EXECUTIVE SUMMARY

Policymakers face the dilemma of how best to respond to the challenges of slackening global activity and continued financial volatility without losing sight of their medium-term adjustment needs. In countries with fiscal space, the pace of near-term fiscal adjustment plans should be calibrated to avoid undue pressures on activity and employment. In 2012, deficits in the advanced economies are projected to decline on average by about 1 percentage point of gross domestic product (GDP) in cyclically adjusted terms and slightly faster in 2013. This is broadly appropriate, although countries with enough fiscal space could consider slowing the pace of near-term adjustment to reduce downside risks. Should growth slow further, countries with fiscal space should allow the automatic stabilizers to operate freely and allow the deficit to rise to avoid excess fiscal contraction, which could worsen economic conditions. 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 sustainable growth. In emerging economies fiscal adjustment will slow considerably this year. Again, in the context of somewhat weaker growth, this slowing is appropriate, and also in light of the stronger fiscal position of these economies with respect to advanced economies. Over the medium term, however, the fiscal space eroded during 2008–09 should be fully rebuilt, so as to restore flexibility to respond to future downturns.

Against that background, this issue of the *Fiscal Monitor* examines in more detail the concept of fiscal space, or the scope that policymakers have to calibrate the pace of fiscal adjustment without undermining fiscal sustainability. Among the conclusions that emerge are the following:

- In the short to medium term, many countries remain vulnerable to unexpected shocks, leaving them with little margin for policy errors. Although debt ratios are expected to begin stabilizing by 2015 in the large majority of countries, the risk of a setback is high, constraining policy options.
- In the current recessionary context, the negative impact of fiscal adjustment on activity can be expected to be large, as confirmed by new work on the size of fiscal multipliers during periods of weak economic activity. When multipliers are on the high side, the beneficial impact of fiscal adjustment on debt ratios and spreads may be delayed. This is another reason why, as long as financing allows, a gradual but steady pace of adjustment seems preferable to heavy front-loading. Adjustment should be accompanied by broad and proactive communication strategies to fuel confidence and credibility.
- Since 2008 the rise in general government gross debt ratios may have overstated short-term pressures on the public finances in some countries, primarily because of the surge in seigniorage and the accumulation of assets by central banks (including government paper). This comes to light when looking at consolidated net balance sheets of governments and central banks. However, large central bank holdings of government debt and other assets will need to be liquidated or rolled over to the private sector as the demand for base money returns to more normal levels, meaning that gross general government debt, alongside net debt, remains a key indicator of public indebtedness over the longer term. The process of reducing central bank balance sheets will be difficult to manage without previous or parallel medium-term fiscal consolidation.
- Countries can have flexibility in the short term without having it in the longer term. The need to reduce debt ratios and to address pressures from entitlement spending means that very few countries have long-term fiscal space. The design and implementation of credible medium-term adjustment plans therefore remains a sine qua non for most advanced, and several developing, economies. Progress in this area is accelerating, but there is still a long way to go, including in the largest economies.

- A growing number of countries are putting in place fiscal rules. Although they are not a substitute for specific long-term adjustment plans, fiscal rules can build confidence and facilitate the establishment of a political consensus on fiscal policy. Second-generation fiscal rules are typically more complex than earlier versions, providing greater flexibility to respond to economic cycles but with more-binding corrections for past deviations. As such, they also raise significant enforcement and monitoring challenges.

Overall, fiscal risks remain elevated, although there are signs that in some key respects they are less acute than six months ago. Past efforts with fiscal consolidation are beginning to bear fruit, particularly when buttressed by credible institutional commitments. Nevertheless, debt ratios in many advanced economies are at historic levels and rising, borrowing requirements remain very large, financial markets continue to be in a state of alert, and downside risks to the global economy predominate. In this uncertain environment, the challenge for fiscal policy is to find the right balance between exploiting short-term space to support the fragile recovery and rebuilding longer-term space by advancing fiscal consolidation.