



Will Fiscal Stimulus Stimulate Confidence?

Leszek Balcerowicz, visiting fellow at PIIE and former chairman of the National Bank of Poland, suggests that countries with high debt levels that embark on fiscal stimulus may weaken public confidence instead of strengthening it.

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Steve Weisman: Welcome to Peterson Perspectives. This is Steve Weisman at the Peterson Institute for International Economics. Our guest today is Leszek Balcerowicz, the former chairman of the National Bank of Poland and now a visiting Fellow at the Peterson Institute. Leszek Balcerowicz's economic reforms in the 1990s in Poland after the fall of communism were widely credited with getting Poland through some difficult times and into a new era of economic growth. But today, Leszek, Poland is experiencing some difficulties. Tell us, to begin with, what is your analysis of the cause of the current downturn in Europe, Poland, and the world at large?

Leszek Balcerowicz: As far as Poland is concerned, and practically most transition economies, the causes are external. They originated first in the United States, then spread to other developed economies. And when the developed world has problems, then everybody suffers to some extent. There's no perfect decoupling, as we know. The extent to which emergent economies would suffer depends on the strengths of the channels of transmission of the problems of developed worlds, how dependent they are on trade, on exports, through, say, the United States or through the eurozone. Clearly smaller countries which depend more on exports would suffer more—say, Hungary, being smaller than Poland—would be more susceptible to this slowdown. Second, the degree to which a country depends on commodities, the prices of which are falling, fortunately, to the importing economies.

Steve Weisman: But not to the exporting.

Leszek Balcerowicz: Let us remember that the prices of oil have exploded and this has contributed to the present problems. From this point of view, say, Russia, which depends clearly on oil, it's going to be affected. Ukraine, which depends very much on the prices of metal, is going to suffer, too. Poland, not being an oil exporter, or Hungary or the Baltics, would not be very much vulnerable to this channel of transmission.

Third, what was the pace of borrowing from abroad most, and if the pace of borrowing goes very high, like it was the case in the Baltics, or to some extent in Ukraine, then the radical changes in international financial markets are going to produce a very deep slowdown. So the faster you are growing, the more you are going to slow down. And then from this point of view, the Baltics, as I mentioned, and Ukraine, when credit growth exploded during the last years are suffering a very deep decline of growth from previous high levels. In Estonia, they were growing 10 percent. Now, their rate of growth is below zero. And the same goes for Latvia. In Poland, the growth of credit was not that pronounced. Now it's 70 percent a year in nominal terms, but 30 percent to 40 percent. We were slowed down from 6 percent to, according to the present forecast, 3 percent in 2009. So I think these transmission channels are present, but to a different extent in different countries.

Steve Weisman: The G-20 meeting last month in Washington prescribed massive stimulus programs for the world's economies. They are now responding to one degree or another. Is this a good idea?

Leszek Balcerowicz: To my knowledge, as far as the fiscal stimulus is concerned, the G-20 communiqué was rather guarded. They said yes, but if appropriate or when appropriate, and I think this is a very important qualification. Let us remember that most countries have done a massive monetary easing, especially in the United States. This is already going on. Second, there's also substantial fiscal easing due to what the economists call "automatic stabilizers." When growth is slowing down, tax revenues are being reduced, some spending items are increasing—and this produces extra deficits. It's in the process. I'm not questioning it to the extent a country can afford to finance a larger deficit. Not everybody can. When people discuss fiscal stimulus, they have in mind what is called "discretionary fiscal stimulus" going beyond. And in my mind, this is something which should be more widely discussed. Not only benefits, but also risks to further widening of deficits due to this discretionary fiscal deficit.

Steve Weisman: Do you see a danger in the widening of these deficits in the United States and in the richer countries of Europe?

Leszek Balcerowicz: First of all, not everybody can afford a further widening of already widened budget deficits. A country has a public debt to GDP ratio equaling 100 percent, like in Italy, a further borrowing may be difficult, first. Second, it should not be taken for granted that private spending will be stimulated because of fiscal stimulus. Consumers are not Pavlov dogs. They are not reacting to current stimulus. They have their expectations and, say, if they are pessimistic about public financing, because they see that the debt is already huge, then they may become even more worried due to the further prospects

of financing. And instead of spending more, they may save. And this is a pretty well-known phenomenon in macroeconomic literature and sometimes it's called the non-Keynesian effect. I'm not saying that every country is likely to have this, but some countries, yes.

Steve Weisman: Where would you put the United States in this analysis?

Leszek Balcerowicz: This depends on how you assess the public debt in the United States. If you define it in a narrow way, the United States is not in the situation of Italy, because public debt as a GDP percentage is much lower. But if you include the uncovered liabilities like pension, Medicare, then of course, public debt is much, much larger. I think one should ask a question whether massive further fiscal stimulus can be fairly stimulating in the short run. And what about longer-run consequences? As far as the short-run is concerned, the hope is—and I think it is now widely believed—that once there is extra fiscal stimulus, meaning extra deficit financing, then this would lead to further spending by consumers. According to the Keynesian multiplier, that multiplier will be positive and substantially high. I would say, this should not be taken for granted because consumers have expectations. So this belief, I would even say sometimes, assumption, should not be taken as a dogma. There's another belief that the larger, the better, so the bigger fiscal stimulus, the better.

Steve Weisman: That seems to be the prevailing view now.

Leszek Balcerowicz: Now, again, looking at empirical literature, I can't find a very strong foundation for this belief saying that in every circumstance, the bigger, the better. Again, we are coming back to consumers. This is not a mechanical question. This is, to some extent, a massive psychology question. So how consumers would form their expectations when the increase of the budget deficit exceeds \$1 trillion, and then some people say, let us spend even more. Would they be more ready to spend the extra dollars or less ready? So I would not take for granted that the bigger, the better. It might well be the case that the bigger, the worse in the sense that the bigger the stimulus, the more worried will be the consumers to spend the extra money. This would mean that the level of value or size of multipliers would decline with the size of initial stimulus. And the main purpose behind stimulus is not just to spend public money, but to revive the private demand. I think, when I listen to the debate, there are a lot of metaphors like jumpstarting the economy, but what's behind this jumpstarting? This means that somehow, consumers would spend.

Steve Weisman: We saw earlier this year in the United States that they saved most of the money that they received in tax cuts.

Leszek Balcerowicz: Very interesting. There are two kinds of responses to this experience. Some people say, “Yes, let us think whether this is a good idea, this discretionary fiscal stimulus.” Some other people say, “This proves that the stimulus should be bigger,” right?

Steve Weisman: How does the concern about inflation become a factor here?

Leszek Balcerowicz: I think nobody’s concerned now about inflation, almost nobody, because psychologically, it is understandable when there is a perspective of a recession and the forecast of the policymaker is on how to minimize it. But one cannot rule it out that, not so much the fiscal stimulus, but the massive increase in money supply due to Fed actions, means accumulation of inflationary potential. This is only a potential. This is not something which has to be activated, but if we think about the long-run, then you should also think about that potential.

Steve Weisman: Pretend that you are the chief policymaker at the G-20. You’re concerned that this fiscal stimulus will, in effect, backfire if it’s too big and lead to a loss of confidence. What would you prescribe?

Leszek Balcerowicz: I think monetary easing, despite these potential inflationary consequences, this is being done. But we should remember that there are time lags. In every policy, there are time lags. There’s some time before you introduce, change policy stance and the effects. Sometimes, I have the impression that people have forgotten about time lags. One day they’re seeing a new initiative and they expect effects the next day, and when the stock exchange does not recover immediately, they demand more. But there are time lags.

Second, I think the forecast on the restructuring of the financial sector is correct while uncertain. I’m not discussing the specifics. There’s a lot of technical questions—whether one should emphasize additional capital in the banking sector or buying toxic assets. These are very important technical questions. But I am, at the moment, not going into them. But basically, trying to restructure the financial sector, given its tremendous importance for the whole economy, is the correct focus, and I think they should continue. Finally, automatic fiscal stimuli or stabilizers. We’re not questioning that to the extent, however, that countries can finance them. Recently, one could read in Financial Times that even Britain and Spain have problems with financing. Of course, investors look at fiscal situation of the sovereign countries.

Steve Weisman: It sounds like one thing that you’re counseling is patience.

Leszek Balcerowicz: I would think so. We should remember that’s a lot. There’s a massive intervention first, and second, given the amount of the size of the previous

bubble. Unfortunately, it is unavoidable that there are some consequences, so we cannot avoid all the consequences of the previous follies. But this has been accumulating over the years so the consequences can be mitigated to some extent by these massive interventions, but not eliminated altogether.

Steve Weisman: And it, therefore, might take another year or two or longer to recover.

Leszek Balcerowicz: That's right, but we should remember that according to the present forecast, there is nothing comparable to the Great Depression. The present forecast would say that there would be a decline in GDP in the United States in the order of below 1 percent, more or less. The same in the Euro Zone. But in the Great Depression, there was a decline in the United States by how much? By 30 percent to 40 percent, so that's a different story than that.

Steve Weisman: Leszek Balcerowicz, thank you very much for joining us today on Peterson Perspectives. It's been great to have you here.

Leszek Balcerowicz: Thank you very much.

