EXECUTIVE SUMMARY

With growth weakening in many parts of the world and downside risks on the rise, fiscal consolidation remains challenging. However, considerable progress has been made over the last two years in strengthening the fiscal accounts following their sharp deterioration in 2008–09, and more is planned. This issue of the *Fiscal Monitor* takes stock of this progress, focusing on its size, composition, and implications for employment and social equity. Several conclusions emerge:

- Most countries have made significant headway in rolling back fiscal deficits. In about half of the countries covered in this *Monitor*, deficits are expected to be at or lower than their precrisis levels next year. The improvement in fiscal balances is most pronounced in advanced economies, where the fiscal shock was larger, followed by emerging market economies and to a lesser extent by low-income countries.
- Efforts at controlling debt stocks are taking longer to yield results. Debt ratios peaked early in emerging market economies but are not expected to stabilize before 2014–15 in many advanced economies. The slower progress in advanced economies is due to the magnitude of the shock and the sluggishness of the recovery thereafter, but in some cases also to high interest rates, which are negatively affected by policy uncertainties and banking fragilities. In many advanced economies, consolidation efforts will need to persist for many years if debt ratios are to be restored to precrisis levels.
- Countries with sizable fiscal consolidation needs have typically relied on a mix of revenue and expenditure policies. However, advanced economies have in general relied more than emerging markets and low-income countries on spending retrenchment. Most countries have tried to focus on measures that would have the smallest negative impact on growth, such as entitlement reforms and increases in less distortionary taxes, for instance, property levies. Overall, the composition of fiscal adjustment as envisaged should result in public finances that are more growth friendly and efficient after the consolidation phase, though some countries—especially those with large fiscal adjustment plans—have needed to include measures like investment cuts and broader tax increases that may weigh on long-term growth.
- Both spending and revenue measures have important implications for employment and social equity, which need to be taken into account if the large consolidation efforts underway are to be sustainable. An appropriate degree of progressivity in taxation and access to social benefits is imperative for limiting the negative social effects of adjustment packages. Better-designed tax and social benefit policies, accompanied by active labor market programs, can help boost labor supply and demand. However, structural reforms remain the key to better growth and employment prospects.

Despite substantial progress in restoring the sustainability of public finances, fiscal vulnerabilities remain elevated. Public debt rollover requirements are still very high and expose countries to the vagaries of financial markets. Partly because of the ample liquidity provided by central banks in support of economic activity, markets have in most cases taken large increases in public debt in stride, with solvency concerns remaining elevated only for a subset of euro area countries. But these benign market responses are premised on continued fiscal adjustment and a favorable growth environment.

With downside risks to the global economy mounting, policymakers must once again tread the narrow path that will permit them to continue strengthening the public finances while avoiding an excessive withdrawal of fiscal support for a still-fragile economic recovery. Whereas most emerging markets and low-income countries can afford to pause their adjustment efforts to await a more hospitable growth outlook, many advanced economies do not have that luxury. To the extent that financing conditions allow, adjustment should proceed at a pace that is consistent with the state of the economy. To take cyclical considerations better into account, policymakers should focus on structural or cyclically adjusted targets. Should growth disappoint, the first line of defense should be monetary policy and the free play of automatic fiscal stabilizers. If growth should fall significantly below current *World Economic Outlook* projections, countries with room for maneuver should slow their pace of planned adjustment over 2013 and beyond. But short-term caution should not be an excuse to slow or delay efforts to put public finances on a sounder footing over the medium term, as this remains a key requirement for growth. And even countries with relatively comfortable fiscal positions should maintain appropriate buffers to be able to confront future shocks.