G R O U P   O F   T W E N T Y

UNITED STATES SUSTAINABILITY REPORT[1]

Prepared by Staff of the

I N T E R N A T I O N A L   M O N E T A R Y   F U N D

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[1] *Report 10 of 10.* At the request of the G-20, IMF staff has provided analyses and assessments of member's economies and policies in a *set* of reports for the Mutual Assessment Process (MAP). These reports serve as inputs for the Action Plan agreed by G-20 Leaders at the Cannes Summit. The 2011 Staff Reports for the 20 MAP consist of the following: (i) an Umbrella Report that provides an integrated summary of the component reports and an upside scenario for G-20 collective action; (ii) an Accountability Report that summarizes members' progress toward policy commitments since the Seoul Summit in 2010; (iii) a MAP Report providing analysis of members' medium-term macroeconomic and policy frameworks; and (iv) Sustainability Reports for seven members (China, France, Germany, India, Japan, United Kingdom, and United States)—indentified by G-20 indicative guidelines—to assess the root causes and policy implications of key imbalances.

Executive Summary

G-20 indicative guidelines identified the United States as experiencing "moderate" or "large" fiscal and external imbalances. Persistent fiscal deficits reflected a structural shortfall in revenues against increased spending commitments, including security-related spending. Weak fiscal balances and low household saving—alongside high foreign demand for dollar assets—were main contributors to U.S. external deficits. To facilitate the requisite rebalancing acts, fiscal consolidation to restore soundness to public finances and a greater reliance on external demand are needed.

Persistent fiscal imbalances have been underpinned by structural factors and budget deficits have widened dramatically with the crisis. A structural shortfall in revenues became evident after tax cuts in the early 2000s. Underfunded entitlement obligations and higher security-related spending commitments, meanwhile, have kept expenditures high. The crisis has weakened public finances sharply through lower tax revenues. Political stalemate poses a major hurdle to agreement and action on decisive consolidation.

Large external imbalances reflected weak fiscal balances and other domestic factors, as well as global factors. In addition to public dissaving, unsustainably low household saving contributed to current account deficits amid housing and credit booms. High foreign demand for U.S. assets (reflecting their financial attractiveness and dollar reserve accumulation by trading partners) and elevated oil prices have also contributed to external deficits.

Given the systemic importance of the U.S. economy and financial system, key imbalances pose domestic and global vulnerabilities:

- High and rising public indebtedness raises sustainability concerns and could weigh on growth. Political stalemate on fiscal adjustment hurts confidence in the authorities' ability to reach agreement on a comprehensive plan. Eventually higher interest rates and higher distortionary taxes to finance high debt service can weigh on future investment and growth. Reduced policy space also creates a vulnerability to future shocks.
- Avoiding a return to low saving and heightened financial risks in the United States is vital for the world economy. U.S. external deficits signaled low national saving, high leverage and a build-up of financial vulnerabilities prior to the crisis. Preventing U.S. financial instability—given large and adverse global spillovers—is critical.

Policies to address imbalances center on restoring soundness to public finances. Credible and durable consolidation with "growth-friendly" composition requires limiting the growth of expenditures—crucially, through entitlement reform—and raising revenues, including through tax reform (such as curtailing exemptions and shifting toward consumption and energy taxes).

Stronger financial regulation and reform are equally important. Financial sector policies will need to better safeguard stability while remaining supportive of growth. Sufficiently strong regulation and supervision, with adequately broad perimeters, should prevent a build-up of financial vulnerabilities that contributed to low household saving and should keep pace with a changing financial landscape.

INTERNATIONAL MONETARY FUND

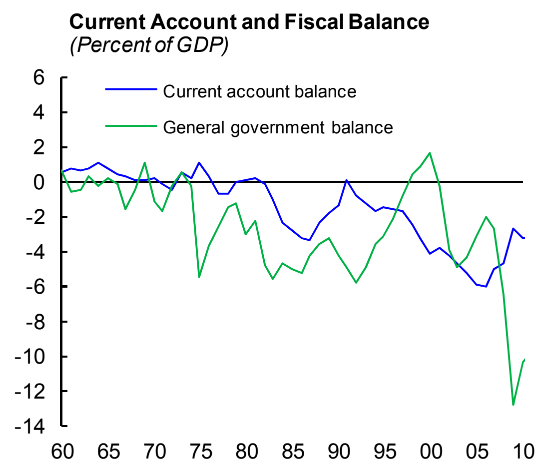
UNITED STATES

SUSTAINABILITY REPORT 2011[1]

The United States has experienced long periods of external and fiscal imbalances. Fiscal deficits were substantial in the mid-2000s and widened significantly during the crisis. External deficits have reflected weak fiscal balances and other factors contributing to low national saving, including external factors that underlie strong foreign demand for U.S. assets. Going forward, large budget and moderate current account deficits are projected to persist, exacerbating U.S. and global vulnerabilities. Policies to restore soundness to public finances include limiting the growth of expenditures (crucially, through entitlement reform) and raising revenues (including through tax reform). Stronger financial regulation and reform are equally important to safeguard stability and to prevent excessive credit and leverage that led to the buildup of systemic risk and unsustainably low household saving in the past. Achieving strong, sustainable and balanced growth would require rebalancing away from a heavy reliance on private consumption (before the crisis), followed by fiscal support (during the crisis), toward an increasing contribution from external demand.

I. BACKGROUND

1. **Fiscal and current account deficits have been a persistent feature of the U.S. economy for several decades.** "Twin deficits" emerged from a near-synchronous deterioration in the budget and external positions in the first half of the 1980s. However, the link has not always been tight—as seen by the experience of the late-1990s. During that time, widening trade deficits were led by business investment and facilitated by large capital inflows in the form of FDI and equity portfolio investment—both in response to an increase in U.S. productivity growth. Meanwhile, an improving fiscal position benefited from a strong economy, a



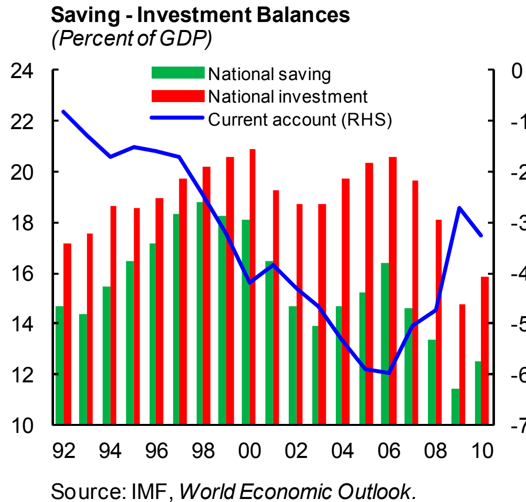
Source: IMF, *World Economic Outlook*.

[1] Prepared by Vladimir Klyuev under the guidance of Hamid Faruqee, with input from Michal Andrle and Stephen Snudden, and the support of Eric Bang, David Reichsfeld, and Anne Lalramnghakhleli Moses.

booming stock market, and tax increases that boosted revenues; the peace dividend; and welfare reform, as well as strengthened budget discipline.[2]

2. **An appreciable widening of U.S. imbalances preceded the Great Recession.** After 2000, twin deficits reasserted themselves, led by both cyclical and structural factors heading into the financial crisis.

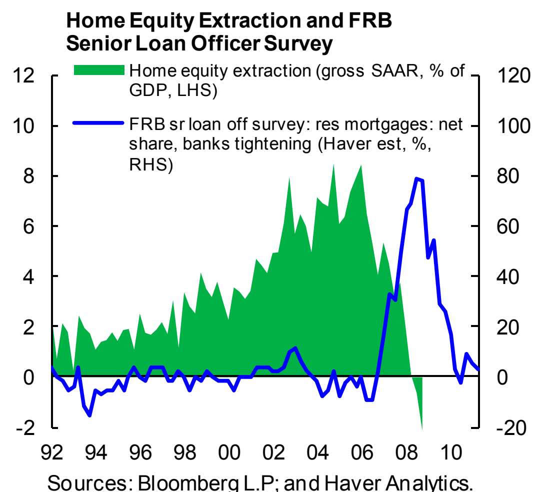
- *U.S. fiscal balances experienced a substantial turnaround from surplus to deficit.* Fiscal loosening reflected a variety of economic and policy-related factors, including tax stimulus following the downturn, complacency from past budget surpluses, and increased military spending. See Box 1.



Source: IMF, *World Economic Outlook*.

- *On the private side, the driver of U.S. external deficits changed from business investment to consumption and construction.* During this period, the current account deficit increasingly reflected falling saving rates and booming homebuilding activity rather than higher business investment following the compression of equity prices and damage to corporate balance sheets. Consumption and residential investment led the recovery and expansion, increasing as a share of GDP. Alongside increasing public dissaving, household saving rates fell to historical lows, fueling the consumption and housing boom.

- *Relaxed financial conditions, weakening credit standards, rising leverage, and booming asset markets contributed to escalating systemic risk.* Easy credit—supported by low interest rates, financial innovation, and lax regulation and supervision—fueled the rapid rise of household consumption. Surging house prices also encouraged a rapid accumulation of private debt and



Sources: Bloomberg L.P; and Haver Analytics.

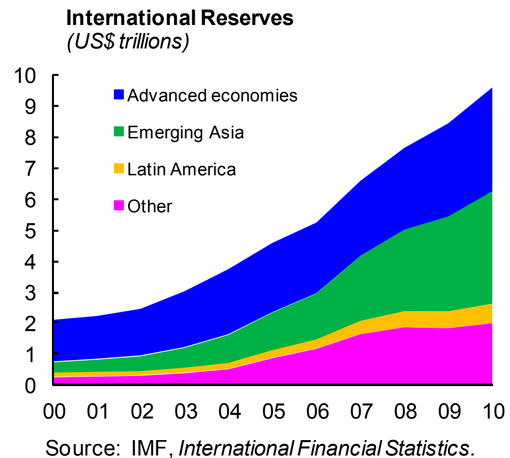
[2]The 1990 Budget Enforcement Act included caps on discretionary spending and PAYGO requirements restrained expenditure growth. See, for example, M. Mühleisen and C. Towe (eds.), (2004) "U.S. Fiscal Policies and Priorities for Long-Run Sustainability," *IMF Occasional Paper* 227.

increasing leverage, including through mortgage equity withdrawals. Lending standards deteriorated and credit risks were mispriced owing to market complacency and "search for yield."

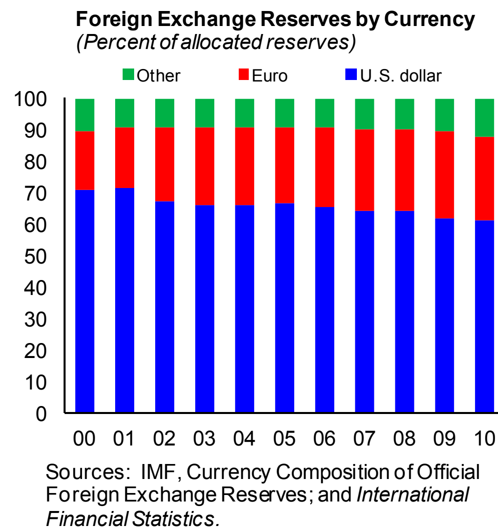
- *U.S. assets were in high demand from international investors, limiting dollar depreciation and allowing large external deficits to persist.* Accumulation of reserves by foreign central banks was a major source of U.S. external financing. Robust private demand from abroad for securitized assets added to capital inflows.

- *Some narrowing of imbalances occurred prior to the crisis—as conditions began to change—but this proved insufficient.* Mortgage interest rates began climbing in 2005, home prices peaked in 2006, and bank lending standards started tightening at the end of that year, bringing the construction and housing boom to an end. With residential investment sharply down and given past dollar depreciation, the current account balance bottomed out in 2006 and improved noticeably over the following two years. While the acute phase of the crisis broke out in September 2008 with the collapse of Lehman, these gradual corrections had started earlier, but unfortunately failed to prevent a systemic financial crisis.

3. **Following the crisis, external imbalances compressed, but fiscal imbalances deteriorated dramatically.** The crisis, which ostensibly originated in the U.S. subprime mortgage market, accelerated a narrowing of the trade balance (partly reflecting sharply falling oil prices), despite a temporary rebound in the dollar (safe haven effect). With consumer spending dampened by extraordinary uncertainty, private saving rebounded while investment contracted. On the contrary, government spending was stepped up and public finances deteriorated substantially as a result of the automatic stabilizers, fiscal stimulus, declining asset prices and large financial system support caused or necessitated by the sharp economic downturn.



Source: IMF, *International Financial Statistics*.



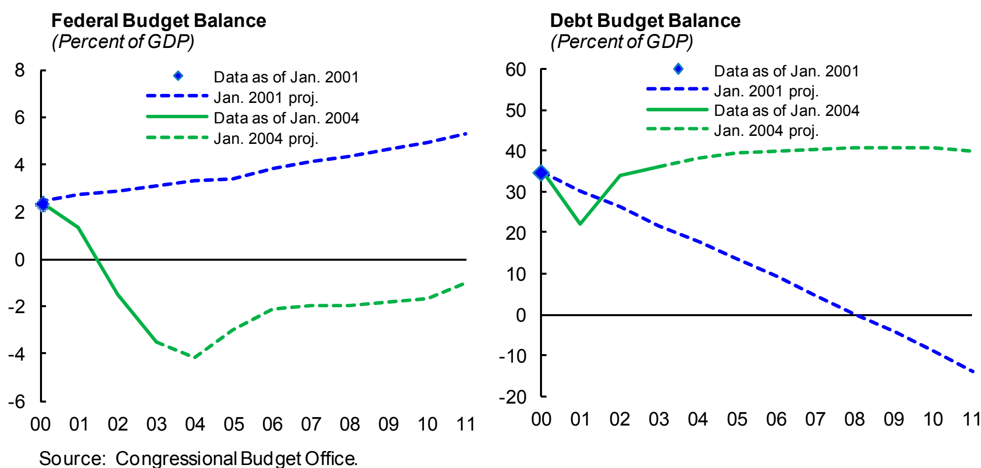
Sources: IMF, Currency Composition of Official Foreign Exchange Reserves; and *International Financial Statistics*.

Box 1. U.S. Fiscal Turnaround

The dramatic turnaround in the U.S. fiscal situation from surplus to deficit was caused by a combination of shocks and policies. The burst of the dot-com bubble in 2000 pushed the U.S. economy into a brief recession in the next year, exacerbated by the shock of the September 11 terrorist attacks. The cyclical downturn and capital losses from lower equity prices lowered federal tax receipts by about one percent of GDP in FY2001 relative to the previous year. A package of major tax cuts was then legislated in 2001, partially motivated by the need to stimulate the economy.

Fiscal complacency and increased security spending were also important factors. Initially there was a perception that tax rates were too high given projected budget surpluses under unchanged policies; projected elimination of (net) public debt and possible accumulation of public assets; and the political desire to share surpluses with current taxpayers. But even as the federal budget balance swung from +2.4 percent of GDP in 2000 to -3.5 percent in 2003, another major round of tax cuts was passed that year. In addition, counterterrorism measures and military operations triggered by the September 11 attacks added to the fiscal burden. Outlays on national defense doubled between FY2001 and FY2008.

CBO Baseline Projections by Vintage



Source: Congressional Budget Office.

Fiscal deficits moderated in the mid-2000s, but budgetary prospects remained worrisome. As the economy came out of recession, the stock market regained momentum; the housing market boomed; and tax receipts recovered some lost ground. However, with population aging and high medical cost inflation, expenditures on social security and health care were still projected to rise at an alarming rate. The pressure was exacerbated by a new prescription drug benefit (Medicare Part D) that came into effect in 2006.

II. Root Causes of U.S. Imbalances

Based on G-20 indicative guidelines, relatively large U.S. imbalances were identified with respect to fiscal and external deficits—calling for an in-depth analysis of their root causes. Several key factors underlying both U.S. fiscal and current account deficits can be identified, related to both domestic and external sources.

A. Fiscal Imbalances

4. **Present and projected large U.S. fiscal deficits reflect several key factors.** This includes: (i) structural factors underlying pre-crisis deficits; (ii) legacy effects from the crisis itself on the fiscal accounts; and (iii) underfunded entitlement obligations.

- *The U.S. fiscal position was structurally unbalanced pre-crisis.* A structural shortfall in tax revenues relative to augmented spending commitments at the federal level became evident in the early 2000s. The 2001 and 2003 tax cuts reduced federal revenue by over $2½ trillion over the following 10 years.[3] Although these tax cuts were scheduled to expire, returning to higher marginal rates has turned out to be politically difficult. Separately, after decades of using tax incentives to promote various objectives, the tax code is extremely complex and ridden with inefficiencies.[4] On the spending side, while discretionary non-defense expenditure had been squeezed before the crisis, high military and security spending persists since the 9/11 terrorist attacks.

- *The adverse impact of the crisis on budget balances has been large and multi-faceted.* Staff assess that a downward shift in potential output relative to the pre-crisis trend has lowered revenue-raising capacity. Direct measures to support a damaged financial system increased public debt (albeit marginally). Finally, the weak cyclical state of the economy makes it harder to undertake fiscal tightening in a situation where the scope for further monetary stimulus is very limited. The reliance of local governments on property taxes, coupled with the expectations of a prolonged housing slump, makes their position particularly difficult.

[3] Part of that sum includes the impact of alternative minimum tax (AMT) relief.

[4] The U.S. report of the National Commission on Fiscal Responsibility and Reform (2010) identifies $1.1 trillion annually in tax expenditures. For corporations, tax loopholes are responsible for a (continued) combination of high statutory rates and relatively low revenue collection. For households, mortgage interest rate deductions to promote home ownership are typically not taken advantage of by low-income households (who need the most help to buy a residence) as they tend not to itemize deductible expenses.

- *Growth in entitlement spending has placed an increasing strain on public finances*. A large part of the increase is driven by population aging, which will also have a negative effect on budget revenue and on GDP by reducing the labor supply. The CBO projects federal spending on social security and health care to increase from 10.3 percent of GDP in FY2010 to 13.2 percent in FY2025.[5] Over longer horizons, the rise in entitlement spending will be increasingly driven by the "excess cost growth." Health care costs per beneficiary (adjusted for changes in the age profile of the population) will grow faster than GDP per capita. Excess cost growth is a common problem in advanced economies, but the *level* of health care spending in the United States is about twice the OECD average, albeit with average health outcomes. On the public pension side, social security benefits are already exceeding contributions.[6] In addition, state and local governments will have increasing difficulty in meeting pension and medical care obligations to their retirees. Underfunded private pensions also pose an additional budgetary risk.[7]

- *Fiscal rules currently do not impose sufficient budgetary discipline*. Since the Budget Enforcement Act expired in 2002, the United States has not had a formal anchor on fiscal policy at the federal level. Unlike most U.S. state governments, there are no balanced budget rules. The PAYGO rule has been bypassed frequently. The debt ceiling, raised periodically with much difficulty, has done more to raise market uncertainty than act as an effective constraint.

- *Political polarization complicates reaching an agreement on budgetary consolidation*. The two main political parties' ideological positions have become entrenched in recent years, with staunch opposition to any tax increase or any major welfare benefit cut. The political stalemate has precluded a general accord on the contours of decisive medium-term fiscal adjustment. The standoff over raising the federal debt ceiling and the inability to pass FY2011 appropriation bills are recent manifestations.

B. External Imbalances

5. **Large external deficits reflected a combination of weak fiscal balances, low private saving, and brisk residential investment.** The configuration of private

[5] Health care programs include Medicare, Medicaid, CHIP, and health-care exchange subsidies. State expenditure on Medicaid will also increase.

[6] The 2011 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds.

[7] While the federal government is not directly responsible for private pensions, systemic underfunding may create a call on the Pension Benefit Guarantee Corporation (PBGC). In that eventuality, PBGC resources would likely prove insufficient, and there may be pressure on the federal government to step in.

saving-investment imbalances, in turn, was driven by an underlying confluence of *domestic* and *external* factors, including strong foreign demand for U.S. assets.

6. **Pre-eminent DOMESTIC factors—reflected inter alia in large *financial* imbalances—included key market and policy failures that led to a dangerous build-up of systemic risk.**[8] The housing boom and bust, the increase in financial and household debt and leverage, and the decline in household saving can be traced to these underlying factors.

- *A rapid rise in private consumption, fueled by a housing bubble, was symptomatic of market complacency and an unsustainable credit boom.* This can largely be attributed to excessive financial risk-taking and inadequate regulation alongside accommodative monetary and financial conditions. Overly optimistic expectations about the future growth in income and particularly rising house prices (extrapolating unsustainable trends) further contributed to the decline in private saving and wider external deficits.
- *Misaligned incentives in the financial system were partly responsible for a fundamental breakdown in market discipline and mispricing of risk.*[9] At the center of the crisis was the combination of factors that led private agents to make poor decisions that ultimately created a build-up of vulnerabilities in a financial system that was increasingly unable to sufficiently regulate itself.[10] This includes excessive leverage and risk-taking in the context of unusually low market volatility, interest rates, and "search for yield"—against the backdrop of a global saving "glut" and the Fed's accommodative monetary stance in the first half of the 2000s that depressed both long and short-term interest rates;[11] moral hazard problems that eroded market discipline in the

[8] See IMF (2009), "Initial Lessons of the Crisis," http://www.imf.org/external/np/pp/eng/2009/020609.pdf for a discussion.

[9] See GFSR (April 2008 and 2009; October 2008 and 2009) for detailed discussions, including faulty credit ratings; the rise and fall of securitization and (continued) incentive problems with the "originate to distribute" lending model; the role of mark-to-market accounting and pro-cyclicality in credit; problems with liquidity management; and the role of off-balance sheet entities and regulatory arbitrage heading into the crisis.

[10] See, for example, Greenspan (2010), "The Crisis," *Brookings Papers on Economic Activity*.

[11] See T. Adrian and H.S. Shin (2010), "Liquidity and Leverage," *Journal of Financial Intermediation*, 19 (3). The role of U.S. monetary policy in the crisis remains controversial. Some have argued that policy rates were too low for too long (e.g., compared to a Taylor rule) contributing to subsequent financial excesses and the housing boom; see J. Taylor (2009), *Getting off Track: How Government Action and Intervention Caused, Prolonged, and Worsened the Financial Crisis* (Stanford, California: Hoover Press). Greenspan (2010), however, argues that the main factor was low long-term interest rates given the global saving glut. From a macroeconomic standpoint, the stance of monetary policy was broadly appropriate given lower equilibrium (or neutral) rates of interest, with output near potential and inflation near target. However, low interest rates encouraged greater financial leverage and risk-taking in the absence of established macro-prudential policy instruments.

case of large, systemically important institutions that were too big to fail; agency and incentive problems surrounding innovative but complex securitization instruments and the "originate to distribute" lending model; and insufficient risk and liquidity management by financial institutions that were increasingly reliant on wholesale funding markets that became disrupted when the crisis began.[12]

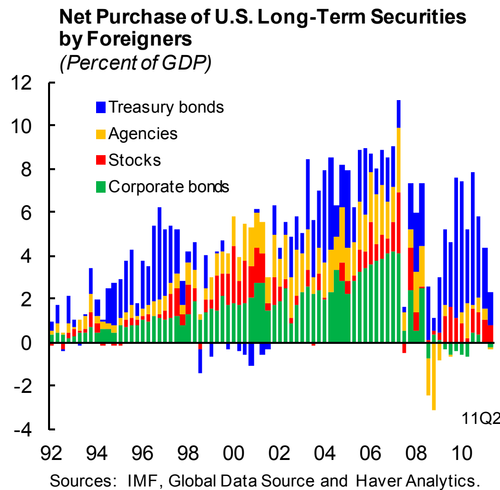
- *Public oversight was insufficient to correct market failures*. A fragmented regulatory system and its frameworks were unable to keep pace with a fast-changing financial landscape. Risky financial activities and credit creation increasingly migrated beyond the traditional banking system—outside a narrow regulatory perimeter that failed to recognize and allowed a build-up of systemic risk in the "shadow banking system." Even with regulated banks, off-balance sheet vehicles were used to circumvent existing regulations (e.g., capital standards). An overreliance by investors on credit rating agencies with conflicts of interest proved costly in case of structured instruments (e.g., CDOs). Rapid financial innovation encouraged the proliferation of these complex and poorly understood instruments that escaped greater financial oversight. Finally, thinly-capitalized government sponsored entities or GSEs (enjoying an implicit public guarantee) dominated mortgage securitization and created a massive contingent liability for the government that was eventually called upon when the housing bubble burst.

[12] See G. Gorton and A. Metrick (2011), "Securitized Banking and the Run on Repo," Yale ICF Working Paper No. 09-14.

7. **Key EXTERNAL factors involved high foreign demand for U.S. financial assets—including reserve holdings; dollar pegs in major surplus emerging economies; and high oil prices.** Burgeoning external deficits were financed at low interest rates by growing purchases of U.S. assets by surplus countries with high saving which slowed dollar depreciation, further encouraging U.S. consumption and imports and affecting export competitiveness through a more appreciated currency than otherwise. Dollar depreciation started in 2002 and continued through 2008 in real effective terms. This did have a delayed effect in narrowing the current account imbalance by the mid-2000s, but its impact on the external position was muted by a run-up in commodity prices.

- *The depth, breadth and innovativeness of U.S. financial markets made them an attractive destination for various classes of investors.* The safety and liquidity of the Treasury bond market reinforced the dollar's role as the leading reserve currency. Agency bonds and mortgage-backed securities provided slightly higher returns with low perceived risk and became popular with both official and private foreign investors. At the same time, the United States was generating an ever-expanding array of innovative and complex securities,

which met steady foreign demand. Surprisingly, perhaps, demand for U.S. Treasuries spiked at the height of the crisis (driven by a "flight to safety") despite the fact that U.S. assets associated with subprime mortgages were considered to be its epicenter.



- *Dollar pegs in several major emerging economies limited effective dollar depreciation.* Currency intervention—most notably by China—helped maintain competitive exchange rates in those economies and created a major source of demand for U.S. securities[13] and led to rapid accumulation of reserves.[14] Consequently, demand for dollar-denominated assets remained broadly stable and strong—accounting for about two-thirds of rapidly increasing global reserves since 2000—despite large U.S. external deficits that made dollars more available abroad.[15]

- *High oil prices have impeded a greater narrowing of U.S. current account imbalances.* The United States is the world's largest consumer of petroleum products, and it relies on oil imports to satisfy more than half of its needs. Petroleum trade deficits account for about half of the U.S. merchandise trade deficit since late 2007. While the non-oil trade balance has improved substantially starting in 2006, the oil trade balance has generally deteriorated. U.S. terms of trade deteriorated sharply in 2007–08, primarily due to rising oil prices, offsetting partially the impact of a turnaround in net exports before the crisis. Relatively low energy taxes encourage domestic consumption.

[13] Demand was primarily for Treasury and agency bonds, but in later years holdings were diversified into riskier investments, particularly via sovereign wealth funds.

[14] Moreover, the growing share of low-cost producers in U.S. imports partially offset dollar appreciation against individual currencies. See C. Thomas et al, "Measuring U.S. International Relative Prices: A WARP View of the World," Federal Reserve Board International Finance Discussion Papers, No. 917.

[15] See I. Mateos y Lago et al, "Debate on the International Monetary System," IMF SPN/09/26.

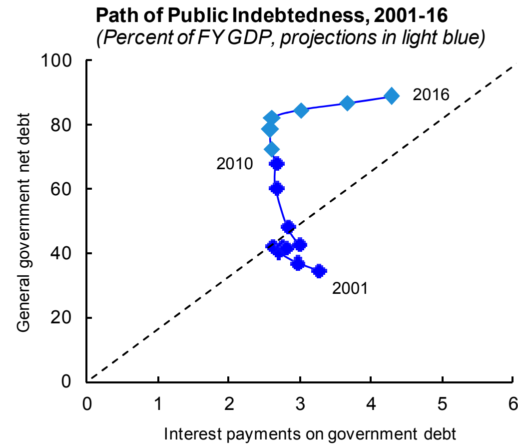
III. ARE U.S. IMBALANCES A PROBLEM?

A. National Perspective

8. **The recent agreement on fiscal consolidation in the context of raising the public debt ceiling has not assuaged concerns pertaining to the sustainability of U.S. public debt.** The recent downgrade of U.S. debt by S&P is a clear sign of market concerns pertaining to its sustainability and the political polarization that has cast doubts on the likelihood of a future comprehensive agreement on the fiscal. While interest rates on U.S. Treasuries remain at historical lows, they are likely to rise over time as debt accumulates, crowding out private investment, and worsening the debt dynamics. From a crowding out perspective, each percentage point increase in the debt-to-GDP ratio is estimated to raise long-term interest rates by 3–4 basis points.[16] High public indebtedness also creates vulnerability to future shocks by reducing available *fiscal space*. It will also eventually require higher primary balances—and higher (distortionary) taxes—to service the debt. This underscores the urgent need for clear, credible and realistic medium-term consolidation plans.

9. **Increasing external indebtedness may carry attendant vulnerabilities, with possible confidence effects for the dollar.** The stock of U.S. net external liabilities is relatively modest at 17 percent of GDP and has not increased in line with large net external borrowing given valuation effects and other factors (e.g., some overstatement of U.S. net capital inflows). Moreover, return differentials on foreign assets versus liabilities remain favorable from a U.S. perspective. However, there are risks that such favorable return differentials may not continue indefinitely (particularly in light of unfavorable public debt dynamics). Moreover, the willingness of foreign investors to continue financing current account deficits (at prevailing terms) becomes increasingly critical as the stock of external indebtedness increases. Even absent an abrupt adjustment, a continuous deterioration in the U.S. net external position that would result from projected current account deficits would imply growing payments overseas and hence the need for a substantial turnaround in the trade balance down the road to stabilize net external debt.

Path of Public Indebtedness, 2001-16
(Percent of FY GDP, projections in light blue)



Source: IMF, *World Economic Outlook*.

[16] See E. Baldacci and M.S. Kumar (2010), "Fiscal Deficits, Public Debt, and Sovereign Bond Yields", IMF Working Paper 10/184; and T. Laubach (2009), "New Evidence on the Interest Rate Effects of Budget Deficits and Debt," *Journal of the European Economic Association*, 7(4).

10. **A return to low household saving, re-leveraging (particularly, in the financial sector), and a precarious fiscal situation may give rise to new financial stability risks.** To the extent that U.S. imbalances partly reflected low saving and high credit, as well as high leverage before the crisis, reducing fiscal, financial, and external imbalances and their associated vulnerabilities going forward will go hand in hand. If left unchecked, key financial risks, if they were to materialize again, would severely disrupt growth.

B. Global Perspective

11. **Given its central role in global trade and finance, all U.S. concerns echo in the international arena.**

12. **An unsustainable fiscal situation creates multiple problems.** As the economy continues to recover, high and increasing public debt would imply not only higher U.S. interest rates but also higher global interest rates, affecting investment and growth.[17] In addition, a downgrade or credit event in U.S. sovereign debt markets or loss of investor confidence could have global repercussions for other sovereign and corporate rates.

13. **Fiscal and external risks are interrelated.** Concerns about sustainability of U.S. public finances could undermine confidence in the dollar. Moreover, U.S. net external liabilities and current account deficits are large as a proportion of world GDP and must rely on significant foreign demand for U.S. assets to be financed. Should demand dwindle in anticipation of subpar returns (e.g., because of dollar depreciation), a mutually reinforcing spiral of capital outflows and asset price declines may ensue. Given the substantial role of the United States in global trade and finance, this possible upheaval would have severe reverberations worldwide.

14. **Financial stability in the United States is vital for the world economy.** In the crisis, major risks associated with U.S. imbalances came through financial markets (rather than exchange rates). U.S. external deficits signaled low domestic saving, high leverage, a build-up of underlying financial vulnerabilities, and systemic risk that materialized with the crisis. As seen, U.S. financial instability can have large adverse cross-border spillovers.[18]

15. **Rebalancing necessarily has a multilateral dimension.** Given the need for U.S. fiscal consolidation, a prospective contraction in domestic demand would need to be offset both at home and abroad to maintain solid growth and to avoid a global "demand deficit." In other words, the United States would need to rely more on external demand (given fiscal consolidation), while G-20 partners—particularly, surplus economies—would need to rely more on internal demand (given weaker demand in the U.S.) to help achieve strong, sustainable and balanced growth over the medium term.

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[17] See IMF (2011) U.S. Spillover Report SM/11/165, which also discusses the potential global impact of higher U.S rates in a pre-crisis versus post-crisis context.

[18] See IMF (2011) U.S. Spillover Report SM/11/165.

IV. How to Address Imbalances

16. **The importance of credible fiscal adjustment is universally recognized; but the menu of policy options is wide.** A credible U.S. adjustment plan that combines spending cuts and revenue increases and is supported by fiscal rules to return public finances onto a sustainable trajectory is required. Broad elements of needed U.S. policy actions include the following.

A. Policy Priorities

- *An agreement on a comprehensive and credible medium-term consolidation road map is required soon.* It is essential to initiate the process very soon and make steady progress to maintain credibility, spread the burden of adjustment more evenly, and avoid downside risks. Building on the recent agreement on the debt ceiling, bi-partisan progress on concrete medium-term deficit reduction plans would also critically provide additional policy flexibility in the short run. With the economy still in a weak cyclical condition and risks to growth tilted to the downside, the pace of adjustment should be measured at the outset, but steady and well-specified over time and underpinned by a coherent medium-term fiscal strategy.

- *Placing entitlements on a sustainable footing is central to containing fiscal deficits.* Parametric changes to Social Security (e.g., gradually increasing the retirement age in line with longevity gains and reducing future benefits for the well-off) would lead to well-identified savings over time with minor impact on current demand. Savings that go beyond those advanced by last year's reform are needed in the health care system, including through greater cost sharing with Medicare beneficiaries and other targeted savings.

- *Revenue raising measures must be part of the consolidation package.* The room for additional revenues exists, given their low level presently relative to most advanced economies and U.S. history. In particular, with discretionary non-security spending already compressed and only gradual entitlement reform possible, raising tax revenue (including through base broadening and tax code simplification) is needed. This could begin, for instance, by allowing the Bush tax cuts for families earning more than $250K to expire. In addition, "growth-friendly" revenue measures could include tax reform that shifts the burden of taxation towards consumption (VAT) from earned income; further gradual cuts in exemptions and deductions, including for mortgage interest; and higher energy taxes. Tax measures that encourage private saving could further help reduce external imbalances.

- *Stronger budgetary rules would be useful to anchor the process and instill discipline.* The fiscal framework should include an explicit Congressional

endorsement of the main medium-term fiscal objectives. Multi-year expenditure caps on non-security discretionary spending would help keep the consolidation on track across annual budget cycles, while a "failsafe" mechanism for the debt ratio along the lines suggested by the President could, if robustly formulated, protect against deficit overruns and other contingencies. It would also be helpful to prepare the administration's budgets using more realistic economic assumptions.

- *Policies that lead to stronger growth would help improve the fiscal situation as well.* These actions include financial sector balance sheet repair; progress in resolving the foreclosure problem, which hangs over the banking system and also gets in the way of labor market adjustment; and active labor market policies, including re-training to facilitate sectoral and geographic reallocation of displaced workers.

17. **Improvement in the current account should rest on several pillars.** The currently depressed levels of investment are expected to rebound with the recovery, boosting growth and potential output. Thus, national saving will need to rise to avoid a reemergence of wider external deficits. Fiscal consolidation will be a major contributor to smaller current account deficits going forward. But maintaining private saving broadly at current levels would help ensure that the effect of lower fiscal deficits on the current account is not offset by deterioration in the private saving-investment balance. To the extent that the increase reflects a decline in net wealth aligned with underlying fundamentals and more realistic income prospects, the rebound in household saving from its pre-crisis levels is likely to persist, and the recent range of 5–6 percent (of disposable income) seems broadly in line with fundamentals, though time will tell. Further adjustment in the dollar, along past depreciation trends, would facilitate external adjustment. The effect of dollar depreciation on import demand should also support higher personal saving.

18. **Financial sector policies will need to better safeguard financial stability while remaining supportive of economic growth.** Future actions will partly depend on the effectiveness going forward of recent reforms.[19] Financial regulation and supervision should be adequately funded and sufficiently strong to prevent another run-up in credit (although not so tight as to stifle lending and growth).[20] Regulatory perimeters need to be sufficiently broad to avoid key "gaps," possible migration of systemic risk,

[19] In July 2010, U.S. authorities introduced the *Wall Street Reform and Consumer Protection Act* (i.e., "Dodd-Frank" Act). The objective of this legislation was to restructure the financial regulatory system to address key fault lines in order to create a sounder and more resilient financial system. While strong implementation of the "Dodd-Frank" Act is needed, its effectiveness will only be learned over time.

[20] For example, rules on loan to value and debt service to income ratios to qualify for lowest-rate mortgages should be sufficiently stringent.

and to keep pace with a changing financial landscape. Actions to improve the resiliency of term funding markets which were severely disrupted may also require greater attention. Coordinated global changes in financial market regulation would make it easier to establish comprehensive global safety nets and appropriately tight and consistent credit standards. The Fed should also be vigilant and maintain appropriate interest rates and liquidity conditions. Developing the macro-prudential toolkit would help monetary policy in meeting the distinct objectives of price stability and financial stability.

19. **Coordinated action by the G-20 would facilitate U.S. consolidation and global rebalancing.** Fiscal adjustment will dampen U.S domestic demand, perhaps while the economy is still in considerable excess capacity and the policy interest rate is at the zero bound. Hence, the pace of adjustment (e.g., path of primary balances) would need to be calibrated with this tradeoff in mind. A large increase in private consumption (return to low saving) to compensate for withdrawal of fiscal stimulus is not desirable. Given the need to maintain the rebound in private saving, fiscal tightening accompanied by stronger external demand would help support recovery and growth. Alternatively, deficiency of external demand may induce delayed fiscal consolidation, risking negative financial market reaction. The tradeoff between growth and consolidation would be more palatable if foreign demand were stimulated by higher domestic demand in surplus economies, accompanied by exchange rate appreciation where appropriate. From the perspective of other G-20 members, prospects of weaker demand from advanced economy partners undergoing consolidation suggests the need to rebalance toward internal demand to support stronger growth. This suggests scope for international coordination.

B. Toward an Upside Scenario

20. **Fiscal consolidation—to restore the sustainability of public finances, while mitigating the short-term impact on growth.** A sufficient scale of U.S. fiscal adjustment with "growth-friendly" composition (to the extent possible) would require 3 essential pillars:

- *Tax reform and higher tax revenues.* To minimize tax distortions and bolster growth, measures could include reducing payroll and capital taxes in favor of higher consumption taxes/VAT; increasing energy taxes; and base broadening to enhance revenue collection (through reducing loopholes and tax expenditures, including mortgage interest deductibility);

- *Spending cuts in key areas.* To meet budget priorities, fiscal measures would also include cuts in entitlement spending through increasing age of retirement and reducing benefits to restore long-term viability of these programs; restraining growth in health care expenditures; some cuts in

discretionary spending (including defense) while preserving or enhancing public investment in critical areas; and

- *Credibility*—clear and effective public communication by the Administration and Congress on concrete fiscal plans that realistically tackle unsustainable items in the budget and establish clear fiscal targets would help align market expectations with the authorities' medium-term fiscal consolidation strategy.

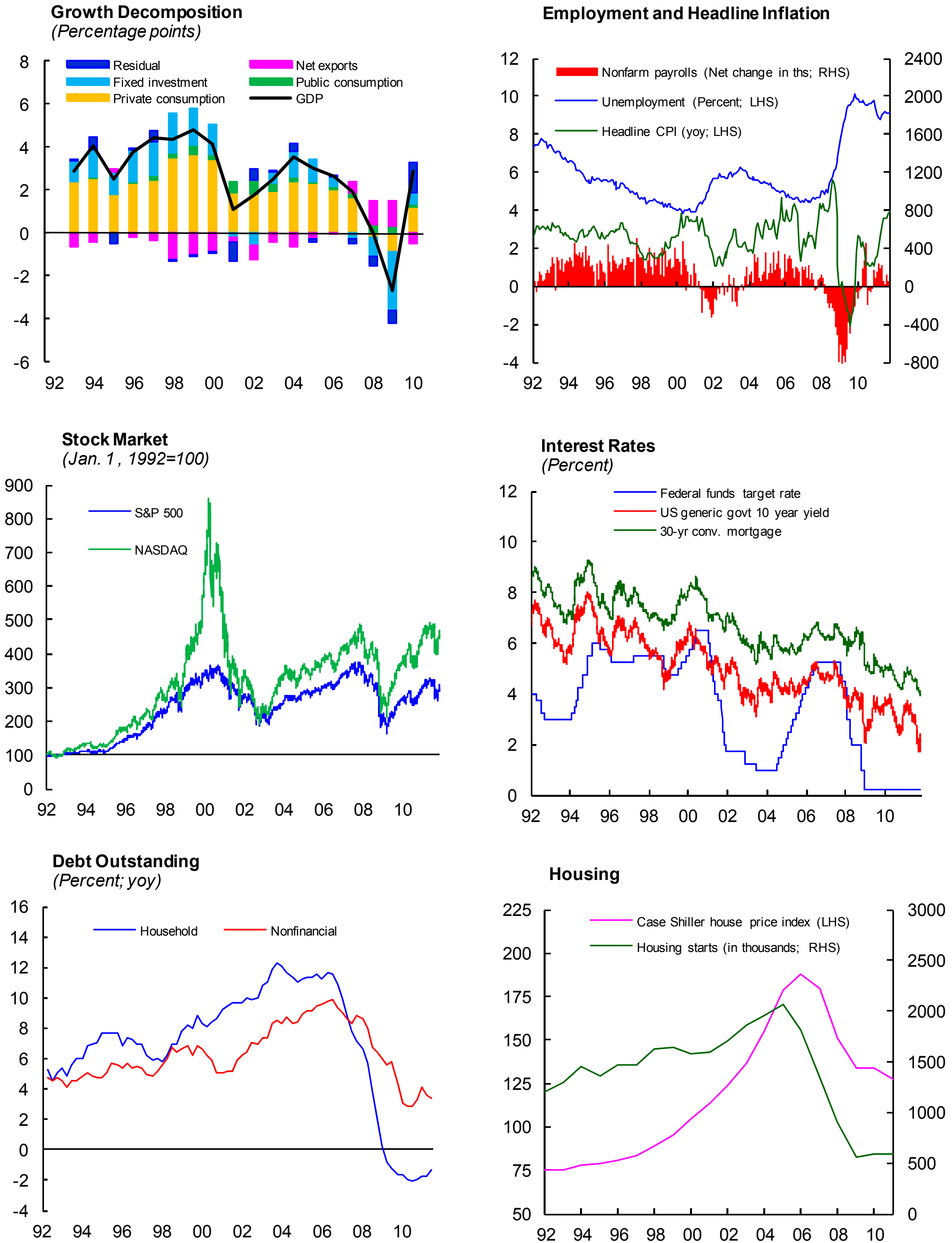
21. **Active Labor Market Policies—to reduce high unemployment**. Some targeted ALMPs (mindful of their budget costs) would help labor activation in problem areas—e.g., to facilitate reattachment of long-term unemployed (given their very high share in total unemployment) and help reduce youth unemployment (given underlying problems with job prospects facing this group).

22. **Financial sector repair and reform—to rebuild a more resilient financial system that can support strong economic growth**.[21] Reducing the build-up of excess leverage smoothly, fostering an adequate flow of bank credit to support activity but preventing a return to low saving rates, while lowering systemic risk will require measures that strengthen balance sheets of viable financial institutions (e.g., recapitalization, including in light of Basel III, and sound dividend policies); better aligning private market incentives (e.g., tackling "too big to fail" and agency problems with securitization); ensuring prudent credit provision (e.g., appropriately tight lending standards and capital adequacy); and, finally, more careful monitoring of the financial system (e.g., avoiding key "gaps" in regulation; including enhanced supervision of systemically important financial institutions).[22]

[21] See IMF (2011) U.S. Financial Sector Assessment Program.

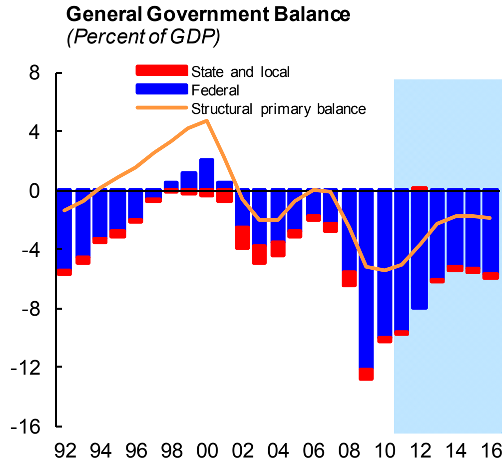
[22] In the IMF's (GIMF) model, only limited and stylized simulations of financial sector reform are feasible, based on implications for the supply and price of credit.

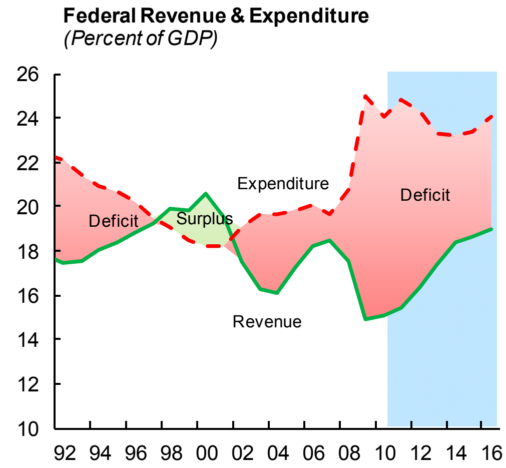
Figure 1: Real and Financial Sector Developments

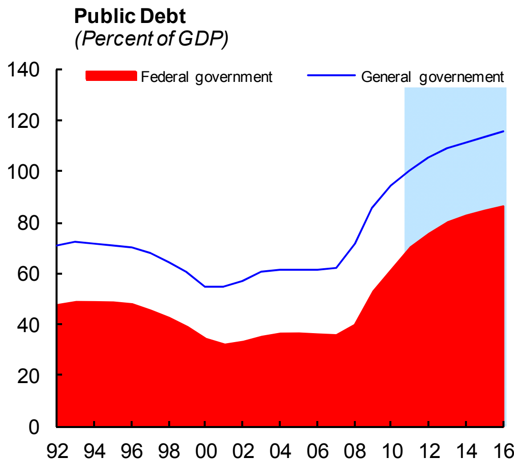


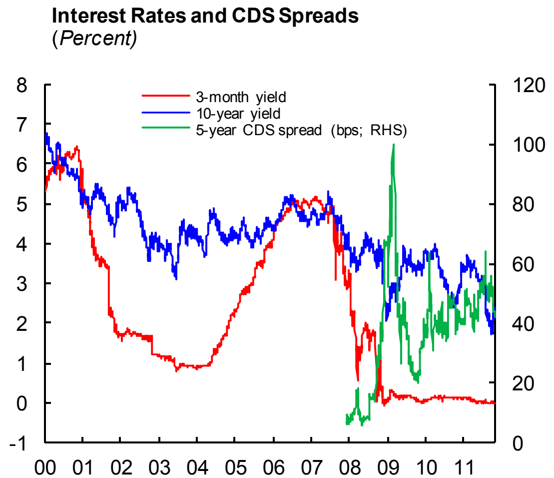
Sources: IMF, *World Economic Outlook;* Haver Analytics; Bloomberg L.P.; and IMF staff calculations.

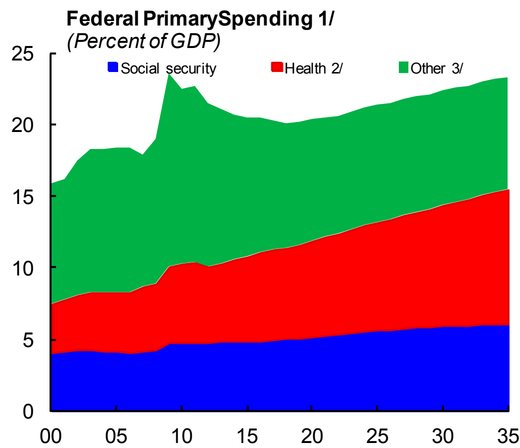
Figure 2: Fiscal Developments

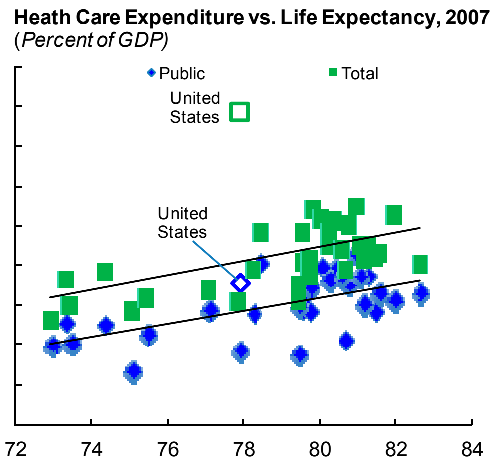












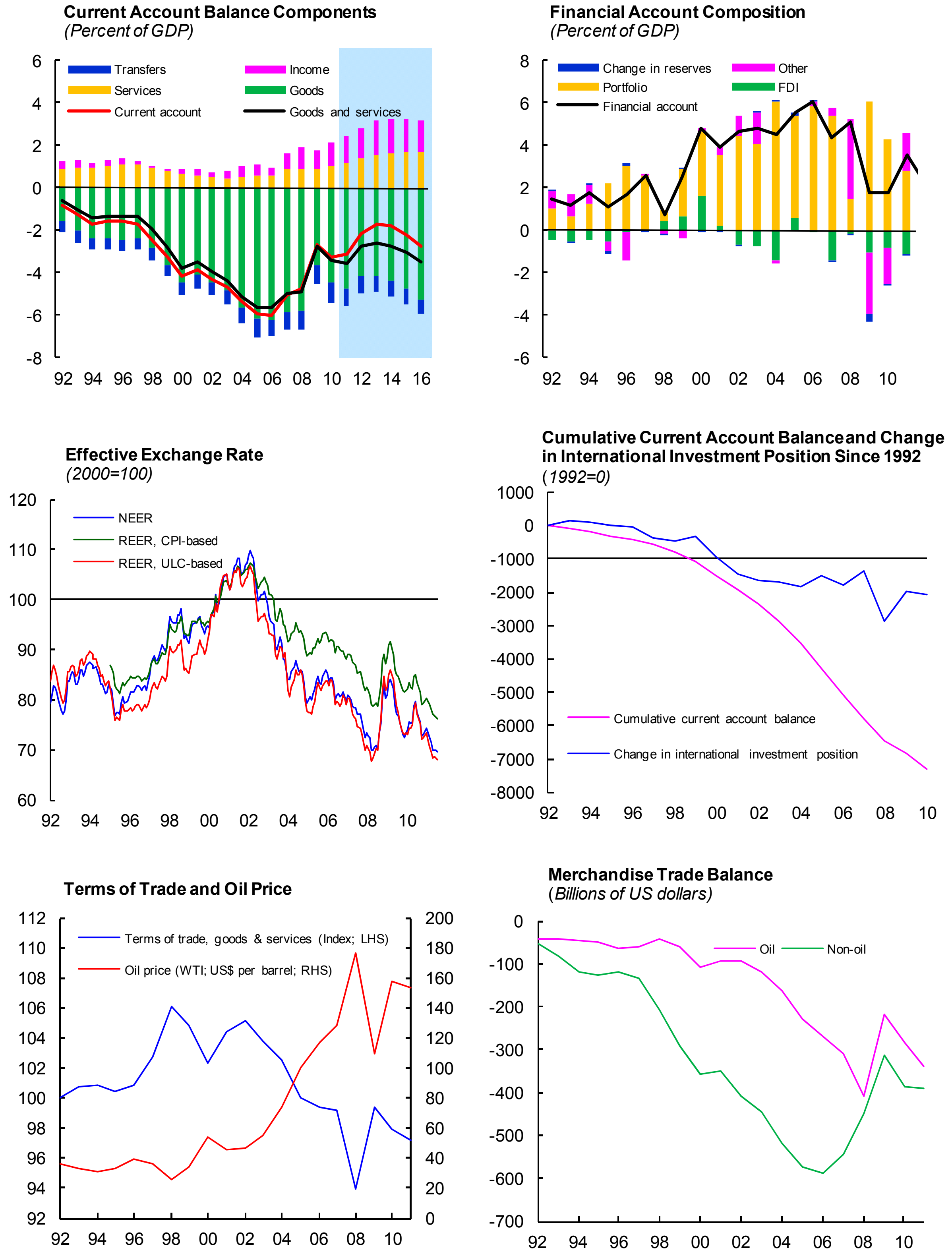
Sources: IMF, *World Economic Outlook;* Haver Analytics; Bloomberg L.P.; OECD; Congressional Budget Office; and IMF, staff projections.

1/ Based on CBO's extended-baseline scenario.

2/ Medicare, Medicaid, CHIP, and exchange subsidies.

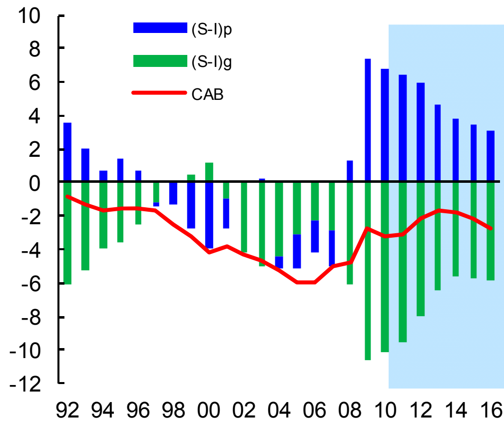
3/ Other noninterest spending.

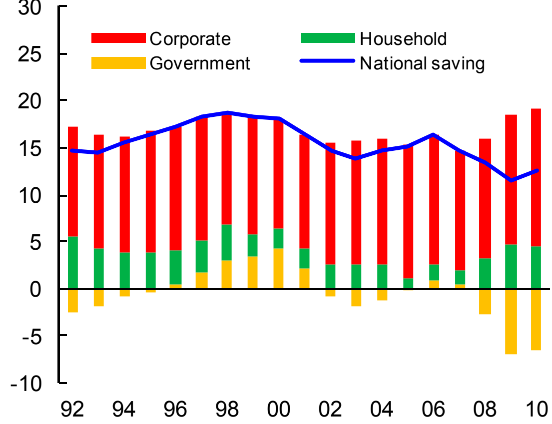
Figure 3: External Developments

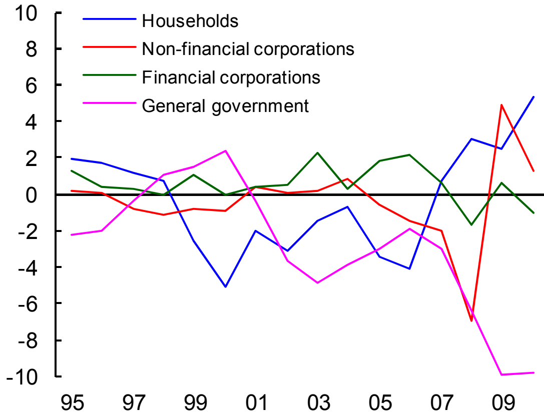


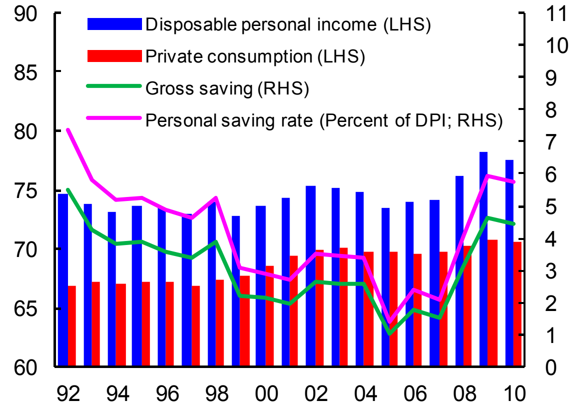
Sources: IMF, *World Economic Outlook;* Haver Analytics; Bloomberg L.P.: and IMF staff calculations.

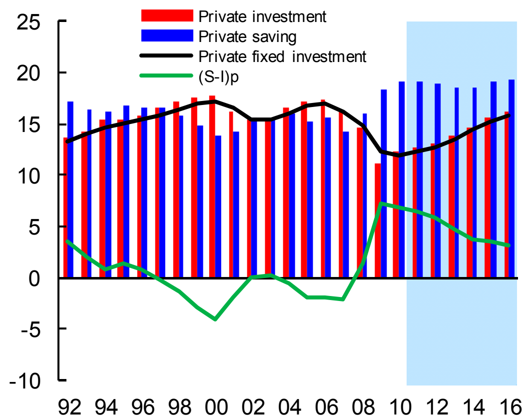
Figure 4: Saving and Investment

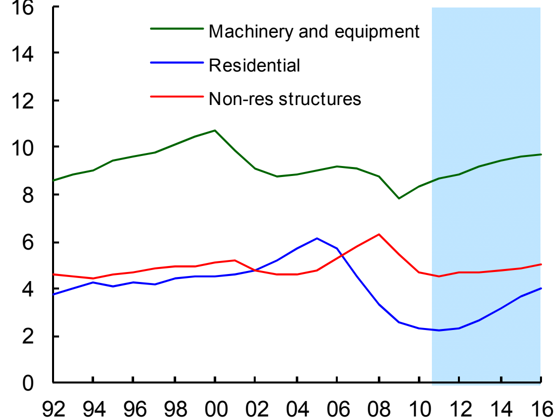












Sources: IMF, *World Economic Outlook;* Haver Analytics; and IMF staff calculations.