.S. financial sector. With regard to broker dealers, we note that no major U.S.-owned broker dealers remain (Goldman Sachs and Morgan Stanley are registered as bank holding companies and subject to consolidated regulation by the Federal Reserve) and that nearly all major banks – whether U.S. or foreign – are engaged in investment banking activities. There is a strong case for prudential monitoring of all global banks' investment banking activities, and we are committed to working with our international partners to promote this.

In general, we have reservations with the pilot spillover report's central claim that spillover effects from financial market linkages far exceed those from the real economy, as transmitted through trade linkages. Financial markets, by their nature, do an excellent job of summarizing consumer and business sentiment and expectations. Event studies, which attempt to quantify the impact of U.S. policy announcements on asset prices at a single point in time, may not provide a full picture of the international impacts of underlying policies. We would also caution against drawing hard conclusions regarding the reasons for financial market movements at any particular point in time.