INTERNATIONAL MONETARY FUND

IMF Country Report No. 13/236

UNITED STATES

2013 ARTICLE IV CONSULTATION

July 2013

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 2013 Article IV consultation with United States, the following documents have been released and are included in this package:

- **Staff Report** for the 2013 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on May 17, 2013, with the officials of United States on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on July 9, 2013. 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.
- **Informational Annex** prepared by the IMF.
- **Staff Statement** of July 24, 2013 updating information on recent developments.
- **Press Release** summarizing the views of the Executive Board as expressed during its July 24, 2013 discussion of the staff report that concluded the Article IV consultation.

The document listed below has 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.

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International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

UNITED STATES

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION

July 9, 2013

KEY ISSUES

Context: The U.S. economic recovery remains modest but is gaining ground, supported by a rebound in the housing market, still easy financial conditions, and a boost to household net worth from higher house and stock prices. These factors are helping to offset the impact of strong fiscal adjustment on consumer spending. But the economy is still far from normal conditions, with high unemployment and a large negative output gap.

Fiscal Policy: The fiscal consolidation should be more balanced and gradual. The automatic spending cuts (sequester) not only reduce growth in the short term but could also undermine potential in the medium term through indiscriminate cuts to education and infrastructure. They should be replaced with back-loaded entitlement savings and new revenues. Even though the fiscal deficit is declining rapidly, approving a plan to restore long-run fiscal sustainability remains a priority. Early action is needed for measures that slow entitlement spending, as their effects build gradually over time.

Monetary Policy: Given the still-large output gap and well-anchored inflation expectations, the highly accommodative monetary policy stance is appropriate. While unwinding monetary policy accommodation is likely to present challenges, including for financial stability, the Fed has a range of tools to help manage the exit. Effective communication and careful timing will be critical to avoid disruptions, for both the United States and other countries.

Financial Outlook and Reforms: The protracted period of low interest rates may have raised vulnerabilities in the financial sector, which warrant close monitoring. While progress on financial reform has been made, reforms need to be completed in a number of areas. Domestic reforms should be coordinated with the global financial reform agenda, as this would help to reduce fragmentation of the global financial regulatory landscape.

Approved By

Alejandro Werner and Vivek Arora

Discussions took place in Washington, D.C., during May 6–May 17, 2013 with concluding meetings on May 31 and June 12, 2013. The team comprised Gian Maria Milesi-Ferretti (head), Roberto Cardarelli, Martin Sommer, Francesco Columba, Deniz Igan, Gabriel Di Bella, Jarkko Turunen (all WHD); Rebecca McCaughrin (MCM); Chris Papageorgiou (SPR); and Tao Wu (ICD). Steve Dawe and Emmanuel Mathias (LEG), and Marshall Mills, Katrin Elborgh-Woytek, Lars Engstrom, and Michele Ruta (SPR) also participated in some meetings.

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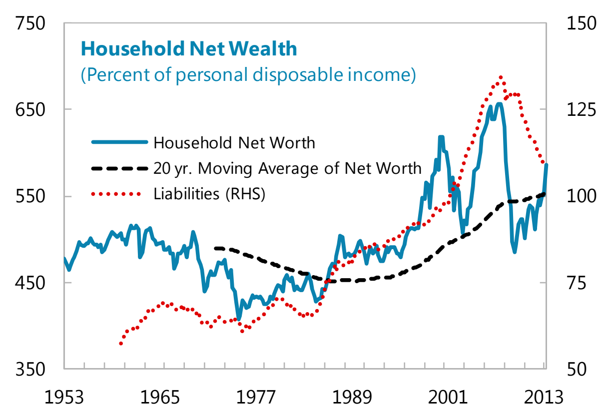
BACKDROP: STILL A MODEST RECOVERY BUT WITH SOME BRIGHT SPOTS

1. **The U.S. recovery has remained tepid, but underlying fundamentals have been steadily improving**. Last year's modest growth of 2.2 percent reflects legacy effects from the financial crisis, continued fiscal consolidation, a weak external environment, and temporary effects of extreme weather-related events. The economy grew at an annual rate of 1.8 percent in the first quarter of 2013, held down by sharp cuts in public spending, and recent economic indicators suggest that growth has remained weak in the second quarter of the year. These developments notwithstanding, the nature of the recovery appears to be changing:

- ***The housing sector has improved significantly***. House prices have sharply rebounded, and, as of May, were about 10 percent above their level a year ago (but still 20 percent below the pre-crisis peak in nominal terms). While the increase was broad-based nationally, house prices have generally increased the most in regions where their decline had been the strongest, suggesting that prices are catching up after the collapse experienced during the Great Recession. Residential construction has recently grown at a double-digit pace, contributing 0.3 percentage points (pp) to growth last year, but the level of activity—2½ percent of GDP in 2012—remains well below its long-term average of 4½ percent.

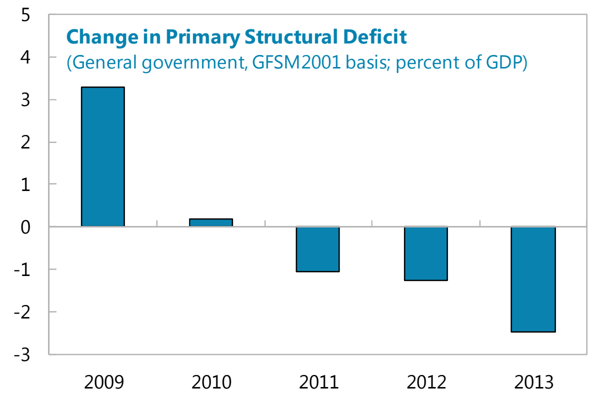
- ***Household balance sheets strengthened*** (see Box 1). In addition to house prices, stock prices also increased sharply—the stock market reached a 5-year high in May. Together with continued progress in reducing debt, this contributed to a further improvement in household net worth (Chart).



Sources: Federal Reserve Board; BEA; IMF staff calculations.

- ***Labor market conditions have been improving, though they are still far from normal***. Employment gains averaged about 200 thousand over the first half of 2013, up from 180 thousand in the previous six months. The unemployment rate continued to fall from its October 2009 peak of 10 percent to 7.6 percent in June 2013, although much of the improvement reflects lower labor force participation. The drop in participation can be partly explained by demographic and other long-term trends, but cyclical factors have also played a role, with the share of discouraged workers significantly above pre-recession levels at 2.7 percent of the working age population. Meanwhile, long-term unemployment remains close to 40 percent of total unemployment, about twice the level before the crisis.

2. The pace of fiscal consolidation has accelerated in 2013. While policymakers successfully avoided the large "fiscal cliff" in January 2013, Congress allowed the automatic across-the-board spending cuts ("sequester") to materialize from March. In combination with other measures, such as higher marginal rates for upper-income taxpayers and the expiration of the payroll tax cut, as well as stronger-than-expected revenue collections, the structural primary withdrawal is estimated to have increased to about 2½ percent of GDP this year, from 1¼ percent in 2012 (Chart).

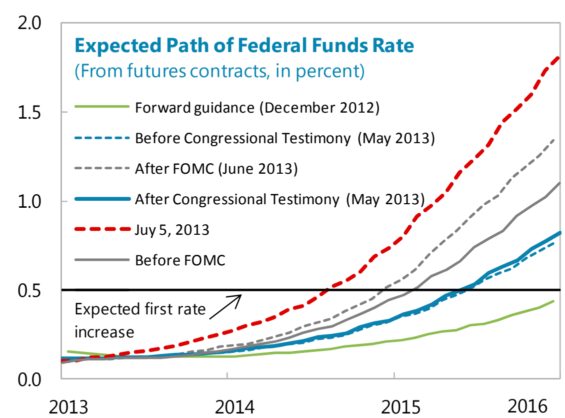


Sources: Congressional Budget Office; BEA; IMF staff estimates.

3. The Fed continued to use innovative tools to further ease the monetary policy stance.

- After the expiration of "Operation Twist" in December 2012, the Fed announced open-ended outright purchases of long-term Treasuries at an initial pace of $45 billion a month. These purchases were in addition to open-ended purchases of mortgage backed securities (MBS) at a pace of $40 billion a month, which began in September 2012.
- At the December 2012 meeting of the Federal Open Market Committee (FOMC), the Fed also switched from a date- to a threshold-based forward guidance for the policy rate. Specifically, the Fed committed to keeping the federal funds rate close to zero at least as long as the unemployment rate remains above 6½ percent, inflation projected 1–2 years ahead is not above 2½ percent, and longer-term inflation expectations remain well-anchored. The highly accommodative monetary policy stance has provided key support to the recovery. Based on staff estimates, the lower long-term yields from unconventional policies resulted in a stimulus equivalent to a federal funds rate easing (in a setting unconstrained by the zero bound) of roughly 250 basis points as of end-2012.

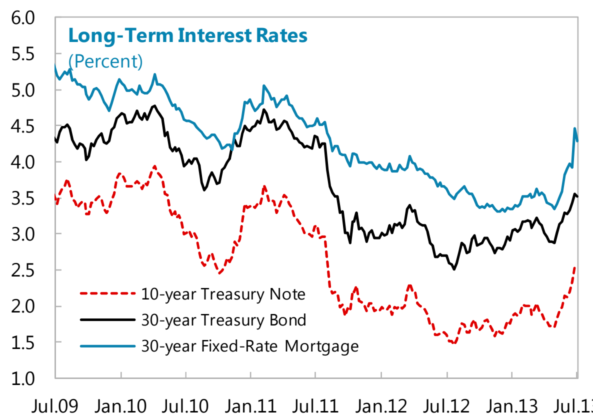
4. With the economic recovery gradually proceeding, the Fed has recently indicated that, based on its current outlook, its asset purchases could be scaled back later this year. In its March 2013 statement, the FOMC indicated that the pace and composition of purchases would be adjusted not only depending on further progress in the labor market and inflation developments, but also on the basis of the likely benefits and costs of such purchases—the latter including potential financial stability consequences. Subsequent Fed commentary—including the Chairman's testimony to the Joint Economic Committee of the U.S. Congress on May 22—discussed the potential to taper asset purchases pending continued improvement in the economy. After the June 2013 FOMC



Source: Bloomberg L.P.

meeting, the Fed noted that if the recent gains in labor market were to continue and the economy were to pick up in the next quarters, then it would be appropriate to begin scaling back asset purchases later in 2013 and end them in the middle of 2014. It also noted that such actions would amount to slowing the pace of further accommodation, rather than tightening the monetary policy stance. Financial markets have reacted by moving forward their expectations about the start of the tightening cycle (Chart). As of early July 2013, market expectations are for the tapering of the Large Scale Asset Purchase (LSAP) program to begin sometime before year-end, and for the first policy rate increase to occur in late 2014, while the large majority of FOMC members expect such increase to occur during 2015.

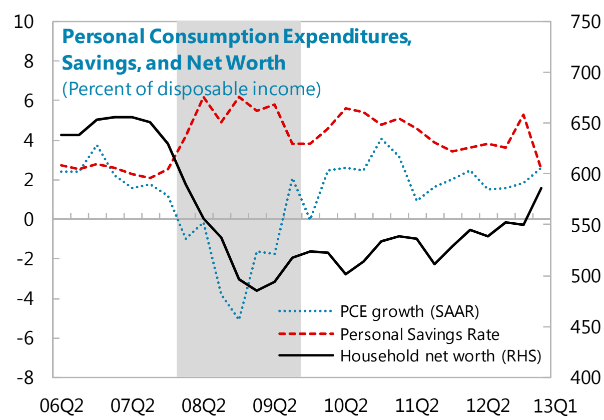
5. Despite tightening somewhat recently, financial conditions remain accommodative. As of early July 2013, stock prices were up over 14 percent since end-2012. Risk spreads have narrowed through mid-May, as markets became more optimistic about growth prospects and global policy actions removed key tail risks. Bank lending attitudes have continued to ease in all market segments, although credit conditions remained relatively tight for mortgages and, to a smaller extent, small and medium enterprises (SMEs) (see Selected Issues Chapter 4). Financial conditions have tightened since May after investors started pricing in an earlier tightening of monetary policy. As of early July, long-term Treasury yields had risen about 100 bps from their trough in May (Chart), with emerging market currencies, stock markets, and bond markets experiencing a sizable correction. Still, financial conditions in the United States remain looser than 12 months ago (Chart).



Sources: Bloomberg L.P; Haver Analytics.

Sources: Goldman Sachs; Bloomberg L.P.
1/ The index is set to 100 for the average since 2000.

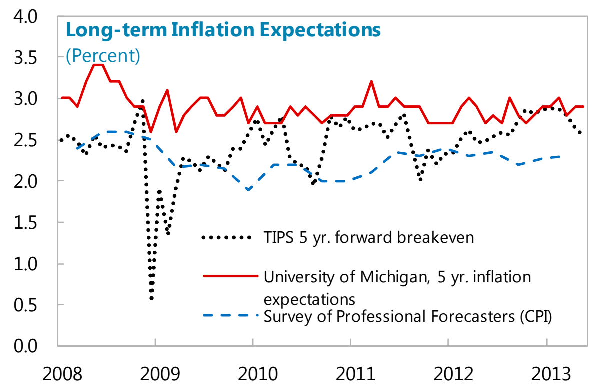
6. Favorable financial conditions and stronger balance sheets helped private domestic demand weather both the fiscal-cliff related uncertainty in late 2012 and the fiscal adjustment so far in 2013. Despite the expiration of the payroll tax cut and other fiscal policy measures, private consumption expenditure (PCE) continued to grow in the first 5 months of 2013 at about the same pace as in 2012 (1.8 percent, from 1.9 percent during 2012), supported by lower gasoline prices, higher payrolls, and rising net worth (Chart). In particular, staff estimates that the 25 percentage points increase in the household net worth-to-income ratio



Sources: BEA; Haver Analytics; IMF staff estimates.

in 2013:Q1 (vis-à-vis 2012:Q4) accounts for about a half of the 2.6 percent increase in PCE growth (SAAR) in 2013:Q1. Helped by elevated corporate profitability, business fixed investment (particularly in equipment and software) continued to grow solidly in 2012, but slowed somewhat in 2013.

7. **Inflation has declined sharply in 2013, although expectations remain well anchored around the Fed's target**. Headline (12-month) CPI inflation slowed to 1.4 percent (year on year) through May 2013, and core CPI has decelerated to 1.7 percent, from 2.3 percent in May 2012. The core PCE price index—the Fed's preferred measure of underlying inflation—increased only 1.1 percent (year on year) in April 2013, a historical low and well below the Fed's 2 percent target for longer-run inflation. While to a certain extent the recent deceleration in inflation reflects transitory factors, including the impact of the sequester on health care inflation (which has a much larger weight in the PCE index than in the CPI), the still sizeable degree of slack in goods and labor markets (with the output gap estimated at about 4 percent as of mid-2013), decreasing gasoline prices, and subdued non-petroleum import prices all contributed to softer inflation dynamics. Despite low underlying inflation pressure, market measures of long-run inflation expectations have remained broadly stable at between 2 and 3 percent (year on year) (Chart).



Sources: Federal Reserve Bank of Philadelphia; University of Michigan; Haver Analytics; Bloomberg L.P.

8. **Despite a weak external environment, the external trade deficit contracted, reflecting in particular continuing increases in domestic oil and natural gas production**. The non-oil trade deficit was little changed in 2012 relative to the year before (at about 2.9 percent of GDP), with slower growth of both imports and exports—the latter reflecting weaker growth in a number of major trading partners. By contrast, the oil trade deficit decreased to 1.9 percent of GDP in 2012 from 2.2 percent in 2011, in part due to the sharp increase in the domestic production of oil and gas extracted through non-conventional techniques. The current account deficit declined to 2.8 percent of GDP in 2012 (from 3 percent of GDP in 2011). While the net international investment position (NIIP) deteriorated to about 25 percent of GDP, the investment income balance remained positive during 2012, at around 1½ percent of GDP.

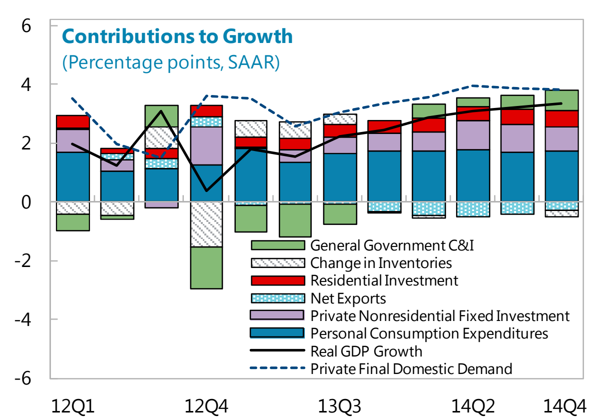
OUTLOOK AND RISKS

9. **Growth is expected to remain slow in 2013, before accelerating in 2014.** After the policy-induced soft patch in the first half of this year, activity should gradually pick up in the second half, with annual average growth for 2013 projected at 1.7 percent, accelerating to 2.7 percent in 2014. The unemployment rate is projected to remain broadly stable during 2013, but to post more significant decreases in 2014. As the transitory factors that have contributed to lower inflation over the past year dissipate, inflation is expected to regain some momentum but to remain subdued given the still wide output gap, with the PCE index below the Fed's longer-run 2 percent objective over the next two years. This central scenario rests on the following main assumptions:

- *Fiscal policy will be a significant drag on growth in 2013, but less so in 2014*. The general government is projected to subtract between 1½ and 1¾ pp from growth this year, in part due to the continuing implementation of automatic spending cuts and tax increases. The debt ceiling, which will likely become binding again in the fall, is assumed to be raised without any disruption to the U.S. and the global economy.

- *Monetary policy will remain accommodative*. Purchases of long-term Treasury bonds and agency MBS are projected to continue at the current pace through late this year, and then to be scaled back gradually over the course of 2014. Policy rates are assumed to remain near zero until early 2016, consistent with staff's macroeconomic forecast. The term premium embedded in long-term Treasury rates is assumed to increase gradually, responding in an orderly fashion to the Fed's announcements about the evolution of its asset purchases, contributing to higher long-term yields.

- *Private domestic demand will continue its recovery from the depth of the Great Recession*. Despite the recent tightening, credit conditions are expected to remain accommodative, as the U.S. banking sector is generally well capitalized and highly liquid and financing conditions in securities markets continue to be favorable. Residential investment should continue its recovery toward levels consistent with trend household formation, although the housing recovery is expected to proceed only gradually (with housing starts back to pre-crisis average levels in 2017), as access to mortgage credit remains relatively tight for many households. Consumption growth is expected to remain resilient in 2013, as stronger balance sheets broadly offset the impact of higher payroll and income taxes, and to strengthen next year reflecting more robust disposable income growth and improved labor market conditions (Chart).



Sources: BEA; IMF staff calculations.

- *Export growth is projected to remain subdued during 2013 but to pick up somewhat thereafter*, in line with the gradual recovery of global demand projected in the July 2013 *World Economic Outlook (WEO)*.

10. Risks to the outlook are still tilted to the downside, although less so than last year (see the Risk Assessment Matrix in Annex I). Among downside risks are the following:

- **Private domestic demand could lose some of its recent momentum**. In particular, the drag from fiscal policy could turn out to be greater than expected in our baseline scenario, especially if the sequester and higher payroll taxes were to have a stronger-than-expected effect on consumption. Also, lower increases in house prices amid tight mortgage conditions could slow household deleveraging and delay its positive spillovers to consumption, particularly if the recent increase in mortgage rates were to continue. A failure to raise the debt ceiling in a timely fashion would have severe domestic and global repercussions, although the threat of exceptionally high costs limits the risk of policy slippage in this area.

- **A worsening of the euro area debt crisis would weigh on U.S. growth**. Investor concerns about adjustment fatigue, political uncertainty, and insufficient euro area-wide backstops can cause financial stress to reemerge in the euro area periphery. In such a scenario, the U.S. would be affected through both trade and financial channels, including higher risk aversion and a stronger U.S. dollar amid safe-haven capital inflows—staff estimates that a 300 bps increase in the euro area periphery spreads would reduce U.S. output by about ¾ pp during the first year. The April 2013 *WEO* has also considered a more benign scenario in which the euro area escapes the worst of the crisis, but remains stuck in a low growth environment. The spillovers to the United States would be more limited in this case, with U.S. output lower by about ¼ percent after two years.

11. The recovery could also be hurt by a faster-than-projected increase in interest rates—which would also pose risks to global growth. While it is difficult to see expectations of future policy rates being revised durably upward in the absence of a faster recovery, there are a few scenarios where long-term rates could potentially increase more than currently anticipated without a stronger recovery.

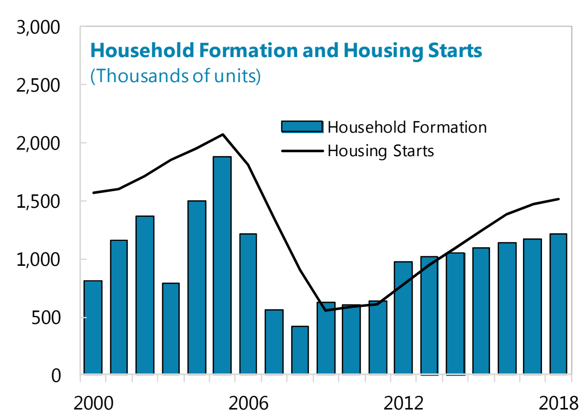
- *Initial steps taken by the Fed to normalize monetary policy conditions could result in an abrupt increase in the term premium*, should investors rush to offload their Treasury holdings to avoid greater capital losses down the road. The increase in market turbulence since late May is illustrative in this regard. The term premium can experience a sharp increase from staff's baseline path in the presence of higher uncertainty over the monetary policy stance and elevated financial market volatility (Selected Issues Chapter 5). Staff simulations using the IMF Global Integrated Monetary and Fiscal (GIMF) model suggest that a 50 bps term premium shock could lead to an output loss of between ¼ and ½ percent in the United States over two years depending on its persistence. The international spillovers could be substantial if the spike in rates were to lead to renewed concerns about global growth, higher global risk aversion, and a sudden reversal of capital flows to emerging markets, and higher volatility in global financial markets.

- *Increased signs of financial market exuberance* could also induce a faster normalization of interest rates than currently projected. There are a few signs that the protracted period of low interest rates may have led to a weakening in underwriting standards and a rise in balance sheet leverage, particularly in the corporate credit sector, as well as increased duration, credit, and liquidity risks in an effort to compensate for diminished returns in the current environment (see the April 2013 *Global Financial Stability Report*). To the extent these risks become less manageable, or unable to be contained through tighter regulation or macroprudential policies, the Fed might need to reassess the benefits derived from its LSAP program, potentially curtailing or ceasing asset purchases sooner than anticipated.

- *A pick-up in inflation expectations* could push long term interest rates higher and/or force the Fed to respond by bringing forward the tightening cycle. With inflation expectations continuing to be well anchored, however, the probability of an inflation scare in the near term appears quite low, and may be considered more as a medium-term risk (especially if potential output turned out to be much lower than estimated). The April 2013 *WEO* considers a scenario where inflation pressures start to build in 2014 as U.S. excess capacity is lower than in the baseline. With the Fed beginning to tighten in 2014, GDP growth in 2016 would be about 2 percentage points lower than in staff's baseline.

- *Over the medium term, lack of further progress on fiscal consolidation could lead to higher sovereign risk premia.* Based on the April 2013 WEO, a 200 bps increase in the sovereign risk premium would subtract between 1½ and 2½ pp from GDP growth over two years. As emphasized in the 2013 Spillover Report, such developments would have severe repercussions on global financial markets, and could lower global growth almost by a similar amount.

12. There are also upside risks to staff's baseline scenario. A faster housing market recovery may jumpstart a virtuous cycle of easier financial conditions, stronger investment, higher wealth accumulation and consumer demand. In particular, easier mortgage conditions could unleash pent-up demand for housing from new households. In the staff's baseline, household formation is expected to gradually return to its trend after the sharp fall observed during the crisis (Chart). But after being several years well below trend, household formation could well 'overshoot' its steady-state level, bringing housing demand and construction activity temporarily above their long-run level. The impact on residential investment would likely depend on whether new households buy or rent, given the lower cost of multifamily housing units that cater to the rental market relative to single family homes. Staff estimates that a 5 percentage point increase in housing starts would add 0.3 percent to output



Sources: U.S. Census Bureau; Haver Analytics; IMF staff estimates.

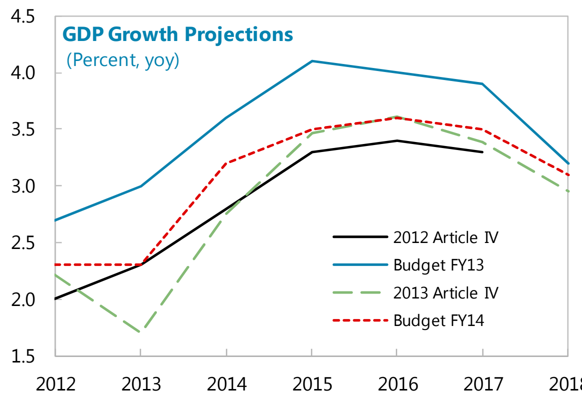
over two years. Also, lower uncertainty and prospects for a faster recovery of consumer demand could induce businesses to shift more aggressively from cash hoarding towards real investment. In the medium term, advances in the extraction of oil and gas from unconventional sources could boost growth more than anticipated, especially if lower domestic energy prices were to significantly boost the competitiveness of U.S. manufacturing (Box 2 and Selected Issues Chapter II).

POLICY DISCUSSIONS

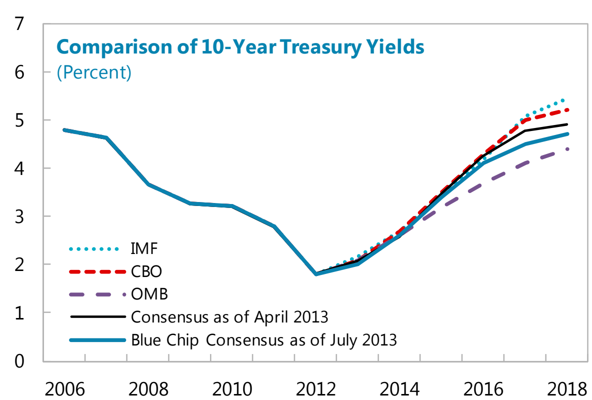
Discussions focused on policies to support the recovery, reduce emerging vulnerabilities, and address key medium-term challenges. In particular, the discussion centered on the appropriate pace, timing, and composition of fiscal consolidation; the appropriate monetary policy stance, side effects of unconventional monetary policies, and challenges related to the monetary policy exit; the merit of additional measures to unclog the housing markets and reduce the risks from persistently high long-term unemployment; the progress made in the reform of financial regulation, as well as issues related to the international coordination of regulatory reforms.

A. Outlook

13. Staff and the authorities broadly concurred on their views about the economic outlook, with some differences in particular on medium-term forecasts for long-term U.S. Treasury bond yields. The authorities' projections (as reflected in the FY2014 federal budget proposal) assume that GDP growth will reach 2.3 percent this year, somewhat above the 1.7 percent projected by staff, in part due to different assumptions regarding fiscal withdrawal but also the recent downward revision of GDP growth in 2013:Q1, which is reflected only in staff's forecast. Both staff and authorities expect growth to pick up from 2014, and views on the medium term have greatly converged since the last Article IV (Chart). That said, notable differences remain in terms of the interest rate forecast, with staff expecting the 10-year Treasury rate to increase to about 5¾ percent in the medium term (about 1 pp above the authorities' forecasts), as policy interest rates gradually return to more neutral levels and Treasury yields (so far compressed by strong safe haven flows and Fed purchases) price a modest penalty for the much higher stock of public debt (Chart). While



Sources: OMB; Haver Analytics; IMF staff estimates.



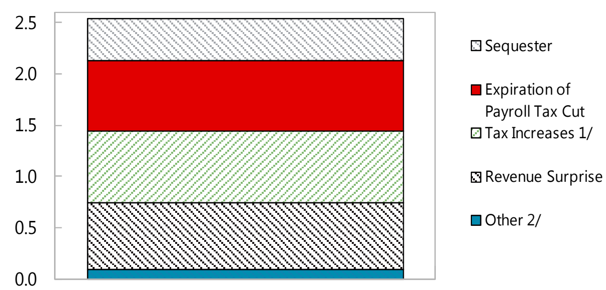
Sources: OMB; CBO; Blue Chip Consensus; Haver Analytics; IMF staff estimates.

acknowledging significant uncertainty in projecting medium-term interest rates, the authorities argued that there is no evidence of a "debt penalty" in current market rates, and over the medium term the Administration's budget plan would place the debt ratio on a downward path anyway.

B. Fiscal Policy

14. There was broad consensus between the authorities and staff that the pace of fiscal consolidation was too fast this year. Staff noted that its projected 2½ percent of GDP reduction of the general government structural primary deficit is too high given the fragile recovery and limited room for monetary policy offset; a deficit reduction of some 1 percentage point of GDP would have been more appropriate. The authorities noted that the Administration's budget proposal was consistent with the staff's recommendation, but the rapid fiscal withdrawal resulted from a political gridlock in Congress which led to implementation of the sequester, while not allowing passage of the Administration's plans for additional infrastructure spending and other support measures. Expiration of the payroll tax cut was necessary to ensure that the temporary tax cut would not become entrenched through repeated extensions by Congress. Unexpected revenue strength also played a significant role in raising the pace of fiscal consolidation (Chart).[1]

Composition of Fiscal Withdrawal in 2013
(General government, calendar year, percent of GDP)



Sources: Congressional Budget Office; IMF staff estimates.
1/ Expiration of 2001, 2003, 2009 tax cuts for upper-income taxpayers (incl. interaction with Alternative Minimum Tax) and health care reform taxes.
2/ Includes war drawdown and removal of emergency funds for disaster relief.

15. The authorities felt that the main short-term priority is to replace the sequester with a back-loaded set of revenue-raising and targeted expenditure-saving policies, although prospects for Congressional action remain unclear. Staff agreed, noting that the indiscriminate expenditure cuts not only exert a heavy toll on growth in the short term (reducing this year's growth by some ½ percentage points of GDP), but could also reduce medium-term potential growth by reducing infrastructure, science, and education spending. Moreover, the reduction falls heavily on discretionary spending while failing to address entitlement programs, the key drivers of deficits over the longer term. The authorities broadly concurred with this assessment and clarified that from FY2014 onward, the cuts required by the sequester—if still in place—would be implemented through caps on aggregate spending, thus providing some flexibility to reallocate funds and protect priority expenditures. Staff agreed with the authorities that measures to boost infrastructure investment, adopt training programs targeted at long-term unemployed, and support the housing market recovery remain desirable at this stage of the economic cycle.

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[1] Some of the strength was likely due to cyclical and one-off factors such as shifting of tax payments in anticipation of higher marginal tax rates from January 2013.

16. Staff expressed concerns that, despite the substantial deficit reduction in recent years, the U.S. fiscal position remains unsustainable over the long term. The general government deficit has more than halved from over 13 percent of GDP in 2009 to a projected 5.9 percent of GDP in 2013. In the staff's baseline scenario, the budget deficit will continue to shrink over the next few years due to a cyclical rebound in revenues, savings from legislated measures, and lower defense spending. Gross general government debt would peak at around 110 percent of GDP and start declining in 2015, also thanks to the favorable interest rate-growth differential reflecting still-low interest rates and a pickup in the pace of recovery. However, staff projects that the impact of population aging and health care costs on spending and the gradual normalization of interest rates would cause the budget deficit to widen and put the ratio of public debt to GDP again on an upward path—and from a relatively high starting point (Panel Figure 5). In particular, absent additional reforms, spending on major federal health care programs and Social Security is expected to increase by about 2 percentage points over the next decade, while higher interest rates would increase net interest outlays almost by another 2 percentage points over the same period. Staff suggested that placing the debt ratio firmly on a downward path would require a general government structural primary surplus of about 1 percent of GDP—implying an additional medium-term fiscal adjustment of about 2 percentage points of GDP, as the staff's current projections point to a general government primary deficit of 1 percent of GDP in 2022 (Table).

U.S. Government Finances

(In percent of GDP)

	2012	2013	2014	2022	2023
IMF staff baseline projection 1/					
Federal budget balance 2/	-6.9	-4.6	-3.4	-3.8	-3.7
Federal budget structural primary balance 2/ 3/	-4.2	-1.9	-0.9	-0.4	-0.1
Federal debt held by public	72.6	75.6	76.6	75.8	76.5
General government budget balance 2/ 4/	-8.5	-5.9	-4.8	-4.8	---
General government structural primary balance 3/ 4/	-4.4	-1.9	-1.2	-0.9	---
General government debt 4/	106.4	108.9	109.8	109.0	---
IMF staff recommended trajectory for reducing the public debt ratio 5/					
Federal budget balance 2/	-6.9	-4.8	-3.9	-1.6	-1.6
Federal budget structural primary balance 2/ 3/	-4.2	-2.1	-1.5	1.6	1.7
Federal debt held by public	72.6	75.7	77.0	69.1	68.0
General government budget balance 2/ 4/	-8.5	-6.2	-5.4	-2.6	---
General government structural primary balance 3/ 4/	-4.4	-2.2	-2.0	1.0	---
General government debt 4/	106.4	109.2	110.3	102.0	---
Memorandum items					
Federal budget balance (authorities) 6/	-7.0	-6.0	-4.4	-2.1	-1.7

Sources: Office of Management and Budget, Congressional Budget Office, and IMF staff estimates.

1/ Projections using the IMF macroeconomic and policy assumptions.

2/ Includes staff's adjustments for one-off items, including the cost of financial sector support. Excludes the portion of payments from the GSEs related to certain accounting changes.

3/ Excludes net interest, effects of economic cycles, and costs of financial sector support. In percent of potential nominal GDP.

4/ Includes state and local governments, figures on a calendar year basis.

5/ Assumes a back-loaded gradual increase in the structural primary balance until a primary surplus of 1 percent of GDP for general government is reached in 2022.

6/ Administration's FY2014 budget proposal.

17. The authorities recognized the existence of long-term fiscal challenges but argued that a smaller fiscal adjustment would be needed. They underscored their commitment to place the debt-to-GDP ratio on a downward path, and highlighted that the latest budget proposal identifies measures to move the federal government primary deficit into a surplus of over 1 percent of GDP in FY2023. This would be sufficient to place the federal debt to GDP ratio on a downward path under the authorities' macroeconomic assumptions (which, as noted earlier, feature lower interest rates on Treasury bonds relative to staff's assumptions).

18. Staff stressed that adopting a medium-term fiscal plan while slowing the pace of short-run fiscal adjustment would also help sustain global growth and favor the rebalancing of global demand and the reduction of global imbalances over the medium term—together with efforts to increase domestic demand in surplus countries, as highlighted in the G-20 Mutual Assessment Process. Less fiscal withdrawal in the short run would allow for a more balanced policy mix by partly relieving monetary policy of its burden of supporting the recovery. In turn, this would support U.S. growth and generate more favorable outward spillovers while reducing the risks to U.S. and global financial stability from a prolonged period of low interest rates. It would also help contain the risk of a future disruptive rise in long-term interest rates on U.S. Treasuries, which would have severe domestic and global repercussions. The authorities broadly concurred with these views.

19. Staff and authorities agreed that a medium-term fiscal consolidation plan should entail both lower growth in entitlement spending and higher revenues.[2] In staff's view, new revenues could be raised through a fundamental tax reform which would simplify the tax code and broaden the tax base through a reduction in exemptions and deductions, as well as through the introduction of a value added tax (VAT) and a carbon tax (Table). The authorities noted that their attention focused on broadening the tax base, and there were no plans for proposing a carbon tax or VAT. There was agreement that spending measures would be needed to curb the growth in public health care and pension outlays. Authorities noted that some measures along these lines, including health care savings and the re-indexation of public pensions to the chained CPI, are proposed in the Administration's budget for FY2014, but staff underscored that additional action would be needed to contain the steady growth in mandatory spending as a share of the economy. In staff's view, early legislative action is important in order to generate meaningful savings in entitlement spending during the next decade, given the very gradual pace at which such savings accrue. The authorities acknowledged the need for further measures to deal with long-run budget challenges, but noted that, with much progress already achieved in deficit reduction, their adoption did not need to be rushed. They also noted that, given the still substantial differences in views in Congress on the appropriate fiscal consolidation strategy, they would likely be adopted gradually as the political consensus builds on various policies.

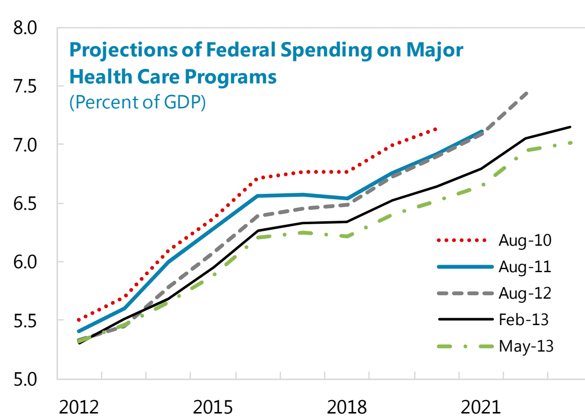
[2] The 2011 Selected Issues Paper discusses possible institutional arrangements for this framework (IMF Country Report No. 11/202).

United States: Illustrative Fiscal Policy Options 1/

Category	Detailed budget option	Annual savings in percent of GDP FY2023
Revenue		
VAT	Impose a 5 percent VAT (Wide base/narrow base)	1.4/0.8
Carbon tax	Impose a carbon tax	0.6
Personal income tax 2/	Cap itemized deductions at 15 percent of income	0.6
	Slowly reduce mortgage interest deduction	0.3
	Replace health-care tax exclusion with a more limited tax deduction	0.4
Spending		
Health care	Increase premia for Medicare Part B, reform cost-sharing	0.2
	Require vendors to pay drug rebates, limit torts	0.1
	Modify the excise tax on high-cost health care plans	0.2
	Reform TRICARE	0.1
	Total health care	***0.6***
Social Security	Base social security COLA on chained CPI-U	0.1
	Progressive price indexing for initial benefits	0.1
	Gradually raise the *earliest and full* eligibility age	0.3
	Increase maximum taxable earnings for Social Security	0.3
	Total Social Security	***0.7***

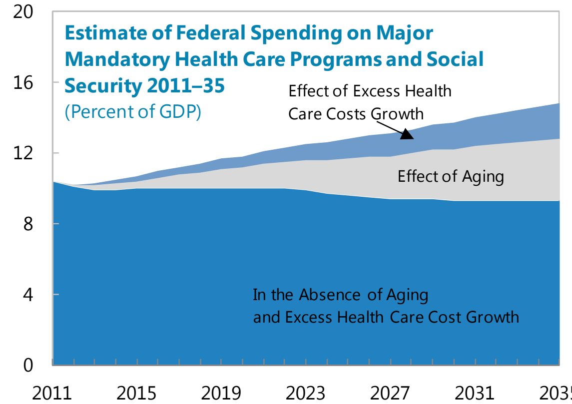
Sources: CBO; National Fiscal Commission; and IMF staff estimates.
1/ These policy options are some of the measures available to design a comprehensive fiscal consolidation plan. Policymakers can choose from this menu of options to achieve a particular level of adjustment.
2/ Certain personal tax expenditure options are not additive.

20. Staff discussed with the authorities the outlook for health care spending—the key driver of long-term budget deficits. The implementation of the Affordable Care Act (ACA) is proceeding, but the law has faced implementation challenges in light of its sheer complexity as well as last year's Supreme Court ruling which made the Medicaid expansion optional for the states. The authorities pointed to early evidence from several states suggesting that the insurance premia offered to individuals through online insurance exchanges are going to be substantially lower than initially projected, highlighting the potential benefits of greater transparency and competitive pressures in curbing health care costs. Staff urged the authorities to fully implement the ACA, which provides other possible tools for cost control (e.g., experiments with alternative payment and delivery methods at the Innovation Center of the Center for Medicare and Medicaid Services). The recent slowdown in health care expenditure growth (Selected Issues Chapter 3) has led both the authorities' and staff to revise down health spending projections (Chart), but both sets of projections still envisage continued growth of health care spending in percent of GDP



Sources: Congressional Budget Office; IMF staff calculations.

over the long term, primarily owing to population aging (Chart). Hence, consideration could be given to additional measures such as cutting health-related tax expenditures (amounting to some 1¼ percent of GDP annually) and imposing greater cost sharing on the beneficiaries.



Source: Congressional Budget Office.

21. The fiscal drag from state and local governments is gradually subsiding, but both staff and the authorities recognized that these governments continue to face medium-term risks from underfunded entitlements. Balanced budget rules have kept the consolidated state and local deficit at around 1 percent of GDP, with the debt ratio under 25 percent of GDP. Borrowing conditions for state and local issuers have remained broadly stable, despite sizeable medium-term risks from pension underfunding (estimated in a wide range of $1–4 trillion) and health care costs, and recent high-profile cases of municipal financial distress. Historically, municipal bankruptcies have been rare, with defaults characterized by high recovery rates for investors. Staff stressed that given rapidly rising revenues, it is now time to rebuild buffers while making further progress on reducing unfunded liabilities, especially from the pension systems. The authorities expressed optimism that last year's decision by the Governmental Accounting Standards Board (GASB) to require the use of riskless discount rate for unfunded pension liabilities could further incentivize state and local governments to address the problem, by providing a more accurate estimate of the size of the unfunded liabilities. The state and local budgetary frameworks could also be enhanced and made less pro-cyclical.[3]

C. Monetary Policy

22. While the highly accommodative monetary policy stance continues to provide essential support to the economic recovery, staff emphasized the need to carefully assess its financial stability implications. The changes in the size and composition of the Federal Reserve's balance sheet—together with forward guidance—have helped to overcome the challenges to monetary policy arising from the zero lower bound. While the macroeconomic benefits of asset purchases continue to outweigh the costs, staff expressed concerns that a long period of exceptionally low interest rates may entail potential unintended consequences for domestic financial stability, such as by spurring financial market froth, and complicate the macro-policy environment in some emerging markets. However, staff and the authorities agreed that a premature withdrawal of monetary stimulus to address these risks could slow the recovery and eventually prolong the period

[3] See Chapter VII of IMF Country Report 11/202. The state and local governments should start making actuarially-sound contributions to their entitlement systems, continue their push toward more risk sharing, streamline benefits when warranted, and avoid bets for resurrection through high risk/high return strategies. Rainy day funds could be allowed to accumulate beyond the prerecession levels to limit pro-cyclicality and consideration could be given to saving revenue over-performance from highly cyclical revenues such as capital gains taxes.

of low rates, thus exacerbating financial stability risks. The authorities noted that they had enhanced their monitoring of such risks, and that they may consider making more use of macroprudential measures to address them if they were to become more tangible.

23. The exit from unconventional monetary accommodation is likely to entail a number of challenges.

- *Potential for abrupt, sustained moves in long-term interest rates and financial market volatility*. Staff emphasized that expectations of a tapering or end of the Fed's asset purchases could trigger a sharper-than-expected sell-off of fixed-income assets, as investors seek to avoid larger capital losses in the future (Selected Issues Chapter 5), with repercussions for global capital flows, emerging market currencies, and asset markets. While effective forward guidance can give the market some time to adjust, a smooth and gradual upward shift in the yield curve might be difficult to engineer, and there could be periods of higher volatility when longer yields jump sharply—as recent events suggest. The authorities acknowledged these challenges, but also argued that, compared to the past, the toolkit at their disposal is broader and their communication policy is better able to respond to unexpectedly large increases in long-term rates. The authorities also stressed that the macro conditions underpinning a potential rise in long-term rates are an important consideration. For instance, higher interest rates owing to a rise in inflation premia would be an adverse outcome, but they agreed with staff that this is a low-risk scenario at this juncture given that inflation expectations are well-anchored and recent data point to subdued price pressures. By contrast, if the rise in long-term rates occurs in the context of a recovery in domestic demand, then the risk of adverse spillovers would be expected to be lower. Further, the authorities expressed some skepticism about long-lasting negative effects of a rise in U.S long-term rates on emerging markets, given the rise in structurally-oriented capital inflows to these economies as well as their improved domestic fundamentals.

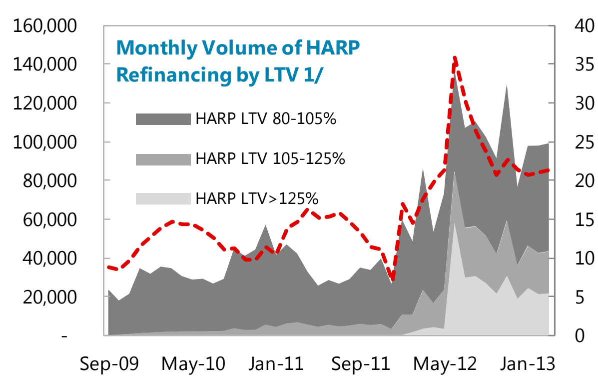
- *Managing short-term rates.* Until excess reserves are substantially reduced, the Fed's ability to target the federal funds rate may be impaired. The Fed's main operational rate at present is the Interest on Excess Reserves (IOER). But its transmission to other market rates is less certain, owing to the large volume of excess reserves and the segmented nature of U.S. money markets (some cash-rich institutions, like the Government-Sponsored Enterprises (GSEs), do not have access to interest-earning facilities at the Fed). This notwithstanding, the authorities were confident that increasing the IOER, combined with draining excess reserves, would be sufficient to drive up short-term interest rates. They stressed the range of tools available, including term deposits and reverse repos (with an extended set of counterparties), should enable a large volume of reserves to be drained. Staff noted that using the IOER also raises a governance issue, since its level is decided by the Federal Reserve Board, rather than the FOMC, but the authorities stressed the intention to closely coordinate policies.

- *Losses to the Fed.* As the interest on excess reserves rises with policy tightening, the Fed would incur larger costs on its liabilities but there will be no change in the coupons on its securities portfolio—increasing the potential for negative cash flow (losses) to appear on the balance sheet. Furthermore, rising long-term interest rates would reduce the value of long-term securities held in the Fed portfolio. While any losses should be judged in the context of the extraordinary profits which have accrued and been remitted to Treasury over the past few years, it is quite conceivable that losses could give rise to political pressure. The authorities were conscious that reduced remittances in the future may lead to some political backlash, and said they were seeking to be transparent and clear about the longer-term evolution of the Fed balance sheet to forestall future concerns.

24. The authorities underscored that their approach to exit from QE would not be a predetermined, mechanical process and that communication would play a key role. Instead, they expect to carefully assess the economic outlook and adjust the pace and composition of purchases over time accordingly. Both staff and the authorities agreed that effective communication will be critical. In the event that domestic conditions deteriorate or global financial turmoil intensifies, staff suggested that the Fed could provide further stimulus by adjusting the asset purchase program. The authorities agreed, noting that if the recovery were to slow, or the inflation outlook were to prove more subdued than currently expected, the Fed could extend asset purchases, while if the economic recovery were to accelerate, the pace of purchases could be trimmed more quickly. The authorities emphasized that reducing the pace of purchases implied a slower pace of adding monetary accommodation, and not a withdrawal of accommodation. They continued to expect a considerable period to elapse between the end of asset purchases and the first increase in the federal funds rate. The threshold-based forward guidance would continue to inform the FOMC's decision on the timing of that increase. They viewed the increase in long-run yields from their lows in May 2013 as a reflection of increased optimism on the economic recovery, realignment in markets participants' views regarding the Fed's reaction function, and the effects of market dynamics as investors adjusted their portfolios in light of these developments.

D. Housing Policy

25. The authorities noted that policies to support the housing market have contributed to the recent recovery. Accommodative monetary policy, including purchases of MBS, has set the stage for a revival of the housing market by lowering MBS yields and, in turn, mortgage rates. Mortgage finance policies (such as the Home Affordable Refinance Program (HARP) and the Home Affordable Modification Program (HAMP), both of which have been extended to 2015) have also contributed by boosting refinancing and helping reduce the weight of the shadow inventory on home prices. After an expansion of the program, HARP refinancing activity increased in 2012 and as of March 2013 amounted to more than 20 percent of total GSE refinancing (Chart).



Sources: FHFA; Haver Analytics; IMF staff estimates.
1/ LTV is the current loan to value ratio; the outstanding mortgage balance divided by appraised home value.

More than 1.1 million homeowners have benefited from a permanent loan modification through HAMP. The 2012 national mortgage settlement has further extended the scope of mortgage remediation efforts.[4] Efforts are underway to enhance these programs, in particular to increase the public's awareness of HARP options and to increase HAMP loan modifications through a streamlined modification process. The Consumer Finance Protection Bureau (CFPB) has recently introduced a qualified mortgage (QM) standard that will take effect in January 2014 and is expected to reduce regulatory uncertainty by clarifying a lender's obligation to determine the borrower's ability to repay. Work is still ongoing on the qualified residential mortgage (QRM) standard, which will set the standards that mortgages must meet to be exempt from the risk retention rules mandated by the Dodd-Frank Act.

26. Staff welcomed progress, but argued that there is still room for policies to support the housing market recovery. Despite the recent rebound in house prices and market activity, the legacy of the housing boom and bust (including continued foreclosure activity, the still large number of distressed loans, and continued tight access to mortgage credit for some households) is expected to weigh on the recovery. The number of households that are "underwater" on their mortgages (i.e., estimated to owe more than what their homes are worth), while declining, is still elevated: more than 10 million homeowners, representing about 20 percent of all mortgages. Mortgage originations for new purchases have also remained subdued, increasing by only 5 percent year-on-year in 2013:Q1, even as mortgage rates have been at their historic lows. In addition, house prices and sales have been boosted, perhaps temporarily, by strong investor demand in some markets. Staff was pleased to see the recent extension of the government-backed housing programs and saw value in extending them in a few areas, including letting the refinancing program cover loans not guaranteed by the GSEs. The authorities said that they were continuing to evaluate HARP expansion, noting that loan modifications and refinancing are preferred over foreclosures and short sales in addressing the remaining stock of distressed loans. Staff stressed the need to expeditiously complete regulations requiring banks to retain part of mortgage risk on their balance sheet (finalizing QRM standards). It also noted that a number of other frictions appear to make lenders more cautious than normal and could require policy intervention. For example, lenders remain concerned about "put back risk"—the risk that they will be required to repurchase defaulted loans from the GSEs. The authorities agreed that mortgage conditions remain relatively tight, but noted that regulatory uncertainty is being lifted, including through the finalization and clarification of standards on qualified mortgages, and current conditions could in some cases reflect excess caution by market participants.

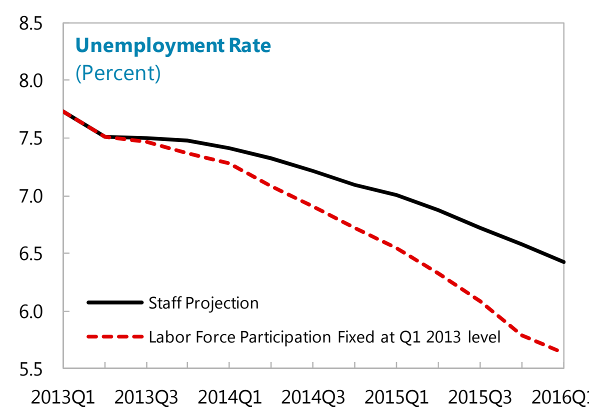
27. With a housing market recovery underway, staff and the authorities agreed on the importance of gradually reducing the dominant role of the GSEs in the mortgage market. Currently, the GSEs (such as Fannie Mae and Freddie Mac) and Ginnie Mae account for nearly all issuance of mortgage-backed securities, up from about 45 percent prior to the crisis, also reflecting the fact that—with only households with high credit scores effectively able to get mortgages—almost all new mortgages meet the "conforming loan" standards required by the GSEs. The

[4] The state attorneys general and the federal government settlement with major banks in February 2012 resolved claims about improper foreclosures and abuses in loan servicing, providing as much as $25 billion in relief to distressed borrowers and in payments to states and the federal government.

authorities noted that efforts were underway to encourage the return of private capital to the mortgage market. The Federal Housing Finance Agency (FHFA) has recently increased the fees charged by the GSEs to guarantee securitized loans, issued plans to develop a more modern securitization platform to be placed outside of the domain of the GSEs and announced that GSE loan purchases will be limited to loans that follow the QM standard. Staff noted that additional measures could involve further increases in guarantee fees and lower thresholds for conforming loans, with the authorities noting that the latter measure would require congressional action. At the same time, staff and authorities agreed that progress in this direction needs to be gradual and take into account the potential for possible negative consequences on the nascent housing market recovery. In regard to staff's suggestion for an early adoption of a fully articulated medium-term strategy to gradually reduce the footprint of the GSEs, the authorities noted that there was growing bipartisan convergence on the issue and that the FHFA had scope to spur the transition process towards one of the long-run structures of the market envisaged by the Treasury's 2011 White Paper, given the many common elements among those structures.[5]

E. Challenges Facing the Labor Market

28. Staff and authorities discussed the extent to which the decline in labor force participation over the past few years is cyclical or structural. If some or most of this decline is cyclical, then the fall in the unemployment rate would overstate the improvement in the labor market, something the Fed would need to take into account in its decisions on monetary policy tightening. The authorities noted that it is very difficult to quantify the relative contribution of trend versus cyclical determinants of labor supply. While there is clearly a cyclical component in declining labor force participation (as well as underutilization of labor), they considered that there was also an important structural component driven by demographic factors (the aging of the baby-boom generation). In light of this, they expect participation to remain broadly constant for the next couple of years, with a cyclical rebound offsetting the trend decline. Staff broadly agreed with this view, but expects participation to rise temporarily over the next couple of years, as individuals who have temporarily abandoned the labor market re-enter the workforce in a stronger demand environment—the share of "discouraged" workers in the working age population increased by a full percentage point by May 2013 relative to December 2007. Underlying staff unemployment forecasts is the assumption that this share begins to decrease in 2014 and returns to its pre-recession level by end-2016, causing participation to increase by about 0.15 pp per year during 2014–16 (Chart).



Souces: BEA; Haver Analytics; IMF staff estimates.

[5] The 2010 Financial Sector Assessment Program (FSAP) called for the possible privatization of the GSE retained asset portfolios and for a move towards a public utility model with a clear separation of their responsibility for social policy.

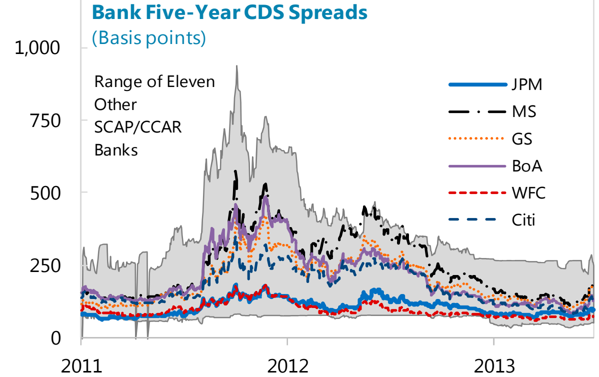
29. Staff and authorities also agreed that policy action is still needed to avoid the risk that long-term unemployment turns structural. Despite having decreased over the past year (to 2.8 percent of the labor force in May 2012 from 3½ percent a year before), the long-term unemployment rate remains high. As a result, the risk remains of human capital loss and reduced attachment to the labor force, which in turn could lead to lower potential GDP output. The authorities stressed the importance of policies to support the recovery in aggregate demand to forestall this important risk. In addition, they emphasized a number of labor market initiatives. First, the extension of emergency unemployment benefits for 2013 will serve as a social safety net and facilitate the skills matching process. Second, a number of ongoing policies—including training and employment programs that serve dislocated workers, low-income adults, and disadvantaged youth—will be maintained. Finally, additional measures were proposed in the FY2014 President budget, including reforms to the "Reemployment Now Program" to help unemployment insurance claimants get back to work more quickly, and a $12.5 billion allocation to the "Pathways Back to Work Fund," helping low-income workers remain in the labor force and gain new skills.

30. In line with previous advice, staff argued for a stronger emphasis on active labor market policies. Staff noted that training and support for job search have shown to improve the prospects of long-term unemployed workers, but that resources for these types of programs continue to be lower in the United States than other OECD countries. Staff welcomed the authorities' efforts to strengthen human capital and skill formation, in particular the programs addressed to make college affordable to students from lower-income families, as well as those designed to provide training to workers in skills needed in advanced manufacturing and other emerging sectors. Efforts to strengthen the link between the education system—particularly community colleges—and employers, including through apprenticeships, would also help improve labor market matching.

F. Financial Sector Conditions and Policies

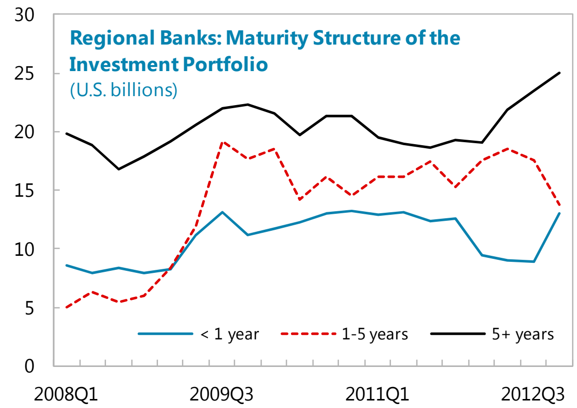
31. The U.S. banking system has improved significantly over the last 12 months and looks resilient to adverse shocks. The authorities noted that profitability continues to benefit from cost-cutting efforts, strong mortgage refinancing activity, and loan loss reserve releases. Asset quality is improving as the housing market recovers and legacy assets are restructured. Capital ratios continue to be supported by robust earnings and liquidity buffers are ample, as signaled by large holdings of cash and high-quality securities. Going forward, however, staff and authorities agreed that cost cutting and loan loss reserve releases are not sustainable sources of long-run growth in earnings. At the same time, as net interest margins are under pressure from protracted low interest rates, banks may have been induced to extend the duration of their securities profile, increase credit risk in loan or

Bank Five-Year CDS Spreads
(Basis points)



Sources: Bloomberg L.P.; IMF staff calculations.

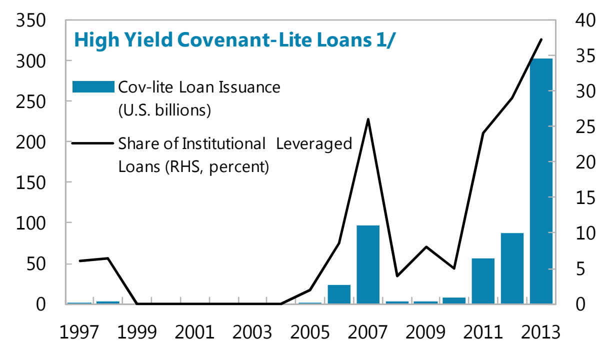
securities books, or relax risk management practices. However, the authorities noted that the results of the 2013 Comprehensive Capital Analysis Review (CCAR) stress tests underscored that the capital of the largest 18 U.S. bank holding companies is resilient to a range of adverse economic and global market shocks—all but one bank met the required capital threshold, and several banks announced increases in dividends and buybacks following the tests. Reflecting the generally strong health of the sector, bank equity valuations have increased and premia on large banks' credit default swaps have decreased substantially over the last year (Chart). On a more cautious note, there is some evidence that small and medium sized regional banks are increasing the maturity of their investment and loan portfolios and their investment in higher-yielding securities (Chart).



Source: SNL Financial.

32. In regard to the nonbank financial sector, staff raised concerns about potential risks arising in a low interest rate and low volatility environment:

- *Excessively loose conditions in corporate credit markets.* Authorities agreed with staff that a prolonged period of low interest rates could have adverse side effects in corporate credit markets. Already, there is evidence of weaker loan standards, rising balance sheet leverage, reduced protection from covenants, weaker quality of new issuances of corporate bonds and, in some cases, less discriminate pricing of corporate loans (Chart). Staff expressed concern that a faster- and larger-than-expected rise in interest rates could expose vulnerabilities currently masked by low rates and excess liquidity, with reduced secondary market liquidity potentially exaggerating dislocations. Authorities acknowledged these risks, which were stressed in the annual report of the Financial Stability Oversight Council (FSOC) and speeches by FOMC members, and noted that regulators have issued guidance against excessive risk-taking. At the same time, investors in these instruments tend to be unlevered, reducing the potential for fire sales triggering negative feedback loops, and corporate bond valuations are not tight relative to historical levels.

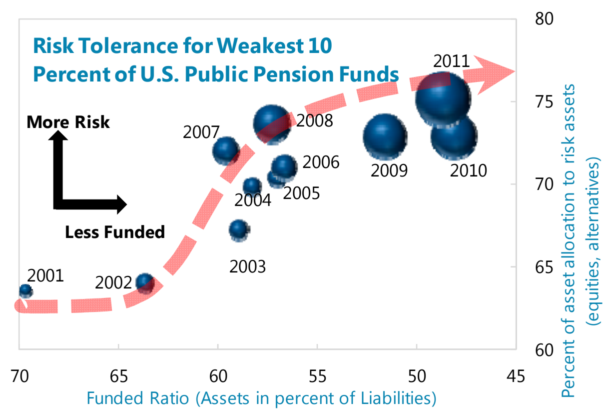


Source: Thomas Reuters.
1/2013 figures are based on annualized data through May.
Note: Covenant-lite (cov-lite) loans are loans in which borrowers are not obligated to meet quarterly maintenance criteria.

- *Rapid growth in mortgage Real Estate Investment Trusts* (REITs). Authorities and staff agreed that mortgage REITs—funds that invest primarily in agency MBS— pose a particular concern, given their rapid expansion over the last couple of years, large exposure to long-dated and highly concentrated assets, and heavy reliance on retail investment and short-term repo funding.

Increased oversight on these funds may be warranted, given their inherent vulnerability to prepayment and interest rate risk and susceptibility to funding pressure. Since the end of the consultations in late May, the combination of higher long-term rates, wider MBS spreads, and increased volatility have caused significant balance sheet losses and underperformance of REIT shares. In turn, this has led to an increase in REITs' borrowing costs and cost of capital. Meanwhile, their need to rebalance hedges as a result of the extension in the duration of their portfolios has reinforced the rise in long-term rates.

- *Diminished margins and underfunding pressures for insurance companies and defined-benefit pension funds*. Staff expressed concern about the risk that structural underfunding and low return on fixed income securities could lead defined-benefit public pension funds to search for yield. Already, the weakest public pension funds appear to have meaningfully increased their allocations to more risky investments (Chart).[6] Authorities acknowledged that unfunded liabilities in public pension funds are a concern, and noted that over 40 states have changed, or are about to change, their pension systems to address this issue. Staff also noted that the low interest rate environment poses challenges for insurance companies: while the industry has managed to lower its guaranteed rates by re-pricing and redesigning products, the net yield earned on its investment portfolio has declined by more, narrowing investment margins. Authorities said that they were closely monitoring the industry on concern that life insurers may take on additional credit and liquidity risk in their investment portfolio to offset margin compression. There is also the possibility that insurers may take additional risk on the liabilities side of the balance sheet, such as by offering more aggressive incentives to policyholders.



33. Staff welcomes the recent finalization of the rule implementing Basel III capital requirements. The Federal Reserve in early July issued a final rule, coordinated with the Federal Deposit Insurance Corporation (FDIC) and the Office of the Comptroller of the Currency (OCC), implementing in the U.S. the Basel III regulatory capital reforms. The phase-in period for larger institutions begins in January 2014, while for smaller banks it will begin in January 2015. The

[6] In the private sector, the funding ratio of the 100 largest defined-benefit corporate pension plans decreased modestly from 79 percent at end-2011 to 77 percent during 2012, owing to the record-low discount rates (Milliman Inc., Pension Funding Study, March 2013). The rising tide of required pension contributions has been mitigated by last year's legislation that allows corporations to smooth the calculations of discount rates over a long horizon. A number of corporations have attempted to reduce their exposure to pension-related risks, for example by offering lump-sum payments to beneficiaries or shifting their pension liabilities to insurance companies.

authorities indicated that proposed rules on Basel III liquidity standards are expected to be issued later this year.

34. Completing the implementation of the financial reform agenda remains essential to mitigate systemic risk. Staff noted that key parts of the Dodd-Frank Act that were considered close to be implemented during the last Article IV consultation had not yet been finalized. The authorities emphasized that the implementation of the Dodd-Frank Act gained momentum over the course of 2013, with a series of key rules expected to be finalized by year-end:

- *Regulation of the shadow banking system.* The designation process of *nonbank Systemically Important Financial Institutions (SIFIs)* has reached the final stage for a few firms. In regard to the regulation of Money Market Mutual Funds (MMMFs), a critical area in the eyes of staff especially given evidence of a pick-up in their risk profile within the low return environment, the SEC has recently proposed rules following a recommendation by the FSOC.[7] Staff sees the proposed rules as a first step in addressing the remaining vulnerabilities. Authorities also pointed to the progress made in reducing systemic risk in the *tri-party repo* market, particularly through reducing the reliance on discretionary credit extended by the two clearing banks. Still, they agreed with staff that more needs to be done to increase the resiliency of the settlement process to a broker-dealer default and the risk of fire sales. More generally, staff underscored the importance of data collection efforts on wholesale funding markets (including repo and securities lending), along the lines of recent initiatives by the Treasury Department's Office of Financial Research (OFR) and the Federal Reserve.

- *Volcker rule*. The authorities argued that the delay in finalizing the rule reflects the complex coordination of the several regulatory agencies involved in writing the rules, the objective difficulty in clarifying the distinction between market-making and proprietary trading, and consideration of all comments received on the proposed rule. Staff emphasized the need to minimize the effect of the rule on bond market liquidity, including negative international spillovers. At the same time regulators would need to be mindful of the migration of risk to less regulated financial institutions and the potential costs imposed on banks and corporates.[8]

- *Insurance regulation.* Staff noted that, in line with the findings of the 2010 FSAP, the fragmented regulatory structure, combined with a lack of timely and publicly-available data, might complicate monitoring the build-up of risks in this sector. The authorities recognized that in the

[7] On June 5 2013, the SEC has proposed that prime MMMFs (currently accounting for over 50 percent of assets under management by money funds) be forced to let their share prices "float". Funds that invest at least 80 percent of their assets in cash or government debt would be exempt from the change, as would funds designated purely for retail customers, which would be required to restrict withdrawals by any one customer to $1m per day. As an alternative, prime funds could keep the stable $1 share price, but would be required to impose liquidity fees on withdrawals and impose restrictions on withdrawals in times of stress. The SEC said it was considering whether to combine both measures into a single reform package, and requested feedback as part of a 90-day public comment period.

[8] These issues are discussed in Viñals et al., "Creating a Safer Financial System: Will the Volcker, Vickers, and Liikanen Structural Measures Help?" IMF Staff Discussion Note 13/4 (May 2013).

absence of a national regulatory framework, strong coordination between state regulators and federal authorities, including better data sharing, is important to ensure effective monitoring and supervision, especially of large and complex insurance groups. For some of them, enhanced supervision and regulation is likely to occur through their designation as nonbank SIFIs.[9]

35. Staff underscored the importance of achieving greater international coordination among national regulators and supervisors, as this would reduce fragmentation of the global financial regulatory landscape, limit the scope for regulatory arbitrage, and reduce uncertainty and compliance costs. Authorities agreed and argued that they strive to achieve coordination with other jurisdictions whenever possible. At the same time, they emphasized that differences across national financial systems justify some regulatory disparities. Furthermore, imposing stricter regulatory domestic standards aims at reducing systemic risk both in the United States and globally, rather than giving national institutions a competitive advantage, and should thus be seen as a "race to the top." The discussion focused on two specific areas:

- *Over-The-Counter (OTC) derivative markets reform.* Authorities noted that many of the commitments agreed to at the G-20 Pittsburgh Summit on OTC derivatives trading and clearing had already been honored. Good progress has been made on the rules for trade execution and reporting, and the movement to central clearing is progressing on schedule. Staff noted that the reform will need to be implemented carefully to resolve conflicts and inconsistencies among jurisdictions given the cross-border nature of OTC derivative markets.

- *Foreign Banking Organizations (FBOs).* Authorities noted that the rule proposed by the Federal Reserve in November 2012 (requiring FBOs to organize all their banks and nonbank subsidiaries active in the United States into a U.S. intermediate holding company) was mandated by the Dodd-Frank Act, and that it will strengthen the U.S. financial system by imposing to FBOs the same capital and liquidity requirements applied to U.S. banks. Authorities also noted that the U.S. banks abroad are generally subject to local regulatory standards and that the proposal is consistent with the FDIC's articulation of a "single point of entry" model, which they view as the most efficient approach to the resolution of cross-border subsidiaries. Staff agreed that the rule would enhance domestic financial stability, having flagged in the past potential risks arising from investment banking activities by foreign banks, but encouraged the authorities to ensure that it remains consistent with the Financial Stability Board key attributes of effective resolution regimes and does not unduly add costs on internationally active banks.

36. Authorities and staff agreed that strong macroprudential oversight and supervision of the financial system remain essential to address emerging vulnerabilities. The authorities argued that the FSOC has fostered a notable increase in inter-agency coordination, including through information sharing and high frequency of meetings, as well as an enhanced focus on systemic risk analysis, as shown in the FSOC annual report. The work of the OFR, including on

[9] Two large insurance companies (AIG and Prudential Financial) have indicated that they were among the nonbank financial institutions that the FSOC intends to designate as systemically important.

developing early indicators of systemic risk and increasing available data for monitoring financial stability, especially on shadow banking and the insurance sector, was also important in this respect. While recognizing that the establishment of the FSOC greatly improved coordination across U.S. regulators and the monitoring of systemic risk, staff argued that it would be important to ensure that FSOC recommendations can be implemented swiftly if needed. Staff also emphasized the need to ensure adequate resources for the regulatory agencies to effectively monitor financial institutions and markets.

37. Staff discussed plans to improve access to information about who ultimately owns and controls companies and trusts. In this respect, staff noted the lack of significant progress since the last Financial Action Task Force mutual evaluation report of June 2006. Measures intended to help prevent the abuse of legal persons and arrangements for financial crimes—including tax evasion—have still not been implemented.[10] Staff encouraged the authorities to proceed along these lines expeditiously, and reinvigorate previously announced initiatives to require the collection of information about beneficial ownership and control when companies are formed or beneficial ownership or control changes, as this will likely be critical to ensure the effectiveness of the overall framework. Authorities expect to issue regulations to strengthen and clarify financial institutions' requirements to identify and verify the identity of the beneficial owners of legal entity customers, in accordance with international standards.

G. The United States and the World Economy

38. Staff argued that the U.S. external position is moderately weaker than implied by medium-term fundamentals and desirable policies. The current account deficit has been around 3 percent of GDP since 2009, and is projected by staff to remain broadly stable over the next few years as higher imports are offset by lower oil prices and increased domestic energy production. As interest rates return to more normal levels, the U.S. net international investment position is projected to deteriorate slightly. In staff's view, the U.S. dollar is mildly overvalued and the current account deficit ½–1 percent of GDP larger than the level consistent with fundamentals and desirable policies (see Box 3). Staff simulations suggest that gradual fiscal consolidation aiming for a general government structural primary surplus of around 1 percent of GDP over the medium term, together with some depreciation of the dollar (in a 0–10 percent range) and adjustment in partner countries' policies geared towards global rebalancing, would result in the desirable strengthening of the current account by ½–1 percent of GDP in the context of full employment.

39. The authorities broadly agreed with the staff's projection for the current account, the external outlook and drivers of rebalancing. The current account deficit is expected to be contained as the economy recovers, in part owing to lower energy imports (reflecting the boom in

[10] There is no official estimate of U.S. tax evasion. The "net tax gap" (tax never collected) was assessed by the Internal Revenue Service at roughly $385 billion in 2006. This estimate consists of non-filing, underreporting, and underpayment but includes only a fraction of international tax evasion, a part of excise tax evasion, and excludes evasion of the state and local taxes. The total tax gap could be in the region of $0.5 trillion.

unconventional energy production) and to remain below pre-crisis levels. As the global recovery continues, the unwinding of "flight to safety" flows and currency appreciations in partner countries may lead to some dollar depreciation, while the lower budget deficit is expected to have a positive impact on external accounts. Demand from trading partners continues to be weak and the authorities viewed possible adverse developments in Europe as the key external risk to the ongoing domestic economic recovery. Authorities did not take a view on the appropriateness of the value of the dollar, which they view as market determined. That said, they argued that the recent reduction in global imbalances seems to reflect cyclical rather than structural factors and, looking forward, they emphasized the importance of global rebalancing through pro-growth policies in trading partners and currency appreciation in emerging markets with controlled exchange rates and current account surpluses.

40. Staff underscored the important spillovers to the rest of the world from policy actions in the United States. As highlighted in the 2013 *Spillover Report,* recent policies, including avoidance of the fiscal cliff and unconventional monetary policy accommodation in the United States, have sustained growth and reduced tail risks, thus lowering uncertainty and financial stress. However, a long period of exceptionally low interest rates has also complicated the macroeconomic policy environment in some emerging markets. Unwinding monetary policy accommodation is likely to present challenges and abrupt and sustained moves in long-term interest rates could result in reversals of capital flows to emerging markets and higher market volatility, as suggested by the market reaction to Fed communication in May–June of this year, concerning the timing of unwinding asset purchases. A rapid increase in long-term rates could imply sharp capital outflows from a number of countries, particularly those with higher risk profiles, as discussed in the 2013 *Spillover Report*. Authorities noted—and staff agreed—that any spillovers from monetary exit are likely to depend on the conditions under which such exit takes place. Authorities also emphasized that capital inflows to emerging markets generally reflect "pull" factors (including strong growth prospects and more favorable macro economic conditions than in the past) rather than "push" factors (including those related to unconventional monetary policies in the United States).

41. The authorities' trade policy agenda has become increasingly active, and they intend to seek Trade Promotion Authority from Congress, which would ease the passage of trade agreements. The agenda prioritizes the pursuit of both multilateral negotiations and plurilateral and bilateral trade agreements—the potentially most important initiatives are the Trans Pacific Partnership (TPP) and the Transatlantic Trade and Investment Partnership (TTIP). Both agreements could entail significant and lasting economic gains if negotiations are successful in reducing non-tariff barriers and making regulatory policy more coherent. In doing so, they could also establish higher-standard norms that will influence future multilateral agreements. At the same time, there is a risk of a fragmentation of the global trading system in the event Free Trade Agreements become closed and much deeper than multilateral agreements. With regard to multilateral negotiations at the WTO, the authorities stressed the need to explore a package with measures related to trade facilitation, as well as some agricultural and development issues, ahead of the Bali Ministerial Meeting in December 2013. The Administration is also prioritizing the enforcement of WTO rulings and trade agreements, particularly with the recent establishment of the Interagency Trade Enforcement Center.

STAFF APPRAISAL

42. **The U.S. recovery has remained tepid, but improving underlying conditions bode well for a gradual acceleration of growth**. Last year's sluggish growth reflected legacy effects from the financial crisis, continued fiscal consolidation, a weak external environment, and temporary effects of extreme weather-related events. However, the underlying recovery is gaining ground, supported by a rebound in the housing market, a boost to household net worth from higher house and stock prices, and—despite the recent tightening—still easy financial conditions. These factors are helping to offset the negative growth impact of strong fiscal adjustment, although average growth is still likely to be slower this year relative to 2012. The pace of recovery is projected to accelerate later this year as the fiscal policy headwinds subside. Growth is also expected to benefit from continued monetary accommodation, and further strengthening of the housing market and household balance sheets.

43. **The fiscal deficit reduction in 2013 is excessively rapid and ill designed**. In particular, the automatic spending cuts ("sequester") not only reduce growth in the short term, but indiscriminate reductions in education, science, and infrastructure spending, if protracted, could also reduce medium-term potential growth. These cuts should be replaced with a back-loaded mix of entitlement savings and new revenues, along the lines of the Administration's budget proposal. The slower pace of deficit reduction would help the recovery at a time when monetary policy has limited room to support it further.

44. **Despite the substantial deficit reduction achieved over the past several years, the gradual normalization of interest rates and the impact of population aging and health care costs on spending imply that public finances remain on an unsustainable path over the longer term**. The general government deficit has more than halved from over 13 percent of GDP in 2009 to a projected 5.9 percent of GDP in 2013, and will continue to shrink over the next few years, partly as revenues recover with faster economic growth. However, the longer-term debt profile remains unsustainable. Despite the slowdown in growth rates over the past few years, spending on major health care programs and Social Security is expected to increase by close to 2 percentage points of GDP over the next decade. Staff projects a similar increase over the same period for net interest outlays, as interest rates gradually return to neutral levels. These factors would cause the budget deficit to widen and put the ratio of public debt to GDP again on an upward path—and from a relatively high starting point.

45. **Together with a slower pace of deficit reduction in the short term, the authorities should promptly adopt a comprehensive and back-loaded plan entailing lower growth in entitlement spending and higher revenues**. New revenues could be raised through a fundamental tax reform which would simplify the tax code and broaden the tax base through a reduction in exemptions and deductions, as well as through the introduction of a carbon tax and a value added

tax. Spending measures would need to curb the growth in public health care and pensions outlays—and early legislative action is important in order to generate meaningful savings in these areas during the next decade, given the very gradual pace at which such savings accrue. Some measures along these lines, including health care savings and the re-indexation of public pensions to the chained CPI, are proposed in the Administration's budget for FY2014, but additional action would be needed to contain the steady growth in mandatory spending as a share of the economy. Overall, reaching over the longer term a primary surplus for the general government of about 1 percent of GDP (compared to a primary deficit of around 1 percent in staff's baseline projection) would put the debt ratio firmly on a downward path.

46. Implementing this fiscal strategy would help global growth in the short run and favor the rebalancing of global demand and the reduction of global imbalances over the medium term—together with efforts to increase domestic demand in surplus countries, as highlighted in the G-20 Mutual Assessment Process. In the short run, it would partly relieve monetary policy of its burden of supporting the recovery, reducing the risks to U.S. and global financial stability from a prolonged period of low interest rates. This more balanced policy mix would support U.S. growth, with more favorable outward spillovers. In the medium run, it would help contain the future rise in long-term interest rates, thus promoting growth, as well as reduce the risk of turmoil in the Treasury market, which would have severe domestic and global repercussions.

47. While the macroeconomic benefits of asset purchases continue for now to outweigh the costs, the Fed should continue its preparations for a smooth exit. The highly accommodative monetary policy stance has provided important support to the U.S. and global economic recovery, and under staff's growth projections a continuation of large-scale purchases through end-2013 is warranted. However, a long period of exceptionally low interest rates may entail potential unintended consequences for domestic financial stability and has complicated the macro-policy environment in some emerging markets. While the Fed has a range of tools to help manage the exit from its current highly accommodative policy stance—including adjusting interest on excess reserves and conducting reserve-draining operations with an expanded list of counterparties—unwinding monetary policy accommodation is likely to present challenges. The large volume of excess reserves and the segmented nature of U.S. money markets could affect the pass-through of the policy rate to short-term market rates. At the same time, effective communication on the exit strategy and a careful calibration of its timing will be critical for reducing the risk of abrupt and sustained moves in long-term interest rates and excessive interest rate volatility as the exit nears, which could have adverse global implications, including a reversal of capital flows to emerging markets and higher international financial market volatility.

48. Despite the improvements over the last 12 months, there is still room for policies to support the housing market. The rebound of the housing sector has benefited from government-backed programs that facilitated refinancing and modification of loans under stress. As a stronger housing market remains an essential component of the U.S. economic recovery, it would be important to maintain those programs in place and extend their reach in a few areas, including an extension of the refinancing program to loans not guaranteed by Government-Sponsored

Enterprises (GSEs). Certain key regulatory rules, such as the Qualified Mortgage rule, have been issued. The finalization of remaining rules on risk retention would help to reduce uncertainty that may have hampered mortgage origination, and favor the return of private capital to the housing finance system. Moreover, as the housing market recovers, consideration should be given to the adoption of a fully articulated medium-term strategy to gradually reduce the footprint of the GSEs.

49. Persistent weak labor force participation rates and high levels of long-term unemployment suggest there is room for active labor market policies to complement efforts to boost domestic demand. These policies can include training and support for job search, as well as efforts to strengthen the link between the education system—particularly community colleges—and employers, including through apprenticeships. These efforts can help reduce the risk of human capital losses which would lower potential growth for the U.S. economy.

50. The U.S. banking system is healthier than last year, but emerging risks from persistently low rates need to be carefully monitored. Banks have expanded their balance sheets, increased loan books, and improved liquidity positions, while at the same time reducing the riskiness of their portfolios. The quality and quantity of capital have been expanded, and the 2013 Fed stress tests and capital planning evaluations for the largest 18 U.S. banks suggest it would be resilient to very severe shocks. That said, there are some incipient signs of rising exposure to both interest rate and credit risk in regional banks that require increased vigilance, as low interest rates squeeze interest margins.

51. In a low interest rate environment, vulnerabilities may also be building in the nonbank financial sector, with a rapid expansion of agency Real Estate Investment Trusts (REITs), weakening underwriting standards in the leveraged loan market (covenant-lite loans issuance has returned to pre-crisis levels), and higher credit and liquidity risks taken by pension funds and insurance companies. Strong macroprudential oversight and supervision of the financial system remain essential to address these emerging vulnerabilities.

52. The regulatory architecture has been strengthened relative to the pre-crisis period, but more remains to be done to increase the resilience of the U.S. financial system while reducing the risk of international financial regulatory fragmentation. Staff welcomes the finalization of the rule implementing Basel III capital requirements. Key items that remain on the agenda are finalizing the designation of nonbank systemically-important financial institutions, further strengthening of regulation of money market funds (the recent proposal by the Securities and Exchange Commission being a useful first step), and reducing systemic risk in the tri-party repo market. Close attention is also needed to ensure that the finalization and implementation of the Volcker Rule take place in a manner that minimizes the effect of the rule on bond-market liquidity, including importantly negative international spillovers. At the same time, regulators would need to be mindful of the migration of risk to less regulated financial institutions. Notable progress has been achieved with new rules on centralized clearing of OTC derivatives, in line with G-20 commitments. These will need to be implemented carefully to resolve conflicts and inconsistencies among jurisdictions given the cross-border nature of the OTC derivative markets. More generally, the bolstering of regulatory policies to support financial stability should be coordinated with the global financial reform agenda as this would reduce fragmentation of the global financial regulatory landscape and limit uncertainty and the scope for regulatory arbitrage. This is particularly important in light of the size and global role of the U.S. financial system.

53. Over the medium term, a strengthening of the U.S. external position through some improvement in the current account deficit, which has remained around 3 percent of GDP since 2009, would be desirable. The current account deficit is expected to remain broadly stable over the next few years as higher imports due to stronger domestic demand are offset by lower oil prices and increased domestic energy production. Still, this would imply a further—if slow—deterioration in the U.S. net international investment position, entailing over time higher interest payments overseas. The mild dollar overvaluation could be unwound and the external position strengthened through a gradual but sustained reduction in the budget deficit, accompanied by some depreciation of the dollar and adjustment in partner countries' policies geared towards global rebalancing. This would allow for a desired strengthening of the U.S. current account balance by ½–1 percent of GDP in the context of full employment.

54. Staff welcomes the authorities' renewed initiatives in trade, including their intention to seek Trade Promotion Authority. The recent progress in promoting plurilateral and bilateral trade agreements should contribute to growth, as they can lead to more open trade and deeper forms of integration, including by addressing non-tariff measures. This progress should be complemented by renewed efforts to advance the multilateral trade agenda.

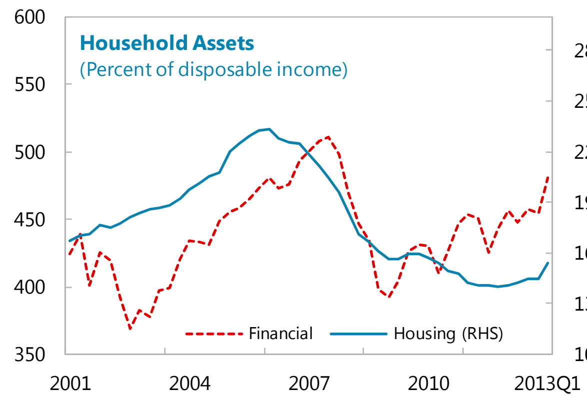
55. It is recommended that the next Article IV consultation take place on the standard 12-month cycle.

Box 1. U.S. Household Balance Sheets After Five Years of Repair

One of the key reasons for the weak U.S. recovery has been the drawn-out process of household balance sheet repair. In the aftermath of the Great Recession, balance sheets were weakened by the bursting of the housing bubble and lower stock prices—household net worth fell sharply from over 650 percent of disposable income (DI) in 2007:Q1 to 485 percent in 2009:Q1. Households were also over-indebted at the onset of the crisis, with the debt-to-income ratio peaking at around 135 percent of DI in 2007:Q3 compared with ratios around 100 percent in the early 2000s. Low net worth and over-indebtedness led consumers to boost their savings, putting a drag on private consumption.

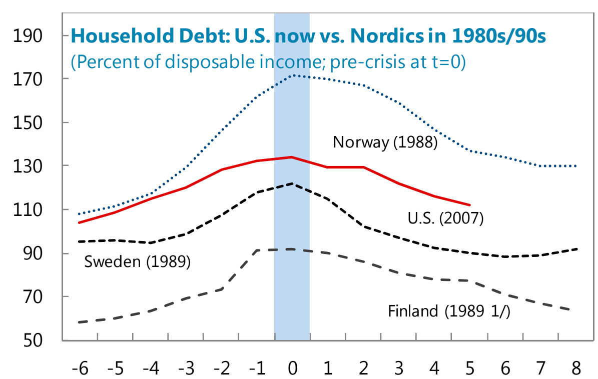
In the aggregate, household finances have improved substantially in recent years, but progress has been uneven across segments of the population.

- ***Household net worth*** recovered to 586 percent of disposable income by the end of 2013:Q1, slightly above to the long-term average and optimal wealth holdings (Carroll, Slacalek, Sommer, 2012). However, much of the recovery in asset values has been driven by higher stock market wealth, that tends to boost private consumption to a smaller degree than housing wealth.



Sources: Haver Analytics; and IMF staff calculations.

- ***Aggregate debt*** has been reduced to about 110 percent of DI. During the severe financial crises in the Nordic economies in the 1980s/1990s, household leverage eventually came down to pre-bubble levels—the United States has followed a similar trend so far. Non-mortgage consumer credit growth has picked up (partly reflecting a boom in student loans), but credit conditions remain tight in the crucial mortgage market. The growing volume of student loans amidst still-difficult labor market conditions also imply a risk that future debt service will weigh on consumption.

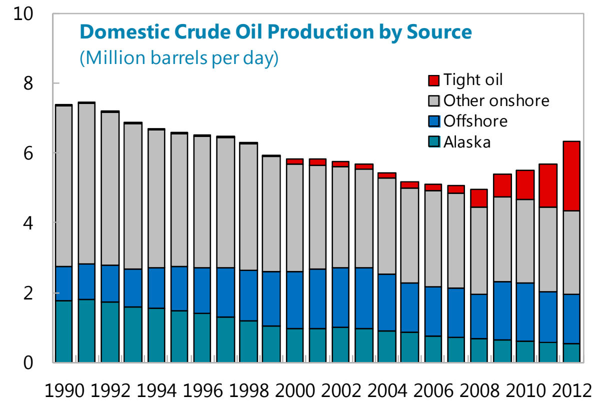


Sources: OECD; Norges Bank: Statistics Finland; Riksbank; and IMF staff estimates.
1/The years in parentheses correspond to the peak in the household debt ratio.

- ***The microeconomic evidence*** provides a cautionary tale. Since about two-thirds of the decline in aggregate household debt reflects households shedding debt through defaults, these households may not be able to borrow when economic prospects improve. In addition, households which had precarious balance sheets before the crisis appeared to have made limited progress in rebuilding net worth through active savings out of income as of 2011 (Celasun, Cooper, Dagher, and Giri, 2012). In the absence of rapid house price appreciation and income gains, these households may need to save more in the future.

Box 2. Unconventional Energy Boom and "Manufacturing Renaissance"

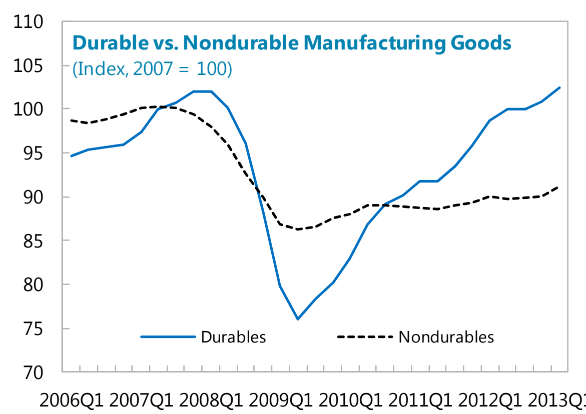
The United States is currently experiencing rapid growth in oil and gas production (Selected Issues Chapter II). Technological advances (especially horizontal fracturing and drilling) have helped to unlock unconventional oil and gas from shale formations, reversing a long period of production declines. Production of crude oil and other petroleum products has increased by roughly 30 percent over the past 5 years, helping to halve the U.S. imports of crude oil. The natural gas sector has been booming as well, with output up by 25 percent over the same period. The U.S. Energy Information Agency expects that crude oil and natural gas production could increase another 15 percent over the next decade, although views differ greatly among analysts, reflecting in part different assessments of infrastructure bottlenecks, environmental risks, and regulatory constrains.



Source: EIA.

The energy boom has already had positive effects on the U.S. economy. The direct benefit from higher oil and gas output is small given the low share of oil- and gas-related sectors in the U.S. economy (around 1½ percent of GDP)—mining contributed only 0.1 percentage point to real GDP growth last year. That said, technological constraints on gas exports have helped to push the domestic price of natural gas well below prices in other major markets, providing a competitive advantage to domestic industries and helping to support consumer demand through lower utility prices. Over time, corporations could choose to relocate some production to the United States, especially in the energy-intensive sectors such as petrochemical and fertilizer industries, aluminum, and steel. Higher capital accumulation would help boost productivity and potential output. U.S. companies could also benefit from exporting their technology for extracting unconventional energy.

Indeed, some analysts have interpreted the recent growth in durable-goods industries as a sign of "manufacturing renaissance" (Selected Issues Chapter I). Besides lower domestic energy prices, other supporting factors such as a weaker exchange rate, volatile shipping costs, and increases in emerging markets' labor costs could support steady increases in manufacturing output and employment, beyond those that could be attributed to just a cyclical rebound (although durable goods manufacturing makes up just 6½ percent of GDP).



Source: Haver Analytics.

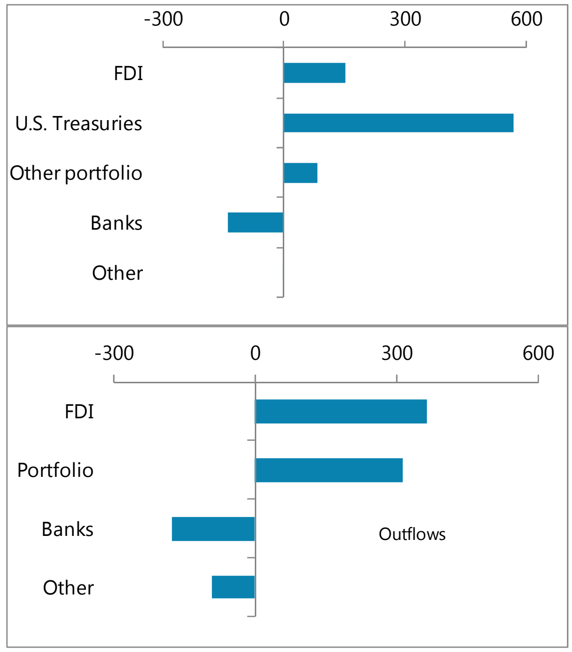
Staff analysis using the GEM model suggests that the macroeconomic effects of unconventional energy boom will remain positive for the United States but may be modest. Under the baseline, the increase in real GDP level attributable to higher domestic energy production could be less than 1 percent after 10 years, although energy production growth has tended to surprise on the upside, and the official production forecasts could prove too pessimistic. The boom could put some appreciation pressure on the U.S. dollar, with the energy trade balance improving further, but the current account implications appear ambiguous since the higher energy production will stimulate domestic consumption and investment.

Box 3. External Sector Developments and External Stability Assessment

During the past year, the dollar has remained broadly stable in real effective terms, generally strengthening during periods of higher risk aversion and weakening as volatility declined.

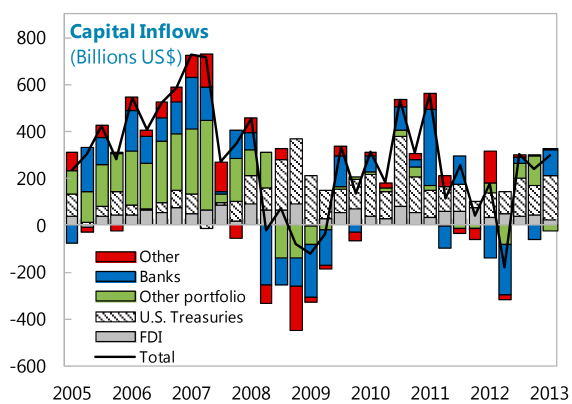
Capital flows to and from the United States remain well below pre-crisis levels. Net foreign purchases of Treasury securities still account for the lion share of inflows (Chart). Portfolio flows out of the United States have picked up in late 2012 and early 2013, while bank cross-border activity shows a continuation of the post-crisis decline.

US Capital Flows, 2012Q2–2013Q1
(Billions of U.S. dollars)

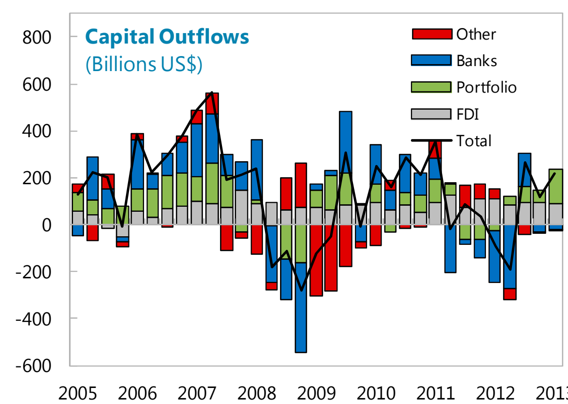


Model-based estimates suggest that the current account deficit is above its medium-term norm and that the real exchange rate is mildly overvalued (see Table).

- Under the External Balance Approach (EBA), model estimates suggest that the cyclically-adjusted current account deficit is about 1 percentage point of GDP weaker than the value implied by medium-term fundamentals and desirable policies.[1]
- Similarly, CGER current account methodologies (such as the Macro Balance (MB) and External Sustainability (ES) approaches) find current account gaps of around ½–1½ percent of GDP. These estimates suggest a mild real exchange rate overvaluation.
- The range of direct estimates of equilibrium real exchange rates is instead centered around zero, reflecting primarily the dollar's current weakness relative to its long-run average.



Sources: BEA; IMF staff estimates.



Sources: BEA; IMF staff estimates.

Box 3. External Sector Developments and External Stability Assessment *(continued)*

Model Based Current Account and Exchange Rate Gaps

	EBA		CGER		
	CA regression, 1/	REER regression, 2/	MB, 3/	ES, 3/	ERER, 4/
Current Account Norm (percent of GDP)	-2.9		-2.5	-1.9	
Current Account Gap (percent of GDP)	-1.0		-0.7	-1.3	
Exchange Rate Gap (percentage points)	7	-9	5	9	6

1/ Current account (CA) regression method. Based on 2012 cyclically-adjusted CA.

2/ Real effective exchange rate (REER) regression method. Based on 2012 average REER.

3/ Macrobalance (MB) and External Sustainability (ES) methods. Based on CA projected in 2018 and (for the ES method) 2011 Net Foreign Assets/GDP.

4/ Equilibrium Real Exchange Rate method. Based on early 2013 REER.

The United States has a fully open capital account, and vulnerabilities are limited by the dollar's status as a reserve currency and the United States' role as a safe haven. The U.S. dollar reserve currency status and safe haven motives boost foreign demand for U.S. Treasury securities during periods of market turbulence even as U.S. overseas investments fall. Hence the outlook for capital flows in the U.S. will depend on global financial stability and the pace of economic recovery, as well as on the outlook for the U.S. economy and public finances. Risks to external stability could come from a decline in foreign demand for U.S. debt securities (the bulk of U.S. external liabilities), driven for example by a protracted failure to restore long-run fiscal sustainability. Still, given the dollar's reserve currency status, current vulnerabilities are limited.

[1] See the 2012 Pilot External Sector Report (www.imf.org) for a discussion of EBA methodologies.

Table 1. United States: Selected Economic Indicators 1/

(Percentage change from previous period, unless otherwise indicated)

			Projections					
	2011	2012	2013	2014	2015	2016	2017	2018
National production and income								
Real GDP	1.8	2.2	1.7	2.7	3.5	3.6	3.4	3.0
Net exports 2/	0.1	0.0	0.1	-0.4	-0.3	-0.1	-0.1	0.0
Total domestic demand	1.7	2.1	1.6	3.0	3.6	3.5	3.3	2.9
Final domestic demand	1.8	2.0	1.5	3.0	3.7	3.5	3.2	2.8
Private final consumption	2.5	1.9	2.1	2.4	2.5	2.6	2.6	2.6
Public consumption expenditure	-2.3	-1.3	-3.5	0.4	3.6	2.0	1.6	1.4
Gross fixed domestic investment	3.4	6.1	4.3	7.8	8.9	7.8	6.4	4.8
Private fixed investment	6.6	8.7	6.3	8.9	9.8	8.4	6.9	5.3
Equipment and software	11.0	6.9	5.2	7.8	9.1	7.4	7.0	5.7
Nonresidential structures	2.8	10.8	1.9	4.4	4.2	4.0	4.0	3.4
Residential structures	-1.4	12.1	15.1	16.7	16.7	14.3	9.1	5.8
Public fixed investment	-7.3	-4.0	-4.4	2.6	4.5	4.8	3.7	2.1
Change in private inventories 2/	-0.2	0.1	0.1	0.1	-0.1	0.1	0.2	0.1
Nominal GDP	4.0	4.0	3.2	4.4	5.4	5.7	5.5	5.2
Personal saving rate (percent of disposable income)	4.3	4.1	3.0	3.5	3.7	4.0	4.1	4.0
Private investment rate (percent of GDP)	12.3	13.1	13.8	14.8	15.6	16.5	17.2	17.6
Employment and inflation								
Unemployment rate	8.9	8.1	7.6	7.3	6.8	6.2	5.7	5.5
Output gap (percent of potential GDP)	-4.7	-4.3	-4.6	-4.0	-2.8	-1.6	-0.6	-0.2
Potential GDP	1.7	1.8	2.0	2.1	2.3	2.3	2.4	2.4
CPI inflation	3.1	2.1	1.7	1.8	1.9	2.0	2.2	2.2
GDP deflator	2.1	1.8	1.5	1.6	1.9	2.1	2.1	2.2
Government finances								
Federal government (budget, fiscal years)								
Federal balance (percent of GDP)	-9.0	-6.9	-4.6	-3.4	-2.7	-2.8	-2.8	-2.7
Debt held by the public (percent of GDP)	67.8	72.6	75.6	76.6	76.0	75.1	74.2	73.6
General government (GFSM 2001, calendar years)								
Net lending (percent of GDP)	-10.0	-8.5	-5.9	-4.8	-4.2	-4.2	-4.1	-4.1
Primary structural balance (percent of potential nominal	-5.7	-4.4	-1.9	-1.2	-1.0	-1.4	-1.4	-1.3
Gross debt (percent of GDP)	102.4	106.4	108.9	109.8	109.0	108.0	107.1	106.5
Interest rates (percent)								
Three-month Treasury bill rate	0.1	0.1	0.1	0.1	0.2	0.9	2.1	3.6
Ten-year government bond rate	2.8	1.8	2.2	2.7	3.5	4.2	5.1	5.4
Balance of payments								
Current account balance (billions of dollars)	-458	-440	-476	-541	-571	-600	-634	-663
Merchandise trade balance (billions of dollars)	-744	-741	-715	-787	-855	-890	-927	-964
Balance on invisibles (billions of dollars)	286	301	239	246	284	289	292	302
Current account balance (percent of GDP)	-3.0	-2.8	-2.9	-3.2	-3.2	-3.2	-3.2	-3.2
Merchandise trade balance (percent of GDP)	-4.9	-4.7	-4.4	-4.7	-4.8	-4.7	-4.7	-4.6
Balance on invisibles (percent of GDP)	1.9	1.9	1.5	1.5	1.6	1.5	1.5	1.4
Export volume 3/	7.2	4.2	-0.3	4.0	6.2	6.4	6.1	5.9
Import volume 3/	5.2	2.1	-0.2	5.8	6.8	5.4	5.1	4.8
Net international investment position (percent of GDP)	-24.7	-24.6	-26.7	-28.3	-29.5	-30.6	-31.7	-32.8
Saving and investment (percent of GDP)								
Gross national saving	12.2	13.4	13.7	14.4	15.2	16.1	16.8	17.3
General government	-6.6	-5.4	-3.0	-1.9	-1.2	-1.1	-1.1	-1.2
Private	18.8	18.7	16.7	16.2	16.5	17.3	17.9	18.4
Personal	3.2	3.1	2.2	2.7	2.8	3.0	3.0	3.0
Business	15.5	15.6	14.4	13.6	13.7	14.3	14.9	15.5
Gross domestic investment	15.5	16.2	16.6	17.6	18.4	19.3	20.0	20.4
Private	12.3	13.1	13.8	14.8	15.6	16.5	17.2	17.6
Fixed investment	12.1	12.8	13.4	14.3	15.3	16.0	16.6	16.9
Inventories	0.2	0.4	0.4	0.5	0.4	0.5	0.6	0.7
Public	3.2	3.0	2.8	2.8	2.8	2.9	2.9	2.8

Sources: IMF staff estimates.

1/ Components may not sum to totals due to rounding.
2/ Contribution to real GDP growth, percentage points.
3/ NIPA basis, goods.

Table 2. United States: Balance of Payments

(Billions of U.S. dollars, unless otherwise indicated)

				Projections					
	2010	2011	2012	2013	2014	2015	2016	2017	2018
Current account	-449	-458	-440	-476	-541	-571	-600	-634	-663
Percent of GDP	-3.1	-3.0	-2.8	-2.9	-3.2	-3.2	-3.2	-3.2	-3.2
Goods and services	-499	-557	-535	-490	-542	-584	-592	-603	-613
Merchandise trade	-650	-744	-741	-715	-787	-855	-890	-927	-964
Exports	1,289	1,496	1,561	1,583	1,670	1,802	1,955	2,117	2,289
Imports	-1,939	-2,240	-2,303	-2,298	-2,456	-2,657	-2,845	-3,044	-3,253
Services	151	187	207	225	245	272	298	324	352
Receipts	556	617	649	684	730	787	848	913	983
Payments	-405	-430	-443	-459	-486	-515	-550	-589	-631
Income	178	233	224	147	135	143	125	107	94
Receipts	678	761	776	586	425	419	476	696	1,044
Payments	-500	-528	-552	-439	-290	-275	-350	-589	-950
Unilateral transfers, net	-128	-134	-130	-133	-133	-131	-133	-138	-144
Capital account transactions, net	0	-1	7	3	6	5	6	7	7
Financial account	438	552	439	447	535	566	594	628	656
Private capital	26	430	-31	113	166	186	190	203	208
Direct investment	-95	-179	-222	-223	-230	-241	-255	-269	-283
Outflows	-301	-409	-388	...	...	...	...	...	...
Inflows	206	230	166	...	...	...	...	...	...
Securities	344	96	263	116	193	191	208	219	231
Other investment	-223	513	-72	219	203	235	237	252	260
U.S. official reserves	-2	-16	-4	-1	...	...	...	...	...
Foreign official assets	398	254	394	335	368	380	404	425	447
Other items 1/	31	-65	78	5	...	...	...	...	...
Statistical discrepancy	12	-93	-6	25	...	...	...	...	...
Memorandum Item:									
Current account excluding petroleum	-167	-109	-127	-197	-274	-307	-345	-385	-419

Sources: IMF staff estimates.

1/ Includes net financial derivatives.

Table 3. United States: Federal and General Government Finances 1/

(Percent of GDP)

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
			Projections										
					(Budget basis; Fiscal years)								
Federal Government													
Revenue	15.4	15.8	17.5	18.1	19.1	19.0	18.8	18.7	18.5	18.5	18.6	18.8	18.9
Expenditure	24.1	22.6	22.1	21.5	21.7	21.8	21.5	21.4	21.6	21.9	22.1	22.6	22.6
Noninterest 2/	22.6	21.2	20.7	20.1	20.2	20.1	19.5	19.1	19.0	19.0	19.0	19.2	19.0
Interest	1.5	1.4	1.4	1.4	1.5	1.7	2.0	2.3	2.6	2.9	3.1	3.4	3.6
Balance 2/	-9.0	-6.9	-4.6	-3.4	-2.7	-2.8	-2.8	-2.7	-3.2	-3.4	-3.5	-3.8	-3.7
Primary balance 3/	-7.2	-5.5	-3.2	-2.0	-1.1	-1.1	-0.8	-0.4	-0.6	-0.5	-0.4	-0.5	-0.1
Primary structural balance 4/	-5.8	-4.2	-1.9	-0.9	-0.3	-0.6	-0.6	-0.4	-0.5	-0.5	-0.3	-0.4	-0.1
Debt held by the public	67.8	72.6	75.6	76.6	76.0	75.1	74.2	73.6	73.7	74.2	74.8	75.8	76.5
Net debt held by the public	61.4	66.8	69.3	69.9	69.0	67.9	66.9	66.2	66.3	66.7	67.3	68.3	69.0
					(GFSM 2001 basis; Calendar years)								
General Government													
Revenue	31.4	31.6	33.6	34.1	34.8	34.7	34.4	34.4	34.1	34.1	34.2	34.3	...
Total expenditure 2/	41.4	40.1	39.6	39.0	39.0	38.9	38.5	38.5	38.5	38.6	38.8	39.1	...
Net lending 2/	-10.0	-8.5	-5.9	-4.8	-4.2	-4.2	-4.1	-4.1	-4.4	-4.6	-4.7	-4.8	...
Primary balance 3/	-7.9	-6.5	-3.9	-2.8	-2.1	-2.0	-1.6	-1.3	-1.4	-1.2	-1.1	-1.0	...
Primary structural balance 4/	-5.7	-4.4	-1.9	-1.2	-1.0	-1.4	-1.4	-1.2	-1.3	-1.1	-1.0	-0.9	...
Gross debt	102.4	106.4	108.9	109.8	109.0	108.0	107.1	106.5	106.8	107.3	108.1	109.0	...
Net debt	82.3	87.1	89.7	90.0	88.9	87.8	86.8	86.2	86.4	86.9	87.5	90.5	...

Sources: Office of Management and Budget; Haver Analytics; and IMF staff estimates.

1/ Data for 2011 general government revenue, expenditure, and net lending are IMF staff estimates.

2/ Includes staff's adjustments for one-off items, including the costs of financial sector support.

3/ Excludes net interest.

4/ Excludes net interest, effects of economic cycle, and costs of financial sector support. In percent of potential GDP.

Table 4a. General Government Statement of Operations 1/

(Percent of GDP)

	2007	2008	2009	2010	2011	2012
Revenue	33.9	32.5	30.8	31.2	31.4	31.6
Taxes	21.3	19.6	17.6	18.2	19.1	n.a.
Social contributions	6.9	6.9	6.9	6.8	6.1	6.1
Grants	0.0	0.0		0.0	0.0	0.0
Other revenue	5.8	5.9	6.3	6.2	6.2	n.a.
Expenditure 2/	36.7	39.2	44.2	42.4	41.4	40.1
Expense	35.6	38.2	43.1	41.4	40.5	39.2
Compensation of employees	10.1	10.4	11.1	11.0	10.7	n.a.
Use of goods and services	8.2	9.1	9.3	9.4	9.2	n.a.
Consumption of fixed capital	1.3	1.4	1.5	1.5	0.0	0.0
Interest	2.9	2.7	2.5	2.6	2.8	2.7
Subsidies	0.4	0.4	0.4	0.4	0.0	0.0
Grants	0.3	0.3	0.3	0.4	0.0	0.0
Social benefits	12.1	13.0	15.1	15.5	15.2	15.6
Of which: Social security benefits	7.7	8.2	9.6	9.7	9.4	9.7
Expense not elsewhere classified	2.4	3.0	5.1	2.9	2.7	n.a.
Net acquisition of nonfinancial assets	1.1	1.0	1.1	1.0	1.0	1.0
Gross/net operating balance 3/	-1.7	-5.7	-12.3	-10.2	-9.1	-7.5
Net lending/borrowing 2/	-2.7	-6.7	-13.3	-11.1	-10.0	-8.5
Net acquisition of financial assets	0.5	3.2	0.3	1.6	-1.9	n.a.
Net incurrence of liabilities	3.5	10.3	11.8	12.4	8.2	7.9

Source: Government Finance Statistics.
1/ Data for 2012 are IMF staff estimates.
2/ Includes staff's adjustments for one-off items, including the costs of financial sector support.
3/ Revenue minus expense.

Table 4b. General Government Financial Assets and Liabilities

(Percent of GDP)

	2007	2008	2009	2010	2011	2012
Net financial worth	-48.0	-54.0	-66.7	-75.1	-82.3	-87.1
Total financial assets	18.5	21.5	22.4	23.1	20.1	19.3
Currency and deposits	2.5	4.8	3.9	4.8	3.1	3.2
Debt securities	6.4	5.7	6.1	5.8	4.5	3.9
Loans	3.2	3.3	4.5	5.2	5.7	6.2
Equity and investment fund shares	1.8	2.8	2.2	2.0	2.0	1.7
U.S. official reserve assets	0.3	0.3	0.7	0.7	0.7	0.7
Other financial asssets	4.4	4.7	5.1	4.6	4.2	3.7
Total financial liabilities	66.5	75.5	89.1	98.2	102.4	106.4
Currency and deposits	0.2	0.2	0.2	0.2	0.2	0.2
Debt securities	52.5	60.7	73.1	81.9	85.8	89.8
Loans	0.0	0.0	0.0	0.0	0.0	0.0
Accounts payable	5.6	6.0	6.0	6.1	6.2	6.3
Insurance reserves	0.3	0.3	0.3	0.3	0.3	0.3
Other financial liabilities	7.8	8.3	9.0	9.3	9.5	9.5
SDR allocations and certificates	0.1	0.1	0.4	0.4	0.4	0.4

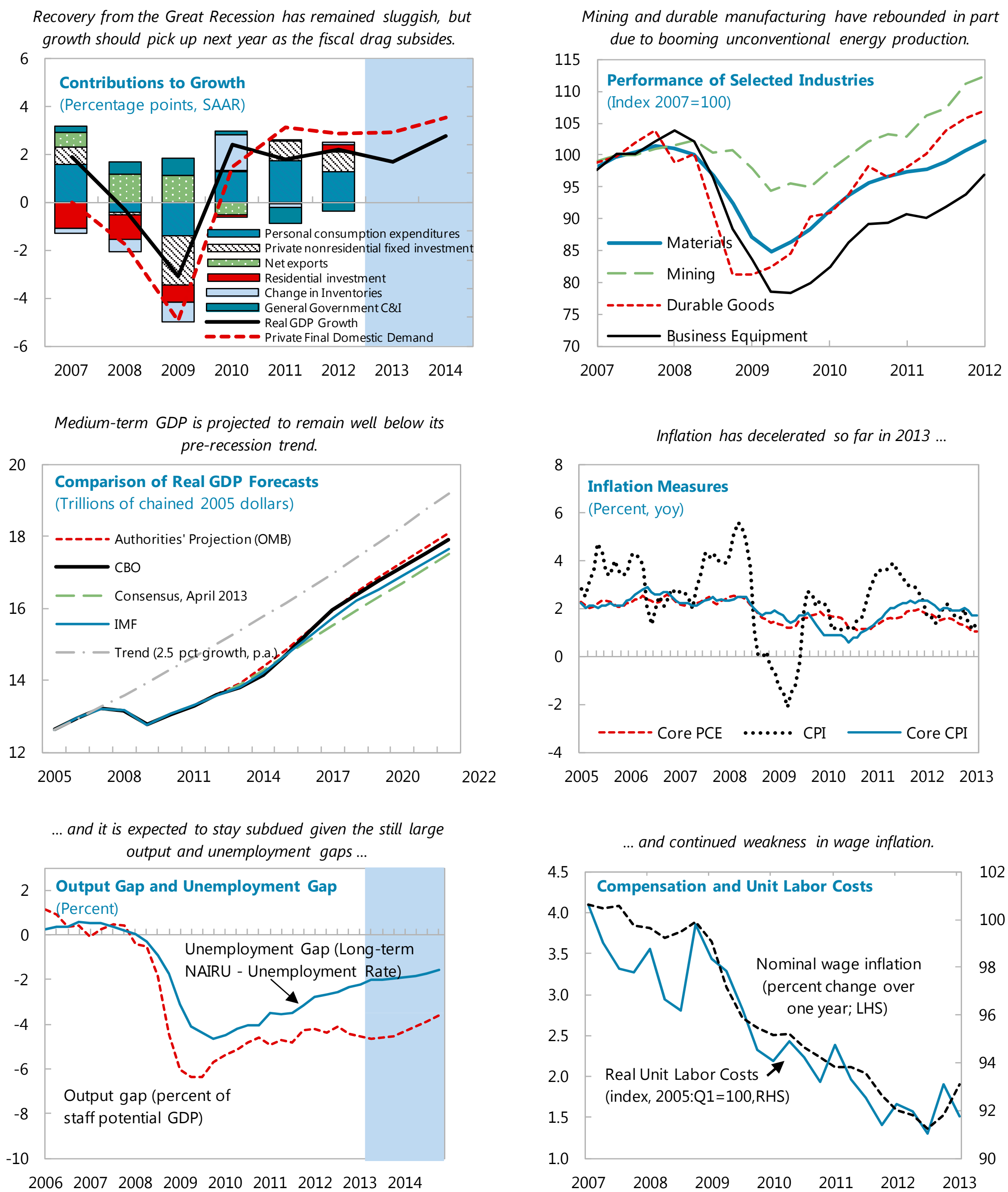
Sources: Board of Governors of the Federal Reserve System; Bureau of Economic Analysis; and Haver Analytics.

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

	2006	2007	2008	2009	2010	2011	2012
External indicators	(In percent of GDP, unless otherwise indicated)						
Exports of goods and services 1/	12.7	13.0	11.1	-14.0	16.2	13.5	4.3
Imports of goods and services 1/	10.5	6.0	7.7	-22.7	19.2	13.0	3.1
Terms of trade 1/	-0.7	-0.2	-5.3	5.8	-1.4	-1.3	0.2
Current account balance	-6.0	-5.1	-4.8	-2.7	-3.1	-3.0	-2.8
Capital and financial account balance	6.0	4.4	5.2	1.7	3.0	3.7	2.8
Of which:							
Net portfolio investment	5.9	5.4	1.5	6.0	5.2	1.5	4.7
Net foreign direct investment	0.0	-1.4	-0.1	-1.1	-0.7	-1.2	-1.4
Net other investment 4/	0.0	0.0	0.1	0.1	0.1	0.0	0.0
Official reserves 2/	65.9	70.6	77.6	130.8	132.4	148.0	150.2
in months of imports	0.4	0.4	0.4	0.8	0.7	0.7	0.7
Central bank foreign liabilities 2/	0.1	0.1	1.4	2.4	3.4	0.2	6.5
Net international investment position 5/	-16.4	-12.8	-22.8	-16.3	-15.5	-24.7	-24.6
Of which: General government debt 6/	20.4	22.7	28.8	31.3	35.1	37.8	39.2
External debt-to-exports ratio	1.5	1.1	1.8	1.4	1.2	1.8	1.8
External interest payments to imports 3/ 7/	32.5	35.8	28.3	23.1	18.1	16.4	16.3
Nominal effective exchange rate 1/	-1.7	-4.9	-3.9	5.5	-3.3	-4.9	3.3
Real effective exchange rate 1/	-0.6	-4.7	-3.9	4.5	-3.9	-4.9	3.0
Financial market indicators	(In percent of GDP, unless otherwise indicated)						
General government gross debt	66.1	66.5	75.5	89.1	98.2	102.4	106.4
Average maturity of privately-held federal debt (months)	58.0	57.0	46.0	52.0	57.0	59.0	54.0
Federal privately-held debt maturing within one year	8.5	9.2	16.8	17.3	17.6	17.5	18.7
Three-month treasury bill yield 3/	4.8	4.5	1.4	0.2	0.1	0.1	0.1
Real three-month treasury bill yield 3/	-0.1	1.6	1.6	-2.3	0.5	-1.5	-2.0
Equity market index (S&P 500) 1/	8.6	12.7	-17.3	-22.5	20.3	11.4	8.7
Banking risk indicators 8/	(in percent, unless otherwise indicated)						
Total assets 2/	11,862	13,034	13,841	13,087	13,319	13,883	14,451
Total loans and leases to assets	61	61	57	56	55	54	53
Total loans to deposits	92	94	87	79	78	73	71
Problem loans to total loans and leases 9/	0.8	1.4	3.0	5.4	4.9	4.1	3.6
Nonperforming assets to assets 10/	0.5	0.9	1.8	3.4	3.1	2.5	2.5
Loss allowance to:							
Total loans and leases	1.1	1.3	2.2	3.1	3.1	2.6	2.1
Noncurrent loans and leases	134.8	91.7	74.4	57.7	64.5	62.5	58.5
Return on equity 11/	17.2	11.2	-1.6	-0.5	8.1	10.8	12.3
Return on assets 11/	1.8	1.2	-0.1	-0.1	0.9	1.2	1.4
Total capital to risk-weighted assets	13.0	12.8	12.8	14.3	15.3	15.3	15.1
Core capital ratio	8.2	8.0	7.5	8.6	8.9	9.1	9.1

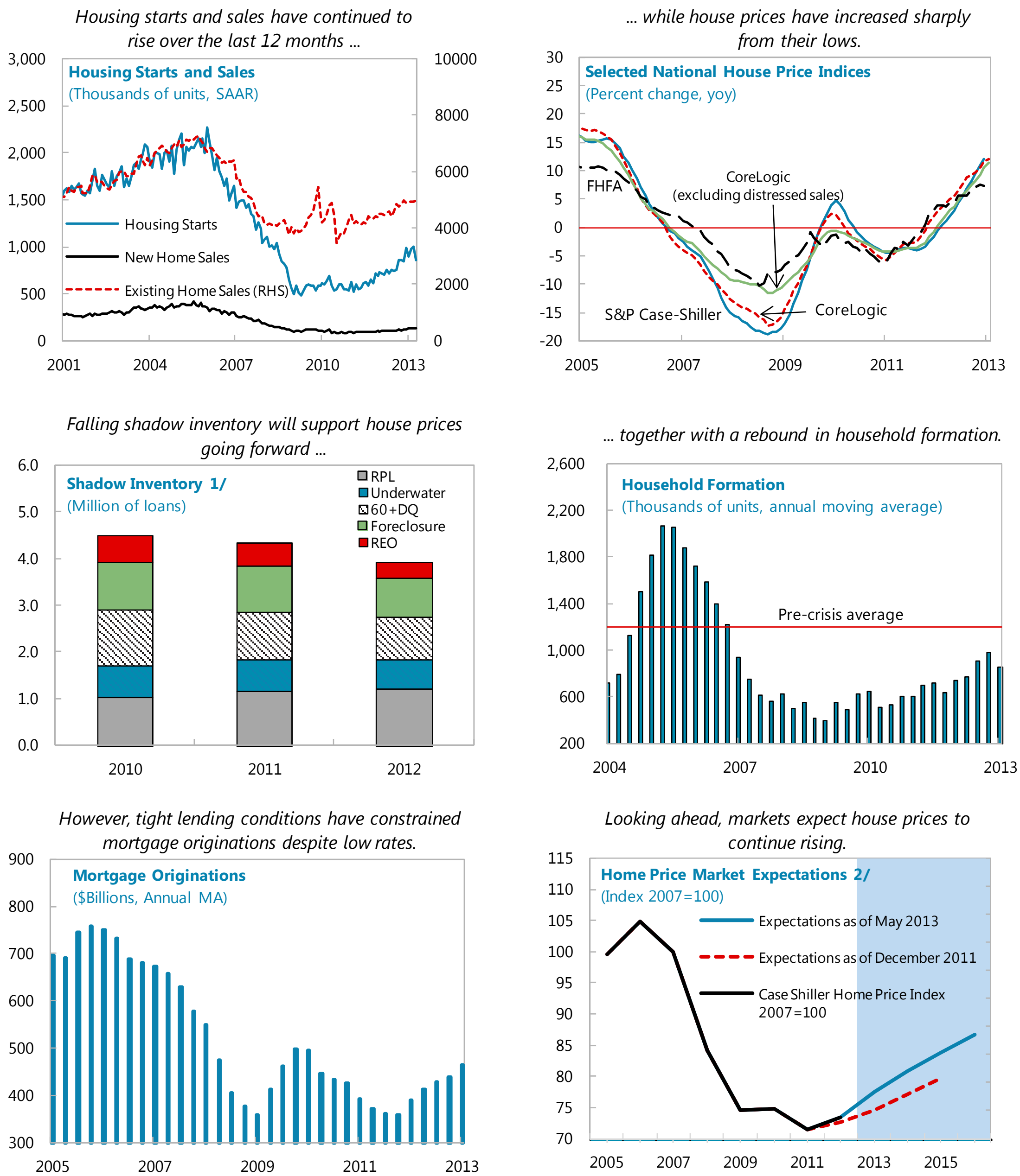
Sources: IMF, *International Financial Statistics*; Federal Deposit Insurance Corporation; and Haver Analytics.
1/ Percent change.
2/ Billions of U.S. dollars.
3/ Percent.
4/ Includes net financial derivatives.
5/ With FDI at market value.
6/ Excludes foreign private holdings of U.S. government securities other than treasuries.
7/ External interest payments: income payments on foreign-owned assets (other private assets plus U.S. government payments).
8/ All FDIC-insured institutions.
9/ Noncurrent loans and leases.
10/ FDIC-insured commercial banks only.
11/ Before extraordinary items and taxes.

Figure 1. Growth and Inflation



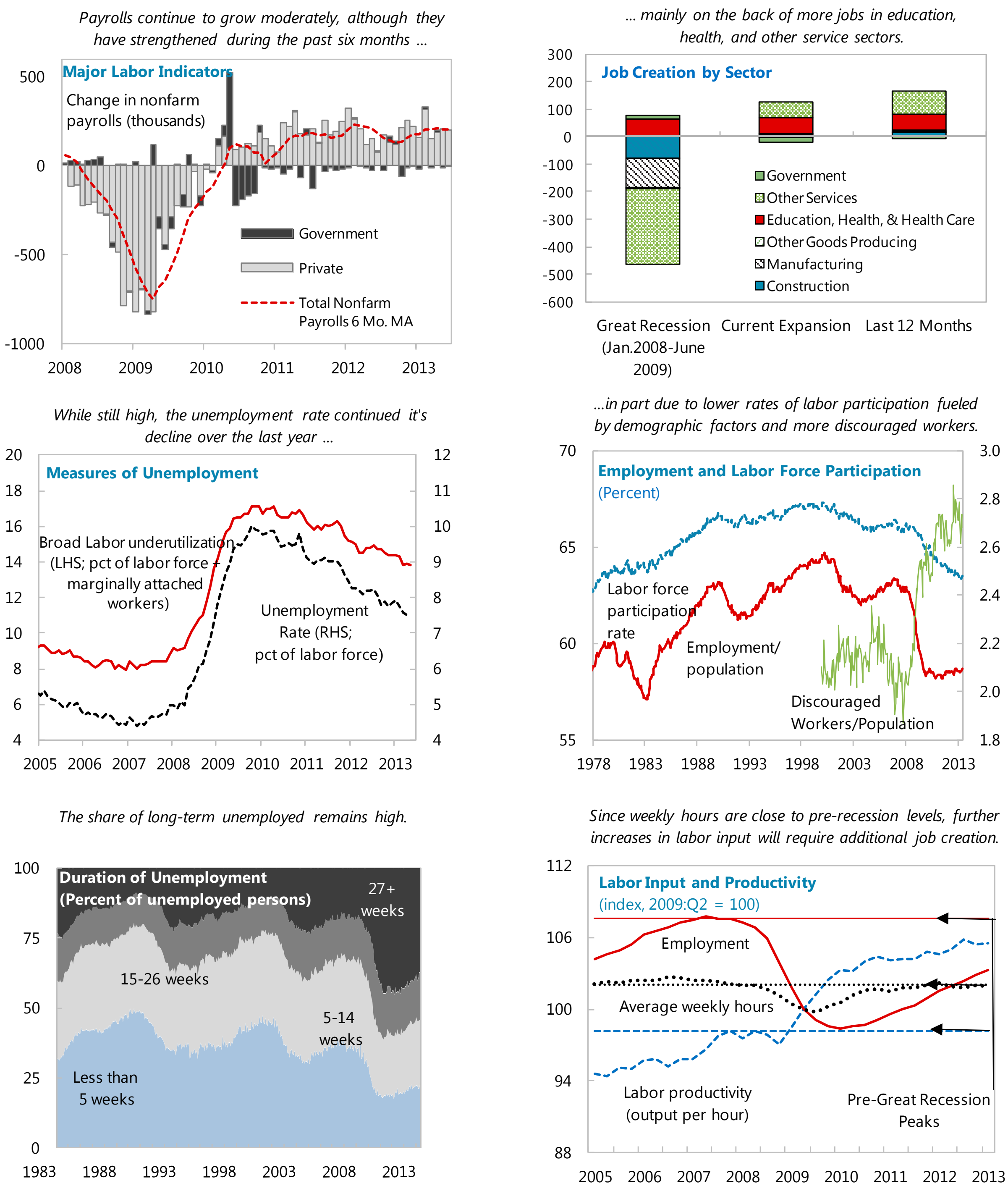
Source: Sources: BEA; Federal Reserve; BLS; Haver Analytics; and IMF staff estimates.

Figure 2. Housing Sector



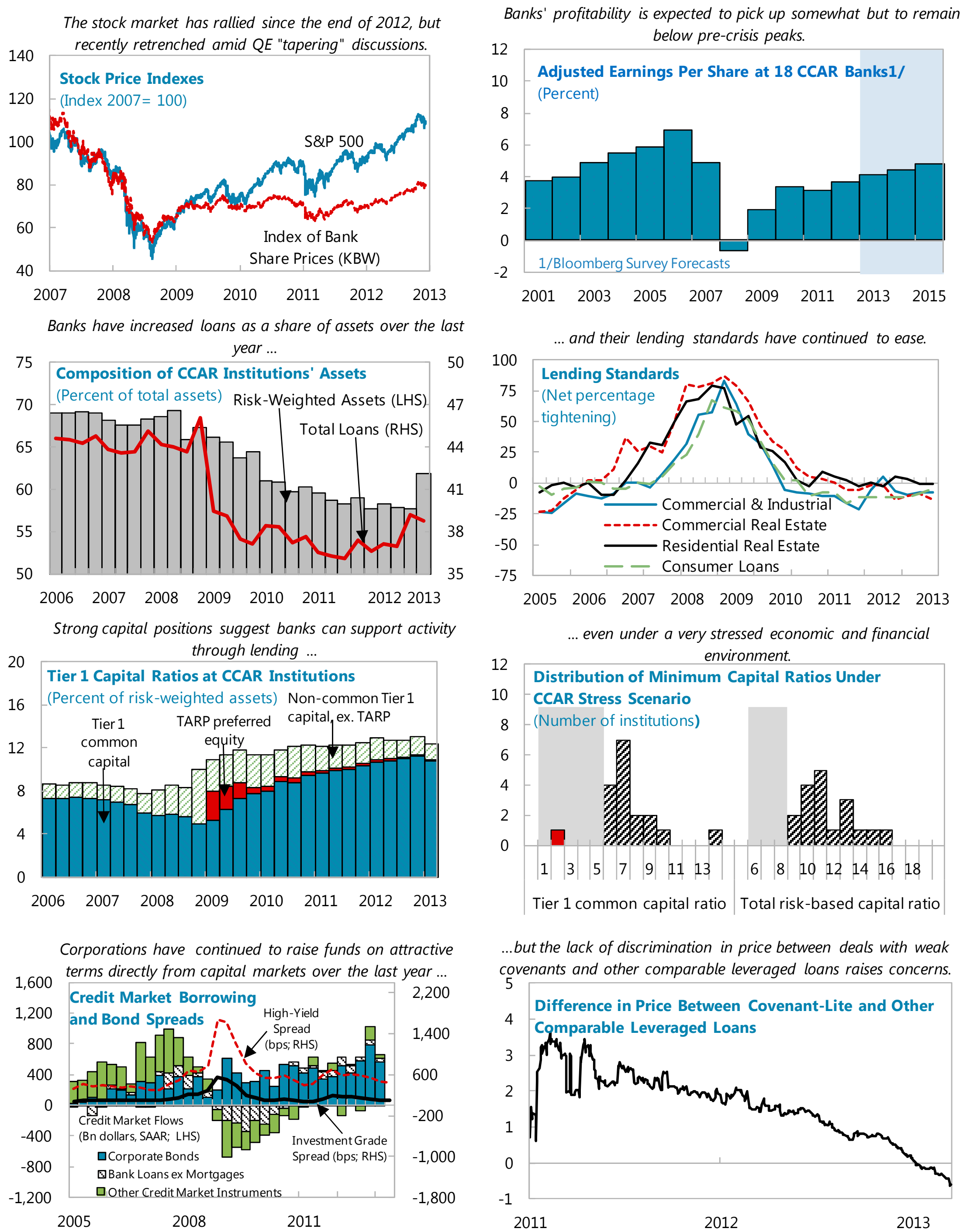
Sources: Amherst Securities, Corelogic, Mortgage Bankers Association, Pulsenomics, Haver Analytics, and IMF staff estimates.
1/ Staff estimate of pending supply of housing units. "Re-Performing Loans" (RPL) represents a share of performing loans previously in default, "Real Estate Owned" (REO) properties that are owned by lenders, "Foreclosure" properties that are in the process of foreclosure, "Delinquent" (60+ DQ) a share of properties that have mortgage payments more than 60 days overdue, and "Underwater" a share of properties that are underwater and likely to be put on the market, but currently not in default (RPL or delinquent)—these are estimated to represent less than 10 percent of total underwater loans.
2/ Zillow Home Price Expectations Survey.

Figure 3. Labor Market



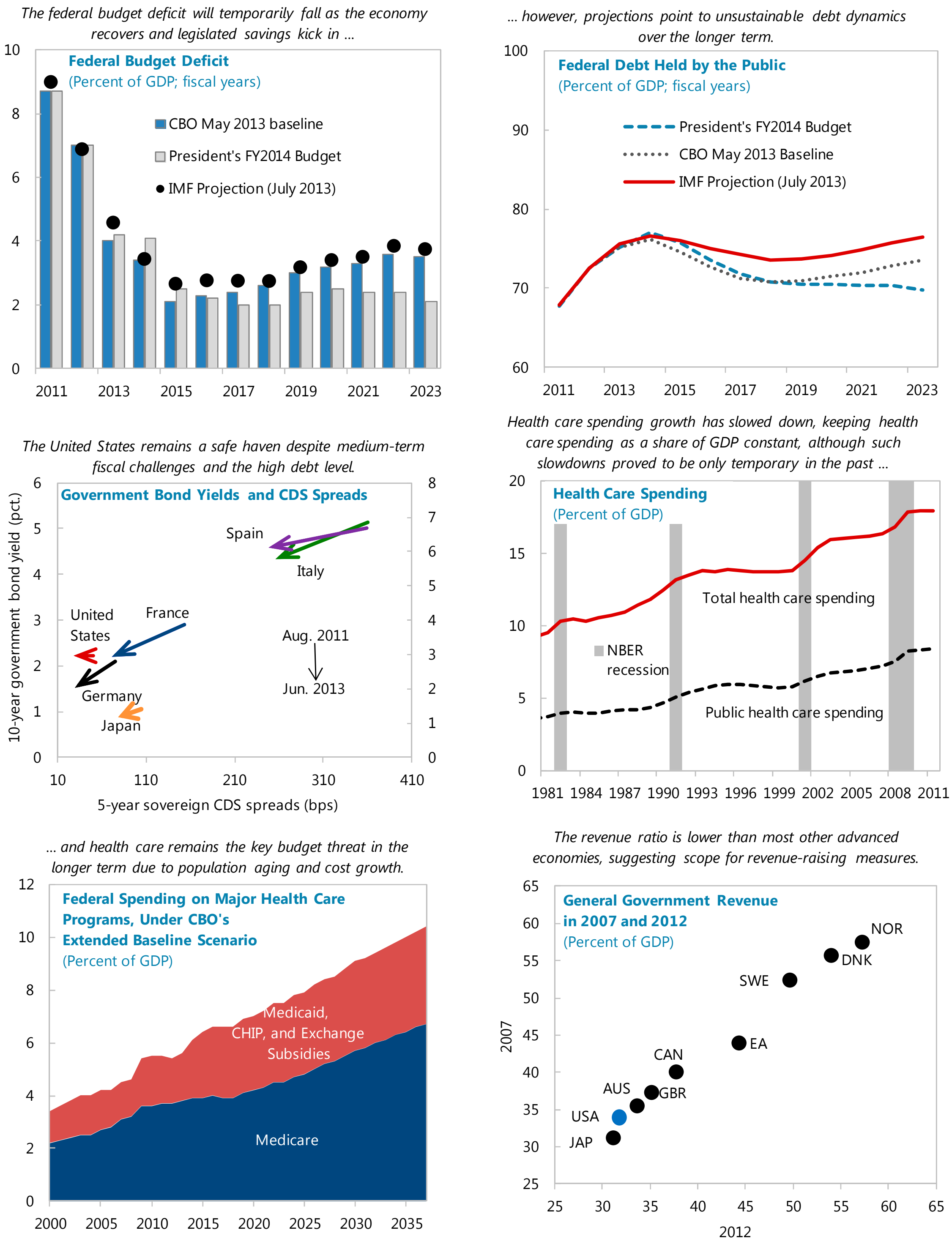
Sources: Bureau of Labor Statistics; The Conference Board; Bloomberg, L.P.; Haver Analytics; and IMF staff estimates.

Figure 4. Financial Sector



Sources: Board of Governors of the Federal Reserve System; Bloomberg, L.P.; SNL Financial; Haver Analytics; Thomson Reuters LPC; and IMF staff estimates.

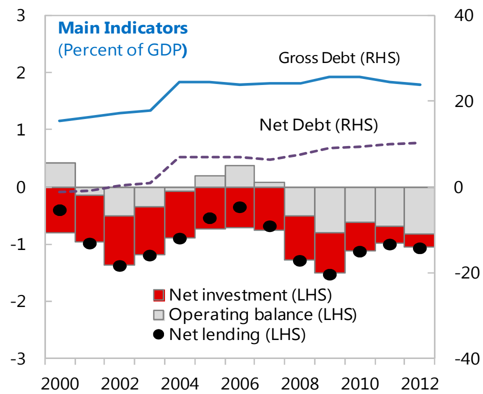
Figure 5. Public Finances



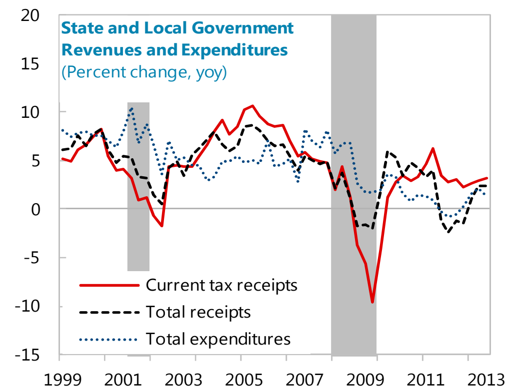
Sources: Congressional Budget Office; Markit; Office of Management and Budget; Bureau of Economic Analysis; Centers for Medicare and Medicaid Services; Haver Analytics; and IMF staff estimates.

Figure 6. State and Local Governments

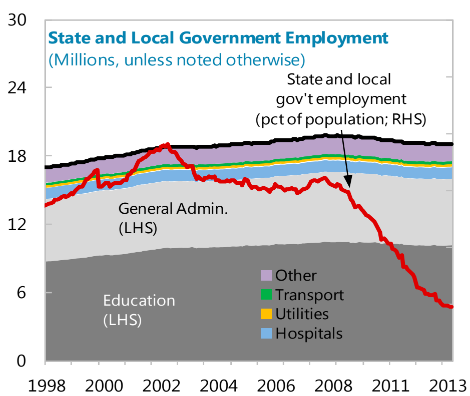
State and local governments (SLGs) operate under balanced budget requirements, which limited debt accumulation during the Great Recession.



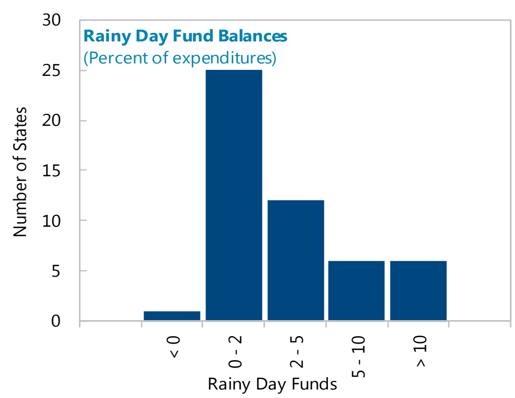
With the economy gradually recovering and asset prices rising, the SLGs have enjoyed strong revenues …



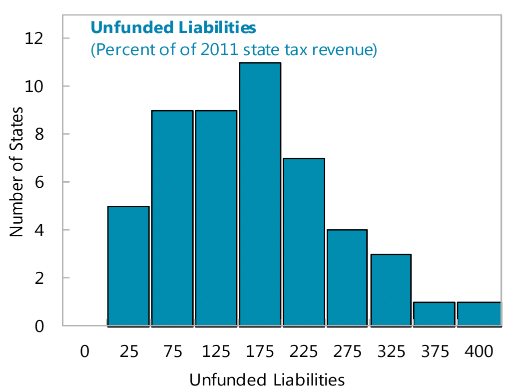
… but continue to downsize their activities, including in education and other social services.



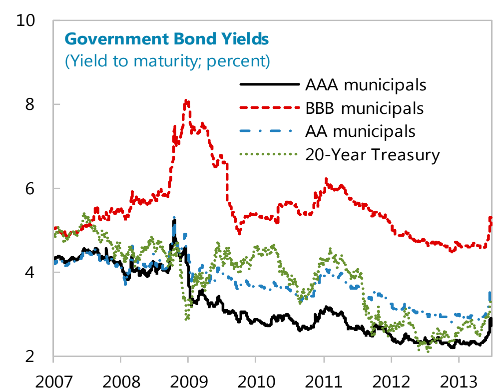
SLG should aim to replenish the "rainy-day" funds depleted during the Great Recession to reduce vulnerability to revenue shortfalls.



Underfunded retirement and health care plans pose medium-term fiscal challenges …



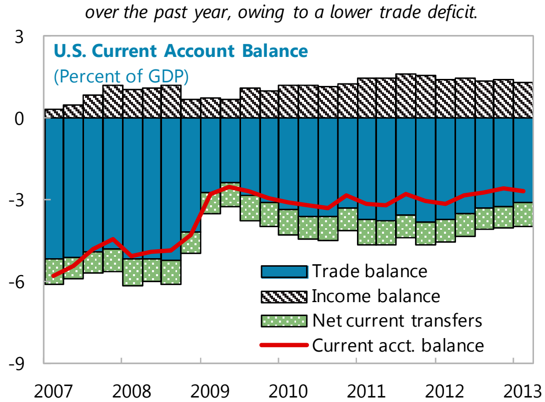
… as reflected in the spreads differences between lower-and higher-quality issuers.



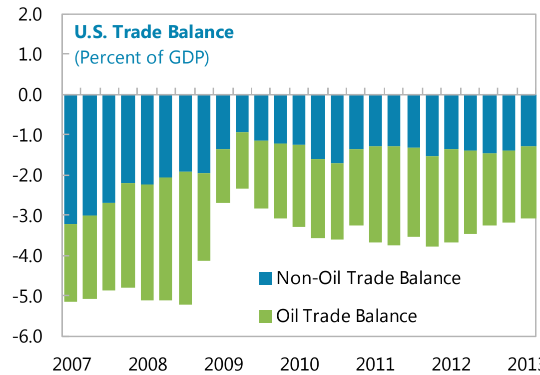
Sources: Bureau of Economic Analysis; Bureau of Labor Statistics; Office of Management and Budget; Markit; Bank of America/Merrill Lynch; Board of Governors of the Federal Reserve System; Haver Analytics; and IMF staff calculations.

Figure 7. The Dollar, Financial Flows, and Trade

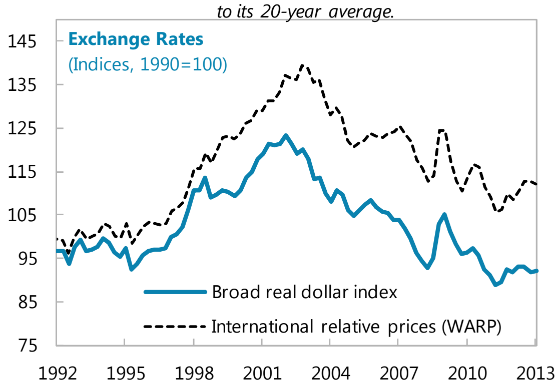
The U.S. current account balance narrowed sligthly over the past year, owing to a lower trade deficit.



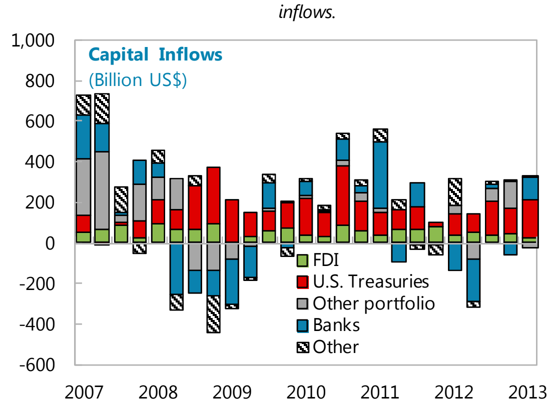
The decline in the goods and services trade balance mainly reflects a lower oil balance.



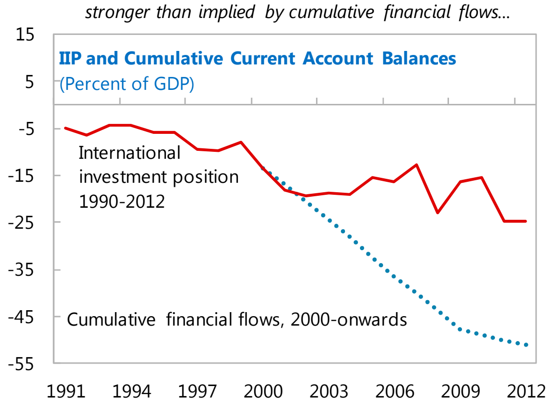
The REER has been close to its 20-year low while the level of U.S. prices relative to main trading partners has been close to its 20-year average.



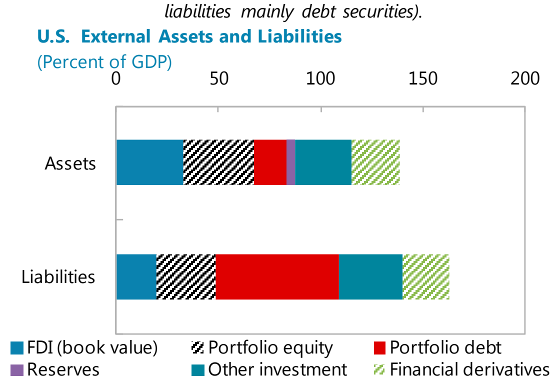
Foreign purchases on U.S. treasuries dominates capital inflows.



The U.S. international investment position is much stronger than implied by cumulative financial flows...



... partly reflecting the composition of U.S. external portfolio (with foreign assets dominated by FDI and equities, and foreign liabilities mainly debt securities).



Sources: : Board of Governors of the Federal Reserve System; United States Department of the Treasury; Bureau of Economic Analysis; and IMF staff estimates.

Annex I. Risk Assessment Matrix

	Nature/Source of Risk	Overall Level of Concern	
		Likelihood of Realization (High, Medium, or Low)	Expected Impact if Risk is Materialized (High, Medium, or Low)
Short-Term Risks	**1. Financial stress in the euro area re-emerges**	**Medium** Renewed financial stress and reintensification of bank-sovereign links in the Euro area.	**Medium** Increased financial stress would shave 0.75 percent from output in the first year.
	2. Housing market recovery	**Medium** Housing recovery unleashes a virtuous cycle of higher spending, wealth, and easier credit conditions, helping to release pent-up demand.	**Medium** A 5 percent increase in (nominal) house prices relative to baseline would add 0.5–0.6 percent to output after two years. A 5 pps increase in housing starts would add 0.3 percent to output over two years.
	3. Distortions from unconventional monetary policy (side effects from exit modalities)	**High** Interest rates could increase more rapidly than in our baseline scenario because of greater concerns on financial stability from the low rates environment, markets over-reaction to initial steps to unwind monetary policy accommodation, or an inflation scare (though this is more a medium term risk).	**Medium** The impact of a spike in long term rates would depend on its size and persistence. A temporary (gradually dissipating after 2 years) increase of 50 bps in 10-year rates could subtract about 0.25 percent from output after 2 years. A permanent shock would subtract about 0.5 percent.
	4. Failure to raise the debt ceiling	**Low** The federal borrowing limit is not raised due to the political gridlock in Congress.	**High** The economic costs would be potentially catastrophic depending on how long the impasse lasts; spillovers to the rest of the world would be severe.
Medium-Term Risks	**5. Protracted period of slower European growth**	**High** Growth in the Euro Area could be durably lower due to larger-than-expected deleveraging or negative surprise on potential growth.	**Low** Low growth in the Euro Area would reduce U.S. output by 0.2 percent after two years.
	6. U.S. bond market stress	**Low** Policymakers do not take sufficient measures to put the long-term debt path on a sustainable trajectory and the lack of fiscal sustainability triggers a sharp rise in sovereign risk premium.	**High** The impact on the U.S. and the world would be significant. A 200bps increase in the benchmark Treasury yields in 2015 would subtract 2.5 pps and 1.5 pps from U.S. growth in 2015 and 2016, respectively.

Annex II. Public Sector Debt Sustainability Analysis (DSA)

1. **Since 2011, Congress has legislated about $2.8 trillion in medium-term fiscal consolidation measures**.

   a. The Budget Control Act enacted in August 2011 capped discretionary spending, saving about $900 billion over 10 years relative to the CBO baseline.

   b. Additional savings worth $1.2 trillion over 10 years were triggered by the failure of the Congressional Committee on Deficit Reduction in November 2011. These cuts took effect in March 2013 through cancellation of budget authority ("sequestration") in FY2013 and they will be executed through caps on appropriation levels in FY2014–21.

   c. The American Taxpayer Relief Act signed into law in January 2013 increased the top ordinary income tax rate the tax rate on capital gains and dividends, phased out personal exemptions, and limited itemized deductions for upper-income taxpayers, raising $700 billion over 10 years relative to the CBO alternative baseline.

2. **Despite the substantial legislated savings in the pipeline, U.S. public finances remain on an unsustainable trajectory**. Under staff's baseline projection which, in addition to these budgetary savings, includes the savings from the drawdown of overseas contingency operations and removal of emergency funding for disaster relief, the public debt ratio is put on a downward path after 2014. However, the debt ratio starts rising again at the end of the decade due to spending pressures from an aging population and excess cost growth in the health care sector (even after taking into account the recent cost slowdown). Federal debt held by the public is projected to increase from 73 percent of GDP at end-FY2012 to 77 percent of GDP in FY2023, with general government gross debt at 109 percent of GDP in CY2022.

3. **The fiscal projections are being substantially improved by a favorable interest rate-growth differential**. Reflecting highly accommodative monetary policy and the safe haven status of the United States, real interest rates have fallen well below GDP growth. As a result, the debt-stabilizing primary balance is currently negative (Annex Table) and will remain so over the standard 5-year DSA horizon despite the staff's projection for a substantial increase in Treasury yields over the medium term. In staff's view, however, aiming for a medium-term primary surplus of about 1 percent of GDP would be appropriate to put the public debt ratio firmly on a downward path. As discussed in the April 2013 *Fiscal Monitor*, the targeted primary

surplus would need to be even higher in the long run to bring the debt ratio closer to the pre-crisis levels by 2030.

4. **The public debt dynamics are highly sensitive to growth and interest rate assumptions**. The analysis in Annex Figure suggests that the public debt dynamics are highly sensitive to growth and interest rate assumptions, primarily reflecting the fact that the general government debt ratio already exceeds 100 percent of GDP.

Annex Table. United States: Public Sector Debt Sustainability Framework, 2008–18

(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Debt-stabilizing primary balance 9/
Baseline: Public sector debt 1/	**75.5**	**89.1**	**98.2**	**102.4**	**106.4**	**109.0**	**109.9**	**109.1**	**108.1**	**107.2**	**106.6**	**-1.3**
Of which: 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	
Change in public sector debt	9.1	13.5	9.1	4.2	4.0	2.6	0.9	-0.8	-1.0	-0.9	-0.6	
Identified debt-creating flows (4+7+12)	5.5	15.1	7.9	6.3	4.5	2.7	0.3	-1.5	-1.7	-1.6	-1.1	
Primary deficit (includes interest receipts)	4.0	10.9	8.6	7.2	5.8	3.1	1.9	1.2	0.9	0.5	0.2	
Revenue and grants including interest receipts	32.5	30.8	31.2	31.4	31.6	33.6	34.2	34.9	34.8	34.5	34.5	
Primary (noninterest) expenditure	36.5	41.7	39.8	38.6	37.5	36.7	36.1	36.0	35.8	35.0	34.7	
Automatic debt dynamics 2/	1.5	4.2	-0.6	-1.0	-1.3	-0.4	-1.6	-2.7	-2.7	-2.1	-1.3	
Contribution from interest rate/growth differential 3/	1.5	4.2	-0.6	-1.0	-1.3	-0.4	-1.6	-2.7	-2.7	-2.1	-1.3	
Of which: contribution from real interest rate	1.3	1.8	1.4	0.7	0.9	1.3	1.2	1.0	1.0	1.4	1.7	
Contribution from real GDP growth	0.2	2.4	-2.1	-1.7	-2.2	-1.8	-2.9	-3.6	-3.7	-3.5	-3.0	
Contribution from exchange rate depreciation 4/	0.0	0.0	0.0	0.0	0.0	...	...	...	...	...	...	
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	
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	
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	
Federal student loans, incurrence of other gross liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes (2-3) 5/	3.6	-1.5	1.2	-2.0	-0.6	-0.1	0.6	0.7	0.7	0.7	0.5	
Public sector debt-to-revenue ratio 1/	232.4	288.9	314.4	326.2	336.3	324.0	321.2	312.7	310.4	310.8	309.3	
Scenario with key variables at their historical averages 7/						**109.0**	**113.5**	**118.1**	**122.7**	**127.3**	**131.7**	**-0.2**
Scenario with no policy change (constant primary balance) in 2013–2018 8/						**109.0**	**111.0**	**112.2**	**113.2**	**114.8**	**117.0**	**-1.5**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	-0.3	-3.1	2.4	1.8	2.2	1.7	2.7	3.5	3.6	3.4	3.0	
Average nominal interest rate on public debt (in percent) 9/	4.2	3.2	3.0	3.0	2.7	2.8	2.8	2.9	3.1	3.5	3.9	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	2.0	2.3	1.7	0.8	0.9	1.3	1.2	1.0	1.1	1.4	1.7	
Nominal appreciation (increase in US dollar value of local currency, in percent)	0.0	0.0	0.0	0.0	0.0	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	2.2	0.9	1.3	2.1	1.8	1.5	1.6	1.9	2.1	2.1	2.2	
Growth of real primary spending (deflated by GDP deflator, in percent)	7.5	10.8	-2.3	-1.1	-0.9	-0.3	1.1	3.2	2.8	1.2	1.9	
Primary deficit	4.0	10.9	8.6	7.2	5.8	3.1	1.9	1.2	0.9	0.5	0.2	

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 - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = 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 - π (1+g) and the real growth contribution as -g.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).

5/ For projections, this line includes exchange rate changes.

6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

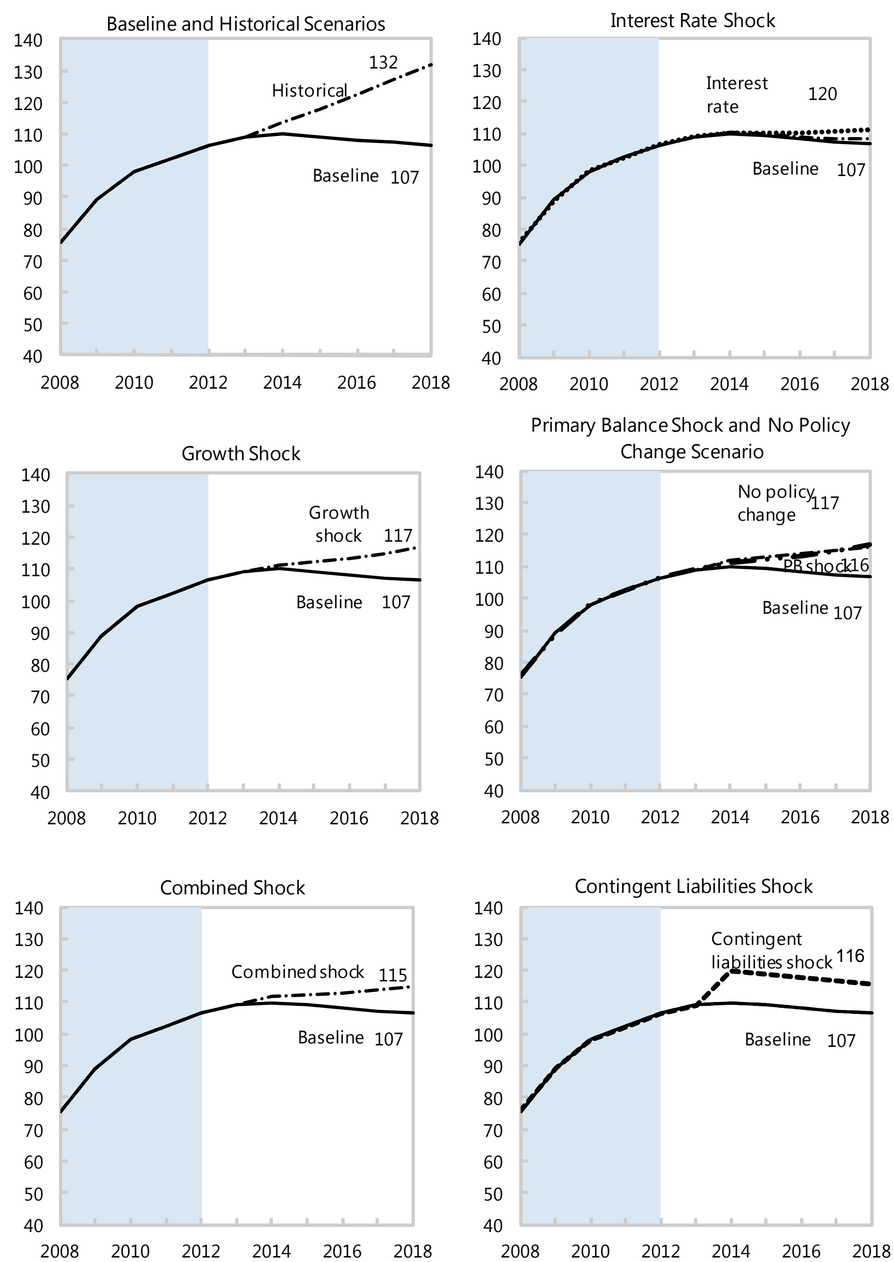
7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

8/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

9/ Derived as nominal interest expenditure divided by previous period debt stock.

Annex Figure. Public Debt Sustainability: Bound Tests 1/ 2/

(Public debt in percent of GDP)



Sources: International Monetary Fund, country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. For interest rates, an additional scenario with a 2 standard deviation shock is also considered. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
4/ A standard 10 percent of GDP shock to contingent liabilities is assumed to occur in 2013.

INTERNATIONAL MONETARY FUND

UNITED STATES

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

July 9, 2013

Prepared By The Western Hemisphere Department

CONTENTS

FUND RELATIONS(AS OF MAY 31, 2013)

Membership Status: Joined 12/27/45; Article VIII

General Resources Account:	**SDR Million**	**Percent Quota**
Quota 42,122.40	100.00	
Fund holdings of currency	28,794.68	68.36
Reserve position in Fund	13,326.97	31.64
Lending to the Fund		
New Arrangements to Borrow	8,524.09	

SDR Department:	**SDR Million**	**Percent Allocation**
Net cumulative allocation	35,315.68	100.00
Holdings	35,826.28	101.45

Outstanding Purchases and Loans: None

Financial Arrangements: None

Projected Payments to the Fund:

(SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2013	2014	2015	2016	2017
Principal					
Charges/Interest		0.20	0.20	0.20	0.20
Total		0.20	0.20	0.20	0.20

Exchange Rate Arrangements: The exchange rate of the U.S. dollar floats independently and is determined freely in the foreign exchange market.

Payments Restrictions. The United States accepted Article VIII of the IMF's Articles of Agreement and maintains an exchange system free of restrictions and multiple currency practices with the exception of limited restrictions on certain payments and transfers imposed for security reasons. The United States currently administers approximately 30 economic sanctions programs, which restrict certain payments and transfers for transactions against particular foreign governments, entities, and individuals. The United States administers sanctions programs relating to, inter alia, Burma, Cuba, Iran, North Korea, and Sudan. Several other sanctions programs, including those relating to Côte d'Ivoire, Liberia, Somalia, Syria, Western Balkans, and Zimbabwe are "list-based" programs, affecting only members of certain government regimes and other individuals and entities whose activities have been determined to threaten the national security, foreign policy, or economy of the United States. The United States also implements similar list-based sanctions programs against: narcotics traffickers; terrorism-related governments, entities, and individuals; and proliferators of weapons of mass destruction.

Article IV Consultation. The 2012 Article IV consultation was concluded in July 2012 and the Staff Report was published as IMF Country Report No. 12/213. A fiscal ROSC was completed in the context of the 2003 consultation. An FSAP involved two missions, during October 14–November 3, 2009 and February 17–March 12, 2010. The FSSA was discussed at the board, together with the 2010 Article IV Consultation, on July 26, 2010.

The 2013 Article IV discussions were conducted from May 6–May 17, 2013. Concluding meetings with Chairman Bernanke of the Board of Governors of the Federal Reserve System, and Treasury Secretary Lew occurred on May 31st and June 12th, respectively. The Managing Director, Ms. Lagarde, and WHD Director, Mr. Werner, participated in the concluding meetings. A press conference on the consultation was held on June 14th, 2013. The team comprised Gian Maria Milesi-Ferretti (head), Roberto Cardarelli, Martin Sommer, Francesco Columba, Gabriel Di Bella, Madelyn Estrada, Deniz Igan, and Jarkko Turunen (all WHD); Chris Papageorgiou (SPR); Rebecca McCaughrin (MCM); and, Tao Wu (ICD), with contributions from Steve Dawe and Emmanuel Mathias (LEG); Marshall Mills, Katrin Elborgh-Woytek, Lars Engstrom, and Michele Ruta (SPR). Ms. Lundsager (Executive Director) and Mr. Weiss (Advisor) attended some of the meetings. Outreach included discussions with Congressional staff and think tanks. Unless an objection from the authorities of the United States is received prior to the conclusion of the Board's consideration, the document will be published.

STATISTICAL ISSUES

Statistical Issues: Comprehensive economic data are available for the United States on a timely basis. The quality, coverage, periodicity, and timeliness of U.S. economic data are adequate for surveillance. Coverage of international capital flows in external sector statistics has been improved, with the June 2007 releases of BOP and IIP data on financial derivatives. 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: Table of Common Indicators Required for Surveillance

(As of June 27, 2013)

	Date of latest observation	Date received	Frequency of data[1]	Frequency of reporting[1]	Frequency of publication[1]
Exchange rates	June 21	June 24	D	W	W
International reserve assets and reserve liabilities of the monetary authorities[2]	June 26	June 27	W	W	W
Reserve/base money	June 26	June 27	B	W	W
Broad money	June 13	June 21	W	W	W
Central bank balance sheet	June 26	June 27	W	W	W
Interest rates[3]	same day	same day	D	D	D
Consumer price index	May 2013	June 18	M	M	M
Revenue, expenditure, balance and composition of financing[4]—general government[5]	2013 Q1	May 31	Q	Q	Q
Revenue, expenditure, balance and composition of financing[4]—central government	May 2013	June 12	M	M	M
Stocks of central government and central government-guaranteed debt	May 2013	June 6	M	M	M
External current account balance	2013 Q1	June 14	Q	Q	Q
Exports and imports of goods and services	Apr. 2013	June 4	M	M	M
GDP/GNP (3rd release)	2013 Q1	June 26	Q	M	M
Gross External Debt	2012 Q4	March 29	Q	Q	Q
International Investment Position[6]	2012	June 25	A	A	A

1 Daily (D), Weekly (W), Biweekly (B), Monthly (M), Quarterly (Q), Annually (A); NA: Not Available.

2 Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

3 Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

4 Foreign, domestic bank, and domestic nonbank financing.

5 The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

6 Includes external gross financial asset and liability positions vis-à-vis nonresidents.

Statement by the IMF Staff Representative on the United States

July 24, 2013

1. **This note reports on information that has become available since the staff report (SM/13/197) was issued and does not alter the thrust of the staff appraisal.**

2. **Recent indicators point to a sharper than expected slowdown in economic activity in the second quarter**. This reflects weakness in inventory accumulation and net exports as well as slower private consumption growth, as suggested by retail sales in June. On a positive note, recent housing indicators (such as the homebuilders' survey) remain relatively upbeat, despite the recent rise in mortgage rates, which has slowed refinancing activity. Headline inflation picked up to 1.8 percent (y/y) in June, mainly due to an increase in gasoline prices, while core inflation inched down to 1.6 percent.

3. **U.S. and global financial markets have somewhat stabilized after the correction in June**. In the United States, financial conditions have improved since early July, with slightly lower long-term Treasury yields and mortgage rates, narrower risk spreads, higher stock prices, a weaker dollar against most major currencies, and lower volatility. However, trading liquidity remains low across a number of markets and outflows from long-term U.S. and emerging market bond funds have continued, albeit at a slower pace. Global equity markets have partly recovered the losses experienced since late May (on July 18, the MSCI for emerging markets was still about 10 percent down relative to May), while emerging market domestic government bond yields and external bond spreads have declined from their peak in June. Second-quarter earnings for major U.S. financial institutions were mostly above expectations, mainly driven by higher trading and investment banking revenues. In his testimony to the House of Representatives on July 17, Chairman Bernanke appropriately reiterated that the pace of asset purchases depends on the performance of the economy, and that the current pace could be maintained for longer if financial conditions were judged to be insufficiently accommodative.

4. **The Mid-Session Review (MSR) released by the Office of Budget and Management (OMB) on July 8 confirms the progress in deficit reduction**. OMB's projection of the federal deficit for FY2013 is now 4.7 percent of GDP, well below the projection in the President's Budget (6 percent), reflecting stronger-than-expected revenues, a one-off payment from Fannie Mae and Freddie Mac,[1] and the fact that the sequester is now assumed to remain in place through FY2013. Growth projections were revised down (and are

[1] The two companies had written down the value of deferred tax assets during the crisis, given the bleak outlook for the housing market. In May 2013, they decided to reverse the write-downs as they returned to profitability. This boosted the net worth of the companies and increased the dividends payable to the Treasury under the bailout agreement. These payments (of about $85 billion) are included in the budget on a cash basis, but are not included in staff's estimates of the fiscal deficit which are on an accrual basis, in line with GFSM 2001.

now closer to staff projections), and this slightly increases the projected deficits in the outer years.

5. **More progress was achieved on the financial reform agenda**. On July 8 the Financial Stability Oversight Council (FSOC) designated two non-bank financial institutions, American International Group (AIG), and GE Capital, as systemically important. Prudential Financial has appealed the proposed designation by the FSOC. Markets' reaction to the designations has been fairly muted, with shares of the designated firms generally rising in line with the broader equity market. On July 9, The Federal Reserve Board, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency issued a notice of proposed rulemaking that would introduce an enhanced supplementary leverage ratio of 6 percent for the largest 8 U.S. banks. On July 11, the Commodity Futures Trading Commission and European Union regulators announced an agreement on derivative regulations which seeks to harmonize cross-border rules, by allowing swap market dealers and participants to be subject only to the relevant rules of domestic authorities.

6. **The Bureau of Economic Analysis (BEA) is scheduled to release a comprehensive revision to the national income and product accounts on July 31st**, together with the first estimate of GDP growth in the second quarter of 2013.

INTERNATIONAL MONETARY FUND
COM
COMMUNICATIONS DEPARTMENT

Press Release No. 13/277
FOR IMMEDIATE RELEASE
July 26, 2013

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Concludes 2013 Article IV Consultation with the United States

On July, 24, 2013, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the United States.[1]

The U.S. recovery has remained tepid, with GDP growing at a modest 2.2 percent in 2012, reflected legacy effects from the financial crisis, budget deficit reduction, a weak external environment, and temporary effects of extreme weather-related events.
While policymakers in Congress averted the fiscal cliff at the beginning of 2013, the expiration of the payroll tax cut and implementation of across-the-board spending cuts ("sequester") are weighing significantly on growth this year, with growth in the first quarter of 2013 at 1.8 percent and indicators suggesting slower growth in the second quarter.

Despite these powerful headwinds, the nature of the recovery appears to be changing. In particular, equity valuations have soared in 2013 and house prices have increased by more than 10 percent over the last 12 months, strengthening household balance sheets and supporting private demand. At the same time, residential construction has accelerated and labor market conditions have improved. To a large extent this owes to very easy financial conditions, with the Fed continuing to add monetary policy accommodation over the past year. Financial conditions have somewhat tightened since mid-May 2013, after the Fed indicated that its asset purchases could be scaled back later in the year, but still remain extremely accommodative. While the rapid pace of fiscal consolidation is expected to keep growth subdued at 1.7 percent in 2013, we expect economic activity to accelerate to 2.7 percent next year as the fiscal drag subsides and the negative legacies of the financial crisis wane further. The unemployment rate is expected to remain broadly stable in 2013, reflecting the pickup in the labor force participation as discouraged workers return to the labor force, and to gradually fall in 2014. Inflation is expected to pick up somewhat but to

[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. An explanation of any qualifiers used in summing ups can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

remain below the Fed long-run objective of 2 percent, given the lingering slack in the economy.

The risks to the outlook appear modestly tilted to the downside. Economic activity could be lower than in our baseline scenario in the presence of a stronger-than-projected impact of fiscal consolidation, a faster-than-expected increase in interest rates, a weaker external environment, or higher structural unemployment. In contrast, the recovery could be stronger than we anticipate if the rebound of the housing market were to ignite a positive feedback loop between higher house prices, easier mortgage conditions, and stronger consumption and investment.

With regard to policy actions, the Federal Reserve has appropriately indicated that it intends to maintain a high degree of monetary policy accommodation for a considerable time after the economy strengthens, and that the pace and composition of its asset purchases will depend on the evolution of economic conditions. The administration's budget proposal envisages a gradual reduction in the budget deficit so as to put the public debt ratio on a downward path, although political gridlock in Congress makes prospects for legislative action unclear. U.S. banks' health has improved significantly over the past 12 months, but there are a few signs of emerging vulnerabilities in the financial sector from persistently low interest rates. Further progress was made on strengthening financial regulation, including introducing rules that adopt Basel III capital standards, designating two systemically-important nonbank financial institutions, and proposing a reform of the money market mutual funds industry.

Executive Board Assessment

Executive Directors welcomed the improvement in the underlying conditions of the U.S. economy, which bodes well for a gradual acceleration of growth, while noting that the balance of risks to the outlook remains tilted to the downside.

Directors generally concurred that the fiscal deficit reduction in 2013 is excessively rapid, and that the automatic spending cuts ("the sequester") not only reduce growth in the short term but could also lower medium-term potential growth. They stressed the importance of adopting a comprehensive and back-loaded medium-term plan entailing lower growth in entitlement spending and higher revenues. Together with a slower pace of deficit reduction in the short run, this fiscal strategy would help sustain global growth, place the U.S. fiscal position on a sustainable path over the medium term, and support the reduction of global imbalances. In this context, a few Directors also expressed concerns regarding the budgetary process and saw room for improvement.

Directors broadly agreed that accommodative monetary policy continues to provide essential support to the recovery, but cautioned that its financial stability implications should be carefully assessed. They considered that a long period of exceptionally low interest rates could potentially entail unintended consequences for domestic financial stability and has complicated the macro-policy environment in some emerging markets. In this context, Directors stressed that strong macro-prudential oversight and supervision of the financial system remain essential.

Directors noted that the Federal Reserve has a range of tools to manage the normalization of monetary policy, but that there are significant challenges involved in unwinding accommodation, including risks of market reactions leading to excessive interest rate volatility that could have adverse global implications. They stressed that effective communication on the exit strategy and a careful calibration of its timing will be critical for reducing these risks.

Directors welcomed the recent improvements in the housing and labor markets. They agreed that the rebound of the housing market has benefited from monetary policy actions and government-backed programs that facilitated refinancing and modification of loans under stress. They saw room for policies that continue to support the housing market while gradually reducing the dominant role of the government-sponsored enterprises. Directors also agreed that the decline in labor force participation and high levels of long-term unemployment suggest room for active labor market policies to complement efforts to boost domestic demand.

Directors noted that while the U.S. banking system is healthier than last year, emerging vulnerabilities and risks from persistently low rates in the financial sector need to be carefully monitored. Directors welcomed the strengthening of the regulatory architecture relative to the pre-crisis period, including through the adoption of Basel III capital rules. They emphasized that completing the implementation of the financial reform agenda remains essential to increase the resilience of the U.S. financial system, while at the same time reducing the risk of regulatory fragmentation at the international level and minimizing negative spillovers.

Directors noted that while the current account deficit has declined, the U.S. external position remains weaker than justified by fundamentals and desirable policies. A gradual but sustained reduction in the fiscal deficit, together with a strengthening of growth in partner countries, would help achieve the desirable strengthening of the current account.

United States: Selected Economic Indicators

(Annual change in percent, unless otherwise indicated)

						Projections	
	2008	2009	2010	2011	2012	2013	2014
National production and income							
Real GDP	-0.3	-3.1	2.4	1.8	2.2	1.7	2.7
Net exports 1/	1.2	1.1	-0.5	0.1	0.0	0.1	-0.4
Total domestic demand	-1.5	-4.0	2.8	1.7	2.1	1.6	3.0
Final domestic demand	-1.0	-3.3	1.3	1.8	2.0	1.5	3.0
Private final consumption	-0.6	-1.9	1.8	2.5	1.9	2.1	2.4
Public consumption expenditure	2.2	4.3	0.9	-2.3	-1.3	-3.5	0.4
Gross fixed domestic investment	-5.1	-15.3	-0.3	3.4	6.1	4.3	7.8
Private fixed investment	-7.1	-19.0	-0.2	6.6	8.7	6.3	8.9
Residential structures	-23.9	-22.4	-3.7	-1.4	12.1	15.1	16.7
Public fixed investment	4.6	0.6	-0.6	-7.3	-4.0	-4.4	2.6
Change in private inventories 1/	-0.5	-0.8	1.5	-0.2	0.1	0.1	0.1
GDP in current prices	1.9	-2.2	3.8	4.0	4.0	3.2	4.4
Employment and inflation							
Unemployment rate	5.8	9.3	9.6	8.9	8.1	7.6	7.3
CPI inflation	3.8	-0.3	1.6	3.1	2.1	1.7	1.8
GDP deflator	2.2	0.9	1.3	2.1	1.8	1.5	1.6
Government finances							
Federal government (budget, fiscal years)							
Federal balance (percent of GDP)	-3.2	-11.5	-9.7	-9.0	-6.9	-4.6	-3.4
Debt held by the public (percent of GDP)	40.5	54.0	62.9	67.8	72.6	75.6	76.6
General government (GFSM 2001, calendar years)							
Net lending (percent of GDP)	-6.7	-13.3	-11.1	-10.0	-8.5	-5.9	-4.8
Structural balance (percent of potential nominal GDP)	-5.2	-8.2	-8.5	-7.7	-6.4	-3.9	-3.2
Gross debt (percent of GDP)	75.5	89.1	98.2	102.4	106.4	108.9	109.8
Interest rates (percent)							
Three-month Treasury bill rate	1.4	0.2	0.1	0.1	0.1	0.1	0.1
Ten-year government bond rate	3.7	3.3	3.2	2.8	1.8	2.2	2.7
Balance of payments							
Current account balance (billions of dollars)	-681	-382	-449	-458	-440	-476	-541
Percent of GDP	-4.8	-2.7	-3.1	-3.0	-2.8	-2.9	-3.2
Merchandise trade balance (billions of dollars)	-834	-511	-650	-744	-741	-715	-787
Percent of GDP	-5.8	-3.7	-4.5	-4.9	-4.7	-4.4	-4.7
Balance on invisibles (billions of dollars)	153	129	201	286	301	239	0
Percent of GDP	1.1	0.9	1.4	1.9	1.9	1.5	0.0
Saving and investment (percent of GDP)							
Gross national saving	13.4	11.1	12.2	12.2	13.4	13.7	14.4
Gross domestic investment	18.1	14.7	15.5	15.5	16.2	16.6	17.6

Sources: IMF staff estimates.
1/ Contribution to real GDP growth, percentage points.