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Research Briefing | Global

The fiscal adjustment predicament – global rankings

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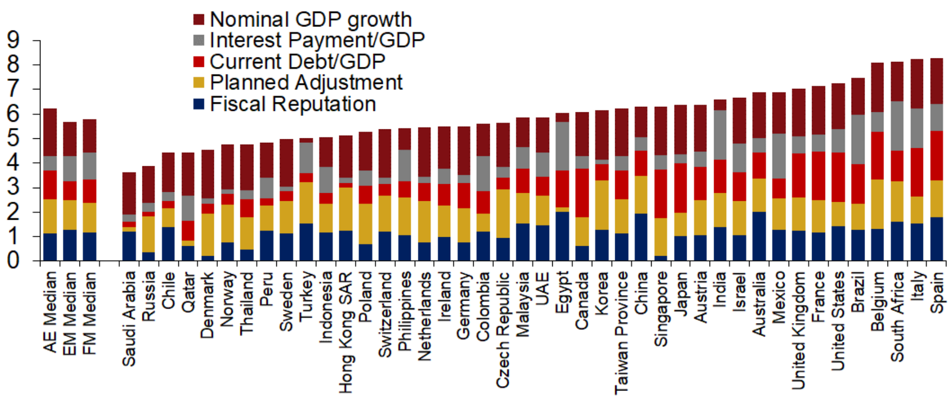
- **We highlight which economies face the most intense medium-term fiscal adjustment predicaments. For each economy, the predicament varies according to various measures of the fiscal outlook and fiscal reputation.**
- **Overall, we see adjustments to be a manageable problem. The fiscal response to Covid has left a legacy of bloated debt, which increased by an average of 20% of GDP in advanced economies (AEs) and 9% in EMs between 2019 and 2021. On a more positive note, there are few ongoing acute funding concerns.**
- **Tough fiscal decisions lie ahead, but for most economies a moderate fiscal adjustment over the next decade will be sufficient to stabilise debt at these higher levels. Even under a stagflationary shock, the average AE and EM would still be able to run significant primary deficits without debt spiralling up further.**
- **But some countries face a more difficult fiscal adjustment predicament, which we assess according to five criteria: debt-to-GDP ratio; interest burden (as % of GDP); nominal GDP growth projections; announced fiscal adjustment plans; and reputation for meeting fiscal projections over the past decade.**
- **We find the prospects for fiscal adjustment are a bit more severe for AEs than EMs overall. AEs typically have higher debt-to-GDP ratios, less ambitious adjustment plans, and weaker growth prospects. But EMs have higher debt service burdens and a slightly inferior reputation for meeting fiscal projections.**
- **Two frontier markets (El Salvador and Sri Lanka) face the most severe of all fiscal predicaments (see Appendix). Among larger economies, our scorecard reveals that Spain, Italy, South Africa, Belgium and Brazil find themselves with the most acute medium-term fiscal predicaments (see Figure 1).**

Figure 1: Our scorecard is based on (1) indebtedness, (2) debt-service burden; (3) nominal GDP growth; (4) fiscal adjustment plans; (5) fiscal reputation

AE & EM fiscal adjustment predicament scorecard

Score (10 is max and indicates the biggest adjustment predicament)



Source : Oxford Economics/Haver Analytics/IMF

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Slow-burn adjustment concerns

First, the good news. Do you remember when there was a funding crisis, back in April 2020? That's still the case if you happen to be Sri Lanka and Mozambique. But for most governments, the quandary is more medium term in nature – it's about balancing the pain of fiscal adjustment with the burden of risks to public finances, such as stagflation.

Now, the bad news. Whatever your view on economic long Covid, virtually every economy's medium-term debt burden has been exacerbated by the pandemic. Government debt issuance has been rising steadily since the GFC, but the pickup has been much sharper post-Covid. The biggest increases were for the previously low-debt countries **(Figure 2)** which have exploited the fiscal space, and high-debt countries, some of which are advanced economies (AEs) that may have been unaware such fiscal space existed.

How do we assess which countries have fiscal adjustment plans that could calm or jangle investor nervousness? We have picked five key metrics:

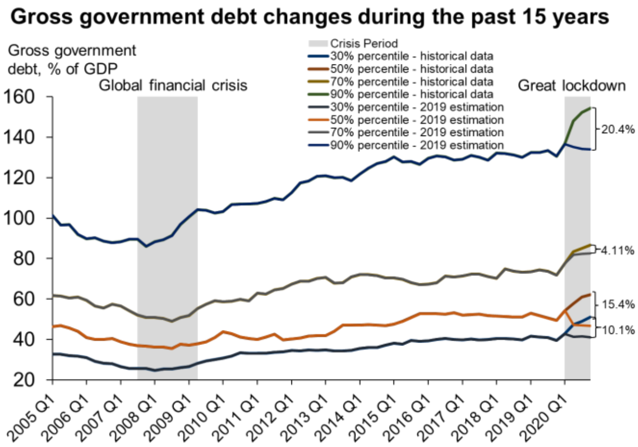
1. How high is the stock of debt (debt-to-GDP ratio)?
2. How big is debt service (interest payments/GDP)?
3. What is the projected nominal GDP growth 2021-25?
4. How ambitious are fiscal adjustment plans (average fiscal deficit in 2024-26 minus pre-Covid average)?
5. How strong is the reputation for achieving fiscal balance targets (based on 10-year average of fiscal adherence)?

There are other factors that determine how concerned we should be over medium-term debt risks, but these are the ones on which we base our global scorecard.

1. AEs are burdened with higher debt levels and lower nominal GDP growth

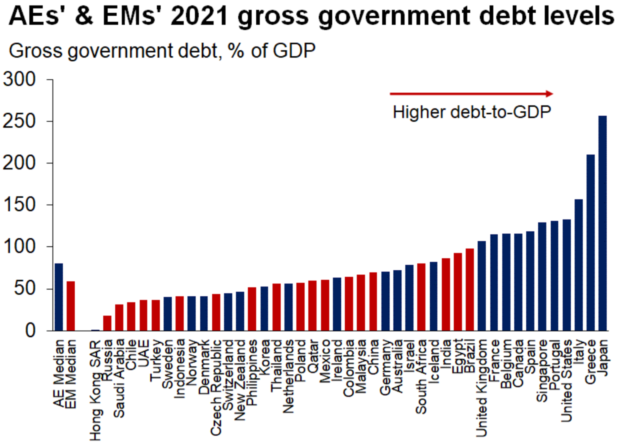
All else being equal, the greater the debt-to-GDP ratio, the more adjustment needs to be done. Although the optimal level of public debt is a thorny issue, we see fiscal adjustment as being necessary over the medium term, otherwise government will be increasingly exposed to a pickup in real interest rates and macro volatility. AEs tend to have much bigger stocks of debt (the AE median is 80% of GDP whereas the EM median is 59%). Of the world's larger economies, 11 AEs are now in the 100% club (that's the debt-to-GDP ratio, **Figure 3**). No EMs are there just yet, though Brazil and Egypt are knocking on the door.
It's also harder for AEs' to grow their way out of debt, as nominal GDP growth is significantly lower (see **Appendix**).

Figure 2: Covid has left its deepest scars on government indebtedness



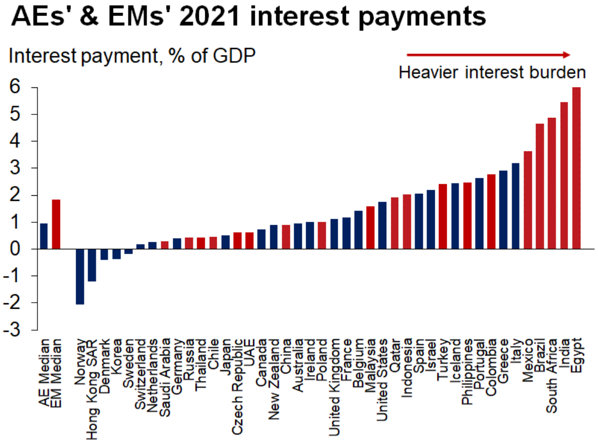
Source : Oxford Economics/Haver Analytics

Figure 3: Advanced economies have much higher debt-to-GDP ratios



Source : Oxford Economics/Haver Analytics/IMF

Figure 4: Despite lower debt, EMs' interest burden is much higher than AEs



Source : Oxford Economics/Haver Analytics/IMF

2. EMs face a bigger interest burden

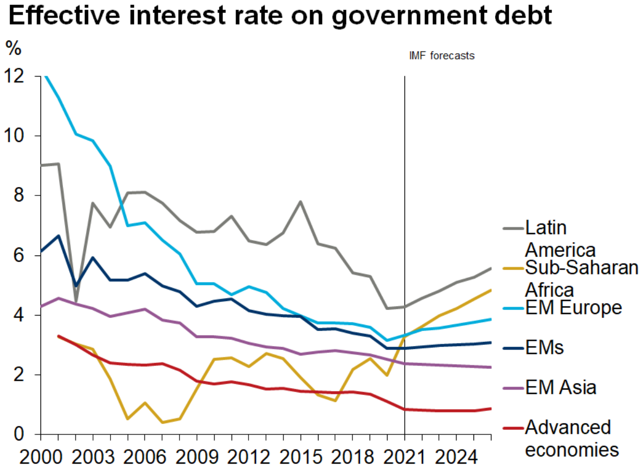
EM governments have higher debt servicing costs (**Figure 4**) because their higher effective interest rates (**Figure 5**) outweigh the impact of lower debt stocks. Over the past 20 years, the gap between EM and AE interest rates has been narrowing sharply, driven by EMs' declining macro volatility, strengthening macro institutions, and deepening domestic financial markets. But according to the IMF's projections, this is set to reverse, with the gap projected to widen significantly. This is more understandable in the case of Africa (owing to an increased share of market finance in total debt) but is more controversial for Latam, where political turbulence and inflation pressures may be insufficient to offset the trend towards secular convergence. It's a key bone of contention and important in affecting views on the urgency of adjustment.

EM public debt service (interest payments) as a share of GDP is nearly double that of advanced economies (**Figure 4**). Five EMs (Egypt, India, South Africa, Brazil, and Mexico) pay at least 3.5% of GDP in interest each year. The highest advanced economy is Italy, with 3.2% of GDP.

In terms of challenges to fiscal adjustment, AEs' higher stock of debt is a slightly bigger burden than EMs' higher interest payments/GDP. To see this, we conducted debt sustainability analysis (DSAs) for EMs and AEs in the aggregate, including a stagflation scenario (**Figure 6**). The approach asks the question: "How low do fiscal deficits need to be to stabilise the debt/GDP ratio at 2021 level?" The advantage of this approach is that it factors in not just the stock of debt and interest rate, but also relative growth and inflation differentials. Two key results are:

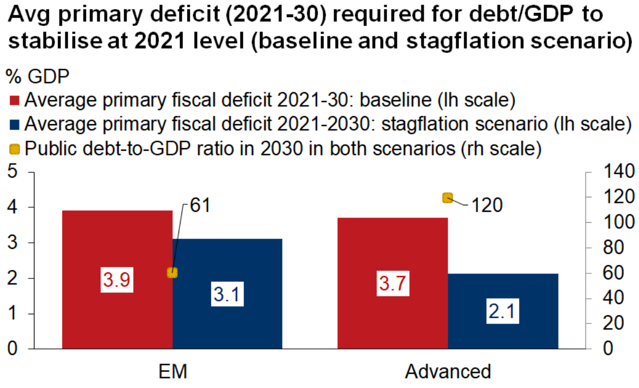
- EM governments can run a slightly looser fiscal stance than AEs to stabilise debt (primary deficits of 3.9% of GDP in a baseline scenario compared with AEs 3.7%).
- AEs are more vulnerable to a nasty stagflation shock that increases interest rates by 200bp. Such an event would require EMs to reduce primary deficits by 0.8% of GDP relative to the baseline (**Figure 6**) to stabilise debt around current levels. AE adjustment would be bigger, at 1.6% of GDP – painful in the context of weak growth.

Figure 5: IMF projects EM and AE effective interest rates will diverge once more; they may be wrong



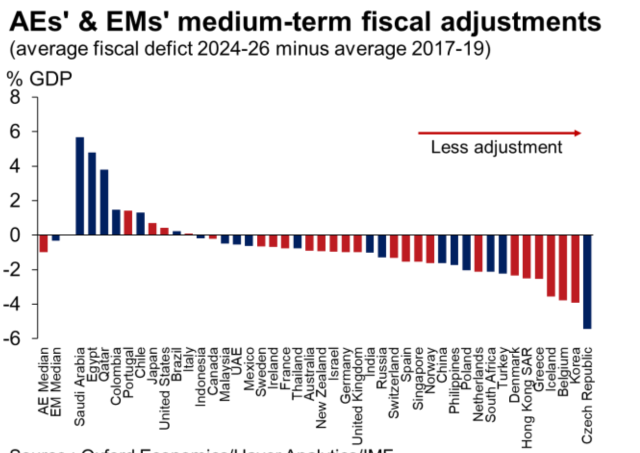
Source : Oxford Economics/IMF

Figure 6: EMs can afford to run bigger primary deficits and still stabilise debt



Note: The stagflation scenario involves inflation 1ppt higher than baseline each year, real GDP growth 1ppt lower than baseline each year, and a sustained 200bps increase in global yields
Source: Oxford Economics/IMF

Figure 7: Medium-term fiscal adjustment plans are unambitious, particularly for AEs



Source : Oxford Economics/Haver Analytics/IMF

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3. AEs have less ambitious adjustment plans

Over the medium term, most economies, especially AEs, are planning little if any fiscal adjustment (as measured by the average fiscal deficit 2022-25 minus the pre-crisis average). Based on announced plans (calibrated by the IMF), the median AE will run a medium-term fiscal deficit 1% of GDP greater than the pre-crisis average (**Figure 7**), while the median EM's will be 0.3pp higher. We find some evidence that the most highly indebted AEs are likely to pursue more ambitious fiscal adjustment. Some EMs are planning for ambitious fiscal adjustments. Among them, Saudi Arabia, Egypt, and Qatar plan strong medium-term adjustments of at least 3.8% of GDP. By contrast, the Czech Republic, Korea, Belgium, and Iceland are projected to have average medium-term deficits rising by at least 3.6% of GDP medium term (**Figure 7**).

4. Most EM and AE fiscal plans are reliable

In the decade leading up to the Covid-crisis, most governments performed well in terms of meeting fiscal projections. We estimate fiscal misses (the gap between projections based on announced plans and actual fiscal balances) compared to the fiscal goals set up six months, one year, and two years ahead for 28 AEs and 24 EMs (**Figure 13 & 14**). Generally, more governments exceeded fiscal targets than missed them. As might be expected, the longer the projection period, the more likely governments were to underperform. EMs are slightly more likely to miss their fiscal goals: in the case of medium-term fiscal goals set up two years ahead, there is a greater than 50% chance that EMs will underperform goals.

Over the past 10 years, Czech Republic, Korea, Belgium, Iceland, and Greece were had the most severe fiscal misses (**Figure 10**). These are the most striking fiscal misses according to our fiscal reputation scorecard, which measures fiscal reputation based on average fiscal misses since 2010.

Watch out South Africa, Spain, Italy, and India

In summary, the fiscal adjustment predicament is truly global (**Figure 1**). According to our scorecard, among major economies, three of the most severe 10 predicaments are faced by EMs (South Africa, Brazil, and Mexico), while seven are AEs (Spain, Italy, Belgium, USA, France, UK and Australia). More broadly, two frontier markets (El Salvador and Sri Lanka) appear to have the most acute of all problems (see **Appendix**).

Figure 8: Most AEs have met fiscal projections over the past decade, though some missed by a mile

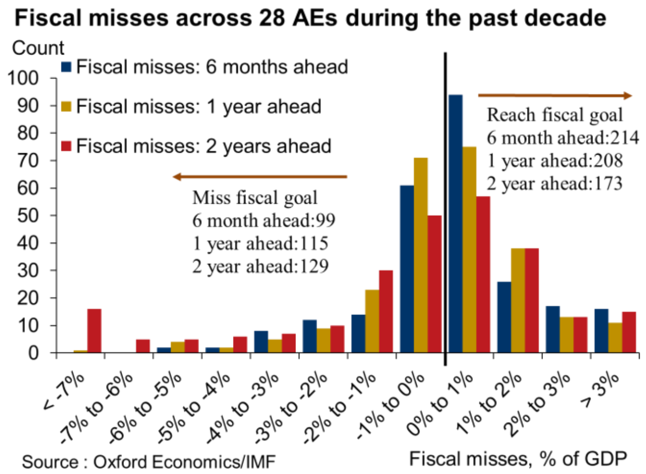


Figure 9: EMs have been almost as reliable on average, though with a fat tail of big misses

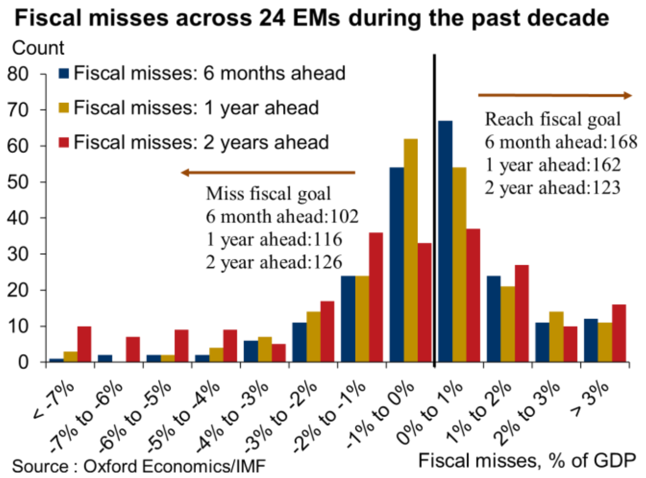
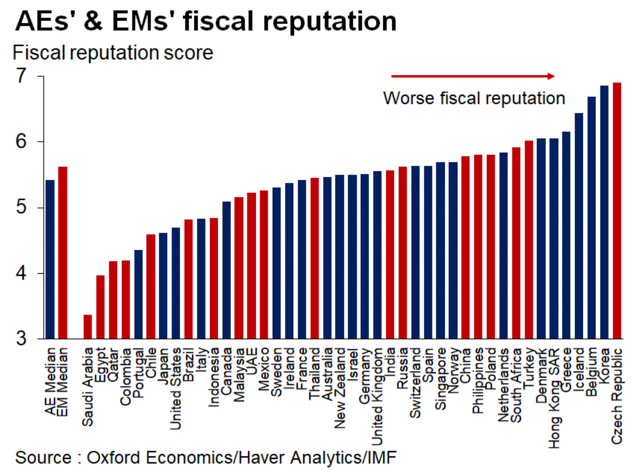


Figure 10: AEs average fiscal reputation better, though most with bad reputation are AEs



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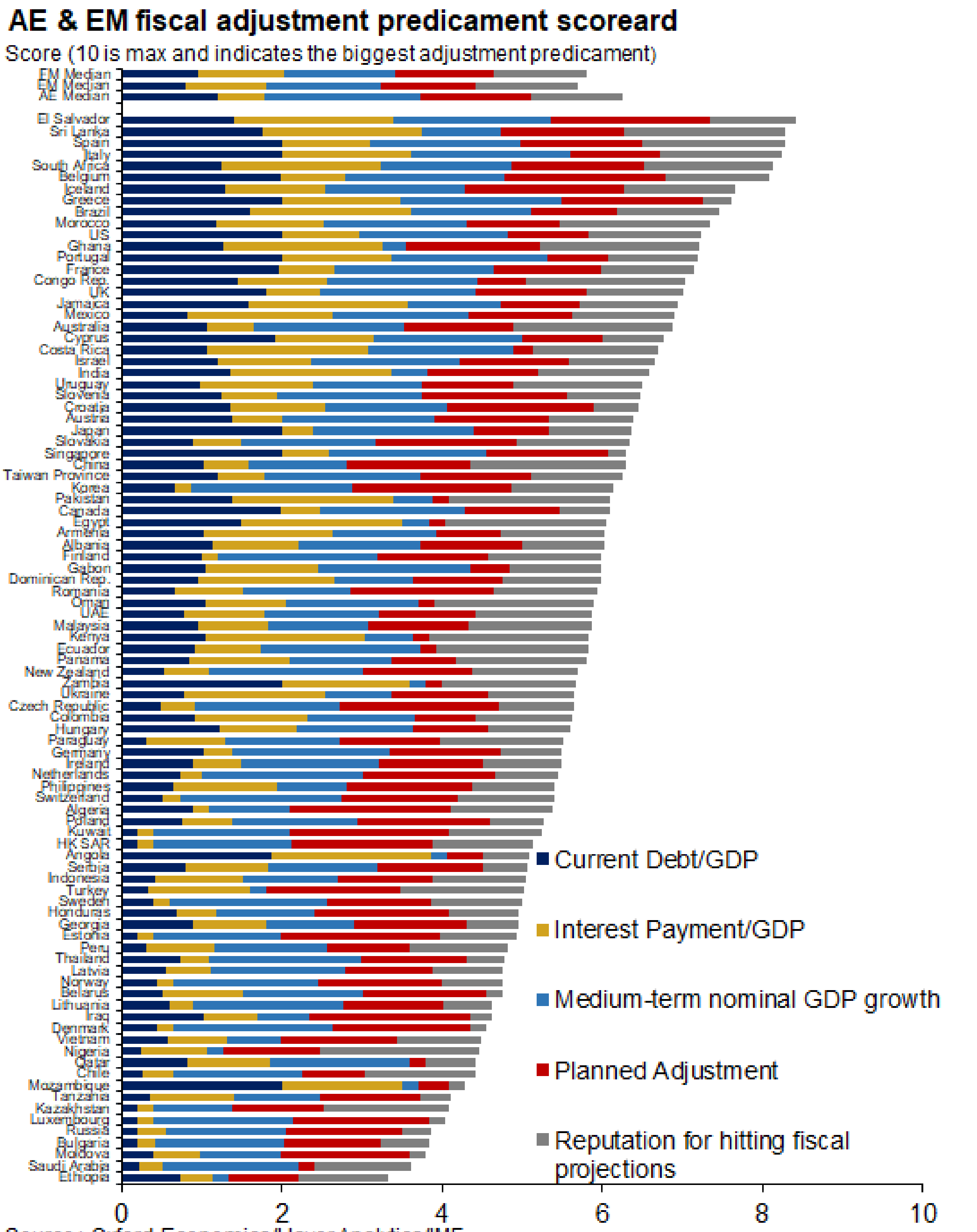
Appendix: Fiscal adjustment predicament scorecard for AEs, Ems, and frontiers



Source : Oxford Economics/Haver Analytics/IMF

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