

Global Recession: Spending Cuts Are Not the Answer

by George Irvin, Professorial Research Associate, Development Studies, SOAS*

Many popular pundits and politicians now seem to agree that a drastic cutback in public sector spending in the rich countries is not just inevitable—but indeed desirable. Fiscal conservatives are currently having a field day. But drastic cuts in a deepening recession do not make sense. So, how can so many intelligent commentators get it so wrong?

In truth, the financial crisis that started with a relatively small number of defaults on subprime loans in the US has had contagious effects, not just for developed nations, where the vulnerability of deregulated finance capital has been exposed, but also for the world as a whole. Unless there is an urgent co-ordinated effort to address global economic needs, it is not just the poorer citizens of rich countries that will suffer, but also the far poorer inhabitants of the developing world.

What's Wrong with Spending Cuts

There are multiple reasons why budget cutting by developed countries in the midst of a major recession is a bad option. First and foremost is the 'paradox of thrift', first signalled as a problem by Keynes during the Great Depression. Keynes famously argued that the more a country tries to save, the more its income and investment fall and, in consequence, the less there is available to save. This point is fundamental, but bankers and businessmen (for whom balance sheets must balance by definition) generally ignore such macroeconomic logic.

Secondly, the combination of financial meltdown and economic recession is deadly. Not only are banks not lending, in hopes of restoring their balance sheets, but also their customers--businesses and households--are rebuilding savings. Households in particular have seen the price of houses, their main asset, fall precipitously; in consequence, they have curtailed consumption and saved more.

Equally, as Richard Koo has warned in his recent book, individual firms switch their attention during a recession from profit maximisation to debt minimisation, particularly when falling share prices exacerbate the mismatch between their assets and liabilities (Koo 2008). With all private-sector actors trying to save, only the public sector can boost aggregate demand. The state emerges as the 'investor of the last resort', restoring the conditions necessary for profitable private investment to resume.

Finally and most ominously, Britain and the US are likely to be headed for a 'double dip' recession, while the rest of the EU lags not far behind. Financial markets, which had been rallying until June 2008, have begun to oscillate, first falling sharply and then rising again. As Nouriel Roubini recently argued, the 'green shoots' of US recovery, when they are examined closely, are largely dead yellow weeds.

The US and the Eurozone

The US economy is particularly important because it is the engine of the world economy. But the Obama administration's stimulus package is faltering: so far, US retail sales, hourly earnings and employment figures for 2009 are worse than expected, housing markets have not yet stabilised and new orders for production are down. The Dow Jones index appears to have peaked in June, and its future direction remains uncertain. Further stimulus is needed.

In the EU, despite the recent injection by the European Central Bank of €440 billion into the money market, the real economy continues to decline, with retail sales looking poor and unemployment rising. The German model of export-led growth has fared particularly badly as financial contagion has reached world-wide proportions. As Paul Krugman said some weeks ago in his LSE lecture in London, unless Germany discovers a new planet to which to sell its goods, its economy will not recover soon.

Developing Country Impacts

Developing countries know all about financial crises: e.g., the 1995 'tequila' crisis in Mexico, the 1997 Asian financial crisis and the 2001 financial meltdown of Argentina. The latter crises were accompanied by the usual strictures on budgetary balance imposed by the IMF.

Thereafter, Asia in particular responded by managing exchange rates and aiming for trade surpluses. The same orthodox economists who backed bitter IMF medicine in 1997 now complain that current global imbalances--in particular the large US and UK trade deficits--are the product of an Asian 'savings glut', which by swamping the rich countries with capital squashed their domestic savings.

Regardless of one's views of the savings-glut hypothesis, what is true is that we face a world-wide crisis, with negative implications certain for the developing world. The World Bank estimates that for every percentage point of growth lost in the developing world, 20 million people will be forced into poverty.

Three effects are most visible. First, recession in the rich countries reduces North-South trade and therefore slows developing-country growth. Secondly, capital flows from the rich countries to the developing world are adversely affected--particularly aid flows, but also FDI. Thirdly, commodity prices are likely to continue trending downward though they will remain relatively high.

Real GDP Growth Rates (annual % change)

Growth Rates	2008	2009*	Difference
Developed Economies	0.9	-3.8	-4.7
Developing Economies	6.1	1.6	-4.5
Africa	5.2	2.0	-3.2
Asia	7.7	4.8	-2.9
Latin America	4.2	-1.5	-5.7
Middle East	5.9	2.5	-3.4

Source: IMF *World Economic Outlook*, April 2009. * Projected.

According to the current IMF *World Economic Outlook* (IMF 2009), while the average growth of developed economies in 2008 was barely positive, for 2009 as a whole their growth will be strongly negative, dragging developing-country growth down with it. Developed-world average growth is forecast to fall 4.7 percentage points in 2009 and developing-country growth by 4.5 percentage points (see Table).

The distribution of these changes between developing continents is uneven, though, with growth in Asia falling only 2.9 percentage points on average--strongly influenced by China's performance--while Middle Eastern and Latin American countries will suffer most, reflecting the twin influence of falling oil prices and the impact of negative US growth on Latin American exports.

Moreover, the availability of finance to developing countries is suffering. As the *World Economic Outlook* states, "emerging and developing economies are expected to face greatly curtailed access to external financing in both years [2009 and 2010]."

This is already reflected in financial markets in emerging-market economies: countries such as Brazil, India, Mexico, Russia and South Africa have suffered very large stock market declines in recent months. Lack of availability of credit is reflected not just in reduced private capital flows from rich to poor countries but also in reduced remittances as developed-country jobs are squeezed.

Moreover, the 'aid gap' is growing: it is likely that Official Development Assistance in 2009 will be of the order of \$100 billion, down by as much as 20% on 2008. By contrast, Birdsall (2009) estimates that no less than \$1 trillion in development assistance must be unlocked to help developing countries cope with the crisis.

The state of commodity prices is a problem too, particularly for those developing countries that are net importers of oil and/or food. Recession in the developed world has recently placed downward pressure on commodity prices. At the same time, changing expectations about the length and depth of the recession are causing commodity traders' expectations to fluctuate, leading to highly volatile prices.

The rise in food prices, starting two years ago, has hurt net food importers badly. Moreover, a recent FAO report finds that, despite recent declines, in 27 sub-Saharan African nations, 80-90% of all cereal prices remain over 25% higher than before the 2007 food price crisis.

Oil prices have been even more volatile: they shot up to nearly \$160 per barrel in July 2008 before falling 75% by December of that year. These increases have been driven by stockpiling--physical withholding of oil from the market--which in turn has depended on expectations about resumed growth. In mid-2008, for example, inventories were bulging as oil prices shot up.

Beyond Recession into Deflation?

Several further points need to be made about recession in the developing world. Not only is poor economic growth blowing a large hole in many EU

government budgets, but also some of the worst-affected countries (e.g., those in Eastern Europe) are being made to adhere to strict budgetary conditions for joining the Eurozone. Drastic spending cuts are driving them further into recession and possible bankruptcy.

Looking beyond the near certainty of a prolonged recession, the spectre of Japanese-style deflation looms in Europe. In May 2009, for example, Eurostat reported that Eurozone inflation (according to the Harmonised Index of Consumer Prices or HICP) was zero, down from 3.7% 12 months earlier.

Once 'deflationary expectations' set in, consumers postpone their consumption decisions, hoping that goods and services will get cheaper. At the same time, the real value of household liabilities rises (i.e., mortgage repayments become more onerous and foreclosures increase). In these conditions, banks become ever more cautious and firms postpone investment decision, thus making the recession even worse.

Changing the Game

It is time to change the rules of the game. The Federal Reserve and the European Central Bank can pour billions into the money markets, but the real economy of the developed world will not revive without continued active fiscal policy--if necessary, financed by the printing press. Monetary policy alone is weak in a recession and cannot do the trick--because of the probability of the 'liquidity trap' problem, as originally identified by Keynes.

While it is true that greater prudential regulation of casino capitalism is needed, it is at least as important to recognise the crucial role of a pro-active macroeconomic policy. Such a stance means far more than recapitalising the banks: it signifies concerted efforts to undertake investment and create new jobs. Without further stimulus, the rich world risks prolonged recession and stagnation, and will surely drag developing countries down with it.

** George Irvin is author of Super Rich: The Growth of Inequality in Britain and the United States, London: Polity, 2008. An early version of the contents of this viewpoint first appeared in the EU Observer on 7 July 2009.*

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