The world economy is teetering on the brink of another major downturn. As in 2008, economic woes in the major developed economies are weakening economic prospects around the world. There are multiple concerns, but policymakers throughout Europe and the United States are mainly fixated on reducing large fiscal deficits and public debt. The concerns are serious, and the ongoing sovereign debt crises in the euro zone have been a source of continuous turmoil in financial markets.

Unfortunately, the present policy responses are highly inadequate. Most developed economies have phased out stimulus measures and shifted to fiscal austerity. With unemployment rates remaining very high and financial sectors still clogged, this approach is pulling the plug on the recovery by exacerbating the lack of aggregate demand, further weakening the prospects for jobs recovery and economic development in the longer run. Bleaker medium and long-term growth prospects would also undermine the financial sustainability of health and pension systems over time, thus achieving precisely the opposite of what policymakers are aiming at through fiscal austerity.

Is there an alternative? Yes. As shown in the UN’s World Economic Situation and Prospects 2012, many developed countries have more than adequate fiscal space for additional stimulus. If well targeted at job creation and green growth and adequately coordinated internationally, additional stimulus could quicken the recovery and put the global economy on a more balanced and sustainable growth path.

Deficits, debt and growth

Fiscal deficits have widened first and foremost because of the global economic crisis, not because of additional spending or tax cuts meant to provide economic stimulus. Debt has increased for essentially the same reason. Available evidence suggests that fiscal austerity is not helping restore economic growth or debt sustainability; countries that made the biggest spending cuts to reduce fiscal deficits have seen their debt-to-GDP ratios rise even further (see figure). Why? Well, their economies grew even weaker, erosion debt sustainability despite fiscal austerity.

Figure 1. More austerity, more debt
(Changes in fiscal balance and public debt as percentage of GDP: 2009-2011)

Source: UN/DESA calculations based upon figures from IMF, Fiscal Monitor September 2011: Addressing Fiscal Challenges to Reduce Economic Risks.
Note: Positive change in fiscal balance means higher surplus or smaller fiscal deficit.

With the Cannes Action Plan, leaders of the G20 have recognized the need for reinvigorating growth and job creation. But these are defined as medium-term objectives, and current policy stances are weakening, rather than strengthening, aggregate demand.

More, not less fiscal stimulus is needed now...

In most developed countries, high public indebtedness should be the medium-term rather than the immediate concern. Governments still have plenty of fiscal space left for additional stimulus measures as most can still borrow at very low cost. Risk premiums on public borrowing have increased significantly for Greece, Italy and a few other European economies, but they remain low and have decreased even further for Germany, Japan, the United States and other developed countries.
In economies with low financing costs, policy should therefore return to a countercyclical stance. The same holds for economies that continue to run current account surpluses: by sustaining or enhancing deficit-financed fiscal stimulus, at least until GDP and job growth have taken effect and unemployment rates have fallen to levels at which more sustained private demand growth may be expected, public demand should shore up faltering private demand.

As there may be time lags for growth effects to kick in, fiscal deficits may still widen further initially, but should decline subsequently as higher growth and employment will boost government revenues and reduce pressure on social security expenditures. The fiscal balance would thus follow a “J-curved” trajectory—worsening initially, but improving strongly thereafter. The same applies to the degree of public indebtedness.

... but needs to be spent wisely....

A “J-curved” process of fiscal consolidation is quite feasible provided that the additional stimulus is carefully designed to maximize impact. A key condition is that the fiscal multiplier should be greater than one, that is, each dollar of additional short-term stimulus should translate into more than one dollar of additional aggregate demand. This condition typically exists in a downturn and should be present now as well. A high multiplier effect can be further ensured by orienting the stimulus towards infrastructure investment and direct job creation. For instance, under the American Recovery and Reinvestment act (ARRA) of 2009, expenditure on goods and services by the United States Federal Government and transfer payments to State and local governments for infrastructure had multipliers ranging between 1.0 and 2.5. In contrast, tax cuts for higher-income households and extension of the first-time homebuyer credit had multipliers of no more than between 0.2 and 0.8.

While the optimal mix of supporting demand will vary across countries (i.e., directly through taxes or income subsidies, or indirectly through strengthening supply-side conditions, including by investing in infrastructure and new technologies), direct government spending tends to generate stronger employment effects.

Policy should therefore target public investments to alleviate infrastructure bottlenecks that constrain growth prospects and to supplement this policy with fiscal efforts to progressively broaden the tax base. One priority area would be to expand public investment in renewable clean energy as part of commitments to reduce greenhouse gas (GHG) emissions and in infrastructure more resilient to the effects of climate change. Such a reorientation of stimulus measures has the potential to provide significantly greater employment effects, as renewable energy generation tends to be more labour-intensive than existing, non-renewable energy production.

...and coordinated internationally

Coordinated additional short-term stimulus by economies with fiscal space is consistent with benign global rebalancing. In Europe, instead of the present asymmetric adjustment through recessionary deflation, which concentrates most of the pain on countries in debt distress, it would entail a more symmetrical approach of austerity and structural reform in the countries in distress combined with euro area-wide reflation. The United States would equally need to consider such a sequenced approach. The first priority should be to boost demand in order to reduce unemployment, especially through public investment and more direct job creation. This would help reduce household debt and boost consumption demand through income growth. Infrastructure investment and other structural measures would underpin strengthened export competitiveness over the medium run. This would give time for China and other Asian economies to rebalance towards greater reliance on domestic demand growth.

The analysis of the World Economic Situation and Prospects 2012 shows that it is feasible to achieve such benign global rebalancing with accelerated jobs recovery. The coordinated short-term global stimulus, together with orderly sovereign debt workouts and structural policies aimed at stronger job creation and sustainable development would lift GDP growth across the globe, reduce public debt-to-GDP ratios and make up the 64 million jobs deficit left by the global crisis of 2008-2009.

Prepared by
Oliver Paddison and Rob Vos
For further information please contact:
Rob Vos, Director, Development Policy and Analysis Division Department of Economic and Social Affairs, Rm. DC2-2020 United Nations, New York, NY 10017, U.S.A.
Tel: +1 212 963-4838  •  Fax: +1 212 963-1061
e-mail: vos@un.org

Follow us on Facebook, LinkedIn and Twitter