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SM/02/200
Supplement 1

CONTAINS CONFIDENTIAL INFORMATION

July 26, 2002

To: Members of the Executive Board

From: The Secretary

Subject: **United States—Staff Report for the 2002 Article IV Consultation**

The attached supplement to the staff report for the 2002 Article IV consultation with the United States (SM/02/200, 7/5/02) has been prepared on the basis of additional information and is tentatively scheduled for discussion on **Monday, July 29, 2002**. At the time of circulation of this paper to the Board, the Secretary's Department has received a communication from the authorities of the United States indicating that they consent to the Fund's publication of this paper.

Questions may be referred to Mr. Collyns (ext. 38383), Mr. Towe (ext. 38489), and Ms. De Masi (ext. 38395) in WHD.

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the WTO Secretariat; and to the Organisation for Economic Cooperation and Development, following its consideration by the Executive Board.

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INTERNATIONAL MONETARY FUND

UNITED STATES OF AMERICA

Staff Report for the 2002 Article IV Consultation
Supplementary Information

Prepared by the Western Hemisphere Department

Approved by Charles Collyns

July 26, 2002

1. ***This supplement reports on information that has become available since the staff report (SM/02/200) was issued.*** Topics covered include recent economic data and financial market developments, the biannual Monetary Policy Report to Congress, the Mid-Session Review of the Budget, legislation on corporate governance and accounting, and trade policy developments. These developments, especially the sharp decline in equity prices in recent weeks, have underscored the downside risks highlighted in the staff report, and staff growth projections are likely to be revised down in the context of the ongoing WEO exercise. However, they do not materially affect the broad policy thrust of the staff appraisal.

Recent economic and financial market developments

2. ***Recent indicators have tended to confirm that growth moderated to around 2–2½ percent (annual rate) in the second quarter, following 6¼ percent growth in the first quarter.*** Industrial production grew by ¾ percent in June and by over 4½ percent in the second quarter (annual rate). While retail sales, excluding automobiles, increased by only 0.4 percent in June and by 1¼ percent in the quarter as a whole, low interest rates and incentive programs helped to spur a 3¾ percent rebound in auto sales in the second quarter.

3. ***Investment and household demand indicators have generally been consistent with a sustained recovery.*** Although housing starts fell in June, at 1.67 million units they remained close to record levels, and strong permit applications suggest continued strength in residential investment. Although durable goods orders fell a surprising 3¾ percent in June, reflecting a sharp drop in the capital goods component, diffusion indices published by the Institute of Supply Management point to continued expansion in both the manufacturing and nonmanufacturing sectors.

4. ***Labor market conditions also appeared to have bottomed out, and inflation has remained low.*** Although the unemployment rate increased slightly to 6 percent in June, private nonfarm payroll employment rose modestly again; the index of hours worked and overtime both increased; and hourly earnings grew by 0.4 percent. The consumer price index

(CPI) rose only 1 percent in June (12-month rate), and while the core CPI rose 2¼ percent, this primarily reflected the large weight on housing prices.

5. ***However, the trade balance widened considerably in May, reaching $37.6 billion.*** Although exports rose ¾ percent, their third monthly gain, imports also continued to rise strongly, increasing by 1¾ percent, reflecting surging inflows of consumer goods and automobiles.

6. ***Notwithstanding relatively strong data releases, recent market developments have severely undermined confidence.***

- ***A major telecommunications company—WorldCom—filed for bankruptcy on July 21, the largest in U.S. history.*** The filing followed the June 25 disclosure that the company had overstated its 2001 earnings by nearly $4 billion by improperly accounting for leasing expenses as capital rather than current outlays. News reports suggest that shareholder equity—which had reached as high as $120 billion during 1999—would be virtually eliminated.

- ***WorldCom's bankruptcy filing, earnings restatements by other companies, and weaker forecasts for third-quarter earnings, have taken a heavy toll on stock markets.*** By July 24, the S&P 500 stock index had fallen by nearly 15 percent from its June 25 level, or roughly 45 percent below its March 2000 peak, to levels not seen since 1997. In July, the University of Michigan's consumer expectations index also fell to its lowest level since November 2001, and the Philadelphia manufacturing survey declined to a low for the year.

- ***Other financial markets have also been under strain.*** The ten-year Treasury bond rate has fallen by around 40 basis points to 4½ percent, and signs emerged of diminished liquidity in corporate bond markets. Declines in shorter-term yields suggest that markets expect that the Federal Reserve will delay beginning to withdraw stimulus until mid-2003. Although the U.S. dollar came under further pressure during the first half of July, it has recovered somewhat against most major currencies during the past week, and has depreciated by only a further 1 percent in effective terms since late June.

7. ***Recent financial market developments have increased the uncertainties surrounding the outlook, and the staff's growth forecast is likely to be revised down.*** The forecast presented in the staff report was for a gradual pickup in real GDP growth from 2½ percent in 2002 to about 3¼ percent in 2003. Although these projections were lower than the July private sector consensus, they now appear somewhat optimistic. For example, model-based estimates suggest that a 20 percent decline in the stock market would lower GDP by around ¾ percent by the end of six quarters. However, a full assessment would need to factor in the effects of a weaker exchange rate and lower longer-term interest rates. The revised projections that will be prepared for the Summer WEO will also need to take into account the July 31 release of second-quarter GDP data and the significant historical revisions that are expected.

Corporate governance and accounting

8. ***House and Senate versions of reform legislation were reconciled by a conference committee.*** The bill would create a new accounting oversight board that would set auditing standards and conduct regular inspections of accounting firms, and would restrict accounting firms from offering certain consulting services. Corporate governance would be strengthened in a number of ways, including by enhancing disclosure, stiffening penalties for corporate fraud, requiring intensified review of corporate financial reports by the SEC, and increasing the scope for shareholder law suits. The bill was passed by both houses and sent to the President for signature on July 25.

Monetary Policy Report to Congress

9. ***In Congressional testimony on July 17–18, Chairman Greenspan delivered a relatively sanguine assessment of the U.S. economy.*** Although he acknowledged that uncertainties had increased with recent financial market turbulence, he emphasized the favorable underlying fundamentals in the economy and prospects for continued strong productivity growth. He indicated that, with little sign of inflation, there was time to wait before tightening monetary policy until "the forces inhibiting economic growth are dissipating enough to allow the strong fundamentals to show through more fully." Markets are now pricing in the expectation that tightening will be delayed until around mid-2003.

Mid-Session Review of the Budget

10. ***The Administration's Mid-Session Review (MSR) of the Budget released on July 15 showed a further deterioration in the fiscal outlook (Table 1).*** The FY 2002 deficit was estimated at $165 billion (1½ percent of GDP), $59 billion larger than projected in February, and the FY 2003 deficit projection was increased by $29 billion to $109 billion (1 percent of GDP). Although the MSR still projected fiscal surpluses to return, on a unified basis, in FY 2005, the budget would remain in deficit over the medium term excluding the Social Security surpluses. Moreover, these estimates still appear subject to considerable downside risks, since they assume that recent tax revenue shortfalls are largely temporary and that strict limits on discretionary spending can be maintained.

Trade policy

11. ***House and Senate versions of trade promotion authority legislation have been reconciled in conference committee.*** The compromise version is reported to include funding for programs to assist workers displaced by trade, as well as requirements that garments entering the United States duty-free from the Caribbean, Africa, or Latin America be produced with fabric dyed and finished in the United States.

12. ***Regarding the U.S. steel safeguard duties***, the U.S. Administration announced further tariff exclusions on July 19, and additional exclusions may be considered up to August 31. As a result, the EU—which had threatened retaliation—indicated that it would postpone a decision on possible countermeasures until September 30.

Anti-money laundering

13. The U.S. authorities have recently provided the staff with a completed AML/CFT questionnaire, which the Monetary and Exchange Affairs Department is presently reviewing. The material is expected to be used as an input for a Board paper providing a broader review of questionnaire responses ahead of the upcoming Annual Meetings. The U.S. Executive Director's office has also recently confirmed that the authorities would be willing to participate in an AML/CFT ROSC.

Table 1. United States: Fiscal Indicators, FY 2002-07

(Fiscal years, in percent of GDP)

	2002	2003	2004	2005	2006	2007
FY 2003 Mid-Session Review						
Outlays	19.3	19.3	19.0	18.7	18.5	18.2
Debt service	1.8	2.0	2.0	2.0	1.9	1.8
Other	17.6	17.4	17.0	16.7	16.5	16.4
Revenue	17.8	18.3	18.6	19.1	18.9	18.8
Unified balance	-1.6	-1.0	-0.4	0.4	0.5	0.6
Primary balance	0.2	1.0	1.6	2.4	2.4	2.5
Unified balance excluding social security	-3.1	-2.5	-2.0	-1.4	-1.4	-1.3
Gross debt held by the public	33.6	33.0	31.8	29.8	28.0	26.0
FY 2003 Budget						
Outlays	19.7	19.5	19.0	18.7	18.5	18.3
Debt service	1.7	1.7	1.6	1.6	1.5	1.4
Other	18.0	17.8	17.3	17.2	17.0	17.0
Revenue	18.7	18.7	18.9	19.2	19.2	19.1
Unified balance	-1.0	-0.7	-0.1	0.5	0.7	0.8
Primary balance	0.7	0.9	1.5	2.1	2.1	2.1
Unified balance excluding social security	-2.6	-2.4	-1.8	-1.2	-1.1	-1.0
Gross debt held by the public	33.4	32.7	31.2	29.2	27.1	25.1

Sources: Budget of the United States Government: Fiscal Year 2003 (February 2002); and Mid-Session Review, Budget of the United States Government (July, 2002).