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All is quiet on the fiscal front: Fiscal policy for the global economic crisis

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DEPARTMENT OF ECONOMICS WORKING PAPER SERIES

**All is quiet on the fiscal front:
Fiscal policy for the global economic crisis**

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Working Paper No: 2010-02

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Abstract

The current economic global crisis has thrown fiscal policy onto the center stage. However, the current crisis episode has not produced any change regarding the standing role and function of fiscal policy in developed and developing market economies that has dominated the economics profession for decades. In fact, the uncertain prospects for recovery underscore the fact that free market economies lack the mechanisms to bring about and maintain full employment. Full employment requires designing and making operational institutions at the national and global levels that can manage aggregate demand. This paper reviews the evidence on current fiscal efforts around the world.

Key Words: Fiscal Policy, Fiscal Deficit

JEL Codes: E62, H62

The opinions here expressed are the authors' own and may not coincide with those of the institutions with which they are affiliated.

Introduction

The current economic global crisis has rescued fiscal policy from oblivion. For over three decades until the start and spread of the current crisis, the prevailing consensus in mainstream economics privileged monetary over fiscal policy. The consensus view argues that active fiscal policy could not stabilize the economy or promote growth, and could do more harm than good. In fact, some authors argued that fiscal consolidation (i.e. contraction) would be good for growth. Governments were advised to maintain fiscal soundness and credibility, and avoid interference with free market forces. Now, in the midst of the most severe economic crisis since the Great Depression, the tide has changed and active fiscal policy is back on stage.

The revival of active fiscal policy reflects an *ad-hoc* belief legated by the 1930's Chicago Economics asserting that fiscal policy can play an important role during business cycles, especially in contractions, when the instruments of monetary policy have outlasted their purpose and usefulness. This position which views fiscal policy as a short term patching device to smooth out the fluctuations in the business cycle contrasted with the Keynes' view giving fiscal policy an essential medium and long-term role in maintaining full employment.

The conventional view has involved, on the one hand, an outright 'rhetorical' economic and even political defense of the usefulness of fiscal policy in economic contractions across developed and developing countries. On the other hand, the policy interventions associated with that rhetoric have been limited, aside from the gigantic rescue efforts of the financial sector, to modest fiscal stimulus packages meant not to endanger sound fiscal finance and the prospects of a healthy economic recovery.

Following the logic of the above argument, this paper states that in spite of statements to the contrary, the current crisis episode has not produced any change regarding the standing role and function of fiscal policy in developed and developing market economies that has dominated the economics profession for decades. The paper is divided into four sections.

The first section analyzes the role played by activist fiscal policy in current mainstream macroeconomics. The second section traces the use of discretionary fiscal policy in contractions to the 1930's Chicago Economics, and contrasts it to the Keynes position on fiscal matters. The third section examines the fiscal packages implemented in the developed and developing world arguing that these are small in magnitude, with little expected effects on real output. The fourth section rounds up the argument by arguing that the insignificance of the fiscal policy efforts responds to the fact that mainstream economists believe that ultimately recoveries, even those following severe crisis such as the current one, are sharp and the rate of growth of output tends to return to its historical trend growth path. The trend growth path is purely determined by supply side factors with no intervention from aggregate demand. The paper concludes noting the limitations of the conventional wisdom on fiscal policy to deal with the current global economic crisis.

Active fiscal policy is the right policy for 'abnormal' times

The mainstream economic profession sustains, that fiscal policy does more harm than good except in periods of 'abnormal' economic activity (i.e., recession). As put by Blinder (2006, p. 52):

“Today’s conventional wisdom holds that discretionary changes in fiscal policy are unlikely to do much good, and might even do harm. Why is that? First, the lags in fiscal policy, especially the inside lags, are long—perhaps longer than the duration of the typical recession. Second, the effects of the most plausible fiscal policy weapon, changes in personal income taxes (or transfer payments), are likely to be weakened by deploying it on a temporary basis. And third, an obviously superior stabilization weapon—namely monetary policy—is readily available.”¹

To this list of reasons undermining the effectiveness of fiscal policy, can be added the standard arguments relating to crowding-out, the Rational Expectations assumption, Ricardian Equivalence, consumption smoothing, and low policy credibility. These are summarized and explained in table 1.

The crowding-out argument is the most common dating back, at least, to the beginning of the 20th Century. In this view, increases in government spending substitute for private expenditure and lead to higher interest rates and lower investment and consumption as the government borrows to finance its deficit. If alternatively, the government opts to raise taxes to bridge the fiscal gap it simply leads to a lower level of disposable income.

The other arguments, which dominate the New Classical and New Keynesian economics, follow logically from the main assumptions of Rational Expectations namely: forward looking agents with full information and market clearing (in the short run for New Classical Macroeconomics and in the long run for both New Classical and New Keynesian macro). These assumptions, in conjunction with infinitely lived agents, lead to the conclusion that agents practice consumption smoothing over their lifetime taking into account the intertemporal budget constraint of the government. Hence, fiscal policy does not alter in the long run any macroeconomic outcome.

In the short run, the introduction of rigidities as in New Keynesian models, provide a role for fiscal policy in affecting the short run path of macroeconomic variables. Nonetheless, the most recent forecasts derived from well known New Keynesian models, such as the Smet-Wouters model, conclude that the effects of expansionary fiscal policy is small in the short run, crowds out private consumption and investment and in the long run has contractionary effects.²

It is thus no wonder, to find that the so-called ‘current consensus’ view of macroeconomics has no role for fiscal policy. In a nutshell, the consensus view consists of three relationships. The first is an aggregate demand equation where the main source of demand is private consumption. The second is a Philips curve specifying inflation as a function of expected inflation and the output gap. The third relationship (a Taylor rule) is a central bank reaction function postulating the real interest rate as function of inflation

¹ See Eichenbaum (1997) and Feldstein (2002) for similar statements questioning the validity of fiscal policy. As put by Feldstein (2002): “There is widespread agreement in the economics profession that deliberate ‘countercyclical’ discretionary fiscal has not contributed to economic stability and may have actually been destabilizing in the past.”

² See, Cogan et al. (2009) and Smets and Wouters (2007).

and the output gap.³ Monetary policy is the tool for stabilizing the economy and government or fiscal policy variables are not included.

Notwithstanding, mainstream economists do recognize that there are also ‘abnormal’ circumstances where the traditional monetary policy tools become non-operative or cannot be used efficiently to stabilize the business cycle. In these ‘abnormal times’ fiscal policy can play the principal role in stabilizing the economy by increasing aggregate demand through deficit spending or tax cuts financed by money supply.

An emblematic example of ‘abnormal circumstances’ is provided by the Japanese recession of the 1990’s. It lasted for fourteen years, interest rates reached the zero bound, crowding effects were negligible and the duration of the recession proved to be longer than the fiscal policy lags.⁴ Other illustrative examples include the Nordic Banking Crises (1991-1994), which affected Finland, Norway, and Sweden, Spain (1977), and the Asian Crisis (1997).

The current global economic crisis, which is deemed by its magnitude and systemic character to be the most significant in the post WWII era, is yet another example of an ‘abnormal circumstance’. In the current crisis as well monetary instruments have exhausted their usefulness. Since the start of the global financial crisis in August 2007, most central banks of the developed and developing world have moved to reduce their key interest rates roughly from a range of 4%-5% to one of 1%-0% turning negative in real terms in many instances. Also, the current credit market dysfunction and illiquidity has prevented and severely limited monetary policy as a stabilizing tool. In fact governments have had to strongly intervene in financial markets, not only providing huge bailouts to financial institutions but also providing liquidity directly to borrowers and investors in the most important credit markets, and to purchase liabilities or assets that could compromise the balance sheet of financial institutions.

³ See, Blanchard (2009), Woodford (2009). Cogan, et al. (2009) suggest that the actual effect of the fiscal stimulus in the US would be 1/6 of that advocated by Romer and Bernstein (2009).

⁴ It is important to note the difference between the zero bound for the interest rate, often caused by the need to reduce interest rates after the burst of a bubble (as in Japan and recently in the US), and the so-called Liquidity Trap, which is caused by the behavior of economic agents having an absolute demand for liquidity.

Table 1
Effects of expansionary fiscal policy and their argumentative logic according to the standard approaches of mainstream economics
(Neo-classical synthesis, New Classical Macroeconomics and New Keynesian economics)

Approach	Effect	Argumentative Logic
Neo-classical synthesis	Crowding-out	Public spending can cause direct and induced crowding out. The former refers to the provision of goods and services by the public sector substituting for their provision by the private sector. The latter refers to a reduction in private consumption and/or investment due to the fact that greater public spending has to be financed by higher taxes or by borrowing which leads to higher interest rates. In an open economy higher interest rates can lead to exchange rate appreciation and thus to a loss of external competitiveness. The existence and strength of crowding out will depend on the sensitiveness of investment and money demand to interest rates; degree of openness and capital mobility, exchange rate regime, price flexibility and the output gap.
New Classical Macroeconomics	Rational expectations	The use of rational expectations assumes that agents use all available, relevant information, that they know the probability distributions and laws of motion of present and future economic events such as say an increase in public spending. As a result agents can distinguish between a temporary and permanent increase in public spending or in an expansionary fiscal stance. The former does alter agents' expectations. The latter leads agents to expect continuing tax or interest rate increases and thus reinforces the 'crowding-out' effect.
	Ricardian equivalence	Ricardian equivalence ensues from the Rational Expectation hypothesis and market clearing logic and other stringent assumptions (including perfect credit markets, infinitely lived agents, lump sum taxes, intergeneration links for all agents). It states that a given path of government spending does not alter aggregate demand, GDP or welfare irrespective of how is financed. Rational expectations agents being aware of the intertemporal government budget constraint realize that a tax cut financed by debt means future tax increases. As such, any increase in disposable income due to the tax cut will be perceived as a temporary increase not a permanent one and thus will not lead to a change in aggregate demand. Hence the 'Ricardian equivalence' between financing an expansionary fiscal policy with taxes or debt.
	Consumption smoothing	Consumption smoothing is part of the explanation of the Ricardian equivalence between tax and debt financed government expenditure. It assumes that agents have infinite lives and that they are not myopic. As such, they balance out any distributional effect of government spending policies and the way they are financed by altering their spending and saving habits over the course of their life.
	Credibility	The use of rational expectations implies that agents learn from their mistakes. As a result, if due to a lack of credibility a government's temporary fiscal expansion, say an increase in government spending, is perceived as permanent, agents will abstain from increasing their consumption above its 'permanent level' as they expect an increase in taxes in the future to balance the budget deficit. In a similar manner, the lack of credibility can be reflected in higher risk premia and thus higher interest rates leading to a reduction in investment spending.
New Keynesian Economics		Follows the same logic as New Classical Macroeconomics in assuming that agents use all available, relevant information, that they know the probability distributions and laws of motion of present and future economic events such as say an increase in public spending. Consumption smoothing and Ricardian Equivalence are part of the New Keynesian Macro box tool. Nonetheless, their effects are not fully felt due to the introduction of rigidities. In the short run fiscal policy has some impact, although empirically small. In the long run it has no impact on consumption, welfare or GDP. In the long run New Keynesian and New Classical macroeconomics are one and the same.

Sources: Hemming et al. (2002); Sargent (1993); Seater (1993); Smets and Wouters (2007); Woodford (2009).

Fiscal policy activism in ‘abnormal times’: a legacy of the Classical Chicago School of Economics

The view that fiscal policy activism is only justified in abnormal circumstances’ is a legacy of the 1930’s Chicago economics that viewed monetary policy as a useful tool to control inflation but ineffective in times of recession. Instead, they advocated the use of discretionary fiscal policy (i.e., budget deficits) and more generally, compensatory public finance, to combat the contractionary effects of recessions. Their focus of analysis was the Great Depression. One of the lead exponents of Chicago economics, Henry Simons (1938, p. 222) put it in the following way:

“Once a deflation has gotten under way, in a large modern economy, there is no significant limit which the decline in prices and employment cannot exceed, if the central government fails to use its fiscal powers generously and deliberately to stop the decline.”

Chicago economists were not convinced of the efficiency of monetary instruments to rein in the effects of the depression on output and employment. For one thing, open-market operations built up commercial bank reserves and they would use these to cancel out debt rather than to end up with bad loans.

Also lowering the discount rate was simply an “idle gesture” for it would do little to boost business confidence since the problem lay in business’ dimmed profit prospects, i.e., in demand conditions. As voiced by Douglas and Aaron (1931) monetary policy is limited because “... the difficulty comes from the demand side as to whether business, exposed to such difficulties, would wish to borrow more.” The problem lay in the response of aggregate demand. Again as put by Douglas and Aaron (1931, p. 225): “The interest of society as a whole does not lie with the fortunes of individual firms, but in the demand for commodities in the aggregate.” Finally, they also pointed to their distrust of the banking system, the instability of the financial system, and the limitations placed upon the workings of monetary policy by underdeveloped and fragile financial market structure, as was the case in the United States in the 1930s.

As an example, for Simons, the existing financial structure generated the conditions for wholesale liquidation as banks were led to curtail loans when faced with unfavorable business conditions. Banks were forced to hoard and liquidate existing loans while individuals converted deposits into currency. In short, according to Simons (1933), the “speculative temper of the community” caused changes in the circulation velocity of money, which were magnified by the existing short term banking lending structure of the economy. Indeed, for him ([1936], 1962, p. 166):

“... the economy becomes exposed to catastrophic disturbances as soon as short term borrowing develops on a large scale. No real stability of production and employment is possible when short-term lenders are continuously in a position to demand conversion of their investments, amounting in the aggregate to a large multiple of the total available circulating media, into such media. Such an economy is workable only on the basis of a utopian flexibility of prices and wage-rates. Short-term obligations provide abundant money substitutes during booms, thus releasing money from cash reserves; and they precipitate hopeless efforts at

liquidation during depressions. The shorter the period of money contracts, the more unstable the economy will be ...”

This view of fiscal policy contrasts with the views developed by Keynes, following the discovery and adoption of the theory of theory of effective demand (1932) to explain employment and output, and by his followers, in particular, Abba Lerner.

In the *General Theory* (1936) (henceforth GT) Keynes, contrary to what most think, did not talk about fiscal deficits, but about the socialization of investment.⁵ His analysis of budget and fiscal policy followed the expenditure category logic of the *General Theory*: he sought to separate the budget in two components, a current (government consumption) and a capital budget (government investment). The capital budget was simply a survey of capital expenditure to keep it at an optimal level. As he put it: “a regular survey and analysis of the relationship between sources of savings and different types of investment and a balance sheet showing how they have been brought into equality for the past year, and a forecast of the same for the year to come.”

The distinction between a capital and an ordinary budget allowed Keynes to distinguish, in turn, between two types of fiscal policy: deficit budgeting (deficit finance) and capital budgeting. Deficit budgeting was a means to cure disequilibrium whereas capital budgeting “is a method of maintaining equilibrium.” Thus, contrary to the Chicago view, Keynes argued against a deficit budgeting strategy to smooth out the phases over the economic cycle and, in particular, he opposed extensive public works and the use of taxation to affect the level of consumption. Regarding the former he asserted: “a fluctuating volume of public works at short notice is a clumsy form of cure and not likely to be completely successful” (1980, p. 319). With regard to the latter he argued:

“In the first place, one has not enough experience to say that short term variations in consumption are in fact practicable. People have established standards of life. Nothing will upset them more than to be subject to pressure constantly to vary them up and down. A remission of taxation on which people could only rely for an indefinitely short period might have limited effects in stimulating their consumption. And, if it was successful, it would be extraordinarily difficult from the political angle to re-impose the taxation again when employment improved.” (ibid., p. 319)

For these reasons Keynes opposed the use of the current budget as a way to stabilize the cycle. Rather, the current budget should show a surplus, which would be transferred to the capital budget. He considered unbalancing the current budget as “a last resort, only to come into play if the machinery of capital budgeting had broken down” (ibid. p. 352).

Fiscal policy in the current global crisis in developed and developing countries

As an abnormal episode, where the instruments of monetary policy have reached their operative limits, the current global economic crisis has renewed the mainstream

⁵ Keynes (1980, p. 368). Though government is present in the GT, it is not a major player and does not appear on the same footing as entrepreneurs, speculators or consumers. In this sense, Keynes’s analysis of government, contained mostly in his *Collected Writings*, Vol. XXVII, truly marks its incorporation into the framework of effective demand.

profession's interest in activist fiscal policy. Indeed the current episode has led a wide spectrum of economists and moreover, all international organizations, including the World Bank and especially the International Monetary Fund (IMF) and the OECD to recommend that governments undertake expansionary fiscal policies to mitigate its effects on output and employment and more precisely to pave the way for the recovery.⁶

The IMF has explicitly argued in favor of a "timely, large, lasting, diversified, contingent, collective and sustainable" fiscal stimulus package (Spilimbergo *et al.*, 2008) and has recommended a global stimulus package of 2% of world GDP (Lipsky, 2009).⁷ The OECD entertains a similar view.⁸ Both the OECD and the IMF have been explicit regarding the composition of the fiscal stimulus packages.

The IMF has recommended that measures of the fiscal package include on the expenditure side investment spending and targeted transfer payments. On the revenue side, the recommended measures include, among others temporary reductions in tax rates, tax rebates, reduction in unemployment insurance contributions and exemptions. For its part the OECD, cognizant of the need to include both expenditure and revenue measures, prioritizes the latter over the former, as spending measures have the largest short-term impact on aggregate demand.

Following these policy recommendations developed (including the greater majority of the OECD countries) and developing countries in different regions of the world (including east and North Asia, North and Central Asia, South and South-West Asia, South East Asia, Middle East, Africa and Latin America) announced in 2009 stimulus fiscal packages with the aim of boosting aggregate demand.

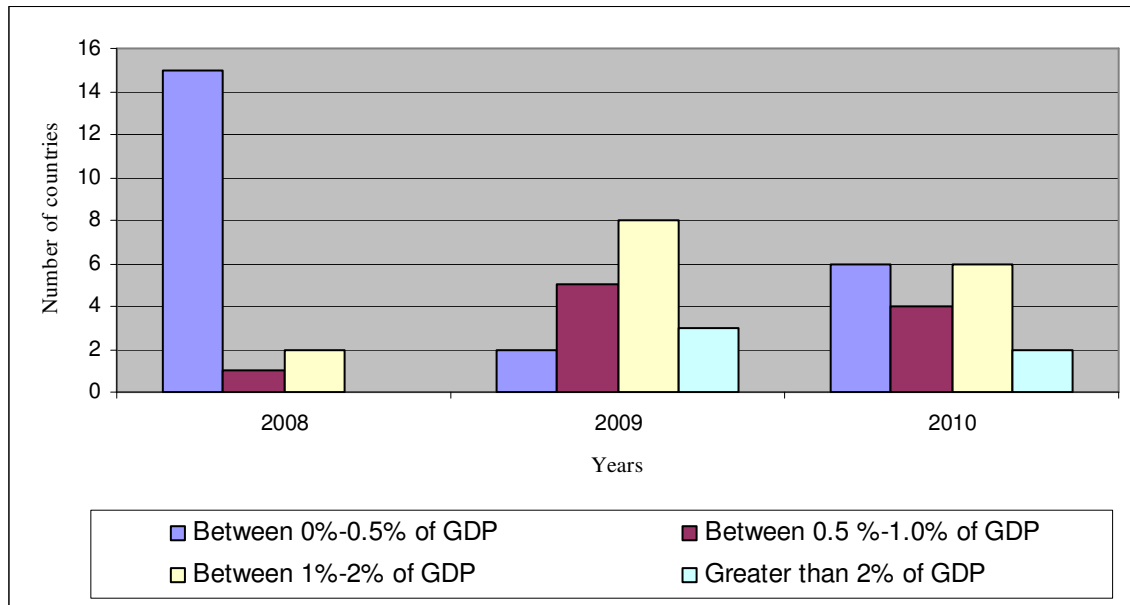
The fiscal packages differ in terms of size and magnitude, composition, scope and timing of implementation. However, overall, the fiscal packages have several shortcomings. They are small in size, and their multiplier effect is also expected to be small. For the world in the aggregate, the economic stimulus provided in 2009 represents roughly 1.3% of world GDP. More complete data available from the OECD for 18 developed countries show that on average the effect of fiscal packages over the period 2008-2010 is equal to 0.3%, 1.4% and 1.1% of GDP for 2008, 2009 and 2010 respectively. The combination of the data between countries, size of the stimulus packages in terms of GDP, and respective years, shows that for 2008, the greater majority of countries (15 out of 18 countries or 83% of the total) stimulus packages' ranged between 0% and 0.5% of GDP (See Figure 1).

⁶ Paul Krugman Joseph Stiglitz, Martin Feldstein, Stanley Fischer are some well know examples of mainstream economists that publicly favor and argue for an expansionary fiscal stance in the current circumstances. Barro and Redlick (2009) and Taylor (2009) are two examples of economists that are not in favor of expansionary fiscal policies.

⁷ See, also Freedman *et al.* (2009).

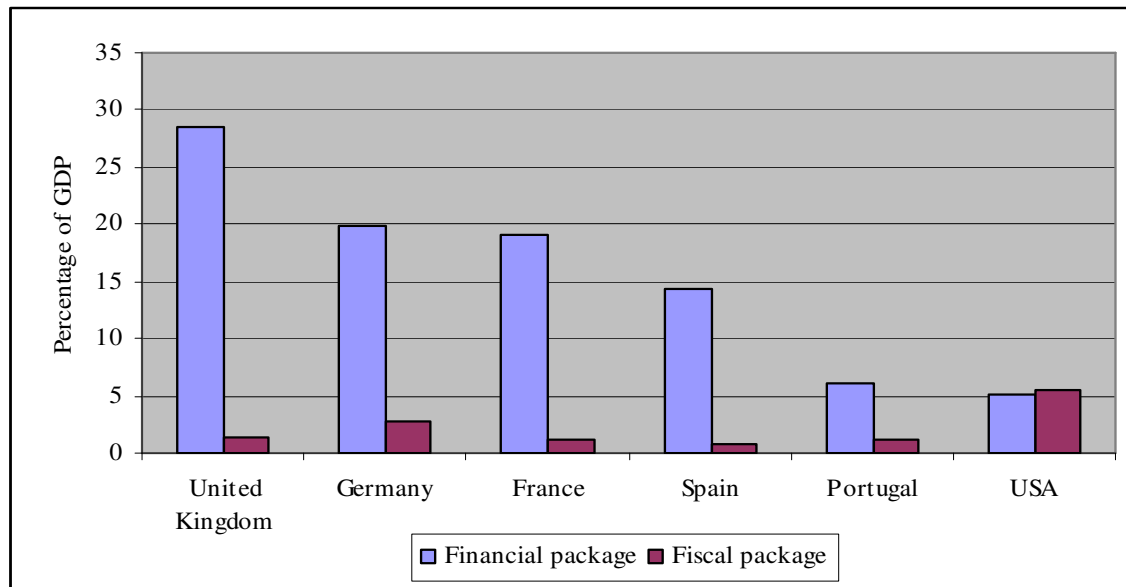
⁸ See, Statement by OECD Secretary-General to the International Monetary and Financial Committee (Washington D.C., 25 April 2009).

Figure 1: Fiscal stimulus packages announced by developed countries and classified by number of countries and their importance in terms of GDP (2009).



Source: On the basis of OECD (2009 a/c/) and Khatiwada (2009).

Figure 2: Comparison of the size of the fiscal stimulus and financial rescue packages (% GDP) for developed countries (2009).



Source: ILO (2009).

For the year, 2009, roughly half of the countries considered (8 or 44% of the total) have announced packages ranging between 1% and 2% of GDP while approximately a third (5 or 27% of the total) announced fiscal packages whose size ranges between 0.5% and 1% of GDP. Finally, for the year 2010, most fiscal stimulus packages remain small in size, but are more evenly distributed across countries. These range within 0%-0.5% of GDP for 6 countries, within 0.5%-1% of GDP for 4 countries, within 1%-2% of GDP for 6 countries and surpass 2% of GDP for 2 countries (See Figure 1).

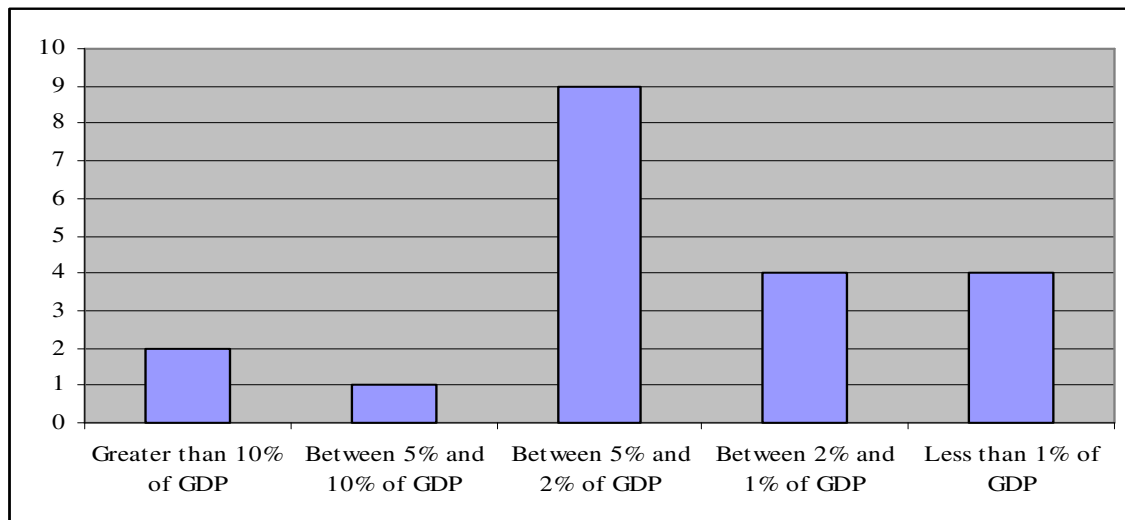
By comparison the efforts to salvage the financial sector in developed countries are literally huge and with the exception of the United States, dwarf that of the size of the fiscal packages. The size of the financial rescue packages represent 22, 18, 17, 7 and 6 times relative to that fiscal package for the United Kingdom, Spain, France, Germany and Portugal respectively (See Figure 2)

Developing countries have followed suit also announcing fiscal stimulus packages to combat the effects of the crisis. According to the available information the fiscal packages vary widely in size, scope and the time framework for their implementation (see Table 2).

In terms of size, these range in Asia and the Pacific from 1% to 13% of GDP (China and Malaysia respectively); in the Middle East from 1% to 9% of GDP (Egypt and Saudi Arabia respectively); in Latin America from 0.3% to 4.7% of GDP (Honduras and Mexico respectively). Overall, the average size of announced fiscal stimulus packages based on a sample of 20 developing countries is equivalent to 3.5% of GDP with a maximum and minimum of 13% and 0.2% of GDP, and a standard deviation which is equal to the mean (3.5% of GDP).

The classification of cross sectional data between number of countries and size of fiscal packages show that roughly half of the countries considered in our sample have announced stimulus packages ranging from 2% to 5% of their respective GDP. Also the number of countries that have announced stimulus packages greater than 5% of GDP is a minority (3 countries) (See Figure 3).

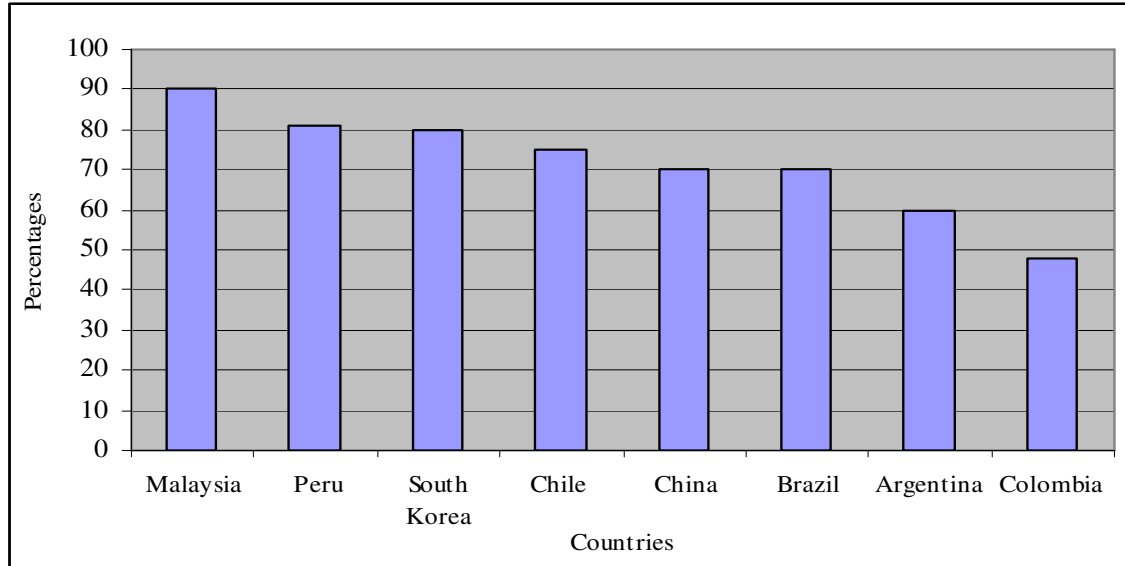
Figure 3: Fiscal stimulus packages announced by developing countries and classified by number of countries and their importance in terms of GDP (2009).



Source: ILO (2009); Khatiwada (200), IMF (2009 a/b/) and official sources.

Spending on infrastructure is one of the main components of the fiscal packages. A sample of eight developing countries including Malaysia, Peru, South Korea, Chile, China, Brazil, Argentina and Colombia shows that the infrastructure component represent at least 70% of the respective fiscal packages in six of these countries and represents 80% or more in three of these countries (including Malaysia, Peru and South Korea) (See Figure 4).

Figure 4: Infrastructure spending in fiscal stimulus packages (In percentages).



Source: Own computations on the basis of official data and Schwatz et A. (2009).

In terms of implementation, data is available only for a few developing countries. The available data indicates that roughly half of the countries in the sample plan to implement the totality of their fiscal stimulus in 2009. For the most part, countries' fiscal expenditure plans for 2009 amount roughly to no more than 1% of GDP. An accurate comparison of the different fiscal stimulus packages among and within regions is nonetheless a difficult task due to the absence of precise data regarding their size, composition, scope, and time framework for their implementation. Moreover, in some cases, such as Mexico, the announcement of expansionary fiscal measures has been followed by contrary policy announcements to actually increase taxes and reign in government spending.

Table 2
Selected Fiscal Stimulus Packages in the Developing World (by region, country, size of stimulus, date announced, period of implementation and composition)

Region	Country	Size (US\$ billion and % of GDP)	Date	Period of implementation	Composition	Effects	
						Deficit	Debt
Asia-Pacific	China	585 (13% of GDP)	Nov. 2008	US\$ 90 billion or 2% of GDP to be implemented in 2009	Expenditure measures (infrastructure accounts for 70% of the total)	0.6 -4.2 -3.2	17.3 19.0 20.7
	Korea	26 (4% GDP)	Dec. 2008	US\$ 11 to 14 billion dollars are expected to be implemented in 2009.	Roughly between 80 to 90% consist of expenditure measures and in particular on infrastructure.	3.5 -5.0 -3.8	27.2 28.2 29.9
	Malaysia	US\$ 2 or 1% of GDP US\$ 16 or 9% of GDP	Nov. 2008 Mar. 2009	....	Nov. 2008 package focuses mainly on infrastructure expenditure (close to 90% of the total). Fiscal injections represent 25% of the Mar. 2009 package.	-3.2 -8.0 -8.3	41.7 49.3 55.4
	Thailand	US\$ 3.3 (1.2% GDP) US\$ 42 or 10% of GDP	Jan 2009 Jun. 2009	The Jun. 2009 package will be implemented over 2010-2012.	Jun. 2009 package comprises mainly infrastructure expenditure measures.	-2.3 -5.6 -3.5	37.7 49.3 57.3
	Vietnam	US\$ 1 (1.1% of GDP) US\$ 17.6 (21% GDP)	Dec. 2008 Mar. 2009	....	....	-7.0 -9.0 -8.0	49.7 50.8 54.3
Middle East and Africa	Egypt	US\$ 2.1	Dec. 2008	...	...	-7.5 -6.9 -8.5	101.2 80.7 85.0
	Saudi Arabia	US\$ 49 or 9.4% of GDP	...	The government will spend US\$ 18 billion in 2009.	...	12.3 -0.3 3.0	24.8 21.9 16.3
	South Africa	US\$ 7 or 2.6% of GDP	...	The government will implement in 2009 half of the US\$ 7 billion stimulus package.	...	0.1 -4.5 -3.6	31.6 35.2 37.5

Note: In the case of Korea, the fiscal stimulus measures do not include the fiscal expenditure under the "Green New Deal Job Creation Plan" which plans to create close to 1 million jobs in a four year period with a fiscal cost of USD\$ 37 billion. In the case of Thailand, the Jun. 2009 package is termed the Thai Khem Khang or Thai Strengh. ... denotes not available.

Table 2 (continued)										
Selected Fiscal Stimulus Packages in the Developing World (by region, country, size of stimulus, date announced, period of implementation and composition)										
Region	Country	Size (US\$ billion and % of GDP)	Date	Period of implementation	Composition	Fiscal indicators (% of GDP)				
Latin America	Argentina	US\$ 30 or 5.2% of GDP	Dec. 2008	The implementation period began in 2009 and will continue in the case of some projects until 2015	Mainly tax measures, consumer loans and infrastructure (60%) and energy projects.	1.1	55.7	-0.9	52.5	
	Bolivia	US\$1.9 or 4.2% of GDP	Dec. 2008	The fiscal stimulus package is expected to be implemented in 2009	Oriented towards public investment.	-1.7	44.2	-2.5	44.4	
	Brazil	US\$ 10 or 0.7% of GDP	Dec. 2008	The time frame of implementation is 2008-2010	Tax breaks (US\$ 3.6 billion); and public works investment (US\$ 6.7 Billion).	-2.2	45.1	-2.8	41.8	
	Chile	US\$ 4 or 2.2% of GDP	Jan. 2009	The time frame for implementation is the year 2009	US\$ 1.5 billion earmarked for spending in infrastructure. Includes subsidies, tax rebates and US\$ 1 billion for capitalization of state cooper enterprise.	8.8	4.1	-4.0	11.2	
	Mexico	US\$ 54 or 4.7% of GDP	Oct. 2008	US\$ 18 billion or 1.6% of GDP are budgeted for 2009.	Price freeze, credit facilities, and firm support	0.0	31.4	-4.0	42.5	
	Peru	US\$ 3.2 or	Dec. 2008	Implemented in 2009. The first phase of the package was implemented as of January 2009 with a disbursement of US\$ 1.4 billion.	Infrastructure (US\$ 2.6 bn), credit lines for Small and Medium Enterprises export oriented firms (US\$ 43 million); and social expenditures (US\$ 18 million).	-2.0	41.1	0.6	46.5	
								-4.6	51.3	
	Costa Rica	2.8% of GDP	Jan. 2009	Implemented in 2009.	0.8% of GDP increase in public investment and 2.0% of GDP in increase in the government's wage bill and transfers.	-3.6	54.0	0.6	46.5	
								-4.6	51.3	
								-3.6	54.0	

Note: In the case of Korea, the fiscal stimulus measures do not include the fiscal expenditure under the "Green New Deal Job Creation Plan" which plans to create close to 1 million jobs in a four year period with a fiscal cost of USD\$ 37 billion. In the case of Thailand, the Jun. 2009 package is termed the Thai Khem Khang or Thai Strenght. The fiscal indicators include the budget balance and public debt expressed as percentages of GDP for 2007, 2009 and 2010. ... denotes not available.

Sources: ILO (2009); Khatiwada (2009); Schwartz et Al. (2009), IMF (2009 a/b/) and on the basis of official sources.

The relatively small size of developed and developing country fiscal stimulus packages is compounded by the fact that the multiplier effect is also estimated, in general, to be very modest. A summary of a set of multiplier range values presented in table 3 for one and two years for ten developed countries for tax and spending measures undertaken by different authors, in different years and using different techniques,⁹ shows disturbing results regarding the effects of the multiplier on economic activity.

The table shows that the multiplier can be negative (that is it can cause a contraction in economic activity) in some cases (Australia, Canada, Germany and the United Kingdom) and that with a few exceptions (Canada, Japan and the United States) the multiplier is less than one. However, it is important to take those results with a grain of salt, since in many cases the multiplier effects, which depend on a variety of different circumstances, are computed on the basis of models that do not allow for significant effects of autonomous spending on the level of activity.

Country	Tax measures		Expenditure measures	
	One year	Two years	One year	Two years
Australia	(-0.6; 0.4)	(-1.7; -1.2)	(-0.3; 0.6)	(0.0- 1.4)
Canada	(-0.4; 0.4)	(-0.2; 1.6)	(-0.3; 1.0)	(-1.1; 0.7)
France	(0.1; 0.3)	(0.1; 0.4)	0.5	....
Germany	(-0.3; 0.7)	(-0.6; 0.7)	(0.4; 0.6)	(-1.1; -0.8)
Japan	(1.7; 2.6)	(0.9; 1.9)	0.5	0.3
Netherlands	0.1		0.4	
Spain	(0.1; 0.2)	(0.1; 0.2)		
Sweden	0.3		0.4	
United Kingdom	(-0.4; 0.2)	(-0.7; 0.2)	(-0.3; 0.5)	(-0.9; 0.0)
United States	(0.3; 1.3)	(0.5; 2.8)	(0.5; 2.0)	(0.3; 1.9)

Source: On the basis of Spilimbergo (2009) and official sources.

A similar result is obtained in the case of developing countries as a whole, where the multiplier has been estimated to be less than one and equal to on average to 0.6-0.7. In the case of East Asia, some of the most recent estimations indicate that the average multiplier is 0.67 (Bank of America-Merrill Lynch, August 2009). This would imply a significant amount of crowding-out, that is, public spending having a negative impact on private spending. Again it must be noted that this result might be a feature of the models used. According to Auerbach and Gale (2009) fiscal stimuli tend to be more effective, and the multiplier effects larger, when the economy is close to the zero bound limit for the rate of interest.

⁹ Although there are different factors that limit the multiplier effect of fiscal expenditure, this is partly explained by the fact that the fiscal stimulus packages show a bias towards tax measures. On average, tax revenue and expenditure measures are estimated to contribute 58% and 52% to fiscal stimulus measures. At the country level, in the case of 10 countries (59% of the total), tax revenue measures contribute more than 50% to the fiscal stimulus packages.

Table 4
Fiscal deficits, public debt and increase in public debt for selected developed countries
2008-2010

Country	Fiscal deficit resulting from discretionary measures (% of GDP)	Public debt (% of GDP)			Increase in public debt (% of GDP)
	Accumulated 2008-2010	2007	2008	2010	2010-2008
Australia	-4.6	15.4	14.2	20.7	6.5
Austria	-1.1	59.5	61.7	75.4	13.7
Belgium	-1.6	84.0	92.7	103.0	10.3
Canada	-4.1	64.2	62.7	75.4	12.7
Denmark	-2.6	26.8	27.4	32.7	5.3
Finland	-3.2	35.7	36.3	41.0	4.7
France	-0.6	63.8	72.2	88.0	15.8
Germany	-3.0	65.0	64.8	80.4	15.6
Japan	-2.0	167.1	172.1	197.3	25.2
Luxemburg	-3.6	4.7	16.5	20.7	4.2
Netherlands	-1.5	44.9	55.3	64.6	9.3
New Zealand	-4.3	20.6	23.6	35.1	11.5
Spain	-3.5	36.2	45.9	64.1	18.2
Sweden	-2.7	41.7	43.6	46.6	3.0
Switzerland	-0.1	43.5	48.0	52.8	4.8
United Kingdom	-1.5	44.2	54.1	90.5	36.4
United States	-5.6		71.9	100.0	28.1
Average	-2.6	50.2	56.6	69.9	13.3
Average a/		40.4	47.9	59.4	11.5

Notes: a/ Excluding Japan and the United States.
Source: OECD (2009 b/ c); Watt (2009); ILO (2009); Khatiwada (2009).

Finally, it is to be noted that the contribution of fiscal stimulus packages will not substantially increase fiscal deficit or public debt levels. On average for developed economies the fiscal stimulus packages will contribute to an increase in their fiscal deficits of 2.6% of GDP (with a maximum of 5.6% of GDP for the United States and a minimum of 0.3% of GDP for Switzerland) but on an accumulative basis over the 2008 to 2010 period (See Table 4). However, on a yearly basis, the average increase in the budget deficit will reach less than 1% of GDP.

In terms of public debt, the fiscal stimulus packages are expected to increase public debt from 56% to 70% of GDP on average. Some countries such as Belgium, Japan and the United States are expected to reach public debt levels by 2010 that are at least equivalent to 100% of their respective GDP.

However, these results are not the exclusive product of the fiscal stimulus packages. They are rather largely explained by initial conditions independent of the effects of the crisis and the announcement and implementation of fiscal stimulus packages. In 2006 and 2007, Belgium, Japan and the United States had public debt levels that were situated at the upper end of developed country international standards. In fact, if Belgium, Japan and the United States were excluded from the sample, public debt levels would have reached, on average, for our sample of developed countries, 48% in 2008

increasing only to 59% in 2010. In other words public debt would increase by less than 5% of GDP per year on average from the time of the contraction (2008) until the date of the expected recovery (2010) (See Table 4).

For developing countries the effects of the fiscal stimulus packages are mixed across different geographical regions. Nonetheless, for the most part, their impact on the fiscal position of the governments and especially public debt levels are not above historical standards.

In the case of Latin America, the packages are not expected to affect substantially the budget positions or the public debt levels. In the case of Latin America, the budget balance, which was positive in 2007 at around 0.4% of GDP, turn negative in 2008 and may reach roughly a manageable -2% of GDP by 2010. It is important to note that primary surpluses have been maintained, meaning that a great deal of the fiscal effort goes to interest payments. Even if public debt grows the falling trajectory of the recent period implies that debt expansion is sustainable.

In the cases of the Asia-Pacific and African regions, budget deficits will increase, but debt levels will remain below 50% of GDP. In the case of the Asia-Pacific region, which registers the largest fiscal stimulus packages, deficits will increase from -2% to -5% of GDP. Debt levels, however, are expected to be contained between 40% and 50% of GDP. Finally, for the Middle East and Africa, the budget position will be negative for South Africa and Egypt but remain in surplus for Saudi Arabia. Public debt levels are expected to be below 20% of GDP for Saudi Arabia and below 40% for South Africa (See Table 2, above).

Concluding remarks

As argued above the theoretical construct of mainstream economics is impervious to fiscal policy. It is not considered a sensible policy or strategy; it is 'neither desirable nor politically feasible' (Eichenbaum, 1997). It becomes, as past historical examples and the present crisis episode shows, a sensible policy 'by default,' in abnormal times when all else has failed or is impracticable. When recession hits, the mainstream rhetoric, calls upon 'a courageous fiscal policy' to pump the recovery prime.

At the same time, notwithstanding the rhetoric, the current crisis episode shows that in practice the fiscal stimulus packages are of a small size. Also, the modest size of the multiplier, even though they might be bigger than reported, indicates that these are expected to have weak effects on output and employment in the majority of cases. Moreover, also in the majority of cases, the packages can hardly be said to endanger future fiscal solvency or macroeconomic stability. The danger to fiscal solvency and macroeconomic stability may come instead from the substantial rescue packages of the financial sector.

Finally, the historical record is consistent with these findings as it is hard to provide robust empirical evidence that for the most part developed and developing countries have traditionally adopted a countercyclical fiscal stance. Evidence presented by Kaminsky *et al.* (2004), for the period 1960-2003 for 104 countries, including developed and developing countries worldwide, shows that the correlation coefficient between the cyclical component of real GDP and real central government expenditure is positive (pro-cyclical) for the majority of countries under study. Only twenty countries

(19% of the total) exhibit a negative correlation (countercyclical fiscal stance) between both variables.

At a more detailed level of analysis, for this subset of countries the correlation coefficient is significant at the 5% level only for 11 countries (10% of the total) among which are 9 OECD countries. These 9 OECD countries represent 38% of total OECD countries. In other words, 62% of OECD countries have not traditionally engaged into countercyclical fiscal policy strategies.

This contradictory position between the rhetoric of fiscal activism and actual practice, which highlights the irrelevance of fiscal policy, follows from a simple fact. Mainstream economists and also the great majority of policy makers believe ultimately that the economy will return to the pre-contraction historical growth path.

The mainstream models of the business cycle assume that market economies, and in particular, developed market economies, tend to operate around their ‘natural’ or full employment (i.e., potential) levels, given by the long-run trend output level. Monetary and real shocks can produce a divergence between the actual and full employment (potential) output levels. Overtime, following a temporary shock output returns to its full employment (potential) trend path. From here follows the idea, that deviations of output from its trend, or recessions are followed by expansions of similar magnitude. In other words, deep (mild) recessions are followed by sharp (mild) recoveries.

An illustrative example of the belief in the self-adjusting nature of the economy is provided in a recent statement of the Council of Economic Advisors of the President of the United States: “a key fact is that recessions are followed by rebounds. Indeed, if periods of lower-than-normal growth were not followed by periods of higher-than-normal growth, the unemployment rate would never return to normal.”¹⁰ Another illustrative example is provided by the IMF, according to which, following the trough in economic activity in 2009, the world as a whole is expected to return to its historical trend growth path in the years 2010-2011.

The IMF as other international organizations and think tanks expect the developing world to recover faster than the developed world due mainly to the fact the bulk of the effects of the crisis occurred in the developed world. In fact, the developing world is forecasted to grow in 2010 within a 4%-5% range recovering its pre-crisis growth rate, one year after registering the worse of the effects (the 2009 rate of growth will be negative ranging between -1% - -2%). In the case of the developed world, recent estimations for France, the United Kingdom and the United States, indicate that these countries will regain their actual pre-crisis historical growth trends by 2011-2012.¹¹

Yet the prospects for world economic recovery are mixed making it increasingly difficult to sustain that the world economy will recover quickly from the current recession, especially in light of the rising and persistent unemployment figures. These arguments provide fertile ground to argue that in fact fiscal stimuli have proven to be inefficient and to underscore the failure of fiscal policy *tout fait* giving credence to the conceptual strength and coherence of mainstream economics.

From our point of view, the uncertain prospects for recovery simply underscore the fact that free market economies lack the mechanisms to bring about and maintain full employment. Full employment requires designing and making operational institutions at

¹⁰ Council of Economic Advisors, February 28th, 2009.

¹¹ See IMF (2009 c/d/e/f)

the national and global levels that can manage aggregate demand. This necessitates in turn a re-thinking of the role and scope of fiscal policies escaping from the patchy, short-run character, which dominates the consensus mainstream view.

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