EXECUTIVE SUMMARY

Chapter 1: On the Path to Policy Normalization

Three years since the outbreak of the COVID-19 pandemic, fiscal policy is returning to normal. After providing extraordinary support simultaneously in 2020, both monetary and fiscal policy tightened in nearly three-quarters of countries in 2022 amid high inflation and the expiration of pandemic-related spending measures. This shift occurred in a highly volatile environment. Just as economies rebounded swiftly from a deep COVID-19-related recession with continued strains in fiscal space, governments were confronted with a cost-of-living crisis, *Russia*'s invasion of *Ukraine,* and instability in the financial sector.

Households and economies, supported by governments, have demonstrated resilience in the face of these challenges. The global economy has recovered swiftly. The economic and social fabric has thus far withstood disruptions to energy supply. But the multiple shocks have reversed gains in poverty reduction, likely pushing the global goal of eradicating extreme poverty by 2030 farther into the future. Lack of fiscal space amid high borrowing costs in developing countries has further stymied progress toward other Sustainable Development Goals—progress that was already slow prior to the pandemic. Food prices in domestic currencies remain high in several countries, owing in part to exchange rate depreciations. Beyond the near-term imperative to safeguard poorer households, long-standing challenges—including the climate agenda and population aging—have likewise become more pressing.

Public finances have undergone major swings, reflecting the unprecedented shocks and government actions. Following a historic surge in public debt to nearly 100 percent of GDP in 2020 as a result of economic contraction and massive government support, fiscal deficits have since declined, as exceptional measures have come to an end. With strong nominal GDP growth in 2021–22, global debt posted the steepest decline in 70 years and stood at about 92 percent of GDP at the end of 2022, still about 8 percentage points above the level at the end of 2019. Primary deficits are falling rapidly and moving closer to prepandemic levels in many countries, but overall deficits have fallen somewhat less owing to rising interest payments. These sizable reductions in debts and deficits stem in large part from atypical growth and inflation dynamics. In 2022, most countries experienced revenue surprises amounting to 3.1 percent of GDP on average for advanced economies and 2.5 percent for emerging market and developing economies, with particularly large revenue windfalls in oil exporters. Many countries saved part of the extra revenues, but many others increased spending to counter the cost-of-living crisis. In some cases, particularly countries with large initial debt stocks in domestic currency, debt ratios fell by more than 10 percentage points in a year as nominal GDP surged. However, debt dynamics deteriorated in emerging market economies and low-income developing countries with sizable shares of debt in foreign currency, as currency depreciation and rising interest rates came together with inflation.

The near-term fiscal outlook remains complex, and it is crucial that fiscal and monetary policies are closely aligned to deliver price and financial stability while responding to an uncertain economic environment and rapidly changing financial conditions. In 2023, overall fiscal deficits are expected to increase slightly to 5 percent of GDP on average, as governments face higher interest bills and pressures to increase public spending, including spending on wages and pensions, to catch up with past inflation. Risks are firmly to the downside (see the April 2023 *World Economic Outlook* and *Global Financial Stability Report*). Instability in the financial sector, if it intensifies, could also put pressure on public sector balance sheets as governments may be called to help.

A tighter fiscal policy—while providing targeted support to the most vulnerable—should complement efforts by the monetary authorities to bring inflation back to target, making it possible for central banks to increase interest rates by less than otherwise (see Chapter 2). Policies will need to be ready to adjust if risks materialize. If inflation proves to be stickier than expected, it will require tighter policies for longer.

In a scenario of systemic financial stress, fiscal policy may need to intervene swiftly to facilitate the resolution process and minimize its costs, while mitigating moral hazard (October 2016 *Fiscal Monitor*). Governance principles, supported by strong insolvency and bankruptcy procedures, should be applied in the decision-making process to safeguard public funds. The appropriate policy package will crucially depend on the available room for fiscal policy action. Given downside risks, fiscal and monetary policies should stand ready to respond if economic growth turns out significantly weaker than expected and unemployment rises. Governments should allow automatic stabilizers to work, especially where inflation is under control and fiscal space is available.

Over the medium term, fiscal deficits are projected to remain above prepandemic levels in the next few years. The fiscal outlook is subject to significant uncertainty as the global economy rebounds from a series of shocks. Much will depend on the pace of long-term (potential) economic growth and the future course of global interest rates (see Chapter 2 of the April 2023 *World Economic Outlook*). Under current projections, the envisaged gradual and moderate fiscal tightening will not be sufficient to prevent public debt ratios from resuming an upward trend, as nominal GDP slows, driven by some large advanced and emerging market economies. Interest payments as a share of revenues in emerging market economies and low-income developing countries are expected to remain higher over the medium term than before the pandemic. In low-income developing countries, concerns persist regarding heightened debt vulnerabilities because of high debt levels, with 39 countries already in or near debt distress. Despite multiple waves of tax reforms in these countries, revenues remain stubbornly insufficient at 13.5 percentage points of GDP lower than revenues in advanced economies. This calls for renewed efforts to raise tax capacity.

Recent crises have taught us that fiscal policy is a powerful tool to foster resilience. To that end, however, governments will need to give greater priority to rebuilding fiscal buffers. Countries should develop credible risk-based fiscal frameworks that promote consistent macroeconomic policies, reduce debt vulnerabilities over time, and build up the necessary room to handle future shocks.

The international community needs to work together to find joint solutions to the multiple challenges that lie ahead. For the most vulnerable economies, it is urgent to strengthen the international financial architecture, especially in debt resolution and enhancement of the Global Financial Safety Net. The latter is a set of institutions and mechanisms that provide insurance against crises and financing to mitigate their impact. Many low-income countries need further international efforts to address sovereign debt vulnerabilities, including debt relief, so that they can make progress toward the Sustainable Development Goals.

Finally, the recent energy crisis has demonstrated the urgency of pressing ahead with the transition to renewable energy, which would safeguard energy security and mitigate climate change. International cooperation on energy strategy, including carbon taxes and subsidies, would help achieve climate goals and avoid trade tensions.