

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 Faruquee, 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.

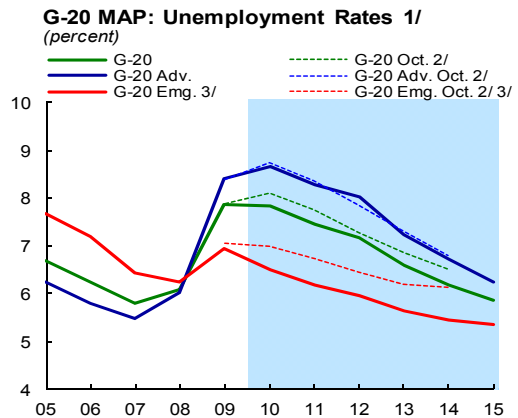
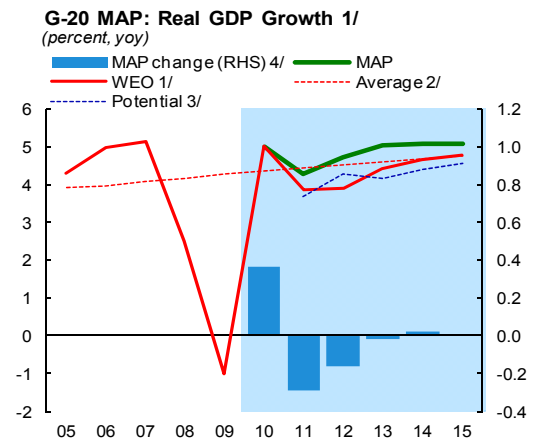
⁴ See the OECD's assessment in "Pursuing Strong, Sustainable, and Balanced Growth: A Note on the Implementation of Structural Reform Commitments," July 2011, and "Pursuing Strong, Sustainable, and Balanced Growth: Taking Stock of the Seoul Action Plan's Structural Reform Commitments," June 2011.

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



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.

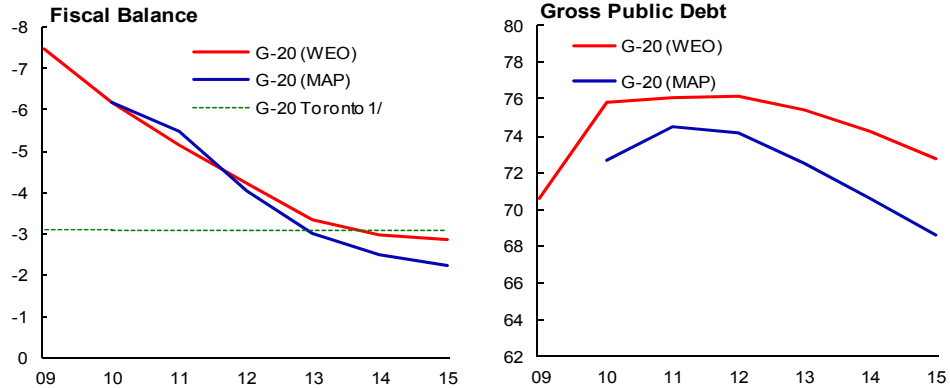
12. Anticipated progress toward rebalancing global demand—essential for ensuring sustainability of global growth going forward—is limited. Global imbalances narrowed during the recession, but are projected (according to G-20 policy frameworks) to stay large over the medium term. This may partly reflect 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.

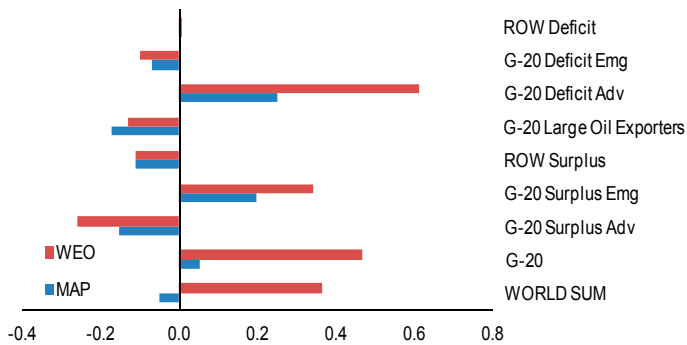
G-20 MAP Framework and WEO Projections of Overall Balances and Gross Public Debt

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



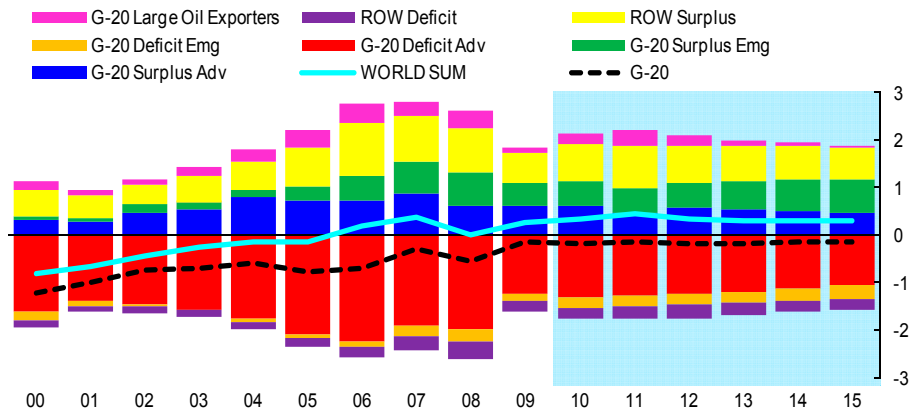
Sources: G-20 authorities and IMF staff estimates.
 1/ Toronto Declaration of at least halving the 2010 deficit by 2013; based on June 2011 MAP projected estimate of 2010 deficit.

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:

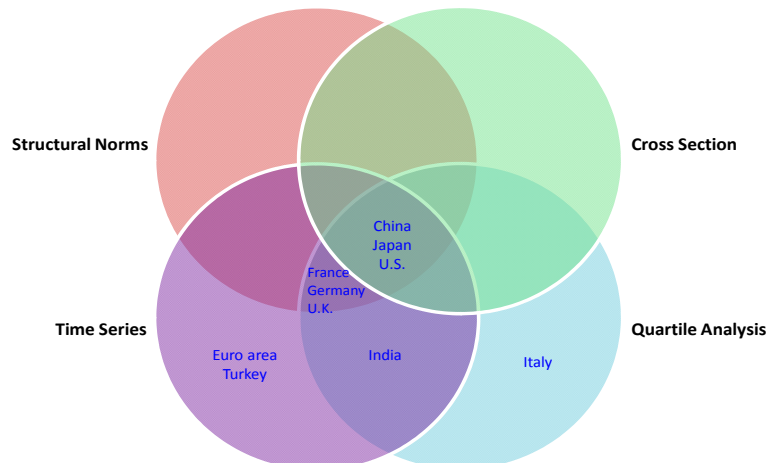
- *Imbalances can be beneficial if they reflect the optimal allocation of capital across time and space.* For instance, to meet its life-cycle needs, a country with an aging population relative to its trading partner may choose to save and run current account surpluses in anticipation of the dissaving 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).

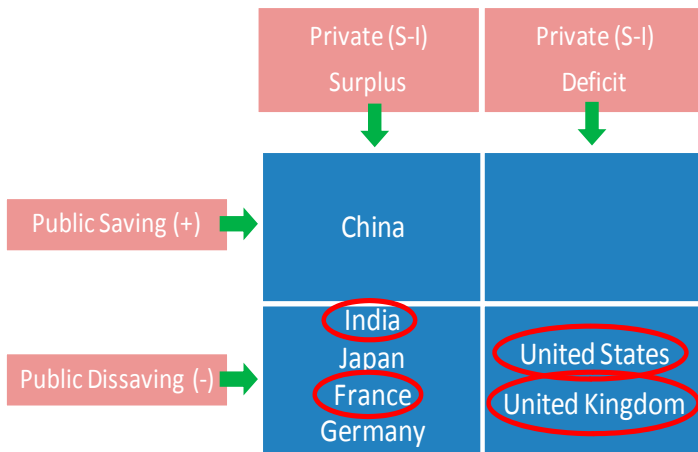
G-20 Indicative Guidelines: Comparison of Approaches
(Systemic rule; at market exchange rates)



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.

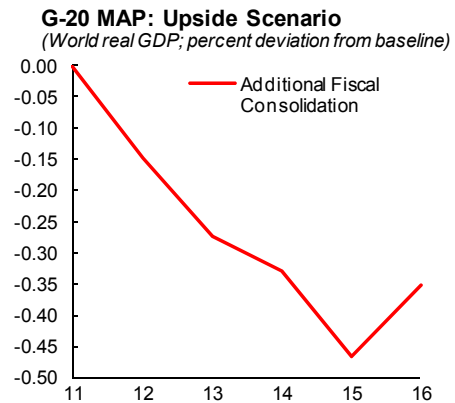
26. **An upside scenario that brings together all the central policy ingredients demonstrates the collective**

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.

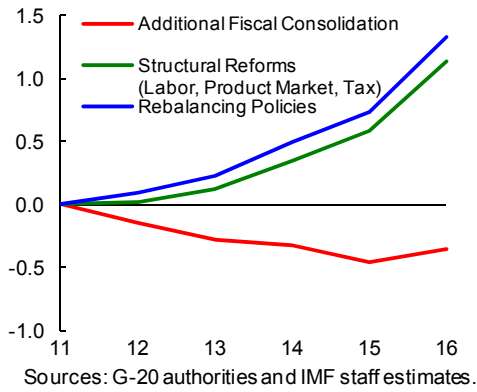
for well-timed fiscal plans to be as “growth friendly” as possible in members requiring fiscal adjustment, as well as supportive action by others to offset weaker demand in partner countries.



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.

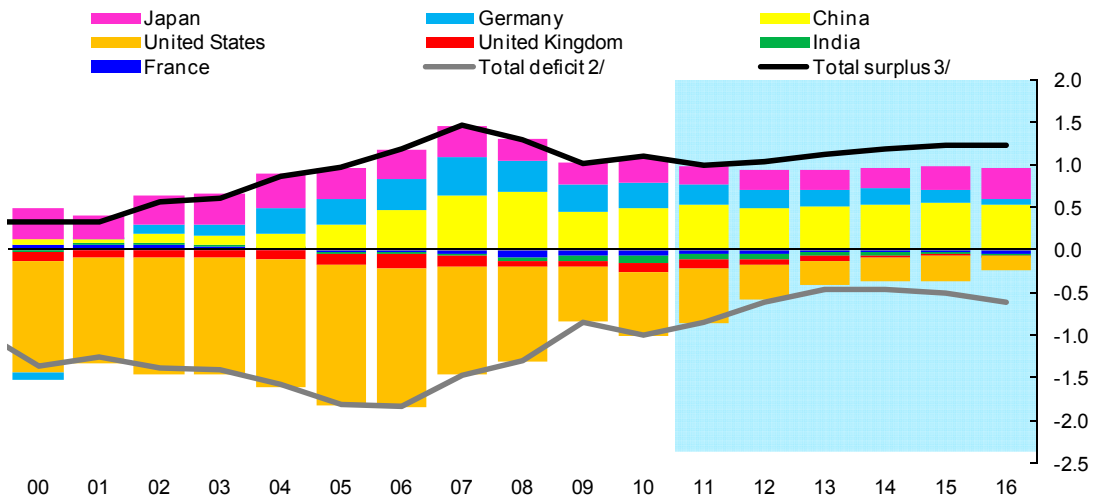
G-20 MAP: Upside Scenario
(World real GDP; percent deviation from baseline)



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)

Real GDP
(Percent)

Fiscal Balance
(Percent of GDP)

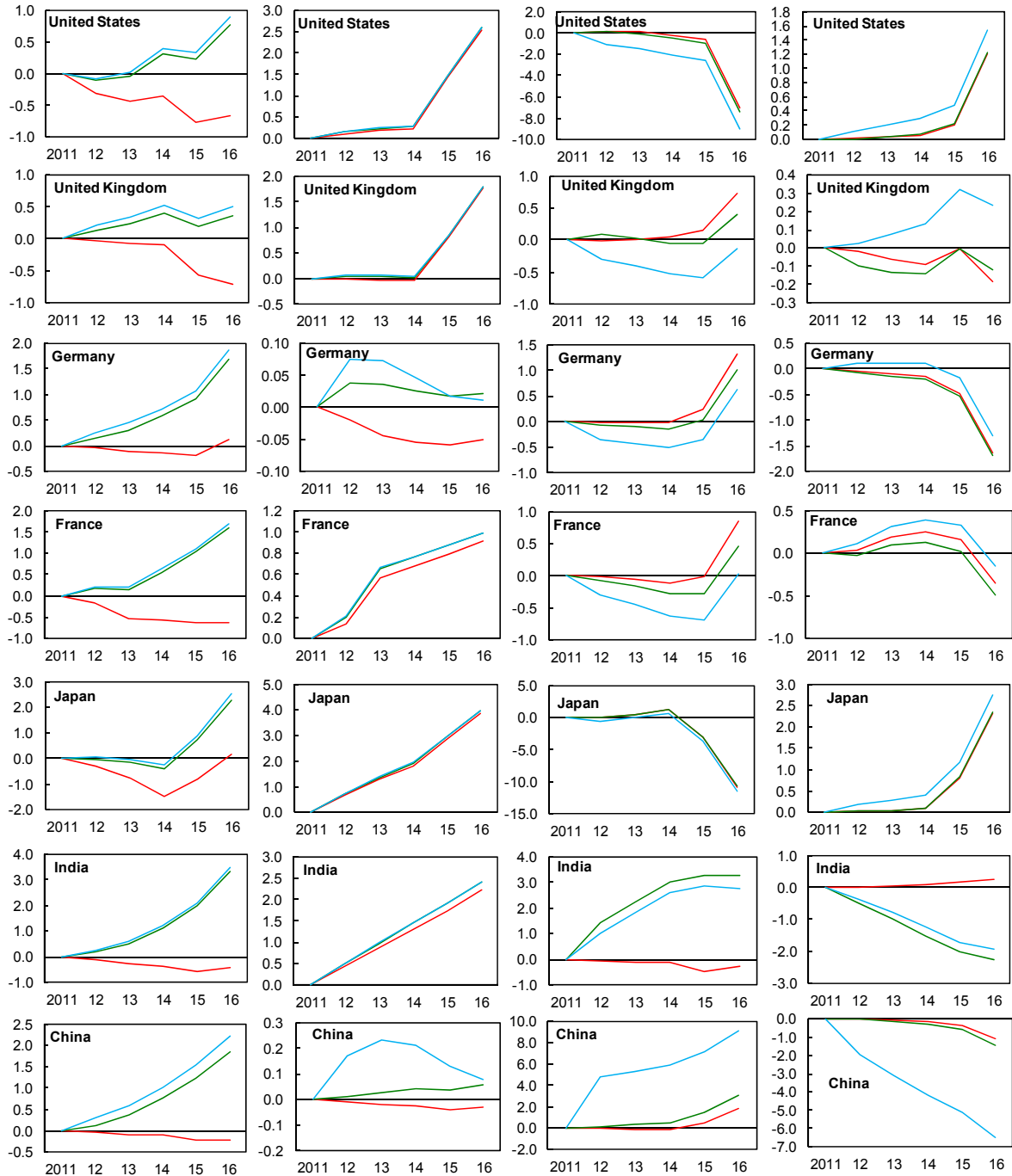
Real Effective Exchange Rate 1/
(Percent)

Current Account Balance
(Percentage point of GDP)

— Additional Fiscal Consolidation

— Structural Reforms (Labor, Product Market, Tax)

— Rebalancing F



Sources: G-20 authorities and IMF staff estimates.
1/ Increase indicates appreciation.

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.