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Do stimulus packages work?

A FRIEND threw a tough question at me the other day (he obviously thought I had the answer to every economic problem in the world): 'Does a stimulus package really stimulate an economy?'

At that moment, I realised that I should have gone to Starbucks alone to enjoy my cafe mocha! But I answered him anyway - with the standard economist's reply: 'It depends.' (Of course, that annoyed him!)

Each stimulus package is different. President' Bush's recent package, for instance, emphasises abolishment of taxes on dividends and acceleration of income tax cuts. While it was argued that it might add about 0.4%-1% to GDP growth, the package has been highly criticised, for reasons that will be explained in the following paragraphs.

Malaysia's stimulus package on the other hand, will focus on projects with a short-term implementation period, according to Prime Minister Datuk Seri Dr Mahathir Mohamad. Nothing can be said about the possible impact of this package at this juncture as details have yet to be made known.

For the benefit of some readers, a stimulus package refers to an economic package put together by policy-makers to boost economic growth through either fiscal or monetary policy or both. Oops, let's go one step backward: fiscal policy deals with government spending and taxes, and is used to influence the level of aggregate demand and to change incentives facing firms and individuals so as to encourage or discourage particular forms of activity. Monetary policy is related to interest rate and the use of other monetary instruments.

Thus, a stimulus package can take the form of direct government spending or tax cut as well as monetary measures. But the key question is, why should the government intervene in the market system in the first place?

That brings us to economic history 101 where names like Adam Smith and John Maynard Keynes have to be thrown in. As a great economist of the 18th century, Smith's fame resides in his masterpiece, *The Wealth of Nations*, published in the year of US independence, 1776 - a book almost everyone who has studied economics has heard of and almost no one has read.

Smith is remembered for his concept of 'invisible hand', a connotation that describes the efficiency of the market system without any government intervention. The invisible hand or market forces will keep society on track, assuring that an economy produces the goods and services it needs.

Brilliant British economist Keynes, on the other hand, had a totally opposite argument. In his famous 1930's *The General Theory of Employment, Interest and Money* (again, a publication many have heard of but few have read), Keynes made it clear his stand for government intervention as a mean to stabilise economic conditions.

Public spending is needed to reflate an economy at a time when the private sector is unable to do so. Keynes' ideology was well accepted (at least until the stagflation period in the early 1970s) and became the thrust of US President Roosevelt's New Deal that brought the economy out of its depression.

MIT economist Lester Thurow says the popular acceptance of Keynes' idea is also related to other reasons: when an economy is in bad shape, policy-makers are pressured to provide a solution and not be seen as not doing anything.

Let us get back to the US stimulus package. First, the total package amounted to US\$670 billion, which will be spread over 10 years. The

biggest chunk consists of the abolishment of taxes on dividends (US\$20 billion for 2003 and US\$364 billion for 10 years), which was argued to benefit investors. Others include an increase in tax-credit per child from US\$600 to US\$1,000 (US\$35 billion for 2003 and US\$149 billion for 10 years) and a cut in the top individual tax rate from 38.6% to 35% from Jan 1, 2003 and a cut in withholding tax (US\$29 billion for 2003 and US\$64 billion for 10 years).

Okay, enough with numbers. What's the impact on the economy? Economists are estimating that the package will boost economic growth by 0.4% in 2003 and by about 1% in 2004. At the same time, the government hopes to create about 2.1 million jobs to replace the estimated 1.6 million that have been lost since the recession started in March 2001.

Sounds logical? Well, the US economy is currently supported by a strong growth of consumer spending which accounts for 2/3 of GDP (see Chart 1). If we just take a very crude estimation of US\$67 billion per year (from the US\$670 billion package for 10 years), and assume the amount will have a direct impact on consumer spending, the effect through private consumption is about 0.45%.

This is the possible impact on GDP if we assume the marginal propensity to consume or MPC equals 1, meaning that a typical American would spend everything he receives in his paycheck (an MPC is simply a proportion of disposable income that an individual will use for consumption).

So far things look good. However, the real problem of the US economy currently is the slow recovery of business investment spending, the key ingredient which will sustain the momentum of economic recovery. A clear indication can be seen from the amount of investment in equipment and software, which has recently managed to post a small positive growth after six consecutive quarters of contraction (see Chart 2). President Bush's package has been criticised for not being able to fulfil this objective.

The other criticism by the Democrats is related to the future amount of budget deficit, which is clearly underestimated by the Congressional Budget Office (CBO). The CBO is projecting a US\$145 billion deficit for the current fiscal year but in the first quarter which started on Oct 1, 2002 alone, the deficit ballooned to US\$109 billion.

The major argument is that a massive deficit will cause a rise in the long-term interest rate because of the need to finance the shortfall some time in the future. This would offset the effort by Fed chief Alan Greenspan to ensure a low level of borrowing cost, and would eventually lead to what economists term as 'crowding out' of private investment.

So, the answer is - and I repeat - 'it depends'. It will depend on consumers' reaction to low borrowing cost, whether mortgage refinancing will continue to increase, whether financing of the budget deficit will cause a rise in interest rate and so on.

However, the immediate effect will probably depend on whether a stimulus package is using fiscal or monetary policy to boost growth. Fiscal policy has a more direct impact because government spending, for instance, will quickly reach targeted sectors and generate the necessary multiplier effect in the economy. Using monetary policy, on the other hand, would mean that everything has to go through the process of alluring individuals and businesses through low interest rates. Interest rate can be lowered but nobody can force individuals or businesses to borrow if they don't want to.

As for Malaysia's stimulus package, the Prime Minister is aiming at accelerating existing projects as well as focusing on sustaining the strength of consumer spending. While no specific measures have been made known, some are speculating on measures such as allowing EPF withdrawals for the purchase of second homes, which may help the property sector and

result in higher consumption of property-related goods and services.

The only concern voiced by some quarters is whether such a package will be fully and quickly utilised. Some are pointing at last year's RM7.3 billion stimulus package and suggest that the government fully implement all the intended projects as fast as possible. This may be the real intention of the Prime Minister.

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