GROUP of TWENTY

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G-20 Mutual Assessment Process—IMF Staff Assessment of G-20 Policies

Prepared by Staff of the International Monetary Fund

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G-20 Mutual Assessment Process—IMF Staff Assessment of G-20 Policies[1]

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Executive Summary

Key Messages:

- Progress is being made, but important policy challenges remain to meet the objectives of strong, sustainable and balanced growth agreed by Leaders.
- Growth outcomes based on revised G-20 frameworks are broadly aligned with the objectives, but remain distinctly optimistic compared to past recoveries.
- Limited progress is being made towards external rebalancing, with current accounts expected to widen again towards pre-crisis levels.
- Fiscal projections are broadly on track to meet Toronto commitments, but there are significant risks to the envisaged consolidation if growth falters.
- Further collective action focused on priority areas would raise growth, lower unemployment and reduce poverty. Priority areas include: structural reforms and greater exchange rate flexibility to strengthen internal demand in emerging economies; further fiscal consolidation in advanced economies based on "growth-friendly" measures; and product and labor market reforms across the membership to boost productive capacity.

G-20 Policy Actions, Commitments, and Challenges

- **Financial policies** have made progress, mainly at the national level. Remaining core policy challenges center around: (i) fully repairing the damage inflicted by the crisis, including through recapitalizing or resolving weak banks; (ii) better managing systemic risk, including through wider national supervision and stronger international frameworks to address cross-border issues; and (iii) developing macroprudential tools and frameworks to augment financial stability frameworks.
- **Fiscal policies** appear broadly on track to meet the Toronto commitments, although medium-term consolidation plans rely on relatively optimistic growth assumptions for some countries. Policy challenges are to formulate clear, credible, and ambitious medium-term plans underpinned by commitments in critical areas—including entitlement and tax reforms that are supportive of growth.
- **Monetary and exchange rate policy** challenges include normalizing the policy stance in advanced economies over time while remaining sensitive to the strength and pace of

[1] The report was produced by staff from the IMF's Research Department, in cooperation with (and inputs from) the ILO, OECD, UNCTAD, and WTO. The IMF team was led by Krishna Srinivasan and Hamid Faruqee and comprised of Douglas Laxton, Emil Stavrev, Eric Bang, Mitali Das, Vladimir Klyuev, Mika Kortelainen, Susanna Mursula, David Reichsfeld, Shaun Roache, and Stephen Snudden.

recovery. To facilitate external rebalancing, key emerging economies need to follow-through on commitments to increase exchange rate flexibility.

- There has been only limited progress on **structural policies**. Major challenges remain to develop more ambitious and detailed reform agendas with specific roadmaps; to target deeper and broader product and labor market reforms that strengthen competition, or enhance flexibility in key market segments in advanced economies; and to boost infrastructure investment and strengthen social safety nets in emerging economies.

Global Developments through the Eyes of the G-20

- Revised G-20 frameworks project "strong" growth over the medium term, accompanied by a sharp decline in unemployment. Growth appears to be "sustainable," since it is increasingly tied to a rapid pick-up in private demand. Growth is projected to be "balanced," in the sense of being broad-based across the G-20 membership.
- Growth and unemployment projections remain distinctly more optimistic than what past recoveries suggest, although G-20 projections are more conservative than in the April submissions, reflecting the moderate pace of the recovery and higher downside risks.
- Improvements in fiscal positions are based on favorable growth and interest rate projections, underscoring risk to the envisaged consolidation if growth falters. Little external rebalancing is anticipated, with current account positions expected to widen.

G-20 Upside Potential

Joint action on three fronts—structural reforms and greater exchange rate flexibility to strengthen demand in emerging economies; further fiscal consolidation through "growth-friendly" measures in advanced economies to put public finances on a sustainable footing; and product and labor market reforms to enhance supply potential across the membership—suggests significant upside potential.

G-20 policy action that is sequenced and timed accordingly would deliver substantially improved outcomes for growth, employment, and poverty. Simulation results show:

- The negative impact of fiscal consolidation in advanced economies on global growth is compensated by positive spillovers from reforms in emerging economies;
- World GDP would be higher by about 2 percent by 2014, equivalent to more than 1 trillion dollars;
- The more broadly-based boost to incomes—including in developing countries—would lift an estimated 37 million people out of poverty based on World Bank analysis; and
- An additional 25 million jobs would be created in the G-20.

Collaborative action is also highly beneficial to the G-20 membership because it avoids substantial costs from a breakdown in policy cooperation. By averting adverse market reaction, loss of policy credibility, and recourse to fragmented or "beggar-thy-neighbor" actions, policy cooperation would prevent substantial welfare costs to the G-20.

I. Introduction

1. **Building on their success with collective action to avoid a deeper financial crisis, G-20 Leaders pledged to mutually assess and adopt policies that would ensure a lasting recovery and a brighter economic future**. To this end, they launched a "framework for strong, sustainable, and balanced growth" at their 2009 Summit in Pittsburgh, where Leaders committed to clarifying key objectives, elaborating policies aimed at meeting those objectives, and a mutual assessment process (MAP) to track progress. The Fund—with input from other international institutions—was asked to assist in analyzing how their respective national and regional frameworks fit together, and to develop a forward-looking analysis of whether policies pursued by individual G-20 members are collectively consistent with strong, sustainable, and balanced trajectories for the global economy.

2. **At the G-20 Summit in Toronto in June 2010, Leaders took stock of progress with the MAP exercise**. They concluded that decisive and unprecedented actions by the G-20 had limited the downturn and spurred recovery, but that serious challenges remained. Leaders welcomed the actions taken thus far and commitments made by G-20 members aimed at boosting demand and rebalancing growth, strengthening public finances, and boosting the strength and transparency of financial systems. At the same time, however, they underscored that more could be done collectively to raise incomes, create more jobs (in line with the recommendations of the G-20 Ministers of Labor and Employment), lift more people out of poverty, and significantly reduce global imbalances. To this end, Leaders committed to taking further concerted policy actions, tailored to national circumstances, aimed at achieving the growth objectives they had agreed in Pittsburgh.

3. **This report assesses policy progress by G-20 members since the Framework was launched at the Leaders Summit in Pittsburgh**. Section II takes stock of all major policy commitments and actions taken since September 2009 by G-20 members, aimed at meeting the growth objectives agreed by Leaders. Section III discusses how the global economy might evolve as envisaged by the revised G-20 projections taken collectively. Section IV examines upside potential of G-20 policies from strengthened collaborative action through alternative policy scenarios and discusses risks of insufficient policy cooperation.

II. Stock-taking of G-20 Policy Actions and Commitments

Securing strong, sustainable, and balanced growth over the medium term rests on two rebalancing acts—internal rebalancing in major advanced economies through strengthening private demand and a gradual reduction of public support; and external rebalancing through a shift toward greater reliance on growth led by domestic demand in external surplus countries and by external demand in deficit countries. Thus, policy challenges and priorities will differ across the G-20 membership. Against this backdrop, a brief summary of key commitments and actions taken by the G-20 since the MAP Framework began is provided below, with relevant details relegated to Appendix 1 in the background document. Remaining policy challenges are summarized in Box II.1.

A. Financial Sector Policies

4. **The G-20 has made progress towards a reformed financial system, better aligned with its growth objectives**. There has been a particular focus on enhanced coordination at the national and regional level, including by establishing or enhancing the role of financial stability councils or committees. Many countries are also in the process of widening the regulatory perimeter. Other areas of progress on regulation and supervision include commitments to publishing regular bank stress tests; enhanced oversight of credit rating agencies; and measures aimed at regulating more closely the activities and compensatory practices of banks.

5. **Macroprudential frameworks to address systemic risk are being introduced, while shortcomings in financial crisis management exposed during the crisis have begun to be addressed**. At the forefront of multilateral coordination across the G-20 has been the agreement on the Basel III framework. Basel III aims to establish new capital requirements and buffers for banks, improve risk management and governance, and strengthen banks' transparency and disclosures. G-20 members have progressed with developing macroprudential frameworks, and many have introduced macroprudential elements in their regulatory and supervisory measures. A few members have prioritized the development of enhanced early warning systems. Some have begun reviewing and improving their crisis management capabilities, including through new institutional arrangements and specific facilities and instruments. Frameworks to minimize damage from the failure of systemically-important financial institutions have also been proposed and begun to be implemented in many G-20 economies.

6. **In some emerging economies, reforms have also been targeted at broadening and deepening the financial sector's capacity to support economic growth**. Specific measures have been proposed to improve the efficiency and competitiveness of the financial sector, as well as to enhance the access to capital markets for SMEs. In advanced economies, financial sector measures have been focused on easing SME access to credit.

7. **Overall, G-20 financial policies have made some progress—mainly, at the national level—but substantial policy challenges remain**. This includes the need for further efforts aimed at: (i) repairing damage from the crisis, including through recapitalizing or resolving weak banks; (ii) better managing systemic risk, including through wider national supervision and stronger international frameworks to handle failing cross-border financial institutions; and (iii) developing macroprudential tools and mechanisms to augment financial stability frameworks.

B. Fiscal Policies

8. **Fiscal consolidation is an essential part of internal rebalancing**. At the Toronto Summit, G-20 Leaders in advanced economies agreed to halve fiscal deficits by 2013 and to stabilize or reduce public debt by 2016. Overall, G-20 fiscal policies appear broadly on track to meet the Toronto commitments, but medium-term consolidation plans for some countries rely

on relatively optimistic growth assumptions and very few countries have thus far articulated credible plans underpinned by specific measures in key areas.

- Responding to severe market pressure earlier this year, notably concerning sovereign risks, some *advanced deficit* economies have announced or brought forward fiscal consolidation plans.[2] Plans differ across countries both in magnitude and pace of adjustment, reflecting the strength of economic recovery, the amount of fiscal space, and the reaction of markets to the strength of public balance sheets. In many cases, consolidation plans are accompanied by measures to increase transparency of the budget process.

- Many *advanced surplus* economies have also announced consolidation plans, but the degree of specificity in identifying measures vary significantly. In many countries, fiscal consolidation over the medium-term is to be achieved through entitlement and tax system reforms and "pay-go" principles. In some cases, new measures to bolster the credibility of public finances have been established or planned, including mechanisms to identify risks in federal and state budgets and to reform the fiscal framework.

- Some *emerging deficit* economies have begun fiscal tightening and announced medium-term consolidation plans. In many cases, the broad measures are dependent upon the pace and durability of economic recovery, and consolidation plans lack sufficient specificity to anchor credibility. *Large oil-exporting* economies have also committed to some consolidation, though budgets retain an emphasis on public investment. In these economies, increased non-oil infrastructure spending is aimed at relieving supply bottlenecks and sustaining growth with less dependence on oil prices.

9. **Notwithstanding progress, central policy challenges are to formulate clear, credible, and ambitious medium-term plans**. Medium-term plans need to be underpinned by specific commitments in critical areas—including entitlement and tax reforms that are supportive of growth. Stronger governance and budgetary institutions in many cases would strengthen such efforts, which will need to be sustained. Beyond the MAP framework, long-term fiscal plans to restore sustainability of public finances will be required to rebuild policy space and to address long-run budgetary pressures.

C. Monetary and Exchange Rate Policies

10. **Short-run monetary accommodation and central bank interventions have been critical for alleviating the financial crisis and the recession**. Almost all *advanced* economies have kept their target policy interest rates constant at highly accommodative levels since the Leaders Summit in Pittsburgh. Some major advanced economies have also provided support

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[2] To maintain comparability with the previous report, theme-based groups of G-20 members are as described in the *Mutual Assessment Process–Appendices to the Report*.

through an expansion of central bank balance sheets. Normalizing the monetary policy stance over the medium term in major advanced economies, while remaining vigilant to potential threats to price and financial stability, and greater exchange flexibility in emerging surplus countries are important for rebalancing global demand and sustaining growth. Several smaller *advanced* economies have started raising policy rates from the low levels, reflecting their lead role in global economic recovery; and, in a few cases with signs of overheating, some *emerging* economies have tightened monetary policy.

11. **Exchange rate adjustment is instrumental for global rebalancing, and while some *emerging surplus* economies have made progress towards increased flexibility, major surplus countries have intervened to limit appreciation**.

- Strong recoveries, declining absolute and relative risk aversion, and wide interest rate differentials vis-à-vis advanced economies have put upward pressure on the currencies of most emerging G-20 members. Many of these countries have allowed their currencies to appreciate substantially in nominal effective terms, but some major emerging economies have intervened in foreign exchange markets and increased their reserve holdings to limit the strengthening of their currencies.

- Despite large exchange rate fluctuations, advanced economies have largely avoided intervening in currency markets, but some have intervened more recently both to stem disorderly movements of their currency and to limit a rapid appreciation.

12. **Overall, the stance of G-20 monetary policies remains broadly appropriate given members' circumstances, but greater exchange flexibility in major emerging economies is essential for meeting the growth objectives agreed by Leaders**. Key policy challenges remaining in advanced economies will be to normalize the accommodative policy stance over time without jeopardizing economic recovery while remaining vigilant to potential threats to financial and price stability. Exchange rates in major emerging economies will need to be more flexible to help facilitate global rebalancing toward stronger, sustainable, and more balanced global growth.

D. Structural Policies

13. **G-20 members have taken some limited steps toward demand rebalancing through structural reform**. Structural policies, including a reform of entitlements, investments in infrastructure, and enhancing competition and flexibility, are important for both internal and external rebalancing. G-20 policy frameworks, however, suggest that only modest progress will be made in this critical area.

- Some *advanced deficit* economies are considering measures that would encourage and facilitate saving for retirement, while several *advanced surplus* countries have announced plans to increase labor market flexibility, pension reforms, and greater investment in "green" technology. However, most countries do not identify specific measures to anchor such reforms. Product and services market reforms to boost potential output are also being considered by several *advanced* G-20 economies, although the scope of reforms appears to be relatively modest.

- *Emerging surplus* economies are also making modest progress towards supporting private consumption through structural reforms, aimed at improving social safety nets. Investments in infrastructure, education, and R&D feature prominently in plans across *emerging* (and some *advanced*) economies. Many emerging economies are also considering measures, mostly unspecified—for enhancing the business environment.

- *G-20 countries have broadly succeeded in avoiding recourse to protectionist trade measures*. There has been some slippage towards increased trade restrictions, targeted largely at the weakest sectors and industries that were already relatively highly protected before the crisis began.

14. **Overall, G-20 structural policies have made limited progress thus far in specifying concrete and far-reaching plans for key reforms**. Major reform challenges include developing a more ambitious and detailed policy agenda (aligned with strategic priorities) with a specific roadmap (e.g., timetables) for reform. Policy challenges would include deeper and broader product and labor market reforms that strengthen competition, or enhance flexibility and mobility in key markets segments in advanced economies; and strengthening infrastructure investment and social safety nets in emerging economies. G-20 members must continue to respect their Summit commitments to avoid protectionism and engage as soon as possible in phasing out new trade restrictions that some have introduced since 2008. Without a credible rollback, there is a danger of an accumulation of trade restrictions that will work against the efforts of structural policies to enhance competition and flexibility.

Box II. 1. Key Policy Challenges for the G-20

Notwithstanding progress already made, significant policy challenges remain for the G-20. Based on staff's stocktaking of main policy achievements since fall 2009, remaining priorities in each area are listed below.

Financial Policies

To repair fully the damage from the crisis and to better align global financial reforms with the medium-term growth objectives of the G-20, key policy challenges include the following:

- *Supervisory frameworks* should be made more proactive to identify activities on the fringe of the regulatory perimeter and broadened to better monitor systemic risks.
- Commitments to publish *regular bank stress tests*. Commitment to undertake regular bank stress tests should be accompanied by commitments to publish the results, and to allow prudential authorities to pro-actively intervene, restructure, or resolve weak banks.
- Reforming *cross-border resolution frameworks* to enhance international cooperation for resolution large, cross-border firms and to reach an international agreement on principles for burden sharing.
- Augment financial stability frameworks by developing *macro-prudential tools* to safeguard against volatile financial market conditions, including the effects of net capital flows.

Fiscal Policies

To put public finances on a sustainable path, promote internal rebalancing, and rebuild policy space, G-20 members—particularly, advanced economies—face the following challenges:

- To outline *clear and credible medium-term consolidation plans* that are ambitious in scope and timing to minimize the risks of significant fiscal slippages going forward, and underpinned by key commitments
- To emphasize specific growth friendly policy measures aimed at reforming rapidly growing *public spending programs* and making *tax reform* more concrete to reduce uncertainty.
- To implement rapidly measures aimed at *strengthening fiscal institutions* to enhance their credibility and improve the budgetary processes and governance and better monitor fiscal developments.
- To sustain the fiscal consolidation effort, notably by developing long-term budgetary plans.

Monetary and Exchange Rate Policies

Remaining policy challenges vary across the membership:

- To normalize over time the current accommodative *monetary policy* stance in major *advanced* economies without jeopardizing economic recovery, while remaining vigilant to potential threats to financial and price stability.
- To enhance greater enhance exchange rate flexibility in *emerging surplus* economies to facilitate global demand rebalancing and paving the way for a healthier, sustained recovery.

Structural Policies

More ambitious structural reforms are required to repair damage to supply potential following the crisis and to reduce high unemployment. Specifically:

- For *advanced deficit* economies, specify concrete measures to encourage and facilitate saving for retirement.
- For *advanced surplus* economies, provide concrete and ambitious plans for labor, product, and services market reforms with specific timeframes.
- For *emerging surplus* expand coverage of social safety nets to reduce high precautionary saving.
- In *oil-exporting countries*, plans and timetables to enhance the productivity of the non-oil sector, including through infrastructure investment, should be more clearly identified.

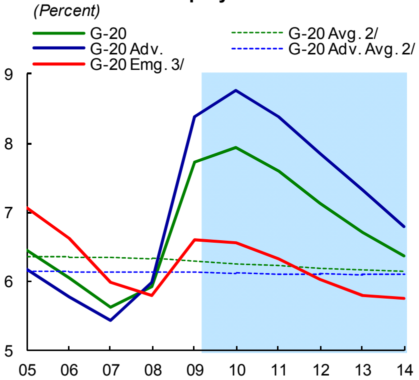
III. Global Developments Through the Eyes of the G-20

Revised G-20 frameworks project growth outcomes that are broadly aligned with medium-term objectives, but external rebalancing is projected to be modest. Overall, reflecting the slowdown in the recovery and the escalation of downside risks since the April G-20 submissions, growth projections are modestly lower and external imbalances wider in the revised frameworks.[3] *Comparisons with past recoveries, however, indicate that growth projections remain fairly optimistic, signifying a vulnerability to weaker growth outcomes.*[4] *Downside risks have intensified since Toronto. The recovery remains fragile and uneven across regions. In particular, downside risks stem from still vulnerable financial systems and sovereign risks in many advanced economies that could lead to adverse real-financial feedback loops, persistently high unemployment, and protectionism and currency instability.*

A. Analysis and Assessment of G-20 Projections

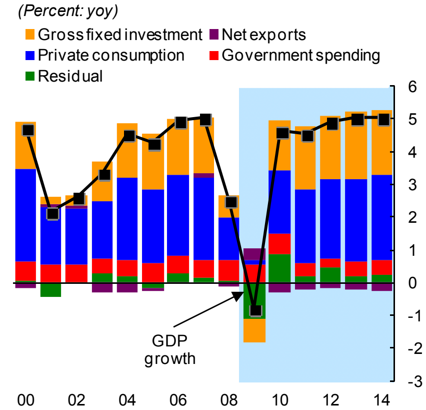
15. **Taken together, the revised G-20 frameworks project "strong" growth over the medium-term, accompanied by a sharp decline in unemployment**. G-20 output growth is projected at 5 percent in 2014. Prospects are strong in both *advanced* and *emerging* economies, albeit with regional disparities. Consistent with strong growth, medium-term output losses relative to pre-crisis trends are projected to be modest. Strong projected growth is accompanied by a rapid decline in unemployment. After peaking in 2010, unemployment in the G-20 is expected to return to its pre-crisis average level by 2014.

G-20 MAP: Unemployment Rates 1/
(Percent)



Sources: G-20 authorities and IMF staff estimates.
1/ 2005-2008 reflects WEO data; 2009-2014 reflects MAP estimates and projections.
2/ PPP weighted average annual rate for 1998 - 2007.
3/ Excludes India and South Africa due to data unavailability.

G-20 MAP: G-20 Contribution to Real GDP Growth 1/ 2/
(Percent: yoy)



Sources: G-20 authorities and IMF staff estimates.
1/ 2000 - 2008 reflects WEO data; 2009 - 2014 reflects MAP estimates and projections.
2/ Residual includes inventories and statistical discrepancy.

16. **Growth appears to be "sustainable" over the medium term, in the sense that output growth is increasingly tied to growth in private demand**. The frameworks project steady progress toward internal demand rebalancing in the G-20, with sustainability prospects contingent on a strong "crowding-in" of private demand as fiscal consolidation gets underway. In 2014, the decomposition of GDP growth at 5 percent reflects private consumption which accounts for more than 2½ percentage points (slightly higher than the pre-crisis average) and gross

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[3] For comparison between the latest G-20 submissions and the April 2010 G-20 MAP base case, see Box III.1.

[4] Some G-20 country submissions were incomplete or had missing data for later years. Forecasts in such cases reflect staff's projections, taking into account the authorities' known policies.

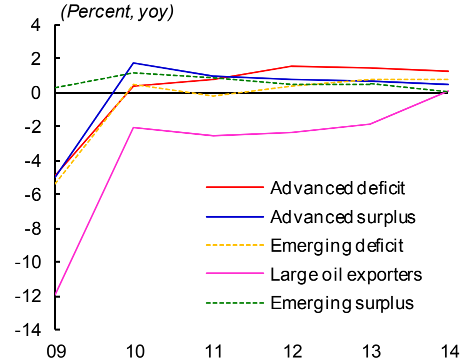
fixed investment which accounts for 2 percentage points (higher than in any year in the last decade).

- Consistent with progress in internal demand rebalancing, fiscal deficits in the G-20 are projected to fall significantly between 2010 and 2014. In *advanced* economies, fiscal deficits are projected to improve by 5.1 percent of GDP, while *emerging* economies foresee an improvement of 2.3 percent of GDP. The G-20 membership envisages an overall decline of 1.8 percentage points in the gross debt-to-GDP ratio between 2010 and 2014.

- Projected improvements in fiscal balances are broadly in line with *Toronto Commitments*, where Leaders agreed to at least halve deficits by 2013 and stabilize or reduce debt ratios by 2016 (see Box III.2).

17. **Growth is projected to be "balanced," in the sense of being broad-based across the G-20 membership**. The pace of recovery in *emerging* economies will be faster initially than in *advanced* economies, although the difference is projected to narrow between 2010 and 2014. Also, the dispersion across countries of growth relative to potential is projected to gradually decrease through 2014, at which time most economies are projected to grow at or around potential.

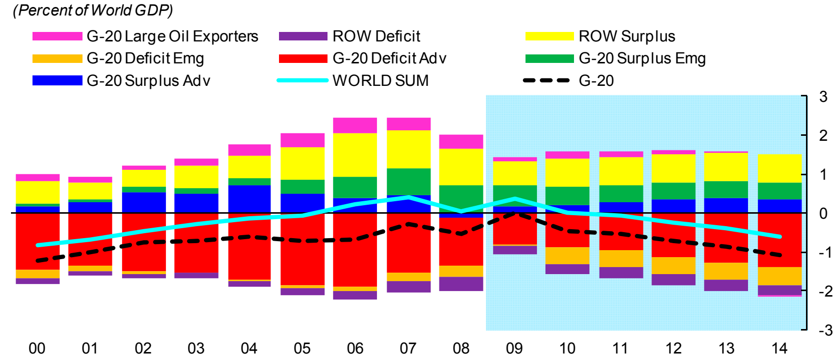
G-20 MAP: Difference of Real GDP Growth from Potential Growth 1/
(Percent, yoy)



Sources: G-20 authorities and IMF staff estimates.
1/ MAP estimates and projections.

18. **External demand rebalancing is limited in G-20 projections, with current account positions expected to widen**. After narrowing substantially in 2009, global imbalances are expected to resume widening through 2014. In *advanced deficit* economies, current account deficit positions are expected to nearly double between 2009 and 2014; net exports are projected to make increasingly negative contributions to growth between 2011 and 2013, before making a modest turnaround in 2014. *Emerging surplus* economies are projected to progressively reduce dependence on external demand in 2010-2014, with net exports making increasingly smaller positive contributions to growth, while current account positions remain unchanged. However, by 2014 the net export contribution to growth is projected to be almost at the pre-crisis average.

Current Account Balances 1/
(Percent of World GDP)



Sources: G-20 authorities and IMF staff estimates.
1/ 2000-2008 reflects WEO data; 2009-2014 reflects MAP estimates and projections for G-20 countries and WEO projections for ROW.

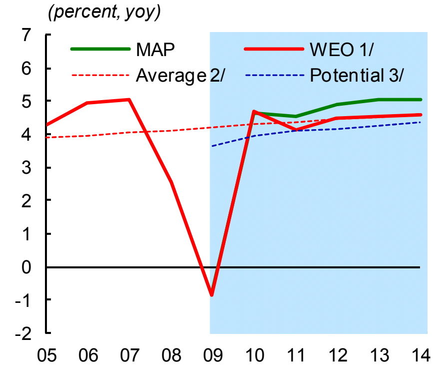
B. Risk Analysis

19. **The recovery remains fragile and uneven across regions, and downside risks have risen**. Uncertainty remains high and downside risks to growth have intensified since Toronto. The speed and strength of recovery differs in important ways across and within regions. Many emerging and developing economies, hit less severely on the financial side, are again seeing strong output and employment growth. By contrast, most advanced and a few emerging economies are experiencing a sluggish recovery, soft private demand, and high unemployment. Financial sector weaknesses remain largely unresolved, restraining credit provision. On account of a still fragile financial system in many advanced economies, sovereign risks and bank funding tensions could lead to adverse real-financial feedback loops. Additional risks stem from weak real estate markets coupled with high unemployment as well as financial and trade protectionism and currency instability.

20. **Against this background, while revised G-20 frameworks project growth more conservatively than previous estimates, forecasts still remain distinctly more optimistic than what past recoveries would suggest**.

- In *advanced* economies, compared to the pre-crisis trend, the projected per capita output loss by 2014 (estimated at 3.6 percent) is modest, and compares favorably with staff estimates of a projected loss of nearly 7 percent. The projections suggest that country frameworks assume the deleterious effects of lower capital, productivity and employment on productive capacity to be reversed much faster than in previous crises.[5]

G-20 MAP: G-20 Real GDP Growth
(percent, yoy)



Sources: G-20 authorities and IMF staff estimates.
1/ 2005 - 2008 reflects historical data; 2009 - 2014 reflects estimates and projections.
2/ PPP weighted average annual growth for 1998 - 2007.
3/ G-20 authorities' estimates.

- *Strong growth projections underlie rapidly declining unemployment*. The rate at which unemployment is projected to decline over the medium-term, conditional on the projected growth of output, implies a significantly faster pace than staff estimates of the historical elasticity of unemployment to output in recoveries, particularly following financial crises, where studies indicate a protracted impact of bank strains on hiring in employment-intensive sectors.

21. **The interplay of strong internal rebalancing envisaged in *advanced* economies and absent external rebalancing poses risks that could undermine the sustainability and**

[5] Staff studies have found that in recessions associated with financial stress, lower productivity, employment and capital investment result, on average, in an output loss of 9 percent six years after the crisis, albeit with significant dispersion across country episodes.

balance of G-20 growth prospects. G-20 growth projections are underpinned by a strong "crowding in" of private demand as public demand is being reduced, but with little external rebalancing.

- *There is a significant risk that internal rebalancing may not occur on the projected scale*. Notably if the rapid normalization of financial market conditions (and stronger pick-up in credit growth) implicit in the G-20 projections fails to materialize, private demand would be weaker. At the same time, there is also a risk that fiscal consolidation could weigh on demand more heavily than projected, particularly if there is a rush to the exits. Under either of these scenarios, a "demand deficit" could emerge, which will undermine recovery prospects.

- A "global demand deficit" could in principle be alleviated by a strong pick of domestic demand in the emerging surplus economies. However, policies—including those on exchange rates—that could strengthen domestic demand in emerging surplus economies are not adequately spelled out in their policy frameworks or lack follow-through in terms of action.

22. **The envisaged fiscal consolidation could fall short of G-20 commitments if growth falters**. Improvements in fiscal positions are based in part on favorable growth and interest rate projections. If private demand and growth are weaker than projected in G-20 frameworks, fiscal outcomes could fall short of G-20 targets and undermine the sustainability of public finances, particularly in advanced deficit economies.

G-20 MAP and WEO Projections of Key Fiscal Variables

(Percent of GDP; changes 2014-10)

	Overall Balance		Government Expenditure		Government Revenue		Gross Debt		Interest Payments	
	MAP	WEO	MAP	WEO	MAP	WEO	MAP	WEO	MAP	WEO
G-20	4.1	3.4	-3.1	-2.3	1.0	1.1	-1.9	1.3	0.4	0.6
Advanced	5.3	4.1	-2.9	-1.7	2.4	2.4	5.2	9.8	1.0	1.0
High debt	5.4	4.2	-2.8	-1.7	2.5	2.6	6.1	11.2	1.1	1.1
Low debt	3.2	2.7	-2.7	-1.8	0.5	0.9	-2.2	-3.8	0.2	-0.2
Emerging	2.4	2.1	-2.1	-1.6	0.2	0.5	-4.0	-2.5	-0.4	0.2
High debt	2.7	1.2	-3.1	-1.0	-0.4	0.2	-9.2	-1.7	-0.9	0.8
Low debt	2.1	2.5	-1.5	-1.8	0.6	0.7	-0.5	-2.0	0.0	0.0

Sources: G-20 authorities and IMF staff estimates.

1/ For the MAP computed as: Historic revenue-to-GDP ratio (5-year average)* (growth rate - potential growth rate); for WEO computed as: (overall balance in 2014 - structural balance in 2014) - (overall balance in 2010 - structural balance in 2010).

Note: Group averages computed using PPP weights. High (low) debt advanced economies are those with public debt-to-GDP ratios of more (less) than 60 percent in 2009 (based on WEO data from March 2010). High (low) debt emerging market economies are those with public debt-to-GDP ratios of more (less) than 40 percent in 2009 (based on WEO data from March 2010).

Box III.1. Comparison of Revised and Initial Projections

In revised frameworks, G-20 members have lowered projections of growth. The majority of G-20 members have revised growth forecasts downward in 2012-2014. *Advanced deficit* economies, *advanced surplus* economies, and *emerging deficit* economies have revised growth significantly down over the projection horizon, while growth in emerging surplus economies is broadly unchanged relative to the April submission. Potential growth assumptions remained largely unchanged, with the exception of *emerging deficit* economies, where potential growth was revised significantly downwards.

G-20 MAP cumulative difference in 2011 - 2014 1/

(Annual percent change)

	Real GDP Growth	Real Potential Growth
G-20 2/	-0.5	-0.4
G-20 Advanced Surplus	-0.5	0.0
G-20 Advanced Deficit	-0.7	-0.1
G-20 Emerging Surplus	-0.1	-0.1
G-20 Emerging Deficit	-0.5	-1.9

Sources: G-20 authorities and IMF *World Economic Outlook* October 2010.
1/ Difference between October and April MAP submissions by G-20 authorities.
2/ See Appendix III in April report for groupings.

Downward revisions to projected growth have been accompanied by downward revisions in unemployment rates. While both *advanced* and *emerging* economies have revised growth projections downward, both have also revised unemployment rates downward. This is true in many, but not all, individual cases as well. A less optimistic growth outlook and a more optimistic employment outlook are not necessarily incompatible. However, policy frameworks have not adequately explained the basis for better projected labor market outcomes against the deterioration in growth outcomes.

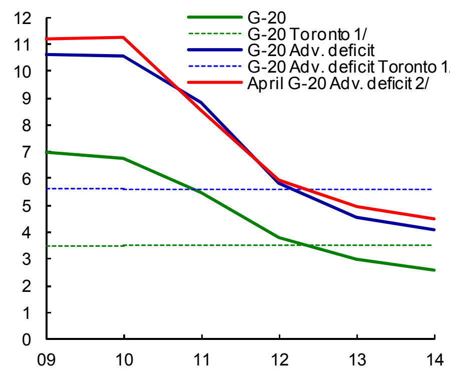
Revised frameworks project a stronger fiscal outlook in *advanced* economies over the medium-term. On balance, relative to April, fiscal deficit projections in *advanced* economies have improved, lead largely by *advanced deficit* economies. Despite lower growth projections, *advanced high-debt* economies foresee no change in the growth in revenues-to-GDP between 2010 and 2014. The fiscal outlook for *emerging* economies has also improved relative to April, while it has deteriorated significantly for *large oil exporters*.

Revised projections for current account balances include significant revisions in advanced deficit and advanced surplus economies. Relative to April, in *advanced deficit* economies, current account deficits are projected to become larger, by as much as 0.3 percentage point by 2014, while among *emerging deficit* economies current account projections remain broadly the same. Projections for current account positions in *emerging surplus* economies are broadly unchanged, while current account projections for *advanced surplus* economies have increased by about 0.3 percentage point during 2011-14. The overall impact of these revisions is to leave the 2014 G-20 current account position unchanged from that in April.

Box III.2. New G-20 Fiscal Commitments

G-20 members have committed to explicit fiscal consolidation targets. From the Toronto Summit Declaration of June 26-27, 2010, G-20 Leaders agreed to the following: "…advanced economies have committed to fiscal plans that will at least *halve* deficits by 2013 and *stabilize* or *reduce* government debt-to-GDP ratios by 2016." These consolidation plans would need to be credible, clearly communicated to the public, and based on country-specific circumstances.[1]

G-20 MAP: Fiscal Deficit
(Percent)



Sources: G-20 authorities and IMF staff estimates.
1/ Toronto Declaration of at least halving the 2010 deficit by 2013.
2/ Based on G-20 authorities April MAP submissions.

G-20 projected fiscal balances appear to be in line with these commitments (see chart). Based on G-20 macroeconomic policy frameworks and projections, the trajectory for fiscal deficits and debt appear to be broadly in line with the Toronto benchmarks (see dashed lines). Deficits are projected to decline to meet these benchmarks by 2013 for G-20 advanced deficit countries. Compared to the previous policy stance (i.e., April G-20 "base case") in the first phase of the MAP, fiscal positions for G-20 advanced deficit economies are strengthened slightly (blue versus red line).

These projections are predicated on the growth assumptions in the G-20 frameworks. The revised G-20 fiscal policy baseline would be at risk if GDP growth were weaker (as discussed in Staff's first MAP report). Section IV provides an assessment of current fiscal plans under the assumptions for GDP and potential output growth in a multilaterally-consistent G-20 baseline.

For the budgetary gains envisaged in G-20 projections to materialize, consolidation will need to be based on "growth friendly" measures. Weaker growth could make the consolidations difficult to achieve both directly and indirectly. Tax revenues, for example, may be weaker than envisaged if weaker growth were to materialize. Moreover, in a context of weaker growth, fiscal consolidation efforts could be more difficult to sustain. Thus, the composition of consolidation would need to emphasize "growth friendly" measures to maximize the chances of successful fiscal adjustment.

[1]To recognize country differences, the declaration added: "Recognizing the circumstances of Japan, we welcome the Japanese government's fiscal consolidation plan announced recently with their growth strategy. Those with serious fiscal challenges need to accelerate the pace of consolidation. Fiscal consolidation plans will be credible, clearly communicated, differentiated to national circumstances, and focused on measures to foster economic growth."

IV. Assessment of G-20 Policies and Upside Potential

G-20 policies make progress toward achieving strong, sustainable, and balanced growth, but more is required to attain the objectives agreed by Leaders. Collaborative action across the G-20 with appropriate timing and sequencing of policies—reflecting inter alia the strength of recovery—will produce benefits. In particular, upside potential can be realized through strengthened joint action on three fronts—namely, structural reforms and exchange rate flexibility to boost internal demand in emerging economies; fiscal consolidation comprising "growth-friendly" measures to put public finances on a sustainable footing in advanced economies; and product and labor market reforms to enhance supply potential across the membership. In terms of policy risks, a breakdown in cooperative action could inflict substantial welfare costs to the G-20.

A. Overview

23. **The purpose of this section is twofold**. First, the analysis examines the scope for strengthened collaborative action that can help realize more fully the *upside potential* of G-20 policies, accounting for policy plans and commitments made during the second phase of the MAP. Second, the *risk implications* of insufficient cooperation among G-20 members are discussed. To that end, the scenario analysis below is based on a multi-country model framework, allowing assessment of G-20 policies in a multilaterally consistent fashion, with due attention to policy spillovers (see Box IV.1).

24. **The upside scenario presented builds on the Toronto Report on Alternative Policy Scenarios, but is extended in important dimensions to take fuller account of country circumstances**. Specifically,

- *Additional policies* announced since the Toronto Report have been incorporated into the baseline to the extent possible.

- The *sequencing* of "policy layers" has been modified to reflect the relative cyclical positions of G-20 advanced and emerging economies.[6]

- The *time profile* of policies (e.g., degree of front-loading) has been modified and allowed to vary across the G-20 countries, to reflect differences in the state of cyclical recovery across the membership and the policy space available to individual countries to address adverse outcomes from reforms.[7]

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[6] These policy "layers" provide *broad* guidelines for key priorities that G-20 members themselves would want to consider when considering *specific* measures at the country level to further realize upside potential or to mitigate downside risks.

[7] In particular, recognizing demand- and supply-side implications of both fiscal and structural policies, the allowance for more gradual phase-in periods where appropriate are considered.

- A *broader menu* of policy actions—better tailored to individual country circumstances—is considered. Policies are better targeted to account for differences in country-specific conditions, adjustment needs, the structure of tax and pension systems, and political economy considerations.[8]

B. G-20 Upside Potential from Collaborative Action

25. **To further realize the upside potential of G-20 collaborative action, strengthened policies along three policy "layers" are considered**.[9] This includes: (i) further structural reform and other policies to boost internal demand in *emerging surplus* economies, including through strengthening social safety nets and sustained infrastructure spending, and increased exchange rate flexibility; (ii) further fiscal consolidation with "growth-friendly" measures in *advanced* economies; and (iii) enhanced structural reforms to boost supply potential in *emerging* economies and to tackle high unemployment and weaker potential following the crisis in *advanced* economies.

- *Sequencing and timing of policy actions take into account the identified risks to the recovery and the cyclical position of each region*. Key policies that should strengthen growth in the medium term may nonetheless have dampening effects in the short run. For instance, on the back of sluggish domestic demand in many advanced economies and a still fragile financial sector, initiating certain product, services, and labor market policies, may, through adjustment costs, increase unemployment and dampen private demand further in the short term. This could exacerbate risks of adverse real-financial sector feedback loops. Accordingly, the sequence of different policy layers is chosen appropriately with this in mind.

- *Given relative cyclical strength and policy space in many emerging economies, they are well placed to play a lead role*. Accordingly, domestic policy actions aimed at boosting internal demand in *emerging surplus* economies (first layer) should strengthen outcomes from their own perspective given weaker external demand from advanced trading partners. In turn, this action should boost net exports and facilitate fiscal consolidation and structural reform (second and third layers) in *advanced* economies that are in a relatively weak cyclical position. However, advanced economies would benefit by formulating and announcing credible medium-term fiscal strategies as soon as possible to forestall potential adverse market reaction.

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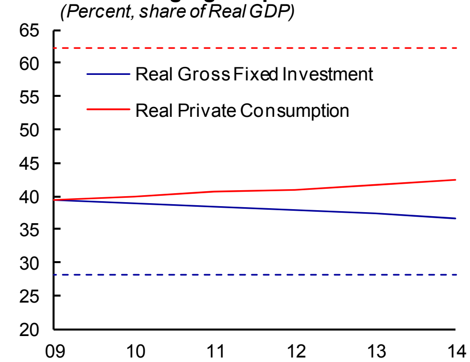
[8] For example, fiscal policies include a *wider* set of "growth-friendly" fiscal consolidation measures, including changes in public transfers and entitlement reform. Accordingly, the composition of fiscal adjustment as part of demand rebalancing is allowed to vary more extensively across G-20 members depending on the economic and policy context.

[9] From the relevant policy "pillars" that are elaborated in this analysis, individual G-20 members would be able to identify country-specific measures consistent under these broader headings that would be desirable and feasible from a national perspective.

Structural reforms to strengthen internal demand in emerging economies

26. **Consumption as a share of GDP in *emerging surplus* economies, while rising, remains relatively low, suggesting a need for additional reform**. Precautionary saving still appears high in the G-20 baseline and rising consumption ratios still remain well below averages for middle-income countries. Thus, *enhanced safety nets* and *targeted public transfers* should be considered. Also, investment ratios in some economies (excluding China) remain relatively low, suggesting that higher *infrastructure spending* could be helpful.

G-20 Emerging Surplus 1/
(Percent, share of Real GDP)



Sources: G-20 authorities and IMF staff estimates.
1/ 2009 - 2014 reflects MAP estimates and projections.
2/ Dashed lines reflect Middle Income Country averages.

27. **Accordingly, the first "policy layer" is intended to boost internal demand in *emerging surplus* economies, given the weaker outlook for advanced trading partners**. While specific structural reform measures will need to be tailored to individual country needs and circumstances, the following (stylized) reforms are considered in the analysis: (i) strengthening social safety nets, namely pension and health insurance, accompanied by increased exchange rate flexibility to facilitate rebalancing of demand towards domestic sources in *emerging surplus* economies; and (ii) higher infrastructure spending in fast-growing economies—including in *large oil exporters*.[10]

- Specifically, the set of policies considered comprise: (i) a gradual increase of government investment of 2 percent of GDP, starting in 2011 and implemented over 3 years in the *emerging Asia* region of the model; (ii) targeted transfers to the poor to strengthen safety nets—amounting to around 2 percent of GDP. The policy measures are largely financed through higher deficits given available fiscal space.

Fiscal consolidation to meet budget commitments in advanced economies

28. **To reach the G-20's fiscal objectives specified in Toronto, more fiscal effort is needed in some countries**. Real GDP growth in a consistent G-20 baseline is lower than that assumed in individual members' submissions in some cases. This would result in higher fiscal deficits than otherwise (i.e., at unchanged policies). In order to halve the 2010 fiscal deficit by 2013, *added fiscal effort* is

Additional Fiscal Adjustment Needed To Achieve G-20 Toronto Commitments 1/
(Percentage points of GDP)

	2010	2011	2012	2013	2014
United States	...	0.3	0.6	1.2	1.4
Euro area excluding Germany	...	0.3	0.6	0.9	1.2
Germany	...	0.1	0.2	0.3	0.4
Japan 2/	...	0.0	0.0	0.9	1.2

Source: IMF staff estimates.
1/ G-20 members committed to halve the 2010 fiscal deficits by 2013.
2/ For Japan, adjustment based on difference between the authorities MAP projections for headline fiscal balance and revised figures based on G-20 baseline growth projections, starting in 2013.

[10] Other relevant policy areas (not modeled) include reform of corporate governance and financial market development that could further lessen household saving by raising capital income distributions (otherwise held as retained earnings by firms).

required (text table). An ambitious implementation of the Toronto Declaration is assumed here based on stabilizing *net* (rather than gross) debt ratios by 2016.

29. **Consequently, further fiscal consolidation in *advanced* economies is considered as a "second layer" to help restore soundness of public finances**. The magnitude of the additional fiscal effort is based on the path of fiscal balances that is consistent with growth in the revised G-20 baseline (see Box IV.2). The improvements in fiscal balances are assumed to be sustained to reduce public debt.[11] Specifically, fiscal adjustment along the following key dimensions are considered:

- *Scale of adjustment*. In the scenario, the magnitude of additional fiscal consolidation over the medium term is determined by the amount of short-fall relative to the Toronto commitments in 2013 under baseline policies (see Box IV.2).
- *Composition of adjustment*. Fiscal consolidation includes "growth-friendly" measures such as tax reform to reduce distortions or entitlement reform to limit growth in public transfers. Specifically, for the *United States*, the package comprises broadening of tax bases, higher energy taxes and lower discretionary spending between 2011 and 2014.[12] Further down the road, to achieve larger budgetary saving and to prevent sizable hikes in (distortionary) income or payroll taxes in the future, gradual entitlement reform to restrain the growth of government spending in key transfer programs (e.g., Social Security and Medicare reform) accompanied by additional tax reform relying more on consumption taxes should be considered.[13] For the *euro area*, *Japan*, and *rest of the world* the composition of additional fiscal consolidation is assumed as in the June 2010 Report on Alternative Scenarios.[14]
- *Time path of adjustment*. Specifically, given elevated downside risks to its recovery, the path of fiscal adjustment for the *United States* is more back loaded than in other countries. The consolidation begins in 2011, but the magnitude of the added adjustment in 2011–12 is small, before increasing progressively in 2013–14. For the *euro area excluding Germany*, fiscal consolidation begins in 2011 and steadily increases through

[11] G-20 MAP submissions do *not* include longer-term fiscal baseline projections (i.e., beyond 2014). Consequently, fiscal consolidation effects on public debt beyond 2014 are necessarily available only as deviation from baseline (not in level terms). Countries with faster growing aging-related spending pressures will have to do more to reduce debt to prudent levels. IMF staff analysis on longer-term fiscal consolidation needs can be found in *Fiscal Monitor* (November 2010).

[12] To close a potential fiscal shortfall of 1.4 percent of GDP for the United States, for example, measures include increases in energy taxes (0.3 percent of GDP), broadening of the tax base (0.8 percent of GDP), and additional cuts in discretionary spending (0.4 percent of GDP).

[13] (Parametric) reform of key entitlement programs to curb spending growth, while mitigating distributional consequences and the impact on current beneficiaries, would include gradual tightening of eligibility criteria (e.g., higher retirement age) or benefits (e.g., partial price indexing of initial pension benefits for upper income earners).

[14] See for details http://www.imf.org/external/np/g20/pdf/062710a

2014. Reflecting its circumstances, *Japan* does not embark on additional consolidation until 2013, but subsequent fiscal adjustment is relatively larger. *No* fiscal consolidation is assumed for emerging surplus countries, represented by *emerging Asia* in the model.

30. **Credibility of fiscal consolidation plans is a key element for successful adjustment**. Credibility is defined in terms of what the private sector believes about the likelihood of a particular policy action. If economic agents gain confidence in policy implementation in the future, the growth-enhancing effects (e.g., through lower interest rates and tax burdens in the future) of the fiscal package would be realized sooner. Clear and effective communication of coherent consolidation plans and strengthening of budgetary institutions and frameworks would help anchor credibility. Even if consolidation begins only gradually, credible medium term plans should be developed now. In the analysis, fiscal policies are assumed to steadily gain credibility over time. Simulations illustrating the role of fiscal credibility—i.e., by delaying expectations of consolidation by 1 or 2 years and affecting the growth impact for the adjusting country—are discussed in Box IV.3.

Product and labor market reform to enhance supply potential

31. **On structural reforms, there is scope for further G-20 action in key priority areas**. A cross-check of Fund staff assessments of the alignment of members' structural reform baseline, with strategic priorities identified by OECD in its "*Going for Growth*" Strategy, identifies further policies that would move the G-20 membership closer to their growth objectives. Plans more closely aligned with key reform priorities for a particular G-20 member are judged to be more effective.[15]

32. **Thus, to gradually boost employment and enhance supply potential following the crisis, product and labor market reforms across the membership are considered as a "third layer."** The following menu of stylized reform measures is introduced:[16]

- *Product and services market reform to strengthen competition in key sectors*. The analysis considers the effects of reducing barriers to competition in network industries, promoting competition in professional services and retail distribution, and simplifying product and services market regulation.

- *Easing the restrictiveness of product and services market regulation to appreciably improve productivity*. The effectiveness of such reform is derived from OECD analysis (for details see Boxes 4 and 5 in the June 2010 Report on Alternative Scenarios). For

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[15] Specifically, in cases where country plans were judged by Fund staff to be "well aligned" with OECD strategic priorities, the scoring in terms of policy effectiveness would be higher (implying less scope for upside potential). To the extent that plans or measures were "broadly" or "not well aligned," the effectiveness of baseline policies is progressively discounted. A summary of IMF staff's qualitative assessment and scoring system of G-20 structural reform policies and OECD staff estimates of the effects of reform measures on growth is provided in Fund Staff's Initial Assessment Report of the G-20 MAP.

[16] See OECD Report for the G-20 MAP for further details on the stylized effects of structural reform, consistent with the analysis presented here.

emerging deficit economies, policy efforts are focused on simplifying product and services market regulation.

- *Complementary labor market policies to further enhance growth prospects and reduce high unemployment*.[17] Labor market reforms that could gradually increase employment include measures that lower hiring costs, reduce long-term unemployment (by facilitating re-entry), and encourage job search, matching, and mobility, in line with the recommendations by the G-20 Ministers of Labor and Employment, which were welcomed by Leaders in Toronto. To increase the effectiveness of the labor market reforms, they should be accompanied by product and services market reforms that could strengthen the employment effects by boosting labor demand and real wages as well as fiscal actions that lower payroll taxes or other non-wage costs that could also strengthen the employment effect.

33. **Across the different policy "pillars," short-term factors are considered in the timing of implementation**. Similar to considerations to determine a helpful sequencing of policies, the assumed implementation schedule (i.e., time profile) for each policy layer in the analysis depends on specific economic conditions of G-20 members and the available policy space to address any adverse short-term impact on demand.[18]

C. Scenario Results

34. **In *emerging* economies, enhancing social safety nets and improving infrastructure increases the region's welfare, while supporting global activity**. By removing bottlenecks, a gradual increase of government investment in infrastructure in *emerging Asia* gradually boosts productivity of the region, while increasing domestic demand. In addition, strengthening of safety nets through targeted transfers to the poor (who tend to be cash and credit constrained) further increases domestic demand in *emerging Asia*. Higher infrastructure spending and enhanced safety nets in *emerging Asia* also improves growth outcomes in rest of the world, via trade linkages, notably in its largest trading partners. Finally, increased exchange rate flexibility in *emerging Asia* (with the real effective exchange rate appreciating around

[17] In the context of an incipient recovery and still weak job growth, ILO analysis, building on the recommendations of the April G-20 Labor and Employment Ministers in Washington, emphasizes the need for reforms that reduce the hiring cost of lower skilled workers, as part of an overall policy for raising the labor force participation of low income households, employment subsidies in the form of broad cuts in social security contributions; support skill improvements through education and better training to closely match skill supply to the needs of enterprises and labor markets, facilitating worker mobility.

[18] Specifically, on structural reforms, given strong cyclical positions of emerging economies, reforms are assumed to begin immediately, i.e., in 2011; for Japan, which has been at the zero interest rate floor for several years, implementation of structural reforms, beyond those already in the baseline, is assumed to be delayed by 2 years (i.e., starting in 2013). For other advanced economies structural reforms are postponed by 1 year (i.e., assumed to start in 2012).

10-15 percent) facilitates rebalancing toward internal demand, while reducing current account surpluses and achieving higher growth (Figure 1).

35. **In *advanced deficit* economies, given their relatively weak cyclical position, fiscal consolidation accelerates only when the recovery strengthens**. Supported by credible fiscal plans and helped by positive spillovers from the first layer, the scenario shows that the *short-term* negative effect of fiscal consolidation on growth in *advanced* economies is smaller (Figure 1). Also, the negative spillovers from reduced public demand on growth in other regions, except *emerging Asia*, are negligible. Over the *medium term*, as fiscal policy gains credibility, private spending is increasingly "crowded in"; investment and employment increase; and real GDP increases relative to the baseline. For *emerging Asia*, real GDP is lower than otherwise over the projection horizon, given their high export dependence.

36. **Further structural reform boosts growth and jobs, particularly in *advanced* economies with high unemployment**. Accounting for policies that are already in the G-20 baseline, additional structural reforms were considered and yield the following:[19]

- *Effective labor market reforms improve growth and employment outcomes in advanced economies over the medium term, particularly in Europe*. Labor market reform comprises three components: (i) front-loaded active labor market policies (ALMP)—implemented in all regions, except Japan—to help reduce high unemployment through working retraining or matching programs (which is in line with ILO analysis);[20] (ii) a gradual reduction of the average replacement ratio (ARR) of unemployment benefits typically through duration limits—implemented in euro area members; and (iii) a phased-in increase in the eligibility/mandatory retirement age (beginning in 2012; phased in over five years in Japan and the rest of the world, and over 10 years in the euro area and the United States).
- *The possible near-term dampening effects of labor market reform can be mitigated*. The potential negative impact of labor market reforms is partially eased by implementing job-friendly ALMP beginning in 2011, while a gradual reduction of the ARR is postponed to 2013. Positive spillovers from domestic-demand boosting policies in *emerging* economies and some monetary accommodation also help mitigate potential short-term negative effects. Employment in some *advanced surplus* and *advanced*

[19] In comparison to the OECD report, IMF staff analysis here focuses on the *incremental* gains from additional structural reform *beyond* what is credited to G-20 baseline policies. The analysis in the OECD Report examines the *full* gains. Both analyses draw from the same set of OECD estimates for the effectiveness of reform.

[20] The level of ALMP expenditure is increased to half of the level of the average level prevailing in the "high ARR and high ALMP spending" group as identified by the OECD. In countries with historically low structural unemployment, such as the United States and the United Kingdom, areas where ALMP spending could most usefully be raised include the public employment service (to allow staff to cope with the major increase in the number of caseloads), (net) hiring subsidies and targeted training, and apprenticeship programs for disadvantaged youths.

deficit countries (euro area members) increases by around 2¼ percent; in the United States by about 1¼ percent, in the rest of the world by 1 percent; and in *Japan* by about ¼ percent over time. Improved labor markets in Europe would have positive spillovers on *advanced deficit* economies outside the euro area and in the rest of the G-20.

- *Complementary product and services market reforms that ease restrictiveness of regulation and lower entry barriers significantly boost productivity and wages for workers*. Moving towards "best practice" regulation (based on OECD analysis) raises overall productivity growth, notably in *advanced surplus* economies, in the range of ¼ to over ½ percentage point per year. Strengthened competition in key sectors, higher productivity, alongside tax reform in some countries (i.e., lower payroll tax wedge), in turn, would boost real wages and disposable incomes for workers.

- *Along with appropriate timing of reforms, credibility is crucial*. Credibility works through expectations.[21] With higher expected productivity, firms increase investment and payrolls; and with higher expected incomes and better job and wage prospects, consumption gradually strengthens. In *emerging Asia* and *ROW*, growth improves appreciably due to their own additional product and services market reforms relative to the first policy layer (Figure 1).

37. **There is appreciable upside potential from cooperative G-20 policy action that is sequenced and timed accordingly across the regions**. The simulation results show that by beginning with reforms in the most cyclically advanced region, the potential dampening effects of fiscal consolidation in advanced economies on global growth are mitigated, as the negative impact of fiscal consolidation is compensated by positive spillovers from reforms in emerging economies. Overall, world GDP would be higher by around 2 percent by 2014, equivalent to more than 1 trillion dollars. The boost to incomes—including in developing countries—would lift an estimated 37 million people around the world out of poverty according to the World Bank's companion report.[22] In terms of G-20 employment, an additional 25 million jobs approximately would be created if upside potential were realized more fully from strengthened collaborative G-20 policy action.

38. **While the benefits of further trade liberalization are not included in the analysis, there is likely to be significant upside potential from completing long-delayed Doha trade negotiations**. The more ambitious the result of those negotiations, and the sooner they can be completed, the more upside potential they would deliver. Multilateral trade liberalization is a clear example of the benefits of joint action, since it leads to gains that are multiples of those that will accrue from countries acting alone. Strengthening the rules-based trading system

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[21] In the model, with insufficient credibility, structural reforms can temporarily dampen growth, often through weaker demand. If the future employment or productivity benefits, for example, of reform are not internalized sufficiently by the private sector, the boost to current consumption or spending plans is limited.

[22] See *Growth and Development in Emerging Markets and Other Developing Countries*: Report prepared by Staff of the World Bank for G20 Growth Framework and Mutual Assessment Process.

will reduce the scope for future protectionism and support market-based structural adjustment policies in other areas.

D. Risk Implications from G-20 Non-Cooperation

39. **Against the backdrop of a slower global recovery, downside risks—including from a breakdown in G-20 policy cooperation—are elevated**. Key downside risks are:

- *The lack of credible medium-term consolidation plans*. If major advanced economies delay announcing credible medium-term plans, underpinned by conservative growth assumptions and concrete policies and measures, there is a risk that confidence will be undermined and bear upon recovery prospects.

- *Spillovers from renewed turbulence in sovereign debt markets, notably in Europe*: This could precipitate an adverse feedback loop with the financial sector, and may spill over to the real economy and across regions through higher funding costs, tighter lending conditions, and retrenchment in capital flows.

- *Capital flows and risks of overheating in emerging economies.* Large capital inflows into major emerging economies—owing in part to accommodative monetary policies in major advanced economies, coupled with insufficient policy levers in some emerging economies—pose risks of overheating and asset price booms, with attendant spillovers that could undermine a sustainable recovery.

- *Financial and trade protectionism and currency instability*: A recent wave of foreign-exchange interventions to limit appreciation in some emerging and advanced economies, predominantly in Asia and Latin America, has raised the specter of protectionism, which could derail the global recovery.

40. **Delaying credible fiscal consolidation could push policies into a reactive mode and render them ineffectual**. Take the example where follow-through on fiscal adjustment in advanced deficit economies was not forthcoming (see Box IV.4). Specifically, in the event of deteriorating market sentiment, higher sovereign risk premia would push up interest rates, with adverse feedback effects on growth and confidence. Forced *fiscal consolidation* would ultimately need to be stronger and more front-loaded to reassure markets but would be less credible and less "growth friendly." With a lack of cooperation, G-20 policies could be pushed into a reactive mode, becoming less credible and ineffectual. Also, many *structural reforms* may not be politically feasible in the downside, such as key entitlement reform to raise retirement ages in line with life expectancy or shortening the duration of unemployment benefits to encourage job search.

41. **Similarly, capital flows to *emerging economies* pose risks of overheating and asset price bubbles if not managed well, underscoring again the importance of policy cooperation**. Capital inflows can help promote external rebalancing, but much depends upon how countries manage such inflows.

- Given fragile recovery, an accommodative monetary policy stance remains appropriate in *advanced economies*, since it can help counteract some of the contractionary effects of fiscal consolidation. At the same time, however, policymakers in these countries should be mindful of the spillovers.

- More generally, capital flows should be viewed as an opportunity to start down the path of correcting global imbalances, not as a hindrance. However, managing large inflows will be a challenge, and the task becomes more onerous in the context of limited exchange rate flexibility in some major *emerging economies*.

42. **A breakdown of policy cooperation, involving capital inflows and firm resistance to currency appreciation, or competitive depreciation, could hinder global rebalancing and be damaging**. Much depends on how capital flows are put to use and—perhaps more importantly—the extent to which they are accompanied by exchange rate appreciation. For surplus economies that exhibit symptoms of domestic overheating and facing capital inflows, efforts to firmly resist currency appreciation could exacerbate overheating pressures or capital account pressures through expectations. This could lead to booms (and busts) in asset prices, growth, and inflation. Moreover, the threat from rising trade protectionism would be serious given the tendency for perceived non-cooperative policy actions to be met with non-cooperative policy responses (i.e., retaliation). Higher barriers to international trade would dampen growth and have adverse welfare implications for all G-20 members, particularly those more dependent on trade.

43. **Thus, collaborative action is highly beneficial to the G-20 membership because it avoids the substantial damage caused by a breakdown in G-20 policy cooperation**. By significantly reducing such downside risks, collaborative action increases the effectiveness of policies in key areas and avoids significant welfare costs to the G-20 members associated with fragmented or "beggar-thy-neighbor" policies.

Box IV.1. Multilateral Framework to Assess G-20 Policies

Staff analysis and assessment of G-20 policies are derived from a consistent multilateral framework to address shortcomings from aggregating individual members' projections. As identified in Section III, there are some potential inconsistencies or tensions across the macroeconomic projections derived from (different) national frameworks of individual G-20 members.

The scenario analysis is conducted using the IMF's Global Integrated Monetary and Fiscal model (GIMF). The model contains 6 stylized countries or regions—the United States, Germany, the rest of the euro area, Japan, emerging Asia, and rest of the world (ROW). While the analysis of policies and their effects are necessarily stylized, this framework provides a useful tool to analyze and illustrate the benefits of G-20 collective action and alternatives policy options within a rigorous and consistent analytical structure for the global economy. Several features of this approach are worth highlighting:

- *The common analytical framework can help address tensions across G-20 members' macroeconomic projections*. A particularly useful feature of the model is that it produces multilaterally- and model-consistent measures of key variables such as the output gap or the unemployment gap. This provides a sounder analytical basis for the policy assessment.

- *The multi-country model also provides estimates of the cross-border spillovers of an individual member's policy actions*. The framework explicitly examines the multilateral implications and interactions of policies that are missing from an aggregation of individual G-20 submissions.

- *The analysis is based on harmonized assumptions for key macroeconomic variables*. The model structure provides the necessary discipline for internal consistency of key variables such as exchange rates, interest rates, and partner country growth.

Box IV.2. Multilateral Consistency of the G-20 Baseline

A multilaterally consistent G-20 baseline was derived using the IMF's Global Projection Model (GPM).[23] A particularly useful feature of GPM in the context of the G-20 MAP exercise is that it produces multilaterally and model-consistent measures of key unobservable variables such as the output gap or the unemployment gap. The model also incorporates recent economic and market developments and accounts for the impact of new policy measures in the derived baseline in a multilaterally consistent way, including spillovers. Thus, the multilaterally consistent G-20 baseline incorporates the latest G-20 commitments and policy plans; features greater multilateral consistency of output gaps to better anchor simulations for the assessment of upside potential; and, reflects in a timely fashion market and economic developments.

On the back of weak data in the second half of 2010, near term growth was marked down in the refined baseline. Recent data suggest that the global recovery continues to lose momentum, while the strength of incoming data has varied across regions. Heightened fears about the sustainability of the U.S. recovery, along with negative developments in Japan and contractionary policy actions in China, have combined to reduce equity prices, dampen sentiment in many economies, and reduce worldwide activity more generally. On balance, developments in the euro area have been more reassuring than previously feared, as countries undergoing substantial fiscal adjustment have fared better than anticipated.

Multilaterally Consistent MAP Projections of Real GDP Growth 1/

	2010	2011	2012	2013	2014	2010 - 2014 Average
	Difference from "base case" (percentage points)					
World	0.0	-0.6	-0.4	-0.1	0.0	-0.2
United States (20.7)	-0.6	-1.1	-0.8	-0.8	-0.8	-0.8
Euro Area (15.4)	-0.1	-0.7	-0.6	0.6	-0.2	-0.2
Japan (6.2)	-0.3	-0.9	0.0	0.0	0.1	-0.2
Emerging Asia (23.7) 2/	0.4	-0.7	-0.2	0.3	0.9	0.1
Rest of World (34.0)	0.1	0.0	-0.2	-0.2	-0.4	-0.1
Memorandum	*Refined baseline (percent)*					
World	4.7	4.0	4.5	4.9	5.0	4.6

Sources: G-20 authorities and IMF staff estimates.
1/ Share of world GDP by PPP in parenthesis (2007 - 2010 average, percent).
2/ Includes: China, Hong Kong SAR, India, Indonesia, South Korea, Malaysia, Philippines, Singapore, Taiwan Province of China, Thailand.

Overall, the refined G-20 baseline growth is broadly similar to the G-20 MAP projections over the medium term. However, there are two exceptions: *advanced deficit* countries at the epicenter of the financial crisis, where real GDP growth was marked down and *emerging Asia* for which real GDP growth was revised up. The estimates for the advanced deficit countries are in line with empirical findings that show large potential output losses in the aftermath of severe financial crisis (see for details MAP's Initial Assessment Report). Therefore, real GDP growth in advanced deficit countries at the epicenter of financial crisis was revised down to ensure multilateral consistency of output gaps across regions, particularly with advanced countries that were further away from the crisis.

Using the revised real GDP projections, the path for fiscal balances was adjusted using standard tax and spending elasticities. Specifically, the elasticity of revenues with respect to growth was assumed equal to one, while the expenditures with respect to growth was assumed zero. Using these elasticities, the cumulative revisions in real GDP growth for each model entity over the projection horizon was used to derive its adjusted expenditure projections. The adjusted headline fiscal balance for each block of the model, consistent with its refined baseline real GDP growth, was obtained by subtracting its adjusted expenditures from its original revenue projections.

Deviations in MAP Fiscal Deficit Projections 1/
(Percentage points of GDP)

	2010	2011	2012	2013	2014
United States	0.4	1.1	1.7	2.0	2.2
Euro area excluding Germany	-0.8	-0.3	0.7	0.9	1.2
Germany	0.4	0.4	0.2	0.2	0.2
Japan	0.2	0.7	0.9	1.0	1.1

Source: IMF staff estimates.
1/ A positive number reflects higher fiscal deficit in G-20 baseline, relative to authorities MAP projections.

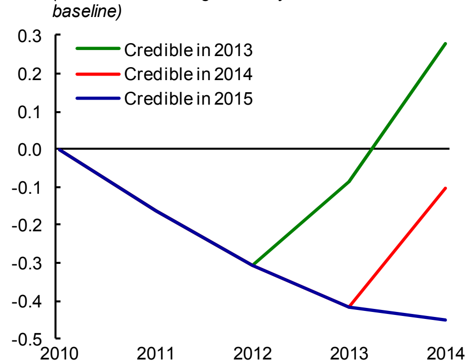
[23] For more information on GPM see the Report on Alternative Scenarios: http://www.imf.org/external/np/g20/pdf/062710a.pdf

Box IV.3. Gains of Enhanced Fiscal Credibility

Credibility is crucial for advancing medium-term gains from fiscal consolidation. In the analysis, credibility brings forward these benefits though the expectations channel. Credibility is defined in the model as private sector beliefs about the implementation of future policies. Greater fiscal credibility implies that economic agents will more fully anticipate lower interest rates and tax burdens in the future. Accordingly, growth-enhancing effects of the fiscal package over the medium term would materialize sooner. Under partial credibility, investors and consumers anticipate some reversal or slippage in consolidation, which results in weaker investment and employment responses over the near term.

Simulations illustrate appreciable costs from lower credibility. The results for the euro area excluding Germany fiscal package provide a useful illustration of the costs associated with insufficient credibility. To model the effect of lower credibility private expectations are assumed to align with public sector fiscal goals later (2014 or 2015) than in base case (2013). The result show that lower credibility significantly increases the short-term adverse effects on GDP, as it takes longer to crowd in private demand.

G-20 MAP: Fiscal Consolidation Under Different Credibility Assumptions
(Euro area excluding Germany; Percent deviation from baseline)



Sources: G-20 authorities and IMF staff estimates.

Credibility of fiscal plans could be strengthened through several policy measures. Specifically, clear and effective communication of coherent plans is important. Strengthening of budgetary institutions and frameworks would also help anchor private sector expectations. In addition, a clear commitment to critical measures, such as entitlement spending reforms, would deliver further credibility gains, while forestalling a need for more painful reforms in the future.

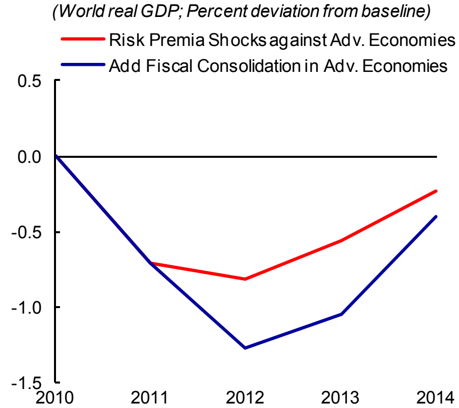
Box IV.4. Potential Costs from a Breakdown of G-20 Policy Cooperation

The potential cost of a lack of policy cooperation among G-20 members could be substantial. The welfare implications would depend inter alia on the severity of market reaction, the loss of credibility in G-20 cooperative policies, as well as the extent of recourse to fragmented or "beggar thy neighbor" actions among members. The interaction or spillovers between non-cooperative actions could exacerbate risks associated with still vulnerable financial systems, sovereign debt concerns, and possible adverse real-financial feedback loops.

One policy risk scenario can be illustrated by considering the impact of postponing credible consolidation in the advanced economies. Postponing fiscal consolidation increases downside risks through adverse market reaction, which would raise advanced economies' sovereign and corporate spreads. This in turn would force these economies into a reactive policy posture, and forced fiscal consolidation may take many years to become credible and to bring spreads back down.

- *The downside scenario assumes a sharp increase in U.S. sovereign spreads*. Specifically, sovereign spreads increase by over 200 basis points, with an additional 150 basis points increase of corporate sector spreads, amid heightened market concern. The increase in spreads is roughly half the size for the other advanced economies. The simulations suggest that the impact on world GDP from this policy risk is sizable—world output declines by over 1½ percent.

G-20 MAP: Downside Scenario
(World real GDP; Percent deviation from baseline)



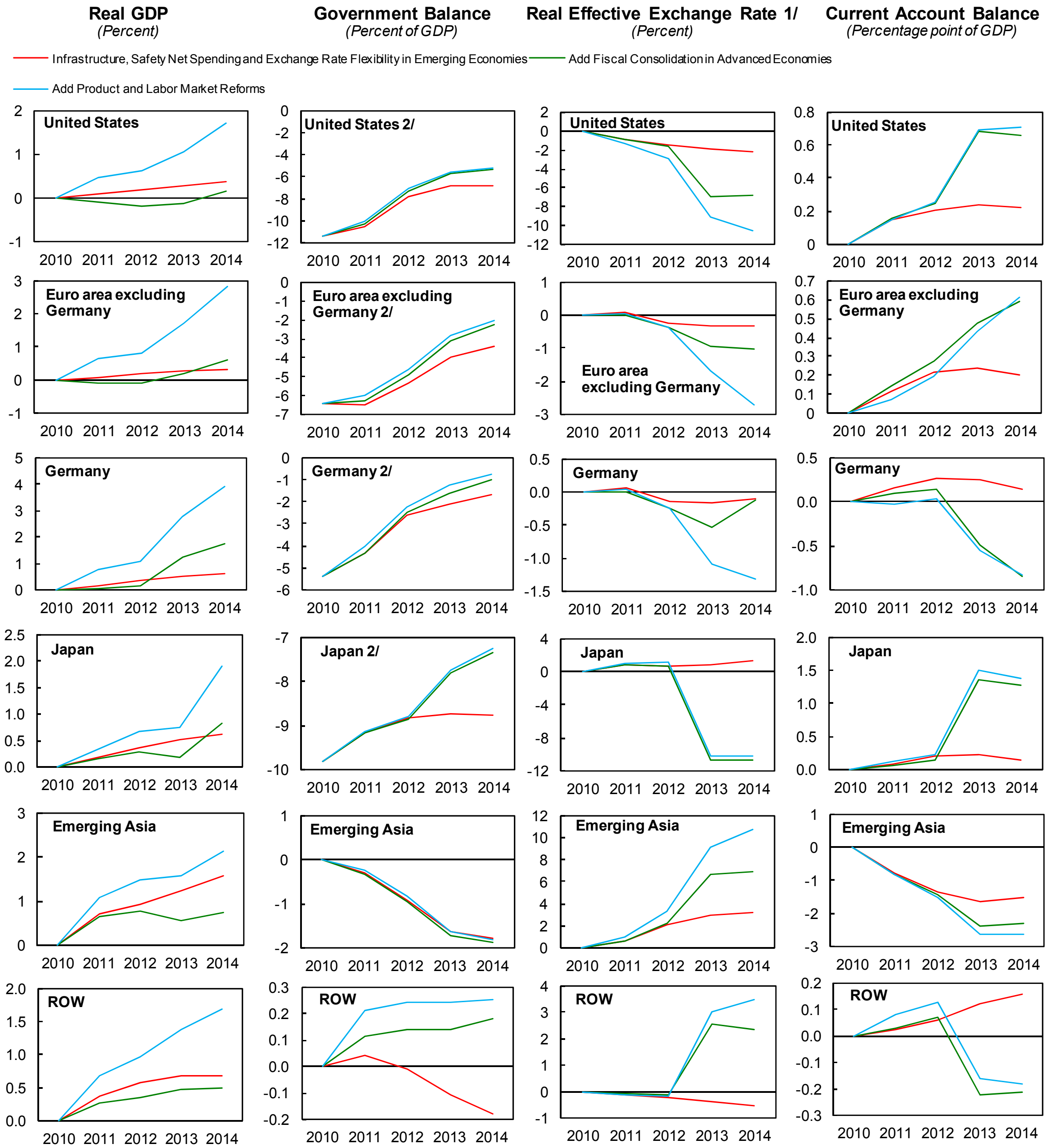
Sources: G-20 authorities and IMF staff estimates.

The increase in market pressure and borrowing spreads forces reactive, front-loaded, and highly contractionary consolidation in the advanced economies. Fiscal consolidation is significantly frontloaded—2 percentage points of GDP in the United States and half as much in the other advanced economies. The simulations suggest that as a result of delayed credibility of consolidation, negative multiplier effects, including spillovers to regions that do not undertake fiscal consolidation, are large. This follows for two reasons. First, the cuts are assumed to be chosen on the basis of implementation speed rather than likely impact on output. Second, the sudden, forced consolidation is assumed to become credible only in 2014, so that their beneficial effects through expectations are quite gradual.

The conclusion from this analysis is that cooperative policy action is highly beneficial to the G-20 membership to insure against such downside risks. By significantly reducing risks, collective action increases effectiveness of policies in key areas and avoids significant welfare costs to the G-20 members.

Figure 1. G-20 Upside Scenario

(Deviation from baseline)



Sources: G-20 authorities and IMF staff estimates.
1/ Increase indicates appreciation.
2/ Levels in percent of GDP.

*Overall, **G-20 financial policies** have made some progress—mainly, at the national level. Remaining core **policy challenges** center around (i) fully repairing the damage inflicted by the crisis, including through recapitalizing or resolving weak banks; (ii) better managing systemic risk, including through wider national supervision and stronger international frameworks to handle failing cross-border financial institutions; and (iii) developing macroprudential tools and mechanisms to augment financial stability frameworks*.

B. Fiscal Policies

Fiscal consolidation is an essential part of internal rebalancing. At the Toronto Summit, G-20 Leaders in advanced economies agreed to halve fiscal deficits by 2013 and to stabilize or reduce public debt by 2016. The magnitude and pace of fiscal consolidation plans differ across countries, reflecting differences in cyclical positions, fiscal space, and market reaction to the strength of public balance sheets. While several countries have articulated medium-term fiscal plans, or are in the process of doing so, many G-20 countries have not yet articulated credible plans underpinned by specific measures. An assessment of the consistency of current fiscal plans with commitments made by G-20 Leaders in Toronto is made in Section IV.

6. ***Advanced deficit* economies have announced or brought forward fiscal consolidation plans, but these differ across countries in magnitude and pace of adjustment, reflecting the strength of economic recovery, the amount of fiscal space, and the reaction of markets to the strength of public balance sheets**.[4]

- *Responding to severe market pressure earlier this year—notably, concerning sovereign risks—several euro area deficit economies have brought forward and deepened their consolidation plans*. Spain, for example, accelerated its consolidation by 0.5 percentage point of GDP in 2010 and 1 percentage point in 2011. Overall, approximately three quarters of deficit reduction in the European countries is projected to be achieved through expenditure cuts. In many cases consolidation plans are accompanied by measures to increase the transparency of the budget process.

[4] To maintain comparability with the previous reports, theme-based groups of G-20 members are identical to those described in IMF staff's *Mutual Assessment Process–Appendices to the Report*. In particular, *advanced surplus* economies refers to Canada, France, Germany, Japan, Korea and the Netherlands and *advanced deficit* economies refers to Australia, the United Kingdom, the United States and the euro area excluding France, Germany and the Netherlands. For the analysis of global imbalances, the euro area is treated as a whole given its common monetary and exchange rate policies. Accordingly, in that case *advanced surplus* refers to Canada, euro area, Japan and Korea whereas *advanced deficit* economies corresponds to Australia, the United Kingdom and the United States. The above groupings are defined based on the sign of the average current account balance over the period 2001-2008.

- *The United Kingdom has also committed to additional tightening and an accelerated consolidation plan*. The plan aims to balance the cyclically-adjusted current fiscal balance and put the public sector net debt ratio on a downward path by FY2014/15, with expenditure cuts and VAT increases partially offset by a reduction in the corporate tax rate. To enhance the transparency and credibility of the budget process and help inform policy decisions, the United Kingdom is establishing a new independent Office for Budget Responsibility, which will be tasked with providing the macroeconomic and fiscal forecasts for the budget and assessing fiscal sustainability and compliance with the fiscal mandate.

- *The United States intends to embark upon an ambitious consolidation over the medium-term, including moving the primary deficit into balance by 2015*. In the near term, however, the focus is placed on supporting economic recovery which has slowed. Fiscal discipline is expected to be supported by PAYGO rules, tax increases for high-income tax payers, a broader corporate tax base, and savings in discretionary spending. Recent health care reforms are anticipated to make some contribution towards consolidation, provided that the planed measures to contain costs are followed through. *Australia* has begun withdrawing fiscal stimulus, plans to return to budget surplus in FY2012-13, and has announced a tax reform package.

7. **Many *advanced surplus* economies have also announced fiscal consolidation plans, although fiscal space, the need for immediate action, and the degree of specificity in plans vary significantly**.

- *Japan is facing the largest fiscal challenge and current plans target halving the primary deficit by fiscal year 2015*. The medium-term fiscal framework aims to achieve this target through entitlement and tax system reforms and pay-as-you-go principles. Spending cuts are focused on non-social security expenditures, but many of the tax reform measures have yet to be specified.

- *Other advanced surplus economies have announced relatively detailed and broad-based consolidation plans*. In some cases, new measures to bolster the credibility of public finances have been established or planned, including mechanisms to review and identify risks in federal and state budgets (e.g., Germany and Korea) and to reform the fiscal framework (e.g., France). *Canada* is continuing to implement stimulus measures, but has articulated a plan to roughly balance the federal budget over the medium term.

8. **Some *emerging deficit* economies have begun fiscal tightening and announced medium-term consolidation plans**. In many cases, the broad measures are dependent upon the pace and durability of economic recovery.

- *India has announced its intention to reduce the fiscal deficit by about 4 percentage points in 2010–15*. Measures addressing tax avoidance are yielding early dividends, but a full breakdown of specific measures has not yet been disclosed. *Mexico* is broadening the non-oil tax base and reducing subsidies. *South Africa* is targeting a near 3 percentage point reduction in the deficit through 2012/13, while taking into account the progress of recovery. *Turkey* has made progress toward reversing the deterioration in the primary balance, although much of the recent improvement reflects improved cyclical conditions.

9. **The *large oil-exporting* economies have committed to some fiscal consolidation**. *Russia*, for instance, is considering a draft budget based on a consolidation of about 3 percent of GDP through 2013, with increases in pensions funded, in part, by higher payroll taxes. In these economies, increased non-oil infrastructure spending could help address supply bottlenecks and sustain growth, with less dependence on oil prices.

*Overall, **G-20 fiscal policies** appear broadly on track to meet the Toronto Declaration commitments, although medium-term consolidation plans rely on relatively optimistic growth assumptions for some countries (See Section III). Central **policy challenges** are to sustain fiscal consolidation efforts and to formulate clear, credible and ambitious medium-term plans underpinned by specific commitments in critical areas—including addressing rapidly growing public spending programs and tax reform that is supportive of growth. Stronger governance and budgetary institutions in many cases would strengthen such efforts. Beyond the MAP framework, long-term fiscal plans to restore sustainability of public finances will be required to rebuild policy space and to address long-run budgetary pressures.*

C. Monetary and Exchange Rate Policies

Short-run monetary accommodation and central bank interventions have been critical for alleviating the financial crisis and the recession. Normalizing the monetary policy stance over the medium term in major advanced economies and greater exchange flexibility in emerging surplus countries are important for rebalancing global demand and sustaining growth. Some emerging surplus countries have allowed greater exchange rate flexibility or announced policy changes to that effect, although intervention and reserve accumulation have restrained currency appreciation in many cases.

10. **Almost all *advanced* economies have kept their target policy interest rates constant at highly accommodative levels since the G-20 Leaders Summit in Pittsburg**. The largest advanced economy central banks had started winding down some of the unconventional measures taken during the crisis, but renewed financial stress and a widespread moderation in the pace of economic recovery during the second and third quarters

of 2010 have prompted provision of additional liquidity support. Several smaller advanced economies have started raising policy rates from the low levels prevalent at the bottom of the recession, but only in Australia, which had avoided a recession, have the rates risen close to neutral levels.[5]

11. **Reflecting their lead role in the global economic recovery and, in a few cases, signs of overheating, some *emerging* economies have tightened monetary policy**. Only two emerging economies—Brazil and India, both deficit countries—have raised policy rates. Many emerging economy central banks have tightened their monetary policy through other means, such as higher reserve requirements. Russia and South Africa are the only G-20 economies to have lowered their policy rates since September 2009.

12. **Exchange rate adjustment is extremely important for global rebalancing, and some *emerging surplus* economies have made progress towards increased flexibility**. Strong recoveries, declining absolute and relative risk aversion, and wide interest rate differentials vis-à-vis advanced economies have put upward pressure on the currencies of most emerging G-20 members. Some of these countries, including Brazil, India, Indonesia, Mexico, Russia and South Africa, have allowed their currencies to appreciate substantially in nominal effective terms since September 2009. But other big emerging economies have intervened in foreign exchange markets and increased their reserve holdings to limit the strengthening of their currencies.

- *China recently announced a return to a more flexible exchange rate regime*. The RMB has appreciated less than 2 percent against the U.S. dollar since the policy announcement, but day-to-day exchange rate volatility has increased markedly.

13. **Despite large exchange rate fluctuations, *advanced* economies have largely avoided intervening in currency markets**. Exchange rate movements among advanced economy currencies have been sizable since September 2009. Through September 2010, the Australian dollar appreciated against the U.S. dollar, the pound depreciated, while the euro depreciated until mid-2010 but has appreciated since then. Korea, while allowing the won to appreciate somewhat, has increased its foreign reserves, and Japan intervened in September 2010 in the foreign exchange market for the first time since 2004 to weaken the yen after its steep rise.

[5] Understandably, the future path of monetary policy is generally not specified in the G-20 submissions. Regarding prospective monetary policy developments, G-20 members have largely confined themselves to describing their monetary policy frameworks and exchange rate regimes and pledging to take actions required to fulfill their central banks' mandates without charting a specific course for interest rates.

*Overall, the stance of **G-20 monetary policies** remains broadly appropriate given individual members' circumstances. Key **policy challenges** remaining in advanced economies will be to normalize the accommodative policy stance over time without jeopardizing the recovery while remaining vigilant to potential threats to financial and price stability. **Exchange rate policies** in emerging economies would need to allow greater flexibility to help facilitate global rebalancing toward stronger, sustained and more balanced global growth.*

D. Structural Policies

Structural policies, including a reform of entitlements, investments in infrastructure, and enhancing competition and flexibility, are important for both internal and external rebalancing. G-20 policy frameworks, however, indicate that only modest progress will be made based on measures being planned in this critical area.

14. **G-20 members have taken some limited steps toward demand rebalancing through structural reform.** Some of the *advanced deficit* economies—namely *Australia* and the *United States*—are considering measures that would encourage and facilitate saving for retirement. The health care reform in the United States should help contain both public and private medical expenses. Several *advanced surplus* countries have announced policies to increase labor market flexibility (e.g., some euro area members, Korea), some are considering pension reforms (France), and Japan and Korea are considering investment in "green" technology.

15. ***Emerging surplus* economies are also making modest progress towards supporting private consumption through structural reforms**. *China* is making progress on social safety nets and tax reform. The coverage of rural pensions and medical insurance is gradually being extended, but large gaps remain. China's plan to broaden the VAT to services will equalize treatment with goods, but may also have an adverse impact on consumption. Plans to broaden the coverage of energy taxation are expected to be pursued. *Indonesia* has committed to improving the design and effectiveness of social safety net spending, although no specific implementation timetable has been announced. *Russia*, an oil exporter, has made progress toward strengthening its social safety nets by raising public pensions a cumulative 45 percent.

16. **Investments in infrastructure, education, and R&D feature prominently in plans across G-20 advanced and emerging economies.** A large number of both advanced and emerging economies from surplus and deficit groups have embarked on public infrastructure investment projects as the means both to stimulate their economies during the slump and to increase future potential output. Similarly, many countries from across the spectrum plan to improve their support for education—another form of investment into the future. Numerous

G-20 members also seek to encourage research and development through tax credits and other incentives.

17. **G-20 plans pledge broad support for labor market reform to increase labor market flexibility and reduce unemployment**. In particular, *EU* members have, of course, endorsed the Lisbon Agenda—aimed at improving labor, product and services market, trade and other policies. However, a comprehensive set of specific measures from individual countries has not been articulated at this stage. A number of countries have announced certain initiatives to enhance labor market flexibility or labor utilization—e.g., by expediting a resolution of disputes (Mexico), by reducing protection for permanent employees (Spain), by increasing future labor supply, including through higher retirement age (France), and by reduced social transfer payments (Germany). Many other countries are contemplating labor market reform, including by promoting higher geographic labor mobility in some emerging economies (e.g., China and Russia), but most plans lack specifics.

18. **Product and services market reforms to boost potential output are also being considered, although the scope of reforms appears to be relatively modest**. Measures include increasing competition in services—through deregulation and other means—in certain advanced deficit and surplus economies. Other avenues for enhancing the business environment being considered by a few G-20 members (several emerging economies) are privatization and increased openness to international trade and foreign investment. Russia is also considering the privatization of large shares of state-owned financial and nonfinancial enterprises (including in the oil sector) over the medium-term. It plans to raise some 2 percent of GDP from privatization during 2011–13.

G-20 structural policies *have made only limited progress thus far in specifying concrete and far-reaching plans for key reforms or have seen limited implementation of measures in current plans. Major* ***reform*** *challenges include developing a more ambitious and detailed policy agenda (aligned with strategic priorities) with a specific roadmap (e.g., timetables) for reform. Policy challenges would include deeper and broader product and labor market reforms that strengthen competition, or enhance flexibility and mobility in key markets segments in advanced economies; and strengthening infrastructure investment and social safety nets in emerging economies.*

Box. Main Policy Challenges Remaining for the G-20

Notwithstanding progress already made, significant policy challenges remain for the G-20. Based on staff's stocktaking of main policy achievements since fall 2009, remaining priorities in each area are listed below.

Financial Policies

To repair fully the damage from the crisis and to better align global financial reforms with the medium-term growth objectives of the G-20, key policy challenges include the following:

- *Supervisory frameworks* should be made more proactive to identify activities on the fringe of the regulatory perimeter and broadened to better monitor systemic risks.
- Commitments to publish *regular bank stress tests*. This should be accompanied by commitments to publish the results and to allow prudential authorities to pro-actively intervene, restructure, or resolve weak banks.
- Reforming *cross-border resolution frameworks* to enhance international cooperation for resolution large, cross-border firms and to reach an international agreement on principles for burden sharing.
- Augment financial stability frameworks by developing *macro-prudential tools* to safeguard against volatile financial market conditions, including the effects of net capital flows.

Fiscal Policies

To put public finances on a sustainable path, promote internal rebalancing, and rebuild policy space, members—particularly, advanced economies—face the following challenges:

- To outline *clear and credible medium-term consolidation plans* that are ambitious in scope and timing to minimize the risks of significant fiscal slippages going forward, and underpinned by key commitments
- To emphasize specific growth friendly policy measures aimed at reforming rapidly growing *public spending programs* and making *tax reform* more concrete to reduce uncertainty.
- To implement rapidly measures aimed at *strengthening fiscal institutions* to enhance their credibility and improve the budgetary processes and governance and better monitor fiscal developments.
- To sustain the fiscal consolidation effort, notably by developing long-term budgetary plans.

Monetary and Exchange Rate Policies

Remaining policy challenges vary across the membership:

- To normalize over time the current accommodative *monetary policy* stance in major *advanced* economies without jeopardizing economic recovery, while remaining vigilant to potential threats to financial and price stability.
- To enhance greater enhance exchange rate flexibility in *emerging surplus* economies to facilitate global demand rebalancing and paving the way for a healthier, sustained recovery.

Structural Policies

More ambitious structural reforms are required to repair damage to supply potential following the crisis and to reduce high unemployment. Specifically:

- For *advanced deficit* economies, specify concrete measures to encourage and facilitate saving for retirement.
- For *advanced surplus* economies, provide concrete and ambitious plans for labor, product, and services market reforms with specific timeframes.
- For *emerging surplus* expand coverage of social safety nets to reduce high precautionary saving.
- In *oil-exporting countries*, plans and timetables to enhance th*e productivity of the n*on-oil sector, including through infrastructure investment, should be more clearly identified.