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

G-20 ACCOUNTABILITY 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 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)—indentified by G-20 indicative guidelines—to assess the root causes and policy implications of key imbalances.

EXECUTIVE SUMMARY[1]

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.

INTRODUCTION[2]

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.

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[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—changes to entitlement programs—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 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.

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.

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

- 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,

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[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.