BUFF/ED/12/119

July 25, 2012

Statement by Ms. Lundsager and Mr. Lindquist on United States
Executive Board Meeting
July 30, 2012

The U.S. economy continues to recover from the worst recession since the 1930s. After decisive fiscal, monetary, and financial policy actions pulled the economy back from the severe recession, the ensuing recovery has produced moderate yet steady growth, notwithstanding considerable headwinds at home and abroad. The United States will continue to support the recovery through appropriately accommodative monetary policies, while pursuing a balanced approach to fiscal adjustment that will seek to maintain near-term economic momentum while restoring fiscal sustainability in the medium term.

Our authorities appreciate the dialogue with the staff and broadly agree with the main messages of the staff report. They also view the staff's policy recommendations as broadly in line with the Administration's policy agenda.

Overall Economic Outlook

The U.S. economy has grown at a slower pace recently, due in large part to headwinds from the crisis in Europe, the aftereffects of the rise in oil prices earlier this year, and a significant drop in the level of government spending. However, most economists still expect the economy to strengthen gradually in the near term and to make further progress repairing the damage from the global financial crisis. According to the July Blue Chip consensus forecast, growth should pick up in the second half of the year, with recent declines in energy prices providing some boost to household purchasing power. Real GDP growth for the year as a whole is projected to be roughly half a percentage point stronger than during 2011. In the near term, the biggest risks to the outlook are spillovers from the euro area crisis and the potential for abrupt and excessive U.S. fiscal consolidation in 2013.

With respect to labor markets, we believe that the bulk of high U.S. unemployment is cyclical. An accelerated pace of growth is necessary for significantly stronger job creation and further declines in the unemployment rate. Thus, the priority has been to support the recovery in private demand using monetary policy tools and fiscal levers such as the payroll tax cut and extended unemployment benefits. The Administration is also pursuing active labor market policies that can help prevent a loss of skills and guard against an increase in structural unemployment.

Fiscal Policy

The Administration is pursuing a balanced approach to restoring fiscal sustainability with three main objectives: (1) to support near-term economic growth; (2) to adopt a balanced medium-term plan to restore fiscal sustainability; and (3) to bolster public investments in infrastructure, education, and research that will underpin the strength of the U.S. economy in the long run. Over the medium term, the goal is to reduce the federal budget deficit to less than three percent of GDP by 2018, to place debt on a declining path as a percentage of GDP, and to return the federal budget to primary balance.

The agreement between the President and Congress to raise the debt ceiling last summer produced the Budget Control Act, which provided for spending cuts of about $1 trillion over ten years, while creating a special bipartisan Congressional "supercommittee" to identify measures to reduce deficits by an additional $1.5 trillion over ten years. The Act mandated that, in the event of Congressional inaction, automatic spending cuts would be triggered starting in 2013. These cuts – divided equally between defense and non-defense discretionary programs – would reduce the deficit by an additional $1.2 trillion over ten years.

The combination of the scheduled enactment of these spending cuts, the expiration of the previous personal income and payroll tax cuts, and other measures are the origin of the so-called "fiscal cliff" at the end of this year. There is broad agreement on the need to alleviate the sharp withdrawal of fiscal support implied by current law while sustaining medium-term consolidation. In addition, Congress has always acted to increase the debt ceiling when necessary, and with the consequences of failing to act clear, we can be confident that it will be raised again in a timely manner.

Housing Outlook and Policies

Conditions in the housing sector appear to be improving, with housing starts and home sales trending higher since last summer, supported by record-high levels of housing affordability and historically-low mortgage rates. The inventory of homes on the market has been shrinking, and consumer and home builder sentiment has improved. Residential investment has now contributed positively to real GDP growth for four straight quarters. Nevertheless, housing activity remains at a low level and continues to face headwinds from tight credit conditions, a large stock of homes in foreclosure, and the high level of unemployment.

U.S. housing policies have continued to expand over the past three years to fit changing circumstances, building on the experience of the early responses to the crisis. The Administration is working with Congress and the Federal Housing Finance Agency (FHFA), the GSEs' conservator, to enable the broadening of programs to support additional refinancing activity and mortgage modification. At the same time, our authorities would caution that housing policy tools are unlikely to be a panacea.

Monetary Policy

The Federal Open Market Committee (FOMC), at its last meeting in June, decided to maintain the target range for the federal funds rate at 0 to ¼ percent. In January, the FOMC extended its forward guidance on policy rates, noting that it expected that economic conditions were likely to warrant exceptionally low rates for the federal funds rate at least through late 2014. The FOMC maintained this conditional forward guidance at its subsequent meetings.

In September 2011, the FOMC decided to extend the average maturity of the securities in the Federal Reserve's portfolio by purchasing longer-term Treasury securities while selling an equal amount of shorter-term Treasury securities. The goal of this action has been, by reducing the supply of longer-term Treasury securities in the market, to put downward pressure on longer-term interest rates, including rates on financial assets that investors consider to be close substitutes for longer-term Treasury securities. At its June meeting, the FOMC decided to extend this program through the end of 2012.

Financial Sector Reform

Two years since the enactment of the Dodd-Frank Act, U.S. regulators have made great strides in its implementation, though completing this will take more time. A major shift in the nature of financial regulation and supervision in the United States is underway, and agencies continue to work to enhance the safety and stability of the financial system.

Since the financial crisis, U.S. banks have made considerable progress in repairing their balance sheets and rebuilding capital. The banks that participate in the Federal Reserve's Comprehensive Capital Analysis and Review (CCAR) have increased their Tier 1 common equity – the best buffer against future losses – by more than $300 billion since 2009 to nearly $760 billion, reaching a Tier 1 common equity ratio of 10.5 percent of risk-weighted assets at the end of 2011.

The Financial Stability Oversight Council (FSOC) continues to strengthen as an institution that allows U.S. regulators and policymakers to discuss and respond jointly to potential threats to financial stability. Dodd-Frank charges the FSOC with critical rulemaking duties, including the designation of non-bank financial companies that will be subject to enhanced prudential standards and supervision by the Federal Reserve. On July 18, the FSOC finalized the designation of eight payment, clearing, and settlement systems as systemically-important financial market utilities, which will subject them to heightened risk management standards and require more coordinated oversight. Regulators are also considering how to enhance the stability of money market funds (MMFs), and the Chairman of the Securities and Exchange Commission (SEC) has recommended a number of reforms, including: (1) a mandatory floating net asset value; and/or (2) a capital buffer to absorb losses, possibly combined with a redemption restriction to reduce the incentive to exit a fund.

Regulators are working to implement Dodd-Frank's "Volcker Rule," which generally prohibits deposit-taking banks from engaging in proprietary trading or owning, sponsoring, or having certain relationships with hedge funds or private equity funds. The five relevant rulemaking agencies have issued a proposed rule which includes definitions of market making, underwriting, and risk-mitigating hedging activities that would be exempt from restrictions. Regulators are reviewing the thousands of comment letters received and are considering these comments, including those related to the international implications of the proposed rule.

Dodd-Frank requires the mandatory clearing of derivatives transactions through regulated central clearing organizations and that derivatives be traded through regulated exchanges. Most of the necessary rules to implement comprehensive oversight of derivatives markets should be finalized this year. For these reforms to have their full effort, international coordination is necessary, and the United States is working to promote progress at the global level.