



GROUP OF TWENTY

GLOBAL PROSPECTS AND POLICY CHALLENGES

Meetings of G-20 Finance Ministers and Central Bank Governors
February 22–23, 2014
Sydney, Australia



Prepared by Staff of the
INTERNATIONAL MONETARY FUND*

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

EXECUTIVE SUMMARY

Global activity has picked up, largely on account of advanced economies. Growth firmed in 2013H2, driven largely by stronger outturns in advanced economies as final demand expanded broadly as expected. In many emerging markets, despite a boost to output from stronger exports, domestic demand has been weaker than expected, reflecting in part tighter financial conditions.

A new bout of financial volatility has affected emerging market economies as markets reassess their fundamentals. While the pressures were relatively broad-based, emerging economies with relatively high inflation and high current account deficits saw the largest asset price declines initially. Markets are showing signs of stabilizing recently, although they are still fragile, on the back of actions by key emerging economies to shore up confidence and strengthen their policy commitments. This episode, however, underscores vulnerabilities and the challenging environment for many emerging economies. The rapid jump in global risk aversion had also driven down advanced economy equity prices.

The outlook remains broadly as projected in the January WEO, assuming that the impact of the recent financial volatility is short lived. In advanced economies, less fiscal consolidation and relaxed financial conditions will support growth this year, while near-term prospects for emerging economies are broadly unchanged. Thus, global growth is projected to increase to about 3¾ percent in 2014 (from 3 percent in 2013) and 4 percent in 2015, similar to the January 2014 WEO Update.

However, the recovery is still weak and significant downside risks remain. Capital outflows, higher interest rates, and sharp currency depreciation in emerging economies remain a key concern and a persistent tightening of financial conditions could undercut investment and growth in some countries given corporate vulnerabilities. A new risk stems from very low inflation in the euro area, where long-term inflation expectations might drift down, raising deflation risks in the event of a serious adverse shock to activity.

Further action and cooperation are needed to promote financial stability and robust recovery. Specifically:

- ❖ *Advanced economies should avoid premature withdrawal of monetary accommodation as fiscal balances continue consolidating.* Given still large output gaps, very low inflation, and ongoing fiscal consolidation, monetary policy should remain accommodative in advanced economies. There is scope for better cooperation on unwinding UMP, including through wider central bank discussions of exit plans. In the euro area, repairing bank balance sheets remains critical to monetary policy transmission. Finally, fiscal consolidation should proceed at a measured pace, while preserving the long-run growth potential of the economy.
- ❖ *In emerging market economies, credible macroeconomic policies and frameworks, alongside exchange rate flexibility, are critical to weather turbulence.* Further monetary policy tightening in the context of strengthened policy frameworks is necessary where inflation is still relatively high or where policy credibility has come into question. Priority should also be given to shoring up fiscal policy credibility where it is lacking; subsequently buffers should be built to provide space for counter-cyclical policy action. Exchange rate flexibility should continue to facilitate external adjustment, particularly where currencies are overvalued, while FX intervention—where reserves are adequate—can be used to smooth excessive volatility or prevent financial disruption.
- ❖ *Further policy actions are needed to reduce unemployment and strengthen medium-term growth, while making it more balanced.* Key policies to boost potential include competition-enhancing product market reforms, infrastructure investment, and labor participation reforms, while further action is needed to avoid a resurgence of global imbalances as the recovery proceeds and ensure sustainable medium-term growth.

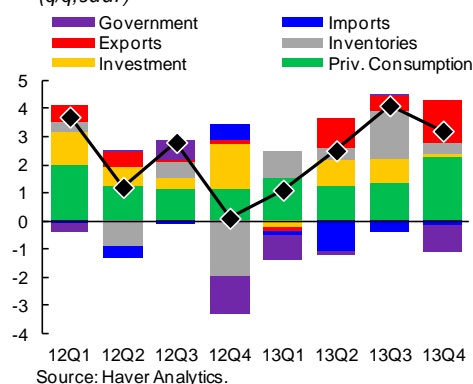
DEVELOPMENTS, OUTLOOK, AND RISKS

Global growth has strengthened as expected in recent months, largely driven by advanced economies, where easier financial market conditions and gradually improving consumer and business confidence have supported growth. While emerging economies have benefited from the stronger external demand, domestic demand has remained weaker than expected in many of them, reflecting in part tighter financial conditions. Many emerging markets have come under renewed market pressure recently. While the trigger is difficult to identify, events are occurring against the backdrop of weakening emerging economy sentiment, including on China, increased risk aversion, and continued UMP tapering. While global growth is projected to continue increasing, the recovery is uneven and fragile and significant downside risks remain.

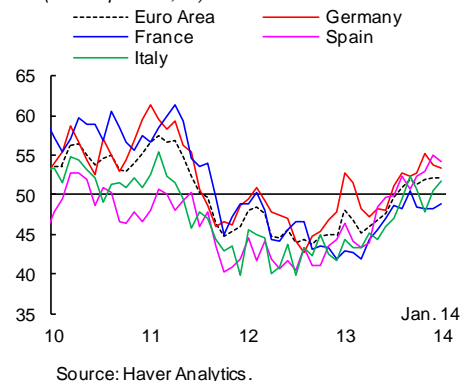
1. **Global activity has picked up in recent months, largely on account of advanced economies.** Following a strong expansion in 2013Q2, global growth was 3.6 percent in the third quarter. The recent uptick in growth has been concentrated in advanced economies, China, and India. Final demand in advanced economies has expanded broadly as expected, and much of the upward surprise in growth can be attributed to higher inventory demand. In emerging economies, activity has been largely driven by exports, while domestic demand has generally been weaker than expected as financial conditions tightened. Looking across regions:

- The underlying momentum in the *United States* appears solid, amidst strong contributions from consumption, investment, and inventory accumulation. Steady job creation and higher equity and home prices are supporting consumption, while non-residential investment continues to improve. Other developments in the housing market have been mixed, as higher mortgage rates feed into weaker mortgage applications and pending home sales.
- The *euro area* is turning the corner from recession to a weak recovery that remains uneven and fragile. Growth resumed in the second quarter of 2013, and recent indicators suggest that activity will continue to expand at a very modest pace. Euro area growth has been largely export-led, while domestic demand turned positive for the first time since the recession for the area as a whole as well as several major members. Germany has continued to expand at a solid pace, output in France has expanded by more than expected, and Spain is tentatively exiting recession. However, the

United States: Contributions to GDP
(q/q;saar)

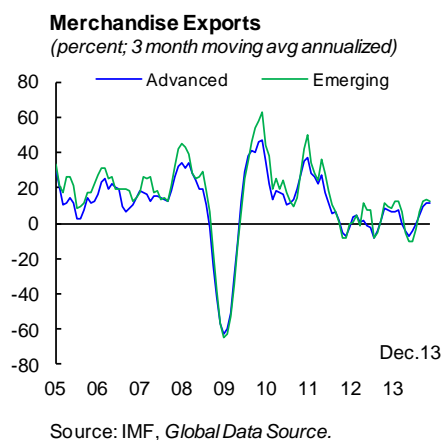
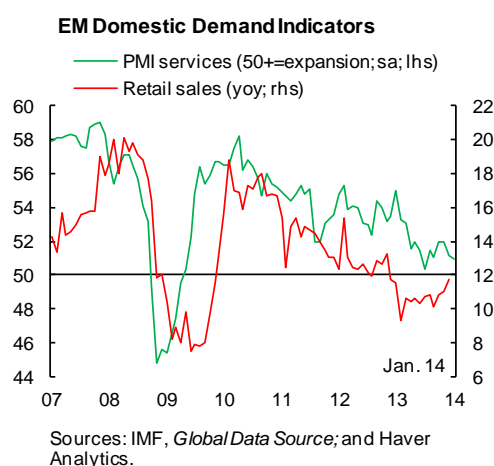


Euro Area: PMI Composite New Orders
(50+=expansion; sa)



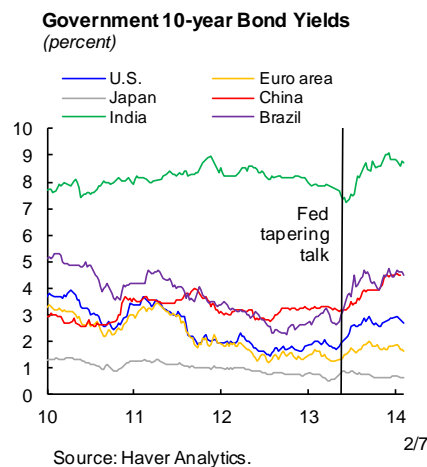
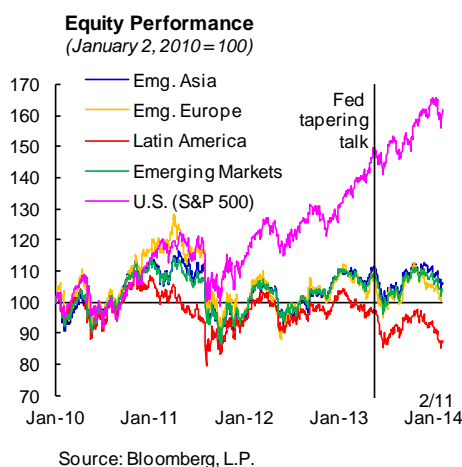
recovery will remain fragile, as balance sheet repair and financial fragmentation continue to weigh on economic activity notwithstanding stronger export performance. Despite a modest revival of activity, inflation is currently well below the ECB's medium-term price stability target and has slowed further in recent months.

- In *Japan*, growth remained firm in the second half of 2013—albeit with a moderation from the early part of the year—supported in part by the front-loading of spending ahead of the consumption tax hike in April. Inflation has begun to rise in recent months and is becoming more broad-based. The economy, however, remains in a stimulus-driven recovery with wages and private investment yet to rise decisively.
- In *emerging economies*, stronger export growth has coincided with the slow-but-steady acceleration of activity in advanced economies, providing a much-needed boost. Domestic demand in many of these countries has remained weaker than expected, reflecting to varying degrees tighter financial conditions and policy stances, as well as policy or political uncertainty and bottlenecks. In *China*, with firming domestic demand in the second half of the year, growth picked up and hit 7.7 percent for the year. *India* also saw some increase in growth, as a result of a favorable monsoon season and higher export growth. In *Brazil* activity weakened in the third quarter as investment growth turned negative amid waning business confidence.



2. **A new bout of volatility in emerging economies has occurred against a confluence of factors.** Many *emerging markets* came under renewed financial pressure in the second half of January—equities fell, spreads rose, and currencies of major economies depreciated. Markets appear to be reassessing emerging market fundamentals as global conditions change. While the pressures were relatively broad-based, countries with higher inflation and current account deficits were amongst the most affected (Brazil, Indonesia, Turkey, and South Africa). The sell-off came against the backdrop of several negative factors in some countries and weakening sentiment toward emerging economies. Specifically, China's shadow banking and weaker-than-expected PMI data, continued or rising political tensions (Thailand, Turkey, South Africa, and Ukraine), and Argentina's depreciation all contributed to the negative sentiment against the broader context of continued Fed tapering. Nonetheless, it is difficult to pinpoint a predominant

cause, as factors' role may vary by country. While market sentiment recovered somewhat recently as key emerging economies took steps to shore up confidence and strengthen their commitment to policy objectives, this latest episode of financial market instability underscores the vulnerabilities of EMs. In *advanced economies*, financial conditions have eased since the release of the October 2013 WEO, despite significant recent falls in equity markets on the back of the rapid jump in global risk aversion. Long-term bond yields are generally lower than the post-taper highs and risk premia on government debt of crisis-hit euro area economies have declined noticeably. However, financial fragmentation persists in the euro area and private sector credit is still contracting.



3. **The outlook is for a further strengthening in the recovery, broadly as projected in the January WEO, assuming the impact of recent volatility is short-lived.** In advanced economies, the 2014 stimulus package offsetting the drag from the consumption tax increase in Japan, less fiscal consolidation in the United States and the euro area, as well as easing financial conditions will support growth. In emerging economies, growth in China is expected to moderate slightly in 2014–15, in part because of policy measures aimed at slowing credit growth and raising the cost of capital. In India, growth should firm up further, thanks to project approvals by the Cabinet Committee on Investment. Elsewhere, growth remains sluggish on account of weak domestic demand, including in Brazil, Indonesia, Russia, and South Africa, although in most cases it is still expected to increase this year and next. For some economies, notably those who raised policy rates given market pressure, growth is likely to be revised downward. However, the global outlook is broadly as in the January WEO Update, with global growth projected to increase from 3 percent in 2013 to about 3.7 percent in 2014 and 4 percent in 2015.

4. **The recovery is still fragile, and significant downside risks (old and new) remain.** In emerging economies, increased financial market and capital flow volatility remains a key concern as the Federal Reserve continues unwinding unconventional monetary policy measures and market conditions start to normalize. Concerns about the withdrawal from UMP in the United States have already provoked sharp price movements in emerging markets. Market normalization will lead to portfolio reallocation and capital outflows in emerging economies, with risks for lower investment and potentially financial disruptions, notably in those with domestic weaknesses. Vulnerabilities related to built-up positions, including a substantial increase in foreign holdings of domestic sovereign bonds and higher leverage, both in the form of more

direct FX borrowing by corporations and a rapid increase in domestic credit, could amplify the impact of shocks. A new risk to activity stems from very low inflation in advanced economies, especially the euro area, which, if below target for an extended period, could de-anchor longer-term inflation expectations. Low inflation raises the likelihood of a deflation in case of a serious adverse shock to activity. In the euro area, low inflation also complicates the task in the periphery where the real burden of both public and private debt would rise as real interest rates increased.

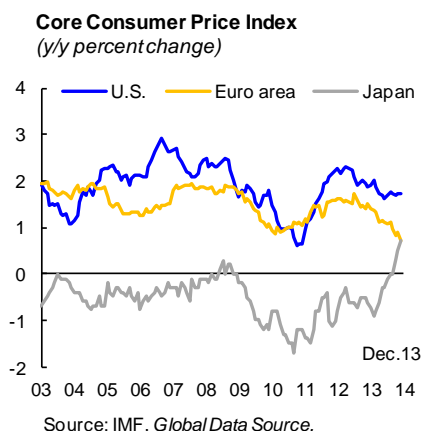
POLICIES FOR A SUCCESSFUL RECOVERY

Monetary policy should remain accommodative in advanced economies, as output gaps are large and fiscal consolidation will continue. Emerging economies need to rebuild policy space and in some cases address domestic imbalances and vulnerabilities to prepare for tighter financial conditions. Further actions, including structural reforms, and cooperation are needed across the membership to lay the foundations for stronger and more balanced medium-term growth.

Advanced Economies

5. **Monetary policy should continue supporting demand given the still-large output gaps and ongoing fiscal consolidation.** With prospects improving, it will be critical to avoid a premature withdrawal of monetary policy accommodation, including in the United States. There is scope for better cooperation on unwinding UMP, especially through wider central bank discussions of exit plans.

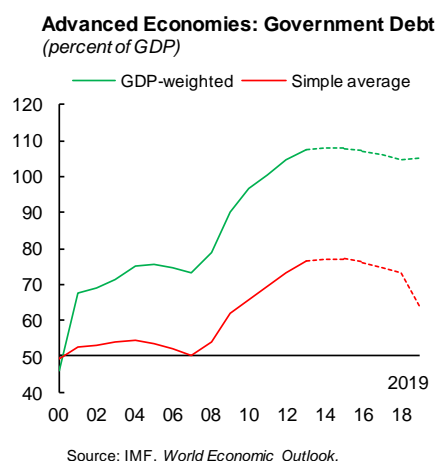
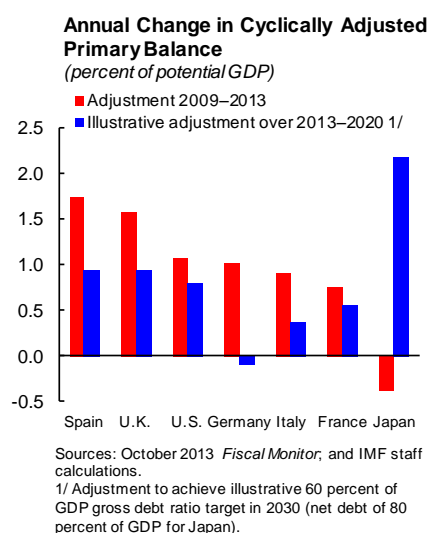
- In the *United States*, continued asset purchases over the next several months, albeit at a lower rate, and strengthened Fed forward guidance on interest rates should help keep expected short-term rates low for some time, and moderate the pace of any increases in long-term rates. Looking forward, the Fed will need to gradually adjust the pace and composition of asset purchases to reflect evolving economic conditions, while continuing its careful policy communication to mitigate the risk of excessive market volatility.
- In the *euro area*, more monetary easing is needed to raise the prospects of achieving the ECB's inflation objective, including by supporting demand, given the weak and fragile growth, large output gaps and very low inflation. Further actions could include longer-term LTROs (possibly targeted to SMEs), and further rate cuts, including mildly negative deposit rates, to support demand and reduce fragmentation. But it would be critical to repair bank balance sheets to reduce financial fragmentation, improve the monetary transmission mechanism, and allow for a sustained recovery in investment. A sound execution of the AQR and stress tests will be a key step toward reducing uncertainty about the health of banks and enabling balance sheet repair. In order to enhance the credibility of the exercise and make it easier to raise private capital, greater clarity is needed on the availability of public backstops as safety nets. National authorities should commit to provide



sufficient national backstops, while the establishment of a common backstop (ESM direct recapitalization) remains crucial to sever sovereign-bank links in countries where debt dynamics are a concern and fiscal space is limited. Completing the banking union is also critical to reducing financial fragmentation. In particular, a Single Resolution Mechanism (SRM) based on an independent centralized authority, with efficient resolution powers—supported by a single resolution fund—would be necessary to ensure least cost and timely resolution. The recent Council agreement on the SRM is a step forward but the process appears complex, and may cause delays in decision making. A quicker transition period for the mutualization of national contributions to the single resolution fund and a clearer decision on a common backstop and its timing are required to adequately break sovereign-bank links.

- In *Japan*, much has been done by the BoJ. Inflation and inflation expectations have picked up, and there does not appear to be a need for further easing at the moment. However, should it become clear that progress toward the 2 percent inflation target has reversed or stalled, the BoJ should ease further, together with action the other two arrows of Abenomics, structural reform (to boost investment, employment, and productivity) and fiscal consolidation.

6. **Fiscal consolidation should continue at a gradual pace, while preserving the long-term growth potential of the economy.** While debt ratios should start declining from 2015 onward, fiscal deficits remain high relative to pre-crisis levels and there is still some way to go to rebuild policy buffers and bring debt ratios to prudent levels. Fiscal consolidation should continue at a gradual pace, within the framework of concrete medium-term plans (notably in Japan and the United States). At the same time, past fiscal consolidation has been heavily focused on tax increases and wage and public investment cuts, exacerbating the trend decline in public capital stocks. Going forward, the design of fiscal policy should be careful to support the long-run growth potential of the economies, including by enhancing infrastructure investment, which will also boost demand. Consolidation should rely on a more balanced distribution of spending cuts, where revenue ratios are already high; where there is scope to raise revenues, the emphasis should be on broadening the tax base. Specifically:



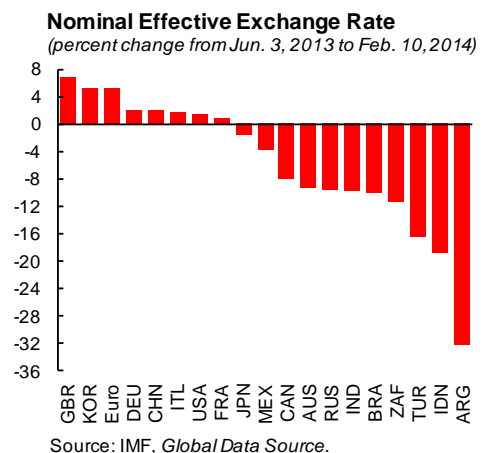
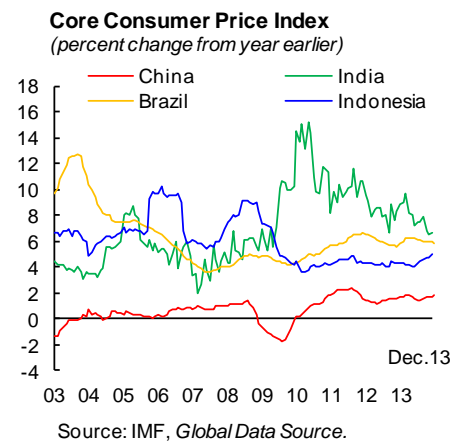
- In the *United States*, the December 2013 budget agreement was an encouraging example of bipartisanship and provided partial relief from the sequester. However, it remains essential to reduce uncertainty surrounding the conduct of fiscal policy, by raising the debt limit in a more durable manner and adopting a balanced and comprehensive medium-term fiscal plan (including entitlement and tax reforms) that puts public debt on a downward path.
- In *Japan*, the decision to implement the first phase of the consumption tax increase sent a strong signal about the government's resolve to tackle the country's fiscal imbalances. However, much more is needed to put the debt ratio on a downward path; the recent fiscal stimulus package increased the urgency of a concrete medium-term consolidation plan. The implementation of the second stage of consumption tax rate increase in 2015 is of great importance, and should go ahead. If, however, growth slows considerably, fiscal measures could be considered in the context of a credible consolidation strategy.
- In the *euro area*, the overall fiscal stance planned for 2014 is neutral, although a number of countries are still tightening, even if at a slower pace. This is broadly appropriate. However, if low growth persists and monetary policy options are depleted, the flexibility in the current fiscal framework may need to be used to respond in these circumstances. Further progress is also needed in improving national fiscal governance in the context of recent fiscal institutions reforms in the euro area.

Emerging Economies

7. **Credible macroeconomic policies and frameworks, alongside exchange rate flexibility are needed to weather the turbulence.** Emerging economies face both near-term and medium-term challenges to support growth. In the near term, priorities include: (i) weathering the current turbulence and capital outflows and (ii) choosing counter-cyclical policy to close output gaps where possible, or the unavoidable pro-cyclical policies for those lacking policy space/credibility. The strengthening of the recovery and unwinding of accommodative monetary policy in advanced economies will lead to tighter external financing conditions and could generate further bouts of volatility in capital flows. As recent turbulences have shown, economies with deteriorating macroeconomic imbalances, larger external funding requirements (relative to reserves) and lower policy credibility see more volatility. And when risk sentiment changes against EMs indiscriminately, having the policy space and credibility to react has been critical. Policy priorities are thus for a coherent macroeconomic policy mix with a credible nominal anchor and good communication. Specifically:

- On the *fiscal* front, emerging market economies need to ensure policy credibility, subsequently buffers should be built to provide space for counter-cyclical policy action. The urgency for action varies across economies and is especially high in economies with large deficits, high debt levels and/or more sensitive to increases in U.S. rates. Some countries (Brazil and China) also need to reduce quasi-fiscal activity, which has increased contingent risks to public finances, and improve the transparency of these operations.

- On the *monetary* front, economies where inflation is still relatively high, or where policy credibility has come into question, need to continue tightening monetary policy in the context of strengthened policy frameworks (India and Turkey).
- *Exchange rates* should be allowed to adjust in response to changing fundamentals. In several emerging economies, the depreciation of the real exchange rate is helping correct the currency misalignment and should contribute to reduce the relatively large current account deficits. However, when the ability to depreciate is constrained by balance sheet mismatches and other financial fragilities and the risk of igniting inflation, policymakers might need to consider tightening macroeconomic policies. At the same time, where very rapid flows lead to financial market disruption and sound macroeconomic policies fail to stabilize the tensions, *liquidity* provision and exchange market *interventions*, where reserves are adequate, can be used to smooth excessive volatility or prevent financial disruption.



- *Macro-prudential and financial stability measures* also have an important role to play. There is a need to strengthen capital and provisioning requirements to provide greater buffers in sudden stop or slow-growth scenarios; ensure that banks address credit quality and profitability problems, which may result from previous rapid credit growth or lower capital inflows; contain and monitor foreign exchange and credit exposures; and finally, control the growth of inadequately regulated shadow banking activities, and overall credit growth rates where these do not appear to be sustainable.

Rebalancing and Structural reforms

8. **Further action across the membership and cooperation are needed to promote financial stability and ensure sustainable medium-term growth.** Progress on global rebalancing and making growth more sustainable has been mixed. External imbalances have declined appreciably since the crisis. This reflects in part healthy adjustments but weaker demand in advanced deficit economies has played a substantial role. Accordingly, in a number of *surplus* countries, further reforms are needed to boost domestic demand or modify its composition. In China, the desired rebalancing toward consumption can be achieved through steadfast implementation of the recently announced reform blueprint, especially through improving financial intermediation, allowing more flexibility in the exchange rate by reducing intervention

over time, and strengthening the social safety net. Germany needs to boost investment, both public infrastructure and private investment, through tax and financial system reform and services sector liberalization. In a number of *deficit* economies, structural reform is needed to improve competitiveness (France, Italy, South Africa, Spain, and U.K.) and remove supply bottlenecks to strengthen exports (India and South Africa).

9. **Product and labor market reforms are also needed across the membership to lay the foundations for stronger medium-term growth.** The crisis has caused important losses in productivity, employment, and investment relative to longer-term trends, especially in advanced economies (see Annex). While these partly reflect still large output gaps, potential output also got hit. At the same time, key emerging economies (Brazil, India, and China), which were a main engine of global growth in recent years, are experiencing slower potential growth, despite still large catch-up needs. In Brazil and India, the slowdown reflects infrastructure and regulatory bottlenecks, while in China it is due to excess capacity created by the credit and investment boom. Most members have considerable scope to improve the functioning of product markets. In surplus economies (China, Germany, Japan, and Korea), action should be mostly focused on liberalizing domestic services and other non-tradable sectors, though in Japan agriculture also needs liberalization. In deficit countries, reforms are generally needed in both tradable and non-tradable sectors. Many emerging economies also have scope to improve the business environment. Labor market reforms, especially to raise participation by women and/or older workers, are important in many members, but especially in advanced economies undergoing population aging (Germany, Japan, and Korea) or where an important fraction of the population remains underemployed. Finally, infrastructure needs are high in emerging economies, especially those that are experiencing supply bottlenecks (e.g. Brazil, India), while some advanced economies would benefit from a modernization of their infrastructure (e.g. Germany, the United States).

10. **Strengthened and cooperative policy actions have substantial gains in terms of lowering financial risks and increasing growth** (Annex). Scenario simulations suggest that reforms would raise world growth by about 0.5 percentage point per year over the next five years (boosting global output by about 2¼ trillion dollars). Product market reforms have the largest growth pay-off, followed by labor participation reforms and infrastructure investment. While the gains stem mostly from policies that countries need to implement for their own good, joint action could produce beneficial growth spillovers in the longer term. Even more importantly, joint action can reduce risks of renewed turmoil in the global economy, both by reducing external imbalances and the associated internal distortions and by improving market confidence.

Table 1. Real GDP Growth*(Percent change)*

	Year over Year					
	2012	2013	Projections (as of Jan. 2014)		Deviations (from Oct. 2013)	
			2014	2015	2014	2015
World 1/	3.1	3.0	3.7	3.9	0.1	0.0
Advanced economies	1.4	1.3	2.2	2.3	0.2	-0.2
Euro area	-0.7	-0.4	1.0	1.4	0.1	0.1
Emerging market and developing countries 2/	4.9	4.7	5.1	5.4	0.0	0.1
Advanced G-20	1.7	1.5	2.3	2.3	0.2	-0.2
Emerging G-20	5.1	5.2	5.5	5.7	0.1	0.0
G-20 3/	3.3	3.2	3.8	3.9	0.1	-0.1
Argentina 4/	1.9	3.5	2.8	2.8	0.1	0.1
Australia	3.6	2.5	2.6	2.7	-0.2	-0.3
Brazil	1.0	2.3	2.3	2.8	-0.2	-0.4
Canada	1.7	1.7	2.2	2.4	0.1	-0.1
China	7.7	7.7	7.5	7.3	0.3	0.2
France	0.0	0.3	0.9	1.5	0.0	0.0
Germany	0.9	0.5	1.6	1.4	0.2	0.1
India 5/	3.2	4.4	5.4	6.4	0.2	0.1
Indonesia	6.2	5.6	5.3	5.8	-0.2	-0.2
Italy	-2.5	-1.8	0.6	1.1	-0.1	0.1
Japan	1.4	1.7	1.7	1.0	0.4	-0.2
Korea	2.0	2.8	3.7	3.8	0.0	-0.2
Mexico	3.7	1.2	3.0	3.5	0.0	0.0
Russia	3.4	1.5	2.0	2.5	-1.0	-1.0
Saudi Arabia	5.8	3.8	4.4	4.2	0.0	-0.1
South Africa	2.5	1.8	2.8	3.3	-0.1	0.0
Turkey	2.2	4.1	3.5	3.7	0.0	-0.6
United Kingdom	0.3	1.7	2.4	2.2	0.6	0.2
United States	2.8	1.9	2.8	3.0	0.2	-0.4
European Union	-0.3	0.1	1.4	1.7	0.2	0.1

Source: IMF, *World Economic Outlook* January 2014.

1/ The quarterly estimates and projections account for 90 percent of the world purchasing-power-parity weights.

2/ The quarterly estimates and projections account for approximately 80 percent of the emerging market and developing countries.

3/ G-20 aggregations exclude European Union.

4/ The data for Argentina are officially reported data. The IMF has, however, issued a declaration of censure and called on Argentina to adopt remedial measures to address the quality of the official GDP data. Alternative data sources have shown significantly lower real growth than the official data since 2008. In this context, the IMF is also using alternative estimates of GDP growth for the surveillance of macroeconomic developments in Argentina.

5/ Real GDP growth numbers are presented on a fiscal year basis and based on GDP at market prices. Corresponding growth forecasts for GDP at factor cost are 5.0, 4.6, 5.4, and 6.4 percent for 2012, 2013, 2014, and 2015, respectively.



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POLICIES FOR GROWTH AND REBALANCING

Annex to the G-20 Surveillance Note



Prepared by Staff of the
INTERNATIONAL MONETARY FUND*

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

SUMMARY

The recovery has been disappointing, with G-20 output still below longer-term trend. Output losses have been especially large in advanced deficit economies, and reflect both cyclical and structural factors. They can be decomposed into losses in productivity, investment, and employment. External imbalances have narrowed alongside weak demand and hence lower imports in deficit countries, while adjustments toward desirable policies have been modest.

Joint action is needed to boost output and to lower global risks substantially through more balanced growth. As the output losses reflect both lower potential growth and the output gap, demand and supply measures are needed. But as output gaps close, external imbalances may increase again, implying that further action on internal and external rebalancing is also required to ensure the sustainability of medium-term growth. Policies should aim at three goals: bringing output back to potential; raising potential; and rebalancing growth.

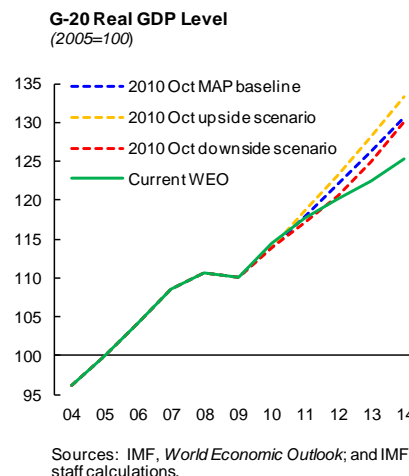
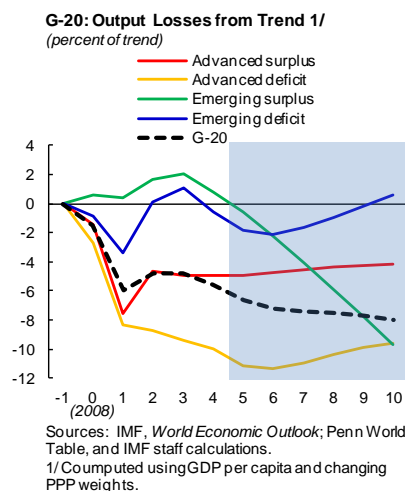
- ❖ *Bringing output back to potential.* Monetary policy should remain accommodative in advanced economies given the still large output gaps and the ongoing fiscal consolidation. In emerging economies, credible macroeconomic policies and frameworks, alongside exchange rate flexibility, are critical to weather turbulences in a context of tighter external financing conditions. There is also scope for better cooperation on unwinding UMP, especially through wider central bank discussions of exit plans.
- ❖ *Raising potential.* Strengthening medium-term growth requires action on structural policy gaps, including product market reforms, labor market reforms, and in some economies, infrastructure investment. Most members have considerable scope to improve the functioning of product markets. Some members also need to make their labor markets more job-friendly, while many can boost employment and output by removing disincentives to participation in the labor market for women, older workers, and youth. Finally, infrastructure needs are high in emerging markets, especially those experiencing supply bottlenecks, while some advanced economies would benefit from a modernization of their infrastructure.
- ❖ *Rebalancing growth.* Further action and cooperation are needed to avoid a resurgence of global imbalances as the recovery proceeds and ensure sustainable medium-term growth. In a number of surplus countries, reforms are needed to boost domestic demand or rebalance demand from investment to consumption. In a number of deficit countries, reforms should boost competitiveness and remove supply bottlenecks to strengthen exports.

Strengthened and cooperative policies would deliver stronger, more balanced, and sustainable medium-term growth while reducing risks of renewed global turmoil. Simulations of a plausible reform scenario suggest that desirable product and labor market reforms, together with rebalancing policies in key external deficit and surplus economies would raise world output by 2¼ trillion dollars by 2018 (about 0.5 percentage point higher growth per year), while reducing substantially global imbalances and lowering public debt ratios. While most of the gains are attributable to domestic policies, joint action could produce beneficial growth spillovers in the medium to long term. Even more importantly, joint action can also reduce risks of renewed global turmoil both by reducing external imbalances and internal distortions and by strengthening market confidence.

RECOVERY FROM THE GREAT RECESSION: STOCKTAKING

The recovery has been disappointingly weak, with G-20 output still far below longer-term trend, reflecting both cyclical and structural factors, and large output losses, notably in advanced deficit economies. At the same time, progress on internal and external rebalancing has been limited.

1. **The recovery from the Great Recession has been disappointing, with G-20 output still below longer-term trend.** Global activity strengthened during the second half of 2013 on account of firming activity in advanced economies, and global output growth is projected to increase from 3 percent in 2013 to around 3¾ percent in 2014 and 4 percent in 2015. However, five years since the Great Recession, output remains far below the longer-term trend level, especially in advanced economies.¹ In 2013, (per capita) output losses relative to trend amounted to 8 percent for the G-20 as a whole, with a higher loss in advanced deficit economies (11 percent). Trade volumes (real exports and imports) remain well below trends as well. Notably, the recovery has also been much slower than was anticipated in the wake of the crisis: the G-20's 2013 real GDP level was 2 percent below the downside scenario projection prepared for the 2010 Mutual Assessment Process. The strong growth projected in 2010 was based on an expected rapid decline in unemployment, accompanied by a strong crowd-in of private demand, which did not materialize.



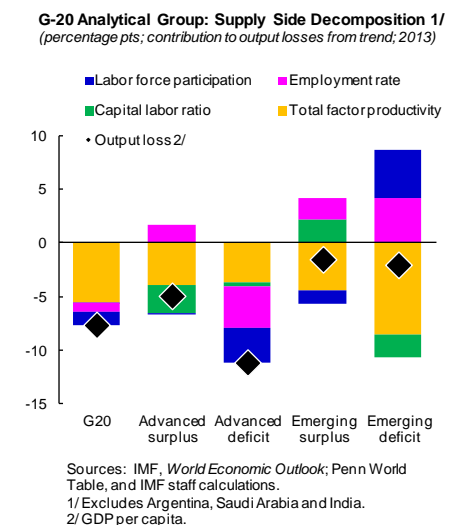
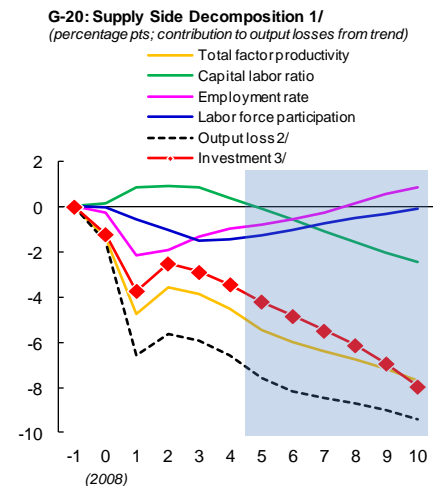
2. **Below trend output levels across the G-20 reflect both cyclical and structural factors.** Output gaps remain significantly negative in advanced deficit countries, suggesting that the demand shortfall is the binding constraint to growth in the short-term. However, potential output was also damaged following the Great Recession in many economies. Importantly, going forward, the WEO baseline projections for the medium term suggest permanent crisis-related output losses for the G-20 as a whole, driven by large losses for advanced economies where potential growth is envisaged to remain generally weak. At the same time, potential growth in

¹ Trend growth is calculated over the period 1998–2005, excluding the boom years just before the crisis. Using an even longer trend (1988–2005) yields qualitatively similar conclusions.

emerging surplus economies, which have been a major engine of world growth in the recent past, is expected to decline (as reflected in growing output losses relative to longer-term trend). This slowdown likely reflects various factors, some of which may be desirable, including policy efforts in China to steer demand away from investment and towards consumption underpinned by the reform blueprint.

3. **Output losses can be decomposed into losses in investment, productivity, and employment.** To better understand the sources of these losses, actual per capita output and its (demand and supply) components are compared with the level they would have reached had they followed their longer-term trend.

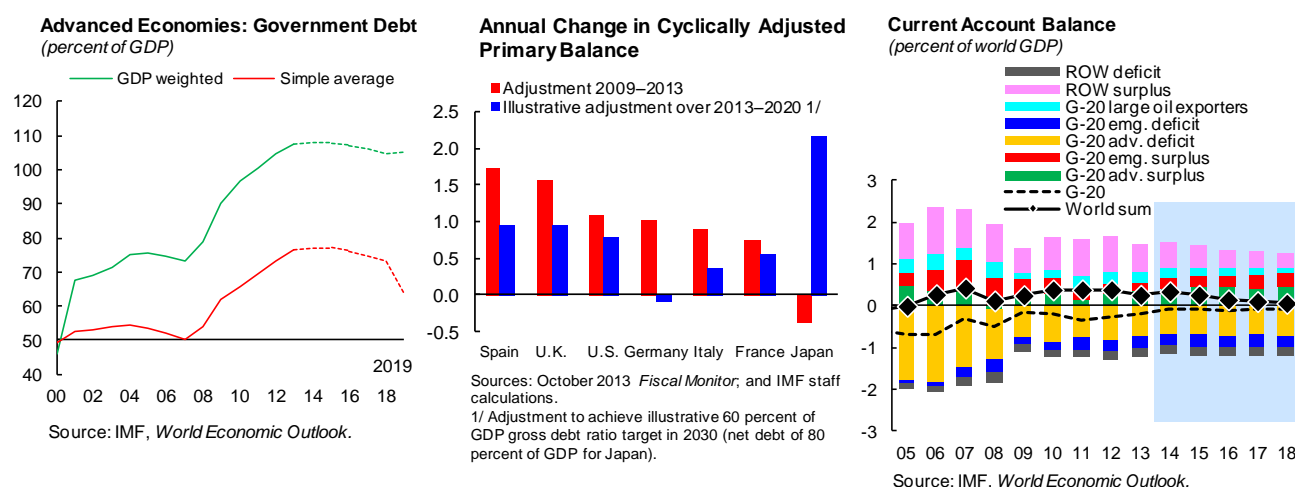
- A demand-side decomposition of output losses shows that *investment* in the G-20 remains well below longer-term trend, by 18 percent. The losses are especially large for advanced deficit economies but also significant in advanced surplus and emerging deficit economies. For the G-20 as a whole, consumption is only mildly below trend; however, this masks regional variation, with consumption depressed in advanced deficit economies and above trend in emerging economies.
- A supply-side decomposition of output losses shows that for the G-20 as a whole the main driver has been *productivity* losses, followed by *labor force participation* and *employment* losses. Weak total factor productivity explains about 5 percentage points of the output losses in all analytical groups, while labor force participation and employment rates account each for 1 percentage point and are an issue mostly for advanced deficit economies.² While the capital-labor ratio appears to have recovered to trend on average in the G-20, this masks a strong slowing of capital accumulation in line with the employment losses, and consistent with the large investment losses implied by the demand side decomposition. The capital-labor ratio also shows worrisome developments from the perspective of rebalancing demand, as it has been above trend in emerging surplus countries (where in key members investment has been too high) and below trend in advanced surplus countries (where investment is deemed too weak) .



² Employment is above longer-term trend in the other groups, while labor force participation has been above trend in emerging deficit economies and close to trend in surplus economies.

4. **Slower productivity growth and capital accumulation undermine long term growth prospects.** While they may partly reflect the weak demand after the global financial crisis, measured TFP losses (relative to trend) are significant and projected to be persistent in the medium term. One could argue that the pre-crisis boom and productivity hike were not sustainable and that the underlying output gaps and TFP losses are smaller than currently estimated. But calculating the trend over a longer period yields similar TFP losses. These losses suggest that the scarring effect of the crisis (for instance difficult-to-reverse misallocation of capital over pre-crisis booms, reductions in research and development spending) may have dominated its cleansing effect (the fact that the least productive firms are forced first out of business). The slowdown in capital accumulation will also affect potential growth negatively. In contrast, labor inputs have been relatively resilient—with the exception of advanced deficit economies—and they are projected to return to their trend in the medium term.

5. **The narrowing of external imbalances has occurred alongside compressed demand in advanced deficit economies.** External imbalances have declined appreciably since the crisis reflecting in part healthy adjustments, such as a rebound in low private saving and, more recently, improvements in fiscal balances in external-deficit economies and resilient domestic demand in key emerging surplus economies. However, a sizable part of the narrowing of imbalances also reflects weaker demand in advanced deficit economies, while adjustments toward desirable policies over the medium term have been modest in general and played only a small role in reducing global imbalances so far. Against this background, there remains a risk that global imbalances may re-emerge when advanced deficit economies close their output gaps, especially if desirable policy adjustments are not taken.³ On the fiscal front, despite sizable consolidation efforts, imbalances remain large in advanced economies, partly on account of slow growth. Fiscal deficits are still above their pre-crisis levels, and public debt is projected to stabilize only at very high levels—too high to rebuild needed policy space or to deal with future challenges such as aging.



³ See IMF (2013): "Imbalances and Growth: Update of Staff Sustainability Assessments for Selected G-20 Members": <https://www.imf.org/external/np/g20/pdf/map2013/map2013.pdf>.

POLICIES FOR GROWTH AND REBALANCING

For a successful recovery, advanced economies should continue supporting their still weak demand, while emerging economies should prepare for tighter external financing conditions. Bringing output back to potential though is unlikely to be enough to deliver a robust recovery. In both advanced and emerging economies, structural reforms are also needed to lay the foundations for stronger medium-term growth. Moreover, further progress on internal and external rebalancing is needed in surplus and deficit economies to ensure sustainable medium-term growth. The beneficial spillovers from joint action could be sizable.

6. **Joint action is needed to achieve the G-20 shared objectives of strong, sustainable and balanced growth.** Policies should aim at three goals: getting output back to potential; increasing potential; and further rebalancing growth, focusing on external demand in deficit countries and internal demand in surplus countries. The relative weights on these three objectives should depend on the relative contributions of output gaps and weaker potential to output losses. If (current and projected) output losses largely reflect weaker potential, then policies should focus on increasing potential output, and the need for rebalancing policies may be less—as the observed narrowing of imbalances would be more durable. In contrast, if the output gap is larger, then getting output back to potential while further rebalancing growth should be a priority. While there is an inherent uncertainty in estimating output gaps (as potential output is unobservable), the above analysis suggests that output losses reflect both large output gaps and weaker potential.

Bringing Output Back to Potential

7. **Monetary policy should continue supporting demand in advanced economies in view of the still large output gaps and ongoing fiscal consolidation.** With prospects improving, it will be critical to avoid a premature withdrawal of monetary policy accommodation, including in the United States. In the euro area, more monetary easing is needed to raise the prospects of achieving the ECB's inflation objective, complemented with further repair of banks' balance sheets and efforts to complete the banking union. In Japan, the BoJ should watch carefully for risks of a loss of momentum in inflation expectations. Should it become clear that progress toward the 2 percent inflation target has reversed or stalled, the BoJ should ease further, together with action on the other two arrows of Abenomics, structural reform to boost investment, employment, and productivity, and strong medium-term fiscal consolidation plans. Fiscal consolidation is still needed in most countries but should remain gradual and anchored in credible and concrete medium-term plans (see below). Consolidation should rely on a more balanced distribution of spending cuts and tax revenues, where revenue ratios are already high; where there is scope to raise revenues, the emphasis should be on broadening the tax base.

8. **Meanwhile, in emerging economies, credible macroeconomic policies and frameworks, alongside exchange rate flexibility, are needed to weather the turbulence.** The strengthening of the recovery and future unwinding of accommodative monetary policy in advanced economies will result in tighter external financial conditions, lower capital inflows, and

possibly further bouts of volatility in capital flows for emerging economies. In economies where inflation is still relatively high, or where policy credibility has come into question, further monetary policy tightening in the context of strengthened policy frameworks is necessary. On the fiscal front, emerging economies need to ensure policy credibility; subsequently buffers should be built to provide space for counter-cyclical policy action. Exchange rate flexibility should continue to facilitate external adjustment, particularly where currencies are overvalued, with FX intervention—for countries with adequate reserves—targeted to smooth excessive exchange rate volatility or prevent financial disruption. Finally, prudential policies should ensure that financial institutions address credit quality and profitability problems, which may have resulted from the recent rapid credit growth or lower capital inflows, while containing excessive leverage and foreign exposure.

Laying the Ground for Stronger and More Balanced Medium-term Growth

9. **Gradual fiscal consolidation should proceed in the medium term, while better supporting long-run growth.** It should be anchored in concrete and credible medium-term plans, which are notably lacking in the United States and Japan. Moreover, past fiscal consolidation in advanced economies has been heavily focused on wage cuts and public investment, exacerbating the trend decline in public capital stocks. Going forward, the design of fiscal policy should be careful to support the long-run growth potential of these economies, including by enhancing infrastructure investment, which will also boost demand. In India, there is a need for sustainable fiscal consolidation and reorientation of spending toward investment and social sectors, requiring subsidy reform and an overhaul of taxation. In Brazil, strengthening the fiscal framework to rebuild fiscal buffers and bolster confidence would entail adherence to a primary balance that puts gross debt firmly on a downward path and more fully recognizing contingent fiscal risks.

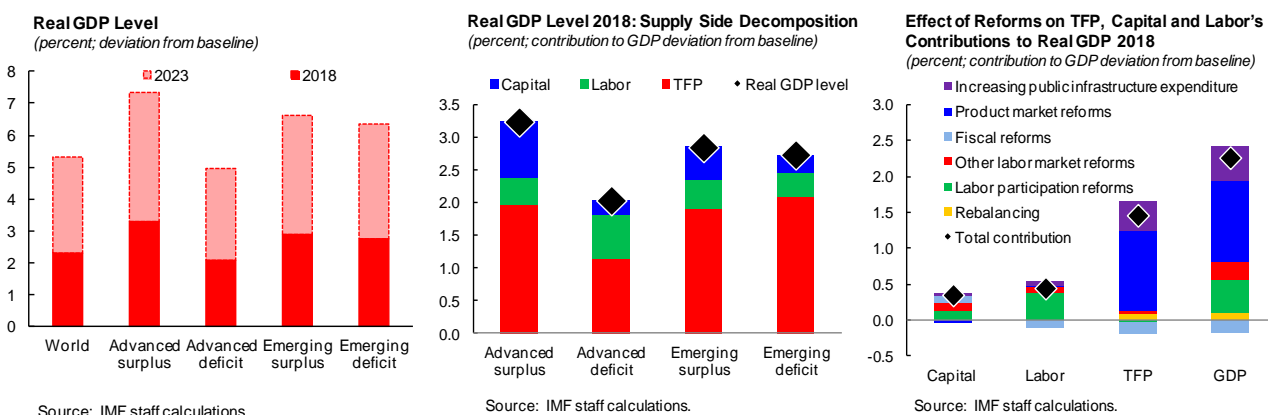
10. **Further action and cooperation are needed to avoid a resurgence of global imbalances as the recovery proceeds and ensure sustainable medium-term growth.** Making growth more balanced and sustainable requires boosting internal demand in surplus countries and shifting from internal to external demand in deficit countries. In a number of *surplus* countries, reforms are needed to increase domestic demand or modify its composition. Specifically, in *China*, steadfast implementation of the recently announced reform blueprint is required to achieve desired rebalancing toward consumption through (i) improving financial intermediation; (ii) strengthening social safety nets; (iii) fostering competition by opening up the services sector and leveling the playing fields; and (iv) allowing more flexibility in the exchange rate by reducing intervention over time. In *Germany*, policy should focus on boosting domestic demand, especially investment, through tax and financial system reform, but also services sector liberalization and higher public investment (see below). In a number of *deficit* economies, structural reform is needed to improve external competitiveness (France, Italy, South Africa, Spain, and U.K.) and remove supply bottlenecks to strengthen exports (India and South Africa). In some cases (e.g. China), the implementation of rebalancing reforms could somewhat slow near-term growth, but they are vital in containing vulnerabilities and achieving sustainable growth. In

other cases, structural reforms can contribute to both rebalancing and stronger growth (see below).

11. **Structural reforms can boost medium-term growth substantially, though with uncertain impact on rebalancing.** Country desks' assessments suggest policy gaps in three main areas which, if addressed, have the potential to boost medium-term growth and employment: product markets, labor market reforms, and in some cases infrastructure investment. These policies can boost growth by addressing the gaps in productivity, employment, and investment identified above. Action on one gap may also help close the others: for instance, increases in productivity will likely lead to increased investment and employment, while higher employment will require additional capital accumulation to accommodate the new workers. The specific reform priorities are as follows:

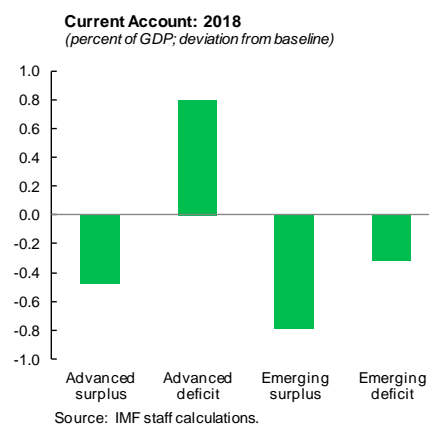
- **Product market reforms** can boost productivity by increasing competition and/or improving the business environment. Most members have scope to improve the functioning of product markets. In *surplus countries* where productivity has been concentrated in the tradable sector (China, Germany, Japan, and Korea), the focus of reforms should be on strengthening productivity in domestic services and other non-tradable sectors to generate more balanced growth, though in Japan agriculture also needs liberalization. In *deficit countries*, improvements are generally needed in both tradable and non-tradable sectors.
- **Labor market reforms** can also boost output substantially by increasing employment. Some countries (France, South Africa, and Spain) need to make their labor market institutions more job-friendly to lower a high natural rate of unemployment and improve competitiveness. Reforms to remove disincentives to female and older workers' participation in the labor market are needed to maintain or increase labor supply in advanced countries undergoing population aging (especially Germany, Japan, and Korea) or where an important fraction of the population remains underemployed.
- Finally, **infrastructure investment** can boost medium-term growth by increasing private investment productivity. Infrastructure investment needs are high in emerging economies, especially those that are experiencing supply bottlenecks (e.g. Brazil, India), while infrastructure modernization would also boost growth in some advanced economies (e.g. Germany and the U.S.). Quality of infrastructure investment is key to ensure that resources are used effectively and boost the productivity of private investment. Countries could also foster higher involvement of the private sector in the provision of infrastructure services, including through PPPs, although this would also often call for a strengthening of the related regulatory and transparency framework.

12. **Model simulations suggest that the above reforms would deliver stronger medium-term growth.** A plausible reform scenario is simulated with the IMF Research Department G-20 model to illustrate the medium-term impact of these policy actions on the shared growth objectives.⁴ The model is calibrated using the 2012 OECD estimates of the impact of product and labor market reforms on productivity and employment. The specific policy assumptions for each country are based on IMF desks' assessments of policy gaps across six reform areas—fiscal, rebalancing, labor supply, other labor market reforms, product market reforms, and infrastructure investment (see Box 1), which are used to scale the OECD estimates for the impact of reforms. The policies assumed in the scenario raise world real GDP by about 2¼ percent (or 2¼ trillion U.S. dollars) in 2018 (relative to the October 2013 WEO baseline), implying 0.5 percentage point higher growth over the next five years. Such gains would be sustained over a longer horizon until all the effects of the reforms have played out. World output gains stem largely from productivity increases, with substantial contributions from higher employment and capital accumulation.⁵ Product market reforms contribute the most to the higher growth, followed by labor participation reforms and infrastructure investment.



13. **Policies aimed at boosting domestic demand in surplus economies and shifting it from internal to external demand in deficit economies, lower sizably global imbalances.**

The assumptions about surplus and deficit economies in this scenario are as follows: (i) *China*—reduction in private saving rate, higher overall cost of capital due to better pricing of risks and liberalizing interest rates, gradual shift towards more productive investment, and increase in government transfers to strengthen social safety nets; (ii) *Germany*—a boost in investment and a small economy-wide increase in productivity driven by services; (iii) *United States*—increase in saving rate. While rebalancing policies do not contribute much to medium-



⁴ The scenarios are based on observed and thus achievable magnitude of reforms in countries that have reformed over the past 10 years.

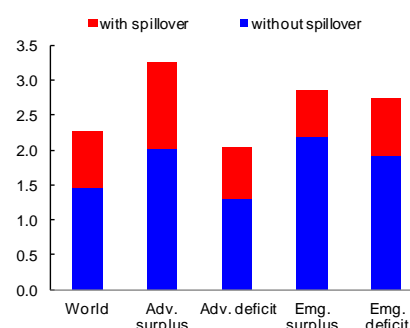
⁵ In line with what would be desired, the contribution from capital is more important in advanced surplus countries, while the employment contribution is more important in advanced deficit countries.

term growth (except in advanced surplus countries where they boost investment), they are needed to reduce risks to the sustainability of growth arising from domestic and external imbalances, including risks of financial crises. Specifically, the reform scenario policies reduce current account imbalances by ½ to 1 percentage point of GDP for each analytical group, except emerging deficit countries.

14. While the gains stem mostly from policies that countries need to implement for their own good, joint action could produce large beneficial spillovers in the longer term.

The reform scenario suggests that most of the gains stem from policies that are beneficial from the country's own perspective. However, about 1/3 of the world output gains in the medium term stem from positive productivity spillovers between members, the main source of growth spillovers. Productivity increases in the home country lead to productivity spillovers in trade partners through technology diffusion, the more so the higher the capacity of the recipient country to adopt technological innovations.⁶ Product market reforms and infrastructure investment, to the extent that they increase productivity, are the strongest sources of growth spillovers. Finally, labor market reforms which increase the domestic supply of labor do not generate productivity spillovers; however, they can create positive welfare spillovers, if consumers in other countries benefit from cheaper imported goods.

World GDP Level 2018: Upside Scenario
(percent; deviation from baseline)



Source: IMF staff calculations.

15. Even more importantly, cooperative action can reduce the risk of renewed global turmoil. Cooperative policies that raise growth, reduce global external imbalances and the internal distortions that give rise to them, would improve market confidence and reduce risks. Demonstrated commitment to these joint actions would send a strong signal to market participants about the importance that global policymakers attach to the objective of reducing global risks through policy cooperation.

⁶ Productivity spillovers are higher for countries closer to the technological frontier which moves further out under the reform scenario.

Box 1. Policy Assumptions for the Reform Scenario

The reform scenario consists of six layers: (i) fiscal consolidation over the medium term; (ii) rebalancing reforms in China, Germany, and the United States; (iii) product market reforms; (iv) labor participation reforms; (v) other labor market reforms; and (vi) infrastructure investment. Specifically:

Fiscal Reforms. Fiscal consolidation is based on the country desks' estimate of the gap between the 2013 cyclically-adjusted fiscal balance and the desirable future fiscal balance. An attempt is made to ensure consistency with the desirable fiscal balances underlying the External Balance Assessment and the External Sector Report, though these numbers are still subject to revisions. The fiscal consolidation is phased in progressively over 5 years, except for Japan where it is phased in over 10 years.

Rebalancing Reforms. In China, additional reforms to education, healthcare, and pensions raise public transfers by 1.1 percent of GDP and reduce private savings by 1 percent of GDP over 5 years. Financial sector reforms help better pricing of risks, raising the cost of capital to tradable sector firms by 50 basis points after 5 years. The financial sector reforms also result in a shift to higher quality investment, implying a reduction in the private capital depreciation rate of 50 basis points after 5 years. These policies are accompanied by a fully flexible exchange rate. In Germany, reforms are implemented to increase economy-wide productivity by 1 percent after 5 years. In the United States, reforms encourage an increase in private saving by about $\frac{1}{2}$ percent of GDP after 5 years.

Labor and Product Market Reforms. Three types of structural reforms are considered: product market reforms, labor participation reforms and job-friendly labor market reforms. *Product market reforms* (PMR) and *labor market reforms* to ease overly restrictive employment protection legislation (EPL) boost productivity. Reforms that increase the labor force participation rate include increases in childcare spending (CHILDC) and pension reforms (PENTOT). Finally, *other labor market policies* cover active labor market policies (ALMP) and in some cases reductions in unemployment benefit average replacement rates (ARR). The magnitude of reforms is based on OECD inputs and scaled by IMF country desk priorities. For instance, PMR reform is defined as a 20 per cent reduction in the degree of regulation in services industries, based on the average decline observed in OECD countries that have made reforms over the past 10 years. Similarly, EPL reform corresponds to a 20 per cent reduction in the strictness of employment protection legislation based on the magnitude of observed reforms in OECD countries over the past 10 years. If the reform is ranked as first priority by desks, the full OECD shock is implemented. For second priority reforms, 75% of the OECD shock is implemented, and if the reform is ranked as low priority, 50% of the OECD shock is implemented. Product market reforms are phased in gradually and the productivity shocks become fully credible in 2018 (see Table 1 below for impact in 2018).

Infrastructure Investment. The reform scenario includes a permanent increase in public investment of $\frac{1}{2}$ percentage point of baseline GDP in the United States, Germany, Brazil, India, and Indonesia. The increase takes place gradually over two years and is financed by a reduction in general transfers.

Table 1. Impact of Reforms

	Impact on Productivity (in percent)				Impact on Participation rate (in percentage points)				Impact on Unemployment rate (-) (in percentage points)			
	PMR	Priority rank	EPL	Priority rank	CHILDC	Priority rank	PENTOT	Priority rank	ALMP	Priority rank	ARR	Priority rank
Argentina	1.22	1.0	...	...	...	...	...	...	...	...	...	...
Australia	0.54	3.0	0.03	3	0.24	3	0.06	3	...	3	...	3
Brazil	1.34	1.0	0.12	1	...	...	...	...	...	...	...	...
Canada	1.03	2.0	0.03	3	0.68	3	0.05	3	0.22	1	...	3
China	1.48	2.5	0.13	3	0.67	2	...	3	...	3	...	3
France	1.16	1.0	0.10	1	0.12	3	0.51	1	0.08	1	0.59	1
Germany	0.69	2.0	0.07	3	0.52	1	0.12	1	0.05	3	0.17	3
India	1.77	1.0	0.13	1	0.67	2	...	3	0.21	1	...	3
Indonesia	1.79	1.0	0.15	1	...	3	0.07	2	0.21	1	...	...
Italy	1.25	1.0	0.10	2	0.23	2	0.05	3	0.16	1	0.20	3
Japan	1.10	1.0	0.10	1	0.56	1	0.27	1	...	1	...	3
Korea	0.85	1.0	0.16	1	0.89	1	0.06	2	0.21	1	...	3
Mexico	0.89	3.0	0.06	3	...	3	...	3	...	3	...	3
Russia	1.44	1.0	0.10	2	0.67	2	0.09	1	0.21	1	...	2
Saudi Arabia	0.64	3.0	...	2	0.67	2	...	3	0.16	2	...	...
South Africa	2.33	1.0	0.12	1	...	3	...	3	0.21	1	...	3
Turkey	2.00	1.5	0.18	1	0.67	2	0.04	2	...	3	...	3
United Kingdom	0.50	3.0	0.03	3	...	3	0.07	3	0.15	2	...	3
United States	0.41	3.0	...	3	0.43	2	0.07	2	0.25	1	...	3
Other Euro Area	0.30	1.0	0.04	...	0.15	...	0.04	...	0.06	...	0.17	...
Other European Union	...	...	...	...	...	...	...	...	...	...	...	...

Source: IMF staff calculations, with inputs from the OECD.