CP Chandrasekhar & Jayati Ghosh[1]

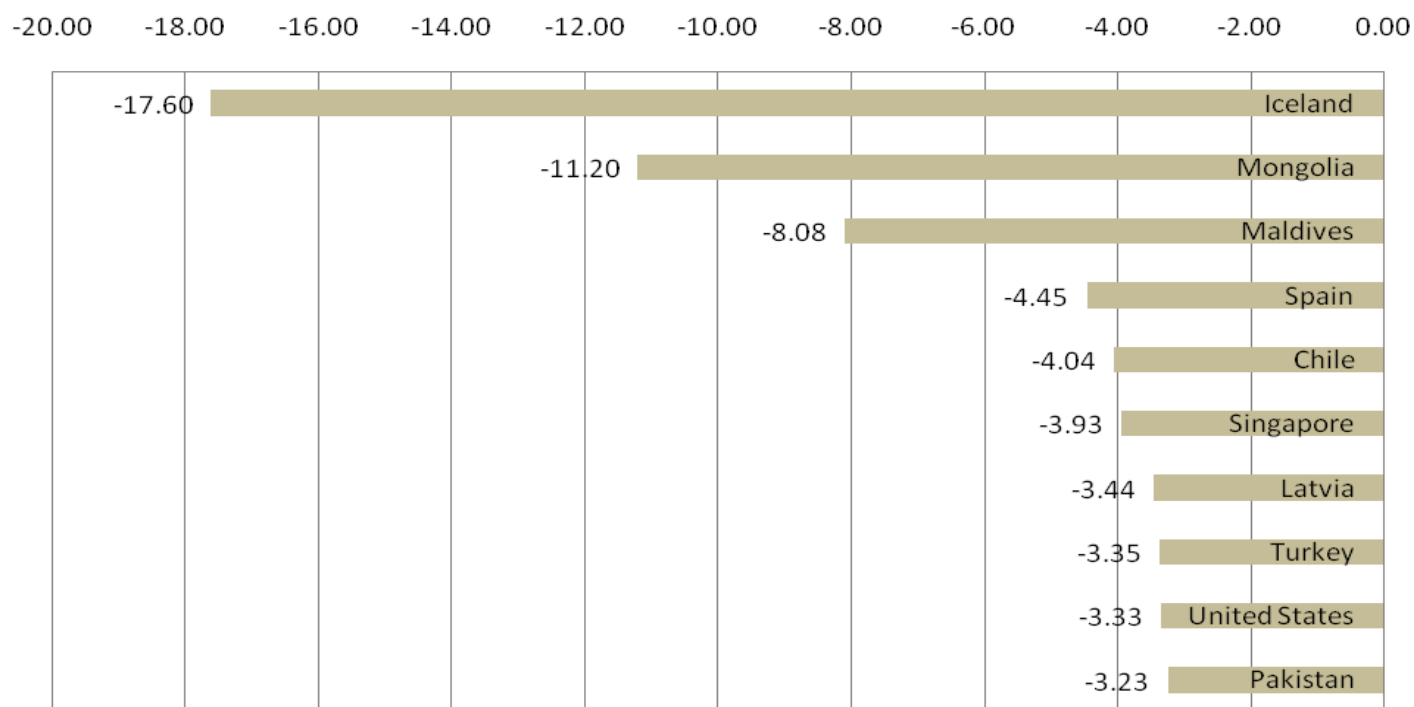
Fiscal Policy and Global Growth

Barely two years since the Great Recession first hit the world economy, global attention has shifted from the crisis and its origins to the ostensible burden imposed by the stimulus measures adopted by governments in response. Not all governments opted for a significant, let alone adequate, fiscal stimulus in response to the crisis; and not all the accumulated fiscal deficits are attributable to voluntary measures.

Indeed, some deficits were the result of the crisis itself because of public spending to bail out banks and other companies and also as output contraction adversely affected tax revenues. Before turning to austerity and fiscal consolidation, therefore, governments should look closely at the recovery measures and their influence on growth a little more closely.

Unfortunately, IMF data on surplus/deficit to GDP ratios for a large enough sample of countries is only available till 2008. After the crisis broke in the second half of 2008, much of the stimulus spending occurred in 2009.

Different policy conclusions can be drawn from the available evidence. Consider, for example, the governments' surpluses or deficits defined as revenue (including grants) minus expenditure, minus net acquisitions of non-financial assets. Of the ten (of 69) countries with the largest decreases in their cash balance to GDP ratios (Chart 1) between 2007 and 2008 (Iceland,



Mongolia, Maldives, Spain, Chile, Singapore, Latvia, Turkey, United States and Pakistan), only Maldives, the US and Pakistan actually had cash deficits in 2007, with deficit to GDP ratios of 5.6%, 2.2% and 4.2% Turkey, United States (US), and Pakistan only Maldives, the US and Pakistan actually had cash deficits in 2007, with deficit to GDP ratios of 5.6%, 2.2% and 4.2% respectively (Table 1). Iceland, Mongolia, Spain, Chile, Singapore Latvia and Turkey had cash surpluses, with surplus to GDP ratios of 4.8%, 7.7%, 2.4%, 8.8%, 12.1%, 0.8% and 1.4% respectively. The 2007 deficits of Maldives, the US and Pakistan widened to 13.7%, 5.4% and 7.4% of GDP respectively in 2008. Iceland, Mongolia, Spain, Latvia and Turkey saw their surpluses turning to deficits of -12.8%, -3.5%, -2.0%, -2.6% and –1.9% of GDP in 2008, while Chile and Singapore maintained cash surpluses of 4.8% and 8.1%.

Table 1. Surplus/Deficit to GDP Ratio, 2007-2008 (%)

	2007	*2008*
Iceland	4.82	-12.78
Mongolia	7.69	-3.51
Maldives	-5.58	-13.66
Spain	2.44	-2.01
Chile	8.82	4.78
Singapore	12.05	8.12
Latvia	0.81	-2.63
Turkey	1.41	-1.94
USA	-2.21	-5.54
Pakistan	-4.17	-7.41

Countries experiencing the largest deterioration in their balance ratios between 2007 and 2008 should be noted. Only Maldives, the US and Pakistan can be seen as countries that lacked the "fiscal headroom" in 2007 to adopt countercyclical fiscal policy measures. The others, recording a surplus balance in their government accounts just before the crisis, were in a position to respond with fiscal measures, since pre-existing deficits had not made new debt "unsustainable". The countries that lacked such fiscal headroom did end up recording significant deficits in 2008.

Secondly, three of the top four countries in terms of fiscal balance deterioration between 2007 and 2008 had recorded cash surpluses in 2007. Of these, only Iceland saw a significant deterioration in its fiscal position, with its deficit to GDP ratio rising to 12.8%.

Thirdly, of the top ten countries in terms of fiscal balance deterioration, only Iceland, Maldives, the US and Pakistan had deficit to GDP ratios in excess of 5% in 2008, while Chile and Singapore had surpluses, as noted above. Thus, by 2008, the crisis had not resulted in any generalized tendency towards substantial fiscal balance deterioration.

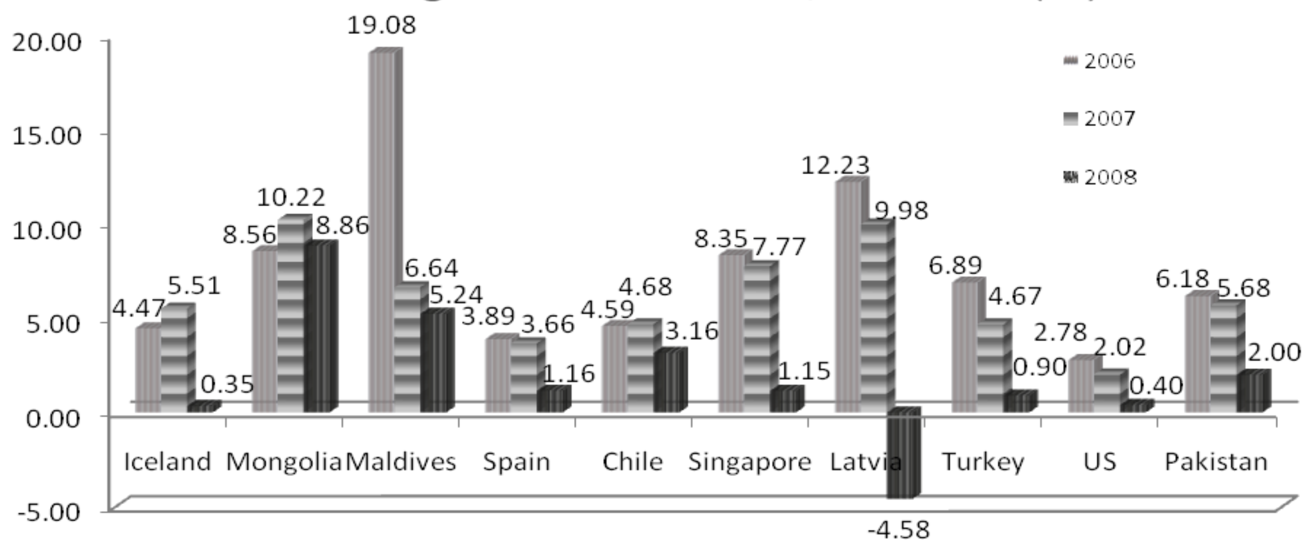
Fourthly, none of these top ten countries, except for Iceland, had recorded increases in expenditure to GDP ratios in excess of 2.5 percentage points of GDP between 2007 and 2008. In other words, at least in 2008, these were not the countries that had resorted to huge fiscal stimuli. The country with an unusually high increase in the expenditure to GDP ratio of 15 percentage points was Iceland, also the country that had to cover the loans and deposits its banks had to repay when the crisis rendered worthless the speculative investments they had made using deposits and credit from abroad. Thus, Iceland's fiscal situation was not a reflection of its stimulus spending, but of the provisioning needed to prevent a financial collapse.

Finally, there is no clear relationship between the decline in the cash balance to GDP ratio between 2007 and 2008 or the level of the cash deficit to GDP ratio in 2008 and the relative GDP growth performance of countries. Almost all countries (except Mongolia) recorded a significant decline in growth rates, with the deterioration varying widely (Chart 2). This clearly was related to the extent to which individual countries were affected by the financial crisis.

Thus, at least till 2008, there could be no clear links established between the impact of the crisis in individual countries, the fiscal response of governments to that crisis and the deterioration of the fiscal position of countries. In fact, slower growth and the need to make large outlays to salvage the financial sector - rather than stimulus packages - may have been responsible for whatever fiscal deteriorations occurred. This would mean that the argument that the stimulus in response to the crisis had gone too far, creating new problems attributable to fiscal deterioration, and therefore needs to be corrected, is simply not valid in most cases and only partially true in others.

The problem however, is that 2008 was still early in the unfolding of the crisis and the responses therefore, analyses based on data till that year may not reveal the full picture.

There are, however, a few countries for which actual or provisionally estimated numbers for 2009 are available



from the IMF's government financial statistics. Evidence from these 37 countries seems to suggest further significant fiscal deterioration in many countries during 2009 with significantly higher declines in the balance of GDP ratio between 2007 and 2009 and significantly higher deficit to GDP ratios in 2009.

However, this fiscal deterioration was accompanied by substantial worsening of growth performance in many of these countries. This suggests either that the fiscal deterioration was not only reflective of the stimulus measures impacts on growth, given the gravity of the crisis in many countries, or that the growth slowdown affected revenues adversely, thereby worsening the fiscal positions of the countries concerned.

Consider, for example, the five countries in the 2009 sample that recorded the largest declines in their balance to GDP ratios between 2007 and 2009 (Table 2). All recorded deficits relative to GDP in 2009. Yet, every one of them also recorded a substantial deterioration in growth rates in 2009.

This evidence, once again, points in three possible directions. First, the deficit does not represent a stimulus effort, but is the result of expenditure, such as bank bail-outs that do not have much of an effect on demand and production. Second, the crisis was so severe that the increased expenditure that constituted the stimulus was inadequate to trigger a recovery. Or third, the impact of the crisis on growth was so adverse that the resulting fall in government revenues substantially widened the deficit, even when increases in stimulus spending were limited or non-existent.

Table 2. Fiscal Balance and Growth in 2008-09

	Decline in Balance to GDP	GDP Growth	GDP Growth
	2007-09	2008	2009
Iceland	-15.5%	12.9%	1.5%
Singapore	-13.7%	3.0%	-3.3%
Chile	-13.5%	3.9%	2.7%
Russian Fedn	-10.4%	24.6%	-5.4%
United States	-9.2%	2.6%	-1.3%

If any of these holds, then it is definitely not true that deficit spending went too far, and that it is now time to cut back on recovery spending.

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[1] C.P. Chandrasekhar & Jayati Ghosh are Professors at Jawaharlal Nehru University, New Delhi