EXECUTIVE SUMMARY

Continued progress in reducing advanced economy deficits and a gradually improving external environment have lowered short-term fiscal risks, but global prospects nevertheless remain subdued, and many advanced economies face a lengthy, difficult, and uncertain path to fiscal sustainability. Deficits in advanced economies fell by some ¾ percent of GDP in cyclically adjusted terms last year and are projected to decline at a somewhat faster pace in 2013. Thanks to steady consolidation following the peak of the crisis in 2009, many advanced economies are now close to achieving primary surpluses that will allow them to stabilize their debt ratios. Although this is an important milestone, it is only a first step. High debt—even if stable—retards potential growth, constrains the scope for future discretionary policy, and leaves economies exposed to further market shocks. Sharp increases in public debt have not yet provoked a surge in interest rates in many advanced economies, but lower rates are unlikely to persist indefinitely, especially as they reflect in part very relaxed monetary conditions that must eventually be reversed. Moreover, structural changes in sovereign debt markets may gradually erode some of the special status countries like Japan and the United States currently enjoy. Furthermore, with financial sector reform still proceeding slowly, the potential for contingent liabilities to materialize from future financial sector disturbances remains sizable. For all these reasons, merely stabilizing advanced economy debt at current levels would be detrimental to medium- and longer-term economic prospects.

Sustained consolidation efforts to reduce debt ratios to more appropriate levels are therefore essential, although in practice it is difficult to pinpoint what constitutes a prudent amount of public debt. Several advanced economies are now within about 1 percentage point of a primary surplus that, if maintained, would bring their debt ratios to 60 percent of GDP by 2030. But even maintaining these surpluses over time may be difficult. Altogether, about one-third of advanced economies—representing some 40 percent of global GDP—still face major fiscal challenges. Most of these countries have never experienced debt levels similar to the current ones, and certainly not for decades. They will need to undertake unprecedented fiscal efforts to bring their debt ratios to traditional norms, even if this is to occur only over a relatively long horizon.

While achieving sufficiently large primary surpluses and then maintaining them for an extended period will be difficult, there are no alternative quick fixes. High inflation aimed at eroding the real value of the debt or a debt restructuring would entail substantial and long-lasting economic and social costs, and thus these are not options to be entered into lightly. Privatization of government assets can contribute to the adjustment process, but the stock of salable assets in most advanced economies is insufficient to substantially reduce the debt. The amount of fiscal adjustment that each advanced economy requires depends on its initial conditions, its ultimate objectives, and the macroeconomic conditions that will prevail in the interim. But to make rapid progress in bringing down debt ratios, it will be critical to maintain the minimum possible differential between the interest rate on public debt and the growth rate of the economy. In most cases, there is scope for structural reforms to raise potential growth, which would help lower the debt-to-GDP ratio more quickly both by buoying the fiscal balance and through denominator effects. Of course, faster growth will likewise help reduce the social costs of fiscal consolidation and enhance its political sustainability. And to keep interest rates low, it will be essential that highly indebted advanced economies continue to undertake policies that will maintain market confidence.

The key elements of the required policy package are well known: foremost among them is setting

out—and implementing—a clear and credible plan to bring debt ratios down over the medium term. The continued absence of such plans in Japan and the United States remains a significant concern, particularly given the introduction of new short-term stimulus in Japan (even though temporary) and insufficient progress on measures to restore medium-term fiscal sustainability, including entitlement reform, in the United States. Such a plan could also allow the United States to avoid the excessively large tightening in fiscal policies that would result if the sequestering of expenditure that began in March were to continue beyond the current fiscal year. In conducting near-term policy, authorities in the advanced economies should focus on structural balances and, if financing allows, let the automatic fiscal stabilizers operate fully, to avoid procyclical policies that would accelerate any downturn in growth (while also ensuring that any upside growth surprises would be used to pay down debt more rapidly). However, some advanced economies in which private demand has been chronically disappointing should consider smoothing the pace of consolidation if they have the fiscal policy room for maneuver to do so.

Debt dynamics have remained relatively positive in most emerging market economies and low-income countries, thanks to a negative interest rate–growth differential, and these countries generally allowed automatic stabilizers to operate fully last year while pausing the underlying fiscal adjustment process. Most of them plan to continue to do so this year. Those with low general government debt and deficits can afford to maintain a neutral stance in response to a weaker global outlook. But countries with relatively high or quickly increasing debt levels are exposed to sizable risks, especially once effective interest rates rise as monetary policy normalizes in the advanced economies and concessional financing from advanced economies declines. Many Arab countries in transition have exhausted their fiscal buffers and need to contain rising deficits and debt levels. The widespread use of energy subsidies makes commodity prices an additional source of vulnerability in many emerging market and low-income economies. Subsidy reform, higher revenue from consumption taxes, and broadening of tax bases would help support consolidation efforts. Commodity exporters also need to strengthen non-resource revenue and establish fiscal frameworks to limit short-term volatility and ensure long-term fiscal sustainability.