INTERNATIONAL MONETARY FUND

Staff Country Reports

July 2005
IMF Country Report No. 05/257

United States: 2005 Article IV Consultation—Staff Report; Staff Statement; and Public Information Notice on the Executive Board Discussion

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2005 Article IV consultation with the United States, the following documents have been released and are included in this package:

- the staff report for the 2005 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on May 25, 2005, with the officials of United States on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on June 30, 2005. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff statement of July 22, 2005 updating information on recent developments.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its July 22, 2005 discussion of the staff report that concluded the Article IV consultation.

The document listed below has been or will be separately released.

Selected Issues Paper

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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INTERNATIONAL MONETARY FUND

UNITED STATES OF AMERICA

Staff Report for the 2005 Article IV Consultation

Prepared by the Staff Representatives for the 2005 Consultation
with the United States of America

Approved by Anoop Singh and Carlo Cottarelli

June 30, 2005

- ***The 2005 Article IV discussions took place in Washington, D.C. during April and May***. The staff team comprised C. Towe (Head), T. Bayoumi, M. Mühleisen, K. Krajnyák, C. Schnure, I. Ivaschenko, and A. Justiniano (all WHD); H. Lankes and K. Alexandraki (PDR); D. Botman (FAD); and W. Lee (ICM). N. Jacklin, M. Lundsager, and J. Leichter, U.S. Executive Director, Alternate Executive Director, and Advisor, respectively, also attended the meetings.
- ***The Managing Director, First Deputy Managing Director, Mr. Rajan (RES), and Mr. Singh (WHD) took part in the concluding discussions with Treasury Secretary Snow and Federal Reserve Chairman Greenspan***. The mission met with officials from U.S. Treasury, Federal Reserve Board, Bureau of Economy Analysis, Bureau of Labor Statistics, Congressional Budget Office, Employee Benefits Security Administration, National Association of State Budget Officers, Office of the Comptroller of the Currency, Office of Management and Budget, Office of the U.S. Trade Representative, and Securities and Exchange Commission. The team also met with financial market participants and the Federal Reserve Bank of New York in March.
- ***The United States is a party to the convention on Combating Bribery of Foreign Public Officials in International Business Transactions and the Financial Action Task Force (FATF)***. To strengthen anti-money laundering (AML) enforcement further and combat the financing of terrorism, the Office of Terrorism and Financial Intelligence (TFI) has been created and become operational. An evaluation of the United States' compliance with FATF recommendations is to be conducted in 2005-06.

Contents Page

I. Introduction and Executive Summary

1. ***The U.S. expansion solidified during the past year despite higher world oil prices***. Robust productivity growth and high corporate profits have contributed to a strong rebound in business investment and some acceleration in employment. Growth is again projected to outstrip that of other G-7 countries by a wide margin in 2005, although the recent softness in indicators has caused some scaling back of growth projections.

2. ***The policy focus has appropriately shifted toward the removal of stimulus***. Having cut the federal funds rate aggressively over the downturn, the Federal Reserve reversed course in mid-2004 as deflation risks receded, and has since raised the rate by a cumulative 2¼ percentage points. The Administration has reaffirmed its commitment to reducing the budget deficit to below 2 percent of GDP by FY 2009 through rigorous spending restraint, and to making earlier tax cuts permanent.

3. ***Against the backdrop of widening global current account imbalances and low national saving, discussions centered on the importance of safeguarding the near-term economic outlook and preparing for demographic challenges***:

- ***Removing macroeconomic stimulus***. With margins of economic slack falling, the mission noted that the pace of interest rate hikes may need to accelerate if inflationary pressures were to mount. At the same time, the team stressed that the burden on monetary policy and the current account would be eased considerably with the adoption of a more ambitious fiscal objective.

- ***Preparing for an aging population***. The team reemphasized that the government debt ratio should be placed on a clear downward path to prepare for the spending pressures from population aging, and that delaying needed reforms of Social Security and the health care system would make subsequent adjustments more painful.

- ***Maintaining high-productivity growth***. The mission discussed tax and other options for enhancing saving incentives and improving investment efficiency, while cautioning that the trade imbalance is beginning to foster protectionism and could undermine U.S. leadership in bringing the Doha Round to a successful conclusion.

Box 1. Impact of Past Fund Advice

U.S. officials generally emphasized that there is a broad consensus with the Fund on the fundamental factors underlying growth in the United States. Chief among these are strong property rights, sound institutions—including world class financial regulators—the flexibility of U.S. factor markets, low taxation, the relatively small size of government, and a high degree of transparency of economic policy decisions.

The Fund has been broadly supportive of the Federal Reserve's conduct of monetary policy in recent years. In July 2004, the Board commended the Fed for its earlier forceful response to signs of deflationary pressures and endorsed the shift in the policy stance in mid-2004 toward a gradual removal of stimulus.[1] The staff has long recommended an explicit statement of the Federal Reserve's long-term inflation objective, but the authorities have argued that the potential benefits would be modest.

More significant differences of view have emerged on the size and speed of fiscal consolidation and global current account imbalances:

- The Fund and the authorities share the view that the fiscal deficit is too large and needs to be reduced. The Administration has adopted a target of reducing the federal deficit to slightly below its long-term average of around 2 percent of GDP by FY 2009. The staff has called for a more ambitious consolidation effort, aimed at balancing the federal budget excluding Social Security over a period of 5-10 years.

- The Fund has also cautioned that revenue measures could be used to support deficit reduction—especially those broadening the tax base and shifting the burden from income to consumption—while the authorities have argued strongly that higher taxes would have damaging efficiency consequences and fuel wasteful government spending.

- Although the authorities and the Fund agreed on the need to boost U.S. national saving, the authorities have disagreed that the large U.S. current account deficit—which they see as largely reflecting weak demand growth in key partners—poses a significant risk of "disorderly adjustment" or that it argues for more aggressive fiscal adjustment.

The Fund has long urged the authorities to address the underfunding of the Social Security and Medicare systems. Although 2003 legislation significantly worsened the financial position of the Medicare system, the Administration has taken encouraging steps to place the Social Security system on a sound financial footing.

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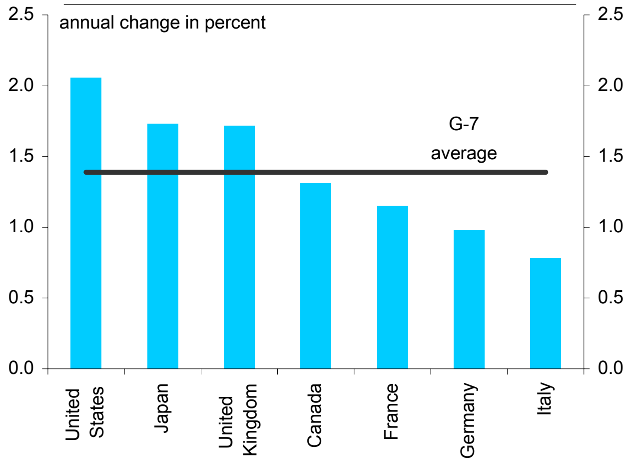
[1] See 2004 Public Information Notice at http://www.imf.org/external/pubs/ft/scr/2004/cr04230.pdf.

II. Economic Outlook, Imbalances, and Risks

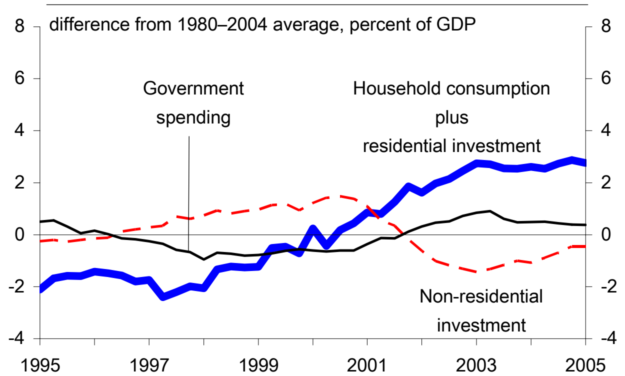
A. Economic Developments and Financial Flows

4. ***The U.S. economy has continued to lead the global recovery over the last year*** (see Figure on next page). The expansion was initially slowed by the effects of the bursting of the IT bubble and geopolitical developments following the 2001 terrorist attacks. More recently, household spending has remained robust and business investment has rebounded, supported by low interest rates. Despite having eased somewhat as the expansion has matured, productivity growth has remained well above longer-term trends and supported record-high corporate profits.

The United States has had the fastest labor productivity growth in the G7 since 1995...



...household spending has been extremely strong and business investment has started to recover.



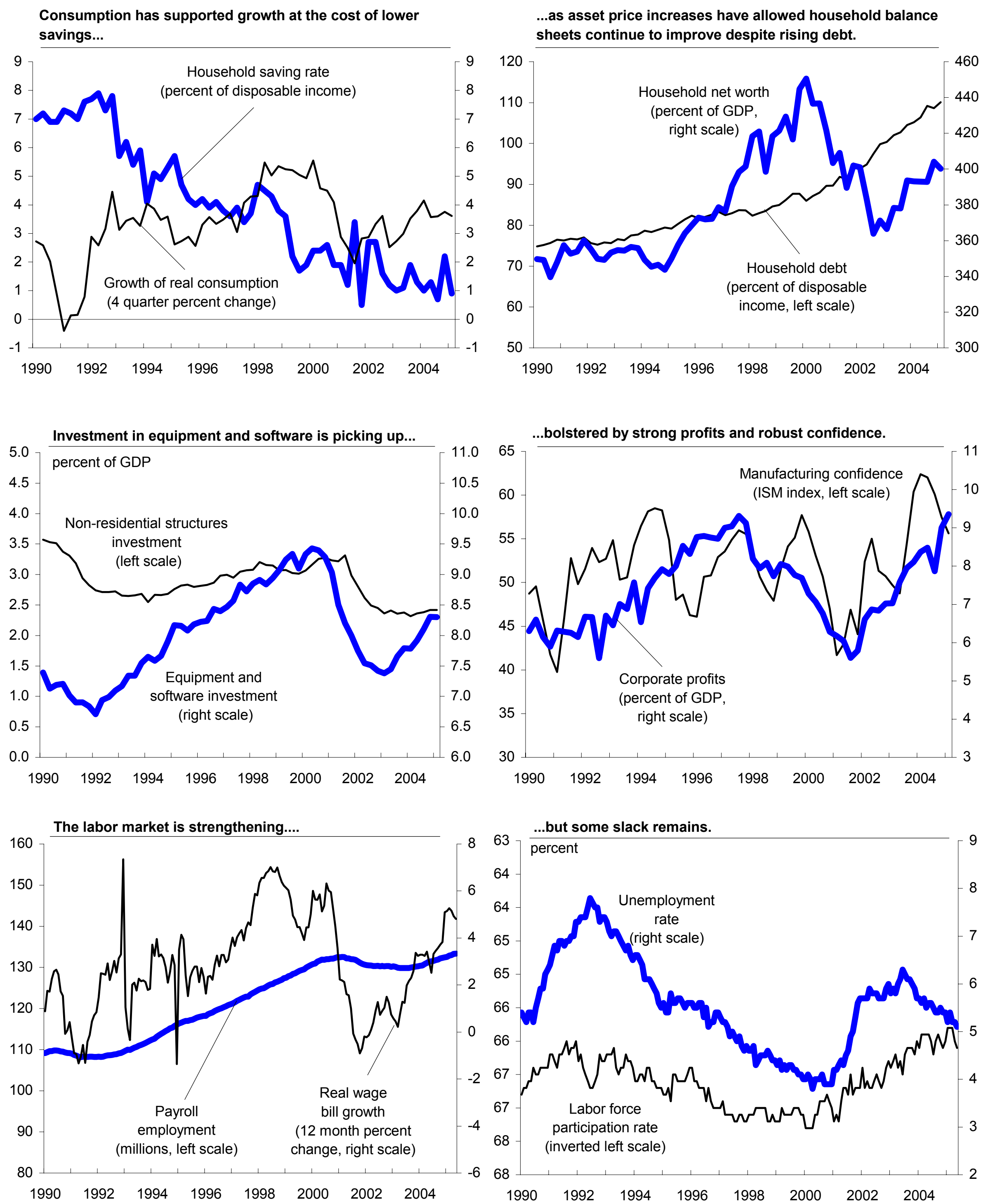
Sources: Haver Analytics, OECD; and IMF staff calculations.

5. ***The financial sector appears well positioned to provide continued support to the recovery***. Equity prices have risen, long-term interest rates remain low, banks are well capitalized and highly profitable, and indicators of credit quality remain strong. The robust housing market has caused financial regulators to tighten oversight of home equity and other residential loans. Notwithstanding strong house price increases in many regions, Chapter 1 of the *Selected Issues* paper suggests that securitization of mortgage debt has limited systemic financial sector risks by allowing significant diversification of real estate exposures.

6. ***The U.S. expansion and low interest rates have provided a substantial boost to the rest of the world at a time of significant global slack***. U.S. net imports have increased growth in the rest of the world by about ¼ percentage point a year since 2001. U.S. financial conditions have also helped compress risk premiums, lowering interest spreads and supporting activity across a wide range of emerging markets.

7. ***High oil prices appear to have contributed to a recent softening in U.S. activity***. After expanding at a 4½ percent rate in 2004, real GDP growth eased to 3¾ percent in the

Anatomy of Economic Trends

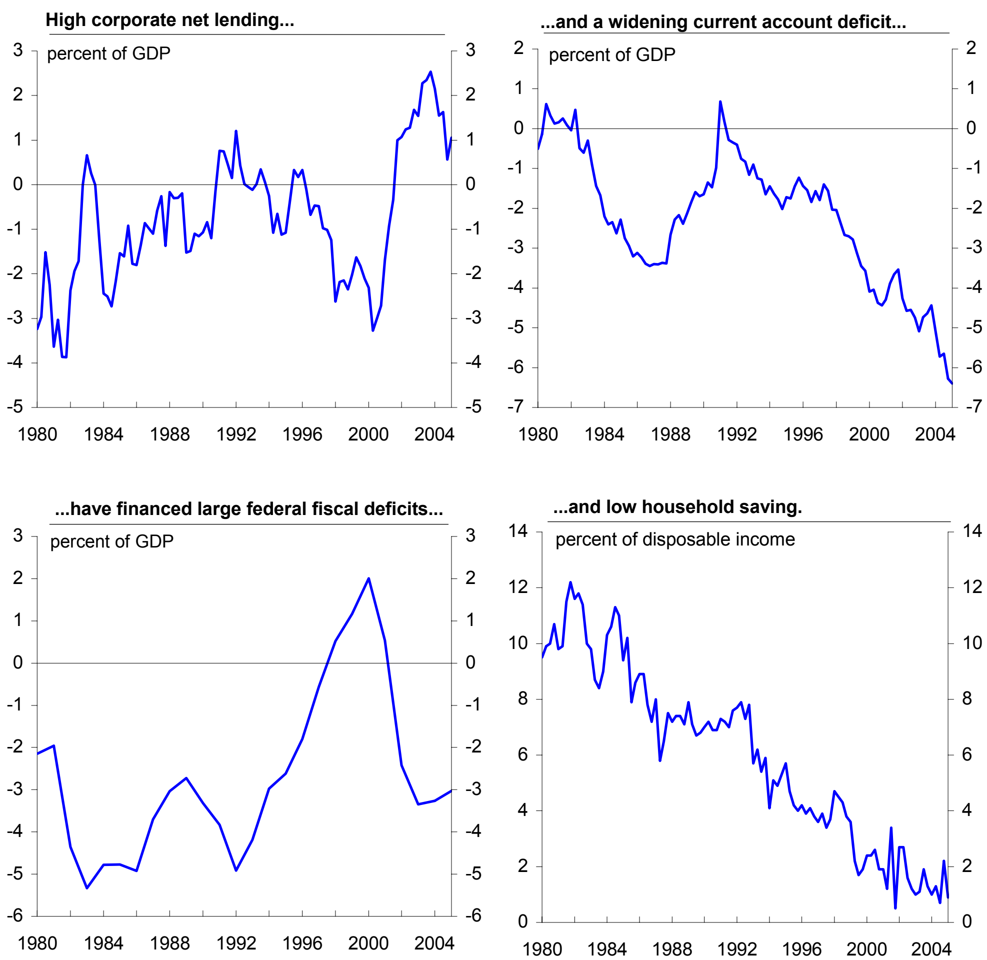


Source: Haver Analytics.

first quarter of 2005. A spate of weaker indicators on activity and spending in March suggested that some softening of growth might persist into the second quarter, although recent reports indicate that domestic demand remains solid.

8. ***As economic slack has narrowed, the inflation environment has become less benign***. Although the core deflator for personal consumption expenditure—the Fed's preferred inflation measure—has risen only modestly and currently stands at just above 1½ percent (12-month rate), higher energy prices have pushed headline CPI inflation to 3½ percent in recent months, accompanied by a moderate uptick in inflation expectations. The labor market has exhibited few signs of overheating—employment growth has been moderate by historical standards and the drop in the unemployment rate to 5.1 percent appears to have largely reflected lower participation. However, weaker productivity growth since mid-2004 has contributed to an acceleration in unit labor costs.

9. ***The current account deficit has steadily widened as U.S. growth has continued to outpace that of most trading partners***. Despite the depreciation of the U.S. dollar by about 15 percent in real effective terms over the past three years, the current account deficit increased to 6½ percent of GDP in the first quarter of 2005. This has been mainly driven by sustained strong growth in real imports of consumption and capital goods and higher oil



Sources: BEA and Board of Governors, Federal Reserve.

prices.

10. ***Financial flows have departed from long-term trends and appear unsustainable,*** with foreign savings and corporate profits increasingly financing government and household spending.

- ***Foreign savings are being provided at record levels***. The counterpart of the record current account deficit has been massive capital inflows, and U.S. net international liabilities are estimated to have risen to about 25 percent of GDP.

- ***Net lending by the corporate sector is also at record highs***. Notwithstanding difficulties with auto and airline sectors, businesses have used high profits to strengthen balance sheets that—along with foreign inflows—has contributed to low long-term interest rates.[1]

- ***Tax cuts and expenditure increases have turned the public sector into a significant borrower***. The federal government budget shifted from a 2½ percent of GDP surplus in FY 2000 to a 3½ percent of GDP deficit in FY 2004, leaving the general government deficit at 4¼ percent of GDP in calendar year 2004.

- ***The household saving rate has fallen to record lows***. Even accounting for the boost from strong asset markets, the staff estimates that the saving rate is currently some 1½-2 percentage points below a level consistent with household income and wealth.[2] Chapter 2 of the *Selected Issues* discusses how technological change and trade openness may be tending to reduce the share of national income going to labor.

B. Short-Term Outlook and Risks

11. ***Barring shocks, the staff projects growth of 3½ percent in 2005 and 2006, slightly above potential and close to the consensus forecast***. Reflecting some rebalancing of growth and normalizing domestic financial flows, both the personal and national saving rate would gradually rise while stronger investment would reduce corporate net lending. Although the trade balance would benefit somewhat from lagged exchange rate effects, the current account deficit would remain at over 6 percent of GDP (assuming an unchanged real effective exchange rate) as increasing foreign debt and higher interest rates would weigh on the income balance. This scenario assumes that:

- ***Short-term interest rates gradually increase through 2006*** and the fiscal balance improves modestly.

[1] The low level of long-term interest rates are discussed in Box 1.2 in the April 2005 *World Economic Outlook*.

[2] Based on an update of analysis presented in Chapter 1 of *United States—Selected Issues* (IMF Country Report 03/245).

- ***Real long-term interest rates and spreads return to more typical values*** as business investment and national saving rebound, while residential investment growth eases.
- ***Productivity growth decelerates*** further as the economy returns to full employment before settling at 2¼ percent, supporting potential growth of 3¼ percent.[3]
- ***Inflation remains contained*** as slack is eroded only gradually and robust labor productivity growth limits unit labor cost increases.

Medium-Term Projections

(Percent changes from previous period, unless otherwise indicated)

	2002	2003	2004	2005	2006	2007	2008	2009	2010
National production and income									
Real GDP	1.9	3.0	4.4	3.6	3.5	3.6	3.6	3.5	3.3
Total domestic demand	2.5	3.3	4.8	4.0	3.5	3.5	3.5	3.4	3.3
Final domestic demand	2.1	3.4	4.4	3.8	3.3	3.4	3.5	3.4	3.3
Private final consumption	3.1	3.3	3.8	3.7	3.4	3.3	3.5	3.1	3.0
Net exports [1]	-0.7	-0.4	-0.6	-0.6	-0.1	-0.1	0.0	-0.1	-0.1
Unemployment rate (percent)	5.8	6.0	5.5	5.2	5.2	5.1	5.0	5.0	4.9
CPI inflation	1.6	2.3	2.7	2.9	2.5	2.5	2.5	2.5	2.5
Unified federal balance [2]	-2.4	-3.3	-3.3	-3.0	-2.8	-2.3	-2.0	-1.9	-1.7
Current account balance [2]	-4.5	-4.8	-5.7	-6.2	-6.1	-6.1	-6.1	-6.1	-6.0
Memorandum items:									
Partner country growth	2.2	1.7	3.3	2.5	2.8	3.0	2.9	2.9	2.8
Oil prices ($/barrel) [3]	25.0	28.9	37.8	50.7	53.0	51.8	50.3	49.5	49.0

Sources: IMF staff estimates and Haver Analytics.

[1] Contributions to growth; NIPA basis, goods and services

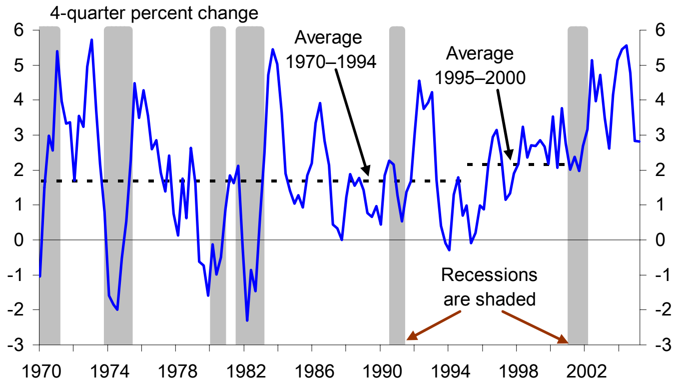
[2] Levels, in percent of GDP

[3] Average petroleum spot price: simple average of U.K. Brent, Dubai, and West Texas prices.

12. ***Officials were in broad agreement with the staff's outlook, and saw short-term risks as largely balanced***. Federal Reserve officials noted, in particular, that the pace of growth in the latter half of 2004 had prompted fears that inflation pressures were building, and that some slowing was an appropriate response to the withdrawal of monetary stimulus. Prospects for business investment remained favorable, given healthy corporate balance sheets, signs that capital stocks remained below trend in some sectors, and still easy financial conditions. Notwithstanding recent softness in business and consumer sentiment, steady employment and income growth, together with buoyant household net wealth, would support solid increases in consumption.

[3] Productivity trends are discussed further in Chapter 1 of IMF Country Report 04/228.

Productivity growth has been extremely strong in recent years.



Source: Bureau of labor statistics.

13. ***Officials were optimistic about near-term productivity trends, which they saw as key to the outlook***. While, in their view, a deceleration of productivity was to be expected at this stage in the cycle, they estimated the underlying rate of productivity growth at a healthy 2½-3 percent. The mission agreed that a variety of indicators suggested that a productivity slowdown would likely be temporary, but observed that substantial uncertainty surrounded estimates of its potential growth. The large financial imbalances facing the United States left it vulnerable to a sustained slowdown in productivity, which could increase cost pressures, shift investor preferences away from U.S. assets, and push up global interest rates and risk premia.[4]

14. ***Officials acknowledged the risk that sustained high oil prices could weigh on activity***. Federal Reserve officials suggested that recent oil price developments are dampening household spending and confidence, and lowering growth by ½-¾ percentage points during 2005. Although this shock was unlikely to derail the expansion, past experience suggested that the macroeconomic response could be stronger than model predictions, especially if higher energy prices were viewed as more than temporary.

15. ***Officials also noted signs of "froth" in the housing sector***. House prices in some regions had moved above levels consistent with personal incomes and rents, and there were signs of increased speculative activity, including more widespread purchases of second homes and use of interest-only loans. However, the situation at the national level was less of a concern, and the most likely scenario was a flattening of prices rather than outright declines. This would affect consumer spending, particularly given recent support through home equity withdrawals. Staff agreed that house price stagnation was the most likely scenario and that, while standard multipliers would imply a reduction in consumption growth of less than 1 percent a year from such an outcome, the impact could be larger given the already extremely low household saving rate.

Risks from Global Imbalances

16. ***Officials agreed that the U.S. current account was likely to widen further in 2005 in the absence of a significant pick-up in partner country growth*** (see Figure on next page). Federal Reserve officials, in particular, indicated that the deficit's widening in recent years

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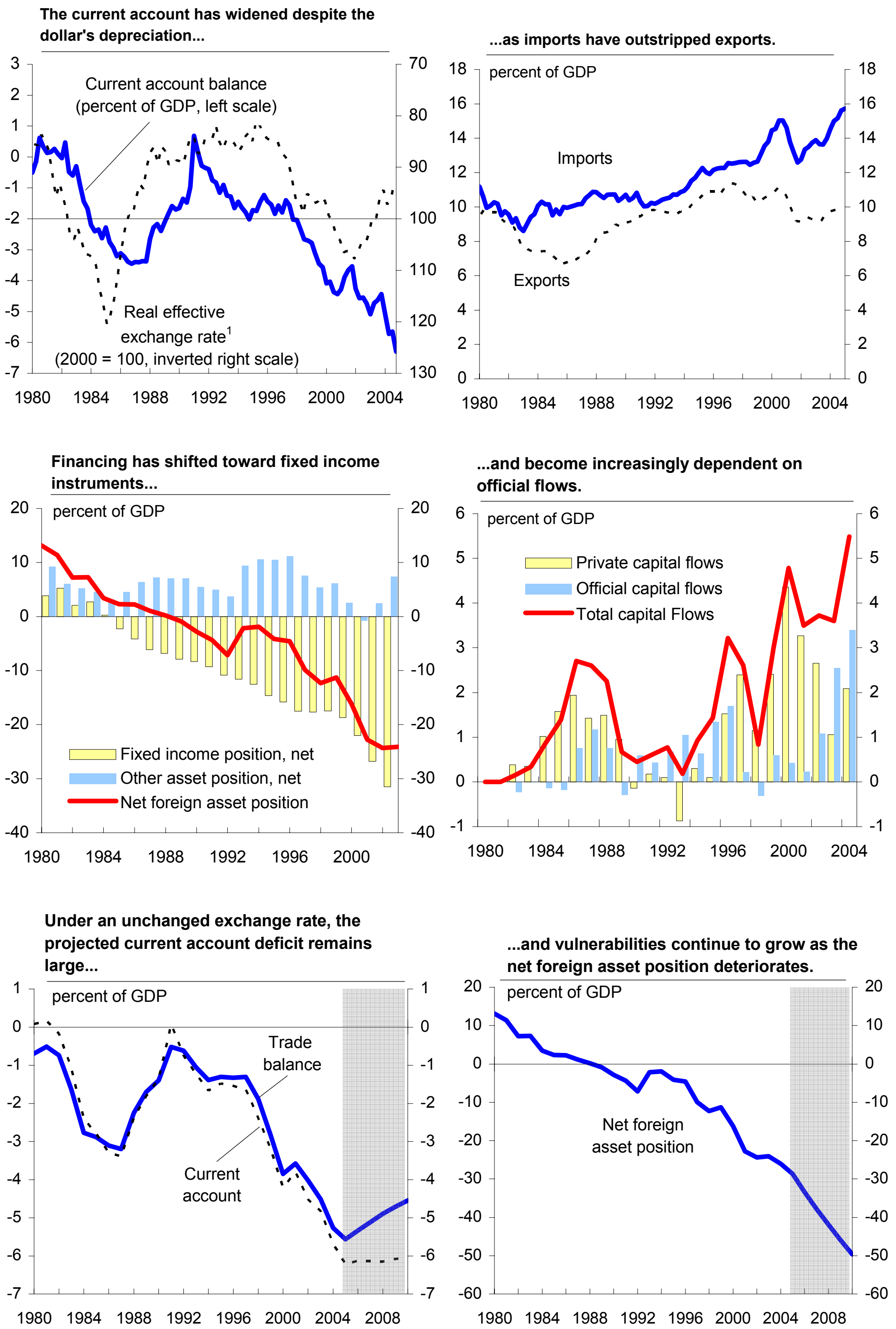
[4] Debt sustainability calculations reported in Appendix III include the impact of persistent shocks to growth and other macroeconomic variables on the fiscal and external position using vector autoregressions.

Balance of Payments Developments



Sources: BEA; Board of Governors of Federal Reserve; International Financial Statistics; and IMF staff calculations.
[1]Federal Reserve broad real trade weighted exchange index (CPI based).

had been broadly consistent with their economic model, and that several factors limited prospects for a significant narrowing in the near-term:

- ***Trade elasticities***. The income elasticity of U.S. demand for imports is typically estimated to be significantly larger than that of foreign demand for U.S. goods.

- ***Openness.*** Exports represent only 10 percent of GDP and, with imports half again as large, exports volumes have to grow significantly faster than imports simply to keep the deficit unchanged.

- ***Pass-through and trade shares***. Recent analyses at the Fed and the Fund suggest that the pass-through may have fallen over time, possibly reflecting changing trade patterns, reducing the impact of exchange rate depreciation on the trade balance (see Box 2 as well as Chapter 3 of the *Selected Issues* paper, which examine reasons for the rapid fall in the trade balance in recent years).

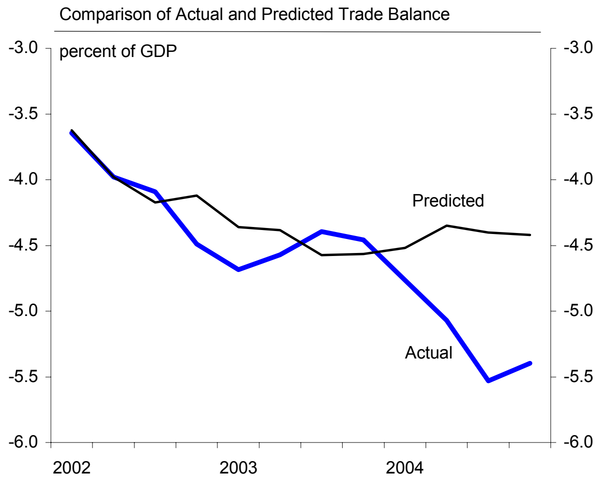
- ***Debt dynamics***. Larger international liabilities, particularly in debt securities, are expected to weaken the income balance of the current account, especially as U.S. interest rates rise. This would increase the correction in the trade balance needed to stabilize the U.S. net international investment position.[5]

17. ***Officials tended to downplay the Fund's well-publicized concerns about a "disorderly adjustment."*** The United States' economic strength and large, liquid financial markets—as well as the absence of more attractive destinations for global capital—meant a sharp reversal of investor sentiment was unlikely. They noted the recent strengthening of the dollar, brisk foreign demand for U.S. corporate bonds, as well as recent analysis suggesting global investment portfolios were generally not overweight in U.S. assets. (Chapter 4 of the *Selected Issues* paper arrives at a similar finding but also suggests that the United States' negative international investment position is large once the size of its economy is taken into account). Fed officials agreed that a significant depreciation of the dollar would be needed to narrow the trade balance and stabilize the net investment position (Box 2 discusses the dollar's overvaluation), although the dollar denomination of U.S. foreign liabilities meant that revaluation of wealth would work in favor of U.S. residents.

18. ***The authorities also observed that there was little more that U.S. policies could do to address global imbalances***. They had acknowledged the need to raise U.S. national saving and, under the G-7 Agenda for Growth, had agreed to halve the nominal federal budget

[5] See, for example, O. Blanchard, F. Giavazzi, and F. Sa, "The U.S. Current Account and the Dollar," CEPR Discussion Paper No. 4888, 2005.

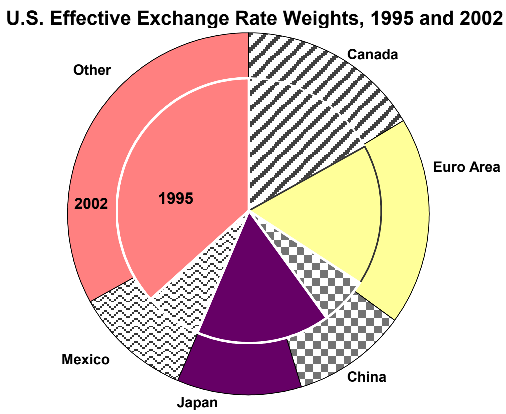
Box 2. Why Has the U.S. Trade Balance Deteriorated So Fast?[1]



The U.S. trade deficit has widened rapidly in recent years, notwithstanding the dollar's 15 percent real effective depreciation since early 2002. Similar to many other forecasters, the staff's trade model would have projected significantly stronger exports and weaker imports over that period, even accounting for robust U.S. growth and higher oil prices. This Box discusses two factors that may have muted the impact of the dollar's fall on the external accounts.

One possibility is that exchange rate pass through has declined as a result of higher competition brought about by the market entry of low-cost producing countries. For example, if U.S. dollar prices of imports respond less to exchange rate movements, then the adjustment of trade volumes to depreciation will be smaller. In this case, staff estimates would suggest some diminution in the short-term impact of the real exchange rate on import prices of manufactures, although whether this reflects slower dynamics or smaller long-term pass through remains unclear (see Chapter 3 of the *Selected Issues* paper). Geographic data on trade prices suggest a regional pattern—unlike for Asian countries, the prices of imports from Canada and Europe responded similarly to exchange rate changes as in the past.

Rapidly changing trade patterns could also be leading to an overestimation of the gain in U.S. external competitiveness. China's weight in U.S. real effective exchange rate weights has doubled from around 5 percent to over 10 percent between 1995 and 2002, mainly at the expense of Japan. The first-round effects of changing trade patterns is typically incorporated by using these changing weights in calculations of effective exchange rates. However, there may be an additional loss in competitiveness if Chinese goods are more price competitive than those from Japan and elsewhere. Calculations using deviations of exchange rates from purchasing power parities suggest that this effect could significantly reduce the measured gain in U.S. competitiveness.



Staff analysis suggests that the U.S. dollar remains significantly overvalued. U.S. exports have lost some market share in recent years, and the current account deficit appears at least 3 percent of GDP higher than suggested by medium-term fundamentals. The Fed's broad CPI-based real effective exchange rate is also above its estimated value using a modified purchasing parity approach. The large correction against major industrial countries since 2002, most notably the euro, has been blunted by almost no movement against the currencies of emerging markets as a group, which account for almost half the weights in the Fed's U.S. exchange rate index.

[1] Prepared by Alejandro Justiniano.

deficit by FY 2009. However, the current account balance was not an appropriate target for U.S. policies, and empirical evidence to support the "twin deficits" hypothesis was weak.[6] Staff were more confident about the link between deficit reduction, saving, and the external balance (simulations in Appendix IV as well as Chapter 5 of the *Selected Issues* paper suggest that a permanent change in the fiscal balance generates a significant current account improvement) but agreed that an international strategy—as outlined in the latest IMFC communiqué—was needed to help move the U.S. external deficit to sustainable levels.

III. Policy Discussions: Sustaining the Recovery

A. Withdrawing Monetary Stimulus

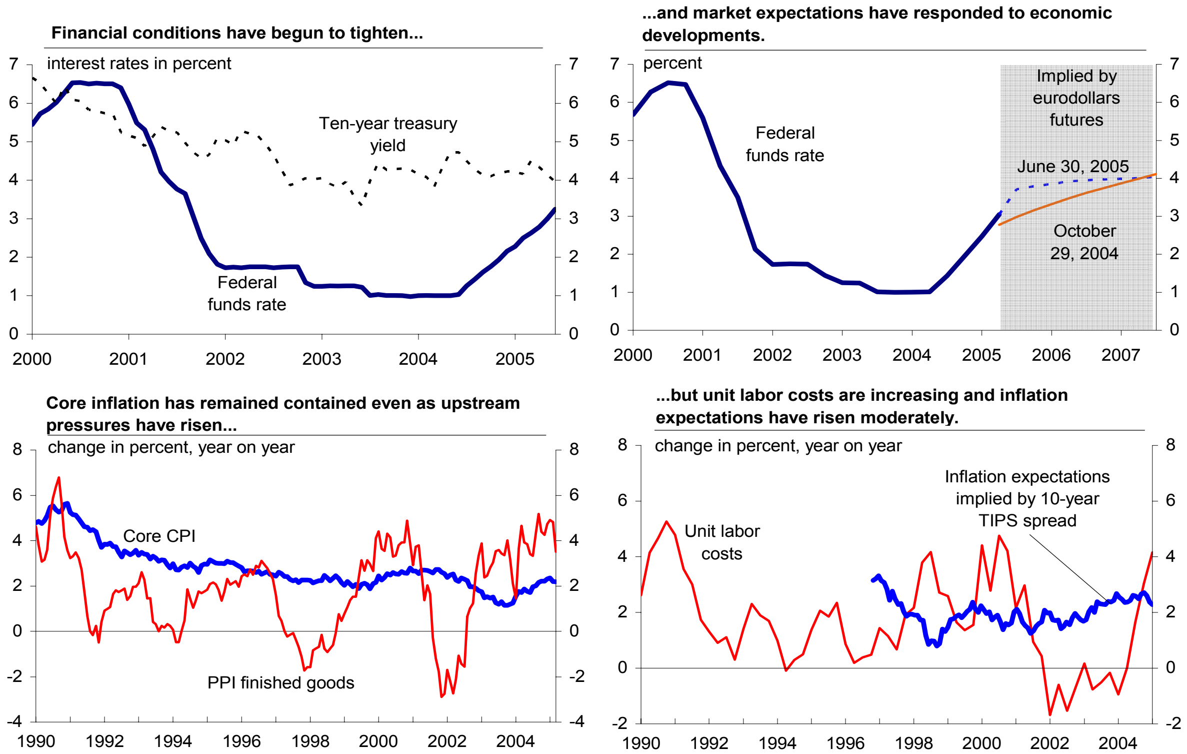
19. ***In mid-2004, the Federal Reserve began to gradually withdraw monetary accommodation***. After having kept overnight rates at 1 percent for over a year to head off deflationary pressures, the Federal Open Market Committee (FOMC) has raised the federal funds rate by 25 basis points at each of its meetings since June 2004, to 3¼ percent. Although the FOMC noted in its June 30 statement that pressures on inflation stayed elevated and monetary conditions remained accommodative, it also observed that long-term inflation expectations were well contained and "policy accommodation can be removed at a pace that is likely to be measured."

20. ***The mission raised for discussion whether the pace of monetary tightening needed to be accelerated to forestall a further pickup in inflation***. Although the careful withdrawal of accommodation had been effective in supporting the expansion and avoiding disruption to bond markets, real short-term interest rates were still around zero. Extremely low long-term rates also suggested that market participants could be unduly discounting future rate hikes, especially given the potential for higher energy prices and rising unit labor costs to feed cost pressures.

21. ***Fed officials replied that the current policy stance appropriately balanced the goals of price stability and growth***. In line with a "risk management" approach to monetary policy, the FOMC had explicitly shifted its attention to inflation over the past year.[7] Against this background, officials saw signs that the withdrawal of monetary stimulus had helped moderate the pace of economic growth to a more sustainable level, suggesting that policy was not overly stimulative. At the same time, they viewed underlying price pressures as relatively benign given the low rate of core PCE inflation, stable inflation expectations, and signs that underlying unit labor cost increases were well contained.

[6] The Federal Reserve has estimated that a deficit reduction of 1 percent of GDP would lead to only a 0.2 percentage point increase in the current account balance.

[7] See Chapter 5 of IMF Country Report 04/228.



Sources: Bloomberg, LLP; Board of Governors, Federal Reserve Bank; and Haver Analytics.

22. ***Against a background of unusually low global bond yields, the Fed's policy stance would necessarily become more data-dependent as interest rates returned to neutral levels***. Officials agreed that short-term interest rates remained well below most estimates of an "equilibrium" neutral rate but noted that this rate was not invariant to economic circumstances. They doubted that the flatness of the yield curve reflected headwinds facing the economy, such as high oil prices and a low household saving rate. More likely explanations for the low level of long-term interest rates internationally included greater confidence that inflation pressures were contained and the strength of global saving relative to investment, which was still suffering from the collapse of the IT bubble.

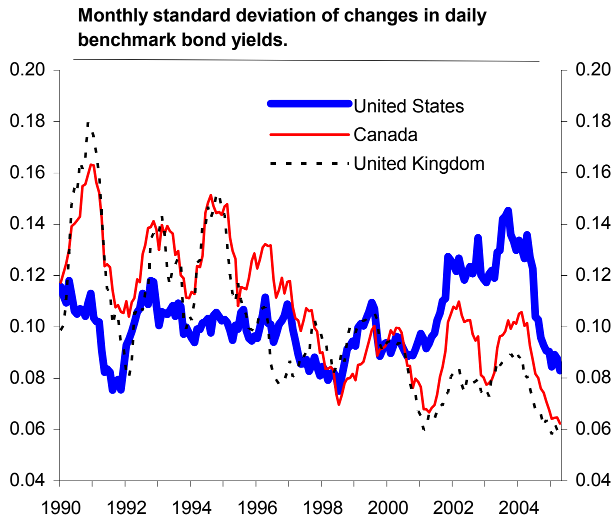
23. ***Staff commended the FOMC's skillful communication policy in recent years***. Fed officials explained that this reflected lessons learned from the 1994 period, when market participants began to feel that policymakers had fallen behind the curve. Then, the Fed was forced to hike the federal funds rate by 125 basis points in two quick steps, which had prompted bond yields to overshoot significantly. In the present cycle, the FOMC had sought to avoid a repetition of this earlier experience by communicating clearly its commitment to price stability early in the tightening cycle while emphasizing that a gradual withdrawal of stimulus was the more likely course.

24. ***The mission repeated its long-standing suggestion that a more explicit long-term inflation objective could further anchor expectations and long-term bond yields*** (see Box 3,

Box 3. Would An Explicit Definition of Price Stability Reduce Bond Price Volatility?[1]

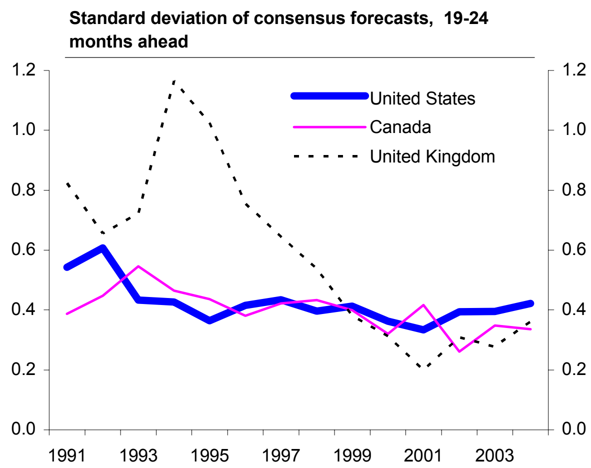
This Box compares the volatility of U.S. bond yields and inflation expectations with those of Canada and the United Kingdom, two other G-7 countries that have adopted inflation-targeting monetary regimes. It examines the suggestion put forward by proponents of a more explicit objective for inflation that such a target could help stabilize medium-term inflation expectations and improve financial intermediation.

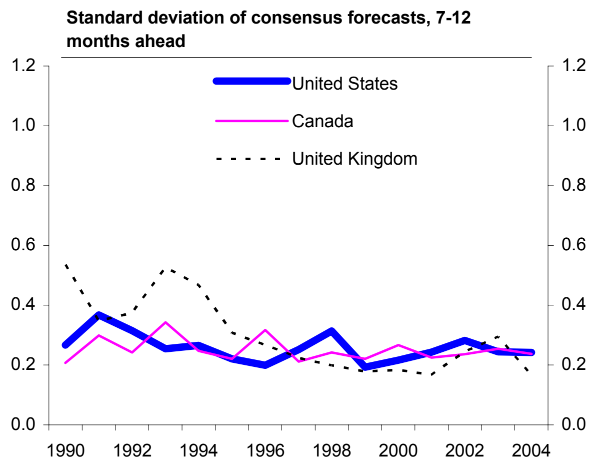
Since 1990, daily volatility of changes in benchmark bond yields has trended down in Canada and the United Kingdom, and is now below that of the United States. A similar pattern exists when volatility is calculated on a weekly and monthly (end to end) basis.



Uncertainty about future inflation in Canada and the United Kingdom also appears to have fallen below U.S. levels. The standard deviation of private sector inflation forecasts over 19-24 months declined rapidly in the United Kingdom after the adoption of an inflation targets in 1992 and full central bank independence in 1997, while trends in Canada (which adopted inflation targets in 1990) and the United States have been more stable.[2] Indeed, uncertainty about U.S. inflation has been slightly higher than in the other two countries since 2002, even though values for 7-12 month inflation forecasts are similar.

These findings suggest that a more explicit definition of price stability might help reduce volatility in bond markets and inflation expectations.





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[1] Prepared by Bennett Sutton.

[2] Inflation volatility over the 19-24 (7-12) month horizon is measured using the standard deviation of individual forecaster's projections of next year's (this year's) CPI inflation in Consensus Forecasts from January to June.

as well as Chapter 6 of the *Selected Issues* paper). Officials noted that the FOMC had debated this issue recently, but had not reached a consensus. Officials also cautioned that the Federal Reserve was subject to a dual mandate—price stability and maximum employment—and that quantifying the inflation objective could trigger efforts to define full employment and unduly constrain the Committee's room for maneuver. In any event, officials stressed that the Fed was already one of the most open central banks in the world, and the FOMC was committed to continued improvements in other areas of transparency.

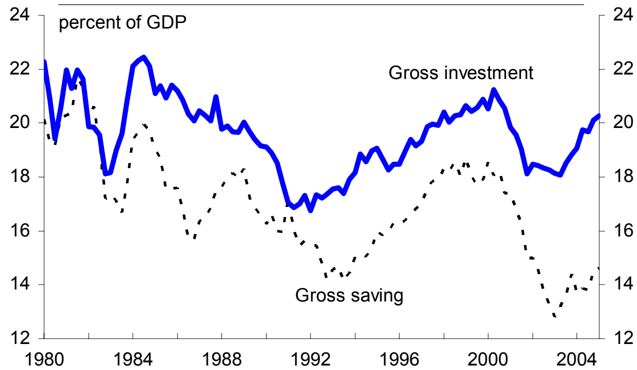
25. ***Officials stressed the headway Administration had made toward its objective of bringing the federal fiscal deficit below 2 percent of GDP by FY 2009***. Government revenues had rebounded strongly over the past year, owing to high corporate profits and steady income growth. Partly as a result, the FY 2004 deficit came in at 3½ percent of GDP—1 percentage point better than expected—and the outcome for FY 2005 could be under 3 percent of GDP. Moreover, prospects for containing the FY 2006 deficit had been boosted by Congress' budget resolution, which was broadly consistent with the Administration's expenditure reduction plans

B. The Pace of Fiscal Consolidation

26. ***The mission welcomed the progress made toward fiscal consolidation, but stressed that this seemed to reflect principally cyclical rather than structural gains***. The structural primary balance—which excludes both cyclical revenue fluctuations and the effects of low interest rates on the cost of servicing government debt—remained close to historic lows, with the budget implying only a modest 1½ percent of GDP improvement over the next five years. The mission also noted that medium-term budget projections assume unprecedented compression of nondefense discretionary spending, which would be difficult to sustain (see chart on next page). In addition, budget projections took no account of funding for operations in Iraq and Afghanistan after FY 2006 or of pressures to limit the growing scope of the Alternative Minimum Tax.

27. ***Staff suggested that the improved growth environment and the better-than-expected revenue performance reinforced the case for bolder deficit reduction***. Staff reiterated their advice to eliminate the deficit excluding the Social Security surplus by early in the next decade—an improvement of roughly 4 percent of GDP relative to the staff's baseline. An early and substantial fiscal effort was supported by:

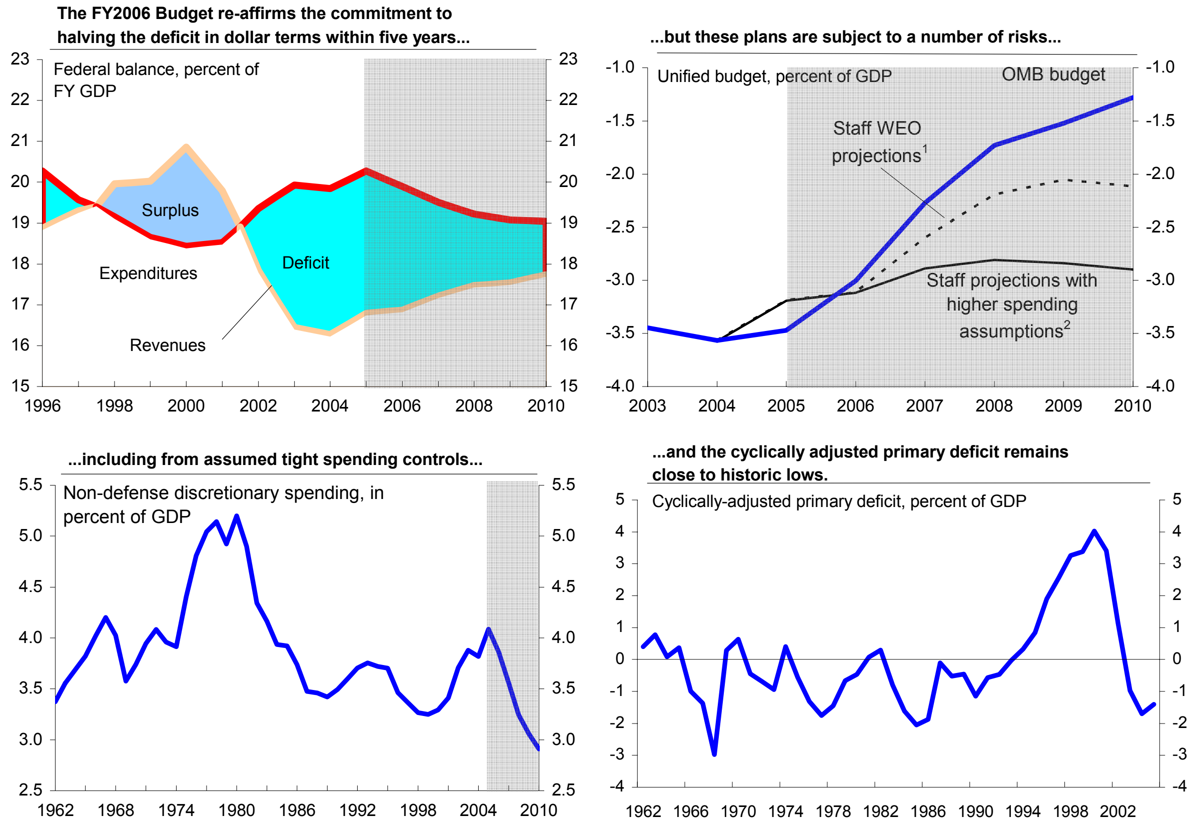
National saving has remained low even as investment has started to rebound.



Source: BEA.

- ***Cyclical considerations***. Measures to reduce the fiscal

The U.S. Fiscal Outlook



Budget Projections

(In percent of GDP)

	Fiscal Years						
	2004 actual	2005	2006	2007	2008	2009	2010
FY 2006 budget							
Unified balance	-3.6	-3.5	-3.0	-2.3	-1.7	-1.5	-1.3
Excl. Social Security	-4.9	-4.9	-4.5	-3.8	-3.3	-3.1	-2.9
Debt held by the public	37.2	38.7	39.7	40.1	39.9	39.6	38.8
Staff WEO estimate [1]							
Unified balance	-3.6	-3.2	-3.1	-2.6	-2.2	-2.1	-2.1
Excl. Social Security	-4.9	-4.6	-4.6	-4.1	-3.7	-3.6	-3.7
Debt held by the public	37.2	38.2	39.3	39.9	40.1	40.2	40.1
Memorandum item							
Unified balance, staff estimate with higher spending [2]	-3.6	-3.5	-3.6	-3.5	-3.4	-3.3	-3.3

Sources: OMB, FY 2006 Budget of the U.S. Government; and IMF staff estimates.

[1] The fiscal projections are based on the Administration's FY2006 Budget projections (February 7, 2005) adjusted to take into account: differences in macroeconomic assumptions; staff assumptions about Alternative Minimum Tax (AMT) relief; and staff assumptions about additional defense spending using analysis by the Congressional Budget Office.

[2] Based on staff WEO estimates, adjusted to keep real discretionary non-defence spending constant.

deficit by roughly 1 percent of GDP per annum over the next few years would reduce the burden on monetary policy to address domestic financial imbalances without placing an undue drag on activity in the short term, as illustrated by an alternative scenario (Appendix IV).

- ***Low national saving and large external deficit***. The staff's simulation suggests that a 4 percent of GDP permanent increase in the fiscal balance raises national saving by some 3 percent of GDP over the next 5 years, while reducing the external deficit by almost 2 percent of GDP (Appendix IV). This would move the current account closer to a sustainable level while significantly improving investment and growth at home and abroad.

- ***Global policy coordination***. By taking decisive steps toward fiscal consolidation, the United States would demonstrate leadership in implementing the G-7 Agenda for Growth, and possibly catalyze other countries to take bolder action, further reducing global current account imbalances and associated vulnerabilities.

- ***Supporting long-term fiscal sustainability*** (see Figure on next page). Most importantly, consolidation formed an essential element in moving toward long-term fiscal sustainability.[8] Putting the government debt ratio on a clear downward path would improve intergenerational fairness by reducing the burden on future generations to pay for the increases in expenditures associated with population aging. Deficit reduction would also allow time to develop and phase in gradually measures needed to reform health and retirement programs.

28. ***Officials agreed that raising national saving was an important policy priority, but saw no need to strengthen their fiscal objective***. The Administration had made substantial progress in putting in place a framework for identifying expenditure priorities and improving spending efficiency that would yield savings in the coming years.[9] Officials emphasized that revenue enhancements could spur higher spending, and the key to fiscal sustainability was the reform of entitlement programs, rather than achieving a more ambitious near-term deficit target. In their view, a fiscal deficit below 2 percent of GDP—which they were confident of reaching—was appropriate since it was well within the range of historical budget deficits and fiscal positions in other industrial countries.

29. ***Nevertheless, the mission suggested that fiscal sustainability would likely require revenue measures***. The President's Advisory Panel on Federal Tax Reform has been charged with reporting on ways to simplify and improve the efficiency of the tax system in a revenue-neutral manner, which officials explained meant a baseline that included AMT revenues. The

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[8] See *U.S. Fiscal Policies and Priorities for Long-Run Sustainability*, IMF Occasional Paper 227, 2004.

[9] The Administration is systematically assessing every program using the Performance Assessment Rating Tool (PART) to evaluate programs' success, efficiency, and objectives. The results are reported annually in the budget, and used to eliminate useless or ineffective programs.

mission strongly supported this undertaking, but argued that the magnitude of the fiscal adjustment that was needed and already ambitious plans for spending discipline suggested that options for revenue enhancements should be actively considered. Officials responded that some additional revenues could be expected from higher growth due to greater economic efficiency.

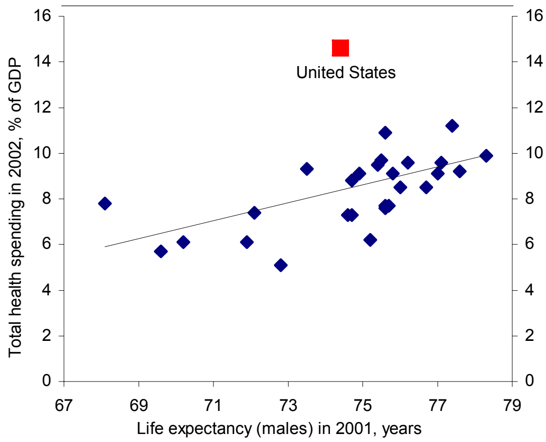
30. ***There was broad agreement that a legislated fiscal rule could support consolidation efforts***. Notwithstanding last year's defeat of a similar bill, the Administration has sought to re-authorize discretionary spending caps and pay-as-you-go (PAYGO) provisions that require the costs of proposals increasing the deficit to be offset elsewhere in the budget. Unlike the mission, however, the Administration preferred that PAYGO provisions apply only to expenditure since they viewed revenue offsets as a potential encouragement to tax-financed spending increases.

C. Long-Term Fiscal Sustainability and Entitlement Reform

31. ***The authorities agreed that long-term unfunded obligations, particularly for health care, posed the largest challenge to U.S. long-term fiscal sustainability***. Although much of the recent debate has been on Social Security, federal health care spending has been rising at a much faster pace. This trend is projected to continue, mainly reflecting cost pressures associated with shifts in demand, technological improvements and, to a smaller extent, the effects of population aging. As a result, the actuarial liability of the Social Security system over the next 75 years—estimated at 30 percent of GDP—is dwarfed by the estimated 200 percent of GDP unfunded liability of the Medicare system, a third of which arose from the prescription drug benefit enacted in 2003.[10]

32. ***With public spending financing half of all U.S. health care outlays, the mission questioned whether Medicare and Medicaid spending could be contained without reforms in the overall health sector*** (Box 4). The United States spends almost twice as much on health care as a ratio to GDP than other OECD countries—a gap only partly explained by income elasticities and consumer preferences. High costs and incommensurate health

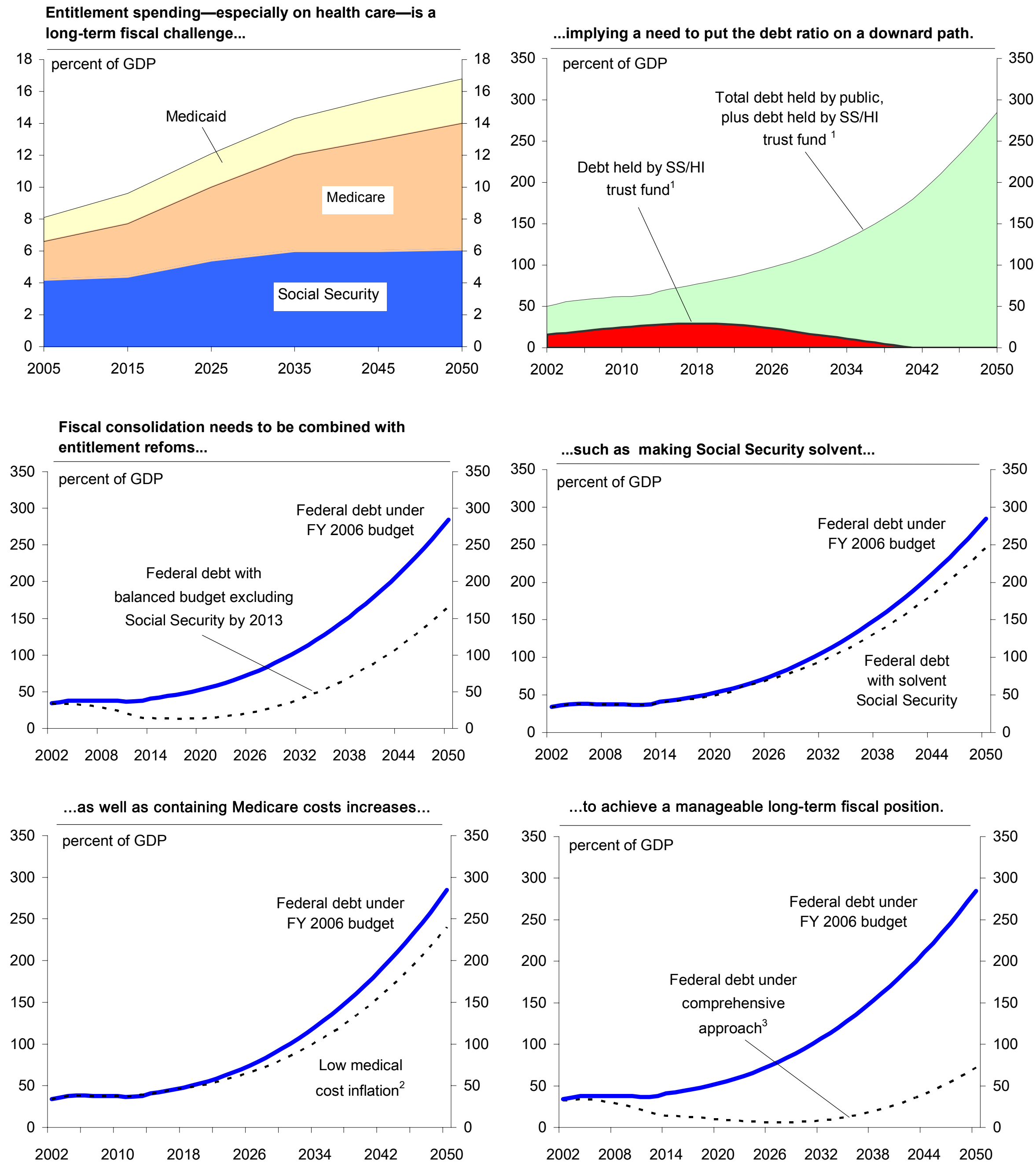
There is scope for increasing efficiency in health care spending.



Sources: CBO and OECD.

[10] Pension projections are subject to some demographic risks economic variables such as underlying productivity growth. Accordingly, the main uncertainties relate to health spending, where Medicare estimates are subject to upside risks. Actuarial calculations assume per-beneficiary spending grows at 1 percentage point a year above the growth rate of per-capita GDP, while the excess over the last decade has been more like 2–2½ percent, a value that would approximately double the unfunded liability over 75 years. In addition, both federal and state governments face future budgetary pressures from Medicaid.

Entitlement Reform and Long-Term Fiscal Sustainability



Sources: CBO; OMB; OECD; and IMF staff calculations.

[1]HI-Hospital Insurance part of Medicare.

[2]Assuming Medicare spending is kept constant as a share of GDP after 2013.

[3]Combines fiscal consolidation with slower benefit growth to make Social Security solvent and keeping Medicare expenditures constant as a share of GDP after 2013.

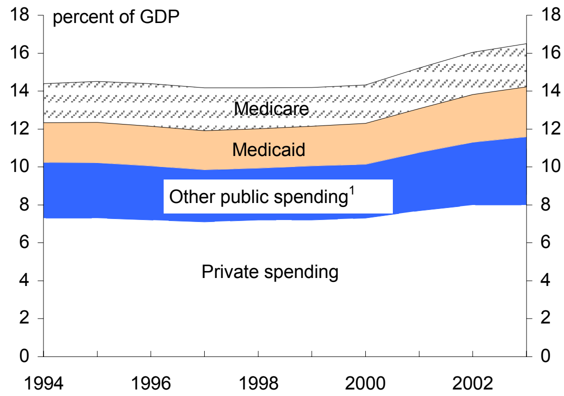
Box 4. Medicare and Medicaid[1]

This box describes the financing of the two main publicly financed entitlement health care programs—Medicare and Medicaid. These programs currently foot over one-third of all U.S. health spending, and are projected to growth rapidly in coming years as health costs rise and the population ages.

Medicare is a federal government program that provides health care for the elderly and disabled. Outlays of some 2½ percent of GDP comprise:

- ***Hospital insurance*** (HI). Funded by a 2.9 percent payroll tax, it is currently running a small surplus (¼ percent of GDP), with assets held in a trust fund. However, *HI* deficits are projected from 2018, and the trust fund will be exhausted by 2030.
- ***Supplemental Medical Insurance*** (SMI). About one-quarter of costs are funded by premiums, with the balance coming from general government revenues.
- ***Prescription drug coverage***. Legislated in 2003, benefits will become available on January 1, 2006. Only about 25 percent of program costs will be covered by premiums and the cost of standard basic coverage is estimated at $593 billion over the 2004-2013 period by the Congressional Budget Office (CBO).

United States: Health spending



Source: OECD; and Office of Management and Budget.
[1]Includes tax expenditures.

Medicaid is a joint state-federal program that provides health and long-term care for the poor. The federal government establishes broad coverage guidelines and pays 50 to 77 percent of state Medicaid expenses, with matching rates varying according to state income per capita. States are responsible for covering the balance and administering the program. Total Medicaid outlays comprise over 2½ percent of GDP.

FY 2006 Budget contains proposals that would further shift fiscal responsibility for Medicaid to the states, reducing federal financing by about $45 billion over ten years. The existing cost-sharing arrangement would be replaced by block grants to states that would be indexed to CPI inflation, rather than increases in the states' outlays. Certain financing vehicles used by the states to increase federal share of funds would be streamlined, and payments to state and local hospitals and nursing homes would be capped. In addition, states would be given more flexibility to reduce the cost of prescription drugs and prevent abuse of the Medicare's long-term care coverage by non-needy individuals through a transfer of funds to their families.

[1] Prepared by Iryna Ivaschenko.

outcomes also seem to stem from inefficiencies and weak incentive structures in the private health insurance system, as well as the large uninsured population (see Chapter 7 of the *Selected Issues* paper).

33. ***Officials emphasized that steps had already been taken to strengthen the health care system***. They noted that legal challenges to the operations of health maintenance organizations had undermined the ability of private insurers to rationalize and economize on medical benefits. Accordingly, the 2003 Medicare Modernization Act (MMA) had introduced tax-preferred Health Savings Accounts aimed at increasing the cost-sensitivity of consumers by encouraging high deductible insurance plans. The MMA also required pilot projects starting in 2010 to test whether competition between private and traditional fee-for-service plans could improve health care delivery and reduce costs. Moreover, the Administration was promoting tax preferences for purchases of health insurance by low-income workers, as well as tort reform to curb defensive medicine. Several years would be needed to gauge the success of these initiatives, during which the difficult political hurdles of Social Security and tax reform could be addressed. Thereafter, a broader national debate on health care reform could well be needed.

34. ***The mission welcomed the impetus the President had recently provided to the debate on fully funding Social Security*** (Box 5). Officials explained that, by linking future increases in initial benefits to a sliding combination of wage and price indexes, "progressive indexing"—which the President had endorsed—would eliminate some 70 percent of the system's unfunded liabilities while preserving replacement ratios for low-income workers. If needed, this approach would enable further adjustment of indexation formulas in the future and, if coupled with other reforms—such as increasing the statutory retirement age—would close the system's 75-year actuarial gap and yield a positive cash flow at the end of the 75-year period. The Administration viewed the latter objective as a critical criterion for judging sustainability.

35. ***The team cautioned that it would be important to couple the introduction of personal retirement accounts (PRAs) with measures to ensure the long-term solvency of the Social Security system***. PRAs would permit younger workers to shift up to 4 percentage points of social security contributions into PRAs, coupled with an equivalent reduction (in net present value terms) in future Social Security benefits. As discussed in Chapter 8 of the *Selected Issues* paper, the proposal would cause a significant increase in federal deficits and debt over several decades as implicit liabilities are recognized and transitional costs borne, even though its direct impact on national saving and financial markets would likely be marginal. This underscores the importance of ensuring that PRAs not be introduced without measures to eliminate the system's unfunded liabilities.

Box 5. U.S. Social Security Proposals in an International Context[1]

Social Security reform eliminating the system's funding gap and involving Personal Retirement Accounts (PRAs) is a top priority of the Administration. The President recently endorsed "progressive indexation" of benefits, which maintains indexation formulas for low-wage workers but slow benefit growth for higher-income workers, and could eliminate some three-quarters of Social Security's 75-year funding gap. The President has expressed a willingness to adopt additional measures to eliminate the remaining funding gap.

PRAs would reduce the size of the current Social Security system. Individuals could direct up to 4 percentage points of their Social Security payroll contributions into PRAs, and have their traditional Social Security benefits scaled back using a 3 percent offset rate. PRA payments would be phased in gradually and individuals would not be able to borrow against PRAs. To minimize risks and administrative costs, PRAs would have strict guidelines, including limited investment options and obligatory annuitization at retirement.

Several industrial countries, facing fiscal pressures from aging populations, have moved toward partially privatized, multi-tier pension systems. Australia, Canada, Sweden, and the United Kingdom have adopted pension systems comprising a public minimum safety net supplemented by various types of vehicles invested by professional asset managers—employment-based retirement accounts that are mandatory in Australia and Canada and voluntary in the United Kingdom, and income-based mandatory accounts in Sweden.[2] In all countries, the public system is supplemented by a number of tax-preferred private and corporate retirement accounts. A number of emerging market economies, following the lead of Chile, have also introduced pension systems that rely fully on private retirement accounts.

Such pension reforms have successfully reduced long-term unfunded liabilities, but concerns about the adequacy of private savings have been an issue in many countries.[3] Most countries supplemented partial privatization efforts with some benefit modification, significantly reducing public pension liabilities. While Australia's mandatory second tier has boosted overall national saving, voluntary private retirement accounts have generated limited retirement savings, reflecting low opt-in rates and insufficient investment expertise of account owners, while high management costs—particularly in systems with less regulation of accounts—have reduced returns. Insufficient private savings may leave some population groups vulnerable to a loss of income at old age, with potential consequences for public finances and the social safety net.

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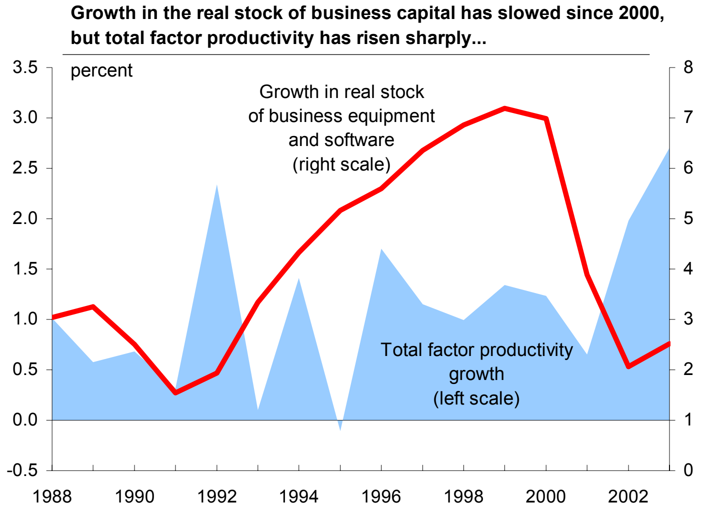
[1] Prepared by Iryna Ivaschenko.

[2] In Sweden, income-based individual accounts are notional—i.e. although contributions are being credited to individual accounts, funds are being used to pay benefits to current retirees.

[3] See Joint Committee on Taxation (JCX 14-99), and Heritage Foundation (various briefs).

D. Tax Reform and Structural Issues



36. ***The mission cautioned that it would be important to raise national saving to support capital accumulation and buttress labor productivity.*** Strong investment in new technology in the late 1990s and flexible factor markets had supported rapid increases in total factor productivity (TFP) growth since 2001, offsetting the negative impact on capital deepening of the collapse in business investment during the recent downturn. However, with TFP growth likely to moderate to a more sustainable level over the medium-term, and the working-age population also set to slow, stronger investment would help support the economy's underlying growth momentum.

37. ***Officials emphasized that raising the personal saving rate was a core objective of the Administration's plans for tax reform***. Tax rates had been lowered significantly on dividends and capital gains, and the Administration supported the complete elimination of the double taxation of the returns to saving. Also, the FY 2006 budget included proposals to consolidate, simplify, and extend existing tax-preferred saving schemes. There were also encouraging signs that key members of Congress would seek to develop a plan that would address tax and Social Security reform in a comprehensive manner that both strengthened individual incentives for saving for retirement security, bolstered regulations governing corporate pension plans, and placed the public pension system on a sustainable footing.

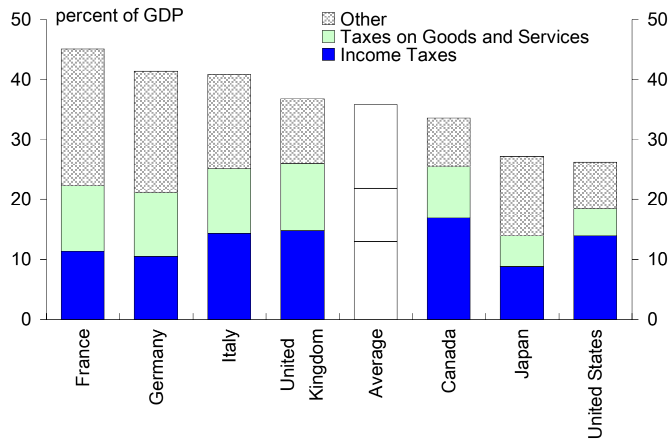
38. ***The mission cautioned that fiscal incentives would be most effective in raising national saving if they were fully financed***. As elaborated in Chapter 8 of the *Selected Issues* paper, reducing the double taxation of capital income would not necessarily raise national saving and investment unless fiscal revenue losses were offset. The staff also cautioned that the Administration's promotion of an "ownership society"—intended to increase share ownership among U.S. citizens—would increasingly shift financial risks on to households already facing reductions in coverage by employer health and defined-benefit (DB) pension plans. Against this background, the mission welcomed recent efforts to promote the use of automatic enrollment and default investment options in private pension plans.

39. ***Staff and officials concurred that there was considerable scope for reducing complexity and inefficiencies in the tax system.***[11] The U.S. tax system has higher statutory tax rates and lower revenue yields than the OECD average, reflecting widespread personal and corporate income tax preferences. These account for about 40 percent of potential tax revenue, and include significant preferences for employer-provided medical insurance, pension contributions, and charitable giving. In particular, the mission noted that tax benefits for housing—including interest mortgage deductibility, the treatment of property taxation, and capital gains—were the most generous in the G-7 and helped to explain the relatively high ratio of U.S. residential to business investment.

40. ***Officials expected the President's Tax Advisory Panel to provide suggestions for significant tax reforms, including base broadening to offset the costs of eliminating the AMT***. They noted that the costs of replacing future AMT revenues were substantial and would rise rapidly over time. Therefore, the panel's report—due in September—would likely need to recommend cutbacks in major tax expenditures, although the panel had been charged with taking into account "the importance of homeownership and charity in American society."

41. ***The mission questioned whether a federal VAT or sales tax would be considered***. Staff noted this could improve the efficiency of the system by shifting the burden from income to consumption and could also help improve intergenerational equity in the face of an aging population. Officials responded that the Administration's tax reform proposals would likely affect taxes on income as well as consumption, although the latter could also be achieved by reducing the double taxation of investment income. The staff also raised the possibility of increased energy taxation as a means to contribute to greater energy self-sufficiency and generate additional revenues. Officials observed that energy taxation was not covered by the mandate of the President's Tax Advisory Panel.

The U.S. is relatively dependent on income tax revenues.



E. Financial Sector and Trade Issues

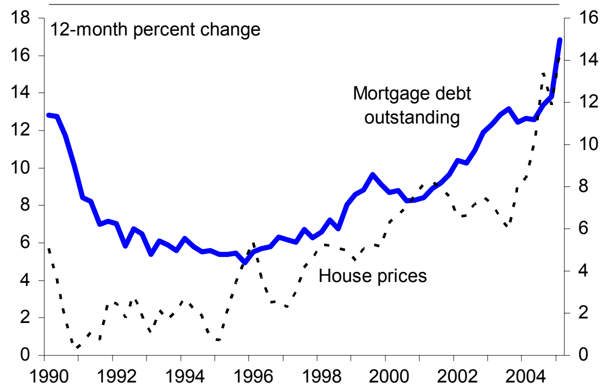
42. ***The U.S. financial sector remains resilient and well regulated.*** At the time of the discussions, supervisory officials were satisfied by the increase in interest rate spreads,

[11] The 2003 *Economic Report of the President* estimates that individual taxpayers spend on average 27 hours each year to comply with the tax code.

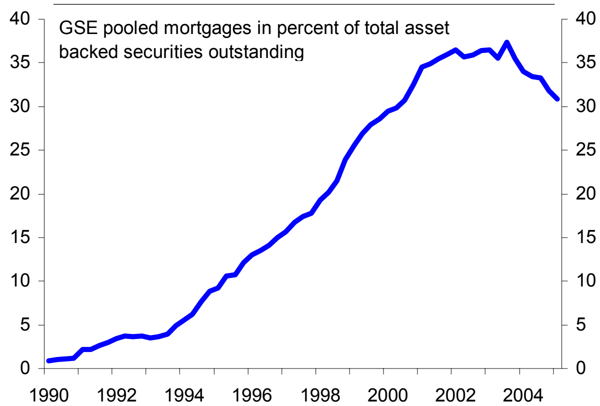
particularly on high yield instruments, from surprisingly low earlier levels. They explained that consumer business had been a major source of bank revenues, with strong gains from home-equity loans and mortgage servicing offsetting slower growth of credit card loans and mortgage originations.

43. ***Risks to banks from a correction in housing markets were judged relatively low***. Despite froth in some regional markets and increasing use of riskier mortgage products, such as interest-only and adjustable rate loans, trends on a national level were less of a concern and loan portfolios were well diversified geographically. Supervisory agencies indicated they were close to finalizing a guidance note (subsequently issued in May) requiring banks to strengthen risk management with regard to riskier mortgage products, a move welcomed by staff.

Low interest rates have supported mortgage borrowing and housing prices...



...and the balance sheets of GSEs have grown rapidly in recent years.



Sources: Board of Governors, Federal Reserve; and Pension Benefit Guarantee Corporation.

44. ***The mission also discussed other efforts to improve supervision in the bank and nonbank sector***:

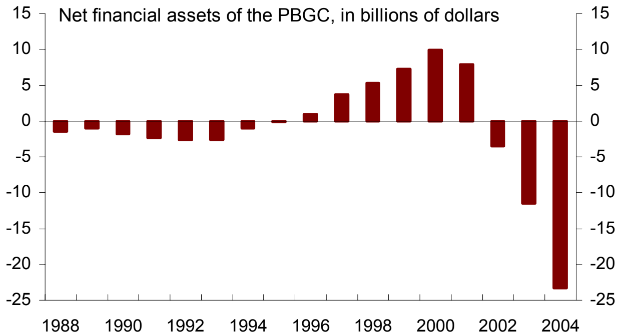
- ***Basel II***. Officials noted that the timetable for implementing the Basle II framework could be missed, given that time was needed to analyze the surprisingly large effects on capital ratios coming from the latest round of bank self-assessments.

- ***Corporate governance***. Officials suggested that reform of corporate governance rules under the Sarbanes-Oxley legislation had progressed smoothly, with concerns over compliance costs likely to diminish as the transition to the new system was complete.

- ***Government-sponsored housing enterprises*** (GSEs). The mission supported the Administration's plans for establishing an independent regulator, involving limits on the size of GSE portfolios and allowing the regulator to set capital requirements, design stress tests, and place a financially-weak GSE into receivership. Congress has subsequently taken up this issue, but draft legislation has not included adequate measures to limit the size of GSE portfolios.

- ***Corporate pension reform***. Noting the large unfunded liabilities in defined benefit pension plans—and the potential cost to the Pension Benefit Guaranty Corporation—the mission also welcomed the Administration's proposals for strengthening funding incentives and raising disclosure requirements, to reduce moral hazard.

The recent failure of several corporate pension plans has contributed to a deterioration in the Pension Benefit Guarantee Corporations's financial position.



- ***Insurance***. Following the recent discovery of irregularities in the insurance sector, the mission inquired whether there was a need for a national approach to regulating systematically important insurance companies, which presently fall under state jurisdiction. The officials responded that state supervision appeared to be adequate and that there was a strong and effective working relationship between federal and state supervisors.

45. ***The authorities welcomed recent progress made in the Doha Round negotiations, but cautioned that key issues remained unresolved***. Officials were pleased with the fresh momentum behind agricultural discussions following the resolution of differences over the conversion of specific into *ad valorem* tariffs. Priorities now were to secure sharp reductions in agricultural tariffs among the large industrial and developing countries, while minimizing the list of sheltered products, and achieving progress in other areas, notably non-agricultural market access and services. Outstanding issues would have to be largely settled before the WTO's ministerial meeting in Hong Kong if the Round was to conclude in 2006.

46. ***Officials hoped for higher-quality offers in the WTO services negotiations, particularly from developing countries***. In order to speed the progress of negotiations, the Administration was exploring ways to streamline the cumbersome request-offer process, including through the design of benchmark offers of varying ambition. Officials indicated that U.S. flexibility on liberalizing services requiring the temporary movement of natural persons—an area of particular interest to developing countries—was severely constrained by immigration and security concerns.

47. ***The authorities reiterated that U.S. free trade agreements (FTAs) were an effective means for promoting multilateral trade liberalization***. Officials emphasized that these were comprehensive in scope, including ambitious commitments for most goods and setting a high standard for multilateral negotiations. The mission stressed the importance of ensuring that this approach did not undermine the fabric of the multilateral trading system, which was based on non-discrimination. There was also a risk of complicating the administration of trade and taxing the limited negotiating capacities of countries to the detriment of the Doha Round.

48. ***The staff expressed concerns over rising protectionist sentiment in the U.S. Congress***. Officials cautioned that containing protectionist sentiment on Capitol Hill would be difficult without a change in Chinese exchange rate policy. In response to surging textile imports from China after quotas expired at end-2004, the United States had introduced safeguard measures on seven textile products in May. Officials emphasized that these were compatible with the protocol for China's WTO accession and preferable to self-imposed export restraints by China or recent measures proposed in Congress. The mission noted that the impact of China-specific safeguards on U.S. manufacturers was uncertain, given that Chinese imports appeared to have displaced primarily suppliers from other foreign countries.[12]

49. ***Officials noted the rise in the U.S. ODA/GNI ratio while observing there were other channels for foreign assistance***. The ODA/GNI ratio had jumped to 0.16 percent in 2004, up from 0.11 in 2001. While this partly reflected spending on Iraq and Afghanistan, underlying funding had increased, and the Administration remained committed to maintaining the assistance provided by USAID even as the Millennium Challenge Account was becoming operational. In response to the staff's observation on the relatively low level of the U.S. ODA/GNI ratio, the authorities noted that U.S. assistance to foreign countries was several times higher once sizeable private donations and outlays such as defense were taken into account.

IV. Staff Appraisal

50. ***The United States has continued to be the main locomotive of global growth, and nearer term prospects appear broadly favorable***. There have been signs in recent months that the pace of expansion has eased somewhat, and concerns about the record-low household saving rate endure. Nonetheless, growth is likely to remain slightly above trend as inflation pressures appear to have been contained despite the rise in world oil prices. U.S. growth is again expected to outperform the rest of the G-7 in 2005.

51. ***Looking forward, however, U.S. policymakers face important challenges***. The United States' heavy reliance on foreign saving and the still-large fiscal deficit have

[12] See Chapter 7 of IMF Country Report 04/228. The mission also cited evidence that Chinese competition primarily affected U.S. producers through lower unit prices, which would not be reversed by import constraints.

contributed to global current account imbalances and fears of systemic risks, especially if U.S. productivity growth were to falter. In concert with the adoption of structural reforms and greater exchange rate flexibility abroad, the critical priority for the United States is ambitious fiscal consolidation coupled with measures to ensure the long-term sustainability of public health and retirement systems.

52. ***The Federal Reserve's gradual and flexible approach to monetary tightening has been been effective***. Interest rate hikes have been coupled with clear messages that more forceful action would be required if price pressures continued to intensify, which has helped anchor inflation expectations and allowed a gradual pace of tightening. Looking forward, however, monetary conditions still appear accomodative and—especially against the background of low unemployment, the recent rise in unit labor costs, and house price inflation—a more aggressive pace of interest rate hikes cannot be ruled out.

53. ***The Federal Open Market Committee has recently taken the welcome step of debating the merits of a more explicit inflation objective***. The Federal Reserve is already among the most transparent central banks in the world. Nonetheless, the experience in other countries suggests that a clearer definition of the central bank's inflation objective can help further anchor inflation expectations and long-term bond yields, without unduly constraining the ability of policymakers to meet shorter-term stabilization objectives.

54. ***The Administration's call for deficit reduction is welcome, but more ambitious efforts appear warranted, especially in the face of looming demographic pressures***. Encouragingly, revenues have strengthened and may again contribute to a better-than-expected fiscal outcomes this year. Nonetheless, budget targets for next year and beyond would yield relatively modest adjustments in the government's structural position, and even these gains may be difficult to achieve given the expected reliance on an unprecedented compression in nondefense discretionary spending. It would be particularly worrisome if the U.S. fiscal deficit and debt remained high until the end of the decade, just as the pressures on entitlement programs from the baby boom generation begin to intensify.

55. ***The current favorable growth conjuncture suggests room for bolder deficit reduction over the coming years***. Achieving a balanced budget excluding Social Security early in the next decade would support national saving, domestic investment, and the external position, forming an important pillar in the international strategy for reducing external imbalances. Most importantly, significantly lowering the federal debt ratio over time would provide room to cope with impending pressures on health and retirement programs and reduce the burden on future generations.

56. ***Expenditure discipline will be an essential part of any deficit reduction, but tax reform should also play a role in supporting fiscal sustainability***. The magnitude of the fiscal adjustment needed and the strict spending discipline already assumed make it seem prudent to explore options for revenue enhancements. To avoid having to unwind recent cuts in tax rates, consideration should be given to broadening the income tax base—by curbing deductions, such as the generous treatment of mortgage interest—or to taxing consumption

more directly in the form of a national consumption or energy tax. A legislated budget rule could also help support fiscal responsibility, and re-authorization of the Budget Enforcement Act (BEA) provisions—including pay-as-you-go provisions that cover revenue measures—would seem appropriate.

57. ***Demographic and other pressures imply that Medicare outlays are on an unsustainable path***. Administration proposals and the provisions of the 2003 Medicare Modernization Act could help moderate price pressures. However, with the Medicaid system under similar strains, a large uninsured population, growing numbers of the elderly, and a projected tripling of public health care outlays as a ratio to GDP in coming decades, further steps are urgently needed to improve the efficiency of the health care system. Indeed, given similar pressures being faced by the private health care sector, a broader reform effort may be required.

58. ***Encouraging steps have been taken to address the solvency of the Social Security system***. The Administration has helpfully offered support to one proposal for slowing the growth of benefits, and relatively modest additional measures would be required to eliminate the system's underfunding and to ensure a positive cash flow over the foreseeable future. The Administration's proposal for personal retirement accounts (PRAs) would not help place the system on a sustainable basis and would significantly raise federal deficits and debt in coming decades, and it will be important to combine PRAs with a comprehensive plan to ensure the long-run solvency of the Social Security system. The key priority is to avoid delays in reforms that fully fund the system, since this would only increase the adjustments that will eventually be needed.

59. ***Structural reforms to support saving and capital accumulation would help sustain high labor productivity growth***. The steady decline in coverage by defined-benefit pension plans and employer-sponsored health care plans in recent years has meant that financial risks carried by households have already been increasing. This suggests the importance of public policies that encourage appropriate saving decisions, including by promoting retirement plans in which participation is the default option.

60. ***The U.S. financial sector has proven exceptionally resilient in recent years, but there remains scope for further reform***. The Administration has placed an appropriate emphasis on strengthening pension funding and improving supervision and shrinking the balance sheets of the housing government sponsored enterprises (GSEs). At the same time, recent irregularities in the insurance sector suggest that there may be a need for supervision of systemically important entities at a national level. Recent regulatory moves to tighten lending standards on mortgage instruments are appropriate, particularly given signs that home prices may be exceeding equilibrium levels in some parts of the country.

61. ***As demonstrated by its role in securing last year's framework agreement for the Doha Round, the United States is an important leader in the quest for global trade liberalization***. Administration proposals for deep reductions in agricultural and non-agricultural tariffs, as well as plans to offer and elicit stronger commitments for liberalization

in services, have been particularly helpful. At the same time, care should be taken to ensure that the U.S. strategy of negotiating a large number of bilateral free trade agreements is consistent with the multilateral trading system. It is also critically important to ensure that the authorities resist protectionism—including in the wake of the expiration of textiles quotas—which is not in the interest of U.S. consumers or the rest of the world.

62. ***Recent increases in U.S. official development assistance (ODA) and progress on the Millennium Challenge Account are welcome***. However, U.S. ODA relative to GNI remains among the lowest across industrial countries, arguing for continued efforts to boost U.S. foreign assistance.

63. It is recommended that the next Article IV consultation take place within the standard 12-month cycle.

United States: Fund Relations
(As of May 31, 2005)

I. **Membership Status**: Joined 12/27/45; Article VIII

II.	**General Resources Account:**	**SDR Million**	**Percent Quota**
	Quota	37,149.30	100.0
	Fund holdings of currency	26,702.13	71.9
	Reserve position in Fund	10,445.32	28.1

III.	**SDR Department:**	**SDR Million**	**Percent Allocation**
	Net cumulative allocation	4,899.53	100.0
	Holdings	7,718.72	157.5

IV. **Outstanding Purchases and Loans**: None

V. **Financial Arrangements**: None

VI. **Projected Obligations to Fund**: None

VII. **Exchange Rate Arrangements:** U.S. dollar floats independently and is determined freely in the foreign exchange market.

VIII. **Payments Restrictions**: The United States has notified the Fund under Decision No. 144 of restrictions on payments and transfers for current international transactions to Libya, Iraq, North Korea, Cuba, and Iran. The United States restricts the sale of arms and petroleum to the National Union for the Total Independence of Angola (UNITA) and to the territory of Angola and has prohibitions against transactions with international narcotics traffickers. The United States notified the Fund under Decision No. 144 on August 2, 1995 of the imposition of further restrictions on current transactions with Iran. On March 21, 2002, the Unite States notified the Fund of exchange restrictions related to the financing of terrorism.

IX. **Article IV**. The 2004 Article IV consultation was concluded in July 2004 and the Staff Report was published as IMF Country Report No. 04/230. A fiscal ROSC was completed in the context of the 2003 consultation.

Statistical Issues

Statistical Issues: Comprehensive economic data are available for the United States on a timely basis. The quality, coverage, periodicity, and timeliness of U.S. economic data are considered to be good both in the context of the Article IV consultation and for purposes of ongoing surveillance. The United States has subscribed to the Special Data Dissemination Standard (SDDS) and its metadata are posted on the Dissemination Standard Bulletin Board (DSBB).

United States: Table of Common Indicators Required for Surveillance

(As of June 10, 2005)

	Date of latest observation	Date received	Frequency of data[6]	Frequency of reporting[6]	Frequency of publication[6]
Exchange rates	same day	same day	D	D	D
International reserve assets and reserve liabilities of the monetary authorities[1]	Jun 3	Jun 7	W	W	W
Reserve/base money	May 25	Jun 2	W	W	W
Broad money	May 23	Jun 2	W	W	W
Central bank balance sheet	Jun 1	Jun 2	W	W	W
Interest rates[2]	Same day	Same day	D	D	D
Consumer price index	Apr 2005	May 18	M	M	M
Revenue, expenditure, balance and composition of financing[3] – general government[4]	2005 Q1	May 26	Q	Q	Q
Revenue, expenditure, balance and composition of financing[3] – central government	Apr 2005	May 11	M	M	M
Stocks of central government and central government-guaranteed debt	Apr 2005	May 11	M	M	M
External current account balance	2005 Q1	June 17	Q	Q	Q
Exports and imports of goods and services	Mar 2005	May 11	M	M	M
GDP/GNP	2005 Q1	May 26	Q	Q	Q
Gross External Debt[5]	Dec 31 2004	Mar 31 05	Q	Q	Q

[1]Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2]Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3]Foreign, domestic bank, and domestic nonbank financing.
[4]The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5]Including currency and maturity composition.
[6]Daily (D), Weekly(W) Monthly(M), Quarterly (Q), Annually (A); NA: Not Available.

United States—Debt Sustainability

1. ***This appendix subjects projections for U.S. public debt and external debt to a series of macroeconomic stress tests***. The first set of tests follows the methodology prescribed in "Assessing Sustainability," (www.imf.org, May 28, 2002), in which baseline trajectories for these debt variables are determined by setting key macroeconomic variables, including the primary fiscal deficit and the non-interest current account at values projected by staff. The fiscal and external baselines are then subjected to two-standard deviation shocks in domestic interest rates, real growth, inflation, real exchange rates, primary fiscal deficit (government debt only) and non-interest current account (external debt only), each lasting two years.

2. ***The exercise focuses on short- to medium-term vulnerabilities for the general government***. Accordingly, net general government debt is defined by combining the net financial liabilities of federal, state, and local government debt to the public (that is, excluding government debt held by the social insurance trust funds). On the external side, staff uses gross external liabilities as the measure of the stock of external financing.

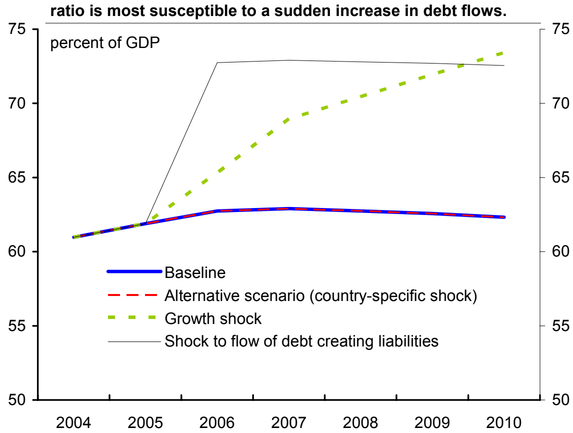
3. ***In all but one case shocks to the fiscal baseline initially boost public debt, but then resume the downward trend of the baseline scenario*** (Table 1a and figure 1a). Shocks lasting two years in interest rate, primary balance, real exchange rate, and flow of liabilities (shock lasting one year) reveal no persistence in the net government debt-to-GDP ratio after the first two years. Only a shock to real growth presents a persistence problem that may require alternative policy actions.

4. ***U.S. external debt appears resilient to shocks in real growth and domestic prices*** (Table 1b and figure 2a). Shocks in the first two years raise the debt ratio, but it then resumes the trend of the baseline forecast. The interest rate shock also initially raises the level of external debt, but following the shock, debt levels then rise slower than in all other scenarios including the baseline.

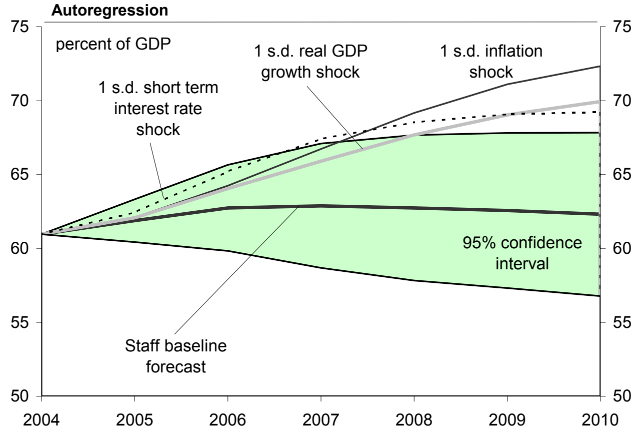
5. ***Alternative stress tests using vector autoregressions (VAR) found persistent shocks to growth and inflation to pose greater threats to domestic debt sustainability than interest rates.*** The staff used a VAR to estimate the impact of growth, inflation and interest shocks on government net debt. A persistent one standard deviation increase in short term interest rates initially accelerates debt accumulation faster than similarly calibrated higher inflation or lower growth, but then stabilizes with debt at 69 percentage points of GDP, whereas persistent shocks to growth and inflation imply continuing increases in government debt over the medium term (figure 1b). Staff also used the VAR model to estimate a 95 percent confidence interval from all macroeconomic shocks included in the VAR (growth, inflation, short- and long-term interest rates, general government fiscal balance, and real effective exchange rates). This experiment suggests that more temporary shocks imply relatively limited risks to the government debt path, with uncertainty of around +/- 5 percentage points of GDP after 5 years.

6. ***The external sector VAR finds that persistent real effective exchange rate shocks could marginally worsen the U.S. debt position*** while higher inflation or lower growth may actually improve the debt profile. For this exercise, staff used the net international investment position (IIP) to better control for the outflow of investment funds by U.S. nationals relative to the financing needs of the current account (figure 2b). Given susceptibility of net international investment position to interest rate, growth, inflation, and real exchange rate shocks, the VAR estimates a 95% confidence interval of +/- 6 percentage points of GDP in the fifth year of the staff forecast.

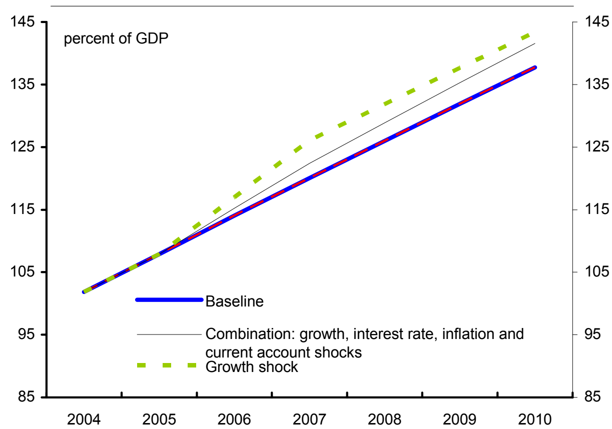
1a. Static stress tests indicates general government net debt ratio is most susceptible to a sudden increase in debt flows.



1b. Sensitivity Analysis: General Government Net Debt Via Vector Autoregression



2a. Gross External Liabilities



2b. Net International Investment Position

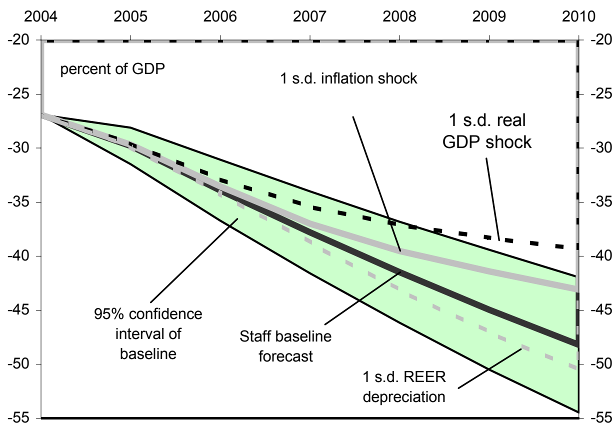


Table 1a. Public Sector Debt Sustainability Framework, 1999–2009

(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2000	2001	2002	2003	2004			2005	2006	2007	2008	2009	2010	
								I. Baseline Projections						**Debt-stabiliz primary balance 10**
Public sector debt 1/	57.1	56.6	58.6	60.5	61.0			**61.9**	**62.7**	**62.9**	**62.7**	**62.6**	**62.3**	**0.7**
o/w foreign-currency denominated	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
Change in public sector debt	-5.6	-0.6	2.0	1.9	0.5			0.9	0.9	0.1	-0.1	-0.2	-0.3	
Identified debt-creating flows (4+7+12)	-4.8	-1.1	2.0	1.9	0.5			0.9	0.9	0.1	-0.1	-0.2	-0.3	
Primary deficit	-5.0	-2.7	0.9	1.9	1.5			1.5	1.0	0.1	-0.4	-0.7	-1.0	
Revenue and grants	31.8	30.7	28.2	27.7	27.9			28.2	28.3	28.5	28.6	28.7	29.4	
Primary (noninterest) expenditure	26.8	28.0	29.1	29.5	29.4			29.7	29.3	28.6	28.2	28.0	28.5	
Automatic debt dynamics 2/	0.2	1.6	1.1	0.0	-1.0			-0.6	-0.2	0.0	0.3	0.5	0.7	
Contribution from interest rate/growth differential 3/	0.2	1.6	1.1	0.0	-1.0			-0.6	-0.2	0.0	0.3	0.5	0.7	
Of which contribution from real interest rate	2.4	2.1	2.1	1.7	1.5			1.5	1.9	2.2	2.4	2.5	2.7	
Of which contribution from real GDP growth	-2.2	-0.4	-1.0	-1.7	-2.5			-2.1	-2.1	-2.2	-2.1	-2.0	-2.0	
Contribution from exchange rate depreciation 4/	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes (2-3)	-0.8	0.5	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
Public sector debt-to-revenue ratio 1/	179.4	184.0	208.0	218.6	218.7			219.2	221.7	220.5	219.5	218.3	211.8	
Gross financing need 5/	-1.3	0.7	4.0	4.6	4.3			4.4	4.2	3.5	3.2	3.0	2.9	
in billions of U.S. dollars	-131.8	66.5	415.7	508.1	501.1	10-Year Historical Average	10-Year Standard Deviation	543.8	555.1	492.5	468.8	472.0	478.9	Projected Average
Key Macroeconomic and Fiscal Assumptions														
Real GDP growth (in percent)	3.7	0.8	1.9	3.0	4.4	3.3	1.3	3.6	3.6	3.6	3.5	3.4	3.3	3.5
Average nominal interest rate on public debt (in percent) 6/	6.2	6.1	5.5	4.9	4.8	6.1	0.7	5.0	5.4	5.8	6.0	6.3	6.5	5.9
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	4.1	3.7	3.9	3.1	2.7	4.2	0.9	2.8	3.4	3.8	4.0	4.3	4.5	3.8
Nominal appreciation (increase in US dollar value of local currency, in percent)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Inflation rate (GDP deflator, in percent)	2.2	2.4	1.7	1.8	2.1	1.8	0.4	2.3	2.0	2.0	2.0	2.0	2.0	2.1
Growth of real primary spending (deflated by GDP deflator, in percent)	3.7	5.2	6.0	4.5	4.0	3.6	1.5	4.7	2.4	1.2	1.8	2.6	5.2	3.0
Primary deficit	-5.0	-2.7	0.9	1.9	1.5	-1.9	2.6	1.5	1.0	0.1	-0.4	-0.7	-1.0	0.1
A. Alternative Scenarios								**II. Stress Tests for Public Debt Ratio**						**Debt-stabiliz primary balance 10**
A1. Key variables are at their historical averages in 2005-10 7/								**61.9**	**60.5**	**59.0**	**57.6**	**56.1**	**54.7**	**0.4**
A2. No policy change (constant primary balance) in 2005-10								**61.9**	**63.2**	**64.7**	**66.4**	**68.5**	**70.7**	**0.8**
A3. Country-specific shock in 2005, with reduction in GDP growth (relative to baseline) of one standard deviation 8/								**61.9**	**62.7**	**62.9**	**62.7**	**62.6**	**62.3**	**0.7**
A4. Selected variables are consistent with market forecast in 2005-10								**61.9**	**62.7**	**62.9**	**62.7**	**62.6**	**62.3**	**0.7**
B. Bound Tests														
B1. Real interest rate is at historical average plus two standard deviations in 2005 and 2006								**61.9**	**64.2**	**65.7**	**65.6**	**65.4**	**65.2**	**0.7**
B2. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006								**61.9**	**65.3**	**69.0**	**70.5**	**71.9**	**73.4**	**0.8**
B3. Primary balance is at historical average minus two standard deviations in 2005 and 2006								**61.9**	**64.9**	**68.2**	**68.1**	**67.9**	**67.7**	**0.7**
B4. Combination of B1-B3 using one standard deviation shocks								**61.9**	**64.3**	**66.8**	**66.7**	**66.5**	**66.3**	**0.7**
B5. One time 30 percent real depreciation in 2005 9/								**61.9**	**62.7**	**62.9**	**62.7**	**62.6**	**62.3**	**0.7**
B6. 10 percent of GDP increase in other debt-creating flows in 2005								**61.9**	**72.7**	**72.9**	**72.8**	**72.7**	**72.5**	**0.8**

1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.
2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi (1+g)$ and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.
5/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
6/ Derived as nominal interest expenditure divided by previous period debt stock.
7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
8/ The implied change in other key variables under this scenario is discussed in the text.
9/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).
10/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Table 1b. External Debt Sustainability Framework, 1999–2009
(In percent of GDP, unless otherwise indicated)

	2000	2001	2002	2003	2004			Projections 2005	2006	2007	2008	2009	2010		
								I. Baseline Projections							**Debt-stabilizing non-interest current account 6/**
External debt	91.5	90.9	87.4	95.6	101.8			**107.9**	**114.0**	**120.0**	**126.0**	**131.9**	**137.7**		**-14.0**
Change in external debt	0.5	-0.6	-3.5	8.1	6.3			6.1	6.1	6.0	5.9	5.9	5.8	0.0	
Identified external debt-creating flows (4+8+9)	-6.1	-1.8	0.2	0.0	-2.1			-1.3	-1.6	-1.9	-2.2	-2.4	-2.8	0.0	
Current account deficit, excluding interest payments	7.5	6.3	6.9	7.1	8.5			8.8	9.6	10.1	10.5	10.5	10.7	14.0	
Deficit in balance of goods and services	3.9	3.6	4.0	4.5	5.3			5.3	4.9	4.6	4.4	4.2	4.1		
Exports	10.9	9.9	9.3	9.3	9.8			10.2	10.7	11.0	11.2	11.5	11.8		
Imports	14.8	13.5	13.3	13.8	15.0			15.5	15.6	15.6	15.6	15.7	15.8		
Net non-debt creating capital inflows (negative)	-5.2	-2.8	-1.2	-0.7	-1.9			-1.4	-1.5	-1.5	-1.5	-1.5	-1.6	-1.6	
Automatic debt dynamics 1/	-8.4	-5.3	-5.5	-6.4	-8.8			-8.8	-9.7	-10.6	-11.2	-11.4	-11.9	-12.5	
Contribution from nominal interest rate	-3.3	-2.5	-2.4	-2.3	-2.9			-3.0	-3.9	-4.4	-4.8	-5.0	-5.2	-5.4	
Contribution from real GDP growth	-3.1	-0.7	-1.6	-2.5	-4.0			-3.5	-3.7	-3.9	-4.0	-4.0	-4.2	-4.3	
Contribution from price and exchange rate changes 2/	-1.9	-2.1	-1.5	-1.6	-2.0			-2.3	-2.2	-2.2	-2.4	-2.5	-2.6	-2.7	
Residual, incl. change in gross foreign assets (2-3)	6.6	1.3	-3.7	8.1	8.4			7.4	7.7	8.0	8.2	8.4	8.6	0.0	
External debt-to-exports ratio (in percent)	838.7	914.6	939.3	1030.4	1041.5			1053.4	1069.3	1094.8	1122.8	1147.3	1169.6		
Gross external financing need (in billions of US dollars) 3/															
in percent of GDP															
Key Macroeconomic Assumptions						10-Year Historical Average	10-Year Standard Deviation							For debt stabilization	Projected Average
Real GDP growth (in percent)	3.7	0.8	1.9	3.0	4.4	3.3	1.3	3.6	3.6	3.6	3.5	3.4	3.3	3.3	3.5
Exchange rate appreciation (US dollar value of local currency, change in percent)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
GDP deflator in US dollars (change in percent)	2.2	2.4	1.7	1.8	2.1	1.8	0.4	2.3	2.0	2.0	2.0	2.0	2.0	2.0	2.1
Nominal external interest rate (in percent)	-3.8	-2.8	-2.7	-2.8	-3.2	-3.8	0.9	-3.1	-3.8	-4.1	-4.3	-4.2	-4.2	-4.2	-3.9
Growth of exports (US dollar terms, in percent)	10.8	-6.0	-3.1	4.6	12.4	5.2	6.6	11.1	10.1	8.7	8.1	8.0	8.0		9.0
Growth of imports (US dollar terms, in percent)	17.9	-5.5	2.1	8.5	16.3	8.4	6.8	9.3	6.1	6.0	5.7	6.0	6.3		6.6
Current account balance, excluding interest payments	-7.5	-6.3	-6.9	-7.1	-8.5	-6.0	1.5	-8.8	-9.6	-10.1	-10.5	-10.5	-10.7		-10.1
Net non-debt creating capital inflows	5.2	2.8	1.2	0.7	1.9	2.4	1.8	1.4	1.5	1.5	1.5	1.5	1.6		1.5
								II. Stress Tests for External Debt Ratio							**Debt-stabilizing non-interest current account 6/**
A. Alternative Scenarios															
A1. Key variables are at their historical averages in 2005-09 4/								**107.9**	**110.1**	**112.4**	**114.7**	**117.1**	**119.5**		**-12.6**
A2. Country-specific shock in 2005, with reduction in GDP growth (relative to baseline) of one standard deviation 5/								**107.9**	**114.0**	**120.0**	**126.0**	**131.9**	**137.7**		**-14.0**
A3. Selected variables are consistent with market forecast in 2005-09								**107.9**	**114.0**	**120.0**	**126.0**	**131.9**	**137.7**		**-14.0**
B. Bound Tests															
B1. Nominal interest rate is at historical average plus two standard deviations in 2005 and 2006								**107.9**	**115.9**	**124.0**	**129.6**	**135.2**	**140.8**		**-14.3**
B2. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006								**107.9**	**117.0**	**126.1**	**131.9**	**137.6**	**143.4**		**-14.6**
B3. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2005 and 2006								**107.9**	**115.0**	**122.0**	**127.9**	**133.8**	**139.6**		**-14.2**
B4. Non-interest current account is at historical average minus two standard deviations in 2005 and 2006								**107.9**	**113.6**	**118.7**	**124.7**	**130.8**	**136.7**		**-13.9**
B5. Combination of B1-B4 using one standard deviation shocks								**107.9**	**115.2**	**122.4**	**128.9**	**135.3**	**141.6**		**-14.4**
B6. One time 30 percent nominal depreciation in 2005								**107.9**	**114.0**	**120.0**	**126.0**	**131.9**	**137.7**		**-14.0**

1/ Derived as [r - g - ρ(1+g) + εα(1+r)]/(1+g+ρ+gρ) times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.
2/ The contribution from price and exchange rate changes is defined as [-ρ(1+g) + εα(1+r)]/(1+g+ρ+gρ) times previous period debt stock. ρ increases with an appreciating domestic currency (ε > 0) and rising inflation (based on GDP deflator).
3/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.
4/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.
5/ The implied change in other key variables under this scenario is discussed in the text.
6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Alternative Scenario of the Impact of Fund Policy Advice

To assess the potential impact of Fund policy advice, staff used the Global Fiscal Model (GFM) to simulate a permanent 4 percent of GDP improvement in the fiscal deficit building over 5 years. As discussed further in Chapters 5 and 8 of the *Selected Issues* paper, GFM is a model developed in the Fund to examine the impact of fiscal policy. It features liquidity constraints consumers and forward-looking individuals who have a wedge between their discount rate and the real short-term interest rate, as well as monopolistic competition and real rigidities, but currently does not include nominal rigidities.

The simulation assumes that labor taxes are raised so as to strengthen the fiscal balance by a percentage point of GDP a year between 2006 and 2009. Over time, as interest costs fall, the labor tax rate is reduced to maintain a constant improvement in the deficit. As a crude adjustment for the impact of nominal rigidities, responses in 2006 were reduced by two-thirds and in 2007 by one-third, except for the impact on the budget deficit. Monetary policy is assumed to aim at stabilizing activity and prices.

As can be seen in the Table, the impact on real activity of this fiscal consolidation path is limited. Growth falls by around ¼ percent a year for the first three years, and then starts to recover as the significant fall in consumption is largely offset by higher investment and stronger net exports. There are significant improvements in government and international indebtedness. By 2010, government debt is some 13 percentage points below its baseline value and net foreign assets are some 7 percentage points of GDP higher.

Impact of Fund Policy Advice

(Percent change from policy baseline)

	2006	2007	2008	2009	2010
Real GDP	-0.3	-0.6	-0.9	-0.9	-0.7
Federal budget balance [1]	1.0	2.0	3.0	4.0	4.0
Federal debt [2]	-1.0	-3.0	-5.8	-9.5	-13.2
Current account [1]	0.5	1.0	1.7	1.9	2.0
Net foreign assets [2]	0.5	1.5	3.1	4.9	6.7
Real exchange rate	-1.9	-3.6	-5.4	-5.3	-5.1

[1] Levels as a ratio to GDP.
[2] Cumulative impact, as a ratio of GDP.

Table 1. Major Industrial Countries: Indicators of Economic Performance

	1997	1998	1999	2000	2001	2002	2003	2004	Projection 2005	2006
	(Annual percent change)									
Per capita GDP										
United States	3.3	3.0	3.3	2.5	-0.3	0.9	2.0	3.4	2.6	2.5
Euro Area	2.1	2.6	2.5	3.3	1.2	0.5	0.1	1.7	1.3	2.0
Japan	1.4	-1.4	-0.2	2.2	-0.1	-0.5	1.2	2.6	0.7	1.9
Canada	3.2	3.2	4.7	4.3	0.7	2.3	1.1	1.8	1.6	1.8
G-7 countries	2.5	2.1	2.4	2.8	0.3	0.6	1.3	2.7	1.9	2.2
Real GDP										
United States	4.5	4.2	4.4	3.7	0.8	1.9	3.0	4.4	3.6	3.5
Euro Area	2.4	2.8	2.8	3.6	1.6	0.9	0.5	2.0	1.6	2.3
Japan	1.7	-1.1	0.0	2.4	0.2	-0.3	1.4	2.6	0.8	1.9
Canada	4.2	4.1	5.5	5.2	1.8	3.4	2.0	2.8	2.8	3.0
G-7 countries	3.2	2.8	3.1	3.4	1.0	1.2	2.0	3.3	2.5	2.9
Real domestic demand										
United States	4.8	5.3	5.3	4.4	0.9	2.5	3.3	4.8	4.0	3.5
Euro Area	1.8	3.6	3.5	2.9	1.0	0.4	1.2	2.0	1.6	2.1
Japan	0.6	-1.5	0.2	1.9	0.7	-0.9	0.8	1.9	0.8	1.6
Canada	5.7	2.4	4.1	4.9	1.3	3.4	4.4	3.6	3.7	2.9
G-7 countries	3.1	3.5	3.8	3.6	1.0	1.4	2.3	3.4	2.6	2.7
GDP deflator										
United States	1.7	1.1	1.4	2.2	2.4	1.7	1.8	2.1	2.4	2.0
Euro Area	1.6	1.7	1.1	1.4	2.4	2.5	2.0	1.9	1.9	1.8
Japan	0.4	-0.2	-1.3	-1.5	-1.3	-1.3	-1.4	-1.2	-0.8	-0.6
Canada	1.2	-0.4	1.7	4.1	1.1	1.0	3.2	3.3	2.5	1.9
G-7 countries	1.4	1.0	0.9	1.2	1.6	1.4	1.5	1.5	1.6	1.6
	(In percent of GDP)									
General government financial balance [1]										
United States	-1.1	0.1	0.6	1.3	-0.7	-4.0	-4.6	-4.2	-4.0	-3.7
Euro Area	-2.7	-2.3	-1.3	-1.0	-1.8	-2.4	-2.8	-2.7	-2.6	-2.6
Japan	-3.8	-5.5	-7.2	-7.5	-6.1	-7.9	-7.8	-7.1	-6.9	-6.5
Canada	0.2	0.1	1.6	2.9	1.1	0.3	0.6	1.4	1.3	1.2
G-7 countries	-2.0	-1.5	-1.2	-0.2	-1.8	-4.1	-4.6	-4.2	-4.0	-3.8
Gross savings										
United States	17.6	18.3	18.1	18.0	16.4	14.2	13.5	14.0	14.1	14.3
Euro Area	21.7	21.7	21.8	21.8	21.3	20.9	20.3	20.9	20.9	21.0
Japan	30.9	29.8	28.6	28.8	27.8	26.8	27.1	27.6	27.5	28.0
Canada	19.6	19.1	20.7	23.6	22.0	21.5	22.1	23.0	23.7	23.6
G-7 countries	20.8	20.9	20.4	20.5	19.3	17.9	17.5	18.0	18.1	18.2
Fixed investment										
United States	15.9	16.4	16.8	17.1	16.3	15.0	15.1	16.1	16.6	16.6
Euro Area	20.1	20.4	21.0	21.5	21.1	20.2	19.8	20.0	20.2	20.5
Japan	28.1	26.8	26.4	26.4	25.7	24.2	24.0	23.8	24.1	24.3
Canada	19.8	19.9	19.8	19.2	19.6	19.6	19.5	19.9	20.0	20.1
G-7 countries	19.1	19.2	19.3	19.6	18.9	17.8	17.7	18.1	18.5	18.5
Current account balance										
United States	-1.6	-2.4	-3.2	-4.2	-3.8	-4.5	-4.8	-5.7	-6.2	-6.1
Euro Area	0.9	0.3	-0.5	-1.2	-0.2	0.8	0.3	0.6	0.4	0.4
Japan	2.2	3.0	2.6	2.5	2.1	2.8	3.2	3.7	3.3	3.5
Canada	-1.3	-1.2	0.3	2.7	2.3	2.0	2.0	2.6	2.6	2.5
G-7 countries	0.3	-0.1	-0.8	-1.5	-1.1	-1.0	-1.1	-1.1	-1.4	-1.4

Sources: *World Economic Outlook;* and IMF staff calculations.

[1] On national accounts basis.

Table 2. United States: Selected Economic Indicators

(Change from previous period in percent at annual rate, unless otherwise indicated)

	2004	2005	2006	2007	2008	2009	2010	2004 Q1	Q2	Q3	Q4	2005 Q1	Q2	Q3	Q4	2006 Q1	Q2	Q3	Q4
National production and income																			
Real GDP	4.4	3.6	3.5	3.6	3.6	3.5	3.3	4.5	3.3	4.0	3.8	3.8	3.3	3.4	3.5	3.6	3.6	3.6	3.6
Net Exports 1/	-0.6	-0.6	-0.1	-0.1	0.0	-0.1	-0.1	-0.8	-1.1	-0.1	-1.4	-0.6	-0.3	-0.2	-0.1	-0.1	-0.1	-0.1	-0.1
Total domestic demand	4.8	4.0	3.5	3.5	3.5	3.4	3.3	5.0	4.2	3.9	5.0	4.1	3.5	3.4	3.4	3.5	3.5	3.5	3.5
Final domestic demand	4.4	3.8	3.3	3.4	3.5	3.4	3.3	3.9	3.5	4.9	4.5	3.5	3.5	3.3	3.3	3.3	3.3	3.4	3.3
Private final consumption	3.8	3.7	3.4	3.3	3.5	3.1	3.0	4.1	1.6	5.1	4.2	3.6	3.3	3.4	3.5	3.5	3.6	3.2	3.2
Personal saving ratio (% of DI)	1.3	2.0	2.7	3.0	3.4	4.0	4.7	1.0	1.3	0.7	2.2	0.9	2.2	2.4	2.6	2.4	2.6	2.9	2.9
Public consumption expenditure	1.7	1.6	1.8	1.4	1.6	2.3	2.8	1.9	1.0	2.9	-0.1	1.9	2.3	1.5	1.8	2.9	0.9	1.7	0.9
Gross fixed domestic investment	9.0	6.0	4.1	5.5	4.8	5.2	4.8	4.7	12.9	5.5	9.7	4.2	4.8	4.3	3.7	2.9	4.4	5.7	5.9
Private fixed investment	10.3	7.3	4.4	6.1	5.3	5.3	5.3	4.5	13.9	8.8	10.5	6.6	5.1	4.4	3.8	2.9	4.8	6.4	6.6
Private investment rate (% of GDP)	16.4	17.1	17.3	17.6	17.7	17.9	18.0	15.9	16.5	16.5	16.9	17.1	17.1	17.2	17.2	17.1	17.2	17.3	17.4
Equipment & software	13.6	10.9	8.9	8.0	8.0	8.0	8.0	8.1	14.2	17.5	18.4	6.1	7.0	9.0	10.0	10.0	8.0	8.0	8.0
Structures (non-res.)	1.4	0.2	3.3	5.2	3.5	3.5	3.5	-7.5	6.9	-1.2	2.2	-2.5	0.0	0.0	2.0	3.0	5.0	6.0	8.0
Structures (res.)	9.7	5.2	-1.6	3.6	2.1	2.0	1.8	5.0	16.5	1.6	3.4	11.5	4.5	0.0	-4.0	-7.0	0.0	4.0	4.0
Public	2.9	-0.4	2.8	2.2	2.0	4.7	1.8	5.6	8.3	-9.4	5.6	-7.5	3.4	3.3	3.2	3.0	2.1	2.1	2.0
Change in private inventories 1/	0.4	0.2	0.1	0.1	0.0	0.0	0.0	1.1	0.7	-1.0	0.4	0.7	0.0	0.2	0.1	0.2	0.2	0.1	0.2
Nominal GDP	6.6	6.1	5.7	5.7	5.7	5.5	5.4	7.4	6.6	5.5	6.2	6.7	5.8	5.7	5.6	5.7	5.7	5.7	5.7
Employment and inflation																			
Unemployment rate (percent)	5.5	5.2	5.2	5.1	5.0	5.0	4.9	5.7	5.6	5.4	5.4	5.3	5.3	5.2	5.2	5.2	5.2	5.2	5.1
GDP gap	-1.6	-1.3	-1.1	-0.7	-0.3	-0.1	0.0	-1.6	-1.7	-1.5	-1.4	-1.3	-1.4	-1.3	-1.3	-1.2	-1.1	-1.0	-0.9
Potential GDP	3.5	3.4	3.3	3.3	3.2	3.2	3.2	3.5	3.5	3.4	3.4	3.4	3.4	3.3	3.3	3.3	3.3	3.3	3.3
CPI inflation	2.7	2.9	2.5	2.5	2.5	2.5	2.5	3.9	4.4	1.6	3.6	2.4	3.9	2.0	2.4	2.4	2.5	2.5	2.5
GDP deflator	2.1	2.4	2.0	2.0	2.0	2.0	2.0	2.7	3.2	1.5	2.3	2.9	2.4	2.2	2.0	2.0	2.0	2.0	2.0
Financial policy indicators																			
Central gov't balance ($ b, public accounts)	-412	-391	-404	-357	-318	-314	-342												
In percent of FY GDP	-3.6	-3.2	-3.1	-2.6	-2.2	-2.1	-2.1												
Central government balance ($ b, NIPA)	-383	-377	-373	-325	-292	-295	-276												
In percent of CY GDP	-3.3	-3.0	-2.8	-2.3	-2.0	-1.9	-1.7												
State & local govt. balance ($ b, NIPA)	-109	-124	-111	-80.5	-93.4	-103	-103												
In percent of CY GDP	-0.9	-1.0	-0.8	-0.6	-0.6	-0.6	-0.6												
General government balance ($ b, NIPA)	-492	-500	-484	-406	-386	-398	-379												
In percent of CY GDP	-4.2	-4.0	-3.7	-2.9	-2.6	-2.6	-2.3												
Three-month Treasury bill rate	1.4	3.3	4.3	4.4	4.4	4.4	4.4	0.9	1.1	1.5	2.0	2.6	3.1	3.6	3.9	4.2	4.3	4.4	4.4
Ten-year government bond rate	4.3	4.8	5.8	6.1	6.1	6.1	6.1	4.0	4.6	4.3	4.2	4.3	4.6	5.0	5.4	5.6	5.7	5.9	5.9
Balance of payments																			
Current account balance ($ b)	-668	-775	-806	-853	-903	-943	-989	-584	-667	-668	-753	-780	-759	-775	-786	-801	-805	-809	-809
In percent of GDP	-5.7	-6.2	-6.1	-6.1	-6.1	-6.1	-6.0	-5.1	-5.7	-5.7	-6.3	-6.4	-6.1	-6.2	-6.2	-6.2	-6.2	-6.1	-6.0
Merchandise trade balance ($ b)	-665	-757	-780	-800	-818	-840	-862	-606	-656	-671	-729	-745	-754	-761	-766	-771	-777	-783	-788
In percent of GDP	-5.7	-6.1	-5.9	-5.8	-5.6	-5.4	-5.3	-5.3	-5.6	-5.7	-6.1	-6.1	-6.1	-6.1	-6.0	-6.0	-6.0	-5.9	-5.9
Export volume 2/	8.8	7.8	9.9	9.3	8.7	8.7	9.0	9.1	6.0	9.5	1.9	8.7	9.6	9.9	10.7	10.0	9.4	9.5	9.5
Import volume 2/	10.8	9.6	7.0	6.2	5.9	6.2	6.5	12.6	13.0	5.0	14.9	9.8	8.4	7.9	7.2	6.7	6.6	6.5	6.3
Balance on invisibles ($ b)	-2.69	-18.4	-26.1	-53.1	-85	-103	-126	21.4	-10.6	3.2	-24.7	-34.9	-4.6	-13.7	-20.7	-30.1	-27.9	-26.0	-20.5
In percent of GDP	0.0	-0.1	-0.2	-0.4	-0.6	-0.7	-0.8	0.2	-0.1	0.0	-0.2	-0.3	0.0	-0.1	-0.2	-0.2	-0.2	-0.2	-0.2
Saving and investment (as a share of GDP)																			
Gross national saving	14.0	14.1	14.0	14.3	14.4	14.7	14.8	13.7	13.9	13.8	14.5	14.9	13.9	13.9	13.9	13.8	13.9	14.1	14.3
General government	-1.0	-1.1	-0.8	-0.1	0.2	0.2	0.5	-1.4	-1.2	-1.2	-0.5	0.2	-1.8	-1.8	-1.0	-1.1	-0.9	-0.7	-0.5
Private	15.0	15.2	14.8	14.4	14.2	14.4	14.3	15.0	15.0	15.0	15.0	14.7	15.7	15.7	14.9	14.9	14.8	14.8	14.8
Personal	1.0	1.5	2.0	2.3	2.6	3.1	3.6	0.8	1.0	0.5	1.6	0.7	1.7	1.8	1.9	1.8	2.0	2.2	2.1
Business	14.0	13.7	12.8	12.1	11.6	11.4	10.7	14.3	14.0	14.5	13.4	14.0	14.1	13.8	12.9	13.1	12.9	12.6	12.7
Gross domestic investment	19.7	20.1	20.2	20.5	20.6	20.7	20.9	19.1	19.8	19.7	20.1	20.3	20.0	20.1	20.1	20.1	20.1	20.2	20.3

Sources: BEA and IMF staff estimates.

[1] Contributions to growth

[2] NIPA basis, goods

Table 3: Key Economic Indicators

(12 month percent change, unless otherwise indicated)

	2004	2004	2005		2004					2005				
		Q4	Q1	Q2	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May
Production and capacity utilization														
Industrial production														
All industries	4.1	4.3	3.7	. . .	5.0	3.9	4.6	3.8	4.4	4.0	3.4	3.9	3.0	2.7
Manufacturing	4.8	5.1	4.6	. . .	6.2	4.7	5.6	4.5	5.1	5.3	4.5	4.1	3.4	3.4
Business equipment	9.4	9.8	9.3	. . .	10.6	9.8	11.0	8.6	9.8	10.1	8.8	8.9	8.6	8.2
Ex hi-tech and autos & parts	3.9	4.4	3.9	. . .	5.4	4.6	5.0	3.8	4.3	4.7	3.5	3.4	2.7	2.5
Capacity utilization (percent of capacity)														
All industries	78.1	78.8	79.3	. . .	78.3	78.0	78.5	78.7	79.2	79.1	79.4	79.4	79.1	79.4
Manufacturing	76.2	77.1	77.5	. . .	76.6	76.3	77.0	77.0	77.3	77.4	77.7	77.4	77.2	77.5
Orders and inventories														
Inventory/sales (ratio)	1.31	1.30	1.31	. . .	-2.9	-3.0	-3.7	-3.0	-2.3	-2.3	-0.8	0.8	-0.8	. . .
Total manufacturers' orders	10.9	10.3	8.3	. . .	12.2	10.7	9.1	11.6	10.2	11.1	9.3	4.7	6.6	9.3
Total manufacturers' shipments	10.5	10.8	9.3	. . .	13.2	10.0	11.1	11.0	10.2	11.3	9.8	7.0	7.8	7.2
Nondef. capital goods ex. aircraft	11.8	11.4	11.9	. . .	14.6	10.7	12.5	11.3	10.6	14.0	12.9	8.9	9.0	12.6
Households														
Retail sales	7.3	8.3	7.3	. . .	4.8	7.6	8.6	7.3	8.9	8.0	8.0	6.0	8.9	6.4
ex. autos, building supplies, and gasoline	8.3	8.9	7.9	. . .	6.8	7.9	9.0	8.7	8.9	8.2	8.7	6.8	8.8	7.4
Motor vehicle sales	1.5	2.4	-0.6	3.9	-7.5	3.1	5.1	-3.3	5.3	-1.0	-1.3	0.3	5.0	-5.9
Consumer confidence (index)	95.2	93.9	94.1	90.2	95.9	94.2	91.7	92.8	97.1	95.5	94.1	92.6	87.7	86.9
Disposable income	6.0	7.4	6.0	. . .	4.1	5.2	5.9	6.1	10.2	6.0	6.0	6.0	5.9	5.5
Housing starts	5.2	-3.1	8.0	. . .	10.5	-1.4	4.8	-13.3	-0.3	13.5	20.3	-8.7	1.9	1.8
Inflation														
CPI	2.7	3.4	3.0	. . .	2.7	2.5	3.2	3.6	3.4	2.9	2.9	3.2	3.5	2.8
excluding food and energy	1.8	2.1	2.3	. . .	1.7	2.0	2.0	2.2	2.2	2.2	2.3	2.4	2.2	2.2
PPI, finished goods	3.6	4.6	4.6	. . .	3.4	3.3	4.4	5.2	4.4	4.3	4.7	4.9	4.8	3.5
excluding food and energy	1.5	2.0	2.7	. . .	1.5	1.8	1.7	2.0	2.3	2.7	2.8	2.6	2.6	2.6
PCE price index	2.2	2.6	2.2	. . .	2.2	2.1	2.5	2.7	2.5	2.2	2.2	2.3	2.6	2.2
excluding food and energy	1.5	1.6	1.6	. . .	1.5	1.6	1.6	1.7	1.5	1.6	1.5	1.6	1.5	1.6
Labor market														
Nonfarm payrolls (millions)	131.5	132.3	132.8	133.4	131.8	131.9	132.2	132.3	132.4	132.6	132.9	133.0	133.3	133.4
Change (thousands)	1475.9	571.0	512.0	591.3	. . .	130.0	282.0	132.0	155.0	124.0	300.0	122.0	292.0	104.0
Unemployment rate (percent)	6.0	5.4	5.3	5.1	5.4	5.4	5.5	5.4	5.4	5.2	5.4	5.2	5.2	5.1
Money and credit (percent change)														
M1	5.5	5.4	4.0	. . .	4.7	5.0	5.0	6.0	5.3	4.7	3.9	3.5	2.1	2.7
M2	4.5	5.2	5.3	. . .	3.2	4.1	4.7	5.4	5.7	5.7	5.3	4.9	4.2	3.2
Bank lending	8.1	10.4	10.2	. . .	7.1	8.6	10.1	10.7	10.3	9.8	10.0	10.8	10.4	10.2
Current account ($ billions)	-668	-753	-780	. . .										
Percent of GDP	-5.7	-6.3	-6.4	. . .										
Merchandise trade balance	-707	-776	-795	. . .	-728	-708	-756	-806	-765	-806	-828	-751	-793	-772
Exports ($ billions)	819	846	865	. . .	827	840	843	834	863	868	858	869	906	907
Imports ($ billions)	1526	1622	1660	. . .	1555	1548	1599	1641	1628	1674	1686	1620	1699	1679

Source: Haver Analytics

Table 4. United States: Balance of Payments

(In billions of dollars, unless otherwise indicated)

	1998	1999	2000	2001	2002	2003	2004
Current account	-214	-300	-416	-389	-475	-520	-668
Percent of GDP	-2.4	-3.2	-4.2	-3.8	-4.5	-4.7	-5.7
Goods and services	-165	-263	-378	-363	-421	-495	-618
Merchandise trade	-247	-346	-452	-427	-482	-547	-665
Exports	670	684	772	719	682	713	808
Imports	-917	-1,030	-1,224	-1,146	-1,165	-1,261	-1,473
Services	82	83	74	64	61	52	48
Receipts	263	282	299	288	295	309	344
Payments	-181	-200	-225	-224	-234	-257	-296
Income	4	14	21	25	10	46	30
Receipts	262	294	351	288	271	310	380
Payments	-258	-280	-330	-263	-261	-264	-349
Unilateral transfers	-53	-51	-59	-52	-64	-71	-81
Government transfers	-13	-14	-17	-12	-17	-22	-23
Private transfers	-40	-37	-42	-40	-47	-49	-58
Capital account transactions, net	-1	-5	-1	-1	-1	-3	-2
Financial account	70	236	486	400	500	561	585
Private capital	97	181	445	378	388	280	186
Direct investment	36	65	162	25	-74	-73	-145
Outflows	-143	-225	-159	-142	-154	-141	-252
Inflows	179	289	321	167	81	67	107
Securities	71	155	267	313	357	191	389
Outflows	-130	-122	-128	-91	-49	-156	-102
Inflows	202	277	395	403	405	347	492
Net U.S. bank flows	4	-16	-16	-17	58	87	-34
Nonbank capital flows	-15	-21	32	58	47	75	-25
U.S. official reserves	-7	9	0	-5	-4	2	3
Foreign official assets	-20	44	43	28	116	278	395
Other items	0	3	-1	0	0	1	1
Statistical discrepancy	145	69	-69	-10	-24	-38	85

Source: Bureau of Economic Analysis.

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

(In percent of GDP, unless otherwise indicated)

	1997	1998	1999	2000	2001	2002	2003	2004
External indicators								
Exports of goods and services (percentage change, BOP basis)	9.8	-0.1	3.5	10.9	-6.0	-3.0	4.6	12.6
Imports of goods and services (percentage change, BOP basis)	9.1	5.3	12.0	17.9	-5.5	2.1	8.5	16.6
Terms of trade (annual percentage change)	1.1	2.9	-2.1	-4.6	2.8	1.5	-1.3	-1.7
Current account balance	-1.7	-2.4	-3.2	-4.2	-3.8	-4.5	-4.7	-5.7
Capital and financial account balance	0.3	0.1	0.2	0.5	0.4	0.5	0.5	0.5
Of which: Inward portfolio investment (debt securities, etc.)	3.5	2.1	2.7	4.0	3.7	3.7	3.0	4.1
Inward foreign direct investment	1.3	2.0	3.1	3.3	1.6	0.8	0.6	0.9
Other investment liabilities (net)	1.8	0.5	0.6	1.2	1.2	0.9	0.9	2.7
Official reserves (in billions of dollars)	70.0	81.8	71.5	67.6	68.7	79.0	85.9	86.8
Broad money (M3) to reserves ratio	110.7	126.7	145.9	170.9	185.0	206.1	207.1	203.0
Central bank foreign liabilities (in billions of dollars)	0.5	0.2	0.1	0.3	0.1	0.1	0.2	0.1
Official reserves in months of imports	0.8	0.9	0.7	0.6	0.6	0.7	0.7	0.6
Net international investment position (in billions of dollars) 1/	-820.7	-900.0	-775.5	-1,388.7	-1,889.7	-2,233.0	-2,430.7	…
Of which: General government debt (in billions of dollars) 2/	1,186.3	1,213.1	1,134.5	1,137.8	1,189.9	1,412.6	1,687.6	…
External debt-to-exports ratio	0.9	1.0	0.8	1.3	1.9	2.3	2.4	…
External interest payments to exports (in percent) 3/	20.8	22.7	22.6	24.8	24.1	21.1	18.0	20.4
Nominal effective exchange rate (percent change)	5.1	16.5	-1.3	3.4	6.4	-0.6	-8.8	-6.3
Financial market indicators								
General government gross debt	69.9	66.2	62.8	57.1	56.6	58.6	60.5	61.0
Three-month Treasury bill yield (percent)	5.2	4.9	4.8	6.0	3.5	1.6	1.0	1.4
Three-month Treasury bill yield (percent, real)	-68.1	-58.0	-67.3	-75.9	-72.8	-60.9	-69.4	-72.6
Change in stock market index (S&P500 percent, year average)	30.1	24.2	22.3	7.6	-16.4	-16.5	-3.2	17.3
Banking sector risk indicators (percent unless otherwise indicated) 4/								
Total assets (in billions of dollars)	4,878.3	5,014.9	5,442.5	5,735.2	6,244.6	6,552.4	7,077.2	7,602.5
Total loans and leases to assets	57.6	59.2	59.5	60.9	61.2	59.3	58.7	58.3
Total loans to deposits	87.9	86.8	88.0	91.1	91.4	88.7	88.6	88.1
Problem loans to total loans and leases 5/	1.0	1.0	1.0	1.0	1.1	1.4	1.5	1.2
Nonperforming assets to assets	0.8	0.7	0.7	0.6	0.7	0.9	0.9	0.8
Loss allowance to:								
Total loans and leases	1.9	1.8	1.8	1.7	1.7	1.9	1.9	1.7
Noncurrent loans and leases	183.5	191.6	183.2	178.1	149.4	131.0	127.2	145.8
Return on equity	14.5	14.7	13.9	15.3	14.0	13.1	14.5	15.3
Return on assets	1.2	1.2	1.2	1.3	1.2	1.2	1.3	1.4
Total capital ratio	12.5	12.2	12.2	12.2	12.1	12.7	12.8	12.7
Core capital ratio	7.6	7.6	7.5	7.8	7.7	7.8	7.8	7.9

Sources: Bureau of Economic Analysis; Department of Commerce; Federal Deposit Insurance Corporation; Federal Reserve Board; and Haver Analytics.

1/ Current cost valuation.

2/ Foreign official assets (U.S. Government securities plus Treasury securities).

3/ External interest payments: income payments on foreign-owned assets (other private payments plus U.S. government payments).

4/ FDIC-insured commercial banks.

5/ Noncurrent loans and leases.

Table 6. United States: Fiscal Indicators

(Fiscal years, in percent of GDP except where noted otherwise)

	2004	2005	2006	2007	2008	2009	2010
FY 2006 Budget, Administration							
Outlays	19.8	20.3	19.9	19.5	19.2	19.1	19.0
Debt service	1.4	1.5	1.6	1.8	1.9	1.9	2.0
Revenue	16.3	16.8	16.9	17.2	17.5	17.5	17.7
Unified balance	-3.6	-3.5	-3.0	-2.3	-1.7	-1.5	-1.3
Unified balance exc. social security	-4.9	-4.9	-4.5	-3.8	-3.3	-3.1	-2.9
Unified balance (in billions of dollars)	-412	-426	-390	-312	-251	-233	-207
Debt held by the public	37.2	38.7	39.7	40.1	39.9	39.6	38.8
FY 2006 Budget, Adjusted for Staff's Budget and Economic Assumptions							
Outlays	19.8	20.2	20.0	19.5	19.1	18.9	18.9
Debt service	1.4	1.4	1.6	1.8	1.9	2.1	2.2
Revenue	16.3	17.0	16.9	16.9	16.9	16.9	16.8
Unified balance	-3.6	-3.2	-3.1	-2.6	-2.2	-2.1	-2.1
Unified balance exc. social security	-4.9	-4.6	-4.6	-4.1	-3.7	-3.6	-3.7
Unified balance (in billions of dollars)	-412	-391	-404	-357	-318	-314	-342
Debt held by the public	37.2	38.2	39.3	39.9	40.1	40.2	40.1
Memorandum items:							
Structural unified balance, FY 2006 Budget 1/	-3.1	-2.9	-2.8	-2.4	-2.1	-2.0	-2.1
Primary structural unified balance	-1.8	-1.4	-1.2	-0.6	-0.1	0.1	0.1
Unified balance, budget resolution (in billions of dollars)	-412	-397	-382	-313	-254	-238	-210
Administration's economic projections (in percent, calendar-year basis)							
Real GDP growth	3.6	3.6	3.5	3.3	3.2	3.1	3.1
CPI inflation	2.4	2.4	2.4	2.4	2.4	2.4	2.4
Three-month Treasury bill rate	1.4	2.7	3.5	3.8	4.0	4.1	4.2

Sources: FY 2006 Budget of the U.S. Government (February 7, 2005), and IMF staff estimates. Staff projections are based on Administration budget adjusted for differences in macroeconomic projections and staff estimates of the cost of ongoing operations in Iraq and AMT reform.

1/ As a percent of potential GDP, based on proposed measures, under IMF staff's economic assumptions.

Table 7. United States: Central Government Receipts, Outlays, and Debt [1]
(as percent of GDP, unless noted otherwise)

								Administration's projections	
	1998	1999	2000	2001	2002	2003	2004	2005	2006
Total Receipts	20.0	20.0	20.9	19.8	17.8	16.4	16.3	16.8	16.9
of which:									
Individual income taxes	9.6	9.6	10.3	9.9	8.3	7.3	7.0	7.3	7.5
Corporation income taxes	2.2	2.0	2.1	1.5	1.4	1.2	1.6	1.9	1.7
Social insurance and retirement receipts, total	6.6	6.7	6.7	6.9	6.7	6.6	6.3	6.3	6.3
Total outlays	19.2	18.7	18.4	18.5	19.4	19.9	19.8	20.3	19.9
Discretionary	6.4	6.3	6.3	6.5	7.1	7.6	7.8	7.9	7.3
of which:									
Defense	3.1	3.0	3.0	3.0	3.4	3.7	3.9	3.8	3.4
Nondefense	3.3	3.2	3.3	3.4	3.7	3.9	3.8	3.8	3.7
Mandatory	10.0	9.9	9.8	10.0	10.6	10.9	10.7	10.9	10.9
of which:									
Programmatic	10.5	10.3	10.2	10.5	11.1	11.4	11.2	11.5	11.5
of which									
Social Security	4.4	4.2	4.2	4.3	4.4	4.3	4.3	4.2	4.2
Means tested entitlements [2]	2.4	2.4	2.4	2.5	2.7	2.8	2.8	2.9	2.8
Net interest	2.8	2.5	2.3	2.0	1.6	1.4	1.4	1.5	1.6
Unified balance	0.8	1.3	2.5	1.3	-1.6	-3.5	-3.5	-3.5	-3.0
Gross federal debt	63.5	61.4	58.0	57.4	59.7	62.4	63.7	65.7	67.5
Held by federal government accounts	20.4	21.6	22.9	24.4	25.6	26.3	26.5	27.1	27.8
Held by the public	43.1	39.8	35.1	33.0	34.1	36.1	37.2	38.6	39.7
Federal reserve system	5.3	5.4	5.3	5.3	5.8	6.1	6.1	...	...
Other	37.8	34.4	29.9	27.7	28.3	30.1	31.1	...	...
Memorandum items:									
Unified balance (in billions of dollars)	69.2	125.5	236.1	128.2	-157.8	-377.6	-412.1	-426.6	-390.1
GDP (in billions of dollars)	8,628	9,125	9,710	10,058	10,389	10,839	11,553	12,227	12,907

Source: OMB.

[1] On a public accounts basis, fiscal years

[2] Includes Medicaid, food stamps, family support assistance (AFDC), supplemental security income (SSI), child nutrition programs, earned income tax credits (EITC and HITC), welfare contingency fund, child care entitlement to states, temporary assistance to needy families, state children's health insurance and veteran's pensions.

Statement by the IMF Staff Representative
July 22, 2005

1. ***This note reports on information that has become available since the staff report was issued***. The topics covered include the budget outlook, legislative developments, and recent economic and financial market developments. They do not affect the staff appraisal.

Recent economic and financial market developments

2. ***Recent developments have been favorable, reducing concerns of a soft patch in activity***. June payroll employment continued its recent steady progress, rising by 146,000 (1¼ percent on an annualized basis) while the unemployment rate fell 0.1 percentage points to 5 percent. In the same month, industrial production and retail sales increased by a larger-than-anticipated 0.9 percent and 1.7 percent (month-on-month), respectively, and relatively strong export growth as well as the benefit from a temporary dip in oil prices helped reduce the trade deficit to $55.3 billion in May from the previous month's $56.9 billion. Consumer and producer sentiment have also improved.

3. ***Inflation pressures appear to be contained***. The June 12-month increase in overall and core consumer prices moderated to 2.5 percent and 2.1 percent, respectively, both below market expectations. Similarly, headline and core producer price inflation fell to 3.6 percent and 2.2 percent, respectively, and spreads between conventional and inflation-indexed 10-year bonds declined slightly to around 2¼ percent.

4. ***These developments have elicited limited financial market responses***. Long-term bond yields have increased by about ¼ percentage point to around 4¼ percent on stronger growth prospects. Market expectations about the Federal Reserve's policy course have remained largely unchanged, with a further 75 basis points of tightening expected by end-2005. Stock prices have strengthened somewhat, and—after some appreciation in early July—the dollar has returned to its June level.

Monetary, fiscal and legislative developments

5. ***The Federal Reserve's semi-annual Monetary Policy Report (MPR) was presented to Congress yesterday by Chairman Greenspan***. The MPR projects core PCE inflation will remain below 2 percent and economic growth will be sustained at around 3½ percent this year and next, assuming no further oil price spikes. With economic slack diminishing, the Chairman indicated that further monetary tightening would likely be necessary.

6. ***Recent budget data suggest a more favorable budget outlook for the current year (FY 2005, ending September 30) and beyond***. Reflecting strong and broad-based revenue growth through June, the Administration's Mid-Session Review lowered the projected unified deficit for this year to $333 billion (2¾ percent of GDP), compared with the February estimate of $412 billion (3½ percent of GDP). Stronger revenues have also led to a reduction

in anticipated deficits of around ½ percent of GDP in subsequent years. Consequently, after remaining at 2¾ percent of GDP in FY 2006, the unified federal deficit is now projected to fall to almost 1 percent of GDP by FY 2010, even including some costs in FY 2009 and FY 2010 from the assumed introduction of Personal Retirement Accounts.

7. ***Limited further progress has been made on moving ahead with Social Security reform***. A consensus has yet to emerge in Congress on steps to reduce the Social Security system's actuarial deficit or whether Personal Retirement Accounts (PRAs) should be introduced, and debate on reform options has been postponed until after the August recess.

8. ***Legislative work on corporate pensions, energy policy, and the Central America Free Trade Agreement continues***. A reconciliation of energy bills passed by the two chambers is underway. A corporate pension reform bill that would tighten defined-benefit pension funding requirements is on track for a vote by the full House. The Central America Free Trade Agreement has passed the Senate, but has yet to be voted on in the House.

United States: Unified Budget
(Percent of fiscal year GDP)

	FY 2004	FY 2005	FY 2006	FY 2007	FY 2008	FY 2009	FY 2010
FY 2006 Mid-Session Review[1]							
Outlays	19.8	20.1	20.2	19.5	19.1	19.0	19.1
Net interest expense	1.4	1.5	1.6	1.7	1.7	1.7	1.8
Revenue	16.3	17.4	17.5	17.7	17.9	17.9	18.1
Unified balance	-3.6	-2.7	-2.6	-1.7	-1.1	-1.1	-1.1
FY 2006 Budget							
Outlays	19.8	20.3	19.9	19.5	19.2	19.1	19.0
Net interest expense	1.4	1.5	1.6	1.8	1.9	1.9	2.0
Revenue	16.3	16.8	16.9	17.2	17.5	17.5	17.7
Unified balance	-3.6	-3.5	-3.0	-2.3	-1.7	-1.5	-1.3
Difference							
Outlays		-0.1	0.3	-0.1	-0.2	-0.1	0.1
Net interest expense		0.0	-0.1	-0.1	-0.2	-0.2	-0.2
Revenue		0.6	0.7	0.5	0.5	0.4	0.3
Unified balance		0.8	0.4	0.6	0.6	0.5	0.2

Source: Office of Management and Budget.

[1] Compared to the FY 2006 budget, this includes an allowance for costs of operations in Iraq and Afghanistan in FY 2006 as well as PRA expenses of $25b in FY 2009 and $50b in FY 2010.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

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IMF Executive Board Concludes 2005 Article IV Consultation with the United States

On July 22, 2005, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the United States.[1]

Background

The U.S. economy has continued to lead the global recovery over the last year. Output growth had been slowed by the effects of the bursting of the IT bubble and geopolitical developments following the 2001 terrorist attacks, but household spending has remained robust and business investment has rebounded, supported by low interest rates. Despite having eased somewhat as the expansion has matured, productivity growth has remained well above longer-term trends and supported record-high corporate profits.

The economy has proved resilient in the face of high energy prices. After expanding at a 4½ percent rate in 2004, real GDP growth eased to 3¾ percent in the first quarter of 2005. Some further softening may have taken place in the second quarter, but recent indicators suggest that activity will regain momentum in the second half. In particular, domestic demand remains solid, based on steady employment gains, a firming of business sentiment, investment, and improving consumer confidence.

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

As economic slack has narrowed, the inflation environment has become less benign. Although the core deflator for personal consumption expenditure—the Federal Reserve's preferred inflation indicator—has risen only modestly to just above 1½ percent (12-month rate), higher energy prices pushed headline CPI inflation to 2½ percent in recent months. The labor market has exhibited few signs of overheating—employment growth has been moderate by historical standards and the drop in the unemployment rate to 5 percent appears to have largely reflected lower participation. However, slower productivity growth since mid-2004 has contributed to an acceleration in unit labor costs.

The policy focus in the United States has appropriately shifted toward the removal of stimulus. Having cut the federal funds rate aggressively over the downturn, the Federal Reserve reversed course in mid-2004 as deflation risks receded, and has since raised the rate by a cumulative 2¼ percentage points. The Administration has reaffirmed its commitment to reducing the budget deficit to below 2 percent of GDP by FY2009 through rigorous spending restraint, and to making earlier tax cuts permanent.

The U.S. expansion and low interest rates have provided a substantial boost to the rest of the world at a time of significant global slack. U.S. net imports have increased growth in the rest of the world by about ¼ percentage point a year since 2001. U.S. financial conditions have also helped compress risk premiums, lowering interest spreads and supporting activity across a wide range of emerging markets.

The current account deficit has steadily widened, however, as U.S. growth has continued to outpace that of most trading partners. Despite the depreciation of the U.S. dollar by about 12 percent in real effective terms over the past three years, the current account deficit increased to a record 6½ percent of GDP in the first quarter of 2005. This has been mainly driven by sustained strong growth in real imports of consumption goods and higher oil prices.

Financial flows in the United States have also departed from long-term trends and appear unsustainable, with foreign savings and corporate profits increasingly financing government and household spending.

- The counterpart of the current account deficit has been massive foreign capital inflows, with U.S. net international liabilities estimated to have risen to over 20 percent of GDP.

- Net lending by the corporate sector is also at record highs. Notwithstanding difficulties with auto and airline sectors, businesses have used high profits to strengthen balance sheets that—along with foreign inflows—have contributed to low long-term interest rates.

- Tax cuts and expenditure increases have turned the public sector into a significant borrower. The federal government budget shifted from a 2½ percent of GDP surplus in FY 2000 to a 3½ percent of GDP deficit in FY2004, leaving the general government deficit at 4¼ percent of GDP in calendar year 2004. Reflecting buoyant revenue growth, however, both deficit measures are expected to continue to improve notably over the medium term.

- The household saving rate has fallen to record lows. Even accounting for the boost from strong asset markets, the IMF staff estimates that the saving rate is currently some 1½-2 percentage points below a level consistent with household income and wealth.

Barring shocks, the staff projects growth of 3½ percent in 2005 and 2006, slightly above potential and close to the consensus forecast. Reflecting some rebalancing of growth and normalizing domestic financial flows, both the personal and national saving rate would gradually rise while stronger investment would reduce corporate net lending. Although the trade balance would benefit somewhat from lagged exchange rate effects, the current account deficit would remain at over 6 percent of GDP (assuming an unchanged real exchange rate) as increasing foreign debt and higher interest rates would weigh on the income balance.

The financial sector appears well positioned to provide continued support to the recovery. Equity prices have risen, long-term interest rates remain low, banks are well capitalized and highly profitable, and indicators of credit quality remain strong. The robust housing market has caused financial regulators to tighten oversight of home equity and other residential loans. Notwithstanding strong house price increases in many regions, securitization of mortgage debt has limited systemic financial sector risks by allowing significant diversification of real estate exposures.

Executive Board Assessment

Executive Directors noted that, despite higher oil prices, the U.S. economy continues to lead the global expansion based on strong fundamentals. U.S. productivity growth has remained well above longer-term trends, supporting corporate profits, a rebound in business investment spending, and some acceleration in employment. Against this background, the policy focus in the United States has appropriately shifted toward the removal of policy stimulus.

Directors observed that, while subject to risks, the near-term outlook for the U.S. economy remains broadly favorable. A moderation in consumption growth as monetary conditions continue to tighten will likely be largely offset by rising investment and an improvement in real net exports. However, Directors cautioned that higher oil prices could begin to weigh more heavily on domestic demand. Many Directors also expressed concern about the rapid inflation of U.S. house prices in recent years, increased reliance of some households on less conventional mortgage products, and the already low personal saving rate. In addition, Directors noted that—with the U.S. external current account deficit expected to remain large well into the medium term—the staff's analysis suggests that the level of the U.S. dollar still remains above that necessary to avoid continuing increases in U.S. net external indebtedness. Against this background, Directors agreed that this underscores the importance of the cooperative strategy for addressing global imbalances.

Directors viewed the extremely low U.S. national saving rate as posing a key policy challenge going forward. In the context of the wide differences in growth across major regions of the world, this has contributed to a widening of global current account imbalances, which pose further associated systemic risks, especially if U.S. productivity growth were to falter. Most Directors accordingly stressed the importance of taking advantage of the present cyclical strength of the U.S. economy to set in train ambitious fiscal consolidation in coming years

which, coupled with reforms to public retirement and health care systems, would help ensure their sustainability in the face of longer-term demographic pressures. Directors recognized that fiscal consolidation in the United States should be complemented by appropriate actions in other regions as part of a shared responsibility.

Against this background, Directors welcomed the commitment to fiscal deficit reduction in the FY2006 budget and the recent improvement in the budgetary outlook due to strong tax receipts. Nonetheless, most Directors considered the Administration's goal of halving the budget deficit to be relatively unambitious, as this would imply limited adjustment in the structural fiscal position in coming years. It is also subject to considerable risk, given the assumption of an unprecedented compression in nondefense discretionary spending.

Many Directors agreed that balancing the budget excluding Social Security by early in the next decade would support national saving, domestic investment, and the external position. This approach would significantly lower the federal debt ratio, providing the room to cope with impending pressures on entitlement programs and improve intergenerational equity.

Most Directors noted that existing fiscal plans already assume strict spending discipline, and accordingly it would be prudent to explore options for revenue enhancements to support deficit reduction. To avoid having to unwind recent cuts in tax rates, many Directors felt that consideration should be given to broadening the income tax base or to taxing consumption more directly in the form of a national consumption or energy tax. A few noted that a legislated budget rule would also help support fiscal discipline, and re-authorization of the Budget Enforcement Act (BEA) provisions—including pay-as-you-go provisions that cover revenue measures—would be appropriate. Many Directors called for a simplification of the tax system and welcomed the establishment of the Advisory Panel on Federal Tax Reform.

Directors recognized the need to address the severe underfunding of the Social Security and, especially, Medicare systems. While the 2003 Medicare Modernization Act contained a number of provisions that could help moderate price pressures, the new prescription drug benefit significantly increases Medicare's underfunding. Thus, with public health care spending projected to triple as a ratio to GDP in coming decades, further steps are urgently needed to improve the efficiency of the overall health care system.

Directors welcomed the Administration's recent commitment to placing the Social Security system on a sustainable basis and the proposed introduction of personal retirement accounts (PRAs). However, they noted that PRAs will not reduce the system's funding gap, and that it was important to introduce accompanying measures that would ensure the system's long-run solvency. In this regard, they welcomed the Administration's recent support for specific measures to reduce the system's unfunded liabilities, and called for early legislative action to eliminate the funding shortfall.

Directors commended the Federal Reserve's gradual and flexible approach to monetary tightening, which has been effective in supporting activity while preserving price stability. Interest rate hikes have been coupled with clear messages that more forceful action would be required if price pressures continued to intensify. Indeed, as monetary conditions still appear

accommodative, a more aggressive pace of interest rate hikes could not be ruled out if price pressures increase.

Directors noted that the Federal Reserve is already among the most transparent central banks in the world. Drawing on experience in other countries, a few Directors suggested that a clearer definition of the Federal Reserve's inflation objective could help further anchor inflation expectations and long-term bond yields, without unduly constraining the ability of policymakers to meet shorter-term stabilization objectives. Most Directors agreed, however, that with the Federal Reserve's impressive track record of maintaining low inflation and effective communication on policy intentions with financial markets, the additional gain from establishing a more explicit inflation objective would be relatively modest.

Directors recognized the importance of structural reforms to support saving, capital accumulation, and high labor productivity growth. These could include aligning the tax burden on saving and consumption, and promoting retirement plans in which participation is the default option.

Directors welcomed the Administration's recent emphasis on strengthening pension funding and improving supervision and shrinking the balance sheets of the housing government-sponsored enterprises (GSEs). At the same time, a few Directors noted that recent irregularities in the insurance sector suggest that there may be a need for supervision of systemically important entities at a national level. Finally, Directors welcomed the recent regulatory moves to tighten lending standards on mortgage instruments.

Directors welcomed Administration proposals for deep cuts in agricultural and non-agricultural tariffs as part of the Doha Round negotiations, as well as efforts to offer and elicit stronger commitments for liberalization in services. At the same time, many cautioned that care should be taken to ensure that the U.S. strategy of negotiating a large number of bilateral free trade agreements is consistent with the multilateral trading system. Directors emphasized that the recent protectionist pressures—including in the wake of the expiration of textiles quotas—are in the interest of neither the United States nor the rest of the world, and should be resisted vigorously.

Directors praised the recent increases in U.S. official development assistance (ODA), and the progress on the Millennium Challenge Account. They noted that U.S. ODA levels as a proportion of Gross National Income (GNI) remain one of the lowest among industrial countries and encouraged the authorities to further increase flows of such assistance.

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Table 1. United States: Selected Economic Indicators

(Annual change in percent, unless otherwise noted)

	1998	1999	2000	2001	2002	2003	2004
NIPA in constant prices 1/							
Real GDP	4.2	4.4	3.7	0.8	1.9	3.0	4.4
Net exports 2/	-1.2	-1.0	-0.9	-0.2	-0.7	-0.4	-0.6
Total domestic demand	5.3	5.3	4.4	0.9	2.5	3.3	4.8
Final domestic demand	5.3	5.4	4.5	1.8	2.1	3.4	4.4
Private final consumption	5.0	5.1	4.7	2.5	3.1	3.3	3.8
Public consumption expenditure	1.6	3.1	1.7	3.1	4.0	2.9	1.7
Gross fixed domestic investment	9.1	8.2	6.1	-1.7	-3.1	4.5	9.0
Private	10.2	8.3	6.5	-3.0	-4.9	5.1	10.3
Public	3.5	7.5	3.6	4.9	6.0	2.1	2.9
Change in business inventories 2/	0.0	-0.1	-0.1	-0.9	0.4	-0.1	0.4
GDP in current prices 1/	5.3	6.0	5.9	3.2	3.5	4.9	6.6
Employment and inflation							
Unemployment rate (percent)	4.5	4.2	4.0	4.8	5.8	6.0	5.5
CPI inflation	1.5	2.2	3.4	2.8	1.6	2.3	2.7
GDP deflator	1.1	1.4	2.2	2.4	1.7	1.8	2.1
Financial policy indicators							
Unified federal balance (billions of dollars)	69	126	236	128	-158	-378	-412
In percent of FY GDP	0.8	1.4	2.4	1.3	-1.5	-3.4	-3.6
General government balance (NIPA, billions of dollars)	8	54	132	-67	-416	-508	-492
In percent of CY GDP	0.1	0.6	1.3	-0.7	-4.0	-4.6	-4.2
Balance of payments							
Current account balance (billions of dollars)	-214	-300	-416	-389	-475	-520	-668
In percent of GDP	-2.4	-3.2	-4.2	-3.8	-4.5	-4.7	-5.7
Merchandise trade balance (billions of dollars)	-247	-346	-452	-427	-482	-547	-665
In percent of GDP	-2.8	-3.7	-4.6	-4.2	-4.6	-5.0	-5.7
Invisibles (billions of dollars)	33	46	36	38	7	28	-3
In percent of GDP	0.4	0.5	0.4	0.4	0.1	0.3	0.0
Saving and investment (as a share of GDP)							
Gross national saving	18.3	18.1	18.0	16.4	14.2	13.5	14.0
Gross domestic investment	20.3	20.6	20.8	19.1	18.4	18.4	19.7

Source: Haver Analytics; and IMF Staff estimates.

1/ National accounts data as available at the time of the July 22, 2005 Executive Board discussion.
2/ Contribution to growth.