FOREWORD

For all countries, it is becoming hard to balance public finances. The difficulties originate in ever-growing demand for public spending, associated with high expectations about what the state can and should do, elevated debts, and high-for-long interest rates and political red lines on taxes. But the way the government budget constraint binds varies widely across countries. In some cases, it is binding with the government having insufficient resources to pay urgent bills and no access to market financing. These countries are often small and poor. For example, in many low-income countries interest expenses represent a large and growing fraction of tax revenues. In other cases, while immediate financial pressures are absent, the perpetuation of current policies entails an unsustainable fiscal path. These countries are, in general, large and rich. In addition, there is another important consideration when pondering budgetary policies. In most countries, tighter fiscal policies are needed, not only to reconstitute buffers and contain public finance risks, but also to contribute to central banks' efforts in favor of a timely return to inflation targets.

Debts are generally elevated around the world, and borrowing costs are rising. Global public debt is expected to turn up in 2023. Why? It would be accurate to answer that the rising trend is due to the major global economies (including the United States and China). Indeed, world debt is projected to increase by about 1 percentage point of GDP per year over the medium term. But, excluding the two largest economies, the ratio would instead decline by about ½ percentage point annually. Nevertheless, it would be more *relevant* to state that the turning up of deficits reflects slowing growth, rising real interest rates, and budget deficits dipping further into the red. The bottom line is that global public debt is now substantially higher, and it is projected to grow considerably faster than in prepandemic projections. At the projected pace, the global public debt ratio would be approaching 100 percent of GDP by the end of the decade.

The *Fiscal Monitor* looks at the fiscal implications from the green transition. The baseline is business as usual. Under such an assumption, it is possible to identify *ambition* gaps—the difference between countries' own nationally defined contributions and what is required to deliver on the Paris Agreement goals—and *policy* gaps—the difference between the national targets and the outcomes achievable under "business-as-usual" conditions. In sum, the baseline scenario fails to deliver net zero, with catastrophic consequences. Our report shows that scaling up the current policy mix—heavy on subsidies and other components of public spending—to deliver net zero leads to an accumulation of public debt by 40–50 percentage points of GDP for a representative advanced economy and for a representative emerging market economy by 2050.

The *Fiscal Monitor* argues that to partially circumvent this terrible trade-off, it is necessary to rely on a combination of policy instruments. Carbon pricing is a necessary component of the policy mix, but it is not sufficient. It must be complemented by instruments aimed at correcting remaining market failures. Fiscal support is also necessary to facilitate the unavoidable costly adjustments required of vulnerable households, workers, communities, and corporations. *Climate Crossroads: Fiscal Policies in a Warming World* presents illustrative combinations of policies that limit the increase in the public debt ratio to the range of 10–15 percentage points of GDP by 2050. That is a pressure that looks manageable through the adjustment of other parts of the budget.

Countries with limited fiscal space, low tax capacity, and expensive or nonexistent access to market financing face large adaptation costs. In many cases, these countries also have to deal with financial difficulties in their efforts to pursue sustainable, inclusive, and resilient development. These countries should prioritize and target spending (for example, eliminating fuel subsidies). They should also intensify their efforts to improve tax capacity with special emphasis on institutional building and enlarging tax bases (see IMF Staff Discussion Note "Building Tax Capacity in Developing Countries").

The private sector has a crucial role to play in a successful green transition. Public policies should provide a framework that favors private sector participation in investment and financing. In 2021 and 2022, the IMF has supported the efforts in more than 150 member states to upgrade tax capacity and to strengthen the market for Treasury liabilities. See the October 2023 *Global Financial Stability Report* for an overview on climate finance.

Ahead of the Conference of the Parties 28, it is important to reiterate that a global pragmatic side agreement among large players—such as the United States, China, India, the European Union, and the African Union—could make a decisive contribution. By incorporating a carbon price floor, the global agreement would provide the most effective and efficient policy instrument to become a focal point for policy action in the world. By including financial and technological transfers and revenue-sharing mechanisms, it could ease the financial divide and contribute to the achievement of the United Nation's Sustainable Development Goals, including the eradication of poverty and hunger.

The IMF has an important role to play at the center of the international monetary system, to help preserve sound public finances and financial stability. It is an essential piece of the global safety net. Urgent support from members is necessary to increase quota resources and secure funding for the concessional Poverty Reduction and Growth Trust and the Resilience and Sustainability Trust.

The logic of the three-way policy trade-off—or policy trilemma—described in the first lines of this foreword applies beyond climate. In fact, it applies to any policy goal that implies additional budget spending. Faced with myriad spending pressures, political red lines limiting taxation, at an insufficient level, translate directly into larger deficits that push debt to ever-rising heights.

Something must give to balance the fiscal equation. Policy ambitions may be scaled down or political red lines on taxation moved if financial stability is to prevail. The *Fiscal Monitor* shows that a smart policy mix maps the way out of the trilemma.

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