How Can (and should) developing countries engage in countercyclical fiscal policies?
Concept Note

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1. Introduction

How should developing countries react to the current crisis in terms of reformulating fiscal policy to provide a growth stimulus—understood as something over and above the effect of automatic stabilizers? Empirical work suggests extreme caution, warning that counter-cyclical fiscal policy has not been effective in developing countries while being fraught with risk. But two issues arise: (i) serious econometric problems with the empirical work from which this conclusion is drawn – even for industrial countries, the results are not clear-cut;[2] and (ii) the unprecedented nature and size of the crisis we face. One often hears the current crisis referred to as the most serious financial crisis since the Great Depression; but at least in one respect—the fall in house prices—it has already topped the Great Depression.[3] While the past should not be ignored in crafting a response to this crisis, it may not always be a useful guide.

Naturally, every developing country should be thinking of ways of increasing aggregate demand and making sure its financial system stays on its feet. The main constraint is affordability in two senses: (i) the government's intertemporal budget constraint; and (ii) the extent of international liquidity. The way this is usually expressed is in terms of low initial public debt and high foreign exchange reserves; but this would suggest for example that a country like India should avoid a fiscal stimulus because general government debt-to-GDP is about 80%, which may not be an appropriate conclusion. For example, if the fiscal stimulus were in the shape of a large increase in infrastructure investment which paid for itself through faster long-run growth and higher taxes, such investment would not only be anti-recessionary, it would strengthen fiscal solvency.[4]

While the India example shows that a formulaic approach should be avoided, the question nevertheless arises about how many emerging market (with international capital market access) or low-income (without such access) countries can afford a fiscal stimulus. Consider the period beginning with the last round of EM crises, which occurred in 1997-98, and ending with the intensification of the global crisis in September 2008. During these 10-odd years, most developing countries (with and without market access, commodity exporters included) had done an exemplary job in terms of cleaning up their government balance sheets (running higher primary surpluses, shifting towards more favorable debt structures, trying to lower public indebtedness) and self-insuring by building up foreign exchange reserves. In addition, many

[1] The author is at the World Bank. This note, written for The Shadow GN 2009, draws upon internal notes prepared by World Bank colleagues ("The Quality of Fiscal Stimulus in Developing Countries" and "Fiscal Policy Responses to the Current Financial Crisis: Issues for Developing Countries") as well as my own work. I take sole responsibility for the particular interpretation herein. The findings, interpretations and conclusions expressed in this note are entirely those of the author. They do not necessarily represent the views of the International Bank for Reconstruction and Development/World Bank and it affiliated organizations, or those of the Executive Directors of the World Bank or the governments they represent.
[2] Perotti, Roberto. 2007. "Fiscal Policy in Developing Countries: A Framework and Some Questions." World Bank Policy Research Working Paper 4365.
[3] Reinhart, Carmen and Kenneth Rogoff. 2008. "The Aftermath of Financial Crises." Paper prepared for the American Economic Association meetings in San Francisco, January 3 2009.
[4] For a formal argument, see Serven, Luis. 2007. "Fiscal Rules, Public Investment and Growth." World Bank Policy Research Working Paper 4382. (p. 13, equation 9).

countries strengthened their fiscal and financial institutions impressively.[5] To a large extent, therefore, the current crisis comes as a unexpected setback, especially in its severity; but the actions taken over the past decade or so explain why countries such as Brazil and Turkey have been much more resilient in the face of the 'biggest financial crisis since the Great Depression' than they might have been had this occurred a decade earlier.

Table 1 contains a list of factors which would define the scope for a fiscal stimulus:

Table 1: Factors determining the Scope for a Fiscal Stimulus

Facilitators	Constraints

• High national savings rates
• Strong micro-foundations of growth
• Good inflation and credit history ('debt tolerant')
• Good reform history
  o Measures taken to 'self-insure' since last round of crises
  o Subnational fiscal reform agenda where applicable
• Slow capital account liberalization and international financial integration
  o Limited balance sheet mismatches
  o Smaller private external debt problem
• Favorable government debt structure (long-term, biased towards local currency)
• High international liquidity
  o big FX reserves
  o willingness to let currency depreciate
	• Size of government debt-to-GDP ratio
	• Fiscal capacity to alleviate infrastructure constraints to sustained high growth
	• Government indebtedness not reduced over recent high growth period
	• Wasteful subsidies, politically difficult to eliminate
	• Tax system inefficiencies (scope for lowering direct marginal tax rates while expanding tax base)
	• Contingent liabilities in banking and corporate sectors

Based on the table, countries with a history of policy credibility (good inflation and credit track record) which are less integrated into the global financial markets, have strong micro-foundations for growth and clearly-identified bottlenecks such as infrastructure would benefit from a fiscal stimulus. These countries would typically have high reserves as well and/or the willingness to let their currencies depreciate. However, the tolerance for permitting exchange rates to fall would be defined by the extent of currency mismatches on the balance sheets of banks, corporates, and in many countries even households, i. e. net liabilities in foreign currency. In such cases, a big depreciation could precipitate bankruptcy and fiscal bailout costs as in 1997-98. In addition, the global nature of the current crisis and the fact that western banks are under pressure in their home markets because of the credit squeeze could mean that corporates and banks in emerging markets which have borrowed from them face rollover risks. This is a serious issue in many emerging markets and has become a prime reason for approaching the Bretton Woods Institutions for financing packages, actual or precautionary. When one adds up all the above, there are very few emerging market countries where one can comfortably think of engaging in a fiscal stimulus: China and India come to mind. Brazil and Turkey have been easing monetary policy and Brazil (like India) has been trying to alleviate export credit constraints.

[5] See, for example, Gill, Indermit and Brian Pinto. 2005. "Sovereign Debt in Developing Countries with Market Access: Help or Hindrance?" Ch 4 in Gerard Caprio, James A. Hanson and Robert E. Litan, *Financial Crises: Lessons from the Past, Preparation for the Future*. Brookings Institution Press.

2. Design and Implementation Considerations

What are some of the design and implementation considerations that apply in this extraordinary situation? I suggest a few, inspired in part by a recent IMF Staff Position Note:[6]

- This is not a time to worry about independence of monetary policy and inflation targets, but rather the pragmatic coordination of fiscal and monetary policies. Policymakers need to ensure the financial system stays robust even as a fiscal stimulus is engineered. Ben Bernanke noted in a recent speech at the London School of Economics that he did not believe that fiscal actions would lead to a lasting recovery without getting the financial system in order.[7] The same applies to developing countries. For instance, India has started doing this. A recent report notes that the Reserve Bank of India has acted to inject Rs. 300,000 crore liquidity into the system—roughly $60 billion, or about 5% of GDP—and that public expenditure is being raised by Rs. 20,000 crore ($4 billion) as part of a first fiscal stimulus package.[8]
- What would the institutional mechanism be for managing the fiscal stimulus? Would it just be Ministry of Finance in a 'business as usual' mode, or should a special committee be established, operating out of the President or Prime Minister's office? A prime reason for favoring a special approach is that the crisis response is likely to involve one-off components.
- The IMF paper emphasizes the need for collective action. But for every collective action problem, there is a free-rider problem and as the crisis worsens, countries might be tempted to take measures that may be politically expedient in the short run but harmful in the longer run. In this context, it is important to stress that it doesn't make sense to raise import tariffs because this would also tax exports by Lerner symmetry and lessen pressure for efficiency, which has been a critical factor in growth turnarounds and accelerations in emerging markets ranging from Poland to India. Besides, import tariff increases might become politically difficult to roll back.
- Fiscal stimulus should not be seen by the markets as seriously calling into question medium-term fiscal sustainability, as noted in the IMF paper: already, EMBI spreads have risen sharply, including in countries which have received financing packages from the IFIs. Clearly, some developing countries are in a better position here than others; but all should use this crisis opportunity, even though its origins may be external, to address a broader fiscal agenda, including tax and subsidy reform. The goal should be to address inefficient subsidies which have long been a drain on the budget but difficult to fix politically; and examine the scope for increasing tax compliance. In such cases, it may actually be possible to raise total taxes collected while lowering marginal tax rates, especially where the latter are high to compensate for narrow bases.[9] Such an approach would spur growth by increasing the private return to capital while also raising total future taxes, thus aiding long-run solvency.[10]
- Page 9 of the IMF paper notes that many countries have succeeded in reducing their public debt burden through growth. Some countries missed this boat during the high growth period

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[6] IMF. 2008. IMF Staff Position Note. *Fiscal Policy for the Crisis*. December 29, 2008. http://www.imf.org/external/pubs/ft/spn/2008/spn0801.pdf

[7] Chairman Ben S. Bernanke, at the Stamp Lecture, London School of Economics, London, England, January 13 2009. "The Crisis and the Policy Response." http://www.federalreserve.gov/newsevents/speech/bernanke20090113a.htm

[8] Reported in *The Hindu*, December 20, 2008. http://www.hindu.com/thehindu/holnus/000200812202060.htm.

[9] For a good example, see the analysis in Helene Poirson (2006). "The tax system in India: Could reform spur growth?" IMF working paper WP/06/93.

[10] The IMF staff position paper (p. 15 first bullet) advises against cutting tax rates, which may be appropriate for industrial countries but not for developing countries where marginal rates continue to be high.

over the past 5 years. A good analysis is needed to know why. It will probably bring the need to subsidy and tax reform on efficiency and equity grounds into sharp relief.

3. Aspects of Fiscal Stimulus

What are the main aspects of fiscal stimulus that need to be focused on—assuming that the stimulus is affordable and will not lead to a debt crisis? Table 2 attempts a summary.

Table 2: Aspects of a Fiscal Stimulus Package

Sector	Comments
1. Infrastructure	• Ideal where connection to long-run growth can be made and projects which were ready to go have been put on hold because of the crisis • Also good possibility for commodity exporters dependent upon a single commodity such as oil, especially if fiscal savings were accumulated during high commodity price period. Infrastructure can be used as fiscal stimulus while also facilitating diversification and inclusion (rural projects)
2. Social safety nets	• Vulnerable should not be compelled to run down assets, as this will affect earning capacity post-crisis and therefore human capital and growth • Best option is to scale up existing programs that are well-targeted and work. To the extent that these are means-tested, will also have the virtue of acting as an automatic stabilizer • Workfare programs with lower-than-market wages will also act as an automatic stabilizer while also creating assets if linked to infrastructure projects
3. Financial sector	• Facilitate trade finance • Recapitalize systemic banks • Recognize and track contingent fiscal liability implications
4. Subnational agenda	• Increase transfers to subnational governments in line with plans to improve infrastructure, ensure on-going social programs (such as school lunches) and delivery of essential social services.

To sum up, any design of a fiscal stimulus for a developing country would need to take into account affordability in the sense of not engendering undue macroeconomic risk while ideally providing a spur to long-run growth and higher future taxes. The latter would be particularly applicable where ready-to-go infrastructure projects have been hit by the financing squeeze but where the micro-foundations for growth are strong and the government's balance sheet is in good shape. Another equally if not more important priority is to protect the most vulnerable people in the country, to avoid situations of malnutrition and the forced sale of the meager assets they possess, as this could have severe long-term consequences in terms of malnutrition of children, stunted growth, reduced cognitive abilities and limited household earning capacity once the crisis subsides. There will be countries where the fiscal strain of responding may be unbearable. In this case, the recent proposal of the President of the World Bank deserves serious consideration: "…as a first step, developed countries should agree to devote 0.7 per cent of their stimulus packages to a vulnerability fund to support the most needy in developing countries. The **World Bank** could manage the distribution of the cash with the United Nations and the regional development banks. We could use existing mechanisms to deliver the funds fast and flexibly, backed by monitoring and safeguards so the money is well spent”.[11]

[11] Zoellick, Robert. January 25, 2009. “Time to herald the Age of Responsibility.” *The Financial Times.*