Fiscal Policy in Latin America and the Caribbean: Past, Present, and Future

FLAR/CAF Conference on Economic Policy
Challenges and Priorities a Decade after the Global Financial Crisis: Outlook for Latin America

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A roadmap of the presentation

- **Past:** A long history of procyclical fiscal policy in LAC, but region is slowly, but surely, escaping the procyclical trap.

- **Present:** With inflation at historical lows, fiscal deficits are undoubtedly the main macroeconomic problem of LAC countries at this juncture.

- **Future:** While most countries in the region still need to undergo fiscal adjustments, the costs will be much lower than in the past and countries should be able to maintain inclusive growth.
THE PAST: AN ERA OF PROCYCALITY
Historically, government spending has been procyclical in most developing countries, including LAC (1960-2017)

Based on 123 countries:
- 22 Industrial (27% procyclical)
- 77 Emerging Markets (81% procyclical)
- 24 LAC (96% procyclical)

Note: Procyclical government spending policy implies higher spending in good times and lower spending in bad times.
Good news: Many LAC countries have switched to countercyclical fiscal policy after 2007

Note: Procyclical fiscal policy implies expansionary fiscal policy in good times and contractionary in bad times
One hundred years of fiscal policy cyclicality: The case of Chile
Chile has become increasingly less procyclical over time and is now clearly countercyclical (1921-2017)

Source: Authors’ calculations based on the PELT algorithm (Pruned Exact Linear Time), which looks for multiple changepoints in fiscal cyclicality regime.
One hundred years of fiscal policy cyclicality: The case of Colombia

Colombia has also become (slightly) countercyclical in the new regime (1921-2017)

Source: Authors’ calculations based on the PELT algorithm (Pruned Exact Linear Time), which looks for multiple changepoints in fiscal cyclicality regime.
One hundred years of fiscal policy cyclicality: The case of Peru
Peru has made steady progress over the last 45 years and has now reached an acyclical fiscal regime (1921-2017)

Source: Authors’ calculations based on the PELT algorithm (Pruned Exact Linear Time), which looks for multiple changepoints in fiscal cyclicality regime.
PRESENT: A FRAGILE FISCAL SITUATION
Current fiscal situation is rather fragile: 31 out 32 countries in LAC with fiscal deficit in 2017 ...

Median fiscal deficit 2017:
- LAC: 2.4 (3.0 in 2016)
- MCC: 1.9 (1.5 in 2016)
- SA: 4.0 (6.0 in 2016)

97% (31/32) have a fiscal deficit
53% (17/32) have a primary deficit

Sources: World Bank staff estimates (March 2018) when available, otherwise WEO (October 2017).
... which keeps adding fuel to already high levels of debt

Sources: World Bank staff estimates (March 2018) when available, otherwise WEO (October 2017).
... and leading to worse credit ratings (i.e., more costly borrowing)

Sources: World Bank staff estimates (March 2018) and Fitch Ratings
(IMMEDIATE) FUTURE:
FISCAL ADJUSTMENT
Why does the region need to adjust?

- Persistent fiscal deficits and high levels of debt endanger the region’s formidable gains over the last 15 years in terms of:
  - Low inflation
  - Reduction in poverty and inequality
  - Expansion of the middle class
  - Inclusive growth

- Fiscal adjustments would ensure:
  - In the long-run, lower inflation and higher long-run inclusive growth
  - In the short-run, lower debt allows countries to access international credit markets more often and at lower cost
  - In the short-run, it creates fiscal space for future countercyclical fiscal policies and frees resources to face future risks
Are there short-run costs?

- Yes; there is no such a thing as a free lunch

- But, short-run costs vary a lot depending on:
  - Speed of adjustment: gradual far better than shock
  - Spending cuts versus tax increases: reduce spending unless tax burden is very low
  - What category of spending is cut: reduce public consumption (public investment and social transfers should be protected)
Costs of gradual fiscal adjustments are substantially lower than those of shock adjustment.

Total cost of fiscal adjustments (in terms of output loss) since 1960

Source: Authors’ calculations based on Global Financial Data, MOxLAD, WDI, and WEO (October 2017).
Costs of spending cuts are lower than that of tax increases (except for very low taxation countries)

Sources: Authors’ calculations based on data from CEPAL and Gunter et al. (2018)
Costs of cutting public investment or social transfers are very high

Source: Authors’ calculations based on data from CEPAL.
Perils of fiscal adjustment in low inflation environments

Source: Authors’ calculations based on Global Financial Data, MOxLAD, WDI, and WEO (October 2017).
Conclusions: Progress and challenges

- **Good news:**
  - Clear trend away from fiscal procyclicality
  - Region now engages in gradual fiscal adjustments (as opposed to shock adjustments)
  - Inflation outbursts of the past are no longer used to dilute real wages and social transfers

- **Challenges:**
  - Immediate future: Continue gradual fiscal adjustment, while preserving social gains and not relying on cuts to public investment (especially infrastructure)
  - Medium/long-term: Consolidate acyclical/countercyclical fiscal regimes by building strong fiscal institutions and gaining fiscal space in good times to use it in bad times
Thank you!
Appendix: Main sources for presentation
