INTERNATIONAL MONETARY FUND

IMF Country Report No. 14/221

UNITED STATES

2014 ARTICLE IV CONSULTATION—STAFF REPORT; PRESS RELEASE

July 2014

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 2014 Article IV consultation with United States, the following documents have been released and are included in this package:

- **Staff Report** prepared by a staff team of the IMF, following discussions that ended on June 12, 2014, with the officials of United States on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on July 7, 2014.
- **Informational Annex** of July 7, 2014 prepared by the IMF.
- **Staff Statement** of July 22, 2014.
- **Press Release** summarizing the views of the Executive Board as expressed during its July 22, 2014 discussion of the staff report that concluded the Article IV consultation.

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

Selected Issues Paper

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

Copies of this report are available to the public from

International Monetary Fund • Publication Services
PO Box 92780 • Washington, D.C. 20090
Telephone: (202) 623-7430 • Fax: (202) 623-7201
E-mail: publications@imf.org Web: http://www.imf.org
Price: $18.00 per printed copy

International Monetary Fund
Washington, D.C.

©2014 International Monetary Fund

INTERNATIONAL MONETARY FUND

UNITED STATES

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION

July 7, 2014

Focus. The 2014 Article IV Consultation focused on five broad themes to strengthen the recovery and improve the long-term outlook: raising productivity growth and labor force participation, confronting poverty, keeping public debt on a sustained downward path, smoothly managing the exit from zero policy rates, and securing a safer financial system.

Main policy issues.

- Policies are needed to boost longer-term potential output through investments in infrastructure, raising educational outcomes, improving the tax structure, and developing and expanding a skilled labor force (including through immigration reform, job training, and providing childcare assistance for working families).
- Forging agreement on a credible, medium-term consolidation plan should be a high priority and include steps to lower the growth of health care costs, reform social security, and increase revenues. In the absence of such a comprehensive agreement, efforts should still focus on identifying more modest opportunities to relax the near-term budget envelope, paid for with future fiscal savings.
- An enduring consequence of the past recession has been a jump in the number of families living in poverty. Improved employment prospects and economic growth will be essential to reverse this upward movement. An expansion of the Earned Income Tax Credit and an increase in the minimum wage should also be part of the solution.
- The goal for monetary policy is to manage the exit from zero interest rates in a manner that allows the economy to converge to full employment with stable prices while avoiding financial instability and negative spillovers to the global economy. This is a complex undertaking. To facilitate it, steps could be taken to expand the Fed's communications toolkit so as to provide greater clarity on how the Federal Open Market Committee assesses progress toward its longer-run goals.
- Continued regulatory oversight is needed to counter the emergence of financial imbalances, particularly those that may be growing outside of the banking system. Policies should also be deployed to keep mortgage credit accessible and attract more private capital into housing finance while minimizing risks to taxpayers.
- The U.S. external position is assessed to be broadly consistent with medium-term fundamentals and desirable policies.

Approved By
Alejandro Werner and Tamim Bayoumi

Discussions took place in New York (April 30–May 2) and Washington, D.C. (May 5–23). Concluding meetings with Chair Yellen and Secretary Lew took place on June 12, 2014. The team comprised N. Chalk (head), R. Cardarelli, R. Balakrishnan, F. Columba, D. Igan, L. Lusinyan, J. Solé, J. Turunen (all WHD), D. Jones (MCM), and N. Westelius (SPR). S. Gray, J. Kiff, D. King (all MCM), S. Dawe, E. Mathias (all LEG), and M. Ruta (SPR) participated in some of the meetings.

AN INTERMISSION IN THE RECOVERY 4

BETTER TIMES AHEAD 5

CONFRONTING POVERTY 13

COUNTERING THE DECLINE IN POTENTIAL GROWTH 14

PUTTING PUBLIC DEBT ON A DOWNWARD PATH 21

THE PATH TO LIFT-OFF 24

SECURING A SAFER FINANCIAL SYSTEM 28

STAFF APPRAISAL 36

BOXES

1. How Reversible is the Decline in U.S. Labor Force Participation? 7
2. External Sector Assessment 11
3. The Earned Income Tax Credit and the Minimum Wage—A Package 15
4. Productivity Growth and Its Determinants: Evidence from the U.S. States 19
5. The Impact of Fed's Forward Guidance 27
6. The Foreign Bank Organizations (FBO) Rule 34

FIGURES

1. Recent Indicators Suggest a Pick-up in Growth 6
2. Policy Priorities for Boosting Potential Growth 17
3. Credit Market Risks 31

TABLES

1. Selected Economic Indicators 39
2. Balance of Payments 40

3. Federal and General Government Finances 41
4a. General Government Statement of Operations 42
4b. General Government Financial Assets and Liabilities 43

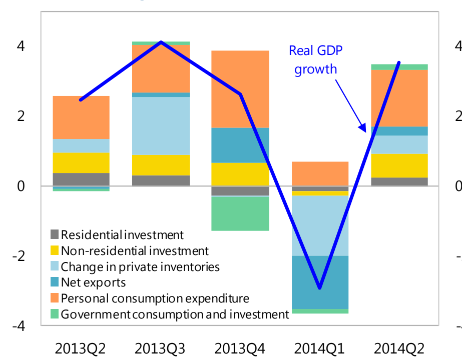
ANNEXES

I. Risk Assessment Matrix: Potential Deviations from Baseline 44
II. Public Debt Sustainability Analysis (DSA) 46
III. U.S. Responses to Past Policy Advice 53
IV. External Stability Assessment 54

AN INTERMISSION IN THE RECOVERY

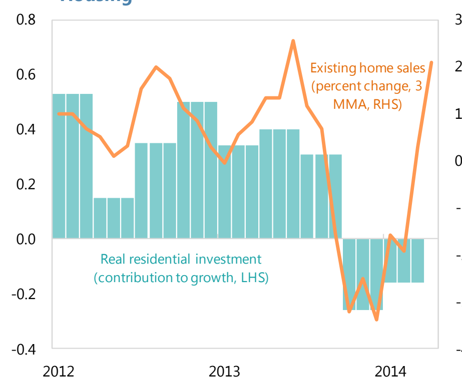
1. ***Overview***. Economic activity in the U.S. accelerated in the second half of 2013, but an unusually harsh winter conspired with other factors—including a still-struggling housing market, an inventory correction, and slower external demand—causing momentum to fade. This led to the first quarterly contraction since early 2011.

Contribution to GDP Growth
(percent change from previous quarter)



2. ***Housing***. After a promising recovery in housing activity for most of 2013, the past several months have seen a retreat characterized by weaker housing starts, declining residential investment, and subdued home sales. New mortgage origination has been particularly sluggish as credit availability remains constrained for lower-rated borrowers and mortgage rates have moved up by around 70 basis points from a year ago.

Housing

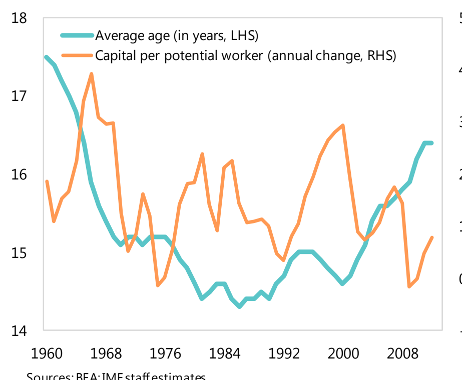


Sources: BEA;, Haver Analytics; IMF staff estimates.

3. ***Corporate investment***. Business investment growth has weakened over the last two years, held back by uncertainty about the strength of future demand. Even after adjusting for the lower growth rate of the labor force, capital accumulation per worker has been disappointing throughout the recovery, and the average age of the non-residential capital stock is at a 40-year high.

4. ***Inventories***. The second half of 2013 saw a significant build-up in inventories that was broad-based across various industries. This over-accumulation was corrected in the first quarter of 2014 causing the drag to growth from inventories alone to amount to 1.7 percentage points on an annualized basis.

Private Fixed Non-Residential Assets



Sources: BEA; IMF staff estimates.

5. ***Net exports*** also weighed heavily on activity in the first quarter of the year, detracting 1.5 percentage points of growth (annualized). This negative contribution followed a surge in exports in the last quarter of 2013.

BETTER TIMES AHEAD

6. ***The growth outlook***. Activity is projected to accelerate in the remainder of this year to above potential (in the 3–3½ percent range). Still, the drag on growth from the first quarter contraction will not be offset. This means growth for the year as a whole will be a disappointing 1.7 percent. Nevertheless, barring unforeseen shocks, growth should accelerate in 2015 to the fastest annual pace since 2005.

Summary of Macroeconomic Forecast

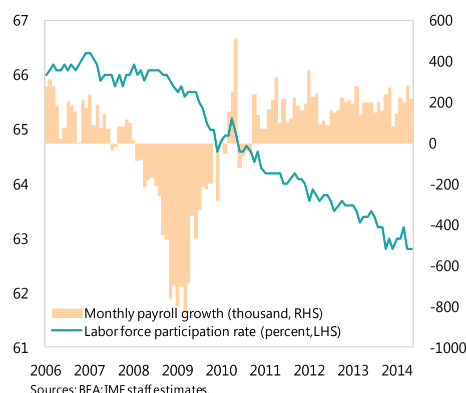
(percent)	2013 Actual	2014 Proj.	2015 Proj.
GDP growth	1.9	1.7	3.0
o/w:			
Personal consumption[1]	1.4	1.5	2.0
Residential investment[1]	0.3	0.1	0.4
Equipment investment[1]	0.2	0.2	0.4
Government spending[1]	-0.4	-0.2	0.1
Net exports[1]	0.1	-0.2	-0.2
Output gap[2]	-3.8	-4.0	-2.9
CPI inflation[3]	1.5	1.9	1.8
PCE inflation[3]	1.2	1.6	1.5
Unemployment rate[3]	6.7	6.2	5.9
10-yr Treasury yield[3]	3.0	2.9	3.6

Source: IMF staff estimates.
[1]Contribution to growth.
[2] Percent of potential GDP.
[3] End of period.

7. ***A number of factors underpin this baseline*** (Figure 1):

- *A steadily improving labor market*. Job growth has been reasonably healthy with over one million jobs created since January 2014. However, the labor force participation rate at June stood at 62.8 percent (its lowest level since 1978). This combination of decent job growth and declining participation has allowed the unemployment rate to fall rapidly (reaching 6.1 percent in June). Going forward, the pace of decline in the unemployment rate is expected to moderate. However, real wages should slowly rise alongside steady employment growth with around one-third of the post-recession decline in the participation rate expected to be reversed (Box 1). This strengthening of the labor market should underpin growth in the coming quarters.

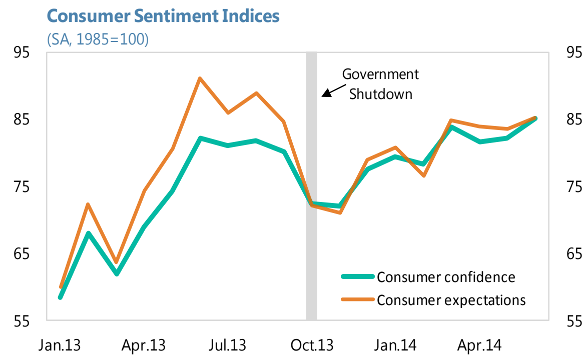
Labor Market



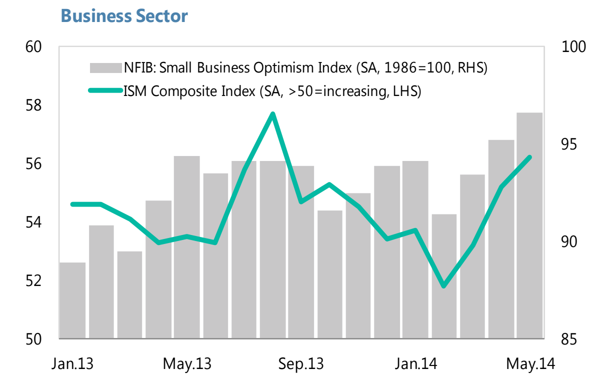
Sources: BEA; IMF staff estimates.

Figure 1. Recent Indicators Suggest a Pick-up in Growth

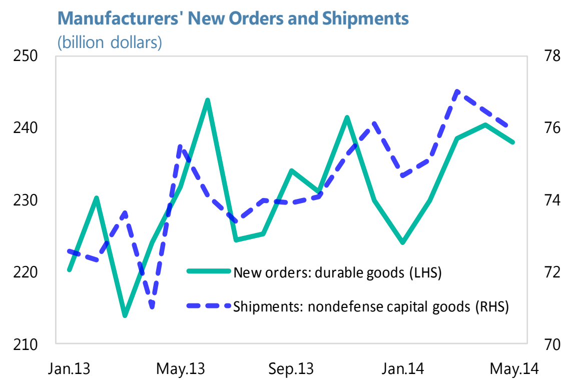
Consumer confidence continues to strengthen.



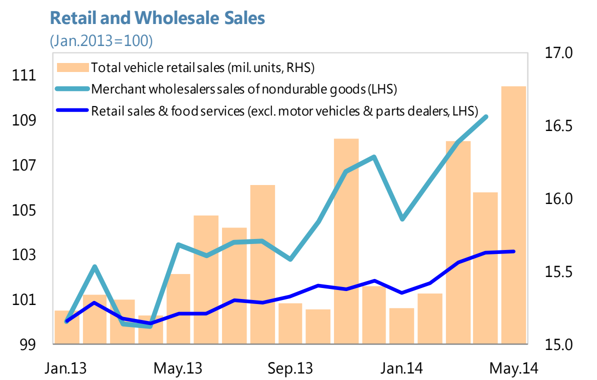
Businesses activity and prospects are also improving.



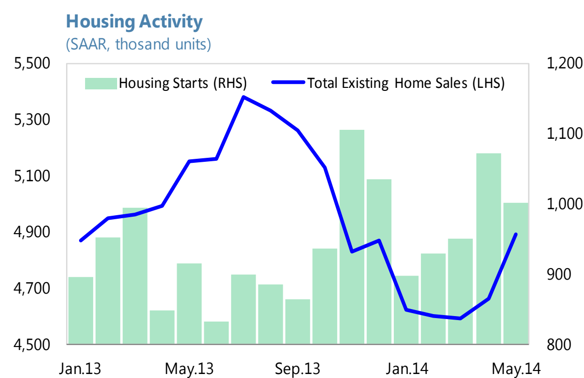
Durable goods and capital expenditures are recovering from the winter pause...



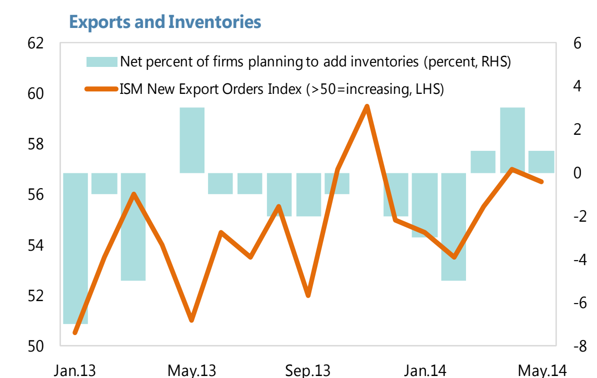
...as are retail and wholesale sales.



Housing activity is regaining momentum.



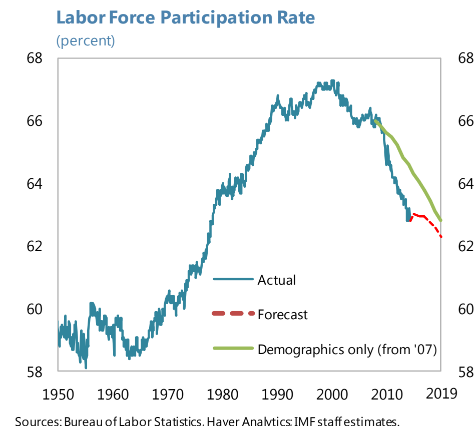
Businesses expect stronger exports and inventory accumulation in the months ahead.



Sources: BEA, Federal Reserve, Haver Analytics; IMF staff estimates.

Box 1. How Reversible is the Decline in U.S. Labor Force Participation? 1/

The U.S. labor force participation rate (LFPR) fell by around 3 percentage points since 2008 and has yet to recover. The falling LFPR is, however, not a recent phenomenon. Labor force participation increased sharply since the early 1960s (as the baby boom generation reached adulthood and women became more represented in the workforce) but then leveled out (reaching an all-time high at 67.3 percent in 2000) and subsequently entered a secular decline (following the 2001 recession). This downward movement accelerated following the global financial crisis.



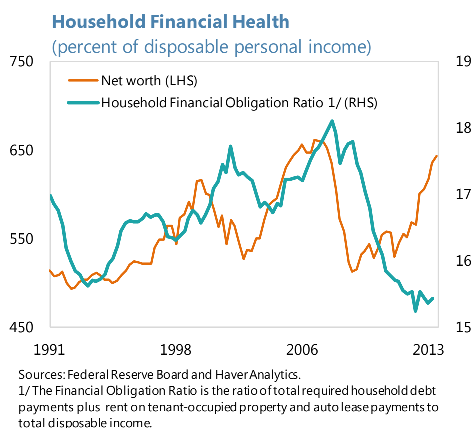
LFPR dynamics are a complex combination of both structural factors (population aging or delayed retirement) and cyclical factors (largely related to the availability of jobs). Staff's demographic models suggest that aging explains around 50 percent of the LFPR decline since 2007. State-level panel regressions suggest that the cyclical effect accounts for a further 30–40 percent of the decline.

The remainder reflects a number of forces at work. For example, the bulk of the decline in youth participation has been driven not by an increase in college enrollment but by a decline (from 43 to 37 percent since 2007) in the number of students that are working. It is unclear how much of this effect will be reversed as the economy improves. Regarding disability insurance, although applications rose following the recession, acceptance rates have fallen. Despite this, disability dynamics are still having an impact on the LFPR: even those denied benefits are likely to exit the labor force while their application is pending and, because of aging, the share of the total population receiving disability insurance has risen.

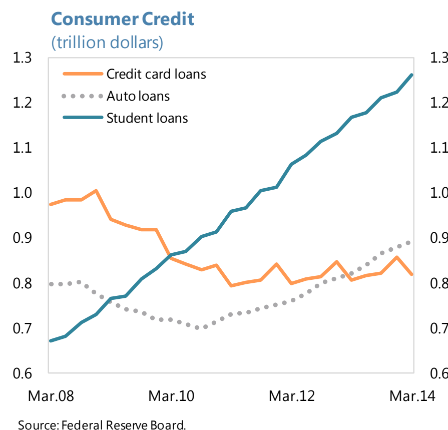
Overall, staff analysis suggests that up to one-third of the post-2007 decline is reversible. This should mean, over the next 2–3 years, there will be a temporary respite in the secular decline of the LFPR. However, after this interim period, participation rates should start declining again as the forces of population aging begin to dominate.

1/ See R. Balakrishnan, M. Dao, J. Solé, and J. Zook, "Recent U.S. Labor Force Participation Dynamics: Reversible or Not?" Selected Issues Paper, 2014.

- *Better household balance sheets*. Since the crisis, total household debt has fallen steadily—albeit with growth in student debt and a surge in auto credit—and wealth gains have been propelled by rising house prices and a booming stock market. As a result, household net worth as a share of disposable income has risen almost back to pre-crisis levels. It is worth noting that the gains in net worth have been unevenly distributed with much of the improvement concentrated in the top two deciles of the income distribution. Despite this, better balance sheets, rising consumer confidence, and the ready availability of consumer credit should support stronger consumption growth in the months ahead.



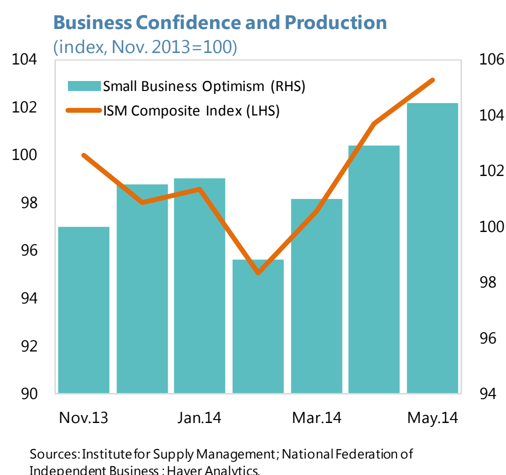
Sources: Federal Reserve Board and Haver Analytics.
1/ The Financial Obligation Ratio is the ratio of total required household debt payments plus rent on tenant-occupied property and auto lease payments to total disposable income.



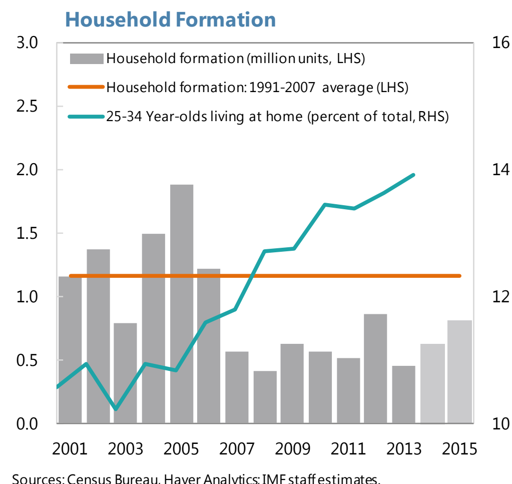
Source: Federal Reserve Board.

- *A healthier housing market*. Household formation is expected to resume a steady path back toward more normal levels as economic growth, more secure job prospects, and a modest improvement in the availability of mortgage credit combine. This, in turn, will create a rising demand for housing (both rental and owner-occupied), supporting a steady pick-up in residential investment.

- *A need to upgrade the capital stock*. With substantial cash holdings, low financing costs, elevated after-tax profit margins, high rates of capacity utilization, and rising business confidence, it is expected that corporations should begin to more assertively upgrade their aging capital stock in the coming quarters, causing an improvement in business investment.



Sources: Institute for Supply Management; National Federation of Independent Business; Haver Analytics.

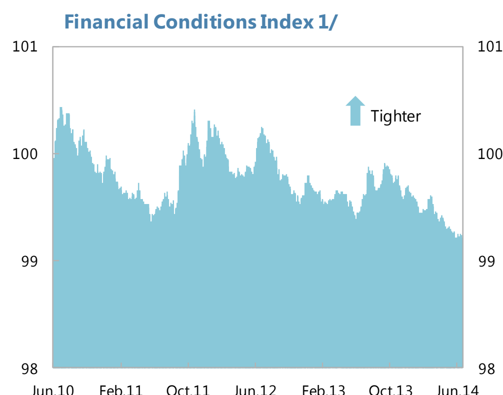


Sources: Census Bureau, Haver Analytics; IMF staff estimates.

- *A dissipating fiscal drag.* After an abrupt fiscal adjustment in FY2013—which indiscriminately cut spending and led to a 1½ percent of GDP improvement in the general government primary structural balance in CY2013—as well as the political gridlock that led to a partial government shutdown at the beginning of FY2014, Congress finally reached a budget agreement in December 2013. This agreement partially replaced the automatic spending cuts in fiscal years 2014 and 2015 with mandatory savings in later years and new revenues from non-tax measures. In addition, in February, the debt limit was suspended until March 15, 2015 which helped reduce near-term fiscal uncertainties. As a result, for this year and next, the cumulative decline in the structural balance is projected to be relatively modest (1¼ percent of GDP). This is estimated to dampen growth by around ¼ percentage point per year. In addition, for 2014, much of this drag has already taken place in the first quarter (when emergency unemployment benefits and bonus depreciation both expired). As a result, government spending is expected to add 0.1 percentage points to growth in the remainder of 2014.

- *Supportive monetary and financial conditions*. Since December 2013, the Fed's Large Scale Asset Purchase Program has been scaled back from net purchases of $85 to $35 billion per month (as of June 2014). At the current pace of withdrawal, asset purchases will finish before the end of this year. The Fed has indicated, though, that it is prepared to maintain the federal funds rate at 0–0.25 percent for a considerable period after asset purchases end. Even after policy rates move away from zero, the subsequent pace of interest rate increase is expected to be relatively slow. The expectation of continued gains in home prices, low term and credit premia, buoyant stock market valuations, and a slow rise in policy rates should mean financial conditions will remain relatively loose for the forseeable future.

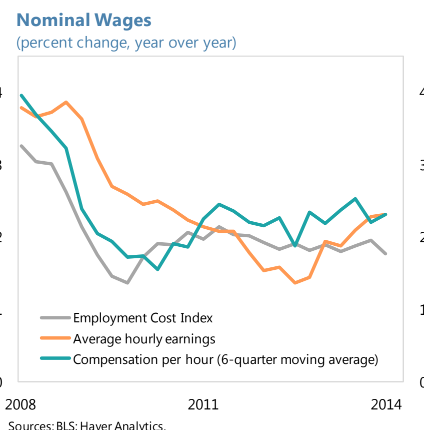
Financial Conditions Index 1/

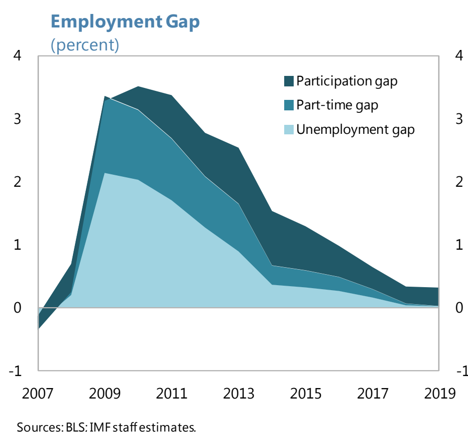


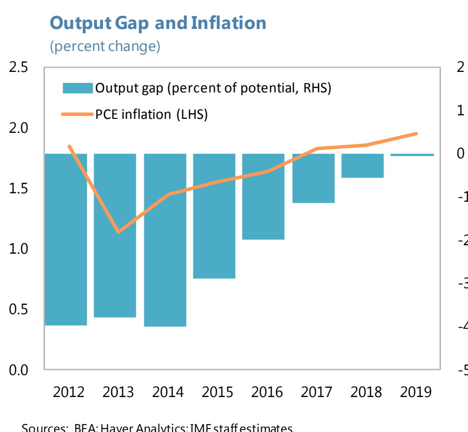
Sources: Goldman Sachs; Bloomberg L.P.
1/ The index is set to 100 for the average since 2000.

8. ***Global spillovers***. The expected acceleration of the U.S. economy in the coming quarters is expected to be a positive force for world growth. Specifically, the projected increase in U.S. growth should add 0.1–0.25 percentage points annually to (non-U.S.) global growth in 2015–16. Spillovers will be largest to those with the strongest trade links (e.g., Canada and Mexico) but other advanced economies and emerging markets should also benefit.

9. ***The output gap and inflation***. Inflation outturns remain well below the Fed's longer-term objective but have steadily risen over the past several months. Core personal consumption expenditure (PCE) inflation at end-May was 1.5 percent (year on year), with headline PCE inflation modestly higher due to rising energy costs. The rise in inflation has been underpinned by increasing shelter costs and the unwinding of the effects that the 2013 sequester had on Medicare costs. There appear to be little sign of labor market tightness or rising wage costs. Around 4½ percent of the workforce are still involuntarily working part-time, and a broad measure of the "employment gap" (i.e., one that combines information on unemployment, underemployment, and the potential unwinding of the fall in the participation rate) suggests that the current level of labor market slack is still significant and will take 3–4 years to be exhausted. As a result, the output gap is estimated at close to 4 percent at end-2013 (and is expected to take until 2018 to close). As a consequence, PCE inflation is forecast to be 1.6 percent at end-2014 and gradually converge (from below) to the Fed's longer-term objective of 2 percent. There is, however, significant uncertainty surrounding these forecasts. If the short-term unemployment rate (which has fallen to 4.1 percent by May 2014, and is close to pre-crisis levels) were to be a more relevant driver of wages—as some researchers have claimed—then inflation could become more evident at an earlier stage.





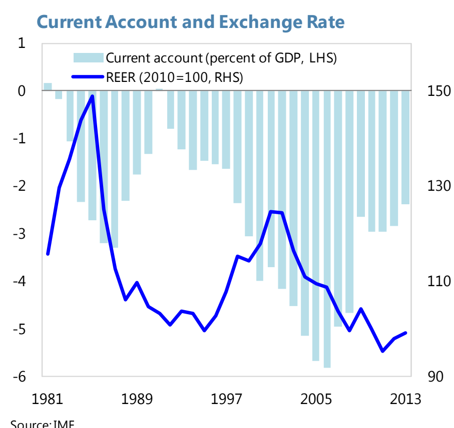


10. The external accounts. The current account deficit is expected to slowly widen as a stronger demand for imports is only partially offset by fiscal consolidation and the improvement in the trade balance that is linked to a rising self-sufficiency in energy. The strong performance of U.S. asset markets and the persistent current account deficit are expected to lead to a continued worsening of the net international investment position (from -27 to -33 percent of GDP over the next five years).

The U.S. external position and the assessed imbalances and fiscal policy gaps have improved considerably in recent years, with positive implications for the global economy. Despite the cyclically-adjusted current account being somewhat on the weaker side, the U.S. external position is assessed to be broadly consistent with medium-term fundamentals and desirable policies (Box 2).

Box 2. External Sector Assessment [1]

The ***current account deficit*** fell to 2.3 percent of GDP in 2013, continuing its descent from the 6 percent of GDP peak reached in 2006. The decline has been due to a falling fiscal deficit, higher private saving, and lower investment in the aftermath of the financial crisis. This shift has been helped by the expansion in unconventional energy production and increased energy independence. The weaker real exchange rate has also supported export growth (in 2013 the REER was around 10 percent below its average value over the past two decades).



The ***net international investment position*** declined from -15 percent of GDP in 2010 to -27 percent of GDP in 2013, reflecting the current account deficit and the stronger performance of the U.S. stock market relative to global markets. Gross assets and liabilities are 131 and 158 percent of GDP, respectively. The U.S. has a positive net equity position vis-à-vis the rest of the world, sizable portfolio equity and direct investment abroad, and a negative debt position owing to sizeable foreign holdings of U.S. Treasuries and corporate bonds.

The ***External Balance Approach*** (EBA) estimates the cyclically adjusted CA deficit to be about 1 percent of GDP weaker than the level implied by medium-term fundamentals and desirable policies. This would suggest some overvaluation of the U.S. dollar (in the 0 to 10 percent range). However, direct analysis of the REER in the EBA would suggest an undervaluation of around 8 percent in 2013.

External Balance Assessment Results

	CA Regression	REER Regression
CA Norm (percent of GDP)	-2.1	
CA Gap (percent of GDP)	-1	
Exchange rate gap (percent)	8	-8

Source: 2014 External Sector Report.

Capital and financial inflows and outflows rose in 2013 but are substantially lower than pre-2008 levels. Portfolio inflows halved in 2013, relative to 2012, but were more than offset by stronger bank inflows. At the same time, there has been a sizable increase in U.S. overseas portfolio investments. The U.S. dollar's reserve currency status continues to support foreign demand for U.S. securities.

[1] This box draws on the 2014 External Sector Report. See also Annex IV.

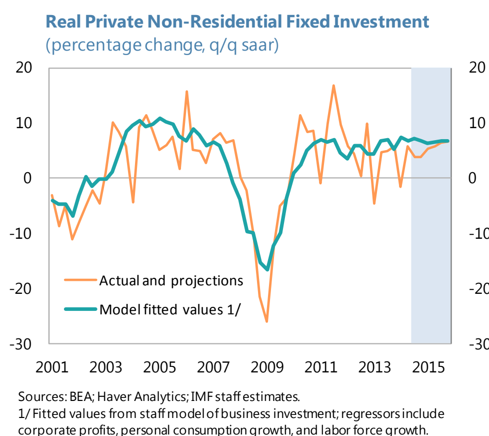
11. *What could go wrong domestically?* There continue to be important uncertainties surrounding the baseline growth forecast (see Annex I) including whether the slowdown in growth earlier in the year will prove to be more permanent than is currently assessed. In terms of specific domestic risks, interest rates could rise more rapidly—either because of an unanticipated shift in the Fed's position, or markets unwinding the recent compression in volatility, term premia, and credit spreads. This could instigate bouts of financial volatility with damaging implications for U.S. growth. Alternatively, a continuation of low interest rates could foster a build-up of greater systemic financial stability risks. The return of fiscal uncertainties in 2015—for example, linked to renewed disagreement on the debt limit or the budget—would create downside risks. Over a longer horizon, a delay in putting in place a credible medium-term fiscal consolidation plan has the potential to precipitate a loss of confidence and an increase in the sovereign risk premium.

12. *Global spillovers*. Given the size and importance of the U.S. economy, all of the domestic risks described above, if realized, would have significant implications for the world economy. For example, a rapid increase in interest rates that is not backed by stronger U.S. growth would have negative consequences for global growth, particularly for those emerging markets with weaker fundamentals. A one percentage point increase in the U.S. term premium could reduce growth in the rest of the world by around 0.2 percent (see the 2014 Spillover Report). Similarly, the low-probability but high-impact risk of U.S. bond market distress could generate a peak world output loss of 3.4–6.0 percent (see the 2012 Spillover Report).

13. *What are the main risks from abroad?* The principal external risk to the U.S. recovery comes from a more pronounced synchronized slowdown in emerging market economies (including in China). A one percentage point fall in emerging market growth could lower U.S. growth by 0.1 percent over a year (see the 2014 Spillover Report). If increasing geopolitical tensions surrounding Ukraine or Iraq were to lead to global financial and trade disruptions, higher commodity prices, and safe-haven capital flows, then the U.S. dollar would appreciate and growth could fall by up to 0.2–0.8 percent in 2014–15, depending on the severity and longevity of the disruption.

14. *What are the upsides?* Non-residential private investment growth is conservatively forecast to be lower than predicted by staff investment models. As a result, the recovery in private investment could be stronger as confidence about future economic prospects grows. There could also be a more energetic rebound in the participation rate than is currently envisaged by staff. This would raise labor incomes and add to consumer demand. Finally, the large destocking that occurred in the first quarter may mean that a rebuilding of inventories in the coming months may provide some upside to growth in 2014. Overall, the distribution of risks around the baseline forecast is believed to be broadly balanced for 2014–15.

Real Private Non-Residential Fixed Investment
(percentage change, q/q saar)



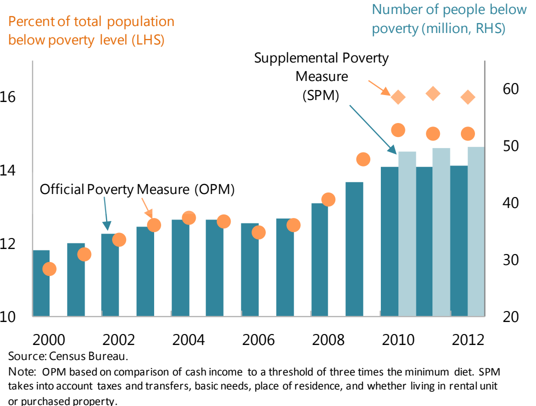
Sources: BEA; Haver Analytics; IMF staff estimates.
1/ Fitted values from staff model of business investment; regressors include corporate profits, personal consumption growth, and labor force growth.

15. *Authorities' views.* The authorities believed the weak first quarter growth outturn was a temporary aberration and partly a weather-related phenomenon. They recognized, though, that this meant 2014 growth would likely come in somewhat below their most recent public forecasts. However, they underlined that solid fundamentals and significant policy efforts to support the recovery would mean that there was a strong possibility that growth could surprise on the upside in the coming quarters. They agreed on the nature of the principal risks facing the U.S. economy but saw a relatively remote likelihood that the downside domestic risks highlighted by staff would materialize and were more concerned over the risks that could accompany the recent decline in market pricing of volatility. They pointed, also, to concerns over Europe's nascent recovery and weaker growth in emerging markets, particularly risks emanating from China linked to either a sharper slowdown and/or financial sector stresses. The authorities envisaged a slow rise of inflation to the Fed's 2 percent objective and a gradual increase in long-term interest rates to around 5 percent over the medium-term.

CONFRONTING POVERTY

16. *The task at hand*. Almost 50 million Americans were living in poverty in 2012, as measured by the Census Bureau's supplemental poverty measure. Poverty rates are higher for children under 18 years and for single-parent households (particularly those headed by single mothers). As troubling as the level of poverty is, perhaps of more concern is the fact that the official poverty rate has been stuck at about 15 percent since the recession, even though the economy has been recovering and average incomes and employment are now both above the levels which prevailed in 2007. Lowering poverty will require a sustained improvement in the economy and in employment opportunities. However, it will also require policy efforts to raise real wages at the bottom end of the distribution and to provide a greater transfer of fiscal resources to society's poorest.

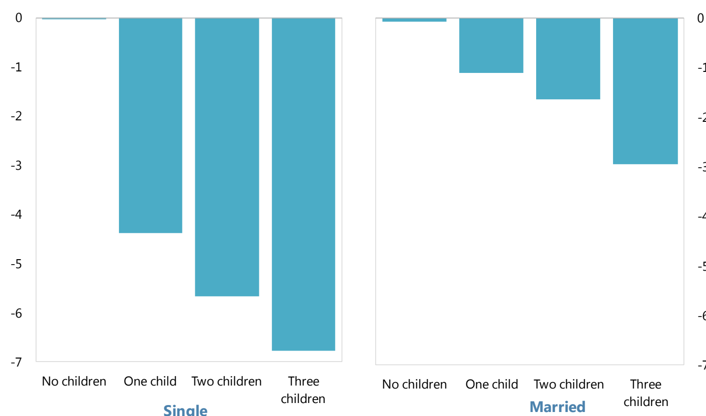
Poverty Indicators



Source: Census Bureau.
Note: OPM based on comparison of cash income to a threshold of three times the minimum diet. SPM takes into account taxes and transfers, basic needs, place of residence, and whether living in rental unit or purchased property.

17. *Supporting the poor*. While not a full solution to rising poverty, much can be achieved by further expanding the Earned Income Tax Credit (EITC) for workers without dependents, low-income youth, and those older workers not yet eligible for social security. In addition, the government should make permanent the extension of the EITC to larger families, the mitigation of the

Reduction in Poverty Rate due to EITC, 2012
(percentage point change after EITC is taken into account)



Source: Congressional Research Service analysis of the 2013 Current Population Survey.

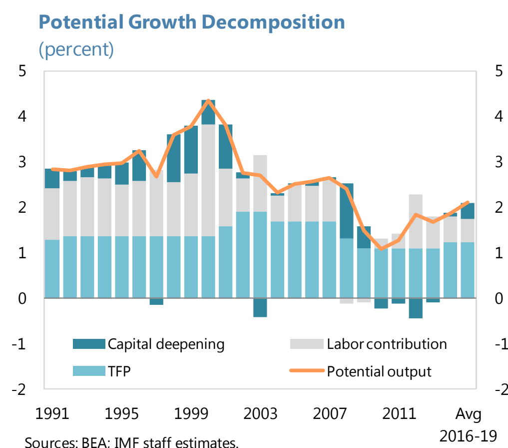
"marriage penalty", and the increase in (and refundability of) the Child Tax Credit, all of which were introduced in 2009 and are due to expire in 2017. Such an upgrade of the EITC would have a relatively low fiscal price tag and would directly target poverty among the working poor while encouraging work. Complementing this with an increase in the federal minimum wage would help ensure that part of the economic costs of raising the income of the lowest decile is borne by firms (rather than the budget). It would also forestall the improved EITC from simply lowering the pre-tax wage without changing the post-tax income of poor households (Box 3).

18. ***Authorities' views***. The President's 2015 Budget underscored the importance of making the EITC a more relevant and effective instrument in tackling poverty and in encouraging people to enter the workforce. It proposed a doubling of the childless worker EITC as well as making younger adult workers eligible for the EITC. The Administration is also committed to increasing the minimum wage. It has already required federal contractors to pay at least $10.10 per hour and has called on Congress to raise the minimum wage to $10.10 for all workers. There have also been initiatives to increase the minimum wage at the state and local levels (as of June 1, 2014, 22 states and the District of Columbia have minimum wages above the federal minimum). Officials agreed that making progress on both the EITC and minimum wage would be a preferred combination but also regarded passage of either in isolation as a valuable step to ensuring that hard work pays off for all citizens and that poor families are able to make ends meet.

COUNTERING THE DECLINE IN POTENTIAL GROWTH

19. ***Pressures on labor supply and labor productivity***. U.S. potential growth is expected to level off at around 2 percent in the coming years. This is well below the average potential growth rate of over 3 percent seen in the decade before the financial crisis. The main drag to potential growth is expected to come from:

Potential Growth Decomposition
(percent)

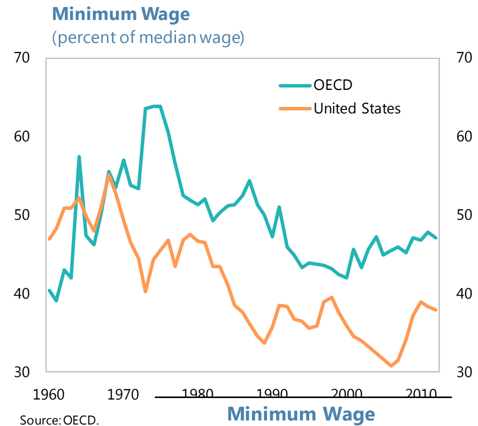


Sources: BEA; IMF staff estimates.

- *A slower expansion of the labor force given population aging*. Under current policies, the labor force is expected to expand at a slow pace (of below ½ percent per year), half the average growth rate seen in 2000–13 and well below the average (1.2 percent) growth seen over the past 30 years.

Box 3. The Earned Income Tax Credit and the Minimum Wage—A Package

"In-work" tax credits such as the Earned Income Tax Credit (EITC) in the U.S. are aimed at stimulating labor force participation and providing income support. More than half of advanced economies use such credits.[1] In the U.S., the credit is phased out as *family* income rises and also varies with the number of dependents in the household. This generates both a "marriage penalty" (the income of one partner can make the other ineligible for the credit) and potentially negative effects on labor supply (since the marginal tax rate, when adding in the loss of the EITC, can be very high for the second earner). The complexity of eligibility for the EITC has also been criticized for leading to high error rates and improper payments.[2]



The minimum wage aims to ensure that low-wage, low-skill workers can afford a basic standard of living. Such wage floors have been shown to raise labor force participation at the margin, reduce poverty, and sustain aggregate demand. However, these benefits may be offset if the floor is set so high as to significantly discourage employers from hiring. The minimum wage in the U.S. is 37.8 percent of the median wage, low by international standards (the OECD average is 47.1 percent of the median wage). Despite periodic increases, inflation has meant the minimum wage has been on a broadly downward trend in real terms since 1968. In 2012, there were 3.6 million hourly paid workers in the U.S. with wages at or below the federal minimum wage of $7.25 per hour; a further 13 million earn below $10 per hour. Slightly more than half of these workers were employed in the leisure and hospitality industry.

Minimum Wage
(percent of median wage, 2012)

Country	
Czech Rep.	36
Japan	38
Korea	42
Canada	45
UK	47
Australia	53
France	62

Source: OECD.

Despite the potential downsides associated with both the minimum wage and the EITC, a combination of the two can have important complementarities and ensure that more of the EITC benefits accrue to the worker.[3] On its own, a minimum wage hike can be a poorly targeted instrument because part of the benefits of a higher minimum wage accrues to higher-income households (the CBO calculates that only a fifth of increased earnings from the minimum wage goes to families living below the poverty threshold). On the other hand, an expansion in the EITC could put downward pressure on pre-tax wages and dilute the benefits to poor households (the increase in after-tax income is only 73 cents for every dollar spent on the EITC[4]). The estimated effects of implementing both an expanded EITC and higher minimum wage are summarized in the text table.

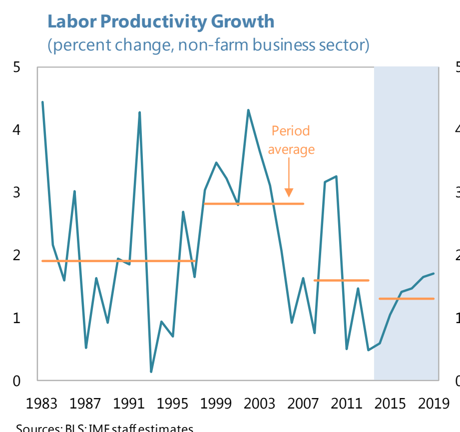
Possible Effects of Poverty-Reducing Policy Alternatives

Policy measure	Fiscal cost ($ over 10 years)	Fiscal cost (percent of GDP)	Employment effect (thousands)	Average increase in take-home pay of poor households (percent of average after-tax income)	Reduction in official poverty rate (percentage points)
Make permanent the extension of the EITC to larger families, the mitigation of marriage penalty, and the increase in CTC (due to expire in 2017)	97.4 billion	0.04	Increase of about 40	6.8	0.5
Double the maximum EITC benefits for individuals without dependents and expand EITC benefits to workers aged 21-24	59.7 billion	0.03	Increase of about 20	4.4	0.4
Raise the federal minimum wage from $7.25 to $10.10	Negligible		Decrease of about 500	2.6	0.3
Combination of all	146.9 billion	0.06	Decrease of about 400	9.7	1.0

Sources: OMB, CBO, JCT, Brookings Institution, Urban Institute; IMF staff calculations.

[1] See IMF, "Fiscal Policy and Employment in Advanced and Emerging Economies," 2012.
[2] See GAO, "Improper Payments: Remaining Challenges and Strategies for Governmentwide Reduction Efforts," 2012.
[3] See O. Blanchard, F. Jaumette, and P. Loungani, "Labor Market Policies and IMF Advice in Advanced Economies During the Great Recession," 2013; CBO, "The Effects of a Minimum-Wage Increase on Employment and Family Income," 2014.
[4] See J. Rothstein, "Is the EITC as Good as an NIT? Conditional Cash Transfers and Tax Incidence," 2010.

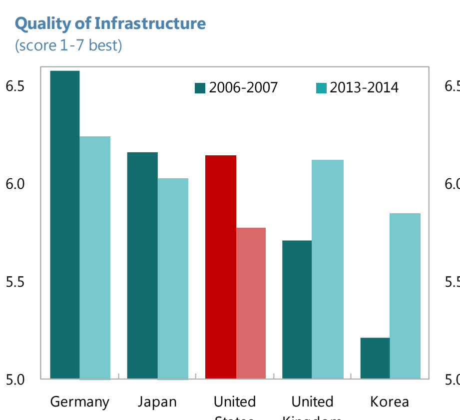
- *A slowdown in productivity.* Recent years have seen a step-down in labor productivity. This has been largely attributed to a smaller contribution from capital deepening and total factor productivity linked to information technology (IT). There is substantial uncertainty as to whether this decline in labor productivity is going to be a long-lasting phenomenon (e.g., due to a diminished pace of IT innovation) or will be partly reversed by newer technological innovations, efficiency gains in infrastructure, and productivity effects from the ongoing energy boom. At this stage, the evidence makes it impossible to distinguish between these two possibilities. Staff's current forecasts assume a middle ground: a partial rebound in labor productivity growth (as measured by non-farm business sector output per hour worked) from 0.5 percent in 2013 (the slowest growth rate since 1993) to around 1.6 percent by the end of the decade (still substantially underperforming the average 2¾ percent productivity gains seen between 1998 and 2007).



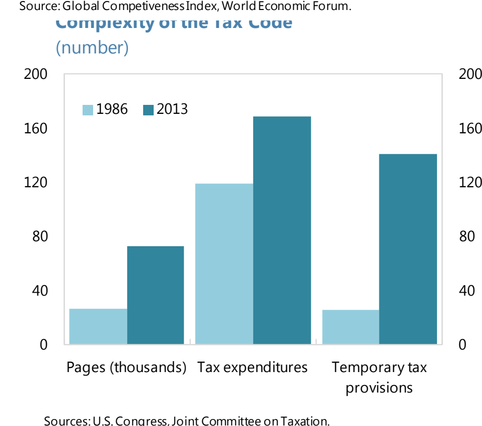
Sources: BLS; IMF staff estimates.

20. *Policies*. Tempering the pace of decline in long-term growth will depend critically on policies that build the (public and private) capital stock, reverse the downswing in productivity growth, and raise labor force participation (Figure 2). Priorities should include:

- *Galvanizing infrastructure investment.* The government capital stock ratio has resumed the downward trend that began in the 1980s. Additional investment is urgently required to improve the quality of infrastructure, particularly for surface transportation. Indeed, the American Society of Civil Engineers estimates that $200 billion (about 1.1 percent of GDP) in funding is necessary to meet the U.S. infrastructure investment needs from 2014 to 2020. Providing clarity on future financing of the Highway Trust Fund is a near-term priority. However, this should be viewed only as a first step. Action is also needed to achieve a sustained increase in both federal and state spending on infrastructure paid for by savings in future entitlement outlays, the raising of additional revenues, and an expansion of infrastructure financing sources (including innovations such as the America Fast Forward Bonds).[1]



Source: Global Competiveness Index, World Economic Forum.

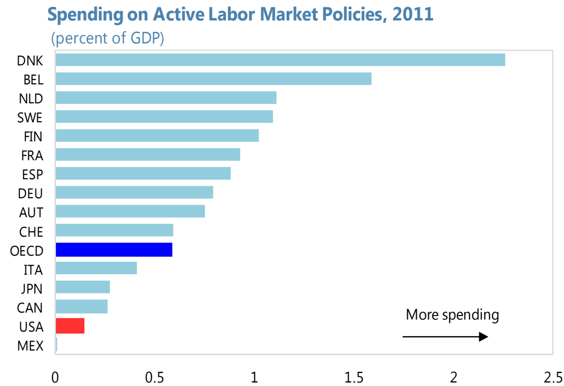


Sources: U.S. Congress, Joint Committee on Taxation.

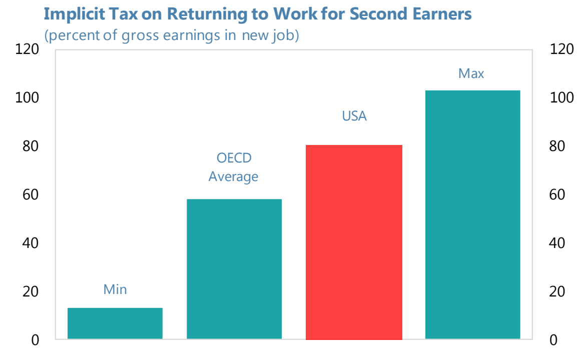
[1] Under this program, the federal government would provide subsidy payments to state and local governments that equals 28 percent of their interest costs on bonds used to finance infrastructure projects and 50 percent if the bonds are issued in 2014 and 2015 to finance the building of schools.

Figure 2. Policy Priorities for Boosting Potential Growth

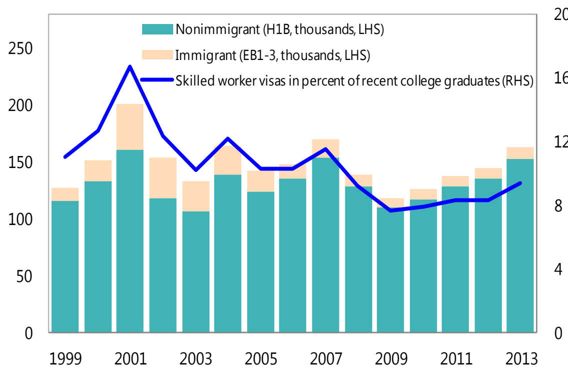
There is scope to strengthen active labor market policies to increase labor supply...



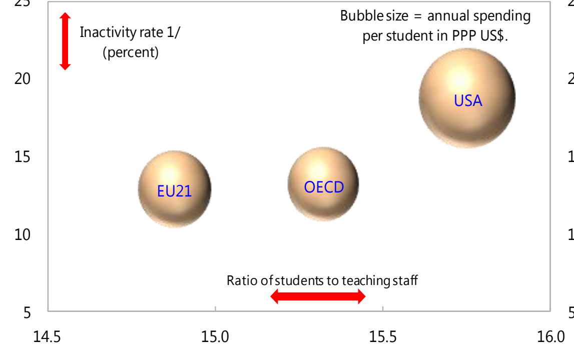
... and tackle other disincentives to work, especially for women with children (e.g. through childcare assistance and tax code changes).



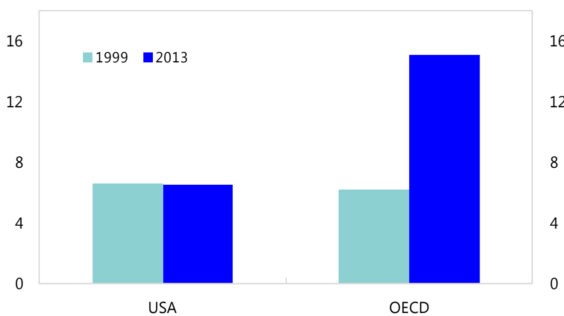
Attracting high-skilled workers through immigration reform would increase labor supply and boost productivity.



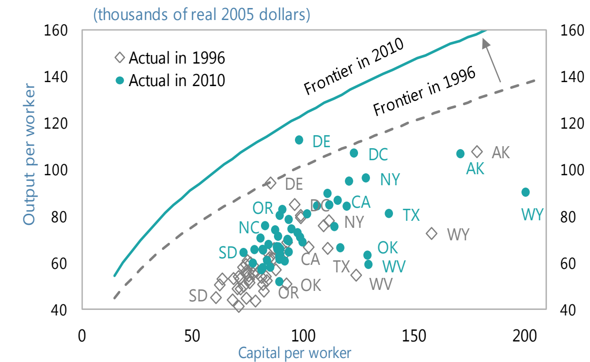
More impactful education expenditures ...



... together with incentivizing greater public and private investment in research and development ...



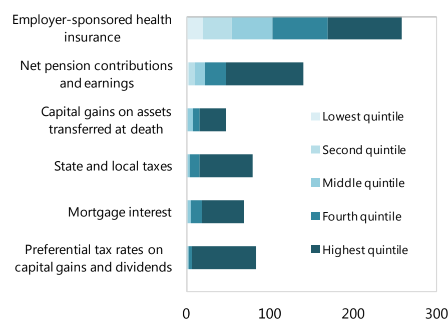
... would add to productivity and allow states to move closer to the production frontier.



Sources: Department of State, Department of Education, Organization for Economic Cooperation and Development; IMF staff estimates
[1/] Inactivity rate on the y-axis is the proportion of the population that is not in the labor force.

- *A better tax system*. A reform of the U.S. tax code is long overdue, as complexity and loopholes have increased over the years. The Joint Committee on Taxation estimates that a comprehensive tax reform—that involves broadening bases and simplification and reduction of statutory tax rates for individual and corporate income tax—would raise the level of real GDP by up to 1.6 percent over the next ten years. Such a reform would also support medium-term fiscal adjustment and facilitate a more equitable distribution of income. On both efficiency and distributional grounds, the individual income tax base should be broadened through a reduction in exemptions and deductions. In particular, itemized deductions for the individual income tax—including the mortgage interest deduction—should, over time, be either capped or eliminated. On the corporate side, there is scope to broaden the base (by cutting back on the value of various tax exclusions and deductions), lower the marginal corporate tax rate, and change the tax treatment of multinational corporations to limit base erosion and profit shifting.[2]

Size and Distribution of Selected Major Tax Expenditures by Income Group
(fiscal year 2013, billion dollars)



Source: Congressional Budget Office.

- *Incentivizing innovation and building skills*. Fiscal measures should focus on incentivizing research and development including by reinstating and making permanent the Research and Experimentation (R&E) tax credit that expired in December 2013. Progress can be achieved in closing skills gaps over the near term by improving training programs conducted at the state level, building partnerships with industry and higher education institutions for apprenticeships and vocational training, and improving government-provided job search assistance. Over a longer horizon, skills development will require better spending on education to raise educational outcomes through prioritizing early childhood education (including universal pre-K) and giving more support for science, technology, engineering, and math programs (Box 4).

- *Boosting labor supply and reducing long-term unemployment*. In addition to expanding the EITC, increased labor force participation could be achieved through better family benefits (including childcare assistance) to reverse the downward trend in female labor force participation. Moreover, the disability insurance program could be modified to provide incentives for beneficiaries to work part-time (rather than drop out of the labor force). Potential output would also benefit (through both labor supply and productivity effects) from reaching an agreement on immigration reform that provides greater opportunities for high-skilled workers to work in the United States. Finally, to accelerate the progress in lowering unemployment and to counter stigma effects, time-bound tax credits or wage subsidies could be offered to those employers who hire the long-term unemployed.

[2] See T. Matheson and J. Grigg, "Raising Revenues from U.S. Personal Income Tax Expenditures" and "International Spillovers from U.S. Corporate Tax Reform," in IMF Country Report No. 12/214, for an extensive discussion.

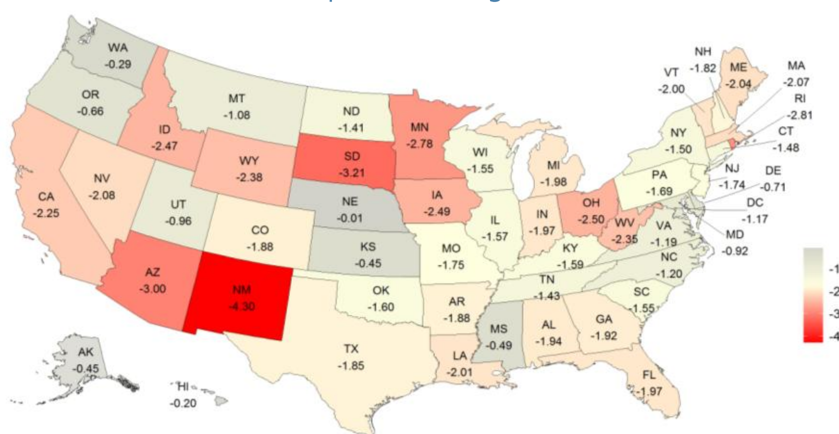
Box 4. Productivity Growth and Its Determinants: Evidence from the U.S. States[1]

Aggregate total factor productivity (TFP) growth slowed in the mid 2000s, well before the financial crisis. Some argue that part of the decline was due to the information and technology (IT) revolution having run its course, while others maintain that the IT revolution has still a long way to go, and could continue to boost U.S. TFP growth in the future.[2]

Examining TFP growth across U.S. states suggests that the productivity slowdown is less related to the IT cycle than is commonly thought. The change in TFP growth over 2005–10 (relative to 1996–2004) varied from over 3 percentage points in New Mexico and South Dakota to below 1 percentage point in states like Washington, Oregon, Nebraska, Maryland, and others. However, there is little evidence to suggest the TFP slowdown was stronger in those states that were either specialized in IT production or that used IT more intensively.

Deceleration in Average TFP Growth, 2005–2010 vs. 1996–2004

(percent change)



Source: IMF staff estimates.

TFP growth reflects not only technological innovation but also the efficiency of production which, in turn, is linked to education, R&D spending, and the concentration of financial services. Using a stochastic frontier analysis, staff decomposes TFP dynamics into the contributions from technological progress and the improvement in efficiency. In this framework, technological progress shifts the production frontier upward for all states, while an improvement in technical efficiency moves each state towards the production frontier. There appears to be a large variation in the efficiency of production across U.S. states and the empirical work suggests that states with better human capital, higher spending on research and development, or a more developed financial system all tend to be more efficient and closer to the technological frontier.

Panel regressions of TFP growth across U.S. states over the last two decades seem to corroborate these findings, showing that higher educational attainment and greater spending on R&D (especially by the government) are linked to higher TFP growth.

---

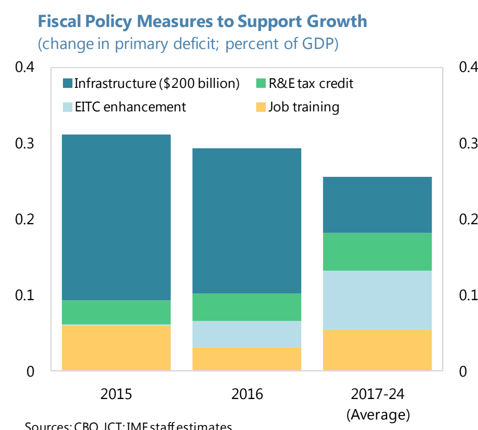
[1] See R. Cardarelli and L. Lusinyan, “U.S. Total Factor Productivity Slowdown: Evidence from the U.S. States,” Selected Issues Paper, 2014.

[2] See J. Fernald, “Productivity and Potential Output Before, During, and After the Great Recession,” NBER 29th Annual Conference on Macroeconomics, 2014; R. Gordon,” Is U.S. Economic Growth Over? Faltering Innovations Confronts the Six Headwinds,” NBER Working Paper 18315, 2012; M.N. Baily, J. Manyika, and S. Gupta, “U.S. Productivity Growth: An Optimistic Perspective, International Productivity Monitor 25, 2013. D.M. Byrne, S.D. Oliner, and D.E. Sichel, “Is the Information Technology Revolution Over?” International Productivity Monitor 25, 2013.

- *Energy independence*. Ongoing investments in the development of U.S. energy resources—including those for shale oil and gas and renewables—as well as improvements in energy efficiency have allowed domestic crude oil production to surpass net imports for the first time since 1995. This should narrow the oil trade balance from -1.4 percent of GDP in 2013 to about ¾ percent of GDP by the end of the decade. The U.S. is also expected to become a net exporter of natural gas by 2018. Fully capitalizing on the benefits of increased energy independence in an environmentally responsible way will require removing remaining export restrictions on crude oil, building infrastructure to transport and export gas (particularly LNG), as well as providing incentives for investment in, and use of, green energy technologies.[3] The recent rule proposed by the Environmental Protection Agency to cut emissions from existing fossil fuel-fired power plants by as much as 30 percent by 2030, compared with 2005 levels, would provide further incentives to upgrade plants, switch from coal to natural gas, improve energy efficiency, and promote renewable energy.

- *Trade liberalization*. Longer-term growth will also be helped by a further reduction of obstacles to free trade in goods and services. The U.S. is prioritizing reaching preferential trade agreements—including the Trans-Pacific Partnership and the Transatlantic Trade and Investment Partnership—as well as plurilateral agreements—such as the Trade in Services Agreement and the Information Technology Agreement. To avoid fragmenting the global trading system, progress in preferential trade agreements should be actively complemented by renewed efforts to advance the multilateral trade agenda. The U.S. should work with trade partners to finalize by end-2014 a work program to advance in the trade agenda at the WTO.

21. *Fiscal implications*. Clearly, many of the measures suggested above to boost long-run growth would have fiscal implications. In particular, passage of bills authorizing additional infrastructure spending, EITC enhancement, increased funding for active labor market policies, and making the R&E tax credit permanent would add about 0.3 percent of GDP to the federal deficit over 2015–16. It should be noted that the fiscal costs would be partly offset by better growth resulting from these policies. Such measures should, however, be accompanied by higher revenues and offsetting expenditure savings in future years (see below).



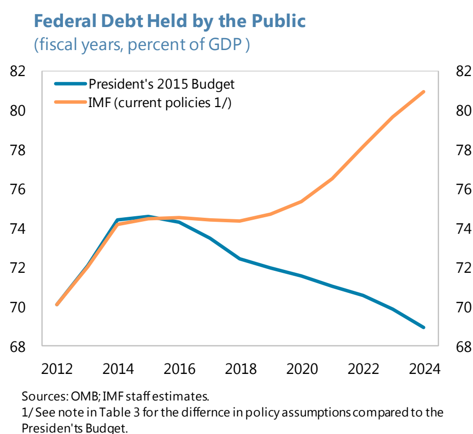
22. *Authorities' views*. The authorities agreed with many of the supply-side priorities highlighted by staff and indicated that the Administration continues to favor policies that raise long-term growth. They particularly highlighted their efforts to raise public spending on infrastructure, job training, research and innovation, preschool education, and to pass

[3] See B. Hunt, M. Sommer, G. Di Bella, M. Estrada, A. Matsumoto, and D. Muir, "Macroeconomic Implications of the U.S. Energy Boom," in IMF Country Report No. 13/237.

pro-work tax cuts. If put in place today, the authorities believed that such policies would push growth up to an average 3¼ percent over the next three years and achieve a potential growth rate of 2¼ percent over the medium-term. On energy policy, the authorities indicated they were taking an active look at the implications of growing domestic energy supplies including the economic, environmental, and security opportunities and challenges that it presents and would evaluate policy options as needed.

PUTTING PUBLIC DEBT ON A DOWNWARD PATH

23. ***Medium-term adjustment***. Past policy advice has emphasized the importance of a medium-term fiscal plan and early action to slow entitlement spending (see Annex III for a summary of past policy advice). It also made the case that less fiscal withdrawal in the short run, accompanied by a medium-term fiscal plan and ambitious structural reforms, would allow for a more balanced policy mix by partly relieving monetary policy of its burden of supporting the recovery. This, in turn, would generate more favorable outward spillovers while reducing the risks to U.S. and global financial stability from a prolonged period of low interest rates.



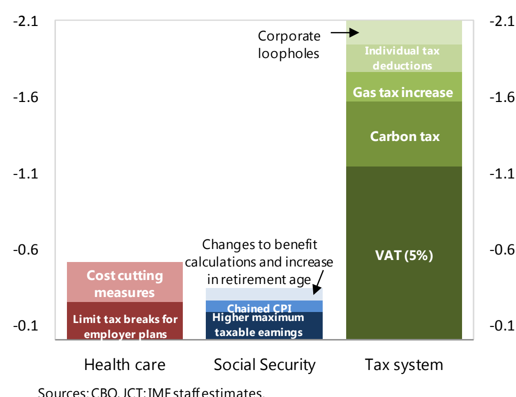
Sources: OMB; IMF staff estimates.
1/ See note in Table 3 for the differnce in policy assumptions compared to the Presiden'ts Budget.

Consolidation in 2011–13 was stronger than had been earlier anticipated (the federal primary structural deficit declined by 1¼ percent of GDP more than was predicted in 2011). However, the outlook for potential growth has worsened, lowering future federal revenues and compounding the long-term fiscal sustainability challenge. As a result, under current policies, after stabilizing in 2015–18, the debt-to-GDP ratio is expected to begin rising again as aging-related pressures assert themselves and interest rates normalize. Staff estimates that, relative to current policies, an additional 2¾ percent of GDP in fiscal adjustment at the general government level would be needed between now and 2023 in order to put the debt-to-GDP ratio on a downward path over the medium term (even as age-related outlays for health and social security start to accelerate).

24. ***A better policy mix***. Given the substantial slack in the economy, there is a strong case to provide continued policy support to the recovery. A credible medium-term fiscal consolidation plan would provide the flexibility for some near-term fiscal support to the economy that is designed with a focus toward reducing poverty and encouraging longer-term growth. Helping to kick-start growth and job creation in this way would have near-term demand effects but, more importantly, lasting implications for potential growth. It may also, at the margin, allow for an earlier withdrawal of exceptional monetary stimulus with some positive spillovers to both domestic and international financial stability.

25. ***Policies***. In this vein, the President's 2015 budget outlines various valuable steps that would move toward such a policy mix. It proposes health care savings (including through higher Medicare premia), immigration reform, and measures that limit tax deductions and exclusions for higher earners. There are also sensible options laid out in various proposals under consideration in Congress. Given the long gestation period of reforms, producing measurable savings over the medium term will require up-front action and will need to encompass:

Options for Federal Fiscal Deficit Reduction
(change in primary deficit in 2014-24, percent of GDP)



Sources: CBO, JCT; IMF staff estimates.

- *Controlling health care costs.* Some progress has already been made in taming the fiscal pressures from rising health care costs and there has been a tangible slowdown in the growth of health spending, partly attributable to the implementation of the Affordable Care Act (ACA).[4] However, it is unclear to what extent this cost slowdown will persist and what are the fiscal and cost implications of the Medicaid expansion under the ACA. As a result, more could be needed. Measures that could be considered to bend the cost curve include the enhanced coordination of services to patients with chronic conditions, the education of patients to reduce the overuse of expensive medical procedures and technology, greater cost sharing with beneficiaries, and the elimination of tax breaks for some of the more generous employer-sponsored health care plans.

- *Strengthening social security finances*. The 2013 Annual Report by the Social Security Trustees projects that the combined trust fund reserves would decline beginning in 2021 and reach zero by 2033, at which point continuing income would be sufficient to pay only 77 percent of benefits. The clock runs faster for the Disability Insurance Trust Fund, which would be exhausted as early as 2016. Addressing the expected depletion of the Social Security Trust Funds will require early and fundamental reforms. These could include a further gradual increase in the retirement age (potentially with steps that link the future retirement age to average life expectancy or other actuarial indicators of the solvency of the system), a modified benefit structure to increase progressivity, an increase in the maximum taxable earnings for Social Security purposes, and an indexation of benefit programs and tax provisions to chained CPI (rather than standard CPI).

- *Improving the tax structure and raising revenues*. In addition to the tax measures described earlier (to enhance long-term growth by making the direct tax system simpler, more equitable, and with less negative incentive effects), there is also a need to raise additional revenues so as to contribute to the needed medium-term fiscal adjustment. To do this, the U.S. could consider a

[4] See D. Igan, K. Kashiwase, and B. Shang, "Risky Business: The Uncertainty in U.S. Health Care Spending," in IMF Country Report No. 13/237.

range of options, including a broad-based carbon tax, a higher federal gas tax, and a federal-level VAT.[5]

26. ***Authorities' views***. The authorities agreed that the benefits to the U.S. economy from a clear fiscal consolidation plan would be significant. They indicated this was exactly the approach that had been taken in the President's 2015 Budget, which proposed a roadmap for accelerating economic growth, expanding opportunity for all Americans, and ensuring fiscal responsibility. Under their budget plan, the federal deficit would be lowered to 1.6 percent of GDP by 2024, bringing debt down to 69 percent of GDP. This would be achieved through improved efficiency savings as well as longer-term health, tax, and immigration reforms. They also agreed that a credible medium-term consolidation plan would give some space to provide more support to the recovery in the near term (particularly through investments in infrastructure, education, and other productivity-enhancing areas). However, they believed that, although it would be politically difficult to agree on a comprehensive medium-term fiscal plan, it could be possible to achieve bipartisan support to pass, by the end of the current administration, a reform of the business tax regime, increased funding for infrastructure and work training programs, and immigration reform. In this regard, the Bipartisan Budget Act of December 2013 could be a blueprint to replace automatic spending cuts in FY2016 with mandatory savings in future years. On health care, officials believed that the full effects of the ACA had yet to be felt and they favored waiting on other health care reforms in order to allow the system time to adapt to the various provisions of the ACA.

27. ***The institutional framework***. The three-week shutdown in October 2013 is estimated to have subtracted 0.3 percentage points (annualized) from fourth quarter growth with the uncertainties generating negative spillovers to various other countries. Fiscal policy uncertainty has been temporarily reduced, but many of the same features—linked to discussions on appropriations, negotiations on removing the sequester provisions for fiscal year 2016, and raising the debt ceiling—could come back to the fore in spring 2015. A more durable, institutional solution to risks from political brinkmanship is needed both for the sake of the U.S. and the global economy. Useful measures could include reaching bipartisan agreement on a clear, simple medium-term fiscal objective (with an integrated view of all budget functions and numerical targets for the debt and deficit); adopting carefully-designed mechanisms to trigger revenue or spending adjustments if targets are breached; an automatic process that would raise the debt ceiling once there is agreement on the broad budget parameters; and shifting to a budget cycle where annual spending levels are agreed for a two-year period (but with the possibility for supplemental budget resolutions during that two-year window under clearly specified conditions).

28. ***State and local finances***. At the state level, higher levels of unfunded pension liabilities and political polarization appear to be associated with lower credit ratings.[6] To support their credit

[5] See IMF, 2010, "From Stimulus to Consolidation: Revenue and Expenditure Policies in Advanced and Emerging Economies," for a broader discussion of tax policy options.

[6] See M. Estrada, D. Igan, D. Knight, "Fiscal Risks and Borrowing Costs in State and Local Governments," Selected Issues Paper, 2014.

ratings and lessen financing costs, state and local governments should adopt budget institutions that reduce the impact of these factors, including less stringent voting requirements to implement revenue increases and more flexible rainy-day fund rules. Steps could also be taken to require states to measure their unfunded liabilities under more realistic actuarial assumptions and to restore actuarial soundness for public sector employee pension and other post-employment benefit programs.

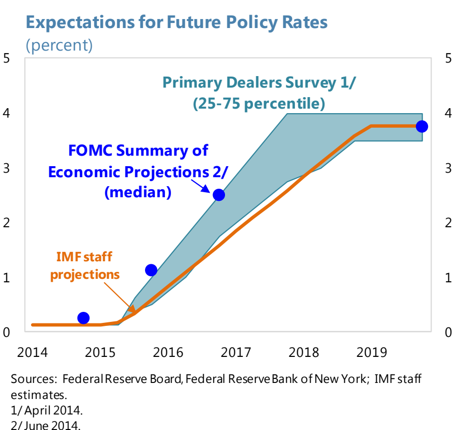
29. ***IMF quota reform***. The implementation of the 2010 reforms remains a high priority and the U.S. was urged to ratify these reforms at the earliest opportunity.

30. ***Authorities' views.*** Counterparts were supportive of the importance of budget process reform, including through a more sensible approach to the debt ceiling, although they expressed skepticism on whether any of these changes would be achievable in the near term. On IMF quota reform, the authorities reiterated their belief that IMF quotas must truly reflect countries' weight in the global economy and indicated that they were actively working with Congress to secure legislation to implement the 2010 IMF quota reforms.

THE PATH TO LIFT-OFF

31. ***Monetary policy***. The Fed currently has to contend with multiple areas of uncertainty including the degree of slack in the economy, the degree to which this slack will translate into future wage and price inflation, and the transmission to the real economy of an increase in policy rates. Currently, the median forecast of participants in Federal Open Market Committee (FOMC) deliberations indicates that the fed funds rate is expected to lift-off from zero by mid-2015, with a gradual path upward toward a 3.75 percent long-term level. Staff's baseline path is somewhat more gradual than this median. However, even with this path for policy rates, the economy is expected to reach full employment slowly and inflation pressures are forecast to remain muted. This could mean that—presuming systemic financial stability risks are contained—there is some scope for policy rates to stay at zero for longer while still keeping inflation under 2 percent. On the other hand, inflation could start rising faster than expected. This would place increasing tension between the Fed's mandates of maximum employment and price stability. In that case, if expectations remained anchored and financial stability risks were low, there could be room for the Fed to tolerate a temporary and modest rise of inflation above the 2 percent target. Much will depend on the source of the higher inflation. If the increase were transitory or not accompanied by rising wages, there could well be more space to defer rate increases. However, if this inflation were driven by an unexpected upswing in wages, then there would be a need to carefully reconsider whether preferred measures of slack were still appropriate, reassess if the economy was actually much nearer to full employment than it currently appears, and potentially begin raising rates at an earlier stage.

Expectations for Future Policy Rates
(percent)



Sources: Federal Reserve Board, Federal Reserve Bank of New York; IMF staff estimates.
1/ April 2014.
2/ June 2014.

32. ***Global spillovers***. The impending increases in U.S. interest rates will have important consequences for the global economy. The 2014 Spillover Report highlights that if these increases come at a time of higher U.S. equity prices and a better U.S. growth outlook, they should generally be a positive factor for other countries. However, there could still be pockets of stress in some of the more vulnerable economies. In contrast, an increase in the long rate that is not accompanied by a U.S. growth improvement (for example, a shift in Fed policy driven by concerns about a pickup in inflation) will have an unambiguously negative outward spillover effect, especially for those emerging markets (EMs) and advanced economies with already-weak fundamentals (as was seen in 2013). The latter scenario would likely mean higher sovereign and corporate spreads, a slowdown or reversal of capital flows, lower asset prices, and a drag on EM growth. Model estimates indicate that the second-round effects—i.e., the multiplier effect of a movement in U.S. rates, spilling out to emerging markets and other advanced economies, and then feeding back into U.S. growth and inflation—are likely to be empirically modest. Of course, there could be larger feedback effects that are not easily captured by such models (for example, in a tail event where U.S. policy action triggers crises in several of the vulnerable countries) but any estimate of their possible size would be necessarily speculative.

33. ***Authorities' views.*** The authorities indicated that monetary policy would adapt to changing economic circumstances, as it always has, and would be focused on achieving the Fed's mandate of maximum employment and price stability. The authorities believed the recent increase in core PCE inflation mainly reflected transitory or seasonal factors and emphasized that inflation is unlikely to return to 2 percent until wage growth moves above labor productivity growth. In the event inflation were to rise close to their longer-term goal but the economy appeared to remain well below full employment, they would have to carefully re-examine their assessment of the degree of slack left in the economy. The authorities also said that, while they would not try intentionally to overshoot that target, if inflation were to rise above 2 percent the pace at which they would try to subsequently disinflate would depend very much on how much progress had been made in achieving their employment mandate. The authorities recognized the international implications of U.S. monetary policy and pointed out that Fed staff had undertaken significant analysis to better understand the size and nature of outward spillovers from policy actions. They also indicated they would not discount the potential risks of second-round effects, but highlighted the uncertainty surrounding the size of both spillovers and subsequent "spillbacks".

34. ***Communication***. The Fed has made important and substantive efforts to increase transparency and has adopted an adaptable approach to communication. So far, the Fed's forward guidance has generally been effective in managing expectations and reducing uncertainty about future policy rates (Box 5). The return to qualitative forward guidance in March provides the Fed with greater flexibility but, at the same time, puts an even higher premium on clear and systematic communication to guide expectations, particularly given the potential adverse effects of miscommunication for international financial markets. Enhancing the Fed's communications toolkit would be a natural evolution that could help temper the likelihood of market volatility or abrupt asset price corrections along the exit path. Specifically, consideration could be given to:

- Scheduling press conferences by the Fed Chair after each FOMC meeting to provide a more frequent, structured environment to explain the committee's evolving thinking.
- Publishing a quarterly monetary policy report, that is endorsed by the FOMC and which conveys more detail about the majority view of the FOMC on the outlook, policies, and the nature of uncertainties around the baseline. Such a report may also convey dissenting views within the FOMC as well as broader information on how the FOMC thinks about policy reactions in plausible, non-baseline scenarios. This would complement the "dots" (i.e., the individual FOMC member's quantitative assessment of future macroeconomic variables and policy interest rates) and provide a more systematic way for the Fed to convey the majority FOMC view.
- Providing greater clarity from the FOMC on how it views current conditions for financial stability, how such considerations figure into its monetary policy decisions—both about the balance sheet and policy interest rates—and how these relate to its current mandate. This would allow the Fed to convey to markets how its monetary policy may be affected by its assessment of a decline in realized and expected volatility, a build-up in leverage, credit risks, unsustainable declines in term premia, or other financial stability concerns.

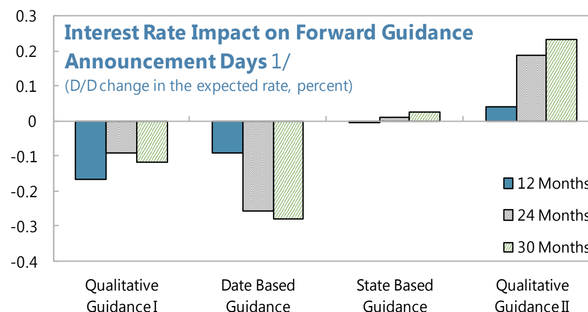
35. *Authorities' views.* The authorities indicated that attempts had been made in the past to agree on some form of monetary policy report but, in the end, it had proved very difficult to reach agreement among the FOMC members on the structure of such a report and on a set of forecasts or scenarios that the FOMC could somehow endorse. They would, however, continue to examine the possibilities of such a product and emphasized the inappropriateness of viewing the median of the summary of economic projections as a representation of the aggregate views of the FOMC. At present, quarterly press conferences coincide with the publication of the summary of economic projections and the authorities felt that tangible benefits from more frequent press conferences were unclear at this stage. In terms of taking account of financial stability concerns, the authorities indicated that this was a complex task because there is no solid analytical structure, as yet, to frame such issues in the context of monetary policy. Nevertheless, the FOMC was highly attuned to financial developments, and their assessment of progress toward maximum employment and price stability certainly took due account of readings on financial developments.

36. *Operational issues*. Barring unforeseen developments, the current pace of tapering should be maintained, implying an end to asset purchases in late 2014. Normalization of the Fed's balance sheet over the medium term should occur by letting asset holdings mature (in line with the June 2011 "exit principles" and subsequent communications). It would be useful, however, for the Fed to provide greater clarity at an early stage, through a formal update of its exit principles. The effectiveness of the fed funds target as the signal for monetary policy may pose a challenge for the operational framework once rates begin to rise. Although the fed funds market is unlikely to operate as it did before the financial crisis, there are arguments for retaining the fed funds target, for now, while maintaining flexibility to respond to market reactions during exit. The use of the overnight reverse repo and interest on excess reserves should allow the Fed to set a solid floor on market rates, and this could be complemented with term instruments to absorb excess liquidity. The recent expansion in Fed counterparties for the overnight reverse repo potentially creates arbitrage

Box 5. The Impact of Fed's Forward Guidance[1]

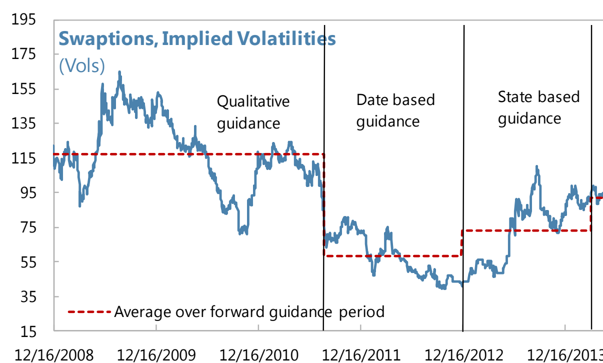
The Fed has used forward guidance since December 2008 to communicate its intention to keep the policy interest rate low, providing added stimulus to the economy and reducing uncertainty about future policy. Several studies find that interest rate expectations shifted at Fed announcements, consistent with a financial market re-evaluation of the Fed's policy reaction function.[2] There is also evidence that forward guidance has reduced the sensitivity of interest rates to macro news.[3] However, less attention has been paid to the impact of forward guidance on uncertainty.

Date-based forward guidance (i.e., where the Fed specified the likely date of future rate increases) was successful in moving the date at which rates were expected to increase further into the future. This helped reduce policy uncertainty. There was, however, little discernible impact on expected interest rates following the shift to *state-based* forward guidance (i.e., where the Fed specified unemployment and inflation thresholds that would need to be reached before rates begin to rise). Most recently, the return to *qualitative* forward guidance coincided with some upward shift in policy rate expectations.



1/ Changes in the implied interest rate of Eurodollar options.
Sources: Bloomberg and staff estimates.

After controlling for economic uncertainty (as measured by the dispersion in analysts' unemployment and inflation forecasts) and other factors (including broader market uncertainty and risk aversion as proxied by the VIX index), forward guidance appears to have been associated with reduced uncertainty about future interest rates (as measured by the implied volatility on swaption contracts). This effect was larger under date-based forward guidance but state-based forward guidance also helped reduce uncertainty (even despite the spike in volatility in mid-2013). Finally, the recent return to qualitative forward guidance has also been associated with lower uncertainty.



Sources: Bloomberg and staff estimates.

---

[1] See T. Mahedy, J. Turunen, and N. Westelius, "Monetary Policy Communication and Forward Guidance," Selected Issues Paper, 2014.

[2] See K. Femia, S. Friedman, and B. Sack, "The Effects of Policy Guidance on Perceptions of the Fed's Reaction Function," Federal Reserve Bank of New York, 2013; and M.D. Raskin, "The Effects of the Federal Reserve's Date-Based Forward Guidance," Finance and Economics Discussion Series, Federal Reserve Board, 2013.

[3] See E. Swanson and J. Williams, "Measuring the Effect of the Zero Lower Bound on Medium and Longer Term Interest Rates," Federal Reserve Bank of San Francisco, 2013.

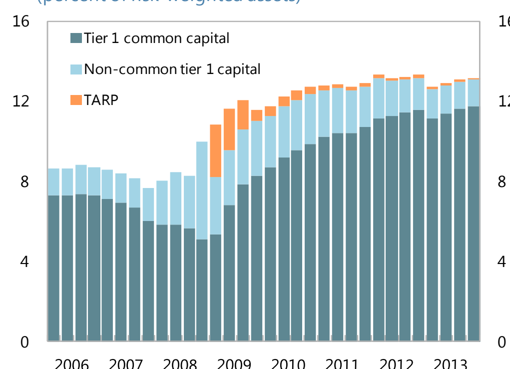
opportunities by encouraging resources to migrate from banks—that are subject to more rigorous regulations and deposit insurance fees—to money market funds that now have access to Fed instruments. However, these risks could be managed through the setting of rates (on the overnight reverse repo) and caps on either an aggregate or per counterparty basis.[7]

37. *Authorities' views.* The authorities noted that the FOMC continues to evaluate the appropriate future operational framework for normalizing the stance of monetary policy in the context of the Fed's large balance sheet, including the appropriate role of the fed funds target in communications regarding monetary policy during normalization. They argued that the fed funds rate currently moves in line with other short term rates and that any reduction of its role would need to be carefully communicated well in advance of its implementation. A new money market survey is likely to help the Fed in better understanding different segments of the money market. The Fed could also employ a variety of other short-term rates (such as the interest on excess reserves and the overnight reverse repo rate) in its policy communications during exit.

SECURING A SAFER FINANCIAL SYSTEM

38. *Progress in the banking sector*. The largest U.S. banks have continued to boost their capital positions: Tier 1 common equity ratio rose to 11.6 percent at end-2013 and the recent Fed stress tests showed the 30 largest U.S. banks are resilient to a severe deterioration of domestic macroeconomic conditions. Further, the majority of the large U.S. banks will add capital over the next two years. Nevertheless, in the latest Comprehensive Capital Analysis and Review (CCAR) stress tests, capital plans were rejected for five banks (including three foreign-owned bank holding companies), of which four were rejected based on qualitative concerns about their internal controls.

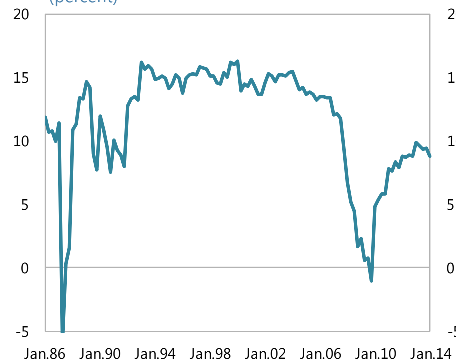
Tier 1 Common Capital Ratios at CCAR Institutions
(percent of risk-weighted assets)



Source: SNL Financial.

39. *Potential pressure points*. The results from the stress tests showed that, if hit by a severe global market shock, the larger U.S. banks would face a significant decline in their capital ratios and sizable losses from trading activities. For investment banks, a non-trivial dependence on wholesale funding continues to be a source of vulnerability in periods of severe financial market distress. Recent regulatory changes aimed at addressing these vulnerabilities have lowered systemic risks but, in doing so, may weigh on

Return on Equity for U.S. Banks
(percent)

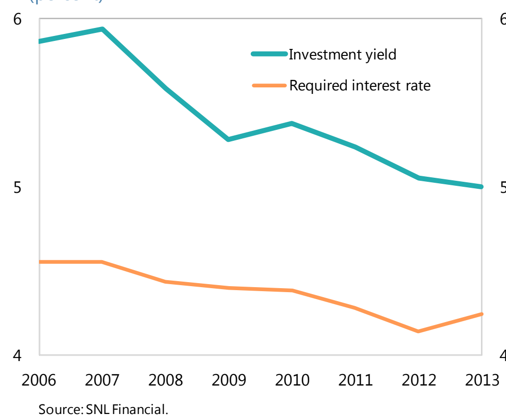


Sources: FRED Database and Federal Reserve.

[7] See S. Gray and D. King, "The Operational Framework for Monetary Policy," Selected Issues Paper, 2014.

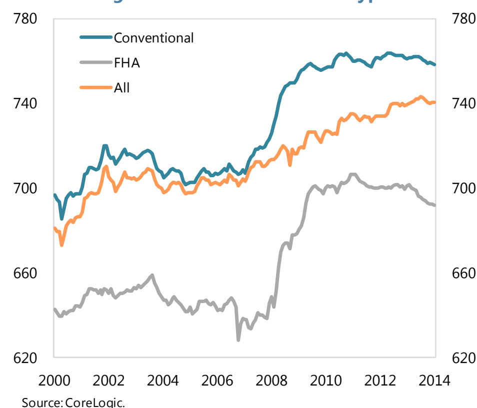
banks' future profitability with the current return on equity well below pre-crisis averages. There is a risk, therefore, that banks will try to restore their profitability through looser lending standards or a lengthening of the duration of assets, boosting returns at the cost of larger asset-liability mismatches. Avoiding such an outcome and preventing such incentives from creating new financial risks will necessitate an intensive approach to bank supervision.

40. ***Insurance***. While difficult to assess, there may well be risks building in the insurance sector, driven by a search for yield in a prolonged low interest rate environment. Indeed, investment returns had been steadily falling, narrowing the gap with the required return on the portfolio. Also, concerns about the ceding of liabilities to affiliated and less-regulated off-balance sheet reinsurance vehicles have emerged. The oversight of the insurance sector is fragmented between state and federal entities, and there is a need for a better consolidated picture of insurance companies' global activities and risks. At the same time, the lack of timely and publicly-available, consolidated data on insurance companies, including their offshore activities, complicates the monitoring of credit and liquidity risks. Such risks should be assessed and publicized through a coordinated, nationally consistent approach to supervision and stress testing. As part of that effort, the Federal Insurance Office should have a significantly larger role in the regulatory framework and be resourced accordingly.



Source: SNL Financial.

41. ***Mortgage availability***. A tighter regulatory regime for mortgage lending has helped better match the costs of such financing with the underlying risks. However, as a consequence, the recovery in the U.S. housing market has been held back by a continued conservative approach to mortgage lending, particularly to lower-rated borrowers. This has been driven by a range of factors that include persistent anxiety about potential "put-back" risks (i.e., where Fannie Mae or Freddie Mac require mortgage originators to repurchase loans because of discrepancies in underwriting or documentation); litigation and reputational risks to lenders; a tighter regulatory environment and supervisory scrutiny; and uncertainty about the future structure of the mortgage industry. Some steps have been taken, including by establishing a safe harbor for Qualified Mortgages that meet a clear set of minimum standards and by clarifying the conditions for put-backs. There is scope to do more to lessen uncertainties facing lenders, without undermining regulatory and supervisory scrutiny. In particular, efforts could be made to improve information sharing during the mortgage origination process and to clarify further the scope of exemptions in "sunset" clauses (i.e., provisions that release lenders from their liability under certain circumstances).



Source: CoreLogic.

42. ***Housing finance***. The federal government continues to play an unprecedented role in this market, guaranteeing nearly 80 percent of newly originated loans. Going forward, there is a need for a more clearly-defined and transparent government participation in the housing finance market with a clear delineation—and transparent fiscal accounting—of public interventions designed to promote social goals linked to housing. In the end, the system should have:

- A substantial first-loss risk borne by private capital (rather than taxpayers);
- An explicit public backstop that is limited to catastrophic credit losses with risk-based guarantee fees;
- A role for regulatory agencies in setting underwriting standards; and
- A common platform for securitization.

The transition to such a system should be carefully phased so as to avoid undermining the ongoing recovery of the housing market and the tentative restart in the private securitization market. It is also essential that along this transition path appropriate underwriting standards and supervision are kept in place to discourage a future cycle of overinvestment and unsustainable leverage in the housing market.

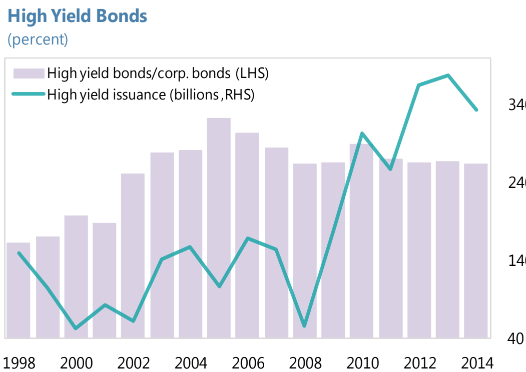
43. ***Corporate credit market risks***. Ample liquidity and low rates have encouraged companies (which already have significant liquid assets) to refinance, extend maturities, and push rollover risks out into the future (Figure 3). At the same time, though, underwriting standards have been weakened in some areas, particularly linked to lending to corporations with weaker credit fundamentals. Indications of such risks include:

- Gross issuance of high yield bonds and loans in 2011–13 is more than double that in 2005–07;
- The share of bonds being issued with non-cash coupons or CCC ratings, and of loans that are covenant-lite or with second-liens, is rising;
- Debt-to-earning levels for corporations taking on highly leveraged loans are increasing.

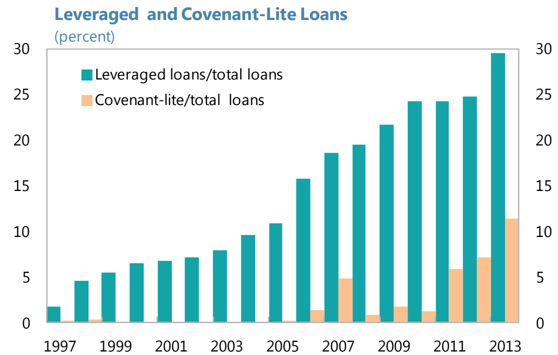
Lower credit costs and longer maturities should lessen the likelihood of corporate stress. However, as the credit cycle matures, increased exposure to more risky borrowers and the aggregate rise in leverage in the nonfinancial corporate sector could contribute to a rising rate of default and lower recoveries on defaulted debt.

Figure 3. Credit Market Risks

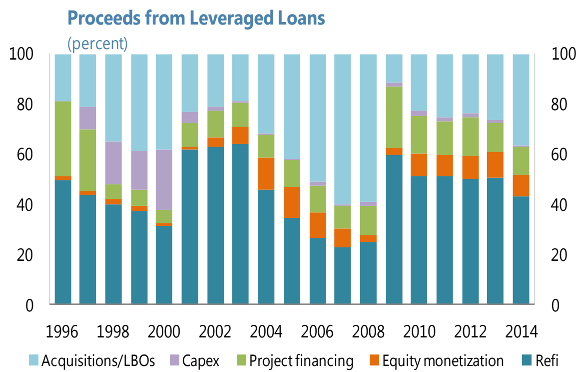
While high-yield bond issuance has picked up over the last two years, their share of total issuance remains stable.



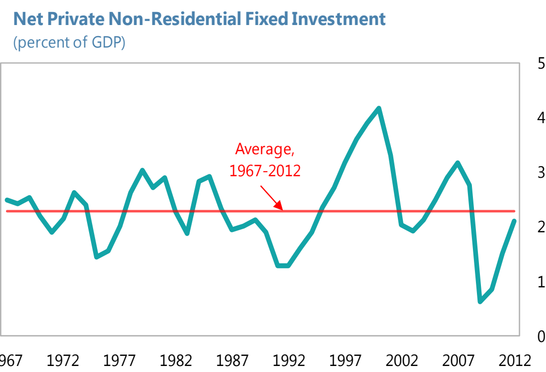
Leveraged loans and covenant-lite loans have also grown although the latter represents a relatively small share of the overall loan market.



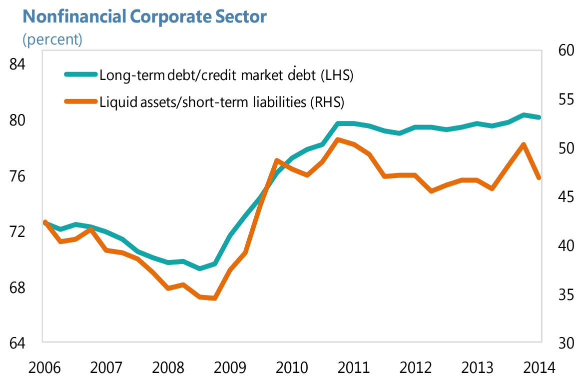
Proceeds from such borrowing have been used mainly to refinance higher cost financing...



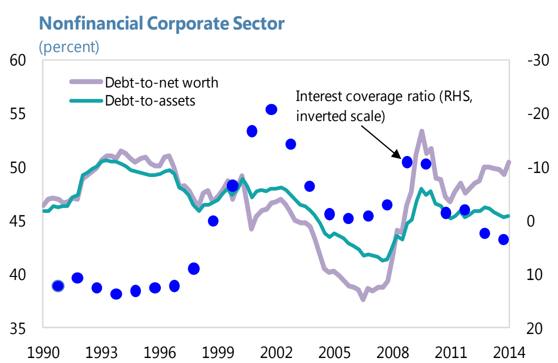
....and total corporate investment remains depressed.



Firms have plenty of cash and have extended their debt maturity.



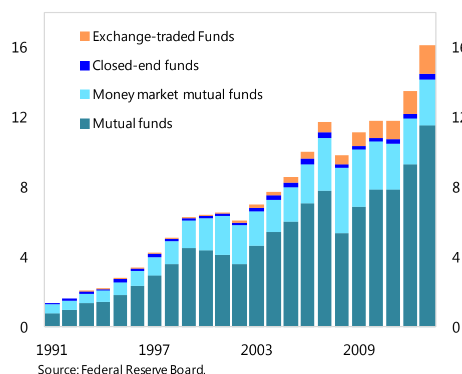
Aggregate leverage has risen but the debt burden is lower than pre-crisis.



Sources: Bloomberg L.P., Census Bureau, Federal Reserve Board, Haver Analytics, Thomson-Reuters, SNL Financial, World Scope; IMF staff estimates.

44. *Nonbank intermediary risks*. Intermediation taking place outside of the banking system is growing, creating a range of potential risks, all of which were highlighted in the 2014 Financial Stability Oversight Council (FSOC) Annual Report and include:

Assets of the Investment Industry
(trillion dollars)

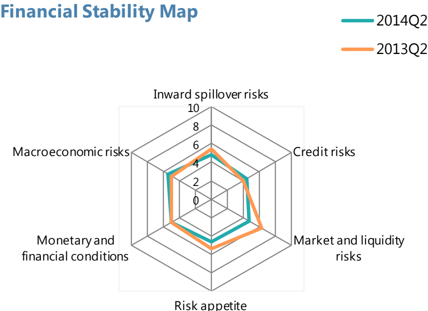


Source: Federal Reserve Board.

- The growing amount of maturity and liquidity transformation that is taking place through mutual funds or exchange-traded funds (ETFs), particularly those investing in credit instruments;
- The volume of nonbank flows being directed to higher credit risk and longer duration assets;
- The uncertain leverage and risks that are embedded in securities lending undertaken by large financial institutions;
- A decline in broker-dealer involvement in market making activity, potentially hampering the functioning of markets and price discovery at times of market stress.

45. *Implications*. Despite these pockets of vulnerability, overall financial stability risks appear to have marginally declined over the past year. However, when set against a backdrop of an upcoming rise in short-term interest rates or the potential for an abrupt unwinding of currently compressed market pricing of volatility and risk and term premia, there is a possibility that these vulnerabilities could manifest themselves in a disruptive way. For example, a tail risk involving a precipitous attempt by investors to exit certain markets—perhaps exacerbated by outflows from exchange traded funds (ETFs) and mutual funds as well as near-term illiquidity in market functioning—could trigger a sudden, self-reinforcing re-pricing of a range of financial assets. While the banking system would be robust to such a set of events, it could have more dramatic implications for the nonbanks which, in turn, would hurt U.S. growth—through wealth effects from lower asset prices, difficulties in rolling over or accessing new financing, and strains in the corporate sector—as well as have negative knock-on effects internationally.

Financial Stability Map



Source: IMF staff estimates.
Note: Away from center signifies higher risks, easier monetary and financial conditions, or higher risk appetite.

46. *Regulatory responses*. Good progress has been achieved in implementing the Dodd-Frank Act and moving ahead the financial regulatory agenda including through the finalization of the Volcker rule, the designation of another systemically important financial institution, implementing the over the counter (OTC) derivative reform, and putting in place liquidity and leverage requirements that appear to be compatible with Basel III standards (an ongoing Regulatory

Consistency Assessment Program will help provide a more definitive assessment). In addition, the U.S. recently put in place a rule to require foreign bank organizations (FBOs) over a certain size to incorporate as holding companies, a move that aligns the treatment of foreign and U.S. banks that are operating in the U.S. and eliminates an existing regulatory distortion (Box 6). To tackle the emerging pockets of risky behavior, there is scope for supervisors to tighten underwriting standards for more risky commercial lending, to attach higher risk weights or tighter limits on large exposures for particular assets (such as leveraged loans or high yield bonds), to strengthen prudential norms for holdings of securitized loans such as collateralized loan obligations (CLOs) by regulated entities, and to put additional capital charges on insurance companies. In addition, specific steps could be taken linked to:

- *Money market mutual funds.* Floating net asset value rules for prime money market mutual funds would be particularly useful in mitigating the risk of runs and should be introduced for those funds which invest in government securities. Other alternatives could include imposing stricter liquidity requirements or investment restrictions. These options are being considered by the SEC and will possibly result in a new rule for such funds.

- *Tri-party repo markets***.** Stricter haircuts and margins would limit the risk of a pre-default sale of repo collateral (although the U.S. already imposes higher haircuts than the minimum defined by the Financial Stability Board). In addition, it will be important to press ahead in developing mechanisms to help counter the risk of 'fire sale' dynamics in the tri-party repo market.

- *Too important to fail.* The U.S. should continue to build on the Dodd-Frank Act provisions that allow for an orderly resolution of systemically important financial institutions. The remaining rules needed to fully implement the orderly liquidation authority for systemic nonbanks should be finalized. The resolution and recovery plans (submitted annually by the large banks) should be thoroughly assessed against severe contingencies that involve a large cross-border component. Progress is also needed in developing cooperative arrangements with regulators in other jurisdictions to manage the resolution of institutions with a significant cross-border presence, building on joint crisis planning exercises and in line with the principles of the Key Attributes of Effective Resolution Regimes. There is also a case for other large, interconnected, and complex financial institutions to be formally designated as systemically important in the insurance and asset management sectors.

- *Strengthening the macro-prudential framework.* Given the complexity of the U.S. regulatory structure, there are potentially large gains in establishing a smoother sharing of data and analysis among regulatory agencies and the Office of Financial Research. The macro-prudential framework could also be made more responsive to the build-up of systemic risk by clarifying how financial stability monitoring by the Office of Financial Research translates into FSOC recommendations and by instituting a timely and structured process for the various regulatory agencies to respond to FSOC recommendations.

Box 6. The Foreign Bank Organizations (FBO) Rule

By July 1, 2016 FBOs with more than $50 billion assets in U.S. bank and nonbank subsidiaries will be required to reorganize their U.S. operations under an intermediate holding company (IHC). The resulting IHC will become subject to a 3 percent Tier 1 leverage ratio and similar prudential standards on liquidity as U.S. Bank Holding Companies (BHCs). FBOs with assets between $10–50 billion will be subject to enhanced prudential standards.

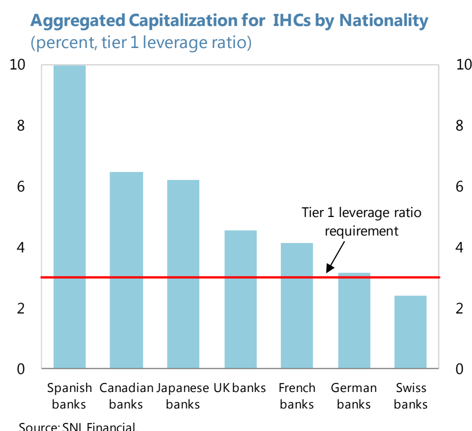
Currently, FBOs play a significant role in the U.S. financial system accounting for 15 percent of the total U.S. banking assets, approximately 40 percent of the reserves held at the Fed, around one-half of the U.S. corporate bond issuance, and one-third of equity trading. Of the 22 primary dealers for the Federal Reserve, 15 are FBOs.

Requiring FBOs to hold more capital and liquidity in the IHCs improves the resilience of the U.S. financial system and aligns FBO governance to U.S. BHC standards. The FBO rule appears to be consistent with Basel III standards and moves the U.S. closer to the capital and liquidity standards applied to investment banking subsidiaries of foreign banks in other jurisdictions (notably the Euro Area, where investment banking subsidiaries are subject to Basel capital requirements, and the U.K., where additional local liquidity requirements are applied to banking subsidiaries of non-U.K. banks).

By requiring IHCs to be separately capitalized within the U.S., the rule may reduce bank profitability at the parent level and induce organizational changes. The impact on U.S. *bank credit* will likely be minor (loans and portfolio holdings of FBOs account for less than 10 percent of lending). The effect on U.S. *capital markets* could be larger. FBO broker-dealer subsidiaries current have an estimated aggregate tier 1 leverage ratio of 1.6 percent and the higher leverage ratio requirement may cause some of these types of FBOs to scale down their U.S. operations rather than raise equity, perhaps moving some balance-sheet-intensive operations to other jurisdictions. This could mean lower liquidity in the U.S. equity and bond markets and higher transaction costs. Moreover, repo transactions will start to count towards total leverage on a gross basis (rather than net as the current rules prescribe) which could make some repo lending by FBOs uneconomic (particularly low margin, balance-sheet-intensive repos of Treasuries and Agency MBS).

Using the limited publicly available data on non-commercial bank subsidiaries as of year-end 2013, it appears that of the 14 FBOs that are likely to be required to form IHCs, 4 currently fail to meet the 3 percent Tier 1 leverage ratio. Assuming zero retained earnings or asset sales between now and July 1, 2016, the total capital shortfall to meet the Tier 1 leverage ratio would be about $17.4 billion (although this estimate is tentative given the lack of public data on the nature of FBO operations in the U.S.).

Aggregated Capitalization for IHCs by Nationality
(percent, tier 1 leverage ratio)



Source: SNL Financial.

47. ***Global spillovers***. Recent regulatory changes in the U.S.—including the Volcker rule and rules on FBOs—will lower financial stability risks and reduce the associated risks of negative spillovers from the U.S. In doing so, though, these changes may increase the capital costs of the market making and trading activities of foreign banks operating in the U.S. There is little evidence, at this stage, to conclude that the range of regulatory changes undertaken by the U.S. are adding to financial fragmentation or are balkanizing the global financial system. Such potential spillovers will, however, be a topic that will be examined further in the context of the upcoming Financial Stability Assessment Program (FSAP).

48. ***Financial integrity***. Initiatives are underway to strengthen financial institutions' requirements to identify and verify beneficial owners and to access information about beneficial ownership and control of U.S. corporations. These initiatives aim to prevent the abuse of legal persons and arrangements for financial crimes and to address deficiencies identified in the last Financial Action Task Force (FATF) mutual evaluation report of June 2006. However, these initiatives may only be implemented after 2015 and would imply an only modest improvement in the transparency of U.S. corporations and trusts. It will remain difficult, in particular, to pursue either the laundering of proceeds of foreign tax crimes taking place inside the U.S. or the use of U.S. corporations to commit tax crimes abroad.

49. ***Authorities' views***. Substantial progress has been made in the regulatory framework, in increasing capital and liquidity buffers, and reducing leverage in the financial system. The authorities also felt that the FSOC process was working well. Low interest rates could create potential financial stability risks but, at this stage, these appear not to be systemic and are limited to pockets of vulnerabilities. Nevertheless, low levels of market pricing of volatility were of concern. Officials underscored that interest and funding risks are being closely watched as are other areas including embedded risks in securities lending and the repo market. The authorities expected the Securities Exchange Commission (SEC) to soon issue rules to tackle risks in the money market mutual funds. The authorities indicated that work is under way to better understand risks in the asset management industry and to modernize the regulatory framework for the insurance sector. Officials noted that the U.S. is committed to adhering to its commitments under the G20 financial reform agenda and is encouraging other jurisdictions to do so also. This has included taking leadership in international derivatives regulation and building on international agreements on leverage ratios for banks. The authorities indicated that they are actively pursuing ways to make access to mortgages for creditworthy borrowers easier but, without passage of legislation, it would be difficult to fully resolve uncertainties on the future of the housing finance system. Finally, the authorities looked forward to the upcoming FSAP as a means to engage in a full assessment of the financial system and the U.S. approach to regulatory reform as well as to discuss the many changes made to the U.S. financial system since the 2010 FSAP.

STAFF APPRAISAL

50. ***Growth***. Recent data suggest a meaningful rebound in activity is now underway. This renewed dynamism will provide only a partial offset to the weak first quarter and GDP is projected to expand at 1.7 percent for 2014 as a whole. Barring unforeseen shocks, growth is expected to well exceed potential for the foreseeable future and, on an annual basis, should rise to 3 percent in 2015.

51. ***Jobs***. Employment growth has been healthy but labor markets are weaker than is implied by the headline unemployment number. Long-term unemployment and the rate of involuntary part-time work are high, labor force participation is well below what can be explained by demographic factors, and wages are stagnant. With better growth prospects, the U.S. should see steady progress in job creation but headline unemployment is expected to decline only slowly—in part because improving prospects will draw discouraged workers back into the labor force—and long-term unemployment will take time to fall back to historic levels.

52. ***Poverty***. Reducing poverty will require, first and foremost, a much more robust return to growth and job creation. However, other policies have a role to play. The recent expansion of Medicaid and the increase in health insurance coverage under the ACA have been concrete steps whose effect on poverty and health outcomes should become more evident over time. An expansion of the EITC (including making permanent the various extensions that are due to expire in 2017) would also raise living standards for the very poor. Finally, given its current low level, the minimum wage should be increased. This would help raise incomes for millions of working poor and would have strong complementarities with the suggested improvements in the EITC, working in tandem to ensure a meaningful increase in after-tax earnings for the nation's poorest households.

53. ***Productivity and labor supply***. To offset the expected slowdown in potential growth immediate steps should be taken to raise productivity, encourage innovation, augment human and physical capital, and increase labor force participation. Such measures should involve investments in infrastructure and education, improving the tax system, active labor market policies, a broad, skills-based approach to immigration reform, and efforts to fully capitalize on the gains from rising U.S. energy independence. No single measure will be sufficient and a manifold solution will certainly be required. There is no shortage of good ideas currently under public debate and so the challenge ahead will be to forge political agreement on specific legislation.

54. ***External assessment***. Assessed imbalances and fiscal policy gaps in the U.S. have improved considerably over the past few years, creating significant positive spillovers to the global economy. The move toward increased energy independence will have a further positive effect on the U.S. external accounts. The U.S. external position appears broadly consistent with medium-term fundamentals and desirable policies.

55. ***Fiscal policy***. The recent experience of debt ceiling brinkmanship and the government shut down once again illustrates the difficulty of finding political common ground on fiscal policy and the negative consequences—for both the U.S. and global economy—from political discord linked to

fiscal policies. The Bipartisan Budget Act, enacted in December 2013, and the subsequent raising of the debt ceiling were important steps to address fiscal risks and improve both the pace and distribution of near-term deficit reduction. Going forward, even in the absence of a fully articulated medium-term consolidation plan, there is room to build on this progress through the identification of targeted areas to expand the near-term budget envelope, funded by offsetting savings in future years. Specific near-term measures that should be supported—many of which were in the Administration's budget proposal—include front-loaded infrastructure spending, a better tax system, active labor market policies, and improving educational spending. Beyond this, further steps will be needed to put the general government debt on a sustainable longer-term path. This will require reaching political agreement on a credible and detailed medium-term fiscal consolidation path that includes measures to lower health care spending, restore solvency to the social security system, reform the tax system, and raise revenues. Finally, while not a panacea, changes to budget procedures—including switching to a two-year budget cycle—could have a lasting effect in lessening fiscal policy uncertainty.

56. ***Monetary policy***. The economy is expected to reach full employment only by end-2017 and inflationary pressures are expected to remain muted. If true, policy rates could afford to stay at zero for longer than the mid-2015 date currently foreseen by markets. Policy would, however, have to remain cognizant of burgeoning financial stability risks, particularly those that are inherently difficult to contain through available regulatory and supervisory tools. If inflation were to rise more rapidly than expected and the economy was still well below full employment, tolerating a modest, temporary rise of inflation above the longer-term goal could be consistent with the Fed's balanced approach as long as inflation expectations remained anchored and financial stability risks were low. There could also be scope to enhance the Fed's communications toolkit. Given the global spillovers from U.S. monetary policy, a well-communicated normalization of U.S. monetary conditions, in the context of robust U.S. growth, would be positive for the global economy.

57. ***Financial stability risks***. Over the past few years, much has been done to reduce financial system risks: the banks are stronger, corporate balance sheets are healthy, leverage has been contained, and the regulatory framework has been greatly improved. Nevertheless, the prolonged period of very low interest rates continues to raise financial stability concerns, particularly related to activities in the so-called "shadow" banks and in other nonbank intermediaries. Steps that could be taken to tackle these risks and lessen the likelihood of negative spillovers to the global economy include tighter underwriting standards, higher risk weights, tighter limits on large exposures to riskier assets, and stronger prudential norms for the holding of securitized loans by regulated entities. Addressing the remaining vulnerabilities of the money market funds and of the tri-party repo market also remains a priority. In addition, the U.S. should continue to implement measures that allow for the orderly resolution of too-important-to-fail financial institutions, including through deepening cooperation with other jurisdictions to manage the resolution of institutions with a significant cross-border presence. The insurance sector warrants particular attention and would benefit from stronger and more uniform capital adequacy and solvency oversight standards, refinement and harmonization of stress testing exercises, greater efforts to close data gaps, further designation of systemically important firms, and a larger federal role in insurance regulation and oversight. The U.S. should

continue to play a lead role in advancing the global regulatory reform agenda, ensuring consistency with international rules and best practices, and limiting the opportunities for regulatory arbitrage while remaining attuned to the spillover implications of regulatory changes on the international financial system.

58. ***Housing finance***. Limited availability of mortgage financing is a pressing constraint on economic growth. Policy efforts have been made to encourage greater availability of mortgage credit. However, the recovery of mortgage lending to lower-rated borrowers is likely to be a slow process. Legislative changes that clarify the future role of government in housing finance would help. While reaching agreement on legislation will be hard, in anticipation of broader legislative actions, many of these objectives can still be realized in the medium term through administrative action including expanding the use of market transactions to transfer first-loss risks from the agencies to private investors; moving gradually to higher and more risk-based guarantee fees; steadily building up capital within the agencies while reducing their role in housing finance; and establishing a single securitization platform.

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

Table 1. Selected Economic Indicators 1/

(percentage change from previous period, unless otherwise indicated)

	2012	2013	2014	2015	2016	2017	2018	2019
			Projections					
National production and income								
Real GDP	2.8	1.9	1.7	3.0	3.0	2.9	2.8	2.6
Net exports 2/	0.1	0.1	-0.2	-0.2	-0.3	-0.2	-0.1	-0.1
Total domestic demand	2.6	1.7	1.8	3.2	3.2	3.1	2.8	2.7
Private final consumption	2.2	2.0	2.2	2.9	2.8	2.7	2.7	2.7
Public consumption expenditure	-0.2	-2.0	-0.6	0.2	0.2	0.5	0.7	1.0
Gross fixed domestic investment	5.5	2.9	2.4	6.3	7.1	6.1	4.4	3.3
Private fixed investment	8.3	4.5	3.5	7.1	8.0	6.7	4.7	3.4
Equipment and software	7.6	3.1	3.9	6.7	7.9	7.3	6.7	4.1
Intellectual property products	3.4	3.1	4.0	3.3	4.0	3.8	3.7	3.0
Nonresidential structures	12.7	1.3	2.2	5.6	5.0	2.7	2.6	2.4
Residential structures	12.9	12.2	3.2	13.4	14.6	11.2	4.2	3.4
Public fixed investment	-4.0	-3.2	-2.1	2.5	2.7	3.2	3.0	2.9
Change in private inventories 2/	0.2	0.2	-0.1	0.1	0.0	0.0	0.0	0.0
Nominal GDP	4.6	3.4	3.3	4.9	4.9	5.0	4.8	4.7
Personal saving rate (percent of disposable income)	5.6	4.5	4.3	4.0	4.2	4.3	4.1	4.0
Private investment rate (percent of GDP)	15.2	15.9	16.1	16.8	17.6	18.1	18.5	18.6
Employment and inflation								
Unemployment rate	8.1	7.4	6.4	6.0	5.8	5.6	5.5	5.5
CPI inflation	2.1	1.5	1.8	1.8	1.9	2.0	2.0	2.0
Core CPI Inflation	2.1	1.8	1.8	1.9	2.0	2.1	2.0	2.0
PCE Inflation	1.8	1.1	1.5	1.6	1.6	1.8	1.9	2.0
Core PCE Inflation	1.8	1.2	1.4	1.7	1.7	1.8	1.9	2.0
GDP deflator	1.7	1.5	1.6	1.8	1.9	2.0	2.0	2.0
Output gap (percent of potential GDP)	-4.0	-3.8	-4.0	-2.9	-2.0	-1.1	-0.6	0.0
Interest rates (percent)								
Three-month Treasury bill rate	0.1	0.1	0.1	0.3	1.2	2.2	3.3	3.8
Ten-year government bond rate	1.8	2.4	2.7	3.3	4.0	4.5	5.0	5.1
Balance of payments								
Current account balance (percent of GDP)	-2.8	-2.4	-2.4	-2.6	-2.8	-2.8	-2.8	-2.7
Export volume 3/	3.8	2.3	1.7	4.7	5.3	5.5	5.8	5.4
Import volume 3/	2.1	1.2	2.3	5.4	6.1	5.9	5.5	5.0
Net international investment position (percent of GDP)	-23.8	-27.2	-28.7	-29.5	-30.4	-31.3	-32.1	-32.8
Saving and investment (percent of GDP)								
Gross national saving	16.2	17.1	17.1	17.6	18.2	18.8	19.2	19.4
General government	-5.3	-2.8	-2.7	-2.0	-1.7	-1.4	-1.4	-1.7
Private	21.6	19.9	19.8	19.6	19.9	20.2	20.6	21.0
Personal	4.2	3.3	3.2	3.0	3.1	3.2	3.0	2.9
Business	17.3	16.6	16.7	16.7	16.8	17.1	17.6	18.2
Gross domestic investment	19.0	19.5	19.6	20.2	21.0	21.6	21.9	22.1
Private	15.2	15.9	16.1	16.8	17.6	18.1	18.5	18.6
Public	3.8	3.6	3.5	3.5	3.4	3.4	3.5	3.5

Sources: IMF staff estimates.

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

2/ Contribution to real GDP growth, percentage points.

3/ NIPA basis, goods.

Table 2. Balance of Payments
(annual percent change unless otherwise indicated)

	2012	2013	Projections 2014	2015	2016	2017	2018	2019
			(annual percent change)					
Real exports growth:								
Goods and services	3.5	2.7	1.7	4.4	5.0	5.2	5.3	5.0
Goods	3.8	2.3	1.7	4.7	5.3	5.5	5.8	5.4
Services	3.0	3.5	1.6	3.8	4.2	4.4	4.2	4.0
Real imports growth								
Goods and services	2.2	1.4	2.3	5.1	5.7	5.5	5.2	4.7
Goods	2.1	1.2	2.3	5.4	6.1	5.9	5.5	5.0
Nonpetroleum goods	4.8	3.1	3.2	7.2	7.6	6.9	6.4	5.7
Petroleum goods	-8.2	-7.3	-2.0	-4.3	-3.2	-1.7	-1.3	-0.5
Services	2.7	2.5	2.2	3.8	4.0	3.9	3.6	3.3
Net exports contribution to real GDP growth	0.1	0.1	-0.2	-0.2	-0.3	-0.2	-0.1	-0.1
			(percent of GDP)					
Nominal exports								
Goods and services	13.5	13.5	13.4	13.4	13.4	13.6	13.7	13.9
Nominal imports								
Goods and services	16.9	16.4	16.3	16.3	16.4	16.6	16.7	16.8
Current account								
Current account balance	-2.8	-2.4	-2.4	-2.6	-2.8	-2.8	-2.8	-2.7
Balance on trade in goods and services	-3.3	-2.8	-2.8	-2.8	-2.9	-2.9	-2.9	-2.8
Balance on income	1.2	1.2	1.1	1.0	0.9	0.8	0.8	0.9
Capital and Financial Account								
Balance on financial account	2.6	2.2	2.2	2.6	2.8	2.8	2.8	2.7
Foreign direct investment abroad	-2.0	-2.1	-1.8	-1.9	-1.9	-1.9	-1.9	-1.9
Foreign direct investment in the U.S.	1.1	1.4	-0.1	0.5	0.5	0.5	0.5	0.5
Foreign acquisition of U.S. securities	2.5	1.7	3.3	2.8	2.9	2.9	2.8	2.9
Foreign acquisition of other U.S. liabilities	-2.6	0.9	1.0	1.1	1.3	1.3	1.2	1.1
Net foreign direct investment	-1.0	-0.7	-1.9	-1.4	-1.4	-1.4	-1.4	-1.4
Net portfolio investment	3.9	0.8	2.2	1.8	1.9	1.9	1.9	1.9
Portfolio investment assets	-1.0	-2.6	-2.5	-2.6	-2.5	-2.5	-2.5	-2.5
Memo:								
Current account balance in billions of dollars	-461	-400	-423	-477	-531	-561	-582	-588
Non-oil trade balance in percent of GDP	-1.5	-1.5	-1.6	-1.8	-2.0	-2.1	-2.1	-2.1
Broad real dollar, index	84.4	84.6	85.8	85.8	85.8	85.8	85.8	85.8
Foreign real GDP growth, pct chg, a.r.	2.7	2.5	2.8	3.2	3.3	3.3	3.2	3.2
U.S. real GDP growth, pct chg, s.a.a.r.	2.8	1.9	1.7	3.0	3.0	2.9	2.8	2.6
U.S. real total domestic demand growth, saar	2.6	1.7	1.8	3.2	3.2	3.1	2.8	2.7

Sources: IMF staff estimates.

Table 3. Federal and General Government Finances
(percent of GDP)

		Projections										
	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
Federal government (staff)	(fiscal years; budget basis)											
Revenue	16.7	17.4	17.9	18.0	17.8	17.7	17.6	17.7	17.7	17.8	17.9	18.0
Expenditure	21.2	20.9	21.0	21.2	21.0	20.8	21.1	21.3	21.6	22.2	22.2	22.2
Non-interest	19.8	19.6	19.5	19.5	19.1	18.6	18.6	18.6	18.7	19.0	18.9	18.7
Interest exp	1.3	1.3	1.5	1.7	1.9	2.2	2.5	2.7	2.9	3.2	3.4	3.5
Budget balance 1/	-4.5	-3.5	-3.1	-3.2	-3.1	-3.1	-3.5	-3.7	-3.9	-4.4	-4.4	-4.2
Primary balance 2/	-3.1	-2.2	-1.6	-1.5	-1.2	-0.9	-1.0	-1.0	-1.0	-1.2	-1.0	-0.7
Primary structural balance 3/ 4/	-2.1	-1.2	-0.9	-1.0	-0.9	-0.8	-0.9	-1.0	-1.0	-1.2	-1.0	-0.7
Change	2.1	0.9	0.4	-0.1	0.1	0.2	-0.2	0.0	0.0	-0.2	0.2	0.3
Federal debt held by the public	72.0	74.2	74.5	74.6	74.5	74.4	74.7	75.4	76.6	78.1	79.7	81.0
General government (staff)	(calendar years; GFSM2001 basis)											
Revenue	30.8	31.5	32.1	32.1	32.0	31.8	31.7	31.7	31.8	31.9	32.0	
Expenditure	37.6	38.2	37.8	37.6	37.1	37.0	37.1	37.3	37.6	38.0	38.0	
Net interest	3.2	3.2	3.2	3.3	3.4	3.6	3.8	3.9	4.1	4.3	4.5	
Net lending 1/	-6.8	-6.6	-5.7	-5.4	-5.1	-5.1	-5.4	-5.5	-5.8	-6.1	-6.0	
Primary balance 2/	-3.6	-3.5	-2.5	-2.1	-1.7	-1.5	-1.6	-1.6	-1.7	-1.7	-1.5	
Primary structural balance 3/ 4/	-2.6	-1.9	-1.3	-1.4	-1.2	-1.3	-1.6	-1.6	-1.7	-1.7	-1.5	
Change	1.5	0.7	0.5	0.0	0.1	-0.1	-0.3	-0.1	0.0	0.0	0.2	
Gross debt	104.0	105.8	106.0	106.0	106.0	106.0	106.2	106.8	107.9	109.2	110.7	
Gross debt incl. unfunded pension liabilities	122.5	124.2	124.3	124.2	124.1	124.0	124.1	124.6	125.6	126.8	128.2	
Memorandum items:												
Federal government deficit (authorities)												
President's FY2015 Budget	-4.1	-3.7	-3.1	-2.8	-2.3	-1.9	-2.3	-2.2	-2.1	-2.1	-1.8	-1.6
CBO's Assessment of the Budget	-4.1	-2.9	-2.8	-2.9	-2.7	-2.6	-3.0	-3.1	-3.1	-3.3	-3.0	-2.8
CBO Baseline Scenario (current law)	-4.1	-2.9	-2.6	-2.8	-2.9	-3.0	-3.3	-3.5	-3.7	-4.0	-3.9	-3.7
Federal government debt (authorities)												
President's FY2015 Budget	72.1	74.4	74.6	74.3	73.5	72.4	72.0	71.6	71.1	70.6	69.9	69.0
CBO's Assessment of the Budget	72.1	73.8	73.6	73.1	72.6	72.3	72.5	72.9	73.3	73.9	74.2	74.3
CBO Baseline Scenario (current law)	72.0	74.1	73.9	73.6	73.3	73.1	73.4	73.8	74.6	75.7	76.6	77.3

Sources: Congressional Budget Office; Office of Management and Budget; and IMF staff projections.

Note: Staff baseline counts in the savings from the reduction in overseas contingency operations and assumes that current tax policies are mostly extended (with the notable exception of bonus depreciation), Medicare payment rates are held constant, and automatic spending cuts are replaced with back-loaded measures (at the same proportion in FY2016 and latter years as the replacement achieved for FY2014 and FY2015 by the Bipartisan Budget Act of 2013). By contrast, the President's Budget assumes only a few of the current tax policies will be extended (Earned Income Tax Credit and Child Tax Credit provisions extended under the American Taxpayer Relief Act of 2012 and due to expire in 2017) and the policy measures proposed by the Administration (including capping of deductions for higher-income taxpayers and immigration reform) will be implemented. CBO baseline does not count in the savings from the reduction in overseas contingency operations and assumes that expiring tax provisions are not extended, Medicare payment rates are reduced, and automatic spending cuts take place as currently written in law. The President's Budget uses the OMB macroeconomic assumptions. CBO uses CBO macroeconomic assumptions both for its own baseline and its assessment of the President's Budget.

1/ Includes staff's adjustments for one-off items, incl. costs of financial sector support.

2/ Excludes net interest.

3/ Excludes net interest, effects of economic cycle, and costs of financial sector support.

4/ In percent of potential GDP.

Table 4a. General Government Statement of Operations
(percent of GDP)

	2007	2008	2009	2010	2011	2012	2013
Revenue	31.7	30.2	28.4	28.8	29.0	29.0	30.8
Taxes	20.6	19.1	17.0	17.6	18.5	18.8	19.3
Social contributions	6.7	6.7	6.7	6.6	5.9	5.9	6.6
Grants	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other revenue	4.3	4.3	4.6	4.6	4.6	4.3	4.9
Expenditure 1/	35.7	38.0	43.1	41.3	40.1	38.7	37.6
Expense	34.0	36.3	41.3	39.6	38.7	37.5	36.6
Compensation of employees	9.5	9.8	10.3	10.3	10.0	9.6	9.3
Use of goods and services	5.8	6.2	6.5	6.5	6.3	6.1	5.7
Consumption of fixed capital	2.4	2.5	2.7	2.7	2.7	2.7	2.6
Interest	3.7	3.5	3.8	3.9	4.0	3.9	3.8
Subsidies	0.4	0.4	0.4	0.4	0.4	0.4	0.3
Grants	0.3	0.3	0.4	0.3	0.4	0.3	0.3
Social benefits	11.8	12.7	14.7	15.0	14.7	14.4	14.4
Of which: Social security benefits	7.5	8.0	9.3	9.3	9.1	9.0	9.0
Expense not elsewhere classified	0.2	0.9	2.5	0.5	0.3	0.2	0.1
Net acquisition of nonfinancial assets	1.7	1.7	1.8	1.7	1.4	1.2	1.0
Net operating balance 2/	-2.3	-6.1	-12.9	-10.8	-9.6	-8.5	-5.8
Net lending/borrowing 1/	-4.0	-7.8	-14.7	-12.5	-11.0	-9.7	-6.8
Of which: Imputed interest on unfunded pension liabilities	0.7	0.7	1.2	1.1	1.1	1.1	
Net acquisition of financial assets	1.1	3.1	1.0	2.0	-1.3	0.3	1.3
Net incurrence of liabilities	4.3	11.2	13.9	13.8	9.8	8.9	7.2

Source: Government Finance Statistics; IMF staff calculations.

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

2/ Revenue minus expense.

Table 4b. General Government Financial Assets and Liabilities
(percent of GDP)

	2007	2008	2009	2010	2011	2012	2013
Net worth	15.1	3.5	-9.4	-19.4	-26.6	-29.8	-28.0
Nonfinancial assets	71.4	74.9	76.9	77.0	78.1	77.0	76.8
Net financial worth	-56.3	-71.4	-86.3	-96.4	-104.6	-106.8	-104.9
Financial assets	19.6	20.6	18.8	19.0	16.1	15.7	16.9
Currency and deposits	2.6	4.9	4.0	4.9	3.3	3.4	3.8
Securities other than shares	5.6	5.6	6.5	6.3	5.1	4.4	4.3
Loans	4.4	4.5	5.7	6.5	7.1	7.5	8.0
Shares and other equity	2.5	1.5	-2.4	-3.2	-3.9	-3.9	-3.6
Financial derivatives	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Insurance technical reserves	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other accounts receivable	4.4	4.1	4.5	4.3	4.2	4.1	4.1
Financial liabilities	75.9	92.0	105.1	115.4	120.7	122.5	121.7
Special Drawing Rights (SDRs)	0.1	0.1	0.4	0.4	0.4	0.4	0.4
Currency and deposits	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Securities other than shares	57.0	65.3	78.1	86.6	90.7	94.1	96.1
Loans	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Shares and other equity	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial derivatives	13.1	20.5	20.5	22.2	23.4	21.8	18.9
Insurance technical reserves	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other accounts receivable	5.5	5.8	5.8	5.9	6.0	6.0	6.2

Source: Government Finance Statistics.

Annex I. Risk Assessment Matrix: Potential Deviations from Baseline[1]

Nature/Source of Risk	Overall Level of Concern	
	Likelihood of Realization	**Expected Impact if Risk Materializes**
1. Faster increase in interest rates	**Medium** The Fed may raise policy rates at a faster-than-expected pace because inflation picks up earlier and/or because of heightened concerns on the financial stability effects of low interest rates. Recent compression in volatility and risk premia could unwind.	**Medium** A 50 bps permanent increase in 10-year interest rates could subtract about ½ percent of GDP after two years. Spikes in term premia could imply greater output losses.
2. Distortions from a protracted period of low interest rates	**Low** Continued search for yield could lead to excess leverage, weaker underwriting standards and potential mispricing of risk.	**High** If unaddressed, distortions could lead to financial instability with significant economic costs and large spillovers to the rest of the world.
3. Recovery in private investment	**Medium** Greater confidence in future economic prospects could cause private investment to recover at a faster pace than in the baseline.	**Medium** A 5 percentage point increase in private investment growth would add about ¾ percentage points to GDP growth.
4. Labor market recovery	**Medium** The labor markets could surprise on the upside, especially if labor force participation were to rebound more than expected.	**Medium** Employment growth of around 1½ percent would be consistent with GDP growth that is ¼ percentage point higher than the baseline.
5. Protracted period of slower growth (and lower inflation) in advanced and emerging economies	**High** Lower-than-anticipated potential growth and persistently low inflation leads to secular stagnation in advanced economies. Maturing of the cycle, misallocation of investment, and incomplete structural reforms leads to prolonged slower growth in emerging markets.	**Medium** Slower growth in advanced and emerging economies could subtract about ½ percent of GDP after two years.

[1] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

Nature/Source of Risk	Overall Level of Concern	
	Likelihood of Realization	**Expected Impact if Risk Materializes**
6. Increasing geopolitical tensions/risks surrounding Russia/ Ukraine or the Middle East	**Medium** A sharp increase in geopolitical tensions surrounding Russia/Ukraine that creates significant disruptions in global financial, trade and commodity markets. Heightened geopolitical risks in the Middle East, leading to a sharp rise in oil prices.	**Low** A rise in oil prices would have a negative impact on the U.S. with a possible flight to safety resulting in dollar appreciation. A sustained 15 percent increase in oil prices above baseline would subtract about 0.2 percent of GDP after two years.
7. Failure to pass budget and raise debt limit in 2015	**Low** The federal borrowing limit is not raised or the budget is not passed in 2015 owing to political gridlock.	**High** The economic cost of failure to raise debt limit would be potentially catastrophic depending on how long the impasse lasts with severe global spillovers.
8. U.S. bond market stress	**Low** Policymakers do not take sufficient measures to put debt on a sustainable trajectory. The lack of fiscal sustainability triggers a sharp rise in the sovereign risk premium.	**High** A 200bps increase in the benchmark Treasury yields would subtract 2.5 and 1.5 percentage points from U.S. growth in 2015 and 2016, respectively.

Annex II. Public Debt Sustainability Analysis (DSA)

The budget deficit in the United States has been reduced significantly since 2011. Yet, the public debt ratio remains on an unsustainable trajectory. Under the baseline scenario, general government gross debt is projected to briefly stabilize in 2015–18 at about 106 percent of GDP but starts rising again as spending pressures on entitlement programs rise and interest rates normalize. The public debt dynamics are highly sensitive to growth and interest rate assumptions, primarily reflecting the fact that the U.S. public debt ratio already exceeds 100 percent of GDP. Gross financing needs are large but manageable given the safe haven status of the United States. A medium-term, credible consolidation plan remains a key policy priority.

Background

About $2.8 trillion in medium-term fiscal consolidation measures were legislated in 2011–13 to tackle the high public debt ratio, which has doubled at the federal government level since 2007 as a result of the financial crisis and the ensuing recession.

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

b. Additional savings worth $1.2 trillion over 10 years were triggered by the failure of the Congressional Committee on Deficit Reduction in November 2011. These cuts took effect in March 2013 through cancellation of budget authority ("sequestration") in FY2013. The Bipartisan Budget Act of December 2013 partially reversed the cuts scheduled to take place in FY2014 and FY2015 but still kept three-fourths of the cuts in place and made up for the partial reversal by extending certain direct spending cuts scheduled to end in FY2021 to FY2022 and FY2023. The cuts in FY2014–23 will be executed through caps on appropriation levels.

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

Despite the substantial deficit reduction achieved so far and the legislated savings in the pipeline, U.S. public finances remain on an unsustainable trajectory.

Assessment

The baseline. For the purposes of the 10-year fiscal projections, real GDP growth is assumed to converge to the potential beyond the standard 5-year WEO horizon. Under staff's baseline projection which, in addition to the legislated budgetary savings, includes the savings from the drawdown of overseas contingency operations and removal of emergency funding for disaster relief, the debt ratio temporarily stabilizes in 2015–18. However, the debt ratio starts rising again at the end of the decade given the spending pressures from an aging population and excess cost growth in the health care sector (even taking into account the more optimistic trend growth based on the recent slowdown in health care expenditure growth rate). Federal debt held by the public is projected to increase from 72 percent of GDP now to 81 percent of GDP in FY2024, with general government gross debt approaching 111 percent of GDP by CY2023.

Debt servicing costs. The fiscal projections are being substantially improved by the current favorable interest rate-growth differential. Reflecting accommodative monetary policy and the safe haven status of the United States, real interest rates have fallen well below GDP growth. Under staff's baseline, as monetary policy normalizes, the average interest rate is projected to rise gradually from the current historical lows and reach about 5¼ percent by 2023 (compared to a pre-crisis average of 6½ percent). As a result, real interest rates will become a major debt-creating flow after 2019. In staff's view, aiming for a medium-term primary surplus of about 1¼ percent of GDP would be appropriate to put the public debt ratio firmly on a downward path. The target primary surplus would be even higher in the long run to bring the debt ratio closer to the pre-crisis levels by 2030.

Realism. Baseline economic assumptions and fiscal projections are generally within the error band observed for all countries. While ambitious, the projected fiscal adjustment is realistic based on the consolidation episodes observed in 1990–2011.

Stress tests. The public debt dynamics are highly sensitive to growth and interest rate assumptions, primarily reflecting the fact that the U.S. public debt ratio already exceeds 100 percent of GDP. An increase of 200 basis points in the sovereign risk premium would mean a debt ratio that is about 17 percentage points above the baseline. If real GDP growth turns out to be one standard deviation below the baseline, the public debt would reach 122 percent of GDP in 2023. A scenario involving a 1 percentage slippage in the planned consolidation over the next two years would lead to a gross debt-to-GDP ratio of 116 percent in 2023. A combined macro-fiscal shock could raise the public debt ratio as high as 137 percent of GDP by the end of the 10-year horizon. An exchange rate shock is unlikely to have important implications for debt sustainability in the United States given that all debt is denominated in local currency and the reserve currency status of the dollar.

Mitigating factors. The depth and liquidity of the U.S. Treasury market as well as its safe haven status at times of distress represent a mitigating factor for relatively high external financing requirements.

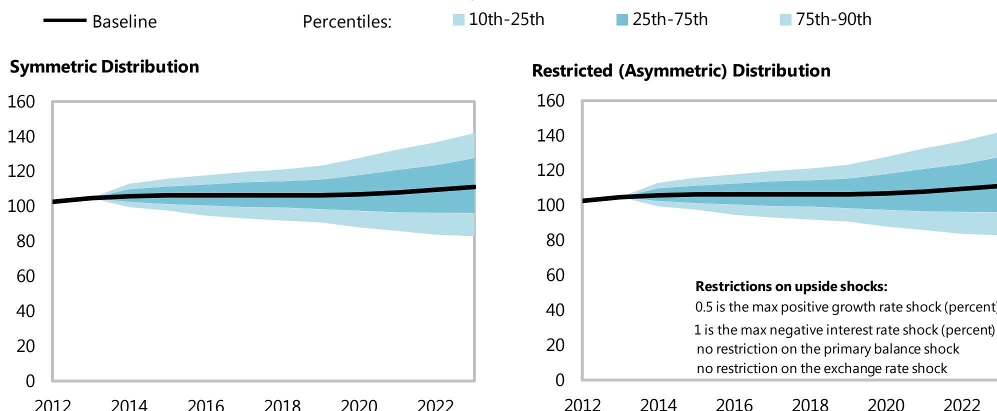
Annex Table 1. United States: Public DSA—Risk Assessment

Heat Map

Debt level 1/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs 2/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile 3/	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

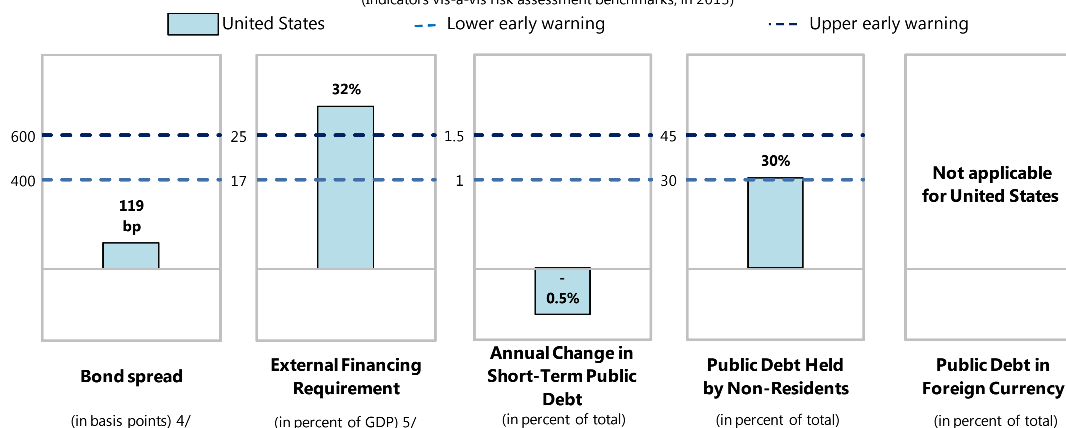
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2013)



Bond spread	External Financing Requirement	Annual Change in Short-Term Public Debt	Public Debt Held by Non-Residents	Public Debt in Foreign Currency
(in basis points) 4/	(in percent of GDP) 5/	(in percent of total)	(in percent of total)	(in percent of total)

Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 85% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 20% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.
Lower and upper risk-assessment benchmarks are:

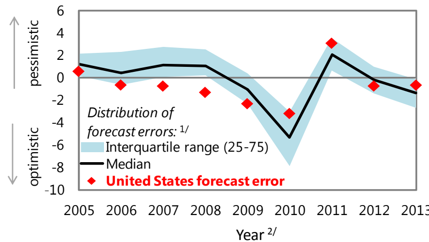
400 and 600 basis points for bond spreads; 17 and 25 percent of GDP for external financing requirement; 1 and 1.5 percent for change in the share of short-term debt; 30 and 45 percent for the public debt held by non-residents.

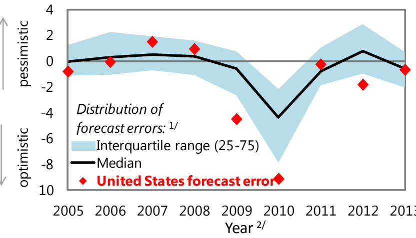
4/ Long-term bond spread over German bonds, an average over the last 3 months, 03-Apr-13 through 02-Jul-13.

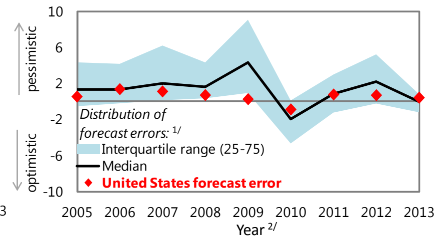
5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

Annex Table 2. United States: Public DSA—Realism of Baseline Assumptions

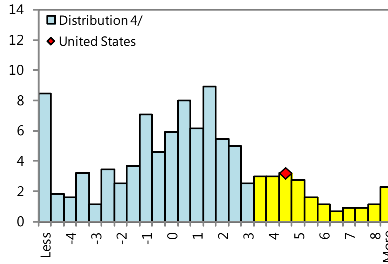
Forecast Track Record, versus all countries

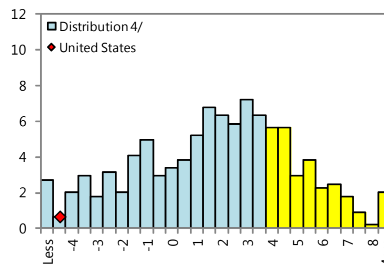




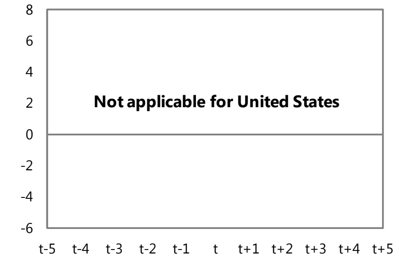


Assessing the Realism of Projected Fiscal Adjustment





Boom-Bust Analysis 3/



Source : IMF staff.

1/ Plotted distribution includes all countries, percentile rank refers to all countries.

2/ Projections made in the spring WEO vintage of the preceding year.

3/ Not applicable for United States, as it meets neither the positive output gap criterion nor the private credit growth criterion.

4/ Data cover annual observations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Annex Table 3. United States: Public DSA—Baseline Scenario

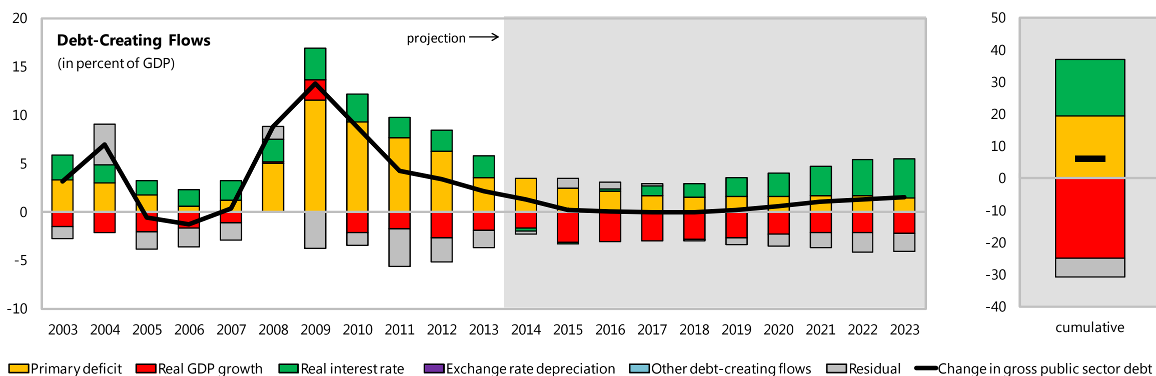
Debt, Economic and Market Indicators [1/]

	Actual			Projections									
	2003-2011 [2/]	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Nominal gross public debt	74.4	102.4	104.5	105.8	106.0	106.0	106.0	106.0	106.2	106.8	107.9	109.2	110.7
Public gross financing needs	18.2	26.2	24.2	24.1	25.6	25.6	23.4	22.2	21.2	20.2	19.7	19.5	20.6
Real GDP growth (in percent)	1.7	2.8	1.9	1.7	3.0	3.0	2.9	2.8	2.6	2.3	2.1	2.1	2.1
Inflation (GDP deflator, in percent)	2.2	1.7	1.5	1.6	1.8	1.9	2.0	2.0	2.0	2.1	2.0	2.0	2.0
Nominal GDP growth (in percent)	4.0	4.6	3.4	3.3	4.9	4.9	5.0	4.8	4.7	4.4	4.1	4.1	4.1
Effective interest rate (in percent) [4/]	5.6	4.1	3.8	1.4	1.6	2.2	3.0	3.5	4.0	4.5	5.0	5.6	5.9

As of July 02, 2013		
Sovereign Spreads		
EMBIG (bp) 3/		134
5Y CDS (bp)		16
Ratings	Foreign	Local
Moody's	Aaa	Aaa
S&Ps	AA+	AA+
Fitch	AAA	AAA

Contribution to Changes in Public Debt

	Actual			Projections											
	2003-2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	4.8	3.4	2.2	1.3	0.2	0.1	0.0	0.0	0.2	0.6	1.1	1.3	1.5	6.2	
Identified debt-creating flows	6.0	5.9	3.9	1.5	-0.8	-0.7	-0.3	0.2	0.9	1.8	2.6	3.3	3.4	12.0	
Primary deficit	4.8	6.3	3.6	3.5	2.5	2.1	1.7	1.5	1.6	1.6	1.7	1.7	1.5	19.5	1.9
Primary (noninterest) revenue and grants	29.1	28.5	30.3	31.0	31.5	31.5	31.2	31.0	30.8	30.8	30.8	30.9	31.0	310.5	
Primary (noninterest) expenditure	34.0	34.8	33.8	34.5	34.0	33.6	32.9	32.5	32.5	32.4	32.5	32.7	32.5	330.0	
Automatic debt dynamics [5/]	1.1	-0.4	0.4	-2.0	-3.3	-2.8	-2.0	-1.4	-0.7	0.1	1.0	1.6	1.9	-7.5	
Interest rate/growth differential [6/]	1.1	-0.4	0.4	-2.0	-3.3	-2.8	-2.0	-1.4	-0.7	0.1	1.0	1.6	1.9	-7.5	
Of which: real interest rate	2.2	2.2	2.2	-0.3	-0.2	0.3	1.0	1.4	1.9	2.4	3.1	3.7	4.1	17.4	
Of which: real GDP growth	-1.1	-2.6	-1.9	-1.7	-3.1	-3.1	-3.0	-2.8	-2.7	-2.3	-2.1	-2.1	-2.2	-24.9	
Exchange rate depreciation [7/]	0.0	0.0	0.0	...	...	...	...	...	...	...	...	...	...	...	
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8/]	-1.1	-2.5	-1.8	-0.3	1.0	0.7	0.2	-0.2	-0.7	-1.2	-1.6	-2.0	-1.9	-5.8	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

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

6/ The real interest rate contribution is derived from the numerator in footnote 5 as $r - \pi(1+g)$ and the real growth contribution as $-g$.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as $ae(1+r)$.

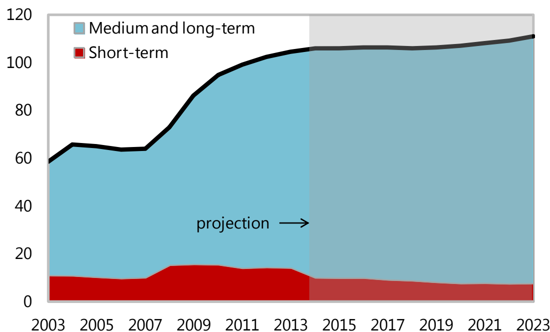
8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

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

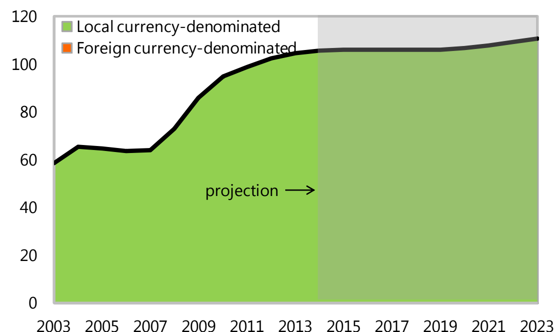
Annex Table 4. United States: Public DSA—Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



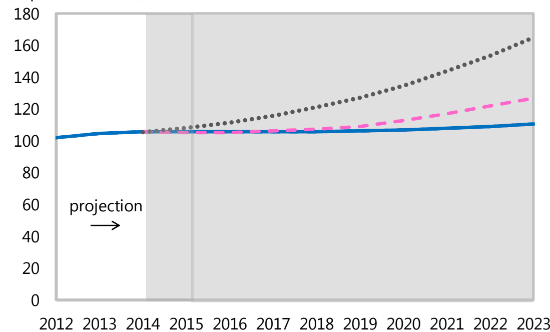
By Currency
(in percent of GDP)



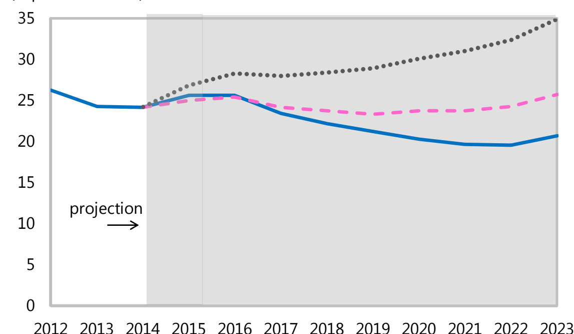
Alternative Scenarios

Baseline — Historical — Constant Primary Balance

Gross Nominal Public Debt
(in percent of GDP)



Public Gross Financing Needs
(in percent of GDP)



Underlying Assumptions
(in percent)

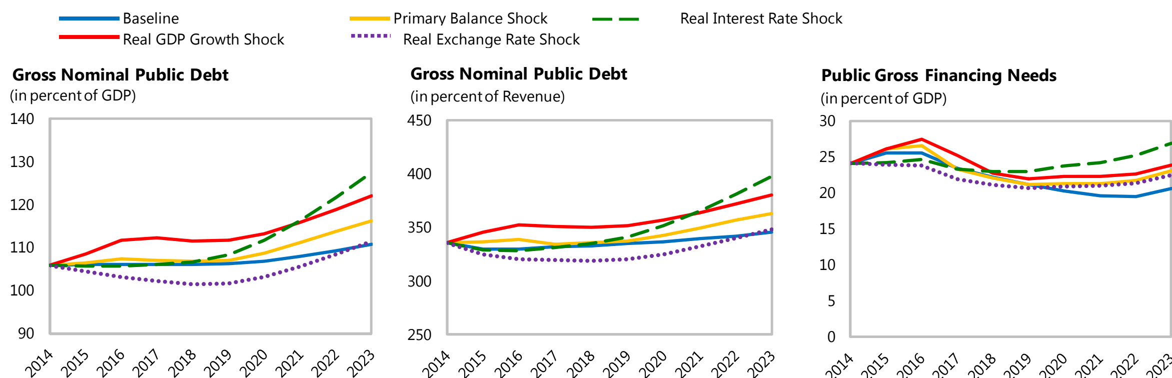
Baseline Scenario	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Real GDP growth	1.7	3.0	3.0	2.9	2.8	2.6	2.3	2.1	2.1	2.1
Inflation	1.6	1.8	1.9	2.0	2.0	2.0	2.1	2.0	2.0	2.0
Primary balance	-3.5	-2.5	-2.1	-1.7	-1.5	-1.6	-1.6	-1.7	-1.7	-1.5
Effective interest rate	1.4	1.6	2.2	3.0	3.5	4.0	4.5	5.0	5.6	5.9
Constant Primary Balance Scenario										
Real GDP growth	1.7	3.0	3.0	2.9	2.8	2.6	2.3	2.1	2.1	2.1
Inflation	1.6	1.8	1.9	2.0	2.0	2.0	2.1	2.0	2.0	2.0
Primary balance	-3.5	-3.5	-3.5	-3.5	-3.5	-3.5	-3.5	-3.5	-3.5	-3.5
Effective interest rate	1.4	1.6	2.2	3.0	3.5	4.0	5.2	5.7	6.1	6.3

Historical Scenario	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Real GDP growth	1.7	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8
Inflation	1.6	1.8	1.9	2.0	2.0	2.0	2.1	2.0	2.0	2.0
Primary balance	-3.5	-5.0	-5.0	-5.0	-5.0	-5.0	-5.0	-5.0	-5.0	-5.0
Effective interest rate	1.4	1.6	2.6	3.9	4.7	5.6	7.0	7.6	8.2	8.5

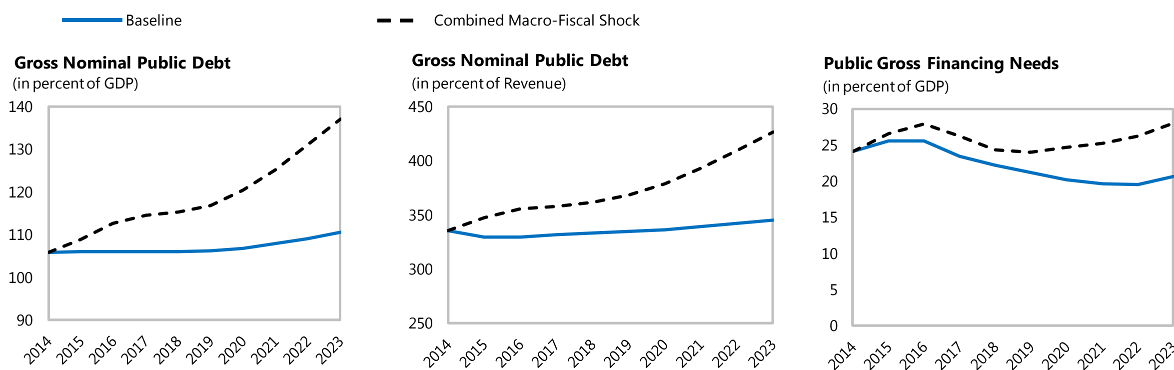
Source: IMF staff.

Annex Table 5. United States: Public DSA—Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions
(in percent)

Primary Balance Shock	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Real GDP growth	1.7	3.1	3.1	3.0	2.8	2.6	2.3	2.1	2.1	2.1
Inflation	1.6	1.8	1.9	2.0	2.0	2.0	2.1	2.0	2.0	2.0
Primary balance	-3.5	-4.3	-4.0	-1.7	-1.5	-1.6	-1.6	-1.7	-1.7	-1.5
Effective interest rate	1.4	1.6	2.2	3.1	3.6	4.1	5.3	5.8	6.3	6.5
Real Interest Rate Shock										
Real GDP growth	1.7	1.8	2.0	2.3	2.4	2.4	2.1	1.9	1.9	1.9
Inflation	1.6	1.8	1.9	2.0	2.0	2.0	2.1	2.0	2.0	2.0
Primary balance	-3.5	-2.5	-2.1	-1.7	-1.5	-1.6	-1.6	-1.7	-1.7	-1.5
Effective interest rate	1.4	1.6	2.5	3.7	4.5	5.3	6.8	7.5	8.2	8.5
Combined Shock										
Real GDP growth	1.7	1.1	1.1	2.3	2.4	2.4	2.1	1.9	1.9	1.9
Inflation	1.6	1.3	1.4	2.0	2.0	2.0	2.1	2.0	2.0	2.0
Primary balance	-3.5	-4.6	-4.3	-3.3	-1.5	-1.6	-1.6	-1.7	-1.7	-1.5
Effective interest rate	1.4	1.6	2.6	3.8	4.5	5.3	6.8	7.4	8.1	8.4

Real GDP Growth Shock	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Real GDP growth	1.7	1.1	1.1	2.9	2.8	2.6	2.3	2.1	2.1	2.1
Inflation	1.6	1.3	1.4	2.0	2.0	2.0	2.1	2.0	2.0	2.0
Primary balance	-3.5	-4.1	-4.3	-3.3	-1.5	-1.6	-1.6	-1.7	-1.7	-1.5
Effective interest rate	1.4	1.6	2.2	3.1	3.5	4.1	5.3	5.8	6.3	6.5
Real Exchange Rate Shock										
Real GDP growth	1.7	3.0	3.0	2.9	2.8	2.6	2.3	2.1	2.1	2.1
Inflation	1.6	1.8	1.9	2.0	2.0	2.0	2.1	2.0	2.0	2.0
Primary balance	-3.5	-2.5	-2.1	-1.7	-1.5	-1.6	-1.6	-1.7	-1.7	-1.5
Effective interest rate	1.4	1.6	2.2	3.0	3.4	4.0	5.3	5.8	6.3	6.5

Source: IMF staff.

Annex III. U.S. Responses to Past Policy Advice

Fiscal policy. Over the last few years staff has emphasized the importance of a medium-term fiscal consolidation plan to restore long-run fiscal sustainability, stressing that early action is needed to slow entitlement spending. The prospects for such a comprehensive plan remain unfavorable, given the lack of political consensus. However, cost saving measures that were part of the Affordable Care Act appear to be lowering health care inflation. Staff also called for a more balanced and gradual pace of fiscal consolidation in the near-term and the replacement of automatic spending cuts (also referred to as the sequester) with back-loaded savings. The Bipartisan Budget Act of December 2013 moved in this direction by raising the spending caps imposed by the sequester for 2014 and 2015 in exchange for savings in future years. In addition, suspending the debt ceiling until March 2015 and passing the Consolidated Appropriations Act in early 2014 were all steps in a positive direction to lessen fiscal uncertainties.

Monetary policy. Given the large output gap and well-anchored inflation expectations, staff supported a highly accommodative monetary policy stance. Last year, it also stressed the importance of maintaining effective communications. The Fed continues to maintain a supportive monetary policy and have made increasing efforts—in FOMC statements, press conferences, and speeches—to articulate is views on progress toward the Fed's longer-term objectives.

Financial policies. Substantial progress has been made on the national and global financial reform agenda over the last few years, and many of the policy suggestions contained in last year's U.S. staff report have been implemented (including Basel III capital standards and the finalization of the Volcker rule). Still, a few reforms emphasized by staff remain to be completed, particularly those concerning the regulation of money market mutual funds.

Housing policy. Staff has stressed the need to reduce regulatory uncertainty (particularly on the risks that banks could be required to repurchase defaulted loans from the GSEs). Measures have been taken to lessen these uncertainties. Staff also called for a rapid completion of the regulation requiring banks to retain part of mortgage risk on their balance sheet (i.e., the Qualified Residential Mortgage standards) and in advancing legislation to reshape housing finance. On the latter, legislative proposals have moved forward in Congress but the likelihood of these becoming law remains slim.

Structural policies. The Administration has launched new initiatives for job training and apprenticeships, in line with staff's recommendations on more active labor market policies. Building a political consensus on a reform of the tax system in the direction envisaged by staff (a less complex system with a broader tax base and lower rates) remains difficult and there is no plan to introduce a VAT or a carbon tax.

Annex IV. External Stability Assessment

	United States	Overall Assessment
Foreign asset and liability position and trajectory	**Background.** The net international investment position (NIIP) declined from -15 per cent of GDP in 2010 to -27 percent of GDP in 2013, reflecting current account deficits as well as the stronger performance of the U.S. stock market relative to global markets. The U.S. has a positive net equity position, with sizable portfolio equity and direct investment abroad, and a negative debt position vis-à-vis the rest of the world, owing to sizeable foreign holdings of U.S. Treasuries and corporate bonds. Gross assets and liabilities are about 130 and 160 percent of GDP, respectively. Under staff's baseline scenario, U.S. NIIP would deteriorate by about 5 percentage points of GDP over the next five years.[1] **Assessment.** Risks to external stability could arise from a decline in foreign demand for U.S. debt securities (the bulk of U.S. external liabilities), driven for example by a protracted failure to restore long-run fiscal sustainability. Still, given the dollar's reserve currency status, current vulnerabilities are limited. Most U.S. foreign assets are denominated in foreign currency and over 50 percent are in the form of FDI and portfolio equity claims, whose value tend to decline when global growth and stock markets are weak, as well as when the U.S. dollar appreciates.	**Overall Assessment:** *The U.S. external position is broadly consistent with medium-term fundamentals and desirable policies.* The US external position has improved considerably in recent years, as have assessed imbalances and fiscal policy gaps. The boom in unconventional energy production contributed to the improvement. Going forward, although there is some uncertainty on its full potential impact on the US current account, the positive term of trade shock is expected to boost national saving, partially offsetting the negative impact of stronger domestic investment. **Potential policy responses:** Over the medium term, fiscal consolidation should aim for a general government primary surplus of about 1¼ percent of GDP (corresponding to a federal government primary surplus of about 2 percent, higher than the 1½ percent surplus envisaged in the President's budget and staff's projection of a small deficit). Structural policies should be implemented to raise productivity and labor force growth including by taking steps to fully exploit the benefits of the boom in unconventional energy production. This would be consistent with maintaining external stability and achieving full employment.
Current account	**Background**. The U.S. current account (CA) deficit continued to narrow from its pre-crisis height of 6 percent of GDP to 2.3 percent in 2013, reflecting a sharp reduction in the fiscal deficit (which also helped to lower the global fiscal gap and hence the impact of U.S. policy distortions on other countries), higher private saving, lower investment in the aftermath of the financial crisis, and a stronger energy trade balance (due to the rapid increase of unconventional energy production). Going forward, the current account deficit is projected to widen to about 2¾ percent of GDP by 2019, as stronger private demand leads to a closure of the output gap but with the effect tempered by a further improvement in the energy balance. **Assessment**. The EBA model estimates a CA gap of -1 percent of GDP for 2013. The staff view is broadly similar, on balance assessing the cyclically-adjusted current account to be between 0 and 1.5 percent of GDP weaker than the level implied by medium-term fundamentals and desirable policies.	
Real exchange rate	**Background**. The real effective exchange rate (REER) appreciated by about 2 percent during 2013, but remains around 10 percent below its average value over the past two decades. **Assessment**. Indirect estimates of the REER (drawing on the EBA current account estimate and the staff's current account assessment range) suggest some overvaluation (within the 0 to 10 percent range). However, direct analyses of the REER in the EBA would suggest an undervaluation of around 8 percent in 2013.[2] Taking into account both methodologies, and acknowledging some uncertainty associated with the boom in unconventional energy production on the US external position, staff assesses the REER to be broadly in line with medium-term fundamentals and desirable policies (with a range of -5 percent to +10 percent).	
Capital and financial accounts: flows and policy measures	**Background.** Inflows and outflows picked up in 2013 but are substantially lower than pre-Lehman levels. Portfolio inflows halved in 2013 relative to 2012 but were more than offset by stronger bank inflows (which were negative in 2012). On the outflow side, there was a large increase in U.S. portfolio investment overseas. The U.S. dollar reserve currency status and safe haven motives boost foreign demand for U.S. Treasury securities during periods of market turbulence. Hence the outlook for U.S. capital flows will depend on global financial stability and the pace of the global recovery, as well as on the outlook for the U.S. economy and its public finances. **Assessment.** The United States has a fully open capital account. Vulnerabilities are limited by the dollar's status as a reserve currency and the United States' role as a safe haven.	
FX intervention and reserves	**Assessment.** The dollar has the status of a global reserve currency. Reserves held by the U.S. are typically low relative to standard metrics, but the currency is free floating.	
Technical Background Notes	[1] Forecasts of U.S. NIIP reflect mainly projected CA flows. [2] Such REER regression models may, however, be less reliable and have difficulty explaining the REER's weakness (relative to its own history) in terms of changing fundamentals or policy distortions.	

INTERNATIONAL MONETARY FUND

UNITED STATES

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

July 7, 2014

Prepared By | The Western Hemisphere Department

CONTENTS

FUND RELATIONS 2

STATISTICAL ISSUES 4

FUND RELATIONS (AS OF MAY 31, 2014)

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

General Resources Account:	**SDR Million**	**Percent Quota**
Quota	42,122.40	100.00
Fund holdings of currency	31,553.57	74.91
Reserve Tranche Position	10,567.04	25.09
Lending to the Fund		
New Arrangements to Borrow	9,130.05	

SDR Department:	**SDR Million**	**Percent Allocation**
Net cumulative allocation	35,315.68	100.00
Holdings	35,844.23	101.50

Outstanding Purchases and Loans: None

Financial Arrangements: None

Projected Payments to the Fund:

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

	Forthcoming				
	2014	2015	2016	2017	2018
Principal					
Charges/Interest		0.24	0.24	0.24	0.24
Total		0.24	0.24	0.24	0.24

Exchange Rate Arrangements. The exchange rate of the U.S. dollar floats independently and is determined freely in the foreign exchange market. The United States has accepted the obligations under Article VIII, Sections 2(a), 3 and 4 of the IMF's Articles of Agreement and maintains an exchange system free of multiple currency practices and restrictions on the making of payments and transfers for current international transactions, except for those measures imposed for security reasons. The United States notifies the maintenance of measures imposed for security reasons under Executive Board Decision No. 144-(52/51). The last of these notifications was made on June 2014 (see EBD/14/35, June 19, 2014).

Article IV Consultation. The 2013 Article IV consultation was concluded on July 24, 2013 and the Staff Report was published as IMF Country Report No. 13/236. A fiscal Report of Observance of Standards and Codes was completed in the context of the 2003 consultation. A Financial System Assessment Program involved two missions, during October 14–November 3, 2009 and February 17–March 12, 2010. The Financial System Stability Assessment was discussed at the Board, together with the 2010 Article IV Consultation, on July 26, 2010.

The 2014 Article IV discussions took place April 30–May 23, 2014. Concluding meetings with Chair Yellen of the Board of Governors of the Federal Reserve System, and Treasury Secretary Lew occurred on June 12th. The Managing Director, Ms. Lagarde, the Deputy Managing Director, Mr. Shinohara, and WHD Director, Mr. Werner, participated in the concluding meetings. A press conference on the consultation was held on June 16th, 2014. The team comprised Nigel Chalk (head), Roberto Cardarelli, Ravi Balakrishnan, Francesco Columba, Deniz Igan, Lusine Lusinyan, Juan Solé, and Jarkko Turunen (all WHD); Niklas Westelius (SPR); David Jones (MCM). Simon Gray, John Kiff, Darryl King (all MCM), Steve Dawe, Emmanuel Mathias (all LEG), and Michele Ruta (SPR) participated in some of the meetings. Mr. Haarsager (Executive Director) and Mr. Weiss (Advisor) attended some of the meetings. Outreach included discussions with Congressional staff and think tanks. Unless an objection from the authorities of the United States is received prior to the conclusion of the Board's consideration, the document will be published.

STATISTICAL ISSUES

Statistical Issues: Comprehensive economic data are available for the United States on a timely basis. The quality, coverage, periodicity, and timeliness of U.S. economic data are adequate for surveillance. Coverage of international capital flows in external sector statistics has been improved, with the June 2014 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 18, 2014)

	Date of latest observation	Date received	Frequency of data[1]	Frequency of reporting[1]	Frequency of publication[1]
Exchange rates	June 16	June 16	D	W	W
International reserve assets and reserve liabilities of the monetary authorities[2]	May 14	May 14	M	M	M
Reserve/base money	June 12	June 12	W	W	W
Broad money	June 12	June 12	W	W	W
Central bank balance sheet	June 12	June 12	W	W	W
Interest rates[3]	same day	same day	D	D	D
Consumer price index	May 2014	June 17	M	M	M
Revenue, expenditure, balance and composition of financing[4]—general government[5]	2013 Q4	Jan. 31	Q	Q	Q
Revenue, expenditure, balance and composition of financing[4]—central government	May 2014	June 11	M	M	M
Stocks of central government and central government-guaranteed debt	May 2014	June 11	M	M	M
External current account balance	2014 Q1	June 18	Q	Q	Q
Exports and imports of goods and services	Apr. 2014	June 4	M	M	M
GDP/GNP (2nd release)	2014 Q1	June 29	Q	M	M
Gross External Debt	2013 Q4	Dec. 31	Q	Q	Q
International Investment Position[6]	2013	March 26	A	A	A

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

Statement by the IMF Staff Representative on the United States

July 22, 2014

1. **This statement reports on information that has become available since the staff report was issued. It does not alter the thrust of the staff appraisal.**

2. **Recent indicators**. Labor market conditions continued to improve. Jobless claims fell in the first week of July and are on a downward path from earlier in the year. The number of job openings rose in May to their highest levels since August 2007. Retail sales growth in June was solid and there were upward revisions to the data for April and May. An increase in the July homebuilder's index suggests improving confidence in the housing recovery. The Fed's Empire manufacturing index for July was at its highest level since May 2010 and industrial production grew at (an annualized) 5.5 percent in the second quarter of the year.

3. **Fed outlook**. In testimony to the Congress on July 15 and 16, Chair Yellen noted that the still-elevated unemployment rate, depressed participation rates, and slow pace of wage growth suggest that the level of slack in the labor market remains considerable, despite recent improvements in labor market indicators. Chair Yellen noted that "almost all" FOMC participants expected the first rate hike at some time in 2015 and that asset purchases would likely conclude after the October FOMC meeting. The Fed Chair assessed that the threats to financial stability at this stage appeared moderate.

4. **Regulatory cooperation**. On July 8, the US Treasury and the European Commission reiterated their commitment to cooperate on financial market regulation, in particular on OTC derivatives regulation and cross-border resolution.

5. **The Mid-Session Budget Review**. The growth projection for 2014 was revised down from 3.1 percent in the March Budget to 2.4 percent (although the estimate does not incorporate the latest GDP estimate for Q1). Average growth in 2015–19 is also projected to be slightly lower than in the Budget. These revisions imply there will be modestly larger fiscal deficits and a higher debt-to-GDP ratio over the medium term. Nevertheless, the federal deficit for FY2014 and 2015 has been revised down by around ¼ percent of GDP in each year (to 3.4 and 2.9 percent of GDP respectively) due to slower-than-expected spending in a range of programs (including the use of Hurricane Sandy recovery funds, defense spending, and healthcare).

6. **Legislative action.** On July 9, Congress passed the "Workforce Innovation and Opportunity Act", a compromise between the Senate and House versions of a bill that reauthorizes and streamlines the existing job training programs and gives states more flexibility in using federal funds. Committees in the House and Senate have both approved measures to temporarily address the funding of the Highway Trust Fund; work will now aim to reconcile the differences between the two proposals.

INTERNATIONAL MONETARY FUND

Press Release No.14/359
FOR IMMEDIATE RELEASE
July 23, 2014

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Concludes 2014 Article IV Consultation with the United States

On July 22, 2014, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the United States.[1]

Economic activity in the U.S. accelerated in the second half of 2013, but an unusually harsh winter conspired with other factors—including an inventory correction, a still-struggling housing market, and slower external demand—caused momentum to fade in early 2014, leading to a contraction in growth of 2.9 percent in the first quarter.

Over the past few months, however, a broad-based improvement appears to be unfolding as evidenced by stronger employment and industrial production numbers. Looking ahead, activity is projected to accelerate in the remainder of this year to well-above potential (in the 3–3½ percent range), although the drag on growth from the first quarter contraction will not be offset. This means growth for the year as a whole will be a disappointing 1.7 percent. More positively, barring unforeseen shocks, 2015 growth should accelerate to the fastest annual pace since 2005, propelled by strong consumption growth, a declining fiscal drag, a pickup in residential investment, and easy financial conditions.

Risks around this outlook include slowing growth in emerging markets, oil price spikes related to events in Ukraine and Iraq, and earlier-than-expected interest rate rises. However, as confidence in the recovery picks up, nonresidential investment could grow more than expected and labor force participation could bounce back.

---

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summing ups can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

Looking at the medium term, potential growth is forecast to average just above 2 percent for the next several years, significantly below the historic average growth rate. This downgrade reflects the effects of an aging population and more modest prospects for productivity growth. This makes it critical for the authorities to take immediate steps to raise productivity, encourage innovation, augment human and physical capital, and increase labor force participation. Moreover, recent growth has not been particularly inclusive, with the latest data pointing to almost 50 million Americans living in poverty (as shown by the Census Bureau's supplemental poverty measure) and the official poverty rate stuck above 15 percent despite the ongoing recovery. In terms of policy actions, the Federal Reserve has made important and substantive efforts to increase transparency and has adopted an adaptable approach to communication. The recent shift to qualitative forward guidance provides the Fed with greater flexibility but puts an even higher premium on clear and systematic communication to guide expectations. On the fiscal side, following the debt ceiling brinkmanship and the government shutdown in October 2013, the Bipartisan Budget Act and the subsequent raising of the debt ceiling were important steps to reduce fiscal risks. However, the need for a medium-term fiscal adjustment to ensure a downward path for the public debt remains. On the financial side, progress has been achieved on variety of fronts, including implementing the Dodd Frank Act, finalizing the Volcker rule, and designating another systemic important financial institution. In addition, the U.S. recently put in place a rule to require foreign bank organizations over a certain size to incorporate as holding companies, a move that aligns the treatment of foreign and U.S. banks that are operating in the U.S. and eliminates an existing regulatory distortion.

Executive Board Assessment[2]

Executive Directors broadly agreed with the thrust of the staff appraisal. They welcomed signs of a meaningful economic rebound following a temporary setback in the first quarter of 2014. Directors noted that stronger growth is expected to be underpinned by a continuation of accommodative monetary policy, a substantial reduction in the fiscal drag, and improved labor and housing conditions. At the same time, however, risks and uncertainties continue to weigh on the outlook, including the pace of interest rate increases and market expectations, and growth prospects in other advanced and emerging market economies. Directors underscored that higher growth in, and strong policy action by, the United States would have important positive global spillovers.

Directors supported focusing policy efforts on managing monetary policy normalization, raising potential growth, reducing long-term unemployment, tackling poverty, and maintaining debt sustainability over the medium term. Achieving these objectives would call for wide-ranging measures—and, more importantly, political consensus—in such areas as

[2] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

investments in infrastructure and education, a comprehensive tax reform, active labor market policies, and a skills-based approach to immigration reform. Directors concurred that an expansion of the Earned Income Tax Credit, possibly complemented by a higher minimum wage, would help address poverty and inequality while promoting labor participation.

Directors welcomed the Bipartisan Budget Act and the subsequent raising of the debt ceiling as important steps to address fiscal risks. They emphasized the critical importance of reaching agreement on a credible medium-term fiscal consolidation plan, which would help to articulate a roadmap for achieving debt sustainability and provide an important anchor for fiscal policy to support the recovery in the short run. In this regard, while a few Directors stressed the need to stay the course of fiscal consolidation, most saw scope for expanding the near-term budget envelope in areas with a high and lasting growth impact, which would need to be funded by savings in future years, including through upfront action to control health care and entitlement spending. Directors also encouraged steps to improve budget procedures and the institutional framework more broadly, with a view to reducing uncertainty in the future.

Directors agreed that the current highly accommodative stance of monetary policy is appropriate, consistent with the Federal Reserve's objectives of maximum employment and price stability. They generally viewed that, in the case of a slow progression toward full employment and continued subdued inflation, policy rates could stay at zero for longer than currently anticipated so long as inflation expectations remain firmly anchored. Directors recommended, however, that the authorities monitor wage developments closely and remain cognizant of financial stability risks. They welcomed the Federal Reserve's forward guidance and recommended continued efforts to enhance its communications to provide greater clarity about monetary policy decisions, ensuring a smooth normalization.

Directors welcomed progress in strengthening the resilience of the financial system over the past few years. They called for continued vigilance to potential systemic risks associated with the prolonged period of very low interest rates, particularly activities of nonbank intermediaries. Directors underscored the benefits of a strong macroprudential framework, and tightened supervision and prudential norms across banks and nonbanks, with a few suggesting that care be taken to ensure a level playing field between domestic and foreign banks. Directors looked forward to continued U.S. leadership in advancing the global financial regulatory reform agenda.

Directors acknowledged recent initiatives to address remaining weaknesses in the housing market. They encouraged further steps to improve the availability of mortgage financing and to clarify the role of the government in housing finance, including through administrative action as efforts on broader legislative changes continue.

Table 1. United States: Selected Economic Indicators 1/
(percentage change from previous period, unless otherwise indicated)

	2012	2013	2014	2015	2016	2017	2018	2019
			Projections					
National production and income								
Real GDP	2.8	1.9	1.7	3.0	3.0	2.9	2.8	2.6
Net exports 2/	0.1	0.1	-0.2	-0.2	-0.3	-0.2	-0.1	-0.1
Total domestic demand	2.6	1.7	1.8	3.2	3.2	3.1	2.8	2.7
Final domestic demand	2.4	1.6	1.8	3.2	3.2	3.1	2.8	2.6
Private final consumption	2.2	2.0	2.2	2.9	2.8	2.7	2.7	2.7
Public consumption expenditure	-0.2	-2.0	-0.6	0.2	0.2	0.5	0.7	1.0
Gross fixed domestic investment	5.5	2.9	2.4	6.3	7.1	6.1	4.4	3.3
Private fixed investment	8.3	4.5	3.5	7.1	8.0	6.7	4.7	3.4
Equipment and software	7.6	3.1	3.9	6.7	7.9	7.3	6.7	4.1
Intellectual property products	3.4	3.1	4.0	3.3	4.0	3.8	3.7	3.0
Nonresidential structures	12.7	1.3	2.2	5.6	5.0	2.7	2.6	2.4
Residential structures	12.9	12.2	3.2	13.4	14.6	11.2	4.2	3.4
Public fixed investment	-4.0	-3.2	-2.1	2.5	2.7	3.2	3.0	2.9
Change in private inventories 2/	0.2	0.2	-0.1	0.1	0.0	0.0	0.0	0.0
Nominal GDP	4.6	3.4	3.3	4.9	4.9	5.0	4.8	4.7
Personal saving rate (percent of disposable income)	5.6	4.5	4.3	4.0	4.2	4.3	4.1	4.0
Private investment rate (percent of GDP)	15.2	15.9	16.1	16.8	17.6	18.1	18.5	18.6
Employment and inflation								
Unemployment rate	8.1	7.4	6.4	6.0	5.8	5.6	5.5	5.5
CPI inflation	2.1	1.5	1.8	1.8	1.9	2.0	2.0	2.0
Core CPI Inflation	2.1	1.8	1.8	1.9	2.0	2.1	2.0	2.0
PCE Inflation	1.8	1.1	1.5	1.6	1.6	1.8	1.9	2.0
Core PCE Inflation	1.8	1.2	1.4	1.7	1.7	1.8	1.9	2.0
GDP deflator	1.7	1.5	1.6	1.8	1.9	2.0	2.0	2.0
Output gap (percent of potential GDP)	-4.0	-3.8	-4.0	-2.9	-2.0	-1.1	-0.6	0.0
Government finances								
Federal government (budget, fiscal years)								
Federal balance (percent of GDP)	-6.7	-4.5	-3.5	-3.1	-3.2	-3.1	-3.1	-3.5
Debt held by the public (percent of GDP)	70.1	72.0	74.2	74.5	74.6	74.5	74.4	74.7
General government (GFSM 2001, calendar years)								
Net lending (percent of GDP)	-9.7	-6.8	-6.6	-5.7	-5.4	-5.1	-5.1	-5.4
Primary structural balance (percent of potential nominal GDP)	-4.1	-2.6	-1.9	-1.3	-1.4	-1.2	-1.3	-1.6
Gross debt (percent of GDP)	102.0	104.0	105.8	106.0	106.0	106.0	106.0	106.2
Interest rates (percent)								
Three-month Treasury bill rate	0.1	0.1	0.1	0.3	1.2	2.2	3.3	3.8
Ten-year government bond rate	1.8	2.4	2.7	3.3	4.0	4.5	5.0	5.1

Balance of payments								
Current account balance (percent of GDP)	-2.8	-2.4	-2.4	-2.6	-2.8	-2.8	-2.8	-2.7
Export volume 3/	3.8	2.3	1.7	4.7	5.3	5.5	5.8	5.4
Import volume 3/	2.1	1.2	2.3	5.4	6.1	5.9	5.5	5.0
Net international investment position (percent of GDP)	-23.8	-27.2	-28.7	-29.5	-30.4	-31.3	-32.1	-32.8
Saving and investment (percent of GDP)								
Gross national saving	16.2	17.1	17.1	17.6	18.2	18.8	19.2	19.4
General government	-5.3	-2.8	-2.7	-2.0	-1.7	-1.4	-1.4	-1.7
Private	21.6	19.9	19.8	19.6	19.9	20.2	20.6	21.0
Personal	4.2	3.3	3.2	3.0	3.1	3.2	3.0	2.9
Business	17.3	16.6	16.7	16.7	16.8	17.1	17.6	18.2
Gross domestic investment	19.0	19.5	19.6	20.2	21.0	21.6	21.9	22.1
Private	15.2	15.9	16.1	16.8	17.6	18.1	18.5	18.6
Public	3.8	3.6	3.5	3.5	3.4	3.4	3.5	3.5

Sources: IMF staff estimates.

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

2/ Contribution to real GDP growth, percentage points.

3/ NIPA basis, goods.