

Chapter 1: Fiscal Policy from Pandemic to War

Just as uncertainty associated with the COVID-19 pandemic was abating, *Russia* invaded *Ukraine*. Uncertainty endured, shifting from pandemic to war. Besides the death toll, human misery, and destruction of infrastructure, the war is causing costly displacement of refugees and loss of human capital, disrupting commodity markets, and further fueling inflation. Higher food and energy prices raise the risks of social unrest. Since the war started, more than 4.5 million refugees have fled *Ukraine* as of April 10. Fiscal policy has a special role to play when things go wrong. It can protect the most vulnerable from the impact of high and rising food and energy prices on household budgets. More generally, governments' responses will be shaped against the difficult background of high and increasing inflation; slowdown in growth; high debt and tightening credit conditions. Budget constraints are increasingly binding, as central banks hike interest rates to fight inflation.

The unusually high degree of uncertainty affects all countries differently. Emerging markets and low-income developing countries serving as net importers of energy and food will be hit by elevated international prices, putting pressure both on growth and public finances. Many of these countries have faced scarring from the pandemic and have little fiscal space to buffer these new shocks. Some commodity exporters, especially large oil exporters, will benefit from significant revenue windfalls. Countries also face uneven effects of the COVID-19 pandemic on households' incomes and poverty. While an estimated 70 million more people (relative to the prepandemic trend) experienced extreme poverty in 2021, poverty was stable or even declined where fiscal support was large. With this support, household incomes grew or were stable in 2020 in some advanced and emerging market economies despite an economic recession. Amid COVID-19 restrictions and high uncertainty, household savings rose sharply relative to prepandemic levels—by a combined \$3½ trillion in the *United States* and the *European Union* during 2020–21. In contrast, fiscal support was insufficient to prevent a fall in household income in many developing economies.

Above-target inflation rates and inflation surprises—the difference between actual and projected inflation rates—and monetary policy reactions to them have significant implications for public budgets. Inflation surprises reduced public debt-to-GDP ratios in advanced and emerging market economies (excluding *China*) by 1.8 and 4.1 percentage points of GDP in 2021. Although inflation surprises can reduce deficits in the short term—as nominal revenues increase faster than nominal spending—their relief to public finances is usually temporary. If inflation expectations and inflation volatility increase, government bonds become less attractive to investors, and the costs of borrowing rise.

The fiscal outlook is subject to elevated uncertainty, as the full consequences of the war and spillovers from sanctions on *Russia* are unknown and will vary across countries. Deficits are falling globally but are expected to remain above prepandemic levels. The average public debt in advanced economies is projected to decline to 113 percent of GDP by 2024, mirroring the recovery from the pandemic-related recession. Debt is projected to continue to rise in emerging markets, mainly driven by *China*, reaching 72 percent of GDP by 2024. Among low-income developing countries, debt is expected to gradually decline to 48 percent of GDP by 2024. Public debt is expected to go down faster in commodity exporters thanks to positive terms-of-trade shocks. There are large risks around the outlook for deficits and debt, especially if economic growth disappoints or inflation dynamics continue to surprise.

High uncertainty and marked divergences across countries require a tailored and agile fiscal policy response. To support economies that will be hardest hit by the war, fiscal policy will need to address the humanitarian crisis and economic disruption. Given rising inflation and interest rates, fiscal support should target those that are most affected and focus on priority areas. If economic activity deteriorates significantly, broader fiscal support could become appropriate for countries with fiscal space but should be done in ways that avoid exacerbating ongoing

demand-supply imbalances and price pressures. In countries where economic growth is less exposed to the conflict and central banks are raising rates to fight high inflation, fiscal policy should move away from the exceptional support provided during the pandemic towards normalization. In many emerging markets and low-income developing countries, trade-offs are harsher. Higher inflation and tightening global financial conditions call for prudence, whereas fiscal support is needed for those countries that will be the hardest hit by the higher commodity prices and where the recovery was already weak. Fiscal reforms can ease these trade-offs. Sound and credible medium-term fiscal frameworks help to manage market expectations, containing sovereign borrowing costs. Mounting public spending pressures in some areas (for example, safety nets and defense) require reprioritizing spending and mobilizing revenues.

Governments around the world are taking measures to shield their economies from the spike in international energy and food prices. Such measures can help protect vulnerable households and preserve social cohesion; however, they can also have undesirable consequences and large fiscal costs. In many cases, countries have taken measures to limit the rise in domestic prices (cut taxes or grant subsidies), which could exacerbate the global imbalances between demand and supply, putting further upward pressure on international prices, and lead to energy or food shortages. This will hurt further low-income countries that import energy and food. Many governments have also provided generalized subsidies or transfers, which can imply large fiscal costs. A better solution would be to provide targeted, temporary, and direct support to vulnerable households, while allowing domestic prices to adjust. This strategy would contain fiscal pressures, as many countries face rising debt burdens, and preserve incentives

for the private sector to increase supply of energy and food.

Measures to address immediate needs from high food and energy prices should not detract from action to tackle long-standing challenges such as climate change. It is even more urgent now to ensure greater resilience through investment in health, food, and energy security from cleaner sources. Moving toward a more diverse, clean, and renewable energy matrix will ensure energy security and facilitate the green transition. For example, increases in carbon taxes in most countries envisage a gradual phasing-in that is far smaller and more predictable than recent gyrations in energy markets. Short-term responses to high energy prices should avoid investing in long-duration and capital-intensive fossil fuel projects.

Global cooperation is more important now than ever—to address the consequences of the COVID-19 pandemic and energy and food disruptions, to help refugees from the war, to prevent and prepare for future potential pandemics, and to mitigate climate change. Unilateral actions, such as restricting food exports, could worsen the food crisis. It will be crucial that countries work together to address supply concerns on fertilizers and food products, like wheat, toward supporting the most vulnerable populations. International cooperation in corporate taxation, transparency, and exchange of information for personal taxation, and carbon pricing can mobilize resources to promote necessary investments, reduce inequality, and alleviate perceptions that the tax burden is not distributed fairly (Chapter 2). Likewise, financial and technical support for low-income developing countries is warranted. Cooperation is crucial where high debts become unsustainable: where reprofiling or restructuring is called for, a multilateral cooperative approach that goes beyond SDR channeling is essential.