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The Fiscal Stimulus

Nelson Barbosa[*]

Creating comparable metrics of stimulus for coordinated action

1. Fiscal stimulus is usually measured in terms of trend GDP, but this is problematic in the current situation because of the probable structural breaks in potential-output growth around the world caused by the crisis. For international policy coordination and comparisons, it would be simpler and more effective to compare stimulus in terms of current GDP.

2. The endogeneity of productivity growth also recommends caution in evaluating the size of the stimulus in terms of trend GDP. The reduction in estimates of potential output brought by the sharp deceleration in economic growth tends to overestimate the size fiscal stimulus in terms of trend GDP and recommend restraint. In contrast, a more optimistic assessment of potential output based on unexplored sources of growth tends to underestimate the size of fiscal stimulus and, therefore, recommend more fiscal activism. The discrepancy between these two views is particularly important for developing economies, where there are still large unexplored sources of growth from scale economies and labor migration from informal to formal sectors.

3. GDP growth acceleration is a useful target for the stimulus, but the ultimate goal of macro policy in the current crisis should be to avoid a sharp increase in unemployment rates. Given the changing time lags between the dynamics of income and employment, economic policy

[*] Secretary of Economic Policy at the Brazilian Ministry of Finance and Professor at the Federal University of Rio de Janeiro. E-mail: nelson.filho@fazenda.gov.br.

should choose the unemployment rate as the main variable to assess the effectiveness of stimulus packages.

4. Estimates of the natural rate of unemployment are also controversial in times of structural breaks. Depending on one's assessment of such a variable, the size and duration of the stimulus would vary substantially. For immediate international coordination, it would be useful to set the reduction in unemployment rates to the average pre-crisis levels as a common objective of the G-20 economies.

5. On the international level, the coordination should be based on an assessment of the bilateral current-account imbalances between the main economic regions or countries. The domestic distribution of such external imbalances should also be integrated into the analysis of monetary and fiscal stimulus in order to map how expenditures and income flows are being distributed between the public and private sectors, as well as within the private sector (low-income households, high-income households, financial business, non-financial business, etc).

6. A simple and straightforward way to assess the impact of the stimulus on external and internal imbalances is to frame the analysis in terms of small-scale social-accounting matrices, so that one can map the fiscal stimulus to the changes in the income and expenditure distribution of the main institutional sectors of the economy.

7. Three-agent taxonomy (foreign, public and private) is readily available for most economies in the world. A more detailed taxonomy that breaks the private sector into smaller units is also useful, but the tools to do that are still too complex to be useful for a coordinated action of the main economies in the world.

<u>How long are we likely to need a stimulus?</u>

8. The current crisis is not a usual recession that calls for stabilizing measures until things go back to normal. This is a deep crisis that puts in doubt the sustainability of the pre-crisis economic system and,

therefore, it calls for both temporary and permanent changes in fiscal policy.

9. A fiscal stimulus is by definition a temporary measure, but the current one will take a long time because of the magnitude of the crisis and the type of fiscal expenditures needed to avoid a sharp downturn. For instance, public investment in infra-structure is a natural tool to boost aggregate demand and employment, especially when targeted at activities with high multipliers. However, the long maturity and the large capital requirements that characterize infra-structure projects imply that such a temporary course of action will take a long time to be completed.

10. There are also structural changes under way in some economies that act as an automatic stabilizer during times of crisis, but that are by no means temporary measures. For instance, some emerging economies like Brazil have been increasing and improving their social safety net to improve living conditions. Such an increase in social expenditures acts as an automatic stabilizer during the crisis, but it will not return to its pre-crisis level after the downswing is over for the simple reason that there was not an adequate social safety net before the crisis. A similar reasoning should be used to assess the recent health-care plans of the US government.

11. At the end of the day both temporary and permanent changes in fiscal policy must be consistent with fiscal stability. Fiscal stability usually means stable ratios of public debt to GDP, as well as a stable tax burden and a non-explosive ratio of public expenditures to GDP. These goals can be achieved through many different ways and, most importantly, through different sizes and roles of the State.

12. The role of the State in the economy tends to change during periods of deep crises and not always in a reversible way. The current crisis is no exception and, therefore, policymakers should be careful to separate what is temporary from and what has come to stay when assessing fiscal responses to the current downturn. Too much emphasis on temporary

and reversible measures can block important structural changes that are necessary to sustain growth and improve income distribution after the crisis is over.