Box 1.1. The Great Divergence of Policies

The current global recovery has followed an unusual path compared with the three previous global recoveries.[1] Specifically, the recovery following the Great Recession exhibits two types of divergences. The first is the sharp divergence of activity across advanced and emerging market economies, which we first noted in the April 2012 *World Economic Outlook* and that has continued since then.[2] The second is the great divergence of monetary and fiscal policies, which has become increasingly pronounced during the past two years. This box first presents a brief review of the former divergence and then provides a detailed account of the latter one.

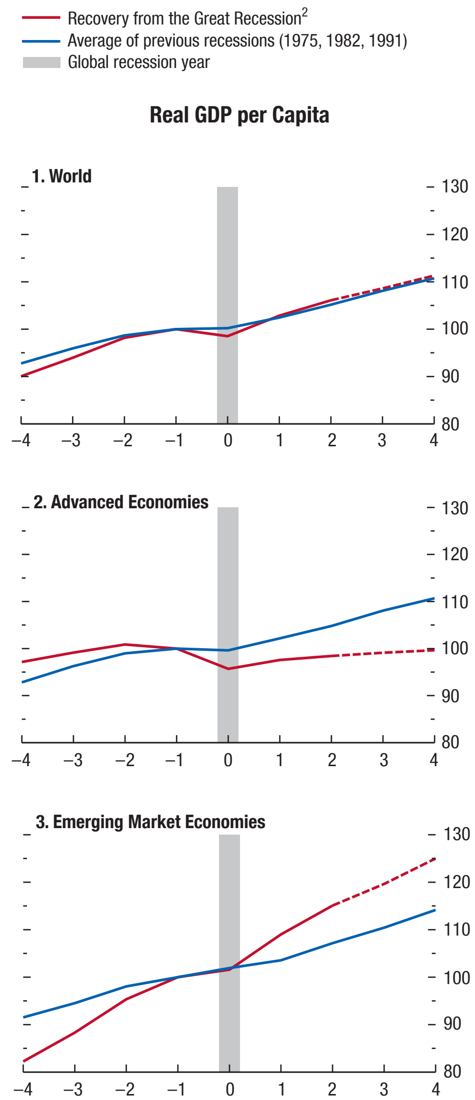
Sharp Divergence of Activity

Overall, the ongoing global recovery has followed the pattern of recoveries in the past (Figure 1.1.1). But this global development masks a sharp divergence between the ongoing recovery paths for advanced and emerging market economies. Specifically, this recovery has been the weakest for advanced economies and the strongest for emerging markets. The advanced economies were the engine of previous global recoveries, but emerging markets account for the lion's share of the ongoing recovery. In light of the current forecasts, the sharp divergence of activity between advanced and emerging market economies is likely to persist in the coming years.

Great Divergence of Policies

The second unique feature of this recovery has been the substantially different paths of fiscal and monetary policies, mainly in advanced economies. In particular, whereas the directions of fiscal and monetary policies were aligned in previous episodes, during the current recovery these policies have marched in opposite directions. Because the focus is on the cyclical properties of fiscal and monetary policies, we use specific measures for policies (that is, real primary government expenditure, short-term interest rate, and the rate of growth of central bank assets) that provide a good reading of the cyclical policy stance (Kaminsky, Reinhart, and Végh, 2005). Other indicators (such as the ratio of government deficits to GDP and real short-term interest rates) often lead to noisy signals about the stance of policies.

Figure 1.1.1. Divergent Recoveries[1]
(Years on x-axis; indexed to 100 in the year before the global recession)



Source: IMF staff estimates.
[1]Aggregates are purchasing-power-parity weighted.
[2]Dashed lines denote WEO forecasts.

The authors of this box are M. Ayhan Kose, Prakash Loungani, and Marco E. Terrones. Ezgi Ozturk, Bennet Voorhees, and Tingyun Chen provided research assistance.

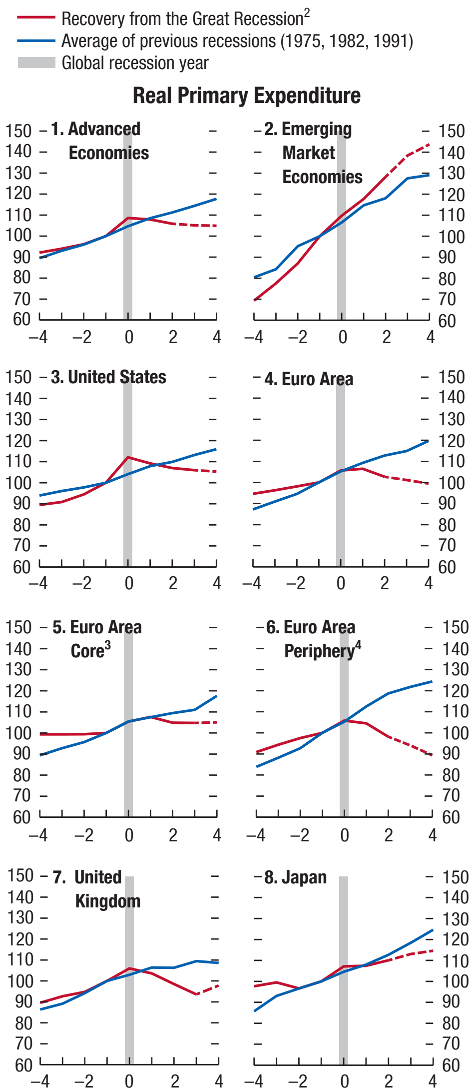
[1]This box focuses on the recovery episodes that followed the four global recessions the world economy experienced over the past half century: 1975, 1982, 1991, and 2009. A global recession is a decline in world per capita real GDP accompanied by a broad decline in other indicators of global activity—specifically, industrial production, trade, capital flows, oil consumption, and employment. A global recovery is a rebound in worldwide activity over the three or four years following a global recession. A detailed discussion of global recessions and recoveries is presented in Kose, Loungani, and Terrones (2013).

[2]See Box 1.2 of the April 2012 *World Economic Outlook.*

Box 1.1 *(continued)*

Figure 1.1.2. Government Expenditures during Global Recessions and Recoveries[1]

(Years from global recession on x-axis; indices = 100 in the year before the global recession)



Sources: IMF, Public Finances in Modern History database; World Bank, World Development Indicators database; and IMF staff estimates.
[1]Aggregates are purchasing-power-parity weighted.
[2]Dashed lines denote WEO forecasts.
[3]France and Germany.
[4]Greece, Ireland, Italy, Portugal, Spain.

With regard to fiscal policy, the current and projected paths of government expenditures in the advanced economies are quite different than during past recoveries, when policy was decisively expansionary, with increases in real primary government expenditures. In some advanced economies, especially in the United States, the fiscal stimulus introduced at the outset of the financial crisis was far larger than during earlier recessions. However, the stimulus was unwound early in the ensuing recovery. Specifically, expenditures fell during the first two years of this global recovery and are projected to continue to decline modestly in the coming years (Figure 1.1.2).

This pattern also holds across the major advanced economies, with the euro area and the United Kingdom showing sharp departures from the typical paths of government expenditures in the past.[3] In contrast, in the emerging market economies the ongoing recovery has been accompanied by a more expansionary fiscal policy stance than during past episodes. This was possible because these economies had stronger fiscal positions this time around than in the past.

Monetary policies in the advanced economies have been exceptionally accommodative during the latest recovery compared with earlier episodes (Figure 1.1.3). In particular, policy rates have been reduced to record-low levels and central bank balance sheets in the major advanced economies have been dramatically expanded compared with earlier episodes (Figure 1.1.4). Monetary policy in emerging market economies has also been more supportive of economic activity than in the past.

What Explains the Divergence of Policies?

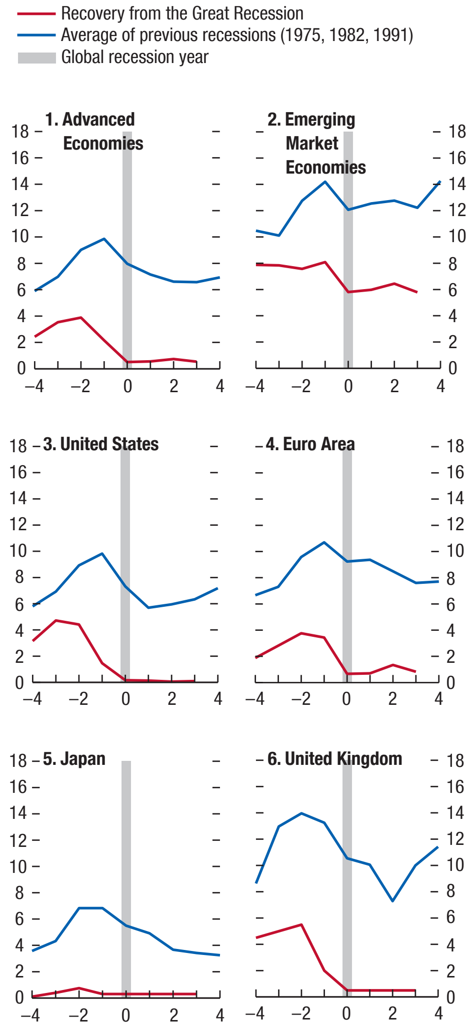
Caution about fiscal stimulus and the pace of consolidation in this recession and recovery are likely explained by high ratios of public debt to GDP and large deficits. Advanced economies entered the Great Recession with much higher levels of debt than in past recessions (Figure 1.1.5). The high debt levels reflect a combination of factors, including expansionary fiscal policies in the run-up to the recession, financial sector support measures, and substantial revenue losses resulting from the severity of the Great Recession. The deficit levels in some advanced economies are currently

[3]We report the average of the three previous episodes here for simplicity, but the general pattern described by the average is valid for each episode as well (Kose, Loungani, and Terrones, 2013). The findings with respect to primary expenditures do not change much when the periphery euro area countries are excluded from the sample of advanced economies.

Box 1.1 *(continued)*

Figure 1.1.3. Short-Term Interest Rates during Global Recessions and Recoveries[1]

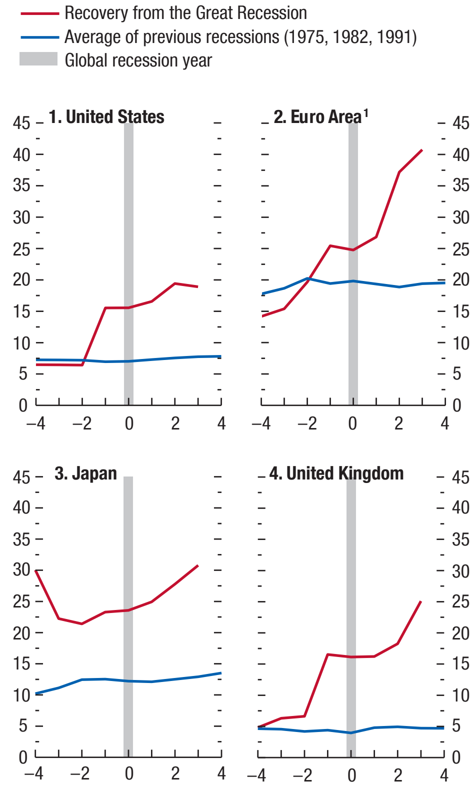
(Percent; years from global recession on x-axis)



Sources: Haver Analytics; IMF, *International Financial Statistics;* and IMF staff calculations.
[1]Aggregates are market weighted by GDP in U.S. dollars; observations are dropped for countries experiencing inflation 50 percent greater than in the previous year. Policy rate used as the principal series. Three- or four-month treasury bill data used as a proxy if data series was longer.

Figure 1.1.4. Central Bank Assets in Major Advanced Economies during Global Recessions and Recoveries

(Percent of real GDP of year before global recession; years from global recession on x-axis)



Sources: Bank of England; Eurostat; Haver Analytics; IMF, *International Financial Statistics;* World Bank, World Development Indicators database; and IMF staff calculations.
[1]Aggregate is market weighted by GDP in U.S. dollars. Data unavailable before 1975.

Box 1.1 *(continued)*

large in part because of the collapse in revenues. Moreover, sovereign debt crises in some euro area periphery countries and challenges associated with market access put pressure on these economies to accelerate their fiscal consolidation plans.[4] At the same time, there was more room for monetary policy maneuvering because inflation rates were much lower at the beginning of the recession than in the past (Figure 1.1.6).

The evidence presented here does not in itself permit an assessment of whether the different policy mix in this recession and recovery was appropriate.[5] The response of policies may have been reasonable given the respective room available for fiscal and monetary policies in advanced economies. But there are also concerns. Even though monetary policy has been effective, policymakers had to resort to unconventional measures. Even with these measures, the zero bound on interest rates and the extent of financial disruption during the crisis have lowered the traction of monetary policy. This, together with the extent of slack in these economies, may have amplified the impact of contractionary fiscal policies.[6] Four years into a weak recovery, policymakers may therefore need to worry about the risk of overburdening monetary policy because it is being relied on to deliver more than it traditionally has.

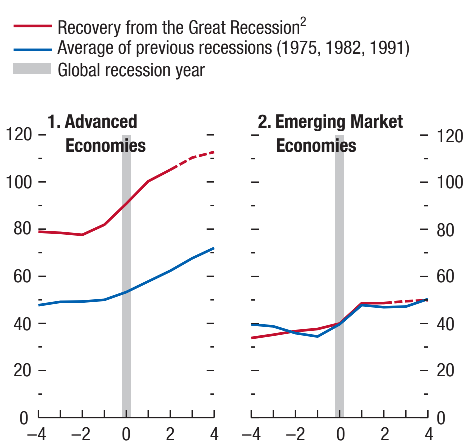
[4]Structural reforms—for example, reforms of labor, goods, and product markets—for the crisis countries are also critical for regaining competitiveness and even for moving up in the value chain.

[5]There is extensive literature on the factors behind the sluggish recovery in advanced economies. Some studies argue that recoveries following financial disruptions tend to be weaker and protracted; others emphasize the importance of relatively higher levels of macroeconomic and policy uncertainty (see, for details, Reinhart and Rogoff, 2009; Claessens, Kose, and Terrones, 2012; Bloom, Kose, and Terrones, 2013).

[6]A large amount of literature analyzes the effectiveness of fiscal and monetary policies under these circumstances. For the effectiveness of fiscal policies, see Blanchard and Leigh (2013); Christiano, Eichenbaum, and Rebelo (2011); and Auerbach and Gorodnichenko (2012). For the effectiveness of monetary policies, see Eggertsson and Woodford (2003); Krishnamurthy and Vissing-Jorgensen (2011); Carvalho, Eusipe, and Grisse (2012); and Swanson and Williams (2013), among others. Some argue that accommodative monetary policies need to be paired with expansionary fiscal policies, especially for countries with sufficient fiscal space (Corsetti, 2012; De Grauwe and Ji, 2013; Werning, 2012; Turner, 2013; McCulley and Pozsar, 2012).

Figure 1.1.5. Public-Debt-to-GDP Ratios during Global Recessions and Recoveries[1]

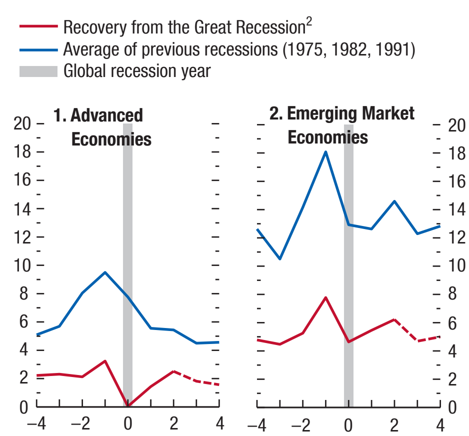
(Percent of real GDP in year before global recession; years from global recession on x-axis)



Sources: IMF, Public Finances in Modern History database; World Bank, World Development Indicators database; and IMF staff estimates.
[1]Aggregates are market weighted by GDP in U.S. dollars.
[2]Dashed lines denote WEO forecasts.

Figure 1.1.6. Inflation during Global Recessions and Recoveries[1]

(Percent; years from global recession on x-axis)



Source: IMF staff estimates.
[1]Aggregates are market weighted by GDP in U.S. dollars. Observations are dropped for countries experiencing inflation 50 percent greater than in the previous year.
[2]Dashed lines denote WEO forecasts.