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August 2007
IMF Country Report No.07/264

United States: 2007 Article IV Consultation—Staff Report; Staff Statement; and Public Information Notice on the Executive Board Discussion

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2007 Article IV consultation with the United States, the following documents have been released and are included in this package:

- The staff report for the 2007 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on June 15, 2007, with the officials of the United States on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on July 11, 2007. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- A staff statement of July 27, 2007 updating information on recent developments.

- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its July 27, 2007 discussion of the staff report that concluded the Article IV consultation.

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

Information Note on the United States Fiscal Data
Selected Issues Paper

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

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

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International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

UNITED STATES

Staff Report for the 2007 Article IV Consultation

Prepared by the Staff Representatives for the 2007 Consultation with the United States

Approved by Anoop Singh and Carlo Cottarelli
July 11, 2007

- ***Scope and focus***. Given the economic slowdown and concern about spillovers from the housing market and subprime delinquencies, a key topic of the discussions was prospects for a soft landing. Beyond this near-term issue, the focus was on improving financial sector regulation, resolving external imbalances, and achieving fiscal sustainability. Trade policy, aid, and anti-money-laundering initiatives were also covered (Table 1).
- ***Outlook***. The baseline anticipates moderate below-trend growth of 2 percent in 2007 and a pickup to 2¾ percent in 2008. However, housing market weakness, tighter credit conditions, and slower productivity growth could all hold back recovery.
- ***Monetary policy***. Current policy settings are consistent with a soft landing and core inflation of under 2 percent. However, tight labor markets and other inflation risks justify caution in lowering interest rates unless activity weakens rapidly.
- ***Financial sector***. Innovation under an "originate to distribute" business model has helped disperse risk and raise capital adequacy of core institutions. But with benign market conditions encouraging risk-taking, lending standards may be falling. Less fragmented and more principles- and risk-based supervision can raise resilience.
- ***Current account***. The large deficit has been easily financed, reflecting the attractiveness of U.S. financial markets. However, markets are not factoring in the significant depreciation likely associated with rebalancing demand and adjusting portfolios, and an abrupt dollar adjustment and financial market turbulence are risks for the global economy. Policies to encourage U.S. saving agreed at the Fund's Multilateral Consultation could reduce this vulnerability, including through further fiscal adjustment.
- ***Fiscal policy***. Deficit reduction has exceeded expectations, but the main fiscal challenge is to address unsustainable increases in entitlement spending from rising medical costs and population aging. Reform of the Medicare, Medicaid, and Social Security programs should be complemented by improvements to the medical system, more ambitious medium-term consolidation, and an overhaul of the tax system.
- ***Analytical work***. Background studies analyze the size and sources of U.S. real spillovers, global bond market linkages, financing of the current account deficit, innovation in the financial system, evolution of the subprime mortgage market, recent buoyancy of federal revenues, and use of GFSM 2001 accounting standards (see *Selected Issues*).

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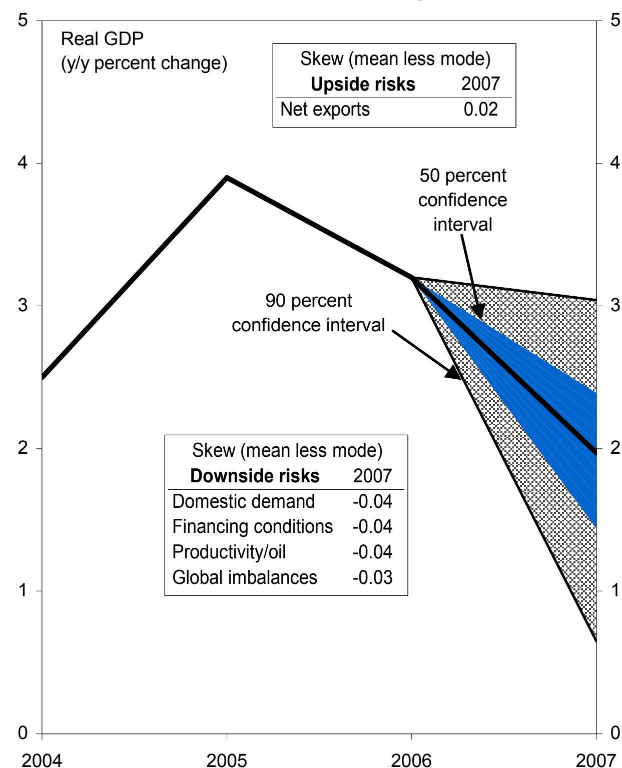
I. Prospects for a Soft Landing[1]

A. Overview

1. ***The U.S. economy has cooled more than expected over the past year, but employment remains strong and growth abroad has picked up***. Following an extended boom led by strong domestic demand, the slowdown has largely reflected a drag from residential investment as housing market activity has fallen rapidly. Unexpected weakness in business investment and net exports, as well as an inventory correction, amplified the downturn in early 2007, although indicators suggest a recovery is underway. Private consumption has continued to grow robustly as solid growth in wage earnings has minimized spillovers from housing, unemployment has remained extremely low, and, as a result, core inflation has only recently started to ease. The global environment remains favorable, with robust growth in the Euro area and Asia.

2. ***The most likely scenario is a soft landing of the U.S. economy***. Officials agreed with staff that there would probably be a gradual acceleration in final domestic demand growth in 2007 as the slowdown in the housing market and associated drag from residential investment lessens, consumption decelerates mildly, business fixed investment recovers from its temporary—and largely unexplained—weakness, and net exports rebound on strong foreign demand. As growth returns gradually to its potential of almost 3 percent by mid-2008, a widening output gap contributes to reducing core inflation to below 2 percent.

There remain risks to the soft landing scenario.



3. ***At the same time, there are risks to this outlook***. Staff noted that year-on-year growth is likely to remain for some time uncomfortably close to the 2 percent "stall speed" associated with past recessions, even though indicators such as unemployment and real interest rates are more favorable. The upside potential from net exports in a robust global environment is more than offset by downside concerns as subprime mortgage difficulties could

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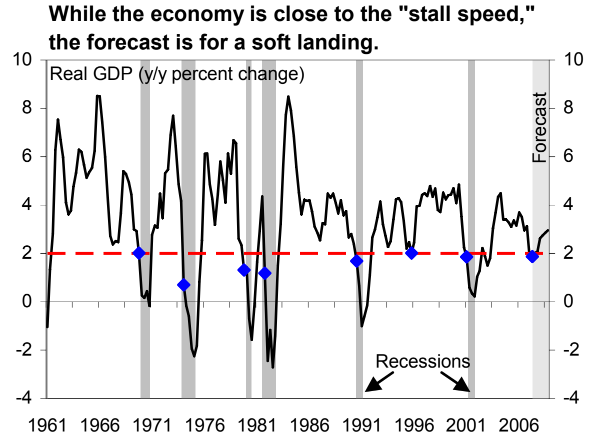
[1] This report was prepared by a staff team comprising R. Teja (head), T. Bayoumi, T. Helbling, R. Balakrishnan, K. Krajnyák, K. Mathai (WHD), A. Bhatia, P. Mills (MCM), and J.-J. Hallaert (PDR).

extend the housing downturn, slowing housing wealth might weaken consumption, and financial conditions could tighten if lax underwriting standards recently uncovered in the subprime mortgage market prove more widespread and systemic. With output close to potential, unemployment low, commodities prices elevated, and productivity growth falling, cost pressures could boost inflation.

While the economy is close to the "stall speed," the forecast is for a soft landing.



United States: Medium-Term Projections
(Percent change from previous period, unless otherwise indicated)

	2006	2007	2008	2009	2010	2011	2012
National production and income							
Real GDP	3.3	2.0	2.8	3.0	3.0	2.9	2.9
Total domestic demand	3.2	1.7	2.6	3.0	3.0	3.0	2.9
Private final consumption	3.2	3.2	2.6	2.7	2.8	2.7	2.8
Nonresidential fixed investment	7.2	3.2	5.9	6.3	6.2	6.2	6.2
Residential investment	-4.2	-13.8	-2.0	2.2	2.0	2.0	2.0
Net exports (contribution to growth)	0.0	0.2	0.0	-0.1	-0.2	-0.2	-0.2
Unemployment rate (percent)	4.6	4.8	5.0	4.9	4.8	4.8	4.8
CPI inflation	3.2	2.6	2.8	2.5	2.4	2.4	2.4
Unified federal balance (percent of GDP; fiscal year)	-1.9	-1.4	-1.6	-2.0	-1.8	-1.7	-1.1
Current account balance (percent of GDP)	-6.1	-6.0	-6.0	-5.9	-5.9	-5.8	-5.8
Memorandum items:							
Output gap (percent of potential GDP)	0.3	-0.7	-0.8	-0.6	-0.4	-0.2	0.0
Partner country growth	3.3	3.0	3.0	2.9	2.9	2.8	2.8
Oil prices (APSP, $/Barrel)	64.3	63.8	68.8	68.5	66.8	66.0	65.5

Sources: Haver Analytics; and Fund staff estimates.

B. Financial Conditions and Developments

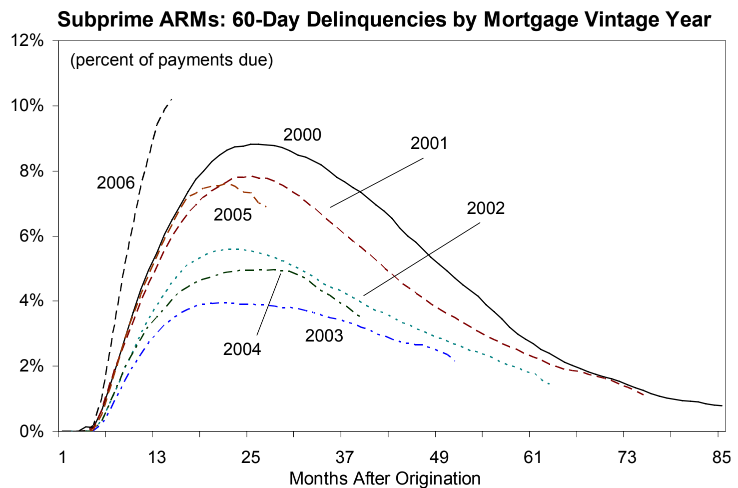
4. ***Underlying the baseline forecast of a soft landing is the continuation of supportive financial conditions, even after the emergence of problems with subprime mortgages***. Rising subprime delinquencies led to a jump in spreads on higher-risk mortgage-backed securities, but there has yet been little contagion outside of the near prime (“Alt-A”) segment of the mortgage market, reflecting the wide dispersion of risk and concentration of difficulties in specialist subprime originators, many of which have failed (Box 1). Recently, long-term yields and spreads have risen on stronger growth expectations and associated inflationary concerns. Despite this latest episode of modest volatility, financing conditions remain easy and spreads low by historical standards (Figure A).

Box 1: The Subprime Shakeout

This box summarizes some of the main issues arising from the subprime shakeout and its potential impact on the housing market and household spending (for further details see Selected Issues Chapter V).

Size. The origination of subprime loans increased substantially in 2005-06, reaching about 20 percent of all new mortgages. While estimates vary, at end-2006 subprime loans probably made up 12-15 percent of outstanding U.S. mortgages, with near-prime ("Alt-A") constituting another 10 percent. This pace was maintained by sharply reducing lending standards, such that many 2006 borrowers would need substantial house price appreciation in order to refinance once their rates reset.

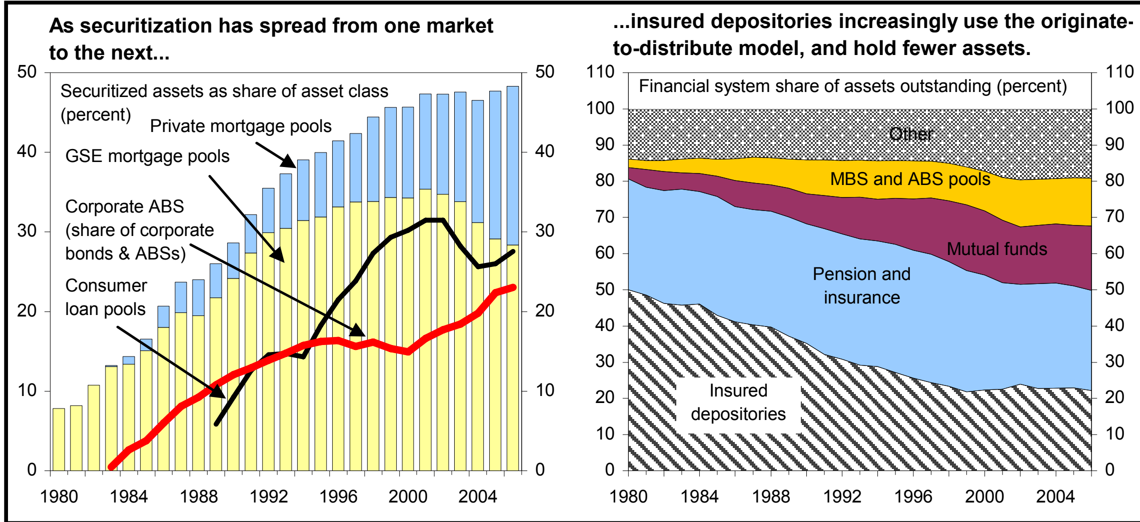
Impact thus far. As shown in the accompanying figure, early payment defaults and delinquencies on recent subprime adjustable rate mortgage (ARM) vintages have risen sharply, while total foreclosures have almost doubled in the year to May 2007. Spreads on lower-rated tranches of asset backed securities (ABSs) and collateralized debt obligations (CDOs) backed by such mortgages widened dramatically in the first half of 2007. As in the last shakeout in 1998-99, most specialized subprime originators have gone bankrupt, been sold, or closed to new business due to insufficient capital to absorb losses. There has been some deterioration in credit risk indicators of affected investment banks but thus far losses from subprime exposures have generally been successfully hedged or overshadowed by profit growth elsewhere. The majority of losses appear to lie with the holders of the riskier tranches of ABS and CDOs exposed to 2006 loans. Despite lending standards tightening sharply, issuance of ABSs backed by subprime loans is continuing, albeit down from 2006. There is little evidence thus far of spillovers to delinquencies on prime mortgages or other forms of consumer credit, with spreads on assets backed by prime mortgages, auto loans, and credit card debt remaining low.

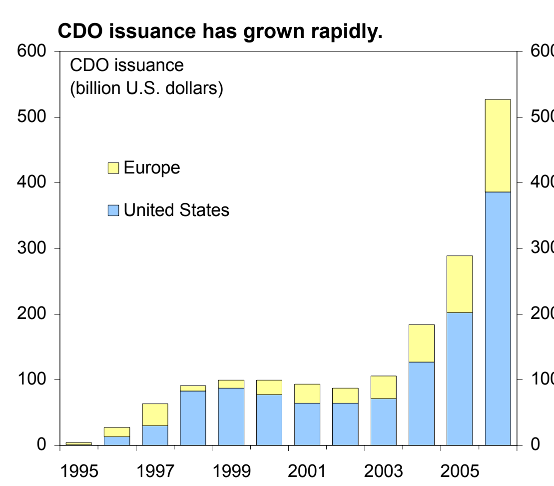


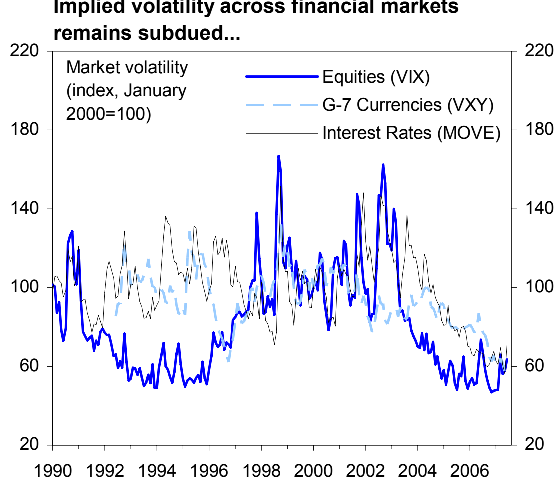
Baseline forecast. With growth in, and access to, home equity already curtailed by stalling house prices and tightening lending standards, subprime delinquencies are expected to rise further, especially as the majority of hybrid ARM resets to higher interest rates are due for late 2007 and early 2008. However, the estimated additional $43 billion in interest costs in 2007 is small relative to total interest costs or consumption. Rising foreclosures are also likely to lengthen the housing cycle and cause hardship in specific localities and minority communities.

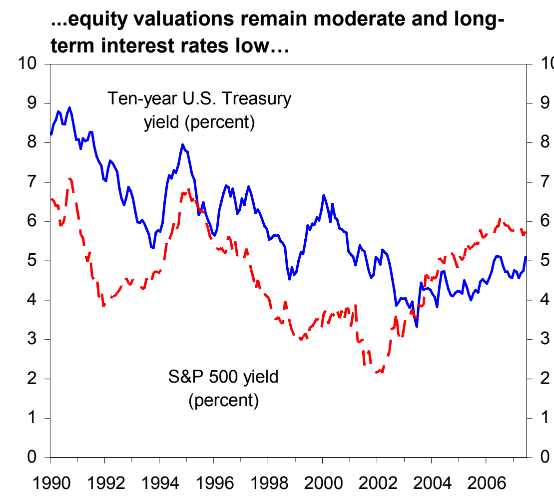
Risks. If mounting troubles in the subprime segment dent broader consumer confidence, there could be a disproportionate impact on consumption. Analysts have noted that tightening lending standards could be exacerbated if Congress, federal regulators, or the States enact severe anti-predatory lending rules. Currently, however, most attention is being given to encourage loan servicers to modify conditions to enable subprime borrowers to stay in their homes.

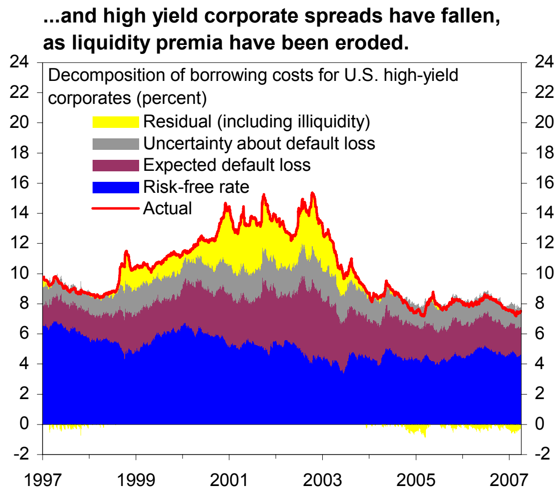
Figure A. Financial Market Trends











Sources: Board of Governors of the Federal Reserve System; J.P. Morgan; Bloomberg, L.P.; Haver Analytics; Bank of England calculations; and Fund staff calculations.

5. ***At the same time, innovation based on an "originate to distribute" model is reshaping the financial sector***. As detailed in *Selected Issues* Chapter IV, the income of institutions at the core of the financial system, the commercial and investment banks, increasingly derives from bundling and servicing securitized assets for investors—asset-backed securities and collateralized debt/loan obligations (CDOs/CLOs)—rather than from holding loans. The system has thus evolved to yield: (i) a profitable and well-capitalized core relatively protected from credit risks; (ii) an innovative and lightly-regulated periphery, including specialized institutions that originate loans and a multitude of hedge funds that support market liquidity and price discovery; and (iii) the transfer and diversification of credit risk via a wider range of securitized assets and credit derivatives. Against this rapidly changing financing landscape, U.S. markets have remained globally pre-eminent and robust to a range of shocks (Figure 1).

6. ***The originate-to-distribute model, however, could be exacerbating incentive problems in financial markets***. The intermediaries at various stages of the process—originators, securitizers, and pool managers—are remunerated primarily through fees and often bear only limited long-term balance sheet exposure to the underlying assets. This can reduce their incentives to maintain loan quality. The problem has been exacerbated by strong appetite for higher-yielding CDOs/CLOs, which has boosted investor demand for higher-risk loans even as these structured products have become more complex. In hindsight, the losses incurred on bundled subprime mortgage securities indicate that rating agencies and investors underestimated the weakening of lending standards and its impact in 2005–06.

7. ***Staff see parallels to subprime mortgage developments in other market segments, including leveraged loans***. In particular, the boom in leveraged buyouts is being funded through CLOs which have been in high demand from investors, and there is evidence that covenants in the underlying loans have eased. A turn in the credit cycle, especially if volatility and risk aversion rise, could expose financial vulnerabilities and unanticipated risk concentrations, with adverse effects on activity. Staff analysis suggests that an unexpected 1 percentage point increase in corporate paper spreads would reduce real GDP by almost ½ percentage point over one year. Officials agreed that rising corporate indebtedness in recent leveraged buyouts and the easing of loan covenants were a concern, but emphasized the strength of corporate and financial sector balance sheets.

C. Housing and Household Spending

8. ***The drag from residential investment is likely to dissipate gradually (Figure 2)***. As the housing market has cooled rapidly and prices have stalled and even started to fall in several cities, residential investment has declined rapidly, subtracting about 1 percentage point from growth since the spring of 2006. With housing starts falling below trend, inventory stabilizing, and builders cutting prices, the share of residential investment in GDP has moved back toward historical averages and the drag on growth should moderate. Staff suggested that the subprime shakeout, with attendant foreclosures and tightening of mortgage

lending standards, could further delay recovery in the housing market. Officials agreed that the rapid expansion of the subprime mortgage market had extended the housing boom, but felt that current sub- and near-prime mortgage market problems were manageable, given that distress was concentrated in areas with weak economies and in recent adjustable rate subprime mortgages.

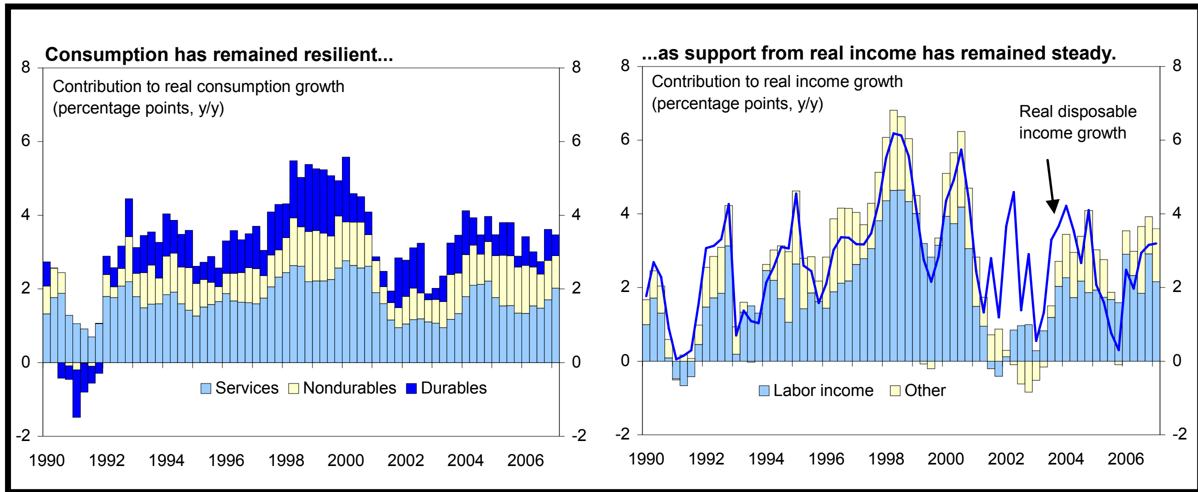
9. ***Private consumption has proven resilient to the housing market correction and is expected to remain solid (Figure B)***. Consumption grew at a robust 3¼ percent in 2006 despite a weaker housing market as household saving remained negative. Indicators have remained solid into the second quarter of 2007 despite high gasoline prices, supported by a steady labor market, continuing income growth, and low long-term interest rates. Rising equity prices have maintained a near-record household wealth-to-income ratio despite the drag on wealth from the sharp slowdown in house prices. Staff agreed with officials that consumption continued to be above its long-term equilibrium value, and its growth would likely moderate as the impact of slower house price appreciation reduces the wealth-income ratio, allowing some modest recovery in household saving.

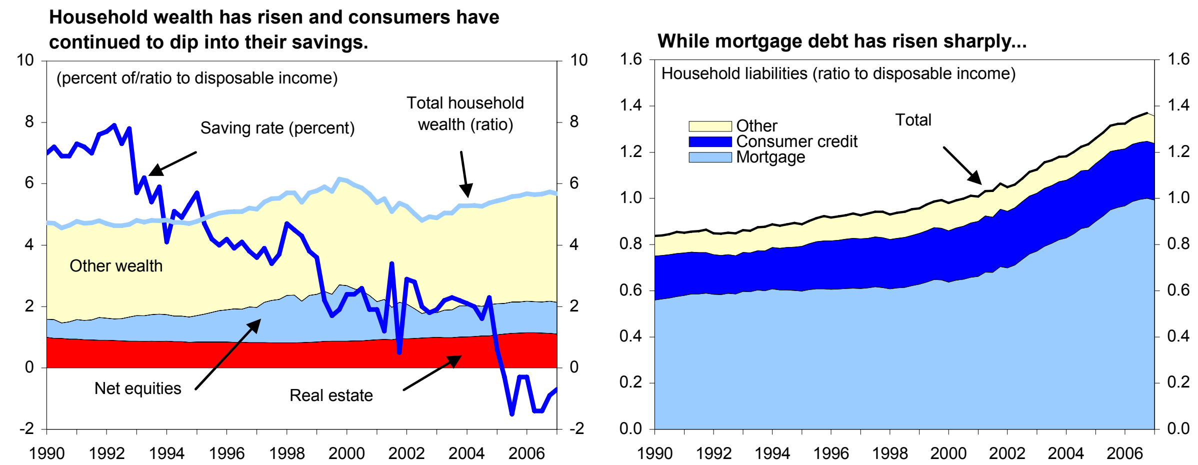
10. ***Nevertheless, there is a risk of more immediate spillovers from the housing market to personal spending (Figure 3)***. Staff noted that tighter mortgage lending standards in the wake of subprime problems and higher mortgage rates could add to pressure on household finances already affected by slowing housing wealth. Officials were more sanguine about the implications of tighter lending, which they saw as largely confined to the sub- and near-prime segment of the market—borrowers that accounted for a relatively small part of aggregate consumption. They agreed, however, that the housing market would be a significant risk for consumption if slower activity undermined employment and income growth.

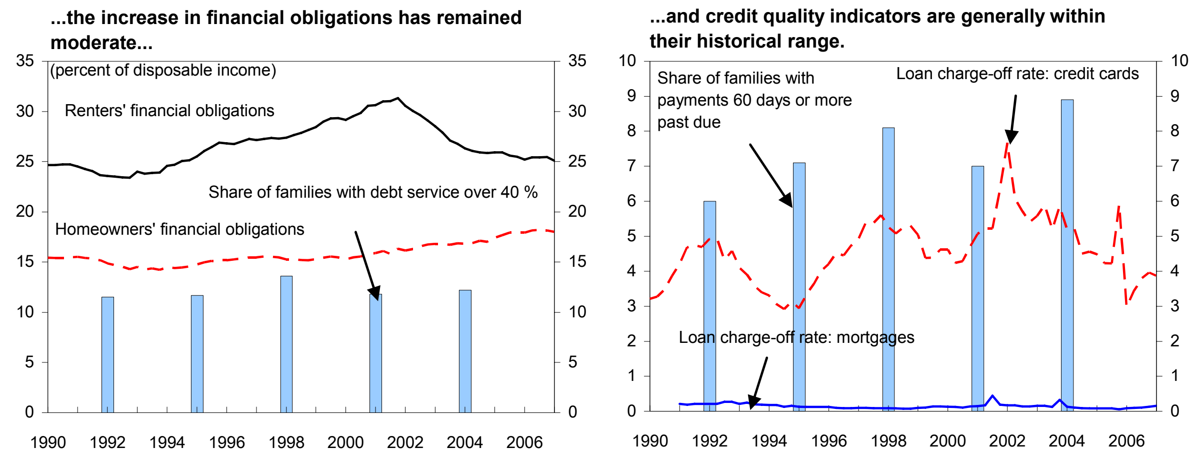
D. Prospects for Business Investment

11. ***Business fixed investment is projected to recover from recent weakness as strong fundamentals reassert themselves***. After expanding solidly during 2003–06, spending on fixed investment slowed rapidly beginning in the last quarter of 2006, although recent leading indicators suggest a revival (Figure 4). The deceleration was faster than explained by fundamentals and temporary factors, such as problems in the automobile and construction sectors and the impact of tighter 2007 emission limits on truck purchases. Officials noted that business contacts remained upbeat and emphasized the strength of corporate balance sheets, as firms had used the payoffs from cost containment to restructure through mergers, return equity to shareholders, and reduced leverage to well below pre-2001 recession levels notwithstanding the spate of leveraged buyouts by private equity funds (Figure 5).

Figure B. Household Activity and Balance Sheets







Sources: Haver Analytics; and Fund staff calculations.

12. ***Nevertheless, there remains uncertainty about prospects for business investment***. Officials observed that since the underlying causes of the weakness in business spending were not fully understood, the anticipated recovery was also not assured. Officials saw much of the recent productivity slowdown as cyclical in nature, and were confident that underlying productivity growth would remain solid on continued strong IT investment. Still, most analysts, the staff, and the authorities had marked down medium-term growth prospects on data revisions suggesting slower historical productivity growth. It was agreed that if slowing productivity turned out to imply a further reduction in potential growth, lower expected future income could reduce support for domestic demand, including business investment. In addition, staff expressed concern that financing conditions could tighten unexpectedly. The rise in long-term bond yields, volatility, and spreads in June/July 2007 illustrates the potential for a reversal to less supportive and more historically typical financing conditions.

E. Inflation Outlook

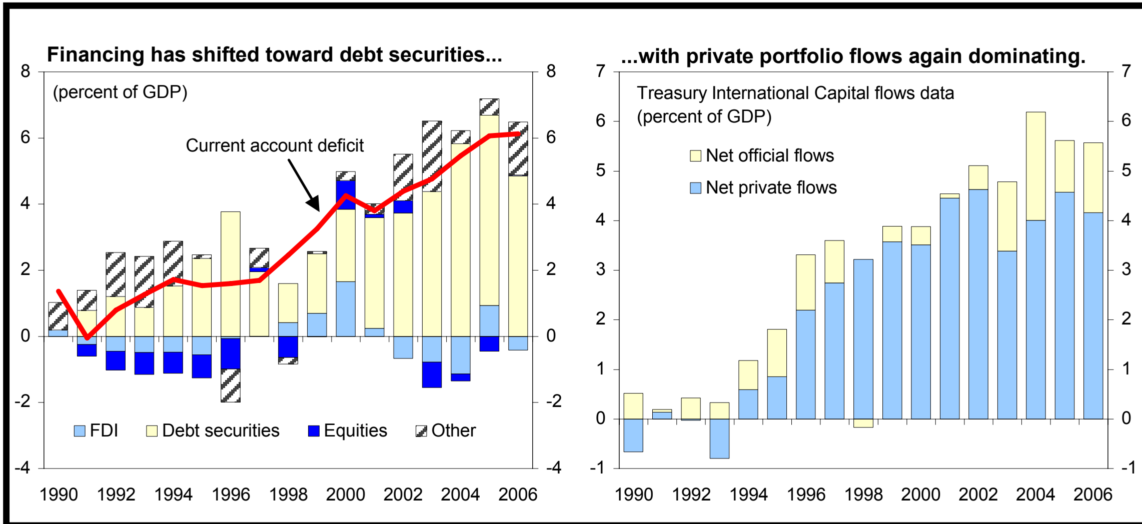
13. ***Core inflation is likely to continue to ease (Figure 6)***. While headline inflation has been dominated by energy price changes, core personal consumption expenditure (PCE) inflation—the Fed's preferred measure—has eased gradually, falling to 1.9 percent (year-on-year) in May; as is typical, the CPI measure is somewhat higher. Officials expected core measures to continue to drift downwards, drawn by the gravitational pull of well-anchored inflation expectations (most measures are consistent with expected PCE inflation of below 2 percent), less pressure from commodity prices (where the pass-through is largely complete), slowing shelter prices as the housing market cools (the catch up of rents to past house price increases has been an important recent driver of core inflation), and, to a lesser extent, growing economic slack.

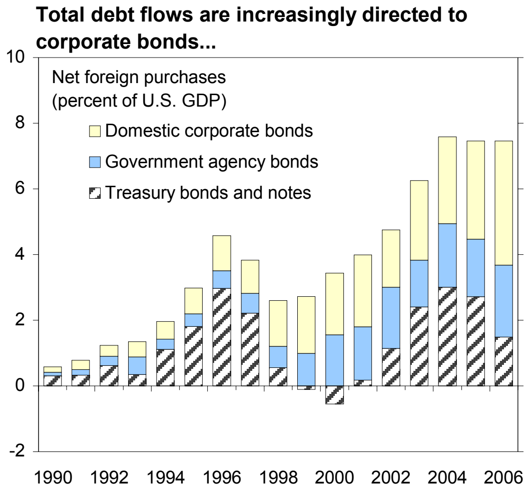
14. ***Risks to inflation are slightly to the upside***. Staff and officials agreed that there were potential cost pressures from recent rises in compensation, slower productivity growth, and the uptick in oil prices. While high profit margins provide a cushion against pass-through of these cost increases, Fed officials cautioned that the tight labor market could yield accelerating unit labor costs and lead to inflationary pressure (Figure 7).

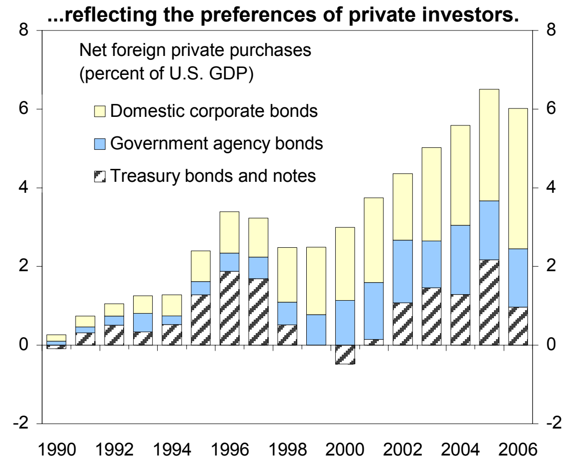
F. Funding the U.S. Current Account Deficit

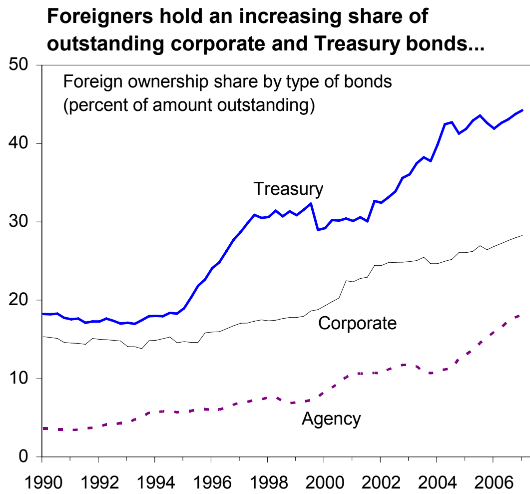
15. ***Continued easy funding of the current account deficit reflects liquid and innovative U.S. bond markets (Figure C)***. As discussed in Chapter III of the *Selected Issues* paper, net financing has come almost entirely from fixed income instruments. In addition to emerging market inflows, lower home bias and a global switch toward buying private bonds, where the U.S. represents over half the global market and dominates issuance of securitized assets, help explain the ready demand and lack of an apparent exchange rate risk premium, suggesting a significant structural element to capital inflows. Officials emphasized that the ability of U.S.

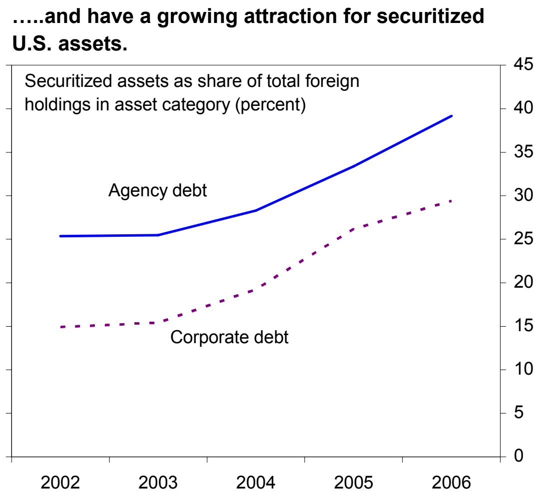
Figure C. Funding the Current Account











Sources: Haver Analytics; Flow of Funds Accounts; Treasury International Capital System; and Fund staff estimates.

markets to create a wide array of liquid assets supports financing, while low global real interest rates and tight spreads have limited funding costs.

16. ***At unchanged real exchange rates, the current account deficit is projected to narrow only slightly***. The deficit stabilized at 6 percent of GDP in 2006, with a stronger nonoil trade balance (of some ¼ percent of GDP) partly offset by the impact of higher oil prices and lower net investment income (Figure 8). Staff and officials agreed that exports would improve on strong global demand, and are an upside to the forecast. However, without further exchange rate changes, the improvement in the nonoil balance would remain modest under the soft landing scenario, as stronger U.S. activity raises imports. The falling income balance would also limit the medium-term improvement in the current account deficit.

17. ***Staff noted, however, that the associated decline in the U.S. net foreign asset position implies long-term real depreciation*** Real dollar depreciation of some 15 percent since 2002 has had only a limited impact on the trade balance, possibly reflecting a shift in trade shares toward lower-cost producers (Figure 9). Nevertheless, massive valuation gains, partly reflecting depreciation against industrial currencies such as the euro, have maintained U.S. net foreign liabilities at under 20 percent of GDP in recent years. Staff and Fed officials agreed that the upward trend would likely resume given continued large current account deficits, with the magnitude depending on the dollar's evolution. According to staff analysis by the Consultative Group on Exchange Rates (CGER), further real effective dollar depreciation of 10–30 percent would be required to eliminate the misalignment relative to medium-term macroeconomic fundamentals. Even taking account of capital market fundamentals, in particular the attractiveness of U.S. financial assets, inflows will likely diminish over time as portfolio demand is satisfied, implying a lower long-term value for the dollar.

18. ***Officials were skeptical about the notion of overvaluation for a market-determined currency such as the dollar***. While they understood the basis for staff's calculations, they stressed that the underlying CGER models failed adequately to factor in nontrade fundamentals such as capital flows. They emphasized that long-term real interest rate differentials continued to signal little market concern about large or disorderly dollar depreciation (Figure 10). Staff agreed that implied volatilities for deep out-of-the money options on the dollar suggest that markets assign a low probability to a sharp change but observed that, precisely because it would be unexpected, a sharp fall could spark turbulence.

II. Policy Discussions

19. ***The discussions focused on policies to mitigate risks to U.S.—and global—macroeconomic stability and growth***. Beyond the near-term issue of calibrating monetary policy to facilitate a soft landing, discussions centered on improving financial market regulation and ensuring long-term fiscal sustainability. Competitive financial markets have been central to the easy funding of large U.S. current account deficits, and desk analysis

suggests that spillovers elsewhere are also largely transmitted through financial channels. The key fiscal challenge is reforming unsustainable entitlement programs, particularly in the area of health care.

A. Monetary Policy

20. ***The current monetary stance is appropriate and consistent with a soft landing and a gradual moderation of inflation***. On signs of slowing growth, and with inflationary expectations well anchored, the Fed stopped tightening in June 2006 despite still uncomfortably high headline inflation (Figure D). Staff and officials agreed that the current federal funds rate of 5¼ percent is "mildly restrictive" and has led to a welcome reduction in core inflation as growth has fallen below trend. Officials saw the persistent divergence between market expectations of policy easing and the Fed's inflation concerns as reflecting differences in view on the outlook, with market participants unconvinced that a soft landing could be achieved without monetary loosening. More recently, market expectations have moved in line with Fed views, and rate cuts are no longer anticipated in 2007.

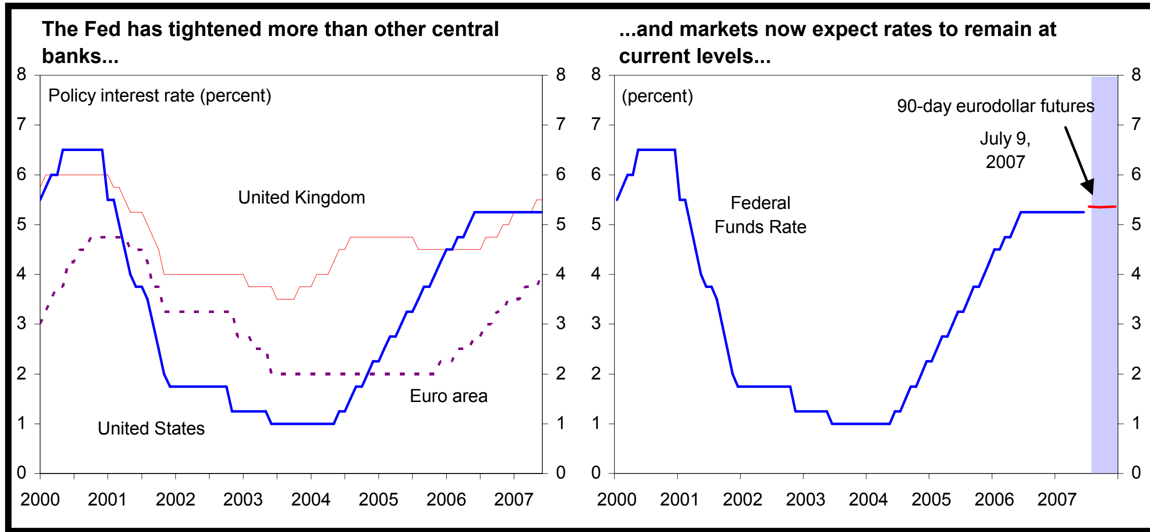
21. ***Fed officials expressed concern over inflation***. Given the stickiness in core inflation, staff and officials agreed that the expected deceleration in inflation was by no means assured. Officials underscored that under their "risk management approach," which takes into account both the likelihood and the disruptiveness of outcomes, upside inflation surprises remained the Federal Open Markets Committee's (FOMC's) dominant policy concern as they could feed through to inflation expectations, which would be socially costly. Nevertheless, monetary policy would respond to further significant unexpected weakening of the economy or tightening of financial conditions.

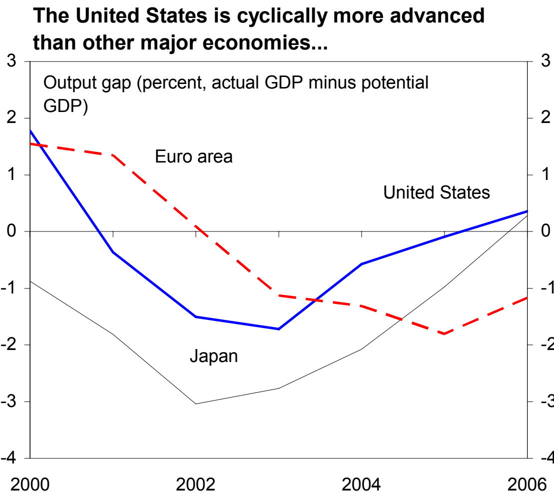
22. ***Improvements in the Fed's communications strategy should bolster its ability to comply with its dual mandate of price stability and full employment***. Staff observed that quantifying the Fed's longer-term inflation objective might help further anchor expectations. Officials responded that, while individual members may have expressed personal opinions, there was no collective FOMC view on the appropriate range for inflation. In addition, a possible inflation objective was only one facet of the evolving communication strategy. A commission led by Vice Chairman Kohn was discussing possible improvements, including the dialogue with markets, Congress, and the general public. Given that changes in communications were generally not reversible and could affect governance, they were best introduced gradually, much as the FOMC had experimented with faster approval of minutes for a year before advancing their publication.

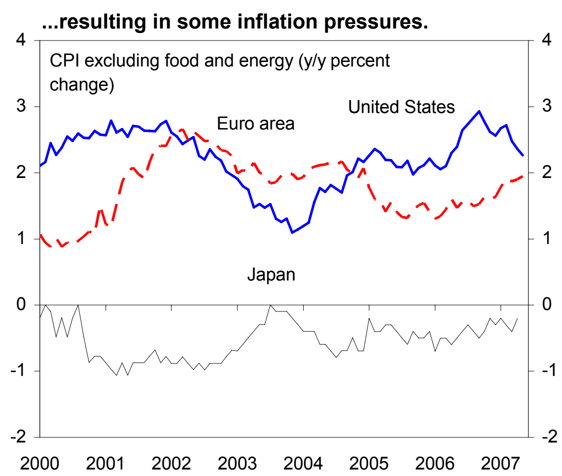
B. Ensuring a Robust Financial System

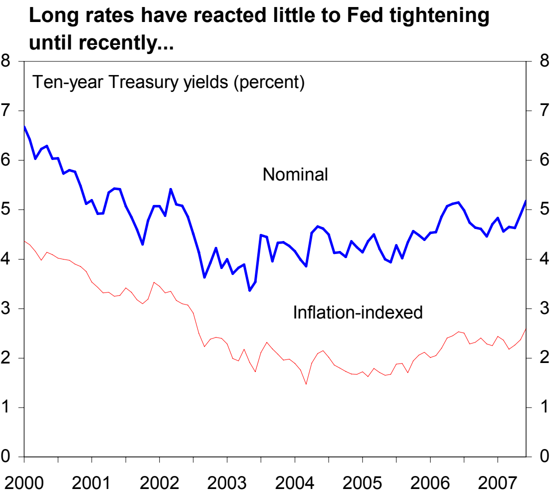
23. ***Core commercial and investment banks are in a sound financial position, and systemic risks appear low (Figure E)***. Profitability and capital adequacy of the banking

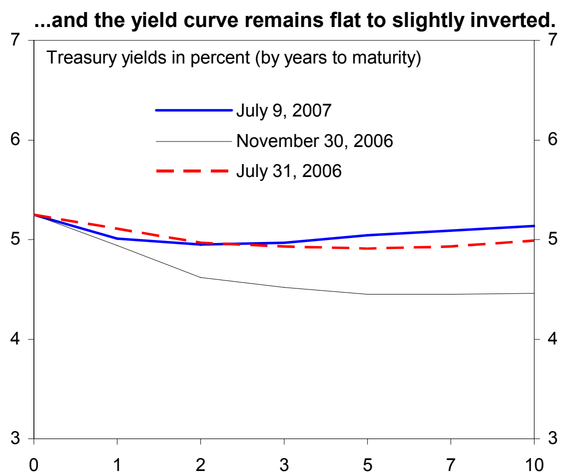
Figure D. Monetary Policy Indicators





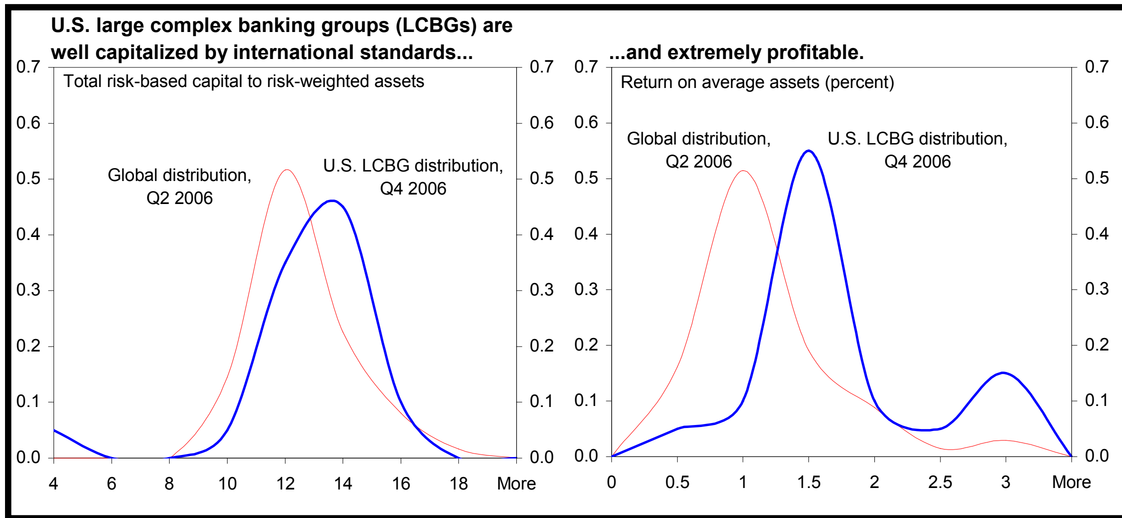


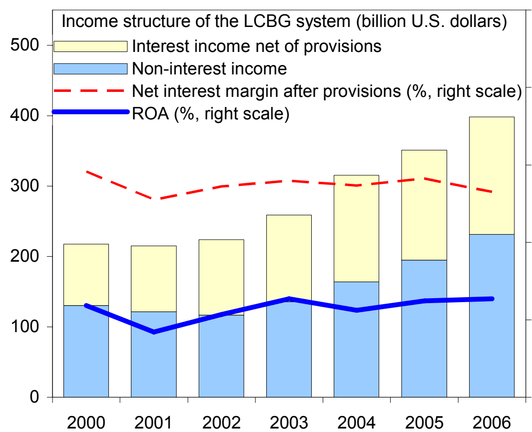


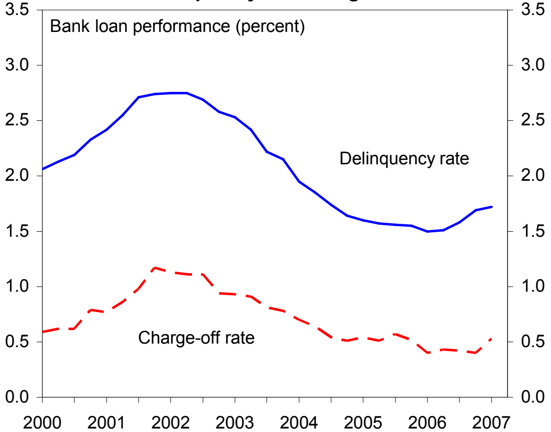


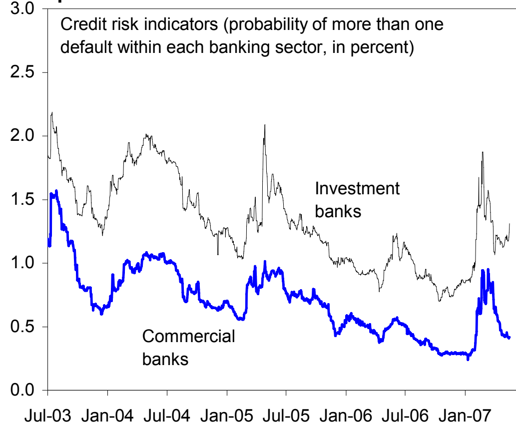
Sources: Haver Analytics; Bloomberg L.P.; OECD; and Fund staff calculations.

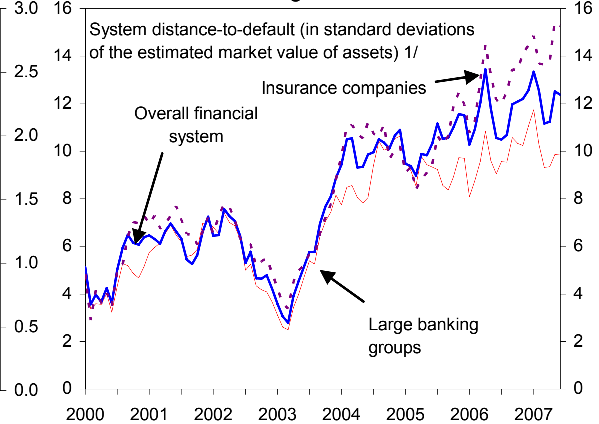
Figure E. Financial Sector Soundness Indicators











Sources: Bankscope; Datastream; Bloomberg, L.P.; Haver Analytics; and Fund staff estimates.
1/ For a discussion of distance-to-default measures, see Chapter 6 of *United States: Selected Issues* (IMF Country Report 04/228).

system are high by international standards. In particular, for large bank holding companies, the reduced interest margins from low long-term interest rates and a flat-to-slightly-inverted yield curve have been more than offset by rising fee income and near record-low defaults. Reflecting this, and despite a recent uptick following subprime difficulties, market measures of default risk have remained benign.

24. ***Federal prudential oversight rightly focuses on depository institutions and systemically important investment banks***. Officials emphasized that depository institutions benefit uniquely from deposit insurance and access to the Fed's discount window, and that the associated moral hazard justifies prudential regulation; in other areas, however, market discipline is the better regulator of risk.

25. ***Even so, financial innovation, has led to new regulatory challenges***:

- ***Systemic risks from tail events***. Staff suggested that, while recent financial developments have helpfully spread risk, the impact of an extremely adverse market outcome may have risen. This is because low market volatility has increased incentives to adopt aggressive and leveraged trading strategies that often assume liquid underlying markets, including in newer derivatives and asset-backed securities. As discussed in the April 2007 editions of the *Global Financial Stability Report* and the Bank of England's *Financial Stability Report,* a sudden rise in risk aversion could uncover unanticipated vulnerabilities, illiquidity in newer markets, and major losses in asset values.

- ***Managing counterparty risks***. Officials shared the concerns regarding increasing systemic risks from a tail event, but argued that private markets, including core institutions, are better placed than regulators to manage their exposures to highly leveraged hedge funds. In particular, they suggested that these risks could be handled through a combination of market discipline, investor due diligence, and systematic risk management, as outlined by the President's Working Group on Financial Markets. While agreeing with this approach, staff were concerned about whether adequate due diligence—including of exposures of the core to hedge funds—was possible with limited hedge fund disclosure, whether risk management systems were sufficiently robust to a shock with consequences across a range of markets and if, given likely shifts in the investor base for hedge funds, consumer protection issues would become more pertinent.

- ***Agency ratings***. Staff observed that credit rating agencies are playing an increasingly important role in how complex financial products are structured, which could involve potential conflicts of interest in that rating agencies have an interest in facilitating continuing investor appetite for such products to generate fees. Concerns have also been raised about whether all investors understand differences in underlying risks (products with similar ratings often have divergent spreads) and about the slow response of CDO ratings to problems in the subprime market (although there were a number of downgrades in June/July 2007). Officials responded that last year's Credit Rating Agency Reform Act

aimed at limiting conflicts of interest and increasing competition in the industry. As detailed regulations to implement the Act are still being finalized, it is too early to assess its success.

- ***Consumer protection***. Fed officials explained that, in light of the subprime shakeout, they are examining whether regulations implementing the Truth in Lending Act could be modified to address concerns of predatory lending, including by nonbanks that are not covered by guidance from federal regulators. Staff supported these efforts, but suggested that, given the importance of state-registered nonbanks in originating mortgages, federal legislation might also be needed to improve the consistency of enforcement.

26. ***A fragmented regulatory system hampers the response to these challenges***. Staff emphasized the disadvantages of a complex system of overlapping regulatory oversight in a rapidly changing financial landscape, noting that it could delay responses to important prudential matters, such as guidance on hybrid subprime mortgages and the implementation of the Basel II framework. While officials acknowledged that the regulatory structure reflected a complex history, they observed that it supports greater deliberation and specialization among regulators. Looking forward, the goal is to move to a more risk-based approach to regulation guided by overarching principles, as recommended by the President's Working Group, which would increase consistency across regulators and their flexibility in responding to innovation.

27. ***The Treasury has recently announced it will study options to streamline the current financial regulatory system***. Staff pointed to the work of the Government Accountability Office (GAO), which had earlier developed a number of useful reform options, including the merger of the Securities and Exchange Commission (SEC) and Commodities and Futures Trading Commission whose responsibilities overlapped (*Selected Issues* Chapter IV discusses these and other reform options). However, observers have noted that rationalization could involve difficulties, in part reflecting the current structure of Congressional oversight of federal agencies.

28. ***Staff reiterated their support for proposals to improve regulatory effectiveness (Table 1)***. These included: instituting a national insurance charter (to reduce compliance costs with state-by-state regulation); reforming oversight of government-sponsored housing enterprises (to limit systemic risks from their portfolios); and modifying the industrial loan company charter (to avoid deposit-taking without consolidated supervision). Staff also suggested that publishing a Financial Stability Report could further improve communication with market participants.

29. ***The Administration has emphasized safeguarding the competitiveness of U.S. financial markets (Figure 11)***. In addition to regulatory cost and complexity, concerns centered on litigiousness in U.S. financial markets given existing tort procedures and the associated vulnerability of the highly-concentrated audit industry (where firms are currently

required to be structured as unlimited private partnerships rather than limited liability companies). Staff welcomed recent initiatives to lower the cost of regulation, including SEC rules making it easier for foreign companies to deregister from U.S. exchanges and providing clearer guidance on Sarbanes-Oxley Section 404 that deals with company internal financial controls, which would lower compliance costs, particularly for small firms. The SEC's decision to consider recognition of some foreign regulators and international accounting standards would also improve domestic and international market efficiency.

30. ***U.S. financial markets remain highly innovative, supporting capital inflows and long-term growth***. Officials noted that some loss of market share is to be expected with capital market development abroad. Despite the attention given to lost market share in areas such as initial public offerings by foreign firms, initiatives to support market competitiveness are mainly a preemptive strategy to ensure U.S. markets remain globally preeminent.

31. ***The proposed Financial Sector Assessment Program (FSAP) will start in late 2009***. Officials explained that the need to formulate new rules to implement the Basel II framework, which was already behind schedule, precludes an earlier start date.

C. External Imbalances and International Spillovers

32. ***Staff underlined the importance of U.S. financial market conditions and soundness to global activity***. Following work in the latest *World Economic Outlook*, desk analysis finds that significant spillovers from U.S. activity to other countries operate mainly through financial markets (rather than trade channels), and with little reverse causation (Figure F, Box 2, and *Selected Issues* Chapter I). As recessions have a markedly greater impact on U.S. financial conditions than mid-cycle slowdowns, these results help explain why U.S. recessions have historically had more-than-proportional effects on foreign activity.

33. ***While a disorderly resolution of global imbalances remains a low probability event, the costs would be extremely high***. Staff and officials agreed that the rebalancing of U.S. demand from foreign to domestic goods was likely to occur gradually given strong foreign demand for U.S. assets. Nevertheless, staff observed that a more abrupt adjustment was possible and would be highly damaging if it involved a flight from dollar assets that led to broader financial market disruption. Officials responded that event studies suggest that even an abrupt exchange rate adjustment, which they considered unlikely, need not imply disorderly markets if macroeconomic policies were sound. That said, they acknowledged that the uniqueness of the current situation—a large deficit in the country at the center of the international monetary system—might limit the value of such comparisons.

Box 2. Size and Sources of U.S. Spillovers Abroad

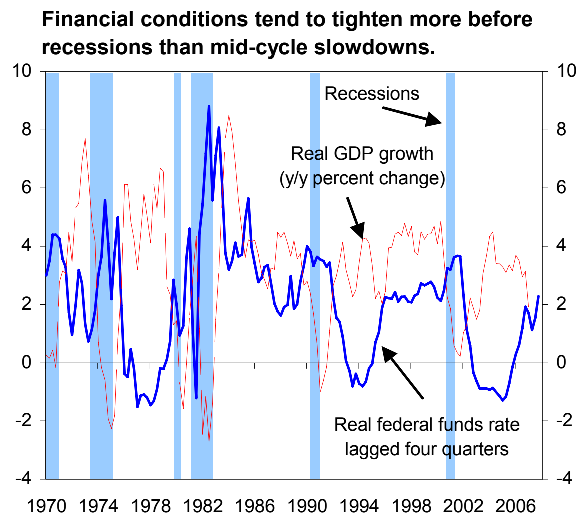
This Box summarizes desk analysis on the size and sources of output spillovers across the major industrial regions—the United States, the euro area, Japan, and an aggregate group of small industrial countries (see also Selected Issues Chapter I).

An issue in earlier work on U.S. spillovers has been separating the impact of global and regional shocks given the high correlation of economic cycles. This analysis uses disturbances to a diverse group of small industrial countries (Australia, Canada, Denmark, Norway, New Zealand, Sweden, and Switzerland) as a proxy for global shocks. Vector autoregressions using real GDP growth for the four regions—the United States, the euro area, Japan, and other industrial countries—were used to measure the size of global and regional spillovers, while sources of spillovers were studied by adding data on real net exports, commodity prices, and financial variables (short- and long-term interest rates and equity prices) to this baseline model.

The results suggest that:

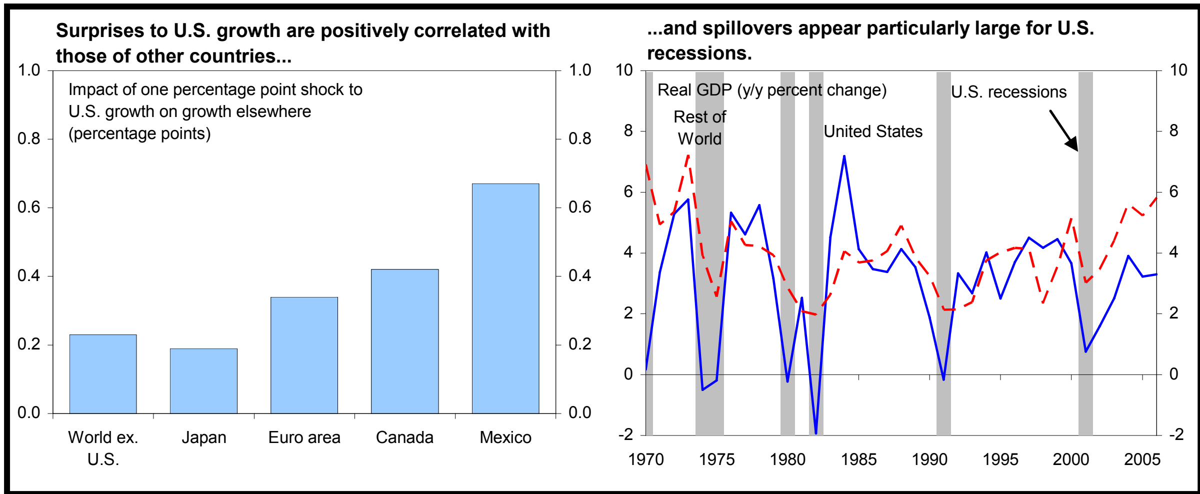
- ***Shocks to the United States have significant implications for growth in all other regions***. The spillovers are roughly ¼ to ½ as large as the disturbance in U.S. growth, with the impact building gradually over a two year horizon (see Figure F). This finding is robust to alternative orderings of the regions, with only spillovers to the rest of the world showing noticeable variation, reflecting a lingering contemporaneous correlation between U.S. and global shocks. By contrast, while the United States responds to global disturbances, it is relatively unaffected by shocks from the Euro area or Japan.

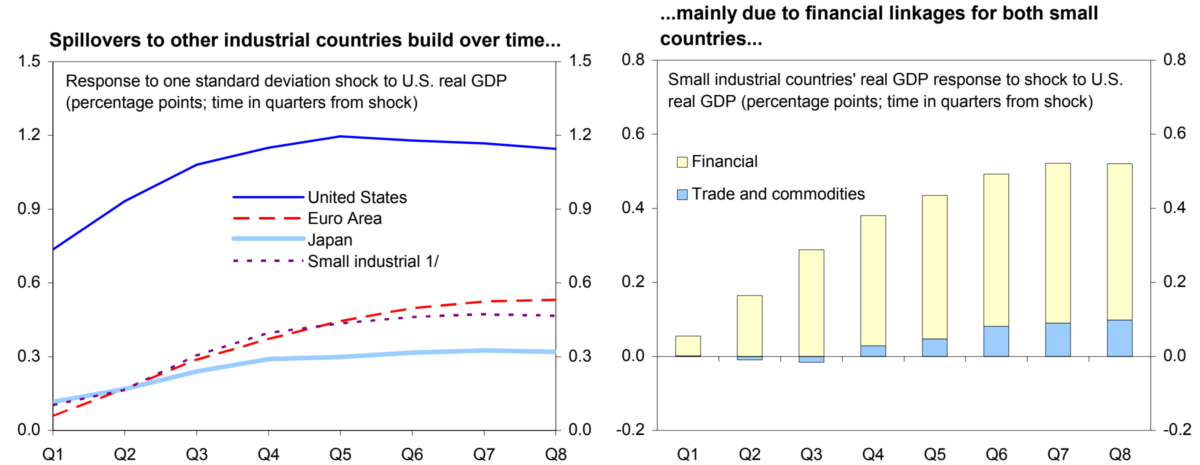
- ***U.S. spillovers to foreign output are largely transmitted through financial channels***. The analysis suggests that trade and commodity prices explain a limited amount of spillovers across regions. By contrast, financial variables explain the majority of growth linkages. The important role for U.S. financial markets is consistent with earlier analysis showing that U.S. financial conditions affect those in other countries with little reverse feedback.

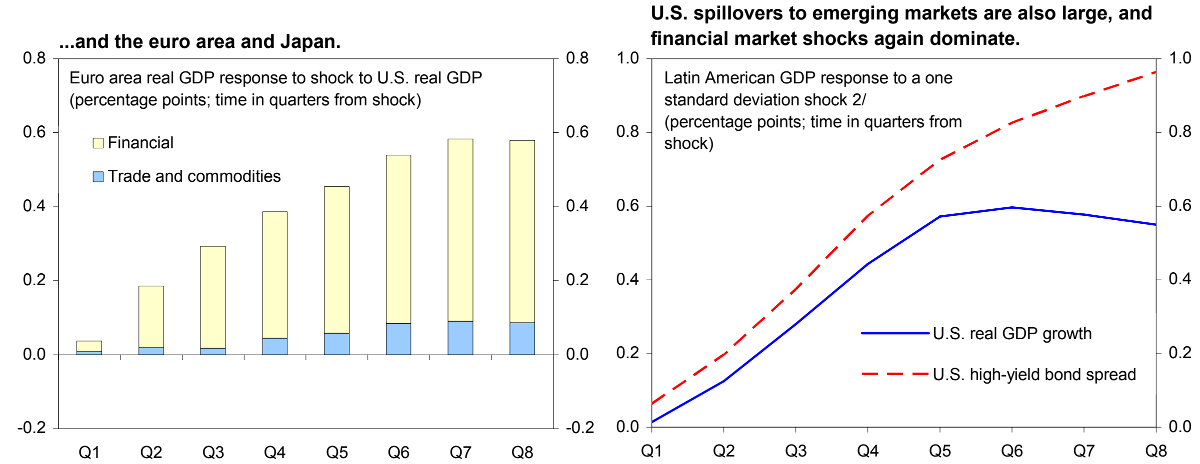


These results support the finding in the latest World Economic Outlook that the impact of U.S. growth on the rest of the world is higher in recessions than mid-cycle slowdowns. This is because U.S. financial conditions have typically tightened rapidly in the run-up to recessions than milder slowdowns in activity (Figure).

Figure F. International Spillovers







Sources: International Monetary Fund, *World Economic Outlook;* Haver Analytics; and Fund staff calculations.
1/ Includes Australia, Canada, Denmark, New Zealand, Norway, Sweden, and Switzerland.
2/ Includes Argentina, Brazil, Chile, Colombia, Mexico, Peru.

34. ***Staff welcomed the Administration's focus on policies to support national savings and stressed the role of fiscal consolidation in reducing the current account deficit***. This commitment, which has been reaffirmed as part of a shared responsibility of key members to address global imbalances in the context of the Multilateral Consultation (MC), would lower the risks of a disorderly resolution of global imbalances (Table 2). Officials responded that the U.S. fiscal deficit had improved much faster than expected during the past two years, obstacles to automatic enrollment in defined-contribution pension plans had been eliminated, and proposals to enhance tax incentives for household savings had been presented in the latest budget. They also noted that the MC had been useful in reaching shared technical understandings among the participants and engagement with them.

35. ***The authorities restated their commitment to resisting rising protectionism***. Staff underscored the importance of maintaining an open trading system and offering a larger reduction in the ceiling of U.S. agricultural subsidies to catalyze an ambitious outcome to the Doha Round. They also suggested that greater support to those temporarily dislocated by rising imports could help ameliorate the impact of trade on workers, and thereby help resist pressure for higher tariffs. Officials emphasized the Administration's "absolute commitment" to openness and progress in the Doha round. They were confident that the President's Trade Promotion Authority, a crucial underpinning for completing the Doha Round that expired on July 1, could be renewed if needed. However, they did not see a case for expanding specific support for workers displaced by trade separate from the regular social safety net given the difficulties of identifying the reason that workers had lost jobs.

D. Achieving Fiscal Sustainability

36. ***Short-run fiscal developments continue to be favorable (Figure 12)***. The Administration's goal of halving the deficit by FY 2009 was achieved three years ahead of schedule, with the unified deficit falling below 2 percent of GDP in FY 2006. The FY 2007 deficit is again likely to significantly outperform expectations and move below 1½ percent of GDP. This success reflects both revenue buoyancy (as profits and capital gains surged) and lower-than-budgeted expenditures.

37. ***Staff welcomed the strong fiscal outcomes but cautioned that the strength of revenues seen in recent years could be partly temporary***. Outperformance since FY 2004 has largely reflected unexpected revenue buoyancy, three-quarters of which is attributable to high corporate profits and capital gains revenues, with much of the remainder explained by rising inequality (*Selected Issues* Chapter VI). Given risks to growth and the apparent slowing of profit growth, it is not clear that revenue buoyancy will persist into FY 2008.

United States: Budget Projections
(Fiscal years; in percent of GDP)

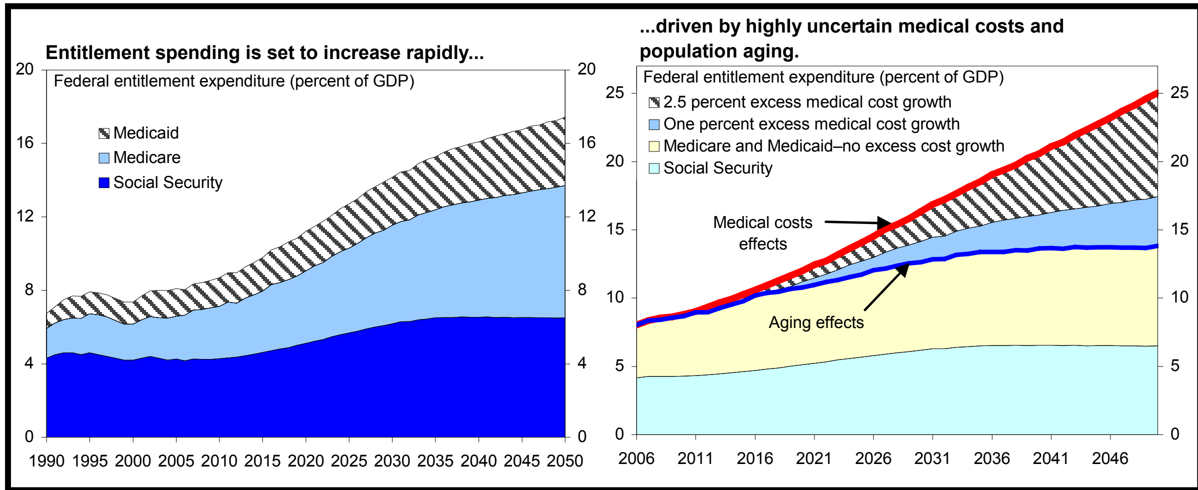
			Projection					
	2005	2006	2007	2008	2009	2010	2011	2012
FY 2008 Budget								
Unified balance	-2.6	-1.9	-1.8	-1.6	-1.2	-0.6	-0.3	0.3
Primary balance	-1.1	-0.2	0.0	0.1	0.6	1.2	1.4	1.9
Unified balance exc. social security	-4.0	-3.3	-3.2	-3.0	-2.6	-2.0	-1.8	-1.1
Debt held by the public	37.4	37.0	36.9	36.7	36.0	34.8	33.4	31.5
Staff Projection 1/								
Unified balance	-2.6	-1.9	-1.4	-1.6	-2.0	-1.8	-1.7	-1.2
Primary balance	-1.1	-0.2	0.4	0.2	-0.2	0.0	0.0	0.5
Unified balance exc. social security	-4.0	-3.3	-2.8	-3.0	-3.5	-3.2	-3.2	-2.6
Debt held by the public	37.4	37.1	36.9	37.0	37.4	37.5	37.5	37.1

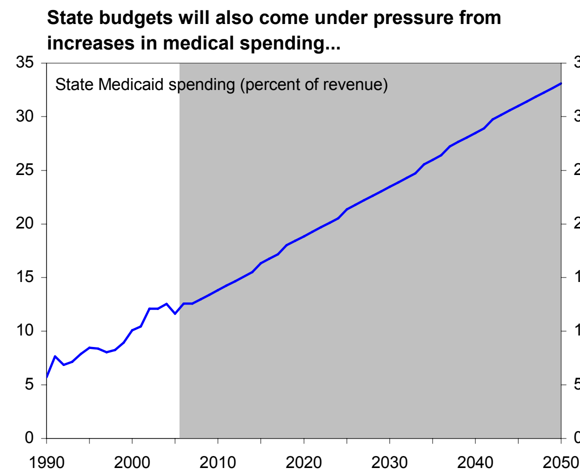
Sources: FY 2008 Budget of the U.S. Government (February 5, 2007); and Fund staff estimates.
1/ Staff projections are based on the Administration's budget adjusted for: differences in macroeconomic projections; staff estimates of the cost of ongoing operations in Iraq; some additional non-defense discretionary expenditure; additional Medicare spending; and continued AMT relief beyond FY 2008. PRAs are also assumed not to be introduced.

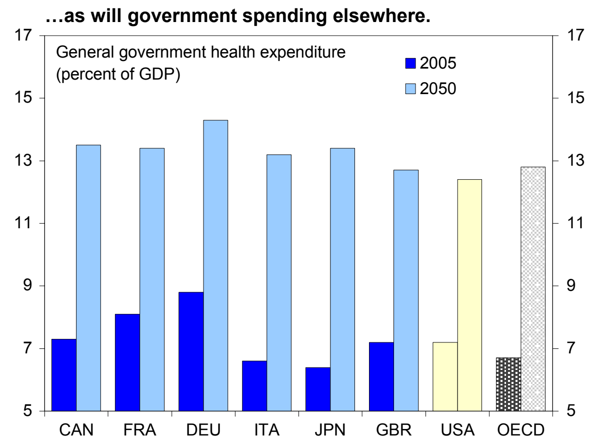
38. ***The Administration aims to balance the budget by FY 2012 while making permanent the 2001/03 tax cuts, but achieving this goal will be difficult***. Officials emphasized that spending restraint would be key to achieving their target, given the importance of preserving the benefits of lower tax rates. Staff welcomed the Administration's commitment to a deficit reduction target and Congress' decision to adopt this target in its own budget resolution, supported by pay-as-you-go rules in both chambers. However, Congress envisages a rather different strategy involving less spending compression while allowing most of the 2001/03 tax cuts to expire (extension of the tax cuts lowers revenue in the baseline by some 1 percent of GDP from FY 2011). Given this lack of consensus, as well as the fact that neither set of projections accounts fully for war costs or, more importantly, for Alternative Minimum Tax (AMT) relief beyond FY 2008 (costed at around ½ percent of GDP annually), staff project the deficit remaining above 1 percent of GDP through FY 2012.

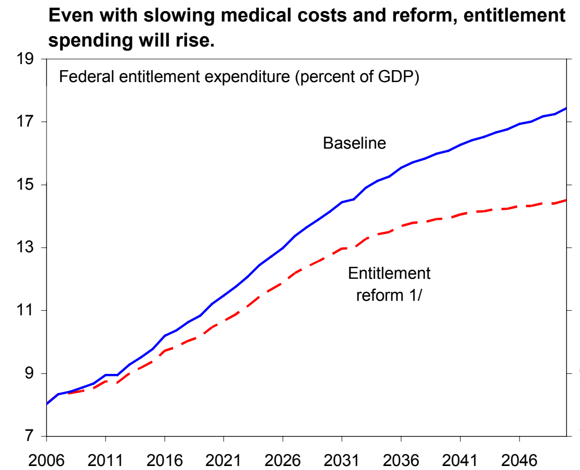
39. ***Entitlement reform is vital to long-term budget sustainability, and early action would reduce the cost of needed adjustment (Figure G)***. Congressional Budget Office (CBO) projections imply that, under current policies, net federal spending on Medicare, Medicaid, and Social Security as a ratio to GDP will more than double to some 17 percent of GDP a year by 2050, driven by health spending. Officials emphasized that the Administration's reform proposals had been held back by limited political support. Staff and officials agreed that including an analysis of long-term sustainability in budget documents—an alternative discussed by the Federal Accounting Standards Advisory Board—would help increase awareness of the challenge posed by rising costs of public health and pension programs. (*Selected Issues* Chapter VII applies GFS 2001 accounting to the U.S. fiscal data.)

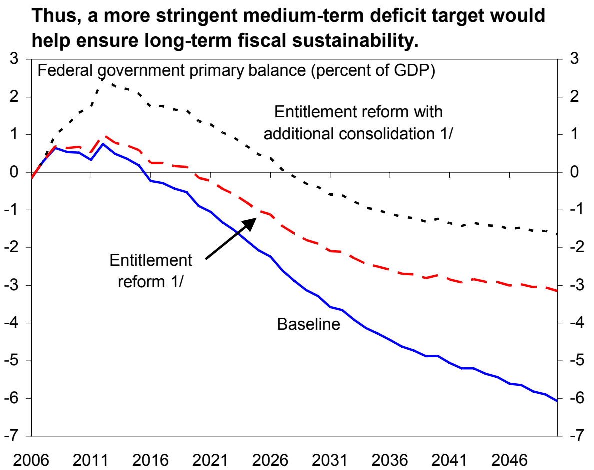
Figure G. Entitlement Spending and the Long-term Fiscal Outlook











Sources: Haver Analytics; Congressional Budget Office (CBO); Office of Management and Budget; and Fund staff calculations.
1/ Reform includes progressive indexation of Social Security; structural measures to facilitate cuts in Medicare provider payments as per the Sustainable Growth Rate (SGR) mechanism; and the President's FY 2008 budget proposals for Medicare. The baseline assumes that Medicare provider payments grow with the Medicare Economic Index.

40. ***The Administration has proposed reductions in Medicare spending by further linking contributions to income and reducing provider payments***. Staff strongly endorsed budgetary proposals on contributions as an important step. However, it may be difficult to lower provider payments, since cuts already required in the Medicare legislation are regularly overturned. The Medicare Trustees have estimated that a more realistic path for payments would increase projected long-term costs for physicians and outpatient services by 25–40 percent. In Medicaid, the main option is reducing long-term care costs—that comprise around half of national spending—through better targeting of services.

41. ***Medicare and Medicaid cannot be sustainably reformed without broader measures to improve the effectiveness of medical spending (Figure 13)***. CBO staff emphasized that rapidly increasing health care costs are a more important driver of future entitlement spending costs than aging. Treasury officials observed that the problem is multifaceted and requires a range of measures, including more appropriate price signals, improved pay-for-performance schemes, better use of information technology, and enhanced information for both consumers and doctors. Staff and officials agreed that further analysis, preferably coordinated in the public sector, is needed to better understand underlying health cost drivers and achieve greater consensus on reform options.

42. ***The latest budget proposals to eliminate the tax bias toward employer-provided coverage would help to control national health costs***. Replacing the uncapped tax break for employer-provided health insurance with a standard deduction for all would reduce incentives for "gold plated" schemes, complementing earlier tax incentives for high-deductible coverage. While agreeing that fostering individual responsibility could lower costs, staff observed that the gains might be limited given most medical spending stems from chronic and catastrophic cases and emphasized the importance of strengthening the individual insurance market. Officials acknowledged these concerns and responded that the Administration is allowing states to redirect some federal funds to support experiments to broaden coverage, which would provide insights about the efficacy of different approaches.

43. ***With Social Security cost drivers and reform options well understood, the priority is achieving consensus on specific proposals***. Staff observed that progressive indexation, in which benefits for the wealthy are slowed gradually while those for the poor are protected, could form the basis for a reform package. Officials emphasized that the Administration is open to proposals and has invited discussion of reform options without preconditions.

44. ***A more ambitious medium-term fiscal consolidation would better prepare for rising entitlement costs, while also helping to reduce the current account deficit***. Entitlement spending is likely to put substantial pressure on the future size of general government (Figure 14). Staff analysis suggests that even if medical inflation is slowed and substantial entitlement reform achieved, long-term fiscal sustainability would require a more stringent fiscal target—for instance, balancing the budget excluding the Social Security surplus. Such a stance would put debt on a clearly declining path and offer room to maneuver in

responding to long-term challenges. Officials responded that budget balance by FY 2012 is appropriately ambitious, and that further adjustment would be largely irrelevant given the size of long-term entitlement pressures.

45. ***Spending restraint is critical to deficit reduction, but revenue increases may also need to be considered***. Staff acknowledged the incentive benefits of the 2001/03 tax cuts, but noted that these are partly offset by crowding out through higher government debt and real interest rates. With nonsecurity discretionary spending as a ratio to GDP moving to historical lows, revenue increases may be needed to support ambitious fiscal consolidation.

46. ***The tax system is in any case in need of reform given its extensive exemptions and high marginal tax rates***. Income tax expenditures are over one-third of revenues, with deductions for employers' health insurance and mortgage interest alone accounting for 1¾ percent of GDP annually. The 2005 Presidential panel on tax reform provided a useful blueprint to eliminate some deductions (state and local tax payments) and better target others (mortgage interest relief), while supporting personal saving. This could usefully be augmented by higher energy taxes, particularly as lower consumption would yield environmental benefits. Officials noted that the Administration remains interested in improving the efficiency of the tax system, but is constrained by a lack of political support, and that the Administration's energy policy emphasizes greater use of biofuels.

III. Staff Appraisal

47. ***The most likely scenario is a soft landing as growth recovers and inflation falls, although both are subject to risks***. Staff's baseline forecast is for activity to pick up as the drag from housing dissipates, business investment revives, and higher foreign growth supports net exports. However, consumption could be weaker given the ongoing housing market slowdown and benign financial market conditions could tighten. At the same time, the expected decline in core inflation may not materialize if cost pressures from rising oil and commodity prices and a tight labor market feed through to prices, despite the cushion provided by wide profit margins.

48. ***Current monetary policy is consistent with a soft landing and can be adjusted flexibly in response to emerging macroeconomic developments***. With inflation above the Fed's comfort level for some time and unemployment low, the FOMC has rightly emphasized maintaining well-anchored inflation expectations. However, policymakers will need to be alert to the speed with which employment and activity can weaken in a downturn.

49. ***Financial innovation and stability have underpinned U.S. economic success and funding of the current account deficit***. The system has been highly resilient, including to recent difficulties in the subprime mortgage market. Innovation has helped disperse risk, and has been instrumental in attracting capital inflows, with foreigners increasingly buying U.S. private sector debt securities.

50. ***But rapid innovation has also created new regulatory challenges***. Prudential oversight should focus on core commercial and investment banks, while market discipline limits risk-taking elsewhere. However, new instruments have made it more difficult to assess risks at a time when benign market conditions have encouraged risk taking and lower lending standards. Tightening financial conditions could expose unanticipated risk concentrations and links across markets. This places a premium on supervisors' ensuring that risk management systems are robust to potential difficulties across a range of markets, particularly for exposures of the core to hedge funds and other private pools of capital. Problems with subprime mortgages also raise the challenge of ensuring consistent consumer protection through federal rules without unduly constraining innovation.

51. ***With several federal and many state regulators overseeing this evolving system, the new emphasis on improving regulatory effectiveness is welcome***. Shared responsibility can encourage informed debate, but it also slows responses to pressing issues (e.g., to issuing guidance on hybrid subprime loans and Basel II accord guidelines). Increased use of general principles as a guide to rule making could ease interagency coordination and shorten reaction times to innovation. We strongly support plans to study the scope for rationalizing the regulatory structure, which can build on options earlier discussed by the GAO. Other measures to improve regulatory effectiveness could include instituting a national insurance charter, reforming oversight of government-sponsored housing enterprises, and modifying the industrial loan company charter.

52. ***Other initiatives to lower the costs of regulation and increase financial market competitiveness will help retain the preeminence of U.S. financial markets***. New guidance will reduce the compliance burden of parts of the Sarbanes-Oxley Act, and new rules now make it easier for foreign companies to delist from U.S. markets. We also welcome recent moves by the Securities and Exchange Commission to consider recognizing international accounting standards for foreign companies and to allow for mutual recognition of regulatory regimes, which would improve market efficiency.

53. ***A disorderly resolution of global imbalances remains a low probability—but high cost—risk***. The rebalancing of U.S. demand from foreign to domestic goods, and associated real depreciation of the dollar and reduction in the current account deficit from an unsustainable level will likely occur gradually given continuing strong demand for U.S. financial assets. However, shocks could provoke a more abrupt elimination of the long-term misalignment. A flight from dollar assets would risk disrupting U.S. financial markets, thus lowering domestic demand and—via financial market spillovers abroad—foreign demand as well. This highlights the importance of: (i) ensuring that U.S. financial markets remain sound and innovative; and (ii) supporting U.S. saving, in particular by further reducing the fiscal deficit, as agreed in the Multilateral Consultation.

54. ***With the large current account deficit spawning initiatives to erect trade barriers, we welcome the U.S. authorities' commitment to free trade***. A more ambitious agenda for liberalizing agriculture could support a positive outcome to the Doha round of trade talks. In

addition, while globalization has undoubtedly raised aggregate welfare, it should be recognized that it has also created winners and losers. Consideration could thus be given to policies to aid workers temporarily dislocated by rising imports, which could also help reduce protectionist sentiment.

55. ***Recent fiscal performance and the adoption of a medium-term fiscal target are commendable, but sustaining deficit reduction requires further political effort***. Congress has adopted the Administration's target of budget balance by FY 2012 and passed supporting pay-as-you-go rules. However, consensus on the means to achieve budgetary balance—whether via tax- or spending-side measures—is lacking. Moreover, uncertain war funding requirements and the cost of fixes to the Alternative Minimum Tax also will need to be taken into account.

56. ***The key fiscal challenge is reforming unsustainable entitlement programs***. Rising health costs and aging imply huge spending increases in Medicare, Medicaid, and, to a lesser extent, Social Security:

- Staff strongly endorse the Administration's proposal to strengthen the link between premiums and income as a first step to contain the costs to the budget of Medicare spending, although further reforms will be needed.
- Administration proposals such as removing the tax bias for employer-sponsored health coverage could help reduce the high cost of U.S. health care but may need to be complemented by more vigorous measures to bolster the individual insurance market. More fundamental reform is necessary, and additional work is needed on underlying medical cost drivers and policy options.
- For Social Security, where the underlying costs and reform options are already well understood, the priority now is to develop a consensus on the direction to take. Progressive indexation is a promising approach.

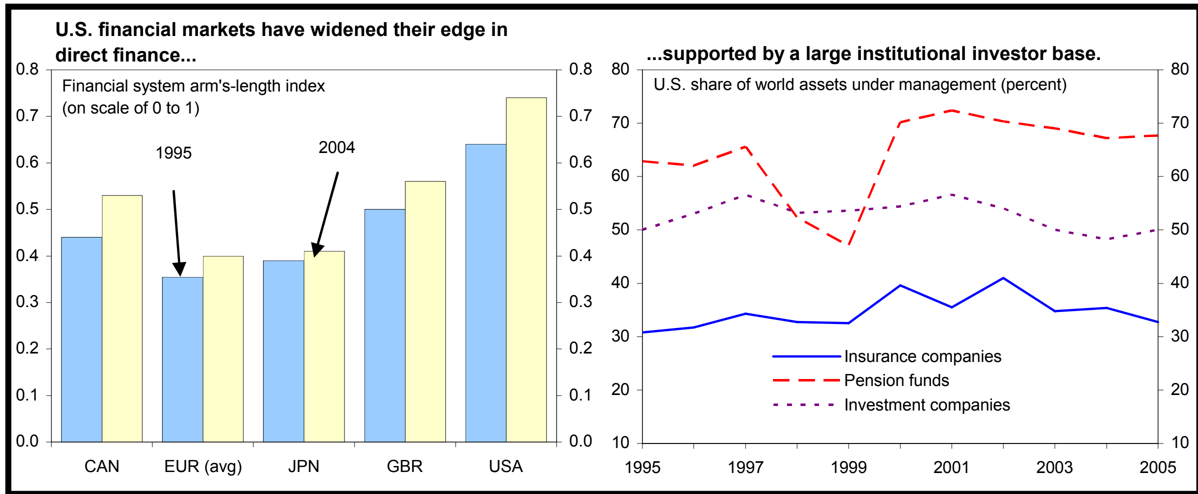
57. ***A more stringent medium-term target than the Administration's would better prepare for these spending pressures, while contributing to current account adjustment***. Balancing the budget excluding the Social Security surplus, for instance, would, by placing government debt and associated interest costs on a clear downward trajectory, offer greater room for maneuver in addressing future fiscal pressures on entitlement spending. The implied structural improvement of slightly over ½ percent of GDP a year is achievable without significant economic disruption.

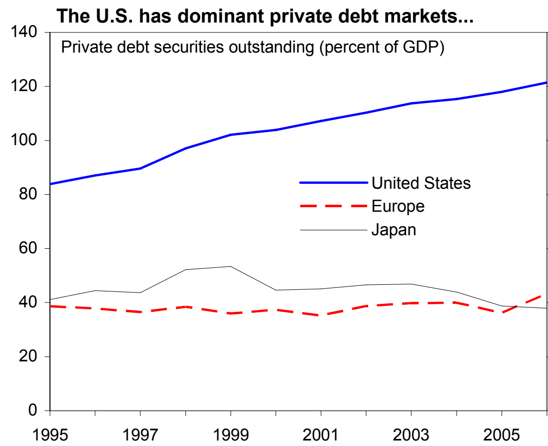
58. ***The reform of entitlement spending should be complemented with tax reform***. Depending on the progress that can be made in controlling spending, revenue increases may also be needed. An overhaul of the complex tax system is in any case overdue. Proposals contained in the President's Advisory Panel on Tax Reform to reduce and better target write-offs while further shielding saving from income taxes are an excellent starting point. This

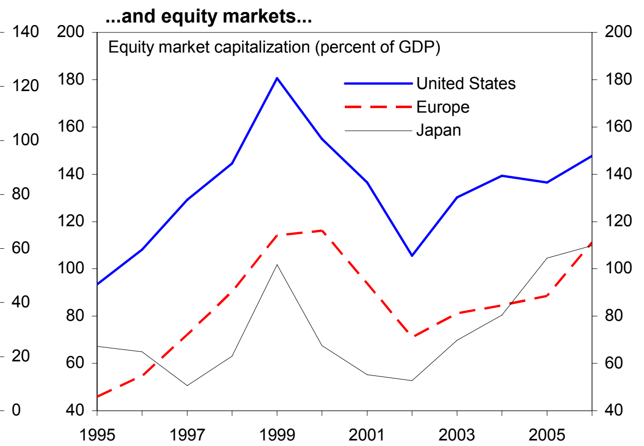
could be augmented by other options, such as in the area of energy taxes, which would also support environmental objectives.

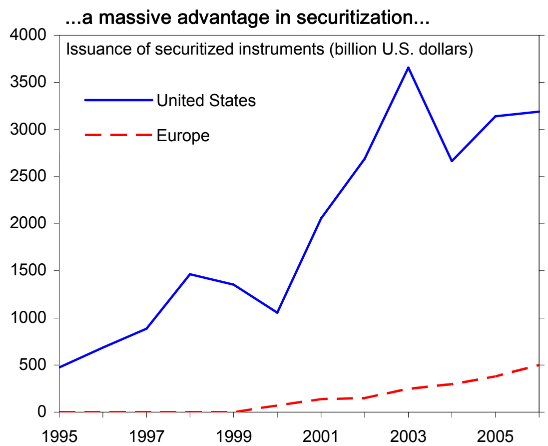
59. ***It is expected that the next Article IV consultation with the United States will be held on the regular 12-month cycle***.

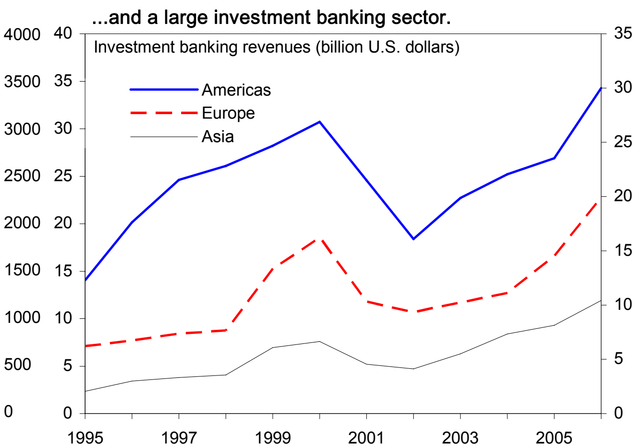
Figure 1. Financial Markets in an International Perspective





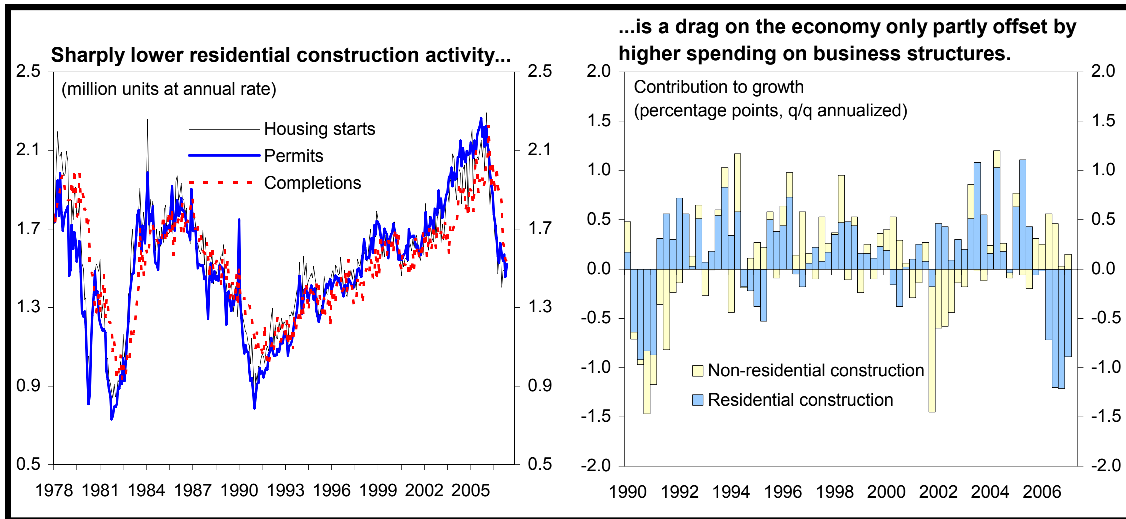


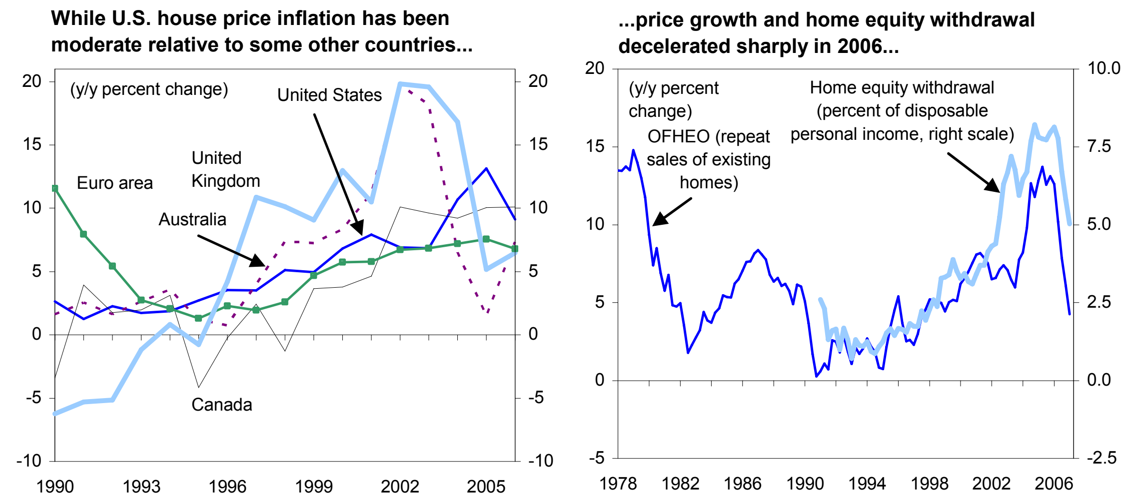


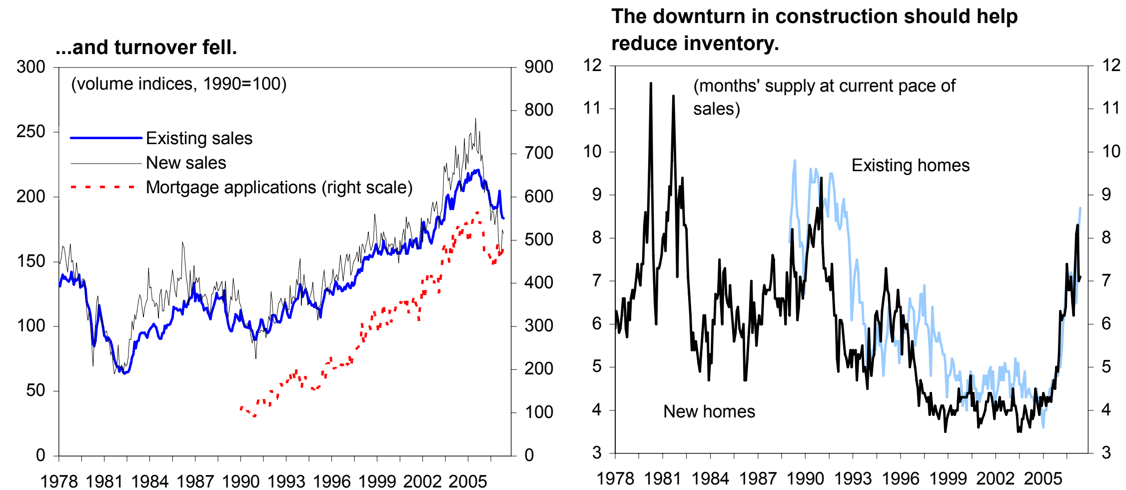


Sources: International Monetary Fund, *World Economic Outlook;* World Federation of Exchanges; Bank for International Settlements; OECD; International Financial Services, London; The Bond Market Association (U.S.); European Securitisation Forum; Freeman and Co.; and Fund staff calculations.

Figure 2. The Housing Market and Real Activity

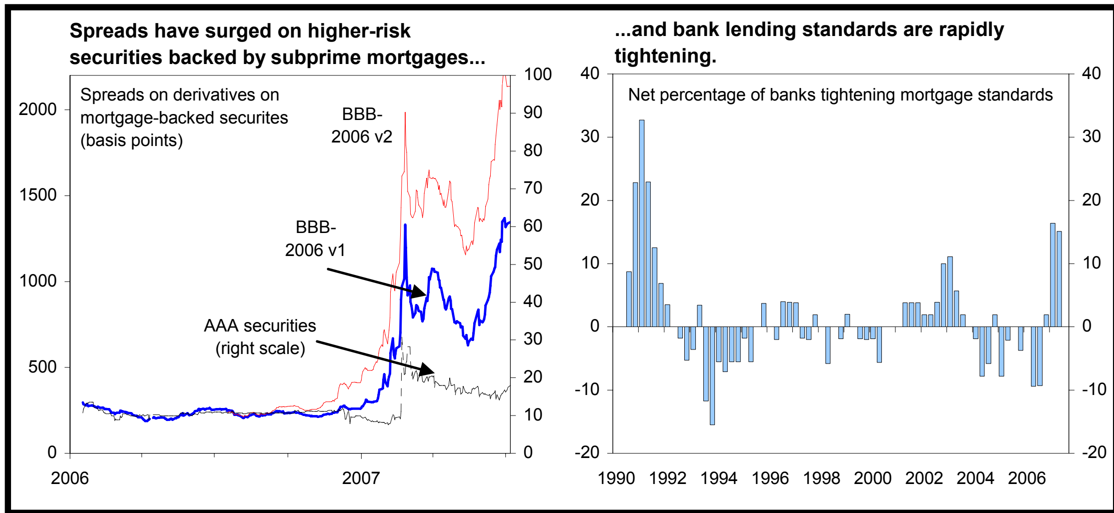


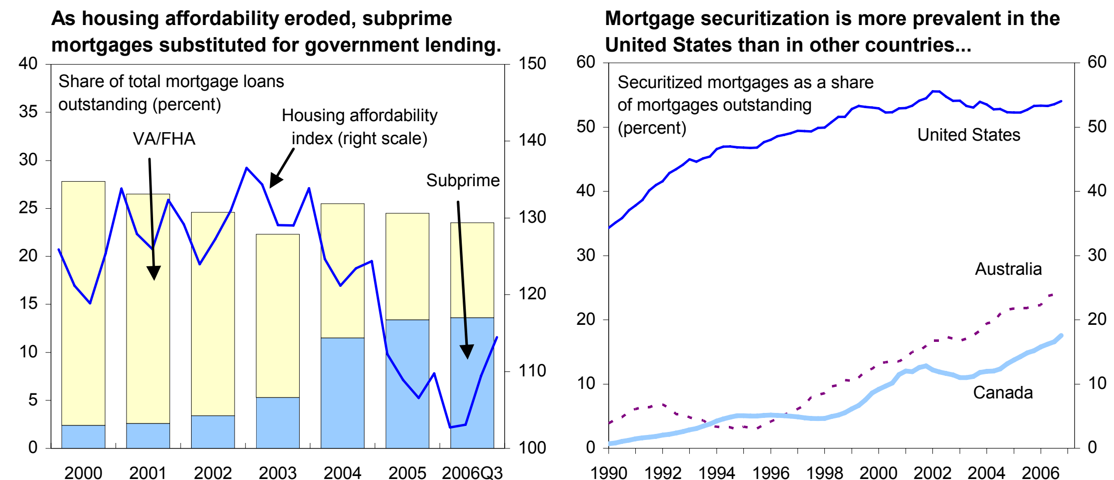


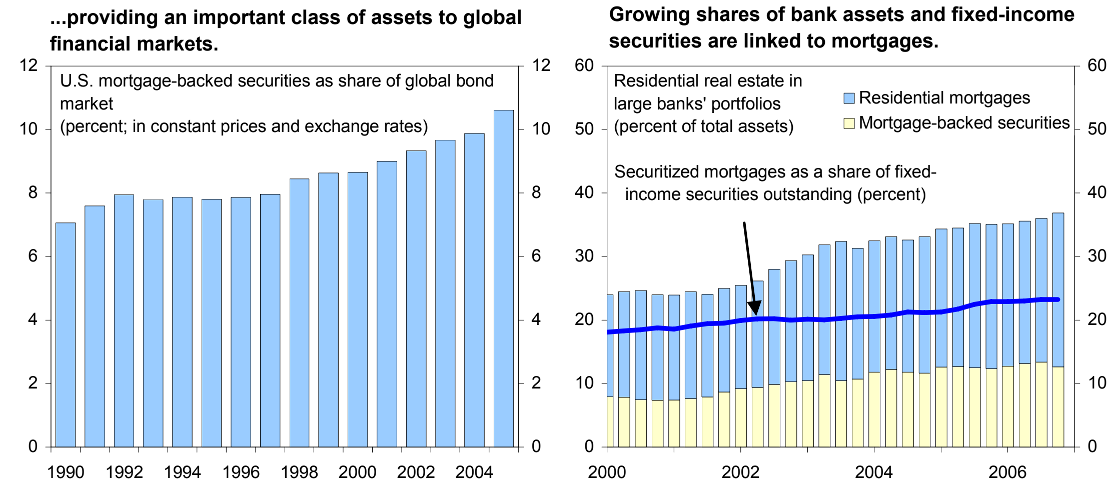


Sources: Haver Analytics; Bloomberg, L.P.; Canadian Real Estate Association; and Fund staff calculations.

Figure 3. The Housing Sector and Financial Markets

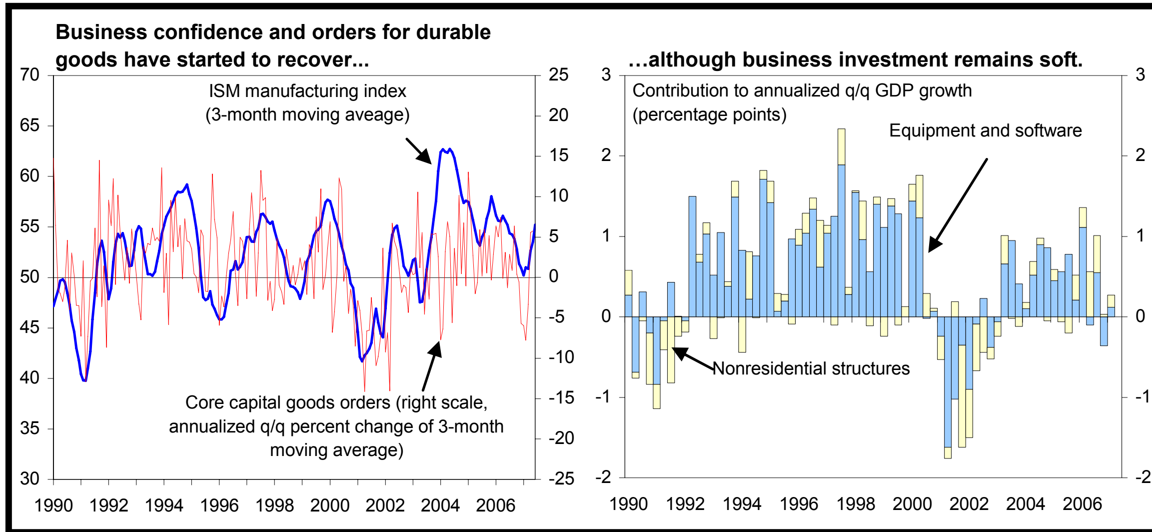


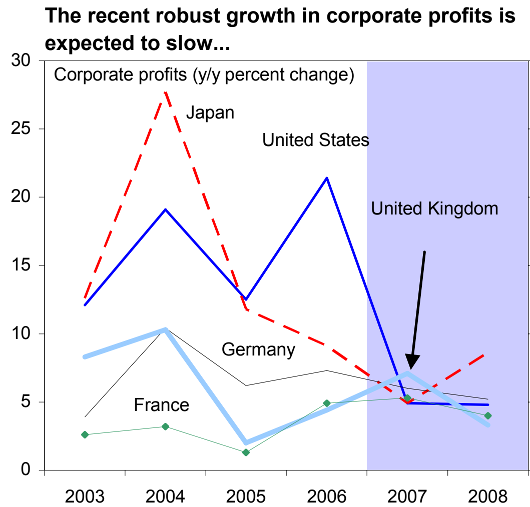


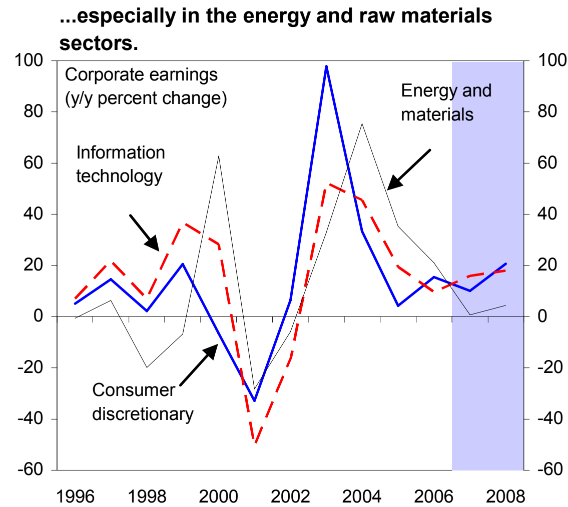


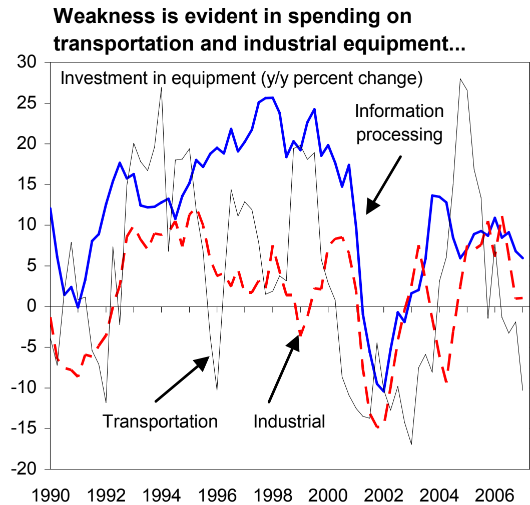
Sources: J.P. Morgan; Haver Analytics; Mortgage Bankers Association; Reserve Bank of Australia; Bank for International Settlements; and Fund staff calculations.
1/ Index equals 100 when median family income qualifies for mortgage of eighty percent of value on an existing single-family home at the median price. A rising index indicates more buyers can afford to enter market.

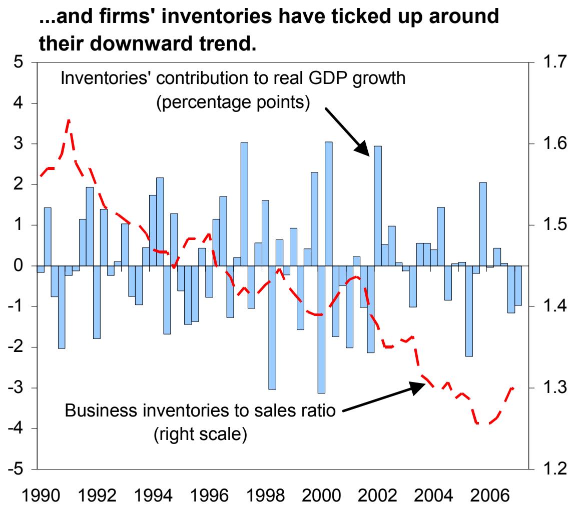
Figure 4. The Corporate Sector and the Real Economy





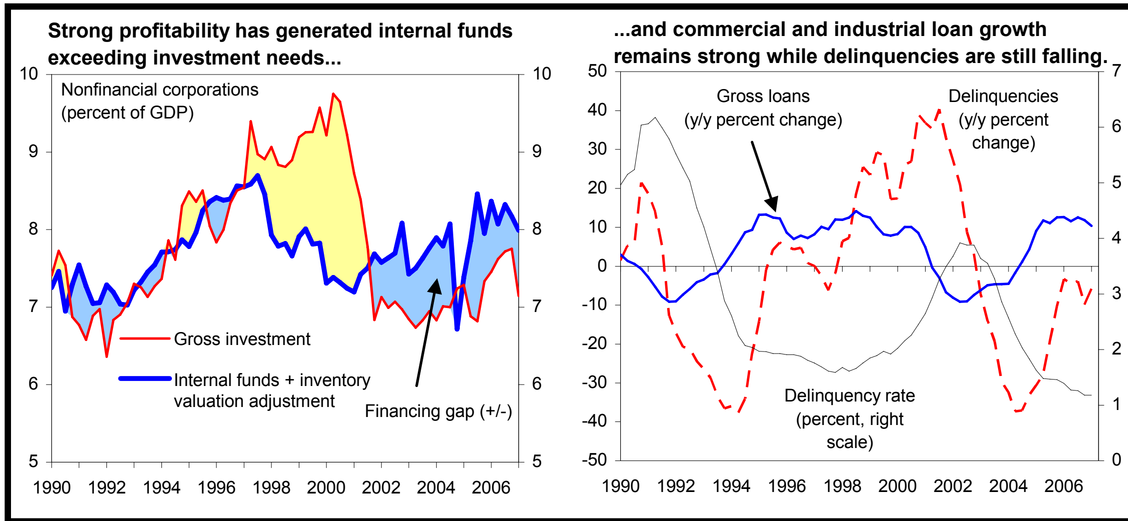


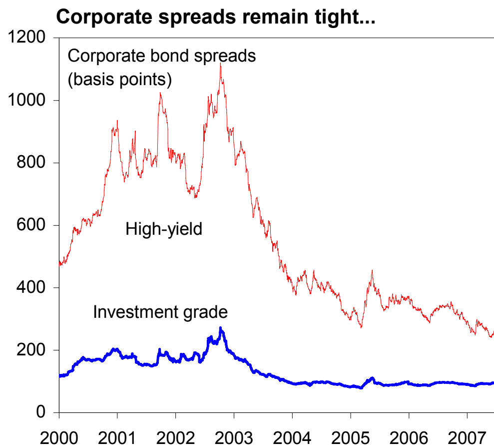


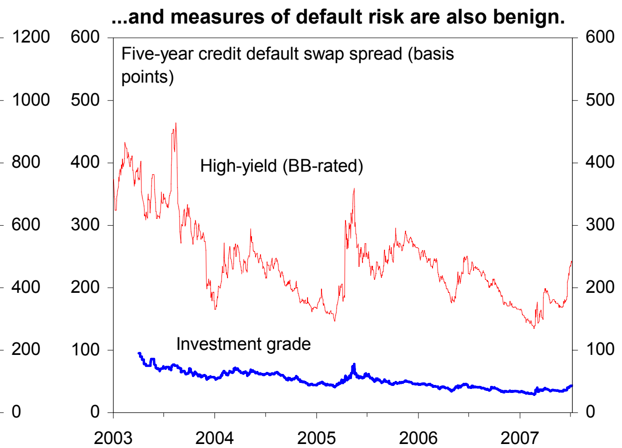


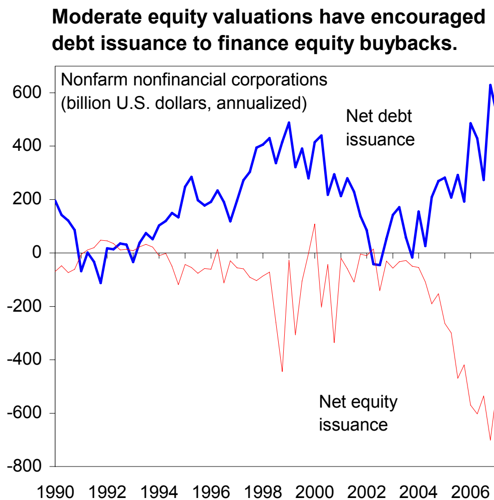
Sources: Haver Analytics; Consensus Forecasts; Thomson One Analytics; and Fund staff calculations.

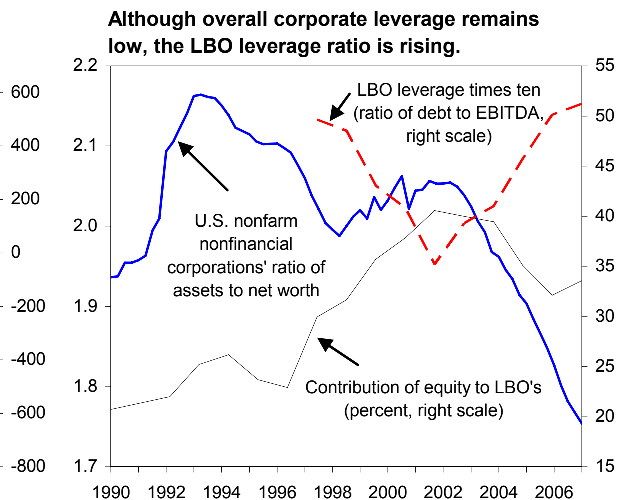
Figure 5. The Corporate Sector and Financial Markets





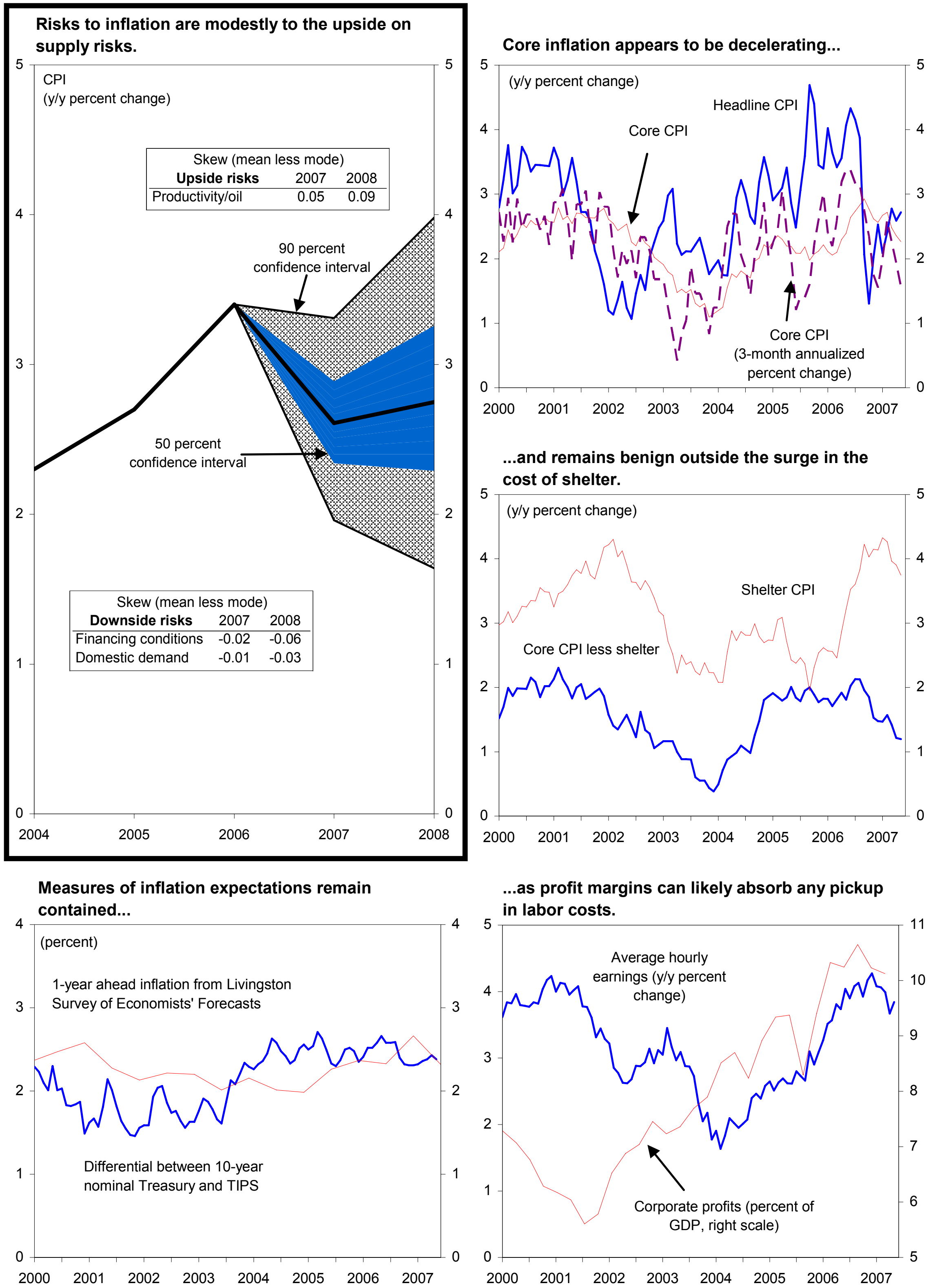






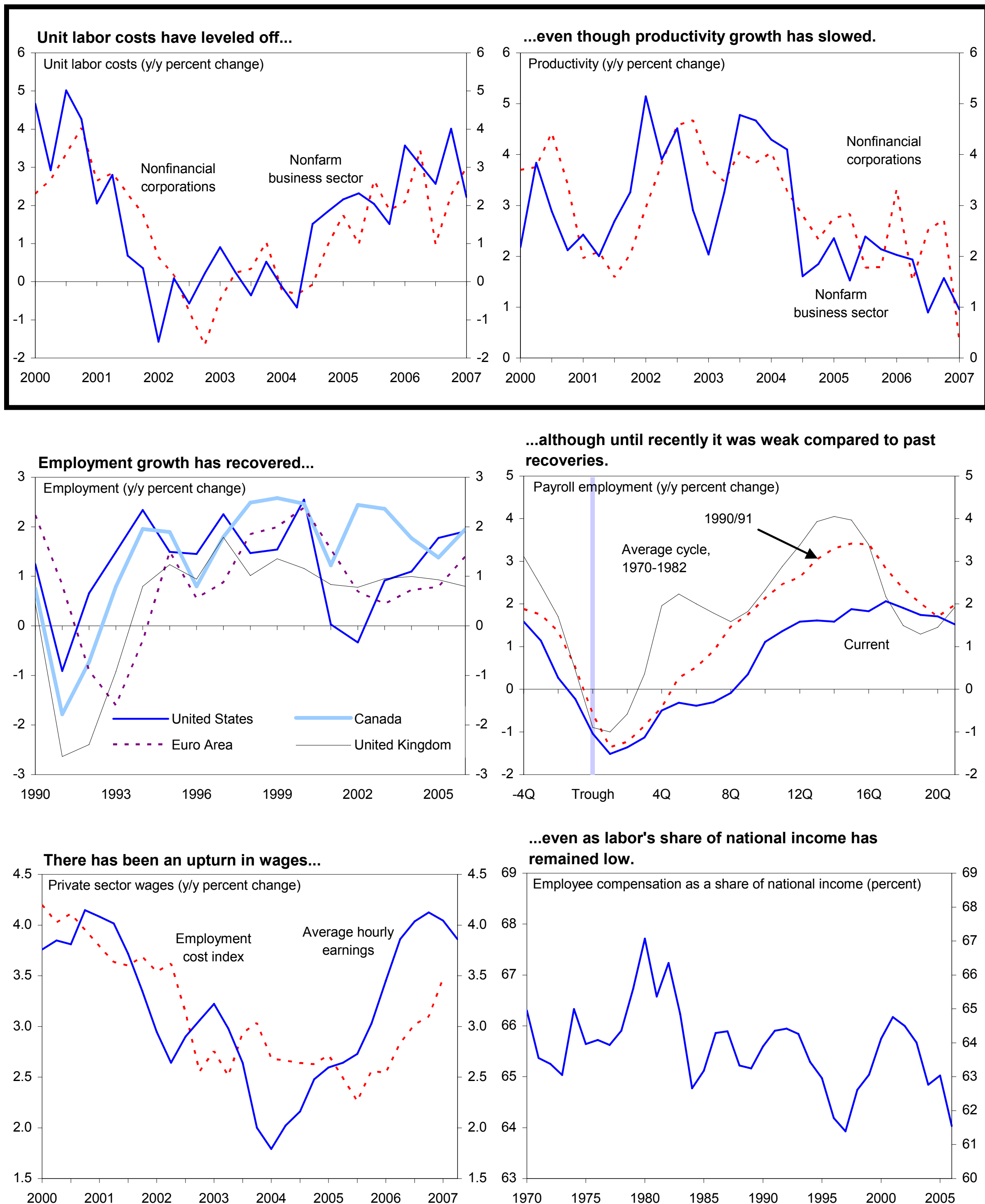
Sources: Haver Analytics; Merrill Lynch; J.P. Morgan; International Monetary Fund, *Global Financial Stability Report;* and Fund staff calculations.

Figure 6. Trends in Inflation



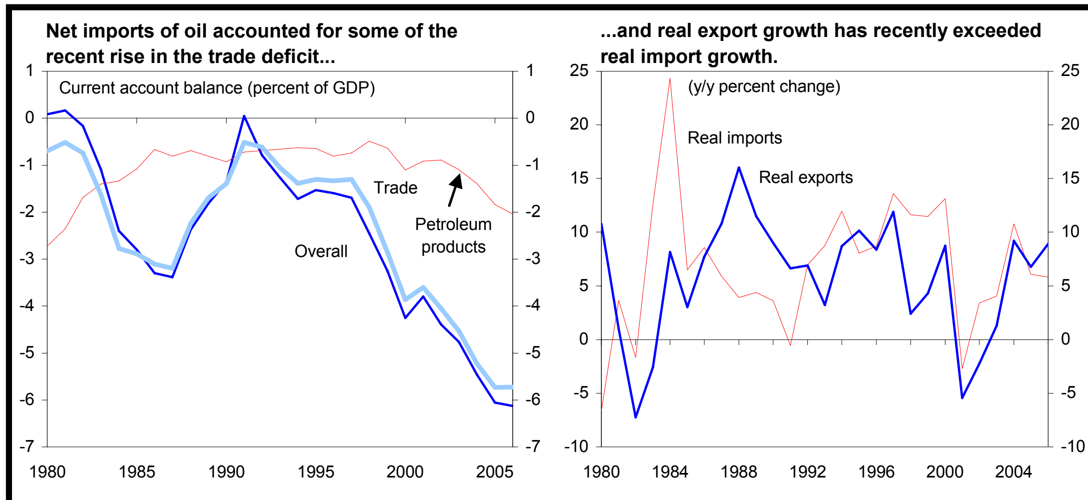
Sources: Bloomberg L.P.; Haver Analytics; and Fund staff calculations.
1/ Skew is measured as mean minus mode.

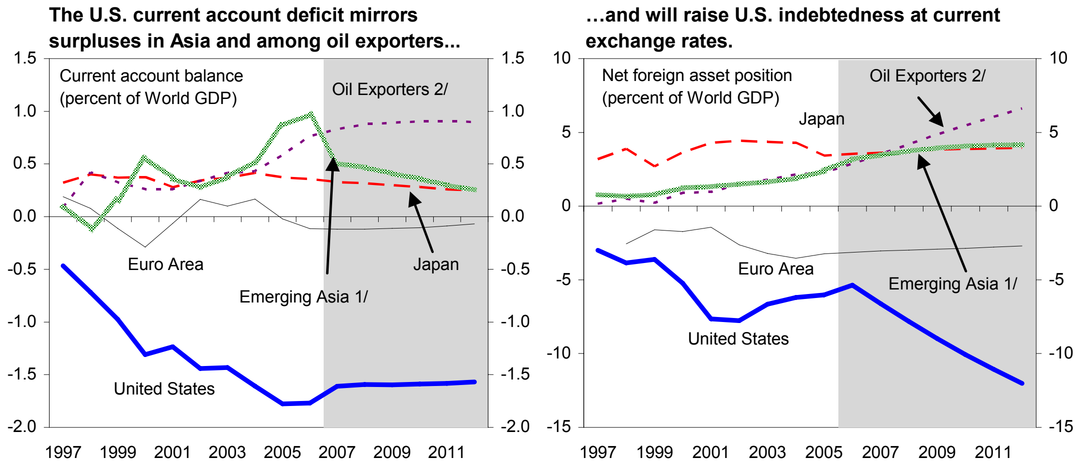
Figure 7. Labor Market Indicators

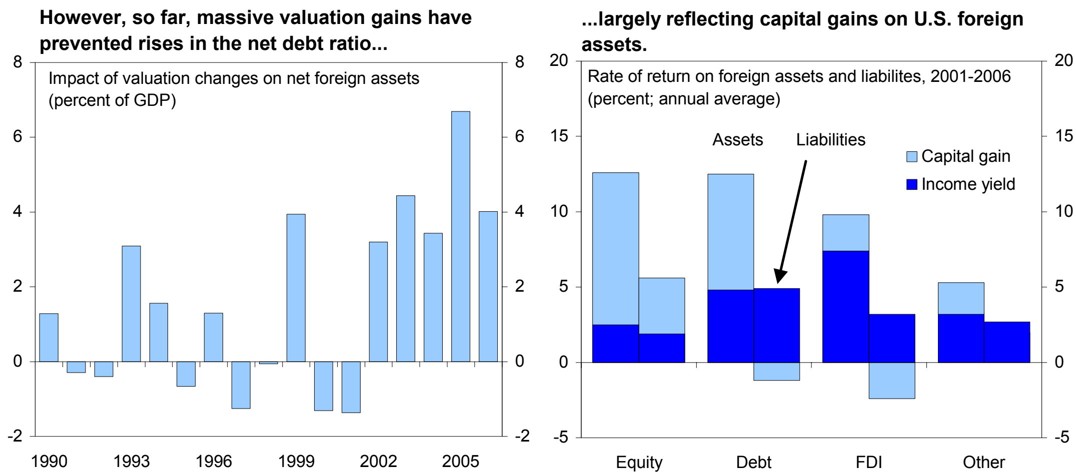


Sources: Haver Analytics; International Monetary Fund, *World Economic Outlook;* and Fund staff calculations.

Figure 8. External Developments





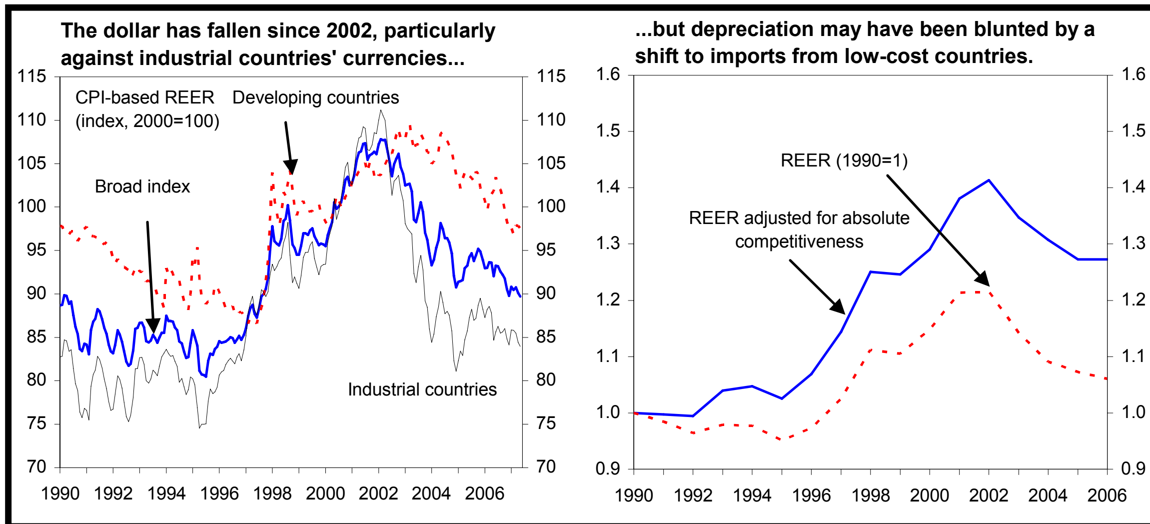


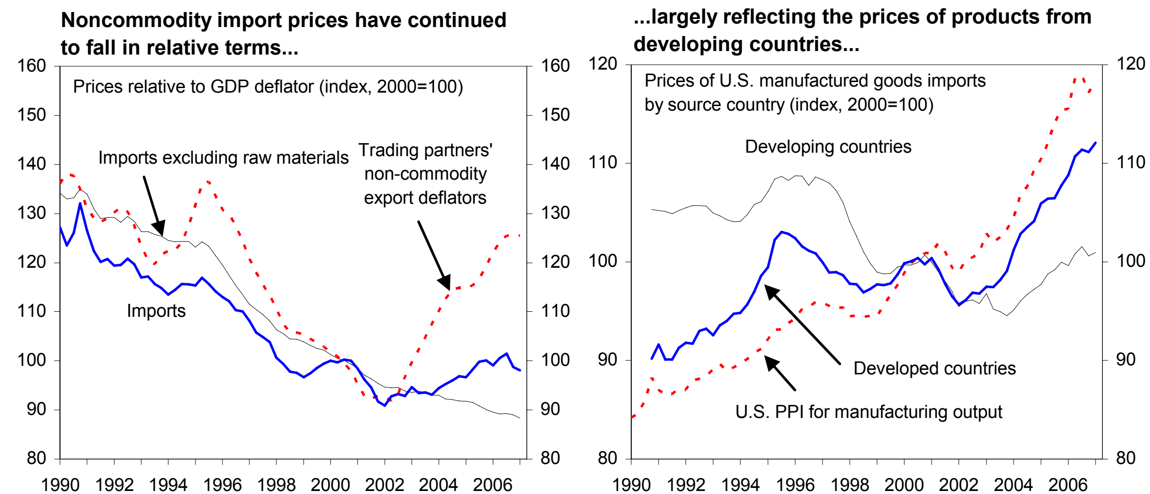
Sources: Haver Analytics; International Monetary Fund, *World Economic Outlook;* Bureau of Economic Analysis; and Fund staff calculations.

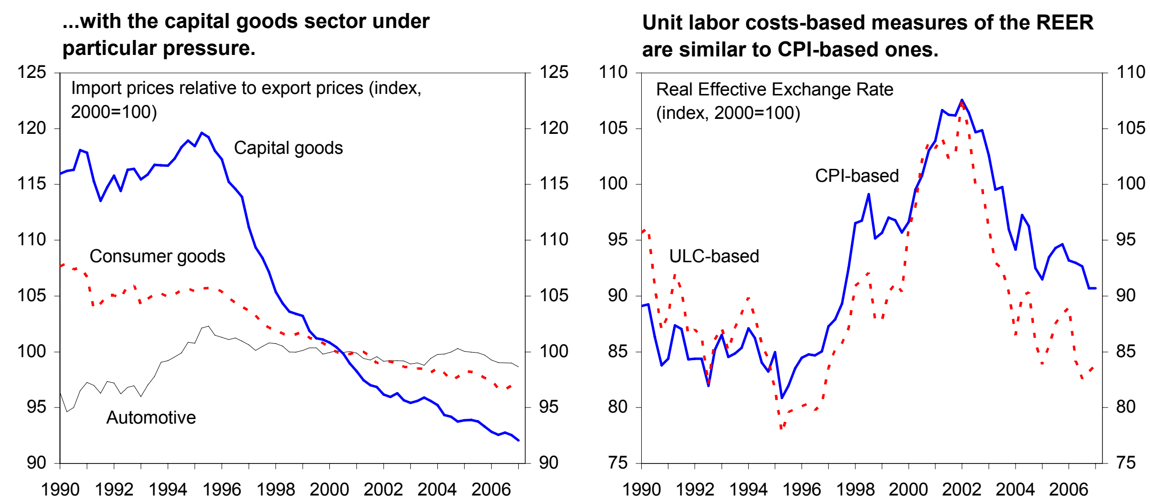
1/ China, Hong Kong SAR, Indonesia, Korea, Malaysia, the Philippines, Singapore, Taiwan Province of China, and Thailand.

2/ Algeria, Angola, Azerbaijan, Bahrain, Republic of Congo, Ecuador, Equatorial Guinea, Gabon, I.R. of Iran, Kuwait, Libya, Nigeria, Norway, Oman, Qatar, Russia, Saudi Arabia, Syrian Arab Republic, Turkmenistan, United Arab Emirates, Venezuela, and the Republic of Yemen.

Figure 9. Indicators of International Competitiveness

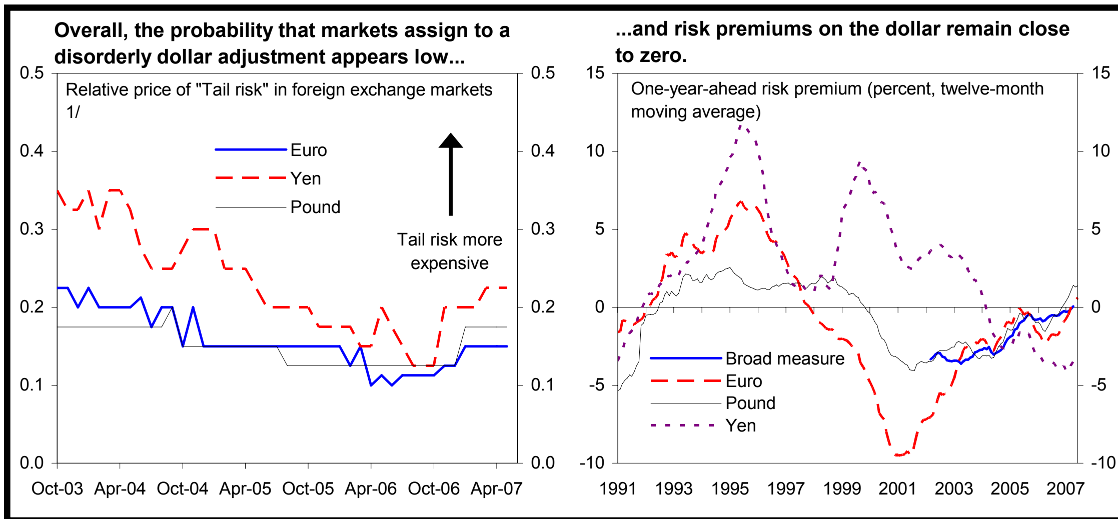


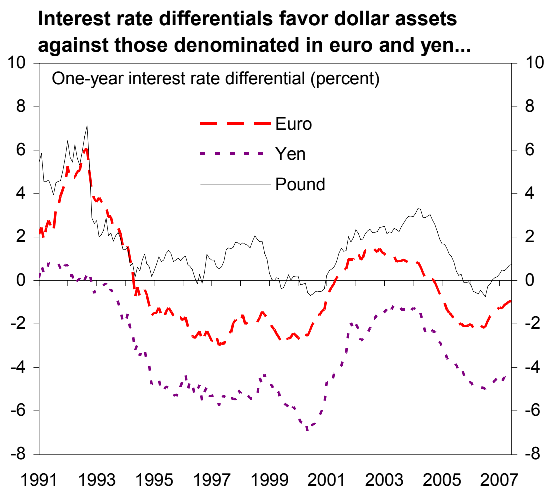


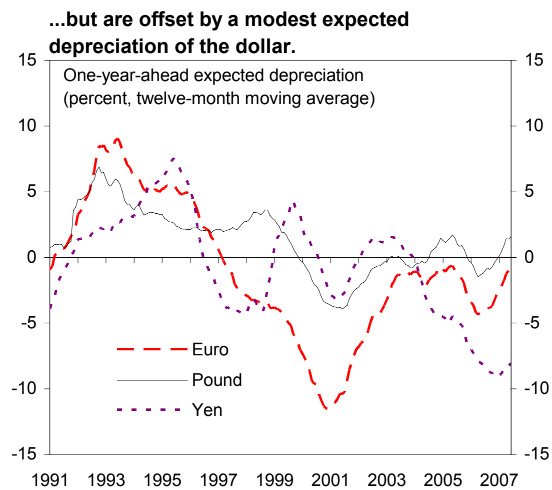


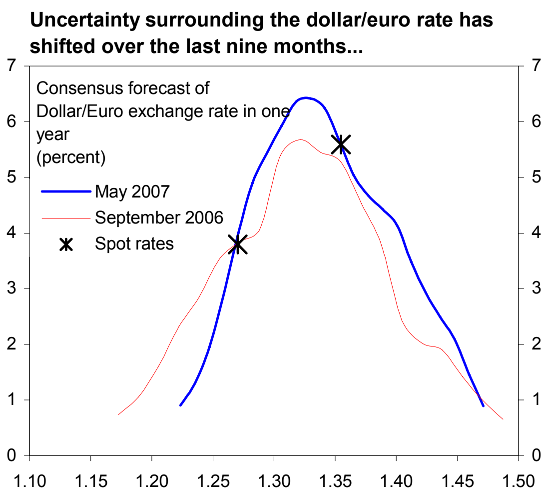
Sources: IMF, *World Economic Outlook;* Haver Analytics; and Fund staff calculations.

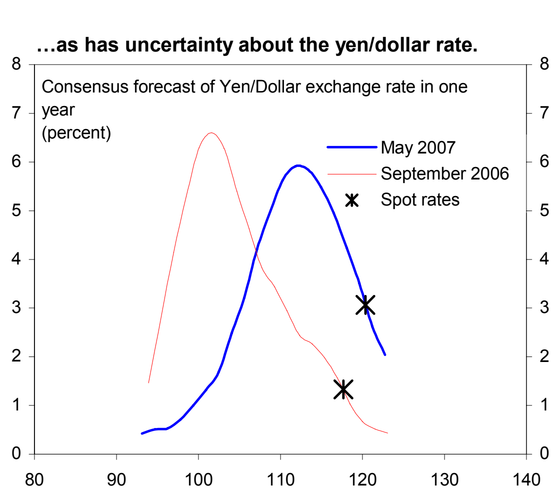
Figure 10. Market Expectations of Exchange Rates





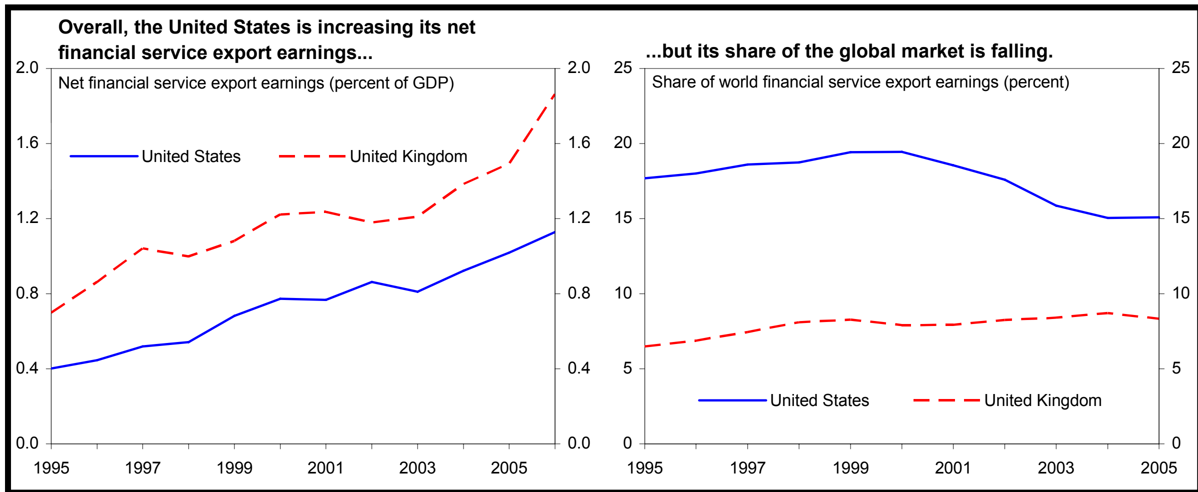


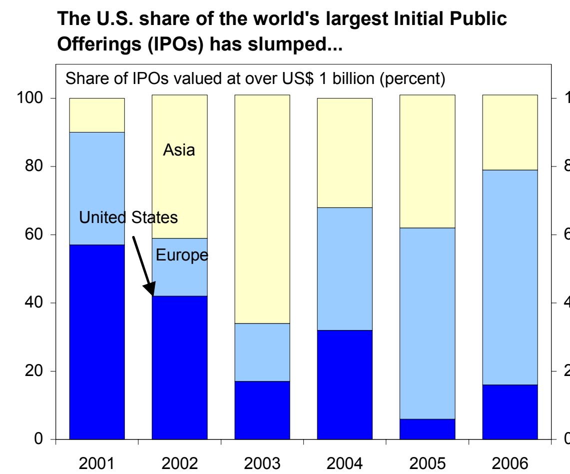


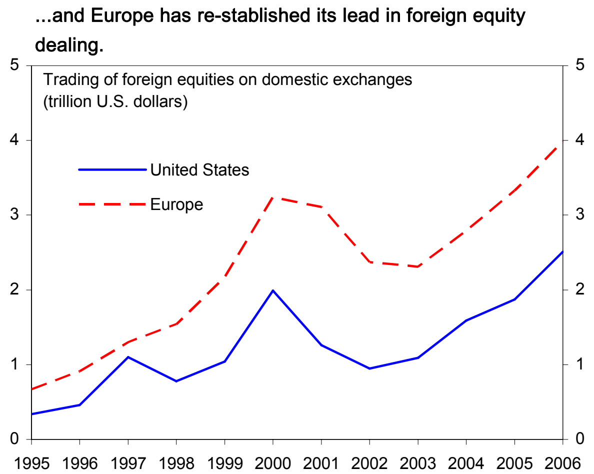


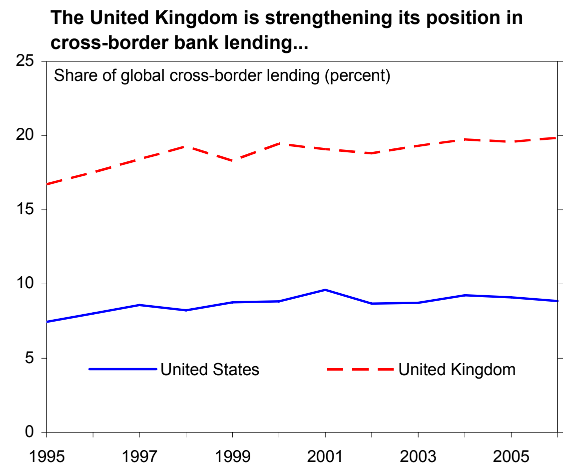
Sources: International Monetary Fund, *Global Financial Stability Report;* Consensus Forecasts; and Fund staff calculations.
1/ Excess implied volatility of deep out-of-the-money options, in percent.

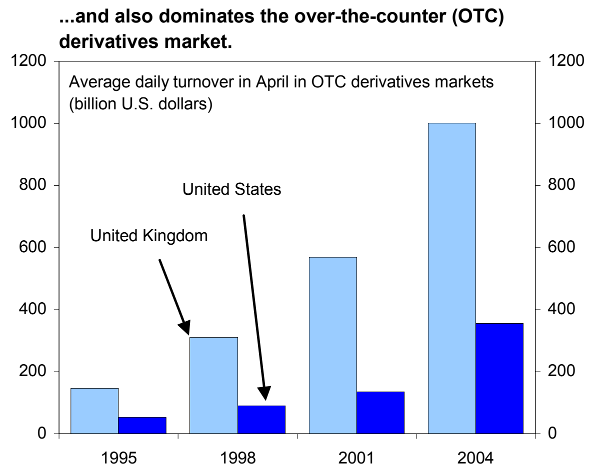
Figure 11. Financial Market Competitiveness





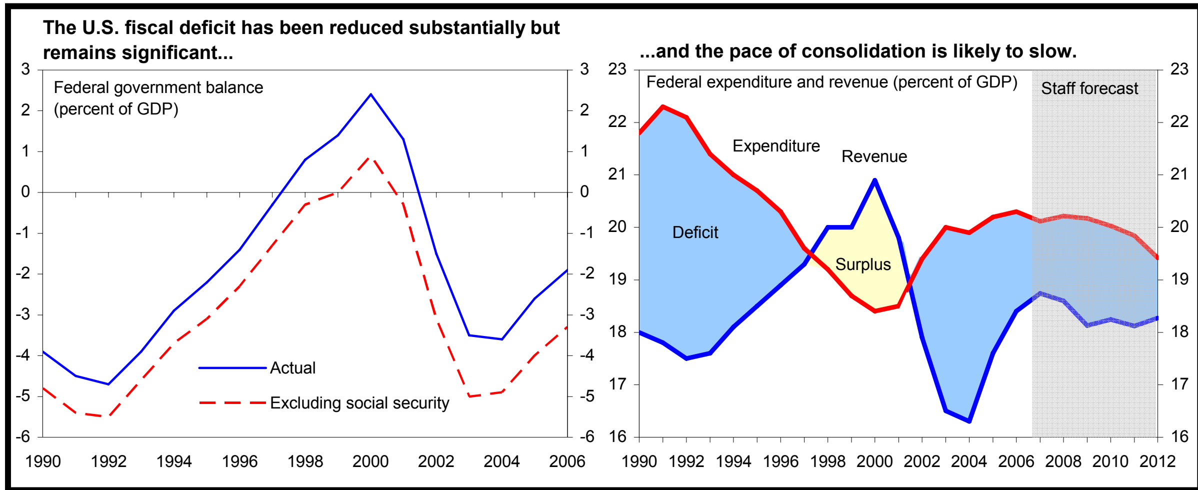


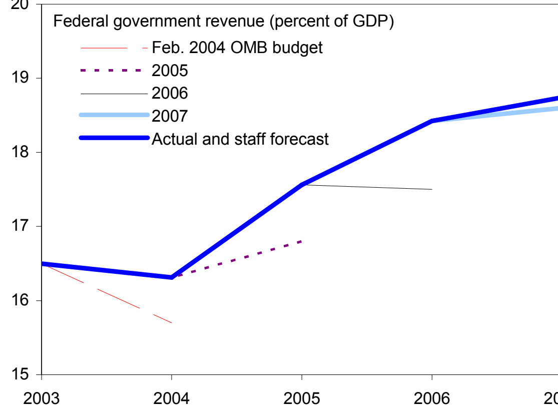


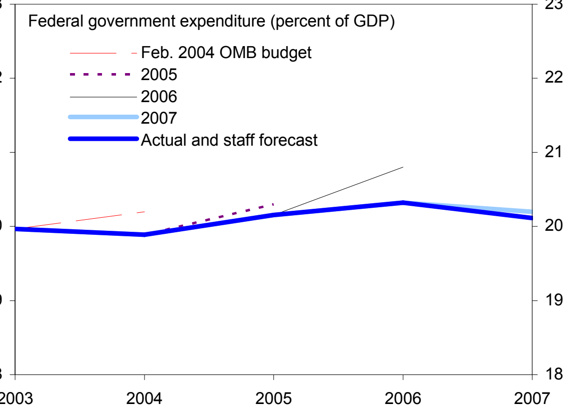


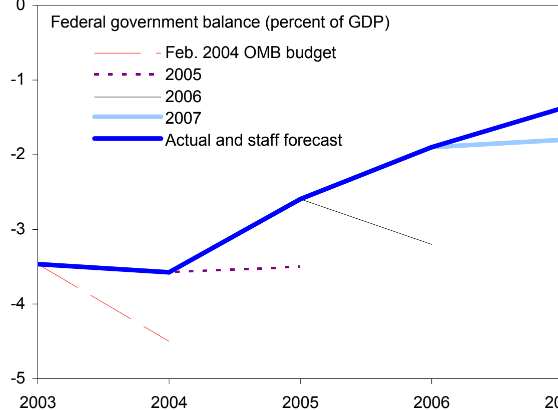
Sources: Bank for International Settlements; World Federation of Exchanges; Dealogic; International Monetary Fund, *Balance of Payments Statistics;* and Fund staff calculations.

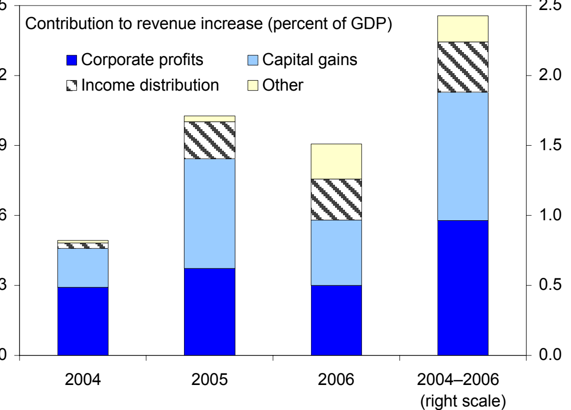
Figure 12. Fiscal Indicators





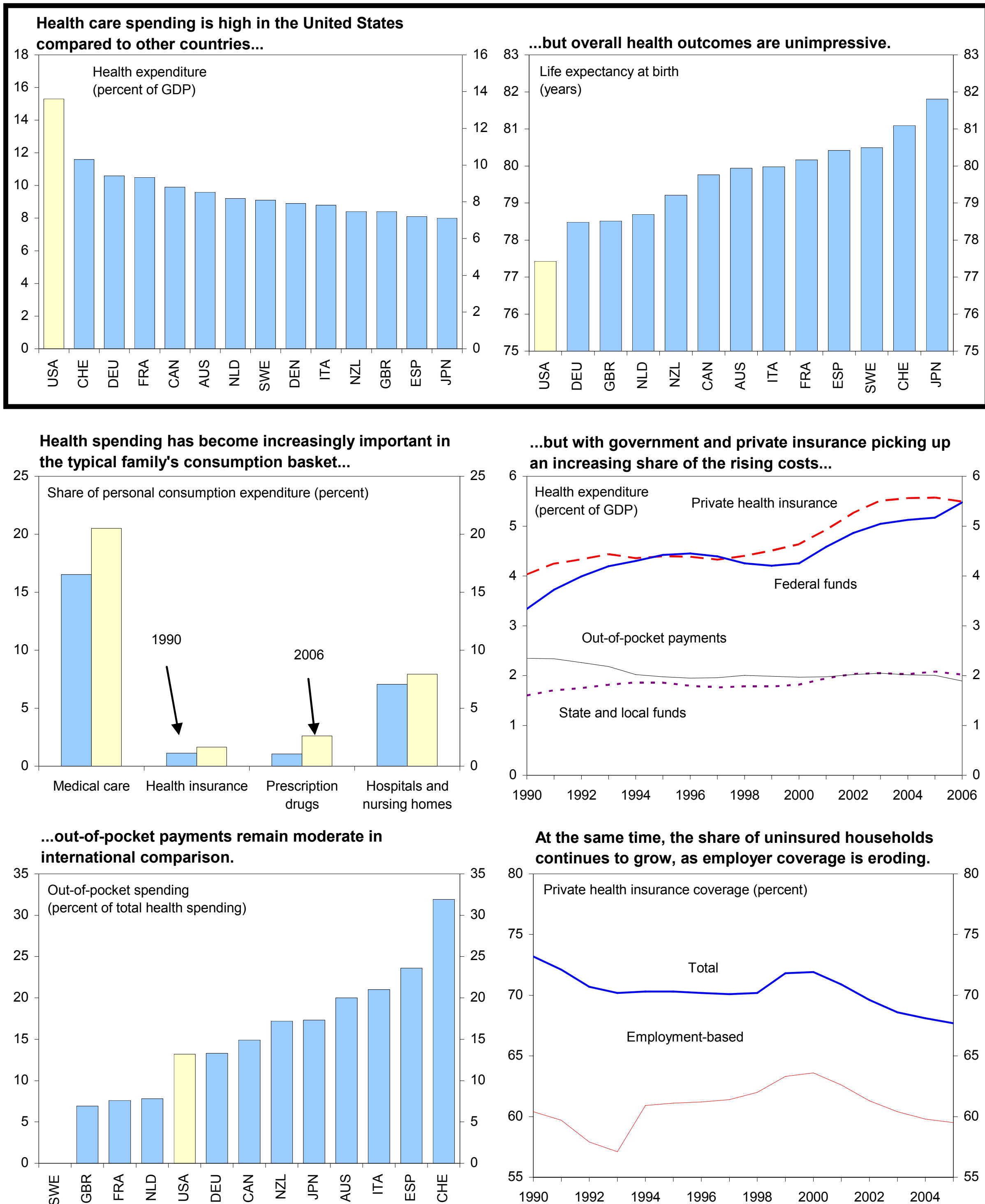






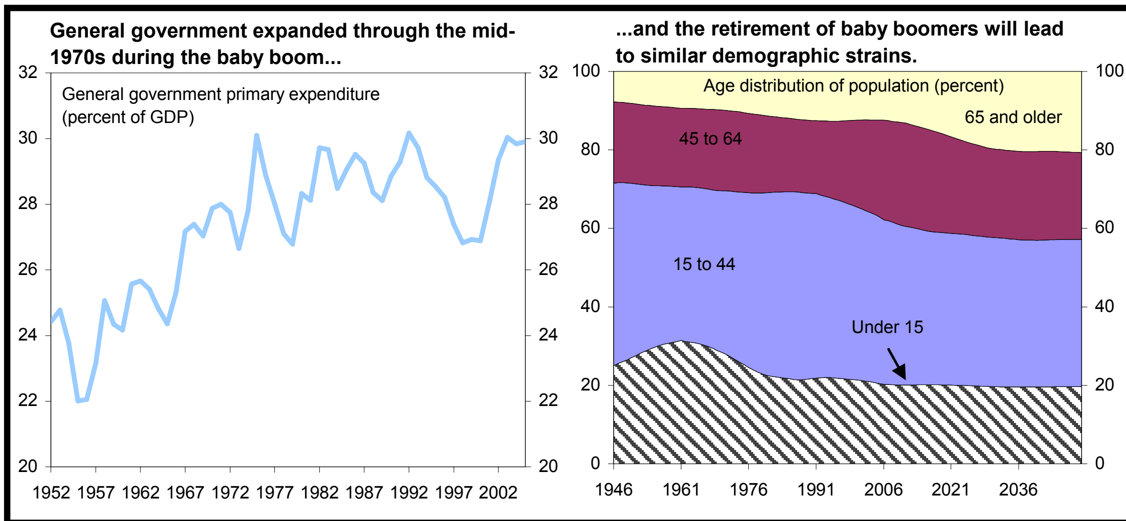
Sources: Haver Analytics; Congressional Budget Office (CBO); Office of Management and Budget; and Fund staff calculations.

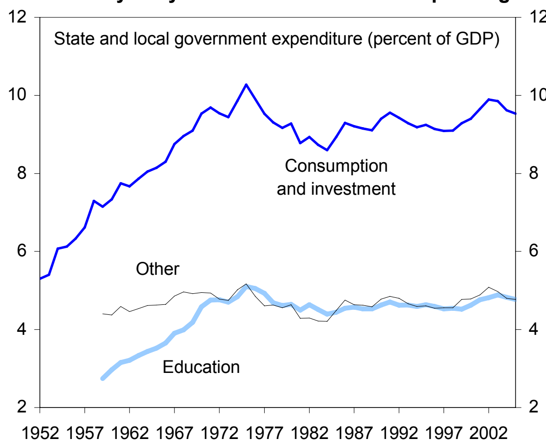
Figure 13. Health Care Indicators

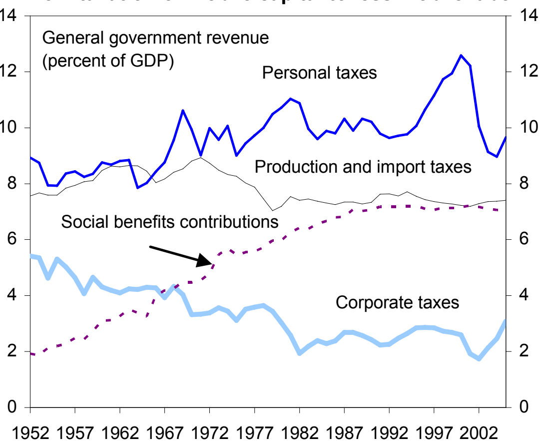


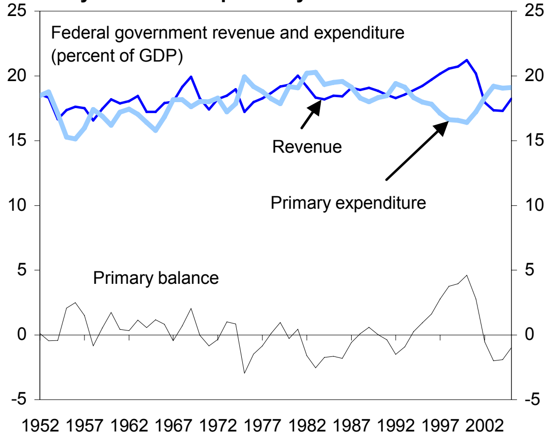
Sources: OECD; World Bank; Haver Analytics; Health Research and Educational Trust; and Kaiser Family Foundation.

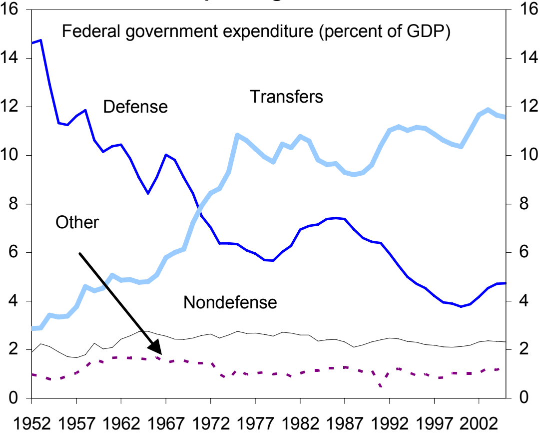
Figure 14. Historical Trends in the Size of U.S. Government











Sources: Haver Analytics; and Fund staff calculations.

Table 1. United States: Long-Standing Fund Policy Advice

Issue	Staff Position	Authorities' Position
	Trade Policy and Foreign Aid	
There are concerns about U.S. leadership in advancing global trade liberalization.	Proliferation of U.S. preferential trade agreements could undermine the multilateral fabric of world trade unless the agreements include open-access clauses and simple rules of origin.	U.S. bilateral free trade agreements complement multilateral negotiations.
Official development assistance (ODA) as a percent of GDP is lower in the U.S. than in most other industrial countries.	U.S. ODA should be increased, in line with G-8 commitments to increase aid to Africa, the Millennium Challenge Account, and HIV/AIDS and malaria initiatives.	The U.S. is steadily increasing aid. Furthermore, overall assistance, including remittances and other private capital flows (which are more important in the U.S. than elsewhere), is higher.
	Financial Policy	
Investment portfolios of the government-sponsored housing enterprises (GSEs) are so large that they may pose systemic risks in the markets for prime mortgages and interest rates derivatives.	Systemic risks could be reduced by imposing stricter capital requirements on GSEs and measures to restore their focus on securitization of conforming mortgages, including through limits on their investment activities.	The Administration has worked toward passage of appropriate legislation. A new draft bill, H.R. 1427, the "Federal Housing Finance Reform Act of 2007," was passed by the House Financial Services Committee in March 2007. It gives a new regulator the power to restrict GSE investment portfolios but does not require this.
There are concerns about the supervisory level-playing field with regard to industrial finance companies (ILCs). Unlike owners of commercial banks, owners of ILCs are not subject to consolidated supervision provisions under the Bank Holding Company Act.	ILCs are, in essence, state-chartered banks, and are insured by the Federal Deposit Insurance Corporation (FDIC). All bank owners should be subject to the same consolidated supervision provisions.	The FDIC has imposed a moratorium on applications for deposit insurance by ILCs until January 2008. Differences in view among regulators about the need to supervise nonfinancial corporate owners of ILCs remain.
Regulation of the insurance sector is entirely in the hands of state Insurance Commissioners, with little federal oversight.	A single, unified regulator should be established. The insurance sector is of systemic importance, but state regulation results in higher costs, regulatory arbitrage, and politically-driven interference in local insurance markets.	The Administration has suggested the need for a stronger federal role in insurance regulation.
The absence of a financial stability report (FSR).	As in many other industrialized countries, publication of an FSR could improve markets' understanding of U.S. financial sector risks and vulnerabilities and, potentially, facilitate greater coordination amongst regulators.	The Fed does not believe that the value added of an FSR--relative to what is already being published by regulators and market participants--outweighs the associated resource costs.
The adequacy of savings for retirement could be improved: many defined-benefit (DB) plans remain underfunded, and weak incentives hamper employee enrollment in defined-contribution (DC) plans.	Reduce tax disincentives to overfunding DB plans to bolster cushions during market downturns; the Public Benefit Guaranty Corporation (PGBC) should set risk-based premia; 'automatic' enrollment in employer-sponsored DC plans should be facilitated.	The Pension Protection Act of 2006 implemented many of these suggestions.
As noted in the September 2006 AML/CFT ROSC, the AML/CFT regime has strengthened significantly, but there remain areas where compliance with FATF recommendations could be tighter.	Areas for improvement include, *inter alia* : (i) strengthening customer due diligence; (ii) making corporate ownership information more readily available; and (iii) extending AML/CFT requirements to certain designated nonfinancial businesses and professions.	The September 2006 AML/CFT ROSC noted not only strong overall progress since the last mutual evaluation in 1997, but also satisfactory compliance with the FATF recommendations on enhanced due diligence for correspondent banking relationships and requirements for money remittance services.

Table 2. United States: Policy Progress and Plans Relevant to the IMFC Strategy

Over the past year, developments in U.S. policies related to the IMFC strategy included:

- **Continued narrowing of the budget deficit**. The unified federal budget deficit declined to 1.9 percent of GDP in FY 2006, a substantial decrease in two years, and on track to outperform initial IMF staff expectations for FY 2007.

- **Passage of saving-focused tax reforms**. Rate cuts for capital gains and dividends were extended for two years, as were increased expensing of allowances for small businesses. Enhancements to tax-advantaged retirement and education savings vehicles were made permanent, and legal barriers to automatic enrollment in employer-sponsored retirement plans were removed. The saver's credit, aimed at low- and middle-income individuals, was also made permanent. Finally, health savings accounts were made more attractive.

Looking forward, the U.S. authorities' policy plans include the following:

- **Further fiscal consolidation over the medium term**. The FY 2008 budget targets eliminating the budget deficit by 2012.

- **Reforming the budget process to contain spending growth**. The FY 2008 budget proposes limits on the use of Congressional budget earmarks and authority for the President to exercise a budget line-item veto.

- **Entitlement reform to strengthen long-term fiscal sustainability**. Policies have been proposed to slow the rate of growth of health care costs while expanding access to care, including providing a standard deduction for health insurance and expanding the use of health savings accounts.

- **Further tax incentives to support private saving**. The FY 2008 budget promotes new tax-advantaged vehicles, replacing IRAs with Retirement Savings Accounts, and introducing Lifetime Savings Accounts. Social Security reform with Personal Retirement Accounts is again proposed.

- **Enhancing energy efficiency**. Net oil imports amount to 35 percent of the U.S. trade balance. The Administration is committed to cutting gasoline consumption by 20 percent in 10 years by requiring 35 billion gallons of renewable and alternative fuels by 2017, and by increasing fuel economy standards for cars and light trucks.

- **Pro-growth, open investment policies**. The United States is committed to pro-growth policies that make the United States an attractive location for foreign investment. Key elements include a strong commitment to an open investment environment, resistance to protectionist pressures, and a commitment to permanently low tax rates.

- **Capital market competitiveness**. The Administration is actively engaged, through the U.S. Treasury, in ways to improve U.S. legal, regulatory, and accounting frameworks and thus better ensure that U.S. capital markets remain the strongest and most innovative in the world.

Table 3. Selected Economic Indicators

(Percentage change from previous period at annual rate, unless otherwise indicated)

									2006				2007			
	2005	2006	2007	2008	2009	2010	2011	2012	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
National production and income																
Real GDP	3.2	3.3	2.0	2.8	3.0	3.0	2.9	2.9	5.6	2.6	2.0	2.5	0.7	2.4	2.5	2.7
Net Exports 1/	-0.3	0.0	0.2	0.0	-0.1	-0.2	-0.2	-0.2	0.0	0.4	-0.2	1.6	-0.8	0.4	0.2	0.1
Total domestic demand	3.3	3.2	1.7	2.6	3.0	3.0	3.0	2.9	5.3	2.0	2.0	0.8	1.4	1.9	2.2	2.5
Final domestic demand	3.6	2.9	2.1	2.6	3.0	3.0	2.9	2.9	5.4	1.6	2.0	1.9	2.4	1.7	2.2	2.5
Private final consumption	3.5	3.2	3.2	2.6	2.7	2.8	2.7	2.8	4.8	2.6	2.8	4.2	4.2	2.2	2.4	2.6
Public consumption expenditure	0.9	1.6	1.9	2.0	2.2	2.0	1.9	1.4	4.4	-0.5	2.5	3.7	0.4	2.0	2.4	2.3
Gross fixed domestic investment	6.4	3.1	-2.0	3.2	4.6	4.6	4.6	4.5	8.1	-0.2	-1.3	-7.3	-2.6	-0.4	1.4	2.6
Private fixed investment	7.5	2.9	-2.8	3.4	5.0	5.0	4.9	4.9	8.2	-1.6	-1.1	-9.1	-3.9	-0.9	1.5	2.7
Equipment & software	8.9	6.5	2.3	7.1	7.6	7.6	7.6	7.6	15.6	-1.4	7.7	-4.8	1.7	4.0	6.0	7.0
Structures (non-residential)	1.1	9.0	5.5	3.4	3.3	3.2	3.1	3.0	8.8	20.3	15.7	0.9	4.8	3.0	3.0	3.5
Structures (residential)	8.6	-4.2	-13.8	-2.0	2.2	2.0	2.0	2.0	-0.3	-11.1	-18.6	-19.8	-15.7	-10.0	-6.0	-4.0
Public fixed investment	1.1	4.1	2.2	2.2	2.6	3.0	2.8	2.2	7.5	7.4	-2.3	2.0	3.9	2.3	1.3	2.1
Change in private inventories 1/	-0.3	0.2	-0.4	0.0	0.0	0.0	0.0	0.0	0.0	0.4	0.1	-1.2	-1.0	0.2	0.0	0.0
Nominal GDP	6.3	6.3	4.6	4.8	5.0	5.0	5.0	4.9	9.0	5.9	3.9	4.1	4.9	4.5	4.7	4.8
Personal saving ratio (% of DI)	-0.4	-1.0	-0.6	-0.4	0.3	1.0	1.8	2.5	-0.3	-1.4	-1.4	-1.0	-0.7	-0.6	-0.6	-0.7
Private investment rate (% of GDP)	16.5	16.7	15.5	15.5	15.6	15.8	16.0	16.2	17.0	17.0	16.8	16.1	15.6	15.5	15.4	15.4
Employment and inflation																
Output gap (percent of potential)	0.1	0.3	-0.7	-0.8	-0.6	-0.4	-0.2	0.0	0.6	0.5	0.2	0.1	-0.5	-0.6	-0.7	-0.8
Potential GDP	3.2	3.1	3.0	2.9	2.8	2.8	2.7	2.7	3.1	3.1	3.1	3.0	3.0	2.9	2.9	2.9
Unemployment rate (percent)	5.1	4.6	4.8	5.0	4.9	4.8	4.8	4.8	4.7	4.6	4.7	4.5	4.5	4.8	4.9	5.0
CPI inflation	3.4	3.2	2.6	2.8	2.5	2.4	2.4	2.4	1.9	5.0	3.1	-2.1	3.8	4.7	2.6	2.7
GDP deflator	3.0	2.9	2.6	2.0	2.0	2.0	2.0	2.0	3.3	3.3	1.9	1.6	4.2	2.1	2.1	2.0
Financial policy indicators																
Central gov't balance ($ b, public accounts)	-318	-248	-188	-231	-307	-283	-287	-200								
In percent of FY GDP	-2.6	-1.9	-1.4	-1.6	-2.0	-1.8	-1.7	-1.1								
Central government balance ($ b, NIPA)	-361	-194	-173	-225	-268	-241	-244	-164								
In percent of CY GDP	-2.9	-1.5	-1.2	-1.6	-1.8	-1.5	-1.5	-0.9								
General government balance ($ b, NIPA)	-456	-299	-285	-336	-391	-384	-399	-333								
In percent of CY GDP	-3.7	-2.3	-2.1	-2.3	-2.6	-2.4	-2.4	-1.9								
Three-month Treasury bill rate	3.2	4.8	5.1	5.2	5.1	5.1	5.1	5.1	4.5	4.8	5.0	5.0	5.1	5.0	5.1	5.2
Ten-year government bond rate	4.3	4.8	4.9	5.3	5.3	5.3	5.3	5.3	4.6	5.1	4.9	4.6	4.7	4.8	5.0	5.1
Balance of payments																
Current account balance ($ b)	-755	-811	-835	-872	-906	-943	-979	-1016	-802	-822	-869	-752	-770	-858	-855	-858
Merchandise trade balance ($ b)	-787	-838	-831	-856	-878	-903	-929	-952	-831	-845	-876	-801	-803	-839	-838	-842
Balance on invisibles ($ b)	32	27	-5	-16	-29	-40	-50	-64	29	23	6	50	33	-19	-17	-16
Current account balance (% of GDP)	-6.1	-6.1	-6.0	-6.0	-5.9	-5.9	-5.8	-5.8	-6.2	-6.2	-6.5	-5.6	-5.7	-6.2	-6.1	-6.1
Merchandise trade balance (% of GDP)	-6.3	-6.3	-6.0	-5.9	-5.8	-5.6	-5.5	-5.4	-6.4	-6.4	-6.6	-6.0	-5.9	-6.1	-6.0	-6.0
Balance on invisibles (% of GDP)	0.3	0.2	0.0	-0.1	-0.2	-0.2	-0.3	-0.4	0.2	0.2	0.0	0.4	0.2	-0.1	-0.1	-0.1
Export volume 2/	7.5	10.5	6.2	7.5	6.7	6.1	6.0	6.1	17.3	6.0	9.4	8.4	0.2	8.5	8.0	7.4
Import volume 2/	6.7	5.9	2.7	4.4	5.2	5.2	5.2	5.2	9.4	0.0	7.1	-4.2	6.0	2.6	3.5	4.1
Saving and investment (as a share of GDP)																
Gross national saving	12.9	13.9	12.8	12.7	13.0	13.2	13.5	13.8	14.5	13.6	13.3	14.3	13.4	12.6	12.6	12.6
General government	-0.5	0.9	1.2	1.0	0.7	0.9	0.9	1.4	1.0	1.0	0.6	1.0	0.7	1.4	1.4	1.3
Private	13.4	13.0	11.6	11.8	12.3	12.3	12.6	12.4	13.5	12.6	12.7	13.3	12.6	11.1	11.2	11.3
Personal	-0.3	-0.7	-0.5	-0.3	0.2	0.7	1.4	1.9	-0.2	-1.0	-1.0	-0.7	-0.5	-0.5	-0.4	-0.5
Business	13.7	13.8	12.0	12.1	12.0	11.6	11.2	10.5	13.7	13.6	13.7	14.0	13.1	11.6	11.6	11.8
Gross domestic investment	19.7	20.0	18.8	18.8	18.9	19.1	19.3	19.5	20.3	20.2	20.0	19.3	18.9	18.8	18.7	18.7

Sources: Haver Analytics; and Fund staff estimates.

1/ Contributions to growth.

2/ NIPA basis, goods.

Table 4. Economic Performance of Major Industrial Countries

	1999	2000	2001	2002	2003	2004	2005	2006	Projection 2007	2008
	(Annual change, in percent)									
Per capita GDP										
United States	3.3	2.5	-0.3	0.6	1.5	2.9	2.2	2.3	1.0	1.8
Euro Area	2.8	3.5	1.5	0.4	0.2	1.3	0.9	2.2	1.8	1.9
Japan	-0.3	2.7	-0.1	0.1	1.2	2.7	1.9	2.2	2.3	1.9
Canada	4.7	4.3	0.7	1.8	0.8	2.3	1.9	1.7	1.1	1.6
G-7 countries	2.4	2.9	0.3	0.5	1.1	2.4	1.6	2.2	1.6	1.8
Real GDP										
United States	4.4	3.7	0.8	1.6	2.5	3.9	3.2	3.3	2.0	2.8
Euro Area	3.0	3.9	1.9	0.9	0.8	2.0	1.4	2.6	2.3	2.3
Japan	-0.1	2.9	0.2	0.3	1.4	2.7	1.9	2.2	2.3	1.9
Canada	5.5	5.2	1.8	2.9	1.8	3.3	2.9	2.7	2.4	2.9
G-7 countries	3.1	3.6	1.0	1.2	1.8	3.1	2.3	2.8	2.2	2.5
Real domestic demand										
United States	5.3	4.4	0.9	2.2	2.8	4.4	3.3	3.2	1.7	2.6
Euro Area	3.6	3.4	1.2	0.4	1.5	1.9	1.6	2.3	2.2	2.3
Japan	0.0	2.4	1.0	-0.4	0.8	1.9	1.7	1.4	2.1	1.9
Canada	4.2	4.7	1.2	3.3	4.7	4.3	4.8	4.1	2.7	3.2
G-7 countries	3.8	3.7	1.1	1.3	2.2	3.2	2.4	2.6	1.9	2.4
GDP deflator										
United States	1.4	2.2	2.4	1.7	2.1	2.8	3.0	2.9	2.5	2.0
Euro Area	0.9	1.5	2.7	2.6	2.1	1.9	1.9	1.7	1.8	1.8
Japan	-1.3	-1.7	-1.2	-1.5	-1.6	-1.1	-1.3	-0.9	-0.3	0.6
Canada	1.7	4.1	1.1	1.1	3.4	3.0	3.2	2.1	1.3	2.1
G-7 countries	0.9	1.2	1.6	1.4	1.6	1.9	1.9	1.9	1.4	1.7
	(In percent of GDP)									
General government financial balance 1/										
United States	0.9	1.6	-0.4	-3.8	-4.8	-4.6	-3.7	-2.3	-2.1	-2.3
Euro Area	-1.4	-1.0	-1.9	-2.6	-3.1	-2.8	-2.4	-1.6	-1.2	-1.1
Japan	-7.4	-7.6	-6.3	-8.0	-8.0	-6.2	-4.8	-4.3	-3.8	-3.5
Canada	1.6	2.9	0.7	-0.1	-0.4	0.5	1.4	0.9	0.6	0.7
G-7 countries	-1.0	-0.2	-1.7	-4.0	-4.8	-4.2	-3.5	-2.6	-2.2	-2.3
Gross national saving										
United States	18.1	18.0	16.4	14.2	13.3	13.2	12.9	13.9	12.8	12.7
Euro Area	21.7	21.4	21.3	20.8	20.7	21.5	21.0	21.3	21.6	21.9
Japan	27.5	28.0	26.9	25.9	26.1	26.8	27.0	28.0	28.5	28.4
Canada	20.7	23.6	22.2	21.0	21.2	22.9	23.8	23.7	23.1	23.5
G-7 countries	20.2	20.3	19.2	17.8	17.3	17.6	17.4	18.1	17.7	17.8
Fixed investment										
United States	16.8	17.1	16.3	15.0	15.1	15.6	16.3	16.3	15.5	15.5
Euro Area	21.0	21.4	20.9	20.2	20.1	20.2	20.5	21.1	21.5	21.8
Japan	25.5	25.2	24.7	23.3	22.8	22.7	23.1	23.8	24.4	24.6
Canada	19.8	19.2	19.6	19.5	19.6	20.2	20.7	21.5	22.2	22.5
G-7 countries	19.2	19.3	18.7	17.7	17.5	17.8	18.3	18.5	18.3	18.4
Current account balance										
United States	-3.2	-4.3	-3.8	-4.4	-4.8	-5.5	-6.1	-6.1	-6.0	-6.0
Euro Area	-0.5	-1.5	-0.3	0.8	0.4	0.7	-0.1	-0.2	-0.3	-0.4
Japan	2.6	2.6	2.1	2.9	3.2	3.7	3.6	3.9	3.9	3.6
Canada	0.3	2.7	2.3	1.7	1.2	2.1	2.3	1.7	0.7	0.6
G-7 countries	-0.8	-1.6	-1.2	-0.9	-1.0	-0.9	-1.5	-1.7	-1.7	-1.8

Sources: IMF, *World Economic Outlook;* and Fund staff estimates.
1/ National accounts basis.

Table 5. Balance of Payments

(Billion U.S. dollars, unless otherwise indicated)

			Projection					
	2005	2006	2007	2008	2009	2010	2011	2012
Current account	-755	-811	-835	-872	-906	-943	-979	-1,016
Percent of GDP	-6.1	-6.1	-6.0	-6.0	-5.9	-5.9	-5.8	-5.8
Goods and services	-714	-759	-735	-751	-763	-779	-795	-809
Merchandise trade	-787	-838	-831	-856	-878	-903	-929	-952
Exports	895	1,023	1,112	1,200	1,286	1,371	1,463	1,564
Imports	-1,682	-1,861	-1,943	-2,056	-2,163	-2,274	-2,392	-2,516
Services	73	80	96	104	114	124	133	143
Receipts	388	423	458	487	521	556	595	635
Payments	-316	-343	-362	-383	-406	-432	-461	-492
Income	48	37	-1	-44	-67	-92	-108	-128
Receipts	505	650	702	745	783	853	938	1,027
Payments	-457	-614	-703	-789	-850	-944	-1,046	-1,155
Unilateral transfers, net	-89	-90	-99	-76	-76	-72	-76	-79
Capital account transactions, net	-4	-4	-3	-3	-3	-3	-3	-3
Financial account	777	804	847	875	909	946	982	1,019
Private capital	533	347	543	657	680	706	730	754
Direct investment	117	-55	-107	-94	-98	-101	-106	-111
Outflows	8	-235	…	…	…	…	…	…
Inflows	109	181	…	…	…	…	…	…
Securities	405	279	211	171	190	198	205	214
Outflows	-197	-289	…	…	…	…	…	…
Inflows	602	569	…	…	…	…	…	…
Other investment	12	122	438	580	589	609	631	651
Outflows	-222	-548	…	…	…	…	…	…
Inflows	234	670	…	…	…	…	…	…
U.S. official reserves	14	2	0	0	0	0	0	0
Foreign official assets	259	440	305	218	229	240	252	265
Other items	-29	15	0	0	0	0	0	0
Statistical discrepancy	-18	11	-10	0	0	0	0	0

Sources: Haver Analytics; and Fund staff calculations.

Table 6. Indicators of External and Financial Vulnerability
(In percent of GDP, unless otherwise indicated)

	1999	2000	2001	2002	2003	2004	2005	2006
External indicators								
Exports of goods and services (percent change)	3.5	10.8	-6.1	-3.0	4.4	13.7	10.9	12.7
Imports of goods and services (percent change)	12.0	17.8	-5.5	2.1	8.3	16.8	12.9	10.4
Terms of trade (percent change)	-2.1	-4.6	2.8	1.5	-1.3	-1.7	-4.0	-1.2
Current account balance	-3.3	-4.3	-3.8	-4.4	-4.8	-5.5	-6.1	-6.1
Capital and financial account balance	2.5	4.9	3.9	4.8	4.9	4.7	6.2	6.0
Of which:								
Net portfolio investment	2.3	3.1	3.3	4.5	4.2	6.4	5.5	5.5
Net foreign direct investment	0.7	1.7	0.2	-0.7	-0.8	-1.1	0.9	-0.4
Net other investment	-0.4	0.2	0.4	1.0	1.5	-0.5	-0.2	1.0
Official reserves (billion dollars)	71.5	67.6	68.7	79.0	85.9	86.8	65.1	65.9
Central bank foreign liabilities (billion dollars)	0.1	0.3	0.1	0.1	0.2	0.1	0.1	0.2
Official reserves (months of imports)	0.7	0.6	0.6	0.7	0.7	0.6	0.4	0.4
Net international investment position 1/	-8.3	-14.1	-19.0	-19.9	-19.5	-19.6	-18.0	-19.2
Of which: General government debt 2/	12.2	11.6	12.1	13.8	15.6	17.7	19.0	20.4
External debt-to-exports ratio	0.8	1.3	1.9	2.1	2.1	2.0	1.7	1.8
External interest payments to exports (percent) 3/	22.6	24.8	23.7	20.7	19.0	20.5	25.8	32.4
Nominal effective exchange rate (percent change)	-0.3	2.6	5.2	0.0	-6.4	-4.9	-2.6	-1.5
Real effective exchange rate (percent change)	-1.0	3.3	5.6	-0.2	-6.4	-4.6	-1.5	-0.3
Financial market indicators								
General government gross debt	60.0	54.5	54.1	56.6	59.8	60.7	61.2	60.5
Three-month Treasury bill yield (percent)	4.8	6.0	3.5	1.6	1.0	1.4	3.2	4.8
Three-month Treasury bill yield (percent, real)	2.5	2.5	0.6	0.0	-1.2	-1.3	-0.1	1.6
Equity market index								
(percent change in S&P500, year average)	22.3	7.6	-16.4	-16.5	-3.2	17.3	6.8	8.6
Banking sector risk indicators (percent unless otherwise indicated) 4/								
Total assets (in billions of dollars)	5,735	6,246	6,552	7,077	7,601	8,414	9,039	10,091
Total loans and leases to assets	60.8	61.1	59.3	58.7	58.3	58.3	59.5	59.3
Total loans to deposits	91.1	91.3	88.7	88.6	88.0	87.7	88.6	88.9
Problem loans to total loans and leases 5/	1.0	1.1	1.4	1.5	1.2	0.9	0.8	0.8
Nonperforming assets to assets	0.6	0.7	0.9	0.9	0.8	0.6	0.5	0.5
Loss allowance to:								
Total loans and leases	1.7	1.7	1.9	1.9	1.7	1.5	1.3	1.2
Noncurrent loans and leases	178.0	149.4	132.4	127.2	145.7	174.7	170.5	147.0
Return on equity	15.3	14.0	13.2	14.4	15.3	13.7	13.3	13.1
Return on assets	1.3	1.2	1.2	1.3	1.4	1.3	1.3	1.3
Total capital to risk-weighted assets	12.2	12.1	12.7	12.8	12.8	12.6	12.3	12.4
Core capital ratio	7.8	7.7	7.8	7.8	7.9	7.8	7.9	7.9

Sources: IMF, *International Financial Statistics;* Federal Deposit Insurance Corporation; and Haver Analytics.
1/ With FDI at market value.
2/ Excludes foreign private holdings of U.S. government securities other than Treasuries.
3/ External interest payments: income payments on foreign-owned assets (other private payments plus U.S. government payments).
4/ FDIC-insured commercial banks.
5/ Noncurrent loans and leases.

Table 7. Fiscal Indicators

(Fiscal years; in percent of GDP except where otherwise indicated)

	2005	2006	2007	2008	2009	2010	2011	2012
			Projection					
FY 2008 Budget, Administration								
Outlays	20.2	20.3	20.2	20.0	19.5	18.9	18.6	18.3
Debt service	1.5	1.7	1.7	1.8	1.8	1.7	1.7	1.6
Other	18.7	18.6	18.5	18.2	17.7	17.2	17.0	16.6
Revenue	17.6	18.4	18.5	18.3	18.3	18.3	18.3	18.6
Unified balance	-2.6	-1.9	-1.8	-1.6	-1.2	-0.6	-0.3	0.3
Primary balance	-1.1	-0.2	0.0	0.1	0.6	1.2	1.4	1.9
Unified balance exc. social security	-4.0	-3.3	-3.2	-3.0	-2.6	-2.0	-1.8	-1.1
Unified balance (billion dollars)	-318	-248	-244	-239	-187	-94	-54	61
Debt held by the public	37.4	37.0	36.9	36.7	36.0	34.8	33.4	31.5
FY 2008 Budget, Adjusted for Staff's Budget and Economic Assumptions 1/								
Outlays	20.2	20.3	20.1	20.2	20.2	20.0	19.8	19.4
Debt service	1.5	1.7	1.7	1.8	1.8	1.8	1.7	1.6
Other	18.7	18.6	18.4	18.4	18.4	18.3	18.1	17.8
Revenue	17.6	18.4	18.7	18.6	18.1	18.2	18.1	18.3
Unified balance	-2.6	-1.9	-1.4	-1.6	-2.0	-1.8	-1.7	-1.2
Primary balance	-1.1	-0.2	0.4	0.2	-0.2	0.0	0.0	0.5
Unified balance exc. social security	-4.0	-3.3	-2.8	-3.0	-3.5	-3.2	-3.2	-2.6
Unified balance (billion dollars)	-318	-248	-188	-231	-307	-283	-287	-200
Debt held by the public	37.4	37.1	36.9	37.0	37.4	37.5	37.5	37.1
Memorandum items:								
Structural unified balance 2/	-2.1	-2.1	-1.3	-1.5	-1.7	-1.6	-1.7	-1.3
Primary structural unified balance	-0.6	-0.4	0.4	0.4	0.1	0.2	0.0	0.3
Administration's economic projections (in percent, calendar-year basis)								
Real GDP growth	3.2	3.3	2.7	3.0	3.1	3.0	3.0	3.1
CPI inflation	3.4	3.2	2.1	2.6	2.5	2.4	2.3	2.5
Three-month Treasury bill rate	3.2	4.8	4.7	4.6	4.4	4.2	4.1	4.3
Central government balance 3/	-2.9	-1.5	-1.3	-1.6	-1.8	-1.5	-1.5	-0.9
General government balance 3/	-3.7	-2.3	-2.1	-2.3	-2.6	-2.4	-2.4	-1.9

Sources: FY 2008 Budget of the U.S. Government (February 5, 2007); and Fund staff estimates.

1/ Staff projections are based on the Administration's budget adjusted for: differences in macroeconomic projections; staff estimates of the cost of ongoing operations in Iraq; some additional non-defense discretionary expenditure; additional Medicare spending; and continued AMT relief beyond FY2008. PRAs are also assumed not to be introduced.

2/ As a percent of potential GDP, based on proposed measures, under IMF staff's economic assumptions. Also incorporates CBO adjustments for one-off items.

3/ Calendar year, on a national accounts basis. The projections use Fund staff budget and economic assumptions.

Appendix Table 1. United States: Net Foreign Asset Position Sustainability Framework, 2002–2012

(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	NFA-stabilizing non-income current account 5/
1 **Baseline: Net Foreign Asset Position**	-19.9	-19.5	-19.6	-18.0	-19.2	**-25.1**	**-30.0**	**-34.5**	**-38.7**	**-42.7**	**-46.5**	**-0.2**
2 Change in net foreign asset position	-1.0	0.4	-0.1	1.6	-1.2	-5.9	-4.9	-4.5	-4.3	-4.0	-3.8	
3 Identified external liability-creating flows (4+8)	4.6	4.9	5.3	6.0	6.1	6.0	5.6	5.3	5.1	5.0	4.8	
4 Current account deficit excluding income flows	4.7	5.2	5.9	6.4	6.4	6.0	5.7	5.5	5.3	5.2	5.0	
5 Deficit in balance of goods and services	4.0	4.5	5.2	5.7	5.7	5.3	5.2	5.0	4.9	4.7	4.6	
6 Exports	9.3	9.3	9.9	10.3	10.9	11.3	11.6	11.8	12.0	12.2	12.5	
7 Imports	13.4	13.8	15.1	16.0	16.6	16.6	16.8	16.8	16.9	17.0	17.0	
8 Automatic debt dynamics 1/	0.1	0.3	0.6	0.4	0.3	0.1	0.1	0.2	0.2	0.2	0.2	
9 Contribution from nominal interest rate	-0.6	-0.6	-0.6	-0.7	-0.8	-0.8	-1.1	-1.3	-1.5	-1.6	-1.8	
10 Contribution from real GDP growth	0.3	0.5	0.7	0.6	0.6	0.4	0.7	0.9	1.0	1.1	1.2	
11 Contribution from price changes 2/	0.3	0.4	0.5	0.6	0.5	0.5	0.5	0.6	0.7	0.7	0.8	
12 Residual (2-3) 3/	3.6	5.3	5.3	7.6	4.9	0.0	0.8	0.8	0.9	1.0	1.1	
Net foreign liabilities-to-exports ratio (in percent)	-214.2	-210.3	-198.3	-174.5	-175.7	-221.5	-257.9	-291.2	-322.1	-349.3	-373.2	
Scenario with key variables at their historical averages 4/						**-25.1**	**-28.5**	**-31.8**	**-35.1**	**-38.2**	**-41.2**	**-0.5**
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (in percent)	1.6	2.5	3.9	3.2	3.3	2.0	2.8	3.0	3.0	2.9	2.9	
GDP deflator in US dollars (change in percent)	1.7	2.1	2.8	3.0	2.9	2.6	2.0	2.0	2.0	2.0	2.0	
Nominal external interest rate (in percent)	3.1	3.1	3.5	4.0	4.4	4.3	4.6	4.5	4.5	4.5	4.4	
Growth of exports (US dollar terms, in percent)	-3.0	4.4	13.7	10.9	12.7	8.6	7.5	7.1	6.7	6.8	6.9	
Growth of imports (US dollar terms, in percent)	2.1	8.3	16.8	12.9	10.4	4.6	5.8	5.4	5.3	5.4	5.4	
Current account balance, excluding interest payments	-4.7	-5.2	-5.9	-6.4	-6.4	-6.0	-5.7	-5.5	-5.3	-5.2	-5.0	

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, ε = nominal appreciation (increase in dollar value of domestic currency), and α = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price changes is defined as $[-\rho(1+g)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with a rising GDP deflator.

3/ Line includes the impact of exchange rate changes.

4/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

5/ Long-run, constant balance that stabilizes the net foreign asset ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Appendix Table 2. United States: Public Sector Debt Sustainability Framework, 2002–2012

(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	**Debt-stabilizing primary deficit 9/**
1 **Baseline: Public sector debt 1/**	38.7	41.7	43.5	44.4	44.2	**45.0**	**45.9**	**46.9**	**47.7**	**48.5**	**48.7**	**0.1**
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	2.9	3.0	1.8	0.9	-0.2	0.8	0.9	1.0	0.8	0.8	0.3	
3 Identified debt-creating flows (4+7+12)	1.6	2.2	1.1	0.3	-1.2	-0.6	-0.6	-0.4	-0.6	-0.6	-1.1	
4 Primary deficit	0.8	2.1	1.9	0.9	-0.6	-0.9	-0.7	-0.5	-0.6	-0.6	-1.1	
5 Revenue and grants	28.6	28.0	28.0	29.0	30.2	30.3	30.2	29.8	29.9	29.8	29.7	
6 Primary (noninterest) expenditure	29.4	30.0	29.8	29.9	29.6	29.5	29.4	29.3	29.3	29.1	28.6	
7 Automatic debt dynamics 2/	0.8	0.1	-0.8	-0.6	-0.6	0.2	0.2	0.1	0.0	0.0	0.1	
8 Contribution from interest rate/growth differential 3/	0.8	0.1	-0.8	-0.6	-0.6	0.2	0.2	0.1	0.0	0.0	0.1	
9 Of which contribution from real interest rate	1.4	1.1	0.7	0.7	0.8	1.0	1.4	1.4	1.4	1.4	1.4	
10 Of which contribution from real GDP growth	-0.6	-0.9	-1.5	-1.3	-1.4	-0.8	-1.2	-1.3	-1.3	-1.3	-1.3	
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	0.0	0.0	0.0	0.0	0.0	0.0	
13 Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
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 Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
16 Residual, including asset changes (2-3) 5/	1.3	0.7	0.7	0.6	1.0	1.4	1.4	1.4	1.4	1.4	1.4	
Public sector debt-to-revenue ratio 1/	135.6	149.3	155.5	152.9	146.4	148.4	152.2	157.2	159.5	162.8	163.9	
Gross financing need 6/	24.0	25.2	25.7	24.1	21.2	20.9	21.2	21.7	21.8	21.9	21.7	
in billions of U.S. dollars	2514.8	2763.7	3005.9	3007.3	2814.0	2897.1	3083.8	3303.6	3486.8	3687.3	3819.9	
Scenario with key variables at their historical averages 7/						**45.0**	**45.0**	**44.9**	**44.9**	**44.8**	**44.6**	**0.2**
Scenario with no policy change (constant primary balance) in 2006-2011						**45.0**	**47.3**	**48.8**	**50.1**	**51.5**	**52.8**	**0.8**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	1.6	2.5	3.9	3.2	3.3	2.0	2.8	3.0	3.0	2.9	2.9	
Average nominal interest rate on public debt (in percent) 8/	5.8	5.1	4.8	4.9	4.9	5.0	5.2	5.2	5.1	5.0	5.0	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	4.0	3.0	1.9	1.9	2.0	2.5	3.2	3.2	3.2	3.1	3.1	
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)	1.7	2.1	2.8	3.0	2.9	2.5	2.0	2.0	2.0	2.0	2.0	
Growth of real primary spending (deflated by GDP deflator, in percent)	6.2	4.9	3.2	3.4	2.4	1.5	2.6	2.7	2.7	2.5	0.9	
Primary deficit	0.8	2.1	1.9	0.9	-0.6	-0.9	-0.7	-0.5	-0.6	-0.6	-1.1	

1/ General government net debt.

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.

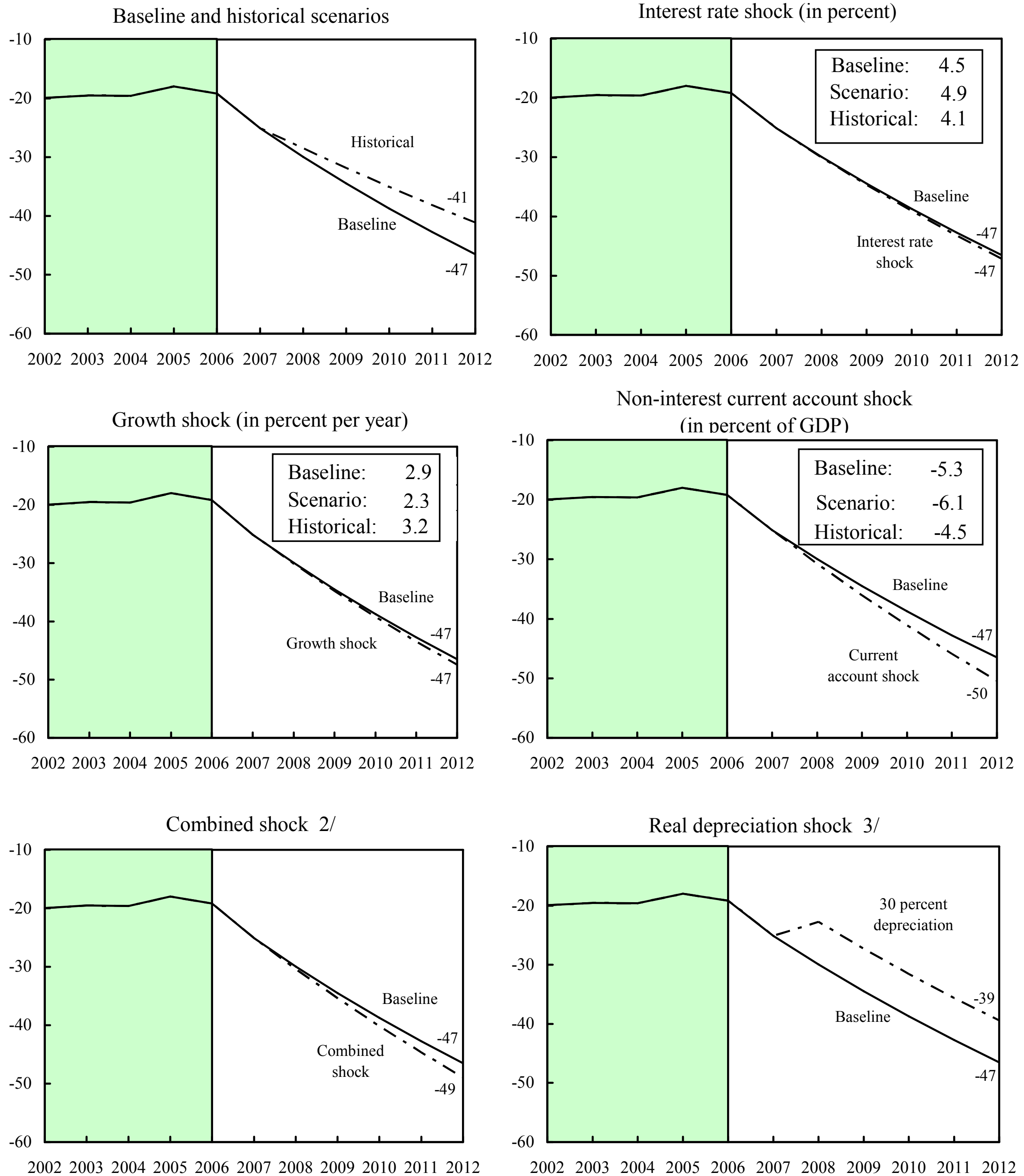
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

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 gross debt stock.

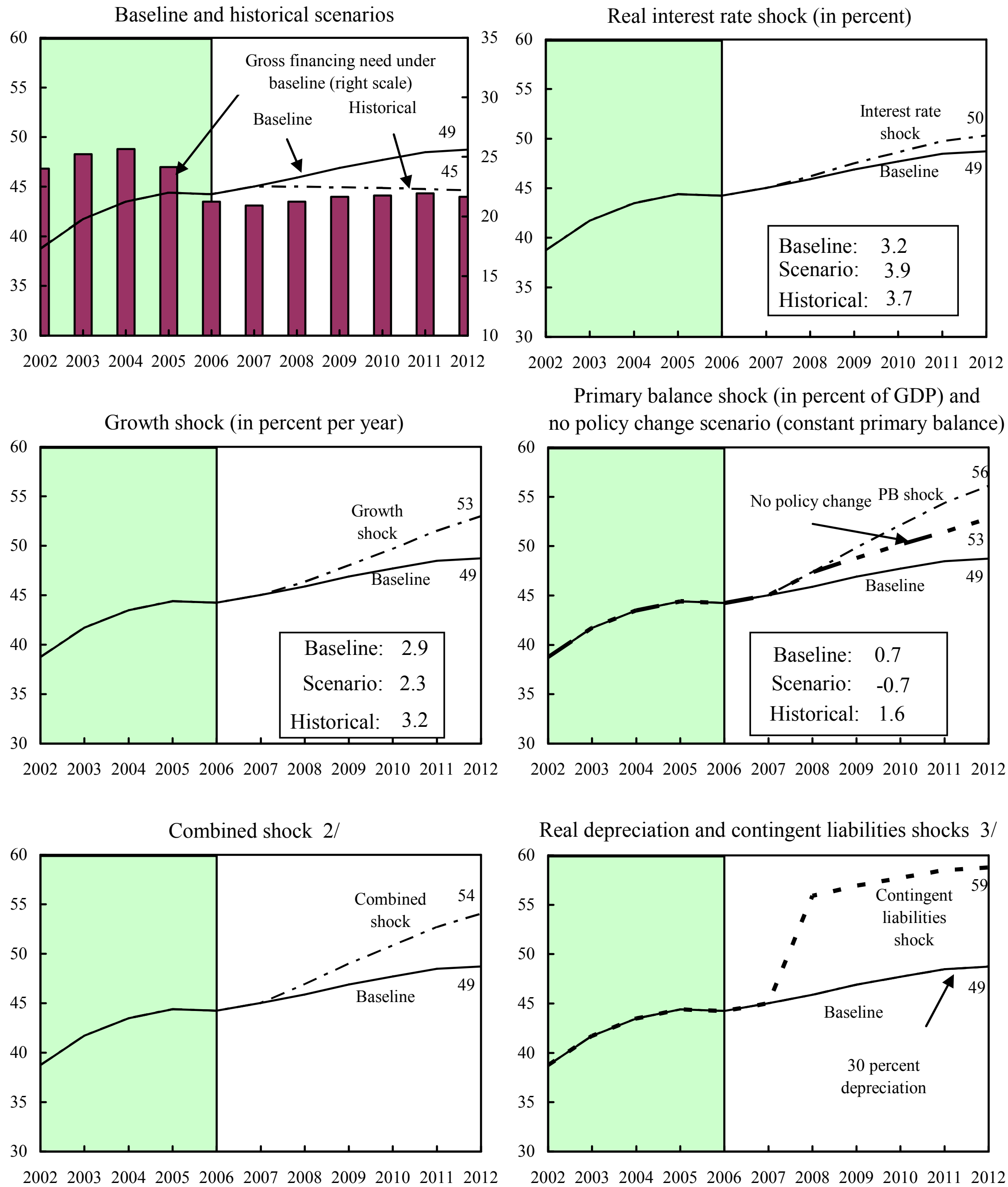
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Appendix Figure 1. United States: Net Foreign Asset Sustainability: Bound Tests 1/
(Net foreign assets in percent of GDP)



Source: Fund staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. 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/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
3/ One-time real depreciation of 30 percent occurs in 2008.

Appendix Figure 2. United States: Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)



Source: Fund staff estimates.
1/ Shaded areas represent actual data.Individual shocks are permanent one-half standard deviation shocks. 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/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2008, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

UNITED STATES—ANNEXES TO THE 2007 ARTICLE IV CONSULTATION STAFF REPORT

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Annex I. United States: Fund Relations

(As of April 30, 2007)

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

II. **General Resources Account:**	SDR Million	Percent Quota
Quota	37,149.30	100.0
Fund holdings of currency	34,161.26	92.0
Reserve position in Fund	2,987.48	8.0

III. **SDR Department:**	SDR Million	Percent Allocation
Net cumulative allocation	4,899.53	100.0
Holdings	5,924.53	120.9

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 maintains restrictions on payments and transfers for current international transactions to the Balkans, Belarus, Cote d'Ivoire, Cuba, Democratic People's Republic of Korea, Iraq, Islamic Republic of Iran, Liberia, Myanmar, Sudan, Syrian Arab Republic, and Zimbabwe and has notified the Fund of these restrictions under Decision No. 144–(52/51). The United States restricts the sale of arms and petroleum to the National Union for the Total Independence of Angola (UNITA) and to the territory of Angola and has prohibitions against transactions with international narcotics traffickers. The United States notified the Fund under Decision No. 144–(52/51) on August 2, 1995 of the imposition of further restrictions on current transactions with Islamic Republic of Iran. On March 21, 2002, the United States notified the Fund of exchange restrictions related to the financing of terrorism. The United States has lifted restrictions previously imposed with respect to Libya. The United States notified the Fund under the Framework of Decision 144 of the imposition of two additional exchange restrictions solely for the preservation of national and international security in March 2007 (EBD/07/34, 3/19/07): (i) the blocking of property of and prohibiting transactions with the Government of Sudan and prohibiting transactions with the petroleum and petrochemical industries in Sudan and (ii) the blocking

of property of certain persons contributing to the conflict in the Democratic Republic of Congo.

IX. **Article IV Consultation**. The 2006 Article IV consultation was concluded in July 2006 and the Staff Report was published as IMF Country Report 06/279. A fiscal ROSC was completed in the context of the 2003 consultation.

The 2007 Article IV discussions were conducted from April 23-May 8. Concluding meetings with Chairman Bernanke of the Board of Governors of the Federal Reserve System and Treasury Secretary Paulson occurred on May 29 and June 15. A press conference on the consultation was held on June 22. The team comprised R. Teja (Head), T. Bayoumi, T. Helbling, R. Balakrishnan, F. Gonçalves, V. Klyuev, K. Krajnyák, and K. Mathai (all WHD); P. Mills and A. Bhatia (MCM); and J.J. Hallaert (PDR). Mmes. Lundsager (Executive Director) and Pollard (Advisor) attended some of the meetings. Outreach included discussions with the private sector and think tanks. The authorities have agreed to the publication of the staff report.

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 is being 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 15, 2007)

	Date of latest observation	Date received	Frequency of data[6]	Frequency of reporting[6]	Frequency of publication[6]
Exchange rates	same day	same day	D	D	D
International reserve assets and reserve liabilities of the monetary authorities[1]	Jun. 18	Jun. 11	W	W	W
Reserve/base money	May 23	Jun. 7	B	W	W
Broad money	May 28	Jun. 7	W	W	W
Central bank balance sheet		Jun.12	Q	Q	Q
Interest rates[2]	Same day	Same day	D	D	D
Consumer price index	Apr. 2007	May 15	M	M	M
Revenue, expenditure, balance and composition of financing[3] – general government[4]	2007 Q1	Jun. 7	Q	Q	Q
Revenue, expenditure, balance and composition of financing[3] – central government	Apr. 2007	May 10	M	M	M
Stocks of central government and central government-guaranteed debt	Apr. 2007	May 10	M	M	M
External current account balance	2006 Q4	Mar. 14	Q	Q	Q
Exports and imports of goods and services	Apr. 2007	Jun. 8	M	M	M
GDP/GNP	2007 Q1	May 31	Q	Q	Q
Gross External Debt[5]	2007 Q1	Jun. 7	Q	Q	Q

[1]Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2]Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3]Foreign, domestic bank, and domestic nonbank financing.
[4]The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5]Including currency and maturity composition.
[6]Daily (D), Weekly (W), Biweekly (B), Monthly (M), Quarterly (Q), Annually (A); NA: Not Available.

Statement by the IMF Staff Representative
July 27, 2007

1. **This note reports on information that has become available since the staff report was issued and does not alter the staff appraisal**.

2. **The Federal Reserve's semi-annual Monetary Policy Report (MPR) was presented to Congress on July 18–19 by Chairman Bernanke**. The Chairman cautioned that some of the recent easing in core inflation could be transitory, but expected this measure to fall below 2 percent on a sustainable basis by 2008. He also indicated that economic growth is likely to pick up modestly, from 2¼–2½ percent this year to 2½–2¾ percent in 2008 (both Q4 on Q4).

3. **The Administration has released its Mid-Session Review of the budget.** The projected FY 2007 deficit was marked down to 1½ percent of GDP, as anticipated in the Staff Report, but projected future deficits were raised modestly due to higher anticipated spending, mainly on Medicare/Medicaid. The changes are not large enough to warrant revisions to the data in the *Staff Report*.

4. **Motivated by continued difficulties in the subprime mortgage market, regulators are taking steps to strengthen consumer protection in mortgage lending.** On July 17, federal regulators announced a pilot project to cooperate with state regulators in checking compliance with consumer protection regulations by (1) non-depository affiliates of depository institutions and (2) by state-licensed mortgage lenders and brokers issuing subprime mortgages. This follows the issuance of final guidance requiring depository institutions to tighten lending standards to subprime adjustable rate mortgages. Federal regulators also announced on July 20 an agreed strategy on Basel II implementation. The agreement resolves major outstanding issues and should be followed by finalized rules relatively soon.

5. **Recent data releases continue to point to easing inflation and moderate growth**. Core CPI inflation fell to 2.2 percent in June. Consumption growth has slowed and the housing market remains weak. However, the data are more positive for other sectors: industrial production increased by 0.5 percent in June, and May export growth was strong. The flash second quarter GDP release is due the morning of the Board discussion.

6. **While subprime mortgage spreads continue to widen, financial market conditions remain generally supportive of activity.** Although high-yield corporate and investment bank credit spreads have widened, they remain at historically low levels. Meanwhile, U.S. equity markets have touched record highs.

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IMF Executive Board Concludes 2007 Article IV Consultation with the United States

On July 27, 2007, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the United States.[1]

Background

The U.S. economy has cooled more than expected over the past year, but employment remains strong and growth abroad has picked up. Following an extended boom led by strong domestic demand, the slowdown has largely reflected a drag from residential investment as the housing market has weakened substantially. Unexpected weakness in business investment and net exports, as well as an inventory correction, amplified the downturn in early 2007, but growth is expected to recover in the remainder of the year. Private consumption has continued to grow robustly as solid employment and wage growth have minimized spillovers from housing, unemployment has remained extremely low, and, as a result, core inflation has only recently started to ease. The global environment remains favorable, with robust growth in the euro area and Asia.

The most likely scenario is a soft landing of the U.S. economy, with growth picking up during 2007 as the housing drag dissipates, business investment recovers, and net exports rebound on strong foreign demand. Core inflation should ease as the output gap widens.

[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.

At the same time, there are important risks to this outlook. Growth is uncomfortably close to the "stall speed" associated with past recessions, even though unemployment and real interest rates are more favorable. Subprime mortgage difficulties could extend the housing downturn, which in turn could weaken consumption, and financial conditions could tighten. And with output close to potential, unemployment low, commodities prices elevated, and productivity growth falling, cost pressures could boost inflation.

Financial innovation and stability have been critical to U.S. economic success. Innovation has been instrumental in attracting capital inflows and easy financing of the current account deficit, and has also helped disperse risk, as core institutions have moved to an "originate-to-distribute" model and derivative markets have grown. At the same time, new instruments have made it more difficult to assess vulnerabilities and have thus created new regulatory challenges.

The current account deficit stabilized at 6 percent of GDP in 2006, with a stronger nonoil trade balance partly offset by the impact of higher oil prices and lower net investment income. At unchanged real exchange rates, the current account deficit is expected to narrow only slightly, implying an accumulation of U.S. net foreign liabilities. Staff analysis suggests that further dollar depreciation would be required over time to realign with fundamentals.

Short-run fiscal developments have been highly favorable, with the Administration's goal of halving the deficit by FY 2009 achieved three years ahead of time, largely on the strength of surging revenues. The Administration and Congress have both endorsed a target of balancing the budget by FY 2012, but agreement on how to achieve this objective, while providing appropriately for war costs and for Alternative Minimum Tax relief, has yet to be reached. Looking further ahead, the key challenge will be entitlement reform; without it, federal spending on Social Security, Medicare, and Medicaid is set to increase sharply over coming years, threatening long-run fiscal sustainability.

Executive Board Assessment

Executive Directors agreed with the thrust of the staff appraisal. Prospects for the U.S. economy are favorable, as activity has cooled following an extended boom led by domestic demand. Nonetheless spillovers from the housing market slowdown and the subprime mortgage market problems cannot be overlooked. Thus, the most likely scenario is a soft landing, with growth recovering and inflation easing, but risks remain. In particular, consumption could be weaker and financial market conditions could tighten rapidly. Directors also cautioned that cost pressures from rising oil and commodity prices and a tight labor market could raise inflation risks.

Against these prospects, Directors considered current monetary policy to be consistent with a soft landing. They commended the Federal Reserve for its emphasis on well-anchored inflation expectations, and saw scope for flexibility in balancing inflation risks with concerns about activity.

Financial innovation and stability have been key to U.S. economic success and the funding of the current account deficit. The financial system has shown impressive resilience, including to recent difficulties in the subprime mortgage market, but new regulatory challenges have been created by rapid innovation. Directors agreed that regulators should focus prudential oversight on core commercial and investment banks and welcomed the authorities' plan to review options for streamlining the financial regulatory system. They cautioned, however, that financial innovation has complicated risk assessment at a time of higher risk taking and deteriorating lending standards in some sectors. As financial conditions tighten, unanticipated risk concentrations and links across markets could come to light. This underlines the importance of ensuring that risk management systems are robust. Recent problems with subprime mortgages also highlight the need for consistent consumer protection, without undue constraints on innovation.

The new emphasis on improving the effectiveness of financial regulation is welcome. To ease interagency coordination and shorten regulatory reaction times, Directors supported increased use of general principles as a guide to rule making and recent initiatives to explore the scope for rationalizing the regulatory structure.

Directors also welcomed initiatives to lower regulatory costs and increase financial market competitiveness. These include guidance reducing the compliance burden of parts of the Sarbanes-Oxley Act on smaller firms, new rules making deregistering from U.S. exchanges easier for foreign companies, and the consideration given to recognizing some foreign regulatory regimes and international accounting standards.

Directors agreed that large valuation gains have stabilized U.S. net foreign liabilities as a ratio to GDP in recent years, but the upward trend is likely to resume given large current account deficits. They noted the staff's assessment that the dollar appears to be overvalued relative to its longer-term value in real effective terms and that a further real depreciation could contribute to rebalancing demand and asset portfolios—although, with rapid financial innovation continuing to attract net capital inflows, the adjustment would likely be gradual. A number of Directors, however, found that the evidence for the overvaluation of the dollar was not convincing.

While a disorderly resolution of global imbalances is unlikely, the potential costs are high as a disruption in U.S. financial markets would lower both domestic and—via financial market spillovers—foreign demand. Directors thus emphasized the importance of sound and innovative U.S. financial markets and implementation of policies to support U.S. saving agreed in the Fund's Multilateral Consultation.

Directors recognized the authorities' commitment to free trade and urged them to adopt a more ambitious agenda to achieve a positive outcome to the Doha Round.

Directors commended recent fiscal performance and the intention to balance the budget by FY 2012. They emphasized, however, that further effort would be needed to forge consensus on how to achieve budgetary balance.

The key fiscal challenge remains reform of unsustainable entitlement programs. Directors welcomed proposals to contain the budgetary costs of Medicare spending by strengthening the link between premiums and income, while cautioning that sustainability would require more fundamental reform of the high-cost health system. They also urged the authorities to develop a consensus on Social Security reform.

A tighter medium-term target would offer greater room for maneuver in addressing long-term fiscal pressures, while also contributing to current account adjustment. A number of Directors supported a target of balancing the budget excluding the Social Security surplus. It was also observed that revenue increases might be needed to achieve this goal, and a number of Directors viewed that higher taxation of energy consumption should be considered. They also emphasized the need to overhaul the complex tax system by reducing and better targeting write-offs while further shielding saving from income taxes.

It is expected that the next Article IV consultation with the United States will be held on the standard 12-month cycle.

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.

United States: Selected Economic Indicators

(Annual change in percent, unless otherwise noted)

	2000	2001	2002	2003	2004	2005	2006
NIPA in constant prices 1/							
Real GDP	3.7	0.8	1.6	2.5	3.9	3.2	3.3
Net exports 2/	-0.9	-0.2	-0.7	-0.4	-0.7	-0.3	0.0
Total domestic demand	4.4	0.9	2.2	2.8	4.4	3.3	3.2
Final domestic demand	4.5	1.8	1.8	2.8	4.0	3.6	2.9
Private final consumption	4.7	2.5	2.7	2.8	3.9	3.5	3.2
Public consumption expenditure	1.7	3.1	4.3	2.5	2.1	0.9	1.6
Gross fixed domestic investment	6.1	-1.7	-3.5	3.2	6.1	6.4	3.1
Private	6.5	-3.0	-5.2	3.4	7.3	7.5	2.9
Public	3.6	4.9	5.1	2.2	0.5	1.1	4.1
Change in business inventories 2/	-0.1	-0.9	0.4	0.0	0.4	-0.3	0.2
GDP in current prices 1/	5.9	3.2	3.4	4.7	6.9	6.3	6.3
Employment and inflation							
Unemployment rate (percent)	4.0	4.7	5.8	6.0	5.5	5.1	4.7
CPI inflation	3.4	2.8	1.6	2.3	2.7	3.4	3.2
GDP deflator	2.2	2.4	1.7	2.1	2.8	3.0	2.9
Fiscal policy indicators							
Unified federal balance (billions of dollars)	236	128	-158	-378	-413	-318	-248
In percent of FY GDP	2.4	1.3	-1.5	-3.5	-3.6	-2.6	-1.9
General government balance (NIPA, billions of dollars)	159	-39.3	-397	-530	-533	-456	-299
In percent of CY GDP	1.6	-0.4	-3.8	-4.8	-4.6	-3.7	-2.3
Balance of payments							
Current account balance (billions of dollars)	-417	-385	-460	-522	-640	-755	-811
In percent of GDP	-4.3	-3.8	-4.4	-4.8	-5.5	-6.1	-6.1
Merchandise trade balance (billions of dollars)	-455	-430	-485	-551	-670	-787	-838
In percent of GDP	-4.6	-4.2	-4.6	-5.0	-5.7	-6.3	-6.3
Invisibles (billions of dollars)	37.3	44.8	25.3	28.8	29.4	32.3	26.8
In percent of GDP	0.4	0.4	0.2	0.3	0.3	0.3	0.2
Saving and investment (as a share of GDP)							
Gross national saving	18.0	16.4	14.2	13.3	13.2	12.9	13.9
Gross domestic investment	20.8	19.1	18.4	18.4	19.3	19.7	20.0

Source: Haver Analytics; and IMF staff estimates.

1/ National accounts data as available at the time of the July 27, 2007, Executive Board discussion.
2/ Contribution to growth.