DOCUMENT OF INTERNATIONAL MONETARY FUND AND FOR OFFICIAL USE ONLY

The contents of this document are preliminary and subject to change.

GRAY/20/2790

July 29, 2020

Statement by Mr. Buisse, Mr. Rozan, and Ms. Gilliot on United States (Preliminary)
Executive Board Meeting
July 31, 2020

We thank staff for this set of excellent documents and Mr. Rosen, Mr. Grohovsky, and Mr. Shenai for their insightful Buff statement. We broadly agree with the assessment of the near-term macroeconomic outlook and the shift to the downside in the balance of risks while recognizing the high uncertainty surrounding projections. Swift and large-scale fiscal, monetary and financial sector policy measures have provided a temporary and welcome relief to households, and there is a need to have a durably expansionist fiscal policy to support the recovery. This is also an opportunity to address significant fiscal needs linked with a deteriorating stock of infrastructure, the correction of inequalities, as well as addressing challenges related to climate change. The crisis has undeniably highlighted the benefits of past reforms to enhance banking sector's prudential requirements and financial system's regulation while revealing the scope and the significance of the supervisory authorities' firepower. Authorities' actions to counter the immediate effects of the pandemic and safeguard financial stability has indeed been prompt and forceful. The pandemic has also been acting as a full-scale test of the robustness of the crisis management framework, and we generally share staff views on the need for continuous efforts in terms of financial regulation and supervision and avoid rolling back important post-GFC efforts. We wish to provide the following comments for emphasis.

Outlook and risks the recovery

Growth projections over the near term are subject to high uncertainty as a resumption of Covid-19 cases is already threatening the recovery in activity and employment. We agree with staff that the major risk weighing on the outlook is the evolution of the health situation. In a context of heightened uncertainty over the pace of growth, consumer confidence and saving behavior will play a key role in shaping the recovery, and the ability of both monetary and fiscal policies to swiftly adapt to the shock is key in this regard. Going forward, a key uncertainty lies with the calculation of the potential growth, as rightly pointed out by staff. In assessing the output gap, *could staff comment on the calculation of the natural unemployment and interest rates (which are more difficult to establish in a context of* *low inflation and flattening of the Phillips curve), the impact of the losses from the current crisis, and the usefulness of integrating financial variable, as done by the BIS ?*

The future direction of fiscal policy

We commend the authorities for their initial proactive response to the first economic blows suffered from the crisis. To support activity and to limit the scarring effects of the pandemic on the economy and the social fabric, it is clear that the prolonged fiscal support will have to be expansionist to support activity. The impact on households, businesses, state and local governments income has been mitigated so far by the large temporary fiscal support, though this will fall short of responding adequately to longer disruptive effects on the economy, and even more so if the economy experiences the kind of persistent shock most forecasters anticipate.

We therefore fully support staff's call for a new round of fiscal measures to boost consumer demand, increase health preparedness and support the most vulnerable. We also believe that the crisis has further shed light on the structural deficiencies of the health system and offers an opportunity to overcome social safety nets shortfall, in the context of rising inequalities, which was rightly emphasized in last year's article IV**.** Fiscal space should be accordingly used to increase health insurance coverage to all, including to low-income households who have disproportionality borne the brunt of rising unemployment. A large increase in discretionary transfers to states should be part of a new stimulus package to support demand, preserve key public goods including health, education and unemployment insurance schemes and alleviate states' budgets already constrained by equilibrium rules, as we share staff concern on the risks of a procyclical fiscal retrenchment of local governments. More broadly and beyond the crisis, this feeds into a broader need to make **federal and social transfers** more automatic and countercyclical. We also fully support staff recommendation on **education**. Finally, massive **investment in infrastructures** is required, both to boost short term demand (with a focus on already existing project), and to accelerate productivity as well as climate resilience. In this regard, an extensive use of the Better Utilizing Investments to Leverage Development scheme is worth considering while full operationalization of the oversight bodies created under the CARES Act is warranted.

Over the medium term, and once the recovery is firmly entrenched, a rebalancing of public finance will be needed, given the already high structural deficit and long-term trends weighing on the public finance. Most of the adjustment should be borne on the revenue side, with due attention paid to the progressivity of new tax measures (when most tax measures proposed in the staff report are regressive). Enhancing the tax administration's efficiency will also be key. Finalizing of BEPS negotiations at the OECD could also help better mobilizing revenues from the corporate sector.

Options for additional monetary stimulus

The Fed's swift, massive and effective response to support the economy and maintain liquidity in the financial system is praiseworthy. Beyond the short-term emergency measures, the challenge would be for the Fed to support the economic recovery over the medium term in a context of sharp deterioration of public finances. As underscored by staff, the introduction of an effective yield curve control policy could usefully complement the strengthening of forward guidance and the extension of Fed's asset purchase programs. Nevertheless, as mentioned during the last FOMC meeting, further cost-benefit analysis would be needed. Forward guidance is a powerful tool and its design, whether outcome-based or calendar-based, can further strengthen the anchoring of agents' expectations.

As already mentioned by this chair in other occasions, unconventional monetary policy measures and direct support from Central Banks to households and firms may have progressively contributed to blur the boundary between monetary and fiscal policy and can affect the Fed's credibility over the long term. Emergency liquidity support targeted at corporates or municipalities has *de facto* placed the Fed (with the US Treasury) in a position of possible arbitrage between beneficiaries. And there is a risk of misallocation of the Fed support to different risky market segment, that should be carefully monitored.

Trade policy

Commitment to an open, multilateral, rules-based trading system is essential to supporting the recovery and reduce the factors of uncertainty on the outlook. We continue to be concerned by the authorities' actions regarding the multilateral trade system, and we fully support staff's view that risks over worldwide trade have been growing. For example, we regret the adoption (or threat of such adoption) of new unilateral trade measures, and in particular, the use of such threats to deter the EU and some of its member states from adopting taxes on digital services, and encourage the authorities to take an active part in the OECD discussion on this matter to ensure a consistent multilateral solution. We also regret the introduction of new barriers as well as to block appointment to the WTO appellate body.

Finally, we share staff's concern on the application of countervailing duties linked with currency manipulation, as it could further accelerate tensions. Besides, there is no consensus on the estimation of equilibrium exchange rates, which differ substantially across methodologies (the US Department of Commerce does not follow the External Balance Assessment methodology and does not give much details about their own approach).

While this article IV was very focused on the direct impact of the crisis (and rightly so), we expect future surveillance engagement with the country to focus on long term and structural issues that are particularly important for the US economy, but also for the global economy. This relates in particular to climate change, where the US is clearly a systemic actor, and where the Fund should be a trusted advisor to ensure good policy making. This also relates to issues surrounding corporate power and competition issues, which was covered in past multilateral surveillance work. Continued attention on issues surrounding entity transparency and beneficial ownership is also essential (as it contributes to networks of international corruption), and staff's comments in this year's report were welcome.

Financial System Stability Assessment

We thank staff for this high-quality and comprehensive report as well as for the efforts to provide a preliminary assessment of the impact of the Covid-19 shock on the financial system. Progress made since the last 2015 FSAP to strengthen and continue reforming banking, insurance and capital markets regulation and supervision are welcome, though some step backs are regrettable**.** As the crisis has brought out high-risk areas, we strongly encourage the authorities to keep up with the monitoring of rising risks including corporate sector and households' growing vulnerabilities, liquidity and profitability constraints for a range of institutional investors and fast expansion of nonbank financial corporations. While covering a wide range of segments of the United States' financial system, we found the key recommendations particularly accurate and balanced not only on account of their target-oriented nature but also because they are meant on preserving lending and liquidity into the economy**.**

Risks and vulnerabilities

A second wave of the Covid-19 infection is likely to accelerate the impairment of balance sheets, economic recession and translate into a sharp reversal of financial markets sentiment. We did appreciate staff's analysis of US' corporate sector vulnerabilities and agree in particularly with the risks and challenges that might in the near term undermine the leveraged loan market and the energy sector including fracking. On the latter and given the large amount of liabilities of the sector, we would appreciate staff's recommendations to mitigate the risk of losses both for corporates and banks. Corporate debt stress testing highlights the important vulnerabilities of the leveraged loan market. In this regard, *we would be interested in staff's analysis of the impact of rating downgrades scenario, including the growing cases of "fallen angels" on financial stability.* A major part of these vulnerabilities has been arising from leveraged loans being structurally provided to already highly leveraged firms some of them with low credit ratings. It is also explained by the loosened regulation and weakening underwriting standards. Finally, we were surprised not to see more development on commercial real estate, *which is currently threatened by a wave of defaults – over the medium term, how does staff assess this risk?*

Looking more deeply at the basic structure of the non-bank mortgage market, we found it replicates the risky past securitization process and CDS arrangements of the last GFC. With the Covid-19 pandemic, liquidity stress has been indeed amplified by the worsening of the underlying loans credit quality and we do not see the transfer of credit risk to the private sector as going without risks for the overall financial system. *While we understand the trade-offs between enhancing GSE's underwriting standards and rules and the need to maintain access for lower-income borrowers, we would however be interested in staff's main advice to avoid primarily mortgage market dislocations in case of surge in default rate?*

Given the high uncertainty over certain assumptions and in a context of pandemic, stress testing results should be interpreted with caution. Part of the analysis has been conducted before the outbreak, focuses on risks in the corporate sector and do not fully incorporate the impact of fiscal policy measures including the temporary postponement of loan repayments granted to banks' borrowers. We thank also staff for the work done on risk analysis approaches which all in all reflect expected results on US banks' resilience and their large capacity to deploy a rapid response and extend credit lines during the Covid-19 crisis**.** US banks, and especially G-SIBs, have entered this crisis much more prepared with strong capital and liquidity buffers although the findings may differ according to the structure of banks' funding and asset portfolios and the level of initial capital buffers.

On the US insurance sector, for a better understanding, the stress tests and sensitivity analysis would have benefited from i) a breakdown of assets portfolios and liabilities, ii) a quantified impact of the health crisis on the industry (rating downgrades/counterpart risk scenario) and iii) the extension beyond 2021 of the sensivity analysis of continued low interest rates' impact on net investment spreads and profitability. As underscored in the report, the absence of a consolidated group capital framework and risks of misalignment in valuation approach between assets and liabilities are likely to make the effective assessment of insurers' resilience to shocks more difficult. Accordingly, staff's recommendations on those issues seem particularly relevant and grounded.

Finally, on market funding, the Fed had been proactive in shifting from passive to active liquidity managements before the health crisis, allowing to bring to banks and markets a valuable support. The last September episode of cash crunch in the repo market might be an explanation that both factors were involved. **We support staff's recommendations to help rebuild money markets resilience, to modify the treatment of the Discount window in resolution plans, we think those actions should go along with reinforcing markets' confidence with an adequate communication strategy.**

Financial sector oversight

We welcome progress made since last FSAP to strengthen supervision and regulation in a rapidly evolving environment, requiring constant action to prevent and address emerging risks including cyber risks, virtual assets or payment services. We do share staff's concern on the introduction, since 2018, of a tailoring of the prudential and supervisory approach according to the Banks' sizes and encourage authorities to rethink this approach. Authorities should also commit to continue to implement Basel regulation (including the leverage ratio) once the crisis has subsided. Finally, we also encourage the authorities to bridge the remaining data gaps since previous FSAP

The macroprudential toolkit and supervisory modalities should also be reinforced and clarified. As the FSOC has the lead in systemic and emerging risk identification, all its members' mandates should explicitly integrated financial stability dimension. Greater and more transparent communication should nevertheless be careful weighted against the need for confidentiality. The toolkit should also be reinforced and used proactively if necessary. More attention should be placed on the supervision of non-banking and insurance entities and share staff's recommendation to have a more activity-based analysis of systemic risks.

The importance of US capital markets along with the rise of technological challenges and emerging risks including cyber risks or digital assets warrant improvements in oversight of all trading operations as well as of AML/CFT risks. *We would be interested in the reasons for the less than full implementation by CFTC of the 2015 FSAP recommendations regarding fund management supervision and regulation and the delay in completing OTC derivatives markets reforms.* As reflected in the FSAP Risk Assessment Matrix (Appendix I), the interconnected nature of the US financial system could amplify the shock created by a cyber-attack leading to harmful disruptions or breakdown in critical market infrastructures including equity market infrastructures. Lastly, beyond the insightful analysis of virtual assets regulation and oversight, we would like to recall the importance of international cooperation to achieve harmonized regulatory standards and exchange of best practices in supervision.

Crisis preparedness and management

US bank resolution and deposit insurance mechanisms have a head start on other major jurisdictions and have proven to be effective so far. We welcome the commitment of the banking and insurance supervisory authorities to ensure an adequate coverage of recovery and resolution planning measures for main institutions. In this regard, staff points out the reduction of requirement for financial companies' DFA Title I resolution plans and recovery plan requirements. *What is driving this decrease?* In line with the report and European Union practices, extending the Loss-absorbing capacity (LAC) in addition to regular capital requirements to some non-GSIB US financial companies would help preserve financial stability.

Recovery and resolution frameworks for CCPs should be developed on the grounds of the work conducted by the FSB in cooperation with US agencies while reflecting on CCPs emergency access to Central Bank liquidity. In line with the report and given increasing interconnectedness of CCPs, the coordination between all US agencies is key to avoid market fragmentation and strengthen the overall financial stability. The FRB's actions to secure efficient and large **liquidity backstops** are welcome. As mentioned above on the Discount Window, we agree that addressing the stigma linked to the use of such facility through strong guidance to depository institutions is a key element of the liquidity support strategy. With efficient tools to support the recovery and resolution of the main segments of the US financial system, the strengthening of inter-agencies coordination and a clear allocation of responsibilities including with the US Treasury would complete appropriately the overall architecture of crisis management.