



**STRICTLY CONFIDENTIAL**

## GROUP OF TWENTY

### GLOBAL PROSPECTS AND POLICY CHALLENGES

G-20 Finance Ministers and Central Bank Governors' Meetings  
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Prepared by Staff of the

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

## EXECUTIVE SUMMARY

**“Brexit” marks the materialization of an important downside risk to global growth.** The global outlook, set for a small upward revision prior to the U.K.’s referendum, has been revised downward modestly for 2016 and 2017, reflecting the expected macroeconomic consequences of a sizable increase in economic, political, and institutional uncertainty. But with “Brexit” still very much unfolding, more negative outcomes are a distinct possibility.

**This setback comes against a background of already weak underlying growth caused by a combination of persistent and interlinked forces.** These include: (i) the pre-crisis trend of slowing total factor productivity growth, compounded by population aging; (ii) the crisis legacy of debt overhang in advanced economies and rising corporate leverage and pockets of excess capacity in emerging economies; and (iii) the scarring of productive capacity, following the crisis, caused by persistent low investment and high unemployment. Not only is growth low, in many cases it has also been shared unequally. This can create more challenges by undermining support for reform as well as for openness to trade and migration.

**Downside risks have become more salient, pointing to the critical importance of strong policies.** Failure to achieve clarity about the future relationship between the U.K. and the European Union (E.U.) would add to uncertainty and weigh on confidence. This short-term risk could be severely heightened by a lack of decisive action to address the weakness in underlying growth. And, if not managed well, China’s transition could further raise volatility around the baseline path of the global economy. Against this background, insufficient rebuilding of policy buffers and tackling of corporate and financial weaknesses in emerging economies would leave them highly vulnerable to shocks.

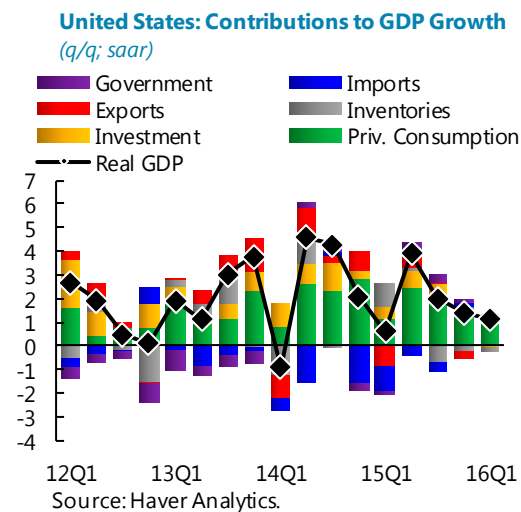
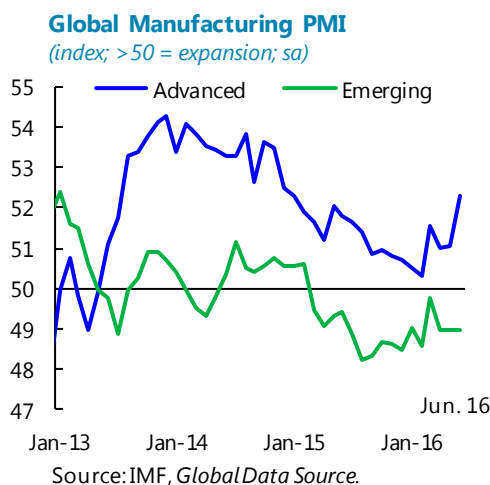
**A broad-based policy effort is urgent to contain risk and reinvigorate growth both in the short and the longer term,** including:

- *Reducing uncertainty around “Brexit” and its repercussions.* A smooth and predictable transition to a new relationship between the U.K. and E.U. that as much as possible preserves gains from trade is essential. While uncertainty about the outcome of negotiations remains, policymakers should stand ready to act decisively should financial market turbulence threaten the global outlook.
- *Implementing effective macroeconomic support.* Where demand is still falling short, this requires a broad-based approach that exploits policy synergies by combining structural and balance sheet reforms with continued monetary support and growth-friendly fiscal policies—including using available fiscal space, anchored by strong policy frameworks. Stronger domestic demand support, especially in creditor countries with policy space, would also help reduce external imbalances.
- *Addressing debt overhangs.* In many advanced economies, balance sheet repair remains critical to lift investment, contain vulnerabilities, and improve monetary transmission. Addressing corporate debt and other financial risks is also important in a number of emerging economies, and a key ingredient of China’s transition to a new growth model. In some cases, this might require the use of public sector resources.
- *Lifting long-term growth and making it more inclusive.* The G-20 can lead by encouraging strong implementation of the G-20 growth strategies, and prioritizing structural reforms that have a high short-term growth impact.
- *Strengthening multilateral action.* Reinvigorating trade integration remains crucial to boost global growth, as is making sure that the gains from trade are shared widely. And it remains important to strengthen global safety nets, including by monitoring geopolitical spillovers that could threaten the global recovery.

## RECENT DEVELOPMENTS, OUTLOOK AND RISKS

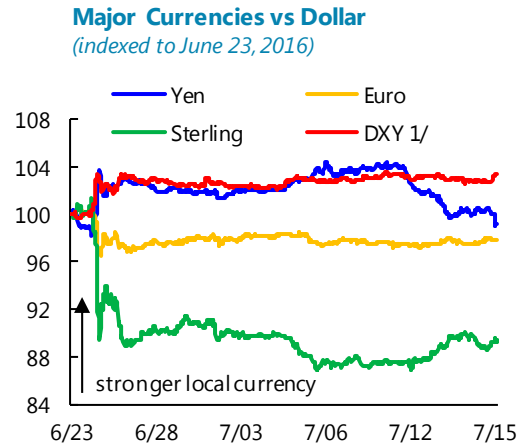
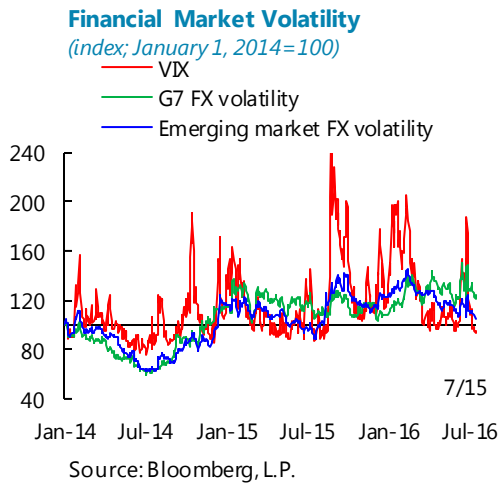
Global growth remains weak and fragile, and “Brexit” marks the materialization of an important downside risk for the world economy. Growth is already being held back by a combination of persistent, interlinked forces—including unfavorable pre-crisis productivity trends, the legacy of high private and sovereign debt, and hysteresis problems. It could be even lower if the current increases in economic and political uncertainty continue and the attendant financial market repercussions take a toll on confidence. This possibility adds to downside risks from insufficient policy efforts to raise the trajectory of global growth, while managing emerging market transitions and vulnerabilities. Strong global growth will not return without decisive policy action.

1. **Even before the “Brexit” shock, global growth had been lackluster.** The euro area started the year with stronger-than-expected momentum, helped by higher investment. However, the level of underlying growth remained weak, and inflation—now projected at just 0.2 percent in 2016—was still uncomfortably low. At the same time, first quarter GDP growth in the *United States*, at 1.1 percent, *saar*, was about half of what had been predicted, though a rebound is foreseen in the second quarter. In *Japan*, the preliminary estimates of first quarter growth suggested a modest rebound, but it remained very weak and headline inflation turned negative again. And, while *emerging economies* data pointed to somewhat better outcomes in the first part of the year, much of it was driven by renewed policy support in China—support that comes with further credit expansion and even higher corporate debt. *Commodity prices* have risen recently but remain low overall and continue to strain large economies such as Brazil, Russia, and Saudi Arabia.

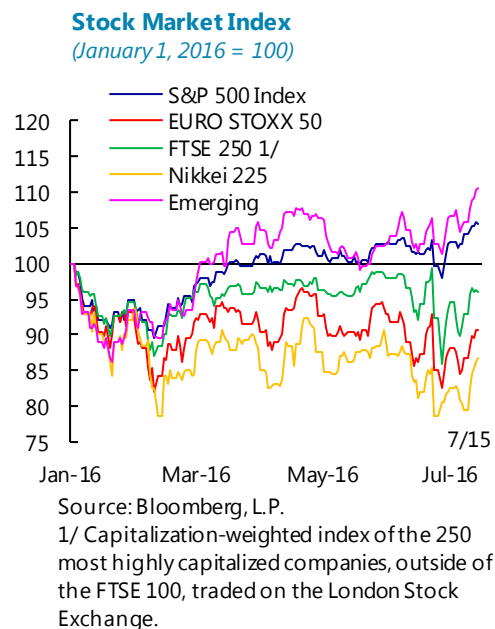
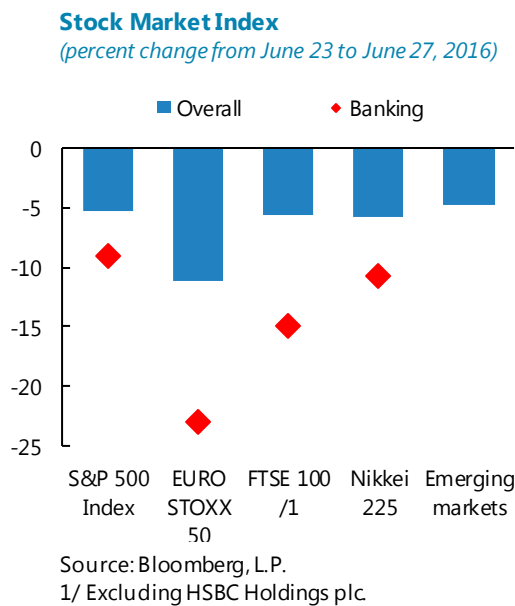


2. **Financial volatility increased following the “Brexit” vote.** Financial and oil markets had started recovering around mid-February, together with a modest recovery in capital flows to emerging markets in the first quarter. Following the British referendum, however, financial markets reacted with a strong global flight from risk, forcing particularly sharp price declines in equities across the world, especially for European banks, and declining yields on safe assets. The pound plummeted while the

yen and the U.S. dollar strengthened on safe haven flows. These adjustments reflected a downgrade to the growth outlook and uncertainty about the terms of the U.K.'s exit from the European Union. While the initial financial market reaction was severe, it was generally orderly. Since then, markets have stabilized and broad equity measures have recovered. However, financial sector stocks remain significantly lower than before the "Brexit" referendum, especially in Europe, and currency shifts continue.



1/ DXY index indicates the general international value of the dollar by averaging the exchange rates between the USD and major world currencies.



3. **These developments have added to the weakness of the outlook.** Prior to the "Brexit" shock, the world economy seemed primed for a small improvement, reflecting primarily the upside surprises in first quarter growth in the euro area and Japan, and in emerging economies due to policy support in China and improved confidence and terms of trade in Brazil and Russia. As a result of the

outcome of the U.K. vote, however, the global outlook for 2016–2017 has been revised downwards modestly, reflecting the expected macroeconomic consequences of a substantial increase in economic, political, and institutional uncertainty, especially in advanced European economies. The July 2016 update of the World Economic Outlook (WEO) foresees growth at 3.1 percent in 2016 and 3.4 percent in 2017—lower by 0.1 percentage points than in the April projections in both years.<sup>1</sup> The modest downward revisions reflect benign assumptions of a gradual reduction in uncertainty going forward, with arrangements between the E.U. and the U.K. avoiding a large increase in economic barriers, no major financial disruption, and limited political fallout from the referendum. More negative outcomes are a distinct possibility.

4. **In advanced economies, the recovery will continue to be modest**, reflecting the continuing weakness in underlying growth and persistent uncertainty related to the outcome of the U.K. referendum. *U.S.* growth is forecast to be 2.2 percent in 2016 and 2.5 percent in 2017—down by 0.2 percentage points in 2016 relative to the April WEO, reflecting further dollar appreciation and weaker global demand, and subdued non-residential investment. In the *euro area*, activity is expected to grow at 1.6 percent and 1.4 percent respectively in 2016 and 2017, as support from low oil prices, the ECB policies and a broadly neutral fiscal stance partly offset the immediate impact of uncertainty and weak confidence related to spillovers from “Brexit.” Delays in tackling legacy issues in the banking sector pose downside risks to the forecast. In the *U.K.*, the large negative demand shock and heightened uncertainty will lead to a significant slowdown. Growth in *Japan* is expected to remain weak at 0.3 percent this year and 0.1 percent next year, reflecting anemic consumption growth, lackluster investment, and the effects of the appreciating yen on net exports. There is, however, upside risk to this forecast from fiscal support expected to be provided by a supplementary budget for 2017.

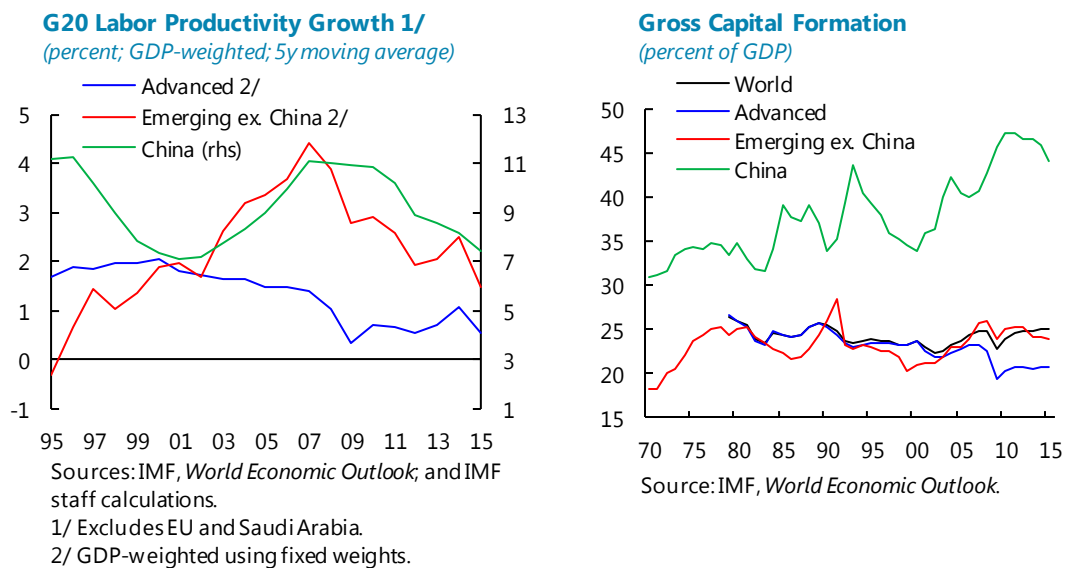
5. **In emerging economies, growth prospects remain muted in historical perspective**, due to the slowdown and rebalancing in China, low commodity prices, and distress in some large emerging market economies. In *China*, the government again resorted to boosting credit and infrastructure spending, supporting near-term growth but further raising vulnerabilities. As a result, the economy is expected to continue to grow strongly this year, at 6.6 percent, exceeding the IMF’s recommended range of 6–6½ percent, before slowing to 6.2 percent in 2017. *India’s* economy is on a recovery path, helped by lower oil prices, positive policy actions and improved confidence. Growth is projected at 7.4 percent in both FY2016/17 and FY2017/18. But headwinds from weaknesses in India’s corporate and bank balance sheets, a decelerating pace of reforms, and sluggish exports will weigh on growth. Finally, conditions in *Brazil* and *Russia* are starting to improve gradually, with a return to positive growth expected for 2017.

6. **A number of persistent and interlinked problems explains the disappointing underlying growth performance.** There are indications that productivity growth in advanced economies already weakened before the global financial crisis. However, the crisis and the consequent sluggish global recovery have added further headwinds, including high levels of (first) private and (then) sovereign debt, chronic investment deficiency, and skill erosion from prolonged high levels of unemployment,

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<sup>1</sup> IMF, *World Economic Outlook* July 2016 Update.

with demographics adding further downward pressure. All these forces, and negative feedback loops between them, are reflected in stubbornly weak investment, which has been the Achilles heel of the recovery. More specifically, the factors at work include:



- Productivity trends:** Empirical evidence suggests that potential growth in advanced economies had started to decline before the crisis, and, along with labor productivity, total factor productivity has been increasing at only modest rates across all major advanced economies. In part this may have reflected the fading impact of the ICT revolution. For example, G-20 advanced economies' average labor productivity growth fell from around 1.8 percent for 1990–99 to just below 1 percent for 2010–15. Moreover, the weakness of total factor productivity growth is compounded by the slowdown (or even decline) in labor input linked to population aging. In emerging markets, potential growth has suffered in the aftermath of the crisis on account of slowing total factor productivity growth, partly due to infrastructure bottlenecks.
- Crisis legacies:** In a number of euro area countries, impaired banks' balance sheets and the need to reduce high levels of debt—public, corporate, or household—continue to weigh on demand and growth. In emerging markets, going forward, increased private sector debt levels could have similar effects. And excess capacity in some sectors could cloud the outlook.
- Post-crisis problems:** An extended period of low growth (such as in the euro area and Japan) reflecting persistently weak private demand can turn into lasting stagnation when the scarring of productive capacity from low investment and employment reduces potential growth. This comes at a time when in key advanced economies, interest rates even at longer maturities have already fallen to very low, or even negative levels.
- Negative feedback loops:** Expectations of low growth lead to weak investment which, in turn, feeds even lower growth—both in the short and (via the scarring or hysteresis effects just described) in the longer term. This feedback loop can be reinforced by high levels of debt, as the need to deleverage will reduce demand and growth, which will ultimately slow the reduction of debt. In

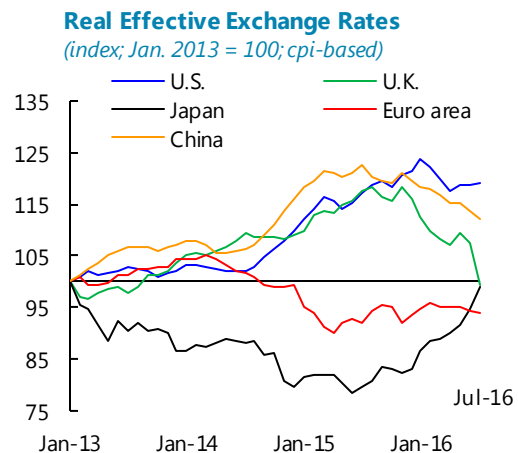
the euro area and Japan, these impediments could be compounded further by protracted low inflation.

7. **The fact that income is not only growing more slowly but is also shared less equally creates additional challenges.** Measures of within-country income inequality, such as Gini coefficients and the income shares of top earners, have been on the rise since the early 1980s. At the same time, the share of produced income that accrues to workers has been on a declining trend in many advanced and emerging economies. This is a potentially significant development in a slow growth context when overall income might not rise fast enough to offset the declining labor income share, resulting in weakly growing or stagnating incomes for many. This dynamic opens the door to another negative feedback loop in which disappointing income growth can reduce the political support for certain necessary structural reforms or foster inward-looking policies on trade and migration—which will further diminish the outlook for long-term growth. In addition, inequality might impact short-term demand, as the propensity to consume out of income tends to be higher for the less well-off.

8. **Reflecting, in part, the different growth paths of the larger advanced economies, external imbalances have widened moderately again.**

In 2015, while the U.S. current account deficit increased, amid the relatively stronger U.S. outlook and the associated steep appreciation of the dollar, surpluses in Japan and the euro area grew, reflecting generally more subdued domestic demand and currency depreciation. In the United States, the gains from better commodity terms of trade were more than offset by a decline in net exports, further widening the deficit. In the euro area, while net exports worsened in real terms, the positive terms-of-trade shock led to an improvement in the current account. For 2015, the U.S. external position was

“moderately weaker” than fundamentals while Japan’s external position has moved to “moderately stronger” than fundamentals.<sup>2</sup> There was little adjustment among the larger surplus countries (e.g., Germany, Korea), whose external positions remained “substantially stronger” than fundamentals. The widening imbalances in systemic economies during 2015 were largely offset by falling surpluses in large oil exporters as well as smaller deficits in vulnerable emerging markets and some euro area countries. Although market conditions remain fluid following the U.K. referendum, currency movements since early 2016 helped partially to reverse some of the trends observed last year—with sterling weakening, and the yen strengthening. The current account implications remain uncertain, and will likely depend on how the U.K.’s transition out of the E.U. is managed and on what new arrangements are adopted.



Source: IMF, GlobalData Source.

<sup>2</sup> IMF, 2016 External Sector Report.

9. **The lack of progress on current accounts rebalancing is likely to lead to a further widening of stock imbalances and associated risks.** Under current policies, this would likely lead to a further widening of imbalances in net foreign asset positions, with larger debtor positions (for instance, in the United States), rising creditor positions (in Japan and Germany), and still large negative net international investment positions (in countries like Spain and Turkey). Risks from large negative exposures are well-known, but ever-increasing creditor positions could also raise concerns, in particular valuation and default risks of holding assets from increasingly indebted countries.

10. **Downside risks to the global growth outlook have increased significantly following the “Brexit” vote.** An important risk at the current juncture is an unnecessarily long period of political and economic uncertainty surrounding the U.K.’s exit from the European Union and the deterioration of financial conditions in some countries. This outcome could have severe macroeconomic repercussions, with advanced economies (particularly Europe) likely to be hit harder, including through the intensification of bank distress in vulnerable economies. Heightened uncertainty also makes it more likely that unforeseen negative shocks translate into global disruptions. That possibility adds to persistent downside risks inextricably linked to the poor longer-term prospects for the global economy. Specifically:

- Policymakers may not do enough to prop up *growth in the short and long term*. This could extend the already protracted period of stubbornly weak growth in advanced economies (e.g., in the euro area), which might be reinforced by negative feedback loops, including a surge in inward-looking policies.
- The continuing *economic transition in China* could add volatility around the baseline—for example because of an abrupt adjustment if unsustainable policies are maintained for too long, or owing to financial market uncertainties surrounding policy intentions.
- There is also a risk that emerging economies do not reduce *vulnerabilities* and rebuild buffers sufficiently before capital flow reversals materialize. Corporate leverage has increased significantly in emerging economies (e.g., Brazil, India, and Turkey), in domestic and foreign currency, against the background of ample global liquidity. A strong pullback of capital flows to emerging economies could tighten financial conditions and weaken their currencies, with the possibility of significant adverse corporate balance sheet effects and funding challenges, and significant repercussions for banking systems.
- Finally, *risks of noneconomic origin* also remain salient. Political divisions within advanced economies may hamper efforts to tackle important challenges, such as the long-standing structural problems and the refugee problem; and a shift toward protectionist policies is a distinct threat. Other ongoing concerns include geopolitical tensions, domestic armed strife, terrorism, climate related factors (e.g., the drought in East and Southern Africa), and diseases such as the Zika virus afflicting the Latin America and Caribbean region.



## AN URGENT AND BROAD-BASED POLICY EFFORT

*To lift growth and counter risks, G-20 policymakers will need to follow a broad-based approach that simultaneously provides better-balanced demand support where needed, addresses private sector balance sheet issues, and implements structural reforms. In emerging economies, the priority should be to rebuild policy buffers and implement sustainable macro policies.*

### A MORE POTENT MACRO-ECONOMIC POLICY MIX

11. **Reducing uncertainties surrounding “Brexit” would help reduce the risk of a protracted tightening of financial conditions.** It will be important to have clarity on the process and objectives that will guide discussions between the U.K. and the E.U. Of primary importance is a smooth and predictable transition to a new set of post-exit trading and financial relationships that as much as possible preserves gains from trade. Where required and feasible, more supportive macroeconomic policies can reduce the short-term impact on growth. Policymakers should stand ready to act more aggressively should the impact of financial market turbulence and higher uncertainty threaten to materially weaken the global outlook. In the euro area, policymakers should work together to demonstrate their continuing commitment to the E.U. and the monetary union including by agreeing on a common policy response to the refugee surge and securing external borders. Over the medium run, priority should be given to completing the banking union, strengthening the single market, and moving closer to a fiscal union.

12. **Short-term demand support still has an important part to play in advanced economies, but needs greater emphasis on growth-friendly fiscal policies.** In a majority of advanced countries, output gaps remain negative, weak labor markets threaten to permanently scar especially the young in the workforce, and inflation is low and far off target. Where monetary policy is becoming overburdened, domestic policy coordination can help to make macroeconomic support effective. This requires a broad-based approach combining all available policy tools and strong policy frameworks, which anchor fiscal and monetary policy in the long run while allowing for effective demand management in the short run. Specifically:

- *Monetary policy.* Central banks should continue to use all available instruments to raise inflation, including negative interest rates, where appropriate, while carefully monitoring the potential impact on banks, pension funds and insurance companies as well as market functioning. In the United States, Federal Reserve policy should remain data dependent. There is a clear case for the Fed to proceed along a very gradual upward path for the fed funds rate, conscious of global disinflationary trends and confirming along the way that wage and price inflation are indeed maintaining their steady upward momentum.
- *Fiscal policy.* Where monetary policy space is narrowing and there is fiscal space, fiscal policy can help support demand and close output gaps—including through measures that will strengthen growth also in the medium and long term (e.g., Canada, Korea) or, where necessary, facilitate balance sheet repair. In most countries, it will be important to adjust expenditure priorities to

finance reforms that increase potential output (e.g., Germany). For the euro area, the use of centralized investment funds to support infrastructure investment in countries without fiscal space would be appropriate. A coordinated use of fiscal space would be beneficial should the global outlook weaken materially.

- *Income policies.* Such policies can play a useful role in some countries—for example, in Japan, ambitious policies such as incentivizing profitable companies to raise wages through a “comply or explain” mechanism and raising administratively controlled wages are a priority to spur wage-price dynamics and raise inflation. In the United States, combining a further expansion of the Earned Income Tax Credit with a raise in the federal minimum wage, as well as upgrading social programs for the non-working poor will help reduce poverty. A more progressive personal income tax could help mitigate income polarization and assist the working poor.
- *Policy frameworks.* Strong fiscal frameworks that ensure sustainability over the longer term, coupled with fiscal reforms, help increase or safeguard policy space in the short run (e.g., United States, Japan). In the United States, achieving a sustained downward medium-term path for public debt would require a comprehensive reform of the tax system, pension reform, and further healthcare cost containment. In Japan, the pre-announcement of a gradual path of consumption tax hikes is needed. In the euro area, the priority is to make full use of the flexibility within existing rules. In the medium term, stricter enforcement and simplifying the Stability and Growth Pact will make it more effective. There is also a strong case for expanding centralized fiscal support.

13. **To avoid the risk of a hard landing and lower their exposure to capital flow reversals, emerging economies should rebuild policy buffers.** In *China*, macro policies need to be adjusted for a moderate slowdown, allowing growth to settle at a sustainable level. This requires slowing credit expansion and switching from off-budget investment to more on-budget, pro-consumption measures. Strengthening transparency, especially in communicating policy objectives and enhancing data quality, will be key to minimize spillovers and financial volatility. In *Brazil*, the room for monetary policy easing is limited by underlying inflationary pressures and fiscal consolidation should continue to reduce large deficits. The new government should complement the proposed cap on federal noninterest spending with tax measures and address spending rigidities and unsustainable mandates, including in the pension system. The quality of fiscal consolidation in *India* should be improved through a comprehensive tax reform (such as introducing the goods and services tax and improving tax administration) and measures to further reduce subsidies. With shrinking fiscal buffers, many *commodity exporters* need to develop new growth models and tackle fiscal adjustment, including through reduced but more efficient public expenditures, stronger fiscal frameworks, and mobilizing new sources of revenues. Exchange rate flexibility can usefully cushion the impact of adverse external shocks, provided that the effects of currency depreciations on balance sheets and domestic inflation rates are contained. Even as vulnerabilities are addressed, emerging economies can continue to be a strong locomotive of global economic and trade growth through well-sequenced structural reforms that provide near-term demand support.

## ADDRESSING THE DEBT OVERHANG

14. **Tackling quickly and decisively remaining financial sector vulnerabilities is key to ensure resilience in periods of uncertainty and to lift investment.** This is particularly relevant in many advanced economies, and especially in Europe. In the aftermath of “Brexit,” major European banks have seen large losses in their equity values, probably reflecting the continent’s still vulnerable banking systems. Bank balance sheet repair has been slow and high levels of nonperforming loans continue to undermine bank profitability and constrain new lending in many countries in Europe’s periphery. Many European countries also suffer from “overbanking,” which points to a need for further consolidation, restructuring, or the exit of nonviable banks. A comprehensive approach to accelerating the resolution of nonperforming loans (NPLs) is needed to help raise bank profitability, stimulate lending, and facilitate consolidation. It should include: stricter supervision, with more conservative provisioning and collateral valuation, capital surcharges, and aggressive time-bound NPL disposal targets; stronger and harmonized household and corporate insolvency frameworks, including shorter court procedures and out-of-court arrangements; and development of distressed debt markets to facilitate NPL disposals. In some cases, this might require the use of public sector resources.

15. **In China, the transition to a more sustainable growth requires addressing the corporate debt problem while improving resource allocation and guarding against financial risks.** Credit-fueled growth has resulted in a substantial increase of the corporate debt-to-GDP ratio by about 50 percentage points after the global financial crisis, while corporate fundamentals, such as debt-servicing capacity and profits are weakening against a backdrop of excess capacity, moderating domestic demand, weak external demand, and declining producer prices. A comprehensive plan and concrete action that entail restructuring or resolving weak firms are needed, requiring banks to recognize proactively and manage impaired assets, hardening budget constraints, facilitating market entry in services (such as telecom, utilities, and health care), and providing government assistance to handle costs of structural unemployment and worker dislocation. Actions are also required to guard against financial risks by boosting bank buffers, reining in shadow bank/product risks, dampening pockets of excessive housing price growth, and improving the supervisory framework.

16. **More generally, emerging economies will have to address corporate and financial vulnerabilities in preparation for an eventual rise in interest rates in advanced economies.** The strong increase in corporate debt of nonfinancial firms across major emerging market economies and associated rising foreign currency exposures raise concerns because historically, many financial crises in emerging markets have been preceded by rapid leverage growth, which made these economies highly vulnerable to a rise in interest rates, dollar appreciation, and an increase in global risk aversion. It is critical to address possible vulnerabilities now. Required measures include monitoring vulnerable and systemically important firms, as well as banks and other sectors closely linked to them, and taking action where needed, including—where appropriate and available—the use of public resources. Policymakers should also limit a further buildup of foreign currency balance sheet exposures and contain excessive increases in corporate leverage, through the use of macro- and micro-prudential policies such as, for instance, higher capital requirements for foreign exchange exposures and caps on the share of such exposures on banks’ balance sheets. Finally, corporate insolvency regimes need

to be strengthened in preparation for a higher future incidence of corporate failures as borrowing costs normalize.

## STRENGTHENING LONG-TERM GROWTH

17. **Given the challenges to long-term growth, the G-20 needs to step up its push for structural reforms.** This year, under the Chinese presidency, the G-20 has enhanced its focus on structural reforms, by identifying critical reform areas and elaborating guiding principles. Countries are now working to update their growth strategies ahead of the Hangzhou Summit in September 2016. While reaching the G-20's original goal of increasing GDP by 2.1 percent by 2018 will be difficult, enhanced implementation of countries' reform commitments is essential to support near-term growth and increase potential over the longer term. Where possible, measures should also be taken to address any adverse impacts such reforms may have on inclusiveness.

18. **Recent IMF work suggests that structural reforms are most effective when carefully prioritized and sequenced, based on each country's position in the business cycle and its policy space** (see Annex). Research on advanced economies shows that, while product market reforms tend to raise investment in the short as well as the medium term, the short-term impact of certain labor market reforms varies with cyclical conditions. For example, reductions in labor tax wedges and increases in public spending on active labor market policies have larger effects during periods of weak demand, in part because they usually entail some degree of fiscal stimulus. In contrast, reforms to employment protection arrangements and unemployment benefit systems, where they are excessive, have positive effects in good times but can exacerbate conditions during periods of slack. In some cases, structural reforms particularly critical for medium-term growth will have to be implemented as soon as feasible.

19. **Reforms in advanced economies can boost labor force participation and productivity, while making growth more inclusive.** For instance:

- In the *United States*, expanding infrastructure investment and addressing the skills gap through better education and training would bolster productivity growth. At the same time, combining a further expansion of the Earned Income Tax Credit with a raise in the federal minimum wage, as well as an upgrading of social programs for the non-working poor would enhance the inclusiveness of growth. Together with specific trade-related programs, many of these policies can also help to ease adjustment to more open international trade.
- The *euro area* should prioritize product and labor market reforms, especially those that support near-term demand, including reducing business entry barriers in the retail and professional services sectors, improving public administration and insolvency regimes, integrating women, refugees, long-term unemployed and older workers into the labor force, and shrinking the labor tax wedge. In addition, reforms that complete the single market in services, energy, digital commerce and transport should be implemented as they would also promote infrastructure investment.

- In *Japan*, easing product market regulations will boost economic activity in the short-term. Harmonizing job protection will enhance long-term productivity growth and reduce inequality. Fostering the labor force participation of women and foreigners will help to address the demographic overhang.

20. **Emerging economies should focus on efficient public investment, as well as product and labor market reforms to improve their business environment.** For example, *China* should pursue its plans to liberalize the economy further, while disentangling the still-pervasive web of market distortions. In particular, bolder reforms of state-owned enterprises (SOE), such as imposing hard budget constraints and opening up the SOE-dominated services sector to competition, are needed. In *India*, further steps to relax long-standing supply bottlenecks (especially in the energy, mining, and power sectors) as well as labor market reforms, are crucial to achieving faster and more inclusive growth. In *Brazil*, structural reforms to raise productivity and competitiveness, along with strong implementation of the infrastructure concessions program, are essential for boosting potential growth. In *commodity exporters* more generally, it is important to plan for and invest in new sectors and activities so as to diversify the economy. In many cases, emerging economies' growth could receive an important boost by opening up domestic sectors, including in services, to foreign capital and technology.

21. **The right policies will also help to reduce external imbalances.** More fiscal stimulus in advanced surplus economies with fiscal space, continuing monetary support and growth-friendly fiscal rebalancing in deficit economies, and structural reforms would contribute to external rebalancing. For instance, streamlining service or product sector regulations in surplus economies (e.g., in Japan, Korea, and Germany) will encourage domestic demand and relative price adjustments. Facilitating diversification and expansion of the non-commodity sector (in Brazil, Saudi Arabia and South Africa), and further labor market reform (e.g., in France, Spain, and South Africa) would boost productivity and competitiveness in economies with external positions weaker than fundamentals.

## STRENGTHENING MULTILATERAL ACTION

22. **Reinvigorating trade integration is a key component of the global policy agenda to boost growth.** The pace of new trade policy initiatives at the global level has slowed notably. At the same time, new restrictions imposed since the global financial crisis have begun to weigh on global trade. Trade policy's new frontiers such as services, regulatory cooperation, and policies toward FDI can bolster efficiency and productivity through greater investment, technology transfer, and integration into global value chains. Regulatory and other "frontier" trade matters are mostly negotiated outside the multilateral trading system, in a collection of bilateral and regional agreements that may lack coherence. With governments differing on whether to continue the World Trade Organization (WTO) Doha Round, there is an urgent need to identify a path forward for the global trading system and to begin to integrate into the WTO the many positive steps—e.g., in services, e-commerce, investment, and regulatory cooperation—currently being taken outside it.

23. **In the wake of heightened political risk, policymakers should revive the spirit of multilateralism and globalization,** notably by ensuring the gains from globalization are shared

widely. This means paying urgent attention to enhancing the gains of globalization, limiting its costs, taking mitigating measures for affected workers and making a positive case for integration to skeptical parts of the public. This will require the use of fiscal resources, for example for training, as well as a clear and persuasive communication strategy.

24. **Finally, multilateral efforts must also be made to strengthen the resilience of the global system in the face of shocks.** These include:

- *Further enhancing the global financial safety net.* The risks from possible capital flow reversals would likely have spillovers on the global economy given the high interconnectedness of the international financial system. There is a case to design new financing mechanisms, for instance to address the risks faced by emerging markets with strong fundamentals but high vulnerability to spillovers. The Fund is also preparing a review of countries' experiences in addressing macroeconomic and financial stability risks associated with volatile capital flows, including through macroprudential and capital flow management policies.
- *Completing and implementing the global regulatory reform agenda.* Both advanced economies and emerging market economies should continue to strengthen the regulation and supervision of rapidly expanding financial activities outside the banking system. Further implementation of agreed frameworks to resolve global systemically important banks and progress toward a framework for central counter parties would address key gaps in the foundation of a sound international financial architecture.
- *Addressing possible geopolitical spillovers that could threaten the global recovery.* Refugee flows triggered by geopolitical conflicts, and global epidemics initially affect some countries and regions, but, if left unchecked, could have significant spillover effects on the global economy. In such instances, a coordinated worldwide initiative to provide financial support to countries at the center of such shocks may be warranted.

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

	Year over Year					
			Projections		Deviations	
	2014	2015	(from Jul. 2016)		(from Apr. 2016)	
		2016	2017	2016	2017	
<b>World 1/</b>	<b>3.4</b>	<b>3.1</b>	<b>3.1</b>	<b>3.4</b>	<b>-0.1</b>	<b>-0.1</b>
Advanced economies	1.9	1.9	1.8	1.8	-0.1	-0.2
Euro area	0.9	1.7	1.6	1.4	0.1	-0.2
Emerging market and developing countries 2/	4.6	4.0	4.1	4.6	0.0	0.0
Advanced G-20	1.8	1.9	1.7	1.8	-0.1	-0.1
Emerging G-20	5.2	4.6	4.6	5.0	0.1	0.0
G-20 3/	3.6	3.3	3.3	3.6	0.0	0.0
Argentina 4/	0.5	2.1	-1.5	2.1	-0.5	-0.7
Australia	2.7	2.5	2.8	2.8	0.3	-0.2
Brazil	0.1	-3.8	-3.3	0.5	0.5	0.5
Canada	2.5	1.1	1.4	2.1	-0.1	0.2
China	7.3	6.9	6.6	6.2	0.1	0.0
France	0.6	1.3	1.5	1.2	0.4	-0.1
Germany	1.6	1.5	1.6	1.2	0.1	-0.4
India	7.2	7.6	7.4	7.4	-0.1	-0.1
Indonesia	5.0	4.8	4.9	5.3	0.0	0.0
Italy	-0.3	0.8	0.9	1.0	-0.1	-0.1
Japan	0.0	0.5	0.3	0.1	-0.2	0.2
Korea	3.3	2.6	2.7	3.0	0.0	0.1
Mexico	2.2	2.5	2.5	2.6	0.1	0.0
Russia	0.7	-3.7	-1.2	1.0	0.6	0.2
Saudi Arabia	3.6	3.5	1.2	2.0	0.0	0.1
South Africa	1.6	1.3	0.1	1.0	-0.5	-0.2
Spain 5/	1.4	3.2	2.6	2.1	0.0	-0.2
Turkey	3.0	4.0	3.8	3.2	0.0	-0.2
United Kingdom	3.1	2.2	1.7	1.3	-0.2	-0.9
United States	2.4	2.4	2.2	2.5	-0.2	0.0
European Union	1.6	2.0	1.9	1.6	0.1	-0.3

Sources: IMF, *World Economic Outlook* April 2016; and July 2016 Update.

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 GDP data for Argentina before 2015 reflect official data, while for 2015 the data reflect IMF staff estimates. On February 1, 2013, the IMF issued a declaration of censure, and in June 2015 called on Argentina to implement additional specified actions to address the quality of its official GDP data according to a specified timetable. The new government that took office in December 2015 reviewed the methodology underlying the system of national accounts and released a new GDP series on June 29, 2016. The Managing Director will report to the Executive Board on this issue again by July 15, 2016, and the Executive Board will review the issue in line with IMF procedures at the end of August 2016.

5/ Permanent invitee.

## Annex. Priorities for Structural Reforms in G-20 Countries<sup>3</sup>

*Structural reforms remain a critical element of a broad-based approach to bolster growth. G-20 countries need to step up the implementation of their G-20 growth strategies, and prioritize structural reforms with a high short-term impact on growth. Structural reforms are most effective when they reflect an economy's structural policy gaps, its level of development, its position in the economic cycle, and its available policy space to support reforms.*

**Given the complex interplay of supply and demand policies, the prioritization of structural reforms needs to be based on macroeconomic considerations.** The larger a country's output gap, the more it should prioritize structural reforms that will support growth in the short term *and* the longer term—such as product market deregulation, given their positive pay-off even under weak macroeconomic conditions, and infrastructure investment, given the larger fiscal multipliers in times of economic slack (as well as the lower borrowing costs).

**Macroeconomic support can help make reforms more effective.** Where the short-term effect of reforms depends on the state of the business cycle, such support can enhance their impact. With the scope of *monetary policy* limited in many advanced economies at the zero lower bound, and given currency pressures and financial stability considerations in emerging economies, *growth-friendly fiscal policy* can play an important role. This is particularly important in cases where there are structural reforms that are so critical for medium-term growth that they should be implemented as soon as feasible.

**Where reforms come with fiscal costs but budget constraints are binding, the sequencing of reforms might have to be adjusted** to favor lower- or no-cost measures with positive demand effects of their own, or budget-neutral reform packages. In contrast, where there is fiscal space, available resources should be used to offset any short-term costs of growth-friendly structural reforms. Fiscal space can also be enhanced by the elaboration of medium-term fiscal plans, which can bolster confidence in the long-term objectives of fiscal policy.

**Macroeconomic policy space differs considerably across the G-20.** Within the G-20, some countries (like *Canada* and *Korea*) appear to have a reasonable degree of fiscal space to support structural reforms that increase potential output, based on indicators like public sector financing costs, the profile of public debt, and future financing needs. Other countries (such as *Brazil* and *Italy*) will need to advance fiscal consolidation, targeting to the extent possible growth-friendly adjustment measures, given their relatively high debt burden.

**Some structural reforms may themselves help to generate policy space—though it can depend on underlying economic conditions.** New IMF staff analysis on advanced economies finds that past *product market deregulation* boosted output sufficiently to reduce the debt-to-GDP ratio by about 4 percentage points on average, after five years. While *job protection reforms* were not found to affect the public debt-to-GDP ratio on average, they *increased* it when carried out at times of major slack, and *lowered* it during times of robust growth.

**With nearly all G-20 economies at below-potential output, the IMF is recommending measures that both boost near-term growth and raise potential growth over the long run.**

- **In advanced economies,** these measures include shifting the composition of public spending toward infrastructure investment (e.g., *Australia, Canada, Germany, U.S.*), and promoting product

<sup>3</sup> This annex is a summary of a staff background paper for the G-20 Surveillance Note, "Priorities for Structural Reforms in G-20 Countries."



and labor market, fiscal, and other reforms. Product market deregulation (particularly in services and network industries) is recommended in many countries (*Australia, Canada, Germany, Japan, Korea, Italy*), and especially where policy space is more limited as this will not generate budgetary costs in the short run. Further policy action is required to ensure a successful integration into the labor market of some groups with lower participation rates, such as women, refugees, and older workers (*Canada, Germany, Japan, Korea, U.K., U.S.*) and better match vocational training to market demand (*Canada, U.K., U.S.*). In *Korea*—where fiscal space is available—expanding benefits for non-regular workers and lowering employment protection for regular workers is desirable when paired with fiscal support. A comprehensive skills-based immigration reform would have large effects on labor supply (*U.S.*). On the fiscal side, tax simplification and broadening measures can reduce inefficiencies, raising revenues to finance other high-payoff reforms (e.g., *U.K., U.S.*). Overall social spending reforms (e.g., *France*) and reforming the pension and health systems to contain future aging-related costs (*U.K., U.S.*) would help ensure fiscal sustainability and create space to support other high-payoff reforms. Other reform priorities include, for example, a more ambitious reform of the banking sector and the judiciary system to improve credit flow (*Italy*).

- **Recommendations for emerging market economies** focus on raising public investment efficiency (*India, Saudi Arabia, South Africa*) and product and labor market reforms. They also address trade and FDI impediments, governance of public institutions, and other institutional reforms. Where fiscal space is limited or consolidation is necessary, governments are encouraged to adjust the composition of fiscal policy to make it more growth-friendly. Promoting market entry and competition is highlighted (*China, Saudi Arabia, South Africa*), and in some cases, would give a quick boost to investment and productivity within tighter budgetary constraints particularly if done in conjunction with easing barriers to trade and FDI (*Brazil, India, Indonesia*). Advice on labor market reforms is focused on improving market flexibility (*Indonesia, South Africa*), and reducing skill mismatches through education and vocational training (*Indonesia, Russia, Saudi Arabia, South Africa, Turkey*). Institutional and regulatory reforms can provide foundational support to other reform initiatives. Priorities include strengthening SOE governance (*China and South Africa*) and hardening budget constraints (*China*). Implementing further subsidy and social spending reforms would create policy space to support other supply-side reforms (*Argentina, China, India, Mexico, Russia*). Areas also being emphasized include improving security, the rule of law, and the judiciary system (*Mexico, Turkey, Russia*) and strengthening the frameworks for public-private sector dispute settlement (*Russia*) and contract enforcement (*India, Mexico, Saudi Arabia, South Africa*).
- Some **commodity exporting emerging economies** (*Brazil, Russia, Saudi Arabia, South Africa*) are facing acute challenges, given a steep and protracted decline in commodity prices. These countries are performing significantly below potential and need to rebuild fiscal buffers. Reform strategies advocated by the Fund are targeted at supporting short-term growth and diversification, with more weight put on product market and legal reforms to improve the business climate and private investment; trade and FDI liberalization to help with diversification and ease balance of payments pressures; and financial deepening to facilitate credit flows.
- **As important complements to reforms that bolster growth, IMF recommendations also aim to promote inclusiveness and macroeconomic resilience.** To promote *inclusiveness*, Fund staff recommends a carefully targeted expansion of social spending toward vulnerable groups in *Mexico*, social spending for the elderly poor in *Korea*, and the upgrading of social programs for the nonworking poor in the *United States*. Recommendations to bolster *macrofinancial resilience* include expanding the housing supply (*U.K.*), resolving the corporate debt overhang (*China, Korea*), coordinating a national approach to regulating and supervising life insurers (*U.S.*), and reforming monetary frameworks (*Argentina and China*).