INTERNATIONAL MONETARY FUND

2002 Article IV Consultation with the United States of America

Statement of the Fund Mission

June 18, 2002

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

2. ***The outlook also appears broadly favorable.*** While IMF staff expects activity to moderate from the rapid growth seen in the first quarter, as the initial push from the inventory cycle and the effect of other temporary factors dissipate, the recovery would be sustained by a rebound of business fixed investment and continued strength in the household sector. Of course, important uncertainties remain, including with regard to the prospects for corporate profits and investment, the underlying strength of household demand, and the large U.S. current account deficit. How these uncertainties are resolved depends critically on the extent to which the U.S. economy can sustain the rapid rates of productivity growth that have been recorded in recent years.

3. ***Against this background, the key policy challenges have shifted from short-term stabilization to strengthening the base for strong and durable growth:***

- Provided that evidence of recovery continues to accumulate, monetary policy will need to start shifting to a more neutral stance.

- Re-establishing a clear medium-term fiscal framework would help to strengthen budget discipline and to prepare for an aging society.

- While the economic downturn and recent corporate failures have demonstrated the resiliency of the financial system, they have also highlighted a number of issues in the areas of corporate governance and accounting standards.

- Recent U.S. trade action and agricultural policy initiatives are likely to impose a significant burden both domestically and abroad, and it will be important to avoid undermining the momentum toward multilateral trade liberalization.

4. ***The large U.S. current account deficit, and the broader imbalance of global growth that it reflects, remain a concern***. The widening of the U.S. current account since the mid-1990s has largely resulted from strong investment and confidence in U.S. productivity

growth relative to other industrial countries, rather than major fiscal or other macro-policy imbalances. Nonetheless, the current account deficit, at current or higher rates, would take the U.S. net foreign liability position to ever increasing levels, and at some point an adjustment will be needed. This adjustment could be achieved in an orderly fashion as a result of improved growth performance among partner countries. However, less orderly adjustments can also be envisaged, including through a sudden reversal of investor sentiment and capital flows, and rapid dollar depreciation. Such a process could jeopardize recovery prospects abroad, disrupt capital market access for developing countries, and also adversely affect U.S. investment and incomes. This risk underscores the importance of boosting U.S. saving—especially through disciplined fiscal policies—as well as continued efforts to ensure that risk management and transparency in the financial and corporate sectors are strong enough to maintain confidence and cope with exchange market and other shocks.

5. ***The fiscal outlook has deteriorated markedly over the past year.*** A year ago, projections were for unified surpluses of 2½ percent of GDP and higher in FY 2002 and beyond, permitting a pay down of net federal debt held by the public by the end of the decade. However, a deficit of well over 1 percent of GDP now seems likely in FY 2002, reflecting the effects of the economic slowdown, as well as the June 2001 tax cuts, additional outlays necessitated by the September 11th attacks, and the March 2002 stimulus package. Although the Administration's budget projects that surpluses would be re-established on a unified basis after FY 2004, deficits would remain after excluding the surpluses of Social Security trust funds.

6. ***Moreover, these medium-term fiscal projections could be optimistic.*** In order to offset significant increases in defense and security-related outlays, the budget proposes squeezing other spending categories to an extent that could be difficult to sustain, especially given the apparent weakening of fiscal discipline in recent years. Budget projections may also significantly understate the growth of Medicare outlays. On the tax side, the revenue/GDP ratio has already eroded owing to the effects of previously enacted tax cuts, and further declines cannot be ruled out given the recent weakness in tax receipts and the likely renewal of tax credits and relief from the individual Alternative Minimum Tax.

7. ***Longer-run pressures on the fiscal system from demographic trends also remain worrisome.*** The cash-flow positions of the Social Security and Medicare trust funds are projected to deteriorate beginning later this decade, owing to the retirement of the baby-boom generation and the rapid growth of medical costs. The deficits that are expected to emerge next decade imply a substantial actuarial shortfall over a 75-year horizon, and the fiscal burden would be even larger if Medicare's Supplemental Medical Insurance is accounted for.

8. ***As a first step toward addressing these longer-term pressures, the IMF staff recommends the establishment of a fiscal framework that sets the clear goal of balancing the budget excluding Social Security as the economy moves toward full employment***. This objective—which the Administration endorsed last year—would allow federal debt to be worked down in anticipation of reforms that would place the Social Security and Medicare systems on a sound financial footing. If achieved over the business cycle, it would also

provide sufficient flexibility for the fiscal position to respond to cyclical shocks. Early action toward establishing such a framework would help bolster fiscal discipline, strengthen confidence in the medium-term fiscal position, and ultimately boost national saving.

9. ***Achieving this goal would require a careful and early review of expenditure and tax priorities.*** The Administration's budget already anticipates tight limits on nondefense discretionary outlays that may be hard to achieve, especially in light of recent pressures for spending on homeland security and agricultural subsidies. Therefore, consideration may need to be given to revenue measures. The Administration has signaled its interest in tax reforms that improve the efficiency and breadth of the system. In this context, the IMF staff suggests that priority be given to reducing tax expenditures for both households and corporations, and the possible increased use of energy taxes. In the absence of alternatives, the pending cuts in marginal income tax rates may need to be reconsidered.

10. ***Strengthening the institutional basis for budget discipline would bolster the credibility of the fiscal framework***. Discretionary spending caps and the pay-as-you-go (PAYGO) requirements played an important role in asserting budgetary discipline during the past decade, but were increasingly circumvented once on-budget surpluses began to accumulate. The credibility and transparency of the budget process also seemed to have been weakened by decisions to legislate last year's tax cuts only through 2010 and to forego ten-year budget projections. Therefore, while an extension of spending caps and PAYGO mechanisms could be useful, strengthening enforcement mechanisms and a strong political consensus for fiscal consolidation are also needed.

11. ***Steps need to be taken to address the longer-term health of the Medicare and Social Security systems***. The budget acknowledges the need for Medicare reform, but the specific measures announced seem geared more toward expanding benefits—including for prescription drugs—than ensuring the system's long-term viability. Placing the system on a sound financial footing will undoubtedly require measures to contain the cost of health care, raise co-payments and deductibles, and increase contribution and premium rates. As for Social Security, the Administration has stressed its preference for solutions that avoid hikes in payroll taxes. However, as the President's reform commission has illustrated, early and relatively modest amendments to other aspects of the current system—for example, amending the indexation of the benefit formula that applies to pre-retirement earnings—could help assure the system's financial solvency and avoid the need for larger and more difficult measures later on. In the staff's view, other alternatives such as gradually increasing the retirement age and raising the ceiling on OASDI contributions could also be considered. Proposed personal retirement accounts could enhance incentives to save and inter-generational equity, but they would not substitute for the measures needed to address the system's long-term solvency, and would require coping with significant transition costs.

12. ***Provided that evidence of recovery continues to accumulate, the Federal Reserve will need to begin to gradually withdraw monetary stimulus.*** Interest rates are highly accommodative, and given expectations of a gradual absorption of slack in the coming year and the usual transmission lags, the market expects action to begin withdrawing stimulus

later this year. To be sure, the Fed has some room to wait until the recovery is more clearly established before acting, given the minimal signs of impending inflation pressures and the still uncertain economic outlook. Nonetheless, these considerations will need to be balanced against the possibility that delaying action would require larger and more disruptive policy adjustments later on.

13. ***The U.S. financial system appears to have successfully weathered the economic slowdown***. Although credit quality weakened further during 2001, banks have maintained healthy returns on equity and boosted capital, and improved risk-management techniques have allowed banks to handle substantial stresses. Pressures may still arise owing to weaknesses in some sectors, but systemic risks appear limited. The new supervisory framework established under the Gramm-Leach-Bliley (GLB) Act of 1999 also seems to have been implemented effectively, and the authorities' intention to reform the deposit insurance system and to press ahead toward a new international capital accord are welcome.

14. ***The failure of the Enron Corporation has triggered valuable scrutiny of U.S. corporate governance and accounting standards***. Spillovers to the financial and corporate sectors appear to have been largely contained, and the event appears to have had the welcome effect of encouraging stricter market discipline. Nonetheless, it has highlighted a number of shortcomings in accounting and audit standards, corporate governance, and regulations governing pension plans. The challenge will be to ensure that reform proposals are developed and implemented in a manner that enhances transparency and market discipline without unduly adding to the regulatory burden.

15. ***The United States has played an important leadership role in advancing the Doha Round,*** and has also demonstrated a willingness to advance the cause of free trade in the context of efforts toward a Free Trade Agreement of the Americas and increased market access for the Caribbean and Sub-Saharan Africa. Looking ahead, advancing the implementation of measures already agreed under the Uruguay Round Agreement would bolster confidence among partner countries that the benefits of trade liberalization are being shared equitably.

16. ***Nonetheless, this leadership role and broader support for multilateralism risks being undermined by domestic pressures.*** The recent safeguard action against steel imports appears likely to impose significant costs both domestically and abroad and, by raising trade tensions, could undermine momentum for multilateral trade liberalization. Also, as slack emerged in the industrial sector, U.S. anti-dumping filings surged in recent years. These actions tend to discourage competition and trade, and encourage similar behavior by partner countries, suggesting the need for reforms that reduce the degree of discretion allowed in findings of injury and more clearly link findings to evidence of noncompetitive behavior.

17. ***The measures contained in the recent Farm Bill were damaging from both a domestic and international perspective.*** The legislation locks in U.S. subsidies at levels that—while lower than in many partner countries—have surged in recent years, undoing many of the 1996 reforms that sought to promote adjustment and efficiency in the farm

sector. By linking support payments to prices of specific commodities, the legislation seems likely to encourage production of crops already in chronic oversupply and adversely affect producers abroad, while also undermining domestic fiscal objectives.

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