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Statement by Mr. Shaalan on United States
(Preliminary)
Executive Board Meeting
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Following the shallow but relatively stubborn recessionary conditions that set in early in 2001, but did not immediately respond to the massive fiscal and monetary stimulus, economic activity appears to be turning the corner. It may be tempting to view the economic data of the past week or two (slow growth in June employment; declining rate of retail sales, particularly the sharp decline in auto sales; and the increase in incidence of profit warnings) as an indication that the recovery in economic activity may be short lived as was the case in the past three years. This view may be supported by the fading effects of the tax cuts and persisting uncertainties. However, at this time, this would be a premature conclusion based, as it were, on a very limited set of data.

The staff attributes the relatively long period of slowdown to the series of negative shocks the economy has been subjected to. There is no doubt that these shocks had a serious effect on economic activity and generated an atmosphere of uncertainty, which is not conducive to investment. The staff, however, did not take into account the excesses of the nineties that contributed to the growth in unutilized capacity, resulting in weak corporate investments. This is an aspect that needs to be highlighted as it may have implications on policy formulation.

The challenges facing the U.S. economy are well identified in the staff report, as well as in the selected issues paper. Following a period of easy monetary conditions, coupled with expansive fiscal policies, both of which may have been called for given the adverse shocks the country experienced, it is now important to gradually withdraw the stimulus to address potential inflationary pressures while promoting sustainable growth. This change in the direction of policy towards a neutral ,as opposed to an accommodative, monetary policy, and the implementation of a credible medium- and long-term budgetary policy to address the large and unsustainable deficit should be ranked high on the policy agenda. In particular, the continuation of expansionary fiscal policies could well endanger the attainment of a gradual increase in interest rates, sending undesirable shocks to financial markets, especially in emerging markets. The latter considerations would be more serious than the consequences on emerging markets of the sharp rise in interest rates of 1994 because of the considerably increased volume and geographic coverage of financial activities for emerging markets asset class.

The challenges posed by changing gears in monetary management, particularly after a relatively long period of low nominal and negative real rates, are daunting. Following this unprecedented period of stimulus, the monetary authorities have cautiously, and much more transparently than in the past, clearly signaled that the accommodative era was coming to an end. We commend the Federal Reserve communicating policies in a timely manner to reduce the chances of creating an undesirable atmosphere of uncertainty in financial markets. In particular, the June increase in the federal fund rate was widely anticipated and future gradual and frequent increases have been clearly communicated to the markets. This should reduce any potential financial instability, not only in domestic markets but also globally. On this score, policymakers have a responsibility that transcends their borders.

There are many unknowns about the core factors affecting growth prospects in the U.S. economy, which render monetary management difficult. While growth so far in 2004 has been robust, there is evidence that the fiscal stimulus in the form of tax cuts is beginning to weaken. Investment incentives are scheduled to expire by the end of the year. In addition, mortgage refinancing may well be on the decline, following the surge earlier this year. Finally, productivity performance, which has been remarkably high, at a rate that is more than double the average for the past five years, was a significant factor in holding prices down. The current rate of productivity increase is unlikely to be sustained, and informed guesses suggest that it will slow down, but will still record a healthy level. All these considerations could suggest a growth outcome that would warrant an approach of modest tightening.

In our view, the biggest challenge facing the U.S. economy is that of credibly reigning in the high fiscal deficit. It was only a few years ago when sizable budget surpluses were projected. This remarkable turnaround needs to be revisited. The authorities have targeted a cut in the deficit (excluding social security) to one-half of the current level over the next five fiscal years. To this end, the fiscal consolidation outlined in the staff report is mainly the result of the expiration of temporary investment incentives, and the restoration of personal tax refunds to more normal levels. The tight limits on outlays are expected to finance both the cost of making the income tax cuts of 2001 permanent, and the proposed preferred savings instrument. These actions will serve to reduce the deficit by about two-thirds of the announced deficit target for the next five fiscal years. However, it is well to note, as the staff points out, that the budget takes no account of the operations in both Iraq and Afghanistan, where there are still question marks about their magnitude. Neither are the implications of the highway and energy legislations now before congress taken into account in expenditures. Moreover, the extremely optimistic projected restraint on spending is likely to be difficult to achieve, and additional revenue cuts are anticipated during the coming fiscal years.

In view of the above considerations, we have serious reservations on the realism of the budget outlook as seen by the authorities over the next five years. It appears almost imperative that revenue measures, along the lines outlined by staff in Box 2, will need to be considered to attain the fiscal consolidation and sustainability envisaged, in the absence of realistic expenditure restraints. In the longer term, the well-known budgetary pressures emanating from the social security sector, and the recent expansion in Medicare benefits, will add to the fiscal imbalances. Implementing a plan to address the weak finances of the entitlement programs should not be delayed.

Finally, on the current account deficit, we have little to add to our previous position voiced on many occasions. The recent depreciation of the dollar may well reduce the pressures on the current account; however, both the budgetary outlook in the U.S., and the slow pace of structural reforms in major European countries will continue to be obstacles to an orderly depreciation of the dollar, and the correction of the current account imbalances. This highlights the need for a collaborative and coordinated approach to addressing the global imbalances that exist today.