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World Economic Outlook

U.S. Economy Returning to Growth, but With Pockets of Vulnerability

Posted on June 4, 2015 by iMFdirect

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IMF staff have just concluded their annual health check of the U.S. economy, and released their concluding statement.

This year we have also undertaken a Financial Sector Assessment Program with the United States. We conduct these once every 5 years for systemically important countries and it is a comprehensive exercise looking at the whole U.S. financial system.

Given this important work, we have focused our review of the U.S. economy on financial stability risks and the appropriate policies to mitigate them, as well as looking at recent movements in the U.S. dollar and the timing, form, and impact of interest rate normalization by the Fed.

A more detailed report on the U.S. economy and on the financial sector will be available on July 8.

Economic outlook

Yet again, the review took place against the background of a shaky first quarter for the U.S. economy. And we revised our growth forecast down to 2.5 percent for 2015. This is largely due to those factors that affected the first quarter.

But this is not our main message. Our main point is that we still believe that the underpinnings for a continued expansion are in place. The labor market has steadily improved over the last year—job growth has averaged about 250,000 per month— and financial conditions remain very accommodative. Moreover, we expect cheaper oil prices to boost consumption in the remainder of 2015, although lower oil prices is going to continue taking a bite out of oil-related investment, as we saw in the first quarter.

As always, there are **risks and uncertainties to the outlook**. For example, further delay of the housing recovery and the strong dollar—notwithstanding the latest improvement in the trade balance—could be a drag on future growth. Nevertheless, when we look at the whole picture, we believe that growth in the coming quarters will be 3 percent or higher.

We see **inflation pressures** as muted. Long-term unemployment and high levels of part-time work both point to remaining employment slack. Wage indicators on the whole have shown only tepid growth. When combined with dollar appreciation and cheaper energy costs, we expect inflation to start rising later in the year, but only slowly, reaching the Federal Reserve’s 2 percent medium-term objective by mid 2017.

Over the medium term, as we highlighted last year, there is still much work to be done. Our forecasts of potential growth are now around 2 percent—a far cry from the over 3 percent average growth rates we saw before the Great Recession.

This leads to our policy recommendations in three key areas.

1. **Monetary policy**

On monetary policy, as we have noted before, the Fed's first rate increase in almost 9 years is being carefully prepared and telegraphed. Nevertheless, regardless of the timing, higher U.S. policy rates could still result in significant market volatility with financial stability consequences that go well beyond U.S. borders.

In weighing these risks, we think there is a case for waiting to raise rates until there are more tangible signs of wage or price inflation than are currently evident. Even after the first rate increase, a gradual rise in the federal funds rate will likely be appropriate. Such a path may create a modest and temporary rise of inflation above the Fed's medium-term goal— perhaps up toward 2½ percent. However, pursuing a cautious and gradual approach to interest rate normalization would provide valuable insurance against the risk of disinflation and needing to cut rates back to zero.

In the coming months, continued clear and effective communication by the Fed will be more important than ever. Last year we made some recommendations on the communications toolkit—such as scheduling press conferences after each Federal Open Market Committee (FOMC) meeting and publishing a quarterly monetary report. We recognize the difficulties with adding more communication, but we continue to believe it merits consideration.

2. **Financial stability**

Our team has taken a detailed and comprehensive look at the health of the financial sector under our Financial Stability Assessment Program.

Much has been done over the past several years to strengthen the U.S. financial system. It will be important to ensure that this progress—including the legislative advances in the Dodd Frank Act—is not rolled back. Diluting the important progress made would clearly be undesirable.

It also seems clear that risks have built up during the long period of exceptionally low interest rates. Nevertheless, today, the data point toward a system with pockets of vulnerabilities rather than one with broad-based excesses. But we shouldn't minimize these risks. These pockets could create serious, macro-relevant sources of financial instability both here and abroad. Some of our concerns include the migration of intermediation to so-called "shadow banks" and the potential for insufficient liquidity in a range of fixed income markets, particularly as these markets come under stress. I know that the U.S. authorities are investing heavily in understanding and assessing these issues.

Some key policy recommendations to reduce financial stability risks include:

- Giving all the individual Financial Stability Oversight Committee (FSOC) members an explicit financial stability mandate so as to further strengthen the effectiveness of the FSOC.
- Undertaking a concerted effort to provide the FSOC and the Office of Financial Research with the data they need to build a comprehensive view and analysis of systemic risks.
- Updating the regulatory regime in the insurance sector to create an independent and well-resourced body that has a nationwide remit.

There are further details, of course, in the concluding statement.

3. **Fiscal Policies**

As we have said before, given our forecast of a steady rise in the public- debt-to-GDP ratio, it remains critically important to adopt and implement a credible medium-term fiscal plan. This requires actions on tax reform, social security reform, and steps to contain healthcare costs.

Tackling these fiscal challenges will provide scope to expand the near-term budget envelope for measures to support future growth, job creation, and productivity. Here, I would prioritize infrastructure spending, better education spending, and policies that raise labor force participation including steps like subsidized childcare assistance.
In conclusion:

- We believe near-term U.S. growth prospects are good.
- It is better to wait for stronger signs of inflation pressures and have an interest rate hike in the first half of 2016.
- Even after the initial step to raise rates, a gradual rise in the federal funds rate will likely be appropriate.
- And although important progress has been made to strengthen the U.S. financial system, there is more to be done to address the pockets of vulnerability.