



Fiscal Policy in Downturns:

Recent Experience and Current Readiness

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(Personal views)

Seminario CEPAL de Política Fiscal
Santiago de Chile, enero 2012

OUTLINE

(Work in progress)

- I. FISCAL PERFORMANCE IN GOOD TIMES
(Better than I thought)
- II. COUNTERCYCLICAL FISCAL POLICY IN DOWNTURNS
 1. Recent Experience *(Good but...)*
 2. Current Readiness *(Not as good)*
 3. Policy Opportunities

I. FISCAL PERFORMANCE IN GOOD TIMES

- Between 2002 and 2007, temporary fiscal revenues grew constantly.
- Temporary revenue is the sum of temporary:
 - GDP-linked revenue (tax on output gap) and
 - Commodity-linked revenue (temporary price effect)
- Analysis for:
 - Typical LAC country (average of sample of 18)
 - Typical LAC7 country
 - LAC region (aggregate)

Estimation methods for structural and temporary

- GDP-linked based on:
 - Trend or Structural GDP (HP quarterly data)
 - Unit marginal tax revenue elasticity
- Commodity-linked based on:
 - HP-filtered commodity revenues mimicking Chilean method
 - Trend or Structural Prices (5-year real-time forecast prices) (MORE LATER)

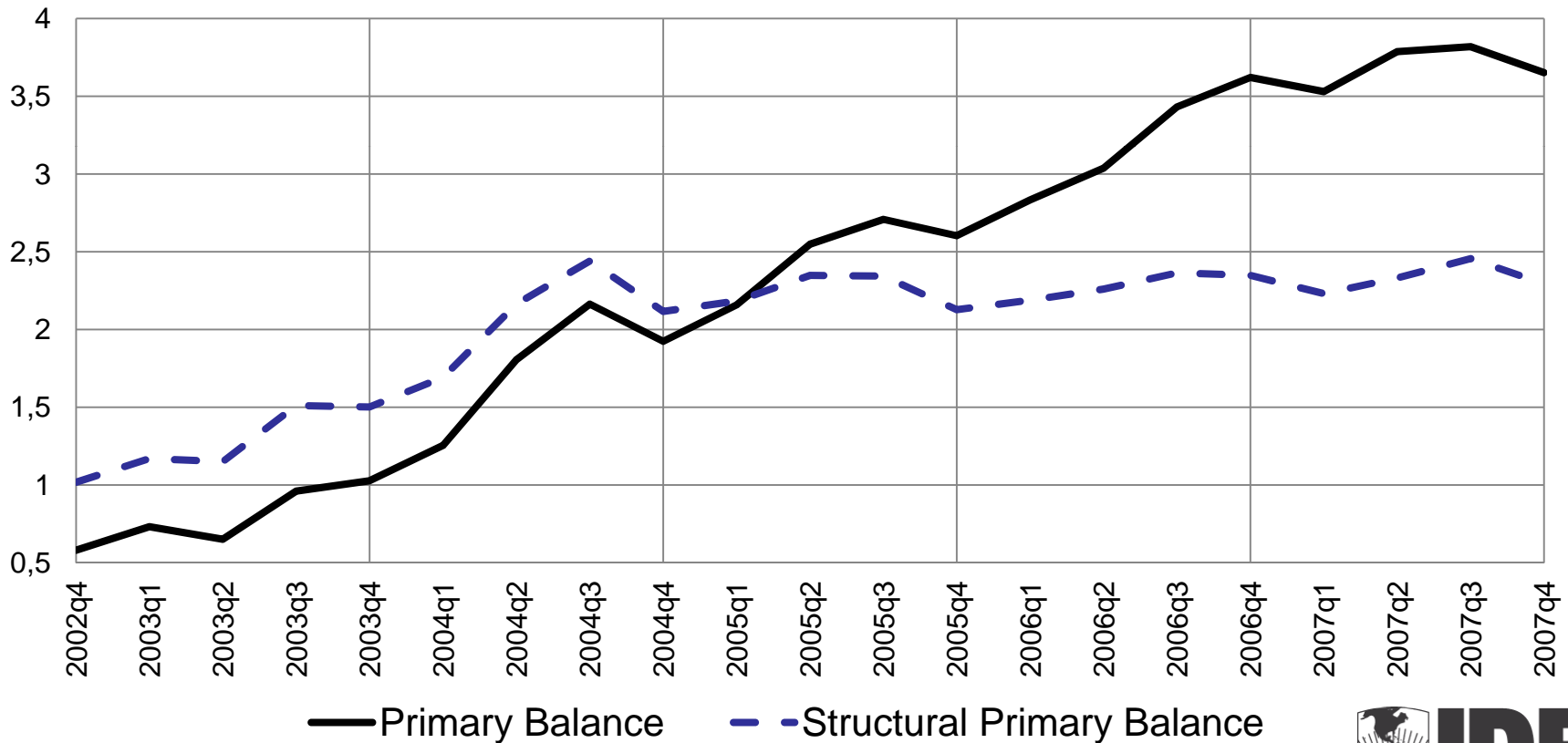
Assessing fiscal discipline in normal times

- Temporary Revenues (TR) are the difference of
 - Observed Primary Balance (B) and
 - Structural Primary Balance (SB)
- Key question: Are changes in TR (positive in this period) saved or spent?
 - If saved, SB constant and B increasing
 - If spent, SB decreasing and B constant
- (Oversaving and overspending would result from behaviour wrt use of structural revenues)

Typical country:

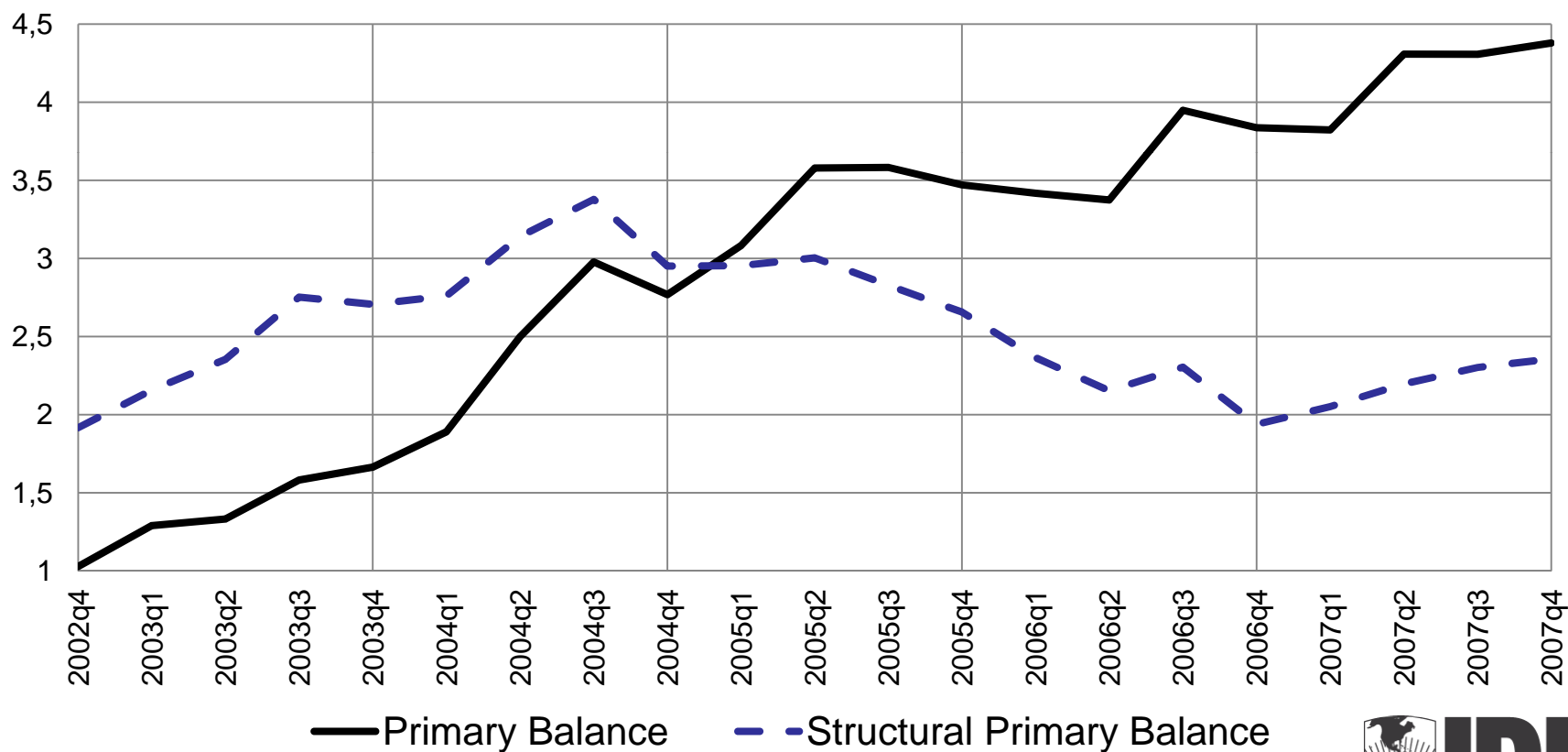
Oversaving first
Full Saving later

**Observed and Structural Primary Balance
Typical LAC Country**



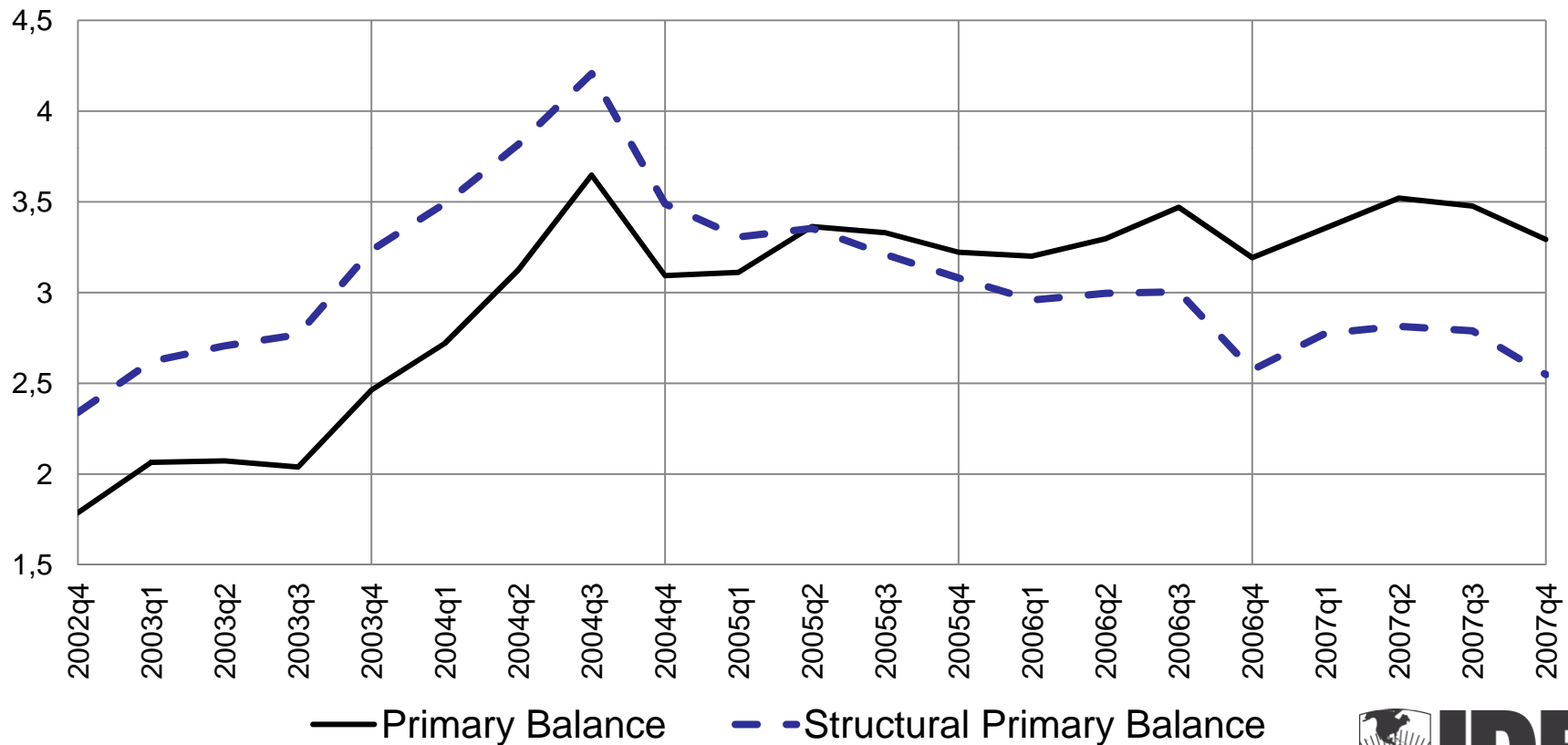
Typical LAC7: Oversave first Partial saving later

Observed and Structural Primary Balance Typical LAC-7 Country



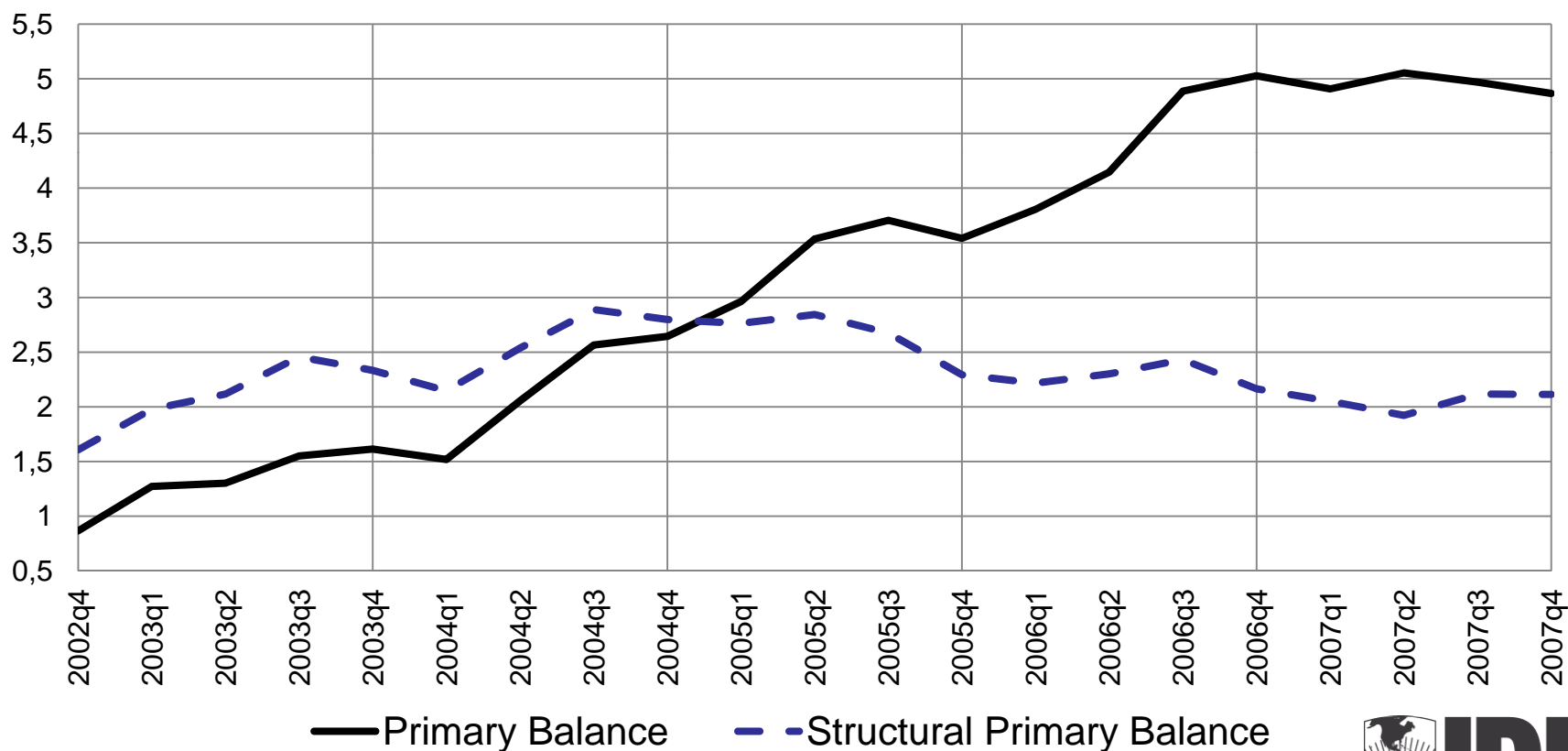
Region Aggregate: Oversave first Full spending later

Observed and Structural Primary Balance Aggregate LAC



Commodity exporters did not spend their temporary price bonanza!

Observed and Structural Primary Balance Typical LAC Commodity Exporter



II. COUNTERCYCLICAL FISCAL POLICY IN DOWNTURNS

1. Recent Experience (2008 onwards)
2. Current Readiness (to confront another downturn with countercyclical fiscal policy)
3. Policy Opportunities (to make the best of it)

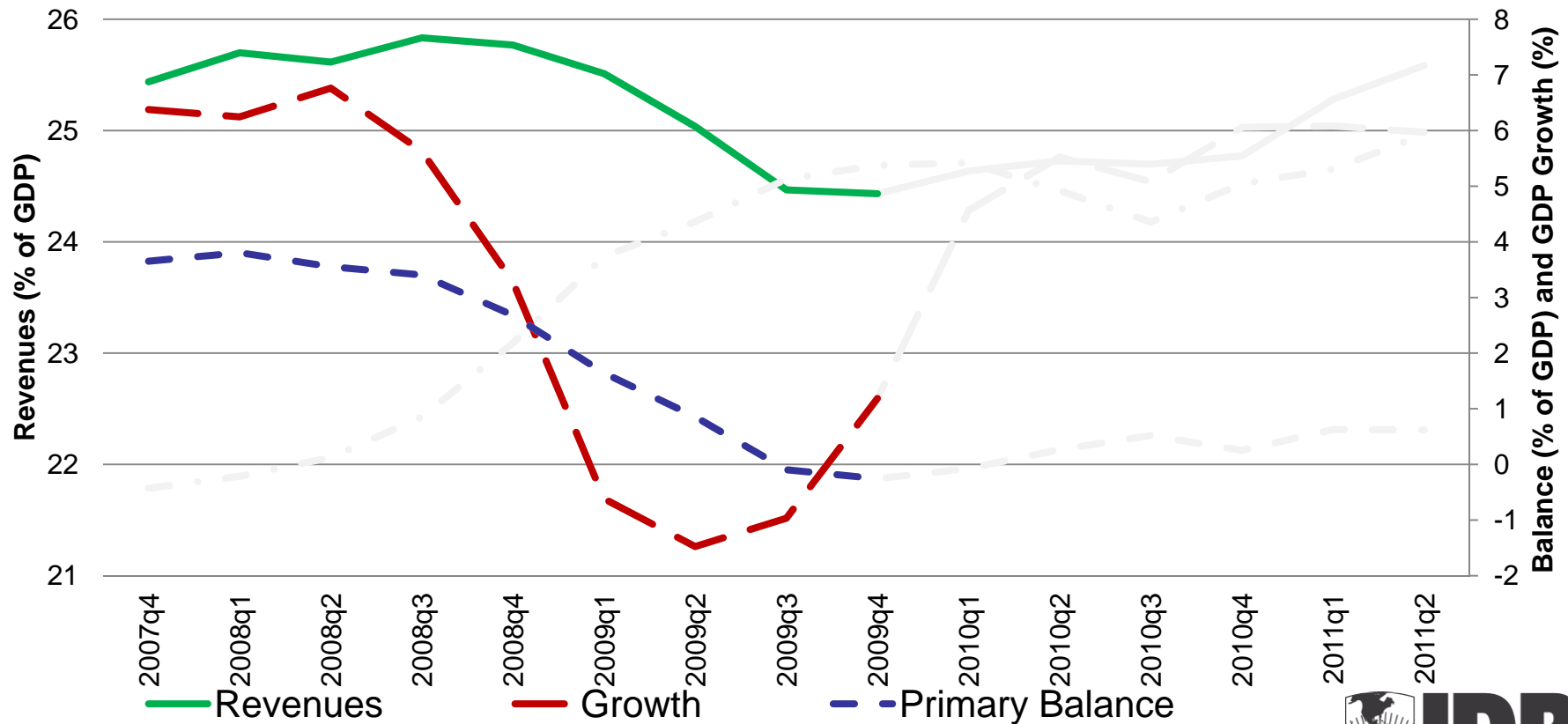
RECENT EXPERIENCE (2008 onwards)

*A successful expansive fiscal response
to the Great Recession (2008/09)...*

*...but slow fiscal retrenchment
afterwards*

In 2008/09, growth slowed, revenues fell even as % GDP and Balance plummeted 4 points...

GDP Growth, Revenues, and Primary Balance Typical LAC Country

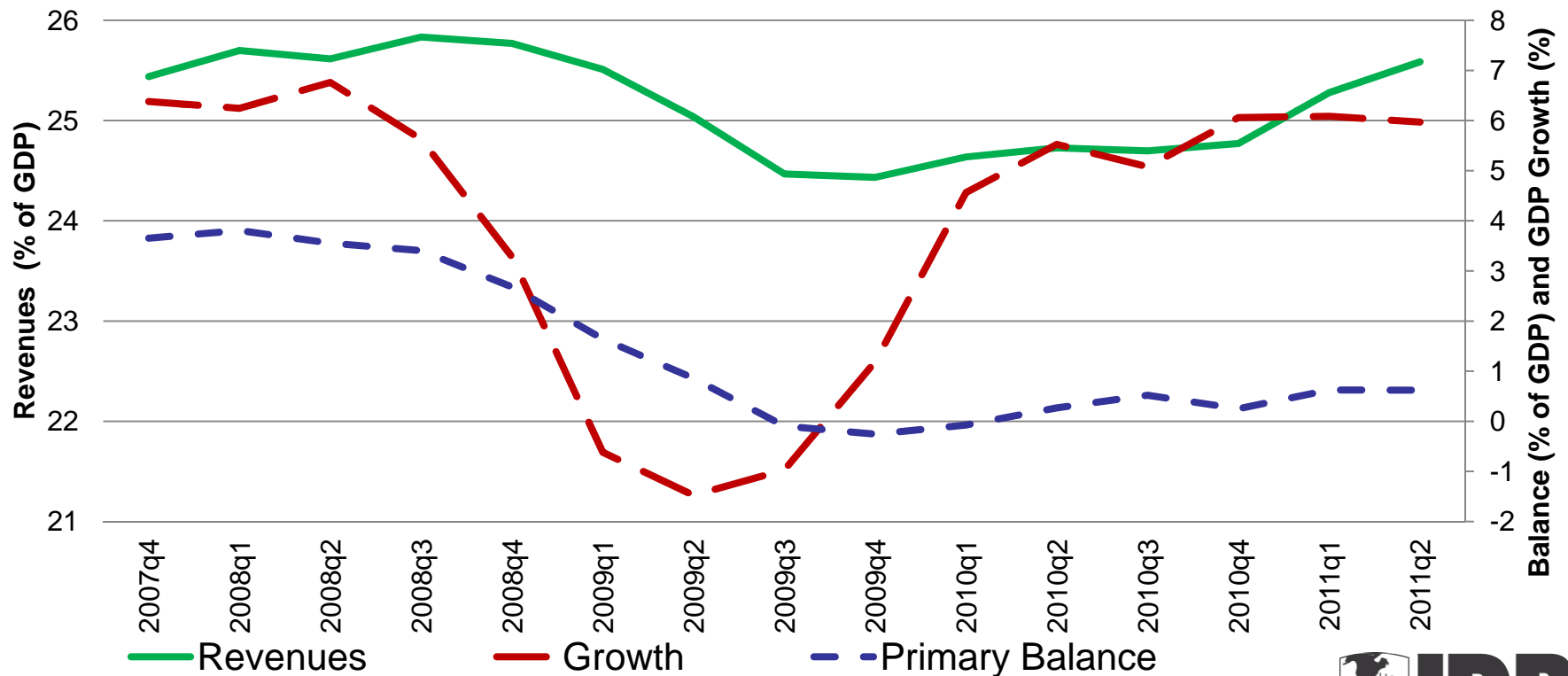


Source: LMW, Author's calculations.



...and then recover to some extent starting in 2010 (2011 1st. Semester preliminary)

GDP Growth, Revenues, and Primary Balance Typical LAC Country



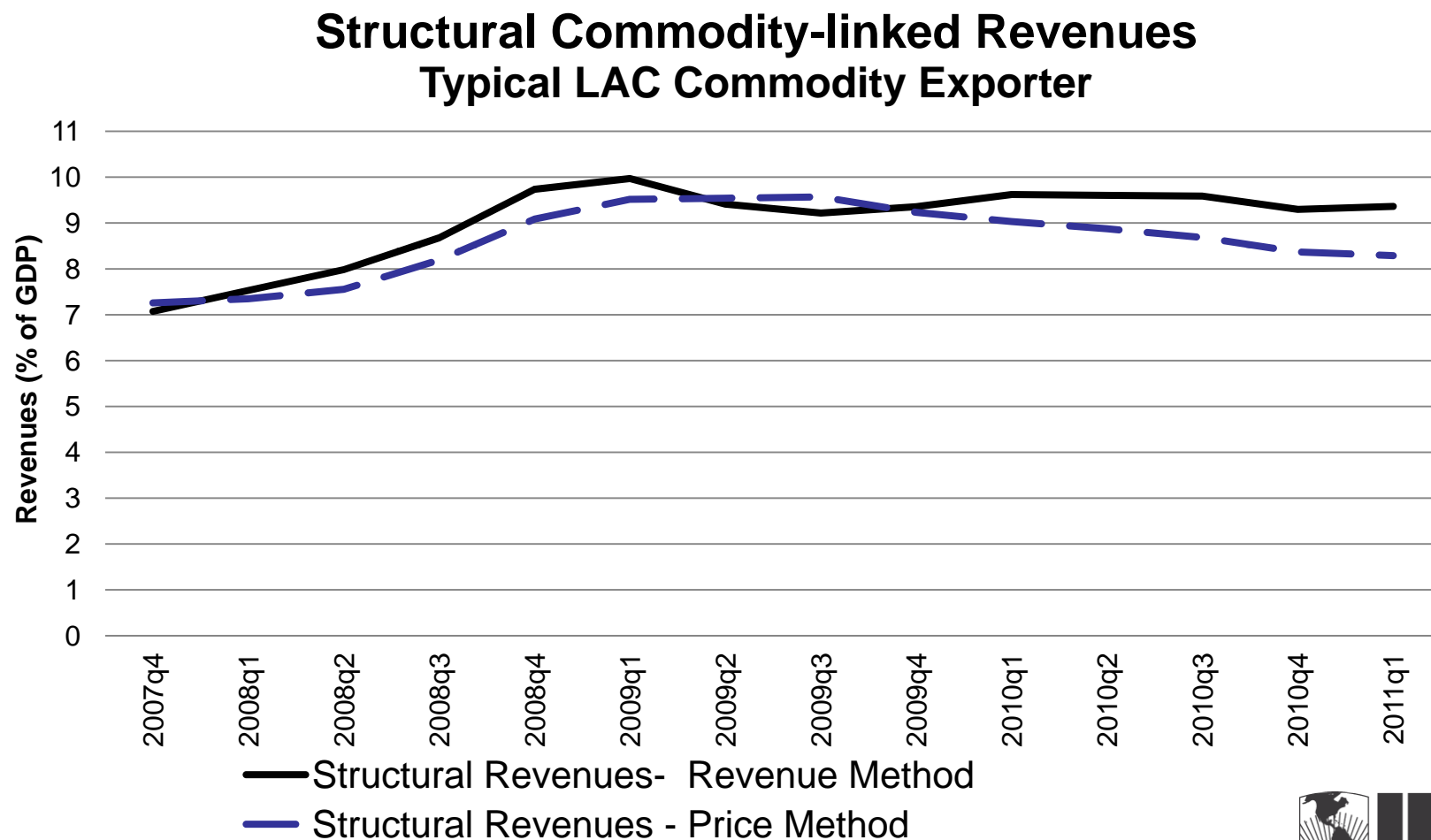
Source: LMW, Author's calculations.



However fiscal policy analysis requires structural fiscal measures (as % of structural GDP)

- Structural measures reveal fiscal stance and fiscal sustainability; temporary fiscal effects even out over time
- Acyclical fiscal policy means that the structural primary balance is constant (delinked from TR)
- Countercyclical fiscal policy means the SB more than offsets the effect of TR (in a downturn, even more spending than normal)

Two estimation methods for structural commodity revenues are similar; we take the average

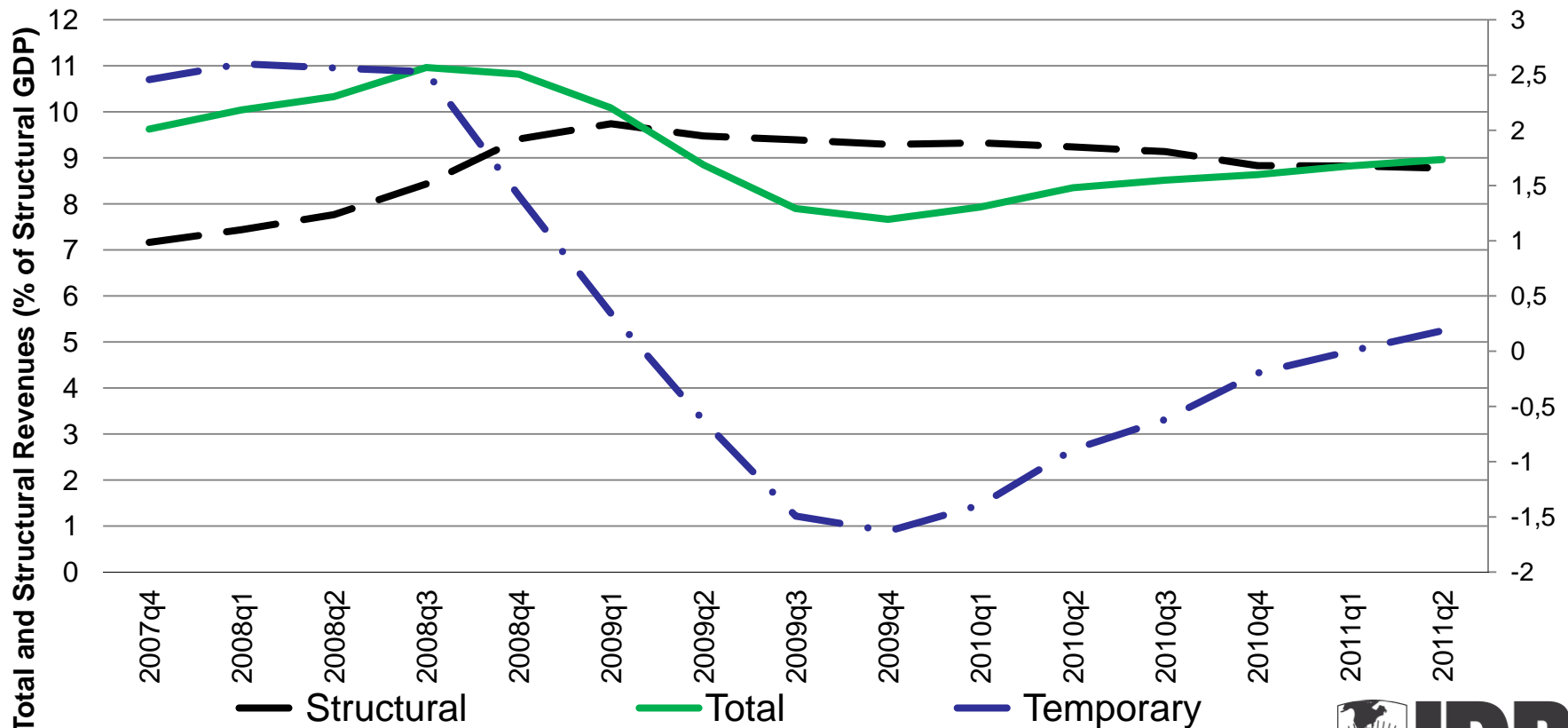


Source: LMW, Author's calculations.



In our region, commodity revenues are large and volatile; structural raises and then flattens

Commodity Linked Revenues Typical LAC Commodity Exporter

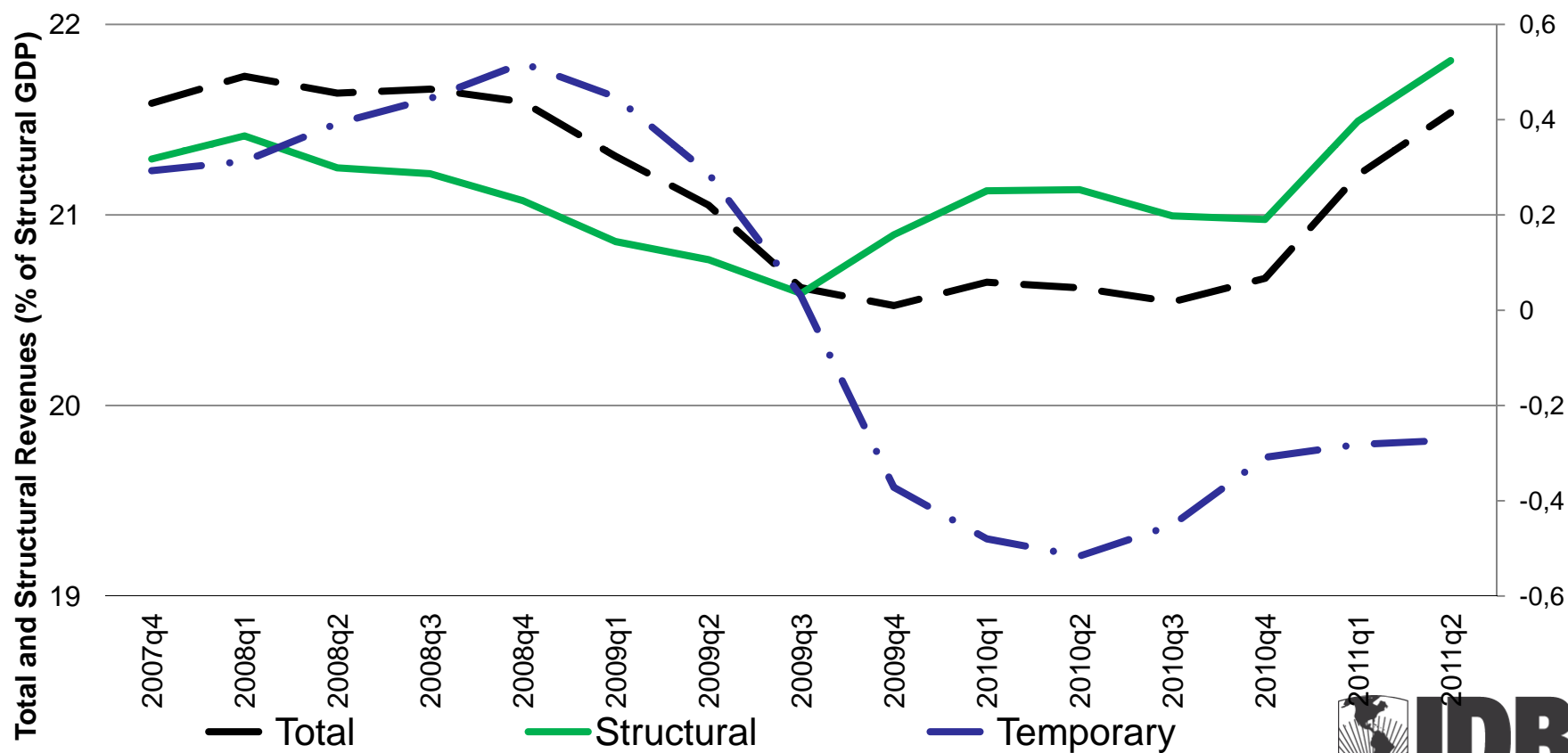


Source: LMW, Author's calculations.



By contrast, structural GDP-linked revenue falls and then recovers

GDP-linked Revenues Typical LAC Country

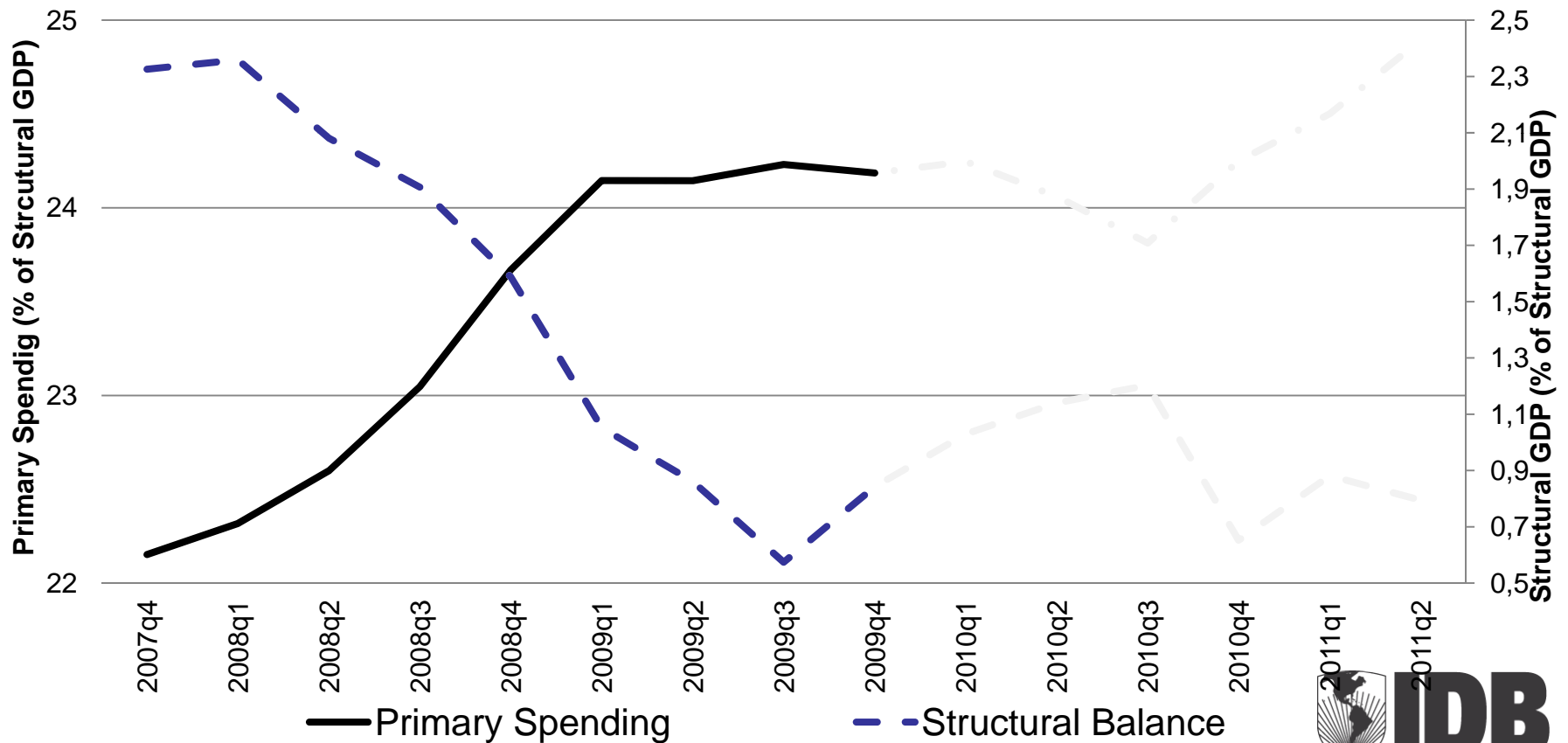


Source: LMW, Author's calculations.



Countercyclical fiscal policy of 1.5 pp included a 2 pp spending stimulus; it was widespread...

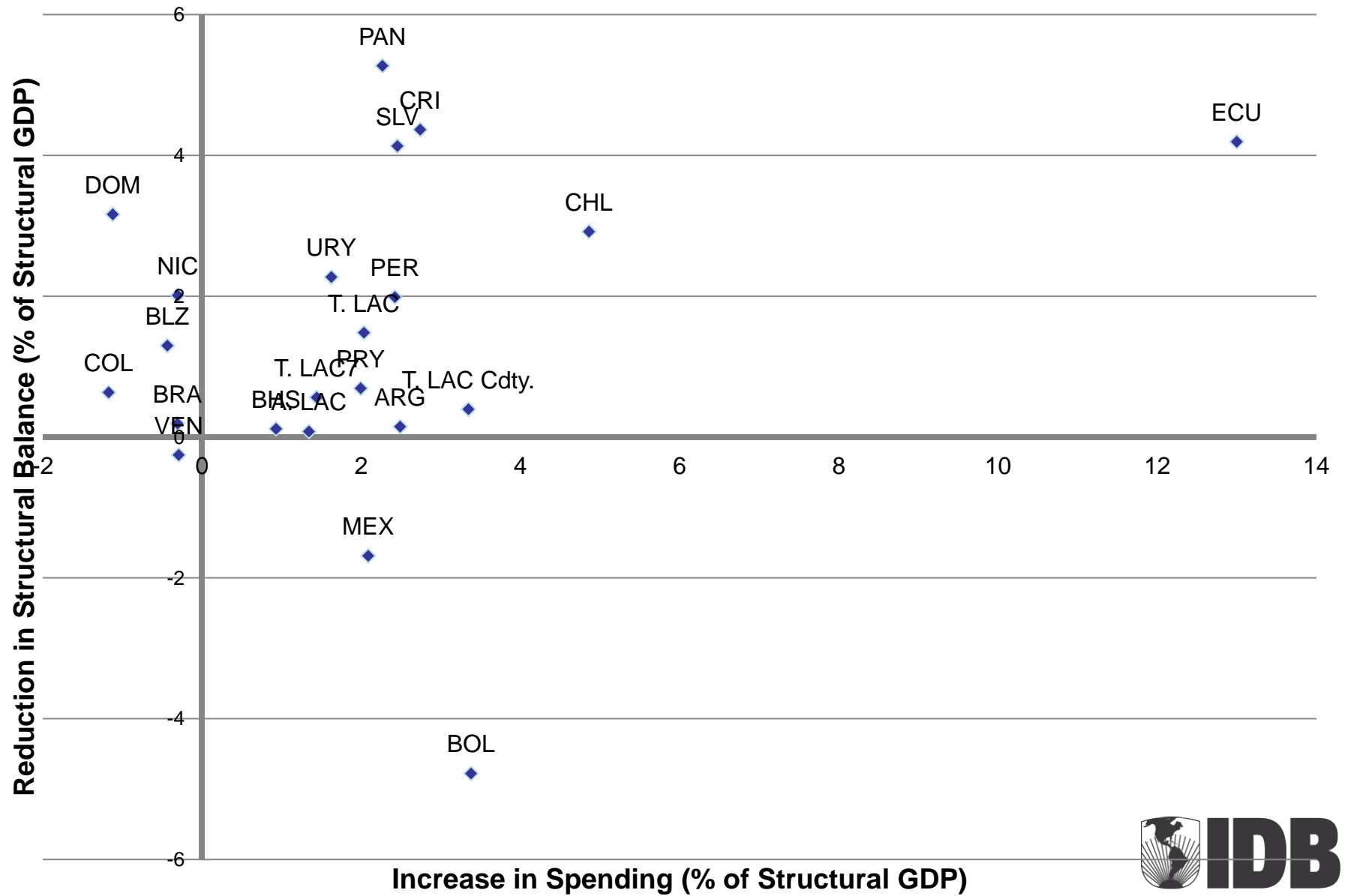
Primary Spending and Structural Balance Typical LAC Country



Source: LMW, Author's calculations.



Structural Balance and Spending 2007-2009



Fiscal package was actually more complex

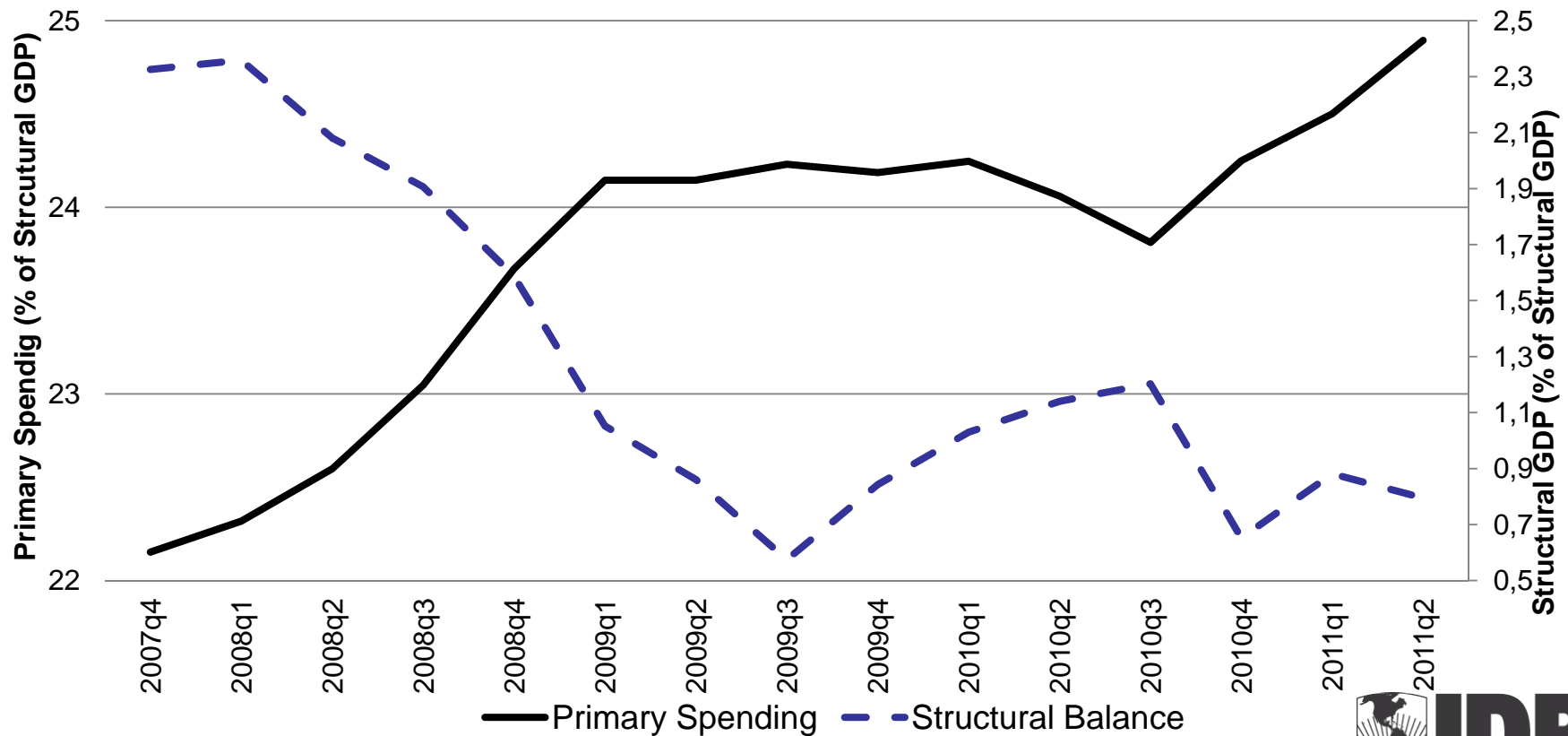
- Stimulus package of 2.4 pp:
 - Spending stimulus 2 pp
 - Tax reduction 0.4 pp
- But translated into a fiscal impulse of only 1.5 pp because structural commodity revenue *increased* by 0.9 pp
 - Structural increased as temporary fell
 - Long-term forecast prices increased by 40%

Successful package as recommended by Fernandez-Arias and Montiel? Yes, but...

- Macroeconomic Space satisfied (evidence points to useful demand booster; efficiency gain) and
- Financing Space turned out well (ample official support and reserves)
- But Fiscal Space not that clear ex-post:
 - Fiscal stimulus was not retired as recovery took hold
 - If expansion becomes entrenched, cost of fiscal sustainability (higher borrowing costs, future fiscal adjustment or debt restructuring) may dominate macroeconomic space.

Spending was not retired and structural balance did not bounce back; also widespread

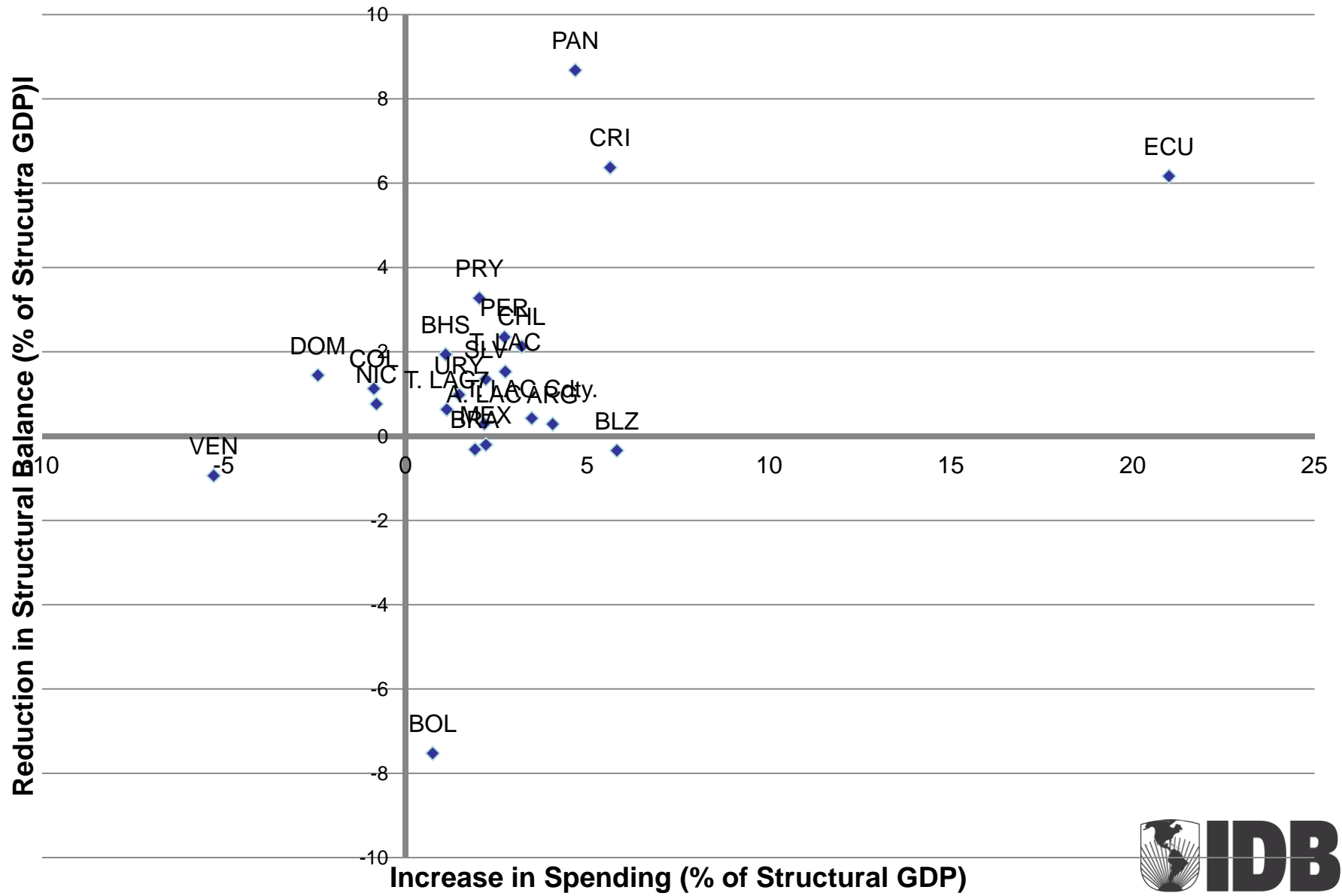
**Primary Spending and Structural Balance
Typical LAC Country**



Source: LMW, Author's calculations.



Structural Balance and Spending 2007-2011



CURRENT READINESS

(to confront another downturn with
countercyclical fiscal policy)

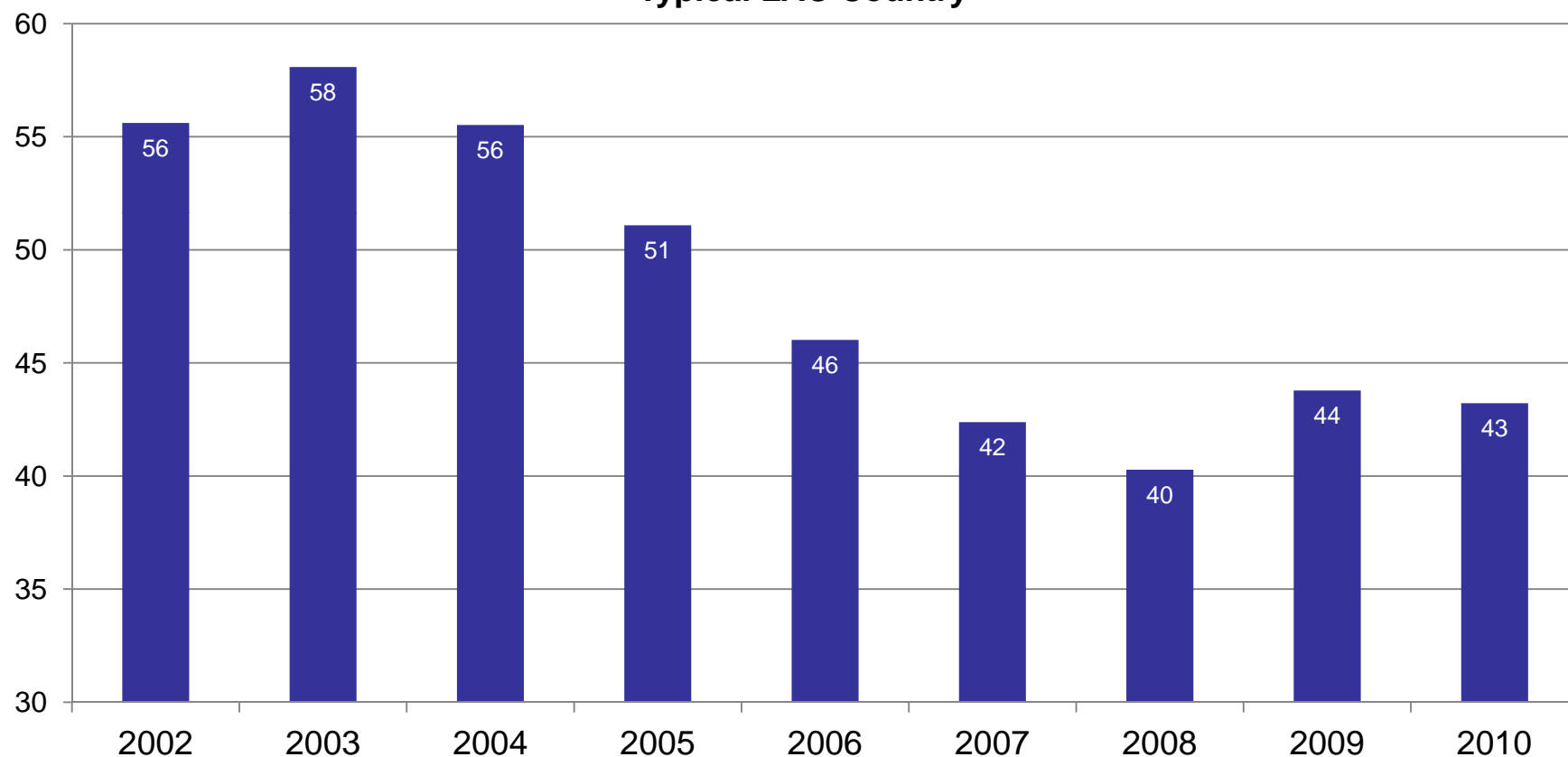
*Not as good as in 2007 and somewhat
risky for many countries*

Structural sustainability model to assess readiness

- Sustainability requires that the expected primary balance equal the interest rate on rolling over structural debt net of growth: $b^* = d (r-g)$
- Taking current SB as a fair measure of expected balance, the required adjustment b^*-SB is an indicator of fiscal space (readiness)
- In four years $(r-g)$ is about the same and d is about the same on average (NEXT): evolution is driven by deteriorating SB

Structural debt (not raw) ceased to decline and actually marginally increased on average...

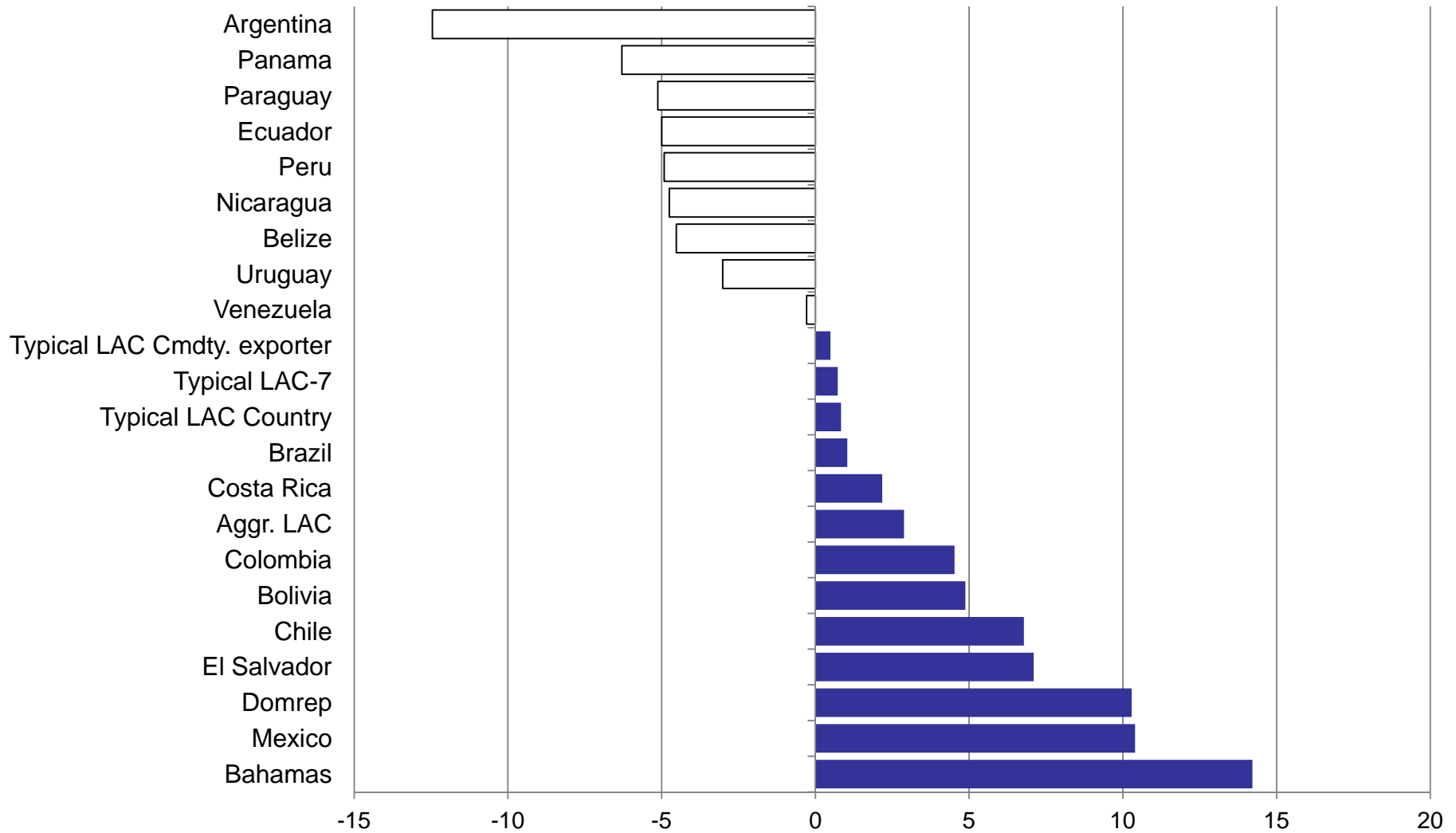
Structural Public Debt (% of Structural GDP)
Typical LAC Country



Source: LMW, Author's calculations.

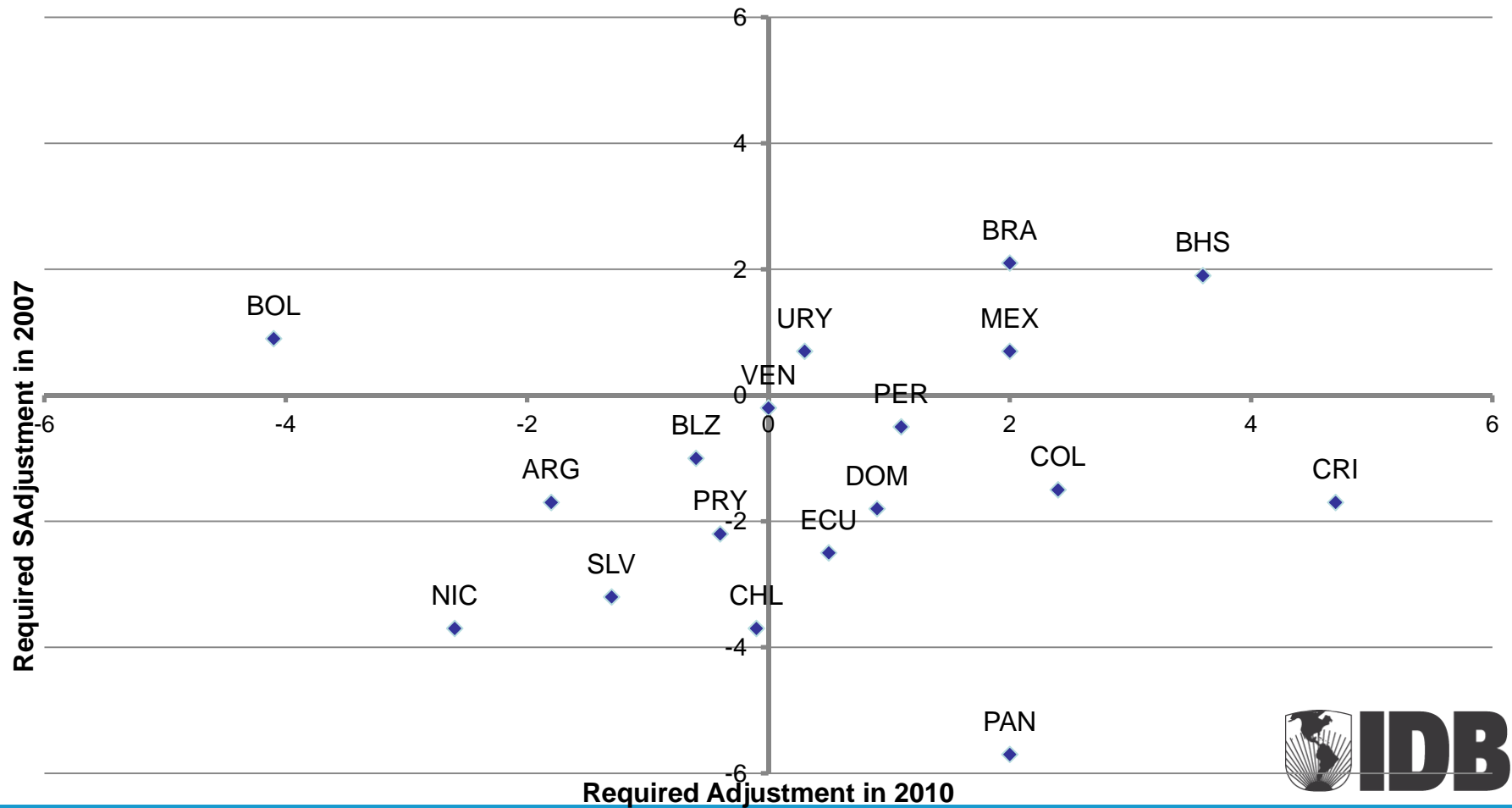


Change in Structural Public Debt 2007-2010: A Mixed Bunch



Almost all countries had more fiscal space in 2007

Required Adjustment for Sustainability



Almost all countries are less ready now

Readiness Relative to 2007	
Lower	Chile Costa Rica Panama Dominican Republic Ecuador Colombia Peru El Salvador Paraguay Mexico Bahamas Venezuela Belize Nicaragua Brazil
Higher	Uruguay Argentina Bolivia



How ready are countries as measured by required fiscal adjustment? It depends...

- Measuring readiness in this metric:
 - Low (more than 1 pp of required adjustment)
 - High (less than -1 pp of required adjustment, that is far from needing adjustment)
 - Intermediate (around the threshold)
- But is current SB a fair indicator of fiscal stance?
 - Optimistic: SB would have bounced back to 2007; shock is persistent and window was too brief
 - Pessimistic: SB deterioration reveals a pattern of ratcheting up expansion (social spending?)



Degree of Readiness			
Scenario	Optimistic	Central	Pessimistic
Lower	<p>Bahamas Brazil Mexico</p>	<p>Costa Rica Bahamas Colombia Panama Mexico Brazil Peru</p>	<p>Costa Rica Panama Colombia Bahamas Ecuador Chile Dominican Republic Peru Mexico Brazil Paraguay Uruguay</p>
Intermediate	<p>Venezuela Uruguay Peru Belize</p>	<p>Dominican Republic Ecuador Uruguay Venezuela Chile Paraguay Belize</p>	<p>El Salvador Venezuela Belize</p>
Higher	<p>Colombia Dominican Republic Costa Rica Argentina Paraguay Ecuador El Salvador Nicaragua Chile Bolivia Panama</p>	<p>El Salvador Argentina Nicaragua Bolivia</p>	<p>Argentina Nicaragua Bolivia</p>



POLICY OPPORTUNITIES

- Under the new threats, too late for retrenchment
- At the same time, where credibility of countercyclical fiscal policy was harmed it should be repaired
- Fiscal space is limited. In a repeat, countries with fiscal space should implement well-designed fiscal stimulus packages that are easily reversible and retire them in due course
- Complementary, perfect time for considering fiscal institutional reform to facilitate efficient and credible fiscal policy in a structural framework

