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Taking Responsibility

FISCAL STIMULI:
WHEN, WHY AND HOW

by John Rapley

A BACKGROUND BRIEF

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Caribbean Policy Research Institute
Guango Tree House
29 Munroe Road
Kingston 7, Jamaica
www.capricaribbean.org

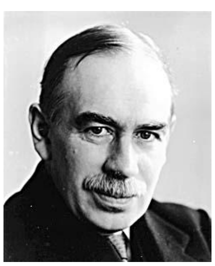
In a recent series of articles in the *Gleaner*, CaPRI evaluated the management of the Jamaican economy by the Golding administration in its first two years of office. This period was dominated by crisis-management, as exogenous shocks – first a surge in global inflation due to rising commodity prices, then a collapse in global demand as the bubble burst -- rocked the Jamaican economy, just as they did virtually all the other world's economies. Our analysis suggested that the government's management of the crisis was, if unexceptional, as good as could be expected in the circumstances.

As we approach the end of 2009, the global economy appears to be stabilising. Most analysts expect the global economy to resume growing, though the bounce-back in the developed countries may be sluggish for some time.[1] Nor can one rule out further crises altogether: the global financial system remains fragile, and the ultra-loose monetary policies of the industrial countries have moved us into uncharted territories. However, it does appear that if we have not yet reached dry land, we may have sailed through the worst.

The question now is what will follow? The debate in Jamaica continues to be dominated by immediate considerations, and in particular the question of what conditions will be attached to an impending loan agreement with the IMF (International Monetary Fund), and what strategies the government should adopt to mitigate the onerous effects of what remains a very challenging and difficult time.

One of the principal fault-lines in the current policy debate lies between those who are calling on the government to focus its attention on tackling Jamaica's poor public finances, and those who are calling for a stimulus package to pull the country out of recession. Although the strategies employed would be sharply divergent, the stated intention of each is to put the country on a growth path.

KEYNESIAN STIMULUS


John Maynard Keynes

The basic principle of Keynesian economics is deceptively simple: save in good times, spend in bad. When times are bad, governments should put money into the hands of consumers, thereby boosting demand and giving the economy a shot in the arm. Even if the government needs to run up a debt to do this, it needn't worry: once the economy recovers, the government can cut back its spending and pay down its debt.

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[1] The International Monetary Fund itself recently said that "Only a recovery in developing and emerging market countries will propel the world economy back into positive growth in 2010, albeit at a relatively weak level of 1.9%." See http://news.bbc.co.uk/2/hi/business/8011907.stm.

Assuming – for the sake of argument – that the theory is correct, does that make it appropriate for Jamaica at this time?

Some Keynesians might actually say no. While Keynes argued that deficit-financing was not to be feared in economic hard times, his fundamental view of fiscal policy was that it should be counter-cyclical. Therefore, in good times, governments should manage growth by reducing public demand and running surpluses. But Jamaica came at this crisis from a different angle: years of chronic deficit-financing left government with one of the world's largest debt overhangs.[2] We had good times, but we didn't save. One by-product of this has been high interest rates, as government soaks up all the available savings in the economy. Higher public spending would probably drive interest rates even higher. While a stimulus programme might boost demand in the short term, by raising borrowing costs, it would inhibit private investment, and so choke off any longer-term growth. But a more prudent stimulus, which avoids running up large expenditures, proves too modest to have any impact on the economy: CaPRI's analysis of the government stimulus package announced late in 2008 found it to have had no discernible impact on growth or employment.[3]

Beyond that, it is not clear that the problem facing the Jamaican economy is a problem of aggregate domestic demand – the principal problem targeted by Keynesian stimulus. Rather, the Jamaica recession has been caused by a drop in external demand. Domestic demand has usually been strong, as evidenced by the country's persistent current-account deficit (the result of the country buying more than it sells abroad). The problem in Jamaica has tended to be one of low productivity which, when it interacts with strong demand, leads to high inflation. In such circumstances, trying to make up for the loss of foreign demand with a domestic stimulus, would at best just lead to a temporary but short-term economic boost – what the business press now popularly calls a "sugar high" – followed by longer-term high inflation. With that comes the high interest rates that would prevent any sustainable economic rebound.

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[2] The third highest in the world: CaPRI report (March 2008) "*Jamaica's Debt: Exploring Causes & Strategies*"**.** As Mohammed Ariff of the Malaysian Institute of Economic Research has noted, "a budget deficit of, say, 5 per cent of GDP would have significant impact for an economy starting with balanced budget, but not for an economy already saddled with a deficit of 4 per cent of GDP." See http://www.voxeu.org/index.php?q=node/2910, 28 January 2009.
[3] CaPRI report (2009)"The Effect of the Global Economic Crisis on Jamaican Businesses: An Analysis of Exposure & Responses"

Deficits and Development

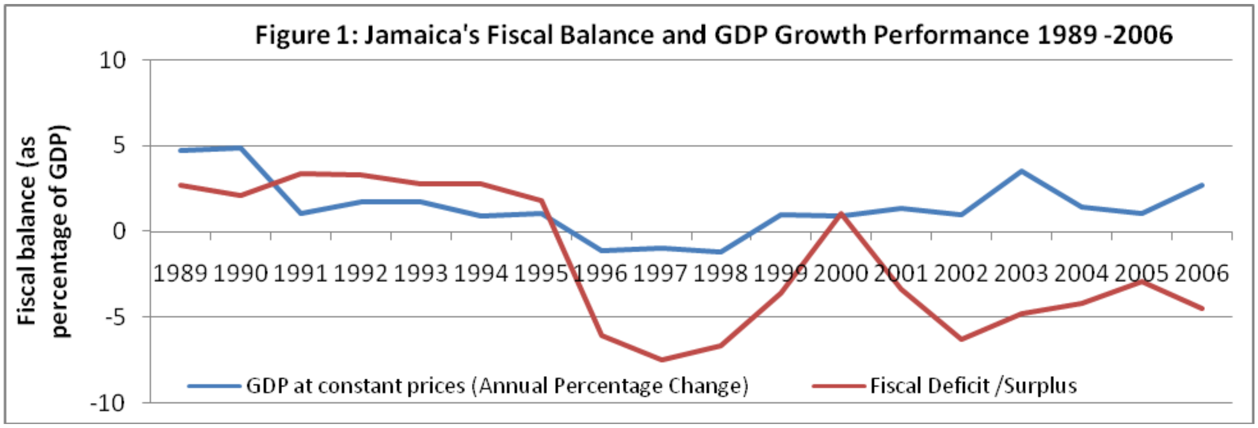
Keynes may have differed from the "new classicals" in saying balanced budgets were not the holy grail of economic policy. But he would not have taken issue with the argument that chronic deficits are a source of economic imbalance. And this appears to be Jamaica's problem. With occasional exceptions, year after year the Jamaican government has been spending more than it earns for a long time now. This appears to have had two deleterious effects on the economy. One is that the surplus of expenditure over revenue has led to a situation in which the supply of money grows faster than the supply of goods and services, with the result being a high rate of inflation. The high rate of inflation, coupled with the excess demand of government for savings, has driven interest rates to the levels with which we are accustomed. Critics sometimes bemoan the fact that the Jamaican financial sector is conservative, risk-averse or disinterested in production. But when a government whose appetite for cash leads it to offer high rates of interest, makes it easy for banks to make money by lending to it, it is only natural that any financial institution will shy away from risky behaviour to favour guaranteed high returns on government paper.

If we imagine a scenario in which the government eliminated its deficit and began reducing the debt: GDP ratio, we can begin to picture a day in which banks, with no easy money available, start to compete for clients. They would do this by lowering the price of credit, which in practice would mean lowering interest rates. Equally, if the inflation rate came down permanently, the greatest beneficiaries would be Jamaica's poorest

The current government's use of "stimulus" programmes has tended towards periodic, relatively small packages – in which tax cuts play a major role -- that favour one or two industries at a time: tourism and manufacturers late last year, car dealerships more recently. CaPRI's research on these initiatives, reveal that they have little effect on demand or employment. Rather, they tend to improve profit margins. This is worrying, for two reasons. Japan's experience since its 1989 market crash with such stimulus programmes – which have favoured transfers to business rather than consumers – reveal that they do little to improve economic growth, and only add to public debt; the evidence suggest that this will be Jamaica's experience as well. Moreover, with the government preparing for a harsh round of budget cuts, it will have reduced its moral authority to demand sacrifices of its employees if it continues to evince a willingness to steer scarce resources to the business community – especially since the evidence suggests that the principal, and in some cases sole, beneficiaries of this policy will be business-owners.

citizens, for whom inflation is an inescapable tax.[4] But falling inflation would itself be good for growth.

The comparative literature appears to bear out the point that if the government of Jamaica wants to put the country onto a growth path, it will need to wrestle its debt burden to the ground – or at least, to far more manageable levels. The actual relationship between the fiscal balance and economic growth is the object of some discussion,[5] so the single-minded pursuit of balanced budgets for their own sake could possibly be contested. However, when it comes to inflation, the empirical literature is nearly unanimous: inflation inhibits growth.[6] Furthermore, as Jamaica's own recent experience illustrates, economic performance tends to follow the performance of the government's finances fairly closely: surpluses correspond to growth, deficits reverse it, and deficit reductions restore growth (see Figure 1).



Global Stimulus and Jamaica

It may also be that the Jamaican government need not stimulate the Jamaican economy, for the simple reason that other governments may do it for us. This may seem a peculiar thing to say, as we know all too well nobody can be expected to for us what we will not do ourselves. However, when one adds up the public spending carried out by the major industrial countries -- as well as China -- in their recent efforts to

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4 The reduction of inflation in the 1990s brought down poverty rates and narrowed the income gap: Sudhanshu Handa and Damien King, "Adjustment with a Human Face: Evidence from Jamaica," World Development 31, No. 7, July 2003.

5 Compare, for instance, Fischer and Sahay (2000), Gupta et al. (2002), and Pushak et al. (2007) on one hand, with Purfield (2003) on the other.

6 Havrylyshyn (2001). See also Wolf, 1997; Loungani and Sheets, 1997; Fischer, Sahay, and Végh, 1998; Berg et al., 1999.

stimulate their own economies, the fact is that literally trillions of dollars of new money has entered the global economy this past year.

However, the global economy today is a very different beast from what it was in the 1930s, when Keynes developed his theory. It is far more globalised. This means that added money need not stay in the economy into which it has been injected. There may already be signs of money, especially US stimulus money, leaving its home economies. It is not just that in liberalised economies, money can be used to spend on imported goods. More may be in play than this. Many observers have noted how the high degree of indebtedness of US households is likely to lead to a long period of "deleveraging" in which Americans spend less, save more and pay down debt. We have already witnessed a sharp increase in the US saving rate.[7] The problem faced by savers in the industrial countries is that returns on their investments may remain low for years to come. The bubble in real estate and stock markets means that it may be years, if not decades, before some Americans make back the cost of their investments. Meanwhile, the interest rates offered by governments on their paper will, at least for the foreseeable future, remain quite low: the Swedish central bank recently moved into uncharted territory when it dropped short-term rates below zero, essentially forcing depositors to pay to save their monies.

The stated goal of such ultra-loose monetary policy is to force consumers to save less, and therefore spend more. But consumers face other options. They can continue saving, by looking for higher returns offshore, in countries where the returns appear to be highest. Already, we have seen a move into emerging markets in the behaviour of, for example, American investors.

These investors will be looking for returns that are both higher than what they can get at home, but also sufficiently secure that their added returns don't get sucked up in a "risk premium."[8] To attract some of this investment, developing countries like Jamaica have to position themselves as attractive destinations for investment. Given the discussion above, this would require not only a serious attack on the deficit and debt; but a perception that the policy is one to which a broad cross-section of the Jamaican body politic is committed.

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[7] The US saving rate, which was around zero earlier this decade, has nearly quintupled over the last year, to 5% as of the second quarter of 2009 (US Department of Commerce, Bureau of Labor Statistics). Many economists expect it to continue increasing, possibly until it reaches the double digits.

[8] This refers to the added return demanded by investors to compensate for such potential losses as currency devaluations.

Conclusion

It would therefore appear that the case for a fiscal stimulus package is, on economic grounds, weak; while the case for deficit-reduction is strong. Increasing the deficit in order to stimulate the economy, will not likely lead to sustainable growth. Whereas eliminating the deficit would probably get the Jamaican economy moving again. All told, the government would do well to mobilise all stakeholders around a strategy of deficit-reduction. In the short term, this will be painful; but the long term gains should warrant the sacrifices made. And while there is not a compelling case for a comprehensive stimulus programme, the need to protect society's more vulnerable citizens during the period of painful adjustment remains central. Therefore, government should rationalise its spending in such a way as to reduce its overall expenditure, while creating and preserving an appropriate safety net for the poor.

The Caribbean Policy Research Institute (CaPRI) is an independent think tank affiliated to the University of the West Indies (Mona).

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