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Fiscal Affairs Department

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As Downside Risks Rise, Fiscal Policy Has To Walk a Narrow Path

Deficits in many advanced economies fell significantly during 2011, and most plan substantial adjustment this year. Continued adjustment is necessary for medium-term debt sustainability, but should ideally occur at a pace that supports adequate growth in output and employment. Given the large adjustment already in train this year, governments should avoid responding to any unexpected downturn in growth by further tightening policies, and should instead allow the automatic stabilizers to operate, as long as financing is available and sustainability concerns permit. Countries with enough fiscal space, including some in the euro area, should reconsider the pace of near-term adjustment. At the same time, some countries—notably, the United States and Japan—need to clarify their medium-term debt-reduction strategies. Adjustment should be supported by the availability of adequate nonmarket financing when, as in the euro area, market confidence is slow to respond to reforms.

Fiscal deficits fell significantly in 2011 in many advanced economies…

In advanced economies, fiscal deficits fell in 2011 by about 1 percent of GDP overall, and by only slightly less after taking into account the narrowing output gap. The headline deficit fell by 2 percent of GDP in the euro area, and by a still sizable 1¼ percent of GDP in cyclically adjusted terms (Table 1). However, a large share of the improvement within the euro area is accounted for by Germany, where the cyclically adjusted deficit fell by 2¼ percent of GDP, reflecting an unusually strong response of revenues and employment to output. The cyclically adjusted balance also strengthened substantially in Spain, while France and Italy posted more modest improvements, as measures announced or approved in these countries will not take full effect until next year (see below). Cyclically adjusted deficits also fell substantially in the United Kingdom and the United States, but rose marginally in Japan owing to reconstruction costs related to the natural disaster.

Among European program countries, headline deficits were larger than expected in *Greece* owing in part to a weaker economic outturn. Slippages in the implementation of revenue and spending measures and lower tax compliance suggest that the cyclically adjusted deficit exceeded expectations as well, notwithstanding an improvement of 3 percentage points of GDP relative to 2010. In Portugal, the fiscal target was met through a one-time partial transfer of banks' pension fund assets, implying that the underlying adjustment in 2011 was smaller than expected there, although still very sizable (4 percentage points of GDP in cyclically adjusted terms). In Ireland, headline fiscal outturns were on track, and the cyclically adjusted balance improved by 2 percent of GDP.

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Table 1. Fiscal Indicators, 2008–13

(Percent of GDP, except where otherwise noted)

			Est.	Projections			Difference from September 2011 *Fiscal Monitor*[1]		
	2008	2009	2010	2011	2012	2013	2011	2012	2013
Overall Fiscal Balance									
World	-2.0	-6.7	-5.5	-4.5	-4.1	-3.4	0.0	-0.4	-0.5
Advanced economies	-3.8	-9.0	-7.6	-6.6	-5.7	-4.6	0.0	-0.4	-0.5
United States	-6.7	-13.0	-10.5	-9.5	-8.0	-6.4	0.1	-0.1	-0.2
Euro Area	-2.2	-6.5	-6.3	-4.3	-3.4	-2.9	-0.1	-0.3	-0.4
France	-3.3	-7.6	-7.1	-5.7	-4.8	-4.4	0.1	-0.2	-0.5
Germany	-0.1	-3.2	-4.3	-1.1	-0.7	-0.1	0.6	0.4	0.7
Italy	-2.7	-5.3	-4.5	-3.9	-2.8	-2.3	0.2	-0.4	-1.1
Spain	-4.2	-11.2	-9.3	-8.0	-6.8	-6.3	-1.8	-1.7	-1.9
Japan	-4.7	-10.8	-9.3	-10.1	-10.2	-8.8	0.2	-1.0	-1.0
United Kingdom	-4.9	-10.4	-9.9	-8.6	-7.8	-6.5	-0.1	-0.8	-1.4
Canada	0.1	-4.9	-5.6	-4.9	-4.4	-3.6	-0.6	-1.2	-1.7
Emerging economies	-0.4	-4.8	-3.6	-2.6	-2.7	-2.5	0.1	-0.4	-0.5
China	-0.4	-3.1	-2.3	-2.0	-2.0	-1.4	-0.4	-1.2	-1.3
India	-7.2	-9.7	-8.9	-8.5	-7.9	-7.6	-0.4	-0.4	-0.2
Russia	4.9	-6.3	-3.5	0.5	-1.4	-1.7	1.6	0.7	0.6
Brazil	-1.4	-3.1	-2.8	-2.6	-2.4	-2.3	-0.2	0.4	0.3
Mexico	-1.1	-4.7	-4.3	-3.0	-2.7	-2.1	0.3	0.0	0.3
South Africa	-0.5	-5.3	-5.1	-4.9	-4.8	-4.2	-0.6	-0.9	-0.9
Low-income economies	-1.3	-4.0	-3.1	-2.8	-2.8	-2.3	0.3	0.1	0.2
G-20 economies	-2.7	-7.6	-6.2	-5.1	-4.7	-3.9	0.1	-0.4	-0.5
G-20 advanced	-4.4	-9.6	-8.2	-7.2	-6.3	-5.1	0.1	-0.3	-0.5
G-20 emerging	-0.2	-4.8	-3.5	-2.5	-2.7	-2.5	0.0	-0.5	-0.6
General Government Cyclically Adjusted Balance (Percent of Potential GDP)									
World	-2.6	-4.6	-4.3	-3.6	-3.0	-2.4	0.0	-0.1	-0.2
Advanced economies	-3.7	-5.9	-5.9	-5.1	-4.2	-3.2	-0.3	-0.4	-0.4
United States[2]	-5.0	-7.5	-7.8	-7.0	-5.6	-4.3	-0.6	-0.7	-0.6
Euro Area	-3.2	-4.8	-4.8	-3.5	-2.1	-1.6	-0.4	0.1	0.2
France	-3.0	-5.3	-5.2	-4.4	-3.3	-3.1	-0.1	0.0	-0.1
Germany	-1.3	-1.3	-3.5	-1.2	-0.4	0.1	0.3	0.5	0.8
Italy	-3.6	-3.5	-3.4	-2.9	-0.8	0.0	-0.4	0.3	0.0
Spain	-5.4	-9.8	-7.8	-6.6	-4.7	-4.1	-2.0	-0.5	-0.2
Japan	-4.1	-7.7	-7.8	-8.0	-8.6	-7.8	0.1	-1.0	-0.9
United Kingdom	-6.5	-9.0	-7.8	-6.3	-5.1	-3.7	0.0	-0.4	-0.8
Canada	-0.5	-2.5	-4.0	-3.8	-3.2	-2.5	-0.8	-1.3	-1.5
Emerging economies	-1.9	-4.1	-3.4	-2.6	-2.4	-2.1	0.5	0.2	0.1
China	0.0	-2.4	-1.5	-0.7	-0.6	-0.2	1.1	0.3	-0.1
India	-9.3	-10.7	-9.5	-8.9	-8.3	-8.0	-0.6	-0.3	-0.1
Russia	3.8	-3.3	-1.9	1.0	-1.3	-1.7	1.3	0.5	0.5
Brazil	-2.2	-2.2	-3.3	-2.8	-2.2	-2.2	-0.2	0.6	0.4
Mexico	-1.3	-3.8	-3.8	-2.8	-2.7	-2.1	0.7	0.4	0.8
South Africa	-2.0	-4.9	-4.6	-4.4	-4.0	-3.6	-0.7	-0.6	-0.5
G-20 economies	-3.0	-5.2	-5.0	-4.2	-3.6	-2.9	0.1	-0.2	-0.2
G-20 advanced	-3.8	-6.0	-6.3	-5.4	-4.5	-3.5	-0.3	-0.5	-0.5
G-20 emerging	-1.7	-4.1	-3.4	-2.6	-2.5	-2.2	0.5	0.2	0.0
General Government Gross Debt									
World	59.5	65.9	70.0	70.1	70.9	70.9	0.6	1.5	2.2
Advanced economies	82.0	93.7	99.7	103.5	107.6	110.2	1.0	2.1	3.0
United States	76.1	89.9	98.5	102.0	107.6	112.0	2.0	2.6	3.1
Euro Area	69.8	79.4	85.3	88.4	91.1	92.5	0.0	1.2	2.4
France	68.3	79.0	82.4	87.0	90.7	93.1	0.1	1.2	2.3
Germany	66.7	74.4	83.2	81.5	81.6	79.8	-1.1	-0.3	-1.2
Italy	105.8	115.5	118.4	121.4	125.3	126.6	0.4	3.9	6.5
Spain	39.9	53.6	60.8	70.1	78.1	84.0	2.6	7.9	11.2
Japan	196.2	216.3	219.0	233.4	241.0	246.8	0.3	2.5	3.8
United Kingdom	52.5	68.4	75.1	80.8	86.6	90.3	0.1	1.8	4.4
Canada	71.1	83.6	85.1	85.5	86.7	84.7	1.4	2.6	2.4
Emerging economies	34.7	36.7	40.8	37.8	36.4	35.0	0.0	0.7	1.2
China	17.0	17.7	33.5	26.6	23.3	20.9	-0.3	1.1	2.5
India	74.7	74.3	67.4	65.8	65.3	64.4	0.9	1.1	1.2
Russia	7.9	11.0	11.7	10.5	11.2	12.1	-1.1	-0.9	-0.5
Brazil	63.5	66.9	65.2	66.0	64.2	62.0	1.0	0.2	-0.5
Mexico	43.1	44.7	42.9	42.7	43.2	43.5	-0.2	-0.4	0.0
South Africa	27.4	31.5	35.3	37.9	40.0	41.5	1.1	1.5	2.0
Low-income economies	39.2	42.4	40.8	40.0	40.3	40.2	-2.1	-1.3	-1.5
G-20 economies	66.4	73.3	78.2	77.8	78.5	78.4	0.7	1.7	2.4
G-20 advanced	87.6	100.1	106.4	110.2	114.6	117.4	1.1	2.2	2.9
G-20 emerging	34.8	35.9	40.8	37.1	35.3	33.8	0.1	0.8	1.5
Memorandum:									
World Growth (percent)	*2.8*	*-0.6*	*5.2*	*3.8*	*3.3*	*3.9*	*-0.1*	*-0.7*	*-0.5*

Sources: IMF staff estimates and projections.

Note: All country averages are PPP-GDP weighted using rolling weights. Projections are based on IMF staff assessment of current policies.

[1] For overall fiscal balance and cyclically adjusted balance, + indicates a smaller fiscal deficit; for gross debt, + indicates a larger debt.

[2] Excluding financial sector support.

… and further substantial consolidation is in the pipeline

- In the *United States,* the cyclically adjusted deficit is forecast to fall sharply this year, by around 1½ percent of GDP. These projections assume that Congress will extend payroll tax relief and jobless benefits for the long-term unemployed beyond their expiration date at the end of February. Without these extensions, the cyclically adjusted deficit would decline by over 2 percentage points of GDP—the largest annual fall in at least four decades—with negative repercussions for the still unsettled economic outlook. The risk of too rapid short-term adjustment stands in marked contrast to the continued lack of progress in clarifying a medium-term consolidation strategy, including the failure of the Joint Select Committee on Deficit Reduction to reach agreement on a medium-term program to strengthen public finances.

- *Japan* is projected to be the only large advanced economy to implement a fiscal expansion in 2012, reflecting in part reconstruction costs related to the natural disaster. Total reconstruction costs are now budgeted at about 4 percent of GDP over 2011–13, financed initially through bond sales. These bonds are intended eventually to be redeemed through sales of government-owned stocks and a temporary increase in the corporate tax rate, for 3 years, and in personal income tax rates, spread over 25 years to minimize its impact. As part of its medium-term fiscal strategy, the government is to submit a tax reform bill, including its proposal for doubling the consumption tax rate to 10 percent by 2015, but this will not be sufficient in itself to put the debt ratio on a downward path.

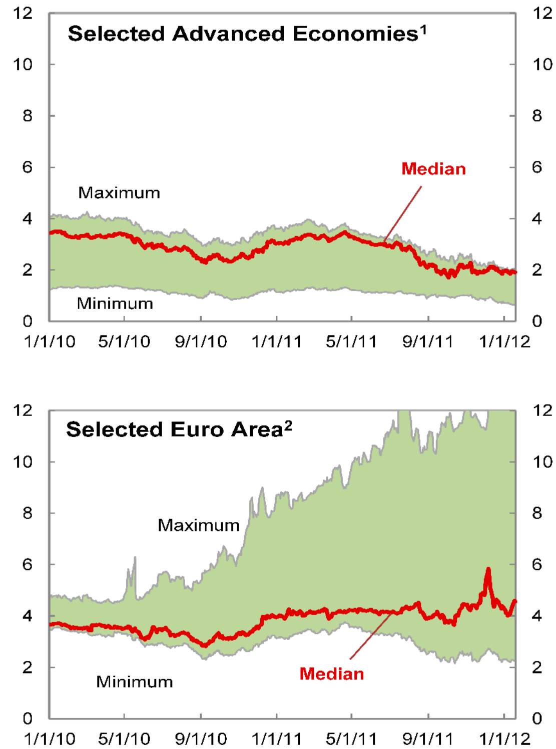
- In the *United Kingdom*, actual and potential GDP growth estimates have been revised down, weakening projected headline and cyclically adjusted balances. To prevent a further slowdown of the economy, the government has indicated that it will accommodate the weakened cyclically adjusted balance and let automatic stabilizers operate freely over the next three years, with the composition of adjustment being reshuffled to make it more growth-friendly. The cyclically adjusted deficit is still expected to fall markedly this year, however. To maintain the government's commitment to balance the current cyclically adjusted budget within five years, further spending cuts in 2015–17 have been announced.

- In *Germany*, fiscal targets for 2012 are expected to be slightly stronger than envisaged earlier, locking in over-performance from last year.

- Many advanced economies have introduced new measures to support the achievement of their deficit targets. The new government in *Spain* has announced a first package of measures of 1.1 percent of GDP, including spending cuts and temporary tax increases on income, capital, and high-value homes. The package also includes a limited increase in social spending and tax expenditures (mortgage deduction). A draft budget for 2012 will be submitted to Parliament by end-March. In *Italy*, the adjustment package approved in December will augment by 1¼ percent of GDP the fiscal consolidation envisaged over 2012–14, following the July and September packages (resulting in a fiscal effort of 3¼ percent and 1¼ percent of GDP this year and next, respectively), enough to bring the budget into balance in cyclically adjusted terms next year. Key elements of the package include the reintroduction of real estate taxes on primary residences and pension reforms (tightening eligibility for early retirement, reducing pension indexation and accelerating the increase in retirement ages). Thanks to these and previous reforms, annual pension spending is forecast to fall over the next twenty years by 1¾ percentage points of GDP. This is the best performance among advanced economies (where average spending is forecast to rise by 1¼ percentage point of GDP), although the initial level of pension spending is among the highest.[1] Following a first set of measures adopted in September, the government of *France* announced an additional fiscal package for 2012–16, amounting to 1 percent of GDP, of which measures equal to 0.3 percent of GDP will be enacted this year. Revenue measures, including the end of incentives to invest in property markets, are front-loaded and make up more than half the adjustment. Pension reform has been accelerated modestly, with the retirement age of 62 now taking effect one year earlier, in 2017, and the health care spending growth norm has been tightened. In *Greece*, the authorities are to enact new revenue and expenditure measures to correct policy slippages. In *Portugal*, new adjustment measures were incorporated in the 2012 budget, including spending cuts, a broadening of the VAT tax base under the standard rate, and a reduction in tax expenditures. In *Ireland*, the overall balance target for 2012 remains broadly unchanged, notwithstanding a sizeable downward revision to growth. The cyclically adjusted balance is expected to strengthen by 0.7 percent of GDP.

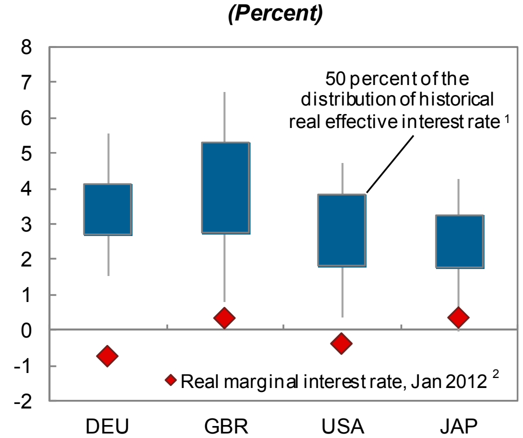
Nevertheless, market interest rates in some advanced euro area economies remain at very high levels, although they have moderated somewhat in recent weeks (Figure 1). By contrast, some large advanced economies thus far remain immune from market pressures, with interest rates that are well below historical levels (Figure 2). See the January 2012 *Global Financial Stability Report Update* for details.

Figure 1. Distribution of 10-Year Sovereign Bond Yields in Selected Advanced Economies
(Percent)



Sources: Datastream; and IMF staff estimates.
[1] Includes Canada, Germany, Japan, Switzerland, U.K., U.S.
[2] Includes Austria, Belgium, Finland, France, Ireland, Italy, Netherlands, Portugal, and Spain.

Figure 2. Real Effective Interest Rates: Historical Distribution and Current Level
(Percent)



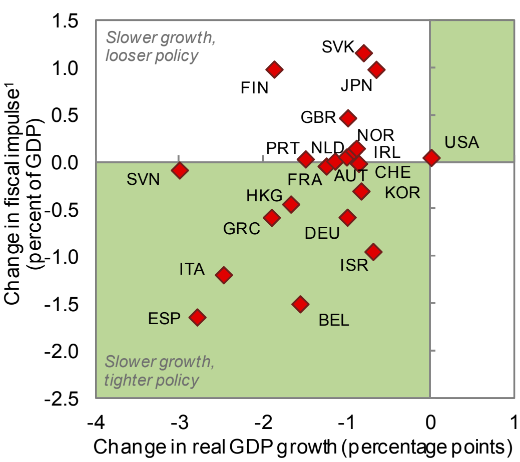
Sources: Bloomberg L.P.; IMF, *International Financial Statistics*; and IMF staff estimates and projections.
[1] Effective interest rates are calculated using interest payments divided by the stock of debt of the previous year, and deflated using contemporaneous inflation. Historical distribution over 1989–2010.
[2] Real marginal interest is calculated using each country's yield curve as of Jan. 9, 2012, assuming that maturity at issuance mirrors each country's maturity profile at end-2011, and deflated using IMF staff inflation projections.

[1] See "The Challenge of Public Pension Reform in Advanced and Emerging Economies" (http://www.imf.org/external/pp/longres.aspx?id=4626).

Too rapid consolidation during 2012 could exacerbate downside risks

While deficits and debt in many advanced economies are high, the pace of consolidation projected in 2012 is considerable given the weak economic environment (see the January 2012 *World Economic Outlook Update*). Moreover, fiscal policy in many countries is already tighter with respect to the cycle than had been projected in the September 2011 *Fiscal Monitor* (Figure 3), partly because a lack of affordable additional financing is compelling some euro area economies to introduce new measures to attain existing headline deficit targets, rather than allowing the automatic stabilizers to operate.

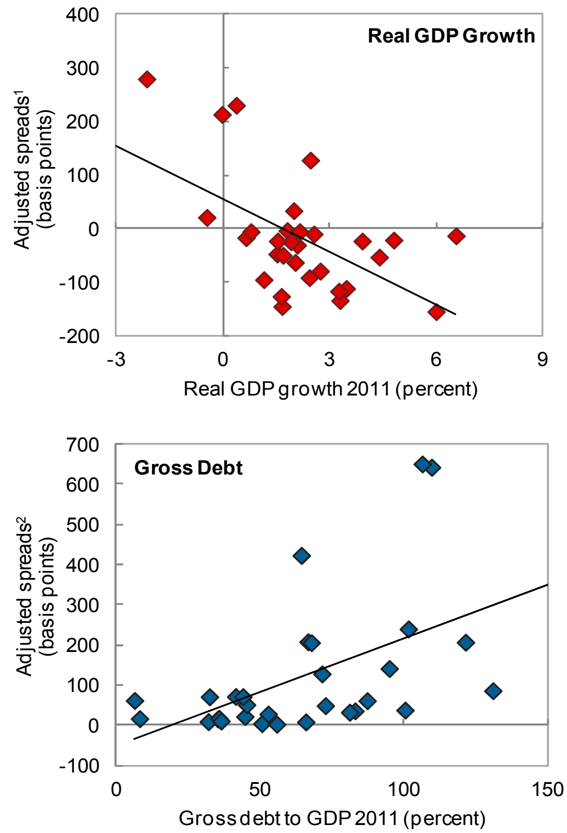
Figure 3. Advanced Economies: Change in Fiscal Impulse and Real GDP Growth, 2012
(Percent)



Sources: IMF staff estimates and projections.
Note: Changes in growth and fiscal impulse refer to January 2012 *Fiscal Monitor Update* data vis-à-vis September 2011 *Fiscal Monitor* data. Shaded area indicates that fiscal policies are more procyclical than expected earlier.
[1] Fiscal impulse is defined as the difference between the 2011 and 2012 cyclically adjusted primary balances. Minus indicates a tighter fiscal position.

Further declines in cyclically adjusted deficits could be undesirable not only from a growth perspective, but possibly from a market perspective as well. While smaller deficits and debt ratios do lead to lower borrowing costs, other things equal, advanced economies with faster output growth are also currently benefiting from lower spreads (Figure 4). This likely reflects in part concerns about the feasibility of fiscal consolidation and solvency in an environment of very weak growth.[2] Thus, further tightening during a downturn could exacerbate rather than alleviate market tensions through its negative impact on growth.

Figure 4. Real GDP Growth, Debt, and Adjusted Spreads



Sources: IMF staff estimates and projections.
Note: Adjusted spreads are actual CDS spreads minus fitted values derived from a regression analysis of the determinants of 5 year CDS spreads for 31 advanced economies using gross debt, domestic and foreign central bank holdings of government debt, primary balances of euro area countries (all as a percent of GDP), inflation, and real GDP growth as explanatory variables. As indicated in the footnotes, an individual regressor was omitted from the calculation of fitted values in each case. For more information please see: http://www.imf.org/external/np/speeches/2011/111811.htm
[1] Real GDP growth was omitted from the fitted values used to calculate adjusted spreads.
[2] Debt to GDP was omitted from the fitted values used to calculate adjusted spreads.

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[2] In principle, the temporary deceleration of growth that normally accompanies a fiscal tightening should not affect long-term solvency risks (for which potential growth matters). However, after four years of high volatility markets seem to be focusing at present on short-term developments and therefore seem to react negatively to even temporary decelerations in growth.

Countries should watch the speed of short-term adjustment, but medium-term consolidation remains a priority

In the near term, sufficient fiscal adjustment is in train in most advanced economies, and they should allow the automatic stabilizers to operate freely, so long as solvency concerns allow and financing for higher deficits can be realized. Among those countries, those with very low interest rates or other factors that create adequate fiscal space, including some in the euro area, should reconsider the pace of near-term fiscal consolidation. However, implementation of credible medium-term debt reduction plans remains a priority, as high debt levels make these countries vulnerable should interest rates increase. For the *United States*, such a plan should feature measures that contain entitlement spending and raise revenues. In *Japan*, an adjustment path that allows debt ratios to begin declining by the middle of this decade is called for.

In some countries, however, market interest rates remain very high despite the significant fiscal consolidation that has been implemented or is in the pipeline. For countries that are adjusting at a rate that is appropriate from a medium-term perspective, the availability of adequate financing—through the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM)—along with credible mechanisms to ensure that these countries remain committed to fiscal discipline over the medium and longer term, could provide an important confidence boost while market perceptions gradually adjust to strengthened fundamentals.

In this context, the new European fiscal compact agreed to by a majority of EU countries in early December is a welcome step toward deeper fiscal integration, although further action is needed. Measures include a new fiscal rule (capping the structural deficit at ½ percent of GDP) with an automatic correction mechanism in case of deviations, to be enshrined in each country's national legal system; stronger monitoring and assessment of budgetary plans by the European Commission; and ex ante reporting of national debt issuance plans to the European Commission.

Countries need to ratify the new measures quickly to ensure the effectiveness of these agreements. Furthermore, over time, stronger fiscal integration and governance will have to be complemented by some fiscal risk sharing across the euro area.

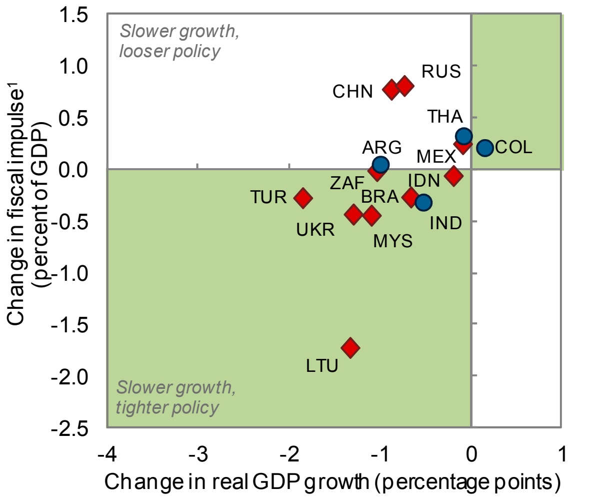
Fiscal policy in EMs should reflect the different conditions and risks they face

Deficits in emerging economies fell by about 1 percent of GDP in headline terms and about ¾ percent in cyclically adjusted terms in 2011. Higher oil revenues led to a dramatic increase in the cyclically adjusted balance in Russia, and to a lesser extent Mexico, but declines in cyclically adjusted deficits were recorded in all other major emerging economies last year, as well.

A looser-than-expected fiscal stance is accompanying the weakening economic environment in some emerging economies this year, but others are tightening policy instead (Figure 5). Some emerging economies with rapidly widening output gaps and declining inflation have room to make policy more supportive of economic activity, given relatively low debt levels. In others, however, high debt and lingering large deficits mean there is little space for more than the operation of automatic stabilizers should growth slow further. Emerging economies highly dependent on commodity revenues and external inflows also need to assess cautiously risks of a large and protracted decline in such financing sources.[3]

[3] Fiscal policy is only one element of the policy response to the slowdown. The Update of the *World Economic Outlook* discusses the overall policy framework for emerging economies.

Figure 5. Emerging Economies: Change in Fiscal Impulse and Real GDP Growth, 2012
(Percent)



Sources: IMF staff estimates and projections.
Note: Changes in growth and fiscal impulse refer to January 2012 *Fiscal Monitor Update* data vis-à-vis September 2011 *Fiscal Monitor* data. Shaded area indicates that fiscal policies are more procyclical than expected earlier. Circles indicate countries with positive output gaps.
[1] Fiscal impulse is defined as the difference between the 2011 and 2012 cyclically adjusted primary balances. Minus indicates a tighter fiscal position.

- In *China,* where policy is expected to be broadly neutral this year, fiscal support could continue by deferring consolidation plans, through lower social contributions and consumption taxes. There is also scope to accelerate investment in social housing. Unlike in 2008, fiscal support should be through on-budget measures that promote transparency and accountability.

- With economic activity slowing, *Brazil* has adopted a policy mix of maintaining fiscal discipline to support easing monetary policy as the main countercyclical tool. As such, a primary surplus target of 3.1 percent of GDP has been set for 2012, implying a ½ percentage point adjustment of the cyclically adjusted balance. Some targeted fiscal steps to support demand have been announced, worth around 0.2 percent of GDP in 2011–12, and it will be important to stand ready to take offsetting fiscal measures as needed to achieve the authorities' overall fiscal targets and policy objectives.

- In *India*, the cyclically adjusted deficit is projected to fall by about ½ percent of GDP this year. However, the space for loosening fiscal policy in response to a growth slowdown is limited by still-high deficits and debt. In case of a substantial fall in output, any prospective expansion should be small, and focused on high-multiplier items such as indirect taxes and backlogged capital projects, rather than additional subsidies.