

## 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 pre-pandemic 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.

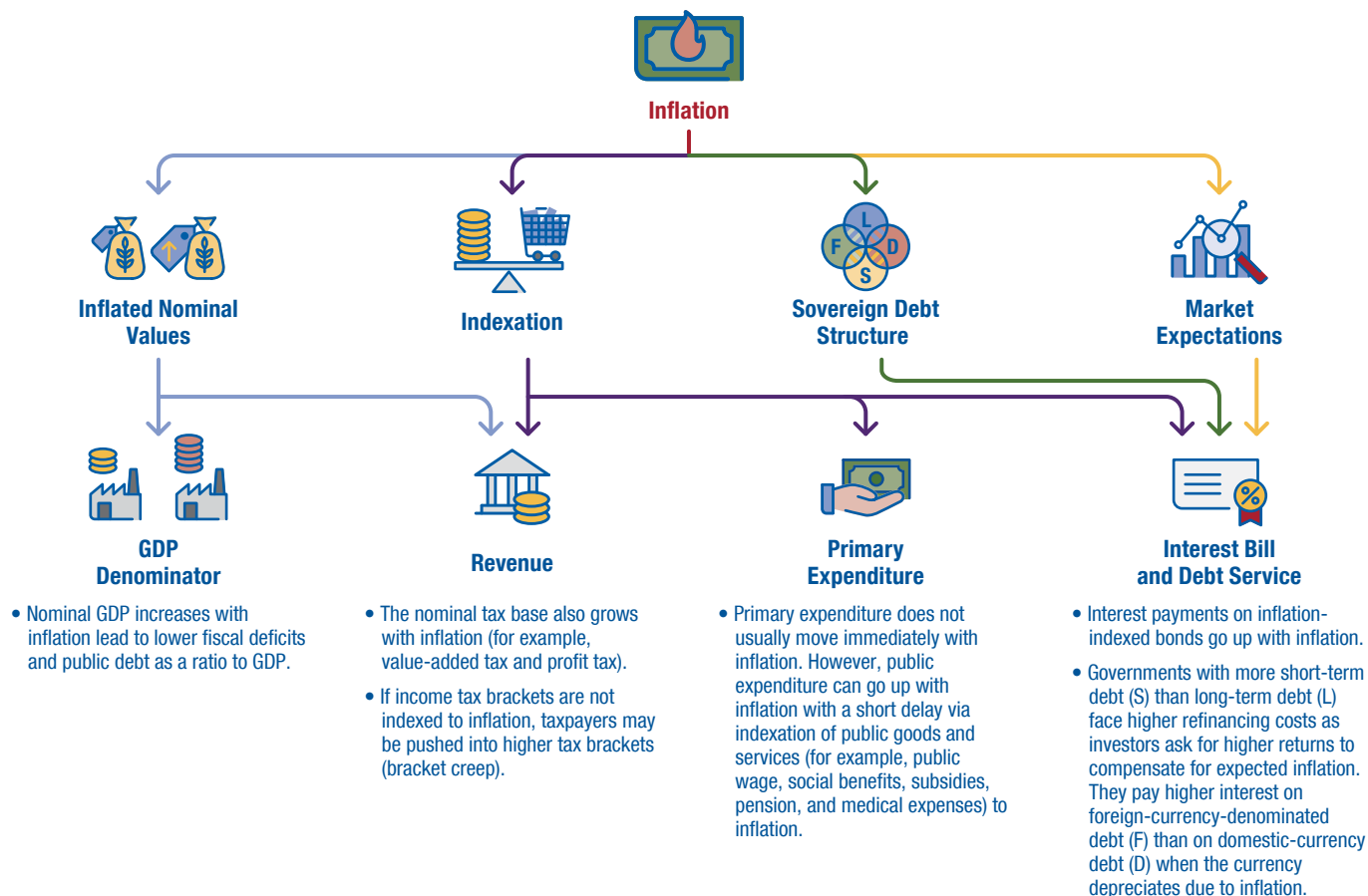
## Chapter 2: Inflation and Disinflation: What Role for Fiscal Policy?

The upsurge in inflation since 2021—the sharpest in more than three decades—has called on policymakers to respond. Government policies need to be informed by an understanding of how inflation affects various groups in society through uneven impacts on the budgets of different households. This chapter examines the multifaceted impact of inflation on fiscal variables (see infographic) and the distribution of well-being, and it explores how fiscal policy can do its part to curb inflation while supporting the vulnerable.

Governments influence how the costs of inflation are distributed not only through discretionary intervention but also through automatic indexation of pensions, transfers to poorer households via social safety nets, wages of civil servants, and tax thresholds. A survey of current international practices shows that indexation varies considerably across countries. Pensions are the most commonly indexed—in nearly all advanced economies and about 40 percent of emerging market and developing economies—followed by cash transfers to vulnerable groups and public wages.

The impact of inflation on the fiscal accounts also depends on redistribution—in this case, between the public sector and the private sector. Unexpected inflation erodes the real (inflation-adjusted) value

### Immediate Impacts of Inflation on Public Finances



Source: IMF staff analysis.

Note: The infographic depicts channels of inflation's immediate impact on fiscal variables, occurring before a policy response.

of government debt, with bondholders taking the brunt of the hit. For countries with debt exceeding 50 percent of GDP, each 1 percentage point surprise increase in inflation is estimated to reduce public debt by 0.6 percentage point of GDP, with the effect lasting over the medium term. These effects are smaller or negligible for countries with a large share of debt denominated in foreign currency. When inflation is expected, it is not associated with a decline in debt ratios, highlighting that inflating debt away is neither a desirable nor a sustainable strategy. Likewise, deficit-to-GDP ratios initially decline as the nominal (current monetary) values of the economy's output increase and, consequently, the tax base rises, generating more tax revenue, while spending fails to keep up. But such effects dissipate over time.

In addition, the chapter shows that redistributive effects of inflation on households are more complex

than usually thought. Based on surveys of thousands of households in *Colombia, Finland, France, Kenya, Mexico, and Senegal*, estimates are provided for the price acceleration from the second quarter of 2021 to the second quarter of 2022 for three channels (see Chapter 1 for more recent developments on the relationship between inflation and public finances): (1) real incomes (wages and pensions), (2) losses in net nominal assets, and (3) faster-than-average price rises for the main goods and services consumed by a given group (such as food prices, which hurt the poor during the period studied). Results show that changes in real income were the most important and differed the most across countries but less so across income groups. Losses on net nominal assets were larger for older groups than for young adults (who often have outstanding mortgage debt) in countries with sizable household credit markets. During the period considered, the estimated impact of inflation

on the poverty rate (prior to new policy measures in response) is about 1 percentage point in three countries in the sample (*France, Mexico, Senegal*).

Fiscal policy also influences aggregate demand and inflation, with its ultimate impact depending on the monetary authorities' response. Estimates indicate that an increase in public spending of 1 percentage point of GDP led to an increase in inflation of 0.8 percentage point in the 1950–85 period and of 0.5 percentage point thereafter. The difference arguably stems from a more forceful response by central banks to rising inflationary pressure in the post-1985 era. Analysis using a model that embeds inequality in incomes, consumption, and asset holdings shows that a reduction in the fiscal deficit leads to a similar level of disinflation but requires a smaller increase in interest rates than when central banks act alone. The analysis also shows that deficit reduction combined with transfers to the poorest yields a smaller drop in total private consumption and a consumption path associated with less inequality across households. These effects are even more important when public debt is high because fiscal restraint limits the rise in the cost of borrowing and reduces debt vulnerabilities.

The chapter offers several lessons for policymakers at the current juncture:

- Although surprise inflation may occasionally offer some breathing room for debt ratios, attempts to keep surprising bondholders have historically proved futile or harmful.
- When reviewing automatic or discretionary indexation, policymakers need to decide which programs and groups to protect from income erosion while avoiding excessive indexation or other policies that make inflation more persistent. The impact of decisions about public wages (including choices regarding indexation) on private wage setting should also be carefully assessed.
- When considering new measures or reforms against the backdrop of significant inflation, policymakers should consider that different groups of households may already be experiencing sizable distributive effects.
- Fiscal policy—involving tough policy choices on what budget items to cut and which to protect or expand—can support monetary policy in the effort to bring down inflation while protecting those most affected by the cost-of-living crisis.