EXECUTIVE SUMMARY

Chapter 1: Policy in an Uncertain Recovery

As the world strives to bring COVID-19 under control, fiscal policy remains key to address the impacts of the still-evolving pandemic, which continues to be marked by uncertainty and unequal access to vaccines across countries. Although the Delta variant has been associated with a resurgence of the virus, fiscal support and, especially in advanced economies, vaccination have saved countless lives and facilitated an economic rebound. The interplay between vaccines and the virus and its variants is among the factors contributing to elevated uncertainty going forward. Therefore, fiscal policy needs to adapt to changing conditions.

In many advanced economies, fiscal policy continues to be accommodative and is shifting toward strengthening economies through a green transition, digital transformation, and other longer-term investments. The large fiscal packages announced or approved by the *European Union* and the *United States* could add a cumulative $4.6 trillion to global GDP between 2021 and 2026. Additional measures (including in *Europe*) are expected with the forthcoming national budgets for 2022. By contrast, in emerging markets and low-income developing countries, growth is held back by the low availability of vaccines, and governments are shifting expenditures toward addressing pandemic-related priorities. Higher interest rates and lower government revenues have strained the capacity of low-income developing countries to provide fiscal support and service their debt.

Overall, fiscal policy remains supportive, with 2021 deficits falling by about 2 percentage points of GDP in 2021, on average. However, deficits are still well above prepandemic levels, especially in advanced economies. Deficits are projected to decrease further by almost 3 percentage points in 2022 and return to their prepandemic levels by 2026. In emerging markets and low-income developing countries, where the fiscal stance is less supportive than in advanced economies, output and tax revenues are not projected to regain their precrisis trajectory and the reduction in deficits will occur largely through lower spending.

Global government debt is expected to remain at record-high levels—close to, but below, 100 percent of GDP—in 2021 and to decrease slightly through 2026. Large purchases of government debt by central banks (especially in advanced economies) and by the domestic banking sector have helped to contain the cost of new borrowing. The debt buildup has led to a rise in governments' gross financing needs. Many low-income developing countries will likely need further international aid and in some cases debt restructuring.

Risks to the fiscal outlook are elevated. A scaling up of vaccine production and delivery, especially to emerging markets and low-income developing countries, would limit further damage to the global economy. On the downside, new variants of the virus, low vaccine coverage in many countries, and delays in some people's acceptance of vaccination could inflict new damage and increase pressures on public budgets. The realization of contingent liabilities—including from loan and guarantee programs—may also lead to unexpected increases in government debt. Further pressures could come from social discontent, with the crisis estimated to have thrown between 65 and 75 million people into poverty in 2021 relative to prepandemic trends. Large government financing needs are a source of vulnerability, especially in emerging markets and low-income developing countries, where financing conditions are sensitive to global interest rates and central banks have begun to raise short-term reference rates.

Fiscal policy will need to respond nimbly to these challenges and facilitate the transformation of the global economy to make it more productive, inclusive, green, and resilient to future health or other crises. At the same time, it will be crucial to ensure transparency and accountability, plot a medium-term path to rebuilding fiscal buffers, and make progress toward the

Sustainable Development Goals. Steps toward achieving these aims include the following:

- International cooperation is vital to address cross-country inequities in the availability of vaccines, treatments, therapeutics, and protective equipment. The general allocation by the IMF of Special Drawing Rights has given a fillip to global liquidity, and the international community has provided valuable financial support to low-income developing countries. However, more needs to be done through grants, loans, and initiatives such as the G20 Common Framework for debt relief.
- In many countries, public investment in high-quality physical capital, education, and health care should be increased; fiscal transfers should be better targeted toward retraining and reallocating workers; and social safety nets should be strengthened.
- It will be crucial to calibrate fiscal policy to the cycle and speed of the recovery while also achieving the right mix between fiscal and monetary policies. If private demand recovers more rapidly than expected, fiscal policy should be tightened, as this would reduce the risk of a sudden rise in interest rates that could disrupt the global recovery.
- As it becomes more difficult to access low-cost borrowing, especially for emerging markets and low-income developing countries, governments should strengthen the credibility of their fiscal policy (Chapter 2). This will require mobilizing more revenue in the medium term and improving expenditure efficiency.

Chapter 2: Strengthening the Credibility of Public Finances

Fiscal support during the COVID-19 pandemic has saved lives and jobs. Appropriate as it has been, fiscal support has resulted in higher gross financing needs, with associated vulnerabilities, and government debt will likely remain high for many years.

Returning to prepandemic debt levels, for example, would require achieving, for more than a decade, larger primary fiscal balances than before the pandemic—a task made difficult not only by crisis-related spending, but also preexisting pressures from aging populations or development needs, and resistance to raising revenues. The appropriate timing to reduce deficits will depend on country-specific conditions, in particular the stage of the pandemic, existing fiscal vulnerabilities, the risk of economic scarring, and the quality of public spending. Consideration should also be given to the distributional effects of any increase in tax revenues or reduction in public spending. Fortunately, financial conditions have been and may remain favorable, despite heightened uncertainty, higher debt levels, and some sovereign defaults. However, a sharp fall in global savings or a sudden jump in interest rates would adversely affect vulnerable emerging markets and frontier economies.

Chapter 2 argues that committing to fiscal sustainability with credible frameworks—the set of rules and institutions that guide fiscal policy—can buy time and make debt stabilization or reduction less painful. When lenders trust that governments are fiscally responsible, financing larger deficits and debt rollovers becomes easier. Countries with access to financing can maintain fiscal support while committing to future adjustment. For countries with limited market access, fiscal credibility is also important to achieve a more predictable outlook and thus foster private investment and macroeconomic stability. Governments can signal their commitment to fiscal sustainability while addressing the ongoing crisis in various ways, including by undertaking structural fiscal reforms or by adopting strong fiscal frameworks that embed deficit reduction in the future.

Fiscal targets, for instance for deficit or debt, should also be set against the fiscal risks faced by individual countries. The course of the pandemic and its impact on long-term economic growth remains uncertain. Public balance sheets have also taken on sizable exposures through loans and guarantees to firms. In this context, the chapter examines the history of unexpected debt jumps over the past 25 years and finds that, when public debt exceeded projections, the median increase in debt ranged between 12 and 16 percent of GDP over five-year horizons. Underlying such negative surprises were disappointing medium-term nominal GDP growth and unexpected stock-flow adjustments, including from firms' bailouts and exchange rate depreciation. These critical risks need to be managed within fiscal frameworks.

Fiscal frameworks should also seek to achieve three overarching goals: sustainability, economic stabilization, and, for fiscal rules in particular, simplicity. However, satisfying all three is challenging. Quantitative objectives may take a narrow view of sustainability while simple rules that reduce fiscal procyclicality (such as an expenditure ceiling) may enable debt to increase.

When procedural rules are the main guide to control fiscal deficits and debt, governments have more flexibility, but it may be harder to communicate and monitor compliance without numerical targets, particularly in the absence of sound fiscal institutions. The chapter shows that numerical rules promote fiscal prudence. For instance, countries that follow debt rules manage to reverse debt jumps of 15 percent of GDP in about 10 years in the absence of new shocks—significantly faster than other countries. For countries with sufficient capacity, anchoring the medium-term fiscal strategy on the public sector balance sheet can preserve credibility and may help protect public investment.

Finally, the chapter shows that commitment to fiscal discipline and clear communication of policy priorities, backed by fiscal transparency, can reduce borrowing costs. Data on private sector expectations suggest that budget announcements have been more credible in countries that follow fiscal rules and where independent bodies monitor the rules. The gap between official and private forecasts of the fiscal deficit was 1 percent of GDP smaller in countries that followed budget balance rules. In turn, credible budget announcements were rewarded with a temporary reduction in 10-year sovereign yields by about 40 basis points. Media reaction to suspension of fiscal rules was also more positive in countries with higher fiscal transparency. However, announcements of large fiscal adjustments do not necessarily build fiscal credibility as private forecasts of the budget deficit typically discount their short-term impact on the deficit. Overall, strong fiscal frameworks can meaningfully contribute to strengthening the credibility of public finances.