INTERNATIONAL MONETARY FUND

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UNITED STATES

2012 ARTICLE IV CONSULTATION

August 2012

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 2012 Article IV consultation with United States, the following documents have been released and are included in this package:

- **Staff Report** for the 2012 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on July 2, 2012, 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 12, 2012. 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**
- **Staff Supplement** of July 27, 2012 updating information on recent developments.
- **Staff Statement** of July 30, 2012 updating information on recent developments.
- **Public Information Notice** (PIN) summarizing the views of the Executive Board as expressed during its July 30, 2012 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.

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UNITED STATES

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION

July 12, 2012

KEY ISSUES

Context: The recovery continues to be tepid, employment remains well below pre-crisis levels, and the housing market is stabilizing but is still at depressed levels. Downside risks around the outlook have intensified, including from the worsening of the euro area debt crisis as well as the uncertainty over domestic fiscal plans.

Short-term policy challenges: Fiscal deficit reduction should proceed at a measured pace, to avoid undermining the fragile recovery. Monetary policy remains appropriately accommodative, with room for some further easing if the outlook were to deteriorate. Authorities' measures to boost the housing market are a step in the right direction, with scope for a more aggressive implementation to speed up the housing adjustment.

Medium-term policy challenges: A credible fiscal consolidation plan including entitlement reforms and higher revenues is crucial for stable medium-term growth, and would allow more room for short-run fiscal policy maneuver. More resources should be devoted to active labor market policies, including those aimed at the long-term unemployed, to prevent long-term unemployment from becoming structural. There has been good progress over the past year in implementing the Dodd-Frank Act, but more remains to be done to increase the resilience of the U.S. financial system.

Spillovers: Striking the right balance between fiscal consolidation and macroeconomic policy support would benefit the rest of the world, as it would avoid the risk of a spike in U.S. interest rates in the medium term and an abrupt decline in U.S. growth next year, at a particularly delicate juncture for the world economy. Further monetary easing may weaken the U.S. dollar, but would have positive spillovers from strengthening the U.S. economy and hedging against downside risks.

Approved By

Nicolás Eyzaguirre and Tamim Bayoumi

Discussions took place in Washington, D.C., during May 21–June 11, 2012 and the concluding meetings on June 27 and July 2, 2012. The team comprised Gian Maria Milesi-Ferretti (head), Roberto Cardarelli, Oya Celasun, Francesco Columba, Jihad Dagher, Geoffrey Keim, Eric Le Borgne, Paulo Medas, Martin Sommer, and Julien Reynaud (all WHD); Sally Chen (SPR); and Stephen Smith (MCM), with contributions from Jack Grigg, Thornton Matheson, and Ian Parry (FAD); Nadia Rendak, Andrew Giddings, Yan Liu, Steve Dawe, and Emmanuel Mathias (LEG); John Kiff (MCM); Ranil Salgado, Marshall Mills, Katrin Elborgh-Woytek, and Lars Engstrom (SPR).

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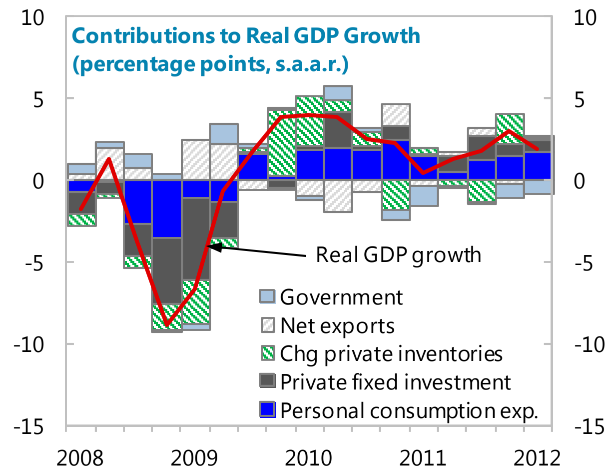
BACKDROP: STILL A FRAGILE RECOVERY

1. The U.S. economy continues to recover at a tepid pace. After rebounding in the second half of 2011, growth has decelerated to around 2 percent in the first half of 2012. Job creation, surprisingly strong at the end of 2011 and in early 2012, has also slowed considerably since April. The deceleration reflects in part a return to the sluggish growth rates that tend to characterize the aftermath of financial crises and housing busts. It is also likely to reflect a number of other factors:

- Continued fiscal withdrawal and less favorable external conditions;
- Seasonal adjustment issues following the Great Recession, which may have made the data for the fall and winter quarters look strong relative to the spring, a pattern also seen over the last two years;
- The unusually mild winter, which may have pulled forward some activity into late 2011–early 2012;



Source: Haver Analytics.

- The boom in gasoline prices between November and February—which reversed after April—may have weighed on private consumption in the spring.

2. Strong headwinds persist on private consumption, as households continue to deleverage amid weak—albeit stabilizing—house prices. For the U.S. household sector as a whole, the net worth-to-disposable income ratio is now slightly above its pre-housing boom levels, largely thanks to the recovery of financial asset valuations. However, these primarily affect upper income groups, and the majority of U.S. households are still left with net-worth ratios well below pre-boom levels, reflecting depressed house prices and elevated debt. Indeed, staff research finds that middle-income households, whose balance sheets were hurt severely by the housing bust, have made limited progress in increasing their net worth through saving (Selected Issues Paper Chapter I). Reflecting the ongoing repair of balance sheets and tight credit conditions for households, the growth of private consumption remains sluggish, broadly in line with weak growth in incomes.[1] House prices have recently shown some signs of stabilization, with the three main house price indices increasing in February, March, and April. However, the risk of further declines remains significant, given the large "shadow" inventory—properties that are likely to end up in

[1] The ratio of personal savings to disposable declined in 2012Q1 as gasoline prices surged. Data on personal income and saving have been subject to large revisions over the past year.

distressed sales (Figure 1).[2] Foreclosures impose high costs on the economy, including through their adverse impact on house prices and the resulting decline in households' wealth and consumption. Households' access to credit remains tight, as weak house prices and broader economic conditions weigh on their creditworthiness (Box 1). Recent actions by the GSEs to expand access to refinancing could ease access to mortgages, and give some support to households' disposable income and spending.

3. **Residential construction has been improving, but from very depressed levels**. The number of housing starts, a major component in residential investment, has been rising since 2011Q3, with starts in 2012Q1 more than 20 percent higher than a year earlier (Figure 2). The recovery is more evident in the multi-family sector, reflecting relatively higher demand for rental units as the homeownership ratio continues to decline toward its pre-bubble levels. However, housing starts remain at only about one half of their 1990s average. Persistently weak construction activity is due to the overbuilding during the boom years and depressed household formation since the crisis. Staff estimates that, despite four years of very low residential construction activity, there is still an excess supply of housing that will be absorbed gradually as household formation normalizes (Selected Issues, Chapter II).

4. **Business fixed investment seems to have lost some momentum, despite extraordinarily low borrowing costs and relatively favorable financial conditions facing the corporate sector**. Indeed, cash-rich firms are tapping bond markets at very low rates, enjoying easier access to bank credit, and have profit margins at historically high levels. The deceleration that started in 2011Q4, following an uptick in 2011Q3, has been fairly broad-based. It likely reflects, in part, the partial phasing out of accelerated depreciation tax incentives in January 2012, which may have pulled equipment purchases forward into the second half of 2011. However, uncertainties surrounding the future tax regime and the economic outlook—given the financial strains in the euro area and risks surrounding fiscal policies at home—may also have played a role.

5. **Net exports failed to add to growth over the last two quarters**. Imports rebounded over 2011Q4 and 2012Q1 after a slowdown associated with the Japanese earthquake's disruptions in mid-2011. Exports, which had been a bright spot in the recovery, decelerated through 2011, in line with generally lower growth in foreign demand. Their rebound in 2012Q1 is likely to be temporary, as evidenced by weak exports in April and May. The 7 percent real appreciation of the dollar between its multi-decade trough in July 2011 and June 2012—driven by a flight to U.S. dollar assets—may also have contributed to slower export growth (Figure 3). Reflecting also sharply higher oil prices, the current account deficit edged up to 3.1 percent of GDP in 2011 and widened further in 2012Q1 to 3.6 percent of GDP.

[2] The "shadow" inventory includes underwater, delinquent, re-performing and Real Estate Owned (REO) properties. The latter are properties owned by a lender or guarantor—typically a bank or a government sponsored agency—after an unsuccessful foreclosure auction. Re-performing loans are loans that were previously delinquent but have become current following a modification.

6. Fiscal policy is also weighing on growth, as the fiscal impulse turned negative in 2011 for the first time since the financial crisis. The U.S. general government deficit, at about 9½ percent of GDP in 2011, remains one of the highest among major advanced economies, reflecting both cyclical weakness and a supportive structural stance. However, for the first time since the onset of Great Recession, the fiscal impulse was negative last year—the general government structural primary deficit fell by ¾ percent of GDP, in part due to stronger-than-expected revenues. Fiscal policy remained a drag on growth also in 2012Q1 as defense spending declined with the ongoing withdrawal of overseas troops, state and local governments continued to downsize, and corporate investment incentives were scaled back. Meanwhile, policymakers have provided support to the weak recovery by extending the payroll tax cut and emergency unemployment benefits through 2012.

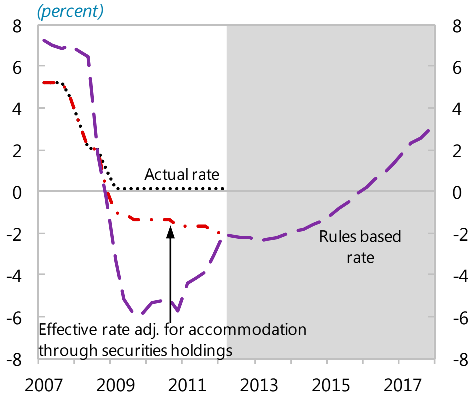
7. The Fed responded to weaker-than-expected growth over the past year with a number of easing actions. With the federal funds rate at its lower bound of zero, it used innovative tools:

- The FOMC started to provide more explicit *guidance on the path of the federal funds rate*, announcing in August 2011 that it anticipated economic conditions to warrant exceptionally low levels for the federal funds rate at least through mid-2013. Since January 2012, it has stated that economic conditions were likely to warrant low rates at least through late 2014.

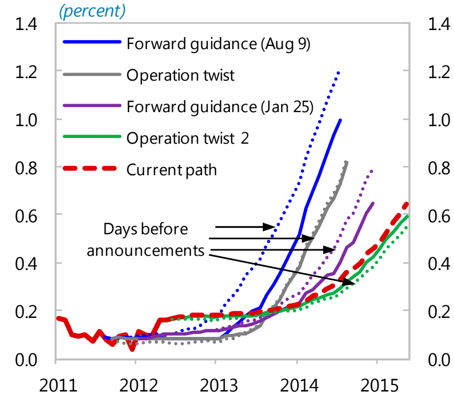
- In September 2011, the Fed launched "*Operation Twist*," comprising purchases of up to $400 billion in Treasury securities with remaining maturities of 6–30 years and sales of an equal amount of securities with remaining maturities of 3 years or less, to be completed by June 2012. In addition, to support mortgage market conditions, it started reinvesting principal payments on agency debt and MBS into agency MBS.

- On June 20, 2012 the Fed announced that it would continue through end-2012 its program to extend the average maturity of its securities holdings. This will entail sales or redemptions of about $267 billion in shorter-term securities, and purchases of longer-maturity Treasury securities of an equal amount, by the end of 2012. Once the maturity extension program is completed, the Federal Reserve will hold almost no securities maturing through January 2016

Actual, Effective, and Rule-Based Federal Funds Rates
(percent)



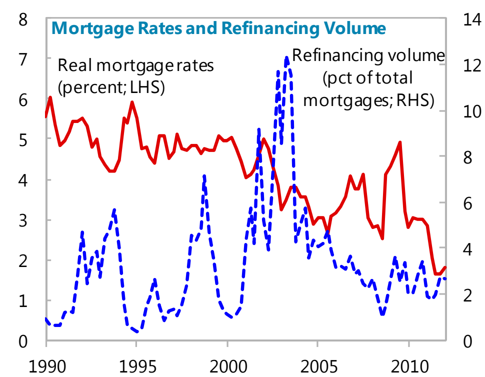
Paths for Federal Funds Rate Implied by Futures Contracts
(percent)



Sources: Board of Governors of the Federal Reserve System; Bloomberg, LP; and Fund staff calculations.
Notes: The "rule-based rate" is the federal funds rate (FFR) predicted by a Taylor-Rudebusch rule (estimated by regressing the FFR on the inflation rate and the deviation of the unemployment from the NAIRU). The "effective rate" is the actual FFR adjusted for the easing provided through the Fed's securities holdings. See Federal Reserve Bank of San Francisco Economic Letter, 2010-18, for more details.

8. These actions are estimated to have reduced yields on ten-year Treasuries by some 60 basis points, supporting economic activity (Box 2). Commonly-used elasticities would suggest the policy-driven 60 basis point decline in the ten-year Treasury yield to be equivalent to a federal funds rate easing of some 150 basis points, with a growth impact of roughly 0.3 percentage points for each of the next two years.[3] The impact of these policy actions has gone beyond the effect on the term premium in longer-maturity Treasury yields: they seem to have postponed market expectations of the start of policy tightening and to have lowered mortgage interest rates, albeit by less than the decline in Treasury and MBS yields.[4] Staff estimates that changes in the size and composition of the Fed's balance sheet provides at present an amount of "effective easing" broadly consistent with the historical relationship between the federal fund rate and inflation and the unemployment gap (the Rudebusch-Taylor rule).

9. The transmission of the massive drop in long-term interest rates to aggregate demand has been hampered by obstacles to refinancing in the mortgage market. While under normal conditions a large decline in interest rates would lead to very significant mortgage refinancing, increasing disposable income and spending, high loan-to-value ratios, tighter credit standards, and rigidities in the mortgage market have prevented this from happening.



Source: Haver Analytics.

[3] See, for example, Federal Reserve Bank of San Francisco Economic Letter 2010–18 on the sensitivity of output to short- versus long-term rates, and Macroeconomic Advisers' Macro Musing Volume 3, Number 15 on the growth effects of changes in Treasury yields.

[4] For instance, in May 2012 30-year fixed mortgage interest rates were about 80 basis points lower than their May 2011 levels, whereas the 10-year Treasury yield and 30-year MBS yields were down by 140 basis points.

10. The degree of resource slack in the U.S. economy remains ample. The output gap remains wide, even though staff has lowered its estimate of potential GDP relative to last year, reflecting lower estimates of trend TFP and labor force participation.[5] Staff's current estimate of the output gap for 2012, a sizable 4.1 percent of potential output, is nonetheless larger than projected one year ago since the downward revision to potential output is more than offset by lower actual output. The pattern of growth since the crisis thus far is in line with the historical experience of advanced economies after financial crises, with a persistent deviation of output from the pre-crisis trend (Selected Issues, Chapter III).

11. The employment-to-population ratio has recovered only modestly after its sharp decline in 2008–09, and long-term unemployment remains stubbornly high. The overall increase in employment since the start of the recovery was barely stronger than the increase in population, implying only a small improvement in the employment-to-population ratio, which remains about 4 percentage points below its level in December 2007. Meanwhile, the labor force participation rate has remained on a downward trend. The sluggish rise in the labor force, together with the moderate increase in employment, enabled a drop of about 1 percentage point in the unemployment rate over the last year, despite GDP growth only moderately above potential (Figure 4). Over 40 percent of the unemployed have been out of work for over six months—marking a record length and level for the United States. While unemployment remains primarily of a cyclical nature, a large and persistent pool of long-term unemployed individuals raises the concern of skill losses and a lower labor force participation rate over the medium term (Selected Issues, Chapter IV).

12. The sizeable economic slack and well-anchored expectations have contained price and wage inflation. Headline consumer price inflation increased to a peak of 3.8 percent in September 2011 due to rising commodity prices, but it has steadily declined since, to 1.7 percent in May 2012, as oil prices have receded (Figure 5). Core consumer price inflation has hovered around 2 percent, market- and survey-based measures of long-term inflation expectations remain stable, and the January 2012 announcement by the Federal Reserve of a formal 2 percent inflation goal should help keep inflation expectations well-anchored. Amid elevated labor market slack, wage inflation has remained subdued throughout the recovery, and stood at 1.4 percent (year-on-year) in May 2012.

[5] The downward revision to trend TFP reflects the downward revision of actual output. Staff revised downward its projection of the labor force participation rate based on evidence suggesting that the older workers that have dropped out of the work-force since the recession are unlikely to come back.

OUTLOOK AND RISKS

13. Growth is likely to remain moderate in the next two years, constrained by household deleveraging, fiscal restraint, and subpar global demand. Staff projects growth of 2 percent in 2012, and a modest acceleration to 2.3 percent in 2013. Underlying these forecasts are the following assumptions:

- Households are projected to continue the process of balance sheet repair. House prices are expected to bottom out around mid-2012 and increase very slowly thereafter, thus providing limited support to household net worth. Bank credit conditions, which are still tight for households and small businesses, are expected to continue to ease slowly. Consequently, consumption growth is projected to remain subdued (Figure 6).

- The fiscal sector is expected to act as a moderate brake on growth. The general government (GG) structural primary balance is projected to improve by 1 percent of GDP in 2012, subtracting about ½ percentage point from growth. The fiscal outlook for 2013 is highly uncertain given the large number of expiring tax provisions and the threat of automatic spending cuts (the so-called "sequester") in the context of highly polarized politics. Staff's baseline envisages a relatively modest reduction in the GG structural primary balance in 2013 (1¼ percent of GDP), largely on account of expiring stimulus measures, such as the payroll tax cut, and a decline in war-related spending. The expiring Bush tax cuts and other revenue provisions are assumed to be extended fully for one year, with the tax cuts for upper-income taxpayers assumed to expire from 2014. The automatic spending cuts triggered by the failure of Congressional Committee on Deficit Reduction last November are expected to be replaced by other back-loaded measures.

- Monetary conditions are expected to remain accommodative, with the tightening of policy rates beginning around late 2014 and a gradual unwinding of the Fed's securities holdings starting in early 2014, as the recovery slowly gains traction.

- Private investment in equipment and software is projected to expand at a slower pace than at the early stages of the recovery, but will remain a strong contributor to growth. After six consecutive years of negative contributions to growth, residential investment is projected to start adding to growth from 2012 onwards.

- A stronger dollar and weaker global demand are projected to weigh on exports, with net international trade subtracting from growth over 2012–2017. Weaker oil prices will partly offset the negative impact of the dollar appreciation and weaker foreign demand on the current account.

- Headline and core inflation are projected to remain subdued, reaching the Federal Reserve's 2 percent medium-term goal only in the medium term, thanks to a large output gap, weaker energy prices, and well anchored inflation expectations.

- The unemployment rate is projected to decline only slowly to 7.9 percent in 2013, as the economy is projected to grow modestly above potential through next year and the labor force participation rate is expected to stabilize. Long-term unemployment, which lags aggregate unemployment, will likely remain elevated.

14. Risks to the outlook remain tilted to the downside. Risks are both external, particularly from a worsening of global conditions from the euro area debt crisis, and domestic, particularly from an impasse on the debt ceiling and a failure to reach an agreement on near-term tax and spending policies, which would trigger a "fiscal cliff". Over the medium term, a failure to adopt a plan that would help achieve fiscal sustainability would also raise risks.

United States: Medium-Term Outlook

	Average			Projections						
	2000-08	2009	2010	2011	2012	2013	2014	2015	2016	2017
	(percent change, unless otherwise noted)									
Real GDP	2.0	-3.5	3.0	1.7	2.0	2.3	2.8	3.3	3.4	3.3
Personal consumption expenditures	2.4	-1.9	2.0	2.2	2.2	2.3	2.4	2.5	2.8	3.2
Gross private fixed investment	0.5	-18.8	2.6	6.8	6.6	8.3	10.3	11.0	9.8	8.4
Change in private inventories 1/	-0.1	-0.8	1.6	-0.2	0.2	0.1	0.0	0.0	0.0	0.0
Government consumption and investment	2.2	1.7	0.7	-2.1	-2.1	-1.5	-0.4	1.2	1.5	0.1
Net exports 1/	-0.1	1.1	-0.5	0.0	-0.1	-0.2	-0.2	-0.3	-0.3	-0.3
Potential GDP	2.7	1.7	1.2	1.7	1.9	2.0	2.1	2.3	2.3	2.4
Output gap 2/	1.1	-6.0	-4.3	-4.3	-4.1	-3.9	-3.2	-2.2	-1.2	-0.3
Consumer price inflation	2.8	-0.3	1.6	3.1	2.2	1.7	1.8	1.9	2.1	2.2
Unemployment rate	5.1	9.3	9.6	9.0	8.2	7.9	7.5	6.9	6.3	5.9
	(percent of GDP, unless otherwise noted)									
Investment rate	19.5	14.7	15.8	15.9	16.4	17.1	17.8	18.7	19.4	20.0
Private saving	15.2	18.4	19.2	18.9	17.9	17.4	16.5	16.6	17.0	17.5
Household saving rate 3/	3.2	5.1	5.3	4.6	3.8	3.8	3.6	3.9	4.2	4.2
Government saving	0.0	-7.0	-6.6	-6.0	-4.6	-3.3	-1.7	-1.0	-0.9	-1.0
Current account balance	-4.9	-2.7	-3.0	-3.1	-3.1	-2.9	-3.0	-3.1	-3.3	-3.5
	(percent)									
Yield on 3-month treasury bill	3.0	0.2	0.1	0.1	0.1	0.1	0.1	0.7	1.8	3.4
Yield on 10-year treasury note	4.6	3.3	3.2	2.8	2.1	2.8	3.6	4.5	5.1	5.6

Sources: Bureau of Economic Analysis; Bloomberg, LP; Haver Analytics, and Fund staff estimates.
1/ Contribution to real GDP growth, percentage points.
2/ Percent of potential GDP.
3/ Percent of personal disposable income.

15. An intensification of the euro area debt crisis would weigh on U.S. growth. While U.S. financial institutions have limited direct claims on the euro area periphery, their claims on the core euro area and the United Kingdom are sizeable. A worsening of the euro area debt crisis that involves these economies may thus affect the United States, through a variety of channels:

- *The trade channel*. Lower demand in the euro area would reduce U.S. exports to the region (which account for about 15 percent of overall U.S. exports or 2 percent of GDP). In addition, renewed financial turmoil in the euro area would likely be accompanied by some U.S. dollar appreciation on safe haven flows, implying a further drag to exports. For example, a two percentage point drop in euro area growth (similar to the downward revision to euro area growth projections for 2012–13 between the September 2011 and January 2012 WEO) accompanied by a 5 percent real effective appreciation of the dollar (as occurred between August and December 2011) could reduce U.S. GDP by between ¾ and 1 percentage point over a two-year horizon.

- *Risks of generalized market contagion.* The intensification of financial turmoil in the euro area could spill over to the U.S. via a generalized increase in risk aversion and lower asset prices, even though safe haven flows would likely reduce yields on safe assets, thereby offsetting part of the rise in corporate bond spreads. While the changes in U.S. financial conditions that would occur under intensified euro area turmoil are highly uncertain, a bout of financial stress similar to that observed during the deterioration of the euro area crisis between July and November 2011 could reduce U.S. real GDP by about 0.6 percentage point over two years.[6]

- *Pressure on money market mutual funds (MMMFs).* MMMFs have been major investors in the liabilities of euro area banks. Although the exposure of prime MMMFs to the core euro area has halved over the last year and its maturity shortened, it remains material. Distress in one of the large euro area banks to which the MMMFs are exposed could trigger a run on MMMFs, hampering wholesale funding conditions and with severe repercussions on the rest of the U.S. financial system as well as U.S. nonfinancial firms.

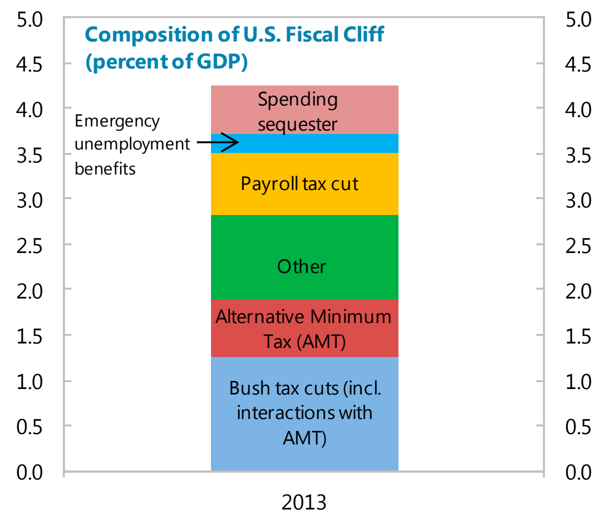
- *Deleveraging by EU banks.* Credit conditions could potentially be affected by a sharper retrenchment of core euro area banks from their activities in the United States than observed so far. The April 2012 *Global Financial Stability Report* projected a reduction of some US$230 billion in the U.S. assets held by EU banks in its "weak EU policies" scenario. Although claims by EU banks on the United States did fall by $170 billion during 2011Q4 (the latest quarter for which data is available), this has not translated into a decline in U.S. bank credit; commercial and industrial loans continued to expand in 2011Q4 and 2012Q1, by about $30 billion and $45 billion, respectively. The reflects the fact the U.S. activities shed by EU banks have been picked up by U.S. banks or other foreign banks, as well as the fact that EU banks' claims on the United States include loans extended to non-U.S. entities.

[6] These estimates are based on simulations using a Financial Condition Index (FCI) for the United States. In particular, staff simulated a one standard deviation permanent shock to financial conditions, using a VAR-based FCI (Swiston, IMF/WP/08/161, 2008). The shocks were similar in size to the changes observed in the Summer/Fall of 2011 for stock prices, corporate spreads, the LIBOR, and oil prices. In this stylized scenario, the higher LIBOR rate and corporate bond yields, and lower equity prices would lower growth by 1 percentage point, but the fall in oil prices would cushion some of their effect and reduce the net impact to -0.6 percentage point.

- *Stock market valuation for nonfinancial firms.* U.S. multinational firms have substantial sales in the euro area, especially through local affiliates, and their profitability and stock market valuations are affected by euro area turmoil.

16. The main domestic downside risk is that inaction driven by political gridlock could prevent or delay key policy decisions which are needed to support the recovery and restore fiscal sustainability. In particular:

- Ongoing political gridlock could block an agreement on near-term tax and spending policies. If all temporary tax provisions were to expire and the automatic spending cuts to take effect, the 2013 fiscal contraction would be very sizable (over 4 percent of GDP). This "fiscal cliff" would reduce annual growth to around zero, and the economy would contract in early 2013. Even if the "fiscal cliff" were quickly unwound, the damage to the economy could be substantial, especially if consumers and businesses were faced with continued uncertainty about tax and spending policies. These strong negative growth effects would in part reflect the limited effectiveness of monetary policy at the zero interest rate bound. Some anticipatory effects from the cliff could be felt already in late 2012, with spending held back by policy uncertainty—subtracting perhaps ½ percent from (annualized) growth in the second half of 2012 according to the Congressional Budget Office (CBO).



Sources: CBO and Fund staff estimates.

- Moreover, the federal debt ceiling will need to be raised most likely in early 2013, bringing back the risk of heightened uncertainty and financial market disruption. Similar to the case of the "fiscal cliff", there is clearly the potential for negative confidence effects and financial market reactions in anticipation of this event.

- At the same time, failing to agree on a credible plan to put the federal debt on a sustainable medium-term path could lead to a gradual erosion of the reserve currency status of the U.S. dollar and put upward pressure on Treasury bond yields over the medium term—despite the deficit reduction measures already legislated, the public debt ratio remains on an unsustainable trajectory (Annex II).

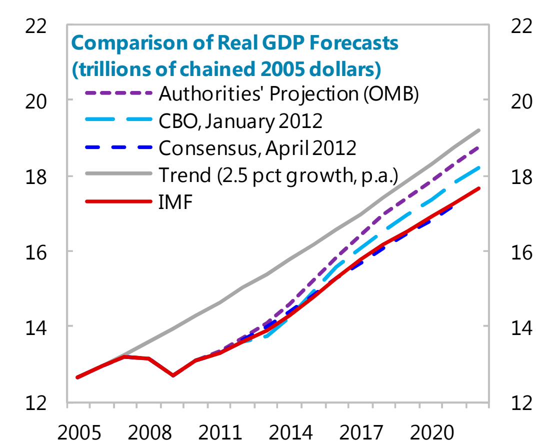
17. There are also upside risks, however, as pent-up demand could provide more support to the recovery. Specifically, capital investment can turn out to be stronger than in staff's forecast, particularly in a less uncertain environment, given the strong balance sheets of non-financial corporations. A more positive outlook for the housing market could also be envisaged, with pent-up demand for housing and increased demand for rental units leading to a faster-than expected recovery of housing starts than in our baseline scenario. Staff estimates that one hundred thousand additional housing starts by end-2013 could lead to an increase in GDP growth of 0.2 percent in 2012 and 2013. And finally, a slower fiscal withdrawal than built in our baseline scenario would help lift growth, especially if embedded in a credible medium-term consolidation framework that removes policy uncertainty.

POLICY DISCUSSION

Discussions focused on what the U.S. authorities could do to sustain the recovery and reduce the vulnerability to downside risks, while at the same time addressing key medium term challenges. In particular the discussion centered on the appropriate pace, timing, and composition of fiscal consolidation; the room and need for further monetary policy easing; the merit of additional measures to unclog the housing markets and reduce the risks from persistently high long-term unemployment; and the progress made over the last year in the reform of financial regulation and the remaining challenges ahead.

A. Context

18. The authorities agreed qualitatively with staff's views on the outlook and risks, but saw greater upside potential for activity. They noted that the economic outlook underlying the President's budget proposal for fiscal year (FY) 2013 incorporated a higher amount of near-term fiscal stimulus than has been approved by Congress so far; the Administration would continue to propose these unapproved measures. They also noted that they are in the process of updating their projections for the FY2013 Mid-Session Review, expected to be released in July. The authorities were optimistic that private demand would rebound next year, highlighting elevated pent-up demand for consumer durables and housing that could materialize rapidly, and incipient signs of a recovery in housing activity and prices. They saw minimal risk of a materialization of the fiscal cliff in 2013, as they were confident that Congress would take the cyclical position of the economy into account when designing fiscal policy for 2013. As in previous consultations, the authorities considered staff's medium-term outlook as excessively pessimistic. They saw the rise in unemployment from its pre-crisis levels as primarily a cyclical phenomenon, highlighting, nonetheless, that structural unemployment could rise in the absence of policy action.



Sources: Consensus Forecasts; Congressional Budget Office; Office of Management and Budget; and Fund staff estimates.

B. Fiscal Policy: Pace of Consolidation and Medium-Term Framework

19. Staff and the authorities agreed that the adoption of a credible fiscal consolidation framework is crucial for stable medium-term growth. The Budget Control Act adopted in the summer of 2011 capped discretionary spending, but the Congressional Committee on Deficit Reduction subsequently failed to agree on additional deficit-reduction measures. As a result, savings in the form of deep automatic spending cuts ("sequester") are scheduled to take effect starting from 2013. The overall savings from the discretionary spending caps and sequester would be significant ($2.1 trillion over 10 years), but still insufficient to stabilize the debt ratio (Figure 7).[7] Since the automatic spending cuts could disrupt government services and create an unwelcome drag on the weak recovery, staff suggested replacing them with specific, back-loaded measures generating an equal amount of savings. More broadly, policymakers should agree on an ambitious and comprehensive consolidation framework, which would stabilize the public debt ratio by mid-decade, and subsequently put it firmly on a downward path.[8] A medium-term primary surplus of at least 1 percent of GDP would help achieve this objective, even if interest rates were to rebound from their current low levels. The authorities noted that they have repeatedly put forth detailed fiscal consolidation plans, but a bipartisan agreement on a consolidation strategy would probably not materialize before the November 2012 elections. Staff reiterated its long-held view that the medium-term growth assumptions embedded in the administration's fiscal proposals appear to be optimistic, and remain well above projections by the IMF, the CBO, and Consensus.

[7] Federal debt held by the public is projected to increase from about 70 percent of GDP to around 85 percent of GDP in FY2022, with general government gross debt approaching 120 percent of GDP by CY2021. These projections assume implementation of legislated measures, additional, modest policy effort over the medium term, and continued low level of interest rates for several years. The Debt Sustainability Analysis in Annex II suggests that—in a downside scenario—policy slippages, negative growth shocks, and much higher interest rates could raise the general government debt ratio above 120 percent of GDP already within a 5-year horizon.

[8] Last year's Selected Issues Paper, Chapter VIII discusses possible institutional arrangements for this framework (IMF Country Report No. 11/202).

United States: Federal and General Government Finances

(Percent of GDP, Fiscal Years for Federal and Calendar Years for General Government)

	2011	2012	2013	2014	2015	2016	2022
IMF staff projection 1/							
Federal budget balance 2/	-9.0	-7.5	-6.0	-4.5	-3.3	-3.3	-4.8
Federal debt held by the public	67.7	73.0	77.1	79.1	79.3	79.1	84.0
General government structural primary balance 3/ 4/	-5.4	-4.3	-3.0	-1.7	-1.1	-1.3	...
General government debt 4/	102.8	106.7	110.7	112.7	113.0	113.0	...
IMF staff recommended plan for stabilizing the public debt ratio 5/							
Federal budget balance 2/	-9.0	-7.5	-6.3	-5.1	-4.0	-2.6	-1.8
Federal debt held by the public	67.7	73.0	77.4	80.0	80.9	80.0	70.9
General government structural primary balance 3/ 4/	-5.4	-4.3	-3.4	-2.4	-1.4	-0.4	...
General government debt 4/	102.8	106.7	111.2	113.8	114.4	113.4	...
Memorandum items							
Federal budget balance (authorities) 6/	-8.7	-8.5	-5.5	-3.9	-3.4	-3.4	-2.8
"Fiscal cliff" scenario (CBO) 7/	-8.7	-7.6	-3.8	-2.3	-1.5	-1.4	-1.2

Sources: IMF staff estimates; OMB; and CBO.

1/ Projections using the IMF macroeconomic assumptions. Compared with the President's budget proposal, staff assumes a lack of action by Congress on the administration's stimulus proposals, delayed and partial implementation of new revenue-raising measures, and an extension of emergency unemployment benefits into 2013.

2/ Includes staff's adjustments for one-off items such as TARP valuation changes.

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

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

5/ Assumes structural primary withdrawal of about 1 percent of GDP annually until a primary balance of 1 percent of GDP for general government is reached in 2018. Further effort will be required in the medium term to bring the debt ratio closer to pre-crisis levels.

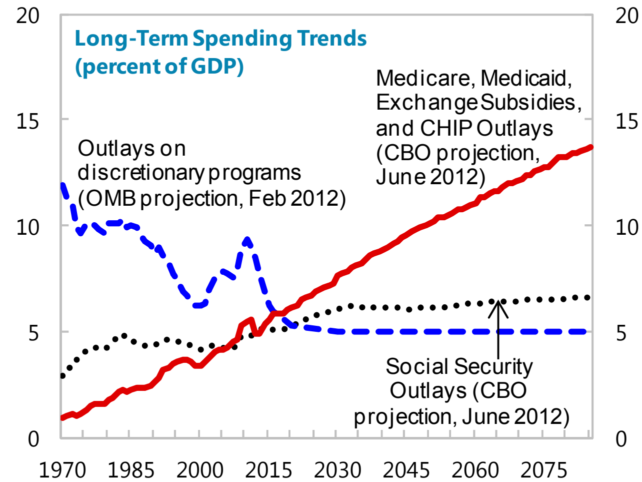
6/ President's budget proposal, February 2012.

7/ CBO projection of the federal budget balance under current law, March 2012.

20. **Staff noted that the consolidation effort will involve politically-difficult decisions on taxes and entitlement spending**. Authorities emphasized that it is too early to predict the details of a possible bipartisan agreement on a comprehensive fiscal consolidation plan, not least because the contours of this plan would depend on the election results, but agreed that the plan will have to address both the spending and revenue sides of the budget. Staff stressed that with discretionary spending capped and defense outlays projected to fall significantly due to the withdrawal of troops from Afghanistan and Iraq, attention must shift to entitlements, the key driver of long-term spending. Given the size of the budget deficit, mandatory spending pressures, and the relatively low U.S. tax ratio, a medium-term consolidation plan would also need to raise revenues. The authorities acknowledged that bipartisan consensus on these issues has so far not been reached, but believed that previous negotiations (including in the context of the President's Fiscal Commission) identified some common ground on which post-election negotiations could be based.

21. **Entitlement spending pressures reflect population aging and, in the health care sector, excess cost growth**. They are mostly linked to the public health care programs (especially Medicare and Medicaid) and public pensions (Social Security).

- *Health care*. The authorities have continued to implement the 2010 health care reform. Notably, the CMS Innovation Center has launched a number of pilot programs intended to find new approaches to the delivery and payments for health care. Staff agreed with the authorities that these initiatives potentially hold the promise of slowing cost growth in the longer term, and urged their aggressive implementation.[9] The authorities acknowledged delays in setting up state-level health insurance exchanges ahead of their scheduled launch in 2014, but thought that the federal government had sufficient legal authority and resources to set up insurance exchanges in those states that are lagging behind.[10] More broadly, the Supreme Court ruling on the Affordable Care Act might provide new impetus for reform implementation, by removing any lingering legal uncertainties.[11] Staff suggested that given the scale of medium-term budgetary challenges, consideration could be given to additional saving measures in the health care sector, such as raising fees, tightening eligibility (for example, raising the Medicare eligibility age), and trimming health-related tax expenditures which tend to be highly regressive (Selected Issues Chapter V). The authorities noted that their budget proposal envisages substantial new health care-related savings (about $360 billion over 10 years), although the measures directly affecting beneficiaries are backloaded toward the end of decade.



Sources: Congressional Budget Office and Fund staff estimates.
Note: Outlays for Medicare are on the net basis including offsetting receipts.

- *Public pensions.* In staff's view, Social Security imbalances warrant an early parametric reform, such as a modest increase in the retirement age, a modified benefit structure to further increase progressivity, and a higher annual ceiling for Social Security contributions. According to a recent report by the Social Security Trustees, the combined Social Security trust funds could run out of resources in 2033—three years earlier than projected last year—at which point elimination of the funding shortfalls would require a 25 percent cut in scheduled benefits. Considered separately, the Disability Insurance trust fund will be depleted already in 2016. A specific reform proposal

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[9] The existing CMS experiments and demonstration projects include expanding primary care to help prevent costly procedures; providing incentives for changes in the delivery process through bundled payments; improving coordination of care through the Accountable Care Organizations and for dual Medicare-Medicaid enrollees. These initiatives affect about 50,000 health care providers.

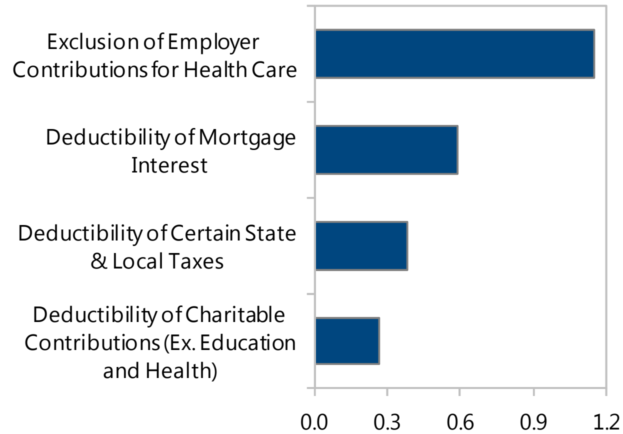
[10] The state-level insurance exchanges (or market places), are meant to facilitate the expansion of insurance coverage, including by helping consumers find plans personalized to their specific health conditions and budgets, promoting insurance transparency and accountability, and facilitating the delivery of insurance subsidies.

[11] The June 2012 Supreme Court ruling upheld most of the Affordable Care Act provisions, although the Court limited the ability of federal government to mandate Medicaid expansion at the state level.

was not included in the President's February budget, but the President has called on Congress to engage in bipartisan talks to put Social Security on a more sustainable footing.

22. Revenues could be raised through a broad menu of options, including lower tax expenditures, the introduction of a VAT and carbon taxes (Box 4), and higher marginal personal income tax rates. Curbing personal tax expenditures (which amount to some 7 percent of GDP) within a fundamental tax reform package would be growth- and distribution-friendly, as spending through the tax code disproportionately benefits high-income households (Selected Issues Chapter V). Authorities indicated that they have repeatedly proposed to let the Bush tax cuts for high-income taxpayers expire, and to limit tax deductions for these taxpayers. More broadly, the tax reform debate could gain traction next year. Staff noted that there is also room for improving the structure of corporate taxation, including broadening the base, lowering marginal rates (the United States has the highest statutory corporate tax rate in the OECD), and achieving a more efficient tax treatment of multinational enterprises. When designing these reforms, however, staff noted that appropriate consideration should be given to their possible international spillovers, especially from changes in the taxation of foreign activities by U.S. corporations (Selected Issues Chapter VI discusses implications of alternative options, including the President's framework for corporate tax reform unveiled in February).

Selected Personal Income Tax Expenditures (percent of GDP)



Source: Office of Management and Budget.

23. Staff called for a measured pace of deficit reduction given the persistent weakness in economic activity. Authorities and staff concurred that the medium-term risks from persistently-high deficits and growing debt need to be weighed against the risks of too rapid a withdrawal, although staff saw the optimal pace of consolidation as more gradual than proposed in the President's FY2013 budget. The President's budget proposal envisages a reduction in the federal deficit by 3 percent of GDP in FY2013 (from 8½ percent to 5½ percent of GDP) due to expiring stimulus, revenue-raising measures, and some defense savings. The authorities felt that this pace of consolidation is consistent with their expectations of a substantial pickup in private demand. According to the CBO, even if the proposed budget policies were implemented in full, the pace of fiscal adjustment would likely be smaller.[12] Staff suggested that, given the weak outlook and downside risks, targeting a federal deficit of about 6¼ percent of GDP for FY2013—some

[12] Specifically, the CBO estimates that the President's budget proposal would imply only a 2 percent of GDP adjustment, in part because the budget overstates spending this year. In addition, Congress has not acted upon certain stimulus proposals by the Administration; if these were to be implemented, the FY2013 withdrawal could be lower than 2 percent of GDP.

¾ percentage point of GDP higher than planned in the President's budget proposal—would be appropriate. This would be consistent with a reduction in the general government structural primary deficit of around 1 percent of GDP in calendar year 2013. The deficit reduction should be as growth-friendly as possible. Potential spending measures to prioritize include infrastructure spending, training programs to limit skill mismatches, and housing initiatives (all of which were proposed by the Administration), as well as a further extension of emergency unemployment benefits. The authorities noted that the discussion of fiscal policies in Congress will be very much influenced by the cyclical position of the economy, and that policymakers generally agree that the budget deficit should not be reduced too quickly if the outlook remains weak.

24. State and local governments (SLGs) have continued their fiscal adjustment, but they need to rebuild buffers and reduce contingent liabilities. The fiscal retrenchment triggered by the balanced-budget rules and a phase-out of federal aid continued last year, with the SLGs subtracting about ¼ percent from GDP growth. State and local employment have recently shown signs of stabilization, but the authorities cautioned that local governments continued to face risks from the weak housing market and property tax collections, and could weigh on growth for some time. The rebuilding of rainy-day funds stopped this fiscal year, and while most states plan to make some progress with rebuilding buffers during FY2013, the reserves in about half of the states remain well below prudent levels, making the SLGs susceptible to spending cuts should revenues surprise on the downside (Figure 8). A number of states have taken action to trim contingent liabilities from the pension and health care obligations to their employees (in some cases supported by favorable court rulings), but these liabilities generally remain sizeable. The authorities hoped that the forthcoming modification of the GASB standards would create further incentives for the SLGs to address unfunded pension liabilities, estimated by private analysts in a wide range of $1–4 trillion.[13]

C. Monetary Policy

25. The discussion on monetary policy focused on whether the outlook and risks justified further easing. Staff and the authorities agreed that the Fed's unconventional monetary policy actions since the crisis had supported economic activity and hedged against deflationary risks, helping to keep inflation expectations well anchored. In the discussions, which occurred before the June 20 easing action, staff argued that the slow pace of reduction in unemployment under its baseline and the escalation of downside risks may call for further easing in the second half of this year. The authorities noted that risk management considerations could argue in favor of this course of action—like staff, they saw the risks to the outlook as being tilted to the downside, and argued that the costs and policy challenges associated with the materialization of downside risks would probably be larger than those associated with the outlook turning stronger than expected. At the same time, the authorities and staff recognized that there were costs and risks associated with providing additional policy accommodation, and that the very low level of long-term interest rates

[13] Last year's Selected Issues Paper VII (IMF Country Report No. 11/202) provides a discussion of SLG finances.

might suggest that the benefits that can be achieved by further monetary policy accommodation are limited.

26. The authorities argued that further easing actions would be effective even in the absence of severe market dislocation. Staff noted that that both Operation Twist and the forward-guidance announcements had lowered long-term yields, but argued that asset purchases may have a greater impact in unsettled financial market conditions—that is, when arbitrage is imperfect, liquidity premia are high, and risk spreads are elevated. The authorities agreed that the Fed's first large-scale asset purchase program, introduced under severely dislocated markets, had eased financial conditions very substantially, but noted that the subsequent, smaller-sized programs had also been effective, even if they were not introduced in particularly stressed conditions.

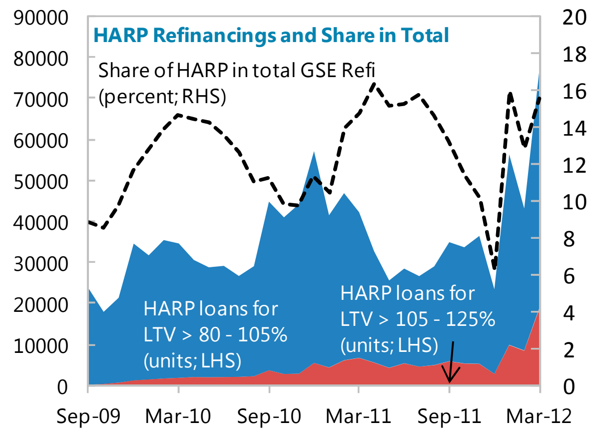
27. Staff and the authorities agreed that easing actions would have a positive effect on activity even if frictions in the mortgage market have weakened the monetary transmission mechanism. Lack of competition and capacity constraints among servicers have reduced the pass-through of lower MBS yields into lower mortgage interest rates. Moreover, many households with high-loan-to-value mortgages could not refinance at the lower rates and many homebuyers were unable to obtain new mortgages due to tighter lending standards. Despite these frictions, staff and the authorities agreed that the effect of lower longer-term yields on aggregate demand remained positive. Moreover, the lessened sensitivity of economic activity to longer-term interest rates could call for more rather than less action to ease monetary conditions. In addition, the authorities noted that monetary policy operates through multiple channels—interest rates and the cost of capital being only one of them.

28. There was agreement that a number of tools could be used for further easing, with staff arguing that additional MBS purchases would be a particularly promising option. Staff argued that in view of the high share of long-maturity Treasury securities held by the Fed and the importance of the housing sector to the outlook, further net MBS purchases could be another effective option. The authorities agreed that further net MBS purchases could be helpful in some circumstances, but also noted a tension between providing accommodation through further MBS purchases and the desire by the FOMC to return, over time, to an all-Treasury securities portfolio. There was also agreement between staff and the authorities that the effectiveness of MBS purchases or other forms of monetary easing in supporting growth would be enhanced if policy actions and proposals to expand access to mortgage refinancing were to gain further traction.

29. Should global financial turmoil intensify, the Fed could intervene with emergency liquidity facilities to mitigate the risks of severe financial disruption. The authorities noted that dollar liquidity swap lines with foreign central banks, authorized by the Fed through February 2013, are already in place to help ease strains in dollar funding markets. Authorities noted that the Fed's ability to provide institution-specific support is limited under the Dodd-Frank Act (DFA), but that it retained the authority to establish broadly-available liquidity facilities to help stabilize funding conditions for financial institutions if appropriate.

D. Housing Policy

30. The authorities noted that the series of measures taken since last year to support the housing market were starting to bear fruit. These measures include in particular an expansion of the Home Affordable Refinancing Program (HARP) for loans owned or guaranteed by the GSEs, and a strengthening of the Home Affordable Modification Plan (HAMP), including loosened eligibility criteria through the elimination of debt service-to-income cutoffs, and the tripling of incentives for investors to carry out principal reductions under HAMP's Principal Reduction Alternative (PRA) (Box 5). Recent data suggests that the October 2011 expansion of HARP seems to have led to a significant increase in HARP refinancing. The share of loans that have benefited from a principal reduction under the modification program (Home Affordable Modification program of HAMP) has also been on the rise, and early signs show that the tripling of the incentives for principal reductions is receiving interest from investors, and is likely to spur further principal reductions in the future. The recent State Attorneys General Settlement with the major banks, which resolved claims about improper foreclosures and abuses in servicing the loans, could lead in the medium run to a non-trivial reduction in foreclosures, including through up to $34 billion of principal reduction. Early signs indicate that the settlement has led banks to delay foreclosures and also to increasingly substitute them with "short sales" of underwater properties, which are less costly and count toward the banks' commitment for principal reduction under the settlement.[14] The authorities highlighted that greater reliance on short sales, as opposed to foreclosures, could support the housing market going forward.



Source: Haver Analytics.

31. The mission welcomed this progress, but also noted that more aggressive policy action may be warranted to accelerate the resolution of the housing crisis. As noted in the Fed's November 2011 white paper, housing markets do not self-correct efficiently and, absent forceful policies to support the market, prices could fall below their equilibrium levels due to feedback loops from prices to demand and supply. If house prices are anticipated to decline, potential buyers could stay out of the market even if interest rates are low. Moreover, a decline in prices reduces housing equity, triggering further defaults and foreclosures. Foreclosures, in turn, put renewed downward pressure on prices, not only by adding to the supply of houses for sale, but also

[14] A short sale consists of the sale of an underwater property by the homeowner after an agreement with the lender. The lender obtains the sale proceeds but releases its lien even though sale proceeds are below the value of the outstanding mortgage. Compared to foreclosures, short sales typically lead to smaller discounts in the property value. They are also likely to exert a smaller negative externality on the value of neighboring properties.

because they lead to a destruction of value and impose "deadweight" losses on the economy, hurting consumer wealth and credit availability.[15]

32. Staff noted that further policy measures could help speed up the recovery of the housing market, while recognizing that there is no silver bullet. These could include:

- ***Supporting mortgage modifications***. Staff sees foreclosure mitigation policies—including through mortgage modifications—as a key priority. Possible ways to strengthen and expand mortgage modifications include the participation of the GSEs in the principal reduction program and a forceful implementation of the recent expansion of HAMP, including by providing appropriate incentives to servicers to ensure their full participation.[16] Staff also noted the potential usefulness of shared appreciation mechanisms, which allow lenders and borrowers to share the benefits from future house price increases and could therefore lead to higher participation by investors in principal reductions. The authorities indicated that the FHFA, the independent conservator of the GSEs, is currently considering the participation of the GSEs in HAMP-PRA, and noted that under the recently-announced increase in investor incentives under HAMP-PRA, the GSEs are encouraged to participate and benefit from the same incentives as private investors. The authorities recognized that the incentive misalignment between servicers and investors has been a barrier to further principal reductions, but noted that an existing program tackles the second-liens problem by forcing participating second-lien holders to reduce the principal on the second liens by an equal proportion to the first lien. In addition, incentives for extinguishing principal on second-lien modifications were increased to further encourage second-lien principal reductions. The authorities agreed on the usefulness of shared-appreciation mechanisms, but argued that technical constraints might make them hard to implement.

- ***Supporting refinancing on a larger scale***. Current refinancing volumes are not in line with the historically low mortgage rates. The barriers to refinancing have clogged the monetary transmission mechanism, which would have otherwise allowed high-propensity-to-consume households to save on their monthly payments, also reducing their risk of delinquency. While the recent expansion of HARP is allowing more underwater GSE loans to refinance, staff noted that more could be done to boost refinancing, along the lines of recent proposals by the Administration. These proposals include an easing of the frictions that hinder cross-servicer refinancing and an expansion of the program to non-GSE borrowers (Box 5). Authorities noted that these measures are contained in three bills that have been recently introduced in Congress.

[15] It is estimated that foreclosed properties sell at around a 27 percent discount and lower the value of neighboring properties by around 2 percent.

[16] Currently, the incentives of servicers are not always aligned with those of investors. Many modifications that would increase the net present value (NPV) of mortgages for investors are not carried out by servicers due to high modification costs, and, in some cases, reluctance by servicers due to their significant holdings of second liens. When servicers hold a second lien on the property in delinquency they have an incentive to avoid modifications since it would also lead to losses on their second liens.

- ***Facilitating the conversion of foreclosed properties into rental units***. The recent pilot program by the FHFA to facilitate the transition of foreclosed houses into rental units would help reduce the negative impact of foreclosures on house prices by averting distressed sales. Staff and authorities agreed on the benefits from a timely expansion of this program, especially given buoyant rents, but authorities noted technical challenges in the implementation that are likely to lead to delays.

- **Allowing mortgages to be modified in personal bankruptcy courts** (the so called "cramdowns"). Implementing this long-standing Fund recommendation would make the treatment of primary residences in personal bankruptcies consistent with that of most other types of secured debt and create incentives for voluntary modifications, at no fiscal cost (Selected Issues Chapter VII). Authorities acknowledged staff's arguments on cramdowns but noted the lack of sufficient political support for this measure.

E. Challenges Facing the Labor Market

33. Staff and authorities agreed that while cyclical factors explain most of the ongoing labor market weakness, there is a risk that structural unemployment may increase in the absence of policy action. The long-term unemployment rate, at 3.5 percent of the labor force, is well above levels in previous recessions and has declined relatively little since the start of the recovery. Elevated long-term unemployment raises the risk of a loss of human capital and attachment to the labor force, and could lead to a lower participation rate or higher NAIRU in the medium term. Staff also noted that the apparent shift in the Beveridge curve for some industries—in particular, manufacturing—may suggest mismatches between the skills available among the unemployed and the skills sought by employers.

34. Authorities observed that a number of measures have been recently adopted to boost employment, while others have been proposed. The Job Creation Act of February 2012 introduced an extension of the payroll tax cuts through 2012 and the requirement that recipients of long-term unemployed benefits take up job search services, as well as training and education services. Other measures to support the labor market by boosting labor demand through tax incentives and helping the unemployed in their job search effort have been proposed by the Administration but have not been approved by Congress. For example, the President's American Job Act of 2011 envisaged a one-year reduction in the portion of the payroll tax paid by employers for incremental increases in their payrolls, and a $4,000 credit to employers for hiring long-term unemployed workers. And the 2013 Budget proposed both active labor market policies, including the Pathways Back to Work program that help low-income youth and long-term unemployed by subsidizing their employment; and a 10 percent tax credit for new jobs and wage increases.

35. Staff was supportive of these measures, and suggested that tax incentives could be better targeted at employment creation and more resources devoted to programs that help the long-term unemployed return to work. Staff suggested that tax incentives aimed at the long-term unemployed deserve more consideration, given these individuals' higher risk of human capital losses. In light of the protracted weakness in labor market conditions, staff also cautioned against an abrupt reduction of the maximum duration of extended unemployment benefits, as these provide an important social safety net. Ensuring adequate funding for active labor market policies, such as training and support for job search, would also be critical, as these measures have been shown to improve the employment prospects of long-term unemployed workers. Resources in this area are generally lower in the United States than other OECD countries, and have fallen since 2007 as a ratio to the long-term unemployed.

F. Financial Sector Conditions and Policies

36. The authorities saw the outlook for the U.S. banking system as broadly positive. They noted that earnings growth for the U.S. banking sector has been positive over the last 11 quarters, and losses and bank failures have peaked in late 2010. However, a few States (Arizona, California, Florida, Georgia, and Nevada) continue to suffer from higher rates of bank failures, reflecting exposures to weak house prices and construction activity, in particular commercial real estate. Authorities indicated that banks continue to report weak loan demand from small and medium enterprises (SMEs), reflecting both the weak demand environment faced by these firms and the decline in available collateral following the housing bust, given that SMEs tend to secure a large share of liabilities with real estate. They also said that the supply of mortgage credit was still tight as evidenced, for example, by the Fed's Senior Loan Officer Opinion Survey, which shows almost no easing of mortgage standards since the crisis. The large backlog of troubled mortgages, regulatory uncertainty, and scaled-down real estate lending operations are weighing on banks' willingness and ability to supply mortgage credit.

37. However, U.S. banks face risks from an intensification of stresses in global financial markets. While agreeing that the banking system has made significant progress since the depth of the recession (Box 3), staff expressed concerns about the potential vulnerabilities of the largest U.S. banks to financial market stresses emanating from turmoil in the euro area, in light of their large derivative portfolios (including with counterparts in the euro area) and relatively high dependence on wholesale funding. The increase in CDS spreads for the largest U.S. banks over the past few months could indeed reflect concerns about contagion from renewed global financial market turmoil.[17] The authorities noted that the stress testing from the second Comprehensive Capital Analysis Review (CCAR) gave reassuring indications on the resilience of the largest U.S. banks to very severe shocks. They agreed that severe shocks affecting large core euro area banks would unavoidably have negative repercussions for U.S. financial institutions, given their size and interconnectedness, but noted that the protracted period of turbulence had afforded U.S. institutions time to adjust their exposures and prepare contingency plans. They also indicated that the upward movements in CDS spreads for major U.S. banks may reflect investors hedging against

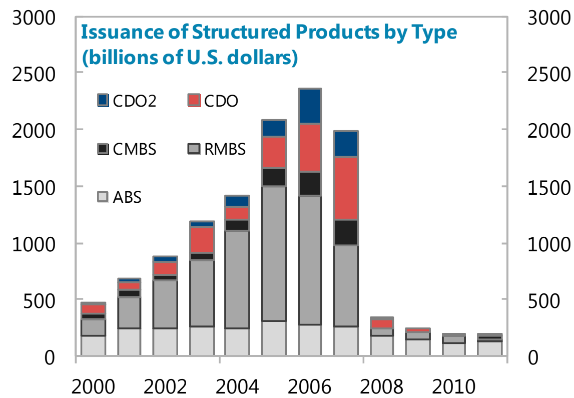
[17] Self-reported data on the six largest U.S. banks (Bank of America, JPMorgan, Citigroup, Morgan Stanley, Goldman Sachs and Wells Fargo) suggest that their aggregate net exposure to peripheral Europe (taking into account the protection purchased and the full set of collateral) was about US$57 billion at end 2011. But the counterparty risk behind these exposures remains a concern, considering that about 75 percent of all CDS trading globally is concentrated amongst 20 major banks/brokers that include the five major U.S. banks.

the risks of greater stress in global financial markets by purchasing CDS of U.S. banks, as their valuations are highly sensitive to changes in global economic conditions.

38. Authorities noted that activity in segments of the shadow banking system is still depressed, and unlikely to return to pre-crisis levels in the foreseeable future.

- The MMMF asset base—US$2.5 trillion—is about one third below its end-2008 peak. Authorities and staff agreed that runs on MMMFs following distress in one of the large euro area banks remain a potential risk, even though prime MMMFs have halved their exposure to the core euro area to about US$215 billion in May 2012 and shortened its duration.

- Almost four years after the peak of the financial crisis, private-label securitization remains well below its pre-crisis level. In particular, issuance of CDOs has evaporated while private-label RMBS issuance has slowed to a trickle, which the authorities attributed to the still-weak housing market, unresolved regulatory reforms (including risk retention rules, as discussed below in paragraph 41), and tight credit rating standards for structured paper.



Sources: Fund staff estimates based on data from JPMorgan Chase & Co., Board of Governors of the Federal Reserve Systems, the CRE Finance Council, and Inside Mortgage Finance.

Note: ABS = asset-backed security; CDO = collateralized debt obligation; CDO2 = CDO-squared and CDOs backed by ABS and MBS; MBS = mortgage-backed security; RMBS = residential MBS; CMBS = commercial MBS.

- Staff asked whether the recent decision of a few foreign broker-dealers to give up their U.S. bank holding group status could presage an expansion of the U.S. shadow banking system, as a reaction to the ongoing process of regulatory reforms. Authorities noted that these entities would still be subject to supervision in the United States by the Securities and Exchange Commission (SEC) (as well as from their home bank regulators), and they could still be required to adopt higher capital standards through their designation as SIFIs. They would also be subject to the Volcker Rule, as long as their parent institution has a U.S. bank branch, agency, or subsidiary.

39. Staff underscored the challenges posed by the low interest rate environment for insurance companies and defined-benefit pension funds. Authorities noted that low interest rates may present challenges for corporations with defined-benefit pension plans, as they boost the present value of future pension liabilities. The official estimate of corporate pension underfunding was about $700 billion as of 2010, concentrated in industries such as airlines, auto, and steel. According to the Society of Actuaries, employers have generally funded their plans in advance of requirements, but the rising tide of required contributions in the coming years could create difficulties for weaker companies.[18] With regard to the insurance industry, the authorities noted that

[18] After the end of consultation, Congress passed legislation that effectively eases the contribution requirements.

the 2011 stress tests were reassuring, as insurance companies would maintain adequate capital ratios even if interest rates stayed low for long. A greater challenge could come from a spike in global financial stress: while the exposure to Europe and derivatives is not substantial, downgrades of counterparties in derivative contracts could result in the specific contracts being out of compliance with a specific state's derivative use laws, in which case the insurer may be required to take action, such as unwinding the contract or novating the contract to a counterparty that is in compliance.

40. Over the last year, continued progress has been made on the implementation of the financial reform program, in line with the Dodd-Frank Act and the international regulatory reform agenda. The authorities emphasized that implementing the reforms had been a daunting process, given the volume of rulemaking to be completed in a relatively short period of time and with limited resources. These difficulties, together with the authorities' desire to "get things right", taking proper account the concerns raised by financial market participants, foreign authorities, and the public during the consultation process were the main reasons for the delay in finalizing and implementing parts of the DFA and global financial reforms. Still, progress was achieved in the following areas, in many cases following the recommendations contained in the 2010 FSAP (Box 6):

- *Systemically important financial institutions (SIFIs).* Final rules have been issued on the submission of resolution plans ("living wills") for SIFIs, and the criteria behind the designation of non-bank SIFIs and Financial Market Utilities (FMU) for enhanced supervision and prudential standards. Initial rulemakings to implement the orderly liquidation authority, which enables the FDIC to place SIFIs into receivership, have been promulgated, and further rulemaking is in progress. The authorities indicated that the designation process for FMUs is almost complete, while that for non-banks is still at an earlier stage. Staff underscored the importance of accelerating the process, as the actual designation of firms and the enhanced regulatory scrutiny would further help identify and address systemic risk challenges.

- *OTC derivatives.* Authorities have laid the groundwork for new regulations imposing mandatory centralized clearing and improving transparency in OTC derivative markets, in line with the Dodd-Frank Act and G20 commitments. While a number of rules have yet to be finalized, authorities emphasized that reforms in this area need to be coordinated internationally, and that the United States is closer to the implementation of new regulations on OTC derivatives than other jurisdictions. Staff encouraged the authorities to finalize the rules as quickly as possible, given the critical role played by the U.S. financial sector in global derivatives markets. Authorities and staff agreed on the need to have strong supervision of Central Counterparties (CCPs), and that systemically important CCPs should have access to Fed liquidity facilities in appropriate circumstances.

- *Basel rules.* Final rules have been issued requiring banks to increase their capital buffers for the trading book and securitization activities, broadly following Basel 2.5 requirements (U.S. banks continue to report capital ratios under Basel I).[19] Initial rulemaking proposals have been issued requiring banks to hold greater and higher quality capital buffers, in line with Basel III requirements. The authorities were confident that the final rule on these standards would be issued around the timeline agreed with the Basel Committee (January 2013), and noted that most major U.S. banks are on track to meet the new requirements. Authorities also indicated that the Dodd-Frank Act's provision on greater capital buffers for systemically important banks (with assets above $50 billion) will be implemented at the same time as the capital surcharge for the Global Systemically Important Banks (G-SIBs) (between 2016 and 2018). While the implementation of the two Basel liquidity standards will not begin until 2015 for the Liquidity Coverage Ratio and 2018 for the Net Funding Stable Ratio, the U.S. authorities are working at initial rulemaking proposals on both standards. Staff welcomed the progress and encouraged the authorities to further advance in the rulemaking needed to fully implement the Basel III framework in line with the internationally agreed timeline.

41. The discussion also focused on areas where more remains to be done to increase the resilience of U.S. financial system:

- *Regulation of the shadow banking system*: Authorities and staff agreed that one area where more progress is needed is the regulation of money market mutual funds. Given the size of this industry, its prominence in short-term funding markets, and its susceptibility to runs, strengthening the regulation of MMMFs is critical to enhance financial stability, especially as the emergency facility used during the financial crisis to backstop the market is no longer available. The menu of options to mitigate the risks posed by the MMMFs includes moving from stable to floating net asset values, and imposing capital requirements and redemption limits. Authorities and staff also concurred on the need to reduce the systemic risk stemming from the dependence of the tri-party repo market on intraday credit provided by the clearing banks, following the recommendation of the tri-party repo task force.

- *Volcker rule*. Staff noted that a ban on proprietary trading could in principle reduce the risk of significant losses on banks' derivatives positions, which has been drawing renewed attention after the recent events involving JP Morgan. But in staff's view the effectiveness of this ban would depend on striking the right balance between too rigid an interpretation of the law—which could trigger a migration of risky activities outside the regulatory perimeter—and an expansive interpretation of the exemptions envisaged by the statute, which could dilute it. At the same time, it is important to minimize the potential adverse international spillovers of the law, as well as its impact on market liquidity more generally. Authorities indicated that they are very mindful of the concerns expressed by foreign authorities and markets, and that an appropriate

[19] The final U.S. regulation on Basel II requirements (which became effective in 2008) fell short of fully adopting Basel II standards, as it only required large U.S. banks adopt the so-called "advanced" approach for the calculation of risk-weighted assets. To-date core banks remain in a transitory regime where they run both Basel I and Basel II calculations, but Basel I capital requirements remain the legal minimum.

definition of market-making activities (allowed under the statute) should address most of these concerns.

- *Insurance regulation*. Staff reiterated their long-standing view that the lack of a national regulatory framework for the industry could be an issue, given the difficulty in coordinating the various state regulators on both domestic and international reform efforts. The authorities pointed to the establishment of the Federal Insurance Office (FIO) at the Treasury as a significant step forward, given FIO's mandate and emerging capacity to coordinate federal effects and develop federal policy on prudential aspects of international insurance matters.

- *Mortgage market reforms*. Staff noted that, 16 months after the issuance of the initial rulemaking proposal, it is important to expeditiously complete the regulation requiring banks that securitize loans to retain a share of the risk, as this would remove uncertainty weighing on the recovery of private securitization. Authorities noted that regulatory agencies are working on finalizing the risk retention rules. Under the law, a bank will have to retain an ownership interest in any mortgage it securitizes if that mortgage does not meet the new requirements of a Qualified Residential Mortgage. The CFPB is still carefully reviewing the comments received on the Qualified Mortgage (QM) proposed rules, which would impose mortgages underwriting standards that ensure borrowers have the ability to repay. While staff argued that the uncertainty related to risk retention and QM rules may be negatively affecting mortgage lending, authorities noted that other frictions may hurt banks' appetite for mortgage lending, including capacity constraints and risks stemming from representations and warranties.

- *The future of the GSEs*. Staff noted the importance of striking the right balance between the need to support the recovery of the housing market and to enact structural reforms of the housing finance system over the medium term featuring a much reduced role for the GSEs (as envisaged in a 2011 Administration report to Congress—Box 7). The authorities noted the need to achieve broad consensus on these reforms, which they saw as high priority for after the upcoming elections. They also noted that the FHFA had recently issued a strategic plan outlining the next phase of the conservatorships of the GSEs. Staff and authorities agreed on the need for a medium-term strategy to reduce the role of GSEs, which may encourage a gradual shift in the mortgage market towards private institutions, helping resolve some of the uncertainty weighing on the housing market.

42. Staff and authorities agreed that ensuring financial stability would require strong oversight of systemic risk. Staff noted that, as the U.S. regulatory architecture remains highly fragmented, it is essential to ensure strong coordination among its various agencies, in order to identify and act on early signals of a build-up of systemic risk. The authorities agreed, but noted that the Financial Stability and Oversight Council (FSOC) had greatly improved coordination and cooperation among agencies, as their representatives meet frequently within the FSOC's various sub-committees and working groups. They also indicated that the Office of Financial Research can play a useful role in this regard, including by allowing agencies to access a centralized database on financial institutions' positions and exposures, and developing a dashboard for systemic risk indicators.

43. Rapid completion and effective implementation of the new regulations requires adequate funding for the regulatory and supervisory agencies. Authorities noted that agencies continue to experience budgetary constraints which limit their ability to meet the deadlines associated with the domestic and international reforms. Going forward, a lack of adequate resources may hinder the ability of the agencies to effectively monitor financial institutions and markets, once the new regulations come into force. Staff argued that lifting these resource constraints should be a priority.

G. The United States and the World Economy

44. Staff stressed that policy actions to raise savings over the medium term, including by restoring fiscal sustainability, and to strengthen the recovery in the short term would make important contributions to global growth and stability. With household saving rates projected to remain close to current levels in the medium term, higher public savings would help ensure that the U.S. current account deficit remains moderate as domestic investment gradually recovers. While current external vulnerabilities are limited by the dollar's reserve currency status and the United States' role as safe haven, restoring fiscal sustainability would also reduce potential future risks to external stability. These could arise, for example, from a future decline in foreign demand for U.S. debt securities triggered by market concerns about public debt dynamics, and imply sharply higher U.S. interest rates, with adverse global spillovers—as discussed in the 2012 Spillover Report (www.imf.org).

45. The authorities agreed on the need for the U.S. to raise its saving rate, particularly through fiscal consolidation, but expressed concerns that global demand could falter, dragging down world growth. In this context, they saw decisive action to forestall the risk of a euro area crisis, and boost demand and increase currency flexibility in surplus countries, as essential to revive world growth and achieve global rebalancing, in line with goals of the G-20 Framework for Strong, Sustainable, and Balanced Growth. Such policy actions would improve the outlook for U.S. exports and the current account, facilitating the rotation from domestic demand to external demand. They also noted that they expect the U.S. bond market to remain deep, liquid, and attractive to foreign investors.

46. While the U.S. current account deficit has narrowed after the crisis, staff noted that the U.S. external position remains weaker than justified by fundamentals and desired policies. The current account deficit is expected to widen modestly in the next few years as the output gap gradually closes, thus increasing imports, but lower oil prices feed through. This would lead to a further deterioration in the net International Investment Position (NIIP) of the United States, which reached -27 percent of GDP at end-2011. Model-based estimates suggest that the cyclically-adjusted current account deficit is 1–2 percentage points of GDP weaker than the value implied by fundamentals and desirable policies and that the real effective exchange rate is moderately overvalued (0–15 percent), also in light of the recent appreciation of the dollar (Box 8). Staff argued that over the medium term, fiscal consolidation aiming for a primary surplus of at least 1 percent of GDP accompanied by some depreciation of the dollar and desired policies in partner countries would allow for a strengthening of the current account balance of the order of 1–2 percent of GDP relative to staff's projections. Such an outcome would be in line with maintaining external stability and full employment. The authorities broadly concurred with staff's current account projections but did not take a view on the appropriateness of the level of the current account balance and the dollar.

47. Staff also stressed the negative impact that a materialization of the fiscal cliff would have on other economies. Should the tail risk of the fiscal cliff materialize, the U.S. economy would at a minimum stall next year, with growth turning negative in early 2013. Staff analysis for the 2012 Spillover Report (www.imf.org) suggests that the spillovers to the rest of the world would mostly propagate through trade channels, with negative effects felt more strongly in the immediate neighbors (Canada and Mexico) and a smaller but non-negligible growth impact elsewhere in advanced Europe and Japan, also given their narrow policy space. Spillovers to emerging markets would be more manageable given the lower sensitivity of their growth rates to U.S. growth, higher trend growth rates, and generally larger policy flexibility. That said, existing models may not fully capture the adverse effects of a drop in U.S. growth through lower commodity prices and export-related investments in emerging market economies, and sizable financial market reactions could imply a much more severe magnitude and propagation of the shock. While acknowledging the potential impact of a large fiscal adjustment on the U.S. recovery, the authorities were confident that a political agreement would be reached to avoid a drastic fiscal tightening in 2013.

48. Monetary policy actions in the United States have helped sustain the U.S. recovery, thus supporting global growth, but also have spillovers on the rest of the world. In principle monetary policy easing in the United States tends to be accompanied by declines in interest rates in other countries, dollar depreciation, and U.S. capital outflows. However, identifying the strength of these effects precisely is difficult, for several reasons: policy actions are often anticipated; they occur in response to other shocks; and other events on domestic and international markets can coincide with policy announcements or actions, making it difficult to disentangle the impact of the latter.

- Staff analysis finds mixed evidence on the impact of recent U.S. monetary policy easing actions on foreign interest rates and exchange rates, reflecting the fact that easing was in some instances undertaken in the context of a material worsening of the global outlook (which tends to strengthen the U.S. dollar on safe haven flows). The authorities broadly agreed with the findings, noting the difficulty of assessing the effects when changes in the global economic backdrop around announcement dates trigger effects that go in the opposite direction.

- With regard to capital flows, staff analysis for the 2012 Spillover Report finds that U.S. investors have significantly reduced their purchases of foreign bonds since the onset of the financial crisis, despite the dramatic decline in U.S. interest rates. The destination of the flows, however, has changed: U.S. residents have scaled down significantly their purchases of euro area and U.K. bonds, and boosted purchases of bonds issued by Australia, Canada, and Latin America (in addition to increasing holdings of U.S. Treasuries). The authorities noted that declining interest rates would have contributed to higher bond outflows, ceteris paribus; however, monetary easing occurred in response to weak growth and an unsettled global environment, where factors such as high risk aversion, flight to safety, and demand for liquidity were key drivers of capital flows. The authorities also noted that there are fundamental reasons for capital to flow to emerging markets. Staff concurred, noting that the significant changes in the destination of flows also reflected changes in relative growth prospects and cyclical positions post-crisis.

49. The mission welcomed the authorities' continued commitment to trade liberalization and market access, in support of economic growth and expanded job opportunities. The authorities are aiming for progress on multiple fronts; however, as a consequence of slower progress in the multilateral trade framework, their short-term focus has shifted to the pluri- and bilateral arenas. Accordingly, the authorities are pursuing opportunities for ambitious trade agreements with certain APEC members in the context of the Trans-Pacific Partnership and, possibly, with the EU, while also defining policies for trade and investment promotion in the Arab transition economies. Following the recent implementation of the FTAs with Colombia and Korea, work with Panama on pending FTA issues is continuing. Key trade-related issues, such as industrial policies of trading partners, and IPR and technology protection will also be addressed under bilateral investment treaties (BITs), based on the newly revised model BIT. Staff welcomed the authorities' efforts to resist protectionist pressures and ensure continued consistency of domestic legislation and practices with WTO principles and international obligations, including in reforms of agricultural support programs. The mission encouraged the authorities to aim for multilateral trade liberalization, including new approaches as necessary.

STAFF APPRAISAL

The main policy challenge is to use effectively the limited policy space available to support the recovery in the near term, while restoring fiscal sustainability with a balanced approach to medium-term consolidation and completing financial sector reforms.

50. It is critical to remove the uncertainty created by the "fiscal cliff" in 2013 and promptly raise the debt ceiling, pursuing a pace of deficit reduction that does not sap the economic recovery. The threat of a fiscal cliff could create headwinds to economic activity already later this year, and should the fiscal cliff materialize, the domestic growth effects would be severe, with negative spillovers to the rest of the world. Policymakers should address the policy uncertainties as soon as possible—including through a temporary extension of current policies if a bipartisan agreement on tax and spending measures proves too difficult to achieve this year. A smaller deficit reduction than envisaged in the President budget would be appropriate in staff's view, given the weak economy and downside risks, limited room for monetary policy to offset the fiscal drag, and the risk of hysteresis effects. Staff's recommended pace of adjustment would be consistent with a federal deficit of about 6¼ percent of GDP for FY2013—some ¾ percentage point of GDP higher than planned in the President's budget proposal. This would imply a contraction of the general government structural primary deficit of around 1 percent of GDP in calendar year 2013. The composition of spending should be as growth-friendly as possible, with emphasis on high-multiplier policies such as infrastructure spending, training programs to limit skill mismatches and hysteresis effects, housing initiatives (measures already proposed by the Administration), and a further extension of emergency unemployment benefits. Meanwhile, the federal debt ceiling should be raised well ahead of the deadline to help reduce uncertainty and avoid the risk of losses in confidence and financial market instability as the cut-off date approaches.

51. At the same time, a credible and comprehensive fiscal consolidation plan remains urgently needed. Policymakers should agree as early as possible on a comprehensive set of measures that would stabilize the public debt ratio by mid-decade, and subsequently put it firmly on a downward path. This would enhance the room for fiscal policy maneuver in the near term, as well as limit the possibility of an eventual spike in risk premia on U.S. sovereign debt, which would be highly damaging both for the United States and the rest of the world. To achieve this objective, policymakers could target a medium-term primary surplus of at least 1 percent of GDP, which would stabilize the debt ratio even factoring in a significant rebound of interest rates from their current low levels. In this context, the deep automatic spending cuts envisaged under the Budget Control Act (the so-called "sequester") should be replaced with specific, back-loaded measures generating at least an equal amount of savings.

52. This medium-term consolidation effort will need to include revenue-raising measures and reforms to slow the growth of entitlement spending. With discretionary spending capped and defense outlays projected to fall significantly, policymakers' attention must shift to entitlements, the key driver of long-term spending. Policymakers should fully implement the cost-saving provisions of the health care reform and additional saving measures could be phased in gradually. The Social Security imbalances warrant an early parametric reform. Given the size of the budget deficit, age-related spending pressures, and the relatively low tax ratio, the medium-term plan should also include higher revenues. Revenues could be raised through a menu of options, including lower tax expenditures (which amount to some 7 percent of GDP and disproportionately benefit high-income taxpayers), the introduction of a VAT and carbon taxes, and higher marginal personal income tax rates. There is also room for improving the structure of corporate taxation, including by base-broadening, lowering marginal rates, and achieving a more efficient tax treatment of multinational enterprises.

53. Monetary policy conditions appropriately remain very accommodative, with some room for further easing should the outlook deteriorate. We welcome the Federal Reserve's recent decision to further extend the maturity of its securities holdings, which should put additional downward pressure on long-term interest rates. Yields on longer-term Treasury securities are extraordinarily low and the spreads between agency MBS and Treasury bond yields remain tight. We estimate that the innovative tools adopted by the Fed over the past year have reduced 10-year Treasury bond yields by some 60 basis points. Should the outlook worsen, further easing may be warranted. In this regard, given the relatively high share of the Fed's holdings of Treasury securities at longer maturities and the importance of the housing sector for the outlook, additional net MBS purchases could be considered. Their effectiveness in supporting growth would be enhanced if policy actions and proposals to expand access to mortgage refinancing were to gain further traction. Should global financial turmoil intensify, the Fed would need to stand ready to intervene with emergency liquidity facilities to mitigate the risks of severe financial disruption.

54. Timely and aggressive monetary policy easing by the Federal Reserve since the fall of 2008 has been instrumental in avoiding the risk of a depression in the United States—which would have had severe implications for the world economy—and in appropriately sustaining the U.S. recovery at difficult junctures. Easy monetary policy in the United States (as in other advanced economies) may encourage portfolio outflows, particularly to economies with favorable growth prospects and open capital accounts, and this can potentially create challenges for their macroeconomic management. However, these effects are likely tempered in the current unsettled external environment, characterized by high risk aversion and safe-haven flows to the United States.

55. The U.S. current account deficit has declined after the crisis, but the external position remains weaker than justified by fundamentals and desired policies. The current account deficit is expected to widen modestly in the next few years as domestic demand strengthens but oil prices decline, leading to a further deterioration in the U.S. net international investment position. Over the medium term, fiscal consolidation aiming for a primary surplus of at least 1 percent of GDP accompanied by some depreciation of the dollar and adjustment in partner countries' policies would allow for a strengthening of the current account balance of some 1–2 percent of GDP, consistent with external stability and full employment.

56. Staff welcomes the authorities' recent measures to boost the housing market, although further action may be warranted to remove the distortions that prevent a faster resolution of the housing crisis. The authorities have responded to the persistent weakness in the housing market with a host of measures—including the expansion of the mortgage modification and principal reduction program and the easing of some of the frictions in the refinancing program. Staff supports the timely and aggressive implementation of these measures, including the participation of Government-Sponsored Enterprises in the principal reduction program and ensuring adherence by servicers to the loosened eligibility criteria under the expanded modification program. However, in light of the importance of the housing market in securing the economic recovery and the downside risks to the outlook, additional steps could be taken to strengthen the housing recovery. These include measures to facilitate the conversion of foreclosed properties into rental units and supporting access to refinancing on a larger scale, in line with the Administration's proposals, which would also strengthen the positive impact of lower interest rates on aggregate demand. Consideration should also be given to allowing mortgages to be modified in personal bankruptcy courts.

57. Policies are needed to reduce the risk that long-term unemployment could morph into higher structural unemployment and reduce potential output. While staff views most of the increase in unemployment as reflecting cyclical factors, the long-term unemployment rate is significantly above levels seen in previous recessions and has declined relatively little since the start of the recovery. Elevated long-term unemployment raises the risk of a loss of human capital and attachment to the labor force, and could lead to a lower participation rate. Active labor market policies, such as training and support for job search, have been shown to improve the employment prospects of the long-term unemployed and thus should be adequately funded. Temporary tax incentives to expand labor demand—particularly if targeted toward the long-term unemployed—are also desirable.

58. Staff welcomes the progress achieved over the past year in implementing the Dodd-Frank Act and global financial reforms. Progress included the issuing of final rules on the submission of resolution plans ("living wills") for systemically important financial institutions (SIFIs); the set up of the orderly liquidation authority; the definition of the criteria behind the designation of SIFIs for enhanced supervision and prudential standards; and the introduction of enhanced capital standards under rules closely aligned with Basel 2.5 as of January 2013. Also, the United States is among the jurisdictions that are close to implementing new rules on centralized clearing of over-the-counter derivatives, in line with G-20 commitments.

59. But more remains to be done to increase the resilience of the U.S. financial system. Given the size of the industry, its prominence in short-term funding markets, and susceptibility to runs, strengthening the regulation of money market mutual funds remains critical, especially as the emergency facility used during the financial crisis to backstop the market is no longer available. Another important remaining task is to reduce the systemic risk deriving from the dependence of the tri-party repo market on intraday liquidity provided by the clearing banks. While the Volcker rule could in principle reduce systemic risk, its effectiveness could be hindered by an expansive interpretation of exemptions allowed under the law and the migration of risky activities outside of the regulatory perimeter. It is also important to minimize the potential adverse spillovers of the rule on foreign entities and markets as well as market liquidity more generally. Removing the uncertainty related to the implementation of the risk-retention provision of the Dodd-Frank Act may help encourage a gradual recovery of private securitization and ease mortgage market conditions. Also, there is a need to fully articulate a medium-term strategy to reduce the role of GSEs, building on the 2011 White Paper, so as to encourage a gradual shift in the mortgage market towards private institutions.

60. At the same time, adequate implementation of the new regulation requires providing appropriate funding to the regulatory and supervisory agencies. Some agencies continue to experience budgetary constraints that limit their ability to meet the deadlines associated with the domestic and international reforms, and may hinder their ability to effectively monitor financial institutions and markets once the new regulations come into force. Staff views the lifting of these constraints as a high priority.

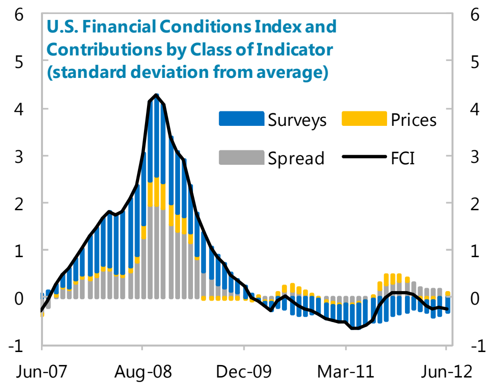
61. A multilateral approach to economic policy management remains critical for systemic countries such as the United States, whose policy actions have significant cross-border effects. In particular, the fiscal consolidation plan would be consistent with the rebalancing of global demand and reduction of global imbalances—together with efforts to increase domestic demand in surplus countries, as highlighted in the G-20 Mutual Assessment Process. At the same time, striking the right balance between fiscal consolidation and macroeconomic policy support would benefit the rest of the world, as it would avoid the risk of a spike in U.S. interest rates in the medium term and an abrupt decline in U.S. growth next year, at a particularly delicate juncture for the world economy. Given the size of cross-border financial linkages, further progress in implementing financial reforms coordinated with other jurisdictions in order to closely align key regulations and standards would be globally beneficial, and reduce the scope for regulatory arbitrage.

62. We welcome the authorities' efforts to resist protectionist pressures, while facing a challenging domestic and global economic environment. We encourage them to continue to ensure consistency of domestic legislation and practices with WTO principles and international obligations, including in reforms of agricultural support programs, and to aim for multilateral trade liberalization, including new approaches as necessary.

63. The next Article IV consultation is scheduled to take place on the standard 12-month cycle.

Box 1. Financial Conditions in the U.S.

After some tightening at the end of 2011, overall financial conditions in the United States loosened in early 2012. Staff's Financial Condition Index—a weighted average of a broad series of financial indicators, with weights given by their contribution to the movements of a common factor (see Matheson, 2011, for further details)—tightened in the last quarter of 2011. Turmoil in global financial markets led to higher credit spreads, weaker asset valuations, and an appreciation of the dollar, more than offsetting the continued easing in U.S. banks lending standards as suggested by surveys. But early in 2012 overall financial conditions in the United States eased again, with lower stress in global financial markets leading to a tightening of spreads and higher asset valuations, while overall bank lending standards remained broadly unchanged.



Source: Matheson (2011); Bloomberg, LP; and Fund staff estimates.
Note: Value above zero line denotes tightening of financial conditions; value below zero line denotes loosening of financial conditions.

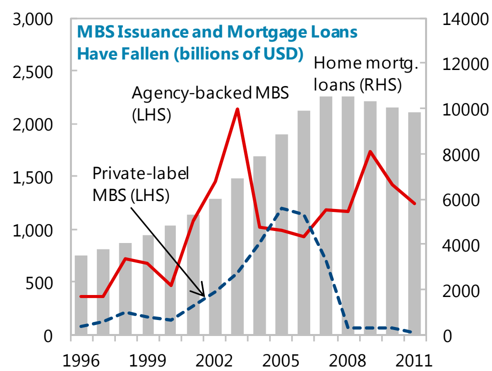
This aggregate picture masks important differences across sectors:

- **Credit conditions facing large corporates continue to be quite accommodative**. Corporates are flush with cash and have easy access to bond finance, while banks have expanded their commercial and industrial loans.

- **Credit conditions for small- and medium-sized businesses are less favorable**. Small businesses rely almost exclusively on credit from banks, and banks' SME lending portfolio is still 15 percent below its peak in 2008. Meanwhile, small- and medium-sized businesses have traditionally relied on personal residence as collateral and have faced difficulties obtaining credit as the value of home collateral remains low. Still, recent surveys suggest that concerns about the sales and profit outlook are driving weak demand for credit, rather than access to credit being a major constraint.

- **Credit conditions for households remain tight**. While consumer loans—e.g., credit cards and auto loans—are stabilizing, tight mortgage lending conditions have curtailed the amount of credit extended to borrowers. Notably, new borrowers' credit scores are higher for both prime and FHA mortgages relative to the pre-crisis years. Additionally, the unresolved issues in the housing sector—shadow inventory, foreclosures, regulatory reform—continue to weigh on banks' appetite and capacity for lending.

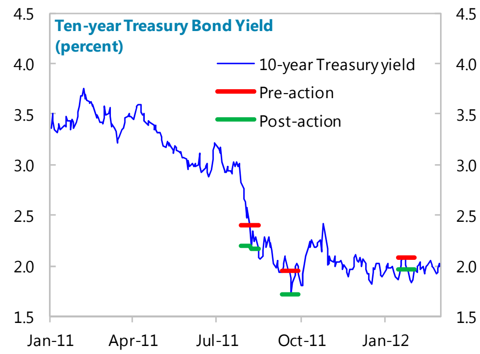
Tight financial conditions for households also reflect the continued weakness of the "shadow" banking system. The "shadow" banking system—including the GSEs, other asset-backed securities providers, broker/dealers, and finance companies—played an important role in credit to the real sector before the crisis, particularly housing finance. With the reduction of its role after the crisis, credit creation has been affected, especially mortgages. Indeed, the decline in home mortgages—from about \$11 trillion in 2007 to about \$10 trillion in 2011—roughly mirrors the \$1 trillion decline in the private-label MBS market, while the volume of GSE-backed MBS is still close to pre-crisis levels. By contrast, corporate bond issuance rose over the same period.



Sources: SIFMA; Flow of Funds Accounts of the United States; and Fund staff estimates.

Box 2. The Effects of Recent U.S. Monetary Policy Actions

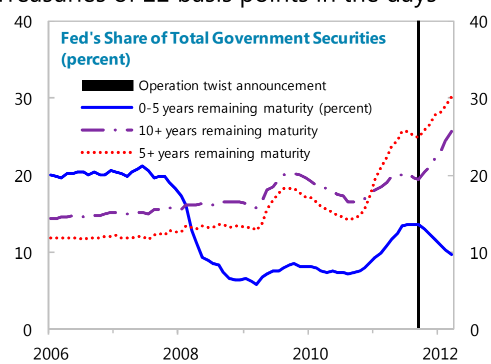
The Fed responded to weaker-than-expected U.S. growth over the past year with a number of unconventional measures to ease financial conditions and support economic activity. The FOMC announced in August 2011 that it anticipated exceptionally low federal funds rates at least through mid-2013, and later (January 2012) extended the period to late-2014. In September 2011, the Fed restarted net purchases of MBS to support the housing sector and launched "Operation Twist" (OT), entailing purchases of up to $400 billion in U.S. Treasuries with maturities above 6 years by June 2012, matched by sales of shorter-term securities.



Source: Haver Analytics.

Staff estimates suggest that Operation Twist was effective in reducing long-term U.S. Treasury yields, but the pass-through to some riskier assets was more than offset by a deteriorating growth outlook. OT aimed at lowering longer-term yields by expanding the share of the outstanding long-term securities held by the Fed. While there is a wide range of estimates, results generally suggest that the Fed's actions had a significant and persistent impact on long-term Treasury yields.

- High frequency event studies show a fall in the ten-year Treasuries of 22 basis points in the days following the announcement, while the 30-year Treasury and agency MBS yields dropped by 30–40 bps. However, the prices of riskier assets (e.g., stock markets and oil prices) declined sharply and the U.S. dollar appreciated. This negative reaction was likely due to the sizable increase in market uncertainty (as measured by the VIX) reflecting concerns with the economic outlook and other adverse news on the same day.
- As a complement to the event studies, staff estimated the sensitivity of the 10-year Treasury yield to the Fed's share of outstanding publicly-held long-term Treasury securities using regression analysis and controlling for underlying economic conditions. The results suggest a decline of 11–50 basis points in the ten-year Treasury rate on the basis of the increase in the Fed's share of long-term government securities since the announcement of OT (through 2012Q1).



Source: Haver Analytics.

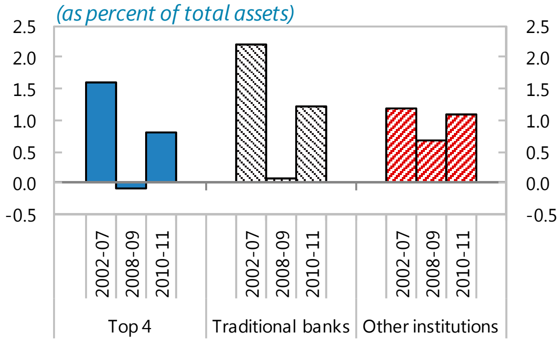
Long-term Treasury and MBS yields also fell following the forward-guidance announcements. By providing explicit forward guidance on the path of the policy rate over a longer period, the Fed helped to lower rates across the yield curve. The communication strategy could be particularly effective under the zero lower bound on policy rates. The 10-year Treasury yields fell by a combined 34 bps in the days following the FOMC statements, while 30-year government securities and MBS drop 20–48 bps. The impact on other (riskier) assets was less noticeable, although stock markets rose and investment-grade yields fell somewhat. The reaction of the U.S. dollar was mixed, depreciating only following the January announcement.

The Fed actions had some impact on mortgage rates. The immediate effect of OT announcement on mortgage rates was subdued (the 30-year mortgage rate fell 7 basis points); however by end-2011, mortgage rates had fallen by 15–20 basis points, partially reflecting the Fed's MBS purchases. In addition, mortgage rates dropped 10–17 basis points following each of the forward guidance announcements; however, the drop was more modest than for the 30-year MBS yields, likely reflecting supply constraints and limited competition.

Box 3. The Health of the U.S. Banking System

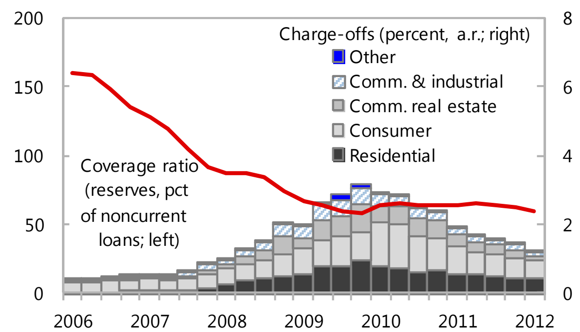
Major U.S. bank holding companies (BHCs) have attempted to strengthen their balance sheets in a challenging operating environment. The major banks have struggled with an environment of low interest rates, an uncertain macroeconomic and regulatory outlook, financial volatility, and continued legal problems. On the whole, banks have realized profits, bolstered capital positions, and girded themselves against shocks. The benefits of these actions were evidenced by most systemic banking institutions performing favorably in the authorities' Spring 2012 Comprehensive Capital Analysis and Review (CCAR) stress test. However, banks continue to be challenged by large European exposures, credit rating downgrades, an uncertain earnings outlook, and investor concerns escalated by a large bank's disclosure of a major trading loss due to deficient risk-management practices. As a result, share prices are low and default risk measures are elevated.

Net Income at Large U.S. BHCs 1/
(as percent of total assets)



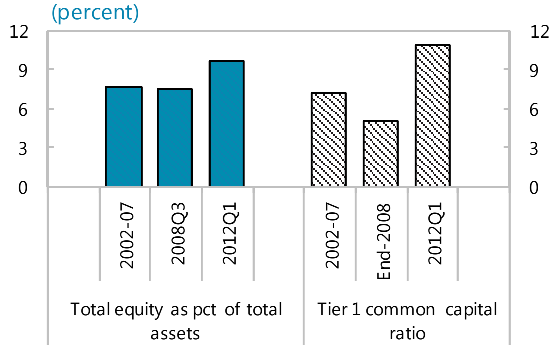
Sources: SNL Financial and Fund staff calculations.
1/ Before taxes and extraordinary items.

Credit Quality Indicators



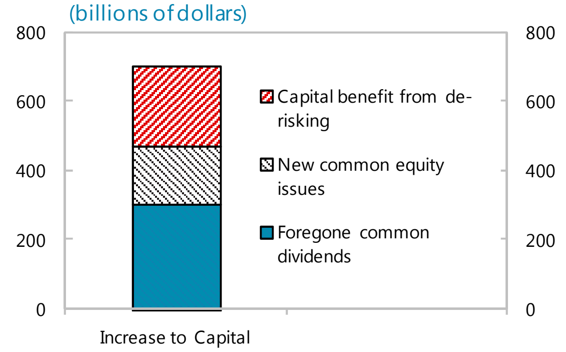
Recent earnings have been volatile and below historical averages. For the full-year 2011, all but one of the 19 CCAR institutions posted positive pre-tax net income. However, banks' earnings are on average lower than in the pre-crisis period at the top 4 BHCs, traditional banks, and other major BHCs. While many factors are contributing to reduced earnings, securitization revenues have been low since the onset of the crisis. Provisioning expenses have supported earnings; however, releases from loan loss reserves have contributed to leave system-wide reserve coverage low by historical standards. Trading revenues have gained in prominence at the top 4 BHCs and the more traditional banks, but they have helped to contribute to significant volatility in net income.

Capital Ratios at Large U.S. BHCs
(percent)



Sources: SNL Financial and Fund staff estimates.

Capital Raising and Benefits
(billions of dollars)



Capitalization has improved substantially since the crisis due to a variety of actions taken by the BHCs. The ratio of total equity to total assets rose to 9.6 percent in the first quarter of 2012, from a low of 7.5 percent in the third quarter of 2008. Likewise, the tier 1 common capital ratio has improved from 5 percent at end-2008 to 10.9 percent as of March, as the composition of capital has shifted towards loss-absorbing common capital. To achieve these gains, the major BHCs have undertaken a variety of measures:

- *Reduced or suspended common dividends*. Over 2008–09, 16 of the 18 publicly-traded CCAR institutions cut common dividends in at least one quarter, in some cases in response to regulators' orders. As banks have become more profitable, bolstered capital positions, and passed regulators stress tests, two-thirds of the

Box 3. The Health of the U.S. Banking System (continued)

publicly traded institutions increased distributions already and more increases are likely, although current common dividends per share remain below 2007 levels at most BHCs.

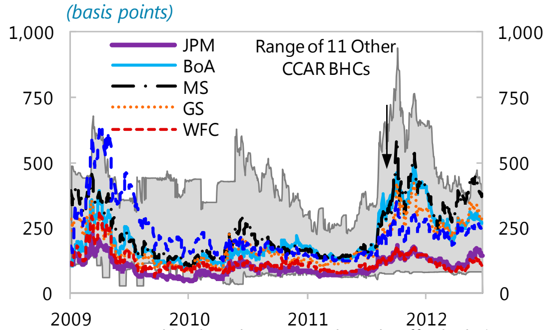
- *Shift toward common equity*. New common equity offerings at the CCAR BHCs have totaled more than $160 billion since 2009. Most transactions occurred as the BHCs raised funds to repay preferred equity issued through the Troubled Asset Relief Program (TARP). New capital issuance has slowed after 2009, when the largest TARP repayments occurred. Transactions in 2010-11 have financed further CCAR institutions' TARP redemptions and acquisitions of new lines of business. Additionally, many BHCs have redeemed trust preferred securities and other preferred equity ahead of the adoption of new capital rules excluding them from regulatory capital. In some cases, BHCs replaced these securities with common equity.
- *Reduced regulatory measures of balance-sheet risk.* Since end-2009, the CCAR institutions' total assets have grown about 10 percent, while risk-weighted assets have decreased 2.8 percent, as banks have recomposed their balance sheets in favor of safer assets. Consequently, the ratio of risk-weighted assets to total assets has fallen to an abnormally low level of 57 percent at the CCAR institutions. Banks have realized a major benefit from de-risking, since they can hold less capital against their assets to maintain a high capital ratio. According to staff estimates, the CCAR BHCs would need to raise about $230 billion in capital if they were to achieve their March tier 1 common capital ratios with a share of risk-weighted assets in total assets in line with historical norms. These actions have reduced the need for banks to further dilute shareholders. Of the 11 BHCs reporting a reduced share of risk-weighted assets to total assets relative to the pre-crisis average, more aggressive de-risking was observed at BHCs that had more depressed share prices relative to their 2007 levels.

The results of the Comprehensive Capital Analysis and Review (CCAR) exercise released in March suggest that the largest U.S. banks would be resilient to a very severe shock. The exercise evaluated the capital adequacy, including capital distribution plans going forward, of the 19 U.S. largest BHCs until end-2013 under stressed scenarios, which included a deep recession, with rising unemployment and plummeting asset prices. The scenario was more severe than those in the 2011 CCAR stress test exercise. Results showed one bank failing to meet the required Tier 1 capital minimum of 5 percent and an additional three institutions missing the required thresholds on the basis of their proposed capital distribution plans. The Fed approved the capital distribution plans of 15 of the 19 institutions and the majority of those outlined increased dividends, share buyback programs or both. Overall the results were reassuring and broadly in line with expectations.

However, market-based measures of the health of the 6 largest U.S. banks' show continued investor concerns, partly reflecting heightened risk aversion worldwide. Recent share prices have remained below their post-Lehman highs, partly reflecting perceptions of both intensifying risks and a weakening outlook. Heightened concerns over banks have not been confined to the U.S., as equity prices for Asian and European banks are also broadly down. In line with depressed share prices, CDS spreads for the 6 largest BHCs have been ratcheting up recently to levels well above the lows achieved in the post-Lehman era. The rise is due in part to concerns about individual BHC's funding structures, exposures to Europe, and expected rating actions, as well as worries about financial institutions globally—the price for credit protection on European banks' debts has also risen.

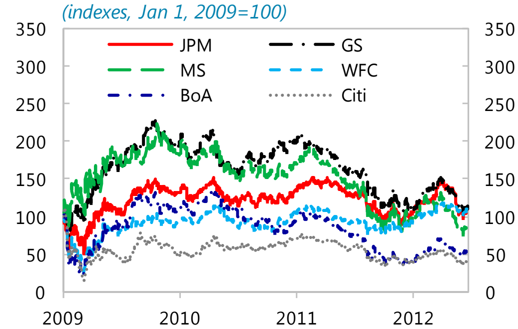
Five-Year Credit Default Swap Spreads

(basis points)



Top 6 BHC's Equity Prices

(indexes, Jan 1, 2009=100)

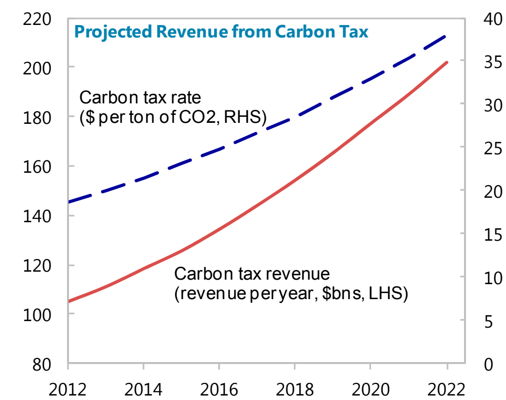


Sources: Markit; Bloomberg, LP; and Fund staff calculations.

Box 4. Meeting Environmental and Fiscal Objectives with a Carbon Tax

The carbon tax is an effective instrument to reduce environmental risks from carbon emissions. Atmospheric accumulations of CO_2 and other greenhouse gases could raise temperatures by up to 6.5 degrees of Celsius over pre-industrial levels by 2100, with substantial risks to the global economy. A carbon tax would provide incentives to reduce emissions and invest in energy-efficient and renewable technologies. Several countries have implemented carbon taxes or similar fiscal instruments—for example, Finland, Netherlands, Norway, Sweden, and Denmark in the early 1990s, and Ireland and Australia more recently. The U.S. Interagency Working Group recommended a carbon tax of about $20 per metric ton of CO_2[1] Such a tax could be raised by about 2–5 percent annually in real terms, cutting emissions by 5–15 percent.

The carbon tax could raise substantial new budgetary revenue, about $100 billion annually, or 0.6 percent of GDP.[2] Imposing the tax could somewhat reduce economic growth in the short term, but the negative medium-term effects should be very modest, especially if the new revenues are used to reduce the national debt or partly lower the burden of other taxes. The potential negative effects would also be mitigated by granting U.S. companies tax credits for purchasing emission offsets abroad—this strategy would also be supportive of financial flows to developing countries.



Source: Krupnick at al. (2010).

The carbon tax is straightforward to administer. The tax can be applied to the carbon content of fossil fuel products 'upstream' in the supply chain, as a natural extension of the existing motor fuel taxes. The tax administration would primarily involve approximately 150 petroleum refineries, 500 large natural gas operators, and about 1,500 coal mines. Motor fuels should not be exempt from the carbon tax as the current fuel taxes (which should continue to be levied) undercharge for the negative side effects of vehicle use such as road congestion and local pollution.

The carbon tax would have distributional effects which need to be addressed through targeted mitigation policies. A $20 carbon charge would increase gasoline prices by about 18 cents a gallon, electricity prices by 1 cent per kWh, and coal prices by $40 per short ton. The carbon charges tend to be regressive, but low-income households could be compensated through transfer payments, earned income tax credits, and higher personal tax thresholds costing less than 10 percent of carbon tax revenues.[3] Energy-intensive, trade-exposed firms could also be granted transitory production subsidies.

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[1] See Interagency Working Group on Social Cost of Carbon. 2010. *Social Cost of Carbon for Regulatory Impact Analysis under Executive Order 12866*. United States Government.

[2] Source: A. Krupnick, et al., 2010. *Towards a New National Energy Policy: Assessing the Options.* Resources for the Future and National Energy Policy Institute, Washington, DC.

[3] See T. Dinan, 2009 (Congressional Budget Office). *The Distributional Consequences of a Cap-and-Trade Program for CO2 Emissions*. Statement to the Subcommittee on Income Security and Family Support, Committee on Ways and Means, U.S. House of Representatives.

Box 5. Recent Housing Policies and Remaining Frictions

The Administration has adopted, since 2009, a series of programs to address the foreclosure crisis. At the center of the Administration's response to the housing crisis is the Making Home Affordable (MHA) program, which was launched in March 2009, and included two key components: the Home Affordable Refinance Program (HARP) and the Home Affordable Modification Program (HAMP).

The impact of the modification and refinancing programs has been so far too muted to make a dent in the foreclosure crisis. Both HAMP and HARP were expected to reach millions of borrowers. While 1.8 million modifications have been initiated under HAMP as of May 2012 (since the program started in April 2009), only one million of these were made permanent. HARP has reached only around a million borrowers, which is far below the potential given the large share of borrowers who are paying above-market interest rates in the universe of GSE-owned and guaranteed loans.

More recently, these programs were expanded.

In October 2011, The FHFA expanded **HARP** by removing restrictions on very high loan-to-value (LTV) loans, lowering the refinancing fees charged by the GSEs, and easing representations and warranties (the legal obligation for originators to repurchase badly underwritten mortgages that become delinquent). In Q1-2012, average monthly HARP refinancing has been around 75 percent higher than its average in 2011. This suggests that the program has had a material impact on the ability of high LTV borrowers to refinance.

As of June 2012 eligibility criteria for **HAMP** were loosened by allowing households with lower debt service-to-income ratios to participate, and incentives for investors to carry out principal reductions under HAMP-PRA were tripled. These incentives were also extended to the GSEs. The Federal Housing Finance Agency (FHFA) is expected to make a final decision on the GSEs' participation in HAMP. The participation of the GSEs would increase the impact of the program given their market share.

However, remaining barriers and frictions in the programs could continue to hamper their success.

- The recent expansion of HARP has eased representations and warranties only for same-servicer refinancing. Refinancing with another servicer (cross-servicer refinancing) remains very challenging for high loan-to-value borrowers. This lack of competition has been a major contributing factor to the weak refinancing activity.
- The disappointing results of the old HAMP have been due to several factors some of which remain unaddressed under the new version. These include, among others: (a) a misalignment of the incentives of investors and servicers due to the fact that modifications can be, in some cases, more costly to servicers than foreclosures, (b) conflicts of interest between senior and junior lien holder, a problem that the "Second Lien Modification Program" tries to address, and (c) legal frictions due to ambiguities in the Pooling and Servicing Arrangements which can limit modifications both explicitly and implicitly.

The Administration has recently proposed to further expand HARP by addressing additional frictions and extending it to non-GSE loans. In the Administration proposals, representations and warranties on cross-servicer refinancing would be eased in order to encourage competition on the refinancing market. The proposal also aims to provide access to low-cost refinancing for non-GSE mortgages through the FHA. Three recently proposed bills aim at implementing these proposals, but approval by Congress is uncertain. If approved, the proposed changes would likely lead to a significant increase in refinancing. However, if rejected, the FHFA has the authority to implement the proposed changes for the GSE market.

Box 6. Progress in Addressing U.S. FSAP Recommendations

Over the last year, further progress has been made in addressing the U.S. FSAP recommendations. The authorities have continued to advance in the implementation of the DFA, as described also in section E, which addresses the majority of the U.S. FSAP recommendations.

The restructuring, albeit limited, of the regulatory architecture has been completed. The transfer of the responsibilities of the Office of Thrift Supervision (OTS) to the OCC, the FDIC, and the Fed has been completed, and the Federal Insurance Office (FIO) and the Consumer Financial Protection Bureau (CFPB) have become fully operational. However, challenges remain in coordinating the regulation and supervision of commercial banks, thrifts, securities and derivative markets.

Regulation and supervision of the financial sector has been strengthened. The banking agencies have begun to conduct annual stress tests, including within the CCAR, frequently conduct assessments across the largest firms and meet periodically, also with foreign regulators, to discuss supervision of these firms. The Fed proposed a rule to implement stricter prudential regulation for the largest BHCs and for SIFIs. The CFTC has finalized the regulation of derivative clearing organizations (DCOs) and proposed rules with regard to capital and margins for un-cleared swaps, and the SEC has proposed rules to improve the risk management of central clearing counterparties (CCCPs). In the insurance sector, rules to strengthen the supervision of insurance groups, the regulation of bond insurance and securities lending, and to increase information sharing among state and federal authorities have been adopted. Resolution plans for large and complex financial groups, “living wills”, are being finalized to meet the deadlines for submission to regulators which span over the period between July 1, 2012 and end 2013 according to the size of the group.

Box 7. Recent Proposals on GSEs Reforms

In February 2011, the Administration issued a report to Congress containing three alternative options for winding down the GSEs and reducing the government's role in housing finance:

- The first option is a completely privatized system of housing finance, with government insurance limited to low-income and other special borrowers, such as veterans.

- The second offers a plan similar to the one above, but would develop "a backstop mechanism" to ensure that new homeowners retain access to credit during a crisis.

- In the third option, the government would continue to leave the mortgage market to private players, but would offer reinsurance for the securities backed by a targeted range of mortgages.

In February 2012, the FHFA set out a strategic plan outlining the next phase of the conservatorships of the GSEs, outlining three key strategic goals:

- Building a new infrastructure that would allow private investors to replace the GSEs in the secondary mortgage market including by helping to create a single securitization platform, a standardized pooling and servicing agreement, and databases that would increase transparency for borrowers and investors;

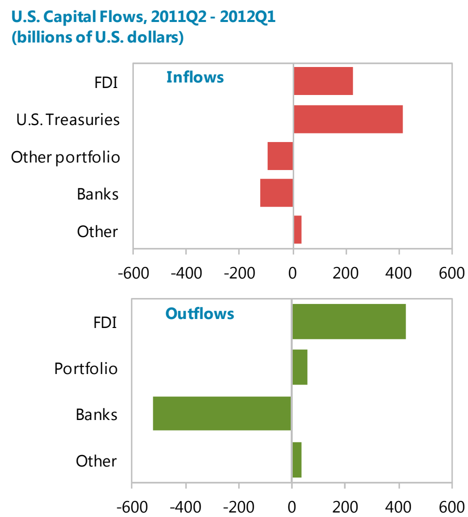
- Contracting the GSEs' footprint and transferring credit risk to private investors through increased guarantee fees, loss-sharing arrangements, and greater reliance on mortgage insurance;

- Maintaining foreclosure prevention efforts through loan modifications, increased focus on short-sales and other foreclosure alternatives, and the implementation of real estate owned (REO) initiative.

Staff will examine reform plans in future consultations.

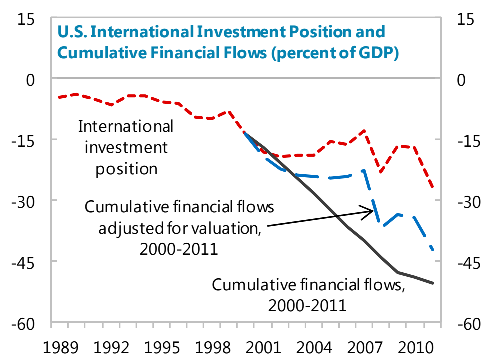
Box 8. The U.S. External Sector: Trends and Model-Based Assessments

After staging a strong rebound in late 2010 and early 2011, capital flows to and from the United States have slowed significantly with the intensification of global financial turmoil. During the period 2011Q2–2012Q1 net purchases of U.S. assets by foreign residents were around 3 percent of GDP, entirely accounted for by foreign purchases of Treasury securities. During the same period net purchases of foreign assets by U.S. residents were virtually zero, with significant FDI and very modest portfolio outflows offset by a $600bn reduction in external bank claims (primarily on the euro area, the United Kingdom, and the Caribbean).



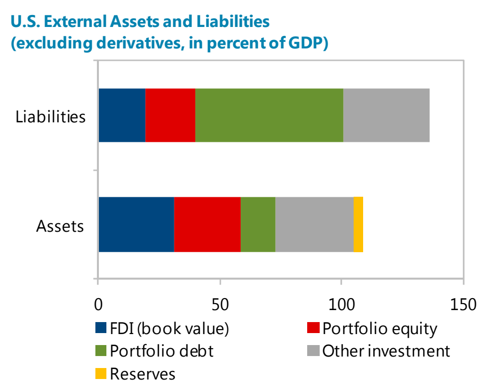
Sources: Bureau of Economic Analysis and Fund staff estimates.

The U.S. NIIP worsened by $1.5 trillion in 2011, reflecting the current account deficit as well as unfavorable valuation effects primarily due to the decline in foreign equity prices (reducing U.S. assets by some $570 billion) and the increase in the value of U.S. bonds due to lower U.S. interest rates (which increased U.S. liabilities by some $250 billion). As of end-2011 the NIIP stood at -27 percent of GDP, a relatively modest level if compared to cumulative net financial flows to the U.S., which are around 50 percent of GDP, also thanks to largely favorable net valuation effects over that period. Based on staff projections for current account balances and growth over the next five years, the U.S. NIIP would gradually deteriorate to -35 percent of GDP by 2017.



Sources: Bureau of Economic Analysis and Fund staff estimates.

U.S. external assets and liabilities have a different instrument and currency composition. U.S. external assets are predominantly denominated in foreign currency, with FDI and portfolio equity together accounting for over 50 percent of total assets excluding financial derivatives. Hence the value of U.S. external assets (and the U.S. NIIP) tends to decline in periods of stress on global stock markets and an appreciating dollar. In contrast, the lion share of U.S. external liabilities are dollar-denominated and consist of debt instruments, consistent with the central role of U.S. government debt securities as reserve assets. U.S. portfolio debt liabilities account for about 45 percent of total U.S. liabilities and about 60 percent of U.S. GDP.



Sources: Bureau of Economic Analysis and Fund staff estimates.

The U.S. dollar has appreciated in recent months (some 7 percent since its trough in July 2011) but remains some 10 percent below its long-run average. An alternative measure of international relative prices constructed by the Federal Reserve Board (measuring the level of U.S. prices relative to those prevailing in its trading partners) is instead closer to its long-run average, reflecting on the one hand the depreciated level of the dollar, and on the other hand the shift in U.S. trading partners over time towards countries with lower price levels than advanced economies.

Box 8. The U.S. External Sector: Trends and Model-Based Assessments (continued)

Model-based current account and exchange rate assessments

Model-based estimates suggest that the current account deficit is above its medium-term norm and that the real exchange rate is moderately overvalued. Specifically, staff's analysis finds that a structural current account deficit of 1½–2½ percent of GDP over the medium term (implying a current account adjustment of 1–2 percent of GDP relative to the staff baseline) and real exchange rate depreciation of about 0–15 percent would be consistent with fundamentals and desirable policy settings.

- Under the new External Balance Approach (EBA), estimates of "policy gaps" (measuring deviations of domestic and partner-country policies, such as the relative fiscal stance or reserve accumulation, from "desirable" levels) imply a current account gap for the United States of around 2 percent of GDP.[1] Similarly, CGER current account methodologies (such as the MB and ES approaches) find current account gaps of around 1-2 percent of GDP.

- Estimates based on real exchange rate models in both EBA and CGER tend to find little sign of overvaluation (0 to 5 percent), with the worsening in fundamentals, such as the terms of trade and the NIIP, broadly offset by the weakness of the dollar relative to its historical average (see above). Measures of relative international price levels, such as the WARP—which find U.S. prices relative to those in trading partners closer to their long-run average—could be consistent with somewhat higher overvaluation, given the weak fundamentals. The estimates for real exchange rate misalignment from the current-account based methodologies mentioned above are in the 5–15 percent range, implying an overall model-based range of about 0–15 percent.

[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					
	2010	2011	2012	2013	2014	2015	2016	2017
National production and income								
Real GDP	3.0	1.7	2.0	2.3	2.8	3.3	3.4	3.3
Net exports 2/	-0.5	0.0	-0.1	-0.2	-0.2	-0.3	-0.3	-0.3
Total domestic demand	3.4	1.6	2.0	2.3	2.9	3.5	3.6	3.5
Final domestic demand	1.8	1.8	1.9	2.3	2.9	3.4	3.6	3.5
Private final consumption	2.0	2.2	2.2	2.3	2.4	2.5	2.8	3.2
Public consumption expenditure	0.9	-1.2	-2.1	-2.0	-0.4	1.4	1.6	0.0
Gross fixed domestic investment	2.0	3.7	4.8	6.8	8.2	9.1	8.5	7.3
Private fixed investment	2.6	6.8	6.6	8.3	10.3	11.0	9.8	8.4
Equipment and software	14.6	10.4	6.7	7.0	8.0	7.7	7.6	7.6
Nonresidential structures	-15.8	4.6	3.3	7.8	8.4	9.0	9.4	10.7
Residential structures	-4.3	-1.3	10.4	12.8	18.8	21.1	15.1	8.2
Public fixed investment	-0.3	-6.7	-2.0	0.8	-0.6	0.4	1.4	0.8
Change in private inventories 2/	1.6	-0.2	0.2	0.1	0.0	0.0	0.0	0.0
Nominal GDP	4.2	3.9	3.9	3.7	4.3	5.0	5.3	5.5
Personal saving rate (percent of disposable income)	5.3	4.7	3.8	3.8	3.6	3.9	4.2	4.2
Private investment rate (percent of GDP)	12.4	12.7	13.3	14.0	14.8	15.8	16.6	17.2
Employment and inflation								
Unemployment rate	9.6	9.0	8.2	7.9	7.5	6.9	6.3	5.9
Output gap (percent of potential GDP)	-4.3	-4.3	-4.1	-3.9	-3.2	-2.2	-1.2	-0.3
Potential GDP	1.2	1.7	1.9	2.0	2.1	2.3	2.3	2.4
CPI inflation	1.6	3.1	2.2	1.7	1.8	1.9	2.1	2.2
GDP deflator	1.1	2.1	1.8	1.4	1.4	1.6	1.9	2.1
Government finances								
Federal government (budget, fiscal years)								
Federal balance (percent of GDP)	-9.7	-9.0	-7.5	-6.0	-4.5	-3.3	-3.3	-3.2
Debt held by the public (percent of GDP)	62.8	67.7	73.0	77.1	79.1	79.3	79.1	78.7
General government (GFSM 2001, calendar years)								
Net lending (percent of GDP)	-10.5	-9.6	-8.2	-6.8	-5.2	-4.3	-4.3	-4.3
Primary structural balance (percent of potential nominal GDP)	-6.2	-5.4	-4.3	-3.0	-1.7	-1.1	-1.3	-1.3
Gross debt (percent of GDP)	98.4	102.8	106.7	110.7	112.7	113.0	113.0	112.8
Interest rates (percent)								
Three-month Treasury bill rate	0.1	0.1	0.1	0.1	0.1	0.7	1.8	3.4
Ten-year government bond rate	3.2	2.8	2.1	2.8	3.6	4.5	5.1	5.6
Balance of payments								
Current account balance (billions of dollars)	-442	-466	-491	-479	-512	-559	-616	-690
Merchandise trade balance (billions of dollars)	-645	-738	-769	-817	-882	-952	-1,022	-1,118
Balance on invisibles (billions of dollars)	203	272	278	338	370	393	406	428
Current account balance (percent of GDP)	-3.0	-3.1	-3.1	-2.9	-3.0	-3.1	-3.3	-3.5
Merchandise trade balance (percent of GDP)	-4.4	-4.9	-4.9	-5.0	-5.2	-5.3	-5.4	-5.7
Balance on invisibles (percent of GDP)	1.4	1.8	1.8	2.1	2.2	2.2	2.2	2.2
Export volume 3/	14.4	7.4	4.1	4.1	4.8	5.2	5.4	5.5
Import volume 3/	14.8	5.7	3.7	4.8	5.5	5.8	6.0	6.3
Net international investment position (percent of GDP)	-17.0	-26.7	-28.5	-30.0	-31.3	-32.5	-33.7	-35.0

Sources: Haver Analytics and Fund 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 1. United States: Selected Economic Indicators (Cont.'d) 1/

(percentage change from previous period, unless otherwise indicated)

			Projections					
	2010	2011	2012	2013	2014	2015	2016	2017
Saving and investment (percent of GDP)								
Gross national saving	12.5	12.9	13.3	14.1	14.8	15.6	16.1	16.5
General government	-6.6	-6.0	-4.6	-3.3	-1.7	-1.0	-0.9	-1.0
Private	19.2	18.9	17.9	17.4	16.5	16.6	17.0	17.5
Personal	4.1	3.6	2.9	2.9	2.8	3.0	3.2	3.2
Business	15.1	15.3	15.1	14.6	13.8	13.6	13.9	14.3
Gross domestic investment	15.8	15.9	16.4	17.1	17.8	18.7	19.4	20.0
Private	12.4	12.7	13.3	14.0	14.8	15.8	16.6	17.2
Fixed investment	11.9	12.4	12.9	13.5	14.4	15.3	16.1	16.7
Inventories	0.5	0.3	0.5	0.5	0.5	0.5	0.5	0.5
Public	3.5	3.2	3.1	3.1	3.0	2.9	2.8	2.8

Sources: Haver Analytics and Fund staff estimates.

1/ Components may not sum to totals due to rounding.

Table 2. United States: Balance of Payments

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

				Projections					
	2009	2010	2011	2012	2013	2014	2015	2016	2017
Current account	-382	-442	-466	-491	-479	-512	-559	-616	-690
Percent of GDP	-2.7	-3.0	-3.1	-3.1	-2.9	-3.0	-3.1	-3.3	-3.5
Goods and services	-379	-495	-560	-587	-609	-652	-704	-757	-839
Merchandise trade	-506	-645	-738	-769	-817	-882	-952	-1,022	-1,118
Exports	1,070	1,289	1,497	1,563	1,621	1,713	1,828	1,964	2,108
Imports	-1,575	-1,934	-2,236	-2,332	-2,438	-2,595	-2,780	-2,986	-3,227
Services	127	150	179	182	208	230	249	265	279
Receipts	509	554	606	629	665	707	753	804	858
Payments	-383	-403	-427	-447	-457	-477	-505	-539	-579
Income	120	184	227	229	260	272	276	276	288
Receipts	602	676	745	666	576	561	659	909	1,381
Payments	-482	-492	-518	-437	-317	-289	-383	-633	-1,093
Unilateral transfers, net	-122	-131	-133	-133	-129	-133	-131	-134	-139
Capital account transactions, net	0	0	-1	-1	-1	-1	-1	-1	-1
Financial account	246	254	394	493	480	514	560	617	692
Private capital	-688	-109	359	257	236	259	293	335	395
Direct investment	-145	-115	-178	-177	-176	-185	-192	-201	-210
Outflows	-304	-351	...	...	...	...	...	...	...
Inflows	159	236	...	...	...	...	...	...	...
Securities	-123	269	50	377	400	408	426	449	472
Other investment	-420	-263	488	57	12	36	59	87	133
U.S. official reserves	-52	-2	-16	0	0	0	0	0	0
Foreign official assets	480	350	165	235	244	254	267	281	297
Other items 1/	608	31	-92	0	0	0	0	0	0
Statistical discrepancy	131	217	80	0	0	0	0	0	0
Memo item: Current account excluding petroleum	-163	-159	-118	-141	-135	-166	-204	-253	-315

Sources: Haver Analytics; and Fund staff estimates.

1/ Includes net financial derivatives.

Table 3. United States: Federal and General Government Finances 1/
(percent of GDP)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
			Projections										
Federal Government						(budget basis; fiscal years)							
Revenue	15.1	15.4	15.8	17.1	18.0	19.0	19.4	19.2	19.2	19.2	19.3	19.4	19.4
Expenditure	24.7	24.4	23.3	23.1	22.5	22.4	22.6	22.4	22.4	23.0	23.4	23.7	24.2
Noninterest 2/	23.4	22.8	21.8	21.6	21.0	20.6	20.6	20.1	19.8	20.0	20.0	20.1	20.4
Interest	1.4	1.5	1.4	1.5	1.5	1.7	2.0	2.3	2.6	3.0	3.3	3.6	3.8
Balance 2/	-9.7	-9.0	-7.5	-6.0	-4.5	-3.3	-3.3	-3.2	-3.2	-3.8	-4.1	-4.4	-4.8
Primary balance 3/	-8.3	-7.4	-6.0	-4.5	-2.9	-1.6	-1.3	-0.9	-0.6	-0.8	-0.8	-0.8	-1.0
Primary structural balance 4/	-6.6	-5.9	-4.8	-3.4	-2.0	-0.9	-0.9	-0.8	-0.6	-0.8	-0.8	-0.8	-1.0
Debt held by the public	62.8	67.7	73.0	77.1	79.1	79.3	79.1	78.7	78.8	79.7	80.9	82.3	84.0
Net debt held by the public	55.7	62.0	66.5	69.9	71.3	71.4	71.3	70.9	70.9	71.9	73.2	74.7	76.6
General Government						(GFSM 2001 basis; calendar years)							
Revenue	31.7	31.8	32.2	33.5	34.4	35.2	35.4	35.2	35.2	35.2	35.1	35.1	...
Total expenditure 2/	42.1	41.4	40.4	40.3	39.6	39.5	39.7	39.4	39.7	40.1	40.4	40.7	...
Net lending 2/	-10.5	-9.6	-8.2	-6.8	-5.2	-4.3	-4.3	-4.3	-4.5	-4.9	-5.2	-5.6	...
Primary balance 3/	-8.5	-7.4	-6.1	-4.7	-3.0	-2.0	-1.8	-1.5	-1.3	-1.5	-1.5	-1.5	...
Primary structural balance 4/	-6.2	-5.4	-4.3	-3.0	-1.7	-1.1	-1.3	-1.3	-1.3	-1.5	-1.5	-1.5	...
Gross debt	98.4	102.8	106.7	110.7	112.7	113.0	113.0	112.8	113.6	114.9	116.5	118.3	...
Net debt	73.1	80.2	83.3	86.7	88.2	88.4	88.4	88.3	89.0	90.5	92.2	94.1	...

Sources: Office of Management and Budget; Haver Analytics; and Fund 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/
(GFSM 2001 basis, calendar years; in percent of GDP)

	2006	2007	2008	2009	2010	2011
Revenue	33.8	33.9	32.5	30.9	31.7	31.8
Taxes	21.2	21.3	19.6	17.6	18.4	...
Social contributions	6.9	6.9	6.9	7.0	6.8	...
Grants	0.0	0.0	0.0	0.0	0.0	...
Other revenue	5.7	5.8	5.9	6.4	6.5	...
Expenditure 3/	35.9	36.7	39.2	44.0	42.1	41.4
Expense	34.8	35.5	38.1	42.9	41.1	40.4
Compensation of employees	9.9	10.0	10.3	11.0	10.8	...
Use of goods and services	7.9	8.0	8.6	8.8	9.0	...
Consumption of fixed capital	1.2	1.3	1.4	1.5	1.5	...
Interest	2.8	3.0	2.8	2.6	2.8	...
Subsidies	0.5	0.4	0.4	0.4	0.4	...
Grants	0.3	0.3	0.3	0.3	0.4	...
Social benefits	11.9	12.1	13.0	15.2	15.6	...
Of which: social security benefits	7.6	7.7	8.2	9.6	9.7	...
Expense not elsewhere classified	2.3	2.5	3.4	5.2	3.0	...
Net acquisition of nonfinancial assets	1.0	1.1	1.0	1.1	1.0	1.0
Gross/net operating balance 2/	-1.0	-1.6	-5.6	-11.9	-9.5	-8.6
Net lending/borrowing 3/	-2.0	-2.7	-6.7	-13.0	-10.5	-9.6

Source: Government Finance Statistics.
1/ Data for 2011 are IMF staff estimates.
2/ Revenue minus expense.
3/ Includes staff's adjustments for one-off items, including the costs of financial sector support.

Table 4b. General Government Financial Assets and Liabilities

(in percent of GDP)

	2006	2007	2008	2009	2010	2011
Net financial worth	-48.6	-48.2	-53.8	-65.9	-73.1	-80.2
Total financial assets	18.0	19.0	22.4	24.0	25.4	22.6
Currency and deposits	2.3	2.6	4.9	4.0	4.9	3.2
Debt securities	6.5	6.6	6.3	7.1	6.8	5.5
Loans	3.1	3.1	3.2	4.5	5.2	5.8
Equity and investment fund shares	1.5	1.6	2.7	2.2	1.9	1.8
U.S. official reserve assets	0.3	0.3	0.3	0.7	0.7	0.7
Other financial asssets	4.4	4.8	5.0	5.6	5.9	5.6
Total financial liabilities	66.6	67.2	76.1	89.9	98.4	102.8
Currency and deposits	0.2	0.2	0.2	0.2	0.2	0.2
Debt securities	53.0	53.1	61.3	73.9	82.1	86.1
Loans	0.0	0.0	0.0	0.0	0.0	0.0
Accounts payable	5.4	5.6	6.0	6.0	6.1	6.3
Insurance reserves	0.3	0.3	0.3	0.3	0.3	0.3
Other financial liabilities	7.6	7.8	8.3	9.1	9.3	9.5
SDR allocations and certificates	0.1	0.1	0.1	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

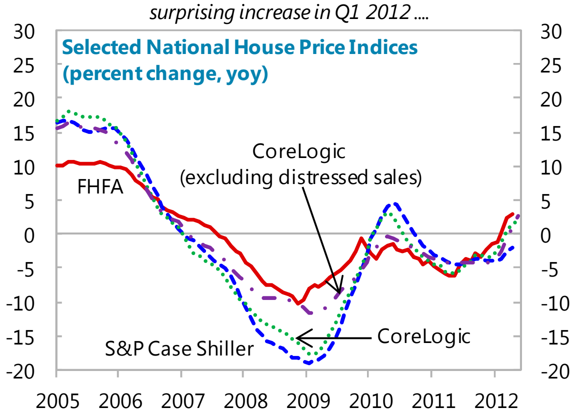
	2005	2006	2007	2008	2009	2010	2011
External indicators	(in percent of GDP, unless otherwise indicated)						
Exports of goods and services 1/	10.7	13.4	13.3	11.4	-14.3	16.7	14.2
Imports of goods and services 1/	12.9	10.9	6.2	8.1	-22.9	19.4	13.9
Terms of trade 1/	-4.0	-1.2	0.6	-4.9	7.8	-1.9	-2.6
Current account balance	-5.9	-6.0	-5.1	-4.7	-2.7	-3.2	-3.1
Capital and financial account balance	5.5	6.0	4.4	5.2	2.1	1.8	2.7
Of which:							
Net portfolio investment	4.6	4.7	5.5	5.6	0.0	3.7	1.0
Net foreign direct investment	0.6	0.0	-1.4	-0.1	-1.0	-0.8	-1.2
Net other investment 4/	0.3	1.1	0.3	-0.1	2.8	-1.3	2.9
Official reserves 2/	65.1	65.9	70.6	77.6	130.8	132.4	148.0
in months of imports	0.4	0.4	0.4	0.4	0.8	0.7	0.7
Central bank foreign liabilities 2/	0.1	0.1	0.1	1.4	2.4	3.4	0.2
Net international investment position 5/	-15.3	-16.4	-12.8	-22.8	-16.7	-17.0	-26.7
Of which: General government debt 6/	18.8	20.4	22.7	28.8	31.4	35.1	37.7
External debt-to-exports ratio	1.5	1.5	1.1	1.8	1.5	1.3	1.9
External interest payments to imports 3/ 7/	25.8	32.5	35.7	28.3	23.0	18.1	16.4
Nominal effective exchange rate 1/	-5.0	-2.5	-1.7	-4.9	-3.9	5.5	-3.3
Real effective exchange rate 1/	-4.7	-1.4	-0.6	-4.7	-3.9	4.5	-3.9
Financial market indicators	(in percent of GDP, unless otherwise indicated)						
General government gross debt	67.9	66.6	67.2	76.1	89.9	98.4	102.8
Average maturity of privately-held federal debt (months)	57	58	57	46	52	57	59
Federal privately-held debt maturing within one year	9.3	8.5	9.2	16.8	17.3	17.5	17.5
Three-month treasury bill yield 3/	3.2	4.8	4.5	1.4	0.2	0.1	0.1
Real three-month treasury bill yield 3/	-1.2	-0.1	1.6	1.6	-2.3	0.5	-1.5
Equity market index (S&P 500) 1/	6.8	8.6	12.7	-17.3	-22.5	20.3	11.4
Banking risk indicators 8/	(in percent, unless otherwise indicated)						
Total assets 2/	10,879	11,862	13,034	13,841	13,087	13,319	13,883
Total loans and leases to assets	61.8	61.0	60.7	56.9	55.6	55.4	53.8
Total loans to deposits	94.1	92.4	94.0	87.1	78.9	78.3	73.3
Problem loans to total loans and leases 9/	0.7	0.8	1.4	3.0	5.4	4.9	4.1
Nonperforming assets to assets 10/	0.5	0.5	0.9	1.8	3.4	3.1	2.5
Loss allowance to:							
Total loans and leases	1.2	1.1	1.3	2.2	3.1	3.1	2.6
Noncurrent loans and leases	154.7	134.8	91.7	74.4	57.7	64.5	62.5
Return on equity 11/	17.8	17.2	11.2	-1.6	-0.5	8.1	10.8
Return on assets 11/	1.8	1.8	1.2	-0.1	-0.1	0.9	1.2
Total capital to risk-weighted assets	12.9	13.0	12.8	12.8	14.3	15.3	15.3
Core capital ratio	8.2	8.2	8.0	7.5	8.6	8.9	9.1

Sources: IMF, *International Financial Statistics*; Federal Deposit Insurance Corporation; and Haver Analytics.

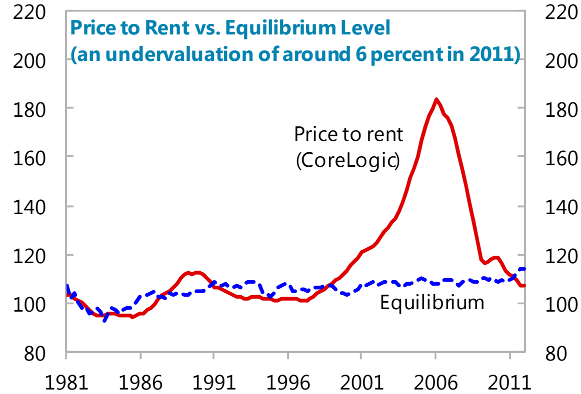
1/ Percent change. 2/ Billions of U.S. dollars. 3/ Percent. 4/ Includes net financial derivatives. 5/ With FDI at market value. 6/ Excludes foreign private holdings of U.S. government securities other than treasuries. 7/ External interest payments: income payments on foreign-owned assets (other private 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. House Prices and Mortgage Market Developments

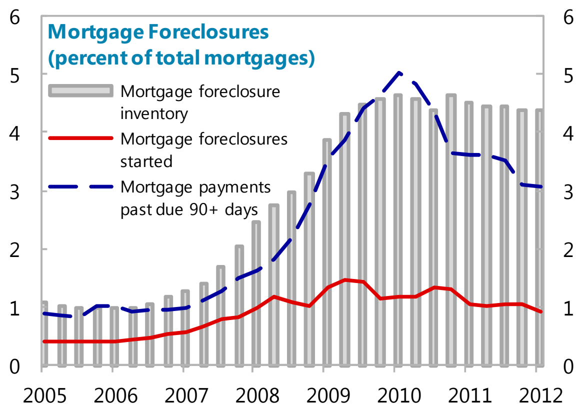
House prices have shown some firming recently, with a surprising increase in Q1 2012 ....



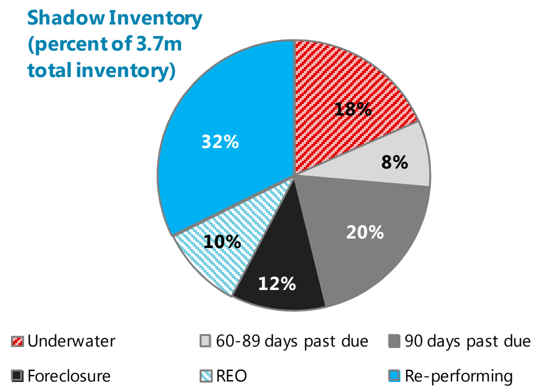
... although they still remain at depressed levels.



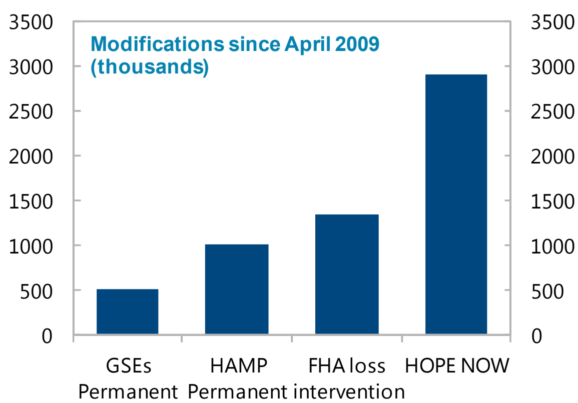
Risks remain, due to a large foreclosure inventory...



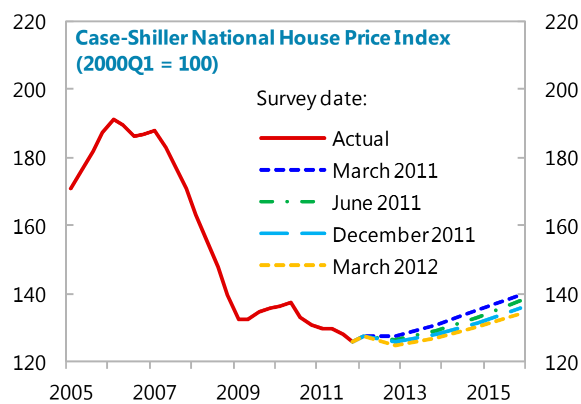
... and a large shadow inventory....



... despite foreclosure prevention efforts.

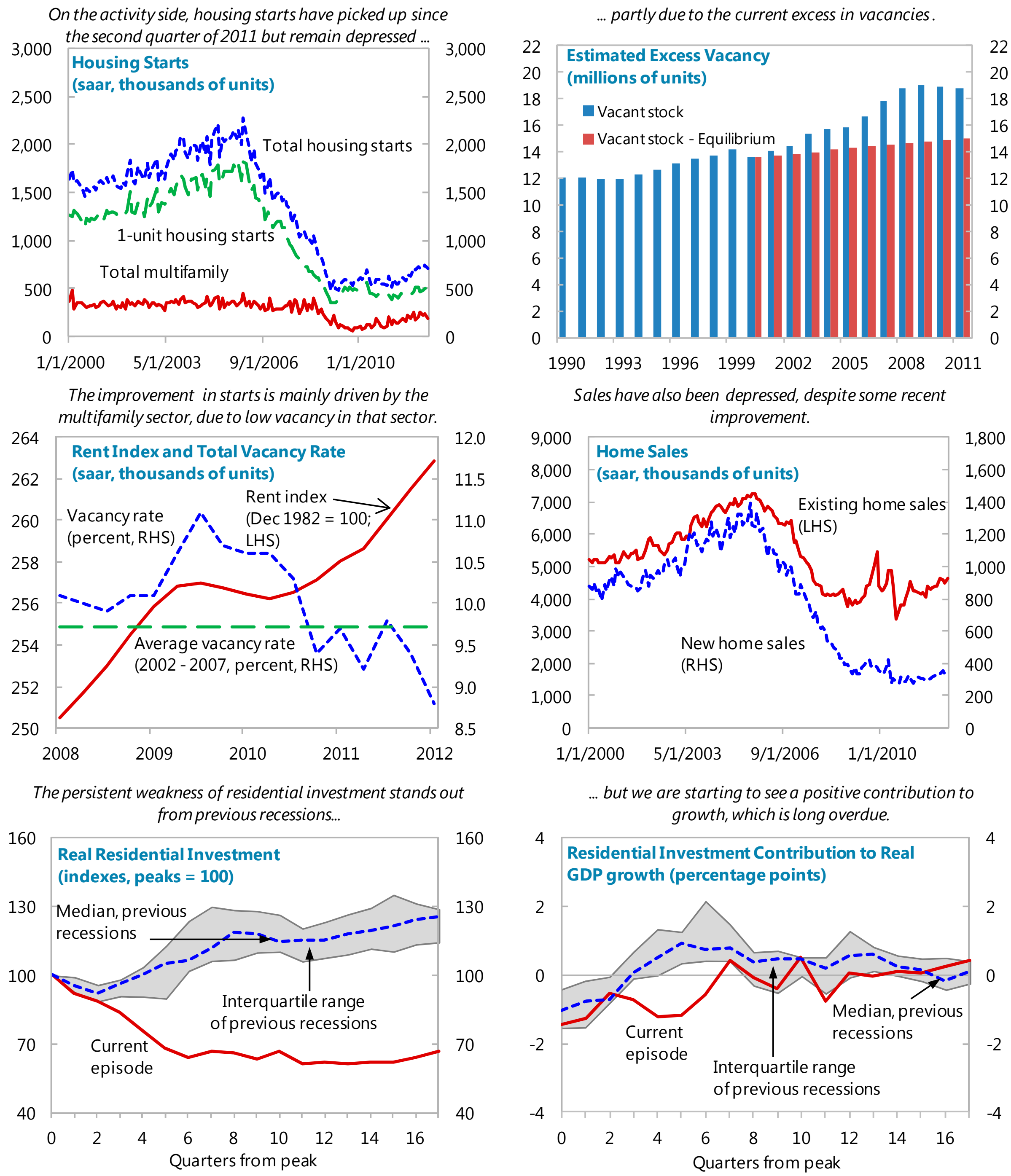


Therefore house price expectations remain subdued.



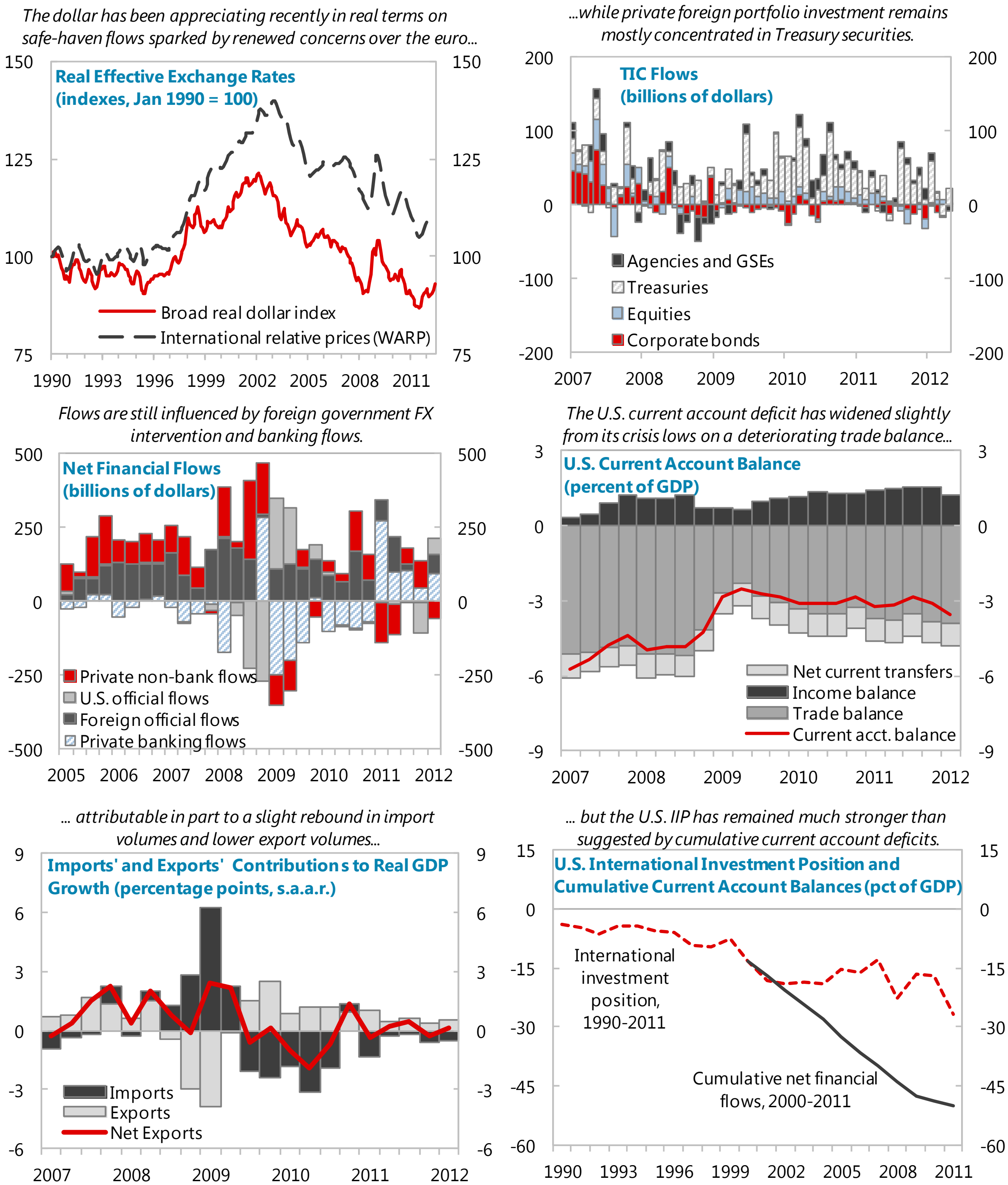
Sources: Mortgage Banker Association; Haver Analytics; and Fund staff estimates.

Figure 2. Housing Market Developments



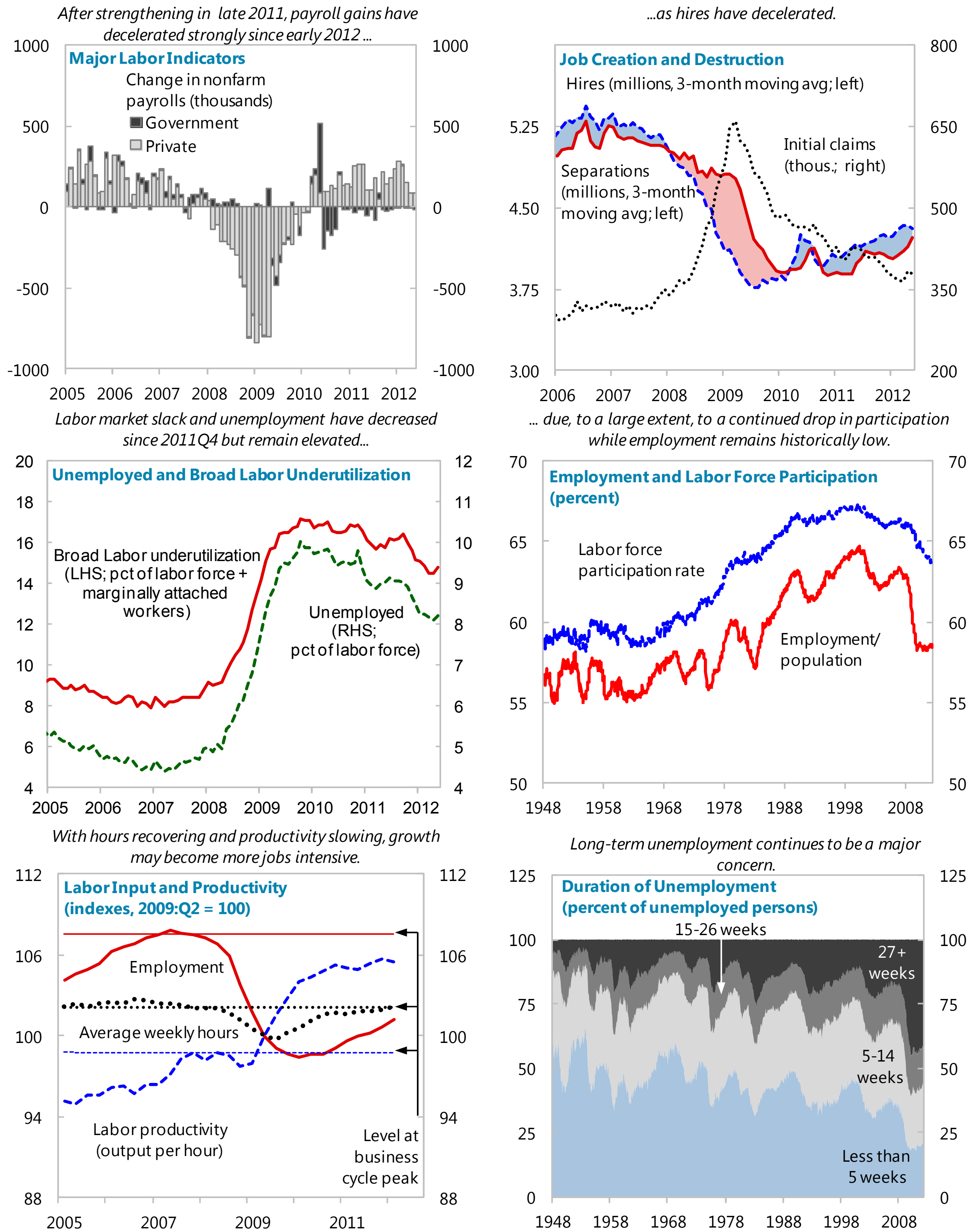
Sources: Mortgage Banker Association; Haver Analytics; Zillow; and Fund staff estimates.

Figure 3. The Dollar, Financial Flows, and Trade



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

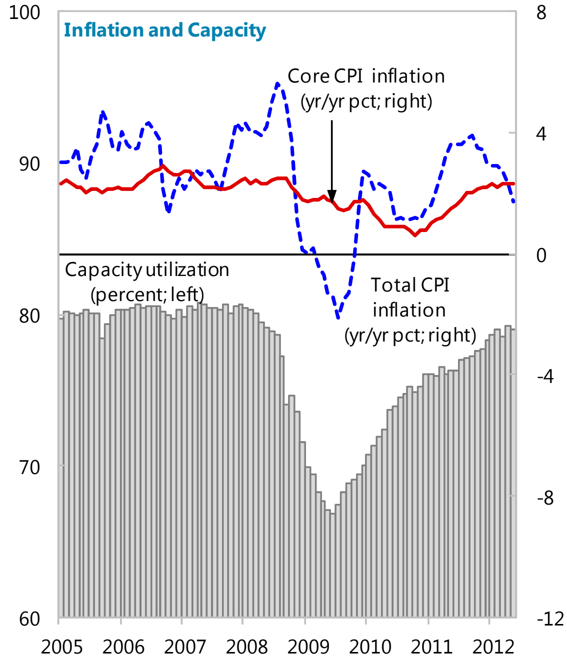
Figure 4. Labor Market Developments



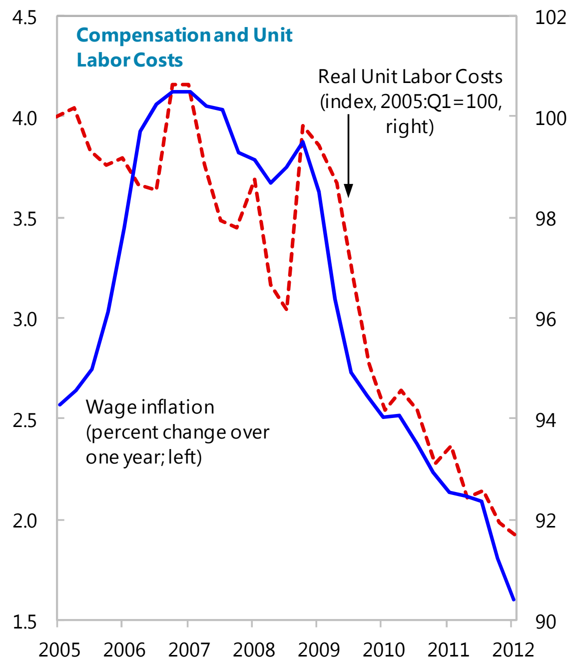
Sources: Bureau of Labor Statistics; The Conference Board; Bloomberg, L.P.; Haver Analytics; and Fund staff estimates.

Figure 5. Core Inflation Remains Subdued

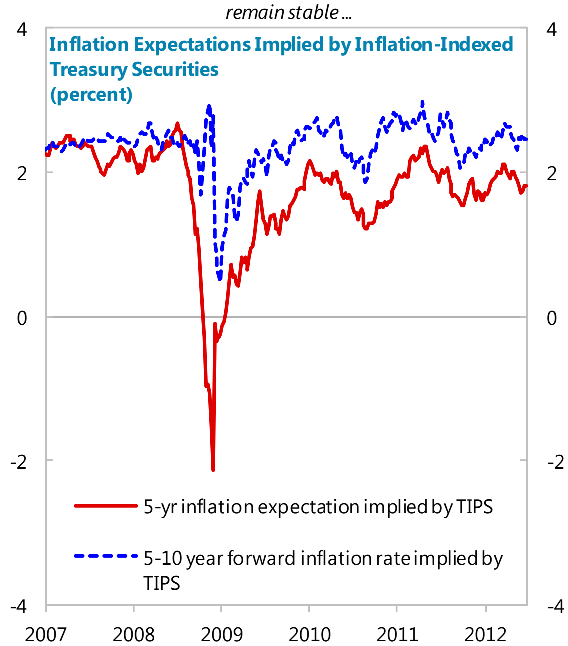
Headline inflation has slowed since September 2011 as commodity prices decreased, while core inflation remains subdued, partly reflecting persistent economic slack.



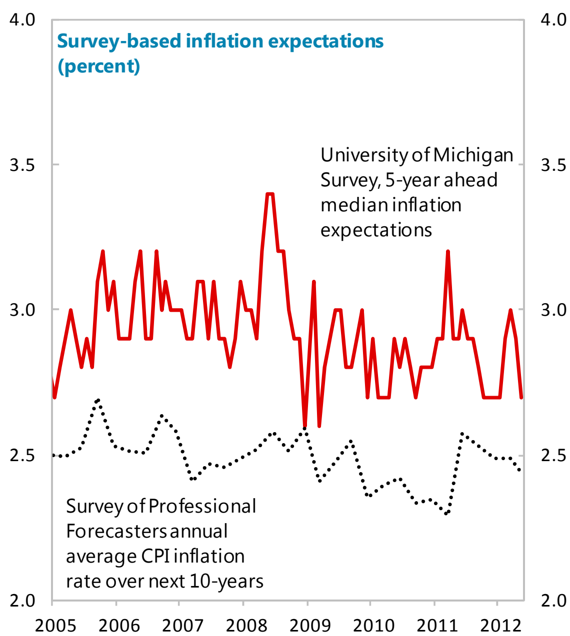
Wage growth and real unit labor costs have decelerated sharply after the recession.



Investors' longer-term inflation expectations remain stable ...

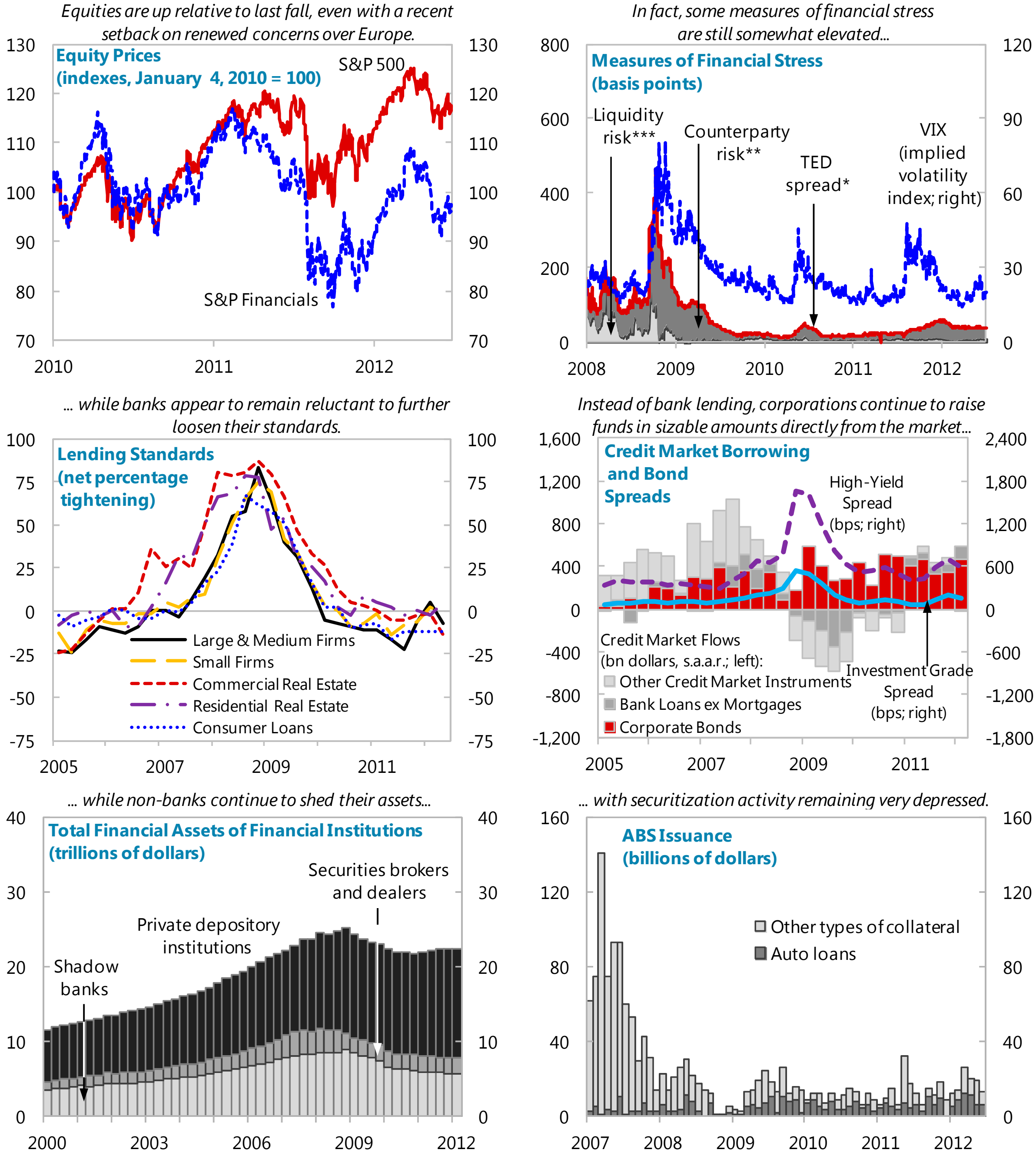


... as are those of consumers and forecasters.



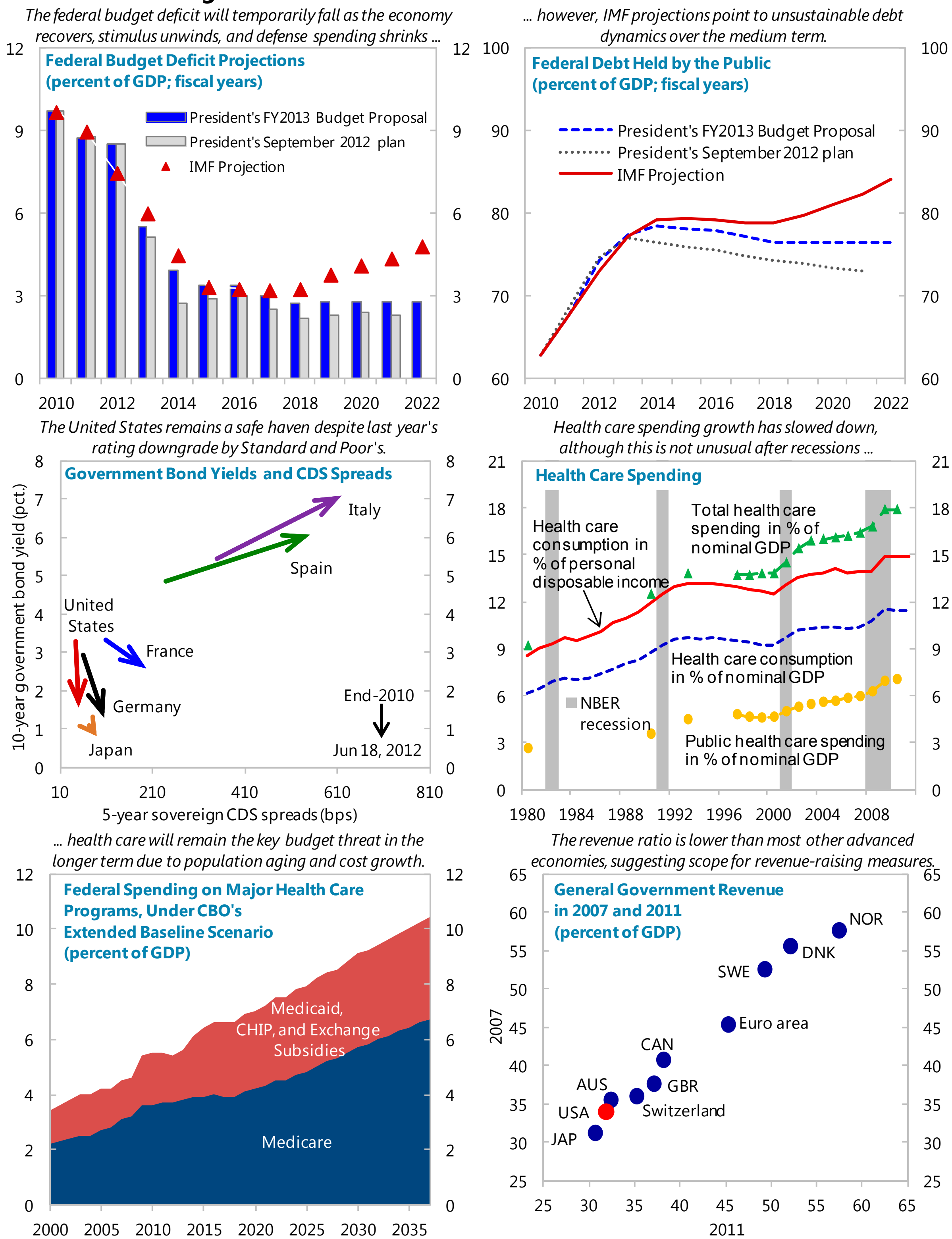
Sources: Board of Governors of the Federal Reserve System; Bureau of Labor Statistics; Bureau of Economic Analysis; University of Michigan; Federal Reserve Bank of Philadelphia; Haver Analytics; and Fund staff estimates.

Figure 6. Slow Financial Sector Healing



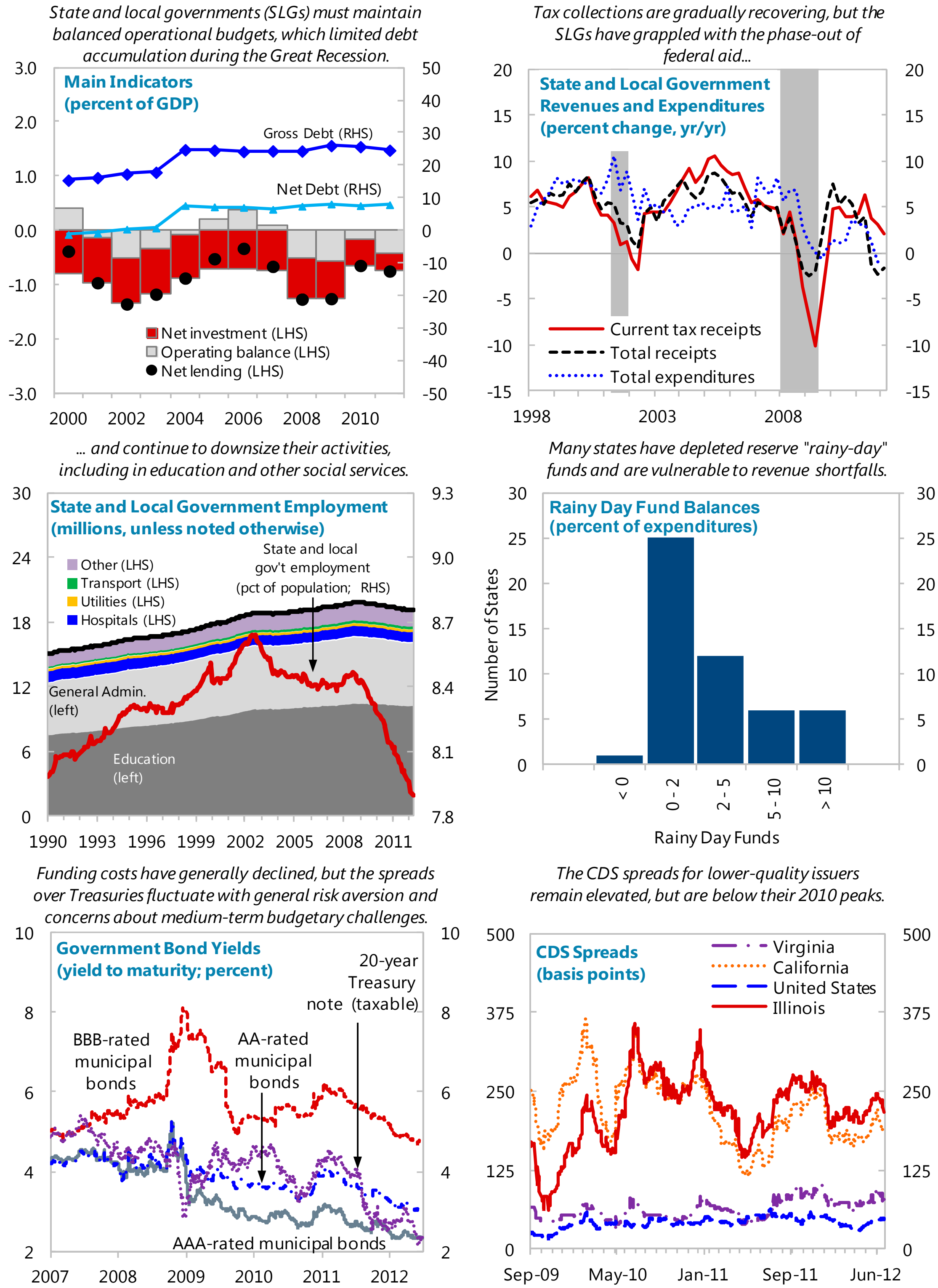
Sources: Board of Governors of the Federal Reserve System; Bloomberg, LP; Haver Analytics; and Fund staff estimates. * The TED spread is three-month LIBOR less the three-month treasury bill yield. ** Counterparty risk is measured as the LIBOR-OIS spread. *** Liquidity risk is the OIS-treasury bill spread.

Figure 7. U.S. Public Finances Remain Unsustainable



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

Figure 8. State and Local Governments Continue Fiscal Adjustment



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 Fund staff calculations.

ANNEX I. UNITED STATES: DOWNSIDE RISK ASSESSMENT MATRIX

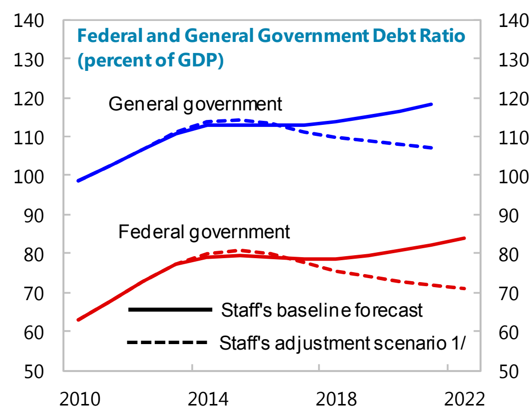
Nature/Source of Main Threats	Overall Level of Concern	
	Likelihood of Severe Realization of Threat in the Next 1–3 Years (high, medium, or low)	**Expected Impact if Threat is Realized** (high, medium, or low)
1. "Fiscal cliff"	**Low** Political gridlock could trigger a much larger fiscal withdrawal than envisaged in our baseline scenario.	**High** A fiscal consolidation of over 4 percent of GDP in 2013 would reduce annual growth to around zero.
2. Lack of medium term plan for fiscal consolidation	**Low** Failure to agree on a credible plan to put the federal debt on a sustainable medium-term path could lead to a gradual erosion of the reserve currency status of the U.S. dollar and upward pressure on Treasury bond yields.	**High** Loss of confidence and higher interest rates would undermine the recovery of private domestic demand, and have severe financial market repercussions, domestically and internationally, given the central role played by US Treasuries in global financial markets.
3. Weaker housing market	**Low** Faster-than-anticipated transitioning of units in foreclosure into distressed sales	**Medium** This could further weaken house prices in the near term. A 10 percent decline in house prices relative to the baseline would subtract about 0.3 percent from 2013 growth.
4. Contagion from Euro area debt crisis	**Medium** A significant worsening of the euro area debt crisis may affect the United States through trade and financial channels	**Medium** Impact would occur through the trade channel, and a tightening of financial conditions, including stress in MMMFs.

ANNEX II. UNITED STATES: PUBLIC SECTOR DEBT SUSTAINABILITY ANALYSIS (DSA)

1. **Congress has legislated about $2.1 trillion in medium-term fiscal consolidation measures**.

- The Budget Control Act adopted in August 2011 capped discretionary spending, saving about $900 bn over 10 years relative to the CBO baseline.
- The Act will trigger additional savings in the form of automatic appropriations cuts ("sequester") worth $1.2 trillion over 10 years. Unless modified by Congress, the cuts are scheduled to come into effect in January 2013.

2. **Despite these substantial legislated savings, U.S. public finances remain on an unsustainable trajectory**. Under the staff's baseline projection which includes medium-term savings from the Budget Control Act as well as an assumption of additional modest deficit-reduction measures enacted from 2014, the debt ratio temporarily stabilizes around the mid-decade, but starts rising again later given the spending pressures from aging population and excess cost growth in the health care sector. Federal debt held by the public is projected to increase from about 70 percent of GDP now to around 85 percent of GDP in FY2022, with general government gross debt approaching 120 percent of GDP by CY2021.



Source: Congressional Budget Office; and Fund staff estimates.
1/ Assumes structural primary withdrawal of about 1 percent of GDP annually until a primary balance of 1 percent of GDP for general government is reached in 2018.

3. **Furthermore, the fiscal projections are being substantially improved by the current low interest rates environment**. Reflecting the weak economy, 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 at least 1 percent of GDP would be appropriate to put the public debt ratio firmly on a downward path, while building a sufficient margin for the higher interest costs of public debt (Treasury bond yields are projected to continue growing beyond the 5-year DSA window). As discussed in the IMF's Fiscal Monitor, the targeted primary surplus would be even higher in the long run to bring the debt ratio closer to the pre-crisis levels by 2030.

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

Annex Table. United States: Public Sector Debt Sustainability Framework, 2007–2017
(In percent of GDP, unless otherwise indicated)

		Actual					Projections						
		2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Debt-stabilizing primary balance 9/
1	**Baseline: Public sector debt 1/**	67.2	76.1	89.9	98.4	102.8	**106.7**	**110.7**	**112.7**	**113.0**	**113.0**	**112.8**	**-0.9**
	o/w foreign-currency denominated	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
2	Change in public sector debt	0.5	9.0	13.7	8.6	4.4	3.9	4.0	2.0	0.3	0.0	-0.2	
3	Identified debt-creating flows (4+7+12)	-0.3	5.5	15.0	6.9	5.9	3.8	4.0	1.7	0.0	-0.4	-0.5	
4	Primary deficit (includes interest receipts)	-0.2	3.9	10.4	7.7	6.7	5.4	3.9	2.1	1.0	0.7	0.3	
5	Revenue and grants including interest receipts	33.9	32.5	30.9	31.7	31.8	31.5	32.9	33.8	34.6	34.9	34.7	
6	Primary (noninterest) expenditure	33.7	36.4	41.4	39.4	38.5	36.9	36.8	35.9	35.6	35.6	35.1	
7	Automatic debt dynamics 2/	-0.1	1.6	4.6	-0.9	-0.8	-1.1	-1.0	-1.5	-2.1	-2.1	-1.9	
8	Contribution from interest rate/growth differential 3/	-0.1	1.6	4.6	-0.9	-0.8	-1.1	-1.0	-1.5	-2.1	-2.1	-1.9	
9	Of which contribution from real interest rate	1.1	1.4	1.8	1.7	0.8	0.9	1.4	1.5	1.5	1.5	1.7	
10	Of which contribution from real GDP growth	-1.2	0.2	2.7	-2.6	-1.6	-2.0	-2.3	-3.0	-3.6	-3.7	-3.6	
11	Contribution from exchange rate depreciation 4/	0.0	0.0	0.0	0.0	0.0	...	...	...	...	...	...	
12	Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	-0.5	1.1	1.0	1.0	1.0	1.0	
13	Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
14	Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
15	Federal student loans, incurrence of other gross liabilities	0.0	0.0	0.0	0.0	0.0	-0.5	1.1	1.0	1.0	1.0	1.0	
16	Residual, including asset changes (2-3) 5/	0.9	3.5	-1.2	1.7	-1.5	0.1	0.0	0.3	0.3	0.4	0.4	
	Public sector debt-to-revenue ratio 1/	198.0	234.2	290.5	311.0	323.2	338.6	336.6	333.4	326.6	323.8	324.6	
	Scenario with key variables at their historical averages 7/						**106.7**	**111.4**	**116.4**	**121.4**	**126.6**	**131.8**	**1.4**
	Scenario with no policy change (constant primary balance) in 2012-2017						**106.7**	**112.2**	**117.5**	**122.1**	**126.7**	**131.4**	**-1.2**
	Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
	Real GDP growth (in percent)	1.9	-0.3	-3.5	3.0	1.7	2.0	2.3	2.8	3.3	3.4	3.3	
	Average nominal interest rate on public debt (in percent) 8/	4.7	4.3	3.4	3.2	3.1	2.8	2.8	2.9	3.1	3.3	3.7	
	Average real interest rate (nominal rate minus change in GDP deflator, in percent)	1.8	2.1	2.3	2.0	0.9	1.0	1.4	1.5	1.5	1.5	1.6	
	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)	2.9	2.2	1.1	1.2	2.1	1.8	1.4	1.4	1.6	1.9	2.1	
	Growth of real primary spending (deflated by GDP deflator, in percent)	3.9	7.5	9.7	-1.9	-0.6	-2.1	1.9	0.3	2.5	3.3	1.8	
	Primary deficit	-0.2	3.9	10.4	7.7	6.7	5.4	3.9	2.1	1.0	0.7	0.3	

1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.

2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as -g.

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

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

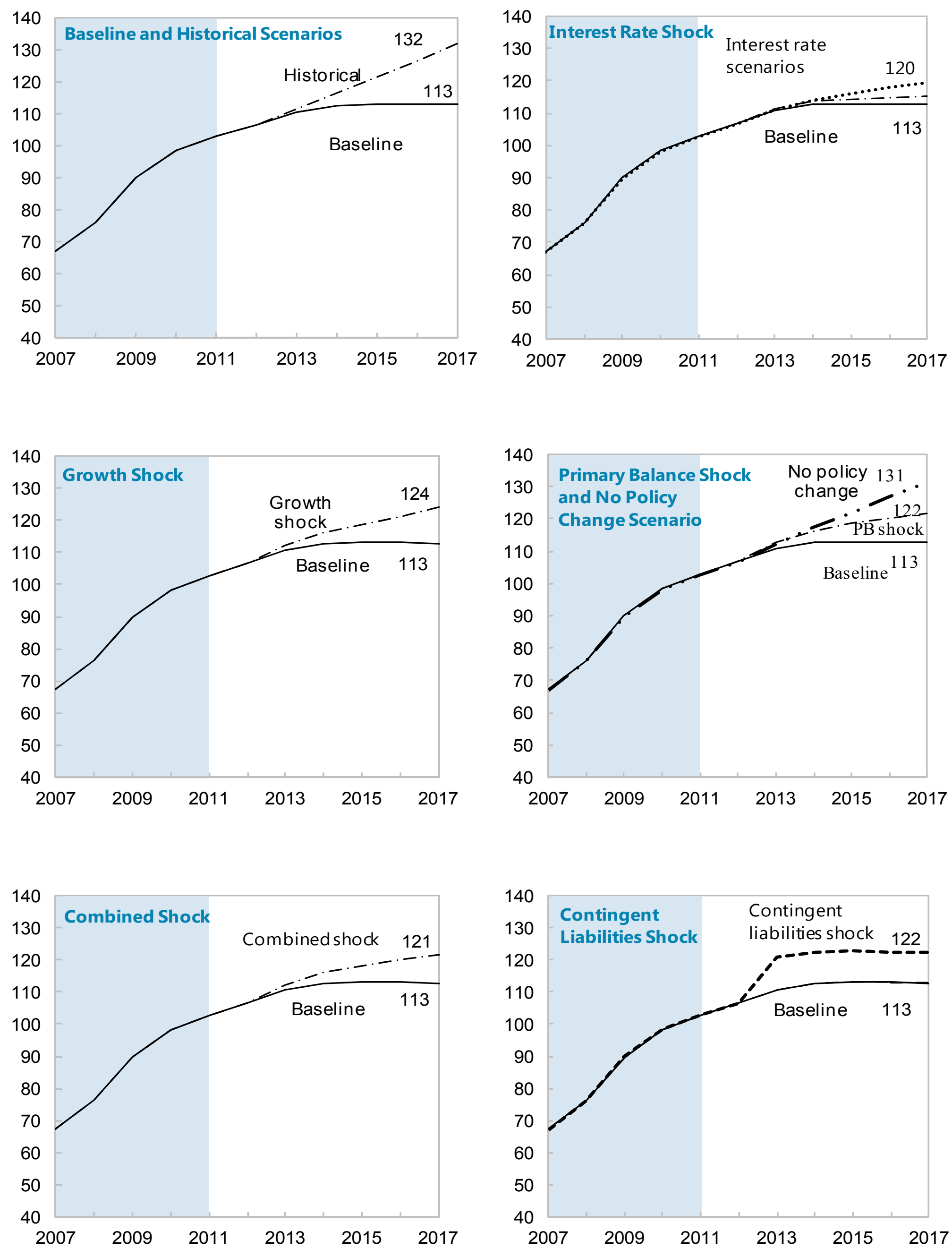
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

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

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

9/ 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.

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 2012 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

July 13, 2012

Prepared By	The Western Hemisphere Department

CONTENTS

Annex I. United States: Fund Relations

(As of May 31, 2012)

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

II. **General Resources Account:**	SDR Million	Percent Quota
Quota	42,122.40	100.00
Fund holdings of currency	27,023.98	64.16
Reserve position in Fund	15,099.45	35.85
Lending to the Fund		
New Arrangements to Borrow	7,048.64	

III. **SDR Department:**	SDR Million	Percent Allocation
Net cumulative allocation	35,315.68	100.00
Holdings	35,808.14	101.39

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

V. **Financial Arrangements**: None

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

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

VIII. **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, inter alia, sanctions programs relating to Burma, Cuba, Iran, North Korea, and Sudan, and continues to block certain previously frozen assets of the former Yugoslavia. 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 groups whose activities have been determined to threaten the 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.

IX. **Article IV Consultation**. The 2011 Article IV consultation was concluded in July 2011 and the Staff Report was published as IMF Country Report No. 11/201. 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 2012 Article IV discussions were conducted from May 21–June 8, 2012. Concluding meetings with Treasury Secretary Geithner and Chairman Bernanke of the Board of Governors of the Federal Reserve System occurred on June 27 and July 3rd, respectively. The Managing Director, Ms. Lagarde, and WHD Director, Mr. Eyzaguirre, participated in the concluding meetings. A press conference on the consultation was held on July 3, 2012. The team comprised (at different times) Gian Maria Milesi-Ferretti (head), Roberto Cardarelli, Oya Celasun, Francesco Columba, Jihad Dagher, Geoffrey Keim, Eric Le Borgne, Paulo Medas, Martin Sommer, and Julien Reynaud (all WHD); Sally Chen (SPR); and Stephen Smith (MCM), with contributions from Jack Grigg, Thornton Matheson, and Ian Parry (FAD); Nadia Rendak, Andrew Giddings, Yan Liu, Steve Dawe and Emmanuel Mathias (LEG); John Kiff (MCM), Ranil Salgado, Marshall Mills, Katrin Elborgh-Woytek and Lars Engstrom (SPR).
Ms. Lundsager (Executive Director) and Mr. Lindquist (Advisor) attended some of the meetings. Outreach included discussions with the private sector 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.

Annex II. 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 22, 2012)

	Date of latest observation	Date received	Frequency of data[1]	Frequency of reporting[1]	Frequency of publication[1]
Exchange rates	June 15	June 18	D	W	W
International reserve assets and reserve liabilities of the monetary authorities[2]	June 15	June 15	W	W	W
Reserve/base money	June 13	June 21	B	W	W
Broad money	June 11	June 21	W	W	W
Central bank balance sheet	June 20	June 21	W	W	W
Interest rates[3]	same day	same day	D	D	D
Consumer price index	May 2012	June 14	M	M	M
Revenue, expenditure, balance and composition of financing[4]—general government[5]	2012 Q1	May 31	Q	Q	Q
Revenue, expenditure, balance and composition of financing[4]—central government	May 2012	June 12	M	M	M
Stocks of central government and central government-guaranteed debt	May 2012	June 6	M	M	M
External current account balance	2012 Q1	June 14	Q	Q	Q
Exports and imports of goods and services	Apr. 2012	June 8	M	M	M
GDP/GNP (2nd release)	2012 Q1	May 31	Q	M	M
Gross External Debt	2011 Q4	March 31	Q	Q	Q
International Investment Position[6]	2010	June 28	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.

INTERNATIONAL MONETARY FUND

UNITED STATES

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION—SUPPLEMENTARY INFORMATION

July 27, 2012

Approved By Gian Maria Milesi-Ferretti and Tamim Bayoumi

This Supplement contains additional information on staff estimates of current account and real exchange rate gaps, capital flows, reserve policies, and the international investment position (IIP) that underpin the exchange rate assessments presented in the Staff Report (¶46 and Box 8). On the first two criteria, the estimates rely on CGER methodologies (as described in IMF Occasional Paper 267), as well as EBA methodologies (as described in an annex of the Pilot External Assessment Report (www.imf.org).

- CGER estimates have been updated to take into account changes in real exchange rates and macroeconomic projections between the reference period for the Spring 2012 World Economic Outlook (on which the estimates are based) and June 2012, as well as staff's estimates for trade elasticities.

- EBA estimates have been updated to reflect changes in real exchange rates, underlying current account estimates, and other fundamentals between the period for which the gap is estimated (the year 2011 for the current account regression, the Spring 2012 WEO reference period for the real exchange rate regression) and June 2012.

The estimates are presented in the Table below. Overall, they are consistent with staff's assessment of a current account deficit 1–2 percentage points of GDP weaker than the value implied by fundamentals and desirable policies in the U.S. and its trading partners and with staff's view of a moderate real exchange rate overvaluation (0–15 percent).

Turning to the other three criteria, the United States has a negative IIP (particularly large in debt securities), continued net portfolio debt inflows, and low levels of reserves. While these would normally imply a significant potential vulnerability, risks are limited given the dollar's role as the world's major reserve currency and associated safe haven status.

Model-based Current Account and Exchange Rate Assessments

	EBA		CGER		
	2011	Spring 2012	Medium term (2017)		
	CA regression	REER regression	MB	ES 1/	ERER
Current account norm (percent of GDP)	-2.0		-2.5	-1.6	
Current account gap (percent of GDP) 2/	-1.7 / -2.2		-1.1	-2	
Exchange rate gap as of estimation period (percentage points)	-9 / -12	-2	6	13	2
Exchange rate gap as of June 2012 (percentage points)	-13 / -16	1	6	13	5
Memorandum items (percent of GDP, unless otherwise noted):					
Percentage change in REER between June 2012 and 2011 average	4				
Percentage change in REER between June 2012 and Spring 2012 WEO reference period	3				
Current account balance (2011)	-3.1				
Cyclically adjusted current account balance (EBA -- 2011)	-4.2				
Projected medium-term current account balance (2017)	-3.6				

1/ Calculated on the basis of the end-2011 net IIP (-26.7 percent of GDP)

2/ Difference between cyclically-adjusted or medium-term current account balance and CA norm. For EBA figures show the CA gap excluding and including the regression residual

Statement by the IMF Staff Representative on the United States

July 30, 2012

1. **This note reports on information that has become available since the staff report (SM/12/192) was issued and does not alter the thrust of the staff appraisal**.

2. **Data released since the completion of the Article IV consultation in early July point to a slowdown in near-term growth**. Annualized real GDP growth is estimated at 1.5 percent for the second quarter, marginally lower than staff's projection of 1.7 percent and lower than the 2 percent growth estimated for the first quarter. The deceleration was largely due to a slowdown in private consumption growth, likely reflecting the run up in gasoline prices through April, and slower job creation and lower income expectations in the face of growing uncertainty. The national accounts revisions released on July 27th indicate that growth was lower in 2010 and higher in 2011 than previously thought.

3. **On July 18, 2012, the Financial Stability Oversight Council (FSOC) designated eight financial market utilities as systemically important**, subjecting them to Fed supervision and heightened prudential standards. The designated utilities perform a variety of functions, including the clearing and settlement of cash, securities, and derivatives transactions. On the same date, the FSOC published its second annual report, followed by the issuance of the inaugural annual report of the U.S. Treasury's Office of Financial Research on July 20th. The potential threats to U.S. financial stability identified in these reports are largely in line with those highlighted in the Staff Report.

4. **Financial conditions do not appear to have changed noticeably since the end of the consultation**, despite intensified financial stresses in the euro area. Second-quarter earnings for major U.S. financial institutions were mostly above expectations, mainly as lower provisioning expenses offset the negative impact of lower trading profits, sluggish loan growth, and low interest rates. The pick-up in mortgage refinancing activity under the Home Affordable Refinancing Program has also boosted revenues. CDS spreads on major U.S. banks and equity prices for financial institutions remain around their end-June levels.

5. **Two notable analytical reports have been published on the fiscal policy front**. First, the Congressional Budget Office and the Joint Committee on Taxation have examined implications of the recent Supreme Court ruling on health care reform. Since the ruling has effectively allowed states to choose whether to expand eligibility for coverage under their Medicaid program, it is projected that about 3 million more people than initially estimated will remain uninsured once the reform is implemented, implying lower federal government spending (around $84 billion over a decade). Second, a task force headed by Richard Ravitch and Paul Volcker highlighted well-known problems with state and local budgets, such as unfunded pension and health care liabilities and lack of transparency in accounting practices. Many of the task force recommendations are in line with those of staff—as described, for example, in the Selected Issues Paper "Fiscal Challenges Facing the U.S. State and Local Governments" (IMF Country Report No. 11/202).

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 12/93
FOR IMMEDIATE RELEASE
August 2, 2012

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

IMF Executive Board Concludes 2012 Article IV Consultation with the United States

On July 30, 2012, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the United States.[1]

Background

The U.S. economy continues to grow at a tepid pace of around 2 percent, employment remains well below pre-crisis levels, and the housing market is stabilizing but remains depressed. Strong headwinds persist on private consumption, as households continue to deleverage amid weak—albeit stabilizing—house prices. Business fixed investment seems to have lost some momentum recently, despite the extraordinarily low borrowing costs and relatively favorable financial conditions facing the corporate sector. Residential construction has been improving, but from very low levels. Exports decelerated throughout the last year, in line with generally slower growth in foreign demand. The U.S. current account deficit has remained broadly stable. Overall, the slow pace of the recovery is consistent with past international experience in the aftermath of housing and financial crises.

Monetary policy remains highly accommodative, and the Federal Reserve responded to weaker-than-expected growth over the past year with a number of easing actions. Fiscal policy has begun weighing on growth, as the budget deficit is being gradually reduced. Continued progress has been made on implementation of the financial reform program, in line with the Dodd-Frank Act as well as the international regulatory reform agenda.

[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.

Growth is likely to remain moderate in 2012 and 2013, constrained by household deleveraging, fiscal restraint, and subpar global demand. Following a robust rebound after the recession, private investment in equipment and software is projected to expand at a slower pace, though it will remain a strong contributor to growth. After six consecutive years of declines, residential investment is projected to start making positive contributions to growth. A stronger dollar and weaker global demand are projected to weigh on exports. Headline and core inflation are projected to remain subdued, reaching the Federal Reserve's 2 percent goal over the medium term. Downside risks around the outlook have intensified, including from the worsening of the euro area debt crisis as well as the uncertainty over domestic fiscal plans. On the financial sector front, the outlook for the U.S. banking system is broadly positive but subject to risks from an intensification of stresses in global financial markets.

With regard to policy actions, the Federal Reserve has indicated that economic conditions are likely to warrant exceptionally low levels of the federal funds rate at least through late 2014, and unveiled plans to further extend the average maturity of its securities holdings. The authorities recently enacted measures to ease mortgage modifications and refinancing. Last summer, Congress legislated budgetary savings worth about $2.1 trillion over the next decade, but negotiations regarding additional measures to reduce deficits over the medium term have been unsuccessful so far. The fiscal outlook for next year is extraordinarily uncertain given the large number of expiring tax provisions and scheduled automatic spending cuts.

Executive Board Assessment

Executive Directors welcomed the continuing moderate economic recovery in the United States, while noting the downside risks to the outlook stemming from external and domestic uncertainties. Directors called on U.S. policymakers to use effectively the limited policy space available to support the recovery in the near term and restore medium term fiscal sustainability with a balanced approach to consolidation. This will be important also to assist the global recovery, given the systemic importance of the United States.

Directors highlighted the need to adopt a measured pace of deficit reduction that does not sap the recovery. In particular, Directors agreed that removing the uncertainty created by the "fiscal cliff" in 2013 and promptly raising the debt ceiling are both critical. They stressed the importance of agreeing as early as possible on a comprehensive medium term fiscal consolidation plan, based on both higher revenues and lower entitlement spending, that would stabilize the debt ratio by mid decade and gradually reduce it afterwards.

Directors broadly agreed that monetary policy will need to remain highly accommodative for quite some time. Most Directors considered that there is room for further easing should the outlook deteriorate, although a number of Directors observed that the effectiveness of additional monetary easing could be limited in the prevailing very low interest rate environment. Some

Directors highlighted the potential adverse global spillover effects of very low interest rates through capital flows and higher commodity prices. Directors also noted that, while the United States external current account deficit has declined, the external position remains weaker than justified by fundamentals and desired policies.

Directors welcomed the recent actions and proposals by the Administration to bolster the housing market, and urged their timely and aggressive implementation. Given the importance of the housing sector to the economic recovery, Directors concurred that further measures may be needed, including measures to facilitate the conversion of foreclosed houses into rental units, allowing mortgages to be modified in personal bankruptcy courts, and facilitating refinancing on a larger scale.

Directors welcomed the slowly improving conditions in the labor market. They noted that persistently high long term unemployment creates the risks of human capital losses and reduced attachment to the labor force. They concurred that training and job-search support should be adequately funded, and temporary tax incentives should be implemented to help reduce long term unemployment.

Directors commended the authorities for the significant progress achieved over the past year in implementing domestic and international financial reforms. They emphasized the need to increase the resilience of the U.S. financial system, including by strengthening the regulation of money market mutual funds, finalizing the Volcker Rule with due consideration of its cross border implications, accelerating the adoption of Basel III capital rules, and winding down the role of government-sponsored entities. They encouraged the authorities to strengthen coordination of financial sector regulation and supervision, and to allocate appropriate resources to regulatory and supervisory agencies.

Directors stressed the importance of a multilateral approach to economic policy management in the United States, and commended the United States for its active engagement in fostering international coordination on financial regulatory reforms. They underscored that the United States can make important contributions to global growth and stability by adopting a credible medium term plan for fiscal consolidation at a pace that does not undermine the recovery, as well as by further strengthening its financial sector. Directors welcomed the authorities' continued commitment to secure the success of multilateral trade negotiations.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 2012 Article IV Consultation with the United States is also available.

United States: Selected Economic Indicators

(annual change in percent, unless otherwise indicated)

	2007	2008	2009	2010	2011	Projections 2012	2013
National production and income							
Real GDP	1.9	-0.3	-3.5	3.0	1.7	2.0	2.3
Net exports 1/	0.6	1.2	1.1	-0.5	0.0	-0.1	-0.2
Total domestic demand	1.2	-1.5	-4.4	3.4	1.6	2.0	2.3
Final domestic demand	1.4	-1.0	-3.6	1.8	1.8	1.9	2.3
Private final consumption	2.3	-0.6	-1.9	2.0	2.2	2.2	2.3
Public consumption expenditure	1.3	2.2	2.0	0.9	-1.2	-2.1	-2.0
Gross fixed domestic investment	-1.4	-5.1	-15.2	2.0	3.7	4.8	6.8
Private fixed investment	-1.9	-7.1	-18.8	2.6	6.8	6.6	8.3
Residential structures	-18.7	-23.9	-22.2	-4.3	-1.3	10.4	12.8
Public fixed investment	1.7	4.6	0.3	-0.3	-6.7	-2.0	0.8
Change in private inventories 1/	-0.2	-0.5	-0.8	1.6	-0.2	0.2	0.1
GDP in current prices	4.9	1.9	-2.5	4.2	3.9	3.9	3.7
Employment and inflation							
Unemployment rate	4.6	5.8	9.3	9.6	9.0	8.2	7.9
CPI inflation	2.9	3.8	-0.3	1.6	3.1	2.2	1.7
GDP deflator	2.9	2.2	1.0	1.1	2.1	1.8	1.4
Government finances							
Federal government (budget, fiscal years)							
Federal balance (percent of GDP)	-1.2	-3.2	-11.6	-9.7	-9.0	-7.5	-6.0
Debt held by the public (percent of GDP)	36.3	40.5	54.1	62.8	67.7	73.0	77.1
General government (GFSM 2001, calendar years)							
Net lending (percent of GDP)	-2.7	-6.7	-13.0	-10.5	-9.6	-8.2	-6.8
Structural balance (percent of potential nominal GDP)	-3.3	-5.5	-7.9	-8.1	-7.5	-6.3	-5.0
Gross debt (percent of GDP)	67.2	76.1	89.9	98.4	102.8	106.7	110.7
Interest rates (percent)							
Three-month Treasury bill rate	4.5	1.4	0.2	0.1	0.1	0.1	0.1
Ten-year government bond rate	4.6	3.7	3.3	3.2	2.8	2.1	2.8
Balance of payments							
Current account balance (billions of dollars)	-710	-677	-382	-442	-466	-491	-479
Percent of GDP	-5.1	-4.7	-2.7	-3.0	-3.1	-3.1	-2.9
Merchandise trade balance (billions of dollars)	-819	-830	-506	-645	-738	-769	-817
Percent of GDP	-5.8	-5.8	-3.6	-4.4	-4.9	-4.9	-5.0
Balance on invisibles (billions of dollars)	109	153	124	203	272	278	338
Percent of GDP	0.8	1.1	0.9	1.4	1.8	1.8	2.1
Saving and investment (percent of GDP)							
Gross national saving	14.6	13.4	11.5	12.5	12.9	13.3	14.1
Gross domestic investment	19.6	18.1	14.7	15.8	15.9	16.4	17.1

Sources: Haver Analytics and IMF staff estimates.

1/ Contribution to real GDP growth, percentage points.