Fiscal stimulus is not a silver bullet

By MOHAMED ARIFF

It was during the Great Depression of the 1930s, when economic misery became the order of the day, with millions of workers losing their jobs and livelihoods, that John Keynes figured it out that pump priming through government spending would arrest and reverse the downward spiral.

The logic was that public spending would create jobs and generate demand for goods and services, even if it entailed no more than digging holes and filling them up again.

Subsequently, fiscal stimulus through tax cuts and increased public expenditures has become an important antidote for economic recessions.

Basically, all this is about augmenting the purchasing power of consumers by putting more money in the pockets of the people through tax cuts and by mounting public projects.

Now that the global economy has come under nasty weather, it is not surprising that Keynesianism is again on the rise, with many countries coming up with stimulus packages of sorts.

The picture looks very gloomy with more and more countries joining the bandwagon. What's more, it is almost certain that the worst has yet to come.

Hardest hit in the developed world thus far is Britain with a projected growth of nearly minus three per cent this year, but there are signs that Germany may compete with Britain in the downhill sprint.

The United States, the epicentre of financial meltdown, is sinking deeper into the doldrums by the day. There were 2.6 million job losses last year in the US, with 500,000 workers being laid off in December.

It is forecast that over 50 million people will become jobless this year all over the world. In Malaysia, more than 200,000 workers are likely to face layoffs this year, way above the 1998 threshold of 85,000.

The situation is so frighteningly tenuous that many governments are pushing the panic button. With nominal interest rates driven close to zero and exchange rates erratic, more governments are resorting to fiscal stimulus.

The US has announced a new stimulus package of about USD 800 billion or six per cent of gross domestic product. President Barack Obama has plans to spend USD 550 billion and cut taxes by USD 275 billion.

China and Japan have come up with their own packages of roughly USD 500 billion each. Germany is working on a package of 50 billion euros. Singapore has crafted a package of over USD 20.5 billion (eight per cent of gross domestic product). In

Malaysia, there is talk of a RM10 billion package (1.6 per cent of gross domestic product), in addition to the RM7 billion announced November last year.

The question is whether all this is tantamount to too little, too late. These packages may not work, not because Keynes was wrong, but because his message is not understood.

As the saying goes, the devil is in the details. Much depends on the various components of the stimulus package.

Tax cuts, for example, tend to have a more limited impact on the economy than government spending, because not all the increase in disposable income will be spent, as some may choose saving over spending.

Studies have shown that lump-sum tax rebates are more likely to be saved than tax reductions spread thinly over a time period.

Public work projects can spur more robust impulses but they take time and tend to arrive too late.

Experience has shown that many projects launched during a downturn see the light of the day only after the economy has bounced back, inadvertently contributing to the next bubble in the making, in which case they would constitute a problem, not a solution. Speed and efficiency are of the essence.

Money handouts by governments may not translate into increased consumer expenditure, as people may use them to pay off debts rather than spend, as shown by the US experience in recent months.

Coupons for spending tend to have a better impact, as the recipients could only use them on a given range of consumer items, as in Taiwan lately.

It is important to view fiscal stimulus as an integral part of an overarching countercyclical policy, which should be used during the upswing as well as the downswing in a symmetrical manner, for the overriding objective of countercyclical policy is to minimise the amplitude of economic fluctuations. Its effectiveness during a recession would depend critically on policy application in the preceding boom period.

Thus, monetary tightening and budgetary austerity during boom years would increase the effectiveness of monetary loosening and budgetary excesses during lean years.

High interest rates and surplus budgets during good times would not only prevent the economy from overheating, but also render interest rate cuts and deficit budgets more effective during bad times.

Lack of monetary and fiscal discipline during boom years would only render subsequent monetary and fiscal easing ineffective, as indeed is the case right now.

Single-minded pursuit of high growth has led some countries to adopt low interest rate regimes and budget deficits even when the going was good.

Others have tried to overcome their structural problems by resorting to low interest rates and budget deficits during fair weather, instead of undertaking serious institutional reforms, which are politically difficult - a serious mistake that deprives them of protection against bad weather. Japan is an outstanding case in point.

Countries like the US and Japan, which have been running deficit budgets and low interest rates for several years prior to the current global meltdown, are likely to be stuck in the mud longer than countries that had more disciplined monetary and fiscal policies in place before the crisis.

Who will pay for all these fiscal packages? If governments print money to finance them, the resulting inflation will force consumers to bear the burden. If governments borrow, the burden will eventually fall on taxpayers. There is also the risk of ballooning public debts sowing the seeds of the next crisis.

The long and short of it is that not much can be expected from stimulus packages, especially in countries that threw caution to the wind when the going was good.

In this regard, Singapore represents a remarkable exception with an impressive track record based on impeccable monetary and fiscal discipline.

To be sure, the crisis that Singapore faces today is not homegrown, and it is badly hit because of its openness, but it is well equipped to face it head-on, thanks to its sound macroeconomic management in yesteryear.

Not many countries can afford a stimulus package of eight per cent of gross domestic product, as Singapore has assembled.

Singapore can do it with no additional burden on taxpayers, simply because it has had many years of sizeable budget surpluses on which it can fall back when the chips are down.

But even for Singapore, fiscal stimulus is no panacea, as it can only mitigate but not prevent the slump.

Adapted from "Pump-priming may be too little, too late", New Straits Times, 19 February 2009