

Reorientation of Economic Policy: Employment (Not Fiscal Consolidation) as a Priority

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1. Introduction

The recovery from the crisis is fragile. There is a risk that fiscal stimulus packages are being withdrawn too soon in developed countries, especially in Western Europe, in an attempt to balance budgets. This could well lead to a double-dip recession and might not solve the fiscal problem since tax receipts will fall rather than rise. After a wide consensus around the need for active policies for supporting demand, many policy makers presently support a shift from fiscal stimuli to fiscal consolidation (IMF, 2011). It is important to understand that in the current policy debate, which is not only about choosing between different policy goals, but it also reflects, explicitly or implicitly, different views on economic mechanisms and on the role of governments.

An argument frequently advanced in support of fiscal consolidation is that, even if at the beginning of the crisis active fiscal policies were useful, there is no more fiscal space for extending them. However, if fiscal space is defined “as room in a government’s budget that allows it to provide resources for a desired purpose without jeopardising the sustainability of its financial position or the stability of the economy” (Heller, 2005), but it would be a mistake to consider this room as exogenously determined rather than a largely endogenous variable.

It is important to emphasize, at this point, that a general misconception in the debate on fiscal consolidation is the mix-up of policy measures or instruments with policy results. Fiscal consolidation (i.e. the improvement of the fiscal balance), which is actually a policy result, tends to be seen as equivalent to fiscal tightening, which is a policy measure. However, fiscal tightening (i.e. increasing taxes and/or cutting expenditures) may improve the fiscal balance, but it could also lead to a deterioration of the fiscal balance. On the other hand, fiscal consolidation can also result from an

¹ The views expressed in the text are the author’s and may not reflect the position of the institution to which he is affiliated.

expansionary fiscal policy stance. The final result will depend on the macroeconomic effects of fiscal measures, in particular on how they affect economic growth and, in turn, fiscal revenues. Therefore, it is important to clearly distinguish between fiscal consolidation as a result of policies and fiscal tightening or expansion when referring to different fiscal policies.

It seems that most calls for consolidation are in fact demands for fiscal austerity. In the case of developed countries, these calls for austerity result from fears of increasing public debt. Within the context of the two speed recovery, it is important to distinguish between debt crises in developing and developed countries. Most of our knowledge about sovereign debt crises arises from the experience of the developing countries. The evidence seems to suggest that contractionary efforts were not particularly successful, and that usually debt sustainability was achieved by promoting higher rates of economic growth.

The rest of the paper is divided in four sections. The following section discusses the main challenges to fiscal policy after the Great Recession, namely: the early pressures for fiscal consolidation and the specific fiscal challenges of resource rich developing countries. The question of fiscal space is discussed next, emphasising the need for a dynamic understanding of the ability to pursue certain objectives without leading to unsustainable accumulation of debt. Finally, the question of public debt accumulation is briefly analyzed. A brief conclusion follows.

2. Fiscal policy challenges

The crisis prompted a rethinking of macroeconomic ideas, as monetary policy showed its limits and the governments were called back as borrowers and consumers of last resort (Blanchard, Dell'Ariccia and Mauro, 2010). It seems however that the acceptance of short-term fiscal stimulus and higher inflation targets did not involve a revision of macroeconomic principles, but just a minor adjustment of policy which would be valid only during exceptional circumstances. In fact, influential policy makers have returned to traditional themes and called for fiscal adjustment. In most advanced economies, they claim that abating too high public debt levels should be the priority goal, even if the recovery is rather moderate and fragile. They also call for

fiscal adjustment in developing economies where debt ratios are generally much lower and have recovered their pre-crisis growth rates, on the grounds that they should prevent overheating and reconstitute the fiscal buffers that could be depleted in case of a new crisis episode (IMF, 2011).

In this view, fiscal space would be the scope for further increases in public debt without undermining sustainability. Such debt limit is difficult to identify in theory, since it depends on the interest rate, economic growth and primary fiscal balances. First, the interest rate is itself a macroeconomic policy variable, and this implies that monetary policy might have a significant impact on debt sustainability. Second, GDP growth and, as tax revenues rise with national income, the primary balance, are influenced by debt financed government spending. Further, identifying public debt as unsustainable when it is growing (Ostry, et al., 2010: 4) might not take into consideration that other factors that are actively reducing the debt burden will eventually come to dominate the debt-to-GDP dynamics. In other words, debt-to-GDP ratios may be growing only temporarily in the short run, and their growth might be instrumental to increase GDP growth and reduce the debt burden in the long run.

In a different but complementary approach, some authors estimated a threshold for public debt ratios that an economy could not surpass without negatively affecting growth rates, which in turn would undermine fiscal solvency; this critical level was estimated to be 90 per cent of GDP for developed economies and 60 per cent of GDP for emerging economies (Reinhart and Rogoff, 2010). The finding that developing countries are constrained by lower debt ratios seems to be linked by the propensity to issue foreign currency denominated debt and to foreign ownership of the debt in those countries. In practice, as noted by Nersisyan and Wray (2010), out of 216 observations of debt-to-GDP ratios, only 5 are for levels of debt of over 90 per cent, which may not be sufficient to conclude that high debt ratios are correlated with low levels of economic growth. More importantly, correlation does not necessarily mean causation.

IMF simulations find an ambiguous effect of fiscal adjustment on growth, involving short-run temporary costs, but also more permanent GDP gains. The losses are expected to be entirely offset by gains after five years (FMI, 2010: 111-112). A

central mechanism that is expected to moderate the short-term costs of fiscal adjustment and deliver long-term gains in advanced economies stems basically from the reduction of interest rates that would be associated to lower debt ratios (Bornhorst et al., 2010). This negative relationship between real interest rates and the level of public debt, however, is far from evident. In a set of advanced economies, either the correlation between the two variables is weak and statistically not significant or (more frequently) it goes in the opposite direction than that expected: higher debt is actually associated to lower interest rates and vice-versa. The same results are obtained when real interest rates are compared to the changes in public debt ratios: a reduction in that ratio is associated to higher, not lower interest rates (Figure 1).²

Hence, one cannot take for granted that a successful fiscal consolidation will lead to lower interest rates, since rates of interest can be managed by monetary authorities. But even if it did, this will not necessarily deliver an improvement in demand, investment and growth. In fact, in the advanced economies that were severely hit by the financial crisis, the private sector has not yet concluded the de-leveraging process, in which non-financial agents try to reduce their indebtedness and banks try to restore their capital ratios. In such a “debt-deflation crisis” (Irving Fisher, 1933) or “balance sheet recession” (Richard Koo, 2010), low interest rates and fresh credit cannot be expected to be the driving force out of the crisis. In such a situation, monetary policy has asymmetrical outcomes: monetary tightening could make things worse, but monetary expansion will have little stimulative effect: to rely on monetary or credit expansion is like “pushing on a string”, while fiscal entrenchment would be fully effective in putting the brakes to economic recovery. If this weakens GDP growth and fiscal revenues, fiscal consolidation itself may not be achieved.

The evidence for fiscal austerity is also not particularly encouraging. In order to obtain IMF support, governments find themselves obliged to adjust the current account deficit through a reduction of domestic absorption (including fiscal retrenchment), which normally entails a cost in terms of GDP growth. Those eventual costs are evaluated by the IMF staff, and reflected in the Letter of Intent (LOI) signed by the governments. These LOIs contain economic forecasts and goals to be reached

² Further, it is important to note that causality here may also run in reverse, from the rate of interest to debt, since total debt is affected by interest payments.

by the countries; it is interesting to compare their short-term forecasts (e.g. concerning the year following the signature of the LOI) with the actual results of the programmes. Figure 2 presents the cases of countries that resorted to the IMF because of a financial crisis in two periods: the late 1990s and early 2000s, and the present crisis. It is possible to see similar patterns.

The crisis-recovery packages recommended by policy-makers, including IMF, during both episodes present a systemic overestimation of the private sector's willingness and ability to recover – or underestimation of the time that it takes for investment and consumption to return to previous levels. There is a divergence between the estimated GDP growth during crisis recovery periods on the horizontal axis (calculated by the IMF on the assumption that countries would put their policies into place), vis-à-vis the actual GDP that was experienced (vertical axis). An imaginary 45 degree line running through the graph indicates what would be a one-to-one mapping between estimate and experience. All countries are located to the right hand side of that line, with the exception of Russian Federation in the late 1990s and Iceland in the late 2000s, indicating that outcomes systemically failed to live up to expectations. Actual gaps are sometimes sizeable: in 1998 Indonesia was forecast to experience 5% GDP growth but in fact experienced minus 13%; Thailand was expected to achieve 3.5% growth but actually contracted by 10.5%; Korea was expected to achieve 2.5% growth but actually recorded minus 5.7%. In recent years, the overestimation in growth outcomes exceeded 5 percentage points in Latvia, Georgia, Serbia and Hungary.

Differences between LOI forecasts and actual outcomes are also systematic in the case of current account and fiscal balances. There is a clear bias to underestimating current account adjustment, while the LOI are overly optimistic in the forecasts of fiscal consolidation. It appears that fiscal adjustments and GDP contraction were excessively severe in order to attain a desired adjustment in the current account; or that the architects of the programmes did not expect these costs to be so high in those countries.

Misjudgements on the effects of fiscal tightening seem to be the rule rather than exception in IMF-backed programmes. A detailed examination of fiscal adjustment in 133 IMF-supported programmes in 70 countries carried out by the IMF's Independent

Evaluation Office notes that there was “a tendency to adopt fiscal targets based on over-optimistic assumptions about the pace of economic recovery leading inevitably to fiscal under performances” and “over-optimistic assumptions about the pace of revival of private investment.” The report observes that “a more realistic assessment in certain circumstances could have justified the adoption of a more relaxed fiscal stance on contra-cyclical grounds” (IMF-IEO, 2003: 3).

The IMF is also pushing for fiscal tightening in fast-growing and developing countries with low public debt levels, which seems contradictory with their preoccupation with counter cyclical policies in developed countries for the reason that public debt levels are high. In particular, governments benefiting from high fiscal revenues owing to high commodity prices should refrain to expand public spending and rather reconstitute financial buffers to be used in times of falling or low commodity prices (IMF, 2011). Of course, if one followed the logic discussed above, it is not clear that fiscal adjustments would actually deliver counter-cyclical effects, because they could further boost investors’ confidence and crowd in more private investment. But in any case, it is true that economic authorities in natural resource-rich countries face specific challenges in their management of fiscal policy, especially in developing and transition economies, where a significant part of government revenues are originated in extractive industries.

These challenges relate, on one hand, to the high volatility of prices of hydrocarbons and mineral resources, which makes government revenues uncertain and unstable, and may lead to boom and bust cycles in expenditure. On the other hand, as natural resources are exhaustible and will eventually be depleted, fiscal authorities also need to address issues of long-term fiscal sustainability and intergenerational distribution of the proceeds of the natural resources. In addition, macroeconomic management in these countries may be complicated by problems of Dutch Disease, as the foreign exchange earnings from the exports in the extractive industries may lead to an appreciation of the currency, which would lead to a loss of competitiveness of other non-resource based sectors of the economy, such as agriculture and manufactures.

Governments in resource-rich countries need to address difficult choices regarding fiscal policies. Initially, a pre-requisite for them to have the fiscal space which is

necessary to run countercyclical fiscal policies and to meet their development objectives, is that they obtain an adequate share of the rents of primary resources. Thus, a fair fiscal regime regarding the distribution of these rents between the government and the private sector, often foreign transnational corporations, should be guaranteed (TDR 2005, chapter III and TDR 2010, chapter V.5). During the commodity price boom of 2002-2008 a number of commodity exporting countries revised their fiscal regimes. These revisions may have paused, or even reversed in some cases, with the eruption of the global financial and economic crisis as the bargaining power of governments was reduced, but continued afterwards with the renewed price increases in 2010-2011.

Once the government receives the revenues from the natural resources, it must decide which share will be spent and which will be saved, either for macroeconomic stabilization purposes – in order to use them in the bad times – or for future generations. For the part to be spent, expenditure can take the form of current consumption or of capital expenditure for building physical and human capital. These choices will have different implications for long-term growth and development, as in the case of capital expenditure it may allow to improve infrastructure and expand the productive capacities in the country and thus facilitate diversification and structural change and reduce commodity dependence. Current expenditure in education and health can also provide a significant contribution to growth by increasing labour productivity. To the extent that all these expenditures increase the production capacities, they will also benefit future generations. Using government revenues from the extractive industries to raise public investment, for instance in infrastructure, presuming that investment in this sector does not increase imports disproportionately, would also be a way to diminish Dutch Disease effects by increasing productivity and competitiveness of the non-resource sectors of the economy. Finally, expenditure can be directed to imports or to domestic goods, which may also provide some stimulus to domestic supply. However, expenditure on imports of capital and technology goods may be particularly necessary in the poorest countries to promote long-term development.

Since resource-rich countries are particularly vulnerable to external factors, policies aimed at creating fiscal policy space during good times are even more important than

in other countries. Without discretionary fiscal policies, these economies tend to endure strong economic fluctuations. In fact, in resource-rich countries, automatic stabilizers that could help counter the external shock are weak or totally missing. In case of falling commodity prices, economic activity contracts and, at the same time, the fiscal balance deteriorates. Such deterioration does not come from lower taxes paid by nationals or from, for example, higher transfers to the unemployed; they are just the result of lower public revenue from the reduction in exports income. Hence, a fiscal deficit will lack any significant automatic stimulus element. Similarly, during periods of high commodity prices, increases in public revenues do not entail any restrictive effect on domestic demand because they do not subtract income from domestic taxpayers. In other words, these countries cannot rely on automatic stabilizers, and must therefore set in place policy rules and mechanisms for creating space for countercyclical policies.

More importantly, the particular problem of resource rich countries suggests that they need to diversify their production and export structure for governments to become less dependent on the revenues obtained from only a small basket of commodities, whose prices are highly volatile. In this context, it is important to integrate the extractive industries into the national development strategies, transforming the natural resources into physical and human capital in such a way that it allows diversifying these economies and achieving long-term economic growth and employment opportunities. This will, in turn, reduce fiscal vulnerabilities and expand fiscal space.

3. A dynamic understanding of fiscal space

At the inception of the Global Financial Crisis it seemed relatively clear and it was consensual that governments, in the developed and developing world, had sufficient fiscal space to cope with the economic downturn. Although, there was early on a significant consensus that expansionary fiscal policy was needed to overcome the crisis (Spilimbergo, et al. 2008), the increasing levels of debt have led, in certain quarters to a fast reversal in public opinion and a demand of fiscal tightening to avoid the perceived risks of higher levels of public debt. This view is in line with conventional wisdom, which tends to suggest that as families cannot spend more than they earn, governments too should mind their purse.

It is important to note, however, that if every economic agent restrains its spending, the flow of income must fall. Unless, some other agent is willing to spend, the logic of “tightening the belt” is counter-productive for the economy as a whole. Income can only be generated if somebody spends by definition. It is evident that economic agents can borrow money to spend. But again conventional wisdom would suggest that borrowing only postpones the problem, since loans and debts have to be repaid eventually. Hence the common sense idea that if families tighten their belts during a crisis, the same must be true for the government.

In this context, only the government can increase spending, in domestic currency, and reverse the downward spiral of less spending and reduced income and employment. Further, since a certain amount of spending takes place on the basis of credit, there is a relation between expenditures and debt, for the economy as a whole, in which part of the debt is private (families and firms) and part is public. If private debt falls, and everything else remains constant, spending would have to fall. In this case public debt would have to increase in order to support spending, and it can only be reduced once the private ability to increase indebtedness has been re-established.

If government spending has an effect on economic activity, and, as a result, if it leads to higher rates of growth than increases in indebtedness the debt-to-GDP ratio would tend to fall (Barba and Pivetti, 2009). In addition, higher fiscal expenditure does not necessarily translate into an equivalent increase in the primary fiscal deficit, because it may also generate (or preserve) some fiscal revenues; on the other hand, one must assess the evolution of the interest rates on public debt, which some analysts link to the level or the evolution of that debt. In other words, it is necessary to evaluate the whole impact of fiscal stimulus on fiscal deficit and growth. If fiscal stimulus impact on growth is greater than its effect on the overall fiscal balance, then the government does not have a solvency problem, even if deficits are large in the short run. The question of sustainability of public debt is then central for any discussion of the appropriate fiscal policy, and the variables that determine sustainability, fiscal deficits, GDP growth and public debt interest rates are central to understand fiscal policy.

Interest rates on public debt are affected by monetary policy, since they tend to fall when the central bank reduces the short-term interest rate. This is to be expected, since government bonds, bills and other low risk assets still pay a liquidity premium vis-à-vis the basic monetary rate, but, unless there is a reason for believing that they pose an additional risk, the liquidity premium should not change and the bond and bill rate should follow approximately the ups and downs of the basic rate.

The central bank can also directly interfere in the bond markets and influence the long-term rate of interest. Quantity easing (QE) is used when setting the short-term interest rate is insufficient to affect economic spending, and the central bank directly targets the long-term rate. In that case the central bank buys government bonds in secondary markets, signalling that interest rates will remain low and stimulating spending (Bernanke and Reinhart, 2004).

More importantly, lower long-term interest rates imply low levels of debt service for the public sector, increasing the fiscal space, since resources allocated to interest payments can now be used for other purposes. In this sense, QE underscores the important interdependence between monetary and fiscal policy. It is not simply the case that fiscal policy is more efficient when short-term nominal interest rates reach their lower zero bound limit (Christiano et al., 2009; Woodford, 2011), which is certainly the case, but also monetary policy, in the form of maintaining lower rates on long-term government debt, provides an essential lever for fiscal policy efficiency.

An important qualitative aspect of fiscal space is that the way in which the public sector spends and taxes is not neutral, with different policy choices being more disposed to generate an amplification of the room in the public sector's budget allowing for resources to be committed to specific objectives. This approach has been sometimes referred to as functional finance, since it concentrates in the function that spending and taxing have in the economy, rather than a priori suggesting that all types of fiscal intervention have similar effects (Berglund and Vernengo, 2006).

In principle, as noted by Spilimbergo et al. (2008), spending should have an immediate advantage over tax cutting, simply because it directly leads to purchases and increased demand, while the latter requires that economic agents spend the

proceeds of their tax returns. This is even clearer in the case of situations in which the private sector is highly indebted, since part of the tax proceeds would be used for repaying outstanding debts rather than consumption and investment.³ Further, it would be expected that in a more open economy some of the effects, both of government spending and tax cuts, would leak to the foreign sector, in which case a concerted global effort would certainly work more efficiently, and the evidence seems to corroborate this view (Ilzetzki et al., 2010).

Further, spending in sectors with larger employment multipliers seem also more suitable to the task of promoting recovery. In other words, some types of spending are bound to have, not only a larger spending multiplier, more additional spending for each dollar the public sector spends, but also a larger employment multiplier, more workers hired for the same amount of money spent. Besides the obvious social advantages of increasing employment, this type of expenditure, by reducing the spending on the safety net for the unemployed, frees resources for other purposes, increasing fiscal space.

Moreover, it would seem that social spending – in unemployment benefits, education, health, housing, pensions and other benefits for low income groups – is a sensible way to promote a recovery, enhancing fiscal space by allowing levels of consumption to be maintained during a crisis, reducing poverty levels, and by increasing productivity, all of which allow more spending and higher rates of economic growth. Lindert (2004) refers to the fact that social spending has a positive effect on long-term growth as the “Free Lunch” Paradox. This suggests that income distribution considerations might have an impact on the implementation of fiscal policy, and not only spending that promotes growth, but also spending that privileges low income groups, with higher propensities to spend, would also be, in principle, an effective way to increase fiscal space.

The way taxes are levied is also an important instrument to deal with recessions without creating an unsustainable increase in public debt. Cuts on social contributions

³ Barro and Redlick (2011) argue that the evidence on the relative effects of government spending vis-à-vis tax cuts for the United States is unreliable. The evidence presented by Zandi (2008), in contradiction, suggests that government-spending programs are more stimulative than tax cuts.

taxes, which tend to have a regressive incidence, should in principle generate a higher income effect than corporate tax cuts. Zandi (2008) suggests that the evidence for the United States backs this proposition. Reductions of sales and value added taxes (VAT), if passed on to prices, would also have a relatively large effect on the level of activity. Finally, income tax cuts should be targeted to the lower income groups with higher propensities to spend. It is expected that tax cuts would have a negative impact on the overall revenue, at least in the short run, but, to the extent that the level of activity recovers, tax rates could be returned to the original levels, minimizing the long-term effects on the fiscal accounts.

Beyond the question of how expenditures and taxes are implemented, which may or may not be fiscal space enhancing, the overall economic context in which fiscal policy is implemented is also important in determining the size of the multiplier. Ilzetzki et al. (2010) highlights the importance of an exchange rate regime that precludes significant appreciation which would weaken the positive effects of fiscal expansion. This concern is related to the conventional view which suggests that fiscal expansions increase interest rates, leading to capital inflows, ultimately creating pressures for appreciation.⁴ A managed exchange rate regime can avoid appreciation and reduce the leakages of domestic demand to foreign markets. In other words, monetary policy by managing not only the interest rate, but also the exchange rate is an essential element to expand the fiscal space available to the public sector.

In this context, fiscal space tends to be smaller in countries which are more vulnerable to speculative capital flows. To the extent that volatile capital flows force these – typically developing – countries to maintain higher rates of interest at home, fiscal policy may turn out to be less effective than in developed countries, which can set interest rates with an eye on the domestic economy. In fact, Ilzetzki et al. (2010) suggest that the effects of fiscal expansion might be smaller in developing countries, since international capital mobility forces these countries to have a less accommodationist monetary policy.

⁴ Ilzetzki et al. (2010) do not find evidence of higher rates of interest associated with fiscal expansions. This suggests that inflows might be simply the result of a growing economy, and that monetary accommodation is the central mechanism by which managed exchange rate regimes have larger fiscal multipliers. There is ample evidence that capital flows to developing countries tend to be pro-cyclical.

However, as noted by Ocampo (2011), the policies of self-insurance against financial volatility, including but not limited to accumulation of foreign reserves and capital controls, have created space for fiscal expansion in the developing world exactly because it increased the degree of monetary autonomy, allowing for lower interest rates to support fiscal expansions. In this sense, it seems more adequate to talk about countries that managed to avoid significant real exchange rate appreciation during the Great Recession, and used monetary policy to accommodate the fiscal expansion (e.g. Argentina, China), and those that were unable to do it (e.g. Greece, Ireland, and Portugal). Further, in the developed world, where the financial bubble was central to the unfolding of the Great Recession, the amount of resource utilized for rescuing financial institutions was much larger than in the developing world. It is reasonable to assume that financial rescue packages, which might be important to avoid a collapse of financial markets, have a limited effect on the level of activity. Hence, financial conditions not only affect the size of fiscal space, they may also influence the way it is used and its impact on economic recovery.

In sum, fiscal space depends not just on how fiscal policies per se are implemented, but also on how well it is supported by monetary policy and the national and international financial environment, beyond the questions related to the political viability of policy changes. If fiscal space is in issue in the design of countercyclical macroeconomic policies, it should be taken into account not when it has allegedly reached a limit, but at the outset, i.e. when decisions are taken on fiscal stimulus measures, because demand and fiscal feedback effects differ widely depending on which specific expenditures or taxes are changed. An optimal combination of such changes would reach a maximum expansionary effect as there will be a minimum drain of demand in the income circulation process from savings and imports and a maximum encouragement of additional private spending. As a result there may be a Debt Paradox in the sense that the income effects of stimulus measures lead to full compensation or even overcompensation of the initial deficit by additional tax incomes. In other words: as a result of multiplier and accelerator effects on income, which raise tax revenue at constant tax rates, a deficit can finance, and under favourable conditions even over-finance, its own debt service, so that expansionary fiscal policy may be more likely to reduce a deficit than a restrictive one.

4. Dealing with growing debt

Debt crises are not recent phenomena. Sovereign lending goes as far back as the 1300s and recurrent defaults show that sovereign lending was always a risky affair (Cipolla 1982; Kindleberger 1996). The long history of sovereign lending led some authors to argue that long term debt cycles are directly connected to the cyclical instability of creditor countries (Marichal 1989). A note of caution on the definition of debt crises is essential at this point. Some authors use the term debt crises in an almost indistinguishable way from balance of payments crises (e.g. Dymski 2003). In that case, for example, the 1997 Asian crisis would be also seen as a debt crisis. It is true that a debt crisis more often than not implies inability to pay foreign obligations and results in a balance of payments crisis with runs on the domestic currency. However, debt crises are also characterized by severe debt overhang problems and the need for debt restructuring. In that case, the Asian crisis is not comparable to the Latin American debt crisis of the 1980s. Also, the African continent was plagued by debt overhang problems before the initiative for Highly Indebted Poor Countries (HIPC), with economic stagnation for decades, while balance of payments crises have only been sporadic. Thus, the term debt crisis will be reserved for crises in which debt accumulation and debt overhang are central.

Two important distinctions are relevant when dealing with debt crises. First, one must differentiate between private and sovereign borrowers. The latter may borrow in their own currency, which is legal tender, and over which they have the monopoly of issuance. Second, it is also important to distinguish cases in which public debt is denominated in domestic and foreign currencies. In the first case, the government can always monetise public debt, or the central bank can buy public debt in the secondary markets effectively financing the government, with different consequences than a situation in which the public sector is unable to service its debt in a foreign denominated currency. Policies aimed at preventing debt crises are different in both cases.

Finally, it is important to emphasize that there are alternative views regarding the causes of debt crises. While debt crises can be caused by excessive fiscal spending for a given tax base, it is often the case that the problem lies with a system of

international finance that provides liquidity to cash starved agents in intermittent cycles, and that capital flows vanish exactly when they are needed. More stable flows of capital and heavier regulation of their uses are the prescribed solution, rather than fiscal adjustment. In other words, debt crises may result both from fiscal mismanagement and/or from financial fragility, to borrow Hyman Minsky's famous term.

Although debt crises do not often have a fiscal origin, there are cases in which they are indeed caused by unsustainable fiscal policies and irresponsible lending and borrowing activities. Even in those cases that the debt crisis has fiscal origins though, it may be very well necessary to promote expansionary fiscal policies to promote growth, which may lead to increasing public debt in the short run, to overcome the worst consequences. In the private sector in the domestic economy, lending booms are usually fuelled by a climate of global optimism, since there internal tendencies for excess credit creation. Creditors benefit from lending expansion as a result of the increasing volumes of trade, and enter into riskier ventures to keep up with the competitors. Further, creditors may also assume larger risks as a result of a perceived sense of security, associated with the notion that the monetary authorities would be ready to bail them out in case of a crisis, the notorious too-big-to-fail issue that generates moral hazard problems. On the demand side, private domestic agents may continue to borrow, because of a misconception about their abilities to continue to obtain credit at very low interest levels. For sovereign borrowers that take loans in international markets, the same problems arise, since creditors have incentives to continue lending, while the debtors believe that fresh inflows at low interest would be available. It is important to note, in this context, that despite the risk of default in the case of sovereign borrowers in international markets, more often than not, lenders and bond holders benefit from their activities, since they can often charge higher interest to borrowing countries, and that is why financial markets do not tend to punish countries that cannot service their debts. For example, Lindert (1989) and Lindert and Morton (1989) show that investors in Latin American government bonds in the period from 1850 to 1914 received more than a third than holders of British consols (bonds) in spite of defaults. Klingen et al. (2009) show that, over and above the various crises, in the period 1970-2000 the average return on developing countries' debt was 9% per year.

These periods of financial euphoria are usually followed by financial crashes and may lead to widespread banking crises (Kindleberger, 1978, Reinhart and Rogoff, 2009). Since banking crises are often followed by sudden increases in public debt associated with particular policy decisions to rescue financial institutions in distress, policies aimed at reducing the risk of debt crises need to include measures to keep in check private sector debt, both domestic and external. Tighter financial regulation, including guarantees that borrowers have income streams compatible with the accumulated debt, restrictions on certain types of predatory lending which misinform borrowers about the payment conditions, caps on interest rates charged by certain types of credit lines, higher capital requirements for banks, and capital controls are all useful instruments for limiting excessive risk taking by the private sector. The financial industry has argued that tighter financial regulation and higher capital requirements will have a negative effect on bank profits and lead to a contraction of lending with large negative consequences on future GDP growth (Institute of International Finance, 2010). These concerns are misguided because there is no evidence that higher capital ratios will reduce the profitability of the banking sector (Admati et al., 2010). For countries borrowing in foreign currency certain circumspection in borrowing might be required, since sudden changes in capital flows, on the international interest rate levels and export performance, in particular if exports depend significantly on the terms of trade, tend to lead to external crisis. The external crisis, manifested in general in the form of current account deficits, is solved more often than not by contractionary fiscal policies, which reduce growth and the public sector's revenue, resulting in low growth and a debt crisis. In this vein, recent work by Arcand et al. (2011) shows that finance starts having a negative effect on output growth when credit to the private sector reaches 110 per cent of GDP. For countries that are above this threshold, tighter credit standards would actually be desirable.

For this reason it is important to note that external shocks are a fundamental cause of debt explosions, since they tend to be associated with the case of sovereign borrowers that obtain credit in foreign currency in increasingly deregulated international financial markets. Further, these external shocks tend to be more problematic for countries that borrow mostly in foreign currencies, which is to say developing nations. These shocks can take the form of natural disasters, rapid changes in a country's terms

of trade or a sudden tightening of external financial conditions, in particular, higher interest rates in developed countries, and sudden stops of external credit. Countries can deal with these shocks by self-insuring via accumulation of international reserves and this is exactly what many developing countries have been doing after the crises of the late 1990s. One problem with self insurance is that not all countries can afford to do it (this is especially a problem for low income countries). Another problem relates to the fact that self insurance could have a cost because it ties up resources in low return assets (UNCTAD, TDR 2009).

Adverse selection relates to the fact that only countries that face significant risks have an incentive to buy insurance. By reducing the insurance pool, this behaviour increases the cost of insurance and further reduces the number of countries interested in insuring. Political economy obstacles are even more important. Self-interested policymakers with a short time horizon have limited incentives to engage into contingent debt contracts which imply a cost that must be paid upfront and a benefit that may accrue only years later. But even altruistic politicians may face difficulties in using contingent debt instrument because, if the risk does not realize, they can be accused of having wasted the country's money (Li et al., 2010). Although, as in the market for health insurance, a universal mandate forcing all countries to issue contingent debt instruments would reduce the problems highlighted here, it is impossible to impose contingent debt contracts on unwilling sovereign borrowers and private lenders.

Currency mismatches are another source of debt crises. Countries that face an external constraint and have a large share of foreign currency debt face harsh trade-offs. As it was noted before too often external imbalances are resolved by a domestic contraction. In the absence of positive terms of trade shock, a real depreciation is the least painful way to restore external sustainability (TDR, 2008). However, when there is significant foreign currency debt, a real depreciation can lead to a sudden jump in the public debt-to-GDP ratio and in debt servicing payments in domestic currency terms. This can have a negative effect on debt sustainability, possibly leading to a debt crisis and a costly debt default. In order to find a solution to this problem it is necessary to start by recognizing that it is during economic booms that countries sow the seeds of future crises. In period of global optimism, surges in capital inflows flood developing

countries, which are often unable to restrict amounts, even if they can change the profile of the inflows with capital controls. This behaviour not only leads to a rapid accumulation of external debt, but it often leads to an appreciation of the real exchange rate and to large external imbalances. When the external imbalance becomes too large, foreign investors start pulling money out. However, because of their large foreign currency debt borrowing countries may have started suffering from 'fear of floating' and may adopt policies aimed to limit outflows or even attract more capital (Calvo and Reinhart, 2003). The situation may last a bit longer, making the problem even more difficult to solve. In the end the unavoidable happen, the capital leaves the country, the currency collapses and the debt crisis starts.

The solution to this trade-off requires a change of behaviour during good times with less external debt, more reserves and policy aimed at limiting currency appreciation. The development of domestic sources of finance, and the reduction of the foreign capital needs are therefore policies that should be encouraged during boom phases. This is exactly what the largest emerging market countries have been doing since the late 1990s. As a change in the composition of public debt and a switch to domestic borrowing can reduce these asymmetries and improve the trade-off discussed above, several developing countries are now retiring external public debt and substituting with domestically issued debt. The recent switch from external to domestic borrowing may lead countries to trade one type of vulnerability for another. For instance, countries that are switching from external to domestic debt could be trading a currency mismatch for a maturity mismatch.

The situation is even more complicated for countries that are member of a monetary union, have a currency board or are dollarized. In this case a real devaluation can only be achieved through deflation (sometimes referred to as internal devaluation) but deflation may even have a larger negative effect on debt sustainability because it would increase the real value of all liabilities, not only those denominated in foreign currency (Eichengreen 2010). This could lead to debt-deflation or balance-sheet crisis, as discussed before.

Although debt crises do not always have a fiscal origin, the standard response to a sudden jump in public debt is often a fiscal retrenchment. This appears to be a

misguided policy because the appropriate response should relate to the nature of the crisis. If a crisis originates from the bursting of an asset bubble brought about by a poor regulatory system, the response should be better regulation, in addition to what could even be the opposite of fiscal retrenchment that is countercyclical policies designed to reduce the macroeconomic slump created by asset deflation (UNCTAD, TDR 2009). If the crisis originates from excessive foreign currency lending and excessive real appreciation, perhaps the best response is to improve the debt structure and put in place policies aimed at avoiding misalignments of the real exchange rate.

Responding to a crisis that was not caused by irresponsible fiscal policies with fiscal retrenchment is problematic for several reasons. Not only do fiscal adjustments tend to affect the most vulnerable groups of society and often have serious social consequences, but they may even be useless in reducing debt ratios because they may amplify the recession and thus lead to an increase of the debt-to-GDP ratio. In fact, fiscal contractions may not only lead to painful adjustments in the short run, but they may even have costs in the long run. There is evidence that, after recessions, output growth tends to go back to its previous trend but the output loss is never recovered (Cerra and Saxena, 2005; Beja Jr., 2007). Recessions, therefore, lead to a permanent output loss and since contractionary fiscal policies amplify both the length and the depth of the recession they also increase this permanent output loss and decrease a country's overall ability to sustain any given level of public debt.

But there is another important channel through which fiscal contractions may have a negative effect on long run growth and thus reduce debt sustainability. Since current expenditure can be hard to adjust (because it is mostly composed of wages and entitlement programs), fiscal retrenchments usually lead to large cuts in public investment (Martner and Tromben, 2005; Easterly et al., 2008), which is often the most productive component of public expenditure. This reduction in growth promoting public expenditure may lead to a drop in the present value of future government revenues which is larger than the fiscal savings brought about by the fiscal retrenchment, resulting in a situation in which the fiscal adjustment improves the immediate cash flow of the government but has negative consequences on long term fiscal and debt sustainability. Fiscal adjustment programs should therefore explicitly keep account of how the fiscal adjustment affects output growth and treat

deficits incurred to finance public investment differently from deficits incurred to finance certain categories of current expenditure that may not be directly connected with economic growth, recognizing that a deficit to finance an investment project, and that some current spending, especially on things like health, education, nutrition, and sanitation, for example, may lead to an increase (and not a decrease) in the country's net wealth.

One problem with this strategy is that even sovereign borrowers that are targeting sound long term fiscal indicators may lose access to credit in international markets and become unable to finance their current cash deficits at a reasonable interest rate. This is where the international community can step in and provide the needed financial support. It should be clear that provision of such a support is *not* a bailout but just an intervention aimed at addressing a market failure. In fact while Bagehot (1873) was right in saying that during crises the domestic lender of last resort should stand ready to lend freely at a penalty rate to solvent but illiquid banks, there are problems in applying Bagehot's suggestion of a penalty rate to the behaviour of an international lender of last resort. Bagehot's idea of lending at a penalty rate was aimed at avoiding moral hazard. However, moral hazard is unlikely to be the main cause of sovereign debt crises. Therefore lending at a penalty rate would not generate any ex-ante gain in terms of disciplining borrower. It would in fact be counterproductive because, by increasing the interest bill, it would contribute to debt accumulation and therefore aggravate the problem that emerging lending is trying to solve. The same line of reasons holds even in a stronger way for countries that are on the hedge of insolvency. In fact, high interest rates which are supposed to protect the resources of the lender of last resort can actually backfire and be the causes of such losses. A lender of last resort that lends at a penalty rate may contribute to pushing the country towards insolvency and, thus, rather than protecting the claims of the lending of last resort would actually increase the probability that the lender of last resort would lose part of its funds.

5. Conclusion

This paper suggests that the best strategy to reduce public debt is to promote growth enhancing fiscal policies. The evidence suggests that fiscal expansions tend to be

more effective if spending prioritized over tax cuts, if spending targets infrastructure and social transfers, and if tax cuts, in turn, target lower income groups, which tend to have higher spending propensities. A fiscal expansion, by increasing the level of activity and income, as noted before, raises the revenue stream, and reduces the debt-to-GDP ratio, in particular, if interest rates are relatively low when compared to GDP growth. In this sense, whenever there are questions about the growth of public debt, in particular in the case in which this is not related to fiscal problems, the best strategy to deal with it is to promote a fiscal expansion.

Further, if for economic and/or political reasons it is argued that there is little space for fiscal expansionism, there is always space to redirect spending and taxes towards more expansionary measures. Again, this suggests that spending should be privileged over tax cuts, and that both measures should benefit low income groups. A more equitable income distribution would make the economic recovery more self-sustaining and a fiscal consolidation more likely. In this sense, expanding real wages, and, in the case of developing countries with large informal sectors, transfers to the low income sectors of society are important complements to fiscal expansion.

Beyond the notion that growth is the best solution to reduce debt-to-GDP ratios, it is important to note that higher rates of public debt, particularly in developed countries, after the crisis do not pose a serious threat to fiscal consolidation, and that fiscal austerity is not the solution for those concerned with the increase in public sector indebtedness. As noted before, public debt is more sustainable than the private debts that were held by economic agents before the crisis, and there is sufficient fiscal space to promote an expansionist fiscal consolidation, in which growth brings about the increase in revenue and the reduction of debt ratios. Further, this also implies that monetary policy should continue to maintain low rates of interest to create the conditions for a low burden of interest payments for the public sector.

If inflation is perceived to be a serious threat to economic stability, it should be noted that, in most cases, where the economies have had a weak recovery, or need to grow to promote rising living standards, the pressures come from the cost side, and should be dealt with income policies rather than restrictive macroeconomic measures. Finally, it is important to note in this context when fiscal expansion cannot be pursued

because of an external constraint, that is, when lack of competitiveness leads to current account deficits, and fiscal expansion would aggravate the external imbalance, that solutions for the balance of payments problem, rather than austerity, should be prioritised. This is of particular importance for countries that have entered rigid exchange rate arrangements.

Figure 1

United States, Germany and Japan: Relationship between public debt and interest rates

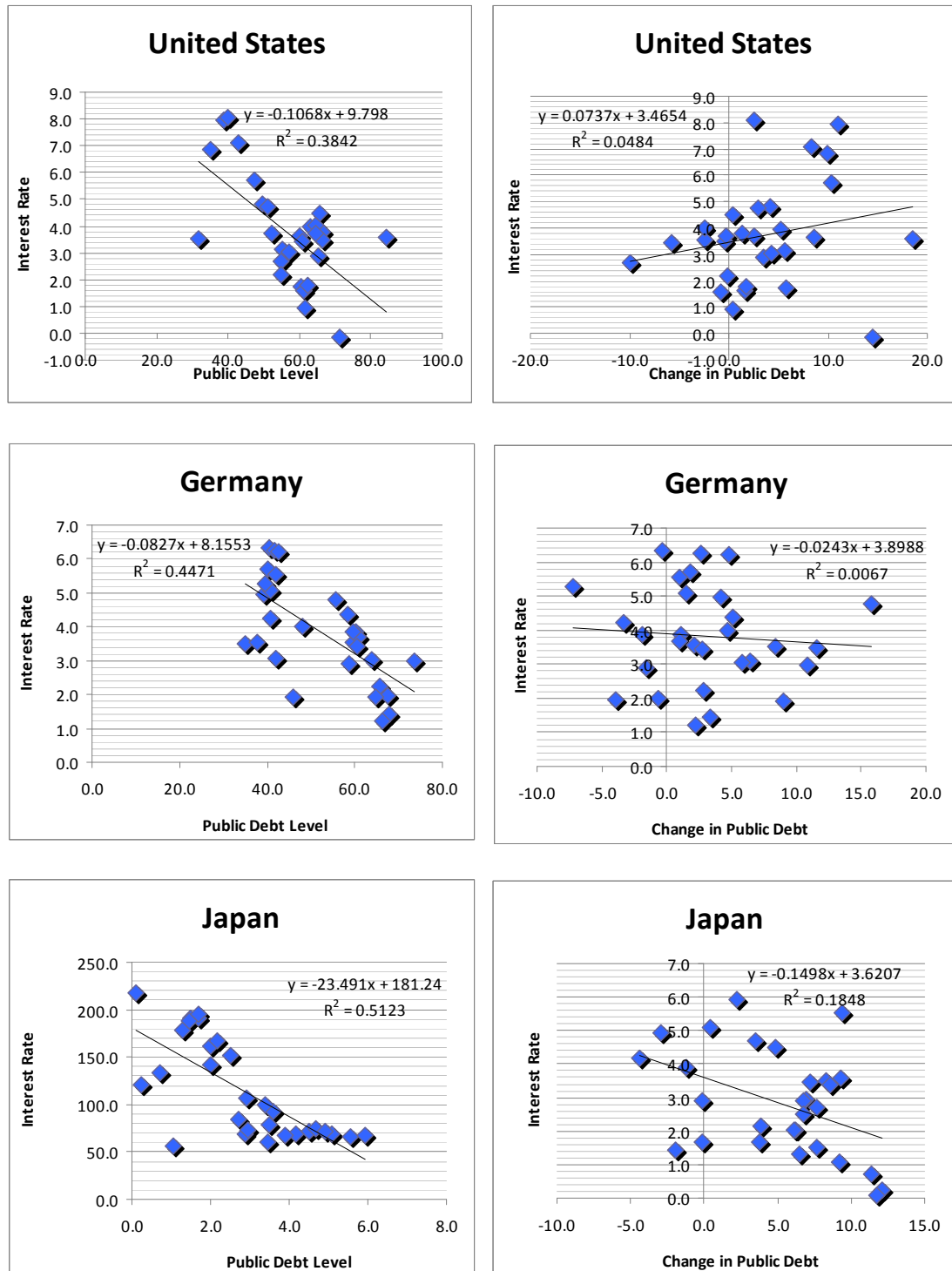
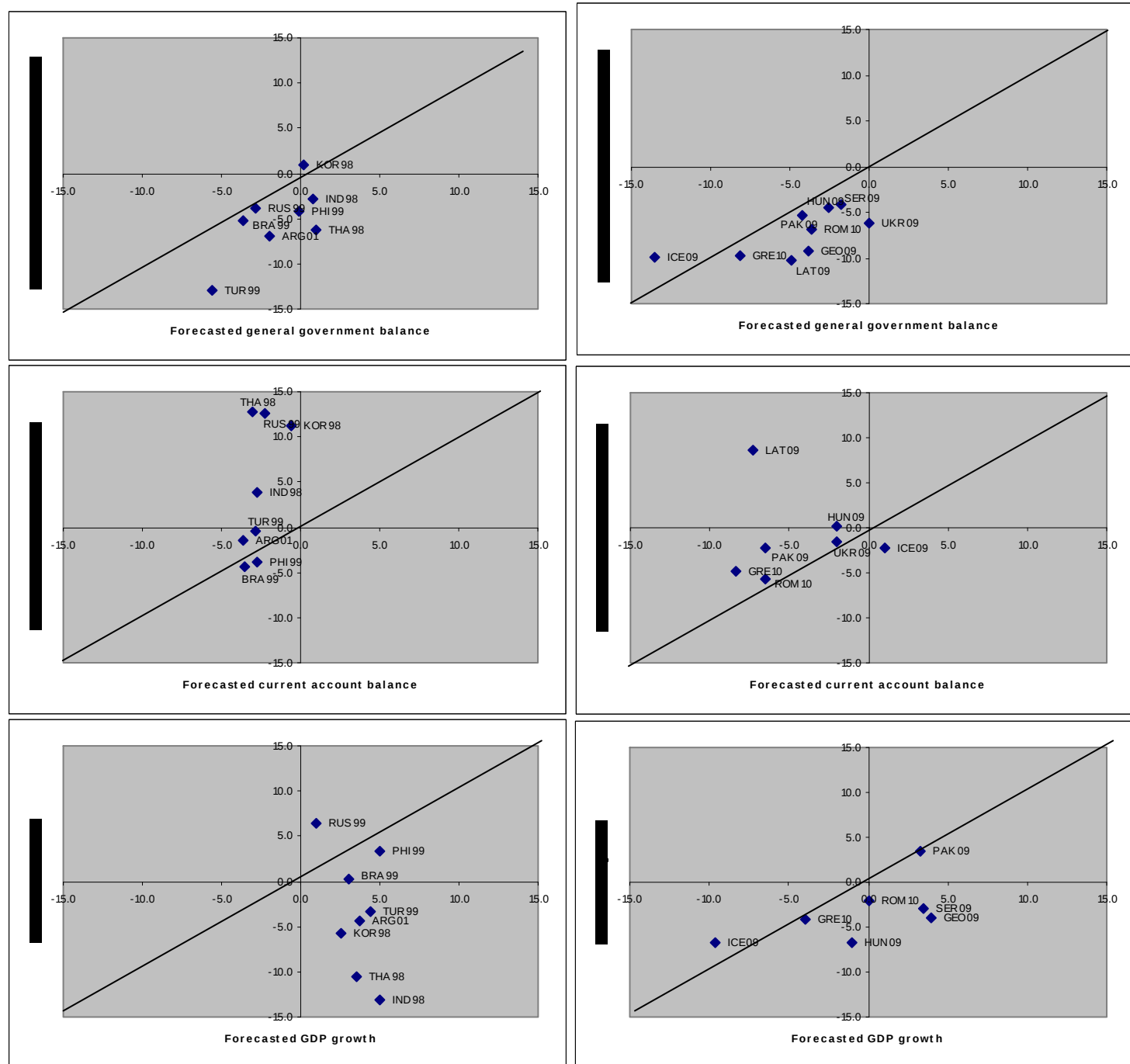


Figure 2
GDP growth, fiscal balances and current account balances: Forecasts in IMF-
sponsored programmes and actual values for selected countries



Sources: IMF. Letter of Intentions and UNCTAD Globstat

Annex: Fiscal Multipliers

It is well known that fiscal multipliers are difficult to measure, because of the endogeneity of fiscal variables, and the difficulty of obtaining reliable instruments for exogenous spending and tax changes. There are fundamentally two methods for estimating fiscal multipliers. The first is the structural macroeconometric models in the Cowles Commission tradition that incorporated the main elements of the Keynesian Revolution. The alternative is a-theoretical Vector-Auto-Regressive (VAR) models, where the specification is purely determined on the information contained in the available data.

The essential difference is that the old macroeconometric models specify the estimation on the basis of a theoretical model and is concerned with measuring coefficients, while VARs do not impose many restrictions on parameters. VARs are associated to the development of Real Business Cycles (RBC) and have been incorporated in New Keynesian Dynamic Structural General Equilibrium (DSGE) models, which assume that the business cycle can be seen as a deviation from the trend. Booms and busts are temporary, and agents with Rational Expectations (RE) know this, and so when they are in a recession they will expect their future income to be high relative to their current income and spend more. There is a strong presumption that the economic system returns to equilibrium after a shock. In other words, VARs were essentially developed to analyze exogenous shocks to auto-regressive mean-reverting series. Not surprisingly the old structural macroeconometric models tend to predict higher values for policy multipliers.

The Table below compiles some recent relevant results from the growing literature on the effects of fiscal policy on the level of activity, using both methods. All the studies show a range of multipliers, which depend on several circumstances, from spending and tax multipliers, to the monetary policy stance, the exchange rate regime and the existence of a financial crisis. Hall (2009), Corsetti et al. (2010), Ilzetzki et al. (2010), and our own estimates use a VAR methodology. Our own VAR estimates for the United States from 1980 to 2010 finds a range of multipliers from 0.71 (for tax cuts) to 1.87 (for spending), which are fundamentally in line with other results in this

literature. The only significant difference is that other works using VAR do not differentiate between tax cuts and spending increases.

Table Tax and Spending Multipliers

Study	Method	Period	Coverage	Approximate Results	
				Tax Cut	Spending
Zandi (2008)	Structural Model (SM)	Indeterminate	United States	0.3 to 1.26	1.36 to 1.73
Hall (2009)	VAR	1930 to 2008	United States	---	0.5 to 1.7 ^a
OECD (2009)	SM	Indeterminate	OECD countries	0.6 to 1.0	0.9 to 1.3
Corsetti et al. (2010)	VAR	1975 to 2008	17 developed countries	---	0 to 1.5 ^a
Ilzetzi et al. (2010)	VAR	1960 to 2007	44 countries (20 developed; 24 developing)	---	0 to 1.5 ^a
Fair (2010)	SM	1960 to 2010	United States	1.0	2.0
CBO (2011)	SM	Indeterminate	United States	0.2 to 1.5	0.7 to 2.5
UNCTAD (2011)	VAR	1980 to 2010	United States	0.71	1.87

^a Multipliers for overall fiscal policy, including changes in taxes and spending.

The OECD Economic Outlook (OECD, 2009) reports fiscal multipliers based on the OECD global model that range from 0.9 (after one year) to 1.3 (after two years) for government expenditure, and from 0.6 to 1 for tax cuts (after one and two years, respectively). The study also reports the numbers from several national models,⁵ showing a higher multiplier for spending (1.1 on average, after one year) than for tax cuts: between 0.3 on average for corporate tax cuts to 0.5 for personal income or indirect tax cuts. Their analysis also suggests that the size of the multiplier varies significantly from country to country.

⁵ These models cover Belgium, Canada, the Euro Area, Germany, France, Italy, Japan, Portugal, Spain, the United Kingdom and the United States.

Fair (2010) using the Cowles Foundation model (Fair Model) shows that for the United States in the period starting in 1960 multipliers for spending are at around 2, while those for cut taxes are half that size. This are essentially in the same range that the estimates presented by the Congressional Budget Office (CBO, 2011), which shows multipliers ranging from 0.7 (low estimate) to 2.5 (high estimate) for government purchases of goods and services, much higher than those resulting from temporary tax cuts for higher income brackets (0.2 to 0.6) or even income tax cuts for low and medium income (between 0.6 and 1.5). The CBO uses the estimates from the Macroeconomic Advisors and Global Insight private models, and the FRB-US model used at the Federal Reserve Board.

It is important to note that almost all models suggest, as expected, that expansionary fiscal policy has a positive effect on the level of activity. Further, it seems that the weigh of the evidence indicates that spending multipliers tend to be larger than tax cut multipliers, and that tax cuts benefiting lower-income households have a stronger effect than those benefiting high-income people.