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Two Tales of Adjustment: East Asian Lessons for European Growth

Anusha Chari

University of North Carolina at Chapel Hill and NBER

Peter Blair Henry

New York University and The Brookings Institution

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Anusha Chari & Peter Blair Henry

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TWO VIEWS ABOUT AUSTERITY

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

TWO CRISES, TWO FISCAL POLICY RESPONSES

The Asian Crisis

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

Course Reversal: Subsequent program revisions allowed for fiscal expansion.

The Global Financial Crisis (Europe)

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

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

ASIA REBOUNDS QUICKLY WHILE EUROPE CONTINUES TO CONTRACT

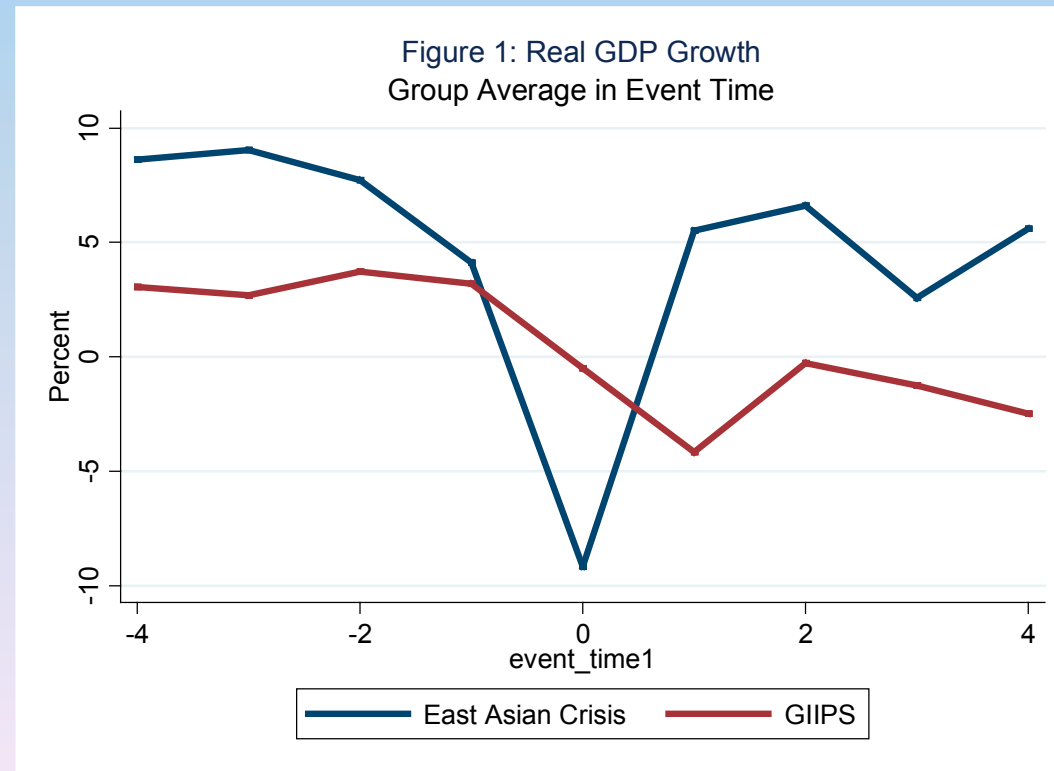
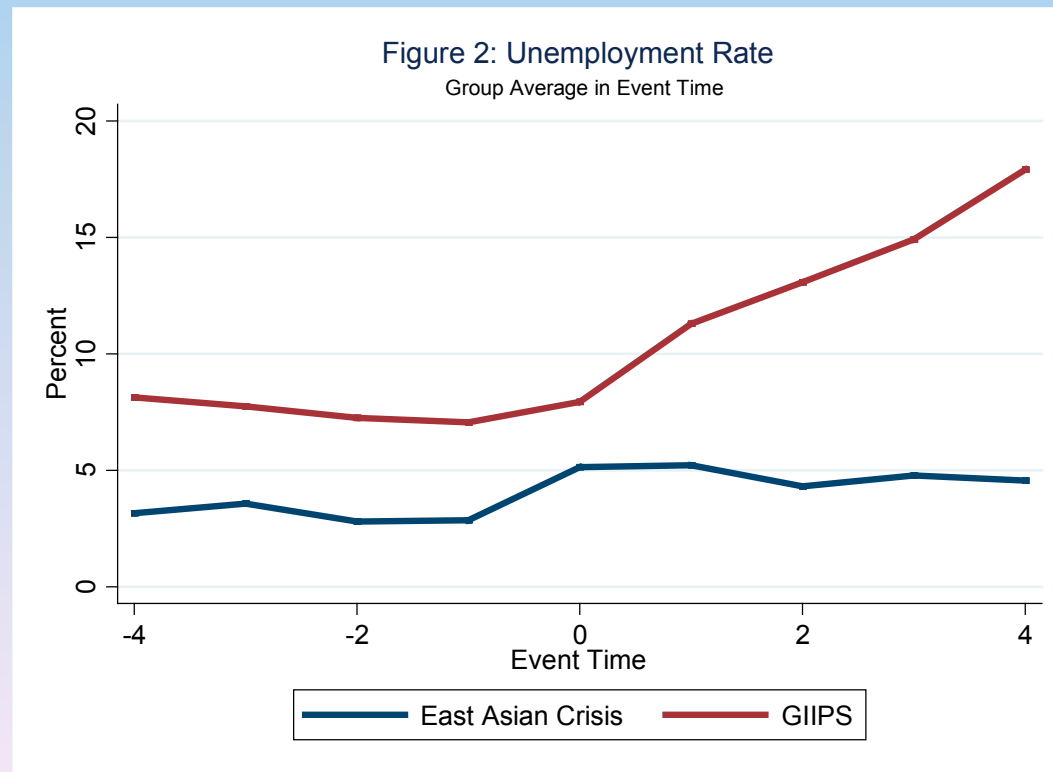


FIGURE 2 TELLS A SIMILAR STORY OF DOWNTURN AND RAPID RECOVERY IN ASIA VERSUS PROLONGED STAGNATION IN EUROPE.



FISCAL POLICY FLEXIBILITY IN EAST ASIA

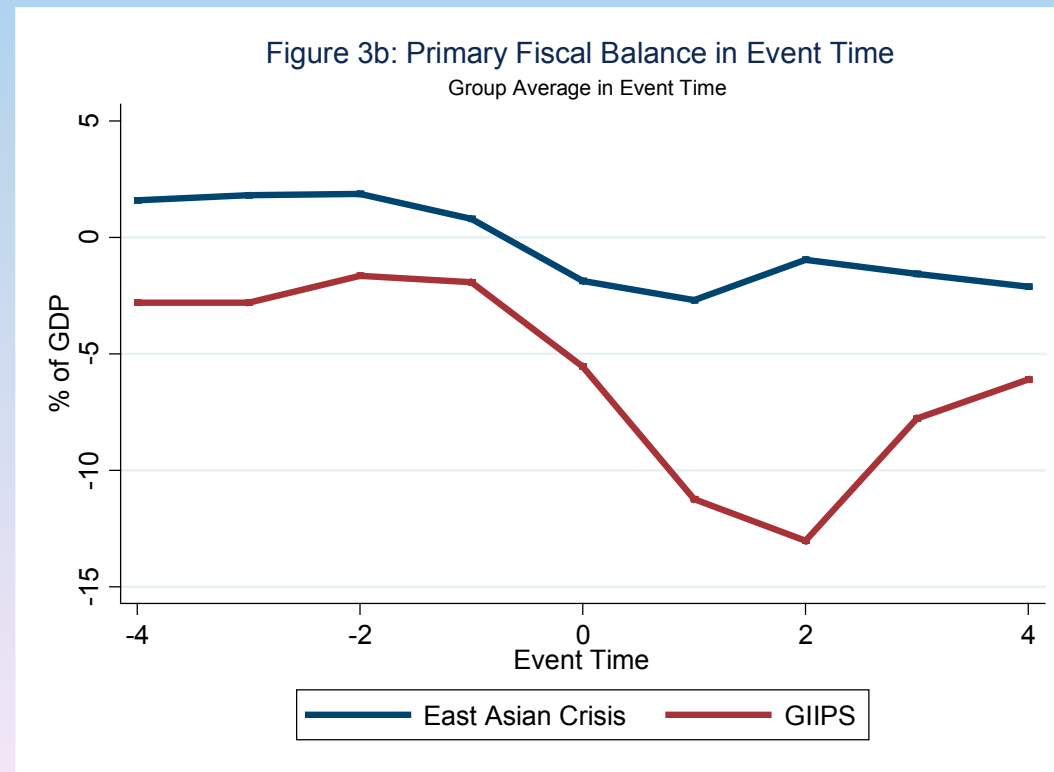
Clearly articulated in April of 1998 by Stanley Fischer:

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

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

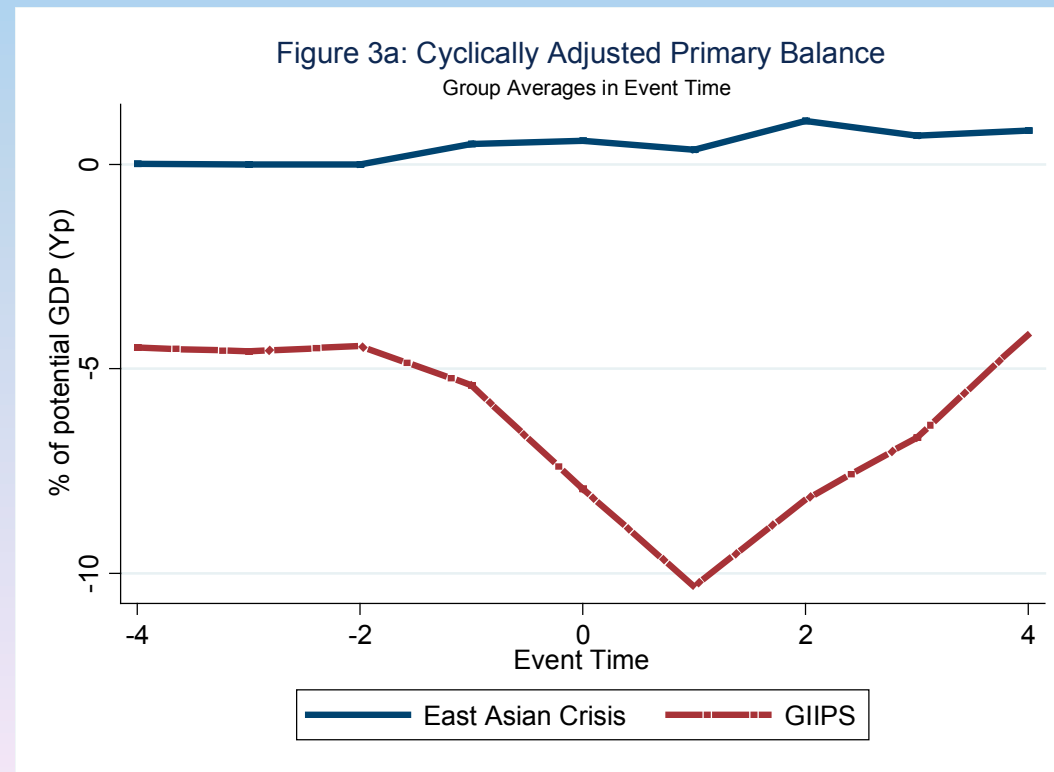
After these initial adjustments, if the economic situation in the country weakened more than expected, as it has in the three Asian crisis countries, the IMF has generally agreed with the country to let the deficit widen somewhat, that is, to let automatic stabilizers operate.”

ASIA STAYS THE COURSE WHILE EUROPE SWITCHES FROM STIMULUS TO AUSTERITY



REVERSAL IN EUROPE STRIKING IN SIZE, SPEED & PERSISTENCE

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



OUR FORMAL STATISTICAL RESULTS SUPPORT THIS SIMPLE VISUAL STORY.

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

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

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

CAVEATS

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

CONCLUSION

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