International Monetary Fund

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April 2015 Fiscal Monitor

Now is the Time:
Fiscal Policies for Sustainable Growth

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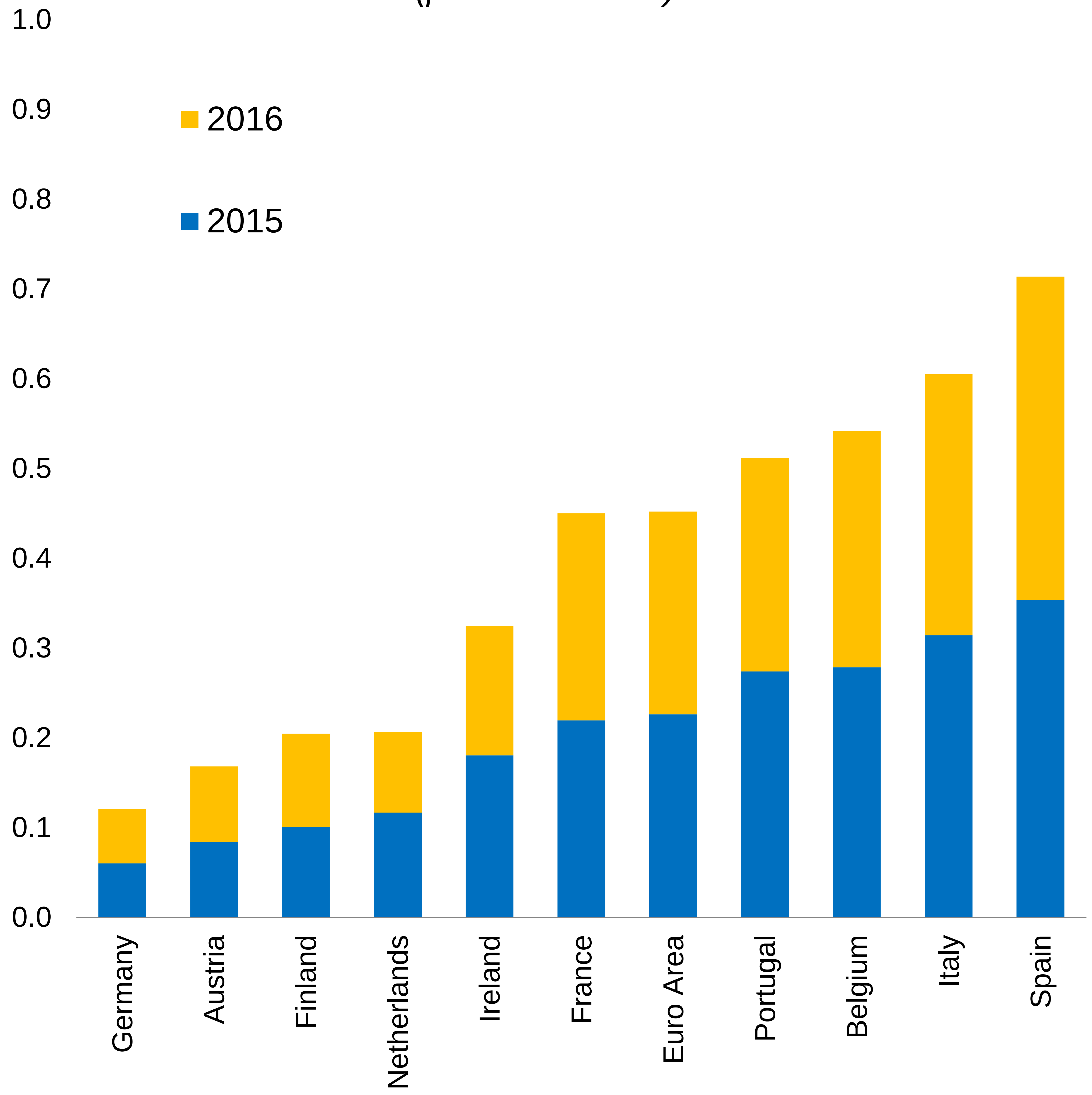
Outline

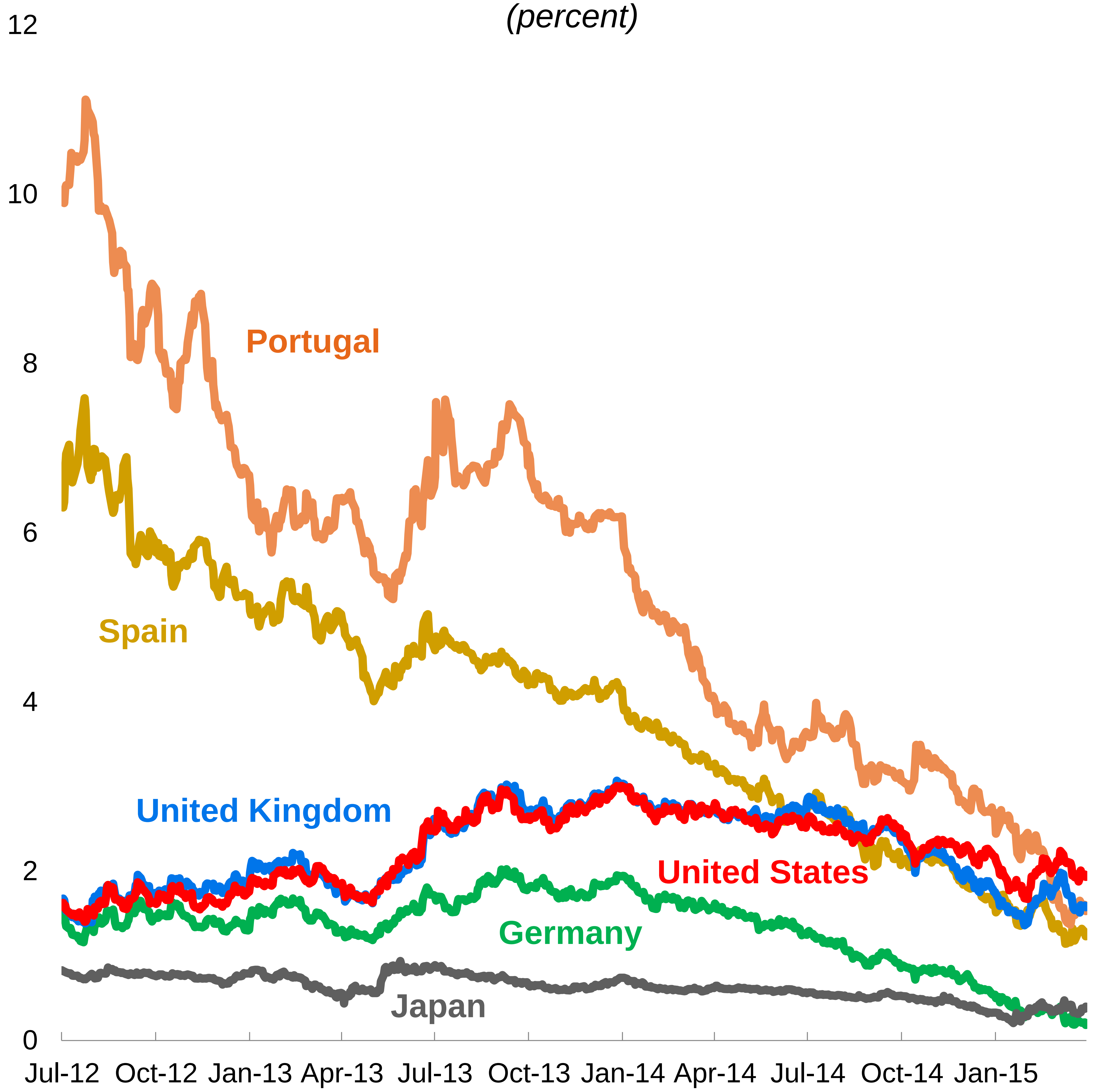
- Highlights from recent fiscal developments and risks
- Selected policy implications
- Stabilize more, grow faster

Euro area: Expected funding cost savings from QE are significant

Selected Euro Area Countries: Estimates of Funding Cost Savings From QE Activation by the ECB, 2015–16
(percent of GDP)

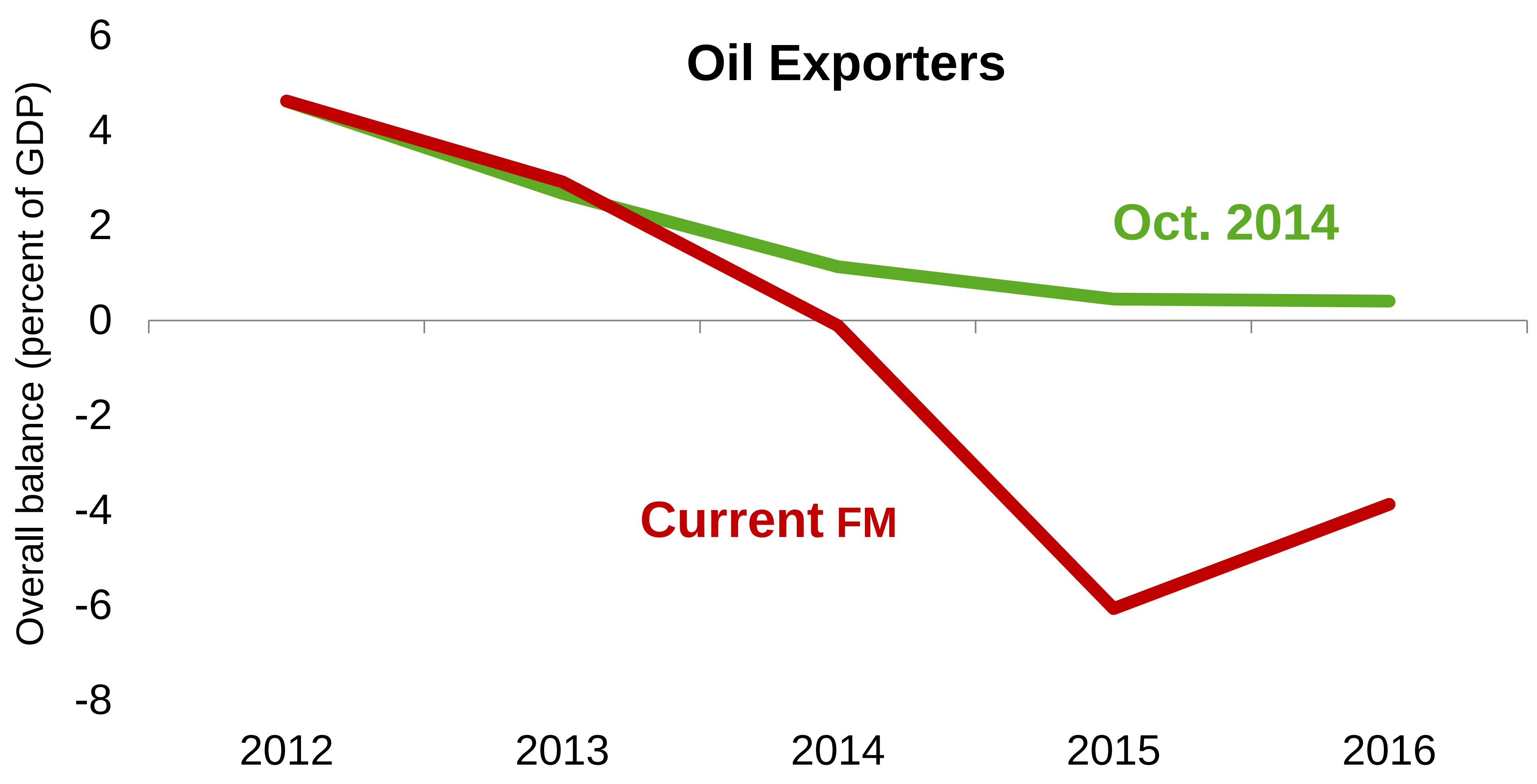


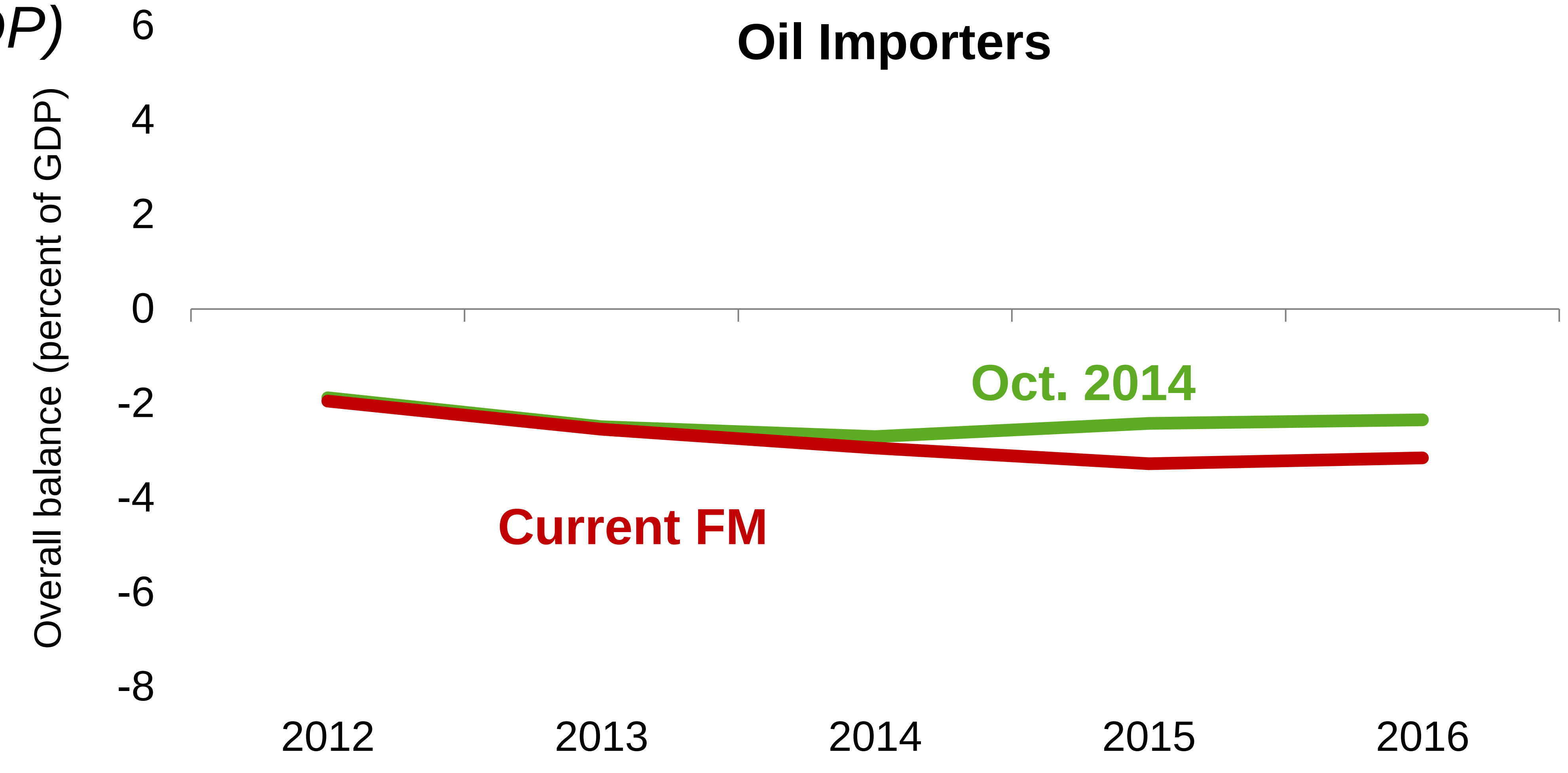
Selected Countries: Nominal 10-Year Bond Yields, 2012–15
(percent)



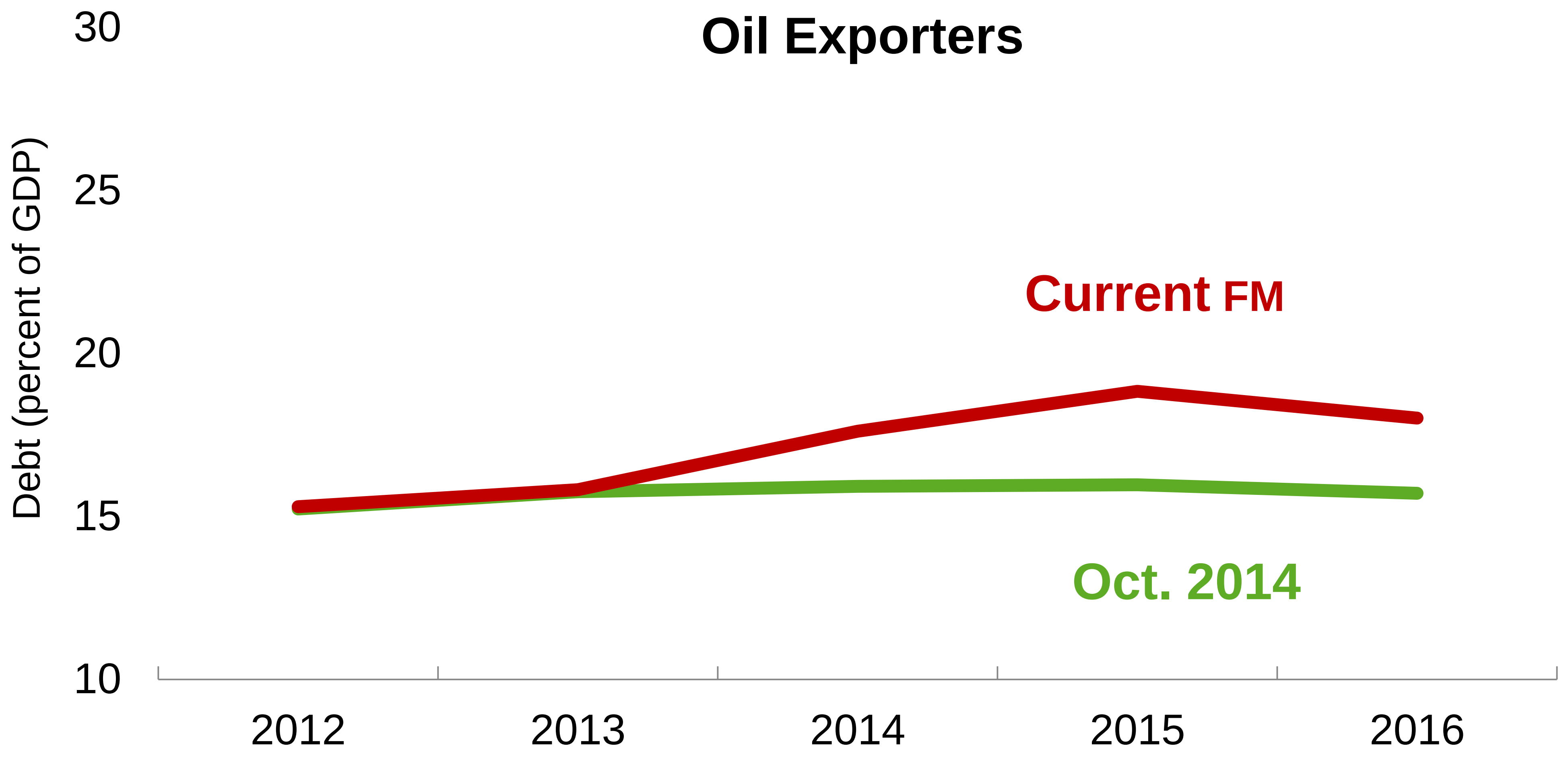
EMs: Projected deterioration in fiscal position driven by oil exporters

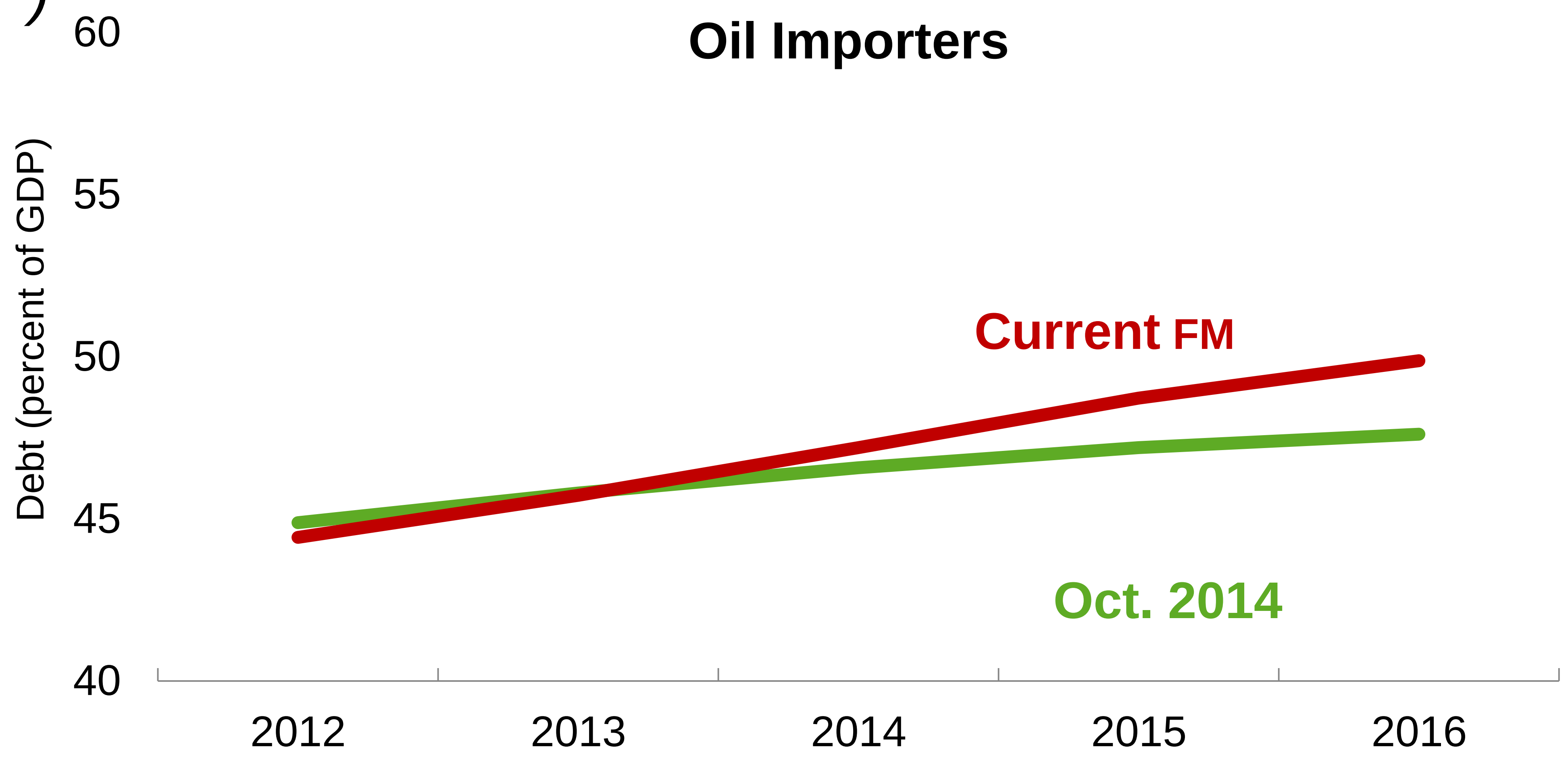
Overall Balance
(percent of GDP)



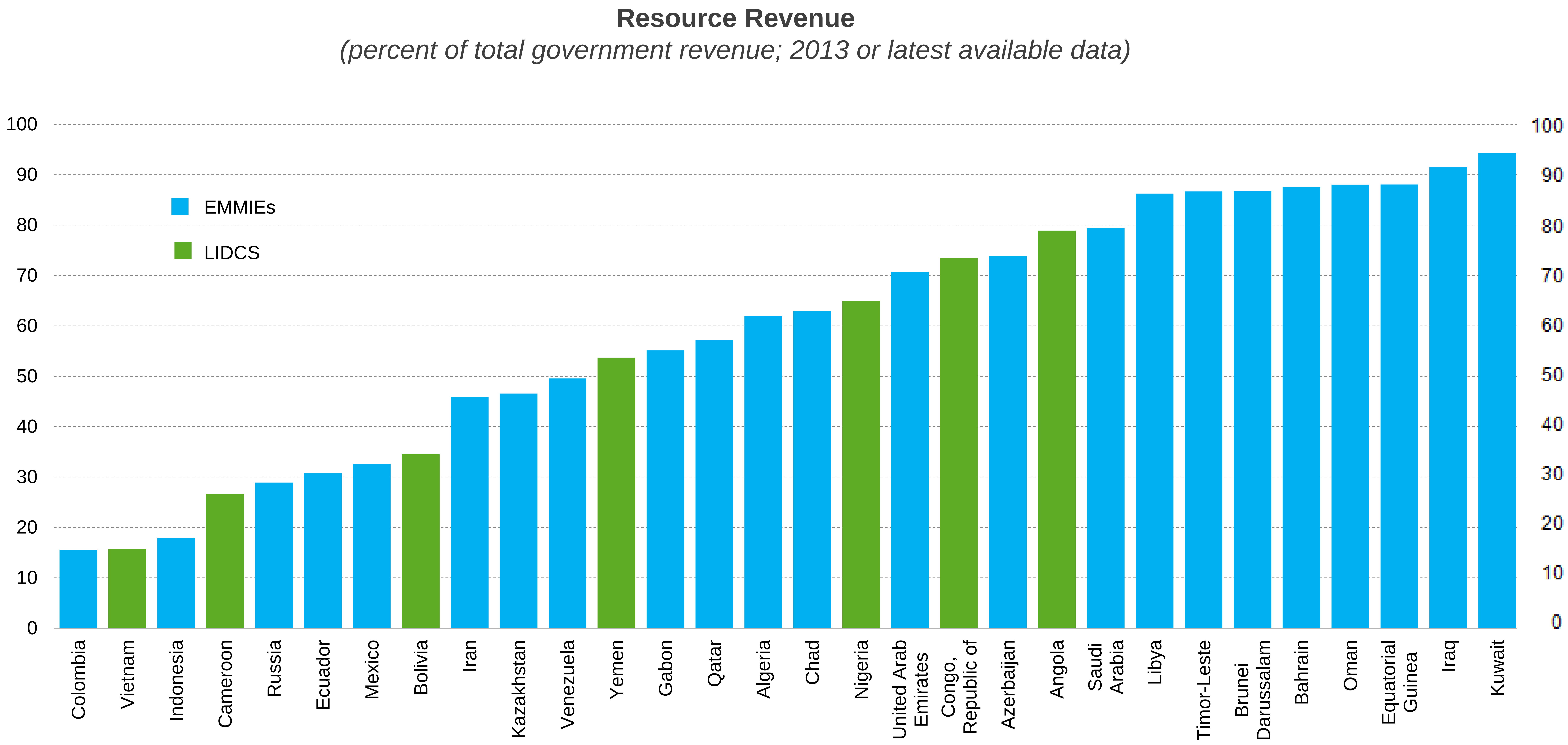


Debt
(percent of GDP)



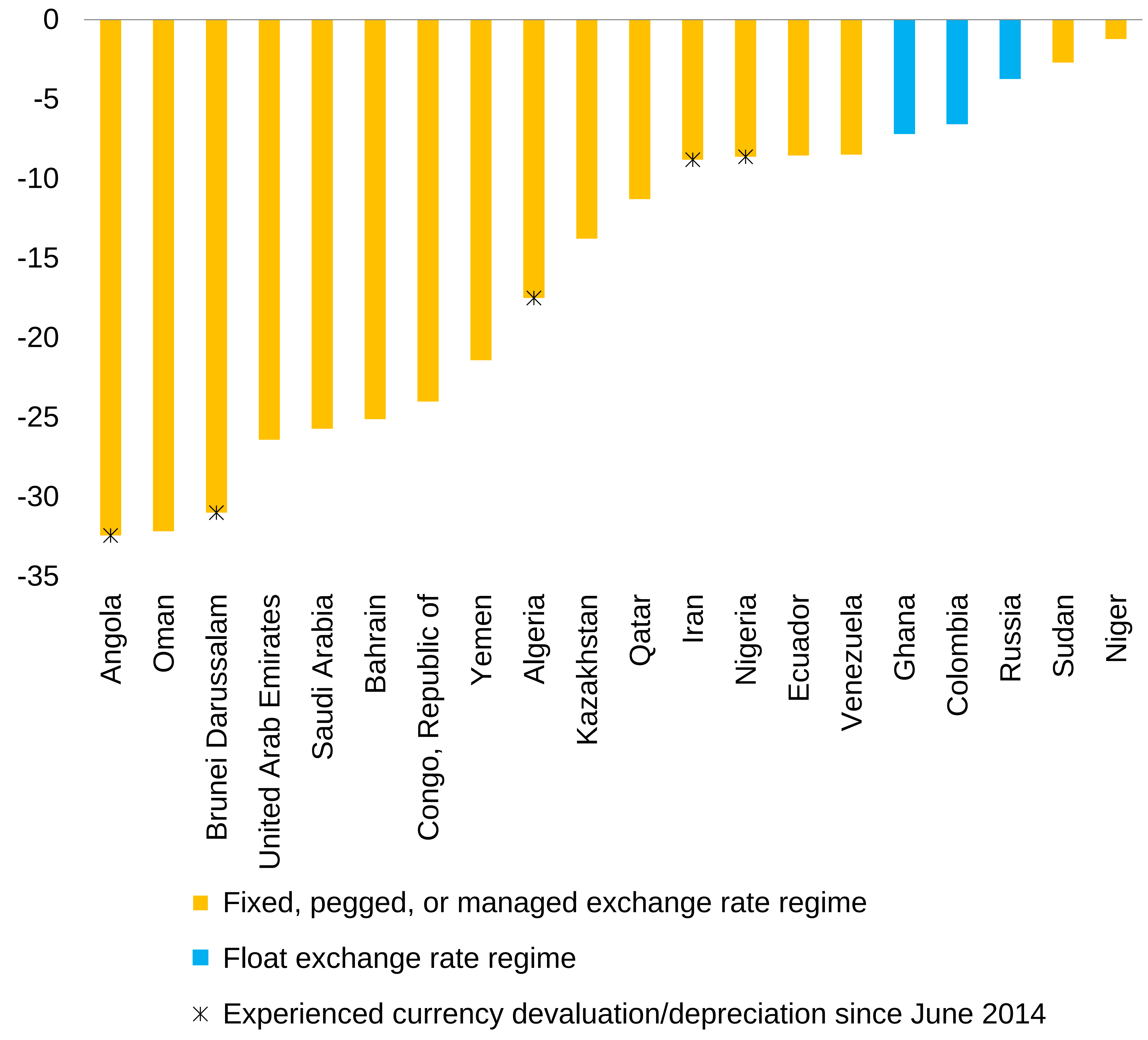


Lower oil prices create fiscal challenges in oil exporting economies

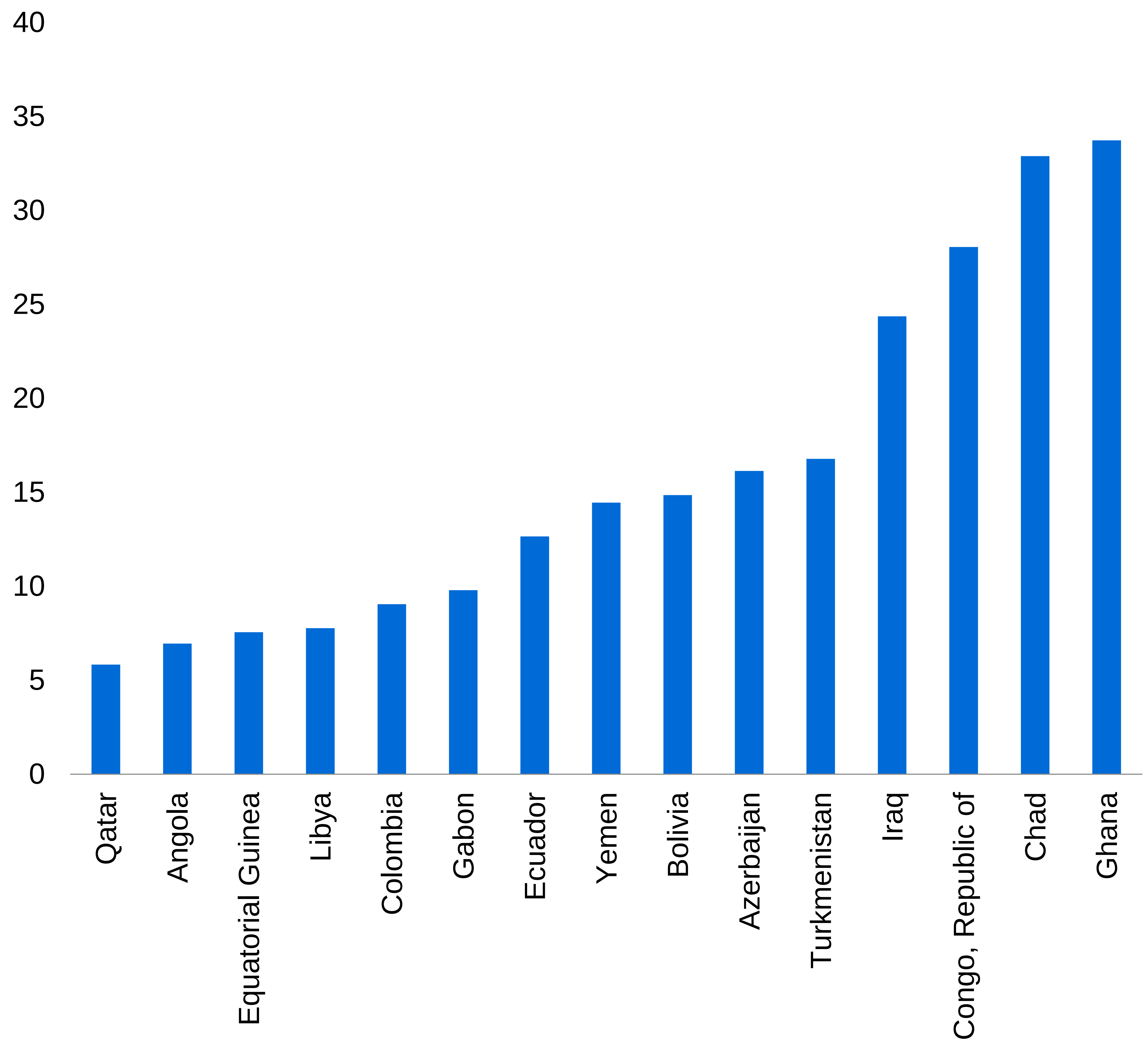


Exchange rate depreciation could offset some of the revenue losses, but some have foreign-currency denominated government debt

Projected Change in Commodity Revenues between 2014 and 2015
(percent of 2014 total revenues)

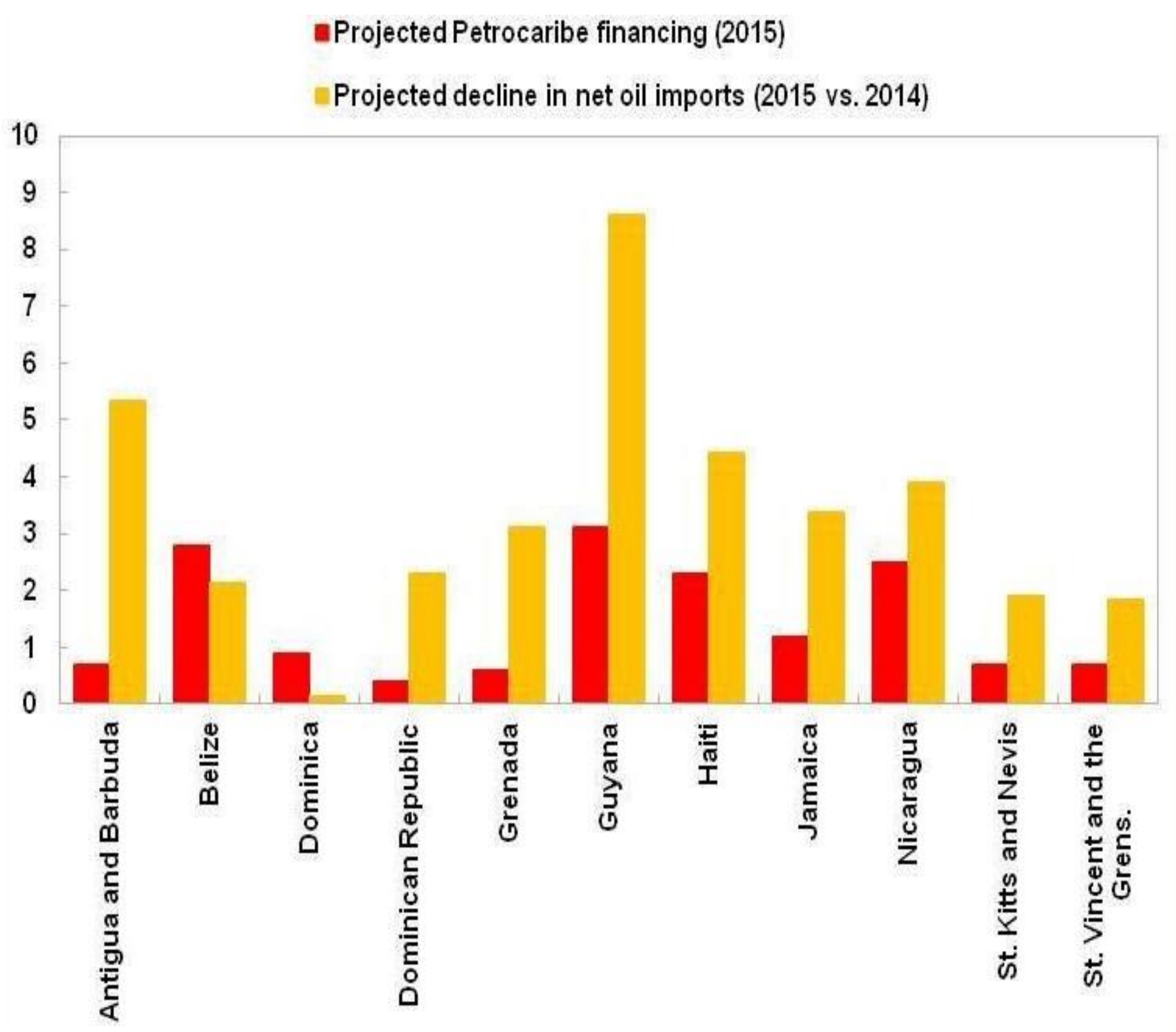


Public External Debt, 2014
(percent of GDP)

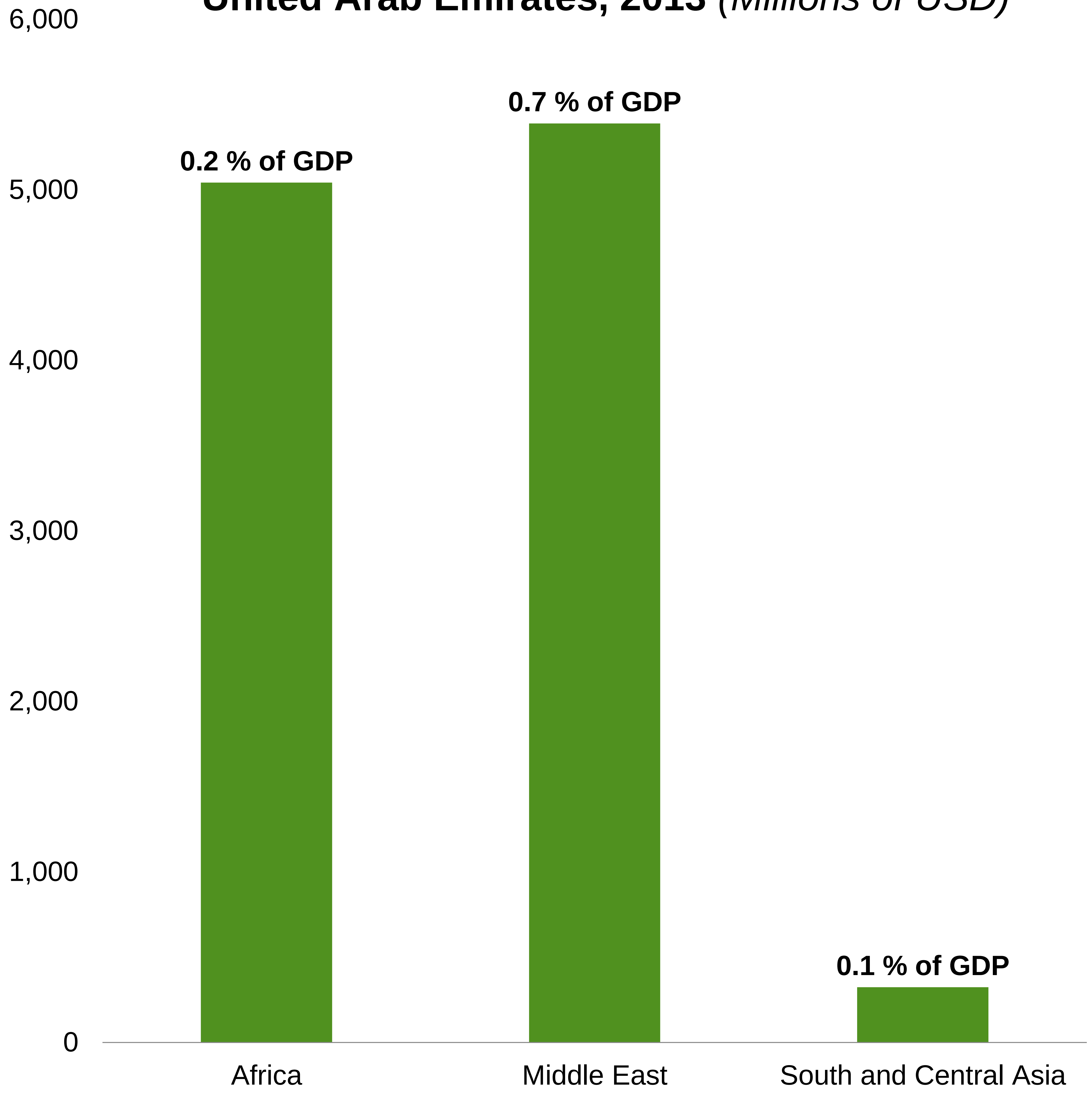


Spillovers from oil exporters: a risk for some developing economies

Decline in Oil imports and Petrocaribe Exposure
(percentage points of GDP)



Aid Flows from Kuwait, Russia, Saudi Arabia and United Arab Emirates, 2013 *(Millions of USD)*



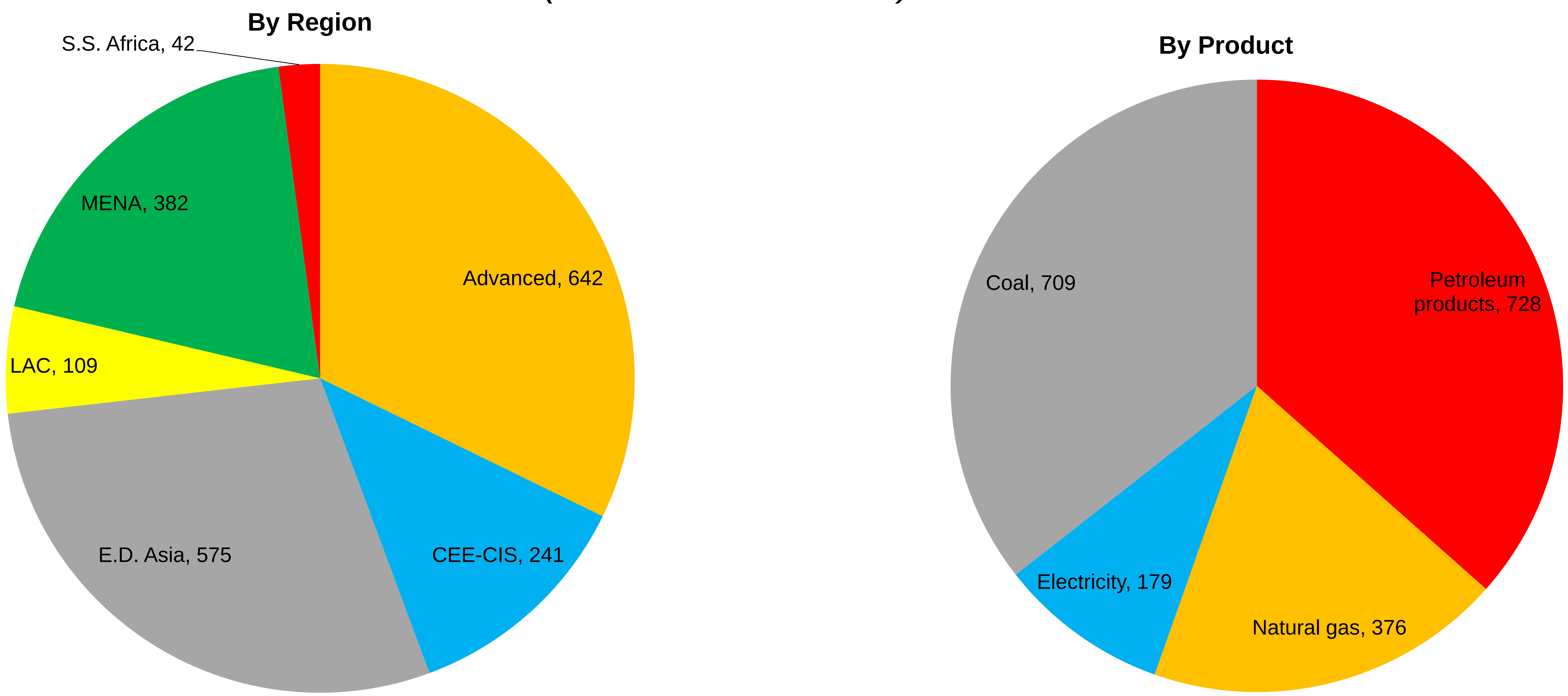
Other sources of risks

- Risks to debt dynamics:
  - Debt dynamics in AEs sensitive to real interest and growth shocks
  - Lower growth prospects and lower commodity prices raise challenges in many EMs and LIDCs
- Geopolitical risks and policy uncertainty:
  - Disruptions in trade and financial transaction (Ukraine/Russia, Middle East, parts of Africa).
  - Policy uncertainty (Greece): reemergence of sovereign-bank feedback loops?
- Financial market volatility:
  - Capital outflows from EMs (investors deleveraging or flight to quality),
  - Surprises related to US monetary normalization (see GFSR)

Selected policy implications

Energy Subsidies Are Large in All Regions

Energy Subsidies, 2011
(billions of US dollars)



Source: B. Clements and others, 2013, *Energy Subsidy Reform: Lessons and Implications.*
Note: Estimates draw on IEA *World Energy Outlook 2012*; and data from OECD and World Bank.

Flexible, growth-friendly fiscal policy

- No additional fiscal consolidation if growth disappoints:
  - Let automatic stabilizers play: see evidence in chapter 2.
  - Condition: credibility is not at risk.
- Countries with fiscal space could boost medium-term growth:
  - Infrastructure investment: can boost short- and medium-term growth (October ‘14 WEO)
  - But this must be done efficiently!
- What if no/little space?
  - Work on composition of spending and taxes,
  - EU-level initiatives,
  - Strengthen fiscal frameworks in support on medium-term fiscal plans: confidence and credibility.

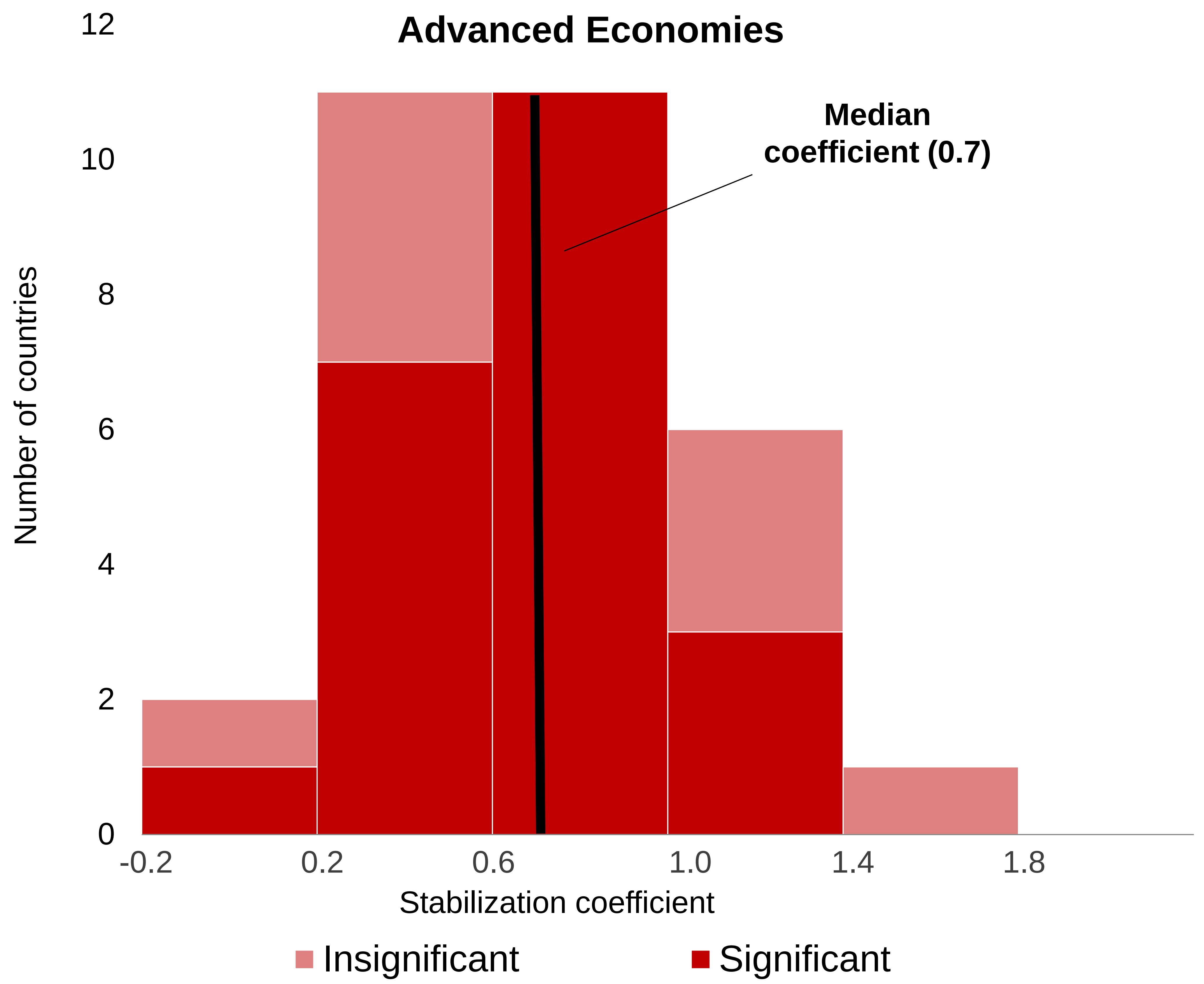
Chapter 2
Stabilize more, grow faster

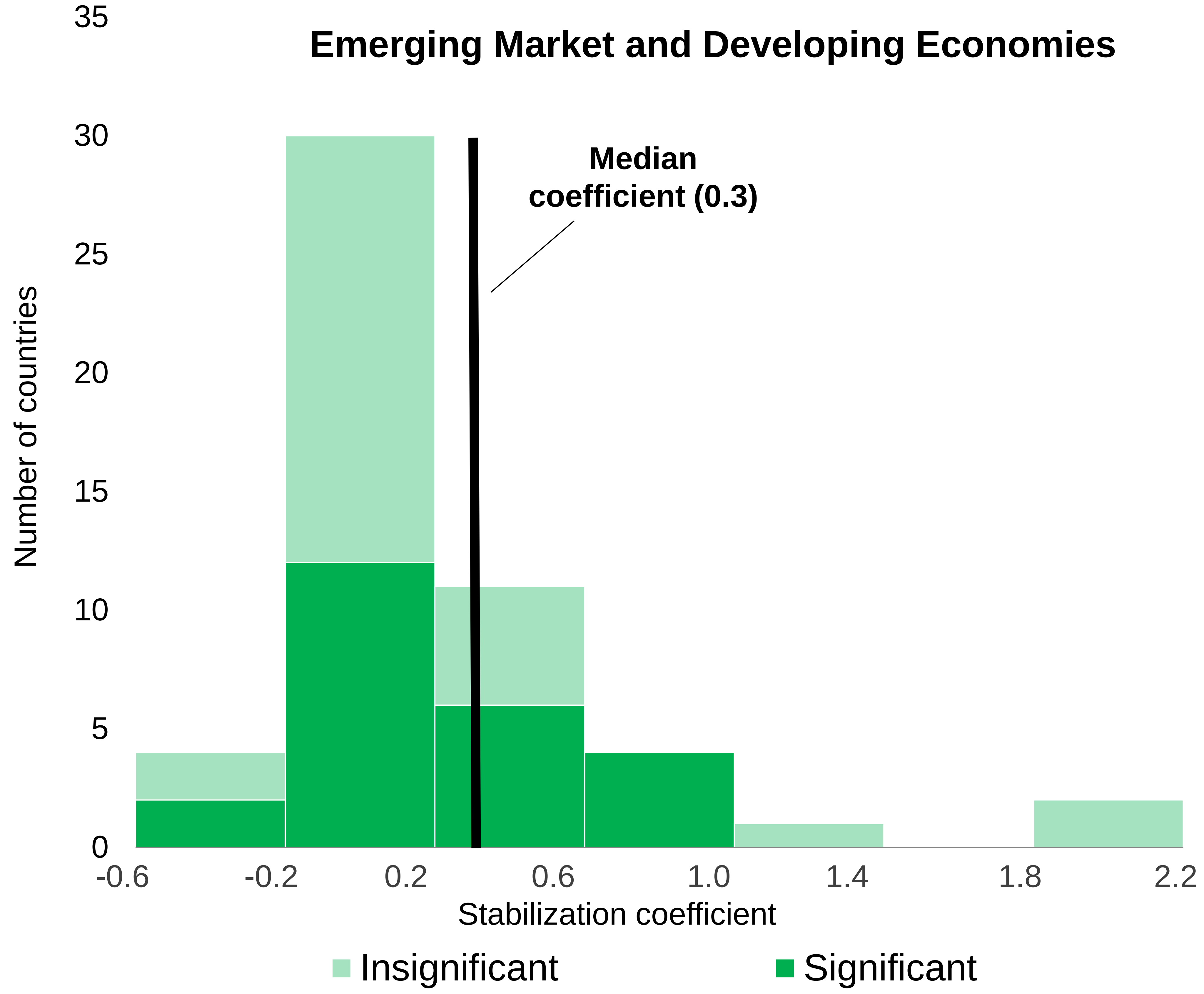
Highlights of chapter 2

- **Comprehensive study:** broad sample (85 countries, 1980-2013)
- **Fiscal policy is, on average, stabilizing:**
  - More in advanced economies, more in bad times, more at low frequency.
- **Automatic stabilizers (AS) are key:**
  - Contribute about 2/3 in advanced economies and 1/3 in developing economies.
  - Main determinants of AS: government size and social transfers.
- **Dividends of fiscal stabilization are significant:**
  - Higher and less volatile growth.
- **Internalize the role of automatic stabilizers**
  - Let AS play freely → avoid procyclicality.
  - Internalize efficiency-stabilization trade-off costs of large AS

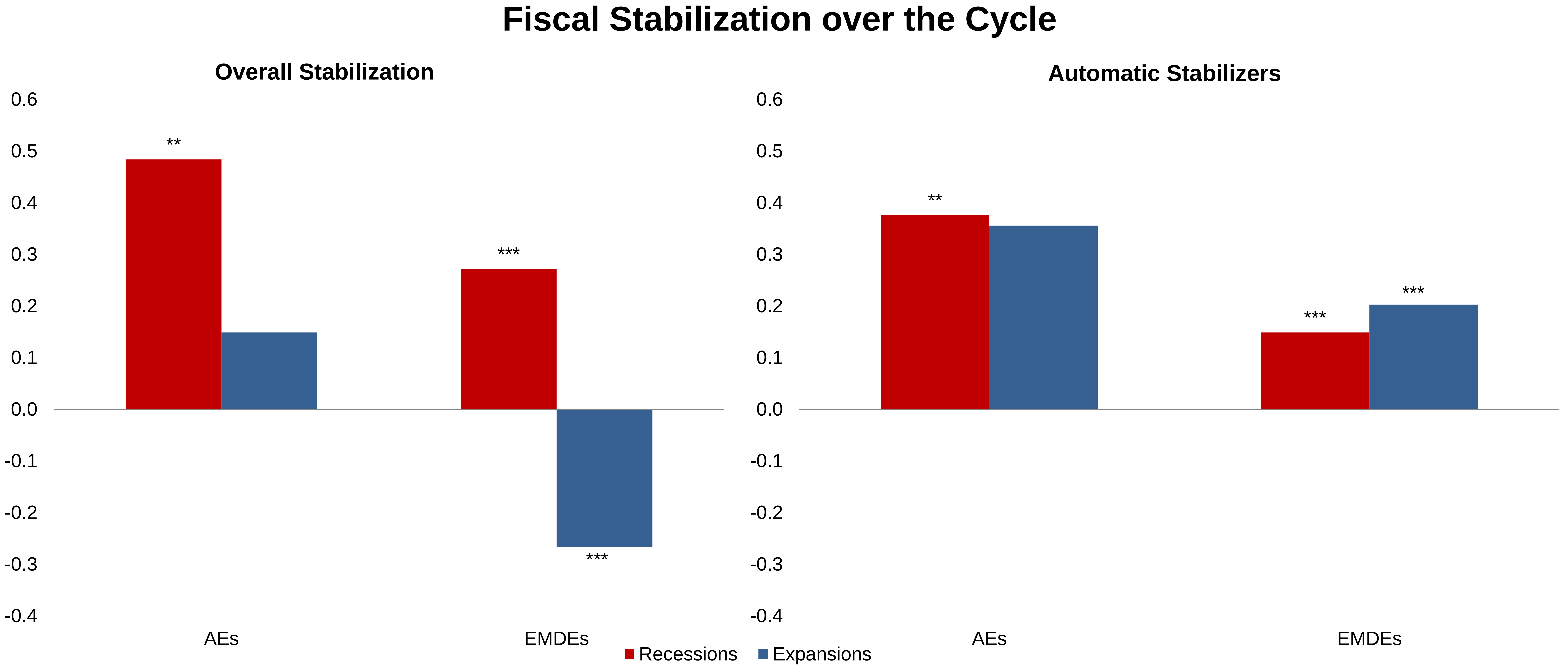
Fiscal stabilization is greater in advanced economies

Distribution of Fiscal Stabilization Coefficients



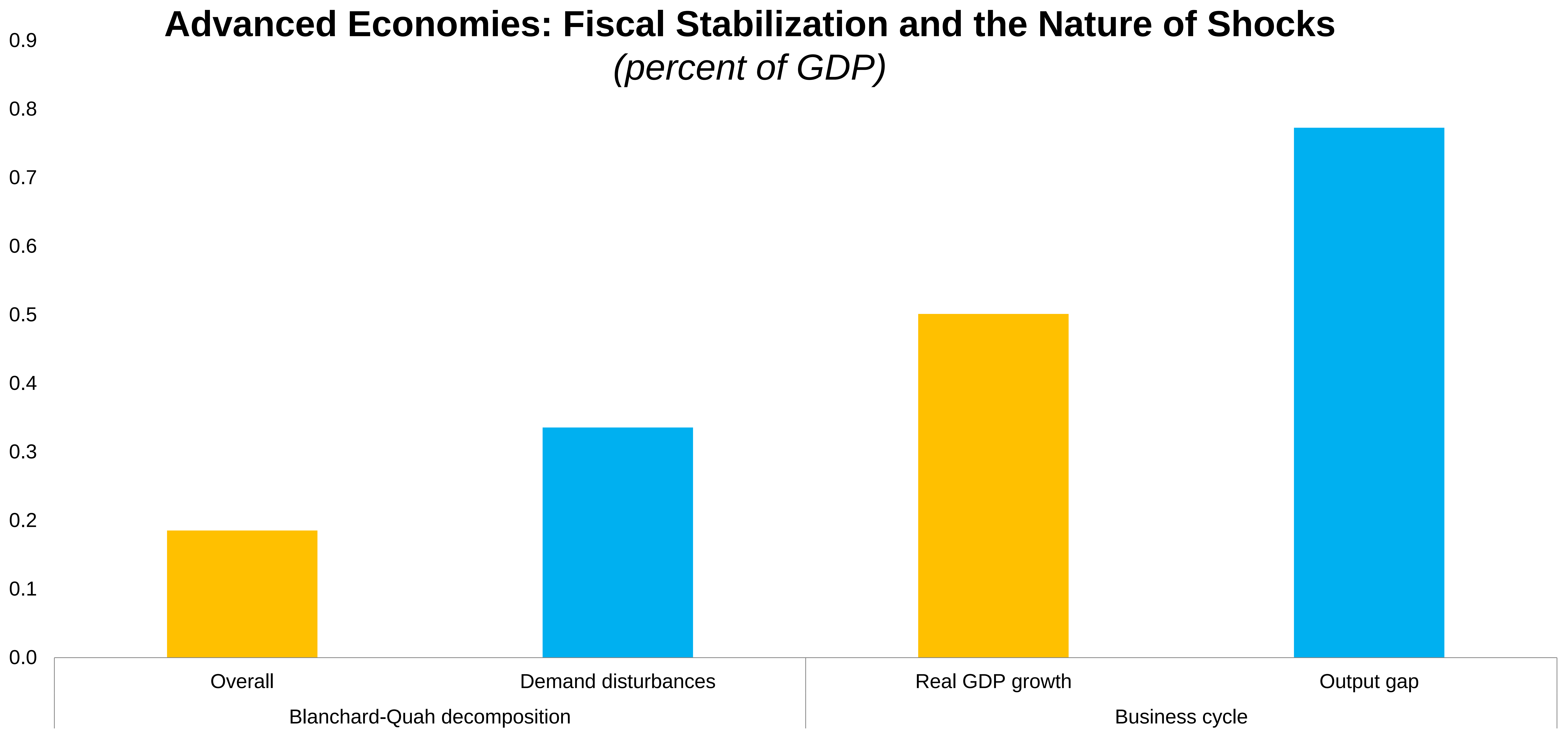


Fiscal stabilization is stronger during recessions



Sources: European Commission; Organisation for Economic Co-operation and Development; and IMF staff estimates.
Note: Recessions and expansions are defined using an approach equivalent to the smooth transition autoregressive model developed by Granger and Terasvirta (1993). The figure displays ordinary least squares regressions with country and time fixed effects and robust standard errors. To reduce heterogeneity in the panel, commodity exporters have been excluded. AEs = advanced economies; EMDEs = emerging market and developing economies. ** $p < 0.05$; *** $p < 0.01$.

Response to transitory (“demand”) shocks seems stronger

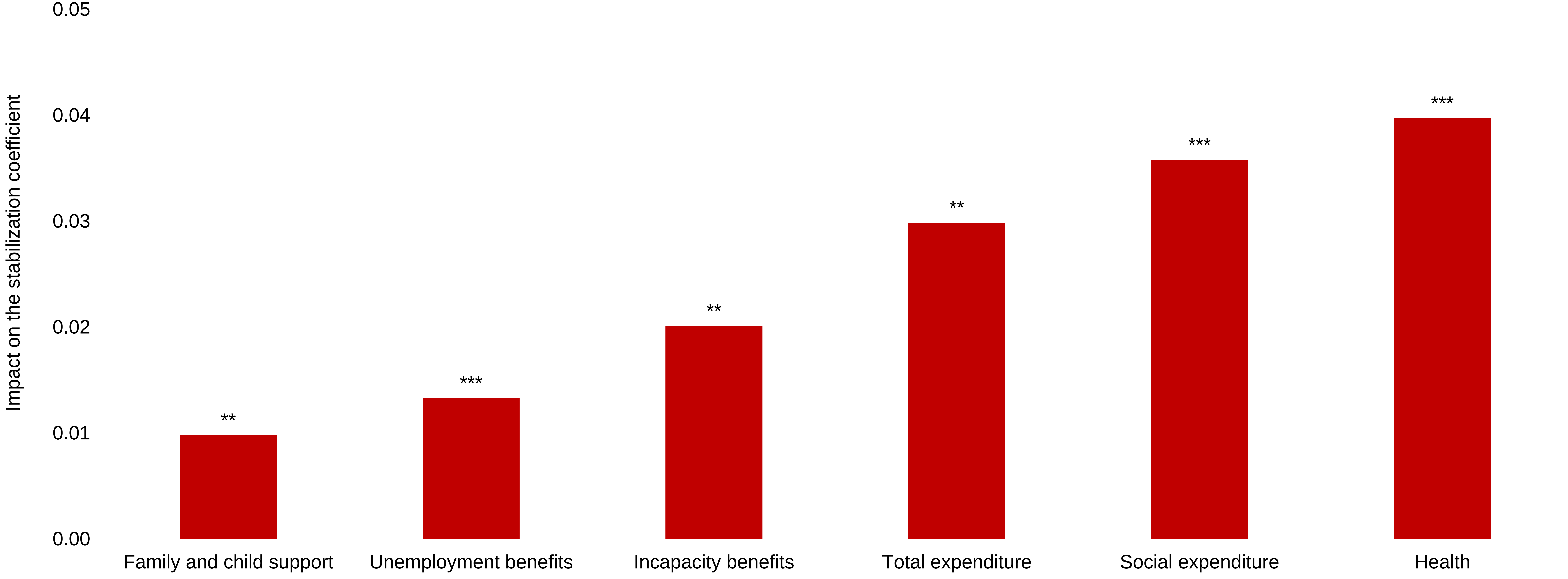


Sources: European Commission; Organisation for Economic Co-operation and Development; and IMF staff estimates.
Note: The bars represent simple averages of country-specific point estimates.

Automatic stabilizers on the spending side boost fiscal stabilization… a little

Advanced Economies: Determinants of Fiscal Stabilization

(impact of a 10 percent increase in selected outlays on stabilization coefficients)

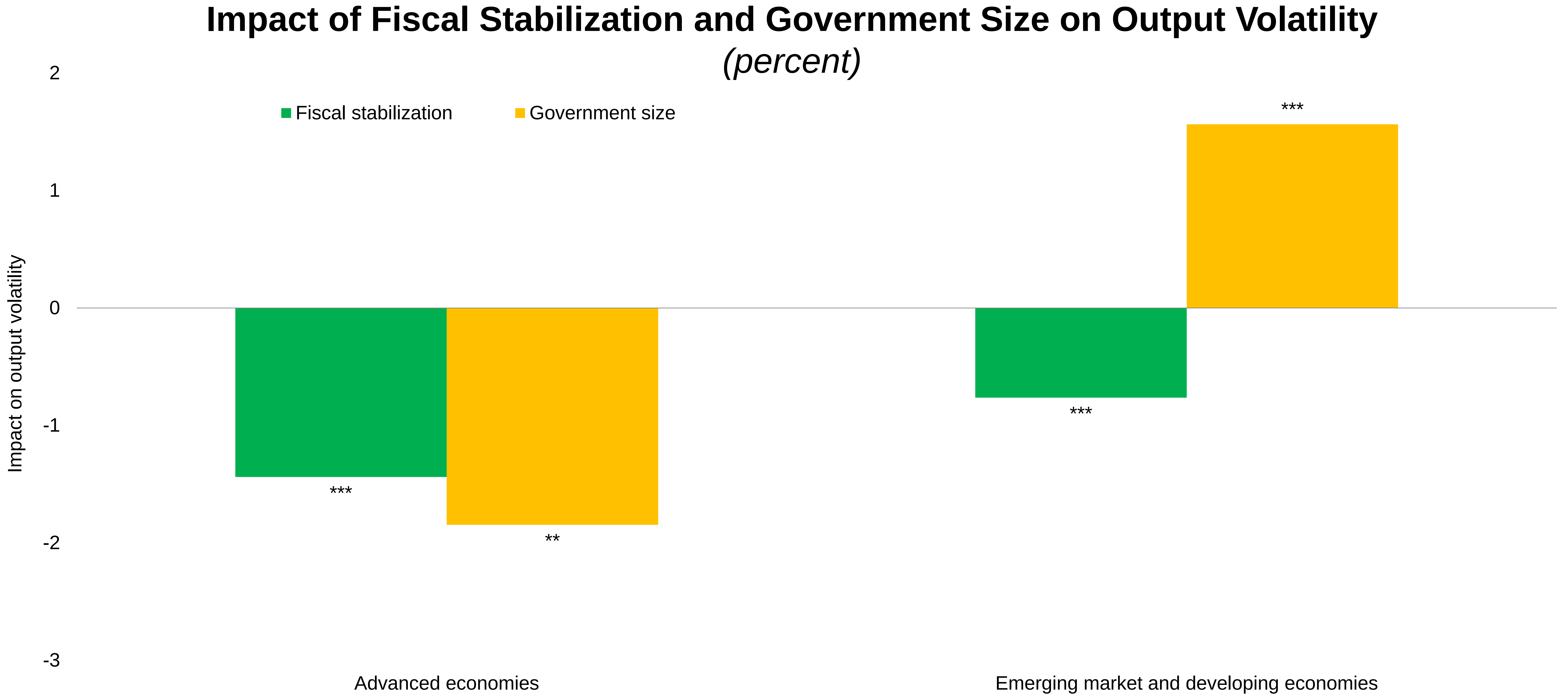


Sources: European Commission; International Country Risk Guide; Organisation for Economic Co-operation and Development; and IMF staff estimates.

Note: Figure estimates reflect panel weighted least squares, with weights inversely proportional to the estimation error of the stabilization coefficients. Additional conditioning variables include output volatility, openness, GDP per capita, and the government debt-to-GDP ratio. Country and time fixed effects are also included.

** $p < 0.05$; *** $p < 0.01$.

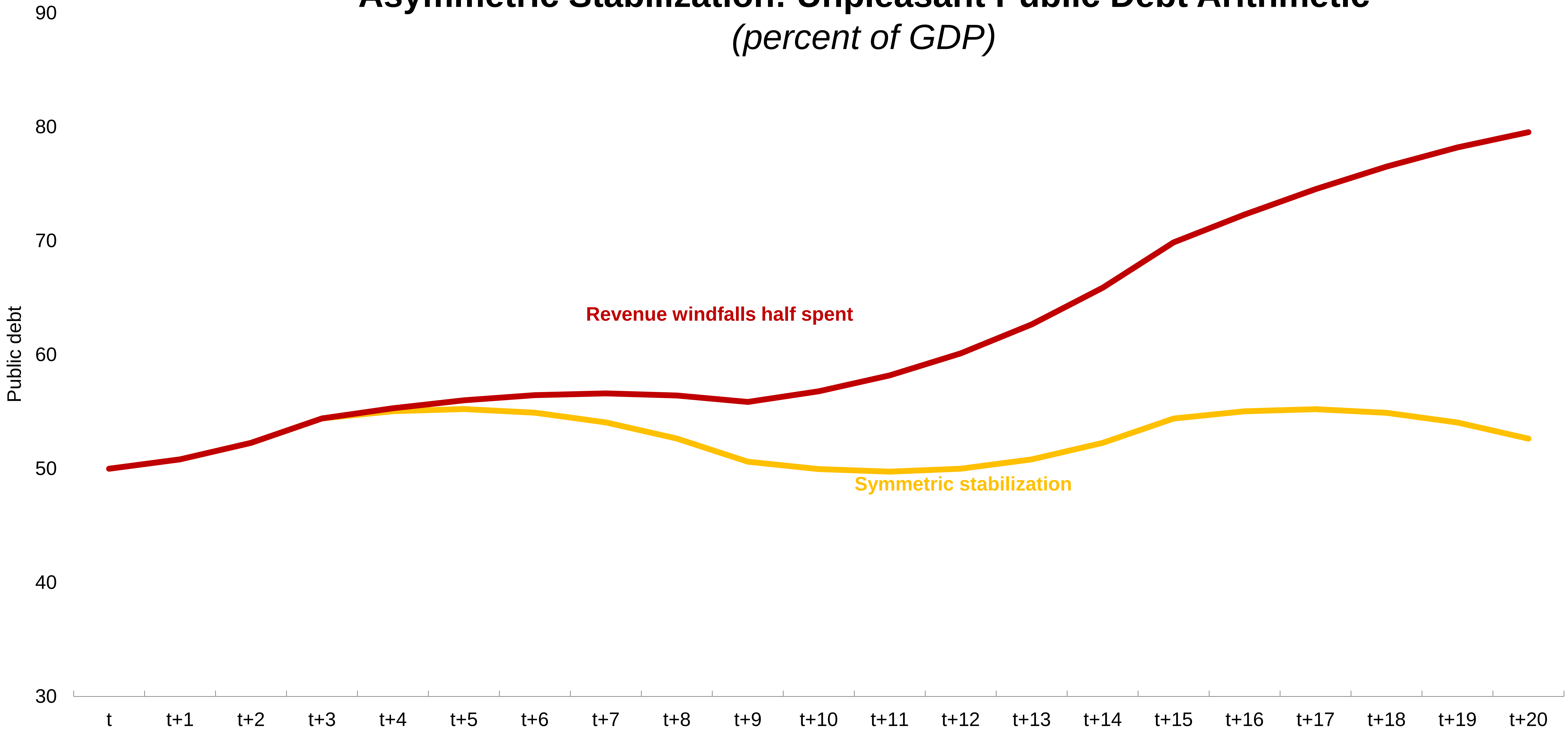
Fiscal stabilization appears effective in reducing output volatility, especially in advanced economies



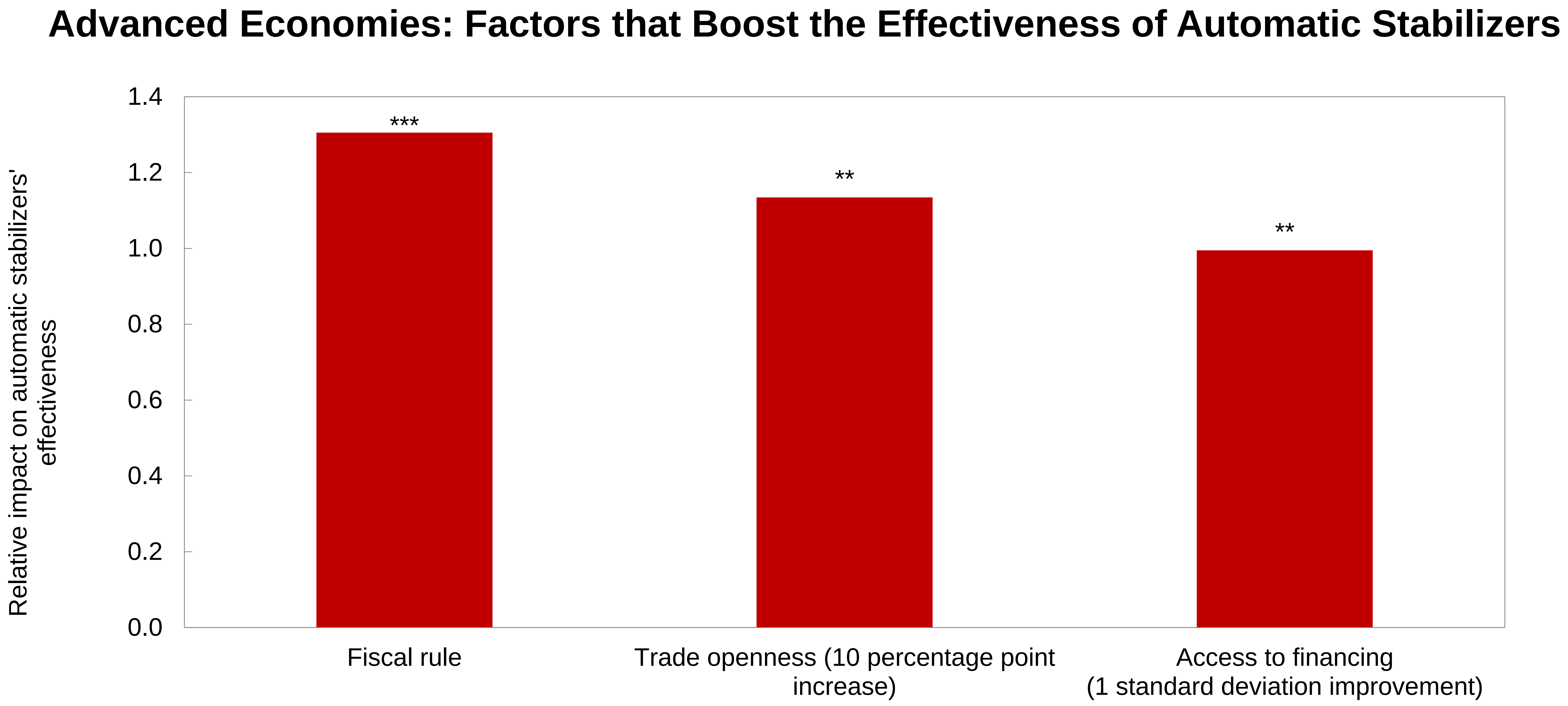
Sources: Mauro and others 2013; World Bank; and IMF staff estimates.
Note: Estimates are based on Arellano-Bond (1991) system generalized method of moments. Output volatility is defined as the standard deviation of the real GDP growth rate over 5-year fixed windows. Emerging market and developing economies include emerging market and middle-income economies as well as low-income developing countries.
** $p < 0.05$; *** $p < 0.01$.

But countries tend to suppress their impact in good times, leading to significant public debt buildup

Asymmetric Stabilization: Unpleasant Public Debt Arithmetic
(percent of GDP)



Automatic stabilizers play more freely in countries with fiscal rules and access to finance



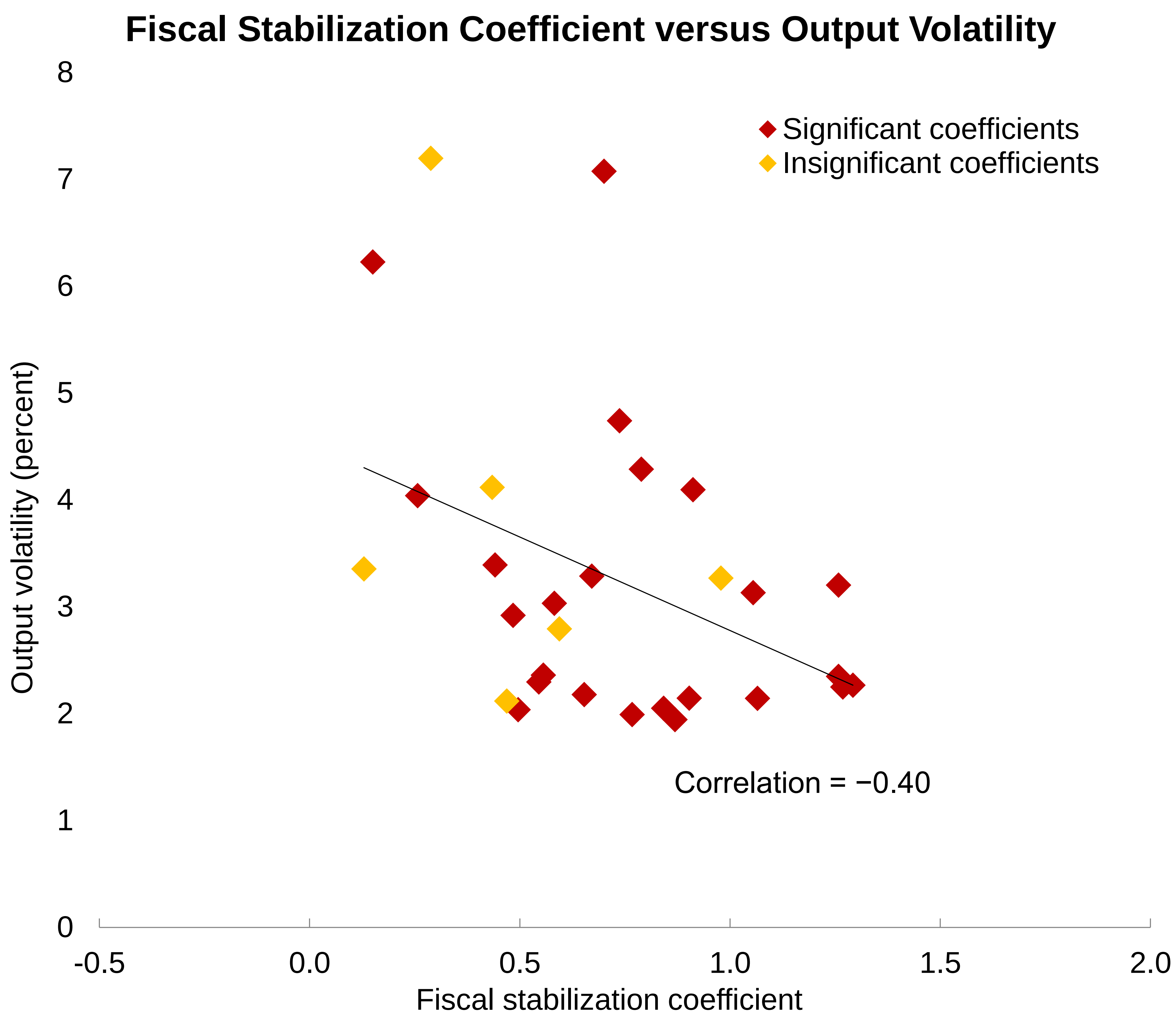
Sources: IMF Fiscal Rules database; World Bank; and IMF staff estimates. Note: Figure estimates use weighted least squares, with weights inversely proportional to the estimation error of the effectiveness coefficients. The number on the vertical axis is the ratio of the estimated impact of the scenario specified on the horizontal axis to the average effectiveness coefficient. For a list of advanced economies, see Economy Groupings in the Methodological and Statistical Appendix. ** $p < 0.05$; *** $p < 0.01$.

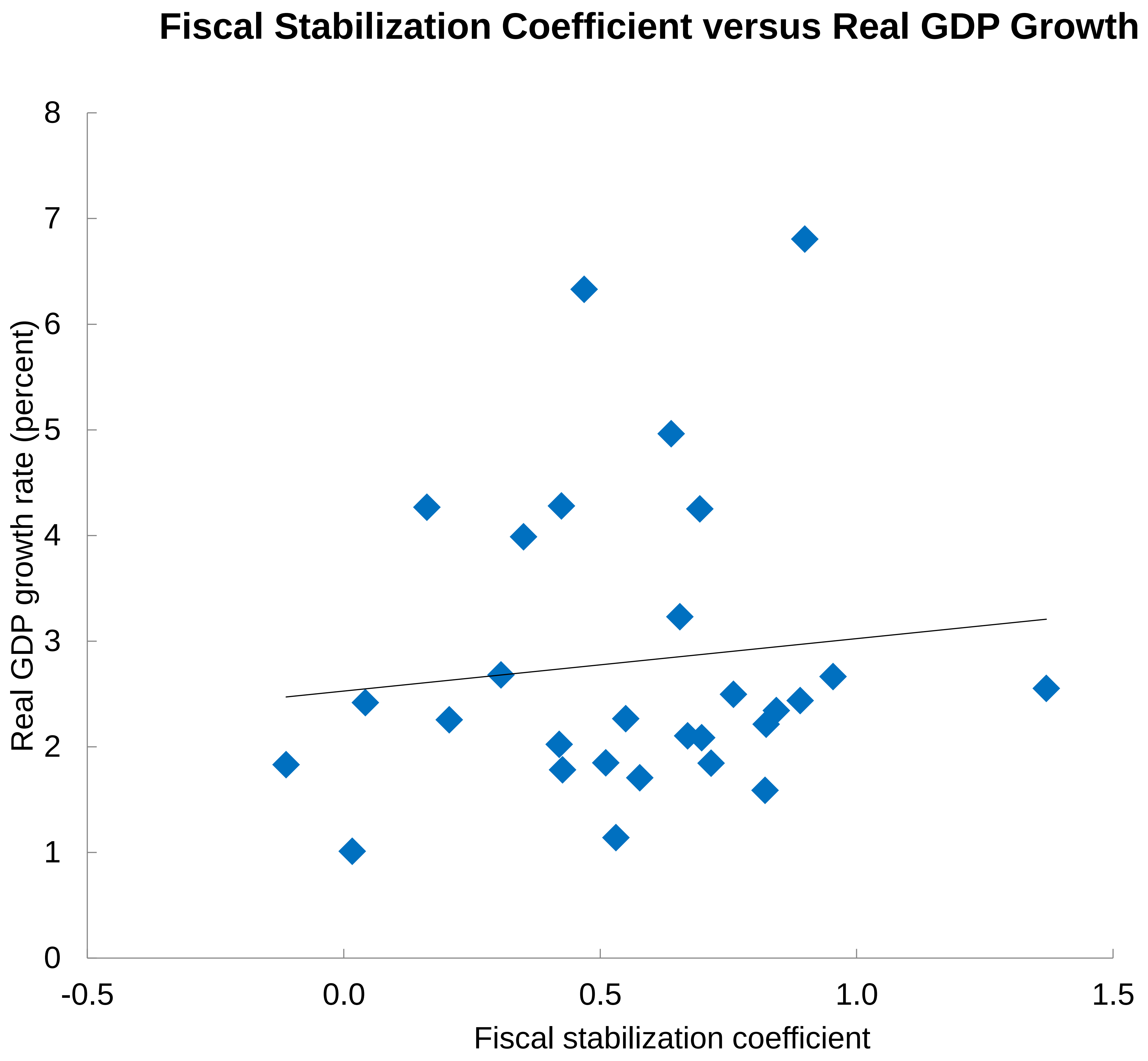
Boosting the effectiveness of automatic stabilizers

- Tax deductions
  - Cyclical investment tax deduction
  - Cyclical bonus depreciation
  - Cyclical loss-carry forward
  - Cyclical property tax
- Expenditure
  - Automatic transfers to local governments
  - Cyclical adjustment of unemployment benefits

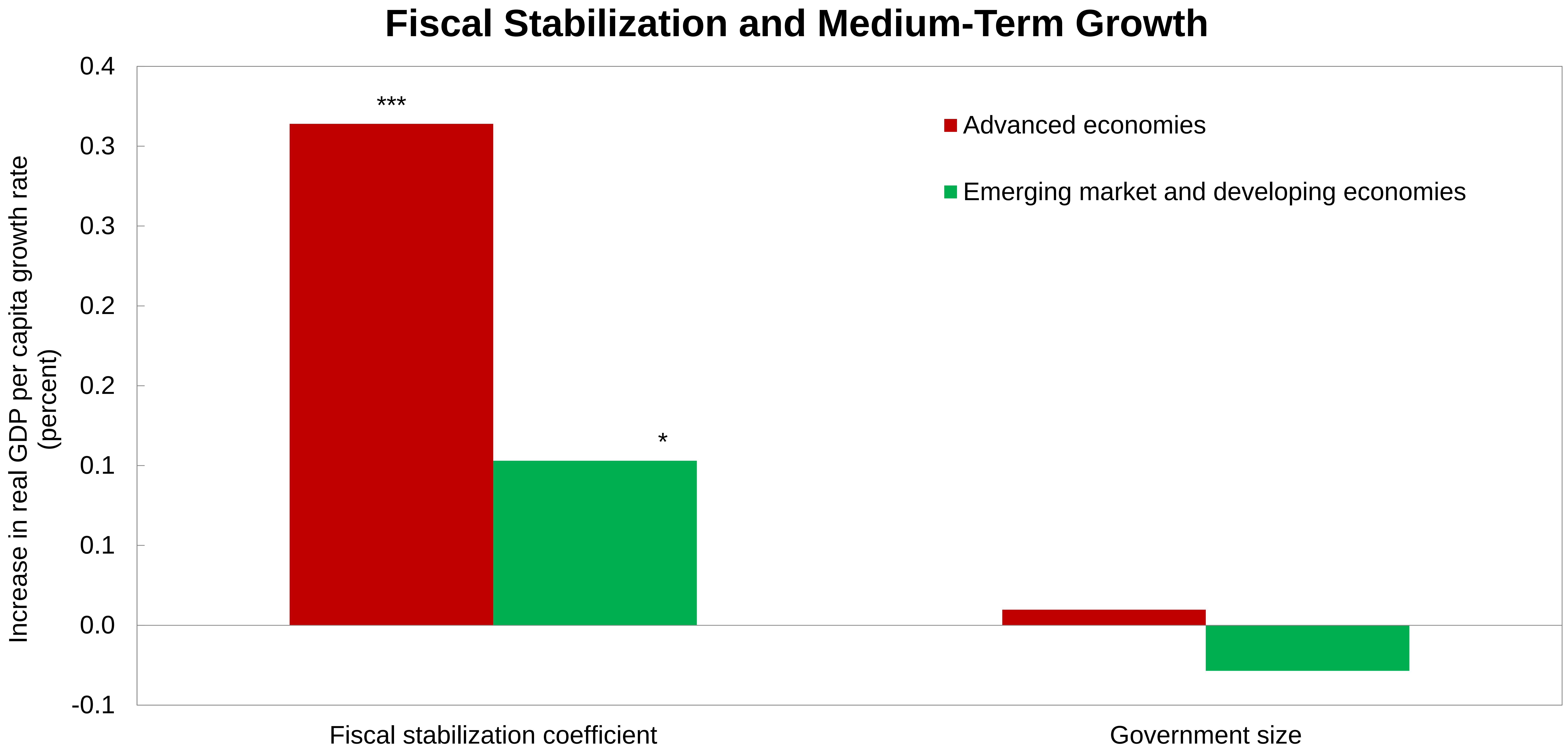
Fiscal stabilization promotes macro stability and growth

Fiscal Stabilization, Output Volatility, and Growth: Cross-Country Correlations, 1980−2013





Fiscal stabilization is positively correlated with real GDP growth and higher fiscal stabilization means more growth



Sources: European Commission; Mauro and others 2013; Organisation for Economic Co-operation and Development; and IMF staff estimates.
Note: Emerging market and developing economies include emerging market and middle-income economies as well as low-income developing countries. For a list of countries in each group, see Economy Groupings in the Methodological and Statistical Appendix.
* $p < 0.10$; *** $p < 0.01$.

Policy implications

- Make fiscal policy more stabilizing through the cycle:
  - Address shortcomings of discretionary stabilization (cyclical unemployment benefits, easy-to-implement capital/maintenance spending)
  - Do not spend revenue windfalls from above-average growth
- Boost automatic stabilizers?
  - Yes but beware of the side effects (government size)
  - Options to boost stabilizers at constant government size
- Sound fiscal institutions help:
  - Credible long-term anchor; no financing constraints
  - Constraint spending in good times
  - Provide short-term flexibility in the face of bad shocks (structural fiscal indicators, well-designed escape clauses)

Concluding remarks

- Risks to public finances are significant
  - Debt dynamics in AEs sensitive to real interest and growth shocks
  - Lower growth prospects and lower commodity prices raise challenges in many EMs and LIDCs
- Policy messages:
  - Seize the moment to get energy prices right (end subsidies, tax carbon)
  - If possible, use fiscal flexibly in response to risks and medium-term challenges
- Strengthening fiscal frameworks can help:
  - Manage fiscal risks, including uncertainty related to commodity prices
  - Promote fiscal stabilization through the cycle and deliver a growth dividend
  - Anchor fiscal policy and support debt sustainability