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POLICY BRIEF

ON THE BRINK: FISCAL AUSTERITY THREATENS A GLOBAL RECESSION

Due to sluggish private demand, several advanced economies are hovering on the brink of a second bout of recession. Yet, in many of these countries political attention has turned to ways to cut fiscal deficits and reduce the domestic public debt. This has created a dangerous accumulation of risks for the world economy. The private sector can only successfully deleverage (i.e., reduce its debt) if someone else is willing to take on higher debt and support demand. If the private and the public sectors try to deleverage simultaneously, they must either find debtors elsewhere, or the economy will tailspin into a depression. As the developing world is both unable and unwilling to accept the role of debtor of last resort, dangerous pressures are building up. Unless there is a rapid policy turnaround, the world is in danger of repeating the mistakes of the 1930s. In today's highly integrated global economy, the contractionary contagion will affect all countries. Emerging and developing economies need to prepare contingency plans.

Another fine mess

During 2011, most advanced economies either suspended or reversed the expansionary policies that had helped to avert the worst symptoms of the global economic crisis. Several governments hoped to bring about an "expansionary contraction" where fiscal restraint would improve private sector confidence and foster a wave of private investment and consumption demand. These hopes are rapidly waning as new data points unambiguously to a fully-fledged recession in key advanced economies in 2012. The pain has brought no gain. UNCTAD and others had warned early on that "expansionary fiscal contraction" was wishful thinking at best. Following in the footsteps of many developing countries since the early 1980s, most advanced countries implementing austerity policies have experienced, instead, a "contractionary contraction". Private sector confidence is reaching new lows, as demand from governments and from public sector employees falls relentlessly. The new head of the IMF, Christine Lagarde, echoed UNCTAD when she warned the world economy has entered "a dangerous new phase". The vicious circle induced by fiscal contraction, weak financial institutions and financially fragile households is fuelling a crisis of confidence and holding back investment and job creation in the private and public sectors simultaneously.

The disappointing results of "expansionary contraction" illustrate persistent and fundamental misconceptions about the functioning of the

macroeconomy. The *Trade and Development Report (2011)* reviews scores of cases where fiscal tightening did not trigger the sought-after macroeconomic expansion but, rather, had the opposite effect. These include a long list of developing countries, whose damaging experiences in the last three decades ought to encourage current policymakers to do better. Chart 1 (A and B), below, summarises the experiences of countries receiving emergency IMF support during the financial crises of the late 1990s and early 2000s and also during the present crisis. Chart 1.A contrasts the forecasted impact on GDP growth of contractionary policies in these economies (in the horizontal axis), as expected in the Letters of Intent signed between the IMF and national governments, with their outcomes (in the vertical axis). Scatterpoints along the 45 degree line indicate cases where the expectations had proven to be correct. Points above that line indicate countries where the outcomes

Key points

- High unemployment is a more pressing problem now than fiscal imbalances.
- Fiscal austerity in the current environment will make matters worse, not better.
- Contractionary contagion will effect all countries -- emerging and developing economies need to prepare contingency plans.

exceeded expectations, and points below the 45 degree line are countries where expectations were not achieved. It is evident on inspection that in virtually all countries the policy outcomes have systematically and unambiguously not met expectations. In some cases the gaps are substantial: in 1998, a GDP growth forecast of 5 per cent for Indonesia actually came in at minus 13 per cent, while Thailand was expected to achieve 3.5 per cent growth but actually contracted by 10.5 per cent. Similarly, in 2009, Latvia and Ukraine experienced a staggering fall in GDP that was three times as large as that anticipated.

Given that GDP growth was normally much lower than had been anticipated, it is not surprising that fiscal balances were also worse than expected (chart 1.B). When GDP growth falters, tax revenues are also likely to fall below expectations. At the same time, public expenditures are bound to overshoot because of the higher than expected benefits and social security payments and other transfers which must be made when the economy slows down. The passive but strongly positive role of these automatic stabilisers has been widely understood since the 1930s. It was also widely known that it is counterproductive to raise taxes or cut public spending during a recession because a fiscal contraction can unleash a vicious circle of economic decline. The adverse impact of many recent policy experiences could have been anticipated, in the light of economic theory and the experiences of dozens of developing countries since the early 1980s. Most tellingly, a detailed examination of the impact of fiscal adjustment in 133 IMF-supported programmes in 70 countries, carried out by the IMF's own Independent Evaluation Office (IEO) noted "*a tendency to adopt fiscal targets based on overoptimistic assumptions about the pace of economic recovery leading inevitably to fiscal underperformance*" and "*overoptimistic assumptions about the pace of revival of private investment.*" (IMF, 2003: vii). The lesson that fiscal tightening systematically fails to deliver fiscal consolidation is important for countries in the current crisis, and for those that are reeling under the pressure of declining growth forecasts.

Further historical insights that resonate today can be gleaned from the Great Depression in the US, which actually included two sharp downturns in succession. During the first wave (August 1929 to March 1933), GDP fell sharply each year until 1932, and declined modestly in 1933. Unemployment rose to unprecedented levels. The recovery started after President F.D. Roosevelt took office, in 1933, with annual real GDP growth exceeding 9 per cent and unemployment falling sharply. However, growth was halted by another severe downturn in 1937-38, when real GDP fell by 3.4 per cent and unemployment surged to 19 per cent. It is now generally accepted that the second downturn was induced by poor government policy, especially the decision to tighten up fiscal policy too early in the recovery.

Chart 1: Comparisons between forecasts of gdp growth and fiscal balances in imf-sponsored programmes and actual values (selected country/year)

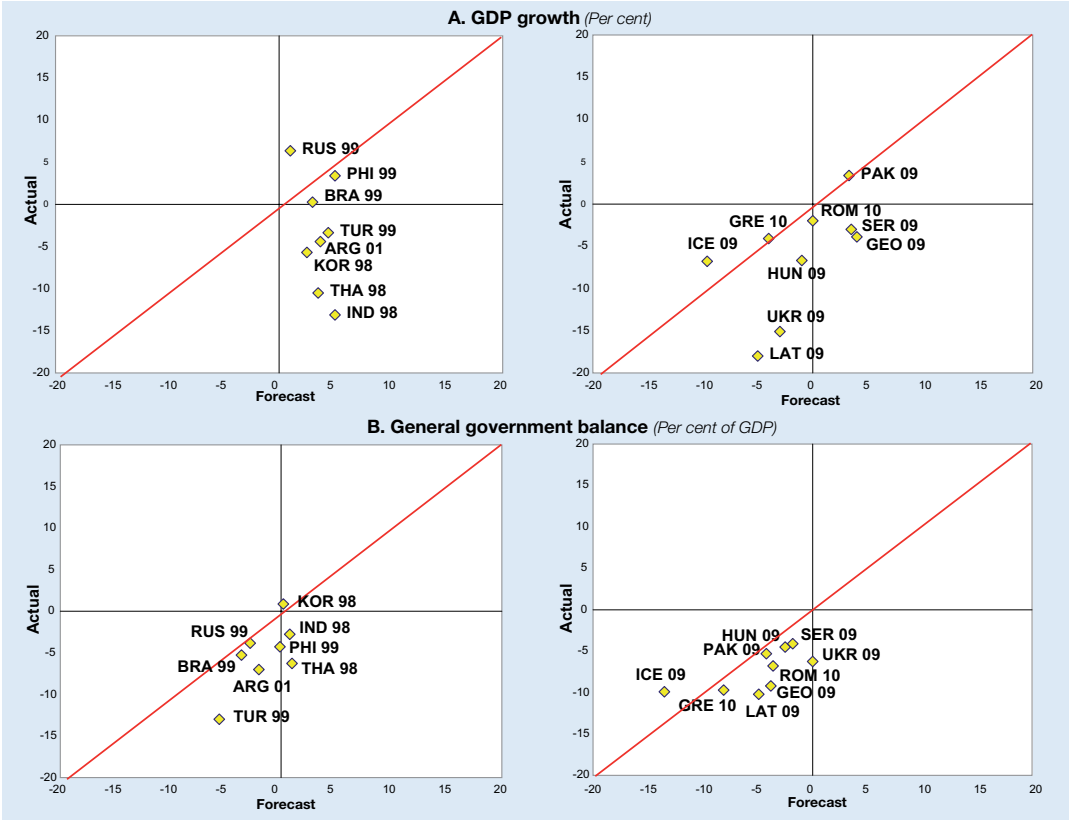
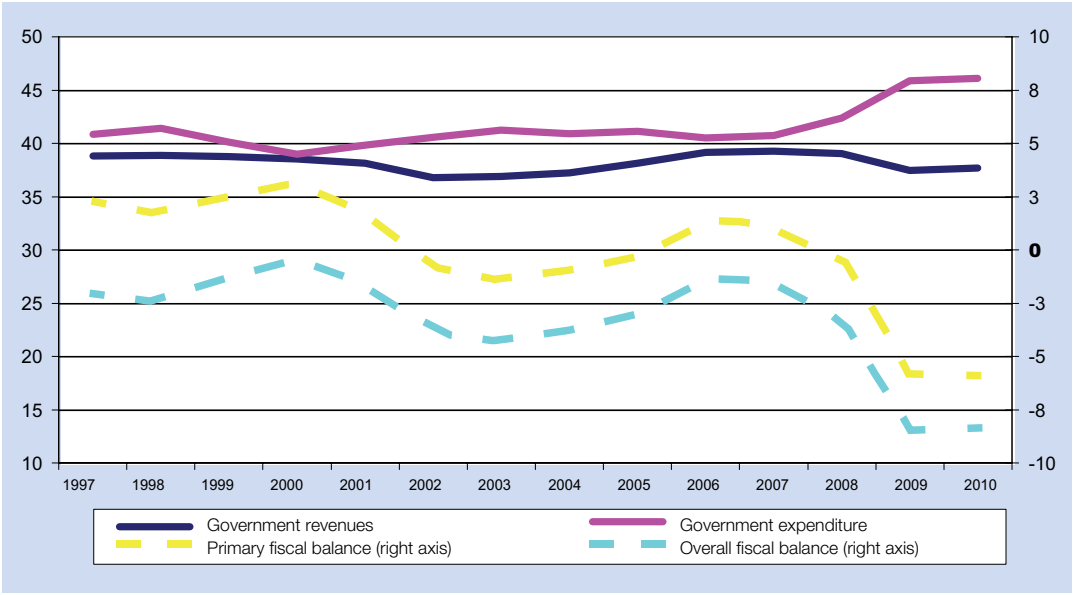


Chart sources: UNCTAD (TDR 2011); IMF, Letters of Intent, accessible at http://www.imf.org/external/np/cpid/default.aspx and UNCTAD Globstat

Chart 2: Government revenues and expenditure and fiscal balance, Developed economies, 1997-2010 (% of current GDP, weighted average)



Misconceptions about debt and interest rates

It is often claimed – and repeating the conventional economic wisdom of the 1920s -- that fiscal austerity is necessary in order to maintain the confidence of the financial markets in the sustainability of government budgets, and to avoid inflation and damaging interest rate hikes which would compromise the economic recovery. However, the European example does not support the case for austerity. Despite the panic in some markets, and a temporary increase of the ECB short-term policy rate by around 0.5 per cent in the Spring of 2011, average bond yields in the Eurozone rose only from 3.3 per cent in October 2010 to 4.1 per cent in October 2011. In the same vein, Japan, the most heavily indebted advanced country government, also enjoys the world's lowest long-term interest rate, and the United States, with a government debt close to 100 per cent of GDP, also enjoys historically low interest rates.

The large dispersion in interest rates between members of the Eurozone which emerged in the aftermath of the 2008 financial crisis has other sources than government debt. For example, although as a percentage of GDP Spain's government debt is smaller than Germany's, the country pays a much higher risk premium. The Eurozone countries penalised with high spreads vis-à-vis Germany are not those with high fiscal deficits or government debt but, instead, those running significant current account deficits. The financial crises in several developing countries also reinforce the argument that the spread over hard currency interest rates reflect mainly a *currency risk*, rather than a genuine risk of government default. The vulnerable countries in the Eurozone do not issue the currency in which they are indebted, and they do not have a reliable lender of last resort. Moreover, there is added currency risk from the (unstated) option to leave the Monetary Union. Experiences in East Asia, Latin America, sub-Saharan Africa and other developing areas affected by systemic crises suggest that interest rates and spreads within the Eurozone can decline only if the competitiveness gap in its peripheral countries is addressed effectively, while Germany stimulates its domestic demand. In the meantime, the financing needs of the peripheral countries could be bridged by eurobonds and/or by unlimited interventions of the ECB on the bond markets, which could bring interest rates down to bearable levels for the affected countries.

A new policy approach is needed

The world stands on the brink of a double-dip recession and a "lost decade" for many countries. UNCTAD calls for a concerted and co-ordinated expansionary policy alternative including the following key elements:

* *The countries threatened by recession and deflation should avoid intensified austerity measures because these are unlikely to produce the intended outcomes and could propel the world into a renewed bout of recession, or even into an outright depression.* Without an increase in domestic demand, employment and wages in the surplus countries, the most likely outcome would be a new round of global economic contraction. This is likely to trigger a ripple of adverse effects at the international level, including a collapse in trade and investment and growing pressures for protectionism.

- **Today's fiscal deficits are the consequence of the crisis, not its cause (chart 2).**
- **In developed countries from 1997-2008, the primary fiscal balance ranged from -1.5% to +3.2% of GDP, while the overall balance ranged from -4.3 to -0.4%.**
- **On average, the primary balance during this period was 0.8% and the overall balance -2.4% of GDP. (Even when factoring in the crisis years, the primary balance during 1997-2010 was on average only -0.1% and the overall balance -3.3%.) It was only AFTER the crisis that deficits slid to today's levels.**
- **Growth, and not the deficit, is the appropriate target for the moment.**

* *Countries should see fiscal policies as tools for growth and development, instead of automatically adopting a fiscal-phobic approach. Instead of asking whether their fiscal deficit is "too big", they sould consider whether it is being used in the best way to stimulate the economy.* In the corporate sector, high levels of debt are typically justifiable if the borrowing costs are tolerable and the debt is financing sustainable profit streams and long-term firm growth. This approach is even more appropriate in the case of government debt because the current fiscal deficits are the *consequence* rather than the cause of the ongoing crisis (chart 2): in many cases, these deficits are due to the transfer of private sector debts to the public sector, making them the wrong target for fiscal policy. Most importantly, however, in terms of global economic revival is the fact that, given the current lack of investor and household confidence, governments must play the role of "growth engine of last resort". Income can be generated only if somebody spends, and experience suggests that, in a recession, the only "someone" available is often the government.

* *Fiscal space can be shrunk or expanded according to the mix of policies that governments choose to implement, with a variable impact on employment, tax revenues and economic growth.* In the countries depicted in charts 1.A and 1.B, tighter fiscal policies often led to reduced investment, job losses, reduced fiscal revenues, and stagnant or falling GDP growth. In contrast, expansionary fiscal policy can boost consumer demand and employment; it can also increase public investment directly, and it can indirectly stimulate private-sector investment and incomes. These can lead to higher tax revenues and a *lower* fiscal deficit, even if tax rates remain unchanged. Social spending in such areas as unemployment benefits, health and housing can also be seen as promoting recovery as they sustain consumption during the crisis, in addition to their direct impact upon poverty. Similarly, distinct tax policies can have very different effects on the fiscal balance: tax cuts that benefit lower income households can have a stronger impact on aggregate demand than cuts aimed at high-income households, because poorer households are likely to spend a larger share of their revenues.

* *Fiscal space can protect vulnerable economies against external shocks*. Countries should seek to enlarge their fiscal space through the use of appropriate tax policies, and by building up a strong fiscal position in times of economic prosperity. Some of the transition economies depicted in the charts above experienced a particularly hard landing during the recent crisis, because their fiscal space had been severely reduced by imposing very low tax rates over several years. This gave them little room to manoeuvre when crisis struck, as they found themselves unable to put into place the stimulus measures used in other countries.

Conclusion

There is a very real risk of new economic crises erupting and, in today's highly integrated world economy; their impact will not be limited to specific sectors or to well-defined regions. The G-20 initially recognised this fact, but recent actions have not been consistent. In particular, the fiscal restraint in the countries with current account surpluses and very low long-run interest rates in Europe, point precisely in the wrong direction. A fragile global economy has a significant interest in the implementation of expansionary, rather than contractionary fiscal policies in key economies. Only the former can open a path towards lower fiscal deficits and falling public debt ratios. A "lost decade" for the world economy would risk the development gains achieved during the recent years, and throw into question the ability of democratic governments to tackle the most urgent challenges of our age.

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UNCTAD (TDR 2011), Trade and Development Report, 2011, Post-crisis policy challenges in the world economy, United Nations publications, Sales No. E11.II.D.3, New York and Geneva.

Electronic versions of this report and related material can be found on http://www.unctad.org/Templates/WebFlyer.asp?intItemID=6060&lang=1

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