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Statement by Mr. Trabinski and Mr. Gindrat on United States
(Preliminary)
Executive Board Meeting
July 19, 2021

We broadly agree with the staff's assessment of the US economic developments. The authorities' policies have initiated a remarkable economic recovery. Effective measures by the authorities led to an impressive turnaround from the situation at the beginning of the pandemic. These policies, however, came at the cost of a considerable worsening of the debt path, higher twin deficits, and increased vulnerabilities in financial markets. Large shifts in demand coupled with less vigorous adjustment of the supply-side could give rise to imbalances and unwarrantedly persistent inflationary pressure.

In order to ensure a long-lasting macroeconomic impact, the unprecedented fiscal response should now be recalibrated. Addressing structural challenges like weak infrastructure, low productivity, and non-inclusive growth, will require tax and spending proposals that should focus on generating a slower demand and higher supply impulse, to help reduce risks of a sustained upswing in inflation. Importantly, as outlined in the DSA baseline scenario, the debt-to-GDP ratio fails to stabilize under the American Jobs and Families Plans. The implementation of a credible medium-term fiscal adjustment that helps reverse the public debt path is therefore crucial.

The Fed's transition to flexible average inflation targeting (FAIT) should support growth in the short term. In August 2020, the Fed transitioned to FAIT to address downside risks to employment and inflation. This new policy framework could support domestic demand in the short term. The slower pace of policy normalization should also result in weakening the dollar, increasing US competitiveness, and boosting exports.

Given a highly accommodative monetary and fiscal policy, the risks of overheating of the US economy and a surge in underlying inflation has risen. Several factors could generate higher-than-expected inflation. First, a slower rebound in labor force participation could create wage and price pressures, which could accelerate in case supply chain disruptions prove to be persistent. Second, the macroeconomic impact of the fiscal stimulus may be larger and more front-loaded than currently assumed. If these upside risks to inflation materialize, we agree with staff that monetary policy would need to adapt quickly.

We encourage the authorities to remain committed to an open and rules-based trading system. We concur with staff that US workers and jobs would be best served by incentives to increase productivity, labor supply and competitiveness. A reduction in trade restrictions and lower tariffs would be helpful in this context. External imbalances should be addressed by identifying and eliminating underlying distortions and establishing sound economic fundamentals. We encourage the authorities to constructively work with trading partners in the context of a rules-based multilateral trading system to better address the underlying macro-structural distortions that are affecting external positions.

Safeguarding financial stability will be important to ensure a smooth economic recovery. Although the financial sector is well capitalized and appears to be resilient, the very accommodative financial conditions are a risk for financial stability. Asset valuations are sharply increasing, and financial leverage has risen. Both developments should be monitored carefully to prevent systemic stress, which could occur in case of a badly received reduction in the accommodative stance by the Fed. We also see the substantial risk taking in the non-banking sector as an important vulnerability in the financial system. Macroprudential regulations should be strengthened to limit the scope for further risk-taking. Full implementation of FSAP recommendations would further help increase the sector's resilience.