

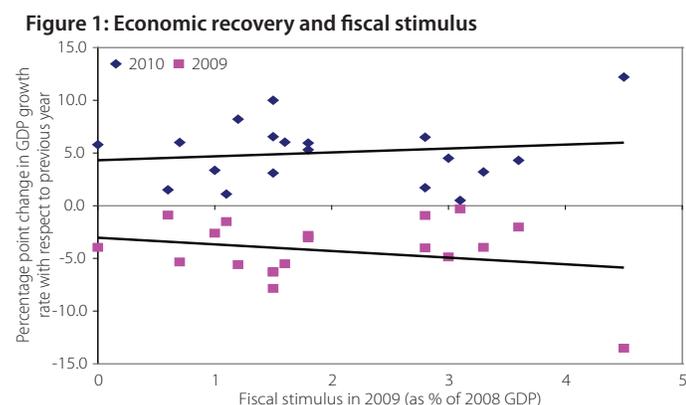


Fiscal stimulus is still needed for global recovery

Responding to the economic and financial crisis, a large number of countries introduced fiscal stimulus packages to support aggregate demand. These have been critical in avoiding the recession becoming a depression. The fiscal stimulus is also upholding the recovery in most economies. Now, many Governments find time has come to withdraw from the stimulus. At the recent G20 gatherings in Busan and Toronto, most Governments indicated fiscal consolidation should be the priority now. Fears for financial market nervousness over rising public debts had overtaken concerns for persistent high unemployment and weak private sector demand. However, cutting fiscal spending at this stage risks pulling the plug out of the recovery and pushing the global economy in a double-dip recession. The first priority, as the Secretary-General stressed at the Toronto G20 summit of June 2010, should therefore be to overcome the global jobs crisis through refocused stimulus measures. Doing so will strengthen the recovery and with it the need for fiscal stimulus will dissipate as tax revenues rise and private demand picks up.

Unbalanced stimulus, uneven recovery

The economic recovery has been rather unbalanced so far. To an important degree, this can be attributed to the difference in size of the stimulus packages. Worldwide, fiscal stimulus measures exceeded \$2.6 trillion during 2009 and 2010, equivalent to 4.3 per cent of the size of the global economy; these stimulus packages ranged from less than 1 per cent to more than 10 per cent relative to the size of the individual economies where these measures were taken. Among G20 members, those countries that experienced larger downturns in 2009 responded, broadly speaking, with larger packages. In turn, larger packages generally contributed to a stronger recovery in 2010 (see figure 1).



Source: UN/DESA calculations based upon various sources.
 Note: Fiscal stimulus in 2009 refers to the fiscal stimulus that was actually spent in 2009. The change in growth for 2010-2009 is based upon estimates and projections of the *World Economic Situation and Prospects Update per Mid-2010*.

The impact of fiscal stimulus seems to vary greatly though, as figure 1 indicates, which suggests that not only size matters. The uneven recovery also appears to be associated with differences in the composition of stimulus packages. Stimulus packages have consisted of varieties of measures, including off-budget loans and guarantees and on-budget items such as increases in public consumption and public infrastructure investment and measures to boost household disposable income through cutting taxes and increasing benefits and subsidies, as well as tax cuts for businesses. In many developed countries tax-related measures accounted for more than half of the size of the stimulus. In developing countries, in contrast, much greater emphasis was put on increased fiscal expenditures. This emphasis was born in part out of necessity given limited scope for tax breaks in countries with weak revenue-collection capacity. The focus on expanding government spending was also justified by the generally stronger multiplier effects on the rest of the economy from the expenditure side, be it by raising social transfer payments to the poor and unemployed (as in the case of Brazil) or putting strong emphasis on infrastructure investment (as in Argentina, the Republic of Korea and China, for instance).

In times of great uncertainty and in a context of market rigidities, tight credit conditions, low interest rates, and high unemployment, putting more income in the hands of the people through tax breaks will be less effective as households will be most worried about uncertain employment prospects and reluctant to increase consumption spending. Equally, tax breaks to firms will not provide much of an incentive to increase business investment.

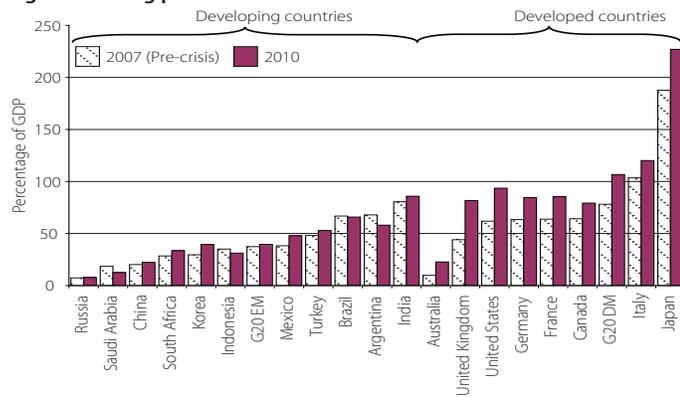
Under such circumstances, direct stimulus through public spending tends to be more effective to reactivate the economy.

Should we worry about debts and deficits?

The crisis and the subsequent policy responses have led to a substantial widening of fiscal deficits in most countries due to a combination of declining tax revenue and rising expenditure. Budget deficits of the countries of the Euro area are projected to average 7.5 per cent of GDP in 2010, up from 0.6 per cent in 2007. In the United States, the fiscal deficit will border 10 per cent of GDP in 2010, compared with 3.2 per cent in 2008. Fiscal balances in many developing countries have also deteriorated; typically by between 3 and 5 per cent of GDP, but in some cases by much more. For example, the budget balances of the Russian Federation, Chile, Hong Kong SAR and Jamaica are forecast to have deteriorated by more than 10 percentage points of GDP between 2007 and 2010.

Levels of public indebtedness are increasing commensurately. Debt ratios for the advanced-economy members of the G20 economies have already increased significantly (see figure 2). They are projected to increase by 37 percentage points of GDP by 2015 relative to pre-crisis levels.

Figure 2: Rising public debt of G20 countries



Source: IMF (2009), The State of Public Finances Cross-Country Fiscal Monitor: November 2009, IMF Staff position note SPN/09/25. November 3, 2009.
Note: G20 EM refers to emerging market economies in the G20 group. G20 DM refers to developed market economies in the G20 group.

Rising debts and deficits have now become a major reason for concern, especially among Governments in Europe and other parts of the developed world. The debt crisis in Greece further increased the sense of urgency among Government leaders to start redressing the fiscal situation even before the recovery has solidified. Several developed economies with high public debts, such as Iceland, Ireland, Greece, Spain and the United Kingdom, have already embarked on programmes of stringent fiscal austerity.

Yes, but premature withdrawal would be self defeating

Withdrawing the fiscal stimulus while consumer and business confidence are weak and levels of unemployment are high risks pulling the plug from the nascent global recovery. It could trigger a double-dip recession and would enhance fiscal problems as tax revenue will lag further. This would not only be devastating for workers in countries where too much austerity further delays the recovery; it may also give rise to renewed problems in developing countries. As simulations with the United Nations' *Global Policy Model* point out, developing countries would be equally hit by a double-dip recession in the developed world, especially where the space for additional fiscal stimulus is absent, as is the case especially among many low-income countries (see *World Economic Situation and Prospects Update per Mid-2010*). In such a scenario debt-to-GDP ratios would continue to increase despite the austerity measures, which may well trigger a downward spiral of pro-cyclical fiscal adjustment.

What is to be done?

In developed countries the principal challenge is to balance the short-term need for continued policy support to strengthen

the recovery with the longer-term need for consolidating public debt to maintain fiscal sustainability. This dilemma can be overcome by making measures more labour and investment intensive in order to create more jobs and to have a more sustainable impact on the recovery. One priority area for most economies would be to expand public investment in renewable clean energy as part of commitments to reduce greenhouse gas (GHG) emissions. Doing so has the potential to provide significant employment as the renewable energy sector tends to be more labour intensive than existing, non-renewable energy generation. Another area could be to expand and improve public transportation networks, which would create potentially significant amounts of new jobs while equally helping reduce GHG emissions, particularly in rapidly urbanizing environments. Thus, these strategies would represent win-win scenarios by orienting the recovery towards job creation and combating climate change.

Countries pressed by debt problems to reduce fiscal deficits should also consider reprioritizing spending in similar directions. International coordination of fiscal policies will be critical to ensuring measures have maximum results. While countries have different priorities given differences in the pace of the recovery and different outlooks for their debt situation, coordination of fiscal stimulus and consolidation measures will be needed to ensure global demand remains strong enough to sustain the momentum of the recovery and to enhance the multiplier effects of fiscal spending. Absent such coordination, an early move to strong fiscal consolidation by a majority of the G20 members could risk a renewed economic slowdown, which itself would make the fiscal adjustment more costly or even self-defeating, as mentioned.

Coordination should also aim at making the global recovery more balanced. This will require ensuring sufficient fiscal space for developing countries to engage in the necessary counter-cyclical responses. Although nine of the ten largest stimulus packages (relative to GDP) were in fact implemented in developing countries, only those economies were able to do so on the back of the vast foreign reserves they had accumulated prior to the crisis. The glaring absence of significant fiscal stimulus measures in low-income countries highlights their constrained fiscal space which was exacerbated by the crisis. Hence, in order to make the global recovery more balanced and sustainable, as the G20 have promised to do, low-income countries need to be urgently provided with adequate resources to ensure that they are not, once again, left behind. ■

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