GROUP OF TWENTY

ENHANCED ACCOUNTABILITY ASSESSMENTS

Annex to Umbrella Report for G-20 Mutual Assessment Process

Prepared by Staff of the

INTERNATIONAL MONETARY FUND*

*Does not necessarily reflect the views of the IMF Executive Board.

ANNEX 3: ENHANCED ACCOUNTABILITY ASSESSMENTS[1]

SUMMARY

Overall, members have made progress towards meeting their policy commitments in the Cannes Action Plan. Specifically:

- ***Financial policy***. Members have advanced the global regulatory reform agenda and implementation of the new capital and liquidity framework is underway, bearing in mind the need to avoid intensifying the headwinds to growth from ongoing bank deleveraging.
- ***Fiscal policy***. The pace of near-term fiscal consolidation is broadly managing a delicate balance between supporting recovery while rebuilding confidence. Most members also have credible medium-term consolidation plans to restore sustainability and/or rebuild policy space.
- ***Monetary and exchange rate policies***. Price stability has been maintained in advanced economies. Some progress has also been made toward increasing exchange-rate flexibility and reducing the pace of reserve accumulation in major emerging surplus economies.
- ***Structural reform***. Advanced economies have taken action to raise labor force participation and to strengthen fiscal frameworks, while emerging economies have been improving social inclusion.

However, further action will be needed *to meet commitment*s and to achieve the shared growth objectives. In particular:

- ***Financial sector reform***. Regulatory reforms need to be implemented on a consistent and steady basis across countries. Further work is needed in a number of key areas—including cross-border resolution and supervision, reform of financial derivatives, and closing critical data and information gaps. Macroprudential frameworks and instruments are needed.
- ***Sound public finances***. Japan and the United States need to promptly adopt credible and more ambitious medium-term consolidation plans to reduce high public debt. Reforms to address longer-term fiscal pressures from ageing and health care costs are also needed in many economies.
- ***Global demand rebalancing***. To complement steady consolidation in deficit economies, more action is needed in emerging surplus economies to facilitate demand rebalancing by addressing domestic distortions—notably, reducing high saving in China and boosting investment in other surplus economies, complemented with further exchange rate appreciation.
- ***Employment and growth***. In advanced economies, more attention is needed to address persistently high unemployment—focusing more on *demand-side* measures (where possible). Scope to enhance potential growth and employment includes strengthening competition in services.

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[1] Prepared by Florence Jaumotte and Samya Beidas-Strom under the guidance of Hamid Faruqee and Emil Stavrev, with the help of David Reichsfeld, Min Kyu Song, and Anne Lalramnghakhleli Moses.

I. FISCAL POLICY

Members committed to securing economic recovery and fiscal sustainability. Near-term consolidation is mostly managing a delicate balance between supporting recovery while rebuilding confidence. Progress has been achieved in reducing deficits in most advanced economies. However, credible and more ambitious medium-term consolidation plans are urgently needed in Japan and the United States, including to guard against risks of future market instability. Fiscal vulnerabilities in India, Russia, and Turkey should also be addressed. Structural fiscal reforms need to be deepened across the membership to address demographic challenges and rising health care costs, encourage demand rebalancing, and strengthen fiscal institutions.

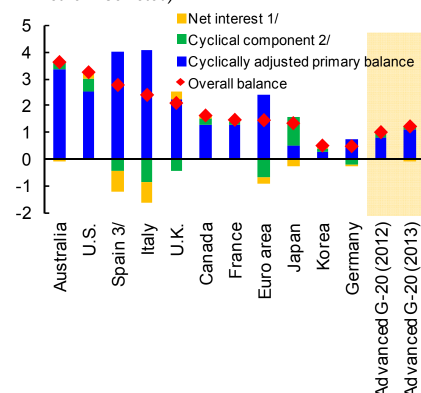
A. Advanced Economies

1. **In the short run, advanced economies appropriately committed to sustaining recovery, while progressing toward fiscal sustainability, considering national circumstances**. Based on Fund staff's projections (which assume likely policies, not authorities' official plans), the pace of near-term fiscal consolidation is generally proceeding in steady fashion (Box 1 explains how to measure the fiscal stance). Overall, the projected increase in the cyclically-adjusted primary balance of about 1 percent of GDP in 2012 is appropriate, further lowering deficits while avoiding an excessive tightening that could worsen economic conditions. From a collective perspective, the projected fiscal consolidation should contribute to global demand rebalancing, as consolidation efforts are larger in advanced deficit economies than surplus economies.

- *Japan* and *the United States* are delivering on their commitments to implement in a timely manner a package of near-term measures to sustain growth and, in the case of Japan, to aid reconstruction after the earthquake. In Japan, a series of supplementary budgets were passed for reconstruction spending, totaling 4 percent of GDP. In February 2012, the U.S. Congress approved a full-year extension of the payroll tax cuts and emergency unemployment benefits, thereby preventing a sharper tightening of fiscal policy.

- Concerns remain, however, regarding excessive tightening in the *United States* over next two years ("fiscal cliff"). Under current U.S. laws, many tax provisions begin to expire in 2013, just when deep automatic spending cuts kick in. The President's latest Budget proposal also implies a large consolidation in 2013 (3 percent of GDP). If either of these were to materialize, it would significantly undermine the recovery. To minimize attendant uncertainties, policymakers should agree as soon as possible on fiscal plans involving a more moderate adjustment for next year, as well as sustained and steady adjustment over the medium term.

Advanced G-20: WEO Projections of Fiscal Consolidation, 2012-13
(percent of GDP; cumulative change unless otherwise noted)



Sources: IMF, *World Economic Outlook;* and IMF staff estimates.
1/ Difference between overall balance and primary balance.
2/ Difference between primary balance and cyclically adjusted primary balance.
3/ WEO projections for Spain preceded the 2012 budget announcement by the new government.

Box 1: Computing Cyclically Adjusted Primary Balances

The change in the cyclically-adjusted primary balance (CAPB) as a share of potential output is a standard measure of the fiscal stance, although the concept is not without drawbacks. Calculating the CAPB entails decomposing the primary balance into two parts: a cyclical component, representing the fiscal response to fluctuations in the business cycle, and a discretionary part, reflecting the policy stance net of the impact of the cycle. Net interest payments are excluded from this concept since they are not directly under the control of the government. Changes in the cyclical component reflect the impact of automatic stabilizers.

Calculating the CAPB involves three steps:

Step 1: Estimating the cyclical position of the economy, or the output gap—that is, the percentage deviation of actual Y from potential output Y*: $gap = \left(Y - Y^{*}\right)/Y^{*}$

Step 2: Estimating the response of budgetary aggregates, or in other words the sensitivity of government expenditure, $\varepsilon_{G,Y}$, and revenue, $\varepsilon_{R,Y}$, to changes in the output gap.

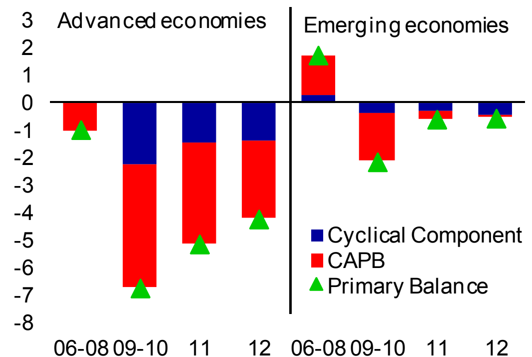
Step 3: Calculating the CAPB as the difference between cyclically-adjusted revenue and expenditure:

$$CAPB = Revenue / \left(1 + Outputgap\right)^{\varepsilon_{R,Y}} - Expenditure / \left(1 + Outputgap\right)^{\varepsilon_{G,Y}}$$

Headline primary deficits in G-20 economies reflect, to a large extent, the discretionary measures adopted in support of the economy (Figure 1). The CAPBs narrow as these discretionary measures are gradually unwound; since output gaps remain negative, the cyclical component of the primary balance accounts for a growing share of the deficit, particularly in advanced economies.

Caution is needed, however, when interpreting CAPBs. First, the output gap is not an observable but an estimated variable. The estimates vary depending on the methodology used to calculate potential GDP. It is often revised backward over time as the assessment of the trend or potential output of an economy changes. Second, cyclically-adjusted revenues may still embed the effect of asset or commodity price fluctuations. These could distort measures of the fiscal stance, especially if they are sizable and temporary (examples are pre-crisis revenue booms associated with financial profits in Spain and the United Kingdom; and the high sensitivity of revenue to commodity prices in oil- or commodity-producing countries). And third, failure to account for changes in the composition of output as well as one-off or temporary revenue and expenditure items can also contribute to over/underestimating the CAPB. The concept of structural primary balance attempts to address the latter two caveats, i.e. adjusting the primary balance beyond the cycle.

Figure 1: Decomposition of Primary Balance, G-20 Countries, 2006-2012 1/
(percent of potential GDP)



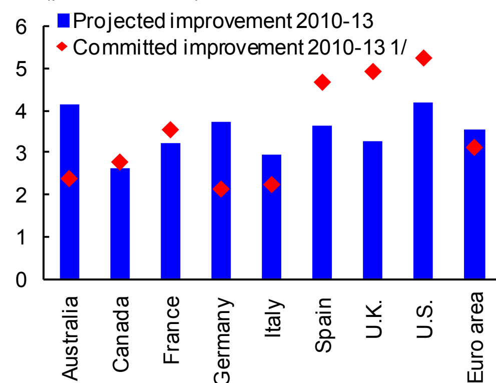
Source: IMF, *World Economic Outlook*.
1/ For the United States, excluding financial sector support.

- In the *euro area*, economies under market scrutiny committed to improve confidence by proceeding with fiscal consolidation and strengthening fiscal frameworks, but market pressures remain elevated for some economies. A few economies, though, should take care to avoid over-tightening in 2013 given a fragile recovery. In *Italy*, an ambitious and frontloaded consolidation is underway, including a significant pension reform. *France* reiterated its commitment to comply with the Toronto deficit target despite a downward revision to growth and passed two fiscal packages in 2011. There is a concern that the nominal targets under the Excessive Deficit Procedure, set some time ago, are proving increasingly tight for some countries as real GDP growth falls short of projections. Countries should let automatic stabilizers work as long as they can comfortably finance deficits, instead of offsetting cyclical revenue losses with additional structural consolidation.

- Given the weak near-term growth outlook, *the United Kingdom* has allowed the pace of structural fiscal adjustment to slow in response to lower estimates of near-term potential growth.

2. **In the medium term, all countries committed to consolidation and returning to sustainability**. Specifically, all advanced economies have reaffirmed their Toronto commitments to halve the general government deficit by 2013 from its 2010 level and to stabilize or reduce government debt-to-GDP ratios by 2016.[2] Many advanced countries have also specified additional medium-term fiscal targets for deficit or debt, which are in some cases more demanding than the Toronto commitments. The commitments appear sufficiently ambitious and are on track to being met by most economies with a few notable exceptions.

Achievement of Toronto Deficit Commitment
(percent of GDP)



Sources: IMF, *World Economic Outlook*; and staff estimates.
1/ "…..advanced economies have committed to fiscal plans that will at least halve deficits by 2013…..". In order to track more closely policy efforts, staff compares the projected 2013 deficit to the 2010 deficit outturn (instead of the 2010 deficit projection at the time of the Toronto summit). The deficit refers to the general government.

- *Most advanced economies have made significant progress toward achieving their 2013 Toronto deficit targets, although several will miss them by some margin. Australia, Canada, France, Germany, Italy, and the euro area* as a whole will achieve their targets.[3] In most other cases, the miss is relatively

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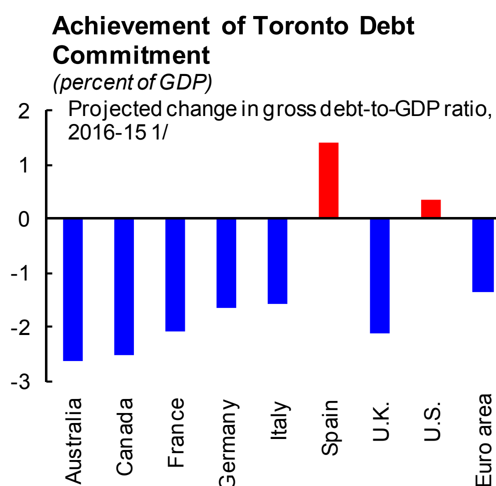
[2] For the United States, the authorities' commitment is understood in terms of halving the federal government deficit. Japan was exempted from the Toronto commitments but has a medium-term plan that consists of (i) reducing the primary deficit (in percent of GDP) by half by FY2015 relative to its FY2010 level; (ii) achieving a primary surplus by FY2020; and (iii) reducing the debt-to-GDP ratio from FY2021 onwards.

[3] In order to track more closely policy efforts, staff compare the projected 2013 deficit to the 2010 deficit *outturn* (instead of the 2010 projection at the time of the Toronto summit). However, a tolerance margin of ±½ percentage point of GDP is allowed in assessing whether the projected 2013 deficit will be reduced by half from its 2010 level. The deficit refers to the general government.

small—at least relative to the achieved efforts—and is in part explained by the short-term Cannes commitment to let automatic stabilizers work and/or take discretionary fiscal measures to support near-term growth. For most countries, deviations from the deficit targets do not threaten the achievement of the longer-term Toronto debt targets.

- *Achieving the Toronto debt target also seems within reach for most countries, with some notable exceptions*. The *United States* and *Spain* are exceptions, with general government debt projected to continue rising in 2016. While the *United States* meets technically the 2016 debt target for the federal government, debt is increasing again thereafter, highlighting the need for a credible medium-term plan. *Japan*, which was exempted from the Toronto commitment, is on track to meet its own medium-term target of halving the primary deficit by 2015 from its 2010 level, provided the government can pass the proposed tax reform bill to raise the consumption tax rate from 5 percent to 10 percent by 2015.

Achievement of Toronto Debt Commitment
(percent of GDP)



Sources: IMF, *World Economic Outlook*; and staff estimates.
1/ The gross debt refers to the general government.

Fiscal Projections versus Toronto Commitment
(percent of GDP)

	Halving deficit by 2013 1/	Stabilizing debt by 2015 2/
Australia	✓	✓
Canada	✓	✓
France	✓	✓
Germany	✓	✓
Italy	✓	✓
Spain		
United Kingdom		✓
United States		
United States (federal deficit) 3/		✓
Euro area	✓	✓

Source: IMF, *World Economic Outlook.*
1/ Toronto Declaration of at least halving the 2010 deficit by 2013; in order to track more closely policy efforts, staff compares the projected 2013 deficit to the 2010 deficit outturn (instead of the 2010 deficit projection at the time of the Toronto summit). However, a projection error margin of +/- ½ percentage point of GDP is allowed in assessing whether the 2013 deficit will be reduced in half from its 2010 level. The average current year forecast error in Fund staff projections of the 2010 headline fiscal balance was 0.5 percent of GDP. The deficit refers to the general government. A thick green checkmark is used for countries which over-perform on the Toronto Commitment by more than 1/2 percentage point of GDP. A light green checkmark refers to countries that satisfy the Toronto Commitment within an error margin of +/- 1/2 percentage point of GDP.
2/ Stabilized debt defined to be debt ratio not rising over 2015-2016.
3/ According to the United States authorities, their Toronto deficit commitment refers to the federal deficit, not the general government deficit.

3. **Sustained and substantial fiscal adjustment over time should be anchored in credible medium-term plans, where the pace of headline consolidation can adjust to economic conditions while maintaining the pace of underlying consolidation (unless growth weakens substantially)**. Leaving aside specific numerical commitments or targets, desirable fiscal adjustment will need to navigate along a narrow *path*—neither too slow (which could undermine credibility) nor too fast (which could undermine growth). Where financing conditions permit, automatic stabilizers should be allowed to operate fully. In terms of the *destination*, the scale of adjustment in the long term must be sufficient to restore sustainability and soundness to public finances. This supports the following:

- Additional fiscal adjustment over the medium term (beyond what has already been proposed) will be needed, notably in *Japan* and the *United States*. In Fund staff's estimates, the fiscal adjustment needed to return general government debt of Japan and the United States to more sustainable levels by 2030 are among the largest in the G-20 membership. Thus, it is crucial that Japan and the United States promptly adopt credible and more ambitious medium-term consolidation plans. The goal in Japan should be to stabilize the net debt ratio around 2016 and reduce it thereafter. In the United States, the objective should be to stabilize the gross debt ratio by mid-decade and subsequently put it firmly on a downward path. In *Canada*, stronger consolidation plans are needed at the provincial level to help with medium-term fiscal consolidation.

- The *euro area* as a whole is projected to reduce its fiscal deficit to below 3 percent of GDP by 2013. The new Fiscal Compact and "six-pack" reform package will provide a stronger anchor for fiscal discipline in the euro area, though the challenge will be to allow for sufficient flexibility in its application.

- Looking further ahead, in most *advanced economies* further consolidation efforts beyond current plans, as well as entitlement reforms, will be needed to return debt to more sustainable levels by 2030 and address age-related spending (Box 2).

Box 2. Calculating Fiscal Adjustment Needs

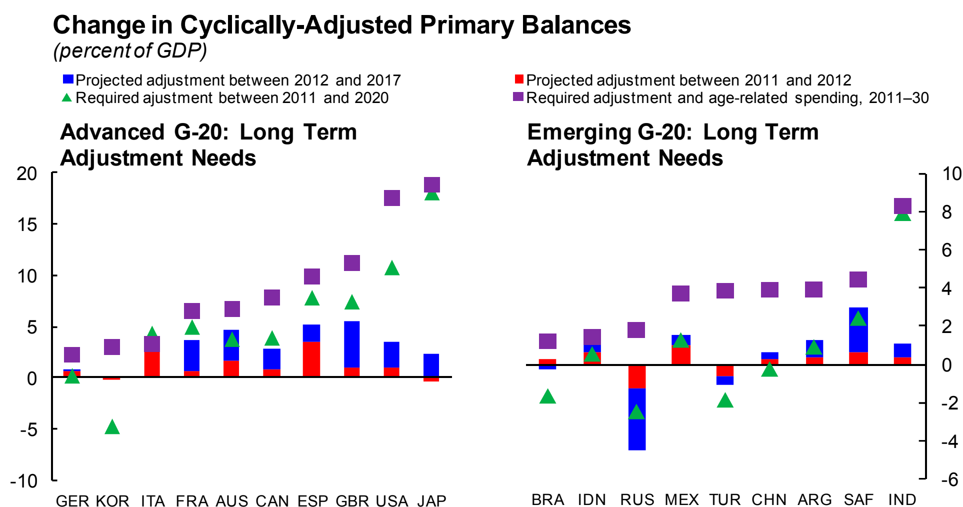
The economic crisis that began in 2008 affected the fiscal positions of most G-20 economies adversely, but its impact was not uniform. As of 2011, three fifths of G-20 economies had general government debt ratios that exceeded, in some cases substantially, their long-term historical averages; most, especially advanced economies, were running primary deficits, suggesting that without fiscal adjustment they would not be able to stabilize the debt ratio, yet alone reduce it, for any positive level of the interest-growth differential. Additional pressures can also be expected to arise from demands for pension and health care spending over the medium term. So, for most G-20 economies, a substantial fiscal adjustment is called for in the decades to come to return debt to sustainable levels.

The medium-term adjustment needs calculations presented in this box follow the standard IMF *Fiscal Monitor* methodology. Adjustment needs are equal to the distance between the current cyclically adjusted primary balance (CAPB) and that needed to reduce the general government debt ratio to 60 percent of GDP in advanced economies (40 percent in emerging economies) by 2030, or to stabilize debt at end-2012 level if it is lower than the above targets. Intuitively, adjustment needs are expected to be larger for countries with a higher initial debt ratio and a lower initial CAPB.

Among advanced G-20 economies, CAPBs must increase on average by a challenging 8.6 percent of GDP to meet the debt targets (i.e., they must move from an average deficit of 3.3 percent of GDP to an average surplus of 5.4 percent). Ambitious and credible medium-term strategies are urgently needed in Japan and the United States to put their public finances on a more sustainable path, given their high debt ratios and large primary deficits. Most other advanced G-20 economies need to improve their primary balance by 4 to 8 percentage points of GDP. Germany and Korea are outliers, thanks to their primary surpluses (and relatively low debt in the case of Korea).

Average adjustment needs are lower for emerging G-20 economies (1.0/0.8 percent of GDP to reach 40/60 percent of GDP debt levels, respectively). Most have relatively low debt and their fiscal accounts are in surplus or close to balance, facilitating achievement of their medium-term debt targets. In contrast India, with a high initial level of debt and a large primary deficit, faces steep adjustment needs. South Africa's primary deficit pushes its adjustment needs up in spite of its reasonably low level of debt, while Brazil's sizeable primary surplus would allow it to meet its debt target despite its relatively high current debt ratio.

For advanced as well as emerging countries, age-related spending is projected to lift adjustment needs significantly (by an average of 3.1 percent of GDP for emerging G-20 economies, and 4.3 percent for advanced G-20 countries). To confront these pressures, several advanced economies are aggressively tackling pension reform, including through accelerating already-legislated increases in retirement ages (France, Italy, and the United Kingdom) and increasing taxation of high pensions (Italy). Adjustment needs become even larger when health-related additional spending is taken into account.



Sources: IMF, *World Economic Outlook;* and IMF, *Fiscal Monitor.*

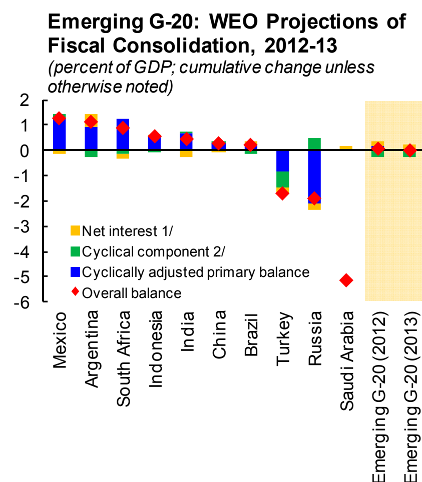
4. **The composition of fiscal adjustment is broadly appropriate in most advanced economies**. About two-thirds of planned fiscal adjustment comes from expenditure reduction and one-third from revenue increases. However, the composition could be improved in *France* and *Italy*, with less recourse to revenues given their already high revenue ratios, and in *Japan* and the *United States,* with more action on entitlement spending. There is also room to raise the consumption tax further in *Japan*.

5. **Advanced economies have made progress on their commitments to structural fiscal reforms, but more is needed**. Commitments in the Cannes Action Plan targeted strengthened *fiscal frameworks* (euro area, France, Italy, Japan, and Spain), *pension reform* (France and the United Kingdom), and *reform of tax systems* (France and Japan). The adoption of the "six-pack" and the Fiscal Compact in the euro area marks important progress in strengthening fiscal governance; careful design of the new national fiscal rules, implementation and enforcement, while retaining sufficient flexibility of fiscal policy, will be key to realizing its potential. Italy is preparing the implementation of balanced-budget rules, following recent parliament approval, whereas a revision of the already existing one in Spain is underway. France and the United Kingdom have delivered on their pension reform commitments. France has made progress toward reducing tax expenditures, but the vote to incorporate existing fiscal rules into the Constitution has been delayed. However, further structural reform is needed or desirable, including tax reform (Australia and the United States), reform of public pensions and further health care reform (the United States), reform of federal system, including the mechanisms to ensure compliance with fiscal rule at state level (Germany), creation of a formal institution/mechanism to consolidate information on the fiscal plans of different levels of government and coordinate their actions (Canada), and, more generally, reforms to address longer-term fiscal pressures from ageing and health costs.

B. Emerging Economies

6. **In the short run, emerging economies with relatively strong public finances also committed to support growth**. The pace of short-term consolidation is slower than in 2011 and than previously planned, especially in *China* and the Middle East. Collectively, the cyclically-adjusted primary balance of emerging economies is projected to improve by a very small amount (about 0.2 percent of GDP over 2012–13). This is broadly appropriate for most emerging economies, given the context of somewhat weaker growth, stronger initial fiscal positions relative to advanced economies, and the need to help with global demand rebalancing in the case of surplus economies. Nevertheless, there are a few exceptions. Fiscal policy is clearly pro-cyclical in *Russia,* which envisages an increase in the non-oil deficit of about 2 percent of GDP despite the closing of the output gap. Tight fiscal policy is also needed in *India*, where the economy is operating close to potential, while in Turkey fiscal policy should be supportive of the efforts to reign in the large current account deficit, the main source of vulnerabilities in the

Emerging G-20: WEO Projections of Fiscal Consolidation, 2012-13
(percent of GDP; cumulative change unless otherwise noted)



Sources: IMF, *World Economic Outlook;* and IMF staff estimates.
1/ Difference between overall balance and primary balance.
2/ Difference between primary balance and cyclically adjusted primary balance.

short run. *China* could act quickly to loosen fiscal policy in the near term should domestic growth slow too much, which would also have positive spillovers for global demand.

7. **Most emerging economies are broadly on track to reach their medium-term targets, with the goal of rebuilding fiscal space eroded during the crisis**. Nevertheless, there are a number of concerns.

- Notwithstanding general guiding principles in its Twelfth Five-year Plan, there is no clear medium-term fiscal target in *China*. Staff recommend that China publish annually well-defined quantitative commitments beyond the current one-year horizon. A transparent medium-term fiscal plan would help clarify the government's macro-fiscal objectives, which is important for multilateral policy coordination given the large size of the Chinese economy.

- The medium-term targets are not sufficiently ambitious in *Russia* and *Turkey*. While the 2012–14 medium-term budget plans would leave the overall deficit by 2014 even better than the objective committed to at the Cannes summit, the relevant fiscal variable for an oil producer like Russia, given the volatility of oil prices and the nonrenewable nature of oil reserves, is the non-oil deficit. Unfortunately, the 2012–14 medium-term budget envisages essentially no consolidation in the non-oil deficit, which remains well above its sustainable level and a major concern, despite the low debt-to-GDP ratio. In Turkey, to reduce dependence on foreign saving while maintaining the positive growth trajectory, greater emphasis should be placed over the medium term on the structural fiscal position, and, in particular, on targeting a structural surplus to accumulate fiscal buffers and allow monetary policy to focus on inflation targeting. This is particularly important given the large rigidities in Turkey's spending.

- *India* may miss its medium-term deficit target and Fund staff estimate a higher deficit over the medium-term under current policies. To achieve its own medium-term deficit target, India would need to take measures to better control subsidies and to restore revenue to pre-crisis levels.

- Looking further ahead, age-related spending is projected to lift adjustment needs significantly, on average by 3.1 percent of GDP between 2011 and 2030. This will require further consolidation efforts beyond current plans and entitlement reforms in most countries (Box 2).

8. **The composition of fiscal adjustment is broadly appropriate in emerging economies**. On average, adjustment relies mostly on expenditures, which is broadly appropriate. The reallocation of spending from health, education and infrastructure programs to defense spending is a concern in Russia. Subsidies should be reformed in India, Indonesia, and Saudi Arabia. In order to improve longer-term fiscal prospects, Mexico, Russia, and Saudi Arabia should improve non-oil revenues, including through improved administration and broadening tax bases, and increased efficiency of expenditures.

9. **Further progress is needed in the area of structural fiscal reforms to facilitate global rebalancing**. A number of countries with current account surpluses committed to increasing spending on social expenditures such as safety nets/health/education (China, Indonesia, and Saudi Arabia) and

on infrastructure (Indonesia and Saudi Arabia). There has been some reallocation or increase in spending toward social expenditures (China and Saudi Arabia) and infrastructure (Indonesia and Saudi Arabia). For instance, in Saudi Arabia, a new unemployment benefit scheme began payments in November 2011 and there are large public investment programs. In China, expenditures on social protection (health, education, and social security and employment) have increased from 5½ percent of GDP in 2007 to just over 7 percent of GDP, but there is further space to increase allocations to these sectors to facilitate a reduction in household precautionary saving and an increase in private consumption. In Fund staff's view, this should also be accompanied by a shift of the tax burden away from households to support private-consumption-led growth and by further improvements in the portability of pensions.

10. **Other important structural fiscal reforms include strengthening fiscal frameworks and management, and tax reform**. Several countries have made a commitment to improve fiscal frameworks and management (China, Indonesia, and South Africa) and in Fund staff's view better fiscal frameworks are also needed in other countries (e.g., Brazil and Saudi Arabia). In Indonesia, the implementation of a medium-term expenditure framework and of performance-based budgeting is ongoing. South Africa has developed fiscal guidelines and will prepare its first long-term fiscal report in late 2012. Overall needs for reform remain large in several countries. In the area of tax reform, China is taking some measures, especially tax cuts for micro enterprises and a VAT reform initiative to replace the sales tax and expand coverage to manufacturing and services, while tax reform is moving slowly in India. In staff's view, proceeding with tax reform is important in Brazil, China, India, Indonesia, and Turkey.

II. MONETARY AND EXCHANGE RATE POLICIES

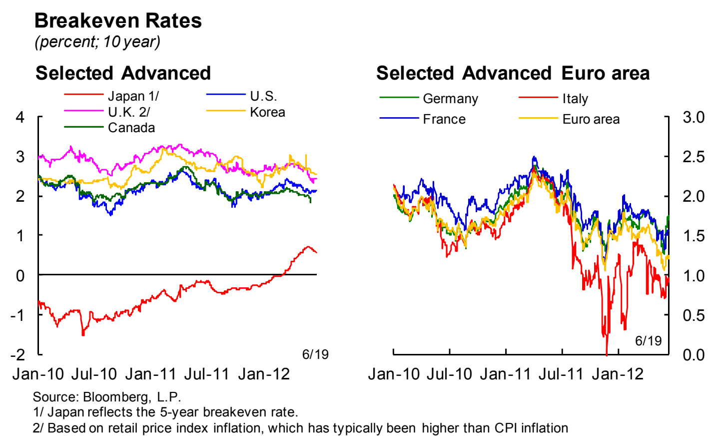
Member commitments center on preserving price stability, moving toward greater exchange rate flexibility, and reducing "excessive" reserve accumulation. In advanced economies, price stability is being maintained as growth remains tepid, and monetary policy remains very accommodative—with scope for further easing in some (including through unconventional measures). In emerging economies, inflation behavior and the monetary policy stance are more differentiated, with the possible need for further tightening in some to safeguard credibility. Against this policy setting and swings in global risk aversion, market pressures on exchange rates, reserves, and capital flows have been volatile. Since Cannes there has been modest change in the degree of exchange rate flexibility, and more ambitious steps in key surplus members would provide more support for global rebalancing. The pace of reserve accumulation has slowed in major surplus economies, while a broad range of policy responses to capital inflows have been taken in several emerging economies.

11. **Members have committed to price stability and exchange rate flexibility**. Main commitments on monetary and exchange rate policies in the Cannes Action Plan include: (i) supporting the economic recovery while maintaining *price stability* over the medium term; and (ii) moving more rapidly toward market-determined exchange rate systems and enhancing *exchange rate flexibility*, as appropriate, to reflect underlying economic fundamentals, while refraining from competitive devaluation of currencies. The latter commitment was intended to facilitate further progress on exchange rate reform and to *reduce excessive reserve accumulation*. The Fund also gives clear guidance to its members to avoid exchange rate policies that secure fundamental misalignments to increase net exports, but does not advocate for any one particular fixed or flexible regime across the membership. This section evaluates member progress with respect to maintaining price stability (including mitigating deflation risks); moves toward greater exchange rate flexibility; and changes in the pace of reserve accumulation.

A. Price Stability and Monetary Policy

12. **In advanced economies, price stability has been maintained alongside appreciable economic slack and inflation expectations have remained well-anchored**.

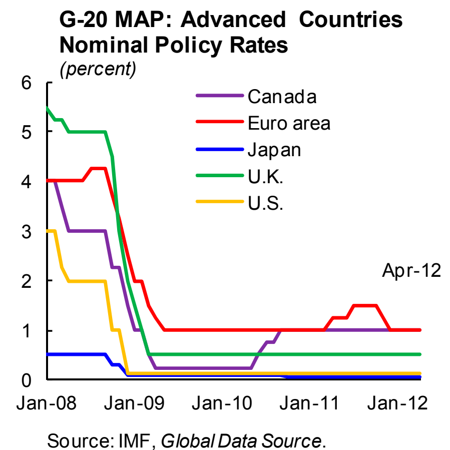
- *Measures of inflation expectations (e.g., breakeven rates) have been broadly stable.* Deflation has been avoided (except in Japan). However, in euro area economies closest to the recent market turmoil—suffering from falling confidence, contracting activity or weak growth and heightened financial stress—inflation expectations have moved down.



Source: Bloomberg, L.P.
1/ Japan reflects the 5-year breakeven rate.
2/ Based on retail price index inflation, which has typically been higher than CPI inflation

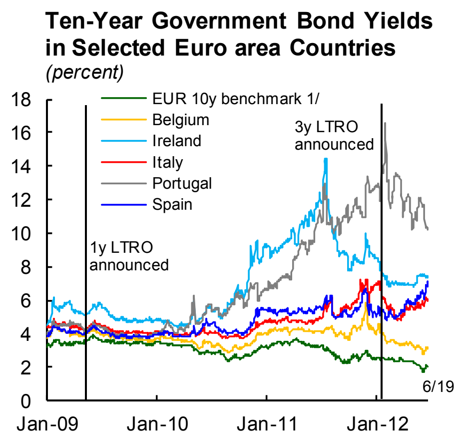
- *Against a setting of sizeable output gaps and high unemployment, headline inflation has either eased or is expected to ease while core inflation and wage gains have remained low but positive*. In the euro area and the *United Kingdom* unit labor costs have continued to recede or stagnate and wage settlements remain modest, and in the *United States* the employment cost index remains subdued.

13. **Monetary policy rates have been very low in advanced economies, though more easing should be considered in some—including through unconventional measures.** Real policy rates have remained low or somewhat negative at end March-2012. But with sluggish growth, high unemployment, and downside risks, more easing could be considered going forward—with the possible exception of *Canada* and *Korea*—if expectations are well anchored and projections show underlying inflation remaining subdued or likely to fall. For example, although headline inflation in the *United Kingdom* is currently elevated, it is falling and risks modestly undershooting in the medium term given a large output gap and weak wage growth. In *Canada* a more rapid improvement in economic activity and a reduction in the output gap are keeping policy rates on hold at present, while in *Korea* still-elevated inflation expectations limit the room to ease. In the *United States*, more easing could be considered if activity threatens to dissappoint.

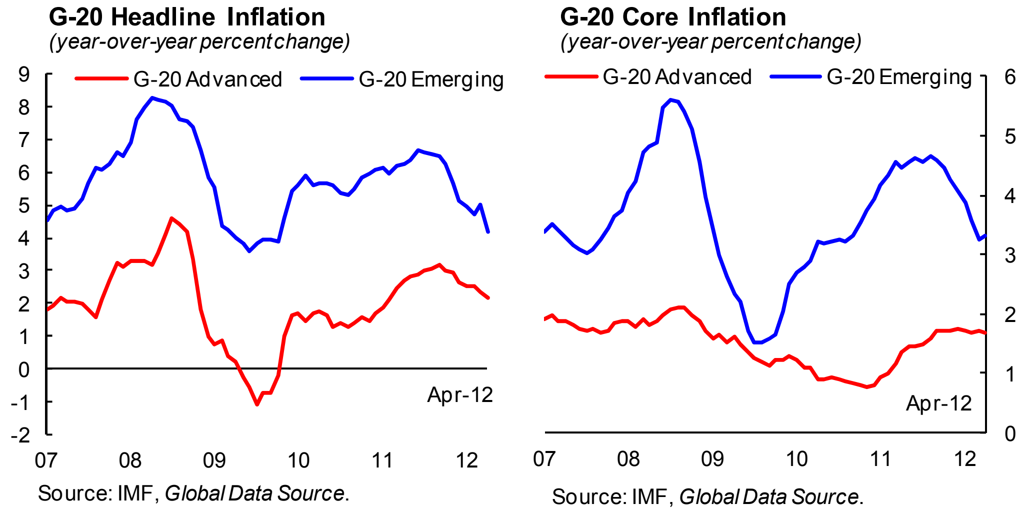


Source: IMF, *Global Data Source*.

- *Unconventional measures have been used to support growth or reduce financial instability to help mitigate deflation risks*. In some advanced economies (Japan and the United States) with policy rates close to the zero bound, unconventional measures have taken place and/or very low rates have been signaled for the foreseeable future. The Bank of Japan announced in February 2012 a 1 percent medium- to long-term price stability objective, and in late April delivered further easing—with a net increase in its asset purchase plan of ¥5 trillion (1 percent of GDP), increasing its total asset purchase program to ¥70 trillion, an extension of the maturity to be purchased, and an unexpected increase in equity purchases. In the *euro area*, the ECB conducted 3-year long-term refinancing operations (LTROs) in December 2011 and February 2012 to reduce funding pressures. The ECB should continue providing ample liquidity and stay engaged in securities' purchases to ensure the orderly functioning of financial markets and hence monetary transmission. In the *United Kingdom*, monetary policy has remained appropriately accommodative, including the launch of another round of government bond purchases in February 2012. However, further easing, including through unconventional measures, may be needed given weak growth, contained underlying inflation, and downside risks.



Sources: Bloomberg, L.P.; and Haver Analytics.
1/ Average of Euro AAA rated sovereigns.

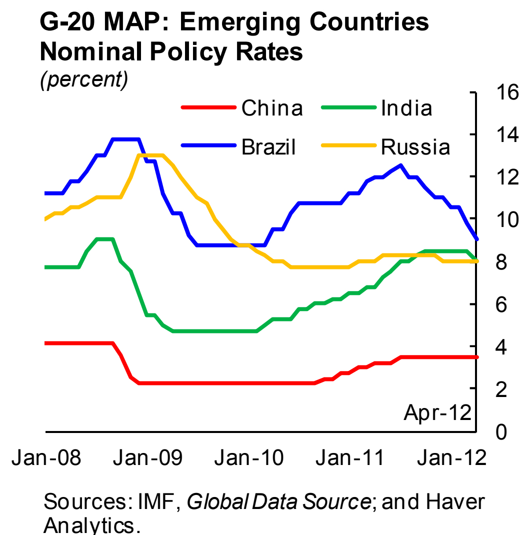


Source: IMF, *Global Data Source*.

Source: IMF, *Global Data Source*.

14. **In contrast to advanced economies, inflation behavior has been more diverse in emerging economies**. More recently, strong economic activity has slowed thus easing inflation pressures, partly as a result of lower non-oil commodity prices and past policy tightening. Despite slower growth in emerging economies, inflationary and overheating pressures remain high in a few, with some concern of second–round effects, including from higher oil prices. Headline inflation remained high or above target, particularly in *Brazil*, *India*, *South Africa*, and *Turkey*. In a few economies (India and Turkey), declines in core inflation have been rather limited.

15. **Correspondingly, monetary policy responses have been more differentiated in emerging economies and further tightening should be considered by some.** Real policy rates have been on average negative, but with variation. Some economies (Brazil, India, Indonesia and Turkey) cut rates to support growth or to help manage capital inflows, while others tightened monetary conditions to cool activity (Russia). To keep expectations anchored, more tightening may be needed in several economies (Argentina, India, Indonesia, Russia, Saudi Arabia, and Turkey) should price pressures increase, as they continue to operate close to full capacity. Others (Brazil, China, and South Africa) could stay on hold provided that inflation expectations remain well anchored and lending to certain sectors (e.g., real estate, household credit) is brought under control or continues to expand at a rate consistent with financial stability. In particular, deficit countries should remain vigilant to overheating risks and rebuild buffers to guard against less favorable external financing conditions and commodity price volatility over the medium term. The objectives or stance of monetary policy have become less predictable or more difficult to judge for various reasons in some (Turkey and China).



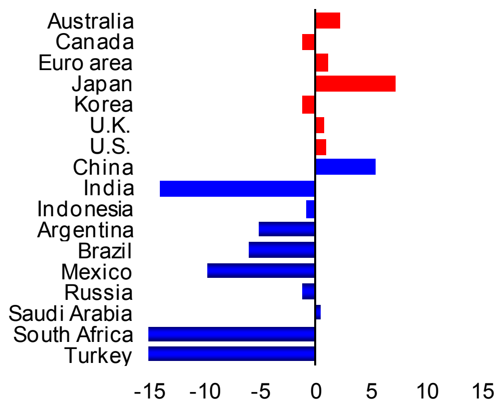
Sources: IMF, *Global Data Source*; and Haver Analytics.

B. Exchange Rates and Reserves

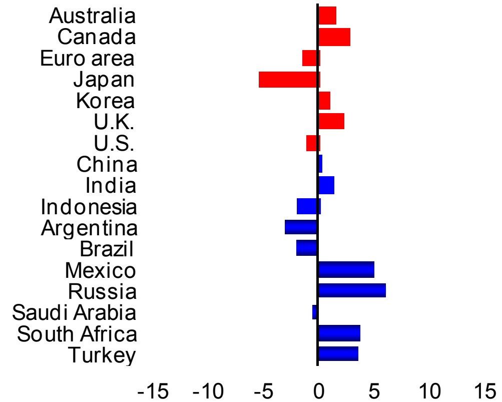
16. **Against this setting of different policy stances, return differentials, and swings in risk perception, emerging market currencies and capital flows have been volatile**. With changes in global financial conditions and risk aversion, there has been a flight to safety away from emerging markets in 2011, resulting in an overall depreciation trend in their currencies in both nominal and real effective terms (see chart). Changes in multilateral exchange rate measures (Box 3) can have meaningful implications for external positions and competiveness. Amongst emerging economies, only *China* (with a relatively closed capital account) and *Saudi Arabia* (with a U.S. dollar peg) saw appreciation during 2011. Following actions to stabilize the euro area crisis, this trend reversed as market sentiment and risk perceptions improved in early 2012, though risk appetite appears to be receding again. A flight into riskier assets and the resumption of capital flows to emerging markets has been accompanied by many currency appreciations (year to date). In contrast, *China* and *Saudi Arabia's* effective exchange rates again continued to buck the trend, reflecting their greater fixity to the U.S. dollar—a safe haven currency.

Nominal Effective Exchange Rate Movements

2011
(percent change; per local currency; Dec 2010 - Dec 2011)



2012
(percent change; per local currency; Dec 2011 - Apr 2012)

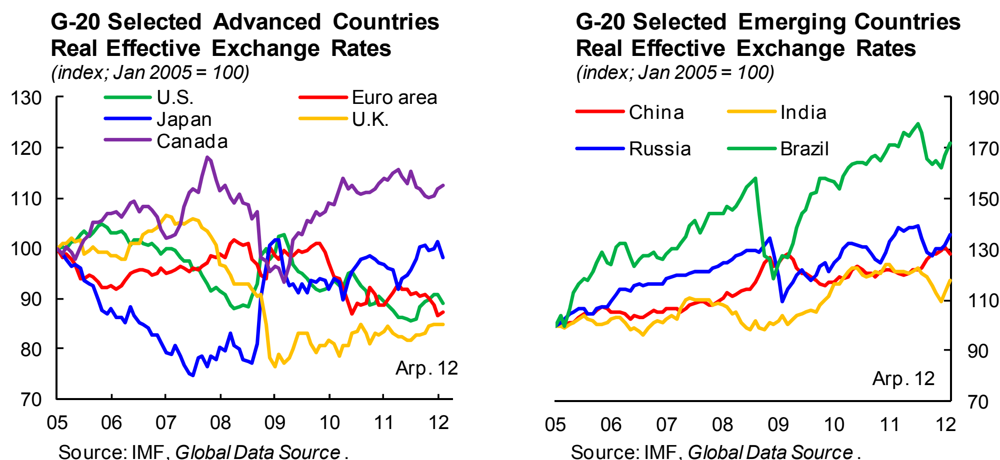


Source: IMF, *Global Data Source*.

Box 3. Multilateral Exchange Rates

Multilateral exchange rates. IMF staff traditionally assess exchange rates in multilateral (rather than bilateral) terms. Changes in multilateral real exchange rates can affect a country's external position (e.g., trade balance and current account) and are often used to understand the behavior of trade flows (e.g., elasticities approach).[1] Notions such as *external balance* as a benchmark to understand medium-term equilibrium exchange rates and consistency with fundamentals are most naturally understood as multilateral concepts (i.e., for a given country vis-à-vis all trading partners).[2] Economic theory such as whether purchasing power parity (PPP) holds between countries (extending the "law of one price" to a basket of goods) also usually examines exchange rates in effective terms. Correspondingly, IMF staff have favored using real effective exchange rates to best measure international relative prices. Effective exchange rate indices aggregate and summarize information contained in a set of bilateral exchange rates. Real effective exchange rates (REERs) are nominal effective exchange rates (NEERs) adjusted by some measure of relative prices or costs, to take into account both nominal exchange rate developments and inflation differential vis-à-vis trading partners. REER indices serve a variety of purposes. These include assessing a country's overall international competitiveness (e.g., relative price of domestic tradable goods in terms of foreign tradables), the equilibrium value of a currency against various benchmarks, as a gauge of the transmission of external shocks (e.g., terms of trade), and as a consideration for monetary policy, among other uses. Under PPP, for example, there should be broad constancy of REERs over time if currencies and prices are broadly in equilibrium. But consumption patterns can change faster than the market baskets are updated—as can trade policies, tariffs and transportation costs—thus deviations from such benchmarks do not necessarily indicate fundamental misalignment in the REER.

Determination of effective rates. To construct useful measures of effective exchange rates, the weights assigned to the exchange rates of different trading partners in the index is thus an important consideration. The IMF calculates REERs and NEERs through a uniform methodology, using geometric weighted-averages of the seasonally adjusted consumer prices (CPI) or unit labor costs (ULC) and the exchange rate index (U.S. dollar per national currency, period average). To reflect the pattern of trade, trade partner weights are composed of bilateral trade shares of manufactures, non-energy commodities, and tourism in the total. The manufacturing component is adjusted to reflect the overall importance of manufacturing and non-tourism service trade, rather than manufacturing alone. Commodity weights are considered unrelated to bilateral trade, and they are determined by the country's share (per commodity category) in the global market. Weights for manufacturing, non-tourism service trade, and tourism take into consideration *third-market* effects, or the direct competition between trading partners in third-country markets. In manufacturing, for example, the importance of third-market effects is determined by the relative importance of imports of manufactures versus sales of home products of the destination country. Hence the weight is smaller the more closed the country is to foreign trade.[3] The chart below shows REERs for select G-20 economies.



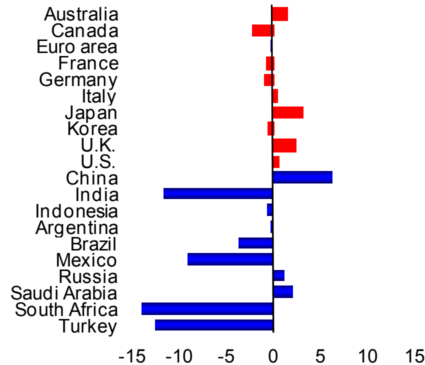
[1] IMF, 1998, Exchange Rate Assessments: Extensions of the Macroeconomic Balance Approach, Washington, DC: IMF Occasional Paper 167.

[2] IMF, 2008, Exchange Rate Assessments: CGER Methodologies, Washington, DC: IMF Occasional Paper 261.

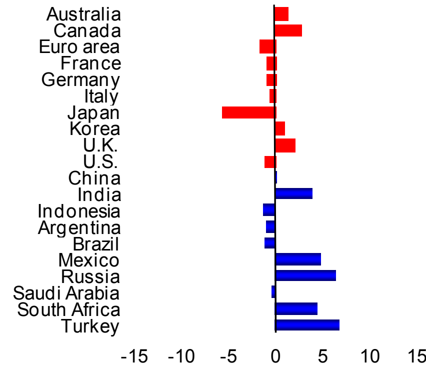
[3] IMF, 2006b, New Rates from New Weights, Washington, DC: IMF Staff Papers, Vol. 53, No.2.

Real Effective Exchange Rate Movements 1/ 2/

2011
(percent change; per local currency; Dec 2010 - Dec 2011)



2012
(percent change; per local currency; Dec 2011 - Apr 2012)



Source: IMF, *Global Data Source*.
1/ The estimates of the REER for the G-20 countries that have trade linkages with Argentina, particularly Brazil, are adversely affected by the innaccurate reporting of Argentina CPI.
2/ Based on Argentina's official CPI data (CPI-GBA). The Fund has called on Argentina to adopt remedial measures to address the quality of their CPI data. IMF staff is also using alternative measures of inflation for macroeconomic surveillance, including data produced by provincial statistical offices and private analysts, which have shown considerably higher inflation figures than the official data since 2007.

17. **G-20 economies, by and large, have operated *flexible* exchange rate regimes combined with inflation targeting**. Based on updated IMF classifications, the table below shows the classification of both monetary policy frameworks and exchange rate regimes. More flexible currencies tend to be associated with inflation targeting—comprised of both surplus (green) and deficit (red) members. Members with less flexible regimes have tended to place greater weight on money and the exchange rate as the nominal anchor. Among the G-20, only emerging surplus economies fall into these categories. Deficit emerging economies have *de facto* floating currencies that have been appreciating of late, with foreign exchange intervention mostly aimed at smoothing volatility. Advanced economies have largely avoided intervening in currency markets to limit volatility with some exceptions (Japan and Korea).

G-20s Monetary and Exchange Rate Regimes

De facto Classification of G-20 Exchange Rate Arrangements 1/ 2/
(provisional; as of end - April 2012)

Exchange rate arrangement (number of countries)	Exchange rate anchor				Monetary aggregate target	Other 3/	Inflation-targeting framework
	Euro (27)	U.S. dollar (48)	Composite (14)	Other (8)	(29)	(33)	(31)
No separate legal tender (13)							
Currency board (12)							
Conventional peg (43)		Saudi Arabia					
Stabilized arrangement (23)							
Crawling peg (3)							
Crawl-like arrangement (12)					Argentina China		
Other managed arrangement (17)						Russia	
Floating (36)						India	Brazil Korea South Africa Indonesia Turkey
Free floating (30)						Japan United States Euro area	Mexico Australia Canada United Kingdom

Source: IMF, 2010 and 2011 Annual Report on Exchange Arrangements and Exchange Restrictions.
1/ Colors represent G-20 countries selected as current account surplus and deficit economies.
2/ Number in brackets indicates number of IMF members within exchange rate classification, as of end-April 2011.
3/ Includes countries that have no explicitly stated nominal anchor, but rather monitor various indicators in conducting monetary policy.

18. **While there have been welcome *de jure* moves toward greater exchange rate flexibility, changes in *de facto* flexibility in the membership since Cannes have been modest**. Based on the IMF's *de facto* exchange rate classification methodology, very few G-20 members changed with respect to moving to more (or less) flexible regimes. How staff assess exchange rate flexibility is described in Box 4. While exchange rates may have been volatile during this period, members' currency flexibility vis-à-vis their reference basket or anchor currency (where applicable) did *not* appreciably change. One exception is Mexico, which has been reclassified as "free floating". In April 2012, China announced a widening of the trading band for the *renminbi* from 0.5 to 1 percent (Box 5). Staff is monitoring developments to ascertain if a change to a more flexible regime classification is warranted, but no increase in market flexibility has yet been observed. Bilateral appreciation of the currency against the U.S. dollar and in effective terms has been minimal in 2012. In previous years, there have been changes in exchange regimes. During 2009–10, amid turbulent financial markets, a few G-20 countries moved toward more fixed arrangements (e.g., Argentina from a floating to a crawl-like arrangement in early 2010, Indonesia from floating to stabilized arraignment in mid-2010, and Turkey to a float from free floating in late 2010). Some members have reversed course in favor of greater exchange flexibility. *China* moved towards greater flexibility in mid-2010 and *Indonesia* shifted back in early 2011 to a *de facto* floating regime (see table).

- *Reforms among a few surplus emerging economies could eventually lead to further flexibility*. In Russia, the operational moving band for the ruble widened further (from 5 to 6 rubles) and intervention amounts were reduced. In China, appreciation (in effective terms) has been allowed—enhanced flexibility may reduce the risks of liberalizing the financial system and opening the capital account.[4] In both China and Russia, further continued increases in flexibility are warranted. Finally, in Saudi Arabia, the combination of the longstanding peg to the U.S. dollar and the increased risk of divergence of the U.S. business cycle from the oil price cycle (with the rising influence of emerging Asia), as suggested by preliminary staff analysis, have the potential to create policy tensions.

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[4] The use of China's RMB for cross-border trade has expanded and become more symmetric across imports and exports. A new scheme allows RMB funds raised in Hong Kong to be channeled into direct and portfolio investment in the Mainland, subject to a quota. For the RMB internationalization process to continue smoothly, steadily opening up more channels that allow RMB funds to flow back into the Mainland will be needed. An unofficial roadmap to open up the capital account was released in February this year laying out the stages for reform over the next 10 years.

Box 4. Assessing Exchange Rate Flexibility

To assess G-20 members' exchange rate flexibility, staff has relied on changes in de facto exchange rate regime classifications to make this determination. While countries announce an official exchange rate regime, IMF staff monitors at high frequency each member's actual, *de facto*, arrangements, which may differ from the de jure announced regime.[1/ 2/ 3/]

De facto classifications. Regimes are classified into four broad types, with increasing degrees of flexibility as follows:

- Hard pegs arrangements: (i) *No separate legal tender* is when the currency of another country circulates as the sole legal tender (formal dollarization), implying complete surrender of domestic monetary policy; and (ii) *Currency board* is an explicit legislative commitment to exchange domestic currency for a specified foreign currency at a fixed exchange rate, combined with the assurance of fulfillment. This implies that the domestic currency is usually fully backed by foreign assets, eliminating traditional functions such as monetary control and lender of last resort, and leaving little room for discretionary monetary policy. Some flexibility may still be afforded, depending on the strictness of the banking rules of the arrangement.

- Soft pegs arrangements: (i) *Conventional peg* is a formal pegging at a fixed rate to another currency or a basket of currencies and involves standing ready to maintain the fixed parity through direct or indirect intervention. No commitment to irrevocably keep the parity is needed, but the exchange rate may fluctuate within narrow margins of less than ±1% around a central rate—or the maximum and minimum values of the spot market exchange rate must remain within a narrow margin of 2% for at least six months; (ii) *Stabilized arrangement* entails a spot market exchange rate that remains within a margin of 2% for six months or more—with respect to a single currency or a basket of currencies, where the anchor currency or the basket is ascertained or confirmed using statistical techniques—and is not floating; (iii) *Crawling peg* involves the currency being adjusted in small amounts at a fixed rate or in response to changes in selected quantitative indicators, with the rate of crawl set to generate inflation-adjusted changes (backward looking) or set at a predetermined fixed rate and/or below the projected inflation differentials (forward looking), with the rules and parameters being public or notified to the IMF; (iv) *Crawl-like* is when the exchange rate remains within a narrow margin of 2% relative to its six month or more trend and is not considered as floating—or when the annualized rate of change is at least 1%, provided it appreciates or depreciates in a sufficiently monotonic and continuous manner; and (v) *Pegged exchange rate within horizontal bands* involves maintenance of the currency within certain margins of fluctuation of at least ±1% around a fixed central rate, or a margin between the maximum and minimum value of the exchange rate that exceeds 2%, with the central rate and width of the band being public or notified to the IMF.

- Residual arrangements: *Other managed arrangement* is used when the exchange rate does not meet the criteria for any other category. Arrangements characterized by frequent shifts in policies may fall into this category.

- Floating regimes: (i) *Floating* is when the exchange rate is largely market determined, without an ascertainable or predictable path. Foreign exchange market intervention may be either direct or indirect and serves to moderate volatility without targeting a specific level incompatible with floating; and (ii) *Free floating* is if intervention occurs only exceptionally and aims to address disorderly market conditions and if the data confirm that intervention has been limited to at most three instances in the previous six months, each lasting no more than three business days.

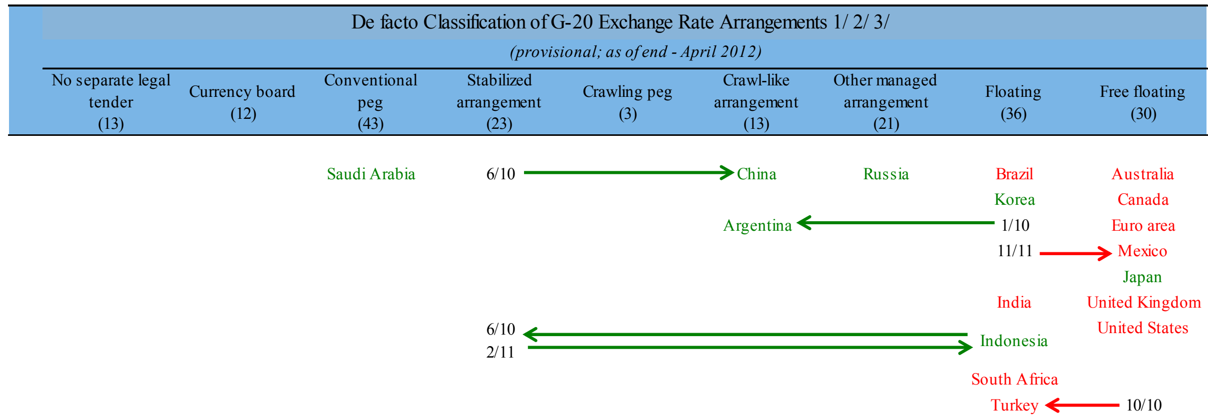
Monitoring. Staff monitors de facto regimes on a routine basis, in the context of review of country briefing papers and staff reports. An annual review of all classifications is *externally* published in the IMF's Annual Report on Exchange Arrangements and Exchange Restrictions (AREAER), covering 187 countries. The staff's assessment primarily is based on the degree to which the exchange rate is *market-determined*—rather than officially determined (e.g. through intervention in foreign exchange markets). This is determined by observing the behavior of the exchange rate (daily spot rates), complemented by information on the monetary and foreign exchange policy actions taken by country authorities (notably intervention).

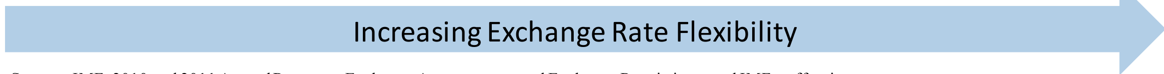
1/ The description and effective dates of the de jure exchange rate arrangements are provided by each IMF member as an obligation under Article IV, Section 2(a), of the IMF's Articles of Agreement and Paragraph 16 of 2007 Surveillance Decision No. 13919-(07/51).

2/ International Monetary Fund, 2011, Annual report on Exchange Rate Arrangements and Exchange Rate Restrictions, Washington, DC (Sept.).

3/ Wherever the de jure arrangement can be empirically confirmed by the staff over at least the previous six months, the exchange rate arrangement is classified in the same way on a de facto basis. Because the *de facto* methodology for classification of exchange rate regimes is based on a backward-looking approach that relies on past exchange rate movement and historical data, some countries have been reclassified retroactively to the date the behavior of the exchange rate changed and matched the criteria for reclassification to the appropriate category.

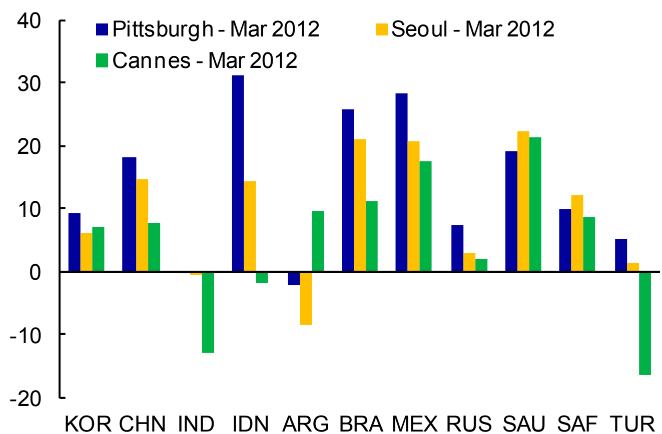
Classification of Exchange Rate Regime





Sources: IMF, 2010 and 2011 Annual Report on Exchange Arrangements and Exchange Restrictions; and IMF staff estimates.
1/ Colors represent G-20 countries selected as current account surplus and deficit economies.
2/ Number in brackets indicates number of IMF members within exchange rate classification, as of end-April 2011.
3/ Arrows indicate change in regime classification; date indicates timing of the change (i.e. 6/10 stands for June 2010)

19. **Reserve accumulation appears to have generally slowed since mid-2011 in key surplus economies**. Notably in China, Russia and, to a lesser degree, Saudi Arabia, the pace of reserve build-up has slowed (or stopped)—although levels remain relatively high and often exceed simple measures of reserve adequacy (e.g., ratio to short-term liabilities, 3-months coverage of imports, etc.). Some deficit economies have also seen reserve losses over the past six to eight months (India, Indonesia, and Turkey). Since November 2011, reserve accumulation picked up in Argentina due to a wide range of administrative measures and restrictions that have been instituted to address the narrowing current account surplus, and in Mexico due to receipts from the oil company Pemex in light of higher oil prices.

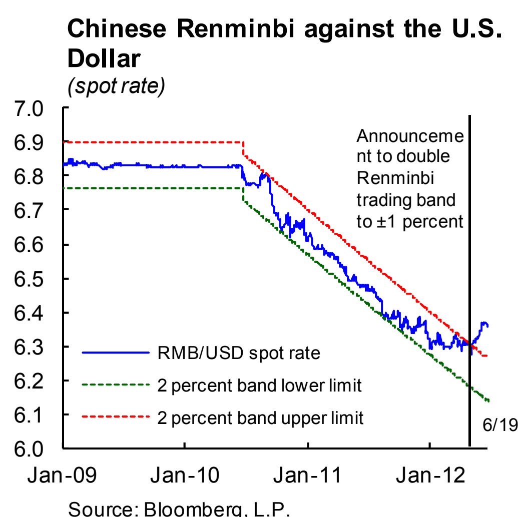


Source: IMF, *International Financial Statistics*.
1/ Valuation effects (arising from difference between cross exchange rates and book/market values of reserve assets) are not taken into account.

Box 5. Announced Changes in China's Exchange Rate Policy

The People's Bank of China (PBC) announced on the 14th of April 2012 that the RMB daily trading band was being widened against the U.S. dollar in the interbank spot foreign exchange market. A wider band of ±1 percent replaces the previous band of ±0.5 percent, effective 16th of April 2012. The PBC noted that the move is intended to promote price discovery of the RMB exchange rate and enhance the currency's two-way flexibility. It intends to keep the exchange rate stable around a reasonable central parity, based on market conditions and with reference to a basket of currencies.

From 21st of June 2010, the RMB was classified as a *de facto* crawl-like arrangement (previously it was classified as a stabilized arrangement). The exchange rate has followed an appreciating trend within a narrow margin of 2 percent (see figure), and official actions continued to have an important influence on the exchange rate.



Implications for IMF de facto classification for China

- As of 30th of April 2012, the cutoff date for the classification of China's *de facto* exchange rate arrangement for the 2012 AREAER, an increased flexibility in the RMB had not yet been observed. Notwithstanding the PBC's 14th of April announcement, the RMB continued to meet the criteria for a crawl-like arrangement. The approach to the *de facto* classification is purely backward looking (on a six-month rolling basis) and largely statistical, looking at the actual behavior of the exchange rate only. It does not take account of future or intended policies.
- Based on the role of official actions in influencing the exchange rate and the actual stability of the RMB vis-à-vis the dollar (see the chart above), the exchange rate is not "largely market determined," as required by the definition of "floating" in the classification methodology. If the RMB shows sufficient flexibility in the course of time (i.e. the exchange rate exhibits volatility, beyond the present 2 percent band, without an ascertainable or predictable path and official foreign exchange intervention only serves to moderate volatility without targeting a specific level), it could in the future be reclassified as floating in accordance with the classification methodology.[1] By contrast, if the exchange rate were to remain for at least 6 months within a 2 percent level band, as it has since the beginning of 2012, a classification as "stabilized" would need to be considered.

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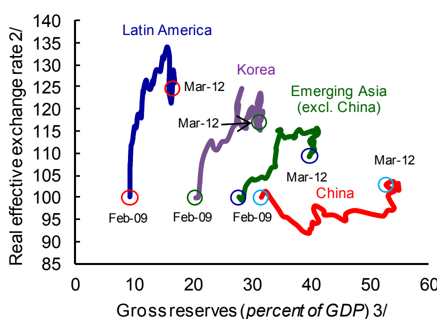
[1] See K. Habermeier et al., 2009, "Revised System for the Classification of Exchange rate Arrangements" http://www.imf.org/external/pubs/cat/longres.aspx?sk=23311.0

20. **Exchange rate appreciation has typically accompanied a slower pace of reserve accumulation—though country experiences vary widely**. As shown in the chart below, several countries or regions have experienced relatively large exchange rate movements (steeper line) over the past two years, while countries with larger reserve ratios have tended to continue accumulating reserves to a greater degree (flatter line) over this period. Specifically, since early 2009, *Korea*, emerging Asia (excluding China), and Latin America have allowed exchange rates to fluctuate—intervening only to smooth excessive volatility—with broadly appreciating trends in real effective terms. Reserve accumulation has slowed or even stopped in these countries. *China* was a notable exception until recently, as reserves grew at fast clip while the effective exchange rate appreciated relatively modestly. For major oil exporters, *Russia* and *Saudi Arabia*'s experiences were quite different—with the former experiencing relatively large appreciation and minimal reserve accumulation. The recent slower pace of reserve accumulation may reflect some easing of balance of payments pressure and/or some willingness to allow greater exchange rate flexibility at the margin in some G-20 members.

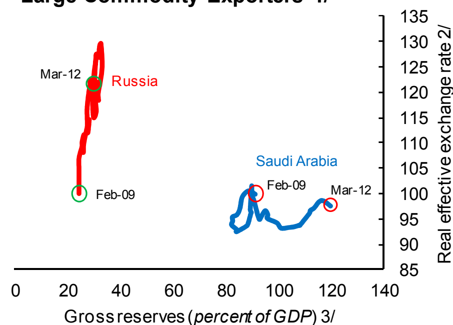
Real Exchange Rates and Reserves
(Feb. 2009=100)

Emerging Asia and Latin America 1/



Sources: IMF, *World Economic* Outlook; and *International Financial* Statistics.
1/ Valuation effects (arising from differences between cross exchange rates and book or market values of reserve assets) are not taken into accounted.
2/ Index Feb. 2009=100. Weighted average using market GDP.
3/ Gross international reserves as a share of 2009–11 average GDP. Weighted average using market GDP.

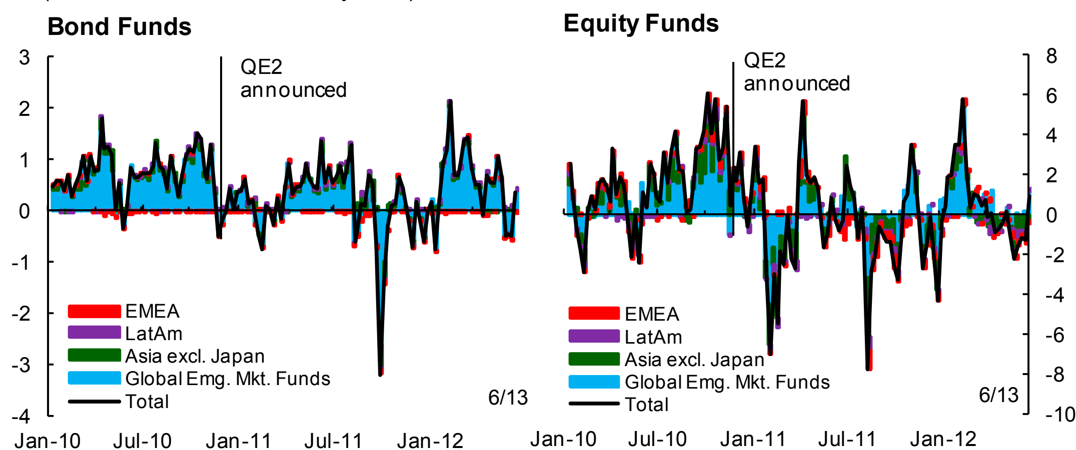
Large Commodity Exporters 1/



Sources: IMF, *World Economic* Outlook; and *International Financial* Statistics.
1/ Valuation effects (arising from differences between cross exchange rates and book or market values of reserve assets) are not taken into accounted.
2/ Index Feb. 2009=100. Weighted average using market GDP.
3/ Gross international reserves as a share of 2009–11 average GDP. Weighted average using market GDP.

21. **Managing volatile capital inflows is another challenge for monetary and exchange rate policies in emerging economies in the present setting**. As shown in the chart, high frequency indicators of portfolio flows suggest that inflows to emerging markets resumed after the end of last year, following some stabilization of the euro area crisis. Unconventional monetary policy actions by the U.S. Federal Reserve and, more recently, by the ECB likely contributed to inflows *indirectly* through an improvement in risk perceptions. Evidence on direct effects linking (say) quantitative easing in advanced economies to emerging market capital inflows, however, has been decidedly mixed. As shown in the chart, there was no apparent generalized surge in emerging economies' inflows following U.S. quantitative easing in 2010 (QE2).[5] More recently, inflows to emerging markets appear to have declined again (particularly, to debt markets) as risk perceptions appear to be rising again.

[5] Staff analysis finds that while U.S. financial spillovers to the rest of the world can be very large, U.S. quantitative easing (QE2) during 2010 and 2011 had very limited spillover effects. See IMF, 2011, U.S. Spillover Report; and 2011 Article IV consultation for the United States.



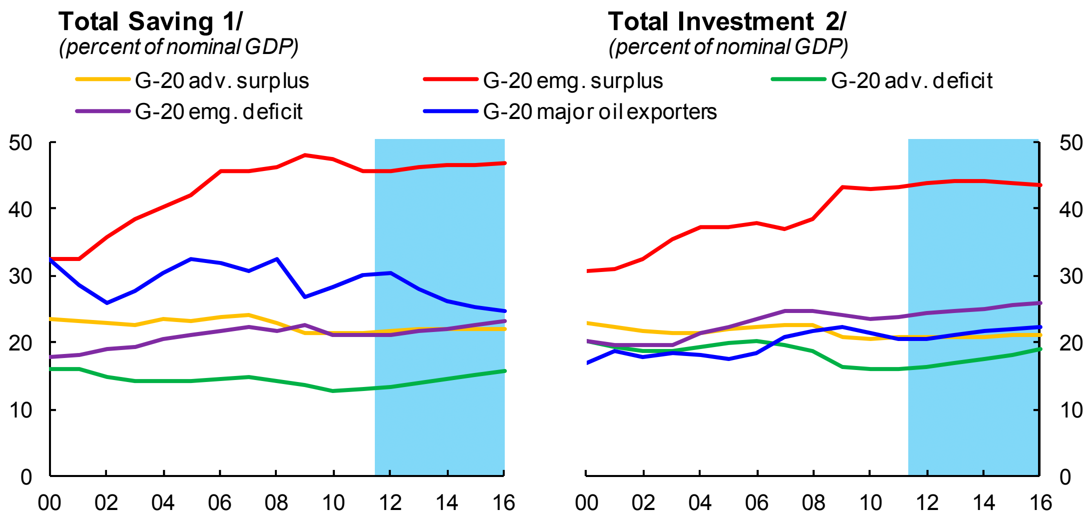
22. **Several economies have responded through a range of measures to manage inflows over the past year—but more could rely on macroeconomic instruments**. Macroeconomic tools for responding to capital inflows remain as options in many emerging economies—for example, allowing the exchange rate to respond, adjusting foreign reserve levels, and calibrating monetary and fiscal policies. Better macroprudential policies and frameworks, as well as building absorptive capacity, could also play an important role in ameliorating the impact of volatile capital flows on financial stability. A wide range of tools were utilized by some to manage persistently large capital inflows given floating regimes of deficit economies, with a strategy to use a combination of policies, including allowing the exchange rate to appreciate and fiscal adjustment. Some have relied more on (sterilized) intervention and reserve accumulation.

23. **Several members, however, deployed more direct or restrictive measures to either slow capital inflows or shore up reserves, while others removed restrictions to encourage inflows.** More direct measures to slow or reduce inflows included taxes on certain inflows, minimum holding periods, changes in repatriation requirements of export proceeds, and raising currency-specific or differentiating residency-specific reserve requirements (e.g., Brazil, China, Indonesia, Korea, Russia, and Turkey).[6] Some measures were appropriately aimed at overheating domestic sectors or cooling demand more generally. A few members have imposed export repatriation requirements to shore up reserves (Argentina and Indonesia), while others eased such requirements. Measures have been used flexibly—for example, Brazil and India rolled back the level of such taxes and restrictions when capital flows slackened earlier, while Turkey decreased them. Other members relaxed controls or administrative measures as part of their capital account liberalization plans, including easing

[6] In *Russia*, following the reintroduction of differentiated reserve requirements in February 2011, capital outflows intensified and the measure appears to have had at best limited impact. *Turkey* increased/decreased currency-specific reserve requirements depending on inflow/outflow episodes.

restrictions on deposits and bonds held by foreigners, and easing restrictions on residents' foreign investments, among others (e.g. China, India, and South Africa).

24. **Staff's collective assessment of G-20 policies suggests that global imbalances have narrowed but significant demand rebalancing has not occurred, leaving growth weaker**. Current account imbalances have been reduced with the crisis, reflecting both cyclical and structural factors. The adjustment has been largely driven by demand *compression* rather than *rebalancing*. As saving has rebounded in deficit economies against an insufficient pick up domestic demand in surplus economies, global growth has slowed. The April 2012 WEO projections suggest that global imbalances are not expected to narrow further. Relative to previous projections, weaker contributions from consumption growth in advanced deficit economies is not expected to be offset by stronger domestic demand growth in surplus economies, resulting in slower global demand growth. Furthermore, some rebalancing in key surplus economies (e.g., China) has been driven by increases in (already-high) investment rates, while private consumption shares remain low as distortions keep saving rates high.



Source: IMF, *World Economic Outlook*.
1/ Saving = fixed investment share + current account balance; both in percent of GDP.
2/ Fixed investment excluding change in inventories.

III. STRUCTURAL REFORMS

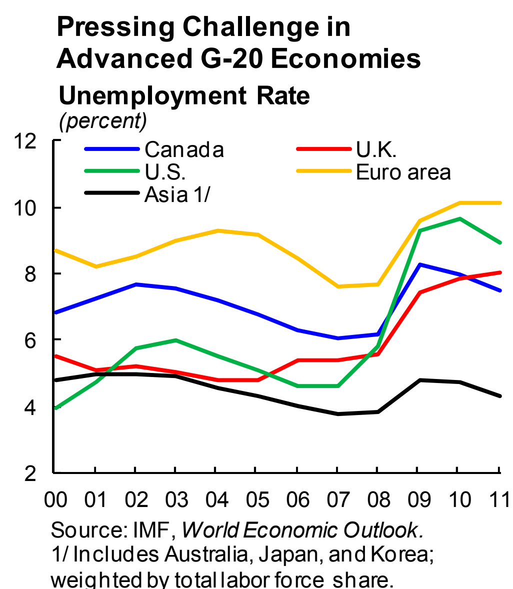
Structural reform commitments by members appropriately aim to raise employment and growth, and facilitate rebalancing over the medium term. Progress on reforms, though, has been uneven. In advanced economies, more policy effort or reform to tackle stubbornly high unemployment and advancing service sector reforms would be beneficial. In emerging economies, reform objectives appropriately aim at boosting and rebalancing growth, improving social inclusion, and increasing competition. However, more ambition and progress is needed on reforms to facilitate demand rebalancing and enhance potential growth.

A. Advanced G-20 Members

25. **Most structural commitments are focused on raising medium-term employment and growth, and some on fostering global rebalancing**. Key commitments included (i) *reforms to raise employment*, essentially by increasing labor supply and, in some instances, by improving the functioning of the labor market; (ii) *productivity-enhancing reforms*, especially product market reforms to promote competition, in some cases increases in R&D, improvement in education or labor skills, and increased investment in infrastructure; and (iii) *reforms to advance global rebalancing* through fostering private saving in deficit countries and through strengthening domestic demand, in particular for services, and alleviating inefficiencies that underpin low investment and high private saving in surplus countries. Finally, a few countries made commitments to reform the energy sector and/or progress toward a green economy.

26. **The commitments are broadly appropriate, but more focus is needed on reducing stubbornly high unemployment and implementing reforms in the service sector**. Commitments are broadly aligned with the medium-term strategic priorities identified by the OECD and Fund staff. Raising labor force participation is an important objective to address population ageing and the risk of lower growth prospects as the labor force declines. Total factor productivity growth also needs to be lifted from its weak or negative level in many member countries, especially in the services sector. However, greater attention should also be given to the persistently high level of unemployment in many member economies to avoid a large rise in long-term unemployment, and, more generally, to improving the functioning of the labor market. Progress has been uneven across reform areas. Members are beginning to take action, particularly in the areas of labor force participation and the green economy. But there has been less action in the area of reforming product markets, especially services. Reforms of the service sector should be accelerated in several members to lift total factor productivity, potential output and employment.

Pressing Challenge in Advanced G-20 Economies



Source: IMF, *World Economic Outlook*.
1/ Includes Australia, Japan, and Korea; weighted by total labor force share.

27. **Cannes commitments on labor market reforms are, by and large, being set in motion, although efforts should be broadened, including to address commitments made in previous summits**.[7]

- *Members are delivering on their Cannes commitments*, in particular those to raise labor force participation in *Australia*, *France, Germany, Japan*, and *Korea*. *Korea* has also made some reforms of its labor market, introducing multiple labor unions and taking measures to promote employment of part-time workers and flex time arrangements. In *Canada,* the rise in employment insurance premium paid by firms has been limited to protect employment. Finally, there has been some reform momentum in the EU, in particular in program countries and in economies under market scrutiny, although implementation will be key. In *Italy,* the Cabinet recently approved a wide-ranging proposal for labor market reform, tackling high dismissal costs and duality, but it needs to be strengthened further. The package is still to be approved by Parliament. *Spain* is implementing a major labor market reform which, if implemented properly, will help foster wage flexibility, facilitate negotiations at the firm level, and address the key problem of excessive protection of insider workers. Within the context of the EU governance framework, other EU countries introduced reforms of pension systems and early retirement schemes, enhanced the incentives to work, and stepped up efforts to facilitate transition from school to work and combat youth unemployment.

- *In the short run, greater attention should be given in many advanced countries to reducing high unemployment to avoid hysteresis effects*. While demand policies (when there is policy space) are a main driver of employment growth, some supply-side policies can also help reabsorb the unemployed into the workforce in the short run. These include improving the efficiency of government employment services as well as active labor market policies—and, in particular, workers' retraining in countries that have undergone sector-specific shocks such as *Spain* and the *United States* (e.g., real estate, financial sectors). Scope for further policy action in advanced members also includes unemployment benefits reform, lowering labor-tax wedges, and wage flexibility to promote employment prospects.

- *More specific commitments and resolute action are also needed to boost employment and job creation in the medium term*, especially in the *European Union*. Overall, the EU countries should do more to enact measures to mobilize labor markets, while commitments under the Euro Plus Pact are not sufficiently ambitious, concrete or binding.

28. **Overall, there has been less action on Cannes commitments on product market reform**. Efforts could be accelerated, including in some surplus economies. *Korea* has lowered entry barriers for qualified professionals and is envisaging further steps for deregulation within five years under Korea-US FTA and Korea-EU FTA. *Japan* has announced its intention to join negotiations for Trans-

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[7] For a broader assessment of the implementation of commitments made in all summits, see "Pursuing Strong, Sustainable and Balanced Growth: A Note on Implementation of G20 Structural Reform Commitments" by the OECD.

Pacific Partnership (TPP) and engaged in preliminary discussions with other TPP countries. In *Germany*, reforms to raise productivity in services are still to be identified. In *France*, a law to reinforce competition in consumer services was not adopted as committed and the reform of the services sector should be broadened to include professional services. *Italy* has approved several key measures in the area of product market reform in March, but commitments to reduce public ownership and pursue privatization could be more specific. Projects in the *European Union* to further deepen the single market integration are also lagging. In particular, the implementation of the Services Directive is lagging in some countries; disagreements remain in the discussions of the Single Market Act proposals; and progress has been mixed in completing the Digital Single Market, with significant delays in some areas. In the *United States,* a more aggressive approach to improving the situation in the housing market is needed. In contrast, more progress is being made on commitments toward a green economy and/or to reform the energy sector (*Australia*, *Japan,* and *Korea*).

29. **There is also scope to advance progress on rebalancing**. In the *United States*, the latest President's Budget has maintained the commitment to boost private saving through an automatic enrollment in the individual retirement accounts and offered a new tax break for businesses to help ease transition costs. However, Congress has not acted on any of these proposals so far. In *Germany*, *Japan*, and *Korea*, reform of the service sector could be accelerated to help rebalancing growth toward domestic sources. Fund staff also recommends removing inefficiencies that maintain investment low in *Germany*, such as the local trade tax and the debt bias in corporate financing.

B. Emerging G-20 Members

30. **Most structural reform commitments by emerging members focused on strengthening growth, social inclusion, and the functioning of markets and cross-border trade**. Key plans included: (i) *rebalancing and enhancing growth potential* through reforming and increasing investment in infrastructure and energy sectors, with increased private sector involvement and ability to absorb capital inflows; (ii) *stimulating social inclusion* through raising education levels, reforming labor markets (to increase participation and formal sector jobs), raising minimum wages, expanding or better targeting social safety nets to lower poverty, increasing access to credit and housing finance, and introducing or broadening health insurance; and (iii) *strengthening competition and trade* through reform aimed at deregulation, reducing wasteful subsidies to households, industry, corporates, and banks alike, increasing regional trade integration, unilateral reduction in trade barriers, and improving the business and investment environment through better regulation, taxation and governance.

31. **Overall, reform objectives appear broadly appropriate except in the areas of rebalancing and growth, although more time is needed to fully assess progress**. According to staff, some plans appear lacking in ambition in important areas. To help rebalance growth, more specific policies are needed to tackle bottlenecks that obstruct investment or consumption as well as to enhance productivity and potential output in key sectors. Tangible progress in certain areas has been made or initiated since Cannes. However, more time is needed to fully assess whether implementation is robust enough and whether reforms being implemented are having the intended effects.

32. **Specifically, more ambition and steady implementation is needed to *facilitate demand rebalancing* and *enhance potential growth***.

- *More reform or progress to tackle key domestic distortions affecting high saving and rent seeking is needed to facilitate rebalancing*. In the case of *China*, rebalancing is centered on reducing incentives to overinvest/save and increasing incentives to consume. However, rebalancing is hindered by implicit subsidies and a low cost of capital (and other factors: water, land and energy) that are not yet fully addressed, and limited progress in corporate and financial sector reform and liberalization. It is either too soon to assess the impact of reforms on consumption or investment in members or progress overall has been relatively limited (China, Indonesia, and Russia).

- *Almost all members committed to boosting growth through investment in infrastructure and energy sectors, with increased private sector involvement, and these reforms have by and large been set into motion*. In several members, what is absent so far are clear policies, beyond Cannes commitments, to improve certain critical shortcomings of the business and investment environment (Brazil, Russia, and Turkey); ensure that investment incentives and fiscal revenue mobilization objectives are not inconsistent (Turkey); reduce implicit subsidies to energy or other factors (China and Saudi Arabia); improve governance and reducing rent seeking (e.g., China and Russia); reduce state dominance—including by deepening reform of state-owned enterprises (China and Russia); and continue to address labor market shortcomings or ensure new labor reforms are designed or implemented in a market-friendly manner to avoid distortions and preserve competitiveness (Indonesia, Mexico, Saudi Arabia, and Turkey). In *Russia*, commitments appear focused on the labor market and unemployment, but improving the ailing investment climate is missing. Reviving investment is also a key issue in India.

33. ***Stimulating social inclusion* appears broadly ambitious and well specified, and progress has been most notable in this area**. Reform has the potential to generate more inclusive growth that could create more formal sector jobs, lift income and education levels, and raise consumption—thus possibly contributing to rebalancing.

- While this commitment appears appropriately ambitious and well set out, the risk is weak implementation, given the enormity of the task. In Indonesia, the challenge is to design and implement a proper safety net, which could take time; the new mortgage law in Saudi Arabia has been in the pipeline for years and still awaits final approval; in South Africa reducing the unemployment rate by 10 percentage points is a mammoth task that hinges on auxiliary reforms in labor and product markets that so far have not been articulated; and in Turkey, there is no consensus yet between the government, employers, and employees that may be holding up key reforms in the labor market.

34. ***Strengthening competition and trade* appears sufficiently ambitious, but strong implementation is needed to see tangible results**. This could raise potential output and stimulate aggregate demand over the medium term (indirectly, through the trade channel).

- *Most members have ambitious, detailed policies here (albeit with some gaps)—but immediate and steadfast implementation will be critical to see a tangible impact on potential output over the medium term*. For example, in *Mexico*, despite a wide range of reforms, initiatives could be bolder given underperforming growth and very high concentration in key sectors. Finally, trade integration plans in *South Africa* and *Saudi Arabia* are ambitious but require concerted efforts to expedite an otherwise lengthy and difficult process given the multiple parties involved.

IV. FINANCIAL POLICY

With regards to financial sector policies, members have advanced the global regulatory reform agenda, but important implementation risks should be addressed to better support shared growth objectives. Key areas of attention for further progress include cross-border resolution and supervision, reform of over-the-counter financial derivatives, and closing critical data and information gaps.

35. **Progress is being made to reshape the financial system and enhance its institutional underpinnings and regulation to safeguard stability—which is critical for growth**. Although work on national regulatory reform agendas has advanced and continues, the international community is sharpening its focus on consistent and steady implementation of the G-20 regulatory initiatives to assure national and global financial stability.

36. **Despite progress to date, implementation and coordination risks are significant**. Strong national and multilateral determination to enact the necessary legal amendments and regulations and see through the reforms is essential to ensure the credibility of the reform agenda, and to maintain momentum and avoid regulatory arbitrage. Risks related to delayed or inconsistent implementation across regimes could create overlaps, gaps or conflicts in regulation—which could be harmful to members' growth objectives.

37. **Speed and sequencing of financial reform can also matter for growth**. More stringent lending standards, for example, could affect the cost and availability of bank credit. Thus, it is crucial to strike a proper balance between the necessary strengthening of the resilience of the financial system via robust implementation and the need to cushion the impact of the adjustment on economic activity with policies, backed up by direct interventions and financial support, including public recapitalization geared toward supporting growth. The long implementation timetables envisaged for the Basel III capital and liquidity rules, combined with appropriate direct measures on the short-term, are designed, in part, to provide time for implementation without undermining the global recovery.

38. **Implementation of the reform agenda is being closely monitored and supported by the FSB**.[8] Specifically, the newly developed Coordination Framework for Implementation Monitoring

[8] See, for example, "Identifying the Effects of Regulatory Reforms on Emerging Market and Developing Economies," Report to the G-20 Finance Ministers and Central Bank Governors by FSB with inputs from the IMF and World Bank.

(CFIM), established by the FSB in collaboration with the relevant standard-setting bodies (SSBs), aims to foster discipline through more structured monitoring and reporting on individual countries' progress. This will be more intensive for priority areas, such as Basel II, 2.5, and III, OTC derivatives markets, and global systematically important financial institutions (G-SIFIs). SSBs will be responsible for monitoring those reforms that fall under their competencies, while the FSB will monitor those reforms that do not fall within the purview of a single SSB. Separately, the Fund will review progress realized by its members via its Article IV surveillance and FSAP assessments.

39. **Implementation of the Basel III capital and liquidity framework is underway in many jurisdictions**. In November 2011, G-20 leaders in Cannes called on jurisdictions to implement fully and consistently Basel II and 2.5 by end-2011, and Basel III starting in 2013. In April 2012, the BCBS published its second progress report on the implementation that showed that most FSB members had implemented Basel II and 2.5 (with a few exceptions), while implementation of Basel III is still at an early stage and is taking place at varying speeds: only two of the 27 FSB member authorities have published final rules, while a third have not yet published a draft regulation. Bearing in mind the need to avoid intensifying the headwinds to growth from ongoing bank deleveraging, many jurisdictions are pursuing an implementation timeline that is in line with the internationally agreed timeframe, while others are contemplating early adoption. Some advanced countries, though, are falling behind their own time tables. Countries are generally awaiting the finalization of liquidity standards, which are being fine-tuned by the BCBS, but some jurisdictions have already introduced domestic regulations that are likely to require eventual revision in order to safeguard the level playing field.

40. **Efforts to address the risks posed by systemically important financial institutions (SIFI) have been fruitful, but the work is not yet complete**. Some critical elements have been agreed within the four major areas of the SIFI framework, notably: (i) the development of a new international standard for resolution regimes ("Key Attributes of Effective Resolution Regimes for Financial Institutions"); (ii) the finalization of requirements for resolvability assessments and recovery and resolution plans (RRPs); (iii) the completion of the methodology for identifying global SIFIs and the accompanying loss absorption requirements; and (iv) more intensive and effective supervision of G-SIFIs. The development of a policy framework for G-SIFI banks is now completed and the development of an assessment methodology for the Key Attributes is ongoing, together with efforts to extend the G-SIFI framework to domestic systemically important banks and non-bank entities.

41. **Key areas of policy reform where further national implementation work is needed include**:

- **Implementation of macroprudential frameworks**. The current regulatory framework and its direction have focused too much on the risk of individual financial institutions. Financial regulation has to become more macro-oriented, focusing on systemic risks. While there is broad recognition for a paradigm shift, the design and implementation of effective macroprudential tools is still ongoing. To be effective, macroprudential regulations should apply comprehensively to avoid incentives to shift activities and risks to less regulated institutions, which is an important implementation risk associated with macroprudential

policies. Finally, macroprudential frameworks will need to be designed in a way that supports existing monetary policy frameworks.

- **More effective resolution tools**. The design of effective domestic and cross-border resolution regimes is not yet completed. Many countries have yet to adopt resolution regimes that will help address weak national financial institutions and G-SIFIs. Strong political commitment is needed to finalize the necessary legislative changes for implementing the missing elements of resolution framework, cross-border cooperation and information sharing.

- **Strengthening of prudential supervision**. Supervisors' powers, resources and early intervention capabilities must be enhanced to curb excessive risk-taking, allow intervention in weak financial institutions, and address markets disruptions. Questions remain in some countries about the independence of supervisory agencies. Strong implementation of the commitments to supervise G-SIFIs more intensively, particularly in risk management and governance, is crucial. The revised Basel Core Principles for Effective Banking Supervision, scheduled to be issued in mid-2012, will apply more scrutiny to the intensity of SIFI supervision.

- **OTC derivatives reform**. The international standard setting bodies have intensified work on developing policy and standards in this area, including publishing reports on the trading and clearing obligations (IOSCO) and reporting requirements (CPSS-IOSCO). The FSB committed in October 2011 to step up its own coordination of international policy work. At the same time, national implementation is proceeding across the globe, albeit at varying paces. Several FSB member jurisdictions have reached important milestones in their own legislative and regulatory processes. However, it is likely that some jurisdictions will not meet the end-2012 deadline for implementation of all G-20 commitments. Important questions remain on the international consistency on entities (and markets) exempted from clearing. Also, given the asymmetry in accounting rules for Risk Weighted Assets (RWA), uncleared trades are likely to seek regulatory arbitrage within RWA and capital surcharge rules. Also, there is no uniformity on collateral segregation rules across central counter parties (CCPs), and additional steps are needed to ensure sufficient consistency among the various regimes.

- **Addressing data and information gaps.** This is paramount to enhance the monitoring of emerging risks and vulnerabilities that might threaten financial stability and, ultimately, economic growth. Key decisions on data requirements, following the publication of a consultation paper on a common data template for G-SIBs, are due this year. Cross-border cooperation in this area is essential, especially between the main global financial centers.

- **Reduced regulatory reliance on credit ratings**. Further efforts are necessary by national authorities, starting with concrete plans of action.

- **Strengthen oversight and regulation of shadow banking**. The FSB is conducting an annual monitoring exercise to assess global trends and risks. Further work is ongoing to develop policy recommendations regarding: (i) banks' interactions with shadow banking entities

(report due July 2012), (ii) money market funds (due July 2012); (iii) other shadow banking entities (due September 2012); (iv) securitization (due July 2012); and (v) securities lending and repo (due end-2012). However, regulatory proposals to enhance the stability of the traditional banking system (such as increased capital requirements and limits on proprietary trading) will likely shift activities to non-banks and increase the shadow banking system, and the regulatory perimeter will have to adapt to an increasingly complex and interconnected financial system.