



# GROUP OF TWENTY

## IMBALANCES AND GROWTH

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

October 2015



Prepared by Staff of the

INTERNATIONAL MONETARY FUND\*

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

# Summary<sup>1</sup>

*Global current account imbalances have narrowed significantly since their pre-crisis peak, although there has been little progress in reducing excess imbalances in the past two years. The decline in imbalances has been mostly driven by demand compression in deficit economies, and is expected to be persistent. Recent trends in oil prices and exchange rates will have mixed effects on current accounts, but they will likely increase imbalances in key surplus economies. On the fiscal front, despite sizable consolidation efforts, public debt in advanced economies remains high. Thus, further policy action across the G-20 is needed to facilitate internal and external rebalancing while strengthening growth prospects.*

## IMBALANCES: OVERVIEW

1. **As a part of the Mutual Assessment Process, Leaders agreed to perform biennial assessments to identify large and persistent imbalances.** In Seoul 2010, Leaders committed to promote external sustainability. It was agreed that “persistently large external imbalances, assessed against indicative guidelines...warrant an assessment...as part of the Mutual Assessment Process.” As a follow up, IMF staff prepared a series of sustainability reports in 2011 on large imbalances in selected G-20 members. In 2013, following Los Cabos’ agreement to have biennial assessments of imbalances against “indicative guidelines,” the staff prepared an update to the 2011 sustainability assessments.<sup>2</sup>

2. **This report summarizes the findings of the 2015 update of sustainability assessments.** Following the first, mechanical step of the G-20 Indicative Guidelines, as in the 2013 exercise, the same 9 members, i.e., *China, the euro area, France, Germany, India, Japan, Spain, the United Kingdom, and the United States* were again identified as having relatively large imbalances that require further assessment (see Box 1).<sup>3</sup> In the second step, for each of these members further analysis is provided in the *Annex*, discussing developments of their key imbalances since the 2013 updates, the outlook for imbalances, risks, as well as staff assessment and policy implications. Developments of external and internal imbalances for the G-20 as a whole as well as policies needed to facilitate rebalancing and achieve the shared objectives of strong, sustainable, and balanced growth are summarized below.

3. **Global current account imbalances have narrowed from their pre-crisis peak, although there has been little progress in reducing excess imbalances in the past couple of years.** Since

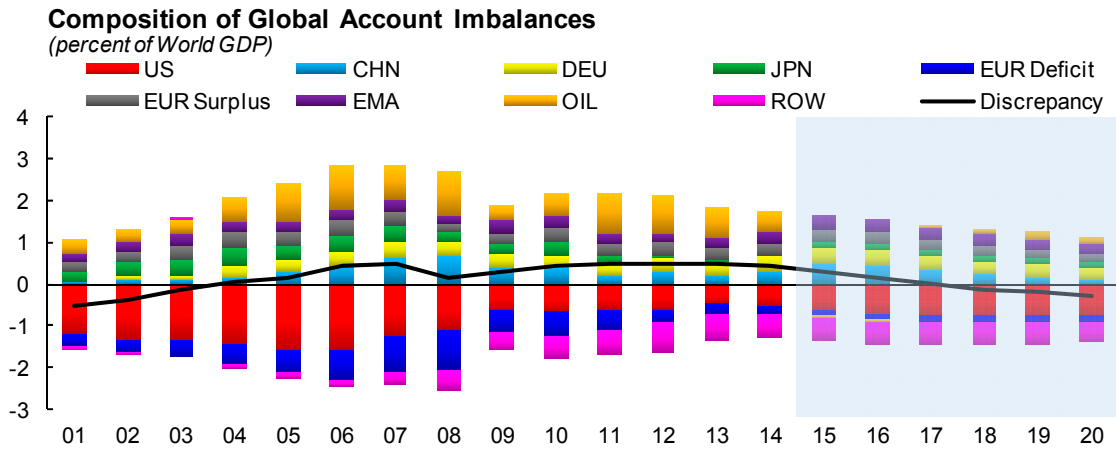
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<sup>1</sup> Prepared by a team from the IMF’s Research Department led by Emil Stavrev, with Esteban Vesperoni, Florence Jaumotte, Sweta Saxena, Carolina Osorio-Buitrón, Seok Gil Park, and Patrick Blagrove, and with support from Eric Bang, Chanpheng Fizzarotti, Ava Hong, Marina Rousset, Daniel Rivera, and Gabi Ionescu.

<sup>2</sup> See [Los Cabos Growth and Jobs Action Plan](#) and the [2013 Sustainability Updates](#).

<sup>3</sup> The Indicative Guidelines is an indicator-based two-step approach agreed by the G-20 for identifying large imbalances that require further analysis (see the [G-20 April 14-15, 2011, Washington Communiqué](#)).

the last updates, global imbalances have declined modestly in 2013, held steady at 3½ percent of world GDP in 2014 (down from over 5½ percent of world GDP during 2006-08), and are projected to remain broadly stable over the medium term. At the same time, the composition of current account imbalances has changed. The imbalances that used to be the main concern during the pre-crisis peak—the large deficits in the United States and the surpluses of China and oil exporting countries—have more than halved. At the same time, the overall current account surplus in the euro area has increased, as surpluses in Germany and the Netherlands remained large, while the deficit economies shifted to a surplus, reflecting to an important degree demand compression. Overall, there has been little progress in reducing excess imbalances in recent years as the absolute sum of the gaps of economies with positive current account gaps and those with negative gaps has remained essentially unchanged since 2013.<sup>4</sup>

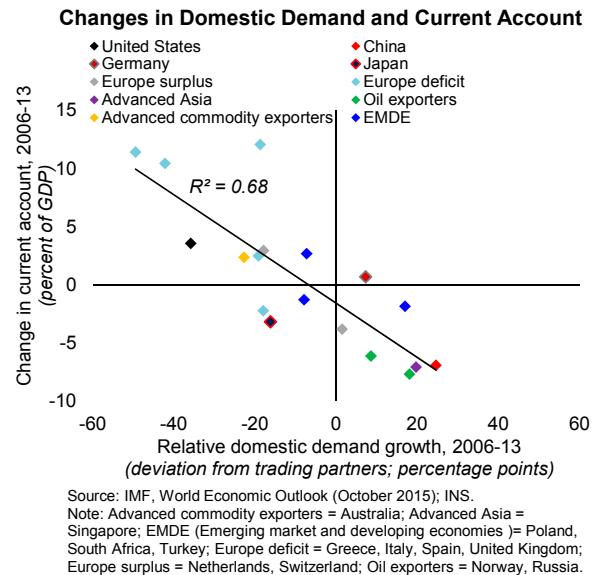


Source: IMF, World Economic Outlook October 2015.

Note: Oil exporters = Algeria, Angola, Azerbaijan, Bahrain, Bolivia, Brunei Darussalam, Chad, Republic of Congo, Ecuador, Equatorial Guinea, Gabon, Iran, Iraq, Kazakhstan, Kuwait, Libya, Nigeria, Norway, Oman, Qatar, Russia, Saudi Arabia, South Sudan, Timor-Leste, Trinidad and Tobago, Turkmenistan, United Arab Emirates, Venezuela, Yemen; EMA = Hong Kong SAR, India, Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan Province of China, Thailand. European economies (excluding Germany and Norway) are sorted in to surplus or deficit each year by the signs (positive or negative, respectively) of their current account balances.

<sup>4</sup> For a further discussion see the 2015 External Sector Report (ESR).

4. **The improvement has been mostly driven by demand compression in deficit economies.** Excess imbalances narrowed, notably in the United States—as financial excesses before the crisis have since corrected—and in China—where large surpluses have halved as a share of world GDP, reflecting demand rebalancing. Exchange rates have facilitated external rebalancing, as real exchange rates generally appreciated in surplus economies and depreciated in deficit economies until early-2014. The improvement in the current account imbalances, however, also reflects to an important extent more subdued domestic demand in deficit economies—in some cases associated with still-large output gaps.<sup>5</sup> Most of the adjustment is expected to be permanent, but—absent further expenditure switching and higher demand in surplus economies—part of the adjustment could reverse in some debtor economies as domestic demand strengthens and their output gaps close, a potential concern for economies with weak net international investment positions.



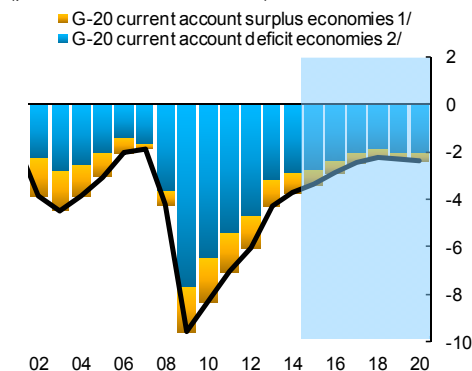
5. **Going forward, trends in oil prices and exchange rates over the past months are projected to have mixed effects on current accounts.** Current accounts surpluses in oil exporters are projected to disappear in 2015 and remain low thereafter even in the context of the expected recovery in oil prices over the medium term. The oil price decline and the real exchange rate changes over the past year—the latter partly related to asynchronous monetary policies among the major economies—would also help rebalancing in countries that would benefit from strengthening their external positions, such as Spain. The impact on imbalances will be mixed in other key economies, notably China and the United States, where the exchange rate adjustment weakens the current account balance, while the oil price decline strengthens it. While the developments in exchange rates and oil prices over the past months will tend to increase external imbalances in countries with (in some cases, large) current account surpluses (e.g., Germany, Japan), excess imbalances might not be affected much.

6. **Despite appreciable consolidation efforts, public debt is still high in advanced economies and further action is needed to put it on a sustainable path.** While the pace of fiscal consolidation in advanced economies has slowed recently to support economic activity, fiscal adjustments over the past several years and record low interest rates have helped containing indebtedness. At the same time, sluggish growth and low inflation have prevented a sizable

<sup>5</sup> See Chapter 4 of the October 2014 WEO: [“Are Global Imbalances at a Turning Point.”](#)

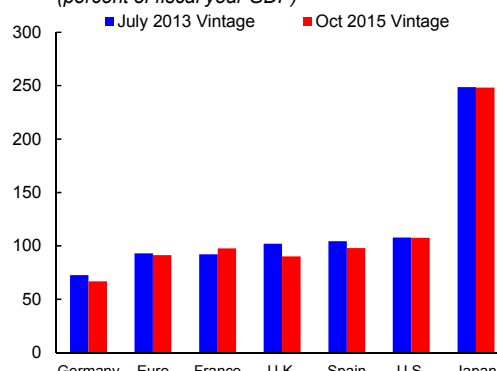
reduction in public debt levels in advanced economies, keeping them broadly unchanged from previous sustainability updates. Thus, efforts are still needed to put public debt on a sustainable path, notably in Japan, but also in the United States.

**Fiscal Deficit in G-20 Advanced Economies**  
(percent of advanced G-20 GDP)



Source: IMF, *World Economic Outlook* October 2015.  
 1/ Advanced surplus comprises Germany, Japan, and Korea.  
 2/ Advanced deficit comprises Australia, Canada, France, Italy, United Kingdom, and United States.

**Public Gross Debt, Average for 2015-18**  
(percent of fiscal year GDP)



Source: IMF, *World Economic Outlook*.

## POLICIES

7. **Further policy actions by both surplus and deficit economies would be mutually supportive in addressing internal and external imbalances while sustaining growth.** Regarding fiscal imbalances, while consolidation efforts have continued, public debt remains high. Global current account imbalances have declined appreciably following the crisis, but excess imbalances still remain. Demand adjustment on excess deficit side, in the absence of higher demand in excess surplus economies, would be contractionary for the global economy, a concern heightened by the fact that world output is still below its potential level. Accordingly, members should collectively strengthen policies that facilitate further internal and external rebalancing, while improving growth prospects. A summary of the main policies is provided below, country details are provided in the annex.

- **Internal rebalancing.** Overall, continued fiscal consolidation should strike the right balance between debt sustainability and ensuring a durable recovery. In *Japan* and the *United States*, credible medium-term consolidation plans are needed, underpinned by enhanced efficiency in public finances and including pension and health reforms. In the *United Kingdom*, the structural deficit should be further reduced over the medium term to rebuild fiscal buffers, while prioritizing growth-enhancing spending such as infrastructure investment. In the *euro area*, countries with fiscal space—such as *Germany*—should use it for investment to boost growth potential and reduce their external surpluses, while those with high debt should take advantage of the low interest rate environment to reduce debt. In *France*, stronger expenditure-based consolidation, underpinned by fundamental spending reform is needed to ensure that public debt is placed on a firm downward trajectory by 2017. In *Spain*, credible measures and a stronger regional fiscal framework are essential to put public debt

on a declining path and reduce sovereign vulnerabilities. In *India*, revenue mobilization and further subsidy reforms would bolster the fiscal position; In *China*, the priority is to avoid a fiscal cliff while pressing ahead with reforms to align local governments' revenue and expenditure responsibilities and improve the social security system.

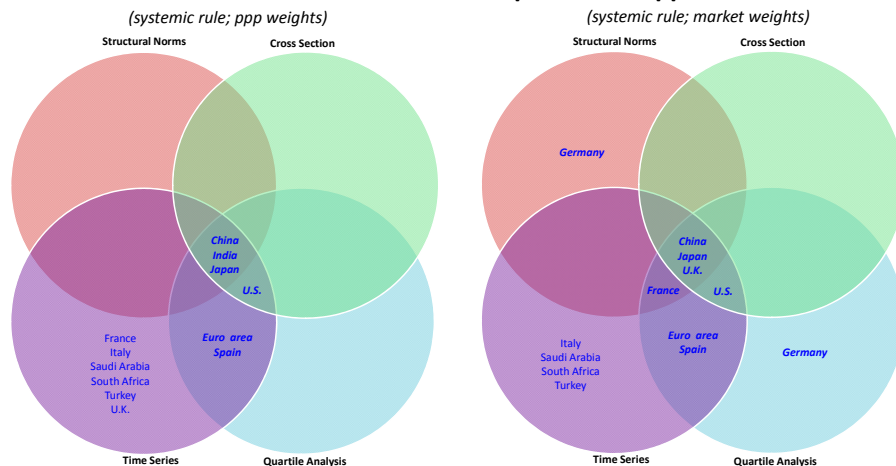
- **External rebalancing.** Joint efforts by surplus and deficit economies are needed to achieve both more balanced and stronger growth. In *China*, policies should focus on reducing imbalances, while preventing too sharp a slowdown in growth. Priorities include further structural reforms to unleash new sources of growth and rebalance the economy towards consumption. In the *euro area* as a whole, continued monetary accommodation complemented by using the fiscal space where available to support investment is needed to raise growth and further rebalancing. At a national level, policy needs vary. In *Germany*, policies should focus on boosting domestic demand, including through public investment. In *France*, strengthening growth prospects would require additional reform efforts, including by removing barriers to employment and enhancing competition. In *Spain*, reforms that improve labor market performance, boost productivity, facilitate private debt reduction, and anchor confidence are necessary to support competitiveness and facilitate rebalancing. In the *United States* and the *United Kingdom*, medium-term fiscal consolidation, supported by accommodative monetary policy, should assist external rebalancing.

## Box 1. Summary of the 2015 Indicative Guidelines and First Step Results

The 2015 biennial update of G-20 Indicative Guidelines followed the methodology agreed by the G-20 in April 2011. This box summarizes the first step of the methodology whereby a set of indicators are mechanically, without normative implications, assessed against reference values to identify the members that need further analysis in the second step, which is provided in the *Annex* for each of the 9 selected economies. Specifically:

- **Indicators** to evaluate imbalances: (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 2017-19 from the IMF's *January 2015 WEO Update*, except for private debt where the latest available data is used.
- **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 "norms" (for the external position, the norm is based on staff's ESR 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 the 4 approaches above show "large" imbalances (i.e., significant deviations of indicators from their reference values) in 2 or 3 sectors (external, fiscal, and private). 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.
- **First Step Results.** The first step of the 2015 Indicative Guidelines identified 9 members (the same as in the 2013 exercise) with relatively large imbalances that require further analysis. Specifically: *China*: high private saving and external surplus; *euro area*: external surplus and public sector debt; *France*: external deficit and high public debt; *Germany*: high external surplus and public debt; *India*: public and private sector imbalances; *Japan*: moderate external surplus and large public debt; *Spain*: external surplus and high public sector debt; the *United Kingdom*: low private saving and high public debt; and the *United States*: fiscal and external deficits.

### 2015 Indicative Guidelines: Comparison of Approaches





## GROUP OF TWENTY

### ANNEX: SUSTAINABILITY UPDATES FOR SELECTED G-20 MEMBERS





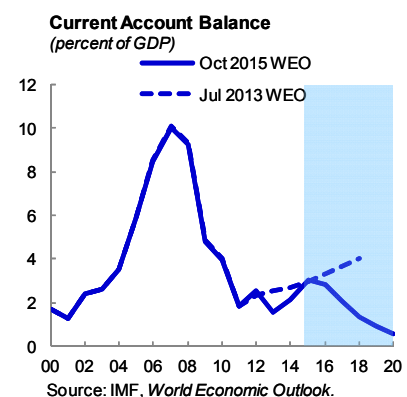
# PEOPLE'S REPUBLIC OF CHINA<sup>1</sup>

China is moving to a new normal, with slower yet safer and more sustainable growth. The transition is challenging but necessary. The authorities have made progress in reining in vulnerabilities built-up since the global financial crisis and embarked on a comprehensive reform program. The challenge is to simultaneously make further progress on: (i) unwinding vulnerabilities while preventing growth from slowing too sharply; and (ii) advancing structural reforms toward a new growth model. Regarding imbalances, considerable progress has been made on external rebalancing with a sharp reduction of the current account surplus from the 2007 peak; while some progress has also been made on domestic rebalancing. Reform priorities include moving to a more market-based financial system; improving the management of government finances; leveling the playing field between SOE and the private sector; and having an effectively floating exchange rate regime within 2–3 years. The faster the progress, the sooner the economy will move to a more balanced—both externally and domestically—and sustainable growth path.

## IMBALANCES: DIAGNOSIS AND RISKS

1. **China is making progress in rebalancing growth, while containing vulnerabilities built-up since the global financial crisis.** The global financial crisis hit China just as the dividends from the last major wave of reforms (late 1990s and early 2000s) were waning, especially the shift of resources from agriculture to manufacturing, and potential growth was slowing. Since then, growth has relied on credit-financed investment. This has led to rising government and corporate debt and declining investment efficiency. Moving to slower but safer growth in the near term, and securing more inclusive, environment-friendly, and sustainable growth in the long run would involve reversing these trends, i.e., reducing some of the main factors supporting growth. Managing this slowdown is a key challenge: going too slow will lead to a continued rise in vulnerabilities, while going too fast risks a disorderly adjustment. Over the medium term, the key to managing this tradeoff is the successful implementation of structural reforms to unleash new sources of growth.

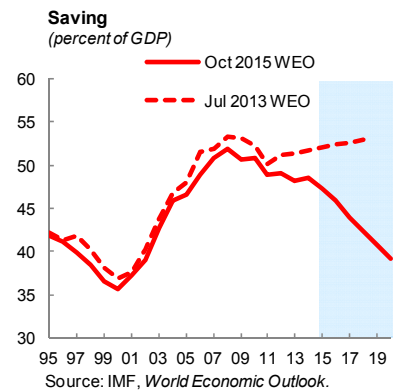
2. **Although external imbalances have fallen considerably, more reforms are needed to reduce the still high saving rate.** The current account surplus in 2014 declined to 2.1 percent of GDP from the 2007 peak of around 10 percent of GDP, reflecting a decline in the saving rate, strong private investment, REER appreciation, weakness in major advanced economies, and more recently a trend widening of the services deficit. Foreign exchange



<sup>1</sup> Prepared by Sweta Saxena.

intervention declined in 2014 and purchases have turned into sales recently.<sup>2</sup> The external position was moderately stronger in 2014 compared with the level consistent with medium-term fundamentals and desirable policy settings, and the renminbi was moderately undervalued. Since then, the real effective appreciation has brought the exchange rate to a level that is no longer undervalued. Nevertheless, the trade surplus has risen and domestic policy gaps remain, which suggests that the external position probably remains moderately stronger than warranted. Hence, achieving sustained external rebalancing will require more policy reforms to further reduce the high saving rates, complemented with a flexible, market-based exchange rate.

3. **Some progress has also been made on internal rebalancing.** Shifting to a more consumption-oriented economy will involve both lowering the household saving rate and increasing households' share of income. In 2014, consumption contributed 0.2 percentage points more to growth than gross fixed capital formation and there was a moderate decline in household saving rates.<sup>3</sup> The real estate is undergoing a needed adjustment, and new budget law is tackling the challenges of local government, and progress has been made in liberalizing interest rates. More progress on internal rebalancing is desirable, because a decrease in investment not compensated by an increase in consumption would widen the savings-investment gap and risk the reappearance of excessive external imbalances.



4. **The biggest risk is inadequate progress in advancing reforms and containing vulnerabilities.** Credit in China has risen rapidly and is high by many metrics. While credit flows have slowed down recently, the credit-to-GDP ratio is still growing. Vulnerabilities would continue to rise if reliance on credit-financed investment as an engine of growth persists. Over the medium term, the likelihood of China falling into a period of protracted weak growth would rise considerably, and the risk of a sharp and disorderly correction would increase as the existing buffers—a still relatively healthy public sector balance sheet and large domestic savings—would diminish. This risk would also increase with the opening up of the capital account—potentially leading to large outflows should market sentiment change—pointing to the importance of careful coordination of liberalization steps with other structural reforms.

## POLICIES TO SUPPORT SUSTAINABLE GROWTH

5. **Policies should focus on reducing vulnerabilities, while preventing too sharp a slowdown in growth and advancing structural reforms.** Further structural reforms will be needed

<sup>2</sup> China's reserves, which were above the level required from a precautionary perspective in 2013, declined in 2014 to fall within the adequate range suggested by the Fund's metric for assessing reserve adequacy, although they remain higher than warranted when adjusted for capital controls (see the 2015 ESR).

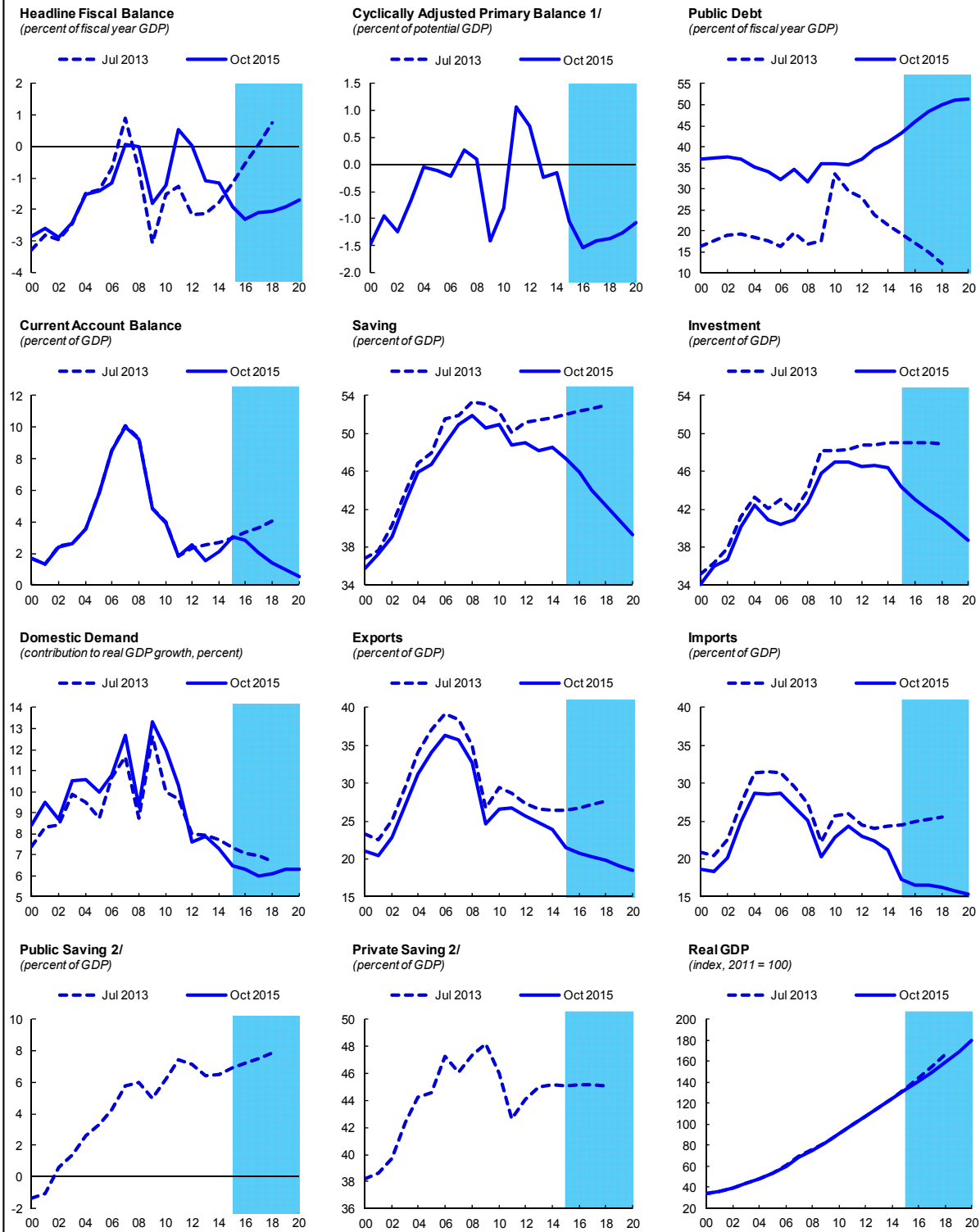
<sup>3</sup> The data for 2015Q1 reveals a sharp decline in the contribution of investment to GDP growth.

to unleash new sources of growth and rebalance the economy towards consumption over the medium term. In the near-term, a reduction in off-budget spending, further reining in credit growth, and slower investment growth are required to contain risks. The drag on activity from these policies is bound to be felt right away, while the growth payoff from structural reforms will be down the road. Finding the right mix of reducing vulnerabilities and maintaining growth will be an ongoing challenge. In this respect, fiscal policy can play a balancing role, taking measures to reduce vulnerabilities faster if growth is likely to exceed the target or providing support, if instead growth looks set to dip below the target to help avoid a sharp slowdown.

6. **Accelerating the implementation of the 2013 Third Plenum reform blueprint will be essential to move the economy to a more sustainable growth path.** Key principles of the blueprint include giving the market a more decisive role, eliminating distortions, and strengthening governance and institutions. Reform priorities should include:

- *Advancing financial sector reforms will help safeguard financial stability and improve the allocation of credit, as well as reduce unproductive investment and promote consumption.* This includes strengthened regulation and supervision, deposit rate liberalization, increasing reliance on interest rates as an instrument of monetary policy, and elimination of the widespread implicit guarantees across the financial and corporate landscape.
- *Deepening SOE reforms to level the playing field.* Important reforms include accelerating the increase in dividend payments, ensuring dividends flow to the budget instead of being recycled to other SOEs, eliminating direct or indirect subsidies of factor costs, and strengthening governance. Ultimately, successful SOE reform will also have to include greater tolerance of SOE bankruptcy and exit while exposing them fully to private competition, especially in services. The result will be a better allocation of resources and unleashing new sources of growth.
- *Further safety net reform to reduce precautionary saving, boost consumption, and address internal rebalancing.* Pension reforms are crucial for achieving the desired rebalancing of the economy toward consumption. Priorities include, reducing social security contributions, which are high and regressive. The lost revenue will need to be offset by a combination of parametric reforms and a broader reform of the tax system and financing of social programs.
- *Strengthening the fiscal framework.* Priorities include improving oversight and management of government finances at the local level, better aligning local government revenue assignments with expenditure responsibilities, and continued improvements in the tax system.
- *A more flexible, market-determined exchange rate* is needed for allowing the market to play a more decisive role in the economy, rebalancing toward consumption and maintaining and independent monetary policy as the capital account opens. Reform should aim to achieve an effectively floating exchange rate—with intervention limited to avoiding disorderly market conditions or excessive volatility—within 2-3 years.

**Figure 1. China: Selected Macroeconomic Indicators**



Source: IMF, *World Economic Outlook*.

1/ General government cyclically adjusted primary balance is available starting October 2014 WEO.

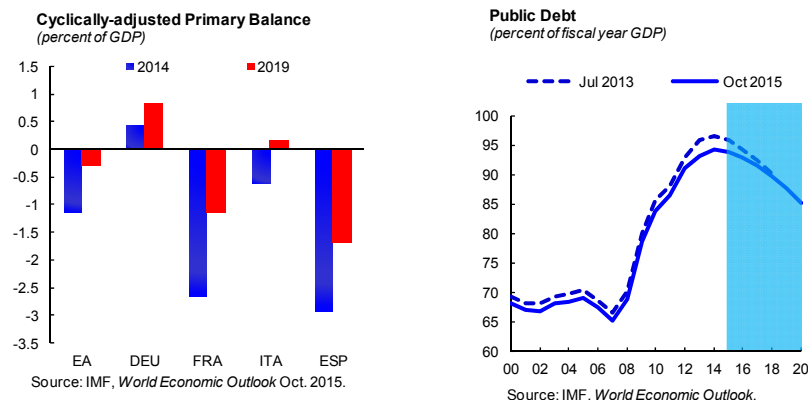
2/ Breakdown of saving is not being reported by the desk due to change in definition.

# EURO AREA<sup>1</sup>

In the euro area, public debt remains elevated and the external surplus has grown further in a context of weak growth. Going forward, the oil price decline, the ECB's quantitative easing, and the euro depreciation will provide a boost to the recovery and help the debt dynamics. But they should also lead to a further rise in the region's current account surplus. The main risks facing the euro area are low medium-term growth, and in the near term financial market volatility related to prospective changes in monetary policies in advanced economies, as well as downside risks to the external environment, including emerging markets. A more balanced policy approach involving the use of the fiscal space available under the SGP and structural reforms is needed to lift the growth trajectory and further internal rebalancing.

## IMBALANCES: OUTLOOK AND RISKS

1. **Public debt remains at elevated levels reflecting in part weak growth and inflation, while fiscal consolidation is slowing.** After proceeding broadly as projected in 2013, fiscal consolidation slowed in 2014 and is expected to remain broadly neutral over the next few years, though this masks differences in adjustment at country level. The still negative headline fiscal deficit, combined with a gradual recovery and low inflation, imply that public debt will decline only modestly and remain elevated at above pre-crisis levels in many countries. This is in spite of recent favorable developments—the decline in oil prices and ECB's QE—which should help the debt dynamics by strengthening the recovery and lowering sovereign borrowing costs.

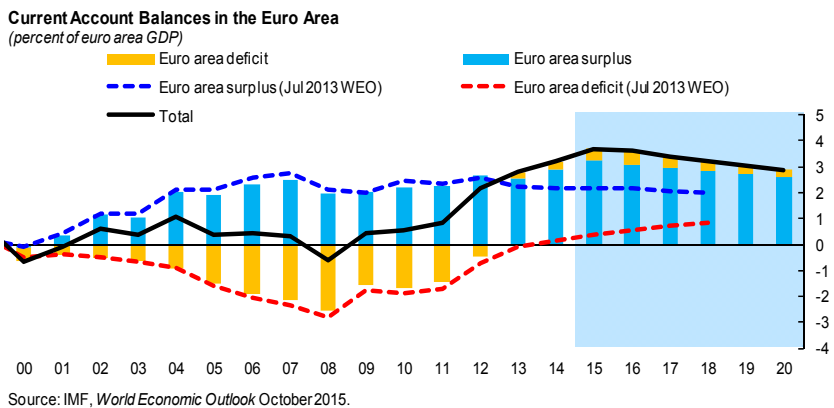


2. **The external surplus continues rising, suggesting room to explore further policies to strengthen domestic demand.** The euro area current account surplus increased slightly in 2014, mainly reflecting increasing public saving and still weak investment (Figure 1). While the current account in 2014 was broadly in line with the level suggested by medium-term fundamentals and desired policies, it is expected to rise further in 2015, reflecting an improved oil trade balance as well

<sup>1</sup> Prepared by Florence Jaumotte.

as still sluggish domestic demand and the weaker euro. The real effective exchange rate (REER) depreciation so far in 2015 is helpful given the current stage of the economic cycle and the need to address low inflation and reduce deflation risks. However, the REER is now moderately weaker than the level consistent with medium-term fundamentals. A broader policy approach to strengthen growth and inflation, alongside accommodative monetary policy, would contribute to a gradual strengthening of the real exchange rate over the medium term. In particular, investment, which had collapsed with the crisis, has only expanded modestly and is expected to recover very gradually. Several factors may be contributing to depressing investment, such as adverse feedback loops between expectations of low growth and weak investment, uncertain growth prospects, and credit constraints in some countries. The weak investment raises concerns about potential growth prospects.

3. **The rising external surplus reflects an asymmetric external adjustment of net creditor and net debtor countries.** Germany and the Netherlands continue to see their large current account surpluses expand, while the improvement among countries previously in deficit has until recently been mainly due to import compression in a context of weak growth, and partly due to some structural improvements, including falling unit labor costs, rising productivity, and trade gains outside the euro area. The fall in oil prices and euro depreciation will help countries with weak external positions; however, it could exacerbate imbalances in countries with large surpluses if they fail to implement at the same time broader policies which strengthen domestic demand. More substantial adjustment is desirable for individual euro area economies, respectively, on internal rebalancing for core economies and on improving productivity and non-cost competitiveness for periphery economies. Real exchange rates seem undervalued in surplus economies and remain overvalued in major deficit economies.



4. **Key risks facing the euro area are a protracted period of low growth and inflation, remaining political uncertainties in Greece, disruptive asset price shifts and financial market volatility, as well as a stronger than expected slowdown in major emerging markets.**

- A protracted period of low growth and low inflation in the euro area would worsen public and private debt dynamics. This could also lead to further “bad” rebalancing, as the current account improvement in debtor countries would reflect mostly import compression. The chronic lack of demand, impaired corporate and bank balance sheets, and slow progress in structural reform underlie the weak medium-term growth outlook.
- Contagion risks from events in Greece have been reduced with the signature of the ESM program in August but political uncertainty means that they remain a possible source of

renewed market stress. The rest of the euro area could be affected through financial links, trade channels and more generalized confidence and contagion effects, possibly leading to a re-intensification of financial fragmentation and bank-sovereign-real economy links.

- In a context of very accommodative monetary policies and compressed term premiums in advanced economies, prospects for changes in monetary policy stance in major economies could trigger higher term premiums, while a much worse growth outlook in emerging economies would weigh on global trade, with adverse spillovers to the euro area.

## POLICIES

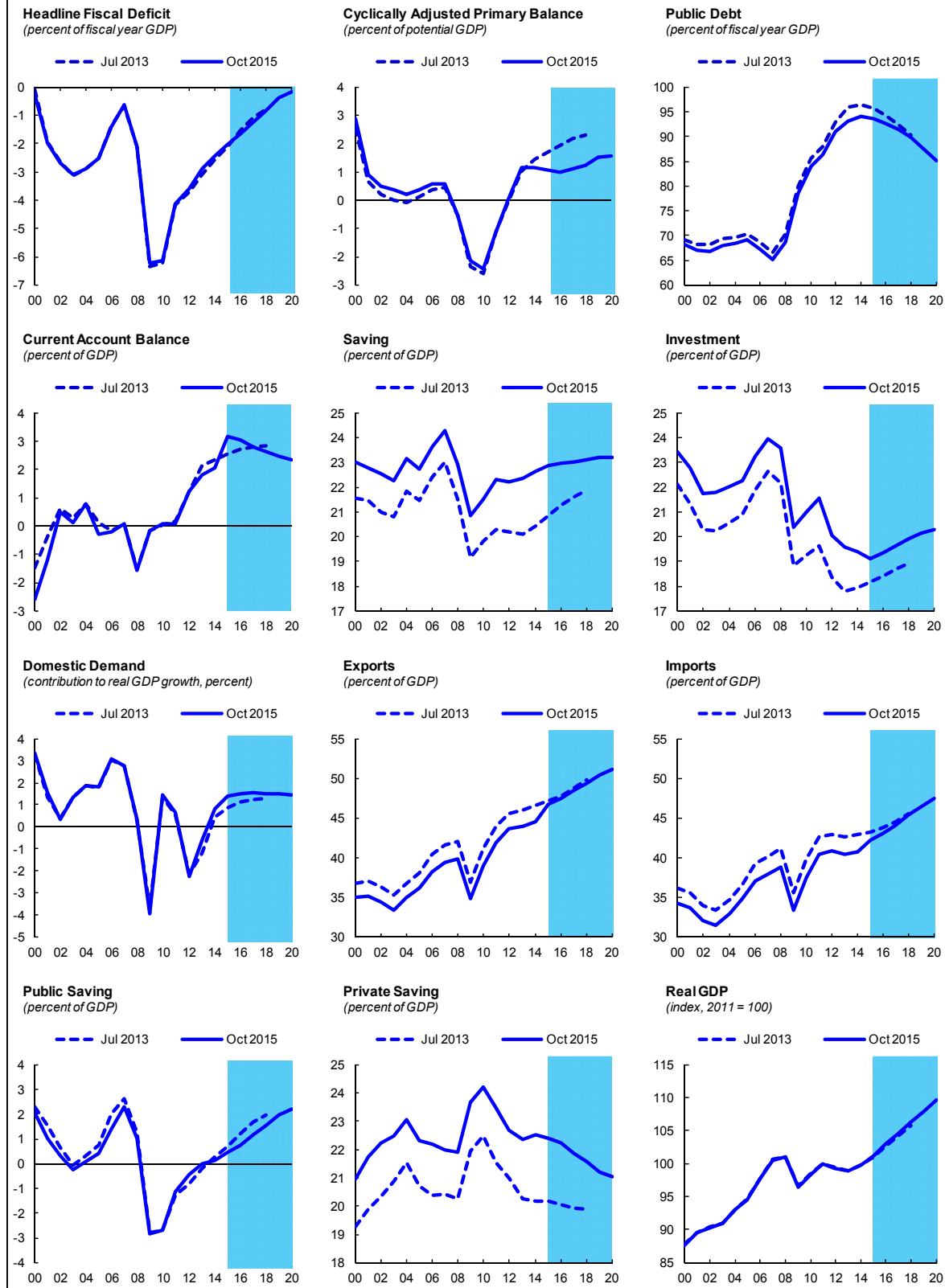
5. **There has been significant progress on policies aimed at reducing fiscal and external imbalances, and addressing risks from low growth and inflation.** At the national level, governments have worked on restoring the health of public finances and banks, and implementing structural reforms. At the regional level, policies have been focused on easing euro area stresses, by establishing a banking union and strengthening fiscal and economic policy governance. Implementation of an ambitious QE program will help anchor inflation expectations.

6. **However, a comprehensive and more balanced policy mix is needed to raise the growth trajectory and further rebalancing in the medium term.** If implemented together, the policies can be mutually self-reinforcing and generate a much larger growth dividend. Specifically, continued monetary accommodation needs to be complemented with:

- Using the fiscal space under the Stability and Growth Pact (SGP) to support investment and structural reforms. Countries with fiscal space (Germany and the Netherlands) should use their fiscal space and the interest windfall from the QE for investment and structural reforms. This would help boost their domestic demand and medium-term growth prospects, while reducing their current account surpluses and producing positive outward spillovers to the rest of the region. In contrast, those with high debt and at risk of breaching the fiscal rules should save their interest windfall to reduce debt. The flexibility under the SGP should be used to prioritize key structural reforms and investment where sound cost-benefit analysis warrants it. Finally, centralized investment initiatives such as the European Fund for Strategic Investment will help support investment;
- Strengthening bank and corporate balance sheets to enhance monetary transmission through accelerated NPL resolution, insolvency reforms, and development of distressed debt markets;
- Pushing more vigorously for structural reforms, supported by a stronger governance framework. At the national level, these include labor market reforms to increase participation and in some cases increase flexibility and reduce duality, product market and service sector reforms to increase competition and improve the business environment. At the regional level, there should be a renewed emphasis on convergence toward resilient economic structures and productivity. Among other steps to further these aims, faster progress is needed on the implementation of the Services Directive and on completing the Single Market in goods, services, capital, transport, energy, and the digital economy, as well as the harmonization of insolvency regimes.



**Figure 1. Euro Area: Selected Macroeconomic Indicators**



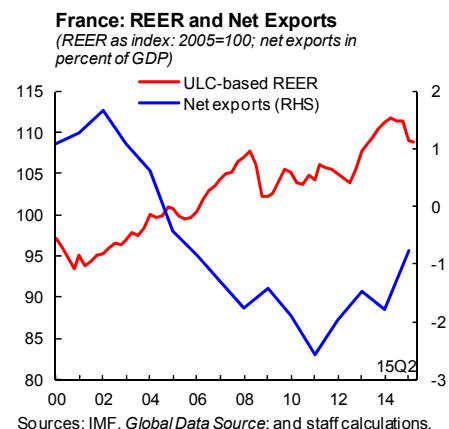
Source: IMF, *World Economic Outlook*.



*External imbalances have narrowed on the back of weaker investment and some improvement in public saving, and are expected to narrow further reflecting the weaker euro and lower oil prices. However, the outlook for public debt has deteriorated in a context of slower activity, thus reducing fiscal vulnerabilities remains a key priority. Stronger expenditure-based consolidation is needed with support from fundamental spending reform. Policymakers should build on recent reforms of product and labor markets to continue strengthening competitiveness and raising employment.*

## IMBALANCES: OUTLOOK AND RISKS

1. **The external position has improved moderately on the back of weaker investment.** The current account deficit has narrowed since 2012, and is now smaller than projected at the time of the 2013 sustainability updates. Even though the ULC-based real effective exchange rate has appreciated by about 6 percent over 2011-14, net exports have rebounded since 2011. The improvement in the external balance has been mainly due to a further weakening of private investment, while national saving rate remained broadly flat as private and public saving rates moved in opposite directions. Private saving decreased with accelerating consumption from late 2014, while public saving recovered with fiscal consolidation (though less than previously envisaged). Nevertheless, France's external position in 2014 was weaker than the level consistent with medium-term fundamentals and desirable policy settings, and the real exchange rate was 5 to 10 percent overvalued in 2014 according to staff estimates. Developments as of May 2015 suggest some strengthening of the external position, but it is still moderately weaker than implied by fundamentals, given high unit labor costs and fiscal deficits.



2. **The recent euro depreciation and the fall in oil prices will help further improve the external balance, but additional action is needed for more durable rebalancing.** The favorable external environment is expected to lead to significant savings including in energy imports and to stronger export growth alongside rising global demand, which will lead to narrowing current account deficits. The negative output gap is also expected to narrow gradually, as the macroeconomic policy mix has become much more accommodative on account of the ECB's QE, the euro depreciation, and slower fiscal consolidation. Nevertheless, some of the underlying causes of

<sup>1</sup> Prepared by Seok Gil Park.

the external imbalance remain, in particular weak competitiveness resulting in continued loss in world export market share, elevated unit labor costs, and a still sizable fiscal deficit.

3. **The fiscal consolidation strategy has run into difficulties, and fiscal slippages remain a risk.** Although fiscal consolidation is ongoing, it fell short of the authorities' target with the headline deficit broadly unchanged at 3.9 percent of GDP. In early 2012, the authorities set out to bring the structural deficit to balance by 2016, with an adjustment equally divided between revenue and expenditure measures. However, the plan ran into difficulties in 2014 when spending freezes did not yield the envisaged savings in the context of low growth and inflation. Both the headline and cyclically adjusted deficits are higher than in the previous projections and this has led to record highs in public debt ratio. The public debt dynamics are particularly vulnerable to a growth shock, and the fiscal adjustment path is subject to implementation risks. A failure to further improve the fiscal position would impair efforts to reduce the current account deficit.

4. **A protracted period of sluggish growth, low inflation, and persistently high unemployment pose also a significant risk, which would affect the public debt dynamics.** While the baseline projections is for a solid short-term recovery supported by accommodative external conditions and robust domestic demand, the recovery could lose steam due to: (i) a less favorable external environment; (ii) insufficient progress in removing growth bottlenecks; and (iii) the re-emergence of financial volatility, including in wholesale funding on which French banks are highly reliant. Such a scenario would significantly affect the public debt dynamics. In addition, France's medium-term growth potential is much weaker than before the crisis, as crisis legacies have left their mark and structural rigidities continue to weigh on medium-term prospects and competitiveness.

## POLICIES

5. **Stronger expenditure-based consolidation is needed to ensure that debt is placed on a firm downward trajectory by 2017.** While the European Council granted France two additional years, until 2017, to bring its headline deficit below the EDP threshold, the current fiscal strategy would only narrowly meet this objective, leaving little room for surprises. Primary general government expenditures should be kept flat in real terms, delivering a structural adjustment of about ½ a percent of GDP per year until structural balance is reached. This objective would adequately balance the needs to anchor debt sustainability and to smooth the impact of fiscal consolidation on demand. It would provide a safety margin to ensure that the headline deficit is reduced to below 3 percent of GDP by 2017 and debt is placed on a firm downward trajectory. It would also create fiscal space for growth-friendly fiscal rebalancing that lowers marginal taxes on labor and capital starting around 2020. In the near term, it is important to clarify the measures underpinning the announced 2015-17 spending package, identifying additional measures and spelling out that any windfall gains will be saved.

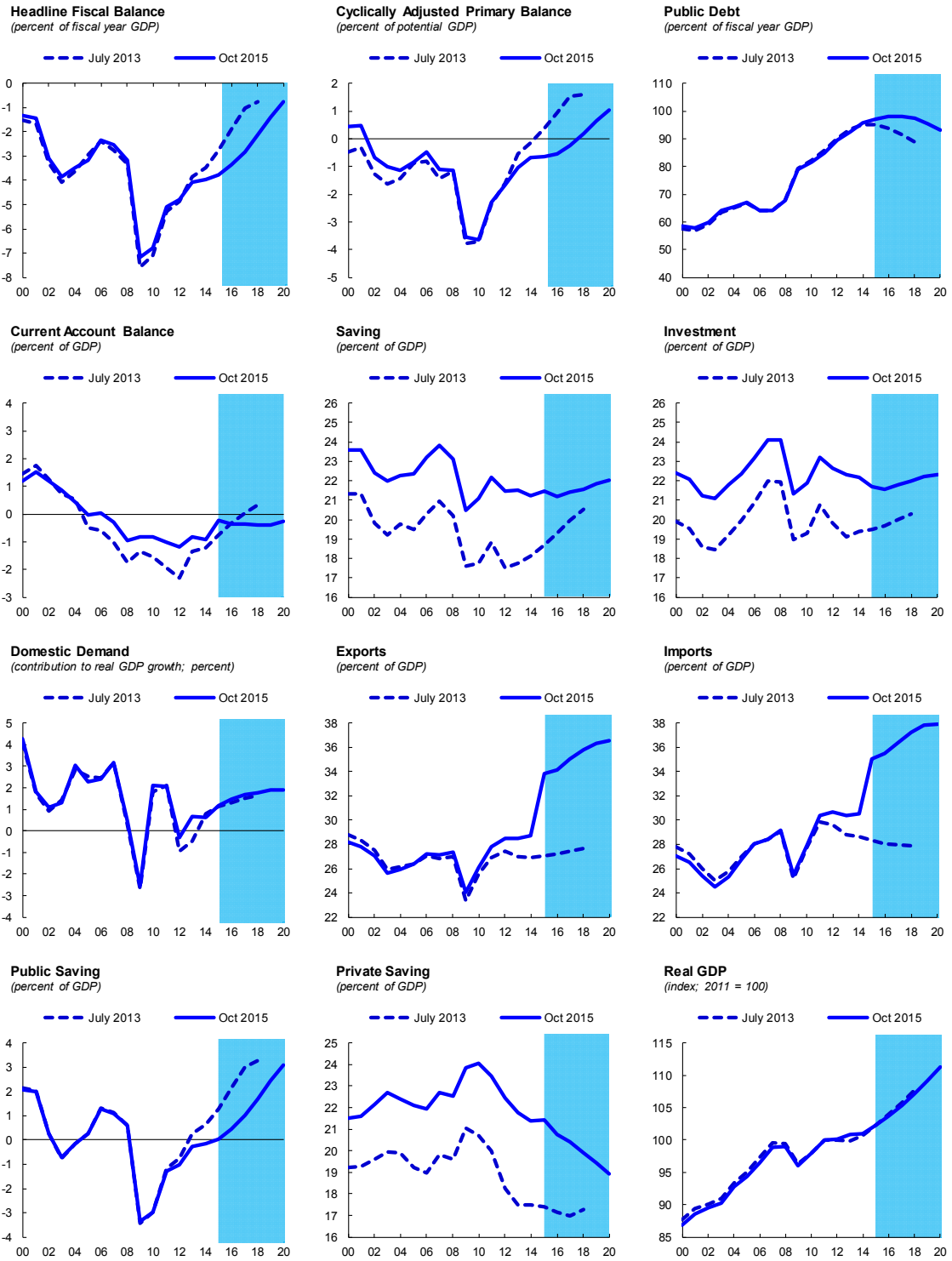
6. **Fundamental spending reforms are called for to underpin a lasting reduction in government expenditure.** Building on recent efforts, a broad review of expenditure programs and

processes at all levels of governments should be launched to prepare for deeper spending reform. For example, local government positions and institutions need to be streamlined by further cuts in transfers, tighter caps on local borrowing and tax rates. Also, the growth in public employment should be reversed, based on reviews of staffing at all levels of government. On the social security spending, there is room for improving the targeting and efficiency of social benefits, and for pension benefit reforms such as increasing the effective retirement age and streamlining special pension regimes.

7. **A lasting reduction of external imbalances and strengthening of growth prospects would require additional reform efforts.** To this end, staff focused its recommendations on the need to underpin fiscal consolidation through deep spending reform, push ahead with broad-based reforms to foster employment creation, while maintaining the recent momentum on product market reforms.

- Labor market reform: Removing barriers to employment will be critical to reversing the rise in structural unemployment. Building on recent efforts such as the reduction of the tax wedge, further broad-based reforms should be implemented including expanding enterprise-level flexibility for social partners to adjust work hours and wages, limiting minimum wage increases to inflation as long as unemployment remains high, strengthening job search incentives for benefit recipients, and better targeting education and training resources to the young and the unemployed.
- Removing growth bottlenecks: France's low productivity growth can be attributed in part to a lack of competition and overregulation, which weaken incentives to innovate and invest. Recent reforms of product markets—including the *Macron* law to enhance competition—are welcomed, but more could be done to alleviate structural rigidities. For example, the authorities could strengthen the Competition Authority and further reduce disincentives for SMEs to grow above certain employee thresholds, and liberalize regulated professions not covered by the *Macron* law.

**Figure 1. France: Selected Macroeconomic Indicators**



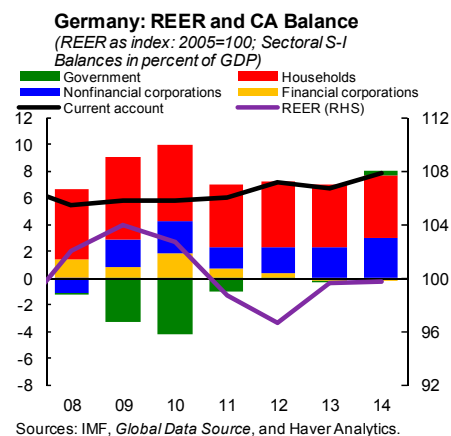
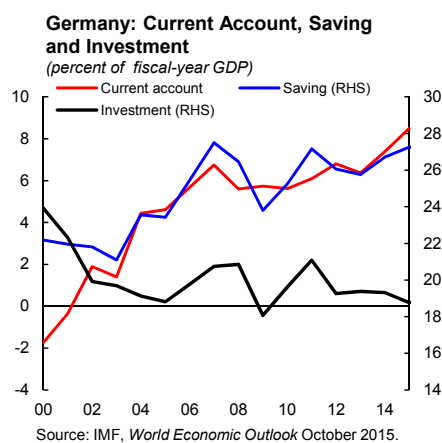
Source: IMF, *World Economic Outlook*.

# GERMANY<sup>1</sup>

Germany's external surplus reached another historical high reflecting weak investment and increasing saving, and it is expected to rise further with the weak euro and lower oil prices. The external position appears to be substantially stronger than that implied by medium-term fundamentals and desirable policy settings. Although the large surplus is not a vulnerability per se, weak investment and slow growth in the medium-term are a worry. Boosting internal demand and potential output by increasing public investment and structural reforms will help external sector rebalancing and would generate positive spillovers to the rest of the region.

## IMBALANCES: OUTLOOK AND RISKS

1. **The external surplus has continued to grow, reflecting weak investment and increasing saving.** The current account surplus reached another historical high at 7.4 percent of GDP in 2014 (a 1 pp. higher than in 2013), mostly reflecting an improvement in the oil and gas trade deficit. While domestic demand regained momentum at the end of last year, supported by lower oil prices and strong real wage growth, private saving remained at a high level. Looking at sectoral saving-investment balances, non-financial corporations and the general government increased their surpluses in 2014 relative to 2013. In fact, the surplus of non-financial corporations, at 3 percent of GDP, reached its highest level since reunification. Public saving also contributed to an increase in the external surplus, as fiscal policy was mildly contractionary in 2014. The current account surplus is projected to grow further in 2015—exceeding 8 percent of GDP—reflecting the oil price drop and the euro depreciation. It is only expected to decline moderately in the medium term, as the windfall from lower oil prices is gradually spent, private investment recovers modestly, and stronger wage growth relative to trading partners realigns competitiveness.



<sup>1</sup> Prepared by Seok Gil Park.

2. **Germany's external position is substantially stronger than implied by medium-term fundamentals and desirable policy settings.** According to staff estimates, Germany's current account balance was about 3 to 5 percent of GDP above its cyclically-adjusted norm, and the real exchange rate was 5 to 15 percent undervalued in 2014. While it is difficult to pin down distortions that explain the large current account surplus, a number of country-specific factors—such as strong competitiveness, elevated saving, weak investment, and low productivity growth in the non-tradable sector—play a role. Compared with other episodes of large and sustained current account surpluses, Germany's current account surplus episode stands out by the weakness of domestic demand and, especially, the relatively strong fiscal position, while the depreciation of the ULC based real effective exchange rate prior to and in the early years of the surplus episode was also likely a contributing factor.

3. **Germany's current account surplus has been associated with weaker domestic demand than in typical large and sustained surplus episodes in advanced economies.** Looking ahead, potential growth would decline appreciably, reflecting the projected decline in working-age population, assuming TFP growth and capital accumulation remain at their current rates. In turn, these weak potential growth prospects may be holding back current private investment, despite the favorable corporate balance sheets and interest rates. Staff analysis suggests that exits from large and sustained current account surpluses have typically been accompanied by an acceleration of GDP growth, both its cyclical and trend components,<sup>2</sup> as investment increases on the back of improved growth prospects.

4. **Fiscal vulnerabilities have declined significantly.** The general government surplus rose to 0.3 percent of GDP in 2014 (reflecting lower-than-expected interest payments and one-off revenue items), which implies a structural improvement of 0.3 percent relative to 2013. Also, in 2014, the budget of the federal government was balanced, one year ahead of schedule. While fiscal policy is expected to turn mildly expansionary in 2015, fiscal balances are set to remain comfortably within the boundaries of the fiscal rules for the remainder of the legislature. The negative interest rate-growth differential is pushing the debt ratio down faster than expected; it is expected to return to 60 percent by 2020. With reduced fiscal risks and infrastructure bottlenecks, there is a scope for more public investment stimulus.

## POLICIES

5. **Policies should focus on boosting domestic demand and potential growth.** This would help reduce the current account surplus and generate positive outward spillovers. Boosting domestic demand and the growth potential would require:

- *Stepping up public investment.* The government announced plans to moderately raise public investment. According to these plans, public investment will increase from 2.2 percent of

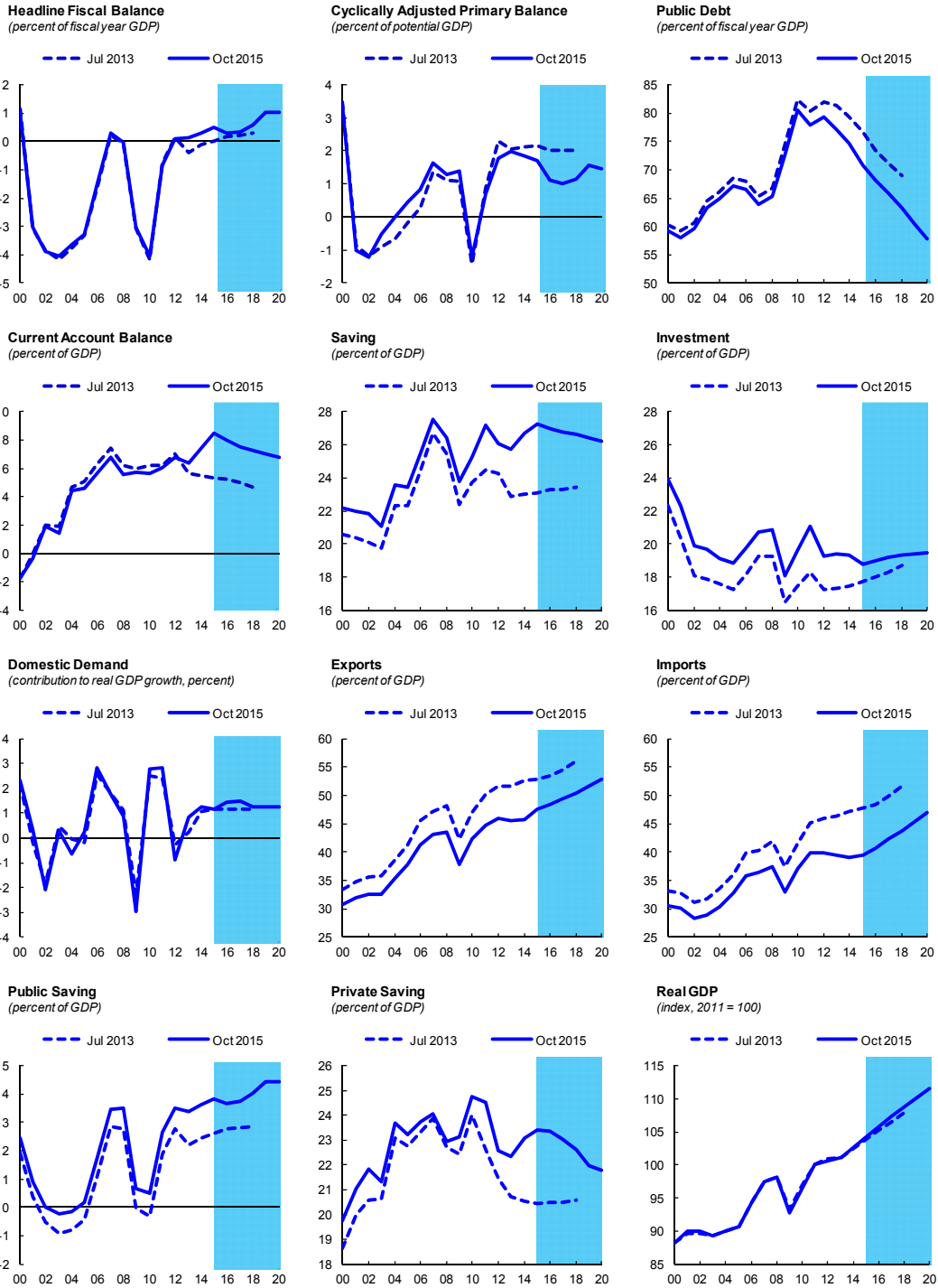
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<sup>2</sup> See Chapter I, Selected Issues Papers of Germany 2015 Article IV Consultation.

GDP in 2014 to 2.3 percent of GDP in 2019. There is scope for more ambitious additional investment expenditure, which could be supported by new initiatives to enable better planning at the local level and facilitate public private partnerships. Such a program would stimulate private investment by removing infrastructure bottlenecks, thereby strengthening potential growth, while increasing domestic demand. Stronger domestic demand potential will lower current account surplus and generate positive spillovers to the rest of the euro area.

- *Implementing structural reforms.* In this regard, reform priority should be given to fostering a more dynamic services sector through greater competition, which would also diversify sources of growth. Removing barriers to competition would boost services sector productivity and potential growth. On the labor market front, disincentives for women to work full time should be reduced as a way to counter the adverse effects of an aging population on the labor supply.

**Figure 1. Germany: Selected Macroeconomic Indicators 1/**



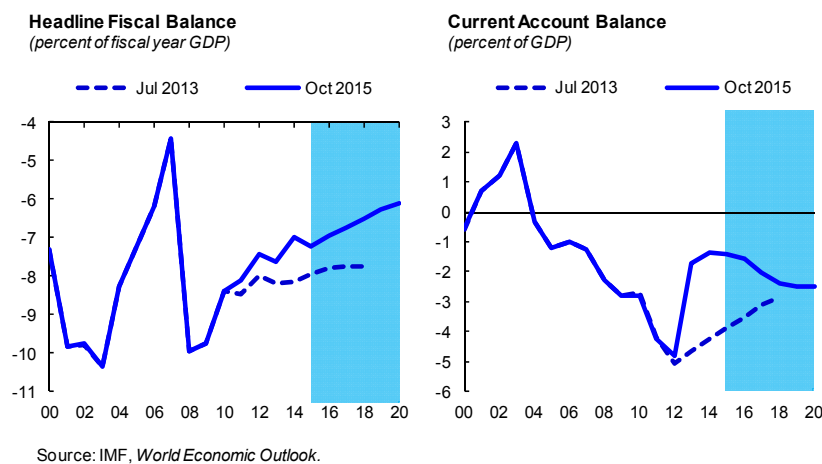
Source: IMF, *World Economic Outlook*.  
 1/ Germany moved to a different system of national accounts (ESA 2010) in September 2014, thus the two WEO vintages shown may not directly comparable.



The previously large external deficit has narrowed considerably in recent years as investment has slowed, bringing it in line with fundamentals. At the same time, the fiscal deficit, though still large, is improving gradually mainly due to expenditure reductions. These positive developments notwithstanding, further policy action is needed to support external and fiscal stability in coming years. In particular, reforms should include more emphasis on revenue-side measures and the adoption of additional structural reforms to boost potential output. The main risks stem from a surge in global financial market volatility, slower-than-expected progress in addressing domestic supply-side bottlenecks, and a supply-induced spike in inflation.

## IMBALANCES: DIAGNOSIS AND RISKS

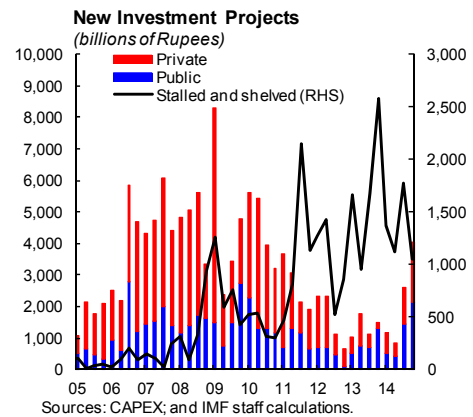
1. **Ongoing fiscal consolidation and other policy measures have narrowed previously large ‘twin’ fiscal and external deficits.** At the time of the 2013 sustainability report economic activity in India was being depressed by supply constraints, and an uncertain regulatory and political environment. These circumstances contributed to significant twin fiscal and external deficits, given a weakened capacity for revenue generation, and a marked rise in commodity and gold imports. Since 2013, reductions in spending have fostered some improvement in the fiscal deficit, and the current-account deficit has narrowed considerably more than expected, largely due to import compression associated with weak private investment, as well as a reduction in gold imports. More recently, economic activity has been strengthening, as business and consumer confidence have rallied in response to favorable policies and increased political certainty following the 2014 election. Going forward, this strong growth is expected to continue as a result of lower oil prices and favorable policy measures, though inflation expectations remain elevated despite relatively tight monetary policy and lower global commodity prices.



<sup>1</sup> Prepared by Patrick Blagrove.

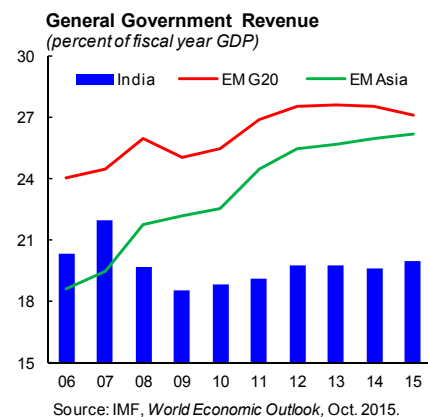
**2. External imbalances have been reduced as investment has slowed sharply.**

The previously large current account deficit has been reduced dramatically since the 2013 sustainability report. Viewed from a savings-investment perspective, this is largely due to further weakening in private investment which took place in late 2013 and early 2014 associated with policy uncertainty and related confidence effects (Figure 1). Investment weakness, alongside a significant reduction in gold imports (reflecting past administrative measures and higher consumer confidence as inflation has declined) reduced imports considerably which, combined with some revival of exports, narrowed the current-account deficit to about 1.4 percent of GDP (FY 2014/15), well below the levels prevailing in the past. The external position is assessed as being broadly consistent with fundamentals, given India's low per capita income, favorable growth prospects, and development needs. In coming years the current account deficit is expected to remain stable, as downward pressure on imports associated with lower oil prices should be largely offset by stronger domestic demand, and stronger external demand should buoy exports. Still, the recent (welcome) increase of private investment could imply somewhat larger future external deficits, particularly if national saving does not increase.<sup>2</sup>



**3. The fiscal deficit has narrowed, primarily as a result of expenditure reductions.**

Relative to its projected level in the 2013 sustainability report, the fiscal deficit has improved considerably, and current projections imply a declining medium-term trajectory for public debt (projected debt-to-GDP ratio to fall below 60 percent by FY 2019/20). However, the mix of reforms which have led to this consolidation could be improved by putting more emphasis on measures to increase revenues, which are low relative to peers. Improvements along these lines would not only be more growth-friendly, but would support medium-term fiscal sustainability by ensuring more robust future revenue streams. Expenditure-side policy reforms remain important, particularly reductions in subsidy spending in certain areas.



**4. There are several risks to economic stability, from both domestic and external factors:**

- On the *external* side, risks stem from the normalization of monetary policy in advanced economies (the US in particular), which could increase global financial market volatility in the short term. Also, a potential increase in oil (and other commodity) prices towards levels seen

<sup>2</sup> The EBA CA regression estimates a norm of -4.2 percent of GDP. However, in staff's judgment, global financial markets cannot be counted on to reliably finance a deficit of that size in light of India's current (though reduced) vulnerabilities. Staff judges that a smaller deficit of about 2.5 percent is a more appropriate norm, so there is some room for the CA deficit to increase as investment strengthens, while still remaining aligned with fundamentals.

in 2014 would put significant upward pressure on India's import bill, given reliance on energy imports in the face of domestic infrastructure bottlenecks.

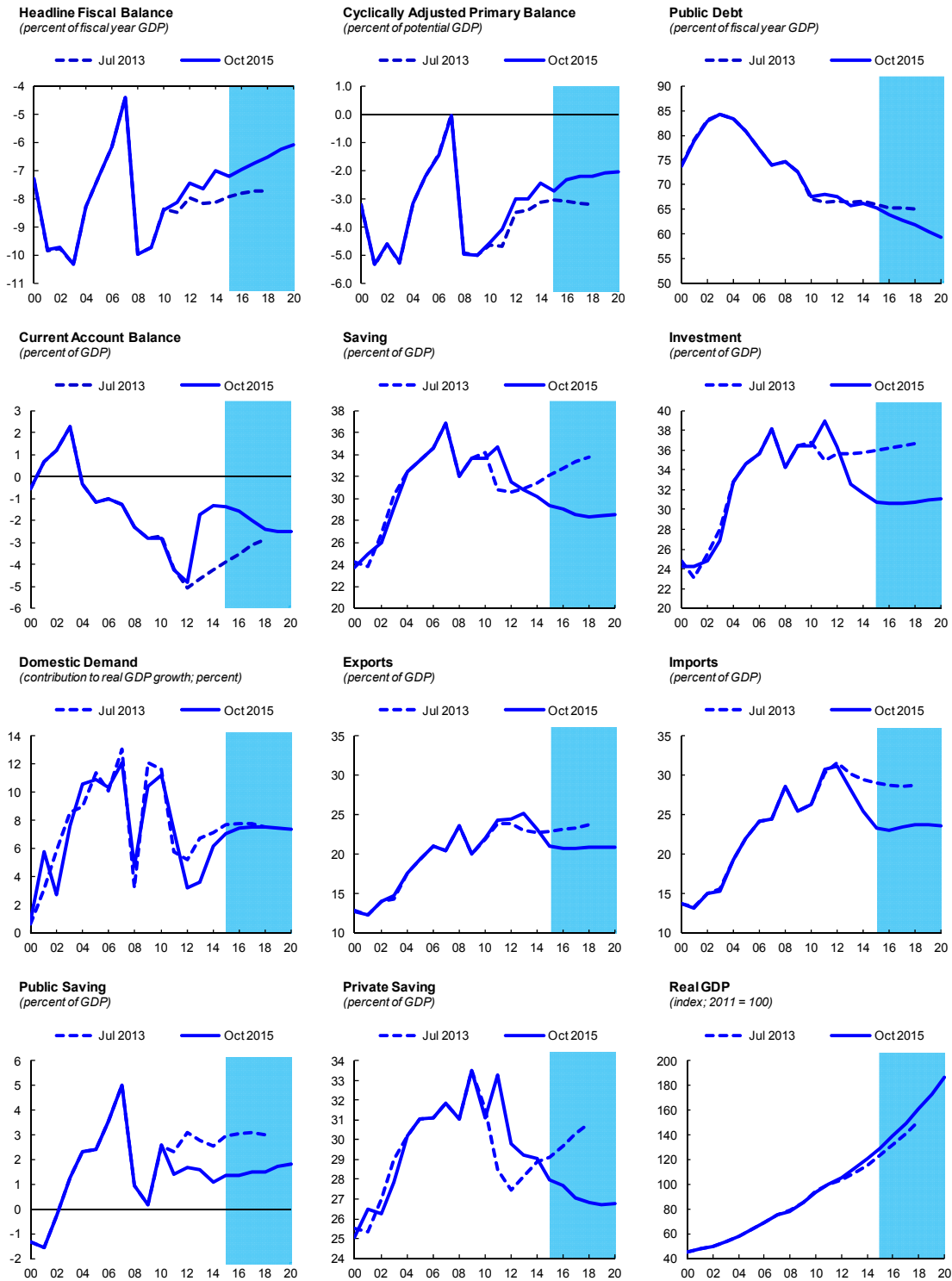
- On the *domestic side*, there are important downside risks to growth prospects, including from possibly slower-than-expected progress on structural reforms (removing infrastructure bottlenecks and strengthening labor and product markets). Meanwhile, although inflation has been reduced relative to past high rates, expectations remain elevated. The recent rate cuts notwithstanding, monetary policy may not be able to support growth if domestic demand were to deteriorate. Furthermore, a positive shock to inflation could lead to an increase of precautionary gold imports, which would widen external imbalances. Finally, although financial-sector vulnerabilities appear to be modest, there has been a gradual increase in non-performing loans in recent years associated with weak growth, and India's banks are likely to require additional capital injections over the next several years.

## **POLICIES: PROMOTING SUSTAINABILITY**

5. **Reforms in a number of areas would further strengthen the Indian economy, and support medium-term fiscal and external sustainability.** Important policy refinements include enhancing revenue collection and reducing subsidy spending; proceeding with additional growth-friendly structural reforms; and encouraging stable capital flows, in particular FDI.

- *Tax and subsidy reform to bolster the fiscal position:* The successful implementation of a national goods and services tax (GST) is a top priority, and emphasis should also be placed on improving tax administration to ensure compliance with this and other tax policies. In addition, although significant progress has been made in recent years, subsidies should be scaled back further.
- *Structural reforms to boost potential growth:* Labor market inflexibility, a challenging business climate, and critical infrastructure bottlenecks in some sectors (most notably power generation and distribution) have been weighing down potential output. Boosting female labor-force participation, addressing issues relating to insolvency, contract enforcement, and cross-border trade, and overcoming structural shortages in the power sector are all policy priorities.
- *Measures to improve the current-account deficit financing mix:* Recently, current account deficits have been financed to a greater degree than usual by debt flows, which are volatile and thus increase external vulnerabilities. Policies aimed at fostering a sound business environment and attracting more FDI could make the funding mix more robust to shocks.
- *In light of upside risks to inflation and to achieve the medium-term target, monetary policy should remain tight.* Inflation has been well-contained recently, but expectations remain elevated implying that possible supply- or demand-induced shocks could have significant and long-lasting effects, possibly undoing much of the recent progress in improving the fiscal position.

**Figure 1. India: Selected Macroeconomic Indicators**



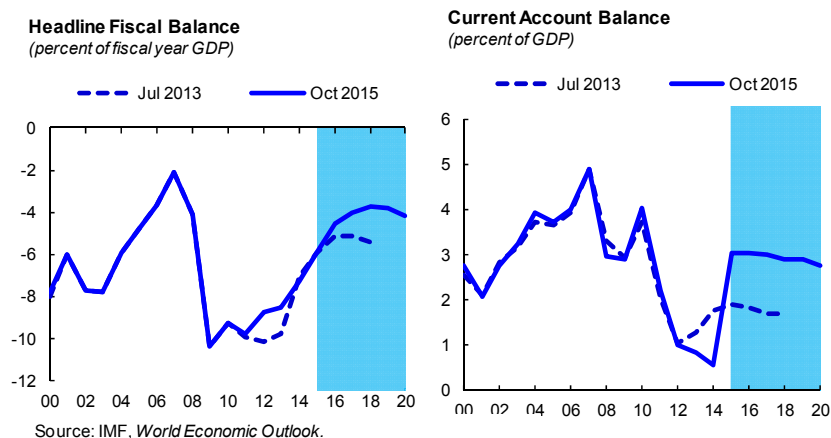
Source: IMF, *World Economic Outlook*.

# JAPAN<sup>1</sup>

*Fiscal imbalances continue to threaten long-term economic stability in Japan. Despite some narrowing in the fiscal deficit since 2013 on the back of recovering economic growth and the VAT increase, it remains high. Going forward, projections for social-security spending requirements and tepid potential-output growth imply that debt is on an unsustainable trajectory. Meanwhile, the external sector is assessed as being in balance, though further currency depreciation and declines in oil prices could push the current-account surplus above its desirable level. In order to reduce fiscal imbalances, structural reforms to increase potential output are warranted, and a credible medium-term fiscal consolidation framework must be put in place with specific revenue and expenditure measures and based on realistic economic assumptions.*

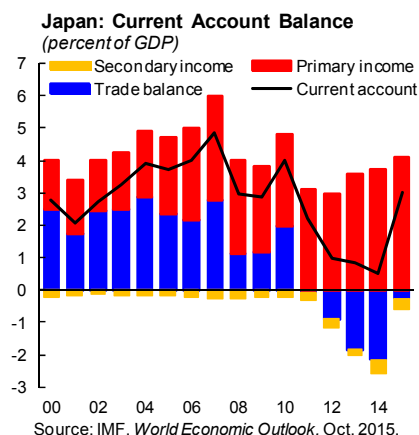
## IMBALANCES: DIAGNOSIS AND RISKS

1. **Persistent large fiscal deficits and sluggish growth have led to mounting debt levels, but recent consolidation efforts are progressing.** For the better part of the last decade the economic environment in Japan has called for fiscal stimulus, as activity was depressed first by the Global Financial Crisis, and then by the Great East Japan earthquake. This stimulus spending alongside weak revenue growth has led to significant fiscal deficits and rising debt levels. Relative to 2013 projections, output has been weaker than expected largely due to a protracted effect on consumption following the April 2014 VAT hike, though the recent decline in oil prices and further easing of financial conditions are likely to foster some recovery in 2015–16. Consolidation efforts undertaken since 2013 (most notably the VAT rate increase) as well as the unwinding of previous reconstruction spending and other fiscal stimuli are expected to narrow the fiscal deficit in coming years. Nevertheless, while the announced medium-term consolidation plan provides a useful anchor, a credible medium-term consolidation framework requires that it be based on realistic economic assumptions and specific structural revenue and expenditure measures identified up front.



<sup>1</sup> Prepared by Patrick Blagrave.

2. **The external sector is assessed as being broadly in balance.** Since 2013, considerable depreciation of the real effective exchange rate, alongside some firming of external demand conditions has begun to increase exports, while weaker domestic demand has weighed on import volumes. Some recent improvement in the trade balance alongside a consistently positive net income balance has led to a current account surplus, which is modest in historical context and falls within the range estimated by staff to be consistent with fundamentals (Figure 1).<sup>2</sup> Going forward, the main risk to the external sector stems from the increasingly divergent stances of monetary policy in Japan and the United States, which could lead to an increase in the current-account surplus above the position consistent with fundamentals.



3. **Low potential growth, the high starting deficit, and rising social-security obligations imply unsustainable debt dynamics under current policies.** The aging Japanese population has the dual effect of depressing potential growth through a declining labor-force, while also increasing government expenditure requirements, especially for health care. Japanese firms are having difficulty filling vacancies, given relatively tight labor-market conditions due to labor-supply constraints, implying either the labor force is too small, or skill mismatches are significant (or both). At the same time, investment activity remains depressed, further undermining potential growth through a slower expansion of the productive capital stock.<sup>3</sup> Finally, tax revenues in Japan remain well below those in many other advanced economies. If left unaddressed, these factors would imply debt dynamics which are unsustainable. However, home bias and a stable base of institutional investors, as well as large Japan Government Bond (JGB) purchases by the Bank of Japan (BoJ) more recently, have thus far kept debt-service costs low, thereby lessening the perceived urgency to address the underlying causes of these imbalances.

4. **Large fiscal imbalances continue to pose a significant risk to domestic economic stability.** Current extremely low debt-service costs should not be taken for granted. Indeed, in recent years the experience of other economies has shown that market sentiment can change abruptly, leading to a sharp increase in funding costs. Such a re-assessment of credit risk would be particularly problematic for Japan, which has the largest financing needs of any advanced economy. In addition, already-challenging debt dynamics are acutely sensitive to alternate, moderately weaker assumptions about future growth rates. Another, more medium-term risk to fiscal sustainability relates to a likely future reduction in demand for JGBs—when the BoJ ceases its asset purchases and domestic savings decline in the face of an aging population, yields will likely come under pressure.

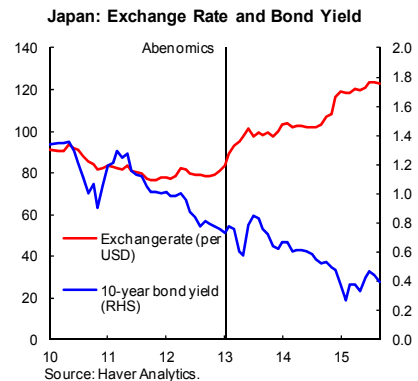
<sup>2</sup> The 2014 external position was broadly consistent with medium-term fundamentals and desirable policies. As of May 2015, the REER has moved toward a moderately weaker level than would be consistent with its fundamentals suggested in the 2014 assessment.

<sup>3</sup> See April 2015 WEO, Chapters 3 and 4.

Finally, the future fate of the financial and external sectors is closely linked to the ambition with which structural reforms are pursued and the sustainability of the fiscal position. Specifically, reducing fiscal imbalances will tend to increase external imbalances unless policies are enacted to strengthen domestic demand.

## POLICIES: PAST MEASURES AND FUTURE NEEDS

5. **The ‘three arrows’ of the Abenomics agenda have fostered some improvements, but considerable further progress is needed.** Reforms to corporate governance practices and rising female labor-force participation have been successes, but there is room for further improvement. Fiscal consolidation efforts have reduced the primary deficit, broadly as envisioned in 2013, but a credible medium-term strategy is needed for this progress to continue. Finally, the Bank of Japan’s quantitative and qualitative monetary easing (QQME) program reduced yields on debt instruments and facilitated portfolio rebalancing. However, it has not achieved the regime change needed to attain the durable inflation of 2 percent which was envisaged by policymakers in 2013.

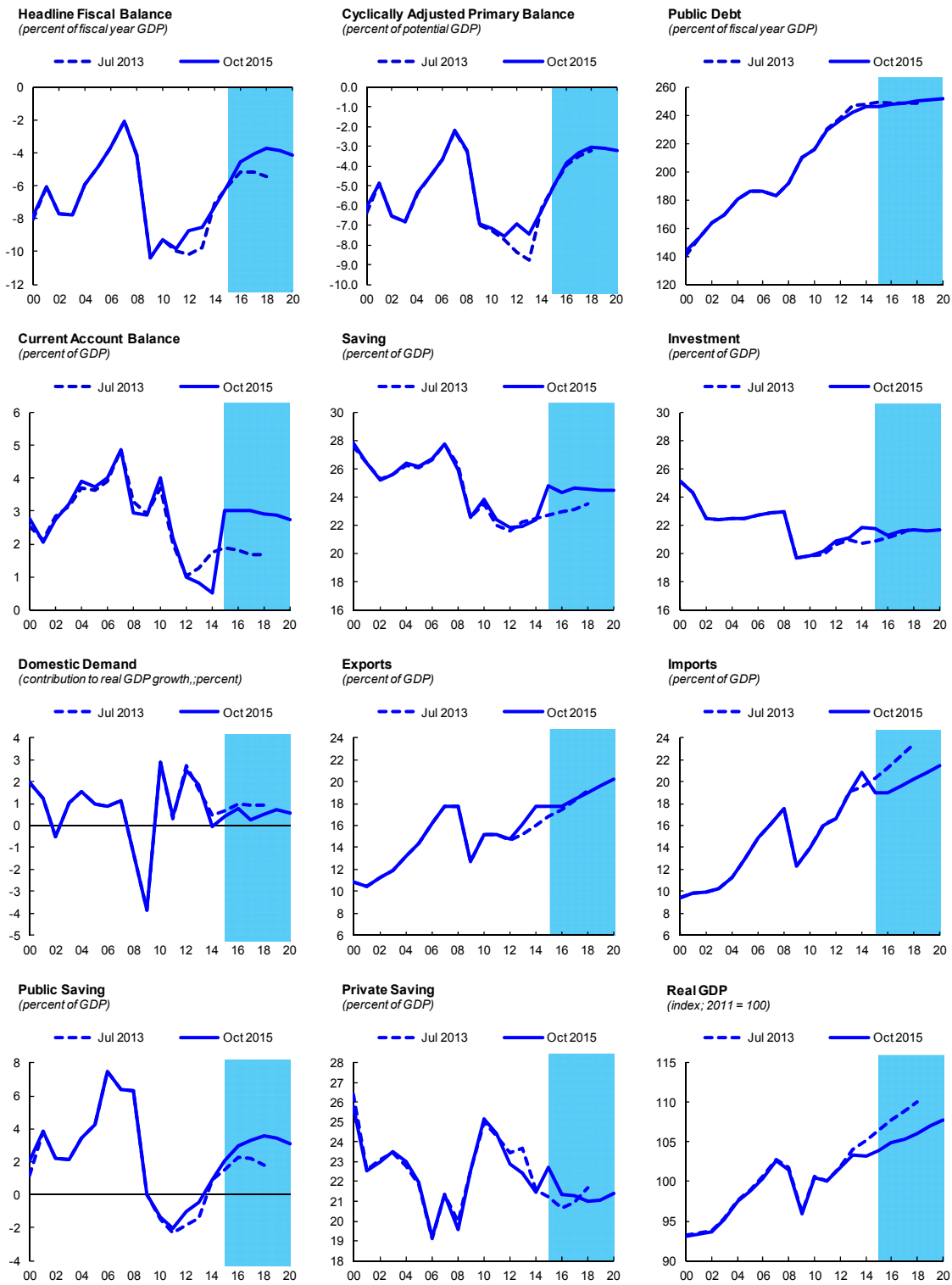


6. **Further fiscal and structural reforms are critical to boost revenue and ensure fiscal sustainability.** Policies must be enacted to increase potential output through structural reforms, and a credible medium-term consolidation framework based on realistic economic assumptions and specific spending and revenue measures must be put in place:

- *Structural reforms to increase potential output:* Increasing the size of the labor force is a priority, and this can be achieved through a mix of policies. Although female labor-force participation has improved, additional reforms are needed to narrow the gap between female and male participation rates. Labor-force growth would benefit further from measures which encouraged participation by foreign workers and additional increases in the retirement age. Policies which encourage investment, such as corporate-income-tax and corporate-governance reform, can also benefit potential growth by gradually increasing the stock of productive capital—in addition, stronger investment would counteract the upward pressure on the current account associated with higher public savings from fiscal consolidation.
- *Need for a concrete and credible medium-term fiscal consolidation framework:* A further hike in the VAT rate (from 8 to 10 percent) is expected in April 2017, but additional consolidation measures will be needed. According to staff estimates, these must amount to around 4.5 percent of GDP over the next decade, and should include more VAT rate hikes (to be implemented gradually), as well as entitlement-spending reductions. Importantly, fiscal projections must be based on growth scenarios which stand a good chance of being achieved, and stronger fiscal institutions will be needed to impart credibility.



**Figure 1. Japan: Selected Macroeconomic Indicators**



Source: IMF, *World Economic Outlook*.

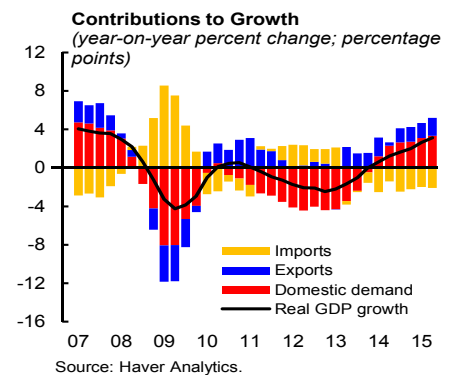


The correction of external and fiscal imbalances continues, helped by stronger-than-expected growth, lower interest rates, and labor market reforms. However, sovereign and external vulnerabilities remain, as public debt has yet to stabilize and the net international investment position is still highly negative. Moreover, competitiveness gains have taken place amid very high unemployment and ongoing private sector deleveraging. The main downside risk is the uncertainty associated with a potential reversal of past reforms, especially if the external environment were to deteriorate significantly. Policies should focus on ensuring job-rich and sustainable medium-term growth, while reducing vulnerabilities. Completing the reform agenda is necessary to sustain a credible and growth-friendly fiscal adjustment, put public debt firmly on a declining path, reducing high structural unemployment, and preserve recent competitiveness gains to bring the net international investment position to safer levels.

## IMBALANCES: DIAGNOSIS AND RISKS

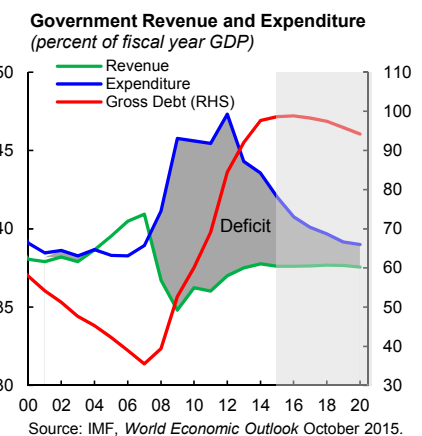
### 1. Against the backdrop of a stronger-than-expected recovery, the fiscal outlook improved, but public debt is still high and increasing, and the external adjustment moderated.

Output growth has been stronger than anticipated in 2013, owing largely to a pickup in private consumption and investment. The ongoing recovery is reflecting rising confidence, supported by strong policies and past reforms, and significant tailwinds from lower oil prices, the depreciation of the euro, and the ECB's expansionary monetary policy. Although the pace of fiscal consolidation has slowed in structural terms, deficit reduction is continuing, helped by higher growth and lower interest rates. However, public debt, despite improved outlook since the 2013 updates, is still high (close to 100 percent of GDP) and increasing. At the same time, part of the current account adjustment following the crisis reversed—reflecting a surge in imports in response to stronger domestic demand—and the negative net international investment position (NIIP) is among the highest in Europe.



### 2. Continued fiscal consolidation, well coordinated across all level of governments, will help maintain market confidence and reduce vulnerabilities.

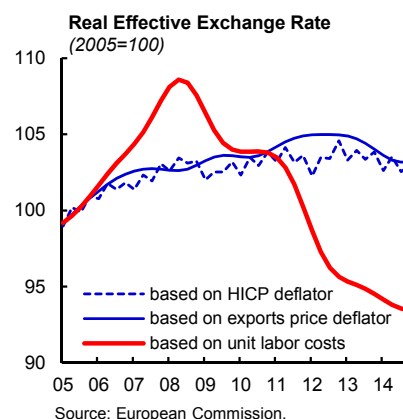
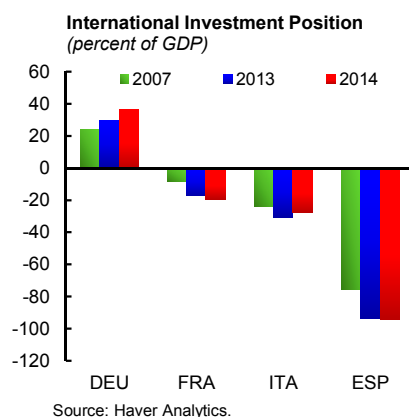
Deficit reduction over the past four years has been critical to restore confidence. While tailwinds are helping to meet the 2015 deficit target of 4.2 percent of GDP, the



<sup>1</sup> Prepared by Carolina Osorio-Buitron.

consolidation is stalling this year in structural terms. Moreover, bringing the headline deficit below 3 percent of GDP to exit the Excessive Deficit Procedure (EDP) in 2016 will be challenging, as well-specified measures fall short of the required structural adjustment effort and implementation risks (particularly at the regional level) are high. Fiscal efforts have been uneven across regions and the overall regional target has been systematically missed, but the government has supported them through debt mutualization mechanisms. While these mechanisms have helped the regions by reducing financing costs and providing a stable source of funding, they are undermining the credibility of fiscal adjustment plans going forward.

3. **Despite noticeable progress since the crisis, further external adjustment is needed to bring the negative NIIP to sustainable levels.** The post-crisis current account improvement has been remarkable, reflecting import compression during the crisis, as well as improving export performance. The adjustment has been achieved through large competitiveness gains, owing to wage moderation and productivity improvements, albeit amid very high unemployment and ongoing deleveraging by households and firms. Indeed, the sharp depreciation of the unit labor cost based real effective exchange rate (REER) since 2008 is linked to large-scale labor shedding during the crisis. In contrast, the depreciation of the consumer price and export price based REER has been limited, suggesting room for additional relative price adjustment. Going forward, current account improvements will be limited by the recovery in private demand—given its strong link with import growth—and structural challenges that hamper export growth—including low labor productivity, limited firm growth, and the relatively low value-added of export goods. Further, at -93 percent of GDP, the NIIP is among the weakest in Europe, implying large gross financing needs from external debt and high sensitivity to valuation losses on the external portfolio. Overall, the external position is substantially weaker than that consistent with medium term fundamentals and desirable policy settings; and the real exchange rate remains overvalued, as reducing unemployment and the very high negative NIIP would require a weaker real effective exchange rate (REER).



4. **Vulnerabilities amplify risks on the downside.**

- The *main domestic risk* is that of past reform reversal, which would create uncertainty and could hamper the recovery, especially if the external environment were to deteriorate.

- Spain remains vulnerable to *external risks*, including weaker euro area demand and a possible rekindling of financial market uncertainty related to Greece, which could weigh on market sentiment and renew sovereign and financial sector stress in Spain. However, these risks should be manageable if timely and effective policy measures are implemented at the euro area level. Domestically, a firm commitment to complete the reform agenda and to reduce the level of sovereign debt through continued fiscal consolidation would help keep market confidence anchored.

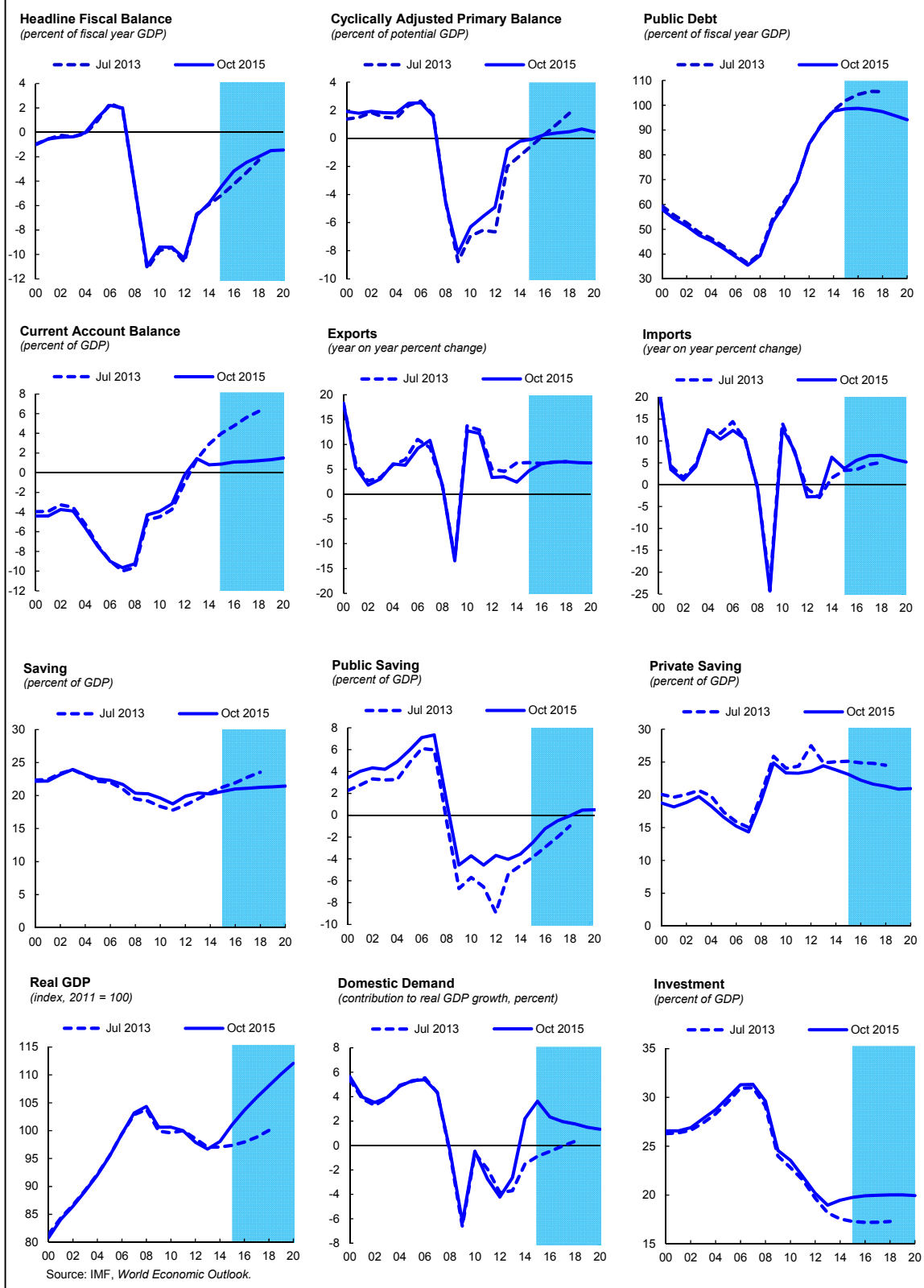
## POLICIES TO ADDRESS IMBALANCES

5. **Sustaining a gradual, growth-friendly fiscal adjustment, and further strengthening the regional fiscal framework are essential to put public debt firmly on a declining path.** While the deficit has been declining, consolidation efforts have slowed. Any windfalls from lower interest rates and higher-than-expected growth should be used to reduce the deficit further. A pace of structural adjustment of around ½ percent of GDP per year would ensure debt is on a declining path. This requires a concerted effort across all government levels through more ambitious and better-specified measures than currently envisaged. Efforts to improve indirect tax collection by raising excise duties and environmental levies and gradually eliminating VAT preferential treatments, along with additional efficiency gains and fiscal savings at the regional level, while protecting the most vulnerable individuals, could support a growth-friendly fiscal consolidation. Moreover, regional fiscal discipline should be further enhanced, including by monitoring and enforcing fiscal targets, improving access to debt mutualization mechanisms and addressing the design drawbacks in the regional finance system, including by better aligning the regions targets with their budgetary capacity.

6. **To address remaining structural challenges and secure higher medium-term growth, the reform agenda should be completed.**

- *Enhancing labor market performance and supporting growth of small firms to foster productivity gains is necessary to support competitiveness.* Labor market policies include maintaining wage growth in line with developments in productivity and external competitiveness, ensuring wages adequately reflect differing business conditions across firms, lowering duality, and enhancing the skills of the long-term unemployed. Improving SME access to financing and removing obstacles for Spain's many small firms to growth will allow them to benefit from economies of scale both in domestic and external markets and raise productivity.
- *Facilitating further private sector debt restructuring would help the external adjustment process.* If implemented effectively, the recent insolvency reforms have the potential to reduce private debt overhangs and support investment and growth. Further strengthening the banking system will ensure that banks can support growth as credit demand recovers.

**Figure 1. Spain: Selected Macroeconomic Indicators**

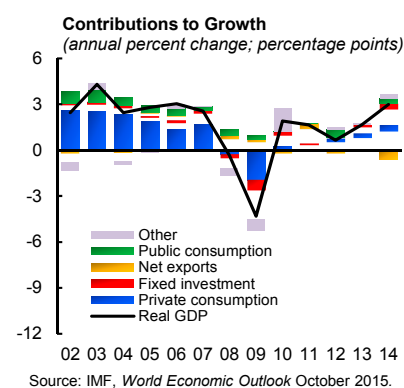


# UNITED KINGDOM<sup>1</sup>

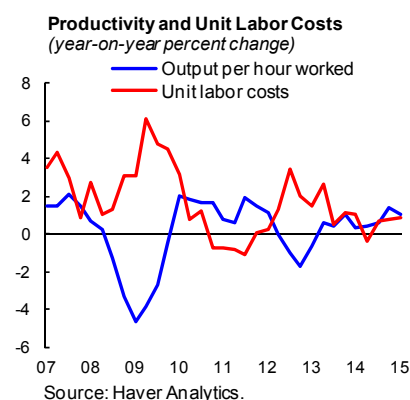
*Stronger-than-anticipated growth has contributed to reduce the fiscal deficit faster than expected, but further adjustments are needed to rebuild fiscal buffers and improve the external position. Despite the strong rebound in the economy, productivity growth has been weak in recent years, limiting competitiveness improvements. The lack of external adjustment also reflects low earnings on foreign investment, some of which may be temporary. Fiscal policy needs to strike the right balance between strengthening public finances and facilitating the recovery, while external challenges include rebuilding competitiveness. Securing the recovery and improving prospects for rebalancing also require continued monetary support and structural reforms.*

## IMBALANCES: DIAGNOSIS AND RISKS

1. **Due to higher growth and lower interest rates, the fiscal position improved more than expected, but the external balance deteriorated.** Output grew by more than what was envisaged in 2013, with private consumption and investment picking up markedly. In addition, the future path of interest rates has been revised down, as inflation prospects are lower due to exchange rate appreciation and lower oil prices. Against this backdrop, the projected headline fiscal balance continued to improve, and public debt is expected to peak at a lower level.<sup>2</sup> These domestic developments were associated with a larger-than-expected widening of the current account deficit—which reached a post-war record of more than 5 percent of GDP in 2014—as private saving continued to decline and the rebound in investment more than offset the upward revision to public saving (Figure 1).



2. **Productivity growth has been persistently weak, limiting improvements in competitiveness.** The slow growth in productivity has occurred on the back of a strong recovery in employment relative to output. While labor productivity is likely to recover somewhat in response to increased investment, it has fallen behind that of other advanced economies, undermining competitiveness. In addition, tax revenues have been weakened as

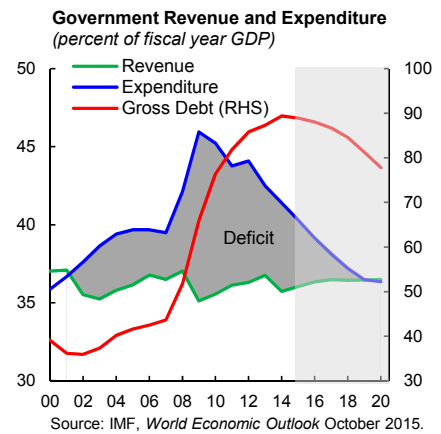


<sup>1</sup> Prepared by Carolina Osorio-Buitrón.

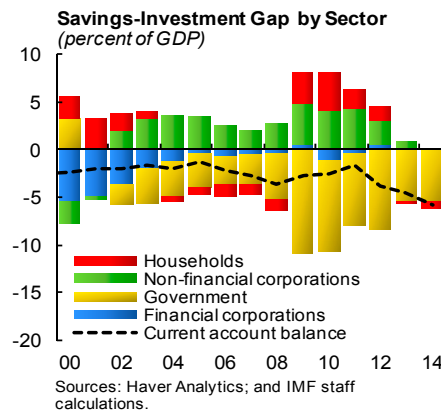
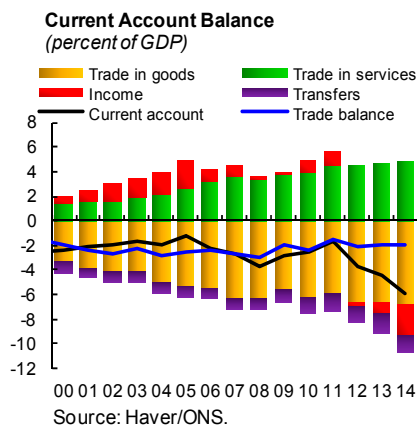
<sup>2</sup> Gross general government and net public debt-to-GDP ratios are expected to peak at slightly over 88 and 80 percent of GDP, respectively, about 10 percentage points below the levels projected in 2013. This partly reflects the government sales of assets acquired through crisis-related interventions in the financial system, which has brought forward cash that would have been received as debt repayments and dividends. Hence, the sales reduce the debt-to-GDP ratio at the cost of (forgone) future revenues.

wage growth has been low; and, household's saving-investment balance has deteriorated accordingly.

3. **To ensure fiscal sustainability, consolidation needs to continue.** The government has undertaken an ambitious fiscal consolidation program, reducing the overall fiscal deficit by about 5 percentage points of GDP between FY09/10 and FY14/15. However, the pace of structural fiscal adjustment (as defined by the change in the cyclically adjusted primary balance) eased somewhat during 2012-14. At 5 percent of GDP, the headline deficit is still large. To help rebuild fiscal buffers and sustain a durable recovery, the structural deficit should be steadily reduced over the medium-term, with the pace of adjustment calibrated to avoid an undue drag on growth.



4. **The recent deterioration in the current account is in part driven by temporary factors, but structural weaknesses continue to weigh on exports.** Since 2013, the principal driver of the widening current account deficit has been a reduction in the income balance. This phenomenon reflects (possibly temporary) lower earnings on direct investments abroad (relative to returns on inward investment of foreign companies), notably on investment exposed to the euro area, which accounts for nearly half of the UK's foreign direct assets. Together with the recovery in business investment, this explains the reduced net lending position of non-financial companies. The trade balance has remained stable at around 2 percent of GDP, despite significant real exchange rate movements during 2007-15. While goods exports have been held back by limited export diversification and lack of competitiveness, services exports have increased since the crisis. Overall, the U.K. external position is weaker than implied by medium-term fundamentals and desirable policy settings, and the real exchange rate is overvalued.



5. **Key downside risks include:** (i) *continued slow growth in productivity*, which could further hurt competitiveness and hold back real earnings growth; (ii) *continued sterling appreciation*, which could worsen the external position; (iii) *risks associated with the buoyant housing market*, which could increase household balance sheet vulnerabilities and financial stability risks; and (iv) *political uncertainty* associated with the outcome of the planned referendum on EU membership. However,

there are also **upside risks**, as positive effects from lower oil prices and ECB's QE could have stronger-than-expected effects on growth and the trade balance.

## POLICIES TO ADDRESS IMBALANCES

### 6. **Public finances should be strengthened further, and monetary policy should remain accommodative.**

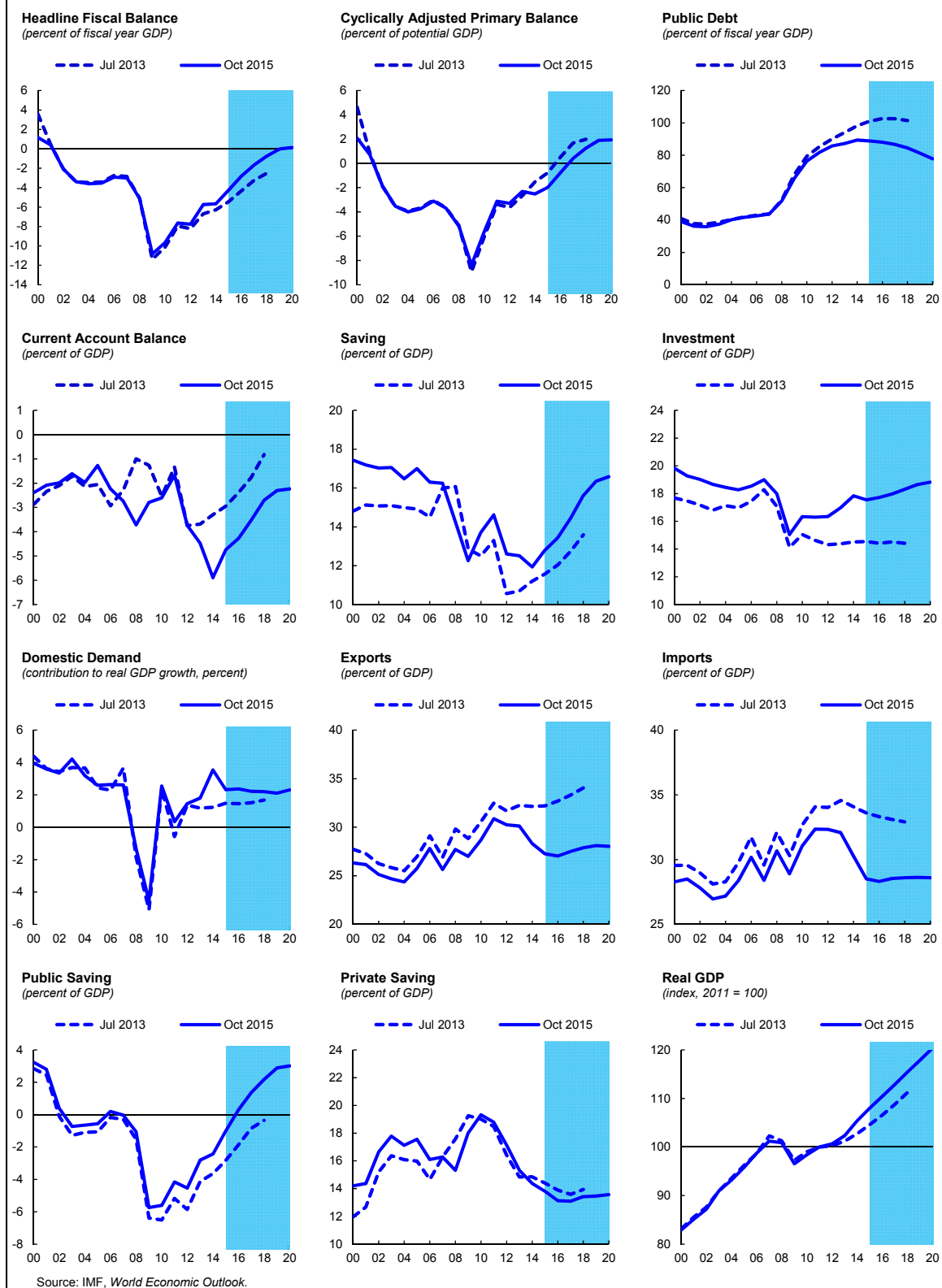
- *Continued fiscal consolidation should strike the right balance between strengthening public finances and facilitating the recovery.* To rebuild fiscal buffers, the structural deficit should be reduced over the medium term, with adjustment calibrated to the pace of the economic recovery. On the expenditure side, continuing to reduce spending through enhanced efficiency that prioritizes the delivery of quality health and education services, as well as infrastructure investment, would help bolster the productive capacity of the economy. On the revenue side, measures could include reductions to tax expenditures (such as the zero-VAT rates) and reforms to property taxation to stimulate housing supply.
- *Monetary policy should stay accommodative for now.* Despite a recent acceleration in wage growth, core inflation remains low and expected inflation is well-contained. With headwinds from fiscal consolidation, accommodative monetary policy is needed to support the recovery in private demand. If financial stability risks from the housing market fail to recede, further macroprudential tightening should be the first line of defense.

### 7. **Structural challenges should be addressed to sustain growth at historical trends and mitigate housing-related risks.**

- *Policies to raise productivity are essential to durably boost growth and assist external adjustment.* Reducing bottlenecks in infrastructure and improving the economy's skill base (through increased investment in human capital and less restrictive immigration laws) reduces unit labor costs and boosts export performance. Such policies would therefore improve the prospects of rebalancing the economy towards greater reliance on external demand.
- *In the housing market, supply-side measures are crucial to safeguard house price affordability and mitigate financial stability risks.* Fundamentally, house prices are rising because demand outstrips supply. The government has introduced major changes to the planning system, but inefficiencies limiting the supply of housing—such as unnecessary zoning restrictions—remain and should be addressed.



**Figure 1. United Kingdom: Selected Macroeconomic Indicators**



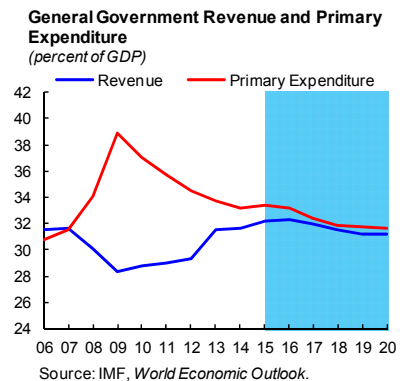


# UNITED STATES<sup>1</sup>

Public and external imbalances are lower than expected in 2013, but the economy faces new challenges from the impending normalization of monetary policies, the dollar appreciation, and the decline in oil sector investment. While a slower pace of fiscal consolidation has been instrumental for the economic recovery, public debt remains on an unsustainable path. External imbalances have moderated, reflecting increasing energy independence and lower oil prices, but declining investment in the oil sector and further strengthening of the dollar could exacerbate imbalances ahead. Policy efforts should focus on a credible medium term fiscal consolidation plan, a well managed monetary policy normalization, and increasing resilience of the financial sector.

## IMBALANCES: DIAGNOSIS AND RISKS

1. **Since the 2013 update, fiscal consolidation continued and the current account remained broadly stable.** Fiscal consolidation continued over the last couple of years, with the deficit measured by the Cyclically Adjusted Primary Balance (CAPB) declining to about 1.8 percent of GDP in 2015 (from 3.2 percent of GDP in 2013). However, the pace of fiscal consolidation has slowed (Figure 1).<sup>2</sup> Growth has been somewhat weaker with less of a handoff from public to private demand than envisaged in the previous sustainability update. There was a modest recovery in investment in the context of somewhat lower private saving, but the current account deficit remained broadly stable, and better-than-projected in the previous sustainability update. This likely reflects improved terms of trade and a sharp increase in oil production that reduced energy dependence on imports.



2. **A slower pace of fiscal consolidation has been instrumental in supporting the recovery, but public debt remains on an unsustainable trajectory.** In 2013, the U.S. recovery was weakened by an excessive policy tightening. Since then, aided by the Bipartisan Budget Act of December 2013, a slower pace of fiscal consolidation has compensated a sluggish recovery in private investment. While this has helped setting the underpinnings for a recovery, the risks associated with lower than envisaged potential growth and the absence of a clear medium term fiscal plan continue to pose challenges. Even with lower than expected interest rates, public debt remains in an unsustainable long-term trajectory. Under the 2015 Article IV baseline scenario, while public debt is projected to

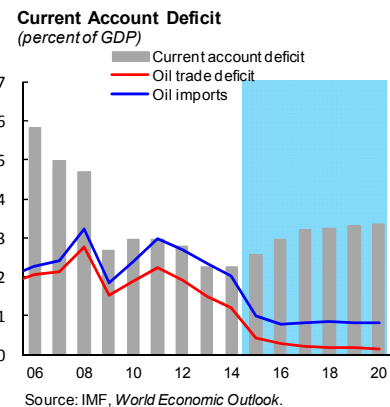
<sup>1</sup> Prepared by Esteban Vesperoni.

<sup>2</sup> The interest bill has been lower than projected in 2013—due to lower interest rates on public debt. Hence the current headline fiscal deficit has been in line with projections in the previous sustainability assessment.

stabilize over the next five years, it would start rising again, driven by aging-related spending pressures on entitlement programs and higher interest rates, reaching more than 110 percent of GDP in 2024. Furthermore, going forward, consolidation should be more balanced and less frontloaded to allow for infrastructure spending, addressing a number of issues, notably: (i) simplifying the tax system and broadening the tax base; (ii) reform of the pension system that avoids the prospective depletion of the social security trust fund; and (iii) containing cost pressures in the health system in the context of an aging population.

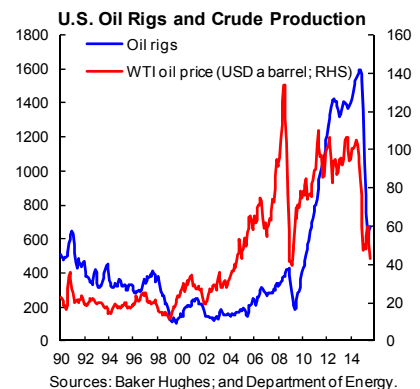
**3. Increasing energy independence and lower oil prices have helped moderate external deficits over the last years.**

The decline in the current account deficit since 2008 has been largely explained by the oil trade balance. The improved balance is explained by the surge in domestic oil production, reducing imports sharply. The decline in oil prices has also kept the current account deficit below 2013 projections.



**4. However, a deterioration of the energy balance and further strengthening of dollar could exacerbate external imbalances.**

The appreciation of the U.S. dollar—reflecting cyclical divergences and asynchronous monetary policies among systemic economies—is beginning to affect exports and manufacturing investment and is lowering the income balance (returns from foreign assets). Moreover, lower oil prices have also prompted a decline in investment in the sector—as illustrated by the oil rig count—which will impact production in 2016. The U.S. external position was broadly consistent with medium-term fundamental and desirable policies in 2014. In the baseline scenario—assuming a constant real exchange rate—the current account deficit would rise to 3½ percent of GDP in the medium term. This would create new challenges, as the U.S. dollar is assessed to be moderately above the level consistent with medium-term fundamentals as of May 2015.



**5. Political gridlock is a source of significant risks to the fiscal position, and may have global implications.**

In the short term, it may trigger disruptions from either a prospective government shutdown or a stand-off linked to the federal debt ceiling towards year-end. From a longer term perspective, this is blocking an agreement on a credible and balanced plan to address fiscal imbalances. Political gridlock can undermine confidence and trigger a sharp increase in the sovereign risk premium, which could be exacerbated if the timing coincides with a Fed lift-off. From the domestic standpoint, a tightening of financial conditions beyond what is already envisaged in the baseline scenario can create challenges, as the U.S. public debt dynamics is highly sensitive to growth and interest rate assumptions. From a global perspective, tighter financial conditions, not accompanied by stronger growth, can trigger negative spillovers to other economies.

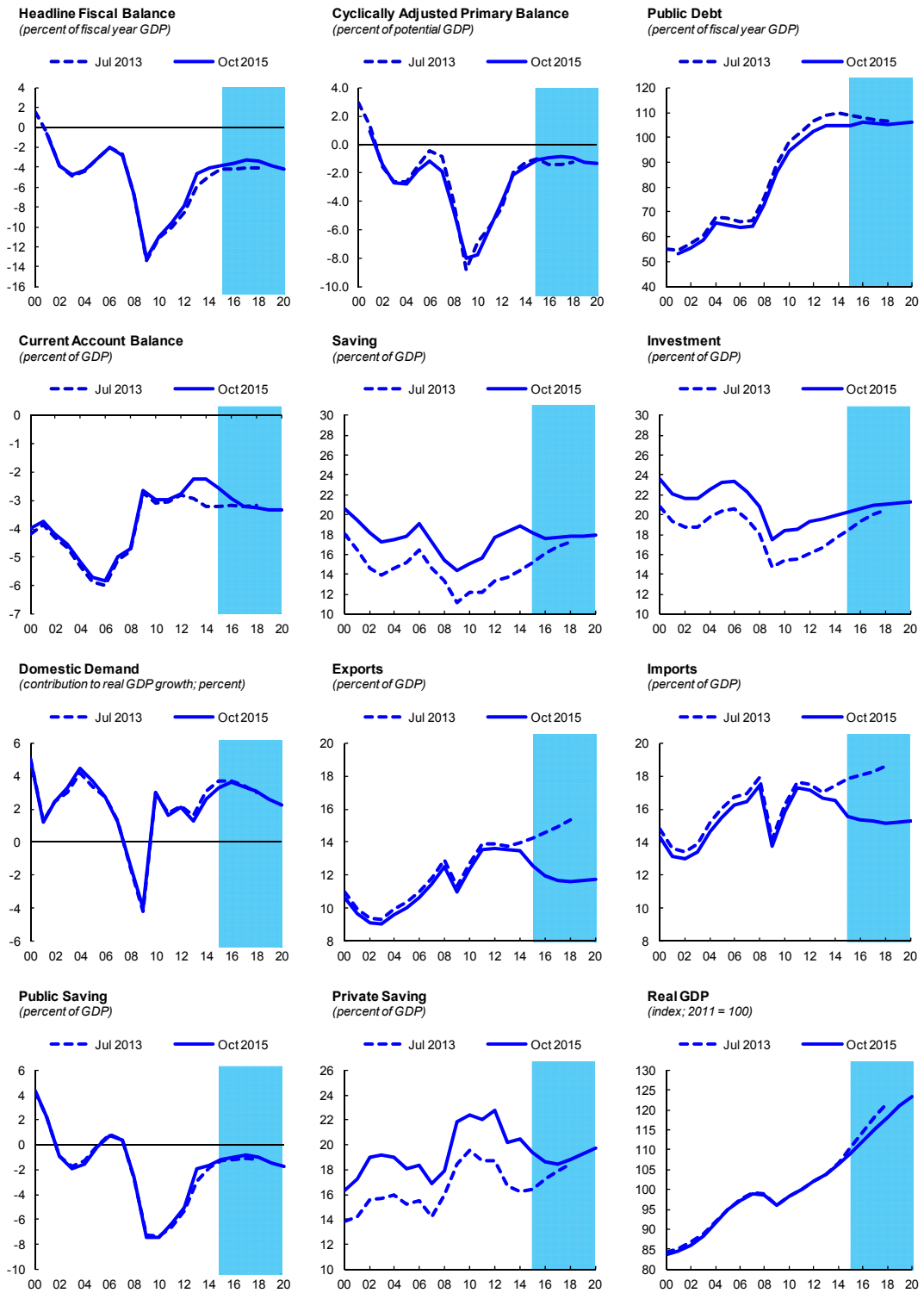
6. **There are also risks associated with the impending increase in interest rate.** The lift off could take place amid large uncertainty about slack in labor markets, the neutral policy rate and the path for inflation and wages. Moreover, higher U.S. policy rates could result in an abrupt rebalancing of international portfolios, high market volatility and an increase of the compressed term premium, which may have global financial stability consequences. From a domestic perspective, should financial conditions tighten more than warranted by cyclical conditions, it may become a drag to the recovery, and may force the Fed to reverse direction, with a potential cost in terms of credibility. From a global perspective, it would lead to higher spreads, volatile capital flows and lower asset prices. A sudden upward shift in risk spreads could also trigger a further dollar appreciation that would pose an important risk to the need to close the U.S. external imbalance.

## POLICIES TO ADDRESS IMBALANCES

7. **A credible medium term fiscal consolidation plan is critical to achieve debt sustainability.** It should reduce policy uncertainty associated with the budget process and close the fiscal gap to achieve debt sustainability in a balanced way, which would require revenue mobilization and reforms the pension and health systems. Revenue mobilization could be achieved through a broad-based carbon tax, a higher federal gas tax, and/or a federal-level VAT. Changes to the tax code should focus on simplifying the system and broadening the tax base by *inter alia* capping or eliminating personal and business income tax deductions and removing tax preferences. A pension reform should gradually increase the retirement age, introduce greater progressivity of benefits, and raise the maximum taxable earnings for social security contributions. Reforms to the health system could focus on ensuring a better coordination of services to patients with chronic conditions, containing overuse of expensive procedures, and introducing a higher degree of cost sharing with beneficiaries. Such a plan would provide near-term fiscal space to finance supply-side measures that support growth. From a global perspective, achieving debt sustainability in the United States would help reducing external imbalances.

8. **A well managed monetary policy normalization and continued efforts on the regulatory fronts will build critical financial resilience.** The Fed is facing a complex trade off in terms of monetary policy. While a slow or later normalization may cause a temporary rise of inflation above the Fed's objective, raising rates too soon or too fast could trigger a greater-than-expected tightening of financial conditions—including through a further upward swing in the U.S. dollar and a repricing of the yield curve that may have negative spillovers. Monetary policy normalization should proceed gradually, and should not be used to reduce leverage or dampen financial stability risks. As for the latter, much has been done over the past years—including *inter alia* enhanced capital and liquidity buffers, strengthened underwriting standards in the housing sector, and greater transparency to mitigate counterparty risks. Given changing financial risks, though, continued evolution of the oversight framework is needed through the deployment of additional regulatory and supervisory tools—including macro-prudential policies.

**Figure 1. United States: Selected Macroeconomic Indicators**



Source: IMF, *World Economic Outlook*.