

U.S. ECONOMY

Ease Off Spending Cuts to Boost U.S. Recovery

- U.S. growth expected to slow to 1.9 percent in 2013, but could pick up in 2014
- Recovery hinges on more balanced, gradual pace of fiscal adjustment
- Exit from monetary policy stimulus requires careful communication, timing

The United States could spur growth by adopting a more balanced and gradual pace of fiscal consolidation, especially at a time when monetary policy has limited room to support the recovery further, the International Monetary Fund said after wrapping up its annual review of the world's largest economy.

"There are signs that the U.S. recovery is gaining ground and becoming more durable. However, it has a way to go before returning to full strength. The IMF's advice is to slow down, but hurry up: meaning slow the fiscal adjustment this year—which would help sustain growth and job creation—but hurry up with putting in place a medium-term road map to restore long-run fiscal sustainability," Managing Director Christine Lagarde said.

Despite some improvements in economic indicators, particularly in the housing market, the very rapid pace of deficit reduction (including automatic spending cuts known as the sequester) is slowing growth significantly, the IMF said.

U.S. growth is expected to slow to 1.9 percent in 2013, from 2.2 percent in 2012. This projection reflects the impact of the sequester, and the expiration of the payroll tax cut and the increase in tax rates for high-income taxpayers.

Growth could pick up to 2.7 percent next year with a more moderate fiscal adjustment and a further strengthening of the housing market, the IMF said.

Strengthening the recovery

According to the IMF, the main policy challenge is to support the recovery, while addressing the vulnerabilities that threaten growth, public finances, and financial stability in the medium term.

In its assessment, the IMF emphasized a fiscal policy strategy to deal with this challenge, including the need to:

- **Repeal the sequester and adopt a more balanced and gradual pace of fiscal consolidation.** The spending cuts not only reduce growth in the short term, but the arbitrary reductions in education, science, and infrastructure spending could also reduce medium-term potential growth.

- **Raise the debt ceiling to avoid a severe shock to the United States and the global economy.**

- **Adopt a comprehensive and back-loaded set of measures to restore long-run fiscal sustainability.** Spending on major health care programs and Social Security is expected to increase by 2 percentage points of GDP over the next decade. Interest outlays are also projected to increase by 2 percentage points of GDP over the same period, as interest rates gradually return to normal levels. These factors would again widen the budget deficit and increase public debt. New revenues could be raised through a reduction in tax exemptions and deductions, as well as through the introduction of a carbon tax and a value added tax. Spending measures would need to curb the growth in public health care and pension outlays.

The IMF also stressed the crucial importance of monetary policy. "Unusual times demand unusual policies and unusual care in managing risks," said Lagarde.

Given the still-large output gap, there is no need to rush to exit from monetary accommodation. But the IMF underscored the need to plan and manage a gradual and orderly normalization of monetary policy conditions, while monitoring financial stability risks. While the U.S. Federal Reserve has a range of tools to help manage the exit, effective communication on the exit strategy and careful timing will be critical to avoid excessive volatility in long-term interest rates as the exit nears.

The IMF also pointed to the need to increase the resilience of the U.S. and global financial system, while reducing the risks of fragmentation of the global financial regulatory framework. Key items on the agenda are finalizing the designation of systemically important nonbank financial institutions, further strengthening regulation of money market funds, implementing the Basel III package of bank regulatory standards, and implementing the Volcker Rule.

More generally, bolstering regulatory policies to support financial stability should be coordinated with the global financial reform agenda, as this would reduce fragmentation of the regulatory landscape and limit uncertainty and the scope for regulatory arbitrage.

Room for more active policies

Despite the improvements over the past 12 months, there is still room for policies to support the housing market, the IMF said. As a stronger housing market remains an essential component of the U.S. economic recovery, it would be important to maintain the government-backed programs that facilitated refinancing and modification of loans under stress.

The IMF also noted that there is room for active labor policies to complement efforts to boost domestic demand and to help reduce the risk of enduring losses of human capital. These policies can include training and support for job search, as well as efforts to strengthen the link between the education system—particularly community colleges—and employers, including through apprenticeships.

A final report will be issued once it has been discussed by the IMF's 24-member Executive Board in late July.
