6. **Systemic risks from the GSEs have long been a well understood problem and key policy issue, but political consensus in Congress has been elusive**. The Treasury, Fed, and Fund have repeatedly emphasized the topic over many years (Box 2).

Box 2. Staff's Analysis of Fannie Mae and Freddie Mac

Staff reports since 2003 have consistently stressed that, in view of Fannie Mae and Freddie Mac's systemic importance, there is a need to monitor closely their risk management and accounting practices and reform their regulation. More specifically:

- **Size of portfolios**. Staff have supported proposals by the Treasury and the Fed to cap these enterprises' portfolios, to restore their focus on securitization of conforming mortgages, and to limit their special status, to discourage the market perception of an implicit government guarantee of their liabilities.
- **Interest and mortgage prepayment risk**. Staff have also repeatedly observed that the growth of these institutions has concentrated interest rate and mortgage prepayment risk, with the attendant hedging operations also leading to concentration in some derivative markets.
- **Overhauling the supervisory arrangement**. The staff have strongly backed Treasury proposals to create a new regulator with full powers to set risk-based capital requirements, to design stress tests, and to place a housing GSE into receivership in the event of a financial insolvency.

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IMF Executive Board Concludes 2008 Article IV Consultation with the United States

On July 23, 2008, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the United States.[1]

Background

Problems in the housing and financial markets over the past year have combined to slow the U.S. economy substantially. As the residential investment downturn accelerated and national indices of house prices started falling, mortgage defaults rose sharply, and bank losses mounted. Increased uncertainty about counterparty creditworthiness triggered a full-blown liquidity and credit crisis late last summer, and credit spreads widened. As banks' balance sheets deteriorated, lending standards that had supported the earlier housing boom were rapidly tightened, and a deleveraging cycle began, impairing the extension of credit to the real economy. With consumption and construction weakening in the face of falling house prices, higher oil prices, and tighter credit, the economy has increasingly been supported by net exports. Headline inflation, as well as near-term inflation expectations, have been pushed up recently by surging commodity prices, but growing slack has for now kept a lid on core inflation and wage demands.

Policymakers have responded aggressively to these developments. The Fed cut the federal funds rate target by 325 basis points over just eight months, facilitated JP Morgan's takeover of

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the [Managing Director], as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

Bear Stearns in March, and introduced a variety of innovative liquidity instruments. These actions have brought greater liquidity and smoother functioning of financial markets, but overall financial conditions have continued to tighten in the face of higher lending standards, falling asset prices, and higher risk spreads. Fiscal policy too has been responsive, with a stimulus package consisting of targeted tax rebates and investment incentives enacted in January. The rebate checks began to arrive at households in late April, providing timely support to the economy.

The international and regional U.S. experience with housing busts suggests that the associated recovery is often slow. With the effects of earlier financial tightening yet to feed fully through the real economy, real GDP growth is likely to remain below potential through mid-2009. Significant uncertainty, however, surrounds this forecast, given the unprecedented nature of the shocks that have hit the U.S. economy. Indeed, many other forecasters view the substantial policy stimulus and rapid raising of bank capital as being likely to ease financial conditions faster than expected in the staff's baseline, suggesting a recovery could start in the second half of 2008.

The turmoil unveiled many weaknesses in the current system of financial regulation and supervision in the United States. The "originate-to-distribute" model has gone into reverse, and assets have returned to banks' balance sheets, straining bank capital at a time when lax mortgage underwriting standards have resulted in substantial losses. The authorities have outlined a blueprint for financial regulatory reform that is a solid starting point for discussion.

The current account deficit has receded from its peak in 2006 on the back of a weakening dollar and robust foreign activity, despite pressures from surging oil prices. At unchanged real exchange rates, the current account deficit is expected to narrow over the medium term. Staff analysis suggests that the dollar is closer to its medium-term equilibrium level, although still on the strong side.

The federal fiscal deficit narrowed substantially in recent years, falling to just above 1 percent of GDP in FY 2007. The growth slowdown and stimulus package are expected to lead to a marked increase in deficits over the next two years, which should then return to about 2 percent of GDP over the medium term. The Administration and Congress share the goal of balancing the budget by FY 2012 but neither outlines a complete plan for achieving the goal, as no provision is made for war-funding authority beyond FY2009, costs of overriding tighter criteria for the alternative minimum tax, or realistic compensation for Medicare providers.

Executive Board Assessment

Executive Directors agreed with the thrust of the staff appraisal. Directors noted that the U.S. economy and financial system are confronting significant challenges, with understandable concerns about their implications for the global economy. The housing correction and the broader financial sector turmoil of recent months have weakened household demand and credit conditions. With added headwinds from oil prices, the U.S. economy will be notably weaker but still register positive growth in 2008, and will recover only gradually in 2009. Although short-term inflation expectations have risen somewhat on surging commodity prices, price pressures are expected to be contained as commodity prices peak and economic slack rises.

Directors observed that the U.S. economy has shown impressive resilience in the face of an unprecedented confluence of shocks, and commended the authorities' decisive and swift policy response. In particular, they welcomed the carefully calibrated and targeted fiscal stimulus, the significant easing of monetary policy, and the willingness to introduce innovative mechanisms to support market liquidity. While not without risk, these measures have helped support economic activity, and played an important role in stabilizing financial markets domestically and globally.

Looking ahead, Directors cautioned that large uncertainties remain, and that the outlook hinges crucially on the evolution of house prices, and the dynamic interaction of financial sector and housing cycles, which have still to play out fully. Directors therefore welcomed the authorities' commitment to carefully monitor developments and continue to respond as necessary to achieve sustainable noninflationary growth and financial stability over the medium term.

Directors generally agreed that monetary policy should stay on hold for now, unless economic and financial conditions deteriorate further. With the real federal funds rate negative, monetary policy is already positioned appropriately to respond to recession risks, although the impact is being dampened by widening spreads and tighter lending standards. Wage demands remain moderate, but there is a risk that elevated headline inflation may seep into inflation expectations. Given the high cost of reversing such expectations once they become entrenched, most Directors underscored that the bias should be toward a decisive tightening once recovery is established and financial conditions ease. At the same time, Directors acknowledged that the downside risks to growth still remain large, adding to the complexity of monetary policy management at this juncture.

While fiscal stimulus is providing well-targeted support to aggregate demand at a critical time, Directors underscored that medium-term fiscal challenges limit the room for further initiatives. Automatic stabilizers should be allowed to operate, and, in the face of looming fiscal challenges that require medium-term fiscal consolidation and reform of unsustainable entitlement programs, any further fiscal action—were it to become necessary—should focus on direct support to housing and financial markets. Directors supported the recent federal backstop to Fannie Mae and Freddie Mac, given the systemic importance of these government-sponsored enterprises in financial and housing markets. They considered that improvements in the regulatory regime of these agencies aimed at better risk management and stricter oversight should also be implemented as a priority.

Directors generally suggested that the government should be prepared to widen support for housing and, if serious dislocations reappear, for financial markets, while limiting the cost to the government and minimizing moral hazard. Housing prices are continuing to fall, and there is a risk that such prices could move significantly below equilibrium, with important macroeconomic consequences. With house prices falling rapidly and the inventory-sales ratio at a near-record high, there is a role for public policy to overcome coordination difficulties by using Federal Housing Administration guarantees to encourage lenders to make voluntary write-downs on mortgage principal to new, more affordable loans. Such legislation would ideally also provide further incentives for lenders to participate. If major systemic financial disruptions recur, the government could support bank liquidity by significantly extending the term of asset swaps. While welcoming the recent regulatory and prudential reforms initiated by the authorities, Directors considered that a comprehensive policy response to improve financial regulation could include further consolidation and specialization of regulatory institutions, as well as strengthening liquidity requirements and raising capital charges for off-balance sheet lending. Directors emphasized that the housing boom has revealed multiple weaknesses in the current regulatory system, including the inadequate consumer protection for mortgage borrowers and perverse incentives in the securitization chain.

Directors welcomed the authorities' intentions to undertake comprehensive reform of the U.S. regulatory model, and saw the Treasury Blueprint as a useful starting point. In addition, the regulation and supervision of major investment banks and government-sponsored enterprises should be improved, and some Directors saw merit in a more consolidated regulatory structure—for example, by merging the oversight of investment banks and GSEs with that for commercial bank holding companies—although the specific modalities for such improvements remain under discussion. The point was made that regulation should yield the benefits of broadened oversight of investment banks while preserving the dynamism and flexibility of the sector. Regulatory reform could also include further measures to reduce the procyclicality of bank lending by augmenting risk-based capital ratios with ancillary measures. Finally, with liquidity having emerged as a major and under-emphasized risk, forthcoming recommendations from the Basel Committee will also merit early implementation, taking into account U.S.-specific nuances. Directors welcomed the authorities' intention to undertake a Financial Sector Assessment Program with the Fund starting in 2009. Directors recognized the importance of stronger market discipline, as a complement to regulatory actions.

Directors noted the staff assessment that the decline in the dollar's real effective exchange rate has moved U.S. competitiveness relatively close to medium-term fundamentals. A number of Directors cautioned that tensions remain in the pattern of bilateral adjustment. In particular, bilateral rate adjustments have not corresponded to the pattern of imbalances, with larger changes against freely floating currencies such as the euro, rather than against currencies of countries with large current account surpluses. Directors also reiterated the importance of structural reforms in facilitating external adjustment across the main economic areas, as envisaged during the Multilateral Consultation on global imbalances. They looked forward to continued U.S. leadership in fostering a positive outcome to the Doha Round and in working with partners to avoid protectionism in trade and finance.

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