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

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This chapter focuses on fiscal policy responses to the global economic crisis of 2008 from the perspective of an emerging-market country, drawing on my experience as minister of finance of Indonesia at that time.

Crises Past and Present

For emerging economies, the 2008 global economic 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 the 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 decade of the new millennium, in contrast, was characterized by the investment of many developing countries 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 gross domestic product in any single fiscal year. Indonesia also adopted a cap on its debt-to-GDP ratio, prohibiting it from exceeding 60 percent. Most important, many developing countries also invested in structural reforms, both on the revenue and expenditure sides but also in investment and trade policy.

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This investment in structural reforms in the last three decades has meant that many developing countries have developed macroeconomic and fiscal space, including significant external reserves. These buffers further strengthened economic growth and stability. However, this stronger domestic performance 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") further aggravated the situation of the domestic banking and financial system in emerging markets. So there 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 policymakers to restore 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 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 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 traveling through the financial system. Other Asian countries 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 to get transactions going again and to help restore confidence to banks so that they would reenter into transactions.

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

First, a key consideration in deploying fiscal policy in this crisis was to choose policies that would immediately affect the economy. This meant identifying policies that are fast to generate demand and that are fast to enact, involving fewer administrative and political processes for implementation. One could opt for a one-time tax facility, whether an income tax reduction, a reduced value-added tax for a year, or a reduced import tariff for raw materials. An example of an expenditure policy that immediately stimulates demand is cash transfers, since these immediately affect disposable income and also help protect the poor, who are usually severely affected by economic crises.

One way to make the 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, for example, if a further banking crisis occurred or if inflation was higher than expected. Providing this discretion to government to react flexibly with fiscal policy in midyear in the case of crisis makes the political process for policy adjustment more expedient. The political concern and consensus were 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. Social-protection programs such as cash-transfer programs are useful in this regard, particularly because they are generally better targeted than commodity subsidies. Social-protection programs that include workfare or food for work might also be prioritized.

Third, thinking ahead is important, and spending must be maintained on those items that will strategically support future recovery and growth. 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 a priority for fiscal stimulus programs during crises.

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The Role of International Cooperation

International cooperation can play an important role during global crises, particularly when market confidence is an issue. During the height of the economic crisis of 2008, there was intense dialog among global leaders and finance ministers. The coordinated action and unified view taken by the leaders of the Group of Twenty at the time (2008 to 2009), first in Washington and then in London, provided a strong boost to confidence. Coordinated action at the time was also facilitated by a common diagnostic of the source and ramifications of the problems that were affecting all countries, as well as the convergence in policy actions that would be needed to address the crisis (that is, expansionary fiscal and monetary policies to counter the weakening economies). Currently, international coordination is more challenging and complicated because countries or regions are at different stages of crisis or recovery, requiring different policy directions and solutions.

There is also a role for international responses during crises 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. In the case of Indonesia, for example, the World Bank issued what it called a “deferred draw-down option” (a contingent financing vehicle), which was of great help. This kind of support helps allow a developing country to speak with confidence in the market. It signals 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 behaves 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

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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 the signs of recovery are anemic, policymakers 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 sovereign debt crises. In addition, partly owing to the weak global recovery, many emerging markets have been trying to cope with rapid capital inflows, which create complications in terms of asset bubbles and inflationary pressures. The timing and sequencing of fiscal consolidation have to account for this dynamic external environment, which poses multiple threats, while focusing on the fundamentals of each country's domestic economic structure.

Regarding strategies for fiscal consolidation among developing-country economies, several aspects need to be stressed. First, many developing countries have a narrow tax base. For them, a priority for structural reform is to broaden the tax base, improve revenue, and put into place an automatic stabilizer that covers the majority of the real economy. Second, countries should cap discretionary spending, which also creates better fiscal discipline. This also avoids politicizing discretionary fiscal policy during a crisis. Third, countries need to focus on improving the quality of their spending, which becomes essential during a 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 policymaker who struggled, along with colleagues, to manage the global economic crisis. The perspective of developing countries in handling such a global crisis may be somewhat different from that of advanced economies. But the recent economic crisis has shown that today's global economy is ever more interconnected. It pays to come together to address international economic contagion and to learn from others' experiences.

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This is a section of doi:10.7551/mitpress/9451.001.0001

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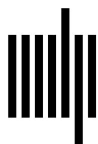
Citation:

In the Wake of the Crisis: Leading Economists Reassess Economic Policy
Edited by: Olivier Blanchard, David Romer, Michael Spence, Joseph E. Stiglitz
DOI: 10.7551/mitpress/9451.001.0001
ISBN (electronic): 9780262301831
Publisher: The MIT Press
Published: 2014



The MIT Press

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This book was set in Sabon by Toppan Best-set Premedia Limited. Printed and bound in the United States of America.

Library of Congress Cataloging-in-Publication Data

In the wake of the crisis : leading economists reassess economic policy / edited by Olivier Blanchard . . . [et al.].
p. cm.
Conference proceedings.
Includes bibliographical references and index.
ISBN 978-0-262-01761-9 (hardcover : alk. paper)
1. Global Financial Crisis, 2008–2009—Congresses. 2. Fiscal policy—Congresses. 3. Monetary policy—Congresses. 4. Economic development—Congresses. I. Blanchard, Olivier.
HB37172008.I6 2012
339.5—dc23

2011040553

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