



TWO TALES OF ADJUSTMENT: EAST ASIAN LESSONS FOR EUROPEAN GROWTH

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TWO VIEWS ABOUT AUSTERITY

- **First View: Austerity is expansionary (Alesina & Perotti, 1995; Alesina & Ardagna, 2010).**
- **Contrary View: Fiscal consolidation in the midst of a crisis is harmful to growth (Blanchard and Leigh, 2013).**
- **Both views ignore the wealth of information inherent in comparing the economic performance of countries that pursue fiscal austerity with those that do not.**
- **Do countries that pursue countercyclical fiscal policy in response to a negative macroeconomic shock experience a faster recovery of output and employment than those that implement fiscal austerity?**

TWO CRISES, TWO FISCAL POLICY RESPONSES

The Asian Crisis

Initial Prescription: Fiscal consolidation as a means of stabilizing the balance of payments.

Course Reversal: Subsequent program revisions allowed for fiscal expansion.

The Global Financial Crisis (Europe)

Initial Prescription: The IMF initially encouraged countries to pursue fiscal stimulus, starting in Fall 2008.

Course Reversal: Austerity measures were announced in 2010, budget deficits as a fraction of GDP were reduced and the European Fiscal Compact was announced in March 2011.

IS THE COMPARISON APT?

| | East Asian Crisis (1997-1998) | Global Financial Crisis (2007-2008) |
|-----------------------------------|----------------------------------|--|
| Largely Unanticipated | ✓ | ✓ |
| Domestic Asset Markets Collapsed | ✓ | ✓ |
| Banks Failures | ✓ | ✓ |
| Bankrupt Firms | ✓ | ✓ |
| Over-borrowing | ✓ | ✓ |
| Insufficient Regulatory Oversight | ✓ | ✓ |
| FX Denominated Debt Burdens | ✓ | x |
| Collapsing Exchange Rates | ✓ | x |
| Deleveraging Cycle | ✓ | ✓ |
| Loss of Investor Confidence | ✓ | ✓ |

ASIA REBOUNDS QUICKLY WHILE EUROPE CONTINUES TO CONTRACT

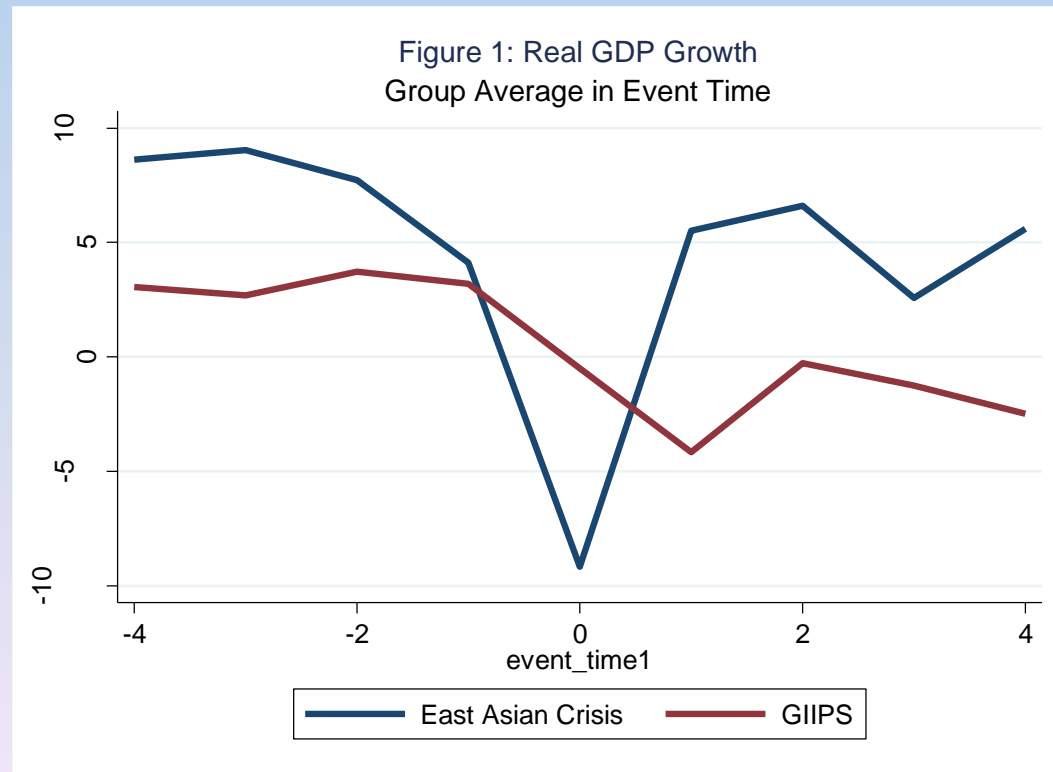
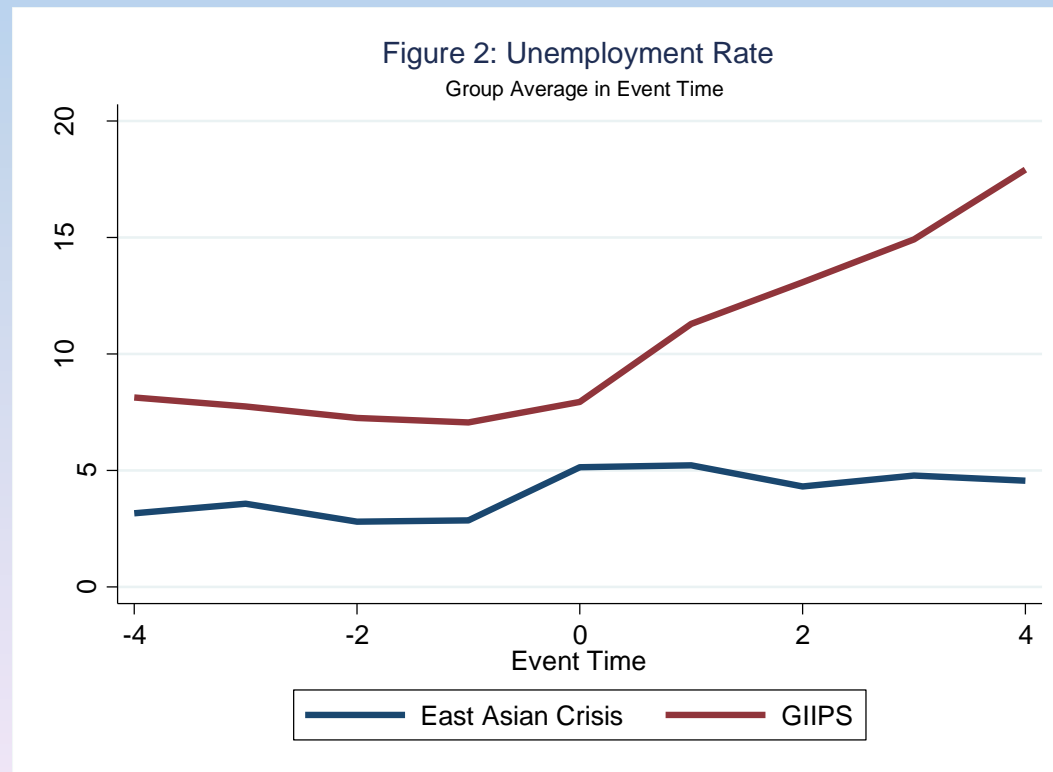


FIGURE 2 TELLS A SIMILAR STORY OF DOWNTURN AND RAPID RECOVERY IN ASIA VERSUS PROLONGED STAGNATION IN EUROPE.



FISCAL POLICY FLEXIBILITY IN EAST ASIA

Clearly articulated in April of 1998 by Stanley Fischer:

“On the question of the appropriate degree of fiscal tightening, the balance is a particularly fine one.....

The amount of fiscal adjustment in Indonesia was one percent of GDP; in Korea it was 1.5 percent of GDP; and in Thailand -- reflecting its large current account deficit -- the initial adjustment was 3 percent of GDP.

After these initial adjustments, if the economic situation in the country weakened more than expected, as it has in the three Asian crisis countries, the IMF has generally agreed with the country to let the deficit widen somewhat, that is, to let automatic stabilizers operate.”

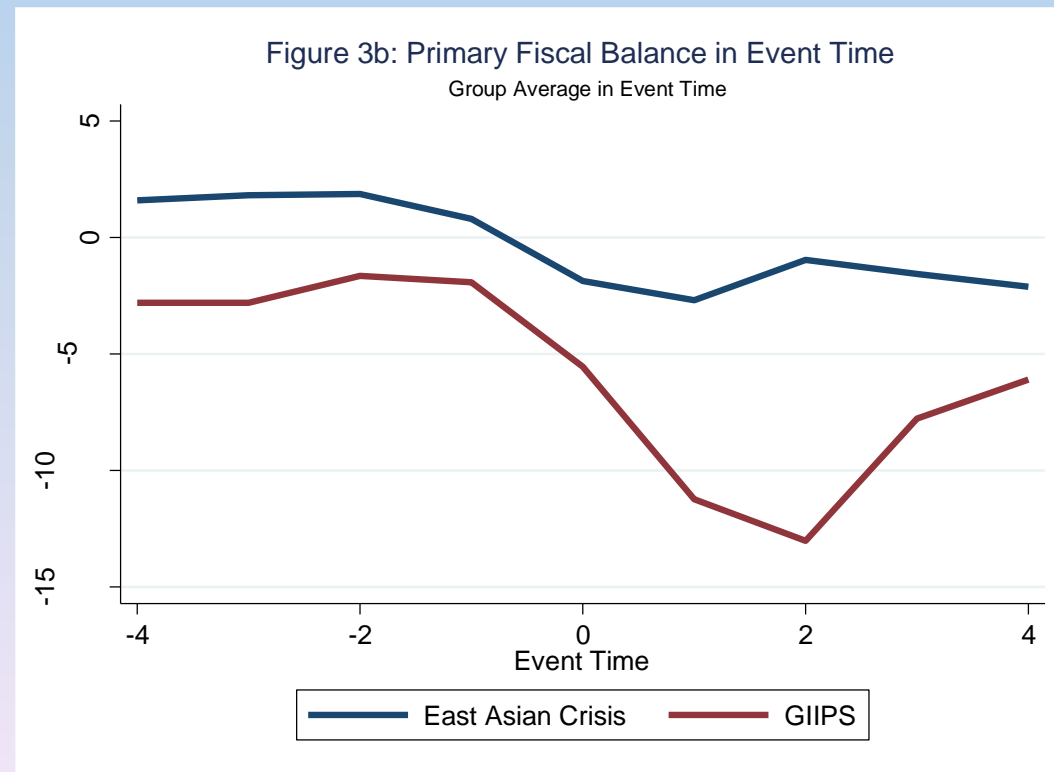
THE DETERIORATION IN THE REAL ECONOMY WAS FAR WORSE THAN ANTICIPATED

| | Indonesia (1998/99) | | |
|----------------------|---------------------|---------------|----------------|
| Real GDP Growth Rate | Original | Revised | Actual |
| | 3% | -12.1% | -13.13% |

| | Korea (1998) | | |
|----------------------|--------------|---------|--------|
| Real GDP Growth Rate | Original | Revised | Actual |
| | 2.5% | -7.0% | -5.71% |

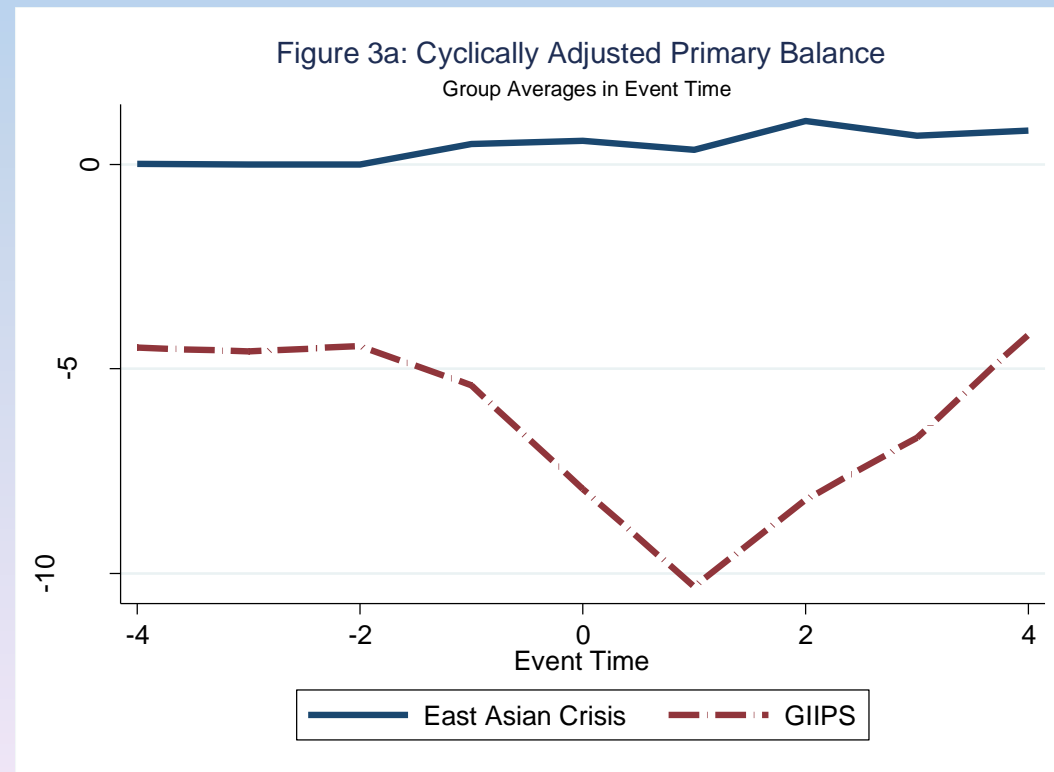
| | Thailand (1998) | | |
|----------------------|-----------------|---------|---------|
| Real GDP Growth Rate | Original | Revised | Actual |
| | 3.5% | -5% | -10.51% |

ASIA STAYS THE COURSE WHILE EUROPE SWITCHES FROM STIMULUS TO AUSTERITY



REVERSAL IN EUROPE STRIKING IN SIZE, SPEED & PERSISTENCE

THE CHANGE IN THE STRUCTURAL BALANCE SHOWS A SIMILAR PATTERN OF AN ABRUPT SWITCH FROM STIMULUS TO AUSTERITY



REVERSAL STRIKING IN SIZE & SPEED

- Especially when compared to the *initial* fiscal adjustment path prescribed by the IMF in East Asia.
- For the European periphery, the primary fiscal balance changed from -13% of GDP to -7.7% of GDP between 2010 -2011.
 - almost twice the adjustments initially prescribed in Thailand
 - three to five times as large as those in Korea and Indonesia.
- Consolidation has been more persistent—further fiscal consolidation 1.6 percentage points of GDP between 2011-2012.
- Consolidation was never fully implemented in Asia because of the IMF's relatively quick change in course.
- Fiscal consolidation in Europe took hold & persisted for more than two years in the midst of a severe downturn.

OUR FORMAL STATISTICAL RESULTS SUPPORT THIS SIMPLE VISUAL STORY.

- **T-tests of means confirm that Asia tightened government finances early & then loosened as the need for countercyclical fiscal policy became clear.**
- **Europe began with fiscal stimulus but tightened & pursued fiscal consolidation before economic recovery took hold.**
- **Patterns are consistent for different measures of the fiscal balance.**
- **T-tests confirm that fiscal consolidation in Europe is achieved via spending cuts and not tax increases.**

TABLE 1

| Panel 3: Government Primary Fiscal Balance (% of GDP) | | | | | | | |
|---|------------|--------|---------------|----------------|------------|---------------|----------------|
| Averages | Pre-Crisis | Crisis | Post-Crisis I | Post-Crisis II | Crisis-Pre | Changes | |
| | (t-4, t-1) | (t=0) | (t+1, t+2) | (t+3,t+4) | | Post I-Crisis | Post II-Post I |
| East Asian Crisis | 1.56 | -1.88 | -1.84 | -1.84 | -3.44** | 0.04 | 0 |
| GIIPS | -2.3 | -5.55 | -12.14 | -6.94 | -3.26* | -6.58** | 5.20** |

| Panel 4: Government Structural Balance (% of Potential GDP) | | | | | | | |
|---|------------|--------|---------------|----------------|------------|---------------|----------------|
| | Pre-Crisis | Crisis | Post-Crisis I | Post-Crisis II | Crisis-Pre | Changes | |
| | (t-4, t-1) | (t=0) | (t+1, t+2) | (t+3,t+4) | | Post I-Crisis | Post II-Post I |
| East Asian Crisis | 0.16 | 0.57 | 0.71 | 0.76 | 0.41 | 0.14 | 0.05 |
| GIIPS | -4.72 | -7.93 | -9.26 | -5.42 | -3.21* | -1.33 | 3.84** |

**Table 2: T-Tests of Means: Debt and Deficits
GIIPS versus East Asia in Crisis Event Time**

| | Pre- Crisis (t-4, t-1) | Crisis (t=0) | Post- Crisis I (t+1, t+2) | Post- Crisis II (t+3, t+4) | Crisis- Pre | Changes Post I- Crisis | Post II- Post I |
|-------------------------------|------------------------------|-----------------|---------------------------------|----------------------------------|----------------|------------------------------|--------------------|
| Average Difference | (GIIPS-East Asia) | | | | | | |
| Gross debt | 42.2 | 41.0 | 44.1 | 71.6 | -1.21 | 3.09 | 27.52*** |
| Primary fiscal balance | -3.9 | -3.7 | -10.3 | -5.1 | 0.18 | -6.62** | 5.20** |
| Structural Balance | -4.9 | -8.5 | -10.0 | -6.2 | -3.62** | -1.47 | 3.78** |
| Revenues | 19.2 | 20.8 | 19.9 | 19.3 | 1.51* | -0.90** | -0.58 |
| Expenditures | 23.1 | 24.4 | 30.2 | 24.4 | 1.33 | 5.72** | -5.78** |

THE DIFFERENCES IN THE CHANGES IN THE FISCAL POLICY STANCE EXPLAIN THE RESPONSE OF OUTPUT ACROSS THE TWO REGIONS.

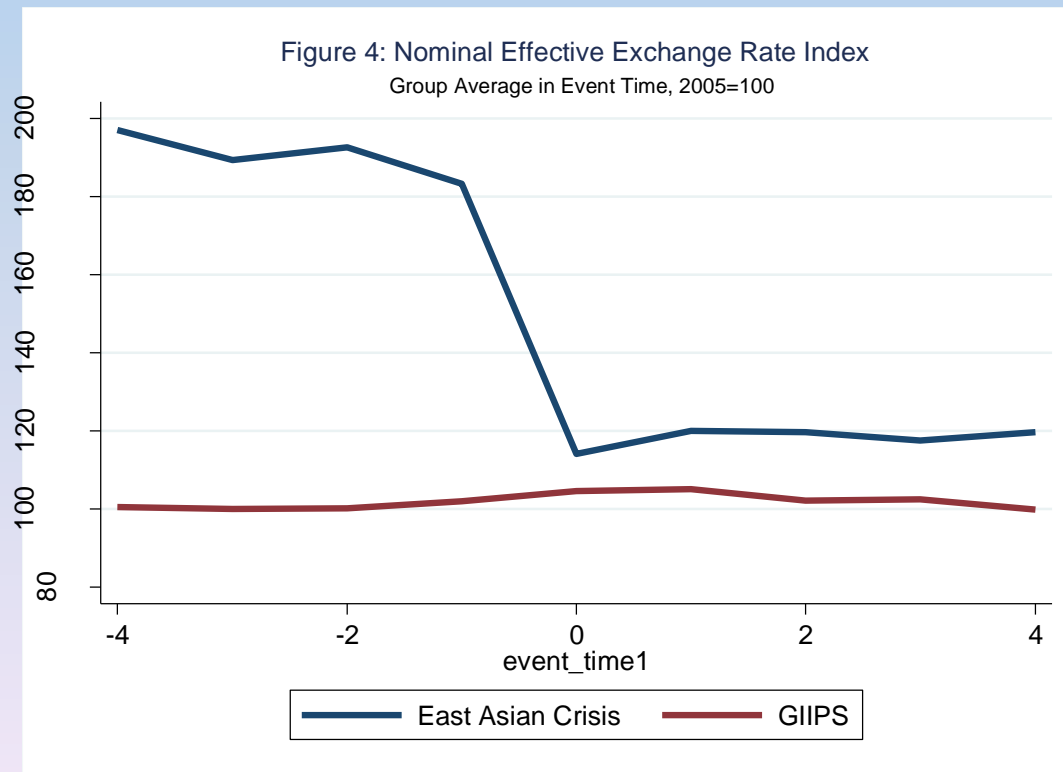
- The change in the CAPB has a negative & statistically significant impact on output growth when the fiscal stance switches from stimulus to austerity in Europe (Table 5, Panels A & B).**
- In East Asia the contractionary impact of fiscal austerity is evident on impact during the crisis, but fiscal policy does not appear to have a statistically significant effect on real GDP growth in the pre-crisis and post-crisis periods (Table 5, Panel C).**

CAVEATS

- A number of other factors at play. Is the comparison apt?
- Price-Adjustment in Asia: Exchange rates played a central role
- Monetary policy
- Structural reforms
- Initial Conditions
- External environment

ALTERNATE CHANNELS OF ADJUSTMENT

FIGURE 4: EXCHANGE RATES DECLINE SIGNIFICANTLY IN EAST ASIA COMPARED TO THE RELATIVE STABILITY OF THE EURO.

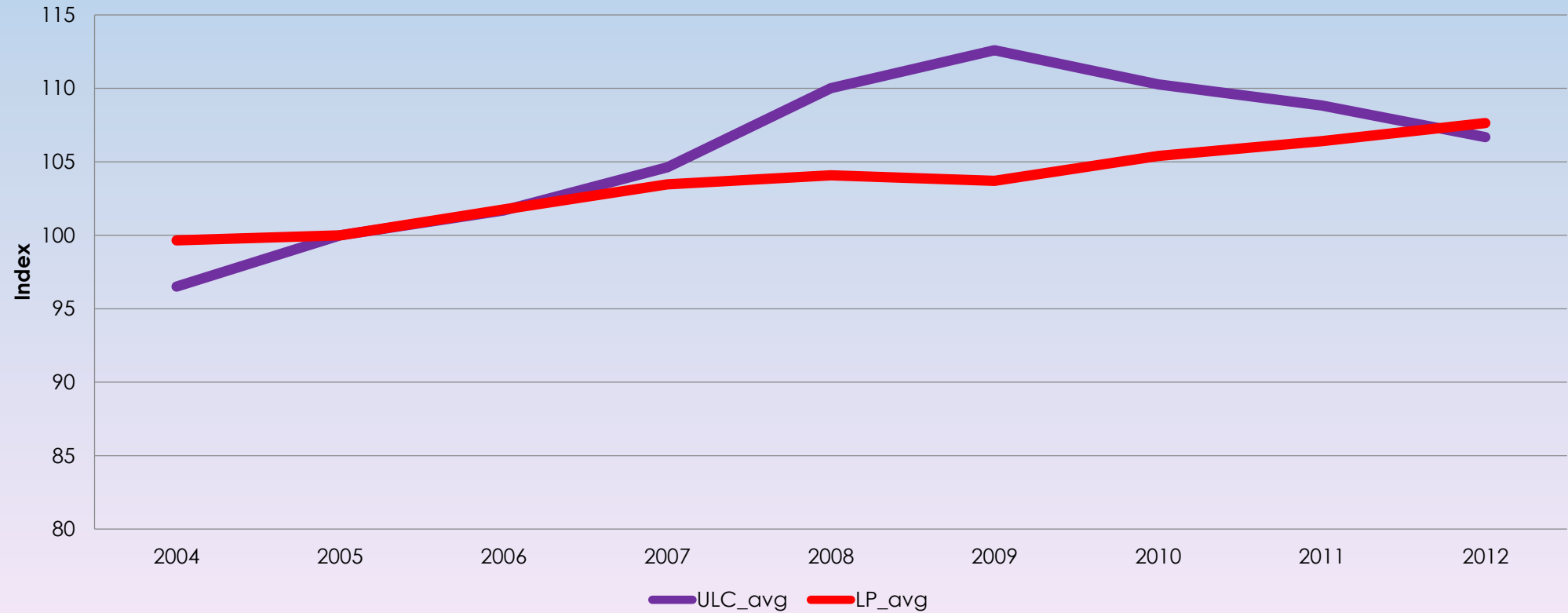


To the extent that policy makers cannot avail themselves of fiscal and monetary policy (exchange rate) to achieve internal and external balance, the remaining choices are to either:

- implement structural reforms that raise the productivity of workers**
- to accept internal devaluation.**

UNIT LABOR COST INCREASES HAVE OUTPACED LABOR PRODUCTIVITY GROWTH IN THE EUROPEAN PERIPHERY

Figure 5: Unit Labor Costs & Labor Productivity Index
(GIIPS, 2005=100)



CONCLUSION

- **Asia's recovery has been more rapid & robust than that of Europe.**
- **Leading candidate is the decision by policy makers in the two regions to adopt very different adjustment strategies.**
 - (i) Counter-cyclical fiscal policy**
 - (ii) Gradualism**
 - (iii) Flexibility**