EXECUTIVE BOARD MEETING

SM/15/92
Correction 2

June 10, 2015

To:	Members of the Executive Board
From:	The Secretary
Subject:	**Fiscal Policy and Long-Term Growth**

Board Action:	The attached correction to SM/15/92 (4/21/15) has been provided by the staff:
Evident Ambiguity	**Page 8**
Comments:	This correction is to rule out the possible misreading that "close to balanced" means Malaysia did not achieve a budget balance in the 1990s. In fact, the fiscal balance was in surplus for 5 years in the 1990s and in deficit for 5 years.
Questions:	Mr. Akitoby, FAD (ext. 36646) Mr. Senhadji, FAD (ext. 38380)

12. The pace of fiscal consolidation is important for medium- to long-term growth. A vast literature, largely from the pre-crisis period, emphasizes the scope for expansionary fiscal adjustments—not only for advanced economies, but also for emerging market economies and low-income countries.[6] However, in a deep and lasting recession, fiscal consolidation is likely to have a negative short-term impact on growth when there are large negative output gaps and monetary policy is constrained by the zero lower bound and/or inoperative credit channels. In such an environment, consolidation policies can be harmful to longer-term growth due to possible hysteresis effects, whereby temporary layoffs become permanent (De Long and Summers, 2012). Furthermore, in a deep recession, investment is likely to remain low for a prolonged period of time, reducing further potential output. Overall, these arguments highlight the need to carefully calibrate the pace of fiscal adjustment during a deep recession. In particular, countries that are not under market pressure should proceed with gradual fiscal consolidation, anchored in a credible medium-term plan (Blanchard and Cottarelli, 2010; IMF, 2013b; Jaramillo and Cottarelli, 2013).

13. The composition of adjustment matters as well. The appropriate mix of revenue and expenditure measures depends on each country's specific conditions. Policymakers need to consider the durability of the selected measures and their impact on growth and equity. For advanced economies, expenditure-based fiscal consolidations have been shown to be more durable (Alesina and Ardagna, 2012), and have been associated with growth in private investment (Alesina and others, 2002). In contrast, for LICs Baldacci and others (2004) find that revenue-based adjustment leads to more durable consolidation episodes, with greater benefits for growth. In addition, credit-constraints matter: in the presence of high private debt and credit supply restrictions, deficit reductions achieved through tax-base broadening while protecting public investment are supportive of medium-term growth in both advanced and emerging economies (Baldacci, Gupta, and Mulas-Granados, 2015). Large expenditure-based consolidations tend to increase inequality, which can undermine long-term growth (Ball and others, 2013; Woo and others, 2013; Berg and Ostry, 2011). Some degree of pragmatism is therefore needed to strike the proper balance between revenue and spending measures.[7]

- Faced with sluggish growth and high fiscal deficits (10 percent of GDP in 1986), Malaysia cut current spending and rationalized inefficient public investment. As a result, the budget registered small surpluses and deficits ~~was close to balanced~~ during ~~most of~~ the 1990s, the private investment-to-GDP ratio more than doubled, and annual growth averaged around 8

can reduce annual average growth by more than 0.1 percentage point. Kumar and Woo (2010) confirm this effect on a sample of advanced and emerging economies. For developing countries, estimated thresholds are generally much lower: Pattillo and others (2011) find that the marginal effect of additional debt becomes negative when the net present value of debt reaches 20-25 percent of GDP. Clements and others (2004) obtain a similar result for low-income countries and external debt.

[6] Key papers include Alesina and Perotti (1995, 1996); McDermott and Wescott (1996); Alesina and Ardagna (1998); Bleaney, Gemmel, and Kneller (2001); Alesina, Ardagna, Perotti, and Schiantarelli (2002); Baldacci and others (2004); Gupta and others (2005).

[7] For a fuller discussion on the nexus between the composition of fiscal adjustment and growth, see IMF (2013b).