

Contemplating the Appropriate Role of the State in Crisis Resolution

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As the global meltdown has prompted many countries to implement policy measures of an unprecedented scale to stabilise their economies, there are increasing concerns that healing today's wounds could leave long-lasting scars. Indeed, as countries attempt to boost domestic demand to reduce recessionary impacts from the global demand contraction, two potentially adverse legacies of today's policies are: (1) greater trade and financial protectionism worldwide and (2) excessive government debt build-up as a result of exceptionally large fiscal stimuli.

Fear of potentially greater trade protectionism to safeguard domestic demand during this crisis period is a valid one. The domino effect of trade protectionism could restrict the potential recovery of world trade, which is necessary for sustaining any global economic recovery over the medium term. Moreover, there could also be a rise of financial protectionism, such as increasing aversion of local investors to investing in instruments issued in other countries. This could lead to deterioration in global financing flows.

Turning to fiscal sustainability, there are two important related issues. First is the source of deficit financing. For the US economy, it is plausible to consider capital inflows coming in to finance the deficit as long as private investors and central banks from other parts of the world are willing to hold the US dollar as an asset. On the contrary, smaller economies, particularly emerging markets and developing economies, will likely finance their fiscal-stimulus packages by domestic borrowing, because capital inflows may be moderate and volatile.

Excessive borrowing by the government today, together with the return to domestic funding by big-name borrowers who previously sought funding abroad, could potentially crowd out funding sources for the private sector in the future. Over a longer horizon, it is possible that the rolling over of government funds could be very large. A pertinent question to ask early on is what is the exit strategy from this present fiscal expansionary phase?

In a number of economies, expansionary fiscal spending has also been used to support the solvency of the private sector, particularly in recapitalizing commercial banks. The unprecedented scale of the state's role raises new questions on how asset prices can impact

governments' future operations in these countries. Conversely, there is also a question of how much and when these governments should unwind their asset positions, and the implications of this for asset prices.

I raise these points to highlight the need to think about the appropriate role of the state in economic crisis management. Recently I heard a very wise guru saying that one should look at the role of the state as "the enabling state" versus "the intervening state". Whereas the former role is welcomed for crisis resolution and correcting market imperfections, the latter role could distort the market mechanism already present after the present crisis has been resolved. My fear is that it is a very thin line dividing the two roles and there is a danger of slipping from the former to the latter role unknowingly.

Views expressed are the author's own.

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