The United States has experienced long periods of external and fiscal imbalances. Fiscal deficits were substantial in the mid-2000s and widened significantly during the financial crisis. External deficits have reflected weak fiscal balances and other factors contributing to low national saving, including external factors that underlie strong foreign demand for U.S. assets. Going forward, large budget deficits and moderate current account deficits are projected to persist, exacerbating U.S. and global vulnerabilities. Policies to restore soundness to public finances include limiting the growth of expenditures (crucially, through entitlement reform) and raising revenues (including through tax reform). Robust financial regulation is equally important to safeguard stability and to prevent excessive credit and leverage that led to the buildup of systemic risk and unsustainably low household saving in the past. Achieving strong, sustainable, and balanced growth would require rebalancing away from a heavy reliance on private consumption (before the crisis), followed by fiscal support (during the crisis), toward an increasing contribution from external demand.

 Fiscal and current account deficits have been a persistent feature of the U.S. economy for several decades (Figure 3.1). These “twin deficits” emerged from a near-synchronous deterioration in the budget and external positions in the first half of the 1980s. However, the link has not always been tight—as evident from the experience of the late 1990s. During that time, widening trade deficits were led by business investment and facilitated by large capital inflows in the form of foreign direct investment and equity portfolio investment—both in response to an increase in U.S. productivity growth. Meanwhile, an improving fiscal position benefited from a strong economy, a booming stock market, and tax increases that boosted revenues, as well as from the “peace dividend” marking the end of the Cold War, welfare reform, and strengthened budget discipline.2

1Vladimir Klyuev is a Senior Economist in the IMF Research Department. This chapter has benefited from guidance from Hamid Faruqee and the support of Eric Bang, David Reichsfeld, and Anne Lalramghakhli Moses.

2The 1990 Budget Enforcement Act included caps on discretionary spending and PAYGO requirements, which restrained expenditure growth. See Mühleisen and Towe (2004).
An appreciable widening of U.S. imbalances preceded the Great Recession (Figure 3.2). After 2000, twin deficits reasserted themselves, led by both cyclical and structural factors heading into the financial crisis. Specifically, the period saw the following turn of events:

- **U.S. fiscal balances experienced a substantial turnaround from surplus to deficit.** Fiscal loosening reflected a variety of economic and policy-related factors, including tax stimulus following a downturn, complacency from past budget surpluses, and increased military spending (Box 3.1).
Fiscal deficits moderated in the mid-2000s, but budgetary prospects remained worrisome. As the economy came out of recession, the stock market regained momentum, the housing market boomed, and tax receipts recovered some lost ground. However, with an aging population and further escalation of already-high medical costs, expenditures on social security and health care were still projected to rise at an alarming rate. The pressure was exacerbated by a new prescription drug benefit (Medicare Part D) that came into effect in 2006.

**BOX 3.1**

**U.S. Fiscal Turnaround**

The dramatic turnaround in the U.S. fiscal situation from surplus to deficit was caused by a combination of shocks and policies. The burst of the dot-com bubble in 2000 pushed the U.S. economy into a brief recession in the next year, exacerbated by the shock of the September 11 terrorist attacks. The cyclical downturn and capital losses from lower equity prices lowered federal tax receipts by about 1 percent of GDP in FY2001 relative to the previous year. A package of major tax cuts was then legislated in 2001, partially motivated by the need to stimulate the economy.

Fiscal complacency and increased security spending were also important factors. Initially there was a perception that tax rates were too high given projected budget surpluses under unchanged policies, projected elimination of (net) public debt and possible accumulation of public assets, and the political desire to share surpluses with current taxpayers. But even as the federal budget balance swung from +2.4 percent of GDP in 2000 to −3.5 percent in 2003, another major round of tax cuts was passed that year. In addition, counterterrorism measures and military operations triggered by the September 11 attacks added to the fiscal burden. Outlays on national defense doubled between FY2001 and FY2008. The associated turnaround in the U.S. fiscal outlook was reflected in the sharp change in Congressional Budget Office projections occurring between 2001 and 2004 (see Figure 3.1.1).

**Figure 3.1.1** Congressional Budget Office Baseline Projections by Vintage *(Percent of GDP)*

Fiscal deficits moderated in the mid-2000s, but budgetary prospects remained worrisome. As the economy came out of recession, the stock market regained momentum, the housing market boomed, and tax receipts recovered some lost ground. However, with an aging population and further escalation of already-high medical costs, expenditures on social security and health care were still projected to rise at an alarming rate. The pressure was exacerbated by a new prescription drug benefit (Medicare Part D) that came into effect in 2006.
• **On the private side, the driver of U.S. external deficits changed from business investment to consumption and construction.** During this period, the current account deficit increasingly reflected falling saving rates and booming homebuilding activity rather than higher business investment following the compression of equity prices and damage to corporate balance sheets. Consumption and residential investment led the recovery and expansion, increasing as a share of GDP. Alongside increased public dissaving, household saving rates fell to historical lows, fueling consumption and housing booms.

• **Relaxed financial conditions, weakening credit standards, rising leverage, and booming asset markets contributed to escalating systemic risk (Figure 3.3).** Easy credit—supported by low interest rates, financial innovation, and lax regulation and supervision—fueled the rapid rise of household consumption. Surging house prices also encouraged a rapid accumulation of private debt and increasing leverage, including through mortgage equity withdrawals. Lending standards deteriorated and credit risks were mispriced owing to market complacency and the “search for yield.”

• **U.S. assets were in high demand from international investors, limiting dollar depreciation and allowing large external deficits to persist.** Accumulation of reserves by foreign central banks was a major source of U.S. external financing (Figure 3.4). Robust private demand from abroad for securitized assets added to capital inflows.

![Figure 3.3](image-url)
Some narrowing of imbalances occurred prior to the crisis as conditions began to change, but this proved insufficient. Mortgage interest rates began climbing in 2005, home prices peaked in 2006, and bank lending standards started tightening at the end of that year, bringing the construction and housing boom to an end. With residential investment sharply down, and given past dollar depreciation, the current account balance bottomed out in 2006 and improved noticeably over the following two years. While the acute phase of the crisis broke out in September 2008 with the collapse of Lehman Brothers, these gradual corrections had started earlier, but unfortunately failed to prevent a systemic financial crisis.

Following the crisis, external imbalances compressed, but fiscal imbalances deteriorated dramatically. The crisis, which ostensibly originated in the U.S. subprime mortgage market, accelerated a narrowing of the trade balance (partly reflecting sharply falling oil prices), despite a temporary rebound in the dollar (the “safe haven” effect), which maintained its status as the dominant reserve currency (Figure 3.5). With consumer spending dampened by extraordinary uncertainty, a sharp drop in asset prices, and tight credit conditions, private saving rebounded while investment contracted. In contrast, government spending was stepped up and public finances deteriorated substantially as a result of the automatic stabilizers, fiscal stimulus, declining asset prices, and large financial system support caused or necessitated by the sharp economic downturn.
The United States: Resolving “Twin” Deficits

ROOT CAUSES OF IMBALANCES

Fiscal Imbalances

Several key factors underpin present and projected large U.S. fiscal deficits. These include (1) structural factors underlying precrisis deficits; (2) legacy effects from the crisis itself on the fiscal accounts; and (3) underfunded entitlement obligations. This section elaborates on each of these areas.

The U.S. fiscal position was structurally unbalanced before the crisis began. Specifically, a structural shortfall in tax revenues relative to augmented spending commitments at the federal level became evident in the early 2000s. The 2001 and 2003 tax cuts reduced federal revenue by over $2.5 trillion over the following 10 years. Although these tax cuts were scheduled to expire, returning to higher marginal rates has turned out to be politically difficult. Separately, after decades of using tax incentives to promote various objectives, the tax code is extremely complex and ridden with inefficiencies. On the spending side, while discretionary nondefense expenditure had been squeezed before the crisis, high military and security spending has persisted since the 9/11 terrorist attacks.

Figure 3.5  Foreign Exchange Reserves by Currency (Percent of allocated reserves)


3Part of that sum includes the impact of alternative minimum tax relief.
4The report of the National Commission on Fiscal Responsibility and Reform (2010) identifies $1.1 trillion annually in tax expenditures. For corporations, tax loopholes are responsible for a combination of high statutory rates and relatively low revenue collection. For households, mortgage interest rate deductions to promote home ownership are typically not taken advantage of by low-income households (who need the most help to buy a residence) as they tend not to itemize deductible expenses.
The adverse impact of the crisis on budget balances has been large and multifaceted. Perhaps the single largest effect of the crisis on the U.S. fiscal position has come through the revenue side because of output and asset price declines. Moreover, a downward shift in potential output relative to its precrisis trend has lowered revenue-raising capacity in the United States. Direct measures to support a damaged financial system also increased public debt (albeit marginally). Finally, the weak cyclical state of the economy necessitated fiscal stimulus and later made it harder to undertake fiscal tightening in a situation where the scope for further monetary stimulus was very limited.

The reliance of local governments on property taxes, coupled with the expectations of a prolonged housing slump, has made their fiscal situation particularly difficult.

Moreover, longer-term fiscal pressures on the U.S. budget continue to grow. Notably, growth in entitlement spending has placed an increasing strain on public finances. A large part of the increase is driven by population aging, which will also have a negative effect on budget revenue and on GDP by reducing the labor supply. The Congressional Budget Office projects federal spending on social security and health care to increase from 10.3 percent of GDP in FY2010 to 13.2 percent in FY2025.\(^5\) Over longer horizons, the rise in entitlement spending will be increasingly driven by what is called “excess cost growth.” This means that health care costs per beneficiary (adjusted for changes in the age profile of the population) will grow faster than GDP per capita. Excess cost growth is a common problem in advanced economies, but the level of health care spending in the United States is about twice the average of the Organization for Economic Cooperation and Development countries, and even then with only average health outcomes (Figure 3.6). On the public pension side, social security benefits are

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\(^5\)Health care programs include Medicare, Medicaid, CHIP, and health care exchange subsidies. State expenditure on Medicaid will also increase.
already exceeding contributions. In addition, state and local governments will have increasing difficulty in meeting pension and medical care obligations to their retirees. Underfunded private pensions also pose some budgetary risk.

In the face of these budgetary pressures, fiscal rules currently do not impose sufficient discipline. During the run-up to the crisis, the United States did not have a formal anchor on fiscal policy at the federal level. The PAYGO rule has been bypassed frequently. The constraints imposed by the discretionary spending caps (established by the 2011 Budget Control Act) and by the debt ceiling are unrealistically tight and for that reason are expected to be lifted. Indeed this has happened to the debt ceiling on several occasions. While having played a useful role in focusing the political agenda on fiscal issues, these constraints have increased market uncertainty. More credible rules would be preferable.

Finally, political polarization continues to complicate reaching an agreement on a roadmap for budgetary consolidation. The two main political parties' ideological positions have become entrenched in recent years, with staunch opposition on one side to any tax increase or on the other side to any major welfare benefit cut. The political stalemate has precluded a general accord on the contours of decisive medium-term fiscal adjustment. The standoff over raising the federal debt ceiling and the inability to pass FY2011 appropriation bills are recent manifestations. In 2012, concerns came to the fore about the “fiscal cliff”—a large, disruptive, and untargeted budget tightening envisaged under current law—with all major actors agreeing on the need to avoid the contraction, but not on how to achieve it.

**External Imbalances**

Large external deficits reflected a combination of weak fiscal balances, low private saving, and brisk residential investment. The configuration of private saving-investment imbalances, in turn, was driven by an underlying confluence of domestic and external factors, including strong foreign demand for U.S. assets. Let’s take each in turn.

Preeminent domestic factors—reflected, inter alia, in large financial imbalances—included key market and policy failures that led to a dangerous buildup of systemic risk. The housing boom and bust, the increase in financial and household debt and leverage, and the decline in household saving can be traced to these underlying factors. More specifically, the imbalances can be attributed to the circumstances outlined below.

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While the federal government is not directly responsible for private pensions, systemic underfunding may create a call on the Pension Benefit Guarantee Corporation (PBGC). In that eventuality, PBGC resources would likely prove insufficient, and there may be pressure on the federal government to step in.

According to the Tax Policy Center, PAYGO, which stands for pay-as-you-go, “is a budget rule requiring that, relative to current law, any tax cuts or entitlement and other mandatory spending increases must be paid for by a tax increase or a cut in mandatory spending.”

See IMF (2009) for a discussion.
• A rapid rise in private consumption, fueled by a housing bubble, was symptomatic of market complacency and an unsustainable credit boom. This can largely be attributed to excessive financial risk-taking and inadequate regulation alongside accommodative monetary and financial conditions. Overly optimistic expectations about the future growth in income and particularly rising house prices (extrapolating unsustainable trends) further contributed to the decline in private saving and wider external deficits.

• Misaligned incentives in the financial system were partly responsible for a fundamental breakdown in market discipline and mispricing of risk. At the center of the crisis was the combination of factors that led private agents to make poor decisions that ultimately created vulnerabilities in a financial system that was increasingly unable to sufficiently regulate itself (Greenspan, 2010). This included excessive leverage and risk-taking in the context of unusually low market volatility, interest rates, and the “search for yield,” all against a backdrop of a global saving glut and the Federal Reserve’s accommodative monetary stance in the first half of the 2000s that depressed both long- and short-term interest rates; moral hazard problems that eroded market discipline in large, systemically important institutions that were too big to fail; agency and incentive problems surrounding innovative but complex securitization instruments and the “originate-to-distribute” lending model; and insufficient risk and liquidity management by financial institutions that were increasingly reliant on wholesale funding markets that became disrupted when the crisis began (Gorton and Metrick, 2011).

• Public oversight was insufficient to correct market failures. A fragmented regulatory system and its frameworks were unable to keep pace with a fast-changing financial landscape. Risky financial activities and credit creation increasingly migrated beyond the traditional banking system—outside a narrow regulatory perimeter that failed to recognize and allowed a buildup of systemic risk in the “shadow banking” system. Even with regulated banks, off-balance-sheet vehicles were used to circumvent existing regulations (e.g., capital standards). An overreliance by investors on credit rating agencies with conflicts of interest proved costly in case of structured instruments

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10See the IMF’s Global Financial Stability Reports for 2008 and 2009 and IMF (2009) for detailed discussions of such issues as faulty credit ratings; the rise and fall of securitization and incentive problems with the “originate-to-distribute” lending model; the role of mark-to-market accounting and procyclicality in credit; problems with liquidity management; and the role of off-balance-sheet entities and regulatory arbitrage heading into the crisis.

11See Adrian and Shin (2010). The role of U.S. monetary policy in the crisis remains controversial. Some have argued that policy rates were too low for too long (e.g., compared to a Taylor rule), contributing to subsequent financial excesses and the housing boom (see Taylor, 2009). Greenspan (2010), however, argues that the main factor was low long-term interest rates given the global saving glut. In his assessment, the stance of monetary policy was broadly appropriate from a macroeconomic standpoint given lower equilibrium (or neutral) rates of interest, with output near potential and inflation near target. However, low interest rates encouraged greater financial leverage and risk-taking in the absence of established macroprudential policy instruments.
(e.g., credit default obligations). Rapid financial innovation encouraged the proliferation of these complex and poorly understood instruments that escaped greater financial oversight. Finally, thinly-capitalized government-sponsored enterprises (enjoying an implicit public guarantee) were major players in mortgage securitization and created a large contingent liability for the government that was eventually called upon when the housing bubble burst.

Key external factors involved high foreign demand for U.S. financial assets (including reserve holdings); dollar pegs in major surplus emerging market economies; and high oil prices. Burgeoning external deficits were financed at low interest rates by growing purchases of U.S. assets by surplus countries with high saving, which slowed dollar depreciation, further encouraging U.S. consumption and imports and affecting export competitiveness through a more appreciated currency than otherwise. Dollar depreciation started in 2002 and continued through 2008 in real effective terms. This did have a delayed effect in narrowing the current account imbalance by the mid-2000s, but its impact on the external position was muted by a run-up in commodity prices. More specifically, the imbalances can be attributed to the circumstances outlined below.

- The depth, breadth, and innovativeness of U.S. financial markets made them an attractive destination for various classes of investors (Figure 3.7). The safety and liquidity of the U.S. Treasury bond market reinforced the dollar’s role as the leading reserve currency. Agency bonds and mortgage-backed securities provided slightly higher returns with low perceived risk and became popular with both official and private foreign investors. At the same time, the United States was generating an ever-expanding array of innovative and

![Figure 3.7 Net Purchases of U.S. Long-Term Securities by Foreigners (Percent of GDP)](chart)

Sources: Global Data Source; Haver Analytics; and IMF staff calculations.
complex securities, which met steady foreign demand. Surprisingly, perhaps, demand for U.S. Treasuries spiked at the height of the crisis (driven by a “flight to safety”) despite the fact that U.S. assets associated with subprime mortgages were considered to be its epicenter.

- **Dollar pegs in several major emerging market economies limited effective dollar depreciation.** Currency intervention—most notably by China—helped maintain competitive exchange rates in those economies, created a major source of demand for U.S. securities, and led to rapid accumulation of reserves. Consequently, demand for dollar-denominated assets remained broadly stable and strong—accounting for about two-thirds of rapidly increasing global reserves since 2000—despite large U.S. external deficits that made dollars more available abroad (Mateos y Lago, Duttagupta, and Goyal, 2009).

- **High oil prices impeded a greater narrowing of U.S. current account imbalances.** The United States is the world’s largest consumer of petroleum products, and it relies on oil imports to satisfy more than half of its needs. Petroleum trade deficits have accounted for over 40 percent of the U.S. merchandise trade deficit since late 2007. In the years immediately preceding the crisis, rising oil prices offset the improvement in the nonpetroleum trade balance. Subsequently, the oil balance has largely been driven by price fluctuations, although in real terms it has stayed on an improving trajectory—thanks, in part, to growing production. At the same time, relatively low energy taxes continue to encourage domestic consumption.

**ARE U.S. IMBALANCES A PROBLEM?**

Concerns pertaining to the sustainability of U.S. public debt remain to be addressed. The downgrade of U.S. debt by S&P in 2011 was a clear sign of market concerns pertaining to its sustainability. Moreover, political polarization has cast doubts on the likelihood of a future comprehensive agreement on the path for adjustment. While interest rates on U.S. Treasuries remain at historical lows, they are likely to rise over time as debt accumulates and the economy recovers, crowding out private investment and worsening the debt dynamics (Figure 3.8). From a crowding-out perspective, each percentage point increase in the debt-to-GDP ratio is estimated to raise long-term interest rates by 3 to 4 basis points (all else being equal) (Balducci and Kumar, 2010; Laubach, 2009). High public indebtedness also creates vulnerability to future shocks by reducing available fiscal space. It will eventually require higher primary balances—and higher (distortionary) taxes—to service the debt. This underscores the urgent need for clear, credible, and realistic medium-term consolidation plans or a roadmap to restore soundness to public finances.

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12Demand was primarily for Treasury and agency bonds, but in later years holdings were diversified into riskier investments, particularly via sovereign wealth funds.

13Moreover, the growing share of low-cost producers in U.S. imports partially offset dollar appreciation against individual currencies. See Thomas, Marquez, and Fahle (2008).
The United States also has to contend with rising external debt. Increasing external indebtedness may carry attendant vulnerabilities, with possible confidence effects for the dollar. The stock of U.S. net external liabilities is relatively modest at around 27 percent of GDP and has not increased in line with large net external borrowing given valuation effects and other factors (e.g., some overstatement of U.S. net capital inflows). Moreover, return differentials on foreign assets versus liabilities remain favorable from a U.S. perspective. However, there are risks that such favorable return differentials may not continue indefinitely (particularly in light of unfavorable public debt dynamics). Moreover, the willingness of foreign investors to continue financing (at prevailing terms) current account deficits—which are projected to exceed somewhat model-based benchmarks over the medium term—becomes increasingly critical as the stock of external indebtedness increases. Even absent an abrupt adjustment, a continuous deterioration in the U.S. net external position that would result from projected current account deficits would imply growing payments overseas and hence the need for a substantial turnaround in the trade balance down the road to stabilize net external debt.

Should the lessons from the crisis be forgotten or ignored, a return to low household saving and releveraging (particularly in the financial sector) may combine with a precarious fiscal situation to give rise to new financial stability risks. To the extent that U.S. imbalances partly reflected low saving and high credit as well as high leverage before the crisis, there needs to be a coordinated effort to reduce fiscal, financial, and external imbalances and their associated vulnerabilities.

Given the central role of the United States in global trade and finance, U.S. concerns echo in the international arena. An unsustainable fiscal situation, for
example, creates multiple problems. As the economy continues to recover, high and increasing public debt would imply not only higher U.S. interest rates but also higher global interest rates, affecting investment and growth. In addition, a downgrade or credit event in U.S. sovereign debt markets or loss of investor confidence (tail risks stemming from the absence of a credible medium-term consolidation plan) could have global repercussions for other sovereign and corporate rates.

Fiscal and external risks are also interrelated. Concerns about the sustainability of U.S. public finances could undermine confidence in the dollar. Moreover, U.S. net external liabilities and current account deficits are sizable as a proportion of world GDP and must rely on significant foreign demand for U.S. assets to be financed. Should demand dwindle in anticipation of subpar returns (e.g., because of dollar depreciation), a mutually reinforcing spiral of capital outflows and asset price declines may ensue. Given the substantial role of the United States in global trade and finance, this possible upheaval would have severe reverberations worldwide.

Financial stability in the United States is vital for the world economy. In the crisis, major risks associated with U.S. imbalances came through financial markets (rather than exchange rates). U.S. external deficits signaled low domestic saving, high leverage, a buildup of underlying financial vulnerabilities, and systemic risk that materialized with the crisis. As seen, U.S. financial instability can have large adverse cross-border spillovers (IMF, 2011).

**HOW TO ADDRESS IMBALANCES**

The importance of credible fiscal adjustment is universally recognized, but the menu of policy options is wide. What is needed is a credible U.S. fiscal roadmap that combines spending cuts and revenue increases and is supported by fiscal rules to return public finances onto a sustainable trajectory. Broad elements of necessary U.S. domestic policy actions include the following:

- **Rapid agreement on a comprehensive and credible medium-term consolidation road map.** It is essential to initiate the process very soon and to make rapid progress to maintain credibility, spread the burden of adjustment more evenly, and avoid downside risks. Building on the agreement on the debt ceiling, bipartisan progress on concrete medium-term deficit reduction plans would also provide critical additional policy flexibility in the short run. With the economy still in a weak cyclical condition and risks to growth tilted to the downside, the pace of adjustment should be measured at the outset, but steady and well-specified over time and underpinned by a coherent medium-term fiscal strategy. In the near term, it is essential to avoid the overly large fiscal contraction envisaged under current law.

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14See IMF (2011), which also discusses the potential global impact of higher U.S. rates in a precrisis versus postcrisis context.
• **Placing entitlements on a sustainable footing in order to contain fiscal deficits.** Parametric changes to social security (e.g., gradually increasing the retirement age in line with longevity gains and reducing future benefits for the well-off) would lead to well-identified savings over time with a minor impact on current demand. Savings that go beyond those advanced by the 2010 reform are needed in the health care system, including through tighter eligibility criteria, greater cost sharing, and trimmed health-related tax expenditures.

• **Revenue-raising measures as part of the consolidation package.** The room for additional revenue exists, given its low level at present relative to most advanced economies and U.S. history. In particular, with discretionary nonsecurity spending already compressed and only gradual entitlement reform possible, raising tax revenue (including by broadening the base and simplifying the tax code) is needed. Possible measures include further gradual cuts in income tax exemptions and deductions, higher marginal personal income tax rates, a national value-added tax or sales tax, and carbon taxes.

• **Stronger budgetary rules to anchor the process and instill discipline.** The fiscal framework should include explicit congressional endorsement of the main medium-term fiscal objectives. A “failsafe” mechanism for the debt ratio along the lines suggested by President Barack Obama could, if robustly formulated, protect against deficit overruns and other contingencies. It would also be helpful to prepare the administration’s budgets using more realistic economic assumptions.

• **Policies leading to stronger growth that would improve the fiscal situation as well.** These actions include further progress in resolving the foreclosure problem, which hangs over the banking system and also gets in the way of labor market adjustment; and active labor market policies, including retraining to facilitate sectoral and geographic relocation of displaced workers.

Active labor market policies could also help reduce stubbornly high unemployment in the United States. Certain targeted policies in this regard (mindful of budget costs) would support labor in problem areas—for example, by facilitating hires of the long-term unemployed (given their very high share in total unemployment) and helping reduce youth unemployment (given underlying problems with job prospects facing this group). This could reduce risks that accompany high structural unemployment with a long duration.

Financial sector policies will need to better safeguard financial stability while remaining supportive of economic growth. Future actions will partly depend on the effectiveness going forward of recent reforms.¹⁵ Financial regulation and

¹⁵In July 2010, U.S. authorities introduced the *Wall Street Reform and Consumer Protection Act* (known as the “Dodd-Frank” Act). The objective of this legislation was to restructure the financial regulatory system to address key fault lines in order to create a sounder and more resilient system. While strong implementation of the Dodd-Frank Act is needed, its effectiveness will only be known over time.
supervision should be adequately funded and sufficiently strong to prevent another run-up in credit (although not so tight as to stifle lending and growth). 16 Regulatory perimeters need to be sufficiently broad to avoid key gaps, head off possible migration of systemic risk, and keep pace with a changing financial landscape. Actions to improve the resiliency of term funding markets that were severely disrupted may also require greater attention. Coordinated global changes in financial market regulation would make it easier to establish comprehensive global safety nets and appropriately tight and consistent credit standards. The Federal Reserve should also be vigilant in maintaining appropriate interest rates and liquidity conditions. Developing the macroprudential toolkit would help monetary policy in meeting the distinct objectives of price stability and financial stability.

**TOWARD GLOBAL ACTION**

The policy priorities described above inform key U.S. contributions to collective action to rebalance the global economy and support global growth. The main policy contours for U.S. policymakers to consider as part of a broader package of multilateral action to help rebalance the global economy would contain several key elements.

First, substantial and steady U.S. fiscal consolidation over time is needed to restore the sustainability of public finances while mitigating the short-term impact on growth. A sufficient scale of U.S. fiscal adjustment with “growth-friendly” composition (to the extent possible) would require three essential pillars:

- **Tax reform and higher tax revenues.** To minimize tax distortions and bolster growth, measures might include reducing payroll and capital taxes in favor of higher consumption taxes or a value-added tax; increasing energy taxes; and broadening the tax base to enhance revenue collection (by reducing loopholes and tax expenditures, including mortgage interest deductions).

- **Spending cuts in key areas.** To meet budget priorities, fiscal measures would also include cuts in entitlement spending by increasing the age of retirement and reducing benefits to restore the long-term viability of these programs; further restraining growth in health care expenditures; and making some cuts in discretionary spending (including defense) while preserving or enhancing public investment in critical areas.

- **Enhancing credibility.** Clear and effective public communication by the administration and Congress about concrete fiscal plans to realistically tackle unsustainable items in the budget and establish clear fiscal targets would help align market expectations with the authorities’ medium-term fiscal consolidation strategy.

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16 For example, rules on loan-to-value and debt-service-to-income ratios to qualify for lowest-rate mortgages should be sufficiently stringent.
Second, improvement in the U.S. current account balance must rest on several pillars that, in turn, must be supported by policy. National saving will need to rise to avoid a reemergence of wider external deficits and financial imbalances. Fiscal consolidation will be a major contributor to smaller external deficits going forward. But maintaining private saving broadly at current levels would help ensure that the effect of lower fiscal deficits on the current account is not offset by deterioration in the private saving–investment balance. To the extent that the increase reflects a decline in net wealth aligned with underlying fundamentals and more realistic income prospects, the rebound in household saving from its precrisis levels is likely to persist, and the recent range of 4 to 6 percent (of disposable income) seems broadly in line with fundamentals, though time will tell. Further adjustment in the dollar along past depreciation trends would facilitate external adjustment and rebalancing.

Third, rebalancing necessarily has a multilateral dimension. Given the need for U.S. fiscal consolidation, a prospective contraction in domestic demand would need to be offset both at home and abroad to maintain solid growth and to avoid a global “demand deficit.” In other words, the United States would need to rely more on external demand (given fiscal consolidation), while G20 partners—particularly surplus economies—would need to rely more on internal demand (given weaker demand in the United States) to help achieve strong, sustainable, and balanced growth over the medium term.

Finally, U.S. financial sector reform needs to be advanced to rebuild a more resilient financial system that can support strong economic growth and reduce global risks (IMF, 2010). Fostering an adequate flow of bank credit to support activity, but preventing a return to low saving rates while lowering systemic risk, will require better aligning private market incentives (e.g., tackling the issue of “too-big-to-fail” institutions and agency problems with securitization); ensuring prudent credit provision (e.g., appropriately tight lending standards and capital adequacy); and more carefully monitoring the financial system (e.g., avoiding key gaps in regulation, including enhanced supervision of systemically important financial institutions). 17

REFERENCES


17In the IMF’s Global Integrated Monetary and Fiscal Model, only limited and stylized simulations of financial sector reform are feasible, based on implications for the supply and price of credit. See Kumsaghof and others (2010) for details about the model.