INTERNATIONAL MONETARY FUND
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Public Information Notice (PIN) No. 09/31
FOR IMMEDIATE RELEASE
March 6, 2009

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Holds Board Seminar on The State of Public Finances: Outlook and Medium-Term Policies After the 2008 Crisis

On February 20, 2009, the Executive Board of the International Monetary Fund (IMF) held a seminar on The State of Public Finances: Outlook and Medium-Term Policies After the 2008 Crisis. The staff papers, including a companion paper, on which the discussions were based are posted on the IMF's website at www.imf.org.

Background

The financial and economic crisis has affected the fiscal accounts of most Fund member countries. The main channels have been through direct support for the financial sector; a decline in revenue from the growth slowdown and collapsing asset prices; and discretionary fiscal stimulus. In many countries, funded pensions schemes have also been affected. Many countries hit by the crisis were already facing significant long-run fiscal pressures arising from demographic changes. The staff paper discussed by the Executive Board quantifies these effects, focusing on advanced and emerging market economies, and updates the fiscal outlook in the context of the crisis. It also proposes a four pillar strategy to ensure fiscal solvency: fiscal stimulus packages should not involve permanent fiscal costs; policies should be cast within medium-term fiscal frameworks; governments should pursue growth enhancing structural reforms; and in countries facing demographic pressures, there should be a firm commitment to reform entitlement programs for health and pensions. Some of these measures are part of long-standing advice from the IMF, but the weakened public finance outlook has raised the cost of inaction.

Executive Board Assessment

The ongoing financial crisis has had a major impact on the fiscal balances and debts of most member countries—in particular, the advanced economies—as a result of direct government support to the financial system, sizable fiscal stimulus packages, and lower revenues due to the economic slowdown and the fall in asset and commodity prices. Directors welcomed the timely assessment of the state of public finances, and the opportunity to discuss the broad principles guiding fiscal policy in the medium term. At the same time, they recognized that the valuable material prepared for today's seminar is still work in progress, and that estimates of the fiscal implications of the crisis are still tentative and should be regularly updated. They also looked forward to broadening the analysis, including on the effects of the crisis on non-G-20 members and low-income countries.

Directors noted that the fiscal outlook for most countries is challenging and subject to considerable downside risks. In advanced countries, the recent increase in government debt and contingent liabilities is unprecedented in scale since the end of the Second World War, and the fiscal outlook is projected to remain weak over the medium term. For countries facing rapid population aging, this deterioration takes place against the backdrop of long-run fiscal pressures in the areas of pensions and health care. In emerging economies, the fiscal balances are also projected to weaken in 2009. Although their medium-term outlook is more favorable, the cost of external borrowing has increased sharply. Directors noted that, although the debt positions of many emerging economies are currently projected to remain stable or even decline over the next few years, the adverse impact of the crisis through trade and financial flows is being felt throughout the Fund's membership.

Directors acknowledged that, going forward, fiscal policy would have to balance two opposing risks: on the one hand, the possibility of a deep and prolonged recession, which might require further government support to the financial sector, as a key priority, and further stimulus to support aggregate demand; on the other hand, the possibility of a loss of confidence in fiscal solvency. Individual country circumstances would play a key role in determining policy choices with respect to this tradeoff. It was pointed out, in this context, that the immediate priority for many countries at this juncture is to use all the tools available to boost growth and employment, and restore financial stability. Recognizing the important role to be played by fiscal policy in the current environment, Directors underscored the merits of coordinating fiscal stimulus efforts, particularly among advanced countries.

Directors highlighted the benefits of the identification and communication of a clear and credible strategy to ensure fiscal solvency over the medium term, while recognizing the need for sufficient flexibility and careful timing. Such a fiscal strategy should be based on four pillars: (i) reliance on temporary or self-reversing measures in fiscal stimulus packages; (ii) medium-term fiscal frameworks envisaging a fiscal correction, once economic conditions improve; (iii) growth-enhancing structural reforms; and (iv) firm commitment to contain the fiscal costs stemming from population aging. While these principles are not new, the weaker state of the public finances has underscored their relevance in helping to maintain confidence in fiscal solvency and underpin the restoration of sustainable growth.

Directors noted the general recognition that fiscal stimulus should be temporary and, to the extent possible, self-reversing. In any event, it would be important for governments to indicate at an early stage how stimulus measures will be offset in the coming years.

Directors highlighted the potentially useful role of medium-term fiscal frameworks, accompanied by clear policy actions to bring public finances back to a more sustainable level over time.

Where appropriate, such frameworks could be usefully supported by fiscal responsibility laws, fiscal rules, and/or independent agencies tasked with monitoring fiscal developments. Transparent treatment of the fiscal accounts, including of government intervention operations in support of the financial system, would be critical to assessing properly the state of the public finances and associated fiscal risks. Appropriate processes will have to be set in place to manage, and eventually dispose of, the assets acquired through the financial support operations, so as to ensure a high recovery rate on troubled assets.

Directors observed that, in addition to fiscal consolidation, rapid economic growth was a key factor underlying many past debt reduction episodes. Accordingly, it is advisable to focus expenditure policies, tax reforms, and other structural reforms on those that foster economic growth.

Directors noted that a major risk to long-term fiscal solvency in countries facing unfavorable demographic trends stems from pre-existing challenges related to pensions and health care. The fiscal impact of the crisis highlights the need for entitlement reforms. These may be challenging to pursue at the current juncture, and should focus on measures that are less likely to undermine efforts to bolster aggregate demand in the near term. Any government assistance to pension plans, where needed, should be exceptional and targeted at low-income households while preserving inter-generational equity.

Directors considered that the Fund has an important role to play in monitoring fiscal developments across countries, and in examining stimulus measures taken by major advanced countries and their potential spillover effects on emerging market countries, including the impacts on financing conditions and trade flows. They encouraged staff to strengthen the use of consistent methodologies and indicators of emerging fiscal risks; advise member countries on the appropriate fiscal response to the crisis and solvency issues; and promote reform as needed—including through cross-country work and well-targeted technical assistance. Directors also pointed to the need for the Fund to communicate clearly to the public its views on, and assessments of, the financial sector measures announced and implemented by its member countries.