

Blue, green or red? A 'rainbow' stimulus to tackle global recession



Dirk Willem te Velde

'What we need now is a 'rainbow' fiscal stimulus, bringing together the best of market, environmental and interventionist approaches'

Political ideologies are often associated with particular colours: blue for conservatism and market forces; green for environmental sustainability; and red for state interventionism. As the global financial crisis hits the developed and developing world, and monetary policy becomes ineffective as people lose faith in the banking sector, attention has shifted to fiscal stimulus as a possible lifeline. But what 'colour' should this stimulus be, and could it really promote development?

The global financial crisis is putting pressure on the main sources of external revenues for developing countries: exports, remittances, foreign direct investment and equity flows. This is likely to hamper growth and efforts to reduce poverty. It is impossible to predict the precise effects, as the news gets worse by the day. Growth revisions from the International Monetary Fund (IMF) over the last six months suggest losses of more than \$50 billion in sub-Saharan Africa and \$750 billion in developing countries as a whole in the 2008-2009 financial year, and a 3.5 percentage point reduction in the level of world output in 2009. World income per head is expected to fall, and in Africa, incomes are likely to stagnate. These predictions include the effect of a fiscal stimulus equivalent to 1.5% of GDP in the G20 countries.

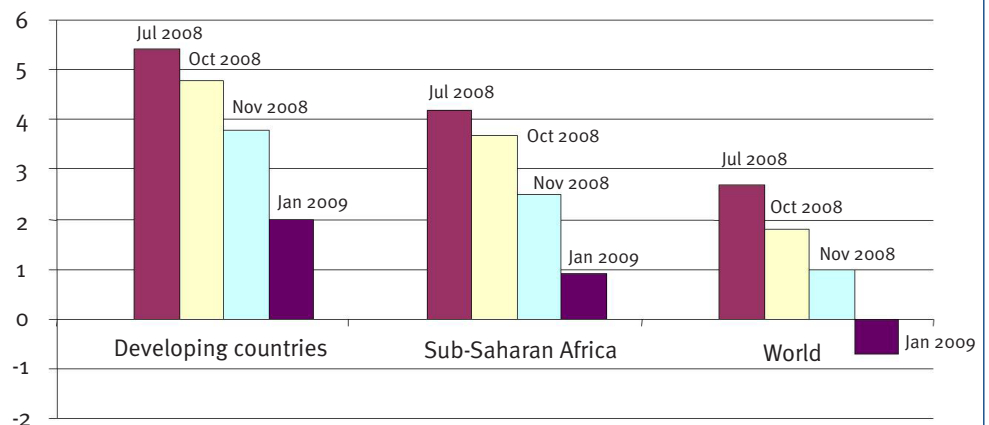
While developing countries have larger reserves

than they had ten years ago, few can afford the kind of fiscal stimulus needed to address a crisis originating in the developed world.

Some, including the Institute of International Finance, estimate that global financial flows to developing countries will tumble from \$1 trillion in 2007 to \$165 billion this year. Banks in developed countries are required to hold more capital at home. Trade finance is under pressure, and global trade is forecast to fall by at least 2% in 2009. Exports and industrial production in China, Taiwan and South Korea were already down, in some cases by around one fifth year-on-year or more at the end of 2008. The International Labour Organization suggests that up to 30 million jobs could be lost between 2007 and the end of 2009. The World Bank suggests around 100 million people will remain poor because of the world economic slowdown, 20 million for each percentage point slower growth.

What should be done? Quite a lot. The G-20 leaders meeting on 2 April could consider more transparent and counter-cyclical rules, and reform of the International Financial Institutions. But, above all, they could encourage a global fiscal stimulus, with a significant part for early disbursement in poor countries, where even a small proportion of a 1.5% stimulus would go a long way.

Figure 1: Revised forecasts for GDP per capita, 2009 (annual change, %)



Source: IMF forecasts and own calculations, scaled for expected population growth (1.3% for developing countries, 2.6% for sub-Saharan Africa and 1.2% for the world).

Overseas Development Institute

ODI is the UK's leading independent think tank on international development and humanitarian issues.

ODI Opinions are signed pieces by ODI researchers on current development and humanitarian topics.

This and other ODI Opinions are available from www.odi.org.uk

Blue, green or red?

A blue stimulus – market – would accelerate support for the private sector on the supply side by creating an appropriate framework for investment and by investing in infrastructure. The market alone, however, will not deliver desirable economic and social outcomes, so the G-20 should respond to and implement global trade rules. The G8 has committed \$4 billion to Aid for Trade but, if infrastructure is included, ODI research suggests that \$12-13 billion is needed in sub-Saharan Africa alone to meet the Millennium Development Goals.

A green stimulus – environmental – would address the two biggest market failures relating to climate change. First: the price of energy does not reflect the negative costs to the environment. If it did, it would change incentives, as well as trade and growth strategies throughout the world. Second: there are information-related market failures linked to technical change and the adoption of green technologies. Green growth – growth that is efficient enough in its use of energy – depends on the level of economic activities, the sector distribution of energy use, and energy efficiency at the firm and household level.

Preliminary research suggests that productive firms tend to be more energy efficient, so private sector development policies that promote productivity growth can also promote greener growth. Support for the adoption of green technology can help to narrow the energy efficiency gap between the actual energy savings and energy savings that are economically and socially efficient. Further stimulus could go to measures to help people adapt to the realities of climate change.

A red stimulus – Keynesian state intervention – would inject finance into the economy to stimulate consumption and demand and aim for short term macroeconomic stabilisation. This would include social programmes to smooth incomes over the cycle, especially for the poorest or those affected by the shocks of price rises or sudden loss of employment. It could include tax reductions or government transfers, which have little impact on growth, or public investment support for growth oriented policies. Small and medium enterprises (SMEs) need additional support as they face greater difficulties in accessing finance than larger firms. The financial crisis will make this worse, as will a lack of trade finance. SMEs need an increase in liquidity.

A 'rainbow' stimulus

We need a 'rainbow' stimulus, bringing together the very best of the blue, green and red. Why should developed countries support such a stimulus?

- The crisis, which could outstrip the capacities of

developing countries to respond, has been caused by failures in developed countries. In addition, the benefits of higher growth in the developing world will be felt in developed countries. China has been responsible for up to 75% of recent world growth, importing large quantities of goods and services from developed countries. It is the developing world that will account for most of the world's growth this year (even if small). We also estimate that every \$6 provided in non-earmarked bilateral aid to developing countries leads to at least \$1 in imports from developed countries.

- Countries such as the US and UK have suffered a period of over-consumption, accumulating large debts. It may be that a fiscal stimulus will have less impact in these countries, where additional resources may be used by households to pay back debt, and will work better in the developing world.
- If the poorest countries are unable to put in place a fiscal stimulus, while other richer countries do so, they will suffer from a kind of beggar-thy-neighbour economic nationalism.

How much fiscal stimulus should be provided? The IMF suggests a stimulus of 2% of GDP. Model simulations by the National Institute of Economic and Social Research suggest that such a coordinated developed country stimulus could lead to a rise in GDP of around 1-1.5% in 2009 and early 2010. The smoothing of incomes would entail a cost of at least 5% of GDP for 2008-2009 alone.

What mechanisms exist to do this? One potential channel is Aid for Trade, which urgently needs more funds. Faster budget support would also help to address balance of payments or other issues. Infrastructure spending could also be streamlined and, perhaps, brought forward through the use of development finance institutions. All of this requires improved shock facilities and finance arrangements with improved disbursement rules. These interventions need to be in tune with private sector needs as the mechanisms need to leverage in, not crowd out, other actors.

To conclude, it is clear that developing countries will be hit by a global financial crisis caused by developed countries. While the benefits of a fiscal stimulus might be greater in developing countries, developed countries could benefit through greater demand for their exports. Developed countries should provide a rainbow stimulus for developing countries, including more aid for trade, investment in infrastructure, support for green growth and improved social protection.

Written by Dirk Willem te Velde, ODI Research Fellow (dw.tevelde@odi.org.uk)

Useful resources and references

ODI on the global financial crisis:
<http://www.odi.org.uk/odi-on/financial-crisis>

Barrell R., Fic T., Liadze I. (2008), Fiscal policy action in the banking crisis, NIESR draft paper.

Cali M, te Velde D.W. (2008), 'The effectiveness of aid for trade: some empirical evidence', Commonwealth Trade

Hot Topic, No 50.

Koopmans, C.C., and te Velde D.W. (2001). 'Bridging the energy efficiency gap: using bottom-up information in a top-down energy demand model', Energy Economics, 23.
 te Velde D.W. (2008), 'Promoting green growth – evidence from firm level analysis in China', Preliminary note – July 2008.



Overseas Development Institute

111 Westminster Bridge Road, London SE1 7JD

Tel +44 (0)20 7922 0300

Fax +44 (0)20 7922 0399

Email publications@odi.org.uk

Readers are encouraged to quote or reproduce material from ODI Opinions for their own publications, but as copyright holder, ODI requests due acknowledgement and a copy of the publication.

© Overseas Development Institute 2009

ISSN 1756-7629