Staff Report on the Multilateral Consultation on Global Imbalances with China, the Euro Area, Japan, Saudi Arabia, and the United States

INTERNATIONAL MONETARY FUND

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Approved by Mark Allen and Michael Deppler

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- Multilateral Consultations are a new tool of multilateral surveillance for the IMF, designed to foster action-oriented debate and policy actions on a problem of systemic or regional importance. The first multilateral consultation focused on facilitating the resolution of global imbalances while sustaining robust global growth. China, the euro area, Japan, Saudi Arabia, and the United States agreed to participate.

- A staff team, comprising Messrs. Deppler and Rajan (heads), Robinson (WHD), Milesi-Ferretti and Faruqee (both RES) held bilateral discussions with participants between July 7 and August 15, 2006. Messrs. Khan and Mansur (MCD), Burton, Dunaway and Citrin (APD), and Singh and Towe (WHD) participated in the individual country legs. Thereafter, the First Deputy Managing Director chaired three meetings of all of the participants between September 2006 and March 2007, in Singapore and in Paris, attended also by Messrs. Deppler, Rajan (first meeting only) and Robinson.

- The participants and Fund staff issued a report on the results of the multilateral consultation, with attachments summarizing the participants' policy progress and plans. The Board was briefed on the key elements on April 9; the report was discussed at the IMFC on April 14 and then released to the public.

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Executive Summary

1. **The first Multilateral Consultation (MC)—a new tool of multilateral surveillance—addressed the issue of resolving global imbalances while maintaining robust global growth**. China, the euro area, Japan, Saudi Arabia, and the United States agreed to participate.

2. **The aim of the MC was to facilitate action-oriented debate and, ultimately, policy actions by participants that could make a significant contribution toward global rebalancing**. To this end, the MC began with bilateral discussions between the staff and each participant, followed by three meetings with senior officials from all participants together, chaired by the First Deputy Managing Director.

3. **The discussions were open and constructive, and contributed to an improved understanding of the issues and of each other's positions**. The participants reaffirmed that reducing global imbalances was a multilateral challenge, and that resolving them in a manner compatible with sustained growth was a shared responsibility. They also stressed that an orderly unwinding of imbalances was in the interest of the world economy more generally, including because sustained imbalances could add to protectionist pressures.

4. **The participants reiterated their support for the IMFC strategy to reduce imbalances through policies that were in each individual countries' own interest as well as desirable from a multilateral perspective, and indicated that their policy plans are consistent with it**. Taken together, these policy plans include substantive steps in all key areas of the IMFC strategy that should significantly reduce imbalances over the medium term.

5. **The key now is implementation**. Since the IMFC, each participant has made some progress toward implementing its policy intentions but much remains to be done. The Fund will be playing an active role in monitoring progress, including through regular reporting on the status of MC policy plans in Article IV consultations with the participants, its multilateral surveillance, and discussions in the IMF Board and in the IMFC.

6. **Overall, the first multilateral consultation helped bring about a better understanding among the participants of the issues and of each others' positions, and culminated with the publication of policy plans by each participant which when implemented could significantly reduce global risks.**

7. **While it is premature to draw general lessons from one experience, the first multilateral consultation suggests that MCs, applied flexibly, are a valuable new instrument for enhancing and deepening Fund surveillance through discussion and cooperation among members on issues of systemic or regional importance that would benefit from a cooperative approach**.

I. The Institutional Context

1. **On June 5, 2006, the Managing Director announced the initiation of the first multilateral consultation (MC) with a focus on addressing global imbalances while maintaining robust global growth**. This announcement embodied a response to two long-running concerns of the international community: the sustained escalation in the size of global imbalances and the need to strengthen the effectiveness of Fund surveillance.

2. **Global imbalances had at the time been widening continuously for some five years, with WEO projections showing little improvement looking forward**. [2] Over this period, Fund Management and staff, as well as the IMF Executive Board, [3] had repeatedly stressed the risks to the global economy stemming from the imbalances, and from early 2004 the IMFC had also begun to set out its views on the policies required to help facilitate an orderly adjustment (the so-called IMFC Strategy—Box 1). Nonetheless, despite widespread agreement with the thrust of the IMFC Strategy, these efforts were widely seen as having had limited practical effect, suggesting the need to develop new avenues for effective action-oriented dialogue.[4]

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[2] In April 2006, WEO projections—based on staff assessments of policy plans at the time, as well as unchanged real effective exchange rates—suggested that the U.S. current account deficit would remain at about 6 ¼ percent of GDP through 2011, leading to a significant build up in U.S. net external liabilities. Correspondingly, projected current account surpluses in oil exporters, emerging Asia, and Japan would lead to a significant accumulation in their net external assets.

[3] For example, the Summing Up to the Executive Board discussion of the World Economic Outlook on March 31, 2006 noted "Of most concern to Executive Directors, however, was the further widening of global imbalances….While noting that financing of the U.S. deficit has not been a problem so far, Directors were of the view that these imbalances pose increasing risks over time to the global economic outlook. Directors generally believed that the probability of a disorderly unwinding of imbalances remained low. However, such an outcome, should it occur, could have sizable negative effects for the global economy and the international financial system. Directors considered that this assessment calls for actions aimed at reducing these vulnerabilities, whose implementation should be facilitated by the current favorable environment."

[4] One such initiative was the organization by the Fund of a Ministerial-level conference on global imbalances on April 21, 2006 (the day before the IMFC meeting), with a preparatory Deputy-level pre-conference on March 10.

BOX 1. THE IMFC STRATEGY

Since April 2004, the IMFC has set out in each Communiqué its views on the measures needed to foster an orderly resolution of global imbalances—the so-called "IMFC Strategy." While the IMFC Strategy has evolved somewhat over time, reflecting the changing nature of the imbalances, in September 2006 the Committee called for:

"...sustained actions to implement the agreed policy strategy to underpin an orderly unwinding of global imbalances. The strategy involves: steps to boost national saving in the United States, including fiscal consolidation; further progress on growth-enhancing reforms in Europe; further structural reforms, including fiscal consolidation, in Japan; reforms to boost domestic demand in emerging Asia, together with greater exchange rate flexibility in a number of surplus countries; and increased spending consistent with absorptive capacity and macroeconomic stability in oil producing countries."

3. **Separately, but interrelatedly, the Fund had been developing its Medium-Term Strategy (MTS),** [5] **a central element of which was to enhance the effectiveness of surveillance**. While this had many aspects, one key proposal—endorsed by the Executive Board when it discussed the implementation of the MTS on April 3, 2006 and then by the IMFC on April 22, 2006—was to establish multilateral consultations (MCs) as a new instrument of Fund surveillance. MCs were designed to bring together a small group of countries relevant to a particular problem of systemic importance to promote a strengthened dialogue and ultimately action to address it. To ensure a free and frank exchange, with an emphasis on policy implementation, it was envisaged that these discussions should involve high-level policy makers and should be informal and confidential in nature.

4. **In initiating the MC, the Managing Director announced that China, the euro area, Japan, Saudi Arabia, and the United States had agreed to participate in the first MC**. Some of these countries/regions were directly a party to the imbalances, through current account deficits or surpluses, and some represented large shares of global output. Between them, they could mitigate vulnerabilities inherent in the present pattern of imbalances and help sustain world growth as demand and savings patterns adjusted. After a series of bilateral and multilateral meetings—see Box 3, Section IV for a description of the process—the MC participants and the IMF staff issued a joint report on April 14, 2007, which was discussed and welcomed by the IMFC, and released publicly.

[5] See The Managing Director's Report on Implementing the Fund's Medium-Term Strategy, IMFC/Doc/13/06/2, paragraph 7.

5. **As foreshadowed by the Managing Director in his initial announcement on the MC, this paper reports to the Fund's Executive Board on the discussions and the outcome of the first MC**. Section II describes the salient features of the economic situation surrounding the MC; Section III provides a report on the policy discussions with the participants and their outcome; Section IV sets out preliminary staff reflections on the MC process itself from the standpoint of its usefulness as an instrument of surveillance; and Section V presents the staff appraisal.

II. The Economic Setting

6. **The discussions took place against the backdrop of a benign global environment**. Global growth remained strong, with staff forecasts revised upwards in both Spring and Fall WEOs in 2006. Downside risks to the outlook, which were seen to be significant at the outset, diminished subsequently, reflecting falling oil prices, limited spillovers from the U.S. housing market, and generally benign financial conditions.

7. **While imbalances were still widening at the time the consultations started, they have since shown some signs of stabilizing, albeit at high levels**. In particular, the U.S. non-oil trade deficit narrowed by ¼ percent of GDP in 2006 (Figure 1), facilitated by some rebalancing of domestic demand—particularly stronger demand growth in Europe and Saudi Arabia and weaker demand growth in the United States—and the lagged effects of past dollar depreciation. Falling crude oil prices also helped reduce imbalances between August 2006 and January 2007, but with prices rebounding since then, the effect has been largely reversed.

8. **Over the past year, the dollar has weakened slightly in real effective terms, and is now around 17 percent more depreciated than at its February 2002 peak**. Developments in other currencies over the past year have also broadly extended earlier trends, with the exceptions of the Chinese renminbi, which has appreciated in real effective terms, and the Japanese yen, which has depreciated significantly over the past 12 months.

Real effective exchange rate changes
(in percent)

	February 2002 May 2006	May 2006 May 2007
China	-13.9	5.9
Euro Area	21.3	2.2
Japan	-7.4	-12.4
Saudi Arabia	-22.4	-1.1
United States	-15.5	-1.3
Emerging Asia	-3.1	4.7
excluding China	5.9	3.8
Oil exporters	-6.3	1.6
GCC	-18.8	-0.8
other oil exp.	3.5	3.2
United Kingdom	3.8	4.5

9. **The U.S. current account deficit has continued to be relatively easily financed,** partly reflecting the size and innovativeness of U.S. financial markets for bonds and structured products. [6] Reflecting a

[6] See the Selected Issues paper for the forthcoming Staff Report on the U.S. Article IV Consultation.

search for higher returns, foreign purchases of corporate and agency bonds have increased in recent years, offsetting a decline in purchases of U.S. Treasuries. Despite large external borrowing, the U.S. net international investment position as a share of GDP has remained broadly unchanged since 2001, reflecting valuation gains from U.S. dollar depreciation and—especially in 2005 and 2006—from domestic returns on overseas equity holdings.

10. **All countries have taken steps in line with the IMFC strategy over the last year (Annex I, Boxes 1-5)**. In particular, the U.S. federal deficit has narrowed; the euro area and Japan have made progress with structural reforms; public investment outlays have risen significantly in Saudi Arabia; and the Chinese renminbi has appreciated by 5 ¾ percent in real effective terms.

11. **As background for the MC, the staff presented various scenarios for an unwinding of global imbalances, using the IMF's Global Economic Model (GEM)**. The three staff scenarios, described in Annex II, were: (i) a purely market-led adjustment scenario, with no additional policy action in any of the major economies; (ii) a disruptive adjustment scenario, characterized by a worldwide decline in demand for U.S. assets and rising protectionist pressure; and (iii) a strengthened policies scenario, assuming—along the lines of the IMFC Strategy—fiscal consolidation in the United States; greater exchange rate flexibility in emerging Asia; growth-enhancing structural reforms in the euro area and Japan; and additional spending by oil exporters.[7]

12. **These staff scenarios highlight that the imbalances will eventually correct, and that implementation of the IMFC strategy would help ensure that this adjustment takes place in an orderly fashion, consistent with maintaining robust global growth**. They also suggest that this adjustment will require changes in both private and public sector behavior; that the necessary rebalancing of demand across regions will need to be accompanied by changes in exchange rates; and that each country/regions' actions would not only be beneficial from a domestic perspective, but could also have significant—and generally positive—spillovers for the rest of the world.

III. Report on the Policy Discussions

13. **The participants welcomed the MC process**, which they saw as a potentially useful vehicle to improve the understanding and analysis of global imbalances, and ultimately to foster action to help resolve them. They stressed, however, that the process could not be rushed, and that it would be essential to avoid generating undue expectations, lest the MC itself become a source of disruption to still-benign financial conditions. For this reason, and also to facilitate free and frank debate, they emphasized the need for the discussions to be

[7] While the model captures many key features of the imbalances and the adjustment process, it is of course only a partial representation of reality. In particular, the financial sector is limited, and does not allow for sterilized foreign exchange intervention, valuation effects from exchange rate or asset price changes, or disruptive effects of sharp movements in exchange rates. The model also does not explicitly incorporate oil prices, although additional spending by oil exporters is captured in one of the scenarios.

completely confidential, and for a very careful communications policy as the process evolved.

14. **The MC began with bilateral visits to the five participants in July and August 2006, followed by three multilateral meetings chaired by the First Deputy Managing Director between September 2006 and March 2007**. During the bilateral visits, the staff sought to get a better understanding of each participant's views on the issues and of their expectations of the process, and made presentations of its background work, as described above. In the multilateral phase, the group sought in its first meeting to establish a common basis for the discussions, drawing on the bilateral discussions. The second meeting focused on preliminary presentations by each participant of their policy intentions in areas relevant to the global imbalances. In the third and final meeting, participants prepared coherent and detailed presentations of their policy intentions, which were discussed in some depth.

15. **During the discussions, the following major themes emerged regarding global imbalances and policy actions**:

- *Global imbalances are a multilateral challenge, and resolving them is a shared responsibility.* Participants noted that global imbalances had multiple causes—some emanating from the private sector and some from the public sector—whose relative importance was difficult to distinguish.[8] Correspondingly, they agreed that an orderly resolution of imbalances—which they stressed was in the interests not just of the participants, but of the world economy more generally—could not be achieved through action on any one front, or by any one country alone.

- *The imbalances were seen as a fundamentally medium-term problem that required medium-term solutions.* There was general agreement that a correction in global imbalances would eventually be necessary, but with the U.S. current account deficit still being relatively easily financed, most saw the immediate risks as low; the greatest concern was that imbalances could add to protectionist pressures, on both the current and capital account. Thus the policy strategy should be gradualist in nature, consistent with and supportive of the necessary adjustment in the private sector, and aiming to build confidence that a credible and consistent strategy to reduce imbalances was being pursued.

- *The objective was not just to reduce imbalances, but to sustain robust global growth.* A reduction in the U.S. current account deficit would likely require a slowdown in U.S. domestic demand growth, which—absent stronger demand elsewhere—would weaken global growth. Therefore, it was critical that measures to boost U.S. national savings be accompanied by measures to strengthen domestic demand and growth

[8] For example, some participants believed that financial factors—such as the attractiveness of U.S. financial markets, the decline in home bias, and the central role of the U.S. dollar in a more globalized financial system—and structural change in the international allocation of production, which were not included in the staff's analytical model, were key factors in explaining imbalances.

elsewhere. These measures would be bolstered by increased exchange rate flexibility in some cases.

- *While there was a need for a joint approach to address imbalances, there was no support for "grand policy coordination".* Participants emphasized that national policies were driven primarily by domestic requirements, although a positive impact on global imbalances was a welcome additional benefit. The direct and indirect spillovers from policy action by others were generally seen as positive, and could facilitate domestic action, primarily through creating a more conducive external environment. However, such spillovers were not considered to be especially large, partly reflecting participants' assessment that the immediate risks from the imbalances were moderate. Consequently, the focus should be on ensuring the broad direction of policies across countries was appropriate, rather than striving for coordinated fine-tuning.

16. **Participants reiterated their support for the IMFC strategy, and indicated that their policy plans—which were discussed in some depth and set out in attachments to the joint report at the time of the IMFC (see Annex I)—were consistent with it**. In particular:

- The *Chinese* authorities indicated that the reduction of external imbalances had been elevated to a major national objective in 2007. In this connection, they are pursuing measures to boost domestic demand—particularly rural consumption; to reform the trade system; accelerate financial sector reform; and gradually increase exchange rate flexibility.

- In the *euro area*, the authorities are pressing ahead with structural reforms across a broad front to strengthen competition and productivity. In product markets, the main planks are the implementation of the Services Directive and the development of more competitive network industries in individual countries. In labor markets, steps are being taken to foster greater labor utilization and productivity and the mobility of labor. Financial market reforms include measures to facilitate mergers and acquisitions, and implementing a range of initiatives aimed at harmonizing and integrating financial markets.

- In *Japan*, the authorities plan to advance structural reform to strengthen competition and enhance flexibility. This included additional steps to enhance labor mobility; facilitate inward foreign direct investment, including through reform of the tax treatment of mergers and acquisitions; broaden the application of deregulation already in force; reform and privatize some government-owned financial institutions; and further advance fiscal consolidation to sustain domestic confidence.

- In *Saudi Arabia*, the authorities intend to continue to increase spending on social and infrastructural investments in key areas, including expanding oil sector capacity. As these investment programs have a high import content, their execution would significantly reduce the current account surplus in the coming years.

- In the *United States*, authorities plan to raise national saving through further fiscal consolidation over the medium term, including the achievement of a balanced unified federal budget by FY2012, accompanied by measures to reform the budget process and slow the rate of growth in health care costs; and measures to support private savings, as well as to enhance energy efficiency, strengthen capital market competitiveness, and ensure the United States remains an attractive environment for foreign investment.

17. **There was agreement that these policies, once implemented, would constitute a significant step towards reducing global imbalances while sustaining economic growth**. While a precise quantification of the proposed measures is difficult, staff estimates suggest that these policies could reduce the U.S. current account deficit by between 1 and 1¾ percent of GDP over the medium term, matched by reductions in surpluses elsewhere (Box 2). The combination of structural reforms and lower global interest rates from U.S. fiscal consolidation would also provide some boost to medium-term global growth.

18. **The participants agreed that a report on the discussions and the details of their policy plans should be provided to the IMFC, and made public (see Annex I)**. The Executive Board was briefed on April 9, 2007 on the results of the process and the main elements of the participants' report, which was still being finalized. The report was circulated to the IMFC and discussed at its breakfast on April 14. The IMFC welcomed the report, noting that the policy plans set out by the participants represented further progress in implementing the strategy that the Committee had previously set out and endorsed. It considered that the experience so far demonstrated that the MC approach has been useful for addressing global issues through discussion and cooperation among members, and that it should prove to be a valuable instrument going forward for enhancing and deepening Fund surveillance. [9] It looked forward to the Executive Board's review of the experience with the process, the conclusions of the first multilateral consultation, and the lessons for the future.

19. **Looking forward, the participants agreed to meet again when developments warrant; the IMF would continue to follow developments through its multilateral and bilateral surveillance**. In the two months since the IMFC meeting, some further progress has been made in implementing the participants' policy plans. In China, the renminbi has appreciated in nominal effective terms since April, and the currency band for daily exchange rate fluctuations against the dollar has been widened from 0.3 percent to 0.5 percent. In the euro area, progress is being made with respect to preparatory work for Target-2 securities and in the implementation of the Code of Conduct for Clearing and Settlement, and the European Commission is working on improving the monitoring of structural reform in the context of the Lisbon Strategy. In Japan, implementation of the reform agenda has included movement on job placement and training and on foreign direct investment. In Saudi Arabia, growth in public expenditures in key areas remains on schedule (and is likely to be higher

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[9] See the Communiqué of the International Monetary and Financial Committee of the Board of Governors of the International Monetary Fund, Press Release No.07/71, April 14, 2007.

than earlier estimates). In the United States, congressional budget resolutions have adopted the administration's balanced-budget objective over the medium term.

BOX 2. HOW WILL THE PARTICIPANTS' POLICY PLANS AFFECT IMBALANCES?

While a precise quantification of the effects of the proposed policy package on global imbalances is difficult, staff estimates based on GEM simulations and other empirical evidence suggest that when fully implemented, the package could reduce the U.S. current account deficit by between 1 and 1 ¾ percent of GDP over the medium term. Surpluses would correspondingly decline in China and Saudi Arabia, as well as in other U.S. trading partners. For the purpose of these calculations, staff assumed financial market reform and an increase in exchange rate flexibility in China,[1] the implementation of growth-enhancing structural reforms in the euro area and Japan, a substantial increase in investment in line with policy plans in Saudi Arabia, and a fiscal adjustment of around 2 percent of GDP (consistent with a balanced federal budget) and measures to stimulate private saving in the United States.

An orderly adjustment in global imbalances, of course, does not depend solely on the participants' policies. In particular:

- *Other countries have an important part to play*. Higher expenditures by other oil exporters, along with greater exchange rate flexibility and higher investment in other parts of emerging Asia could reduce the U.S. current account deficit by a further ¼–½ percent of GDP, matched by reduced surpluses in these regions, assuming a broadly comparable effort to that in MC participants.

- *Private sector adjustment can also be expected to play a key role,* including, as discussed in the baseline scenario in Annex II, through an increase in household savings in the United States and strengthened private domestic demand in surplus countries. While the size of this adjustment could be significant, its pace is very uncertain, not least because it depends on variables which are difficult to forecast—such as developments in house prices in the United States. These uncertainties—as well as other imponderables such as oil prices—reinforce the case for early public policy adjustment, especially since this is also consistent with the domestic interests of the countries concerned.

[1] The Chinese exchange rate was assumed to appreciate in real effective terms broadly in line with current market expectations as embedded in forward rates and Consensus Forecasts.

IV. STAFF REFLECTIONS ON THE MC PROCESS AS A SURVEILLANCE INSTRUMENT

20. **MCs are a new and distinct instrument of surveillance intended to focus on systemically important macroeconomic or financial issues that would benefit from a cooperative approach**.[10] Formally, they are part of the Fund's multilateral surveillance responsibilities, and are not intended to provide oversight over members' observance of their obligations under Article IV, which is the role of bilateral Article IV consultations. MCs are intended to build on and complement bilateral surveillance, focusing less on diagnosing appropriate actions in each country, and more on addressing multilateral issues with the objective of building consensus around policy responses to issues of systemic or regional importance.

21. **An MC's objective of seeking agreement on a joint approach may imply a different role for staff than is the case in an Article IV, which focuses on an assessment of individual members' policies**. In the first MC, the staff sought to facilitate the discussions and provide technical advice; at the end of the process, however, the participants requested that the report presented to the IMFC be joint, with the staff endorsing the approach that had been agreed. Staff consented since the participants had set out significant policy measures consistent with the IMFC strategy, even if not as ambitious as recommended in the WEO and Article IVs. Such decisions are necessarily judgment calls, for subsequent consideration by the Executive Board and, possibly, the IMFC.

22. **Given that the purpose of an MC is to foster a joint approach to the issue at hand, full engagement of the members involved is clearly required**. To that end, the framework for the first MC was based on the following broad principles:

- Voluntary participation by a small number of countries/regions that were possible major contributors to a solution to imbalances;

- Involvement of high-level policymakers, to ensure an efficient and effective process, focusing on the policy actions that can be implemented;

- High levels of informality and confidentiality so that country representatives could talk freely and frankly to one another;

- Appropriate involvement of, and reporting to, the Executive Board and the IMFC to enhance legitimacy, seek the views of the broader international community, and authorize suitable follow up by the Fund in both multilateral and Article IV contexts.

The work program for the first MC was built around these principles (Box 3), although—the MC being a new endeavor—it was stressed that the staff would need to be flexible and adjust its thinking and planning as events unfolded.

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[10] Multilateral consultations are based on the Fund's mandate to "oversee the international monetary system in order to ensure its effective operation" (Article IV, Section 3 (a) of the Articles of Agreement).

BOX 3. THE MC1 PROCESS

In its June 2006 briefing to the Executive Board, staff outlined a multi-stage process for the first MC, based on that followed in Article IV consultations. It comprised:

- First, a *bilateral phase* in which small mission teams would visit individual countries to hold confidential sessions with top policy makers to ascertain their views of the global imbalances—the causes and risks, the likely consequences of multilateral action, the feasibility of national action, and the role and impact of policy actions in other countries.

- Second, a *multilateral phase*, beginning with a discussion between the heads of the consultation and the five countries/areas at the technical (deputy) level, followed by a meeting at the Ministerial level with the Managing Director, aimed at reaching understanding on the direction of policy actions, some possible immediate steps, and a process to monitor progress.

- Third, staff would write a *report* for formal Board discussion to give the Board the opportunity to assess the outcome of the consultation, and offer its views on the analysis and policy actions agreed. It was also expected that *the IMFC would want to assess the outcome of the first MC*, and provide further guidance to the process.

- Finally, since it was unlikely that matters would be resolved in one shot, some *follow-up process* would be explored, subject to the consent of participants.

23. **In the event, the structure of the MC generally worked well**. This was considerably facilitated by the fact that the Executive Board and the IMFC had already endorsed a broad strategy to address imbalances, which had been underpinned by considerable staff analytical work, and discussed in depth with participants in previous Article IV consultations. This allowed the MC discussions to focus on how best to accelerate policy action rather than on the design of the strategy itself, ensuring that the MC remained complementary to bilateral surveillance. The bilateral meetings proved helpful in setting the stage for more effective multilateral discussions; the relatively small number of high-level participants permitted more intimate and policy-focused discussions; the flexibility afforded by there being no pre-set frequency for the meetings allowed for more sustained engagement than might otherwise have been the case; and the need to provide a progress report to the IMFC provided an important focal point to complete the work.

24. **While it would be premature to draw general conclusions from just one MC, the experience with the first MC underlines the following broad points:**

- *The MC process requires a high degree of confidence and mutual trust.* To permit a candid and constructive policy dialogue, it is important that participation is voluntary;

that there is broad acceptance by each member of the group of the participation of others; and that discussions are confidential, and free from the fear of leaks. The process of building a shared view, and the informal contacts developed during the MC itself—which should help foster cooperation if the underlying situation were to deteriorate—should be an integral part of the value-added of the MC exercise.

- *MCs are likely to be resource intensive—both for the Fund and the participants—and to require a flexible schedule.* Extensive staff preparatory work is required to ensure that the key issues are well articulated, the basis for constructive discussions laid, and staff positions and analyses well grounded. Moreover, management participation may be needed to ensure sufficiently high-level involvement by participants. At the same time, it is impossible to know how long it will take to reach consensus on how to tackle a complex global problem. Thus the MC process needs to be managed flexibly, and it may in practice be difficult for the Fund to conduct more than one MC at the same time.

- *The search for agreement on a joint approach that is at the core of MCs implies a more sustained involvement of staff with participating authorities on global issues, a dimension that strengthens Fund surveillance.* As such, MCs are a useful complement to the WEO, which has no formal engagement, and to Article IVs, where the engagement is periodic and national.

- *The Executive Board can play an important role at the outset of an MC, particularly through the endorsement of staff positions as noted above, and later on in expressing the views of the international community on the results.* It is likely to be easier to reach a shared view if staff background work has been seen and discussed by the Executive Board. More generally, maintaining the Board's confidence in the MC process is important, especially given the need for confidentiality while the discussions are proceeding.

- *Given the relatively long and complex process involved, MCs may be better suited to problems that are medium- rather than short-term in nature* (although once an MC group is established, it should facilitate a more rapid response to unexpected developments).

V. Staff Appraisal

25. **Perceptions of the risks associated with global imbalances have generally diminished over the past year**. The reasons are manifold, including signs that imbalances have finally begun to stabilize, accompanied by some rebalancing of global demand, as well as the fact that economic policies and developments among the participants as well as other countries have increasingly evolved in a manner consistent with the IMFC strategy.

26. **The MC1's role has been constructively supportive of an orderly adjustment in imbalances**. The discussions helped to bring about a better understanding among the participants of the issues, of each others' positions, and of their collective responsibility. In that regard, it is significant that all the participants reaffirmed that reducing global imbalances is both a multilateral challenge and a shared responsibility, and emphasized that an orderly unwinding of imbalances would benefit all countries in the world.

27. **On the policy side, the discussions solidified agreement on a medium-term approach consistent with the IMFC policy strategy** centered on measures that have strong ownership; that are beneficial from a national and international perspective; and that would reduce imbalances gradually over time while also supporting global growth. The discussions culminated with the participants setting out reasonably detailed statements of policy intentions. Taken together, these include significant steps in all key areas of the IMFC Strategy, and once implemented should noticeably reduce imbalances over the medium term. The publication of these policy intentions has provided a roadmap for the future that fosters confidence that the countries are working together to help reduce imbalances. While these policies are less ambitious than the staff—and the Executive Board—have recommended in Article IVs or the World Economic Outlook, they are nonetheless in line with the medium-term perspective of the IMFC strategy and have the potential to substantially reduce global risks.

28. **Nonetheless, while perceptions of risks may have eased, global imbalances remain a key global concern**. While the private sector will need to play an important role in the ultimate adjustment, the pace at which this will take place—as well as developments in other key variables, including oil prices—remain very uncertain. Moreover, the strategy is to a degree dependent on smooth and gradual adjustments in portfolio preferences that cannot be taken for granted e.g. in the face of a sharp adjustment in risk appetite. These risks are exacerbated in the current environment by the strength of protectionist sentiments which could intensify if imbalances remain high or if global growth were to slow.

29. **The key going forward, therefore, is implementation**. Over the last two months, each participant has made progress toward implementing its policy intentions, but much still remains to be done. The Fund will play an active role in monitoring progress, including through regular reporting on the status of MC policy plans in staff reports for Article IV

consultations with the participants;[11] through its multilateral surveillance activities, including the World Economic Outlook and Global Financial Stability Reports; and through discussions in the IMF Executive Board and in the IMFC.

30. **While the participants have key roles in facilitating an orderly adjustment, other countries must also play their part**. In particular, as stressed in the April 2007 World Economic Outlook, adjustment in global imbalances would be facilitated by continuing efforts to boost absorption in oil exporters in general, especially in the Middle East, consistent with absorptive capacity constraints, as well as by greater exchange rate flexibility in some other parts of emerging Asia.

31. **The experience so far suggests that MCs, flexibly applied, are a valuable new instrument for enhancing Fund surveillance**. MCs are likely to be best suited to addressing medium-term macroeconomic or financial problems of systemic importance, and compared to other forums for discussion among top policymakers, have two unique aspects: participation can be tailored to the problem at hand, and the voice of the international community can be heard through the Executive Board and through the IMFC. While it may be too early to draw general lessons, the experience to date suggests that MCs may be most effective when carried out against the background of significant staff work and discussions in the Executive Board. Procedurally, the first MC underscored the importance of operational flexibility to adjust to unexpected developments and accommodate the preferences of the participants, as well as of high-level and confidential meetings to ensure an effective dialogue. Finally, MCs should be complementary to the Article IV process, and appropriate involvement of the Executive Board and the IMFC is crucial to give the process legitimacy and allow the international community to assess the results.

[11] In the 2007 Article IV consultations—all of which took place just after the MC report was issued to IMFC—the mission teams raised and discussed the status of the participants' policy plans and progress with implementation. These discussions will be reported in the Article IV staff reports. In subsequent consultations, it is envisaged that each Article IV report would include a box summarizing the implementation of each participant's MC policy plans, as well as any subsequent modifications to reflect developments.

ANNEX I: MULTILATERAL CONSULTATION ON GLOBAL IMBALANCES (April 14, 2007)

1. Over the past year, we[12] have participated in a multilateral consultation convened by the International Monetary Fund. Our goal has been to discuss the policies necessary to address global imbalances while maintaining robust growth. The consultation process has proved a useful initiative, bringing together representatives of relevant economies to discuss how best to make progress in addressing this critical challenge. The discussions have been open and constructive, and have contributed to an improved understanding of the issues and of each other's positions.

2. The global economy remains on course for sustained, solid, and better balanced growth. While global imbalances increased further in 2006 from already high levels, they are showing some signs of stabilizing more recently and deficits have been relatively easily financed. Each economy has made progress over the past year in implementing policies consistent with the strategy endorsed by the International Monetary and Financial Committee.[13]

3. Reducing global imbalances is fundamentally a multilateral challenge, and resolving them in a manner compatible with sustained robust global growth is a shared responsibility. The policies set out in the IMFC strategy are in each individual economy's own interest, as well as desirable from a multilateral perspective. Moreover, an orderly unwinding of imbalances would benefit the world economy more generally, including because sustained imbalances could add to protectionist pressures.

4. Looking forward, we discussed our future policy plans, and how they could contribute to achieving the goals of the consultation. It was agreed that a rebalancing of domestic demand growth across economies would be key to reducing imbalances while sustaining the robust global expansion. Each participant indicated that its policies, as set out in the attachments, are consistent with the IMFC strategy. The implementation by each participant of these policies would in combination constitute a significant further step toward sustaining solid economic growth and resolving imbalances.

5. The IMF will continue to follow developments. We agreed to meet again when developments warrant.

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[12] Representatives of China, the Euro Area, Japan, Saudi Arabia, the United States, and Fund staff.

[13] As stated in the IMFC Communiqué of September 17, 2006, this strategy comprises "steps to boost national saving in the United States, including fiscal consolidation; further progress on growth-enhancing reforms in Europe; further structural reforms, including fiscal consolidation, in Japan; reforms to boost domestic demand in emerging Asia, together with greater exchange rate flexibility in a number of surplus countries; and increased spending consistent with absorptive capacity and macroeconomic stability in oil-producing countries."

ANNEX BOX 1. CHINA: POLICY PROGRESS AND PLANS RELEVANT TO THE IMFC STRATEGY

Over the past year, China's policy developments related to the IMFC strategy included:

- **Raising household income and stabilizing income expectations**. To increase rural household income, agricultural taxes were eliminated and support for grain producers increased. The civil servant compensation system was reformed, and the income distribution system improved. In 2006, growth in real urban and rural per capita disposable income rose to 10.4 percent and 7.4 percent, respectively. To promote social development, central government spending on science and technology, education, health, and cultural services was substantially increased. To enhance employment and social security, the pilot rural cooperative health system was extended to cover more than half of the counties, and 25 provinces established a preliminary mechanism for provision of subsistence living for rural households.

- **Promoting balanced external sector development**, including through streamlining export tax rebates, tariff and processing trade policies and restricting energy-intensive and environmentally unfriendly exports. Policies were adopted to increase imports, including lowering the general tariff level to 9.9 percent. Banking, distribution, and telecommunications sectors became more open to foreign competition, and steps were taken to encourage overseas investment. In fully honoring WTO commitments, China improved external sector policies, laws and regulations.

- **Deepening financial reform**. Significant progress was made in the joint-stock reform of the state-owned commercial banks. The Bank of China and the Industrial and Commercial Bank of China were successfully listed on domestic and foreign markets. The reform of rural credit cooperatives made headway. The non-tradable share reform of listed companies was generally completed. The institutional infrastructure of the securities market was strengthened, and the insurance sector reform advanced. The reform of the foreign exchange management system deepened. Measures were taken to facilitate the holding and use of foreign exchange by corporate and individual residents, and encourage qualified domestic institutional investors, including banks, insurance companies and securities institutions, to make overseas financial investment.

- **Increasing flexibility of RMB exchange rate**. Since the July 2005 exchange regime reform, the RMB has appreciated 7 percent against the U.S. dollar as of March 19, 2007; as of February 2007, its nominal and real effective exchange rates appreciated by around 6 percent and 5½ percent respectively. The foreign exchange market infrastructure has been significantly improved, including introducing the OTC market and market-maker system, improving the mechanism to determine the RMB central rate, and developing forward and swap transactions.

Looking forward, China's policy plans include the following:

- **The government has made reduction of the external imbalance a major objective of economic and social development for 2007**. Comprehensive steps will be taken to expand domestic demand, accelerate structural adjustment, and achieve a rough external balance over time.

- **Boosting domestic demand, particularly consumer demand, and rebalancing investment and consumption**. Care will be taken to ensure appropriate fixed-asset investment growth, improve investment structure and efficiency, and deepen the reform of the income distribution system. Various measures will be adopted to increase income of households, particularly low-income households, to boost consumer demand. Emphasis will be given to boosting rural consumption, strengthening the rural market infrastructure, and improving the consumption environment in rural areas. Starting from this year, tuition and fees for rural compulsory education will be waived completely and the pilot rural cooperative health system will cover more than 80 percent of the counties. The Property Rights Law will come into effect on October 1, 2007.

- **Further promoting balanced external sector development**. The list of products eligible for export tax rebate and rebate rates will be reduced. Measures will be taken to reduce the trade surplus, improve the quality and structure of foreign investment, and encourage overseas investment. The Corporate Income Tax Law unifying income tax for domestic and foreign-funded enterprises will come into effect in 2008.

- **Speeding up financial reform**. Steps will be taken to deepen the reform of the state-owned banks, improve their corporate governance, steadily promote the reform of the Agricultural Bank of China; expedite rural financial reform, and improve rural financial services; develop capital and insurance markets, particularly the bond market; further open up the financial sector in an active and steady manner; and enhance financial regulatory capacity and ensure financial stability.

- **Further improving the exchange regime**. The exchange rate formation mechanism will be improved in a gradual and controllable manner. Exchange rate flexibility will gradually increase, with attention paid to the value of a basket of currencies. Efforts will be made to cultivate the foreign exchange market and deepen reform of foreign exchange administration. Restrictions will be further relaxed on holding and use of foreign exchange by enterprises and individuals.

ANNEX BOX 2. EURO AREA: POLICY PROGRESS AND PLANS RELEVANT TO THE IMFC STRATEGY

Over the past years, policies related to the IMFC strategy included structural reforms in three main markets:

- **Product market**. Under the renewed Lisbon Strategy, competition in product markets has strengthened (the OECD's index of product market regulation shows a decline by more than 0.5 points from 1998 to 2003 to reach the OECD average), driven by the liberalization of network industries, more effective competition policy, and enhanced efficiency of public interventions. A revised Services Directive was adopted to strengthen competition and productivity in the services sector. Specific policies to stimulate private R&D and to promote information technologies are being implemented.

- **Labor market**. Under the renewed Lisbon Strategy, a series of measures have produced concrete progress, with a fall in the average tax wedge in most countries, an increase in labor force participation (by 6.6 percentage points to 64.5 percent between 1995 and 2006) and a decline in the standardized unemployment rate to 7.5 percent by the end of 2006 (its lowest level since 1993). Eight euro-area countries have reformed their public pension systems since 2001 and many countries have tightened early-retirement schemes.

- **Financial market**. EU financial integration is delivering concrete results in wholesale markets, bond markets, and equity trading. Implementation of the legislative measures adopted under the Financial Services Action Plan (FSAP) is continuing. An industry-led Code of Conduct was introduced for the clearing and settlements industry to enhance price transparency, interoperability, and competition in post-trading activities.

Looking forward, policy plans include the following:

- **Further reform in product market**. Priorities include further reducing market regulation and improving the business environment. The Services Directive is expected to be transposed in all Member States by December 2009 at the latest. Euro area Member States will continue to implement measures that strengthen competition (developing an internal market for network industries like gas and electricity and removing barriers in regulated trades and professions).

- **Further reform in labor market**. Priorities featured in the Lisbon-led National Action Plans include further reform to foster labor utilization and productivity (increasing fiscal incentives to work and further adjusting benefit systems; fostering flexibility and security in the labor market including by modernizing employment protection legislation; better aligning wage and productivity developments; and enacting measures to promote labor mobility across borders and between occupations). Member States will also implement policies aimed at modernising higher education, ensuring high-quality and attractive vocational education and implementing national lifelong learning strategies. An important further step in facilitating the mobility of workers will be the adoption of legislation on improving the vesting and the preservation of supplementary pension rights.

Further reform in financial market. Political agreement was reached on the Payment Services Directive (PSD), which aims at creating more efficient and competitive payments systems and facilitating the creation of a single EU payments area (SEPA) by 2010, as well as on a new EU Directive that will provide common and transparent criteria and procedures for mergers and acquisitions in the financial sector. The Markets in Financial Instruments Directive (MiFID)—aimed at creating a "single passport" for investment firms while protecting investors—will come into effect on November 1, 2007. Work is underway on the TARGET2 Securities (T2S) project which aims at creating a common technical platform for settlement in central bank money of securities transactions, with the objective to make cross-border transactions within the EU and the euro area as cost effective and secure as domestic ones, thereby complementing further integration of cash settlement through the implementation of TARGET2. A final decision on implementation will be taken in spring 2008. Implementation of legislative measures adopted under the FSAP at the national level is proceeding. Further initiatives include the preparation of a new Solvency Directive for insurance and work to create a more integrated market to finance housing at both wholesale and retail levels, which should further ensure financial market completeness by facilitating the securitization of loans.

Annex Box 3. Japan: Policy Progress and Plans Relevant to the IMFC Strategy

Over the past year, developments in Japan's policies related to the IMFC strategy included:

- **Incentives to encourage young and female labor force participation**. Expenditures for reducing skills mismatches for women and younger workers have been included in the FY2007 budget, and tax relief for FY2007–08 expenditures on child care has been raised. A stronger law on equal job opportunity has been passed and will take effect in FY2007. Job placement services have been partly liberalized.

- **Measures to enhance competition**. A new anti-monopoly law granting stronger authority to the Fair Trade Commission was enacted in April 2005 and has been effective since January 2006.

- **Advancing fiscal consolidation**. In order to forestall a possible loss of confidence to the economy, which could result in adverse external spillovers, and in order to achieve sustainable private demand-led growth, the government has been making every effort to advance fiscal consolidation. In the FY2007 budget, the issuance of new government bonds is reduced by ¥4.5 trillion (15 percent in year-on-year terms), the largest such reduction in history. As a result, the primary deficit of the central and local governments combined will be reduced from 1.7 percent of GDP in FY2006 to 0.6 percent of GDP in FY2007.

Looking forward, Japan's policy plans include the following:

- **Labor market reforms**. A bill to extend pension coverage to temporary workers is in the works, and some job placement services are under "market-testing" with a view toward further liberalization. Reform priorities (to be elaborated in June), for inclusion in the cabinet's Basic Policies for FY 2007, include enhancing labor mobility and market attachment, and retraining marginalized workers.

- **Facilitating inward foreign direct investment (FDI)**. The tax treatment of mergers and acquisitions involving noncash transactions is under parliamentary debate. The government will implement the program for acceleration of FDI in Japan in order to achieve its strategic goal to increase the FDI stock to 5 percent of GDP by 2010.

- **Strengthening competition in key sectors**. The importance of raising productivity, especially in the non-tradable sector, is well recognized. The government has worked out modalities for rolling out the deregulation measures in the "Special Zones for Structural Reform." A draft bill for reform and eventual privatization of some government-owned financial institutions is under legislative review. A Council of Economic and Fiscal Policy committee is looking at ways to promote additional Economic Partnership Agreements bilaterally and regionally. Agricultural and immigration reforms will also be addressed.

- **Further advancing fiscal consolidation**. The government has set fiscal targets to reduce the debt-to-GDP ratio in a stable manner by the mid 2010s and, as a first step, to achieve a surplus in the primary balance of the central and local government combined by 2011.

ANNEX BOX 4. SAUDI ARABIA: POLICY PROGRESS AND PLANS RELEVANT TO THE IMFC STRATEGY

Over the past year, developments in Saudi Arabia's policies related to the IMFC strategy included:

- **Public expenditure policies** have increased spending broadly as envisaged in the areas of oil sector investment and toward meeting social and infrastructure needs. In 2006, total expenditures increased by over 12 percent, 16 percent above the original budget. From the $25 billion set aside to finance social projects over the medium term, about $1.5 billion was spent in 2006.
- **Reflecting increased government expenditure** and robust private sector activity, imports and payments for services continued to increase during 2006, with their amounts rising by more than 27 percent.
- **Oil production and refining capacity expansion plans** remained on schedule, including progress on plans to expand upstream oil production capacity to 12½ million barrels per day by 2009.

Looking forward, Saudi Arabia's policy plans include the following:

- **Government spending plans** continue to envisage increased outlays on social and infrastructure investments and on expanding oil sector capacity, notwithstanding the recent fall in oil prices. The announced budget for 2007 has total expenditures growing by around 13–14 percent, with spending on social and infrastructure components growing by nearly 20 percent. The amount set aside for social projects—mainly, for housing and SME credit—has been increased to $32 billion over the next five years.
- **In the hydrocarbon sector**, Saudi ARAMCO is pursuing an ambitious $80 billion investment program to boost its crude oil production capacity, increase oil refining capacity both at home and abroad, and expand gas processing facilities.
- **Investments** to be implemented under Public-Private Partnerships during 2006–10 outside the hydrocarbon sector are expected to exceed $200 billion.
- **Exchange rate policy**. The authorities indicated their intention to maintain the peg to the U.S. dollar, which continues to serve the economy well and is in line with the GCC agreement to establish the Monetary Union in 2010. The openness of the trade regime and the labor market should continue to preserve price stability.

ANNEX BOX 5. UNITED STATES: POLICY PROGRESS AND PLANS RELEVANT TO THE IMFC STRATEGY

Over the past year, developments in U.S. policies related to the IMFC strategy included:

- **Continued narrowing of the budget deficit**. The unified federal budget deficit declined to 1.9 percent of GDP in FY 2006, a substantial decrease in two years, and on track to outperform initial IMF staff expectations for FY 2007.

- **Passage of saving-focused tax reforms**. Rate cuts for capital gains and dividends were extended for two years, as were increased expensing of allowances for small businesses. Enhancements to tax-advantaged retirement and education savings vehicles were made permanent, and legal barriers to automatic enrollment in employer-sponsored retirement plans were removed. The saver's credit, aimed at low- and middle-income individuals, was also made permanent. Finally, health savings accounts were made more attractive.

Looking forward, the U.S. authorities' policy plans include the following:

- **Further fiscal consolidation over the medium term**. The FY 2008 budget targets eliminating the budget deficit by 2012.

- **Reforming the budget process to contain spending growth**. The FY 2008 budget proposes limits on the use of Congressional budget earmarks and authority for the President to exercise a budget line-item veto.

- **Entitlement reform to strengthen long-term fiscal sustainability**. Policies have been proposed to slow the rate of growth of health care costs while expanding access to care, including providing a standard deduction for health insurance and expanding the use of health savings accounts.

- **Further tax incentives to support private saving**. The FY 2008 budget promotes new tax-advantaged vehicles, replacing IRAs with Retirement Savings Accounts, and introducing Lifetime Savings Accounts. Social Security reform with Personal Retirement Accounts is again proposed.

- **Enhancing energy efficiency**. Net oil imports amount to 35 percent of the U.S. trade balance. The Administration is committed to cutting gasoline consumption by 20 percent in 10 years by requiring 35 billion gallons of renewable and alternative fuels by 2017, and by increasing fuel economy standards for cars and light trucks.

- **Pro-growth, open investment policies**. The United States is committed to pro-growth policies that make the United States an attractive location for foreign investment. Key elements include a strong commitment to an open investment environment, resistance to protectionist pressures, and a commitment to permanently low tax rates.

- **Capital market competitiveness**. The Administration is actively engaged, through the U.S. Treasury, in ways to improve U.S. legal, regulatory, and accounting frameworks and thus better ensure that U.S. capital markets remain the strongest and most innovative in the world.

ANNEX II. HOW MIGHT GLOBAL IMBALANCES ADJUST?

1. This annex provides a brief description of adjustment scenarios featuring an unwinding of global imbalances, which make use of the Fund's Global Economic Model (GEM). [14]

The Model

2. The simulations are based on a 4-region version of GEM, comprising the United States, the euro area and Japan, Emerging Asian economies, and the rest of the world. In the model, described in more detail in Faruqee and others (2007), each region produces both tradable and nontradable goods, with bilateral trade flows taking place between the blocs. Both goods markets and labor markets are characterized by imperfect competition and nominal rigidities, and consumers are non-Ricardian—that is, they treat a portion of government debt as net wealth—so that changes in macroeconomic policies can have significant short-term and long-term effects.

3. Monetary policy in the United States, the Japan-euro area bloc, and the rest of the world is characterized by an interest rate feedback rule that gradually moves inflation toward its target rate. In contrast, in emerging Asia the exchange rate is assumed to be pegged to the U.S. dollar (although the implications of a shift to a more flexible exchange rate regime, accompanied by a monetary policy rule similar to the other regions, are also considered). Fiscal policy plays a more passive role, stabilizing the debt-to-GDP ratio in the medium term. The desired level of net foreign assets (or foreign liabilities) in each region over the medium term plays a key role in determining the equilibrium level of current account balances—and therefore exchange rates. In the long run, the United States is assumed to be the only debtor region, with the remaining regions holding positive net foreign assets.

4. In the model, the initial constellation of current account imbalances is primarily generated by low private (and public) saving in the United States, together with strong foreign demand for U.S. assets, particularly from emerging Asia; low productivity growth in the euro area and Japan as well as an increase in the appetite for imports from emerging Asia also play some role. [15]

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[14] See also Box 1.3, World Economic Outlook, September 2006; and Annex 1.2, World Economic Outlook, September 2005 for a more detailed description of an earlier version of these scenarios. The Global Fiscal Model was also used for some simulations.

[15] Clearly the causes of imbalances are more complex. In the second half of the 1990s, the widening U.S. current account deficit and appreciating dollar were primarily associated with high productivity growth and a shift in preference toward U.S. assets. In the early 2000s, following the bursting of the stock market bubble, expansionary fiscal and monetary policies in the United States—both absolutely and relative to other countries—played an increasing role, with booming house prices fueled by low interest rates contributing to a reduction in household

(continued…)

5. The staff developed three adjustment scenarios, which were provided to the participants as background for the discussions:

- A purely market-led adjustment, with no additional policy action in any of the major economies.
- A disruptive adjustment scenario, characterized by a worldwide decline in demand for U.S. assets and rising protectionist pressure.
- A strengthened policies scenario, assuming—along the lines of the IMFC Strategy—fiscal consolidation in the United States; greater exchange rate flexibility in emerging Asia; growth-enhancing structural reforms in the euro area and Japan; and additional spending by oil exporters.

A Market-led Adjustment

6. The **baseline scenario** assumes that imbalances adjust through gradual changes in private sector saving behavior and portfolio preferences, with no additional policy action in any of the major economies. As the various shocks that drive the current constellation of imbalances unwind, the world economy gradually adjusts towards its long-run equilibrium (the blue line in Figure A1). In the *United States*, there is a gradual increase in the private savings rate accompanied by a further 15 percent real effective depreciation, generating a steady improvement in the current account deficit to about 4 percent of GDP by 2015, with U.S. net foreign liabilities rising substantially over time. The main counterpart of U.S. adjustment is in *emerging Asia*, where demand expands due to a sharp decline in the private savings rate, while growth slows somewhat as productivity catches up with the levels prevailing in more advanced economies. This more balanced growth pattern is reflected in a real exchange rate appreciation of about 15 percent which—if nominal exchange rates do not adjust—is achieved through persistent positive inflation differentials vis-à-vis trading partners. The current account surplus declines to about 2 percent of GDP by 2015, mirroring the fall in the current account deficit in the U.S. The impact of adjustment on the *euro area and Japan* and the *rest of the world* is more limited, with both regions experiencing a depreciation against emerging Asian currencies but an appreciation against the U.S. dollar.

7. Overall, real exchange rate and current account adjustments in this scenario are sizeable but orderly. However, the viability of this scenario depends critically on two benign assumptions. First, foreigners are assumed to be willing to accommodate a further very

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saving. Historically low investment rates in emerging Asia and other countries—and in China unusually high private savings—also contributed to surpluses elsewhere. Finally, from 2003 onwards, sharply rising oil prices contributed to worsening current account balances in oil importing countries, including the United States, matched by higher national saving and current account surpluses in oil exporters.

substantial buildup in U.S. foreign liabilities—ultimately to around 85 percent of GDP—without demanding a large risk premium, notwithstanding continued foreign exchange losses. Second, it is assumed that protectionist pressures are held in check. It is therefore important to explore the sensitivity of the baseline scenario to more pessimistic assumptions.

A Disruptive Adjustment

8. In the **disruptive scenario,** it is assumed that there is a rise in protectionist pressures, accompanied by a worldwide decline in demand for U.S. assets—including an abandonment of pegs in emerging Asia. The consequence of these shocks—displayed in the red line in Figure A1—is an abrupt contraction in economic activity in the United States, accompanied by a large real depreciation of the U.S. dollar and a sharp correction in the U.S. trade balance. Together with the increase in protectionism, this leads to rising inflationary pressures requiring a significant short-term monetary tightening, which amplifies the effect on growth. The remaining three regions also experience a sharp slowdown in economic growth, which is compounded by the decline in external demand. Emerging Asia experiences the sharpest real exchange rate appreciation, which, together with the slowdown in demand from the United States, leads to a broadly balanced current account by 2010.

9. Overall this scenario emphasizes the potential dangers that sudden shifts in market sentiment, along with rising protectionist pressures, could entail for global growth. Given the very large short-term exchange rate adjustments that take place in this scenario, there is also a significantly greater risk of financial market disruption—not explicitly included in GEM—with further negative implications for global stability and growth.

The Impact of the Joint Strategy

10. The **strengthened policies scenario** examines the impact of the implementation of the joint strategy along the lines recommended at IMFC.[16] The cumulative effect is shown in green in Figure A1; Figure A2 shows the individual impact of these policies on two key variables—global growth and U.S. net external liabilities. There are four key elements of the policy strategy (see Table A1 for details):

- *Greater exchange rate flexibility in emerging Asia.* It is assumed that exchange rates in emerging Asia become more flexible, accompanied by a rise in domestic consumption, and—over the longer term—a boost to productivity growth, driven for countries such as China by financial sector reforms. The resulting real exchange rate appreciation occurs through nominal exchange rate flexibility, rather than inflation, and is more rapid than in the baseline. Correspondingly, the current account surplus is reduced more sharply—and

[16] Policy actions other than the ones mentioned here may be feasible, including measures to boost private investment in some parts of Asia, and measures to encourage private saving in the U.S.

the U.S. current account improves relative to the baseline. Nevertheless, the impact of increased exchange rate flexibility and higher private consumption relative to the baseline may be understated, especially in the short run, because real appreciation takes place in the baseline scenario as well, since the model has no room for sterilized intervention.[17] In the short run, regional growth declines by about 1 percent per year over two years, as the gradual pick-up in private consumption does not fully offset the decline in net exports, but over the medium term it rises by 0.2 percent per year. Importantly, the adjustment leads to more balanced growth in the region, with a much stronger contribution coming from consumption, thereby boosting welfare.

- *Fiscal consolidation in the United States.* We assume a substantial reduction in the U.S. budget deficit over the medium term (some of which is already under way) that becomes fully credible to investors after a period of 2 years. The adjustment, consisting of a combination of tax increases and expenditure cuts, leads to a broadly balanced budget excluding social security by 2012 [18] and results in a more than 30 percent reduction in the government debt-to-GDP ratio over the longer term. Results are shown as the difference between the black and red lines in Figure A2. Overall, the 3 percent of GDP fiscal consolidation leads to roughly a 1 ½ percent improvement in the current account in the medium to long run, as households do not fully offset the increase in government saving; U.S. net foreign liabilities fall by about 9 percent of GDP relative to baseline after 5 years, and considerably more than that thereafter. This lowers the world real interest rate by 25 basis points so that—after the initial contraction—GDP growth rises over time as both investment and consumption are crowded in. [19] Current account surpluses in the rest of the world are correspondingly reduced, and medium-term growth benefits everywhere from lower world interest rates.

- *Structural reforms in the euro area and Japan.* It is assumed that the degree of competition in product and labor markets in Europe and Japan gradually increases, eliminating about two thirds of the gap with the level prevailing in the United States over a 10-year period. These policies are assumed to become increasingly credible over time, inducing households and firms in this region to invest relatively more in their home economies and to

[17] Over the medium term the understatement would be more modest, since equilibrium real appreciation would be likely to take place even with fixed exchange rates through inflation differentials. Furthermore, the assumption of fixed exchange rates vis-à-vis the dollar in emerging Asia is admittedly crude—real effective exchange rates appreciated by around 10 percent in nominal and real effective terms between December 2004 and June 2007.

[18] Over the long term, the deficit rises again on account of demographic pressures, and is eventually stabilized at 3 percent of GDP.

[19] Recent staff work suggests that the effects of government debt on world real interest rates and economic activity could be significantly larger. See Kumhof, Laxton, and Muir 2005, "Consequences of U.S. Fiscal Consolidation for the U.S. Current Account" in United States: Selected Issues, IMF Country Report No. 05/258.

correspondingly reduce their desired net creditor position vis-à-vis the rest of the world. Inside the region growth picks up and current account surpluses decline, while current accounts improve elsewhere, principally in the United States. Due to positive spillover effects, global growth rises by about ¼ percentage points over the medium term (see the difference between the dark green and broken black lines in Figure A2). [20]

- *Additional spending by oil exporters.* The final strengthened policies scenario assumes that oil exporters use part of the wealth transfer generated by higher oil prices to raise the level of productive capacity and diversify their economies. Results are shown as the difference between the grey and dark green lines in Figure A2. Increased imports by this region would reduce its currently high current account surpluses, thus reducing deficits elsewhere, especially in the United States. There would also be a positive longer run impact on world growth as productivity in oil exporters increases and spillovers benefit other regions.

11. The *combined effects* of these policies are compared to the baseline and disruptive scenarios in Figure A1. Joint policy action would help ensure a more orderly and significant unwinding of external imbalances. Global growth would be better balanced between regions, with a recovery in productivity growth in the euro area and Japan. And within regions growth would be better balanced between the components of aggregate demand, with lower but more sustainable consumption growth in the United States and higher consumption growth in the euro area, Japan and emerging Asia.

12. Joint policy action could also generate important *spillover effects*, particularly:

- *Stronger medium-term growth*. While the joint strategy could have modest negative effects on short-run growth in emerging Asia and the United States, it would ensure a beneficial and durable increase in growth everywhere over the medium and long term. For each country and region, faster growth in the rest of the world increases external demand, with a positive indirect effect on domestic economic performance. Domestic growth is also boosted by lower world interest rates from U.S. fiscal consolidation.

- *Enhanced external stability*. Joint action along the lines set out in the strengthened policies scenario would buttress global financial stability by reducing the risk of a disorderly adjustment. The size of this spillover benefit—which for each country derives primarily from actions in other countries—depends importantly on the assessment of the underlying risks and costs of a disorderly adjustment, as well as on the magnitude of the reduction in imbalances achieved by policy action.

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[20] These positive effects may not materialize over the short term, to the extent that product and especially labor market reforms increase uncertainty among firms and households. In this case, reforms could be associated with a temporary increase in precautionary savings and current account surpluses.

- *Valuation changes*. Movements in exchange rates can have significant effects on the value of countries' external assets and liabilities, with U.S. dollar depreciation leading to capital losses for holders of U.S.-dollar denominated assets, matched by capital gains for the issuers in the United States and elsewhere (Table A2).[21] The less prolonged the adjustment in imbalances, the smaller the likely accompanying adjustments in exchange rates, and the lower the resulting potential capital losses and gains; for the world as a whole, of course, the gains and losses cancel out.

13. In summary, the short-run cost of buying insurance against a potential disorderly adjustment and the threat of protectionism is modest. And while each region clearly benefits directly from its own policy actions, joint action magnifies the benefits obtainable by each region on its own, this being a clear instance in which joint action would be a public good.

Reference

Faruqee, Hamid, Douglas Laxton, Dirk Muir, and Paolo Pesenti (2007), "Smooth Landing or Crash? Model-Based Scenarios of Global Current Account Rebalancing," in *G7 Current Account Imbalances: Sustainability and Adjustment*, edited by Richard H. Clarida, University of Chicago Press for National Bureau of Economic Research.

[21] This assumes that currency movements are not anticipated by markets and incorporated in interest rate differentials (in which case capital gains /losses are compensated by higher interest payments/receipts).

Figure 1. Current Account Components and Real Effective Exchange Rate

(In percent of GDP; unless noted otherwise)

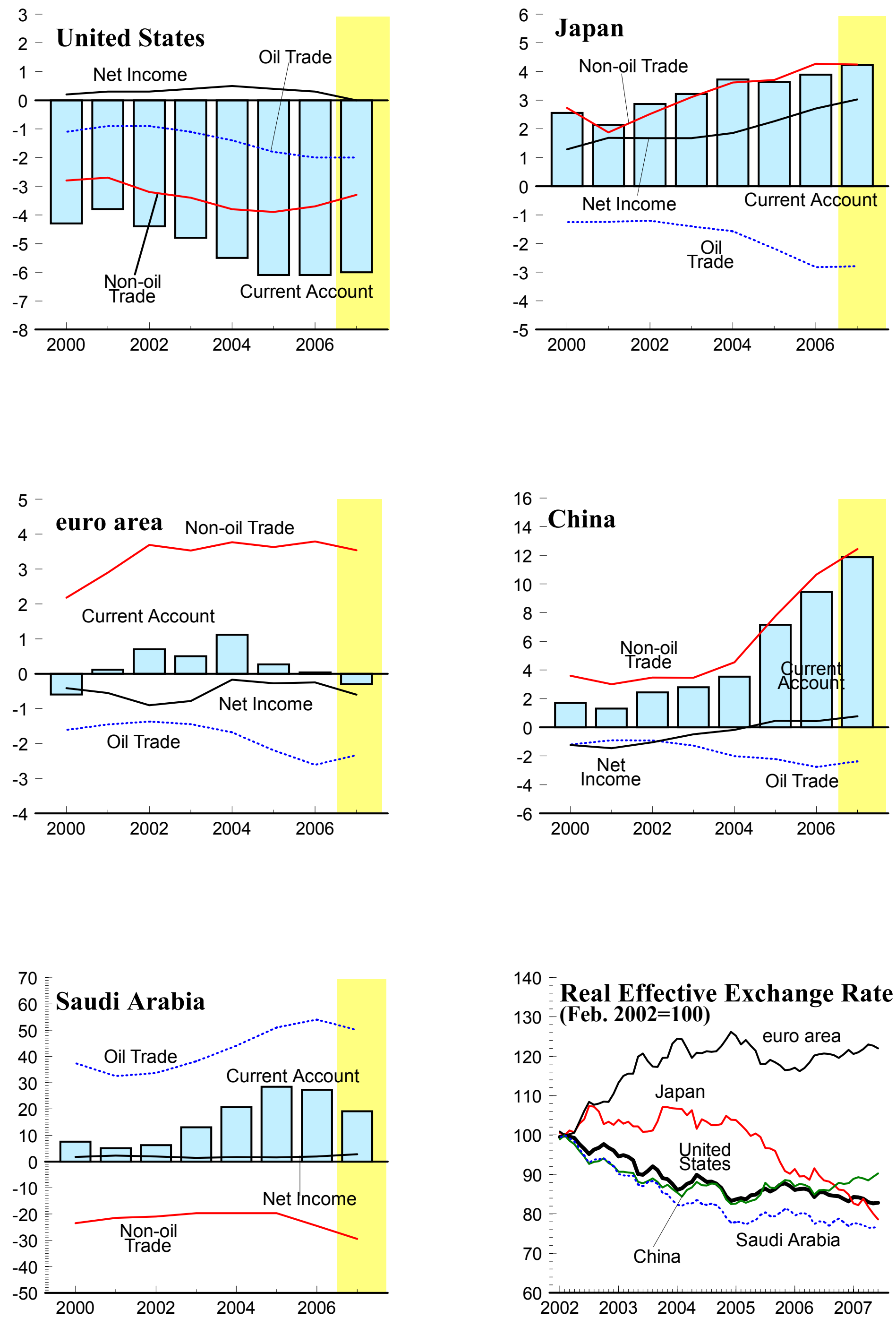
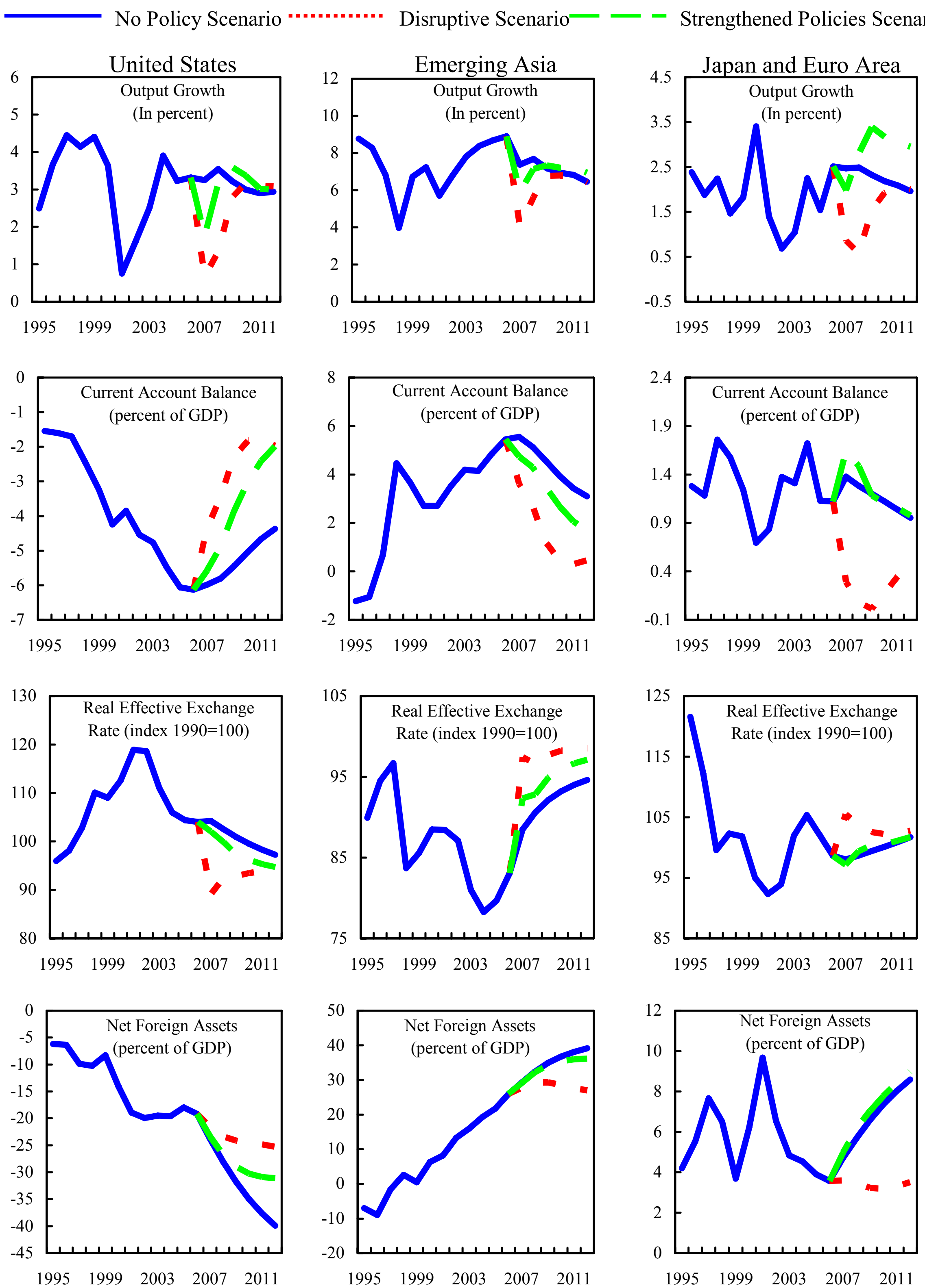


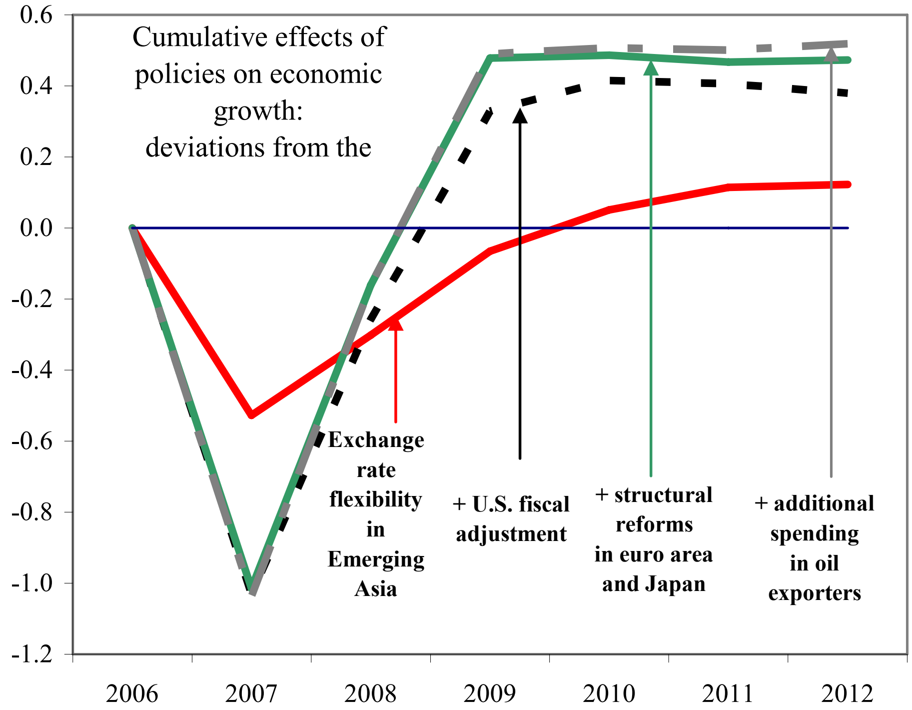
Figure A1. How Will Global Imbalances Adjust? GEM Scenarios, 1995-2012 1/

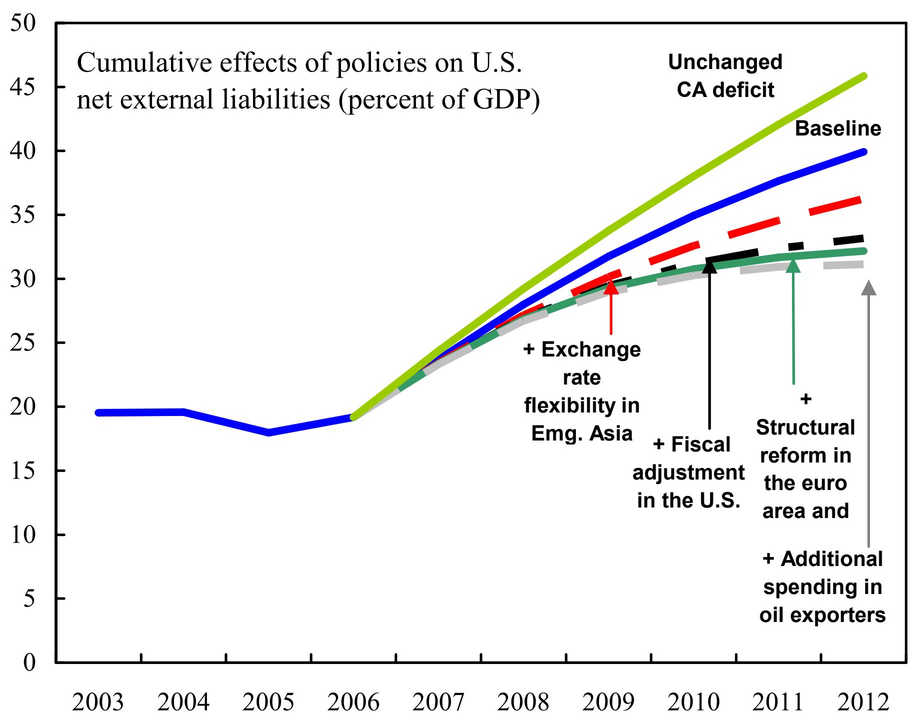


Source: staff estimates.

1/ An increase in the real effective exchange rate index indicates a real appreciation.

Figure A2. Cumulative Effects of Policies on Economic Growth and U.S. External Liabilities 1/





Source: Staff estimates.

1/ The charts show the cumulative impact of policy measures on growth and U.S. external liabilities, relative to the GEM baseline. The order of the policies is (i) increased exchange rate flexibility in emerging Asia; (ii) fiscal adjustment in the United States; (iii) structural reform in the euro area and Japan; and (iv) additional spending in oil exporters.

Table A1. Adjustment Scenarios—Key Assumptions

Disruptive adjustment	• Abandonment of the peg in emerging Asia. • Worldwide decline in the demand for U.S. assets and increase in the U.S. country risk premium. • Increasing protectionist pressures resulting in lower competition globally and higher markups.
Increased exchange rate flexibility and higher consumption in emerging Asia	• Abandonment of the peg in emerging Asia • Increase in private consumption (decline in desired holdings of net foreign assets) • Measures that raise productivity in the region (reducing distortions in goods and financial markets; increasing spending on physical capital to improve productive capacity).
Fiscal adjustment in the United States	• Gradual reduction in the U.S. federal budget deficit by about ½ percentage points of GDP per annum, until the budget is balanced excluding social security. This is equivalent to a surplus of 1 ½ percent of GDP in 2012 including social security. • The deficit reduction is assumed initially to be non-credible, resulting in significant negative short-run Keynesian effects. • The non-Ricardian effects assume an elasticity of -0.5 between the government debt ratio and the desired U.S. NFA-to-GDP ratio.
Structural reforms in Japan and the Euro area	• Increase in productivity (driven by an increase in the degree of competition) • Reforms are phased in gradually. Planned future reforms only become credible over time. • Decline in precautionary saving (decline in desired holdings of foreign assets)
Additional spending by oil exporters	• Increased spending to improve productive capacity and raise productivity growth • Reduction in the current account surplus of the oil exporters by 5 percentage points of GDP.

Table A2. Currency Composition of Net External Position (2006)
(in percent of GDP)

	Net External Position excl. gold	Net Domestic Currency Position	Net Foreign Currency Position	of which: U.S. dollars
China	20.3	-29.4	49.7	....
Euro Area	-13.5	-74.6	61.1	20.0
Japan	42.0	-32.7	74.7	48.8
Saudi Arabia	100.0	-9.6	109.6	...
United States 1/	-20.4	-74.5	54.1	

Source: national sources and staff estimates.
1/ FDI assets and liabilities evaluated at current cost.