FOR INFORMATION

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July 29, 2020

To: Members of the Executive Board

From: The Secretary

Subject: **United States—Statement by the European Central Bank Representative**

Board Action:	Executive Directors' **information**
Additional Information:	For the Executive Board discussion on the United States to be held on Friday, July 31, 2020.

July 29, 2020

Statement by Rasmus Rueffer (ECB representative) and Kleopatra Nikolaou on the United States - Article IV Consultation and Financial Stability Sector Assessment 2020
(Preliminary)

IMF Executive Board Meeting

31 July 2020

We thank staff Mr Rosen, Mr. Grohovsky and Mr. Shenai for their Buff Statement and the Staff for their reports.

The pandemic brought the longest economic expansion in the United States to an abrupt end. As elsewhere in the world, it was initially necessary to lock down economic and social activity on a broad scale to preserve lives. This was associated with an unprecedented loss in economic output. After the earlier gradual opening up of the economy, the renewed restrictions imposed locally in response to resurgent infection rates point to a difficult and highly uncertain recovery path looking forward. We therefore agree with Staff that the outlook is associated with important downside risks and the return to pre-pandemic output level may take longer than initially expected, as containment and social distancing measures may be needed for a while. Nevertheless, we also agree with Staff that the collapse of economic activity seems to have bottomed out, as reflected by industrial production, retail sales and both manufacturing and non-manufacturing PMIs. Having said that, major uncertainty and downside risks to the outlook remain.

The report rightly stresses the importance of tackling inequality and rising levels of poverty in the United States, also in view of the macrocriticality of these issues for ensuring a robust economic recovery. The crisis exposed existing vulnerabilities related to income and wealth polarisation, declining socio-economic mobility, and shortcomings in education and the healthcare system. As pointed out by staff, lower-income groups of the population have been disproportionally hit by the insufficient access to healthcare services and the massive employment losses. We agree with Staff that addressing inequality is relevant not only for equity reasons but also for economic efficiency reasons stemming inter alia from the negative externalities resulting from low health insurance coverage of those groups. Overall, addressing these issues is important for a smooth and sustainable recovery. Investment in infrastructure, ideally also used to accelerate investments for the transition towards a low-carbon economy, could also help with supporting employment and tackling poverty.

Addressing these social and economic challenges, while fighting a pandemic has important implications for fiscal policies. The fiscal policy response so far has been timely and forceful and has helped significantly to cushion the devastating effects of the pandemic on economic activity. We note that some of those measures may need to be prolonged and that a second round of fiscal support may be required to support employment and economic activity, as the pandemic continues to take its toll on people and the economy. Given the additional burden of such measures on the already high levels of public debt, actions to place the debt-to-GDP ratio on a sustainable path should be considered again once the recovery is fully entrenched. Such actions include a reform of entitlements (notably, retirement and health spending) and a broadening of the fiscal base. Finally, we welcome Staff's observation that the confluence of current events provides a historic opportunity to adopt fiscal policies that will facilitate a shift toward more environmentally-sustainable economic growth model.

The monetary policy response to the pandemic has also been forceful and timely, with more space available in case needed. The Federal Reserve responded aggressively and deployed a wide range of new and existing tools in order to support the liquidity of financial institutions, foster improved conditions in financial markets and provide lending support to various sectors of the economy. We agree with Staff that further monetary stimulus can be provided, if required by the Federal Reserve to fulfil its statutory objectives for monetary policy. As Staff also notes, disinflationary pressures may be indeed stronger than inflationary ones, which could increase further monetary policy space. Potential financial stability side effects of a very accommodative stance should be carefully monitored.

We agree with Staff that the recent pandemic crisis was a real-time economic and financial stress test, which has shown the U.S. financial system to be both resilient and flexible, but note further risks for negative real-financial feedback loops. The banking system entered the crisis well capitalised and with sizeable liquidity buffers, following the regulatory overhaul after the Global Financial Crisis. In addition, the large policy support, including the relaxation of prudential requirements, also helped support financial markets and contained the crisis to being primarily an economic one. Nonetheless, as Staff cautions, the crisis is at an early stage. Negative financial stability risks prevail as economic disruption continues: The apparent disconnect between developments in the real economy and the financial markets can abruptly reverse, leading to tighter financing conditions. In addition, deteriorating credit quality of both household and corporate lending is likely to be increasingly visible in the coming months. In combination with the high levels of non-financial sector debt, a highly leveraged loan market and a significant migration of risks to the non-financial system, adverse macro-financial feedback loops may intensify. Therefore, continued policy support may be needed to maintain the stability of the financial system and the soundness of the financial institutions – notably in case the economic activity remains subdued longer than expected. We take note that banks' capital depletion rates in the FSAP stress test are high, yet manageable, and concur with Staff that continued restraint on banks' capital distribution plans would help conserve banks' capital and retain loss-absorbency. Looking ahead and once the crisis period is over, supervisors and regulators will face the challenge to adapt the stringency of prudential requirements in a balanced manner that mitigates pro-cyclicality and preserves the resilience of the banking sector, and to expand the perimeter of regulatory and prudential requirements for the non-bank sector.

On the external sector, the US current account position appears moderately weaker than implied by medium-term fundamentals. However, a number of factors may lead to a higher current account deficit compared to the 2% of GDP in 2020 projected by Staff, driven by such factors as more debt financing by foreign investors, lower-than-expected saving rates in case of a more rapid economic recovery and a removal, even if partial, of policy support. A prolonged period of low oil prices may also hinder the export capacity of the shale industry and energy sector in general.

We welcome and fully support the Staff conclusion that trade restrictions and tariff increases should be avoided and that multilateralism should be the platform to resolve trade conflicts. In general, policies that distort trade, including tariffs, non-tariff barriers and subsidies, should be avoided. We support a modernization of the multilateral rules-based trading system and a restored, well-functioning World Trade Organisation (WTO) dispute settlement system. We do agree with Staff that restrictive trade policies, including countervailing duties, have had negative consequences on the US and global activity and remain an important downside risk. Without prejudice to potential issues regarding the WTO consistency of countervailing duties linked to exchange rate valuations, these duties risk complicating effective dialogue and economic surveillance over the underlying macro-structural distortions affecting external positions.