WHAT KIND OF STIMULUS

(not just in the US – but worldwide)

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Conference on the Shadow G-N

February 2009

The Problem

The decline in private demand is very large reflecting the large fall in asset prices. Negative expectations and unfavourable "animal spirits" also play a role aggravated by unprecedented price volatility and uncertainty. Positive messages by political leaders underlining courage, decisiveness and coherence, the rebuilding of trust and measures to reduce volatility can play an important role in helping the recovery. But the two central measures that can counteract the negative wealth effect's impact on private demand are 1) public spending, and 2) the resolution of the banking sector's solvency problems. This note focuses on public spending only.

The "Quality" of Public Spending

The "best" kind of public spending is one that (i) has large immediate multiplier effects, (ii) creates jobs, and, (iii) contributes to long-term productive capacity of the economy. For example, in some countries improving the mass transit system may have all these characteristics. For projecting short-term increased effective demand based purely on existing marginal propensities to consume, the traditional multiplier effects are all that matters. But job creation should be an additional "end in itself" both because of its importance as a social objective, and because of the impact unemployment numbers have on expectations and "animal spirits". These will in turn alter marginal propensities to spend. Depending on a country's public sector indebtedness, very large amounts of spending that do not generate productive capacity in the economy could backfire by creating doubts about sovereign solvency and thereby putting upward pressure on longer term interest rates. If the spending is linked to the creation of productive capacity it will be easier to allay these fears about the future path of debt indicators. What matters are not total amounts of debt, but the debt to GDP ratio, expected and actual GDP growth, and the level of long term interest rates.

Tax Cuts?

General tax cuts are unlikely to work since they will simply be saved by most consumers trying to rebuild the net worth they have lost. The exception may be temporary cuts in sales or VAT type taxes. If income tax cuts or cash transfers are truly targeted at the poor, they may work in terms of immediate spending, as the poor are likely to spend them on essentially subsistence consumption. They are still not going to create long-term productive capacity. Some conservative economists have argued for permanent rather than temporary tax cuts, because spending by middle and higher income groups is determined by permanent rather than temporary income. Apart from inequality increasing distributional consequences, such permanent tax cuts would be much more dangerous, however, in terms of long-term public sector balances, and could be self-defeating by triggering an early increase in long-term interest rates. Long-term growth enhancing public investment is the "best" public spending to encourage recovery. What may be needed are some special and temporary measures regarding procurement to accelerate the process needed to get these investments underway. In the US, for example, temporary special powers may have to be given to State governors to accelerate the implementation of infrastructure projects. Some of these investments could also be organized as public-private partnerships, "crowding in" private investments and laying the ground for decreasing the need for public funds over time.

Inflation?

Given today's very low levels of interest rates and the overall deflationary spiral in the world economy, it is much riskier to do too little in terms of fiscal stimulus than do too much. Some point to the risks of future inflation. In the period from late 2007 to mid-2008 with huge increases in commodity prices, it looked for a while as if inflation would be a short term danger. This is no longer the case. The bigger danger today is deflation. If and when significant inflationary pressures appear in the future, interest rates could be raised rapidly and substantially. Central banks will be able to act effectively to forestall future inflation. The pressing problem of today is recession and the danger of deflation.

Global Interdependence and Coherence

From the point of view of the world economy as a whole, national expenditure programs can be considered additive in a particular year. If the world economy needs a fiscal stimulus worth 3 or 3.5 percent of world GDP, this can be achieved through the aggregation of a wide variety of national programs. For example, the US could contribute 60 percent, the EU 15 percent, Japan 10 percent, China 10 percent and the rest of the world 5 percent. Or the US could contribute 40 percent, the EU 20 percent, Japan 15 percent, China 15 percent and the rest of the world 10 percent (these figures are meant to be broadly illustrative only …for a prescriptive scenario careful calculations based on consensus projections for 2009 and 2010 would be needed. This is not attempted in this Note). The results may be roughly similar in the immediate short term (the "leakage ratios" are in fact different across major countries and the second order effects of the same global amount of stimulus would of course be different depending on geographical composition). But the first scenario would do nothing to correct global imbalances and would lead to further instability. The second scenario, with the surplus countries doing more of the "fiscal lifting", has the advantage that it would help correct global imbalances and promote longer term stability. Another point in this context is that while the fiscal stimulus can be considered an "aggregate effort" type global public good, the incentives for individual countries, particularly those with large trade to GDP ratios, are to wait for others to expand so that they could export their way out of the recession while keeping their domestic indebtedness lower. I f every country behaved in accordance with such calculations, the world would get a very sub-optimal amount of fiscal expansion. There is therefore a very strong argument for a worldwide coordinated fiscal expansion, at least involving the major economies.

Fiscal policy in developing countries?

There is a particularly tough challenge for many small and medium sized developing countries that have large current account deficits and fairly high levels of public debt and that are being hit by the worldwide collapse in demand for their exports and decline in foreign investment, bank financing, tourism and remittances. They are not individually of “systemic importance” for aggregate world demand, but taken as a whole they do represent 10 to 15 percent of world GDP. They are not therefore insignificant as a group. Moreover they face aggravated domestic problems due to the huge external shock of the world crisis. For most of these countries short-term fiscal retrenchment would make the crisis worse in terms of unemployment, bankruptcies and growth collapse. What they need is moderate amounts of short-term fiscal expansion accompanied by very clear and comprehensive structural reforms that will allow them to reduce their current account deficits and levels of indebtedness over time. One size does not fit all but large and immediately available foreign financing by the IMF and surplus country central banks is needed to accompany their efforts and help them avoid a deepening crisis. Such a concerted effort at helping this whole group of countries will in turn have a positive feedback on worldwide effective demand and help alleviate the global recession.