



14TH JACQUES POLAK ANNUAL RESEARCH CONFERENCE  
NOVEMBER 7–8, 2013

---

## Comments of “Two Tales of Adjustment: East Asian Lessons for European Growth”

Morris Goldstein  
Peterson Institute

Paper presented at the 14th Jacques Polak Annual Research Conference  
Hosted by the International Monetary Fund  
Washington, DC—November 7–8, 2013

**The views expressed in this paper are those of the author(s) only, and the presence of them, or of links to them, on the IMF website does not imply that the IMF, its Executive Board, or its management endorses or shares the views expressed in the paper.**

Comments (as delivered) on Chari and Henry's "Two Tales of Adjustment:  
East Asian Lessons for European Growth"  
by Morris Goldstein  
Non-Resident Senior Fellow, Peterson Institute for International Economics  
Fourteenth Jacques Polak Annual Research Conference  
Research Department, IMF, November 7-8, 2013

I. Introduction

I am delighted to participate in this IMF conference in honor of Stan Fischer. Over the past 25 years, I have benefitted greatly from Stan's guidance, support, and friendship and I am profoundly grateful for that.

The Chari and Henry (2013) paper on "Two Tales of Adjustment" is a good one and a welcome addition to the literature on the appropriate conduct of fiscal policy during a financial crisis. It brings fresh perspective to the ongoing debate on austerity in the European debt crisis by emphasizing how a flexible, gradual, and counter-cyclical fiscal policy in the Asian Financial Crisis of 97-98 helped to generate a speedy and strong recovery. Anusha and Peter's main conclusion seems sensible and credible -- namely, that it would have been better if the GIIPS had implemented a decrease in the cyclically-adjusted primary deficit that was smaller and more gradual than the sharp cut of almost 4 percent of potential GDP that actually took place between 2010 and 2012.

I will first discuss several factors that I think deserve more attention in a comparison of the two crises than they get in the paper. I will then speculate on "why" fiscal policy conditionality was less flexible and less counter-cyclical in the European crisis than what the Fund probably wanted and I will propose a reform that might lessen the problems we have seen in crisis management by the Troika..

Sorry, but since I am now largely retired, I no longer can speak in Power Point or Acrobat -- only in prose; a written version of my remarks is however available.

II. Differences between the Asian and European Financial Crises: Comparing Apples to Apples

I assume that the authors chose the Asian crisis countries as a comparator for the GIIPS in large part because the Asian economies (and the Fund) adopted a fiscal

policy strategy in 1997-2002 that was different than the one undertaken by the GIIPS during this later crisis. The authors recognize that “other” factors and shocks beside fiscal policy were also relevant for the growth and unemployment outcomes and they make a good faith effort to account for these other factors . That said, I think the paper would benefit from a deeper look into the global synchronicity of cycles, the bounce-back effect after deep recessions, and the pre-crisis public debt ratio.<sup>1</sup>

Consider the analysis in Chapter 3 of the April 2009 World Economic Outlook (IMF, 2009). There, Fund staff examine 122 recessions over the 1958-2008 period for 21 advanced countries, including all of the GIIPS. Three conclusions merit explicit mention.

First, recessions that are highly synchronous across countries tend to be longer and deeper than those confined to one region, and recoveries from synchronized recessions are typically weak, as export expansion plays a limited role. The Fund defines a synchronous crisis as one where 10 or more of the 21 advanced countries are in recession at the same time, and notes that there have been only four such cases since 1960, namely, in 1975, 1980, 1992, and in 08-09. Conclusion number two is one often emphasized by my late Peterson colleague, Mike Mussa, namely, that deep recessions tend to be associated with steep recoveries. And third, fiscal stimulus during recessions has a larger impact on the strength of the recovery in economies with low levels of public debt than in those with higher levels.<sup>2</sup> Each of these conclusions seems relevant for a comparison of the GIIPS with the Asian crisis countries.

---

<sup>1</sup> A closer look into the extent of currency mismatches would also pay dividends – given the extent of these mismatches in the Asian crisis countries during the run-up to the 1997-98 crisis and given the broader evidence that such mismatches are the best explanation we have for why many currency crises in emerging economies have shown such large output losses; see Goldstein and Turner (2004). I omit discussion of mismatches above merely for time and space reasons.

<sup>2</sup> In a similar vein, the April 2010 World Economic Outlook (IMF, 2010) finds that the output effects of fiscal retrenchment tend to be different for countries that face different perceived levels of sovereign default risk (as measured by credit ratings).

The recession associated with the 97-98 Asian Financial Crisis was non-synchronous and mostly “regional.” In contrast, the recession in the GIIPS has been highly synchronous and “global”, with the euro crisis following soon after the Great Recession. Global growth was significantly more vigorous during the Asian Financial Crisis and its aftermath than during and after the global economic and financial crisis of 08-09.<sup>3</sup> As the authors show, the contraction in and recovery from the Asian crisis has a deep, narrow V shape, while that in the European crisis resembles  $\frac{3}{4}$  of a W-shape – with a weak and intermittent recovery. Finally, there is a big difference in the average public debt ratio, with the pre-crisis debt ratio being about 40 percent of GDP higher in crisis Asia than in the GIIPS, and with that difference growing to roughly 70 percent of GDP four years after each crisis began.

By introducing informal control groups for Other Europe (seven other original members of the Euro-zone plus the UK) and Other Asia (six other emerging Asian economies), one might argue that the authors have largely accounted for these (non-fiscal policy) differences between the GIIPS and the Asian crisis economies. After all, Other Europe was also subject to the global crisis of 08-09, while Other Asia was operating in the Asian regional crisis of 97-98. In addition, differences in the depth of the recession and in pre-crisis debt ratios are probably smaller within each region than across the Asian-GIIPS divide. But bringing in these regional control groups creates another problem. One wants a control group that is not only similar in relevant respects to the treatment group but that is also unaffected by the “treatment” applied to the treatment group (Goldstein and Montiel, 1986). That is unlikely to be the case with such regional control groups. The GIIPS and the Euro-zone members of Other Europe have the same central bank; they share the same currency; they face the same set of fiscal policy guidelines; they contribute to the same regional bailout fund; and most of all, their economies are highly connected in

---

<sup>3</sup> For the Asian crisis, Truman (2013) reports that global real GDP growth averaged 3.5 percent in both the pre-crisis period (1994-96) and in the post-crisis period (1999-2003) and was actually a little higher at 3.8 percent during the crisis years of 1997-98. In contrast, global growth slowed from an average of 5.1 percent in 2004-07, to 1.1 percent in 2008-09, and only recovered to an (estimated) average of 3.9 percent in 2010-14.

trade and finance. If there is say, a large debt restructuring or a large fiscal policy change in the Euro-zone periphery, it can affect banks, bank lending, exports, and economic activity in the Euro-zone core. So too with a comparison between the Asian crisis countries and Other Asia (albeit sans the special links associated with a currency zone.) Such treatment spillover effects mean that the total effects of fiscal policy changes in the treatment group will not be visible solely from outcomes in the treatment group, since some of those effects will show up in the outcomes for the control group – complicating group comparisons. [On this count, an advantage in comparing the GIIPS to the Asian crisis countries is that we don't have to worry that whatever is done in the GIIPS in 2007-13 will affect outcomes or policies during the Asian crisis of 97-98].

I don't want to suggest for a minute that the authors are unaware of these potential pitfalls. [As I noted earlier, they go to some effort to avoid them]. Still, one could be more confident in the fiscal policy results and in the wider policy implications if they undertook some additional robustness checks.

In this connection, the following questions come to mind. Would the fiscal policy results for the GIIPS look different if we compared their performance not to the Asian crisis countries but to other cases -- say, those in 1975, 1980, or 1982, where the recession was a synchronous one? Would GIIPS performance in this debt crisis be evaluated differently if compared to other W-shaped recessions and where the crisis economies entered the post-crisis period with relatively high public debt ratios? [Symmetrically, how would recovery of the Asian crisis countries be evaluated if judged against the backdrop of other cases where the recovery was V-shaped, like say, Mexico in 1995, or Argentina in 1998-2006, or some of the V-shaped recoveries in the United States]? Would the Chari-Henry fiscal policy findings be significantly altered if they used a pooled sample of GIIPS and non-GIIPS recessions and inter-acted their fiscal policy variable with either the level of public debt or the country's sovereign debt rating? [Now that more advanced countries have high public debt ratios, are we more likely to see greater recourse to pro-cyclical fiscal policy -- much as we saw in developing countries over the 1960-2003 period (Kaminsky, Reinhart, and Vegh, 2005)]. Alternatively, and to take a page

from Paul Krugman's Mundell-Fleming lecture (Krugman, 2013), suppose the real constraint on the use of counter-cyclical fiscal policy during a recession is not the level of debt, but rather occurs when the country does not have its own currency, does not borrow in it, does not have a floating exchange rate, and does not have a well-functioning lender of last resort; if this is right, then shouldn't control variables for the currency regime, currency mismatch, and lender-of-last-resort interact somehow with the fiscal policy variables? Given the substantial evidence that recessions associated with financial crises are relatively severe and long lasting, shouldn't we have some precursors of banking crises – like the rate of credit growth and the growth of real property prices – as control variables in the output growth equations. And finally, given the increasing availability of large data bases on recessions and crises, isn't there another potential control group for the GIIPS that: exhibits a different fiscal policy stance; that is similar to the GIIPS recession in synchronicity, depth of the recession, and pre-crisis public debt ratios; and that is relatively unaffected by treatment spillover from the GIIPS. Maybe that control group is the null set – but it would be worth a look.

### III. The EU Crisis, the Troika, and the Fund as a Minority Creditor

I turn next to the question of why the Fund found it so difficult to implement a significant easing of fiscal policy in the GIIPS – even as growth outcomes continued to disappoint.

I think part of the answer lies in the Troika relationship between the Fund, the European Commission (EC), and the European Central Bank (ECB), and in the Fund's limited leverage over its Troika partners as a minority creditor in GIIPS rescue packages. Suppose that by say, early 2011 the Fund would have preferred a strategy in the European financial crisis that included: a more gradual pace of fiscal consolidation in the GIIPS; larger debt restructuring in Greece: more OSI (Official Sector Involvement); more aggressive bank recapitalization throughout the EU; and an approach that saw the crisis as one of the currency zone as a whole, with an accompanying need for conditionality not just on the deficit countries but also on

the surplus ones and on the ECB. If that was more or less the Fund's view, I share it. This was not of course the view that prevailed.

Everybody in the official crisis management business sometimes makes mistakes. The question is who is more likely to recognize earlier those mistakes and move more forcefully to correct them. Warts and all, I think the Fund is better placed to do that than are regional official crisis lenders. Relative to regional institutions, the Fund has greater experience with policy conditionality. Its decisions are less sensitive to both election cycles in the major economies and to lobbying pressure from the financial industry. And its more diverse membership provides some protection against errant group think being sustained for long periods.

My proposal is that countries seeking official crisis financing be offered two options. Option One would be to use regional financial arrangements plus whatever bilateral assistance could be mobilized -- but without financial assistance from the Fund. Option Two would be to ask the Fund to join-in with other official lenders, but with the stipulation that the Fund would then become the majority official creditor (with the Fund's contribution being larger than that of any regional financial assistance or any bilateral creditor). While there is a need for compromise and cooperation among official creditors in all major crises and while leverage is not just a function of financial contribution alone, if there is a difference in view among official creditors, then, other things equal, he who pays the piper calls the tune.

Yes, some large non-Fund official creditors would lose power relative to the status quo, but as then a minority creditor, they would also be less seen as the villain for imposing their unpopular brand of policy conditionality on their neighbors. And yes, such a reform would interrupt the trend toward a more decentralized official safety net -- but I see little evidence that this trend is producing bottom-line results for growth or balance-of-payments adjustment that are better than what would likely occur if Fund views on policy conditionality trumped those of regional hegemons.

## References

- Anusha Chari and Peter Henry, 2013, "Two Tales of Adjustment: East Asian Lessons For European Growth," Paper presented at Jacques Polak Research Conference, IMF, Washington DC, November.
- Goldstein, Morris and Peter Montiel, 1986, "Evaluating Fund Stabilization Programs With Mult-country Data: Some Methodological Pitfalls," IMF Staff Papers, June.
- Goldstein, Morris and Philip Turner, 2004, Controlling Currency Mismatches in Emerging Markets, Peterson Institute for International Economics, Washington DC, June.
- International Monetary Fund, 2009, "From Recession to Recovery: How Soon and How Strong," Chapter 3 in World Economic Outlook, IMF, Washington DC, April.
- International Monetary Fund, 2010, "Will It Hurt: Macroeconomic Effects of Fiscal Consolidation," Chapter 3 in World Economic Outlook, IMF, Washington DC, October.
- Krugman, Paul, 2013, "Currency Regimes, Capital Flows, and Crises," Mundell-Fleming Lecture, Jacques Polak Research Conference, International Monetary Fund, Washington DC, November.
- Kaminsky, Graciela, Carmen Reinhart, and Carlos Vegh, 2005, "When It Rains, It Pours: Procyclical Capital Flows and Macroeconomic Policies," in Mark Gertler And Kenneth Rogoff (eds), NBER Macroeconomics Annual, 2004, NBER, Cambridge.
- Truman, Edwin, 2013, "Asian and European Financial Crises Compared," Working Paper No. 13-9, Peterson Institute for International Economics, DC, October.



