FIGURES

BOXES

BACKDROP: A TEPID RECOVERY AMID STRAINED MACROECONOMIC POLICIES

1. **The U.S. economy continues to recover at a modest pace, in line with international experience following severe financial crises**. The recovery of U.S. output has in fact been somewhat stronger than in a number of other major advanced economies during the current cycle. However, unemployment in the United States increased more sharply than in all other major advanced economies during the recession and remains high. When judged against past U.S. experience, the recovery stands out as very modest given the extent of the contraction (Figure 1).

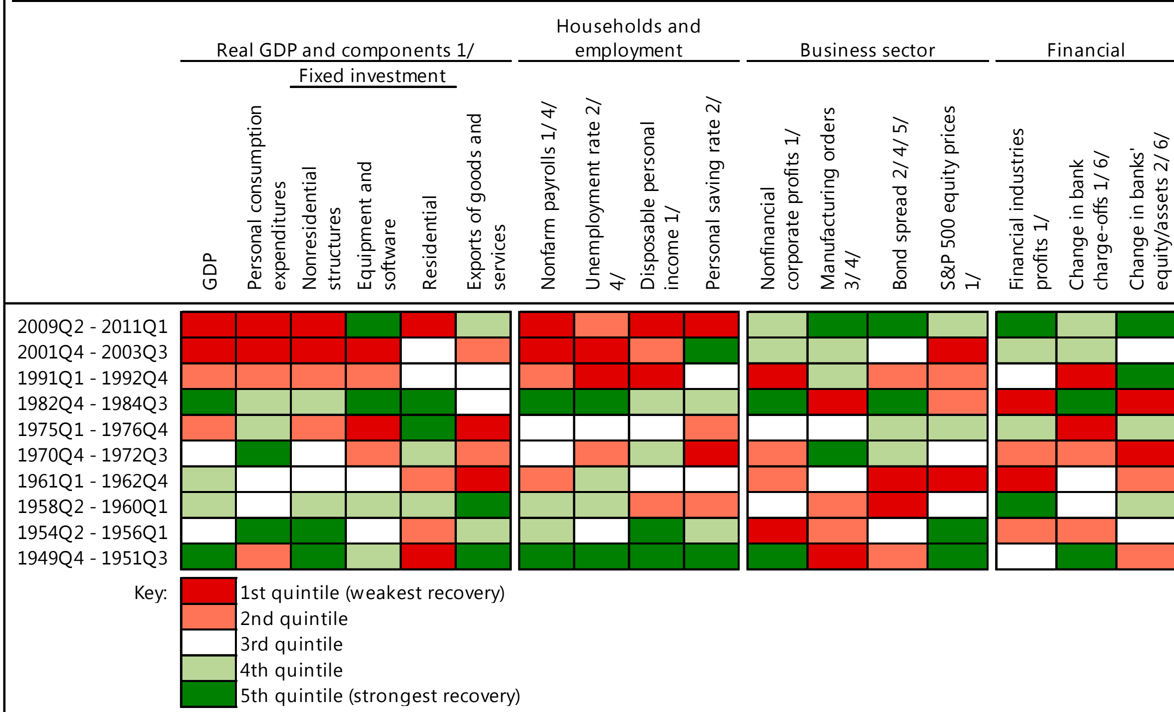
2. **Several indicators point to a significant growth slowdown in the first half of 2011, which appears partly related to transient factors**. Private consumption has lost some impetus since December, reflecting to a large extent higher world oil prices. Likewise, transient factors such as the disruptions to global supply chains from the Japanese earthquake have depressed specific sectors (Figure 2). The effect of these shocks on labor markets and sentiment could carry part of the weakness into the second half of 2011. Core inflation, which weakened to multi-decade lows in late 2010, has started to firm but remains contained given elevated resource slack.

3. **Macroeconomic policies have thus far remained supportive, but face tighter constraints going forward**. An appropriately sizable policy response helped prevent dramatic output declines in the wake of the crisis, and monetary and fiscal policies have continued to support demand in the last two years. However, unsustainable public debt dynamics and the associated risks of interest rate pressures or a credit rating downgrade have brought the need for fiscal consolidation to the forefront, leaving monetary policy as the main tool to shore up the recovery going forward (Figure 3). At the same time, near-zero policy interest rates and a Fed balance sheet more than three times larger than at the start of the economic crisis, together with firming core inflation, suggest limited room for significant further easing. A still-wide output gap, persistent housing and labor market fragilities, and downside risks to the outlook call for a cautious approach to unwinding macroeconomic support. Thus, the main policy challenge is to strike the right balance between exiting from extraordinary support and sustaining the recovery.

ANATOMY OF A SLOW RECOVERY

4. The current recovery has been held back by significant adverse feedback loops between housing, consumption, and employment. Housing and labor markets have been the weakest links. An overhang of vacant houses from the bubble years has restrained new construction, and, together with surging foreclosures, pushed down house prices. Weaker housing wealth and tighter lending standards have held back private consumption. Weak consumption, in turn, has interacted with a sluggish recovery in job creation, with unemployment also exacerbating the housing market weakness. Financial conditions have improved, particularly for large firms that face favorable bond financing terms, but remain tight especially for small firms and real estate. On the bright side, exports and the performance of businesses and the financial sector have improved significantly.

Recovery Comparisons, Seven Quarters After Business Cycle Trough



Sources: Bureau of Economic Analysis; Bureau of Labor Statistics; Institute for Supply Management; Board of Governors of the Federal Reserve System; Federal Deposit Insurance Corporateion; and Fund staff estimates.

1/ Percent change from trough. 2/ Change in level from trough. 3/ Level of diffusion index in latest quarter. 6/ Data are montly and end 21 months following the business cycle trough 5/ Moody's seasoned Baa corporate bond yield to composite long-term treasury. 6/ Data prior to 1991 are annual and the change is measured from the year of the trough to the year six quarters later.

5. Housing markets remain depressed, given a large overhang of vacant or distressed properties—a key legacy of the housing bubble (Figure 4). The overhang of vacant residential units—estimated by staff at around 3 million—has pushed new construction to historic lows. Residential fixed investment, which rebounded relatively quickly after most post-war recessions, has thus been a drag on output and employment in the current recovery. House prices are also weak, having dropped again after the expiration of homebuyers' tax incentives in mid-2010. The decline in house prices is in part a natural consequence of past excesses—as reflected in a still-significant inventory of houses for sale. But it is also an outcome of elevated foreclosures, which have a large negative effect on prices (beyond the usual effect of adding to the inventory of houses for sale), and continue to weigh heavily on house prices in many regions. Many analysts expect price declines of 3½ percent in 2011 on a fourth-quarter over fourth-quarter basis (with staff slightly more pessimistic), coupled with a very subdued recovery over the medium term (Selected Issues Paper, Chapter 1).

6. **Household balance sheets have suffered considerable damage from the housing bust**. The leverage of the household sector—the ratio of liabilities to net worth—surged as asset prices plummeted during the crisis and has been declining since then, but remains elevated (Figure 5). Household debt, which steadily increased in the years before the crisis given a sense of ever-rising house prices, peaked at 133 percent of disposable income at the end of 2007, declined to 119 percent as of the first quarter of 2011, and remains above the pre-bubble average of about 90 percent of disposable income. The decline in debt has occurred mainly through defaults, with subdued new loan originations also contributing.

7. **The state of the housing market plays an important role in explaining the weakness of U.S. private demand**. Housing wealth—which accounts for about one quarter of household assets—is an important driver of private consumption; the recent literature suggests that the sensitivity of consumption to housing wealth is about twice the sensitivity to net financial wealth.[i] The estimates presented in Chapter 2 of the Selected Issues Paper similarly point to sizable effects—a 10 percent house price appreciation is estimated to raise consumption by 1.5 percent over the medium term. While the overall net worth of the household sector has improved since the start of the recovery (from about 455 to 500 percent of disposable income between the second quarter of 2009 and the first quarter of 2011), this reflects a rebound in stock prices that offset the decline in real estate wealth. If real estate and net financial wealth are weighted by their estimated impact on consumption (by 9 and 4 cents per one dollar, respectively), there has been no sustained improvement (Figure 6).

8. **Job growth has been held back by the weak recovery of aggregate demand as well as by the low employment intensity of output gains** (Figure 7). Employers responded to the crisis mostly by laying off workers rather than by shortening the workweek, and the recovery has featured a relatively rapid increase in productivity but sluggish job creation, for reasons not yet well understood. The unemployment rate peaked at 10.1 percent in October 2009 and has fluctuated around 9 percent in 2011. As of May 2011, aggregate employment was 6.6 million below the pre-crisis peak, and more than 40 percent of the unemployed have been out of work for six months or more—a record level of long-term unemployment for the United States. Broader measures of labor underutilization (including individuals

marginally attached to the labor force and those working part-time for economic reasons) also remain near the historic peaks reached in 2010. The labor market participation rate fell significantly since the crisis given the bleak job market, and the employment-to-population ratio has fluctuated around its cycle-trough, the lowest level in more than 25 years.

9. **Major labor market dislocations may have pushed up the structural unemployment rate**. Even if the bulk of the increase in unemployment is cyclical (with staff estimating the output gap at around 4 percent in 2011) , mismatches between labor supply and demand originating from large sectoral shocks (especially the decline of construction activity) and weak housing markets appear to have put upward pressure on structural unemployment, especially in regions where both effects are present.[ii] So far, the recovery has produced uneven employment gains across sectors, suggesting that structural changes could be at play (Selected Issues Paper, Chapter 3). Long unemployment spells (which erode work skills) and evidence of a decline in the efficiency of the matching process between vacancies and job seekers are also consistent with some increase in structural unemployment.[iii]

10. **Improving financial conditions have helped underpin the recovery, but healing is still incomplete** (Figure 8). Liquidity is abundant thanks to near-zero policy rates and unconventional easing. Stock prices are about 15 percent above their August 2010 level, and market volatility has been contained. However, lending standards remain tight, especially for residential mortgages, small enterprises, and commercial real estate. Commercial banks are highly capitalized and the quality of their assets has improved slowly, although the coverage ratio and the ratio of risk-weighted assets to total assets are both low. The financial sector still faces the challenges of subpar bank earnings and asset shedding by nonbanks. Net borrowing by the domestic private sector turned positive in the second half of 2010, but the household sector is also still shedding debt.

11. **Securitization activity remains substantially below pre-crisis levels**, with the virtual disappearance of private-label residential mortgage-backed securities (RMBS) and complex structures (Selected Issues Paper, Chapter 4 and Box 1). The market for mortgage-backed securities guaranteed by the GSEs fared better than other residential asset-backed securities (ABS) classes, largely as a result of government support, while private issuance of RMBS is still basically nil. Much of the decline in residential ABS issuance is a result of reduced demand for housing as well as a rise in investor risk aversion.

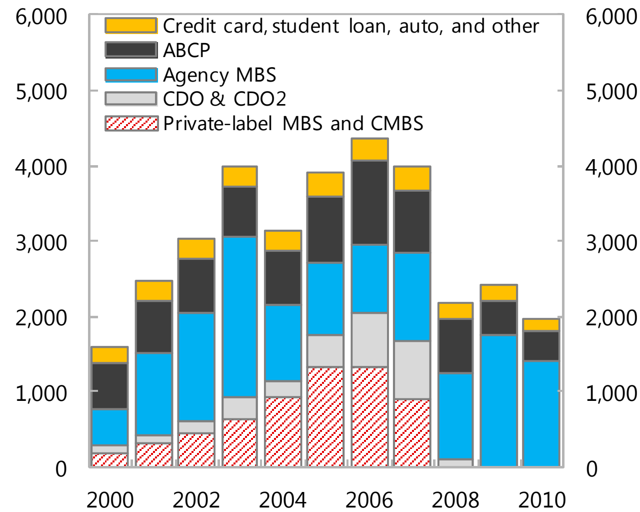
Box 1. The State of Securitization in the United States

Since the onset of the financial crisis, ABS supply has fallen to a fraction of its peak. In particular, the issuance of MBS—the largest of the ABS classes—has declined sharply amid high levels of home foreclosures and still-restrictive mortgage credit. Agency MBS issuance has remained strong on the back of government sponsorship and the overwhelming funding advantage of the GSEs, while private MBS supply has fallen sharply. In addition, uncertainties over the future of the GSEs are muddying the outlook for private-label housing finance.

Much of the decline in ABS issuance is a result of reduced demand for housing and reduced investor appetite following the financial crisis. Sizeable legacy assets still sitting on balance sheets have dampened investor interest. Household deleveraging has reduced demand for loans and correspondingly, the supply of ABS collateral.

Total U.S. Asset-backed Securitization Issued per Year

(Billions of U.S. dollars)



Sources: Board of Governors of the Federal Reserve System, JPMorgan, SIFMA, and Fund staff calculations.

The Dodd-Frank Act could also affect securitization incentives. Specifically, it will require originators to retain at least five percent of the securitized credit risks, in response to concerns that there was poor alignment of securitizer and investor interests. Securitized mortgages that meet "qualified residential mortgage" (QRM) criteria will be exempt from retention requirements. How strict the criteria will be has not yet been determined, but few private-label loans are likely to meet the criteria. Preliminary estimates suggest that the impact of these proposed new rules on the cost and availability of consumer credit will be limited. Furthermore, in order to ensure the effectiveness of the retention requirement, the regulatory agencies have proposed that if the securitizers sell the unretained securities at a premium (i.e., for an amount greater than par) they must place some of this premium into "premium capture" cash reserve accounts. Industry professionals argue that this provision could severely reduce securitization activity by significantly shrinking upfront profit realization and cost recovery.

A number of other factors may have also reduced incentives to securitize loans. These include:

- historically-low funding rates;
- recently introduced accounting rules which make it difficult for banks to remove securitized assets from their balance sheets and get regulatory capital relief;
- the demise of resecuritization vehicles such as structured investment vehicles (SIVs). Markets for these products are unlikely to revive, given the new higher Basel III risk weights on resecuritization vehicles. Also, investors are shying away from complexity, as evidenced by the relative simplicity of the products that have weathered the crisis (e.g., auto ABS).

12. While corporate spending remains relatively weak, firms have had record-high profit growth and large firms face easy financing conditions (Figure 9). The deep cuts in labor input during the crisis were associated with sharp increases in labor productivity as the recovery progressed. The flip-side has been a record-high growth of profits and stronger corporate balance sheets, with firms retiring older debt in favor of newer bond issuance at lower interest rates. Private investment in equipment and software has picked up relatively early in the recovery given strong replacement demand after the plunge in the crisis. Investment in nonresidential structures, however, remains very weak. Overall, non-residential private fixed investment remains somewhat low in comparison with pre-crisis averages (9.9 percent of GDP in 2011Q1 as opposed to 11.4 percent on average between 1997 and 2007). While it is hard to pin down the exact causes for this weakness, uncertainties on future demand and widespread unused capacity utilization seem to be relevant factors. Importantly, historical correlations suggest that elevated cash hoardings signal higher investment going forward (Selected Issues Paper, Chapter 5).

13. U.S. exports have been buoyed by strong external demand, even though the external sector has not added to growth. With the recovery in external and domestic demand, both exports and imports rebounded strongly in 2010, and the current account balance deteriorated slightly to -3¼ percent of GDP in 2010, also reflecting sharply higher oil prices. Nevertheless, the current account balance remained well below the average -5¾ percent of GDP in the three years preceding the crisis (Figure 11). After appreciating in the first half of 2010, when the European sovereign crisis boosted flight-to-quality flows to the United States, the dollar has weakened substantially over the past year, with the real effective exchange rate index reaching its lowest level in decades. This depreciation should help support U.S. exports and current account adjustment going forward.

14. Despite a string of very large current account deficits, the U.S. net international investment position (IIP) has deteriorated only modestly during the past decade, and the net income balance remains positive. Since 1999, the cumulative value of U.S. current account deficits exceeded US$6.3 trillion. This notwithstanding, the U.S. net IIP (the difference between U.S. financial claims and liabilities vis-à-vis the rest of the world) was only -$2.5 trillion (17 percent of GDP) as of end-2010, in part thanks to substantial valuation gains due to dollar depreciation and asset price changes.[iv] In addition, given the preponderance of low-yielding debt instruments in U.S. liabilities and favorable return differentials on foreign direct investment, the net income balance is still positive.

OUTLOOK AND RISKS

15. Looking ahead, the recovery is expected to continue despite the expected fiscal tightening, helped by accommodative monetary policy, while inflation should remain subdued. Staff expects GDP growth between 2¾ percent and 3 percent from 2012 onwards. This implies a slowly narrowing output gap, in contrast to the rapid narrowing seen in previous recovery episodes. This steady but relatively slow recovery is consistent with the ongoing repair of household balance sheets and sluggish aggregate labor income growth (given the slow decline in unemployment), as well as the projected medium-term fiscal adjustment. Private investment in equipment and software is expected to continue growing at robust rates to make up for the decline in the rate of capital accumulation during the recession, while construction activity is likely to remain weak in the near term. Given the persistent output gap, core inflation is projected to remain tame, despite the recent pickup in commodity prices (Selected Issues Paper, Chapter 6).

16. Over the medium term, both saving and investment are projected to rise, leaving the current account deficit broadly stable around current values. Household saving is expected to soften with the fiscal withdrawal in the next couple of years but return roughly to its current level over the medium term, as fiscal deficits remain high, interest rates rise, and incomes recover with declining unemployment. Public saving is also projected to rise as the output gap shrinks, stimulus expires, and some corrective budgetary measures come into place. Private investment would recover toward pre-crisis averages as a percentage of GDP, with construction activity rebounding in line with the normalization of new household formation. The current account deficit is projected to remain around 3 percent of GDP over the medium term.

17. Core inflation remains subdued, despite some recent firming (Figure 10). Against a backdrop of persistently high unemployment, wage inflation is tepid. Twelve-month core consumer price inflation trended up to 1.5 percent in May 2011, after declining to 0.6 percent at the end of 2010, reflecting some pass-through from commodity prices and a number of temporary factors. Twelve-month headline consumer price inflation climbed to 3.5 percent in May 2011, on firmer core inflation and the spike in commodity prices. Elevated resource slack and stable longer-term inflation expectations should keep core inflation trends in check in the near term.

United States: Medium-Term Outlook

	Average 2000-08	2009	2010	Projections 2011	2012	2013	2014	2015	2016
	(percent change, unless otherwise noted)								
Real GDP	2.1	-2.6	2.9	2.5	2.7	2.7	2.9	2.9	2.8
Personal consumption expenditures	2.5	-1.2	1.7	2.5	2.0	2.3	2.4	3.0	2.8
Gross private fixed investment	0.5	-18.3	3.9	5.3	7.5	9.7	9.4	7.0	6.1
Change in private inventories 1/	-0.1	-0.7	1.4	0.1	0.1	0.1	0.1	0.0	0.0
Government consumption and investment	2.2	1.6	1.0	-1.5	-0.7	-1.9	0.5	0.8	1.5
Net exports 1/	-0.2	1.3	-0.4	0.4	0.3	0.1	-0.2	-0.3	-0.3
Potential GDP	2.6	1.7	1.5	1.6	1.8	2.0	2.1	2.2	2.2
Output gap 2/	-0.4	-6.0	-4.7	-3.9	-3.1	-2.5	-1.7	-1.0	-0.5
Consumer price inflation	2.8	-0.3	1.6	2.8	1.6	1.5	1.7	1.8	1.9
Unemployment rate	5.1	9.3	9.6	8.9	8.4	7.7	6.9	6.2	5.6
	(percent of GDP, unless otherwise noted)								
Investment rate	19.5	14.8	15.9	16.1	16.7	17.4	18.0	18.3	18.6
Private saving	14.9	17.6	18.2	18.7	18.7	18.0	17.9	18.2	18.6
Household saving rate 3/	2.9	5.9	5.7	4.7	4.7	4.6	4.7	4.8	4.9
Government saving	0.0	-6.7	-6.6	-6.3	-4.6	-2.9	-2.3	-2.5	-3.0
Current account balance	-4.9	-2.7	-3.2	-3.2	-2.6	-2.3	-2.4	-2.6	-3.0
	(percent)								
Yield on 3-month treasury bill	3.0	0.2	0.1	0.2	0.4	0.9	1.9	2.9	3.9
Yield on 10-year treasury note	4.6	3.3	3.2	3.5	4.4	5.4	5.8	6.0	6.2

Sources: Bureau of Economic Analysis; Bloomberg, LP; Haver Analytics, and Fund staff estimates.
1/ Contribution to real GDP growth, percentage points.
2/ Percent of potential GDP.
3/ Percent of personal disposable income.

18. Downside risks to the outlook have increased. These include:

- *Renewed housing market weakness*, with the possibility of larger-than-expected house price declines. Foreclosure starts have come down in past months, but this reflects, to a large extent, delays due to legal problems with past foreclosures. A future uptick in foreclosure starts is thus likely, in light of the very large "shadow inventory" of houses (estimated by staff at around 6 million units),[v] and this may not be fully reflected in current price dynamics;
- *Unfavorable fiscal outcomes*. These could take the form of a sudden increase in interest rates and/or a sovereign downgrade if an agreement on medium-term consolidation does not materialize or the debt ceiling is not raised soon enough.[vi] These risks would also have significant global repercussions, given the central role of U.S. Treasury bonds in world financial markets. At the opposite extreme, an excessively large upfront fiscal adjustment could significantly weaken domestic demand;
- *Further commodity price shocks, which could impact both growth and inflation;*
- *Credit supply constraints*. The ability of the financial sector to support a faster economic expansion remains uncertain, with weak securitization markets and tight loan standards for most sectors;

- *Challenging conditions for some European sovereigns.* A renewed bout of instability in European sovereign and bank debt markets could lead to global financial turmoil, including increased tensions in U.S. money markets, given their short-term dollar funding to major European banks.

On the positive side, the recovery could surprise on the upside if confidence improves and pent-up demand for consumer durables materializes more quickly, or if hiring picks up faster than expected, given healthy corporate balance sheets.

19. The authorities broadly agreed with staff's near-term outlook and risks, but considered that the recovery could be firmer next year as headwinds lessen. They saw subdued residential construction as the key impediment to a faster recovery going forward, and a less prominent role for further household balance sheet repair. The authorities were optimistic about a rebound of construction at some point in the next few years, in view of the expected normalization in household formation rates and the eventual absorption of excess supply. They also saw the risk of unfavorable fiscal outcomes as more contained than staff. As in previous consultations, the authorities considered staff's medium-run outlook as excessively pessimistic, in view of their own higher estimates of potential output. Relatedly, they saw most of the increase in unemployment as cyclical, but acknowledged risks that the natural rate could have risen somewhat.

POLICY DISCUSSIONS

Discussions focused on the challenges posed by the need to exit from extraordinarily accommodative policies with a still fragile recovery, including the urgent task of adopting a politically-backed plan for stabilizing public finances in the years ahead; the policies needed to secure the recovery over the medium term; accomplishments and remaining tasks in financial sector reform; as well as current account adjustment and the challenges of global rebalancing. U.S. policy choices are of central importance for the global economy—U.S. growth spillovers are uniquely large since the United States is the world's largest economy and has globally-dominant financial markets. Policy spillovers have been a particular focus of this year's analysis, as discussed in the relevant sections below and in more detail in the accompanying U.S. Spillover Report (see also Box 2).

Box 2. U.S. Policy Spillovers to the Rest of the World

Process. Spillover reports examine the external effects of policies in five systemic economies (the "S5"): China, the Euro Area, Japan, the United Kingdom, and the United States. In each case, key partners are asked about outward spillovers from the economy in question, on the basis of which staff choose issues for analysis. To facilitate candor, spillover reports do not cite who raised a specific issue. Those consulted were officials and analysts from the other S5 and from selected emerging markets—Brazil, Hong Kong SAR, India, Indonesia, Korea, Mexico, Poland, Russia, Singapore, and Thailand. The report focuses on a few forward-looking issues raised by partners, brings to bear relevant analysis, and describes the reactions of the U.S. authorities.

Policy issues. Other authorities expressed concerns on U.S. policy spillovers from quantitative easing and its exit, as well as ongoing fiscal and financial policies. Interlocutors mainly discussed financial market spillovers, including the impact of abundant dollar liquidity on commodity prices, emerging market exchange rates, and associated capital flows. This is consistent with the team's analysis which finds that, beyond close neighbors, U.S. spillovers to foreign activity come mainly through financial market links. This underscores the need for clear communication of major policy moves, such as the eventual ending of the zero interest rate policy, to avoid financial market disruption.

Findings. The main messages flowing from staff analysis are:

- **Short-term U.S. spillovers on growth abroad are uniquely large, mainly reflecting the pivotal role of U.S. markets in global asset price discovery**. While U.S. trade is important, outside of close neighbors it is the global bellwether nature of U.S. bond and equity markets that generates the majority of spillovers.

- **Spillovers from macroeconomic stimulus supported foreign activity more in 2009 than in 2010**. Facing global turmoil, 2009 initiatives calmed global markets. In the less fraught environment of 2010, similar policies produced a less favorable market response.

- **Overall, U.S. and foreign interests may be better aligned for fiscal and financial policies than for monetary ones**. For the former, there is a common interest in limiting global tail risks, while for the latter low interest rates inevitably support financial risk-taking that can complicate policy options for countries with strong cyclical positions.

A. Fiscal Policy: In Search of a Medium-Term Framework

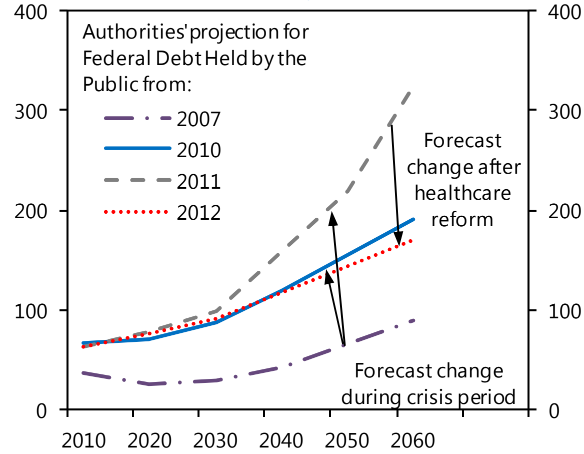
20. Staff and authorities concurred on the need for fiscal stabilization, with staff emphasizing the urgency of agreement on a politically-backed framework. Discussions surrounded the desirable pace, extent and form of consolidation. It was agreed that policies should stabilize the public debt-to-GDP ratio by mid-decade and gradually reduce it afterwards. But despite the recent health care reform and the proposed 5-year freeze on non-security discretionary spending, federal finances remain unsustainable (Box 3); state and local government finances also face significant challenges (Box 4 and Selected Issues Paper, Chapter 7). This year, the federal deficit could reach 9 percent of GDP, with the general government deficit nearly 10 percent of GDP.[vii] While this is less than projected at the time of April 2011 World Economic Outlook due to revenue overperformance and lower-than-expected outlays, the deficit would remain among the highest for advanced economies.

Box 3. Long-Term Outlook for the U.S. Federal Government Finances

The U.S. federal finances are on an unsustainable trajectory. According to the authorities' budget projections, federal debt held by the public is projected to increase from 62 percent of GDP in FY2010 to about 90 percent in FY2030, and continue rising thereafter owing to pressures from population aging and rapid cost growth in the health care sector. The debt dynamics are even bleaker under the IMF staff's more conservative macroeconomic assumptions. Because the financial crisis is expected by IMF staff to cause a permanent loss of output and budgetary revenues, federal debt could exceed 95 percent of GDP already by the end of this decade—approaching the levels last seen in the aftermath of World War II—and put upward pressure on interest rates both in the United States and abroad.

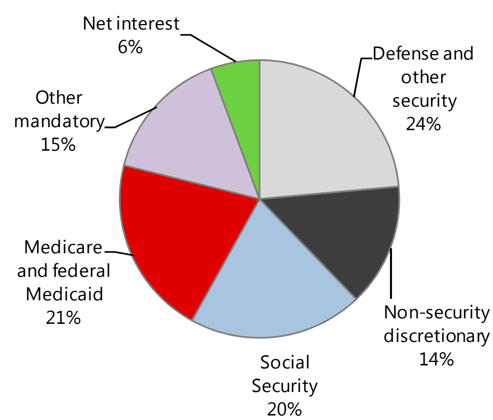
Long-Term Debt Projections, 2010-2060

(percent of GDP, fiscal years)



Source: Office of Management and Budget.

Composition of Federal Spending, FY 2010



Sources: Office of Management and Budget; and Fund staff calculations.

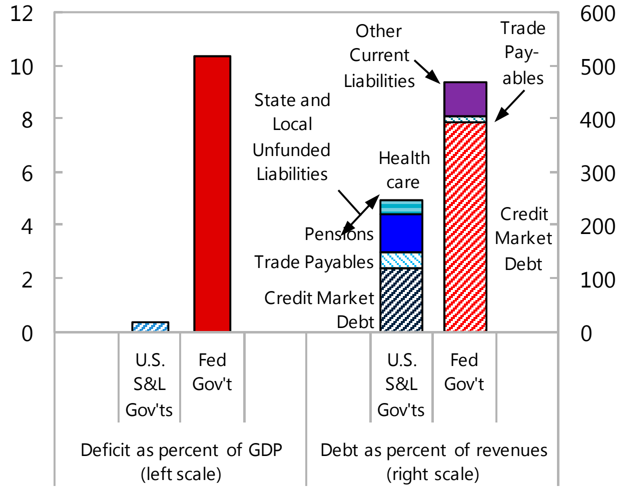
The long-term budgetary outlook remains troublesome despite the existing efforts to curb deficits. Although last year's health care reform is expected to bend the health care "cost curve" to some (highly uncertain) degree, the federal health care bill could still increase by 3 percent of GDP over the next 20 years according to the Congressional Budget Office. Other measures proposed by the administration as part of the draft FY2012 budget such as the 5-year freeze on non-security discretionary spending and defense savings are helpful, but cannot on their own address the fundamental long-term budgetary pressures, because mandatory health care, pension, and other spending make up a greater share of the budget and are projected to grow faster (see Figure 12).

The authorities have a number of options to achieve fiscal sustainability without large negative short-term effects on activity. Social Security reform would help reduce long-term fiscal imbalances without undermining the ongoing recovery—measures such as increasing the retirement age while indexing it to longevity and trimming future benefits for upper-income retirees would have a minimal impact on current private spending. Identifying additional saving in health care and other mandatory spending categories would also be highly desirable, including through greater cost sharing with the beneficiaries, curbs to the tax exemption for employer-provided health care, and targeted savings identified by the President's Fiscal Commission. Meanwhile, the tax system is riddled with loopholes and deductions worth over 7 percent of GDP. Gradually reducing these tax expenditures (including eventually the mortgage interest deduction which largely benefits upper-income taxpayers) would help raise needed revenue while enhancing efficiency. In the longer term, consideration could also be given to introducing a national VAT or sales tax, as well as carbon taxes.

Box 4. Fiscal Challenges Facing the U.S. State and Local Governments

State and local governments (SLGs) have so far managed to cope with the fallout from the Great Recession, but at a considerable social cost. The recession hit tax collections very hard given the exposure to very weak housing and labor markets and consumer spending (Figure 13). Aggressive spending cuts, some revenue measures, and reserve drawdown have kept the operating budgets roughly balanced as required by law, with a significant federal emergency aid smoothing adjustment to the lower revenue trend. However, the involuntary fiscal consolidation at the state and local level has imparted considerable social costs, with significant cuts in education, health, transport, and welfare systems.

Comparison of State and Local & Federal Government Finances (2010)



Sources: Bureau of Economic Analysis; Board of Governors of the Federal Reserve System, *Flow of Funds Accounts of the United States*; Collins and Rettenmaier (2010); and Fund staff calculations.
Notes: Deficit outturns are reported here on the national income and product accounts (NIPA) basis, with financial liabilities reported on the Federal Reserve' Flow of Funds basis. The chart does not include federal unfunded liabilities for Social Security, Medicare, and other programs.

Although the tax receipts are now recovering, state and local governments will need to need to continue fiscal adjustment, while addressing unfunded long-term commitments. Emergency federal aid will be phased out soon, and the renewed declines in house prices pose risks especially to local governments. Rainy-day funds which have been depleted in almost half of the states will need to be replenished to rebuild room for maneuver. The state and local government will also need to continue addressing their large unfunded entitlements, especially pensions (estimated in a wide range of $1–3 trillion), which present a long-term risk in a number of states due to strong legal protections of the already-accrued pension benefits. The SLGs will also face structural spending pressures from health care, both through higher Medicaid outlays and health benefits for government retirees.

Following a spell of risk aversion in the state and local government bond markets late last year, the situation has calmed down significantly (Figure 13). Lower bond supply following the expiration of the Build-America-Bond program, stronger tax collections, and adjustment measures adopted by the lowest-rated states (California, Illinois) helped improve market sentiment. More generally, defaults are unlikely at the state level given low debt, balanced budget rules, and statutory protections for investors. Some vulnerabilities remain at the local level, with risks from the housing market and cuts in state and federal transfers. That said, local defaults have historically been rare events.

21. On the pace of consolidation, the authorities' envisage a frontloaded withdrawal, but details remain under Congressional debate. The President's February budget proposal would cut the federal deficit to 4.6 percent of GDP in FY2013, over-delivering on the G-20 Toronto commitment to halve the federal deficit by FY2013. Deficit reduction over FY2012–13 would largely reflect expiring stimulus, lower military spending, and cyclical recovery. However, ongoing discussions over the debt ceiling and FY2012 appropriations, the recent soft patch in growth, and technical factors complicate an assessment of the likely pace of adjustment.[viii]

22. Staff considered the February budget could be too front-loaded given the cyclical weakness and downside risks.

- *The staff recommended a broadly uniform reduction of the federal structural primary deficit over the next five years within a fully-specified and politically-backed consolidation plan* (Staff Adjustment Scenario in table). This strategy would rein in the deficit without taking an undue toll on the still-sluggish recovery (Box 5). The staff's recommended FY2013 deficit target would be around 6 percent of GDP—over 1 percentage point of GDP higher than under the administration's scenario. Although financing conditions are benign for now (Figure 3), starting a withdrawal in FY2012 would hedge the risk of a disruptive loss in fiscal credibility. Absent a fully-specified consolidation framework, fiscal adjustment should proceed more rapidly. The authorities agreed that fiscal consolidation should proceed gradually, but considered the anticipated growth drag from their current plans as manageable.

Box 5. Short-Run Effect of Fiscal Policy on Activity

The pace and composition of fiscal adjustment is important because it matters for short-term economic activity. Under the staff projections, expiration of temporary stimulus programs, lower defense spending and new deficit reduction measures will help reduce the federal deficit by 3¾ percent of GDP over the next two fiscal years, subtracting roughly 1 percentage point from GDP growth in both 2012 and 2013.

- Expiration of targeted spending measures such as infrastructure investment, emergency aid to local governments, and unemployment benefits will be felt more with growth multipliers between 0.75–1. Expiring tax provisions will have a somewhat smaller effect with multipliers between 0–0.6, with the multipliers for corporations and upper-income taxpayers closer to the lower bound. Lower defense spending will directly affect output by reducing government consumption and investment.

- The October 2010 World Economic Outlook finds that while fiscal consolidation is beneficial in the medium run, the short-term effects on output are negative. The average short-run multiplier is estimated at around ½, but fiscal consolidation has a larger negative effect in the short run if the perceived risk of sovereign default is low, monetary policy is close to the zero bound, and trading partners are also consolidating. Consolidation is less contractionary when it relies on cuts in transfers and government consumption (multipliers are around ¼). The multipliers are larger for public investment, above ½. They tend to be largest for indirect tax hikes with a more than one-for-one fall in output, because central banks tend to tighten in response to inflationary pressures associated with such tax changes.

Fiscal Projections for Federal and General Government

(Percent of GDP, Fiscal Years Unless Otherwise Noted)

	2010	2011	2012	2013	2014	2015	2016
Staff Baseline Fiscal Projection 1/							
Federal budget balance 2/	-9.6	-9.3	-7.6	-5.6	-4.7	-4.8	-5.3
Federal primary balance 3/	-8.2	-7.9	-6.2	-3.9	-2.5	-2.0	-1.9
Structural primary balance 4/	-6.4	-6.5	-5.1	-3.1	-2.0	-1.6	-1.7
Federal debt held by public	62.1	70.2	74.6	78.3	80.7	82.7	85.0
General government net lending 5/	-10.3	-9.9	-7.8	-6.0	-5.3	-5.6	-6.0
General government gross debt 5/	93.5	99.0	103.0	106.2	108.2	110.2	112.7
Authorities Fiscal Projection (President's February draft budget) 6/							
Federal budget balance	-8.9	-10.9	-7.0	-4.6	-3.6	-3.2	-3.3
Federal debt held by public	62.2	72.0	75.1	76.3	76.3	76.1	76.1
Staff Adjustment Scenario 7/							
Federal budget balance 2/	-9.6	-9.3	-7.4	-5.9	-4.7	-3.6	-2.4
Structural primary balance 4/	-6.4	-6.5	-4.9	-3.4	-2.0	-0.4	1.1
Federal debt held by public	62.1	70.2	74.5	78.4	80.8	81.7	81.1
General government gross debt 5/	93.5	99.0	102.9	106.3	108.1	108.3	108.1
Memorandum item							
Federal budget balance (CBO projection) 8/	-8.9	-9.5	-7.4	-5.5	-4.4	-4.1	-4.4

Sources: Fund staff estimates; Office of Management and Budget (OMB); and Congressional Budget Office (CBO).

1/ Projections using the IMF macroeconomic assumptions. Relative to the President's February budget proposal, staff assumes further temporary extensions of emergency unemployment benefits and the payroll tax cut, some delay in implementing revenue-raising measures, and a more front-loaded spending restraint.

2/ Includes staff's adjustments for one-off items such as TARP valuation changes.

3/ Excludes net interest.

4/ Excludes net interest, effects of economic cycle, and costs of financial sector support. In percent of potential nominal GDP.

5/ GFSM-2001 basis, calendar years.

6/ President's budget proposal, February 14, 2011.

7/ Structural primary withdrawal of 1.5 ppt of GDP a year, with total adjustment of 7.5 pct of GDP.

8/ CBO analysis of the President's budget proposal, April 15, 2011.

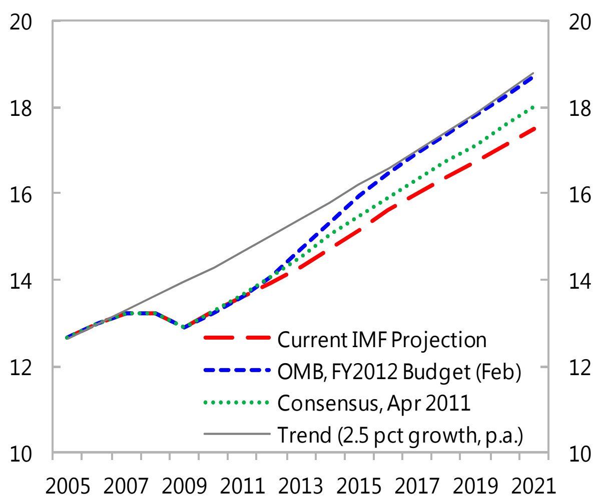
- On balance, staff expects some expiring stimulus measures to be extended by Congress, implying a less front-loaded path than in the President's February budget proposal (Staff Baseline Projection in table). Staff projects a FY2013 deficit of 5½ percent of GDP, assuming that the temporary payroll tax cut and emergency unemployment benefits are renewed. The structural primary withdrawal would be around 3½ percent of GDP over two years, broadly in line with the staff's preferred scenario with a fully-specified consolidation plan. Should the growth outlook worsen considerably, consolidation could proceed at an even slower pace over the next two years, provided—crucially—that a medium-term framework is in place and financing conditions remain favorable.

23. On the extent and form of consolidation, the President's April speech outlined the administration's medium-term strategy. The proposed framework would save about \$4 trillion over 12 years (some 20 percent of GDP) and would—according to the authorities—put public debt on a downward path in the second half of the decade.[ix] Measures worth \$1–2 trillion could be decided during June and July amid the debate on raising the debt ceiling (which must be raised by August 2, per the Treasury). In addition, a debt stabilization mechanism ("debt failsafe") would trigger automatic spending cuts or revenue increases if the debt ratio does not stabilize.

24. Staff considered that a larger and wider-ranging consolidation than envisioned in the budget and the President's speech would be needed, on the basis of staff's less favorable macroeconomic assumptions.

- *Under the staff's adjustment scenario, a cumulative structural primary deficit reduction of 7½ percentage points of GDP (about 1½ p.p. per year) would achieve the* objective *of stabilizing the debt ratio by mid-decade, and then gradually reducing it.* The President's February budget proposal (based on above-consensus growth projections) falls short of this target by 2½ percent of GDP. Savings identified in the April speech would reduce but not eliminate the required additional adjustment.

Comparison of Real GDP Forecasts
(trillions of chained 2005 dollars)



Sources: Congressional Budget Office; Consensus Economics; Office of Management and Budget; and Fund staff estimates.

Macroeconomic Projections

	2012-16	2017-21
Office of Management & Budget		
Real GDP growth	3.9	2.6
10-year Treasury note yield	4.5	5.3
IMF staff		
Real GDP growth	2.8	2.3
10-year Treasury note yield	5.6	6.3
Consensus (Apr 2011 Survey)		
Real GDP growth	3.1	2.5
10-year Treasury note yield	5.0	5.3

Sources: Office of Management and Budget; Consensus Economics; and Fund staff estimates.

- *The deficit reduction plan will need to include both changes to entitlement programs and revenue-enhancing measures*, given pressures from population aging and excess cost in the health care sector. Administration proposals would already cut the share of non-security discretionary spending in GDP to very low levels. Additional measures (discussed in Box 3) can include Social Security reform, additional savings in health care and other mandatory spending categories, and reducing tax expenditures (which amount to 7 percent of GDP according to the President's Fiscal Commission). In the longer term, consideration could also be given to introducing a national value added tax (VAT) or sales tax, as well as carbon taxes. The administration agreed on the need for broad-based adjustment, but noted that given the divided Congress, a fundamental reform of entitlements and the tax code may need to wait until after the 2012 elections. Discussions on deficit reduction measures are ongoing in the context of the debt ceiling debate.

25. Staff and the authorities agreed that institutional enhancements could play a useful role in supporting fiscal consolidation. The debt "failsafe" mechanism and a multi-year expenditure envelope for non-security discretionary spending could help keep consolidation on track across the annual budget cycles. While welcoming the proposed reforms, staff cautioned against overemphasizing the failsafe mechanism given the mixed experience with automatic spending cuts (see Selected Issues Paper, Chapter 8). It recommended that the deficit reduction plan include as many specific measures as possible, and noted that clear specification of the medium-term fiscal objectives—formally endorsed by Congress—was essential. In addition, since the administrations' growth projections remain well above the Consensus and CBO forecasts, staff saw merit in attaching greater weight to private sector forecasters and other outside institutions, as is customary in countries such as Canada and Germany. The authorities argued that the proposed failsafe mechanism would provide a protection against deficit overruns in case of weak medium-term growth.

26. Spillovers analysis suggests that fiscal consolidation has clear long-term global benefits (Box 2). Staff analysis suggests that short-term losses are likely small beyond close trading partners (Canada and Mexico). Indeed, consultations with other authorities on U.S. policy spillovers underscored their concerns with the possible international ramifications of lack of U.S. fiscal adjustment on long-term interest rates and the dollar. Staff analysis suggests that a credible, phased-in U.S. fiscal consolidation would forestall a rise in U.S. (and foreign) yields, and hence limit short-term negative spillovers, reinforcing the case for such a policy. Authorities agreed that U.S. fiscal stabilization would bring global benefits, but saw growth spillovers from fiscal policy as larger and more wide-ranging than in staff's analysis.

B. Housing Markets: The Challenge of Easing Adjustment

27. With the housing market slowly adjusting to past overbuilding, discussions focused on whether and how to alleviate its strains and the risk of a severe further drop

in house prices. Staff and authorities expect the housing market to stabilize over the next couple of years, and to gradually recover thereafter. However, there is a risk of house price undershooting given the sizable shadow inventory of potential distress sales. Such sales have a disproportionately large effect on average house prices (and thus on the broader economy), likely reflecting a combination of factors including negative neighborhood externalities from foreclosed houses as well as destruction of value linked to lack of maintenance. In turn, administrative complexity, capacity constraints, and conflicting incentives among banks, servicers, and bond investors have thus far hindered potentially efficient loan modifications that would avoid at least part of the costly foreclosures. Taken together, these factors can justify further policy action to mitigate distress sales, even though the housing market already has different forms of subsidies (Selected Issues, Chapters I and II). Authorities and staff agreed that distress sales are the main driving force behind the recent declines in house prices—in fact, excluding distress sales, house prices had stopped falling.

28. **Staff advocated strengthened foreclosure mitigation policies, given the common view that the existing programs have had limited effectiveness (Box 6)**. The authorities noted that the Making Home Affordable programs were not originally designed to address underwater and unemployed borrowers (the biggest proportion of borrowers in default at the moment) and pointed to the complexities in designing and implementing modifications. They also pointed to their efforts to address problems related to mortgage servicers, including through the establishment of national mortgage servicing standards, an initiative supported by staff. Staff further advocated:

- ***Allowing mortgages to be modified in courts ("cramdowns")***. Implementing this long-standing Fund recommendation would create incentives for voluntary modifications at no fiscal cost. The authorities agreed on its potential usefulness but noted that a similar proposal had failed to garner sufficient political support in 2009.
- ***Expanding state programs that assist unemployed homeowners and adopting parametric changes to existing programs*** (*e.g., lowering the back-end debt-to-income ratios and bringing the loan-to-value ratio below 100 percent in programs like HAMP-PRA)*. The authorities noted that the former is currently under consideration and acknowledged that high back-end debt to income ratios raise re-default rates. However, they noted that modifications to aggressively reduce loan-to-value (LTV) ratios would lead to moral hazard, and pointed out that a large proportion of negative equity mortgages (where the outstanding loan balance exceeds the value of the home) remains current. Staff suggested to attach clauses to these modifications to ensure the sharing of gains from future home price appreciation between homeowners and the counterparty in the modification.

Box 6. Administration's Response to the Housing Crisis

The Administration has undertaken a variety of measures to tackle the foreclosure epidemic, but so far with limited results. For example, as of end-March 2011 only $1.4 billion out of the $45.6 billion allocated through the Troubled Asset Relief Program (TARP) for housing support measures has so far been disbursed. More specifically:

- The Home Affordable Modification Program (HAMP), which reduces monthly payments on existing first-lien mortgages, provides financial incentives for servicers and investors to perform sustainable modifications, including by requiring lenders to consider a Principal Reduction Alternative. HAMP has only completed 670,000 permanent modifications out of the 1.6 million modifications started since the program's inception; another 2,174 permanent modifications have been completed on Federal Housing Administration (FHA)-insured loans through the FHA-HAMP program.
- With lenders reluctant to write off second-lien mortgages, the Second Lien Modification Program has only completed 21,230 modifications so far.
- The Home Affordable Foreclosure Alternatives Program, aimed at encouraging short sales and deed-in-lieu for borrowers unable to complete a modification, has so far completed only 5,250 short sales or deeds in lieu of foreclosure transfers.
- The Administration's Home Affordable Unemployment Program, providing temporary forbearance on the unemployed, has only 7,400 participants thus far.
- The Hardest Hit Fund Program has committed $7.6 billion to heavily distressed states for foreclosure mitigation policies, but so far only $165 million have been spent. FHA's Short-Refinance Program (an $8-billion foreclosure prevention and mortgage relief plan launched in September 2010 to assist qualified non-FHA insured underwater homeowners to refinance into an-FHA-insured mortgage if the lender agrees to write off at least 10 percent of the first mortgage's principal balance) had only refinanced 107 loans through end-March.

Other policy initiatives were relatively more successful in supporting the housing market. The homebuyers tax credit—that expired last summer—has supported, at least temporarily, housing sales while the private sector, including the GSEs, has started 2.2 million modifications under Hope Now. The homebuyer tax credit brought forward future demand so there has naturally been some payback after its expiration (Figure 4). More than 800,000 FHA-insured mortgages have avoided foreclosure via loss mitigation plans, while support to Fannie Mae and Freddie Mac facilitated continued access by households to affordable mortgage credit. The Federal Reserve and the U.S. Treasury purchased more than $1.4 trillion in agency mortgage-backed securities (MBS) through independent purchase programs, helping to keep mortgage rates low.

- ***Encouraging GSEs to participate in principal write-downs*** would significantly increase the scope for modifications. The Federal Housing Finance Agency (FHFA) estimates that, out of its 30 million pool of guaranteed mortgages (worth US$5 trillion), around 600,000–800,000 are currently underwater and in default. The FHFA, the regulator of the conservatorship, has so far declined to allow principal writedowns on the grounds that many have subordinate liens and mortgage insurance, which would mean that the benefits of successful modifications would mostly benefit others, writedowns would impose losses on GSEs, which is inconsistent with the mandate of conservatorship, and they would induce underwater homeowners to intentionally default. Staff agreed that the latter risk existed but noted that the positive externalities from lowering the housing market uncertainty induced by the large shadow inventory of houses would likely outweigh these costs, especially taking into account the large contingent fiscal liability of the U.S. Treasury.[x] Furthermore, staff pointed to the analysis by the Office of the Comptroller of the Currency (OCC) which indicate that modifications significantly reducing monthly principal and interest payments consistently perform better. Staff also suggested providing additional incentives for further deed in lieu and short sales (Selected Issues Paper, Chapter 9).

C. Labor Markets: Lowering Unemployment and Improving Matching

29. Authorities noted that a number of recently adopted measures helped buoy the labor market and speed up hiring. The administration has enacted several programs to speed up hiring, including the "jobs agenda" and the December 2010 stimulus package, which included a temporary payroll tax cut for employees. Authorities attributed part of the pickup in hiring at the end of 2010–beginning of 2011 to the payroll tax cuts and viewed past efforts as important to limit labor market slack. Staff suggested that some measures (extension of unemployment insurance and the payroll tax cuts) could be extended in 2012 and/or new targeted measures to induce hiring of the long-term unemployed could be enacted, given the long-term consequences of degradation in work skills with adverse effects on productivity, real wages, and trend consumption spending. Authorities stressed that any deviation from existing policies would depend on labor market performance in the remainder of the year.

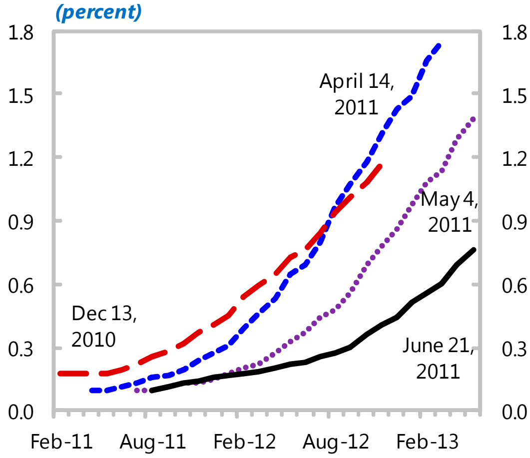
30. Staff inquired whether risks of higher structural unemployment justify a re-evaluation of existing policies to train and place the unemployed into jobs. Staff remarked that the federal government has nearly 50 different programs dispersed across nine federal departments geared toward helping the unemployed, but with a cumulative budget of only 0.1 percent of GDP. Moreover, a large part of this budget is transferred to states, which have many programs of their own.[xi] Thus, it could be important to assess whether some consolidation of the system—with better funding—would be more effective in facilitating the labor market adjustment. Authorities recognized that some reevaluation of existing programs could be productive but stressed that the education system—which is not part of this array of programs—also plays an important role in re-training the unemployed. Officials argued for using community colleges (as in a recent government initiative geared toward manufacturing jobs), which offer flexible curricula and are more aligned to the demands of local employers, as a way to channel training programs.

31. Looking ahead, institutional reforms could limit the volatility of U.S. employment during the next cycle. The U.S. labor market has benefited from great flexibility, but at the cost of high employment volatility, which may have medium-term consequences when the unemployment rate does not recover quickly. Staff and authorities agreed that adopting some aspects of the short-time compensation programs present in other countries (e.g., Germany and, to a lesser extent, Canada) could help reduce the cyclical burden on employment.

D. Monetary Policy: Continued Accommodation

32. Staff viewed monetary policy as having provided needed support to the recovery while maintaining inflation expectations well anchored. The strategy has included near-zero policy rates, clear communication that conditions would likely warrant exceptionally low policy rates for an extended period, and a second round of unconventional easing beginning in the Fall of 2010 in response to the weakening of inflation and growth. Federal Reserve officials considered that large-scale asset purchases had effects on the real economy through conventional monetary transmission channels, even if their impact on longer-term yields had been more direct than those of conventional policy.[xii] They noted that the impact of the second large scale asset purchase program on longer-term yields had been harder to detect, as markets incorporated the policy into their expectations over a period of time, rather than in response to discrete policy announcements as in the first round of asset purchases.[xiii]

Federal Funds Futures Contracts
(percent)

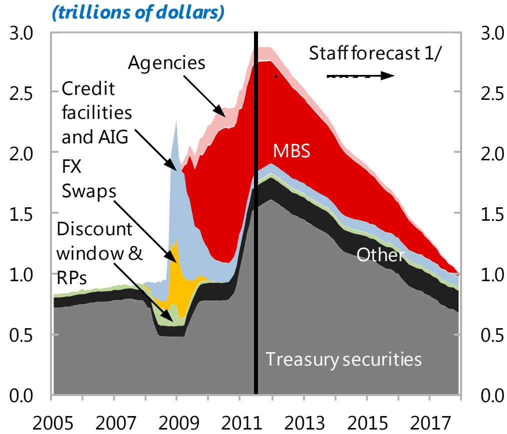


Source: Bloomberg, LP.

33. Well-anchored inflation expectations and significant resource underutilization suggest that the extraordinarily low level of short-term interest rates will likely remain appropriate for quite some time. The mission and the authorities agreed on the importance of remaining vigilant to the risk of an unmooring of long-term inflation expectations in either direction. More generally, the speed and timing of future actions should depend on incoming data on core inflation, longer-term inflation expectations, and growth, with scope to react to a more aggressive fiscal consolidation through a slower withdrawal of monetary stimulus. Although temporary factors—including pass-through from higher commodity prices—had recently pushed core inflation up, the authorities anticipated that inflation would fall back to more subdued levels over the coming quarters as those effects passed and as persistent labor market slack would keep wages in check.

34. The mission and authorities agreed that ending the policy of reinvesting the principal of maturing securities seems to be a reasonable first step in normalizing monetary conditions when warranted by the economic outlook. Against the backdrop of a passive unwinding of the Fed's securities holdings through ceasing the reinvestment of maturing securities, short-term policy interest rates would serve as the main active tool to fine tune the adjustment of monetary conditions. Reducing excess reserves by ceasing reinvestments of the principal of at least a portion of maturing securities, as well as other reserve-draining operations, including the use of repos and term deposits, would also help tighten the link between the federal funds target rate and the interest rate on reserves. A clearly communicated and gradual path of asset sales would be an additional step in the exit process. Federal Reserve officials stressed that members of the Federal Open Market Committee would continue to weigh the relative merits of various sequencing options for the eventual normalization of monetary policy.

Effects of Ending Principal Reinvestment on the Federal Reserve Balance Sheet
(trillions of dollars)



Sources: Board of Governors of the Federal Reserve System, *Factors Affecting Reserve Balances (H.4.1)*; Haver Analytics; and Fund staff calculations.
1/ Assumes that reinvestment of maturing securities stops early 2012: (a) Treasuries and Agencies run down at scheduled maturities; (b) MBS stock runs down (with both prepayments and scheduled run-offs) at the pace of $2.8 billion per week, consistent with the recent trend.

35. From the perspective of monetary policy spillovers to the rest of the world, the main risk is a likely reversal of some of the inflows to emerging markets if markets suddenly bring forward expectations of monetary tightening, suggesting a premium on clear communication. While the second large scale asset purchase program had limited spillovers and its ending will have even less as it is fully anticipated, there is a risk that when the Fed gets closer to tightening, e.g., by draining liquidity, Treasury yields could jump and there could be sharp capital outflows from emerging markets, particularly if this were unexpected. This is because such a shift would be the precursor to future rate hikes (or swift balance sheet unwinding), thereby signaling smaller interest rate differentials and either greater confidence in the U.S. expansion or rising inflationary pressures. Senior Fed officials considered that most capital flows to emerging markets were structural, suggesting limited risk of significant pull-backs in response to monetary tightening. The spillovers analysis highlights that clear monetary policy communication has benefits from an international perspective, further to the well-known domestic benefits. In this context, staff welcomed the introduction of regular press briefings to present the Federal Open Market Committee's economic projections and to provide further context to its decisions.

E. Financial Policy: Restoring Financial Resilience

36. Discussions focused on the health of the financial system and the policy response to the crisis. On financial system health, the authorities noted that government investments were being steadily repaid, with banks paying a net $12 billion so far, and Fed financial system support at minimal levels (Table 6). Banks' tier 1 risk-based capital ratios stood at 13 percent and the leverage ratio at 9.1 percent at the end of 2011Q1 (compared with just under 10 percent and 7½ percent respectively at end-2008), while the tier 1 common capital ratio for SCAP institutions stood at 9.8 percent.[xiv] Liquidity indicators had improved as well, although increased reliance on business deposits (boosted by the increase in holdings of liquid assets by nonfinancial corporates) was a concern. Profits were recovering, but largely owing to reduced provisioning (with some concerns by the authorities that this might be premature). Meanwhile, the return on assets remained weaker than pre-crisis levels, partly reflecting the de-risking of balance sheets (as the share of risk-weighted assets declined to low levels), and was likely to remain soft given the subpar economic recovery.

37. Staff and authorities agreed that important vulnerabilities remained, especially from potential spillovers from possible turmoil in Europe.[xv] While direct credit exposures to the most stressed countries were modest (see Box 7), banks had substantial exposure to major European institutions. These institutions also played important roles in U.S. derivatives, securities and lending markets, raising additional channels for spillovers. Last but not least, strains among the European banks could disrupt U.S. money market funds, which hold considerable amounts of their paper. Staff also expressed concerns that stress in the U.S. Treasury market related to the approaching debt limit could severely disrupt global financial stability. Treasury officials expressed confidence that a budget agreement would be reached in time to ward off Treasury market volatility.

38. While banks' balance sheets were strong enough to support lending, a revival of securitization was seen as essential to supply the needed credit into a stronger recovery. Securitization had collapsed to a fraction of its pre-crisis level, notably in private residential mortgage-backed securities, which were weighted down by a combination of housing market fragility, weak demand for residential properties, and regulatory uncertainty. The team and the authorities agreed that initiatives to strengthen risk retention and disclosure and redefine the roles of the rating agencies (with greater emphasis on investor due diligence along with steps to address potential conflicts of interest) were essential. Authorities disagreed with private concerns that proposals for risk retention were stifling private securitization, noting that reforms would over time revive the market by improving investor confidence. Authorities saw the dominance of the housing GSEs as a more important obstacle to a recovery of private mortgage securitization, but also as a needed support at the current juncture—and thus as an issue for the longer term.

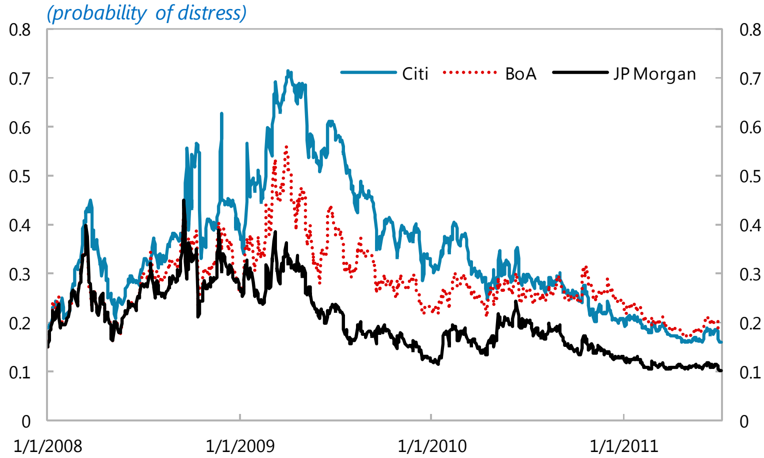
Box 7. U.S. Financial Exposure to Europe

U.S. money market funds (MMFs) continue to have sizeable exposures to European financial institutions. According to market analysis, based on a sample of the 10 largest MMFs, which represent 45 percent of the total prime fund universe, exposure to European banks account for roughly half of total U.S. MMFs assets. French banks (at nearly 15 percent of MMFs assets) form the largest country exposure while 40 percent of the funds' total assets are concentrated in 15 banks. Therefore, if European sovereign distress reverberated to European banks, U.S. MMFs could face significant strain.

Evidence on exposure of U.S. banks to Euro area peripheral countries is mixed. Banking statistics from the BIS and the Federal Reserve indicate limited direct claims of U.S. banks on European peripheral countries at the end of 2010, while potential exposure—including derivatives, unused credit commitments, and guarantees—is much larger. However, estimates of these potential exposures are amplified by the lack of data on the insurance bought by U.S. banks against default in European peripheral countries, which would offset default insurance sold.

Despite heightened sensitivity to the outlook on Euro area sovereign debt, market information suggests that investors do not appear overly concerned about the potential spillover to U.S. banks.[1] Using market information, the estimated Conditional Probabilities of Distress (CoPoD) represent the market's assessment of potential spillovers through a variety of channels such as direct exposure to governments and banks, deleveraging and market confidence.[2] These results suggest that U.S. banks remain more sensitive to domestic events. Specifically, spikes in CoPoDs occurred between 2008 and 2009, around credit downgrades, the Lehman bankruptcy, and the launch of various government programs—such as the Term Asset-Backed Securities Loan Facility (TALF) and aid to the American International Group (AIG). Since then, despite rising concerns regarding Euro area sovereign debt, U.S. banks' sensitivity to events in Euro area peripheral countries appears modest (chart). The low sensitivity may reflect U.S. banks' modest direct exposures to these countries, as well as their robust investment banking returns over 2010. Still, were distress in Euro area peripheral sovereigns spill over to core Euro area banks, the potential impact on U.S. banks could be much higher, given their significant exposures to those banks.

Probability of Distress in U.S. Banks Given Distress in Selected European Countries[1]
(probability of distress)



Source: Fund staff calculations.

Overall, the exposure of the U.S. to Europe via financial linkages is a cause for concern. As discussed in Box 5 of the 2010 Article IV staff report, financial linkages with Europe are much stronger than trade linkages. While exposure of US banks' to European periphery would seem limited, the main concern is that if sovereign credit events in Europe adversely affected European banks, including in core countries, U.S. money market funds could be severely strained via their exposure to those banks.

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[1] The sample consists of Greece, Ireland, Portugal and Spain, and the three largest banks in the United States by capital: JP Morgan, Citi and Bank of America.

[2] Distress is defined as a (hypothetical) credit event that triggers credit default swap (CDS) contracts, where a credit event could be a failure to pay on schedule, default, or, more broadly, a restructuring where bondholders are forced to bear losses. CoPoDs are estimated as in Segoviano (2006), "Consistent Information Multivariate Density Optimizing Methodology," Financial Markets Group, London School of Economics (FMG, LSE) Discussion Paper 557, Segoviano (2006), "The Conditional Probability of Default Methodology," FMG, LSE Disc. Paper 558, and Segoviano and Goodhart (2009), "Banking Stability Measures," IMF WP/09/04.

39. On the policy overhaul in response to the crisis, discussions were shaped by the FSAP conducted in 2010, as well as the Dodd-Frank Act (DFA) enacted in July 2010. The DFA—along with the range of international initiatives under the Basel Committee, Financial Stability Forum and other groups—broadly spanned the issues raised by the FSAP. While the authorities noted that 32 of the 33 key FSAP recommendations had been completed or were being implemented (Box 8), staff expressed concerns that the regulatory system remained fragmented (a key unaddressed recommendation), posing challenges to coordination domestically and internationally. Also the effectiveness of the new regulatory framework in stemming systemic risk and containing risks from too-big-to-fail was yet to be tested. Moreover, headwinds to implementation—including funding new activities and making key appointments—posed concerns for the team. Despite these headwinds, the authorities felt that implementation had progressed well, with many key regulations issued. They considered that the Financial System Oversight Council (FSOC) was off to a strong start, with several technical level committees (with representatives of all agencies) working fully engaged. Fed officials noted the work of the newly-established Office of Financial Stability Policy and Research as playing an important role in their surveillance of systemic risks.

40. The team saw it as essential to move ahead expeditiously in three key areas:

- *Dealing with systemically important financial institutions (SIFIs):* The team urged prompt designation of SIFIs—a key FSOC responsibility. SIFIs—including investment banks and other nonbanks—should face tough capital and liquidity standards to internalize systemic risks. The authorities concurred, noting the key role of measures to strengthen the ex-ante resilience of the financial system to future crises. They thought that banks could meet stiffer capital requirements without difficulty, but saw enhanced liquidity requirements as a higher hurdle (specifics remained to be decided). Designation would take time, given the complexity of the associated analysis. Authorities thought that resolution plans ("living wills") for SIFIs could reduce systemic risks and strengthen crisis resolution, even though they were no substitutes for ex-ante measures to reduce systemic risk. Staff was skeptical that several large institutions could be resolved simultaneously in stressed markets, and encouraged officials to use DFA powers to preemptively streamline firms that were too complex to resolve in a crisis.

- *The potential migration of risks to "shadow banking":* the team saw it as essential to apply rules and supervision that avoided the reemergence of this destabilizing dynamic. In addition, steps such as floating asset valuation, capital, or backstops are needed to deal with fragilities in money market funds, to avoid the "runs" that occurred post Lehman. Strengthening nonbank liquidity management was especially important given the possible migration of liquidity risks outside banks, the fact that nonbank liquidity support was limited to emergency facilities (the Fed's

13 (3) powers), and that DFA required the Fed to defer to the fullest extent possible to examinations by extant regulators. The authorities were vigilant for liquidity risks and risk migration, and considered that they had adequate tools to respond, with the FSOC playing the role of "residual claimant" of financial system risks that might otherwise fall through the cracks.

Box 8. U.S. FSAP Recommendations One Year Later and DFA Implementation

Nearly all of the FSAP recommendations were addressed by the Dodd-Frank Act, but their implementation is an ongoing process and it is premature to assess the effectiveness of the new oversight framework. The Dodd-Frank Act (DFA) in July 2010 changed the landscape of U.S. financial sector oversight addressing many of the deficiencies identified in the U.S. Financial Sector Assessment Program (FSAP) concluded in early 2010 (see Table 7 on FSAP recommendations). As of June 1, 2011, 24 of the 87 studies required by DFA had been completed. At the same date, as per the estimated 385 DFA statutory deadlines for rulemaking, rules had been finalized in 24 instances and proposed in 115, while 28 deadlines had been missed and 218 were forthcoming.[1] The lengthy implementation process will likely impede for some time a firm assessment of the impact of the new regulation on the financial system and on the effectiveness of its oversight. However, a preliminary assessment of the thrust of the progress in meeting the six main categories of FSAP recommendations is discussed below.

First, the FSOC has defined its internal structure and processes and has started work on key issues institutionalizing systemic risk oversight. The FSOC established a deputies' committee to coordinate and oversee its work, a systemic risk committee and two sub-committees to analyze emerging threats to financial stability, and five standing committees of staff from the member agencies for the regular and ongoing responsibilities. The authorities reported that the committees meet frequently and that individual agencies are actively involved in supporting FSOC activities and in healthy discussions on systemic risk. The FSOC held five meetings and issued three Notices of Proposed Rulemaking: respectively on the designation as systemically important financial institutions (SIFIs) of financial market utilities, non banks, and on data collection. Two studies were issued, on the Volcker's Rule and on the concentration limit for large financial companies. No systemically important financial institutions to be subject to heightened prudential standards have been designated yet. The first annual report is expected to be published in the second half of the year.

Second, the limited restructuring of the regulatory architecture is progressing. Although the substantial simplification of the U.S. regulatory system along functional lines advocated by the U.S. FSAP was not pursued, the modest streamlining introduced by the DFA, with the transfer of the responsibilities of the Office of Thrifts and Supervision (OTS) to the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC) and the Federal Reserve (Fed) is on track. The Federal Insurance Office (FIO) and the Bureau of Consumer of Financial Protection (BCFP) were established, although the delay in the designation of the director of the BCFP poses concerns on the effectiveness of its actions.

Third, micro-prudential regulation and supervision are being strengthened. The authorities reported that supervision for the banking sector within the Fed has taken a more macro-prudential orientation and cooperation among banking agencies have significantly increased. The implementation of enhanced prudential regulation for designated SIFIs and banking organizations with more than $50 billion in assets is also forthcoming. As for the oversight of securities and derivative markets, the Securities and Exchange Commission (SEC) and the Commodities Futures Trade Commission (CFTC) have proposed a large number of rules and are working closely together to get those implemented. Progress is expected on the recommendations on discouraging the use of deposits in the shadow banking system and on the repo market, while for money market funds disclosure has already been increased. Finally, in the insurance sector, which continues to be a complex state-based regulatory system, a number of rules to strengthen regulation are being considered.

Box 8. U.S. FSAP Recommendations One Year Later and DFA Implementation (continued)

Fourth, the oversight of market infrastructure is being reinforced. The Fed is working to implement the provisions of the DFA that allow the Fed to offer accounts and services to designated systemically important financial market utilities. The Fed is also working with other agencies to bolster the oversight of clearing, payment, and settlement systems. The CFTC and the SEC proposed rules to adopt many of the Committee on Payment and Settlement Systems (CPSS) and IOSCO recommendation for central clearing counterparties.

Fifth, crisis management, resolution and systemic liquidity arrangements are being bolstered. Rules implementing the new orderly liquidation authority (OLA) of the FDIC over bank holding companies and designated SIFIs are being proposed. Rulemaking to implement "living wills" for large and complex financial groups is also underway. The size of the Deposit Insurance Fund was allowed to increase, and a limited widening of the range of counterparties and collateral in open market operations was pursued.

Finally, the too-big-too fail issue is being addressed with additional prudential provisions, while reform of the GSEs is being contemplated. In addition to OLA and living wills, the Fed is developing heightened prudential standards for large banking organizations and non-bank SIFIs. The DFA also provided regulators with authority to take pre-emptive actions when the above institutions pose a grave threat to the financial stability of the U.S. or fail to submit a credible living will. Various proposals on the future of the GSEs are being examined, most notably those laid out in the Administration's white paper.

[1] Number of studies and rulemakings estimated, with a judgmental component, by DavisPolk. Where multiple agencies are required to issue a rule jointly, the rulemaking requirement is counted for each of the agencies involved. If joint rules are excluded, the number of required rulemaking decreases to 243. The number of proposed rules does not include rulemaking requirements for which the deadline has been missed.

- *Financial surveillance under the FSOC:* staff saw as essential to have transparent and proactive surveillance of systemic risks and policy responses under FSOC as it moves beyond the initial implementation stage. Given the complexity of the supervisory framework and the fact that only two of ten FSOC voting members have a macroeconomic remit, transparency would be key to reinforce the focus on systemic risk; in this context, the team welcomed the forthcoming annual report. The authorities saw the FSOC process as working well, fostering continuous interaction among committee and subcommittee members on financial stability issues. The authorities stressed their commitment to the transparency of the FSOC, while they also considered that a balance needs to be struck as the disclosure of sensitive information could precipitate market volatility. The DFA requirement that FSOC voting members submit signed statements to Congress affirming whether they believe that all reasonable steps are being taken to ensure financial stability and mitigate systemic risks would guarantee strong accountability.

41. Authorities agreed that international coordination was key to avoid cross-border regulatory arbitrage. They saw coordination as working well. Supervisors and regulators were in frequent close contact under the aegis of international groupings such as the Basel Committee, Financial Stability Forum, and the International Organization of Securities Commissions (IOSCO), with overall agendas and key principles and standards closely aligned. That said, some major issues—such as cross-border resolution of SIFIs (given the large number of complex, systemic cross border firms and international differences in legal frameworks for resolution) and derivatives (the level of clearing and rules for margining of uncleared swaps) would be complex and remained under active discussion. Authorities saw their timetable as more aggressive than in their overseas partners, opening up the possibility of regulatory gaps, notably in securities and over-the-counter (OTC) derivatives regulation.

42. Staff noted that the risk of spillovers to and from the U.S. financial system strengthened the case for making the U.S. financial system more resilient. In this connection, the Dodd-Frank Act seemed to have reduced the risk of potential knock-on effects from U.S. financial instability. That said, analysis in the Spillovers Report highlighted that the investment banking activities (including by non-U.S. firms) could propagate shocks internationally via the U.S. dollar wholesale funding markets, underscoring the need for strong prudential supervision of those activities. The authorities agreed that cross-border financial linkages remained sizeable, but also considered that the domestic and international agendas were well aligned at a high level, and coordination would continue to improve going forward.

43. Looking to the longer term, authorities and staff agreed that the current government presence in the housing market was neither sustainable nor desirable. The Administration's plans, articulated in their February 2011 report to Congress (Reforming America's Housing finance Market) would shift the government's focus to (i) oversight and consumer protection, (ii) assistance for low- and moderate- income homeowners and renters, and (iii) support for market stability and crisis response. The report offers three long-term options: (i) a fully privatized system of housing finance, with the government helping low and middle-income borrowers; (ii) a privatized system plus a public guarantee mechanism that can be scaled up in a crisis, with an above-market guarantee fee that would be attractive only during market stress; or (iii) a privatized system plus public catastrophic reinsurance, with first-loss insurance coverage from private sources. Staff urged that housing finance reform should be complemented by gradually reducing distortions such as the mortgage interest deductions, which are expensive, regressive, and bias homeownership towards large homes. Congress could deliberate proposals as early as this fall.

F. The United States and the World Economy

44. Staff stressed that policy actions to raise savings, including by restoring fiscal sustainability, and strengthening the financial sector would make an important contribution to global growth and stability. With household saving rates projected to remain close to current levels in the medium term, higher public savings would help ensure that the U.S. current account deficit remains moderate as domestic investment gradually recovers, as well as forestall the risk of adverse global spillovers from higher U.S. interest rates driven by public debt dynamics.

45. Staff saw the medium-term U.S. current account deficit remaining at around 3 percent of GDP, still somewhat in excess

of CGER benchmarks (which are around 1½–2½ percent of GDP), implying some dollar overvaluation. The April CGER calculations suggested a 0-15 percent overvaluation range for the U.S. dollar.[xvi] The authorities broadly concurred with staff's range for current account projections. They did not take a view on the appropriateness of the level of the dollar, but noted that the change in U.S. trading partners towards emerging markets with lower costs and prices implied that the level of U.S. prices relative to trading partners was not as low as traditional real effective exchange rate indices would suggest.

46. The authorities agreed on the need for a global rebalancing of demand, but expressed some concerns that global imbalances may be widening again. They agreed that U.S. fiscal consolidation was essential over the medium term and would contribute to global rebalancing, and argued that policy actions in surplus countries to boost domestic demand and increase currency flexibility were crucial to achieving the goals of the G-20 Framework for Strong, Sustainable, and Balanced Growth.

47. The mission encouraged the authorities to intensify their efforts to secure the future of multilateral trade negotiations. With the prospect of concluding the Doha Round by year-end diminishing, the authorities expressed their commitment to engage on concluding a subset of "early deliverables." At the same time, the authorities' trade negotiations will focus on concluding the three pending FTAs with Colombia, South Korea, and Panama by year-end, and on advancing the Trans-Pacific Partnership (TPP) with APEC members.[xvii] The authorities' objectives of these negotiations will remain firmly on expanding jobs and economic growth by creating new export opportunities. Noting that U.S. recourse to protectionist measures has remained limited, staff welcomed authorities' efforts to resist these pressures and to ensure that any trade-related legislation is consistent with WTO and other international obligations.

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48. Policies must strike the right balance between exiting from extraordinary support and sustaining the recovery amid renewed headwinds. Fiscal consolidation needs to proceed as debt dynamics are unsustainable and losing fiscal credibility would be extremely damaging for the United States and for the rest of the world. With a still-fragile recovery, the pace and composition of fiscal adjustment need to be attuned to the cycle, with the current sizeable monetary policy accommodation remaining in place, unless inflation prospects change significantly. Housing and labor market policies can help cushion the ongoing adjustment process and help lay the foundations for a more sustained recovery going forward.

49. The key priority for fiscal policy is to stabilize the debt ratio by mid-decade and gradually reduce it afterwards, consistent with the administration's objectives. In this context, staff sees early political agreement on a comprehensive medium-term consolidation framework based on realistic macroeconomic assumptions as a cornerstone of a credible fiscal adjustment strategy. With a well-defined multi-year framework in place, the pace of deficit reduction in the short run could be more attuned to cyclical conditions without jeopardizing credibility. And of course, the federal debt ceiling should be raised expeditiously to avoid a severe shock to the U.S. economy and world financial markets.

50. Staff's recommended adjustment strategy entails a reduction of the federal structural primary deficit at a broadly uniform pace over the next five years, within a fully-specified and politically-backed consolidation framework. Fiscal adjustment should start in FY2012 to guard against the risk of a disruptive loss in fiscal credibility, and encompass cuts in mandatory spending (including through entitlement reforms) as well as revenue increases (including by reducing tax expenditures) given the relatively limited size of non-security discretionary spending and the large cuts already envisaged in this area. Consideration could also be given to a national VAT or sales tax and carbon taxes, consistent with past advice by Fund staff.

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

52. Subdued inflation and significant resource underutilization suggest that the extraordinarily low level of short-term interest rates will likely remain appropriate for quite some time. The Fed should remain vigilant to the risk of an unmooring of long-term inflation expectations, and respond decisively should the risk materialize in either direction. More generally, the speed and timing of future actions should depend on incoming data on core inflation, longer-term inflation expectations, and growth, with scope for cushioning a larger fiscal consolidation through a more back-loaded withdrawal of monetary stimulus.

53. When appropriate, a gradual unwinding of the Fed's balance sheet seems to be a reasonable first step in normalizing monetary conditions. Against the backdrop of a passive unwinding of the Fed's securities holdings through ceasing the reinvestment of the principal of maturing securities, short-term policy interest rates would serve as the main active tool to fine tune the adjustment of monetary conditions. Reducing excess reserves by ceasing reinvestments, as well as other reserve-draining operations including the use of repos and term deposits, would also help tighten the link between the federal funds target rate and the interest rate on reserves. A clearly communicated and gradual path of asset sales would be an additional step in the exit process.

54. Staff sees merit in further policy efforts to ease the adjustment of housing and labor markets within the fiscal envelope.

- While policy design is complicated by operational capacity constraints and the risk of inducing moral hazard, housing difficulties are central to the slow recovery and pose a critical risk. Therefore, consideration should be given to allowing for the terms of residential mortgages to be changed in courts ("cramdowns"), strengthening federal mortgage modification programs, expanding state programs that assist unemployed homeowners, and encouraging the GSEs to participate in principal write-downs.

- Persistently high unemployment rates and the need for significant job reallocation across sectors warrant a re-examination of existing active labor market programs (e.g., job training and job-search assistance). The education system could also play a strong role in retraining the unemployed, including through community colleges. Further tax cuts attached to programs aimed at spurring hiring of long-term unemployed workers could be enacted.

55. The U.S. financial system continues to heal, but remains vulnerable. Bank profitability has recovered and bank capital has increased, but underlying profits are weak, and the rise in capital ratios also reflects a shift towards less risky assets. Mortgage markets remain largely government dependent. Turmoil in European financial markets could impact both liquidity and credit provision. Even more significantly, the tail risk of a U.S. sovereign rating downgrade and sharply higher interest rates on federal debt more generally could trigger renewed turbulence in global financial markets, with adverse consequences for global growth.

56. A sustainable rebound in private securitization, driven by reforms to avoid the past excesses, would help meet credit demand as the recovery takes hold. The reforms underway—in particular, steps to increase disclosure and risk retention—will strengthen incentives for sound underwriting, and should help revive investor demand. On the supply side, clarity on the final scope of the new rules would help the market recovery. Looking forward, reforms to streamline the role of GSEs (preferably, confining their activities to providing credit guarantees for high-quality mortgages under tail risks) would encourage a gradual shift in the mortgage market towards private institutions.

57. Progress in implementing the Dodd-Frank Act is encouraging, with nearly all U.S. FSAP recommendations being addressed, but headwinds to implementation are of concern. Appropriate budgetary resources to fund improvements in supervision and regulation should be promptly allocated, and efforts to delay or water down the legislation should be resisted. Prolonged delays or outright failures in addressing the regulatory gaps revealed by the crisis, in an environment of plentiful liquidity and increased financial concentration, could feed another very dangerous buildup in systemic risks.

58. Strengthening the domestic and international crisis-prevention architecture for financial institutions should be a priority. Key is promptly and comprehensively identifying systemic institutions to be subject to heightened supervisory scrutiny, regulatory standards, and capital surcharges. These should include investment banks and other nonbank financial institutions, which provide significant cross-border dollar funding. Authorities are also encouraged to continue their work on improving resolvability of systemically important institutions. Systemic issues and risks to financial stability are central to the FSOC mandate and staff looks forward to their discussion in the first FSOC annual report. The authorities also need to be alert to potential new risks arising from changes in the regulatory framework that could contribute to shifts in financial stability risks across borders or intermediaries. International collaboration will be critical for progress in this area, and the U.S. authorities should continue exercising leadership on these matters.

59. A multilateral approach to economic policy management remains critical. This is particularly important in systemic countries like the United States, whose policy actions have significant cross-border effects, as discussed in the spillovers report. Staff welcomes the authorities' leading role in multilateral fora and their efforts to promote international stability. For the medium term, the key contributions that the United States can make to global growth and stability, consistent with the G-20 Mutual Assessment Process, are (i) raising domestic savings, particularly through fiscal consolidation, to ensure that the current account deficit declines further and to forestall potentially destabilizing increases in public indebtedness; and (ii) strengthening its financial sector through enhanced regulation and supervision. The United States can no longer play the role of global consumer of last resort, underscoring the importance of measures to boost demand in current account surplus countries to sustain world growth. The U.S. dollar depreciation over the past year would help increase demand for U.S. exports and contribute to global rebalancing.

60. Staff welcomes the limited recourse to protectionist measures, and encourages the authorities, together with other countries, to redouble their efforts to secure the future of multilateral trade negotiations, especially if the Doha Round is not concluded by year-end. Increased and more secure market access would promote U.S. and global exports.

61. Staff proposes to hold the next Article IV Consultation on a 12-month cycle.

Table 1. United States. Selected Economic Indicators 1/

(percentage change from previous period, unless otherwise indicated)

	2009	2010	Projections 2011	2012	2013	2014	2015	2016
National production and income								
Real GDP	-2.6	2.9	2.5	2.7	2.7	2.9	2.9	2.8
Net exports 2/	1.3	-0.4	0.4	0.3	0.1	-0.2	-0.3	-0.3
Total domestic demand	-3.6	3.2	2.0	2.2	2.4	2.9	3.1	3.0
Final domestic demand	-3.1	1.9	2.0	2.1	2.4	3.0	3.1	3.1
Private final consumption	-1.2	1.7	2.5	2.0	2.3	2.4	3.0	2.8
Public consumption expenditure	1.9	0.9	-1.7	-1.0	-1.8	0.7	1.1	1.9
Gross fixed domestic investment	-14.8	3.3	4.0	6.0	7.2	7.5	5.6	4.9
Private fixed investment	-18.3	3.9	5.3	7.5	9.7	9.4	7.0	6.1
Equipment and software	-15.3	15.3	11.4	9.5	8.5	6.0	4.2	4.0
Nonresidential structures	-20.4	-13.7	-3.0	2.6	4.9	5.2	6.2	7.1
Residential structures	-22.9	-3.0	-3.4	6.4	19.0	23.4	14.2	9.9
Public fixed investment	0.2	1.3	-0.6	0.7	-2.4	-0.5	-0.6	-1.0
Change in private inventories 2/	-0.7	1.4	0.1	0.1	0.1	0.1	0.0	0.0
Nominal GDP	-1.7	3.8	4.0	3.9	3.8	4.2	4.5	4.5
Personal saving rate (percent of disposable income)	5.9	5.8	4.7	4.7	4.6	4.7	4.8	4.9
Private investment rate (percent of GDP)	11.3	12.5	12.7	13.4	14.2	14.9	15.3	15.6
Employment and inflation								
Unemployment rate	9.3	9.6	8.9	8.4	7.7	6.9	6.2	5.6
Output gap (percent of potential GDP)	-6.0	-4.7	-3.9	-3.1	-2.5	-1.7	-1.0	-0.5
Potential GDP	1.7	1.5	1.6	1.8	2.0	2.1	2.2	2.2
CPI inflation	-0.3	1.6	2.8	1.6	1.5	1.7	1.8	1.9
GDP deflator	0.9	1.0	1.4	1.2	1.1	1.3	1.5	1.7
Government finances								
Federal government (budget, fiscal years)								
Federal balance (percent of GDP)	-11.4	-9.6	-9.3	-7.6	-5.6	-4.7	-4.8	-5.3
Debt held by the public (percent of GDP)	53.5	62.1	70.2	74.6	78.3	80.7	82.7	85.0
General government (GFSM 2001, calendar years)								
Net lending (percent of GDP)	-12.7	-10.3	-9.9	-7.8	-6.0	-5.3	-5.6	-6.0
Primary structural balance (percent of potential nominal GDP)	-5.1	-5.5	-5.5	-4.0	-2.5	-1.8	-1.7	-1.6
Gross debt (percent of GDP)	84.2	93.5	99.0	103.0	106.2	108.2	110.2	112.7
Interest rates (percent)								
Three-month Treasury bill rate	0.2	0.1	0.2	0.4	0.9	1.9	2.9	3.9
Ten-year government bond rate	3.3	3.2	3.5	4.4	5.4	5.8	6.0	6.2
Balance of payments								
Current account balance (billions of dollars)	-378	-470	-489	-410	-375	-409	-473	-553
Merchandise trade balance (billions of dollars)	-507	-647	-703	-702	-723	-769	-839	-918
Balance on invisibles (billions of dollars)	129	177	214	293	348	360	366	365
Current account balance (percent of GDP)	-2.7	-3.2	-3.2	-2.6	-2.3	-2.4	-2.6	-3.0
Merchandise trade balance (percent of GDP)	-3.6	-4.4	-4.6	-4.4	-4.4	-4.5	-4.7	-4.9
Balance on invisibles (percent of GDP)	0.9	1.2	1.4	1.8	2.1	2.1	2.0	2.0
Export volume 3/	-12.0	14.7	9.5	6.5	5.5	5.5	5.4	5.3
Import volume 3/	-15.8	14.8	4.3	3.2	4.3	5.7	6.2	6.2

Sources: Haver Analytics and Fund staff estimates.
1/ Components may not sum to totals due to rounding.
2/ Contribution to real GDP growth, percentage points.
3/ NIPA basis, goods.

Table 1. United States: Selected Economic Indicators (Cont.'d) 1/

(percentage change from previous period, unless otherwise indicated)

			Projections					
	2009	2010	2011	2012	2013	2014	2015	2016
Saving and investment (percent of GDP)								
Gross national saving	10.9	11.6	12.3	14.1	15.1	15.6	15.7	15.6
General government	-6.7	-6.6	-6.3	-4.6	-2.9	-2.3	-2.5	-3.0
Private	17.6	18.2	18.7	18.7	18.0	17.9	18.2	18.6
Personal	4.6	4.5	3.6	3.6	3.5	3.6	3.6	3.8
Business	12.9	13.7	15.0	15.1	14.5	14.4	14.6	14.8
Gross domestic investment	14.8	15.9	16.1	16.7	17.4	18.0	18.3	18.6
Private	11.3	12.5	12.7	13.4	14.2	14.9	15.3	15.6
Fixed investment	12.2	12.0	12.2	12.7	13.5	14.2	14.7	15.0
Inventories	-0.9	0.5	0.5	0.7	0.7	0.7	0.7	0.6
Public	3.6	3.5	3.4	3.3	3.2	3.1	3.0	2.9

Sources: Haver Analytics and Fund staff estimates.
1/ Components may not sum to totals due to rounding.

Table 2. United States: Balance of Payments

(billions of U.S. dollars, unless otherwise indicated)

			Projections					
	2009	2010	2011	2012	2013	2014	2015	2016
Current account	-378	-470	-489	-410	-375	-409	-473	-553
Percent of GDP	-2.7	-3.2	-3.2	-2.6	-2.3	-2.4	-2.6	-3.0
Goods and services	-375	-496	-528	-498	-491	-521	-571	-632
Merchandise trade	-507	-647	-703	-702	-723	-769	-839	-918
Exports	1,068	1,289	1,490	1,577	1,669	1,784	1,909	2,044
Imports	-1,575	-1,936	-2,194	-2,279	-2,393	-2,553	-2,748	-2,961
Services	132	151	175	204	232	249	268	286
Receipts	502	546	591	643	691	739	788	839
Payments	-370	-394	-416	-438	-459	-491	-521	-553
Income	121	163	170	211	237	234	224	210
Receipts	588	662	558	501	584	793	1,081	1,432
Payments	-467	-499	-388	-290	-346	-559	-857	-1,223
Unilateral transfers, net	-125	-137	-131	-123	-121	-123	-126	-131
Capital account transactions, net	0	0	0	0	0	0	0	0
Financial account	216	35	489	410	375	409	474	553
Private capital	-688	-72	260	172	128	151	204	272
Direct investment	-134	-151	-126	-129	-132	-135	-140	-144
Outflows	-269	-346	...	...	...	...	...	...
Inflows	135	194	...	...	...	...	...	...
Securities	-70	360	312	307	323	336	349	364
Other investment	-484	-280	75	-6	-63	-49	-5	53
U.S. official reserves	-52	-2	0	0	0	0	0	0
Foreign official assets	450	298	229	238	247	258	269	281
Other items 1/	609	28	0	0	0	0	0	0
Statistical discrepancy	163	235	0	0	0	0	0	0
Memo item: Current account excluding petroleum	-160	-186	-128	-46	-9	-39	-94	-162

Sources: Haver Analytics; and Fund staff estimates.

1/ Includes net financial derivatives.

Table 3. United States: Federal and General Government Finances

(percent of GDP)

			Projections										
	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Federal Government	(budget basis; fiscal years)												
Revenue	14.9	14.9	15.3	16.3	17.4	18.4	18.6	18.9	19.1	19.3	19.4	19.5	19.7
Expenditure	26.4	24.5	24.6	23.8	23.0	23.1	23.4	24.2	24.5	24.6	25.1	25.5	25.9
Noninterest 1/	25.0	23.1	23.2	22.4	21.4	21.0	20.6	20.8	20.6	20.5	20.7	20.9	21.1
Interest	1.3	1.4	1.4	1.4	1.6	2.2	2.8	3.4	3.8	4.1	4.4	4.6	4.8
Balance 1/	-11.4	-9.6	-9.3	-7.6	-5.6	-4.7	-4.8	-5.3	-5.3	-5.3	-5.7	-6.0	-6.2
Primary balance 2/	-10.1	-8.2	-7.9	-6.2	-3.9	-2.5	-2.0	-1.9	-1.5	-1.2	-1.3	-1.4	-1.3
Primary structural balance 3/	-5.5	-6.4	-6.5	-5.1	-3.1	-2.0	-1.6	-1.7	n.a.	n.a.	n.a.	n.a.	n.a.
Debt held by the public	53.5	62.1	70.2	74.6	78.3	80.7	82.7	85.0	87.2	89.2	91.6	94.3	96.9
Net debt held by the public	47.1	54.4	61.3	66.4	69.4	71.4	73.1	75.2	77.2	79.2	81.6	84.3	87.0
General Government	(GFSM 2001 basis; calendar years)												
Revenue	30.8	30.8	31.1	32.2	33.6	34.6	35.0	35.3	...	...	...	...	...
Total expenditure 1/	43.5	41.1	41.0	40.0	39.6	39.9	40.5	41.3	...	...	...	...	...
Net lending 1/	-12.7	-10.3	-9.9	-7.8	-6.0	-5.3	-5.6	-6.0	...	...	...	...	...
Primary balance 2/	-10.9	-8.5	-8.2	-6.0	-4.0	-2.8	-2.5	-2.3	...	...	...	...	...
Primary structural balance 3/	-5.1	-5.5	-5.5	-4.0	-2.5	-1.8	-1.7	-1.6	...	...	...	...	...
Gross debt	84.2	93.5	99.0	103.0	106.2	108.2	110.2	112.7	...	...	...	...	...
Net debt	59.9	67.7	71.9	76.7	79.8	82.0	84.1	86.5	...	...	...	...	...

Sources: Office of Management and Budget; Haver Analytics; and Fund staff estimates.

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

2/ Excludes net interest.

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

Table 4a. General Government Statement of Operations

(GFSM 2001 basis, calendar years; in percent of GDP)

	2005	2006	2007	2008	2009
Revenue	32.9	33.8	33.8	32.6	30.8
Taxes	20.4	21.2	21.2	19.6	17.2
Social contributions	6.9	6.9	6.9	6.9	6.9
Grants	0.0	0.0	0.0	0.0	0.0
Other revenue	5.6	5.6	5.8	6.1	6.7
Expenditure 2/	36.1	35.8	36.6	39.0	43.5
Expense	35.0	34.8	35.5	38.0	42.4
Compensation of employees	10.0	9.9	10.0	10.3	10.9
Use of goods and services	7.8	7.9	8.0	8.6	8.7
Consumption of fixed capital	1.3	1.3	1.4	1.5	1.6
Interest	2.7	2.8	3.0	2.8	2.6
Subsidies	0.5	0.4	0.4	0.4	0.4
Grants	0.3	0.3	0.3	0.3	0.4
Social benefits	11.8	11.9	12.1	12.9	15.0
Of which: social security benefits	7.4	7.8	7.9	8.3	9.7
Expense not elsewhere classified	2.6	2.3	2.5	3.4	5.2
Net acquisition of nonfinancial assets	1.1	1.0	1.1	1.0	1.1
Gross/net operating balance 1/	-2.1	-1.0	-1.6	-5.4	-11.6
Net lending/borrowing 2/	-3.2	-2.0	-2.7	-6.5	-12.7

Source: Government Finance Statistics.
1/ Revenue minus expense.
2/ Includes staff's adjustments for one-off items, including the costs of financial sector support.

Table 4b. General Government Financial Assets and Liabilities

(in percent of GDP)

	2005	2006	2007	2008	2009	2010
Net financial worth	-42.7	-41.9	-42.8	-48.4	-59.9	-67.7
Total financial assets	19.0	19.1	19.4	22.8	24.3	25.8
Currency and deposits	2.2	2.3	2.6	4.9	3.9	4.8
Debt securities	6.8	7.0	6.8	6.5	7.3	6.8
Loans	3.3	3.2	3.2	3.3	4.5	5.3
Equity and investment fund shares	1.6	1.6	1.6	2.7	2.2	1.9
U.S. official reserve assets	0.3	0.3	0.3	0.3	0.7	0.7
Other financial asssets	4.8	4.7	4.9	5.1	5.7	6.3
Total financial liabilities	61.7	61.0	62.2	71.2	84.2	93.5
Currency and deposits	0.2	0.2	0.2	0.2	0.2	0.2
Debt securities	48.0	47.4	48.2	56.5	68.3	77.2
Loans	0.0	0.0	0.0	0.0	0.0	0.0
Accounts payable	5.4	5.4	5.6	5.9	6.0	6.2
Insurance reserves	0.3	0.3	0.3	0.3	0.3	0.3
Other financial liabilities	7.6	7.6	7.8	8.2	8.9	9.2
SDR allocations and certificates	0.1	0.1	0.1	0.1	0.4	0.4

Sources: Board of Governors of the Federal Reserve System; Bureau of Economic Analysis; and Haver Analytics.

Table 5. United States: Indicators of External and Financial Vulnerability

	2004	2005	2006	2007	2008	2009	2010
External indicators	(in percent of GDP, unless otherwise indicated)						
Exports of goods and services 1/	13.6	10.7	13.4	13.3	11.4	-14.5	16.7
Imports of goods and services 1/	16.8	12.9	10.9	6.2	8.1	-23.0	19.5
Terms of trade 1/	-1.7	-4.0	-1.2	0.6	-4.9	7.8	-1.9
Current account balance	-5.3	-5.9	-6.0	-5.1	-4.7	-2.7	-3.2
Capital and financial account balance	4.5	5.5	6.0	4.5	4.1	1.9	1.6
Of which:							
Net portfolio investment	5.8	4.5	4.7	5.4	5.6	-0.2	4.2
Net foreign direct investment	-1.4	0.6	0.0	-1.0	-0.2	-0.9	-1.0
Net other investment 4/	0.1	0.3	1.1	0.1	-1.2	2.7	-1.6
Official reserves 2/	86.8	65.1	65.9	70.6	77.6	130.8	132.4
in months of imports	0.6	0.4	0.4	0.4	0.4	0.8	0.7
Central bank foreign liabilities 2/	0.1	0.1	0.1	0.1	1.4	2.4	3.4
Net international investment position 5/	-19.0	-15.3	-16.4	-12.8	-22.7	-17.0	-16.9
Of which: General government debt 6/	17.5	18.7	20.4	22.6	28.6	31.0	34.3
External debt-to-exports ratio	1.9	1.5	1.5	1.1	1.8	1.5	1.3
External interest payments to imports 3/ 7/	20.5	25.8	32.5	35.7	28.3	23.1	18.1
Nominal effective exchange rate 1/	-5.0	-2.5	-1.7	-4.9	-3.9	5.5	-3.3
Real effective exchange rate 1/	-4.7	-1.4	-0.6	-4.7	-3.9	4.5	-3.9
Financial market indicators	(in percent of GDP, unless otherwise indicated)						
General government gross debt	61.4	61.7	61.1	62.2	71.2	84.6	91.6
Average maturity of privately-held federal debt (months)	58	57	58	57	46	52	57
Federal privately-held debt maturing within one year	9.7	9.3	8.5	9.2	16.7	17.1	17.4
Three-month treasury bill yield 3/	1.4	3.2	4.8	4.5	1.4	0.2	0.1
Real three-month treasury bill yield 3/	-1.2	-1.2	-0.1	1.6	1.6	-2.3	0.5
Equity market index (S&P 500) 1/	17.3	6.8	8.6	12.7	-17.3	-22.5	20.3
Banking risk indicators 8/	(in percent, unless otherwise indicated)						
Total assets 2/	10,107	10,879	11,862	13,034	13,841	13,087	13,321
Total loans and leases to assets	60.6	61.8	61.0	60.7	56.9	55.6	55.4
Total loans to deposits	93.0	94.1	92.4	94.0	87.1	78.9	78.3
Problem loans to total loans and leases 9/	0.6	0.5	0.5	1.1	2.2	3.9	3.5
Nonperforming assets to assets 10/	0.6	0.5	0.5	0.9	1.8	3.4	n.a.
Loss allowance to:							
Total loans and leases	1.3	1.2	1.1	1.3	2.2	3.1	3.1
Noncurrent loans and leases	232.3	239.4	204.7	117.4	102.4	79.4	88.6
Return on equity 11/	18.0	17.8	17.2	11.2	-1.6	-0.6	8.2
Return on assets 11/	1.9	1.8	1.8	1.2	-0.1	-0.1	0.9
Total capital to risk-weighted assets	13.2	12.9	13.0	12.8	12.8	14.3	15.3
Core capital ratio	8.1	8.2	8.2	8.0	7.5	8.6	8.9

Sources: IMF, *International Financial Statistics*; Federal Deposit Insurance Corporation; and Haver Analytics.

1/ Percent change. 2/ Billions of U.S. dollars. 3/ Percent. 4/ Includes net financial derivatives. 5/ With FDI at market value. 6/ Excludes foreign private holdings of U.S. government securities other than treasuries. 7/ External interest payments: income payments on foreign-owned assets (other private assets plus U.S. government payments). 8/ All FDIC-insured institutions. 9/ Noncurrent loans and leases. 10/ FDIC-insured commercial banks only. 11/ Before extraordinary items and taxes.

Table 6. United States: Status of Major Financial Stability and Fed Programs

(billions of dollars)

	Proposed or peak use	As of May 31, 2011 Disbursed	As of May 31, 2011 Outstanding	Purpose
TARP programs	**473**	**412**	**131**	
Housing programs	46	2	n.a.	Direct payments to help homeowners refinance their mortgages. Includes HAMP, 2nd Lien Modification Programs, Agency-Insured Programs, FHA Short Refinance Program, and Housing Finance Agency Program.
Bank-related programs	250	245	23	Bank recapitalization and asset guarantees. No longer active.
Other financial stability programs	95	85	69	Support for AIG, the auto sector, and other programs. No longer active.
Federal Reserve facilities				
Asset purchases	2350	2350	900	Fed announced plans to buy $500 billion in MBS and $100 billion in Agency securities in November 2008. Purchases were expanded in March 2009 to include another $750 billion in MBS, up to $100 billion in Agencies, and $300 billion in Treasuries; additionally, the Fed announced in November 2010 purchases of $600 billion in Treasuries.
Treasury securities	900	900	900	
Purchases in 2009-10	300	300	300	
Purchases in 2010-11	600	600	600	
Government Agency and Mortgage-Backed Securities	1450	1450	1037	
American International Group and Bear Stearns related programs	195	195	64	Non-recourse loan to JP Morgan against assets of Bear Stearns, purchases of residential mortgage backed securities from AIG, purchases of CDOs insured by AIG, and loan to AIG.
Term Asset-Backed Securities Lending Facility	48	48	14	Lending (non-recourse) against newly issued ABS, legacy CMBS, and other legacy securities. Loans of up to 3 years, underlying securities may be of longer maturity.
Support for Government-Sponsored Enterprises 1/				
Total Senior Preferred Equity injections	n.a. 2/	156	156	Equity injections for each GSE to operate at a minimum level of capital under FHFA conservatorship.
Fannie Mae	n.a. 2/	91	91	
Freddie Mac	n.a. 2/	65	65	

Sources: Quarterly Report to Congress by the Office of the Special Inspector General for the Troubled Asset Relief Program; U.S. Department of the Treasury; Board of Governors of the Federal Reserve System; and Federal Housing Finance Agency.

1/ Data available through 2011Q1. 2/ Commitments are unlimited.

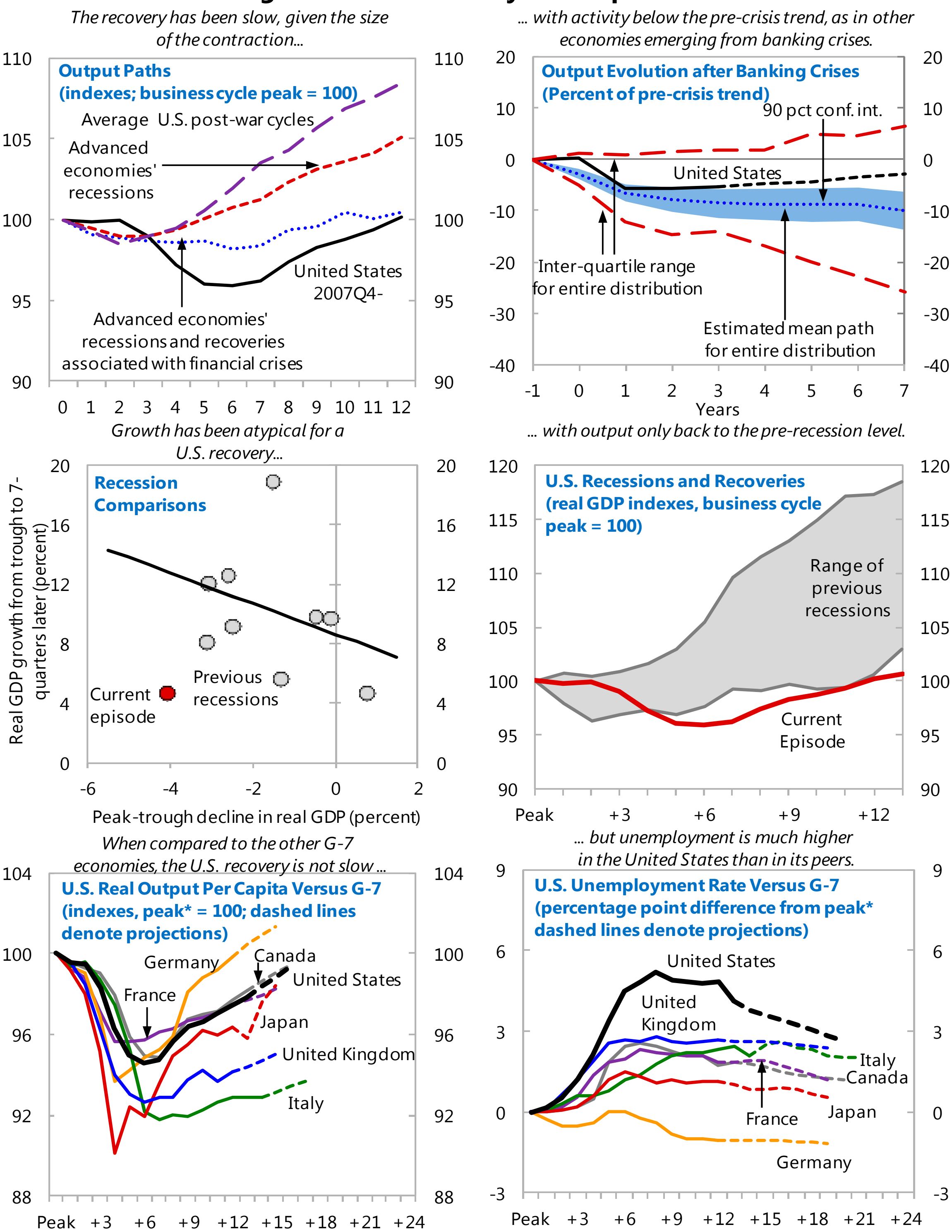
Table 7. U.S. FSAP Key Recommendations

(ST: short-term, implementation within 12 months; MT: medium-term, 1–3 years; HP: high priority; MP: medium priority.)

Recommendation	Timing, Priority
Institutionalize and strengthen systemic risk oversight	
• Establish a council of the regulatory agencies, the Fed, and the Treasury, with a mandate for financial stability and powers inter alia to designate potentially systemic financial firms for enhanced regulation and supervision focused on systemic risk	ST, HP
• Define the Fed as the lead executor of this council and the consolidated supervisor of designated potentially systemic financial firms, to work with other regulators	ST, HP
• Provide the Fed oversight authority over systemically important payment, clearing, and settlement infrastructure	ST, HP
Redesign the regulatory architecture	
• Strengthen the Fed's role in consolidated regulation and supervision, including by enhancing coordination with bank and functional regulators and restricting deference requirements	ST, HP
• Unify safety-and-soundness regulation and supervision of commercial banks and thrifts in a single federal agency and eliminate the federal thrift charter	ST, HP
• Unify federal securities and derivative market regulation into one federal agency	ST, MP
• Establish an independent and accountable federal consumer protection agency, removing this responsibility from the other agencies to enhance their focus and effectiveness in their primary roles	ST, MP
• Establish a federal office tasked with promoting greater regulatory uniformity in the insurance sector	MT, MP
Strengthen micro-prudential regulation and supervision	
Banking	
• Enhance the capacity for group-wide oversight of banking groups and conduct regular inter-agency horizontal assessments of complex groups (possibly by establishing domestic supervisory "colleges")	MT, HP
• Boost timeliness and forcefulness of supervisory and regulatory interventions to address weaknesses in enterprise-wide risk management practices	MT, HP
• Strengthen channels for cooperation, coordination, and learning from best practices—within and among the federal banking agencies (FBAs), market regulators, and the states—to close regulatory gaps and prevent regulatory arbitrage, including with regard to charter conversions	MT, HP
Securities and derivative markets	
• Enhance enforcement and oversight capacities and re-examine capital rules and other prudential requirements, such as risk management standards, to ensure that risks are fully addressed	ST, HP
• Implement the recommendations of the Joint Report to enhance investor protection and improve cooperation between the Commodity Futures Trading Commission (CFTC) and Securities and Exchange Commission (SEC); close legislative and regulatory gaps identified in the Joint Report	MT, HP
• Complete the consolidation of equity and equity option market surveillance into a single entity taking into account issues of dark pools, high-frequency trading, predatory algorithms, and other technology-based practices	ST, MP
• Promote standardization of OTC derivatives in order to increase market reliance on exchange trading and multilateral clearing and require proper collateralization of all derivative transactions, whether held at a clearinghouse or bilaterally	MT, MP
• Improve transparency of OTC derivative and securities markets by requiring timely reporting of transactions and providing better information to investors	MT, MP

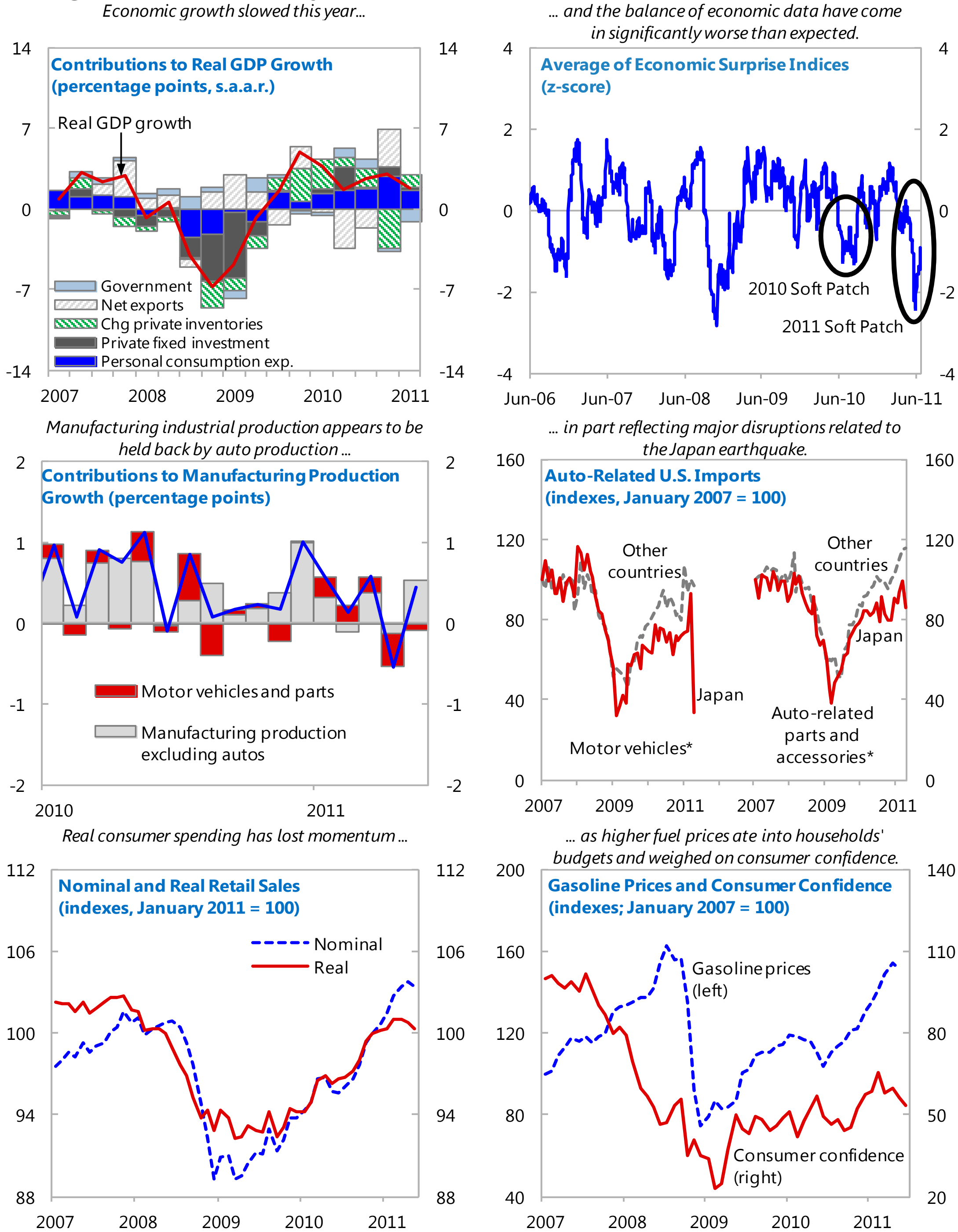
Recommendation	Timing, Priority
Shadow banking and other short-term funding markets	
• Discourage the use of deposit-like instruments outside the formal banking sector and ensure appropriate liquidity management by sectors potentially falling within the systemic liquidity safety net	ST, HP
• Set minimum haircuts for repo transactions and address incentives for the repo clearing banks to extend intraday credit in the clearing and settlement cycle	ST, HP
• Require money market funds to make real-time disclosures of their actual (as opposed to "stabilized") net asset values	MT, MP
Insurance	
• Develop the supervision of insurance groups through consolidated financial reporting and establish policies and procedures for the regulation of systemically important institutions, markets, and instruments in the insurance sector	MT, HP
• Increase information sharing and coordination between state regulators and federal authorities, including through representation of state regulators in national bodies with responsibilities for system-wide oversight	MT, MP
• Strengthen regulation of bond insurance and securities lending and modernize solvency requirements	MT, MP
• The National Association of Insurance Commissioners (NAIC) and state legislatures should undertake reforms covering the terms of Commissioners' appointments, the rulemaking powers of state insurance departments, and their funding and staffing to bolster specialist skills	MT, MP
Strengthen oversight of market infrastructure	
• Allow systemic payment, clearing, and settlement infrastructures to have accounts at the Fed in order to settle in central bank money and to have emergency access to Fed liquidity under terms and conditions established by the Fed's Board of Governors as an additional buffer against systemic risk	ST, HP
• The Fed should continue to assess payment, clearing, and settlement infrastructures for their ability to cope with extreme liquidity stress and explore the introduction of a queuing and offsetting mechanism in the Fedwire Funds Service similar to those in other G10 countries' large value payment systems	ST, MP
• Clearing and settlement infrastructures should enhance their risk management procedures by increasing the frequency of stress testing from monthly to weekly and strengthening liquidity back-up facilities	ST, MP
Enhance crisis management, resolution, and systemic liquidity arrangements	
• Extend the special powers of the Federal Deposit Insurance Corporation (FDIC) to enable receivership or conservatorship of BHCs and systemically important financial firms	ST, HP
• Review the funding arrangements for the Deposit Insurance Fund by removing the ceiling on the size of the fund and increasing its size	MT, MP
• Implement "living will" requirements for large and complex financial groups, and address group structures that appear likely to severely impede effective resolution	MT, HP
• Consider widening the range of counterparties and collateral used for open market operations (OMO) and articulating policies for future Fed lending to nonbank financial firms to enhance the scope and predictability of systemic liquidity provision	MT, HP
Address too-big-to-fail issues and the future of the GSEs	
• Discourage size and complexity by subjecting systemic financial institutions to more stringent prudential requirements	ST, HP
• Provide regulators the authority to take pre-emptive actions when vulnerabilities build at potentially systemic financial firms	ST, HP
• Reform the housing GSEs, possibly by privatizing their retained asset portfolios and re-assigning responsibilities for social objectives/system support to an explicitly guaranteed public utility	MT, HP

Figure 1. The Recovery in Perspective



Sources: IMF, *World Economic Outlook* April 2009 and June 2011; Bureau of Economic Analysis; Bureau of Labor Statistics; Haver Analytics; and Fund staff estimates.
* The dates of the peaks are 2007Q3 for Italy, 2007Q4 for the Canada and United States and 2008Q1 for France, Germany, Japan, and United Kingdom.

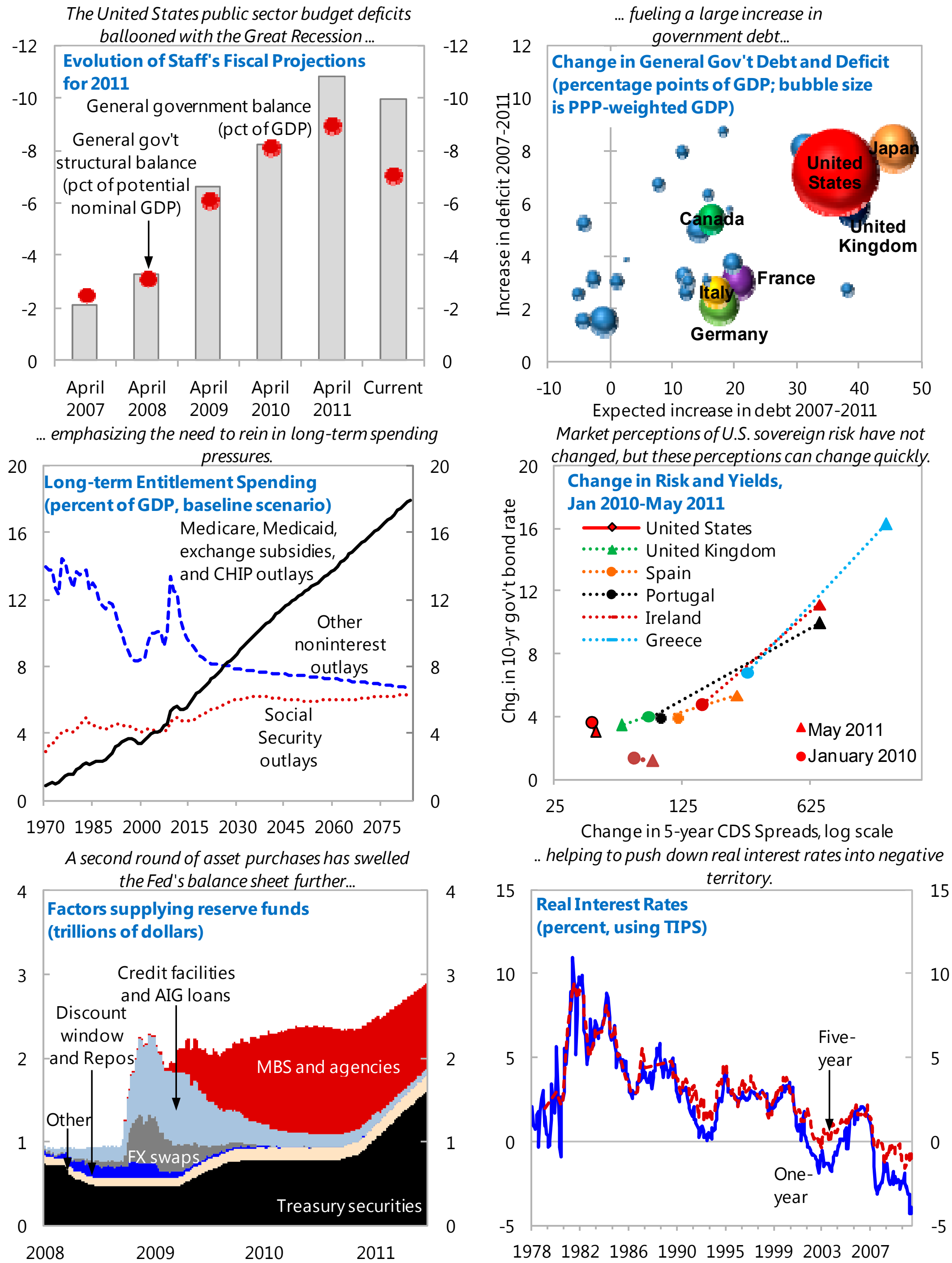
Figure 2. The Economy Hit Another Soft Patch in the First Half of 2011



Sources: Bureau of Economic Analysis; Bloomberg, LP; Barclays Capital; Citigroup, Inc; Goldman Sachs; Board of Governors of the Federal Reserve System; United States International Trade Commission; Bureau of Labor Statistics; the Conference Board; Haver Analytics; and Fund staff estimates.

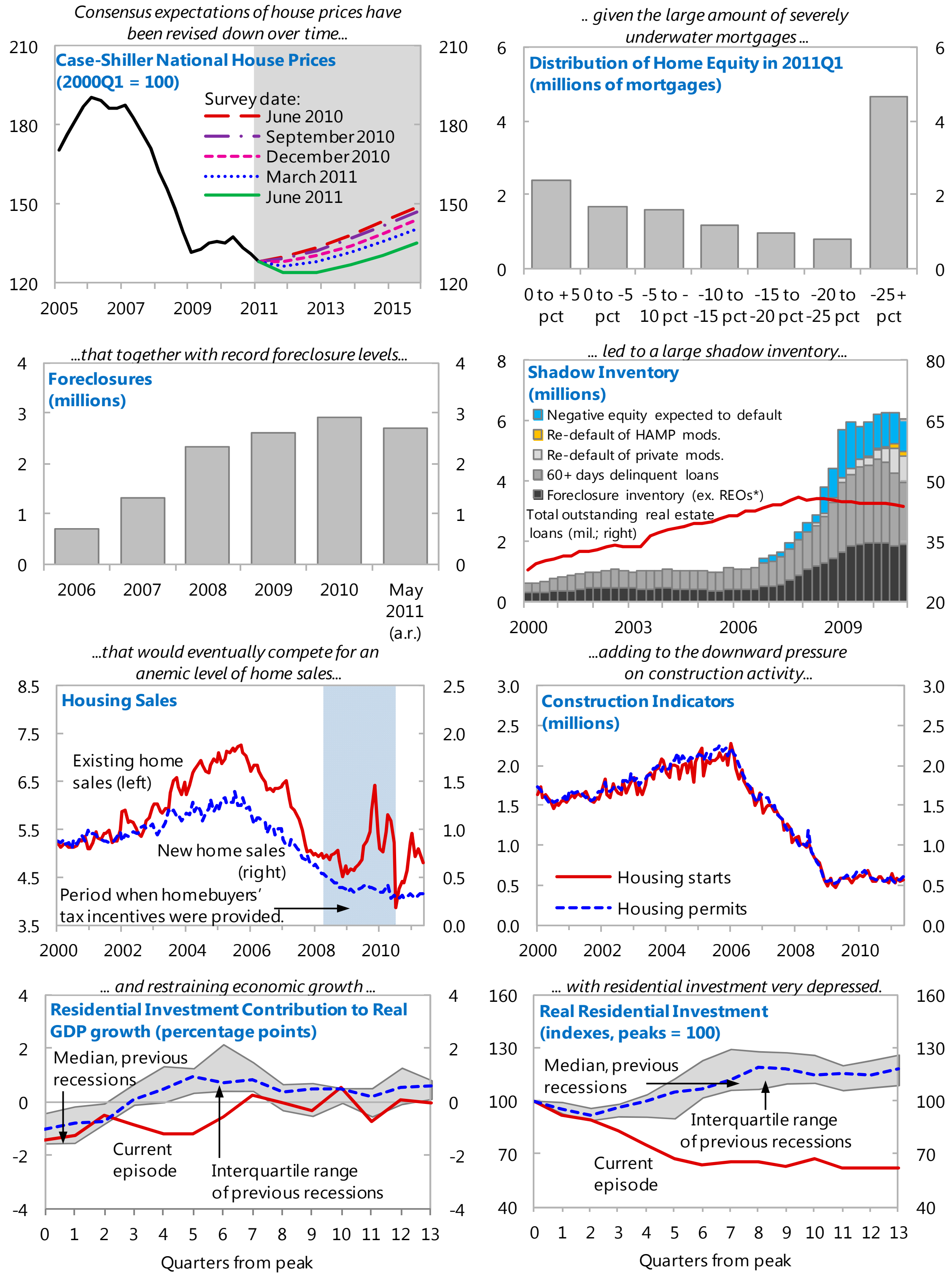
* Motor vehicles includes imports with Harmonized Trade System (HTS) classifications 8701-05 and 8709-11. Auto-related parts and accessories includes imports with HTS classifications 8706-09. These series are seasonally adjusted by Fund staff.

Figure 3. Macro Policy Levers are Strained



Sources: IMF, *World Economic Outlook* and *Fiscal Monitor*, Congressional Budget Office; Bloomberg, LP; Markit; Board of Governors of the Federal Reserve System; Haver Analytics; and Fund staff estimates.

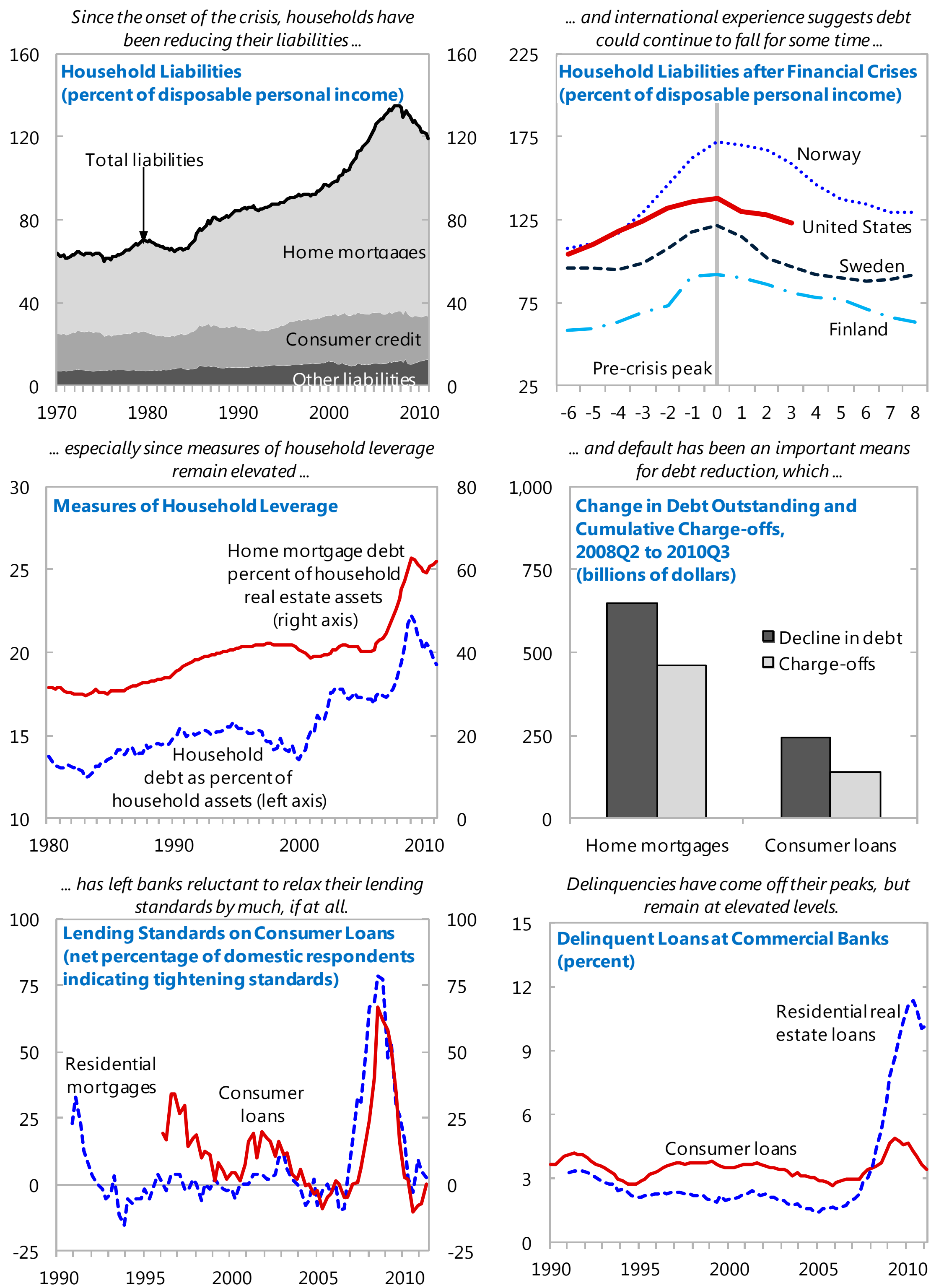
Figure 4. Real Estate Still Under Stress



Sources: MacroMarkets, LLC; CoreLogic; RealtyTrac; U.S. Census Bureau; National Association of Realtors; Bureau of Economic Analysis; Haver Analytics and Fund staff estimates.

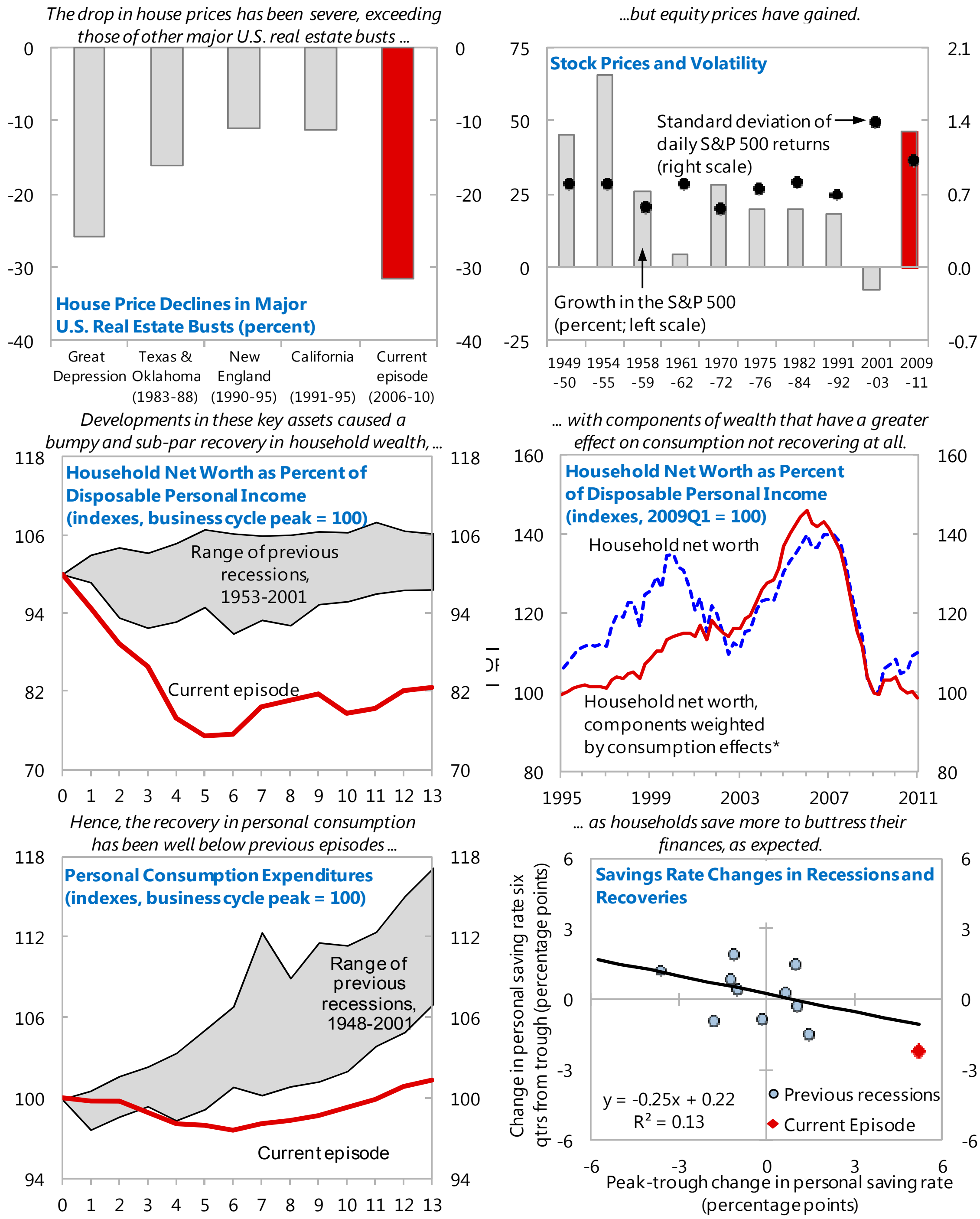
* REOs stands for real estate owned by banks.

Figure 5. Households Shedding Debt Burdens



Source: Board of Governors of the Federal Reserve System; OECD; Norges Bank; Statistics Finland; Riksbank; IMF, *World Economic Outlook*; Bureau of Economic Analysis; Haver Analytics; and Fund staff estimates.

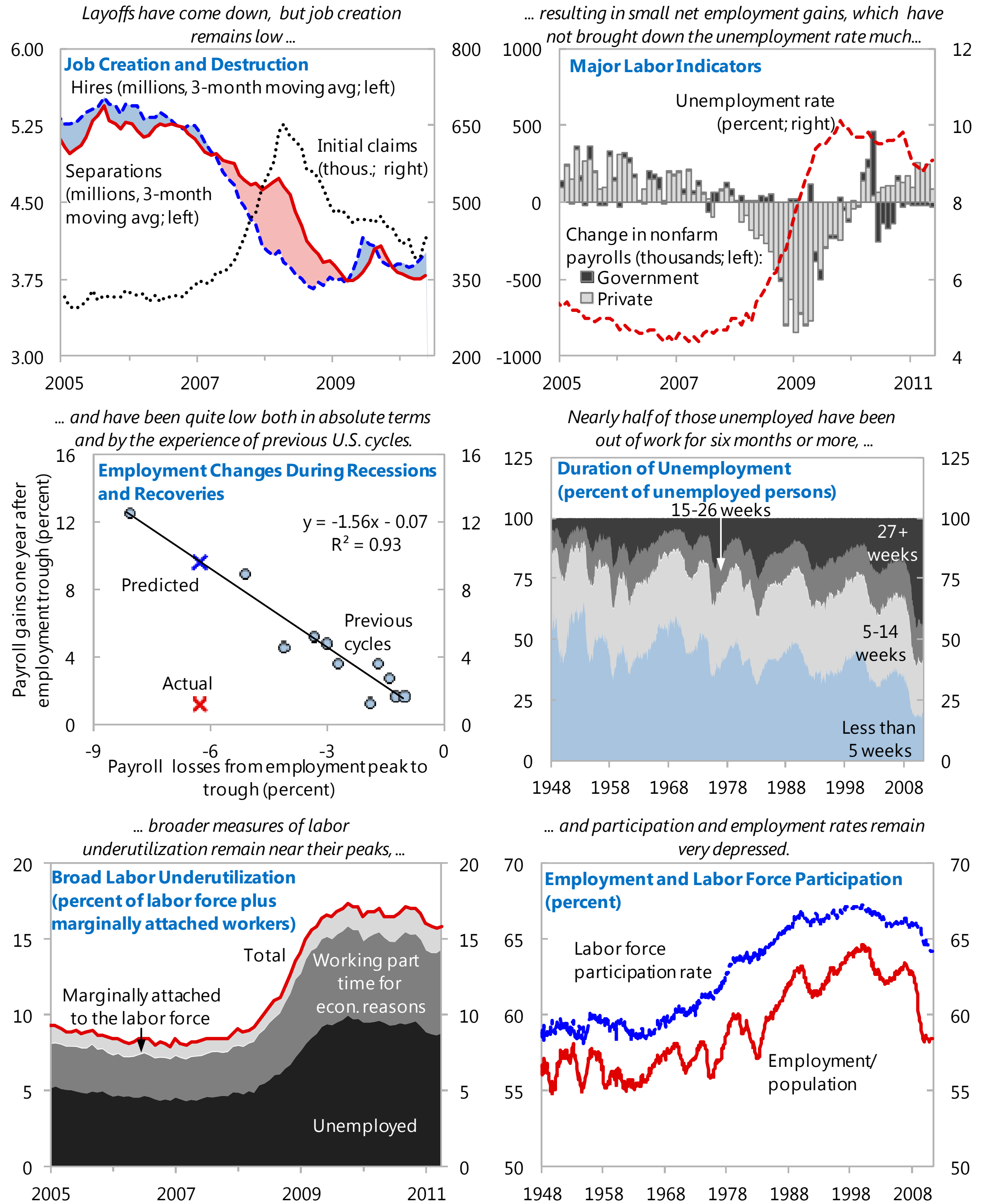
Figure 6. Loss of Household Wealth Weighing on Consumption



Source: Robert Shiller; Freddie Mac; MacroMarkets, LLC; Bloomberg, LP; Board of Governors of the Federal Reserve System; Bureau of Economic Analysis; Haver Analytics; and Fund staff estimates.

* Household real estate wealth is weighted by 9/13 and financial wealth net of liabilities is weighted by 4/13 percent as in Chris Carroll, Misuzu Otsuka, and Jirka Slacalek ("How Large Are Housing and Financial Wealth Effects? A New Approach," Journal of Money, Credit and Banking, 43(1), 2011) who find a cumulative effect on consumption of about 9 cents per dollar for changes in real estate wealth, and about 4 cents per dollar for changes in financial wealth net of liabilities.

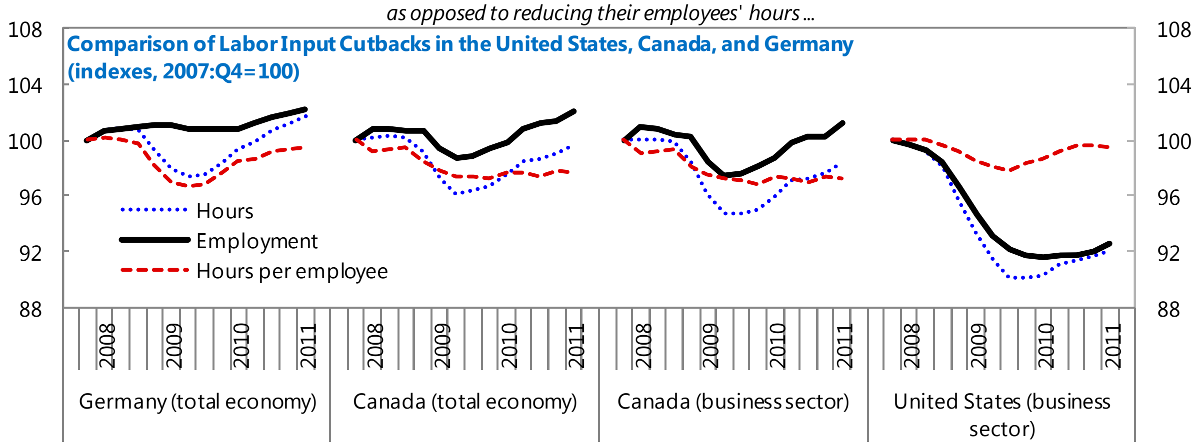
Figure 7. Lack of Dynamism in Labor Markets



Source: Bureau of Labor Statistics; U.S. Department of Labor;; Haver Analytics; and Fund staff estimates.

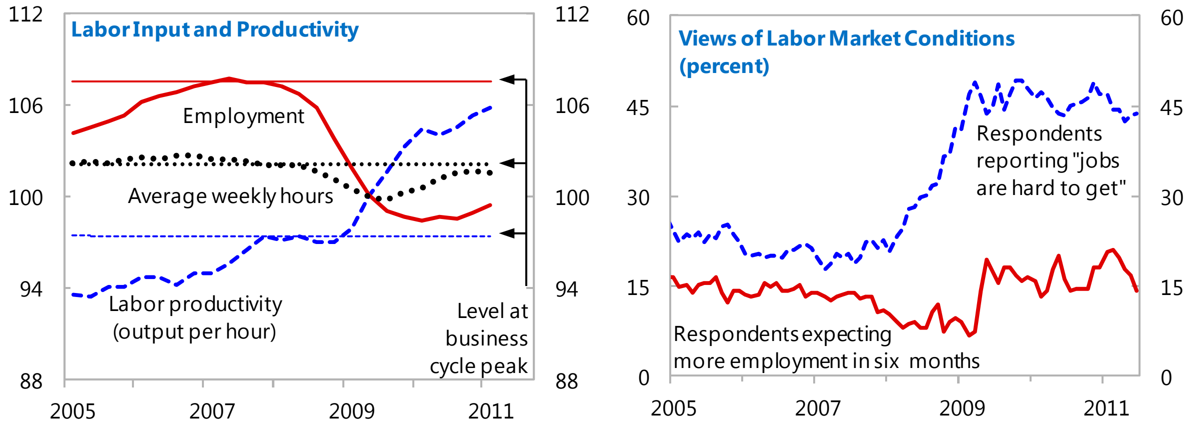
Figure 7. Lack of Dynamism in Labor Markets (continued)

In contrast to other advanced economies, employers in the United States achieved labor cutbacks through layoffs, as opposed to reducing their employees' hours ...



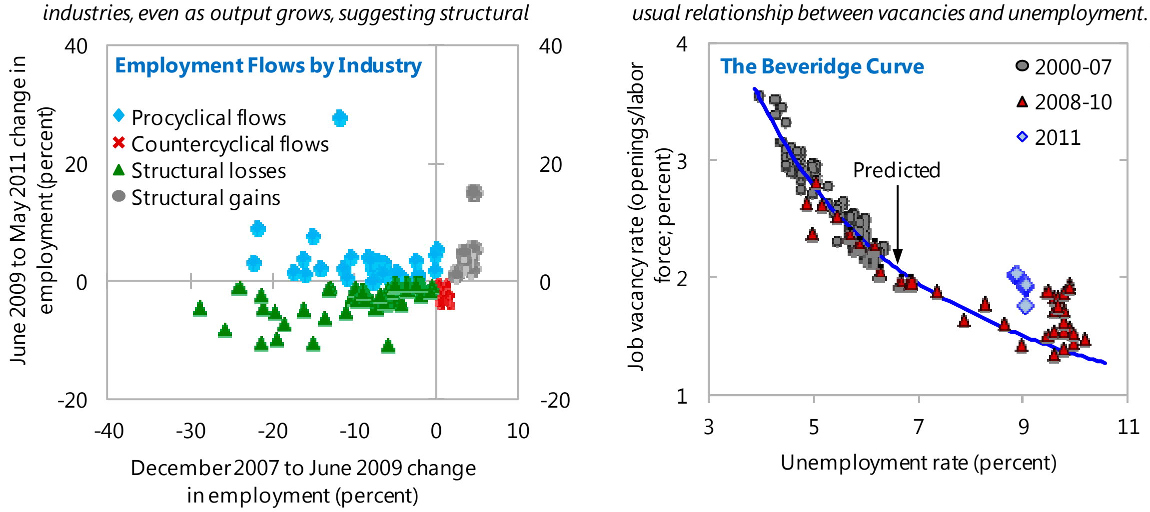
... allowing them to rely heavily on higher productivity and boosting weekly hours to fuel output gains.

Households view labor market conditions as tough, ...



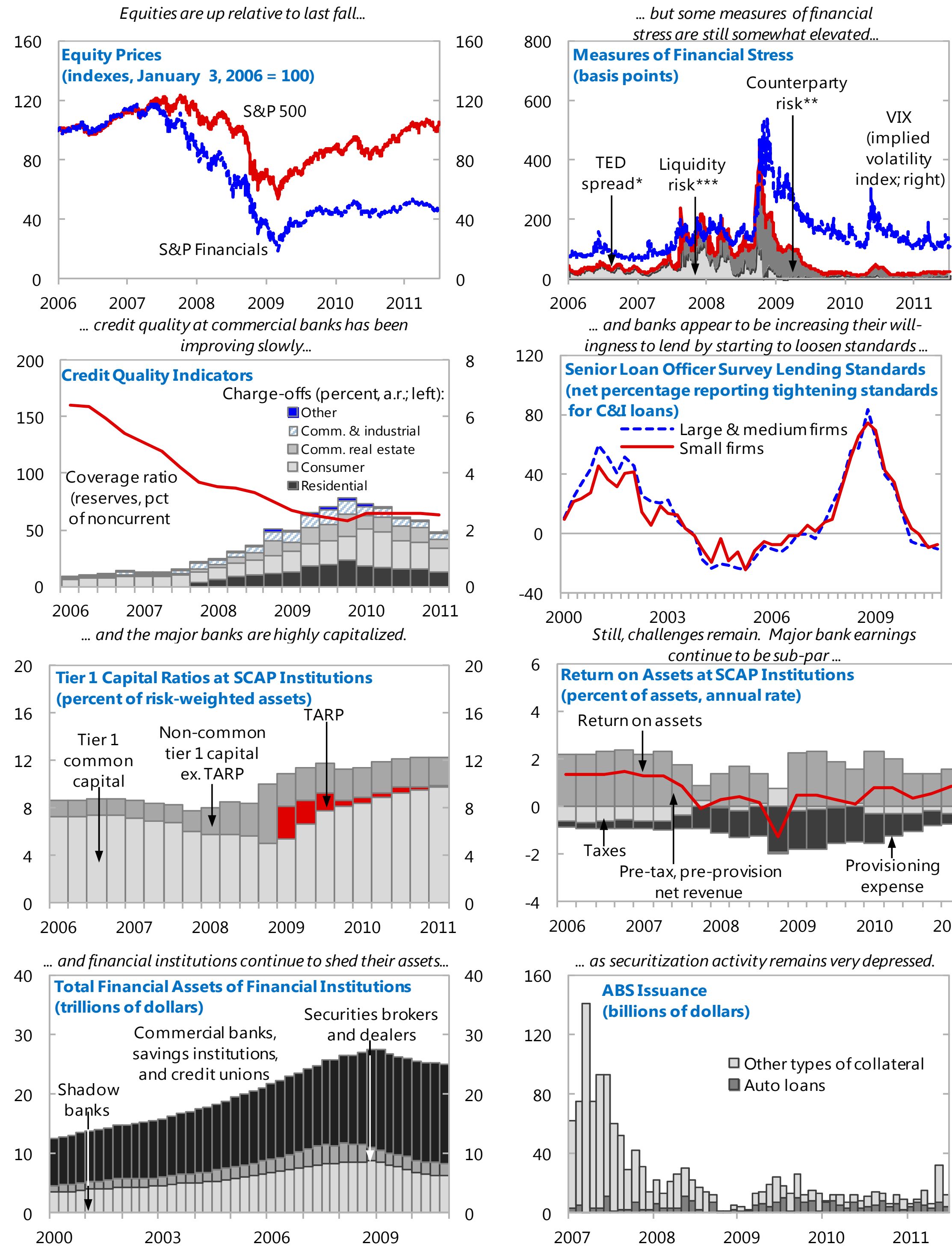
... possibly reflecting continued job losses in several industries, even as output grows, suggesting structural

... and potentially contributing to an apparent shift in the usual relationship between vacancies and unemployment.



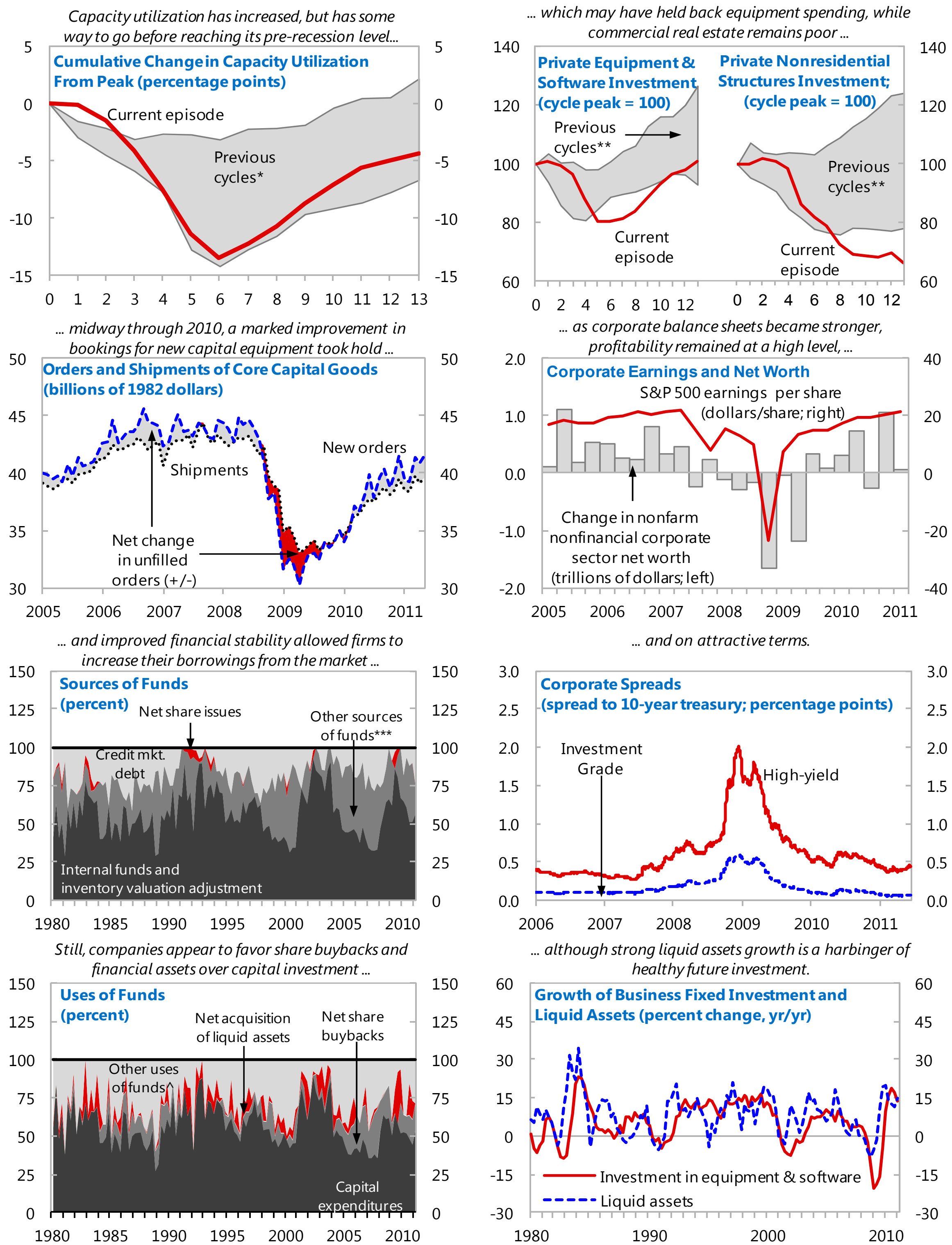
Sources: Statistiches Bundesamt; Statistics Canada; Bureau of Labor Statistics; the Conference Board; Bloomberg, LP; Haver Analytics; and Fund staff estimates.

Figure 8. Slow Financial Sector Healing



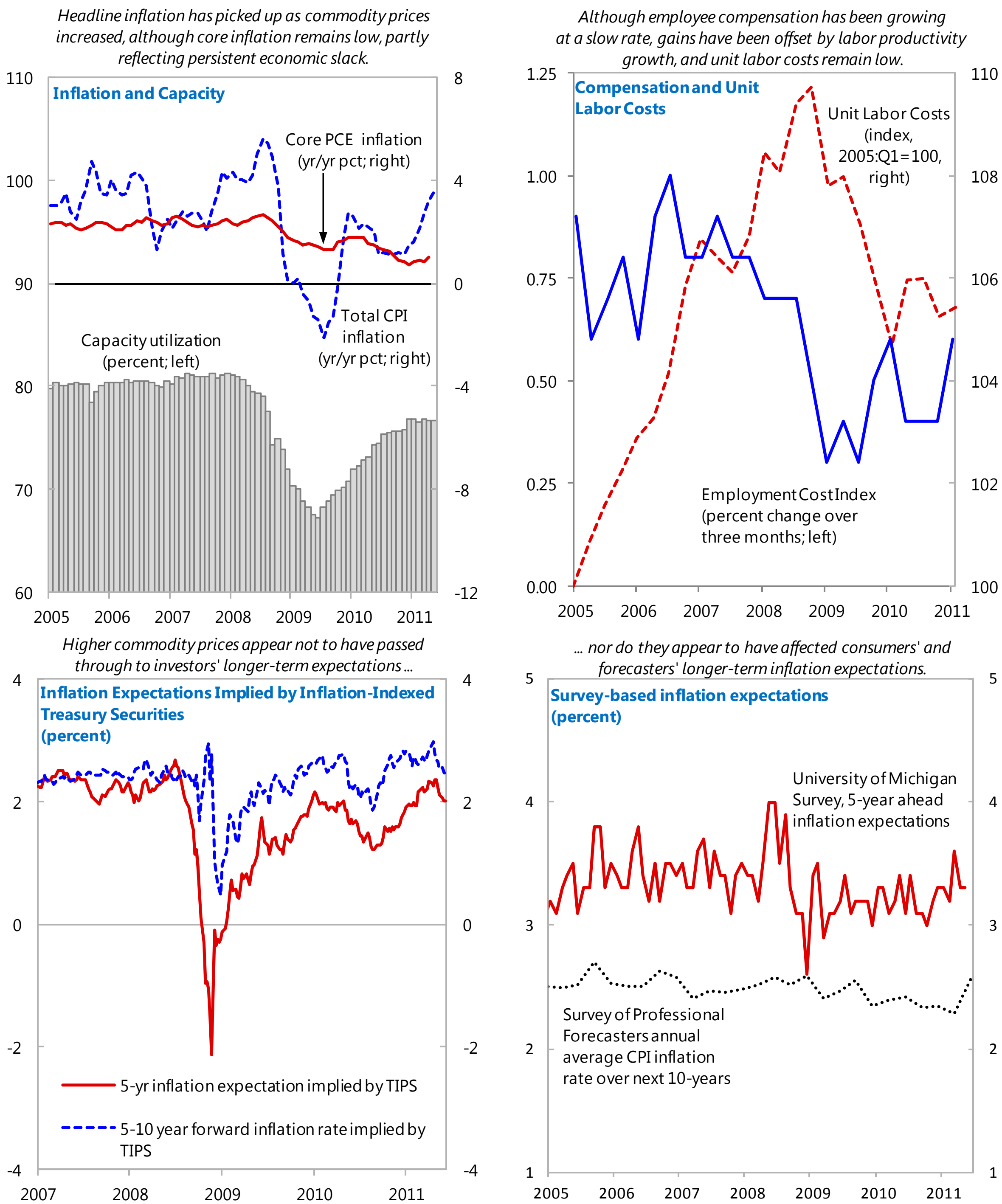
Sources: Federal Deposit Insurance Corporation; Board of Governors of the Federal Reserve System; SNL Financial; Bloomberg, LP; Haver Analytics; and Fund staff estimates. * The TED spread is three-month LIBOR less the three-month treasury bill yield. ** Counterparty risk is measured as the LIBOR-OIS spread. *** Liquidity risk is the OIS-treasury bill spread.

Figure 9. Corporate Sector Gaining Strength



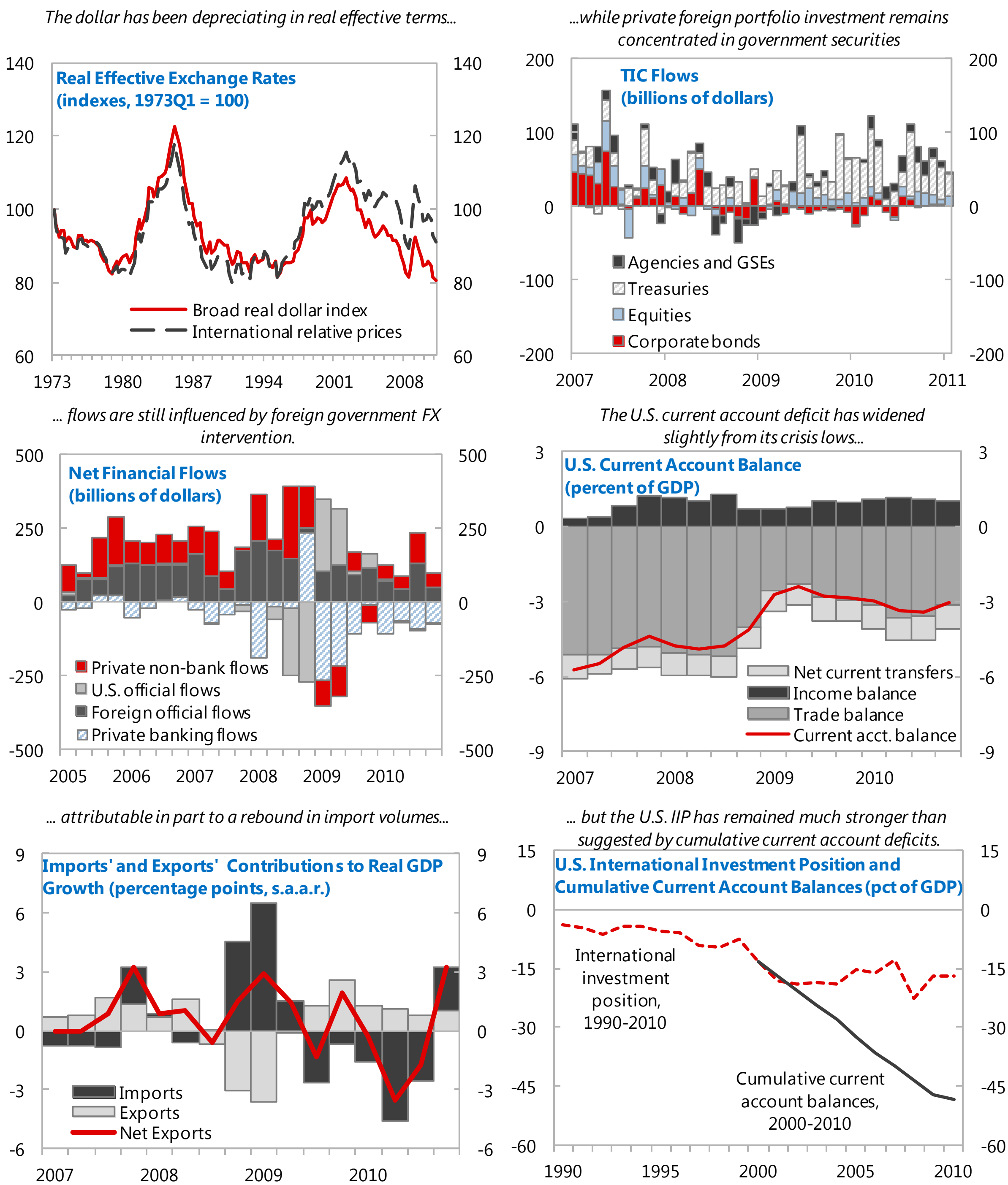
Sources: Board of Governors of the Federal Reserve System; Bureau of Economic Analysis; U.S. Census Bureau; Standard & Poor's; Bank of America/Merrill Lynch; Bloomberg, LP; Haver Analytics; and Fund staff estimates.
*Cycles from 1969 to 2001, excluding 1980. ** Cycles from 1948 to 2001, excluding 1980. *** Net gain in other liabilities, net decrease in assets, and discrepancy. ^ Net gain in other assets and net decrease in other liabilities.

Figure 10. Core Inflation Remains Subdued



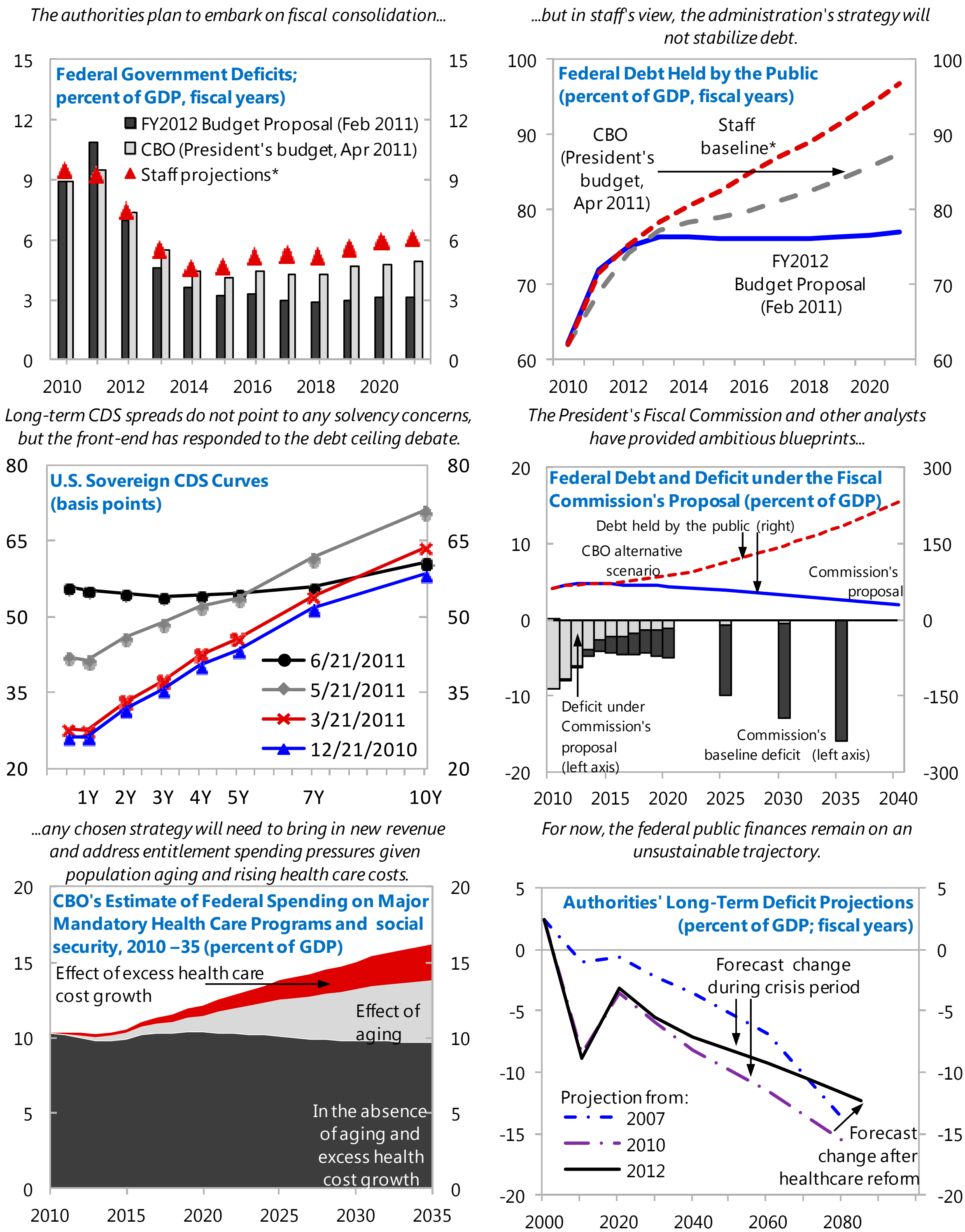
Sources: Board of Governors of the Federal Reserve System; Bureau of Labor Statistics; Bureau of Economic Analysis; University of Michigan; Federal Reserve Bank of Philadelphia; Haver Analytics; and Fund staff estimates.

Figure 11. The Dollar, Financial Flows, and Trade



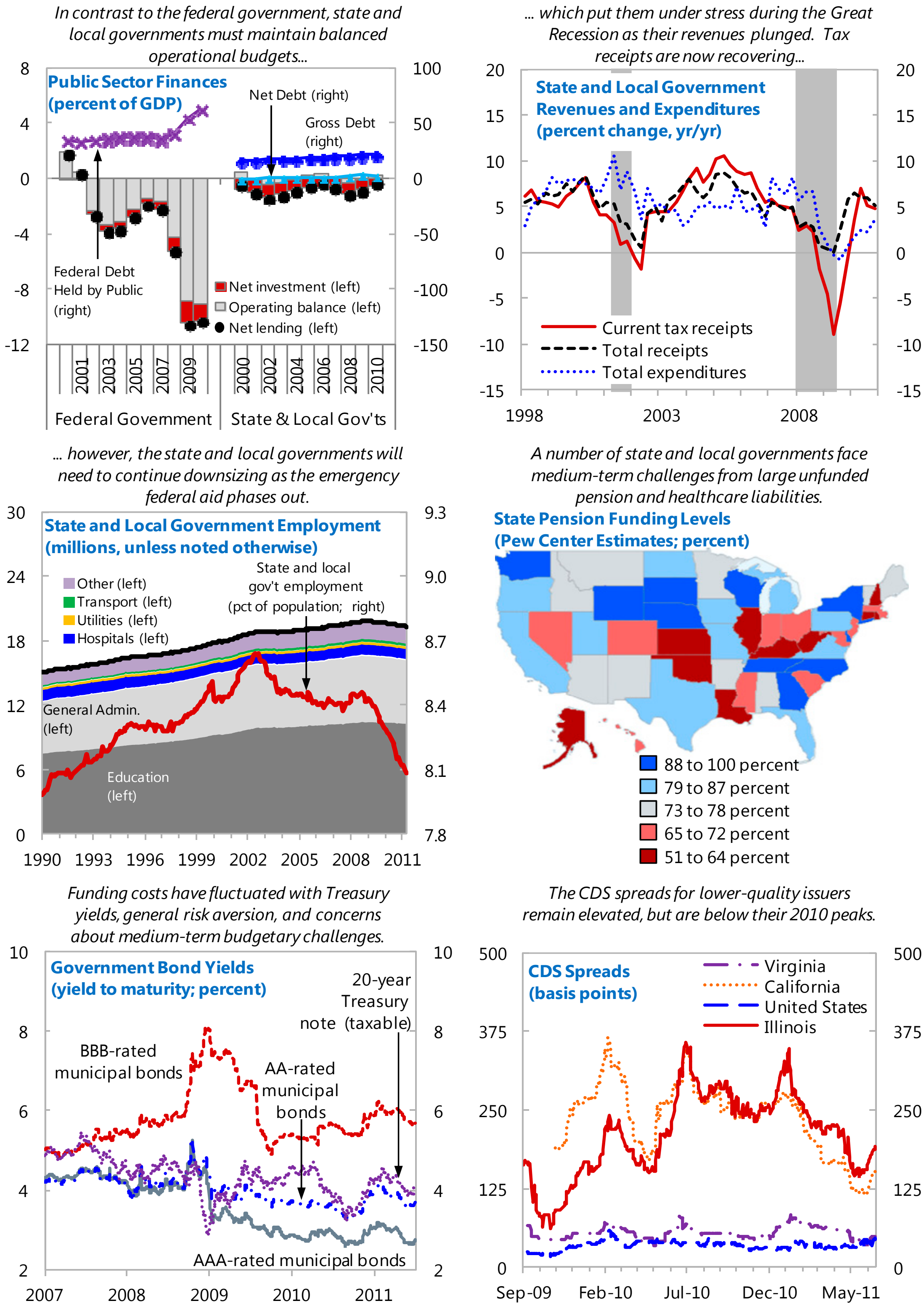
Sources: Board of Governors of the Federal Reserve System; United States Department of the Treasury; Bureau of Economic Analysis; and Fund staff estimates.

Figure 12. U.S. Federal Government Plans to Embark on a Fiscal Consolidation



Sources: Congressional Budget Office; Bloomberg, LP; National Commission on Fiscal Responsibility and Reform; Office of Management and Budget; Haver Analytics; and Fund staff estimates.
* Projections are prepared under staff's macroeconomic and policy assumptions.

Figure 13. State and Local Government Finances Are Under Pressure



Sources: Bureau of Economic Analysis; Bureau of Labor Statistics; Office of Management and Budget; Markit; Pew Center for the States; Bank of America/Merrill Lynch; Board of Governors of the Federal Reserve System; Haver Analytics; and Fund staff calculations.

[i] For instance, Chris Carroll, Misuzu Otsuka, and Jirka Slacalek ("How Large Are Housing and Financial Wealth Effects? A New Approach," Journal of Money, Credit and Banking, 43(1), 2011) find a cumulative effect of about 9 cents on the dollar for changes in housing wealth, and a about 4 cents on the dollar for changes in financial wealth (net of liabilities).

[ii] Marcello Estevão and Evridiki Tsounta, "Has the Great Recession Raised U.S Structural Unemployment?" IMF Working Paper, 11/105, 2011.

[iii] On the latter subject, see for instance, Rob Valletta and Katherine Kuang, "Is Structural Unemployment on the Rise?", FRBSF Economic Letter, 2010-34, Federal Reserve Bank of San Francisco, November, 2010.

[iv] See Curcuru, Thomas, and Warnock, "Current Account Sustainability and Relative Reliability". in J. Frankel and C. Pissarides (eds.) NBER International Seminar on Macroeconomics 2008, University of Chicago Press, and Lane and Milesi-Ferretti, "Where Did All The Borrowing Go? A Forensic Analysis of the U.S. External Position", Journal of the Japanese and International Economies vol. 23 no. 2, 2009, for a discussion of these issues.

[v] The "shadow inventory" is the set of properties that could enter the resale market, such as those that are in foreclosure, 90+ days delinquent, or with a high probability of default given negative equity or a prior modification.

[vi] Congress sets a binding ceiling on the total amount of gross Treasury debt which can be issued.

[vii] Unless otherwise noted, all figures in this section refer to the federal government budget data on a fiscal year basis (the fiscal year ends September).

[viii] Government agencies responded to uncertainties created by the delayed FY2011 appropriations by postponing spending, and it remained unclear how quickly the outlays could rebound. There is also uncertainty about durability of the recent revenue overperformance.

[ix] A number of other policymakers and analysts have outlined their consolidation plans—see a website by the Committee for a Responsible Federal Budget for a detailed summary: http://crfb.org/compare/index.php?id=01 .

[x] According to FHFA, a 25 percent drop in house prices would lead to about $110 billion in net additional GSE injections by end-2013 (the gross injection would be about twice as large, including the injections that would be paid back to the Treasury in the form of dividends).

[xi] U.S. Government Accountability Office, "Employment and Training Programs: Opportunities Exist for Improving Efficiency," Testimony to Congress, April 7, 2011.

[xii] Under the first round of unconventional easing, the Federal Reserve purchased $1.25 trillion of agency MBS, about $175 billion of agency debt, and $300 billion of longer-term Treasury securities, with purchases completed in March, 2010. The Fed launched a second round of large asset purchases in November, 2010, with $600 billion in purchases to be completed by the end of June, 2011.

[xiii] Research by Federal Reserve economists (e.g., by Gagnon, Maskin, Remache, and Sack, "Large-Scale Asset Purchases by the Federal Reserve: Did They Work?", Federal Reserve Bank of New York Staff Reports, No. 144) finds that the first round of unconventional easing lowered the ten-year Treasury yield by 50–75 basis points (3–4 basis points for each $100 billion in purchases). A similar elasticity would suggest an effect of around 20 basis points for the second round of unconventional easing. The cumulative effects would correspond to a federal funds target rate cut of roughly 300 basis points (see Rudebusch, "The Fed's Exit Strategy for Monetary Policy" San Francisco Fed Economic Letter No. 2010–18).

Annex II. Statistical Issues

Statistical Issues: Comprehensive economic data are available for the United States on a timely basis. The quality, coverage, periodicity, and timeliness of U.S. economic data are adequate for surveillance. Coverage of international capital flows in external sector statistics has been improved, with the June 2007 releases of BOP and IIP data on financial derivatives. The United States has subscribed to the Special Data Dissemination Standard (SDDS) and its metadata are posted on the Dissemination Standard Bulletin Board (DSBB).

United States: Table of Common Indicators Required for Surveillance

(As of June 28, 2011)

	Date of latest observation	Date received	Frequency of data[1]	Frequency of reporting[1]	Frequency of publication[1]
Exchange rates	June 24	June 27	D	W	W
International reserve assets and reserve liabilities of the monetary authorities[2]	June 17	June 27	W	W	W
Reserve/base money	June 15	June 23	B	W	W
Broad money	June 13	June 23	W	W	W
Central bank balance sheet	June 22	June 23	W	W	W
Interest rates[3]	same day	same day	D	D	D
Consumer price index	May 2011	June 15	M	M	M
Revenue, expenditure, balance and composition of financing[4]—general government[5]	2011 Q1	June 24	Q	Q	Q
Revenue, expenditure, balance and composition of financing[4]—central government	May 2011	June 10	M	M	M
Stocks of central government and central government-guaranteed debt	May 2011	June 6	M	M	M
External current account balance	2011 Q1	June 16	Q	Q	Q
Exports and imports of goods and services	Apr. 2011	June 9	M	M	M
GDP/GNP (3rd release)	2011 Q1	June 24	Q	M	M
Gross External Debt	2011 Q1	June 9	Q	Q	Q
International Investment Position[6]	2010	June 28	A	A	A

[1] Daily (D), Weekly (W), Biweekly (B), Monthly (M), Quarterly (Q), Annually (A); NA: Not Available.

[2] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

[3] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

[4] Foreign, domestic bank, and domestic nonbank financing.

[5] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents.

Statement by the IMF Staff Representative on the United States
July 21, 2011

1. **This note reports on information that has become available since the staff report (SM/11/167) was issued and does not alter the thrust of the staff appraisal**.

2. **Incoming data since the completion of the Article IV consultation in mid-June point to downside risks to the staff's near term forecast**. Recent data indicate a marked slowdown in the growth of employment, aggregate labor income, and consumption, and weaker consumer confidence. All told, activity has been weaker than expected, with GDP growth in the second quarter of 2011 tracking between 1.5 and 2 percent at an annualized rate, below the staff's WEO projection of 2.6 percent. Twelve month core consumer price inflation increased to 1.6 percent in June, slightly above expected, while headline consumer price inflation was around 3.5 percent.

3. **Negotiations over the federal debt ceiling are ongoing.** Both the Democratic and Republican leaders have committed to lifting the ceiling before the August 2 deadline, but a basic political agreement on the underlying fiscal consolidation framework is still lacking. Moody's placed the U.S. sovereign credit rating on a review for downgrade last week, citing concerns about possible technical default. Standard and Poor's has indicated a more than 50 percent likelihood of downgrade over the next three months given the lack of consensus on the medium-term fiscal consolidation framework. The market reaction has been muted so far, with the 10-year Treasury yield trading below 3 percent and the CDS spreads remaining broadly stable. Adverse market dynamics cannot be ruled out, however, as policymakers approach the debt ceiling deadline without basic contours of an agreement. Failing to raise the debt ceiling on time would have disastrous consequences for the U.S. and global economy.

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July 25, 2011

International Monetary Fund
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IMF Executive Board Concludes 2011 Article IV Consultation with the United States

On July 21, 2011, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the United States.[1] The consultation documents are accompanied by a report analyzing the spillovers from U.S. policies to the rest of the world.

Background

The U.S. economy continues to recover from its worst financial crisis since the Great Depression, aided by supportive macroeconomic policies. Monetary policy remains highly accommodative, with policy rates near zero and a significantly expanded Federal Reserve balance sheet. Fiscal policy provided a sizable stimulus to demand over 2009–2010, but the fiscal impulse for the current fiscal year is likely to be about zero. The financial system continues to strengthen, although lending conditions remain tight for some segments. Household balance-sheet repair has continued amidst still declining house prices and high unemployment rates, weighing on consumption, while construction activity remains depressed. Corporate spending and hiring remain relatively weak, despite record-high profit growth and easy financing conditions for large firms. GDP growth slowed from 2¾ percent (saar) in the second half of 2010 to just under

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

2 percent (saar) in the first half of 2011, reflecting *inter alia* the impact of higher oil prices and several transient factors. The U.S. current account deficit has moved broadly sideways as higher oil prices have offset the effects of strong external demand and the dollar's depreciation. Overall, the slow pace of the recovery is consistent with past international experience in the aftermath of housing and financial crises.

The outlook is for continued albeit modest growth. With sluggish private domestic demand economic slack remains large: in particular, the unemployment rate has declined only modestly from its recent peak. As a result, inflation pressures will likely remain contained, despite the recent firming in core inflation. Risks are elevated and tilted to the downside, especially from the housing market and possible global financial market disruptions from the sovereign crisis in Europe.

On the policy front, the administration and Congressional policymakers have presented medium-term fiscal adjustment proposals, and current negotiations suggest that fiscal policy is set to enter a consolidation phase to address its unsustainable trajectory. The Federal Reserve has indicated that economic conditions are likely to warrant an accommodative monetary policy stance for an extended period and any future policy moves would depend on incoming data, including on inflation expectations.

On the financial sector front, the official financial support deployed during the crisis is being wound down and the legislated reform of financial supervision and regulation is being implemented. In particular, the Financial Stability Oversight Committee (FSOC) has ramped up operations and numerous rules are being promulgated. However, many issues remain to be worked out, notably in areas involving systemically important financial institutions and international coordination.

Executive Board Assessment

Executive Directors observed that the economic recovery continues at a modest pace, though slowing down recently due partly to some transient factors. Directors noted that depressed real estate markets, persistent high unemployment, and weak consumer confidence have held back growth prospects. While macroeconomic policies have remained supportive thus far, fiscal policy faces tighter constraints going forward, given unsustainable public debt dynamics. With a still-wide output gap and downside risks to the outlook, especially potential spillovers from European financial markets, Directors called for a cautious approach to unwinding macroeconomic support.

Directors agreed that placing public debt on a sustainable path is critical to the stability of the U.S. economy, with positive spillovers to other countries. They welcomed the administration's objective to stabilize the debt ratio by mid-decade and gradually reduce it afterward. Directors highlighted the urgency of raising the federal debt ceiling and agreeing on the specifics of a comprehensive medium-term consolidation plan. With a well-defined, credible multi-year framework in place, the