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How should governments respond to economic crises?

Speech by Deputy Minister of Finance Nhlanhla Nene, MP
at the UKZN Faculty of Management Studies' Business Management Conference
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The present economic crisis has again brought to the fore economic arguments on how best government's should respond to economic crises. For some, the recent crisis also settled long-standing debates. Today, few economists would argue that governments should do nothing or that governments should not intervene to support economic activity. The debate mainly centres on what the appropriate sets of policies are to respond to a crisis.

This debate is complicated by two factors. Firstly, not all crises are the same. Some are induced by a shock to demand (such as a sharp fall in household spending) while others might be due to a supply side shock, such as a country running out of power. Different problems have different solutions. In the first instance, government's role is to increase spending to stimulate demand, in the latter case, government is best advised to take steps to slow consumption spending down to prevent blockages in network industries.

Secondly, economists are never quite sure how severe a downturn is likely to be or how long it is likely to last. The response to a severe and protracted downturn is different from the response to a mild slowdown. In a mild slowdown, policy makers are often advised to do nothing, to allow the automatic stabilisers to take effect and to allow inefficient industries to die while in a severe recession, government is often advised to stabilise the economy at all costs.

Let me start by turning to the literature. There are broadly two schools of thought on how government should respond to economic crises. The first school of thought, often referred to as the Austrian school was made famous by Joseph Schumpeter. This school argues that government intervention should be minimal because economic downturns are a natural way of forcing inefficient firms and industries to go under, releasing resources and skills to feed new industries that emerge from the ashes of the old. They argue that even though this adjustment is painful, in the long term economies recover faster and then grow more quickly because the allocation of resources punishes inefficient industries. While adjustments do not occur overnight, these adjustments are a necessary process. This process is referred to as creative destruction.

Karl Marx in his writings on dialectical materialism also spoke of the negation of the negation, a process by which new economic systems emerge from the ashes of the old, taking on board the best aspects but ditching what is inefficient.

Schumpeterian scholars argue that government intervention slows down this process of change and while it protects jobs today, it actually prevents new jobs from being created in other sectors. In the US, government has given large doses of support to the motor industry. Schumpeterian scholars argue that it is better to allow these firms to fail because then resources would either flow to more efficient motor manufacturers or ones that are more green or into public transport projects and so forth. Money has an opportunity cost and so spending to save today’s jobs in General Motors for example, means that resources are less likely to flow into other firms or competing industries.

Modern day Schumpeterians would argue that there is strong evidence to suggest that firm level productivity rarely changes but more productive firms grow faster and so aggregate productivity growth in an economy occurs by inefficient firms going out of business, not by everyone raising their productivity levels at the same time. They would argue that today's bailouts of the banks and motor manufacturers would merely postpone a painful economic adjustment, to a world less reliant on finance and less reliant on big, gas-guzzling motor vehicles. Schumpeterians would argue that it was the fiscal and monetary stimuli after the dot-com bubble in 2001 that gave rise to the excess lending in the US that led to the sub-prime crisis and the eventual collapse of large parts of the financial system. Lastly, ladies and gentlemen, the adherents of this school of thought would argue that today's robust response to the economic crisis is merely postponing an even larger crash and an even more painful adjustment, especially for the US economy.

The opposite school of thought is most closely associated with John Maynard Keynes. Keynesians argue that government must respond robustly to severe economic shocks because the damage that such shocks have on real economies would take years if not decades to repair. They argue that the creative destruction argued by Schumpeterians not only affects inefficient producers but too many other people too, even if these are in efficient firms. For example, a canteen operating outside a car plant might be a very efficient firm but would be forced to close down and retrench people if the car plant collapses. The suppliers to this canteen would then also be forced to scale back and so forth. The knock-on effects of the crisis would affect too large a proportion of the population, damaging household savings, the skills of workers, societies and communities.

Keynesians acknowledge that some jobs must be lost and that some firms will go under. Nevertheless, they argue that government should support demand because too large a fall in demand would do more than just weed out inefficient firms. It would hurt capacity permanently.

Higher government spending financed by borrowings will help stimulate demand for goods and services, helping to keep some sectors and businesses afloat. The most successful form of stimulus spending is infrastructure projects because they have both short and longer term benefits and these projects can be curtailed if economic activity picks up. Higher wages increase demand but they are also a permanent step change in public spending meaning that either taxes would have to rise or spending would have to be cut at some point in the future. Both prospects reduce economic activity going forward.

The economic theory around which Keynesians argue their point is that in a recession, people stop spending and consuming and so the economy has greater capacity to produce than there is demand and therefore demand needs to be increased.

Today, the Keynesian school of thought is in ascendancy. However, it must be noted that there is some truth in both schools of thought and that extreme arguments on both sides are often wrong. Secondly, it should be noted that relying too heavily on government to support demand can only be a short term intervention. If done for too long, public debt would rise to unsustainable levels, imposing a harsh cost on the next generation. Thirdly, higher government spending often goes to sectors that shout the loudest rather than the most worthy. Fourthly, in small open economies, such as our own, higher government spending could simply result in increased imports rather than higher domestic production.

The key lessons from this crisis are the following:

- Government has a strong role to play in stabilising the economy, through its use of fiscal and monetary policy as well as through the regulation of the financial sector
- Countries should take steps to protect jobs through various policy measures
- Having a low debt to GDP ratio going into a crisis is a huge advantage
- Governments should use the crisis to correct structural weaknesses in the economy including stepping up investment and skills development

- Having a sound social security net that is able to cushion individuals during a crisis is essential for economic and social stability.

Many of these lessons are contained in our Framework agreement in response to the economic crisis, developed under the guidance of NEDLAC.

Ladies and gentlemen, allow me to turn to some of the analysis of the present crisis and what policy considerations occupy the minds of South Africa’s policy-makers.

It is appropriate for government to increase borrowings to sustain public spending and to raise investment, but it must be able to reduce its borrowings when the economy recovers. This implies that increases in spending must be on items that can be reversed when the economy shows signs of recovery. Tax revenue is seen as an automatic stabiliser that falls during a recession and then recovers as profitability returns.

Deficits rise during a recession, leading to higher levels of debt. If debt levels rise too much, then borrowing costs for government goes up, leading to a rising interest burden going forward. Higher interest costs require either cuts to spending or higher taxes, both which may be negative for the economy.

And so while it is appropriate for government to increase their deficits during a crisis, it must present a credible path back to a sustainable budget balance after the crisis has ended. Failure to do so would mean lower growth for many years after the crisis has ended.

In our case, we have generally done the right things. We have allowed revenue to fall and we have borrowed to protect public spending. We have also been able to increase investment during this recession, something that would benefit the economy for generations to come.

However, it is also true that we have increased spending on permanent programmes such as salaries, social grants and transfers to municipalities. A permanent change in spending in one area has to be offset by either lower spending in other areas or by tax increases. This highlights the importance of us finding money within our budget to fund both the priorities and these pressures.

Government is embarking on a deep and far reaching savings and reprioritisation exercise. In phase one, we have been able to find about R14.5 billion at national level and about R12.6 billion a provincial level. We need to look closely at how we spend our money, how we procure, whether we employ the right people and whether there are alternative ways to deliver a particular service.

While government should support sectors and firms to ride out a cyclical downturn, this must not be at the expense of newer, more efficient firms and sectors to emerge from the ashes of the old. It is often better to put in place proper unemployment insurance benefits and to offer skills development than to support businesses that do not have a long term chance of succeeding. The training lay-off scheme developed in terms of our framework agreement is an example of this principle.

Ladies and gentlemen, in conclusion, I wish to leave you with a simple thought that we’ve repeated often in the past few weeks. This crisis presents us with an opportunity. Our two imperatives are to increase employment and to improve the quality of public services. What are you going to do differently from tomorrow to see these objectives being realised?