

THE ROLE OF FINANCIAL RISKS IN ASSESSING AND OPTIMIZING THE IMPACT OF GOVERNMENT SPENDING ON ECONOMIC GROWTH

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Annotation: This thesis examines, from a theoretical perspective, how financial risks shape the assessment and optimization of government spending's effect on economic growth in developing countries. It argues that while public expenditure on infrastructure, health, and education can raise both short-run demand and long-run productive capacity, three financial risks debt sustainability, inflation, and contingent liabilities substantially condition the size and direction of fiscal multipliers. High and growing public debt narrows fiscal space, raises borrowing costs, and can reduce or reverse the growth impact of additional spending. Inflation, whether driven by monetary financing or capacity constraints, erodes the real value and effectiveness of public investment and raises uncertainty for private investors. Contingent liabilities (guarantees, bailouts, PPP commitments) represent hidden fiscal exposures that can abruptly raise public debt and crowd out development spending. The thesis synthesizes theoretical frameworks (Keynesian demand management and endogenous growth models) with institutional guidance from the IMF and World Bank (Debt Sustainability Framework and fiscal-risk best practices), and concludes that optimizing fiscal policy in developing economies requires careful composition of spending, medium-term fiscal frameworks, explicit fiscal risk management, and strong institutions to preserve both growth and macro-financial stability.

Keywords: Fiscal policy, debt sustainability, inflation risk, contingent liabilities, government spending multiplier, economic growth, developing economies, fiscal space.

Government spending can play a crucial role in promoting economic growth, especially in developing countries where infrastructure, education, and health deficits are large. By directly adding to aggregate demand or by building productive capacity, fiscal expansions are often used to jump-start growth and development. However, the financial risks associated with such spending have heightened importance in emerging and low-income economies. Rapid credit accumulation or spending surges can lead to unsustainable debt, fuel inflation, or entail hidden obligations (contingent liabilities) that undermine long-run stability. Developing countries typically have limited fiscal buffers, weaker institutions, and greater exposure to external shocks, making them particularly vulnerable to these risks.

This thesis analyses, from a theoretical perspective, how debt sustainability, inflation, and contingent liabilities affect the assessment and optimization of government spending's impact on growth. In other words, we explore how these risks influence both the measurement of fiscal multipliers and the choice of optimal spending policies. We draw on economic theory (Keynesian demand management, neoclassical growth, fiscal multiplier literature), as well as perspectives from the IMF and World Bank. These institutions provide practical frameworks – such as the IMF–World Bank Debt Sustainability Framework (DSF) – that embody theoretical insights in policy advice. The analysis clarifies the mechanisms by which financial risks can dampen or distort the growth benefits of public spending, and outlines policy implications for developing-country governments seeking to balance growth objectives with fiscal prudence.

Theoretical Foundations: Fiscal Policy and Growth

The impact of government spending on economic growth is classically modelled in macroeconomics via fiscal multipliers and growth models. In Keynesian demand-driven frameworks, an increase in government expenditure raises aggregate output directly and indirectly through induced consumption and investment. The multiplier ($\Delta\text{GDP}/\Delta\text{G}$) depends on leakages: higher if spending is domestic and targeted to high-propensity-to-consumer groups, lower if the economy is open (imports leak demand) or if monetary policy tightens. Empirical estimates suggest positive but modest multipliers in developing countries (e.g. one-year multiplier ≈ 0.4), reflecting often limited absorptive capacity. In endogenous-growth models, public spending on infrastructure, human capital, or technology can enhance productivity and the economy's steady-state growth rate (Barro, 1990). This “supply-side” channel means composition matters: capital and health/education expenditures can raise long-run output, whereas purely transfer-type spending may have smaller effects. However, expanding spending often requires financing via taxes or debt, which can crowd out private investment. In neoclassical theories, higher government borrowing may push up interest rates (especially if capital markets are shallow) and reduce private capital formation. In developing countries, crowding-out can be acute due to smaller financial markets, but in slack economies or where credit demand is low, public spending can sometimes “crowd in” by boosting demand and confidence. Crucially, these frameworks assume fiscal policy has no or limited adverse side-effects. Introducing financial risks modifies these predictions. If public debt rises too far, or inflation soars, the net multiplier can shrink or even become negative. Below we examine each risk factor in turn.

Debt Sustainability and Fiscal Multipliers

Debt sustainability means that a country's debt can be serviced without undue future adjustments or crises. When debt is low and growth prospects are strong,

governments have “fiscal space” to finance spending that boosts growth. The IMF–World Bank Debt Sustainability Framework (DSF) formalizes this by assigning countries to debt-carrying-capacity categories (“strong/medium/weak”) and setting indicative debt thresholds. For example, the DSF suggests that in strong performers the present value of public debt can be up to about 70% of GDP (vs. ~35% for weak performers) without triggering high risk. These thresholds embed theoretical ideas that beyond certain debt levels, returns from additional debt-financed spending are outweighed by the costs. Theoretical channels through which high debt undermines growth include: crowding out (as mentioned above); increased interest costs (reducing resources for productive spending); and risks of a fiscal crisis or default. If markets doubt a country's solvency, interest rate spreads rise and private investment falls. The multiplier literature acknowledges that “multipliers can be small or even negative if the expansion raises concerns about sustainability”. In other words, if a fiscal expansion signal mounting future deficit, private agents may react by saving more or moving assets offshore, offsetting the stimulus. Debt also affects the assessment of spending. When debt is high, a given increase in spending should be discounted more heavily in growth projections because it may induce deleterious side effects. For optimization, governments must then target the composition of spending to maximize returns per debt unit. For instance, financing long-lived infrastructure (with high social returns) might be justified even at higher debt, whereas current consumption spending might be curtailed if debt is already large. Empirical studies suggest non-linear debt–growth links, with growth turning negative past thresholds (roughly 60–90% of GDP in many estimates. This aligns with the IMF view that deficits “too large and linger too long” can undermine confidence. Indeed, the IMF advocates that stimulus be temporary and offset by fiscal consolidation later. The policy implication is that debt sustainability constraints limit how much and how quickly developing-country governments can expand spending. In practice, medium-term fiscal frameworks and debt rules (as often recommended by the World Bank/IMF) embody these constraints, linking spending plans to sustainable debt paths.

Inflation and Fiscal Policy

Inflation is both a risk factor and an outcome of fiscal expansions. Theoretically, an expansionary fiscal stance can be inflationary if the economy is near full capacity or if monetized. In many developing countries, persistent inflation often reflects a mix of factors, including supply shocks (food, energy) and structural rigidities, but excessive deficits can exacerbate inflation through monetary financing or by fuelling demand beyond the economy's real output capacity. High inflation undermines fiscal spending's growth effect through several channels. First, inflation erodes the real value of public investment: if projects are priced in nominal terms, rising costs can dilute real capital stock. Second, inflation tends to raise nominal interest rates (through inflation

risk premia or tight monetary policy to curb prices), increasing the cost of new debt. Third, inflation introduces uncertainty: volatile prices can deter private investment and distort resource allocation. Empirical evidence underscores this interplay: IMF staff find that fiscal consolidation strongly helps tame inflation – for example, cutting expenditure by 1% of GDP (over time) can reduce inflation by about 0.5 percentage points. Conversely, unchecked spending can contribute to inflationary pressure.

There is a subtle trade-off where inflation can momentarily reduce debt burdens: “unexpected inflation... erodes the real value of government debt” (each 1 pp surprise inflation can cut the debt/GDP ratio by roughly 0.6 pp if debt is high). However, this is not a free lunch: inflation must be unexpected, and persistent inflation eventually raises nominal payments and risk premium, nullifying the benefit. Moreover, relying on inflation to ease debt simply shifts burden to creditors and often leads to higher long-run inflation. In terms of optimization, high inflation risk means governments should be wary of large deficits financed by central bank money creation. The need for price stability can impose an implicit budget constraint: if the central bank resists financing deficits, higher deficits may force interest hikes that choke off growth. Thus, public spending plans must respect inflation targets or bounds. The IMF emphasizes coordination: “fiscal tightening makes it possible to increase interest rates by less to contain inflation”, implying that fiscal discipline eases monetary policy and supports growth stability. In developing countries, this often translates into adhering to inflation-adjusted fiscal rules or prioritizing expenditures with less short-run inflation impact (e.g., social transfers with indexation rather than unproductive subsidies).

Contingent Liabilities and Fiscal Risk

Contingent liabilities are potential government obligations triggered by future events (e.g. bank failures, PPP guarantees, or natural disasters). They are a form of hidden debt: not recorded in standard budget deficits until realized, but capable of abruptly raising public indebtedness. Theory and past crises show that contingent liabilities pose serious fiscal risks. If a government is forced to honour large guarantees or bail out failing entities, its debt may jump suddenly, undermining growth prospects and fiscal credibility. From a theoretical standpoint, contingent liabilities affect both assessment and optimization of spending. In assessment, unaccounted contingent obligations mean that apparent fiscal space is overstated. A government might budget for ambitious growth-promoting projects, only to have its funds diverted to service a realized guarantee. The IMF and World Bank stress this risk: Polackova (1999) notes that “sizable hidden fiscal risks may arise from contingent forms of government support”, encouraging institutions to incorporate these risks in sustainability analysis. Modern practice (e.g. IMF Article IV consultations) often includes a fiscal risk statement quantifying likely contingent obligations. The cost of contingent liabilities can be large. An IMF working paper (Bova et al. 2016) finds that when such liabilities

materialize, they impose an average fiscal cost of about 6% of GDP (up to 40% for major banking bailouts). Crucially, such shocks tend to occur during crises or growth reversals, exacerbating downturns and crowding out countercyclical fiscal support. In optimizing spending, governments therefore should strengthen institutions (better regulation of banks and SOEs, clear rules on guarantees) to keep contingent risks low. They may also hold fiscal reserves or insurance buffers. The World Bank advocates fully recognizing and disclosing fiscal risks: countries should “incorporate contingent liabilities into their analytical, policy, and institutional public finance frameworks” and “disclose information regarding their exposure”.

In effect, contingent liabilities shrink effective fiscal space: two countries with identical debt ratios may face very different risks if one has large undisclosed guarantees. For developing economies, where financial sectors and SOEs are often less robust, this is especially critical. Optimal fiscal planning must therefore be conservative, possibly limiting new projects to those with clearly identified funding and low spill over risks. If a project (say a public-private highway) carries substantial state guarantees, its expected social return must be weighed against the potential future debt it could induce.

Conclusion

This theoretical analysis emphasizes that government spending's effect on economic growth in developing countries cannot be assessed in isolation from financial risks. Debt sustainability, inflation, and contingent liabilities each alter the calculus of fiscal multipliers and dictate how fiscal policy should be conducted. High debt reduces the growth impact of spending even turning it negative if investors lose confidence and forces governments to commit to medium-term consolidation. Inflation risk means fiscal expansions must be balanced against price stability goals; evidence suggests that spending cuts can significantly reduce inflation, so unchecked deficits may erode public investment effectiveness. Contingent liabilities impose hidden constraints on fiscal policy, as their implementation can abruptly raise debt burdens. For policy, the implications are clear: optimizing growth-enhancing spending requires strong fiscal frameworks. Developing countries should follow IMF/World Bank guidance by conducting regular Debt Sustainability Analyses (tailored to their capacity), enforcing fiscal rules that cap deficits and debt, and maintaining explicit reserves or contingency plans. Careful composition matters: prioritize high-return, multi-generational investments (infrastructure, human capital) while phasing out low-productivity expenditures if fiscal space is limited. Institutions should be strengthened to identify and manage contingent risks – through transparency of government guarantees and prudent oversight of state-owned entities. Finally, coordination with monetary policy is essential: to avoid inflationary spiral, fiscal stimulus should be paired with credible inflation targets and, if necessary, offsetting policies later. Further research could

develop richer models that integrate these financial risks endogenously. For example, extending growth models to incorporate fiscal crises triggered by debt or contingent shocks would improve our understanding of nonlinear dynamics. Empirically, more work is needed to quantify contingent liabilities in low-income settings and to estimate how inflation and debt thresholds vary across country contexts. As developing economies navigate limited resources and lofty development goals, combining theoretical insights with robust data will be crucial for designing fiscally sound growth strategies.

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