Article IV Consultation with the United States of America: Concluding Statement of the IMF Mission

June 22, 2016

The United States economy is, overall, in good shape. A total of 2.4 million new jobs were created over the past year and unemployment has fallen to 4.7 percent, its lowest level since the eve of the "Great Recession." Inflation remains contained, and the U.S. economy has repeatedly demonstrated its resilience in the face of financial market volatility, a strengthening dollar, and subdued global demand.

Despite these important achievements, the U.S. faces potentially significant longer-term challenges to strong and sustained growth. Concerted policy actions are warranted, sooner rather than later. The latest IMF review of the U.S. economy—the 2016 Article IV Consultation—explores these policy challenges, focusing on the causes and consequences of falling labor force participation, an increasingly polarized income distribution, high levels of poverty, and weak productivity. The IMF's staff recommends the following policy actions to alleviate these long-running supply side issues:

- *Increase state and federal infrastructure investment.*
- *Adopt comprehensive skills-based immigration reform.*
- *Expand the Earned Income Tax Credit combined with an increase in the federal minimum wage.*
- *Upgrade social programs for the nonworking poor.*
- *Deepen and improve family-friendly benefits including paid family leave and childcare assistance.*
- *Increase funding for training programs, vocational partnerships, and early childhood education. Raise the effectiveness of spending on science, technology, engineering and mathematics programs.*
- *Comprehensively reform the corporate income tax.*
- *Ratify the Trans Pacific Partnership, conclude a trade and investment treaty with Europe, and resist all forms of protectionism.*

Insofar as these measures require additional fiscal resources, they should be funded from new revenues or a reallocation of spending priorities and fit within a path for the fiscal deficit that ensures a steady decline in the public debt-to-GDP ratio.

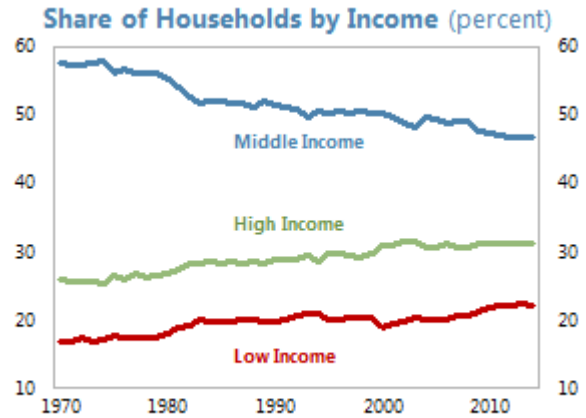
Macroeconomic Outlook

	2015	2016	2017
Growth (%, average)	2.4	2.2	2.5
Headline PCE inflation (%, eop)	0.5	1.2	2.2
Core PCE inflation (%, eop)	1.4	1.8	2.1
Unemployment rate (%, eop)	5.0	4.9	4.8
Current account (% of GDP, average)	-2.7	-2.9	-3.5

1.

The past few quarters have seen a temporary growth setback. The U.S. is entering its seventh consecutive year of expansion. The unemployment rate has fallen to 4.7 percent, household net worth is close to pre-crisis peaks, and inflation remains contained. Nonetheless, the past few quarters have been characterized by a deceleration that is attributable to a continued contraction in energy sector investment; weak non-energy, non-residential investment; and a persistent drag from net exports (linked to weaker global growth and the strength of the U.S. dollar). Although it is more difficult to find proximate causal factors, consumer demand has also slowed. However, real household disposable income is growing at 3 percent, the housing market appears solid, and both household and corporate balance sheets are in generally good shape (aided by historically low interest rates). Weighing these various forces, growth is forecast to be 2.2 percent in 2016 and 2.5 percent in 2017. The output gap is expected to close by end-2017 and PCE inflation is expected to rise slowly toward 2 percent. At today's levels of the real effective exchange rate, the current account deficit is expected to rise above 4 percent of GDP by 2020, pointing to the U.S. dollar being overvalued by 10-20 percent.

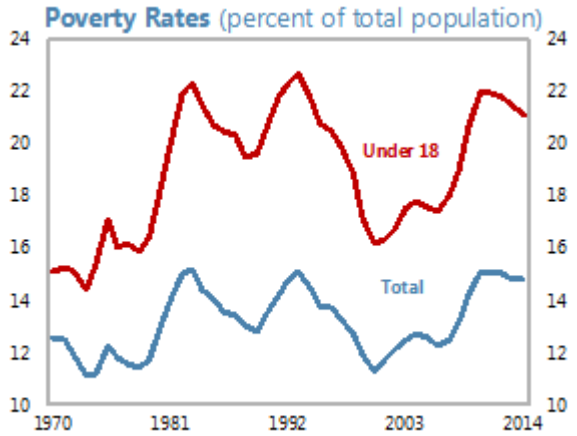
2. There are two-sided risks to the growth outlook. The latest jobs report raises concerns that U.S. growth may be losing momentum. However, jobs data is typically a lagging indicator. Indeed, high frequency indicators point to activity already reaccelerating in the second quarter. Going forward, the U.S. dollar represents a symmetric risk to growth and there are upside risks from oil—both in terms of a delayed effect on consumption (given the rise in the saving rate) and a lesser drag from oil-related investment. The slowdown in non-oil corporate investment, though, is not well understood and may continue to weigh on the outlook in the coming quarters. Downside risks to global growth may also be a headwind. A more complex risk to judge is the possibility that the recent weaker activity numbers actually reflect a lower potential growth rate and a smaller output gap than previously estimated. If true, this would mean the U.S. economy could increasingly bump up against capacity constraints. Further, it could imply that, with less slack in the economy, the near-term will see more pronounced inflationary pressures, necessitating a more assertive increase in policy rates, even in the face of weaker growth. If realized, this risk could have important negative spillovers to the global economy through both lower U.S. growth and higher interest rates.



3. Source: Current Population Survey
Note: Adjusted for family size using OECD's equivalence scale

Despite the ongoing expansion, the U.S. faces a confluence of forces that will weigh on the prospects for continued gains in economic well being. A rising share of the U.S. labor force is shifting into retirement, basic infrastructure is crumbling, productivity gains are scanty, and labor markets and businesses appear less adept at reallocating human and physical capital. These growing headwinds are overlaid by pernicious secular trends in income: labor's share of income is around 5 percent lower today than it was 15 years ago, the middle class has shrunk to its smallest size in the last 30 years, the income and wealth distribution are increasingly polarized, and poverty has risen.

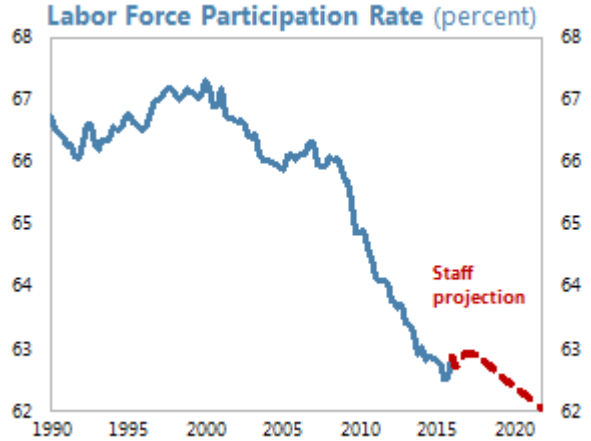
4. These secular forces both interact and reinforce each other. Demographic changes are slowing potential growth, delaying the renewal of business equipment, and depressing labor force dynamism. Reduced dynamism in the corporate sector has the potential to diminish innovation, deepen the loss of middle income jobs, and further polarize the income distribution. Income polarization itself can prevent productivity-improving investments in education by poorer households, lessen social mobility, add to economic insecurity, and limit consumption prospects. The causes of and interactions between these various forces are complex and not well understood. However, what is clear is that these trends are coinciding with a well-documented decline in potential growth (from above 3 percent in the early 2000s to below 2 percent today) that is being mirrored across a range of advanced and emerging economies. If left unchecked, these forces will continue to drag down both potential and actual growth, diminish gains in living standards, and worsen poverty.



5. Sources: Census Bureau; Haver Analytics; and IMF staff calculations

There is an urgent need to tackle poverty. In the latest data, 1 in 7 Americans is living in poverty, including 1 in 5 children and 1 in 3 female-headed households. Around 40 percent of those in poverty are working. A more generous earned income tax credit (including eligibility for workers without dependents, those under 25, and older workers that are not yet eligible for social security) combined with a higher federal minimum wage would help alleviate poverty. These two measures would have strong complementarities. The improvements in the EITC can work in tandem with the

minimum wage to ensure a meaningful increase in after-tax earnings for the nation's poorest households. Upgrading social programs to support the nonworking poor would also be a step forward. Efforts to improve K-12 education, investing in early childhood education, subsidizing childcare for lower income families, and expanding needs-based support for tertiary and vocational education can have important effects, over a longer horizon, in reducing the inter-generational persistence of poverty.



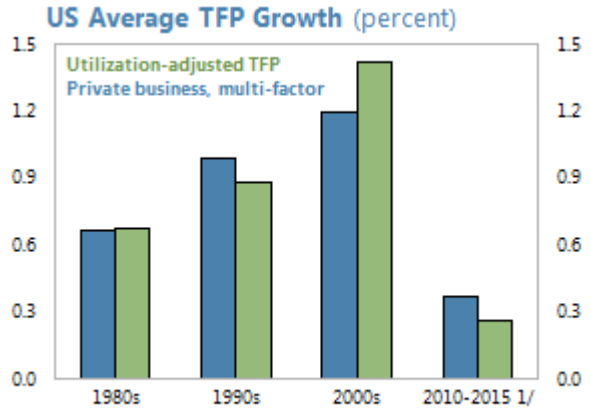
6. Sources: BLS; and IMF staff estimates

Falling labor force participation is an inevitable consequence of an aging society but those demographic effects can be mitigated. Improvements in the EITC, discussed above, will help encourage work. It will also be important to:

• Adopt *family-friendly benefits*, particularly as a policy lever to slow the downward trend in female labor force participation. These would include providing means-tested support for childcare and introducing paid family leave in line with standards in ILO conventions.

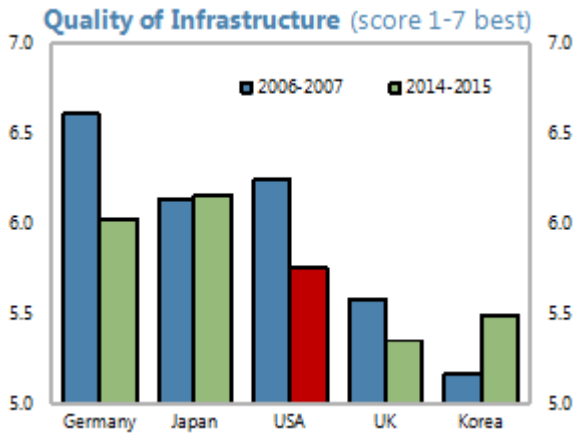
• Rework the *disability insurance* program to provide incentives for beneficiaries to work part-time (rather than drop out of the labor force).

• Finally, perhaps the largest effect on the labor supply would come from an agreement on an *immigration reform* that is skill-based, changes the underlying demographic trends, reduces the dependency ratio, and raises the average level of human capital in the labor force.



7. Sources: BLS; FRB; Haver Analytics; and IMF staff calculations
1/ For multi-factor, 2011-2015. 2010 is included in 2000s

Raising productivity and bridging the skill divide will be essential. Since the boom of the late 1990s, total factor productivity has slowed significantly. This appears to be a global trend that is not confined to the U.S. Notwithstanding this, public policy tools could help facilitate innovation and technological progress, and support efficiencies in private activity:

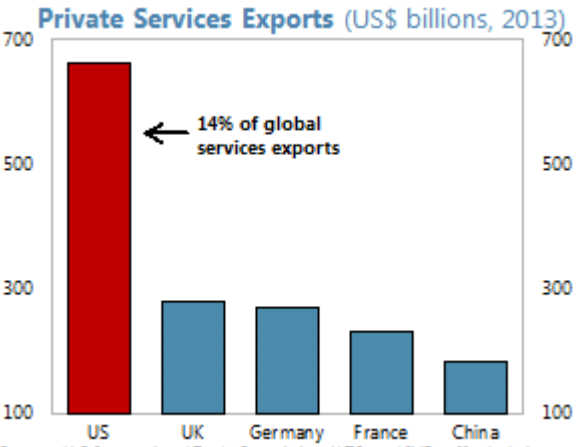


• Source: Global Competitiveness Index, World Economic Forum

Expanding infrastructure investment. The public capital stock is aging and has been declining as a share of GDP for some time. New investment is urgently required to improve the quality and reliability of infrastructure, particularly for surface transportation. This will help remove bottlenecks and congestion and add to the productivity of private activity. Public projects to upgrade infrastructure technologies (e.g. in high speed rail, ports, or telecommunications) would be particularly valuable. In parallel, innovative solutions should be sought to facilitate the financing (both public and private) of U.S. infrastructure. It is estimated that such investments could cost about 5–8 percent of GDP over the next 10 years.

• *K-12 education*. There is a clear need for better spending on education so as to raise educational outcomes. This could include prioritizing funding for early childhood education (including financing of universal pre-K) and supporting science, technology, engineering, and math programs.

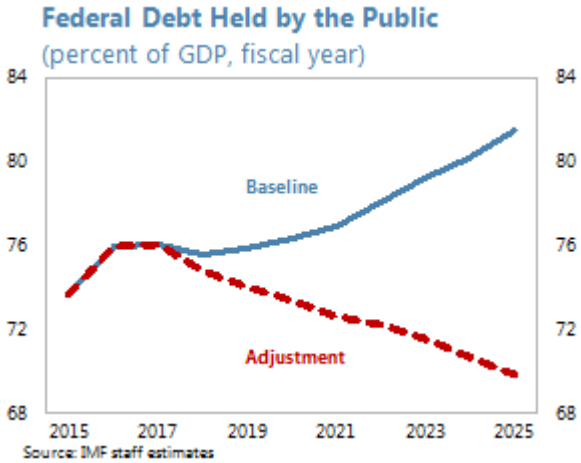
• *Vocational education*. Closing the skills gaps would be facilitated by greater federal support for state-level training as well as the expansion of partnerships between industry and higher education institutions to facilitate apprenticeships and vocational training.



• Sources: U.S. International Trade Commission; WTO; and IMF staff calculations

Trade integration. The free exchange of goods and services has been a hallmark of American economic success. New trade agreements, such as the Trans Pacific Partnership (TPP), cement and extend this principle by going beyond the removal of tariff barriers—which are already low—and include rules on investment, competition policy, intellectual property rights, and regulations. By preserving a level playing field in future growth areas, such as services, the TPP has the potential to set a new standard and pathway for international economic cooperation. It would also aid the U.S. economy by capitalizing on its strength in the fast growing area of tradable services. Resisting all forms of protectionism will also be essential. There will likely be transition costs, to both jobs and incomes, from greater trade integration as well as potential effects on income polarization. The consequences for trade-affected U.S. workers should be taken into account and policy efforts should be taken to mitigate the downsides through training, temporary income support, and job search assistance, including the deployment of the existing trade adjustment assistance program.

Since many of the policies needed to boost growth and tackle poverty will have implications for federal and state budgets, their costs should fit within a deficit envelope that achieves a sustained downward medium-term path for public debt.



8.

Near-term fiscal and monetary policies have been well-calibrated to the prevailing economic circumstances but demographic trends and rising interest rates will lead to larger fiscal imbalances over the medium-term. This will cause the federal debt to begin rising in 2019 and exceed 80 percent of GDP by 2022. Regrettably, the U.S. continues to lack a detailed medium-term fiscal consolidation plan to prevent this renewed rise in the public debt. Such a plan would need to target a medium-term federal government primary surplus of about 1 percent of GDP (a general government primary surplus of about ¾ percent of GDP). Achieving this and creating space for supply-side reforms will require actions on multiple fronts:

• *Tax reform*. A comprehensive reform of the U.S. tax system should aim at removing exemptions, simplifying the system, rebalancing from direct to indirect taxes, and reducing statutory rates for individual and corporate income taxes. Reform of the corporate income tax is badly needed and could help revitalize business dynamism and investment. In addition to rate reduction and a streamlining of business tax expenditures, tax avoidance opportunities should be reduced by tightening income-stripping rules through limits on interest deductions. For outbound investment, the U.S. corporate tax system should adopt a territorial system but impose a minimum rent tax on the foreign earnings of U.S. corporations. There should also be a mandatory tax on the existing stock of un-repatriated, foreign-sourced earnings (with payment spread over the next several years). For the personal income tax, the structure could be made more progressive so as to help mitigate income polarization and assist the working poor. This could involve capping itemized deductions, including for mortgage interest, to lessen the tax benefit for the most well off. Finally, as has been advocated in past consultations, additional revenues should be generated through the introduction of a federal level VAT and a broad-based carbon tax, including an increase in the federal gas tax (which has been 18 cents per gallon since 1993).

• *Pension reform*. The expected depletion of the social security trust fund calls for early steps toward fundamental reform of the pension system. These would include raising the income ceiling for social security contributions, indexing benefits and contribution provisions to chained CPI, raising the retirement age, and instituting a greater progressivity in the benefit structure.

• *Healthcare cost containment*. Recent reforms were accompanied by a slowdown in cost and premium increases. However, more is needed to sustainably lower the path of future healthcare costs. This could be achieved through better coordination of services to patients with chronic conditions, greater cost sharing with beneficiaries, innovations in efficiency technologies (e.g. electronic health care records, remote consultations with doctors, international outsourcing of some diagnostic functions), and changing incentives away from remuneration per procedure and toward payments for achieving specified health outcomes. Higher Medicare premiums would also help address financial imbalances in the publicly-funded health system.

9. Steps should be taken to avoid self-inflicted wounds from future disagreements on the path for fiscal policy. Whatever gains could be achieved in supporting growth through the supply-side

measures described above could be easily dissipated by a repetition of past political brinkmanship over appropriations and the debt ceiling. Near-term uncertainties have certainly been diminished by the passage of the Bipartisan Budget Act of 2015, the Protecting Americans from Tax Hikes Act, and the Fixing America's Surface Transportation Act. However, it will be important to identify more lasting institutional solutions. One possibility would be to replace the debt ceiling with a bipartisan agreement on a clear, simple medium-term fiscal objective (with an integrated view of all budget functions and numerical goals for both debt and deficit). Alternatively, a legislative process could be introduced that adjusts the debt ceiling automatically, consistent with whatever agreement is struck on the broader budget parameters. Consideration could also be given to more permanently shifting to a budget cycle where annual spending levels are agreed for a two-year period (helping to divorce budget decisions from the electoral calendar).

10. Evidently, monetary policy should remain data dependent. At this point in the cycle, there is a clear case to proceed along a very gradual upward path for the fed funds rate, conscious of global disinflationary trends and confirming along the way that wage and price inflation are indeed maintaining their steady upward momentum. Given the likelihood and severity of downside risks to inflation, the potential for a drift down in inflation expectations, the Fed's dual mandate of maximum employment and price stability, and the asymmetries posed by the effective lower bound, the path for policy rates should accept some modest, temporary overshooting of the Fed's inflation goal to allow inflation to approach the Fed's 2 percent medium-term target from above. Doing so will provide valuable insurance against the risks of disinflation, policy reversal, and ending back at a zero fed funds rate. The Fed should be clear in communicating its intentions and emphasize that its medium-term inflation goal is symmetric and that inflation could well approach their target from above. If either wage or price inflation becomes visible at a faster pace than is embedded in staff's current forecasts, interest rates should be raised on a more front-loaded timetable.

11. Regulatory reforms, improved risk management practices, and changing business practices have strengthened the U.S. banking system. Nevertheless, a small number of non-systemic banks with a high portfolio concentration in distressed sectors (notably energy and mining) are likely to see increases in loan losses. Furthermore, a potential worsening of credit quality for auto and commercial real estate loans could create a broader increase in provisioning needs. All in all, though, these downsides represent pockets of vulnerability but are unlikely to prove systemic.

12. Intermediation activity is further migrating from banks to nonbanks and is likely to continue to do so as policy rates increase. For instance, mortgage origination and servicing have, to a large extent, moved off of bank balance sheets into specialized entities that sell the loans for eventual securitization by government sponsored agencies. As the structure of the housing finance industry evolves, the associated risks bear close examination. Many of the policy recommendations for this and other segments of the nonbank system made during the 2015 Financial Sector Assessment Program remain pertinent today. But two areas are worth reiterating:

- *Asset managers*. To adequately analyze the evolution of interconnections, exposures, and potential buildup of risks among asset managers, there is a strong case to accelerate the work on building a more complete and transparent data landscape of the asset management industry. This should go hand in hand with a structured effort to implement comprehensive stress testing programs for the asset management industry that focus on liquidity and counterparty risks.
- *The life insurance industry*. The absence of harmonized national standards or consolidated supervision makes any assessment of risks in the industry necessarily tentative and incomplete. A coordinated, nationally consistent approach to regulation (particularly valuation and solvency requirements), supervision, and stress testing is needed with regulatory oversight assigned to an independent agency with a nation-wide mandate, operational independence, and appropriate powers and accountability. For designated institutions, enhanced prudential standards should be implemented without further delay.

13. The gains made in improving financial oversight need to be preserved. Over the past several years a series of decisive measures were put in place to lessen the potential for financial stability risks, including enhanced capital and liquidity requirements, strengthened underwriting standards in the housing sector, greater transparency to mitigate counterparty risks, and limits on proprietary trading. The Dodd Frank Act requirements have stimulated supervisory intensity, with increased

emphasis on banks' capital planning, stress testing, and corporate governance. The Federal Reserve's Comprehensive Capital Analysis and Review process has proven to be particularly valuable. However, eight years after the inception of the financial crisis, political support behind the reform of the financial system has clearly ebbed and there is a danger that the indispensable progress that has been made may stall or be rolled back. Of course, it is natural to recalibrate some aspects of the oversight system as changes are seen in action. Nevertheless, it will be important to oppose any wholesale or broad-based efforts to dilute the provisions of the Dodd-Frank Act.

14. The withdrawal of correspondent banking relationships has created prospective spillover risks for some countries, particularly those that are unable to substitute to other financial connections in a timely manner. As in other jurisdictions, a number of globally active U.S. banks have been reducing their correspondent banking relationships with counterparts in a range of countries. There is a confluence of factors potentially driving this phenomenon—including shortcomings in the anti-money laundering / combatting the financing of terrorism (AML/CFT) framework in recipient countries, higher supervisory scrutiny, the changing global economic environment, profitability concerns, low margins in correspondent banking, changing liquidity and capital requirements, a broader reorientation of bank business models, insufficient regulatory clarity, reputation concerns of the banks, possible conflicts in regulations (e.g. with data privacy laws), and economies of scale in compliance. Adherence to the international standards on AML/CFT and the sharing of tax information would help to alleviate concerns about the adequacy of controls at recipient institutions. On the U.S. side, the legal framework for sanctions, AML/CFT, and tax information sharing appears to be applied in a manner that is proportional to the seriousness of the violation. Nevertheless, regulators should continue their investments in outreach and in the ongoing clarification of regulatory expectations. While the risk-based regulatory approach should strive to provide more clarity, there should be no expectation that U.S. regulators and enforcement agencies are able to offer either certainty or "safe harbor". The U.S. should continue its efforts to assist recipient countries to build capacity and work with other jurisdictions to foster global and bilateral solutions to data privacy impediments. It is worth exploring mechanisms for U.S. financial intermediaries to lessen the fixed costs of compliance and risk management by pooling resources and exploiting economies of scale (e.g. utilizing specialist transfer and clearing services, building common platforms, and sharing information on clients). There may also be scope for U.S. banks to vary more the risk-pricing of correspondent services so as to factor compliance costs into their fee structure and make the risk-return profile more efficient.

15. A more structured, uniform and complete solution is needed to the current lack of transparency in beneficial ownership in the U.S. Given that corporate registration and trusts are governed by the states under a variety of statutes, this will require federal legislation to make beneficial ownership information readily available to regulatory and law enforcement bodies.