



## Massive, globally coordinated fiscal stimulus is needed: going from the drawing board to swift action

In just over a year, the mid-2007 sub-prime housing debacle in the United States has escalated into a global financial crisis and pushed the world economy into recession—arguably the deepest since World War II. Bold monetary policy action and massive bailout packages in the United States and other major developed countries may have stemmed the financial blood-letting, but have not worked to avoid the current economic downturn. At the start of 2009, credit markets remain constrained, asset and commodity prices have deflated, and global trade is seriously depressed as industrial production has moved sharply into negative territory. Unemployment rates are up throughout the developed world and prospects in developing countries are getting dimmer by the day. The threat of a prolonged depression remains very real.

In the face of ongoing financial turmoil and absent coordinated and strong fiscal stimulus, what was the *pessimistic* scenario of the *World Economic Situation and Prospects 2009*, with global output falling by 0.4 per cent in 2009 and economic recovery postponed well into 2010 or later (figure 1), now seems very likely and things may still turn out a good deal worse. Although the slowdown is being led by developed economies, the downturn has now spread to developing economies, as manifested in high exchange-rate volatility, plunging export demand and commodity prices, and precipitous drops in private capital inflows since the third quarter of 2008. Recent news that China's economic growth dropped below 7 per cent in the final quarter of 2008 seems likely to be a harbinger of worse to come.

### Pushing on a string?

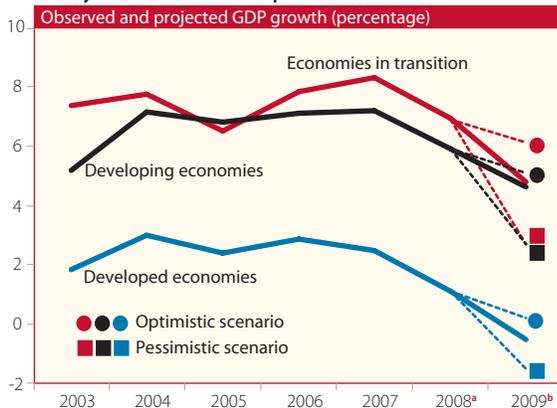
At the onset of the crisis in 2007, the initial policy response was limited in scope and scale, with only a handful of major developed

economies taking action. In Europe and the United States, the responses initially focused on providing additional liquidity to financial markets and were oblivious to the greater underlying risk of insolvency of large financial institutions. In emerging economies, policymakers were under the mistaken impression that they would be immune from the crisis (the so-called decoupling thesis) and were more concerned with inflationary pressures until the fourth quarter of 2008.

As the crisis deepened, the United States switched to more aggressive monetary policy in the first half of 2008 to stave off a recession, while central banks in Europe maintained a tight stance over inflationary concerns. This ad-hoc approach was subsequently abandoned for a more comprehensive and coordinated approach as six major central banks decided to cut their respective official target rates simultaneously by 50 basis points (bps). The United States Federal Reserve Bank and other central banks also scaled up measures totalling about \$4 trillion in direct financial support and guarantees aimed at unfreezing credit and money markets and recapitalizing ailing financial institutions. Since then, more central banks have followed suit by reducing interest rates drastically (figure 2).

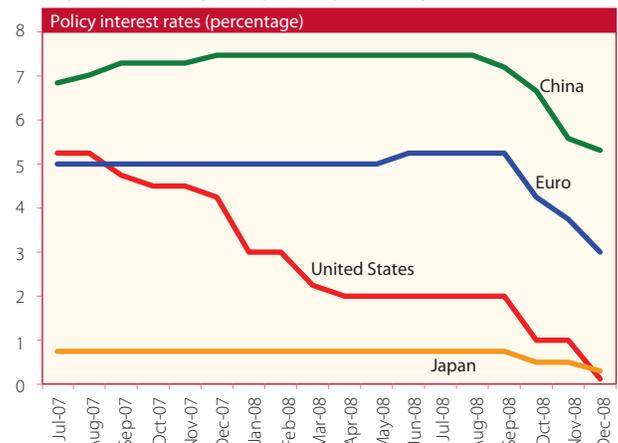
Has this worked? Since November 2008, the spread between the interbank lending rate and the return on treasury bills in the United States, which surged in the preceding month, has narrowed. Yet, the sharp contraction in real output suggests policymakers are pushing on a string, with monetary policy being increasingly ineffective as interest rates approach zero. This is where Japan found itself for most of the 1990s following the bursting of its own financial bubble. If this experience is any

**Figure 1: Synchronized global slowdown, led by a recession in developed countries**



Source: World Economic Situation and Prospects 2009 (<http://www.un.org/esa/policy/wess/wesp.html>).

**Figure 2: Monetary easing nearing a liquidity trap**



Source: National central bank websites.

guide, consumer and business confidence can remain seriously depressed for years, with banks reluctant to lend; further lowering of interest rates by central banks would do little to encourage private spending. With limited space for monetary stimulus, the fiscal response needed to revive the global economy will have to be sizeable, strategic and sustained. It will also have to be well coordinated internationally.

## Pulling the strings globally: A new 'New Deal' for the world economy

According to conservative assessments, the size of the fiscal stimulus should be in the order of between 1 and 3 per cent of world output, with a growing consensus in favour of the higher estimate. In a seriously depressed economy with extreme low levels of consumer and business confidence, stimulus effects are greatest in the form of direct government expenditures. By acting in a coordinated fashion, policy makers around the world can amplify the positive multiplier effects of increased fiscal spending by as much as 30 per cent or more.

Governments have been hesitant to move quickly on such packages, fearing negative medium-run implications of running large fiscal deficits. Yet, the absence of strong fiscal policy will almost certainly prolong the recession and raise its economic and social cost. The stimulus could gain economic traction and political support if the additional resources are aligned with long-term sustainable development goals. This applies to developed countries where much of the stimulus could take the form of investments in infrastructure, renewable energy and energy efficiency in the fight against climate change. Similarly, developing countries should try to align the new fiscal stimulus with their long-term development goals. Increased public spending on infrastructure, clean technologies, agricultural development, education and health would help diversify their economic structures and reduce their dependence on a few commodity exports, thereby helping them meet key development goals. This includes achieving greater food security, addressing climate change and meeting the Millennium Development Goals.

The scope for countercyclical fiscal stimuli varies greatly across developing countries, however. Some countries with sufficient policy space have already proposed large-scale plans that could contribute to reinvigorating global demand. China's fiscal stimulus package of \$586 billion (or 15 per cent of China's GDP), aimed at strengthening domestic demand through investment in public infrastructure and social transfers, is one such example. Both surplus and deficit countries should follow suit.

This should also apply for countries with limited fiscal space, including those with little foreign-exchange reserves and those which have already seen a sharp deterioration in their terms of trade, steep declines in export earnings and remittances, and reversals of private capital inflows. In order to enhance the scope for countercyclical responses in the short run, these countries will need to be able to rely on improved access to compensatory financing, while additional reliable foreign aid flows will be

needed to cope with drops in export earnings and reduced access to private capital flows because of the global financial crisis. This could be achieved by eliminating onerous policy conditionalities attached to most existing sources of compensatory financing and by greater pooling of international reserves to expand available international liquidity. More stable aid flows should be achieved through enhanced donor coordination and multi-annual agreements on levels of support to low-income countries.

The strategy of global fiscal stimulus is not without risks. First, the positive effects may not be felt overnight, especially if the focus correctly is on serving long-term development needs, and consequently the prospects of high fiscal deficits could further depress consumer and business confidence. Governments therefore need to define the stimulus as part of a global package to ensure sufficient stimulus as much as through medium-term fiscal frameworks, which lay out anticipated spending increases along with future tax increases and other financing sources perceived as viable. Second, there is the risk of a disruptive dollar collapse. A key impulse will need to come from the United States and, in doing so, the country would have to run an even larger fiscal deficit in the short run, to be financed by more issuance of treasury bills. Until recently, this would seem feasible as investors considered dollar assets 'safe', but this confidence in the greenback could fade if the stimulus does not take effect soon enough and the United States fiscal and trade deficits continue to widen in an ever more depressed economy. Under such a scenario, there would be a clear and present danger of a hard landing of the dollar, which would send new shock waves through the financial system and depress the global economy even further. This underscores the need for globally concerted efforts through which countries should seek sound forms to finance massive fiscal stimuli and avoid disruptive realignment of exchange rates. Concerted stances by the central banks of the major economies and the pooling of international reserves could underpin such efforts.

Such obstacles to a benign solution stress the need for more fundamental reforms of the international financial architecture. The broader agenda has also been laid out in the *World Economic Situation and Prospects 2009* and would include, among other issues, reform of the international reserve system away from reliance on the US dollar as the major reserve currency, besides the establishment of a credible and inclusive mechanism for international policy coordination and an overhaul of existing mechanisms for international financial regulation and supervision. ■

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