Fiscal Monitor UPDATE
Fiscal Affairs Department

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Nurturing Credibility While Managing Risks to Growth

Fiscal adjustment is proceeding generally as expected in advanced economies, with headline and underlying fiscal deficits that are broadly in line with projections in the April 2012 Fiscal Monitor. *Overall, advanced economy deficits are forecast to decline by about ¾ percentage point of GDP this year and about 1 percent of GDP next year in both headline and cyclically adjusted terms, a rate that strikes a compromise between restoring fiscal sustainability and supporting growth. However, continued focus on nominal deficit targets runs the risk of compelling excessive fiscal tightening if growth weakens. In addition, there is a risk in the United States of political gridlock that puts fiscal policy on autopilot and results in a sharp and sudden decline in deficits—the "fiscal cliff." In most advanced economies, a steady pace of adjustment focused on the measures to be implemented rather than on headline deficit targets is preferable, especially in light of heightened downside risks to the outlook. In most emerging economies, headline and cyclically adjusted deficits are projected to remain broadly unchanged over 2012–13, which is appropriate given these countries' generally stronger fiscal positions and the downside risks to the global economy. However, some emerging economies need to be more ambitious to reduce vulnerabilities.*

Underlying fiscal adjustment on track

Fiscal imbalances are being gradually corrected in line with expectations in most advanced economies. Cyclically adjusted deficits in 2012–13 are expected to fall by close to 1 percent of GDP annually on average in advanced economies—about the same amount as last year and broadly as projected in the April 2012 *Fiscal Monitor*—with greater reductions in countries under market pressure (Table 1, Figure 1).

The two largest such countries are implementing sizeable fiscal consolidation in the next two years in efforts to improve debt dynamics and regain market confidence.

- Market turbulence has intensified in *Spain* due to renewed concerns about the health of the financial system and its possible fiscal implications (Figure 2). Despite an ambitious and largely expenditure-based consolidation package, revenue underperformance due to the recession and higher spending pressures from unemployment insurance costs, social security outlays and interest payments were expected to push the deficit close to 7 percent of GDP this year before the announcement of new measures on July 11. This is about 1 percent of GDP more than projected in April, but still about 2 percentage points of GDP below last year's outturn. The cyclically adjusted deficit projection had also been revised up. This may reflect factors that are leading to a temporary increase in the sensitivity of the budget balance to output. Deficit targets have been revised to 6.3 percent of GDP this year and 4.5 percent of GDP next year under the EU's Excessive

Table 1. Fiscal Indicators, 2008–13
(Percent of GDP, except where otherwise noted)

				Est.	Projections		Difference from April 2012 *Fiscal Monitor*[1]		
	2008	2009	2010	2011	2012	2013	2011	2012	2013
Overall Fiscal Balance									
Advanced economies	-3.5	-8.8	-7.6	-6.5	-5.8	-4.7	0.0	-0.1	-0.2
United States	-6.7	-13.0	-10.5	-9.6	-8.2	-6.8	0.0	-0.1	-0.5
Euro area	-2.1	-6.4	-6.2	-4.1	-3.2	-2.5	0.0	0.0	0.2
France	-3.3	-7.6	-7.1	-5.2	-4.5	-3.9	0.1	0.1	0.0
Germany	-0.1	-3.2	-4.3	-1.0	-0.7	-0.4	0.0	0.1	0.2
Greece[2]	-12.2	-15.6	-10.5	-9.2	-7.0	-2.7	0.0	0.2	1.9
Ireland	-7.3	-14.0	-31.2	-13.1	-8.3	-7.5	-3.3	0.2	-0.2
Italy	-2.7	-5.4	-4.5	-3.9	-2.6	-1.5	0.0	-0.2	0.1
Portugal	-3.7	-10.2	-9.8	-4.2	-4.5	-3.0	-0.2	0.0	0.0
Spain[3]	-4.5	-11.2	-9.3	-8.9	-7.0	-5.9	-0.4	-1.0	-0.2
Japan	-4.1	-10.4	-9.4	-10.1	-9.9	-8.6	0.0	0.1	0.2
United Kingdom	-5.0	-10.4	-9.9	-8.6	-8.1	-7.1	0.1	-0.2	-0.5
Canada	-0.1	-4.9	-5.6	-4.4	-3.8	-2.9	0.2	-0.2	0.0
Emerging economies	0.2	-4.5	-3.3	-1.7	-1.9	-2.0	-0.1	-0.3	-0.3
China	-0.4	-3.1	-2.3	-1.2	-1.3	-1.0	0.0	0.0	0.0
India	-8.8	-9.7	-9.4	-8.9	-8.9	-8.8	-0.2	-0.6	-0.6
Russia	4.9	-6.3	-3.5	1.6	0.1	-0.7	0.0	-0.5	-0.4
Turkey	-2.4	-5.6	-2.7	-0.3	-1.7	-2.0	0.0	0.0	0.0
Brazil	-1.3	-3.0	-2.7	-2.6	-1.9	-2.1	0.0	0.5	0.3
Mexico	-1.1	-4.7	-4.3	-3.4	-2.4	-2.2	0.0	-0.1	-0.1
South Africa	-0.5	-5.3	-4.8	-4.5	-4.4	-3.8	0.1	-0.1	-0.1
Low-income economies	-1.0	-4.0	-2.7	-2.4	-3.0	-2.5	-0.1	-0.1	-0.2
General Government Cyclically Adjusted Balance (Percent of potential GDP)									
Advanced economies	-3.8	-6.0	-6.1	-5.4	-4.7	-3.6	-0.2	-0.2	-0.2
United States[4]	-5.5	-7.9	-8.1	-7.5	-6.3	-5.0	-0.4	-0.4	-0.6
Euro area	-3.1	-4.5	-4.6	-3.3	-2.0	-1.4	0.0	0.0	0.1
France	-3.1	-5.1	-5.1	-3.8	-3.1	-2.6	0.2	0.1	0.1
Germany	-1.3	-1.3	-3.4	-1.2	-0.6	-0.4	0.0	0.0	0.1
Greece[2]	-16.4	-18.5	-12.5	-9.0	-4.5	0.2	-2.2	0.1	2.9
Ireland	-11.9	-10.6	-9.8	-7.7	-6.0	-5.6	…	…	…
Italy	-3.3	-3.0	-3.1	-2.7	-0.5	0.7	0.0	-0.2	0.0
Portugal	-3.6	-8.8	-9.1	-2.9	-2.1	-0.9	-0.2	-0.1	-0.1
Spain[3]	-5.6	-9.7	-7.6	-7.3	-5.0	-3.9	-0.4	-1.1	-0.3
Japan	-3.5	-7.4	-7.9	-8.2	-8.8	-7.9	0.0	-0.1	0.1
United Kingdom	-7.2	-9.7	-8.4	-6.6	-5.5	-4.2	-0.3	-0.4	-0.4
Canada	-0.6	-2.6	-4.1	-3.4	-3.0	-2.2	0.2	-0.2	0.0
Emerging economies	-1.5	-3.6	-3.1	-1.9	-1.7	-1.7	0.0	-0.1	0.0
China	0.0	-2.4	-1.5	0.0	0.0	0.2	0.0	0.0	0.0
India	-8.8	-9.8	-9.6	-9.1	-9.0	-8.7	0.0	-0.2	0.0
Russia	3.9	-3.3	-2.2	1.7	-0.2	-1.1	0.1	-0.4	-0.3
Turkey	-3.2	-4.7	-3.4	-1.8	-2.8	-2.8	0.0	0.0	0.0
Brazil	-2.1	-2.2	-3.2	-2.8	-1.5	-2.0	-0.1	0.6	0.3
Mexico	-1.3	-3.8	-3.9	-3.2	-2.4	-2.2	0.0	-0.1	-0.1
South Africa	-2.3	-5.1	-4.5	-4.1	-3.7	-3.3	0.1	-0.1	-0.1
General Government Gross Debt									
Advanced economies	81.6	95.4	101.5	105.6	110.0	112.2	0.0	0.8	1.0
United States	76.1	89.9	98.4	102.8	106.7	110.7	-0.1	0.1	0.5
Euro area	70.2	80.0	85.8	88.1	91.4	92.4	0.0	1.4	1.4
France	68.3	79.2	82.4	86.1	88.2	90.1	-0.2	-0.9	-0.7
Germany	66.9	74.7	83.5	81.2	82.2	80.1	-0.3	3.3	2.7
Greece[2]	112.6	129.0	144.5	165.4	162.6	171.0	4.6	9.4	10.1
Ireland	44.2	65.1	92.5	108.2	117.6	121.2	3.2	4.4	3.5
Italy	105.8	116.1	118.7	120.1	125.8	126.4	0.0	2.5	2.6
Portugal	71.6	83.1	93.3	107.8	114.4	118.6	1.0	2.0	3.3
Spain[3]	40.2	53.9	61.2	68.5	90.3	96.5	0.0	11.2	12.5
Japan	191.8	210.2	215.3	229.9	234.5	240.0	0.1	-1.3	-1.1
United Kingdom	52.5	68.4	75.1	82.3	88.6	92.7	-0.2	0.2	1.3
Canada	71.1	83.6	85.1	84.7	85.4	82.7	-0.3	0.7	0.8
Emerging economies	33.3	35.4	40.1	36.4	34.2	32.7	0.0	0.3	0.5
China	17.0	17.7	33.5	25.8	22.0	19.4	0.0	0.0	0.0
India	75.2	72.2	67.7	67.1	68.0	68.6	-1.0	0.4	1.8
Russia	7.9	11.3	11.8	12.0	11.5	11.3	2.4	3.1	3.4
Turkey	40.0	46.1	42.2	39.4	36.0	34.6	0.0	0.0	0.0
Brazil	63.5	66.9	65.2	64.9	64.2	61.7	-1.2	-0.9	-1.4
Mexico	43.1	44.5	42.9	43.8	42.7	42.9	0.0	-0.1	0.0
South Africa	27.4	31.5	35.3	38.7	40.2	41.3	-0.1	0.2	0.5
Low-income countries	40.8	42.5	40.2	39.3	41.6	39.7	0.4	0.9	0.3
Memorandum:									
World Growth (Percent)	*2.8*	*-0.6*	*5.3*	*3.9*	*3.5*	*3.9*	*0.0*	*-0.1*	*-0.2*

Sources: IMF staff estimates and projections.

Note: All fiscal data country averages are weighted by nominal GDP converted to U.S. dollars at average market exchange rates in the years indicated and based on data availability. Projections are based on IMF staff assessment of current policies.

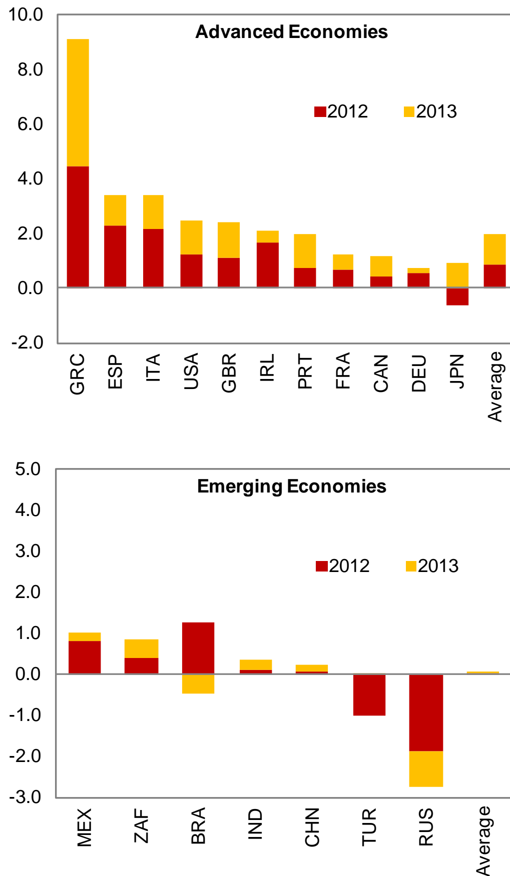
[1] For overall fiscal balance and cyclically adjusted balance, positive values indicate a smaller fiscal deficit; for gross debt, positive values indicate a larger debt.

[2] For Greece, projections to be revised.

[3] For Spain, projections do not reflect the measures announced on July 11, 2012.

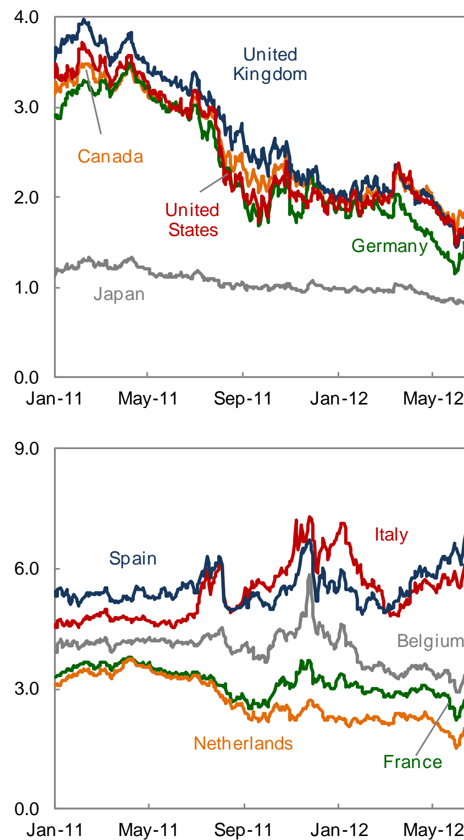
[4] Excluding financial sector support.

Figure 1. Change in the Cyclically Adjusted Balance
(Percent of potential GDP)



Sources: IMF staff estimates and projections.
Note: Averages are weighted by nominal GDP converted to U.S. dollars at average market exchange rates in the years indicated. For further details see footnotes in Table 1.

Figure 2. Sovereign Bond Yields
(Percent)



Source: Datastream, Thomson Reuters.
Note: Secondary markets 10-year sovereign bond yields.

Deficit Procedure. The new targets, respectively 1 and 1½ percentage points above the previous ones, appropriately accommodate the weak growth outlook. On July 11, the government announced a series of measures—including increases in VAT rates, the elimination of mortgage interest deductibility under the income tax, and cuts in civil service pay and unemployment benefits—to help achieve the new targets. To recapitalize the banking system, Spain's bank support fund—Fondo de Reestructuración Ordenada Bancaria (FROB)—is to have access to a financial sector recapitalization loan by the European Financial Stability Facility (EFSF) for up to 9 percent of GDP (€100 billion) committed by the Eurogroup, which would be reflected in the general government gross debt. However, once a single supervisory system is established in the euro area, the European Stability Mechanism (ESM) will be allowed to inject capital directly into the banks.[1]

- *Italy's* headline and cyclically adjusted deficits for 2012–13 continue to be broadly in line with expectations. Fiscal adjustment over the next two years would allow the authorities to achieve a small structural surplus in 2013 (against the medium-term objective of a structurally balanced budget[2]).

[1] IMF staff projections currently include the maximum amount of the loan in the debt but not in the deficit.

[2] The structural budget balance is equal to the cyclically adjusted balance adjusted for one-off measures. As one-off measures are typically not included in projections, structural and cyclically adjusted balances are expected to be equivalent in 2012–13.

This focus on structural fiscal targets is enshrined in a recently approved constitutional balanced budget rule coming into force in 2014. The bill amending the Constitution also mandates the establishment of a fiscal council whose remit and institutional features will be defined in secondary legislation currently under discussion. The authorities plan to use spending reviews more systematically to identify fiscal savings; a first phase, approved in July, legislates spending cuts in order to rebalance the earlier fiscal consolidation package away from tax increases.

In the three euro area countries with programs supported by EU/IMF lending, adjustment is proceeding, but the recent deterioration in the political and economic climate in Greece serves as a warning about the potential onset of "adjustment fatigue," which remains a threat to continued program implementation.

- The situation in *Greece* remains fluid. Macroeconomic deterioration and uneven reform implementation have weighed on revenues this year, while financing constraints are leading to under-execution of budgeted expenditures. Absent further policy changes, the primary deficit would trend towards 1½ to 2 percent of GDP, versus the 1 percent foreseen at the time of the Extended Fund Facility (EFF).
- Fiscal adjustment is proceeding as targeted in *Portugal,* where the deficit is expected to fall to 4½ and 3 percent of GDP this year and next, respectively, with this decline to be achieved mainly through expenditure restraint. The adoption of a medium-term expenditure framework—with indicative expenditure ceilings—is expected to strengthen program implementation. The authorities are also to provide capital injections into three of the largest banks (amounting to 4 percent of GDP) to meet capital requirements set by the European Banking Authority, increasing the ratio of gross debt to GDP (but not the measured deficit).
- In *Ireland*, the authorities are on track to meet the program targets and keep pace with the objective of reaching the 3 percent of GDP EU threshold for the headline deficit by 2015.[3] The general government deficit target of 8.6 percent of GDP for 2012 appears likely to be met, especially given the slightly better than expected fiscal performance through May.

In advanced economies with easier market access, fiscal adjustment in 2012–13 is broadly on track to meet medium-term targets.

- Projected fiscal withdrawal in *Germany* for 2012 and 2013 is unchanged since April at relatively modest levels.
- In the *United Kingdom*, the cyclically adjusted deficit will continue to decline this year and next, but by less than last year, which is fitting given the weak growth outlook. The government has appropriately maintained its commitments to balance the structural current budget within five years and to put net debt on a declining path, with additional consolidation in store in 2015–17.
- In *France*, the new administration has committed to reducing its headline deficit by about 1 percent of GDP this year and 1½ percent of GDP next year to 3 percent of GDP, in line with earlier projections (with a commitment to a balanced budget by 2017, a year later than envisaged earlier).[4] With a view to reaching these targets, the supplementary budget includes new measures of about 0.3 percent of GDP, mainly on the revenue side, to compensate for revenue shortfalls. The underlying adjustment implicit in these targets is appropriate under the baseline scenario. However, in the event that

[3] Changes to the 2011 deficit compared to the April 2012 *Fiscal Monitor* reflect a revision to include part of the bank recapitalizations (already accounted for in the debt ratio) in the deficit.

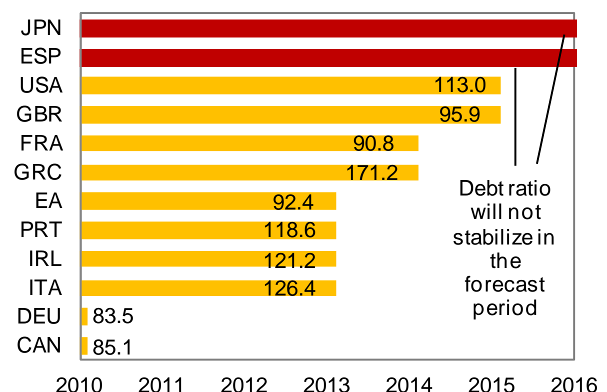
[4] IMF staff projections in Table 1 are based on current policies and do not take into account forthcoming additional measures that will be taken to reach the 3 percent deficit target.

growth disappoints, these targets could entail an excessive structural adjustment. Thus a shift to structural deficit targets could be desirable.

- The *United States'* fiscal position is projected to improve this year (broadly in line with the April 2012 *Fiscal Monitor* projections), but the outlook for 2013 remains a significant concern.[5] Expiring tax provisions (such as income and payroll tax cuts and limitations on the reach of the Alternative Minimum Tax through an adjustment of the income threshold) and automatic spending cuts mandated by the 2011 Budget Control Act would imply a fiscal withdrawal of more than 4 percent of GDP—the so-called 'fiscal cliff'—which would severely affect growth in the short term.[6] A more modest retrenchment in 2013—of around 1 percent of GDP in structural terms—would be a better option. Early action on the federal debt ceiling, which is expected to become binding late this year or early next, would mitigate risks of financial market disruptions and a loss in consumer and business confidence.
- Following a political agreement in *Japan*, the draft bill to double the consumption tax rate in stages to 10 percent by 2015 passed the lower house in late June and has been sent to the upper house. This welcome development sends a positive signal of commitment to fiscal adjustment and reform. However, the tax increase would remain only part of the consolidation necessary to put the debt ratio on a downward path. To support further fiscal consolidation and mitigate the negative economic impact of the consumption tax increase, adjustment measures should be complemented by efforts to raise growth through structural measures, supportive monetary policy, and fiscally-prudent, growth-friendly tax and expenditure reforms.

The decline in deficits is gradually affecting public debt dynamics. While the average debt-to-GDP ratio among advanced economies is projected to continue to rise over the next two years, surpassing 110 percent of GDP on average in 2013, debt ratios will by then have peaked in several advanced economies (Figure 3). Already this year, about one-third of advanced economies will have declining debt ratios, although debt ratios will still exceed their 2007 levels in almost all cases. In the euro area other than Greece, gross debt dynamics in 2012–13 will be negatively (and temporarily) affected by the pooling of resources to support countries in crisis (Figure 4, box). Of course, the corresponding acquisition of assets leaves net debts unchanged.

Figure 3. Advanced Economies: When Will Debt Ratios Peak?



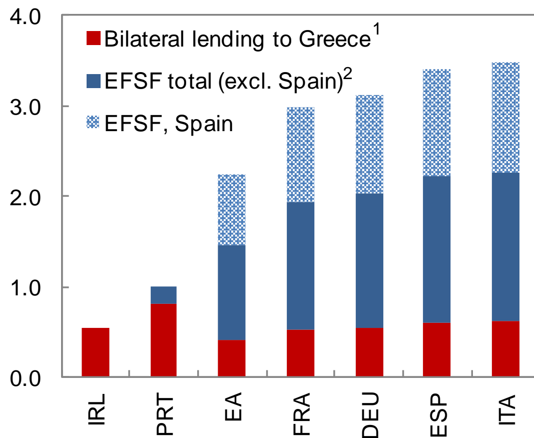
Sources: IMF staff estimates and projections.
Note: Red bars indicate countries whose debt-to-GDP ratios will not stabilize within the next five years. Numbers in bars refer to the projected peak debt-to-GDP ratio. EA refers to the euro area average.

Deficits in emerging economies are expected to be somewhat weaker than projected in April, as some draw on fiscal space in response to slowing economic activity. No significant fiscal consolidation is on tap in 2012–13, reflecting generally stronger fiscal positions than in advanced economies and downside risks to global growth.

[5] Changes in the cyclically adjusted balance in 2011–12 with respect to the April 2012 *Fiscal Monitor* are due mainly to revisions to the estimate of potential GDP.

[6] The IMF staff's baseline scenario incorporates a 1¼ percent of GDP reduction in the structural primary balance in 2013, largely on account of expiring stimulus measures and some savings in defense spending. The Bush tax cuts and certain other revenue provisions are expected to be extended fully for at least one year, while the automatic spending cuts are assumed to be replaced by other measures over the medium term.

Figure 4. Selected Euro Area Countries: Increase in Gross Debt through Exposure to Regional Firewalls
(Percent of GDP)



Sources: European Financial Stability Facility; and IMF staff estimates and projections.
Note: Data as of June 5, 2012. EA refers to the euro area average.
[1] Affects debt directly to the extent that loan disbursements were financed through sovereign bond issuances of individual countries.
[2] Affects debt directly once loan disbursements from this facility take place.

- In *Brazil*, the overall balance for 2012 is expected to be ½ percent of GDP stronger than envisaged earlier, mainly on account of lower interest payments. Despite recently announced measures to support selected industrial sectors and investment (estimated at about 0.4 percent of GDP), the authorities are still expected to achieve the 3.1 percent of GDP primary surplus target.

- Fiscal consolidation is projected to advance gradually in *Mexico* in 2012–13, in line with earlier projections. In 2013, the authorities are expected to return to their balanced budget target.

- In *China*, fiscal consolidation is expected to be put on hold this year—which is appropriate in light of slower growth and a strong fiscal position (headline deficit of around 1¼ percent of GDP)—before resuming slowly in 2013.

- In *South Africa*, improving revenue performance and a gradual withdrawal of fiscal stimulus should contribute to a decline in the cyclically adjusted fiscal deficit by 0.9 percent of GDP over the next two years, in line with earlier projections.

That said, some emerging economies should pursue more ambitious consolidation strategies, reflecting macroeconomic or fiscal considerations.

- In *Russia*, fiscal policy will continue to exhibit a strong procyclical bent. With oil revenue windfalls financing expenditure growth, this year's non-oil deficit is expected to increase by about 1 percentage point to 10½ percent of GDP, despite the closing of the output gap. Meanwhile, the 2012–14 medium-term budget does not provide for a meaningful improvement in the non-oil deficit, making public finances highly vulnerable to petroleum market developments.

- In *Turkey*, revenue shortfalls related to slowing activity are expected to increase the overall deficit by 1½ percent of GDP this year, leaving the structural primary deficit broadly unchanged. Looking forward to 2013 and beyond, a tighter fiscal stance seems appropriate to help reduce the large current account deficit.

- In *India*, overall deficits for 2012–13 were revised upward to almost 9 percent of GDP, more than ½ percentage point higher than in the April 2012 *Fiscal Monitor*, mainly due to higher fuel subsidies and revenue shortfalls. A determined reduction in costly subsidies would be a strong signal of a credible fiscal turnaround. It would also allow relaxation of financial restrictions, spurring private investment and growth.

Reconciling Credibility and Growth

Governments face the task of credibly dealing with large fiscal adjustment needs in a time of slow and uncertain growth. Reconciling these needs may be challenging, but following some

Effects of EU Firewalls on Gross Public Debt Ratios

Pooling of resources through the EFSF and contributions to the paid-in capital of the ESM largely explain upward revisions to projected gross debt levels for this year and next compared to the April 2012 *Fiscal Monitor* in several euro area countries, notably Germany (3 percentage points of GDP) and Italy (2½ percentage points).[1]

EFSF disbursements directly increase gross liabilities of the countries guaranteeing the EFSF's debt in proportion to these countries' capital shares in the European Central Bank (ECB) adjusted to exclude countries with EU/IMF supported programs. Existing loans represent slightly more than 1 percent of euro area GDP in mid-2012, with a corresponding increase in EFSF guarantors' debt. In the case of Italy and Spain, this represents 1.6 percent of GDP. The recently announced financing of the Spanish bank recapitalization will initially be channeled through an EFSF loan to the sovereign, increasing the euro area debt by an additional ¾ percent of GDP. Of course, these additions to public debts are by nature temporary and matched by an accumulation of assets.

Because it predates the EFSF, the first Greek program was largely financed by €80 billion in bilateral loans, pooled by the European Commission (EC) in proportion to countries' ECB capital shares. Disbursements to Greece amounted to ½ percent of euro area GDP, though loans provided by Italy, Portugal, and Spain were higher in proportion to their GDP.

[1] A second firewall, the European Financial Stabilization Mechanism (EFSM), allows the EC to borrow up to €60 billion on behalf of the European Union. The corresponding bond issuances do not affect national public debts. Euro area countries must also capitalize the ESM, slated to become operational in July 2012 once ratified by national parliaments. The ESM will have an initial lending capacity of €500 billion and a total subscribed capital of €700 billion, of which €80 billion will be in the form of paid-in capital to be phased in with a maximum of five installments. Part of these capital contributions has already been incorporated into debt projections, as mentioned earlier.

basic fiscal principles (to be adapted on a case-by-case basis) should help:[7]

- To anchor market expectations, country authorities need to specify adequately detailed medium-term plans aimed at lowering debt ratios and backed by binding legislation or fiscal frameworks. Among large advanced economies, both the United States and Japan still lack such plans.

- Within these plans, and to the extent that market financing remains at sustainable rates, adjustment should take place at a steady pace defined in cyclically adjusted terms. On average, an annual pace of adjustment of about 1 percentage point of GDP—as in advanced economies in 2011–13—seems to be broadly adequate in reconciling the need to address the challenge of fiscal consolidation while managing risks to growth, although the appropriate pace of adjustment for each country should reflect the size of the overall fiscal imbalance. Defining targets in cyclically adjusted terms allows automatic stabilizers to operate, thus mitigating possible shocks. In Europe, several countries have explicitly adopted structural balance targets, including Germany, Italy, and the United Kingdom, and the EC has increasingly used the flexibility embedded in the corrective arm of the Stability and Growth Pact to formulate recommendations in structural terms—except in the case of program countries, where limited financing makes headline targets necessarily more binding.

- The pace of underlying fiscal adjustment should not be changed in response to

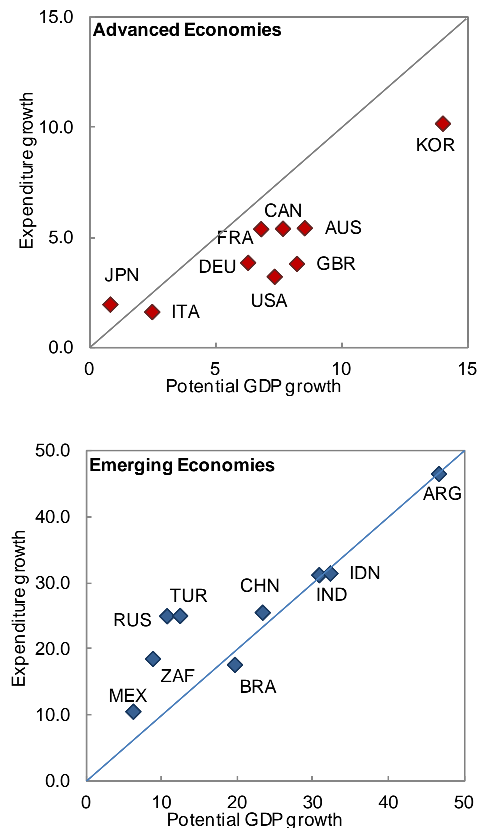
[7] Of course, other policies must work in tandem with fiscal policy to mitigate downside risks to growth and boost activity and employment in the longer term. These policies are discussed in more detail in the *WEO* and *GFSR Updates*.

relatively contained variations in the growth outlook. This position is consistent with the long-standing view that fiscal policy is not an effective instrument for fine tuning the cycle. However, in case of a major shock to the recovery, fiscal policies may need to be recalibrated in countries with fiscal space, in the context of a reassessment of the overall macroeconomic policy mix. To ensure a timely fiscal response, contingency plans should be ready, prioritizing temporary revenue and expenditure measures with the highest payoffs in terms of economic activity (see the April 2012 *Fiscal Monitor*).

- The composition of fiscal adjustment should be guided primarily by the need to foster the economy's growth potential over the longer term and by country-specific factors. Specifically, priority should be given to cutting spending in countries where expenditure is already high and correspondingly heavy tax burdens limit the scope for raising revenues without adversely affecting economic efficiency and growth. Ideally, cuts should target unproductive outlays identified through comprehensive expenditure reviews. Figure 5 illustrates that for most advanced economies, expenditure restraint is indeed part of their consolidation plans. Where there is room for revenue increases, as in the United States and Japan, opportunities should be exploited to widen bases by eliminating exemptions and unwarranted special treatment under the tax code rather than just raising rates. Fiscal policy in many countries can also be adjusted to better support employment—for instance, through revenue-neutral reductions in the labor tax wedge—which would also boost potential growth.[8] Some emerging economies (notably Egypt, India, Indonesia, and Saudi Arabia) could benefit from eliminating fuel and other subsidies,[9] while Turkey, Russia,

Figure 5. Potential GDP and Expenditure Growth, 2011–13

(Percent; cumulative change in current prices)



Sources: IMF staff estimates and projections.

and South Africa should take measures to prevent expenditure growth from outpacing the economy's medium-term income growth.

- Reforms affecting long-term spending trends remain important to help strengthen fiscal credibility.[10] For advanced Europe, the EC's recently issued *2012 Ageing Report* reiterates the risks to fiscal sustainability arising from demographic changes. The *Report* estimates that over 2010–30, pension costs would increase by 0.5 percent of GDP, and health care costs by 0.7 percent of GDP. While the pension projections are broadly consistent with those prepared by the IMF staff,[11] the

[8] See IMF, "Fiscal Policy and Employment in Advanced and Emerging Economies" (forthcoming).

[9] See IMF, "Recent Developments in Fuel Pricing and Fiscal Implications" (forthcoming).

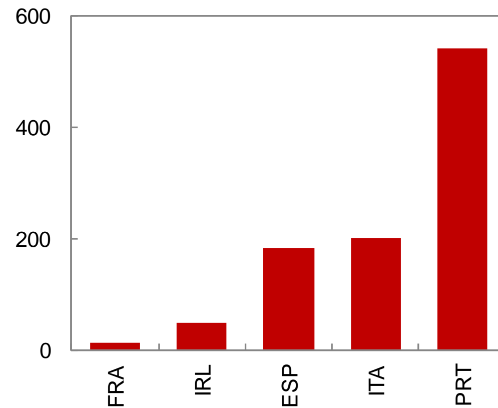
[10] It will be equally important not to reverse previously introduced reforms. For instance, France has recently cut back the pension age to 60 for some long-time workers, at an estimated cost of 0.1 percent of GDP by 2017, fully covered by higher labor taxes.

[11] See IMF, "The Challenge of Public Pension Reform in Advanced and Emerging Economies," IMF Policy Paper

increase in public expenditure on health care is likely underestimated by about 1 percent of GDP as the cost pressure arising from technological change is not fully taken into account.[12]

However, fiscal policy alone cannot stabilize market conditions in the euro area. Current sovereign spreads are well above what could be justified on the basis of fiscal and other long-term fundamentals (Figure 6), suggesting that wide-ranging reforms durably affecting expectations—discussed in more detail in the *WEO* and *GFSR Updates*—are needed. In particular, it will be critical to delink sovereigns' and banks' balance sheets. The European leaders agreed at their June summit upon significant steps to address the immediate crisis, which, if implemented in full, will help break these adverse links. In particular, once a single supervisory mechanism is established, the ESM would be able to recapitalize banks directly. These initiatives are steps in the right direction, but will need to be complemented by more progress toward deeper fiscal integration and a full-fledged banking union. In the meantime, there has been notable progress in ongoing initiatives to strengthen fiscal governance in the last few months. To date, 10 of the 25 EU member signatories have ratified the so-called Fiscal Compact treaty, which mandates the adoption by 2014 of rules-based national fiscal frameworks capping structural deficits. The recent adoption by the European Parliament of two draft regulations aimed at further enhancing fiscal policy coordination in the euro area (known as the "two-pack") is also welcome, and swift approval by the Council would be desirable. Among other proposals, the two-pack mandates harmonized national fiscal rules under nonpartisan oversight, establishes common budget timelines, and enhances surveillance by the Commission.

Figure 6. Selected Euro Area Economies: Sovereign Bond Spreads Not Explained by Long-Term Fundamentals *(Basis points)*



Sources: IMF staff estimates and projections.
Note: 10−year bond yield spreads with respect to Germany (average between January and June 2012) that cannot be explained by key fiscal and other fundamentals commonly used in the literature, as obtained from a panel error correction model explaining real long-term government bond yields in 21 advanced economies over the period 1980–2010.

Nevertheless, these steps would usefully be complemented by plans for fiscal integration, as anticipated in the report of the "Four Presidents" submitted to the summit. It is encouraging that the leaders have asked the Council President to develop proposals for a more complete union over the next three months. Ultimately, this could mean sufficiently large resources at the center matched by proper democratic controls and oversight. Introduction of a limited form of common debt, with appropriate governance safeguards, could provide an intermediate step towards greater fiscal integration. Issuance of such securities could, at first, be relatively small and restricted to shorter maturities, and could be conditional on more centralized control (e.g., limited to countries that deliver on policy commitments; veto powers over national deficits; pledging of national tax revenues). Common bonds/bills financing could, for example, be used to provide the backstops for the common frameworks within the proposed banking union (see the *GFSR Update*).

(Washington, 2011), available via the Internet: http://www.imf.org/external/pp/longres.aspx?id=4626

[12] This issue had already been raised with respect to the previous *Ageing Report*; see B. Clements, D. Coady, and S. Gupta, eds., *The Economics of Public Health Care Reform in Advanced and Emerging Economies* (Washington: IMF 2012), available via the Internet: http://www.imf.org/external/pubs/ft/books/2012/health/healthcare.pdf