

With Russia's invasion of Ukraine, war is back in Europe. The world is facing renewed uncertainty, as war comes on top of the persistent and still-evolving COVID-19 pandemic.

Since the start of the pandemic in early 2020, fiscal policy has demonstrated unexpected power and agility. Governments jumped into action, extending support to households and firms affected by the Great Lockdown. They delivered on their role of protecting the most vulnerable when things fell apart. Together with exceptionally accommodative monetary policies by major central banks, fiscal policies prevented a much deeper and prolonged recession. In the early stages of the pandemic, monetary and fiscal policies worked harmoniously toward the common objective of preventing deflation. It worked, although it came at the cost of large deficits adding to already-elevated global debt levels.

Unprecedented macroeconomic policy support combined with supply disruptions eventually led to a situation where the recovery in demand outpaced supply. In 2021, inflation surprises began to pile up. As a result, the backdrop against which fiscal policy operates has now shifted abruptly. As interest rates are raised to keep inflation in check, fiscal space is becoming more constrained. The question of how much—and how fast—deficits and debts should be reduced is taking center stage.

When global credit conditions tighten, the most vulnerable countries suffer the biggest squeeze. Some emerging market spreads have reached dangerous territory, and 60 percent of the lowest-income economies are already in or at high risk of debt distress. The Debt Service Suspension Initiative (DSSI) expired at the end of 2021, and the G20 Common Framework for Debt Treatments beyond the DSSI has yet to deliver on its promise. Additional efforts are also needed for emerging markets and developing economies not eligible for it. Muddling through will amplify costs and risks to debtors, creditors and, more broadly, global stability and prosperity. The IMF will work with creditors and debtors to find effective frameworks for collective action.

In emerging markets, the rise in sovereign debt during the pandemic was financed to a large extent by domestic banking sectors. As Chapter 2 of the April 2022 *Global Financial Stability Report* highlights, this has led to deepened linkages between the sovereign and commercial banks, which means that as sovereign assets come under stress, the risk of an adverse feedback loop being set off has risen.

Treasuries in advanced economies must heed rising inflation. For the past two decades, they have benefited from declining debt service costs, stemming from trends both in nominal interest rates and neutral real interest rates. It is true that inflation surprises contribute to lower debt ratios but in a regime of permanently high and volatile inflation, the attractiveness of sovereign bonds is undermined, making it harder to sustain elevated levels of debt.

The war has led to spikes in energy and food prices coming on top of already elevated levels. As in 2020 and 2021, governments must act to protect people from the worst consequences of this new shock. But as before, it remains crucial that chosen policies are implemented in timely, targeted, and temporary fashion, particularly given the more limited fiscal space and heightened public finance risks. A fundamental principle is to support people while allowing domestic prices to adjust, which will help spur additional supply and avoid shortages. In some countries, targeted and temporary transfers may go a long way to help. Where social safety nets and information systems are less complete, other measures can be considered, such as smoothing consumption bills or lump-sum utility bill discounts. In all cases, ensuring access to adequate nutrition for everybody is imperative for public policies. Where needed, pass-through can be gradual, for example for the prices of staple foods and cooking fuels.

Chapter 2 of the *Fiscal Monitor* discusses how global cooperation on tax policy—income taxes but also carbon pricing—can move us toward a fairer and greener economy. Tackling the looming climate crisis is now especially urgent. We are dramatically off-track to limit global warming to 2°C. A commitment to an international carbon price floor by key emitters—appropriately differentiated and accommodating

equivalent measures—would curb emission sufficiently to deliver on such a goal. To reconcile the management of the energy crisis today with the looming climate crisis, countries should commit now to gradually eliminate fossil fuel subsidies and to increase carbon prices. COP-27 in Egypt must deliver effective action, including on finance for development, climate adaptation and a commitment to international cooperation to deliver on 2030 mitigation targets. Policy makers must also manage the implications of the green transition on labor markets, a topic covered by Chapter 3 of the April 2022 *World Economic Outlook*.

Given the ongoing war in Ukraine, the most urgent priority is to reach a peaceful settlement

that puts a stop to the associated humanitarian crisis. Amid a changed political landscape, global cooperation remains possible and is necessary more than ever, including to manage the legacies of COVID-19, to prevent and prepare for future pandemics, to address the immediate needs created by soaring food and energy prices, to fight climate change, to improve sovereign debt resolution and, more generally, to promote sustainable development with an urgent emphasis on the elimination of poverty and hunger.

Vitor Gaspar  
*Director of the Fiscal Affairs Department*