The case for a concerted international fiscal response

November 2008

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Contents

		Page
Executive summary		3
Chapter 1	The global economic downturn	5
Chapter 2	Role of fiscal policy in the current context	11
Chapter 3	Concerted international fiscal action	19
Chapter 4	International response	25

Executive summary

The world economy faces a serious economic downturn arising from the severe dislocation in the financial system. The magnitude and speed of the downturn, and the uncertainty over the effectiveness of monetary policy in current conditions, warrant a substantial fiscal policy response in line with the agreement of the G20 leaders on 15 November. To be effective this needs to be timely and targeted, and also temporary so as to ensure sustainable public finances in the medium term. A concerted international fiscal response, tailored to each country's specific situation, would enhance its effectiveness and help build confidence. Action now would help to limit the depth of the downturn and restore growth.

Since mid-2007, the world economy has experienced a series of significant economic shocks. Developments in the US sub-prime mortgage market triggered a period of severe stress in global financial markets that escalated in the run-up to the rescue of Bear Sterns in March 2008, and again when Lehman Brothers failed in September 2008. The surge in oil and commodity prices during the first half of 2008 put additional pressure on inflation and real incomes around the world. Together these have contributed to a severe global downturn in economic activity (Chapter 1).

Governments around the world have intervened decisively to address the root causes of the financial crisis: shortages of liquidity, capital and confidence. While the period of financial instability is not over, and more remains to be done to implement these measures, the G20 leaders summit on 15 November agreed to: "take whatever further actions are necessary to stabilise the financial system". The G20 statement also agreed that more needed to be done to support economic growth.

This paper focuses on the use of fiscal measures as part of the broader policy response to stimulate domestic demand and in particular, the role of concerted international fiscal policy in reviving economic activity and private sector confidence. With evidence that the global economy has slowed sharply, fiscal policy, alongside monetary policy, needs to support demand, in order to limit and reverse the adverse impacts on output and employment. Support for the real economy is also vital to insure against a further increase in expected financial losses.

This is a global crisis, and therefore requires a global solution. The combined effect of coherent actions taken across countries will be more effective than each country acting alone. A concerted stimulus among major trading partners would increase trade flows in both directions. By working together, each country can expect to need to do less than would be required if the country's trading partners were to not participate, or receive a larger impact from the same measures. Decisive concerted action by the world's leading economies will also provide a strong signal to the private sector of the willingness of governments to act effectively together, and help to reduce the risk of an adverse feedback between low expectations, cautious spending and weak outcomes.

Chapters 2 and 3 examine respectively the case for using fiscal policy in macroeconomic stabilisation, and the question of whether fiscal responses should be coordinated across countries. While it is clear that fiscal policy can and should play a role in supporting monetary policy in the current situation, they draw a number of important conclusions:

- The nature of the financial crisis, with credit constraints becoming more binding and the effectiveness of monetary policy becoming more uncertain, points to more use of fiscal stimulus in the macroeconomic policy response, than would normally

be expected. The magnitude and the speed of the current downturn also warrant a more substantial fiscal response.

- Any fiscal response needs to be consistent with maintaining sustainable fiscal policies in the medium term. This argues for measures that are temporary and against those that are hard to reverse, such as some new spending commitments.
- Discretionary fiscal actions can take time to agree and implement, and can therefore become pro-cyclical, supporting growth when the economy is already recovering. While the likely duration of the current slowdown makes this less of an issue, the rate with which the world economy is slowing down means that rapid action is called for. Measures that can be introduced quickly are at a premium: this makes some spending options less attractive.
- The effectiveness of domestic fiscal actions will be increased if they are introduced as part of a concerted international response.
- This does not mean that all countries should take identical actions. Fiscal actions need to be tailored to the situation of each country, depending on their budgetary positions. Countries that already have high levels of public debt relative to GDP have less scope to undertake fiscal expansion than those with lower debt to GDP ratios.
- Short-term fiscal measures should also be designed in a way that takes account of the impact on global imbalances in the medium term. Countries with high levels of national saving and strong external positions have more scope to sustain fiscal expansions in the longer term.

Overall, a fiscal stimulus will be most effective if it is: timely, so it delivers a stimulus when it is needed; temporary, to ensure longer term sustainability; targeted, to maximise its impact; and part of a concerted international response, tailored to individual country circumstances.

The final chapter reviews actions taken in the UK and other countries. In addition to actions to support their financial systems and actions to ease monetary policy, a number of countries, including the US, Japan, Germany, Spain, South Korea and China have announced, or are planning, significant fiscal stimulus packages. The EU has also recognised that fiscal policy has a role to play, with public statements calling for the Stability and Growth Pact to be applied in a way that balances short-term flexibility in the current exceptional circumstances with a continued commitment to the long-term sustainability of public finances.

In the Pre-Budget Report the UK has announced a fiscal package that delivers an effective fiscal stimulus while maintaining sustainable public finances. The main elements of the package comprise a temporary reduction in the VAT rate and the bringing forward of some capital spending.

The VAT rate cut should boost consumers' purchasing power and encourage them to bring forward consumption, while bringing forward capital spending will provide rapid near term support for employment and the construction sector.

These measures are designed to provide significant support to the economy in the near term. Additional measures to help modest and middle income taxpayers will also support growth and incomes during the downturn.

Chapter 4 also concludes that fiscal measures must be part of a broad international policy response to restore growth, avoid negative spill-overs and support emerging markets and developing countries, and to strengthen the international financial system. G20 Leaders will meet again before 30 April 2009 to review progress against their agreed actions. The UK assumes the Chair of the G20 in 2009 and will take a leading role in driving forward this work.

1 The global economic downturn

Global economic shocks

1.1 Since mid-2007, the world economy has been hit by major economic shocks. The surge in global commodity prices, which built over a number of years but gathered pace in the first half of 2008, has recently receded significantly. The disruption in global financial markets that was triggered in summer 2007 intensified dramatically in September 2008, with a number of large and small financial institutions across a broad range of advanced and emerging economies receiving government support, in conjunction with unprecedented generalised support for banking systems across the world. The origins of the financial crisis are numerous and shared internationally, underpinned by global imbalances that helped drive long-term interest rates lower. Chapter 3 of the Pre-Budget Report discusses the origins of the crisis in more detail.

Global financial crisis

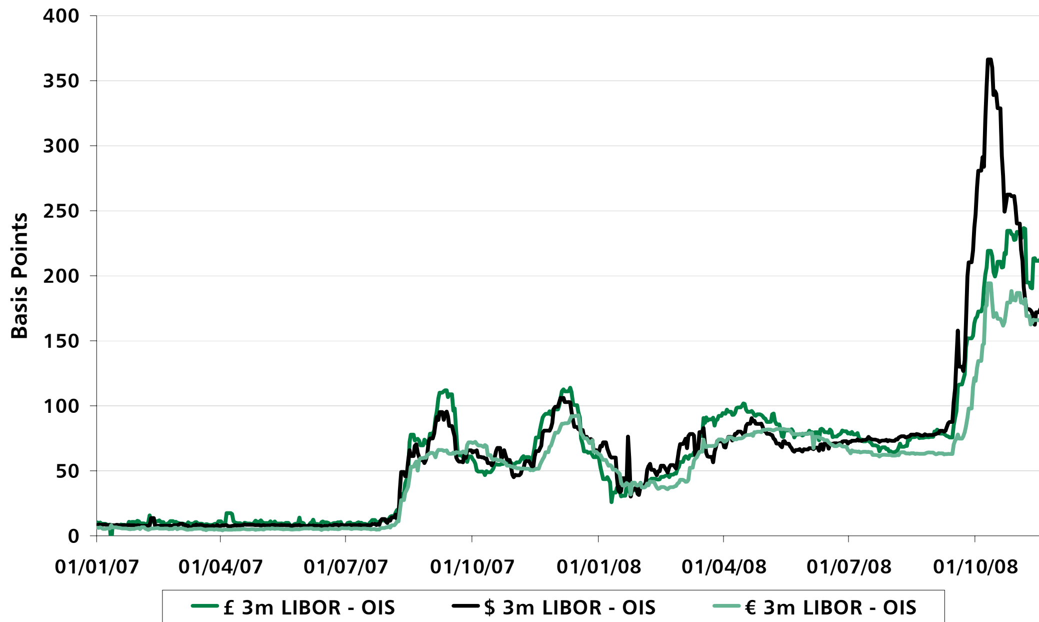
1.2 In summer 2007, the announcement of unanticipated losses on assets related to US sub-prime mortgages, where default rates had risen sharply, triggered adverse market conditions across an array of credit and money markets. Spreads on asset-backed securities increased very sharply and interbank lending costs moved up sharply relative to risk-free interest rates.

1.3 What began as a disruption to the functioning of specific credit and money markets has spread and intensified to the extent that all financial markets have been affected and financial institutions and financial systems in both advanced and emerging market economies have been put under severe pressure. Strains in financial markets escalated in the run-up to the rescue of Bear Sterns in March 2008, and again when Lehman Brothers failed in September 2008. The spread between interbank lending costs over implied market expectations of future policy rates increased from around 10 basis points[1] in the first half of 2007 to highs of 100 basis points in September 2007 and again in March 2008, before reaching more than 200 basis points over the past two months (Chart 1.A). The EMBI Global Composite index[2], which measures the cost of borrowing for emerging economies on international capital markets relative to interest rates on US government securities, has similarly spiked since September as emerging markets have become increasingly affected by the financial crisis (Chart 1.B).

[1] A basis point is equal to 0.01 percentage points.

[2] The Emerging Market Bonds Index, compiled by JP Morgan. The EMBI shows the spread between emerging market sovereign bonds and US Treasury bills, the benchmark safe asset.

Chart 1.A: Spread of 3-month interbank lending rates over expected policy rates



Source: Bloomberg

Chart 1.B: J.P. Morgan, EMBI Global Composite Index

Source: J.P. Morgan & Co. Incorporated

Impact of the financial crisis on economic activity

1.4 Tighter credit conditions caused by the credit shock and by the squeeze on real incomes due to high oil and commodity prices pushed many advanced economies to the brink of recession by mid-2008. The intensification of the global financial crisis in recent months has further weighed on economic prospects. Credit conditions facing households and companies have tightened very significantly. The availability of credit has been restricted, the terms on lending tightened, and the price of private credit has risen relative to official policy rates and government borrowing costs.

1.5 Measures taken in advanced economies to stabilise the financial system (see Chapter 4, Box 1.A) have helped to ease market perceptions of default risks among financial institutions and reduce interbank lending rates, although spreads over expected policy rates remain high. Despite these measures, credit conditions around the world remain tighter than before the crisis and this is contributing to a sharp slowdown in activity across the advanced economies, with unemployment rising, continued steep declines in asset prices and significant drops in business and consumer confidence. These developments have led many commentators to revise their forecasts down sharply over the last few months. Events continue to unfold in unpredictable ways, and the extent of the impact on the real economy is still emerging, making the outlook particularly uncertain.

1.6 In the advanced economies economic activity has contracted more sharply than had previously been expected:

- in the US, it now looks inevitable that the economy will enter recession in the second half of 2008 with output having fallen slightly in the third quarter. The unemployment rate has risen to 6.5 per cent in October 2008 up from 4.8 per cent a year ago with employment falling sharply since the summer;
- latest data show the euro area was in recession in mid-2008. The euro area unemployment rate was 7.5 per cent in September, up 0.3 percentage points on March, and employment growth has slowed; and
- the Japanese economy also moved into technical recession in mid-2008 as falling business investment and weak export volumes, reflecting slowing global demand and a sharply appreciating currency, pulled GDP growth lower.

1.7 Recent data for the major emerging markets, which had been sheltered from the direct impact of the crisis, have weakened. For example, China's industrial output grew at its slowest rate in October for seven years, while latest data for India shows manufacturing output growing at its slowest rate for 10 years.

1.8 World trade growth is set to slow. Export orders in many economies have fallen sharply. The Baltic Dry Index, which measures the global prices of shipping dry raw materials (grain, coal, iron etc), reached unprecedented heights in the first half of 2008, driven by high raw material demand and port congestion, mainly in Australia. Since May, prices have fallen by over 90 per cent due to reduced demand, notably from China for Brazilian iron ore, and easing of port congestion. There is also anecdotal evidence that the system of trade finance through letters of

credit has been adversely affected by the financial crisis. These letters of credit underpin much of the trade that occurs globally, and may have compounded the collapse in shipping costs.[3]

Sharp deterioration in economic outlook

1.9 On 6 November, the IMF revised down its economic forecasts substantially in light of significantly deteriorating economic data. The IMF now project that world output will expand by just 2.2 per cent in 2009, down by some 1½ percentage points from its April World Economic Outlook and down ¾ of a percentage point from the October Outlook published just a month earlier.

Table 1.A: Comparisons of IMF GDP growth forecasts

	Percentage change on year earlier		
	2008	2009	
	November	April	November
USA	1.4	0.6	-0.7
Japan	0.5	1.5	-0.2
Germany	1.7	1.0	-0.8
Canada	0.6	1.9	0.3
Italy	-0.2	0.3	-0.6
France	0.8	1.2	-0.5
UK	0.8	1.6	-1.3
Brazil	5.2	3.7	3.0
Russia	6.8	6.3	3.5
China	9.7	9.5	8.5
India	7.8	8.0	6.3
Advanced Economies	1.4	1.3	-0.3
Emerging Markets	6.6	6.6	5.1
World	3.7	3.8	2.2

Source: IMF Economic Outlook 83

1.10 The latest IMF projections for the advanced economies forecast that output will contract on a full-year basis in 2009, the first such fall in the post-war period. Similarly the latest OECD forecasts[4] suggest that output in the OECD area as a whole will fall, with unemployment expected to rise by 1 percentage point in 2009.

1.11 The financial markets shock in advanced economies has spread to emerging economies as investors have retreated from all sources of potential risk, including emerging market assets, leading to sharply falling stock markets and currencies. The capital flight from emerging markets has the potential to expose serious weaknesses in some countries' financial systems, particularly those with large external financing requirements.

1.12 Growth in large emerging economies is expected to slow to rates below recent trends, and the risk of contagion, leading to much sharper contractions in smaller emerging economies, has increased. The latest IMF World Economic Outlook projects that growth in emerging economies will slow appreciably but still reach 5 per cent in 2009. Although growth at these rates is high

[3] The UK Government welcomes the announcement by the World Bank International Finance Corporation of an increase in its trade-financing programme by $500 million, but the international community needs to remain vigilant and stand ready to act further if necessary.

[4] OECD, *Economic projections for the US, Japan & Euro area*, 13th November 2008

relative to advanced economies, such rates can be far below potential growth rates in emerging economies, generating spare capacity and the possibility of falling employment. This can present significant problems: for example, it is estimated that around 25 million new workers enter the Chinese labour force each year, and analysts estimate that economic growth of at least 8 per cent a year is needed to absorb them.

The Pre-Budget Report world forecast

1.13 The Pre-Budget Report projects that world GDP growth will slow to 3½ per cent in 2008 and further to just 2 per cent in 2009. That would be well below recent trends, and a marked slowdown from the 4¾ per cent expansion in 2007, reflecting slower domestic demand growth in advanced economies and weaker trade growth around the world. Growth across the G7 economies is expected to have slowed to 1 per cent this year, and to turn negative in 2009, the first year of contraction in the G7 economies as a whole since 1982.

1.14 The outlook for world trade has weakened significantly in line with world growth prospects. World trade is expected to grow by just 2 per cent in 2009, down from over 5 per cent in 2008 and 7 per cent in 2007. UK export markets growth is expected to slow more significantly given the greater weight of advanced economies in the UK's export markets than in world trade as a whole. Full details of the economic forecasts can be found in the Pre-Budget Report Annex A *The economy*.

1.15 The economic forecasts discussed above are based on current policies. Economic and financial policy makers around the world must take action to guard against the risk of a deeper and more prolonged downturn across advanced and emerging economies. The IMF have highlighted that global action to support financial systems and provide further fiscal stimulus and monetary easing can help limit this decline in world growth. Against this backdrop the OECD have also made the case for additional macroeconomic stimulus.

1.16 Leaders of the Group of Twenty (G20) industrialised and emerging economies, met in Washington on 15 November 2008, to discuss the serious challenges facing the world economy and financial markets. The G20 leaders agreed that a broader policy response is needed, based on closer macroeconomic cooperation, including the use of fiscal measures to stimulate domestic demand to rapid effect, as appropriate, while maintaining a policy framework conducive to fiscal sustainability (Box 1.A).

Box 1.A: G20 Summit on financial markets and the world economy

Leaders of the G20 industrialised and emerging economies, met in Washington on 15 November, 2008, to discuss the serious challenges facing the world economy.

Their declaration points to the search for higher yields without an adequate appreciation of risks as one of the root causes of the crisis. The development of increasingly complex and opaque financial products, and excessive leverage combined to create vulnerabilities in the system. They also point to a number of underlying factors including inconsistent and insufficiently coordinated macroeconomic policies, and inadequate structural reforms, which led to unsustainable global macroeconomic outcomes. Together, these developments ultimately resulted in severe market disruption.

The Summit Declaration sets out a broad policy response, based on closer macroeconomic cooperation, to restore growth, avoid negative spillovers and support emerging market economies and developing countries. G20 countries will:

- take whatever further actions are necessary to stabilize the financial system;
- recognize the importance of monetary policy support, as deemed appropriate to domestic conditions;
- use fiscal measures to stimulate domestic demand to rapid effect, as appropriate, while maintaining a policy framework conducive to fiscal sustainability;
- help emerging and developing economies gain access to finance in current difficult financial conditions, including through liquidity facilities and program support. Leaders stressed the International Monetary Fund's (IMF) important role in crisis response;
- encourage the World Bank and other multilateral development banks (MDBs) to use their full capacity in support of their development agenda, and welcome the recent introduction of new facilities by the World Bank in the areas of infrastructure and trade finance; and
- ensure that the IMF, World Bank and other MDBs have sufficient resources to continue playing their role in overcoming the crisis.
- in addition to these actions, leaders agreed to implement reforms to strengthen financial markets and regulatory regimes so as to avoid future crises.

The full text of the declaration is available at http://www.whitehouse.gov/news/releases/2008/11/20081115-1.html

2 Role of fiscal policy in the current context

2.1 Consumer and business confidence has been profoundly affected by the deterioration in financial market conditions, and by the effect that this has had on the availability of credit. Policies have already been enacted to tackle aspects of the crisis, notably through support provided to the banking sector.

2.2 This chapter reviews the role that fiscal policy might play in providing support to the wider economy. The first part of the chapter reviews the case for using fiscal policy in macroeconomic stabilisation. It highlights that there is an important balance to be struck between providing a fiscal stimulus and ensuring that this does not unduly impair the ability to meet other objectives. In particular, the fiscal response needs to be consistent with maintaining sustainable public finances in the medium term.

2.3 The chapter then reviews the case for using fiscal policy to support demand at the current time. It argues that the root cause of the crisis, the malfunctioning of financial markets, needs to be tackled directly. However, while these measures are taking effect, there is an important role for both monetary and fiscal policy to support aggregate demand, in order to limit and reverse the adverse impacts on output and employment and to allow the necessary adjustment in private sector balance sheets to proceed in an orderly fashion.

2.4 In a normal downturn, it would be expected that monetary policy would provide most of the counter-cyclical support to aggregate demand, with fiscal policy playing a more limited supporting role. Typically, the focus has been on allowing the automatic stabilisers to operate to the full to avoid fiscal policy tightening when the economy is weakening. But both the magnitude and the speed of the current downturn warrant a more substantial fiscal response. The nature of the financial crisis, with credit constraints becoming more binding, and the effectiveness of monetary policy becoming more uncertain, also points to more of a fiscal response.

2.5 A problem with discretionary fiscal actions in the past has been that it has taken time to agree and implement them, and as a result they have ended up being pro-cyclical. While the likely duration of the current slowdown makes this less of an issue, the rate with which the world economy is slowing down means that rapid action is called for.

2.6 Overall, a fiscal stimulus will be most effective if it is: timely, so it delivers a stimulus when it is needed; temporary, to ensure longer term sustainability; and targeted, to maximise its impact. These considerations imply that measures that take effect quickly and measures that stimulate spending rather than all going into saving are most appropriate for boosting output and employment.

Fiscal policy stabilisation

2.7 The experience of the 1930s provided the backdrop for Keynes' General Theory of Employment, Interest and Money. This has had a profound influence on subsequent thinking

about the role fiscal policy can play in enabling the economy to deliver high levels of output and employment. The context of the 1930s was one of a deep and prolonged slump in economic activity, characterised by high levels of unemployment. Keynes argued that this represented a lack of effective demand. Classical economic theory had argued that movements in the interest rate and in prices would tend to ensure aggregate demand would equal the full employment level of aggregate supply in the economy. Keynes argued that this was not always the case, and that circumstances could arise in which fiscal policy might be required to bolster effective demand in order to maintain high levels of employment.

2.8 Keynes's analysis proved highly influential. Fiscal policy was used extensively to manage aggregate demand in the 1950s and 1960s in some countries, including the UK. However, the experience of this time revealed a number of limitations associated with its use:

- It proved difficult to use fiscal policy to 'fine-tune' aggregate demand. Recognition, decision and implementation lags meant that it was difficult to ensure that a fiscal stimulus was delivered at the most appropriate time.
- The use of fiscal policy for stabilisation purposes did not always fit easily with other government objectives. Changes in tax instruments generally affect economic incentives to save, work or invest, and these might be adversely affected by uncertainty about both the direction and the timing of future changes to the tax structure. Changing the tax structure will also often affect the post-tax distribution of incomes, giving rise to potential conflicts between the government's objectives for macroeconomic stabilisation and income distribution.
- High levels of public debt imply increased competition for loanable funds. This can lead to higher interest rates and the crowding-out of private sector investment. While small changes in public debt can be easily absorbed by capital markets, the risk of crowding-out increases as the level of public debt to GDP rises. Other things equal, it would be greater for a concerted international fiscal expansion.
- High debt to GDP levels may also raise the cost of servicing the debt and limit the expansionary effect of any stimulus.
- A related point is that deficit financing only provides a stimulus to aggregate demand if households do not reduce current spending in order to save to pay for higher debt service costs in the future. This implies that expansionary measures are likely to prove more effective in raising aggregate demand if they are targeted at households that have limited access to credit, since they are more likely to increase their spending rather than their saving.
- There is uncertainty about the magnitude of fiscal multipliers, which may themselves vary according to the context in which a fiscal expansion occurs. So for example, multipliers might be larger when a larger proportion of households and businesses are finding it difficult to obtain credit.

2.9 These limitations have led to the increasing use of monetary policy as the primary instrument to manage the normal fluctuations in economic activity, both in the United Kingdom and the wider world (Box 2.A). But the exceptional circumstances that currently exist warrant using fiscal policy more actively.

Box 2.A: Role of fiscal and monetary policy in macroeconomic stabilisation

In the UK and in many other countries monetary policy has become the main demand management policy instrument with fiscal policy used in a supporting role. Monetary policy:

- can be more easily and frequently adjusted in either direction as required;
- has fewer effects on other policy objectives, such as ensuring fiscal sustainability;
- and can be effectively delegated to independent central banks, thereby reducing the perceived risk that demand management policy could be unduly influenced by political considerations.

Although monetary policy has become the primary demand management instrument, fiscal policy has continued to play an important role. Fiscal policy provides some 'automatic' stabilisation that arises from the way that government spending and revenues respond to the fluctuations in economic activity.[1] An important element in the design of the UK fiscal framework has been to ensure that these automatic stabilisers are allowed to operate.

Under the macroeconomic policy framework established by the UK Government in 1997:

- Monetary policy is the primary instrument of demand management, assigned to an operationally independent Monetary Policy Committee whose remit is to maintain price stability; and subject to that, to support the economic policy of the Government, including its objectives for growth and employment.
- Fiscal policy may support monetary policy, notably through the unconstrained operation of those elements of the automatic stabilisers. But the framework specifies that the use of fiscal policy for macroeconomic stabilisation purposes must be credibly and transparently consistent with the objective of ensuring sustainable public finances in the medium term.

A more detailed description of the UK fiscal framework is provided in *The Government's fiscal framework.*[2]

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[1] More detailed accounts of the automatic stabilisers can be found in *Fiscal Stabilisation and EMU,* HM Treasury, 2003 and in *Public Finances and the Cycle,* Treasury Economic Working Paper no. 5, 2008

2 *The Government's fiscal framework,* HM Treasury, 2008.

Criteria for effective fiscal stabilisation instruments

2.10 In an earlier assessment[1], the UK Treasury set out criteria for assessing the effectiveness of alternative fiscal instruments for stabilisation purposes. They should:

- maximise the impact on activity;
- minimise the delays associated with deciding and implementing the policy; and

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[1] *Fiscal stabilisation and EMU,* HM Treasury, 2003

- minimise any negative impact on economic efficiency and the distribution of incomes.

2.11 An effective stabilisation tool should maximise the impact on activity appropriate to the stabilisation requirement. A number of factors will determine the size of the impact of a particular instrument, notably:

- the magnitude of the base of the stabilisation instrument relative to GDP; and
- the size of the fiscal multiplier for the stabilisation instrument.

2.12 A second important property for a stabilisation instrument is that it should minimise delays before it takes effect. Otherwise there is a risk that changes to policy could ultimately have a destabilising rather than stabilising impact on the economy. The combination of lags that lead to a time delay between the economy requiring a stabilising action and the eventual impact of that action need to be taken into account. These delays consist of:

- recognition lags: the time taken to obtain the information on which decisions are based;
- decision-making lags: the time taken for policymakers to reach a decision as to whether action needs to be taken;
- implementation lags: the time between when a decision is taken and when the policy comes into effect; and
- transmission lags: the time between when the policy is implemented and when it has its full effect on economic activity.

2.13 In the case of fiscal policy, an added consideration is that the institutional arrangements may limit the ability to change certain instruments in a timely manner. For example, tax and spending decisions are typically made in an annual Budget. This provides the private sector with greater certainty as to the timing of fiscal decisions. But it also limits the scope for fiscal instruments to be used for stabilisation purposes.

2.14 The Government structures the tax and benefit system to achieve a wide range of objectives. Adjusting existing taxes or spending to meet a stabilisation objective will necessarily impact on some of the efficiency and equity goals that the Government is seeking to achieve. It is important therefore to ensure that stabilisation policy measures are consistent with wider policy objectives.

2.15 These considerations have important implications for the effectiveness of different fiscal instruments for promoting macroeconomic stabilisation:

- Government spending boosts demand directly, but care needs to be taken that the spending provides value for money. This can lead to delays before changes to spending can take effect. Changes to spending that are credibly temporary are more suitable for stabilisation purposes than changes that risk becoming permanent.
- Changes to direct taxes affect the disposable income of households. Their impact on demand will however depend on whether households choose to adjust their saving or spending. As a general rule, households that have limited access to credit are more likely to alter their spending.

- Changes to indirect taxes affect households' purchasing power, and their incentive to spend. Pre-announced changes to indirect tax rates may also encourage households to change the timing of their spending, notably on durable goods, such as cars and televisions.

Policy requirements in the current context

2.16 The root cause of the current crisis has been the extensive and prolonged strains in financial markets. These have impaired considerably the process of financial intermediation: that is the financial sector's ability to ensure that the financial resources of savers are channelled to businesses and households that would like credit. The limited availability of affordable credit has had direct effects on the spending of credit-constrained households and firms.

2.17 An important requirement in this context is to address directly the stresses that afflict the financial system. Governments in many countries have already implemented policies to this effect[2]. In addition, a strong macroeconomic policy response is required to support household and business spending and to arrest the sharp decline in household and business confidence that could exacerbate the contractionary effects of tight credit market conditions.

2.18 As discussed above, monetary policy is the primary instrument for demand management, both in the United Kingdom, and in the wider world. Central banks have an important role to play in ensuring that the stance of monetary policy is appropriate, supporting aggregate demand while maintaining private sector confidence that price stability will be maintained.

2.19 Ordinarily, it would be expected that fiscal policy would play a supporting role, through allowing the automatic stabilisers to operate fully. However, in the current context there are a number of reasons that warrant a more substantial fiscal policy response:

- In conditions of financial market stress, the monetary transmission mechanism may not work as effectively as it would normally do (Box 2.B). There has been a substantial and prolonged increase in the spread between policy interest rates and those prevailing in financial markets. In addition, lending standards have tightened substantially.

- Relatedly, it is more likely that discretionary fiscal action can complement monetary policy rather more than would be the case in a milder downturn. In general, using two policy instruments directed at the same goal means that each instrument needs do less than it would otherwise need to, provided that the responses are complementary. Uncertainty about the effects of each instrument may also be addressed by using both.

- A risk with fiscal expansion is that it can add to inflationary pressures. This should not be an issue in the current context, since demand is weak and levels of spare capacity are expected to increase.

- The scope for further conventional monetary policy easing is already limited in some countries, particularly in Japan and the United States.

[2] See Chapter 4.

- The strength and likely duration of the current downturn mean that although it remains important that the fiscal response has a rapid impact, the risk that a poorly timed response might prove to be pro-cyclical is low.
- The circumstances of the current crisis has prompted increased demand for government debt, as investors have sought low-risk assets. This has given governments greater scope to increase their borrowing at comparatively low cost. That said, current high levels of risk aversion are unlikely to persist once a recovery takes hold. This underscores the need to ensure that the fiscal response is credibly temporary, with an effective commitment to ensuring fiscal sustainability once the current crisis has subsided.

Fiscal response: timely, temporary, targeted

2.20 The preceding discussion implies that fiscal action can best help stabilise the economy effectively if it is:

- timely – it needs to have a rapid impact. This requires both that the policy change can be implemented swiftly, and that it has a rapid impact on behaviour;
- temporary - to maximise its immediate impact and avoid undermining medium-term fiscal sustainability. If action is not taken to ensure fiscal discipline, there is a risk that higher long-term interest rates will outweigh its stimulus effect; and
- targeted – it is important that the support boosts spending to maximise its impact on economic activity.

Box 2.B: Effectiveness of monetary policy under conditions of financial market stress

The main mechanism through which a change in the short-term interest rate set by the central bank is transmitted to the economy is from the pass through to market interest rates. This pass through is influenced by the behaviour of banks in response to official rate changes, which will be subject to banks' cost of funding, balance sheet strength and perceived risk. A change in the official rate is also transmitted to the economy through more indirect channels such as asset prices, expectations and confidence and the exchange rate.

The efficiency of the market interest rate channel of the transmission mechanism may be impaired during a financial crisis. When there are problems with the health of the banking sector, for example due to loan losses or the prospect of losses which impair banks' balance sheets, the result may be a tightening in credit conditions, i.e. an increase in the price and reduction in the quantity of credit extended by banks. Those banks most affected may become less willing to extend credit in order to rebuild the capital base of their balance sheets. Healthy banks might also be affected due to an increase in risk aversion in the interbank market in which banks lend to each other, which increases their funding costs. As a result there may be a marked widening in credit spreads.

Many advanced economies have been experiencing such circumstances recently. This may mean that changes in the official rate no longer summarise changes in the cost of finance for borrowers. Central banks' own credit surveys have shown that there has been considerable tightening in credit terms in the US and Euro area and a worsening in the availability of credit in the UK since August 2007, for most types of lending. This will further dampen the impact of official rate cuts on domestic demand.

Since summer 2007 there has been evidence that the transmission of UK monetary policy to market rates is working less effectively; cuts in Bank rate have not been fully passed on to the rates at which banks lend to each other and are consequently not reaching corporate or personal customers. Part of this change in the UK is undoubtedly an unwinding of compressed spreads prior to summer 2007 when increases in Bank rate were not fully passed on to consumers and businesses. However a large part of the weakening of the transmission mechanism is due to the wider crisis in financial markets and this requires a variety of policy responses.[1]

In the current circumstances, both the IMF[2] and OECD[3] have recently highlighted that monetary policy may have lost some of its power to stimulate aggregate demand. In the UK, members of the Monetary Policy Committee have also concluded that the transmission mechanism has become less potent.[4] Although there are signs that interbank lending rates may be beginning to ease in response to the latest Bank rate cut in the UK, they remain at very elevated levels in relation to the Bank rate.

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[1] Speech by External MPC member Timothy Besley at the UBS Conference centre, 28 October 2008, "There is now a widespread recognition that a variety of policy responses is necessary to deal with these global problems. In addition to interventions targeted at the problems in financial markets, fiscal policy also has a role to play in supporting the process of adjustment."

[2] IMF World Economic Outlook Update, 6 November 2008, "Monetary easing may be less effective in the face of difficult financial conditions and deleveraging. Also, in some cases room for further easing is limited as policy rates are already close to the zero bound. These are conditions where broad-based fiscal stimulus is likely to be warranted."

[3] OECD Economic Projections for the US, Japan and Euro area, Press Conference, 11 November 2008, "In the current conditions of extreme financial stress, the monetary transmission mechanism may have weakened."

[4] At the November Inflation Report press conference, the Governor of the Bank of England commented, "the transmission mechanism of Monetary Policy has been in part impaired through the banking crisis."

3 Concerted international fiscal action

3.1 Chapter 2 reviewed the arguments for a stronger fiscal policy response to the current downturn than would normally be warranted. It also highlighted that such a fiscal response should be timely, temporary and targeted. This chapter considers the question of whether the fiscal response should be co-ordinated across countries. It concludes that the effectiveness of international fiscal actions would be enhanced if they were concerted and coherent. Action now would help to limit the depth of the downturn and restore growth. Concerted fiscal actions should complement policies that tackle the root causes of the current crisis that have impaired the functioning of financial markets.

3.2 A simple, but nonetheless powerful, argument for concerted fiscal action is that this is a global crisis, and therefore requires a global solution. The combined effect of coherent actions taken across countries will be more effective than each country acting alone. One reason for this is that part of a fiscal stimulus taken by an individual country will be transmitted abroad through the demand for other countries' exports. A concerted stimulus among major trading partners allows each country to benefit from stronger demand in both domestic and export markets.

3.3 These arguments apply especially to smaller and more open economies. That said, the logic of the argument, together with the increased integration of the global economy implies that a concerted and coherent stimulus applied across countries will maximise the impact of fiscal actions. By working together, each country can expect to need to do less than would be required if its trading partners were to not participate, or receive a bigger impact from the same measures.

3.4 However, a concerted and coherent approach should not imply that all countries take identical actions. An important aspect of a coherent approach is that fiscal actions need to be tailored to the situation of each country. Countries that already have high levels of public debt have less scope to undertake fiscal expansion than those with low levels of debt, and are likely to find it harder to finance an equivalent fiscal expansion.

3.5 It is also necessary to take account of the impact on global imbalances in the medium term. Countries with high levels of national saving and strong balance of payments surpluses have more scope to sustain fiscal expansions in the medium term. In short, the arguments that fiscal responses should be credibly temporary carry added force for those with high levels of public debt or large balance of payment deficits.

Global crisis requires a global response

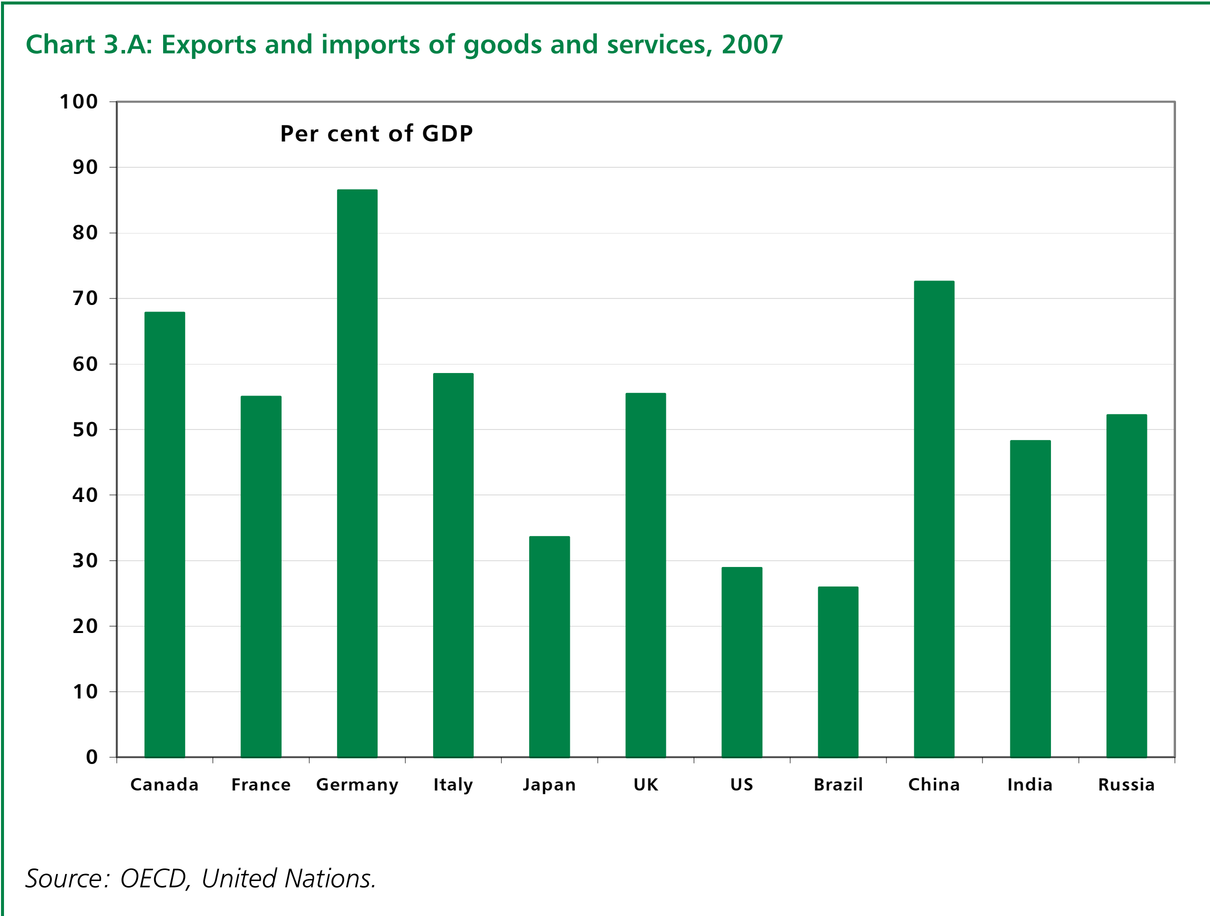
3.6 In the past few months it has become increasingly apparent that the current downturn is significantly affecting economies across the world. Initially it was thought that the slowdown would be concentrated in the United States, with more limited effects on other high income countries and in emerging markets. In such a scenario, a differentiated policy response would have been appropriate. However, more recently it has become evident that the downturn in

economic activity will be both deeper and more broadly based. This implies the need for a concerted policy response.

3.7 The G20 summit on November 15 sent a clear message that leaders in both high income countries and in emerging markets have recognised that action is required. A number of actions have already been taken. And in its Pre-Budget Report, the United Kingdom has announced a number of timely, temporary and targeted fiscal measures designed to complement both the monetary policy response in the United Kingdom, and the measures that are being undertaken in other countries. Chapter 4 reviews the policy response in both the United Kingdom and in the wider world.

3.8 For fiscal expansions, an important consideration is the transmission of any fiscal stimulus to other countries. In open economies, a proportion of any fiscal stimulus will be spent on imports, hence benefiting the exporting country. Such leakage abroad will tend to be more significant in smaller, more open economies. For these countries, the effect of a domestic expansion would be considerably enhanced if it is part of a concerted policy with its main trading partners. The benefits of a concerted fiscal expansion are likely to be especially evident within the European Union, reflecting the high levels of trade between European economies (Chart 3.A). Fiscal policy in the EU, within the framework of the Stability and Growth Pact, is discussed further in Chapter 4.

Chart 3.A: Exports and imports of goods and services, 2007



Source: OECD, United Nations.

3.9 An additional reason for a concerted global response is the strong signal that it sends to the private sector of the willingness of governments to act co-operatively to counter the contractionary forces prevailing on economic activity. The strength of those contractionary forces

depends importantly on the level of confidence among both households and firms in the efficacy of the policy response. Decisive concerted action by the world's leading economies will also provide a strong signal to the private sector of the willingness of governments to act effectively together, and help to reduce the risk of an adverse feedback between low expectations, cautious spending and weak outcomes.

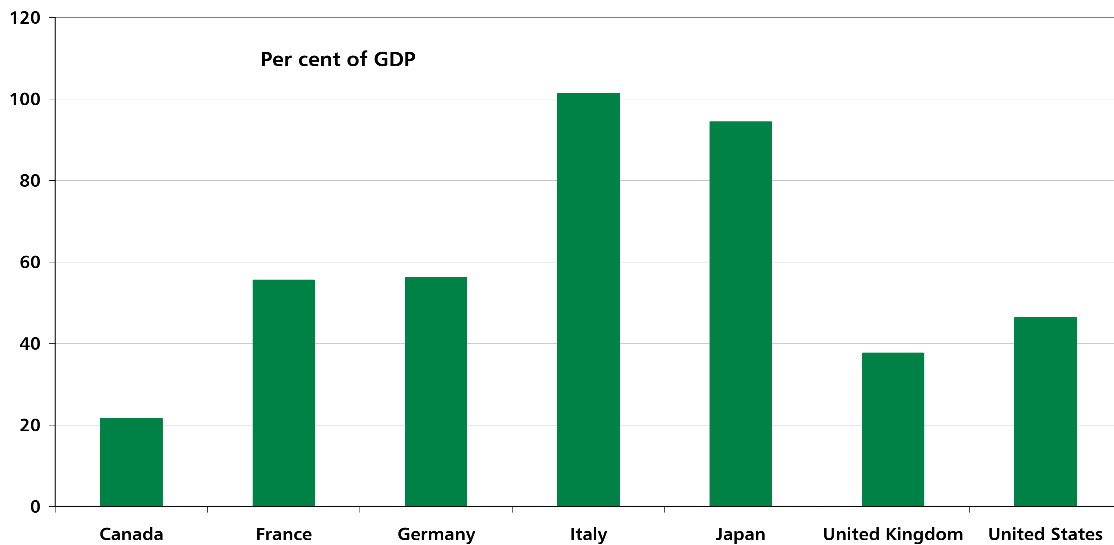
Tailored response to individual circumstances

3.10 The preceding arguments imply that concerted fiscal actions across countries could provide a strong stimulus to private sector spending and confidence. However, this does not imply that all countries should respond in an identical manner:

- cross-country differences in institutional and legal processes provide important practical reasons why individual countries may need to commit to different actions on a time-scale that is appropriate to their own circumstances;
- there are differences in the scope for reducing interest rates across countries. In particular there is limited scope for further reductions in policy interest rates in both Japan and the United States. These countries may need to rely more on fiscal stimulus than in countries where a more aggressive monetary policy easing is possible;
- similarly, countries differ in their capacity to use fiscal policy. In designing their response each country will need to achieve an appropriate balance between using fiscal policy to provide timely support to economic activity while maintaining a credible commitment to longer-term sustainability. Countries with high levels of public sector debt as a proportion of GDP face stronger constraints than those with lower debt levels (Chart 3.B);
- countries where the automatic stabilisers are stronger will require a smaller discretionary adjustment to fiscal policy to provide an equivalent degree of support to the economy[1]; and
- fiscal responses should be consistent with the reduction of global imbalances in the medium term. Countries with high levels of national saving and strong external positions have more scope to sustain fiscal expansions in the longer term. They should aim either to direct more of their domestic saving towards domestic investment or in some cases to increase their consumption.

[1] See Chapter 5 of *Fiscal Stabilisation and EMU,* HM Treasury, 2003

Chart 3.B: General Government net debt, 2008 estimates



Source: International Monetary Fund, World Economic Outlook Database, October 2008

3.11 These considerations imply that it is appropriate for the details of each country's policy response to be tailored to best reflect its own circumstances. This principle was endorsed in the statement released by G20 Heads of Government on 15 November (see Box 1.A). However, the effectiveness of the international fiscal response could be reduced if countries undertake actions that are perceived by markets and the private sector as being piecemeal and incoherent. To counter this risk, it is vital that governments across the world implement policies that are not only appropriate to their domestic needs but that also complement and reinforce the actions taken by other countries. These points have also been emphasised by both the IMF and the OECD (Box 3.A). Chapter 4 reviews the international response, including the measures announced by the United Kingdom in its Pre-Budget Report.

Box 3.A: The need for fiscal action: IMF,OECD and other views

The IMF and the OECD have both stated that fiscal policy should be used to support demand in current circumstances. In an update to its World Economic Outlook projections the IMF wrote: "These are conditions where broad-based fiscal stimulus is likely to be warranted. Fiscal stimulus can be effective if it is well targeted, supported by accommodative monetary policy, and implemented in countries that have fiscal space."[1]

The IMF's Chief Economist, Olivier Blanchard, said: "We think that global fiscal expansion is very much needed at this point. If it comes, then the forecast we have will be on the pessimistic side."[2]

Commenting on the G20 summit, the IMF's Managing Director Dominique Strauss-Kahn said: "I welcome the emphasis on fiscal stimulus, which I believe is now essential to restore global growth. Each country's fiscal stimulus can be twice as effective in raising domestic output growth if its major trading partners also have a stimulus package....Those countries - advanced and emerging economies - with the strongest fiscal policy frameworks, the best ability to finance fiscal expansion, and the most clearly sustainable debt should take the lead."[3]

In presenting new projections ahead of the G20 summit, the OECD said: "In this unusual situation, fiscal policy has a role to play … However it is vital that any discretionary action be timely and temporary and designed so as to ensure maximum effectiveness. Tax cuts aimed at credit-constrained households, for instance, might prove effective. At the same time, with high public debt in many OECD economies, it will be equally important that a credible framework is in place to ensure fiscal sustainability over the long run."[4]

Barry Eichengreen and Richard Baldwin summarised the views of a number of leading economists as follows: "There is an urgent need for immediate, substantial, internationally coordinated fiscal stimulus … tailored to the circumstances of the individual country and taken with a view toward the impact on the rest of the world."[5]

Others have noted that: "A budgetary boost is needed on top of the rescue package for the financial sector and further lowering of interest rates by central banks. This budgetary boost should be closely coordinated at EU level to ensure consistency and avoid free-riding behaviour … A substantial portion of the budgetary boost [should] be delivered through a coordinated cut in VAT rates."[6]

Simulations undertaken on the National Institute's NIGEM model show that the effects of a co-ordinated fiscal expansion in the US, UK and the Euro Area would strengthen the impact on GDP substantially compared with expansions taken alone.[7]

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[1] IMF World Economic Outlook update, November 2008

[2] Press conference presenting World Economic Outlook update, November 2008

[3] IMF Press Release No. 08/286, November 2008

[4] Press release, accompanying OECD economic projections for the US, Japan and Euro area, November 2008

[5] Introduction to *What G20 leaders must do to stabilise our economy and fix the financial system*, Centre for Economic Policy Research, 2008. http://voxeu.org/index.php?q=node/2543

[6] *A European recovery programme*, Bruegel Policy Brief, November 2008

7 *Fiscal Policy in a Financial Crisis,* Ray Barrell, Tatiana, Fic and Iana Liadze, available at www.niesr.ac.uk

4 International response

4.1 The scale of the financial crisis and its impact on real economies has led to an unprecedented policy response across advanced and emerging economies. Leaders of the G20 industrialised and emerging economies, met in Washington on November 15, 2008, to discuss the serious challenges facing the world economy and financial markets. In addition to further actions to strengthen financial markets and regulatory regimes they agreed that a broader policy response is needed, based on closer macroeconomic cooperation, to support growth including the use of fiscal measures to stimulate domestic demand to rapid effect, as appropriate, while maintaining a policy framework conducive to fiscal sustainability.

4.2 Many advanced economies, including the UK have already taken significant actions to support financial markets. Complementing these, many have already eased monetary and fiscal policy as part of their response to the economic crisis. This chapter reviews the actions that have been already been taken at the European, international, and domestic level, and endorses the calls that have been made by the IMF and OECD for a concerted and coherent fiscal response across all countries. A global crisis requires a coherent global response.

International action to date

4.3 Authorities in advanced economies have taken significant measures to support financial markets and restore confidence in the international financial system. Central Banks and national authorities have delivered substantial injections of liquidity, taken steps to unfreeze credit and money markets and agreed frameworks to recapitalise their banking systems – see Box 4.A.

4.4 As commodity prices have fallen and the risk of higher inflation has receded, many central banks have eased monetary policy. On 8 October, six central banks, including the Federal Reserve, European Central Bank and Bank of England, announced a coordinated ½ percentage point interest rate cut. Since then:

- the Federal Reserve cut its target rate a further 50 basis points to 1 per cent on 29 October, 425 basis points lower than in July 2007;
- the ECB cut interest rates by a further 50 basis points in November to 3.25 per cent;
- the Bank of England reduced the official Bank Rate by 150 basis points to 3 per cent on 6 November;
- Bank of Japan cut interest rates by 20 basis points to 0.3 per cent in October;
- the People's Bank of China has also cut rates three times since September, bringing the benchmark lending rate down to 6.66 per cent.

Box 4.A: International action to stabilise financial markets

On 8 October, the UK Government announced a comprehensive set of measures to address the liquidity, capital and funding issues that were aggravating the severe stress in financial markets.

On 10 October, G7 countries committed to a five-point plan of action on how they would work together to stabilise financial markets:

- use all available tools to support systemically important financial institutions;
- take all necessary steps to unfreeze credit and money markets;
- ensure that banks have access to sufficient capital to continue lending to households and businesses;
- ensure that national deposit insurance and guarantee programmes are robust, and retail depositors continue to have confidence in the safety of their deposits; and
- take action to restart the secondary markets for mortgages and other securitised assets.

Within this framework, both the US Government and the Euro Area have announced proposals similar to the UK's approach. Treasury Secretary Paulson has announced that the US will introduce a standardized equity purchase programme as part of its $700bn financial package. The Euro Area has committed to a common approach based on guaranteeing bank funding and the recapitalisation of banks as necessary: in particular, France and Germany have announced rescue packages of €880 billion, out of which up to €120 billion will be used for recapitalisation. Central banks have also coordinated injections of liquidity into the system.

European member states are also working together to coordinate their responses. On 7 October, member states committed to take all necessary measures to enhance the soundness and stability of the banking system and protect the deposits of individual savers. They agreed to remain in daily contact to share information and ensure a comprehensive and coordinated response. Common EU principles to guide public interventions at national level were also agreed.

4.5 Alongside this a number of countries have announced fiscal packages to support their economies in the face of the downturn.

The European fiscal response

4.6 Under the Treaty, European Member States have agreed to coordinate their economic policies within the Council, and regard them as a matter of common concern. Collective fiscal discipline and co-ordination are essential for a successful monetary union, and the high degree of integration of the European economies makes it beneficial for all EU Member States. The Stability and Growth Pact is a rules-based framework for the coordination of national fiscal policies in the EU. It is designed to ensure sound public finances, and plays a central role in securing low inflation and low interest rates, which are essential contributions for achieving stable long-term economic growth. While maintaining the 3 per cent and 60 per cent of GDP

reference values for deficit and debt, revisions made to the Pact in 2005 put greater emphasis on debt and long-term sustainability and improved flexibility in "exceptional circumstances". The UK Government welcomed these reforms and has since emphasised the importance of applying the additional economic judgement the revisions allow.

4.7 In the current climate, there is widespread recognition in Europe that fiscal policy has an important role to play. Statements by the European Commission, the Eurogroup and the European Council have reaffirmed that these are "exceptional circumstances" and that this should be reflected in application of the Stability and Growth Pact. There is also a consensus that the appropriate fiscal response will vary from country to country; different countries are affected to different extents by the current crisis, and the fiscal room for manoeuvre also varies between countries. This position is summarised by the October ECOFIN Conclusions, which state that*: "The application of the Stability and Growth Pact should… reflect the current exceptional circumstances, in accordance with the provision of the pact… In countries facing more severe slowdown and where room for manoeuvre exists, temporary and targeted measures may be taken, notably towards those most affected by the current economic situation."*

4.8 While it is acknowledged that fiscal policy has a role to play in the current crisis, it is important that all Member States remain committed to the long-run sustainability of public finances. In a recent Communication[1], the Commission stated that fiscal policy should be maintained on a "*sustainable course, anchoring expectations of an ordered resolution of the crisis",* and emphasised the importance of *"credible national budgetary institutions, and medium term budgetary frameworks".*

4.9 Fiscal policy is part of a wider European approach in responding to the current financial crisis and the worsening macroeconomic situation. On financial policies, coordinated national action has been carried out guided by a set of clear EU principles. Monetary policy has also played an important role. In a preliminary Communication setting out a "European framework for action", the European Commission noted the importance of structural reforms that strengthen resilience and enhance sustainability over the long run, while recognising that timely, targeted and temporary fiscal policies have a role to play. The Commission has announced that it will propose a more detailed EU recovery framework on 26th November.

4.10 Within the context of the Stability and Growth Pact, a number of European countries have announced fiscal packages in recent weeks. Germany announced a stimulus package on 5th November 2008, which is expected to cost an extra €4.2 billion in 2009 (0.15% of GDP) and a further €7.7 billion in 2010 (0.3% of GDP). The package includes measures to support SMEs, including additional lending by the state-owned KFW bank; investment to reduce carbon dioxide emissions; a doubling of the tax allowance for craftsman services and a tax holiday for new cars in 2009. The Government has also introduced measures to tackle unemployment including an employment subsidy for companies who retain their staff on lower working hours from 12 to 18 months. Earlier in October, the Government announced a decrease in social security contributions and an increase in family tax allowances, reducing the tax burden by €6bn in 2009 and €14bn in 2010. Taken together the October and November measures amount to €32 billion over 2009 and 2010, which the Government hopes will induce an injection of around €50 billion into the economy over the next two years.

4.11 Spain has also announced a significant series of measures. Most recently, a package was announced in November, intended to support the unemployed, including postponing mortgage

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[1] From financial crisis to recovery: a European framework for action, European Commission, 29 October 2008.

payments by 50 per cent for two years for unemployed meeting certain criteria. The package also included incentives for firms hiring unemployed workers with dependents and the option for homeowners with a monthly income below a certain threshold to defer 2 per cent of their monthly personal income tax payments. Earlier in the year the Spanish Government announced measures to support consumers including a €400 tax rebate, worth around 0.6 per cent of GDP.

4.12 Other European countries, including France, Italy, the Netherlands and Portugal have introduced measures to support SMEs, bring forward infrastructure investment, and boost consumers' purchasing power.

The wider international fiscal response

4.13 In the US, President Bush signed into law the Economic Stimulus Act of 2008 in February. The package is estimated to have cost a total of $151bn, or around 1% of GDP in 2008. The package included $106 billion in one-off personal tax rebates. Low income households received $300 per adult and an additional $300 for each dependant. Middle-income households received $600 per adult plus the $300 for each dependant. For high-income households the rebate was then reduced by five cents for each dollar of income over $75,000. A further $45 billion was for a bonus depreciation scheme for firms to support investment. The business tax provisions, allowed firms to offset an additional 50 per cent of the cost of capital investment purchases off their tax claims. In addition, the limit on capital purchases at which small businesses need to start paying tax was raised to $250,000. The US administration sent out the rebates quickly, distributing around $80 billion in May, supporting stronger growth in the second quarter. President-elect Barack Obama has indicated that he would introduce a further fiscal stimulus when he takes office in January 2009, although further details have yet to be announced.

4.14 Japan announced a small fiscal stimulus at the end of August worth 0.35 per cent of GDP. A second package was unveiled at the end of October with new government expenditure worth 0.97 per cent of GDP. The first package included financial assistance to SMEs through credit guarantees and households through lower insurance payments for lower income people under the health system. The supplementary budget for the second package is yet to be formulated, but will include government loans and credit guarantees, and subsidies for low-income households and SMEs, including measures to promote energy efficiency.

4.15 The Australian government announced a A$10.4 billion (£4.5 billion) fiscal stimulus package on the 13th October 2008 which amounts to around 1 per cent of GDP, including support for pensioners, low and middle-income groups and for first-time home buyers. This is in addition to tax cuts for middle-income families announced in the August 2008 Budget.

4.16 South Korea has announced two stimulus packages since the beginning of August, totalling $17.5 billion or 2.5 per cent of GDP. The first package increases budget spending in 2009 and includes new tax incentives and extra money for social infrastructure, SMEs and low-income households. The second package gives support to the construction and housing sector, with the main measures being funds to purchase unsold apartments and unused land.

4.17 Among the emerging markets, China's State Council announced a package of measures to boost domestic demand on 10th November. The package is worth RMB 100 billion in Q4 2008 – equivalent to 1/3 per cent of GDP – with further planned spending in 2009 and 2010 of up to RMB 4 trillion, including both new and previously announced measures. The package focuses on infrastructure investment including social housing and transport, as well as bringing forward planned investment including in earthquake reconstruction. The domestic focus of China's

stimulus package is particularly noteworthy, as it is important for the long-term development of China's economy to boost domestic demand and reduce its dependency on exports. This will also be beneficial for the wider international economy, as it will tend to reduce China's current account surplus and the rate at which it accumulates foreign exchange reserves which been an integral part of the large global imbalances which have developed in recent years.

Fiscal measures taken by the United Kingdom

4.18 Since Budget 2008, the Government has taken a number of actions to deliver support to the economy, including by raising the income tax allowance by £600, delivering support to basic-rate taxpayers, and packages of support for homeowners and households facing rising energy bills. The Pre-Budget Report announces that, to provide further support for growth and incomes during the economic downturn, the Government will:

- complement the action taken to date with a temporary reduction in the VAT rate of 2½ percentage points with effect from the start of December until January 2010; and
- bring forward capital spending from 2010-11 to 2008-09 and 2009-10, the years when the impact of the shock is likely to be the strongest.

4.19 Full details of the UK stimulus package can be found in the 2008 Pre-Budget Report.

4.20 As set out in Chapter 2, the criteria for a successful fiscal stimulus are that it should be:

- timely – so it delivers a stimulus when it is needed. This requires both that the policy change can be implemented swiftly, and that it has a rapid impact on behaviour;
- temporary – to maximise its immediate impact and avoid undermining medium-term fiscal sustainability; and
- targeted – to maximise its impact. It is important that the support changes the behaviour of individuals, to stimulate economic activity.

4.21 The Government has therefore chosen to take fiscal action that meets these criteria. A reduction in VAT has been chosen as the main lever for the fiscal action as this change can be implemented rapidly, will impact immediately on the purchasing decisions of firms and individuals to boost spending, and is reversible. The bringing forward of planned capital spending will provide an important additional source of stimulus.

4.22 In addition, the other measures the Government is announcing in the Pre-Budget Report, including for those affected by the removal of the 10 pence starting rate of tax in Budget 2007, will also support growth and incomes during the downturn.

4.23 In total, this amounts to significant fiscal support being delivered to the economy in 2008-09 and 2009-10.

VAT

4.24 The Pre-Budget Report forecast assumes that due to the competitive nature of the UK retail sector, especially during the coming downturn, the majority of the VAT cut will be passed through to consumer prices, although they will probably be reduced progressively. This is in line

with international evidence. The reduction in prices will lead to a direct increase in consumers' purchasing power.

4.25 In addition, the temporary nature of the reduction will lead to a relative price effect. The temporary change in rates reduces the relative price of spending today compared with spending in the future when the VAT rate returns to its previous level, in a similar way to a reduction in the interest rate. It will therefore incentivise consumers to bring forward the purchase of goods that will help support firms and the people they employ as the economy slows.

4.26 The tightening in credit conditions may limit the availability to some consumers of any credit required to make these purchases. However, much of the shift in consumption would be expected to come through in the months immediately before the increase in VAT, by which time credit conditions are assumed to have eased.

4.27 An important feature of the temporary reduction in VAT – as opposed to, for example, a cut in direct taxes – is that its legislative and practical implementation can be achieved rapidly. The Government's existing 'tax regulators' powers allow rates of VAT and duty to be varied outside the normal Budget and Finance Bill process using secondary legislation. In particular, the VAT regulator (VAT Act 1994) allows the rate of VAT to be changed by a maximum of 25 per cent of the existing rate. Making use of these regulators – which are not available in most countries - allows the Government to minimise the policy implementation lag normally associated with tax changes. This means that the change in VAT rates can take effect before the main Christmas/New Year spending period – around one fifth of annual retail sales take place in December and January.

4.28 The temporary change of an indirect tax is likely to have limited impact on the supply side of the economy. The choice of VAT also reflects the fact that it has a much larger tax base relative to the other duties that could be varied rapidly using the Government's existing regulator powers. A given rate change therefore will have a much bigger impact on consumption in comparison with changes in individual duties.

4.29 The reduction in VAT is therefore expected to support families' and businesses' finances and spending power in the short term:

- in Britain's competitive retail sector, it is expected that the majority of the VAT reduction will be passed on to consumers through lower prices, increasing the purchasing power of families and individuals;
- where households choose to use this increased purchasing power to increase consumption, it will support growth now, contributing to the profits of businesses and helping to support employment; and
- where it is saved, it will help those households to adjust their finances, enabling them to fund future spending.

4.30 The precise economic impact of the VAT measure depends on a number of factors, including the extent to which the reduction in prices is passed through to consumers, the amount of support that is spent rather than saved, and the amount that is spent on domestically produced goods and services rather than imports. The Pre-Budget Report forecast assumes that households will spend around half of the increase in real disposable income that results.

Capital spending

4.31 The capital spending measures will have a similarly rapid effect on the economy. As discussed in *Fiscal stabilisation and EMU,*[2] the results from macroeconomic models suggest that the short–term impact of government spending changes might exceed that of tax changes. However, these models implicitly assume that it is possible to change government spending as needed to achieve stabilisation. In practice there can be long decision and implementation lags. The bringing forward of existing valuable public investment plans can therefore support the economy in a timely way, whereas starting new investment plans often takes considerable time. If rushed, there is a risk that any additional capital expenditure could be misdirected and inefficiently allocated so care needs to be taken to ensure that any extra spending provides value for money.

4.32 The Government has taken action to bring forward capital spending to support the economy increasing capital budgets for 2008-09, 2009-10. In turn, this means that capital budgets in 2010-11 can be set at a lower level. Overall net investment is projected to be higher in 2008-09 and 2009-10 compared with Budget 2008 projections but lower in 2010-11, allowing capital spending to support the economy in the short term but also protect the fiscal position over the medium term.

4.33 Bringing forward valuable public investment directly affects economic activity, in particular providing near-term support for employment and the construction sector, which is expected to be disproportionately affected by the economic downturn.

4.34 Focussing the changes in public spending on capital, rather than current, expenditure reduces the need to consider the complex trade-offs of changes to incentives to work, save and invest. The fact that the measure simply brings forward planned spending also ensures that it is credibly temporary.

Overall impact

4.35 By acting quickly and decisively to provide support to the economy when it needs it most, fiscal action – working alongside monetary policy – can help to reduce the broader economic impact on individuals and households of the financial shock.

4.36 In the short term, the UK's fiscal stimulus package will be financed by borrowing. Over the medium term, the Government's fiscal policy objective is to ensure the sustainability of the public finances, in order to protect economic stability, employment and growth.

4.37 Taken together the stimulus package and the measures to support growth and incomes will provide significant support to the economy in the near term, reducing the extent of the expected fall in GDP in 2009 by around ½ a percentage point.

[2] Fiscal stabilisation and EMU, HM Treasury (2003).

Wider international response

4.38 As G20 Leaders made clear in their declaration, fiscal measures must be part of a broad policy response to restore growth, avoid negative spill-overs and support emerging markets and developing countries, and to strengthen the international financial system.

4.39 Financial contagion to emerging markets has contributed to the slowing of their economies. The international community must take action to prevent further contagion and therefore support economic activity in these countries and the wider world. This is particularly important at a time when the contraction in G7 advanced economies means the majority of world growth will be generated by emerging markets.

4.40 A number of countries have approached the International Monetary Fund for support. The IMF has already fast-tracked multi-billion dollar support packages to Hungary and Ukraine and has established a new short-term liquidity instrument to channel funds quickly to emerging markets that have sound fundamentals but that need rapid help during the current financial crisis to get them through temporary liquidity problems. The Federal Reserve has also extended temporary currency swap lines to the Banco Central do Brasil, the Banco de Mexico, the Bank of Korea, and the Monetary Authority of Singapore to help improve liquidity conditions in global financial markets and to mitigate the spread of difficulties in obtaining U.S. dollar funding in fundamentally sound and well-managed economies. The EU must also stand ready to provide financing to Member States in support of IMF programmes. The UK welcomes the support extended to Hungary under the Medium Term Balance of Payments facility in November, and supports the European Commission's proposals to extend the level of financing available under the facility.

4.41 As a precaution, this should be supported by an increase in the resources available through the IMF. Countries with large accumulated reserves should take action to rebalance domestic growth as appropriate, and to support other vulnerable countries in their regions, including through contributing to the Regional Development Banks and the IMF.

4.42 The international community must also be vigilant to the impact on the poorest countries. While many have been insulated from the first round effects, as their financial systems are less connected, reductions in growth will slow or reverse progress on the Millennium Development Goals and hurt the poorest communities the most.

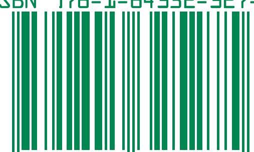
Next steps

4.43 Alongside closer cooperation on the macroeconomic policy response, G20 Leaders also agreed to implement reforms to strengthen financial markets and regulatory regimes so as to avoid future crisis. Specifically Finance Ministers will take work forward in the following five areas:

- strengthening transparency and accountability to foster enhanced openness and disclosure so that value-impaired assets cannot be hidden. Executive compensation schemes should be reviewed to ensure that they do not encourage excessive risk-taking;
- enhancing sound regulation ensuring that all financial institutions and products are regulated, including credit rating agencies, private capital funds and hedge funds; and making regulatory regimes more effective over the economic cycle;

- promoting integrity in financial markets – promoting investors and consumers by implementing measures to prevent conflicts of interest, illegal market manipulation, fraudulent activities and illicit finance risks;
- reinforcing international cooperation to ensure global consistency of national and regional regulation through enhanced collaboration on crisis prevention, management and resolution including through the development of international colleges of regulators and cross-border stability groups; and
- reforming the International Financial Institutions so that the IMF, in collaboration with the expanded FSF and other bodies, can better identify vulnerabilities, anticipate potential stresses, and act swiftly to play a key role in crisis response.

4.44 Leaders will meet again before 30 April 2009 to review progress against their agreed actions. The UK assumes the Chair of the G20 in 2009 and will take a leading role in driving forward this work. The UK will lead preparations for the next leaders summit working alongside the previous and next Chairs of the G20, Brazil and Korea. The UK Government will set out the schedule of work – events, meetings and papers – that will take us to the next summit and ensure that the rapid action, that is urgently required, is taken.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