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Growth, Austerity and Public Policy

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The Global Financial and Economic Crisis

Global growth averaged 3.4% annually in real terms in the decade 1994-2003 (2.8% in advanced economies and 4.4% in emerging markets and developing economies). It rose to an impressive 5% in the four years 2004-07 (about 3% in developed economies and 8% in EMDEs), during what is often described as the Great Moderation. This was **followed by one of the most severe global financial and economic crisis in the post war period**. The ensuing financial panic had a devastating impact on the real economy, as most advanced economies slipped into recession, and growth in EMDEs fell sharply. As a result, global growth fell to 2.8% in 2008 and -0.6% in 2009 (0 and -3.6 in advanced economies, and 6 and 2.8 in EMDEs). Although the global economy has since grown out of recession, this crisis is by no means over.

The G 20 Policy Response

The G 20 orchestrated a much acclaimed co-ordinated global policy response to the financial and economic crisis. The focus was on aggressive liquidity management by central banks and an equally aggressive use of fiscal policy. Over the medium term, it was expected that structural reforms (to boost growth potential and competitiveness) and global demand rebalancing (to rotate final consumption demand from deficit countries where there may have been a permanent reduction in demand to surplus countries) would strengthen the recovery and also make it sustainable by generating the confidence necessary for rebalancing of demand back from the public sector to the private.

Policy Impact

The initial response of the real economy to the strong, coordinated policy actions was encouraging. This was particularly so as at first it appeared that this was not just another recession, or downturn in the business cycle, and that the world could be headed for a second Great Depression. Global growth in 2010 was a robust 5.3% (3.2% in advanced economies and 7.5% in EMDEs), almost back to where it was before the crisis. **Thus the G 20 could declare at their third Summit at Pittsburgh in November 2009 that "It (i.e the policy response) worked",** and launch their seminal 'Framework for Strong, Sustainable and Balanced Growth' to address medium to long-term issues constraints on global growth.

The Recovery in Comparative Perspective

The nature of the recovery from the Great Recession, however, is intriguing. Global growth fell back to 3.9% in 2011 (1.6% in advanced economies and 6.2% in EMDEs), and is projected to be even lower, at 3.5% in 2012 (1.4% on advanced economies and 5.6% in EMDEs). What this means is that **on average global growth is currently not appreciably below the pre-boom period. However, EMDEs are growing at higher than, and advanced countries at about half, the pre-boom growth rates. This is despite the fact that advanced economies remain on macro-economic life support.** Economic history indicates that the worse the recession, the more robust the rebound to make up the lost output. By this yardstick, since this is the worst recession in the post war period, it was expected that the recovery in advanced countries would also be the most robust. This, however, does not appear to be happening. Indeed, growth is expected to drift even lower in 2012, with the recovery in EMDEs stalling dramatically. **The current recovery has consequently been described by some experts as the 'worst economic recovery in history'. As a result, policy makers felt constrained to continue the stimulus over an extended period, leading to a negative feedback loop between the sharp increase in public debt and lower growth as pointed out by Reinhart and Rogoff.**

The Policy Dilemma

Advanced economies have been growing significantly below trend for several quarters despite aggressive policy support. Unemployment remains at crisis highs if discouraged workers who have fallen out of the work force are included. **There is a pressing need to find a solution to the slow growth and high unemployment.** At the sixth and seventh G 20 Summits at Cannes and Los Cabos held in 2011 and 2012 respectively, Leaders therefore put growth and jobs at the heart of the recovery in their Action Plans for the Framework for Strong, Sustainable and Balanced Growth.

The short-term answer lies in increasing government expenditure but medium term considerations require that the fiscal deficit and debt are brought under control. In fact, some will argue that even short term considerations require reduction in the fiscal deficit as markets might penalize the government by increasing borrowing costs[1], and because the medium to long-term is nothing but an aggregation of the short-term. **Continued fiscal**

[1] This appears to be a vicious cycle: markets are concerned about escalating public debt and therefore implicitly demand austerity; austerity in the absence of trend growth would further undermine growth, and make existing levels of debt even more unsustainable, further spooking markets.

stimulus in the absence of strong growth has severely dented sovereign balance sheets.

This fundamental tension pitting austerity against growth is reflected in the G 20's current policy guidance that can be gleaned from the Leaders' Cannes and Los Cabos Statements. In effect, these statements exhort G 20 countries to continue to stimulate if they have fiscal space, and to consolidate if they do not. It is intriguing that while the Los Cabos Leaders Declaration exhorted countries with fiscal space to continue with stimulus, the linkage between fiscal space and stimulus that featured prominently in the Cannes Action Plan has been dropped in the Los Cabos Action Plan. This is perhaps because the general government debt/GDP ratios of the countries committing to further discretionary measures have deteriorated beyond the prudential 60% (***IMF Fiscal Monitor***) and even 90% (***Reinhart and Rogoff***). The borrowing costs of these countries are no doubt low currently because of the flight to quality, but market confidence can be fickle. This severance between fiscal space and stimulus allowed the US, which was not included in the group of countries with fiscal space at Cannes, and now faces a 'fiscal cliff' deriving from the double whammy of automatic federal expenditure cuts and expiry of tax cuts, to now commit to continuing stimulus.

There have, of course, been **several episodes where fiscal consolidation has been accompanied by growth.** While this strategy might work where there is a crisis in one part of the global economy, the argument that **this may not be possible during the current episode is rooted in what Keynes described at the 'paradox of thrift'**. A protracted synchronized downturn in advanced countries has, as we have seen, stressed public sector balance sheets, which is in turn leading to synchronized fiscal consolidation. However, a reduction in both private and public demand must be offset by an increase in external demand, which is not possible in a synchronized downturn, where there is a also synchronized effort to expand export markets to push up growth on account of weak domestic demand.

Monetary Policy

Fiscal policy is not, of course, the only tool to stimulate the economy back to growth over the short term. Indeed, over the last few decades, and especially in the wake of the stagflationary seventies, the mantle of countering business downturns had largely shifted to monetary policy conducted by independent central banks that are more insulated from political pressures. **However, in an environment of risk aversion, deleveraging by financial institutions and uncertain economic regulatory and economic conditions, monetary policy transmission channels are still clogged,** with neither zero bound interest rates, nor the supplemental quantitative and credit easing, able to stimulate investment in the real economy. Monetary expansion found its way back to the US Federal Reserve through a vast increase in the holdings of depository institutions, far above mandated levels, with the excess liquidity spilling over into financial asset and commodity price inflation. Therefore, despite repeated attempts to stimulate economies back to growth through aggressive and unconventional monetary policy, the burden may have to fall back on fiscal policy. This has generated a lively debate on the trade-offs involved between austerity and growth. While ordinarily fiscal consolidation against a backdrop of mounting fiscal deficits and public debt is desirable, the current debate on the likely negative impact of the US fiscal cliff – the double whammy of lapsing tax cuts and enforced government expenditure cuts -- is to be seen in the light of the likely impact on growth at a time private demand continues to be weak.

Crisis Generated Fiscal Space

In normal times, sovereign borrowing costs respond to macro-economic fundamentals, but during severe crises these are 'over-determined' by the large safe haven flows. This is particularly so during balance sheet recessions caused by large scale deleveraging and flight of capital out of risk assets to seemingly risk free reserve currency treasury assets.

Thus, while expansionary fiscal policy amidst high levels of fiscal deficits and debt can be expected to push up interest rates and borrowing costs, the yields on treasury bonds in major developed economies have in fact been falling. **Safe haven flows have been supplemented by non-conventional monetary policies to keep borrowing costs of reserve currency countries low.** Several economists have argued that notwithstanding high levels of deficits and debt, this fiscal space could and should be utilized to stimulate growth, in the absence of which fiscal consolidation is also not possible.

Obstacles to Recovery: Limitations of Monetary and Fiscal Policies

The problem, however, is that **the global economy in general, and advanced economies in particular, have been on macro-economic life support ever since the onset of the global financial crisis in 2008.** Central banks in advanced countries, led by the US Federal Reserve, as we have seen, have kept monetary policy unusually and unconventionally easy for an extended period. U.S federal outlays rose sharply from 19.6% of the GDP in 2007 to 24.7% in 2009, and were at 24.1% even in 2011, which are post-war highs. The situation in other advanced countries is similar. Rather than trying to do more of the same, **we need to address the obstacles coming in the way of fiscal multipliers and transmission channels of monetary policy.**

There are three possible explanations for low and/or declining fiscal multipliers and ineffectual monetary policy that are not having a commensurate or desired effect on private consumption and investment, **firstly Ricardian equivalence, secondly, the clogging of transmission channels** through which macroeconomic policy works, and **thirdly, the nature of the demand rebalancing that has occurred.** These obstacles would need to be addressed to improve the effectiveness of macro-economic policy tools.

Ricardian equivalence

It is argued by some that the reason why fiscal stimulus has very low multipliers, may derive from the structure of stimulus packages, in particular the rational expectation that the sharp increase in public debt to finance the stimulus would ultimately need to be paid back through tax increases down the line. This Ricardian equivalence, the rational expectation that tax cuts and/or increase in public expenditure today would be offset by equivalent tax increases tomorrow may be undermining the efficacy of fiscal policy. There needs to be some reassurance that the increase in income is not temporary. Fiscal policy may therefore need to be restructured to reduce Ricardian equivalence and improve fiscal multipliers.

Weak transmission channels of macro-economic policy tools

Another plausible explanation of why **the protracted stimulus has failed to revive consumption and animal spirits is that the extra income generated by fiscal and monetary expansion is simply accelerating the private deleveraging underway in the financial system instead of boosting consumption and investment.**

We need to understand that prior to the crisis the US – the overwhelming global consumer of last resort – had seen a sharp increase in inequality, with returns to capital rising much faster than the incomes of labour. This should have depressed both consumer demand, and ultimately investment and growth. There was, instead, a consumption boom, facilitated by financial innovation that allowed households to pile up high levels of debt against future appreciation in asset prices, especially in the housing sector. Demand raced far ahead of the sustainable current income necessary to support it. This consumption boom in the US economy, which accounts for just 4.5% of the global population, but 21.7% of global demand, lay at the heart of the 'Great Moderation' of record global growth.

This boom ended with the financial crisis and the Great Recession. Highly indebted households are now paying down this debt, even as household income has moved further in the direction of the top quintile, and unemployment rates remain persistently high. As a result, the once almighty American consumer is but a shadow of its former self since 2008. Over the last 18 quarters, annualized growth in real consumer demand has averaged a mere 0.7% compared with 3.6% in the decade before the crisis erupted. Never before has the American consumer been this weak for this long.

Low interest rates and easy liquidity should accelerate repair of household balance sheets on the one hand, and also stimulate consumption through the 'wealth effect' caused by rising asset prices. There is evidence, however, that both these impulses are currently weak. Easy monetary policy is accompanied by a tightening in credit conditions on account of regulatory changes, including the new Basel III norms that mandates banks to set aside more and better capital to discourage runaway balance sheet expansion and imprudent lending. The shadow banking system, that lay at the heart of the recent financial crisis, that provided much of the liquidity in the financial system, including consumer credit, during the Great Moderation, is yet to recover on the one hand, and is constrained by a great degree of regulatory uncertainty. Thus highly indebted households, who are most in need of credit, are finding it difficult to obtain it on account of low credit scores. Low interest rates are mostly helping the relatively better off and less indebted households, who have a higher propensity to save, and to pay down or refinance costly debt.

On the investment side, abnormally low interest rates and easy liquidity make projects with lower returns profitable, and should ordinarily be expected to induce private investment and fire animal spirits. However, despite extraordinarily low interest rates and repeated quantitative and credit easing for an extended period, private investment is not picking up.

The experience of past recessions in the United States is that the recovery in employment is led by small and medium enterprises. Supply side constraints however currently constrain SMEs because they are dependent on bank funding that has become more risk averse. Bank funding does not constrain larger Corporates who have direct access to capital markets. However, large Corporates are sitting on large amounts of cash are also unwilling to use this for investment. The problem in their case at least therefore seems to lie more on the demand than on the supply side. Policy uncertainties arising from regulatory, fiscal and central bank actions may also be accentuating depressed consumption and investment.

The Nature of Demand Rebalancing

It is rational to expect that the ongoing deleveraging in developed markets combined with financial regulatory reform would not permit the return of leveraged consumption. The resultant downward shift in consumer demand, and hence growth, may therefore be permanent. In these circumstances it is only the expectation of a major rebalancing of the global economy that can fire the 'animal spirits' of private investors. China's current account surplus has shrunk sharply since the crisis began, but this has been offset not by a rise in domestic consumption but by a sharp rise in investment. Moreover, new imbalances have arisen on account of a sharp and sustained increase in oil prices. The correction of 'intra European external imbalances' necessary for the peripheral countries to chart a sustainable recovery path also remain to be addressed.

The global rebalancing that has taken place so far is also not conducive to making global growth more sustainable in future. What should have happened is an increase in domestic consumption in China, and an increase in investment in the United States. This would have reduced structural external imbalances in both countries over the medium term. The structure of their fiscal programmes, however, has been quite the reverse. Be it as it may, even with some degree of global demand rebalancing, per capita incomes in China and other big emerging market economies are still too small for them to shoulder the full or even substantial burden of the sharp increase in savings in the United States and other advanced economies as these countries still account for about two thirds of global demand at market exchange rates, with just 15% of the total global population. Europe and Japan are major nodes of potential demand, but have structural impediments to demand expansion that are more severe than those currently afflicting the United States. It is therefore easy to see why private confidence and animal spirits are still not firing. **The drivers of future growth that can push the global economy back into the growth trajectory of the Great Moderation are unclear.**

Revisiting G 20's Crisis Response Strategy

In view of the structural obstacles in the way of monetary and fiscal policies at the current juncture, it is perhaps time both the IMF and the G 20 introspects and revisits its crisis response and growth revival strategy to see if some elements need to be fine-tuned or even fixed, especially since the downturn in growth may not be just be a short-term or cyclical problem. Markets need credible assurances that structural problems in the way of a sustainable recovery will be, and are being, fixed.

There has been overwhelming consensus in the last few meetings of the G 20, and particularly at the sixth and seventh Summits at Cannes and Los Cabos respectively, that high levels of deficits and debt notwithstanding, there needs to be a continued focus on growth and jobs. **Although the strategy for**

growth is not clearly articulated it appears to rest on three pillars. First, countries with fiscal space should continue with stimulus policies, until growth returns or they are penalized by markets at which point there should be greater emphasis on fiscal consolidation. **Second, monetary policy in advanced countries should remain accommodative** since there are no inflationary pressures there. **Third, there should be continued reliance on supporting private consumption and investment over the short-term, and on structural reforms to boost competitiveness and growth potential over the long-term.** ***This strategy, however, does not appear to be working as it does not adequately address the three structural obstacles rendering macroeconomic policies impotent.***

The Role of Public Investment in Infrastructure

Since short-term policies are not working because of problems on the demand side it could be argued that **while the G 20 has by and large avoided several of the policy mistakes of the Great Depression, it has perhaps overlooked the role that public investment, particularly in infrastructure** in which there is a big gap in developing countries in particular, including public works on a large scale (which were undertaken during the Great Depression), can play in the global recovery. The latter can substitute for the lack of private investment.

When consumers, investors and export markets are in retreat, arguably the only way to sustain growth and employment is through an expansion in government demand. Governments can stimulate the economy either through tax cuts, or by directly increasing their own expenditure. While tax cuts have the advantage of being easier to roll back, these may not translate into consumption and/or investment. In a recession induced by a financial crisis, therefore, tax cuts may be less effective than an increase in direct government investment that creates jobs and income streams, thereby **giving consumers confidence that the increase in income is permanent**. Apart from counteracting Ricardian equivalence, this could also fire animal spirits to invest and crowds in private investment. Direct public spending to stimulate the economy also **makes the role of macro-economic policy transmission channels of secondary importance.** To the extent that much of this investment, including in infrastructure, will occur in developing countries, **it would also help address this underlying instability by rebalancing global demand.** Some developed countries may also need to increase investment and upgrade their infrastructure. While construction works would stimulate local growth and job creation, the large demand for capital goods created for modern infrastructure would also stimulate private investment and job creation globally.

It also needs to be to be recognized that greater funding and investment in infrastructure may not be an optimal solution in all countries that may need to focus more on rebalancing demand towards domestic consumption. It also goes without saying that the focus on public investment should not detract from the imperative for structural reforms necessary to encourage private sector job creation. The dangers of creating 'white elephants' and 'pork barrel politics' would also need to be mitigated. Regardless of these caveats, taking EMDEs as a whole (and perhaps some advanced economies as well) there is an argument that long-term funding and investment in infrastructure may assist the objectives of furthering development and rebalancing in EMDEs, and reviving growth and creating jobs in advanced economies.

There are a number of ways in which investment and infrastructure could be dovetailed into the G-20 work-streams, especially through the Working Groups on the International Financial Architecture (raising resources), the Framework on Strong, Sustainable and Balanced Growth (inducing G 20 countries to make commitments on investment), and through the regulatory reform agenda (such as asymmetric capital requirements for investment in the real economy and in financial assets).

A major thrust in public investment in infrastructure is likely to push up growth rates over the short-term, create jobs and increase growth potential. **But will it be self-sustaining? Japan is a cautionary tale in this regard.** It has been trying to stimulate its economy back to growth over the last two decades through public investment, but private growth and investment is still to materialize, while its public debt has ballooned. Another big dose of public investment in the post Tsunami period has again boosted growth, but nobody expects this to be permanent. **For the growth to be self-sustaining, there would also need to be back loaded demand rebalancing from public to private.** While this could partly be done through transfer of public works to private hands, where appropriate, this would ultimately come with the revival of household demand. It may be recalled that the high growth rates during the Great Moderation was facilitated by excesses of the financial system that enabled consumers in advanced countries, particularly in the US, to go on a consumption spree far in excess of their income generating ability. While accelerated deleveraging is a necessary condition for revival of consumer demand, return to former levels of consumption is both unsustainable and unlikely without new growth drivers. Infrastructure investment can be one such growth lever. Increase in final consumer demand in surplus countries can be another. For deficit countries to exploit these opportunities, they would need to become more competitive through implementing ambitious product and labour market reforms.

Unwinding Expansionary Policies

It is by no means certain that a huge push in public investment would revive the global economy on a self-sustaining basis which would involved a rebalancing of demand from deficit to surplus countries, and from public to private. There is certainly a **good case for trying, for at least four reasons. Firstly, other options, both monetary and fiscal, have been tried** and don't seem to be working. **Secondly, theoretically it makes eminent sense**, and although arguable this seems to have made a difference during the Great Depression. **Thirdly, sovereign borrowing costs in major advanced countries remain low** making low return investments profitable. **Fourthly, we may otherwise need to reconcile to reverting to lower trend growth in developed countries compared to even the pre-boom period.**

The question is whether the world can, or should, live with this lower growth, especially since it is not appreciably lower than the pre-boom average. **As long as EMDEs grow at or above the pre-boom rate, the case for continuing stimulus is not very sound, especially where public debt, deficit and inflation levels are high**. These countries could overheat at growth rates they had got used to in the recent past, and some of them have already done so.

Public investment in the current juncture is not, of course, an argument for governments to take over the commanding heights of the economy or crowd out private enterprise, but for public investment to take the space vacated by private enterprise due to a prolonged absence of animal spirits. **Once confidence returns, it would be time for exit from such policies.**

Policy makers would need to know when to start exiting. They need to be open to the possibility that a return to the Great Moderation growth rates may not occur on account of a permanent loss in global demand. Therefore, policy makers **should not be looking to growth rates to begin exiting, but rising treasury yields and inflation. This point has already been reached in several EMDEs,** but not in advanced economies. **Inflation and rising yields on sovereign bonds in advanced countries would be like canaries in the goldmine signalling the revival of animal spirits and closing of the output gap.** At that point monetary policy would need to take over the mantle of macro-economic stabilization from fiscal policy, finely balancing the need to anchoring inflationary expectations on the one hand by gradually normalizing interest rates and unwinding unconventional monetary measures, while gradually inflating away high levels of public debt through some degree of financial repression. **The return to higher growth in advanced economies would also enable EMDEs to shift to a higher growth trajectory.**

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