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IMF Country Report No. 04/230

United States: 2004 Article IV Consultation—Staff Report; Staff Supplement; and Public Information Notice on the Executive Board Discussion

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2004 Article IV consultation with the United States, the following documents have been released and are included in this package:

- the staff report for the 2004 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **June 11, 2004,** with the officials of the United States on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on June 28, 2004.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a staff supplement of **July 22, 2004** updating information on recent developments.
- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its July 23, 2004 discussion** of the staff report that concluded the Article IV consultation.

The document listed below have been or will be separately released.

Selected Issues Paper

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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INTERNATIONAL MONETARY FUND

UNITED STATES OF AMERICA

Staff Report for the 2004 Article IV Consultation

Prepared by the Staff Representatives for the 2004 Article IV Consultation
With the United States of America

Approved by Anoop Singh and Liam P. Ebrill

June 28, 2004

- ***The 2004 Article IV discussions took place in Washington, D.C. during May.*** The staff team comprised C. Towe (Head), T. Bayoumi, M. Mühleisen, C. Schnure, R. Cardarelli, and P. Rabanal (all WHD); H. Lankes and K. Alexandraki (PDR); R. Thorne (ICM); A. Bhatia, G. De Nicolo, and P. Hayward (MFD); and K. Ueda (RES). N. Jacklin and M. Lundsager, and A. Baukol, U.S. Executive Director, Alternate Executive Director, and Advisor, respectively, also attended the meetings.
- ***The Acting Managing Director Ms. Krueger, Mr. Singh (WHD), and Mr. Rajan (RES) took part in the concluding discussions with Treasury Secretary Snow and Federal Reserve Chairman Greenspan.*** The mission met with officials from the U.S. Treasury, the Federal Reserve Board, the Bureau of Economy Analysis, the Bureau of Labor Statistics, the Congressional Budget Office, the Employee Benefits Security Administration, the National Association of State Budget Officers, the Office of the Comptroller of the Currency, the Office of Management and Budget, the Office of the U.S. Trade Representative, and the Securities and Exchange Commission. The team also met with financial market participants and the Federal Reserve Bank of New York in March, and officials of the California state government and the Federal Reserve Bank of San Francisco in April.
- ***The 2003 Article IV consultation was concluded in July 2003 and the Staff Report was published as IMF Country Report No. 03/244.*** During the Board discussion, Executive Directors highlighted the valuable support that the U.S. economy had provided for global growth, but stressed the need for decisive action to be taken to re-establish a strong fiscal position to help strengthen national saving and prepare for the pressures of population aging. They urged the authorities to establish a credible fiscal framework with the clear objective of bringing the budget to balance, excluding Social Security, over the next five to ten years to provide room to phase in reforms needed to place retirement and health care systems on a sound financial footing. Directors commended the Federal Reserve for its aggressive response to the economic slowdown and also welcomed the considerable progress made toward strengthening the oversight of accounting and corporate governance. Directors also called upon the United States to continue to play a leadership role in promoting an open multilateral trading system, including by ensuring that efforts to promote bilateral and regional free-trade arrangements are complementary to the multilateral approach.
- ***The United States has accepted the obligations of Article VIII (Appendix I).*** Comprehensive economic data are available for the United States on a timely basis. The United States subscribes to the Fund's Special Data Dissemination Standard, and its metadata are posted on the Fund's Data Standards Bulletin Board (Appendix II). A fiscal ROSC was completed in the context of the 2003 consultation. Appendix III contains fiscal and external sustainability calculations.

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I. Introduction and Executive Summary

State of the economy

1. ***The 2004 consultation discussions took place against increasing signs that the recovery was becoming self-sustaining.*** Although the 2001 recession was relatively shallow, it was followed initially by an unusually tepid recovery, as a series of negative shocks offset unprecedented fiscal and monetary stimulus. Nonetheless, labor productivity growth remained remarkably robust and an increase in the momentum of the recovery over the last year has been followed more recently by a long-awaited improvement in employment growth. A pickup in price pressures also appears to have fully erased earlier deflation fears.

Policy stance

2. ***As a result, the focus of both monetary and fiscal policies has shifted toward consolidation.*** After commendably aggressive and effective action to address the deflation risks that emerged last year, the monetary authorities have now clearly signaled that stimulus will be withdrawn soon, albeit at a measured pace. While emphasizing a commitment to make recent tax cuts permanent, the FY 2005 budget also aimed to halve the budget deficit over the next five years, largely through significant spending restraint.

Discussions

3. ***Against this background, the policy discussions focused on how to manage the withdrawal of stimulus and ensure long-run fiscal sustainability, in particular:***

- ***Restoring a sustainable fiscal position.*** With entitlement programs significantly underfunded and an external current account deficit of 5 percentage points of GDP, early steps are needed to establish a credible plan to restore fiscal surpluses and reform health and retirement programs.

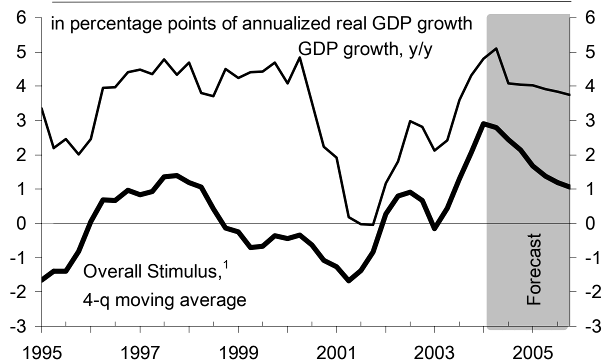
- ***Ensuring an orderly withdrawal of monetary stimulus.*** Having successfully forestalled earlier deflation risks, the challenge is now to return interest rates to neutral levels without disrupting financial markets or kindling inflation.

- ***The global ramifications of the U.S. economy and policies.*** The U.S. recovery has led the global upturn; looking ahead, key issues include the impact of monetary policy tightening on exchange rates and global borrowing conditions, including in emerging markets, and the spillover effects of U.S. fiscal policy on global investment.

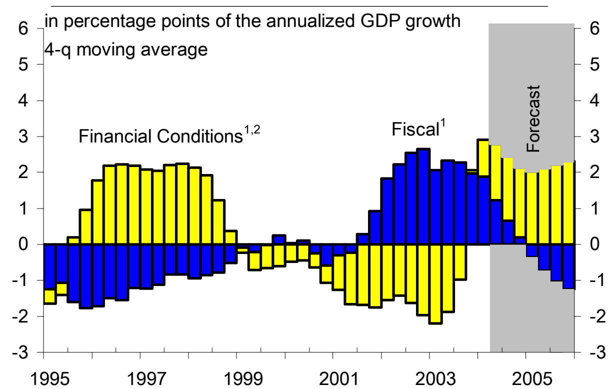
II. Recent Economic Developments

4. ***With the broadening of the economic recovery in recent months, concerns have shifted from the sustainability of the upturn to the possible emergence of inflationary pressures*** (see the figure on the next page, Tables 1–2). Following an initially anemic recovery from the 2001 recession, economic activity began to gather steam in 2003, with real GDP growth beginning to exceed potential around mid-year. The acceleration in growth since last year's consultation has been somewhat stronger than anticipated and has provided welcome support to the global recovery. Risks that a lack of employment growth and correspondingly weaker household incomes could derail the recovery have dissipated earlier this year as payroll employment finally started to accelerate.

An uprecedented degree of policy stimulus has supported output recently...



...reflecting both monetary and fiscal stimulus.



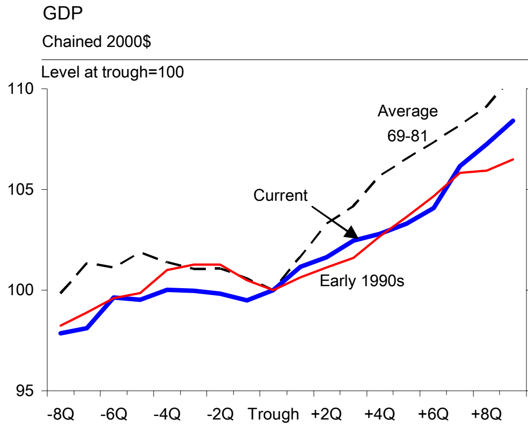
Sources: Haver Analytics; IMF staff calculations; and Macroeconomic Advisors, a private sector consultancy.

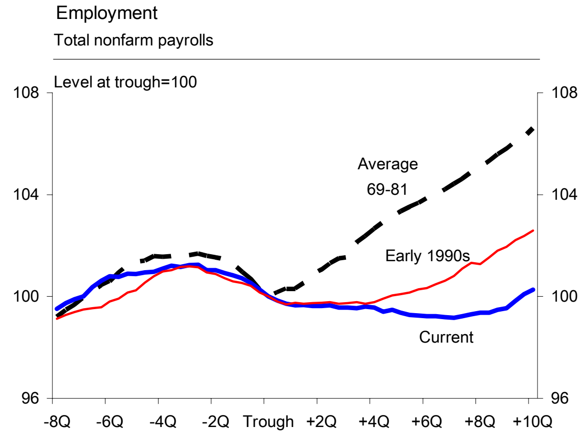
[1]Financial and fiscal stimulus are calculated by Macroeconomic Advisors, based on their macroeconomic model.

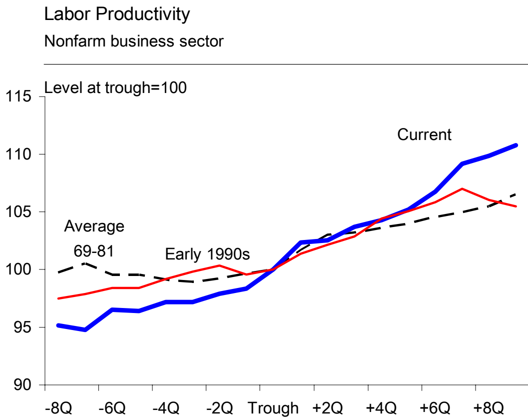
[2]Financial conditions include the impact of the interest rate, the exchange rate, and stock market valuations on the economy.

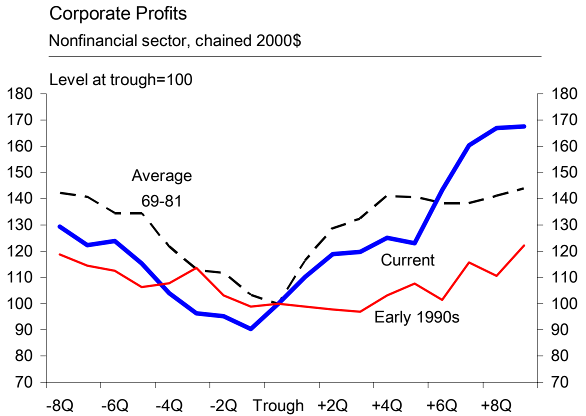
5. ***Monetary and fiscal policies have provided significant support to activity.*** The Federal Reserve has eased aggressively since 2001 and—with deflation becoming a growing concern—cut the federal funds rate to a 40-year low of 1 percent in mid-2003. Post-war lows in long-term interest rates helped spur a boom in housing markets and offset the effect on household demand from the equity price collapse in 2001. Domestic demand has also been supported by fiscal stimulus, with the structural fiscal balance shifting by some 5 percentage points of GDP since 2001 due to tax cuts, temporary investment incentives, and a rapid increase in government outlays. Lower interest rates helped trigger a depreciation of the dollar and stem the drag on activity from weak growth abroad as well as from the effects of the dollar's strong appreciation during 1995–2001.

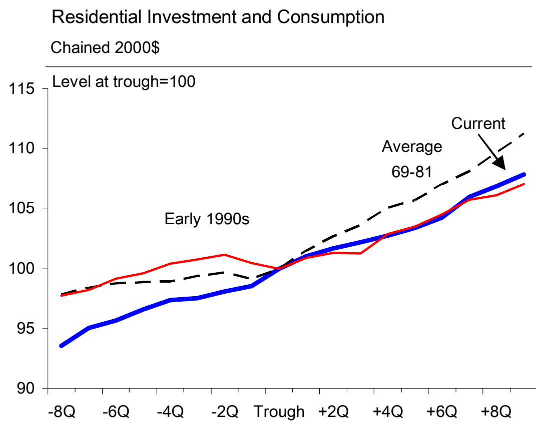
The recovery has been marked by strong growth in productivity and profits, but recovery of investment and employment has lagged, although recently they have both started to turn up.

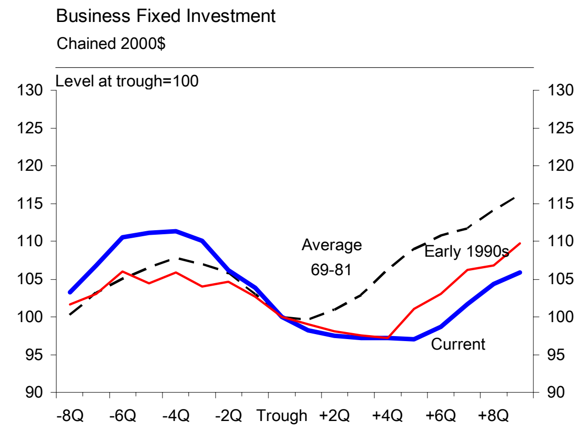












Source: Haver Analytics and IMF staff calculations.

Table 1. United States: Selected Economic Indicators

(Change from previous period in percent, unless otherwise indicated)

							2003				2004				2005			
	2001	2002	2003	2004	2005	2006	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
National production and income																		
Real GDP	0.5	2.2	3.1	4.5	3.9	3.6	2.0	3.1	8.2	4.1	3.9	4.3	4.0	4.0	3.9	3.8	3.7	3.6
Net exports 1/	-0.2	-0.7	-0.4	-0.1	0.1	0.0	0.8	-1.4	0.8	-0.3	-0.7	0.0	0.2	0.1	0.0	0.0	0.0	0.0
Total domestic demand	0.7	2.8	3.3	4.5	3.7	3.6	1.1	4.3	7.0	4.3	4.4	4.1	3.6	3.7	3.7	3.7	3.5	3.5
Final domestic demand	1.6	2.4	3.4	4.2	3.5	3.2	1.8	4.5	7.2	3.6	3.8	3.9	3.5	3.6	3.6	3.5	3.3	3.1
Private final consumption	2.5	3.4	3.1	3.9	4.1	4.1	2.5	3.3	6.9	3.2	3.8	3.1	3.6	3.8	3.7	4.8	5.2	4.5
Personal saving ratio (% of DI)	1.7	2.3	2.1	2.5	3.3	4.0	1.9	2.3	2.4	1.9	2.2	2.4	2.6	2.8	3.0	3.2	3.4	3.6
Public consumption expenditure	2.8	3.6	3.8	1.7	0.4	-1.9	0.8	7.1	0.1	0.7	1.8	2.5	1.5	1.3	2.3	-1.1	-2.9	-2.7
Gross fixed domestic investment	-2.3	-2.3	3.9	7.4	3.7	3.8	-0.2	6.6	14.8	7.5	5.7	8.0	4.6	4.9	4.0	2.3	1.0	2.4
Private fixed investment	-3.2	-3.7	4.4	7.6	3.6	5.1	1.1	6.1	15.7	9.9	5.1	6.7	5.1	4.5	2.5	2.6	3.1	3.8
Private investment rate	15.9	15.2	15.2	15.9	15.8	16.2	15.0	15.0	15.2	15.7	15.9	16.0	15.9	15.9	15.8	15.8	15.8	15.9
Equipment & software	-5.2	-2.8	5.5	11.9	10.1	9.2	0.5	8.0	17.6	14.9	9.2	12.0	10.0	10.0	10.0	10.0	10.0	10.0
Structures (non-res.)	-2.5	-18.4	-4.6	-2.1	0.8	1.0	-4.1	3.9	-1.8	-1.3	-7.4	0.0	0.0	1.0	1.0	1.0	1.0	1.0
Structures (res.)	0.3	4.9	7.5	5.6	-5.0	0.0	4.6	4.4	21.9	7.9	4.6	2.0	0.0	-2.0	-8.0	-8.0	-7.0	-5.0
Public	2.5	5.1	1.4	6.7	4.0	-2.6	-5.9	8.9	10.4	-3.6	9.0	14.3	2.6	6.5	12.0	1.1	-8.5	-4.2
Change in private inventories 1/	-0.9	0.4	0.0	0.3	0.2	0.3	-0.7	-0.2	-0.1	0.7	0.6	0.2	0.1	0.1	0.1	0.2	0.3	0.4
Nominal GDP	2.9	3.8	4.8	6.9	6.6	5.7	4.3	4.2	10.0	5.7	6.9	6.9	7.1	7.1	6.6	6.3	6.0	5.7
Employment and inflation																		
Unemployment rate (percent)	4.8	5.8	6.0	5.5	5.4	5.3	5.8	6.1	6.1	5.9	5.6	5.5	5.5	5.4	5.4	5.4	5.4	5.4
GDP gap	-0.7	-1.9	-2.2	-1.1	-0.6	-0.3	-2.8	-2.8	-1.8	-1.6	-1.4	-1.2	-1.0	-0.9	-0.7	-0.6	-0.5	-0.4
Potential GDP	3.4	3.4	3.5	3.3	3.3	3.3	3.5	3.5	3.5	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3
CPI inflation	2.8	1.6	2.3	2.7	2.6	2.4	3.9	0.6	2.3	0.7	3.6	3.9	3.2	3.0	2.5	2.0	2.2	2.4
GDP deflator	2.4	1.5	1.7	2.3	2.6	2.0	2.3	1.1	1.6	1.5	2.9	2.5	3.0	3.0	2.6	2.4	2.2	2.0
Financial policy indicators																		
Central gov't balance ($ b, public accounts)	127	-158	-375	-486	-432	-327	...	...	...	...	...	...	...	...	...	...	...	...
In percent of FY GDP 2/	1.3	-1.5	-3.5	-4.2	-3.5	-2.5	...	...	...	...	...	...	...	...	...	...	...	...
Central government balance ($ b, NIPA)	45	-259	-454	-496	-363	-335	...	...	...	...	...	...	...	...	...	...	...	...
In percent of CY GDP 2/	0.4	-2.5	-4.1	-4.2	-2.9	-2.5	...	...	...	...	...	...	...	...	...	...	...	...
General government balance ($ b, NIPA)	-16	-345	-538	-545	-419	-417	...	...	...	...	...	...	...	...	...	...	...	...
In percent of CY GDP 2/	-0.2	-3.3	-4.9	-4.6	-3.3	-3.2	...	...	...	...	...	...	...	...	...	...	...	...
Three-month Treasury bill rate	3.47	1.63	1.03	1.36	3.38	4.94	1.18	1.06	0.95	0.93	0.93	1.25	1.50	1.75	2.25	3.00	3.75	4.50
Ten-year government bond rate	5.02	4.61	4.02	4.66	5.63	6.00	3.92	3.62	4.23	4.29	4.02	4.75	4.85	5.00	5.25	5.50	5.75	6.00
Balance of payments																		
Current account balance ($ b)	-386	-474	-531	-556	-548	-556	-553	-536	-527	-508	-580	-560	-546	-539	-542	-551	-552	-548
In percent of GDP	-3.8	-4.5	-4.8	-4.7	-4.4	-4.2	-5.1	-4.9	-4.7	-4.5	-5.1	-4.8	-4.6	-4.5	-4.4	-4.4	-4.4	-4.3
Merchandise trade balance ($ b)	-427	-483	-548	-620	-636	-671	-552	-542	-539	-558	-603	-628	-623	-624	-628	-633	-639	-645
In percent of GDP 3/	-4.2	-4.6	-5.0	-5.3	-5.1	-5.1	-5.1	-5.0	-4.8	-5.0	-5.3	-5.4	-5.3	-5.2	-5.1	-5.1	-5.1	-5.0
Export volume 3/	-6.1	-4.0	1.9	10.5	8.1	7.9	1.9	-1.7	8.6	21.3	9.4	9.0	8.8	8.5	8.0	7.5	7.8	8.0
Import volume 3/	-3.2	3.7	4.8	9.4	5.1	6.9	-6.6	13.7	-1.5	18.3	12.2	10.6	2.2	3.9	5.7	5.0	6.0	6.3
Balance on invisibles ($ b)	41	9	17	64	88	115	-1	7	12	50	24	68	78	85	86	82	86	97
In percent of GDP	0.4	0.1	0.2	0.5	0.7	0.9	0.0	0.1	0.1	0.4	0.2	0.6	0.7	0.7	0.7	0.7	0.7	0.8
Saving and investment (as a share of GDP)																		
Gross national saving	16.4	14.7	13.5	14.4	15.9	15.1	12.9	13.2	13.4	14.5	13.1	14.5	14.6	15.4	15.8	16.1	16.1	15.5
General government	2.7	-0.3	-1.9	-1.5	-0.2	-0.2	-1.4	-2.0	-2.4	-1.9	-2.1	-1.8	-1.4	-0.7	-0.4	-0.1	0.1	-0.3
Private	13.7	15.0	15.3	16.1	16.2	15.5	14.3	15.3	15.7	15.8	15.3	16.5	16.3	16.3	16.3	16.3	16.1	16.0
Personal	1.3	1.7	1.6	1.9	2.5	3.0	1.4	1.7	1.8	1.4	1.6	1.8	2.0	2.1	2.3	2.4	2.6	2.7
Business	12.4	13.2	13.7	14.2	13.7	12.4	12.9	13.6	13.9	14.4	13.7	14.7	14.3	14.2	14.1	13.9	13.6	13.2
Gross domestic investment	19.0	18.3	18.2	19.2	19.1	19.3	18.0	17.9	18.2	18.8	19.0	19.2	19.2	19.3	19.2	19.1	19.0	19.0

Sources: Haver Analytics; and preliminary IMF staff calculations.

1/ Contributions to growth.
2/ Staff projections allow for differences in macroeconomic assumptions, as well as incorporating AMT reform and somewhat faster spending growth.
3/ NIPA basis, goods and services.

Table 2. United States: Monthly Indicators

(Percent changes from previous period, unless otherwise indicated)

		2003			2004	2003										2004
	2003	Q2	Q3	Q4	Q1	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May
		Q/Q at annual rate (except where noted)				y/y percent change (except where noted)										
Production and capacity utilization																
Industrial production																
All industries	0.3	-4.1	3.8	5.6	6.8	-0.6	-0.5	0.2	0.7	1.5	2.3	2.3	2.9	3.6	5.1	6.3
Manufacturing	0.1	-3.6	4.4	6.2	6.2	-0.8	-1.1	0.1	0.8	1.8	2.5	2.1	3.4	4.1	5.4	6.4
Business equipment	0.7	-4.9	5.2	7.7	12.3	0.3	0.3	1.7	1.8	2.8	3.7	4.2	5.1	5.5	7.8	9.4
Ex hi-tech and autos & parts	-1.2	-3.6	0.6	4.6	4.4	-1.9	-2.0	-1.6	-0.8	0.7	1.1	0.7	1.4	2.2	3.6	4.9
Capacity utilization (percent of capacity)																
All industries	74.8	74.1	74.6	75.5	76.5	74.5	74.5	74.9	75.0	75.7	75.8	76.2	76.7	76.6	77.1	77.8
Manufacturing	72.8	72.0	72.6	73.6	74.5	72.5	72.4	73.0	73.1	73.8	73.9	74.0	74.6	74.8	75.1	75.7
Orders and inventories																
Inventory/sales (ratio)	1.37	1.40	1.36	1.34	1.32	1.36	1.36	1.35	1.35	1.34	1.33	1.33	1.33	1.30	1.30	...
Total manufacturers' orders	3.7	-3.7	15.2	13.3	10.3	1.9	1.7	6.4	6.8	6.6	8.8	6.1	7.8	11.5	12.5	...
Total manufacturers' shipments	2.6	-4.3	13.5	9.6	12.1	2.7	1.7	3.5	3.2	4.6	7.8	5.7	6.9	9.7	12.0	...
Nondef. capital goods ex. aircraft	2.2	5.6	15.6	12.2	12.1	3.0	1.1	5.7	5.4	5.6	12.2	9.4	10.8	13.8	13.8	11.6
Households																
Retail sales	5.6	5.6	11.8	4.3	11.0	5.6	6.1	7.2	6.7	7.3	6.7	6.4	9.1	8.9	8.6	9.3
ex. autos, building supplies, and gasoline	4.9	4.4	10.9	5.8	10.5	5.5	6.3	6.7	6.3	6.6	6.6	7.5	8.2	7.9	8.2	7.8
Motor vehicle sales	-0.7	11.0	28.0	-12.3	-11.3	-6.5	-1.5	4.4	3.3	5.8	-3.1	-0.3	4.9	3.1	0.0	9.3
Consumer confidence (index)	87.6	89.3	89.3	92.0	98.0	90.9	89.3	87.7	89.6	93.7	92.6	103.8	94.4	95.8	94.2	90.2
Disposable income	4.6	5.4	8.7	2.2	8.3	5.3	6.1	4.8	5.1	5.4	5.6	6.1	6.2	6.1	6.5	6.4
Housing starts	8.3	-0.5	35.7	36.2	-16.8	14.4	12.4	6.5	20.3	17.2	15.6	4.2	14.4	15.7	21.0	12.5
Inflation																
CPI	2.3	0.6	2.3	0.7	3.6	2.1	2.2	2.3	2.0	1.8	1.8	2.0	1.7	1.7	2.3	3.0
excluding food and energy	1.5	1.1	1.4	1.0	1.8	1.5	1.3	1.2	1.3	1.1	1.1	1.1	1.2	1.6	1.8	1.8
PPI, finished goods	3.2	-1.3	2.8	3.7	3.8	3.0	3.5	3.5	3.4	3.4	3.9	3.3	2.1	1.4	3.6	4.9
excluding food and energy	0.2	-0.4	1.0	1.9	1.2	0.2	0.4	0.1	0.4	0.5	1.0	1.0	1.1	0.7	1.4	1.7
PCE price index	1.8	0.5	1.8	1.0	3.2	1.7	1.7	1.7	1.7	1.5	1.4	1.7	1.5	1.6	2.0	2.5
excluding food and energy	1.2	0.8	1.0	1.2	2.0	1.3	1.0	0.8	1.1	1.0	0.8	1.1	1.2	1.4	1.6	1.6
Labor market																
Nonfarm payrolls (millions)	129.9	129.9	129.8	130.0	130.4	129.8	129.8	129.9	129.9	130.0	130.0	130.2	130.3	130.6	131.0	131.2
Change (millions)	-0.4	-0.2	-0.1	0.2	0.4	-0.5	-0.5	-0.4	-0.4	-0.3	-0.1	0.0	0.2	0.7	1.1	1.4
Unemployment rate (percent)	6.0	6.1	6.1	5.9	5.6	6.2	6.1	6.1	6.0	5.9	5.7	5.6	5.6	5.7	5.6	5.6
Money and credit (percent change)																
M1	6.0	8.9	6.6	2.4	6.2	6.6	8.3	7.6	6.8	6.5	6.2	5.4	5.7	6.8	6.0	4.9
M2	6.8	8.5	7.1	-1.5	3.2	8.0	8.1	7.2	6.0	5.1	4.6	4.1	4.2	4.5	4.5	4.8
Bank lending	7.6	11.3	7.5	-1.6	11.5	9.6	9.2	7.9	6.3	5.7	5.7	7.1	7.1	6.9	6.8	6.1
Current account ($ billions)	-531	-536	-527	-508	-580	...	...	...	...	...	...	...	...	...	...	...
Percent of GDP	-4.8	-4.9	-4.7	-4.5	-5.1	...	...	...	...	...	...	...	...	...	...	...
Merchandise trade balance	-578	-571	-568	-592	-640	-568	-561	-576	-589	-568	-619	-632	-635	-653	-676	...
Exports ($ billions)	725	711	726	758	788	734	711	732	743	770	761	752	791	822	802	...
Imports ($ billions)	1303	1282	1294	1350	1428	1302	1272	1308	1332	1338	1380	1384	1425	1475	1478	...

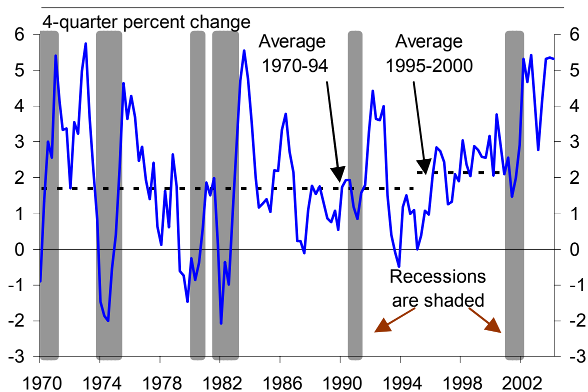
Source: Haver Analytics.

6. ***However, macroeconomic stimulus is starting to wane.*** Financial conditions have tightened somewhat in recent months as stronger data and statements from Fed officials have led to expectations that monetary stimulus will soon begin to be removed. The 10-year benchmark bond yield, in particular, has risen by around a percentage point since late March, and part of the dollar's earlier depreciation has been reversed. On the fiscal front, the stimulus from this year's surge in personal tax refunds associated with the 2003 tax cuts is starting to fade, and investment incentives generated by accelerated depreciation allowances are slated to expire at end-December.

7. ***Increasing asset prices have helped support aggregate demand.*** Equity markets have risen nearly 50 percent from their lows just before the Iraq war, although prices have stagnated somewhat in recent months on concerns that the removal of monetary stimulus would hurt corporate earnings. House prices have continued to increase rapidly, further boosting household balance sheets, and a temporary surge in refinancing activity in the first months of 2004 reflected households' efforts to reduce interest payments and lengthen debt maturities ahead of an expected tightening of interest rates.

8. ***Labor productivity growth remains remarkably strong, and has accelerated compared with the late 1990s*** (Box 1). Productivity growth rose strongly in the latter half of the 1990s and has accelerated further through the current cycle, moving U.S. growth ahead of major competitors (Table 3). Although this recent strength appears to reflect partly temporary factors, there is increasing evidence that it also reflects the reorganization of production in response to the IT revolution and other innovations in business practices, suggesting a further upward shift may have also taken place.[1]

Labor productivity growth has been robust recently, even compared to the late 1990s.



Source: Haver Analytics.

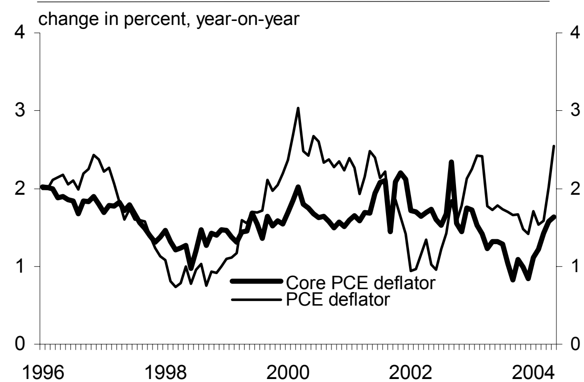
9. ***Job creation was unusually slow compared with other cyclical episodes, but has begun to revive in the last few months.*** Tepid employment earlier in the recovery appears to have largely reflected cost cutting in the face of uncertain growth and geopolitical prospects but, as confidence has firmed over the last few months, almost a million new jobs have been created and the unemployment rate has fallen to 5.6 percent. Although data are sketchy, offshoring of jobs appears too small to have any significant impact on these overall trends.[2]

[1] See Chapter 1 of the accompanying *Selected Issues* paper.

[2] See Council of Economic Advisers, 2004, *Economic Report of the President*, and M. Amiti and S. Wei, 2004, "Fear of Service Outsourcing: Is it Justified?," unpublished manuscript, IMF Research Department.

Box 1. Inflation and Productivity

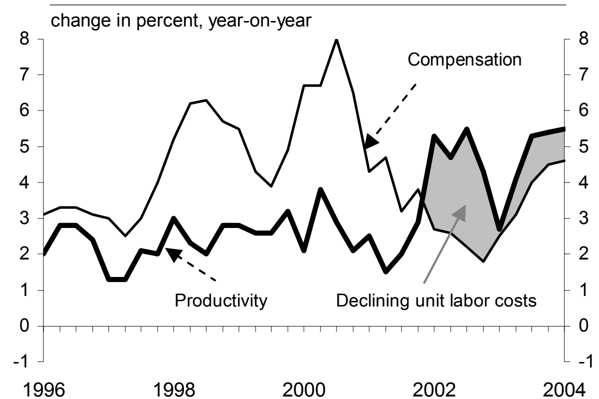
After an extended period of disinflation, price increases are starting to accelerate. Inflation rates have reversed much of last year's decline, with the core personal consumption expenditure (PCE) deflator moving up to 1.6 percent (yoy) in May 2004, from 0.8 percent (yoy) at end-2003 (Chart).



The pickup of inflation reflects in part the effects of the global recovery and geopolitical events on commodity and other upstream prices. Increasing global output has led to a general increase in raw material prices and, together with tensions in the Middle East and elsewhere, has led to a spike in energy prices, which futures markets indicate could be more long-lasting than those caused by the Gulf or Iraq wars. Producer prices of crude and intermediate materials excluding food and energy have risen 22 percent and 5 percent, respectively, over the 12 months ended May 2004, while the weaker dollar contributed to a 3 percent rise in non-oil import prices. Although the pass-through to final prices has historically been small—past estimates suggest a permanent 10 percent rise in raw materials costs is associated with a 0.1 percent or less increase in final consumer prices—the magnitude of the upstream price increases has caused concern.

Inflationary pressures may be dampened by significant economic slack in factories and labor markets. While real GDP has expanded at a brisk 5 percent over the past year, at 76 percent, the manufacturing capacity utilization rate remains well below the long-term average of 82 percent. The unemployment rate remains above most estimates of the NAIRU, which center at around 5 percent, and the low labor force participation rate may represent additional slack through "hidden unemployment." Staff estimates show that monthly job gains of 300,000 would be needed to bring the economy to full employment in late 2005 or early 2006, after allowing for a rise in the participation rate and growth of the labor force.

A key determinant of current and future price pressures is the rate of growth of labor productivity. For a given rate of growth of activity, higher underlying labor productivity growth implies more economic slack and a slower return to potential. Output per hour has risen at a 3¾ percent annual pace since 2000, leading to speculation that in addition to cyclical factors, the underlying trend has accelerated further from the already elevated 2½ percent rate recorded in the late 1990s. As a result of this rapid increase in productivity, unit labor costs have declined (yoy) for a record nine consecutive quarters, helping hold price pressures in check (Chart).



Data suggest that the improved performance of the U.S. economy since 1995 reflects a broad-based acceleration in total factor productivity (TFP) rather than just the gains in the information technology sector. Recent research has found an acceleration in TFP growth across a range of industries outside of the IT sector as businesses use new technologies and other innovations to improve the efficiency of production (see Chapter 1 of the accompanying *Selected Issues* paper).

Faster labor productivity growth may also temporarily reduce employment. Analysis by the staff and others finds that increases in output per worker reduces employment, but that this effect lasts only about a year-and-a-half. This suggests that the recent acceleration in labor product growth may help explain both the limited job creation over much of the recent recovery and hence some of the muted inflationary pressures that have been observed, but is unlikely to have significant consequences for job growth over a longer period.

Note: The author of this box is Calvin Schnure.

Table 3. Major Industrial Countries: Indicators of Economic Performance

	1996	1997	1998	1999	2000	2001	2002	2003	Projection 2004	2005
					(Annual percent change)					
Per capita GDP										
United States	2.5	3.3	3.0	3.3	2.5	-0.5	1.2	2.1	3.6	2.9
Japan	3.2	1.5	-1.5	0.0	2.6	0.2	-0.5	2.5	3.2	1.8
Germany	0.5	1.2	2.0	2.0	2.7	0.7	0.0	-0.1	1.6	1.9
Canada	0.6	3.2	3.2	4.7	4.3	0.9	2.2	0.8	1.4	1.9
France, Italy, and United Kingdom 1/	1.4	2.2	2.6	2.3	3.4	1.6	0.8	0.6	1.8	2.0
G-7 countries	2.1	2.5	2.1	2.4	2.8	0.2	0.7	1.6	2.9	2.4
Real GDP										
United States	3.7	4.5	4.2	4.4	3.7	0.5	2.2	3.1	4.5	3.9
Japan	3.6	1.8	-1.2	0.2	2.8	0.4	-0.3	2.7	3.4	1.9
Germany	0.8	1.4	2.0	2.0	2.9	0.8	0.2	-0.1	1.6	1.9
Canada	1.6	4.2	4.1	5.5	5.3	1.9	3.3	1.7	2.6	3.1
France, Italy, and United Kingdom 1/	1.6	2.4	2.8	2.6	3.7	2.0	1.1	0.9	2.2	2.3
G-7 countries	2.3	2.7	2.2	2.6	3.0	0.4	0.9	1.7	3.0	2.5
Real domestic demand										
United States	3.8	4.8	5.3	5.3	4.4	0.7	2.8	3.3	4.5	3.7
Japan	4.1	0.8	-1.5	0.3	2.3	1.1	-1.0	2.0	2.7	1.4
Germany	0.3	0.6	2.4	2.8	1.8	-0.8	-1.6	0.2	1.5	2.0
Canada	0.9	5.7	2.4	4.1	5.0	1.7	3.4	4.2	3.5	3.3
France, Italy, and United Kingdom 1/	1.5	2.3	4.1	3.6	3.5	2.0	1.8	1.7	2.5	2.3
G-7 countries	2.8	3.1	3.5	3.8	3.6	0.9	1.5	2.5	3.4	2.8
GDP deflator										
United States	1.9	1.7	1.1	1.4	2.2	2.4	1.5	1.7	2.3	2.6
Japan	-0.8	0.3	-0.1	-1.5	-2.0	-1.5	-1.2	-2.5	-2.4	-1.4
Germany	1.0	0.7	1.1	0.5	-0.3	1.3	1.6	1.0	1.0	1.2
Canada	1.7	1.2	-0.4	1.7	4.0	1.0	1.0	3.4	1.4	1.9
France, Italy, and United Kingdom 1/	3.4	2.2	2.1	1.4	1.4	2.2	2.7	2.6	2.4	2.4
G-7 countries	1.6	1.4	1.1	0.9	1.2	1.5	1.3	1.2	1.4	1.8
					(In percent of GDP)					
General government financial balance 2/										
United States	-2.2	-0.8	0.4	0.9	1.6	-0.2	-3.3	-4.9	-4.6	-3.3
Japan	-5.1	-3.8	-5.5	-7.2	-7.5	-6.1	-7.9	-8.2	-7.1	-6.6
Germany	-3.4	-2.7	-2.2	-1.5	1.3	-2.8	-3.5	-4.0	-3.5	-3.1
Canada	-2.8	0.2	0.1	1.6	3.0	1.4	0.8	1.2	1.0	1.3
France, Italy, and United Kingdom 1/	-5.1	-2.6	-1.8	-0.8	0.6	-1.1	-2.3	-3.2	-3.3	-3.0
G-7 countries	-3.5	-1.9	-1.3	-1.0	0.0	-1.5	-3.7	-4.7	-4.4	-3.5
Gross savings										
United States	16.5	17.6	18.3	18.1	18.0	16.4	14.7	13.5	15.7	18.2
Japan	30.6	30.9	29.8	28.6	28.8	27.8	26.7	27.1	27.4	27.6
Germany	21.1	21.0	21.2	20.5	20.3	19.8	20.8	19.6	20.9	21.6
Canada	18.8	19.6	19.1	20.7	23.8	22.4	21.9	22.3	22.1	22.2
France, Italy, and United Kingdom 1/	19.0	19.6	19.8	19.3	19.0	18.9	18.5	17.3	17.1	17.3
G-7 countries	20.1	20.8	20.9	20.4	20.5	19.4	18.4	17.5	18.7	20.0
Fixed investment										
United States	15.5	15.9	16.4	16.8	17.1	16.3	15.1	15.2	15.7	15.4
Japan	28.5	28.1	26.8	26.4	26.4	25.7	24.2	23.9	24.3	24.4
Germany	21.8	21.4	21.4	21.6	21.7	20.3	18.6	18.0	18.4	18.7
Canada	17.9	19.8	19.9	19.8	19.3	19.9	19.7	19.5	20.2	20.5
France, Italy, and United Kingdom 1/	17.8	17.6	18.1	18.4	19.0	18.9	18.5	18.2	18.2	18.2
G-7 countries	19.1	19.1	19.2	19.3	19.6	18.9	17.8	17.7	18.0	17.9
Current account balance										
United States	-1.5	-1.6	-2.4	-3.2	-4.2	-3.8	-4.5	-4.8	-4.7	-4.4
Japan	1.4	2.2	3.0	2.6	2.5	2.1	2.8	3.2	3.1	3.2
Germany	-0.6	-0.4	-0.6	-1.2	-1.4	0.2	2.8	2.4	3.1	2.7
Canada	0.5	-1.3	-1.2	0.3	2.9	2.4	2.0	2.1	1.8	1.7
France, Italy, and United Kingdom 1/	1.2	1.8	1.3	0.3	-0.5	-0.2	-0.1	-0.8	-0.9	-0.7
G-7 countries	-0.2	-0.1	-0.4	-1.1	-1.7	-1.4	-1.4	-1.6	-1.6	-1.4

Sources: *World Economic Outlook* ; and IMF staff calculations.

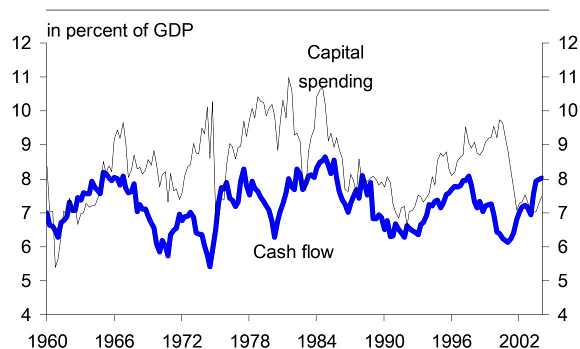
1/ Composites for the country groups are averages of individual countries weighted by the average value of their respective GDPs converted using PPP weights over the preceding three years.

2/ On national accounts basis.

By contrast, the expansion of the U.S. labor force due to immigration appears to have contributed to the longer-term growth of the U.S. economy, while also enabling the flow of remittances to lower-income countries, most notably in Central America and Mexico.[3]

10. ***The business and financial sectors have strengthened as a result of productivity growth and the recovery.*** With a sharp rebound in profits and investment spending at a low ebb, the nonfinancial corporate sector is in the unusual position of being a net provider of funds to the rest of the economy. The share of after-tax profits in GDP has risen to a post-war high as firms have strengthened their balance sheets and taken advantage of low bond rates and narrowing corporate spreads to extend the maturity of their debt even as investment spending has started to pick up. At the same time, the banking system booked record profits in 2004Q1 and near-record returns on assets.

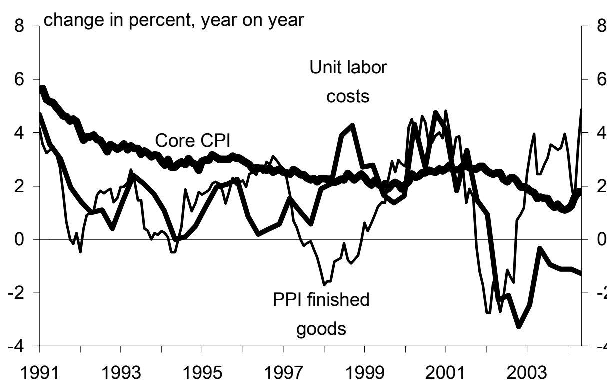
Nonfinancial corporations are currently providing funds to the rest of the economy.



Source: Haver Analytics.

11. ***Oil prices have spiked upward as faster global growth has spurred demand.*** Industry analysis suggests that rapid demand growth in China and elsewhere has reduced the supply cushion to unusually low levels, while geopolitical developments have also raised fears of possible supply disruptions. The spike in energy prices—which also reflects supply constraints in the natural gas sector—has raised overall inflation, but pass-through to non-energy prices has been limited. Nonetheless, higher fuel bills are expected to erode discretionary income and dampen aggregate demand, while boosting the current account deficit.[4]

Core inflation has started to increase on upstream presssures, but unit labor costs remain contained.



Source: Haver Analytics.

12. ***Fears of deflation have recently been replaced by concerns that price pressures are growing.*** After falling to

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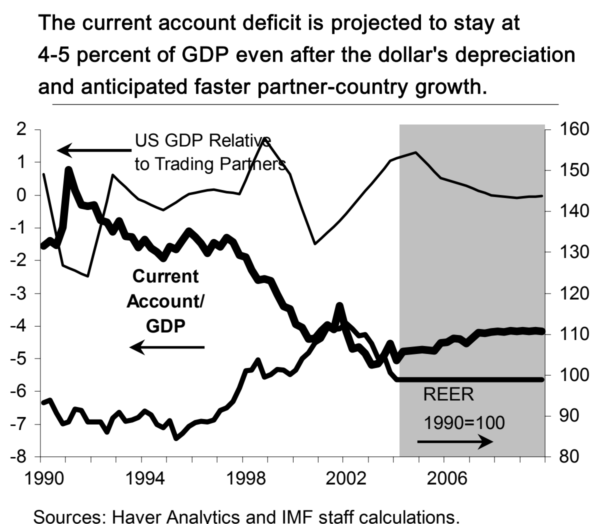
[3] See Chapter 2 of the accompanying *Selected Issues* paper.

[4] The impact of higher oil prices on aggregate activity has fallen over time as conservation and the increasing role of services in U.S. GDP has lowered the energy intensity of output in the United States (see M. Mühleisen and C. Towe (eds.), 2004, *U.S. Fiscal Policies and Priorities for Long-Run Sustainability*, IMF Occasional Paper 227). Staff estimates from a range of sources suggest that a sustained increase of $5 in the price of a barrel of oil reduces U.S. economic activity by around ¼–½ percentage point over two years.

a 40-year low of around 1 percent in early-2004, year-on-year core inflation has recently started to rise, reaching over 1½ percent in May.[5] The recent increase reflects a deceleration of deflation in goods prices as the global recovery has increased costs of materials and intermediate inputs, most notably energy. The depreciation of the dollar has added to these pressures, although the exchange rate pass-through of the weaker dollar appears to have been limited as foreign firms have reduced profit margins or benefited from earlier hedging.[6] At the same time, rapid labor productivity growth continues to dampen unit labor costs, and service price inflation remains moderate.

13. ***The current account deficit is close to its record high of 5 percent of GDP—representing around 6 percent of global saving—despite some dollar depreciation*** (Tables 4–5). While the dollar has rebounded somewhat in recent months on expectations of monetary tightening, in real effective terms, it remains some 10 percent below its peak in early 2002, partly reversing its appreciation since the mid-1990s. The depreciation has been almost exclusively against industrial country currencies, while the competitive position against major developing country partners has remained largely unchanged. The effect of the weaker dollar on real net exports, which continued to subtract from real GDP growth in 2003 and early 2004, has been modest, reflecting the usual lags between changes in real exchange rates and trade volumes as well as the relatively slower revival of foreign demand.

The current account deficit is projected to stay at 4-5 percent of GDP even after the dollar's depreciation and anticipated faster partner-country growth.



Sources: Haver Analytics and IMF staff calculations.

III. Economic Prospects and Risks

14. ***Staff projections are for output growth to remain above potential through 2004 and 2005, closing the output gap by 2006.*** The baseline forecast—which is broadly similar to the private consensus and the assumptions in the FY 2005 budget—is underpinned by continued strength in business fixed investment and an improvement in external demand. This is expected to help offset a slowdown in household demand, responding to the waning effects of tax cuts and a gradual rebound in the household saving rate, as well as weaker

[5] These patterns are true of both the CPI and the personal consumption deflator (the measure preferred by the Federal Reserve Board), although the recent rise in core inflation has been more marked for the CPI.

[6] There is some evidence that pass-through has been declining over time. See, for example, E. Choudhri, H. Faruqee, and D. Hakura, 2002, "Explaining the Exchange Rate Pass-Through in Different Prices," IMF Working Paper WP/02/224.

Table 4. United States: Balance of Payments

(In billions of dollars, unless otherwise indicated)

	1997	1998	1999	2000	2001	2002	2003
Current account	-136	-210	-297	-413	-386	-474	-531
Percent of GDP	-1.6	-2.4	-3.2	-4.2	-3.8	-4.5	-4.8
Goods and services	-108	-165	-263	-378	-363	-422	-497
Merchandise trade	-198	-247	-346	-452	-427	-483	-548
Exports	678	670	684	772	719	682	713
Imports	-876	-917	-1,030	-1,224	-1,146	-1,165	-1,261
Services	90	82	83	74	64	61	51
Receipts	256	263	282	299	288	294	307
Payments	-166	-181	-200	-225	-223	-233	-256
Investment income	13	4	13	21	24	7	33
Receipts	257	261	293	350	287	267	294
Payments	-244	-258	-280	-330	-263	-260	-261
Unilateral transfers	-40	-48	-47	-56	-47	-59	-67
Government transfers	-12	-13	-14	-17	-12	-17	-22
Private transfers	-28	-35	-33	-39	-35	-42	-46
Capital account transactions, net	-1	-1	-5	-1	-1	-1	-3
Financial account	221	76	237	477	416	570	546
Private capital	203	103	182	436	393	460	295
Direct investment	1	36	65	162	25	-62	-134
Outflows	-105	-143	-225	-159	-142	-135	-174
Inflows	106	179	289	321	167	72	40
Securities	200	77	161	273	319	423	309
Outflows	-117	-124	-116	-122	-85	16	-72
Inflows	317	202	277	395	403	407	381
Net U.S. bank flows	8	4	-22	-32	-7	66	65
Nonbank capital flows	-5	-15	-21	32	58	33	55
U.S. official reserves	-1	-7	9	0	-5	-4	2
Foreign official assets	19	-20	44	43	28	114	249
Other items	0	0	3	-1	0	0	1
Statistical discrepancy	-84	135	65	-63	-29	-95	-12

Source: Haver Analytics.

Table 5. United States: Indicators of External and Financial Vulnerability

(In percent of GDP, unless otherwise indicated)

	1996	1997	1998	1999	2000	2001	2002	2003
External indicators								
Exports of goods and services (percentage change, BOP basis)	7.2	9.8	-0.1	3.5	10.8	-5.8	-3.3	4.6
Imports of goods and services (percentage change, BOP basis)	7.3	9.1	5.3	12.0	17.8	-5.5	2.0	8.4
Terms of trade (annual percentage change)	-0.5	1.1	2.9	-2.1	-4.6	2.8	1.5	-1.3
Current account balance	-1.5	-1.5	-2.3	-3.1	-4.2	-3.9	-4.6	-4.9
Capital and financial account balance	0.2	0.3	0.1	0.3	0.5	0.4	0.5	0.5
Of which: Inward portfolio investment (debt securities, etc.)	3.2	3.5	2.1	2.7	3.9	4.0	3.7	3.4
Inward foreign direct investment	1.1	1.3	2.0	3.1	3.3	1.5	0.4	0.7
Other investment liabilities (net)	0.2	1.8	0.5	0.6	1.2	1.2	0.9	0.9
Official reserves (in billions of dollars)	75.1	70.0	81.8	71.5	67.6	68.7	79.0	85.9
Broad money (M3) to reserves ratio	90.8	110.4	126.5	145.5	170.2	184.3	205.3	204.7
Central bank foreign liabilities (in billions of dollars)	0.2	0.5	0.2	0.1	0.3	0.1	0.1	0.2
Official reserves in months of imports	0.9	0.8	0.9	0.7	0.6	0.6	0.7	0.7
Net international investment position (in billions of dollars) 1/	-521.5	-833.2	-918.7	-797.6	-1,387.7	-1,979.9	-2,387.2	…
Of which: General government debt (in billions of dollars) 2/	1,071.9	1,198.8	1,231.8	1,156.5	1,150.9	1,187.8	1,401.6	…
External debt-to-exports ratio	0.6	0.9	1.0	0.8	1.3	2.0	2.5	…
External interest payments to exports (in percent) 3/	19.1	20.4	22.1	21.9	24.6	23.9	20.7	17.6
Nominal effective exchange rate (percent change)	5.1	8.1	7.8	-1.3	3.4	6.4	-0.6	-8.8
Financial market indicators								
General government gross debt	70.8	69.0	66.1	62.2	57.7	55.8	56.8	58.5
Three-month Treasury bill yield (percent)	5.1	5.2	4.9	4.8	6.0	3.5	1.6	1.0
Three-month Treasury bill yield (percent, real)	2.1	2.8	3.3	2.5	2.5	0.6	0.0	-1.2
Change in stock market index (S&P500 percent, year average)	23.9	30.1	24.2	22.3	7.6	-16.4	-16.5	-3.2
Banking sector risk indicators (percent unless otherwise indicated) 4/								
Total assets (in billions of dollars)	4,878.3	5,014.9	5,442.5	5,735.2	6,244.6	6,552.4	7,077.2	7,602.5
Total loans and leases to assets	57.6	59.2	59.5	60.9	61.2	59.3	58.7	58.3
Total loans to deposits	87.9	86.8	88.0	91.1	91.4	88.7	88.6	88.1
Problem loans to total loans and leases 5/	1.0	1.0	1.0	1.0	1.1	1.4	1.5	1.2
Nonperforming assets to assets	0.8	0.7	0.7	0.6	0.7	0.9	0.9	0.8
Loss allowance to:								
Total loans and leases	1.9	1.8	1.8	1.7	1.7	1.9	1.9	1.7
Noncurrent loans and leases	183.5	191.6	183.2	178.1	149.4	131.0	127.2	145.8
Return on equity	14.5	14.7	13.9	15.3	14.0	13.1	14.5	15.3
Return on assets	1.2	1.2	1.2	1.3	1.2	1.2	1.3	1.4
Total capital ratio	12.5	12.2	12.2	12.2	12.1	12.7	12.8	12.7
Core capital ratio	7.6	7.6	7.5	7.8	7.7	7.8	7.8	7.9

Sources: Bureau of Economic Analysis; Department of Commerce; Federal Deposit Insurance Corporation; Federal Reserve Board; and Haver Analytics.

1/ Current cost valuation.

2/ Foreign official assets (U.S. Government securities plus Treasury securities).

3/ External interest payments: income payments on foreign-owned assets (other private payments plus U.S. government payments).

4/ FDIC-insured commercial banks.

5/ Noncurrent loans and leases.

government demand as the fiscal position improves. Core inflation is expected to remain contained as the Federal Reserve withdraws stimulus broadly in line with current market expectations. The current account position is anticipated to improve only modestly, with the deficit falling close to 4 percent of GDP in 2009, as the lagged effect of the recent real depreciation of the dollar and economic recoveries in partner countries support net exports.

Selected Indicators of Economic Activity
(In percent changes from previous period, unless otherwise indicated)

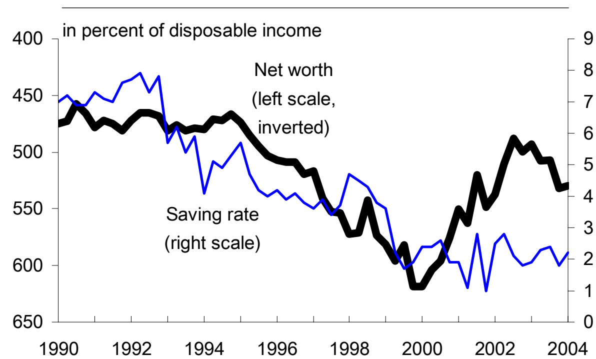
								2004				2005				2006			
	2003	2004	2005	2006	2007	2008	2009	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Real GDP	3.1	4.5	3.9	3.6	3.3	3.1	3.1	3.9	4.3	4.0	4.0	3.9	3.8	3.7	3.6	3.6	3.5	3.5	3.5
Final domestic demand	3.4	4.2	3.5	3.2	3.3	3.3	3.2	3.8	3.9	3.5	3.6	3.6	3.5	3.3	3.1	3.1	3.1	3.3	3.5
Private consumption	3.1	3.9	4.1	4.1	3.7	3.6	3.4	3.8	3.1	3.6	3.8	3.7	4.8	5.2	4.5	3.8	3.7	3.8	3.5
Business fixed investment	3.0	8.9	8.0	7.5	6.6	6.6	6.7	5.3	9.3	7.8	8.0	8.0	8.0	8.1	8.1	8.1	6.5	6.6	6.6
Residential investment	7.5	5.6	-5.0	0.0	2.0	2.0	2.0	4.6	2.0	0.0	-2.0	-8.0	-8.0	-7.0	-5.0	3.0	4.0	6.0	4.0
Inventories 1/	0.0	0.3	0.2	0.3	0.1	0.0	0.0	0.6	0.2	0.1	0.1	0.1	0.2	0.3	0.4	0.3	0.3	0.3	0.3
Net exports 1/	-0.4	-0.1	0.1	0.0	-0.2	-0.2	-0.2	-0.7	0.3	0.4	0.3	0.0	0.0	0.0	0.0	0.0	0.0	-0.1	-0.2
Unemployment rate (percent)	6.0	5.5	5.4	5.3	5.3	5.3	5.3	5.6	5.5	5.5	5.4	5.4	5.4	5.4	5.4	5.3	5.3	5.3	5.3
Central government balance 2/	-3.5	-4.2	-3.5	-2.5	-2.3	-2.4	-2.3	...	...	...	...	...	...	...	...	...	...	...	...
Current account balance 2/	-4.8	-4.7	-4.4	-4.2	-4.2	4.1	-3.9	-5.1	-4.8	-4.6	-4.5	-4.4	-4.4	-4.4	-4.3	-4.2	-4.2	-4.3	-4.1

Sources: Haver Analytics; and IMF staff calculations.

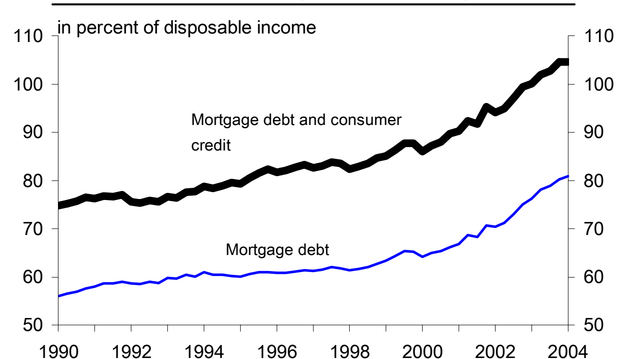
1/ Contribution to growth.
2/ As a share of GDP.

15. ***Officials broadly shared the staff's macroeconomic outlook and agreed that downside risks to the recovery had diminished in recent months.*** Businesses appeared to have worked off the excess IT capital stock built up in the late 1990s and had strong cash-flow positions. The boost to business spending from the cyclical upturn would likely offset the effects of the expiration of accelerated depreciation allowances later this year. In addition, firms would need to restock inventories from their current record-low relative to sales.

Household net worth has started to recover, but the saving ratio remains low...



... and the debt ratio is high and increasing.



Source: Haver Analytics.

16. ***Officials were less concerned than the staff about domestic risks to household spending.*** They agreed that the household saving rate appeared low, but noted that net worth as a share of disposable income had rebounded recently and had surpassed levels reached in the

mid-1990s.[7] While the ratio of debt to income had risen to a record level, it was largely to finance real estate purchases, and interest burdens remained manageable as homeowners had locked in low interest rates. Some retrenchment of consumer spending growth was expected as the boost from past tax cuts and mortgage refinancing faded and rising energy costs reduced discretionary incomes. Nevertheless, in the absence of a geopolitical shock, officials regarded the risks of an abrupt slowing of spending as small, given the signs that employment and labor compensation were firming.

17. ***Officials also indicated that, in their view, risks from recent housing price developments were limited.*** They agreed with staff that some regional markets appeared overheated but observed that house prices in general were recovering from relatively sluggish increases during the 1990s and were broadly in line with disposable income.[8] In any event, officials noted that nominal house prices had never fallen on a national basis, suggesting that any cooling of the real estate market would likely involve a slowing of future appreciation.

18. ***Federal Reserve officials noted that unemployment and capacity utilization suggested continued economic slack, limiting the risk to inflation.*** Their models were consistent with the consensus view of the NAIRU of around 5 percent, although there was a large degree of uncertainty surrounding such estimates. For example, the sharp drop in inflation last year and the unusual decrease in the participation rate recently suggested the potential for a lower NAIRU. Capacity utilization in manufacturing—which they regarded as a relatively good measure of aggregate economic conditions—also remained well below its long-term average. Thus, the overall picture was broadly consistent with the staff's estimate of an output gap of 1½ percent of GDP.

19. ***Staff and officials agreed that the rapid labor productivity growth of recent years represented an upside risk to the outlook.***[9] Official and staff forecasts have generally treated the recent acceleration conservatively, assuming that productivity growth would slow to 2 percent or so over the medium term. A faster trend would boost domestic incomes, as well as ease policy challenges by moderating pressures on prices, raising government revenues, and encouraging capital inflows needed to fund the external deficit.

IV. Fiscal Discussions

20. ***The FY 2005 budget signaled a welcome shift in policy emphasis toward fiscal consolidation*** (Table 6). The budget—released in February 2004 and covering the next five

[7] The staff's analysis of the U.S. saving rate and housing markets was published in the March 2004 issue of *Finance and Development*.

[8] For further discussion of house prices, see K. Case and R. Schiller, 2003, "Is There a Bubble in the Housing Market?," *Brookings Paper on Economic Activity 2,* pp. 299–362.

[9] Chapter 1 of the accompanying *Selected Issues* paper reviews productivity developments in more detail.

Table 6. United States: Fiscal Indicators, FY 2000–09

(In percent of GDP, unless otherwise indicated)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
	FY 2005 Current Services Baseline (Administration projection)									
Revenue	20.9	19.8	17.9	16.5	15.7	17.0	17.7	17.9	18.0	18.1
Outlays	18.4	18.6	19.4	19.9	20.2	19.9	19.6	19.5	19.5	19.4
Debt service	2.3	2.1	1.6	1.4	1.4	1.5	1.7	1.8	1.9	2.0
Other	16.1	16.5	17.7	18.5	18.9	18.5	17.9	17.7	17.5	17.4
Unified balance	2.4	1.3	-1.5	-3.5	-4.5	-2.9	-1.9	-1.6	-1.5	-1.3
Memorandum items:										
Unified balance (in billions of dollars)	236	127	-158	-375	-520	-352	-240	-211	-209	-188
Balance excl. Soc. Sec. and Medicare (HI)	0.6	-0.6	-3.4	-5.1	-5.9	-4.5	-3.6	-3.4	-3.3	-3.1
Primary balance	4.7	3.3	0.1	-2.1	-3.2	-1.4	-0.2	0.2	0.4	0.7
Net debt held by public	36.7	34.6	35.6	37.6	39.9	41.0	41.1	40.8	40.4	39.8
	FY 2005 Administration Budget									
Revenue	20.9	19.8	17.9	16.5	15.7	16.9	17.4	17.7	17.8	17.8
Outlays	18.4	18.6	19.4	19.9	20.2	19.9	19.6	19.5	19.5	19.4
Debt service	2.3	2.1	1.6	1.4	1.4	1.5	1.7	1.9	2.0	2.0
Other	16.1	16.5	17.7	18.5	18.9	18.5	17.9	17.7	17.5	17.4
Unified balance	2.4	1.3	-1.5	-3.5	-4.5	-3.0	-2.1	-1.8	-1.7	-1.6
Memorandum items:										
Unified balance (in billions of dollars)	236	127	-158	-375	-521	-364	-268	-241	-239	-237
Balance excl. Soc. Sec. and Medicare (HI)	0.6	-0.6	-3.4	-5.1	-5.9	-4.6	-3.8	-3.6	-3.6	-3.5
Primary balance	4.7	3.3	0.1	-2.1	-3.2	-1.5	-0.4	0.0	0.3	0.4
Net debt held by public	35.1	33.1	34.1	36.1	38.6	39.8	40.1	40.2	40.0	39.8
	FY 2005 Budget (Staff Projection) 1/									
Revenue	20.9	19.8	17.9	16.5	16.0	16.6	17.0	17.0	16.9	16.8
Outlays	18.4	18.6	19.4	19.9	20.2	20.1	19.5	19.3	19.2	19.1
Debt service	2.3	2.1	1.6	1.4	1.3	1.5	2.0	2.2	2.2	2.3
Other	16.1	16.5	17.7	18.5	18.9	18.6	17.5	17.2	17.0	16.9
Unified balance	2.4	1.3	-1.5	-3.5	-4.2	-3.5	-2.5	-2.3	-2.4	-2.3
Memorandum items:										
Unified balance (in billions of dollars)	237	127	-158	-375	-486	-432	-327	-322	-341	-349
Balance excl. Soc. Sec. and Medicare (HI)	0.6	-0.6	-3.4	-5.1	-5.6	-4.9	-5.3	-4.1	-4.2	-4.1
Primary balance	4.7	3.3	0.1	-2.1	-2.9	-2.0	-0.5	-0.2	-0.2	0.0
Net debt held by Public	35.1	33.1	34.1	36.1	38.0	39.4	39.3	39.3	39.3	39.1
	Structural Unified Balance (Staff Projection) 1/									
Revenue	20.8	19.8	17.9	16.5	16.0	16.6	17.0	17.0	16.9	16.8
Outlays	18.9	18.6	19.0	19.4	19.9	20.0	19.4	19.3	19.2	19.1
Unified balance 2/	1.9	1.2	-1.1	-2.9	-3.9	-3.4	-2.4	-2.3	-2.4	-2.3
Memorandum items:	(in percent, calendar-year basis)									
Real GDP growth										
Administration	3.7	0.5	2.2	3.1	4.4	3.6	3.4	3.3	3.2	3.1
Staff	3.7	0.5	2.2	3.1	4.5	3.9	3.6	3.3	3.1	3.1
10-year government bond yield										
Administration	6.0	5.0	4.6	4.0	4.6	5.0	5.4	5.6	5.8	5.8
Staff	6.0	5.0	4.6	4.0	4.7	5.6	6.0	6.0	6.0	6.0

Sources: *Fiscal Year 2005 Budget of the United States Government* (February 2004), and IMF staff calculations.

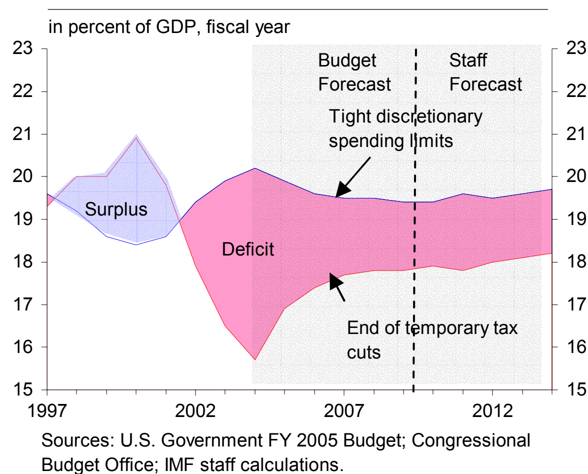
1/ Staff projections allow for differences in macroeconomic assumptions, as well as incorporating AMT reform and somewhat faster spending growth.

2/ As a percent of potential GDP, based on proposed measures, under staff's economic assumptions.

fiscal years—adopted the goal of halving the deficit in nominal terms by FY 2009, implying a reduction of almost 3 percent of GDP relative to the projected FY 2004 deficit. The vast majority of this decline would occur over FY 2005–06, when consolidation is projected to occur at over 1 percentage point of GDP per annum (compared to one-sixth of a percentage point per annum during the subsequent three fiscal years). The near-term adjustment would mainly result from the expiration of temporary investment incentives and the restoration of personal tax refunds to more normal levels. Tight limits on spending—as well as an easing of pressures on defense outlays—are assumed to provide room over the medium-term for making the 2001 tax cuts permanent and to introduce new tax-preferred savings instruments. Recent data also suggest that the FY 2004 deficit could be as much as ½ percent of GDP lower than projected in the budget.

21. ***Congressional approval of the budget is still awaited.*** Agreement on a budget resolution has been hampered by differences about the cost of further tax measures. Whereas the House already approved bills that would make many of the 2001 tax cuts permanent, the Senate would require the cost of any tax cuts in FY 2005 to be fully offset by other measures. Analysts also anticipate difficulties in passing a full set of budget appropriations, given that 60 votes would be required to block costly amendments to each bill in the Senate. This could again necessitate bundling appropriations into an omnibus spending bill, which has reduced fiscal transparency and weakened expenditure discipline in the past.

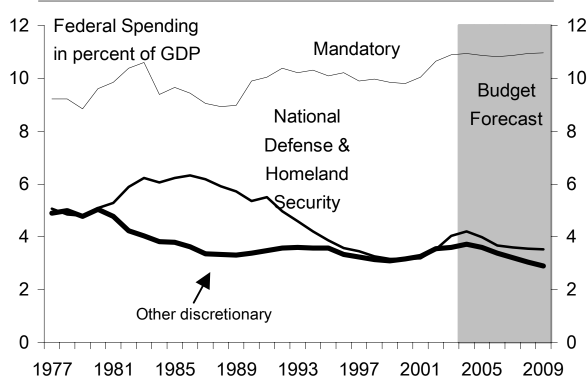
The FY 2005 Budget foresees a narrowing of the deficit through FY 2006 but relatively small changes thereafter.



Sources: U.S. Government FY 2005 Budget; Congressional Budget Office; IMF staff calculations.

22. ***The mission agreed that the rate of fiscal adjustment envisaged for the coming two years was appropriate, and focused on associated risks and the longer-term context.*** In this regard, the team noted that while the shift to consolidation was consistent with past Fund advice, the budget took no account of the cost of ongoing operations in Iraq and Afghanistan, as well as highway and energy legislation presently before

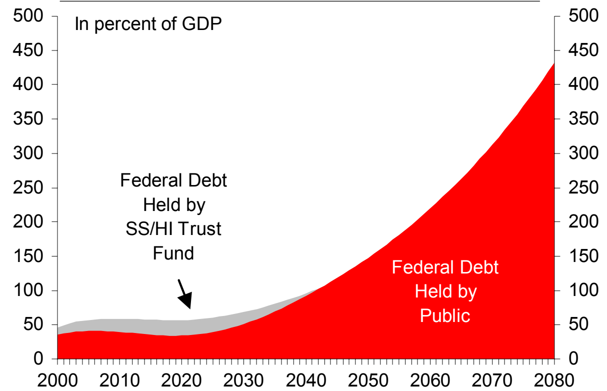
The FY 2005 Budget projects a decline in discretionary spending, particularly on items unrelated to defense and homeland security.



Source: Office of Management and Budget.

Congress. It also assumed sustained spending discipline that would take nondefense discretionary spending as a share of GDP to its lowest level since the early 1960s. On the revenue side, the repeal of the Foreign Sales Corporation Act was likely to involve additional tax cuts, and the budget's revenue projections were predicated on a significant increase in the number of tax filers falling under the Alternative Minimum Tax, which was almost certain to trigger corrective legislative action at potentially significant fiscal cost.

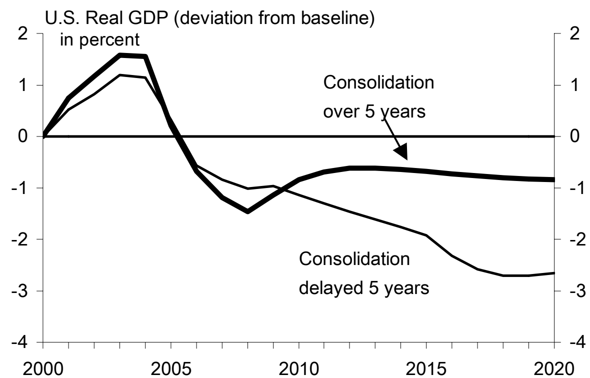
In the absence of reforms, federal debt is projected to rise steadily as a ratio to GDP.

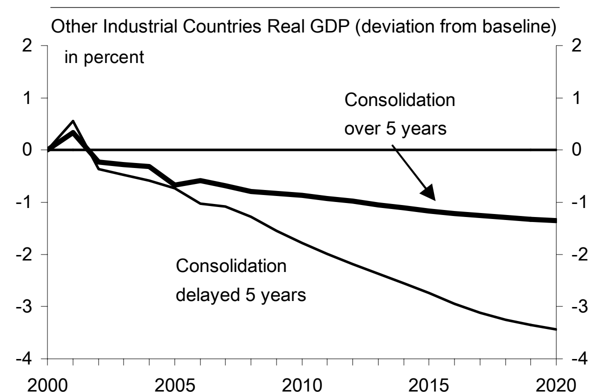


Sources: Social Security and Medicare Trustees' Reports.

23. ***Regarding the longer term, the mission noted that a significant effort would be needed to address the sustainability of the U.S. fiscal position.*** Although the Administration has recognized the pressures that are expected to build from the Social Security and Medicare systems, last year's expansion of Medicare benefits has exacerbated the long-run fiscal imbalance. Staff estimates now place the actuarial liability of major entitlement programs over a 75-year horizon at about 230 percent of current GDP, roughly equivalent to a 13 percentage point hike in payroll taxes.

An early withdrawal of fiscal stimulus would reduce the long-term drag from higher debt.





Source: *World Economic Outlook*, May 2004.

24. ***Against this background, the team saw the need for a clear long-term fiscal goal to anchor expectations, consistent with previous Fund advice.*** The mission proposed that the authorities aim at balancing the budget, excluding the Social Security surplus, by the end of decade. This would enable a substantial reduction of U.S. federal debt ahead of the retirement of the baby-boom generation and provide room to build consensus on the entitlement front. Reducing the deficit by 1 percentage point of GDP each year through the rest of this decade—roughly the rate envisioned for FY 2005–06—could provide significant supply-side benefits to the United States and elsewhere by raising public saving and thereby reducing

pressures on global interest rates and investment, with only modest effects on short-term activity.[10] To maximize these benefits, the mission considered that consolidation could be achieved in a manner that would preserve the supply-side benefits from recent reductions in marginal tax rates.

25. ***Officials stressed the Administration's commitment to reducing the deficit, agreeing that persistent deficits would be harmful to the economy, including by driving up interest rates.*** While seeing little merit in establishing a more formal longer-term fiscal goal, given the uncertainties involved in budget projections, they emphasized that a balanced budget remained the Administration's longer run objective. By FY 2009, the ratio of the fiscal deficit to GDP would fall below its long-term average, which they regarded as an appropriately ambitious goal, especially in light of the need to give priority to spending on defense and homeland security. They added that considerable care had been taken to ensure that the budget rested on prudent macroeconomic and technical assumptions, but did not expect that a better-than-expected outcome this year would translate into a more ambitious medium-term target.

26. ***The mission supported the Administration's call for a reauthorization of the 1985 Budget Enforcement Act (BEA), but saw risks in the decision to limit its scope.*** Although the Administration's proposal would establish caps on discretionary spending and tighten restrictions on "emergency" appropriations, it could significantly weaken fiscal discipline by exempting most tax measures from "pay-as-you-go" provisions and shortening the horizon of the legislation's discipline to five years. This would allow lawmakers, for example, to circumvent spending restrictions by granting targeted tax relief, or to design measures with the fiscal impact concentrated in the outer years.

27. ***The team discussed the role revenue enhancements could play in helping to achieve consolidation.*** The mission agreed that spending cuts represented a preferable option for restoring fiscal balance but noted that revenue reform could play an important role, especially given the magnitude of the fiscal adjustment required and already ambitious plans for cutting nondefense discretionary spending. In order to preserve potential supply-side benefits of lower marginal tax rates, the mission suggested that emphasis should be laid on reforms to broaden and simplify the tax base. As discussed in Box 2, potential options to improve the equity and efficiency of the tax system could include lowering personal income tax expenditures, such as the deductibility of mortgage interest payments, reducing corporate tax exemptions, raising energy taxes, and introducing a national value-added or similar indirect tax.[11]

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[10] Chapter 2 of the *World Economic Outlook* (April 2004) illustrates this point by reporting MULTIMOD simulations that suggest that a delayed fiscal adjustment places greater downward pressure on investment and output, both domestically and abroad, as higher government debt reduces private saving.

[11] See also Chapter 3 of the accompanying *Selected Issues* paper.

Box 2. Options for Fiscal Consolidation[1]

Estimates of the size of measures needed to balance the budget excluding Social Security differ depending on assumptions about policies and future growth. Using the Administration's FY 2005 budget proposals, the CBO projects a unified federal government deficit excluding the Social Security of 3¼ percent of GDP ($570 billion) by 2014, while a baseline that includes AMT relief and somewhat faster expenditure growth yields a gap of 4 percent of GDP. Estimates of the fiscal gap are sensitive to underlying growth assumptions, with the required adjustment falling (rising) by 1½ percent of GDP for each ½ percentage point, the potential growth rate is higher (lower) than in the baseline.

Further spending cuts may be difficult to achieve. The Administration's FY 2005 budget already aims to reduce nondefense discretionary expenditure to under 3 percent of GDP over five years, the lowest level since the 1960s. Additional cuts could include reigning in agricultural and other commercial subsidies, including curbing agricultural price support, closing or privatizing federal agencies, such as NASA, the FAA, or the Export-Import Bank, and ending a range of other federal programs. While such measures could yield savings worth up to 2½ percent of GDP by 2009, realistic targets are likely to prove considerably smaller. Similarly, reductions in federal transfers to the states would simply move the fiscal problem from the federal to state budgets.

Even under relatively optimistic assumptions regarding expenditure restraint, sizeable revenue increases appear necessary to restore the budget to balance excluding Social Security. Efficiency considerations suggest that broadening the personal income tax base and introducing a federal consumption tax should take priority over raising marginal income tax rates. The potential revenue impact of such measures could be significant:

- The U.S. **personal income tax** system provides substantial tax deductions and exemptions, leading to total revenue losses of about 6 percent of GDP in 2003. Savings could be achieved by bringing these exemptions partly under the tax net. For example, the maximum mortgage amount on which tax exemption can be claimed (currently $1 million) could be gradually reduced or phased out.
- The **corporate income tax** system has been characterized by a widening gap between corporate book and taxable profits. Potential revenue gains from closing corporate tax loopholes and stepping up enforcement of existing rules are hard to estimate, but could be a multiple of the $25 billion (¼ percent of GDP) annual cost of corporate tax expenditures projected over the medium term.
- A gradual increase in **energy taxes** could raise revenues and help limit U.S. energy use especially since from an international perspective energy use in the United States is relatively lightly taxed, even accounting for geographical and climatic idiosyncrasies. Estimates suggest that raising gasoline taxes by 20 cents per gallon could yield around ¼–½ percent of GDP in revenues.
- Experience from other industrial countries suggests that a **federal VAT** could yield about ½ percent of GDP per percentage point. A VAT could help improve intergenerational equity by implicitly taxing retiree wealth, and—once established—would provide an economically more efficient means to raise revenues to respond to spending pressures from population aging.

While no alternative to long-term fundamental reform of the Social Security and Medicare programs, faster-acting measures to reduce entitlement spending could also be implemented. These could include, among others, advancing the next phase of the increase in retirement age, currently slated for 2017; improving the formula for cost-of-living adjustments to align benefit levels more closely with actual cost increases; and adjusting benefit payments for increases in life expectancy. On the revenue side, the share of taxable earnings currently included in the payroll tax base could be increased, and there also remains scope for raising premium levels for the SMI part of Medicare. These measures could provide annual savings of ½–¾ percent of GDP by 2014.

Note: The author of this box is Martin Mühleisen.

[1] This box is based on U.S. government budget documents as well as: CBO, 2003 *Budget Options*; C. Edwards, 2004, "Downsizing the Federal Government," *Policy Analysis*, No. 515 (The Cato Institute); M. Mühleisen and C. Towe (eds.), 2004, *U.S. Fiscal Policies and Priorities for Long-Run Sustainability*, IMF Occasional Paper 227, A. Rivlin and I. Sawhill (eds.), 2004 *Restoring Fiscal Sanity: How to Balance the Budget* (Brookings Institution).

28. ***Officials ruled out tax increases to close the medium-term budget gap, but saw scope for revenue-neutral tax reform.*** This reflected a fundamental view that budget discipline should rest on curbing government spending. The Administration's policy was aimed at maximizing incentives for economic growth, including by keeping the ratio of tax revenue to GDP low, encouraging private saving, and reducing the regulatory burden, while maintaining a reasonable level of government. Nevertheless, officials acknowledged that the expected increase in the number of taxpayers falling under the Alternative Minimum Tax (AMT) ran counter to the AMT's original purpose of securing a minimum amount of tax revenue from wealthy individuals and would likely trigger broader reform proposals.[12]

29. ***The Administration also remains committed to simplifying and extending existing tax-exempt vehicles to provide incentives for enhanced private saving.*** Existing tax-preferred savings plans would be replaced by Retirement Savings Accounts, which would enable tax-free investment so long as withdrawals were made following retirement (so-called tax-prepaid plans). The Administration has also proposed tax-prepaid Lifetime Savings Accounts—which would allow households to withdraw funds before retirement for a range of purposes—as a means to support saving especially amongst low-income households that tend to suffer more from liquidity constraints than other groups of the population. Health Savings Accounts were already introduced as part of the 2003 Medicare reform bill to help make medical insurance more affordable. Staff cautioned that existing evidence on the effectiveness of tax-exempt vehicles in raising net private saving was mixed, suggesting that a positive impact on national saving was not assured.

30. ***In view of the continued underfunding of the Social Security system, the team noted that delaying reform would require larger and more painful measures later on*** (Box 3). The 2004 *Economic Report of the President* analyzes a reform option already proposed and discussed by a 2001 Presidential Commission. It involves indexing benefit accruals to inflation instead of wage growth, which would slow benefit growth and eliminate the system's underfunding, and diverting part of the existing payroll tax to personal retirement accounts (PRAs). While PRAs would have a limited impact on unfunded liabilities, the team noted that debt and deficits would rise during the transition to a more funded system.

31. ***Officials responded that the Administration had sought to foster debate around alternative approaches to Social Security reform rather than identify specific policies.*** Although it had not endorsed any particular reform plan, the Administration was deeply committed to the introduction of PRAs. Officials discounted concerns about the associated rise in public debt and deficits, noting that these would be transitory and would only reflect an explicit recognition of implicit obligations. Indeed, the expectation was that the higher deficits in the transition period would assist in disciplining spending in these and other areas. Accordingly, they saw no need for offsetting measures, such as broadening the base of the Social Security tax noting that indexing accruals to prices, in combination with the introduction of PRAs, would eliminate the program's funding gap over the infinite horizon.

32. ***Officials agreed that the financial problems of the Medicare system were much more daunting than Social Security.*** The system is expected to begin running cash-flow

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[12] See Chapter 4 of the accompanying *Selected Issues* paper.

Box 3. The Real Fiscal Problem—An Intergenerational Accounting Approach[1]

The recent re-emergence of large U.S. budget deficits has heightened concern regarding the extent to which the retirement and health care systems are prepared to cope with the pressures of an aging population. Actuarial estimates for the Social Security and Medicare systems show that the present value of the unfunded liability of these two programs is around 230 percent of current GDP over a 75-year horizon (and higher if calculated over a longer horizon; Table). This suggests the need for either benefit cuts or premium increases with a yield roughly equivalent to an immediate and permanent 13 percentage point hike in the current payroll tax rate.

***Reform options for Social Security were discussed in the* 2004 Economic Report of the President.** One plan, which was outlined by the 2001 Presidential Commission, slows the growth of Social Security benefits by indexing accruals of benefits to inflation instead of wage growth, and offers beneficiaries the option to deposit part of their payroll taxes in personal retirement accounts. The accumulated contributions, to be invested in private securities, would be available for workers at retirement in exchange for reductions in the traditional Social Security benefit. While indexing accruals to inflation would eliminate the program's funding gap, staff estimates (assuming that price-indexing ends after 75 years) suggest that the introduction of personal retirement accounts would likely still leave the system with a small remaining liability.[1]

Unfunded Liabilities

(In percent of 2003 GDP)

Years of projections	50	75	150	∞
Social Security 1/ 2/				
Current system	9.0	31.1	71.0	80.6
Indexing accruals to prices	(5.2)	(5.6)	(9.1)	(10.2)
Indexing accruals to prices plus PRA				
with 67% participation	10.1	8.5	7.6	(0.4)
with 100% participation	17.8	15.6	12.5	4.5
Medicare 2/				
Current system	124.7	202.4	338.1	...
Of which:				
Hospital insurance	30.7	60.2	116.5	...
Supplementary medical insurance (Part B)	55.5	83.3	129.4	...
Medicare prescription drug (Part D)	38.4	58.8	92.2	...
Tighter Spending	97.8	138.0	202.0	...

Source: IMF staff calculations based on SSA data.

1/ Present value of the projected costs less the sum of the trust fund assets at the beginning of 2003 and the present value of the projected tax income.

2/ Present values are obtained using the projected 2004 OASDI Trust Fund Report intermediate long term yield rate (5.8 percent).

The unfunded liabilities of Medicare are much larger than Social Security. On current policies, including the prescription drug benefit introduced in 2003, spending on Medicare is projected to rise from about 2½ in 2004 to about 10 percent of GDP by 2075, and Medicare's 75-year actuarial imbalance is estimated at around 200 percent of 2003 GDP (Table). Population aging is only one of the factors behind the projected increase in Medicare spending. Due to the increase in the cost of medical technology and drugs, per capita health expenditure has increased significantly faster than wages over the last decade, and projections assume this trend to continue. As indicated in the "tighter spending" scenario reported in the table above, staff estimates indicate that containing Medicare spending to the rate of productivity growth would reduce its actuarial imbalance by about one-third.

A frequently ignored aspect of the debate concerns the intergenerational consequences of the reform. Estimates based on an intergenerational accounting framework similar to that used by Gokhale and Smetters (2003) show that the size of the U.S. fiscal gap over an infinite horizon may be nearly five times the present level of U.S. GDP. The adoption of policy measures to close the gap would require an immediate and permanent increase in personal and corporate income tax revenues of two-thirds or, alternatively, an immediate and permanent halving of Social Security and Medicare outlays for all current and future generations. Delaying the reforms would not only increase the total size of the adjustment eventually needed, it would also involve a substantial redistribution of the fiscal burden from current to future generations.

Closing the Fiscal Imbalance

	Percent Increase in Income Taxes	Percent Cut in Social Security and Medicare
Baseline	67.1	-51.0
Adjustment delayed to 2010	73.5	-53.8
Adjustment delayed to 2020	85.3	-58.8

Sources: Budget of U.S. Government, FY2005; Old-Age and Survivors and Disability Insurance (OASDI) 2004 Trust Funds Annual Report; and IMF staff calculations.

Note: The author of this box is Roberto Cardarelli.

[1] Estimates of the effect of this option are only available from the Social Security Administration for 75 years. IMF staff assumptions for subsequent years include the indexation of benefit accruals to wages rather than prices, as discussed further in Chapter 4 of *U.S. Fiscal Policies and Priorities for Long-Run Sustainability*, IMF Occasional Paper No. 227 (2004). As with all long-term projections, changes to the underlying assumptions could affect the results.

deficits by the end of the next decade, and outlays are projected to rise rapidly as a share of GDP, particularly given the drug benefits introduced last year. Officials stressed that the problems went beyond the increase in the elderly population. Rising costs, in part, reflect improvements in technology that have encouraged the increased use of more expensive procedures and equipment, including for relatively expensive chronic illnesses, such as diabetes and coronary heart disease.

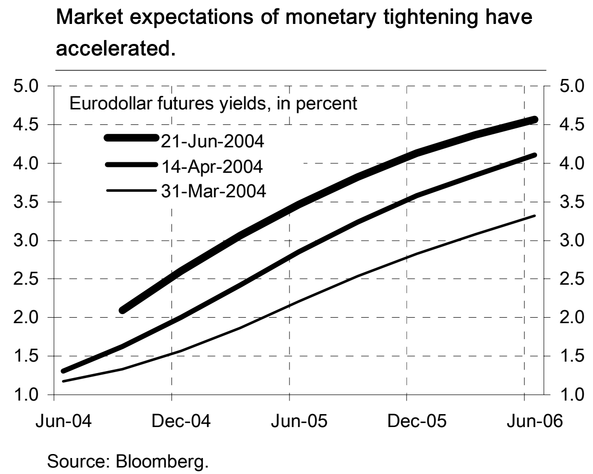
33. ***The mission asked about prospects for reform and whether it should involve the broader health care system.*** Although the health system is largely run by the private sector, half of U.S. medical spending is publicly financed, with this share likely to rise with population aging. Consequently, durable reform of the public system would also seem to require measures that could address the cost pressures and incentives in the private system. Officials responded that recent and prospective reform proposals would help increase efficiency and slow health care costs. The Health Savings Accounts established as part of last year's Medicare legislation were designed to give consumers greater responsibility and choice over their health care and encourage them to play a greater role in containing costs. The 2003 legislation also introduced the principle of means-tested benefits, contained initiatives to promote preventative care and the use of information technology, and increased private sector involvement in administering benefits. Although private health management organizations have had only mixed success in containing costs thus far, officials viewed these systems as likely to be effective in reducing costs related to excess capacity, which was especially significant in urban rather than rural areas.

34. ***Health care issues also remain of central importance at the state level.*** Financial conditions among the states have improved since mid-2003 reflecting expenditure cuts, some revenue measures, and a recovery in economic activity. However, most states continue to seek budgetary savings to cope with the steep drop in tax revenues after 2001, and some were concerned that new federal mandates in areas such as education and homeland security had only been partly funded. In the long run, however, the states' fiscal position was largely dominated by health care spending, which was projected to continue to trend upwards at a rate of 8–9 percent per year. With diminishing room for further expenditure cuts, states are expected to increasingly turn toward revenue measures, with the taxation of internet transactions emerging as an area of potential friction in state-federal fiscal relations.

V. Monetary and Exchange Rate Policies

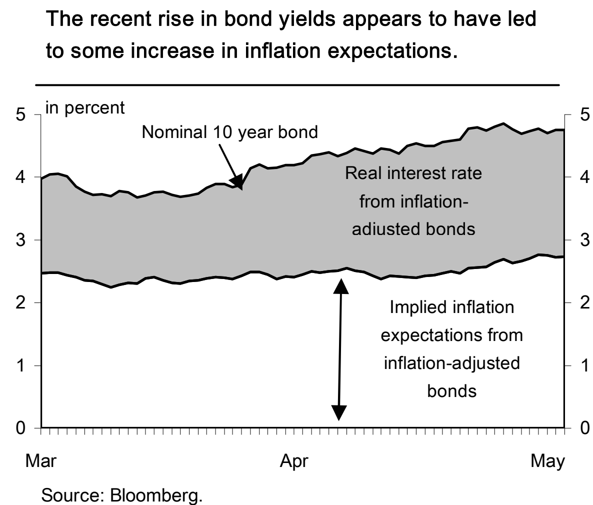
35. ***In recent months, the Federal Open Market Committee (FOMC) has begun to lay the ground for a withdrawal of stimulus.*** Following the August 2003 formulation that an accommodative stance would be maintained for a "considerable period," the FOMC's January 2004 statement suggested that deflationary risks had eased by stressing that the Fed could be "patient" before withdrawing stimulus. In subsequent speeches, FOMC members downplayed fears that low interest rates were fueling a speculative bubble in asset markets, but also cautioned that households and businesses should be prepared for a higher interest rate environment. In May, the FOMC's statement shifted toward a balanced assessment of inflation and noted that policy accommodation could be removed at a pace that was likely to

be "measured." More recent speeches have emphasized that, if necessary, the FOMC stands ready to move rapidly to maintain price stability.



36. ***The team commended the authorities for their success in stemming deflation risks during the past year.*** The further easing that had been introduced in early 2003, and the subsequent statements by policymakers that the authorities were prepared to respond further, including through unconventional means, appeared to have effectively anchored expectations and reassured markets. Fed officials responded that, with the recovery now becoming well advanced, the focus of their communication strategy had shifted toward preparing financial markets for the inevitable withdrawal of monetary stimulus. This emphasis reflected a desire to avoid the type of market over-reaction that had occurred in 1994, when bond yields rose sharply in response to Fed tightening. FOMC statements seemed to have been effective in signaling that policymakers were committed to a gradual policy adjustment, and officials expressed broad satisfaction with the extent to which this signal had been reflected in bond yields.

37. ***At the same time, however, the team discussed whether recent price pressures suggested that an earlier withdrawal of stimulus might have been warranted.*** The core PCE deflator had accelerated by some ½ percent (year-over-year) since January and inflation expectations—as measured by the spread between nominal and inflation-indexed bonds—seemed to be drifting upward. In this circumstance, a gradual increase in the federal funds rate might not be consistent with price stability given that the economy was expected to return to potential around mid-2006, the transmission lag for monetary policy was around 18 months, and there remained a large gap between the current federal fund rate of 1 percent and conventional estimates of a neutral rate of 4–5 percent.



38. ***Fed officials saw little likelihood that an abrupt removal of stimulus would be needed.*** Indeed, they suggested that the rate of withdrawal of stimulus in 2005 implied by yield curves seemed more rapid than warranted by cyclical conditions. Although the federal funds rate was a considerable distance from its neutral level, bond yields had increased and

headwinds associated with the higher oil prices, the anticipated rebuilding of the household saving rate, and the withdrawal of fiscal stimulus, meant that monetary policy could be easier for longer than otherwise.

39. ***Thus, while Fed officials acknowledged that the recent rebound in inflation was a cause for concern, they saw the risk of a significant acceleration in core prices as limited.*** Recent price pressures seemed to largely reflect increases in margins rather than unit costs and, with the share of profits in national income unusually elevated, there was considerable room for margins to accommodate a further rise in material costs. Moreover, since the disinflation through late 2003 and early 2004 had been larger than projected by conventional models, the recent price increases likely represented a return to more normal conditions. Although inflation expectations had increased, the rise was modest and to be expected in the face of higher energy prices and the cyclical recovery, and surveys indicated that expectations remained well anchored.

40. ***Officials observed that the Fed continued to take a "risk-management approach" to policy.*** The weight that policymakers placed on the Fed's dual mandate of price stability and full employment tended to vary depending on which of these objectives were at greatest risk. Thus, greater weight was given to real output growth during economic downturns, with a larger weight attached to inflation and interest rate smoothing during upturns (Box 4).[13]

41. ***The Federal Reserve remains one of the most transparent central banks.*** That said, as in the past, the staff queried whether introducing a more explicit definition of price stability and medium-term target for inflation would provide valuable additional guidance to markets. They noted that a greater number of FOMC members appeared amenable to this idea than in the past. Officials acknowledged that there were different views on the merits of adopting an explicit inflation target within the FOMC, but key objections included the Fed's dual mandate, the fact that inflation expectations were already well anchored, and that inflation indices tended to be biased. A number of options for increasing transparency—such as adopting a standard formula for describing the FOMC's policy stance, releasing more detailed macroeconomic forecasts, and accelerating the publication of minutes—had been discussed at the FOMC's January 2004 meeting, but there had been no agreement on these proposals.

42. ***Staff discussed the implications of the large U.S. current account deficit and associated risks of market disruption.*** Especially against the background of a large fiscal deficit, the low U.S. national saving rate could be a significant drain on global saving as the global recovery matures, potentially dampening global investment and growth.[14] In addition,

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[13] The cyclical response of monetary policy is discussed in Chapter 5 of the accompanying *Selected Issues* paper.

[14] See Chapter 2 of the *World Economic Outlook*, April 2004, "The Global Implications of the U.S. Fiscal Deficit and of China's Growth."

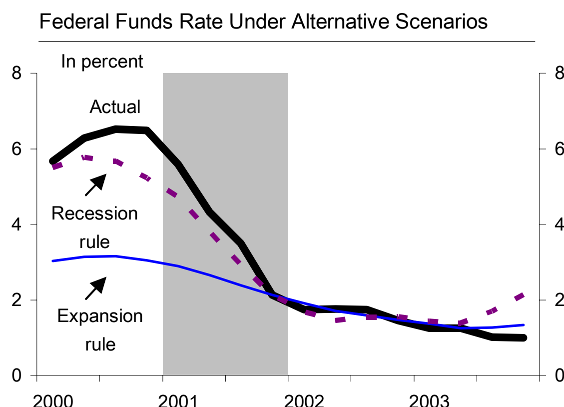
Box 4. How Typical Was the Federal Reserve's Response To This Recession? [1]

To compare the monetary policy response to past cyclical episodes, the staff has estimated a monetary response function in which the coefficients on the Taylor rule vary depending on the state of the cycle. More precisely, Taylor rules were estimated separately for recessions (i.e., periods of negative output growth) and expansions. Given uncertainties about the true state of the economy, the implied policy being followed at any one time is a weighted average of these two rules, with the weights depending on the relative probabilities assigned to being in either situation.

The results indicate that in expansions the Federal Reserve puts a high weight on combating inflation and on smoothing interest rate changes, while in recessions more weight is assigned to output growth and responses are faster. The focus on inflation in recoveries and output growth in recessions plausibly reflects differing economic risks and costs as well as possible nonlinearities in the relationship between inflation and output over the cycle. Similarly, the difference in speed of response is consistent with some stylized features of the cycle, including that the onset of recessions is less predictable than recoveries and that output tends to fall more rapidly than it increases.

The two-state Taylor rule captures the broad contours of the Federal Reserve's recent behavior. The figure shows the actual path of the federal funds rate and the path implied by the two extreme rules adjusted to equal the actual rate at the end of the recession. As can be seen, the "recession" policy rule suggests a rapid fall in the federal funds rate over the downturn that is relatively similar to the actual easing, reflecting the focus on anemic output growth. Similarly, the "expansion" rule, with its greater concentration on inflationary developments and interest rate smoothing, suggests that the tightening cycle would normally have started but be at an early stage.

Federal Funds Rate Under Alternative Scenarios



The analysis also suggests, however, that current stimulus is larger than typical. A closer examination of the results reveals that the easing cycle this time around was particularly aggressive. The speed of easing appears to have reflected fears of deflation and the limited room to provide future interest rate reductions due to the closeness of the zero interest rate bound, which generated a greater-than-usual emphasis on ensuring adequate current stimulus. However, this also implies that the current stance is more simulative than would be typical at this stage in the cycle. This suggests that at some point, the tightening cycle might be expected to be somewhat more aggressive than in a more typical environment.

Note: The author of this box is Pau Rabanal.

[1]More details of the staff's work is contained in Chapter 5 of the accompanying *Selected Issues* paper.

the projected continuing rise in U.S. net foreign liabilities as a ratio to GDP posed the risk of a disorderly adjustment as financial markets might become saturated with U.S. instruments. Finally, market conditions could be affected by a reversal of the recent trend toward an increasing proportion of the deficit being financed by foreign official flows.

43. ***Treasury officials emphasized that they viewed the current account deficit as a reflection of the buoyancy of the U.S. economy and weakness of demand abroad rather than a policy concern.*** Capital inflows still largely reflected market-based decisions by investors, and they expressed confidence that if official purchases diminished, private investors would fill the gap without significant consequence, since a mild depreciation of the dollar would make U.S. securities cheaper and more attractive to foreign investors. Treasury officials and Federal Reserve officials agreed that market developments during the past year had illustrated that fears of disorderly market adjustments were largely overdone.

44. ***Nonetheless, Federal Reserve officials acknowledged that the U.S. current account deficit could not remain in the present range over the long term.*** The relative strength of the U.S. economy, recent increases in global oil prices, and the likelihood that higher interest rates would begin to raise payments abroad to holders of U.S. Treasuries, could keep the deficit at or higher than 5 percent of GDP for the foreseeable future (Box 5 discusses prospects for the trade balance). Officials recognized that the steady rise in net external indebtedness could not be sustained indefinitely, and stabilizing the external debt-to-GDP ratio would require a much larger adjustment in the trade balance than may be assumed, given the need to service the net liability position.

VI. Financial Sector and Corporate Governance

45. ***Officials expressed strong confidence in the stability of the banking system.*** While the improvement in overall economic conditions was helping to create record profits and near-record returns on assets, sound risk management practices had also made important contributions. The system was well prepared for interest hikes and, given high levels of capital, the system appeared unlikely to face significant threats to its financial stability. Staff agreed that banking profitability and capital measures looked healthy, especially compared with their levels following the 1991 recession. At the same time, the importance of large, complex banking groups continued to increase, and staff welcomed the authorities' continued efforts to adapt inter-agency supervisory arrangements.[15]

46. ***The authorities remain committed to the Basel II Accord.*** Outstanding issues within the Basel Committee, largely involving the treatment of credit card debt, were likely to be resolved soon. The main concern among U.S. regulators was to ensure that Basel II did not significantly affect the competitive position of adopting banks relative to non-adopters. Were this to be the case, implementation might be delayed until supervisors were satisfied that any such unintended consequences could be mitigated. That said, officials viewed the benefits of

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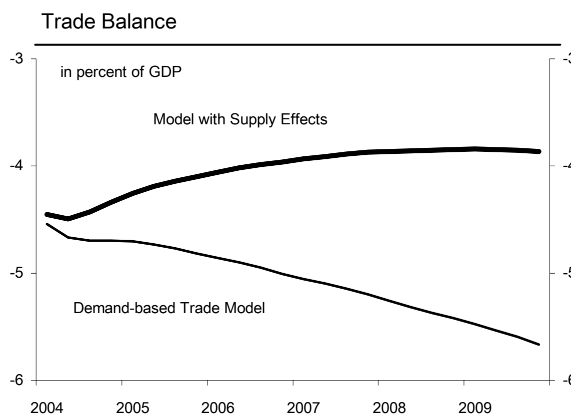
[15] See Chapter 6 of the accompanying *Selected Issues* paper.

Box 5. Prospects for the Trade Deficit

Standard trade models suggest that the expansion in the U.S. trade deficit over recent years reflects U.S. growth relative to competitors, and that the U.S. trade deficit will continue to widen as a consequence of domestic economic vibrancy. However, this view may be unduly pessimistic and, if supply-side effects are important, the trade deficit as a ratio to GDP could stabilize even with rapid domestic growth.

Traditional trade models imply that countries in which growth accelerates should suffer a deterioration in their trade balance or a trend depreciation in their exchange rates. In such models, trade only reflects demand factors. Exports depend on relative prices (e.g., the trade-weighted real exchange rate) and a measure of global demand. Similarly, imports depend on relative prices and growth at home.



Source: IMF staff calculations.

For the United States, estimated income elasticities are typically found to be larger for imports than for exports. This implies that if growth in the United States is the same or faster than its trading partners, the trade deficit will expand inexorably with unchanged relative prices.[1] Staff estimates of such a specification imply that, on current WEO assumptions about growth in the United States and its trading partners and unchanged real exchange rates, the trade deficit would reach 5¾ percentage points of GDP by 2009.

Some authors, however, have argued this prediction reflects the absence of "supply-side" effects.[2] They note that countries with fast underlying growth rates tend to also have higher estimated activity elasticities on exports compared to imports. As a result, rapid development in countries such as Japan or South Korea was not associated with growing trade deficits or trend depreciations in their exchange rates. This suggests that an expansion of domestic supply creates a demand for exports and reduces the demand for imports. Such an effect could occur if growth increases the range of goods produced by that country. If consumers enjoy variety, they will purchase more goods from a fast-growing economy.

Forecasts that incorporate such supply effects suggest a more modest deterioration of the trade balance. For example, in a model that assumes that demand factors dominate in the short term, but that exports and imports respond equally to demand and supply factors in the long run, the trade balance as a ratio to GDP is projected to fall modestly over the next 5 years and stabilize at around 4 percent of GDP.

Note: The authors of this box are Tamim Bayoumi and Pau Rabanal.

[1] The original result was reported in H. S. Houtakker and Stephen Magee, 1969, "Income and Price Elasticities in World Trade," *Review of Economics and Statistics*, 51, pp. 111–24. Updated regressions that find basically the same result include Peter Hooper, Karen Johnson, and Jaime Marquez, 1998, "Trade Elasticities for the G-7 Countries," Board of Governors of the Federal Reserve System Working Paper No. 609.

[2] See, for instance, Paul Krugman, 1989, "Differences in Income Elasticities and Trends in Real Exchange Rates," *European Economic Review*, 33, pp. 1031–54.

adopting Basel II, in terms of risk improved measurement and management, as exceeding the costs of implementation.

47. ***Officials and staff agreed on the need for stronger regulation of the major government sponsored enterprises (GSEs)*** (Box 6). Although they expressed confidence in the financial position and risk-management practices of the GSEs, officials saw the rapid expansion of their asset holdings as posing potential concerns due to the concentration of interest rate risk, particularly given the incorrect perception by many market participants that the GSEs benefited from an implicit government guarantee. The Administration had proposed legislation to create a new regulator with powers to set capital levels, define stress tests, and place a GSE into receivership if necessary. It appeared doubtful that the legislation would be enacted in the current year, however, largely due to a lack of agreement on the receivership issue, and officials were exploring how the current regulatory framework could be used to tighten oversight. Staff welcomed the proposed measures, but noted that strengthened regulation would not necessarily curb the growth in GSE activities if the perception that these agencies were too big to fail remained, and allowed funding at an advantageous rate.

48. ***Corporate governance reforms contained in the Sarbanes-Oxley legislation were largely in place.*** There had been few difficulties in implementing these changes and—notwithstanding some concerns in the corporate sector—officials said they had found little evidence that the rules had hampered firms from expanding activities or attracting qualified candidates for boards and audit committees. The Public Company Accounting Oversight Board (PCAOB) had made significant progress in strengthening the oversight of the auditing profession by initiating registration of domestic auditors and conducting "limited procedure" inspections of the top accounting firms. Official agreed with staff that recent revelations of questionable practices in the mutual fund industry underscored the need for continued vigilance with regard to the integrity of markets.

49. ***Officials noted the improvement in finances of defined benefit corporate pensions, but indicated additional reforms could further strengthen the system.*** Such plans remain an important, if declining, part of the U.S. pension system. Rising stock prices and increased contributions had generally improved balance sheets, although there were still significant funding issues in several plans, particularly in the steel and airline industries.[16] Recently-enacted legislation would improve the accuracy of measuring pension liabilities but also would provide relief to most severely underfunded plans, reducing overall funding and raising issues of moral hazard. Administration proposals to strengthen future funding levels included measures to reduce incentive problems by restricting the benefits severely underfunded plans may offer. Officials acknowledged that restructuring the Pension Benefit Guarantee Corporation's (PBGC) premium structure to reflect pension plan risks was one of the measures under consideration to improve PBGC funding.

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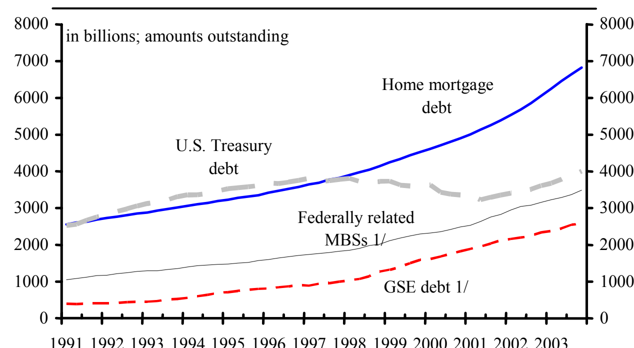
[16] For details, see Chapter 3 of *United States: Selected Issues*, IMF Country Report No. 03/235, August 2003.

Box 6: Proposed Regulatory Reform of the Government Sponsored Enterprises (GSEs)

During the past year, debate has intensified over regulation of the two major housing GSEs, Fannie Mae and Freddie Mac. The authorities and Congress have been considering measures that would enhance the supervision of their activities and could reduce the potential moral hazard arising from the continued market perception of an implicit government guarantee on their debt.

The activities and balance sheet size of the GSEs have expanded significantly in recent years (see Chart). Not only is the quantity of mortgage-backed securities (MBSs) guaranteed by the GSEs of a comparable size to the U.S. Treasury market, but the GSEs' own balance sheets are more than half the size of the securitized markets they have fostered. The implicit guarantee that markets attach to GSE debt has enabled them to acquire large amounts of mortgage-related assets at a lower cost than other market participants and, in the process, take on interest rate exposures.

Size of Mortgage Market and GSEs.



Source: Flow of Funds.
1/ As of end-2003, over 80 percent of federally related MBSs were guaranteed by Fannie Mae and Freddie Mac, and almost 70 percent of GSE debt was issued by Fannie Mae and Freddie Mac.

Besides their size, the GSEs are important to financial stability for several reasons: About 30 to 50 percent of their liabilities are short-term; their role as one of the largest counterparties in the interest-rate swap and swaption market; and possible amplification of market volatility from their readjustments of hedges when yields move and expectations of mortgage prepayments change. The GSEs' activities are large enough to give them price-setting influence in the interest rate derivatives markets.

Concerns about the GSEs' potential impact have been heightened by accounting problems. Freddie Mac was required to restate earnings upwards for 2000–02, and its 2003 statement is still under preparation. The Office of Federal Housing Enterprise Oversight (OFHEO) is conducting a special examination of accounting policies and practices at Fannie Mae. These accounting problems have not cast doubt on the GSEs' underlying financial soundness, but do raise questions about the transparency and control of their complex risk management operations.

The potential for future problems is exacerbated by the continued perception of an implicit government guarantee. The perception persists because of several factors, including: a line of credit from the Treasury; exemption of GSE debt from banks' large exposure limits; exemption of their income from state and local taxes; exemption from SEC securities registration requirements; and, perhaps most importantly, the widespread belief that they are "too big to fail." As a result, investors and counterparties may take on greater exposures to the agencies than they would to an equivalent institution without such links to government.

The Treasury has proposed legislation that would treat the GSEs more like other financial institutions. The proposal would establish a new regulator, under the oversight of the Treasury, with more discretion to set capital and other requirements. In the same way as bank regulators, the new regulator would have the power if necessary to place GSEs in receivership, take other enforcement actions, and fund itself through GSE assessments. However, the current version of the bill in Congress does not contain the receivership provision, which the Treasury regards as essential, and legislation is therefore unlikely to be enacted this year.

Federal Reserve officials have proposed more directly addressing the size of the GSEs. Noting that stricter regulation could actually increase perceptions of the guarantee, Chairman Greenspan has suggested limiting the size of the GSEs' own debt as a proportion of the debt they securitize. Limiting their ability to fund holdings on their balance sheet, relative to the overall size of the mortgage-backed securities market should reduce their potential impact while enhancing the liquidity of the securitization market.

With legislation unlikely in the short term, the Administration is exploring more modest interim steps that can be taken under existing law. In the absence of receivership, OFHEO is developing rules for applying conservatorship. The Treasury intends to request more ongoing information on the GSEs' debt issuance policy.

Note: The author of this box is Rupert Thorne.

[1] Wayne Passmore, 2003, "The GSE Implicit Subsidy and Value of Government Ambiguity," Finance and Economics Discussion Paper No. 2003-64 (Federal Reserve Board, December).

50. ***Officials and staff concurred with the Financial Accounting Standard Board (FASB) proposal that stock option grants should be expensed.*** Officials noted that stock options are a form of compensation and that pricing them at zero in income statements was not transparent. Moreover, although there was some discussion in Congress of weakening this proposal—as had occurred in 1994—expensing options would bring the United States more in line with international accounting standards. Indeed, officials noted with satisfaction the more general convergence of accounting standards, and that FASB and the International Accounting Standards Board (IASB) were working to eliminate differences in treatment with an emphasis on adopting whichever measure was stronger.

51. ***Officials noted that the United States has largely complied with the 40+8 Financial Action Task Force (FATF) recommendations on Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT), and progress was being made on the remaining issues.*** The authorities are continuing their efforts to implement the provisions of the Patriot Act, and will be in full compliance with FATF recommendations when regulations requiring all nonbank financial institutions to report suspicious activities are in place. Given the range of regulators involved in supervising different types of financial institutions, a new Office of Intelligence and Analysis is being created to increase information sharing.

VII. Trade Policy and Official Assistance

52. ***Officials explained that the Administration is pursuing a multi-pronged trade policy strategy.*** On the multilateral front, the office of the U.S. Trade Representative (USTR) had been active in efforts to reinvigorate the Doha trade round, promoting regional free trade agreements (FTAs), and building trade capacity among developing countries. On the bilateral front, the authorities also placed an emphasis on bilateral FTAs and on ensuring a level playing field with major trading partners such as China.

53. ***The USTR representatives suggested that prospects for progress in the Doha Round had improved recently, but agriculture held the key to success.*** Officials welcomed recent EU proposals on agriculture and noted that, since the Cancún Ministerial, the United States had indicated flexibility with regard to trade-distorting domestic supports. The central issue now was to achieve agreement on an ambitious formula for agricultural market access, and officials stressed the need for all sides to make concessions to secure a useful framework agreement.

54. ***The authorities' Doha Round objectives also included ensuring that developing countries faced disciplines and adopted liberalization commitments commensurate with their importance in world trade.*** In particular, officials argued that large and competitive developing countries should be subject to the same market access formula as developed countries. However, the Administration was of the view that less developed countries should not be asked to deliver results that were beyond their capacity and supported flexible approaches that combined a gradual phasing of commitments with trade-related technical assistance. The key was to avoid permanent "opt-outs" and excessive dilution of market access goals, which could further disassociate such countries from the global trading system.

55. ***Officials noted that the U.S. trade liberalization agenda also included aggressive pursuit of bilateral and regional FTAs.***[17] This was partly founded on the view that such agreements helped establish momentum in favor of free trade that could carry over to multilateral negotiations. The staff cautioned, however, that the competitive advantage that current and possible future FTAs could yield to participants might weaken their support for multilateral liberalization, while also straining the administrative and negotiating capacity of some developing countries, posing concerns regarding fragmentation of global trade.

56. ***Officials noted that it would be difficult to meet the January 2005 deadline for completion of the Free Trade Area of the Americas.*** The Miami Ministerial in November 2003 concluded without a consensus on the specific issues to be negotiated and with relatively modest commitments in nine broad negotiating areas. Key sticking points included the U.S. emphasis on addressing issues related to domestic agricultural support within the WTO framework and some Latin American countries' aversion to including provisions on investment, intellectual property rights, and government procurement.

57. ***Officials confirmed the Administration's commitment to the end-2004 deadline for eliminating textile and apparel quotas.*** This was likely to prompt a rise in textile imports from China, with negative implications for less competitive developing-country suppliers as well as for domestic textile manufacturers. With regard to other competitors, the authorities pointed out that some recent FTAs, such as the one with Central America, were partly designed to mitigate the effect of the quota elimination. On the domestic front, measures to alleviate trade-related adjustment costs were already in place to provide financial support to affected industries and retrain workers—indeed, the textile sector had been the largest beneficiary of such schemes over 1997–2003.

58. ***Officials noted that China had remained an important focus of trade policy over the past year.***[18] China had continued to provide an important area of opportunity for U.S. exports and, while imports from China had also risen rapidly, this had largely been at the expense of third-country suppliers rather than domestic production. In addition, important safeguards had been introduced as part of China's WTO membership, which could be triggered under less stringent conditions, and these had been applied by the U.S. government in December 2003. Looking forward, U.S. authorities placed important emphasis on China's full and timely compliance with its market access commitments at the WTO, as well as on enforcement of intellectual property rights. The team welcomed the Administration's outward-looking approach and cautioned against a defensive recourse to trade remedy action.

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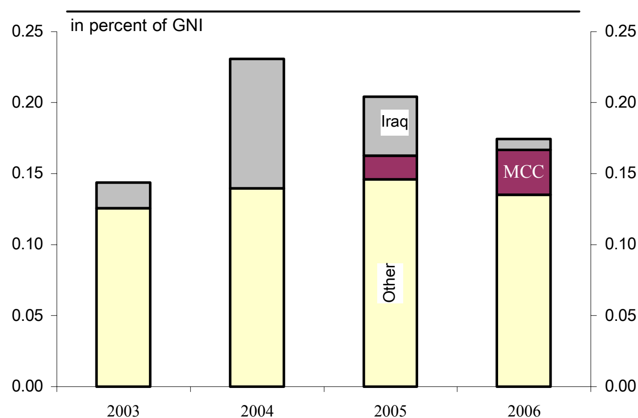
[17] Over the past year, FTAs have been signed with Australia, Chile, five Central American countries, and Singapore, and negotiations have been launched with Bahrain, Colombia, the Dominican Republic, Panama, Peru, the Southern African Customs Union, and Thailand. Officials noted that the busy legislative agenda meant that ratification of many recently-signed FTAs by Congress was unlikely this year.

[18] Trade relations with China are discussed in Chapter 7 of the accompanying *Selected Issues* paper.

59. ***Official development assistance (ODA) has increased rapidly in recent years, but at 0.13 percent of GNI in 2002 is still the lowest ratio among industrial countries.*** Significant increases in ODA spending are planned for the next three years, although some of this increase would be temporary as it is related to reconstruction in Iraq as well as Afghanistan. Sixteen of the 63 countries that qualified for the Millennium Challenge Corporation (MCC) had been asked to submit plans, and operations would start shortly. MCC programs will be fully funded, which has the advantage that they will not be subject to future appropriations, but also implies that fewer programs could be approved initially. The authorities reiterated the President's commitment to allocate $15 billion in five years to fight HIV/AIDS, including $10 billion of new money, and outlined other initiatives to ensure that humanitarian relief remains adequate, such as the creation of a famine fund.

On current plans, ODA spending is projected to rise rapidly in 2004 and then fall back, reflecting supplemental spending for Iraq. However, underlying spending is projected to rise significantly as percent of GNI.



Source: U.S. Agency for International Development (USAID).

VIII. Staff Appraisal

60. ***The U.S. recovery has gathered considerable momentum since last year, and is again leading the global recovery.*** The economy has shaken off an unprecedented series of adverse shocks and—supported by the sizeable injection of monetary and fiscal stimulus since the onset of the downturn—has expanded strongly during the past year. To be sure, downside risks remain, including those related to high energy prices and the course of household demand given high debt loads and concerns that some real estate markets are overvalued. However, productivity growth continues at an exceptional rate, balancing these downside risks and holding out the possibility of further upside surprises to the economy's supply side.

61. ***The FY 2005 budget signals a welcome shift toward fiscal consolidation especially in the nearer term.*** With the recovery now well on track, the deficit reduction projected for the coming two fiscal years is appropriate. Nonetheless, the challenge remains to sustain expenditure discipline, contain budgetary pressures—including those related to ongoing operations in Iraq and Afghanistan and a number of legislative initiatives presently before Congress—and anticipate costs of likely AMT reform. It will help that the budget outcome this year will likely be better-than-expected, providing the opportunity to strengthen subsequent deficit-reduction objectives.

62. ***Continuing the pace of deficit reduction beyond the next two years will help place the long-run fiscal position on a sustainable basis.*** Federal deficits and debt will come under increasing pressure as the baby boom generation retires and places greater demands on entitlement programs, especially in the context of the expansion of Medicare benefits and plans to make tax cuts permanent. Against this background, it will help if the deficit reduction pace envisaged over FY 2005–06 is extended to subsequent years.

63. ***Bringing the budget back to balance, excluding Social Security, within a reasonable period would leave the U.S. fiscal position much better placed to cope with impending demographic pressures.*** Although entitlement reform holds the key to long-run fiscal sustainability, restoring a fiscal surplus equal to the cash-flow surplus of the Social Security system by the end of the decade would achieve significant debt reduction ahead of the retirement of the baby boom generation and provide greater room to build consensus for and implement entitlement reforms. This more ambitious fiscal objective could also have significant supply-side benefits for the United States and the rest of the world by reducing pressures on global interest rates and investment.

64. ***The recovery provides a valuable opportunity for embarking upon the fiscal effort that is needed to achieve such a medium-term objective.*** Helpfully, the authorities have supported budget enforcement legislation that could provide the necessary framework for solidifying fiscal responsibility and expenditure discipline but proposals to limit the pay-as-you-go requirement from covering most tax measures and to shorten its horizon to five years risks weakening the legislation's discipline.

65. ***Revenue measures in the context of efficiency-building tax reform warrant consideration.*** While expenditure discipline will need to be an essential element of the consolidation effort, given the magnitude of the fiscal adjustment required and already ambitious plans for cutting nondefense discretionary spending, revenues may also need to rise. To avoid having to unwind recent marginal tax rate cuts and give up their potential supply-side benefits, emphasis could be laid on reforms to broaden and simplify the tax base, for example by cutting tax expenditures, which significantly reduce revenues and distort resource allocation, or by introducing a national indirect tax.

66. ***Delaying actions to address the Social Security system's funding problems will likely entail larger and more painful adjustments later on.*** The Administration has already taken the important step of commissioning reform proposals, which show that amending indexation formulas to slow benefit growth would eliminate the system's underfunding. However, the proposed diversion of a portion of the payroll tax into private retirement accounts would significantly boost the federal budget deficits and debt in coming decades, and care is needed to ensure that this measure is coupled with durable steps to address long-term fiscal sustainability.

67. ***The financial problems of the Medicare system dwarf those of Social Security, and also reflect the effects of the additional drug benefits introduced last year.*** The Medicare Reform legislation included useful initiatives to introduce competition and increase

efficiency in health care delivery, and the means-testing of Part B premiums could enable enhancements of system revenues. However, the Medicare system is still expected to begin running cash-flow deficits by the end of the next decade and outlays are projected to triple as a share of GDP by mid-century. Early steps to address these adverse trends are needed, but may also require broader, efficiency-enhancing reforms of the U.S. health care system.

68. ***The Federal Open Market Committee (FOMC) has appropriately begun preparing markets for the gradual withdrawal of stimulus.*** The aggressive easing of recent years has provided essential support to the recovery, and the monetary authorities are to be commended for forestalling fears of deflation that emerged last year. Nonetheless, with signs that the recovery is maturing, labor market conditions are improving, and concerns that higher energy prices could revive inflation expectations, the time has come to start removing stimulus. Although there appears scope for a measured tightening, recent statements by officials have helped market participants recognize that the withdrawal of monetary stimulus will not be unduly delayed.

69. ***Building on the Fed's already high transparency, the mission discussed the scope for providing further guidance to financial markets.*** Useful options were a subject of recent FOMC discussions, and there would also seem to be merit in the Federal Reserve further anchoring expectations by clarifying its definition of price stability and its medium-term inflation objective.

70. ***Financial markets have demonstrated during the past year their ability to digest significant exchange rate movements.*** Nonetheless, the U.S. current account deficit is still expected to remain large at around 5 percent of GDP and highly dependent upon foreign private and official investor appetite for net claims against U.S. residents, with the attendant risk that shifts in such demand could result in abrupt adjustments of interest and exchange rates. Although stronger growth abroad should play a key role in fostering the resolution of global current account imbalances, determined efforts to strengthen the U.S. fiscal position would help boost national saving and ensure that the adjustment is orderly and avoids an undue burden on investment, both domestically and abroad.

71. ***The banking sector has proven its resilience over recent years and ongoing reforms of corporate governance have helped increase confidence in market integrity.*** Strong fundamentals have left the financial system well prepared for the expected withdrawal of monetary stimulus. At the same time, the authorities have also moved effectively in response to recent corporate scandals to strengthen corporate governance. Looking ahead, it will be important to ensure that the Financial Standards Accounting Board is able to fulfill its responsibilities in an independent manner.

72. ***The Administration has raised justified concerns about the large and increasing share of mortgage-backed securities held by the main government sponsored enterprises (GSEs).*** The growth of these institutions has concentrated interest rate and mortgage prepayment risk, and the Administration's proposal to overhaul the current supervisory regime and establish an independent regulator warrants legislative support.

73. ***The U.S. authorities have taken welcome steps to provide impetus to the Doha Round negotiations.*** Continued U.S. leadership and commitment to multilateral approaches to trade liberalization, especially with regard to agriculture, will be critical to the success of the Round.

74. ***Recent increases in U.S. official development assistance (ODA) and progress on Millennium Challenge Account are welcome.*** However, U.S. ODA remains the lowest among industrial countries as a share of GNI and the mission supports Administration plans to boost U.S. foreign assistance as a ratio to GNI over coming years.

75. It is recommended that the next Article IV consultation take place within the standard 12-month cycle.

United States: Fund Relations
(As of March 31, 2004)

I. **Membership Status**: Joined 12/27/45; Article VIII

II. **General Resources Account:**	**SDR Million**	**Percent Quota**
Quota	37,149.30	100.0
Fund holdings of currency	22,530.07	60.5
Reserve position in Fund	14,617.58	39.4

III. **SDR Department:**	**SDR Million**	**Percent Allocation**
Net cumulative allocation	4,899.53	100.0
Holdings	8,572.00	175.0

IV. **Outstanding Purchases and Loans**: None

V. **Financial Arrangements:** None

VI. **Projected Obligations to Fund**: None

VII. **Payments Restrictions**: The United States has notified the Fund under Decision No. 144 of restrictions on payments and transfers for current international transactions to Libya, Iraq, North Korea, Cuba, and Iran. The United States restricts the sale of arms and petroleum to the National Union for the Total Independence of Angola (UNITA) and to the territory of Angola and has prohibitions against transactions with international narcotics traffickers. The United States notified the Fund under Decision No. 144 on August 2, 1995 of the imposition of further restrictions on current transactions with Iran. On March 21, 2002, the United States notified the Fund of exchange restrictions related to the financing of terrorism .

VIII. **Statistical Issues**: The quality, coverage, periodicity, and timeliness of U.S. economic data are considered to be good both in the context of the Article IV consultation and for purposes of ongoing surveillance. The United States has subscribed to the Special Data Dissemination Standard (SDDS) and its metadata are posted on the Dissemination Standard Bulletin Board (DSBB).

United States: Core Statistical Indicators
(As of June 3, 2004)

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP/ GNP	External Debt/Debt Service
Date of latest observation	Same day	May 21	May 28	May 5	May 5	Same day	April 2004	March 2004	2003Q4	April 2004	2004Q1	2002
Date released	Same day	June 3	June 2	June 2	June 2	Same day	May 14	May 12	March 12	April 30	May 27	July 2003
Frequency of data	daily	weekly	weekly	weekly	weekly	daily	monthly	monthly	quarterly	monthly	quarterly	annual
Frequency of reporting	daily	weekly	weekly	weekly	weekly	daily	monthly	monthly	quarterly	monthly	quarterly	annual
Source of data	Federal Reserve	Treasury	Federal Reserve	Federal Reserve	Federal Reserve	Federal Reserve	Dept. of Labor	Dept. of Commerce	Dept. of Commerce	Treasury	Dept. of Commerce	Dept. of Commerce
Mode of reporting 1/	electronic	electronic	electronic	electronic	electronic	electronic	electronic	electronic	electronic	electronic	electronic	electronic
Confidentiality	none	none	none	none	none	none	none	none	none	none	none	none
Frequency of publication	daily	weekly	weekly	weekly	weekly	daily	monthly	monthly	quarterly	monthly	monthly	annual

1/ Most data are available from statistical releases and from private electronic databases.

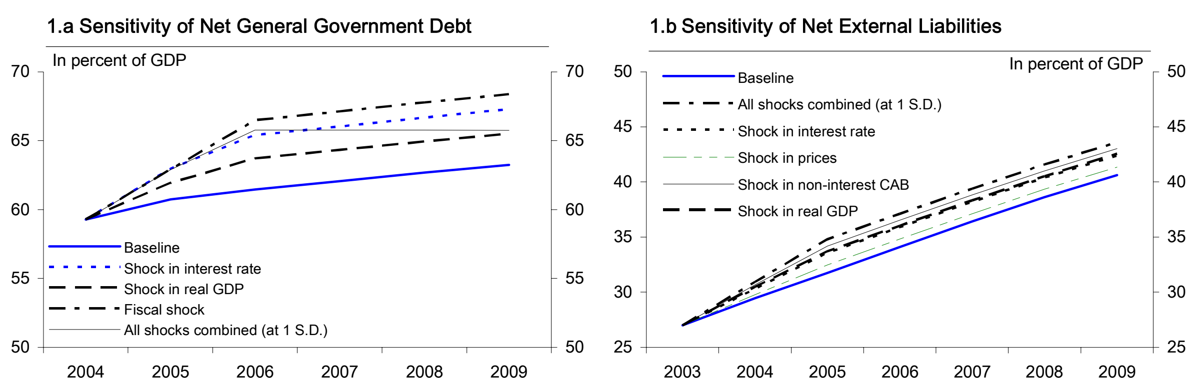
United States—Debt Sustainability

1. ***This appendix subjects projections for U.S. public debt and net external liabilities to a series of established macroeconomic stress tests***.[1] Following the methodology prescribed in "Assessing Sustainability," (May 28, 2002, www.imf.org), a baseline trajectory for these two debt variables is determined by setting key macroeconomic variables, including the primary fiscal deficit and the non-interest current account balance, at values projected by staff. The fiscal baseline is then subjected to two-standard deviation shocks in domestic interest rates, real growth and the primary fiscal deficit, each lasting two years before the variable returns to normal. For external debt, similar shocks are assumed for real growth, domestic prices, the foreign interest rate, and the non-interest current account balance.

2. ***The exercise focuses on short- to medium-term vulnerabilities for the general government***. Accordingly, net general government debt is defined by combining the net financial liabilities of federal, state, and local government debt to the public (that is, excluding government debt held by the social insurance trust funds).

3. ***In all but one case, shocks to the fiscal baseline lead to an upward path of public debt*** (Figure and Table 1a). Under adverse interest rate, fiscal, and real GDP shocks, the debt-to-GDP ratio continues to grow after an initial jump in the first two years. Under a combination of all shocks (at one standard deviation) the ratio plateaus after the initial rise. The greatest vulnerability is with regard to fiscal and interest rates shocks—both shocks induce a temporary increase in the debt ratio in 2005 and 2006 and leave the 2009 ratio at more than 5 percent of GDP above the baseline.

4. ***Shocks to the external baseline all imply a faster accumulation of foreign debt by 2009*** (Figure and Table 1b). In the baseline scenario, the ratio of net external liabilities to GDP increases from 22 percent in 2003 to 37 percent in 2009. Non-interest current account and real GDP would have the largest influence on debt accumulation. External debt would be within 37–40 percent of GDP in all simulated cases. These simulations reflect the higher historical volatility of the external variables, which increases the magnitude of the two standard deviation shocks.



[1] Net external liabilities equal the U.S. net international investment position.

Table 1a. United States: Public Sector Debt Sustainability Framework, 2004-2009
(In percent of GDP, unless otherwise indicated)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	Projections 2004	2005	2006	2007	2008	2009
I. Baseline Medium-Term Projections																
1 Public sector debt 1/	71.2	70.9	71.3	70.8	69.0	66.1	62.2	55.8	56.8	58.5	**59.3**	**60.7**	**61.5**	**62.1**	**62.7**	**63.3**
o/w foreign-currency denominated	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
2 Change in public sector debt	71.2	-0.3	0.4	-0.5	-1.8	-2.8	-4.0	-6.4	1.0	1.7	0.8	1.5	0.7	0.6	0.6	0.6
3 Identified debt-creating flows (4+7+12)	0.2	-0.6	0.0	-1.6	-3.4	-3.9	-4.6	-5.0	1.3	2.3	0.9	-0.2	-0.1	0.0	-0.1	-0.3
4 Primary deficit	0.2	-1.0	-1.7	-2.5	-3.7	-4.7	-4.7	-3.3	0.2	2.1	2.1	0.5	-0.2	-0.3	-0.5	-0.7
5 Revenue and grants	32.3	32.6	33.0	33.5	33.8	34.3	34.5	34.4	32.1	31.0	30.3	31.3	31.4	31.2	30.9	30.7
6 Primary (noninterest) expenditure	32.5	31.6	31.4	31.0	30.1	29.6	29.8	31.2	32.3	33.1	32.4	31.8	31.3	30.9	30.4	30.0
7 Automatic debt dynamics 2/	0.0	0.4	1.7	0.9	0.3	0.8	0.1	-1.7	1.0	0.2	-1.2	-0.7	0.1	0.3	0.4	0.5
8 Contribution from interest rate/growth differential 3/	0.0	0.4	1.7	0.9	0.3	0.8	0.1	-1.7	1.0	0.2	-1.2	-0.7	0.1	0.3	0.4	0.5
9 Of which contribution from real interest rate	0.0	3.1	3.4	3.3	3.3	3.5	2.9	0.7	2.2	1.9	1.3	1.5	2.2	2.2	2.2	2.3
10 Of which contribution from real GDP growth	0.0	-2.7	-1.7	-2.5	-3.0	-2.7	-2.8	-2.4	-1.2	-1.7	-2.5	-2.2	-2.1	-1.9	-1.8	-1.8
11 Contribution from exchange rate depreciation 4/	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
12 Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
13 Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
14 Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
15 Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
16 Residual, including asset changes (2-3)	70.9	0.3	0.4	1.1	1.6	1.1	0.6	-1.5	-0.3	-0.6	-0.1	1.7	0.8	0.6	0.7	0.8
Public sector debt-to-revenue ratio 1/	220.2	217.1	215.7	211.2	204.1	193.0	180.3	162.0	177.0	188.4	195.4	194.2	195.4	199.0	203.0	205.9
Gross financing need 5/	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...
in billions of U.S. dollars	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...
Key Macroeconomic and Fiscal Assumptions																
Real GDP growth (in percent)	2.7	4.0	2.5	3.7	4.5	4.2	4.4	4.2	2.2	3.1	4.6	3.9	3.6	3.3	3.1	3.1
Average nominal interest rate on public debt (in percent) 6/	7.2	6.8	7.1	6.9	6.7	6.5	6.2	6.0	5.7	5.2	4.8	5.2	5.8	5.9	5.9	5.9
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	4.9	4.7	5.0	5.0	5.0	5.4	4.7	1.4	4.1	3.6	2.5	2.8	3.8	3.9	3.9	3.9
Nominal appreciation (increase in US dollar value of local currency, in percent)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Inflation rate (GDP deflator, in percent)	2.3	2.1	2.0	1.9	1.7	1.1	1.4	4.6	1.5	1.7	2.3	2.4	2.0	2.0	2.0	2.0
Growth of real primary spending (deflated by GDP deflator, in percent)	1.6	1.1	1.7	2.5	1.5	2.3	5.1	9.0	6.0	5.6	2.5	1.9	1.9	2.1	1.3	1.9
II. Stress Tests for Public Debt Ratio																
1. Baseline											**59.3**	**60.7**	**61.5**	**62.1**	**62.7**	**63.3**
2. Real interest rate is at historical average plus two standard deviations in 2005 and 2006											**59.3**	**62.9**	**65.4**	**66.0**	**66.7**	**67.3**
3. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006											**59.3**	**61.9**	**63.7**	**64.3**	**64.9**	**65.5**
4. Primary balance is at historical average minus two standard deviations in 2005 and 2006											**59.3**	**62.9**	**66.5**	**67.1**	**67.8**	**68.4**
5. Combination of 2-4 using one standard deviation shocks											**59.3**	**62.9**	**65.8**	**65.8**	**65.8**	**65.7**

Historical Statistics for Key Variables (past 10 years)	Historical Average	Standard Deviation	Average 2003-09
Primary deficit	-1.9	2.3	0.1
Real GDP growth (in percent)	3.6	0.9	3.6
Nominal interest rate (in percent) 6/	6.4	0.6	5.6
Real interest rate (in percent)	4.4	1.2	3.5
Inflation rate (GDP deflator, in percent)	2.0	1.0	2.1
Revenue to GDP ratio	33.2	1.1	31.0

1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.
2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.
5/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
6/ Derived as nominal interest expenditure divided by previous period debt stock.
7/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table 1b. United States: External Debt Sustainability Framework, 2003-2009
(In percent of GDP, unless otherwise indicated)

	Actual										Projections						
	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
I. Baseline Medium-Term Projections																	
1 **External debt**	4.6	4.4	6.7	6.7	10.0	10.5	8.6	14.1	19.6	22.8	**26.7**	**30.0**	**32.8**	**35.5**	**38.0**	**40.2**	**42.4**
2 Change in external debt	4.6	-0.2	2.3	0.0	3.4	0.5	-1.9	5.5	5.5	3.2	3.9	3.3	2.8	2.7	2.4	2.3	2.2
3 Identified external debt-creating flows (4+8+11)	1.1	1.4	1.2	1.1	1.2	1.9	2.6	3.7	3.4	3.8	3.8	3.1	2.8	2.7	2.4	2.3	2.2
4 Current account deficit, excluding interest payments	1.1	1.5	1.1	1.2	1.2	1.9	2.8	3.6	3.0	3.8	3.7	3.6	3.3	3.0	2.7	2.5	2.4
5 Deficit in balance of goods and services	1.0	1.4	1.3	1.3	1.3	1.9	2.8	3.9	3.6	4.0	4.5	4.6	4.2	4.0	3.8	3.7	3.6
6 Exports	9.6	9.9	10.7	10.9	11.3	10.7	10.4	10.9	10.0	9.3	9.3	10.0	10.6	11.1	11.5	11.8	12.2
7 Imports	10.7	11.3	12.0	12.2	12.6	12.6	13.3	14.8	13.6	13.3	13.8	14.6	14.9	15.1	15.3	15.6	15.8
8 Net non-debt creating capital inflows (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
9 Net foreign direct investment, equity	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
10 Net portfolio investment,equity	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
11 Automatic debt dynamics 1/	0.0	-0.1	0.1	0.0	0.0	0.0	-0.2	0.1	0.4	0.0	0.0	-0.5	-0.5	-0.3	-0.2	-0.2	-0.2
12 Contribution from nominal interest rate	0.0	0.2	0.3	0.3	0.4	0.5	0.4	0.6	0.8	0.7	1.1	1.2	1.3	1.5	1.6	1.7	1.7
13 Contribution from real GDP growth	0.0	-0.2	-0.1	-0.2	-0.3	-0.4	-0.4	-0.3	-0.1	-0.4	-0.7	-1.2	-1.1	-1.1	-1.1	-1.1	-1.2
14 Contribution from price and exchange rate changes 2/	0.0	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.2	-0.3	-0.3	-0.4	-0.6	-0.8	-0.7	-0.7	-0.7	-0.8
14 Residual, incl. change in gross foreign assets (2-3)	3.6	-1.6	1.1	-1.2	2.1	-1.4	-4.5	1.8	2.0	-0.6	0.1	0.2	0.0	0.0	0.0	0.0	0.0
External debt-to-exports ratio (in percent)	47.8	44.4	62.5	61.3	89.1	98.4	82.5	129.6	196.7	244.6	287.4	300.8	309.2	320.9	330.7	339.7	347.9
Gross external financing need (in billions of US dollars) 3/	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...
in percent of GDP	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...
Key Macroeconomic and External Assumptions																	
Real GDP growth (in percent)	2.7	4.0	2.5	3.7	4.5	4.2	4.4	3.7	0.5	2.2	3.1	4.6	3.9	3.6	3.3	3.1	3.1
Exchange rate appreciation (US dollar value of local currency, change in percent)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
GDP deflator in US dollars (change in percent)	2.3	2.1	2.0	1.9	1.7	1.1	1.4	2.2	2.4	1.5	1.7	2.2	2.6	2.0	2.0	2.0	2.0
Nominal external interest rate (in percent)	2.7	3.5	6.9	4.9	7.0	4.8	3.6	7.0	6.0	3.8	5.0	4.9	4.8	4.7	4.6	4.6	4.6
Growth of exports (US dollar terms, in percent)	4.2	9.4	13.0	7.2	9.8	-0.1	3.5	10.8	-6.0	-3.1	4.6	15.0	13.4	10.2	9.2	8.6	8.2
Growth of imports (US dollar terms, in percent)	8.7	12.4	11.1	7.3	9.3	5.3	12.0	17.9	-5.5	2.1	8.5	12.8	8.9	7.3	6.9	6.7	7.0
II. Stress Tests for External Debt Ratio																	
1. Baseline											**26.7**	**30.0**	**32.8**	**35.5**	**38.0**	**40.2**	**42.4**
2. Nominal interest rate is at historical average plus two standard deviations in 2003 and 2004											**26.7**	**30.8**	**34.7**	**37.3**	**39.7**	**42.0**	**44.2**
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004											**26.7**	**31.0**	**34.8**	**37.5**	**39.9**	**42.2**	**44.3**
4. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2003 and 2004											**26.7**	**30.3**	**33.6**	**36.3**	**38.7**	**41.0**	**43.2**
5. Non-interest current account is at historical average minus two standard deviations in 2003 and 2004											**26.7**	**30.7**	**34.5**	**37.2**	**39.6**	**41.9**	**44.0**
6. Combination of 2-5 using one standard deviation shocks											**26.7**	**31.0**	**35.1**	**37.8**	**40.2**	**42.5**	**44.6**
Historical Statistics for Key Variables (past 10 years)							Historical Average		Standard Deviation				Average 2002-07				
Current account deficit, excluding interest payments							2.1		1.1				3.1				
Net non-debt creating capital inflows							0.0		0.0				0.0				
Nominal external interest rate (in percent)							5.0		1.6				4.8				
Real GDP growth (in percent)							3.2		1.3				3.6				
GDP deflator in US dollars (change in percent)							1.9		0.4				2.1				

1/ Derived as [r - g - ρ(1+g) + εα(1+r)]/(1+g+ρ+gρ) times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.
2/ The contribution from price and exchange rate changes is defined as [-ρ(1+g) + εα(1+r)]/(1+g+ρ+gρ) times previous period debt stock. ρ increases with an appreciating domestic currency (ε > 0) and rising inflation (based on GDP deflator).
3/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

INTERNATIONAL MONETARY FUND

UNITED STATES OF AMERICA

Staff Report for the 2004 Article IV Consultation
Supplementary Information

Prepared by the Western Hemisphere Department

Approved by Christopher Towe

July 22, 2004

1. ***This supplement reports on information that has become available since the staff report was issued***. The topics covered include the June 30 meeting of the Federal Open Market Committee (FOMC), the Federal Reserve's Monetary Policy Report to Congress, recent economic and financial market developments, and an update on the budget outlook. These changes do not affect the staff appraisal.

Monetary policy developments

2. ***As widely anticipated, the FOMC raised its target for short-term interest rates by one-quarter percentage point to 1¼ percent on June 30.*** The accompanying statement offered a balanced assessment of the risks to both growth and inflation, and reaffirmed that the pace of tightening "is likely to be measured." Nonetheless, in an apparent acknowledgement of the recent pickup in inflation, the FOMC cautioned that it "will respond to changes in economic prospects as needed." The move was fully discounted in markets, and bond, equity, and currency prices were little affected.

3. ***The Federal Reserve Board's semi-annual Monetary Policy Report was presented to Congress on July 20.*** The FOMC's central forecast is for growth to moderate to between 3½–4 percent in 2005 (Q4 on Q4), with the core deflator for personal consumption expenditure stable between 1½–2 percent (Q4 on Q4), both consistent with staff projections. The FOMC expects the economy to continue to benefit from improving labor market conditions, brisk increases in capital spending as a result of strong corporate financial conditions, stock building, and a pickup in activity abroad.

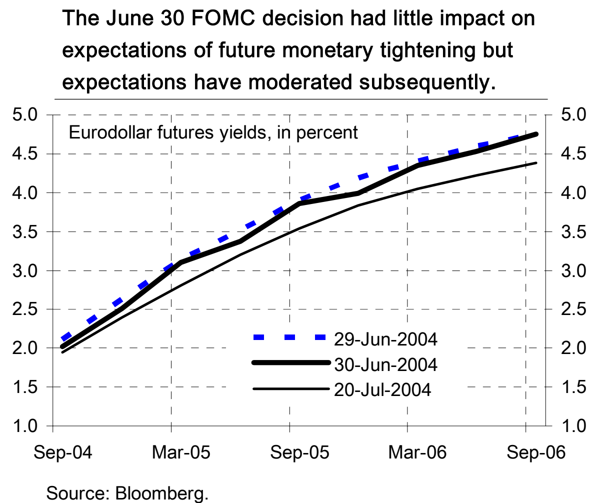
4. ***In his testimony, Chairman Greenspan expanded on the FOMC's view that the pace of policy tightening can remain "measured."*** The Chairman acknowledged that productivity growth had slowed from the extraordinary pace in 2003, contributing to a modest increase in unit labor costs in recent quarters, but emphasized that these developments did not appear to pose a risk to long-term price stability. However, the Chairman also reiterated the FOMC's view that a rise in inflationary pressures as a result of the Fed's recent accommodative stance could not be ruled out, and that the Federal Reserve would therefore pay close attention to incoming data, especially on costs and prices.

Recent economic and financial market developments

5. ***Although recent data suggest a somewhat slower rate of growth in the second quarter than previously projected, the staff's forecast for the year as a whole still appears appropriate.*** In June, payroll employment rose by 112,000 (1 percent on an annualized basis), about half the pace of the first five months of the year; industrial production fell 0.3 percent; and retail sales declined 1.1 percent. However, strong export growth helped lower the trade deficit to $46 billion in May from the previous month's record $48 billion. Moreover, forward-looking indicators also remain positive, with the Conference Board's consumer confidence index rising above 100 in June for the first time in two years and diffusion indices for both the manufacturing and nonmanufacturing sectors also consistent with strong growth of output and employment. Thus, while second-quarter growth may dip below 4 percent, most forecasters expect faster activity in the second half of the year, supported by continuing strength in profits and compensation.

6. ***Inflation pressures appear to be contained.*** Although higher energy prices continued to boost the overall consumer price index, taking the 12-month inflation rate to 3.3 percent, the core consumer price index rose by only 0.1 percent in June leaving the 12-month core inflation rate at 1.9 percent. Similarly, the headline and core producer price indexes rose by 4 percent and 1.8 percent over the past 12 months. Against this, oil prices have returned near their recent highs due to strong demand and the reemergence of supply concerns.

7. ***Weaker recent data have helped scale back market expectations of the pace of future interest rate hikes.*** The yield curve now suggests a federal funds rate of 3¼ –3½ percent by end-2005, almost 50 basis points lower than before the rate hike (figure). Similarly, 10-year Treasury bond yields have fallen by some ¼ percentage point to around 4½ percent. Stock prices have also eased, partly on concerns that energy prices will hurt earnings prospects, and the dollar has weakened moderately.



Fiscal developments

8. ***Recent budget data continue to suggest an increasingly favorable budget outlook for this year***. Reflecting stronger-than-anticipated revenue growth through June, a recent Treasury report suggested that the FY 2004 deficit would likely fall below the CBO's March estimate of $477 billion (4¼ percent of GDP) and well below the administration's February estimate of $520 billion (4½ percent of GDP). Progress toward passing the FY 2005 budget has been slow—since late June, the House has completed work on five spending bills and the Senate on one.

After a lengthy debate, the House rejected a proposal by the Administration that would have effectively reauthorized the Budget Enforcement Act (BEA). The bill would have required budgetary offsets for changes in mandatory spending, but would have exempted most future tax cuts from this obligation. Although Congress may yet agree on some budget enforcement measures during the ongoing appropriations process, the debate on restoring BEA provisions is unlikely to resume before next year.

INTERNATIONAL MONETARY FUND
Public Information Notice

EXTERNAL RELATIONS DEPARTMENT

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July 30, 2004

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes 2004 Article IV Consultation with the United States

On July 23, 2004, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the United States.[1]

Background

Following a rather tepid recovery, the economy gathered strength in 2003. Supported by continued robust productivity growth, real GDP growth began to exceed the growth rate of potential output around mid-year. The recovery broadened in early 2004 as payroll employment strengthened, easing concerns that a lack of employment growth and correspondingly weaker household income could weigh on consumer demand. Both the pickup in economic activity and higher world energy prices have contributed to a rise in inflation that has helped erase earlier deflation fears. Although the pace of recovery appears to have slowed recently, partly owing to the dampening effect of higher oil prices on demand and the waning effects of earlier fiscal stimulus, prospects appear favorable for continued strength in the second half of the year.

Stronger asset prices have played an important role in supporting aggregate demand. Equity markets have risen nearly 50 percent from their lows just before the Iraq war, although prices have stagnated somewhat in recent months on concerns that the removal of monetary stimulus and higher energy costs would hurt corporate earnings. Nonetheless, house prices have continued to increase rapidly, and households have continued to refinance mortgage debt in order to reduce interest payments and lengthen debt maturities.

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

Both monetary and fiscal policies have provided significant support to the recovery, but stimulus is now being withdrawn. The Federal Reserve acted to raise the Federal funds rate by ¼ percentage point on June 30, long-term interest rates have risen by around 1 percentage point since late March, and part of the dollar's earlier depreciation has been reversed. On the fiscal front, the stimulus from this year's surge in personal tax refunds associated with the 2003 tax cuts is starting to fade, and investment incentives generated by accelerated depreciation allowances are slated to expire at end-December.

Labor productivity growth has remained remarkably strong during the past year, and job creation has also begun to revive. Tepid employment growth earlier in the recovery appeared to have largely reflected cost cutting in the face of uncertain growth and geopolitical uncertainties. With confidence firming, however, payrolls have expanded by 1¼ million in the first half of 2004 and the unemployment rate fell to 5.6 percent in the second quarter.

Strong productivity growth has also contributed to significant improvements in corporate and financial balance sheets. A sharp rebound in operating profits and relatively low levels of capital expenditure have helped elevate the share of after-tax profits in GDP to a post-war high. While this left the nonfinancial corporate sector in the unusual position of being a net provider of funds to the rest of the economy, firms have also taken advantage of low interest rates to extend the maturity of their debt. At the same time, the banking system booked record profits in 2004Q1 and near-record returns on assets.

Year-on-year core CPI inflation rose to almost 2 percent in June, after having fallen to a 40-year low of around 1 percent in early-2004. The rise reflects a deceleration of deflation in goods prices as the global recovery has increased costs of raw materials and intermediate inputs, but also some effect of the depreciation of the dollar. Nonetheless, rapid labor productivity growth continues to dampen unit labor costs, and service price inflation remains moderate. The pass-through from higher energy prices to non-energy prices has been limited, but higher fuel bills have lowered discretionary income, dampened aggregate demand, and weighed on the external trade balance.

Reflecting strong demand and higher import prices, the current account deficit has remained close to its record high of 5 percent of GDP. Although the dollar has rebounded somewhat in recent months, it remains some 10 percent in real effective terms below its peak in early 2002. The depreciation has been almost exclusively against industrial country currencies, while the dollar's position against major developing country partners has remained largely unchanged. The effect of the weaker exchange rate on real net exports, which continued to subtract from real GDP growth in 2003 and early 2004, has been modest, reflecting the usual lags between changes in real exchange rates and trade volumes as well as a relatively slow revival of foreign demand.

Fund staff projects output growth to remain above potential through 2004 and 2005, closing the output gap by 2006. The baseline forecast is predicated on continued strength in business fixed investment and an improvement in external demand. This is expected to help offset a slowdown in consumer demand, following the waning effect of recent tax cuts and a gradual rebound in the household saving rate, and weaker growth in government expenditure as the fiscal position

is improved. Core inflation is expected to remain contained as the Federal Reserve is assumed to withdraw stimulus broadly in line with current market expectations. The current account position is anticipated to improve only modestly, with the deficit falling to close to 4 percent of GDP in 2009 as the lagged effects of dollar depreciation and economic recoveries in partner countries support net exports.

Executive Board Assessment

Executive Directors noted that the economy has shaken off an unprecedented series of adverse shocks and, with the support of significant monetary and fiscal stimulus that has been injected since the onset of the downturn, expanded strongly during the past year and is again providing valuable support to the global economy.

Directors observed that the short-term outlook for the U.S. economy remains relatively favorable, although subject to some uncertainty. While they acknowledged some downside risks—such as those related to high energy prices, the low household saving rate, and rapid recent increases in house prices—many viewed these as balanced by upside risks associated with rapid productivity growth that has kept price pressures at bay. Looking further ahead, however, most Directors stressed that continued robust growth of the economy will require decisive action to strengthen the U.S. fiscal position to avoid a crowding out of investment.

Against this background, Directors welcomed the emphasis that was placed on fiscal consolidation in the FY 2005 budget. With the recovery now well on track, most Directors agreed that the pace of deficit reduction projected in the budget over the coming two fiscal years is appropriate. They noted that sizeable budgetary pressures exist, and underscored the importance of ensuring that these pressures do not slow the pace of deficit reduction over this period. Indeed, most Directors also suggested that the likely better-than-expected budget outcome for the current fiscal year offers an opportunity to strengthen the near-term deficit-reduction objective.

Most Directors, however, questioned whether the Administration's medium-term fiscal objective—of halving the deficit in five years—is ambitious enough, especially given the increasing pressure on the Social Security and Medicare/Medicaid programs that is expected with the retirement of the baby boom generation. While acknowledging that entitlement reform holds the key to long-run fiscal sustainability, a number of Directors encouraged the authorities to aim toward bringing the budget back to balance, excluding Social Security, by the end of the decade, in order to provide greater fiscal room for placing entitlement programs on a sound financial footing. Directors also re-iterated their longstanding call for the establishment of a clear long-term fiscal goal, embedded in a credible medium-term fiscal framework, to anchor expectations and discipline policies.

Directors discussed the role of both expenditure discipline and revenue measures in ensuring longer-run fiscal sustainability. In this regard, they emphasized the helpful role that could be played by budget enforcement legislation, and cautioned against exempting tax cuts from the requirement that expansionary measures be accompanied by offsets to ensure budget neutrality. Indeed, given the magnitude of the fiscal adjustment considered necessary and the

already-ambitious plans for cutting nondefense discretionary spending, most Directors felt that revenue enhancements should be actively considered. In this regard, it was noted that the focus might be on policies aimed at broadening and simplifying the tax base to help avoid unwinding recent cuts in marginal tax rates.

Directors recognized the need to address the severe underfunding of the Social Security and Medicare systems, noting that delaying reforms would only entail larger and more painful adjustments later. In this context, a number of Directors agreed that recent proposals to amend indexation formulas to slow the growth of Social Security benefits merit consideration, but several cautioned that diverting a portion of the payroll tax into private retirement accounts would significantly lower fiscal revenues and would have to be coupled with durable steps to ensure long-term fiscal sustainability. Directors observed that the underfunding of the Medicare system dwarfs that of Social Security, and has increased significantly as a result of the additional drug benefits introduced last year. Therefore, early steps to contain the growth of health care outlays are needed.

Directors observed that the Federal Open Market Committee (FOMC), after earlier providing essential support to the recovery and forestalling fears of deflation, has more recently appropriately prepared markets for the gradual withdrawal of monetary stimulus. Given signs that the recovery is maturing and labor market conditions are improving, and concerns that higher energy prices could revive inflation expectations, Directors supported the recent decision to start removing stimulus. Directors agreed that that there remains scope for a measured withdrawal of stimulus, with due regard for the pace of economic recovery, but—given the substantial gap between the current and neutral level of the federal funds rate and the usual transmission lags—Directors also welcomed recent statements by FOMC members that this process would not be unduly delayed.

Directors commended the Federal Reserve for its already high level of transparency, noting the effective manner in which the recent policy shift had been communicated to financial markets. A number of Directors suggested, however, that there could be merit in further anchoring market expectations by clarifying the Federal Reserve's definition of price stability and its medium-term inflation objective.

Directors reiterated their long-standing concern about the large U.S. current account deficit. While they acknowledged that the past two years had illustrated the market's ability to absorb a significant depreciation of the dollar, the current account deficit is expected to remain large, leaving the United States highly dependent upon private and official inflows from abroad. Directors noted that determined efforts to strengthen the U.S. fiscal position would help boost national saving, avoid an undue burden on investment—both domestically and abroad—and help achieve an orderly adjustment in resolving global current account imbalances. Directors also recognized that stronger growth abroad should play an important role in facilitating this adjustment.

Directors agreed that the banking sector has proven its resilience in recent years and that measures to strengthen corporate governance have helped increase confidence in market integrity. They observed that strong fundamentals have left the financial system well prepared

for the withdrawal of monetary stimulus. Directors also commended the authorities for moving effectively in response to recent corporate failures. Directors agreed with the authorities' concerns about the large and increasing share of mortgage-backed securities held by the government sponsored enterprises (GSEs), and supported the Administration's efforts to strengthen supervision of these enterprises.

Directors recognized the important role of the United States in providing impetus to the Doha Round negotiations. They stressed that continued U.S. leadership and commitment to multilateral approaches to trade liberalization, especially with regard to agriculture, will be critical to the success of the Round. Directors welcomed recent increases in U.S. official development assistance (ODA) and progress achieved in implementing the Millennium Challenge Account. They noted, however, that U.S. ODA remains low as a share of Gross National Income and encouraged further increases in ODA in coming years.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The Staff Report for the 2004 Article IV Consultation with the United States is also available.

United States: Selected Economic Indicators

(Annual change in percent, unless otherwise noted)

	1997	1998	1999	2000	2001	2002	2003
NIPA in constant prices 1/							
Real GDP	4.5	4.2	4.5	3.7	0.5	2.2	3.1
Net exports 2/	-0.3	-1.2	-1.0	-0.9	-0.2	-0.7	-0.4
Total domestic demand	4.8	5.3	5.3	4.4	0.7	2.8	3.3
Final domestic demand	4.3	5.3	5.4	4.5	1.6	2.4	3.4
Private final consumption	3.8	5.0	5.1	4.7	2.5	3.4	3.1
Public consumption expenditure	1.8	1.6	3.1	1.7	2.8	3.6	3.8
Gross fixed domestic investment	8.0	9.1	8.2	6.1	-2.3	-2.3	3.9
Private	9.2	10.2	8.3	6.5	-3.2	-3.7	4.4
Public	2.2	3.5	7.5	3.6	2.5	5.1	1.4
Change in business inventories 2/	0.5	0.0	-0.1	-0.1	-0.9	0.4	0.0
GDP in current prices 1/	6.2	5.3	6.0	5.9	2.9	3.8	4.8
Employment and inflation							
Unemployment rate (percent)	4.9	4.5	4.2	4.0	4.8	5.8	6.0
CPI inflation	2.3	1.5	2.2	3.4	2.8	1.6	2.3
GDP deflator	1.7	1.1	1.4	2.2	2.4	1.5	1.7
Financial policy indicators							
Unified federal balance (billions of dollars)	-22	69	126	236	127	-158	-375
In percent of CY GDP	-0.3	0.8	1.4	2.4	1.3	-1.5	-3.5
Central government balance (NIPA, billions of dollars)	-47	48	101	189	45	-259	-454
In percent of CY GDP	-0.6	0.5	1.1	1.9	0.4	-2.5	-4.1
General government balance (NIPA, billions of dollars)	-66	38	79	159	-16	-345	-538
In percent of CY GDP	-0.8	0.4	0.9	1.6	-0.2	-3.3	-4.9
Three-month Treasury bill rate	5.2	4.9	4.8	6.0	3.4	1.6	1.0
Ten-year government bond rate	6.4	5.3	5.6	6.0	5.0	4.6	4.0
Balance of payments							
Current account balance (billions of dollars)	-136	-210	-297	-413	-386	-474	-531
In percent of GDP	-1.6	-2.4	-3.2	-4.2	-3.8	-4.5	-4.8
Merchandise trade balance (billions of dollars)	-198	-247	-346	-452	-427	-483	-548
In percent of GDP	-2.4	-2.8	-3.7	-4.6	-4.2	-4.6	-5.0
Export volume (NIPA, goods and services)	14.4	2.2	3.8	11.2	-6.1	-4.0	1.9
Import volume (NIPA, goods and services)	13.6	11.6	11.5	13.1	-3.2	3.7	4.8
Invisibles (billions of dollars)	62.1	37.1	49.2	39.0	41.5	9	17
In percent of GDP	0.7	0.4	0.5	0.4	0.4	0.1	0.2
Saving and investment (as a share of GDP)							
Gross national saving	17.6	18.3	18.1	18.0	16.4	14.7	13.5
General government	1.9	3.1	3.7	4.4	2.7	-0.3	-1.9
Private	15.7	15.2	14.4	13.6	13.7	15.0	15.3
Personal	2.6	3.2	1.7	1.7	1.3	1.7	1.6
Business	13.1	12.0	12.7	11.9	12.4	13.2	13.7
Gross domestic investment	19.8	20.6	20.9	21.1	19.0	18.3	18.2

Source: Haver Analytics; and IMF staff estimates.

1/ National accounts data as available at the time of the July 23, 2004 Executive Board discussion.
2/ Contribution to growth.