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Fiscal Implications of the Global Economic and Financial Crisis

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I Overview

The financial and economic crisis is affecting the fiscal accounts of virtually all IMF members through several channels. First, many countries have supported the financial sector directly, primarily through "below-the-line" operations affecting governments' assets and liabilities, as well as operations giving rise to contingent liabilities. Second, the growth deceleration, coupled with asset and commodity price declines, is affecting revenues (and, in some cases, spending). Third, discretionary stimulus has been used to support aggregate demand. Moreover, the losses suffered by funded pension schemes may involve contingent liabilities for the state. For many countries, these developments come in the context of a projected long-term deterioration in fiscal balances reflecting demographic changes. Indeed, in these countries, fiscal policy before the crisis was expected to focus on prepositioning the fiscal accounts to make room for increased aging-related spending. The opposite has happened.

It is now critical to reassess the state of public finances in light of the crisis and pursue strategies to ensure fiscal solvency. Major doubts about fiscal solvency would lead to a surge in risk premia on government paper, destabilize expectations, and further shake market confidence. A clear strategy to ensure fiscal solvency is, therefore, an important element for the resolution of the current crisis.

This paper quantifies the fiscal implications of the crisis, assesses the status of fiscal balances after the shock, and discusses the strategy to ensure fiscal solvency. The focus is primarily on advanced and emerging market economies, complementing the recent paper on the effect of the crisis on low-income countries.[1] While, for practical purposes, some of the empirical evidence presented refers only to the G-20 countries, information is provided also for other countries, and the analysis also applies to them.[2] Section II estimates the fiscal costs and contingent liabilities arising from direct support extended to financial institutions and markets, looking both at the upfront gross costs and the likely recovery from asset sales. Section III assesses the budget impact of the recession related to the automatic stabilizers, other nondiscretionary effects (e.g., revenue losses from asset price declines), and the discretionary stimulus. Section IV looks at fiscal risks arising from the losses suffered by funded pension schemes. Section V presents the overall fiscal outlook for advanced and emerging economies, adding together the effects discussed in the earlier sections, and discusses risks to the baseline. The projections are based on the IMF's April 2009 *World Economic Outlook*. Section VI assesses the outlook for fiscal solvency, calls for the early identification of a fiscal strategy to ensure solvency, and outlines the key components of such a strategy. The Appendixes include supporting material. As a general caveat, the estimates presented are subject to a significant degree of uncertainty, and developments should be closely monitored as new information becomes available.

[1]See IMF (2009).

[2]The G-20 group is defined in this paper as inclusive of Spain.