

Prudence or Abstinence?

Deficit, pro cyclical and anti investment biases in fiscal policies in Latin America

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The World Bank**

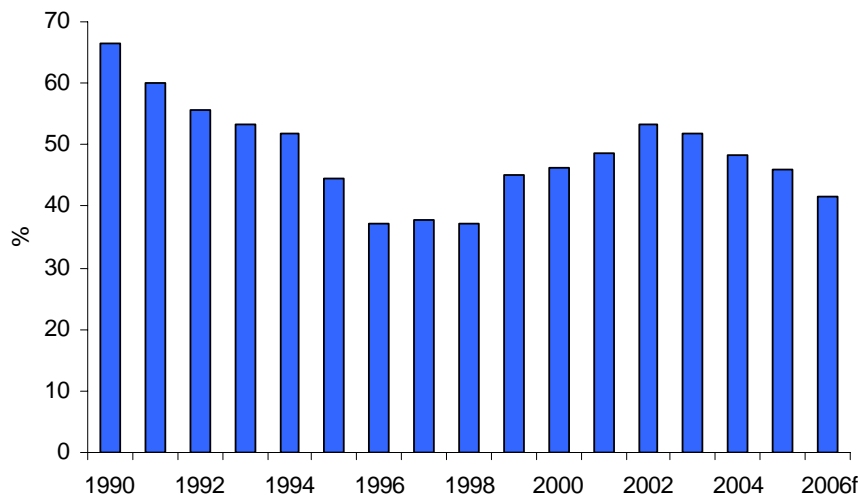
**“Workshop in International Economics and Finance”
Banco Central, Santiago de Chile, 2007**

This presentation

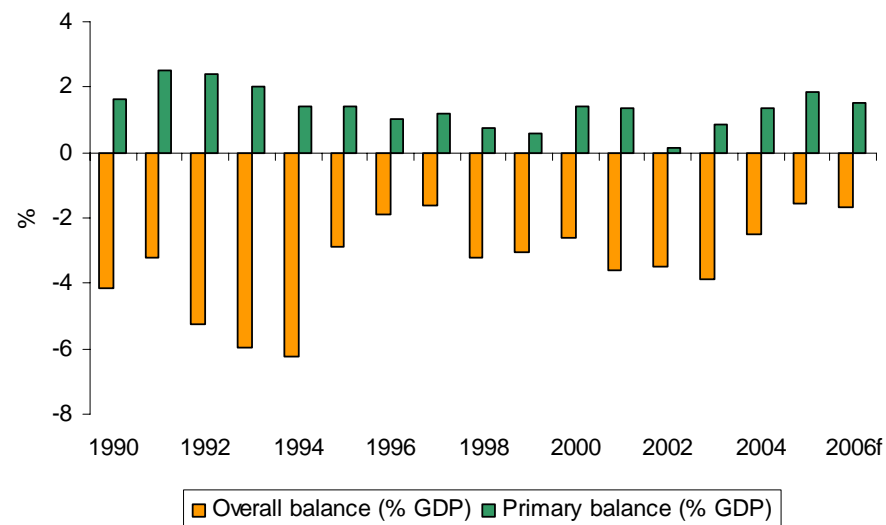
- 1. Problem: **Debt sustainability**
 - Fact: excessive debt levels or poor debt composition?
 - Policy issue: higher primary surpluses or better debt management and capital markets development?
- 2. Problem: **Underinvestment in Infrastructure**
 - Fact: fiscal adjustment has affected growth through excessive cuts in infrastructure.
 - Policy issue: how to avoid anti investment biases while keeping debt sustainability? Rules vs. ad hoc solutions.
- 3. Problem: **Pro cyclicality**
 - Fact: High welfare costs and pro cyclical biases lead to debt unsustainability and to anti investment biases
 - Policy Issue: The case for structural balance rules

1. Short Term Fiscal Indicators: Deja Vu?

Public debt (% of GDP)



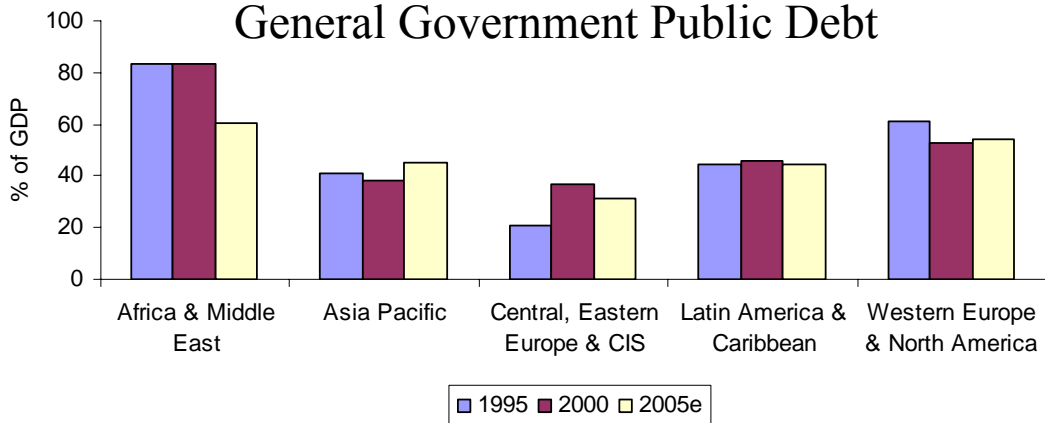
Fiscal balance (% of GDP)



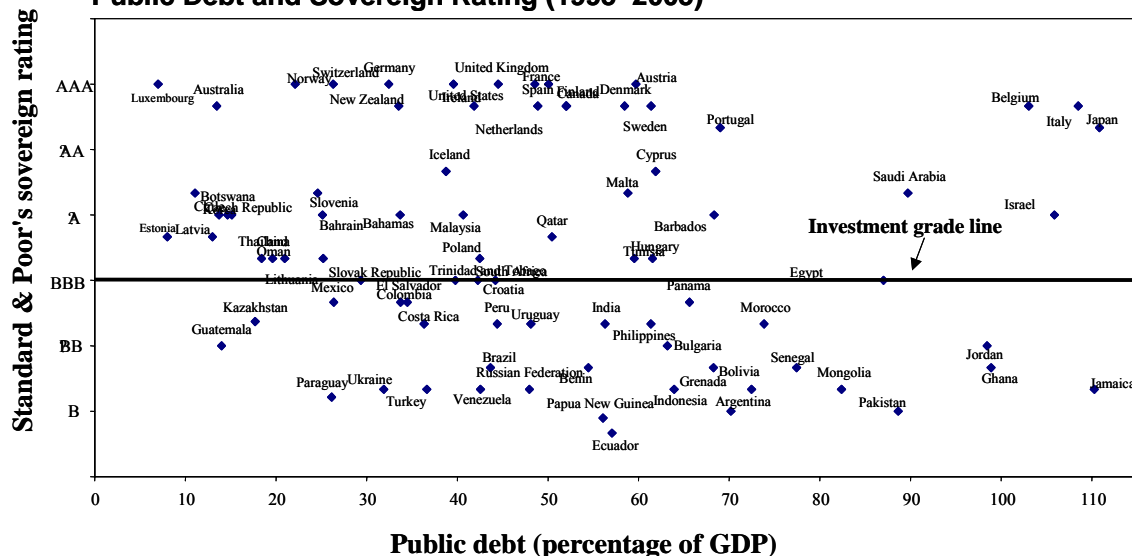
Source: Source: FITCH database and authors' calculations.

1. Are debt levels the Problem?

General Government Public Debt

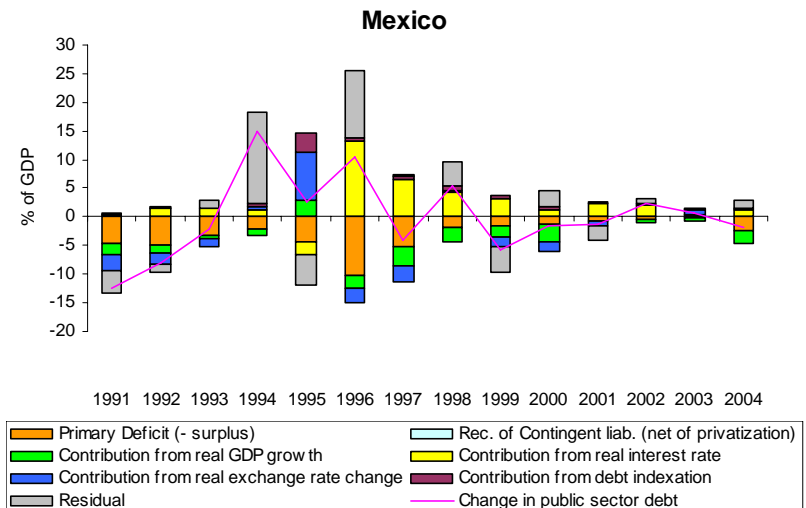
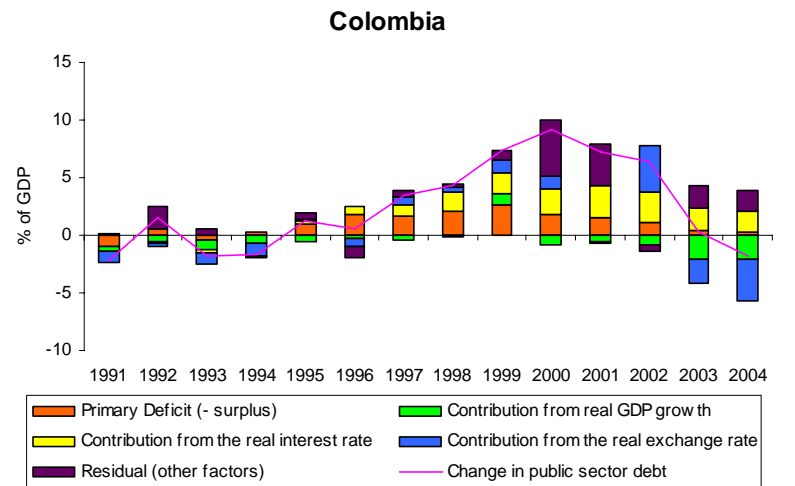
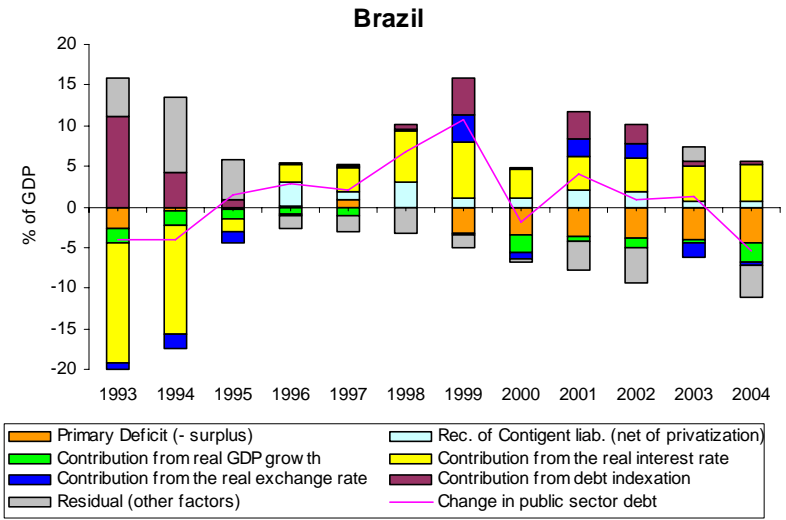
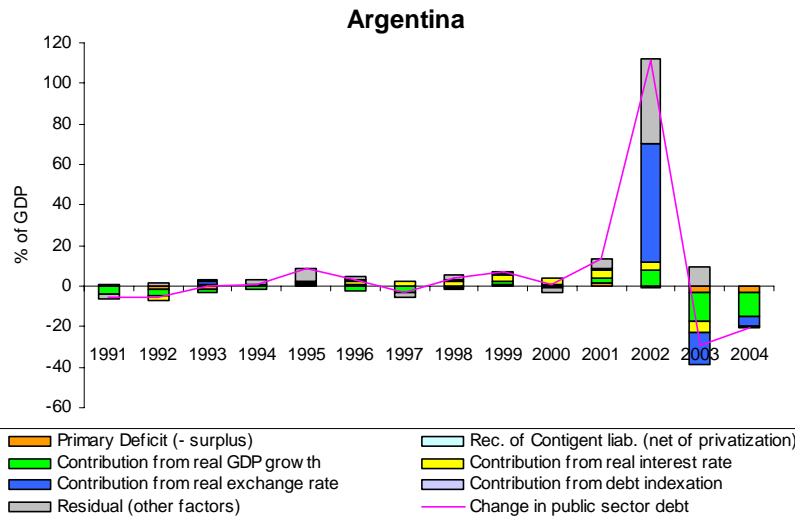


Public Debt and Sovereign Rating (1995–2005)

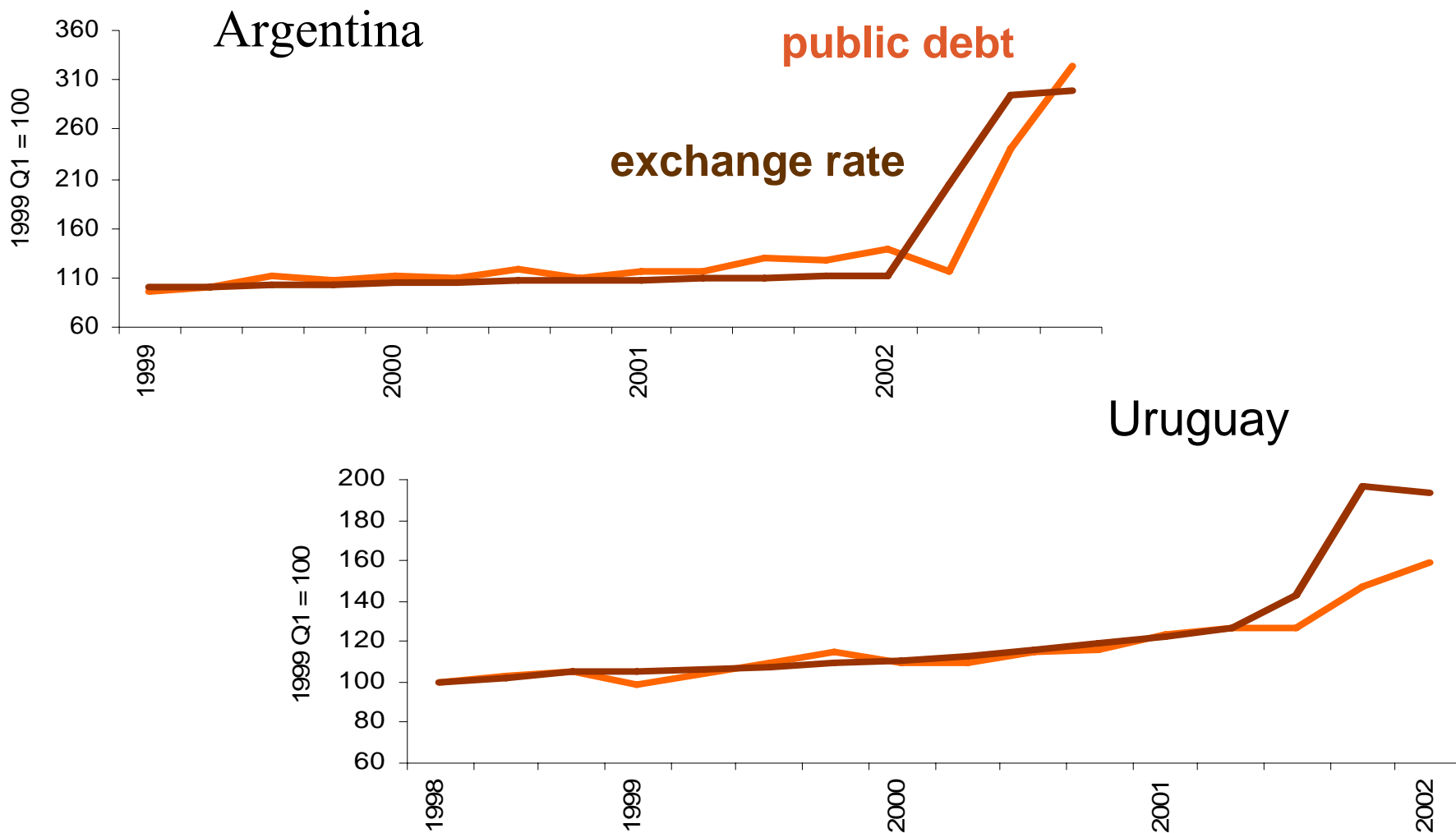


Source: IADB, IPES (2007), and FITCH database

1. Or is debt composition the problem?: Explaining increases in debt/GDP ratios

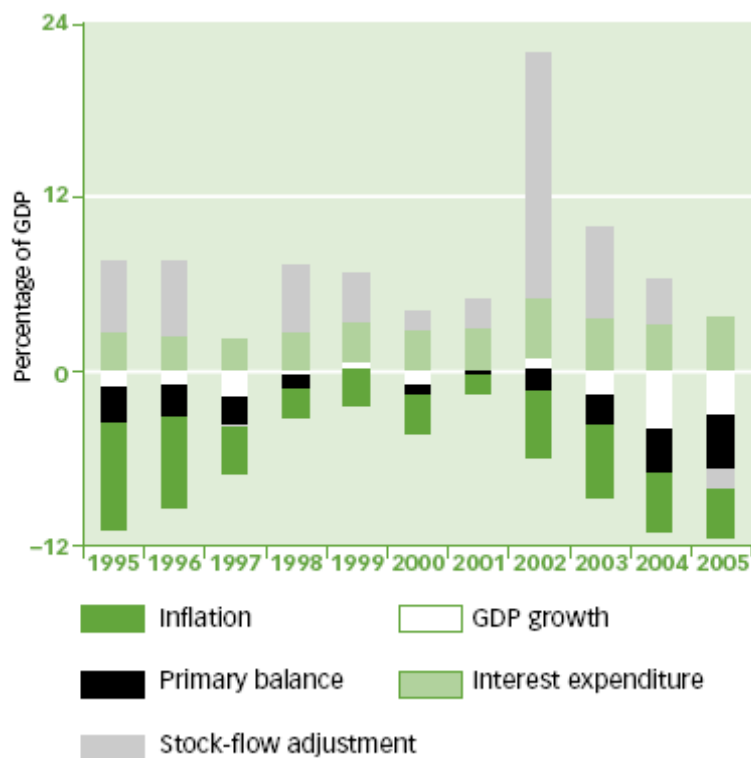


1. Or is debt composition the problem? ..vulnerable given high currency exposures..

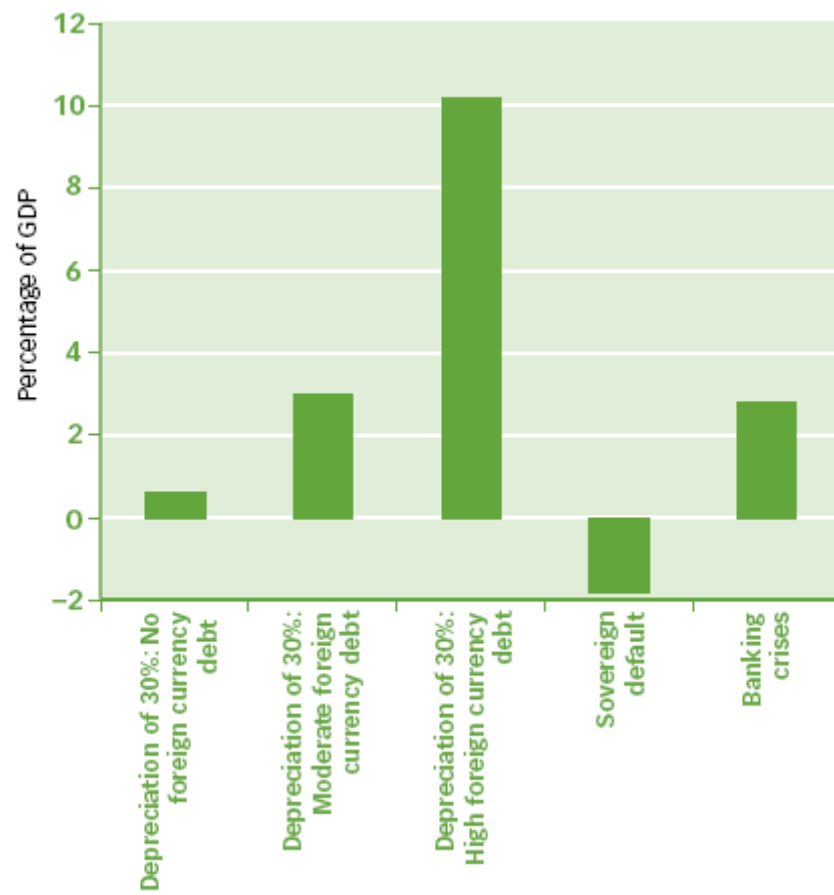


1. Or is debt composition the problem?

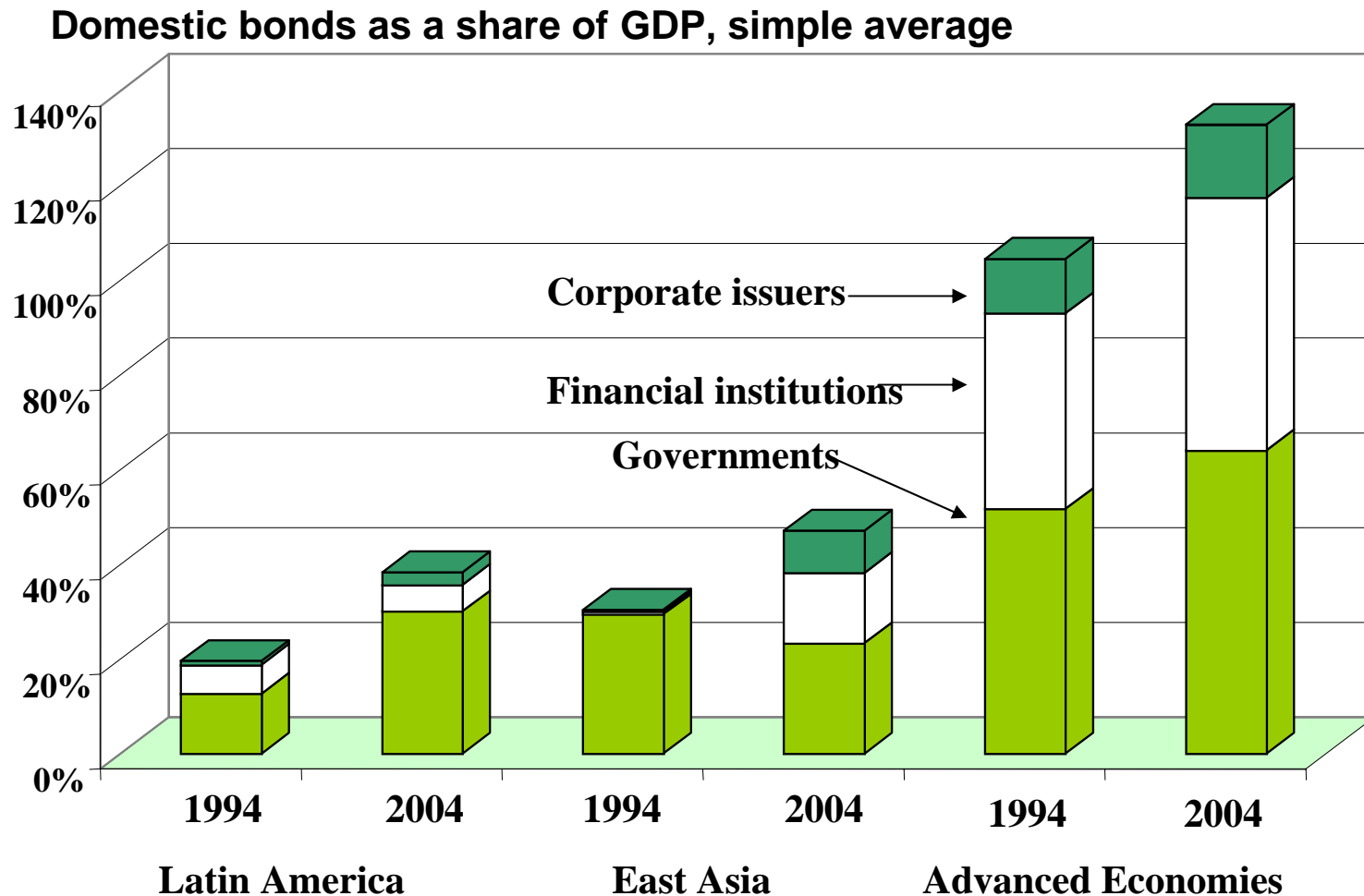
Decomposition of Debt Growth in Seven Largest Latin American Economies



Determinants of Stock-Flow Adjustment

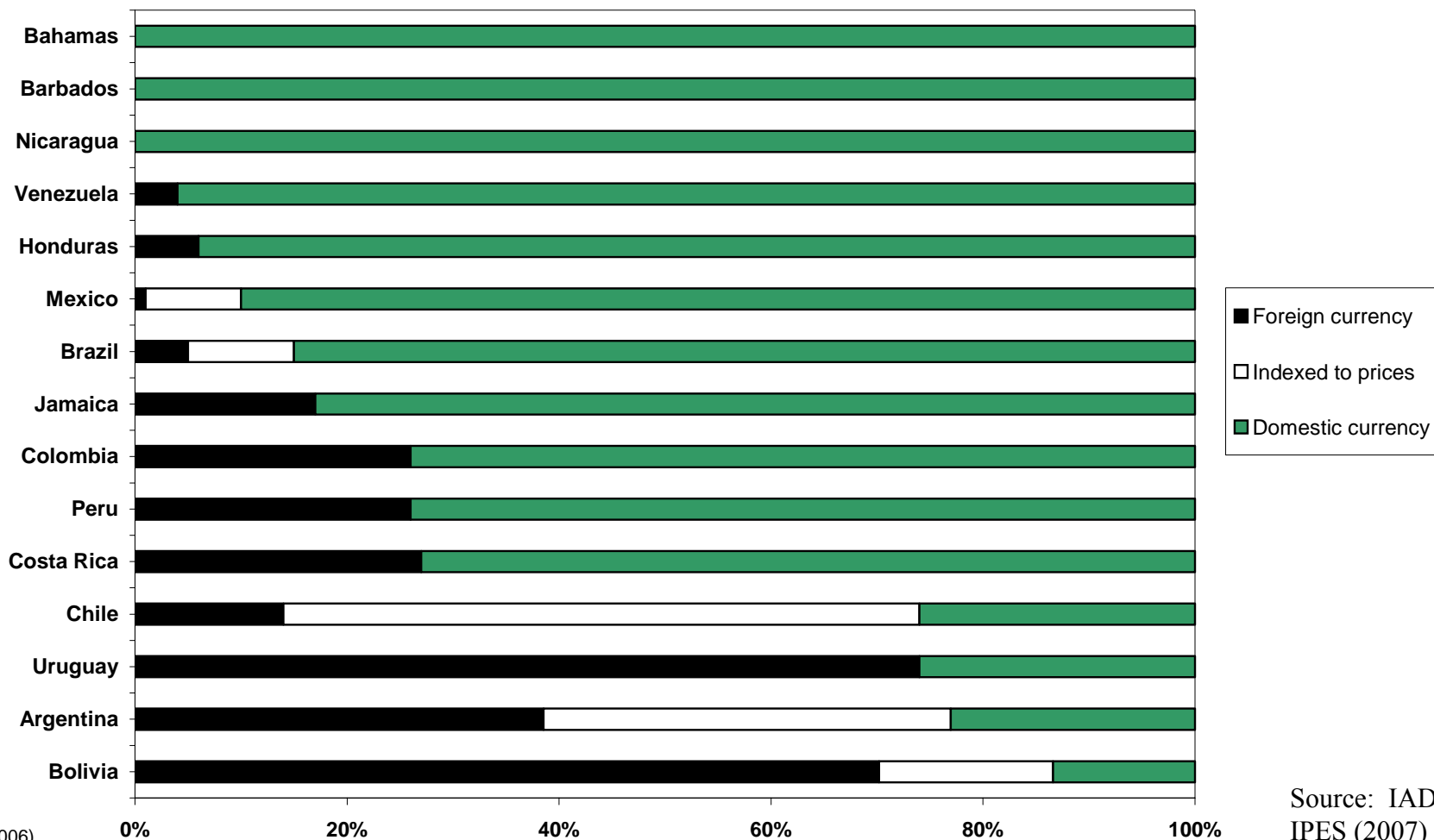


Growing from low levels...



...peso-denominated...

Currency Composition of Domestic Public Debt, 2004



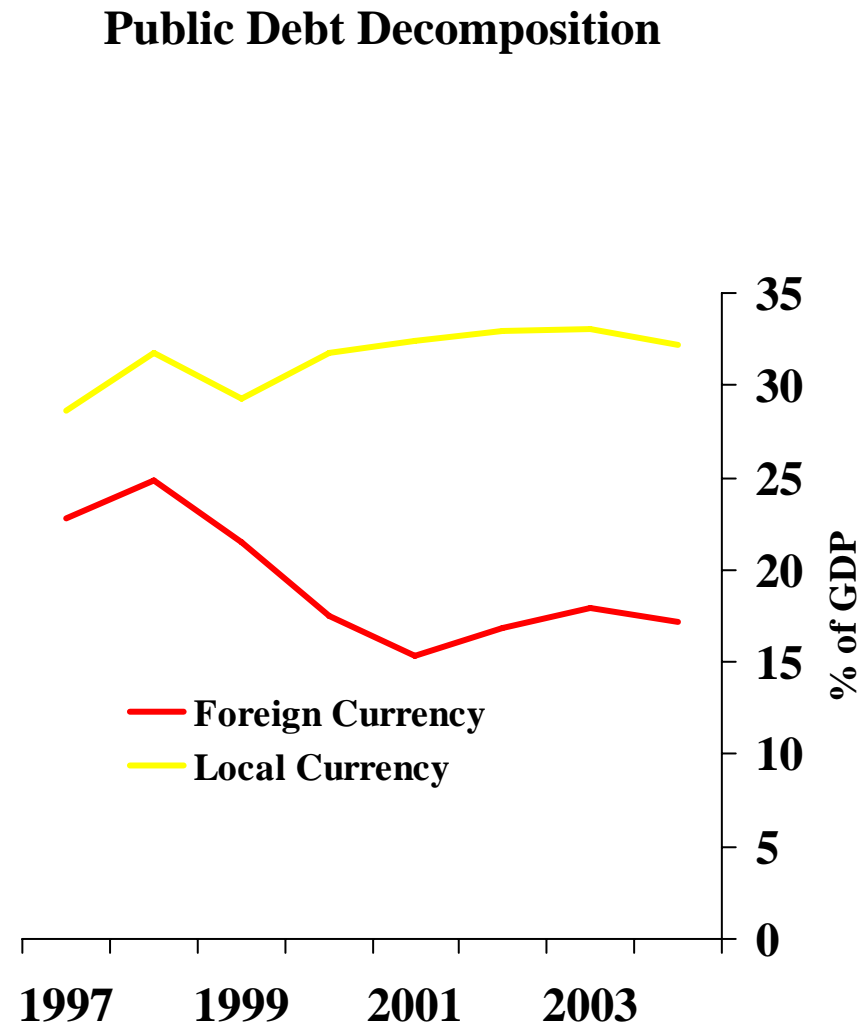
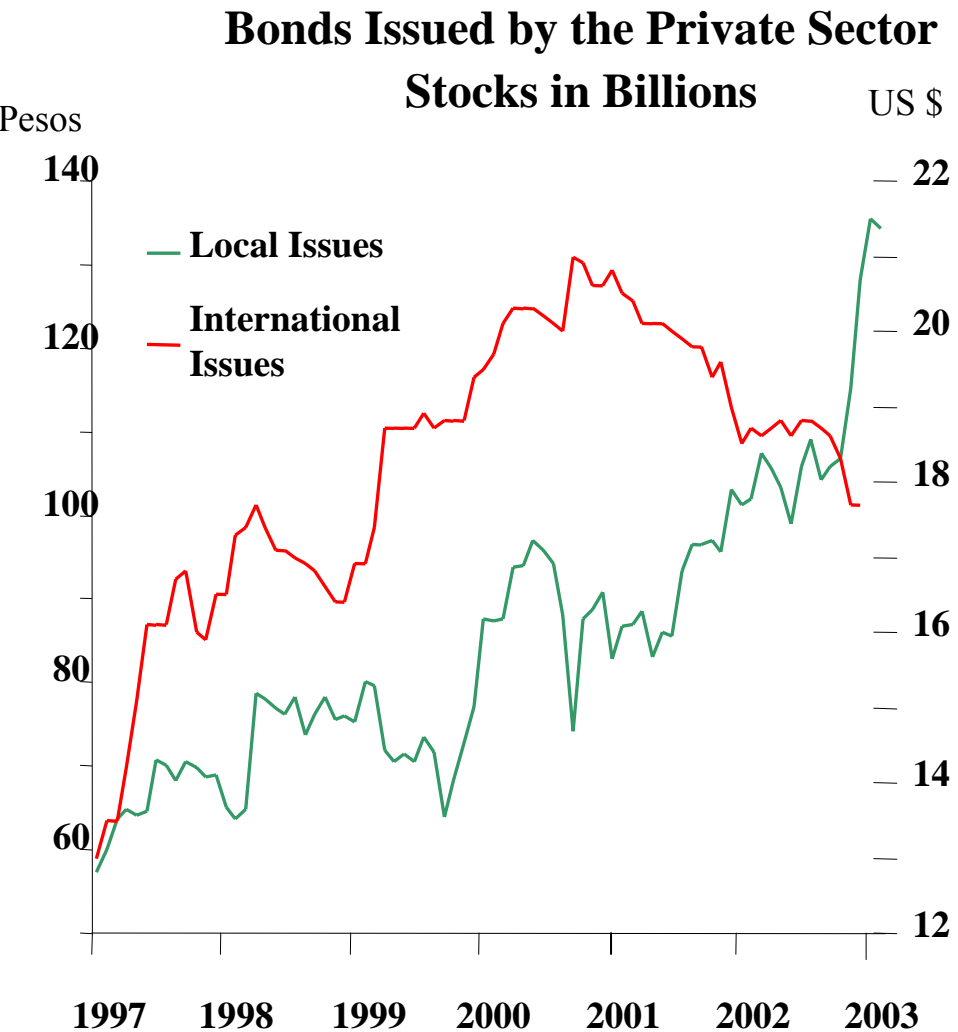
Source: IADB, IPES (2007)

1. Policy Issue: Debt management and capital markets development

Determinants of Bond Market Development

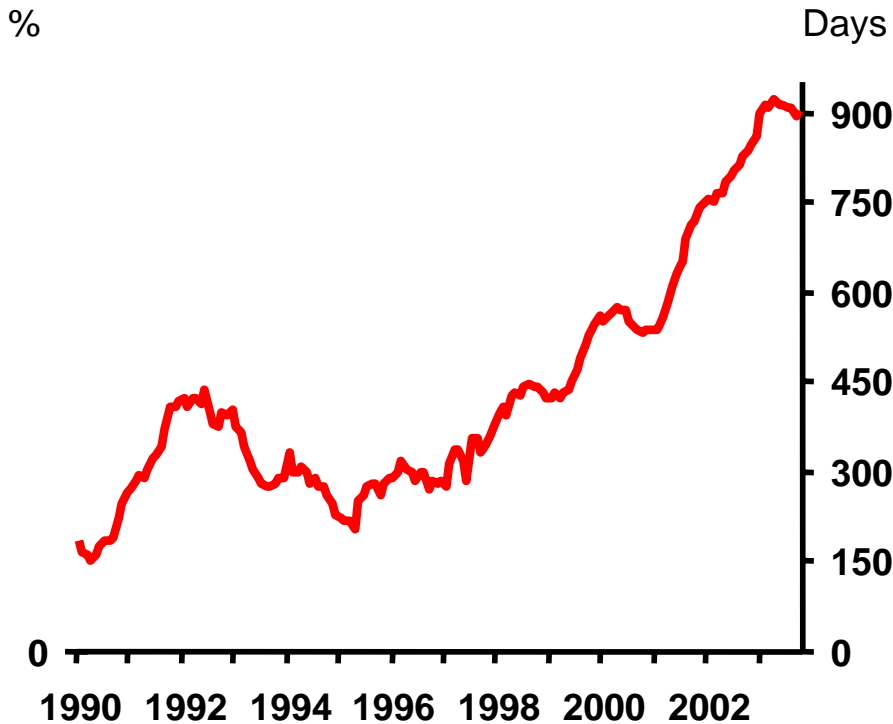
- ❑ Macroeconomic and institutional fundamentals (foster *both* local and foreign currency bond markets)
- ❑ Flexible exchange rate policies (pegs induce foreign currency bonds issuance against domestic currency bonds)
- ❑ Size (determine liquidity and risk diversification options)
- ❑ Investor base (pension funds, insurance companies)
- ❑ Market regulation and Infrastructure
- ❑ Public debt management (provide base yield curve)
- ❑ Inflation indexing

1. Policy Issue: Debt management and capital markets development: The Mexican example

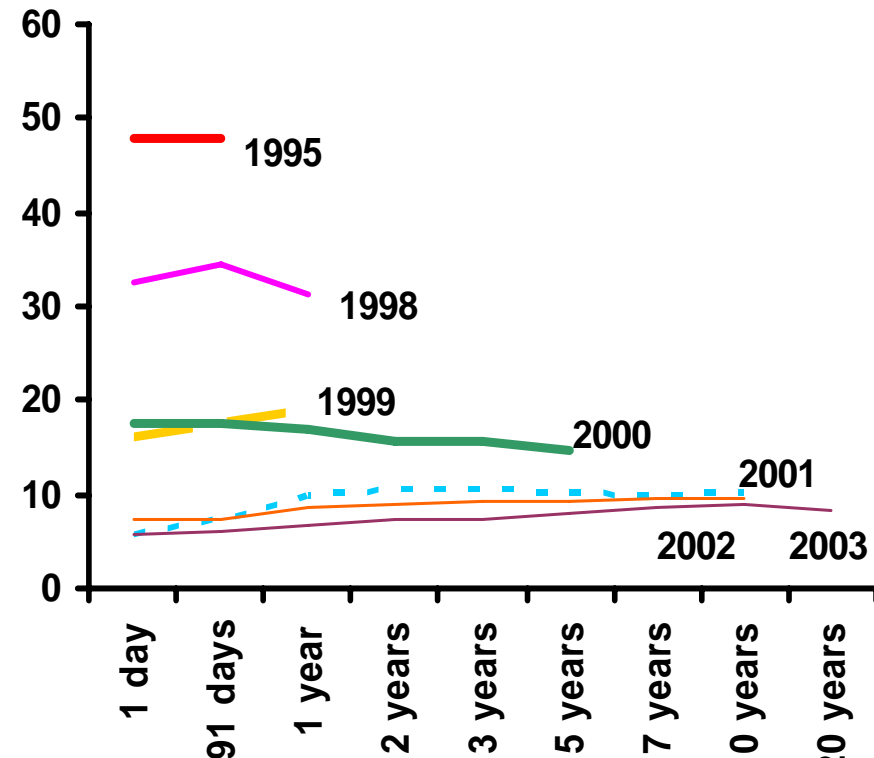


1. Policy Issue: Debt management and capital markets development: The Mexican example

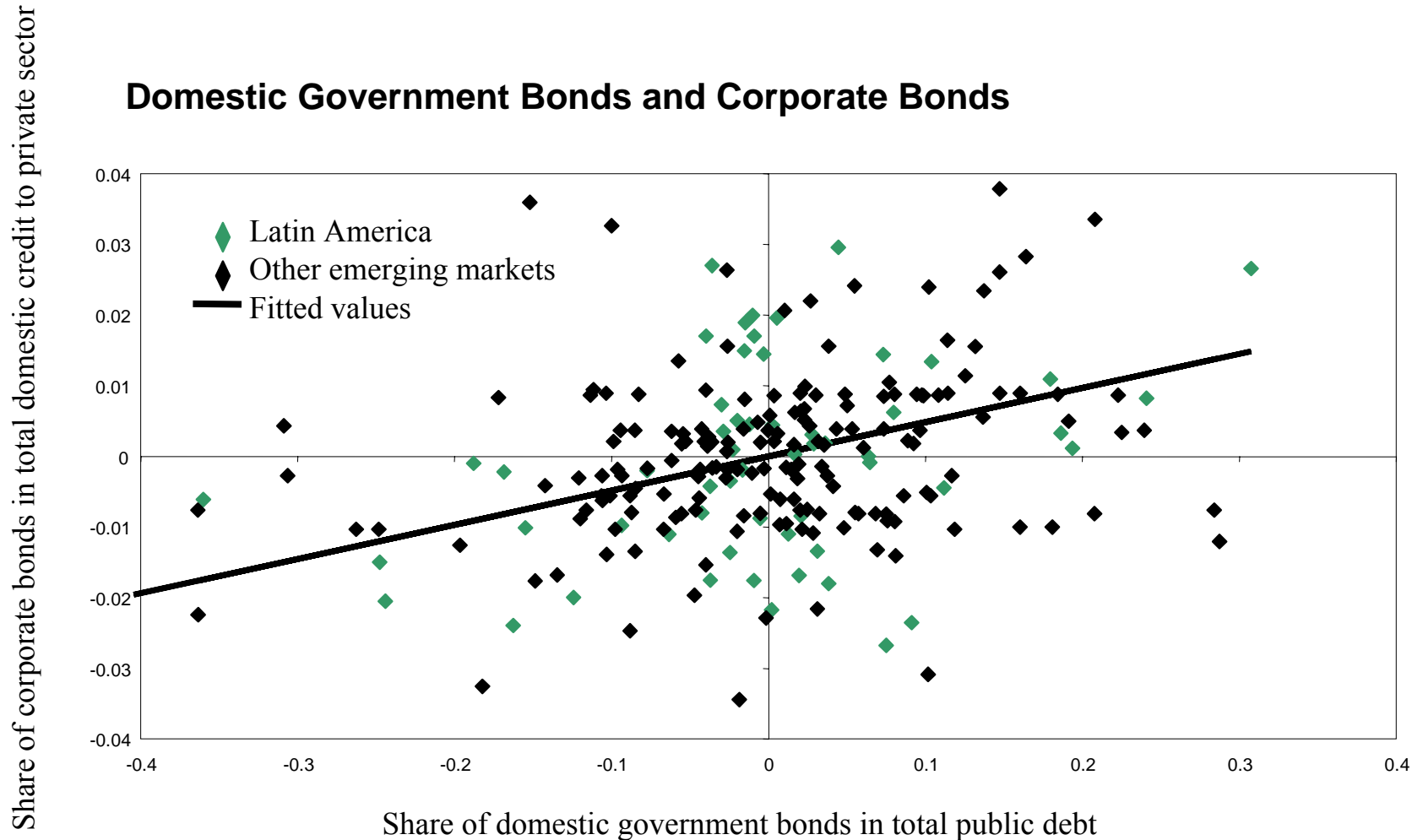
Maturity of Domestic Public Debt



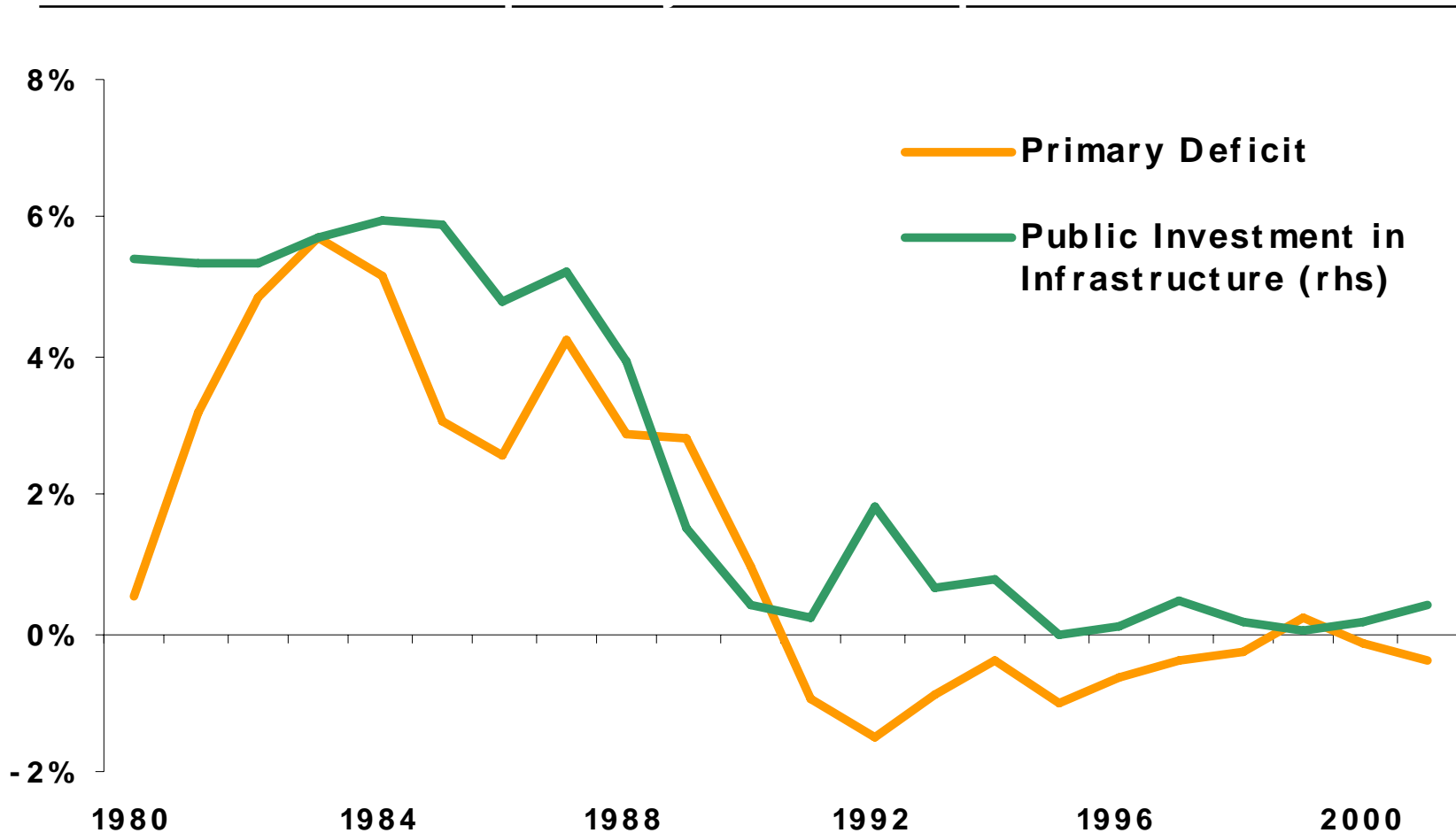
Yield Curve at various points in time (in percent)



Crowding out or crowding in?

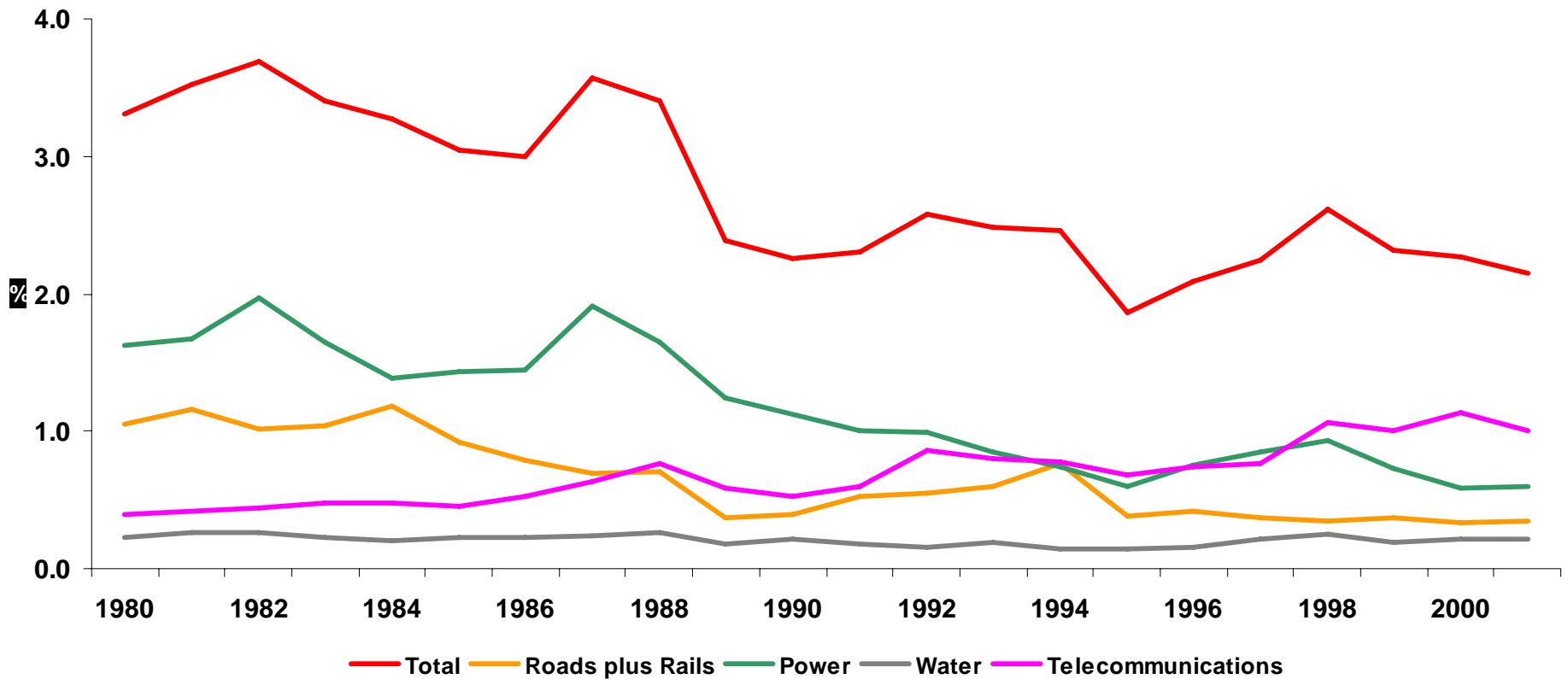


2. Fiscal adjustment has affected growth through excessive cuts in infrastructure



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**Latin America: Investment in Infrastructure (public + private)
(weighted average of 7 countries, percent of GDP)**



2. Fiscal adjustment has affected growth through excessive cuts in infrastructure

The cost of the widening infrastructure gap: EAP vs LAC

	Avg. 1991-00 vs. Avg. 1981-90	Avg. 1996-00 vs. Avg. 1981-85
<i>1. Change in relative infrastructure endowments (%)</i>		
Main Phone Lines	27.6	41.1
Electricity Generating Capacity	37.9	58.0
Roads	30.3	50.3
<i>2. Change in Relative GDP per worker (%)</i>	31.6	41.9
<i>3. Contribution of the infrastructure gap</i>	9.3	14.5
<i>4. Relative contribution (as % of [2])</i>	29.2	34.7

2. Policy Issue: a biased fiscal policy framework

- The current emphasis on fiscal liquidity blurs the distinction between consumption and investment spending: both have the same effect on short-run debt and deficits, even though they may have opposite effects on long-term solvency.
- Combined with pro cyclical fiscal policies it leads to an *anti-investment bias* (current expenditures are increased in booms, and investment bears the brunt of cuts in busts)
- This *anti-investment bias* is a key factor behind the public investment compression -- and an obstacle to its reversion.
- In effect, it tends to magnify the growth cost of fiscal adjustment – which may thus even weaken, rather than strengthen, public finances in the long run.

2. Policy issue: how to avoid anti investment biases while keeping debt sustainability?

- Two strategies under discussion (in EU and between WB/IMF/country governments):

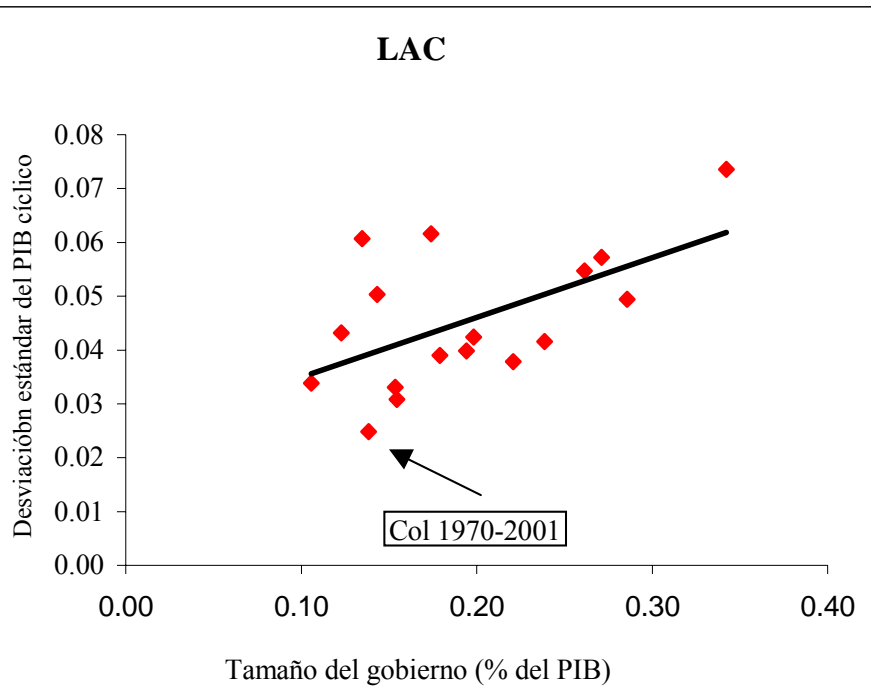
(1) Different fiscal rules without anti-investment bias

Problem: they may open the door to low-quality projects ('white elephants') – unless there is a strong project selection / evaluation capability- and to debt sustainability problems – unless keeping debt limits a la UK.

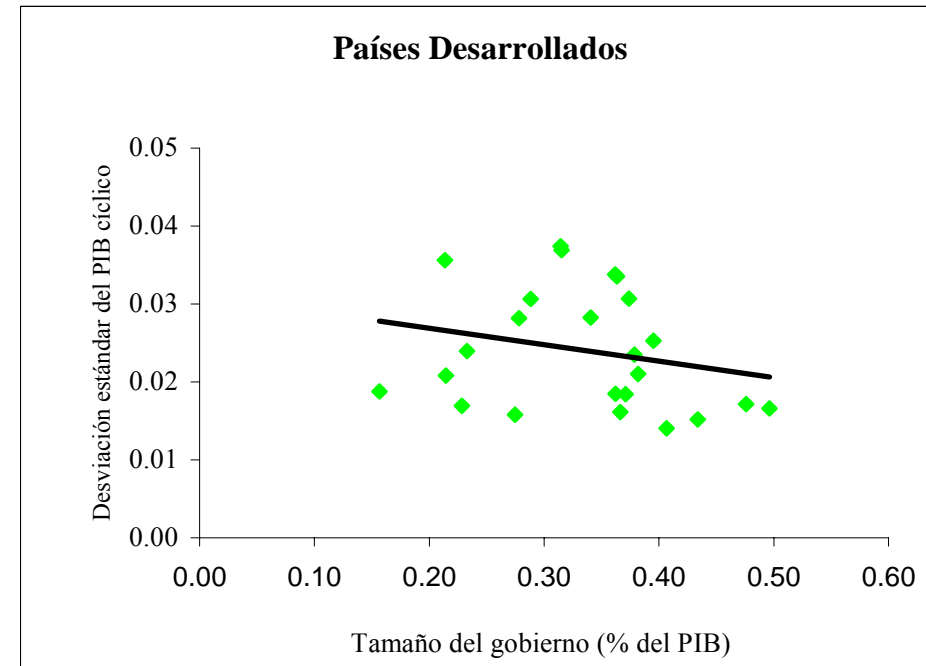
(2) Special treatment for *some* public investment projects: they will be exempted from existing fiscal rules

Problem: incentive to bias (or misclassify) spending to make it fit under the “permitted” categories: e.g. **Invest more in oil if the public oil company is “commercial” or in projects that attract private sector involvement**

3. Pro-cyclicality: Government stabilizes in OECD countries, but not in LAC ..



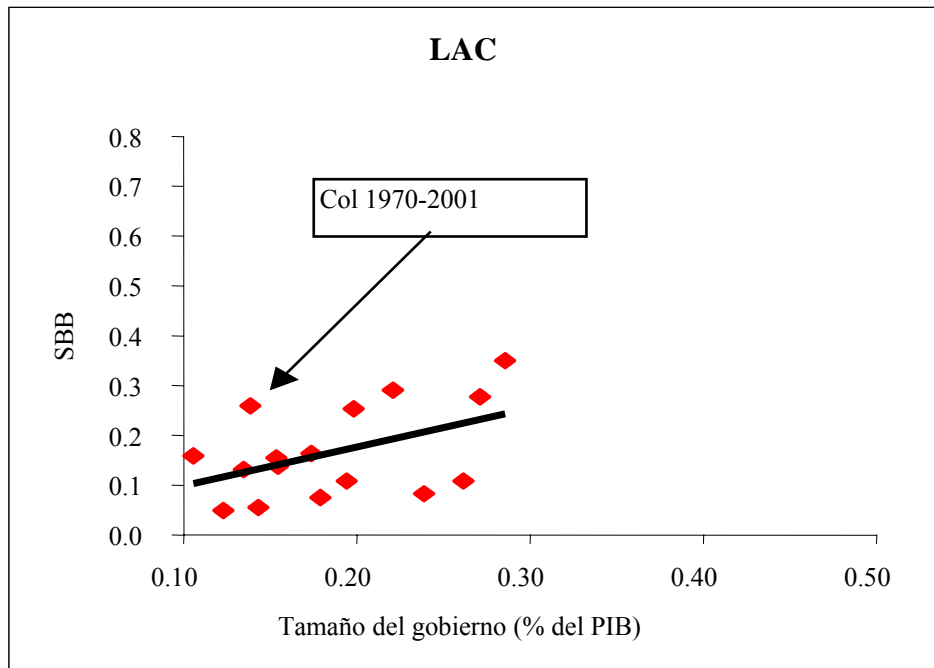
Promedios 1970-2001



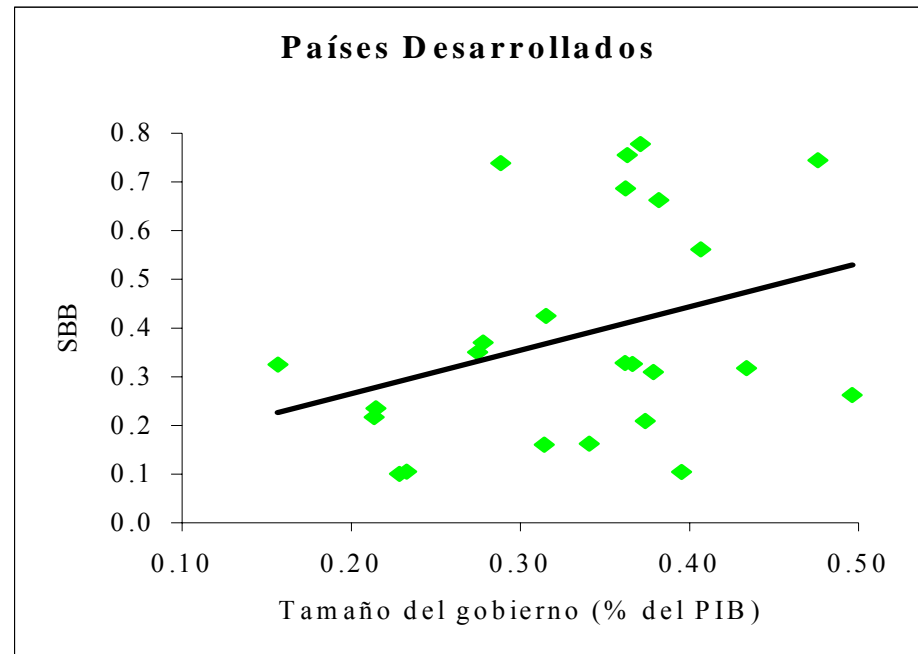
Promedios 1970-2001

(Volatilidad del PIB contra tamaño del Estado)

3. ..in part due to smaller automatic stabilizers



Promedios 1970-2001

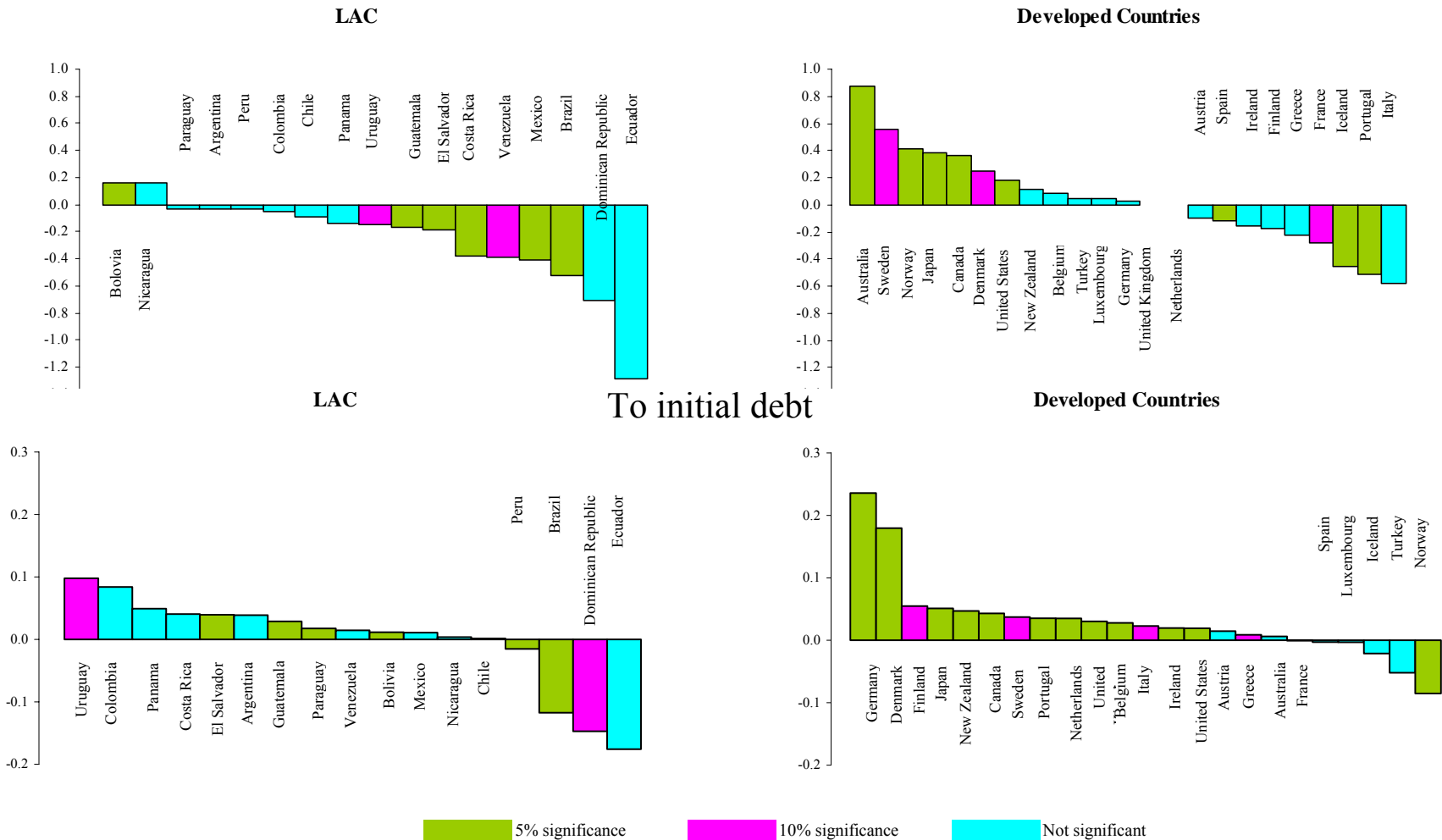


Promedios 1970-2001

(Cambio en la relación ingresos tributarios a PIB ante una desviación cíclica del PIB del 1%)

3. ...and Pro Cyclical Discretionary Policies

Discretionary Fiscal Policy Response to Cyclical Conditions

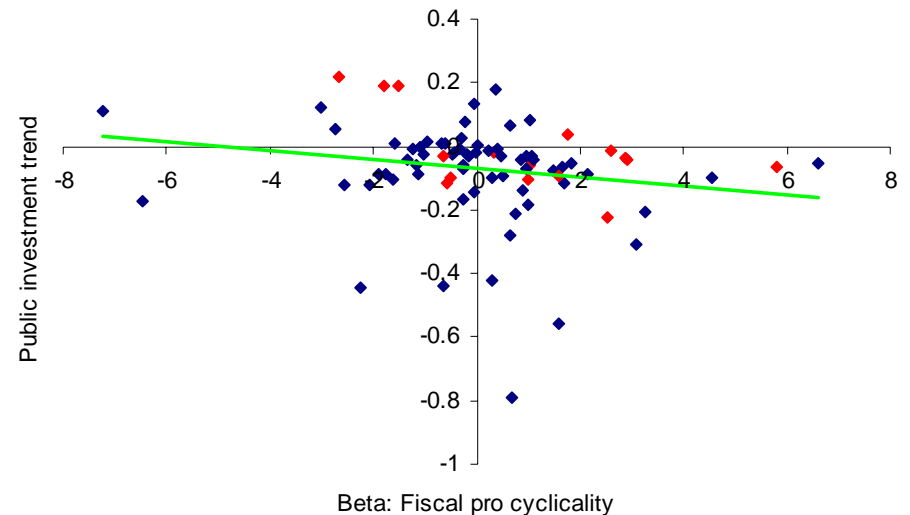
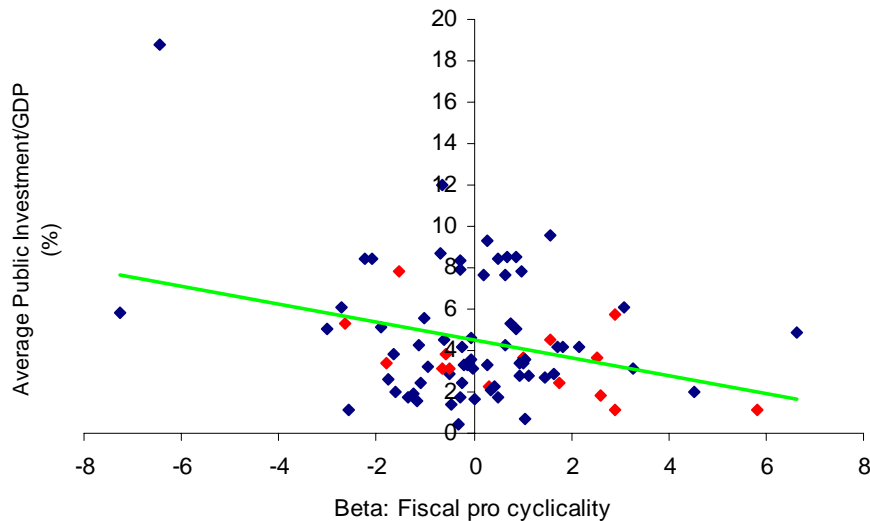




3. Procyclical bias leads to anti investment and deficit biases

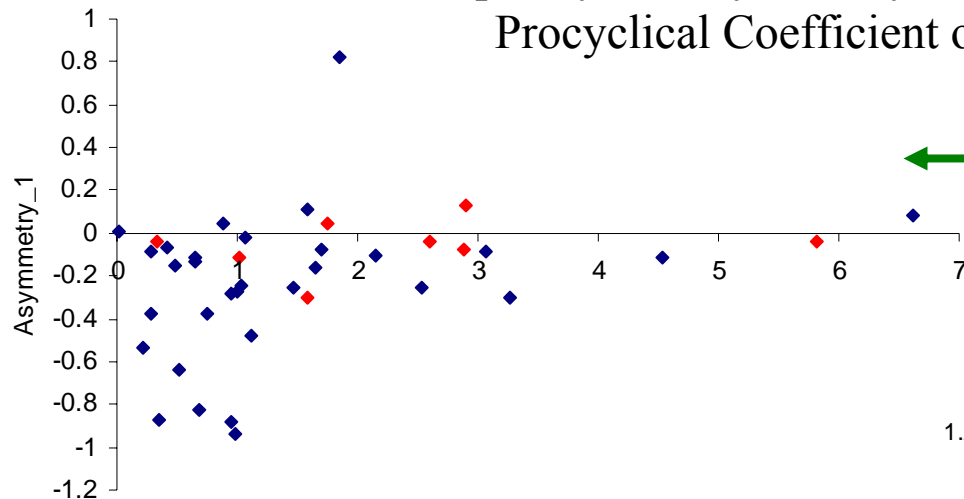
- Current expenditures are increased in booms, and investment bears the brunt of cuts in busts.
- Tough cuts in bad times may become socially and politically impossible (and economically self-defeating as by deepening recessions may increase perceptions of debt un-sustainability)
- Thus procyclical fiscal policies may lead to crises (e.g. Argentina after 1999)

3. Pro cyclicality is associated with low public investment levels and trends



3. Due to asymmetric response of public investment along the business cycle

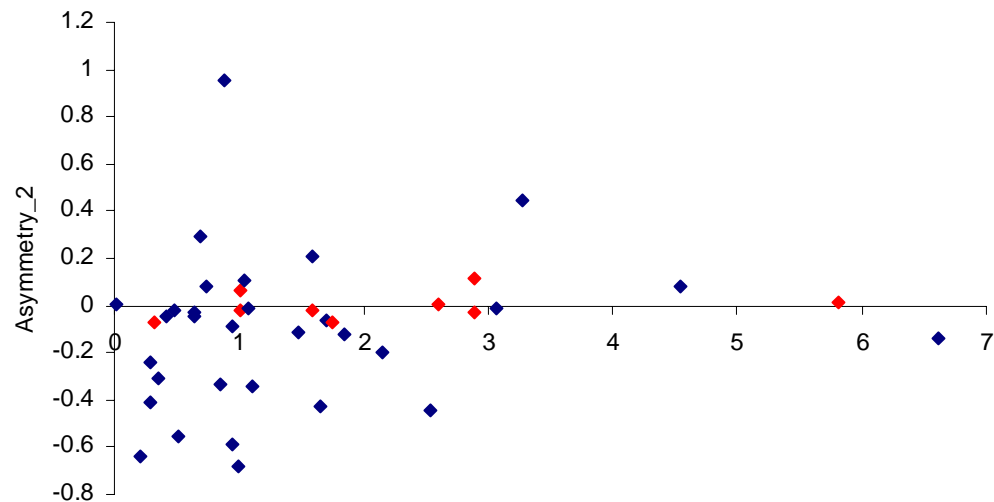
Fiscal pro-cyclicality and asymmetry of public investment responses
Procyclical Coefficient on Real Current Expenditures



Beta: fiscal pro-cyclicality

$$\left(\frac{\text{Public Investment}}{\text{GDP}}\right)_t = \alpha_1 + \alpha_2 (D_{\text{pos}}) * (\text{Cycle_GDP}_t) + \alpha_3 (D_{\text{neg}}) * (\text{Cycle_GDP}_t) + T_t + v_t$$

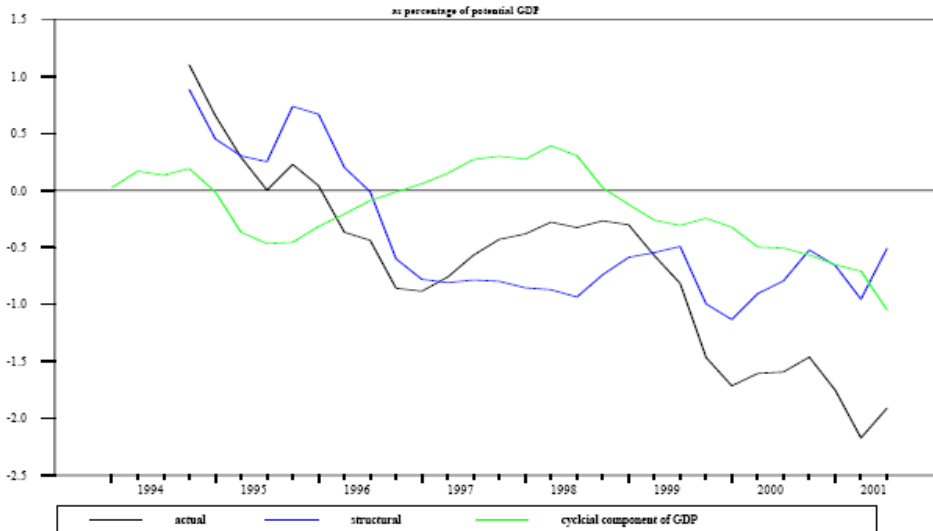
$$\left(\frac{\text{Public Investment}}{\text{GDP}}\right)_t = \alpha_1 + \alpha_2 (D_{\text{pos}}) * (\text{GDPgrowth}_t) + \alpha_3 (D_{\text{neg}}) * (\text{GDPgrowth}_t) + T_t + v_t$$



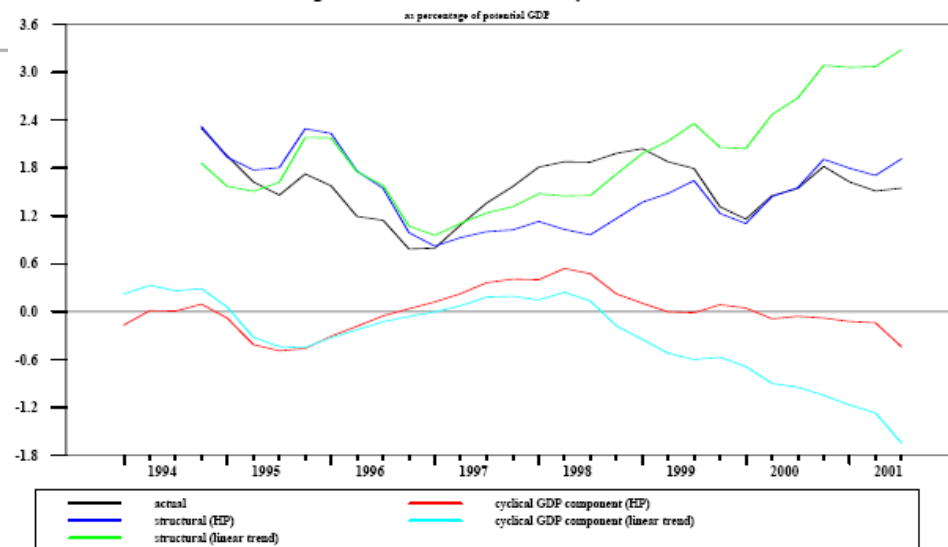
Beta: Fiscal pro cyclicity

3. Pro cyclicality and deficit bias: Argentina in the 90's

Argentina: Structural Economic Balance



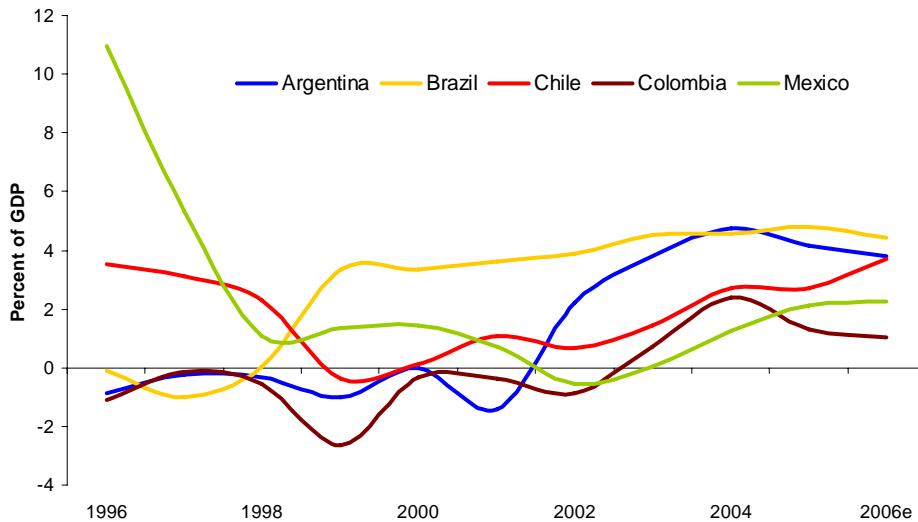
Argentina: Structural Primary Balance



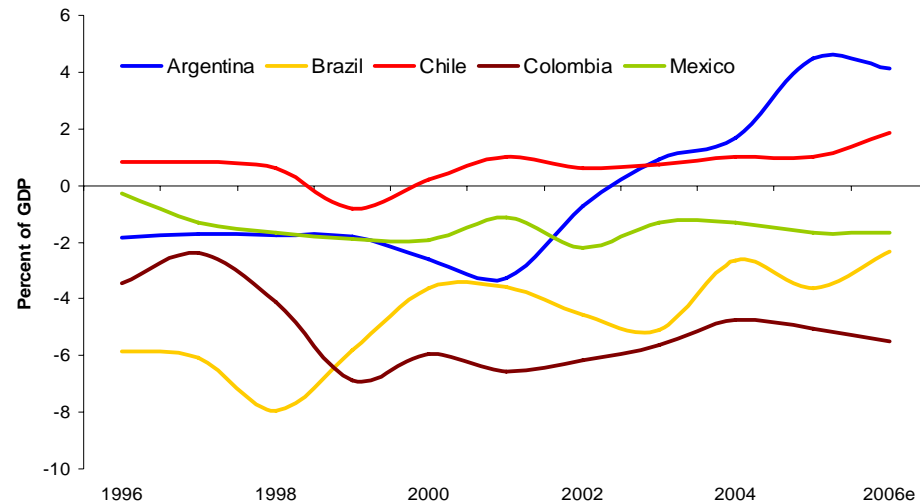
Source: Perry and Servén (2003)

3. How much structural improvement during the present boom?

General Government Structural Primary Balance



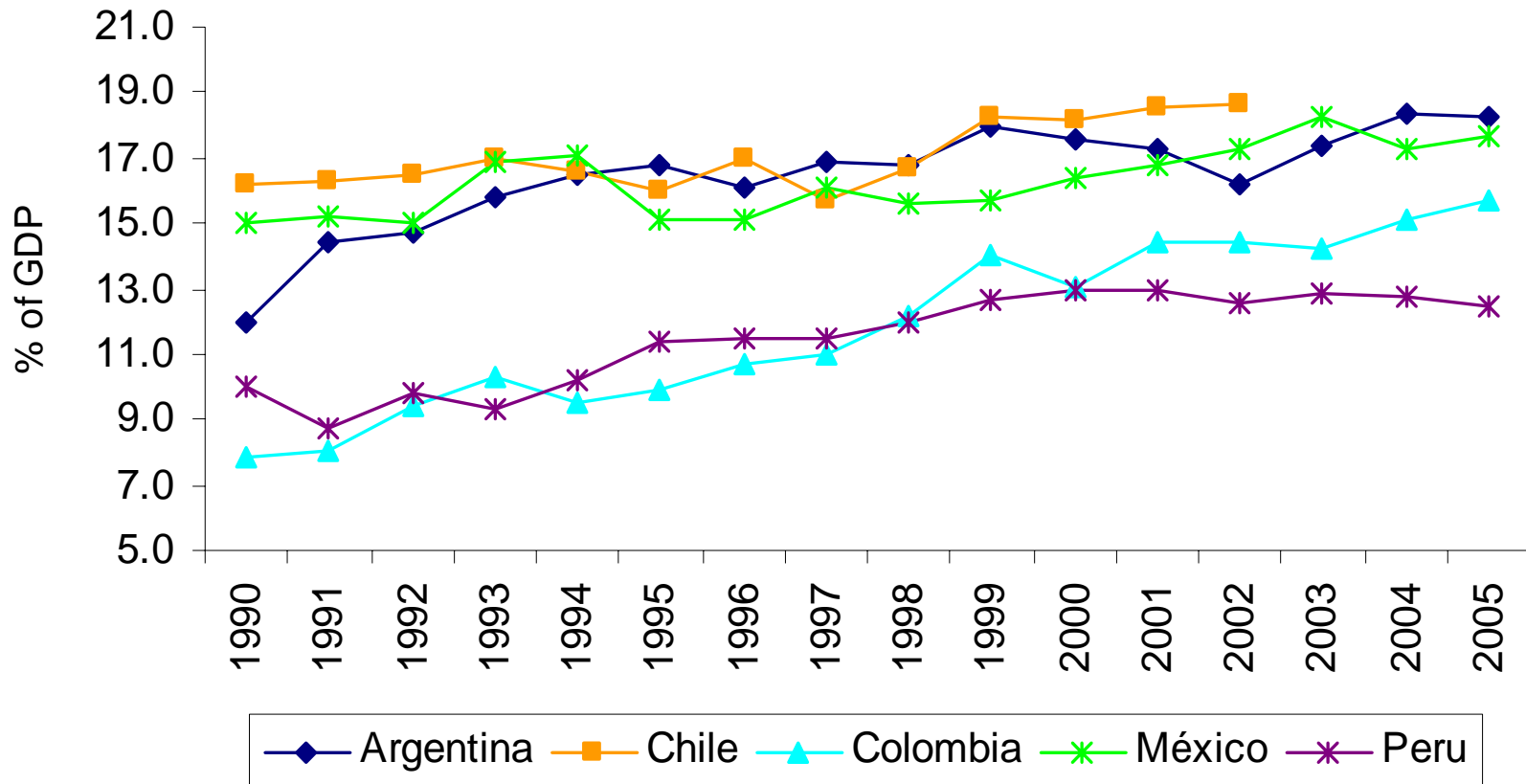
General Government Structural Overall Balance



Source: WEO, WDI and Author's Calculation.

3. How much structural improvement during the present boom?

Current Primary Expenditure

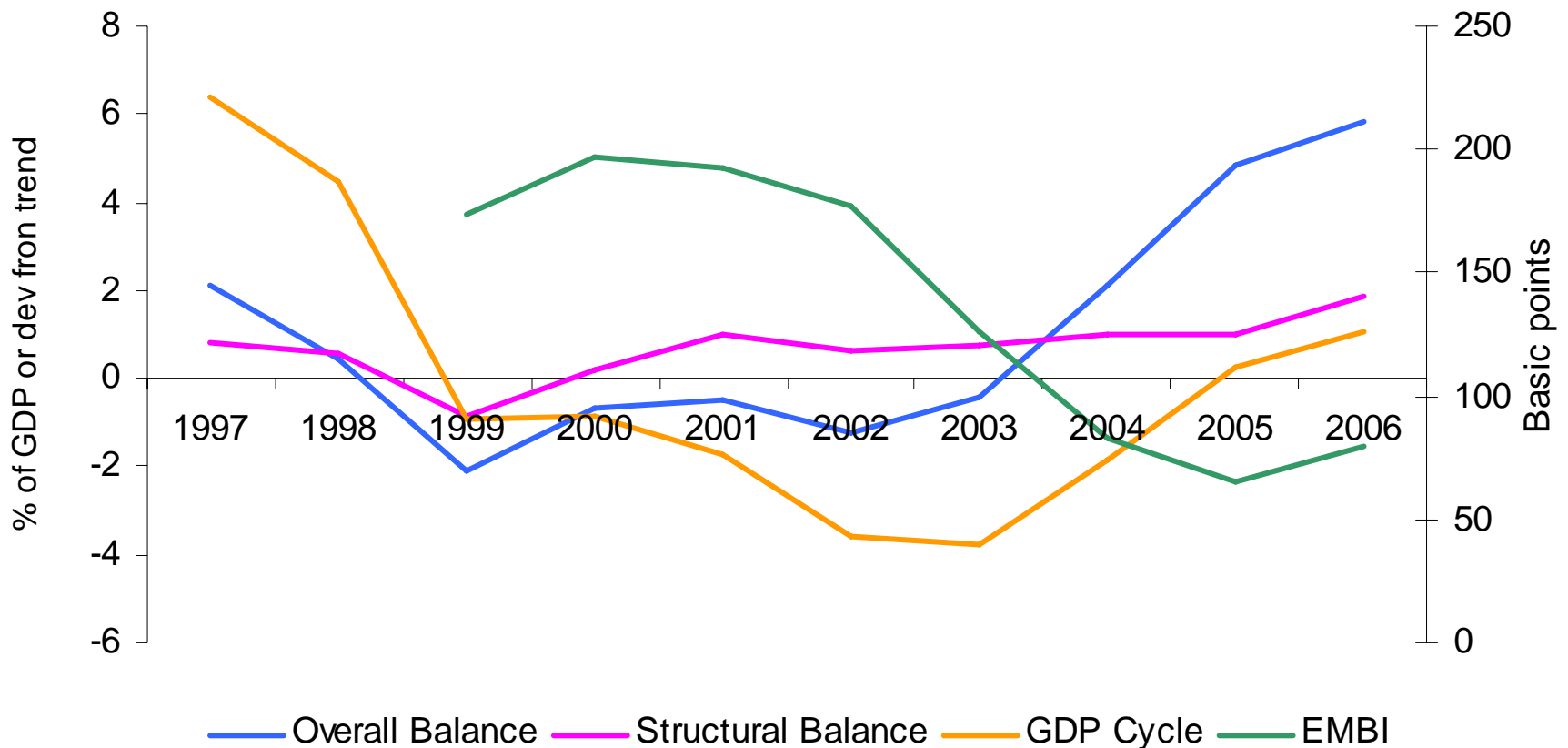


3. Behind pro cyclical: political economy and asymmetric information

- Political pressures to spend surpluses away in good times
- Markets do not finance deficits in bad times because they can not distinguish between a responsible counter cyclical fiscal policy and fiscal loosening (track record in good times!)
- Excessive emphasis in Short Term Indicators and “Bad rules” can aggravate pro cyclical and deficit bias: fiscal responsibility laws with rigid nominal goals in Argentina and Peru

3. But “Good rules” help overcome both problems: Chile’s structural balance rule

Chile: Structural and Actual Balance (1997-2006)



Source: WDI, WEO, Bloomberg and Author's calculations



□ THE END