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Statement by Mr. Sobel and Ms. Douglass Kochman on United States
Executive Board Meeting
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The U.S. economy remains on a solid footing and underlying fundamentals support above-trend growth going forward. Notwithstanding a slight contraction in the first quarter due in large part to transitory factors, the momentum behind the U.S. recovery continues, underpinned by consumption buoyed by robust job growth, wealth effects and improved household balance sheets, a firm housing market outlook, and a broadly neutral fiscal stance. External factors, including the lack of robust global growth, pose a downside risk to the recovery, as growth is being restrained by a significant drag from net exports.

In 2014, our economy achieved a number of important milestones. We added more jobs than any year since the late 1990s, building on five years of private sector job growth, driven by the manufacturing sector. The U.S. is producing more oil than it imports for the first time in two decades and is now the world's leading producer of petroleum and natural gas.

After fiscal policy played a supportive role at the outset of the crisis, the federal deficit has improved considerably, exhibiting the largest five-year decline since the demobilization from World War II. Inflation remains below the Federal Open Market Committee's (FOMC) longer-run objective, partly reflecting earlier declines in energy prices and decreasing prices of non-energy imports. The FOMC continues to judge that the first increase in the federal funds rate will be appropriate when it has seen further improvement in the labor market and is reasonably confident that inflation will move back to its 2 percent objective over the medium term.

Growth and financial stability have been supported by measures taken since the crisis to provide a credible and transparent assessment of our financial system's weaknesses and implement regulatory reform. We welcomed the opportunity to engage with the staff in the context of the Financial Sector Assessment Program. The Dodd-Frank Act (DFA) celebrates its fifth anniversary this month and has already transformed and strengthened the U.S. financial regulatory landscape. We will continue to finalize its implementation, while remaining vigilant about emerging risks.

We thank the staff for their dialogue with our authorities and are in general agreement with many of their analyses and policy recommendations. We also thank them for their thoughtful working papers and Selected Issues Paper, which explore a number of issues relevant to the U.S. economy.

ECONOMIC OUTLOOK

The U.S. economy appears to have entered a period of self-sustaining growth. While the economy contracted by 0.2 percent in the first quarter of 2015, activity was held back by transitory factors, including harsh weather, the West Coast ports labor dispute, a drop in business investment for oil exploration in response to low oil prices, and a decline in U.S. exports.

Nevertheless, the economy remains on solid footing. Consumer spending growth appears to have accelerated to a 2.5 to 3 percent annual rate in the second quarter. Consumer confidence is near its highest levels since 2007, before the recession, as labor market conditions continue to improve and stronger household balance sheets are underpinning disposable income. Nonfarm payroll employment rose 280,000 in May, accelerating from April and March, with a total of 12 million jobs added since early 2010. The unemployment rate was 5.5 percent in May, just 0.1 percentage point higher than the seven-year low reached in April as more workers joined the labor force; and the labor force participation rate has stabilized – albeit at a relatively low rate. Household debt as a share of disposable income is near a thirteen year low, while net worth has risen 54 percent from its 2009 low and is about $17 trillion above its peak in second quarter 2007.

The pace of business investment has been modest during this recovery as firms have held large amounts of cash, suggesting they may have lacked sufficient confidence in the strength and durability of the recovery to undertake substantial capital expenditures. However, as recovery takes hold, there is substantial room for strengthening. As the staff report notes, investment in the energy sector, in particular, has fallen in 2015 much faster and more significantly than many expected.

INTERNATIONAL OUTLOOK

The U.S. economy is helping propel economic expansion globally. But the rest of the world should not depend on the United States to be a key engine of growth. In this light, we are not persuaded by staff's characterization that global adjustment of exchange rates has represented a warranted shift of demand, in particular to large surplus countries that are threatened by deflation and stagnation. Staff projects net exports will subtract nearly three-quarters of a percentage point from GDP growth this year and a medium term widening in the current account deficit reflecting global growth differentials. In our view, the first-best outcome for the global economy and the U.S. economy would be further efforts to lift overall global growth by strengthening domestic demand, especially in surplus economies, rather than continued reliance on external demand. The U.S. cannot be the importer of first and last resort, or a "sponge" for the global economy as our authorities stated during the Article IV consultations.

FISCAL POLICY

In the wake of the crisis, fiscal policy was targeted at supporting near-term growth and job creation. As the economy found its footing, measures were taken to reduce spending and increase revenue, although these actions had a more immediate impact than desired at the time. Nevertheless, combined with rising growth, they helped set in motion the fastest pace of U.S. fiscal consolidation in more than 60 years, reducing the deficit from a peak of 9.8 percent of GDP in 2009 to 2.8 percent of GDP in FY 2014, its lowest share since 2007. Private sector estimates point to further reductions this year in the deficit. This progress reflects the effects of both legislation and economic growth.

After this considerable reduction in the federal fiscal deficit, fiscal policy is no longer a drag on economic activity. Further, over the past year, we have seen real progress in returning to regular order in conducting fiscal policy. The Bipartisan Budget Act of 2013 reversed a portion of sequestration and allowed for higher investment levels in 2014 and 2015. The Administration's FY 2016 Budget would lower the deficit to a sustainable level and put debt as a share of GDP on a declining path as early as next year, while envisioning a fully paid-for increase in the discretionary budget caps to make room for a range of investments, including in education, job training, research, manufacturing, and infrastructure.

The Administration's FY 2016 Budget includes a set of detailed business proposals that would close loopholes and provide incentives for growth in a fiscally responsible manner. These proposals would simplify compliance and provide tax relief to small businesses, and provide incentives for manufacturing, research, clean energy, regional growth, and infrastructure. The proposals also would eliminate fossil fuel preferences, reform the taxation of financial and insurance products, and close loopholes in and fundamentally reform the U.S. international tax system. One of the principal proposals would impose a one-time transition toll charge on untaxed foreign earnings that U.S. companies have accumulated overseas, which would raise enough revenue to fill the projected shortfall in the Highway Trust Fund and make new investments as part of the President's six-year surface transportation reauthorization.

We appreciate the report's attention to the policy agenda in areas affecting long-term growth. The issues of poverty and inequality are important ones, as the benefits of growth are not being shared by all Americans. The Administration's FY 2016 budget would simplify and expand child care tax benefits; enhance educational opportunities by partnering with states to make community college and career and technical schools free for responsible students; expand education tax incentives; make it easy and automatic for workers to save for retirement; and raise the minimum wage.

Looking forward, the deficit is forecast to decline slightly further on net over the next few years, stabilizing at 2.5 percent over the latter half of the 10-year budget window. At the same time, our ongoing growth-oriented investments will help enhance the sustainability of the public debt ratio by boosting the denominator. Debt would stabilize at 75 percent of GDP in the current fiscal year and decline slightly over the next ten years.

MONETARY POLICY

On June 17, the FOMC reaffirmed the current 0 to 0.25 percent target range for the federal funds rate. Inflation continues to run below its longer-run objective, but some of the downward pressure resulting from earlier sharp declines in energy prices is abating. The FOMC continues to indicate that the first rate increase will be appropriate when it has seen further improvement in the labor market and is reasonably confident that inflation will move back to its 2 percent objective over the medium term.

In regard to the timing of policy normalization, Fund staff expresses the view that it is preferable to move later, rather than too early. The FOMC has emphasized repeatedly that it will determine the timing of the initial increase in the federal funds rate on a meeting-by-meeting basis, depending on its assessment of incoming economic information. More fundamentally, while the timing of the first rate hike receives a lot of attention, the path of subsequent policy rate changes is of greater importance. Indeed, the stance of monetary policy will likely remain highly accommodative for quite some time after the initial increase in the federal funds rate in order to support continued progress toward the objectives of maximum employment and 2 percent inflation.

Effective communications have been a cornerstone of the FOMC's approach. The Federal Reserve has been and remains committed to communicating as clearly and effectively as possible to help mitigate the risk of sudden changes in the policy outlook among market participants that could spur unintended effects in global financial markets. In terms of potential spillovers, staff rightly emphasizes that higher interest rates that are driven by a robust economy moving closer to maximum employment should be a positive force for the world economy.

When considering staff's recommendations on communications more generally, such as more press conferences and a quarterly monetary policy report, it is important to note that the Federal Reserve already has at its disposal many avenues of communication. These include the issuance of the Summary of Economic Projections four times per year, press conferences by the FOMC Chair four times per year, and publication of the monetary policy report twice yearly, as well as speeches and testimony by Federal Reserve officials. Building consensus around an FOMC-endorsed forecast, as staff recommends, would be practically challenging given its 19 members and their varying views. Such an approach risks eliminating the richness of information currently provided on the diversity of views within the FOMC.

We appreciate the staff's thoughtful consideration of the role for monetary policy in promoting financial stability but agree that it faces significant limitations in this respect. Its effects on financial vulnerabilities are not well understood and are less direct than a regulatory or supervisory approach. Further, efforts to promote financial stability through adjustments in interest rates would increase the volatility of inflation and employment.

FINANCIAL SECTOR

In undertaking the FSAP, the Fund rightly holds the United States to the highest and most stringent standards, given the complexity, maturity, and systemic importance of our financial sector. Despite this higher standard, the assessment found the U.S. regulatory system to be very strong and, in many ways, more rigorous than international standards.

We agree with staff's conclusion that with a strengthened capital position, less leverage, and more liquid assets, the U.S. banking system appears resilient to a range of extreme market and economic shocks. Staff also notes that federal banking agencies have improved considerably in effectiveness and achieve a high degree of compliance with international standards. Global and domestic reforms, particularly the DFA, have increased the intensity of supervision and the resilience of our financial system. All banks are required to hold significantly more capital, with higher standards applied to the largest, most systemically important firms. Large institutions have also been required to substantially increase their liquidity. Substantial improvements have been made in risk management and the oversight of large bank organizations by putting enhanced emphasis on banks' capital planning, stress testing, and corporate governance. The U.S. not only meets many Basel III requirements, as reflected in the FSAP, but significantly exceeds some of the most important ones for our largest, most global, systemic bank holding companies, especially those related to capital, leverage, and liquidity.

Taking into account the lessons from the crisis, we have built on the FDIC's world class resolution framework for banks and, as staff concludes, we have significantly strengthened our resolution framework to help end too-big-to-fail. One of the DFA's key reforms is the Orderly Liquidation Authority (OLA), which under certain conditions allows regulators to take over a failing financial company and wind it down in an orderly manner. We found the process underpinning the Technical Note on the Key Attributes for Effective Resolution especially valuable, as it generated feedback to enhance the ongoing development of the assessment methodology, while staff concluded that our resolution regime as set out in OLA and the Federal Deposit Insurance Act is in broad conformity with the FSB Key Attributes.

As staff emphasizes, the U.S. remains at the forefront of international policymaking in matters pertaining to bank resolution. The FDIC and Bank of England developed a "Single Point of Entry" strategy, which is a top-down approach that reduces the incentives of host countries to ring fence assets and promotes financial stability by allowing subsidiaries to continue operating. The U.S. helped lead the effort at the FSB to develop a new standard on total loss absorbing capacity for globally systemic important banks. Already, the Financial Stability Oversight Council (FSOC) recommended in its 2015 annual report that the U.S. authorities work to propose regulations regarding the maintenance of minimum amount of long term debt at the holding company level of systemically important financial institutions.

Like staff, we believe that the derivatives and securities regulatory and supervisory framework has improved considerably. We have led the way in implementing the G-20 Pittsburgh Summit commitments to clear, trade, and report OTC derivatives transactions. Mandatory reporting and trading requirements for certain OTC swaps are now in effect. Central clearing of credit derivatives by firms in the U.S. has grown from zero in 2009 to 81 percent in 2014. At the end of 2014, approximately 65 percent of interest rate swaps were cleared.

Market based financing makes our economy more resilient and dynamic because it provides a valuable alternative to bank funding. This strengthens the way that the financial system supports economic growth. At the same time, "shadow banking" can be a source of potential systemic risk and we remain vigilant about the migration of activities to the non-bank financial sector. The DFA has widened the perimeter of regulation to cover more market-based financing activities, and the FSOC has a thorough process for reviewing such risks and proposing remedies by the appropriate regulator or supervisor, if needed. The U.S. has taken regulatory action in relation to money market funds, securitization activities, and the tri-party repo market. The FSOC continues to analyze whether and how asset management products and activities could pose risks to U.S. financial stability. The SEC has expanded and deepened its oversight of the asset management industry to better identify, monitor, and evaluate risks and facilitate appropriate responses. Recent efforts have included developing recommendations to modernize and enhance data reporting; considering whether broad risk management programs should be required for mutual funds and ETFs to address risks related to their liquidity and leverage; and considering ways to implement the new requirements for annual stress testing by large investment advisers and large funds, as required by DFA. We welcome the FSB's continued work on developing policy recommendations aimed at further strengthening shadow banking into resilient market-based financing and this year's FSB-led peer review of shadow banking frameworks in member countries represents a notable milestone.

Staff underscores that the FSOC filled a major gap in our financial stability framework. Five years into its operations, it has made substantial strides in risk identification and designation and addressed data gaps. It has demonstrated a sustained commitment to working collaboratively to fulfill its statutory mission in a transparent and accountable manner. In response to stakeholder suggestions, it has adopted a number of policy and procedural changes over the past year, including supplemental guidance to the nonbank designations process, committee structure reforms, and transparency policy revisions.

Last year, regulators took steps to improve data scope, comparability, and transparency, including through a joint effort by the CFTC and Office of Financial Research to enhance the quality, types, and formats of data collected from swap data repositories. Recognizing that gaps remain, the FSOC recommended that regulators and market participants continue to work to improve data quality, access, and comprehensiveness and member agencies continue to explore best practices for data sharing and reporting efficiency.

We appreciate staff's attention to liquidity conditions, and the evolution of market structures deserves close attention. However, data do not reveal clear evidence of a widespread, substantial decline in market liquidity. Staff makes the case that new financial regulation has substantially reduced liquidity in many markets, but there are many other forces that need to be considered in order to mandate changing market dynamics, including the expansion of electronic trading, changing business models, and the risk appetite of broker-dealers, and other competitive and technological changes. Looking forward and consistent with periods preceding previous interest rate increases, it may be reasonable to expect a possible increase in market volatility as monetary policy conditions are normalized. Further, financial regulation has clearly made the system safer and more resilient.

We welcome staff's conclusions that the U.S. insurance system broadly indicates compliance with Insurance Core Principles; that insurance supervision has been significantly strengthened; and that many of the 2010 FSAP recommendations are being addressed. The FSOC has recommended that the Federal Insurance Office and state insurance regulators continue to closely monitor and assess the growing risks that insurers have taken by extending the duration of their portfolios and investing in lower-quality or less-liquid assets.

Finally, the Administration remains committed to long-term housing finance reform. In the absence of comprehensive legislation, we believe significant progress can be made administratively.