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I. INTRODUCTION

1. ***The 2002 consultation took place as the U.S. economy started to recover from an unusually mild recession.*** Following a decade marked by the longest U.S. expansion on record, low inflation, and a remarkable turnaround in the federal fiscal position of roughly 7 percentage points of GDP, the U.S. economy slipped into recession in early 2001. However, the economy has proven exceptionally resilient, even in the face of the September 11th terrorist attacks. Timely fiscal and monetary stimulus in 2001, strong consumer spending, and continued productivity gains contributed to a turnaround in late 2001 and early 2002.

2. ***The discussions, therefore, centered on prospects and policies for a renewed and durable expansion.*** Despite the rebound in activity, uncertainties still remain regarding both the underlying strength of final domestic demand and the extent to which the rapid productivity growth achieved during the latter half of the 1990s will be sustained. At the same time, progress toward a number of the key policy objectives that the new Administration had adopted following the 2000 elections—including preserving the Social Security surplus and trade liberalization—has been disrupted. Against this background, the key issues for the consultation included:

- ***Re-establishing a clear medium-term fiscal framework.*** The fiscal outlook has been significantly eroded by the economic slowdown, tax cuts, and additional defense and security outlays. Ambitious efforts toward re-establishing fiscal surpluses will be necessary to prepare for the fiscal pressures arising from the retirement of the baby-boom generation that will begin at the end of the decade.

- ***The pace and timing of the withdrawal of monetary stimulus.*** Monetary policy remains highly accommodative, and interest rates will need to be moved to more neutral levels, provided that evidence of recovery continues to accumulate.

- ***Concerns about corporate governance.*** The U.S. financial system has been resilient in the face of the economic downturn, but recent corporate failures have increased investor uncertainty and highlighted the need to strengthen governance and accounting practices.

- ***Multilateral implications.*** The persistently large U.S. current account deficit continues to raise concern regarding the risk of disorderly exchange rate adjustment, while protectionist pressures risk imposing significant costs, both domestically and abroad, and disrupting multilateral trade negotiations.

II. RECENT ECONOMIC DEVELOPMENTS

3. ***The U.S. economy slowed in the second half of 2000 and slipped into recession in early 2001 (Table 1).*** The downturn was marked by a sharp drop in industrial production, declining investment and exports, and falling employment and weekly hours. Real GDP growth slowed to 2¾ percent during 2000 (Q4/Q4), from 4½ percent during the previous year, and growth in the second quarter of 2001 was only ¼ percent (annualized rate). The

economy's weakness was exacerbated by the September 11th terrorist attacks, which triggered a plunge in consumer and business confidence, as well as further job losses (Box 1). As a result of the underlying recessionary pressures and the temporary disruptions to activity caused by the attacks, real GDP fell by 1¼ percent in the third quarter of 2001.

Box 1. The Macroeconomic Effects of September 11th

The events of September 11th dealt another blow to the already weak U.S. economy.[1] In the wake of the attacks, equity prices and consumer and business confidence dropped sharply, and economic activity was disrupted, including the shutdown of the air transport system, and segments of New York's financial infrastructure.

However, swift and forceful policy actions—an aggressive easing in monetary policy and an emergency spending package—helped to mitigate the short-run negative impact of the attacks. Indeed, by year-end, equity prices and confidence had returned to their pre-attack levels, and the impact on the economy over the medium term is generally expected to be modest.

Estimates of the impact of the attacks include:

- The destruction of private and government capital is estimated to have been around $15 billion in the third quarter.[2] In addition, insurance losses are estimated at $30–$58 billion, the largest insurance event in history.
- The fiscal costs include $40 billion in emergency spending that was appropriated in the immediate aftermath of the attacks, and $15 billion in direct grants and loan guarantees for the airline industry. The FY 2003 budget proposed significant increases in defense and homeland security in response to the attacks.
- Over the medium term, increased security costs in the private sector are expected to have a small effect on the productive capacity of the economy, lowering the level of potential output by about ½ percent by 2007.[3]

[1] For a detailed analysis, see "Economic Consequences of Terrorism," *OECD Economic Outlook*, 71, 2002. See also the December 2001 *World Economic Outlook*.

[2] Based on national income accounts.

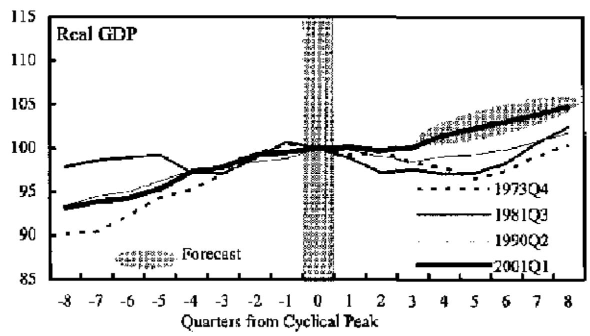
[3] Council of Economic Advisers, *Economic Report of the President, 2002.*

4. ***The recession appears to have been remarkably short and shallow (Box 2).*** Bolstered by significant monetary and fiscal stimulus in early 2001, and the additional measures taken in the immediate aftermath of the attacks, the economy began to recover at the end of 2001. Output rebounded by 1¾ percent (annual rate) in the fourth quarter, and then surged by 6¼ percent in the first quarter of 2002. More recent monthly data, while generally positive, indicate that the pace of the expansion slowed in the second quarter and point to continued uncertainties regarding the strength of the recovery (Table 1 and Figure 1).

Box 2. Comparing the U.S. Recession to Past Downturns

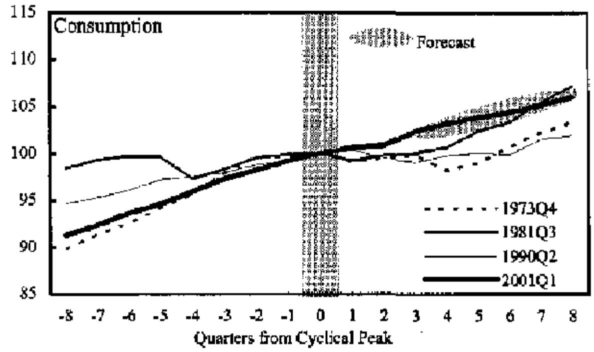
The recession in the United States that began in March 2001 was atypical in a number of respects.

- **The downturn was shorter and much milder than those of the past three decades.** GDP contracted in only one quarter, falling just ¼ percent below the previous peak. Past recessions generally lasted four to six quarters with GDP declines of at least 1½ percent.



- **An investment collapse—particularly in the techology sector—**triggered the downturn. Business fixed investment and inventories both fell earlier and by much more than in previous recessions.

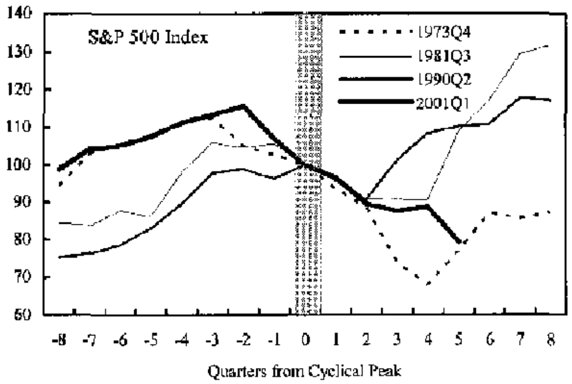
- **Consumption remained relatively strong.** Unlike in past downturns, consumption remained steady, sustained by low interest rates that boosted purchases of durables such as autos, as well as tax cuts, low energy prices, and strong wage growth.

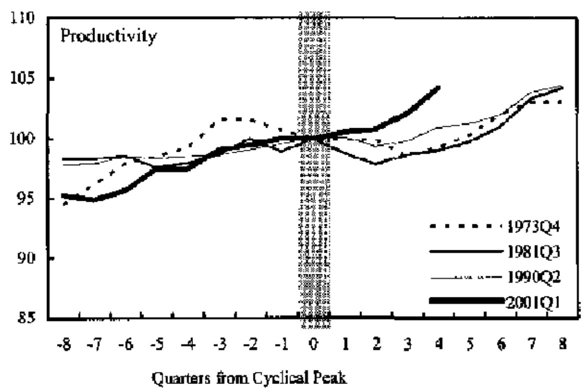


- **Balance sheets have not acted as a significant constraint.** Stock prices—which typically have rebounded in the initial phase of previous recoveries—remain weak but past stock market gains and the strength of housing prices have helped keep household net wealth relatively high. Although corporate indebtedness is at an unprecedently high level, low interest rates have kept debt service manageable.

- **Forceful counter-cyclical policies** were facilitated by favorable starting conditions. Low inflation and a credible commitment to price stability allowed the Federal Reserve to cut interest rates more aggressively than in past recessions. At the same time, the fiscal surplus provided room for counter-cyclical tax cuts and spending increases reflected in a turnaround in the federal government's structural balance projected at more than 3 percent of GDP from 2000 to 2002.

- **Productivity growth remained unusually strong.** Productivity growth in the nonfarm business sector accelerated to 5½ percent (saar) in the fourth quarter of 2001 and 8½ percent in the first quarter of 2002. In contrast, output per worker has typically declined in past recessions.





5. ***The bursting of the "IT bubble" helped trigger the recession (Figure 2).*** The tech-heavy Nasdaq composite index plunged by 60 percent in the year following its peak in March 2000 and corporate profits also weakened sharply. Investment in equipment and software—especially in communications equipment and trucks—slowed in the second half of 2000 and then fell sharply in 2001 before appearing to have bottomed out in early 2002. Spending on nonresidential structures also declined sharply, although declining mortgage interest rates have helped to sustain residential investment.

Figure 1. United States: Real GDP

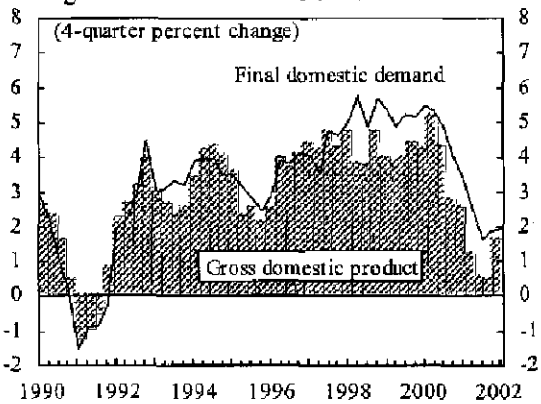


Figure 2. United States: Stock Market

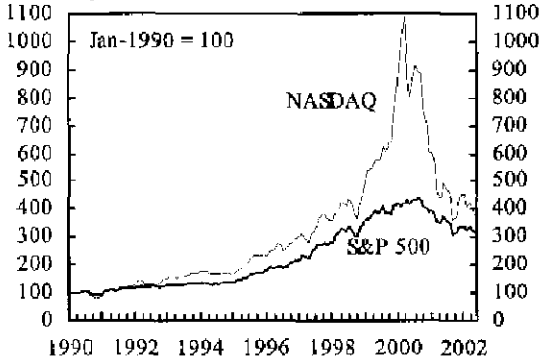
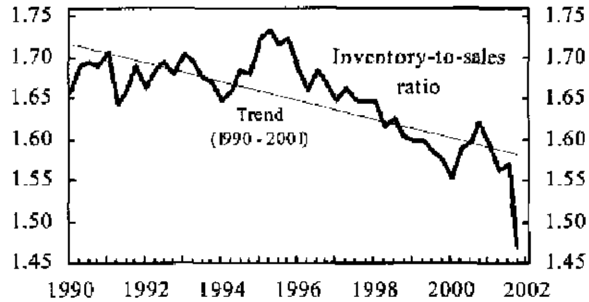


Figure 3. United States: Retail Inventories



6. ***Inventory adjustments played an important role in contributing to the slowdown and in the subsequent turnaround.*** Slowing sales in late 2000 and early 2001 left the inventory-to-sales ratio above its trend of the past decade. Production cuts combined with buoyant consumption in late 2001 caused inventories to fall sharply implying a significant negative contribution to growth (Figure 3). However, with stocks reaching relatively lean levels by end-2001, the pace of inventory adjustment slowed, contributing 3½ percentage points to GDP growth in the first quarter of 2002.

7. ***Household demand held up unusually well during the downturn.*** Consumption growth slowed to an annual rate of around 3¼ percent during 2001 and through the first quarter of 2002, from an average of around 5 percent in recent years. Moreover, following the initial shock to confidence after the September 11th attacks, household spending rebounded strongly in the subsequent two quarters, with especially strong spending on consumer durables. Employment declines and the stock market correction acted to moderate spending growth but demand was bolstered by strong wage growth, interest rate cuts, mortgage refinancing, the June 2001 tax cuts and the associated tax rebate, and special incentives offered by automakers and other manufacturers late in the year.

8. ***Household and corporate balance sheets have remained relatively healthy, despite the downturn (Figures 4 and 5).*** While household net worth as a percent of disposable income declined to 537 percent in 2001 from its earlier peak of 622 percent in early 2000, this ratio remained well above its 1952–95 average of 470 percent, as the effect of the stock market correction was partly offset by the strength of housing prices. Although household debt has increased significantly, this largely reflected a rise in mortgage debt, much of which has been locked in at low interest rates. Corporate debt reached an unprecedented 48 percent of GDP in late 2001. However, firms have also taken advantage of low interest rates and lengthened terms to maturity, and the debt service-to-income ratio remained well below recent cyclical peaks and started to decline in late 2001.[1]

Figure 4. United States: Households

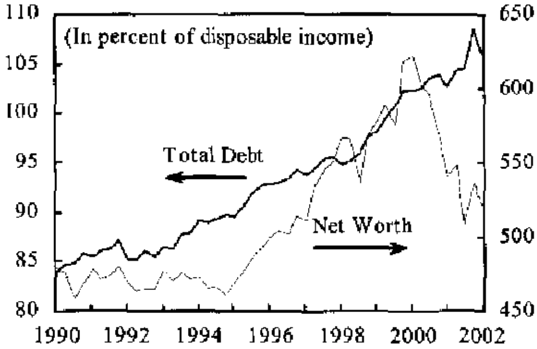
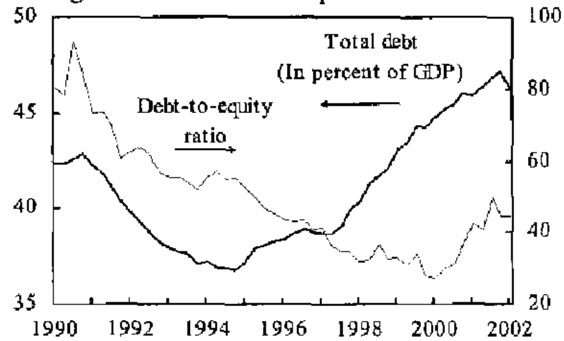


Figure 5. United States: Corporate Sector



9. ***Corporate profits have also begun to recover, although questions remain regarding longer-term prospects.*** Profit growth turned negative in the fourth quarter of 2000 and continued to decline to the third quarter of 2001. However, with employment and debt-service costs moderating, and continued strength in labor productivity, profits for the domestic nonfinancial sector as measured in the national accounts rebounded strongly in 2001Q4 and 2002Q1. Nonetheless, stock prices have remained unusually weak for the early stages of a recovery, reflecting lingering concerns regarding future earnings growth and accounting standards in the wake of Enron's failure.

Figure 6. United States: Employment

10. ***Employment fell sharply in response to the economic slowdown, but labor market conditions have shown signs of stabilizing.*** After dropping to a 30-year low of just under 4 percent during 2000, the unemployment rate rose rapidly, reaching 6 percent in April 2002 (Figure 6). Job losses were initially concentrated in the manufacturing sector, but following

[1] In the selected issues paper, a Corporate Vulnerability Index is developed—which combines measures of corporate indebtedness, macroeconomic conditions, and equity volatility—which illustrates that despite higher debt ratios, corporate vulnerability has fallen since early 2001.

the September 11th attacks, significant employment declines were felt in the service sectors. However, employment seemed to have bottomed out by May 2002, and the unemployment rate eased to 5¾ percent.

11. ***The economic slowdown, strong productivity growth, and declines in energy and non-oil import prices helped contain inflation (Table 2 and Figures 7 and 8).*** With the level of output falling an estimated 1½ percent below potential by the end of 2001, consumer price inflation fell to 1½ percent by December 2001 (12-month rate), from about 3½ percent during 2000, and fell to 1¼ percent in May 2002. Core-CPI inflation has remained around 2½–2¾ percent, although inflation measured by the chain-weighted price index for core personal consumption expenditures (PCE) slowed to 1½ percent during 2001, from just under 2 percent during 2000, and remained at around 1½ percent in May 2002. Despite a 4¼ percent increase in the employment cost index during 2001, unit labor costs fell in the fourth quarter of 2001 and the first quarter of 2002, reflecting strong gains in productivity growth, which surged over these two quarters (Figure 9).[2]

Figure 7. United States: Inflation

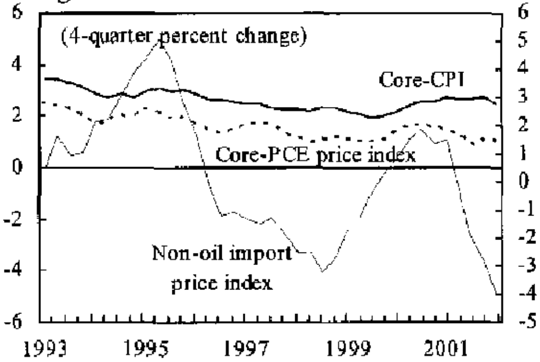


Figure 8. United States: Real GDP and Potential Output

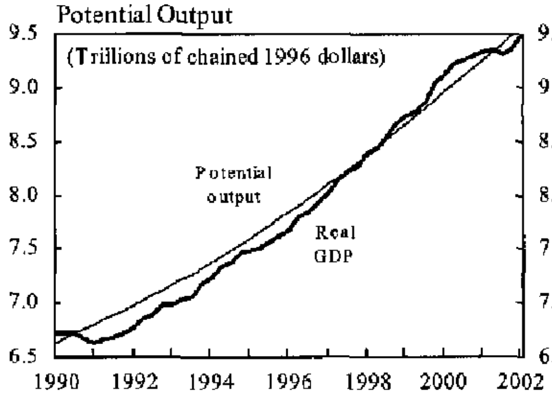
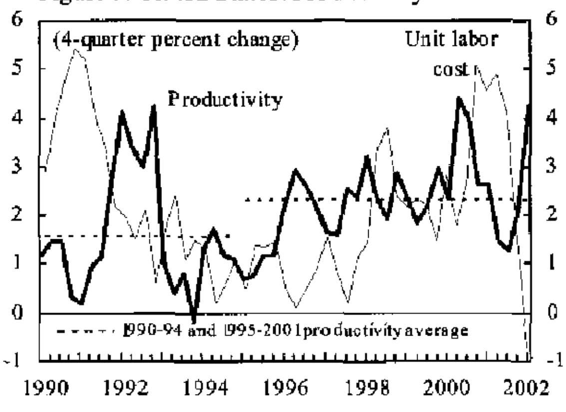


Figure 9. United States: Productivity



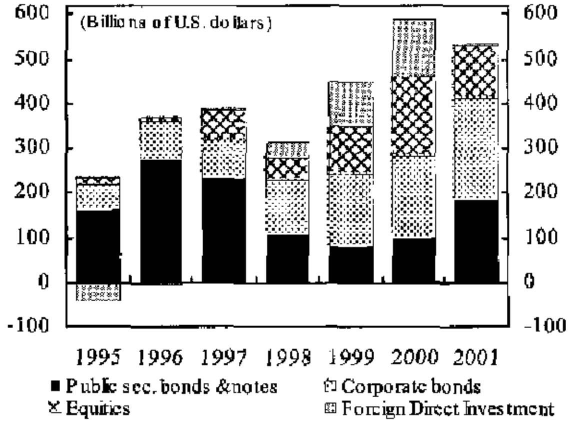
12. ***Despite the weakness in domestic demand, the current account deficit narrowed only modestly from its recent peak of 4¼ percent of GDP in 2000 to about 4 percent in 2001 (Table 3).*** Imports of goods and services—particularly capital goods—fell by 6 percent. The decline was partly offset by a 6¼ percent drop in exports of goods and services, especially exports of high-technology goods and machinery, reflecting the slowdown in global demand

[2] Given the acceleration in labor productivity growth since the mid-1990s, substantial uncertainty surrounds estimates of the output gap and underlying potential output growth. Various methodologies, which are reviewed in the forthcoming selected issues paper, suggest potential output growth in the range of 3–3¼ percent.

and the strength of the U.S. dollar (Table 4). However, the current account deficit widened to 4¼ percent of GDP in the first quarter of 2002, partly reflecting a pickup in import demand as U.S. economic conditions firmed.

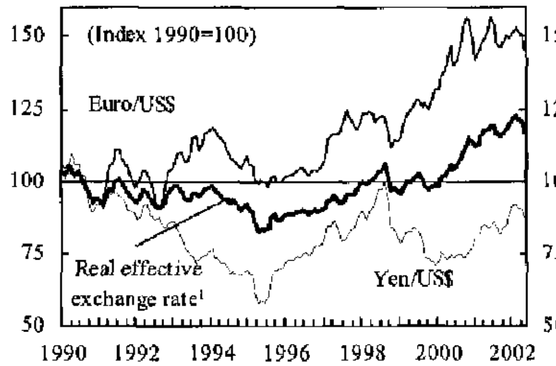
13. ***With continued market confidence in U.S. medium-term growth prospects, net private capital inflows have remained robust (Figure 10).*** However, inflows eased somewhat in 2001, reflecting a drop in net direct investment and equity inflows, partly due to the turnaround in sentiment toward IT investments, which outweighed a pickup in foreign purchases of corporate and agency bonds.

Figure 10. United States: Global Net Inflows



14. ***Reflecting strong capital inflows, the dollar appreciated in real effective terms until early 2002, when it began to give up some of its earlier gains (Figure 11).*** The dollar had risen against most major currencies during the past two years, appreciating by over 20 percent in real effective terms. However, the dollar began to weaken in early 2002, especially against the euro, the Japanese yen, and the Canadian dollar, falling by just over 4 percent in real effective terms during February–May, with further losses in June. Market commentary suggests that the dollar's recent decline reflects less optimistic assessments of U.S. growth prospects, concerns regarding accounting and governance irregularities following Enron's failure, and questions regarding the financing of the large U.S. current account deficit.[3]

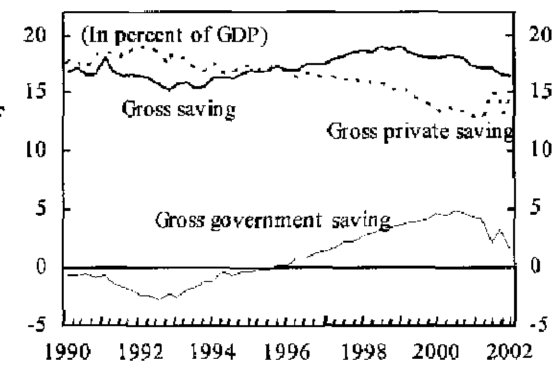
Figure 11. United States: Exchange Rates



1/ Based on unit labor costs.

15. ***After rising steadily from 1993 to 1998, gross national saving as a percent of GDP fell by 1¾ percentage points to 17 percent during 1998–2001 (Figure 12).*** Government saving

Figure 12. United States: Saving

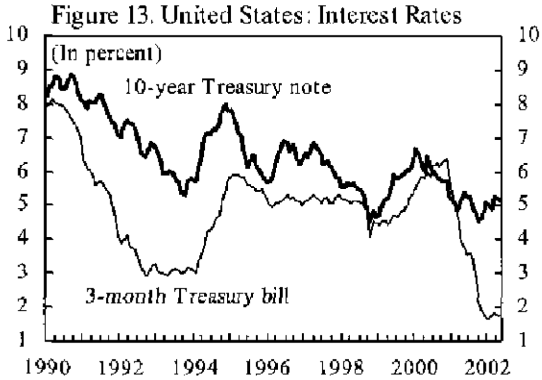


[3] Based on estimates of the equilibrium U.S. saving-investment balance of around -2 percent of GDP, CGER analysis in March 2002 suggested that a depreciation of the dollar of over 20 percent would be required for consistency with medium-term fundamentals.

declined as a result of tax cuts, rising expenditures in the wake of the attacks, and the impact of slower growth on tax revenues. Business saving also fell in 2001 as corporate profits slumped. The personal saving rate—which has been trending downward since the 1980s—reached a historical low of 1 percent of personal disposable income in 2000, but rose to 1½ percent in 2001 and to 3 percent in early 2002, partly in response to the June 2001 tax cuts.

16. ***Monetary policy was eased aggressively during the course of 2001, although several factors moderated the effect of interest rate cuts on monetary conditions.*** Following a series of tightening moves during the previous two years, which had taken the federal funds rate to 6½ percent by end-2000, the Federal Reserve lowered its interest rate target eleven times in 2001, bringing the federal funds rate to 1¾ percent (Figure 13). However, the effect of this easing on overall monetary and demand conditions was at least partly dampened by the appreciation of the dollar and the correction in stock prices.[4] Moreover, spreads on long-term corporate debt rose sharply in 2000 and 2001, reflecting concern about the underlying strength of corporate finances, and credit standards applied by banks to household and corporate customers also tightened during this period. Since late 2001, corporate spreads and lending conditions appeared to have eased somewhat, but still remain restrictive.

Figure 13. United States: Interest Rates



17. ***Fiscal policy turned expansionary beginning in FY 2001, with the June 2001 tax cuts, security-related outlays after the attacks, and a stimulus package enacted in March 2002.*** The unified budget surplus declined from 2½ percent of GDP in 2000 to 1¼ percent of GDP ($127 billion) in FY 2001, and the staff estimates that the balance will shift to a deficit of 1½ percent of GDP in FY 2002. The economic slowdown accounted for only part of the fiscal deterioration, and the structural balance is estimated to have shifted from a surplus of 2 percent of GDP to a deficit of 1½ percent of GDP between FY 2000 and FY 2002. In addition to policy measures, lower capital gains realizations also contributed to a structural deterioration in personal income tax revenues. State budgets have also come under pressure, reflecting the effects of weaker economic conditions and federal tax cuts on revenues, but the impact on outlays has been partly mitigated by drawdowns from reserves and proceeds from settlements with the tobacco industry.[5]

[4] A forthcoming selected issues paper reviews the evidence regarding the effect of monetary policy and financial conditions on economic activity.

[5] State and local government surpluses fell by just less than 0.1 percent of GDP in 2001, and are expected to be adversely affected in 2002 by the fact that state income tax rates are, in many cases, linked to federal rates.

III. Economic Outlook and Risks

18. ***The staff projects a gradual acceleration of GDP growth from 2½ percent in 2002 to 3¼ percent in 2003 as business activity recovers (see table below).*** Inventory restocking provided a substantial boost to growth in the first half of 2002, while business fixed investment is projected to gather strength in the second half of 2002 and into 2003. Consumption growth is expected to moderate in mid-2002—reflecting in part the waning effects of tax cuts—but pick up in 2003 as income growth strengthens. With the U.S. recovery leading that of its major trading partners, the current account deficit would widen to around 4½ percent of GDP in 2002 and 2003. Output would gradually return to potential in 2004, and with price pressures remaining subdued, CPI inflation would settle at around 2½ percent.

Medium-Term Projections
(In percent)

	2000	2001	2002	2003	2004	2005	2006	2007
Real GDP growth	4.1	1.2	2.5	3.3	3.6	3.4	3.1	3.1
Total domestic demand	4.8	1.3	3.2	3.9	3.7	3.5	3.2	3.2
Of which:								
Private consumption	4.8	3.1	3.0	3.2	3.3	3.3	3.2	3.2
Private fixed investment	7.6	-2.0	-2.0	6.4	6.8	4.7	4.0	3.9
Net exports (contribution)	-0.8	-0.1	-0.6	-0.5	-0.3	-0.2	-0.2	-0.3
Unemployment rate	4.0	4.8	5.9	5.7	5.4	5.3	5.3	5.3
CPI inflation	3.4	2.8	1.4	2.4	2.5	2.5	2.5	2.5
Unified federal balance/GDP	2.4	1.2	-1.6	-1.3	-0.6	0.1	0.1	0.2
Current account balance/GDP	-4.2	-3.9	-4.4	-4.5	-4.4	-4.3	-4.2	-4.2

Source: Staff estimates.

19. ***The staff's forecast broadly mirrors the private sector consensus, but recent data have highlighted the downside risks.*** In particular, signs of a slowdown of household demand and an erosion of stock market sentiment underscore several key vulnerabilities in the near-term outlook:

- ***Business fixed investment.*** Staff analysis does not suggest a severe investment overhang from the late 1990s, and there are early signs—including the pickup in orders for capital goods—of a turnaround (Box 3). Nonetheless, spending in some sectors, most notably telecommunications, will likely remain weak. Without a revival in final sales and a sustained improvement in corporate profits, an investment rebound could be short-lived.

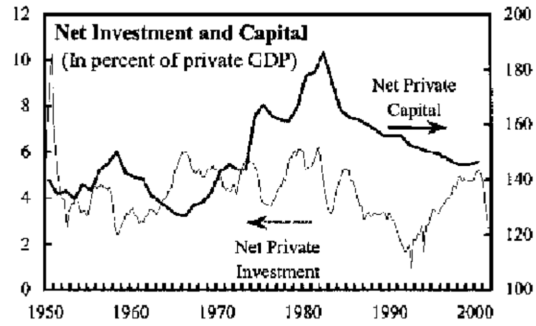
Box 3. Is There a Capital Overhang?

The investment boom of the late 1990s and its subsequent collapse have raised fears that a capital overhang would retard U.S. investment and growth. This concern has centered on the high technology sectors, given high profile bankruptcies and the tremendous growth in computer equipment investment in the second half of the 1990s (600 percent).

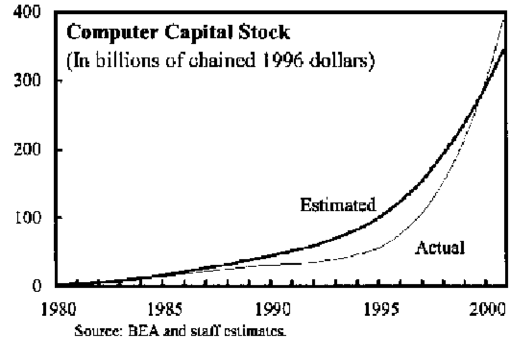
Surprisingly, however, the recent growth rate of the real capital stock has actually been lower than in previous decades. The average annual growth rate of private, fixed nonresidential capital accelerated to 3½ percent during 1995–2000, from 2 percent during 1990–95, but this was much slower than the 4 percent rate during the 1960s and 1970s. Unlike the 1960s and 1970s—when the stock of structures grew quickly—structures investment grew more slowly in the late 1990s. Indeed, equipment and software investment accounted for nearly 90 percent of investment growth in the late 1990s.

The increase in the investment rate can be viewed as a rebound from unusually low levels in the late 1980s and early 1990s (see figure). This earlier period of low net investment also resulted in a decline in the ratio of net private capital to net private GDP, which was arrested only late in the 1990s.

Recent empirical evidence also does not support the hypothesis of a widespread capital overhang, and staff analysis supports these results.[1] A simple neoclassical model that relates the long-run trend in the capital stock to output and the relative price of capital to output (which reflects borrowing costs, inflation, depreciation, and taxes) suggests that the capital stock fell below its equilibrium level during 1992–98, reflecting low net investment. By end-2000, the noncomputer capital stock remained below equilibrium, but over investment of computer equipment of $43 billion—equivalent to less than ½ percent of GDP, but almost 13 percent of the capital stock in computers—emerged. However, high technology goods have very high rates of depreciation, suggesting that most of this excess capital would be erased by the end of 2001. Other studies report a capital overhang of a similar size.[2]



Source: BEA and staff estimates. All data are nominal.



Source: BEA and staff estimates.

Prospects appear favorable for an investment rebound in late 2002. Strong productivity growth, low unit labor costs, continued declines in the relative price of capital, and the March 2002 investment incentives are widely expected to boost purchases of equipment.

Nevertheless, there remain uncertainties about the outlook for investment. Capacity utilization is low, and profits have yet to fully recover. While unit labor costs moderated at the end of 2001 and early 2002, productivity growth will need to remain high to sustain profit growth and net cash flow, especially as debt service rises with the expected tightening of monetary policy. Borrowing may also become more difficult in the face of accounting and corporate governance concerns. Finally, overinvestment in selected sectors and cities, especially in structures, could restrain spending.

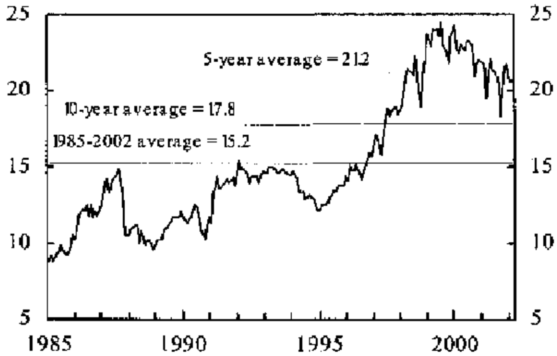
A forthcoming selected issues paper explores these issues in greater detail.

[2] See Macroeconomic Advisers, 2002, *Economic Outlook*, February, p. 15.

- ***Household demand.*** The unusual strength of consumption during the downturn means that there is a lack of pent-up consumer demand that usually helps drive recoveries. The U.S. personal saving rate is expected to rise gradually over the medium term, but a more rapid increase in the saving rate cannot be ruled out, especially in the face of a weaker labor market or asset market conditions.[6]

- ***Asset prices.*** Although valuation assessments are sensitive to assumptions regarding the equity premium, price-earnings ratios still look high relative to historical standards (Figure 14). Uncertainties about earnings prospects have been exacerbated by recent accounting scandals. Moreover, while the recent strength in housing prices is generally viewed as consistent with underlying fundamentals, some metropolitan areas may be vulnerable to correction.[7]

Figure 14. United States:
12-month Forward P/E Ratio for S&P500



- ***Current account.*** Staff projections are for the current account deficit to remain above 4 percent of GDP over the medium term, and for the U.S. net foreign liability position to rise from around 19½ percent of GDP at end-2001 to around 35 percent of GDP by end-2007, an exceptional level by post-war standards. This suggests potential vulnerability to a sudden loss of confidence or a shift in portfolio preference that could trigger a substantial dollar depreciation, upward pressure on interest rates, and a disruption of recoveries both in the United States and abroad.

- ***Oil shocks.*** The energy intensity of U.S. production has declined by over 44 percent since 1970, but per capita consumption has increased since the early 1980s and sharp increases in world oil prices would squeeze profit margins and discretionary household incomes.

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[6] Recent studies suggest that the trend decline in the U.S. personal saving rate reflects several factors, including the treatment of capital gains in the national accounts, the rise in household wealth, Medicare transfers, financial innovation, the increased share of pension distributions from defined benefit plans, and low inflation. However, with the recent decline in net wealth, and without strong capital gains in the future, the saving rate would be expected to rise over the medium term.

[7] Although housing prices have accelerated, many analysts argue this reflects a catch-up from the 1990s, when prices lagged household income growth. The FDIC has cautioned in its *Regional Outlook: First Quarter 2002* that loan-to-purchase price ratios have risen and that certain markets may be vulnerable to corrections if employment conditions worsen.

20. ***The resolution of these risks depends critically on whether the strong U.S. productivity growth since the mid-1990s can be sustained***. Recent evidence suggests that IT played an important role in boosting productivity growth, and the economy's strength during the past year provided encouraging evidence that earlier productivity growth can be sustained. This assumption underlies the staff and most other forecasts.[8] However, it remains an open question whether innovation and the diffusion of technology will be sufficient to justify these forecasts, or whether even mainstream growth projections will be sufficient to generate corporate earnings growth sufficient to support current stock valuations and a turnaround in investment, or provide the sustained growth of labor incomes necessary to restore saving rates while maintaining strong consumer demand.

21. ***Staff simulations illustrate the implications of these risks (Box 4).***[9] In particular, if productivity gains are not sustained, corporate profitability would be adversely affected, stock prices would be depressed, labor market conditions would deteriorate, and household balance sheets would become strained. International investor portfolio preferences would likely shift away from U.S. assets, weakening the U.S. dollar and helping to spur net exports. Although monetary policy could provide some further support to domestic demand, U.S. real GDP would fall well below baseline over the medium term, with adverse spillovers to the rest of the world, including to developing countries. These spillovers would be exacerbated by the capital losses that foreigners would suffer on their U.S. dollar-denominated holdings of U.S. assets.

22. ***Despite the generally high quality of U.S. data, large revisions and statistical discrepancies add to the uncertainty surrounding the current situation and prospects***. Revisions to the quarterly GDP data can be large, and gross domestic income has grown significantly faster than GDP raising questions about underlying productivity growth and the size of the saving-investment imbalance.[10] Substantial GDP revisions are expected in July—recent data suggest that personal income has been overstated by as much as $90 billion (nearly 1 percent of GDP) in 2001, which would also imply a downward revision to the personal saving rate.

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[8] The staff assumes annual labor productivity growth of around 2 percent, which is ¾ percentage point less than the rate during the second half of the 1990s, but roughly ½ percentage point higher than the 1973–95 average. For a recent review of the literature on the role of IT and the outlook for productivity growth, see CBO, *The Role of Computer Technology in the Growth of Productivity*, May 2002, and P. De Masi, "Does the Pickup in Productivity Growth Mean That There is a New Economy?" *United States: Selected Issues*, IMF Country Report No. 01/112.

[9] See the forthcoming selected issues paper for details.

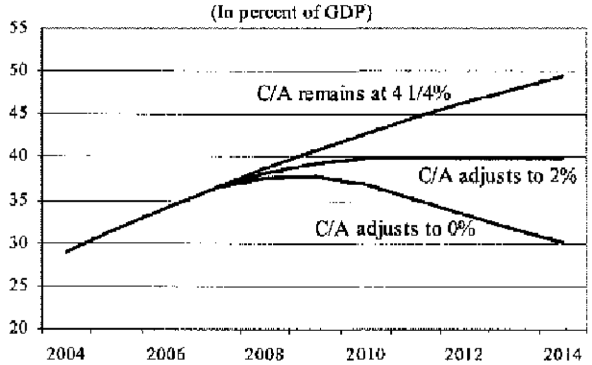
[10] See Council of Economic Advisers, *Economic Report of the President*, 2002.

Box 4. The U.S. Current Account Deficit and its Multilateral Implications

The U.S. current account deficit is again approaching 5 percent of GDP, which is expected to take the U.S. net foreign liability (NFL) position to over 20 percent of GDP this year. Federal Reserve Chairman Greenspan has suggested that "eventually the current account deficit will have to be restrained," and empirical analysis also suggests that current account deficits of this magnitude tend to trigger adjustments.[1] The critical question remains, however, when and how such an adjustment might take place, and what implications it might have for the U.S. dollar and the global economy.

A large current account adjustment would undoubtedly be required to stabilize or reduce the NFL position. Simulations of the dynamics of U.S. debt accumulation illustrate that a rapid adjustment of the current account deficit from 4½ percent of GDP to around 2 percent of GDP would be required to stabilize the NFL/GDP ratio at around 40 percent. Even with a much larger adjustment of the current account—to zero—the NFL ratio would still not return to its 2002 level within five years.

Alternative U.S. Net Foreign Liability Paths
(In percent of GDP)



It is useful to consider the factors underlying the widening of the current account deficit. Simple trade elasticities suggest that the 2½ percentage point increase in the deficit during 1995–2001 is largely explained by the roughly 30 percent real effective appreciation of the dollar, which contributed as much as 2 percentage points, and the relative weakness of partner country growth, compared with the first half of the decade, which contributed a further 1 percentage point.

Thus, the current account deficit primarily reflects the relative strength of U.S. productivity growth, which spurred investment and attracted capital inflows that supported dollar appreciation. Over the past decade, foreign holdings of U.S. assets have doubled as a share of GDP to around 80 percent. Capital inflows have been largely directed toward private assets, particularly in the form of foreign direct investment and equities. The composition of inflows shifted somewhat recently toward corporate and government debt, in response to the economic slowdown and the bursting of the IT bubble. Nonetheless, the share of equities and FDI in total nonresident holdings reached 37 percent by 2000, compared with 30 percent in 1990.

Simulations of the IMF's multi-country model (MULTIMOD) illustrate that a relatively smooth and protracted adjustment could result from a gradual pickup in productivity growth abroad and a rebalancing of investor portfolio preferences.[2] This scenario would involve a potentially large but gradual depreciation of the U.S. dollar over time, and strong growth both in the United States and in partner countries.

Less benign adjustments can also be envisaged. If U.S. productivity growth were to disappoint relative to current expectations and/or portfolio preferences shifted rapidly away from U.S. assets, a much more rapid depreciation of the dollar could ensue, with potentially weaker U.S. growth and demand. Since most U.S. liabilities are denominated in dollars, the adverse balance sheet effects would fall mainly on the rest of the world. For example, if all nonresident holdings of U.S. assets (80 percent of GDP at end-2001) were dollar-denominated, and all U.S. resident holdings of foreign assets (62 percent of GDP at end-2001) were foreign-currency denominated, the effect of a 20 percent depreciation would be to lower the U.S. NFL position by 12½ percentage points of GDP, and to lower foreign investors' wealth by 16 percent of GDP.

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[1] A. Greenspan, 2002, Speech before the Independent Community Bankers of America, March 13. The empirical result is based on examination of 25 episodes of current account adjustment in industrial countries over the 1980s and 1990s by C. Freund "Current Account Adjustment in Industrialized Countries," Board of Governors of the Federal Reserve System, IFDP No. 692 (December 2000). See also C. Mann, 2002, "Perspectives on the U.S. Current Account Deficit and Sustainability," *Journal of Economic Perspectives*, forthcoming.

[2] MULTIMOD simulations of the current account are presented in past and forthcoming U.S. selected issues papers and the *World Economic Outlook*. The forthcoming WEO will also address these issues in detail.

IV. Policy Discussions

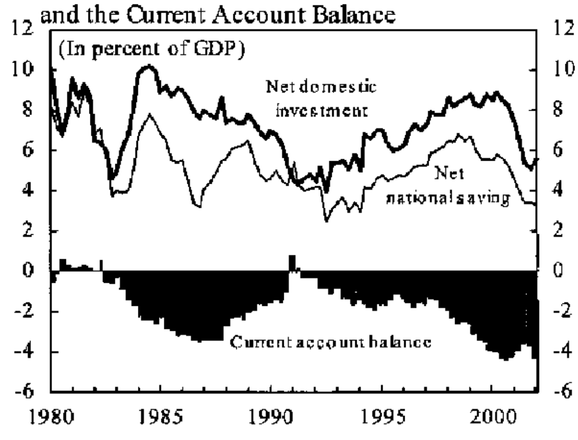
A. Economic Conditions and Prospects

23. ***U.S. officials broadly shared the staff's views on the economic outlook.*** They agreed that activity had been remarkably resilient, especially in the face of the September 11th attacks. Although the Administration's forecast would not be finalized until the summer Mid-Session Review, growth seemed likely to remain at around 3 percent for the balance of 2002, with the economy accelerating to its potential growth rate of just over 3 percent in 2003. The recovery would be underpinned by a rebound in investment from presently very low levels, and sustained but moderate consumer spending.

24. ***Officials acknowledged that significant uncertainties remained, with several factors weighing on business investment.*** These included lingering concerns over the strength of final demand and profits, the considerable excess capacity in the manufacturing sector (especially in telecommunications), and some signs of an overhang in the commercial real estate market. Moreover, Enron's collapse had increased risk aversion and affected credit conditions, especially for second-tier borrowers in the commercial paper market. Nonetheless, these risks were balanced by the likelihood that corporate profits would continue to rebound strongly, given the lagged effect of last year's interest rate cuts, and the investment incentives contained in the 2002 stimulus bill, and continued productivity gains.

25. ***The U.S. representatives did not view the condition of household balance sheets or the low personal saving rate as major downside risks.*** The recent strength of consumer spending had been broadly consistent with normal empirical relationships and the level of household debt was not expected to restrain spending, especially given low interest rates and a still relatively high level of household net worth. The full effect of last year's interest and tax rate cuts had yet to be realized and therefore would also support demand. Thus, while the personal saving rate was expected to rise, the adjustment was likely to be gradual rather than abrupt.

Figure 15. United States: Saving, Investment and the Current Account Balance



26. ***A disorderly adjustment of the current account was seen as unlikely (Figure 15).*** Officials viewed the high current account deficit and the dollar's buoyancy in recent years as reflecting the response of capital flows and market forces to the fundamental strengths of the U.S. economy and relatively weaker growth prospects abroad. They agreed that foreign investors would not remain willing to take on additional U.S. assets at present rates indefinitely, and that a depreciation of the dollar would eventually be required to narrow the deficit and stabilize the U.S. net foreign investment position. Nonetheless, they expected the adjustment to be gradual, especially since it was unclear

which partner countries' currencies were presently in a cyclical position to appreciate against the dollar. While rapid movements in the dollar could not be ruled out, the experience from the mid-1980s and mid-1990s had illustrated the financial system's ability to absorb even large and rapid adjustments in bilateral exchange rates without a major impact on activity. U.S. market participants were particularly well-placed to weather significant exchange rate volatility since most U.S. liabilities were denominated in dollars and risk management and capitalization in the U.S. financial system were strong.

27. ***The staff suggested that the large current account deficit underscored the need to raise national saving—including through more disciplined fiscal policies—in order to reduce the risk of a disorderly adjustment.*** The U.S. representatives broadly agreed that an increase in national saving would be helpful, but they saw no need for U.S. policies to respond specifically to the large current account deficit. In their view, gearing domestic policies toward exchange rate or current account objectives would be inappropriate, especially in the absence of major policy imbalances. Moreover, they did not expect that fiscal instruments would have significant leverage over the U.S. saving rate. In their view, the U.S. current account deficit would best be resolved by partner countries pursuing structural and other policies necessary to yield stronger growth.

28. ***Officials agreed that the economic outlook hinged on continued productivity growth.*** They presently assumed annual productivity growth of around 2 percent, and given that capital deepening was not expected to provide as large a contribution to growth as in the late 1990s, this implied potential GDP growth of around 3¼ percent, broadly in line with the staff estimate. They acknowledged the considerable uncertainty surrounding these forecasts, but the fact that productivity growth had remained robust during the past year in the face of considerable shocks suggested that the benefits of the IT revolution were likely to be sustained, and could possibly be larger than presently projected.

B. Monetary and Exchange Rate Policies

29. ***The Federal Open Market Committee (FOMC) has kept its policy stance on hold thus far in 2002.*** Since January, the FOMC has maintained its target for the federal funds rate, but announced in March that the risks had become balanced and were no longer tilted toward economic weakness. In May and June, the FOMC again left its target and its characterization of the balance of risks unchanged, noting that although the stance of monetary policy was accommodative, the degree of strengthening of final demand in the coming quarters was still uncertain.

30. ***The discussions focused on the likely pace and timing of the eventual withdrawal of monetary stimulus.*** The staff noted that interest rates appeared highly accommodative and with the expected absorption of slack in the coming year and the usual transmission lags, actions to begin withdrawing stimulus would normally be expected relatively soon. Indeed, at

the time of the discussions market expectations, including those embodied in yield curves, suggested that monetary tightening would begin around August/September.[11]

31. ***Federal Reserve officials agreed that the policy stance would eventually need to tighten but saw room to wait until the recovery was more clearly established.*** In their view, the shocks that the economy had endured over the last year had left residual deflationary forces in the economy. As a result, inflation pressures were dormant, with PCE inflation well below 2 percent, inflation expectations well-anchored, and labor compensation decelerating. Since strong productivity growth was holding down cost pressures and there remained considerable uncertainty regarding the underlying strength of final demand, particularly with regard to investment, the risks associated with too early a withdrawal of stimulus seemed greater than those of waiting.

32. ***Officials noted that structural factors also supported a more cautious approach to withdrawing stimulus.*** The recent experience had made the FOMC mindful of the zero bound on nominal interest rates and—with U.S. short-term interest rates at very low levels—policy makers were ready to be more aggressive than otherwise to counter the risk that the zero bound could become binding. Indeed, they explained that this had been a consideration behind the decision to act in a decisive fashion following the September 11th attacks. There also appeared greater scope to wait given the apparent shortening of the transmission lags between monetary policy and activity. Although the importance and magnitude of this change were not well established, underlying factors could include increases in the share of financial assets in household balance sheets, the role of short-term funding in capital markets, and the size of the external sector.

33. ***Officials suggested that improvements in policy transparency might also have helped enhance policy effectiveness.*** Since the mid-1990s, the Federal Reserve had taken a series of steps to increase transparency, including the publication at the conclusion of every FOMC meeting; the Committee's target for the federal funds rate, the policy bias, and the minutes of the previous meeting. In early 2002, the FOMC had taken the additional step of releasing a record of the committee members' votes. These moves seemed to have helped anchor inflation expectations and increase policymakers' leverage over real interest rates, and by enhancing the predictability of monetary policy, they had possibly increased the speed with which policy affected the economy.

34. ***In light of the dollar's recent weakness and concerns regarding the large current account deficit, the mission inquired about the authorities' exchange rate policy.*** The U.S. Treasury representatives responded that the authorities' views on the exchange rate were unchanged—the focus of policies was on ensuring conditions to support strong domestic growth, and the authorities had no particular objective for the level of the exchange rate. They also reiterated their view that intervention in foreign exchange markets could have, at

[11] With weaker data in June, yield curves shifted down significantly, consistent with a shift in the consensus toward a view that interest rate hikes would likely be delayed until the Fall.

best, only a transitory effect on exchange rates. Federal Reserve officials commented that a sharp depreciation of the dollar also would not necessarily require a shift in the monetary policy stance. The relatively small share of trade in the U.S. economy meant that the exchange rate had a relatively modest effect on prices and inflation expectations, and—depending on the factors that might be contributing to the dollar's weakness—the stimulative effect of improved competitiveness on overall financial conditions might be offset, including by softer equity prices.

C. Fiscal Policy

35. ***Policy initiatives, as well as cyclical and other shocks, have taken a large toll on the fiscal situation.*** Last year's budget projected a FY 2002 surplus of about 2½ percent of GDP on a current-services basis and, with the surplus rising further over the medium term, net federal debt held by the public was projected to fall from 33 percent at end-FY 2001 to zero by the end of the decade. However, these projections were quickly overtaken by the economic slowdown, the June 2001 tax cuts, and additional outlays enacted following the September 11th attacks. Monthly tax receipts have also recently fallen well short of target—principally reflecting weaker tax payments by households for capital gains and other non-labor income—and the March 2002 economic stimulus legislation and the Administration's FY 2003 budget issued in February 2002 have further eroded the fiscal outlook (Box 5):[12]

- The ***stimulus package*** enacted in March 2002 included measures totaling around $50 billion (½ percent of GDP) in FY 2002.

- The budget proposed ***tax cuts,*** amounting to nearly $550 billion over FY 2003–FY 2012. The majority of revenue losses would occur in the latter two years of the ten-year period, reflecting proposals to make permanent the June 2001 tax cuts that expire in 2010.

- The budget also proposed ***increased outlays,*** notably for defense and homeland security. Over FY 2003–FY 2012, discretionary spending would increase by around $295 billion—reflecting a $480 billion increase in defense offset by a $188 billion decrease in nondefense spending—and mandatory spending would rise by about $440 billion.

Budget Projections
(In percent of GDP)

	Fiscal Years		
	2002	2003	2007
FY 2003 budget			
Unified balance	-1.0	-0.7	0.8
Excl. Social Security	-2.6	-2.4	-1.0
Debt	33.4	32.7	25.1
Staff estimate			
Unified balance	-1.6	-1.3	0.2
Excl. Social Security	-3.2	-2.9	-1.6
Debt	33.6	33.4	27.2

Sources: *Budget of the United States Government, FY 2003;* and staff estimates.

[12] Estimates based on CBO, *An Analysis of the President's Budgetary Proposals,* March, 2002.

Box 5. Recent Fiscal Policy Initiatives

Over the last year, important fiscal policy initiatives were implemented—most notably the June 2001 tax cuts and the March 2002 economic stimulus package—and further tax cuts and spending increases were proposed in the Administration's FY 2003 budget, released in February 2002.

The June 2001 tax cuts—the largest cuts in 20 years—featured a phased reduction of marginal income tax rates, new targeted incentives, and the repeal of the estate tax. To keep the cost of the tax cut in line with the agreed level of $1.35 trillion over the period FY 2001–FY 2011, the legislation included a "sunset" provision, whereby the tax cuts are effective only through the end of 2010, and thereafter, the tax system would revert to the one in place before the new tax law was enacted. Specific measures include:

- Individual income tax rate cuts are phased in over the period 2001 to 2006 with the top rate falling from 39.6 to 35 percent, and the 28, 31, and 36 percent rates falling by 3 percentage points (Table). A new 10 percent tax bracket was added for lower incomes in 2001.

- A gradual elimination of the estate tax during 2002–10 with increases in exemptions and reductions in rates during 2002–09 and repeal of the tax in 2010. Also included were a gradual increase in the child credit; enhanced alternative minimum tax relief—through an increase in exemptions—for the period 2001–04; and additional relief for married couples phased in over 2005–09.

Scheduled Marginal Income Tax Rate Cuts
(in percent)

Pre-2001 Tax Rate	2001	2002	2004	2006
39.6	39.1	38.6	37.6	35.0
36.0	35.5	35.0	34.0	33.0
31.0	30.5	30.0	29.0	28.0
28.0	27.5	27.0	26.0	25.0

An economic stimulus package—expected to cost $51 billion in FY 2002, and $46 billion in FY 2003—was signed into law in March 2002.[2] The package:

- Allows businesses to take an additional first-year depreciation deduction of 30 percent on certain investments made during the three years after September 10, 2001; temporarily extends the business loss-carry-forward rule from two to five years; provides tax cuts for New York City businesses damaged by the September 11th terrorist attacks; and introduces an additional 13 weeks of unemployment benefits in states with unemployment rates greater than 4 percent.

The Administration's FY 2003 budget proposes increased spending, particularly for defense and homeland security, and further tax cuts, which together would reduce projected budget balances by about $1.7 trillion over the period FY 2003–FY 2012. Key proposals include:

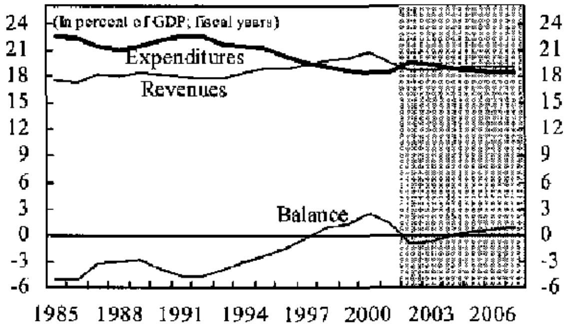
- Eliminating the "sunset" provision of last year's tax cuts, which would reduce revenues as a share of GDP in FY 2011 and FY 2012 by ¾ percent and 1¼ percent of GDP, respectively; permanently extending the research and experimentation tax credit; temporarily extending most other expiring tax provisions; reforming the corporate alternative minimum tax; and introducing tax incentives for charitable giving, and tax credits for the uninsured, long-term care insurance, and single-family housing.

- A $480 billion increase in defense spending over the ten-year horizon, which is partially offset by a $188 billion cut in nondefense spending; restructuring and expanding Medicare (including a prescription drug benefit), health insurance assistance, and increased spending on agriculture.

[1] The Economic Growth and Tax Relief Reconciliation Act of 2001.

[2] The Job Creation and Worker Assistance Act of 2002.

Figure 16. United States: Budget (Unified)



36. ***As a result, the fiscal outlook has weakened considerably.*** The Administration's FY 2003 budget estimates assumed a deficit of 1 percent of GDP in the current fiscal year, with a gradual narrowing of the deficit until FY 2005, when surpluses would be re-established (Table 5 and Figure 16). However, these surpluses would be relatively modest, implying that the Administration's previous commitments to avoid spending the Social Security trust fund would not be met even by FY 2007. Moreover, as a result of more recent policy actions and tax shortfalls, the authorities' projections appear somewhat optimistic. The staff expects the unified budget deficit to reach at least 1½ percent of GDP in FY 2002 and 1¼ percent of GDP in FY 2003, with only a very modest surplus achieved by the end of the medium term.

37. ***During the discussion, the U.S. representatives stressed that the turnaround in the FY 2002 fiscal position reflected an appropriate and timely response to the cyclical and other shocks suffered during the past year.*** The September 11th attacks necessitated additional outlays, including for reconstruction, homeland security, and the broader war on terrorism. Moreover, the June 2001 tax cuts provided a fortuitously timed boost to the economy. Officials also disagreed with the mission's suggestion that the March 2002 stimulus package may not have been necessary given the strong recovery in activity. In their view, the additional investment tax incentives and the extension of unemployment benefits were important to help ensure the eventual turnaround in private investment and to provide continuing support to household demand.

38. ***Turning to the medium-term outlook, the mission raised concerns that the budget projections appeared subject to downside risks.*** On the expenditure side, to accommodate increased outlays on defense, the budget assumed a squeeze of other spending categories to an extent that could be difficult to sustain. For example, nondefense discretionary outlays were envisaged to increase at an average annual rate of only 1½ percent during FY 2004–FY 2007, implying cuts in real terms, especially if the additional outlays for homeland security are excluded. Moreover, Congressional Budget Office (CBO) estimates suggest that Administration projections for Medicare outlays may be understated by as much as $220 billion over FY 2003–FY 2012. On the tax side, the projections do not take into account the likely renewal of various tax credits and the relief from the individual Alternative Minimum Tax (AMT), which expires in 2004. The annual fiscal cost of these could reach more than ¾ percent of GDP.

39. ***The mission noted that longer-term fiscal pressures were also looming.*** The retirement of the baby-boom generation, which is expected to begin in the latter half of the decade, and the continued rapid growth of medical costs, would increase outlays for Social Security and Medicare. As a result, within two decades, the Social Security and Medicare Hospital Insurance (HI) trust funds are projected to start running sizable deficits, and their

combined actuarial deficit over a 75-year horizon would be roughly 80 percent of GDP. The deficit would be nearly twice this amount if the Supplemental Medical Insurance (SMI) portion of Medicare were taken into account.

40. ***Against this background, the staff suggested establishing a medium-term fiscal framework aimed at balancing the budget excluding Social Security over the cycle.*** This objective—which the Administration had endorsed last year—would provide sufficient flexibility for the fiscal position to respond to cyclical shocks, while allowing federal debt to be worked down in anticipation of a more durable solution to the longer-run insolvency of the Social Security and Medicare systems. The mission observed that achieving this goal over the next five years would appear to require measures of at least 1 percent of GDP (relative to the FY 2003 budget proposals) and therefore a re-evaluation of expenditure and tax priorities. Given already tight spending projections for nondefense discretionary spending, proposed new initiatives may need to be reconsidered or put on hold. On the revenue side, options included base-broadening or other tax reforms, including reductions in the number of tax expenditures, shifting the emphasis from income-based to consumption-based taxes, or increasing energy taxes.[13] In the absence of alternative proposals, the further reduction in tax rates that was legislated in June 2001 could be delayed.

41. ***The U.S. representatives responded that while the Administration was broadly committed to re-establishing unified fiscal surpluses and a gradual reduction in federal debt, it was not yet in a position to endorse a specific fiscal objective given the change in budget priorities following the September 11th attacks.*** While they acknowledged that the fiscal outlook was less strong than had been anticipated last year, the debt-to-GDP ratio was relatively low by historical and international standards and was still expected to remain on a declining path over the medium term. They acknowledged the risks to the budget projections, but they stressed that the key would be to contain spending growth, especially discretionary outlays, which had been inflated in recent years owing to Congressional "earmarks." They agreed that care would be needed to ensure that the rapid build-up of defense and security-related spending not result in waste and inefficiency.

42. ***The U.S. representatives ruled out revenue-raising measures.*** Although the revenue/GDP ratio had dropped below its recent peak, it remained well above its longer-run average. Therefore, they saw no rationale for postponing the remaining tax cuts, given their valuable supply-side effects, especially for the small business sector, and the authorities' broader commitment to reducing the overall tax burden. Although the authorities were interested in pursuing broader tax reforms, specific proposals would not be advanced until after the November mid-term elections, and they would likely focus on budget-neutral measures to reduce the complexity of the system.

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[13] For example, the OECD estimates that corporate and personal income tax expenditures are almost 8 percent of GDP, and that gasoline price increases of at least $0.40/gallon would be justified simply to account for pollution and other externalities associated with motor vehicles.

43. ***The U.S. representatives agreed with the mission on the importance of placing the Social Security system on a sound financial footing.*** A Presidential commission had already been established to develop reform options, subject to the authorities' strong preference for solutions that included the introduction of voluntary personal retirement accounts (PRAs), but avoided increases in payroll taxes or cuts in benefits for current retirees or those close to retirement. The commission's December 2001 report illustrated a number of alternative proposals that involved introducing PRAs and slowing the growth of benefits by amending the indexation formula. The U.S. representatives acknowledged that shifting Social Security contributions to personal retirement accounts would have a significant adverse transition effect on the federal deficit. However, the decrease in public saving would be at least offset by an increase in personal saving, especially if incentives for additional voluntary contributions were adopted. They stressed that the commission's report was intended mainly to foster a national debate on reform options and the Administration had not yet formulated a well-defined proposal of its own.

44. ***The mission noted that the financial situation of the Medicare system appeared to be even more worrisome.*** The team welcomed the inclusion of actuarial estimates for the SMI portion of Medicare in the FY 2003 budget documents, but noted that despite this large liability and the budget's acknowledgement of the need for reform, no specific measures were advanced for ensuring the system's long-term viability. Rather, a new prescription drug benefit was proposed that would seem likely to exacerbate the problem. The U.S. representatives stressed the authorities' continued commitment to reforming the system. In their view, reforms needed to center on modernizing Medicare and reducing costs, including by expanding the role of the private sector in the delivery of health care services to the elderly.

45. ***The mission raised concerns about the expiration of institutional mechanisms for ensuring budget discipline.*** In particular, the discretionary spending caps and the pay-as-you-go (PAYGO) requirements under the Budget Enforcement Act (BEA) of 1990 were due to expire at the end of FY 2002.[14] The effectiveness of these rules had clearly waned in recent years—with the routine use of "emergency appropriations" and other techniques. Nonetheless, the mission called for renewing and extending these mechanisms, including by defining realistic discretionary spending caps and tightening their enforcement, especially in the context of a re-commitment to a well-specified medium-term budgetary objective. The team also noted that budget transparency seemed to have diminished during the past year, especially with the decision to phase in last year's tax cuts and to legislate their expiration in 2010, and to shorten the budget's projection horizon from ten to five years, both of which tended to obscure longer-term fiscal pressures.

[14] The BEA established medium-term spending caps over so-called discretionary spending—i.e., spending that is not controlled by permanent law—and established the PAYGO system, which required that legislated changes to revenues or mandatory spending programs be budget neutral over a five-year horizon. A forthcoming selected issues paper explores these topics in detail.

46. ***The U.S. representatives explained that they remained committed to fostering budget discipline.*** They stressed that the decision to shorten the budget horizon had simply reflected recognition of the extreme uncertainties surrounding ten-year projections. The Administration had signaled its willingness to go along with an extension of the BEA rules, and had also proposed a joint budget resolution early in the annual budget cycle, in order to establish an over-arching framework for the appropriations committees, which would be enforced by Presidential veto. However, at this stage there seemed little momentum in Congress to carry such initiatives forward.

47. ***Indeed, the U.S. representatives stressed that the impending breach of the debt ceiling was a more pressing priority.*** With the recent weakness in tax receipts, the various mechanisms used thus far to avoid a breach of the ceiling would be insufficient to cope with large interest payments coming due at end-June and it was essential for the Congress to approve an increase as soon as possible.[15] The U.S. representatives viewed the current system of periodic hikes in the debt limit as anachronistic and they saw merit in reinstating earlier mechanisms that provided for automatic increases at the time of budget authorizations.

D. Financial Sector Issues

48. ***The U.S. representatives and the mission agreed that, despite the economic downturn and the failure of several large corporations, the financial system had remained resilient (Table 6).*** Officials emphasized that corporate credit markets had displayed an increased degree of caution and sensitivity to risk exposure during the past year, in response to continued stresses in the energy, telecom, and high-tech sectors, and especially in the wake of Enron's bankruptcy in late 2001. Nonetheless, financing remained available to credit-worthy borrowers, and given the breadth of U.S. credit markets, pressures in some segments had been absorbed with relative ease. Derivatives and off-balance-sheet exposures, including by insurance companies, were well-managed, and by fostering improvements in risk management, they reduced rather than increased systemic risk.

49. ***The mission inquired how well U.S. banks had weathered the downturn.*** The U.S. representatives responded that banks had entered the slowdown with high levels of capital, sound risk-management systems in place, and well diversified balance sheets, including relatively modest exposures to the IT sector. The easing of monetary conditions had also helped to reduce funding costs and sustain profitability, with commercial banks posting a 12½ percent return on equity in 2001. Nonetheless, there remained pockets of vulnerability—including with regard to smaller banks, where the scope for compressing funding costs was more limited, and with regard to exposures to commercial real estate, specific manufacturing

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[15] At end-June, Congress passed a $450 billion increase in the debt ceiling.

sectors, and households. However, while nonperforming loans might still increase, provisioning was considered more than adequate.[16]

50. ***Banking supervisors viewed the supervisory framework established under the 1999 Gramm-Leach-Bliley Act as functioning well.***[17] Coordination and information-sharing agreements had been reached between the Federal Reserve—which acted as the umbrella supervisor of financial holding companies (FHC)—and the other functional regulators of banks, securities firms, and insurers. Joint inspections of institutions were also conducted, where necessary, and any differences of views between supervisors were generally resolved. The firewalls that were part of the new supervisory framework for FHCs had also been effective in limiting the risks to insured deposit-taking institutions.[18] Questions remained regarding the ability of state insurance supervisors to cope with the increasing complexity of that sector's financial transactions—especially since insurance regulations were geared more toward consumer protection than financial soundness—but the sector was well-capitalized.

51. ***The U.S. representatives stressed the importance of completing the Basel II Accord.*** In their view, current capital adequacy standards insufficiently accounted for risk and the proposal to embed internal risk-management systems into a regulatory framework would improve supervision and encourage better risk management. However, they also acknowledged that important hurdles remained, including with regard to the complexity of the new requirements, calibrating the new system to avoid capital shedding, and reconciling disclosure and other standards with the diversity of countries' regulatory regimes and market conditions. Nonetheless, they were encouraged by the apparent broad-based consensus on the need to move forward in a coordinated fashion.

52. ***Legislation to further reform the deposit insurance system was being considered by Congress.*** Proposals would ensure that risk-based premiums, which presently only applied to around 10 percent of institutions, would apply to all institutions; merge the insurance funds of banks and thrifts; amend existing rules to avoid sharp and procyclical increases in premiums when fund reserves fell below pre-set limits; and raise the limit on the size of insured deposits. The U.S. representatives broadly endorsed these proposals, except for the increase in coverage limits, which was viewed as unnecessary, given the scope for multiple insured deposits, and also as likely to increase systemic costs and reduce market discipline.

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[16] In 2001, banks increased provisions by 30 percent in response to deteriorating asset quality, especially in the commercial and industrial portfolios of large banks.

[17] For a detailed discussion, see P. De Masi, 2000, "U.S. Financial Sector Reform: The Gramm-Leach-Bliley Act," *United States: Selected Issues*, IMF Staff Country Report No. 00/112.

[18] Regulations restrict FHCs from lending more than 10 percent of their capital to a single affiliate and from lending more than 20 percent of capital to all affiliates.

Box 6. Governance and Accounting Practices in the Wake of the Enron Debacle

In December 2001, after announcing third-quarter losses and a downward restatement of previous years' earnings, Enron Corporation filed for bankruptcy. Enron's stock price dropped from a high of $90/share to well under $1/share, virtually eliminating market capitalization of over $60 billion (½ percent of GDP) and also impairing the value of its employees' 401(k) pension assets, which were heavily invested in Enron's stock.

Enron's failure and subsequent announcements of accounting irregularities by other large corporations have adversely affected market sentiment. Investor sentiment toward a number of U.S. firms with complex structures or whose balance sheets appeared similarly vulnerable has soured, most notably following the June 2002 announcement by WorldCom that improper accounting had resulted in an overstatement of its 2001 earnings by nearly $4 billion.

These events have prompted calls for strengthening U.S. accounting frameworks and systems for corporate governance in a number of areas:[1]

- **Corporate governance**—Suggested reforms in this area include strengthening the effectiveness and accountability of boards of directors, including by improving the quality of audit committees and increasing the role of outside directors. Under existing rules, members may be current or former employees of the company, or may have significant business relationships with the company, and there are only limited requirements regarding their financial expertise.

- **Regulation and supervision of auditors**—Currently, the American Institute of Certified Public Accountants—an industry trade group—monitors auditor independence and quality, but lacks legal authority, including to issue subpoena or to enforce punishments. Proposals for reform include the establishment of a new independent oversight body, empowered with the necessary legal authority and funding.

- **Conflicts of interest**—Audit companies provide significant consulting services to their clients, yielding as much as three times the revenue generated by audit fees. Companies also frequently recruit their senior managers from their auditors. Proposals have been made to restrict these practices and require regular rotation of audit companies, to limit conflicts of interest.

- **Special purpose entities (SPEs) and limited partnerships**—SPEs have been used to understate liabilities as current rules—allowing SPEs to remain off-balance sheet if outside equity capital investment is no less than 3 percent of total SPE capital— often do not reflect that sponsor retains substantive risks of the assets transferred to an SPE. In addition, Enron's use of limited partnerships, off-balance-sheet activities, and aggressive accounting with regard to nontraded or thinly traded assets and treatment of future revenues also are considered to have helped inflate earnings and understate debts. Proposals have been made to improve disclosure and accounting in these areas.

- **Stock options**—The growing share of compensation of senior managers in the form of employee stock options is thought to create undue incentives to mask performance problems in order to boost stock valuations. Although grants of stock options are currently reported in financial statements, existing accounting rules do not require companies to expense the implicit cost of this form of compensation, providing scope to overstate earnings.

Other accounting issues—Enron is also considered to have understated its debt by the use of "trust preferred securities." These securities are preferred shares backed by subordinated debt to trust subsidiaries, allowing companies to treat dividend payments as interest expenses for tax purposes without increasing their reported debt. In order to address these and similar issues, suggestions have been made to gradually move toward more principles-based accounting standards—as opposed to the current rules-based system—and "forensic audits" focusing on specific areas of concern.

[1] A more detailed discussion is contained in the selected issues paper.

53. ***The mission expressed concern that the failure of Enron could reflect broader systemic weaknesses and the need for reforms*** (Box 6).[19] The U.S. representatives responded that they were confident that, while a full assessment of the factors underlying Enron's failure would have to wait for the completion of ongoing investigations, the apparent shortcomings in Enron's business practices were not widespread. Indeed, they suggested that the event had illustrated the resilience of the U.S. financial and corporate systems. Financial markets had withstood Enron's bankruptcy relatively well, reflecting the breadth of the credit delivery system and its ability to spread risk. Moreover, markets and market institutions had already responded by strengthening their discipline of the corporate sector—investor scrutiny of accounting and other practices had intensified, and companies with relatively opaque balance sheets had seen their stock prices weaken. Nonetheless, officials acknowledged that the incident had illustrated the potential for strengthening the U.S. system of corporate transparency and disclosure; accounting standards and oversight of the accounting profession; and corporate governance.

54. ***The U.S. representatives suggested that a measured approach to reform would be important.***[20] In general, they preferred to rely on strengthened market-based rules and institutions to bolster market discipline, rather than on direct government regulation. Therefore, the Administration's ten-point reform plan had emphasized strengthening transparency, corporate accountability, and the audit system, rather than a substantial increase in regulatory burdens. Proposals for a new government body to oversee the accounting profession appeared unwarranted, and they preferred the more limited approach of establishing an independent regulatory board, under the supervision of the Securities and Exchange Commission. They supported recent moves by stock exchanges to make listing requirements more demanding, which they saw as helping to improve transparency and governance, and there also was room to tighten accounting standards, including with regard to the treatment of off-balance-sheet entities and the expensing of stock options. They also saw possible merit in moving the U.S. accounting system away from a rules-based approach to one based on principles, which would better align the U.S. system with international norms. However, this approach would be difficult to mesh with existing legal systems, and any moves in this direction would need to be implemented gradually and in a manner that did not sacrifice the acknowledged strengths of the U.S. system.

55. ***In response to the impact of Enron's failure on its employees' pension plan, reforms have also been proposed to limit the extent to which employer-sponsored plans are invested in the sponsors' stock.*** The U.S. representatives noted that the Administration supported proposals that aimed to increase diversification of pension plan assets—including by requiring that either the employee or the employer contribution be invested in assets other than the employer's stock; reducing the time period during which matching contributions may not be diversified; improving disclosure requirements; easing rules governing blackout

[19] The discussions pre-dated the late-June announcement by WorldCom of its accounting irregularities.

[20] These issues are reviewed in the selected issues paper.

periods; and encouraging the provision of financial advice to plan participants. The U.S. representatives noted that more stringent approaches—including those that would cap the amount of employer stock held in such plans—were viewed as overly intrusive and, by increasing pension plan costs, could reduce workers' coverage.

56. ***U.S. anti-money laundering (AML) systems have been strengthened in the aftermath of the September 11th attacks.***[21] New legislation—the USA Patriot Act—was enacted in October 2001, and established a framework for information sharing between enforcement agencies, regulators, and financial institutions; provided regulators with new powers with respect to terrorist financing; and strengthened and broadened AML reporting requirements. The U.S. representatives noted mechanisms to insure compliance were in place and operating effectively, but acknowledged that challenges remained in extending AML rules to a wide range of nonbank institutions for the first time. The United States was still only in partial compliance with a number of the Financial Action Task Force recommendations, largely reflecting the absence of regulations requiring insurance companies to file suspicious activity reports. In the officials' view, AML efforts should be focussed on other areas of the nonbank financial sector where the incidence of money laundering was higher.

E. Agriculture, Trade, and Other Issues

57. ***The mission expressed a number of concerns regarding the Farm Security and Rural Investment Act of 2002 (the "Farm Bill").*** The legislation appeared to lock in recent "emergency" payments to producers and, by linking some payments to prices and increasing the number of commodities eligible for support, would undermine 1996 reforms that sought to improve efficiency and discourage overproduction by eliminating price supports in favor of income supplements. The mission suggested that this shift seemed inconsistent with the multilateral consensus reached last year in Doha to liberalize agricultural trade and would have a substantial negative impact on developing country producers of agricultural commodities. Moreover, projected declines in outlays over the next ten years were predicated on increases in commodity prices and a reduction in the target price. If these were not achieved, the fiscal cost would be significantly higher and existing WTO commitments on producer supports could be breached.[22]

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[21] The United States has also implemented and ratified the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions. For U.S. legislation see www.usdoj.gov/criminal/fraud/fcp2.html and for recent and planned future actions, see OECD, "Report by the Committee on International Investment and Mutinational Enterprises: Implementation of the Convention on Combating Bribery of Foreign Public Officials in International Business Transactions and the 1997 Recommendation," May 2002.

[22] CBO estimates suggest that the Farm Bill would increase subsidies over FY 2002–FY 2011 by $58 billion to $146 billion, relative to the baseline implied under the 1996 legislation. The new Farm Bill maintains the existing system of loan-deficiency payments (LDPs), which pays farmers when current crop prices fall below the loan rate, and it adds a system of counter-cyclical payments. See the selected issues paper for further details.

58. ***The U.S. representatives stressed that the Farm Bill was consistent with the authorities' WTO commitments***. A sizable portion of U.S. outlays on agriculture would not be classified as trade-distorting, so that total producer supports remained below the limits agreed under the WTO.[23] Although adverse price shocks would boost payments, the legislation contained language that directed the Secretary of Agriculture to adjust expenditures to meet WTO commitments should it be necessary. The U.S. representatives further stressed that the Farm Bill did not represent a step back from the U.S. commitment to the Doha Round objectives of reducing agricultural subsidies, and observed that U.S. agricultural subsidies were well below those in other major trading partners.

59. ***The mission inquired about the authorities' broader trade agenda, including their goals for the Doha Round.*** The U.S. representatives responded that these goals were still being formulated, and the authorities' immediate priority was to obtain final Congressional approval of Trade Promotion Authority (TPA). They acknowledged that the versions of the legislation passed in the House and Senate contained language that called for consultations on labor and environmental standards with Congress. However, the Administration was opposed to using trade sanctions to enforce standards in these areas. The authorities remained committed to advancing the Free Trade Agreement of the Americas (FTAA), and officials noted that negotiations have proceeded, although important questions regarding the pace and scope of liberalization still needed to be resolved.

60. ***The mission encouraged the authorities to adopt more ambitious U.S. policies to increase market access for developing countries.*** The U.S. representatives responded that while the authorities were committed to the broader Doha Round objective of improving market access for developing countries, the only specific commitment thus far was to provide these nations with technical assistance on negotiations and customs reform. However, they noted that there had been a number of significant U.S. initiatives in this area. For example, although the coverage of the African Growth and Opportunity Act (AGOA) had been limited to selected textile products from specific countries, it had still resulted in substantially higher levels of trade. Moreover, restrictions that had been placed on the enhancement of the Caribbean Basin Initiative had been largely aimed at clarifying ambiguities in the original legislation. In response to the mission's query about the apparent back-loading of the Uruguay Round agreement on textile quotas, they disagreed that there was risk that the agreement would not be implemented as scheduled, and noted that considerable adjustment by U.S. producers had already taken place in anticipation of this move.

61. ***The U.S. representatives disagreed with the mission's suggestion that recent steel tariffs could undermine the momentum toward broader multilateral trade liberalization (Box 7).*** In their view, the recent comprehensive safeguard action under Section 201 was a

[23] Under the WTO, the United States has agreed to limit trade-distorting (or "amber box") agricultural subsidies to no more than \$19 billion (trade-distorting subsidies are those based on output and prices). Countries, however, do not need to report amber box subsidies for a crop if subsidies are less than 5 percent of the value of production.

Box 7. The Global Impact of the U.S. Steel Safeguard Tariffs[1]

In early 2002, the Administration imposed duties on most steel products through safeguard tariffs. Duties ranging from 8–30 percent were applied in the first year, and the rates are scheduled to fall to 7–24 percent and 6–18 percent in the next two years. A broad range of products was exempted, as were all imports from Canada, Mexico, and many developing nations. As a result, tariffs were imposed on about half of steel imports covered by the original safeguard investigation.

WTO rules permit imposition of safeguards under certain conditions. Members may impose temporary trade barriers (typically, tariffs or tariff-rate quota) when an import surge causes or threatens serious injury to a domestic industry. However, the barriers must: (i) apply to imports from WTO members in a proportionate manner; (ii) be gradually liberalized after the first year; and (iii) be eliminated by the end of three years unless compensation is offered. A developing country is also exempt from a safeguard action if it accounts for less than 3 percent of imports of that product and if developing countries with less than a 3 percent import share, collectively, account for less than 9 percent of total imports of that product.

Estimates suggest that the U.S. measures will cause important welfare losses, both domestically and abroad. The first-year impact was estimated using a general equilibrium model of the international economy—the Global Trade Analysis Project (GTAP)—and is summarized in the table.[2] Welfare losses to the United States total $1.2 billion (in 1997 dollars, equivalent to 0.02 percent of GDP), and a roughly equivalent net loss would be felt overseas. Losses abroad would be concentrated in the EU, former Soviet Union (FSU), and Japan. Canada, Mexico, Brazil, and South Africa would benefit from the effects of trade diversion and increased exports to the United States. Although employment in the U.S. steel sector would increase by 3 percent, as steel imports fall by nearly 12 percent, the cost would be up to $250,000 per job.[3]

Effects of U.S. Safeguard Action

	Welfare Losses (1997 $million)	Steel Employment (percent)	Volume of Steel Trade: Exports (percent)	Volume of Steel Trade: Imports (percent)
USA	-1,165	3	0	-12
Canada & Mexico	425	5	19	2
EU	-645	-1	-3	0
Japan	-270	-1	-4	0
Korea	-117	-1	-5	-1
China	-8	0	-2	0
Former Soviet Union	-901	-4	-6	-2
Brazil	199	1	4	0
RSA & Namibia	84	1	3	0
Rest of the world	333	0	1	0
Total	-2,064			

Retaliation could substantially increase these costs. The EU has announced that it will impose an import surcharge on steel and could impose tariffs on U.S. goods. Estimates vary on the effect (because the final retaliation measure has yet to be approved), but global welfare would fall by an additional $1 billion, with most of the losses concentrated in the FSU (from import surcharges) and the United States (from retaliatory tariffs). China and Japan have also announced retaliatory tariffs on U.S. exports.

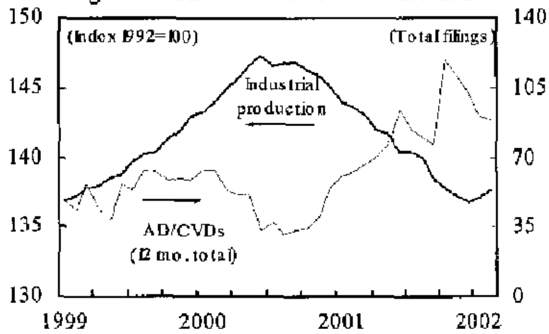
[1] A forthcoming selected issues paper will explore these issues in greater detail.

[2] See T. Hertel, 1997, *Global Trade Analysis: Modeling and Applications* (Cambridge: Cambridge University Press). Following a surge in 1998, U.S. trade policy sharply limited steel imports. The model is based on import volumes in 1997, which are broadly similar to those currently, except for China and Brazil, implying that the losses to China and gains to Brazil are significantly understated.

[3] In 1997 dollars. G. Hufbauer and B. Goodrich, 2002, "Time for a Grand Bargain in Steel?" *IIE Policy Briefs* (Washington, DC: IIE) construct similar estimates based on more recent data and covering more imports, but show a significantly higher cost per job (around $500,000) because the cost is based on consumer losses, whereas the table above reports net welfare losses.

WTO-consistent response to a surge of imports in 1998 and 2000 and was designed to provide temporary room for domestic firms to adjust. The measures were also part of a broader multilateral strategy, which included efforts to work with trading partners to address the problem of global overcapacity and to limit government subsidies to the steel sector.

Figure 17. United States: Trade Protection



62. ***The mission expressed concern regarding the rise in antidumping (AD) and countervailing duty (CVD) petitions.*** Such petitions had increased markedly as the U.S. economy entered a recession, and tended to both adversely affect and encourage similar behavior by trading partners (Figure 17).[24] The U.S. representative responded that the laws governing AD and CVD petitions were an essential element of maintaining the domestic political consensus for trade liberalization, since these laws provided reassurance that producers would be compensated for unfair competition. They saw little need for reform to U.S. practice in this area. The current system was fair and transparent, and proposals to shift the criterion for anti-dumping judgments to an anti-competitive test would not be appropriate, as it would involve a major shift in emphasis toward consumer versus producer protection. In their view, the more important concern was the lack of transparency in the operation of AD and CVD laws in other countries.

63. ***The mission also expressed concern with the low level of U.S. overseas development assistance (ODA).*** U.S. ODA had increased slightly in 2001 to about $10 billion, but still remained at only about 0.1 percent of GNP—the lowest ratio among industrial countries. The U.S. representatives responded that the authorities had recently proposed the establishment of the Millennium Challenge Account (MCA), which would provide performance-based development assistance to developing countries showing a strong commitment toward good governance, health and education, enterprise development, and entrepreneurship.[25] MCA funding was expected to increase gradually beginning in FY 2004 and reach $5 billion in FY 2006. At the same time, however, the U.S. representatives reiterated the Administration's strong view that increases in more traditional forms of ODA outlays were not warranted without clearer evidence of their effectiveness.

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[24] For further discussion, see M. Leidy, 1996, "Macroeconomic Conditions and Pressures for Protection Under Antidumping and Countervailing Duty Laws," *IMF Staff Papers*, 44(1), pp. 132–144.

[25] In June 2002, the Administration also announced a new HIV-prevention program that would involve additional grant aid totaling $500 million.

V. Staff Appraisal

64. ***The U.S. economy has demonstrated impressive resilience during the past year.*** Following the longest expansion on record, the economy slipped into recession in early 2001. However, despite the subsequent shock to confidence and activity from the September 11th terrorist attacks, domestic demand bounced back, and timely fiscal and monetary stimulus in 2001, as well as continued productivity gains, contributed to an unusually mild downturn. As a result, the U.S. economy has contributed importantly to the recent improvement in global prospects.

65. ***The outlook appears broadly favorable, but uncertainties remain significant.*** While activity is likely to moderate from the rapid growth of the first quarter, as the initial push from the inventory cycle and the effect of other temporary factors dissipate, the recovery is expected to be sustained by a rebound of business fixed investment and continued strength in the household sector. At the same time, however, the outlook remains subjected to important downside risks, especially in light of lingering questions regarding the prospects for corporate profits and investment, the underlying strength of household demand, and the large U.S. current account deficit. A satisfactory resolution of these uncertainties hinges critically on whether the U.S. economy can sustain the strong productivity growth of recent years.

66. ***Against this background, the policy focus will need to shift from short-term stabilization to strengthening the base for strong and durable growth.*** While care will be needed to avoid an abrupt shift away from supportive policies, as evidence of recovery accumulates, monetary policy will need to start shifting to a more neutral stance. The fiscal authorities will need to re-establish a clear medium-term framework to strengthen budget discipline and to prepare for an aging society. Moreover, effective reforms in the areas of corporate governance and accounting standards would help boost investor confidence and, from a multilateral perspective, it will be important for U.S. trade and agricultural policies to contribute to the momentum toward trade liberalization.

67. ***The large U.S. current account deficit, and the related broader imbalance of global growth, remain a concern.*** The widening current account deficit since the mid-1990s appears to have largely reflected the effects of strong investment in the United States and investor confidence in U.S. productivity growth relative to other industrial countries, rather than major fiscal or other macro-policy imbalances. Nonetheless, the current account deficit, at current or higher rates, would take the U.S. net foreign liability position to ever-increasing levels, and at some point an adjustment will be needed. The adjustment could be achieved in an orderly fashion, as a result of improved growth performance among partner countries. However, less orderly adjustments can also be envisaged, including through a sudden reversal of investor sentiment and capital flows, and rapid dollar depreciation. Such a process could jeopardize recovery prospects abroad, disrupt capital market access for developing countries, and also adversely affect U.S. investment and incomes. This risk underscores the importance of boosting U.S. saving—especially through disciplined macroeconomic policies—as well of ensuring that risk management and transparency in the financial and

corporate sectors are strong enough to maintain confidence and cope with exchange market and other shocks.

68. ***The fiscal outlook has weakened considerably over the past year.*** A substantial deficit is likely this fiscal year, and while budget projections anticipate that surpluses would be re-established on a unified basis after FY 2004, deficits would still remain excluding the surpluses of Social Security trust funds. Moreover, these medium-term projections could be optimistic given pressures on discretionary spending and relatively hopeful revenue assumptions.

69. ***Significant pressures on the fiscal system from demographic trends also loom over the longer-run horizon.*** The cash-flow positions of the Social Security and Medicare trust funds are projected to deteriorate beginning later this decade, owing to the retirement of the baby-boom generation and the rapid growth of medical costs. With deficits expected to emerge next decade, the present system implies a substantial long-run fiscal liability.

70. ***A key step toward addressing these fiscal pressures would be to establish a framework that sets the clear goal of balancing the budget excluding Social Security over the business cycle.*** This objective—which the Administration endorsed last year—would allow federal debt to be worked down in anticipation of reforms that would place the Social Security and Medicare systems on a sound financial footing, while providing flexibility for the fiscal stance to respond to cyclical shocks.

71. ***Achieving this goal over the next few years as the economy returns to full employment would require a careful and early review of expenditure and tax priorities.*** The Administration's budget already anticipates tight limits on nondefense discretionary outlays that may be hard to achieve, especially in light of recent pressures for spending on homeland security and agricultural subsidies. Therefore, revenue measures may be needed, preferably in the context of tax reforms that could include reductions in tax expenditures for both households and corporations and possible hikes in energy taxes. In the absence of alternatives, the pending reductions in marginal income tax rates may also need to be reconsidered.

72. ***Strengthening the institutional basis for budget discipline would bolster the credibility of the fiscal framework.*** The rules under the Budget Enforcement Act (BEA) played an important role in asserting budgetary discipline during the past decade, but were circumvented once on-budget surpluses began to accumulate. Thus, while extending the BEA rules could be useful, enforcement mechanisms also need to be strengthened. Consideration should also be given to reforms of the mechanisms by which the debt limit is periodically adjusted in order to avoid unnecessary disruptions to debt management.

73. ***Steps need to be taken to safeguard the longer-term health of the Medicare and Social Security systems.*** The federal budget acknowledges the need for Medicare reform, but the specific measures announced seem geared more toward expanding benefits than ensuring the system's long-term viability. Placing the system on a sound financial footing will

undoubtedly require measures to contain the growing cost of health care, raise co-payments and deductibles, and increase contribution and premium rates. As for Social Security, early and relatively modest adjustments to the current system—for example, amending the indexation formula that applies to pre-retirement earnings, increasing the retirement age, or raising the ceiling on contributions—could help assure the system's financial solvency and avoid the need for larger and more difficult measures later on. Although personal retirement accounts along the lines proposed by the President's reform commission could have important benefits, they would not eliminate the need for other measures to address the system's long-term solvency.

74. ***Provided that evidence of recovery continues to accumulate, the Federal Reserve will need to begin to gradually withdraw monetary stimulus.*** Interest rates are highly accommodative, and given expectations of a gradual absorption of slack in the coming year and the usual transmission lags, the market expects action to begin withdrawing stimulus later this year. The importance of monetary policy continuing to support the recovery will need to be balanced against the possibility that delaying action would require larger and more disruptive adjustments later on. Nonetheless, given the minimal signs of impending inflation pressures and the still uncertain economic outlook, the Fed has some room to wait until the recovery is more clearly established before acting.

75. ***The U.S. financial system appears to have successfully weathered the economic slowdown.*** Although credit quality weakened further during 2001, banks maintained healthy returns on equity and boosted capital, in part reflecting improved risk-management techniques, and systemic risks appear limited. The new supervisory framework established under the Gramm-Leach-Bliley (GLB) Act of 1999 seems to have been implemented effectively, and the authorities' intentions to reform the deposit insurance system and to press ahead toward a new international capital accord are welcome.

76. ***Recent corporate failures and instances of accounting irregularities have triggered valuable scrutiny of U.S. corporate governance and accounting practices.*** These events have had the welcome effect of encouraging stricter market discipline, but they have also brought attention to important shortcomings in accounting and audit standards, corporate governance, and regulations governing pension plans. The challenge will be to ensure that reform proposals are developed and implemented in a manner that restores confidence and further enhances transparency and market discipline without unduly adding to the regulatory burden.

77. ***The United States has played an important leadership role in advancing the Doha Round, but this leadership role and broader support for multilateralism risks being undermined by domestic protectionist pressures.*** The recent safeguard action against steel imports appears likely to impose significant costs both domestically and abroad, and could erode confidence in WTO disciplines. Also, as slack emerged in the industrial sector, U.S. anti-dumping filings surged in recent years. These actions tend to discourage competition and trade, and encourage similar behavior by partner countries, suggesting the need for reforms

that reduce the degree of discretion allowed in findings of injury and more clearly link findings to evidence of noncompetitive behavior.

78. ***The measures contained in the recent Farm Bill were damaging from both a domestic and international perspective.*** The legislation locks in U.S. subsidies at levels that—while lower than in many partner countries—have surged in recent years, undoing many of the 1996 reforms that sought to promote adjustment and efficiency in the farm sector. By linking support payments to prices of specific commodities, the legislation seems likely to encourage production of crops already in chronic oversupply and adversely affect producers abroad, while also undermining domestic fiscal objectives. The Farm Bill also risks undermining the momentum toward agricultural reform worldwide, including in the context of the Doha Round.

79. ***U.S. overseas development assistance (ODA) remains low.*** Despite increases in 2001, U.S. ODA remains only around 0.1 percent of GNP, one of the lowest ratios among industrial countries. Recent Administration proposals to increase ODA outlays beginning in FY 2004 are welcome, but these would still leave overall ODA spending as a share of GNP far below the U.N. target and the lowest among industrial countries.

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

Table 1. United States: Selected Economic Indicators

(Percent changes from previous period, unless otherwise indicated)

	1999	2000	2001	2002	2003	2001 Q1	2001 Q2	2001 Q3	2001 Q4	2002 Q1	2002 Q2	2002 Q3	2002 Q4
NIPA in constant prices													
Real GDP	4.1	4.1	1.2	2.5	3.3	1.3	0.3	-1.3	1.7	6.1	2.0	2.5	3.0
Net exports 1/	-1.0	-0.8	-0.1	-0.6	-0.5	0.6	-0.1	-0.3	-0.1	-0.8	-1.2	-0.7	-0.5
Total domestic demand	5.0	4.8	1.3	3.2	3.9	0.7	0.4	-1.0	1.7	6.7	3.1	3.8	3.8
Final domestic demand	5.2	4.9	2.3	2.6	3.8	3.2	0.8	-0.3	3.9	3.2	2.3	3.3	3.6
Private final consumption	5.0	4.8	3.1	3.0	3.2	3.0	2.5	1.0	6.1	3.3	1.6	2.4	2.9
Personal saving ratio (% of DI)	2.4	1.0	1.6	2.8	3.2	1.1	1.1	3.8	0.4	2.9	3.3	2.6	2.6
Public consumption expenditure	2.2	2.8	3.1	4.6	3.9	4.7	2.7	3.7	5.4	5.6	4.2	4.1	4.0
Gross fixed domestic investment	7.9	6.7	-0.8	-0.2	6.0	2.9	-6.0	-7.0	-4.9	1.2	3.6	6.0	5.9
Private	7.8	7.6	-2.0	-2.0	6.4	1.9	-9.7	-5.7	-11.4	-0.8	3.4	6.4	6.2
Private investment rate	17.7	17.9	16.0	15.6	15.9	17.0	16.4	15.9	14.8	15.3	15.5	15.7	15.8
Public	8.2	2.0	5.6	9.0	4.1	8.3	15.7	-13.4	33.7	10.7	4.4	4.3	4.2
Change in business inventories 1/	-0.2	-0.1	-1.1	0.5	0.1	-2.6	-0.4	-0.8	-2.2	3.4	0.8	0.5	0.2
GDP in current prices	5.5	6.5	3.4	4.1	5.6	4.6	2.4	0.9	1.5	7.5	4.2	4.8	5.3
Employment and inflation													
Unemployment rate (percent)	4.2	4.0	4.8	5.9	5.7	4.2	4.5	4.8	5.6	5.6	5.9	6.0	5.9
GDP gap	0.9	1.6	-0.4	-1.0	-0.8	0.8	0.0	-1.1	-1.4	-0.7	-1.0	-1.1	-1.1
CPI inflation	2.2	3.4	2.8	1.4	2.4	3.9	3.1	0.8	-0.3	1.4	2.0	2.2	2.5
GDP deflator	1.4	2.3	2.2	1.5	2.2	3.3	2.1	2.2	-0.1	1.3	2.2	2.2	2.2
Financial policy indicators													
Unified federal balance ($ b)	126	236	127	-170	-146								
In percent of CY GDP	1.4	2.4	1.2	-1.6	-1.3								
Central government balance ($ b, NIPA)	117	218	60	-159	-121								
In percent of GDP	1.3	2.2	0.6	-1.5	-1.1								
General government balance ($ b, NIPA)	55	145	-16	-239	-205								
In percent of GDP	0.6	1.5	-0.2	-2.2	-1.8								
Three-month Treasury bill rate	4.8	6.0	3.5	1.9	3.8	4.9	3.7	3.2	1.9	1.8	1.7	1.9	2.1
Ten-year government bond rate	5.6	6.0	5.0	5.1	5.8	5.1	5.3	5.0	4.8	5.1	5.1	5.1	5.2
Balance of payments													
Current account balance ($ b)	-293	-410	-393	-468	-505	-429	-395	-364	-385	-447	-460	-476	-488
In percent of GDP	-3.2	-4.2	-3.9	-4.4	-4.5	-4.2	-3.9	-3.6	-3.8	-4.3	-4.4	-4.5	-4.5
Merchandise trade balance ($ b)	-346	-452	-427	-469	-519	-452	-431	-423	-403	-426	-463	-486	-502
In percent of GDP	-3.7	-4.6	-4.2	-4.4	-4.6	-4.5	-4.2	-4.1	-3.9	-4.1	-4.4	-4.5	-4.6
Export volume (NIPA, goods and services)	3.2	9.5	-4.5	-2.6	6.1	-1.2	-11.9	-18.8	-10.9	2.8	6.8	5.4	6.9
Import volume (NIPA, goods and services)	10.5	13.4	-2.7	2.6	8.4	-5.0	-8.4	-13.0	-7.5	8.3	15.4	9.6	8.8
Invisibles ($ b)	53	42	34	2	14	23	36	59	18	-21	4	10	14
In percent of GDP	0.6	0.4	0.3	0.0	0.1	0.2	0.3	0.6	0.2	-0.2	0.0	0.1	0.1
Saving and investment (as a share of GDP)													
Gross national saving	18.4	18.1	17.1	16.2	15.9	17.3	17.2	17.1	16.6	15.8	16.6	16.0	16.3
General government	3.9	4.7	3.5	1.2	1.6	4.4	4.2	2.1	3.4	1.0	1.1	1.2	1.4
Private	14.6	13.4	13.5	15.0	14.3	12.9	12.9	15.0	13.2	14.8	15.5	14.7	14.9
Personal	1.7	0.7	1.2	2.1	2.3	0.8	0.8	2.8	0.3	2.2	2.4	1.9	1.9
Business	12.8	12.7	12.4	12.9	12.0	12.1	12.2	12.2	13.0	12.7	13.1	12.8	13.0
Gross domestic investment	20.9	21.1	19.4	19.0	19.4	20.3	19.7	19.1	18.3	18.8	18.9	19.1	19.3

Source: IMF staff estimates.

1/ Contribution to growth.

Table 2. United States: Key Economic Indicators

(Percent changes from previous period, unless otherwise indicated)

				2001		2002	2002				
	1999	2000	2001	Q3	Q4	Q1	Jan	Feb	Mar	Apr	May
Production and capacity utilization											
Industrial production											
All industries	3.7	4.5	-3.7	-1.2	-1.7	0.7	0.7	0.4	0.4	0.3	0.1
Manufacturing	4.2	4.7	-4.2	-1.3	-1.6	0.8	0.7	0.2	0.4	0.2	0.2
Capacity utilization (index)											
All industries	81.4	81.8	76.8	76.2	74.7	75.0	74.8	75.0	75.3	75.4	75.5
Manufacturing	80.6	80.7	75.1	74.5	73.1	73.6	73.4	73.5	73.8	73.8	73.9
Orders and inventories											
Inventory/sales ratio	1.59	1.59	1.55	1.57	1.47	1.50	1.50	1.50	1.50	1.48	...
Total manufacturers' orders	4.0	5.2	-7.2	-2.5	-0.6	0.3	1.0	-0.7	1.2	0.6	...
Households											
Retail sales	8.8	6.6	3.6	-0.3	3.3	-1.0	-0.1	0.5	-0.1	1.3	-0.9
Motor vehicle sales	11.9	4.9	5.7	-0.9	11.9	-8.7	-4.1	0.8	-1.4	1.6	-2.6
Consumer confidence (index)	135.3	139.0	106.6	109.1	88.3	101.2	97.8	95.0	110.7	108.5	110.3
Disposable income	4.1	6.2	5.5	2.9	-1.9	3.6	2.8	0.7	0.5	0.3	0.3
Housing starts	1.6	-4.5	1.9	-1.3	-1.9	9.7	8.2	4.4	-6.3	-7.3	11.6
Prices (percent change, same period previous year)											
CPI	2.2	3.4	2.8	2.7	1.9	1.2	1.1	1.1	1.4	1.6	1.2
Excluding food and energy	2.1	2.4	2.7	2.7	2.7	2.5	2.6	2.5	2.4	2.5	2.5
PPI, finished goods	1.8	3.7	2.0	1.6	-1.0	-2.4	-2.8	-2.7	-1.6	-2.0	-2.7
Excluding food and energy	1.7	1.3	1.4	1.5	0.9	0.4	0.3	0.5	0.5	0.3	0.1
PCE price index	1.6	2.7	1.9	1.6	1.3	0.7	0.7	0.6	0.9	1.2	1.0
Excluding food and energy	*1.5*	*1.9*	*1.6*	*1.3*	*1.6*	*1.3*	*1.3*	*1.3*	*1.4*	*1.5*	*1.6*
Labor market											
Nonfarm payrolls (millions)	128.90	131.72	131.93	131.94	131.13	130.76	130.87	130.71	130.70	130.71	130.75
Change (millions)	3.05	2.81	0.21	-0.25	-0.81	-0.37	-0.02	-0.17	-0.01	0.01	0.04
Unemployment rate (percent)	4.2	4.0	4.8	4.8	5.6	5.6	5.6	5.5	5.7	6.0	5.8
Money and credit (percent change, same period previous year)											
M1	2.0	0.2	3.0	5.4	6.8	7.6	7.9	7.8	7.2	6.0	5.9
M2	7.5	6.1	8.7	9.4	10.3	9.2	9.7	9.6	8.4	7.2	7.9
Bank lending	7.9	11.4	6.2	4.7	3.8	2.0	2.4	2.2	1.5	0.8	1.3
Current account ($ billions)	-292.9	-410.3	-393.4	-365.3	-380.3	-449.9					
Percent of GDP	-3.2	-4.2	-3.9	-3.6	-3.7	-4.3					
Merchandise trade balance ($ billions) 1/	-346.0	-452.4	-427.2	-423.0	-402.7	-425.7	-401.6	-436.2	-439.2	-479.0	...
Exports ($ billions)	684.0	772.0	718.8	693.1	669.4	658.6	660.2	655.9	659.7	682.7	...
Price	-1.4	1.1	-0.7	-0.6	-0.9	-0.3	0.2	-0.2	0.5	0.3	...
Volume	3.9	11.3	-5.6	-5.3	-2.6	-0.7	-0.4	-0.1	0.4	2.7	...
Imports ($ billions)	1030.0	1224.4	1145.9	1116.1	1072.1	1084.3	1061.8	1092.1	1099.0	1161.7	...
Price	0.2	4.8	-3.0	-1.8	-2.9	-0.6	-0.3	-0.1	1.2	1.9	...
Volume	12.4	13.5	-2.8	-2.6	-0.9	1.7	2.5	3.0	-0.6	3.7	...

Sources: U.S. Department of Labor, Bureau of Labor Statistics; U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Department of Commerce, Census Bureau; and U.S. Federal Reserve.

1/ Monthly data derived from Census data; quarterly data and prices derived from NIPAs. 2002Q1 merchandise trade data are from monthly Census data.

Table 3. United States: Balance of Payments

(In billions of dollars)

	1994	1995	1996	1997	1998	1999	2000	2001
Current account	-118	-106	-118	-128	-204	-293	-410	-393
Percent of GDP	-1.7	-1.4	-1.5	-1.5	-2.3	-3.2	-4.2	-3.9
Goods and services	-97	-96	-102	-108	-167	-262	-379	-358
Merchandise trade	-166	-174	-191	-198	-247	-346	-452	-427
Exports	503	575	612	678	670	684	772	719
Imports	-669	-749	-803	-876	-917	-1,030	-1,224	-1,146
Services	69	78	89	90	80	84	74	69
Receipts	201	219	240	257	262	273	292	279
Payment	-132	-141	-151	-166	-183	-189	-219	-210
Investment income	17	25	24	20	8	18	22	14
Receipts	165	212	226	261	259	291	353	284
Payment	-149	-187	-202	-240	-252	-272	-331	-269
Unilateral transfers	-38	-34	-40	-41	-45	-49	-53	-49
Government transfers	-15	-11	-15	-12	-13	-14	-17	-12
Private transfers	-23	-23	-25	-28	-31	-35	-37	-38
Capital account transactions, net	0	0	1	0	1	-3	1	1
Financial account	130	86	137	219	64	265	409	382
Private capital	85	-13	5	201	91	210	373	382
Direct investment	-34	-41	-5	1	36	101	129	3
Outflows	-80	-99	-92	-105	-143	-189	-178	-128
Inflows	46	58	87	106	179	289	308	131
Securities	54	59	118	198	65	148	252	329
Outflows	-60	-123	-150	-119	-136	-128	-128	-95
Inflows	115	181	268	317	202	277	379	424
Net U.S. bank flows	100	-45	-75	8	4	-22	-32	-18
Nonbank capital	-35	14	-33	-5	-15	-17	23	68
U.S. official reserves	5	-10	7	-1	-7	9	0	-5
Foreign official assets	40	110	127	19	-20	44	38	5
Other items	0	-1	-1	0	0	3	-1	0
Statistical discrepancy	-11	19	-20	-91	139	31	0	11

Source: U.S. Department of Commerce, Bureau of Economic Analysis.

Table 4. United States: Indicators of Economic Performance

	1996	1997	1998	1999	2000	2001	Projection 2002	2003
	(Annual percent change)							
Per capita GDP								
United States	2.6	3.4	3.3	3.2	3.2	0.2	1.3	2.4
Japan	3.2	1.6	-1.3	0.5	2.0	-0.6	-1.2	0.7
Germany	0.5	1.2	2.0	1.8	2.9	0.3	0.9	2.7
Canada	0.5	3.2	3.0	4.2	3.5	0.5	1.0	1.8
France, Italy, and United Kingdom 1/	1.3	2.1	2.5	1.9	2.9	1.7	1.3	2.6
G-7 countries	2.1	2.6	2.2	2.4	2.9	0.4	0.8	2.2
Real GDP								
United States	3.6	4.4	4.3	4.1	4.1	1.2	2.5	3.3
Japan	3.6	1.8	-1.0	0.7	2.2	-0.4	-1.0	0.8
Germany	0.8	1.4	2.0	1.8	3.0	0.6	0.7	2.7
Canada	1.6	4.2	4.1	5.4	4.5	1.5	3.2	3.4
France, Italy, and United Kingdom 1/	1.6	2.5	2.8	2.2	3.2	2.1	1.5	2.9
G-7 countries	2.7	3.3	2.8	2.9	3.5	1.1	1.4	2.8
Real domestic demand								
United States	3.7	4.7	5.4	5.0	4.8	1.3	3.2	3.9
Japan	4.1	0.9	-1.4	0.8	1.8	0.3	-1.3	0.4
Germany	0.3	0.6	2.4	2.6	2.0	-1.0	0.7	2.6
Canada	0.9	5.7	2.4	4.4	5.0	1.3	2.2	4.0
France, Italy, and United Kingdom 1/	1.5	2.4	4.1	3.2	3.2	2.2	1.8	2.8
G-7 countries	2.8	3.2	3.5	3.6	3.7	1.0	1.7	3.0
GDP deflator								
United States	1.9	1.9	1.2	1.4	2.3	2.2	1.5	2.2
Japan	-0.8	0.3	-0.1	-1.4	-1.9	-1.5	-1.3	-1.1
Germany	1.0	0.7	1.1	0.5	-0.4	1.3	1.7	1.2
Canada	1.7	1.2	-0.4	1.7	3.9	1.0	0.0	1.9
France, Italy, and United Kingdom 1/	3.3	2.2	2.2	1.5	1.5	2.2	2.4	2.0
G-7 countries	1.7	1.5	1.1	0.9	1.2	1.4	1.3	1.5
	(As percent of GDP)							
General government financial balance								
United States	-2.4	-1.3	-0.1	0.6	1.5	-0.2	-2.2	-1.8
Japan	-4.9	-3.7	-5.6	-7.6	-8.5	-8.5	-8.7	-7.6
Germany	-3.4	-2.7	-2.2	-1.6	1.2	-2.7	-2.7	-2.1
Canada	-2.8	0.2	0.1	1.7	3.1	1.8	0.8	0.8
France, Italy, and United Kingdom 1/	-5.1	-2.4	-1.7	-0.7	0.8	-0.7	-1.4	-1.1
G-7 countries	-3.4	-1.9	-1.6	-1.2	-0.3	-1.7	-2.6	-2.2
Gross savings								
United States	17.3	18.1	18.8	18.4	18.1	17.1	16.2	15.9
Japan	30.6	30.9	29.8	28.4	28.5	27.6	26.7	26.3
Germany	21.3	21.4	21.5	20.9	21.2	20.5	21.0	21.5
Canada	18.7	19.6	19.2	20.7	23.4	22.1	19.6	20.4
France, Italy, and United Kingdom 1/	18.9	19.5	19.8	19.3	19.4	19.6	19.2	19.4
G-7 countries	20.5	21.1	21.2	20.6	20.6	19.4	19.7	20.1
Fixed private investment								
United States	15.5	16.0	16.7	17.0	17.4	16.6	15.6	15.8
Japan	19.9	20.5	19.4	18.4	19.5	19.3	17.5	17.5
Germany	19.6	19.5	19.5	19.7	19.8	18.5	17.6	17.5
Canada	15.4	17.5	17.6	17.6	17.5	17.4	16.7	16.7
France, Italy, and United Kingdom 1/	15.4	15.4	15.9	16.2	16.6	16.5	16.2	16.3
G-7 countries	16.7	17.1	17.3	17.4	17.8	17.2	16.6	16.7
Current account balance								
United States	-1.5	-1.5	-2.3	-3.2	-4.2	-3.9	-4.4	-4.5
Japan	1.4	2.2	3.0	2.5	2.5	2.1	3.0	3.4
Germany	-0.3	-0.1	-0.3	-0.9	-1.0	0.5	0.7	0.8
Canada	0.5	-1.3	-1.2	0.2	2.6	2.8	2.3	2.0
France, Italy, and United Kingdom 1/	1.2	1.8	1.2	0.3	-0.2	0.5	0.2	0.1
G-7 countries	0.7	-2.1	-1.9	0.2	3.6	4.0	2.7	3.1

Sources: World Economic Outlook; and staff estimates.

1/ Composites for the country groups are averages of individual countries weighted by the average value of their respective GDPs converted using PPP weights over the preceding three years.

Table 5. United States: Fiscal Indicators

(For fiscal years, in percent of GDP except where noted otherwise)

	2000	2001	2002	2003	2004	2005	2006	2007
FY 2003 Budget current-services baseline under Administration's economic assumptions								
Outlays	18.4	18.4	19.4	19.0	18.6	18.2	17.9	17.6
Debt service	2.3	2.0	1.7	1.6	1.5	1.4	1.3	1.2
Other	16.1	16.4	17.7	17.4	17.0	16.8	16.6	16.4
Revenue	20.8	19.7	19.3	19.4	19.4	19.5	19.2	19.2
Unified balance	2.4	1.3	-0.1	0.4	0.8	1.2	1.3	1.6
Primary balance	4.7	3.3	1.6	2.0	2.3	2.6	2.7	2.8
Unified balance excluding social security	*0.9*	*-0.4*	*-1.7*	*-1.3*	*-0.9*	*-0.5*	*-0.4*	*-0.2*
Net debt held by public 1/	35.1	32.8	32.5	30.7	28.4	25.8	23.2	20.6
FY 2003 Budget current-services baseline under staff economic assumptions								
Outlays			19.2	18.7	18.1	17.8	17.5	17.2
Debt service			1.7	1.6	1.5	1.5	1.4	1.3
Other			17.5	17.1	16.6	16.4	16.1	15.8
Revenue			19.1	19.3	19.2	19.3	19.0	18.9
Unified balance			-0.1	0.6	1.1	1.5	1.6	1.7
Primary balance			1.6	2.1	2.6	2.9	3.0	3.1
Unified balance excluding social security			-1.6	-1.1	-0.6	-0.2	-0.2	0.0
Net debt held by public 1/			32.1	30.1	27.4	24.5	21.8	19.0
FY 2003 budget under Administration's economic assumptions								
Outlays			19.7	19.5	19.0	18.7	18.5	18.3
Debt service			1.7	1.7	1.6	1.6	1.5	1.4
Other			18.0	17.8	17.3	17.2	17.0	17.0
Revenue			18.7	18.7	18.9	19.2	19.2	19.1
Unified balance			-1.0	-0.7	-0.1	0.5	0.7	0.8
Primary balance			0.7	0.9	1.5	2.1	2.1	2.1
Unified balance excluding social security			-2.6	-2.4	-1.8	-1.2	-1.1	-1.0
Net debt held by public 1/			33.4	32.7	31.2	29.2	27.1	25.1
FY 2003 Budget under staff economic and budget assumptions								
Outlays			19.4	19.6	19.1	18.9	18.7	18.5
Debt service			1.7	1.7	1.7	1.7	1.7	1.7
Other			17.6	18.0	17.4	17.1	16.9	16.8
Revenue			17.7	18.3	18.5	18.9	18.8	18.7
Unified balance			-1.6	-1.3	-0.6	0.1	0.1	0.2
Primary balance			0.1	0.3	1.1	1.8	1.9	1.9
Unified balance excluding social security			-3.2	-2.9	-2.3	-1.6	-1.6	-1.6
Net debt held by public 1/			33.6	33.4	32.3	30.5	28.9	27.2
Memorandum items:								
Structural unified balance (staff) 2/	*2.1*	*1.2*	*-1.4*	*-1.1*	*-0.5*	*0.1*	*0.1*	*0.2*
Administration economic projections (calendar years, in percent)								
Real GDP growth	4.1	1.0	0.7	3.8	3.7	3.6	3.2	3.1
CPI inflation rate	3.4	2.9	1.8	2.2	2.3	2.4	2.4	2.4
Three-month Treasury bill rate	6.0	3.4	2.2	3.5	4.0	4.3	4.3	4.3

Sources: *Budget of the United States Government, FY 2003, February 2002;* and staff calculations.

1/ Gross debt held by the public minus excess government cash balances.

2/ As a percent of potential GDP.

Table 6. United States: Indicators of External and Financial Vulnerability

(In percent of GDP, unless otherwise indicated)

	1996	1997	1998	1999	2000	2001
External indicators						
Exports of goods and services (percentage change, BOP basis)	7.3	9.7	-0.2	2.6	11.2	-6.2
Imports of goods and services (percentage change, BOP basis)	7.1	9.3	5.5	10.9	18.3	-6.0
Terms of trade (annual percentage change)	-0.5	1.1	2.9	-2.1	-4.6	2.8
Current account balance	-1.5	-1.5	-2.3	-3.2	-4.2	-3.9
Capital and financial account balance	0.2	0.3	0.1	0.3	0.4	0.4
Of which: Inward portfolio investment (debt securities, etc.)	3.2	3.5	2.1	2.7	3.8	3.9
Inward foreign direct investment	1.1	1.3	2.0	3.1	3.1	1.3
Other investment liabilities (net)	0.2	1.8	0.5	0.6	1.2	1.1
Official reserves (in billions of dollars)	75.1	70.0	81.8	71.5	67.6	68.7
Broad money (M3) to reserves ratio	90.8	110.4	126.6	145.6	170.2	184.2
Central bank foreign liabilities (in billions of dollars)	0.2	0.5	0.2	0.1	0.3	0.1
Official reserves in months of imports	0.9	0.8	0.9	0.7	0.6	0.6
Net international investment position (in billions of dollars) 1/	-521.5	-833.2	-918.3	-784.1	-1,350.8	-1,948.1
Of which: General government debt (in billions of dollars) 2/	1,071.9	1,198.8	1,231.8	1,156.5	1,150.9	1,187.6
External debt-to-exports ratio	0.6	0.9	1.0	0.8	1.3	2.0
External interest payments to exports (in percent) 3/	19.1	20.4	22.1	22.0	24.6	23.8
Nominal effective exchange rate (percent change)	5.1	8.1	7.8	-1.3	3.4	6.3
Financial market indicators						
General government gross debt	72.8	70.3	66.6	63.4	57.4	55.6
Three-month Treasury bill yield (percent)	5.1	5.2	4.9	4.8	6.0	3.5
Three-month Treasury bill yield (percent, real)	2.1	2.8	3.3	2.5	2.5	0.6
Change in stock market index (S&P500 percent, year average)	23.9	30.1	24.2	22.3	7.6	-16.4
Banking sector risk indicators (percent unless otherwise indicated) 4/						
Total assets (in billions of dollars)	4,878.3	5,014.9	5,442.5	5,735.2	6,244.6	6,569.2
Total loans and leases to assets	57.6	59.2	59.5	60.9	61.2	59.3
Total loans to deposits	87.9	86.8	88.0	91.1	91.4	88.7
Problem loans to total loans and leases 5/	1.0	1.0	1.0	1.0	1.1	1.4
Assets of troubled banks to total bank assets	0.1	0.1	0.1	0.1	0.3	0.5
Loss allowance to:						
Total loans and leases	1.9	1.8	1.8	1.7	1.7	1.9
Noncurrent loans and leases	183.5	191.6	183.2	178.1	149.4	131.0
Return on equity	14.5	14.7	13.9	15.3	14.0	13.1
Return on assets	1.2	1.2	1.2	1.3	1.2	1.2
Total capital ratio	12.5	12.2	12.2	12.2	12.1	12.7
Core capital ratio	7.6	7.6	7.5	7.8	7.7	7.8

Sources: Board of Governors of the Federal Reserve System; U.S. Department of Commerce, Bureau of Economic Analysis; and Federal Deposit Insurance Corporation.

1/ Current cost valuation.

2/ Foreign official assets (U.S. Government securities plus Treasury securities).

3/ External interest payments: income payments on foreign-owned assets (other private payments plus U.S. government payments).

4/ FDIC-insured commercial banks.

5/ Noncurrent loans and leases.

United States: Fund Relations
(As of May 31, 2002)

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

II. **General Resources Account:**	**SDR Million**	**Percent Quota**
Quota	37,149.30	100.00
Fund holdings of currency	24,364.13	65.58
Reserve position in Fund	12,782.48	34.41
Financial Transaction Plan transfers (net)	465.00	

III. **SDR Department**	**SDR Million**	**Percent Allocation**
Net cumulative allocation	4,899.53	100.0
Holdings	8,752.82	178.65

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

V. **Financial Arrangements:** None

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

VII. **Payments Restrictions:** The United States has notified the Fund under Decision No. 144 of restrictions on payments and transfers for current international transactions to Libya, Iraq, North Korea, Cuba, and Iran. The United States restricts the sale of arms and petroleum to UNITA and to the territory of Angola and has prohibitions against transactions with terrorists and international narcotics traffickers. The United States notified the Fund under Decision No. 144 on August 2, 1995 of the imposition of further restrictions on current transactions with Iran (EBS/95/107).

VIII. **Statistical Issues:** The quality, coverage, periodicity, and timeliness of U.S. economic data are considered to be excellent both in the context of the Article IV consultation and for purposes of ongoing surveillance (see Appendix II for a summary). The United States has subscribed to the Special Data Dissemination Standard (SDDS) and its metadata are posted on the Dissemination Standard Bulletin Board (DSBB).

IX. **Summary of 2001 Executive Board Discussion:** At the conclusion of the 2001 consultation on July 27, 2001, Executive Directors called for policies to revive growth, given the economic slowdown since the first half of 2001 and the uncertain outlook.[26] They commended the Federal Reserve's aggressive easing of monetary

[26] See EBM/01/79, SM/01/196, and IMF Country Report No. 01/149.

policy since early 2001, and noted that subdued inflation pressures left ample room for monetary policy to further support activity. Directors also agreed that the June 2001 tax cuts were appropriate in order to insure against a sharper economic slowdown. Nonetheless, they stressed the need to act to ensure the financial soundness of the social security system and balance the remaining budget over the cycle. Disciplined macroeconomic policies—in addition to strong productivity growth—were viewed as essential for ensuring the orderly adjustment of the large current account deficit and the other imbalances affecting the U.S. economy. Directors generally expected that the U.S. financial system was well-placed to weather the economic slowdown without undue difficulty, but cautioned against the use of off-balance-sheet instruments. They also stressed the importance of curbing the use of antidumping and countervailing duty actions, containing supports for domestic agricultural producers, and increasing U.S. overseas development assistance.