GROUP OF TWENTY

TOWARD LASTING STABILITY AND GROWTH

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.

Executive Summary

To attain their growth objectives, G-20 members must effectively manage rising risks, deliver on past commitments, and enact more complete and collective policies. Specifically, this will require:

- **Effective crisis and risk management to restore stability and to insure against the possibly damaging effects of significant downside risks**. Global growth appears to be weakening and remains susceptible to serious risks. The euro area crisis remains the most immediate threat to financial stability and, thus, global growth (through spillovers). Gains following exceptional policy actions taken in Europe have been eroding. Recent steps toward providing external support to help recapitalize banks in Spain are welcome, but major economic, financial and political challenges remain for the euro area. Furthermore, the risk of excessive fiscal tightening in the United States and in a few advanced economies next year, as well as a possible adverse supply shock from oil markets, cannot be overlooked given the fragility of the recovery. Thus, achieving a durable and prompt exit from the euro area crisis, as well as avoiding the U.S. "fiscal cliff," is crucial for sustained global recovery.

- **Advancing progress toward members' commitments made at Cannes, as well as further action**. While members have made progress toward their commitments, certain gaps remain in key areas. More attention is required to tackle stubbornly high *unemployment* in the near term in advanced economies, while doing more to ensure the soundness of *public finances* over time—especially in light of longer-term fiscal challenges. To complement steady consolidation in deficit economies, more action is needed in emerging surplus economies to facilitate *demand rebalancing* by addressing domestic distortions. Across a large part of the membership, *financial reforms* need to be implemented steadily and consistently to help lay the foundations for durable growth.

An upside scenario suggests that strengthened collective action by the membership would deliver appreciable mutual benefits towards achieving lasting stability and growth. Complementary and mutually reinforcing action in *all* members would help secure stronger and healthier global growth. The upside scenario shows that tangible benefits for the entire membership in terms of jobs and growth are within reach—global output would be higher by about 2½ percent in five years and global imbalances would be lowered further by ¾ percent of GDP. Cumulative gains would be larger. Collective and comprehensive policy action also helps insure against possible welfare losses associated with downside risks.

I. INTRODUCTION[1]

1. **At Cannes, G-20 Leaders committed to the Action Plan for Jobs and Growth—setting the course for the Mutual Assessment Process (MAP) in 2012**. The destination remains the same, anchored by shared objectives of strong, sustainable and balances growth. Two key guideposts were specified—containing key *risks* and enhancing *accountability* among members with respect to their policy commitments. With weakening global growth and deepening crisis in Europe in 2011, Leaders agreed to strengthen cooperation to address the dangers and bolster the foundations for growth. Moreover, members pledged to "hold ourselves accountable for meeting our commitments to address near-term vulnerabilities and move ahead on reforms… [and] enhance our reporting and monitoring in 2012 and future years, developing a framework to assess progress against our commitments…"

2. **Achieving lasting stability and growth remains the core challenge—requiring complete and collective action among the membership**. Defining features of desirable policies are complementary or mutually reinforcing actions within *and* across G-20 members. For example, financial stability is a requisite for economic growth. Thus, critical short-term imperatives to contain and durably resolve the crisis, as well as managing other key risks, are necessary for laying the foundations for growth over the medium term. Conversely, comprehensive medium-term collective action can provide an essential anchor for policies to secure stability in the near term and shore up confidence in policymakers' efforts to succeed, as well as promote rebalancing to secure a path with healthier global growth.

3. **This *umbrella* report provides an integrated assessment of G-20 risks, policies and progress for the MAP along two main dimensions**:

- *Global risks and risk management policies*. Serious short-term risks can jeopardize growth—as evident at the time of the Cannes summit when systemic risks began materializing in Europe. Thus, at this juncture, greater attention to downside risks, their potential costs and spillovers, and policies to insure against them is warranted.

- *Possible policy or progress gaps relative to past commitments*. Enhancing accountability has become an increasingly important aspect of mutual assessment to increase its traction. Focusing on commitments elaborated in the Cannes Action Plan, staff re-examine individual members' plans and track progress achieved in key areas in light of changing circumstances, the need for rebalancing, and achieving the shared growth objectives.

4. **These components provide the basis for staff's *upside* scenario—toward informing the Los Cabos Action Plan**. Assessments also examine the *collective* implications of member policies and scope for strengthened collective action—motivating staff's scenario analysis. The structure of the report is as follows. Section II presents a summary of the global conjuncture and key risks. Section III provides a summary of staff's enhanced accountability assessments of progress across the main policy areas—fiscal policy, monetary and exchange rate policies, structural reform, and financial sector policies. Finally, an upside scenario of strengthened collective action is constructed in Section IV.

[1] Prepared by Research Department team led by Hamid Faruqee and Emil Stavrev, in collaboration with African, Asia and Pacific, European, Middle East and Central Asia, Western Hemisphere, as well as Fiscal Affairs, and Monetary and Capital Markets Departments.

II. GLOBAL RISKS

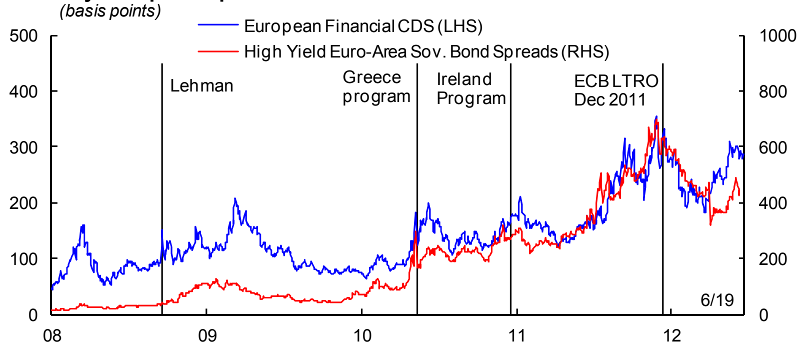
Global risks have risen again. Notwithstanding exceptional steps taken by European policymakers, the euro area crisis remains the most immediate threat to financial stability—with possible global spillovers. In the United States, a sharp budgetary contraction or "fiscal cliff" is set to occur that—if not avoided—would jeopardize recovery, while a few other economies will also need to carefully manage fiscal risks next year. An adverse supply shock from oil markets given reduced policy space is another key global risk. To secure stability, euro area policies to manage and contain the crisis are essential to build on recent efforts, complemented by measured but steady fiscal consolidation and very accommodative monetary policies to support growth. Elsewhere, credible and ambitious medium-term consolidation plans need to be adopted in Japan and the United States to anchor sustained and steady adjustment and minimize risks down the road. Policy challenges in emerging economies are more differentiated—depending on policy space, inflation risks, and volatile capital flows.

A. Conjuncture & Outlook

5. **The global economy is struggling to regain its footing**. After an intense bout of market volatility in late 2011—including adverse self-fulfilling dynamics—exceptional liquidity provided by the ECB and a strengthened firewall averted a systemic crisis. This brought a respite to the markets and helped pull vulnerable economies from a potential sharp downturn. Policy easing in several emerging economies helped reignite growth. As a result, the global economy appeared to regain momentum early this year, but recent indicators suggest that momentum is weakening again. Job creation in the United States has slowed while growth in the euro area is weak or negative. Emerging economies have been a relatively bright spot, although recent signs point to slowing growth in key countries.

6. **Notwithstanding exceptional actions and welcome improvement earlier, the financial crisis is far from over as stability risks remain elevated**. Bold steps taken have helped avert a systemic banking crisis in Europe and created much-needed breathing space at the end of last year. However, while the EU strategy to address the crisis continues to be implemented, recent gains are fragile and have been eroding—partly reflecting increased market concerns over political will and reform fatigue in some economies. Past relief during the crisis has proven to be short-lived and appreciable reversals in market conditions have occurred. Bank funding costs and sovereign spreads in the periphery remain noticeably elevated, while market sentiment indicators and equity prices in certain markets are sharply lower

Key European Spreads
(basis points)

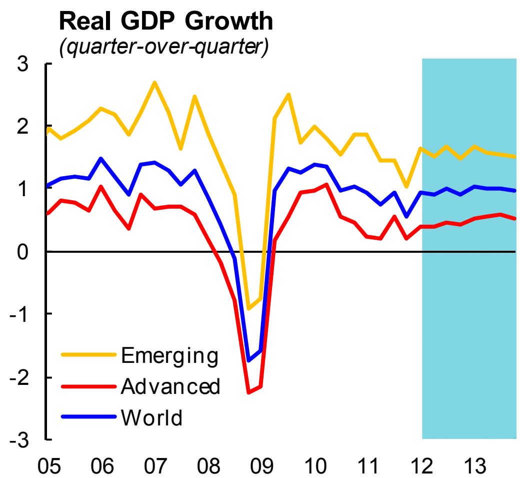


Source: IMF, Global Financial Stability Report.

and market focus on weaker periphery banks has intensified, exacerbating adverse feedback loops between vulnerable sovereigns and banks reminiscent of events in 2011Q4.

7. **Policymakers have yet to get ahead of the crisis, underscoring the need to maintain policy momentum and to overcome political constraints**. Recent moves by Spain to seek external support (to be provided by the EFSF/ESM) to help shore up its banks and market confidence are welcome. However, more action is likely to be required in the euro area to sever adverse feedback loops underlying the sovereign debt challenges and to resolve the wider challenges facing EMU. At the heart of the crisis is a lack of clarity and confidence in the direction and effectiveness of policies—given market concerns over debt restructuring, firewalls, and how to complete EMU to make it more resilient. Moreover, key economic and financial pressures remain in place. Specifically: (i) *European banking systems continue deleveraging* (Annex 1), including re-fragmentation along national lines (e.g., reduced cross-border claims) as banks remain vulnerable to sovereign stress and weaker growth; (ii) *public finances remain under pressure*, with spreads elevated; and (iii) *weak growth prospects dent the credibility of adjustment*, as fiscal austerity adversely affects output in the short run.

8. **Against this backdrop, global growth will only gradually pick up in the near term**. Overall, global growth is expected to accelerate gradually from 3½ percent (annual rate) in 2012 to about 4 percent in 2013 in the baseline, driven by emerging and developing economies. Slow growth in advanced economies is envisaged given legacies of the crisis. In this setting, with accomodative monetary policy and swings in market risk perceptions, capital flows to emerging economies are likely to remain volatile.



Source: IMF, *Global Data Source*.

B. Key Risks

9. **The global economy remains highly vulnerable to key risks**. Downside risks remain elevated. The most immediate threat is a re-intensification of the euro area crisis. Other key downside risks are a sharp fiscal contraction (see below) in the United States, a large spike in oil prices triggered by fears over geopolitical tensions or supply disruptions, and an unwinding of credit booms in some emerging economies that may lead to a sharp growth slowdown and banking strains. Less proximate risks include fiscal sustainability concerns and the absence of credible medium-term fiscal adjustment plans in Japan and the United States that might lead to disruptions in their bond markets down the road. Upside risks include stronger-than-assumed policy responses to the euro area crisis that could significantly bolster confidence.

10. **The euro area still remains in the danger zone amid elevated financial stress**. More severe consequences from a possible deepening of the crisis cannot be ruled out as yet—including more serious pressures on weak banking systems and loss of market access for some sovereigns. A key threat is a renewed escalation of adverse feedback loops between weak sovereigns, banks, and growth. In a downside scenario, a loss of confidence, heightened risk aversion, and forced front-loaded fiscal consolidation in several euro area economies would appreciably lower area-wide growth (Annex 1). While the impact of intensified stress would be felt most acutely in Europe, the rest of the world would also be affected via financial and trade linkages. To achieve a durable exit from the crisis would also require a stronger, more resilient monetary union.

11. **Fiscal risks in the near term could jeopardize recovery**. In the United States, fiscal policy is scheduled to contract markedly under current law (a so-called "fiscal cliff"). Specifically, several contractionary actions are set to occur—notably, expiring income tax cuts as well as activation of automatic spending cuts—that would altogether amount to roughly 4 percent of GDP in 2013 (see Annex 1). Uncertainty about the outcome of contentious political decisions on the budget can provoke market turbulence. Therefore, it is essential to reach an agreement that durably removes uncertainty over fiscal plans. In the euro area, while steady consolidation must continue, there are risks of overdoing fiscal tightening in a few countries next year in an environment of weak growth and credit. Risks from a more negative short-run impact on growth from fiscal consolidation remain a concern given low confidence. Moreover, synchronized fiscal retrenchment across many economies poses risks of reinforcing dampening effects on global demand (via trade spillovers) while the recovery remains fragile.

12. **An adverse oil supply shock would hurt growth given reduced policy space**. Notwithstanding higher production by G-20 oil exporters,[2] upside risks to oil prices remain a concern given geopolitical uncertainty and limited spare capacity. Supply-side risks along with high demand in Asia have, until recently, countered downward price pressure from slow activity in advanced economies, notably in the euro area. Although average spot prices have now eased some from their peak in March and oil inventories have increased, upside risks to oil prices remain. A major disruption in oil supply related to geopolitical tensions could have a large impact on oil prices and economic activity given the lack of policy space (e.g., limited fiscal room for maneuver) to help offset weaker demand or confidence. In an adverse oil shock scenario in which the real price of oil is 40 percent above the baseline, global output is about 1 percent lower (Annex 1).

13. **Less proximate risks—notably, unwinding of past credit booms in emerging economies and fiscal sustainability concerns in major advanced economies—should still be**

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[2] Saudi Arabia, for example, has significantly ramped up oil production to historically high levels since 2011Q2 in an effort to calm markets in line with the G-20 commitment. However, spare capacity in OPEC has now been reduced.

watched. Rapid credit expansion may have pushed output growth above sustainable rates in some emerging economies and could amplify a possible boom-bust cycle. Throughout the crisis, Japan and the United States have retained their safe haven status, but investor confidence cannot be taken for granted amid rising sovereign debt levels. A disruption to their sovereign bond markets, given their size and special role, could destabilize global financial and currency markets, with severe implications for economic activity.

C. Policy Implications

14. **Moving toward lasting stability and growth will first require comprehensive policies to exit from the crisis**. This requires both short- and medium-terms actions that are effective, complementary, and mutually reinforcing to shore up the baseline for growth:

- *Securing stability and managing risks in the near term*. To lay the foundations for growth over the medium term, resolving the euro area crisis will require prudent fiscal adjustment as part of a broader package. If conditions worsen, for example, countries should adhere to their announced fiscal measures but not necessarily to nominal targets. In combination, further easing of monetary policy should be considered, alongside ample liquidity support for banks from the ECB to alleviate their elevated funding strains. These measures, however, can only provide a temporary reprieve and should be complemented with restructuring and recapitalizing the banking system, if necessary with direct equity injections from official sources using pan-European funds, to avoid disorderly deleveraging. To be effective, the strengthening of the European firewall needs to be ratified by national parliaments as soon as possible.

- *Addressing excessive euro area imbalances to further support lasting stability and growth*. These imbalances provide an important perspective on the current crisis and its resolution. They largely reflected overly optimistic expectations; mispricing of risks; and insufficient adjustment to shocks, as well as cyclical factors (Annex 2). Neither markets, nor governments, nor supranational bodies imposed enough restraint on the exuberant borrowing that financed them. As market perceptions changed, there was no effective mechanism in place to deal with a wider banking and sovereign debt crisis that ensued. Improving EMU's architecture to address these shortcomings would thus make the union stronger over time and less prone to excessive imbalances and future crises.

- *Building a stronger monetary union that can robustly grow over the medium term*. Beyond immediate challenges, the euro area should anchor crisis management efforts by building a stronger, more resilient EMU through governance and structural reform. Key building blocks are deeper *fiscal integration* (strong fiscal governance and ex ante risk sharing); *structural reform* to improve competitiveness of deficit economies through a combination of wage adjustment and accelerated productivity; and *financial policies* and integration (e.g., centralized supervision and resolution; and common deposit insurance) to monitor systemic risks, ensure efficient bank resolution, inject capital as needed into banks directly from centralized resource pools (sooner rather than later), and maintain a cooperative process of deleveraging.

- *Many key elements of this approach are embodied in the EU 5-point strategy to address the euro area sovereign debt crisis*—through strengthening firewalls; funding and recapitalizing banks; strengthening euro area governance; supporting growth through structural reform; and differentiated and growth-friendly fiscal consolidation. Effective follow-through remains critical, and policy momentum needs to be sustained to get ahead of the crisis.

15. **Policies for many other *advanced economies*, with similar, if less acute, challenges will also need to navigate along a narrow path**. Given the dangers, a risk management approach is warranted. Where financing conditions allow, countries should maintain a gradual but steady pace of underlying consolidation given a fragile recovery, while allowing automatic stabilizers to operate freely if growth weakens. Japan and the United States should also urgently adopt credible and substantial consolidation roadmaps—partly to set course for the long journey ahead but also, in the U.S. case, to avoid abrupt fiscal retrenchment in the short run due to inaction. Monetary policy should be kept very accommodative, including through the use of unconventional measures, and some countries should consider or pursue further easing. Financial reform still needs to be implemented; regulation and supervision need to be improved, particularly over shadow banks; and cross-border cooperation of supervisory authorities must be strengthened to help secure lasting stability.

16. ***Emerging economies* face a difficult balancing act and policies vary across countries**. Weaker growth in advanced partner countries places pressure on domestic growth through trade. On the financial side, volatile capital flows, reflecting both push and pull factors, in the current environment complicate macroeconomic management. Appropriate policy responses in the baseline will vary by country. In those with easing inflation pressures but weaker fiscal positions, monetary policy can be used to support activity if necessary, with macro-prudential measures employed as needed to prevent asset bubbles. In those where inflation is under control, public debt is modest, and external surpluses are large, fiscal consolidation may be deferred and social spending, for example, used to support poorer households. Where inflation and public debt are high, focus should be on rebuilding policy space.

Implications of Staff's Risk Analysis for the Upside: *As possibly severe consequences from a deeper financial crisis cannot be ruled out, sufficient member policies and crisis and risk management are necessary to preserve the integrity of the baseline, to guard against rising and serious risks, and to avoid costly downside scenarios (as described in the annex). Staff presume that key member policies—notably, gradual but steady fiscal adjustment; accommodative monetary policy; restructuring and recapitalization of the banking system; and financial reform—are effectively implemented to avert a re-intensification of crisis feedback loops between banks, sovereigns and growth. The upside scenario is predicated on first securing staff's baseline, and potential gains are expressed relative to that point of reference.*

III. POLICY PROGRESS AND POSSIBLE GAPS

Enhanced accountability assessments find that G-20 members have made progress towards meeting their commitments in the Cannes Action Plan. The pace of fiscal consolidation in the near term appears broadly appropriate so far (with a few exceptions); many (but not all) members have credible medium-term consolidation plans; reserve accumulation has slowed in major surplus emerging economies; there has been some action on structural reform; and the global financial reform agenda has advanced. However, further action is needed to meet commitments and achieve the shared growth objectives. Greater focus is needed on addressing persistently high unemployment in advanced economies, while Japan and the United States should chart a clear course to firmly place their public finances on a sounder footing. Further action is required in emerging surplus economies to facilitate rebalancing by addressing domestic distortions, complemented by further exchange rate appreciation. Finally, financial regulation needs to be implemented on a consistent and steady basis across countries to safeguard financial stability—essential for sustained economic growth.

17. **Fiscal consolidation is, by and large, managing a delicate balance between supporting recovery and rebuilding confidence**. Japan and the United States have delivered on their commitments to implement *near-term* measures to sustain growth. Canada and the United Kingdom have allowed the pace of near-term consolidation to slow in response to a weaker near-term growth outlook (and for the U.K. lower estimates of potential growth). Consolidation in the euro area economies under market scrutiny was stronger and fiscal frameworks in the European Union as a whole were strengthened, although market pressures remain elevated. The broad pace of near-term consolidation is also appropriately slower than in 2011 and than previously planned in emerging economies—which have stronger initial fiscal positions. Overall, fiscal consolidation efforts are strongest in advanced deficit economies and weakest in emerging surplus economies as well as major oil exporters, which should contribute to rebalancing.

18. **Many (but not all) have credible and ambitious consolidation plans, though some members should reconsider the pace of adjustment given current conditions**.

- *With respect to G-20 commitments, most advanced economies have made significant progress toward achieving their 2013 Toronto target of halving the deficit from its 2010 level*. Some will miss by a relatively small margin—at least relative to observed efforts—in part due to the Cannes commitment to support recovery. Achieving the Toronto debt target to stabilize or reduce public debt by 2016 also seems within reach. However, if growth turns out weaker, it is important not to adhere to targets mechanically.

- *With respect to desirable adjustment, all members should have concrete medium-term roadmaps in place to anchor credibility, but a few advanced members may need to recalibrate their plans*. For 2012, fiscal consolidation plans appear appropriate both individually and collectively across the membership, but a few euro area economies should take care to avoid too much tightening in 2013. Meanwhile, avoiding a "fiscal cliff" in the United States in 2013 will need to be paired with stronger adjustment over the longer term. Current medium-term consolidation efforts anticipated in Japan and the United States are insufficient to put their high debt decisively on downward paths by mid-decade. Most emerging economies are broadly on track to reach their medium-term targets to rebuild fiscal space eroded during the crisis. However, India will require cuts in key subsidies and revenue enhancement to attain its objectives; and medium-term targets should be more clearly specified in China and be more ambitious in Russia and Turkey.

19. **Reserve accumulation has generally slowed and there have been welcome *de jure* moves toward greater exchange rate flexibility, but increases in *observed* flexibility remain modest**. Major surplus economies have slowed reserve accumulation since mid-2011, although levels remain relatively high and often exceed simple measures of reserve adequacy. Some deficit economies have seen some reserve losses over the past six to eight months (India and Turkey). China allowed some appreciation last year of its exchange rate (in effective terms) partly through gradual appreciation against the U.S. dollar; Russia has reduced foreign exchange interventions; and both have widened the fluctuation bands for their currency, which could eventually lead to further flexibility. Overall, however, the IMF's *de facto* exchange rate classifications indicate little *change* in exchange rate flexibility since Cannes. For example, while China has recently announced a wider band for its currency against the U.S. dollar, increased RMB flexibility has not yet been observed to warrant a change in its regime classification to a more flexible designation (Annex 2). Bilateral appreciation of the currency against the U.S. dollar and in effective terms has been minimal in 2012. Managing volatile capital inflows has been another challenge for emerging economies due to return differentials and swings in risk perceptions. A broad range of policy responses to capital inflows have been taken in several emerging economies, but more could rely on macroeconomic instruments.

20. **Progress on structural reform has been uneven and some commitments fall short**. Advanced economies have taken action to strengthen fiscal frameworks (notably, the European Union) and to raise labor force participation. Some economies under market scrutiny (Italy, Spain) have outlined major labor market reforms. But commitments tend not to be focused on addressing currently high and persistent unemployment in many advanced economies. Progress in the area of product market reform is also lagging with a few exceptions. Some emerging economies have acted on their commitments to improve social inclusion—through higher spending on safety nets, education, and health—and to increase investment in infrastructure and energy sectors. But overall ambition and progress are lacking on reforms to facilitate demand rebalancing and enhance growth potential, including by improving the business and investment environment.

21. **Members have advanced the global financial regulatory reform agenda, though implementation risks remain**. Work on the regulatory reform agenda has advanced and continues, and the implementation of the Basel III capital and liquidity framework is underway in

many jurisdictions, albeit it is still at an early stage and could be uneven, with some advanced economies falling behind their timetables. The newly developed Coordination Framework for Implementation Monitoring (CFIM) aims to foster discipline through more structured monitoring and reporting members' progress. The development of a policy framework for global systemically important banks is now completed and work on an assessment methodology is in progress.

22. **Policy or progress gaps in key areas relative to member commitments point to a need further action**. In particular:

- ***Financial sector reform***.[3] Ensuring financial stability, including by preventing a reemergence of the excesses of the last decade, is key to sustained and shared growth. Implementation of the agreed regulatory reform across countries on a consistent and steady basis, striking a balance between strengthening the resilience of the banking system and cushioning the impact on economic activity, is needed. Further work is also 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 still need to be developed.

- ***Sound public finances***. Fiscal policy may need further adjustment to navigate between supporting growth and restoring sustainability. In the near-term, excessive consolidation due to expiry of measures and inaction should be avoided in the United States, as well as in a few euro area countries due to discretionary overtightening. Japan and the United States need to promptly adopt credible and more ambitious medium-term consolidation plans to reduce high public debt and to guard against risk of future market instability. Fiscal vulnerabilities in India (high debt and slow adjustment), Russia (low debt but high non-oil deficit) and Turkey (medium debt but slow adjustment) should also be addressed. Finally, reforms to address longer-term fiscal pressures from ageing and health care costs are needed in many economies.

- ***Global demand rebalancing***. While global imbalances have narrowed with the crisis, this has reflected demand *compression* more than rebalancing—i.e., it has been asymmetric between surplus and deficit economies—leaving global growth weaker. To complement steady consolidation in deficit economies, more action is needed in emerging surplus economies to facilitate demand rebalancing by addressing domestic distortions, complemented with further exchange rate appreciation. In China, rebalancing should be centered on boosting relatively low consumption by removing distortions that lead to excessive saving and investment, including through financial sector reform and removing

[3] 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.

implicit subsidies to the cost of capital. In other surplus economies, the focus should be on boosting investment, including through improvements in the business environment and infrastructure.

- ***Employment and growth***. Finally, more action may be directly needed to support the main objectives themselves. In advanced economies and some emerging economies (South Africa and Turkey), more decisive action is needed to address persistently high unemployment. Scope for further policy action includes cost-effective active labor market policies (and in particular worker retraining and employment services in countries which have undergone sector-specific shocks such as Spain and the United States), lowering labor taxes, removing impediments to hiring, and fostering greater wage flexibility. Accountability assessments also reveal gaps in the alignment of structural reform plans with the OECD's medium-term strategic priorities. More determined progress on *product market* reform, in particular reducing regulatory barriers to firm entry and strengthening competition in sheltered sectors such as services, would also enhance potential growth and employment.

Implications of Staff's Accountability Assessment for the Upside: *Key policy or progress gaps at the member level that are identified form the basis for strengthened actions for the upside. Specifically, steady fiscal consolidation over time, laid out in credible roadmaps; monetary easing; demand rebalancing, including by addressing domestic distortions and more flexible exchange rates; and policies tackling high unemployment are central. Accounting for spillovers—notably to support global demand—the upside further illustrates the benefits of collective action and potential gains at the global level toward achieving lasting stability and growth.*

IV. ACHIEVING LASTING STABILITY AND GROWTH—AN UPSIDE SCENARIO

Further collective action is still needed to attain the shared objectives of strong, sustainable, and balanced growth. Synergies exist between key policies and strengthened collective action across the membership can be mutually reinforcing—facilitating global rebalancing and securing more durable recovery. An "upside scenario", where members address progress and policy gaps, offers appreciable gains. The scenario illustrates that collaborative policies—focused on steadily improving fiscal positions, easing monetary policy where appropriate, advancing healthy global rebalancing, and further promoting jobs and growth—would lead to welfare gains for the membership and help mitigate key risks threatening the recovery.

23. **Positive synergies exist between near-term policies that can kick-start growth and policies to secure medium-term objectives**. Given a still-fragile recovery, members need to strike the right balance between measures supporting growth in the near term and those aimed at achieving medium-term objectives. Risk management policies identified by the global risks analysis are necessary to ensure the baseline and avoid a costly downside scenario. Building on that baseline, an upside scenario considers scope for further collective gains by membership with adjustment suited to individual member circumstances. Cooperative action across the membership in key areas—namely, strengthened fiscal consolidation plans, further easing of monetary policy, key structural reform, global rebalancing polices, and post-crisis financial sector reform—will help members better achieve their medium-term growth objectives. Importantly, this will also improve private sector confidence and support growth in the near term, helping to guard against downside risks to the recovery.

24. **The upside scenario brings together key policy requisites at the *member* level identified in accountability assessments and the benefits of collective action**. The main policy contours and motivation are as follows:

- ***Financial sector reform***. A stable and healthy financial sector is a prerequisite for durable growth. Given modeling limitations, additional financial sector reform is not explored in the upside scenario. Analysis elsewhere, however, suggests that further progress on financial sector reform would help reduce stability risks and lay the foundations for the strengthened growth prospects.

- ***Sounder fiscal positions***. Sound public finances are requisite for durable growth. Greater medium-term consolidation efforts over time should be considered in some countries (e.g., India, Japan, and the United States) to restore soundness to public finances and to anchor shared growth objectives. The precise composition of expenditure and revenue measures differs across countries and is informed by staff's bilateral surveillance. A general shift toward greater reliance on indirect taxes (e.g., VAT) away from more distortionary taxes, which is budget neutral in some countries (e.g. Germany) or part of broader consolidation efforts in others (e.g., Australia and Japan) would be beneficial. While fiscal positions are relatively stronger in emerging economies, some emerging economies could adopt budget-neutral measures to boost further public investment in infrastructure and education (e.g., Brazil, India, and Indonesia).

- ***Easing monetary policy***. Where appropriate, monetary policy should be eased further in some major advanced economies consistent with price stability objectives given weaker growth and continued fiscal consolidation. Given constraints on nominal policy rates in many regions, a mix of conventional and unconventional measures should be considered. This would not only cushion the impact of tighter fiscal policy in home countries, but will also help dampen their demand spillovers to other regions as well.

- ***Global demand rebalancing***. As a multilateral undertaking, achieving global rebalancing and healthy growth requires effort in both deficit and surplus economies. Notably, policy scope exists for reducing key imbalances in China, Germany and the United States. In China, added rebalancing policies to reduce high private saving can tackle distortions that keep the cost of capital low, reforming the financial system, and strengthening the social safety net, complemented with greater exchange rate flexibility.[4] In Germany, measures would focus on encouraging private investment. For the United States, efforts would be focused on raising or preserving higher private saving (e.g., through entitlement reform) as public finances consolidate.

- ***Employment and growth***. Finally, direct actions should also be pursued to strengthen job creation and growth. Where possible, *demand-side* policies should be the focus in the short run given that they are a main driver of employment growth when involuntary unemployment is high. *Supply-side* policies should be medium- and long-term priorities, but a policy tradeoff involves deciding on good supply-side policies that may be less demand-friendly in the short run. *Advanced deficit economies* can make greater policy efforts to reduce persistently high unemployment—focusing, where possible, on effective active labor market policies to facilitate search, matching and reattachment of displaced workers. Further structural reform effort or reorientation is assumed to raise employment and potential output over the medium term, notably in *advanced surplus economies*—where those with rapidly-aging populations (Germany, Japan, and Korea) could also take additional measures to encourage female and old-age labor force participation (e.g., reducing the secondary earner tax wedge and raising retirement ages). Many emerging economies have considerable scope to boost formal sector employment and labor force participation.

25. **For evenhandedness, policy actions in *all* G-20 members are considered for the upside scenario**. Previous staff analysis for the upside had focused on *systemic* members largely

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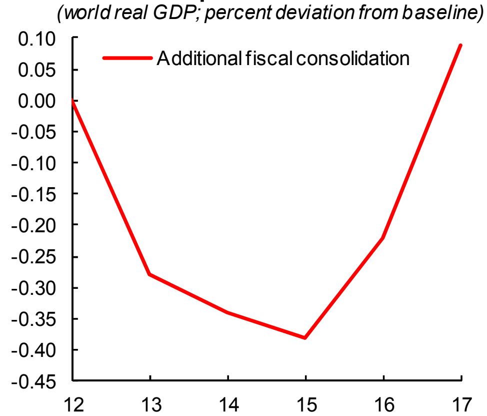
[4] In each upside layer, China's exchange rate is assumed to be freely floating.

based on sustainability reports.[5] Informed by accountability assessments, the present scenario is conducted using a new global macroeconomic model developed to support the G-20 MAP exercise (G20MOD), which treats each G-20 member separately. This allows policies to be considered and tailored to every member's individual circumstances.[6] While any model is necessarily stylized, staff's multi-country framework provides essential and explicit structure to the analysis of G-20 economies and their interdependence. The upside scenario builds on the Fund's April WEO economic baseline and policy assumptions.

26. **A *complementary* package of polices results in stronger medium-term growth and rebalancing**. Box 1 provides details of the policy and technical assumptions underpinning the scenario.[7] At a higher level, key elements are as follows:

- ***Stronger consolidation over time is necessary to ensure debt sustainability and rebuild policy space, but this will reduce growth on impact (including through spillovers)***. Additional fiscal consolidation (around 1½ percent of world GDP) would reduce world GDP by around ½ percent by 2015. More front-loaded consolidation would risk deepening the negative effects on growth. This underscores the need for fiscal plans to be well timed and as "growth friendly" as possible. Fiscal consolidation would also have negative spillovers on trading partners. To limit the dampening effects on global demand through spillovers, some countries should *not* tighten further and instead consider budget-neutral adjustment where appropriate (see below). This also highlights the need for a complementary set of polices to offset the temporary dampening effects of fiscal consolidation and weaker demand from trading partners.

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



Source: IMF staff estimates.

- ***Easing monetary policy, through both conventional and unconventional means, can substantially mitigate the near-term fiscal drag.*** Several members, particularly those

[5] See http://www.imf.org/external/np/g20/pdf/110411.pdf

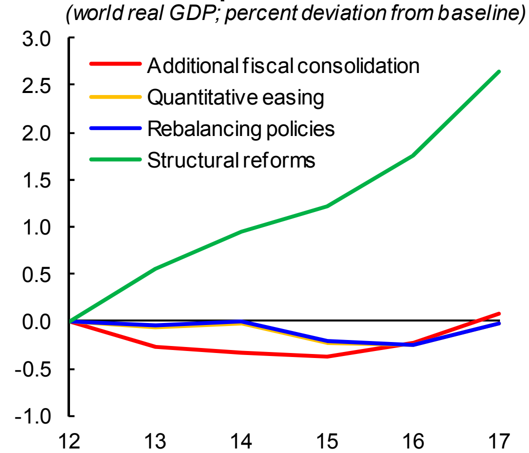
[6] G20MOD is similar in structure to the Global Integrated Monetary and Fiscal (GIMF) model used in previous MAP work. The model has 23 blocks, comprising all G-20 countries plus three aggregate country groups (other non-euro-area European Union countries, other industrial countries, and the rest of the world).

[7] Work on the upside scenario was undertaken in close partnership with the OECD. The OECD contributed simulations of the effects of stylized and country-specific structural reforms for individual G-20 members.

with acute needs to further strengthen fiscal positions, should ease monetary policy through lower policy rates where recovery is weakening and price pressures are likely to diminish. In countries with monetary policy rates already close to zero, (further) unconventional easing should be pursued or considered. In the model, if unconventional measures equivalent to 100 basis points of short-term rate cuts were implemented in the euro area, Japan, and the United Kingdom for two years, the negative impact on global growth from required fiscal measures would be largely offset. In terms of spillovers, this would lead to currency appreciation elsewhere but also stronger import demand from countries where monetary stimulus is introduced. On balance, the effects on partner country growth are broadly neutral.

- ***Complementing consolidation, structural and tax reform and rebalancing policies would lead to stronger and more balanced growth***. Budget-neutral adjustment, where tax reform shifts the composition of revenue away from distortionary taxes, limits the adverse impact on growth. Structural reforms in labor and product markets boost productivity and potential growth. Meanwhile, in the near term, active labor market policies mitigate potential negative near-term effects of some labor market reforms. G20MOD simulations suggest that key structural reform not only have own benefits to members by boosting jobs and growth domestically but have also positive spillovers via trade, strengthening overall growth and helping further rebalance the global economy. Rebalancing policies would support growth by avoiding more asymmetric adjustment that would hurt global demand. This is critical for healthier, more sustainable growth over time by further shifting to a more balanced global pattern of domestic demand and would help narrow large external imbalances. Stronger internal demand in surplus members, through positive spillovers, would help offset the need to rebuild saving in deficit members.

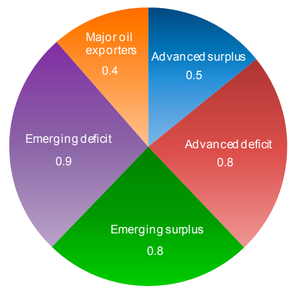
G-20 MAP: Upside Scenario
(world real GDP; percent deviation from baseline)



Source: IMF staff estimates.

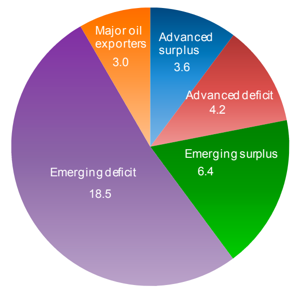
27. **Further collaborative action would have appreciable benefits for growth and jobs**. The upside scenario shows that joint actions by all members would result in an overall increase in world GDP of over 2½ percent relative to the WEO baseline in 2017. Moreover, if fully implemented, the comprehensive set of policies would add almost 36 million jobs across the G-20. Cumulative output gains over the medium term are about 2¾ times larger than the 2017 gains. Across the membership, there are relatively large gains in GDP for advanced surplus economies, with GDP rising by around 4 percent relative to baseline. The growth benefits from collective action for advanced deficit economies and emerging surplus economies are also significant, with their GDP rising by around 2 to 3 percent relative to the baseline by 2017.

Contributions to G-20 GDP in 2017 by Thematic Groups 1/ 2/
(percentage points deviation from baseline)



Source: IMF staff estimates.
1/ Scenario includes all reforms.
2/ The overall increase in G-20 GDP in 2017 is 3.3 percent.

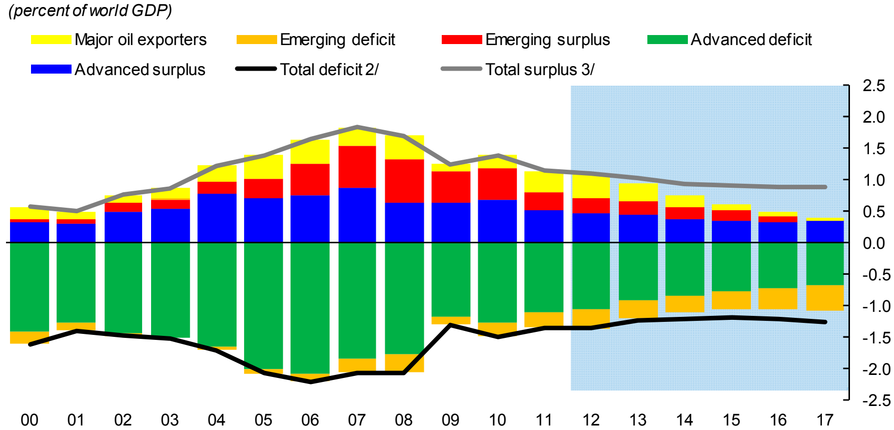
Total Jobs Increase by Thematic Groups 1/ 2/
(millions)



Source: IMF staff estimates.
1/ Scenario includes all reforms.
2/ The overall increase in G-20 number of jobs in 2017 is 35.7 million.

28. **Stronger growth is accompanied by global rebalancing**. The upside scenario shows a reduction of global imbalances by around ¾ percent of world GDP relative to the WEO baseline by 2017. This is driven by a narrowing of imbalances for both surplus and deficit countries. The reduction is relatively large for advanced deficit and emerging surplus economies, largely reflecting the effects of rebalancing polices in China and the United States. Current account surpluses narrow across all advanced surplus economies, except Japan, where greater efforts to achieve fiscal sustainability take priority and result in an increase national saving.

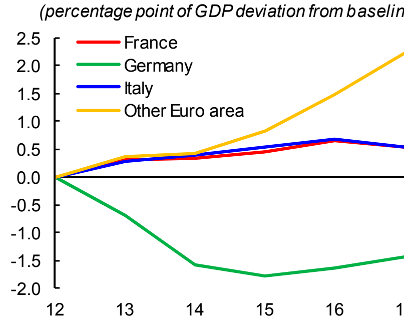
Current Account Balances 1/
(percent of world GDP)



Sources: IMF, World Economic Outlook and staff estimates.
1/ 2000 - 2011 reflect WEO history; 2012 - 2017 reflects WEO projections + upside scenario except for total deficit/surplus lines, which reflect WEO baseline.
2/ Total for deficit countries in the WEO baseline.
3/ Total for surplus countries in the WEO baseline.

- ***Euro area imbalances would narrow in the upside***. Germany's current account surplus and the deficits of France, Italy, and other euro area countries diminish. The policy tradeoff for Germany involves accepting higher (relative) inflation to facilitate area-wide adjustment, while supporting stronger area-wide growth through stronger domestic demand and investment. Deficit countries experience improvements in competiveness through structural reform and relative price adjustment,

G-20 MAP: Upside Scenario for Euro Area Current Account Balances 1/
(percentage point of GDP deviation from baseline)

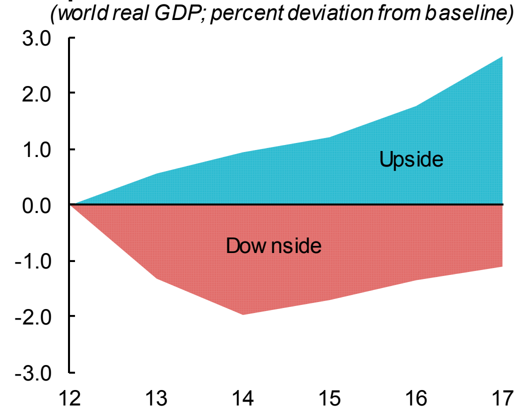


Source: IMF staff estimates.
1/ Scenario includes all reforms.

helping to facilitate rebalancing within the region. Overall, the scenario shows that more symmetric adjustment across surplus and deficit euro area economies can lead to stronger, more balanced growth and strengthen the foundations of the monetary union.

29. **Finally, upside policies to deliver stronger growth, alongside a risk management approach, is the best insurance against downside risks and potential losses**. Securing stability opens the way to durable growth and stronger confidence. In turn, stronger growth helps reinforce fiscal consolidation and financial sector repair. This can help reverse the damaging adverse feedback loops that have characterized this crisis (Annex 1). Thus, upside gains can also be viewed in relation to the avoidance of costs associated with less complete, indecisive, and inconsistent policies. Viewed from this perspective, the relative gains are compelling. The gains in the upside compared against the downside (relative to baseline) amount to 4 percent of GDP and 58 million jobs in 2017. Cumulative output gains over five years between 2012 and 2017 would be 3½ times larger (see blue plus red shaded area).

Upside Gains vs. Downside Losses 1/
(world real GDP; percent deviation from baseline)



Source: IMF staff estimates.
1/ Downside losses based on Euro area stress scenario starting in 2012.

Box 1. Policy Assumptions for the Upside Scenario

The upside scenario consists of four layers: (i) additional fiscal consolidation over the medium term; (ii) monetary easing in euro area, Japan and U.K.; (iii) structural reforms in product and labor markets (based on simulation results from the OECD, scaled to account for policies assumed in the baseline), including budget-neural fiscal reform; and (iv) rebalancing reforms in China, Germany, and the United States.

G-20 members are assumed to fully implement their policy commitments and take *additional* actions that are desirable to anchor the members' growth objectives. In particular:

- **Fiscal consolidation and budget-neutral fiscal reform**. Specifically:

Total Consolidation and Contributions in 2017 (in percent of GDP)

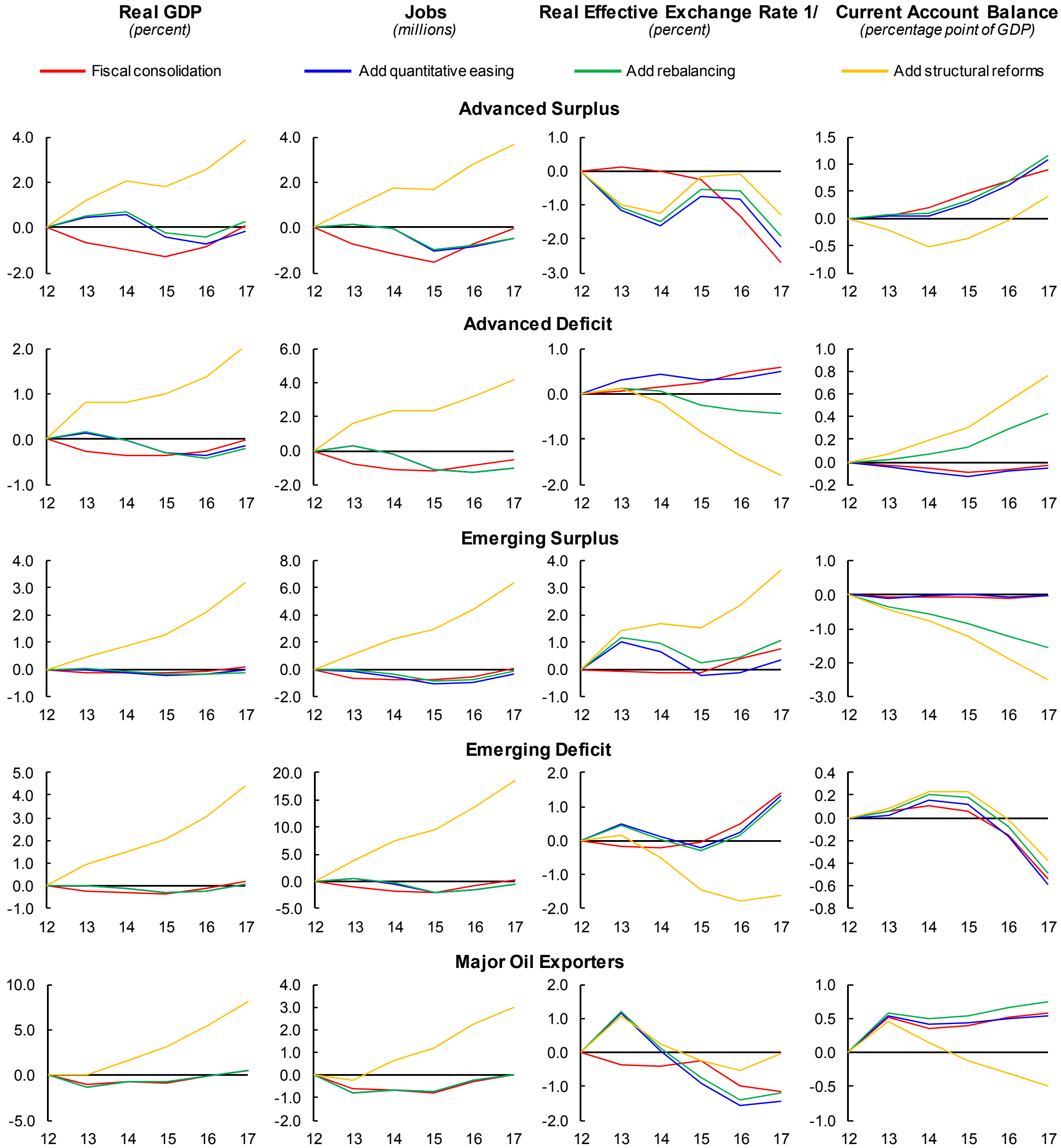
	Expenditure Cuts			*Revenue Increases*			*Total Consolidation*
	Transfers	Consumption	Investment	VAT	Labor Tax	Corporate Tax	
Australia	-0.2	-0.2		0.2			0.6
Brazil	0.5		-0.5	1.0	-1.0		
Germany				2.0	-2.0		
France		0.3					0.3
India	2.1		-1.0	1.9	-0.5	-0.5	2.0
Indonesia	1.0		-1.0				
Italy		0.5		2.0	-1.5	-0.5	0.5
Japan		2.5		5.9	-2.0		6.4
Russia	3.3	1.1					4.4
Turkey		3.5					3.5
United States	0.5	0.5		1.5		-0.5	2.0
Other EU (not in euro area)		1.0					1.0

- **Structural reforms**. Two types of structural reforms are considered—product market and labor market reforms. The reforms assumed for each member are shown in the table below. Product market reforms (PMR) boost productivity across tradable and non-tradable sectors. Labor market reforms comprise: active labor market policies (ALMP); easing overly restrictive employment protection legislation (EPL); reducing average replacement rates (ARR); actuarially neutral pension reform (AN); retirement age reform (RA); and policies that boost general or female labor force participation (PR). The labor market reforms reduce unemployment (ALMP and ARR) and increase labor productivity (EPL) and labor force participation (AN, RA, and PR).

	PMR	ALMP	EPL	ARR	AN	RA	PR
Advanced Deficit							
Australia	✓		✓		✓	✓	
Canada	✓	✓	✓		✓	✓	
France	✓	✓	✓	✓	✓	✓	
Italy	✓	✓	✓				✓
United Kingdom	✓	✓	✓	✓	✓	✓	
United States	✓	✓			✓	✓	
Other Euro Area	✓	✓	✓	✓	✓	✓	
Advanced Surplus							
Germany	✓	✓	✓	✓	✓	✓	✓
Japan	✓		✓		✓	✓	✓
Korea	✓	✓	✓	✓	✓	✓	✓
Emerging Deficit							
Brazil	✓		✓				
India	✓		✓				✓
Mexico	✓	✓	✓				✓
South Africa	✓	✓	✓				✓
Turkey	✓		✓		✓	✓	✓
Other EU (not in euro area)	✓	✓	✓	✓	✓	✓	✓
Emerging Surplus							
Argentina	✓		✓				✓
China	✓		✓				✓
Indonesia	✓	✓	✓				✓
Major Oil Exporters							
Russia	✓	✓	✓				✓
Saudi Arabia	✓	✓					✓

- **Global rebalancing reforms**. In *China*, additional reforms to education, healthcare, and pensions raise public consumption and reduce private saving by 2 percent of GDP over 5 years. Financial sector reforms eliminate implicit subsidies to capital, raising its cost by 50 basis points after 5 years. These policies are accompanied by a fully flexible exchange rate. In *Germany*, reforms are implemented that reduce the cost of capital by 85 basis points after 5 years. In the *United States*, reforms encourage an increase in the private saving by 1½ percent of GDP after 5 years.

G-20 Upside Scenario
(deviation from baseline)



Source: IMF staff estimates.
1/ Increase includes appreciation.