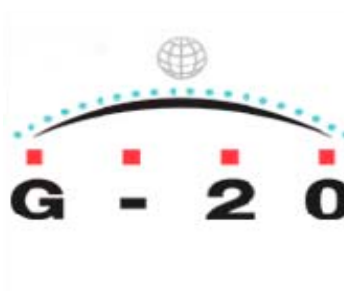


G R O U P O F T W E N T Y



IMF STAFF REPORTS FOR THE G-20 MUTUAL ASSESSMENT PROCESS

Global Economic Prospects and Policy Challenges
Prepared by Staff of the International Monetary Fund



INTERNATIONAL MONETARY FUND

G R O U P O F T W E N T Y



G-20 MUTUAL ASSESSMENT PROCESS: FROM PITTSBURGH TO CANNES—IMF UMBRELLA REPORT¹



Prepared by Staff of the
I N T E R N A T I O N A L M O N E T A R Y F U N D

¹ *Report 1 of 10.* At the request of the G-20, IMF staff has provided analyses and assessments of member's economies and policies in a set of reports for the Mutual Assessment Process (MAP). These reports serve as inputs for the Action Plan agreed by G-20 Leaders at the Cannes Summit. The 2011 Staff Reports for the 20 MAP consist of the following: (i) an Umbrella Report that provides an integrated summary of the component reports and an upside scenario for G-20 collective action; (ii) an Accountability Report that summarizes members' progress toward policy commitments since the Seoul Summit in 2010; (iii) a MAP Report providing analysis of members' medium-term macroeconomic and policy frameworks; and (iv) Sustainability Reports for seven members (China, France, Germany, India, Japan, United Kingdom, and United States)—identified by G-20 indicative guidelines—to assess the root causes and policy implications of key imbalances.

I. INTRODUCTION¹

1. **At the 2009 G-20 Summit in Pittsburgh, Leaders committed to achieving strong, sustainable, and balanced growth—creating a new Framework that has evolved over time to support these objectives.** An embodiment of that collective commitment in Pittsburgh was the launch of the Mutual Assessment Process (MAP) to evaluate the consistency of G-20 policies and frameworks with members' shared growth objectives. Since then, the Framework has been augmented to enhance its effectiveness. At the 2010 Summit in Seoul, members advanced the process by "outlining an action-oriented plan with each member's concrete policy commitments" with the aim of delivering on their growth objectives and to assess members' progress. Leaders also committed to enhancing the MAP to promote external sustainability. It was agreed that "persistently large external imbalances, assessed against indicative guidelines...warrant an assessment of their nature and the root causes of impediments to adjustment as part of the Mutual Assessment Process..." These three key pillars—the *MAP analysis*, *policy progress accountability*, and *sustainability assessments of imbalances*—form a basis to help inform the 2011 Action Plan aimed at achieving the growth objectives, to be discussed by Leaders at the Cannes Summit.

¹ Prepared by Krishna Srinivasan and Hamid Faruqee, with input from Derek Anderson, Michal Andrlé, Mika Kortelainen, Dirk Muir, Susanna Mursula, Stephen Snudden and the support of Eric Bang, David Reichsfeld, and Anne Lalramnghakhleli Moses.

2. **The MAP is a medium-term exercise, but is very much relevant for the current conjuncture.** It was clear at the G-20 Summit in Pittsburgh that resolving the financial crisis, sustaining a durable recovery and anchoring strong, sustainable and balanced growth requires "two rebalancing acts"—one internal, involving a hand-off from public to private demand led growth; one global, involving rebalancing demand in countries with large current account deficits toward external demand and in countries with large current account surpluses toward internal demand.

- *The "dual rebalancing" acts, however, are stuck in midstream, because of which global activity has weakened and become more uneven, while financial stability risks have risen sharply.* Indeed, fiscal consolidation has gained traction, but private demand has not picked up the slack, owing both to unresolved crisis-related fragilities and a barrage of new shocks, including the devastating earthquake and tsunami in Japan and major financial turmoil in the euro area. In the context of lower growth, adverse feedback loops between the real economy, fiscal tensions and the financial sector have strengthened, posing risks to financial stability. At the same time, global demand rebalancing has stalled, as domestic demand in key surplus countries has not accelerated because underlying impediments remain unaddressed.

- *Recovery remains in low gear in major advanced economies with elevated risk of falling back into recession.* Policy paralysis and incoherence have contributed to exacerbating uncertainty, a loss of confidence, and heightened financial market stress—all of which are inimical to demand rebalancing and global growth prospects.
- *Thus, understanding large imbalances within and across countries has taken on renewed importance.* Policy makers need to move with a greater sense of urgency on reaching an agreement on policies that will reduce imbalances and lay the foundation for restoring the global economy to health.

3. **The IMF—working with other IFIs—was asked by the G-20 to provide a series of assessments on these issues for an enhanced MAP, to assist the membership in pursuit of its goals.**² The main component reports from IMF staff consist of the following:

- An **Accountability Report** to take stock of progress made in delivering upon policy commitments made in the Seoul (and Toronto) Action Plan;
- A **MAP Report**, consisting of an updated assessment of G-20 macroeconomic frameworks to develop a forward-looking analysis of whether

² Work on the set of MAP reports was undertaken in close partnership with the OECD, World Bank, ILO and UNCTAD.

policies pursued by individual members are collectively consistent with the growth objectives; and

- A **Sustainability Report** to undertake an in-depth assessment of the nature of large imbalances, root causes, and impediments to adjustment that may undermine growth. The first step of an integrated two-step process—based on G-20 indicative guidelines—identified key imbalances in *seven* members for further analysis.³

4. **This report provides an integrated summary of the analysis and assessment in IMF staff’s component reports for the G-20 MAP—toward informing a desirable action plan.** Section II provides a summary of members’ progress with regard to policy commitments made in Seoul and Toronto, and identifies gaps that need to be bridged. Section III discusses how the global economy might evolve as envisaged by the revised G-20 projections taken collectively. Section IV provides a summary assessment of the root causes and policy implications of imbalances in the seven members identified by G-20 indicative guidelines. Integrating these various assessments, Section V examines upside potential of G-20 policies from strengthened collaborative action. The details of the underlying analyses and assessments are presented in three component reports accompanying this umbrella report.

³ The seven countries are China, France, Germany, India, Japan, United Kingdom, and United States.

II. DELIVERING ON POLICY COMMITMENTS

G-20 economies have been making progress toward the policy commitments made at the Toronto and Seoul Summits. At the same time, however, the global environment has become much more challenging, as growth in advanced countries has slowed sharply and financial stress has increased. As a result, swift and decisive action is now needed to secure the agreed objectives. Major advanced economies urgently need to articulate credible medium-term fiscal plans and further financial sector reforms to resolve underlying problems and weaknesses that led to the crisis; key emerging surplus economies need to address impediments to rebalancing and allow greater exchange rate appreciation; and all need to focus on structural reform, including in the financial sector, aimed at alleviating key impediments to higher growth.

5. **Deflation has been avoided and price stability has been maintained in advanced economies, but inflationary pressures remain high in some emerging economies.**

- The major advanced G-20 economies have kept policy rates exceptionally and appropriately low, given that underlying inflation remains subdued in environments of weak demand and high unemployment. The *European Central Bank* has raised policy rates, but they remain at low levels, and monetary policy rates remain close to the zero bound in the *United Kingdom*, *United States*, and *Japan*. The major advanced economies have also used unconventional monetary policy measures to stimulate the economy. Policy rates have been raised in other economies but may yet need to rise further, especially in emerging economies where inflation remains stubbornly high (and growth remains robust). In *India*, *Korea*, and *Russia*, nominal policy rates have been raised, but real rates remain very low or even negative. In *Brazil*, policy rates have

been raised substantially and macroprudential measures deployed, but further rate action may be needed, as long as growth prospects remain buoyant. In *China*, strong policy measures have slowed credit growth, but inflation has not yet decelerated. In *Turkey*, policy rates have been lowered, but credit growth is nonetheless moderating, partly due to deteriorating external financing conditions and a tightening of macroprudential measures.

- ### 6. **On the fiscal side, slow policy progress and weaker global recovery have placed the Summit commitments in jeopardy.**
- In particular, there is now considerable uncertainty about how fiscal sustainability will be achieved in the *United States*, *Japan*, and some *euro area* economies. To reduce this uncertainty, these economies need to move quickly to put in place credible medium-term consolidation plans, which will help preserve room for adequate short-term fiscal support to the recovery. Indeed, given the still-fragile nature of the

recovery, fragility of demand in key advanced economies, more emphasis should be given to the medium-term and less to front-loaded cuts.

- In the *United States*, the August fiscal package represents an important step forward. But much more progress needs to be made to elaborate a credible medium-term consolidation plan that commands broad political support, based on realistic macroeconomic projections. The projected improvement of fiscal balances in *Japan* falls short of what is needed to put the debt to GDP ratio on a downward path before 2020.
- Fiscal consolidation plans that meet the Toronto criteria have been outlined in the *euro area*. Germany is well on track to meeting the Toronto targets. *France, Italy, and Spain* are pursuing ambitious plans and have recently announced additional consolidation measures, but actual consolidation could prove to be less than projected, because growth projections remain overly optimistic; revenue and spending measures lack specificity; and funding costs are likely to be greater-than-projected. More generally, the euro area needs a consistent, coherent, and cooperative approach to crisis resolution, including swift enactment of the measures agreed at the July EU summit.
- While the Toronto commitments do not encompass emerging market

economies, fiscal consolidation is still warranted in many of these economies, including *Brazil, India, and Turkey*, to help moderate demand pressures.

7. G-20 members have generally pursued exchange rate policies consistent with greater flexibility, but more appreciation is needed in major emerging surplus economies.

- Key advanced G-20 economies with external deficits (such as the *United States*) have seen their currencies weaken, while those with stronger external positions (*euro area* and *Japan*) have appreciated. Advanced economies have largely avoided intervening in currency markets, although the G7 made a coordinated intervention in March after *Japan's* earthquake and tsunami led to an unusually sharp appreciation of the yen.
- Some emerging economies (e.g., *India*) have abstained from intervening in foreign exchange markets, while others (e.g., *Brazil*) have experienced substantial exchange rate appreciations while intervening and deploying capital flow measures to manage the pressure of strong capital inflows. Meanwhile, some major surplus emerging economies (notably *China*) have intervened extensively to limit appreciation—in *China*, the exchange rate has depreciated in real terms.

8. G-20 economies have announced structural reforms, but much more needs to be done in key areas. Structural reforms are crucial for achieving the growth objectives, ensuring fiscal sustainability, and rebalancing economies. Yet many of the announced plans are not well aligned with the critical priorities identified by the OECD, while others are only at early stages of discussion and planning.⁴ In particular, measures are needed to increase labor participation; boost competition; increase flexibility of product, service and labor markets; bolster training and education; and improve the business climate. Also, in some cases, implementation of key structural reforms needs to be speeded up (e.g., the EU Services Directive in *France* and *Italy*).

9. Significant agreements have been reached on reforms to financial supervision and regulation, but some difficult issues remain. As a result of the important work by the FSB and its members, a number of initiatives to reform the financial sector are being advanced. Capital and liquidity standards will be increased under Basel III. The regulatory/supervisory framework for

Systemically Important Financial Institutions (SIFIs) is being augmented, particularly in the *United Kingdom*, *United States*, and *euro area*. But to safeguard financial stability more work is needed. Moreover, these international initiatives need to be translated into robust and consistent implementation at the national level. Further progress on international coordination is also needed, inter alia to avoid regulatory arbitrage. And most urgently (though this is beyond Summit criteria), financial institutions should be forced to rebuild capital, and those institutions that are deemed not viable and not able to access private funds need to be resolved smoothly and expeditiously.

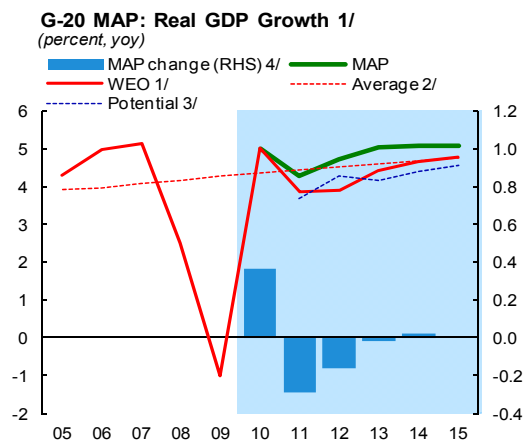
⁴ See the OECD's assessment in "Pursuing Strong, Sustainable, and Balanced Growth: A Note on the Implementation of Structural Reform Commitments," July 2011, and "Pursuing Strong, Sustainable, and Balanced Growth: Taking Stock of the Seoul Action Plan's Structural Reform Commitments," June 2011.

III. GLOBAL OUTLOOK THROUGH THE EYES OF THE G-20

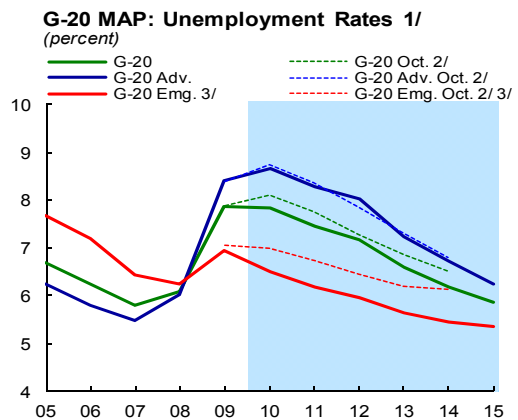
Against the backdrop of weakening global activity and rising downside risks, G-20 growth projections (admittedly based on submissions made in May, when the global outlook looked better than it is currently) appear overly optimistic relative to both the WEO and compared with experiences following past financial crises. This, in turn, implies that projected marked improvements in fiscal positions may not be realized if growth rates are lower than expected. Progress towards rebalancing global demand remains modest.

10. G-20 macroeconomic frameworks project *strong* growth over the medium term, but risk being optimistic when compared with previous recoveries.

Projected growth is above both the pre-crisis trend and potential, and is accompanied by a rapid decline in unemployment. Growth is projected to be broadly *sustainable* and *balanced*, in the sense that it is increasingly underpinned by private demand and is broad-based across the G-20. However, in the context of recent developments and when assessed against recoveries from previous crises and the WEO projections, growth projections appear too sanguine, particularly for advanced deficit countries (notably, the United States)—in the current context of continuing weak private sector spending and activity, owing in part to insufficient repair of household and bank balance sheets. Thus, the projected hand-off from public to private demand is rather optimistic.⁵



Sources: G-20 authorities and IMF staff estimates.
 1/ 2005 - 2009 reflects historical data; 2010 - 2015 reflects projections.
 2/ PPP weighted average annual growth for 1998 - 2007.
 3/ G-20 authorities and IMF staff estimates.
 4/ June 2011 vs. October 2010 MAP projections; 2010-2014.



Sources: G-20 authorities and IMF staff estimates.
 1/ 2005-2009 reflects WEO data; 2010-2015 reflects MAP projections.
 2/ Reflects October 2010 MAP projections.
 3/ Excludes India due to data unavailability.

⁵ Comparative perspectives are based on the October 2011 WEO.

11. Projected fiscal balances are broadly consistent with the Toronto commitment of halving the 2010 deficit by 2013 and stabilizing debt by 2016, but in many cases are predicated on optimistic assumptions and not well-identified measures. The projections foresee a narrowing of fiscal deficits by around 4 percentage points of GDP over 2010–15, and a reduction in public debt ratios by almost 4 percentage points. G-20 plans, however, continue to rest on more optimistic macroeconomic assumptions than *WEO* projections, particularly for advanced economies. A more favorable path for public debt in the MAP projections partly reflects a lower initial value for 2010 (due to vintage issues).⁶

- Advanced economies are projecting a much larger improvement in fiscal balances over the medium-term than emerging economies, reflecting different starting positions. While fiscal projections in advanced countries are consistent with the Toronto commitments, Fund staff projections indicate that these may be difficult to achieve for some (including France and the United

States), because of both optimistic growth projections and since consolidation measures are not well identified.

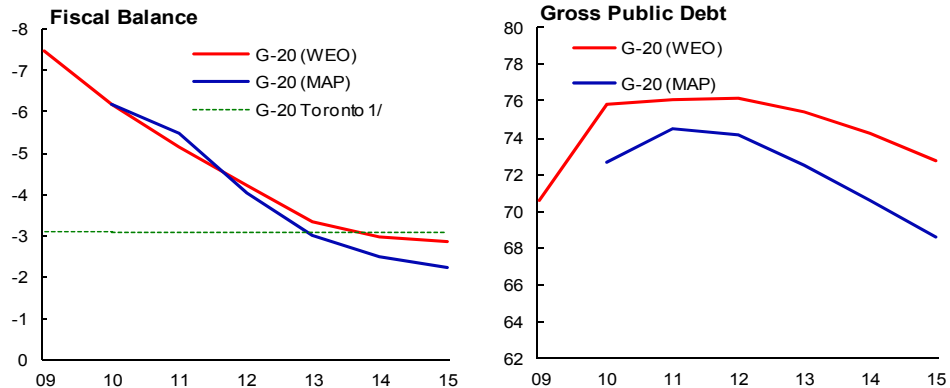
12. Anticipated progress toward rebalancing global demand—essential for ensuring sustainability of global growth going forward—is limited. Global imbalances narrowed during the recession, but are projected (according to G-20 policy frameworks) to stay large over the medium term. This may partly reflect that members' projections do not fully internalize the effects of others' planned policies or perhaps doubt their effectiveness.

- Projected changes in current account balances over 2010–15 reveal slow and limited progress toward rebalancing global demand. Current account deficits of *emerging deficit economies* are projected to widen, while deficits of *advanced deficit economies* are projected to narrow somewhat. At the same time, *emerging surplus economies* project their surpluses to expand, while both *advanced surplus economies* and *large oil exporters* expect a reduction in their surpluses.

⁶ Using comparable vintages, earlier estimates for public debt in the June 2011 *WEO* quarterly update would be very close to the MAP figures shown below. However, *WEO* estimates for debt levels have subsequently been revised up.

G-20 MAP Framework and WEO Projections of Overall Balances and Gross Public Debt

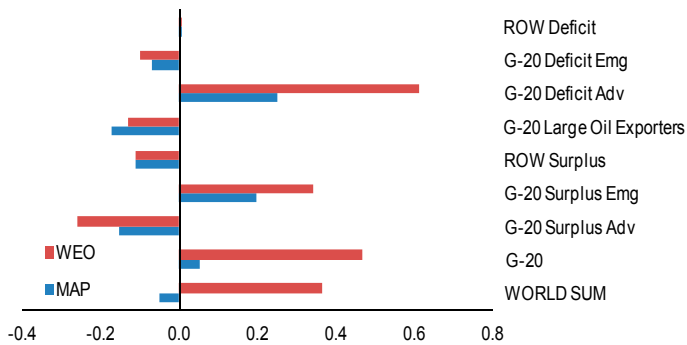
(percent of GDP; group averages computed using PPP weights)



Sources: G-20 authorities and IMF staff estimates.
 1/ Toronto Declaration of at least halving the 2010 deficit by 2013; based on June 2011 MAP projected estimate of 2010 deficit.

2010 - 2015 Projected Change in Current Account Balances 1/

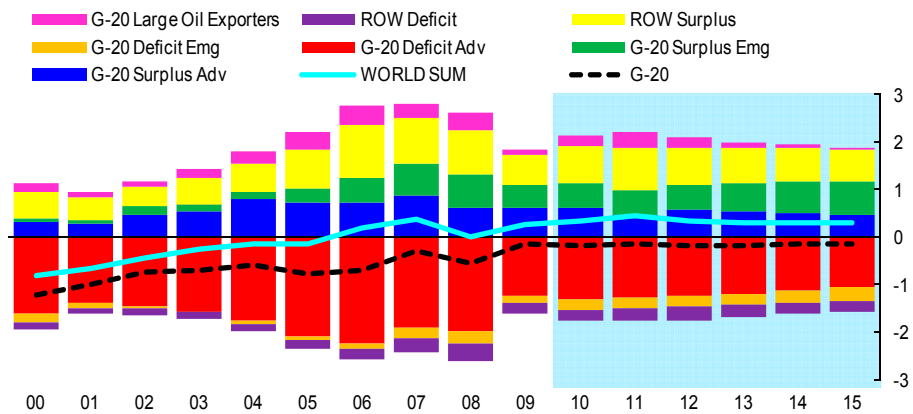
(percent of World GDP)



Sources: G-20 authorities and IMF staff estimates.
 1/ Percentage points.

Current Account Balances 1/

(percent of World GDP)



Sources: G-20 authorities and IMF staff estimates.
 1/ 2000-2009 reflects WEO data; 2010-2015 reflects MAP estimates and projections for G-20 countries and WEO projections for ROW.

IV. REDUCING IMBALANCES—LESSONS FROM THE SUSTAINABILITY REPORT

Seven systemic members were identified as having “moderate” or “large” imbalances that warranted more in-depth analysis. Sustainability assessments indicate that global imbalances have been driven primarily by saving imbalances—generally too low in advanced deficit economies and too high in emerging surplus economies—owing to a combination of equilibrium factors (demographic patterns), structural weaknesses and domestic distortions. Corrective steps, including through collaborative action, aimed at addressing structural impediments and underlying distortions, will be needed to better support G-20 growth objectives.

A. Imbalances—Conceptual Issues

13. **There is agreement in the G-20 that securing strong, sustainable and balanced growth will require a reduction of excessive imbalances.** If large imbalances—internal or external—persist for an extended period, they could pose systemic problems, including the risk of disruptive adjustments. For this reason, there is already market pressure on some G-20 countries to address their medium-term fiscal imbalances, notwithstanding the need to provide short-term fiscal support to recovery. Alleviating external imbalances is also a pressing need in the current conjuncture, where large external surpluses in emerging economies combined with a liquidity trap in major advanced deficit economies (facing rising demands for fiscal consolidation) underpin low output and deflation risk in the latter and slower growth for the world, more generally.

14. **Based on G-20 indicative guidelines, seven members were identified as having “moderate” or**

“large” imbalances (external or internal) that warranted more in-depth assessment of their root causes, implications for growth, and possible need for corrective action (see Box 1).

The discussion further below summarizes the sustainability assessment, evaluated in the context of fiscal, monetary, financial sector, exchange rate and other policies.⁷ Some conceptual issues are as follows:

- The discussion of internal imbalances will focus *primarily* on public finances—*cyclically-adjusted* primary balances (CAPB) and public debt—since large fiscal imbalances are likely to bear upon external imbalances, can stifle growth, and heighten vulnerability to market financing pressures.

⁷ For details on the root causes of imbalances in the seven G-20 members, please see the Sustainability Reports.

- The discussion of external imbalances focuses *primarily* on the current account—a core component of the balance of payments which provides a concise summary of a country's net external position.
- Internal and external imbalances are interlinked. The current account reflects the excess or shortfall of national saving over investment, and, thus, connects external and internal imbalances. Moreover, viewing current accounts through the prism of saving-investment balances provides a good sense of various inter-linkages and the levers for adjustment.

15. **Imbalances are not *prima facie* “bad”, and warrant remedial action only to the extent that they are underpinned by distortions.** In particular, imbalances may reflect differences in saving and investment patterns and portfolio choices across countries, owing to differences in levels of development, demographic patterns, and other underlying economic fundamentals. If so, such imbalances are not a reason for concern. At the same time, however, imbalances may also reflect policy distortions, market failures, and externalities at the level of individual economies or at a global level. If so, they are a cause of concern, since they could *inter alia* undermine the strength and sustainability of growth. In particular, the following typology is useful:

- *Imbalances can be beneficial if they reflect the optimal allocation of capital across time and space.* For instance, to meet its life-cycle needs, a country with an aging population relative to its trading partner may choose to save and run current account surpluses in anticipation of the dissaving that will occur when the workforce shrinks. Similarly, a country with attractive investment opportunities may wish to *finance part of its investment through foreign saving, and thus run a current account deficit.*
- *Imbalances can be detrimental if they reflect structural shortcomings, policy distortions or market failures.* For instance, large current account surpluses may reflect high national saving unrelated to the life-cycle needs of a country but instead to structural shortcomings, such as a lack of social insurance or poor governance of firms that allows them to retain excessive earnings. Similarly, countries could be running large current account deficits because of low private saving, owing to asset-price booms that are being fueled or accommodated by policy distortions in the financial system that impede markets from equilibrating. Imbalances could also reflect systemic distortions, reflected, for instance, in the rapid accumulation of reserves by some countries to maintain an undervalued exchange rate.

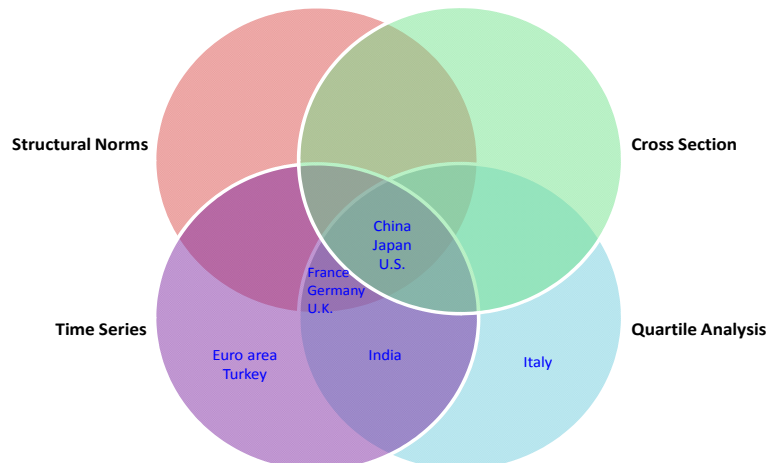
Box 1. G-20 Indicative Guidelines for Identifying Large Imbalances

To take forward the G-20's commitment in Seoul to promote external sustainability, indicative guidelines were developed to help identify persistently large imbalances among members that warranted deeper analysis. This two-step process identified seven members for in-depth assessments (i.e., sustainability reports) in the second stage, using the following approach:

- A set of key indicators were agreed upon by the G-20 to evaluate key imbalances. These indicators were: (i) public debt and fiscal deficits; (ii) private saving and private debt; and (iii) the external position—composed of the trade balance and net investment income flows and transfers.
- Indicative guidelines consisted of comparing indicators to reference values to determine if deviations were significant based on four different approaches. While not policy targets, reference values were derived based on: (1) a structural approach based on economic frameworks to derive suitable “norms”; (2) a time series approach to provide historical trends; (3) a cross-section approach to provide benchmarks based on group averages for countries at similar stages of development; and (4) quartile analysis to provide median values based on the full G-20 distribution. Values of the indicators were based on staff WEO projections for 2013–15.
- Members were selected if imbalances significantly exceeded their reference values in at least two of the approaches. “Large” imbalances were identified as such if two or more of the methods found deviations from indicative guidelines to be significant in two of the three sectors (external, fiscal, and private sector). Systemic countries (who account for 5 percent or more of G-20 GDP) were evaluated on stricter criteria (requiring only moderate-sized imbalances), recognizing that imbalances in systemic members are more likely to affect others.
- On this basis, seven member countries were selected for sustainability assessments of imbalances (see figure). The countries and imbalances chosen were as follows: China (high private saving and external surplus); France (high external deficit and public debt); Germany (high public debt and external surplus); India (high private saving and fiscal deficits); Japan (high public debt and private saving); United States (large fiscal and external deficits); and United Kingdom (low private saving and high public debt).

G-20 Indicative Guidelines: Comparison of Approaches

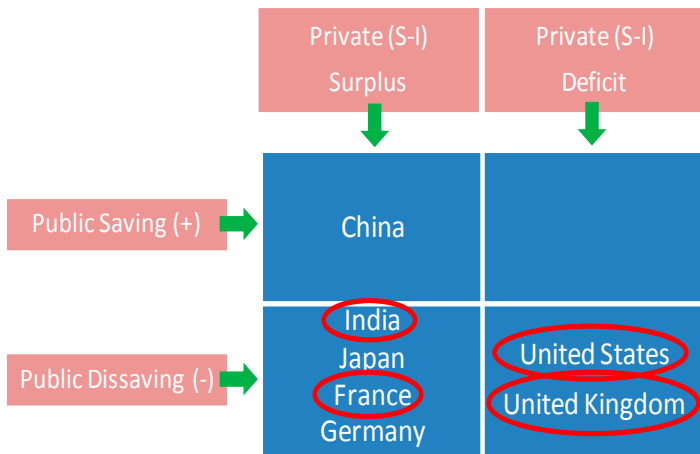
(Systemic rule; at market exchange rates)



Sources: IMF, *World Economic Outlook* and staff estimates.

B. Explaining Imbalances

16. **The sources of external imbalances in the run-up to the crisis vary widely across the seven economies, largely reflecting factors that have led domestic saving behavior to differ widely.** Current account deficits before the crisis have reflected low public and private saving (*United Kingdom and United States*); or low public saving, which has been partly offset by high private saving (*France and India*). Surpluses, on the other hand, have reflected high national saving, owing, in particular, to exceptionally high private saving that exceeds high private investment (*China*); or positive private saving-investment balances, owing to high saving and low investment (*Germany and Japan*), which has offset high (modest) public dissaving in the case of Japan (*Germany*).



Source: IMF staff estimates.
Note: Countries circled in red denote those with current account deficits.

17. **Abstracting from the financial crisis—which adversely affected budget balances in all countries, a variety of structural and equilibrium factors, reflecting country circumstances, have driven public saving behavior.** These will need to be addressed to reduce external imbalances and bolster public finances. In particular, factors underpinning fiscal deficits include:

- Persistently low growth (making it difficult to balance the budget), reflecting a decline in productivity, a shrinking labor force, and low investment, as well as the needs of a rapidly aging population (*Japan*);
- Structural imbalances between tax revenues and spending commitments pre-crisis, underfunded entitlement obligations, the lack of agreement on fiscal adjustment priorities, and the lack of fiscal rules and strict enforcement mechanisms to impose sufficient budgetary discipline (*France, United Kingdom and United States*);
- Political economy considerations exerting strong pressure on spending and resistance to raising taxes (*India, Japan, and United States*), a weak revenue system, and financial repression (*India*).

18. At the same time, domestic policy distortions (defined broadly as factors that impede a market from equilibrating) have also played an important role in driving imbalances.

- *Distortions in financial systems have fueled low private saving and large current account deficits.* Weak private saving-investment imbalances before the crisis, reflecting underlying problems in financial sectors, have played a role in fueling current account deficits in major advanced economies, notably the *United States* and *United Kingdom*. In particular, distortions in the financial system, pertaining to regulatory and supervisory frameworks, were partly responsible for a fundamental breakdown in market discipline and mispricing of risk (reflected in credit and housing booms) and contributed to a widening of external imbalances. In the *United Kingdom*, constraints on the supply of housing precluded a construction boom but further fueled a house price boom, which, in turn, contributed to low household saving and high private debt.
- *High national saving in China reflects significant underlying distortions.* Policy distortions or gaps—reflected by inadequate social safety nets, restrictive financial conditions, an undervalued exchange rate, subsidized factor costs, limited dividends and lack of competition in product markets—have underpinned exceptionally high

national saving and, in turn, current account surpluses in *China*. Large current account and balance of payment surpluses have, in turn, led to massive reserve accumulation in *China* (and elsewhere), contributing to the low-cost financing of U.S. current account deficits.

- *Weak investment in some advanced economies also reflects policy distortions.* Modest external surpluses in *Japan* reflect, in part, favorable private saving-investment balances—owing to distortions, private investment growth (particularly by SMEs) has remained weak, while corporate savings are large. In the case of *Germany* too, large external surpluses reflect, in part, favorable private saving-investment balances—distortions in the financial sector may be a drag on domestic investment.
- Distortions have also played a role in fueling public dissaving in some emerging deficits economies. In *India*, tight financial restrictions have allowed the perpetuation of large fiscal deficits.

C. Policy Implications

19. Broadly speaking, sustainability assessments indicate that imbalances have been driven primarily by saving imbalances—too low in major advanced economies and too high in key emerging surplus economies. This, in turn, implies that policymakers need to proceed with a greater sense of urgency to facilitate the dual rebalancing acts—a

hand-off from public to private demand led growth in major advanced economies; and a shift from growth led by domestic demand in major advanced deficit economies toward external demand and vice versa in major emerging surplus economies. However, these have stalled in the current conjuncture.

20. Policies tailored to individual country circumstances, aimed at addressing underlying distortions, are needed to facilitate the dual rebalancing acts and to anchor members' growth objectives.

- Fiscal consolidation, that is appropriately timed and paced, is needed across major advanced economies, including *France, Japan, United Kingdom, and United States*, as well as in *India* to reduce persistent deficits, create policy space, and anchor sustainability—this is currently in train in many of these economies. Fiscal consolidation will, however, depress growth in the near term. Hence, closing the output gap will require complementary policies. In the case of the United Kingdom, United States, and, to a smaller extent, France, current levels of private saving are broadly appropriate and, if maintained, would ensure that the effect of lower fiscal deficits on the current account is not offset by deterioration in the private saving-investment balance. This implies growth in these countries will need to be fueled by higher net exports.
- To offset weaker demand in major advanced partner countries, internal demand will need to increase elsewhere, notably *China* (and other surplus countries in the G-20) to support domestic and global growth. This will require lower national saving in China, notably by reducing the distortions that have kept saving exceptionally high. To avoid overheating, China's net exports will have to moderate, implying a lower current account surplus. There is also room to bolster domestic demand by reducing private saving-investment balances in Japan and Germany, notably by lowering corporate saving and boosting investment by reducing distortions.

V. SECURING G-20 GROWTH OBJECTIVES—AN “UPSIDE SCENARIO”

Against the backdrop of weaker global growth and heightened downside risks, the urgency for stronger and more complementary policy action by the G-20 membership has risen to secure the expansion. Staff assessment of members’ projections, policy progress, and imbalances indicate the need for strengthened collaborative action to anchor growth over the medium term and to avoid damaging setbacks to the recovery. Thus, an “upside scenario”—informed by staff assessment of G-20 macroeconomic frameworks, as well as the assessment of imbalances and policy commitments to date—is developed to better promote strong, sustainable and balanced growth. While G-20 baseline policies have strengthened over the past few years, further collective action on three key policy fronts—fiscal, structural, and other rebalancing policies—would be desirable as demonstrated by the upside analysis. This collective effort would reduce problem imbalances and support growth, mitigating key risks that could derail the global expansion.

21. **Strengthened collective policy action on key fronts will be needed to achieve the G-20’s shared growth objectives and reduce major imbalances.** The assessment of G-20 policy frameworks, the analysis of the root causes of imbalances across seven members, and a stocktaking of G-20 policy commitments to date suggest *three* key policy areas for further action:

- *Greater medium-term fiscal consolidation in major advanced deficit countries, aimed at restoring sustainability of public finances.* The stocktaking of policy commitments suggests that greater consolidation will be needed, in the context of credible and realistic medium-term fiscal frameworks, to anchor shared growth objectives; the assessment of macroeconomic frameworks suggests

that further consolidation will be needed to guard against a possible shortfall in growth, as the anticipated improvement of public finances is partly predicated on optimistic growth assumptions in authorities’ projections and may not fully materialize under staff’s baseline growth projections; finally, the sustainability assessments suggest that additional fiscal adjustment will be needed to help reduce persistently moderate or large external imbalances in key deficit economies through higher national saving.

- *Further structural reform to support growth, particularly in advanced surplus economies.* In addition to near-term efforts to reduce high unemployment and financial sector repair and reform to support the

private sector recovery, further action is needed to enhance growth potential. It is evident from the accountability assessment that there are significant gaps in the alignment of structural reform plans in G-20 economies with the OECD's strategic priorities in going for growth; the assessment of members' macroeconomic frameworks also points to low potential growth in advanced surplus economies, highlighting the need for structural reform; and, finally, the sustainability assessments indicate that reducing imbalances will necessitate structural reforms to *inter alia* boost potential growth in major advanced economies.

- *Reform policies that remove key distortions and help narrow problem imbalances in emerging surplus economies.* It is clear from an assessment of G-20 macroeconomic frameworks that limited progress has been made in rebalancing global demand and reducing external imbalances. The sustainability assessments indicate that policies aimed at reducing distortions underpinning high national saving in China—including large gaps in the social safety net, financial restrictions, and undervalued exchange rates—will be needed to reduce imbalances, rebalance global demand and anchor G-20 growth objectives.

22. These three policy layers underpin a potential upside scenario.

Policies are tailored for the G-20

economies to reflect individual country circumstances. These are derived both from the Accountability and Sustainability assessments, as well as Fund staff analysis in the context of its regular surveillance activities.

23. Fiscal rebalancing is already advancing, but more will be needed in some deficit members—preferably, through “growth friendly” measures including tax and entitlement reform.⁸

As highlighted in the component reports, budgetary consolidation is generally underway (i.e., part of the baseline), but members' efforts will need to be sustained over time. Some will also need to do more fiscal adjustment under staff's baseline assumptions to meet their commitments, to rebuild needed policy space, and to ensure sustainable public finances in an upside scenario.⁹ On timing, given the still-fragile nature of the recovery, some members will also need to strike the right balance between supporting growth in the near term and more decisive action to consolidate over the medium term, especially if economies weaken further. Thus, where added fiscal effort is required, the upside considers

⁸ See Box 2 for a more detailed description of the policy and technical assumptions underpinning the upside scenario.

⁹ For the upside scenario analysis, staff estimates based on members' budgetary plans envisage the need for an additional 1¼ percent of GDP reduction in the overall G-20 fiscal deficit in 2016 (and 3 percent cumulative reduction in fiscal deficits) over the medium term (2012–216).

timing of adjustment that depends on country circumstances. Finally, budgetary actions that mitigate the dampening effects on short-run growth and help further support external rebalancing and medium-term growth are preferable to help secure members' shared objectives. Specifically:

- *Tax and entitlement reform are critical elements to underpin credible consolidation of sufficient scale.* Where possible, a shift toward greater reliance on indirect taxes (e.g., VAT) rather than direct taxes on factor inputs would help limit tax distortions and improve incentives to save and invest. This could be budget neutral (for instance, in Germany and France) or part of consolidation (e.g., the United States). In an upside scenario, this could help further reduce external imbalances, depending on the composition quality of fiscal adjustment, while better supporting growth over the medium term. Entitlement reform is a necessary ingredient of any credible fiscal consolidation plan in several G-20 members given underfunded obligations and population aging. This includes added pension reform to advance the move toward actuarial balance (e.g., France). More credible adjustment, in turn, helps better anchor private sector expectations to advance gains over the medium term.

24. Private sector rebalancing is at risk of stalling, and more targeted structural reform effort in key areas

should be considered to support potential growth. To tackle still-high unemployment and weak private sector spending in some advanced members, activation policies in labor markets (i.e., ALMPs) could be considered to facilitate reallocation and reattachment of displaced workers. Other demand-friendly policies—for example, to encourage investment—could also be considered in some members. However, it will be important that the rebound in private saving in key deficit economies is maintained and that underlying distortions in the financial sector that gave rise to stability risks are effectively addressed. Over the medium term, structural factors behind low growth potential could be addressed more effectively as highlighted in the accountability report. Besides reducing implementation risk, baseline structural reform policies could be strengthened through some reorientation toward problem areas. Specifically:

- *More labor and product market reform in strategic priority areas would enhance growth potential.* Based on OECD recommendations, lagging productivity in insular or restricted service sectors could be boosted in several members (i.e., Japan, France, Germany, China and India) through competition policies to limit distortions and regulatory reform toward best practice. Product market reforms are also envisaged in other G20 economies (e.g., Australia, Canada, Indonesia, Italy, Korea,

Mexico, Russia, and South Africa). On the labor market side, lowering hiring costs (e.g., *France, India, Italy, Japan, Korea, and Turkey*) and reforming disability insurance benefits (United Kingdom) would strengthen employment prospects. Measures to strengthen female participation rates (in Japan and Germany) could also support medium-term growth.

- *Financial sector repair and reform are crucial to sustain the recovery.* Against the backdrop of heightened financial stability risks, it is crucial that decisive near-term action is pursued to resolve the sovereign debt crisis in Europe. Moreover, many advanced economies appear to be mired in the repair-and-recovery phase of the credit cycle with incomplete balance sheet repair. More progress is needed to reduce sovereign spillovers and to break the adverse feedback loop between the financial sector and real economy that could jeopardize the recovery.
- *From a modeling perspective, technical limitations prevent an in-depth macroeconomic analysis of financial sector repair and reform in the upside scenario.* Nonetheless, from an economic perspective, such policy measures are essential for securing the shared growth objectives and as part of a G-20 action plan. Further action to reduce near-term financial sector risks would critically lay the necessary foundations for the strengthened medium-term economic

prospects examined in the upside scenario.

25. **External rebalancing has been poor overall—partly reflecting global recession, and effort will be needed to tackle underlying distortions behind high saving in some surplus members to facilitate better adjustment.** To facilitate greater rebalancing of global demand, actions on several fronts would help reduce exceptionally high saving, strengthen consumption, and enhance welfare in key emerging surplus economies. For the purposes of the upside scenario, further rebalancing policy efforts are considered only in the systemic case of China based on its sustainability assessment, but they are relevant for other emerging surplus economies. Specifically, education reform and strengthened safety nets (through higher public expenditures) could help reduce high precautionary saving in China. Financial sector reform could help reduce distortions for firms and grant greater access to credit for liquidity-constrained households. This could help boost consumption and reduce inefficient investment. Finally, allowing greater market determination of the exchange rate and accepting greater currency appreciation would reinforce demand rebalancing at higher employment levels and facilitate the reallocation of resources across tradable to non-tradable sectors.

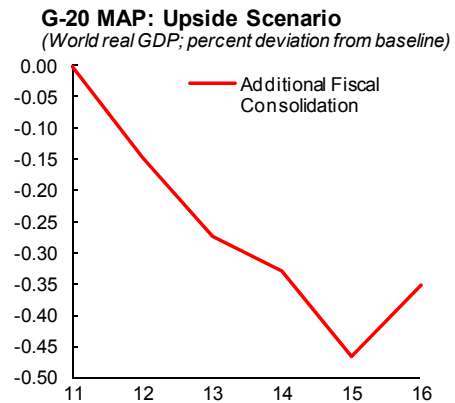
26. **An upside scenario that brings together all the central policy ingredients demonstrates the collective**

benefits through higher growth and lower imbalances. See Box 2 for a more detailed description of the policy and technical assumptions underpinning the upside scenario for individual members using the IMF's Global Integrated Monetary and Fiscal (GIMF) model. The effects of upside policies are shown with respect to (i.e., as deviations from) staff's WEO baseline.¹⁰ The main findings associated with the collection of upside policies are as follows:

- *Additional fiscal consolidation alone would be inimical to global growth on impact* (text figure). While critical for restoring soundness to public finances over time, further fiscal consolidation (beyond staff's baseline adjustment) in the major advanced economies will, in isolation, result in a decrease of world GDP by around ½ percent relative to the baseline at the time this withdrawal takes place. More front-loaded consolidation would further risk advancing and deepening these dampening effects on growth (especially, given present constraints on monetary policy near the zero interest rate floor). Moreover, fiscal consolidation by itself would carry negative spillovers for partner countries. This underscores the need

¹⁰ Work on the upside scenario analysis for the Umbrella report was undertaken in close partnership with the OECD. The OECD contributed simulations of the effects of stylized and country-specific structural reforms for individual G-20 members based on their past work and expertise.

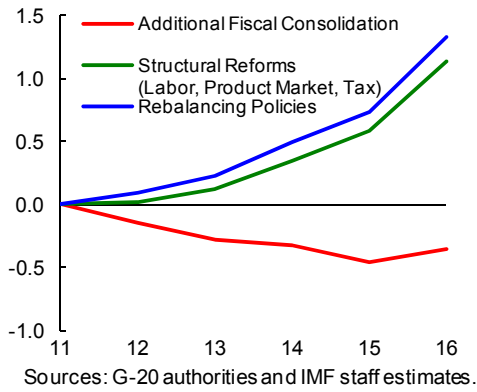
for well-timed fiscal plans to be as “growth friendly” as possible in members requiring fiscal adjustment, as well as supportive action by others to offset weaker demand in partner countries.



Sources: G-20 authorities and IMF staff estimates.

- *Specifically, a complementary package of policy actions is required.* If the necessary fiscal adjustment is combined with supporting policy measures, the picture changes. First, consolidation when combined with budget-neutral tax reform—shifting the composition of revenue instruments away from distortionary taxes—produces adjustment which is more “growth friendly.” Also in this second layer, better targeted structural reform in product and labor markets to boost potential growth would add to the growth benefits. Finally, rebalancing policies to reduce domestic distortions and boost internal demand in emerging surplus economies (i.e., China in the simulations) would further lift growth to help offset weaker domestic demand in partners.

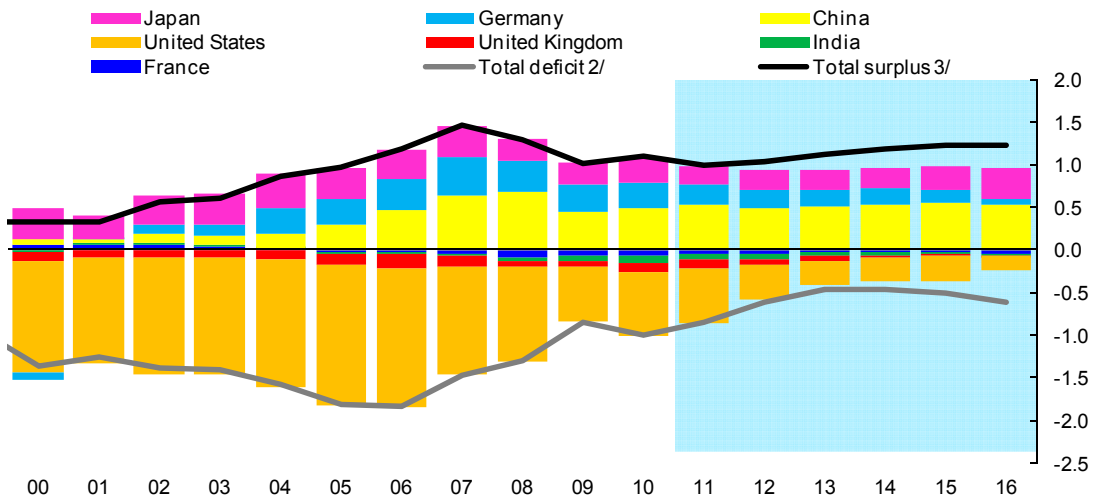
G-20 MAP: Upside Scenario
(World real GDP; percent deviation from baseline)



world GDP by 1½ percent in 2016. This is equivalent to a global income gain of more than ¾ of a trillion dollars. This sizeable increase in income would add around 20-40 million new jobs if strengthened collective policy actions were fully implemented. In cumulative terms, the upside gains amount to nearly 3 percent higher global GDP over the medium term.

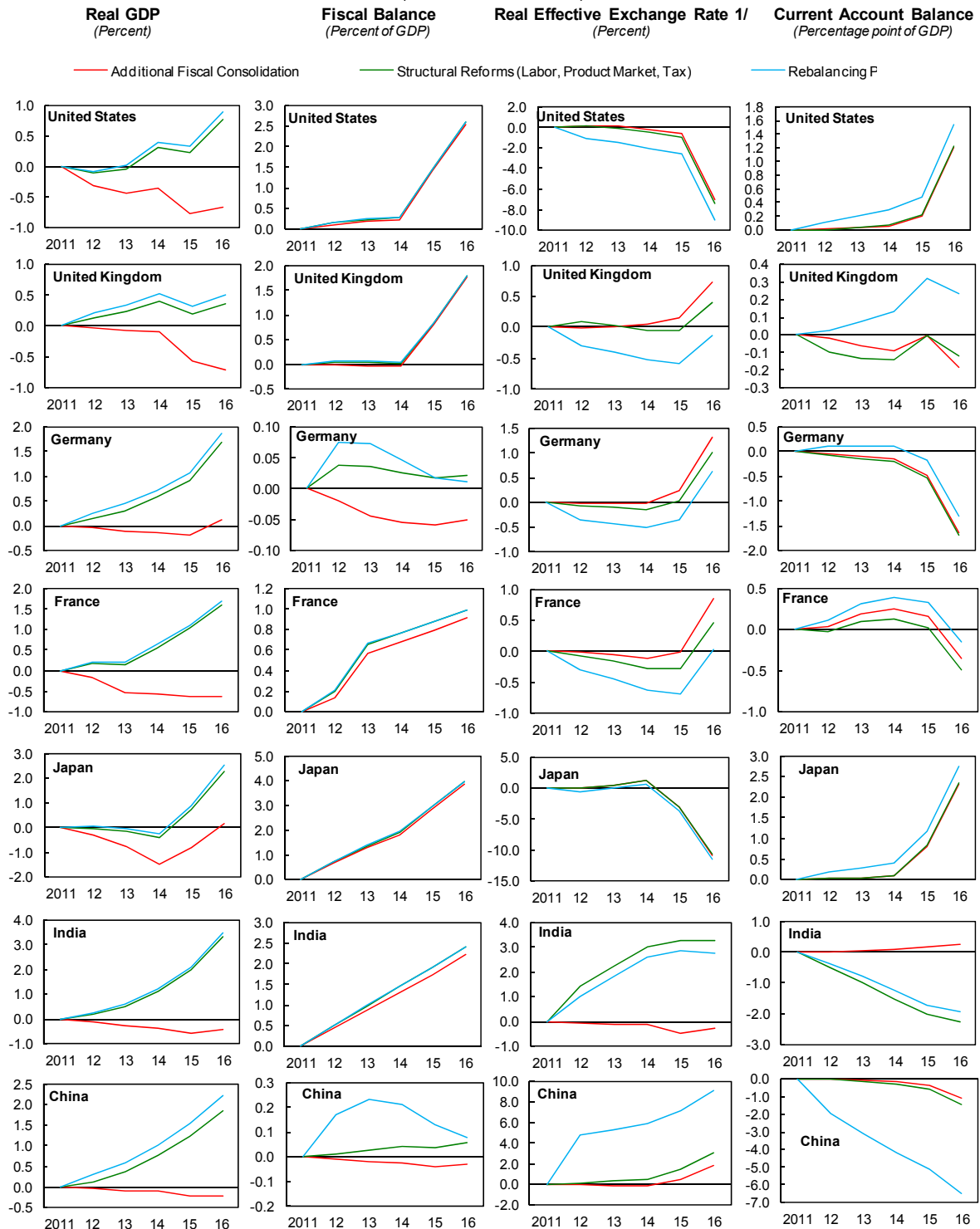
- Taken together, a cooperative policy action plan has appreciable upside potential for growth. The simulation results show that joint actions by the G-20 members consistent with all three policy layers described above will result in an overall increase of
- Improved growth prospects across the G-20 are accompanied by significantly lower global imbalances. The simulation results suggest an appreciable reduction of global imbalances by about ¾ percent of World GDP relative to staff's baseline in 2016. Overall, this improvement is driven by narrowing external imbalances in both deficit and surplus countries.

Current Account Balances 1/
(percent of world GDP)



Sources: IMF, World Economic Outlook and staff estimates.
 1/ 2000 - 2010 reflect WEO history; 2011 - 2016 reflects WEO projections + upside scenario rebalancing shock except for total deficit/surplus lines, which reflect WEO baseline.
 2/ Total for deficit countries in the sustainability report.
 3/ Total for surplus countries in the sustainability report.

G-20 Upside Scenario
(Deviation from baseline)



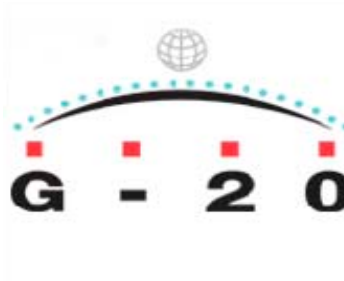
Box 2. Policy Assumptions for the Upside Scenario

The upside scenario consists of three layers. They are: (i) additional fiscal consolidation and budget-neutral tax reform; (ii) structural reforms in labor and product markets (productivity effects are based on simulation results from the OECD, but have been scaled to take account of G-20 members' policies in staff's baseline projections); and (iii) rebalancing reforms in China.

G-20 members are assumed to fully implement country-specific policies that are identified by the sustainability, accountability, and MAP reports. In particular,

- **Additional fiscal consolidation** (relative to currently identified plans). A cumulative reduction of headline deficit by 2016 (in percent of GDP) is assumed for *Japan* (3¾), the *United States* (2.8), the *United Kingdom* (2), *France* (1.1), *India* (2.3), and *other EU* (1). The share of instruments used to achieve the consolidation is: *Japan* (0.2 transfers; 0.8 VAT), the *United States* (0.25 government consumption; 0.5 transfers, 0.25 VAT), the *United Kingdom* (0.5 government consumption; 0.5 transfers), *France* (0.65 government consumption; 0.35 VAT), *India* (0.5 government consumption; 0.5 VAT), and *other EU* (0.3 government consumption; 0.2 VAT; 0.5 transfers). Fiscal actions are assumed to be permanent in the year in which they occur.
- **Tax reform.** A revenue-neutral tax reform is simulated for *Germany* and as part of consolidation for the *United States*. For all three countries, the tax reform lowers distortions by shifting from direct to indirect taxes. For Germany and the United States, the increase in indirect taxes (2 and 1.35 percentage points of GDP respectively) is used to finance equal reductions in personal and corporate income taxes; for France, the higher revenue from indirect taxes (1.5 percentage points) is split 2 to 1 in favor of lowering labor income taxes (mainly social security contributions) versus corporate income taxes.
- **Structural reforms.** Two types of structural reforms are considered—*product market* and *labor market* reforms. Reforms that change the participation rate are assumed to be fully credible, while the credibility of those that raise the level of productivity are assumed to grow over time, becoming fully credible after 5 years. To mitigate deflation risk, reforms to enhance supply potential are phased in gradually and, where possible, “demand friendly” action in labor markets (e.g., ALMPs) are also considered in the near term.
 - For the seven countries selected for sustainability analysis, *product market* reforms are simulated for *Japan, France, Germany, China, and India* to boost productivity in the non-tradable sector. In line with the OECD recommendations, the product market reforms comprise an improvement of product market regulation towards best practice. *Labor market reforms* in the form of lower hiring costs are included for *Japan, France, and India*. In the *United States*, active labor market policies (ALMP) are considered to help reduce the high long-term unemployment rate, while in the *United Kingdom*, a reduction in the average replacement rate (ARR) of disability benefits is assumed. Furthermore, in *Japan and Germany*, measures to increase female participation rate are considered, while for France, additional actuarially neutral pension reform is assumed.
 - For the rest of the membership, the simulations include: *product market reforms* (*Australia, Canada, Indonesia, Italy, Korea, Mexico, Russia, and South Africa*); *labor market reforms* (lowering hiring costs for *Italy, Korea, and Turkey*); ALMP in *Brazil*; ARR in *Canada*; and pension reform in *Turkey*.
- **Reform in China to facilitate global rebalancing.** With exchange rate flexibility, the following are considered:
 - *Reform in education and safety nets.* These reforms raise public consumption expenditure by 4 percent of GDP after 10 years and reduce private savings by 10 percent of GDP after 10 years.
 - *Financial sector reform.* These reforms raise the cost of capital to tradable sector firms by 100 basis points after 5 years and reduce the proportion of liquidity constrained households by 5 percentage points after 5 years (10 percentage points after 10).
 - *Non-tradable sector reforms.* These reforms encourage growth in the non-tradable sector that raises both output and demand. The level of service sector productivity increases by 4 percent after 10 years, with the demand for services increasing sufficiently to prevent any exchange rate depreciation.

G R O U P O F T W E N T Y



G-20 ACCOUNTABILITY REPORT¹



Prepared by Staff of the

I N T E R N A T I O N A L M O N E T A R Y F U N D

¹ *Report 2 of 10.* At the request of the G-20, IMF staff has provided analyses and assessments of member's economies and policies in a set of reports for the Mutual Assessment Process (MAP). These reports serve as inputs for the Action Plan agreed by G-20 Leaders at the Cannes Summit. The 2011 Staff Reports for the 20 MAP consist of the following: (i) an Umbrella Report that provides an integrated summary of the component reports and an upside scenario for G-20 collective action; (ii) an Accountability Report that summarizes members' progress toward policy commitments since the Seoul Summit in 2010; (iii) a MAP Report providing analysis of members' medium-term macroeconomic and policy frameworks; and (iv) Sustainability Reports for seven members (China, France, Germany, India, Japan, United Kingdom, and United States)—identified by G-20 indicative guidelines—to assess the root causes and policy implications of key imbalances.

EXECUTIVE SUMMARY¹

Progress has been made toward policy commitments made at the Toronto and Seoul Summits in 2010:

- Deflation has been avoided and price stability maintained in advanced economies. Some progress has been made toward greater exchange rate flexibility.
- Budgets have been prepared in advanced economies that show reductions in deficits and debt stabilization.
- A number of initiatives to reform the financial sector have been enacted or are under way, including those included in the Basel III agreement.
- Authorities have announced a wide variety of structural reform plans.

More will be needed, however, to achieve the agreed growth objectives. In particular:

- Substantial long-term fiscal adjustment measures are needed in the United States and Japan. In some other cases, fiscal consolidation may be more challenging than assumed in official projections.
- Risks to price stability are currently finely balanced in many emerging

economies, which should be prepared to tighten more if needed, mainly through a combination of monetary and fiscal policy.

- Many important financial sector reforms are well identified and defined at the international level, but implementation is lagging at the national level. Even with recent reform efforts, the problem of institutions that are Too Big To Fail has arguably become worse. Progress on cross-border resolution will take time.
- Structural reforms could be better targeted and implementation has fallen behind. More is needed to increase labor participation, make markets more flexible, boost competition and skills, and improve business climates.

More generally, there is an urgent need for credible policy initiatives that reduce the uncertainty that is currently hampering the recovery. This implies, in particular:

- Immediate initiatives that firmly resolve doubts about long-run fiscal sustainability but do not damage current growth prospects.
- Measures to address weak financial institutions.

¹ This report was prepared with input from (and in close collaboration with) the OECD.

INTRODUCTION²

1. **At the Seoul Summit in November 2010, G-20 Leaders reaffirmed their commitment to cooperation by “outlining an action-oriented plan with each member’s concrete policy commitments” with the aim of delivering strong, sustainable, and balanced growth.** To assist the G-20 membership in pursuit of its goals, the Fund—working with other IFIs—was asked to provide an assessment of progress made by G-20 countries in acting on the policy commitments made in the Seoul Action Plan.

2. **This report responds to the G-20’s request by assessing policy actions by members over the course of the past year.** It examines progress with policy implementation against the specific commitments made at the Toronto and Seoul Summits in four key policy areas: (i) monetary and exchange rate, (ii) fiscal, (iii) financial, and (iv) structural. The report also assesses progress toward the broader goals of strong, sustainable and balanced growth, by evaluating whether the specific commitments outlined in the Summit declarations are sufficient. No attempt is made to list all policy initiatives by all member countries. Instead, countries are classified, where useful, into groups that face common issues, with specific citations in notable cases.

3. **The report comes against a background of weakening global demand and sharply elevated financial volatility.** The recovery has stalled in major advanced economies and fiscal and financial problems threaten global contagion. The urgency of the need for progress toward growth-enhancing policies has therefore increased. Major advanced economies need fiscal policies that resolve uncertainty about long-run fiscal sustainability without further damaging the recovery; structural reforms to raise potential growth; and actions to address weak financial institutions. Emerging economies will need to be flexible with monetary and fiscal policy in potentially volatile conditions, while pursuing structural reforms to facilitate continued growth and the rebalancing of their economies.

² Prepared by Alasdair Scott under the guidance of Krishna Srinivasan, with the support of Eric Bang, David Reichsfeld, and Anne Lalramnghakhleli Moses.

I. ASSESSING POLICY IMPLEMENTATION

4. **In general, there has been more progress toward satisfying the letter of the Summit declarations than addressing the difficult reforms needed for long-run sustainability and balanced growth.** More progress has been made toward fiscal cuts that notionally satisfy the terms of the Toronto declaration but less toward credible reforms (such as on health care and pensions) that are needed to secure long-run fiscal sustainability. Of all policy options, such reforms would likely make the most significant contribution toward the broader goals of strong and sustainable growth, and could significantly encourage rebalancing of world demand. There have been many initiatives toward structural and financial reforms, which are also necessary for strong and stable growth, but progress has been slow. Regrettably, in some cases, judgments have been made that structural reforms should be delayed.

A. Monetary and Exchange Rate Policies

Policy rates have been maintained at appropriately low levels in major advanced G-20 economies given muted inflation pressures, but may need to be raised further in some emerging economies. Some progress has been made toward exchange rate flexibility, but more is needed. Macro-prudential policies are useful, but not a substitute for appropriate tightening of policy rates. Beyond the Summit criteria,

monetary policy in emerging economies needs to be supported by other policies to

achieve price stability, such as appropriate fiscal stringency; and enhanced financial sector regulation and supervision and structural reforms across all G-20 economies.

5. **Key commitments on monetary and exchange rate policies in the Seoul Action Plan include:** (i) price stability, and (ii) enhancing exchange rate flexibility and moving toward more market-determined exchange rate systems, while refraining from competitive devaluation of currencies. G-20 members also stipulated that carefully designed macro-prudential measures might be called for in economies that face strong capital inflows and have adequate reserves and increasingly overvalued flexible exchange rates.

6. **Deflation has been avoided and price stability maintained in advanced economies, but inflationary and overheating pressures remain high in some emerging economies.** Policy rates are appropriately low in major advanced economies but may yet need to be raised in some emerging economies.

- Monetary accommodation has been crucial for alleviating the financial crisis and recession. Economies hardest hit by the crisis—the major advanced G-20 economies—have kept policy rates exceptionally, but appropriately, low. Headline inflation

in these economies rose earlier in the year because of commodity prices (and, in the notable case of the *United Kingdom*, because of consumption tax increases), but underlying inflation remains subdued in environments of weak demand and high unemployment. The recent moderation in energy and food prices will further dampen inflationary pressures. The *European Central Bank* has raised policy rates (but they remain at low levels), and monetary policy rates remain close to the zero bound in the *United States*, *United Kingdom*, and *Japan*. Should downside risks materialize, further easing would be warranted.

- The major advanced economies have also used unconventional monetary policy measures to stimulate the economy. In the *United States*, the second round of quantitative easing measures was completed as scheduled in June. The Bank of *Japan* introduced a new asset purchase program that covered private securities, in addition to government securities. The *ECB* has extended the full allotment regime of its refinancing operations until at least October 2011 and reinstated its supplementary refinancing operations, and has resumed buying euro area government bonds and extending credit through its securities market program. In the *United Kingdom*, the stock of bond purchases has remained unchanged

since early 2010.

- More tightening may be needed in a number of other G-20 economies, should inflationary pressures increase. Monetary policy is broadly appropriate or finely balanced in the cases of *Australia*, *Canada*, and *Mexico*, where inflation expectations appear well anchored, and *Indonesia* and *South Africa*, where inflation is low by historical standards. However, real rates remain very low and even negative in *China*, *India*, *Korea*, and *Russia*, despite recent increases in nominal policy rates.³ In *Brazil*, policy rates have been raised substantially, with macro-prudential measures also deployed to slow credit, though some further action may be needed. In *Turkey*, policy rates have been lowered and the authorities relied on other instruments to arrest the earlier rapid credit expansion. In these economies, should demand pressures continue, more tightening would be needed, especially in cases where inflation expectations are not well anchored.
- Price and credit controls used in some G-20 emerging economies are unlikely to be effective in maintaining price stability. Administered prices for goods (e.g., *Korea* and *India*) are likely to be ineffective in the long run and

³ Money growth targets are currently appropriate in *China*, but would be better achieved through exchange and interest rate mechanisms than quantity restrictions.

could create inefficiencies. Similarly, attempting to reign in credit growth by direct quantity restrictions is likely to have little effect on loan demand and bank's incentives to lend (*China*); using interest rates instead would be preferable.

7. **Some progress has been made toward greater exchange rate flexibility, but key surplus economies continue to intervene to limit appreciation.**

Exchange rate adjustment is critical for global rebalancing and sustaining strong growth. Most G-20 members have floating exchange rate regimes with minimal interventions. Some members have made good progress toward exchange rate flexibility with fewer interventions (e.g., *India*), but in other cases, progress has been limited (e.g., *China*).

- More exchange rate adjustment in key emerging surplus economies would help cool inflationary pressures, while facilitating rebalancing growth towards domestic sources. The real exchange rate has actually depreciated in *China*; greater nominal exchange rate appreciation would allow the central bank to run a more proactive monetary policy to restrict credit growth and tackle inflation problems, alleviate the pressure to absorb liquidity from large-scale foreign exchange intervention, and allow progress toward financial liberalization that is needed for sustained and balanced growth. Similarly, reducing exchange

rate interventions would help reinvigorate the non-tradeables sector in *Korea*. *Brazil* has experienced considerable real exchange rate appreciations while intervening, but further appreciation might be preferable for easing inflation pressures as sterilization costs are high. *Russia* has made substantial progress toward greater exchange rate flexibility—a wider band for the ruble and fewer interventions will create more room for monetary policy to focus on inflation.

- Advanced economies have largely avoided intervening in currency markets, but *Japan* has intervened three times over the past year by selling yen to reduce exchange rate volatility after the March earthquake (which was coordinated with other G-7 partners) and during the recent period of global financial distress.

8. **Monetary authorities have made increasing use of macro-prudential instruments.**

Macro-prudential instruments, when carefully designed, can help to contain financial stability risks that arise from rapid credit expansion. Many emerging economies are now using a wide range of macro-prudential tools effectively to complement other macroeconomic instruments. Capital management tools can be a particularly useful complement to conventional monetary policy for economies facing strong capital inflows. Such tools have had useful effects on, for example, the

composition of inflows (e.g., *Brazil*). But macro-prudential instruments should not be viewed as alternatives to more conventional macroeconomic policy tools, including a tighter fiscal position and raising the policy rate, if the former fail to raise the cost of private sector credit (e.g., *Turkey*).

9. **Monetary policy needs to be supported by other policies.** In major *advanced economies*, accommodative monetary policy is currently appropriate, but cannot subsidize weak financial institutions or compensate for low potential growth indefinitely. In many *emerging deficit* economies, monetary policy objectives could be difficult to achieve if not supported by other policies. In particular, in the event of stronger inflationary pressures, more emphasis on structural fiscal tightening may be needed to cool economies that face strong capital inflows (e.g., *Brazil* and *Turkey*).

B. Fiscal Policy

Fiscal consolidation is an essential part of internal rebalancing. Progress on fiscal tightening is well underway in many advanced economies, but uncertainty about how sustainable paths will be achieved in the United States, Japan, and some euro area economies remains high and is damaging for growth. Beyond the Summit criteria, fiscal tightening should also be used by a number of emerging economies to ease the burden on monetary and financial policies. Across all G-20 economies, fiscal policies should address structural and demographic challenges and encourage rebalancing of demand.

10. **G-20 members stipulated the following key objectives for advanced economies:** (i) to formulate and implement clear, credible, ambitious and growth-friendly medium-term fiscal consolidation plans (Seoul Summit), and (ii) to halve deficits by 2013 and stabilize or reduce government debt-to-GDP ratios by 2016 (Toronto Summit).

11. **Many advanced economies have plans that satisfy the Toronto and Seoul objectives, but there are important exceptions, and fulfillment of plans will be challenging in some other cases.** To ensure sustainability, promote internal rebalancing, and rebuild policy space, advanced economies need to put in place and implement credible medium-term consolidation plans.

- In the *United States*, stimulus is ongoing, consisting mostly of a temporary extension of tax cuts, emergency unemployment benefits, and accelerated depreciation for businesses; earlier measures also included hiring incentives, infrastructure investment, emergency aid for state and local governments, and homebuyer credit. The February 2011 budget proposal would meet the Toronto fiscal targets, but the authorities would narrowly miss the 2013 Toronto deficit target under IMF staff's less optimistic assumptions. The administration identified consolidation measures in April, but these have not been passed by the legislative branch. Progress has been made with the August package;

however, it does not include any the key drivers of rising expenditures—or new revenue. U.S. public finances therefore remain, according to Fund staff, on an unsustainable trajectory in the long-run.

- In the euro area, *Germany* is well on track to meeting the Toronto targets. *France* has undertaken front-loaded adjustment tilted toward expenditure containment, but in absence of additional measures it will not meet the Toronto commitment under the IMF staff's less optimistic assumptions. *Italy* has approved two fiscal adjustment packages that aim for a budget close to balance by 2013, and *Spain* also has a budget that meets the Toronto criteria. However, meeting the targets could be challenging, especially if growth turns out to be less than assumed in some members. A lack of specific measures for boosting revenues and cutting expenditures, and greater than expected funding costs would also affect long-run plans.
- A European Financial Stability Facility has been created to provide temporary assistance to euro-area members facing financial difficulties. (This mechanism will be replaced by a permanent funding mechanism, the European Stability Mechanism, by 2013.) Further steps are needed to bolster the euro area crisis resolution framework to ensure confidence in the currency.
- *Australia*, *Canada*, and the *United Kingdom* are on track to meet the

changes to entitlement programs—Toronto criteria, with Australia likely to return to surplus by 2012–13 and Canada to achieve a balanced budget by 2014/15. Consolidation in the United Kingdom in 2010/11 puts it well ahead of the deficit reduction criterion, with many measures (such as consumption tax increases) already in place. However, the debt projections depend crucially on growth, which has proven weaker than expected in 2011.

- *Japan* is currently exempted from meeting the Toronto criteria, and reconstruction costs from the subsequent tsunami and earthquake will be considerable. On current trends, Fund analysis suggests that the projected improvement of the structural primary balance between 2010 and 2020 falls short of what is needed to reduce the debt to GDP ratio on a downward path before 2020.

12. **Although no specific fiscal commitments for emerging economies were detailed in the Toronto and Seoul Declarations, fiscal tightening is also warranted in some emerging economies to fulfill the objectives of sustainable and balanced growth.** Some emerging economies should tighten fiscal conditions to moderate demand pressures and maintain price stability (e.g., *Brazil*, *India*), while mitigating potential financial imbalances from strong credit growth (e.g., *Brazil*, *Turkey*). Some emerging economies need to break away from procyclical policy setting patterns to raise fiscal space and

reduce the risk of damaging boom-bust swings (e.g., *Russia, Turkey*).

13. **Across the membership, strong, sustainable, and balanced growth will require improved fiscal policy frameworks.** Clear policy frameworks have helped some economies to weather the crisis relatively well (e.g., *Mexico*). Debt and deficit projections need to be seen to be credible; this can be helped by external vetting (e.g., the Office of Budget Responsibility in the *United Kingdom*), improved transparency (e.g., *Australia, Brazil*), or legislated limits (e.g., *Germany*). In the particular case of the *euro area*, initiatives at the level of the European Commission to strengthen the discipline of the Stability and Growth Pact (such as caps on expenditure growth) are welcome but could go further.

14. **Achieving the broad goals of strong and sustainable growth also implies that fiscal policy initiatives are needed to support financial and structural reforms.** Aging populations in nearly all advanced and some emerging G-20 economies require changes to tax policies to encourage greater labor participation (as have been initiated by, e.g., *Australia*), especially by women and older cohorts, and increases in pension eligibility (such as have been implemented in *France* and *Spain*). In *Japan*, new tax measures will be needed to restore the health of public finances, given the already relatively low expenditures compared to other advanced economies. Infrastructure spending will be important for greater efficiency (e.g., *India, South Africa*), but tax

coverage will need to be broadened to pay for it (as has been initiated in *Indonesia*). In general, there is over-reliance on direct over indirect taxes.⁴ Across all economies, tax treatments generally favor debt financing over equity issuance, and hence encourage over-use of leverage to generate returns.

C. Financial Policies

Necessary reforms are well identified and defined at the international level. Capital and liquidity standards have been raised and the framework for the supervision and regulation of Systemically-Important Financial Institutions has been augmented. But many initiatives await implementation at the national level. Even with recent reform efforts, the problem of institutions that are "Too Big To Fail" has arguably become worse, owing to the increase in concentration and size of financial institutions. Authorities must continue their efforts on the difficult issue of cross-border resolutions. To ensure financial stability, more work is needed to force financial institutions to rebuild capital and resolve those that are not able to access private funds.

15. **Key areas of financial sector reform in the Seoul Action Plan include:** (i) tightening standards, especially those concerning bank capital and liquidity, and implementing global standards

⁴ Efforts to rebalance the composition of taxes include, for example, the reduction of the corporate tax rate and increase in the VAT tax rate in the *United Kingdom*.

consistently; (ii) improving supervision, regulation, and resolution of Systemically-Important Financial Institutions (SIFIs); and (iii) addressing too-big-to-fail (TBTF) problems. Dealing with these issues is a very complex task, and will take some time, and the Financial Stability Board will continue to play an important role in coordinating initiatives.⁵

16. A number of initiatives to reform the financial sector have been well identified and defined at the international level, but implementation has been slow at the national level.

- The Basel III framework has been developed and represents a significant step toward tighter capital and liquidity standards. However, the framework will likely not be fully operational until 2019. Consistent with its importance for world financial markets, the *United States* has made good progress with higher capital ratios and improved liquidity ratios. Authorities in the *euro area* have conducted a new round of stress tests, but exposures to sovereign risks may not have been fully tested.
- According to the FSB, some G-20 financial centers are still in the process of upgrading supervisory structures to apply all pillars of the Basel II framework.

⁵ See “A Consistent Framework for Monitoring and Assessing the Implementation of Agreed Reforms,” Financial Stability Board, 14 July 2011 and references therein.

17. Authorities in major advanced economies have taken significant steps to improve the supervision and regulation. Measures in the *United States* include stronger supervision, more regulation of critical markets, and a new Financial Stability Oversight Council charged with identifying and responding to threats to financial stability. The *United Kingdom* has moved to a “triple peak” structure for macro-prudential, micro-prudential, and market regulation. A Financial Policy Committee within the Bank of England has been created with a remit to identify system-wide risks. The European Systemic Risk Board and the European System of Financial Supervisors have been created to address weaknesses in the current supervisory structure.

18. Ensuring cross border consistency of standards and harmonizing approaches across jurisdictions is proving challenging.

- Convergence to single set of accounting standards is behind schedule. Moreover, it is not clear that the current national implementation of accounting standards is always consistent with global policy.
- Work on prudential standards is ongoing. However, according to the FSB, some jurisdictions have chosen not to implement parts of standards. Internal regulatory coordination remains a substantial problem for the *United States* and *euro area*, with consequent implications for international coordination.

- Standards for identifying SIFIs have been established. However, notwithstanding significant efforts coordinated through the FSB and Basel working groups, the implementation of harmonized cross-border resolution procedures will likely take some time.
- Regulations for strengthening the regulation and oversight of the shadow banking system will likely be finalized by the end of the year. However, national implementation is well behind global policy development, and with current coordination difficulties deadlines for harmonized treatment will likely not be met.
- Harmonization of derivative market reforms is proceeding more successfully, with standardization of central clearing, exchange or electronic platform trading, and reporting of transactions on track.

19. Significant steps have been taken to address TBTF, but their effectiveness is unclear.

- Higher regulatory ratios and/or bank levies have been introduced in *France*, *Germany*, and the *United Kingdom*.
- In the *United States*, the Dodd-Frank Act contains a number of provisions aimed at the problem, such as new supervisory powers, new resolution authority for SIFIs, “living wills” to assist in orderly liquidation, and new regulatory authority to set capital and liquidity requirements. However, the banking industry is nonetheless

significantly more concentrated than before the crisis, raising questions about the willingness to use these provisions in the event of a new crisis, and the Act lacks provisions to facilitate cross-border resolution to address the failure(s) of multinational financial institutions.

20. Across the membership, further efforts are needed to meet the Seoul criteria:

- **Capital and liquidity standards:** Authorities in Europe should consider more ambitious capital ratios than the minimum requirements set in the Basel III framework, given the high interconnectedness of banks within the euro area and the lack of a pan-European resolution framework. The FSB notes concern in markets over the consistency of the application of Basel III standards.
- **Supervision and resolution:** Progress on national resolution regimes in G-20 economies has, on average, been limited. In particular, a true European Resolution Authority is needed, but supervision remains governed at the national level. As an intermediate step, resolution tools and deposit guarantees should be harmonized. A timeline for a harmonized resolution framework has not yet been set.
- **TBTF:** More should be done to reduce the risks and consequences of failure, but this will require a comprehensive range of complementary measures, such as “ringfencing” bank operations,

burden sharing arrangements, recovery plans, and cross border resolution requirements.

21. **Developing frameworks and capacity is increasingly important for emerging economies.** Financial systems in emerging economies are in better shape than those in advanced economies. Nonetheless, emerging economies will need deeper financial systems to sustain growth, and, with that, more comprehensive regulatory and supervisory frameworks. In *Mexico*, a cross-agency financial stability council has been established to monitor systemic risks. In *Brazil*, a Financial Stability Committee has been established at the central bank. In *Russia*, financial market and insurance supervision has been merged, but the central bank should be granted greater supervisory powers.

22. **Financial systems remain fragile—satisfying the Summit criteria alone will not be sufficient to ensure financial stability.** More needs to be done to raise capital in weak financial institutions and resolve those that are not able to access private funds.

D. Structural Policies

Structural reform is essential for medium-term growth, but plans could be better aligned with key priorities. Implementation of structural reforms has been less impressive than progress on fiscal and monetary policies. Progress has been made on product market competitiveness and labor utilization. More is needed, however, to increase labor participation; boost

competition; make product, service and labor markets more flexible; bolster training and education; and improve the business climate by cutting regulation, increasing transparency and accountability of government, and improving rule of law and security.

23. **Key policy commitments on the structural front in the Seoul Action Plan include:** (i) product market reforms to promote competition and enhance productivity, particularly in *advanced surplus* economies; (ii) labor market reforms to increase participation; (iii) in *surplus countries*, reforms to reduce the reliance on external demand and focus more on domestic sources of growth, and, in *deficit countries*, reforms to promote higher national saving; (iv) in emerging *surplus economies*, reforms to reduce precautionary saving, plus corporate governance and financial market development.

24. **Progress on structural reforms has been limited.** A wide range of policies are stipulated in national authorities' submissions as part of the MAP process. However, many of the priorities indicated by authorities are not well aligned with those identified by the OECD, and many of the initiatives are only at early stages of discussion and planning.⁶ In some cases,

⁶ See the OECD's assessment in "Pursuing Strong, Sustainable and Balanced Growth: A Note on the Implementation of Structural Reform Commitments", July 2011, and "Pursuing Strong, Sustainable and Balanced Growth: Taking Stock of the Seoul Action Plan's Structural Reform Commitments", June 2011.

structural reform agendas have been delayed (e.g., only part of the E.U. Services Directive has been implemented so far).

25. **Some progress has been made in product market reforms, but implementation is lagging.** Health care reform in the *United States* aims to boost competition through health care exchanges, which, if successful, could lead to significant cost reductions for businesses and more efficient allocation of resources. Across the *euro area*, barriers to competition in services still remain; The Lisbon Agenda has identified targets, but commitments under the Euro Plus Pact are not sufficiently ambitious, concrete or binding. *Japan* would likely benefit from increased competition in sectors such as health care and agriculture. Efforts have been made to bolster the competition commission in *South Africa*, but more is needed for critical “network” industries (e.g., transportation) to improve potential growth rates. In *Russia*, plans to increase competition and advance privatization have been announced, but without implementation dates. In *Mexico*, good progress has been made toward anti-trust measures, telecommunications competition, and energy sector reform.

26. **Labor market policies have generally been more successful in terms of labor utilization, but less successful in terms of labor market flexibility.** The size of the labor force and tax base is a serious concern for many economies (e.g., *Italy, Japan, Korea, and South Africa*) but current plans to increase participation by women and older workers in those economies are

few and only at early stages. Efforts to encourage greater labor market flexibility (such as more differentiated wage bargaining, as has been initiated in *Spain*) are needed (e.g., *Italy*) but face stern resistance (e.g., *South Africa, Turkey*). Human capital development is particularly important for emerging economies, and initiatives include programs to improve access to education in *Brazil, India's* Right to Education Act, and a national skill development strategy in *South Africa*. Overall, however, reform of (particularly tertiary) education has been slow.

27. **Both advanced and emerging economies face challenges to boost potential growth.** In most advanced economies, productivity growth rates will need to rise to compensate for falling population growth rates and to make fiscal commitments sustainable. In emerging economies, measures are needed to ensure that high growth continues and is not held back by capacity constraints and bottlenecks. Many G-20 economies need to make progress on improving product market access, competition, and efficiency. Most G-20 economies need to improve labor market flexibility and increase participation. This will require attention to education policies, labor market regulation, and complementary attention to tax policies. Increasing labor participation may require increased childcare support (as instigated in e.g. *Germany*) and/or changes to taxation (e.g., *Australia, France, Germany*). Economies also need to engage in reforms to improve business climates. These include property rights and the rule

of law (e.g., *Russia*); transparency and accountability of government (e.g., *India*); regulation and bureaucracy (e.g., *Italy*), and domestic security (e.g., *Mexico*).

28. **Structural reforms are needed for rebalancing.** Improved social safety nets in emerging surplus economies are important for facilitating the transition toward private consumption. To this end, significant progress has been made in *China*, with resources allocated to improving the pension, healthcare, and education systems, as well as increases in minimum wages.

Key Policy Challenges for the G-20

The global economy is at a dangerous stage. Growth has weakened further in advanced economies because of insufficient private demand. **Uncertainty** about future policies is hurting confidence, causing households and firms to defer spending, investment and hiring, with the potential for sharp increases in market risk premia and spillovers to other G-20 members. Active policies are needed to promote job growth and resolve household debt legacies. In addition:

A key priority for major advanced economies is achieving **fiscal sustainability**. Authorities in major advanced economies must implement credible plans for long-term adjustment to sustainable fiscal positions, addressing both spending (e.g., entitlements) and tax policies (e.g., tax expenditures, subsidies and loopholes). Overly harsh fiscal tightening without credible long-term plans will only make fiscal situations worse, by depressing growth.

A second key priority is addressing ongoing **financial sector weakness**. Resolution and recapitalization of weak institutions will come at some short-run cost, but are important for strengthening the financial system. Authorities must implement harmonized international standards quickly. More work is needed on resolution of globally systemically-important financial institutions.

Structural reforms are needed by all members to boost growth and facilitate rebalancing. Structural adjustment should not be slowed while fiscal adjustment takes place—the two policy agendas are linked and complementary.

Emerging G-20 economies need to bolster their economies to cope with continuing **capital inflows** and the associated risks of **overheating**. The secular trend for capital to shift from advanced to emerging economies is likely to continue, as will low interest rates in advanced economies for the immediate future. Macro-prudential tools are useful, but not substitutes for reforms to bolster financial supervision and regulation, remove bottlenecks in product, service and labor markets, invest in human capital, and boost capacity through infrastructure investment. In the short run, monetary conditions may need to be tightened in some economies, depending on demand; absorbing excess demand through fiscal tightening would usefully bolster public finances.

External rebalancing is now more important than ever. Net exports have to replace private demand in indebted advanced economies. Impediments to realigning saving and investment—inflexible exchange rates, barriers to entry and lack of competition, excessive precautionary saving, poor investment incentives—must be eliminated.

G R O U P O F T W E N T Y



G-20 ECONOMIC OUTLOOK: ANALYSIS AND PERSPECTIVES ¹



Prepared by Staff of the

I N T E R N A T I O N A L M O N E T A R Y F U N D

¹ *Report 3 of 10.* At the request of the G-20, IMF staff has provided analyses and assessments of member's economies and policies in a set of reports for the Mutual Assessment Process (MAP). These reports serve as inputs for the Action Plan agreed by G-20 Leaders at the Cannes Summit. The 2011 Staff Reports for the 20 MAP consist of the following: (i) an Umbrella Report that provides an integrated summary of the component reports and an upside scenario for G-20 collective action; (ii) an Accountability Report that summarizes members' progress toward policy commitments since the Seoul Summit in 2010; (iii) a MAP Report providing analysis of members' medium-term macroeconomic and policy frameworks; and (iv) Sustainability Reports for seven members (China, France, Germany, India, Japan, United Kingdom, and United States)—identified by G-20 indicative guidelines—to assess the root causes and policy implications of key imbalances.



INTERNATIONAL MONETARY FUND

EXECUTIVE SUMMARY

Summary of the G-20 Outlook

- G-20 members project growth outcomes that are broadly consistent with the agreed objectives of *strong, sustainable, and balanced* growth.
- Unemployment is projected to decline in-line with strong growth, but is expected to remain high relative to pre-crisis trends.
- Fiscal balances are projected to improve, underpinned by strong growth, with G-20 fiscal projections broadly in line with the Toronto commitments.
- G-20 members expect a smooth handoff from public to private demand to sustain growth. However, progress toward rebalancing global demand is expected to be slow.

Comparative Perspectives and Risks

- Global growth prospects have deteriorated since the G-20 members submitted their projections in May, and downside risks have intensified. As such, G-20 growth projections appear highly optimistic relative to the October 2011 WEO and experiences following past financial crises, and are subject to significant downside risks.
- Accordingly, the projected marked improvement in fiscal positions faces significant risks. Moreover, the smooth handoff from public to private demand assumed by authorities appears

increasingly unlikely, particularly in *advanced economies*.

- G-20 projections appear to rely on a rapid improvement in financial market conditions, which, without further policy action to reduce vulnerabilities in the global financial system, also seem unlikely.

Policy Implications

The downside risks identified in the G-20 baseline projections call for urgent collective policy actions to both achieve desired objectives and help guard against adverse growth outcomes.

- In key *advanced economies*, the most urgent task is to advance medium-term fiscal adjustment plans while, to the extent possible, supporting economic activity in the short run; and further reforms are needed to fully repair the financial system and make it more resilient to shocks.
- In *emerging surplus* and *advanced deficit economies*, policies aimed at changing long-term saving patterns to rebalance global demand are needed, facilitated by greater exchange rate flexibility in key emerging economies.
- Product and labor market reforms are needed across the membership to boost potential output, notably in *advanced surplus economies*.

I. G-20 ECONOMIC OUTLOOK: ANALYSIS AND PERSPECTIVES¹

G-20 members project growth outcomes that are broadly consistent with the agreed objectives of strong, sustainable, and balanced growth. But progress toward rebalancing global demand—essential to the durability of the recovery—continues to be slow. Moreover, global growth prospects have deteriorated since the G-20 members submitted their projections in May, and downside risks have intensified. As such, G-20 projections for growth, fiscal positions, and financial conditions appear highly optimistic.

A. Introduction

1. **At the November 2010 G-20 Summit in Seoul, Leaders launched the Seoul action plan.** The plan was designed with an overarching goal of ensuring an unwavering commitment to cooperation toward achieving *strong, sustainable, and balanced* growth.

2. **Against this backdrop, G-20 members, based on a template agreed among the membership, provided their macroeconomic projections for analysis.**

Overall, the projections were submitted by the required deadline in May, but they generally contained significant data gaps. Specifically, projections for some variables were missing and some were incomplete. Following guidance from the G-20, Fund staff filled these data gaps in the “raw” submissions, based on its understanding of authorities’ policy projections (see Appendix I: Summary of G-20 Inputs). This has helped construct the “baseline” for the analysis contained in this report.²

3. **This report assesses the macroeconomic outlook as seen by G-20 members following the launch of the Seoul action plan.**³ Section II evaluates the G-20 projections against the agreed objectives of *strong, sustainable, and balanced* growth. Section III provides a comparative perspective of the G-20 projections relative to the October 2011 WEO and identifies potential risks to the outlook.⁴ Section IV discusses policy implications.

supporting appendices, for more details on the construction of the “baseline.”

³ Analysis in the report is based on country aggregates grouped along geographic and theme-based dimensions. *Advanced surplus countries* include Germany, Japan, and Korea; *advanced deficit countries* include Australia, Canada, United Kingdom, United States, and the euro area minus Germany; *emerging surplus countries* include Argentina, China, and Indonesia; *emerging deficit countries* include Brazil, India, Mexico, South Africa, Turkey, and other EU countries; and *major oil exporters* include Russia and Saudi Arabia.

⁴ While, admittedly, the G-20 projections were submitted before the deterioration of global growth prospects, a comparison with the June 2011 WEO Update yields qualitatively similar results.

¹ Prepared by Troy Matheson under the guidance of Emil Stavrev with the support of Eric Bang, David Reichsfeld, and Anne Lalramnghakhleli Moses.

² See *Mutual Assessment Process—Analysis and Perspectives*, International Monetary Fund, 2010, and (continued)

II. THE G-20 VIEWS ON THE OUTLOOK

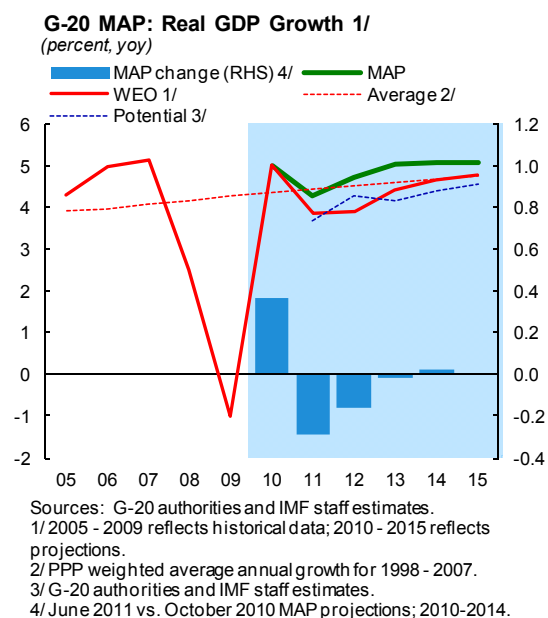
The G-20 macroeconomic frameworks collectively indicate growth outcomes that are broadly consistent with the agreed objectives of strong, sustainable, and balanced growth. Growth is projected to be “strong” in the sense that it exceeds both potential growth and its pre-crisis average, translating into rapidly declining unemployment; it is “sustainable” in the sense that it is expected to be increasingly led by private demand; growth is also projected to be “balanced” in terms of being broad based across G-20 members. However, progress toward rebalancing global demand continues to be slow.

Growth is Projected to be “Strong”

4. **The G-20 baseline projects strong medium-term growth, notably in those advanced economies most affected by the financial crisis.** Collectively, the G-20 projects growth to exceed both potential growth and its long-term average over the medium term. Prospects are projected to improve most notably in *advanced economies*, with growth expected to exceed both potential and its long-term average beyond 2012. Growth is particularly strong in the advanced economies that were at the epicenter of the crisis, notably the United States. Growth in *emerging Asia* is projected to slow from the rapid pace set in 2010, to around 9 percent over the medium term. In *Latin America*, growth is projected to remain above potential, which itself is assumed to exceed average growth over the past decade by over 1 percentage point, while, growth in *EMEA economies* is expected to slow relative to its historical average, but will remain above potential over the medium term.⁵

⁵ *Advanced economies* comprise Australia, Canada, euro area, Japan, Korea, United Kingdom and United States. *Emerging Asia* comprises China, India and

(continued)

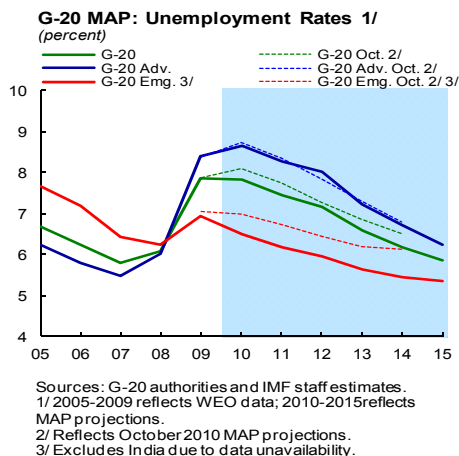


5. **The G-20 baseline is less optimistic about near-term growth relative to previous submissions in October 2010, owing largely to tempering of optimism about prospects in advanced economies.** G-20 growth surprised on the upside in 2010, but

Indonesia. *Latin America* includes Argentina, Brazil and Mexico. *EMEA* denotes Europe, Middle East and Africa. The countries included in the group are Russia, Saudi Arabia, South Africa, Turkey and other EU (EU excluding euro area and the United Kingdom).

2011–12 projections have been revised down (Figure 1). The positive growth surprise for 2010 was largely due to better-than-expected outcomes in *emerging Asia* and *Latin America*. Downward revisions to growth over 2011–12 are mostly the result of less optimism amongst *advanced economies*, with the revisions driven by a slower-than-expected growth in early 2011 in the United States and the earthquake in Japan.

6. **Strong growth is accompanied by rapid declines in unemployment across the G-20.** In *advanced economies*, unemployment peaked at around 9 percent in 2010 and is projected to decline to just over 6 percent by 2015. Unemployment is also projected to decline rapidly in *emerging economies*, reaching about 5 percent in 2015, which is lower than pre-crisis levels. Relative to the October 2010 baseline, the outlook for unemployment has improved, largely as a result of a marked improvement of the outlook in *emerging economies*, notably in Russia, Brazil, and China.



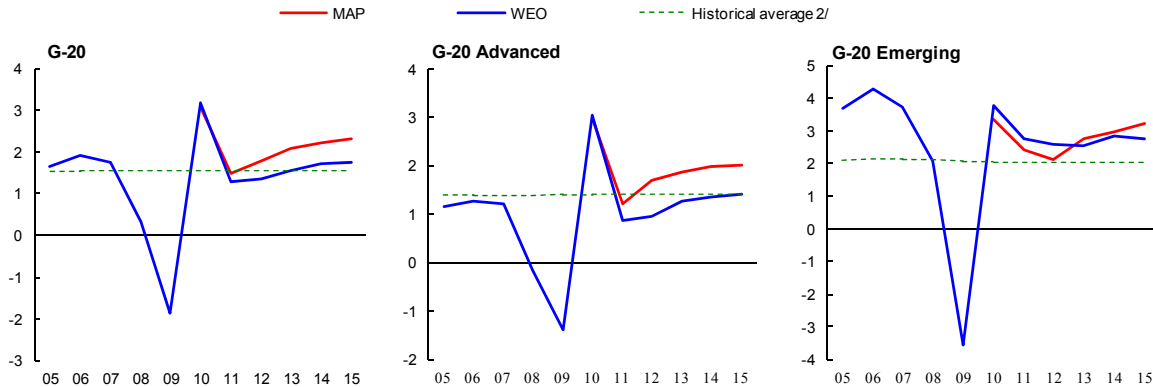
7. **Strong growth is underpinned by robust labor productivity growth across the G-20.** G-20 labor productivity growth is

projected to be almost 1 percent higher than its historical average in 2015, with strong growth projected for both *advanced* and *emerging economies*, particularly in the United States and euro area. In *emerging economies*, labor productivity growth is projected to slow temporarily over 2011–12 before picking up to just over 3 percent by 2015. In contrast, after slowing in 2011, *advanced economies* expect labor productivity growth to rise to around 2 percent by 2015—around 1 percent lower than expected amongst *emerging economies*, reflecting long-term trends in income convergence.

Growth is Projected to be “Sustainable”

8. **Growth in the G-20 baseline is projected to be broadly sustainable, as it is expected to be increasingly underpinned by private demand** (Figure 2). A shift of the underlying sources of domestic demand away from the public sector toward the private sector is an important condition to ensuring the sustainability of growth and fiscal positions going forward. Fiscal consolidation efforts have begun across the G-20, and projections show increasing reliance on private sector demand over the medium term. Specifically, for the G-20 as a whole, private consumption and gross fixed capital formation are projected to account for an increasingly higher share of real GDP growth (over 4½ percentage points of the projected 5 percent growth in 2015). Moreover, in 2015, the contributions by both private consumption and gross fixed capital formation are expected to be higher than in any year over the past decade.

G-20 MAP: Labor Productivity Growth 1/
(percent)



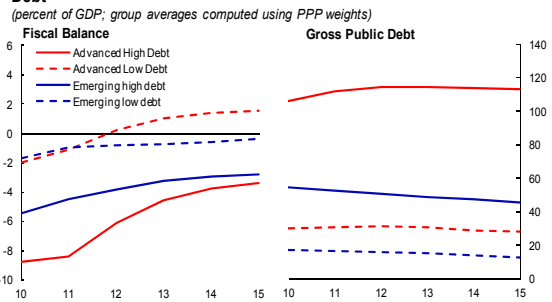
Sources: G-20 authorities and IMF staff estimates.
1/ Excludes China, India, Indonesia, and Saudi Arabia due to data unavailability.
2/ 1998 - 2007 PPP weighted average.

9. **The counterpart of strong growth led by private demand is a marked improvement in fiscal balances across the G-20, with the largest improvements planned in the United Kingdom and United States.** Overall, the G-20 fiscal projections are broadly in line with the Toronto commitment to halve 2010 deficits by 2013 and stabilize debt to GDP ratios by 2016 (Box—Where do G-20 Countries Stand Relative to the Toronto Commitment?). To achieve this, the G-20 foresees a narrowing of fiscal deficits and a reduction in public debt ratios of around 4 percentage points over 2010–15.

- Reflecting worse fiscal positions, *advanced economies* project a much larger improvement of fiscal balances than *emerging economies* over the medium term (5¼ and 2 percent of GDP, respectively). Nevertheless, the 2015 headline balances for both *advanced* and *emerging economies* are expected to be somewhat weaker than immediately before the crisis. And, while debt ratios are broadly stable by

2015—Russia and Japan are the only exceptions—debt levels are projected to remain very high in several *high-debt advanced economies*, particularly Japan, the United States, and the United Kingdom.

G-20 MAP Framework Projections of Overall Balances and Gross Public Debt



Sources: G-20 authorities and IMF staff estimates.

10. **The medium-term fiscal outlook has generally deteriorated since October 2010.** Projections for overall balance and debt ratios have become less optimistic. Downward revisions to growth have likely contributed to the change in the outlook for *advanced economies*, with overall balances and debt deteriorating owing to both higher expenditures and lower

revenues. In contrast, fiscal outlook in *emerging economies* appears to have deteriorated largely due to higher-than-

expected expenditures, with higher revenues driven by favorable revisions to growth projections.

G-20 MAP Projections of Key Fiscal Variables 1/

(percent of GDP; changes 2015 - 2010)

| | Overall Balance | Government Expenditure | Government Revenue | Gross Debt | Cyclical Component 2/ | Interest Payments |
|-----------------|-----------------|------------------------|--------------------|------------|-----------------------|-------------------|
| | MAP | MAP | MAP | MAP | MAP | MAP |
| G-20 | 4.0 | -2.7 | 1.3 | -4.1 | 1.3 | 0.4 |
| Advanced | 5.3 | -2.9 | 2.3 | 6.4 | 1.5 | 1.2 |
| High debt | 5.4 | -2.8 | 2.5 | 7.5 | 1.6 | 1.3 |
| Low debt | 3.6 | -3.3 | 0.2 | -2.1 | 0.1 | 0.0 |
| Emerging | 1.9 | -0.2 | 1.7 | -7.0 | 0.3 | -0.4 |
| High debt | 2.6 | -3.2 | -0.6 | -8.5 | 0.3 | -0.9 |
| Low debt | 1.3 | 1.8 | 3.1 | -4.6 | 0.4 | 0.0 |

Sources: G-20 authorities and IMF staff estimates.

1/ Country averages computed using rolling PPP weights. High (low) debt advanced economies are those with public debt-to-GDP ratios of more (less) than 60 percent in 2009 (based on WEO data from March 2010). High (low) debt emerging market economies are those with public debt-to-GDP ratios of more (less) than 40 percent in 2009 (based on WEO data from March 2010).

2/ In percent of potential GDP; computed as: Revenue-to-GDP ratio * output gap.

G-20 MAP Changes in Projections of Key Fiscal Variables (Jun 2011 vs. Oct 2010) 1/

(percent of GDP; changes 2014 - 2010)

| | Overall Balance | Government Expenditure | Government Revenue | Gross Debt |
|-----------------|-----------------|------------------------|--------------------|------------|
| | MAP | MAP | MAP | MAP |
| G-20 | -0.4 | 0.7 | 0.2 | -0.1 |
| Advanced | -0.3 | 0.2 | -0.1 | 2.0 |
| High debt | -0.4 | 0.3 | -0.1 | 2.1 |
| Low debt | 0.3 | -0.5 | -0.3 | 0.7 |
| Emerging | -0.6 | 1.9 | 1.2 | -1.2 |
| High debt | -0.2 | 0.2 | 0.0 | 2.2 |
| Low debt | -1.0 | 3.1 | 2.0 | -2.6 |

Sources: G-20 authorities and IMF staff estimates.

1/ Country averages computed using rolling PPP weights. High (low) debt advanced economies are those with public debt-to-GDP ratios of more (less) than 60 percent in 2009 (based on WEO data from March 2010). High (low) debt emerging market economies are those with public debt-to-GDP ratios of more (less) than 40 percent in 2009 (based on WEO data from March 2010).

2/ In percent of potential GDP; computed as: Revenue-to-GDP ratio * output gap.

WHERE DO G-20 COUNTRIES STAND RELATIVE TO THE TORONTO COMMITMENT?

The declaration made by advanced economies at the Toronto summit was to halve deficits by 2013 and stabilize or reduce debt-to-GDP ratios by 2016. This box assesses the progress advanced economies have made towards meeting this commitment.

For the purposes of this analysis, the first part of the commitment (halving the deficit by 2013) is assumed to be satisfied if the overall deficit-to-GDP by 2013 is at least half the size of 2010 deficit ratio, according to each country's baseline submission. Because baseline submissions only contain projections up to 2015, the second part of the commitment (stabilizing debt-to-GDP by 2016) is assumed to be satisfied if authorities' debt ratios are not projected to rise over 2014–15.

The Toronto commitment is broadly satisfied by G-20 advanced economies, based on authorities' submissions. Japan was exempt from the specifics of the Toronto commitment. Its progress toward fiscal sustainability has been adversely affected by the additional stimulus required following the tragic and unforeseen events surrounding the earthquake and tsunami in early 2011.

G-20 MAP Fiscal Projections versus Toronto Commitment

(percent of GDP)

| | Halving deficit by 2013 1/ | Stabilizing debt by 2015 2/ | Satisfy Toronto Declaration? |
|----------------|-------------------------------|--------------------------------|---------------------------------|
| Australia | ✓ | ✓ | ✓ |
| Canada | ✓ | ✓ | ✓ |
| Euro area | ✓ | ✓ | ✓ |
| Japan 3/ | ... | ... | ... |
| Korea | ✓ | ✓ | ✓ |
| United Kingdom | ✓ | ✓ | ✓ |
| United States | ✓ | ✓ | ✓ |

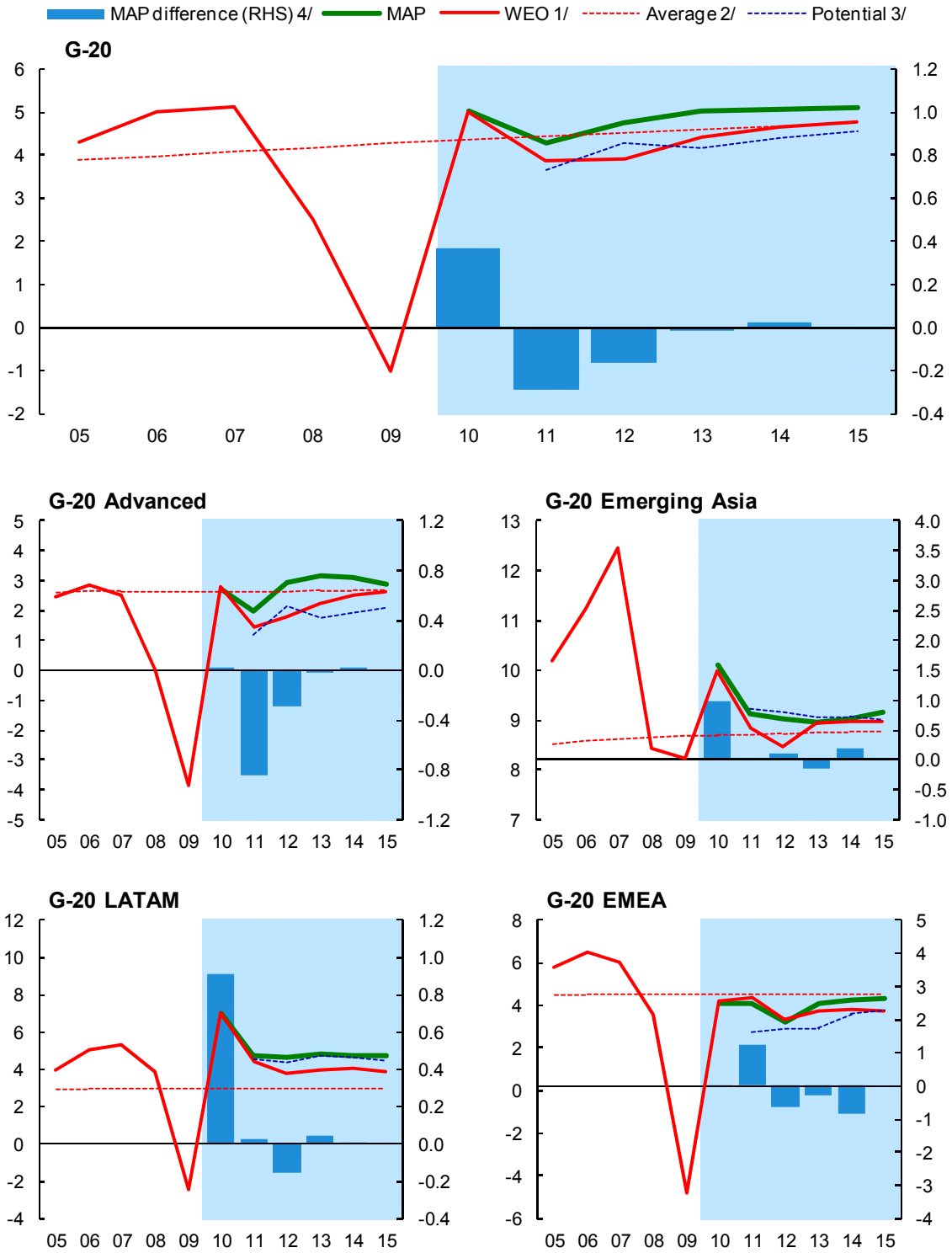
Sources: G-20 authorities and IMF staff estimates.

1/ Toronto Declaration of at least halving the 2010 deficit by 2013; based on June 2011 MAP estimates.

2/ Stabilized debt defined to be debt ratio not rising over 2014-2015.

3/ Japan was exempt from the Toronto commitment.

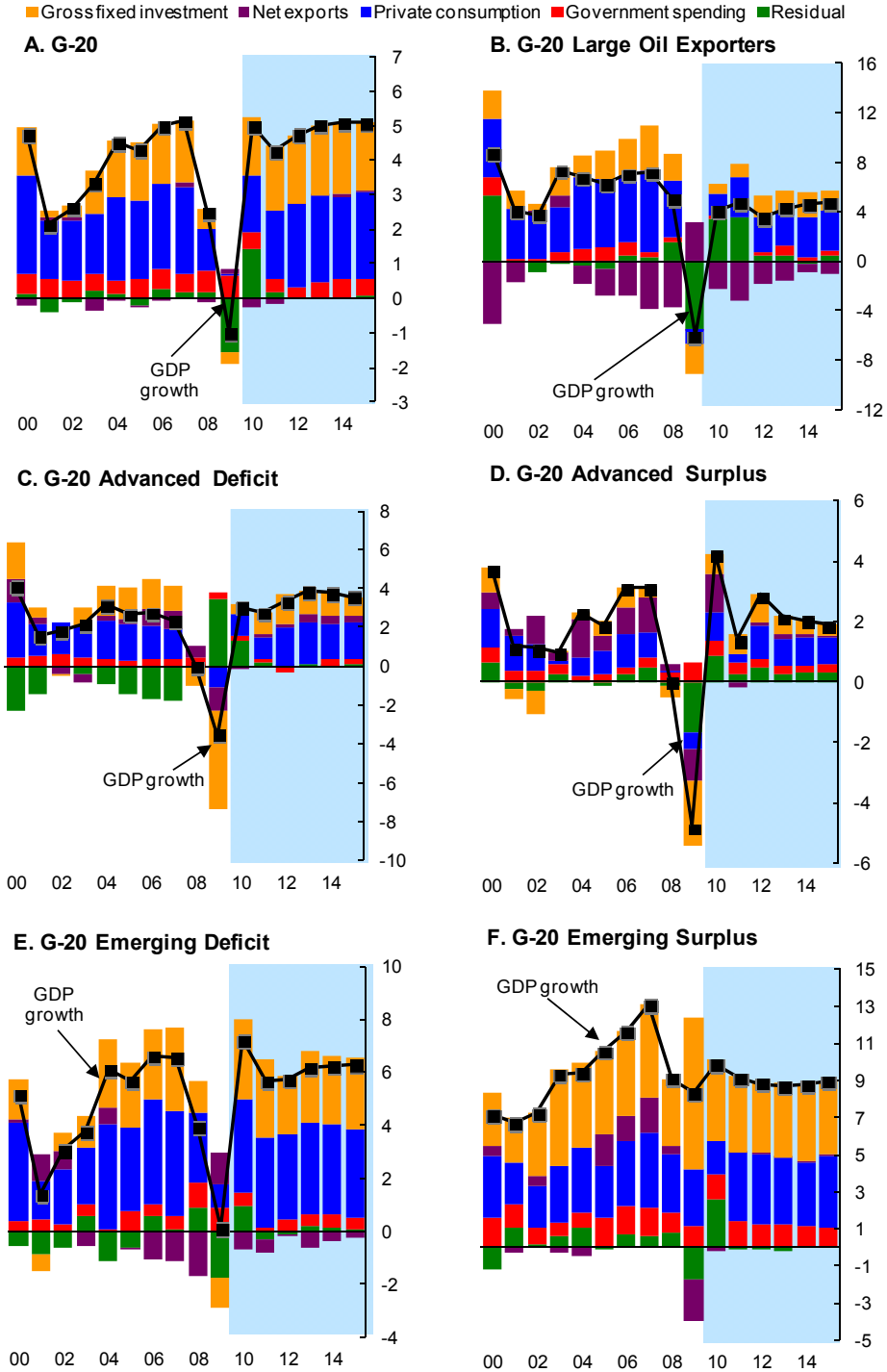
Figure 1. G-20 MAP Geographic Groups: Real GDP Growth
(percent, yoy)



Sources: G-20 authorities and IMF staff estimates.
 1/ 2005 - 2009 reflects historical data; 2010 - 2015 reflects estimates and projections.
 2/ PPP weighted average annual growth for 1998 - 2007.
 3/ G-20 authorities and IMF staff estimates.
 4/ June 2011 vs. October 2010 MAP projections; 2010-2014.

Figure 2. G-20 MAP Thematic Group: Contributions to Real GDP Growth 1/ 2/

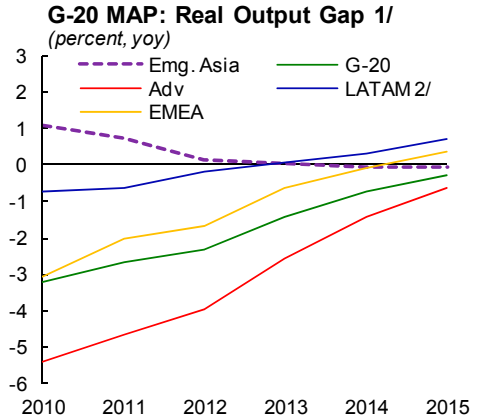
(percentage points, yoy; growth in percent, yoy)



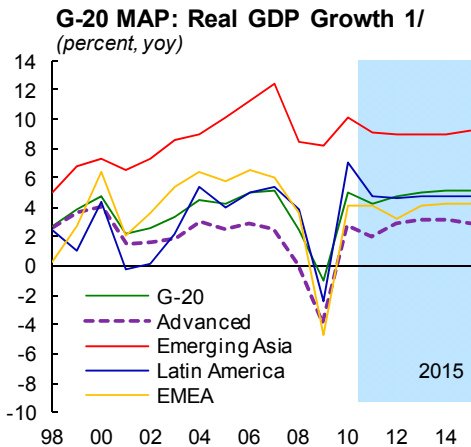
Sources: G-20 authorities and IMF staff estimates.
 1/ 2000 - 2009 reflects WEO data; 2010 - 2015 reflects MAP estimates and projections.
 2/ Residual includes in inventories and statistical discrepancy.

Growth is Projected to be “Balanced”

11. **As in the October 2010 baseline, growth is projected to be balanced in terms of being broad-based across G-20 members.** Income convergence is projected to continue, with *emerging economies* growing more rapidly than *advanced economies* over the medium term. Growth is also projected to be broadly balanced in the sense that most G-20 economies are expected to be growing close to their potential growth rates in 2015.



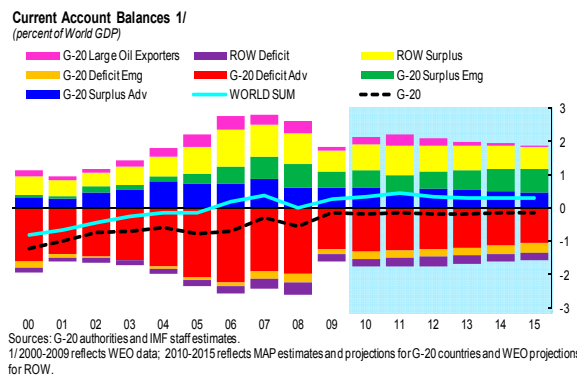
Sources: G-20 authorities and IMF staff estimates. 1/ Data for Argentina, China, India, Saudi Arabia and Japan reflect IMF staff estimates of output gap. 2/ Excludes Argentina.



Sources: G-20 authorities and IMF staff estimates. 1/ 1998 - 2009 reflects WEO data; 2010 - 2015 reflects MAP projections.

- Nevertheless, output gap projections reveal differing cyclical positions in 2010, with significant excess capacity amongst *advanced* and *EMEA economies*. Excess capacity is projected over the entire 2010-15 period for *advanced economies*, while *Latin America* collectively expects output gaps to close in 2013. In contrast, excess demand is prevalent in *emerging Asia* during the early part of the projection period.

12. **Progress toward rebalancing global demand continues to be slow, with external imbalances expected to persist over the medium term.**⁶ Global imbalances declined during the recession, but are projected to remain large over the medium term. This is because many of the underlying policy distortions that led to the build-up of imbalances before the crisis remain entrenched.



Sources: G-20 authorities and IMF staff estimates. 1/ 2000-2009 reflects WEO data; 2010-2015 reflects MAP estimates and projections for G-20 countries and WEO projections for ROW.

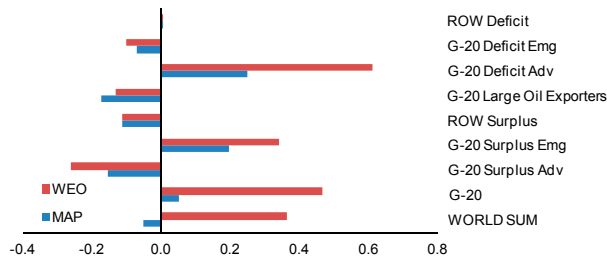
- Projected changes in current account balances over 2010-15 reveal slow progress toward rebalancing global demand. Current account deficits of

emerging deficit economies are projected to widen, while deficits of *advanced deficit economies* are projected to narrow. At the same time, *emerging surplus economies* project their surpluses to expand, and both *advanced surplus economies* and *large oil exporters* expect a reduction in their surpluses.

- The outlook for global imbalances has changed somewhat since October 2010, particularly for *emerging surplus economies*. These economies projected surpluses to shrink in the October baseline, albeit marginally, but they now expect them to expand.

and public sector balance sheets and facilitate external rebalancing. However, the projected rise in public saving is largely offset by lower private saving, leaving only modest increases in national saving over 2010-15. National saving is much higher in *emerging surplus economies*, notably China, reflecting limited rebalancing toward domestic demand, with saving rates projected to remain around 50 percent over the medium term. Projected saving patterns are broadly unchanged in *advanced surplus economies* and *large oil exporters*, while they are increasing amongst *emerging deficit economies*. Investment patterns broadly mirror those of saving, with a rise in investment rates amongst *large oil exporters* being the only notable exception.

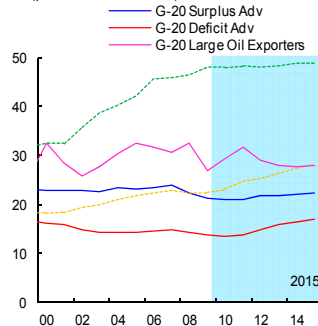
2010 - 2015 Projected Change in Current Account Balances 1/
(percent of World GDP)



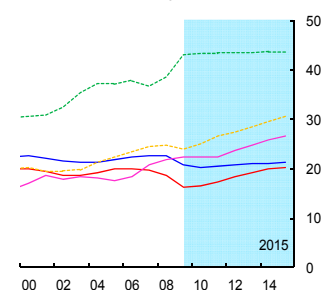
Sources: G-20 authorities and IMF staff estimates.
1/ Percentage points.

13. **Saving and investment patterns are expected to remain broadly unchanged, reflecting modest rebalancing of global demand.** Savings need to rise in *advanced deficit economies*, notably the United States, to bolster private

Total Saving 1/ 2/
(percent of nominal GDP)



Total Investment 1/ 3/
(percent of nominal GDP)



Sources: G-20 authorities and IMF staff estimates.
1/ 2000-2009 reflects WEO data; 2010-2015 reflects MAP projections.
2/ Saving = fixed investment share + current account balance; both in percent of GDP.
3/ Fixed investment excluding change in inventories.

III. COMPARATIVE PERSPECTIVES AND RISKS

The G-20 growth and unemployment projections (admittedly based on submissions made in May, when the global outlook looked better) are highly optimistic relative to the WEO and past experiences following financial crises. Accordingly, the projected marked improvement in fiscal positions is at risk, and the smooth handoff from public to private demand hoped for in advanced economies appears increasingly unlikely. Growth projections for some advanced economies rely on favorable developments in financial markets, which, without further policy action to reduce vulnerabilities, also appear unlikely.

Growth and Unemployment Projections are too Optimistic

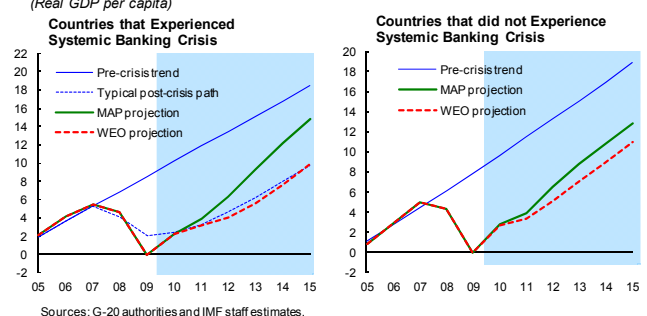
14. **Since the G-20 projections were submitted in May, global growth has slowed, and downside risks have intensified.** Growth in many *advanced economies* is still weak, and a smooth transition from public to private demand appears increasingly unlikely. Renewed financial volatility from concerns about the depth of fiscal challenges in the euro area periphery and market concerns about possible setbacks to the U.S. recovery have heightened downside risks to the global recovery. Downside risks also come from persistent fiscal and financial sector imbalances in large *advanced economies*, while some emerging economies are facing volatile capital flows and rapid credit growth. Also, a squeeze of wholesale funding for *advanced economies* banks could reverse the recent normalization of lending standards.

15. **Against this background, G-20 growth projections remain significantly higher than what is suggested by past recoveries following financial crises.** Growth is projected to be above both potential and the pre-crisis average, largely

as a result of expected strong outcomes in *advanced economies*. However, historical evidence shows that recessions underpinned by financial crises typically result in significant output losses relative to pre-crisis trends, with output on average remaining about 9 percent lower seven years after the crisis.⁷

- For the group of advanced economies that experienced a banking crisis, output losses average only about 4 percent in 2015 relative to the pre-crisis trend. This compares to a projected loss of around 9 percent in the WEO. Interestingly, for advanced economies less affected by the crises, output losses are larger, though still

G-20 MAP Advanced Countries: Growth and Recovery from the Crisis with and without Systemic Banking Crisis
(Real GDP per capita)



⁷ *World Economic Outlook*, International Monetary Fund, October 2009.

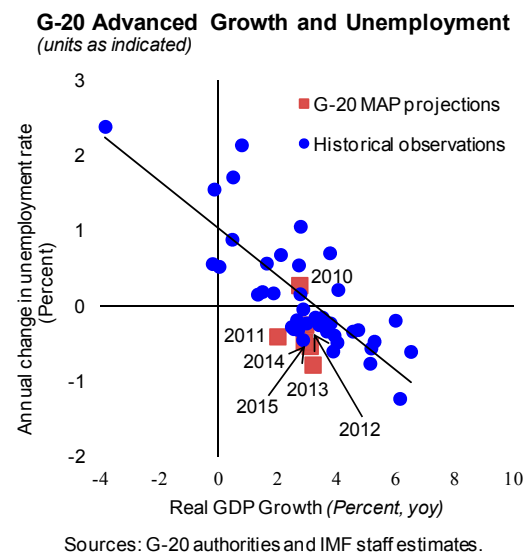
somewhat less than WEO projections (6 percent versus 8 percent in 2015).

- G-20 projections generally suggest that losses to potential output following the crisis are minimal, and will dissipate quickly. The large and persistent output gaps and the strong growth projected by some *advanced economies* suggest that authorities assume small, temporary losses of productive capacity relative to experiences following past financial crises.
- G-20 projections assume a strong private demand (consumption and investment) in the face of fiscal consolidation. However, historical evidence suggests that this would require highly credible and growth-friendly fiscal adjustment.⁸ Moreover, the smooth transition from public to private demand generally suggests continued normalization of financial market conditions, which, without further policy action, currently seems unlikely.

16. **The projected rapid decline in unemployment is also optimistic, particularly for *advanced economies* close to the crisis.** At the aggregate level, G-20 growth and unemployment projections broadly reflect historical relationships (Okun's law). However, recent studies show that following recessions underpinned by financial crises,

⁸ *World Economic Outlook*, International Monetary Fund, April 2010.

unemployment decreases by *less* for every percentage point increase in growth than in a typical business cycle.⁹ In this context, the unemployment projections look particularly optimistic for *advanced economies*—where the effects of the crisis were larger—with unemployment rates projected to fall by *more* for every percentage point increase in growth than historical relationships suggest.



17. **There are downside risks to the G-20 projections for growth and unemployment, particularly for *advanced economies*.** The G-20 growth and unemployment projections are subject to downside risks when compared with WEO projections and experiences following past financial crises. While downside risks appear to be more apparent for those *advanced economies* closest to the financial crisis, other *advanced* and *emerging*

⁹ This reflects the persistent impact that financial sector strains have on employment-sensitive sectors of the economy. See *World Economic Outlook*, International Monetary Fund, April 2010.

economies also face important downside risks. To the extent that G-20 projections are consistent across countries, weaker-than-expected growth in some countries will have adverse effects on growth prospects across the G-20 due to trade and financial linkages.

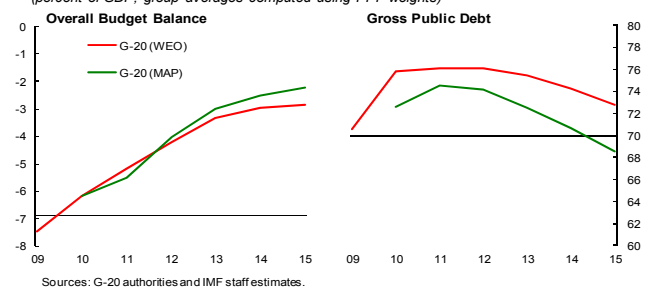
Fiscal Projections Are Relatively Optimistic

18. **G-20 fiscal plans are more optimistic than the WEO because of more favorable growth assumptions.** The G-20 projects an improvement in overall balances of around $\frac{3}{4}$ percentage point of GDP more than the WEO. For *advanced economies*, the improvement in overall balances is around 1 percentage point more than the WEO, while the difference is smaller for *emerging economies* (less than $\frac{1}{2}$ a percentage point). The relatively-rapid fiscal consolidation in the G-20 projections is driven largely by declining expenditure shares in *advanced economies*, in line with the stronger growth projections.

19. Consistent with a more optimistic outlook for growth and fiscal balances, G-20 debt projections are generally more optimistic than the WEO, particularly for high-debt economies.

Overall, the G-20 projects more favorable debt ratios (4 percentage points lower than the WEO by 2015). The divergence is largest amongst *high-debt economies*, with the WEO projecting higher debt in 2015 for both *advanced economies* (by about 4 percentage points of GDP) and *emerging economies* (by about 8 percentage points of GDP). These differences reflect lower growth and less favorable overall balances relative to the G-20 baseline.

G-20 MAP Framework and WEO Projections of Overall Balances and Gross Public Debt
(percent of GDP; group averages computed using PPP weights)



G-20 MAP and WEO Projections of Key Fiscal Variables 1/

(percent of GDP; changes 2015 - 2010)

| | Overall Balance | | Government Expenditure | | Government Revenue | | Gross Debt | | Cyclical Component 2/ | | Interest Payments | |
|-----------------|-----------------|-----|------------------------|------|--------------------|------|------------|-------|-----------------------|-----|-------------------|------|
| | MAP | WEO | MAP | WEO | MAP | WEO | MAP | WEO | MAP | WEO | MAP | WEO |
| G-20 | 4.0 | 3.3 | -2.7 | -2.6 | 1.3 | 0.7 | -4.1 | -3.0 | 1.3 | 0.5 | 0.4 | 0.3 |
| Advanced | 5.3 | 4.4 | -2.9 | -2.0 | 2.3 | 2.4 | 6.4 | 11.0 | 1.5 | 0.8 | 1.2 | 0.8 |
| High debt | 5.4 | 4.5 | -2.8 | -1.9 | 2.5 | 2.6 | 7.5 | 12.8 | 1.6 | 0.9 | 1.3 | 0.8 |
| Low debt | 3.6 | 2.6 | -3.3 | -1.9 | 0.2 | 0.7 | -2.1 | -6.0 | 0.1 | 0.1 | 0.0 | -0.1 |
| Emerging | 1.9 | 1.6 | -0.2 | -1.4 | 1.7 | 0.2 | -7.0 | -11.8 | 0.3 | 0.0 | -0.4 | -0.2 |
| High debt | 2.6 | 1.2 | -3.2 | -1.9 | -0.6 | -0.7 | -8.5 | -4.9 | 0.3 | 0.0 | -0.9 | -0.3 |
| Low debt | 1.3 | 1.7 | 1.8 | -0.9 | 3.1 | 0.8 | -4.6 | -14.6 | 0.4 | 0.0 | 0.0 | 0.0 |

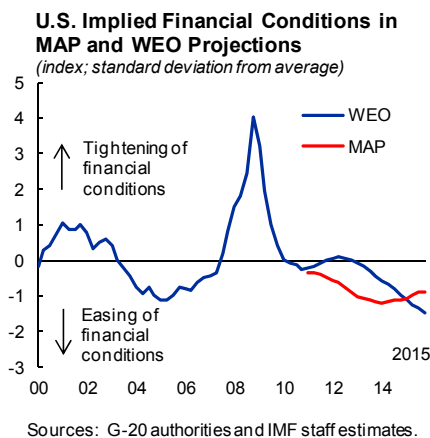
Sources: G-20 authorities and IMF staff estimates.

1/ Country averages computed using rolling PPP weights. High (low) debt advanced economies are those with public debt-to-GDP ratios of more (less) than 60 percent in 2009 (based on WEO data from March 2010). High (low) debt emerging market economies are those with public debt-to-GDP ratios of more (less) than 40 percent in 2009 (based on WEO data from March 2010).

2/ In percent of potential GDP; computed as: Revenue-to-GDP ratio * output gap.

The Financial System may not be Able to Support G-20 Growth Objectives

20. **Overall, for *advanced economies*, the G-20 projections appear to rely on favorable developments in financial markets relative to the WEO, which seem unlikely.** For example, to support the projected strong growth, financial conditions are expected to continue normalizing rapidly in the United States. In contrast, the projected growth outcomes in the WEO reflect a much less optimistic view about financial conditions.¹⁰



21. **Accordingly, there are downside risks to medium-term growth and fiscal positions, should a rapid improvement in financial conditions fail to materialize.** In *advanced economies* hardest hit by the crisis, the health of financial institutions has

not been fully restored and the global financial system remains vulnerable. This in turn implies that *emerging economies* will be subject to spillover effects and attendant downside risks. This underscores further the need for taking appropriate policy actions to put the global financial system on a more resilient footing, notably in Europe. Without further progress on financial sector reform, the financial system may not be able to adequately support the G-20 growth objectives.

¹⁰ The financial conditions index used in the analysis comprises a wide range of financial indicators, including interest rate spreads, credit growth, and bank-lending surveys. See *World Economic Outlook*, International Monetary Fund, April 2011, for more details. The implied path for the financial conditions index is derived from its historical relationship with growth, inflation, and short-term interest rates.

IV. POLICY IMPLICATIONS

The risks identified in the G-20 baseline projections call for urgent collective policy actions to both achieve the agreed growth objectives and to help guard against adverse growth outcomes. Specifically, in advanced economies, the most urgent task is to advance medium-term fiscal adjustment plans while, to the extent possible, supporting economic activity in the short run; in emerging surplus and advanced deficit economies, policies aimed at changing long-term saving patterns are needed to rebalance global demand, facilitated by greater exchange rate flexibility in key emerging economies; further reforms are also needed in advanced economies to fully repair the financial system and make it more resilient to shocks; product and labor market reforms are needed across the membership to boost potential output, notably in advanced surplus economies.

22. **For key advanced economies, the most urgent task is to advance medium-term fiscal adjustment plans while, to the extent possible, supporting economic activity in the short run.** In some countries, notably the *United States* and *Japan*, the immediate priority is for credible efforts to resolve unsustainable debt dynamics in the long run. The fragile state of financial market confidence makes the implementation and communication of credible and coherent plans even more pressing. The plans should include entitlement reforms, caps on discretionary spending, higher revenues through reforms of the tax system, and the establishment or strengthening of fiscal institutions. Plans should be appropriately timed and paced to reduce persistent deficits, create policy space in the short run, anchor sustainability, and restore confidence.

23. **In many advanced economies, long-term fiscal sustainability will also require fiscal consolidation to be accompanied by structural reforms to increase potential growth.** Reforms are needed in the areas of labor and product

markets, particularly in *advanced surplus economies*, where potential output growth is relatively low. For instance, reforms aimed at supporting greater competition and lower markups, lowering hiring costs, and increasing labor force participation, can increase competitiveness, raise potential output growth, and support long-term fiscal solvency.

24. **There is an urgent need to put the global financial system on a firmer footing to ensure G-20 growth objectives.** While financial sector reform—critical to the normalization of financial conditions in many *advanced economies*—is more pressing in Europe due to risks related to sovereign debt and contagion, so far the pace of financial sector reform has been too slow, and the financial system remains vulnerable to shocks, jeopardizing growth objectives. In addition to larger capital buffers, more intensive oversight and scrutiny, enhanced transparency and disclosure requirements, and effective resolution mechanisms at the national and global level are urgently needed. *Emerging surplus economies* also need to strengthen

and deepen financial sectors to better channel savings to more productive use, and to more effectively manage capital flows.

25. Further collective action is needed to reduce global imbalances.

Greater progress is required to reduce imbalances and put the global recovery on a firmer footing to ensure strong, sustainable, and balanced growth. Many of the distortions underlying the large pre-crisis imbalances remain entrenched, including high saving and undervalued exchange rates in some *emerging surplus economies*, and insufficient saving in *advanced deficit economies*. Thus, in *emerging surplus economies*, policies should aim to reduce reliance on external demand through, enhancing social safety nets, reforming corporate governance, reducing factor-market distortions, and developing better-functioning financial markets, supported by greater exchange rate flexibility. In *advanced deficit economies*, concrete measures should be developed to encourage and facilitate higher saving rates.

APPENDIX I: SUMMARY OF G-20 INPUTS

Summary of G-20 MAP Inputs

(as of July 15, 2011; Raw)

| | Argentina | Australia | Brazil | Canada | China | India | Indonesia 1/ | Japan | Korea | Mexico | Russia | Saudi Arabia | South Africa | Turkey | U.K. | U.S. | Euro area | European Union | France | Germany | Italy | Spain |
|--|-----------|-----------|--------|--------|-------|-------|-----------------|-------|-------|--------|--------|-----------------|-----------------|--------|------|------|-----------|-------------------|--------|---------|-------|-------|
| Domestic Variables | | | | | | | | | | | | | | | | | | | | | | |
| Real GDP (% yoy) | | | | | | 2013 | | | | | 2014 | | | | | | 2014 | 2014 | 2014 | | 2014 | 2014 |
| Nominal GDP (% yoy) | | | | | | 2013 | | | | | 2014 | | | | | | 2014 | 2014 | 2014 | | 2014 | 2014 |
| Output Gap (% of GDP) | | | | | | | | | | | | | | | | | | | | | | |
| Private consumption (% yoy) | | | | | | 2013 | | 2011 | | | 2014 | | | | | | 2014 | 2014 | 2014 | | 2014 | 2014 |
| Government consumption (% yoy) | | | | | | 2013 | | 2011 | | | 2014 | | | | | | 2014 | 2014 | 2014 | | 2014 | 2014 |
| Gross fixed investment (% yoy) | | | | | | 2013 | | | | | 2014 | | | | | | 2014 | 2014 | 2014 | | 2014 | 2014 |
| o/w private fixed investment (% yoy) | | | | | | 2010 | | | 2010 | | 2014 | | | | | | 2014 | 2014 | 2014 | | 2014 | 2014 |
| o/w government fixed investment (% yoy) | | 2011 | | | | 2010 | | 2011 | 2010 | | 2014 | | | | | | 2012 | 2012 | 2014 | | | |
| Change in Inventory (% yoy) | | 2013 | | | | 2010 | | 2011 | 2010 | | 2014 | | | | | | 2012 | 2012 | 2014 | | | |
| Imports of goods and services (% yoy) | | | | | | 2013 | | 2011 | | | 2014 | | | | | | 2014 | 2014 | 2014 | | 2014 | 2014 |
| Exports of goods and services (% yoy) | | | | | | 2013 | | 2011 | | | 2014 | | | | | | 2014 | 2014 | 2014 | | 2014 | 2014 |
| Monetary and financial policy | | | | | | | | | | | | | | | | | | | | | | |
| Credit Growth (% yoy) | | | | 2010 | | 2013 | | | | | 2014 | 2012 | | | | | 2010 | | | 2012 | 2010 | 2010 |
| Consumer price inflation (% yoy) | | | | | | 2010 | | | | | 2014 | | | | | | 2014 | 2014 | 2014 | | 2014 | 2014 |
| Private savings (% of GDP) | | | | 2010 | | 2013 | | | | | 2010 | | | | | | 2012 | 2012 | 2012 | | 2010 | 2014 |
| Private debt (% of GDP) | | | | 2010 | | | | | | | | | | | | | 2010 | | | 2012 | | 2010 |
| Fiscal policy (% of GDP) | | | | | | | | | | | | | | | | | | | | | | |
| Primary Balance | | | | | | 2013 | 2014 | | | | | | | | | | 2014 | 2014 | 2014 | | 2014 | 2014 |
| General Government Balance | | | | | | 2013 | 2014 | | | | 2014 | | | | | | 2014 | 2014 | 2014 | | 2014 | 2014 |
| Government revenue (general government) | | | | | | 2010 | 2014 | | | | 2014 | | | | | | 2014 | 2014 | 2014 | | 2014 | 2014 |
| o/w tax revenue | | | | | | 2010 | 2014 | | | | 2014 | | | | | | 2014 | 2014 | 2014 | | 2014 | 2014 |
| Government expenditure (general government) | | | | | | 2010 | 2014 | | | | 2014 | | | | | | 2014 | 2014 | 2014 | | 2014 | 2014 |
| o/w interest payments | | | | | | 2013 | 2014 | | | | 2014 | | | | | | 2014 | 2014 | 2014 | | 2014 | 2014 |
| Gross government debt (general government) | | | | | | 2013 | 2014 | | | | 2014 | | | | | | 2014 | 2014 | 2014 | | 2014 | 2014 |
| Net government debt (general government) | | | | | | 2013 | 2014 | | | | 2014 | | | | | | 2014 | 2014 | 2014 | | 2014 | 2014 |
| Interest rate (short-term - 3 month T-bill) (%) | | | | | 2010 | 2013 | 2014 | 2010 | | | | 2010 | | | | | 2014 | 2014 | 2014 | 2013 | 2014 | |
| Interest rate (long-term - 10 year T-bond) (%) | | | | | 2010 | 2013 | 2014 | | | | | | | | | | 2014 | 2014 | 2014 | 2013 | 2014 | 2014 |
| Labor markets | | | | | | | | | | | | | | | | | | | | | | |
| Population growth (% yoy) | | | | | | 2013 | | | | | 2014 | 2010 | 2010 | | | | 2012 | 2012 | | | 2014 | |
| Employment Growth (% yoy) | | | | | | | | 2010 | | | 2014 | 2010 | | | | | 2014 | 2014 | 2014 | | 2014 | 2014 |
| Unemployment rate (%) | | | | | | | | | | | 2014 | 2010 | | | | | 2014 | 2014 | 2014 | | 2014 | 2014 |
| External development | | | | | | | | | | | | | | | | | | | | | | |
| Value of imports from developing countries (US\$) | | | | 2010 | | 2010 | 2010 | | | | | | | | | | | | | 2012 | | 2010 |
| Value of remittances to developing countries (US\$) | | | | 2010 | | 2010 | 2010 | | | | | | | | | | | | | | | |
| Foreign direct investment to developing countries (US\$) | | | | 2010 | | 2010 | 2010 | | | | 2014 | | | | | | | | 2010 | 2010 | | 2010 |
| Official development assistance (US\$) | | | | 2010 | | 2010 | 2010 | 2010 | | | 2014 | | | | | | 2010 | | | 2012 | 2010 | 2011 |
| External variables | | | | | | | | | | | | | | | | | | | | | | |
| Current account (external) balance (% of GDP) | | | | | | 2013 | | | | | 2014 | | | | | | 2012 | 2012 | 2012 | 2012 | 2014 | 2014 |
| Trade balance (Good and Services, % of GDP) | | | | | | 2013 | | 2010 | | | 2014 | | | | | | 2012 | 2012 | 2012 | 2012 | 2014 | 2014 |
| Net income flows and current transfers (% of GDP) | | | | | | 2013 | | 2010 | | | 2014 | | | | | | 2012 | 2012 | 2012 | 2010 | 2014 | 2014 |
| Financial account (excluding official reserves transactions, % of GDP) | | | | | | 2010 | 2013 | | | | 2014 | | | | | | 2010 | 2010 | 2010 | 2010 | | |
| Net international investment position (% of GDP) | | | | | | 2010 | 2010 | | | 2010 | 2014 | | | | 2010 | | | | | 2012 | 2010 | 2010 |
| Trade weighted export market growth rate (%) | | | | | | | | | | | | | | | | | 2012 | 2012 | 2012 | | 2014 | 2014 |
| Nominal exchange rate assumption (currency unit/US\$) | | | | | | 2010 | 2010 | 2011 | 2011 | | 2014 | | | | | | 2012 | | 2014 | | 2014 | 2014 |
| Real exchange rate assumption (currency unit/US\$) | | | | | | | | | | | 2010 | | | | | | | | | | | |
| Real effective exchange rate assumption (currency unit/US\$) | | | | | | 2010 | | | 2010 | | 2014 | | | | | | 2012 | 2012 | 2014 | | | |
| Oil and other relevant commodity price assumptions (US\$) | | | | | | 2013 | 2012 | 2011 | | | 2014 | | | | | | 2014 | 2014 | 2014 | | 2014 | 2014 |

Full Submission (20010:2015)
 Partial Submission (last year available)
 No submission

1/ Private and government fixed investment: partial submission (2011-2015).

G R O U P O F T W E N T Y



PEOPLE'S REPUBLIC OF CHINA SUSTAINABILITY REPORT ¹



Prepared by Staff of the

I N T E R N A T I O N A L M O N E T A R Y F U N D

¹ *Report 4 of 10.* At the request of the G-20, IMF staff has provided analyses and assessments of member's economies and policies in a set of reports for the Mutual Assessment Process (MAP). These reports serve as inputs for the Action Plan agreed by G-20 Leaders at the Cannes Summit. The 2011 Staff Reports for the 20 MAP consist of the following: (i) an Umbrella Report that provides an integrated summary of the component reports and an upside scenario for G-20 collective action; (ii) an Accountability Report that summarizes members' progress toward policy commitments since the Seoul Summit in 2010; (iii) a MAP Report providing analysis of members' medium-term macroeconomic and policy frameworks; and (iv) Sustainability Reports for seven members (China, France, Germany, India, Japan, United Kingdom, and United States)—identified by G-20 indicative guidelines—to assess the root causes and policy implications of key imbalances.

EXECUTIVE SUMMARY

G-20 indicative guidelines identified China as experiencing significant imbalances in private saving and the current account. These imbalances reflect extensive distortions, which have affected saving behavior in all the main sectors—households, firms, and the government. Rebalancing the economy consequently requires wide-ranging reforms, including strengthening social insurance, appreciating the exchange rate, and raising domestic interest rates. Such steps would improve welfare, both in China and the rest of the world. That is why the Chinese authorities have made these measures the crux of the nation's new Five-Year Plan.

The roots of China's imbalances lie deep in the economy's structure.

- Household saving is high, primarily because holes in the social safety net and credit rationing have forced families to accumulate funds for education, health, and old age.
- Corporate saving has been boosted by subsidized inputs (such as land, water, energy, and capital), lack of domestic competition for state-owned enterprises, and a lack of incentives for SOEs to pay dividends.
- Government saving is also high, partly because foreign exchange intervention (to limit appreciation and offset low domestic demand) has been sterilized at below-market interest rates, effectively transferring income from households to the budget.

Removing these distortions would benefit China and the rest of the world.

- Rebalancing could re-equilibrate the distribution of income back toward households, allowing them to raise consumption from relatively low levels as a percent of GDP.

- Greater reliance on domestic demand would also have wider benefits, because it would offset the impact on world growth of slower domestic demand in major advanced economies and reduce the risks that arise from global imbalances.

Rebalancing China's economy requires a range of measures.

- These include strengthening social safety nets; liberalizing and developing the financial system; increasing distributions from SOEs; removing factor cost distortions; and allowing greater competition in domestic markets.
- The exchange rate would need to appreciate, to redirect resources and prevent overheating as domestic demand accelerates.
- Most of these policies are already contained in China's new Five-Year Plan. But determined and sustained implementation will be needed to alter the deeply entrenched incentives to save.



INTERNATIONAL MONETARY FUND

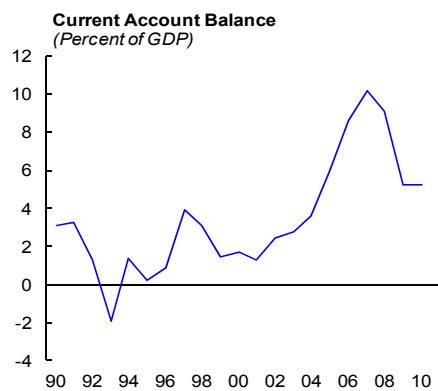
PEOPLE'S REPUBLIC OF CHINA SUSTAINABILITY REPORT 2011¹

China's rapid growth has been accompanied by large external surpluses, reflecting an exceptionally high level of national saving. Behind this high saving lie a number of distortions, which have reduced welfare both in China and the rest of the world. To address this problem, policies will need to bolster social insurance, increase exchange rate flexibility, and liberalize domestic interest rates.

I. BACKGROUND

1. **China has followed an unusual development path, combining exceptionally rapid growth with large external surpluses.** Most other countries in the early stages of economic take off have run current account deficits, drawing on foreign saving to fund their abundant investment opportunities. But China has been different: it has run a current account surplus persistently for the past two decades. For some time, the surplus remained quite stable and modest, but in 2003 it suddenly began to surge, reaching 10 percent of GDP by 2007. A rising trade surplus accounted for over three-quarters of the rising current account balance, with the remainder largely due to a higher income surplus.² Since then, the current

account surplus has receded to about 5 percent of GDP. Still, it remains well above its 1990s levels and significantly above the G-20 average.



Source: IMF, World Economic Outlook.

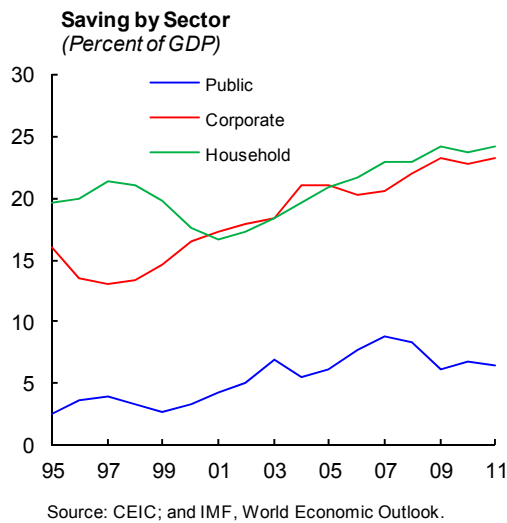
2. **The large current account surpluses reflect exceptionally high rates of saving.**

- *National saving as a percent of GDP has been rising steadily for the past two decades. Nearly half of the total has traditionally come from the household sector, but the contribution of corporate saving has increased very rapidly and is now almost equally*

¹ Prepared by Shaun Roache under the guidance of Josh Felman, with input from Derek Anderson and the support of Eric Bang, David Reichsfeld, and Anne Lalramnghakhleli Moses.

² This reflects, in part, rising net interest income receipts from accumulating net foreign assets comprised mainly of foreign exchange reserves.

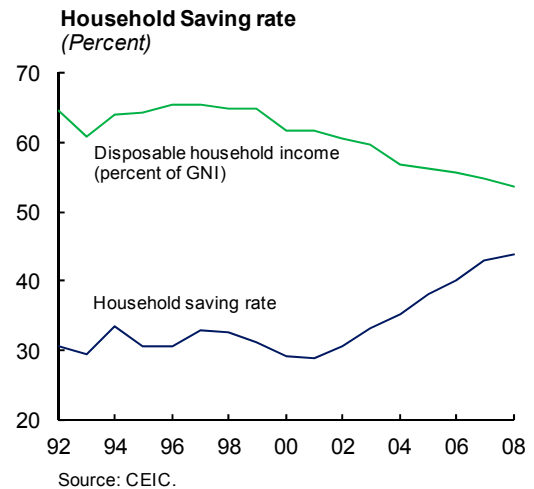
large, while public saving has also made a significant contribution. Saving by all three sectors as a percent of GDP is now among the highest in the G-20 (excluding oil exporters). As a result, the overall national saving rate now stands at 54 percent of GDP, more than double the average for the other G-20 countries (excluding oil exporters).



- *The rise in household saving as a percent of GDP has been particularly striking, because household incomes have actually been falling relative to GDP. Employment growth has been disappointing relative to the pace of economic growth, while rural wages and business incomes have stagnated, and capital income has been hit by a sharp decline in real deposit rates. These factors have more than offset a rapid rise in wages in the modern manufacturing sector.³ Accordingly, the*

³ The link between labor compensation in urban and rural areas is weakened by the household
(continued)

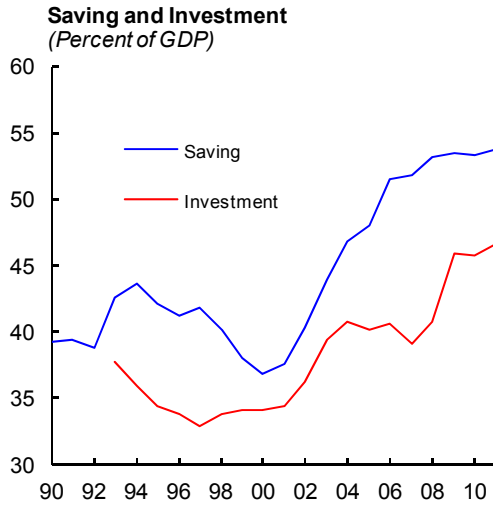
rate of household saving has soared to extraordinary heights when measured relative to disposable income. As household saving has risen, the consumption share has fallen to less than one-third of GDP.



3. The rise in saving has been accompanied by a similar—but less pronounced—increase in the investment rate.

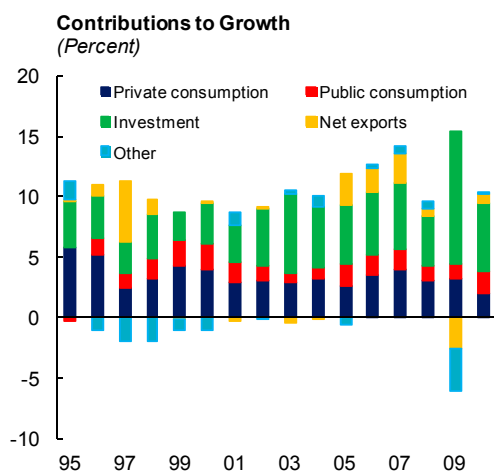
- *In fact, China's growth model has been remarkably capital-intensive, considering the country's abundance of labor. The capital stock has grown at an estimated 12 percent annual rate since 2000, far exceeding employment growth, which has averaged less than 1 percent per year.*

registration system, which impedes labor mobility and sustains wage gaps, even after accounting for differences in productivity. As a result, the disparities between rural and urban incomes, as well as health and education outcomes, have widened significantly in recent years. See Meng and Zhang (2001).



Source: IMF, World Economic Outlook.

- *From a demand perspective investment—not net exports—has been the primary contributor to the country's 10 percent average growth over the past two decades. The surge of investment has taken place in two waves, the first coming in the early 2000s as the country built up its heavy industries (such as steel, machinery, and chemicals) and the second following the global financial crisis, as the government's stimulus package set off a large construction boom.*



Source: IMF, World Economic Outlook.

- *Following these surges, investment now stands at 46½ percent of GDP, higher than in any other G-20 country.⁴ Even so, it remains well below the level of national saving.*

4. **China's model of growth, while resulting in important imbalances, has also lifted a remarkable number of people out of poverty.** Between 1981 and 2004, the proportion of China's population below the World Bank's defined poverty line fell from 65 percent to 10 percent, a decline of over half a billion people.⁵ A fall in the number of poor of this magnitude over such a short period is without historical precedent.

A. Prospects

5. **Both the Chinese authorities and IMF staff expect that the surges in saving and investment will come to an end over the medium term.** The prospects for the current account depend on whether saving slows more than investment.

- *Both expect that the current investment boom will fade as the macroeconomic stimulus unwinds and construction returns to a more normal pace.*
- *Assessments of the prospects for saving differ significantly, however. The Chinese authorities believe that the*

⁴ Based on IMF staff estimates for 2010 in the September 2011 WEO and excluding inventory accumulation.

⁵ *An Assessment of Poverty and Inequality in China*, 2009, World Bank report no. 47349-CN.

wide-ranging reform agenda set out in the Five-Year Plan (Box 1) will rebalance the economy in favor of consumption. Accordingly, they expect that saving will decelerate at about the same pace as investment, so the current account surpluses would remain below 5 percent of GDP. As for the exchange rate, they emphasize progress made in increasing its flexibility, while noting the generally weak relationship between exchange rate movements and the current account.

- *In contrast, IMF staff perceives that the incentives to save have not yet changed sufficiently to alter fundamental behavior.* While the Five-Year Plan holds out considerable potential to

change this situation, it may take some time before a critical mass of measures is in place, and further time before the effects are felt. Accordingly, IMF staff expects the current account surplus to rise again as the investment boom fades, gradually reaching about 8 percent of GDP over the medium term. (This projection assumes that the saving rate falls only gradually, while the real effective exchange rate is maintained at current levels.) In other words, without additional and prompt action, large imbalances will reassert themselves.

6. **Accordingly, China was identified in stage 1 of the Sustainability Exercise as having significant imbalances in private saving and the current account.**

Box 1: How the Twelfth Five-Year Plan Targets a Rebalanced Economy

China's Twelfth Five-Year Plan, covering the period 2011–16, sets out an ambitious reform agenda that—if implemented in a timely manner and sequenced appropriately—would move the economy much further towards a balanced growth path.

The agenda includes:

Expanding domestic consumption, to be achieved through: stronger social safety nets (including health and retirement programs); an increased supply of health services; and economic growth that is more labor-intensive and which can raise the growth rate of wage income, particularly for the lowest-paid (including raising the minimum wage).

Rebalancing the sectoral structure. One notable target is to raise the service sector's contribution by 4 percentage points of GDP to 47 percent, in part by liberalizing markets (including reducing barriers to entry), equalizing factor costs (including power, water, and heating) with the industrial sector, and improving the managed floating exchange rate regime based on market supply and demand. Enhanced environmental protection and safety may also moderate investment growth in heavy industry.

Further liberalizing the financial sector and improving access. Plans include market-based reform of interest rates, increasing capital account openness, and the strengthening of rural financial institutions to boost access to credit and other financial services.

II. ROOT CAUSES OF IMBALANCES

China's imbalances are rooted deep in the economy's structure. They can be traced back to the signature measure of the 1990s, the reform of state-owned enterprises (SOEs), which first paved the way for rising saving and external surpluses. Subsequent policies, together with distortions that have built up over the years, have resulted in an economic framework that has sustained high saving and exacerbated external imbalances.

7. **By the 1990s, a reform of the SOEs was much needed.** In previous decades, agriculture had been liberalized and private enterprise allowed to flourish. But the manufacturing sector remained dominated by large state firms, which were absorbing the bulk of the country's saving yet were producing little economic return. In response, the government enacted a sweeping set of measures, aimed at improving SOE efficiency and profitability. Most notably, enterprises were relieved of their obligation to provide social services (such as medical insurance and pensions) to their employees and were instructed to operate instead on a commercial basis. In addition, many enterprises benefitted from capital injections and debt reductions.

8. **The reform proved remarkably successful.** The newly unshackled SOEs improved their efficiency significantly, becoming internationally competitive in many cases, particularly in heavy industries. This triggered an investment boom, which has led to a significant increase in China's industrial capacity—that is, the size of its tradable goods sector.

9. **At the same time, the subsequent evolution of policies produced the**

imbalances that characterize the economy today. In effect, the SOE reform transferred resources from the household sector (and the government) to firms. In and of itself, this was hardly decisive. As the SOEs improved their productivity, the returns would normally have flowed back to households and the government, thereby restoring the distribution of income and minimizing any consequences for imbalances. But this did not happen. Instead, the imbalances only grew larger, reflecting a complex variety of factors. In part, the evolving growth model brought to the fore some existing distortions (such as the failure of SOEs to pay dividends). In part, SOE reform created new ones (such as the lack of a social safety net). Also important was the government reaction (such as its foreign exchange policy). All of these factors acted to preserve and even intensify the imbalances.

A. Corporate Saving

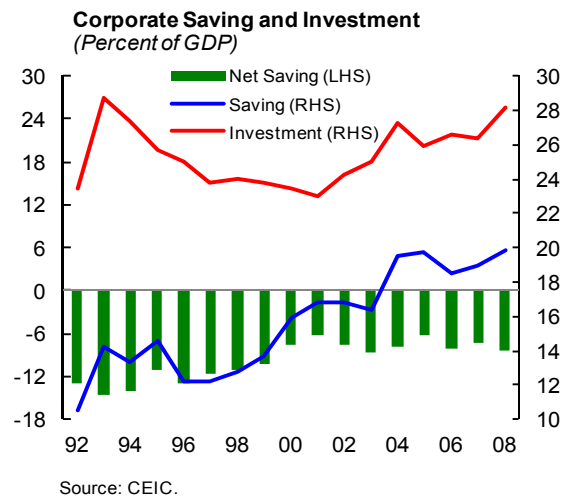
The high levels of corporate saving are partly the product of market forces, but importantly the result of sizeable distortions—to the prices of factor inputs, product market competition, and dividend policy.

10. **The SOE reforms initially produced a sharp rise in corporate saving.** As firms improved their efficiency and expanded their operations, profits soared and investment followed. In most cases, the increase in capital intensity would have eventually driven down rates of return, causing profitability to subside. Remarkably, the opposite has occurred: the corporate saving rate has continued to increase for nearly two decades (though at a diminished pace since 2005).

11. **Several factors explain why, some related to market forces at work in the economy.** For example, the composition of the economy has been changing, as the SOEs that have encountered diminishing returns have been giving way to an even more efficient private sector. Over the past few decades, the locus of global manufacturing activity has shifted to China, as the country has become the “workshop of the world”. This shift has boosted profits not only in China but in companies throughout the world, as both sides have benefitted from the specialization allowed by international trade.

12. **Another factor sustaining profitability may be the abundant supply of labor.** The large reservoir of poorly-paid rural workers may have depressed manufacturing wages, preventing them from rising in line with productivity, and allowing firms to capture the benefits as profits. This may be a key reason why the labor share of income has fallen. Official data on the manufacturing sector, however, shows that wages have

risen rapidly, essentially in line with productivity.



13. **Other factors are directly related to policy distortions:**

- *Subsidized factor input prices.* Factor inputs, such as land, water, energy, and capital, have increasingly been subsidized in recent years, effectively transferring growing amounts of public resources to the corporate sector. Studies estimate the total value of China’s factor market distortions has now reached almost 10 percent of GDP.⁶
- *Market power of SOEs.* Profits in key sectors have not been competed away by other firms, because the policy framework has encouraged large SOE “national champions” that enjoy significant domestic market power.⁷

⁶ China: Article IV Staff Report, July 2010. See also the related China Spillover Report, July 2011.

⁷ Song, Storesletten, and Zilibotti, 2011; Tyers and Lu, 2008.

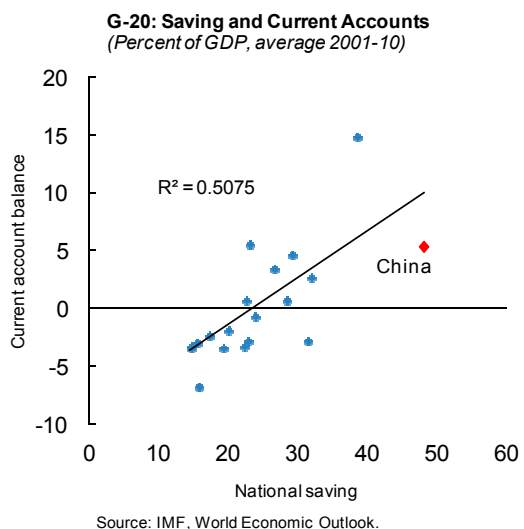
- *Dividend policy.* Finally, the increase in profits has largely been saved, since SOEs have had no incentive to pay dividends, nor have they really been forced to do so. (In some cases, dividends have been paid out to state administrators, which have then recycled them back to the firms.)

14. **But all this raises a question: if these distortions have boosted profits, why haven't they had a similarly powerful effect on investment?**⁸ In countries where capital controls allow interest rates to be determined domestically, higher saving normally reduces interest rates and spurs investment. China's real interest rates have declined, but the rise in investment, until recently, has been smaller than the rise in saving. The likely reason is that as the level of investment increases, implementation costs (managerial and otherwise) rise even more rapidly, putting a brake on this activity. And China's rate of investment is remarkably high—at 45 percent of GDP, it is the highest in the G-20 by far, implying that the "adjustment costs" (i.e., of further increases in investment) are exceptionally high.⁹ Accordingly, countries with unusually high levels of gross national

⁸ Ferri and Liu, 2010; Huang and Tao, 2010.

⁹ For this reason, investment is quite insensitive to the marginal value of additional capital (represented by Tobin's Q, the ratio of the market value of an asset to its replacement cost). For example, estimates of the elasticity of investment to Q often range between 0.01-0.05.

saving tend to have positive *net* saving; i.e., current account surpluses.



B. Household Saving

Household saving has been affected by three key distortions: large holes in the social safety net, credit rationing and interest rate distortions, and, to a lesser extent, the household registration system.

15. The 1990s SOE reform affected household saving in two key ways.

- *Dismantled social safety nets.* The removal of SOEs' social obligations shifted much of the burden of providing for sickness and old age onto households. They responded by increasing their precautionary saving, a phenomenon that has only intensified in recent years as the population has begun to age.

- *Housing privatization.* The related privatization of the housing stock has led younger households to increase their saving to accumulate the funds required to purchase property. A growing population of young workers must now save for the substantial down payments required for a property purchase.¹⁰ As the economy has boomed and housing prices have increased, saving requirements have grown commensurately.

16. **These changes interacted with distortions from financial sector restrictions and controls:**

- *Credit rationing and interest rate distortions.* With interest rates being held below market levels, loan demand has long been high and banks have been forced to ration credit. In these circumstances, banks have preferred to lend to SOEs that benefit from implicit state guarantees. Accordingly, saving has been the only way for most households to insure against risks, smooth their consumption in the event of unanticipated expenditures, or purchase housing.¹¹ Rationing has also forced smaller businesses to self-fund

¹⁰ The increasing number of households and rising demand for upgraded property relative to the supply of pre-SOE reform housing stock mean that privatization should increase aggregate household saving.

¹¹ Though mortgages have become increasingly common in recent years.

investment projects. At the same time, low real interest rates reflecting controls have reduced household deposit income (see the following section).

- *Household registration system.* Finally, labor income itself has been held back, in part, because the household registration system has fragmented the labor market, so that demand for labor in the fast-growing coastal provinces has had only limited effects on wages inland. Empirical research has found significant evidence that rural migrants are segregated from their urban counterparts in terms of job opportunities and wages, although labor market competition between the two groups is increasing.¹²

17. **In recent years, China has been repairing the social safety net, but still more needs to be done.** Significant resources have been allocated to improving the pension, healthcare, and education systems. A new rural pension scheme has been launched, pension benefits have been made portable, subsidies for health insurance increased. But gross social transfers are still well below international comparators, and large gaps in the net consequently remain. For example, the health system still creates a strong incentive for precautionary saving because out-of-pocket expenses are high

¹² Knight and Yueh (2009); Wu (2005).

and coverage for catastrophic illnesses is limited.

C. Policy Response: Adapting to High Saving

The government has reacted to rising saving by encouraging exports, so that aggregate demand will be sufficient to sustain output close to potential. To do this, they have intervened on the foreign exchanges and accumulated reserves, thereby keeping the exchange rate at a low (i.e., depreciated) level. In effect, this approach has allowed the economy to adapt to high levels of saving. Moreover, the way in which this intervention has been sterilized has transferred income to the government, reinforcing domestic saving and thereby sustaining the imbalances.

18. As higher saving has pushed up the current account balance, the authorities have reacted in a variety of ways.

- *Exchange rate appreciation.* To a certain extent, the exchange rate has been allowed to appreciate. The real effective exchange rate (REER) during the first eight months of this year has been about 13 percent higher than the average for the previous two decades. This is a significant amount. But it falls far short of what might be expected, given the evolution of China's economy over this period, particularly its productivity gains relative to trading partners. And while market forces have played a growing role in exchange rate determination since 2005, it is striking that there has

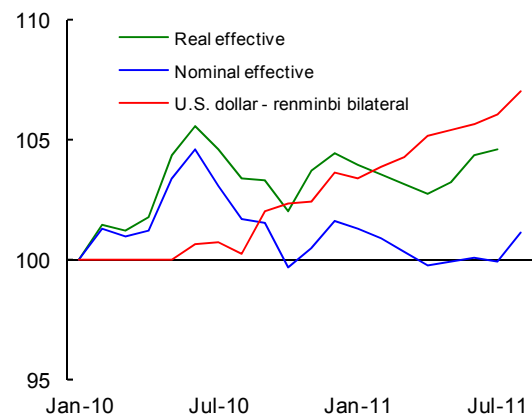
been almost no appreciation of the real effective exchange rate so far this year, despite an unusually large increase in international reserves. One possible explanation is that the real exchange rate has had to remain low so that weak domestic demand could be offset by high external demand, thereby keeping aggregate output close to potential. According to Fund staff estimates, this leaves the REER substantially below the level consistent with medium-term fundamentals.

Relative Productivity and the Real Exchange Rate 1/
(log change multiplied by 100 from 1990)



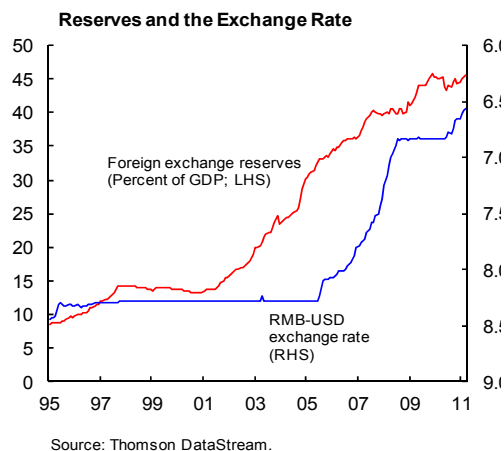
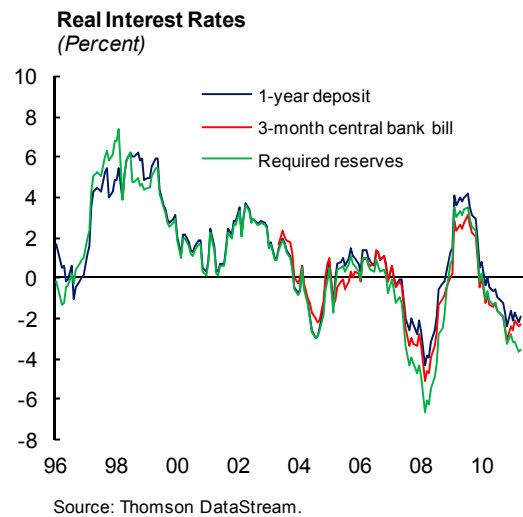
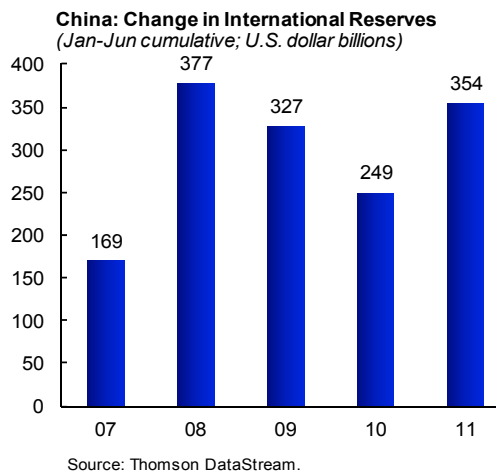
Source: IMF staff estimates.
1/ Relative productivity of tradables-nontradables in China (relative to trading partners).

China - Recent Exchange Rate Developments
(Jan 2010=100, + = appreciation)



Source: Thomson DataStream.

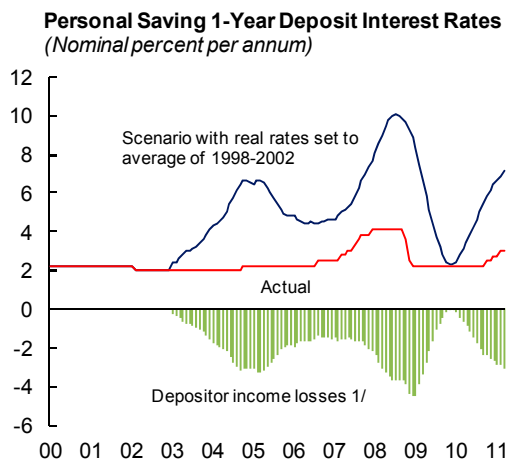
- Massive sterilization.* China has responded to the large current account surpluses by purchasing foreign exchange and sterilizing the proceeds. As a result, reserves now exceed \$3 trillion, nearly half of GDP, while sterilization instruments account for almost the same amount. Since reserves began rising sharply in 2001, the required reserve ratio on domestic renminbi deposits has been ratcheted higher on more than 30 occasions to reach its current 21 percent. The central bank has also issued a large quantity of short-term bills.
- Distorted interest rates.* This sterilization has been achieved at below-market interest rates. Key interest rates declined in real terms after the surpluses started to accelerate in the early 2000s. In fact, real rates on required reserves (the key sterilization instrument), central bank bills, and deposits have been very low for most of the subsequent period and negative when the current account surplus was at its peak. Savers have been unable to respond by shifting funds abroad, because of extensive capital controls.



- *Implicit transfers from households to government.* As a result, sterilization has resulted in a large transfer from households (depositors) to the government (borrowers).¹³ Since 2003, annual household interest earnings have been up to 4 percentage points of GDP lower than if real interest rates had been maintained at their 1998–2002 average.¹⁴

that might have been consumed, thereby adding to national saving. The process was only reversed in the wake of the global financial crisis, when the government decided to shift its fiscal stance and stimulate the economy.

19. **In summary, key elements of the policy response have actually helped sustain the imbalances.**



- *Increased national saving.* This process of sterilization-and-transfer reinforced the current account surplus in the period leading up to 2008, because the government effectively saved funds

¹³ Corporations have benefitted much less, because they have large deposits as well as loans, a reflection of their high saving rate.

¹⁴ Note that the peak transfers occurred in 2008, close to when the current account surplus reached its peak (2007).

III. ASSESSMENT OF IMBALANCES

China's growth model has been based on high domestic saving, counterbalanced by high external demand and equilibrated by a low real exchange rate. In many respects, it has been remarkably successful, delivering rapid growth and lifting millions out of poverty. But as the authorities recognize, the model ultimately needs to change.

20. The removal of key distortions would bring two critical benefits to China (see section IV below for details):

- *Higher household consumption.* Rebalancing could re-equilibrate the distribution of income back toward households, allowing them to raise their consumption share from its current low level (as a percent of GDP), which is less than half the level in most other G-20 countries. Rebalancing could also address rising inequality between rural and urban households, since it is the former that particularly lack social insurance, access to credit and other financial services, and the ability to supply labor to fast-growing industries.
- *Enhanced macroeconomic control.* Rebalancing could enable the monetary policy framework to move away from quantitative controls (which have the side-effect of shifting transactions away from the regulated banking system) toward a market-based framework that can aim more efficiently at inflation and financial stability targets. It would also allow broader financial sector reforms that would end credit rationing and improve the allocation of the nation's saving.

21. A reduction in China's imbalances would also benefit the global economy.

Typically, the rest of the world would respond to an increase in saving by a large country such as China by reducing interest rates. This would have the advantage of bolstering domestic demand, thereby maintaining output at potential. But in the current circumstances advanced countries do not have this option: their interest rates are already so low they cannot decrease them if desired global saving increases. In other words, they are in a liquidity trap.¹⁵ In this case, large current account surpluses in some countries can lead to low aggregate demand and lower output in other countries.¹⁶ Conversely, if China were able to rebalance its economy toward domestic demand, this could increase global output.

22. That said, global rebalancing needs to be a multilateral exercise—as emphasized in the G-20 MAP.

¹⁵ Blanchard and Milesi-Ferretti (2011).

¹⁶ In principle, these countries could use fiscal policy to sustain domestic demand, but in the current circumstances the room for fiscal policy is severely curtailed by debt sustainability concerns.

IV. HOW TO ADDRESS IMBALANCES?

To rebalance its economy, China needs to address the underlying structural factors that contribute to its high saving and current account surpluses. Most of the needed measures are already contained in the Five Year Plan. But implementation will be key, and in some cases (such as the exchange rate) more needs to be done.

A. Policy Priorities

23. **Strengthen social safety nets.**

Recent analysis by IMF staff indicates that higher government social spending allows households to reduce their precautionary saving, with important income, insurance, and distributional (and welfare) effects. In particular, a sustained 1 percentage point of GDP increase in government social spending would allow households to increase their consumption ratio by up to 1¼ percentage points of GDP.¹⁷ Accordingly, China should continue to improve access to high quality healthcare, reduce out-of-pocket expenses, and bolster coverage for catastrophic illness. It would also be important to consolidate the complex and fragmented patchwork of various national, provincial, government and occupational pension schemes for migrant and rural workers.

24. **Increase exchange rate flexibility.**

Boosting domestic consumption, including through social safety net reforms, would increase domestic demand. To avoid overheating, and a possibly disruptive real exchange rate appreciation through higher

domestic inflation, the nominal exchange rate should be allowed to appreciate on a multilateral basis (that is, in nominal effective terms). This would also change firms' incentives, encouraging them to rebalance their investment away from the export-focused tradable sector and towards the domestic service sector. Moreover, by allowing the exchange rate to absorb more of the ongoing appreciation pressures, it would also reduce the need for sterilization. Interest rates could then be allowed to rise to market levels, reducing the implicit tax on households and allowing them to raise their consumption.¹⁸

¹⁷ Baldacci, Callegari, Coady, Ding, Kumar, Tommasino, and Woo (2010) and Barnett and Brooks (2010).

¹⁸ China 2011 Article IV IMF staff report.

Box 2. Processing Trade and Rebalancing in China¹

A recent note by UNCTAD, prepared for the G20, emphasized the role of processing trade in China's external imbalances.² It argues that, because of the large role that processing plays in China's external commerce, exchange rate appreciation may not have much impact on reducing imbalances.^{3 4} As evidence, UNCTAD claims that China's real effective exchange rate based on unit labor costs (REER-ULC) has appreciated strongly since 1994, but rebalancing has not yet occurred. How valid are these arguments?

Certainly, processing trade is important. Nearly half (though the proportion is diminishing) of China's exports are processed goods that use imported technology, raw materials, and intermediate inputs. This means that gross exports significantly overstate the domestic value added in China's export activities.

This indeed matters for rebalancing. The greater the proportion of processing in total trade, the smaller the impact of real exchange rate (RER) changes on trade volumes because such changes only affect the competitiveness of domestic value added operations, rather than total gross exports. However, a second opposing effect is that domestic services are used as an intermediate input in manufacturing exports—for example, transportation and financial intermediation. The competitiveness of these services will also factor into the competitiveness of manufactured exports, increasing trade sensitivity to the RER.

In fact, these two effects largely seem to cancel each other out. Recent IMF staff analysis suggests that for a given reduction in China's trade surplus as a percent of GDP, the presence of processing trade alone would increase the required multilateral RER appreciation by around 50 percent (relative to a "gross trade" baseline model), as implied by the UNCTAD analysis. But the additional required appreciation is reduced to 7 percent when account is taken of domestic service sector inputs into manufactured exports. Similar offsetting effects are found for the relatively smaller processing trade sector in the United States. This means that traditional "gross trade" models still provide useful insights into the RER adjustment that would be consistent with external rebalancing in China.

But what of the claim that the REER-ULC has appreciated by 40 percent between 2000 and 2010, without a noticeable impact on China's external imbalances? In fact, IMF measures show no such appreciation; UNCTAD's figures seem to stem from flawed or incomplete wage data. For example, the claim of deteriorating competitiveness is difficult to square with the steady rise in corporate saving (essentially, profits). Also, if wages have been outstripping productivity, then the labor share of income should be rising, not falling. So, most likely there has not actually been a sharp appreciation of the REER-ULC.

In the end, as other IMF studies indicate, the effects of multilateral exchange rate appreciation on the current account are likely to be broadly similar in China to those in other countries.

¹ This box draws on Bems (2011).

² UNCTAD, 2011, Background Note on Processing Trade and China's External Imbalances. See also WTO, 2011, Measuring Trade in Value Added and its Implications for Understanding Global Imbalances.

³ Empirical estimates of this ratio for China range between 0.50-0.70. In comparison, for the world as a whole the ratio is estimated at 0.75.¹

⁴ At one point, the note emphasizes a different – and entirely valid point -- that a *bilateral* appreciation against the U.S. dollar will not have much impact on imbalances, if it does not translate into an REER appreciation (e.g., if the renminbi just "follows the dollar down").

25. **Liberalize and develop the financial system.** This would provide households and firms with a broader range of financing possibilities, again allowing them to increase their consumption and investment. Recent IMF staff estimates suggest that financial sector reform, together with an appreciated real exchange rate and more developed capital markets, would have a significant impact on external imbalances.¹⁹ For example, the expansion of nonbank financial intermediation, including a well-functioning bond market, could facilitate growth in private pensions and insurance, reducing the need for households to save (and effectively help the government expand the safety net).

26. **Raise distributions from the profits of state-owned enterprises.** Majority state-owned publically listed Chinese enterprises pay dividends to stockholders but have not distributed significant amounts to the government. Raising the current payout rate of zero to 15 percent (as announced in 2007 but not yet implemented) would bring China closer into line with international comparators and reduce gross corporate saving. If the proceeds are, in turn, consumed by the government or transferred to households, this would boost aggregate consumption.

27. **Improve labor mobility by liberalizing the household registration system.** This would ease labor market constraints in fast-growing regions, and spur more labor-intensive growth in these parts of the country. At the same time, it would improve incomes in rural areas, thereby helping to narrow the wide rural-urban income inequalities.

28. **Remove factor cost distortions and allow greater competition in domestic markets.** The costs of major factor inputs, such as land, energy, and water need to be raised to market levels, to ensure a more efficient allocation of resources and a more appropriate pricing of externalities. Steps should also be taken to reduce barriers to entry. Both steps would help scale back the corporate saving that arises from redistribution, rather than competition and market forces.

¹⁹ Geng and N'Diaye (forthcoming).

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G R O U P O F T W E N T Y



FRANCE

SUSTAINABILITY REPORT ¹



Prepared by Staff of the

I N T E R N A T I O N A L M O N E T A R Y F U N D

¹ *Report 5 of 10.* At the request of the G-20, IMF staff has provided analyses and assessments of member's economies and policies in a set of reports for the Mutual Assessment Process (MAP). These reports serve as inputs for the Action Plan agreed by G-20 Leaders at the Cannes Summit. The 2011 Staff Reports for the 20 MAP consist of the following: (i) an Umbrella Report that provides an integrated summary of the component reports and an upside scenario for G-20 collective action; (ii) an Accountability Report that summarizes members' progress toward policy commitments since the Seoul Summit in 2010; (iii) a MAP Report providing analysis of members' medium-term macroeconomic and policy frameworks; and (iv) Sustainability Reports for seven members (China, France, Germany, India, Japan, United Kingdom, and United States)—identified by G-20 indicative guidelines—to assess the root causes and policy implications of key imbalances.

EXECUTIVE SUMMARY

France's public finances have deteriorated over the past decade—owing, in part, to rising social spending pressures. At the same time, the current account balance has gradually worsened from a surplus to a moderate deficit—largely due to rising labor costs. Consolidation is needed to ensure fiscal sustainability, while structural reforms are critical to improving competitiveness and keeping the current account deficit in check.

Large fiscal imbalances reflect structural factors and the impact of the financial crisis. Public debt has increased due to rising expenditures on social security and by local governments, weaknesses in fiscal institutions, and the costs associated with the global recession.

The deterioration of the current account reflects worsening competitiveness. Wages have grown faster than in neighboring countries, while total factor productivity growth has grown relatively slowly.

France's internal imbalances need to be addressed, notably in light of the recent market concerns pertaining to its fiscal position and public debt. Sustaining confidence in sovereign creditworthiness is critical for France and the rest of the euro area.

External imbalances should be viewed with care. While the current account deficit remains modest, France should not maintain deficits for extended periods, given that demographic changes will likely put pressure going forward.

To address imbalances and achieve strong, sustainable, and balanced

growth, France will require additional fiscal consolidation efforts over the medium term and growth-enhancing structural reforms.

- Fiscal options include: limiting local government expenditure growth, improving targeting of social transfers, reducing VAT exemptions and incentives, and moving towards a more growth-friendly tax system. It would also be critically important to improve bank capitalization to reduce risk and guard against the cost of bailouts.
- Structural reforms should be implemented to boost competitiveness and keep external imbalances in check. Reforms that improve competitiveness will bolster exports and help counterbalance the dampening effects on growth from fiscal consolidation. A comprehensive strategy should include policies to promote innovation and create favorable conditions for businesses, notably by easing regulatory restrictions. In addition, labor market reforms, such as reducing the labor tax wedge, will help increase labor force participation and productive potential.



FRANCE

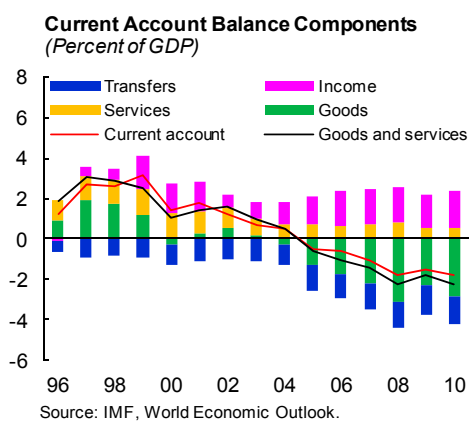
SUSTAINABILITY REPORT 2011¹

France's external balances have gradually deteriorated from a surplus in late 1990s to moderate deficit in the second half of 2000s, reflecting worsening competitiveness on the back of declining trend growth. Public debt, which was on a growing path prior to the crisis, owing to rising expenditures by local governments and social security administrations, deteriorated significantly thereafter due to crisis-related costs. Going forward, France needs to improve its competitiveness to keep current account deficits in check and reduce its public debt to ensure fiscal sustainability. A comprehensive strategy to boost growth and productive potential should be implemented, including through a strengthening of incentives for work and increasing competition in product and services markets.

I. BACKGROUND

1. **France's current account balance has deteriorated gradually since the late 1990s.** Over the past decade, the current account deteriorated gradually from a surplus of 3.1 percent of GDP in 1999 to a deficit of 1.7 percent of GDP in 2010. This was led by a

worsening of the trade balance on goods and services, which moved from a surplus of 2.5 percent of GDP in 1999 to a deficit of 2.3 percent in 2010, while income and transfers balances have been relatively stable.

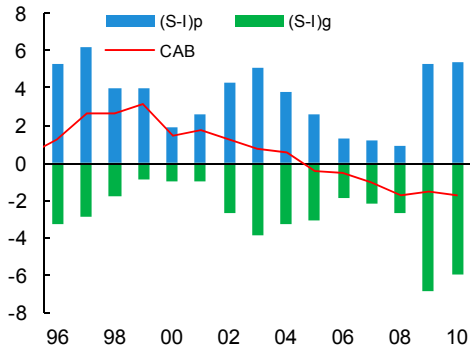


¹ Prepared by Joong Shik Kang under the guidance of Emil Stavrev, with input from Stephen Snudden and the support of Eric Bang, David Reichsfeld, and Anne Lalramnghakheleli Moses.

- The deterioration of the current account during the first half of the 2000s was cyclical, as *stronger domestic demand* in France relative to its key trading partners, notably Germany, resulted in worsening net exports. However, since the mid-2000s the deterioration was largely due to a worsening *exports* performance, with France's export growth lagging behind the export growth of its key competitors.
- From a *saving-investment* perspective, the current account deterioration between 1999 and 2007 (by 4.2 percentage points of GDP) was driven largely by a narrowing

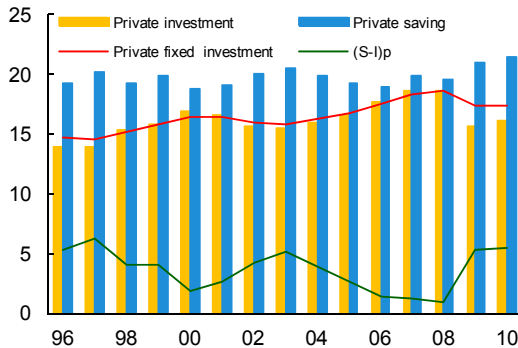
of the private saving-investment balance on account of higher investment in construction and services (2.8 percentage points of GDP). Since 2007, notwithstanding a significant improvement in the private saving-investment balance, the current account deficit widened further as a result of a sizable deterioration of the public sector saving-investment balance (by 3.8 percentage points of GDP).

Private and Public Saving - Investment Balances
(Percent of GDP)



Sources: IMF, World Economic Outlook and staff estimates.

Private Saving and Investment
(Percent of GDP)



Sources: IMF, World Economic Outlook and staff estimates.

2. The current account is projected to improve only gradually over the medium term. Following a further deterioration in 2011, the current account deficit is projected

to narrow, but only slowly on account of sluggish demand from the rest of Europe and continuing competitiveness issues.

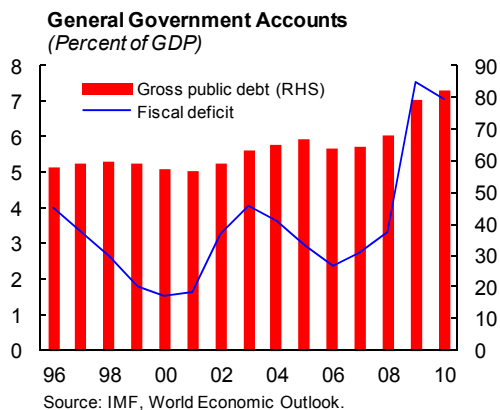
3. Fiscal balances improved sizably in the run-up to the Economic and Monetary Union (EMU), were generally weak during EMU, and deteriorated significantly following the recent crisis.²

- To meet the Maastricht criteria, France introduced a medium-term consolidation plan in 1994. The general government deficit was reduced significantly to 1.5 percent of GDP in 2000 (from over 6 percent of GDP in 1993), while public debt declined to about 57 percent as a share of GDP in 2001 after peaking near 60 percent in 1998.
- In the early 2000s, rising expenditures by local governments and social security administrations pushed up the general government fiscal deficit. Overruns in social security spending continued in the early 2000s, partly undoing the gains from the previous consolidation and the deficit exceeded 4 percent of GDP in 2003. Under the EU's rules, France entered the Excessive Deficit Procedures (EDP) of the Stability and Growth Pact (SGP). The significant consolidation package in response to the EDP, helped by the global economic boom, reduced the deficit to below 3 percent of GDP by 2005.

² Fiscal balances include the central government, the local governments, and the social security administration.

- *Public finances deteriorated significantly in the context of the global crisis.* Crisis-related costs, on the back of declining trend growth, resulted in sizable general government deficits (over 7 percent of GDP in 2009-10), while public debt exceeded 80 percent of GDP in 2010 and is projected to increase further in the near term. Thus, France entered the EDP again in 2009.

4. **Going forward, fiscal balances are projected to improve.** In their Stability Program, the authorities have started a large fiscal adjustment that is projected to bring down the deficit significantly by 2014 (to 2 percent of GDP) and put the public debt on a declining path. The implementation of pension reform enacted in late-2010, which includes a gradual increase of the legal retirement age from 60 to 62 years and the full pension age from 65 to 67 years, together with the recent extension of the contributory period to 41.5 years for people born after 1955 (to be adjusted in line with gains in life expectancy), will also help lower the deficits over the long term. These changes will help achieve financial equilibrium in the pension system by 2018 from a current deficit of almost 1.5 percent of GDP.



II. ROOT CAUSES OF FRANCE'S IMBALANCES

5. **G-20 indicative guidelines identified France as experiencing “moderate” or “large” external deficits and public debt, calling for a deeper assessment of the causes.**³ Reflecting structural factors and weakness of fiscal institutions, public finances were weak prior to the crisis, despite relatively strong growth, and have deteriorated significantly thereafter owing to crisis-related costs. The external current account has gradually deteriorated (from a surplus in the early-2000s to a deficit by the end of the decade) driven by strong domestic demand and a loss in competitiveness.

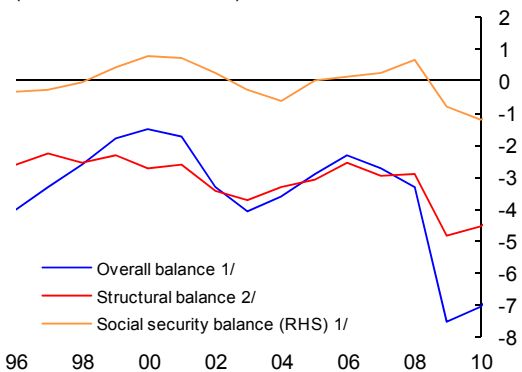
A. Fiscal Imbalances

6. **The deterioration of French public finances over the past decade reflects structural factors and the costs associated with the global recession.** In the context of some weakness in fiscal institutions, the fiscal position worsened in the run-up to the crisis, largely due to rising social security spending, while crisis-related costs have added to the fiscal burden thereafter. Specifically,

³ Gross private debt in France, which was also identified as “moderate” or “large” by the indicative guidelines, has gradually increased by about 40 percentage points of GDP over the last decade, partly driven by household mortgage financing. However, it does not present imminent risks to the economy or the financial system since the financial wealth of private sector has also risen strongly during this period.

- *Structural factors, including aging-related social security spending, have contributed to the gradual deterioration of the fiscal balance.* While cyclical factors and corresponding consolidation efforts have accounted for large fluctuations in the fiscal balance, the structural balance has remained weak, mainly due to rising social security spending, including on pension and health care. Despite several efforts to increase the efficiency of the pension and health care systems, expenditure overruns on social security spending continued, contributing to the weakening of the fiscal position.

Fiscal Indicators
(Percent of nominal GDP)



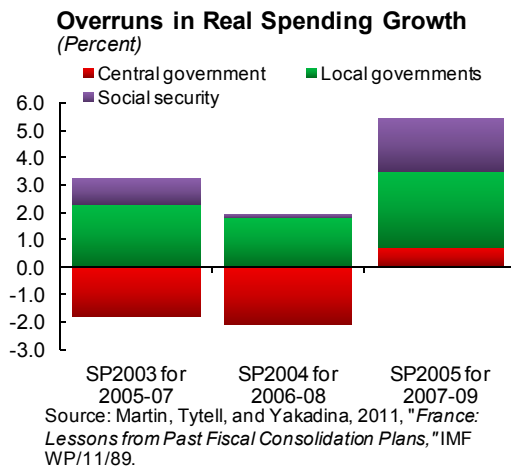
Source: IMF staff estimates.

1/ Maastricht definition. Estimate for 2010 includes one-off transfer to ODAC for future-oriented investments, which amounts to about 0.6 percent of GDP.

2/ In percent of potential GDP.

- *Weaknesses in fiscal institutions have hampered efforts to restore fiscal sustainability.* Strong growth in the mid-2000s did not lead to a much needed fiscal consolidation. The significant decentralization efforts in the early 2000s resulted in a rapid

growth of local government spending (on average 5 percent annually during 2001–10). While the favorable global economic boom contributed to the end of the first EDP in the mid-2000s, the deficit targets set in the successive Stability Programs (SPs) were frequently missed, mainly due to spending overruns by the local governments and social security system, which account for about 21½ percent and 46¼ percent of total expenditures (as of 2009), respectively, but also by the central government in the second half of the 2000s.



- *Public finances deteriorated significantly in the context of the recent crisis, with both the deficit and the debt rising sharply.* In addition to the full operation of automatic stabilizers, the government provided discretionary fiscal stimulus in the amount of 2¼ percent of GDP over 2009–10 to

cushion the downturn.⁴ Combined with declining trend growth, these measures have pushed the general government deficit to above 7 percent of GDP and public debt increased to over 80 percent of GDP—one of the highest among all European AAA-rated countries.

B. External Imbalances

7. The current account has deteriorated largely due to a worsening competitiveness of French exports as well as strong domestic demand.⁵

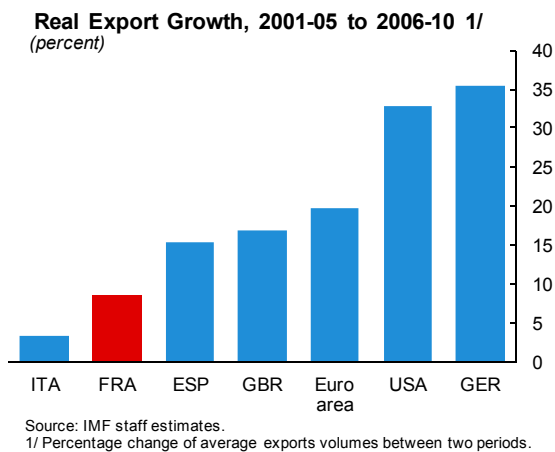
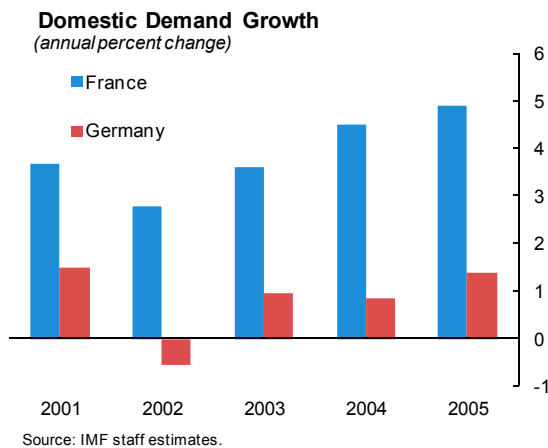
- The deterioration of the trade balance in the early-2000s was mainly due to cyclically lower foreign demand. While France faced consistently lower foreign demand than its large euro area neighbors, strong domestic demand growth in France, exceeding that of its largest trading partner Germany, on average by 3 percent per year over 2001–05, resulted in strong French imports and worsening net exports, which turned negative in 2005.
- Since 2005, export growth in France has fallen significantly below the euro area average, pulling down French export market shares both worldwide

⁴ Only part of this fiscal stimulus had an impact on the general government deficit as some measures, e.g., public enterprise investments are not included in the general government accounts.

⁵ Higher energy costs also contributed to the worsening current account during 2005–08.

and within the euro area. Combined with strong domestic demand, trade and current account balances continued to deteriorate, raising concerns about competitiveness of French exports.

- The current account has deteriorated further during the Great Recession as public sector demand, supported by the stimulus, more than offset the decline of private sector demand.



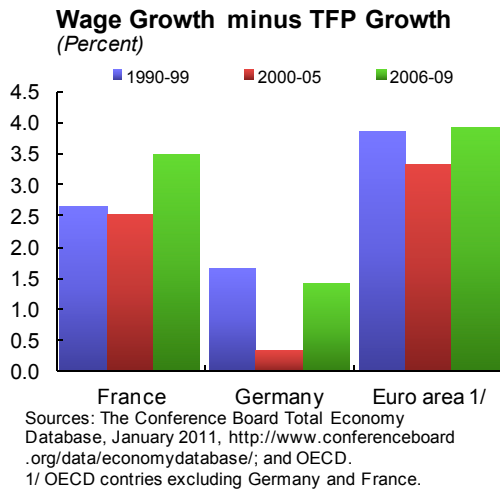
8. The deteriorating competitiveness of French exports, and associated loss of market share, reflects both price and non-price factors. France has lost about 2½ percentage points of world export

market share in the last decade.⁶ While most advanced economies have lost market share, owing to the increasing role of emerging economies in global trade, France's loss has been more severe than its peers. Moreover, its loss of market share in the euro area is noteworthy, given that the area accounts for about half of France's total exports—during the latter half of the 2000s, France lost about 1½ percentage points of market share in the euro area, compared to a ¼ percentage point loss for Germany.

- A key factor behind this weakening of competitiveness was a larger gap between wage growth and total factor productivity (TFP) growth relative to neighboring countries since the mid-2000s. In particular, relative to Germany, wages grew much faster, while TFP growth lagged for more than a decade. Traditional price-based indicators are insufficient to explain France's weaker export performance. Since the mid-2000s, all countries in the euro area experienced a real appreciation relative to the U.S. in terms of the CPI-based real effective exchange rate (REER), mainly due to the appreciation of the euro. However, relative to the other core countries in

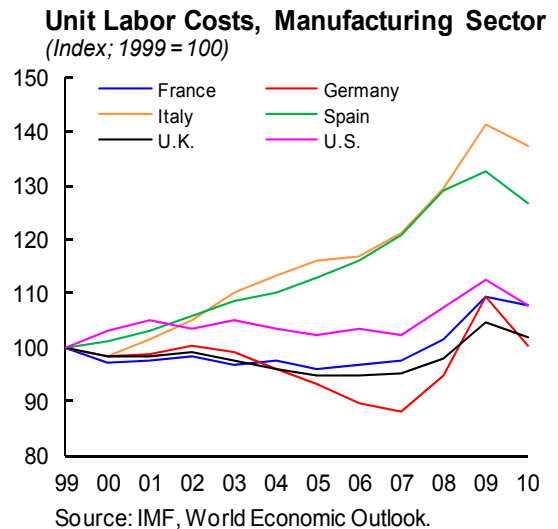
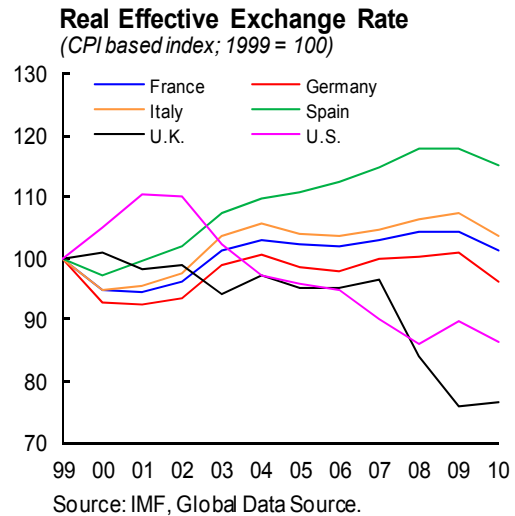
⁶ Export market share is calculated by dividing France's exports by world imports. European Commission (2010, "Surveillance of Intra-Euro-Area Competitiveness and Imbalances") also pointed that France's share of exports of goods in world trade (including intra EU exports) declined by 2.2 percentage points between 1998 and 2008.

the euro area (Germany, Italy, and Spain), France lost competitiveness only to Germany in terms of REER, export prices, unit labor costs, and labor productivity. In contrast, France experienced a smaller real appreciation, slower increase in export prices and unit labor costs, and faster increase in labor productivity than Italy and Spain. This implies that non-price factors, which are related to structural issues, are likely to have contributed to the underperformance of the French export sector.⁷



- *French exports have faced stronger competition from emerging economies than its large euro area peers.* French exports consist of some high-tech products (aeronautics and pharmacy),

⁷ Cheng (2010, "Developments in France's external competitiveness—an update") also found that traditional price and foreign demand factors can only partly explain the decline of French exports market share during the 2000s, suggesting that non-price factors may have played a significant role in the competitiveness loss.



but also contain a large share of low-to medium-tech products that face competition from both industrialized and emerging economies.⁸ Although France's exports to fast-growing emerging and developing countries have increased significantly during the last decade, its export growth to these

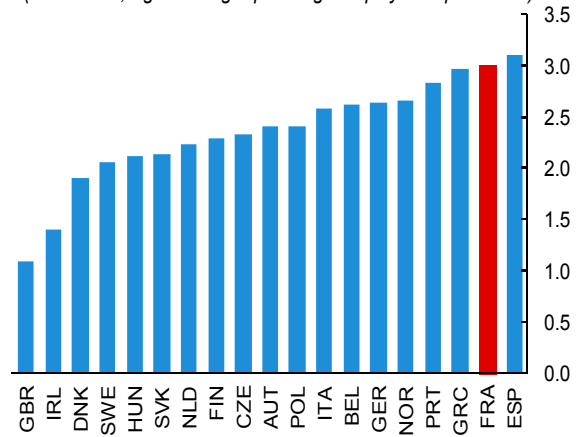
⁸ See more details in European Commission (2010, "Surveillance of Intra-Euro-Area Competitiveness and Imbalances").

destinations lagged behind that of the other euro area countries. France has also lost market share in fast-growing sectors, including some of its large export sectors, in marked contrast to Germany.

- *The underperformance of the French export sector also reflects labor and product market rigidities.* Labor market rigidities have restricted firms' flexibility to adjust to the changing economic environment. A high level of employment protection, a high minimum wage, and one of the highest labor tax wedges in the OECD⁹, among others, have led to high unemployment and lower working hours, contributing to low labor input. OECD estimates show that France's product market policies have also inhibited competition relative to its EMU peers.¹⁰ These rigidities have led to loss of efficiency, inability to make a breakthrough in new markets, insufficient research and innovation, and loss of technological edge, contributing to the underperformance of France's export sector.

Employment Protection

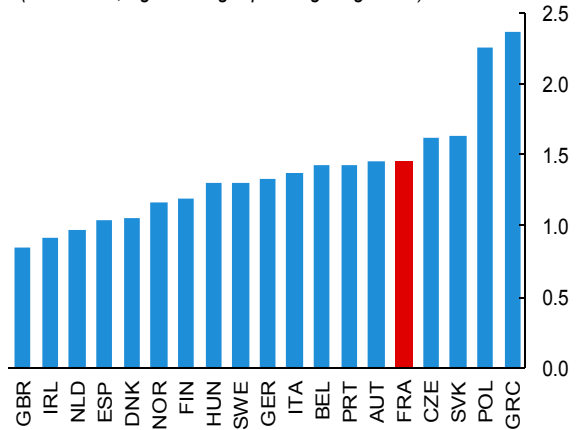
(2008 index; high reading implies high employment protection)



Source: OECD.

Product Market Regulation

(2008 index; high reading implies high regulation)



Source: OECD.

⁹ Earlier reforms aimed at reducing employer-paid social security contributions for low wage levels (between 1 and 1.6 times the minimum wage) have significantly lowered the tax wedge at the bottom of the income distribution.

¹⁰ Kabundi and Nadal De-Simone (2009, "Recent French export performance: Is there a competitiveness problem?") find that adjustment to a negative cost shock tends to be more via quantities than via prices, pointing to an insufficient flexibility of labor and product markets.

III. ARE FRANCE'S IMBALANCES A PROBLEM?

A. National Perspective

9. **While a moderate current account deficit does not pose risks, it is not desirable at this stage for France.** At less than 2 percent of GDP in 2010, France's current account deficit is not excessively large. However, given demographic factors, it is not desirable for France to maintain current account deficits for extended periods. In addition, given the need for fiscal consolidation, maintaining strong growth would require a larger contribution from external demand through restoring competitiveness. Also, since lower potential growth and loss of competitiveness share common underlying factors, addressing potential growth would lead to higher welfare for French population, while also help to reduce the external imbalance.

10. **Market concerns pertaining to France's fiscal position and public debt have risen.** The recent widening of bond spreads relative to German bunds and rising CDS spreads suggest that markets are concerned about the sustainability of debt and underscore the need to stick to the announced consolidation path. High public debt reduces policy space to deal with future shocks and can crowd out private investment, lowering growth prospects. Also, as higher public debt inevitably implies a higher tax burden in the future, given the already high level of France's tax rates, it could create other

distortions, undermining the on-going efforts to revitalize the economy.

B. Multilateral Perspective

11. **France's external and internal imbalances should be viewed with care, notably in light of the recent market concerns pertaining to its fiscal position.** France is the second biggest economy in the euro area. A credit event in the French debt market or a loss of investor confidence in the creditworthiness of the sovereign could therefore have significant repercussions for other sovereigns (including for the European Financial Stability Facility (EFSF), which is critical for managing the on-going euro area crisis) as well as corporate spreads. Also, given the close inter-linkages between the real and financial sectors, the risks of contagion are high, as evident from the sovereign debt crisis in peripheral euro area countries.

12. **Financial instability in France could have large cross-border spillovers.** French banks have large cross-border exposures to the euro area countries under IMF programs or experiencing higher market scrutiny.

IV. HOW TO ADDRESS IMBALANCES?

13. **The announced fiscal consolidation path is needed to keep public finances on a sustainable path, while long-standing structural reforms should be implemented to boost competitiveness and growth.** The external and fiscal imbalances are closely interlinked. A more competitive and growth-oriented economy is essential not only for keeping external balances in check, but also for putting public finances on a sustainable path. Fiscal policy that puts public finances on a sustainable path, combined with growth-friendly tax reform, could usefully support growth- and competitiveness-enhancing structural reform policies and help contain external imbalances by ensuring an improved public saving-investment balance.¹¹

A. Anchoring Fiscal Sustainability

14. **A key policy priority is keeping public debt on a sustainable track.** To achieve this goal, the Stability Programs under the second EDP strike a balance between growth and sustainability concerns—they aim to reduce the fiscal deficit to 3 percent of GDP by 2013 and 2 percent by 2014. According to IMF staff assessment, the additional fiscal measures announced by the French authorities in August 2011 would help meet the deficit

targets for 2011 and 2012¹² but additional measures would be required from 2013 onwards to meet the fiscal targets and to maintain public debt on a sustainable path—failing to implement such additional measures would result in higher public debt ratios (about 91 percent of GDP projected by staff versus around 85 by the authorities in 2014). Previous consolidation experience highlights that a strong political will and a shared resolve for consolidation at all levels of government, including local governments and the social security system, are critical factors for the success of fiscal consolidation.

15. **Additional consolidation efforts are needed to achieve the fiscal targets for 2013 and 2014.** Options for additional adjustment include: (i) limiting local government expenditure growth, including rationalization of responsibilities of departments, regions, and municipalities; (ii) improving targeting of social transfers through enforcing a tighter budget constraint on social security entities by replacing earmarked “social taxes” with subsidies; (iii) reducing the VAT policy gap through a gradual elimination of VAT exemptions and incentives; and (iv) a more growth-friendly

¹¹ Policy recommendations are based on the latest 2011 Article IV discussion.

¹² According to the government the measures would increase revenues by 1 bn euros in 2011 and by 11 bn euros in 2012 and reduce spending by 0.5 bn euros in 2011 and by 1 bn euros in 2012.

tax system, which shifts more of the burden of taxation from direct to indirect taxes.

16. Adopting a fiscal rule based on independent macroeconomic forecasts would entrench fiscal credibility.

Adopting the draft law (already voted by the Parliament and Senate) that envisages enshrining a fiscal rule would provide for a binding medium-term budget framework and a post-consolidation anchor for fiscal policies. Since the need for realistic macroeconomic assumptions is more acute at a time when economic growth is fragile, establishing an independent public institution or fiscal council to provide forecasts that would be mandatory for budget preparation and medium-term planning would enhance the credibility of the multi-year budget.

17. Furthermore, to ensure long-term sustainability, deeper reforms of key pension and health care parameters are also needed. On the pension side, increasing further the legal retirement age in line with life expectancy would prevent continued increases in time spent in retirement as medical advances continue to lengthen life spans.¹³ On the health care front, as the rise in living standards and technical progress will continue to put pressure on public expenditures, in addition to initiation of a planned reform of long-term care in 2012, continued

¹³ The 2003 pension reform linked the contribution years for a full pension to life expectancy.

efficiency gains are necessary to prevent an unsustainable rise in health and long-term care spending. It should be noted however, that France is among the lower-to medium-risk countries in terms of future healthcare costs, with the projected increase of annual spending on public health being lower than European average over the next 20 years.¹⁴

18. Ensuring adequate capitalization of French banks can help limit potentially large adverse cross-border spillovers and guard against costly bailouts.

Capital adequacy has improved since the crisis but some French banks are increasing their capital at a slower pace compared with other large European banks, some of which have already met and even exceeded Basel III capital requirements (French banks announced they will fulfill Basel III criteria by 2013). If the use of a 10 percent core Tier 1 threshold became standard for market participants, some French banks would have capital deficit with respect to this threshold. Supervisors should continue to ensure that the banks implement their announced capital augmentation programs, including through limiting dividend distributions and share repurchases, if needed.

B. Enhancing Competitiveness

19. To keep external imbalances in check, France needs to improve its

¹⁴ See the April 2011 Fiscal Monitor for details.

competitiveness by pursuing structural reforms to increase total factor productivity while moderating wage growth. France's lagging export performance over the last decade indicates the importance of strengthening competitiveness. The latest overall exchange rate assessment suggests the possibility of some real effective exchange rate overvaluation, indicating the need for wage moderation and cost containment is especially important given that France is a member of a currency union. To address non-price factors which have played significant roles in the underperformance of France's export sector, it is important to pursue comprehensive structural reform strategies in the product market, labor market, and tax area.

20. **The reform strategy in product markets should be focused on promoting innovation and creating favorable conditions for business.** Enhancing further competition by lowering regulatory restrictions would help increase productivity and employment. In this context, the easing of regulatory entry barriers to service industry¹⁵, including professional services, would raise value-added in the service sector but also have positive spillovers to the manufacturing sector by reducing costs of key inputs.

¹⁵ A new reform that is envisaged to reinforce competition in the services sector is expected to be adopted by the end of 2011.

21. **Labor market reform should focus on increasing labor market participation as well as re-absorbing the unemployed.** Although welcome progress has been made to re-absorb the unemployed by providing appropriate incentives for both firms and job-seekers, including by simplifying the layoff procedures and enhancing the work-study schemes, more efforts are needed. While easing high employment protection would provide appropriate incentives for firms to create more jobs, reducing the comparatively long duration of unemployment benefits or lowering benefit levels over time could strengthen incentives for job search and increase the effective labor supply.

22. **Labor market participation of young and low-skilled workers as well as seniors needs to be increased.** The high minimum wage (SMIC) has priced out of the labor market low-skilled workers, especially the young. To increase labor demand for these groups, it is important to continue to limit the increase of the SMIC, for example by reviewing the indexation formula, which is currently partly based on inflation. To increase further the labor force participation of seniors (among the lowest in Europe), it is important to continue the phasing out of pre-retirement benefits, relaxation of constraints on combining employment and retirement benefits, and pension reforms.

Employment Ratios

| | Total 1/ | Women 2/ | Older workers 3/ |
|----------------|----------|----------|------------------|
| | 2010 | 2010 | 2010 |
| Belgium | 62.5 | 56.5 | 37.3 |
| Finland | 69.3 | 66.9 | 56.3 |
| France | 64.4 | 59.9 | 39.7 |
| Germany | 72.4 | 66.1 | 57.7 |
| Greece | 60.7 | 48.1 | 42.3 |
| Ireland | 61.9 | 56.4 | 50.8 |
| Italy | 57.8 | 46.1 | 36.6 |
| Netherlands | 76.0 | 69.4 | 54.1 |
| Portugal | 70.0 | 61.1 | 49.2 |
| Spain | 59.9 | 53.0 | 43.6 |
| United Kingdom | 72.4 | 65.3 | 56.7 |
| United States | 69.8 | 62.4 | 60.3 |
| OECD countries | 67.3 | 56.7 | 54.0 |

Source: OECD.

1/ Percent of working age population.

2/ Percent of female population (15-64)

3/ Percent of population aged (55-64)

23. **Reform of labor and business income taxation would improve incentives for employment and growth.**

Lowering the labor tax wedge, which remains high on average relative to the OECD countries, could increase labor demand, while preventing higher wage claims by unions. Reforms of the tax-benefit system targeting work incentives to the high labor supply margins—senior workers and women with school-age children—are expected to be effective and cost-efficient.^{16 17} Notwithstanding the already-existing social benefit RSA (“Revenu de Solidarité Active”) and tax credit PPE (“Prime pour l’emploi”) that encourage labor supply, more generous earned income tax credits and special

¹⁶ While the employment rate of prime-aged women (30–54 years) has increased in line with that of other OECD countries, French women’s average hours worked have declined markedly since the late 1970s.

¹⁷ See Poirson (2011, “Toward a Growth-Oriented Tax System for France”) for more details.

credit for social security contributions paid for these groups of workers could be considered. A corporate tax reform, through lowering the statutory rate along with base broadening and reducing complexity, would help to make the system fairer and simpler and make the corporate tax system less biased against small firms, which are often the source of innovation and job creation. Reducing the relatively large bias toward debt financing from interest deductibility would reduce banks’ excess leverage and promote greater reliance on equity finance which could ultimately boost innovative investments.

C. **Toward an Upside Scenario**

24. **The following policy elements will be explored in an upside scenario:**

- *Additional fiscal consolidation to put public finances on a sustainable track.* Despite the fiscal measures announced in August 2011, on account of revised growth projections, additional measures of about 0.4 percent of GDP are needed to meet the Toronto commitment of halving the deficit by 2013, and further fiscal consolidation (over 1 percent of GDP by 2016) would be needed to achieve fiscal sustainability as targeted in the Stability Program. The consolidation could be financed by expenditure cuts and additional revenue measures (roughly 2 to 1 in favor of expenditure cuts), including through an increase in VAT revenue.

- *Tax reform to reduce distortions and raise potential output.* Corporate income tax (CIT) could be lowered to raise investment and potential output. Labor taxation could also be reduced to increase labor participation. These tax and social security contribution cuts could be financed with further increases in VAT revenue and a cut in tax expenditures.
- *Structural reforms to boost productivity in nontradables together with wage moderation.*¹⁸ Product market reforms to boost productivity, particularly in services, could include convergence of regulation in network industries, retail trade, and professional services to best practice. Additional labor market reforms and minimum wage moderation are also crucial to improve productivity and reduce unemployment (notably of the young and low-skilled workers).

¹⁸ The structural reform scenario was developed in close partnership with the OECD, which provided estimates of the impact of structural reforms on productivity.

G R O U P O F T W E N T Y



GERMANY SUSTAINABILITY REPORT ¹



Prepared by Staff of the

I N T E R N A T I O N A L M O N E T A R Y F U N D

¹ *Report 6 of 10.* At the request of the G-20, IMF staff has provided analyses and assessments of member's economies and policies in a set of reports for the Mutual Assessment Process (MAP). These reports serve as inputs for the Action Plan agreed by G-20 Leaders at the Cannes Summit. The 2011 Staff Reports for the 20 MAP consist of the following: (i) an Umbrella Report that provides an integrated summary of the component reports and an upside scenario for G-20 collective action; (ii) an Accountability Report that summarizes members' progress toward policy commitments since the Seoul Summit in 2010; (iii) a MAP Report providing analysis of members' medium-term macroeconomic and policy frameworks; and (iv) Sustainability Reports for seven members (China, France, Germany, India, Japan, United Kingdom, and United States)—identified by G-20 indicative guidelines—to assess the root causes and policy implications of key imbalances.

EXECUTIVE SUMMARY

G-20 indicative guidelines identified Germany as experiencing “moderate” or “large” external and fiscal imbalances. Following external deficits in the decade after reunification, the current account improved strongly reflecting buoyant exports, given trade patterns and strong external demand. Private saving rose sharply, while investment declined on the back of tepid domestic demand. Although Germany has generally been fiscally prudent, the public debt and deficit exceed SGP limits, reflecting the costs of reunification and financial crisis. Thus, structural and tax reform are central to reducing imbalances and supporting growth.

Imbalances reflect both domestic and external causes—notably, reunification and the global cyclical upswing followed by the financial crisis.

- A rapidly rising current account surplus reflects a combination of factors, including: (i) favorable product specialization that allowed exporters to take advantage of a cyclical upswing in global demand; (ii) moderate wage growth supportive of competitiveness; (iii) weak investment, reflecting in part financial sector distortions; (iv) high private saving, given life-cycle needs of an aging population; and (v) an overhang from a construction boom following reunification.
- High public debt accumulation can be traced fundamentally to reunification efforts and policy measures in response to the financial crisis.

Reducing imbalances will have a positive impact on domestic and global growth and stability.

- *External surpluses* in Germany do not primarily reflect market failures or policy-induced distortions. Boosting domestic demand would, however, raise potential output while also supporting stronger and more balanced global growth.

- Germany plays a key anchoring role in the euro area and its solid *fiscal position* is essential for maintaining stability.

Structural reforms of the tax system, as well of financial, labor, and product markets will bolster growth and could help reduce external surpluses.

- A growth-friendly tax reform, reducing the taxation of secondary-earners’ income and lowering corporate income taxes, would lower the current account surplus over the medium run.
- Further development of venture capital and private equity markets will help increase the availability of risk capital, spurring investment and productivity growth. Reorienting German Landesbanken to serve domestic clients could help increase investment and consumption.
- Streamlining regulation in the service sector and improving education could boost productivity growth and would reduce the trade surplus over the medium term.

The pace of consolidation envisaged and anchored by the new constitutional rule is appropriate. However, it could be more growth-friendly within the budget envelope. In case the economy slows considerably, less front-loaded tightening would be warranted.



GERMANY

SUSTAINABILITY REPORT 2011¹

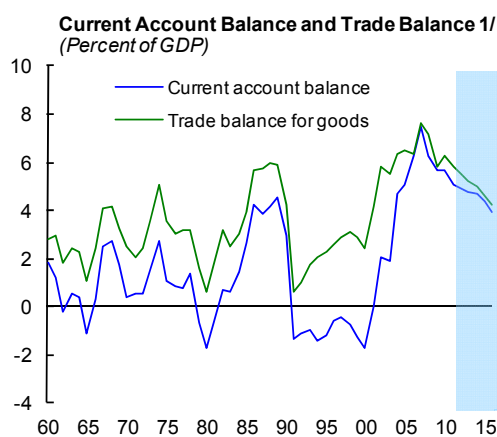
Germany has experienced large current account surpluses over the past decade, while public debt has remained high. Large external surpluses can be attributed to a confluence of factors, including a cyclical surge in global demand for exports and modest wage growth that has helped strengthen competitiveness. An improvement in the private saving-investment balance has been driven by a decline in investment following the reunification boom and higher precautionary saving because of increased uncertainty. High public debt can be traced in a fundamental sense to reunification efforts and policy measures in response to the crisis. Structural policies—including tax and financial sector reforms—could help boost growth and reduce external surpluses. Fiscal space needs to be rebuilt, but the pace of consolidation can be measured—broadly in line with the authorities' current plans.

I. BACKGROUND

1. **Germany has had a long history of external surpluses and its fiscal record has been relatively strong, except around reunification.**

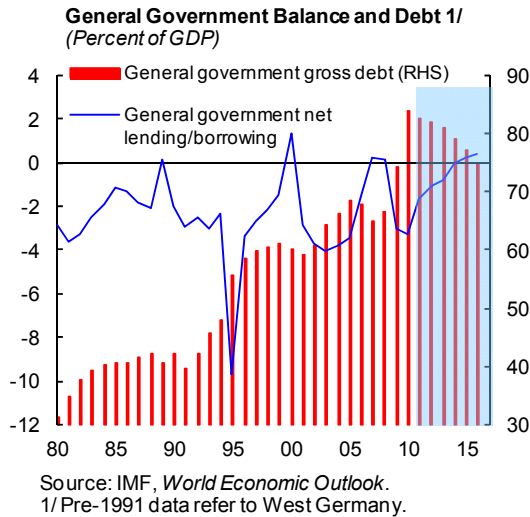
The merchandise trade balance has been in surplus continually since the early 1950s, while the current account has stayed positive, with a few exceptions, notably in the 1990s. Germany enjoys a solid reputation for fiscal prudence. Nonetheless, the general government deficit has often exceeded the 3 percent

Stability and Growth Pact (SGP) limit, and the general government debt stands well in excess of the 60 percent ceiling. Developments in Germany can be viewed across four broad time frames.



Source: IMF, *World Economic Outlook*.
1/ Pre-1991 data refer to West Germany.

¹ Prepared by Vladimir Klyuev under the guidance of Emil Stavrev, with input from Stephen Snudden and the support of Eric Bang, David Reichsfeld, and Anne Lalramnghakhleli Moses.



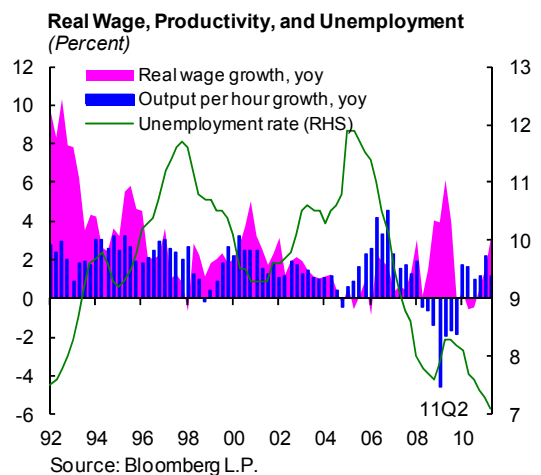
A. Pre-unification

2. **There are considerable similarities between the 1980s and the period in the run-up to the crisis, but also key differences.** During both periods, the German trade surplus improved dramatically, buoyed by strong global demand. At the same time, national saving increased, helped in part by fiscal consolidation, even as private investment, as a share of GDP, declined. An analysis of the reasons for the strong trade performance, in the context of generally subdued growth in output, investment, and employment, pointed to structural rigidities rather than macroeconomic policies.² An important difference, however, is that during the 1980s the German economy had substantial structural rigidities, which were significantly smaller in the 2000s, following a number of reforms in the first half of the decade.

² L. Lipschitz, J. Kremers, T. Mayer, and D. McDonald, 1989, "The Federal Republic of Germany: Adjustment in a Surplus Country," *IMF Occasional Paper* 64.

B. Reunification

3. **The 1990 reunification had long-lasting implications for Germany's growth, external balances, and public finances.** Efforts to reduce the income gap between eastern and western Länder (including the one-for-one currency conversion) led to a construction boom; a surge in wages, buttressed by generous unemployment support, and a narrowing of wage differentials, despite large productivity gaps; an increase in fiscal deficits and public debt levels underpinned by large transfers to the east, a liberal early retirement scheme, and the cost of converting East German enterprises into private firms; and a shift away from external surpluses to deficits as domestic demand exceeded production.



4. **Subsequent correction of the excesses of the early 1990s laid the ground for future current account improvement.** Both residential and non-residential construction declined steadily as a share of GDP. The wage growth slowed, owing to changes in worker bargaining behavior in the face of rising

unemployment.³ A combination of tax and expenditure measures helped contain fiscal deficits even as the economy decelerated after the unification boom. In the meantime, the CPI-based real exchange rate depreciated 18 percent in the second half of the 1990s, more than reversing appreciation that occurred in the first half of the 1990s.

C. The 2000s

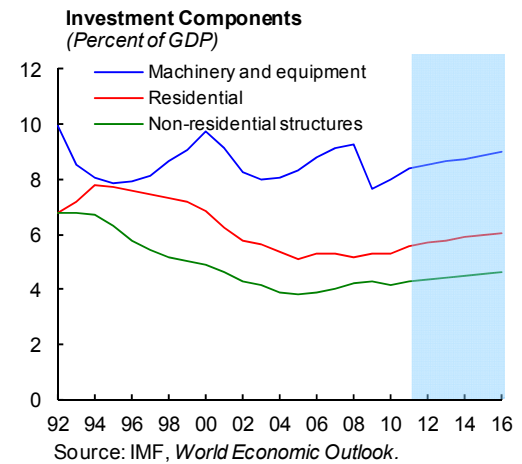
5. **After a decade of deficits, Germany's external position moved into surplus in the 2000s, while the fiscal position improved in the run-up to the crisis.** The current account balance rose sharply from a deficit of 1½ percent of GDP in 2000 to a surplus of 7½ percent in 2007, owing largely but not exclusively to an increase in the merchandise trade surplus,⁴ noticeably against other Euro area members. The dramatic improvement in the current account between 2000 and 2007 reflected primarily a sharp swing in private saving-investment balances.

- *Net exports* contributed about four fifths of the 9½ percent increase in Germany's real GDP over that period, while domestic

³ The unemployment rate climbed steadily from just over 5 percent in 1991 to nearly 10 percent in 1997. See also J. Decressin, M. Estevão, P. Gerson and C. Klingen, 2001, "Job-Rich Growth in Europe," Chapter III in *Selected Issues Paper SM/01/307*.

⁴ Over that period both exports and imports rose substantially, as German firms extended their production lines into neighboring countries. About 4 percentage points of the increase in the current account was due to a decline in the deficit of the services account and a turnaround in the income account.

demand increased modestly by around 1½ percent. Despite the export boom and strong corporate profits, private fixed investment declined as a share of GDP by 2½ percentage points between 2000 and 2007. All major investment components declined as a share of GDP between 2000 and 2007, with construction continuing its long post-unification slide (with a tentative recovery starting just before the crisis), while M&E investment went through a major cycle.⁵



- *Private saving* as a share of GDP rose 5¼ percentage points, owing largely to an increase of corporate saving. Household saving increased modestly (one percentage point), even as the labor share of national income fell from 71 to 64 percent. In contrast to the 8 percentage point turnaround in the private saving-investment balance,

⁵ It should be noted that in real terms the growth of M&E investment looks stronger, as its deflator declined relative to the GDP deflator.

the general government S-I balance improved only 1¼ percentage points.

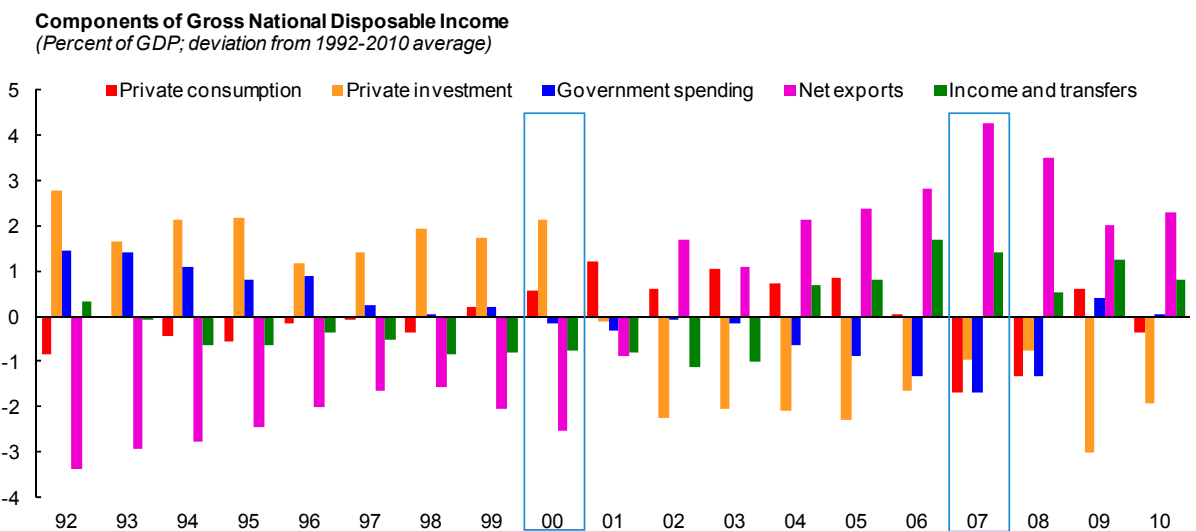
- *Fiscal consolidation efforts led to a surplus in 2007.* This was driven by spending cuts (including pension reform and a reduction of unemployment benefits, public-employee fringe benefits, and various subsidies) and supported by strong growth in output and corporate profits. Nonetheless, the ratio of general government debt to GDP has remained in excess of 60 percent since 2002.

D. The Crisis and Its Aftermath

6. **The current account and merchandise trade surplus narrowed noticeably during the crisis.** The surpluses are projected to decline further through 2016 in line with maturing global recovery and some deterioration in the terms of trade. The contribution of net exports to real GDP growth is expected to remain positive,

although it is projected to decline gradually.

7. **The crisis delivered a significant blow to public finances.** Fiscal deficits reappeared and stood at about 3 percent of GDP in 2009 and 2010, reflecting the impact of automatic stabilizers and a relatively large stimulus. The increase in public debt well exceeds what is implied by cumulated general government deficits, notably because of financial system support measures, and is expected to remain close to 83 percent of GDP in 2011. The government has specified a set of consolidation measures, largely on the expenditure side, to bring the fiscal balance in line with its commitments under the SGP, G-20 Toronto commitments, and the national fiscal rule. As a result, the debt ratio is projected to decline to 77 percent on average in 2014–16, which is still above the SGP limit.



Source: IMF, *World Economic Outlook*.

II. ROOT CAUSES OF IMBALANCES

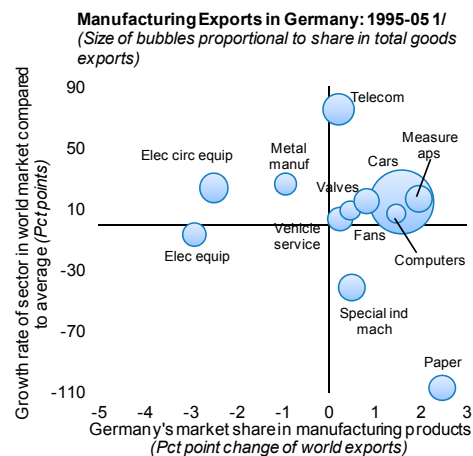
G-20 indicative guidelines identified Germany as experiencing “large” or “moderate” external surpluses and public debt, calling for an in-depth assessment of the root causes. External imbalances reflect a number of factors, such as improvement in competitiveness, niche exports, low investment rates, and increased national saving, some of which are clearly more important than others. Public debt increased largely due to reunification costs, the weak economy in the first half of the 2000, and the recent financial crisis.

A. External Imbalances

8. **The rapid increase in Germany’s current account surpluses before the crisis reflects a combination of factors, led by wage behavior and the structure of exports.** In particular, favorable product specialization and wage moderation positioned Germany well to take advantage of a cyclical surge in global demand in the years preceding the crisis. Even as exports boomed, the private saving-investment balance improved, owing to a slowdown in private investment following the reunification boom and a rise in precautionary saving because of the increase in policy uncertainty, as a result of the reforms in the late 1990s and the early 2000s.

9. **Niche exports allowed Germany to benefit from a cyclical boom in global demand.** Exports benefited from a strong demand for capital goods, consumer durables and pharmaceuticals—products where the country is specialized and enjoys significant market share. Capital goods accounted for 45 percent on average of German merchandise exports in the 2000s, while motor vehicles and parts constituted another 18 percent.

Unlike most other advanced economies, Germany was able to maintain its share of key markets, with the rise in world trade translating one-for-one into a rise in German exports.

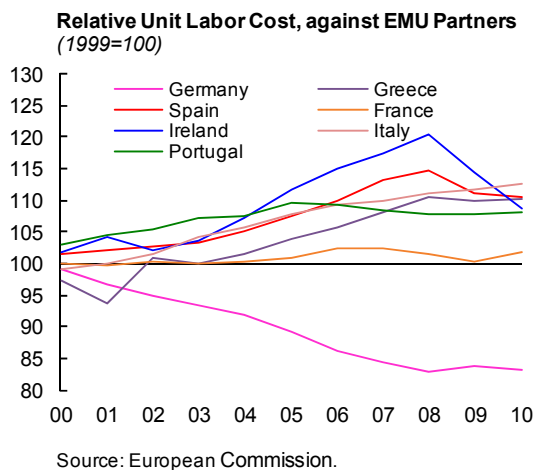
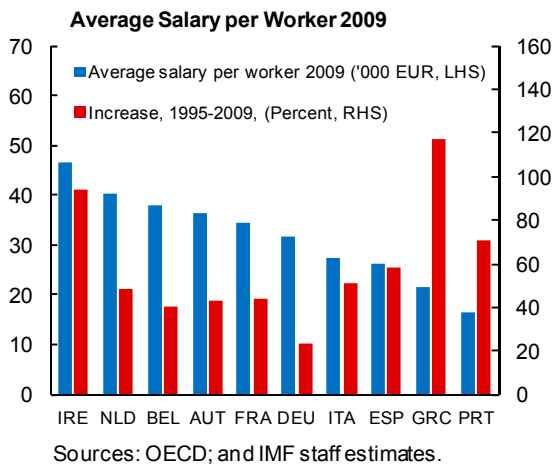


Source: UN Comtrade database.
1/ Excluding food and chemicals.

10. **Wage moderation boosted competitiveness, supporting exports, while dampening domestic demand.** Wage growth remained moderate during the expansion, helping firms maintain a competitive edge.⁶ The euro appreciated

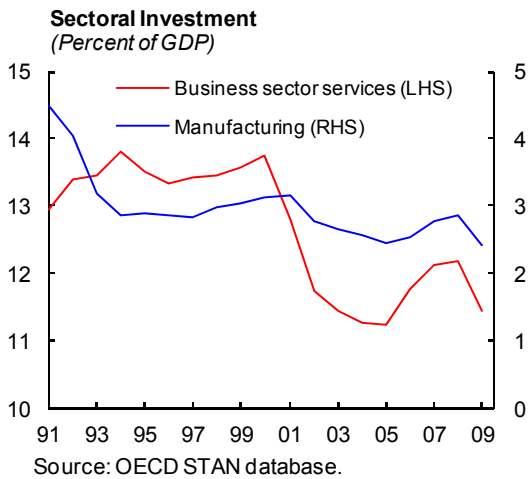
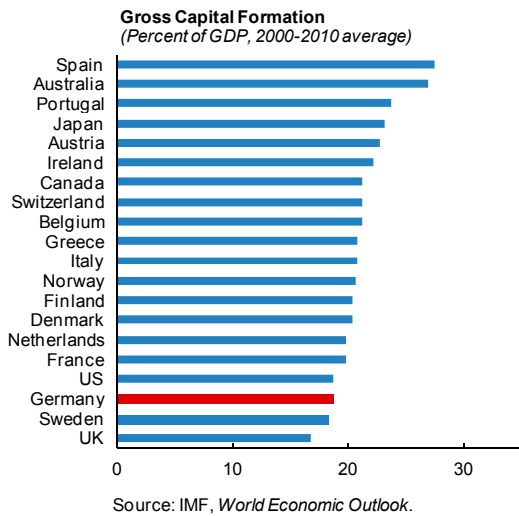
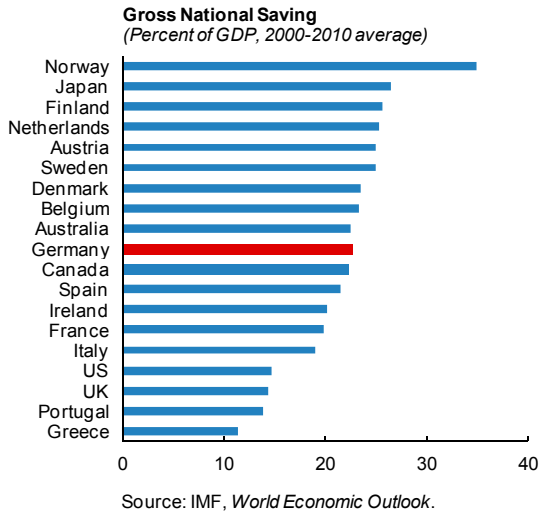
⁶ It should be noted, though, that for German exporters the importance of competing on price has declined.

nearly 50 percent against the U.S. dollar between 2000 and 2007. However, since roughly half of its exports go to other euro area countries, Germany's nominal effective exchange rate strengthened only 14 percent, the CPI-based real exchange rate only about half of that, and the ULC-based REER declined slightly by 2007. At the same time, wage moderation resulted in declining labor income share, which dampened consumption and domestic demand, while boosting net exports by improving relative ULCs.



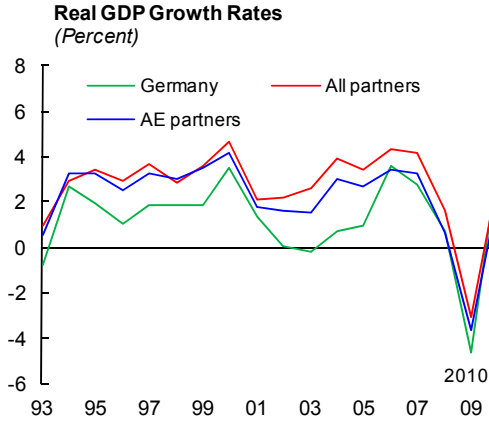
11. **Cyclical divergence within the euro area also contributed to intra-area imbalances.** Domestic demand in Germany was considerably weaker than demand growth in several euro area members, notably in the periphery. Thus, the area-wide policy interest rate was arguably too low for the periphery and too high for slow-growing Germany, hindering equilibration of demand across the member states. In addition, because of structural rigidities in the euro area, wage and price adjustments were slow to operate and did not compensate for the lack of an exchange rate adjustment channel.

12. **The private saving-investment balance improved.** Both lower investment and higher saving contributed to the large increase in the current account balance before the crisis. Despite booming exports and rising corporate profits, private investment remained particularly lackluster, including relative to peers (the level of non-construction investment in Germany is lower than in most advanced economies). Indeed, investment as a share of GDP declined between 2000 and 2007. This is true not only for construction—which could be attributed to a long-lasting hangover from the reunification boom—but also for machinery and equipment. As a share of GDP, investment fell not only in services, but also in the booming manufacturing sector.

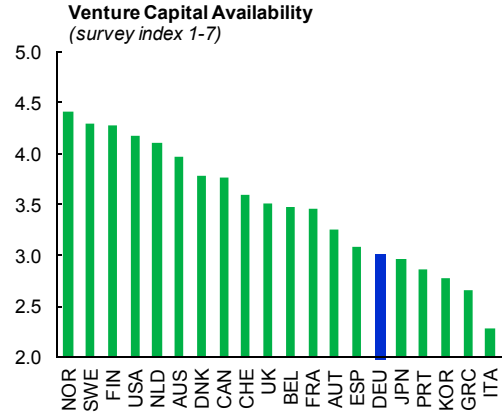


13. The reasons for investment being low in Germany are not entirely clear. Several explanations, without unequivocal evidence, have been suggested, including the uncertainty about the durability of the expansion, low productivity growth, particularly in the non-tradable sector, and gaps in the availability of financing. Further research would be needed to pin down the reasons behind the low investment rates in Germany.

- *Caution in the face of a surge in external demand.* The weakness of investment possibly reflected the fact that the strong export expansion may not have been viewed as durable. Germany's growth is linked to external developments to a greater extent than in most other large countries, and strong foreign demand may have been viewed as reversible. Indeed, soon after private investment finally started picking up, the global crisis broke out.



Source: IMF, *World Economic Outlook*.



Source: The Global Information Technology Report 2009-10, World Economic Forum.

- *Gaps and distorted incentives in the financial system.* A relatively underdeveloped framework for venture capital and private equity, as well as an inefficient insolvency process, has impeded investment in high-risk, high-growth sectors. At the same time, a broader issue concerning access to financing may have played a role, although supporting evidence is limited. In particular, it has been suggested that following the phasing-out of state guarantees, large state-owned banks have been more inclined to invest overseas—including in structured products originated in the U.S. and sovereign and bank debt of peripheral euro area nations, without adequate consideration of risk—rather than financing domestic investment.⁷ While there may be some merit in this

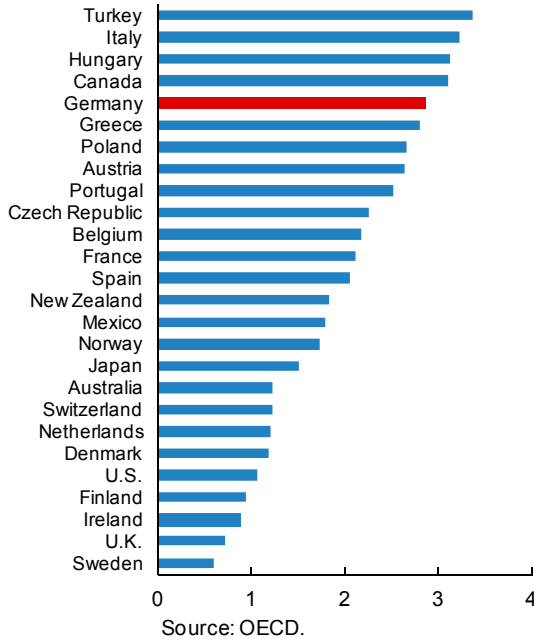
hypothesis, given high corporate saving and a wide network of savings and cooperative banks that are geared toward financing domestic investment, including SMEs, the ill-conceived investment strategy of Landesbanken may be a more relevant consideration for issues pertaining to financial stability rather than for access to financing.

- *Low productivity growth in non-tradables.* Germany's labor and total-factor productivity growth has been relatively low, dragged down by a lackluster performance of the service sector. Fairly restrictive regulation of professional services; remaining barriers to entry and exit of firms; and certain deficiencies in the education system⁸ impede productivity growth in the non-tradable sector.

⁷ Arguably, public ownership may have distorted their incentives and accounts for the lack of a viable business model.

⁸ The 2010 OECD Economic Survey of Germany identified three main challenges: low tertiary graduation rates among younger cohorts; vocational training system that provides too much (continued)

Regulation in Professional Services
(Higher index = stricter regulation)

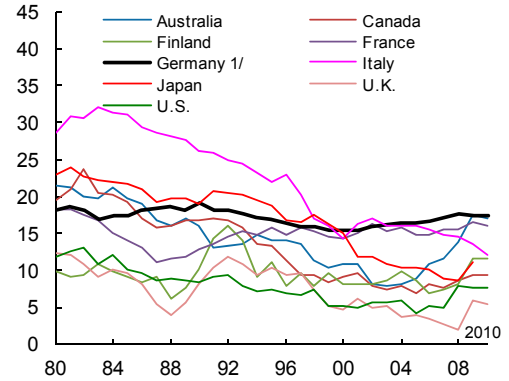


14. **Higher saving reflected both public and private sources.** National saving rose about 6 percentage points as a share of GDP between 2000 and 2007. Government, corporate, and household saving all increased.

- *Government saving* increased in the years just preceding the crisis, owing to fiscal consolidation efforts in the context of rapid growth.
- High *corporate saving* reflected an increase in profits during the export boom. Dividend payouts increased less than profits, possibly because of doubts regarding the sustainability of that boom. High profits did not fuel greater investment but rather were

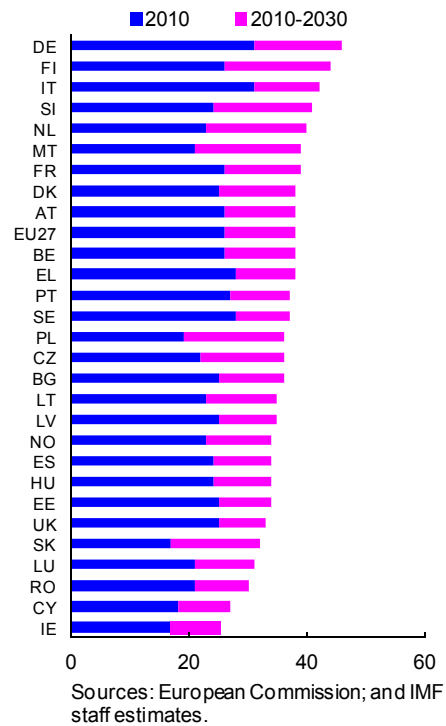
specialized and too little general knowledge, making it hard to adjust to changes in labor demand; and relatively low participation in lifelong learning.

Household Saving Rates
(Percent of disposable income, sa)



Source: Haver Analytics.
1/ Data prior to 1991 are for West Germany.

Old Age Dependency Ratio
(Population 65+ as % of population 15-64)



used to strengthen corporate balance sheets.

- The increase in *household saving* reflects the needs of an aging society and, possibly, policy uncertainty. Germany has one of the highest household saving rates in the OECD—it remained high even as it declined in

many other advanced economies, in some cases spurred by overly easy access to credit. Moreover, after a decade-long post-unification slide, the saving rate rebounded over the course of the 2000s—even as the disposable income fell as a share of GDP. This reflects both tradition and the life-cycle needs of an aging society. At the same time, it is quite likely that the rise in household saving also reflects the impact of pension and labor market reforms in the first half of the 2000s, which reduced the generosity of pension and unemployment benefits.

which added 13 percentage points to the debt-to-GDP ratio. Discretionary measures and cyclical factors also contributed, as the fiscal balance deteriorated by 3.4 percent of GDP due to a combination of fiscal stimulus (1.5 percent of GDP in 2009 and 0.7 percent in 2010) and automatic stabilizers, while nominal GDP was nearly unchanged.

B. Fiscal Imbalances

15. **The factors leading to accumulation of public debt have shifted over the years.** The cost of reunification largely explains the big leap in the debt-to-GDP ratio that occurred in the 1990s. A run-up in debt in the first half of the 2000s was mostly due to the weak economy and the attempts to improve growth prospects by cutting taxes. Intergovernmental relations also played a role, with federal co-financing of regional projects skewing the incentives toward their expansion and resulting in high administrative costs.⁹ The SGP has not prevented Germany from maintaining a debt ratio above 60 percent during the last decade. Finally, between 2008 and 2010, the increase in the debt ratio was largely driven by financial sector support,

⁹ OECD, 2006, Economic Surveys: Germany.

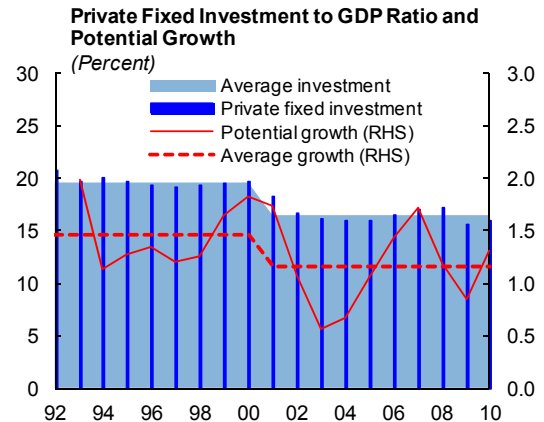
III. ARE GERMANY'S IMBALANCES A PROBLEM?

A. National Perspective

16. **Factors behind Germany's external surpluses do not primarily reflect market failures or policy-induced distortions.** Wage moderation was a reasonable reaction to its earlier excessive growth, which had led to a surge in unemployment, and there is little reason to believe that German institutions or government policies are holding wage growth down. While moderation may have led to some overshooting on the competitiveness front, now that the unemployment rate is at all-time lows, wage moderation may well dissipate. The strong growth of Germany's export markets was a development that was largely exogenous to Germany. Finally, with unfavorable demographic projections, it is not unreasonable for the country to run current account surpluses, although—as CGER estimates indicate—not as large as those observed lately.

17. **This said, from a domestic perspective, there are good reasons for boosting private demand and reducing vulnerability to external shocks.**

- *Low output and productivity growth reflect a trend decline in investment relative to GDP.* The impact is twofold—on demand in the short run and on productive capacity in the longer term.



Source: IMF, *World Economic Outlook*.

- *Lackluster productivity growth in the non-tradable sector is holding back growth prospects.* An acceleration of services productivity would strengthen incentives to invest in the sector and also stimulate consumption, boosting domestic demand, by raising permanent income. This would improve the standard of living, while reducing current account surpluses over the medium term.
- *Germany has benefited from its dependence on foreign markets, but it also makes the country susceptible to external shocks.* German exports have so far remained largely isolated from low-wage competition, making a hefty contribution to GDP growth. Going forward, however, the country's position is likely to be challenged as emerging market producers move up the technological ladder, significantly limiting the external sector's contribution. Accordingly, this may

result in sluggish GDP growth if domestic demand remains weak.

- *To some extent, these factors are mutually reinforcing.* Weak productivity growth, particularly in the non-tradable sector, lowers incentives to invest, holding back potential output and income, and thus consumption. In turn, lower domestic demand reduces the incentive to invest, notably in the services sector, thus dampening demand for labor and keeping wages and consumption in check.

18. **High public debt has well-known vulnerabilities associated with it.**

However, it should be noted that Germany's public debt (both gross and net, in percent of GDP) is among the smallest in advanced G-20 economies. German bunds continue to be the benchmark asset in the euro area, and CDS spreads on German debt remain low. Thus, while fiscal space needs to be rebuilt, fiscal consolidation can afford to proceed at a measured pace, helping the output to recover from the crisis.

B. Global Perspective

19. **Germany could contribute to higher and more stable global growth by relying less on exports and more on domestic demand.** Increasing domestic demand in Germany could raise global growth, while a lower reliance on external growth sources could contribute to global rebalancing and thus to a more sustainable global growth.

20. **Germany's solid fiscal position is essential for maintaining stability in the euro area.**

Because of its size and history of (relative) fiscal prudence, demonstrated again by the introduction of a constitutional-based structural balance rule, Germany plays a key anchoring role in the euro area. Should investors lose confidence in Germany's creditworthiness, the implications may be severe, with borrowing costs going up all across Europe. In addition, respect for the SGP by the largest member state is key for maintaining stability and budget discipline in the euro area.

IV. HOW TO ADDRESS IMBALANCES?

A. Policy Priorities

21. **A number of factors should reduce Germany's current account surplus going forward.** The need for budget consolidation is smaller in Germany than in most of its trading partners, and the smaller fiscal improvement (relative to trading partners) would (other things being equal) lower its current account balance.¹⁰ With anemic growth in advanced economies, the demand for German exports is likely to be low for a protracted period. This may, however, be offset by rising demand from emerging economies, particularly if they reorient their demand toward more consumption and investment. At the same time, the ongoing increase in productive capacity and technological sophistication of emerging market manufacturers may threaten Germany's competitive position. And with the unemployment rate at its lowest in nearly 20 years and 5 percentage points below its fairly recent peak, wage moderation may be running its course. In fact, wage growth had picked up just prior to the crisis, interrupting a period of wage discipline—but then the crisis put a lid on wages.

22. **Structural policies directed at promoting growth and stability could**

also help reduce external imbalances.

Importantly, policies that stimulate consumption and investment would shift growth towards domestic demand and reduce Germany's dependence on foreign demand, thus lessening the uncertainty and decreasing vulnerabilities. That, in turn, should boost investment, which is key to higher growth and potential output, and lower the need for precautionary saving. Overall, these structural policies, including tax reform, will raise welfare and are likely to lower current account balances over the medium term. Action on several fronts can help achieve these objectives.

- *Lower corporate taxation would stimulate investment.* While the 2008 corporate income tax reform improved Germany's tax competitiveness, abolishing the inefficient, volatile, and geographically uneven trade tax imposed by municipalities would further reduce the marginal effective tax rate.
- *Further development of venture capital and private equity markets would increase availability of risk capital, spurring investment and productivity growth.* The measures could include: (i) removing uncertainties regarding the tax treatment of venture capital firms; (ii) redesigning the change-of-ownership rule, which eliminates loss and interest carry-forward; and

¹⁰ "Hitting Two Birds with One Stone: Does Fiscal Adjustment Lead to External Adjustment?" WEO September 2011, Chapter 4.

(iii) promoting faster restructuring proceedings for insolvent entities.

- *Reorienting German banks to serve domestic clients could help increase investment and consumption.* While the small institutions (cooperative banks and Sparkassen) are domestically oriented, the large, state-owned Landesbanken shifted a considerable part of their portfolio abroad in the run-up to the crisis and have now found themselves in a difficult situation and in need of government support. Reducing the states' ownership of these institutions (direct and via Sparkassen) would spur them to establish a viable business model, which would likely involve greater domestic lending. Staff research has found that a smaller public share of the banking system is associated with smaller current account balances.¹¹ Even if such reform has insignificant impact on investment and current account, it will benefit financial stability.
- *Less regulation and measures to improve education would spur productivity growth and domestic demand.* In the long run higher productivity would mean higher output, higher income, and commensurately higher domestic

demand without a first-order effect on the current account. However, on the likely protracted transition path the prospect of higher productivity growth would stimulate additional investment, and higher permanent income would push current consumption up, reducing the trade surplus.

23. **The government has identified a set of measures to set the public debt ratio on a declining path.**

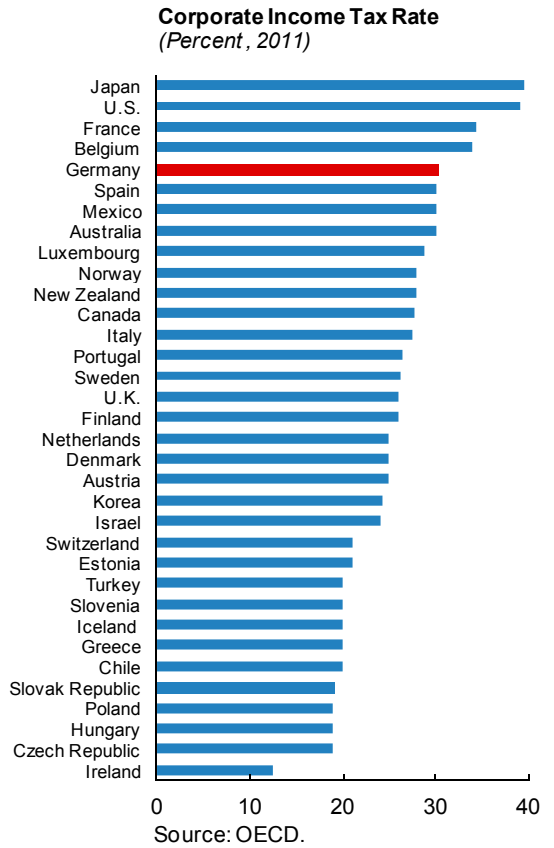
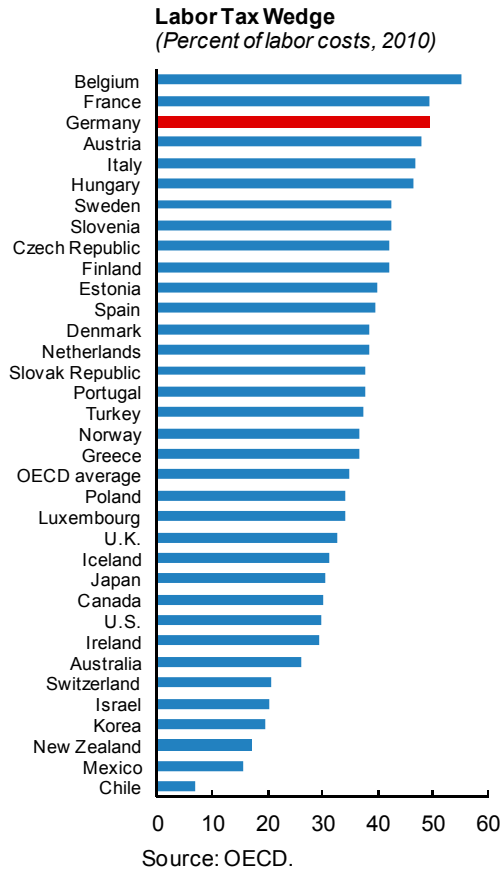
The envisaged pace of consolidation is appropriate, balancing the budget around 2014, although it could be slowed in case of a substantial negative shock to growth. Fiscal adjustment is anchored by a new limit on structural deficits of the federal and state governments, which is enshrined in the constitution and should therefore improve the national implementation of the SGP.

- *Within the budget envelope there is scope for making the adjustment more "growth-friendly."* The large labor tax wedge facing low earners could be reduced by introducing in-work and earned income tax credits or by raising the threshold for low-income tax relief and reducing the speed of benefit withdrawal. A reform of the income-splitting regime could improve incentives for labor market participation by secondary earners. Abolishing the inefficient and volatile local trade tax would reduce the burden on corporations. Reduction in direct taxes would promote employment, investment, and growth,

¹¹ A. Ivanova, 2011, "Current Account Imbalances: Can Structural Policies Make a Difference?" forthcoming *IMF Working Paper*.

and could be paid for by eliminating concessions in the VAT, raising property and inheritance taxes, and cutting some poorly targeted social

benefits (such as unconditional child support). There is also scope for increasing the efficiency of education spending.



B. Toward an Upside Scenario

To address Germany's imbalances, possible elements contributing to an upside scenario could comprise product and labor market reforms combined with a tax reform to boost investment.

24. **Structural reform in the services sector to boost productivity and investment.**¹² In *product markets*, gradual convergence to best practice of regulations in retail trade and professional services would increase productivity in nontradables and raise investment. In *labor markets*, improving the availability of child care, along with tax reform, would increase labor participation of secondary earners, elderly, and low-skill workers (see below).

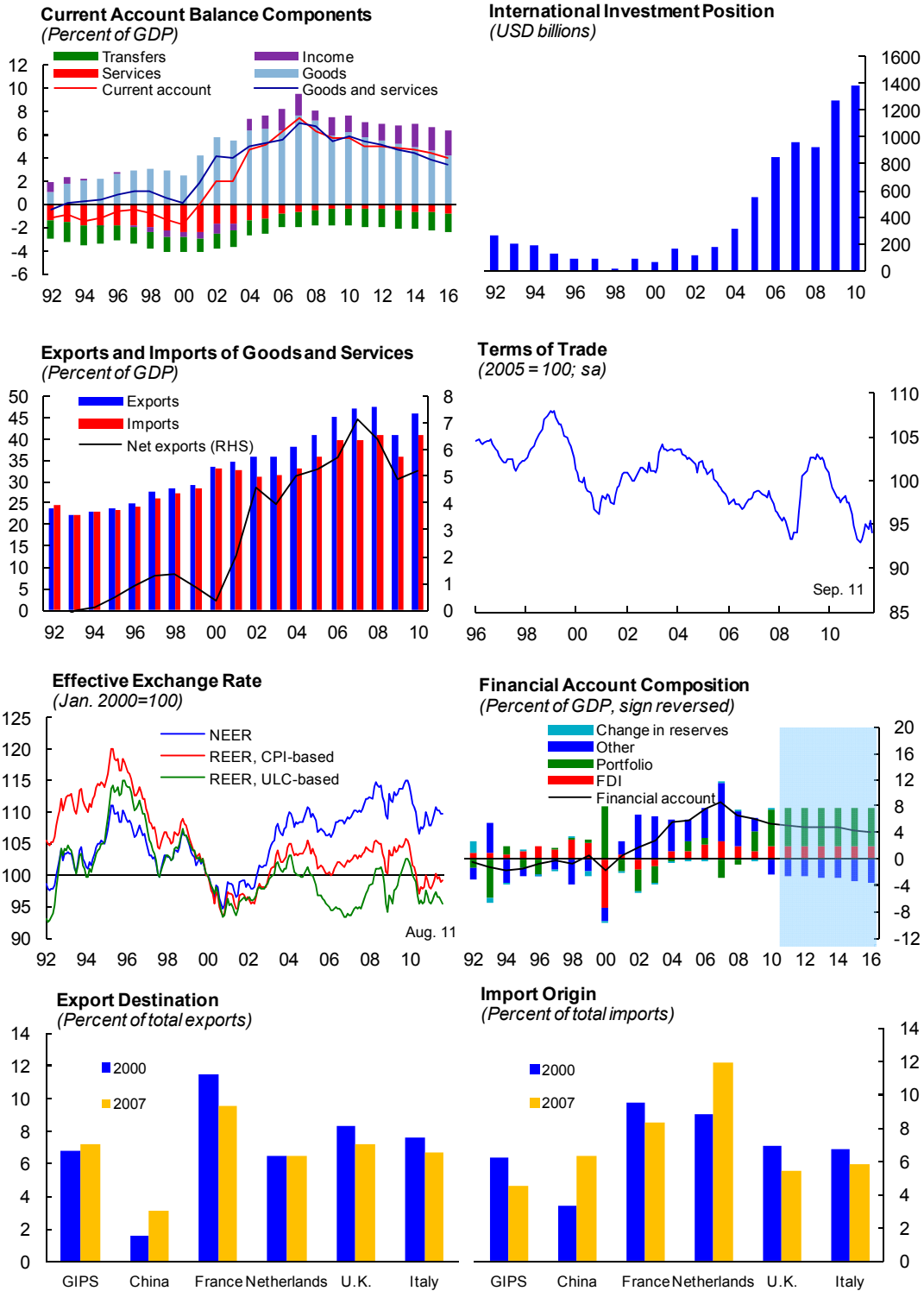
25. **A tax reform, alongside structural reform, to further support investment and employment, while minimizing distortions.** Alongside structural reform, a revenue-neutral tax reform that shifts taxes away from more distortive direct corporate income and personal income taxes to less distortive indirect taxes will help further promote investment, employment, and growth. Specifically, corporate taxes and personal income taxes are lowered (by 1 percent of GDP each) to increase investment and employment. For *corporations*, this emulates elimination of the municipal trade taxes and introducing an allowance for the normal return on new equity (to remove the debt bias). For *individuals*, the

reforms (described briefly in paragraph 23) would affect those marginally attached to the labor force (secondary earners; elderly; low-skill workers) and hence may be expected to have a considerable effect on labor supply.¹³ These tax cuts are financed by an increase in the consumption tax collection in the amount of 2 percent of GDP. This is achieved by moving towards best practice via eliminating concessions (reduced rates and exemptions) in the VAT.

¹² Structural reform scenario was done in close cooperation with the OECD, which provided estimates of the impact on productivity.

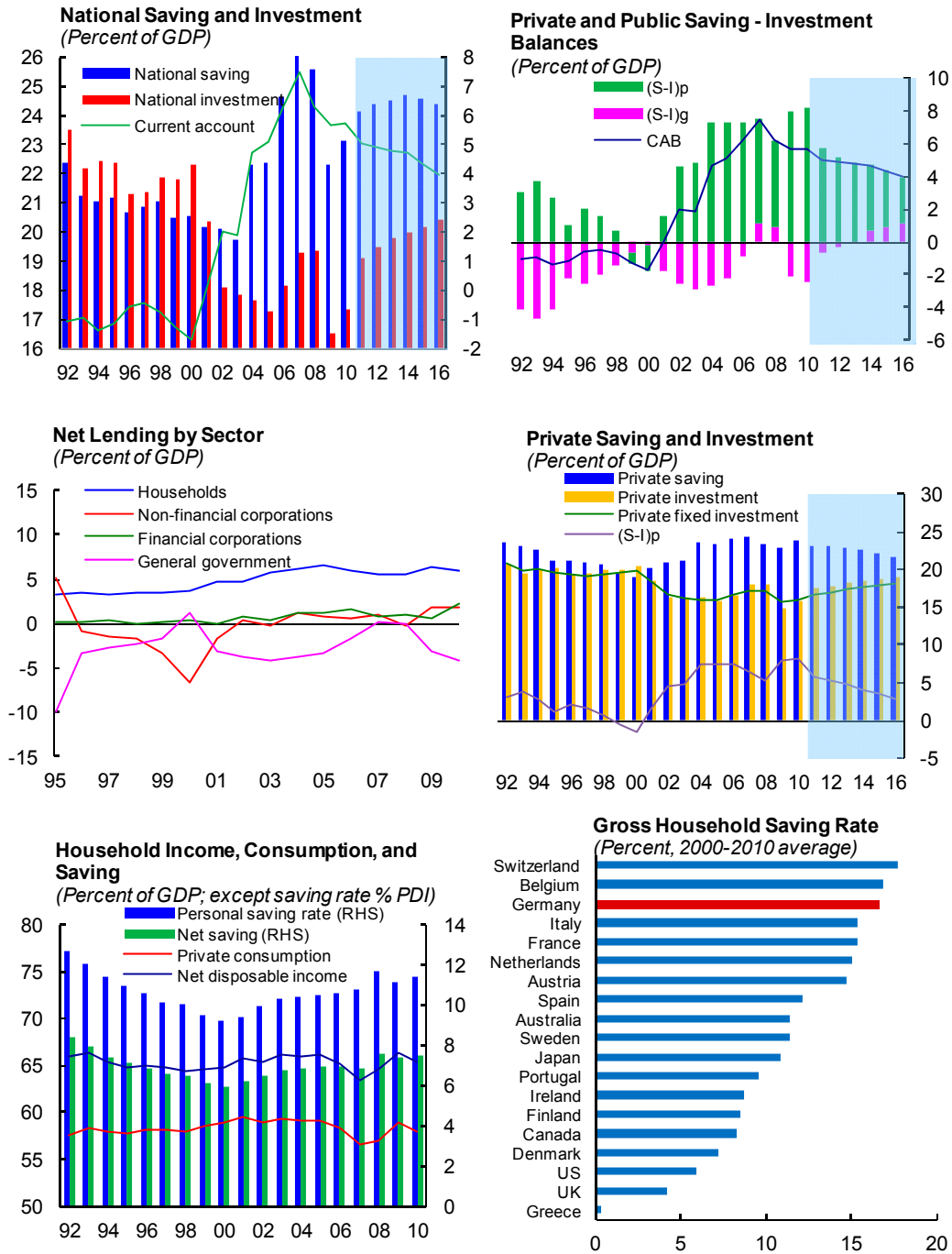
¹³ The reason is that for these groups the incentives affect the participation margin (the decision of whether to seek employment as opposed to how many hours to work).

Figure 1. Germany: External Sector



Sources: IMF, *World Economic Outlook*; *International Financial Statistics*; *Direction of Trade Statistics*; Global Data Source; Haver Analytics; and Bloomberg L.P.

Figure 2. Germany: Investment and Saving



Sources: IMF, *World Economic Outlook*; Global Data Source; Haver Analytics; and Bloomberg L.P.

G R O U P O F T W E N T Y



INDIA

SUSTAINABILITY REPORT ¹



Prepared by Staff of the

I N T E R N A T I O N A L M O N E T A R Y F U N D

¹ *Report 7 of 10.* At the request of the G-20, IMF staff has provided analyses and assessments of member's economies and policies in a set of reports for the Mutual Assessment Process (MAP). These reports serve as inputs for the Action Plan agreed by G-20 Leaders at the Cannes Summit. The 2011 Staff Reports for the 20 MAP consist of the following: (i) an Umbrella Report that provides an integrated summary of the component reports and an upside scenario for G-20 collective action; (ii) an Accountability Report that summarizes members' progress toward policy commitments since the Seoul Summit in 2010; (iii) a MAP Report providing analysis of members' medium-term macroeconomic and policy frameworks; and (iv) Sustainability Reports for seven members (China, France, Germany, India, Japan, United Kingdom, and United States)—identified by G-20 indicative guidelines—to assess the root causes and policy implications of key imbalances.

EXECUTIVE SUMMARY

G-20 indicative guidelines identified India as experiencing "moderate" or "large" fiscal and private saving imbalances. Fiscal imbalances have remained large even as trend growth has accelerated, posing medium-term risks. Yet they continue to be financed at relatively low cost, owing to the conjunction of high private saving and restrictions that channel this saving into government bonds. Fiscal adjustment and an unwinding of financial restrictions are consequently needed to reduce imbalances and sustain growth.

Fiscal imbalances reflect a weak revenue system, large spending pressures, owing in part to political economy considerations, and financial market restrictions that permit fiscal excesses to persist with little market stress.

- Rising expenditures reflect a high incidence of poverty that creates persistent pressure to increase social spending, which is difficult to resist in an era of rapid growth; coalition governments at the national level; and complex federal-state fiscal arrangements. At the same time, the resources to fund such spending are limited by a narrow tax base, low compliance, and weak collection efforts.
- There is little market pressure for adjustment, because high private saving, external capital controls, and statutory investment requirements in government securities have ensured a stable and relatively low-cost funding base.

Private saving imbalances reflect structural factors, especially rapid trend income growth.

- As growth has quickened, a growing proportion of households has vaulted above subsistence consumption levels, while a rising share of working age population has prompted life-cycle saving (e.g., for retirement) and a poorly developed health insurance system has encouraged saving for precautionary purposes.

Fiscal imbalances pose medium-term risks to stability and growth.

- A perpetuation of fiscal imbalances limits the space for deploying counter-cyclical fiscal policy or addressing contingent needs and, as evident from recent market reactions to sovereigns with unsustainable fiscal imbalances, raises the risk of higher risk premiums.
- Subjecting financial institutions to high levels of mandatory government financing crowds out lending to the private sector and distorts interest rates, making it difficult to develop the private bond market and thereby finance much needed infrastructure investment.

Consequently, to anchor strong, sustainable and balanced growth, India needs to fiscally consolidate and alleviate financial sector restrictions.

- Revenues should be raised by implementing the long-awaited goods and service tax and reforming the personal income tax code. Expenditures could be limited by scaling back fuel and other subsidies, and improving spending efficiency.
- Financial sector restrictions, including capital controls, should be wound back gradually, and insurance markets developed.



INDIA

SUSTAINABILITY REPORT 2011¹

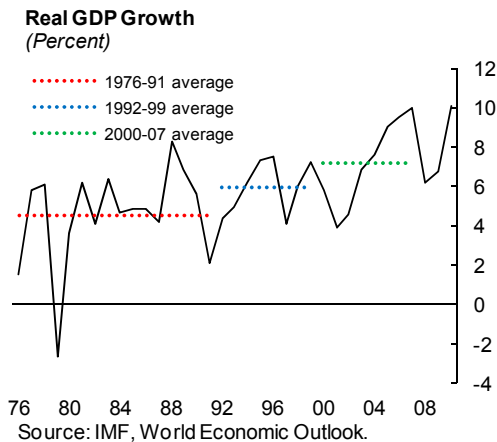
India's fiscal imbalances have remained large despite a sustained period of high economic growth. Large budget deficits and high public debt can be traced to a political economy that exerts strong pressure on spending, a weak revenue system, and financial restrictions that permit weak fiscal balances to persist with little market stress. At the same time, high growth and favorable demographics have caused private saving to surge. The perpetuation of fiscal imbalances poses risks for macroeconomic stability, as evident from recent developments in major advanced economies, and may serve as an impediment to India's fundamental objective of sustaining high growth. Highly favorable growth-interest differentials, which have periodically helped restrain a rise in the gross debt ratio, are unlikely to persist indefinitely. So, fiscal adjustment is needed to reduce imbalances and sustain growth, through a combination of revenue reforms, a change in the size and composition of expenditures, and alleviating financial distortions.

I. BACKGROUND

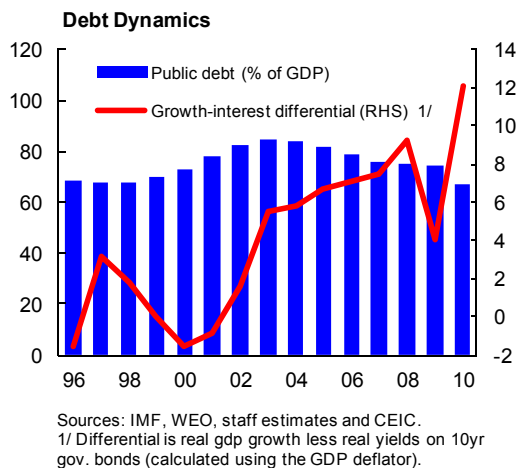
1. **Widespread economic reforms following an external crisis in 1991 ushered in an era of impressive growth in India.** Widening fiscal and external deficits came to the fore in 1991 when a rapid deterioration in public finances, coupled with an oil price shock and heightened political uncertainty, resulted in a classic balance of payments crisis. The post-crisis adjustment, which included a

wide spectrum of fiscal, financial sector and capital account reforms aimed at reducing government control, decreasing the pervasiveness of the "license raj" and providing a larger role for market forces, raised the potential for higher growth. Real output growth, which had averaged an annual rate of 4½ percent in 1976–1991, rose to an annual average of 6 percent in 1992–99. Growth then edged higher, to an average 7.2 percent between 2000 and the run up to the global financial crisis. The crisis only modestly slowed this momentum, as output continued to grow in excess of 6 percent each year in 2008–2010.

¹ Prepared by Mitali Das under the guidance of Josh Felman, with input from Michal Andrlé and the support of Eric Bang, David Reichsfeld, and Anne Lalramnghakhleli Moses.



2. **Despite highly favorable growth-interest differentials, fiscal imbalances have remained large.** General government deficits averaged 7.7 percent of GDP

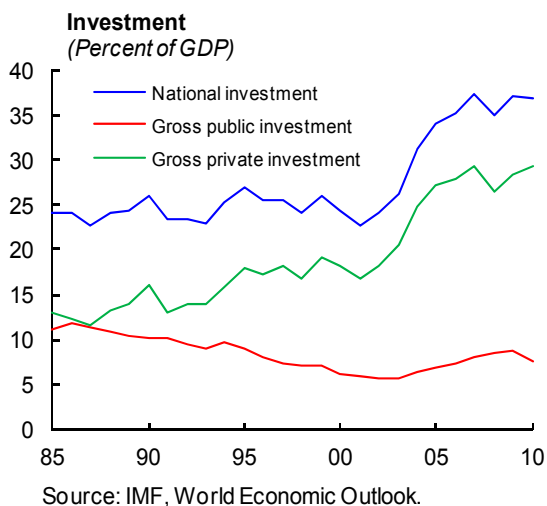
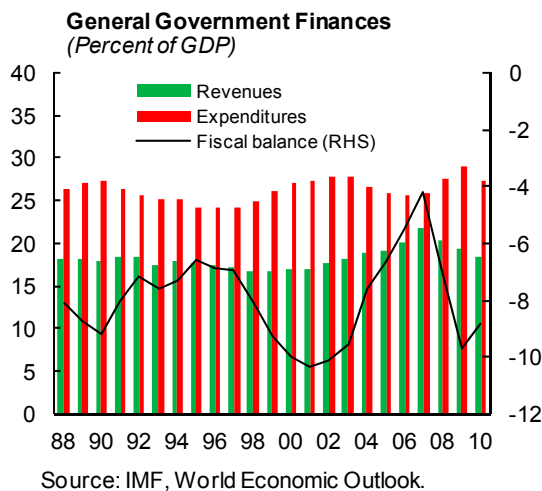


between 1992 and 2007. Primary deficits were lower, averaging 2.4 percent, but large enough to result in a steady increase in the gross public debt ratio over 1995–2003, which rose over 14 percentage points, peaking at 84.3 percent in 2003. A sustained consolidation effort, including the adoption of fiscal rules in 2003, put fiscal positions on the mend in the years preceding the crisis. But fiscal imbalances deteriorated again with the onset of the crisis.

- *After a modest improvement for a few years following the 1991 crisis, fiscal positions worsened through the early 2000s.* The revenue share of GDP stayed broadly flat over the 1990s, while the expenditure share was on a mild upward trend. Thereafter, despite significant improvement in revenue collections, which rose some 2.1 percentage points of GDP in 1998–2004, expenditures rose nearly in parallel. This occurred in part due to rising interest payments and in part due to unrelenting increases in subsidies, wages, pension payments and defense spending.
- *A strong effort at fiscal tightening then helped lower deficits and the debt ratio.* The government passed the Fiscal Responsibility and Budget Management Act (FRBMA) in 2003. Following this, public debt receded nearly 10 percentage points between 2004 and 2008, to 74.7 percent of GDP in 2008, assisted by a brief surplus in the primary balance and sizable growth-interest differentials.
- *Progress with deficit reduction reversed following the global financial crisis.* A combination of spending measures introduced prior to the crisis, a soaring subsidy bill, a large fiscal stimulus and a cyclical downturn in revenues widened the overall deficit from 4.2 percent of GDP in 2007 to over 9 percent in 2009. However, a spike in the growth-interest differential, reflecting the swift recovery and low real interest rates, helped keep the growth of public debt in check,

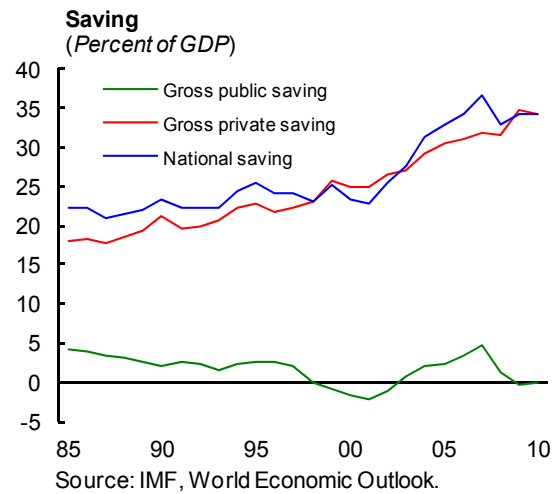
which fell to 67.3 percent in 2010, remaining, however, highest among the G-20 emerging economies.

3. **Large public dissaving and high investment needs have kept the external position in modest deficit despite a secular increase in private saving.** In particular, national saving and national investment have evolved on parallel trajectories, each only modestly rising



between 1985 and the late 1990's, before escalating sharply through 2009. Trends in national saving and investment have been

driven overwhelmingly by private sector behavior.

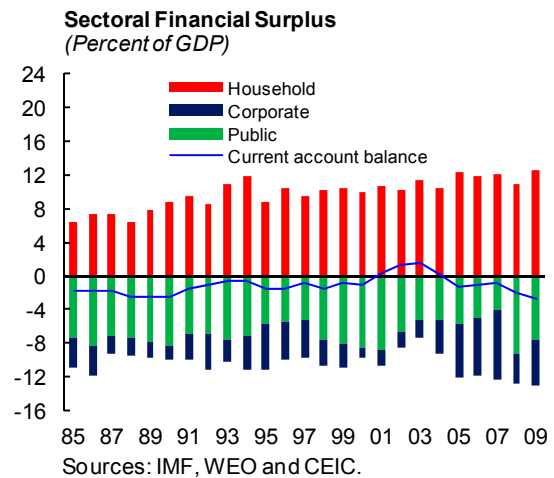


- *Private sector investment boomed following the economic reforms of the 1990s, while public sector investment went through a steep decline (over 4 percentage points of GDP in 1991–01), particularly in much-needed infrastructure investment, spurred by the government's early efforts in deficit reduction. Public sector capital expenditures rose modestly in 2001–09, but have played a negligible role in the dramatic rise in national investment. Although private gross investment is relatively high,² private sector participation in the critical area of infrastructure development has been disappointing in the past, owing to a combination of limited financial sector*

² India's private investment rate is the highest among emerging G-20 economies (and other economies at a similar level of per capita income). Among emerging G-20 economies, India's national investment rate is second to China's.

deepening, capital controls and governance problems.³

- *The surge in private saving has been led by the household sector.* An era of high income growth combined with the life-cycle implications of a rising working-age population has resulted in a rapid increase in household saving rates, which rose 10 percentage points as a share of GDP, to 24 percent, between 1991 and 2009. Corporate gross savings rose as well, about 5 percentage points in this period, reflecting improved profitability since the 1990s financial reforms. Corporate excess saving (gross corporate saving less corporate investment), though, remained negative, as private investment boomed. At 34 percent of GDP in 2010, India's private saving rate was second to China among G-20 economies.



4. **Risks of a perpetuation of imbalances over the medium-term are high.** With growth projected to remain robust and the government's announced commitment toward fiscal consolidation, staff's baseline projection is for the public debt ratio to fall 5 percentage points between 2010 and 2015, to 62 percent, in line with authorities' targets. However, risks to this forecast are high, stemming from pressures for social spending and infrastructure investment, inertia in withdrawing fiscal stimulus and continued delays in planned tax reforms. Staff projects that high growth and favorable demographics will push private saving rates higher in the medium-term, to 37 percent of GDP, by 2015.

5. **The remaining sections of the report will explore the root causes of imbalances, discuss their implications from the domestic and multilateral perspective and outline policy recommendations to address them.**

³ However, during the first half of the 11th Five-Year Plan (2007–12), private sector participation in infrastructure investment has exceeded Plan projections.

II. ROOT CAUSES OF KEY IMBALANCES

G-20 indicative guidelines identified India as experiencing “moderate” or “large” fiscal and private saving imbalances. Root causes of fiscal imbalances can be traced to political economy factors that exert strong pressure on spending and resistance to raising taxes, a weak revenue system, and government regulations that permit fiscal excesses to be financed with little market stress. Rapid growth and favorable demographics underlie private saving imbalances, while missing insurance markets also play a role.

A. Fiscal Imbalances

6. The rising share of expenditure in GDP through the late 1990s and early 2000s, then again in the years before the global financial crisis, without a commensurate increase in the revenue share of GDP reflects the failure of the government to take advantage of a sustained boom to build fiscal space. On the expenditure side, major factors include large outlays on subsidies, including because of a high incidence of poverty, a succession of coalition governments and federal-state fiscal arrangements. The key factor on the revenue side is a complex and outdated tax code. High private saving, capital controls, and statutory purchase of government securities by financial institutions combine to provide stable and relatively low-cost financing for public debt.

What lies behind rising expenditures?

7. The benefits of greater economic prosperity have accrued unevenly, resulting in persistent pressure to increase government social spending. India’s social indicators compare unfavorably regionally as well as with other G-20 emerging economies. In particular,

while poverty rates have declined over the last two decades, the World Bank estimates that 42 percent of the population (410 million individuals) remained impoverished as of 2005.⁴ As a consequence, political pressure for increasing social spending and subsidizing commodities (notably, fuel and food) is persistent. Subsidy spending accounted for 2.1 percent of GDP in 2009, almost as much as expenditures on all of health and rural development. Meanwhile, the expansion of safety nets in recent years has resulted in

India's Social Indicators: G-20 Emerging Economies Perspective

| | Poverty 1/ | Malnutrition 2/ | Employment 3/ |
|--------------|--------------|-----------------|---------------|
| Argentina | 0.87 | 2.3 | 56.5 |
| Brazil | 3.8 | 2.2 | 63.9 |
| China | 15.92 | 4.5 | 71.0 |
| India | 41.64 | 43.5 | 55.6 |
| Indonesia | 19.73 | 3.4 | 61.8 |
| Mexico | 3.44 | 5.3 | 57.1 |
| Russia | 0 | n.a. | 56.7 |
| Saudi Arabia | n.a. | 5.3 | 47.2 |
| Africa | 17.35 | n.a. | 41.1 |
| Turkey | 2.72 | n.a. | 42.3 |

Source: World Bank.

1/ Percent of population earning less than \$1.25 a day at PPP.

2/ Percent of children malnourished, weight for age (under 5 years).

3/ Percent of population aged 15+.

⁴Using a World Bank indicator of poverty: headcount of persons (percent of population) earning less than \$1.25 a day at PPP.

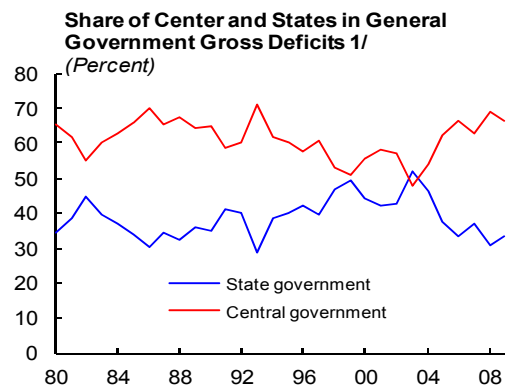
steady ascension of non-subsidy social expenditures as well, which accounted for 3.1 percent of GDP in 2009.

- *Rising expenditures are partly a result of an era of coalition governments.* Since the mid-1990s, as regional parties with diverse regional interests have strengthened, the central government has had to depend on coalitions of as many as sixteen distinct political parties to stay in power. Catering to a wide range of ideologies and constituencies has necessitated fiscal forbearance and made it politically more difficult to withdraw or reform populist schemes such as subsidized commodities and cheap electric power, which have often been poorly targeted.
- *Widening the scope of social assistance is an important step in improving human welfare,* but efficiency of implementation has been low, resulting in large leakages and denial of benefits to eligible persons.⁵ This has reflected the absence of a system of unique identification or national registers (that is only now being gradually implemented), and poor enforcement.

8. The federal-state tax and spending structure has made it difficult to enforce fiscal discipline. Under India's fiscal federalism, about two-thirds of tax revenue is collected by the central

government while states are tasked with carrying out a similar proportion of general government expenditures—using tax-sharing and transfers from the central government—to implement government policies.⁶ With implicit central government guarantees on state government debt, the system offers a high degree of autonomy to states and, in the past, few incentives to maintain fiscal restraint (since the mid-2000s, a majority of states have adopted their own fiscal responsibility rules).

- *During the 1990s, deteriorating general government balances reflected rising fiscal excesses at the state level.* In particular, the trend decline in central tax collection over the 1990s led to a reduction in transfers to states. However, states not only failed to raise



Sources: IMF staff estimates and CEIC.
1/ Gross fiscal deficit is the excess of total expenditure, inclusive of net loans, over revenue and non-debt capital receipts.

⁶ The share of states in central government revenues changes over time. It is set by the Finance Commission, a constitutional body, which meets every five years with the primary purpose of determining the sharing of centrally collected tax proceeds between the central and state governments, and the distribution of grants-in-aid of revenue across states.

⁵ Comptroller and Auditor General of India (2008).

their own revenues, but retained a high level of spending.⁷ Consequently, their contribution to the general government deficit rose from 35 percent in 1992 to nearly 50 percent in 1999.

- *Differences in tax collection responsibilities partially explain the varying evolutions of their fiscal deficits.* The central government is assigned tax collection from customs and excise duties, from which it draws its largest share of revenues, while states collect taxes on commodities and services, which constitutes the preponderance of state revenues. This system has meant that both the economic cycle and structural changes (e.g., in demand for commodities) have played a role in determining the evolution of central versus state government deficits.

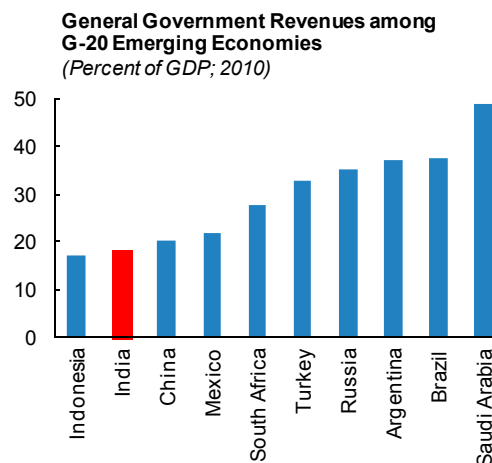
Revenue mobilization is low

9. **A narrow tax base, poor compliance and weak collection efforts have eroded tax revenues.** A comparison of general government revenues across emerging G-20 economies indicates that India (with a 2010 revenue share of GDP equal to 18.5 percent) is at the bottom end in revenue collection.⁸ In part, this reflects

⁷ Both central and state budget deficits rose in part due the large wage increases recommended by the Fifth Pay Commission.

⁸ India's revenue share of GDP fell in the lower third of the distribution each year of 2007–10, among economies whose nominal US dollar GDP per capita was between \$648 and \$1488 in those years.

the low buoyancy of the tax system, which is narrowly based on indirect taxes and manufacturing activity, with agriculture and the rapidly growing service sector largely outside the tax net. It also reflects weak enforcement, extensive loopholes, and political resistance to raising taxes in a still-poor economy.



Source: IMF, World Economic Outlook.

10. **Incomplete tax reforms after the external payments crisis contributed to declining revenues over the course of the 1990s.** Revenue collection dropped by 1.6 percentage points of GDP in 1992–99, even as household and corporate incomes surged. In part, this reflected the impact of trade and financial liberalization reforms, which narrowed the tax base by cutting trade tax rates and customs duties, but without (planned but not implemented) compensating hikes in direct taxes and measures to reduce exemptions and loopholes.

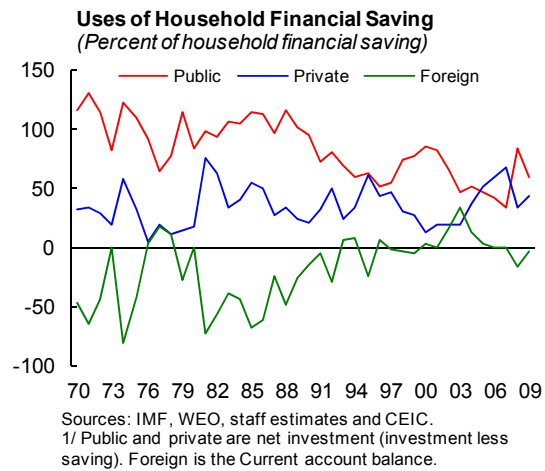
11. **Income tax revenues have been stagnant due to constant adaptation of exemption levels and income brackets.** Despite a highly progressive income tax code, and private nominal incomes that

escalated seven-fold in 1991–2008, the share of personal income tax revenues in GDP has remained very low in this time period, exceeding no more than 3.6 percent of GDP.⁹ While any explanation must include low compliance, political economy has played a significant role. In particular, the tax schedule has been changed repeatedly in this time period, with continuous increases in exemption thresholds and income brackets.¹⁰ Notably, the rise in thresholds in this period has been almost as large as the rise in nominal income growth itself. As a result, the population subject to income tax has risen modestly, from about 1 percent in 1991 to 3 percent in 2008.¹¹ This is a reflection of strong political resistance to taxation given the still-high incidence of poverty, and the ineffectiveness of tax policy given the very large share of informal workers.

Financial controls and fiscal imbalances

12. High private saving, capital controls and statutory requirements for investing in government securities have permitted fiscal deficits to be financed without discernible market stress. Major financial sector reforms

since the 1990s notwithstanding, the government’s statutory liquidity ratio (SLR) currently requires banks to hold one-fourth of their deposits in the form of government or other approved securities,¹² while insurance and provident funds are also subject to similar investment regulations. In combination with capital controls and an increasingly large pool of household saving, this system has provided a stable and relatively low-cost source of funds for financing government debt. Indeed, in 2001–07, on average, 50 percent of household saving was used to finance fiscal deficits. Moreover, regulatory requirements that direct private sector resources toward the purchase of government securities have hindered development of the corporate debt market.



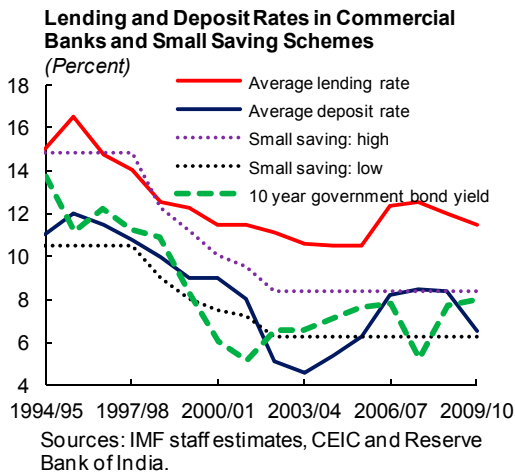
⁹ Staff estimates using data from WEO and CEIC, calculated as the ratio of direct taxes paid by households and miscellaneous receipts of government to GDP.

¹⁰ Piketty and Qian (2009).

¹¹ Piketty and Qian (2009).

¹² As part of the reforms in the financial sector in the 1990s, the SLR was progressively reduced from 38.5 percent in 1991 to 25 percent in 1995. In December 2010 it was lowered to 24 percent.

13. **High administered interest rates on small saving schemes have reinforced the effects of statutory requirements on banks.** Small saving schemes are government-operated deposits, in post offices and provident funds, which are used exclusively to finance government debt. These schemes drew about 21 percent of aggregate bank deposits in 2000–08 and provided an average 16 percent of funding for government debt in this period.¹³ The need to ensure adequate resources to finance the government’s large borrowing has kept (administratively set) interest rates on these schemes high.¹⁴

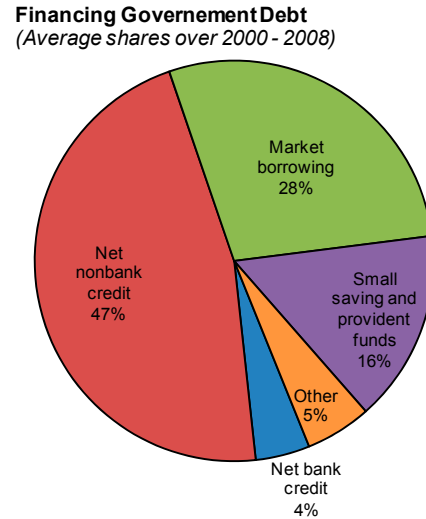


14. **High interest rates on small saving schemes have distorted lending and borrowing behavior in the banking**

¹³ Public sector debt to foreign creditors peaked at 37 percent of GDP during the external payments crisis, declined thereafter and is virtually absent at the current time. The only external debt the public sector has currently is to multilateral institutions.

¹⁴ In the pie chart above, market borrowing refers to bank bond purchase under the SLR.

sector. In effect, they force banks to keep their deposit rates high and thus, lending rates high as well. For borrowers, this has served to dampen credit demand, particularly for SMEs, who have few financing options beyond bank credit.



Source: CEIC.

15. **SLRs and high administered rates on small savings, in conjunction with inadequate improvement in the financial sector’s risk assessment framework, have resulted in perpetuating distortive financial restrictions.** In particular, while economic reforms in the 1990s raised competition, they also raised the risks of lending, without an accompanying increase in banks’ capacity to evaluate or handle these risks.¹⁵ As a result, in periods of high administered (and consequently, high bank lending and deposit) rates, investment in government securities has provided a relatively attractive and less risky

¹⁵ See Banerjee and Duflo (2002); and Singh and Srinivasan (2005).

alternative than providing credit to the private sector, given the lack of opportunities for investing in corporate bonds and external capital controls that limit investment abroad.¹⁶ As a consequence, while the 1990s reforms reduced the SLR from nearly 40 percent to 25 percent, banks' investment in government securities has since systematically surpassed these requirements, notably in long-maturity government bonds.¹⁷ This confluence of distortions created by the SLR and high administered rates, along with very gradual improvement in banks' regulatory framework, has contributed to sustained periods of "lazy banking", reducing banks' role in financial intermediation. In addition, it has raised interest rate risk due to a significant maturity mismatch in banks' balance sheets.

¹⁶ Investment in government securities also has the added advantage of having low risk rating in meeting capital adequacy requirements.

¹⁷ In part, some excess holding of government securities could be due to banks' liquidity needs given that the SLR cannot be used to obtain liquidity from the Reserve Bank of India. More recently, holdings above the SLRs could be due to an upward shift in the yield curve, which may have discouraged banks from unwinding such holdings as that would have resulted in losses being crystallized. However, these are unlikely to be a complete explanation given that banks have held as much as 40 percent of deposits in government securities, including in periods (e.g., 2003) when bond yields remained largely flat.

Commercial Banks' Holding of Securities

(Percent of deposits)

| | Government Securities | Other Securities |
|---------|-----------------------|------------------|
| 1996-99 | 32.6 | 5.6 |
| 2000-05 | 39.1 | 2.1 |
| 2006-07 | 32.1 | 0.6 |
| 2008-10 | 30.9 | 0.2 |

Source: CEIC.

B. Private Saving Imbalances

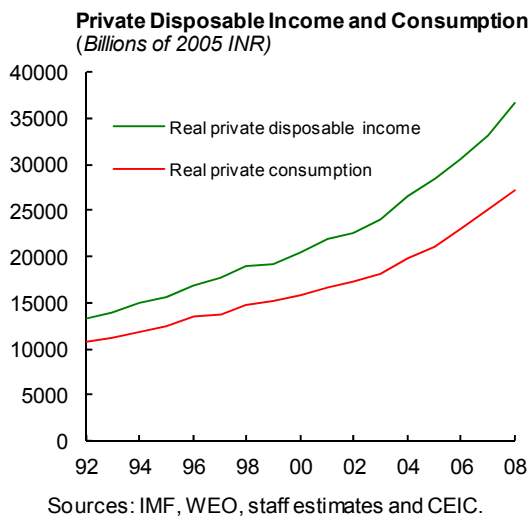
16. The surge in household saving reflects the dramatic rise in disposable incomes and a rise in the working-age ratio. Household saving rates in India have been on the rise for over four decades, increasing steadily from 9 percent of GDP in 1970 to nearly 24 percent in 2009.¹⁸

- *High growth has boosted household incomes beyond subsistence consumption levels.* Indeed, personal disposable income nearly tripled in real terms in 1991–2008, resulting in higher household saving ratios, as many households surpassed their subsistence levels of consumption. As a result, the real private consumption share of real GDP has been in steady decline, falling from 69 percent in 1991 to 59 percent in 2010. Even so, real private

¹⁸ Staff's analysis suggests that demographic, socio-economic and macroeconomic variables partially explain India's high private saving rate (IMF, 2010). These empirical estimates do not explicitly take into account whether the lack of insurance affects private saving.

consumption grew at a robust annual rate of 6 percent during this period.

- *A significant rise in the working-age dependency ratio has contributed to high saving rates.* India is in the midst of a demographic transition that has lifted the share of the working-age population from 58 percent to 64 percent over the last two decades. The observed rise in household savings thus conforms to the predictions of the life-cycle hypothesis.



- *Inadequacy of insurance vehicles and limited access to credit have played a role in the accumulation of household savings.* Households and SMEs face barriers in obtaining credit, which has contributed to the high rate of saving. Moreover, a poorly developed and state-dominated system of life insurance, a nascent private health insurance industry, combined with little scope for provident savings for informal workers, forces households to save. However, as these factors have

been in place for decades, they are not an explanation for the sudden escalation in household saving rates.

- *Corporate savings have also played a role in the growth of private saving rates.* Corporate saving rates languished between 1½–2½ percent of GDP in 1970–1990, and then rose modestly in the 1990s. It was only in the early 2000s that corporate savings rose much more sharply, from 4.5 percent in 2003 to a peak of 9.5 percent prior to the global financial crisis. This occurred primarily due to significant restructuring of corporate balance sheets in the early 2000s.

III. ARE INDIA'S IMBALANCES A PROBLEM?

Large fiscal imbalances pose risks to macroeconomic stability and domestic growth objectives, perpetuate financial restrictions that create distortions and restrain development of the financial sector. The primary effects of fiscal imbalances fall on India, although a collapse in India's growth would slow the global economy, and a sudden stop in capital inflows could create financial disruptions for other economies

A. Financial Sector and Growth Implications

17. Perpetuation of financial sector investment restrictions will pose a significant constraint on realizing India's development potential. Subjecting domestic financial institutions (banks, insurance and provident funds) to punitive regulatory requirements, and distorting credit markets by setting deposit rates that do not necessarily reflect market conditions, distorts the allocation of private saving, crowds out private investment and potentially lowers growth.¹⁹

- *Financial restriction on asset purchases will limit financial deepening and restrain much-needed infrastructure investment.* Mandated purchase of government securities has curtailed the availability of domestic credit for the private sector and restrained development of a corporate bond market. Although caps on foreign purchases of domestic bonds have increased substantially in recent years,

foreign participation has seen limited uptake, reflecting minimum maturity requirements, unfavorable tax treatment, as well as lock-in periods.

- *Firms have been forced to borrow from commercial banks at adjustable rates, or long-term in foreign currency, to fund investment projects, which has raised exposure to currency and interest rate risk.* Given segmentation in credit markets, credit constraints have been particularly acute for SMEs. Aside from the usual crowding out of private investment due to large public dissaving, policy-induced distortions in lending and borrowing rates have also served to reduce credit for the private sector.
- *With large infrastructure needs, and limited fiscal space, India's 11th Plan has called for higher private sector involvement in much-needed infrastructure investment.* The long-term nature of these projects has, however, laid bare the impediments in meeting these goals. A particular concern for the bank-dominated financial system is the risk of large maturity mismatches, while capital controls have limited foreign financing. Coupled with deep structural rigidities, including governance problems and implementation risks, envisaged

¹⁹ The positive effects on growth from unwinding investment restrictions could potentially involve some trade-offs. In particular, it could affect fiscal dynamics by raising the growth-adjusted effective interest rate paid on government debt.

participation of the private sector in this critical sphere of development could again fall short of targets.

- *Capital account restrictions:* Capital controls, instituted with a view toward minimizing exchange rate risk and preserving macroeconomic stability, have hindered firms' access to foreign saving at competitive prices. If capital account restrictions were gradually eased, there could be further efficiency gains in financial intermediation and greater availability of credit for domestic entities.²⁰

B. Implications for Macroeconomic Stability

18. **Fiscal consolidation will help maintain macroeconomic stability, create policy space for contingent needs and limit vulnerability to external shocks.** As evident from recent developments in major advanced economies, market sentiment toward sovereigns with large fiscal imbalances can shift abruptly, resulting in

higher risk premiums and adverse debt dynamics.

- *Narrowing of the growth-interest differential.* Public debt has grown even as growth-interest differentials have been large and positive. In part, this is because a number of factors have kept the cost of government borrowing low, including the captive base for government securities and capital controls. But the large differential is unlikely to persist, especially if integration with global financial markets continues to increase and SLR requirements on domestic financial institutions ease. Independently, a protracted growth shock could set public debt on a potentially unstable path.
- *Reconstituting fiscal space:* A perpetuation of fiscal imbalances limits the space for counter-cyclical policies when needed, and raises the risk of a higher risk premium on debt over the medium term. Interest payments currently absorb 25 percent of total revenues, and could become explosive if yields were to rise.
- *External balance:* Higher public and private sector investment, notably in infrastructure projects, and lower private saving (to the extent that household saving reflects the lack of social insurance) are both desirable. To minimize pressure on the current account, these shifts in national investment and private saving must be offset by smaller government budget deficits.

²⁰ Since the 1990s, capital controls have been gradually liberalized, and remaining restrictions are focused on areas such as foreign purchases of Indian bonds and resident outflows. The full removal of capital controls must, however, be mindful of the risks involved, including a possible increase in domestic interest rates (if Indian financial intermediaries decide to move assets abroad), as well as higher volatility of interest rates which could be damaging for growth. Furthermore, as capital controls strengthened India's resilience to potentially destabilizing outflows during the recent crisis, authorities must retain sufficient flexibility to put them in place if circumstances dictate doing so.

IV. ADDRESSING IMBALANCES

To address imbalances and sustain high growth, India must embark on fiscal consolidation, while increasing public investment in much-needed infrastructure projects. The plan to bring the general government deficit down to 5.5 percent by 2015, anchored by a broad-based consumption tax, is an appropriate objective; the key will be implementation. Relaxing investment restrictions on financial institutions would create a favorable environment for increasing private sector participation in infrastructure development. To the extent that high private saving reflects the lack of social insurance, safety nets could be strengthened.

A. Tax Reforms

19. Given the projected and necessary increase in public infrastructure investment, and pressing social needs, tax reforms are critical for fiscal adjustment. Over-performance of public finances during the current expansion will help reconstitute fiscal space. Although revenue growth has been relatively strong in the recovery, there is further scope to widen the tax base, streamline collection and improve compliance. A key challenge of current tax proposals is in surmounting the political economy of shifting tax collections from the centre to the state, given the increasing relative power of the states.

- *A nationwide Goods and Services Tax (GST) will simplify the tax system, widen the tax base and increase revenues in the long run. The government has recommended implementing a GST as a value-added tax.²¹ This tax would replace India's*

web of state- and national-level excise, sales and value-added taxes with a unified consumption-tax framework, and draw in the entire consumption base by taxing imports while excluding exports. Although this reform has been designed to be revenue neutral, the replacement of India's current system with the more streamlined GST is likely to raise compliance and hence revenues.

- *Reform of the personal and corporate income tax code is long overdue. The scope of the government's proposal for a new Direct Tax Code (DTC), which has provisions to limit deductions and widen the tax base, could be expanded. Although the DTC is planned as revenue-neutral, implementation of the DTC in combination with the GST will likely be growth-enhancing due to reduced distortions.*

²¹ The proposal is that the central government will tax goods at 10 percent, services at 8 percent and
(continued)

essentials at 6 percent, with the recommendation that states add identical rates. That is, the total rate on goods will be 20 percent.

- *Raising tax compliance and improving enforcement could significantly raise tax revenues.* That less than 5 percent of the population pays income tax even as the ranks of the middle class have swelled is indicative of room to raise income tax revenues by increasing compliance. Accelerating the development of a National Population Register, thus far discussed in context of better targeting subsidies to the poor (see below), could vastly improve tax collections.
- *Finally, more ambitious revenue-raising reforms should also be considered.* For example, collections from the top income brackets (where the rate is currently 30.9 percent) could be raised, possibly by reversing the recent reduction of the highest income tax bracket. Given the scope for tax arbitrage if personal income tax rates are raised and corporate tax rates are reduced, any reform of the tax code must take into account the full impact of a tax revision on raising revenue.

B. Spending Reforms

20. **Greater spending efficiency of government programs is key to square the stated consolidation objectives with high social and infrastructure needs.** Policy priorities are to shift government funds from non-essential expenditure toward infrastructure development, better allocate funds for subsidies, improve targeting, and increase the use of performance-based incentives to improve

spending efficiency. Other reforms, such as land reforms and reducing red tape, while improving governance and policy predictability, are also critical for infrastructure development.

21. **There is significant potential for subsidy reforms to reduce costs and improve social outcomes.** Major subsidies, notably on fuel products, impose a high cost on the government budget, are poorly targeted (and mostly regressive) and present opportunities for arbitrage. Recent subsidy reforms, including liberalization of petrol prices, are a step in the right direction. Additional reforms include replacement of some subsidies with targeted support (e.g. cash vouchers), and accelerating development of the National Population Register and Unique Identification number (UID) to help target subsidies more effectively.

22. **The planned expansion of social spending must be undertaken with a view toward increased efficiency of implementation.** Given the country's pressing social needs, plans to expand education and employment programs are necessary to achieve inclusive growth. Furthermore, steps could be taken to ensure that the food security bill currently being discussed, which proposes to provide subsidized rice or wheat to eligible households, is affordable and well-targeted. To reconcile expansion of social programs with planned fiscal consolidation, it is critical to improve spending efficiency (e.g. by making greater use of performance-based incentives) since, without such gains, targets in the

FRBMA could only be met by tightly constraining public investment, which would undermine growth.

C. Strengthening Fiscal Accountability

23. The commitment to fiscal consolidation made in the 2011/12 budget as well as the Government Debt Report (GDR) has improved transparency and strengthened India's medium-term budget framework.

Authorities could also provide details quantifying how they envisage fitting rising capital and social expenditures into a budget envelope that declines as a share of GDP. To minimize the risk of reversals in consolidation, amending the FRBMA as the TFC recommended, including by tightening escape clauses and introducing a fiscal oversight committee, will be crucial.

D. Financial Sector Reforms

24. Ensuring more efficient intermediation of domestic savings will require a concerted effort toward financial sector reforms. Gradually reducing the SLR will not only free up funds for private borrowing but will also allow government bond interest rates to become truly market determined. Then, government rates can become true benchmarks, paving the way for the development of the corporate bond market. At the same time, steps should be taken to boost bond market liquidity and develop securitization and hedging instruments both to ensure sufficient long-term rupee debt resources for

domestic investment needs, and to help banks manage their liquidity and concentration risks.²² Meanwhile, continued reduction of the SLR and opening of the financial sector would provide government the incentive to adjust by narrowing its base of captive finance.

E. Strengthening Social Safety Nets

25. Development of a health insurance industry will aid in reducing households' precautionary saving.

Studies indicate that Indian households' financial burden from health spending is significant.²³ Over 70 percent of all health spending is out-of-pocket,²⁴ and the 2004 National Sample Survey revealed that about 6 percent of families became impoverished due to health expenses. A slowly growing private health care industry is largely unregulated and costly for most, and only 20 percent of the population has any form of health insurance. Steps must be taken to expand hospitalization insurance, including by government-NGO partnership, to improve access to healthcare, minimize out of pocket expenses and reduce the precautionary basis for household saving.

²² Steps taken to reduce statutory requirements on purchase of government securities must be mindful that banks continue to abide by international best practice (i.e. Basel liquidity standards).

²³ Balarajan, Selvaraj and Subramaniam (2011).

²⁴ USAID (2008).

F. Toward an Upside Scenario

26. **Strengthened policy actions should consider fiscal consolidation along with removing distortive financial restrictions.** Fiscal adjustment—improving the government’s budget deficit by 2.3 percent of GDP (relative to the WEO baseline) after five years—would be in accordance with the Thirteenth Finance Commission’s medium-term plans. Fiscal adjustment scenarios would rely primarily on revenue-raising measures. Reduced SLR requirements on banks would free resources for the private sector, reducing their real cost of capital and thereby boosting investment. For the government, liberalizing financial controls would entail higher interest rates (larger debt service) which would be offset by higher VAT and labor income tax revenues. Specific reforms would include

- *An increase in the GST.* To minimize tax distortions, higher tax revenues via an increase in consumption tax/GST, which is very low in international comparative perspective.
- *An increase in labor income taxes.* Raising the GST may not suffice to reduce the budget deficit to target levels, in which case remaining revenues would come from increase in labor income taxes.

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G R O U P O F T W E N T Y



JAPAN SUSTAINABILITY REPORT ¹



Prepared by Staff of the

I N T E R N A T I O N A L M O N E T A R Y F U N D

¹ *Report 8 of 10.* At the request of the G-20, IMF staff has provided analyses and assessments of member's economies and policies in a set of reports for the Mutual Assessment Process (MAP). These reports serve as inputs for the Action Plan agreed by G-20 Leaders at the Cannes Summit. The 2011 Staff Reports for the 20 MAP consist of the following: (i) an Umbrella Report that provides an integrated summary of the component reports and an upside scenario for G-20 collective action; (ii) an Accountability Report that summarizes members' progress toward policy commitments since the Seoul Summit in 2010; (iii) a MAP Report providing analysis of members' medium-term macroeconomic and policy frameworks; and (iv) Sustainability Reports for seven members (China, France, Germany, India, Japan, United Kingdom, and United States)—identified by G-20 indicative guidelines—to assess the root causes and policy implications of key imbalances.

EXECUTIVE SUMMARY

G-20 indicative guidelines identified Japan as experiencing “moderate” or “large” fiscal and private saving imbalances. Fiscal imbalances have risen steadily over the past two decades, to unsustainable levels. Thus far, the government has been able to finance its debt at low cost because private savings has remained high. But to reduce the risks to domestic stability and the global economy, growth-enhancing structural reforms and fiscal consolidation are urgently needed.

The root cause of Japan’s fiscal imbalances lies in its “lost decades” of low growth.

- Since the asset price collapse of the early 1990s, potential growth has slowed sharply, because of a shrinking labor force, weak investment and a trend decline in total factor productivity.
- Slow growth amidst an aging population has perpetuated a cycle of adverse debt dynamics. It has depressed government revenue, while swelling social security payments and encouraging stimulus spending to revive demand. As a result, fiscal deficits have been large, pushing the public debt ratio to unsustainably high levels.
- Policy missteps—including the absence of any major revenue-raising reforms in over twenty years—have also played a part in the rapid rise in public debt.

Abundant private saving embeds a deeper imbalance, namely a high corporate saving rate and a very low household saving rate.

- High corporate saving reflects a sustained drive toward deleveraging, facilitated by wage moderation and favorable financial conditions.
- At the same time, household saving has fallen to less than 3 percent of GDP, owing to life cycle implications of a rapidly aging population and stagnating wages among younger households.

Public debt is on an unsustainable path, carrying risks to domestic and global stability.

- As evident from recent developments, market sentiment toward sovereigns with unsustainably large fiscal imbalances can shift abruptly, with adverse effects on debt dynamics. Should JGB yields increase, they could initiate an adverse feedback loop from rising yields to deteriorating confidence, diminishing policy space, and a contracting real economy.
- Higher yields could result in a withdrawal of liquidity from global capital markets, disrupt external positions and, through contagion, put upward pressure on sovereign bond yields elsewhere.

To address imbalances and anchor strong, sustainable and balanced growth, Japan needs to undertake growth-enhancing structural reforms and fiscally consolidate.

- Structural reforms, including improving competition in services and raising labor force participation, will help boost productivity and potential growth. Such reforms will also help minimize the negative demand effects of fiscal consolidation over the medium term.
- Fiscal adjustment will need to rely on a combination of revenue-raising measures, such as a higher consumption tax, and limits on spending, including through pension reform.



INTERNATIONAL MONETARY FUND

JAPAN SUSTAINABILITY REPORT 2011¹

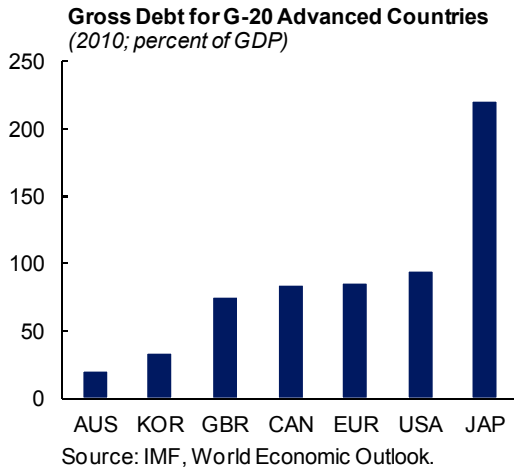
Japan has experienced a sustained period of fiscal deficits that have led to a dramatic increase in public debt. Large fiscal deficits have resulted from persistently low growth—reflecting a trend decline in productivity, a shrinking labor force and low investment—as well as the needs of a rapidly aging population and policy missteps. At the same time, private saving rates have remained high, helping Japan maintain persistent external surpluses. Unsustainable fiscal imbalances pose risks to domestic stability, and also carry risks for the global economy through possibly disruptive adjustment in global external positions and turbulence in sovereign bond markets. Growth-enhancing structural reforms, aimed at boosting investment and potential growth, and fiscal consolidation measures (through a combination of entitlement reform and tax measures) are needed to reduce imbalances and anchor sustainability.

I. BACKGROUND

1. **The collapse of asset markets in the early 1990s marked the origin of a prolonged period of economic stagnation in Japan, which has had long-lasting effects on growth, public debt and saving.** From 1973 to 1991, Japan was one of most dynamic economies of the G-20, growing at an average annual rate in excess of 4 percent. But growth came to an abrupt halt with the bursting of the asset

market bubbles in 1991. Private demand collapsed, leading to repeated fiscal stimulus over a decade to sustain overall demand. Despite steadily widening fiscal deficits and policy rates that were brought down to nearly zero, output remained largely unresponsive, growing at an average annual rate of 1.1 percent in 1991–2001. In the event, Japan suffered from a string of negative output gaps and intermittent deflation. Growth improved modestly in 2002–07, averaging 1.8 percent annually, before the financial crisis caused a severe contraction in output.

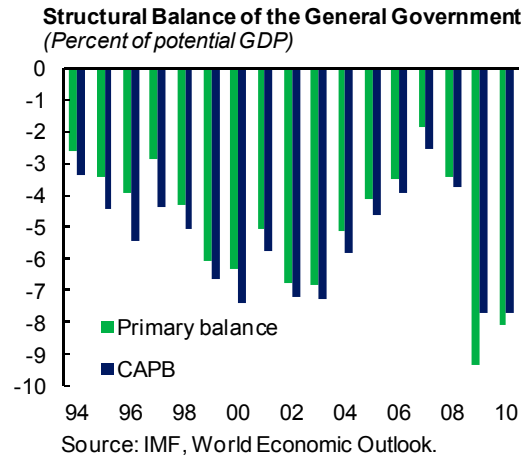
¹ Prepared by Mitali Das under the guidance of Josh Felman, with input from Michal Andrlé and the support of Eric Bang, David Reichsfeld, and Anne Lalramnghakhleli Moses.



2. Low growth, deflation, and large primary deficits have had adverse implications for the public debt ratio.

The steady increase in primary deficits, from an average 1.7 percent of GDP in the 1990s to an average 5 percent of GDP in 2000–07, is reflected in the evolution of the net debt ratio, which rose from 12 percent of GDP in 1991 to 81 percent in 2007 (67 to 188 percent in gross terms).² Following the global financial crisis, net debt escalated sharply, to 117 percent in 2010.

² Net public debt is gross financial liabilities less gross financial assets of the general government (central and local governments, and the social security fund), while gross public debt refers to gross financial liabilities of the general government. Net public debt is the more relevant concept for long-run debt sustainability, while gross debt is the key indicator from a market perspective, given Japan's large rollover requirements.

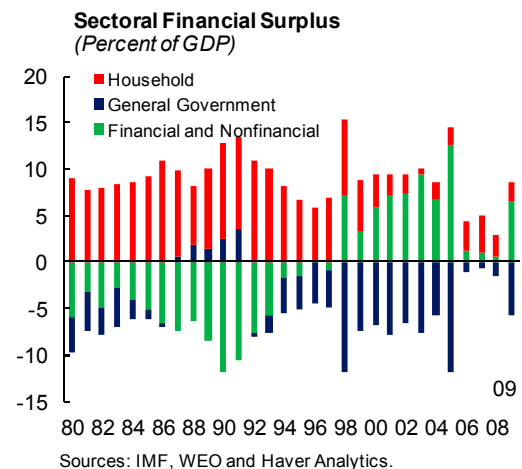


- *In the decade following the asset price collapse, rising deficits were primarily a consequence of increasing expenditures, including fiscal stimulus, and a series of tax cuts, with a lower (relative) contribution from revenues. In the late 1990s, the cyclically-adjusted deficit began to widen significantly, as entitlement spending began to rise with an aging population and structurally low revenues began to play a more significant role. The share of social security expenditures in GDP rose from 10 percent in 1991 to 16 percent in 2007.*
- *The deep recession and the fiscal response that followed the global financial crisis pushed debt to unprecedented levels. The rise in the public debt ratio reflected the combination of a steep decline in nominal output, a drop in revenue, fiscal stimulus (around 2½ percent of GDP in both 2009 and 2010) and automatic stabilizers. Recovery from the financial crisis was interrupted by the March 2011 earthquake, which*

brought fiscal balances under further pressure. Reconstruction efforts are likely to add fiscal costs of around 3 percent of GDP over the next several years.

3. Despite substantial public dissaving, Japan's external balance has remained in surplus for over two decades. This has occurred because deteriorating public balances have been roughly offset by rising private sector surpluses. In particular, deep structural changes effected by the asset price collapse led both national saving and national investment to fall about 7 percentage points of GDP between 1992 and 2008. More recently, during the financial crisis, the rapid increase in public expenditures resulted in a much larger decline in national saving than investment, temporarily compressing the external surplus.

- *The trend decline in national investment has been driven by the private sector.* Private capital formation fell from a high of 26 percent of GDP in 1990 to 18 percent in 2008, reflecting deep structural transformations in the economy, including the unwinding of overinvestment in the bubble era, a protracted process of corporate deleveraging and expectations of low growth.
- *Public investment was a key stimulus measure* in the years immediately following the asset price bust, rising



about 2 percentage points of GDP in 1990–95, to 8 percent in 1995. Thereafter, the public investment ratio steadily declined to around 4 percent in 2008, and the share of public investment in stimulus measures was relatively small in the recoveries following the Asian crisis, the IT bubble crash and the recent financial crisis (where it contributed ½ percent point of GDP in the 2009 stimulus package).

- *The decline in national saving has been led by large public sector dissaving.* In particular, private saving rates ranged between 20 and 26 percent for nearly the entire period of 1990–2008,³ while gross public saving declined 7 percentage points in 1990–2004, before rising modestly in the years before the financial crisis.

³ Private saving abruptly and briefly spiked to 31 percent of GDP in 1998.

- *The composition of private saving rates, however, has undergone dramatic reversal in this time period.* Household saving rates declined from 8 percent of GDP in 1991 to under 3 percent in 2009, reflecting an aging population and stagnating incomes, while corporate saving rates surged from 16 percent to 21 percent, as a result of a sustained drive toward restructuring and favorable financial conditions.

from the domestic and multilateral perspective and outline policy recommendations to address them.

4. **Fiscal imbalances are projected to remain large going forward.**

Following the global financial crisis and the March 2011 earthquake, staff projects that a near-term decline in GDP and reconstruction efforts will push the net public debt ratio to 160 percent by 2015. This implies that stabilizing the net debt ratio by the mid-2010s and reducing it to around 135 percent of GDP by 2020 would require a reduction of the structural primary fiscal deficit by 10 percentage points of GDP over a 10 year horizon.⁴ Reflecting the slow recovery, projections are for private saving imbalances to persist as well, at high levels over the medium-term.

5. **The remaining sections of the report will explore root causes of imbalances,** discuss their implications

⁴ These targets are more ambitious than the government's Fiscal Management Strategy, adopted in June 2010, which calls for halving the primary deficit by 2015, and starting the reduction of debt only in 2021.

II. ROOT CAUSES OF IMBALANCES

G-20 indicative guidelines identified Japan as experiencing “moderate” or “large” fiscal and private saving imbalances. The fundamental reasons for the imbalances are the long duration of the economic slump and adverse demographics.

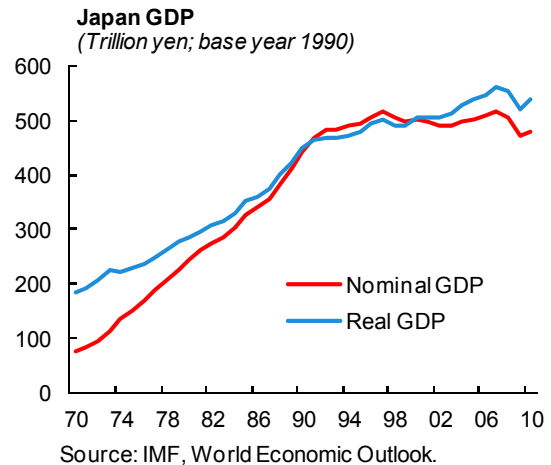
A. Fiscal Imbalances

6. **Large and rising fiscal imbalances in Japan are fundamentally a reflection of persistently low growth.** Low growth has spurred public spending and depressed tax revenues over many years, perpetuating a cycle of adverse debt dynamics. Low growth has also made it politically difficult to introduce corrective measures: Japan has had no major tax (revenue-raising) reforms in over twenty years. High private saving, strong home bias and the existence of stable institutional investors have enabled fiscal imbalances to persist thus far.

Explaining Anemic Growth

7. **Stagnating output reflects the confluence of a trend decline in total factor productivity, a shrinking labor force, low capital investment and inadequate policy adjustment after the asset price collapse.** In real terms, output grew just 25 percent between 1990 and 2007 and the contraction experienced during the recent crisis reduced real output in 2010 to its 2005 level (in nominal terms, to its 1995 level).⁵

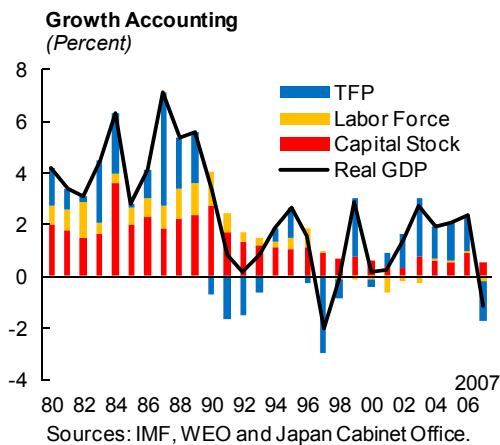
⁵ For reference, between 1990 and 2007, real output grew 33 percent in Germany, 37 percent in France, 53 percent in the United Kingdom, 64 percent in the United States, about 300 percent in India and about 500 percent in China.



- *TFP growth decelerated steadily after the collapse of asset markets in 1991.*⁶ The slowdown in the growth of TFP is significant not just because of its impact on output growth but because, by lowering the expected rate of return on capital, it has hindered private investment. While some of the TFP deceleration may have been inevitable after exhaustion of technological catch-up after the 1980s, policy distortions have played a significant role. These

⁶ Estimates of TFP in 1990-2008 vary widely, but most economists agree that TFP growth has slowed considerably since the 1990s; see Hayashi and Prescott (2002), Jorgenson and Motohashi (2005) and Naoki (2011). Calculations here are based on a standard Cobb-Douglas production function, with capital share of output set at 0.32 (average in 1980-1989).

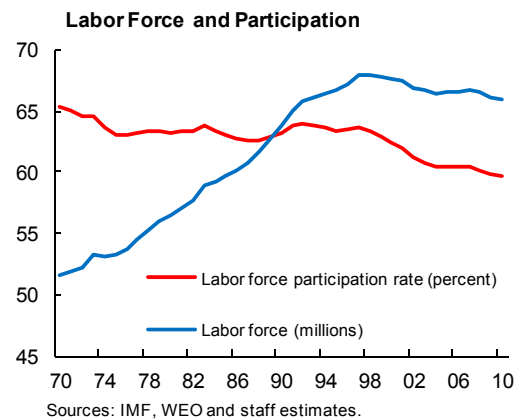
include government policy schemes that subsidize inefficient firms through credit guarantees; barriers to entry in key service industries that inhibit competition and limit incentives for firms to invest in productivity-enhancing technology;⁷ and restrictions on inward FDI that limit spillovers such as transfer of technology. Credit guarantees to SMEs have perpetuated the “zombie” problems of the 1990s, as inefficient firms have lingered, constraining investment by healthier firms.⁸ Japan’s low aggregate productivity is largely a consequence of low productivity in services, as manufacturing has witnessed sustained productivity gains over the last decade.



⁷ Service sector investment in R&D and particularly in information and communication technology (ICT), which was instrumental in accelerating productivity elsewhere (e.g., the United States), is notably low.

⁸ The widespread practice in the 1990s, of Japanese banks lending to unprofitable firms, or *zombies*, whose presence discouraged entry and investment by healthier firms. See Caballero, Hoshi and Kashyap (2008).

- *Demographic changes have been inimical to growth.* The growth rate of Japan’s labor force has steadily declined since the early 1990s, turning negative in the early 2000s, with direct consequences for output and potential output growth. Participation rates have also been on a trend decline. Trends in the labor force reflect an aging population and declining fertility. The share of the elderly in the population rose 14 percentage points in 1980–2010 (in part due to rising longevity), making Japan the most aged as well as the fastest aging population in the world, while fertility rates fell from 1.75 births per woman to 1.3.⁹



- *Private investment has been weak.* While investment by large manufacturers, particularly in the export sector, has seen brief periods of expansion, investment by SMEs has stagnated for

⁹ That the decline in the growth rate of output since the asset price collapse has been much smaller in *per capita* terms than in level terms only underscores the importance of demographics in Japan.

decades. Structural changes in the Japanese economy, from lower potential growth, deflation (and its effect on real interest rates), and from distortions in the regulatory environment, lie behind these trends.

- *Inadequate restructuring in SMEs has held back investment.* In the late 1990s, large manufacturing firms restructured aggressively, spurred by pressures from competing in global markets and helped by favorable overseas conditions. Restructuring in insulated sectors of the domestic economy—notably, among SMEs in services—has been much slower. In part, this reflects credit guarantees for SMEs which limit incentives for bank-led workouts and restructuring.¹⁰ As a consequence, balance sheet problems and high leverage have lingered in SMEs, making it difficult for them to secure financing for investment. Meanwhile, the practice of directing the bulk of credit guarantees to established firms has acted as a barrier to entry against new, more productive firms, further restraining investment.
- *Investment has adjusted to expectations of lower trend growth.* The decline in the growth of the labor force, and expectations of a continued slowdown,

has implied a slower steady state growth of the capital stock and lower trend growth in the years ahead. Low growth expectations have resulted in a downward adjustment of investment. Export-oriented manufacturing has been less affected by domestic prospects as brighter growth prospects, lower production costs and bigger markets abroad have encouraged firms to substitute FDI for domestic investment.¹¹ But even in this sector, investment has been subdued barring brief episodes (e.g., 2003–07), while weak domestic prospects have dampened investment demand by domestically-oriented firms, notably SMEs in the service sector.

¹⁰ Credit guarantees to SMEs have ceilings and duration limits from 7–10 years but the credit guarantees are sometimes granted with limited evaluation on potential credit risks; (see McKinsey Global Institute, 2000).

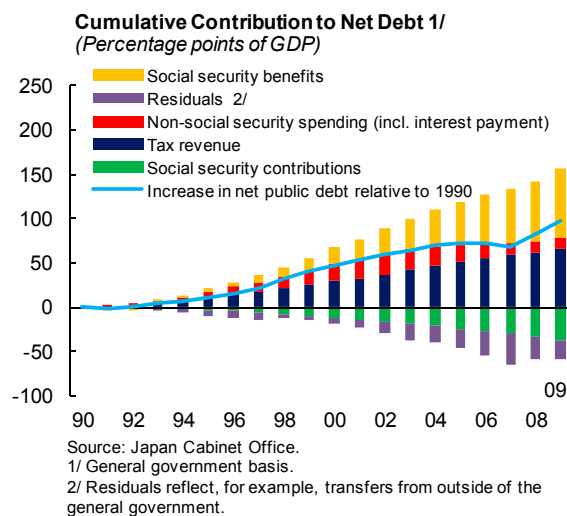
¹¹ Although outward FDI as a share of GDP is small, the share steadily increased from 0.5 percent of GDP in the 1990s to over 1 percent in the 2000–07 period.

- *Policy missteps have played a part.* Monetary policy could have been eased faster in the years following the asset price collapse. Real policy rates were lowered only gradually, from over 5 percent to 1 percent in 1990-95, providing inadequate stimulus to revive demand and prevent the emergence of deflation. In addition, the stop-start nature of fiscal policy dampened its effectiveness. With only nascent signs of recovery in 1997, fiscal stimulus was withdrawn and a consumption tax, to initiate fiscal consolidation, was put in place on the eve of the Asian crisis. But the contraction in output that followed the outbreak of the crisis led to a resumption of stimulus measures. Moreover, weak corporate governance, along with delays in recognizing the severity of NPLs and balance sheet damage for over a decade after the asset price collapse also proved costly, both in terms of taxpayer funds and in holding back a recovery as “zombie” firms lingered, constraining investment by sound firms.

8. **In the near term, many factors that have contributed to Japan’s growth slowdown are likely to persist or intensify.** Pressures from demographics are going to increase, concerns about growth expectations will be amplified by the sluggish global recovery and the earthquake, and major reforms will be needed to comprehensively address much-needed SME restructuring.

Low Growth Has Perpetuated Adverse Debt Dynamics

9. **Weak output growth has eroded tax revenue collection.** A declining revenue share of GDP has played a significant role in the buildup of public debt. This share fell 3 percentage points from the peak of the bubble to the late 1990s, and then stagnated till the mid-2000s. Stagnant revenues in the 1990s resulted from a series of tax cuts, while a narrowing of the household tax base has played an important role since. The household compensation share in GDP was fairly constant from the 1980s through the mid-1990s but thereafter, with stagnating incomes in the 2000s, it declined 2 percentage points by 2007. As a consequence, the elasticity of household tax revenue vis-à-vis GDP deteriorated.¹²



¹² Tax elasticity calculations in this section are done with respect to central government revenue.

Japan: Trends in Tax Elasticity 1/*(Percent average)*

| | 1981-1985 | 1986-1990 | 1991 - 1996 | 1997 - 1999 | 2003 - 2007 | 2008 - 2009 |
|--|-----------|-----------|-------------|-------------|-------------|-------------|
| Total tax elasticity | 1.29 | 1.31 | -0.96 | 0.55 | 4.15 | 0.97 |
| Household income tax elasticity | 1.27 | 1.56 | -5.06 | 3.48 | -2.05 | 1.77 |
| Corporate tax elasticity | 1.34 | 1.40 | -3.87 | 2.19 | 8.12 | 13.59 |
| Household compensation share in GDP | 0.54 | 0.54 | 0.54 | 0.53 | 0.52 | 0.53 |
| Household property income share in GDP | 0.10 | 0.11 | 0.11 | 0.07 | 0.05 | 0.05 |
| Corporate profit share in GDP | 0.15 | 0.15 | 0.17 | 0.18 | 0.24 | 0.23 |

Sources: IMF staff estimates and Japan Cabinet Office.

1/ Tax elasticities are vis-a-vis GDP.

- *Household tax elasticity in the 1990s was initially large and negative during the period of positive growth, then large and positive during the recession in the late 1990s, reflected in a significant drop in tax revenues over the decade as a whole.* The main reasons appear to be the provision for the deduction of asset market losses and progressivity of the income tax system.¹³
- *In 2003–07, a period of healthy GDP growth, household tax elasticity vis-à-vis GDP turned large and negative, drawing revenues down further.* Decomposing this elasticity into the elasticity of household tax revenues vis-à-vis the household tax base, and the elasticity of the household base itself vis-à-vis GDP reveals that the deterioration was largely driven by a severe narrowing of the household tax base. In particular, household incomes stagnated even as output grew at a

healthy pace, resulting in a significant drop in tax revenues.¹⁴

- *The high volatility of total tax elasticity over the last two decades is indicative of ongoing structural changes in the economy, and thus gives little indication of the impact of future taxes on future tax revenues.*

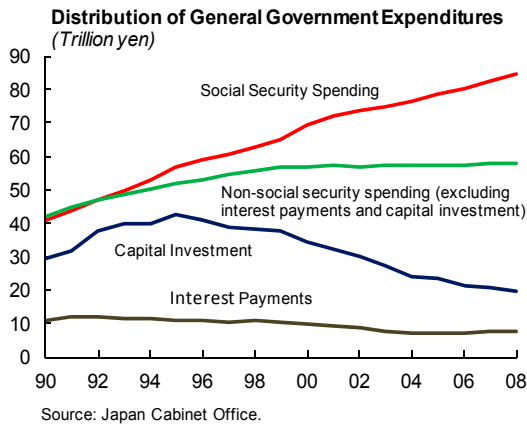
10. **Further pressure on fiscal balances has come from entitlement spending.** Since the early 2000s, Japan's non-social security spending has been well contained and, at about 16 percent of GDP in 2010, was the lowest among G-20 advanced economies. Meanwhile, social security benefits have risen steadily due to population aging. Social security spending rose 60 percent in 1990–2010, accounting for about half of consolidated government expenditures in 2010.¹⁵ Moreover, a sustained increase in the old-age dependency ratio has implied larger social security payments supported by a

¹³ See Mühleisen (2000), who notes that loss carry forwards may have depressed corporate tax elasticity in the mid-1990s.

¹⁴ While the corporate tax base has progressively grown since the 1990s, it is significantly smaller than the household tax base.

¹⁵ Estimates put old-age related expenditures at about 70 percent of social security spending.

shrinking pool of workers, which has rapidly deteriorated the social security balance¹⁶ (Appendix Figure 1).



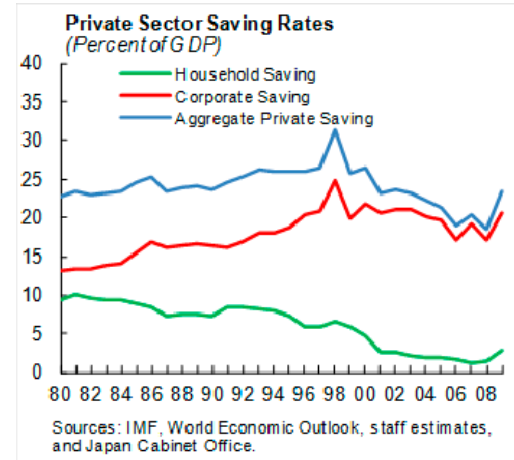
B. Private Saving Imbalances

11. **The high aggregate private saving rate embeds a deep imbalance.** In particular, it reflects a high corporate saving rate, which trended up from 13 percent of GDP in 1981 to 21 percent in 2009, and a very low household saving rate, which declined from 10 percent of GDP to less than 3 percent over this period.¹⁷ Spending retracted during the financial crisis, pushing the private saving rate up to 23 percent in 2009, highest among the advanced G-20.

¹⁶ The social security system is partially funded. The social security balance refers to the difference between social security contributions (plus government transfers) and social security payments.

¹⁷ The evidence indicates that households partially pierced the corporate veil in this period. See Box 1 in the Appendix.

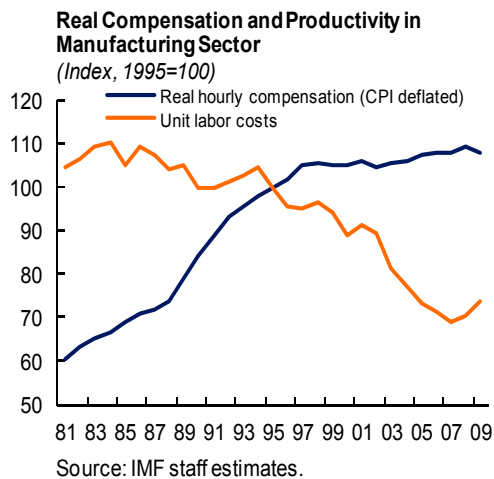
12. **The decline in household saving rates reflects a rapidly aging population and the stagnation of household incomes.**



After growing at an average annual rate of 5 percent in the 1980s, nominal disposable income growth slowed to an average 2 percent in the 1990s and was flat in 2002–07. Stagnating household disposable income has been accompanied by a rising consumption share of disposable income and declining saving among younger households, which has reinforced dissaving done by elderly households.

13. **The rise in corporate saving reflects a sustained drive towards restructuring after the excessive indebtedness built during the bubble, and has been facilitated by wage moderation and a long period of low interest rates.** Strong demand from China, and periods of real effective depreciation associated with deflation and a weak yen, along with the strong and stable income balance from corporate

overseas operations, contributed to a sharp rise in profitability (measured by asset turnover and profit margins) for a sustained period between 2002 and the financial crisis.¹⁸ The rise in corporate gross saving led to a rise in corporate excess saving (i.e., net lending) as well, reversing many years of net borrowing through the 1980s and 1990s.



- *Globalization of labor and product markets, and deregulation in domestic markets resulted in low wage growth.* Real wages stagnated, growing just 1 percent in 1996–2007. The integration of large emerging economies into the global economy facilitated the relocation of manufacturing to regions with low production costs, keeping manufacturing wages flat despite impressive gains in productivity. In nontradables, stagnating productivity

¹⁸ See Kang, Tokuoka, and Syed (2009) for a more detailed discussion of this period of corporate profitability.

and a rapid rise in the hiring of temporary low-wage non-regular workers (facilitated by deregulation) put downward pressure on wages, which helped maintain lower wages in the tradable sector as well. As a consequence, the labor income share dropped from 65 percent in 1991 to 60 percent in 2005.¹⁹ These wage developments must be viewed in the context of a longer-term decline in the labor income share in advanced economies. In particular, historically, Japan's labor income share was significantly higher than that in other advanced economies but has since declined, and is now at the G-7 average.

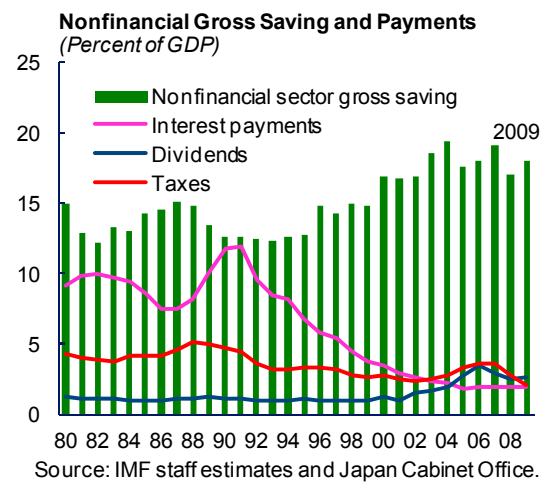
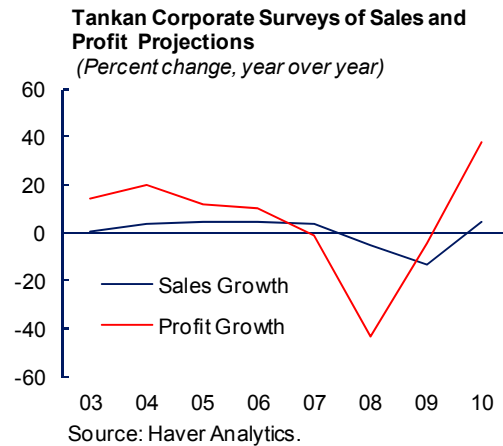
- *Favorable financial conditions aided the rise in nonfinancial corporate saving.*²⁰ The surge in profits was partly a result of a striking decline in interest payments, which dropped from 12 percent of GDP in 1991 to less than 2 percent in 2009, reflecting both lower borrowing rates and a protracted process of corporate deleveraging. Corporate profitability and saving were also boosted by lower tax payments, resulting from a decline in statutory

¹⁹ Sommer (2009).

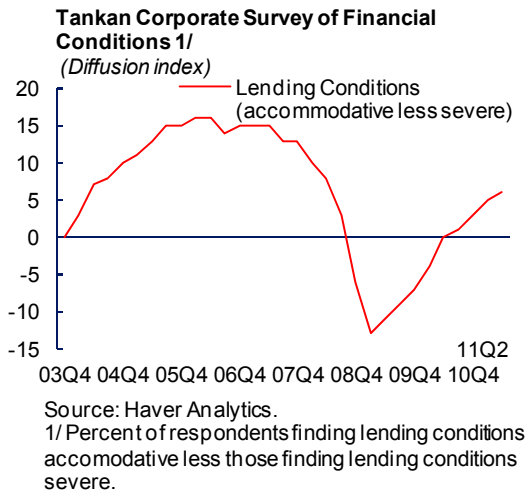
²⁰ The gross saving ratio in the financial sector has been on a mild upward trend between the asset price bust and 2009, and does not contribute significantly to the large increase in corporate saving.

corporate tax rates since the late 1980s, and stagnant dividend payouts, which have persisted between 1–2 percent of GDP in periods of stress as well as in boom years.

- *Corporates have devoted an increasingly smaller share of profits to upgrading or expanding their capital stock.* Japanese nonfinancial corporates were net borrowers continuously in 1980–97, but have since increased their net lending position from 1 percent of GDP in 1998 to 5 percent in 2009. Notably, in this time period, slightly more than half the increase in net lending emerged from a decline in capital investment rather than an increase in saving. Against the backdrop of high profitability, the subdued level of nonfinancial corporate investment is tied to both cyclical and structural factors.
- *Corporates may have viewed high profitability as unlikely to be sustained going forward, and thus held back investment in light of growth expectations.* This appears to be corroborated in the BOJ's Tankan surveys conducted during 2003–07, where firms revealed relatively subdued growth in sales.



- *Corporates may have increased saving to reduce dependence on external financing.* Faced with high debt ratios since the collapse of asset markets, Japanese nonfinancial corporates have used profits to repay debt. Moreover, concerns about vulnerability to volatile financial market conditions have spurred firms to reduce their dependence on external financing. This is supported by Tankan surveys which reveal that, since 2003, only a small majority of corporates have viewed lending conditions as accommodative.



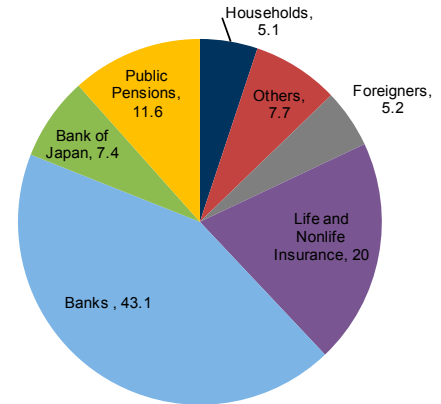
Private Saving Financing Public Dissaving

14. **Despite the large and increasing public debt, the government’s interest burden has remained low.** Between 1992 and 2009, the net debt ratio rose about a 100 percentage points while nominal yields on 10-year Japanese Government Bonds (JGBs) steadily declined and stabilized at less than 2 percent.²¹ These developments in the government bond market reflect the confluence of several factors. In effect, while high private saving (equivalently, low private spending) has forced a government that wants to maintain output to run large deficits, low risk appetite and strong home bias of

²¹ Given very mild deflation (CPI inflation averaged -0.30 percent in 2000–10), real long-term bond yields have also been low, ranging from 0.1 to 2.7 percent in 2000–10 (calculated as nominal long term bond yields less CPI inflation; data source: WEO).

institutional investors²² has led to a large domestic base for JGBs that has enabled the government to finance its debt at very low cost.²³ Notably, in 2009, 95 percent of outstanding JGBs were held by domestic financial institutions and households. Without recourse to this vast pool of savings, funding costs and debt service would have arguably risen faster, and possibly forced an earlier resolution of fiscal imbalances.

Holdings of Japanese Government Bonds 1/
(Percent)



Source: Ministry of Finance
1/ As of end 2009

15. **Government-owned saving and insurance institutions have provided a captive domestic base for government**

²² This includes banks, pension and life insurance funds, where the vast majority of household financial assets are held.

²³ Some argue that historically high real estate prices in Japan have encouraged private investors, notably households, to accumulate JGBs to achieve the correct portfolio balance between risky assets (i.e., housing) and safe assets; see Iwaisako, Mitchell and Piggot, 2004. The share of currency and deposits in households’ financial assets was 55 percent in 2008.

financing needs. Japan Post Bank and Japan Post Insurance remain fully government-owned and, until 2007, were not subject to regulation by the Financial Services Authority (FSA) under the same set of rules, risk-controls and disclosure as other financial institutions. In return, funds have been required to be invested in safe assets, particularly JGBs.²⁴ The recent suspension of plans to privatize Japan Post and proposals to double its deposit ceiling potentially increases the demand for JGBs. At the same time, it threatens to increase the size of an already large financial institution, raising the potential for systemic risk.

16. **In summary, large fiscal and private saving imbalances primarily reflect Japan's inability to resolve multiple structural weaknesses.** Low and declining trend growth, low productivity, mild deflation and the declining labor force must be tackled simultaneously, given that these structural weaknesses are mutually reinforcing.

²⁴ As of end-2010, Japan Post Bank held about 76 percent of its assets in JGBs (amounting to 19 percent of outstanding JGBs), and Japan Post Insurance held about 66 percent of its assets in JGBs (amounting to about 8 percent of outstanding JGBs).

III. Are Japan's Imbalances a Problem?

Large fiscal imbalances pose risks to domestic stability and also carry risks for global external positions and sovereign bond markets.

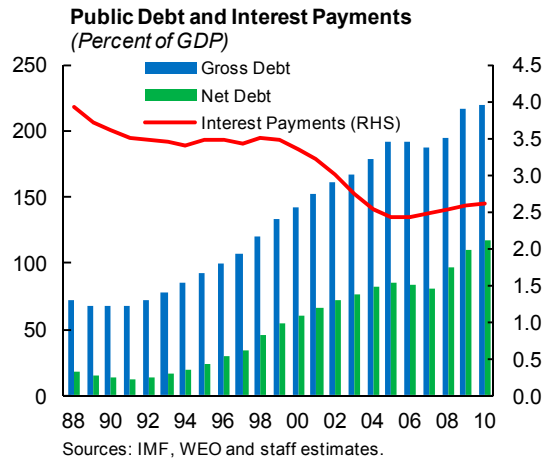
A. Domestic Perspective

17. **Should JGB yields rise from current levels, Japanese debt could quickly become unsustainable.** Recent events in other advanced economies have underscored how quickly market sentiment toward sovereigns with unsustainable fiscal imbalances can shift. In Japan, two scenarios are possible. In one, private demand would pick up, which would lead the BOJ to increase policy rates, in which case the interest rate-growth differential may not change much. The other is more worrisome. Market concerns about fiscal sustainability could result in a sudden spike in the risk premium on JGBs, without a contemporaneous increase in private demand. An increase in yields could be triggered by delayed fiscal reforms; a decline in private savings (e.g., if corporate profits decline); a protracted slump in growth (e.g., related to the March earthquake); or unexpected shifts in the portfolio preferences of Japanese investors. Once confidence in sustainability erodes, authorities could face an adverse feedback loop between rising yields, falling market confidence, a more vulnerable financial system, diminishing fiscal policy space and a contracting real economy.

- *Public Balance Sheets:* With exceptionally low nominal yields on JGBs, interest payments in 2010 were still 2 percent of GDP. An increase of just 100 basis points in average yields would raise the interest bill by an additional 2 percent of GDP, or more if there were a contemporaneous increase in debt. Absent an offsetting effect from more rapid growth, debt dynamics could deteriorate precariously.
- *Private Balance Sheets:* A JGB bond shock, particularly if accompanied by an equity price drop, would imply large capital losses for the principal creditors, which are Japanese banks and pension funds. Capital losses could raise counterparty risks and force banks into abrupt deleveraging. Staff's analysis suggests that if the shock is sufficiently large, bank credit would contract as well.²⁵ Moreover, should banks' deleveraging extend to their positions abroad, exchange rate appreciation could follow, further squeezing aggregate demand.²⁶

²⁵ IMF (2011b).

²⁶ If the risk premium shock were accompanied by an equity price drop, large capital outflows by residents could induce net depreciation and offset some of the decline in demand.



B. Multilateral Perspective

18. **A spike in JGB yields could result in an abrupt withdrawal of liquidity from global capital markets and possibly disruptive adjustments in exchange rates.** Japan's private net international investment position is significant, about \$1½ trillion, consisting primarily of the outward investments of banks, life insurers, and corporate pension funds. Capital losses following a spike in JGB yields could trigger rapid deleveraging from positions abroad.

- *In the event of a rise in JGB yields, Japanese banks may need to cut their foreign credit lines.* For example, analysis in the IMF Spillover Report for Japan indicates that in an extreme shock (e.g., a 450 basis point increase) would cut Japan's credit to foreign borrowers by close to 50 percent, assuming that foreign loans are cut first. G-20 economies, notably the U.K.

and Korea, would be among the most exposed to the loss in funding.²⁷

- Given evidence from past bouts of global turmoil, abrupt adjustments in exchange rates of major economies are likely to follow.

19. **The rise in JGB yields could put upward pressure on sovereign yields elsewhere.** The risk of transmission of sovereign debt shocks has increased considerably since the 2008 crisis, including from Japan to other sovereigns. Contagion could thus translate a rise in JGB yields into higher interest rates elsewhere. Staff's analysis suggests that sovereign bond yields in economies where public debt is already high would be most vulnerable.

²⁷ As emphasized in IMF (2011b), however, it must be noted that since Japan's cross-border banking links are relatively limited, a sudden withdrawal of funding from Japan, in isolation, is unlikely to threaten systemic stability of any other banking system.

IV. Addressing Imbalances

To address imbalances and anchor strong, sustainable and balanced growth, Japan needs to undertake growth-enhancing structural reforms and growth-friendly fiscal consolidation. Over time, these reforms should help close the output gap, thereby helping to end deflation, encourage investment and rebalance the economy toward domestic demand. In the short run, however, a key challenge will be to fiscally consolidate while minimizing the negative effects on aggregate demand.

Growth-enhancing Structural Reforms

20. **Raising productivity is key to raising potential growth over the medium-term.** Policy priorities include restructuring SMEs and reducing barriers to entry (particularly for startups) to improve productivity in services; removing distortions that impede investment; and raising labor force participation. Anticipation of higher productivity could itself encourage business investment, strengthening aggregate demand.

- *Strengthening competition in the service sector:* Regulatory reforms that lift barriers to entry in key service industries (medical care, education, transport, utilities); policies that encourage competition, including through stronger penalties on antitrust violations; broader trade and financial liberalization (such as participation in the Trans Pacific Partnership (TPP)); and weaker restrictions on inward FDI (e.g., lower equity restrictions and easing merger and acquisitions rules); would strengthen competition and raise productivity in insulated industries (OECD, 2006).
- *Restructuring SMEs and phasing out credit guarantees:* Establishing asset management companies to purchase distressed loans would promote bank-led restructuring and reduce SME leverage. Phasing out credit guarantees and assisting the exit of unproductive SMEs would remove a key barrier to entry for more efficient firms and create space for new investment.
- *Raising labor force participation:* Japan has the lowest level of female labor force participation among OECD economies, reflecting, in part, the lack of childcare services and unfavorable tax treatment that discourages female labor participation. Reducing dualism in the labor market, increasing childcare services and reforming aspects of the tax code that reduce work incentives for secondary earners would encourage more women to join the workforce. The labor force could also be raised by increasing immigration.

Fiscal Consolidation

21. **The Fiscal Management Strategy, adopted by the government in June 2010, is a step in the right direction but a more ambitious strategy is required to maintain confidence in public finances.**

The government's current plans—including targets for halving the primary deficit (in percent of GDP) by 2015, raising the consumption tax rate from 5 to 10 percent, increasing the pension retirement age and adjusting pension benefits for deflation—are welcome, but the plan does not specify steps beyond 2015 for meeting the final target of reducing the debt ratio starting in 2021 at the latest.

22. **Given limited scope for cutting expenditure, fiscal adjustment would need to rely mainly on new revenue sources and limits on spending growth.**

Japan's non-social security spending is lowest among G-20 advanced economies and capital spending has fallen to modest levels, leaving little room for spending cuts. Meanwhile, tax revenue is among the lowest in the advanced G-20 economies, primarily reflecting lower consumption and personal income tax revenue.

- *Among various revenue measures, raising the consumption tax (VAT) is the most appealing.* The consumption tax rate in Japan, at 5 percent, is the lowest among the advanced G-20. Staff's analysis indicates that a gradual increase in the consumption tax from 5 percent to 15 percent over several years could provide roughly half of the

fiscal adjustment needed to put the public debt ratio on a downward path within the next several years.²⁸

- *Raising the VAT would dampen growth in the short-run, but this could be offset over time by improved confidence in the fiscal outlook.* Relative to the no-adjustment case, staff estimates that a gradual increase of the VAT would reduce growth (compared to the baseline) by 0.3–0.5 percentage points per year in the near term. But, the GDP (level) impact would eventually turn positive as public debt declines and improved confidence reduces precautionary savings and boosts spending. However, it is critical to target a relatively high VAT rate and initiate the process of a rate increase as soon as a cyclical recovery is underway, to strengthen credibility of fiscal adjustment and maximize the debt-reducing benefits of the VAT. Staff analysis indicates that a positive investment response from a small reduction in the corporate tax that raises after-tax returns could modestly alleviate negative demand effects. Furthermore, the VAT could raise demand through an inter-temporal substitution effect, which would raise prices, inflation and lower the real interest rate.²⁹

²⁸ See IMF (2011a) for more information on the recommended adjustment strategy.

²⁹ Announcing in advance a gradual increase in the VAT could also lift inflation expectations.

- *Containing public spending growth and reforming pension entitlements in line with rising life expectancy could generate additional savings.* Staff's analysis indicates that freezing central government contributions to the public pension system in nominal terms, including by raising the pension retirement age (currently at 65 years), could yield ½ percent of GDP in savings over 10 years. Additional savings would come from freezing nonsocial security spending in nominal terms and introducing caps on social transfers.
- A scenario in which the government adjusts the fiscal position, but does not undertake the structural reforms needed to increase trend growth. As in the recent Article IV staff report, the scenario could assume that fiscal efforts are strong enough to stabilize net debt (at around 150 percent of GDP by 2016), and reduce it over time (to around 135 percent of GDP by 2020). Accordingly, the scenario would explore the implications of a gradual rise in the consumption tax from 5 to 15 percent, perhaps with a partially offsetting reduction in the corporate income tax, to spur investment. The question, then, is how this would affect the growth outlook.

Toward an Upside Scenario

23. **Japan needs both fiscal adjustment and structural reform.** Fiscal adjustment would depress growth in the short run, while structural reforms could buoy growth only after a transitional period in which the measures take hold and begin to produce positive effects. Growth effects could be particularly severe if Japan was hit by a sovereign risk premium shock. Accordingly, it would be useful to use simulations to assess the interplay of these effects, both in the short term and the longer run.

- Possible policy elements toward contributing to an upside scenario would include both fiscal consolidation and structural reform in Japan. To highlight the contributions of each on Japan's economy, the following layers could be considered:
 - A scenario in which both fiscal and structural reforms are implemented.
 - Preliminary simulations done by the OECD show that if reforms were implemented rapidly, they could add about 0.7 percentage points to growth within a few years. This work assumes that Japan's framework gradually converges to best practices in terms of barriers to FDI, regulation of network industries (ETCR), and barriers to entry in services (especially retail trade and professional services). Further work could explore the implications of restructuring SMEs.
 - A "full reform" scenario could also examine the magnitude of increase

in labor force participation that would be needed to meaningfully improve growth. The question is whether efforts to increase participation by nonworking females are likely to make a substantive difference. Is greater immigration the only solution?

24. **A comprehensive and simultaneous approach toward fiscal consolidation and structural reforms could generate considerable gains in growth over the medium-term.** Staff's model simulations indicate that although fiscal consolidation has short-term costs, the potential long-term benefits are considerable and reforms that raise potential growth could support consolidation.

Box 1. Have Japanese Households Pierced the Corporate Veil?

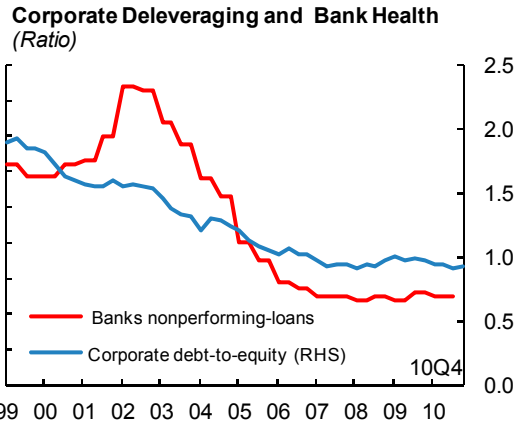
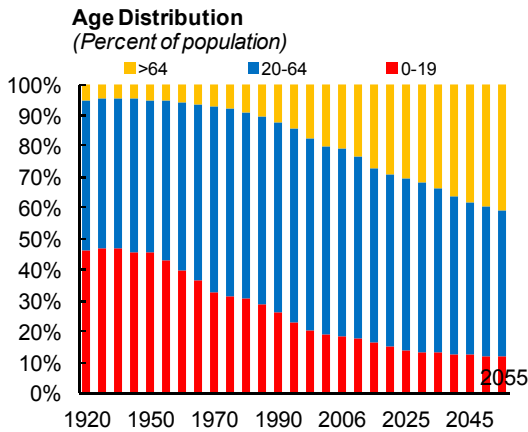
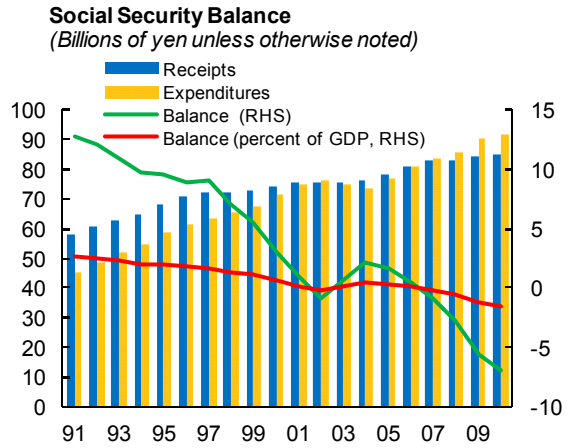
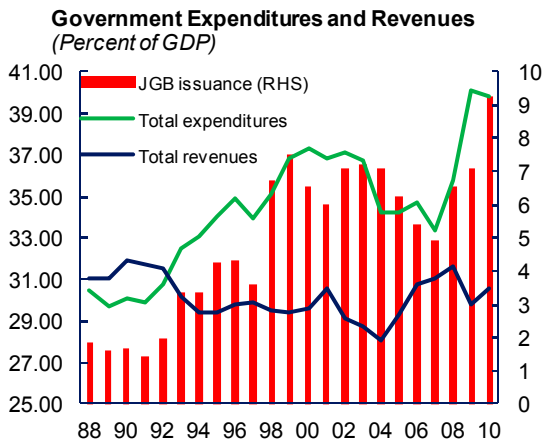
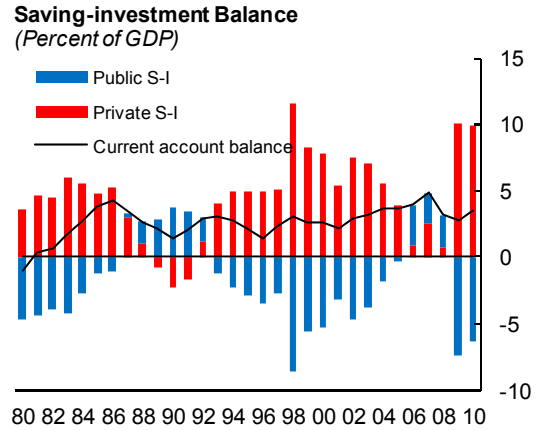
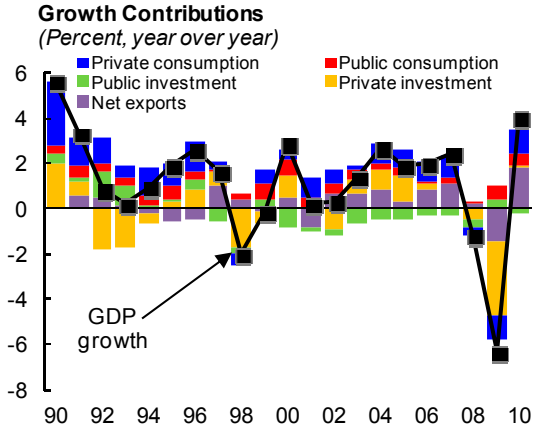
The striking decline in household saving rates over the same period, and by approximately the same magnitude, as the increase in the corporate saving rate is suggestive that households in Japan “pierced the corporate veil”, adjusting their own saving plans to offset the saving done by corporates on their behalf. The argument is that, as ultimate owners of firms, sophisticated shareholders understand that an increase in corporate saving (retention of earnings rather than paying it out as dividends) increases their own net worth and reduce their private saving, re-optimizing in accordance with the life-cycle model of consumption.

Well-known limits to this theory are that households may be myopic, liquidity constrained, imperfectly informed about changes in corporate savings and have differential propensities to consume out of wealth versus disposable income. Furthermore, even if shareholder households successfully pierce the corporate veil, their marginal propensities to save may be different from non-shareholder households (Poterba, 1987). In Japan’s case, specifically, the corporate veil argument may be harder to rationalize since the share of equities and trusts held by households is about 10 percent of total household wealth (compared to 40 percent in the United States and 20 percent in other G-5 economies).

Nevertheless, determining whether household and corporate saving in Japan is indeed fungible is ultimately an empirical question. Ongoing regression analysis indicates that Japanese households’ piercing of the corporate veil is incomplete. In particular, a ¥1 increase in corporate saving reduces household saving by between ¥0.65 and ¥0.8.¹ These estimates are higher than the estimated degree of substitutability between U.S. households and corporates; see Poterba (1987).

¹ Regression of household saving rates (as a percent of disposable income) on covariates that include corporate saving (share of GDP), household wealth (share of GDP), output gap, old-age dependency ratio; dividend payout (share of GDP) and the real interest rate.

Appendix Figure 1. Japan: Selected Indicators



Sources: IMF, World Economic Outlook, staff estimates, Haver analytics and Japan Cabinet Office.

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G R O U P O F T W E N T Y



UNITED KINGDOM SUSTAINABILITY REPORT¹



Prepared by Staff of the
I N T E R N A T I O N A L M O N E T A R Y F U N D

¹ *Report 9 of 10.* At the request of the G-20, IMF staff has provided analyses and assessments of member's economies and policies in a set of reports for the Mutual Assessment Process (MAP). These reports serve as inputs for the Action Plan agreed by G-20 Leaders at the Cannes Summit. The 2011 Staff Reports for the 20 MAP consist of the following: (i) an Umbrella Report that provides an integrated summary of the component reports and an upside scenario for G-20 collective action; (ii) an Accountability Report that summarizes members' progress toward policy commitments since the Seoul Summit in 2010; (iii) a MAP Report providing analysis of members' medium-term macroeconomic and policy frameworks; and (iv) Sustainability Reports for seven members (China, France, Germany, India, Japan, United Kingdom, and United States)—identified by G-20 indicative guidelines—to assess the root causes and policy implications of key imbalances.

EXECUTIVE SUMMARY

G-20 indicative guidelines identified the United Kingdom as experiencing low private saving and high public debt. Before the crisis, growth was over-reliant on private and public consumption, financed by high domestic and external borrowing. Household saving fell to unsustainably low levels alongside an overheated housing market. Financial sector excesses contributed to a build-up of imbalances and stability risks. Public finances which entered the crisis with little policy space are now left in a severely weakened state. Thus, the United Kingdom can best contribute to strong, sustainable and balanced global growth by taking prudent steps to restore soundness to public finances and to maintain stability in its systemically important financial sector.

The striking fall in household saving and, distinctly, the rise in private debt was due, in part, to problems in the financial sector and housing market. Relaxed lending conditions, expanded credit availability, and rising net wealth (supported by overshooting house prices) encouraged lower saving and higher borrowing to support consumption. Weaknesses in the financial sector policy framework and housing market distortions—notably constraints on new supply—contributed importantly to these outcomes.

Low public saving and high public debt after the crisis reflect structural weaknesses in the fiscal policy framework. Established fiscal rules were insufficiently strong prior to the crisis. They did not adequately adjust for the cycle and allowed for a structural and excessive increase in discretionary public spending. Economic growth and tax revenues became over-reliant on the financial sector as related business services were taking on more risk. Revenue was also over-reliant on inflated asset prices and related windfall gains were not saved.

High public debt or a return to low private saving could threaten future growth.

Crowding out effects and higher tax distortions associated with heavy public debt burdens could weigh on investment and growth down the road. A return to very low private saving could again give rise to widening macroeconomic imbalances and financial stability risks that severely disrupted growth when the crisis materialized. Moreover, given the U.K.'s central role in global finance, ensuring stability is essential for achieving G-20 members' shared growth objectives.

Financial sector reform and prudent fiscal consolidation are central to address key imbalances. To support growth and prevent another buildup of imbalances and stability risks, financial sector reform in key areas is still needed. A sustainable increase in public saving with "growth friendly" composition is needed to stabilize and reduce high public debt that would help rebuild policy space and crowd in private investment. Monetary policy should remain accommodative for some time—so long as underlying inflation remains in check. Housing policy reforms should aim at increasing affordability to mitigate excessive house price volatility (affecting household saving and debt).



UNITED KINGDOM

SUSTAINABILITY REPORT 2011¹

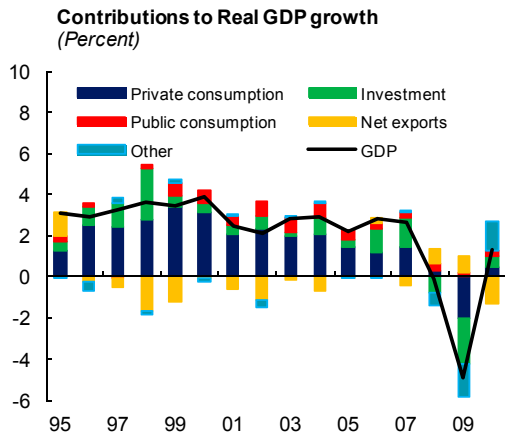
The United Kingdom's key imbalances over the past decade originate in low saving. Growth was reliant on private and public consumption—financed by high domestic and external borrowing. Public finances entered the crisis with little policy space and are now left in a much weakened state. Household saving fell to unsustainably low levels alongside an overheated housing market. Against the backdrop of low interest rates globally, financial sector excesses contributed to a build-up of imbalances and stability risks. Since the crisis, repair of both public sector and household balance sheets is underway, notably through increased saving. Budgetary consolidation efforts will need to be sustained and the performance of the new fiscal framework closely monitored. The rebound in household saving needs to be maintained. Securing strong and sustained growth will therefore require a rebalancing of demand—toward net exports and investment and away from consumption. Stronger financial reform is also crucial to safeguard stability—a key priority given the United Kingdom's role as a global financial center.

I. BACKGROUND

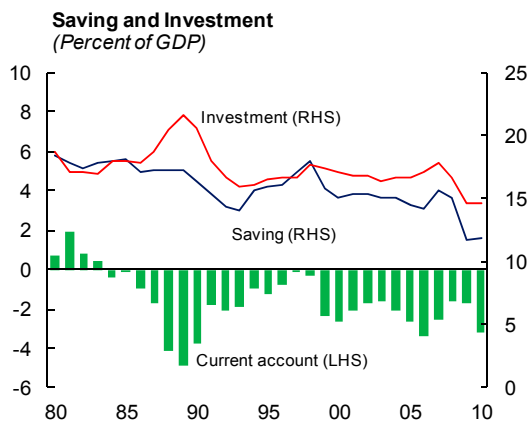
1. **Leading up to the financial crisis, the United Kingdom enjoyed a sustained period of solid growth, driven largely by consumption.** GDP growth averaged about 2¾ percent per year between 2000 and 2007, close to the average for the previous two decades. Private consumption growth was higher

but also close to its long-run average, at about 3 percent; and it remained the most important contributor to overall growth. Investment remained a modest contributor to growth and net exports were a persistent drag. The most notable difference during the 2000–07 period was the pick-up in public consumption growth to around 2½ percent, as fiscal deficits re-emerged following a period of net public saving at the end of the 1990s and early 2000s.

¹ Prepared by Shaun Roache under the guidance of Hamid Faruqee, with the support of Eric Bang, David Reichsfeld, and Anne Lalramnghakhleli Moses.

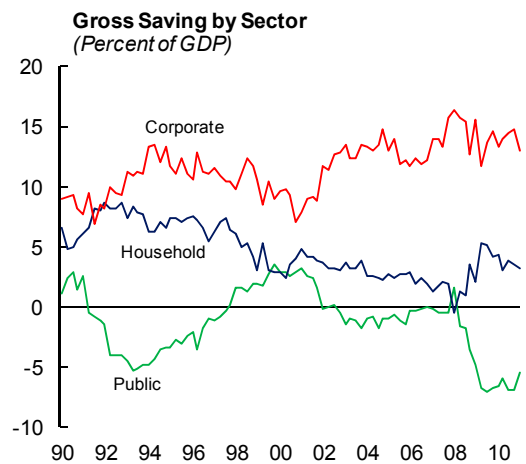


2. **Strong domestic demand, partly from robust private consumption and partly from fiscal expansion, led to sustained growth but a deteriorating current account balance.** The current account deficit increased in the early 2000s and averaged about 2¼ percent during the 2000–07 period. It subsequently fell during the recession, but has begun to rise back towards pre-crisis levels more recently. The accompaniment to this deficit was strong capital inflows into U.K. issued debt, including (as in the United States) securitized residential mortgage instruments.



3. **Similar to the United States, a sharp and sustained decline in national saving explains a rising current account deficit.** National gross saving was lower by about 1 percent of GDP between 2000 and 2007 compared to the previous decade. Gross investment was largely unchanged, but quite low, over the same period. High external (and domestic) borrowing came against the backdrop of low global interest rates, and steady foreign demand for U.K. assets, to finance high private and public spending relative to income and revenue. Specifically:

- *Household saving gradually declined on a trend basis for almost two decades before rising sharply during the recession.* The gross household saving rate (measured as a percent of disposable income) averaged over 9 percent during the 1990s and declined to near zero by 2008 before rebounding by 5 percentage points during 2009–10.
- *Corporate saving increased modestly during the pre-crisis period.* Rising



gross operating surpluses, particularly in the financial sector, and lower dividend growth both contributed to rising saving.² Dividend payouts grew more slowly than profits due in part to higher precautionary saving related to expected contributions to corporate pension funds as a result of new accounting standards for defined benefit schemes introduced in 2001.³

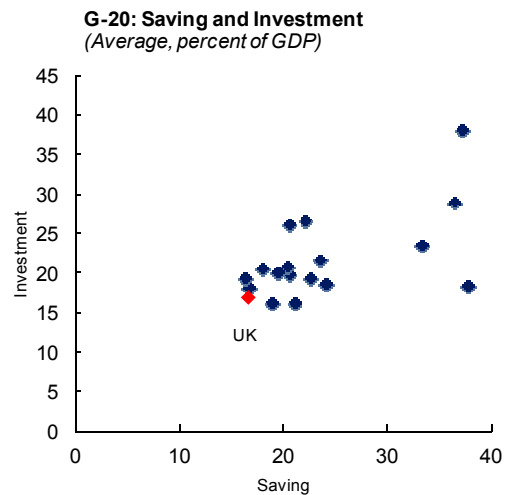
- *Public saving fell towards zero during the early 2000s and has turned significantly negative as a result of the crisis. During the late 1990s and through 2001, unexpected revenue buoyancy, faster-than-expected growth, and tight expenditure constraints inherited from the previous government helped public saving rise to over 3 percent of GDP. From 2002–07, saving was slightly negative on average as discretionary consumption spending—particularly non-entitlement National Health Service spending—picked up. Since 2008, public saving has average nearly -5 percent of GDP.*

4. **Investment and productivity are both relatively low.** The step-increase in corporate saving in the early 2000s did not lead to higher investment (as it might if firms were, say, credit-constrained). Investment has remained around 17 percent of GDP, towards the bottom

² OECD Economic Outlook 82.

³ Bunn and Trivedi (2005).

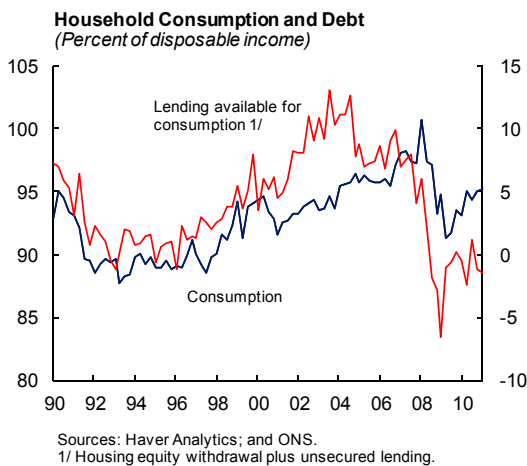
end of the range of G-20 countries. There has also been a persistent gap in productivity levels between the United Kingdom and its major competitors that was only partially closed during the modest pick-up in productivity growth during the pre-crisis period. Recent analysis indicates that this is due to lower total factor productivity and, particularly relative to France and Germany, lower capital-to-labor ratios that result from weak investment.⁴



5. **The financial sector played a contributing role in U.K. imbalances, evident in the link between rising household borrowing and consumption.** Rising household borrowing helped sustain consumption's strong contribution to growth. While the household share of national income fell

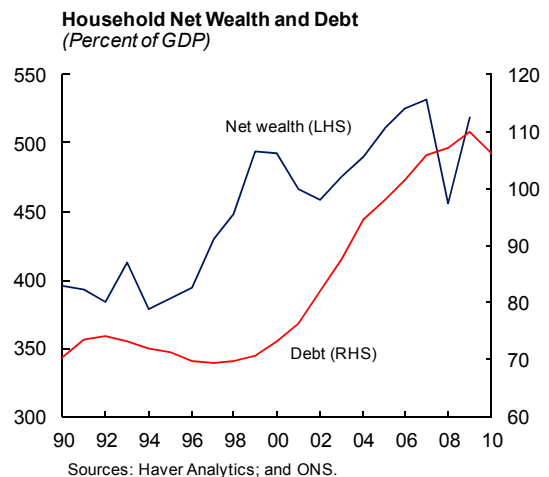
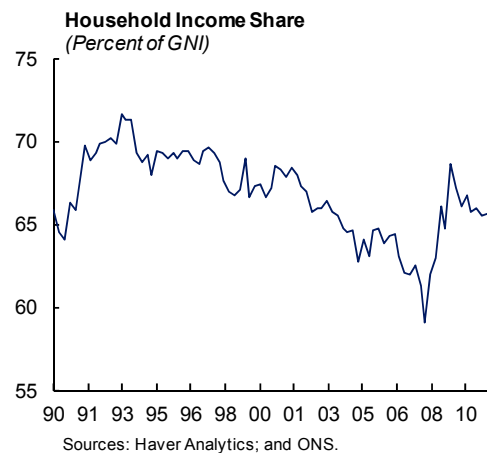
⁴ U.K. Department for Business Innovation and Skills, Economic Paper no. 9, November 2010.

(by about 5 percentage points between 2000 and 2008, in part reflecting a declining wage share), households reduced their saving and borrowed more to sustain consumption growth. Lending available for consumption—related to housing equity withdrawals and new unsecured debt—increased from an average of 2½ percent of household disposable income in the 1990s to about 9 percent between 2002 and 2007. This debt can be used to acquire financial assets, enhance home values, or for consumption. Some portion of this new debt was used to acquire financial assets (or upgrade homes), but as the net acquisition of assets of households remained largely unchanged while consumption rose over the period (as a percent of income), a significant part of this borrowing is likely to have been used for consumer spending.



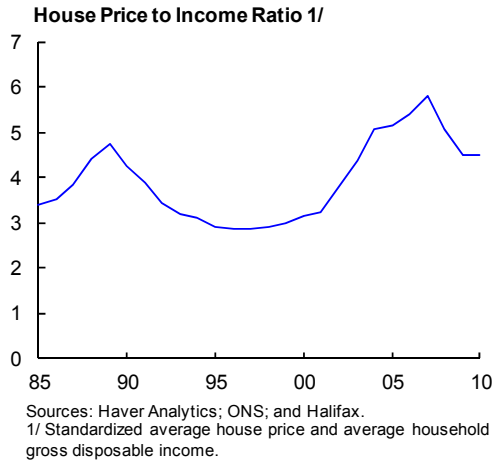
6. Against the backdrop of low interest rates, household balance sheets correspondingly took on more debt—and became more leveraged—in the run-up to the crisis. Household debt increased by 34 percentage points of GDP

between 2000 and 2008. At the same time, net wealth was rising, in large part due to higher house prices, but was still outpaced by debt accumulation. The result was an increase in household leverage—defined as the ratio of total debt to net worth—by 9 percentage points to 23 percent at its peak in 2008. Since 2008, households have begun to repair their balance sheets by increasing saving (i.e., rebuilding net wealth damaged by house price declines) and reducing debt relative to wealth (i.e., deleveraging), albeit gradually.



7. Linked to falling household saving rates, increased borrowing and inflated tax revenues accompanied the

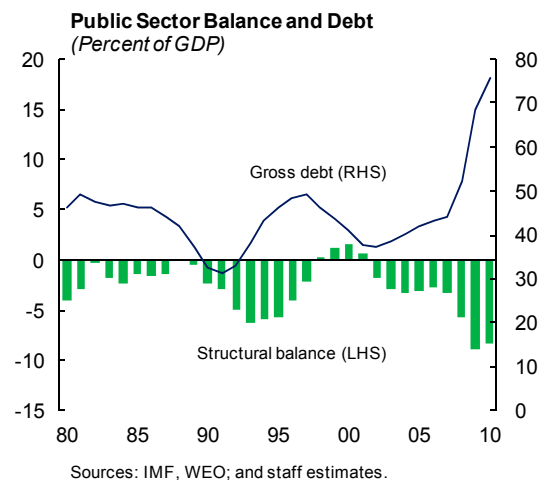
run-up in property prices. U.K. house prices experienced a large and sustained increase (rising by an annualized 8-9 percent between 1993 and 2007) well ahead of modest growth in household incomes. At the time the market peaked, the ratio of house prices to average household disposable income had risen to historically high levels. Notwithstanding recent declines in house prices, housing valuation ratios remain about 30 percent above their historical averages.⁵ The combination of low household saving, increased borrowing and indebtedness, and rising property prices against modest income growth was self-reinforcing during this episode before the crisis. Rising asset prices also boosted public sector accounts.



8. Public finances entered the crisis with underlying structural weaknesses and less policy space, before public debt surged when the crisis hit. Public

debt increased by about 7 percentage points in the five years leading into the crisis and rose by 32 percentage points of GDP between 2007-10. A number of factors explain the sharp rise in public debt since the onset of the crisis.

- *Much of the deterioration in the fiscal position is structural, reflecting permanent revenue losses (including those related to asset prices and the financial sector) and a sharp drop in potential GDP during the crisis that, in part, reflects the adverse shock to the financial sector.*
- *Discretionary stimulus has contributed relatively little, in part because the stimulus has been unwound relatively early and rapidly.*
- *The direct net costs of public sector interventions in the financial sector are so far small, although the government continues to face large contingent liabilities.*



⁵ United Kingdom 2011 Article IV Staff Report.

Prospects⁶

9. **Higher public saving and less consumption growth over the medium term implies that growth must rely more on investment and exports.**

Medium-term *fiscal consolidation* is already underway. Specifically, with public finances on an unsustainable path, the government embarked last year on an ambitious 5-year adjustment plan that would cut the deficit from 11 percent of GDP at the peak of the crisis to 1½ percent of GDP by 2016. Similarly, *private consumption* growth is likely to be restrained as cuts in government transfers slow household income growth and as the need to repair balance sheets keeps the household saving rate high. Tighter fiscal policies and subdued private consumption growth provides the room for monetary policy to remain accommodative for some time (consistent with meeting the inflation target). The outlook for *private investment* is brighter, reflecting the likelihood of interest rates remaining low, very high corporate cash surpluses, and relatively faster expected growth in the export sector, which is more capital-intensive. Sterling has depreciated significantly in real effective terms, though net export volumes have yet to pick up significantly.

10. **Repair and reform in the financial sector will strongly influence the rebalancing process and growth.**

Most importantly, the supply of credit is

likely to be tighter in the post-crisis period and likely to restrain demand growth and price increases for housing. Accordingly, to rebuild net wealth damaged by lower house prices, households will need to maintain higher saving. The financial sector will also likely contribute less to overall GDP growth than it did between 2000-07 and, given its current relatively high share of the economy—at about 10 percent of GDP--this will depress potential growth and tax revenues for some time.⁷

11. **Fiscal adjustment plans give strong reasons to expect a narrowing of the current account deficit.**

Fiscal consolidations are associated with current account adjustments because they compress domestic demand directly and allow looser monetary policy, which helps keep the exchange rate competitive. Studies suggest that each 1 percent of GDP of fiscal consolidation typically reduces the current account deficit by 0.2-0.6 percent of GDP. With fiscal adjustment of nearly 7 percent of GDP planned between 2010 and 2015, this implies that the current account deficit might fall by about 2–3 percent of GDP over this period, bringing the current account close to balance.

⁶ This section draws on the 2011 Article IV Staff Report.

⁷ See *Economic Contribution of U.K. Financial Services 2010*, www.thecityU.K.com

II. ROOT CAUSES OF KEY IMBALANCES

Based on G-20 indicative guidelines, relatively large U.K. imbalances were identified with respect to low private saving and high public debt. Underlying causes include external factors such as low global interest rates that encouraged borrowing (similar to the United States). On the domestic side, relaxed financing conditions and increased credit availability facilitated the increase in household indebtedness, which supported consumption and lowered saving. Fiscal imbalances partly reflected underlying structural weaknesses—notably, fiscal frameworks that were not able to maintain sufficient budgetary discipline.

Low Household Saving (and High Private Debt)

12. **At the heart of imbalances in the U.K. economy was unusually low and declining saving by households, against the backdrop of relaxed financial conditions.** A number of factors help explain the striking fall in household saving and, separately, the rise in debt. Recent analysis by Fund staff finds a clear link to real interest rates and house prices.⁸ Relaxed lending conditions and increased credit availability in the financial sector further encouraged higher borrowing to support consumption relative to subdued growth in incomes. Similar forces were at work in the United States. Some of these developments reflect the natural response of the economy to expanding conditions, but others—notably the high pro-cyclicality of credit supply and overshooting house prices—are due to weaknesses in the

financial sector policy framework and market distortions. Specifically:

- *Low real interest rates.* Short and long-term interest rates declined over two decades through 2007, against the background of lower global interest rates. This reduced the real return on saving and redistributed income from savers to borrowers. If borrowers have a higher marginal propensity to consume (as is likely), this would contribute to lower aggregate household saving. Low interest rates also allowed and encouraged households to support larger balance sheets (e.g., indebtedness), against expectations of further asset price increases.
- *Credit conditions.* The supply of credit improved significantly early in the 2000s, which allowed credit-constrained households to borrow more (and save less). The spread of household mortgage rates over the Bank of England's policy rate declined from over 100 basis points to less than 50 basis

⁸ *What Drives the U.K.'s Household Saving Rate*, United Kingdom 2011 Article IV Selected Issues Paper.

points in the decade through 2007.⁹ At the housing market peak, there was evidence that credit conditions had become excessively lax, but in retrospect financial sector supervisors and policymakers failed to respond appropriately (see below).¹⁰

- *Rising asset prices, notably housing.* Sharply higher house prices—partly, due to supply constraints on the U.K. housing market—boosted net wealth. For households targeting a specific level of wealth (for example, to fund retirement) this reduced incentives to save.¹¹ House price gains also increased collateral values, thereby increasing the amount of secured borrowing property-owning households could obtain (notably, through mortgage equity withdrawals) and reinforced borrowing demand. Expectations of further asset price increases may also have contributed to increased borrowing and indebtedness. Higher prices may also have had distributional effects and encouraged higher saving by younger

⁹ Bank of England *Quarterly Bulletin*, Q3 2009.

¹⁰ For example, the FSA estimates that of total mortgage approvals: 45 percent were not income verified; 35 percent were interest only; and 15 percent were at a loan-to-value ratio of 90 percent or above. Adair Turner, “The Mortgage Market: Issues for Debate,” FSA Mortgage Conference, 12 May 2009.

¹¹ The effect of housing wealth on saving is not straightforward theoretically, since higher house prices imply both more wealth and higher implicit housing costs going forward (*What Drives the U.K.’s Household Saving Rate*, 2011 Selected Issues Paper).

households, but this was partly offset in the U.K. by increased credit availability.

- *Constraints on housing supply* are likely to have contributed to high and rising prices. The U.K. is subject to restrictive planning laws that severely restrain the designation of new building areas. This has lowered the price elasticity of housing supply, which is now very low and has declined in recent decades.¹² As a result, the boom in house prices was *not* accompanied by a construction boom (unlike the United States where residential investment also rose sharply prior to the crisis).

Public Debt

13. **The crisis and recession exposed structural weaknesses in the United Kingdom’s fiscal policy framework.** In particular:

- *Established fiscal rules were not sufficiently strong.* The government actually met its own fiscal rules for the 10 years following their adoption in 1998.¹³ However in retrospect, these rules and actual policies did not adequately adjust for the cycle. Fund

¹² Barker Review of Housing Supply, Interim Report, 2003.

¹³ Specifically, these were: the *golden rule*, which stated that over the economic cycle, the government will borrow only to invest and not to fund current spending (equivalently that public saving will be positive, on average over the cycle); and the *sustainable investment rule*, which stated that public sector net debt as a proportion of GDP will be held over the economic cycle at a stable and prudent level.

staff estimate that the United Kingdom was running a sizable structural deficit at the same time as the economy's output gap was either closed or positive between 2000 and 2007. The bulk of the deterioration in public finances before the crisis was structural and primarily reflected increases in spending on public services. The rules also failed to build in a sufficient safety margin for uncertainty, which may have been underestimated.

- *Projections for the public finances were consistently over-optimistic and not subject to formal independent review.* The fiscal policy framework in place before the crisis was often criticized because it provided insufficient monitoring, transparency, and accountability. Institutional reforms recently adopted by the government should address these weaknesses. In particular, the government recently passed legislation to put the independent OBR on a permanent footing. This new institution should help strengthen the credibility of fiscal analysis and forecasts.
- *Economic growth, estimates of potential growth, and tax revenues became over-reliant on the financial sector and related business services which were taking on more risk.* Thin fiscal buffers became more important over time as the U.K. economy and tax revenues grew increasingly reliant on the financial sector for growth. Between 2000 and 2007, the financial and business services sector (including real

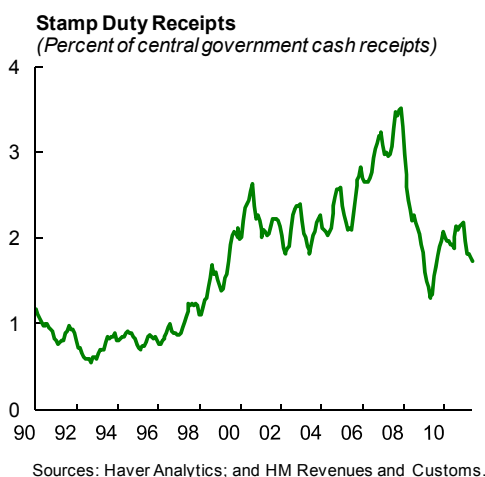
estate) accounted for just over half of overall GDP growth. To some extent, higher growth contributions reflected greater risk-taking by the financial sector rather than an underlying increase in productivity.¹⁴ In turn, the financial sector is estimated to have contributed about 14 percent of government's total tax receipts in 2007. This tax stream is relatively volatile, as shown by the 21 percent decline in the total collected by the financial sector between the fiscal years 2006/07 and 2009/10.¹⁵

- *Revenue was over-reliant on inflated asset prices and windfall gains were not saved.* The United Kingdom taxes both capital gains (although not on an individual's main residence) and equity and property market transactions (through stamp duty). Stamp duty on property is progressively graduated based on its value and this amplifies the sensitivity of the duty's receipts to prices. The OECD has estimated that "excess" revenue related to asset prices at

¹⁴ As noted by Haldane (2010), three related balance sheet strategies boosted the added value and risk exposure of the U.K. financial sector: increased leverage (on and off balance sheet); an increasing share of assets held at "fair value" as asset prices rose; and writing deep out-of-the-money options.

¹⁵ *Total Tax Contribution*, PricewaterhouseCoopers LLP study of the U.K. Financial Services Sector for the City of London Corporation (December 2008). This includes tax payments collected from firms and income and national insurance payments by sector employees.

cyclical peaks can lead to the over-estimation of structural budget balances of the order of 1½ to 3 percentage points in some countries, including the United Kingdom.¹⁶ Revenue windfalls, for example from stamp duty receipts, in turn, were not saved and left a shortfall relative to spending when they disappeared as asset markets declined.



Financial Sector—Lending Practices, Leverage, and Funding

14. **The financial sector contributed importantly to private and public sector imbalances.** Banks and other financial institutions aggressively expanded credit, contributing to inflated output growth, asset values and tax revenues, and eventually, creating large public sector contingent liabilities. Households' heightened access to expanding credit, in

turn, lowered saving and increased debt. This boom-bust pattern reflected market failures and distortions, as well as shortcomings in policies. Banks were increasingly reliant on short-term funding, including from foreign counterparties, to finance the credit boom. Alongside weaker credit standards, this allowed banks to expand credit much more aggressively than would have been the case if constrained by deposit growth.

15. **Shortcomings with a “light touch” regulation and supervision facilitated financial sector excesses.** The FSA's focus on outcomes rather than business practices and rules enforcement obscured how risks were rapidly changing as new financial markets and instruments developed. Supervision of liquidity risks was inadequate, as financial firms became increasingly reliant on term funding markets. Cross-border supervision was also insufficient, including the inherent risks in foreign exposures of U.K. banks, particularly to U.S. subprime mortgages. Insufficient monitoring contributed to a buildup of financial sector vulnerabilities that, in turn, contributed to macro imbalances.

¹⁶ Girouard and Price, 2004 and Price and Dang, 2011.

III. ARE U.K. IMBALANCES A PROBLEM?

National Perspective

16. **Large deficits and high public debt reduce policy space and threaten to crowd out private investment—and impede rebalancing.** The current very high fiscal deficit, if left unaddressed, would cause debt to balloon to over 100 percent of GDP by 2016 and be on a steeply rising path to even higher levels. Notwithstanding the likelihood that interest rates will remain low for some time, over the medium term as activity returns to potential, interest costs on public debt are likely to rise, although this would be limited by the relatively long maturity of outstanding U.K. debt. This would reduce available fiscal space. Higher interest rates would also adversely affect investment, which must contribute more to growth in a rebalancing scenario. Higher (distortionary) taxes associated with high public debt may also weigh on growth. Moreover, market sentiment should not be taken for granted as it may change suddenly—possibly affecting risk spreads, fiscal financing costs and debt dynamics.

17. **A return to low household saving and high leverage, given large public debt burdens, may give rise again to widening imbalances or financial stability risks.** U.K. Imbalances are all linked to some degree and reducing fiscal, financial, and external imbalances and their vulnerabilities will all serve to reinforce balanced and sustained

growth. If left unchecked, key financial risks—were they again to materialize—could severely disrupt growth.

Global Perspective

18. **The United Kingdom plays a central role in global finance and, thus, avoiding large financial imbalances and ensuring stability is essential for strong, sustainable and balanced growth in the G-20.** U.K. external assets and liabilities account for $\frac{1}{4}$ of world GDP, far greater than its share in global trade and output. Global spillovers are therefore limited largely to the financial sector, while trade and other real economy links are modest.¹⁷ Thus, U.K. financial sector stability is a global public good, requiring the highest quality regulation and supervision. The gradual repair of U.K. fiscal and financial sector balance sheets and limiting distortions that encouraged previous excesses should benefit global financial stability and growth.¹⁸

¹⁷ See IMF (2011) U.K. spillover report SM/11/181.

¹⁸ Given its role in global financial markets, corrective policy actions themselves in the United Kingdom—to prevent future imbalances and mitigate systemic risk—could affect partner countries. Coordinated efforts will thus be needed to ensure reform consistency and to minimize unintended consequences (e.g., arbitrage, location shifts, etc.) See IMF U.K. spillover report.

IV. HOW TO ADDRESS IMBALANCES

Rebalancing in the United Kingdom requires a rise in public saving and greater reliance of demand on investment and net exports.¹⁹ While the near-term policy mix of fiscal consolidation and monetary accommodation is broadly helpful, important challenges remain and risks should be carefully monitored. Securing fiscal sustainability will need further structural reforms that address longer-term imbalances and bolster medium-term growth. Housing policies should address distortions that have contributed to large swings in household saving and debt. Additional efforts are also required to address shortcomings in the regulation and supervision and to enhance the macroprudential toolkit to prevent key imbalances from re-emerging and to safeguard financial stability.

19. **A sustainable increase in public saving should be secured by additional structural reforms that address longer-term fiscal imbalances.** Higher public saving would raise national saving and lower the external deficit. The pace of fiscal adjustment though will need to take account of its dampening effect on growth in the short run as the recovery gains traction. A stronger improvement in net exports would allow for stronger consolidation, which will need to be sustained over the medium term. In particular, further accelerating increases in the state pension age and indexing it to longevity would reduce the fiscal burden of an ageing society. Reform of public-service pensions (along the lines of the *Independent Public Service Pensions Commission*) would help improve their structure and better align average public-service compensation with private-sector equivalents. The new fiscal framework that is anchored by medium-term targets and enhanced independent oversight would

complement these efforts, but its performance should be closely monitored.

20. **Monetary policy should remain accommodative for some time—so long as underlying inflation remains in check.** With public finances being consolidated, accommodative monetary policy will help keep real interest rates low and sterling competitive, thereby promoting expansion of investment and net exports. However, attendant risks associated with low interest rates will need to be watched closely.

21. **Housing policy reforms should aim at increasing affordability to mitigate excessive house price volatility (affecting household saving and debt).** Policies to increase supply should focus on lowering barriers to land access for housing and providing sufficient incentives for local communities to allow development. One aspect of the current system of housing taxation (the council tax) is regressive,

¹⁹ This section draws on the 2011 Article IV staff report, 2011 U.K. Financial Sector Stability Assessment, and the 2011 U.K. spillovers report.

encouraging excess demand for housing and should be modified to better reflect the value of ownership. This would reduce distortions that have contributed, in the past, to excessive swings in household saving and debt. Reforms would also contribute to improved competitiveness by increasing household (and labor market) mobility and, by reducing the cost of living, helping to contain labor costs.

Financial Sector Policies

22. **To support growth and prevent another buildup of imbalances and stability risks, financial sector reform in key areas is still needed.** Liquidity buffers need to be increased, although progress has been made in building capital buffers with core tier 1 ratios now above 10 percent for all major banks. Enhanced supervision and oversight are needed to prevent imprudent credit lending and excessive leverage that contributed to low saving. These are elaborated below.

23. **The macroprudential toolkit should be enhanced and actively used.** Monetary policy working alone through interest rates may not be sufficient to safeguard both price and financial stability. The newly-formed Financial Policy Committee (FPC) should focus on tools that are most effective against the credit cycle—including loan-to-value ratios—and minimize efficiency costs and scope for regulatory arbitrage.

24. **To safeguard stability, continued build up of capital and liquidity buffers is essential for resilience to shocks.** Capital buffers should continue to be built

up ahead of Basel III requirements, and approval of dividend and variable remuneration should continue to be linked to the outcome of stress tests. Liquidity requirements should be accompanied by home-host coordination to help address cross-border liquidity needs in times of stress. Requirements currently more stringent than in other major jurisdictions are appropriate given the specific vulnerabilities of the U.K. financial system.

25. **Further enhancements to the supervisory framework should remain a priority to promote prudent lending.** To avoid a return to weaker lending standards and mispricing of credit risks that contributed to excessive borrowing and low household saving, efforts should be made to:

- *Strengthen the FSA's assessment of banks' processes*, including loan classification, impairment determination, and valuation practices.²⁰
- *Introduce a proactive intervention framework.* It is important that framework legislation include explicit support for early intervention by the supervisor in dealing with prudential problems.
- *Provide the regulatory authority with oversight powers at the holding company level.* This will improve consolidated supervision.

²⁰ The FSA is conducting a review of mortgage markets that addresses some of these issues. See *Mortgage Market Review*, FSA Discussion Paper 09/3.

- *Enhance data reporting standards.* The U.K. lags behind many other countries in standards for the public disclosure of bank and insurance sector data. Regular and comparable data on an institution basis should be published, including non-confidential data from prudential returns.

26. **Progress made in addressing “too-important-to-fail” needs to be further advanced to restrain excessive risk taking.** Specifically, incentives for excessive leverage could be reduced through further tax reform. Ring-fencing of retail operations and establishment of depositor preference²¹ would improve resolvability of the retail entity. However, ring-fencing should be weighed against the costs and does not necessarily improve resolvability of the whole entity, unless complemented by more comprehensive measures on which international coordination is critical.

A. Toward an Upside Scenario

27. **The U.K.’s contribution to the upside scenario for the G-20 as a whole would rely mainly on longer-term fiscal consolidation measures.** This reflects that the government’s planned near-term fiscal consolidation is sufficiently strong given the current output gap and the projected path for economic growth. In particular, further reforms to entitlement programs such as

the state pension and public service pensions that would be announced soon but implemented beyond the MAP 2011-16 horizon are included. Other measures include further reforms to reduce the relatively high share of the working age population that receives disability benefits. As well as contributing to the fiscal consolidation effort, this would also boost the supply of labor.²²

28. **These measures would have significant effects near the end of the MAP horizon.** In 2015, when the additional consolidation measures start to be implemented, UK authorities will have built up considerable fiscal credibility and the analysis assumes that households believe that all the announced policies will be fully implemented. Consequently, households recognize the need to substitute toward foreign assets in their wealth portfolios given the reduction in UK government bonds. This increased desire to accumulate foreign assets leads to a depreciated pound and an improvement in the current account balance. Over the map horizon, the impact on GDP of the consolidation measures is negative. However, beyond the map horizon, lower debt service costs eventually lead to lower tax rates. Lower tax rates combined with slightly lower real interest rates, owing to less public demand for savings, leads to a higher level of GDP.

²¹ This would elevate claims of depositors on assets of a failed institution over claims of general creditors.

²² *Economic Policy Reforms 2011: Going for Growth*, OECD.

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G R O U P O F T W E N T Y



UNITED STATES SUSTAINABILITY REPORT¹



Prepared by Staff of the
I N T E R N A T I O N A L M O N E T A R Y F U N D

¹ *Report 10 of 10.* At the request of the G-20, IMF staff has provided analyses and assessments of member's economies and policies in a set of reports for the Mutual Assessment Process (MAP). These reports serve as inputs for the Action Plan agreed by G-20 Leaders at the Cannes Summit. The 2011 Staff Reports for the 20 MAP consist of the following: (i) an Umbrella Report that provides an integrated summary of the component reports and an upside scenario for G-20 collective action; (ii) an Accountability Report that summarizes members' progress toward policy commitments since the Seoul Summit in 2010; (iii) a MAP Report providing analysis of members' medium-term macroeconomic and policy frameworks; and (iv) Sustainability Reports for seven members (China, France, Germany, India, Japan, United Kingdom, and United States)—identified by G-20 indicative guidelines—to assess the root causes and policy implications of key imbalances.

EXECUTIVE SUMMARY

G-20 indicative guidelines identified the United States as experiencing “moderate” or “large” fiscal and external imbalances. Persistent fiscal deficits reflected a structural shortfall in revenues against increased spending commitments, including security-related spending. Weak fiscal balances and low household saving—alongside high foreign demand for dollar assets—were main contributors to U.S. external deficits. To facilitate the requisite rebalancing acts, fiscal consolidation to restore soundness to public finances and a greater reliance on external demand are needed.

Persistent fiscal imbalances have been underpinned by structural factors and budget deficits have widened dramatically with the crisis. A structural shortfall in revenues became evident after tax cuts in the early 2000s. Underfunded entitlement obligations and higher security-related spending commitments, meanwhile, have kept expenditures high. The crisis has weakened public finances sharply through lower tax revenues. Political stalemate poses a major hurdle to agreement and action on decisive consolidation.

Large external imbalances reflected weak fiscal balances and other domestic factors, as well as global factors. In addition to public dissaving, unsustainably low household saving contributed to current account deficits amid housing and credit booms. High foreign demand for U.S. assets (reflecting their financial attractiveness and dollar reserve accumulation by trading partners) and elevated oil prices have also contributed to external deficits.

Given the systemic importance of the U.S. economy and financial system, key imbalances pose domestic and global vulnerabilities:

- High and rising public indebtedness raises sustainability concerns and could weigh on growth. Political stalemate on fiscal adjustment hurts confidence in the authorities’ ability to reach agreement on a comprehensive plan. Eventually higher

interest rates and higher distortionary taxes to finance high debt service can weigh on future investment and growth. Reduced policy space also creates a vulnerability to future shocks.

- Avoiding a return to low saving and heightened financial risks in the United States is vital for the world economy. U.S. external deficits signaled low national saving, high leverage and a build-up of financial vulnerabilities prior to the crisis. Preventing U.S. financial instability—given large and adverse global spillovers—is critical.

Policies to address imbalances center on restoring soundness to public finances. Credible and durable consolidation with “growth-friendly” composition requires limiting the growth of expenditures—crucially, through entitlement reform—and raising revenues, including through tax reform (such as curtailing exemptions and shifting toward consumption and energy taxes).

Stronger financial regulation and reform are equally important. Financial sector policies will need to better safeguard stability while remaining supportive of growth. Sufficiently strong regulation and supervision, with adequately broad perimeters, should prevent a build-up of financial vulnerabilities that contributed to low household saving and should keep pace with a changing financial landscape.



UNITED STATES

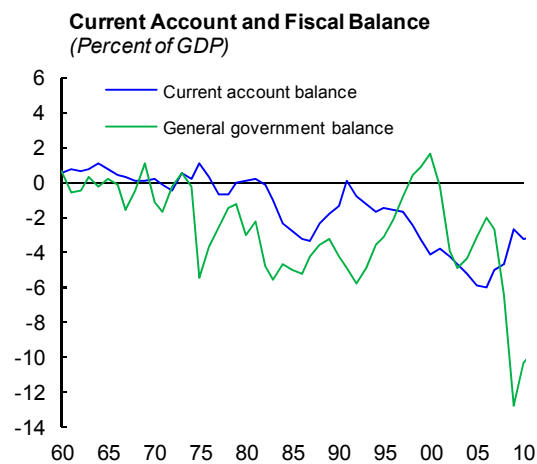
SUSTAINABILITY REPORT 2011¹

The United States has experienced long periods of external and fiscal imbalances. Fiscal deficits were substantial in the mid-2000s and widened significantly during the crisis. External deficits have reflected weak fiscal balances and other factors contributing to low national saving, including external factors that underlie strong foreign demand for U.S. assets. Going forward, large budget and moderate current account deficits are projected to persist, exacerbating U.S. and global vulnerabilities. Policies to restore soundness to public finances include limiting the growth of expenditures (crucially, through entitlement reform) and raising revenues (including through tax reform). Stronger financial regulation and reform are equally important to safeguard stability and to prevent excessive credit and leverage that led to the buildup of systemic risk and unsustainably low household saving in the past. Achieving strong, sustainable and balanced growth would require rebalancing away from a heavy reliance on private consumption (before the crisis), followed by fiscal support (during the crisis), toward an increasing contribution from external demand.

I. BACKGROUND

1. **Fiscal and current account deficits have been a persistent feature of the U.S. economy for several decades.** “Twin deficits” emerged from a near-synchronous deterioration in the budget and external positions in the first half of the 1980s. However, the link has not always been tight—as seen by the experience of the late-1990s. During that time, widening trade deficits were led by business investment and facilitated by large capital inflows in the form of FDI and equity portfolio

investment—both in response to an increase in U.S. productivity growth. Meanwhile, an improving fiscal position benefited from a strong economy, a



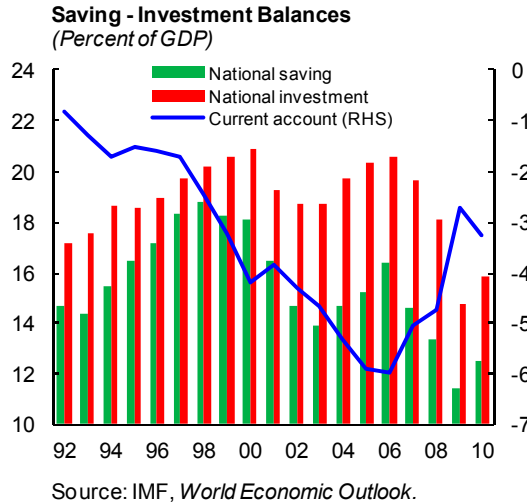
Source: IMF, *World Economic Outlook*.

¹ Prepared by Vladimir Klyuev under the guidance of Hamid Faruquee, with input from Michal Andrie and Stephen Snudden, and the support of Eric Bang, David Reichsfeld, and Anne Lalramnghakhleli Moses.

booming stock market, and tax increases that boosted revenues; the peace dividend; and welfare reform, as well as strengthened budget discipline.²

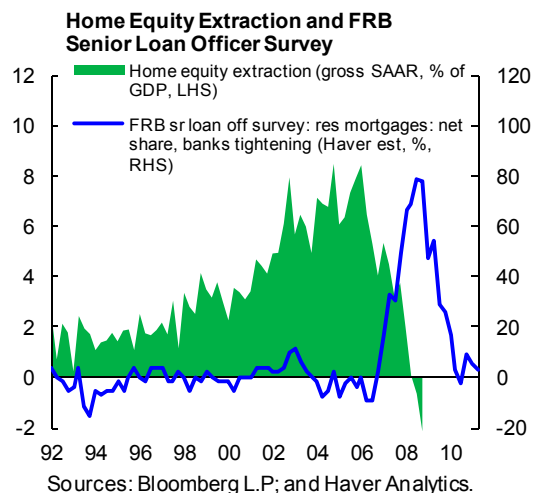
2. An appreciable widening of U.S. imbalances preceded the Great Recession. After 2000, twin deficits reasserted themselves, led by both cyclical and structural factors heading into the financial crisis.

- *U.S. fiscal balances experienced a substantial turnaround from surplus to deficit.* Fiscal loosening reflected a variety of economic and policy-related factors, including tax stimulus following the downturn, complacency from past budget surpluses, and increased military spending. See Box 1.



²The 1990 Budget Enforcement Act included caps on discretionary spending and PAYGO requirements restrained expenditure growth. See, for example, M. Mühleisen and C. Towe (eds.), (2004) "U.S. Fiscal Policies and Priorities for Long-Run Sustainability," *IMF Occasional Paper 227*.

- *On the private side, the driver of U.S. external deficits changed from business investment to consumption and construction.* During this period, the current account deficit increasingly reflected falling saving rates and booming homebuilding activity rather than higher business investment following the compression of equity prices and damage to corporate balance sheets. Consumption and residential investment led the recovery and expansion, increasing as a share of GDP. Alongside increasing public dissaving, household saving rates fell to historical lows, fueling the consumption and housing boom.
- *Relaxed financial conditions, weakening credit standards, rising leverage, and booming asset markets contributed to escalating systemic risk.* Easy credit—supported by low interest rates, financial innovation, and lax regulation and supervision—fueled the rapid rise of household consumption. Surging house prices also encouraged a rapid accumulation of private debt and

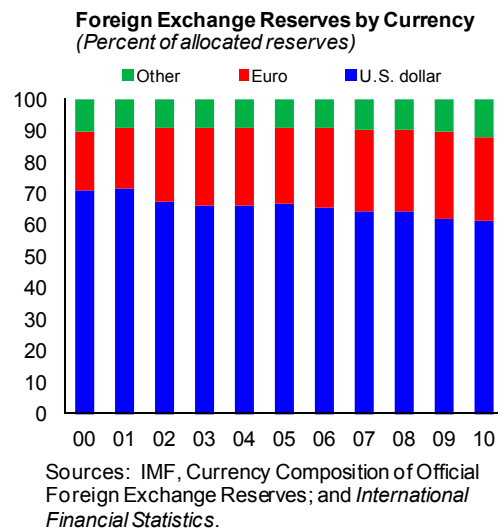
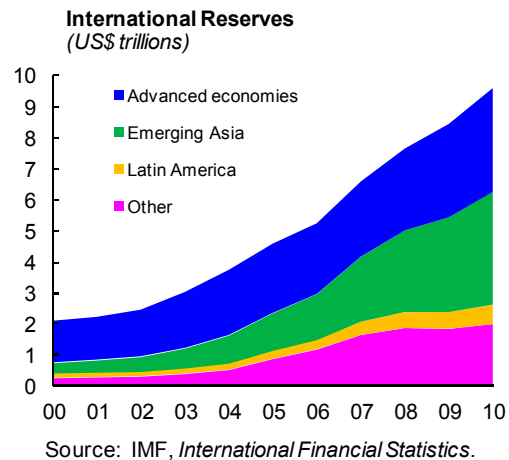


increasing leverage, including through mortgage equity withdrawals. Lending standards deteriorated and credit risks were mispriced owing to market complacency and “search for yield.”

- *U.S. assets were in high demand from international investors, limiting dollar depreciation and allowing large external deficits to persist.* Accumulation of reserves by foreign central banks was a major source of U.S. external financing. Robust private demand from abroad for securitized assets added to capital inflows.
- *Some narrowing of imbalances occurred prior to the crisis—as conditions began to change—but this proved insufficient.* Mortgage interest rates began climbing in 2005, home prices peaked in 2006, and bank lending standards started tightening at the end of that year, bringing the construction and housing boom to an end. With residential investment sharply down and given past dollar depreciation, the current account balance bottomed out in 2006 and improved noticeably over the following two years. While the acute phase of the crisis broke out in September 2008 with the collapse of Lehman, these gradual corrections had started earlier, but unfortunately failed to prevent a systemic financial crisis.

3. Following the crisis, external imbalances compressed, but fiscal imbalances deteriorated dramatically. The crisis, which ostensibly originated in the U.S. subprime mortgage market, accelerated a

narrowing of the trade balance (partly reflecting sharply falling oil prices), despite a temporary rebound in the dollar (safe haven effect). With consumer spending dampened by extraordinary uncertainty, private saving rebounded while investment contracted. On the contrary, government spending was stepped up and public finances deteriorated substantially as a result of the automatic stabilizers, fiscal stimulus, declining asset prices and large financial system support caused or necessitated by the sharp economic downturn.

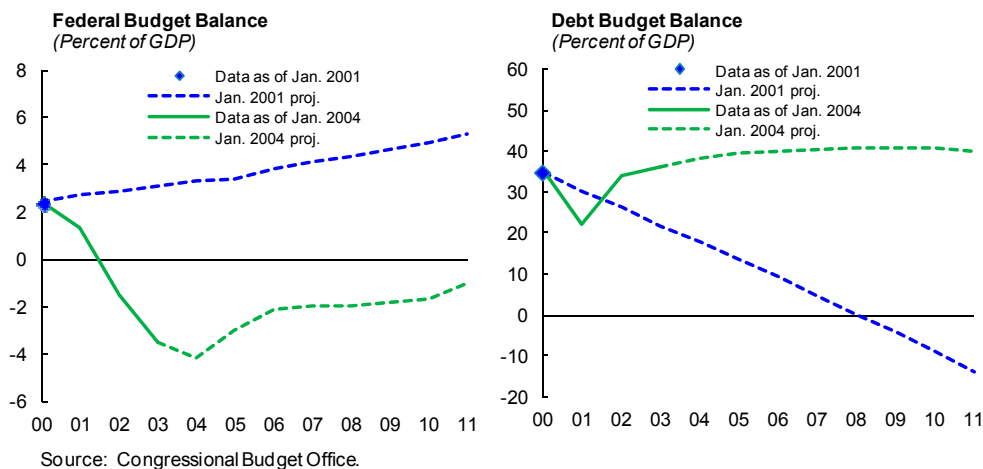


Box 1. U.S. Fiscal Turnaround

The dramatic turnaround in the U.S. fiscal situation from surplus to deficit was caused by a combination of shocks and policies. The burst of the dot-com bubble in 2000 pushed the U.S. economy into a brief recession in the next year, exacerbated by the shock of the September 11 terrorist attacks. The cyclical downturn and capital losses from lower equity prices lowered federal tax receipts by about one percent of GDP in FY2001 relative to the previous year. A package of major tax cuts was then legislated in 2001, partially motivated by the need to stimulate the economy.

Fiscal complacency and increased security spending were also important factors. Initially there was a perception that tax rates were too high given projected budget surpluses under unchanged policies; projected elimination of (net) public debt and possible accumulation of public assets; and the political desire to share surpluses with current taxpayers. But even as the federal budget balance swung from +2.4 percent of GDP in 2000 to -3.5 percent in 2003, another major round of tax cuts was passed that year. In addition, counterterrorism measures and military operations triggered by the September 11 attacks added to the fiscal burden. Outlays on national defense doubled between FY2001 and FY2008.

CBO Baseline Projections by Vintage



Fiscal deficits moderated in the mid-2000s, but budgetary prospects remained worrisome. As the economy came out of recession, the stock market regained momentum; the housing market boomed; and tax receipts recovered some lost ground. However, with population aging and high medical cost inflation, expenditures on social security and health care were still projected to rise at an alarming rate. The pressure was exacerbated by a new prescription drug benefit (Medicare Part D) that came into effect in 2006.

II. ROOT CAUSES OF U.S. IMBALANCES

Based on G-20 indicative guidelines, relatively large U.S. imbalances were identified with respect to fiscal and external deficits—calling for an in-depth analysis of their root causes. Several key factors underlying both U.S. fiscal and current account deficits can be identified, related to both domestic and external sources.

A. Fiscal Imbalances

4. Present and projected large U.S. fiscal deficits reflect several key factors.

This includes: (i) structural factors underlying pre-crisis deficits; (ii) legacy effects from the crisis itself on the fiscal accounts; and (iii) underfunded entitlement obligations.

- *The U.S. fiscal position was structurally unbalanced pre-crisis.* A structural shortfall in tax revenues relative to augmented spending commitments at the federal level became evident in the early 2000s. The 2001 and 2003 tax cuts reduced federal revenue by over \$2½ trillion over the following 10 years.³ Although these tax cuts were scheduled to expire, returning to higher marginal rates has turned out to be politically difficult. Separately, after decades of using tax incentives to promote various objectives, the tax code is extremely complex and riddled with inefficiencies.⁴ On the spending

side, while discretionary non-defense expenditure had been squeezed before the crisis, high military and security spending persists since the 9/11 terrorist attacks.

- *The adverse impact of the crisis on budget balances has been large and multi-faceted.* Staff assess that a downward shift in potential output relative to the pre-crisis trend has lowered revenue-raising capacity. Direct measures to support a damaged financial system increased public debt (albeit marginally). Finally, the weak cyclical state of the economy makes it harder to undertake fiscal tightening in a situation where the scope for further monetary stimulus is very limited. The reliance of local governments on property taxes, coupled with the expectations of a prolonged housing slump, makes their position particularly difficult.

³ Part of that sum includes the impact of alternative minimum tax (AMT) relief.

⁴ The U.S. report of the National Commission on Fiscal Responsibility and Reform (2010) identifies \$1.1 trillion annually in tax expenditures. For corporations, tax loopholes are responsible for a
(continued)

combination of high statutory rates and relatively low revenue collection. For households, mortgage interest rate deductions to promote home ownership are typically not taken advantage of by low-income households (who need the most help to buy a residence) as they tend not to itemize deductible expenses.

- *Growth in entitlement spending has placed an increasing strain on public finances.* A large part of the increase is driven by population aging, which will also have a negative effect on budget revenue and on GDP by reducing the labor supply. The CBO projects federal spending on social security and health care to increase from 10.3 percent of GDP in FY2010 to 13.2 percent in FY2025.⁵ Over longer horizons, the rise in entitlement spending will be increasingly driven by the “excess cost growth.” Health care costs per beneficiary (adjusted for changes in the age profile of the population) will grow faster than GDP per capita. Excess cost growth is a common problem in advanced economies, but the *level* of health care spending in the United States is about twice the OECD average, albeit with average health outcomes. On the public pension side, social security benefits are already exceeding contributions.⁶ In addition, state and local governments will have increasing difficulty in meeting pension and medical care obligations to their retirees. Underfunded private pensions also pose an additional budgetary risk.⁷
- *Fiscal rules currently do not impose sufficient budgetary discipline.* Since the Budget Enforcement Act expired in 2002, the United States has not had a formal anchor on fiscal policy at the federal level. Unlike most U.S. state governments, there are no balanced budget rules. The PAYGO rule has been bypassed frequently. The debt ceiling, raised periodically with much difficulty, has done more to raise market uncertainty than act as an effective constraint.
- *Political polarization complicates reaching an agreement on budgetary consolidation.* The two main political parties’ ideological positions have become entrenched in recent years, with staunch opposition to any tax increase or any major welfare benefit cut. The political stalemate has precluded a general accord on the contours of decisive medium-term fiscal adjustment. The standoff over raising the federal debt ceiling and the inability to pass FY2011 appropriation bills are recent manifestations.

B. External Imbalances

5. **Large external deficits reflected a combination of weak fiscal balances, low private saving, and brisk residential investment.** The configuration of private

⁵ Health care programs include Medicare, Medicaid, CHIP, and health-care exchange subsidies. State expenditure on Medicaid will also increase.

⁶ The 2011 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds.

⁷ While the federal government is not directly responsible for private pensions, systemic
(continued)

underfunding may create a call on the Pension Benefit Guarantee Corporation (PBGC). In that eventuality, PBGC resources would likely prove insufficient, and there may be pressure on the federal government to step in.

saving-investment imbalances, in turn, was driven by an underlying confluence of *domestic* and *external* factors, including strong foreign demand for U.S. assets.

6. Pre-eminent DOMESTIC factors—reflected inter alia in large financial imbalances—included key market and policy failures that led to a dangerous build-up of systemic risk.⁸ The housing boom and bust, the increase in financial and household debt and leverage, and the decline in household saving can be traced to these underlying factors.

- *A rapid rise in private consumption, fueled by a housing bubble, was symptomatic of market complacency and an unsustainable credit boom.* This can largely be attributed to excessive financial risk-taking and inadequate regulation alongside accommodative monetary and financial conditions. Overly optimistic expectations about the future growth in income and particularly rising house prices (extrapolating unsustainable trends) further contributed to the decline in private saving and wider external deficits.
- *Misaligned incentives in the financial system were partly responsible for a fundamental breakdown in market discipline and mispricing of risk.*⁹ At the

⁸ See IMF (2009), "Initial Lessons of the Crisis," <http://www.imf.org/external/np/pp/eng/2009/020609.pdf> for a discussion.

⁹ See GFSR (April 2008 and 2009; October 2008 and 2009) for detailed discussions, including faulty credit ratings; the rise and fall of securitization and

(continued)

center of the crisis was the combination of factors that led private agents to make poor decisions that ultimately created a build-up of vulnerabilities in a financial system that was increasingly unable to sufficiently regulate itself.¹⁰ This includes excessive leverage and risk-taking in the context of unusually low market volatility, interest rates, and "search for yield"—against the backdrop of a global saving "glut" and the Fed's accommodative monetary stance in the first half of the 2000s that depressed both long and short-term interest rates;¹¹ moral hazard problems that eroded market discipline in the

incentive problems with the "originate to distribute" lending model; the role of mark-to-market accounting and pro-cyclicality in credit; problems with liquidity management; and the role of off-balance sheet entities and regulatory arbitrage heading into the crisis.

¹⁰ See, for example, Greenspan (2010), "The Crisis," *Brookings Papers on Economic Activity*.

¹¹ See T. Adrian and H.S. Shin (2010), "Liquidity and Leverage," *Journal of Financial Intermediation*, 19 (3). The role of U.S. monetary policy in the crisis remains controversial. Some have argued that policy rates were too low for too long (e.g., compared to a Taylor rule) contributing to subsequent financial excesses and the housing boom; see J. Taylor (2009), *Getting off Track: How Government Action and Intervention Caused, Prolonged, and Worsened the Financial Crisis* (Stanford, California: Hoover Press). Greenspan (2010), however, argues that the main factor was low long-term interest rates given the global saving glut. From a macroeconomic standpoint, the stance of monetary policy was broadly appropriate given lower equilibrium (or neutral) rates of interest, with output near potential and inflation near target. However, low interest rates encouraged greater financial leverage and risk-taking in the absence of established macro-prudential policy instruments.

case of large, systemically important institutions that were too big to fail; agency and incentive problems surrounding innovative but complex securitization instruments and the “originate to distribute” lending model; and insufficient risk and liquidity management by financial institutions that were increasingly reliant on wholesale funding markets that became disrupted when the crisis began.¹²

- *Public oversight was insufficient to correct market failures.* A fragmented regulatory system and its frameworks were unable to keep pace with a fast-changing financial landscape. Risky financial activities and credit creation increasingly migrated beyond the traditional banking system—outside a narrow regulatory perimeter that failed to recognize and allowed a build-up of systemic risk in the “shadow banking system.” Even with regulated banks, off-balance sheet vehicles were used to circumvent existing regulations (e.g., capital standards). An overreliance by investors on credit rating agencies with conflicts of interest proved costly in case of structured instruments (e.g., CDOs). Rapid financial innovation encouraged the proliferation of these complex and poorly understood instruments that escaped greater financial oversight. Finally, thinly-capitalized government sponsored entities or GSEs (enjoying an

implicit public guarantee) dominated mortgage securitization and created a massive contingent liability for the government that was eventually called upon when the housing bubble burst.

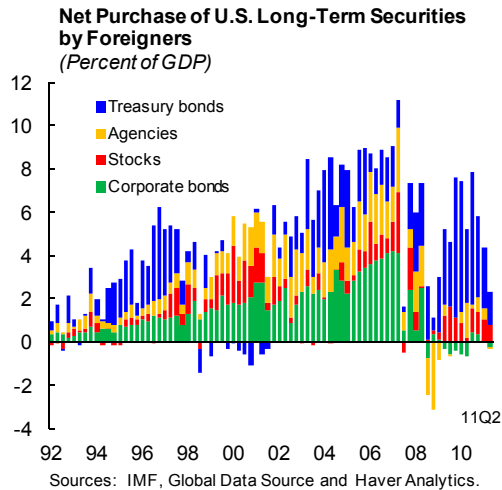
7. Key EXTERNAL factors involved high foreign demand for U.S. financial assets—including reserve holdings; dollar pegs in major surplus emerging economies; and high oil prices.

Burgeoning external deficits were financed at low interest rates by growing purchases of U.S. assets by surplus countries with high saving which slowed dollar depreciation, further encouraging U.S. consumption and imports and affecting export competitiveness through a more appreciated currency than otherwise. Dollar depreciation started in 2002 and continued through 2008 in real effective terms. This did have a delayed effect in narrowing the current account imbalance by the mid-2000s, but its impact on the external position was muted by a run-up in commodity prices.

- *The depth, breadth and innovativeness of U.S. financial markets made them an attractive destination for various classes of investors.* The safety and liquidity of the Treasury bond market reinforced the dollar’s role as the leading reserve currency. Agency bonds and mortgage-backed securities provided slightly higher returns with low perceived risk and became popular with both official and private foreign investors. At the same time, the United States was generating an ever-expanding array of innovative and complex securities,

¹² See G. Gorton and A. Metrick (2011), “Securitized Banking and the Run on Repo,” Yale ICF Working Paper No. 09-14.

which met steady foreign demand. Surprisingly, perhaps, demand for U.S. Treasuries spiked at the height of the crisis (driven by a “flight to safety”) despite the fact that U.S. assets associated with subprime mortgages were considered to be its epicenter.



- *Dollar pegs in several major emerging economies limited effective dollar depreciation.* Currency intervention—most notably by China—helped maintain competitive exchange rates in those economies and created a major source of demand for U.S. securities¹³ and led to rapid accumulation of reserves.¹⁴ Consequently, demand for

¹³ Demand was primarily for Treasury and agency bonds, but in later years holdings were diversified into riskier investments, particularly via sovereign wealth funds.

¹⁴ Moreover, the growing share of low-cost producers in U.S. imports partially offset dollar appreciation against individual currencies. See C. Thomas et al, “Measuring U.S. International Relative Prices: A WARP View of the World,” Federal Reserve Board International Finance Discussion Papers, No. 917.

dollar-denominated assets remained broadly stable and strong—accounting for about two-thirds of rapidly increasing global reserves since 2000—despite large U.S. external deficits that made dollars more available abroad.¹⁵

- *High oil prices have impeded a greater narrowing of U.S. current account imbalances.* The United States is the world’s largest consumer of petroleum products, and it relies on oil imports to satisfy more than half of its needs. Petroleum trade deficits account for about half of the U.S. merchandise trade deficit since late 2007. While the non-oil trade balance has improved substantially starting in 2006, the oil trade balance has generally deteriorated. U.S. terms of trade deteriorated sharply in 2007–08, primarily due to rising oil prices, offsetting partially the impact of a turnaround in net exports before the crisis. Relatively low energy taxes encourage domestic consumption.

¹⁵ See I. Mateos y Lago et al, “Debate on the International Monetary System,” IMF SPN/09/26.

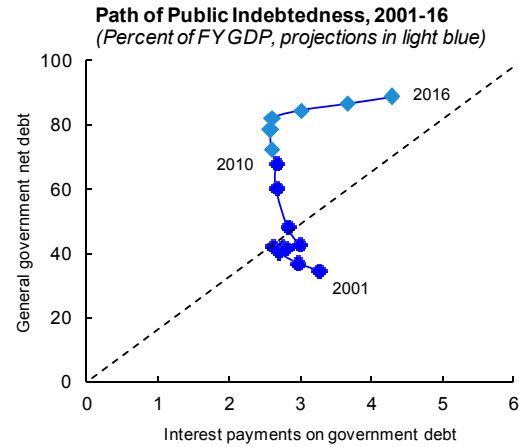
III. ARE U.S. IMBALANCES A PROBLEM?

A. National Perspective

8. **The recent agreement on fiscal consolidation in the context of raising the public debt ceiling has not assuaged concerns pertaining to the sustainability of U.S. public debt.** The recent downgrade of U.S. debt by S&P is a clear sign of market concerns pertaining to its sustainability and the political polarization that has cast doubts on the likelihood of a future comprehensive agreement on the fiscal. While interest rates on U.S. Treasuries remain at historical lows, they are likely to rise over time as debt accumulates, crowding out private investment, and worsening the debt dynamics. From a crowding out perspective, each percentage point increase in the debt-to-GDP ratio is estimated to raise long-term interest rates by 3–4 basis points.¹⁶ High public indebtedness also creates vulnerability to future shocks by reducing available *fiscal space*. It will also eventually require higher primary balances—and higher (distortionary) taxes—to service the debt. This underscores the urgent need for clear, credible and realistic medium-term consolidation plans.

9. **Increasing external indebtedness may carry attendant vulnerabilities, with**

¹⁶ See E. Baldacci and M.S. Kumar (2010), "Fiscal Deficits, Public Debt, and Sovereign Bond Yields", IMF Working Paper 10/184; and T. Laubach (2009), "New Evidence on the Interest Rate Effects of Budget Deficits and Debt," *Journal of the European Economic Association*, 7(4).



possible confidence effects for the dollar. The stock of U.S. net external liabilities is relatively modest at 17 percent of GDP and has not increased in line with large net external borrowing given valuation effects and other factors (e.g., some overstatement of U.S. net capital inflows). Moreover, return differentials on foreign assets versus liabilities remain favorable from a U.S. perspective. However, there are risks that such favorable return differentials may not continue indefinitely (particularly in light of unfavorable public debt dynamics). Moreover, the willingness of foreign investors to continue financing current account deficits (at prevailing terms) becomes increasingly critical as the stock of external indebtedness increases. Even absent an abrupt adjustment, a continuous deterioration in the U.S. net external position that would result from projected current account deficits would imply growing payments overseas and hence the need for a substantial turnaround in the trade balance down the road to stabilize net external debt.

10. **A return to low household saving, re-leveraging (particularly, in the financial sector), and a precarious fiscal situation may give rise to new financial stability risks.** To the extent that U.S. imbalances partly reflected low saving and high credit, as well as high leverage before the crisis, reducing fiscal, financial, and external imbalances and their associated vulnerabilities going forward will go hand in hand. If left unchecked, key financial risks, if they were to materialize again, would severely disrupt growth.

B. Global Perspective

11. **Given its central role in global trade and finance, all U.S. concerns echo in the international arena.**

12. **An unsustainable fiscal situation creates multiple problems.** As the economy continues to recover, high and increasing public debt would imply not only higher U.S. interest rates but also higher global interest rates, affecting investment and growth.¹⁷ In addition, a downgrade or credit event in U.S. sovereign debt markets or loss of investor confidence could have global repercussions for other sovereign and corporate rates.

13. **Fiscal and external risks are interrelated.** Concerns about sustainability of U.S. public finances could undermine confidence in the dollar. Moreover, U.S. net external liabilities and current account

deficits are large as a proportion of world GDP and must rely on significant foreign demand for U.S. assets to be financed. Should demand dwindle in anticipation of subpar returns (e.g., because of dollar depreciation), a mutually reinforcing spiral of capital outflows and asset price declines may ensue. Given the substantial role of the United States in global trade and finance, this possible upheaval would have severe reverberations worldwide.

14. **Financial stability in the United States is vital for the world economy.** In the crisis, major risks associated with U.S. imbalances came through financial markets (rather than exchange rates). U.S. external deficits signaled low domestic saving, high leverage, a build-up of underlying financial vulnerabilities, and systemic risk that materialized with the crisis. As seen, U.S. financial instability can have large adverse cross-border spillovers.¹⁸

15. **Rebalancing necessarily has a multilateral dimension.** Given the need for U.S. fiscal consolidation, a prospective contraction in domestic demand would need to be offset both at home and abroad to maintain solid growth and to avoid a global “demand deficit.” In other words, the United States would need to rely more on external demand (given fiscal consolidation), while G-20 partners—particularly, surplus economies—would need to rely more on internal demand (given weaker demand in the U.S.) to help achieve strong, sustainable and balanced growth over the medium term.

¹⁷ See IMF (2011) U.S. Spillover Report SM/11/165, which also discusses the potential global impact of higher U.S. rates in a pre-crisis versus post-crisis context.

¹⁸ See IMF (2011) U.S. Spillover Report SM/11/165.

IV. HOW TO ADDRESS IMBALANCES

16. **The importance of credible fiscal adjustment is universally recognized; but the menu of policy options is wide.**

A credible U.S. adjustment plan that combines spending cuts and revenue increases and is supported by fiscal rules to return public finances onto a sustainable trajectory is required. Broad elements of needed U.S. policy actions include the following.

A. Policy Priorities

- *An agreement on a comprehensive and credible medium-term consolidation road map is required soon.* It is essential to initiate the process very soon and make steady progress to maintain credibility, spread the burden of adjustment more evenly, and avoid downside risks. Building on the recent agreement on the debt ceiling, bipartisan progress on concrete medium-term deficit reduction plans would also critically provide additional policy flexibility in the short run. With the economy still in a weak cyclical condition and risks to growth tilted to the downside, the pace of adjustment should be measured at the outset, but steady and well-specified over time and underpinned by a coherent medium-term fiscal strategy.
- *Placing entitlements on a sustainable footing is central to containing fiscal deficits.* Parametric changes to Social Security (e.g., gradually increasing the retirement age in line with longevity gains and reducing future benefits for

the well-off) would lead to well-identified savings over time with minor impact on current demand. Savings that go beyond those advanced by last year's reform are needed in the health care system, including through greater cost sharing with Medicare beneficiaries and other targeted savings.

- *Revenue raising measures must be part of the consolidation package.* The room for additional revenues exists, given their low level presently relative to most advanced economies and U.S. history. In particular, with discretionary non-security spending already compressed and only gradual entitlement reform possible, raising tax revenue (including through base broadening and tax code simplification) is needed. This could begin, for instance, by allowing the Bush tax cuts for families earning more than \$250K to expire. In addition, "growth-friendly" revenue measures could include tax reform that shifts the burden of taxation towards consumption (VAT) from earned income; further gradual cuts in exemptions and deductions, including for mortgage interest; and higher energy taxes. Tax measures that encourage private saving could further help reduce external imbalances.
- *Stronger budgetary rules would be useful to anchor the process and instill discipline.* The fiscal framework should include an explicit Congressional

endorsement of the main medium-term fiscal objectives. Multi-year expenditure caps on non-security discretionary spending would help keep the consolidation on track across annual budget cycles, while a “failsafe” mechanism for the debt ratio along the lines suggested by the President could, if robustly formulated, protect against deficit overruns and other contingencies. It would also be helpful to prepare the administration’s budgets using more realistic economic assumptions.

- *Policies that lead to stronger growth would help improve the fiscal situation as well.* These actions include financial sector balance sheet repair; progress in resolving the foreclosure problem, which hangs over the banking system and also gets in the way of labor market adjustment; and active labor market policies, including re-training to facilitate sectoral and geographic reallocation of displaced workers.

17. Improvement in the current account should rest on several pillars.

The currently depressed levels of investment are expected to rebound with the recovery, boosting growth and potential output. Thus, national saving will need to rise to avoid a reemergence of wider external deficits. Fiscal consolidation will be a major contributor to smaller current account deficits going forward. But maintaining private saving broadly at current levels would help ensure that the effect of lower fiscal deficits on the current account is not offset by deterioration in

the private saving-investment balance. To the extent that the increase reflects a decline in net wealth aligned with underlying fundamentals and more realistic income prospects, the rebound in household saving from its pre-crisis levels is likely to persist, and the recent range of 5–6 percent (of disposable income) seems broadly in line with fundamentals, though time will tell. Further adjustment in the dollar, along past depreciation trends, would facilitate external adjustment. The effect of dollar depreciation on import demand should also support higher personal saving.

18. Financial sector policies will need to better safeguard financial stability while remaining supportive of economic growth.

Future actions will partly depend on the effectiveness going forward of recent reforms.¹⁹ Financial regulation and supervision should be adequately funded and sufficiently strong to prevent another run-up in credit (although not so tight as to stifle lending and growth).²⁰ Regulatory perimeters need to be sufficiently broad to avoid key “gaps,” possible migration of systemic risk,

¹⁹ In July 2010, U.S. authorities introduced the *Wall Street Reform and Consumer Protection Act* (i.e., “Dodd-Frank” Act). The objective of this legislation was to restructure the financial regulatory system to address key fault lines in order to create a sounder and more resilient financial system. While strong implementation of the “Dodd-Frank” Act is needed, its effectiveness will only be learned over time.

²⁰ For example, rules on loan to value and debt service to income ratios to qualify for lowest-rate mortgages should be sufficiently stringent.

and to keep pace with a changing financial landscape. Actions to improve the resiliency of term funding markets which were severely disrupted may also require greater attention. Coordinated global changes in financial market regulation would make it easier to establish comprehensive global safety nets and appropriately tight and consistent credit standards. The Fed should also be vigilant and maintain appropriate interest rates and liquidity conditions. Developing the macro-prudential toolkit would help monetary policy in meeting the distinct objectives of price stability and financial stability.

19. Coordinated action by the G-20 would facilitate U.S. consolidation and global rebalancing. Fiscal adjustment will dampen U.S. domestic demand, perhaps while the economy is still in considerable excess capacity and the policy interest rate is at the zero bound. Hence, the pace of adjustment (e.g., path of primary balances) would need to be calibrated with this tradeoff in mind. A large increase in private consumption (return to low saving) to compensate for withdrawal of fiscal stimulus is not desirable. Given the need to maintain the rebound in private saving, fiscal tightening accompanied by stronger external demand would help support recovery and growth. Alternatively, deficiency of external demand may induce delayed fiscal consolidation, risking negative financial market reaction. The tradeoff between growth and consolidation would be more palatable if foreign demand were stimulated by

higher domestic demand in surplus economies, accompanied by exchange rate appreciation where appropriate. From the perspective of other G-20 members, prospects of weaker demand from advanced economy partners undergoing consolidation suggests the need to rebalance toward internal demand to support stronger growth. This suggests scope for international coordination.

B. Toward an Upside Scenario

20. FISCAL CONSOLIDATION—to restore the sustainability of public finances, while mitigating the short-term impact on growth. A sufficient scale of U.S. fiscal adjustment with “growth-friendly” composition (to the extent possible) would require 3 essential pillars:

- *Tax reform and higher tax revenues.* To minimize tax distortions and bolster growth, measures could include reducing payroll and capital taxes in favor of higher consumption taxes/VAT; increasing energy taxes; and base broadening to enhance revenue collection (through reducing loopholes and tax expenditures, including mortgage interest deductibility);
- *Spending cuts in key areas.* To meet budget priorities, fiscal measures would also include cuts in entitlement spending through increasing age of retirement and reducing benefits to restore long-term viability of these programs; restraining growth in health care expenditures; some cuts in

discretionary spending (including defense) while preserving or enhancing public investment in critical areas; and

- *Credibility*—clear and effective public communication by the Administration and Congress on concrete fiscal plans that realistically tackle unsustainable items in the budget and establish clear fiscal targets would help align market expectations with the authorities' medium-term fiscal consolidation strategy.

21. ACTIVE LABOR MARKET POLICIES—to reduce high unemployment. Some targeted ALMPs (mindful of their budget costs) would help labor activation in problem areas—e.g., to facilitate reattachment of long-term unemployed (given their very high share in total unemployment) and help reduce youth unemployment (given underlying problems with job prospects facing this group).

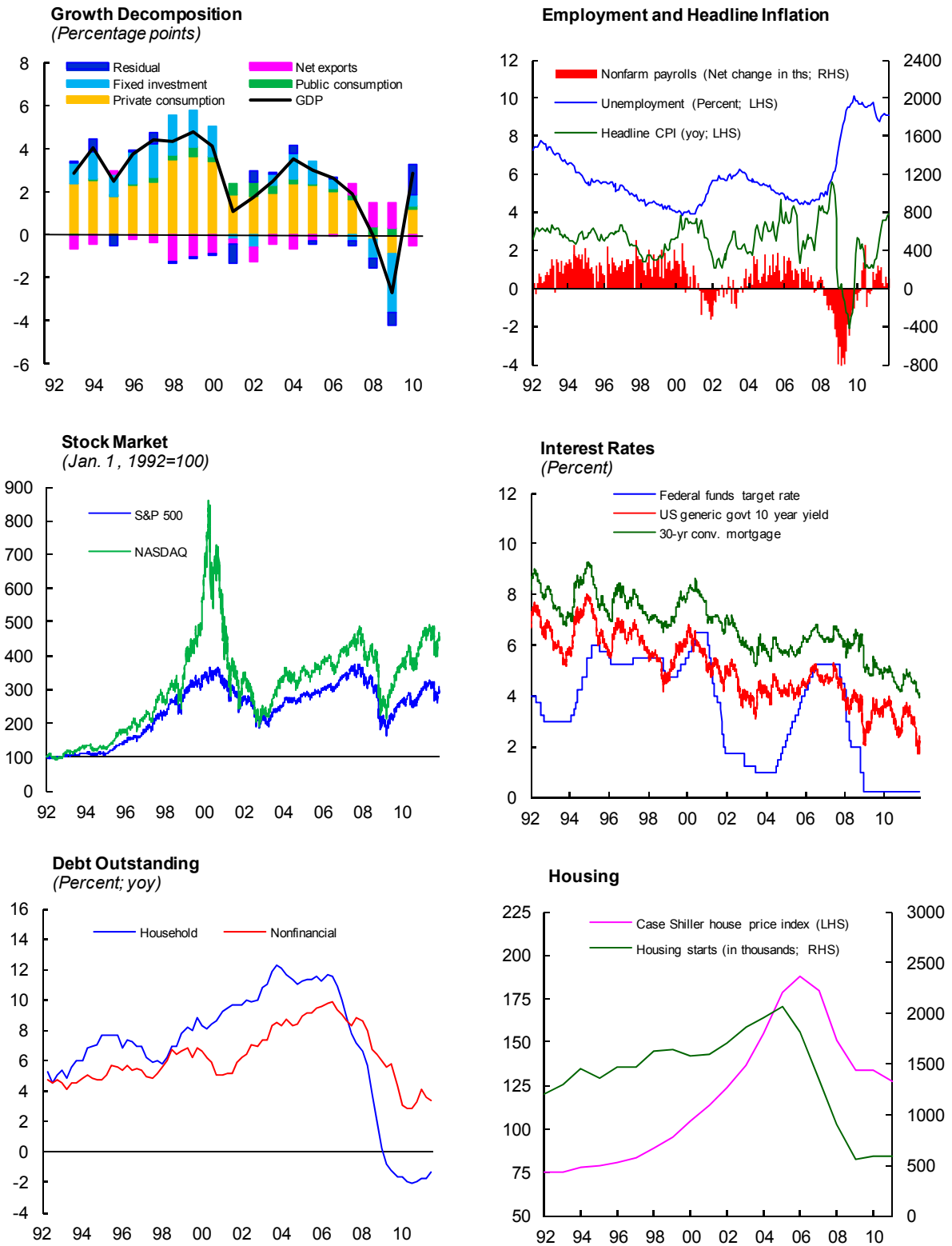
22. FINANCIAL SECTOR REPAIR AND REFORM—to rebuild a more resilient financial system that can support strong economic growth.²¹ Reducing the build-up of excess leverage smoothly, fostering an adequate flow of bank credit to support activity but preventing a return to low saving rates, while lowering systemic risk will require measures that strengthen balance sheets of viable financial institutions (e.g., recapitalization,

²¹ See IMF (2011) U.S. Financial Sector Assessment Program.

including in light of Basel III, and sound dividend policies); better aligning private market incentives (e.g., tackling “too big to fail” and agency problems with securitization); ensuring prudent credit provision (e.g., appropriately tight lending standards and capital adequacy); and, finally, more careful monitoring of the financial system (e.g., avoiding key “gaps” in regulation; including enhanced supervision of systemically important financial institutions).²²

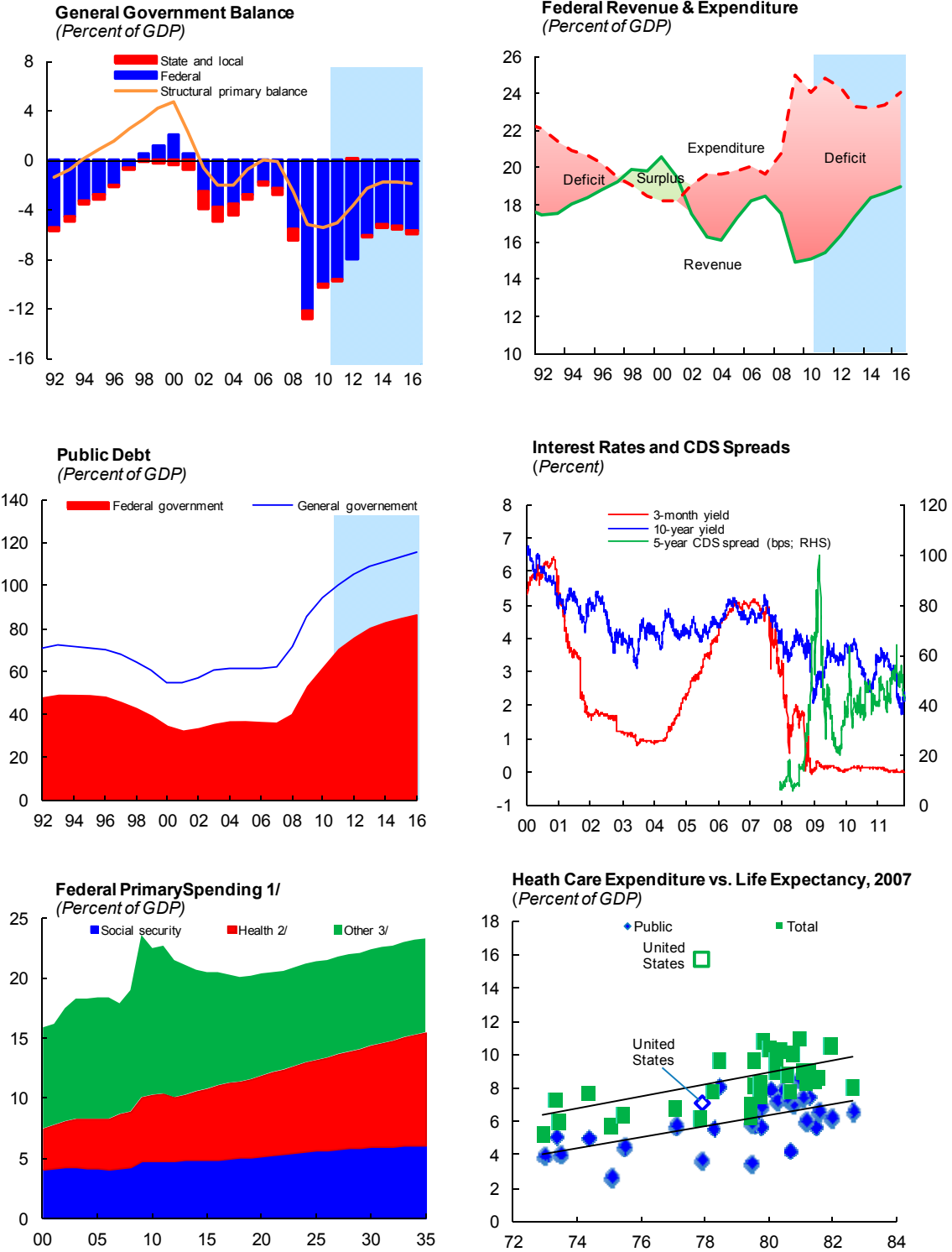
²² In the IMF's (GIMF) model, only limited and stylized simulations of financial sector reform are feasible, based on implications for the supply and price of credit.

Figure 1: Real and Financial Sector Developments



Sources: IMF, *World Economic Outlook*; Haver Analytics; Bloomberg L.P.; and IMF staff calculations.

Figure 2: Fiscal Developments



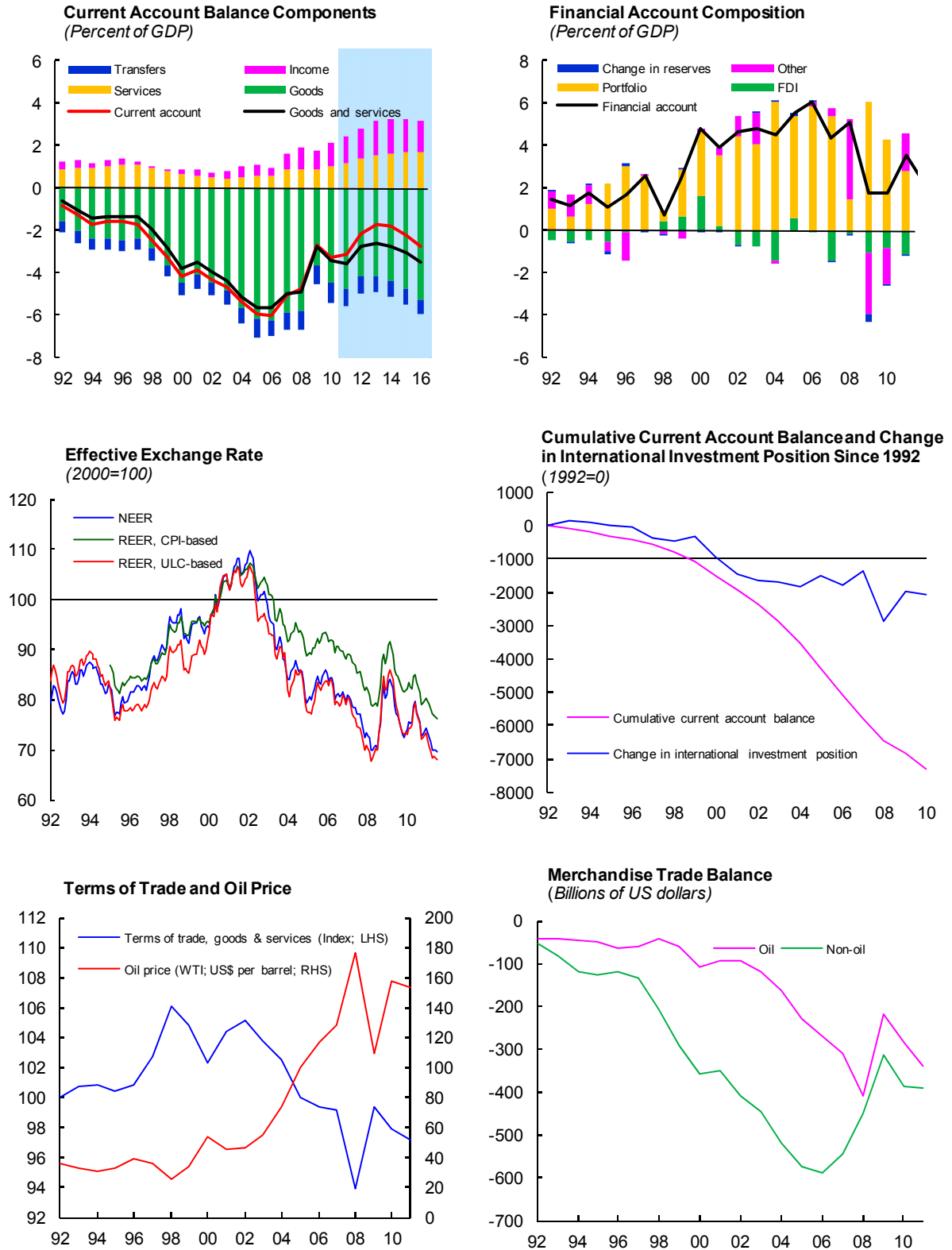
Sources: IMF, *World Economic Outlook*; Haver Analytics; Bloomberg L.P.; OECD; Congressional Budget Office; and IMF, staff projections.

1/ Based on CBO's extended-baseline scenario.

2/ Medicare, Medicaid, CHIP, and exchange subsidies.

3/ Other noninterest spending.

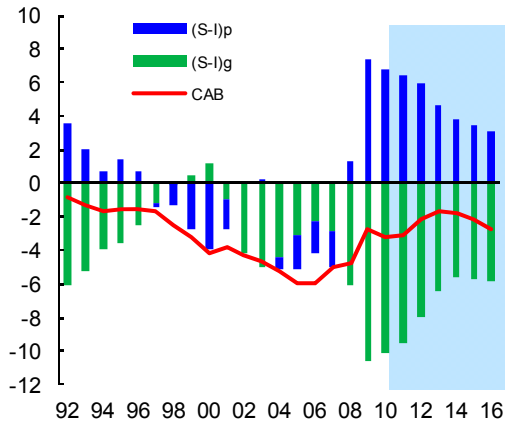
Figure 3: External Developments



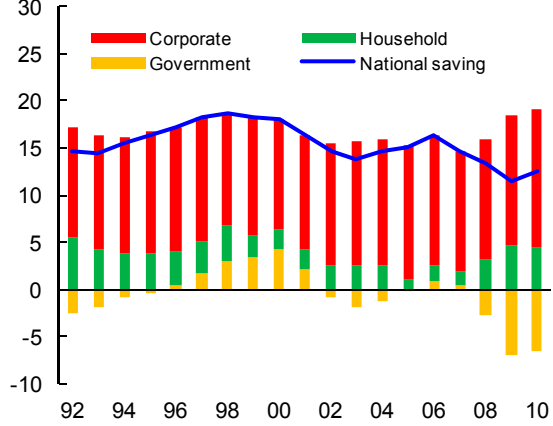
Sources: IMF, *World Economic Outlook*; Haver Analytics; Bloomberg L.P.; and IMF staff calculations.

Figure 4: Saving and Investment

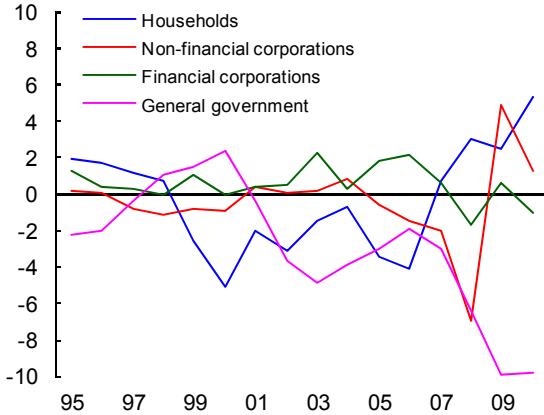
Private and Public Saving - Investment Balances
(Percent of GDP)



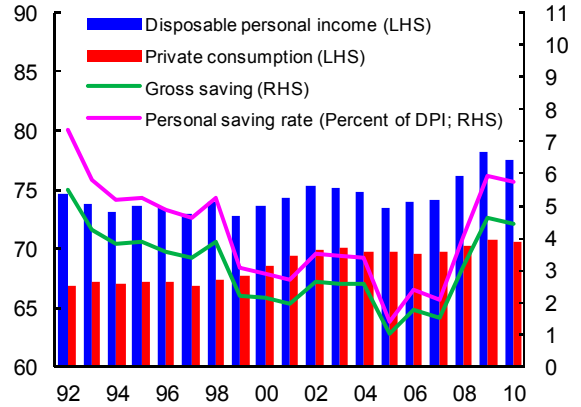
Saving
(Percent of GDP)



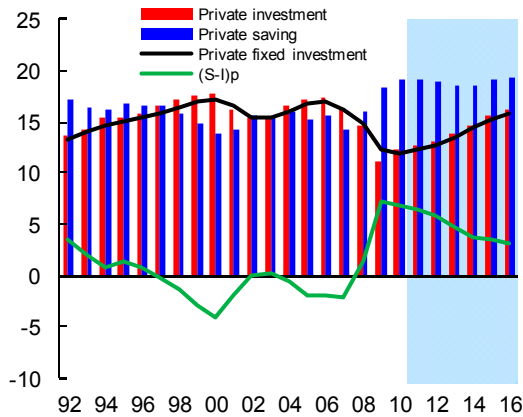
Net Lending
(Percent of GDP)



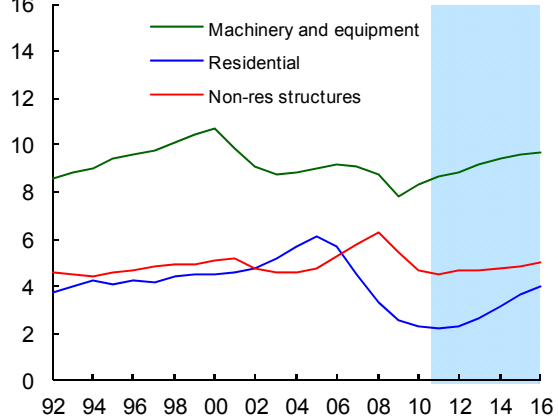
Household Income, Consumption, and Saving
(Percent of GDP)



Private Saving and Investment
(Percent of GDP)



Investment Components
(Percent of GDP)



Sources: IMF, *World Economic Outlook*; Haver Analytics; and IMF staff calculations.