

HOW TO SOLVE THE GLOBAL ECONOMIC CRISIS
Making Fiscal Stimulus Packages Work across the World¹

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ABSTRACT

Facing the deepest financial crisis since the Great Depression, governments and monetary authorities around the world have acted swiftly and forcefully to coordinate their policy responses. Yet, traditional macroeconomic remedies, such as looser monetary policy, are weakened in a global credit crunch and situations of excess capacity in many industrialized countries. Fiscal stimulus packages which are being advocated as a complement to monetary policy are also likely to be ineffective: on the one hand, many emerging countries may not be in the position to afford counter-cyclical policies due to their lack of fiscal space or constraints on foreign exchanges. On the other hand, industrialized countries may face the issue of Ricardian Equivalence (i.e., government deficits are anticipated by individuals who increase their saving because they realize that borrowing today has to be repaid later).

As the crisis now becomes a self-fulfilling prophecy, there is a major risk of global deflation. Drawing from lessons of history, this note discusses possible steps for avoiding a long, protracted recession. It proposes a bold new recovery plan for global development that would make fiscal stimulus packages work by channeling funding from developed countries to projects and programs that release bottlenecks to growth in developing countries. Such a facility would provide business opportunities for industrialized economies and stimulate both their domestic demand and exports. For countries with large foreign exchange reserves, it would be a mechanism to restore stability in global trade and manage their surpluses in the most efficient way possible. For poor countries, it would provide the much needed resources for domestic or regional projects that meet the market test—i.e. those projects with good returns.

1. INTRODUCTION

Back in the summer of 2008 when the world was grappling with the subprime crisis and its implications for global finance and economic growth, many economists were confident that the problem could be resolved without much difficulty, and that the world would not suffer from the kind of deep recession that marked the 1930s or the protracted recession of the lost decade in Japan in the 1990s. While some dissenting voices² warned about the high likelihood of a deep recession, the general consensus among mainstream economists and preeminent central bankers was that the crisis could be circumscribed and that the world economy, especially the developing countries, would keep a decent rate of growth for years to come.

Many of the optimists were confident that mistakes from the past would not be repeated, and that lessons from history and economy theory would facilitate policy decisions. The Great Depression has been studied thoroughly over the years and subsequent major economic crises such as Japan's deflation of the 1990s or the East Asian crisis had been analyzed and understood well enough to provide clear policy choices.

Things have not quite turned out that way. The once pessimistic scenario of US financial institutions incurring losses well beyond subprime mortgages and of the US and global economy spinning into a severe financial crisis and a deep recession has now materialized. The world has witnessed rising losses not only on subprime mortgages but also on near prime and prime mortgages; commercial real estate; credit cards, auto loans, student loans; industrial and commercial loans; corporate bonds; sovereign bonds and state and local government bonds. Large losses have also been incurred on all of the assets (asset backed securities, collateralized debt obligations, and other credit derivatives) that had securitized such loans. Write-downs by US banks are now well beyond \$1 trillion and institutions such as the IMF and Goldman Sachs predict losses of over \$2 trillion—which is also amount of the Financial Stability Plan announced by the US Treasury Secretary.

As US President Barack Obama said, “things will get worse before they get better”. The financial crisis has translated into a full-blown global economic crisis, which is likely to cause even more social woes and slow down progress towards the Millennium Development Goals. Conventional wisdom among economists is now that the current crisis is likely to be deep and protracted. The magnitude of the collapse in equity and the real estate markets is almost comparable to that of the Great Depression. IMF Managing Director Dominique Strauss-Khan has uttered the “d” word of depression to describe the global outlook. Projections by the IMF and the World Bank are now being revised downwards.

Fortunately, Governments and monetary authorities around the world have reacted quickly and forcefully to weather the storm. They have provided various types of rescue plans to help financial institutions, recapitalize them, and facilitating the revival of credit markets. Recognizing that this is “a crisis of confidence, of capital, of credit, and of

² One example is New York University's Nouriel Roubini.

consumer and business demand” as Tim Geithner recently noted, they have also adopted fiscal stimulus packages aimed at fueling the world economy. While it appears unlikely that the world will suffer a brutal 20-30 percent decline in gross domestic product (GDP) as was the case in the 1930s, at the recent World Economic Forum in Davos most participants agreed that the duration and depth of the current global crisis will depend on whether the leaders of the world economy can resist protectionist pressures, and coordinate their fiscal policy stimulus package to resume global aggregate demand.

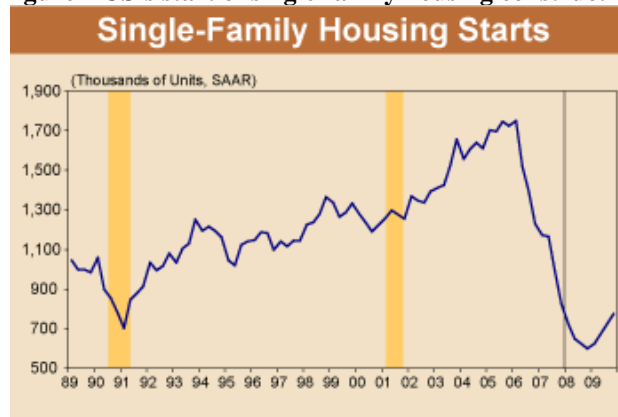
With the upcoming G-20 Summit, it is urgent that the economic community reflects on the unique nature of the current global crisis, its potential implications, and lessons from past major recessions. We appear to face the real threat of deflation, and, with that in mind, what follows is an ambitious proposal for resources that could lay the foundations of a more inclusive growth, particularly in developing countries.

2. EXCESS CAPACITY POSES MAJOR RISKS OF GLOBAL DEFLATION

The current crisis was preceded by six years of boom. In reaction to the bursting of the US tech-stock bubble in 2000-01, which had a substantial wealth effect on American households, the Federal Reserve aggressively loosened monetary policy. It lowered either the Fed funds rate or the discount rate 27 times between January 2001 and June 2003, with the funds rate falling from 6.5 percent to 1.0 percent over that period. The excess liquidity, which resulted from low interest rates and financial innovations, contributed to the large increase in real-estate and equity investments, as well as private capital flows into the developing countries, jumping from \$200 billion in 2000 to \$ 1 trillion in 2007. In 2003-2007, the world economy experienced a period of rapid growth not seen in several decades.

The expansionary monetary policy helped stimulate a boom in the housing market (which later became a housing bubble, bigger than the equity bubble due to the larger share of the housing stock in household wealth). The disequilibria were aggravated by high-leveraged financial innovations in the context of insufficient oversight from government regulators. The combination of easy money and a large fiscal deficit in the U.S. led to a surge of demand. Starting from 2002, real estate prices in the U.S. increased at a double digit rate for several years. For example, the start of constructions of single-family housing³ surged over one-third from 1300 thousands of units in 2002 to almost 1800 at the peak of mid-2006.

³ The start of construction of a privately-owned housing unit is when excavation begins for the footings or foundation of a building intended primarily as a housekeeping residential structure and designed for non-transient occupancy.

Figure 1 US's start of single-family housing construction

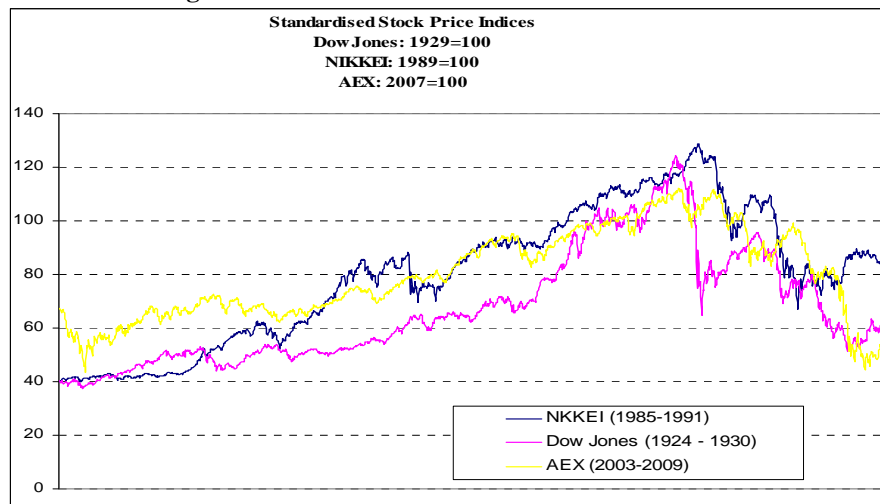
The large inflow of liquidity also boosted real estate and stock market prices in the US and around the world. As markets surged, households diverted a steadily increasing share of their income to consumption thanks to the wealth effects. Financial institutions adjusted their balance sheets to accommodate the expansion in underlying money by increasing outstanding loans. Many households even decided to monetize their assets, most often housing, to fund further consumption. Borrowing ballooned. US household debt as a percentage of annual disposable personal income increased from 77 percent in 1990 to 127 percent at the end of 2007. Household final consumption expenditure surged from just over 67 percent in 1997 to 70 percent in 2001 and remained over that level afterwards. The same trends in aggregate demand could be observed in developing countries where the growth rate of investment rose from 1.6 percent per year in the 1980s to 2.9 percent in the 1990s and 11.9 percent in the period 2002-2007.

The boom was bound to burst, especially given the explosion of sophisticated and unregulated financial derivatives which had sustained the process. The excess liquidity eventually resulted in asset bubbles: unsustainable booms in consumption, investments, and trade; and commodity prices increases. By 2007, there was clear evidence of bubbles in many assets markets. The first clear sign that the US housing bubble was bursting, the mid-2007 crisis in the sub-prime mortgage market (stemming from the significant increase in defaults), transmitted losses to a whole set of securitized financial products such as mortgage-backed securities. Many of these new securitized financial products, with layers of underlying off balance sheet assets, were revealed to be far riskier than their credit ratings indicated. The drop in value of these and other assets pushed many financial institutions into insolvency. Even worse, the financial innovations of the past decade – many of which had been sold on the promise that they would diversify and minimize risk – turned out to be transmission mechanisms for instability. The subprime mortgage crisis thus became a full-fledged financial crisis, which in turn has led to a collapse in equity markets.

The housing price collapse and the meltdown in equities have dealt US homeowners trillions of dollars in capital losses, and much more with the continuing plunge in stock markets. Global equity markets have collapsed in unison in 2008 as the U.S. housing

downturn triggered a credit crunch that ultimately tipped the global economy into recession—most major indices posted declines in the 35-to-45 percent range. The total capitalization of world stock markets has almost halved in 2008. In other words, \$30 trillion of wealth has disappeared in the past twelve months.⁴ In the US alone, the wealth losses for households related to the fall in home prices are roughly \$4 trillion so far, and are clearly bound to increase further as home prices continue to fall –eventually reaching the \$6-8 trillion range.⁵

Figure 2: Stock Prices Before and After Recessions



Losses of this magnitude have significant wealth effects on consumption and savings.⁶

The collapse of the banking sector in industrialized countries has been prevented but the catalyst of the financial sector crisis—the collapse of the US housing bubble—will not be reversed soon. Many US households are now constrained by no longer being able to borrow against their home equity. This will lead to a fall in consumption and increase in saving, as households adjust to their new circumstances. Personal consumption, which has been resilient in the past, has started to decline in the last quarter of 2008. With a negative wealth effect of 6 cents on the dollar, the reduction in personal consumption, which makes up over two-thirds of aggregate demand, could amount to a \$500 billion. In addition, negative wealth effect from the fall in equity prices – in the wake of a bleak 2009 for corporate profits – will also contribute to the contraction in personal consumption by an estimated \$100 billion (comparable with a 25 percent contraction in the stock markets). US homeowners will no longer be able to count on rapid price increases that will allow them to downsize homes after retirement and live off the capital gains. Instead, they will need to become more cautious in consumption and to save more of their current income. In addition, losses from 401K pension-schemes and in stocks are likely to increase savings propensity by US households.

⁴ Source : <http://www.marketoracle.co.uk/Article7923.html>

⁵ Source: RGE Monitor, January 7, 2009.

⁶ In the past, collapses in asset prices have not always dampened consumption by as much as feared, perhaps because in many cases households viewed prices at either the peak or the trough as transitory, and also because they did not monetize their asset to support consumption.

All the investment made during the period 2002-07 has now become excess capacity.

The decline in consumption and aggregate demand in the US is already reflected in the evolution of capacity utilization rates⁷, which reflects the relationship between actual output that is produced with the available equipment and the potential output which could be produced with it, if capacity was fully used.

Many economies may become trapped in a vicious deflationary cycle. The unprecedented national fall in house prices is reducing household wealth and with it consumer spending. According to Martin Feldstein, each 10 percent decline cuts US household wealth by about \$2 trillion and this eventually reduces annual consumer spending by about \$100 billion. With excess capacity, firms have lower profitability and are forced to cut jobs, which in turn decrease consumption and production still further. More companies go bankrupt or are forced to cut their workforce even more, which aggravates the general crisis. The pessimistic expectation and the wait-and-see attitude of consumers and investors may sustain the fall in output. Such a deflationary vicious cycle would arise in part from the reduction of consumption due to the concerns about job security and low confidence about the future, which in turn cause the excess capacity to become larger, and trigger a vicious deflationary cycle. In part, the deflationary pressures would arise from business investment, which has been frozen due to the market uncertainties. The empirical evidence currently available suggests that excess capacity could have long-lasting, negative effects on corporate profits, investment, employment, wages and consumption:

- Consumer confidence indicators are down. In December 2008, the US index of consumer confidence fell to a record low at 38, from 105.9 in 2006 (1985 = 100).
- Industrial production is down all over the world, while, at the same time, inventories are rising. The inventory-to-sales ratio in the US now stands above 1.3, up from its remarkably low 1.23-1.24 range less than a year ago.
- Wages in some sectors are likely to decline, further putting pressure on personal consumption. Recent empirical work by Philippon and Reshef predicts that up to half the wage differential observed in recent years can be expected to disappear, even if the adjustment takes some time.⁸
- Unemployment is on the rise all over the world. ILO estimates global job losses of over 18-30 million with the risk of reaching 50 million in 2009. In all of 2008, 2.6 million people lost their jobs in the US, the largest slump in employment since a 2.75 million drop in 1945. According to Conference Board, a private research group, the US job market could lose another 2 million jobs in 2009.

⁷ Capacity utilization indicators are monitored for signs of inflation pressures. If market demand grows, capacity utilization will rise. If demand weakens, capacity utilization will slacken.

⁸ T. Philippon and A. Reshef, *Wages and Human Capital in the U.S. Financial Industry, 1909-2006*, NBER working paper, January 2009.

In such a situation, political leaders are often tempted to turn to protectionism. Because of the loss of jobs and the accompanying political ramifications, policies that favor free trade and globalization become harder to implement. Moreover, policies to avoid the economic and social costs of liquidations through bailouts to large firms in various industries are costly and can lead to similar measures abroad, the resurgence of protectionism or even trade wars. One reason that the Great Depression caused such a big decline in global GDP was the wide spread of protectionism. This is a lesson that we need to learn and to prevent.

3. MAKING FISCAL STIMULUS PACKAGES WORK

This may indeed be the first “synchronized” crisis in almost eight decades. The prospects for the global economy have now become so somber that the world’s economies will not return to balanced growth and full employment unless the protectionism is avoided and a coordinated new set of fiscal stimulus policies are implemented. Unfortunately, it does not appear that traditional Keynesian economics will be enough to get the world out of the slump. Policymakers around the world have been very aggressive in responding to the current crisis. In addition to reducing interest rates quickly, the US has recapitalized banks, the latter action, in effect, has done in a few months what it took post-bubble Japan a decade to do. Even as the world economy plunges deeper into recession, credit market stress appears to be easing, raising cautious hopes among policymakers that far-reaching government intervention is delivering results. Nevertheless, demand for liquidity is still very low.

There have been some improvements in segments of the financial system targeted for direct support by US authorities: the short-term interbank money market, top-rated commercial paper and mortgage-backed securities issued by Fannie Mae and Freddie Mac, the government-sponsored mortgage financiers. The Federal Reserve’s unconventional easing of monetary policy and the planned fiscal stimulus package have reduced the risk of a more disastrous economic outcome. Indeed, there is some evidence that the Government is not simply substituting for private activity in the markets, but pulling in private capital as well. Risk premiums in the interbank lending market have declined substantially as lenders have grown comfortable with the support provided by recapitalizations and funding guarantees. The 3-month dollar Libor – the benchmark rate paid by banks to borrow from each other for a period of three months –has come down sharply from its peak in early October 2008. These improvements indicate a greater flow of credit to the economy, and perhaps the likelihood that the recession may not last too long.

However, monetary policy is likely to be ineffective to stimulate investment and consumption in the presence of excess capacity:

- First, the issue of the so-called toxic assets has not yet been resolved, which continues to exert downwards pressure on asset prices. Even if the policy prescriptions in the Financial Stability Plan recently proposed by the US Treasury appear to be sound, they will take time to be implemented and yield results.

- Second, while recapitalization was clearly an important step to prevent major bank insolvencies, the underlying problem of the so-called “toxic assets” has not yet been addressed systematically. In most banks, they are still not properly valued or isolated from other assets. This makes it difficult to attract private capital. Moreover, even if a bad bank is set up and takes all toxic assets from the banks, as long as the excess capacity is not reduced, asset prices will be repressed and toxic assets remain toxic.
- Third, the collapse of confidence in credit markets is still preventing the normal flow of credit. The sharp decline of credit creation includes not only the banks but also the bond markets, hedge funds, insurance companies and mutual funds. Securitization, leveraged buyouts and credit insurance have also dried up to a large extent.
- Fourth, even if it was possible to restore confidence within the financial markets and to unclog the channels of credit, increasing money supply/lowering interest rate would not be effective to stimulate demand: excess capacity in developed economies implies limited profitable investment opportunities, pessimistic expectations, low confidence about the future, and the likelihood of a liquidity trap. The process is as follows: when confronted with excess capacity, companies cut prices to reduce their excess inventories. This aggravates the slack in labor markets, which in turn leads to decline in wage growth and prices. Even when nominal interest rates are low as is currently the case around the world, investment opportunities are limited by the excess capacity. The ensuing fall in demand and prices is self-reinforcing—the increase in unemployment and decline in wages results in further falls in demand and prices, and the increase in the real value of nominal debts can create severe problems of default, which may exacerbate credit losses of financial institutions and further result in a vicious cycle of debt deflation.

There is an urgent need for a global, coordinated fiscal stimulus. Dealing alone with this large synchronized financial crisis is beyond the capability of any single country. To overcome this synchronized financial crisis, decisive and concerted efforts are needed. Major fiscal stimulus packages are proposed around the world to complement monetary policy. Last December, the IMF suggested a stimulus of 2 percent of global GDP, equivalent of about \$1.2 trillion a year. And, in the recent meeting of G-20 Deputies, many participants noted the potential need for further coordinated fiscal action to boost global demand, and also that the risks of doing too little were higher than those associated with doing too much.

There are two major problems with fiscal stimulus packages: first, most developing countries are constrained by either fiscal space or/and foreign exchange reserve. Developing countries might not be in the position to implement counter-cyclical policies. Many low-income countries entered the current crisis with fiscal deficit because of the fuel and food crises, which had led them to increase subsidies. Their fiscal position is

already weak. Moreover, an estimated one-third of developing countries currently have large current account deficits of 10 percent of their GDP. Those fiscal and foreign exchange constraints bring into question the feasibility of the fiscal stimulus policies currently proposed or implemented elsewhere.

Table 1: Developing countries with large estimated financing gaps in 2009

\$ billions

	External financing	Private capital flows			Financing gap ¹	International reserves ²	Financing gap / int. reserves
		Debt	Equity	Total			
Russian Federation	224.4	-6.2	8.8	2.6	-221.8	396.2	-56.0
Poland	111.7	15.9	11.4	27.4	-84.4	71.2	-118.4
India	93.8	-2.9	14.9	12.1	-81.7	244.5	-33.4
Turkey	92.4	12.0	14.0	26.0	-66.4	76.7	-86.5
Argentina	54.0	-4.7	4.5	-0.1	-54.2	43.5	-124.6
Indonesia	48.9	-4.5	3.2	-1.4	-50.2	48.8	-102.9
Romania	54.4	-0.1	8.7	8.6	-45.8	34.8	-131.7
South Africa	45.6	0.7	1.9	2.6	-43.0	30.8	-139.5
Ukraine	40.9	1.0	6.7	7.7	-33.2	31.3	-106.3
Brazil	53.8	6.4	16.3	22.7	-31.1	193.8	-16.1
Kazakhstan	35.6	6.2	5.3	11.5	-24.1	19.2	-125.4
Bulgaria	30.0	-0.3	6.3	6.1	-23.9	17.2	-139.3
Latvia	21.9	-0.5	1.3	0.8	-21.1	5.4	-391.0
Mexico	47.2	9.4	20.4	29.8	-17.4	84.9	-20.5
Chile	19.9	3.7	1.4	5.1	-14.8	22.9	-64.5
Belarus	13.8	-0.4	0.7	0.3	-13.5	4.2	-318.0
Sudan	15.0	-0.8	2.8	2.0	-13.1	1.5	-875.3
Peru	13.7	-0.5	2.4	1.9	-11.8	33.8	-34.9
Croatia	13.8	1.5	2.9	4.5	-9.4	12.3	-75.9
Pakistan	9.2	-1.9	3.6	1.7	-7.6	4.6	-162.6
Subtotal	1030.8	36.0	133.9	169.9	-860.8	1373.0	-62.7
Other countries	199.2	-12.7	67.3	54.6	-146.6	424.5	-34.5
Total:	1230.0	23.3	201.2	224.5	-1007.5	1797.5	-56.1

Notes:

1. Financing gap = external financing needs - total private capital flows.

2. Most recent monthly data from IMF IFS database.

Source: GDF, 2009

Second, developed countries are constrained by the Ricardian Equivalence. Developed countries are less constrained by fiscal space or foreign exchanges. However, questions about the effectiveness of their fiscal stimulus packages usually arise from two issues. One is whether a large multiplier from public spending ever exists and one is whether such multipliers are subject to diminishing returns. Contrary to Keynesian theory, proponents of the so-called Ricardian equivalence point to the fact that households tend to adjust their behavior for consumption or saving on the basis of expectations about the future. Any fiscal stimulus package is then perceived as immediate spending or tax cuts which will need to be repaid in the future. In such situation, it is conceivable that the multiplier could be less than 1, with the GDP seen as given so that an increase in government spending does not lead to an equal rise in other parts of GDP.⁹ Whilst skepticism, based arguments of Ricardian Equivalence about the effectiveness of fiscal stimulus packages is inspired by theoretical model that relies on stringent assumptions, it is also clear that tax cuts or spending programs financed through borrowing will eventually have to be paid.

⁹ In neoclassical theory, it is even possible to have some rare instances of negative multipliers, which points to situations where fiscal contractions become expansionary. See G. Francesco and M. Pagano, "Can Severe Fiscal Contractions Be Expansionary?—Tales of Two Small European Countries," in: O.J. Blanchard and S. Fischer, *NBER Macroeconomics annual 1990*, Cambridge, MA., MIT Press.

Without over-generalizing its characteristics and manifestations, it appears that the current crisis could put many developed countries in the situation that Japan suffered in the 1990s. During that “lost decade”, Japan's government was very aggressive in implementing a fiscal stimulus. In 1991, public debt represented 60 percent of the country's GDP. By 2002, it had increased to about 140 percent—that 80 percent increase in government debt over a period of just 11 years implies a very large and very decisive stimulus of 7 percent of GDP per year. Yet, Japan did not get out of the crisis. This was because people chose to increase saving, which mitigated the effects of government spending.

The effectiveness of fiscal stimulus packages depends on how they are paid off. The relevant lesson from Japan's experience is clear: even if governments around the world agree to implement coordinated fiscal stimulus packages, there is still the issue of whether these fiscal programs will increase aggregate demand enough to offset the excess capacity that has been built up during the 2002-07 bubble. It seems that if public spending delivers higher levels of investment and rational economic agents believe that their income will not be taxed for repayment in the future, the Ricardian equivalence effect will not exist. If policymakers can design a system that allows public projects and programs to generate enough returns to repay themselves, the chance of success is high.

China's economic stimulus of 1998-2002 is an example of a successful fiscal policy strategy that enhances growth by targeting binding constraints of growth. It illustrates the possibility of combating deflation effectively while overcoming the Ricardian equivalence problem. The Chinese economy entered a period of deflation for nearly five years at the end of 1997. In the midst of the Asian financial crisis, China's neighbors all depreciate their currencies with sharp economic slumps in Indonesia, Korea, Malaysia, the Philippines, and Thailand. There was heavy deflationary pressure on China, with many economists advocating a parallel depreciation of the RMB. Instead, the authorities decided to hold the exchange rate steady, and to orchestrate a very large fiscal expansion, 1998-2002. The Government issued an estimated RMB 660 billion in bonds specifically to finance infrastructure—which may have induced a total of four times more of bank loans, private and local government investment. As a result, China went through a deflationary period whilst at the same time still recording an average growth rate of 7.8 percent—the highest in the world at that time. More importantly still, most of the projects in the stimulus package were targeted to the release of bottlenecks to growth. Examples of these include the highway system, port facilities, telecommunications, and education.¹⁰ The Chinese economy got out of deflation in 2003; average annual GDP growth rate increased from annual average of 9.6 percent in 1979-2002 to 10.8 percent in 2003-2008. The high growth rate led to an increase in government revenue, which allowed public debt to decline from about 30 percent of GDP in the 1990s to about 20 percent in 2007.

The way to break the constraint of Ricardian Equivalence is therefore to invest the fiscal stimulus in projects and programs that release bottlenecks to growth. When examining the impact of fiscal stimulus, it is important to note that public investment has

¹⁰ In 1998, China only had 4,700 kilometers of highway. With the fiscal stimulus, the highway system increased more than five times in five years.

the highest short-run multiplier. Tax cuts on the other hand are likely to have minimal multiplier effects (Only about 15 percent of the 2008 tax rebates in the US led to additional spending)¹¹ particularly in the current environment, as liquidity constrained households save a proportion in anticipation of future tax rises. Despite this fact, recent stimulus packages in developed countries, such as the United States, the United Kingdom and Germany, have allocated a significant proportion of funds to tax cuts. This inefficiency reflects, not only the lack of so-called “shovel-ready” projects that can be used for quick injection of demand, but also the fact that in matured high-income countries, much of the critical infrastructures already exists. It is therefore hard to find “bottlenecks” impeding developed country growth. As a result, many projects, such as those in which the Japanese government invested in the 1990s, would not increase growth potential. Therefore, the effect of Ricardian Equivalence should not, therefore, be dismissed in developed countries.

Developing countries have more of the type of projects that remove bottlenecks to growth than developed countries. High-return shovel ready opportunities may be limited in developed countries where a large share of effective investment and consumption demands have already been realized under the market system (especially thanks to the easy credit in the previous years). By contrast, they tend to abound in developing countries. Clearly, some fraction of fiscal resources must be injected in developed countries that are the epicenter of current crisis. But the main policy objective should be to create demand as quickly and efficiently as possible. This can be done by channeling investment to where it can be most effectively utilized and by investing in the developing world. Infrastructure investment, both domestic and regional, can generate strong forward and backward linkages with other sectors and facilitate growth and further investment in traditionally poorer areas of the population. The importance to growth of infrastructure is all the more acutely felt in developing countries due to the binding constraints it imposes on business.

4. The Global Recovery Fund: A Win-Win Solution

To overcome global recession characterized by excess capacity, fiscal stimulus must be bold and generate an immediate and sustained increase in global demand and productivity. To get out of the current crisis, there is a need to take bold coordinated fiscal stimulus to boost global demand. In today’s increasingly globalized economy, external demand and domestic demand can have the same effect on overcoming the crisis. Directing an appropriate share of the \$1.2 trillion fiscal stimulus envisaged by the IMF to invest in high-return/high-growth potential projects in the developing world can not only help absorb existing excess capacity and create immediate effective demand for exports from the developed world, but it can also help strengthen the long-term fiscal position of the developed world. To accomplish this with the greatest effect, it is important that fiscal stimulus should be targeted at releasing bottlenecks. Given the large disparities in fiscal space - across countries and between the developed and developing world - and given the significant externalities associated with fiscal stimulus, an

¹¹ Feldstein, M. 01/30/2009 Washington Post

appropriate response must be concerted, collaborative, and internationally coordinated such that international fiscal stimulus can be targeted to where its impact will be greatest, irrespective of national borders.

There is a strong rationale and justification for extraordinary support measures. It is now widely acknowledged that the world economy is going through a global recession the likes of which we have not seen in eight decades. Unlike previous crises, this one originated in the United States, at the heart of the international financial system, and it involves the world's main global reserve currency. The inability to rely on export stimulus anywhere also makes it evident that no one country or group of countries can emerge from the crisis on its own. Cooperation among industrialized and emerging economies and coordination of policies across the board are essential.

The magnitude of the current global crisis requires bold objectives and the strengthening of the international financial architecture. The Vulnerability Fund and the "1 percent solution" proposed by World Bank President Robert B. Zoellick, aims at addressing this issue. Along this line, the international community should consider a new funding mechanism—the Global Recovery Fund in the spirit of the Marshall Plan. It would be devoted to providing loans from high-income and reserve-rich countries to finance investment opportunities that remove binding constraints to growth in developing countries.

There is strong consensus on the idea that a coordinated fiscal stimulus at the global level—including both high-income countries and low-income countries—is necessary. However, low-income countries are constrained by their fiscal space or their low levels of foreign reserves. High-income countries should therefore devote part of their resources to the Global Recovery Fund for the financing of bottleneck-releasing projects in low-income countries. These projects would create demand domestically for developing countries and enable them to achieve sustained growth after the crisis. Such an arrangement would solve not only the problems of insufficient fiscal space in low-income countries, but it would also ensure that these fiscal stimulus projects will pay for themselves in the future. It would also facilitate the emergence of a more inclusive, sustainable growth for the world. In an increasingly open global economy, developing countries would also create demand for the high-income countries. It should be noted that such a fund would not be limited to low-income countries--it would also provide financing for middle-income countries that are constrained by fiscal space or foreign exchange.

High-income countries such as the U.S. or the European countries can also invest in the same kinds of projects domestically. Carefully designed investment projects in the "green economy" for instance or certain types of infrastructure would release bottlenecks to growth. But because of their level of development, the space for such high-return projects is limited.

A target of \$2 trillion spread over five years with \$400 billion per year (roughly 1 percent of GDP of the developed world) could be set for the Global Recovery Fund. The

developing countries' GDP accounted for about one third of global GDP (in PPP term). The IMF proposed a coordinated fiscal stimulus to be \$ 1.2 trillion (2 percent of global GDP). Based on this, the fiscal stimulus in the developing countries needs to be about \$ 400 billion per year. However, as argued, most developing countries' fiscal space is limited. Many of them also have large current account deficits. Furthermore, the World Bank's Global Development Finance projects that private capital inflows to developing countries will decline from an estimated \$923 billion (5.8% of GDP) in 2008 to around \$414 billion in 2009 (4.5% of GDP). Therefore, it should be appropriate for the high-income countries and foreign reserve-rich countries to provide up to \$400 billion of loan a year in a Global Recovery Fund to assist developing countries invest in growth-enhancing, bottleneck-releasing type of infrastructure projects so that the developing countries can participate in the globally coordinated fiscal stimulus. However, as former Tanzania President Benjamin W. Mkapa recently noted, "there has to be a strategy for ending aid dependence, to exit from it".¹² For such a fund to work, it would have to draw lessons from the initial Marshall Plan, and be timely (supporting projects that are ready and economically justified), targeted (projects with the highest economic and social payoff and positive externalities), and temporary (covering a 5-year timeframe, just like the Marshall Plan covered a specific period 1947-1952). Therefore, in a similar spirit, the total amount of the Global Recovery Fund should be targeted at \$ 2 trillion with \$ 400 per year for five years.

The high income and reserve-rich countries should take the lead in the creation of a Global Recovery Fund. The high-income countries, including the US, the EU, Japan and reserve-rich countries, such as China and other oil-exporting countries, should jointly contribute to this Fund. For high-income countries, the Global Recovery Fund would be an effective way of getting out of the protracted recession: just like the Marshall Plan, the facility would provide business opportunities for industrialized economies and stimulate both their domestic demand and exports. For countries with large foreign exchange reserves, it would be a mechanism to restore stability in global trade and manage their surpluses in the most efficient way possible. For poor countries, it would provide the much needed resources for domestic or regional projects that meet the market test—i.e. those projects with good returns.

5. CONCLUDING REMARKS

There are many lessons to be learnt from our recent experience; not least among these lessons is the extent to which we are interconnected. This is a global crisis and we must look for a global solution. We must target stimuli, irrespective of national borders, to where their marginal impact will be the greatest. Right now this means investing in projects that release the bottlenecks that are impeding, not just the growth of developing countries, but the growth of the world.

The Global Recovery Fund is a framework and a funding mechanism that would provide a useful outlet for some of the surplus capacity held by rich countries. It could help

¹² B. W. Mkapa, "Aid: Rethinking Old Concepts," *The New Times*, February 2, 2009.

release the bottlenecks to growth that are hampering trade, business and private-sector investment in low-income countries. Such a fund could offer a win-win solution for developed and developing countries alike and could help the world overcome the crisis in the short-term and to pave the way for inclusive, sustained growth for the world in the long-term.

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