

Faulting Internationally Coordinated Fiscal Stimulus

Anthony J. Makin

Introduction

To counter the impact of the global financial crisis (GFC), governments around the world implemented unprecedented fiscal stimulus in 2008–09 as agreed at a series of G20 heads of government summits that entailed a combination of tax cuts, income transfers and public infrastructure spending. At the first Washington G20 summit in November 2008 and at the London and Pittsburgh summits in 2009, coordinated fiscal expansion in G20 economies was deemed necessary to counter the recessionary impact of the GFC on the world economy. Yet, by the Toronto G20 summit in June 2010, the fiscal focus shifted to the need for budget deficit reduction.

Since the onset of the GFC in late 2008, frequent comparison has been made with the Great Depression, which spanned the macroeconomically disastrous 1930s. However, the impact of the global financial crisis on the real sectors of economies was far less than the depths reached then, when many advanced economies including Australia, Britain, Canada and the United States experienced huge falls in production, deflation and unemployment rates that ranged from 20–30% of the workforce.

In commentary on the crisis, it has become commonplace to credit the G20's fiscal stimulus measures, which were strongly encouraged by the IMF, for subsequent recovery in many economies. Whether it was the avoidance of severe recession, higher than expected retail sales or other



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miscellaneous measures of spending, we have been led to believe that things would have been much worse in the absence of globally coordinated fiscal activism.

Yet, in an open letter to President Barack Obama published in leading US newspapers in early 2009, hundreds of US academic economists, including Nobel laureates James Buchanan and Edward Prescott, endorsed a statement¹ that more government spending was not the way to improve US economic performance. Believing otherwise, they said, was ‘a triumph of hope over experience’.

The most recent comparable geo-financial crisis was the Asian banking and currency crisis (the ‘Asian crisis’) of the late 1990s. Yet, many non-Asian economies coped well during that crisis, relying mainly on rapid monetary responses and shock-absorbing exchange rate adjustment, with no fiscal response at all. So whether this time around so many advanced and emerging economies needed to engage in the largest ever coordinated fiscal responses in the world remains controversial. This paper canvasses the problems associated with the Keynesian inspired policy in reaction to the GFC and highlights the associated macroeconomic risks going forward. It also proposes that by targeting unproductive public expenditure, fiscal contraction rather than expansion can bolster economies via higher domestic saving, lower long-term interest rates and improved business confidence, which in turn raise private investment and national output.

The revival of Keynesian economics

Motivated by fears of a repeat of the Depression of the 1930s, the fiscal stimulus in response to the GFC was justified on intellectual grounds by the Depression economics of John Maynard Keynes (1936). Though dormant as an influence on macroeconomic policy for years leading up to the crisis, Keynesianism has unexpectedly reappeared centre stage as the sole theoretical rationale for fiscal stimulus (see Spilimbergo *et al.* 2009). Yet, as the above-mentioned group of US economists assert, ‘More government spending by Hoover and Roosevelt did not pull the US economy out of the Great Depression.’

¹ The statement by economists against the US fiscal stimulus is available at http://www.cato.org/special/stimulus09/cato_stimulus.pdf.

It should not come as a surprise that policies reflecting Keynes' ideas should provoke controversy. After all, Keynes in the concluding chapter of his best-known work, *The General Theory of Employment, Interest and Money*, asserted, incorrectly as it transpired, that in the post-Depression era 'somewhat comprehensive socialisation of investment will prove the only means of securing an approximation to full employment'. The enduring appeal of Keynes's theory was that it offered a cogent explanation of the main components of the national accounts and the phenomenon of the business cycle, while simultaneously asserting that governments could easily and at little cost correct macroeconomic misbehaviour at will and as they saw fit.

Yet this has always put Keynesianism at odds with the centuries-old tradition of economics that emphasised how prices automatically equilibrated markets and suggested minimum government involvement in commercial exchange as the best means of allocating an economy's resources. Such a way of thinking underpins, for instance, international trade theory and policy, which few question. By asserting the opposite – that there was a greater need for government intervention in the economy – Keynes's theory of fiscal activism introduced a logical inconsistency to economics that his critics have always found discomfiting.

Keynes's central planning approach to fiscal policy was credited by his disciples in the 1940s and 1950s with saving western capitalism from itself. However, later critics of Keynesianism have argued that it was not fiscal expansion that ended the Depression, but that the Depression lasted much longer than it should have, especially in the US, because of a prolonged contraction of liquidity, policy-induced investment uncertainty, a return to the gold standard after the First World War and large-scale retreat to international trade protectionism. For related discussion, see Bernanke (2004), Eichengreen (1992), Friedman and Schwartz (2008) and Temin (1991).

The great appeal of the naive short-term Keynesianism underpinning fiscal stimulus measures is that it provides governments with a seemingly costless economic solution for quickly addressing recession and unemployment. As a theory, simple Keynesianism focuses exclusively on the short term, emphasises aggregate spending as the source of economic growth, and largely ignores the future consequences of unproductive public spending and the fiscal deficits that result. This is in keeping with Keynes' own comment that 'in the long run we are all dead'. While that

comment is undeniably true, what it fails to recognise is that the vast majority of the population can in their lifetimes expect to suffer the consequences of the public debt legacy that Keynesian activism bequeaths, through higher taxes, higher interest rates and higher inflation.

Problems with Keynesian theory

Keynes's general theory was anything but general in its original form, and was premised on a special set of Depression conditions. These included interest rates at zero, ongoing deflation and a prolonged collapse in international trade, none of which the vast majority of economies in the world suffered from during the GFC. The theory also ignored the fact that economies could be heavily reliant on foreign capital to fund their investment. In short, the characteristics of many open economies removed from the epicentre of the GFC were unlike those Keynes sought to address.

It was left to another English economist, John Hicks (1937), to make Keynes's theory more general in its application, while retaining its most useful elements, such as his theory of consumption, investment and money demand. Hicks's adaptation of Keynes's contribution, sanctioned by Keynes himself, synthesised the aggregate spending and monetary sides of an economy and for years was the mainstay of intermediate macroeconomics textbooks. Yet, this framework shows that fiscal stimulus can quickly drive up interest rates, crowding out private investment to the longer-term cost of the economy.

Keynes is widely considered the most influential macroeconomist the United Kingdom ever produced. However, Irving Fisher, Keynes' American contemporary, also made multiple original contributions to macroeconomic thought of relevance to fiscal policy, and left a body of work that exhibits a clarity and consistency of thought sometimes lacking in Keynes's work. While Keynes proposed a way of addressing depressions in the wake of banking crises, Fisher (1933) actually explained how banking crises can develop. However, Fisher's most notable contribution was his theory of inter-temporal choice (Fisher 1930), which related saving, investment and interest rates through time. In sum, it proposes that spending decisions made in the present are central to our economic well-being in the future, and therefore that economic decision making always has to be undertaken with the future in mind.

Fisher's theory also implies that short-term economic policies that foster consumption and unproductive public spending without regard to the future are detrimental to achieving higher long-term living standards. In a Fisherian world it's quite rational to pass on a big night out because the hangover the next day is not worth it, just as

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it's best not to run ill-advised budget deficits that unproductively add to public debt and prove to be a future drain on the economy. Although Keynesianism has dominated fiscal thinking since the financial crisis began, Fisherian thinking is reflected in the strong emphasis that the IMF has placed on exit strategies from stimulus and the need to exercise fiscal restraint. Yet, the application of restraint in the future to rein in budget deficits will have quite different effects to those implemented during the expansionary phase.

For example, given the aversion to cutting public spending in democracies, it is inevitable that taxes will have to rise to address the debt escalation due to earlier public spending and, in some economies, cash handouts dispersed to favoured groups. There were no beneficial supply-side effects in providing relief to these groups but there will be adverse supply-side effects through higher future taxes, or foregoing the option of lower marginal income tax rates that past fiscal action now prevents.

A rationale for implementing fiscal stimulus is to counter the loss of confidence that causes a sudden spending stop. The spending that stopped most dramatically during the GFC was business investment expenditure, a key driver of the business cycle and whose recovery is essential for a strong economic rebound. Yet there is a glaring contradiction in the argument that extensive fiscal stimulus is necessary for building business confidence. This is because higher government spending, and the higher than necessary long-term interest rates that result, are inimical to asset price recovery, private investment and the strength of future economic growth.

Another critical assumption of Keynes's 1936 work was that wages were inflexible downwards. While rigid wages were necessary to make Keynesian fiscal policy work in theory, this assumption is now less

relevant in practice with workplaces in many advanced economies now less unionised. The prime purpose of fiscal stimulus has always been to preserve jobs. Yet, ironically, greater labour market flexibility than in previous recessions in many economies, such as Australia, the UK and New Zealand, did that by itself.

The Mundell (1963) Fleming (1962) model of an open economy tells us that in an open economy with a floating exchange rate, a growing budget deficit due to increased government spending puts upward pressure on domestic interest rates, other things being the same. This induces foreign capital inflow and strengthens the exchange rate. In turn, this worsens the economy's competitiveness in relation to its trading partners, resulting in lower exports and higher imports. The upshot is that worsened international competitiveness offsets any possible effect fiscal stimulus may have had on employment elsewhere.

Due to an overvalued exchange rate, possible gains from fiscal stimulus therefore come at the expense of export and import competing industries, including the labour-intensive manufacturing sector where employment shrinks as competitiveness deteriorates. In other words, the 'twin deficits' phenomenon, where the consolidated budget deficit for all levels of government leads to higher trade and current account deficits, can reappear in susceptible economies that have implemented relatively large fiscal stimulus packages.

Widening current account deficits also signify a reduction in national saving relative to national investment. Fiscal expansion lowers national saving because it increases household and government consumption relative to national income. Meanwhile, within the investment component of national spending, productive business investment can be displaced by less productive public investment. Therefore international capital inflow, or net foreign borrowing, required to bridge this national saving–investment gap funds economic activity that is not as productive as it was, pre-fiscal stimulus.

Yet, ultimately, foreign funding of current account deficits has to be linked to highly productive investment spending. Otherwise, foreign investors at some stage take fright and current account deficits become unsustainable, leading to credit-rating downgrades and further spikes in interest rates payable on public debt, as has occurred in Iceland, Ireland, Greece, Portugal and Spain.

Fiscal activity and foreign borrowing

The large trade and current account imbalances that arose around the world over the past decade played a central role in the GFC and international recession that followed. Globally, the most significant external imbalances have been those of the US, with its external deficit and foreign borrowing on one side, and East Asia, most notably China, as well as the oil-exporting nations, with their external surpluses on the other.

With a current account deficit that reached 6% of its GDP in 2006, the US was by far the world's largest international borrower, drawing in over half of traded global saving; see Eichengreen (2010), Dunaway (2009) and Uzan (2009) for related discussion. Given the attention these current account imbalances have received, it is worth relating in simple terms what economic theory tells us about the significance of external deficits, and when we should be wary of them. Although rarely acknowledged in economic policy debate, current account deficits and the associated external borrowing are, in theory, economically beneficial under certain conditions.

This is because allowing saving to move across borders into economies where it earns the highest rate of return can raise living standards in both lender and borrower economies. In other words, just as free international trade in goods and services confers mutual national income gains on participating economies, so too can free international trade in saving. Viewed in this light, external imbalances benignly reflect differences in nations' saving habits and investment opportunities, rather than differences in nations' trade competitiveness, and should not normally be considered a policy concern.

However, this interpretation of the benefits of international borrowing and lending for advanced economies depends on some critical preconditions. Many of these conditions prevailed in advanced borrower economies such as the US, Australia and New Zealand through the 1980s and 1990s, but failed to hold for the US in the years just before the crisis. A long debate has ensued in academic and policy circles on the issue, and two polar views about the significance of foreign debt emerged. One is that escalating foreign debt was a financial-crisis-in-waiting and that policymakers should use the macroeconomic policy instruments at their

disposal, notably restrictive fiscal and monetary policy, to minimise borrowing from abroad (see IMF 2007, 2009).

The other is that external deficits and debt should not be a target of economic policy (see Makin 2009a; Xafa 2007) because they essentially reflected commercial decisions by private firms and financial institutions that should be expected to act in their and the economy's best interests. If not, they go into receivership, at no direct cost to tax payers. To avoid that possibility, it was also in foreign lenders' interests to ensure that their loaned funds were used productively.

Numerous studies (see, for instance, Haveman *et al.* 2001; Chandra 2005; Klein & Olivei 2006) find that capital inflow does positively influence national income, especially through the foreign investment channel. Foreign funds overwhelmingly borrowed by the domestic enterprises can also contribute positively to economic growth. Foreign borrowing can fund higher rates of productive investment than otherwise would occur and, by facilitating higher domestic asset values, can raise net national wealth in debtor economies.

Although this interpretation of current account deficits and foreign debt has been accepted in some advanced economies, such as Australia and New Zealand, the view that future foreign debt increases will necessarily be benign needs qualifying in light of prospective global financial conditions. The conditions necessary for interpreting external deficits and borrowing positively are as follows. First, economies engaged in international trade in saving should not unduly restrict private international capital flows and should preferably have flexible exchange rates. Second, foreign borrowing in deficit economies needs to generate a rate of return in excess of the servicing costs on the debt. This follows if foreign borrowing is predominantly undertaken by the private sector for productive purposes. However, if undertaken by the public sector for unproductive purposes, in net terms the national budget should be in surplus or in relatively small deficit. A third condition for interpreting foreign debt positively is that foreign funds are freely available and continue to be provided on reasonable terms. Fourth, as the Asian financial crisis of 1997–98 also demonstrated, if foreign borrowing is mainly channelled through domestic banks, the banking system has to be very robust and not artificially distorted by government guarantees.

When examining the rise of global imbalances in the years just before the global financial crisis, it is clear that some of these pre-conditions were violated in the case of the US. For instance, a significant component of capital inflow to the US pre-crisis came from China and other East Asian nations with heavily managed exchange rates and controls over private international capital flows (see Goldstein & Lardy 2006; Makin 2009a). By undervaluing their currencies against the US dollar, trade surplus economies accumulated trillions of US dollar holdings. As central banks and sovereign wealth funds were buying US government bonds and mortgage-related debt instruments that were underwritten by government agencies with these dollars, it was effectively international trade in public, not private, saving.

Public debt sustainability

It was once a tenet of Keynesian economics that public debt was not a problem because ‘we owed public debt to ourselves’. Neglecting that future generations have to pay it back, it meant that governments could run up public debt, without worrying unduly because its citizens and local financial institutions within the economy earned interest on it. But this is not the case for large external borrower economies such as Iceland, Greece, Italy, Portugal, Spain, Ireland, the UK, and Australia and New Zealand. Japan, a large external lender economy, is in a different category; its large and rising public debt burden has hitherto been sustainable because it is owed mainly to Japanese individuals, banks and corporations.

Public debt that doubles as foreign debt precisely reduces national income by the interest payable abroad. If too much public debt funds consumption or fails to generate a sufficient rate of return to the economy, the risk rises that foreign lenders will cease to roll over escalating public debt. This then has serious consequences for nations’ creditworthiness, interest rates and future economic growth.

Another factor that is usually ignored by advocates of fiscal stimulus is that the public debt incurred by governments as a percentage of GDP can take on a life of its own. Even when governments stop adding to it, public debt will grow automatically whenever the interest being paid on the debt exceeds the economy’s growth rate. Even as economies recover, government debt can continue to grow as a percentage of GDP if long-term

interest rates rise faster than the economic growth rate. This can occur for a number of reasons.

First, interest rates will increase as governments around the world soak up funds to cover their huge budget deficits, with the unfortunate side effect that this lessens the availability of funds for private investment. This means that future potential national income will be lower than it would otherwise have been because the nation's productive capital stock will be lower. In other words, because governments borrowed to spend on relatively unproductive investment, there will be relatively less productive investment by the private sector.

Second, the composition of foreign debt for international borrower economies like the US, Australia, New Zealand and the UK in coming years will include an even bigger share of public debt relative to private debt that is not backed by productive capital accumulation, as compared with the pre-crisis situation. Before government guarantees were introduced, foreign debt was predominantly the liability of the private sector and, while global finance was more freely available, not a cause for concern. Now, as the public component of foreign debt rises, entities borrowing from abroad can expect to pay a higher interest risk premium.

Lastly, long-term interest rates will rise if expectations of higher inflation take hold, especially if financial markets think central banks are more likely to buy up (or monetise) public debt, while simultaneously expanding money supplies. In other words, the large amount of money pumped into the system by governments and central banks will fuel inflation. This occurred around the world after the Keynesian fiscal excesses of the 1970s and resulted in prolonged stagflation, which in turn exacerbated unemployment. Considerably higher interest rates therefore seem highly likely in coming years and, the more they rise, the more aggressively the public debt to GDP ratio will feed on itself, requiring more drastic fiscal management than currently anticipated to bring it under control.

Refocusing fiscal policy

What has remained largely unrecognised in the GFC context is that fiscal consolidation that targets wasteful government programmes and increases domestic saving can bolster macroeconomic performance. Public spending best improves national output and income in a lasting sense if

it raises the economy's productive capacity. This finding is consistent with the lessons of conventional growth theory, but applies in the medium term, not just the long term, as modelled theoretically by the author in Makin (2007, 2009b).

Numerous empirical studies contradict the Keynesian premise that public spending of any kind is always and everywhere an effective countercyclical measure (see, for

instance, Alesina & Ardagna 1998; Giavazzi *et al.* 2000; Gupta *et al.* 2005). Fiscal consolidation can actually improve macroeconomic performance by cutting wasteful public spending, which in turn increases domestic saving, reduces long-term interest rates, which improves business confidence and private investment, which in turn stimulates national production.

In sum, fiscal stimulus, as traditionally interpreted, does not necessarily generate sustained economic activity following a boost in public consumption, the blunting of incentives to work and save, or through poorly conceived infrastructure spending that generates a very low, or nil, rate of return. On the contrary, cutting unnecessary government spending, including industry and other subsidies and middle-class welfare, can be expansionary for economies. Every dollar of spending that is cut frees up funds that are in short supply. Preserving wasteful programmes because cutting them would be contractionary is misguided.

On the contrary, many fiscal packages unveiled by governments in response to the global financial crisis were mainly aimed at boosting consumption in the short term, in keeping with IMF advice. Yet, for many struggling firms, falling sales were initially less of a problem than the unavailability of credit. Paradoxically, the raft of hasty public spending initiatives implemented across the world could have retarded recovery to the extent that households and markets became alarmed about higher future taxation, interest rates and inflation.

A different mix of measures could have recognised that the financial crisis first struck the aggregate supply side of the economy, not the demand side. Unemployment is the scourge of recessions. However, the business

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sector, not households, ultimately employs most people, creates most of gross domestic product and invests in the economy's future. Hence, an arguably sounder fiscal response for numerous economies would have been to focus more on the production rather than the spending side of the economy, with greater emphasis on infrastructure projects, business tax relief and business regulation problems to bolster private investment and production.

For instance, rather than following the aggregate demand-orientated approaches adopted by the US, Britain and other countries, the New Zealand government emphasised supply-side measures. Specifically, New Zealand's response included measures to improve the efficiency and effectiveness of public consumption expenditure, bringing forward infrastructure spending, flattening marginal taxes levied on individuals, welfare reform and reducing the regulatory burden on small businesses.

What matters most is the quality of fiscal stimulus, not its quantity. More productive public investment in human capital, and tax changes that improve incentives to work or induce greater private investment that creates or saves jobs, are all worthwhile. Unproductive public consumption, or measures that artificially boost private consumption as if economies were giant hydraulic machines closed off from the rest of the world, are not. The benefit of pumping up total spending by any means, like digging potholes for the sake of it, is a Keynesian delusion.

For open economies, the rate of return on government spending is critical. It should, in principle at least, cover the additional interest incurred, bearing in mind that if an economy spends more than it earns, the additional government borrowing to fund higher budget deficits has to come from abroad. Moreover there is heightened risk if a high proportion of borrower economies' total external debt is short-term debt held by domestic financial institutions. A prudent fiscal response to financial crises provides greater insurance against such risk and forestalls the threat of creditworthiness downgrades – for instance, as faced post-crisis by Ireland, Greece, Portugal and Spain.

Concluding comments

Due to increased financial globalisation over recent decades, we have seen that whenever particular regions become the epicentre of financial insta-

bility, that instability is instantly transmitted around the world. The Asian crisis of 1997–98 was in retrospect the first major regional financial crisis of the modern financially globalised era and comparable to the recent GFC, arguably more appropriately named the North Atlantic financial crisis.

However, the international macroeconomic policy response to the Asian crisis was very different. There were no calls for an internationally coordinated fiscal action, yet the global economy managed to survive it quite well. Instead, the international response relied on monetary easing by independent central banks in economies distanced from the epicentre of the crisis. The same kind of internationally coordinated monetary easing could conceivably have worked as well in response to the GFC instead of G20 economies relying so much on their fiscal armouries at the behest of the IMF, irrespective of how stricken their banking and financial systems were, and with little distinction made between useful and useless forms of stimulus.

The formation of the G20 has been highly consequential and the body has great potential as the pre-eminent international economic forum. However, its future effectiveness will depend on the consistency and soundness of its calls for coordinated macroeconomic policy action by its members. Fiscal stimulus has undoubtedly played some role in cushioning the short term impact of the GFC on economies removed from the crisis epicentre by adding to short-term domestic aggregate demand, but with adverse longer-term consequences.

On the monetary side, the coordinated initial response of central banks was to dramatically lower official interest rates worldwide at the time. An important issue for empirical resolution is whether the use of monetary policy, through interest rate reductions and associated exchange rate adjustment, with limited or no resort to fiscal activism, would in future be a sufficient macroeconomic response for counteracting future crisis events in economies distanced from a particular crisis epicentre.

For many smaller economies such as Australia and New Zealand, monetary responses to the GFC were greatly assisted by highly flexible exchange rates that central banks allowed to depreciate massively. By automatically boosting industry competitiveness and net exports, this enabled them to absorb most of the external shock. Flexible labour markets also mitigated the impact on unemployment, way beyond official expectations.

However, while monetary policy responses have been widely applauded, the same cannot be said of fiscal responses, where no consensus is ever likely to emerge. This is because fiscal stimulus of the nature and scale that was enacted has lasting effects that temporary, more easily reversible, monetary stimulus does not. Historically, Keynes's intellectual influence over policymaking reached its zenith in the 1970s, which was easily the single worst decade for economic performance in the OECD region since the Depression. That decade was characterised by Keynes's legacy of high budget deficits and high public debt, which in turn contributed to persistently high inflation, stagnant stock markets and high unemployment.

Recognising this, former British Labour Prime Minister James Callaghan declared in 1977:

We used to think we could spend our way out of recession. I tell you, in all candour, that that option no longer exists, and that if it ever did exist, it only worked by injecting bigger doses of inflation into the economy followed by higher levels of unemployment as the next step. That is the history of the past 20 years.

There is a chance that history could be repeated because the GFC and fears of the consequent so-called Great Recession spawned what can only be termed a Great Fiscal Over-reaction, especially in Australia, the US and Britain, where faith in Keynes has always been strongest.

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