GROUP OF TWENTY

IMBALANCES AND GROWTH

Update of Staff Sustainability Assessments for G-20 Mutual Assessment Process
September 2013

Prepared by Staff of the

INTERNATIONAL MONETARY FUND*

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

SUMMARY[1]

External imbalances have generally decreased. These improvements are partly permanent, partly transitory. Fiscal imbalances are slowly improving as well. In both cases however, more needs to be done to reduce imbalances while strengthening growth prospects. Nine members were identified as having relatively large medium-term imbalances based on indicative guidelines—including all seven flagged previously in 2011. This overview provides general trends and assessments, while the individual situation and policy advice to address medium-term imbalances are discussed for the nine economies in the annex. Overall, the analysis suggests that further policy action across the G-20 membership, tailored for deficit and surplus economies, is needed to facilitate further internal and external rebalancing to support stronger growth.

I. OVERVIEW

1. **For the Mutual Assessment Process (MAP), G-20 members have agreed to re-assess imbalances**. As follow up to Summit commitments made in Seoul 2010 to promote external sustainability, IMF staff prepared a series of sustainability reports in 2011 on major imbalances in selected members as inputs for the MAP.[2] In Los Cabos 2012, Leaders agreed to biennial assessments to identify large and persistent imbalances against "indicative guidelines" beginning in 2013 toward working to meet their shared growth objectives.[3] This report provides an *update* to staff's sustainability assessments.

2. **Nine members were identified with relatively large imbalances in 2013**. On the basis of G-20 indicative guidelines, *China*, the *euro area*, *France*, *Germany*, *India*, *Japan*, *Spain*, the *United Kingdom* and the *United States* were identified as having relatively large internal or external balances over the medium term based on staff projections (see Table 1 and Box 1). For the seven members previously selected in 2011, essentially the same imbalances were identified again in 2013. In the case of the

Table 1. Indicative Guidelines for G-20 Imbalances 1/

	Imbalances		
	External	Fiscal	Private
China	✓		✓
Euro area	✓	✓	
France	✓	✓	✓
Germany	✓	✓	
India	✓	✓	✓
Japan	✓	✓	
Spain	✓	✓	✓
United Kingdom		✓	✓
United States	✓	✓	✓

1/ Staff estimates based on IMF, *World Economic Outlook* January 2013 Update.

[1] Prepared for the July 19–20, 2013 G-20 Ministerial Meeting by a team from the IMF's Research Department led by Hamid Faruqee and Emil Stavrev, with Samya Beidas-Strom, Florence Jaumotte, Troy Matheson and Joong Shik Kang, and with support from Eric Bang, Shuda Li and Gabi Ionescu.

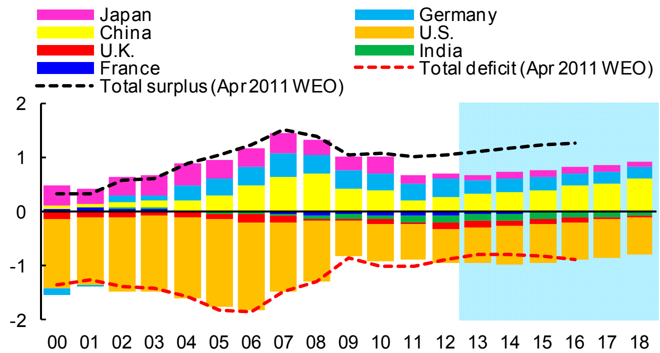
[2] See http://www.imf.org/external/np/g20/map2011.htm.

[3] See *Los Cabos Growth and Jobs Action Plan*, June 19, 2012. A summary of indicative guidelines (drawing on IMF staff analysis) is provided in the G-20 Communiqué—Washington, DC, 14–15 April 2011.

euro area and *Spain*, they were newly identified given relatively large fiscal and external imbalances that are likely to persist or emerge over the medium term in the wake of the crisis. Specifically, IMF staff projections envisage continued high (or rising) public debt and sharply rising external surpluses in these economies relative to the indicative guidelines. Staff updates provide the latest medium-term outlook, diagnosis and risks, and policy implications associated with key imbalances for each of these nine members—focused on developments and changes to the outlook for G-20 imbalances since the previous reports (see Annex). Recent trends across the membership since 2011 are summarized below.

3. **Staff's baseline foresees a largely durable narrowing in global imbalances**. External imbalances have decreased noticeably since the crisis (see chart). Compared to 2011 projections (dashed lines), imbalances in major G-20 economies have narrowed more than expected in 2011–13. While temporary factors have played some role here, global imbalances are unlikely to return to pre-crisis levels assuming key policy commitments are met.[4] Under staff's baseline—which assumes no major differences between the output gaps in deficit and surplus economies, staff envisages this narrowing largely to remain going forward, albeit with some widening towards the end of the horizon. Most of the adjustment, however, took place during the Great Recession, when global growth was negative, and mainly reflects lower demand in external deficit economies. This came with large declines in investment, some increase in private saving, and much lower government saving to cushion the fall in demand in these economies.

Current Account Balances
(percent of world GDP)



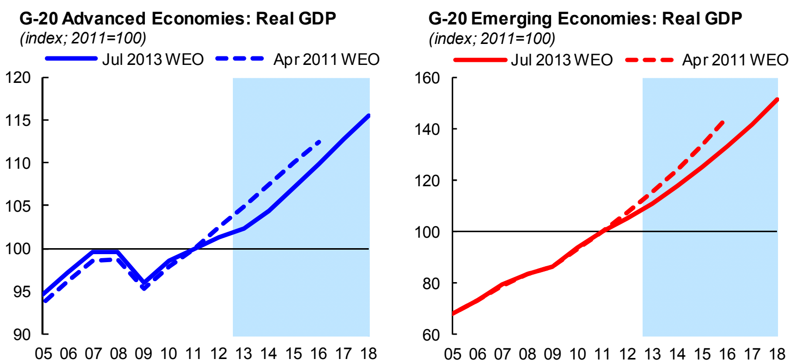
Source: IMF, *World Economic Outlook* July 2013.

4. **Part of the adjustment has been healthy**. It reflects financial excesses before the crisis that have since corrected. At the same time, some demand rebalancing in key emerging surplus economies has occurred, given weaker external demand. Exchange rates have also broadly moved in the right direction to help rebalancing, though with some exceptions. Real exchange rates have generally appreciated in surplus countries and depreciated in deficit countries since mid-2011, although there is a need for more exchange rate adjustment over the medium term in several economies.[5]

[4] See IMF Pilot External Sector Report (2013) for further discussion of the role of cyclical and structural factors behind the evolution of global imbalances following the crisis (p. 4).

[5] For further discussion of exchange rates and staff assessments of their consistency with economic fundamentals and desirable policies, see the IMF Pilot External Sector Report (2013).

5. **Part of the adjustment, however, comes from low internal demand in advanced deficit economies**. Compared to what was envisaged in 2011, the path for real GDP has been generally disappointing. The outlook for G-20 advanced economies has been marked down further below earlier trends given the lasting effects of the crisis. In particular, developments in current account imbalances since 2011 largely reflect compressed demand in advanced deficit economies, in part given corrections in housing and credit markets, as well as cyclical weakness. Comparing surplus and deficit economies, the post-crisis path of output in the former is holding up better—led by emerging surplus economies. Despite some growth disappointments more recently (relative to forecasts), economic activity and internal demand in emerging economies have been more resilient, which has contributed to narrower external imbalances through some demand rotation. Adjustment toward desirable policies over the medium term, however, has been modest in general and played only a small role in reducing global imbalances thus far.[6]

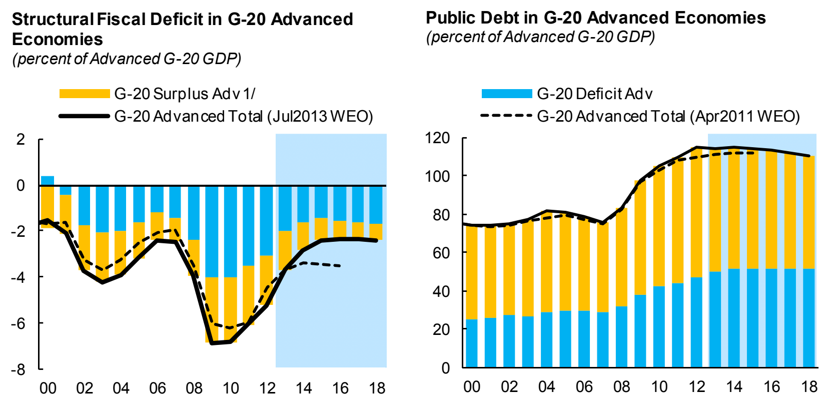


Source: IMF, *World Economic Outlook*.

6. **Against this background, risk that large external imbalances could re-emerge depends on the size of output gaps and how countries return to potential**. The risks revolve around: (i) the relative magnitude of the output gaps in advanced deficit economies; (ii) how the negative gaps in these economies are closed (i.e., by relying on domestic or foreign demand); and (iii) the future course of policies through the adjustment. Slippages over the medium term relative to policy commitments would pose a key risk to staff's baseline outlook. Staff's baseline also assesses that output gaps in advanced economies are not relatively very large (e.g., no major differences between the output gaps in deficit and surplus economies). This is consistent with extensive evidence that large financial crises tend to involve durable losses in the level of output relative to their pre-crisis trends. Accordingly, as output gaps close, global imbalances move broadly sideways in WEO projections. However, if the output gaps turn out to be larger in advanced deficit economies or they are closed primarily by internal demand, global imbalances may re-emerge, especially if desirable policy adjustments are not taken.

[6] See IMF Pilot External Sector Report (2013) for further discussion on the relative role of policy drivers in reducing imbalances.

7. **Despite sizable consolidation efforts, fiscal deficits in advanced economies remain high and should be reduced further**. In spite of narrowing fiscal deficits, public sector imbalances remain large, partly on account of slow growth and continued banking sector weaknesses. Notwithstanding smaller structural deficits relative to 2011, public debt is projected to stabilize only at very high levels—too high to rebuild needed policy space; or to deal with future challenges such as aging; or to reduce fiscal vulnerabilities to a more comfortable level.



Source: IMF, *World Economic Outlook*.
1/ Advanced surplus comprises Canada, Euro area, Japan, and Korea.

II. POLICIES

8. **To achieve its shared objectives, members should strengthen policies that facilitate internal and external rebalancing while supporting growth**. Some narrowing of imbalances has occurred as discussed, but it has been driven mainly by demand compression that has hurt growth. Thus, further progress is needed on both internal and external rebalancing in a manner supportive of growth. The main contours of collective action drawn from the imperatives for individual members can be broadly summarized as follows (see Annex for elaboration).

- ***Internal rebalancing***. Substantial fiscal consolidation should proceed at a measured pace to support near-term growth.[7] Implementation should be anchored with credible fiscal roadmaps, underpinned by policies to strengthen efficiency in public finances—particularly, in advanced deficit economies such as the *United States, France* and *Japan*. In the *U.K.*, fiscal policy needs to balance debt sustainability with growth concerns, considering, within the context of the medium-term fiscal framework, growth-enhancing initiatives (e.g., bringing forward planned capital investment, reducing business taxes) to fully offset the drag from planned fiscal tightening in the near term. In *France*, a more measured pace of structural fiscal adjustment is appropriate in the near term and it should be backed by well-specified expenditure containment measures over the medium term to credibly anchor sustainability. In *India*, addressing fiscal deficits requires tax and

[7] As discussed in the April 2013 Fiscal Monitor, for advanced economies, the magnitude of the required improvement in the cyclically adjusted primary balance over 2014–30 varies from 2 to 16 percent of GDP.

subsidy reform. Fiscal consolidation efforts over time in deficit economies will also support the narrowing of global current account imbalances.

- ***External rebalancing***. Additional policies should be implemented in key G-20 surplus and deficit economies to further reduce external imbalances. In *surplus economies*, structural reforms are needed to strengthen internal demand (*Germany*) or modify its composition (*China*). This includes removing key impediments (e.g., strengthening social safety nets, reform of state owned enterprises, and allowing a more market determined exchange rate) or financial distortions (*China*); and tax and financial system reform and services sector deregulation (*Germany*). In *deficit economies*, structural reform is needed to improve external competiveness. This includes product market reforms (*Spain*, *France*), services sector liberalization (*France, Germany*), improving physical and human capital, and R&D and technology enhancements (*United Kingdom*), and removing supply bottlenecks to strengthen exports (*India*). While structural reform efforts in strategic areas would boost growth potential across the G-20 membership, further exchange rate adjustments (depreciation in deficit economies and appreciation in surplus economies) are also needed to facilitate external rebalancing.

Box 1. Summary of the 2013 Indicative Guidelines for Imbalances

For the biennial update of G-20 indicative guidelines, the 2013 exercise followed the methods agreed by members in April 2011 as follows:

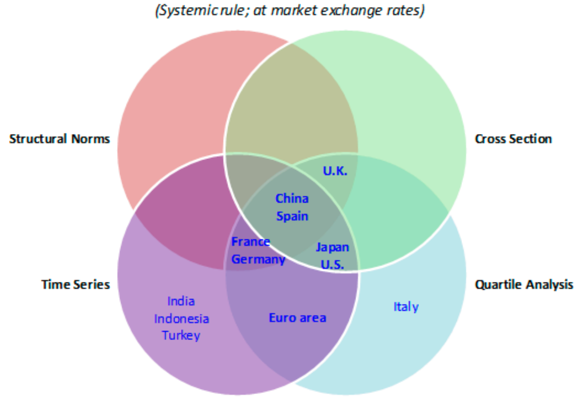
- ***Indicators***. The indicators used to evaluate key imbalances are: (i) public debt and fiscal deficits; (ii) private saving and private debt; and (iii) the external position, comprising trade balance, net investment income flows, and transfers. The indicators are based on average projected values for 2016-18 from the IMF's *January 2013 WEO Update*, except for private debt where the latest available data is used.

- ***Reference points***. Reference values, against which the indicators are compared, are derived from the following four approaches: (i) a structural approach based on economic frameworks to calculate suitable "norms" (for the external position, the norm is based on staff's CGER methodology); (ii) a time series approach to provide historical trends; (iii) a cross-section approach to identify benchmarks based on averages of countries at similar development stages; and (iv) quartile analysis to provide median values for the full G-20 distribution.

- ***Selection criteria***. Members are selected if at least 2 of 3 sectors (external, fiscal, and private) in at least 2 of the 4 approaches above show "large" imbalances (i.e., significant deviations of indicators from their reference values). For "systemic" members (i.e., whose share in the G-20 GDP is 5 percent or more), a "moderate" imbalance is used for selection to account for their systemically important roles.

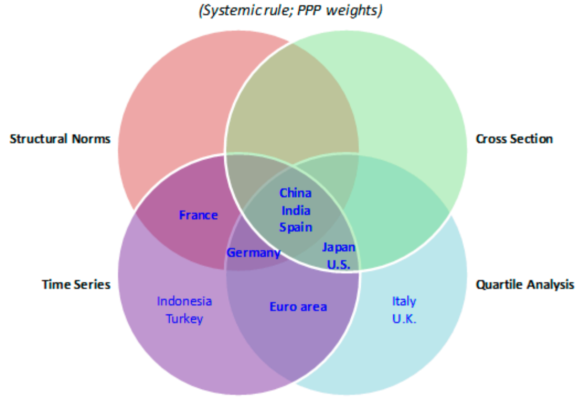
- ***Results***. The updated assessment identifies 9 members with significant imbalances, 7 of which were previously identified in the 2011 exercise. The imbalances identified for these 7 members are: *China*: high private saving and external surplus; *France*: high external deficit and public debt; *Germany*: high external surplus and public debt; *Japan*: moderate external surplus and large public debt; *United Kingdom*: low private saving and high public debt; *United States*: large fiscal and external deficits; and *India*: significant public and private sector imbalances. In addition, two new members, *euro area* and *Spain*, were identified because of higher external surplus and public sector debt following the crisis (see Table 1).

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



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

G-20 Indicative Guidelines: Comparison of Approaches
(Systemic rule; PPP weights)



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

GROUP OF TWENTY

ANNEX: SUSTAINABILITY UPDATES FOR SELECTED G-20 MEMBERS

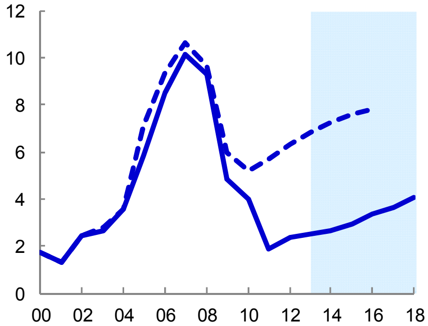
People's Republic of China[1]

China's external imbalances have narrowed markedly, reflecting rebalancing towards internal demand on the back of continued high investment and some decline in saving. However, whether the rebalancing seen thus far will be sustained and move toward greater reliance on private consumption remains a question given key impediments. A broad package of reforms is needed to more durably reduce still exceptionally high private saving and shift toward more consumption-driven growth over the medium term. This will require addressing distortions in the financial and services sectors, improving the social security system, and moving towards a more market-determined exchange rate.

I. IMBALANCES: DIAGNOSIS AND RISKS

1. **External imbalances have narrowed markedly, reflecting a decline in external demand, matched by resilient domestic demand**. Reflecting greater rebalancing than envisaged in 2011, the large decline in the current account surplus has partly been the result of very high levels of investment that have helped offset to some extent a weak global environment. High levels of investment spending have bolstered domestic demand, but household saving has remained (and is likely to remain) at high levels as expected in 2011 (see Figure 1). However, the slow pace of domestic demand rebalancing and the expected recovery in the global economy should, all things equal, lead to some rebound in the current account surplus over the medium term.

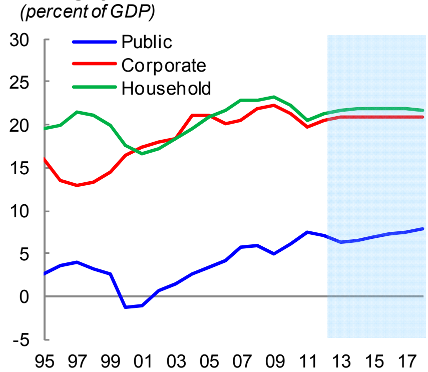
Current Account Balance
(percent of GDP)



Source: IMF, *World Economic Outlook*.

2. **Distortions in China's financial sector and factor markets continue to favor investment and hinder consumption**. Key distortions remain in place, including the perception of implicit guarantees for banks and corporates, credit constraints and ceilings on deposit rates hampering private consumption, as well as inefficiencies in factor markets. Policymakers have pointed toward the rising contribution to growth of services and consumption, but the necessary adjustment will require further policy action for a decisive shift toward a more consumer-based economy. Likewise, efforts have begun to strengthen the social safety net to reduce precautionary saving, but saving is still projected to

Saving by Sector
(percent of GDP)



Sources: CEIC; and IMF, *World Economic Outlook* July 2013.

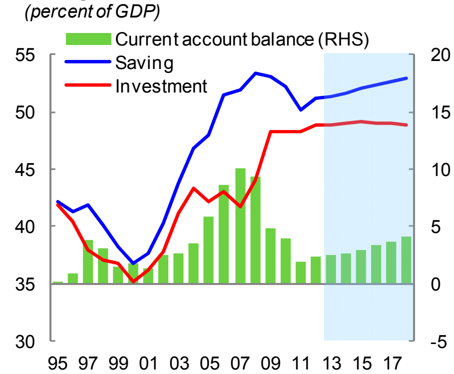
[1] Prepared by Troy Matheson.

remain exceptionally high over the medium term. At the same time, while some progress has been made toward greater exchange rate flexibility, the external position appears moderately stronger, and the real effective exchange rate moderately undervalued compared with the level consistent with medium-term fundamentals and desirable policy settings.[2]

3. **China's growth has become too reliant on investment and an unsustainable surge in credit, raising domestic vulnerabilities**. While rising levels of investment have helped narrow external imbalances, very high investment and diminishing returns to capital accumulation raise questions about allocation inefficiencies as well as growing financial sector vulnerabilities and sustainability concerns. Failure to change course and accelerate reforms, increases the likelihood of an accident or shock that could trigger an adverse financial-real feedback loop. At the same time, a significant fall in investment without a corresponding rise in consumption would markedly widen external surpluses.

4. **While financial tail risks are small, vulnerabilities are building, as indicated by a sharp rise in a broad measure of credit**. Removing distortions in the financial sector is instrumental to addressing domestic vulnerabilities, increasing the effectiveness of resource allocation, and facilitating a shift to a more consumer-based growth model. Existing distortions direct the flow of credit toward local governments and state-owned enterprises rather than to households and private enterprises, perpetuating high investment, misallocation of resources, and low private consumption. Meanwhile, vulnerabilities are building. Given relatively low levels of headline public sector debt, fiscal policy can likely address adverse shocks without triggering a general loss of confidence. If off-budget and quasi-fiscal activities are appropriately accounted for, the underlying fiscal position is less strong, but still at a manageable level. Thus, while China has the resources and capacity to maintain stability even in the face of an adverse shock, the margin of safety is narrowing.

Saving and Investment
(percent of GDP)



Source: IMF, *World Economic Outlook* July 2013.

II. POLICIES TO ADDRESS IMBALANCES

5. **Financial sector reform is an urgent priority to prevent a further buildup of risks**. Reducing unproductive investment and promoting consumption will require removing implicit guarantees for banks and the corporate sector and addressing factors hampering households' consumption decisions through liberalizing the financial system, improving financial regulation,

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[2] See IMF Pilot External Sector Report (2013).

and strengthening corporate governance. These reforms have become increasingly urgent to contain financial sector risks and help safeguard macroeconomic stability. Removing impediments or distortions to more market determined interest and exchange rates would also lay solid foundations toward a more open capital account.

6. **Structural reforms on multiple fronts are required to achieve more balanced and sustainable growth**. While progress has been made, the reform process needs to be accelerated, as implementation will take time. Moreover, looming demographic changes, a buildup of risks in the financial sector, local governments, and the real estate market all point to the urgency of rapid progress in transforming the growth model. Areas where further efforts are needed include:

- *State Owned Enterprise (SOE) Dividends:* The SOE sector in China is highly profitable (mainly due to industries where entry barriers are high), yet limited dividends are distributed. Instead, most of the profits are used to finance investment; recycled among subsidiaries of state holding companies; or held as retained earnings. Increasing SOEs dividends payment would reduce self-financed investment and improve financial discipline.

- *Opening Markets:* Widening labor market opportunities and raising productivity and household disposable income will require dismantling barriers to entry in many markets, (e.g., services and upstream industries) and opening them to more foreign competition.

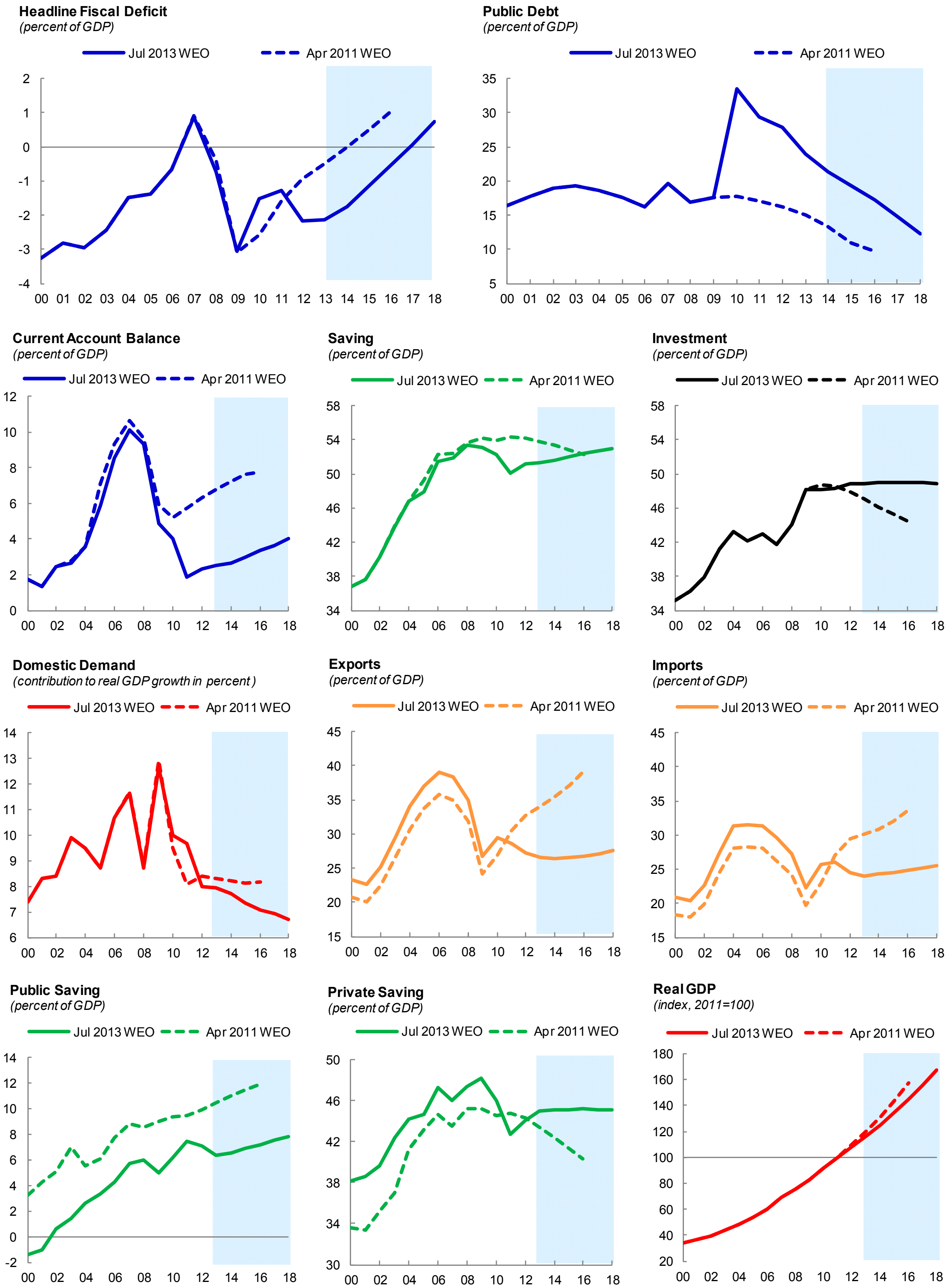
- *Social security:* Reducing precautionary saving will require further action on pensions and healthcare. Rules and regulations covering the multiple national, provincial, private and public pension programs can be simplified to encourage greater participation in pension schemes. Further reductions in out-of-pocket healthcare expenses can be achieved through lower co-pays on medical procedures and drugs, and more comprehensive coverage for catastrophic and chronic conditions.

- *Social contributions:* Marginal social contribution rates are high and should be lowered, with the revenue losses replaced by more efficient measures, such as less regressive income taxes and or value-added tax. General budget resources are better means than payroll contributions to cover substantial legacy costs as well as the welfare components of the current system.

- *Factor market reforms:* Progress has been made in raising resource prices, but more needs to be done. Raising factor input costs (such as energy, land, and water), including through taxation, will help rationalize investment, especially in energy-intensive sectors, and help protect the environment.

- *Exchange rate policy:* Allowing a more market determined exchange rate will better facilitate resource allocation, including a shift towards domestically-oriented sectors.

Figure 1. China: Selected Macroeconomic Indicators



Source: IMF, *World Economic Outlook*.

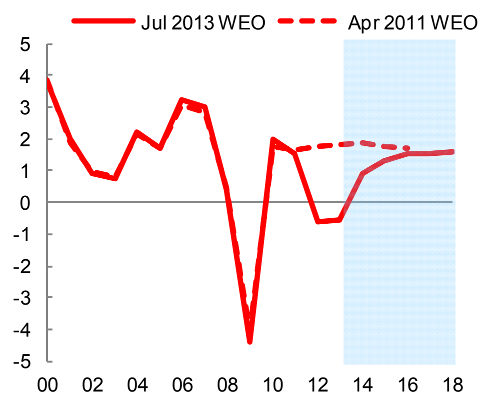
EURO AREA[1]

In the euro area, public debt has increased and the external surplus is growing in the context of weak growth following the crisis. Fiscal adjustment proceeded broadly as planned (though unevenly across countries), but stagnant growth has worsened the debt dynamics. While broadly in line with fundamentals, the external surplus masks continued wide divergences among euro area economies. The higher surplus largely reflects adjustments in deficit economies. The main risks facing the euro area are a protracted period of low growth, diverging growth and financial sector prospects between the core and the periphery, and a stalled or incomplete policy implementation. While progress has been made, further action is needed to support growth and rebalancing, including through advancing the banking union and fiscal integration.

I. IMBALANCES: DIAGNOSIS AND RISKS

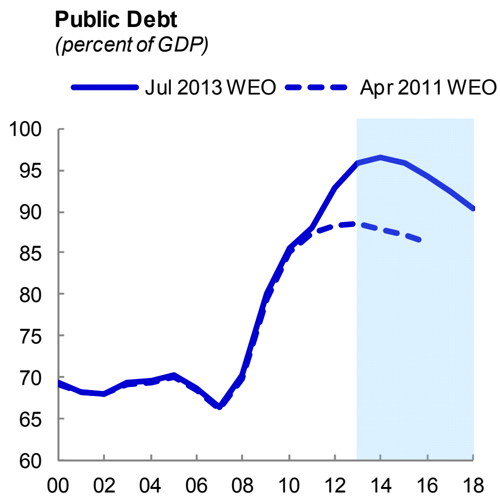
1. **Weak demand growth and, to some extent, better export performance in the periphery are leading to a significant rise in the external position but debt dynamics have worsened as fallout from the crisis.** The growth outlook for the euro area has worsened considerably compared to what it was in 2011 as private demand has not been picking up from public demand (see Figure 1). In the *periphery*, economic activity will likely remain weak for some time reflecting fiscal consolidation, bank balance sheet repair and in some cases debt overhang of corporations and households. Moreover, the negative impact of financial fragmentation in the euro area has weighed on growth and pressured external adjustment. *Core* economies have slowed down substantially as the crisis in the periphery spilled over. Meanwhile, exports are more resilient, as the adjustment in price competitiveness is proceeding. Weak growth is leading to a worsening of the debt dynamics despite substantial fiscal consolidation: public debt is now projected to peak at 97 percent in 2014—noticeably higher than earlier staff projections—before gradually easing. At the same time, import growth has remained subdued relative to export growth, and investment is weak, translating into a rising external surplus. The medium-term outlook is for a sizeable area-wide current account surplus of 2.8 percent of GDP—significantly above what was envisaged in 2011 (though, admittedly, the assessment may be affected by relatively large aggregation and forecasting errors in the euro area current account).

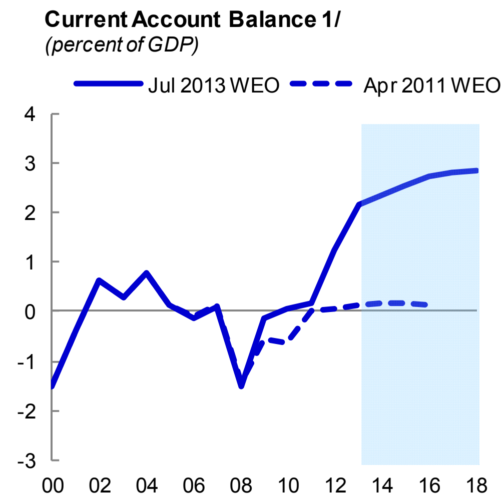
Real GDP Growth
(percent)



Source: IMF, *World Economic Outlook*.

[1] Prepared by Florence Jaumotte.





Source: IMF, *World Economic Outlook*.
1/ Current account position corrected for reporting discrepancies in intra-area transactions.

2. **Fiscal consolidation proceeded broadly as planned, though weak growth has contributed to deteriorating debt dynamics**. Despite substantial adjustment of the structural balance, debt dynamics have worsened as the euro area growth outlook deteriorated considerably relative to 2011 forecasts. Pro-cyclical fiscal adjustment has contributed to weaker growth in the short run and adverse fiscal-real economy feedback loops, temporarily worsening public debt dynamics. The fragmentation of euro area financial markets also weighs directly on the fiscal outlook through high borrowing costs for sovereigns.

3. **Rising external surpluses are emblematic of an asymmetric adjustment between the core and the periphery**. The euro area external position was balanced for many years but it masked very large intra-euro area imbalances, with large current account deficits in the periphery and very large surpluses in some core countries.[2] The crisis forced a sizable reduction in current account deficits in the periphery, driven by domestic demand compression alongside financial fragmentation that heightened financing constraints, but also by some structural improvements, including falling unit labor costs, rising productivity and trade gains outside the euro area. At the same time, external positions of surplus countries increased further, on the back of intrinsically weak domestic demand. While the external position for the euro area as a whole is broadly in line with medium-term fundamentals and desirable policies, more substantial adjustment is desirable for individual euro area economies on internal rebalancing and improving competitiveness. Real exchange rates seem moderately undervalued in surplus economies and remain overvalued in most deficit economies.[3]

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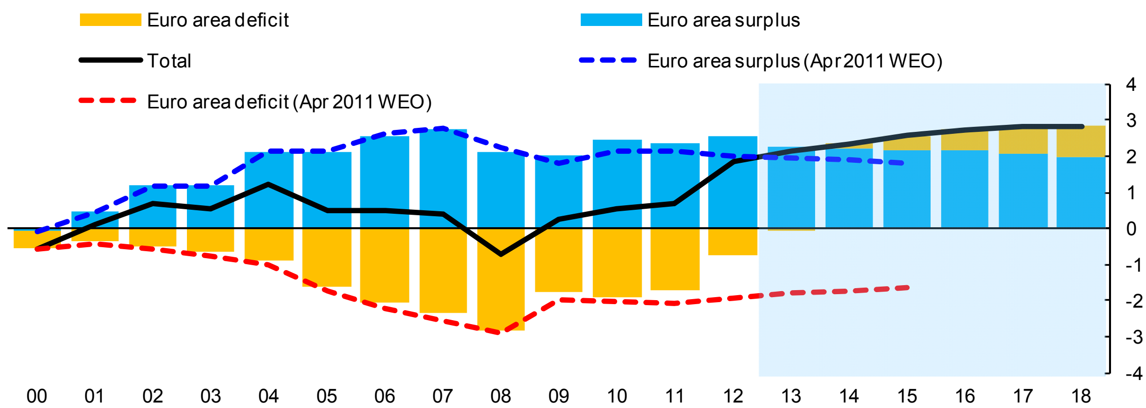
[2] See IMF Staff Reports for the G-20 Mutual Assessment Process (2012).

[3] See IMF Pilot External Sector Report (2013).

Current Account Balances in the Euro Area 1/ 2/
(percent of euro area GDP)



Source: IMF, *World Economic Outlook* July 2013.
1/ Calculated as the sum of the balances of individual euro area countries.
2/ Euro area surplus and deficit countries are based on 2000-2007 averages. Euro area deficit comprises Cyprus, Estonia, France, Greece, Ireland, Italy, Malta, Portugal, Slovak Repoublic, Slovenia, and Spain. Euro area surplus comprises Austria, Belgium, Finland, Germany, Luxembourg, and Netherlands.

4. **Weak investment is the main driver of the strong rise in the euro area current account position**. Saving is still projected to increase, driven by public saving, which is only partly offset by a decline in private saving from a peak at the height of the recession. Investment however, has collapsed well below previous projections and is only expected to recover very slowly (see Figure 1). Several factors could explain depressed investment: an adverse feedback loop between expectations of low growth and weak investment; high borrowing costs for periphery countries due to the financial fragmentation of the euro area; and, finally, uncertainty about growth prospects. The large contraction in investment raises concerns about potential growth.

5. **Key risks facing the euro area are prolonged stagnation, an increasing divergence between the core and the periphery, fiscal vulnerabilities, and stalled delivery of policy commitments**.

- *The key risk for the euro area is a protracted period of low growth in the region*. Such a scenario would lead to unfavorable public and private debt dynamics and rising imbalances, including diverging growth and financial sector prospects between the core and the periphery. The adverse impact of the ongoing public and private sector deleveraging on the real economy could also be larger than currently expected, leaving sizable output gaps and potentially spurring debt-deflation dynamics. Job skills could become obsolete due to long unemployment spells, and investment would remain subdued, reducing potential growth.

- *A stalled or incomplete delivery of euro area policy commitments is another important risk, especially because fiscal vulnerabilities remain high*. Amid diminishing market pressure and very high unemployment, there are near-term risks of incomplete policy implementation at both the national and European levels, including embracing a backloaded adjustment without a strong commitment to medium-term consolidation. Incomplete policy implementation could result in a reversal of financial market sentiment, further financial fragmentation and a re-intensification of bank-sovereign-real economy links.

II. POLICIES TO ADDRESS IMBALANCES

6. **There has been significant progress on policies aimed at reducing external and fiscal imbalances**. At the regional level, policies have been focused on easing euro area financial stresses by reinforcing the collective commitment to the monetary union—the ECB's OMTs initiative late 2012, the agreement on Greece in summer 2012, completing the ESM firewall, progress on the banking union, and strengthening of fiscal governance with the adoption of the fiscal compact and the voting of the two-pack. Despite substantial fiscal consolidation at the euro area level, progress has been uneven across countries, with some achieving rapid adjustment, while others having to slow the pace of consolidation. At the national level, governments have worked on restoring the health of banks and public finances and implementing structural reforms.

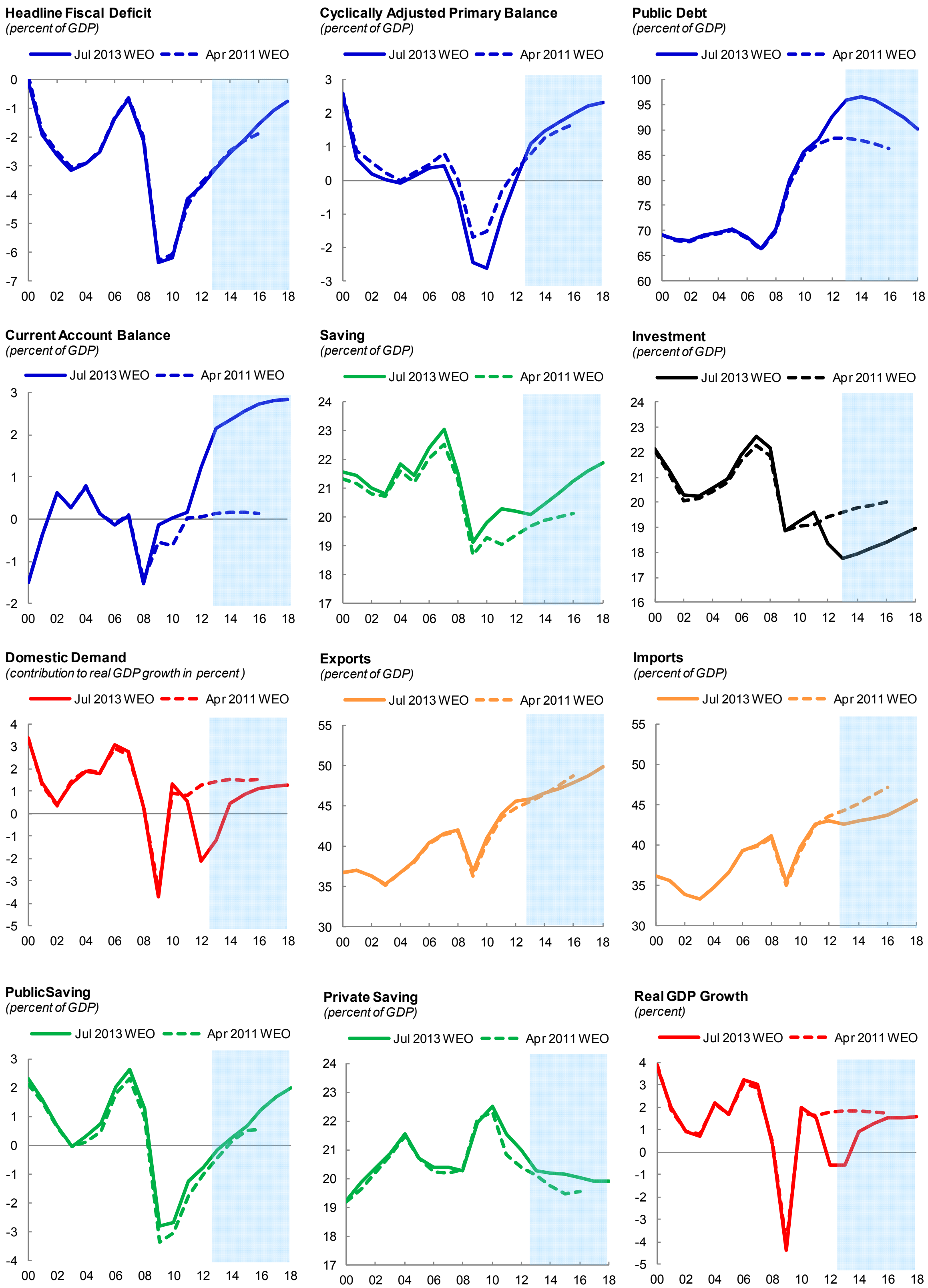
7. **Further action is needed to support growth and advance on banking union and fiscal integration**. The main recommendations are:

- *At the national level, policy action is needed on multiple fronts.* The priority should be to clean up and repair the balance sheets of banks, firms, and households to lay the conditions for a revival of credit growth and activity. This may require a stronger framework for debt work-outs and additional capital. Fiscal consolidation should proceed gradually, though at a pace that remains credible, with targets set in structural rather than nominal terms; and, the new EU regulations to improve fiscal governance should be implemented swiftly. Further progress is needed to increase competitiveness in deficit countries, including by tackling labor market duality, promoting bargaining arrangements conducive to sustainable wage developments, and implementing further product market reforms. Surplus countries would benefit from policies which increase domestic sources of growth. A real exchange rate appreciation would lead to an increase in purchasing power for their workers, and a desirable reduction of their external surpluses, while reducing the risk of a prolonged period of stagnation in the region. Over the medium term, structural reforms are needed in surplus economies to generate a more vibrant services sector.

- *At the euro area level, alleviating financial fragmentation is key to supporting growth in the periphery.* Repairing bank balance sheets is essential to restore confidence in the financial markets, reduce fragmentation and restore the monetary policy transmission. To unclog the flow of bank credit, the planned forward looking asset quality review should be comprehensive and supported by common backstops. To complement these efforts, the

ECB could implement further liquidity measures to ensure term funding for viable banks and help alleviate the effects of financial fragmentation on access of private sector to credit. At the same time, further progress toward a banking union is essential to do away with fragmentation. Alongside the decision to establish a Single Supervisory Mechanism (SSM), a single *resolution* mechanism centered on a single resolution authority with common backstops and universal deposit insurance is also needed to weaken adverse sovereign-bank links. Finally, moving toward greater fiscal integration would help address current gaps in EMU design that amplify country-level shocks into zone-wide events.

Figure 1. Euro area: Selected Macroeconomic Indicators



Source: IMF, *World Economic Outlook*.

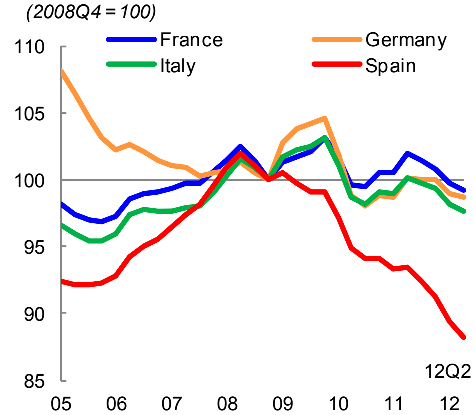
FRANCE[1]

In France, the outlook for public debt has deteriorated, and external imbalances have narrowed on the back of weaker growth. A protracted period of slow growth could undermine fiscal consolidation efforts. Going forward, a more measured pace of structural fiscal adjustment is appropriate in the near term and it should be backed by well-specified expenditure containment measures over the medium term to anchor credibility. Reform priorities should be aimed at product and labor markets to strengthen competitiveness and raise employment and potential output.

I. IMBALANCES: DIAGNOSTICS AND RISKS

1. **External imbalances are expected to narrow but in the context of weaker domestic demand**. After declining in the aftermath of the crisis, saving has improved, led by public sector, while investment, following a temporary increase in 2011, has declined—both weighing appreciably on domestic demand (Figure 1). Exports have rebounded, as the ULC-based real effective exchange rate has improved somewhat, partly due to France's weaker cyclical position, but underperformed compared to previous projections. Against rising unemployment rate weak demand has compressed imports. Accordingly, the current account deficit is projected to narrow gradually towards zero in the medium term. The external position however, appears moderately weak compared to medium-term fundamentals and desirable policies.[2] There is a need to improve cost and non-cost competitiveness, through productivity enhancing reforms. Going forward, the "Crédit d'impôt compétitivité emploi" should help reduce labor costs, at least temporarily. The economic impact of the recently adopted labor market reform is uncertain because much depends on implementation.

ULC-based Real Effective Exchange Rate 1/
(2008Q4 = 100)



Sources: Haver Analytics; and IMF, INS.
1/ Against a panel of 36 countries: EU 27 + Australia, Canada, United States, Japan, Norway, New Zealand, Mexico, Switzerland, and Turkey.

2. **The outlook for public debt has deteriorated in a context of slower activity**. Despite some slippages (e.g., exceptional factors related to financial sector), fiscal

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[1] Prepared by Joong Shik Kang.

[2] The External Balance Assessment methodology (from the IMF Pilot External Sector Report (2013)) does not find evidence of a meaningful exchange rate gap, but finds evidence of a meaningful current account gap, which according to EBA comes from the residuals rather than policy gaps.

consolidation continued broadly in line with previous projections, with a structural adjustment of 2 percent of GDP in 2011–12 and an additional 1.8 percent of GDP assumed in the 2013 budget. Nevertheless, amid a deteriorated macroeconomic environment, the outlook for public debt has worsened relative to 2011 projections. The debt-to-GDP ratio is projected (as of July 2013) to peak at 94 percent of GDP in 2015, higher than envisaged in 2011.

3. **Reducing fiscal vulnerabilities remains key for France, both from a national and euro area perspective, but the risk of a protracted weak growth poses challenges**. Sovereign and financial sector risks have diminished over the last two years, and banks' capital and liquidity buffers should suffice to face renewed tensions, provided they are not systemic. However, a protracted period of slower growth in France, as well as the euro area as a whole, could undermine the authorities' effort on fiscal consolidation.

4. **While moderate external deficits do not pose direct risks, they are not desirable for France at this stage**. Despite relatively favorable demographics, France should not run large current account deficits for extended periods. Also, the external sector should support growth to facilitate the needed fiscal consolidation.

5. **Guarding against financial instability remains important**. Although financial stability risks have abated considerably and French banks have improved funding structures and implemented deleveraging plans, they remain exposed to wholesale funding and the euro area periphery risks. Also, reemergence of financial stress could impact French sovereign yields and disrupt funding markets even if France has enjoyed a relatively safe haven status.

II. POLICIES TO ADDRESS IMBALANCES[3]

6. **Measured fiscal consolidation should be coupled with a strong commitment to a medium-term plan with measures concentrated on the expenditure side**. Limiting fiscal pro-cyclicality is of the essence. While over the near term, the pace of fiscal consolidation should be eased, substantial consolidation efforts over the medium term are needed to restore health to public finances. A strong commitment to targeting more explicitly expenditure growth would strengthen fiscal credibility and help secure sustainability. In that regard, entitlement reforms, if well designed (e.g., shifting from universal to means-tested social benefits), could help as they may detract less from near-

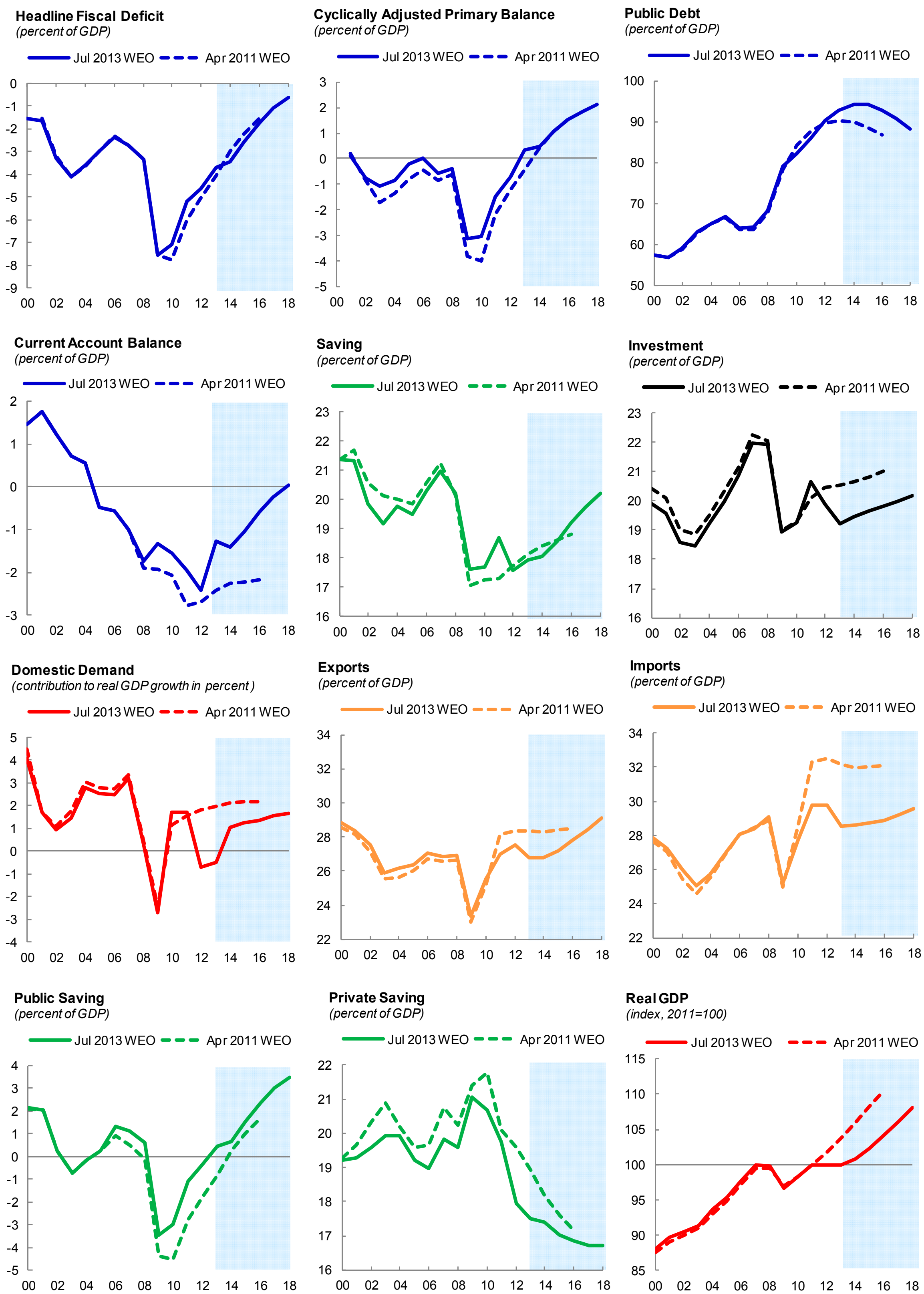
[3] The thrust of staff's policy advice remains broadly the same as in the 2011 France Sustainability Report. For further discussion on policies, see also the 2013 France Article IV staff report.

term growth than across the board spending cuts, while help achieve sustainability. The adjustment should focus on quality, rather than quantity, increasing efficiency of spending (e.g., there is potential for large efficiency gains in health and education spending) and containing spending growth (e.g., by reducing the inefficiencies related to the overlapping responsibilities across levels of government), to anchor credibility and put public finances on a sustainable path.

7. **A lasting reduction of external imbalances and raising potential output would require a resolute acceleration of structural reform**. The key to improved outcomes in terms of growth and employment lies in reforming the labor market so as to increase the capacity of enterprises to invest, adapt, and create jobs. The recently agreed labor market reform opens the door for negotiating more flexible working arrangements at the enterprise level, but its coverage is limited to firms facing difficulties and to wages above a certain threshold; the reduction of the labor tax wedge (through a corporate income tax credit) will bring about some relief in labor costs. Liberalization in the services sector, and greater competition in product markets generally, would enhance the impact of labor market reform on productivity and employment. Strong action on the structural reform front could dissipate current policy uncertainty, unlocking pent-up business investment and private consumption.

8. **Financial sector priorities should aim at solidifying the progress achieved to safeguard financial stability while ensuring the efficiency of financial intermediation**. Reaching regulatory liquidity and funding ratios remains a challenge for many French banks, requiring continued improvement in funding structures, higher deposit collection and a move toward more market-intermediated credit. Given ongoing international regulatory changes, better alignment of tax incentives on financial products with bank regulatory objectives would enable a more effective intermediation of saving to the economy. Managing the vulnerabilities inherent to the French banks' exposure to wholesale funding and the euro area periphery is critical to safeguarding financial stability.

Figure 1. France: Selected Macroeconomic Indicators



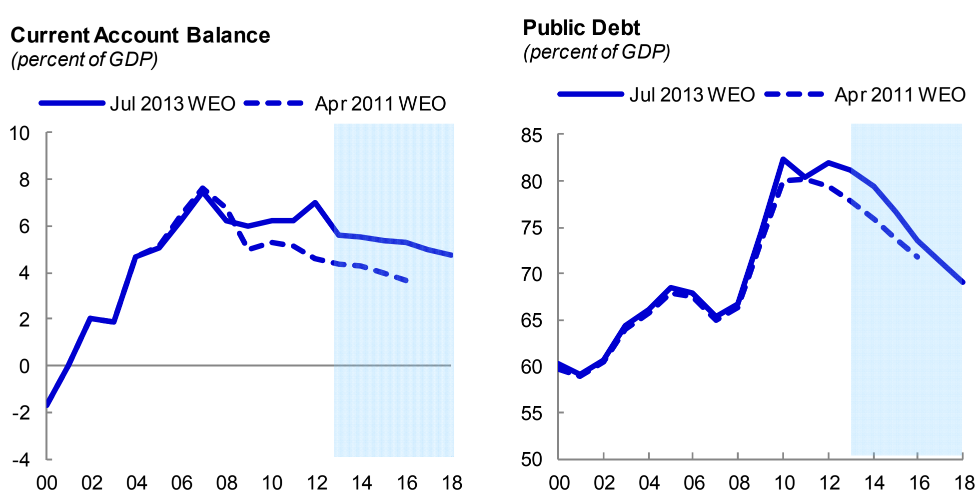
Source: IMF, *World Economic Outlook*.

GERMANY[1]

While fiscal adjustment is mostly accomplished in Germany, the medium-term outlook is for wider current account surpluses than envisaged earlier, which makes rebalancing more challenging. The large external surplus, though not a vulnerability per se, is partly a symptom of structurally weak domestic demand and appears stronger than that implied by medium-term fundamentals and desirable global policy settings. Against this background, the main risk facing the German economy both in the short and medium run is low growth. The large external surplus cannot easily be attributed to policy distortions or market failures. Nevertheless, Germany would benefit from boosting internal sources of growth, which would also boost the region's growth. This would require tax and financial system reform and service sector deregulation.

I. IMBALANCES: DIAGNOSIS AND RISKS

1. **In a context of weak investment and fiscal consolidation, the external surplus has remained high**. Fiscal rebalancing is mostly accomplished, with the fiscal balance already in line with commitments under the Fiscal Compact. Progress on reducing the debt-to-GDP ratio has been a bit slower, due in part to financial sector and EU support measures. However, if the deficit is kept at the current level, and support to the financial sector and to the EU does not increase significantly, the debt-to-GDP ratio is expected to fall substantially over the medium-term (see Figure 1). In a context of weak growth and rising public saving, the projected narrowing of the external surplus has not happened: instead, the current account surplus is estimated to have increased further between 2011 and 2012 to 7 percent of GDP, a higher level than projected during the 2011 exercise, including over the medium term.

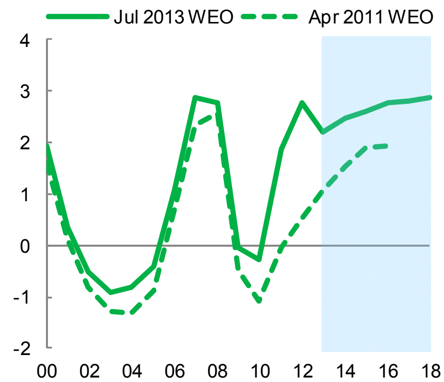


Source: IMF, *World Economic Outlook*.

[1] Prepared by Florence Jaumotte.

2. **Large and increasing external surpluses are partly cyclical and partly structural**. The recent rise in the current account is partly due to unexpectedly weak investment but also to stronger public saving, as fiscal imbalances were reduced. Part of the current account surplus is expected to reverse over the medium term, as growth becomes increasingly more driven by domestic demand amid robust labor market and a gradual recovery of investment. However, the current account surplus will remain very large over the medium-term, reflecting structurally low investment and to a lesser extent an elevated household saving rate. The cyclically-adjusted current account is stronger than implied by fundamentals and desirable policies and would still remain above equilibrium in the medium term despite the natural rebalancing process. The real effective exchange rate at the end of 2012 was about 8 percent below its historical average; and various methodologies point to moderate undervaluation relative to the value consistent with medium-term fundamentals and appropriate policies.[2]

Public Saving
(percent of GDP)



Source: IMF, *World Economic Outlook*.

3. **The sizeable external surplus cannot easily be attributed to policy distortions or market failures**. While it is difficult to pin down market failures or policy-induced distortions that explain the large current account surplus, a number of country-specific factors have been advanced that help explain it:[3]

- *Strong competitiveness* based on a favorable product specialization and a long period of wage moderation;
- *Elevated household saving* on account of population ageing and precautionary saving induced by the pension and labor market reforms of the late 1990s and early 2000s;
- *Weak investment* reflecting the unwinding of the post-reunification construction boom and uncertainty about economic prospects; and
- *Low productivity growth in the non-tradable sector* has also been highlighted as a factor depressing investment and consumption and therefore raising the current account. This last factor is amenable to policy action.

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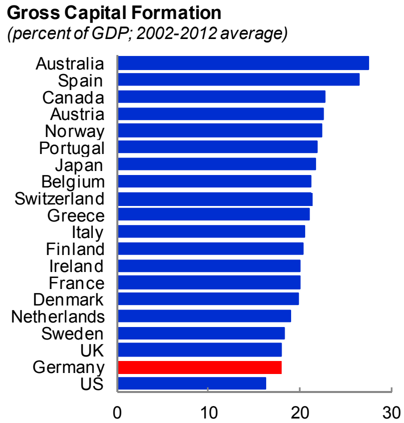
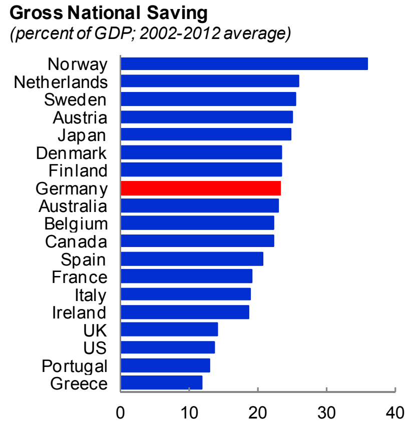
[2] See IMF Pilot External Sector Report (2013).

[3] See IMF Germany Sustainability Report (2011).





Source: IMF, *World Economic Outlook* July 2013.

4. **The main risk facing the German economy is that of low growth**. *In the near term*, there are risks to growth from negative spillovers from the euro area crisis. In this light, Germany's current policy stance which involves a small fiscal expansion seems appropriate. Over the *medium term*, the reliance on external sources of growth and weak underlying domestic demand keep the economy vulnerable to external shocks. Stronger internal demand in Germany would also help mitigate risks of a weaker growth path for the euro area, especially at a time when deficit members have to rely less on domestic demand and more on external demand for growth.

5. **Fiscal vulnerabilities remain very moderate**. Germany benefits currently from a safe haven status. But a protracted period of economic stagnation in the region and in Germany could make it more difficult to reduce the public debt going forward. Keeping a solid fiscal position is key given Germany's anchoring role in the euro area.

II. POLICIES TO ADDRESS IMBALANCES

6. **Staff's policy advice remains to boost internal demand, in particular investment**. Policies that would increase internal demand and lead to some real exchange rate appreciation (through higher relative wages and prices) are desirable from a welfare perspective in countries, such as Germany, with large external surpluses. They would lead to an increase in purchasing power for workers, a desirable reduction of the current account surplus, and more resilient growth through diversifying its drivers. This would be also beneficial for the region more broadly, by boosting growth and possibly facilitating the rebalancing of deficit countries.

7. **Reforms of the tax and financial system and service sector deregulation could help boost domestic demand**. Policy actions should be taken in three areas:

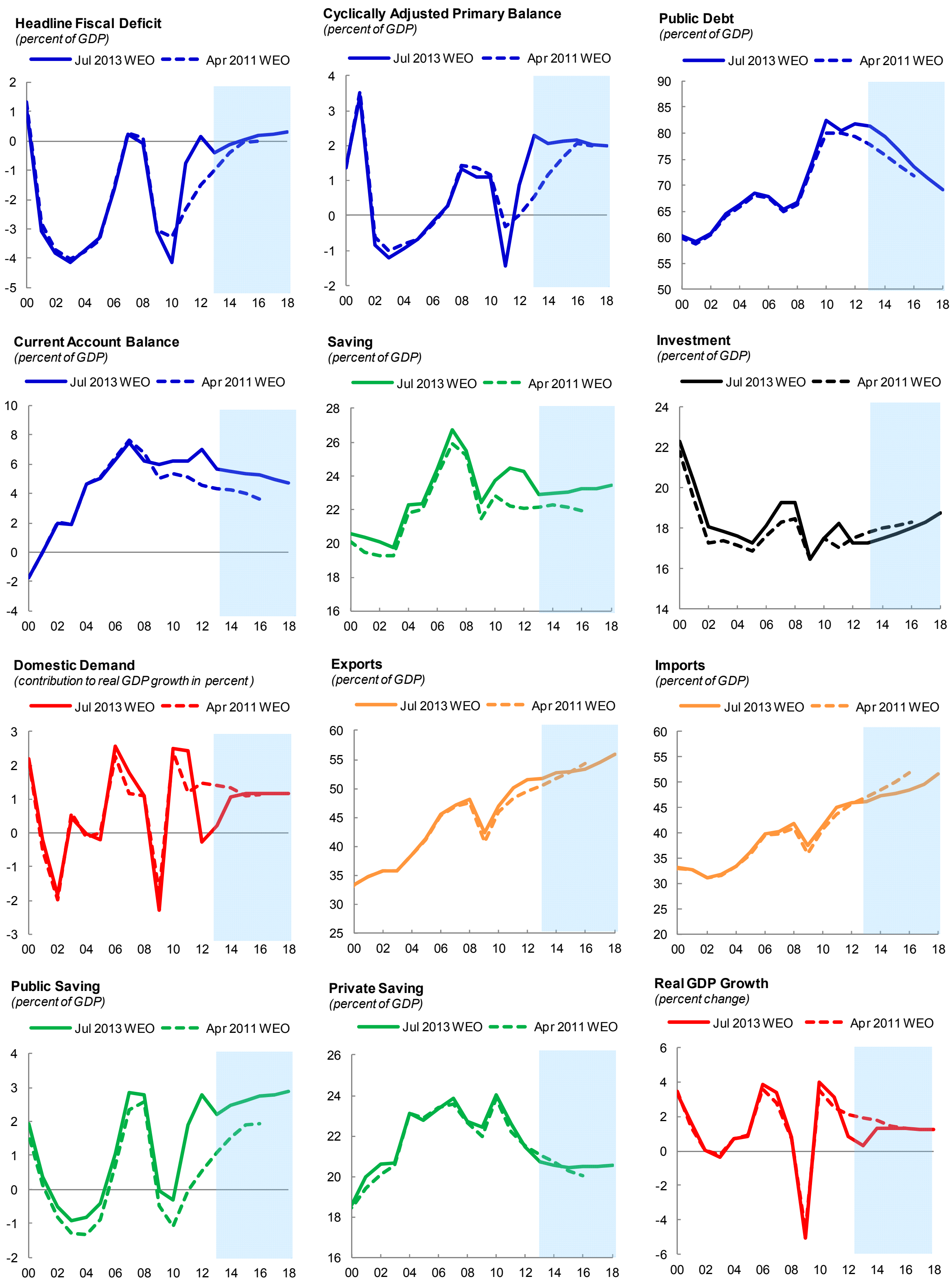
- *Tax reform:* priorities include reducing labor taxes at the participation margin to increase labor force participation, particularly among women, and potential growth (e.g., the introduction of in-work and earned income tax credit programs and a reform of the regime of income splitting to encourage the participation of secondary earners). Further improvements in the corporate tax regime would also stimulate investment and growth, and potentially reduce the current account surplus. In particular, a reduction in the debt bias from interest deductibility would promote equity investments. However, tax reforms should be paid for within the current budget envelope.[4]

- *Financial market reform*: broadening the channels of financial intermediation outside traditional banking, using so-called arms-length finance, would facilitate the allocation of resources towards innovation and new engines of growth. It would also stimulate investment and help reduce the current account. Changes to regulation and supervision would have to keep pace with the development of a more arms-length system in order to ensure financial stability.

- *Services sector productivity:* streamlining regulation in the services sector and improving education would raise productivity growth and thereby investment incentives and consumption (through an increase in permanent income). Again, this would help boost domestic demand and growth, and lower the current account.

[4] For instance by eliminating concessions in the VAT, raising property and inheritance taxes and cutting some poorly targeted social benefits. There is also scope for increasing the efficiency of education spending.

Figure 1. Germany: Selected Macroeconomic Indicators



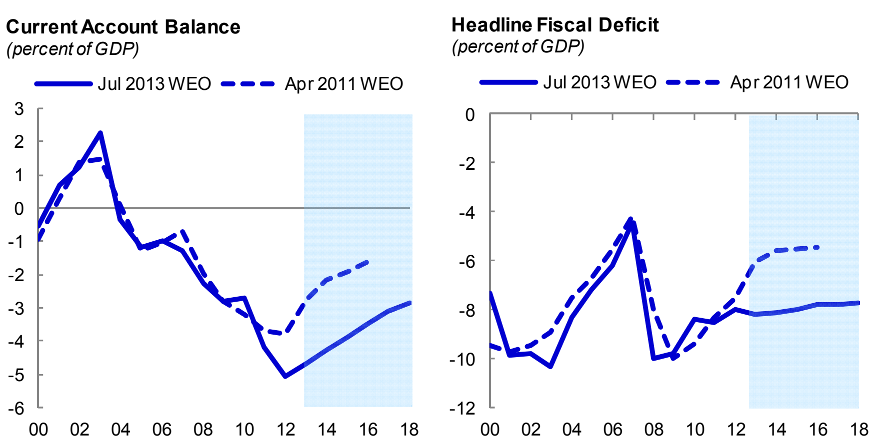
Source: IMF, *World Economic Outlook*.

INDIA[1]

Against a backdrop of lower growth and higher inflation, India is saddled with large fiscal and external deficits. Fiscal imbalances reflect high expenditures and low revenues, aided by financial restrictions that have shielded deficits from market pressure. External deficits have risen as supply bottlenecks have increased import demand and weighed on export performance. To address fiscal imbalances, policies should center on sustained consolidation through making tough choices on tax overhaul and subsidy reform, while further relaxing financial restrictions. To raise potential output and stem the deterioration of the current account in the medium term, policies should alleviate supply bottlenecks, reduce policy uncertainty, and improve the business climate.

I. IMBALANCES: DIAGNOSIS AND RISKS

1. **Weaker macroeconomic performance and widening "twin" fiscal and external imbalances have raised policy concerns**. Relative to 2011, the macroeconomic outlook has deteriorated on several fronts (see Figure 1). Growth has declined sharply from an average of 8½ percent in the decade prior to the crisis to 5 percent in 2012, on the back of supply constraints and less policy space. Supply constraints and rising regulatory uncertainty have weighed on business confidence and corporate profitability and, in turn, investment. Despite weaker investment, external deficits have widened through falling saving—leaving a weaker path for fiscal and external imbalances. Inflation has remained high. Households' inflation expectations are running at double digits on the back of high food inflation, persistent supply-side bottlenecks, and large fiscal deficits. With slower growth and persistent twin deficits, investor sentiment has weakened and risks have risen alongside recent market turbulence.



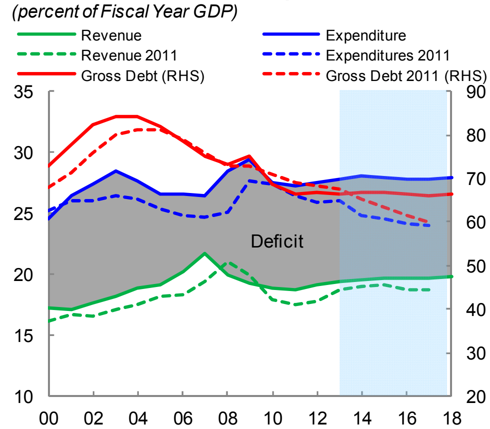
Source: IMF, *World Economic Outlook*.

[1] Prepared by Samya Beidas-Strom.

2. **The outlook for public finances has deteriorated on the back of a slowing economy**. Under current projections, public debt and the headline fiscal deficit will likely stabilize over the medium term at high levels—about 65 and just under 8 percent of GDP, respectively, on the heels of the large crisis stimulus. In the context of a substantial slowdown and downward revisions to potential growth, the announced medium-term consolidation path, amounting to 3 percent of GDP by 2016 will be challenging. The outlook therefore, is for large fiscal deficits (about 7–8 percent of GDP) to persist albeit narrowing gradually, as expenditures remain too high, while revenues too low.[2]

- *Expenditures are too high*. While the recent liberalization of diesel prices and quantity limits on subsidized LPG bode well for some reorientation away from costly untargeted transfers and subsidies along with other unproductive spending towards investment, this will be undertaken gradually. For example, an expansion in food subsidies is planned. In addition, contingent liabilities and debt restructuring plans arising from loss-making energy-related SOEs and public bank recapitalization needs are sizeable, but will be spread over the medium term.

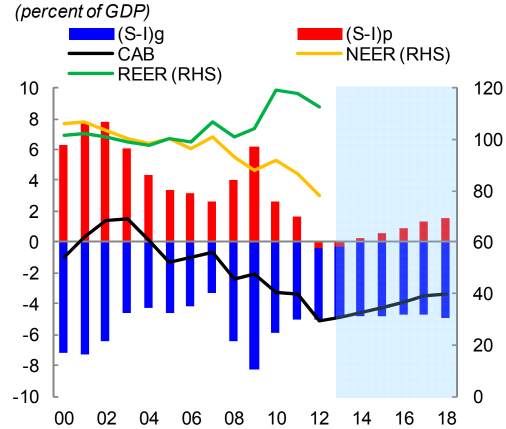
Government Revenue and Expenditure
(percent of Fiscal Year GDP)



Source: IMF, *World Economic Outlook* July 2013.

- *Revenues are too low*. Revenue to GDP has fallen below peers, with weak activity a contributing factor. Pending passage of legislation for the Goods and Services Tax (GST) will be the most important reform, boosting growth through the creation of a single Indian market. But while some progress has been made, the needed legislative changes require a qualified majority and implementation is probably unlikely in 2013/14.

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



Source: IMF, *World Economic Outlook* July 2013.

3. **Near-term fiscal risks are low due to captive domestic debt markets**. Commitment to gradual consolidation is strong. In addition, the statutory liquidity requirement (SLR) on banks to hold 23 percent of their liabilities in government paper and the largely closed capital account lower near term fiscal risks—albeit not without potential

[2] See India 2011 Sustainability Report.

adverse medium term repercussions for public finances and growth prospects.[3] To minimize these adverse effects, the SLR should be lowered further as fiscal consolidation proceeds. Also, a loose fiscal stance has not helped in lowering inflation and reducing the current account deficit. Accordingly, if durable fiscal and structural reforms remain elusive, fiscal risks could rise and depress sentiment.

4. **Despite falling investment, external imbalances have risen, driven by falling savings**. The current account deficit peaked at about 5 percent of GDP last year, as the decline in private and public saving outpaced the fall in investment.[4] Part of the fall was cyclical, on the back of a protracted growth slowdown and capacity bottlenecks which have reduced corporate profitability and investment.[5] However, persistently high inflation since 2008/09, combined with regulated deposit rates, have also contributed, as real interest rates turned negative, inducing households and corporates to shift into gold as a store of value or an alternative financial asset.[6] Also, strong demand for imported commodities (e.g., oil, coal, and gold) given structural supply bottlenecks in power and mining and high retail inflation, along with large and widespread subsidies, led to a high import bill, while deteriorating competitiveness has weighed on exports.

5. **The outlook for the current account deficit has deteriorated and near-term external financing risks have risen**. While the deficit is projected to narrow somewhat on weaker commodity prices, this is unlikely to have material effect unless public savings rise (including through subsidy reforms) and policy measures to durably ease domestic supply bottlenecks and improve the business climate are undertaken. From a medium-term perspective India's external position is broadly in line with medium term fundamentals and desirable policies.[7] Prior to the crisis, funding the current account had been tilted towards equity rather than debt, with FDI and equity portfolio flows accounting for over 60 percent of inflows. More recently, the mix has shifted in favor of debt in a low foreign interest rate environment, with a steady uptick in debt liabilities in the overall International Investment Position, although external debt (at 21 percent of GDP) is in the middle of the range of its peers. Alongside recent capital account pressures, foreign exchange reserve cover of imports has declined (from 12 months in 2007 to about 6 months in 2013).

[3] The effective SLR is estimated to be higher—at about 50 percent of financial sector liabilities—see the 2013 Article IV Consultation, Box 7.

[4] If gold imports are excluded, the current account deficit would have been halved.

[5] Indian corporates are now amongst the most leveraged across EM peers (see 2013 Article IV Staff Report; Annex I).

[6] While CPI and WPI inflation have moderated to 9 and 5 percent respectively in April 2013, household inflationary expectations remain elevated at 11–12 percent and wage growth continues to be in the high single digits.

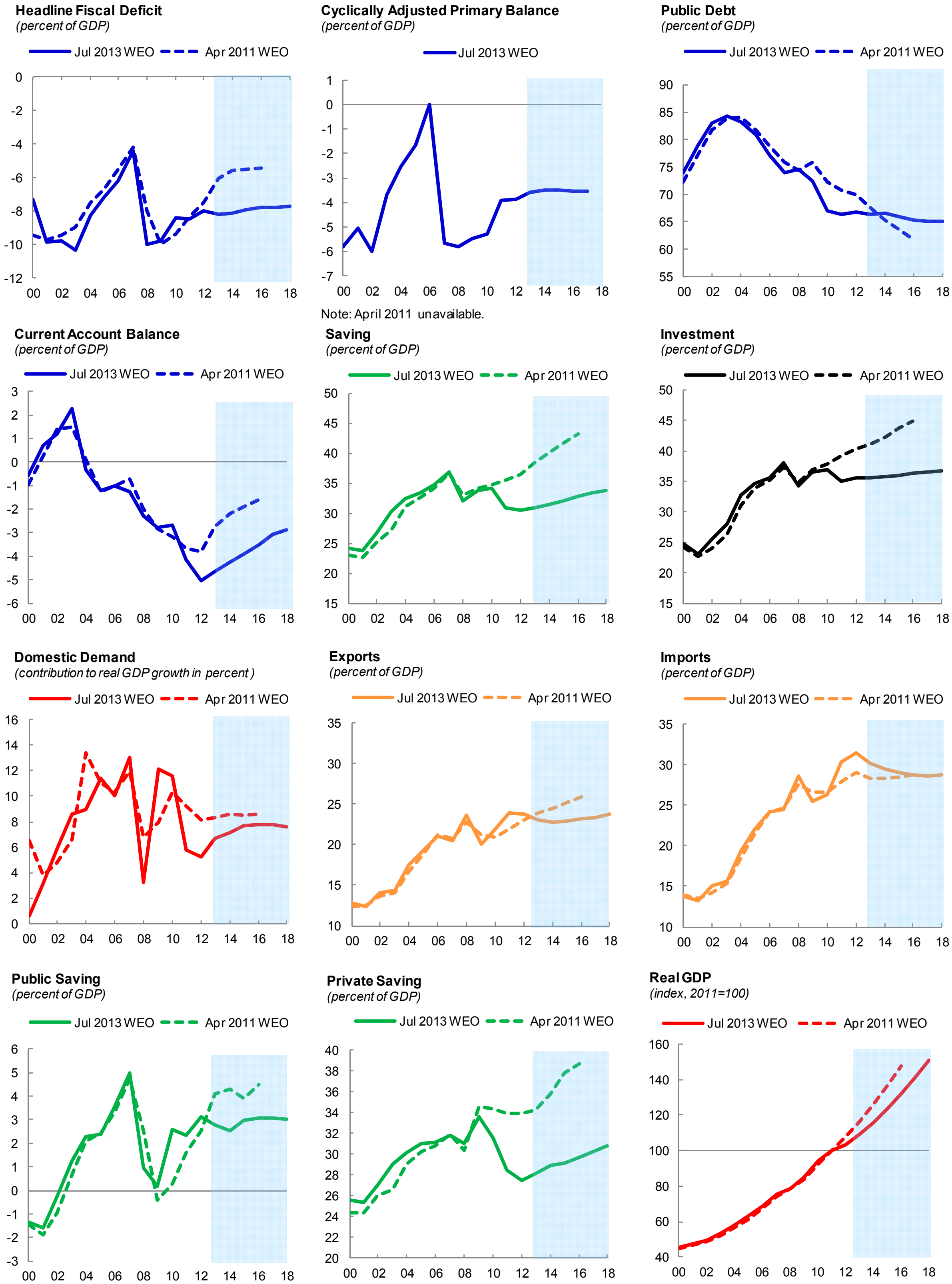
[7] See IMF Pilot External Sector Report (2013).

II. Policies to Address Imbalances

6. **Addressing fiscal imbalances requires tackling tough choices on tax and subsidy reforms, while further relaxing financial restrictions**. *Revenues* should be increased by broadening and overhauling taxes—through the creation of the more efficient single GST for the whole Indian economy, would have positive effects on growth. If agreement on the GST is not reached or is delayed, then raising excise taxes along with other reforms including approving a new Direct Tax code with streamlined/smaller deductions would be needed. *Expenditures* efficiency should be increased by reorienting spending away from untargeted subsidies toward capital and social spending while trimming the overall envelope. Coupled with further reduction of financial restrictions, this would lower the burden on monetary policy, improve resource allocation, and boost growth.

7. **Removing supply bottlenecks and improving the business climate would help reduce medium-term external imbalances, lift growth, and improve fiscal dynamics**. Policies should focus on several areas. In particular, addressing near-term supply bottlenecks remains important—including by accelerating government approvals and implementation of projects; moving towards market-based pricing and allocation mechanism of natural resources; restructuring the debt and reducing the losses of the state power distribution companies; and reducing untargeted subsidy spending to free fiscal space for capital and social spending. More broadly, there is a need for reforms to facilitate investment and broaden financial services to encourage better intermediation of private saving to bring both saving and investment back to their (higher) pre-crisis levels.

Figure 1. India: Selected Macroeconomic Indicators



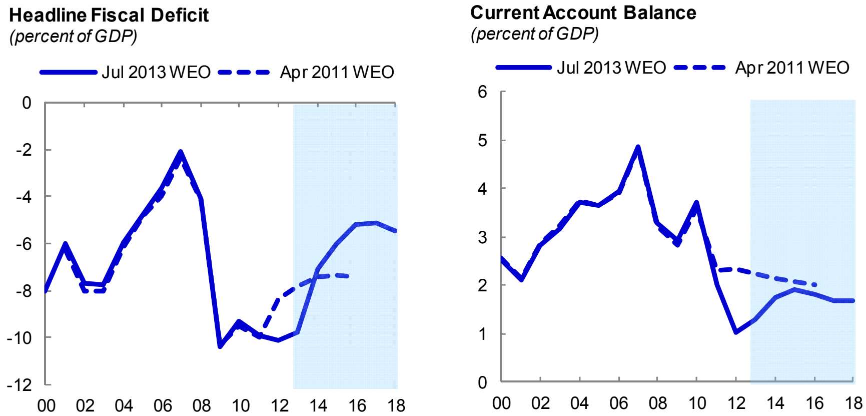
Source: IMF, *World Economic Outlook*.

JAPAN[1]

In Japan, key imbalances continue to center on unsustainable public finances in the context of persistently weak growth, steady deflation, and adverse demographic trends. To cushion growth, fiscal and external imbalances more recently have acted as "shock absorbers." Fiscal deficits have been larger than expected and external surpluses have moderated in the face of country shocks, despite the recent depreciation of the yen. Very large fiscal deficits and high debt pose key sustainability risks, which are interrelated to financial stability risks, with possible global spillovers. To end deflation and revive growth, the authorities have recently adopted a comprehensive reform strategy, but this comes with significant risks and should be accompanied by further consolidation—anchored by a strong and credible medium-term fiscal roadmap and structural reform strategy.

I. IMBALANCES: DIAGNOSIS AND RISKS

1. **To cushion the impact on growth, fiscal deficits have widened while external surpluses have moderated following the crisis and earthquake**. Following the 2011 Great East Japan earthquake and related reconstruction, high external surpluses have moderated, while high fiscal deficits have widened further to support growth in the face of these shocks (see Figure 1). Growth has evolved largely as envisaged in 2011, but fiscal deficits have been larger than expected (about 10 percent of GDP), leading to a further rise in public debt (net debt-to-GDP ratio exceeded 134 percent in 2012). The current account has narrowed more than expected to 1 percent of GDP; and the trade balance moved into deficit for the first time since 1980, in part due to high energy imports, disrupted exports after the earthquake, and increased public spending since the financial crisis.



Source: IMF, *World Economic Outlook*.

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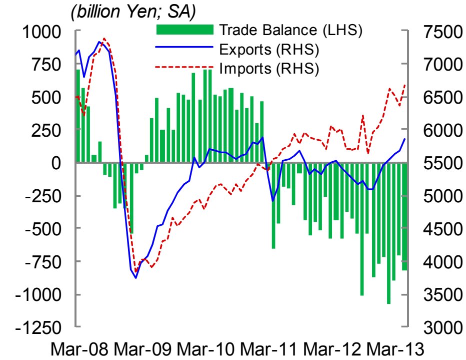
[1] Prepared by Joong Shik Kang.

This represents some shift from the past pattern of key imbalances. Historically, despite substantial public dissaving, Japan's external balance has remained in sizeable surplus, as national saving and investment have generally declined at a similar pace. While the decline in saving has been led by the public sector, the trend decline in investment has been driven by the private sector.[2]

2. **External surpluses are expected to rebound gradually, as certain factors may continue to exert downward pressure**. Since the onset of the financial crisis, the rapid increase in public expenditures and trade-related factors has resulted in narrowing the current account surplus. Acting partly as a buffer to help smooth the disruptive economic impact of the earthquake, however, part of this narrowing in the external surplus over the past two years is expected to reverse as the effects of the country-specific shock fade. High energy imports following the earthquake though may not be entirely temporary given the time needed to reopen nuclear plants. So despite some export growth, on the back of the recent sharp depreciation of yen, the trade balance is expected to remain in deficit over the medium term, though a (small) external surplus would still remain owing to the positive income balance. From a medium-term perspective, the current account is assessed to be moderately stronger than implied by fundamentals and desirable policies (and the exchange rate moderately undervalued), but this assessment is subject to an unusual degree of uncertainty in light of a major shift in the overall macroeconomic framework that has taken place since 2012.[3]

Trade Balance

(billion Yen; SA)



Sources: CEIC; and IMF staff calculations.

3. **Unsustainable public finances remain Japan's core imbalance and a major area of medium-term concern**. Very large fiscal imbalances have been driven by low growth. Persistently low GDP growth reflects the confluence of a trend decline in total factor productivity, a shrinking labor force, low capital investment and delayed policy adjustment after the collapse of asset markets in 1991.[4] This has spurred public spending and depressed tax revenues over many years, together with no major tax (revenue-raising) reforms in over twenty years, perpetuating a cycle of adverse debt dynamics. Most recently, as a part of the "three arrow strategy (so-called "Abenomics")" to end deflation and low growth, the

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[2] Private capital formation fell from a high of 26 percent of GDP in 1990 to 19 percent in 2008, reflecting deep structural changes, including the unwinding of overinvestment in the bubble era, protracted corporate deleveraging, shrinking workforce, and expectations of low growth.

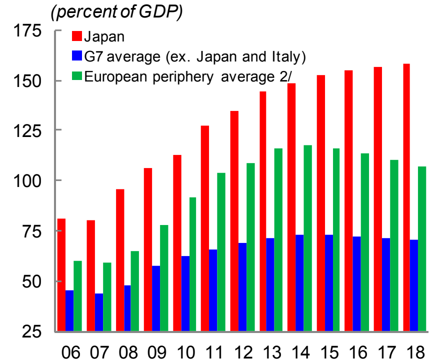
[3] See IMF Pilot External Sector Report (2013).

[4] See 2011 Japan sustainability report, http://www.imf.org/external/np/g20/map2011.htm.

authorities introduced additional fiscal stimulus of 1.4 percent of GDP for 2013–14, increasing public borrowing. However, high private saving, strong home bias, and stable institutional investors have enabled low-cost financing of high fiscal imbalances to persist thus far. A durable improvement in the fiscal outlook partly hinges on the success of reforms to boost private-sector led growth and higher inflation.

4. **If recent policy actions prove successful, the budgetary outlook will improve somewhat.** The authorities have introduced several consolidation plans, including the increase in consumption tax in 2014–15, a withdrawal of stimulus, and curbs to non-social security spending. On the back of these measures, together with assuming an improved nominal GDP outlook on a new comprehensive reform package, the medium-term debt outlook has been somewhat improved relative to the previous assessment in 2011, but the fiscal imbalance still remains high. The fiscal deficit is projected to narrow gradually to 5½ percent of GDP by 2018, but the net government debt-to-GDP ratio would further rise to about 155 percent during this period.

WEO Baseline Projections for General Government Net Debt 1/
(percent of GDP)



Source: IMF, *World Economic Outlook* July 2013.
1/ Net debt is defined as gross debt minus financial assets.
2/ Greece, Ireland, Italy, Portugal and Spain.

5. **High fiscal imbalances pose the most significant risk to domestic stability and carry risks for global external positions.** The fiscal position is extremely vulnerable to even a moderate rise in yields. Staff estimates show that an increase in JGB yields by 100 bps over the next 5 years would lead to a long-term net public debt-to-GDP ratio of more than 150 percent of GDP even after a 10 percentage points of GDP adjustment in fiscal balances.[5] Moreover, fiscal sustainability and financial stability risks are interrelated—as bank holdings of JGBs have more than doubled since the crisis.[6] The 2012 spillover analysis shows that a sharp rise in JGB yields could lead to sizable fall in global output if global risk premia also rose substantially in line with historical correlations.[7] Successful implementation of a new comprehensive reform strategy

[5] See Lam, Raphael W. and Kiichi Tokuoka, 2011, "Assessing the Risks to the Japanese Government Bond (JGB) Market," IMF Working Paper, WP/11/292 (Washington: International Monetary Fund).

[6] The recent FSSA points out heightened concerns about possible feedback from vulnerabilities in fiscal sustainability and financial stability. In a scenario with a sharp increase in JGB yields coupled with a broader growth shock (e.g., a global downturn), asset prices would fall and borrowing costs would rise, leading to a deterioration of credit quality and a worse outcome for growth that will then challenge financial stability. See 2012 FSAP Update for Japan, http://www.imf.org/external/pubs/cat/longres.aspx?sk=26137.0.

[7] See 2012 Spillover Report, http://www.imf.org/external/np/pp/eng/2012/070912.pdf, and its background papers, http://www.imf.org/external/np/pp/eng/2012/071012.pdf.

("Abenomics"), through higher nominal GDP growth and aggressive monetary easing by the BoJ, would lower the risks stemming from these imbalances, but also carry accompanying risks (see below).

II. POLICIES TO ADDRESS IMBALANCES (& GROWTH)

6. **Under the new monetary policy framework, exceptional easing is planned to end deflation and support growth**. The BoJ seeks to double the monetary base by end-2014, primarily through JGB purchases (*quantity aspect*). In addition, the scope of central bank purchases was widened to include bonds of all maturities—with the goal of doubling the average remaining maturity of the Bank's JGB purchases, and planned purchases of private assets (mainly ETFs and REITs) was enlarged to lower risk premia *(quality aspect)*.

7. **Unprecedented monetary easing—supported by fiscal stimulus—would boost the near-term outlook, but also carries major risks**. Hence, it is essential to complete a full package of reforms, including medium-term fiscal consolidation and growth-enhancing structural reform.[8]

- *Fiscal consolidation*: Structural fiscal adjustment (of 11 percent of GDP by 2020) is needed to place public debt firmly on a declining path. The reversal of past and current stimulus and higher consumption taxes account for half of this, provided that previous budget caps are adhered to. Thus, an added structural adjustment of 5½ percent of GDP through a mix of expenditure and revenue measures is needed. The fiscal framework should be strengthened by adopting medium-term rules to curb expenditure in the context of multi-year budgetary planning, and limiting the conditions under which supplementary budgets can be used so that hard-won savings cannot be easily spent.
- *Structural reform*: Additional reforms are also needed,[9] including (i) deregulation in agriculture and domestic services to allow for more competition, inward FDI, and productivity growth; (ii) a greater role for the financial sector to support growth by providing risk capital for SMEs and start-ups; (iii) reforms to raise the employment of women and the elderly by creating more flexible work environment and support systems; and (iv) a reduction of Japan's excessive labor market duality.

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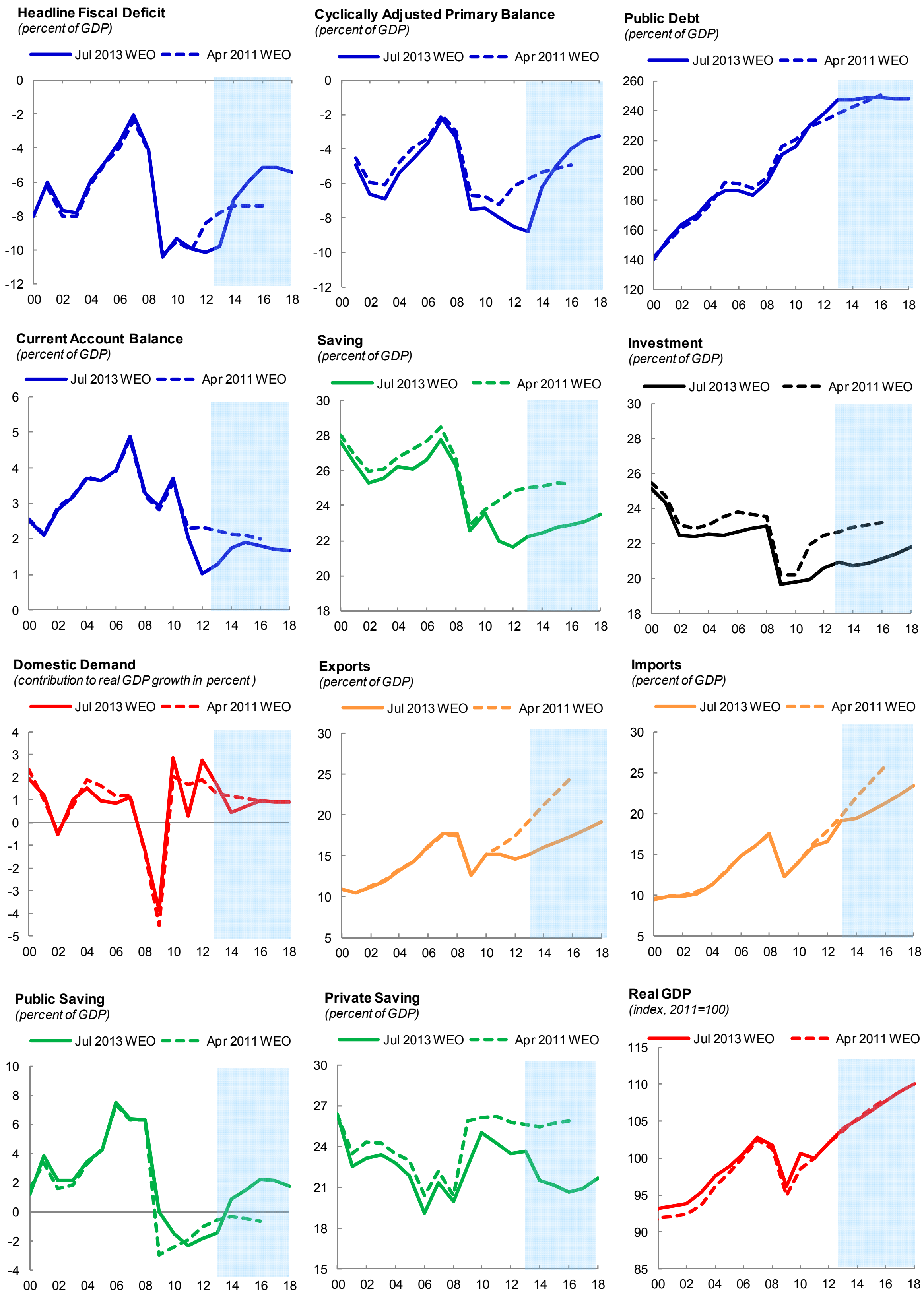
[8] See 2013 Article IV Staff Report for more details. On structural reform, a "Revitalization Strategy" for Japan was announced in mid-June.

[9] Staff estimates that Japan's growth potential will increase gradually by 0.1–0.2 percentage points as a result of Japan's participation in Trans Pacific Partnership (TPP) and higher investment as the country emerges from deflation. The effects of TPP could be larger if it becomes a catalyst for domestic reforms.

- *External adjustment*: Going forward, higher public saving from fiscal consolidation would offset a rebound of private investment supported by the new comprehensive reform strategy, leading to higher growth and a gradually improving external surplus.

Figure 1. Japan: Selected Macroeconomic Indicators



Source: IMF, *World Economic Outlook*.

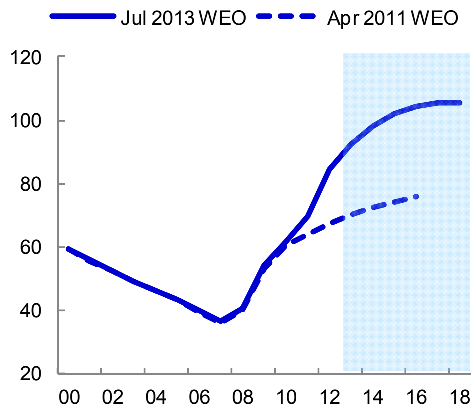
SPAIN[1]

In Spain, the economy is adjusting from external deficit to a growing surplus but high public debt continues to rise given weak growth. The correction of the external and fiscal deficits and the sharp fall in sovereign spreads were helped by strong progress on reforms since last year. But strong headwinds have kept the economy in recession amid unacceptable levels of unemployment, although there are signs the economy is stabilizing. The central risks are a protracted period of low growth and high unemployment; fiscal stress; and private sector balance sheet vulnerabilities, though there are also upside risks. Policies should focus on generating jobs and growth: making the labor market more job-friendly and inclusive; helping the private sector delever; supporting credit while safeguarding financial stability; and minimizing the drag on growth from the inevitable fiscal consolidation. Progress at the euro area level to reduce financial fragmentation and move faster to a full banking union are also critical to ease Spain's adjustment.

I. IMBALANCES: DIAGNOSIS AND RISKS

1. **Key imbalances are correcting, although weak demand has deteriorated the fiscal outlook compared to 2011**. Domestic demand has been falling and is expected to remain very subdued in the medium term, reflecting market corrections, balance sheet repair by the public and private sector, and financial fragmentation within the euro area. While weak growth, rising unemployment, and financial sector support have worsened the outlook for fiscal imbalances relative to 2011 projections, substantial adjustment has nevertheless been achieved. The fiscal deficit (excluding financial sector costs) fell sharply from 9 percent of GDP in 2011 to 7 percent in 2012, despite the interest bill increasing and the recession. The cyclically-adjusted primary balance improved by 3 percent of GDP. And in contrast to 2011, the deficit of regional governments fell sharply in 2012, with all regions reducing their deficits. Public debt is expected to stabilize in 2017–18 and fall rapidly thereafter. The current account has improved rapidly and by more-than-projected, reflecting a large fall in investment, while stronger private saving broadly

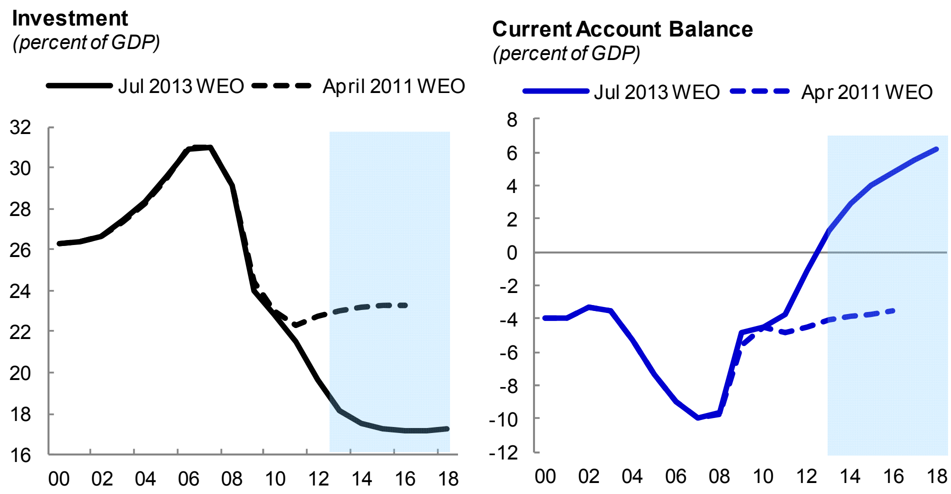
Public Debt
(percent of GDP)



Source: IMF, *World Economic Outlook.*

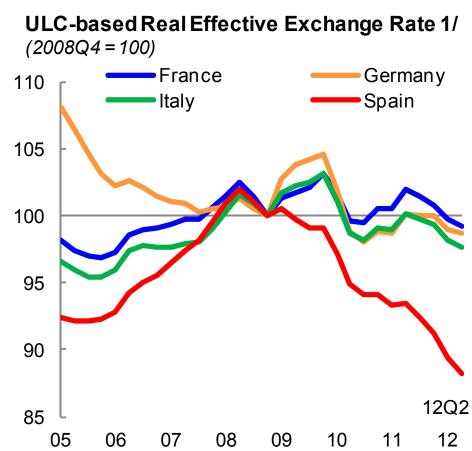
[1] Prepared by Florence Jaumotte.

offset the slippage of public saving. It is now projected to turn into a sizeable surplus in the medium term (see Figure 1).



Source: IMF, *World Economic Outlook*.

2. **Spain's improvement in external balances is partly due to weak activity, but also to stronger export performance**. While domestic demand compression and a sizeable output gap are key factors behind the stronger current account, there are also clear signs of internal devaluation and improvement in external competitiveness. While the CPI-based REER shows only a limited reversal of the appreciation since euro entry, the ULC-based REER shows a nearly full reversal and exports have performed strongly. However, these improvements have been achieved against the background of very high unemployment, and although output has started reorienting from non-tradables to tradables, employment continues to fall even in the tradable sector. The improvement in unit labor costs and productivity has been largely driven by labor shedding, though wage moderation is starting to play a larger role.



Sources: Haver Analytics; and IMF, INS.
1/ Against a panel of 36 countries: EU 27 + Australia, Canada, United States, Japan, Norway, New Zealand, Mexico, Switzerland, and Turkey.

3. **Going forward, further internal devaluation is needed.** The real effective exchange rate is moderately above the level consistent with medium-term fundamentals and desirable policies. Achieving domestic equilibrium, especially full employment, would likely imply an even greater gap. Looking at it from the current account, model-based estimates of current account norms do not suggest a significant gap; nevertheless, the overriding need to sharply improve the net international investment position suggests that, in line with

medium-term projections, a significant improvement in the cyclically-adjusted current account balance would be appropriate.

4. **Key downside risks are stagnant growth with prolonged high unemployment, fiscal stress, and private sector balance-sheet vulnerabilities, though there are also upside risks**.

- *The unavoidable and ongoing internal devaluation process could lead to a protracted period of low growth and high unemployment*. The internal devaluation process could be very difficult and long, especially if the adjustment in wages and prices is too slow. As a result, growth could remain low for a protracted period with very high unemployment, and lead to further negative real-financial feedback loops.
- *Fiscal vulnerabilities continue to be high*. The authorities have gained credibility with the large 2012 adjustment, but the deficit remains high and the economy vulnerable to a resurgence of financial stress in the euro area. Moreover, achieving the needed fiscal consolidation while managing a very weak economy is difficult. Tightening too much or with low quality measures risks prolonging or aggravating the recession, which, in turn, would make the fiscal consolidation goals more difficult to achieve.
- *Balance-sheets of the private sector remain vulnerable*. Four years into the housing bust, private sector over-indebtedness remains high, with the problem possibly more acute in the corporate than household sector. While the banking sector program in place is helping strengthen the banking system, the macro downsides could trigger a negative feedback look between credit and the economy with deteriorating loan books and pressure on profits.
- *But there are also upside risks*. In particular, reforms (by both Spain and the euro area) could accelerate and gain more traction, and with more growth-friendly fiscal measures, lead to a stronger recovery.

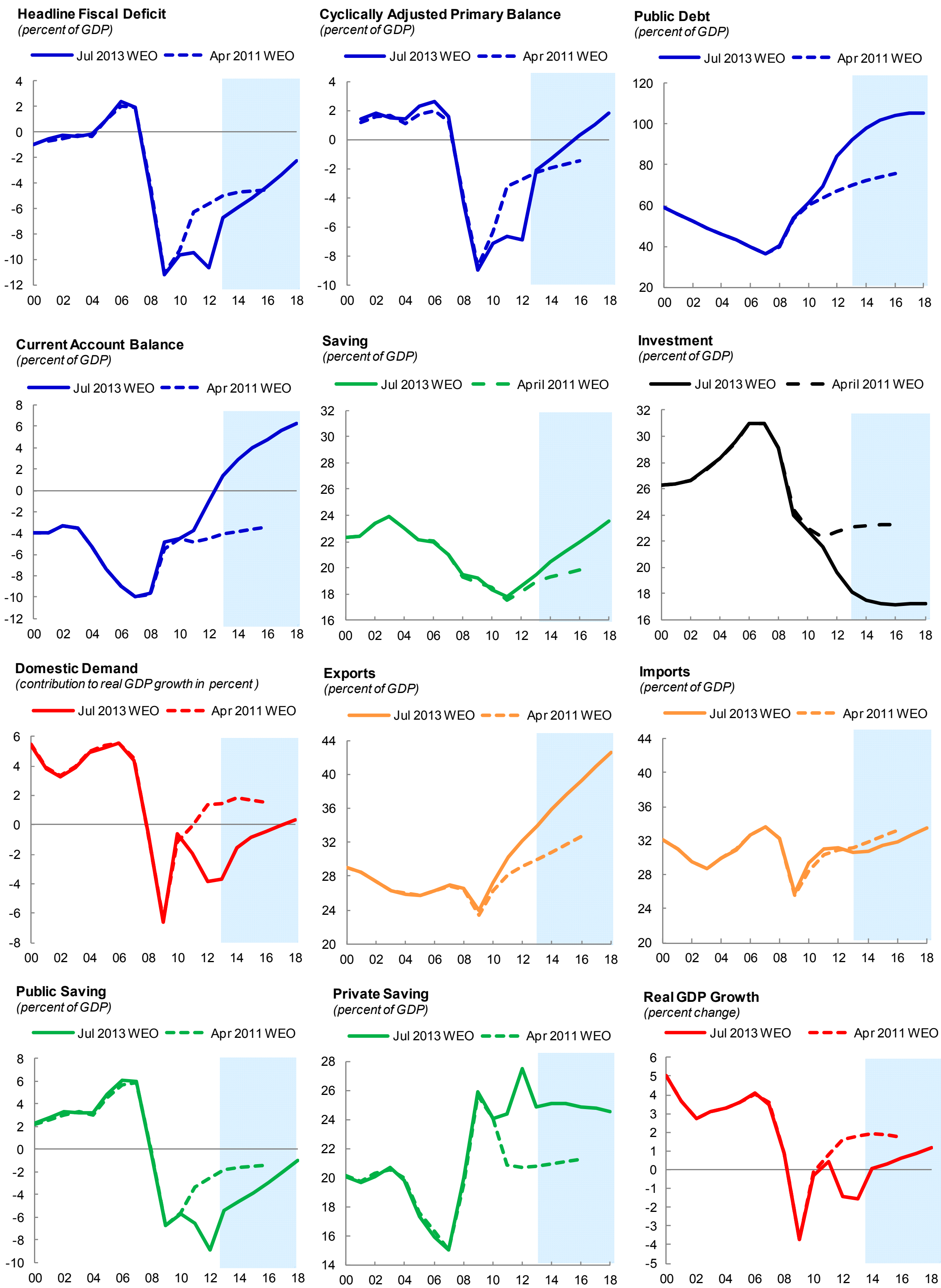
II. POLICIES TO ADDRESS IMBALANCES

5. **Policies need to focus on generating growth and jobs, including through helping the private sector delever and supporting credit.** Private sector deleveraging is underway, but there is scope to smooth the adjustment process by continuing to improve the insolvency regime, without compromising financial stability. Banks, the other side of the deleveraging coin, also need to play their part. Under the banking sector program in place, substantial progress has been achieved in recapitalizing parts of the banking sector as well as transferring assets to an asset management company. Building on this, banks should continue cleaning up loan books and promptly disposing of distressed assets to avoid tying up resources that could flow to more productive uses. Well-designed guarantee and risk-

sharing schemes targeted at SMEs would also help support credit. Last but not least, more should be done at the euro area level to move faster to a full banking union, which would help break the sovereign-bank loops, and to reduce the much higher borrowing costs faced by Spain's private sector. While further fiscal adjustment is needed, it should be as gradual and growth-friendly as possible. The government's new medium-term structural deficit reduction targets strike a reasonable balance between reducing the deficit and supporting growth. But the nominal (and, if necessary, structural) targets should be flexible in the event growth falls short.

6. **Further structural reforms of labor and product markets are needed to support growth and make the labor market more job-friendly and inclusive**. The needed realignment of wages relative to trading partners and to the large excess supply of labor should continue to be pursued and help revert the large destruction of jobs. While last year's labor reform made significant improvements, further reforms may be needed to promote bargaining arrangements more responsive to economic conditions and reduce labor market duality. Active labor market policies, in particular retraining and placement of workers who have to switch sectors, should also be strengthened to support the reorientation of the economy from nontradables to tradables. Finally, faster progress in boosting competition and the business environment would complement the labor reform by reducing prices and spurring employment.

Figure 1. Spain: Selected Macroeconomic Indicators



Source: IMF, *World Economic Outlook*.

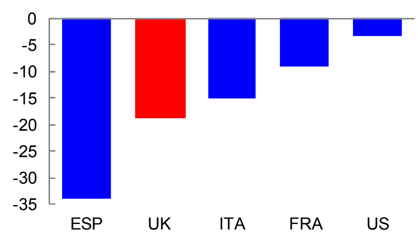
UNITED KINGDOM[1]

The United Kingdom has struggled to reduce key medium-term imbalances—namely, high public and external deficits—in the context of weak growth. Lower-than-expected growth reflects both weaker demand and supply. In this setting, fiscal and external deficits have been wider than expected. Rebalancing appears stalled at both margins. Internal rebalancing from public to private spending has been slow due to legacies of the crisis and weaker income growth. External rebalancing has been held back by structural weaknesses amplified by cyclical factors. Fiscal policy needs to balance debt sustainability with growth concerns, while external challenges include redirecting exports from low to high growth markets. Policy action is required to secure the recovery, restore competitiveness, and improve prospects for rebalancing—including finely balanced macroeconomic policies and support from structural and financial reform.

I. IMBALANCES: DIAGNOSIS AND RISKS

1. **Low growth and dampened external demand have widened U.K. fiscal and external imbalances**. Relative to what was envisaged in 2011, growth has been noticeably weaker (see Figure 1). Alongside weaker activity, the fiscal position has deteriorated compared to earlier projections, notwithstanding consolidation efforts. Despite weaker activity (notably, dampened investment), the external deficit has widened as expenditures have held up better than incomes through some cushion from lower public and private saving (vis-à-vis 2011 projections)—although private saving rates themselves have rebounded from low levels prior to the crisis. Moreover, external demand has been very weak due to the large trade share with the euro area. From the supply side, the substantial impact of the crisis (including on the size, health and functioning of the financial sector) has weakened the outlook for the U.K. economy—with relatively high losses in GDP relative to pre-crisis trends and risks of lower potential output over the medium term.

Real GDP Deviations 1/
(percent)

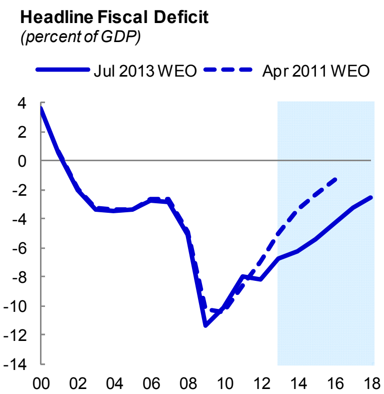


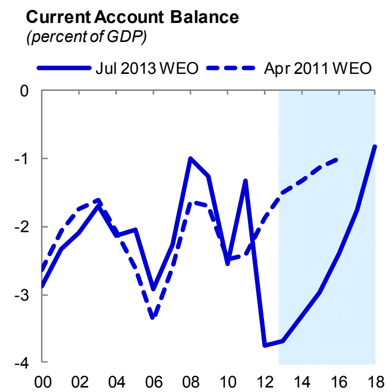
Sources: IMF, *World Economic Outlook* July 2013; and IMF staff estimates.
1/ 2016 to 2018 averages of real GDP deviations from pre-crisis trends. Trended data starts in 2008 and takes into account historical data from 2000 to 2007.

2. **Policy efforts to reduce high fiscal deficits have been hindered by low growth**. Notwithstanding expenditure-led consolidation efforts and narrower deficits since 2009, fiscal imbalances remain sizeable owing to weak growth. While discretionary spending has been trimmed, the government has allowed the automatic stabilizers to operate freely, which

[1] Prepared by Samya Beidas-Strom.

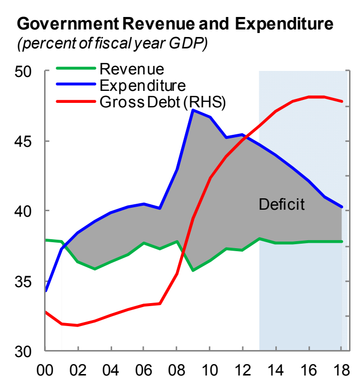
has driven up related expenditures. Weaker revenue collection has been boosted by one-off transfers—from SOEs and Bank of England profits. Consolidation, in turn, has weighed on growth given weakness of private demand. While the pace of structural consolidation slowed in 2012, the drag on growth continues. Overall, the authorities envisage an adjustment of about 1 percent of GDP in cyclically adjusted terms over FY2013/14.





Source: IMF, World Economic Outlook.

3. **Fiscal challenges extend from short to longer-term horizons.** The immediate challenge is to strike the right balance on the pace of consolidation given a weak recovery. The deteriorated fiscal outlook is partly due to weaker potential and reduced tax collection given the state of the economy. Corporate taxes have been lower due to weaker financial sector profitability since 2008–9 and decreases in effective tax rates on firms, while personal taxes have underperformed due to sluggish growth in incomes. Headline deficit figures are flattered, in part, by non-durable revenue measures, including transfers of profits from the central bank's bond purchases, which will have to be reversed as monetary conditions normalize. The medium-term debt target will be missed with public sector net debt forecasted to fall in 2017/18, two years later than targeted. Loss in confidence from slippage in reducing public debt appears more remote, given the tangible consolidation effort to date and strong fiscal institutions. And, with the exceptionally long average maturity of U.K. sovereign debt, even sharp changes in marginal yields would pass only slowly to effective rates. Nevertheless, longer-term risks and fiscal sustainability challenges remain—given high and rising public debt; significant exposure to financial sector shocks; and risks of lower potential (i.e., possibly higher structural deficits).



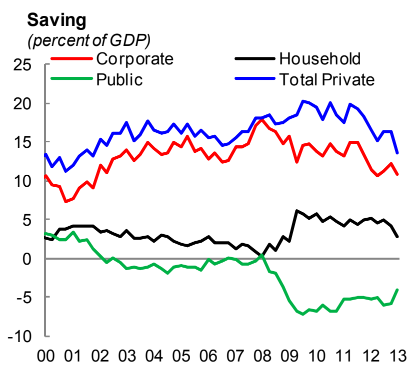
Source: IMF, *World Economic Outlook* July 2013.

4. **Internal rebalancing (towards investment) is held back by weak growth and protracted balance sheet repair in the aftermath of the crisis**. Following a rebound and recent peak, private saving rates have eased some due to weaker income growth rather than

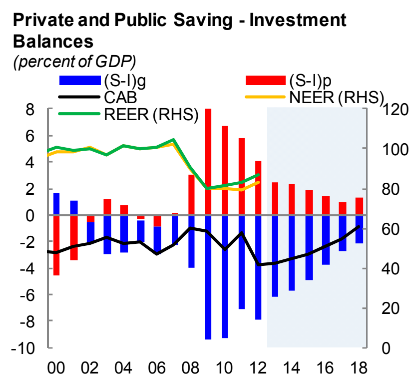
stronger spending. Investment has fallen from 18 to 14 percent of GDP since 2007—should this persist, supply potential might be durably damaged.

- *Firms have been reluctant to invest given weak final demand.* Following a rebound, corporate saving (or retained earnings) has fallen in percent of GDP, reflecting high domestic costs such as those related to SME credit constraints (e.g., funding costs) and (surprisingly) stable employment. Weaker trading partner (i.e., euro area) demand is also weighing on corporate incomes.

- *Following market corrections, household saving appears to have durably improved as spending (and borrowing) was curbed.* As nominal house prices fell about 10–20 percent since the onset of the crisis, household saving rates increased (though levels remain relatively low) to help rebuild wealth. Balance sheet repair has been largely passive, with debt leveling off—though debt ratios to income are declining. Deleveraging is expected to continue, albeit only gradually given weak incomes.



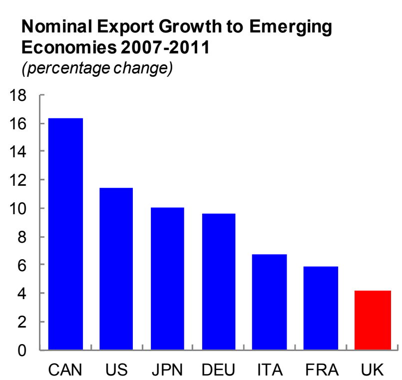
Source: Haver Analytics.



Source: IMF, *World Economic Outlook* July 2013.

5. **External rebalancing is needed to strengthen growth, but is held back by weak partner demand and structural weaknesses in exports.**[2]

- *Unfavorable trade patterns.* Among the G-7, the UK has the lowest trade share with fast-growing emerging markets and a high trade share with the euro area. External demand has thus not contributed to rebalancing. Despite sizable real effective exchange rate (REER) depreciation recently and subpar investment, the current account deficit is likely to narrow slowly, given the weak outlook for main trading partners. The UK's external position is moderately weaker than



Source: OECD.

[2] For further discussion, see the 2013 U.K. Article IV Staff Report.

implied by medium-term fundamentals and desirable policies.[3]

- *Relatively weak labor productivity and competitiveness*. High unit labor costs and low labor productivity growth relative to trading partners has hurt competitiveness. The UK has witnessed a dramatic decline in manufacturing as a share of gross value added; a loss of exports market share in goods; and a lackluster performance of high-technology exports.

II. POLICIES TO ADDRESS IMBALANCES

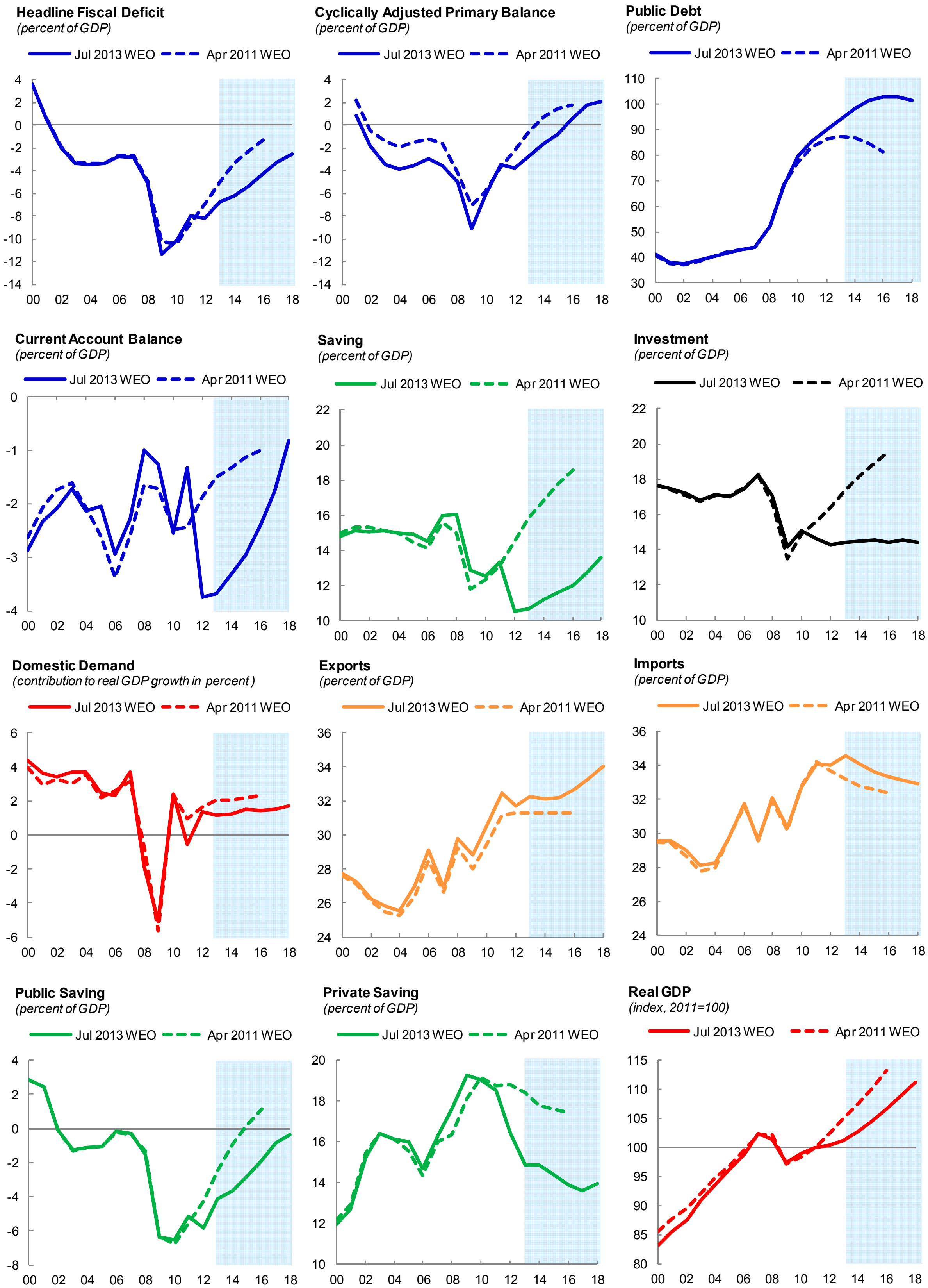
6. **Fiscal policy needs to balance debt sustainability with growth concerns**. Within the context of the medium-term fiscal framework, several growth-enhancing initiatives could be considered now to fully offset the drag from planned fiscal tightening in the near term. Specifically, bringing forward planned capital investment where possible would help catalyze private investment and spur much-needed growth. Similarly, reducing business taxes, including a lowering of the effective marginal corporate tax rate and providing an allowance for corporate equity, could help boost private investment. The budgetary impact of these measures however, could be offset over the medium term by broadening the VAT base and undertaking a reform of property taxes.

7. **Policy action is required to rebuild competitiveness and improve prospects for external rebalancing in the United Kingdom**. Exports should be retooled and repositioned to benefit from faster growing markets, including through new trade agreements, better physical and human capital, and R&D/technology enhancements. These policies would strengthen export performance, help facilitate a shift towards high-value added manufacturing and energy, and reorient exports to fast-growing and diverse markets (including middle income economies). This would help the current account deficit to narrow.

8. **Internal rebalancing would benefit from fuller restoration of banking sector health to facilitate the flow of credit and supply side measures to ease house price pressures**. Continued loosening of credit conditions (given the large output gap) to temporarily support growth until other policies gain traction is critical, as is arresting renewed concerns about banking sector health—including a resolution of the two systemically important intervened banks. While recent policies (i.e., "Help to Buy" scheme) might help boost confidence in housing, supply side measures are needed to boost availability and contain house price increases. This could include addressing land held without development and implementation of planning reforms.

[3] See IMF Pilot External Sector Report (2013).

Figure 1. United Kingdom: Selected Macroeconomic Indicators



Source: IMF, *World Economic Outlook*.

UNITED STATES[1]

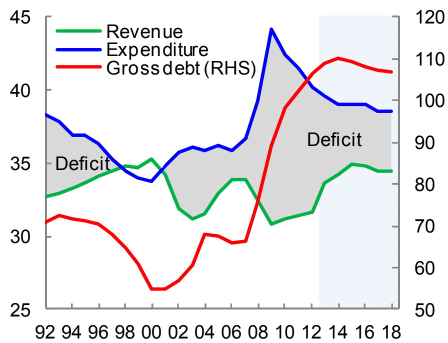
In the United States, "twin deficits" have moderated with ongoing fiscal consolidation, higher private saving, and gradually improving domestic demand. The fiscal position and outlook has improved but remains the major area of concern. Fiscal challenges are two-fold—between managing the right consolidation pace in the short run and restoring sustainability in the long run. Fiscal risks include a loss of confidence that could raise risk premia, hurt growth, and worsen debt dynamics. External deficits have narrowed in the wake of the crisis due to market-led corrections, and steady fiscal consolidation over time would help support smaller external deficits going forward. However, risks remain that financial imbalances and a return to low private saving could reemerge down the road. Key policy measures include a credible and comprehensive consolidation roadmap to anchor fiscal adjustment, while tightening at a pace that the recovery can handle, and sustaining momentum on financial sector reform to reduce vulnerabilities.

I. IMBALANCES: DIAGNOSIS AND RISKS

1. **U.S. "twin deficits" have narrowed against the backdrop of gradually improving private demand.** Broadly as expected in 2011, the hand off from public to private demand is ongoing with the drag from fiscal consolidation being mitigated by gradually strengthening private domestic demand (See Figure 1). At the same time, rising public saving and subdued investment growth have contributed to a narrowing of the current account deficit. While fiscal deficits have narrowed by more than envisaged in 2011 due to budget sequestration and recent revenue over-performance, key fiscal challenges continue to threaten the outlook. The outlook for the external deficit is broadly stable as public saving and private investment increase in tandem.

2. **Fiscal imbalances are being reduced, but two sets of difficult challenges confront policymakers.** Two-fold challenges are to restore fiscal sustainability in the longer term by addressing key structural shortcomings, while managing the near-term pace (and quality) of adjustment in a manner that does not jeopardize the recovery and growth.

General Government Revenue and Expenditure
(percent of GDP)



Sources: Haver Analytics; and IMF, *World Economic Outlook* July 2013.

- *While progress has been made in reducing fiscal deficits, policy tightening has been excessive from*

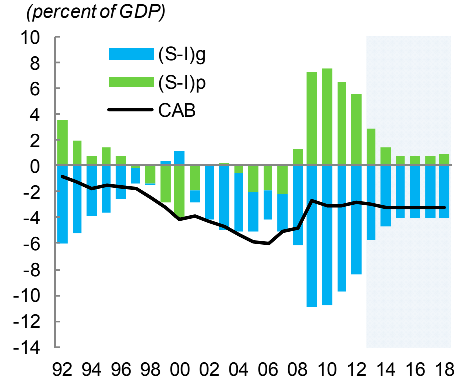
[1] Prepared by Troy Matheson.

a cyclical standpoint.[2] Due to political gridlock, the nature of short-term fiscal consolidation has not been ideal. While policymakers essentially avoided the fiscal cliff through the American Taxpayer Relief Act (ATRA), the budget sequestration was not avoided. This has brought discretionary spending cuts forward in an across-the-board (i.e., untargeted) manner, including to education and public investment. The resulting pace of fiscal consolidation in 2013 is excessive (about 2.5 percent of GDP in structural primary terms).

- *Moreover, measures adopted so far are not sufficient to address longer-term fiscal challenges given an aging population and escalating health care costs.* While the medium-term fiscal outlook has improved due to more favorable interest rate assumptions and some expected cost slowdown in health care relative to earlier assumptions, the public debt profile remains unsustainable.[3] Approving a plan to restore long-run fiscal sustainability remains a priority, with debt projected to stabilize by mid-decade before rising again over the longer term. Key issues that still need to be addressed are the low revenue ratio, entitlement spending pressures, including due to rising healthcare costs.[4]

3. **External deficits have narrowed significantly since the crisis began and are not expected to widen again significantly over the medium term.** In response to market-led corrections (and subsequent balance sheet repair), private sector saving-investment balances adjusted sharply in the wake of the crisis and market-led corrections. For example, falling house prices and tighter bank credit were accompanied by a rebound in low household saving and decline in residential investment from its pre-crisis peaks. Private saving (household and corporate) is now close to its highest level in three decades, with economic uncertainty boosting corporate saving while households continue to repair balance sheets. At the same time, government saving dropped significantly with the onset of the crisis to support demand and has been slow to recover given the sluggish recovery. External rebalancing could be stronger to support growth. Current account deficits are projected to be broadly stable over the next few years as higher imports are offset by lower oil prices

Private and Public Saving - Investment Balances 1/
(percent of GDP)



Source: IMF, *World Economic Outlook* July 2013.

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[2] See IMF *Fiscal Monitor* (April 2013).

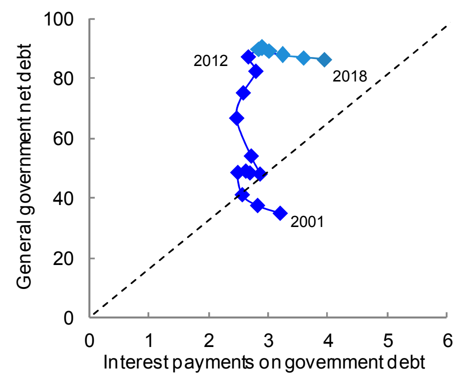
[3] A Supreme Court ruling on health care reform has reduced expected costs of Medicaid expansion.

[4] See staff's 2011 Sustainability Report for the United States: http://www.imf.org/external/np/country/2011/mapus.pdf

and increased domestic energy production. The U.S. external position is moderately weaker than implied by medium-term fundamentals and desirable polices, and the real effective exchange rate is mildly overvalued.[5] Signs of strong export growth and more reliance on external demand have been limited to date, amid weak growth among some trading partners.

4. **Fiscal risks remain important for the United States and the global economy.** While the sequester has triggered upfront budgetary consolidation, political gridlock has so far prevented agreement on a longer-term strategy for comprehensive fiscal reform. Thus, a longer-term risk is that market confidence weakens over time about the political system's ability to deliver the required and desirable fiscal adjustments in a timely, smooth and durable fashion. While some increase from very low interest rates and financing costs will likely raise public debt servicing burdens over time, a loss of confidence would increase risk premiums and worsen debt dynamics, with potentially large effects on the global economy. At the same time, budget sequestration and a failure to smoothly raise the debt ceiling later in the year could unnecessarily restrain economic activity, and the drag on growth could be much greater if confidence in policymakers begins to erode.

Path of Public Indebtedness, 2001-18
(percent of FY GDP; projections in light blue)



Source: IMF, *World Economic Outlook* July 2013.

5. **Financial risks stem from the possibility of new financial excesses down the road alongside widening external deficits.** While progress has been made on financial sector reform, and the health of banks has improved, more remains to be done to increase the resilience of the financial sector. With ongoing fiscal consolidation and a heavy reliance on monetary policy, a prolonged period of low interest rates carries risks of distorted incentives and search for yield that could spark new financial excesses, presenting tradeoffs against the risks of premature exit from monetary accommodation. There is already some evidence that risks may be mounting in the non-bank sector, with incipient signs of excessively lose conditions in some corporate markets.[6] If left unaddressed, financial excesses could reduce private saving and widen external imbalances in the future. Uncertainty about future exit from exceptional monetary accommodation (including unwinding unconventional policies) may also carry implications for financial volatility, including in treasury markets.

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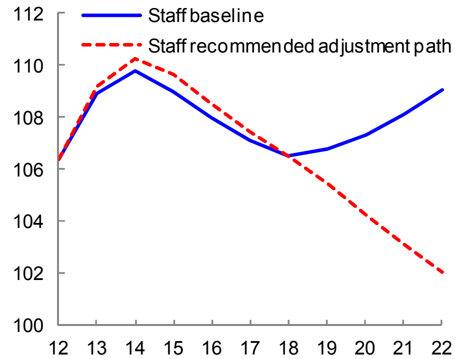
[5] See IMF Pilot External Sector Report (2013).

[6] See IMF *Global Financial Stability Report* (April 2013).

II. POLICIES TO ADDRESS IMBALANCES

6. **Fiscal policy**: *A comprehensive medium-term fiscal framework should be promptly adopted*. At the same time, the pace of the 2013 fiscal withdrawal is excessive and needs to be addressed. Fiscal policy should be better attuned to the pace of the recovery by increasing the room for policy maneuver in the short run, while ensuring fiscal sustainability and minimizing the risk of turmoil in the Treasury market in the medium term. The consolidation framework should include a balanced mix of new revenues, preferably raised through fundamental tax reform that simplifies the tax code and broadens the tax base, and ambitious measures to curb longer-term growth in entitlement spending, especially public health care and pensions.

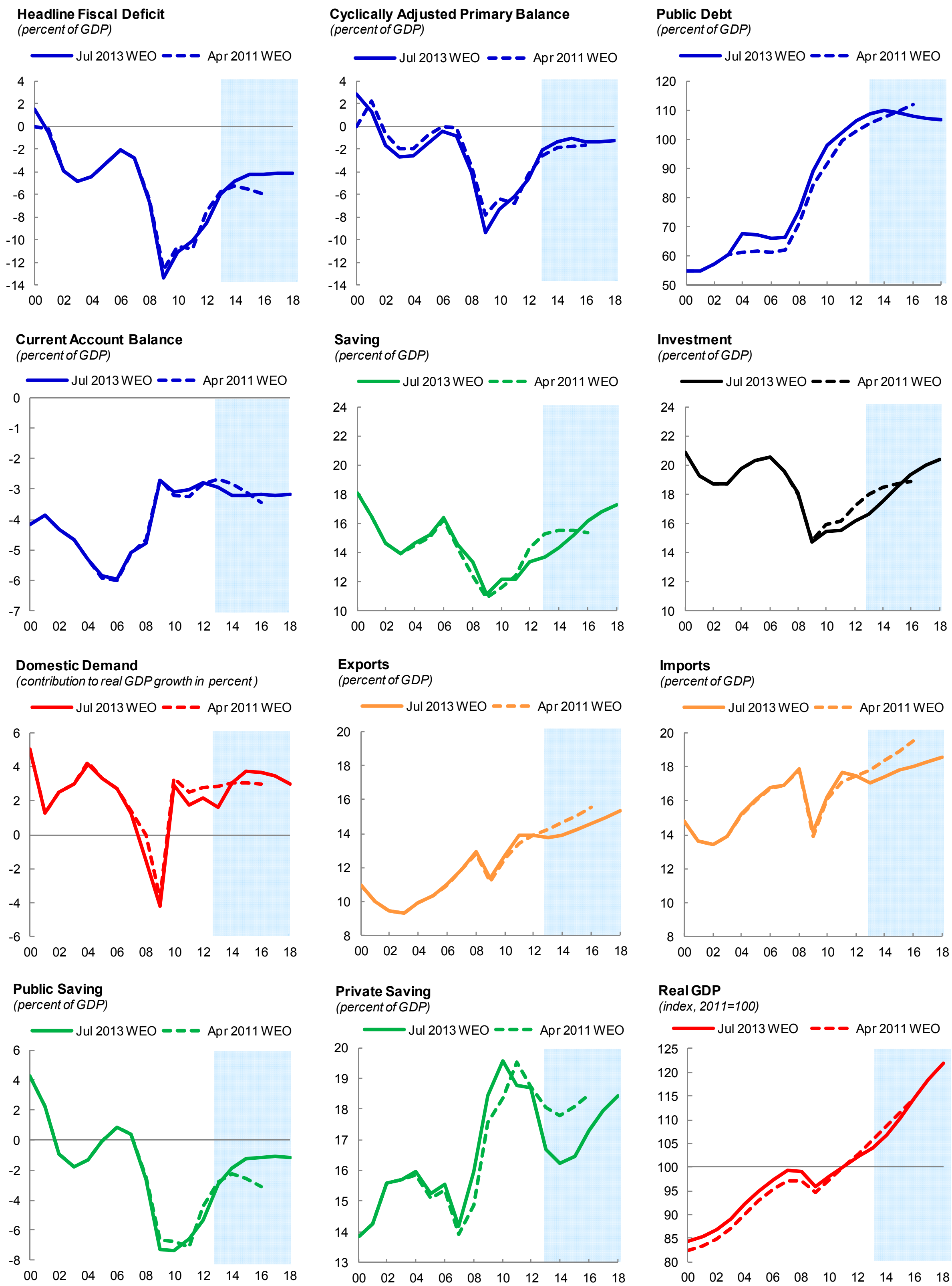
General Government Debt
(percent of GDP)



Source: IMF staff estimates.

7. **Financial Policies**: *While the regulatory architecture has been strengthened relative to pre-crisis levels, more remains to be done to safeguard stability of the financial system.* Financial stability is a prerequisite for economic growth and sustainability. Progress has been made implementing new rules on centralized clearing for over-the-counter derivatives, in line with G-20 commitments. Additional progress is needed on completing the process of designating systemically-important institutions, strengthening the regulation of money market mutual funds, reducing the systemic risk in the tri-party repo market, carefully implementing the Volcker Rule, and progressing with Basel III implementation. It is important for U.S. policymakers to complete domestic reforms and continue to play a leadership role in advancing, on a consistent basis, the international regulatory reform agenda to reduce fragmentation of the global financial landscape and limit uncertainty and scope for regulatory arbitrage.

Figure 1. United States: Selected Macroeconomic Indicators



Source: IMF, *World Economic Outlook*.