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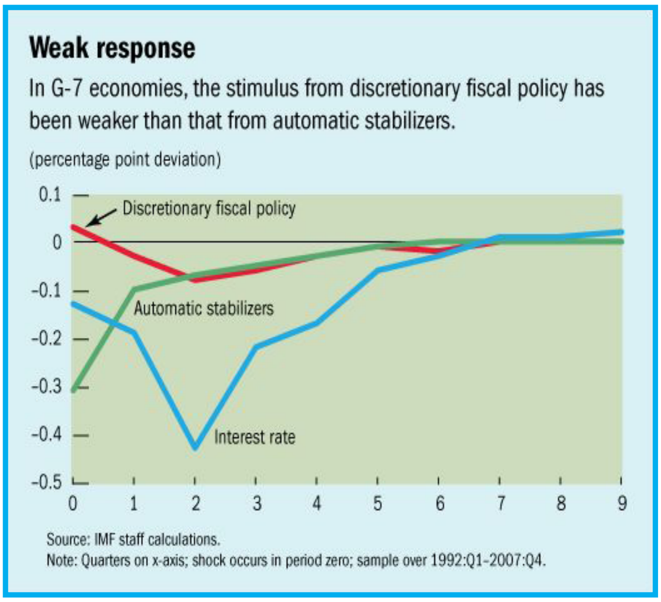
A Non-Stimulating Stimulus?

By Leszek Balcerowicz and Andrzej Rzońca

As the financial crisis continues to attack the global economy, there is increased pressure on governments around the world to introduce discretionary fiscal stimulus programs. Up until now, we have observed massive interventions in the financial sector, massive easing of monetary policy, especially in the US, and the allowance of automatic stabilizers to produce a very substantial easing of fiscal policy. A discretionary fiscal stimulus program has just been enacted in the UK. In the US, a growing number of policymakers are proposing larger and larger stimulus packages, while the European Union is debating its own future fiscal stimulus program. Additionally, the IMF has just called for additional fiscal stimulus programs. Even Japan, with a public debt exceeding 170% of GDP, is urged to engage in fiscal activism.

Diverging views of success

The assumption appears to be that discretionary fiscal stimulus will automatically revive private spending. But this belief contrasts with an extensive empirical literature showing there is a considerable uncertainty about the size and even the sign of fiscal multipliers[1].



Source: IMF, *World Economic Outlook*, October 2008

1 For a recent useful review of the literature, see the International Monetary Fund, *World Economic Outlook*, October 2008.

Some say that monetary policy in the US, given its low interest rates, is no longer an effective policy tool and that only a fiscal stimulus can revive the economy. Similarly, in the 1990's and early 2000's Japan had interest rates that were just as low as or even lower than US rates. Interestingly, some prominent proponents of current fiscal stimulus programs acknowledged that past expansionary fiscal policies did not always bring the desired economic outcomes.

Others believe that a financial crisis in developed economies has created favorable conditions for strong Keynesian multipliers to operate, with no crowding out effects and no confidence problems among consumers. According to this school of thought, a discretionary fiscal stimulus would boost consumers' confidence and increase their readiness to spend the extra money. It is believed that the larger the stimulus, the stronger its impact on this confidence and, therefore, the size of fiscal multipliers. But in what ways this fortunate effect will be produced is left unexplained. Instead of a strong empirical basis for this very important proposal, mechanical metaphors, such as "jump-starting" the economy, are often employed.

Impact on consumer spending and economic recovery

Common sense and massive research tells us that consumers should not be regarded as Pavlov's dogs, automatically responding to current stimuli offered to them by politicians. Consumers are human beings guided by expectations. They have a longer term view in mind when making their current spending and savings decisions. This perspective limits the stimulating effect of most temporary tax cuts relative to permanent ones.

In their assessment of disposable income on a longer term basis, consumers also have concerns about fiscal sustainability. Substantial empirical literature suggests that when the public debt to GDP ratio is already high, fiscal multipliers are very low. In extreme cases, fiscal expansion may even be contractionary. This fact should help to reduce the number of countries tempted to initiate fiscal stimulus programs, especially taking into consideration their unfunded liabilities and the fiscal consequences of public interventions undertaken thus far. Not only is there a danger that the high initial level of public debt relative to GDP will limit the impact of any fiscal stimulus, but that the sheer size of a stimulus package, which would be proportionate to the deterioration of a country's fiscal position, may adversely affect consumers' confidence.

Consider the developments in Sweden during the early 1990's, a period of very deep banking crisis. From 1990 until 1994, the primary balance of general government spending in Sweden deteriorated by 14.1% of GDP. Less than one fourth of the fiscal deterioration could be attributed to cyclical factors. Discretionary fiscal stimulus was immense, but counter-productive. With public debt growing fast, households and entrepreneurs became very pessimistic about the economic future of the country. Their pessimism pulled private spending down which was deepened to some extent by an increase in interest rates. The risk premium rose to the same level as in Italy, a country with a long tradition of excessively loose fiscal policy[2]. This is a warning that easy and cheap financing of radically increased budget deficits should not be taken for granted.

Impact on financial markets

The current crisis has taught consumers in many countries that there are limits to one's personal debt level. Should these consumers apply the same lessons to their country's public debt, especially once they are made aware of the potential costs associated with a fiscal response to the crisis in the financial sector?

A large fiscal stimulus may in fact turn out to produce a negative impact upon financial intermediation. Financial turbulence generates the risk of a credit crunch. Effective ways to mitigate this danger is a major concern for many governments. One of the major reasons for banks' reluctance to lend is their lack of sufficient capital. According to the IMF's recent *Global Financial Stability Report*, banks need globally close to $700 billion of additional capital. Were governments to simultaneously accrue their borrowings in order to finance their fiscal stimulus, banks would have to work harder to gain access to global capital markets, with the result of potentially limiting any further increases in their capital and lending capabilities. The ability of the emerging economies to finance their growth would be strongly altered too.

Lastly, an increase in the supply of governments' securities could restrict the banks' private sector lending activities. Such a swelling of the "crowding out" effect has in past recessions particularly affected less developed economies with limited financial markets. The present crisis is likely to reduce the size of these markets in developed countries as well. Thus one can hardly rule out similar outcomes occuring in these countries. Furthermore, an improvement in the quality of assets portfolio of banks due to an increased share of government securities could weaken banks' incentives to deal with inherited bad assets and heighten political pressures put on banks to lend to large enterprises that are considered too big to fail.

Future Challenges

Contrary to Keynes' famous dictum, the long run should not be forgotten. One thing is sure: a large fiscal stimulus would considerably increase public indebtedness, imposing a burden on future growth. Moreover, large increases in public investment spending are likely to be wasteful, as it is not possible to have a comprehensive backlog of well prepared projects. As a result, political pressures may dominate efficiency considerations.

Under certain conditions a buildup in spending may also raise the likelihood of corruption. Such worries were recently reported in China. A fiscal stimulus that temporarily lowers indirect taxes at the cost of future increases in marginal income taxes (for example, in the UK) does not improve the most precious aspect of the supply side, *i.e.*, the incentives to work, invest and innovate.

To sum up, the stimulating effects of large fiscal stimulus programs in most countries are likely to be disappointing, while the longer term effects would be rather negative. The present financial crisis is blamed, among other things, on deficient risk management. The proposals for a large fiscal stimulus may suffer from the same weaknesses.

Mr. Balcerowicz, a former Finance Minister, Deputy Prime Minister and Central Bank President in Poland, is Head of the International and Comparative Studies Department at the Warsaw School of Economics, visiting fellow at the Peterson Institute for International Economics and member of the CASE Supervisory Council. Mr. Rzonca is an adjunct professor of economics at the Warsaw School of Economics and the Chief Economist of the FOR Foundation.

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2 Giavazzi F. and Pagano M., Non-Keynesian Effects of Fiscal Policy Changes: International Evidence and the Swedish Experience, *Swedish Economic Policy Review*, vol. 3, no. 1, Spring 1996, pp. 67-103.