Meeting of G-20 Deputies
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Global Economic Prospects and Policy Challenges

Prepared by Staff of the International Monetary Fund
EXECUTIVE SUMMARY

**Economic recovery has advanced despite setbacks to financial recovery.** Global growth has been somewhat stronger than expected during the first half of 2010, but is projected to slow temporarily during the second half of 2010 and the first half of 2011. In *advanced economies*, recovery remains fragile since employment and household consumption remain sluggish, although investment is beginning to show some strength. In *emerging economies*, activity is fairly broad based, but growth is expected to moderate while remaining robust.

**Turbulence in financial markets has receded in recent weeks, but confidence remains fragile.** Unprecedented European policy initiatives have eased concerns about sovereign solvency in the euro area, while market concerns have prompted the most vulnerable economies to front-load fiscal adjustment and some others to announce or adopt new consolidation measures.

**Downside risks to the recovery have intensified.** The combination of sovereign risk and a still weak financial sector in many advanced economies poses significant risks to the recovery. Renewed turbulence in sovereign debt markets could precipitate an adverse feedback loop between sovereigns and the financial sector, with spillovers to the real economy through higher bank funding costs, tighter lending conditions, and retrenchment in capital flows. An unexpected weakening in activity could unsettle real estate or credit markets generally, with adverse consequences for banks with weak balance sheets. Given significant trade and financial linkages, spillovers across regions could be rapid, with attendant impact on economic recovery.

**Sustained, healthy recovery continues to rest on two rebalancing acts**—internal rebalancing, led by a strengthening of private demand in advanced economies; and external rebalancing, reflecting an increase in net exports in deficit countries and a decrease in net exports in surplus countries, notably emerging Asia.

- The two rebalancing acts interact in strong ways. Increases in net exports in advanced countries would bolster their growth, allowing for more room for fiscal consolidation. Strengthened domestic demand in emerging market economies would help these countries maintain growth in the face of lower exports.

- A number of policies are required to support these rebalancing acts. In advanced economies, the repair and reform of financial sectors needs to accelerate further to enable a normalization of credit intermediation that would help support the transition to growth led by private demand. At the same time, these countries need to put in place now credible medium-term fiscal consolidation plans. Specific plans to cut budget deficits in the future need to be legislated soon in order to establish credibility and create room for fiscal policy maneuver.

- Fiscal adjustment needs to begin in 2011, even if activity is modestly weaker than presently projected. Fiscal consolidation remains essential for strong, sustained growth over the medium run. If however, downside risks materialize and global growth threatens to slow appreciably more than expected, monetary policy should be the first line of defense, although this line has become thin. Accordingly, countries with fiscal room should allow automatic stabilizers to play freely; additionally, in these countries some of the planned consolidation for 2011 may also need to be put on hold, temporarily. At the same time, key emerging economies will need to further develop domestic sources of growth, supported by greater exchange rate flexibility.

**Exits from extraordinary policy measures are proceeding on some fronts but not on others, owing to still fragile conditions in major advanced economies.** Almost all G-20 economies have announced an exit from crisis-related fiscal stimulus. Exit from monetary policy and financial support remains appropriately on hold in the major advanced economies, while proceeding gradually in emerging economies. More recently, planned withdrawal of unconventional support measures has been reversed or slowed in the United States and the euro area, owing respectively to weak economic data and the recent financial market stresses.
I. A GLOBAL RECOVERY WITHSTANDS NEW FINANCIAL SHOCKS

Notwithstanding setbacks to global financial stability, global economic recovery is advancing. In emerging economies, the growth outlook remains strong, although activity is moderating to more sustainable levels. Recovery is fragile, however, in the advanced economies, with prospects for a transition to stronger, privately-led growth still uncertain, notwithstanding some strength in investment, since unemployment remains high and household consumption is sluggish. Financial markets and institutions remain vulnerable, although strains have receded in recent weeks, following unprecedented European policy initiatives that have eased market concerns about sovereign solvency. Markets remain acutely sensitive, however, to sovereign risks, prompting vulnerable economies to front-load fiscal adjustment and some others to articulate additional consolidation measures. The near-term global outlook is subject to significant downside risks, principally due to the interaction of sovereign risk and a fragile financial system.

1. The global recovery has advanced despite setbacks to global financial stability, but recent developments indicate that the pace of recovery is slowing. In emerging economies, activity is moderating from an exceptional pace set in the first half of the year. This has helped support external demand rebalancing. However, internal demand rebalancing in advanced economies is proceeding only slowly. Investment is beginning to show some strength as policy stimulus and inventory rebuilding fade, but unemployment remains high and household consumption sluggish.

- **Advanced G-20 economies:** Recovery is beginning to transition from inventory rebuilding to investment, but consumption remains weak. In the United States, revised second quarter estimates indicate a slower pace of recovery than previously assumed. Despite rebounding capital investment, weak labor and housing markets have been holding back consumer spending, while inventory accumulation has begun to flatten and the trade deficit has widened. In Japan, strong fiscal stimulus and demand from Asian trading partners has helped the recovery. However, domestic demand remains sluggish, and activity slowed abruptly in the second quarter, remaining appreciably below pre-crisis levels. Growth in the euro area has strengthened in recent months, in part reflecting seasonal factors. On the back of robust domestic demand led by private consumption and investment, the depreciation of the euro from the previous high levels reached in mid-2008 and healthy foreign demand for capital goods, the second-quarter has been strong in its largest economy, Germany. The area’s heavy reliance on bank credit and still-tight lending conditions, however, continue to weigh on demand.

- **Emerging G-20 economies:** Activity in emerging economies has been sustained by strong domestic demand and the recovery of global trade. Major economies in emerging Asia—China, India, and Indonesia—remain in the lead, followed by Brazil in Latin America. In both regions, fixed investment has begun accelerating beyond its 2009 momentum despite less stimulative policies, suggestive of an increasingly self-sustaining recovery. More recently, retail sales and manufacturing activity have begun
to moderate from the very elevated levels earlier in the year. The recovery remains notably more subdued in parts of emerging Europe and the Commonwealth of Independent States.

2. **Financial market confidence remains fragile, holding back credit and private demand, particularly in advanced and a few emerging economies.** Despite extraordinary EU-ECB measures, concerns regarding sovereign and banking sector vulnerabilities persist, amid increasingly broader concerns about the global recovery.

- Spain and Portugal conducted successful government bond auctions between mid-June and mid-July with significant demand from foreign investors, albeit at high yields. Sovereign bond spreads in the euro periphery tightened between June and early-August, with the exception of Greece where they remain elevated. More recently, spreads have been widening again in Ireland, Portugal and Spain.

- The uneventful liquidity rollover of the ECB’s expiring one-year long-term refinancing operation (LTRO) in early July bolstered market confidence, and against the background of low expectations markets have welcomed the July 23 CEBS stress tests on individual bank capital. European banks have also benefited from the recent announcement of the Basel regulatory reforms, which were less strict than anticipated.

- After declining 10-15 percent at the height of the turbulence in April-May, equity markets in advanced economies have recovered substantially in June-August, and nonfinancial corporate bond issuance has resumed at a strong pace. Short-term funding
markets have also recovered, but funding strains remain for second tier borrowers. Interbank markets remain tiered and recourse to the ECB liquidity facilities is high.

3. **Capital flows to emerging economies have rebounded after falling sharply during the height of the recent crisis.** While this should help external rebalancing, much depends on how inflows are put to use. After narrowing appreciably over the past year, recent trade data point again to growing trade surpluses in emerging economies with large surpluses.

- Equity markets in emerging Asia, and to a lesser extent in Latin America, have recovered substantially from losses suffered in April-May. However, stock prices in emerging Europe, which were hit hardest given strong linkages with core Europe, are yet to make a comeback. Inflows to emerging market mutual funds, particularly debt funds, have accelerated, and emerging market external corporate and sovereign issuance has resumed at a strong pace after almost a complete halt in May. Resurgent inflows to emerging markets have revived concerns about the potential volatility of inflows and the urgent need to augment financial stability frameworks to safeguard against sudden stops or asset price inflation.

- Currencies of emerging G-20 economies have continued to appreciate over the first half of 2010 in both nominal and real effective terms. However, there is notable diversity in the pace of appreciation, with many Asian currencies remaining undervalued from a medium-term perspective. In the majority, appreciation pressure has been met with the continued build-up in foreign reserves. Recent high-frequency trade data that point to a widening of the trade surplus in external surplus emerging economies amid an increase of the trade deficit in the United States are consistent with the expected modest widening of current account imbalances in 2010.

4. **The latest turbulence in financial markets has not derailed the incipient recovery in private sector credit but markets and banks remain fragile.**

- Bank lending surveys in the United States and Japan indicate that lending standards have almost ceased to tighten. Private credit growth in advanced G-20 economies has in general begun to turn up, except in the United Kingdom and Japan. Credit growth nevertheless remains low relative to pre-crisis rates, consistent with the historical behavior of credit following financial crises. While setbacks from the turbulence in euro area lending have been smaller than feared, the heavy refinancing schedules facing
European banks and the exposure to real-estate among small and medium-sized U.S. banks present important risks in the continued normalization of credit conditions.

- Among emerging economies, credit growth has been picking up in most regions. Accelerating real-estate driven credit growth in parts of emerging Asia has eased considerably since earlier this year, following successful intervention with prudential measures. With the exception of Turkey, bank credit in emerging Europe remains weak, with private sector credit growth still in negative territory.

5. **Unemployment in advanced economies remains high and persistent, slowing down the recovery of consumption necessary for a durable, private-sector-led recovery.**

- In most advanced G-20 economies, unemployment rates have receded only modestly from their peaks. In the euro area, the labor market shows continued resiliency in Germany, considering the depth of the recession, but has persisted at high levels in others (e.g., Ireland and Spain). In the United States, unemployment duration is at a record high and recent payroll data point to a slowdown in employment growth in the second quarter. Weaknesses in U.S. labor and housing markets have been mutually reinforcing as high unemployment has fed into higher mortgage delinquencies and negative housing equity has impeded labor reallocation.

- In emerging G-20 economies, unemployment has broadly declined in parallel with strengthening recoveries, with the notable exception of South Africa where, owing to structural wage rigidities and weak demand conditions, the unemployment rate exceeds 25 percent.

6. **Commodity prices have stabilized since the financial turbulence, and are expected to stay broadly unchanged in the near term.** After rising through early May, commodity prices declined and have since remained broadly constant. While demand pressures are expected to continue to support commodity prices as the global recovery progresses, price pressures will likely remain moderate and balanced by other forces, including excess capacity and inventory buffers. Most recently, disappointing harvests in some countries have resulted in sharply escalating wheat prices. Current market pricing indicates this is anticipated to be a temporary supply shock, and the spillovers to other food prices have thus far been limited. Nonetheless, higher wheat prices could pose hardships in some low income countries where food represents a large fraction of household expenditures.
II. PROSPECTS AND RISKS

Prospects

7. **The global recovery has entered a new phase.** In advanced economies, support from fiscal stimulus and inventory rebuilding is diminishing, and growth will be increasingly driven by consumption and investment. The recovery is projected to continue, with some weakness from the second half of 2010 likely to carry over into the first half of 2011. Thereafter, higher investment in equipment in these economies, alongside continued financial healing, is expected to strengthen employment and consumption. However, risks are to the downside, with high uncertainty in financial markets of particular concern. Projections are for still-robust growth in emerging and developing economies, where domestic demand is likely to slow but remain strong, supporting global growth. However, activity in these economies remains dependent on demand in advanced economies, particularly in emerging Asia. The modest effects, to date, of the financial turbulence on commodity prices are not expected to detract significantly from commodity producers’ relatively solid near-term growth prospects.

8. **Despite some improvements for 2010, the medium-term fiscal outlook in G-20 advanced economies remains challenging, while the fiscal outlook for G-20 emerging economies is more favorable.** Fiscal exit from accommodative policy stances is set to begin in most advanced and emerging economies in 2011.

- In advanced G-20 economies, after deteriorating by about 5 percent of GDP in 2009, fiscal balances are expected to improve by ¾ percentage points in 2010 compared to ½ percentage point projected in April.\(^1\) The improvement also reflects some front-loading of fiscal adjustment in vulnerable euro area economies, tightening measures announced in the United Kingdom, and a lower projected deficit in the United States. However, the medium-term fiscal outlook remains challenging. By 2015, the overall increase in the average gross debt-to-GDP ratios since the beginning of the crisis is still projected to be nearly 40 percentage points.

- The fiscal outlook for emerging G-20 economies is generally more favorable, with debt ratios expected to decline over the medium term and remain, on average, below 40 percent. The fiscal outlook has generally improved thanks to rebounding activity, including in some countries with large fiscal deficits (e.g., India). Most countries will be consolidating in 2011.

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\(^1\)The overall budget balance improvement in 2010 compared to 2009 stems largely from the decline in financial sector support in the United States. Without it, the overall balance for the advanced G-20 economies would worsen by ¼ percentage point of GDP.
Inflation will remain generally subdued, except in some emerging economies. In advanced economies, continued excess capacity and high unemployment will keep inflationary pressures muted. With core inflation slowing to less than 1 percent and considerable economic slack, deflation will be the more pertinent risk. In emerging economies, inflation in 2010 is projected at 6¼ percent. With commodity prices expected to stabilize, headline inflation is expected to subside to 5 percent in 2011. However, inflationary pressures will be more elevated in economies that have had less stable inflation in the past or, such as for example, India, are operating closer to capacity.

### Table 1. Overview of World Economic Outlook Projections 1/

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Note: Real effective exchange rates are assumed to remain constant at the levels prevailing during November 19 - December 17, 2009. Country weights used to construct aggregate growth rates for groups of countries were revised.

1/ IMF World Economic Outlook July 2010 update.
2/ G-20 yearly projections exclude European Union and quarterly projections exclude Saudi Arabia and European Union.
3/ The quarterly estimates and projections account for 90 percent of the world purchasing-power-parity weights.
4/ The quarterly estimates and projections account for approximately 77 percent of the emerging and developing economies.
Risks

10. **Downside risks to the recovery have risen over the course of the year, as the momentum of activity has slowed.** On the back of weak private sector balance sheets in many advanced economies and sovereign, financial, and real estate-related risks remaining elevated, a key risk is that turbulence in sovereign debt markets precipitates an adverse feedback loop between sovereigns and the financial sector, and spills over to the real economy. Significant deterioration in sovereign risk could result in spikes in bond yields, tighter lending conditions, and higher funding costs that interrupt the transitions toward stronger privately-led demand in advanced economies. A more marked slowdown in advanced economies together with heightened risk aversion would quickly spill over to emerging and developing economies, potentially triggering another adverse feedback loop between real and financial sectors. Against this backdrop, there are two key sources of fiscal risks that could trigger a rapid loss in market confidence:

- **Unsuccessful rollovers of maturing debt:** Sovereign debt maturing in vulnerable euro area economies in the second half of 2010 and 2011 exceeds $400 billion. In refinancing this debt, these countries will face competition from the significant rollover needs of both other advanced economies (amounting to around $4 trillion) and European banks, that are also faced with heavy refinancing schedules. Turmoil in sovereign bond markets, either due to unsuccessful rollovers or capital shortfalls in the banking sector, could add significant pressure on public finances, trigger a loss of confidence in markets, and prompt substantial additional fiscal tightening by vulnerable sovereigns that could undermine the global recovery.

- **Underperformance in fiscal balances:** Market perceptions may be adversely affected if fiscal balances in 2010 underperform relative to budget plans, owing either to a deterioration in the macroeconomic environment or because of implementation delays. Even if fiscal outturns are in line with projections, markets may lose confidence in some sovereigns, if authorities’ efforts in addressing public debt sustainability are perceived as inadequate or lacking credibility. This could have wider ramifications via real and macro-financial linkages.

11. **Another risk to the outlook stems from the possibility of renewed weakness in U.S. property markets.** The foreclosure backlog in U.S. property markets is large and growing, in part due to the recent expiration of the home buyer’s tax credit. When realized, this could further depress real estate prices. Small and medium-sized U.S. banks, which have significant real estate exposure, could experience disproportionate losses and hinder bank supply of credit; labor market conditions may further deteriorate as losses in housing equity restrain mobility; and the adverse macro-financial linkages could precipitate a loss of market confidence in the recovery.
Medium-term prospects

12. Medium-term prospects are for subdued growth in advanced economies and limited external demand rebalancing. As discussed on other occasions, the crisis is likely to permanently lower output of many advanced economies relative to pre-crisis trends. This view has been broadly confirmed by the data over the past year, although the extent of output losses remains very uncertain and dependent on policy choices. At the same time, domestic demand in key emerging economies is not projected to make up for lower demand in advanced economies. This partly reflects structural constraints—e.g., the low consumption base in some countries—and partly rebalancing policies that go in the right direction but need further strengthening.

III. POLICY CHALLENGES

Short- and medium-term prospects point to a slow, sluggish recovery that is subject to mainly downside risks. Policies need to accelerate the rebalancing of demand from public to private sources in advanced economies and from external deficit to surplus economies. In many advanced economies, the financial sector remains the Achilles heel of recovery prospects for private demand. Insufficient progress with repair and reform is weighing on credit, and slowing the normalization of monetary and fiscal policies, with adverse spillovers on emerging economies. Accelerated financial sector restructuring and reform should thus be top priorities. Government budgetary policies are in the process of moving from short-term stimulus to medium-term consolidation. However, fiscal policies need to urgently deliver measures that lower deficits over the medium term. This is needed not only to halt and ultimately reverse the large rise in public debt ratios, but also to help create room for policy maneuver to support private demand. Additionally, fiscal adjustment needs to be supported with structural reform. Policies that eliminate distortions to domestic demand in key emerging economies would strengthen prospects for external demand rebalancing, supporting a more robust recovery in both emerging and advanced economies.

Fiscal Consolidation

13. Fiscal adjustment needs to begin in 2011. Fiscal consolidation remains essential for strong, sustained growth over the medium run. If downside risks to global growth materialize, threatening to slow growth appreciably more than expected, monetary policy should be the first line of defense, although this line has become thin. Accordingly, in countries with fiscal room, automatic stabilizers should be allowed to play freely, and where stabilizers are small, temporary support, such as extended unemployment benefits or wage subsidies, could be continued. Additionally, to sustain recovery in these countries some of the consolidation planned for 2011 might also have to be temporarily postponed.

14. Policymakers need to specify further measures and begin to deliver on ambitious, credible and “growth-friendly” medium-term consolidation plans, particularly in key advanced economies. Plans should emphasize policy measures that reform rapidly growing
spending programs—pensions and public health care\(^2\)—and make permanent reductions to non-entitlement spending, with a view to improving medium-term conditions for labor supply and investment. Moderate adjustments, such as increasing the retirement age, may entail no affect on demand in the short-run. Strengthening fiscal institutions, such as by improving budgetary processes, better fiscal monitoring, and, in the EU, improving the governance framework can play important roles in consolidation.

15. **Successful fiscal adjustment will require that consolidation plans are accompanied by structural reforms.** Markets view announced fiscal consolidation plans thus far as necessary but not sufficient to achieve fiscal sustainability, amid concerns that nominal growth may be restrained in a disinflationary environment. Indeed, history has shown that fiscal adjustment is much more effective in the context of high growth.\(^3\) It is thus crucial that adjustment plans be complemented with reforms that raise the trend level of growth. In many economies facing large fiscal adjustment, structural reforms, particularly in labor and product markets—such as eliminating dualism and supporting greater competition and lower markups respectively—can raise potential growth, increase competitiveness, and thereby support long-run fiscal solvency.

**Financial Sector Repair and Reform**

16. **Recent events in global financial markets underscore the urgent need to accelerate financial sector repair and reform, and build a robust global financial system.** This is crucial to allow for a solid recovery of private demand as fiscal consolidation proceeds. Insufficient progress in addressing the legacies of the crisis—bank funding concerns and the resolution of weak banks—together with regulatory uncertainty has left the system vulnerable.

- Regular, rigorous bank stress tests will help resolve uncertainty about bank exposures, and clarify banks’ abilities to withstand a further deterioration in financial conditions. Recently conducted EU bank stress tests—which were commended for their transparency—underscore that greater disclosure of results, along with credible recapitalization or resolution mechanisms, can provide clarity about counterparty risks and help bolster market confidence. Additionally, prudential authorities need to more pro-actively intervene, restructure, or resolve weak banks.

- The final agreement on regulatory reforms must deliver a credible and coherent package of changes—one that will signal both clear intent and announce firm action to strengthen the global financial system. Recently published analysis led by the BCBS

\(^2\)The net present value of future increases in health care and pension spending is more than ten times larger than the increase in public debt due to the crisis.

\(^3\)A one percentage point increase in potential growth—assuming a tax ratio of 40 percent—lowers the debt ratio by 10 percentage points within 5 years, and by 30 percentage points within 10 years, if the resulting higher revenues are saved.
and the FSB, conducted in close collaboration with the IMF, regarding the macroeconomic impact, suggests that the proposed Basel reforms to strengthen bank capital and liquidity requirements would have only a modestly adverse impact on aggregate output and clear net long term economic benefits. The recent agreement on revisions to the Basel proposals reduces regulatory uncertainty and clarifies timetables for implementing regulatory reform. While the new package constitutes a significant improvement over what was in place prior to the crisis, it also implies a degree of accommodation, with transition periods that in some cases far exceed the four years suggested by the macroeconomic impact studies. The deferment of some of the implementation dates implies that many of the same regulatory inadequacies that were exposed during the crisis for a longer period will remain in place for now, increasing the chances of renewed financial instability and placing a higher burden on supervisors to act as systemic safeguards.

- Supra-national sovereign funding backstops should be made demonstrably functional. This applies particularly to the European Financial Stability Fund (EFSF), upon whose functioning markets are relying to prevent the spread of sovereign financing risk. Risks will be mitigated by establishing the EFSF’s financial structure, its credit rating, and the seniority of its claims relative to other creditors.

External Demand Rebalancing

17. **Emerging economies must augment the financial stability frameworks to safeguard against uncertainty in volatile financial market conditions.** Despite stronger fundamentals, emerging economies are not immune to downside risks from advanced economy slowdowns. Upside risks, particularly renewed surges in capital flows, also pose challenges. The current environment may entail targeted use of macro-prudential tools (such as limits on foreign-currency loans by banks) to reduce volatility of capital inflows and asset price pressures, including some use of carefully designed capital controls when other measures are not sufficient, in combination with macroeconomic and exchange rate policies.

18. **Policies in external surplus economies need to facilitate global demand rebalancing and pave the way for a sustained, healthy recovery.** Progress is being made in building up domestic sources of activity in these economies. Nonetheless, WEO forecasts suggest that the external rebalancing that has take place during 2009-10 may be stalling. Policies to support stronger domestic demand will help maintain activity in emerging economies the face of lower demand from advanced economies. They will raise net exports of advanced economies, allowing for a better transition from publicly to privately-led demand, even if this crucially relies on better fiscal, financial, and structural policies in the advanced economies.

19. **Policies to facilitate external rebalancing vary across economies.** In many surplus economies, policies could usefully raise productivity in the non-tradable sector. In key economies, structural reforms need to eliminate distortions underlying structurally high
household and corporate savings rates. These reforms can also help raise the quality of growth, spreading the gains of rising productivity and financial deepening more widely across society. In some cases, more flexible exchange rates are also needed. The challenges and policies are complex and a deeper discussion of useful measures and their potential payoffs can be found in the G20 MAP reports.

IV. EXITS FROM EXTRAORDINARY SUPPORT

The timing, pace, and sequence of exiting from supportive policies will vary by country, depending on how robust the recovery of private demand as well as financial conditions. In most G-20 advanced economies, public debt sustainability requires exits from crisis-induced policies as well as broader adjustments to improve net debt levels. Reflecting market concerns, vulnerable economies have front-loaded fiscal adjustment. There is increasing divergence in the monetary policy stances between advanced and emerging economies, reflecting macroeconomic developments, while financial sector support has been extended in some European countries.

Fiscal Policy

20. The timing and pace of fiscal consolidation will vary across the G-20, dictated by differing country circumstances.

- Countries that have come under market pressure and those facing the greatest fiscal challenges/lacking fiscal room have already started to consolidate and announced further front-loading (see below). In these countries, strong signals to see these adjustments through, even if politically difficult, will be critical to prevent adverse market reaction that forces yet additional front-loaded adjustment. Most other advanced G-20 economies should start tightening in 2011, and the average adjustment implicit in current plans appears broadly appropriate.

- Fast-growing advanced and emerging economies can, and have in part, already started tightening policies. In economies with excessive external surpluses and relatively low public debt, which are principally those in Asia, monetary tightening and exchange rate adjustment should be the first responders to address demand pressures; withdrawal of fiscal stimulus can wait. This macroeconomic policy mix would support domestically-based growth and external rebalancing. In other emerging economies where public debt is relatively high and external positions broadly in line with medium-term fundamentals, fiscal tightening can start immediately since the recovery is well underway.

21. Reflecting financial market pressures, adjustment plans of several vulnerable European economies have become more front-loaded. Projected changes in the cyclically-adjusted primary balance due to front-loading are shown in Figure 1. Under these plans, more
than three-fourths of the targeted fiscal improvement by 2013 in Greece, Portugal, and Spain would take place during the current year and 2011.

Figure 1. Frontloading of Fiscal Adjustment: Projected Changes in Cyclically Adjusted Primary Balances 1/ 2/
(Percent of potential GDP)

Selected Advanced Economies

Source: IMF World Economic Outlook July 2010 Update.
1/ Excludes financial sector support for the United States recorded above the line.
2/ For Australia the data do not reflect the most recent data published in late July in the Pre-Election Economic and Fiscal Outlook.

22. **The pace of planned fiscal deficit reductions in several advanced economies is at least as fast as suggested in the June 2010 Toronto declaration.** Advanced G-20 economies committed to at least halve deficits by 2013 and stabilize or reduce debt-to-GDP ratios by 2016 in the Toronto declaration, implying an annual improvement in headline balances of 1½ percent of GDP. Under national plans, however, targeted average annual improvements in headline balances are higher at about 1¾ percent of GDP (Table 2). This is largely due to the more optimistic paths for growth and revenues envisaged in national plans relative to the Toronto declaration.

23. **Several advanced G-20 economies have recently identified specific measures in their fiscal consolidation plans.** France has announced an intention to raise the statutory retirement age from 60 to 62 years. In Germany, announced expenditure cuts on social spending, defense and public sector wages have been complemented by revenue measures, such as the reduction of some tax exemptions. In Italy, the government has approved, among other measures, a freeze on public sector pay and measures to combat tax evasion. The U.K. emergency budget foresees additional expenditure cuts compared to the previous government’s budget with further details to be provided in the October Spending Review. However, broader
plans for reining in entitlement spending, in particular for health care, with a view to ensuring long-term fiscal sustainability are generally missing.  

Table 2. Advanced G-20: Fiscal Adjustment Under the Toronto Declaration and Current National Plans  
(Percent of GDP)

<table>
<thead>
<tr>
<th>Country</th>
<th>WEO 2010</th>
<th>Toronto Declaration 2013</th>
<th>Toronto Declaration 2013</th>
<th>Annual Adjustment 1/</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>-4.8</td>
<td>-2.4</td>
<td>0.1</td>
<td>0.8</td>
</tr>
<tr>
<td>Canada 2/</td>
<td>-5.7</td>
<td>-2.8</td>
<td>-0.5</td>
<td>0.9</td>
</tr>
<tr>
<td>France</td>
<td>-8.0</td>
<td>-4.0</td>
<td>-3.0</td>
<td>1.3</td>
</tr>
<tr>
<td>Germany</td>
<td>-5.2</td>
<td>-2.6</td>
<td>-3.0</td>
<td>0.9</td>
</tr>
<tr>
<td>Italy 3/</td>
<td>-5.2</td>
<td>-2.6</td>
<td>-2.7</td>
<td>0.9</td>
</tr>
<tr>
<td>Japan</td>
<td>-9.8</td>
<td>-4.9</td>
<td>-7.2</td>
<td>1.6</td>
</tr>
<tr>
<td>Korea 4/</td>
<td>0.8</td>
<td>...</td>
<td>1.9</td>
<td>...</td>
</tr>
<tr>
<td>United Kingdom 5/</td>
<td>-10.4</td>
<td>-5.2</td>
<td>-4.0</td>
<td>1.7</td>
</tr>
<tr>
<td>United States 6/</td>
<td>-10.7</td>
<td>-5.4</td>
<td>-4.2</td>
<td>1.8</td>
</tr>
<tr>
<td>Average (excl. Korea) 7/</td>
<td>-9.1</td>
<td>-4.6</td>
<td>-4.0</td>
<td>1.5</td>
</tr>
<tr>
<td>Average (excl. Korea and Japan) 7/</td>
<td>-9.0</td>
<td>-4.5</td>
<td>-3.5</td>
<td>1.5</td>
</tr>
</tbody>
</table>

Sources: National authorities and IMF World Economic Outlook July 2010 Update.  
1/ Annual adjustment over a three year period (2011-13).  
2/ Authorities' plans for Federal government.  
3/ Official plans are only until 2012. The same target is assumed here for 2013.  
4/ Central government based on GFS86.  
5/ Fiscal year targets for 2012/13 of 5.6 percent of GDP and for 2013/14 of 3.6 percent of GDP transformed into calendar year target.  
6/ Authorities’ plans for Federal government for FY 2013. The annual adjustment over the period 2011-16 is envisaged at about 1.5 percent of GDP.  
7/ Weighted average based on 2009 PPP-GDP.

Monetary Policy

24. Monetary policy has remained highly accommodative in many economies. Policy rates in major advanced economies are exceptionally low, and markets expect them to remain low for an extended period. A tightening cycle has begun in other advanced economies (e.g., Australia, Canada, Korea), but these central banks have signaled caution in further tightening given increased downside risks to the global economy. In emerging economies, the central banks of Brazil and India have raised policy rates given the pace of output recoveries, but others, such as Russia, have maintained rates or even reduced them.

25. There has been some slowing in the withdrawal of unconventional measures. Central banks in emerging economies (e.g., Russia) and some advanced economies (e.g., Australia, Canada and Sweden) have largely unwound liquidity support measures. Most recently, however, the Federal Reserve has slowed the withdrawal of some unconventional measures in light of weak economic data.

With important pension reforms having already been enacted in a number of countries, pension spending in the advanced economies is projected to rise by about 1 percentage point over the next two decades, compared to about 3 percentage points without such reforms. Health care spending is estimated to surge by 3¾ percentage points of GDP.
• The Federal Reserve ended the Term Asset-Backed Securities Loan Facility (June 30) in light of improved functioning of asset-backed securities markets. Most recently (August 10), citing the slower pace of recovery, it announced the decision to reinvest principal payments on its portfolios of government-sponsored enterprise (GSE) debt and mortgage-backed securities into longer-term Treasuries.

• In the euro area, the ECB terminated the covered bond purchase program as scheduled. To conduct interventions in the euro area public and private debt securities markets and to ensure depth and liquidity in those market segments which are dysfunctional, it launched a new Securities Market Program in response to the recent financial market strains.

Financial Sector Intervention

26. Several countries have closed debt guarantee programs to new applicants, but in many European economies they have been extended. The outstanding usage of governments’ debt guarantee and recapitalization programs remains substantive in advanced economies, while demand for these programs has declined and some are being expired.

- G-20 countries that have already withdrawn debt guarantee programs include the United States, the United Kingdom, France, Italy, Korea, Canada, and Australia.

- In July 2010, the European Commission approved the extension of debt guarantee programs from end-June to end-2010 in Austria, Denmark, Germany, Greece, Ireland, Netherlands, Portugal, Slovenia, Spain, and Sweden. Guarantee fees have been raised to discourage banks from relying on state support. In recent months, guarantee programs have been almost exclusively used by banks with credit ratings of A- or below or by unrated banks.

27. Recapitalization programs have been extended in several European economies, although actual capital injections have declined. With the approval of the European Commission, Germany, Greece, Portugal, and Spain extended their programs, from end-June to end-2010.

28. The expanded coverage of deposit insurance schemes remains in place. Where either the coverage of deposit insurance has been expanded or a special protection scheme has been introduced as a temporary measure, the majority of the related measures are not due to expire until the end of 2011.