

United States of America: Staff Concluding Statement of the 2023 Article IV Mission

May 26, 2023

A Concluding Statement describes the preliminary findings of IMF staff at the end of an official staff visit (or 'mission'), in most cases to a member country. Missions are undertaken as part of regular (usually annual) consultations under [Article IV](#) of the IMF's Articles of Agreement, in the context of a request to use IMF resources (borrow from the IMF), as part of discussions of staff monitored programs, or as part of other staff monitoring of economic developments.

The authorities have consented to the publication of this statement. The views expressed in this statement are those of the IMF staff and do not necessarily represent the views of the IMF's Executive Board. Based on the preliminary findings of this mission, staff will prepare a report that, subject to management approval, will be presented to the IMF Executive Board for discussion and decision.

Washington, DC:

Resilient Demand and a Robust Labor Market

The U.S. economy has proven resilient in the face of the significant tightening of both fiscal and monetary policy that took place in 2022. Consumer demand has held up particularly well, boosted initially by a drawdown of pent-up savings and, more recently, by solid growth in real disposable incomes. Prime age labor force participation has risen above its pre-pandemic peak, the unemployment rate for women and African Americans has fallen to historical lows, and real wages have been rising faster than inflation since mid-2022. Growth of around 1.2 percent (on a q4/q4 basis) is expected for this year, modestly picking up momentum later in 2024. This slowing, but still-solid, growth is expected to be associated with unemployment rising slowly to close to 4½ percent by the end of 2024.

Rising wages for lower income workers, rapid employment growth, and pandemic-related government transfers made important inroads into reducing poverty in 2021. Most notably, the share of the population living in poverty fell markedly from 11.8 percent in 2019 to 7.8 percent in 2021 and the poverty rate for black and Hispanic households fell by almost twice as much as the national average. Close to half of this improvement came from fewer children living in poverty (mostly due to the economic impact payments and the fully refundable child tax credit). Unfortunately, these impressive gains in tackling poverty appear to have been largely unwound in 2022 as pandemic benefits expired and real wage growth for lower income workers moderated.

A Persistent Inflation Problem

The strength in demand and in labor market outcomes is a double-edged sword, contributing to more persistent inflation. Goods inflation has leveled out and shelter price growth is expected to start moderating in the coming months. However, past nominal wage increases are now feeding into non-shelter services. While core and headline PCE inflation are expected to continue falling during 2023, they will remain materially above the Fed's 2 percent target throughout 2023 and 2024.

Achieving a sustained disinflation will necessitate a loosening of labor market conditions that, so far, has not been evident in the data. To bring inflation firmly back to target will require an extended period of tight monetary policy, with the federal funds rate remaining at 5¼–5½ percent until late in 2024. Model estimates suggest such a path would be sufficient to slow demand, restore balance to the labor market, and lower wage and price inflation. However, insofar as models are calibrated on past experiences, they offer only an imperfect guide to the current conjuncture.

Given the important uncertainties facing the U.S. economy, it will be essential for the Federal Reserve to communicate carefully how it assesses the incoming data and to provide clear guidance on what this means for its expected path of the policy rate. In this regard, greater emphasis should be placed on the need for interest rates to remain at high levels for an extended period of time. This may help align financial conditions more closely with the intended path for policy. Communications should continue to underscore, though, that the FOMC's forward guidance is not set in stone and actual policy outcomes will depend critically on incoming data.

United States: Selected Economic Indicators

	2022	2023	2024
Real GDP (annual growth, percent)	2.1	1.7	1.0
Real GDP (Q4/Q4, percent)	0.9	1.2	1.1
Headline PCE inflation (Q4/Q4, percent)	5.7	3.8	2.6
Core PCE inflation (Q4/Q4, percent)	4.8	4.1	2.8
Unemployment rate (Q4 average, percent)	3.6	3.8	4.4
Current account balance (percent of GDP)	-3.7	-2.8	-2.5
Federal funds rate (end of period, percent)	4.4	5.4	4.9
Ten year government bond rate (Q4 average, percent)	3.8	4.0	3.7

Federal fiscal balance (percent of GDP)	-5.5	-5.6	-5.7
Federal debt held by the public (percent of GDP)	97.0	96.6	98.4

Important Near-Term Risks

The resilience of the economy and the robustness of labor markets are good news. However, it is possible that the large and rapid increase in interest rates that has already been put in place may not be sufficient to expeditiously bring inflation back to target. With a large share of household and corporate debt contracted at relatively long duration and fixed rates, household consumption and corporate investment have proven less interest-sensitive than in past tightening cycles. This creates a material risk that the Federal Reserve will have to raise the policy rate by significantly more than is currently expected to return inflation to 2 percent. On the positive side, near-term growth outcomes could be better than currently anticipated. However, this would only mean that the economy would slow more abruptly at a later stage (possibly in 2024), creating a recession as tighter monetary policy takes hold. The combination of higher U.S. interest rates, a stronger dollar, and a sharper slowdown in U.S. activity would have significant negative macro-financial spillovers to the rest of the world.

The downside risks associated with a less effective monetary transmission, and a more protracted disinflation, could be further complicated by two additional considerations:

First, a higher path for interest rates could reveal larger, more systemic balance sheet problems in banks, nonbanks, or corporates than we have seen to-date. Unrealized losses from holdings of long duration securities would increase in both banks and nonbanks and the cost of new financing for both households and corporates could become unmanageable. Such a tightening of financial conditions could trigger an increase in bankruptcies, worsen credit quality, and heighten stress for those entities carrying high levels of leverage and with large near-term gross financing needs. These financial stability problems could be further exacerbated if the functioning of the Treasury market also becomes compromised. The longer that higher interest rates persist, the greater the likelihood that such fractures will be revealed. Recent failures of large, non-internationally active banks—which have, so far, only had a modest effect on credit conditions—could potentially be a prelude to more serious and ingrained systemic financial stability problems.

Second, brinkmanship over the federal debt ceiling could create a further, entirely avoidable systemic risk to both the U.S. and the global economy at a time when there are already visible strains. To avoid exacerbating downside risks, the debt ceiling should be immediately raised or suspended by Congress, allowing negotiations over the FY2024 budget to begin in earnest. Furthermore, a more permanent solution to this recurring stand-off should be found through institutional changes that ensure that, once appropriations are approved, the corresponding space on the debt ceiling is automatically provided to finance that spending.

Fiscal Imbalances Remain Unaddressed

On a general government basis, fiscal policy is expected to be procyclical in 2023. With the economy operating well above potential and inflation a persistent problem, there is a

strong case for greater fiscal restraint in 2023-24. A tighter fiscal stance would lessen the burden on the Federal Reserve in disinflating the economy, potentially reducing the downside risks outlined above.

Beyond the near-term need for fiscal tightening, a more significant adjustment (i.e., an increase of around 5 percent of GDP in the general government primary balance) is required to put public debt on a decisively downward path by the end of this decade. It is worth noting that, even with such an ambitious adjustment, debt would remain well above pre-pandemic levels over the next decade.

Generating social and political consensus to undertake such an adjustment will be challenging. However, precluding increases in the taxation of those earning under US\$400,000 per year or changes to social security and Medicare will ultimately make such an adjustment infeasible. Rather, a smaller federal deficit will require deploying multiple policies. Revenues could be increased through a broad-based federal consumption tax, a carbon tax, higher taxation of corporates and high-income individuals, scaling back poorly targeted tax expenditures (such as for employer-provided health care, sale of the principal residence, mortgage interest, and state and local taxes), closing tax loopholes, reducing the minimum threshold for the estate tax, and further improving revenue administration. Social security benefits could be indexed to chained CPI, the income ceiling for social security contributions could be raised and increases in the retirement age could be more front-loaded. Health care costs could be lowered through greater cost sharing with beneficiaries and changes in the mechanisms for remunerating healthcare providers.

Maximizing the Benefits from Open Trade

Over the last few years, global concerns have been raised over the resilience of supply chains, including as relates to national security. In this context, the Inflation Reduction Act, the CHIPS Act, and the Build America, Buy America Act have included provisions that are explicitly designed to favor goods and services produced in the U.S. or in North America. We know from experience that protectionist provisions distort trade and investment and risk creating a slippery slope that will fragment global supply chains and trigger retaliatory actions by trading partners. As such, these “Made in America” policies are ultimately bad for U.S. growth, productivity and labor market outcomes.

Rather than favoring domestic producers over foreign, the U.S. would be better served by maintaining the open trade policies that have been vital to boosting growth. In addition to instituting new preferences, the U.S. has also kept in place many of the tariffs and other trade distortions that were introduced over the past five years. These should be rolled back as a means to facilitate similar reductions in tariffs by trading partners.

Trade policy would be better bolstered by increasing productivity and competitiveness through investments in worker training, apprenticeships, and infrastructure, thus lifting the ability of U.S. firms and workers to compete internationally. The U.S. should actively engage with all major trading partners to address the core issues that risk fragmenting the global trade and investment system. This includes finding common ground in areas such as tariffs, farm and industrial subsidies, and services trade. It also includes ensuring that new trade initiatives are used to further trade integration between trading partners, and not as discriminatory tools that create incentives for fragmentation.

Finally, to better capitalize on the significant economic benefits that multilateralism and open trade have brought the U.S. should redouble efforts to strengthen the WTO. This

would mean avoiding discriminatory measures that undermine the rules-based trading system. It would also mean working to restore a well-functioning WTO dispute settlement system by 2024. Taken together, these actions would help promote the trade policy certainty that is essential to investment and growth.

Financial Stability Risks at the Forefront

Recent bank failures highlight the potential systemic risks posed by even relatively small financial intermediaries. The past few months have focused attention on poor risk management by individual institutions, vulnerabilities created by the regulatory “tailoring” that was put in place in 2018, and inadequate supervisory oversight. Important questions have been raised about the insufficiently assertive stance taken by bank supervisors as well as the effectiveness of the stress tests that were undertaken to identify the extent of bank vulnerabilities and the potential for systemic contagion. It has become clear that, despite correctly diagnosing the vulnerabilities in the system, the actions that were subsequently taken by supervisors neither prevented the most vulnerable banks from continuing to grow rapidly nor precipitated fundamental changes to these banks’ operations.

To better mitigate systemic risks, prudential requirements should be made more stringent for mid-sized banks, subjecting them to similar requirements as larger banks. Specific changes for non-internationally active banks (i.e., Category III and IV firms) should include (i) subjecting them to stress testing as part of the annual supervisory stress testing process; and (ii) aligning their capital and liquidity requirements with the Basel framework (including applying coverage of the liquidity coverage ratio and the net stable funding ratio). More explicit rules and processes should be instituted to escalate supervisory actions in the event a bank does not undertake a timely response to address supervisory warnings. There would be benefit in also strengthening the stress testing framework to examine a broader range of possible scenarios and undertake integrated solvency-liquidity stress tests. A more methodical process should be adopted to assess banks’ exposure to interest rate risk—in both the available for sale and the hold to maturity portfolios—and have a supervisory response in cases where these risks are seen to be building. More standardized disclosure requirements on interest rate risk may also help. Finally, the practice of not applying margins to collateral at the discount window (that were introduced in March) should be viewed as an extraordinary step and, as such, should be discontinued when the Bank Term Funding Program is scheduled to expire.

High leverage, liquidity and duration mismatches, as well as interconnectedness between banks and non-bank financial institutions pose additional risks. Flows into money market funds have accelerated following the regional bank failures and there are risks that banks become increasingly disintermediated. This reallocation across intermediaries may encounter issues in market liquidity and functioning, with unpredictable consequences. Furthermore, the various failures of crypto-related entities illustrate the need for greater oversight of that sector, including from the perspective of consumer protections. Finally, nonbank intermediaries play an important role in commercial real estate including through real estate investment trusts and commercial mortgage-backed securities. Commercial real estate contains significant leverage, has important near-term financing needs, is going through a significant adjustment to changing patterns of demand, and may well come under pressure as regional banks reduce exposure. This could, in turn, have uncertain spillover effects to the nonbanks which merit further analysis and monitoring.

The last few years have seen U.S. fixed income markets prove to be insufficiently resilient under stress. Data on the operations of the Treasury market has been improving and a standing repo facility has been established by the Fed to provide liquidity and contain upside spikes to short-term interest rates. The interagency working group on Treasury market resilience has put forward proposals to improve market functioning including an expansion of all-to-all trading and greater use of central clearing. Increasing dealer capacity to intermediate the Treasury market by excluding Treasuries from the calculation of the Supplementary Leverage Ratio may also help. Some of these have led to rule change proposals that have been circulated for public comment. There now needs to be an effort to translate this work into institutional changes that strengthen the functioning of the Treasury market.

An Urgent Need to Invest in Supply Side Reforms

A range of policies were proposed in the President's budget that would help address supply side constraints to growth. These include:

- Tackling poverty by increasing the child tax credit, making it fully refundable and advanceable, expanding the earned income tax credit for workers without qualifying children, broadening Medicaid coverage, and expanding nutrition support.
- Incentivizing greater labor force participation by providing more federal resources for childcare and guaranteeing paid family leave for private sector workers.
- Expanding healthcare coverage through tax credits for lower income individuals that purchase privately provided health insurance.
- Increasing access to education including through universal pre-school, subsidizing higher education for lower income households, and supporting vocational training and apprenticeships.
- Improving progressivity by increasing income tax rates on high earners, taxing carried interest as ordinary income, and ensuring that when appreciated assets are given as a gift (or upon death), capital gains would be realized and represent taxable income to the donor (or the decedent's estate).
- Revising the global minimum tax regime, adopting an undertaxed profits rule, and limiting the scope for tax inversions.
- Limiting opportunities for tax avoidance by scaling back various embedded corporate income tax incentives (including eliminating all tax preferences for fossil fuel producers).

These proposed policies merit adoption but should be couched within a medium term fiscal framework that puts debt-GDP onto a downward path.

Forward Momentum on Climate But There's More To Do

Policies in the Inflation Reduction Act are a big step forward and have the potential to decarbonize the U.S. economy, lowering greenhouse gas emissions by around 36 percent by 2030 (relative to 2005 levels). However, rapid deployment of green energy generating capacity and achieving the full potential of the Act's measures will hinge on overcoming

implementation challenges, such as delays in permitting projects and electricity transmission siting.

Beyond this important policy package, more remains to be done to ensure emission reductions reach the U.S. objective of a 50–52 percent reduction by 2030. Additional steps could include a further tightening of state-level or federal regulations (including on fuel efficiency or tighter regulation of CO₂ emissions from power plants), ensuring that the upcoming reauthorization of the Farm Bill prioritizes changing incentives for carbon intensive agriculture and supports carbon sequestration, and start building the necessary social consensus to begin pricing carbon. The U.S.'s very flexible labor markets will be an advantage in facilitating decarbonization. Nonetheless, training and financial support for the most affected workers would help facilitate a faster reallocation of labor and lower societal costs of the transition. This would help ensure that reducing emissions garners broad societal support and does not leave behind those communities that are currently reliant on fossil fuels for jobs, activity, and local tax revenue.