ECONOMIC STIMULUS PACKAGES: RETURNING TO GROWTH

ADDRESS

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The global economic and financial crisis has galvanised public economic policy in many countries. Because the core of the problems is located in the United States and Western Europe, world attention has focussed on economic measures being taken to arrest the economic and financial decline and stimulate growth in those regions. China has also been of special interest because of its significance in world trade and finance and the massive size of its own economic stimulus package. However, precisely because the economic and financial crisis is global in the sense of having negative spill-over effects on many other economies, many other countries have had to design and implement adjustment policies to mitigate the risk of economic recession and financial disorder.

Economic stimulus packages vary in detail from country to country. Nonetheless, some general characterisation is possible. One common feature is expanded fiscal expenditures on economic and social infrastructure. Transportation and education are sectors frequently targeted. The intention of this kind of public economic intervention is both short term and medium term. The short-term economic objective is to boost aggregate demand and create employment opportunities for workers retrenched by failing business enterprises. The purpose is to minimise the severity of the economic recession and its social consequences. The medium-term objective is to lay a foundation of enhanced infrastructural capacity and human capabilities for future economic growth.

In many instances, also, economic stimulus packages provide direct expenditure subsidies and budgetary grants to business enterprises in specified industries or sectors. The subsidies and grants are intended to moderate decreases in profits caused by contractions in aggregate demand when production costs are relatively inflexible downwards. They are also intended to minimise contraction of employment and encourage new capital investment. In the extreme case of bailouts, the purpose of the public expenditures is to prevent bankruptcies and business closures. If enterprises would be financially viable other than for negative external shocks to the demand for their products, temporary subsidies and grants would serve a useful purpose in maintaining economic confidence and preventing a cumulative downward spiral through contagion effects on other industries and sectors. However, if there were pre-existing serious weaknesses in the enterprises, subsidies, grants and even bailouts unaccompanied by clear programmes for rationalisation and efficiency improvements in the enterprises would not induce economic recovery and contribute to future growth. In such circumstances, there ought too be explicit conditionalities attached to the provision of public funds.

Sometimes, the economic stimulus packages make provision for tax waivers and other reliefs on payments obligations by enterprises and households to the government. The intent of tax reliefs and waivers applicable to individuals and households is generally two-fold. One purpose is to minimise the slump in aggregate demand by providing an implicit income cushion through more disposable income to employed persons. Another purpose is to moderate reductions in household levels of living. The efficacy of tax reliefs to individuals and households would be vitiated by pre-existing high levels of unemployment and job losses during the course of the economic recession since only the employed can benefit. The intent of waivers and reliefs to business enterprises is to boost profits or reduce the severity of falls in business profitability. It is hoped that the tax concessions would enable enterprises to remain in operation and in some circumstances induce new capital investment. An overall problem with the tax relief approach to economic stimulus is the weak fiscal capacity of many developing countries in the hemisphere and the further erosion of fiscal revenue capacity that this strategy entails.

Two features of the economic and financial crises are the reduced access to finance and the higher cost of such access. They are evident in respect of credit for production, trade credit, direct foreign investment and personal sector credit. To address these problems, economic stimulus packages have variously included provisions for interest rate reductions, special credit lines or windows of private financial institutions and development finance institutions, and expansion of trade credit facilities of Central Banks and specialist trade finance agencies. Interest rate reductions seek to lower the cost of finance as an incentive or inducement for accumulation of debt by business enterprises for investment in inventories and fixed capital but also to reduce the cost of financing current production. Given the well-established long response time of capital investments to interest rate changes, there should be little expectation of quick responses of the economic growth rate to the price of the credit component of the stimulus packages. What one should expect to see is a reduction in the current costs of doing business. Augmented credit windows or similar facilities are a more direct and generally more effective growth-stimulating mechanism. They focus on the quantity of finance variable rather than the price of credit, seeking to ensure that funds are available at the prevailing price.

In situations where private financial institutions have become more risk-averse and are less willing to lend, economic stimulus packages to be effective may need to include arrangements for loan guarantees by the respective governments. Similarly, a heightened aversion to risks in foreign direct investment might have to be attenuated by greater access to political risk insurance.

In extreme financial crisis situations where private financial institutions themselves have crashed or are in imminent danger of crashing, governments have intervened to provide liquidity support and to recapitalise them. In such instances, the economic objectives being pursued are avoidance of systemic risk in the financial sector and the associated contraction in the supply of private finance to enterprises and the personal sector.

In assessment of economic stimulus packages, it is necessary not to lose sight of the fact that economic recessions and financial collapse impose huge social costs, such as foreclosures on mortgages and loss of residential property, job losses and consequential psychological damage, abrupt and substantial loss of savings and accumulated pension entitlements, and a diminished capacity to maintain levels of living. These social costs spill over into production and commerce and into public governance, compounding the problem of economic recovery and reducing the capacity for future economic growth. The social dimension, therefore, cannot be ignored in the design and implementation of economic stimulus packages.

The weak fiscal situation of most countries in the Americas and the Caribbean is a severe limitation on their capacity to implement economic stimulus packages of sizes warranted by their economic downturns. For this reason, among others, the outcome of the G20 Summit in London on April 2, 2009 is of great significance. The Summit endorsed a range of financial programmes with expanded capacity to be offered by the World Bank and affiliated institutions and by the International Monetary Fund (IMF).

“ We have agreed to make available an additional $850 billion of resources through the IMF and the multilateral development banks to support growth in emerging markets and developing countries by helping to finance counter-cyclical spending, bank recapitalisation, infrastructure, trade finance, balance of payments support, debt rollover, and social support.”

(*Declaration on Delivering Resources Through the International Financial Institutions – London, April 2, 2009)*

The various facilities and programmes at the World Bank include the Global Food Response Programme, the Rapid Social Response fund, MIGA political risk insurance, the Global Vulnerability Fund and the Global Trade Liquidity Programme. Developing countries in the Americas and the Caribbean will not all have access to each of these facilities. In particular, only IDA-eligible countries of which there are nine in Latin America and the Caribbean can have access to the Rapid Social Response Fund of $2 billion which is to be used for safety nets, infrastructure, education and health; similarly for the Global Food Response Programme. This means that most developing countries in the hemisphere would be confined to MIGA’s political risk insurance programmes, the IFC’s crisis response facility for banking, infrastructure and trade funded at $2 billion, and the $50 billion Global Trade Liquidity Program.

The IMF’s Flexible Credit Line (FCL) created in March 2009 would also not be very accessible to most developing countries because they are unlikely to satisfy pre-set criteria with respect to matters such as sound public finance, a record of steady sovereign access to international capital markets on favourable terms, capital accounts dominated by private flows, low and stable inflation, and a comfortable foreign reserve position. Thus far, only Mexico has drawn on the FCL. For most developing countries, access would be limited to the Enhanced Standby Arrangements which have doubled country’s annual limit to 200 per cent of quota and increased the cumulative limit to 600 per cent of quota.

The countries represented in this Fifth Summit of the Americas could well ask themselves whether they have been adequately served by the decisions of the G20 Summit or whether they will still be very much on their own as they fashion a response to an economic crisis not of their making.