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July 29, 2020

Statement by Mr. Ray on United States
(Preliminary)
Executive Board Meeting
July 31, 2020

We thank staff for the Article IV report and financial sector surveillance assessment and Mr. Rosen, Mr. Grohovsky, and Mr. Shenai for the detailed Buff statement. The US has not been spared from the COVID pandemic and is in the middle of a huge, rapid, negative economic shock characterized by extreme uncertainty. Given this, we would have welcomed a sharper discussion of the challenges that the US authorities face over the next 12 – 18 months and how they might think about navigating them, particularly given that their actions will have spillover effects for the global economic recovery.

In particular, we have reservations about the usefulness of some of staff's policy recommendations to the authorities, reaffirmed by the Buff statement. We would have preferred a focused discussion that considered how to tackle COVID-19 and ensure a sustained and equitable recovery in the face of elevated uncertainties including the potential for significant health setbacks. The report falls short of the aspiration of short and succinct surveillance during the COVID-19 pandemic: it is neither short nor succinct.

The US has taken aggressive, well-designed and timely monetary and financial policy actions to respond to the sudden collapse in economic activity and to developments on financial markets and in the financial system. While the easing of monetary policy in March is unlikely to have had a large economic impact yet, extremely low interest rates should support activity in the recovery. Given the Federal Open Market Committee's own forecasts, we agree with staff that the authorities should consider whether they need to do more. Staff's approach of setting out the pros and cons of alternative additional actions in a US context has merit. No doubt the Federal Reserve's own review of its monetary policy framework and toolkit is doing just that; its completion could prove fortuitously timed. One element of the staff's assessment that we found unbalanced was the discussion of yield curve control. Staff state that there is little empirical evidence on the extent to which yield curve control supports demand; there is a range of empirical evidence of the effectiveness of lower risk-free rates. Staff also note that yield curve control could see the Fed losing control of the quantities it purchases. This view runs counter to the experience with central bank price-based facilities that are credible (including yield curve control in Japan and Australia, and the Fed's own backstops in corporate credit markets).

The Federal Reserve's swift interventions to act as the market-maker of last resort in the Treasuries and mortgage-backed securities markets were critical in restoring stability to the global financial system. Our authorities also valued the Fed's support of global dollar funding markets, including through extending bilateral swap lines to a wider range of central banks and establishing a repo liquidity facility for foreign central banks. Just as with some of its other actions, the fact that some of these facilities may not have been used much by no means indicates that they have not been effective in restoring stability. As staff note, the Federal Reserve has also very effectively played its more traditional role as the lender of last resort to the financial system and, together with Congress and the Treasury, a more modern role as the lender of last to the non-financial sector. We agree with staff that unwinding these emergency facilities at an appropriate time will be important. We would value a full assessment of why the Fed had to step into the Treasuries and mortgage-backed securities markets: ie, why did the usual market making facilities not work more effectively? *Is staff planning to undertake such an assessment*?

T**he US has also taken decisive and strong fiscal action to protect households and firms from the immediate economic shock and so support economic activity.** Even so, the impacts on the labor market and the economy more broadly have been considerable. As is often the case in recessions, poorer households have been hit harder, though the distributional impact has been aggravated by the uneven exposure to COVID-19 and the large impact on certain low-wage services sectors. The path ahead is extremely uncertain: initially driven by COVID-19; but also driven by potential behavioral change, including in saving, consumption patterns and modes of work, and, if the spread of COVID-19 is not contained quickly, potential scarring.

The challenge for fiscal policy is to balance the need to continue to protect households and firms, while also allowing reallocation of labor and capital. Given the extraordinarily high level of unemployed labor, both formally still in the labor market and those no longer participating in it, and the very high uncertainties about the composition of the post-crisis economy, this is a particularly delicate policy choice. It is one faced by most of our authorities and we would have appreciated staff's assessment of how and at what pace to step through it.

The US has substantial fiscal space. Now is not the time to worry about debt sustainability. Indeed, while it is possible to see a future scenario that would raise debt sustainability concerns – deflation for example – we are not convinced by staff's judgment that US public debt is on an unsustainable path. History indicates that elevated debt levels are rarely reduced through running substantial fiscal surpluses for an extended period. Given current expectations about interest rates into the medium term, it is feasible for the US public debt to GDP ratio to trend downwards without aggressive tax increases or spending cuts, just as it did after the last peak in the 1940s, and without inflation getting out of control. Much will depend on the strength and sustainability of the recovery.

We strongly support staff's call for reversing trade restrictions and tariff increases, and for constructive collaboration with trade partners to address distortions in trade flows and investment decisions. We note the authorities' objectives in this regard. We consider that a more open, transparent and rules-based international trading system is the best way to ensure fairer and stronger global trade. The current pandemic underscores the need to avoid policies that distort trade, including tariffs, non-tariff barriers and subsidies. We reiterate that the application of currency-based countervailing duties not only poses a significant risk to the multilateral trading and international monetary systems but would also harm the US economy and have negative spillovers to other countries.

We note staff's overall positive assessment of the US financial system going into the COVID-19 crisis and agree that the real time economic and financial stress test of the past few months has shown the US financial system to be resilient and flexible. Nonetheless, the set of severe but plausible stress tests show that further action may be needed to preserve the soundness of financial institutions if the pandemic persists for longer than expected or has a more severe economic impact. We broadly agree with the FSAP recommendations and welcome the recognition that some are more medium term, and intended to be considered only once the impact of the pandemic on the economy and the banking sector becomes clearer.

We are concerned about the build-up of leverage in the corporate sector alongside liquidity, leverage and interconnectedness issues in the non-bank sector. The build-up of leverage in some investment funds during a prolonged period of low interest rates and low volatility, and the related rapid deleveraging that contributed to the market dysfunction in March spilled over to other parts of the financial system. We agree that more could be done to fill data gaps in this area, develop prudential tools to address risks and vulnerabilities in non-banks and mitigate liquidity risks in fund management by strengthening stress tests or introducing mandatory liquidity buffers. In addition, given the growing systemic importance of non-banks in the US, public sector backstops to the non-bank sector may need to be reconsidered in light of the current shock.

We welcome the finding that US supervisory and regulatory framework is sound overall and that the authorities have made progress on implementing the 2015 FSAP recommendations. We agree that it is important to ensure that the complex regulatory environment does not lead to gaps in coverage or impede effective policymaking. We also note staff's assessment that the authorities acted decisively to counter the immediate effects of the pandemic and safeguard financial stability. From this perspective, we encourage staff to focus FSAP recommendations on demonstrated outcomes and avoid prescribing specific institutional arrangements as the only way to achieve effective policy outcomes. We are yet to be convinced, for example, that the case has been made for changes to the institutional set up and resourcing of US financial regulators, which is a repeated non-implemented recommendation from the previous FSSA in 2015.