

FOREWORD

The war in the Middle East is affecting economies and markets, with the potential of rocking public finances worldwide—on top of the sobering human and economic toll in the region. Fiscal effects are uneven across countries and are hitting at a moment when buffers are weak in many places. Higher oil prices are the most visible consequence, but increases in Liquefied Natural Gas (LNG) and food prices, disruptions to tourism flows, lower regional remittances, and heightened uncertainty are also significant.

Historically, large supply-driven oil price shocks have widened the fiscal deficit of a typical oil importer and improved the balance of a typical exporter, though outcomes vary widely across episodes and countries. Weaker activity erodes revenues everywhere, while measures to cushion higher fuel and food prices raise spending or lower revenues. Tighter financial conditions increase refinancing costs, especially for energy-importing emerging market economies as risk premiums rise. Unexpected inflation, however, can temporarily help debt dynamics. Taken together, these forces are likely to weaken fiscal positions in many countries, through both direct and indirect channels.

In this context, this issue of the *Fiscal Monitor* examines how recent shocks may unfold and what policy responses are needed. First, policy needs to avoid unwanted demand stimulus at a time when monetary policy is addressing inflationary effects of the disruption. A fiscal reaction, beyond automatic stabilizers and some specific support, even under ample fiscal space, would lead to persistently higher inflation and interest rates. Second, support measures should be commensurate with the severity of the shock, targeted and temporary, focused on the most vulnerable, and designed to preserve fiscal sustainability. Under limited fiscal space, budget reallocation should take precedence as new adverse events may arise and destabilizing government debt markets would be very harmful. Broad-based energy subsidies are distortionary, fiscally expensive, regressive, and difficult to unwind and carry sizable international spillovers. When supply is constrained, demand must adjust worldwide.

If some (especially larger) countries insulate consumption from price changes, the global price will be higher and others face larger adjustment. International coordination and cooperation are therefore essential.

At the same time, the war's immediate fiscal consequences should not obscure deeper and more persistent fiscal challenges. One year after the previous *Fiscal Monitor* conjunctural chapter, global fiscal conditions have progressed only minimally. Public debt remains historically high and continues to rise. Borrowing costs are well above pre-pandemic levels, and the favorable mix of low real interest rates and growth is fading. Spending pressures are intensifying: aging populations are straining budgets; defense outlays are rising, notably in Europe; and the investment needs associated with the climate transition and energy security are growing. Yet fiscal policy has, in many countries, largely stood still.

As a result, global public debt dynamics remain unfavorable. Although increases in debt are concentrated in the China and the United States, vulnerabilities are widespread. Many countries across income levels face high debt, unfavorable dynamics, or both. This leaves them more exposed to tighter financing conditions and less able to respond to future shocks.

Stronger trend growth—driven by bolder reforms or by artificial intelligence meeting expectations—could improve fiscal dynamics by lowering $r - g$ and strengthening the primary balance, as long as spending does not rise as fast as revenues.

Policymakers should recognize that markets are becoming less forgiving. Over the past year, investors have increasingly questioned assumptions of unlimited sovereign borrowing capacity—even for large advanced economies. Episodes of market repricing in Japan, the United States, and parts of Europe reflect heightened sensitivity to fiscal slippages and weak medium-term frameworks. Although none have matched the scale of the United Kingdom's 2022 episode, the message is clear: higher debt, fiscal uncertainty, and delayed consolidation now translate more rapidly into higher borrowing costs.

Rebuilding fiscal buffers once conditions stabilize is more important than ever. Crises rightly demand emergency support, but the ability to respond depends critically on pre-existing fiscal space. Too often, consolidation is deferred once conditions normalize. Debt ratios then ratchet upward—rising during economic downturns and failing to return to pre-shock levels. As investors become less willing to absorb ever increasing debt, delays raise the risk of abrupt and costly adjustment later on. The opposite is also true: more fiscal credibility built with timely efforts lowers risk premiums and interest costs, opening space for urgent spending.

Political economy constraints are real, and fiscal consolidation requires political support. In many countries, debate has shifted away from fiscal restraint even as aging demographics reshape electorates. Delay is costly. Credible medium-term frameworks, transparent communication, and well-designed measures that efficiently protect the vulnerable are essential to keep the fiscal house in order.

Constraints are the tightest for low-income countries. Financing has become more expensive, official development assistance has declined, and rising debt service often crowds out priority spending.

Strengthening domestic resource mobilization is critical. Reforms to tax policy and administration—broadening tax bases, reducing exemptions, improving compliance, and leveraging digital technologies—can deliver durable revenues. On the spending side, there are opportunities to improve quality and efficiency, while stronger public investment management and governance are needed to ensure scarce resources translate into growth and social outcomes. In addition, risks stemming from weakly designed public-private partnerships and inadequate state-owned enterprise governance should be addressed in a timely manner.

The message of this *Fiscal Monitor* is clear. High debt, higher interest rates, and persistent spending pressures leave little room for complacency. Countries that rebuild buffers in calm periods will be better placed to protect their citizens when shocks arrive. Clear communication and credible sequencing of measures will strengthen that effort. Those that do not comply may find, when the next test comes, that fiscal space cannot be improvised.

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