

# trade hot topics

## Sustaining Recovery: The Role of Macroeconomic Policy and Trade

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### Background

In 2009, the financial crisis in advanced economies turned into a global economic crisis affecting almost all developing countries. According to a World Bank (2010) estimate, the crisis caused a 2.2 per cent contraction in global output last year. The drying up of trade finance, the rise of protectionism and the collapse of global aggregate demand precipitated by the crisis contributed to a significant decline in trade flows. Thankfully, there is now evidence that the worst of the crisis has passed. Trade flows have started growing again and the International Monetary Fund (2009) estimates that global economic activity rose by 3 per cent during the 2nd quarter of 2009 and accelerated throughout the rest of the year. However, sustaining this turnaround, and preventing backsliding into recession, will require the continued use of concerted macroeconomic policy measures that have been collectively adopted in the face of the downturn. The global context for these national responses was the imperative felt around the world to avoid the mistakes which turned the financial shock of the late 1920s into the Great Depression of the 1930s. This has seen unprecedented global co-operation and co-ordination in macroeconomic policy as well as the use of novel policy instruments. Reliance on such measures will need to be gradually reduced once the recovery is solidified. In the mean

time, however, policy-makers remain in uncharted territory.

This issue of Commonwealth Trade Hot Topics provides an overview of the policies adopted in response to the crisis and considers the policy options faced by different countries. For the largest Commonwealth countries which have contributed importantly to the global stimulus, managing rising debt levels, especially in the context of continuing medium term fiscal difficulties, will become an increasing challenge. For developing countries, policy options are typically more restricted – especially following the adverse impact of the food and fuel crises in 2008. The poorest countries need increased international support in the form of external financing to mitigate the impact of the crisis on the achievement of the Millennium Development Goals (MDGs). In all countries the timing of the withdrawal of macroeconomic support is of crucial importance to sustaining recovery. In small states, and other Commonwealth developing countries that are open to trade, accommodative trade policy will be necessary to secure recovery.

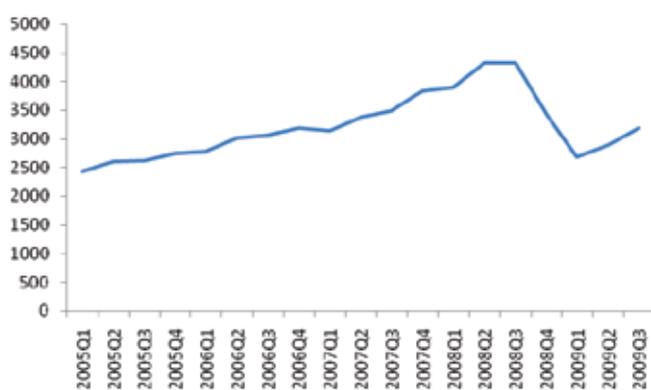
### Trade flows

As can be seen from Figure 1, world trade flows have been severely affected by the economic crisis with world merchandise exports contracting sharply at

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the end of 2008 and the beginning of 2009. While some sectors (such as automotive products, iron and steel) have been more adversely hit than others, the nature of the crisis means that most sectors, and hence most countries, have been affected. The downturn is particularly worrisome for small states, which account for 32 out of the 54 Commonwealth countries, and are typically highly exposed to trade shocks due to their greater dependence on trade.<sup>1</sup> Economic recovery in such countries, and in countries where domestic demand continues to flag as a result of the crisis, will depend heavily on exports.

Figure 1: World Merchandise Exports (US\$ billion)



Source: Based on data from the World Trade Organisation

Trade flows have started to rebound thanks to global economic recovery and the thawing of trade credit. Moreover, many emerging economies, particularly China, have been providing a much needed source of demand for global produce. Despite the economic slowdown, emerging economies are estimated to have achieved 1.7 per cent gross domestic product (GDP) growth on average last year (IMF, 2009). Indeed, according to World Trade Organisation (WTO) data, in the last quarter of 2009, Chinese import growth was up 56 per cent on the previous year, whereas export growth was only up by 18 per cent. However, overall global trade flows still remain below the pre-crisis levels.

## Macroeconomic policy responses

### Fiscal policy

In the wake of the crisis the World Bank (2009) estimates that fiscal deficits in advanced countries have increased by approximately 3 per cent of GDP on average in 2009. This is due to a number of factors including: reduced tax revenue; support to financial systems; operation of automatic stabilisers;

and discretionary fiscal stimulus measures. In G20 countries that are Commonwealth Members fiscal deficits are likely to have increased significantly from pre-crisis levels: in Australia the fiscal balance switched from a surplus of 1.5 per cent of GDP in 2007 to a deficit of 4.3 per cent in 2008; in Canada the shift was from a surplus of 1.6 per cent of GDP to a deficit of 4.2 per cent; South Africa suffered a drop from a 1.2 per cent surplus to a 2.8 per cent deficit; India's deficit increased from 5.2 per cent of GDP to 9.8 per cent of GDP; and the fiscal deficit in the UK increased from 2.6 per cent of GDP to 11.6 per cent of GDP. Government debt is also projected to increase from pre-crisis levels by 2010 by 124.7 per cent in Australia, 86.4 per cent in the UK, 19.3 per cent in Canada, 7 per cent in South Africa and by 5.6 per cent in India.<sup>2</sup>

These along with other members of the G20 have supported global demand through this fiscal expansion which helped to mitigate the depth of the recession in the global economy. Discretionary fiscal stimulus measures in G-20 countries are estimated to have averaged 2 per cent of GDP in 2009 and to average 1.6 per cent in 2010. In proportionate terms, the largest Commonwealth G-20 discretionary stimulus package in 2009 was provided by India (3.5 per cent of GDP) – followed by South Africa (3 per cent), Australia (2.9 per cent), Canada (1.9 per cent) and the UK (1.6 per cent). In general, emerging market fiscal measures are more focused on infrastructure investment and less on income tax cuts, and have been larger than in advanced countries.

However, the fiscal position of developing countries has deteriorated more than in advanced countries. According to the World Bank (2009), fiscal deficits in developing countries are estimated to have increased by 4.4 per cent of GDP on average in 2009. The deterioration is particularly acute for South Asia where the fiscal deficit is estimated to have increased by 10.9 per cent, followed by a 5.0 per cent increase in Sub-Saharan Africa, a 3.9 per cent increase in East Asia and the Pacific, and a 2.4 per cent increase in Latin America and the Caribbean. While some developing countries have pursued discretionary action, for the most part the deterioration in fiscal positions has been the result of exogenous adverse impacts on taxation receipts rather than discretionary spending.

<sup>1</sup> See Cali and Kennan (2009) for a more detailed discussion of the impact of the downturn on small states.

<sup>2</sup> Figures are taken from Horton et al. (2009).

## Monetary policy responses

In terms of monetary policy, the primary global action lies outside the Commonwealth. Broadly speaking monetary policy has been eased throughout the global economy with policy interest rates falling, especially in the USA and Euro Zone. Among advanced countries, rates have fallen by an average of 180 basis points since mid-September 2008. Policy rates have also been cut in three quarters of developing countries by an average of 75 basis points with the highest falls in Latin America and the Caribbean (228 basis points) and East Asia and the Pacific (200 basis points).<sup>3</sup>

## Supporting recovery with fiscal policy: further issues

It is widely accepted that, for the time being, supportive fiscal policies will continue to be necessary to galvanise recovery and, if the recent resurgence dissipates, may need to be enhanced where the underlying fiscal position allows. Three key considerations in this regard are as follows.

### *Existence of fiscal policy space*

In many advanced Commonwealth countries fiscal deficits and public debt ratios have expanded sharply. While these countries can afford to run moderate fiscal deficits for extended periods without adversely affecting the cost of financing, short-term choices have medium-term consequences. Nevertheless, there are questions about medium-term debt sustainability and fiscal solvency – which can raise long-term interest rates, harm recovery and worsen debt dynamics further. The use of looser fiscal policy to meet the crisis also plays directly into the longer term fiscal pressures in many developed economies associated with long-term demographic change.

Conversely, Commonwealth developing countries are less able to use fiscal policy to support economic recovery as fiscal space has been limited as a result of the food and fuel price hikes in 2008. In addition, the crisis has caused a further deterioration of their fiscal positions. Weakening growth due to falling export prices and volumes, remittances, tourism and capital flows translate into significant government revenue loss. Combined with limited access to external sources of finance at reasonable cost this constrains most countries' ability to utilise further supportive fiscal policies.<sup>4</sup>

### *Effectiveness*

To maximise effectiveness, the design and

composition of fiscal policies – as well as their size – matters. Policy-makers need to consider whether revenue or expenditure based measures are more effective. Discretionary government spending increases (either for consumption or investment) and targeted tax cuts and transfers are more likely to be effective than general tax cuts – which can lead to increased saving, not spending – or general subsidies. Moreover, in many Commonwealth developing countries a focus on expenditure is likely to be most effective, as the scope for reducing tax rates is likely to be limited given low revenue ratios and the fact that doing so may be inequitable.

A lesson from the Asian crisis in the late 1990s is that a broad-based crisis can disrupt development momentum well into the future. Policy-makers should give priority to protecting MDG spending and expanding social safety nets to cushion the impact of the crisis on the poor and ensure that recent progress in poverty reduction is not reversed. Any further fiscal support should be targeted to those who are vulnerable and those who have a higher propensity to consume.

Another lesson from the Asian crisis is that it is important to protect public infrastructure investment to ensure that post-crisis long-term growth is not undermined. Emphasis should be placed on bringing forward approved investment projects while preserving existing infrastructure by protecting operations and maintenance.

### *Timing and credibility*

The stimulus packages have been exceptional. Their withdrawal poses challenges for policy makers. There is a need to balance the risks of 'easing bias' where the stimulus during the downturn is greater than the tightening during the upturn, leading to a ratcheting up of public debt levels with tightening fiscal policy too early and pushing the economy back into recession. The timing decision will vary from country to country depending on how badly damaged they were during the crisis, their speed of recovery and their fiscal space.

A credible exit strategy is thus needed to unwind fiscal support measures once the recovery is on a firm footing. To this end, fiscal policy needs to be anchored in a credible medium-term framework. However, credibility is more difficult to build – and

<sup>3</sup> basis point is equal to 1/100th of 1 per cent.

<sup>4</sup> Where many countries absorbed the impact fiscally in order to minimise social and political impacts. For example, in Sub-Saharan African oil importing countries the fiscal cost of delaying the pass-through to domestic prices averaged 1 per cent of GDP in 2008 (World Bank, 2009).

more easily lost – in developing countries. The result is that the impact of higher budget deficits on financing conditions and interest rates – as markets insure against future inflation and taxation – is potentially much stronger in developing countries than in advanced countries.

### **Sustaining recovery with monetary policy**

As is the case for fiscal policy, the scope for continuing loose monetary policy will depend on country circumstances. Three issues shape the determination of monetary policy in the short to medium term.

#### ***Existence of monetary policy space***

To the extent that the risk of deflation outweighs the risk of high inflation, policy space exists in many advanced countries. Monetary policy should remain supportive until the recovery is solidified and deflationary risks recede. Should the recent recovery dissipate, policy-makers should make use of any remaining room to cut policy rates further while exploring nonconventional policy to ease credit constraints.

While inflation in developing countries fell throughout 2009, the monetary policy options facing developing countries are constrained by the continuing volatility and uncertainty of capital flows and, in some countries, managed exchange rate regimes. In contrast to advanced countries where the crisis was mainly felt through financial system disruption, developing countries faced a shock whose impact – from worsening terms of trade, decreased export demand, remittances and capital flows – was felt mostly through the balance of payments. In many economies the weakening of balance of payments positions will put greater pressure on fixed exchange rate regimes where they exist. Monetary policy can be relaxed more easily where the exchange rate can be allowed to adjust. This allows external forces to relieve the pressure on the domestic economy. There remains the need to balance considerations: on the one hand depreciation can boost exports; but on the other it can also increase inflation and the local currency cost of servicing debt denominated or indexed to foreign currencies which could adversely impact the balance sheets and budget positions of households, private sector and government.

Where capital flows have collapsed and where countries are facing large or growing external deficits, external adjustment will be required.

This pressure can be relieved temporarily through sustainable external financing or by running down international reserves. Several Commonwealth countries, notably, in the Caribbean and Sub-Saharan Africa have already opened up lines of credit with the IMF, while others are meeting shortfalls by reducing international reserves.

#### ***Effectiveness***

A main feature of this crisis has been financial sector disruption and the emergence of widespread credit constraints. As a result, conventional monetary policy has become less effective in some advanced countries as policy interest rates have fallen towards zero combined with greater caution in lending by banks and rising risk premiums. For these reasons policy-makers are resorting to unconventional monetary policy measures such as quantitative easing and credit easing to improve the availability and cost of credit.

While policy rates are not near the zero floor level in developing countries, policy-makers in some developing countries may also need to turn to unconventional monetary policy to improve the availability and cost of credit until financial markets fully recover.

#### ***Timing and credibility***

In all countries to minimise risks to the balance sheet and credibility of central banks, and to avoid disrupting markets once conditions normalise, a credible exit strategy needs to be articulated early on. As is the case for fiscal policy, policy-makers will have to carefully manage the trade-off between the risk of a premature tightening of policy that would stunt any recovery, and the risk of inflation and creation of new asset price bubbles that would arise from a prolonged period of loose monetary policy. The situation is particularly tricky in economies where inflationary pressures will force earlier monetary tightening. In these circumstances, exchange rate manipulation may be required to stave off an influx of foreign capital as a result of low interest rates elsewhere.

### **International macroeconomic policy challenges**

The chief lesson of the crisis at the global level is that the management of a globally integrated economy requires increased levels of macroeconomic dialogue and co-ordination. Restoring financial sector stability requires co-ordination internationally to avoid

regulatory arbitrage and competitive distortions, and to ensure reasonable burden-sharing of crisis costs.<sup>5</sup>

Global imbalances contributed to the unsustainable policy mix which created the conditions for the financial and economic crisis. Rebalancing global demand is needed to ensure stable and sustainable growth in the medium term. This will necessarily entail a rise in saving in advanced countries which will need to be matched by an increase in demand and decrease in saving in emerging countries. This will require increased co-operation and co-ordination amongst countries to implement structural, exchange rate, fiscal and monetary policies which both reduce unsustainable imbalances and support global economic growth.

### Trade policy

The continued use of macroeconomic policies to stabilise economic activities will be crucial in sustaining recovery. However, the path out of recession requires more than just steadying the tiller; it requires steering the economy in the right direction. For many Commonwealth developing countries that are particularly open to the world economy, especially those that are small states, the effects of the global crisis were primarily channelled through falling trade flows. For them, macroeconomic policies can do little more than cushion the blow of the recession; they cannot be relied upon to provide a source of demand sufficient to counteract the drop in export demand triggered by the crisis. Now that the crisis is beginning to recede, the focus of attention in such countries can shift away from emergency macroeconomic measures to policies designed to assist exporters in meeting the nascent resurgence in global demand.

There are several areas of action that could be considered. Export capacity could be maximised via the removal of all forms of export restrictions. Indeed, as noted by Cali and Kennan (2009), Vanuatu recently scrapped the fee charged to cruise ships to dock in the port which contributed to a beneficial rise in tourist arrivals by sea. Moreover, economic disruption engendered by the crisis will inevitably lead to production bottlenecks that inhibit export activity. Policy-makers could focus any further fiscal stimulus measures on dealing with such bottlenecks and facilitating imports of intermediate goods by eliminating unnecessary tariffs. Furthermore, through export promotion programmes and careful exchange-rate management, policy-makers should ensure that exporters are well placed to capitalise on new export opportunities that arise as a result of

global demand rebalancing.

Finally, while a wave of overt protectionism has not hit, there are signs that some policy responses have been viewed as beggar-thy-neighbour trade restrictions motivated by crisis-induced political pressure (Evenett, 2009). In order to forestall further backsliding of this kind as the recovery proceeds, policy-makers should endeavour to complete the Doha round of WTO negotiations as soon as possible to provide exporters with a guarantee that their efforts will not be thwarted by future protectionism.

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<sup>5</sup> These issues are discussed further in paper FMM(09).

# International Trade & Regional Co-operation Section at the Commonwealth Secretariat

This Trade Hot Topic is brought out by the International Trade and Regional Co-operation (ITRC) Section of the Economic Affairs Division (EAD) of the Commonwealth Secretariat, which is the main intergovernmental agency of the Commonwealth – an association of 54 independent states, comprising large and small, developed and developing, landlocked and island economies – facilitating consultation and co-operation among member governments and countries in the common interest of their peoples and in the promotion of international consensus-building.

ITRC is entrusted with the responsibilities of undertaking policy-oriented research and analysis on trade and development issues and providing informed inputs into the related discourses involving Commonwealth members. The ITRC approach is to scan the trade and development landscape for areas where orthodox approaches are ineffective or where there are public policy failures or gaps, and to seek heterodox approaches to address those. Its work plan is flexible to enable quick response to emerging issues in the international trading environment that impact particularly on two highly vulnerable Commonwealth constituencies – least developed countries (LDCs) and small states.

## Scope of ITRC Work

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- It supports Commonwealth developing members in their negotiation of multilateral and regional trade agreements that promote development-friendly outcomes, notably their economic growth through expanded trade.
- It conducts policy research and consultations that increase understanding of the changing of the international trading environment and of policy options for successful adaptation.
- It contributes to the processes involving the multilateral and bilateral trade regimes that advance the more beneficial participation of Commonwealth developing country members, particularly small states and LDCs.

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7-8 July 2009: Conference on Managing Regional Integration in South Asia, held in Dhaka, Bangladesh

24 June 2009: Conference on Political Economy of Competition and Regulation in Developing Countries, held in Jaipur, India

23-24 June 2009: ACP Preparatory Meeting for the WTO Second Global Review of Aid for Trade, held in Geneva, Switzerland

15-17 June 2009: Workshop on Strengthening Skills of Government Officials in Sub-Saharan Africa on Commercial Diplomacy and Trade Policy Issues, held in Nairobi, Kenya

10 June 2009: Prime Ministerial Caribbean Banana Policy Review Meeting, held in Castries, St Lucia

10 June 2009: Discussion meeting on Challenges to Small States in the Multilateral Trading System, organised during the World Trade Week, UK (8-12 July 2009), held in London, UK

9-10 June 2009: Commonwealth Investment Experts' Meeting, held in London, UK

18 May 2009: Seminar on Preference Erosion: How Much and What To Do About It?, held in London, UK

## Selected ITRC Publications

Grynberg, R and Kabuleeta, P (forthcoming). Investment and Economic Partnership Agreements: Issues for ACP Negotiators. London: Commonwealth Secretariat.

Milner, C et al. (forthcoming). Policy Response to Trade Preference Erosion: Options for Developing Countries. London: Commonwealth Secretariat.

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**ISSN: 2071-8527** (print) **ISSN: 2071-9914** (online)

Series editor: Dr Mohammad A Razzaque  
Produced by the Economic Affairs Division of the Commonwealth Secretariat

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