Fiscal consolidation, growth and employment recovery

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(Acknowledgement: Anis Chowdhury)
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G20 Toronto declaration

• "Advanced economies have committed to fiscal plans that will at least halve deficits by 2013 and stabilize or reduce government debt-to-GDP ratios by 2016,"

• "Those with serious fiscal challenges need to accelerate the pace of consolidation"
G20 Toronto summit

• Agreed to adopt multi-track economic policies around
  – fiscal consolidation
  – govt spending restraints

• Ostensibly for balanced + resilient growth and sustained recovery
G20 fiscal consolidation

• Projected debt-to-GDP ratio in advanced (N) G-20 economies by 2014: 118%
• Scenario used by IMF suggests that N governments need to improve budget balances by about 8% of GDP by 2020 – revised upward to 8.7%
• Adjustment will enable them to reach Maastricht Treaty norms by 2030
Required fiscal adjustments

IMF April 2010 target debt/GDP ratios by 2030:

Benchmark:
- Developed countries, 60% debt/GDP ratio
  – median pre-crisis ratio
- Developing economies, 40% debt/GDP ratio
  – no explanation how figure derived

Average fiscal adjustments:
- 8.7% of GDP for developed countries
- 2.7% of GDP for developing economies
Debt distress (GMR 2010)

- 67 low income countries analyzed
- Debt vulnerability:
  - Low 20
  - Moderate 24
  - High 15
  - Debt distress 8 (12%)
- Yet recommends: fiscal consolidation for ALL countries
Conventional framework

• ‘A …budget deficit in excess of 1-2% of GDP is evidence of…policy failure’ (Williamson 1990)
• Developing economies should focus on containing inflation and … (GMR 2010)
• ‘Should adopt credible fiscal adjustment plans to boost confidence in macroeconomic policies’ (GMR 2010)
• Maintaining confidence in macroeconomic stability remains priority for all countries (GMR 2010, p. 82)
1996 IMF study of 74 cases in 20 industrialized countries during 1970-95:

- **Strong** global economic growth helps achieve successful consolidation
- **Weak** global growth reduces chances that consolidation will cut debt-to-GDP ratio
- Fiscal retrenchments + loose monetary policy offset recessionary impacts
IMF: WEO, Oct. 2010

Fiscal consolidation contractionary: 1% of GDP fiscal contraction reduces real GDP by ~1%, raises unemployment ~0.3%

Figure 3.2. Impact of a 1 Percent of GDP Fiscal Consolidation on GDP and Unemployment

Fiscal consolidation is normally contractionary. A fiscal consolidation equal to 1 percent of GDP typically reduces real GDP by about 0.5 percent and raises the unemployment rate by about 0.3 percentage point.
Research findings

- Fiscal consolidation typically **contractionary**
- Little empirical support that fiscal austerity stimulates economic activity in short term
- 2 years after fiscal consolidation of 1% of GDP:
  - reduces real GDP by ~ 0.5% after 2 yrs
  - increases unemployment rate by ~ 0.3%
- Even for likely sovereign debt-default risk countries, results not expansionary – output, on average, still falls by ~0.4% after 2 years
Fiscal consolidation based on cuts to government transfers is less contractionary than that based on cuts to government consumption or government investment. But the differences between the three spending types are within the margin of error.
Composition matters

- Largest contractionary effect: cuts to public investment
- Even for transfer cuts, no strong evidence of expansionary effects – results statistically insignificant
Synchronized consolidation

• When exchange rate cannot stimulate net exports, and as easing monetary policy cannot stimulate domestic demand, output losses of fiscal consolidation much larger

• With zero interest rate floor, there could be large output losses due to urgent or premature fiscal retrenchment across all large economies at same time
Other studies

• 2003 European Commission study: In > 50%, fiscal austerity programs + expansionary monetary policy sustained growth

• Broyer + Brunner: net –ve impact on growth in 8 European economies (Germany, France, UK, Italy, Spain, Netherlands, Portugal, Greece): Even by 2016, all but one will suffer output contraction

• Alesina + Perotti, 1995; Alesina + Ardagna, 2010: biased toward finding expansionary effects -- methodological and measurement problems
Enabling factors more important than fiscal actions, including:

- global business cycle,
- monetary policy,
- exchange rate policy,
- structural reforms.
Weak debt instability correlation

Figure 4. Government Debt and Macroeconomic Volatility
Weak debt-growth relationship driven by outliers

Figure 1. Government Debt and Per Capita GDP Growth
More fiscal rules restricting fiscal space
GMR2010: MDGs threatened

• Progress on full and productive employment …lacking even before crisis’ (p. 18)
• ‘Serious shortfalls’ for human development MDGs at global level even if pre-crisis growth path maintained and despite significant progress in the past (p. 14)
• Sub-Saharan Africa lags on all MDGs, including poverty reduction (p. 21)
• Many countries likely to fall short on most goals (p. 21)
Growth needed for MDGs

Stronger policies unlikely to fully compensate for deterioration in human development indicators from slower growth

Better development outcomes depend on speed global economic recovery supports increases in developing countries’ export revenues and external finance (p. 97)
Need for fiscal space

• Macro policies should not be driven by fear of outliers
• Most developed countries have fiscal space – no inflationary pressure
• General principle of debt sustainability; but specific debt-GDP target arbitrarily determined → fiscal policy residual, not geared to development
Developmental monetary policy

• IMF Article IV: “reasonable” price stability; NO specific target
• Inflation target <5% too restrictive
• Monetary policy should support developmental objectives
• Ease access to finance for SMEs, agriculture
# References

G24 Policy Briefs: [http://www.g24.org/briefs.htm](http://www.g24.org/briefs.htm)

- No 57: “Fiscal Consolidation, Growth and Employment: What Do we Know?” by Iyanatul Islam & Anis Chowdhury

- No 58: “The Fallacy of Austerity-Based Fiscal Consolidation” by Iyanatul Islam & Anis Chowdhury

Voxeu commentary:


“Rethinking Macroeconomics from the perspective of the Millennium Development Goals in the Post-Crisis Era” by Anis Chowdhury & Iyanatul Islam
Thank you

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