The Fiscal Package

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The Government of India has made a huge fiscal package to pull the economy out of recession. Increased demand from Government-funded schemes will make up for the decline in private demand. This policy is based on the experience of America during the Great Depression of the 1930s. The American economy was buoyant during the twenties. Share markets were in a bull run and the Government was following the policy of balanced budget. But this has been the same advice for the last 15 years of economic reforms— Government expenditures must be kept low so that confidence of private investors is secured and economy continues to move along.

The events of 1929 did not lead to such a happy result, however. The share market collapsed suddenly and factories downed their shutters. Economists proposed two contrary solutions to this crash. The mainstream advised the Government to hold on to the policy of balanced budget. They said that lower prices will soon generate new demand and the economy will revive. The deepening recession led to lesser revenues for the American Government which continued to reduce its expenditures in tandem. This policy led to further deepening of the recession. Lower prices in the market did not revive private demand and reduced Government expenditures did not help. The recession continued to get worse as a result.

Famed economist John Maynard Keynes suggested an exactly opposite policy. He reasoned that consumers were caught in a psychology of fear and were unwilling to increase spending. In normal conditions the expenditure of one person becomes income of another. The expenditure on purchase of potatoes by the homemaker becomes income for the farmer. Expenditure by the farmer for purchase of seeds becomes income for the seed companies. This virtuous circle of expenditure and income has got broken because people are not spending their income. The farmer is keeping his income in steel safe and not buying new-seed leading to less demand and recession. Keynes suggested that reduced Government expenditures were only making matters worse. The Government must instead increase expenditures by incurring fiscal deficit. Just as the mechanic pours water into the pump to prime it, and then the pump lifts much larger amounts of water, similarly the Government must 'pump-prime' the economy by jumpstarting the virtuous cycle of expenditure and income. Keynes said that it was okay for the Government to balance its budget in times of high growth. The opposite policy must be followed in times of recession. President Truman listened to Keynes' advice. He undertook massive investments in the Interstate Highway system. At the same time a huge demand for armaments was created though Government expenditures for the Second World War. Economists are generally welcoming the fiscal stimulus packages being made by governments across the globe on the basis of this happy experience.

This policy is unlikely to deliver for the developed countries like America in present circumstances. Instead it will push them into deeper darkness. The basis of this policy is that for some unknown reasons the consumers have developed a psychology of fear and are unwilling to make expenditures despite having the income. They are stacking their earned currency notes in the safes instead of going out and buying cars and TVs. But this is not the case in America at present. The American people are not keeping their earning in the safes, rather they have no earnings. Jobs of American workers are being lost to factories in China and BPO outfits in India. American people are being forced to live in cardboard boxes or back seats of their cars. Increased expenditures in building of infrastructure like airports will not bring about a virtuous cycle of expenditure and income in this situation. Instead the expenditures will simply go down like water in a dry well. There is no underlying demand in the economy which can be jumpstarted by such expenditures.

Question arises why a similar stimulus package was successful in pulling America out of recession in the thirties? In reality the Great Depression was broken not by the fiscal stimulus package advocated by Keynes but by the expenditures made by the US Government towards the Second World War. Military expenditures went into an overdrive in 1939. The fiscal stimulus package of 1937 onwards had a limited role of covering the bad patch of two or three years. Its role was like the UPS that keeps the computer going for a short period of power outage. These military expenditures made up for the loss of demand, which, truly speaking, came from bad distribution of income. The twenties saw the play of unbridled free market. Distribution of income became perverse. A handful of companies made huge profits while income of the masses remained stagnant. The correct solution was to repair this bad distribution of income. This was done indirectly by increase in war expenditures. It was like the American people consuming war instead of bread. The true story of the American recession, therefore, was like this. The free market led to bad distribution of income and reduced demand in the market. This lack of demand was broken by military expenditures. The fiscal stimulus package had a small positive role towards the beginning of the war. The fiscal package did not cure the main disease of bad distribution of income and was not truly responsible for pulling America out of recession.

India's situation today is different than America in the thirties or now. The recession in India is not due to lack of domestic expenditures. There is no fear phobia among Indian consumers. The recession is due to fleeing of foreign capital and due to contraction of export markets. This reduction of external demand can surely be made up by increase in Government expenditures provided the external demand bounces back in a short while. The fiscal package made by the Government of India is like a UPS system that can run the computer for a short while. A UPS cannot run the computer for days. Similarly the fiscal stimulus package can generate demand in the economy for a short while. Fortunately, there is a good chance that such a revival of foreign demand will indeed take place. Oil exporting countries may invest their petrodollars here. American companies may undertake more outsourcing to India in their effort to lower their cost of production. Wages in India are near the global minimum hence Indian products will continue to retain their competitive edge. The fiscal package announced by the Manmohan Singh Government, therefore, stands on sound footing. But there is a need for caution. The success of the package will depend upon restarting the virtuous cycle of expenditure and income. In other words the money should reach the common man. It will not do to make more highways if the demand from the common man is not revived. Thus the Government will do well to place more money in the hands of the common man than in the hands of highway contractors. □