Fiscal Policy Responses to Economic Crisis: Perspectives from an Emerging Market

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This presentation will focus on fiscal policy responses to the global economic crisis of 2008 from the perspective of an emerging market country, drawing from my experience of Minister of Finance of Indonesia at that time.

Crises past and present

For emerging economies, the 2008 crisis was markedly different from previous crises of the 1980s and 1990s. Most of those economic crises were the result of policy or institutional problems in these emerging market countries themselves. These problems included bad macroeconomic policy, bad governance, or weak institutions that led to instability, low growth, high inflation, credit collapse and balance of payments problems.

The first couple of decades of this new millennium, in contrast, were characterized by many developing countries investing significantly in strengthening their own policies, including adopting more sound macroeconomic policies. Many of the central banks in developing and emerging countries became more independent. They adopted inflation targeting. Fiscal policy became more prudent. Some countries even adopted a fiscal cap, which in Indonesia's case prohibited the fiscal deficit from exceeding 3 percent of GDP in any single fiscal year. Indonesia also adopted a cap on its debt-to-GDP ratio, prohibiting it to exceed 60 percent. Most importantly, many developing countries also invested in structural reforms, both on the revenue and expenditure side, but also in investment and trade policy.

This investment in structural reforms in the last three decades meant that many developing countries had developed macroeconomic and fiscal space, including significant external reserves. These buffers further strengthened economic growth and stability. However this stronger domestic performance of course did not prevent emerging markets from being exposed to external shocks, particularly when efforts had also been made to open up to trade and foreign investment and to integrate into the global economy.

The 2008 crisis was thus different from crises of the past for most developing countries. The source of the shock was external, coming from the global economy, and from problems that had their inception in more advanced countries. What affected developing countries most from this crisis was the sense of a global collapse in confidence, particularly in financial markets. The market ceased to work. There was no liquidity. There ceased to be transactions across banks, even in Indonesia. There was no trust among banks. There was a real and imminent threat to the banking system, whose intermediary function was not working. The capital outflow from emerging countries that ensued during this crisis (in an irrational flight to “quality”) only further aggravated the situation of the domestic banking and financial system in emerging markets. So there now was a collapse not only in external demand but also in domestic demand.

Policy levers in managing the crisis

What were the options for developing country policy-makers at that time? The issue was restoring confidence in the financial system while stimulating demand.

With regard to financial sector measures, with a collapse in markets, we resorted to some unconventional measures in an effort to restore liquidity and confidence. As Finance Minister, I used my discretion to move government funds out of the government accounts at the central bank and into state-owned banks, instructing them in turn to channel this liquidity into the commercial banking system. Even then, given the lack of confidence across these market segments, the funds were slow in travelling through the whole financial system. Other Asian countries even adopted a blanket guarantee on bank credit. In addition, we delayed implementing mark-to-market accounting for government bonds held by banks and mutual funds. Again, this measure was taken with a view to get transactions going again, and to help restore some modicum of confidence for banks to re-enter into transactions.

For emerging economies, the most critical policy lever for addressing the collapse in external and internal demand was to resort to fiscal policy. Hence fiscal policy – both on the revenue and expenditure side – was critical in helping countries deal with this recent crisis.

First, a key consideration in deploying fiscal policy in such an instance was to ensure that one chose policies that had an immediate impact on the economy. This meant identifying not only policies that are fast to generate demand, but also policies that are fast to enact, involving fewer administrative and political processes to implement. One could opt for a one-off tax facility, whether an income tax reduction or reduced VAT for a year, or even easing the import tariff for raw materials. Relatedly, an example of an expenditure policy that has an immediate impact in stimulating demand are cash transfers, since these immediately affect disposable income , and also allow you to protect the poor, who are usually severely affected by economic crises.

Moreover, one way to make fiscal policy response faster is to put into place automatic stabilizers, even if temporary. In Indonesia’s 2009 budget, it was agreed that the government would be allowed discretion for increased fiscal spending should economic indicators deteriorate further than agreed parameters. The government was authorized to increase spending to “stabilize” the economy, particularly to help protect employment and the poor, should for example there be a further banking crisis or higher than expected inflation. Providing this discretion to government to react flexibly with fiscal policy in mid-year in the case of crisis of course makes the political process for policy adjustment more expedient. The political concern and consensus was such that government was given this authority.

Second, as noted above, a high priority for fiscal policy during economic crises are programs that protect the poor and can support employment generation or cushion income during these times. As noted, social protection programs such as cash transfer programs are useful in this regard, all the more so because they are generally better targeted than commodity subsidies. Social protection programs that include work-fare or food for work might also be prioritized.

Third, it is important to think ahead, and maintain spending on those items that will strategically support future recovery and growth. In particular, many developing countries are still underinvested in infrastructure for growth. Investing in development expenditure, such as on infrastructure, which stimulates employment while positioning the country for future growth should be priority for fiscal stimulus programs during crises.

Role of international cooperation

International cooperation can play an important role during global crises, and particularly when market sentiment and confidence are an issue. During the height of the economic crisis of 2008, there was intense dialogue among global leaders and Finance Ministers. The coordinated action and unified view taken by the leaders of the G-20 at the time (2008/2009), first in Washington and then in London, provided a strong boost to confidence. The ability for coordinated action at the time was also facilitated by a common diagnostic of the source and ramifications of the problem that were affecting all countries, as well as the convergence in policy actions that would be needed to address the crisis, i.e. expansionary fiscal and monetary policies to counter the weakening economies. Currently, during the recovery period, international coordination becomes more challenging and complicated when countries or regions are at different stages of recovery, requiring different policy directions and solutions.

There is a role for international responses during crises also in the area of financing. As noted, even with sound policies, during the global economic crisis, international financial markets were thin and even irrationally skittish, leading to high risk premia. Emerging market economies, which were trying appropriately to undertake fiscal stimulus packages to get domestic and global demand going again, were having a hard time entering the market to raise deficit financing. This is where, in the case of Indonesia for example, the World Bank's issuing what it called a "deferred draw down option" (a contingent financing vehicle) was of great help. This kind of support is helpful for a developing country to speak with confidence in front of the market. It serves as a signal that the international community views the fiscal stance as appropriate. It enables developing countries to avoid paying an unreasonable interest rate, especially when the market was behaving irrationally.

Challenges for fiscal policy in the wake of the crisis

The main challenge for fiscal policy in the wake of the crisis is determining the timing, sequencing and strategies for fiscal consolidation.

In designing the path for consolidation, sequencing is important. In particular, restoring confidence and securing the structural reforms necessary to cement and anchor that confidence are critical before a country starts cutting spending. In addition, timing is also dictated by the nature of the external environment and shocks. In the case of this global economic crisis, even if we may see anemic signs of recovery, policy makers are appropriately concerned about other uncertainties in the external environment. Today these include escalating commodity prices, including food and fuel, instability in the Middle East, and the repercussions of the natural disaster in Japan. In addition, partly due to the weak global recovery, many emerging markets are trying to cope with rapid capital inflows, which create complications in terms of asset bubbles and inflationary pressures. Clearly the timing and sequencing of fiscal consolidation has to take into account this dynamic external environment, which poses multiple threats, while focusing on the fundamentals of one's own domestic economic structure.

With regards to strategies for fiscal consolidation among developing country economies, there are several aspects to stress. First, many developing countries have narrow tax bases. For them, a priority for structural reform will be to broaden the tax base, improve revenue, and put into place an automatic stabilizer that would cover the majority of the real economy. Second, it could serve countries well to put a cap on discretionary spending, which would also create better fiscal discipline. This would also serve to avoid politicizing discretionary fiscal policy during a crisis. Third, countries need to focus on improving the quality of their spending, which becomes so essential during crisis. Prioritizing spending in areas such as the social sectors and infrastructure might be key, as well as ensuring that spending is well targeted.

Conclusion

These are some insights and lessons learned from the perspective of an emerging market country policy maker who struggled, along with colleagues, to manage the global economic crisis. In summary, the perspective from developing countries in handling such a global crisis may be somewhat different from advanced economies. But the recent economic crisis has shown that today's global economy is ever more inter-connected. It pays to cooperate together to address international economic contagion and to learn from each others' experiences.