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Statement by Mr. Haarsager and Mr. Weiss on United States
Executive Board Meeting
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The United States' recovery from its worst downturn since the Great Depression continues and is expected to strengthen over the coming year. While growth in the first quarter was weak due to largely transitory factors, including an unusually harsh winter, economic indicators point to the strength of our recovery. Over the past 52 months, U.S. businesses have created over 9.7 million jobs, the longest streak of consecutive job growth on record. The expansion is expected to strengthen further this year as private sector demand increases, fiscal drag lessens, and household balance sheets and the housing market continue to improve. Healthy growth for the rest of the year will be supported by accommodative monetary policy, a significant reduction in fiscal drag, and robust employment gains and we note the staff's projection for a return next year to the fastest pace of growth since 2005. Ongoing banking sector repair and further progress implementing the regulatory reform agenda is also helping to support growth while promoting greater financial stability.

We thank the staff for their dialogue with our authorities and are in general agreement with most of their analyses and policy recommendations. We also thank the staff for their in-depth Selected Issues Papers, which helpfully illuminate a number of important issues facing the United States.

ECONOMIC OUTLOOK

The first quarter of 2014 was unusually weak, but this was largely driven by transitory factors – in particular, an exceptionally harsh winter, a sharp decline in exports, and a large inventory overhang – that do not change the strong foundations for recovery. These include rising household wealth, a gradual housing market recovery, further easing of credit conditions, and an improving global growth outlook. Private demand has been bolstered by policy actions, including continued highly accommodative monetary policy and diminished fiscal drag at the federal, state, and local levels, most notably actions that reversed much of the drag from the sequester that challenged growth in 2013.

Incoming data suggest that the economy will return to a healthy pace of recovery over the rest of 2014. Real consumer and capital spending appear to have picked up in the second quarter. New and existing home sales rose in May (with the former at a post-recession high), as did industrial production. Manufacturing surveys over May and June suggest an increased pace of business activity, while motor vehicle sales were at an eight-year high in June. We are encouraged that the Fund staff also expects a post-Q1 rebound over the remainder of the year, with a return to much stronger growth in 2015. Our authorities anticipate growth of 3.5 percent in 2015, higher than the staff's forecast of 3.1 percent and some private forecasters' projections of 3.0 percent.

A pickup in activity is also suggested by the continued improvement in the U.S. labor market, although slack remains. Nonfarm payrolls increased by 288,000 jobs in June, well above market expectations and up by 9.1 million jobs since early 2010. This helped lower the unemployment rate to 6.1 percent, its lowest level since September 2008. Moreover, the long-term unemployment rate fell to its lowest level in over five years. However, both of these measures remain too high, and the labor force participation rate, while stabilizing in recent months, is still low. Our authorities' proposed policies to support the labor market are in line with the staff's recommendations and would help to decrease long-term unemployment and raise labor force participation, per the staff's Selected Issues Paper (although, as the staff point out, much of the labor force participation rate decline was occurring before the recession and driven by structural factors). These include policies to support working parents, improve job training and apprenticeship programs, and expand the Earned Income Tax Credit (EITC). Our authorities also support comprehensive immigration reform, which could boost the size of the labor force.

The staff's report indicates that potential growth in the United States has fallen since the crisis, driven by the recession-related rise in long-term unemployment and sector-driven trends that predated the crisis, notably slower productivity growth. The labor policies discussed above would help to enhance both the size and the quality of our labor force and raise potential growth over the longer term. Our authorities' policy agenda includes a number of other measures to raise potential growth, including its infrastructure investment initiative aimed at increasing the capital stock; increased spending on education and training and research and development; and tax incentives such as the research and experimentation tax credit. In addition, potential growth will benefit as business fixed investment gains a more solid footing, generating a faster increase in the capital stock and hence flow of capital services.

The elevated poverty levels since the recession, highlighted by the staff, are a serious concern to our authorities. Last year, our authorities reintroduced the EITC for those in lower income brackets. Our authorities have also proposed further expanding the EITC to childless earners and raising the minimum wage (which would also boost near-term aggregate demand). In addition, a number of states are considering optional Medicaid expansion in the context of the increasing success of the Affordable Care Act (ACA). So far, 26 states and the District of Columbia have voted to expand the program.

FISCAL POLICY

Our authorities acted late last year, and earlier this year, to reduce fiscal drag and policy uncertainty in the near term: The Bipartisan Budget Act of 2013 set funding levels for the federal government through the end of FY 2015 and replaced much of the automatic budget cuts that had been set to occur for the next two years under sequestration. Our authorities estimate that fiscal drag will fall from between 1.5 to 1.75 percentage points of GDP in 2013 to 0.25 percentage points of GDP this year. In January, Congress passed a bill to fund the federal government through the rest of FY 2014, while in February agreement was reached to extend the debt ceiling through March 15, 2015.

Our authorities have achieved significant deficit reduction in recent years, with an adjustment from 10 percent of GDP at the height of the crisis to a projected 2.9 percent in FY 2015. Going forward, our authorities are also working to ensure long-term fiscal sustainability and put the debt ratio on a declining path. President Obama has proposed a budget in which annual deficits fall gradually through FY 2018 (to 2.2 percent of GDP) and, by the end of the forecast horizon in 2024, are at their lowest level (2.1 percent of GDP) since 2007. Along similar lines, debt held by the public would peak at nearly 75 percent of GDP over the next year and fall to 72 percent over the next 10 years.

The President's budget would increase revenues through higher growth and tax reforms. It proposes $1.8 trillion in new revenues, including a limit on high-income tax expenditures and higher tax rates for wealthy individuals. It also proposes $400 billion in spending reductions, including on overseas defense spending (allowing non-defense discretionary budget authority caps to be raised) and net interest, and proposes closing tax loopholes and achieving savings in mandatory spending.

Continued ACA implementation, which remains in its early stages, will also contribute to deficit reduction, and the President's budget proposes additional healthcare measures. The rate of healthcare cost increases has been declining in line with utilization rates and full ACA implementation should have a significant further cost impact.

MONETARY POLICY

Monetary policy continues to support the recovery. In December 2013, the Federal Open Market Committee (FOMC) saw improved economic activity and labor market conditions consistent with growing underlying strength in the economy and ongoing progress toward its objectives of maximum employment and stable prices. As such, it began modestly reducing the pace of its asset purchases and has done so at each of its subsequent meetings. However, it also reaffirmed its highly accommodative stance given still-recovering employment and inflation running below its longer-run goal of 2 percent. Asset purchases continue, albeit at a lower rate of, currently, $35 billion per month. At its last meeting in June, the FOMC confirmed that it likely will be appropriate to maintain its current target range for the federal funds rate (0 to 0.25 percent) for a considerable time after its asset purchase program ends, particularly if inflation continues to run below its 2 percent goal and inflation expectations remain well-anchored.

We appreciate staff's in-depth focus on the Federal Reserve's communications policy and welcome their finding that qualitative forward guidance has lowered uncertainty about the inflation outlook. The Fed has made significant changes in communicating its policy intentions in recent years and is focused on conveying as clearly as possible its policy intentions and the conditional nature of its policy. Improved communication should help reduce any negative spillover effects of policy decisions. At the same time, as staff notes, higher growth in the United States will have positive spillover effects on the rest of the world. Additional innovations in communication, as suggested by staff, can present significant challenges given the large and diverse nature of the FOMC and the value of retaining flexibility in decision making.

Our authorities are acutely aware of the potential risks posed to financial stability in the context of prolonged low interest rates and currently low volatility and risk spreads. Nonfinancial credit growth remains moderate while financial system leverage and reliance on short-term wholesale funding are significantly lower than before the crisis. However, there are pockets of vulnerability that are being closely monitored by the Federal Reserve and other regulators. Since the crisis, the Federal Reserve has greatly increased its monitoring of threats to financial stability, has frequently communicated its views on financial stability issues, in conjunction with other agencies on the Financial Stability Oversight Council (FSOC), and is working to refine its macroprudential policy approach to address these risks as necessary. In the United States, macroprudential tools have been utilized, for example, via capital surcharges for systemically important institutions and stress tests that require large financial institutions to maintain sufficient capital to weather shocks.

The staff's report also highlights some of the issues to be considered with regard to the Fed's operational framework during the period of policy normalization and over the longer run. The FOMC is currently considering a broad range of normalization issues and has indicated that it will provide additional information to the public later this year. It has also emphasized that this work is being undertaken as a matter of prudent planning and does not indicate a change in the FOMC's policy intentions.

FINANCIAL SECTOR

The U.S. financial sector has become sounder and stronger since the crisis. Banking institutions are carrying more and higher quality capital, are more liquid, and have lower leverage. While the Fed's 2014 stress tests identified concerns over internal controls at a few banks, as noted in the staff's report, it also found that the largest banking institutions in the United States are collectively better-positioned to continue lending and meeting their financial commitments in an extremely severe economic downturn than they were five years ago, reflecting continued broad improvement in their capital positions. Bank credit has grown as the economy has improved, better supporting consumption.

Our authorities continue to make strong progress on the regulatory reform agenda, and we welcome the staff's assessment that this has not led to fragmentation within the global financial system. U.S. banking agencies have finalized Basel III rules, including a much higher leverage ratio for U.S. global systemically important banks (G-SIBs) than the Basel III standards. The United States continues to lead the way in implementing derivatives reform, with clearing and reporting requirements for interest rate and credit default swaps currently in place and more than 100 swap dealers registered. Our authorities have also taken significant steps to address potential risks in the shadow banking system, including those posed by money market mutual funds, securitization activities, and the tri-party repo market, though more work remains to be done. The Volcker Rule was finalized in December 2013, incorporating thousands of public comments to help achieve the rule's objective of restricting risky proprietary trading and investment activities by banks. Our authorities have made significant progress implementing orderly liquidation authority, and continue to work with our international colleagues to achieve better coordination. And a rule was adopted to ensure that large foreign banking organizations operating as subsidiaries in the United States are sufficiently capitalized.

The FSOC has the authority – which it has used – to designate nonbank financial companies for consolidated supervision and enhanced prudential standards by the Federal Reserve. The FSOC has also issued four annual financial stability reports, with recommendations supported by all members. The Office of Financial Research, also established by the Dodd-Frank Act, has proven invaluable in working to more closely identify systemic risks and potential regulatory gaps.

The U.S. housing market continues to gradually recover, despite some weakness related in part to the first quarter's unusually harsh winter weather, with prices increasing and inventory rising. Our authorities are working to boost mortgage access for creditworthy borrowers, in part, by moving to clarify practices and standards related to credit (such as put-back risk).

INTERNATIONAL OUTLOOK

The U.S. external position remains stable. Some recovery in foreign demand led to a strong export performance in late 2013, and lower oil imports and higher domestic energy output and efficiency continue to contain the energy deficit. However, the growth slowdown in emerging markets, and continued insufficient demand in Europe, mean that this pattern may not be sustainable. Asian and some European current account surpluses are still far too high. In short, much of the progress to date, on global rebalancing, has been driven by demand compression, not by strong, sustainable, and balanced growth.

A structural global rebalancing requires steps to stimulate demand in current account surplus countries; internal rebalancing within the euro area, where very low inflation poses a significant risk to global stability; and more exchange rate flexibility in some Asian economies.

Open trade and investment policies promote strong, balanced global growth and foster the product market flexibility that facilitates macroeconomic adjustment. To this end, the United States will continue to pursue trade liberalization through high-quality bilateral, regional, and multilateral trade agreements. Our authorities also remain firmly committed to resisting protectionism and promoting the multilateral, rules-based trading system.

We welcome the inclusion of the U.S. country page from the External Sector Report (ESR) in the staff report (Annex IV). We encourage the staff to adopt this as standard policy in Article IV reports for all countries included in the ESR.