Deficits, debts and politics: Some Lessons from Latin America

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May 2021

Road Map

1. Fiscal policy in emerging market economies: the issues

2. Chile´s experience with fiscal rules

3. Recent developments: the Covid-19 crisis

4. What are the limits to fiscal expansion today?

5. Fiscal space and its limits: the case of Brazil

The basic problem

"The economic history of Latin America is littered with the corpses of commodity booms that ended in disaster"

(C. Díaz-Alejandro, 1982)

Fiscal policy in commodity-rich emerging markets: the problems

- Deficit bias and debt
- Procylicality
- Important caveat: this is not about the size of the state!

Deficit Bias

- Drop in government net assets even when standard smoothing considerations suggest the opposite
- Consequence: inefficiently high debt

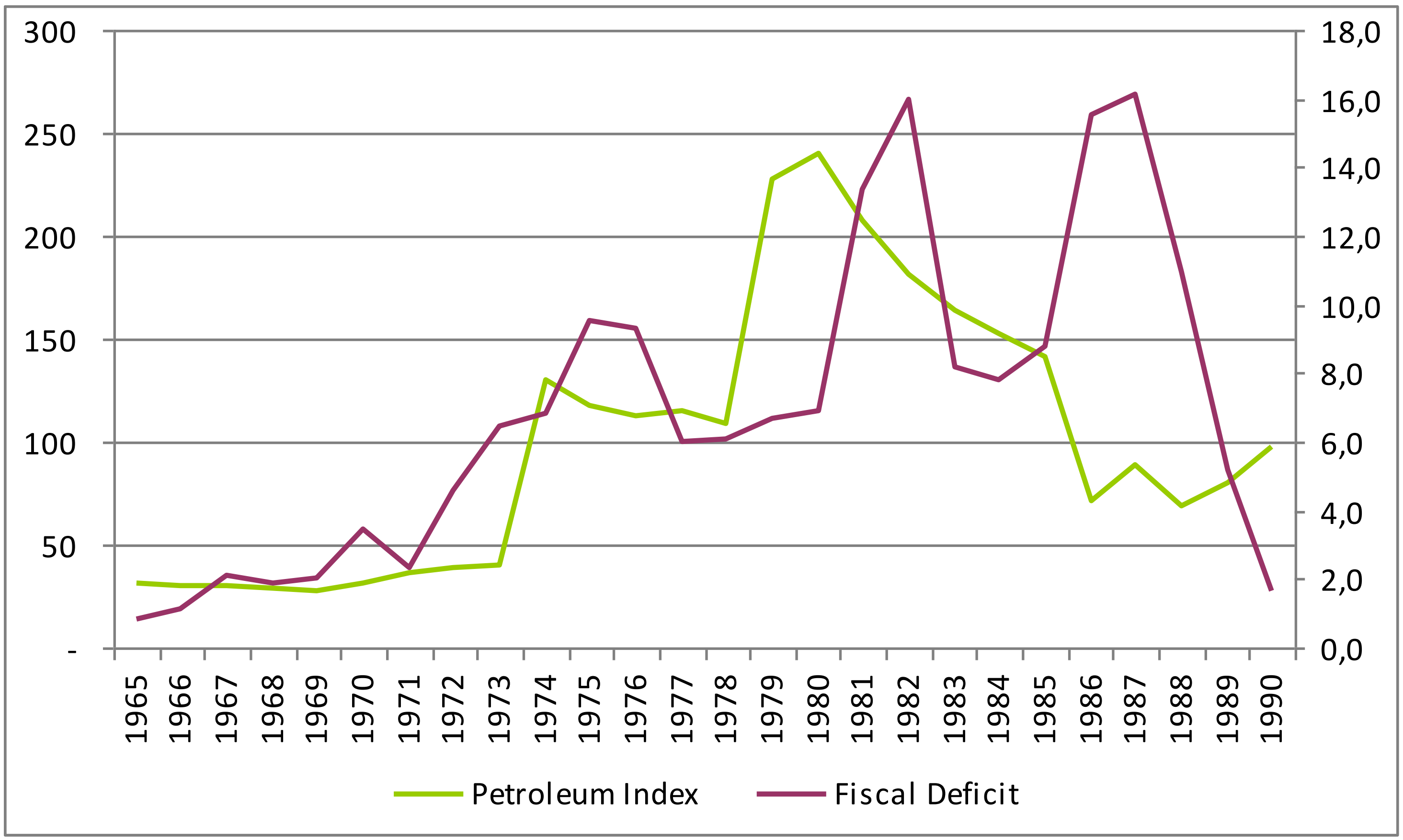
Procyclicality

- Conventional wisdom: save in booms and dis-save in recessions
- Reality: save too little in booms or even dis-save

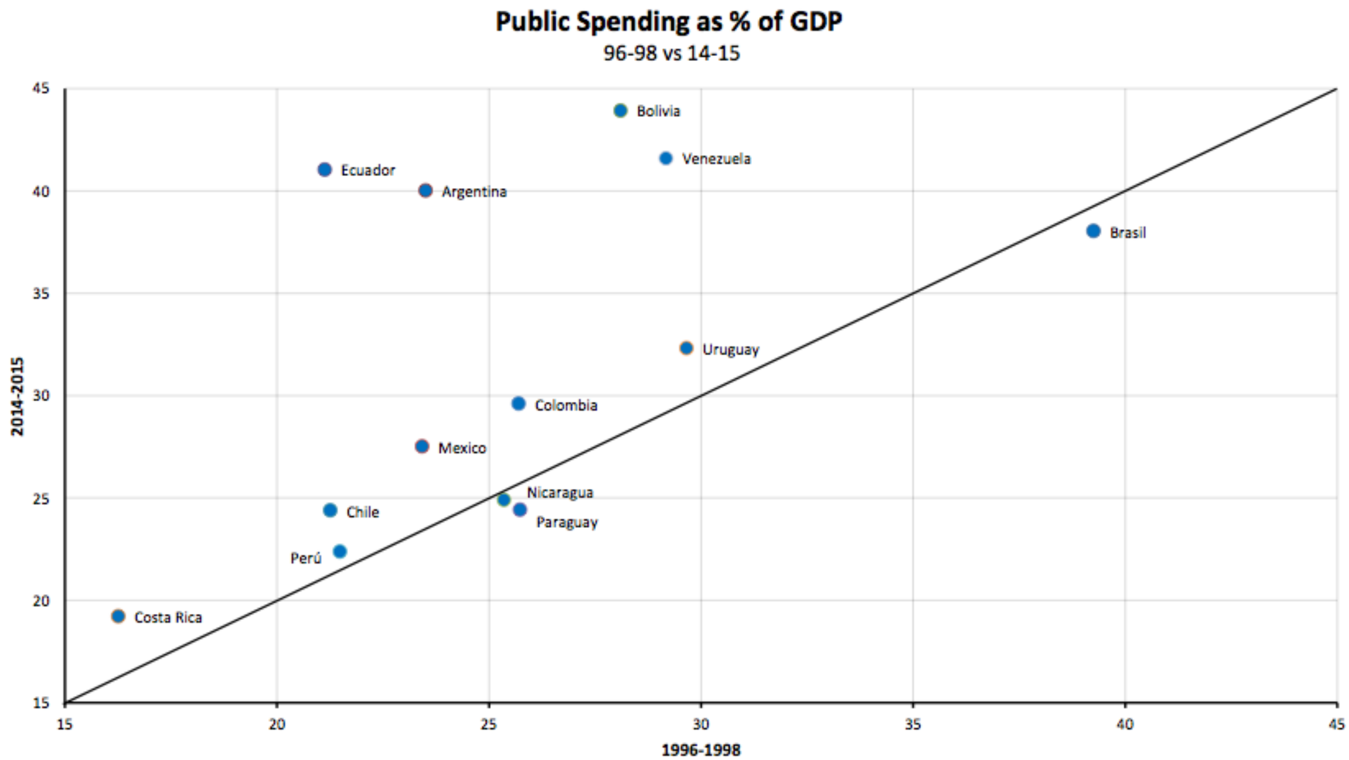
Procyclicality among commodity exporters

- Commodity-linked revenues (taxes, royalties, profits) can be a large portion of government revenue.
- Commodity price volatility is large
- International capital flows are also procyclical: borrowing constraints are relaxed during booms.

Mexico in the 1970s: extreme example of procyclicality



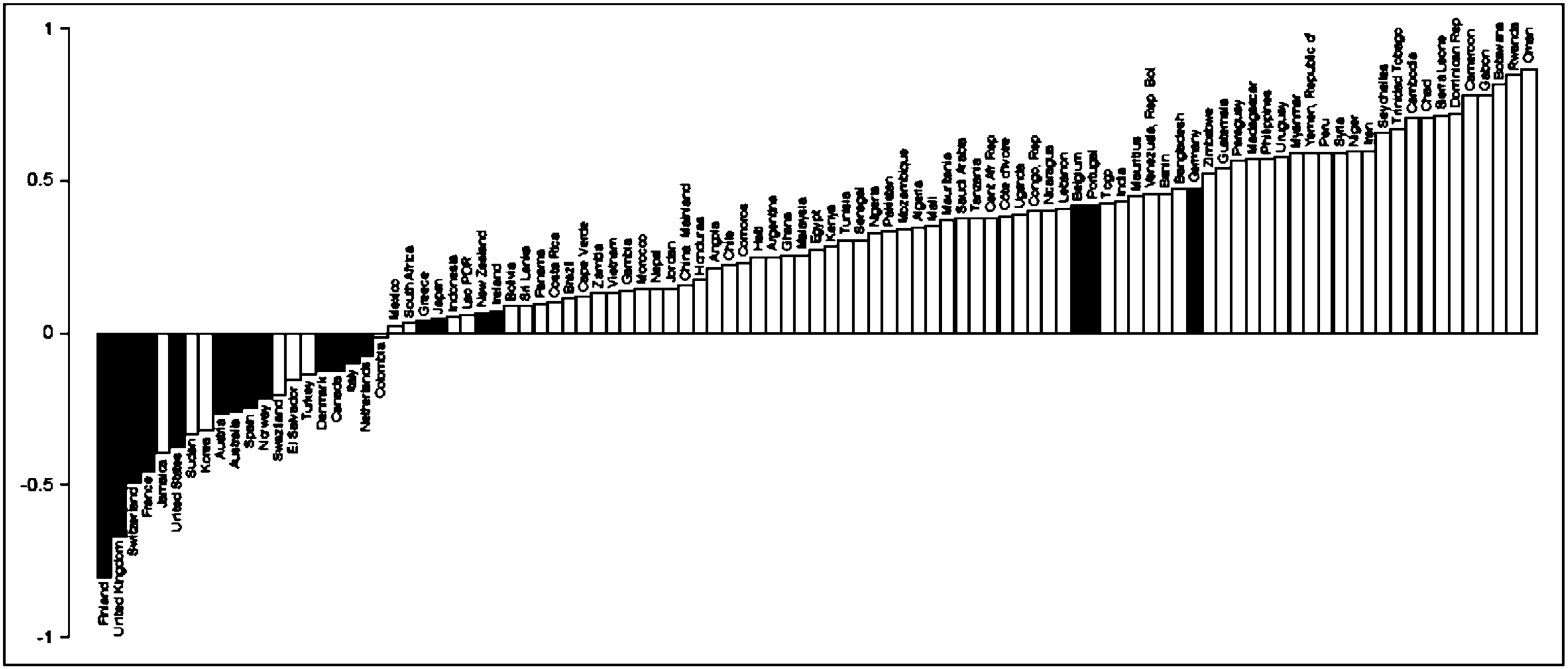
But not just in Mexico…



Fuente: World Economic Outlook, Oct 2017

And not just in Latin America…

Correlations between Government Spending and GDP (1960-2010)



Why fiscal procyclicality?

- Economic story: borrowing constraints are relaxed in good times, bind in bad times
- Political story: the voracity effect: political game becomes more intense (and yields more spending) in good times
- Exchange rate regime matters: flexible rates provide more discipline

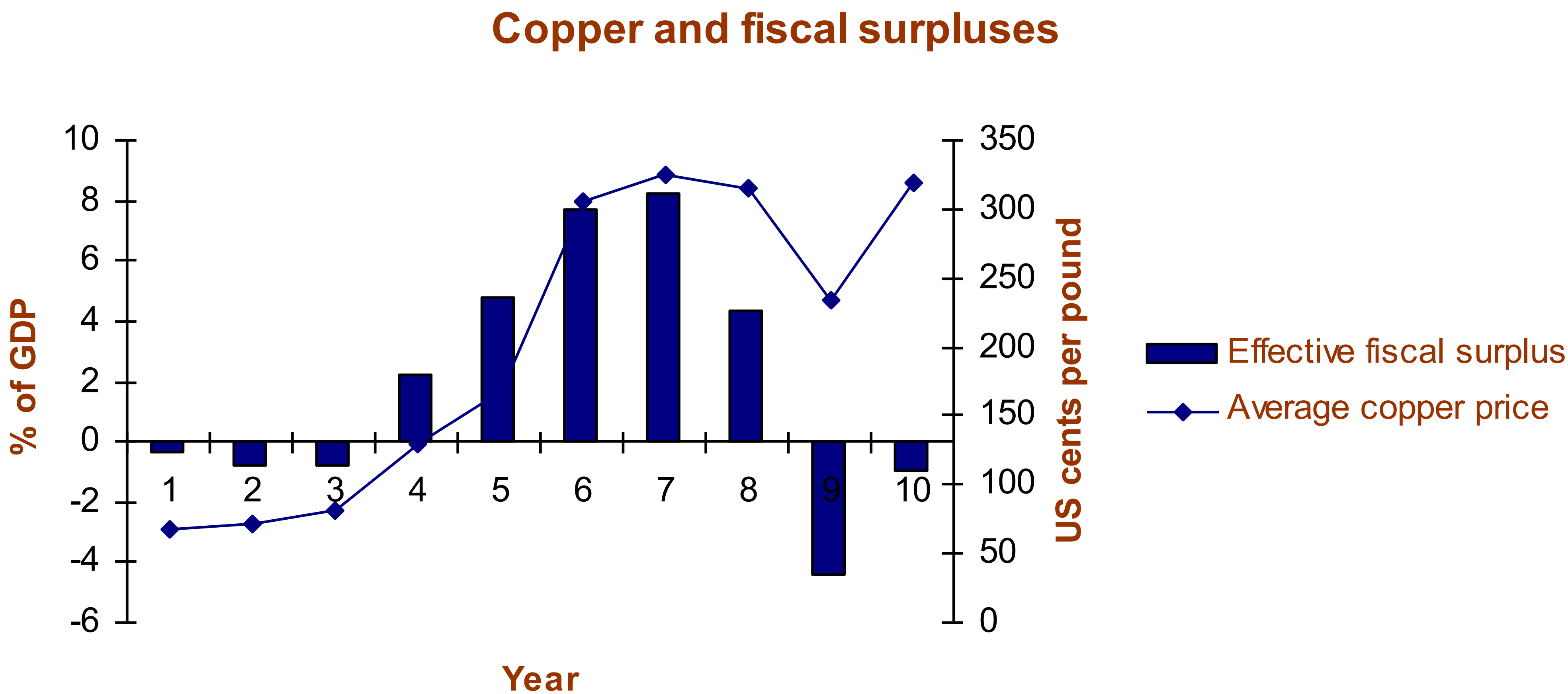
Deficit bias and procyclicality: what can you do?

- One possibility: adopt fiscal rule that guides expenditure over long horizons, and constraints its over the cycle
- Chile did that starting in 2001, and took further steps in 2006
- Rule in operation (though not fully during Covid-19 crisis) until now

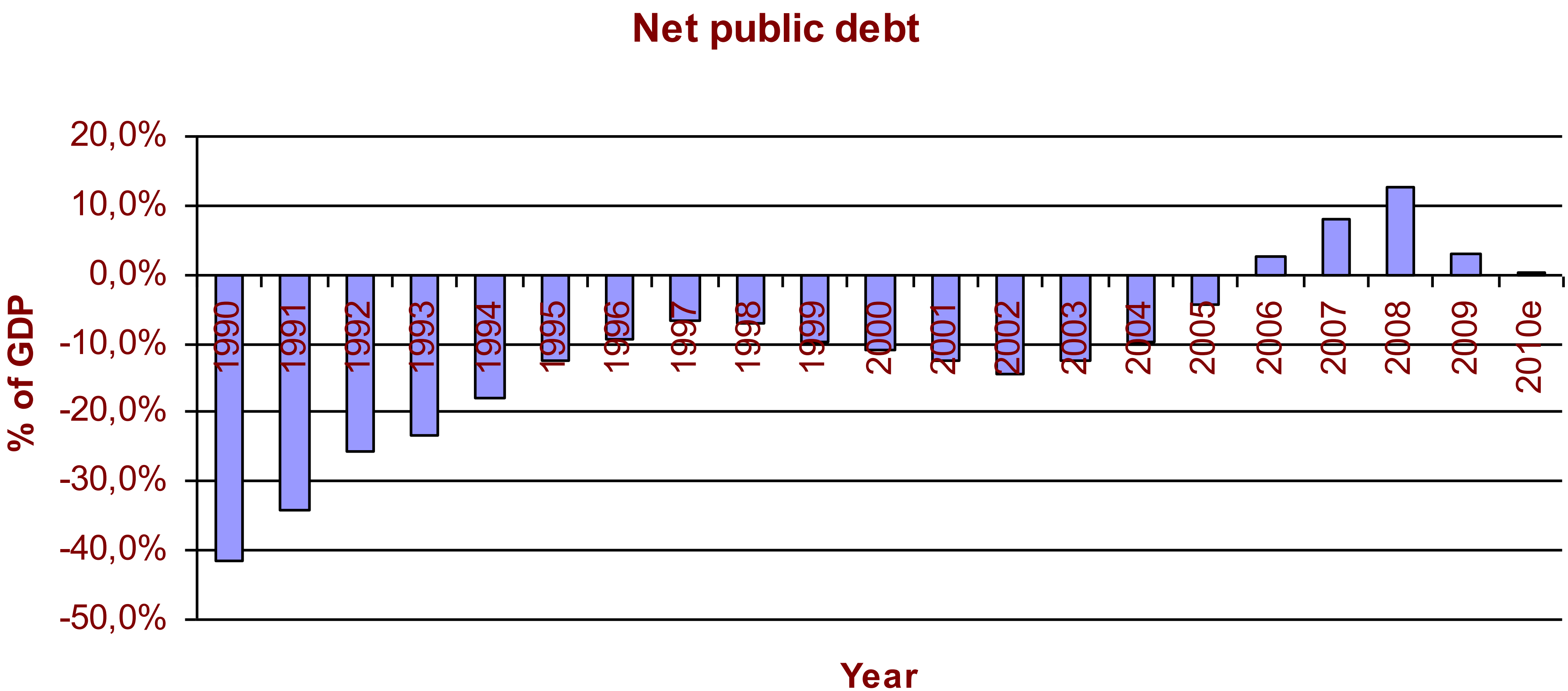
Dealing with flows: the structural balance approach

- Come up with parameters for cyclical adjustment using independent committees
  - Copper
  - Trend GDP growth
- Apply cyclical adjustment methodology: close to OECD procedure
- Arrive at estimate of “structural” or long-term income
- Spend X% of GDP less than long term income

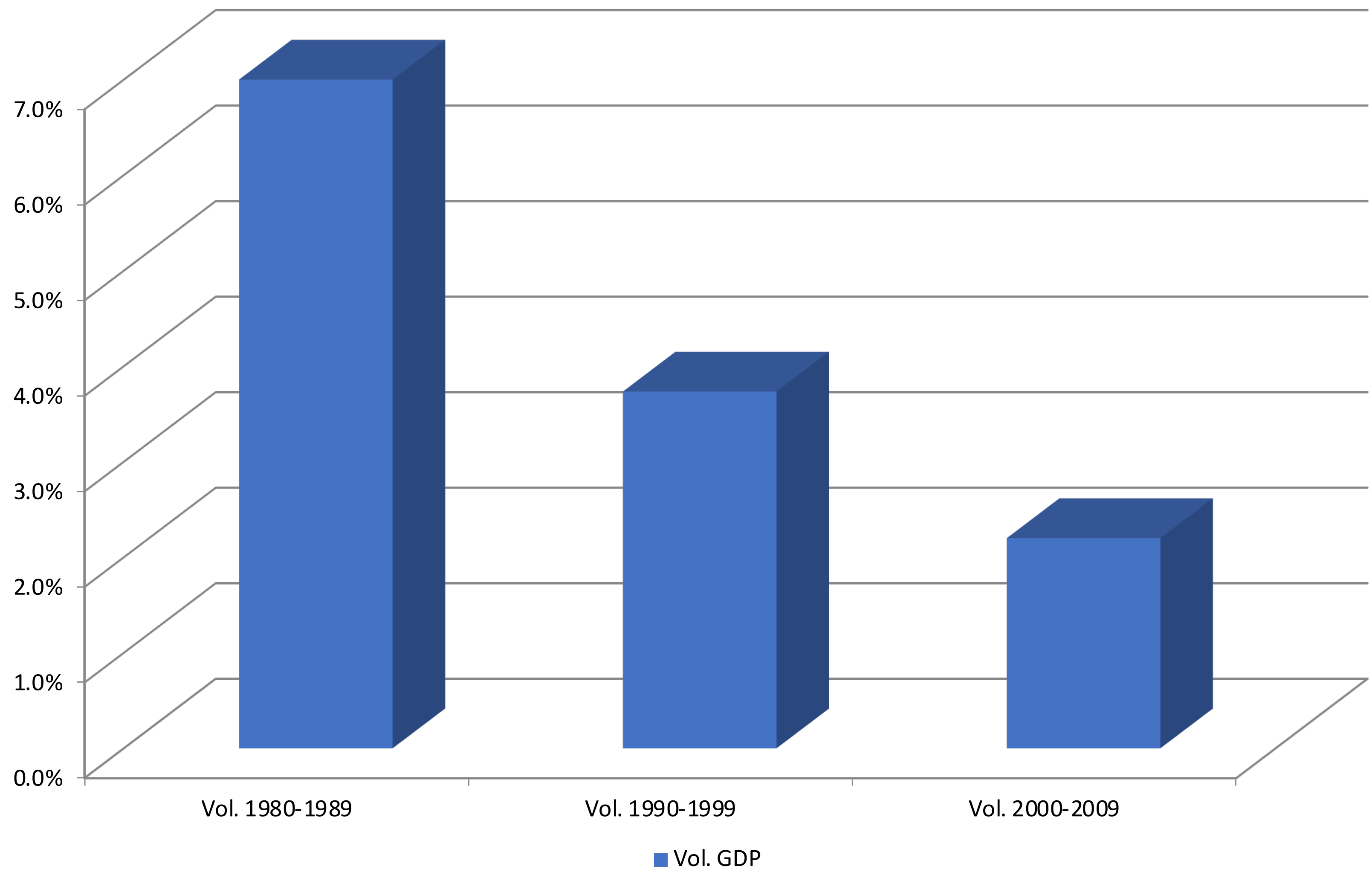
The end of procyclicality?



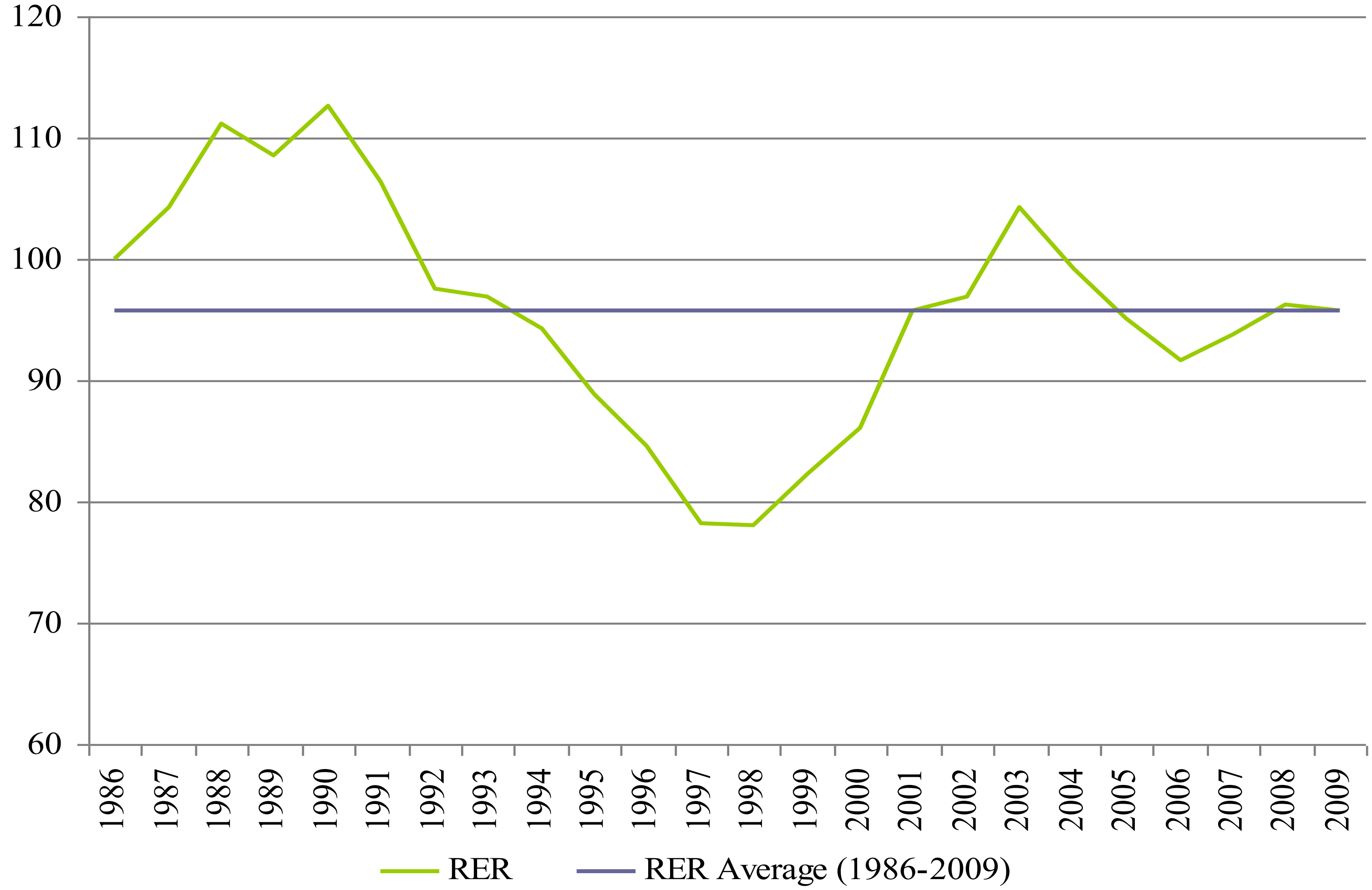
Public debt: far away from Europe



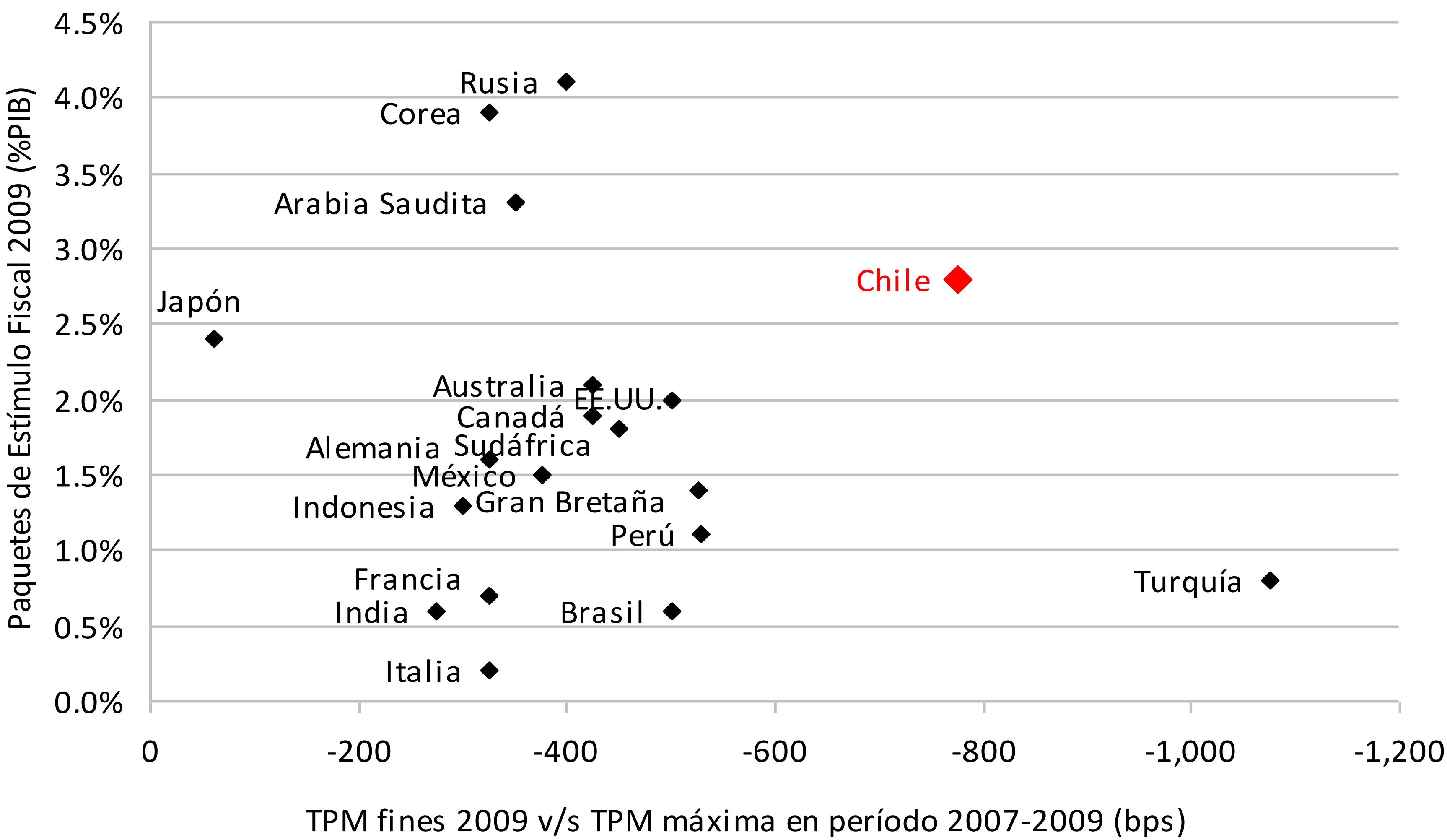
Falling output volatility



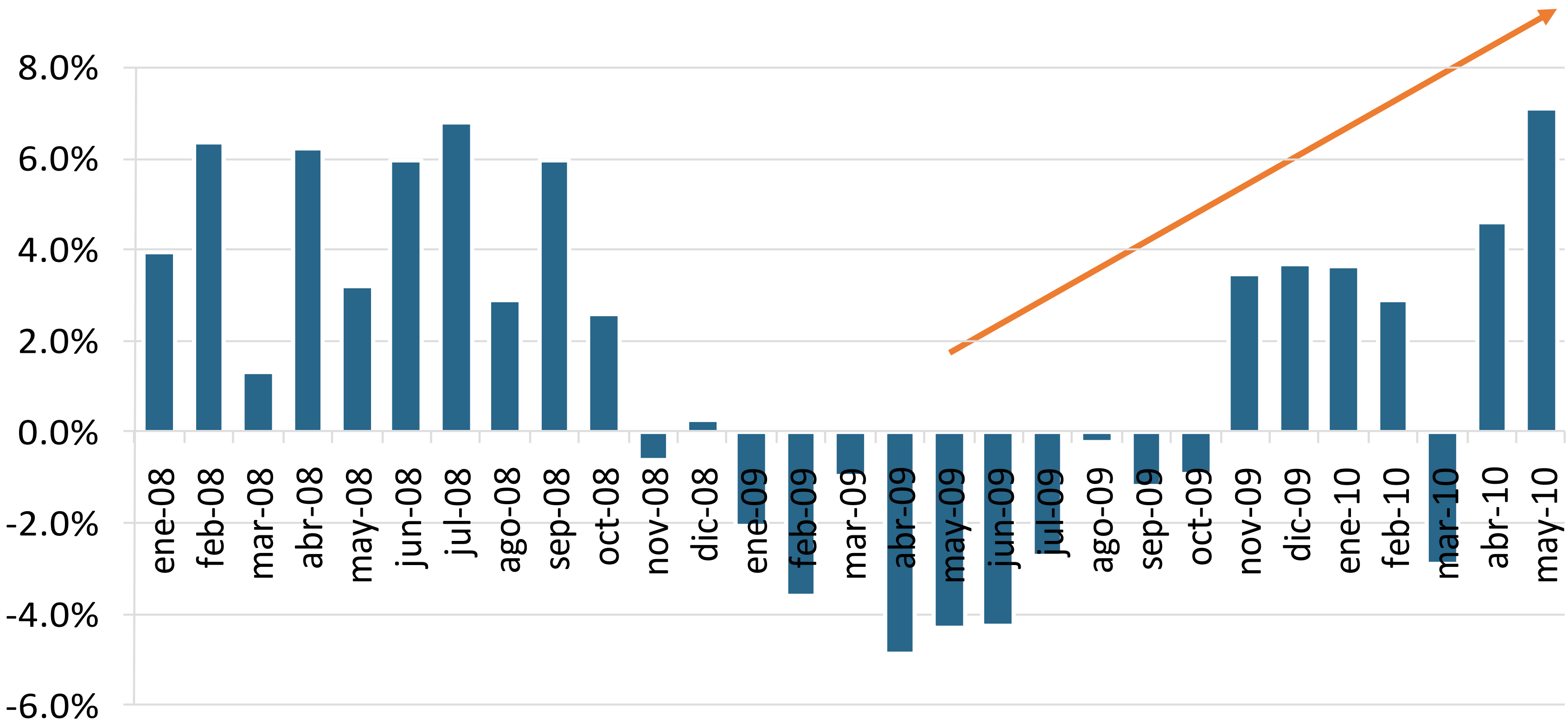
Avoiding Dutch disease



Stimulus during the GFC



Quick recovery from the GFC

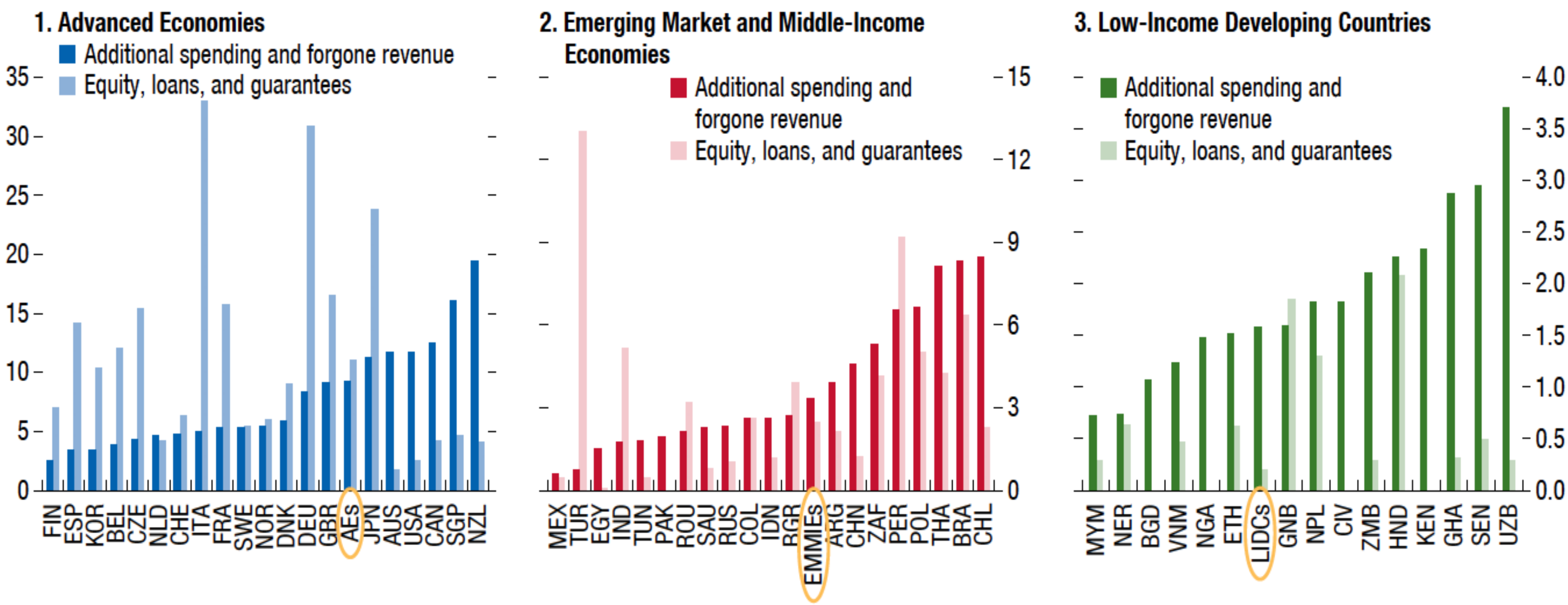


Fiscal rules: lessons from Chile

- Political economy
  - Ministers
  - Provinces and regions
- Keep it simple
- Crises and escape clauses
- Who should administer the rule?

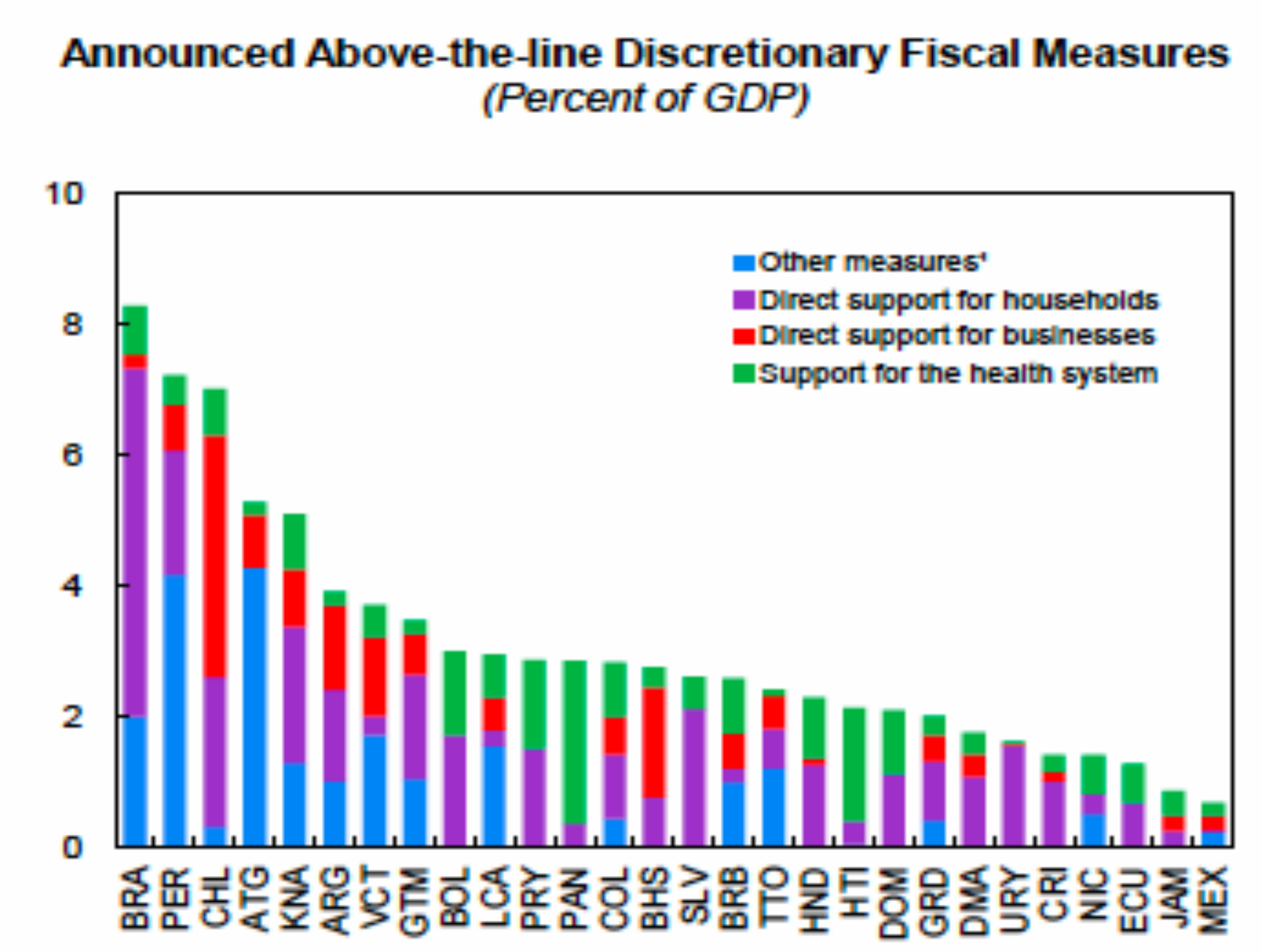
Responding to the pandemic: fiscal policy

Responding to the pandemic: Whatever it takes versus Whatever we can afford



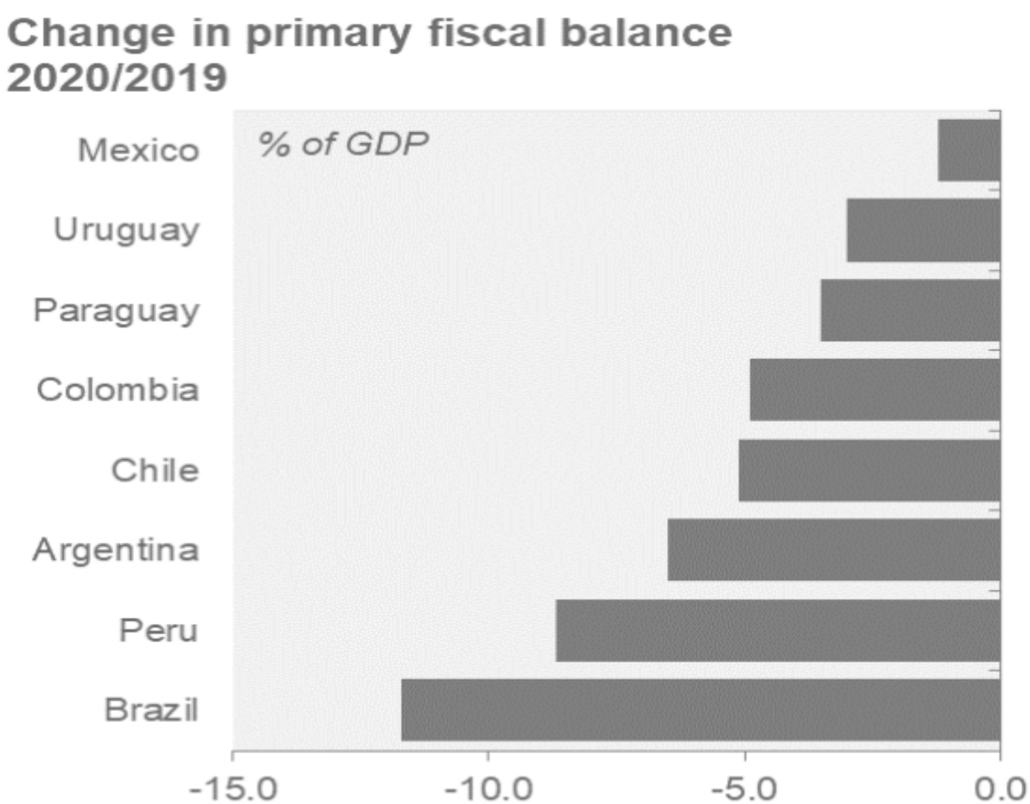
Source: IMF Fiscal Monitor, October 2020

Latin America: strong fiscal response with Brazil in the lead



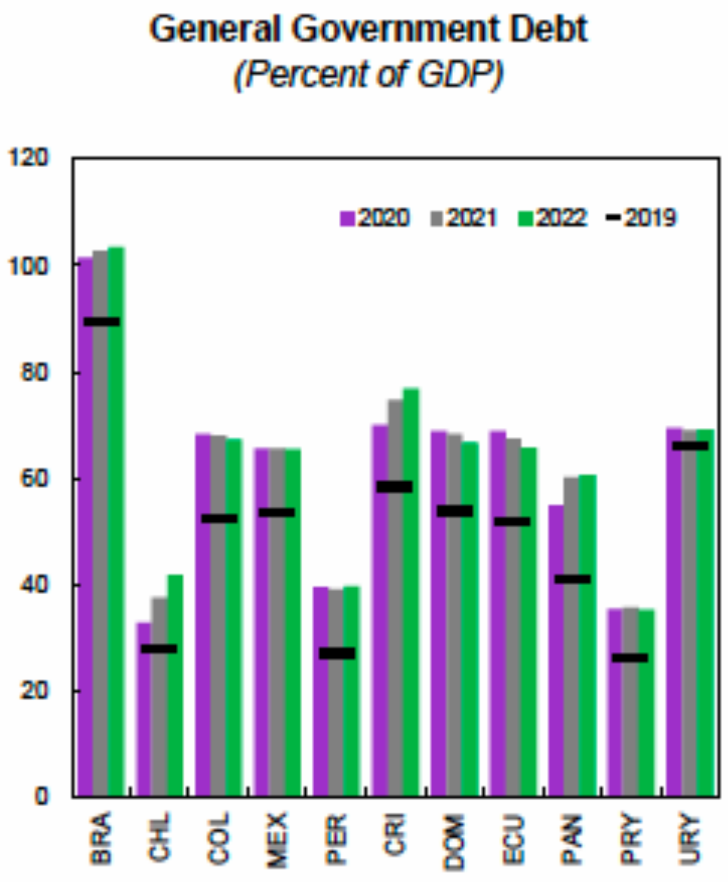
Source: IMF Regional Economic Outlook, October 2020

Latin America: sharp swing in the fiscal balance

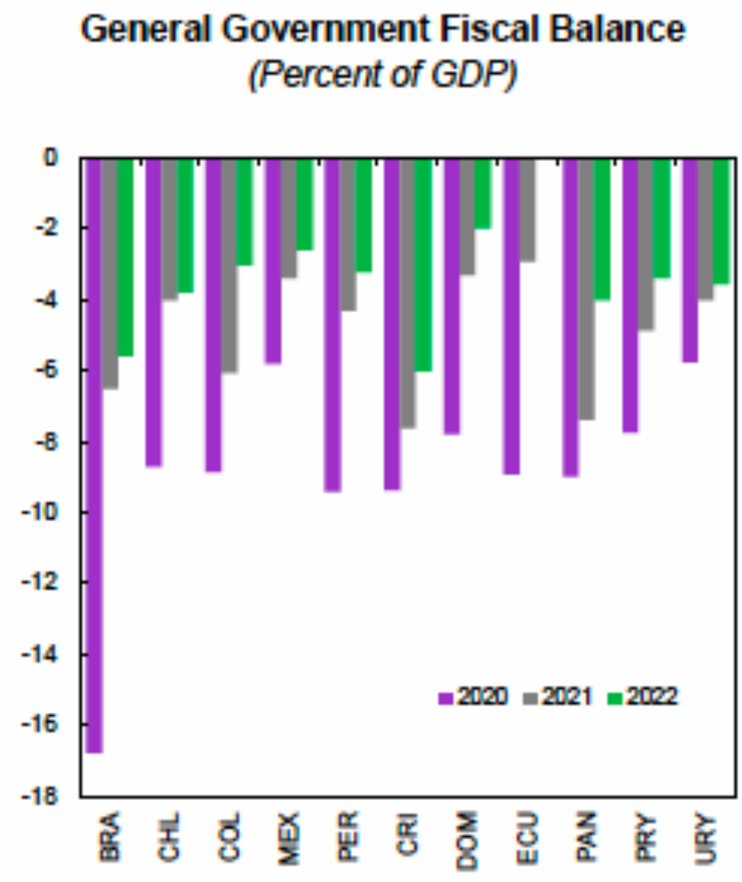


Source: IMF Regional Economic Outlook, October 2020

Latin America: larger debts and deficits almost everywhere



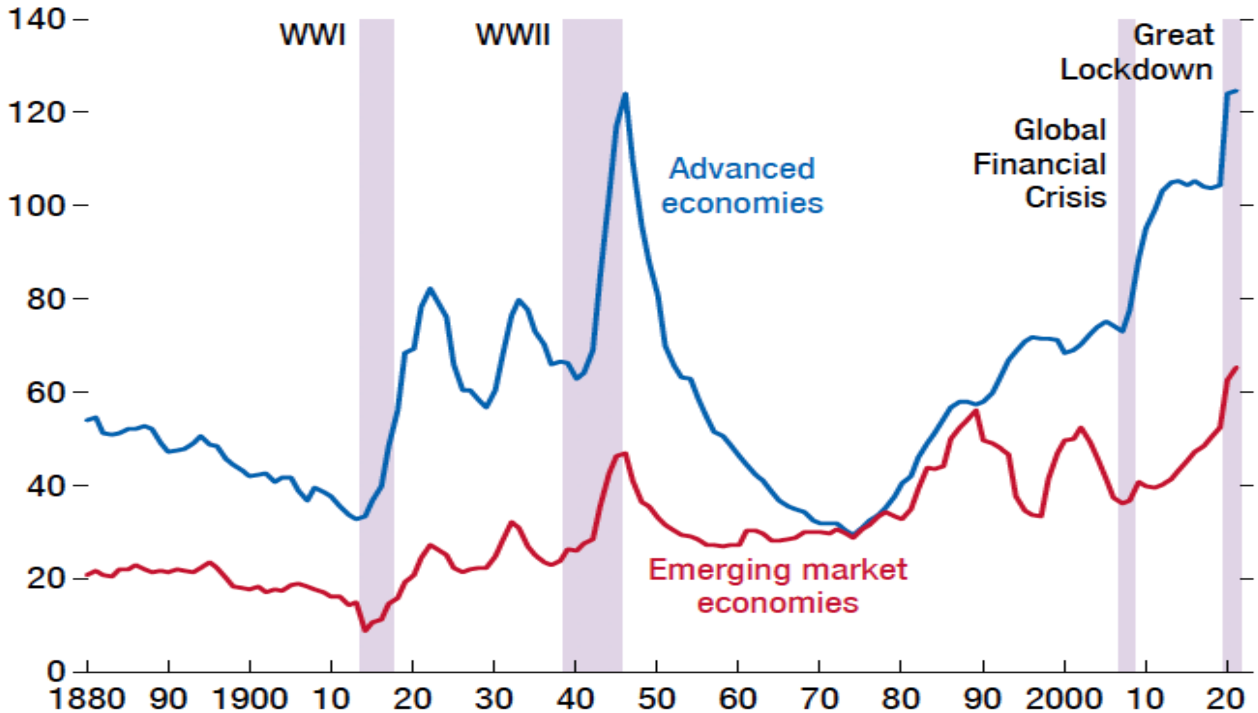
Source: : IMF, World Economic Outlook database.



Source: : IMF, World Economic Outlook database.

Implications for the future of public debt

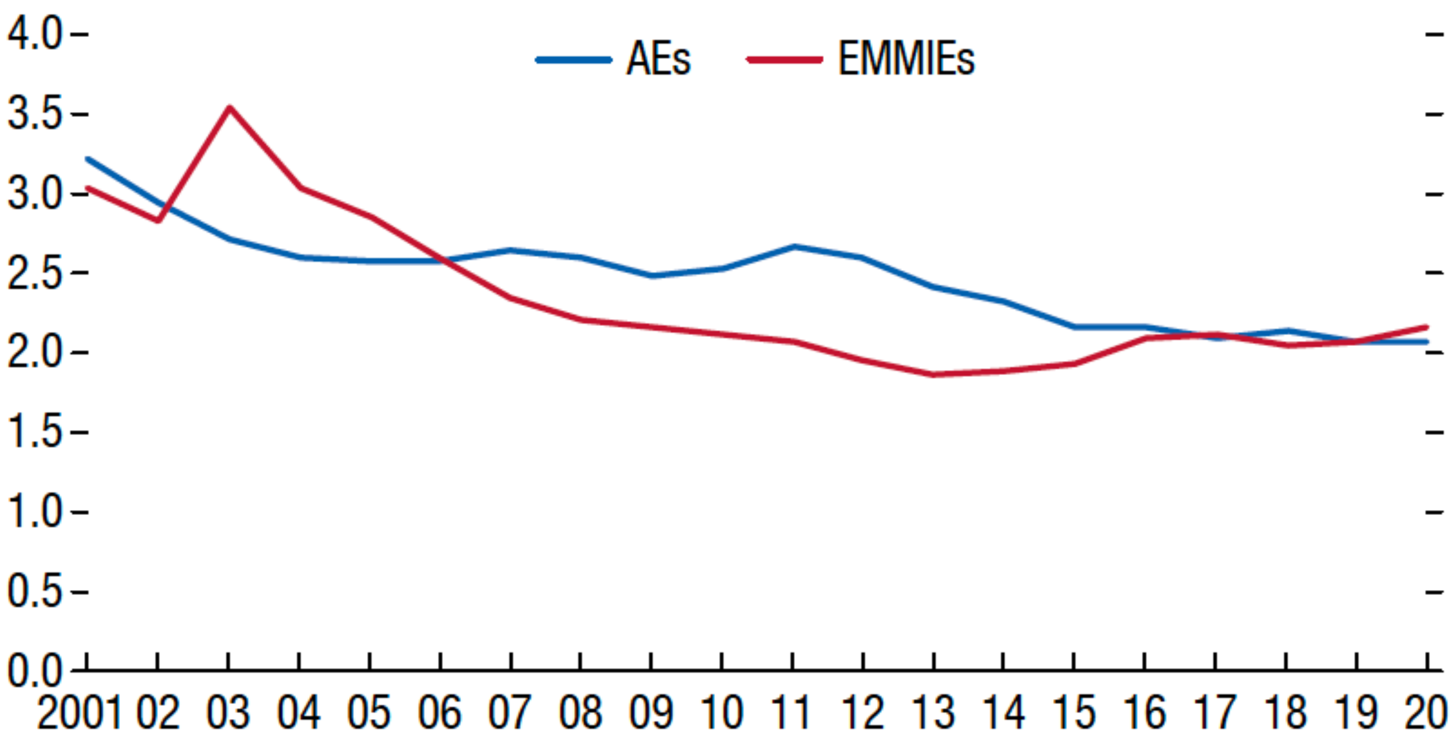
Piling on the debt: is the sky the limit?



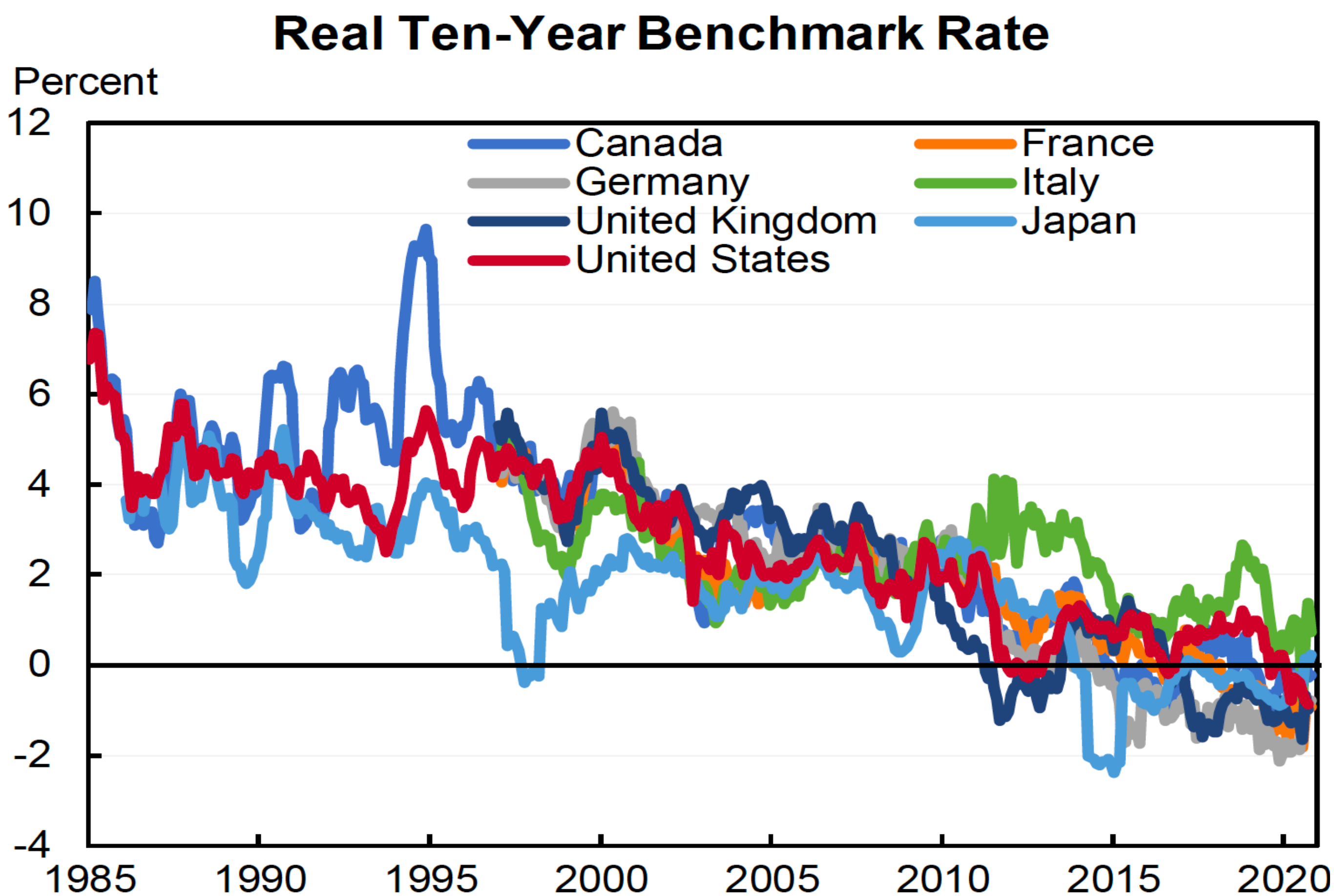
Sources: IMF, Historical Public Debt Database; IMF, World Economic Outlook database; Maddison Database Project; and IMF staff calculations.
Note: The aggregate public-debt-to-GDP series for advanced economies and emerging market economies is based on a constant sample of 25 and 27 countries, respectively, weighted by GDP in purchasing-power-parity terms. WWI = World War I; WWII = World War II.

Source: IMF Fiscal Monitor, October 2020

While the burden of interest payments falls



As a result of sharply falling nominal and real interest rates

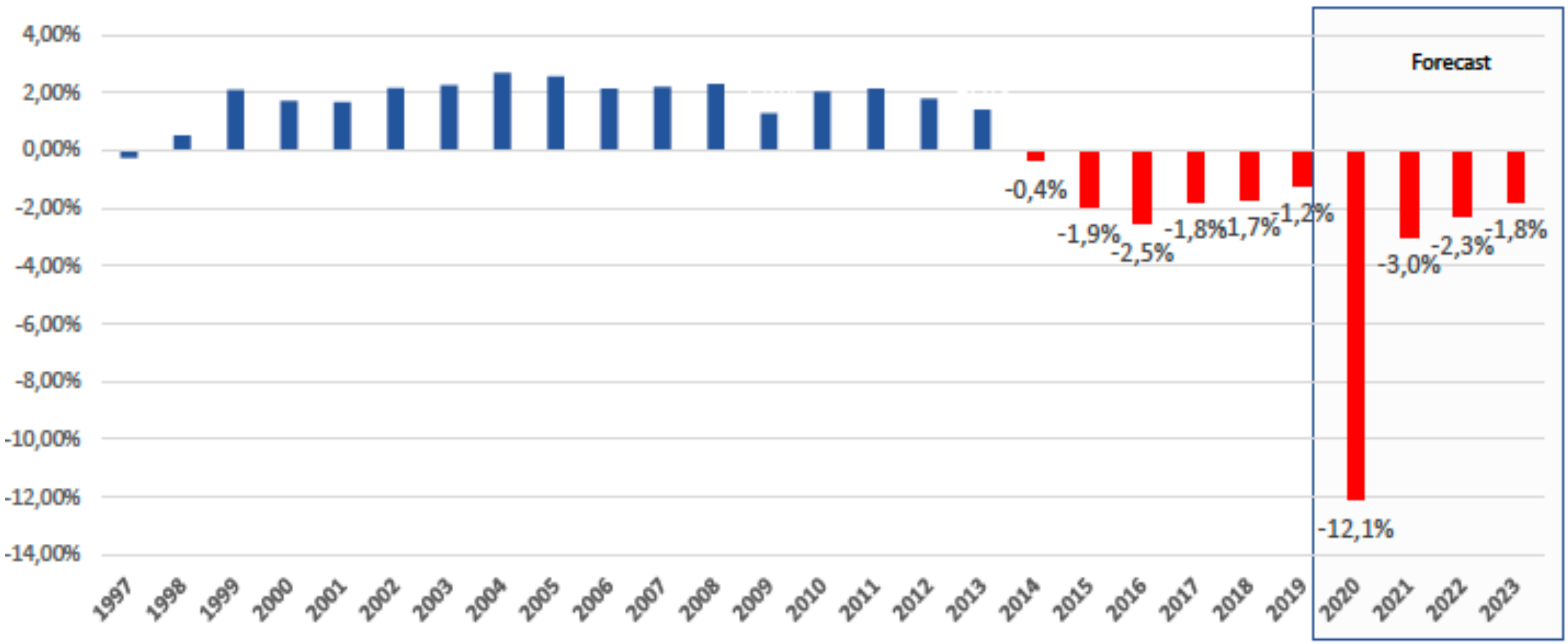


Does this mean there are no limits to deficit spending? No

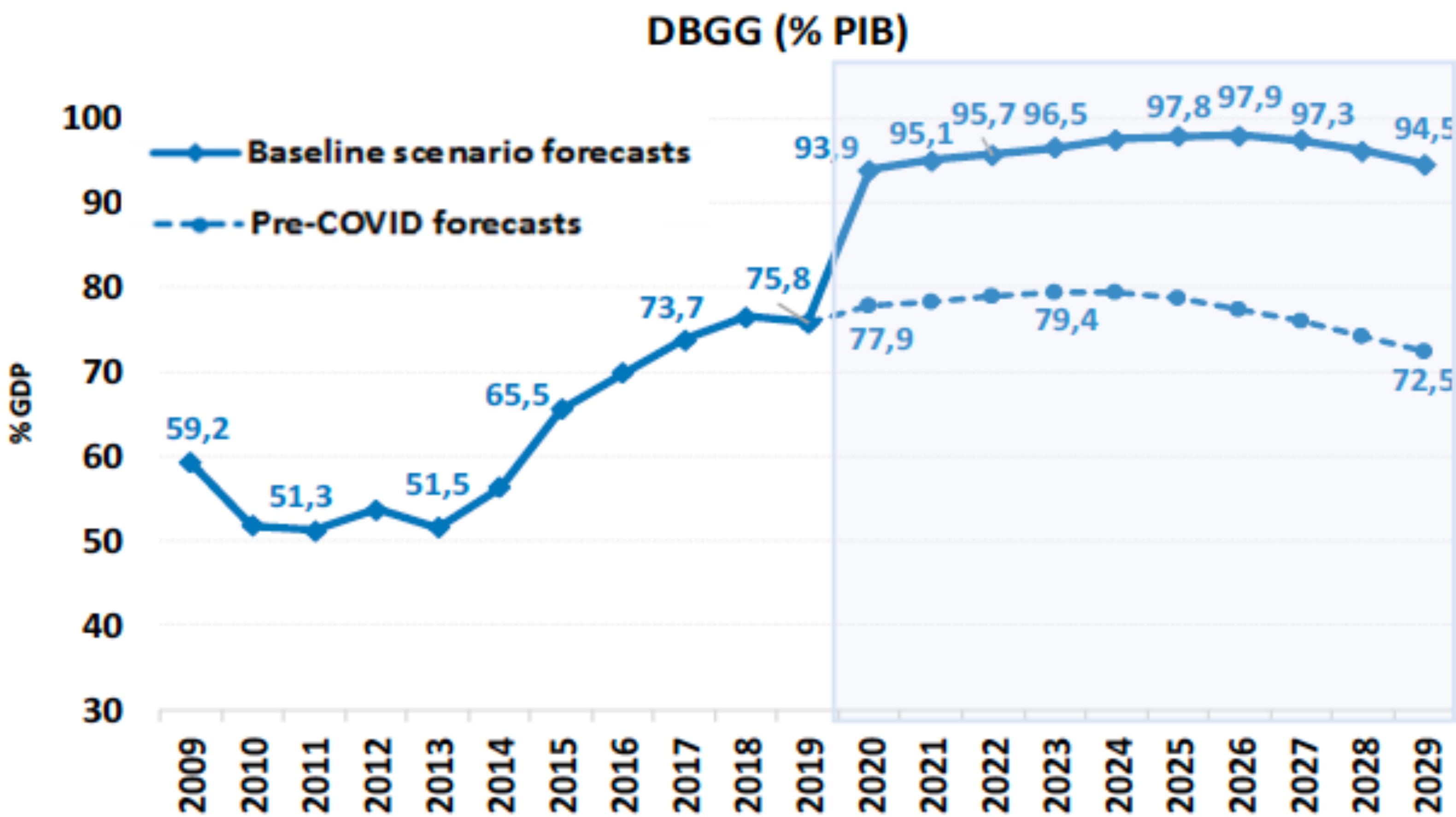
- When $r < g$, public debt takes on the characteristics of a bubble
- And there is a limit to how large a primary deficit the bubble will finance
- Also crucial: interest rates are endogenous
- They will begin to rise if
  - There are limits to capital mobility and/or arbitrage
  - The perceived risk of default rises

Brazil: an illustration of the limits

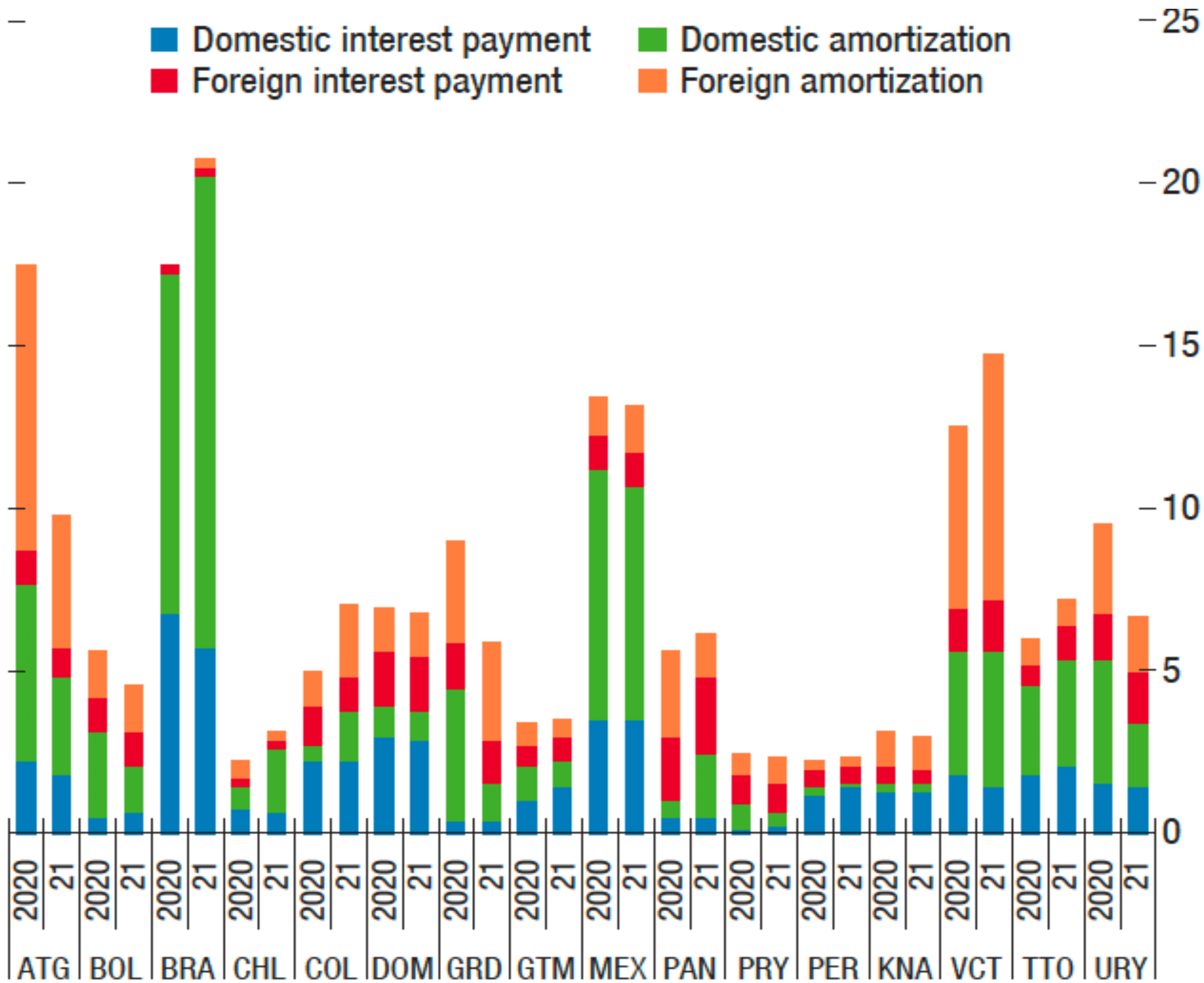
Brazil: sharp deterioration of the primary fiscal balance



Brazil: sharp increase in forecasts of public debt ratios

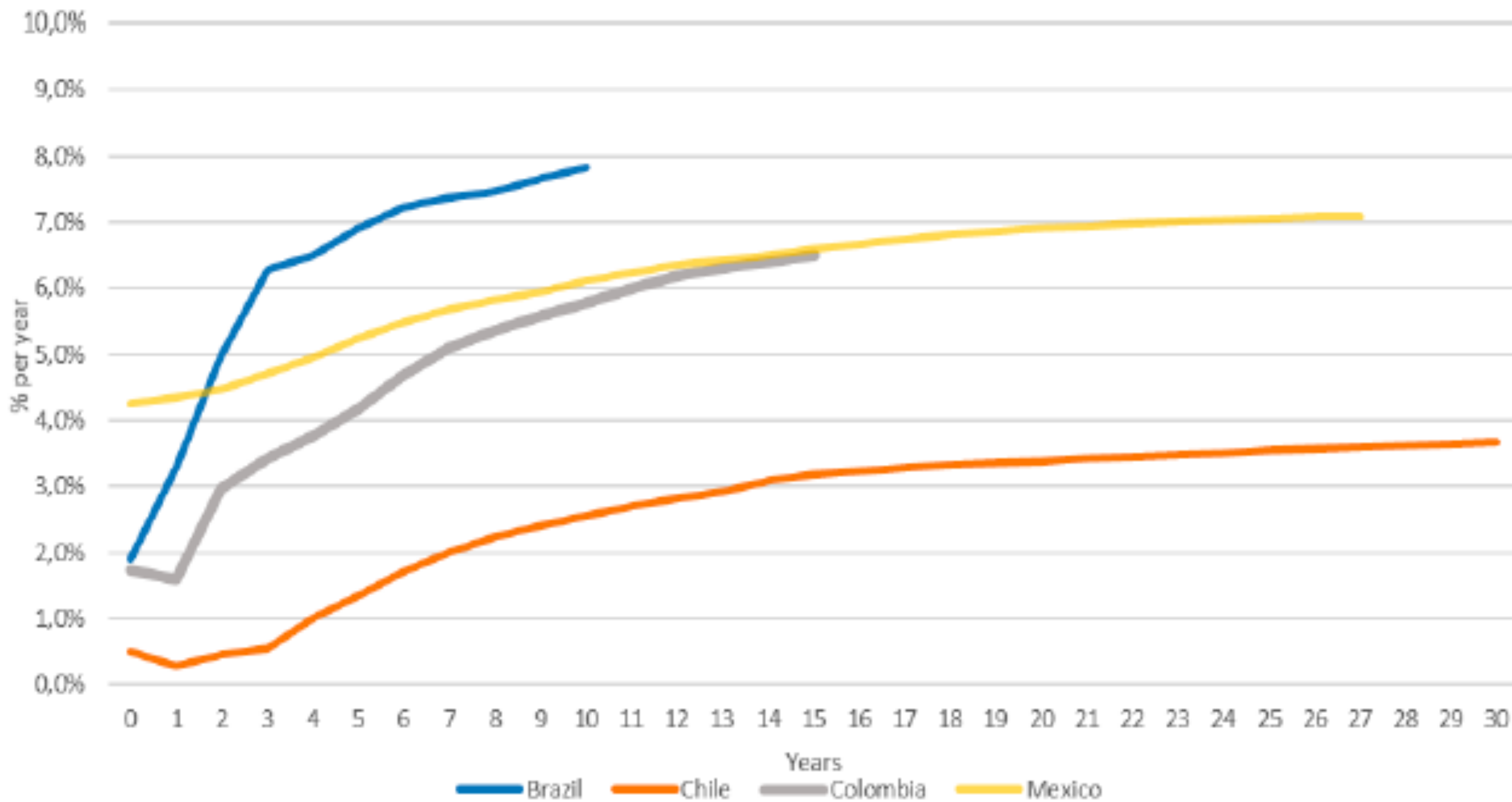


Brazil: debt service burden higher than in the rest of Latin America

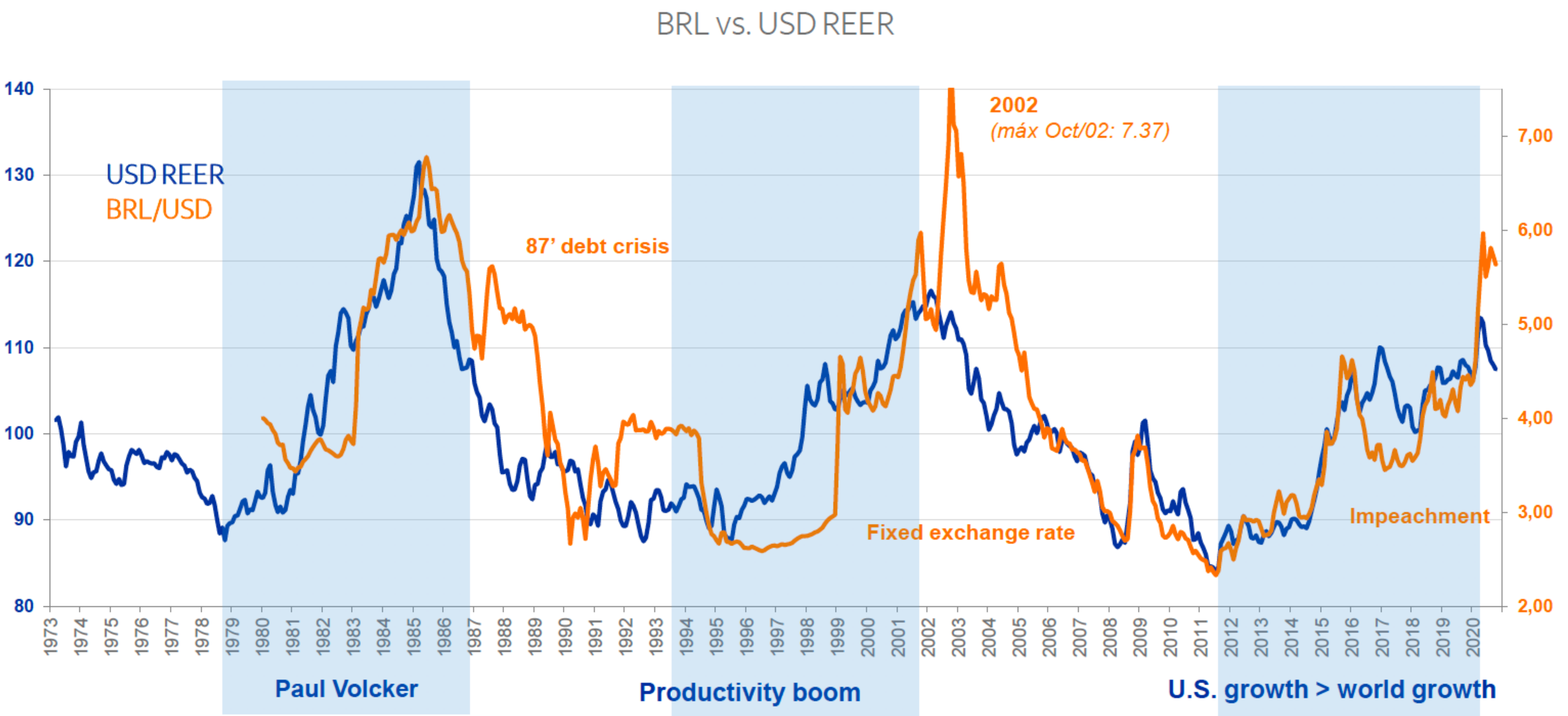


Source: IMF Regional Economic Outlook, October 2020

Brazil: unusually steep yield curve



All of this matters for the value of the currency as well



Brazil: some concluding thoughts

- In spite of low interest rates world-wide, there are limits to debts and deficits in the Post-Covid world
- Brazil is an example of where those limits lie
- Brazil has very high debt ratios for an EM --and a history of high interest rates
- Today the yield curve is unusually steep, reflecting issues around fiscal policy and debt sustainability
- Given substantial tax ratios, limited space to move only on the revenue side
- One does not have to be a believer in expansionary fiscal consolidation to believe that both stability and growth would benefit from more fiscal certainty

Thank you!