Post-pandemic Fiscal Policy Challenges in LAC

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Objectives of Fiscal Policy: Stabilization, Long-Term Growth, Redistribution

- On stabilization, LAC has made progress. But challenges remain: capital flow volatility, limited success addressing the pandemics, social unrest.

- On redistribution and long-term growth there is room for significant improvement.

- Beyond the pandemics, these are not new themes for the region. Neither is the variability of conditions across countries (despite the common shock represented by the pandemics). LAC is not a uniform region.

Consumers prefer a stable consumption path. Consumption volatility has a welfare cost. In LAC, the cost of consumption volatility has decreased in the last decade for most countries.
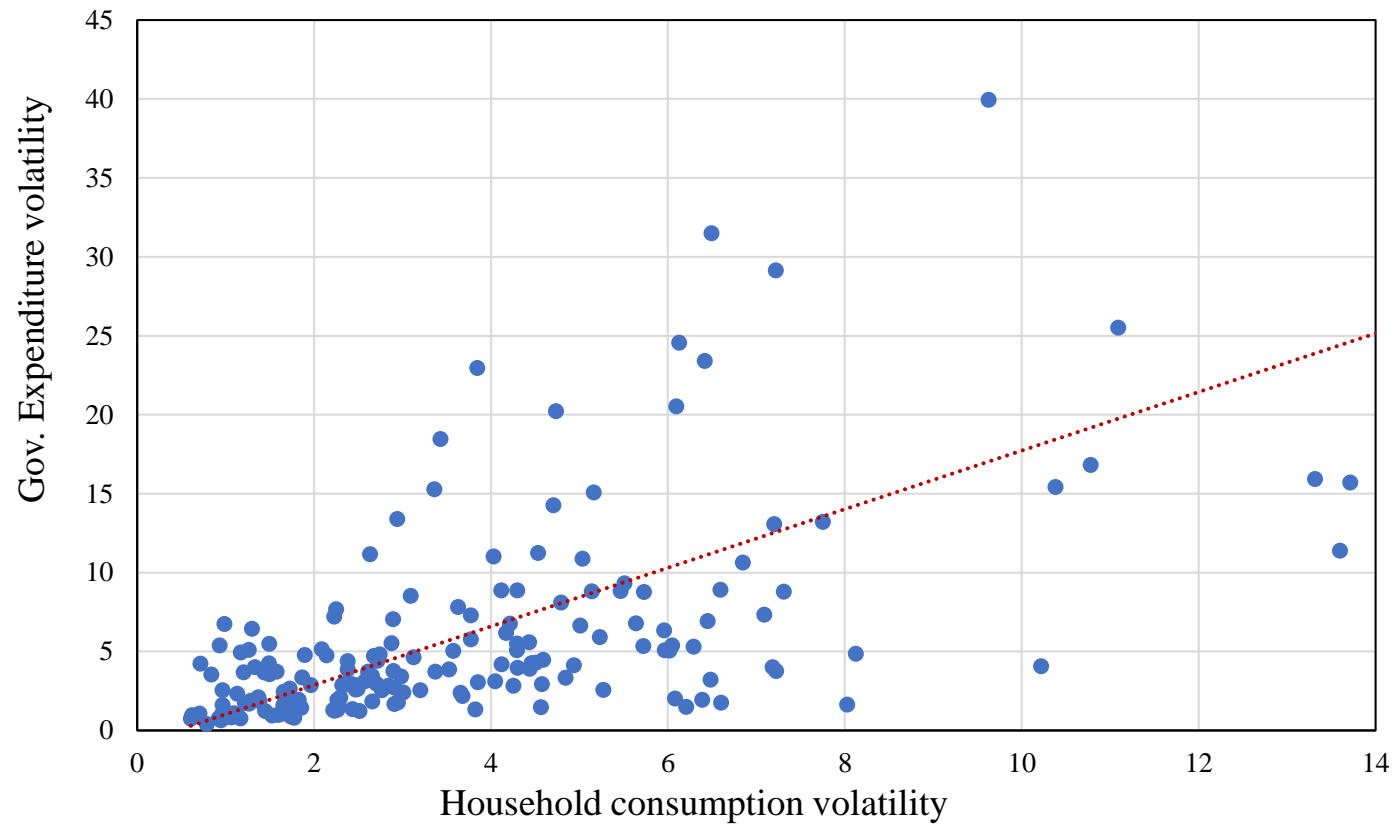
Cost of consumption volatility

	1960-2018	1990-2018	2001-2018
	Countries		
Argentina	17.76	17.90	21.74
Bolivia	2.54	0.42	0.49
Brazil	10.48	3.73	3.57
Chile	16.71	4.70	3.50
Colombia	2.39	2.73	1.24
Costa Rica	7.84	2.22	0.88
Dominican Republic	14.44	7.21	4.15
Ecuador	6.56	6.09	2.89
Guatemala	1.04	0.20	0.27
Honduras	0.68	0.81	0.76
Haiti	3.47	3.61	3.56
Jamaica	5.99	6.13	6.08
Mexico	12.74	4.05	2.69
Nicaragua	42.35	21.58	2.02
Panama	18.38	15.21	1.90
Peru	12.05	4.75	2.53
Paraguay	5.23	4.18	2.93
El Salvador	13.76	11.29	2.97
Uruguay	13.71	11.34	10.35
Venezuela, RB	29.68	34.09	51.88

Historically, consumption volatility has been associated with higher government expenditure volatility

Household Consumption and Fiscal Policy Volatility

Consumption volatility has fallen, mostly due to stabilization role of fiscal policy

Determinants of consumption volatility

	Advanced Economies			
	1960-1974	1975-1989	1990-2004	2005-2018
Consumption volatility	0.85	0.85	0.66	0.45
Fiscal policy volatility	1.53	1.68	2.18	1.72
Government size	15.58	18.24	18.45	19.41
Trade 1 (level)	61.44	74.05	82.43	104.11
Trade 2 (volatility)	-.-	2.18	2.30	2.82
Income volatility	0.09	0.10	0.09	0.06
Financial liabilities	3.69	3.92	4.22	4.59
Vol. of financial liabilities	0.10	4.44	8.00	4.15
Financial openness	0.48	0.59	0.87	0.95

	Emerging Market Economies			
	1960-1974	1975-1989	1990-2004	2005-2018
Consumption volatility	1.35	1.63	1.32	0.92
Fiscal policy volatility	2.33	2.31	2.71	2.07
Government size	11.07	13.67	13.26	14.04
Trade 1 (level)	41.34	56.30	67.24	70.57
Trade 2 (volatility)	-.-	4.36	4.92	5.02
Income volatility	0.12	0.14	0.13	0.06
Financial liabilities	3.11	3.38	3.58	3.81
Vol. of financial liabilities	0.13	7.94	8.61	5.15
Financial openness	0.27	0.27	0.45	0.54

Source: Herrera and Butron (2021). Forthcoming. Trade 1 refers to exports and imports as a percentage of GDP. Trade 2 refers to external sector volatility, captured by the ratio of trade adjusted by the volatility of the terms of trade.
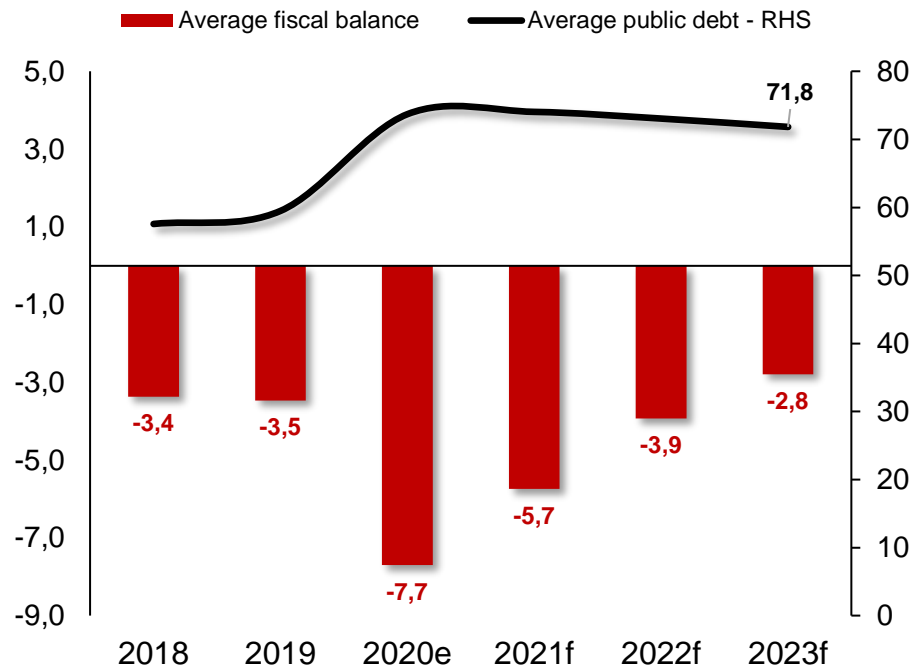
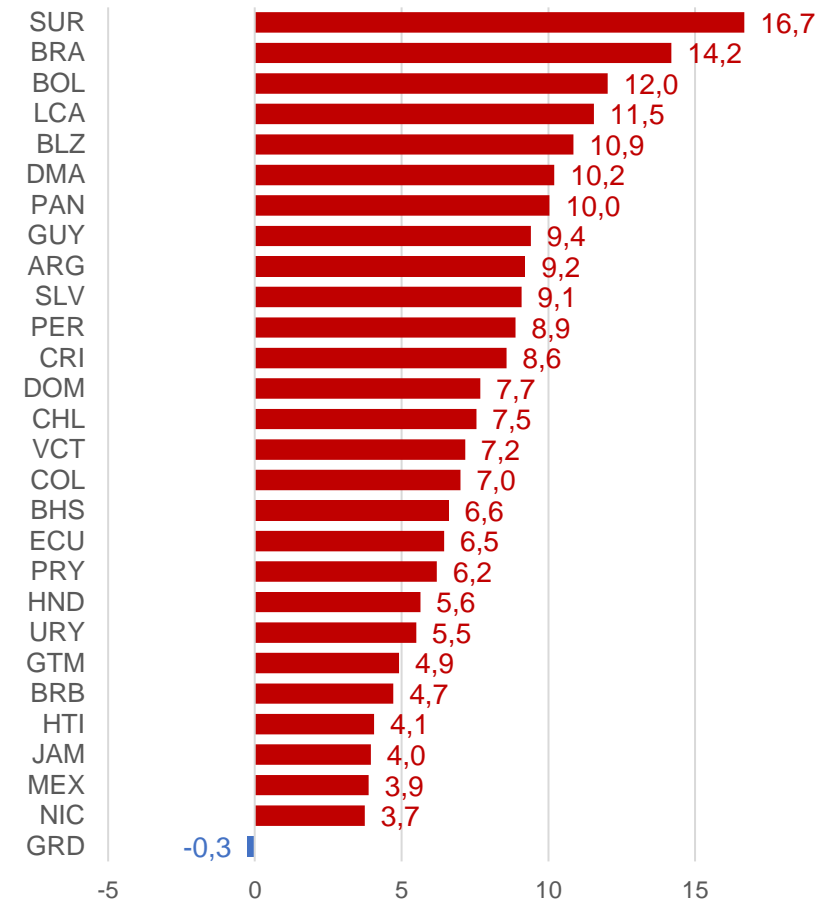# Macro fiscal frameworks have improved and included explicit fiscal rules

Expenditure fiscal rules among countries

Legend:
— Share of countries adopting expenditure rule
— Number of countries adopting a expenditure rule - RHS
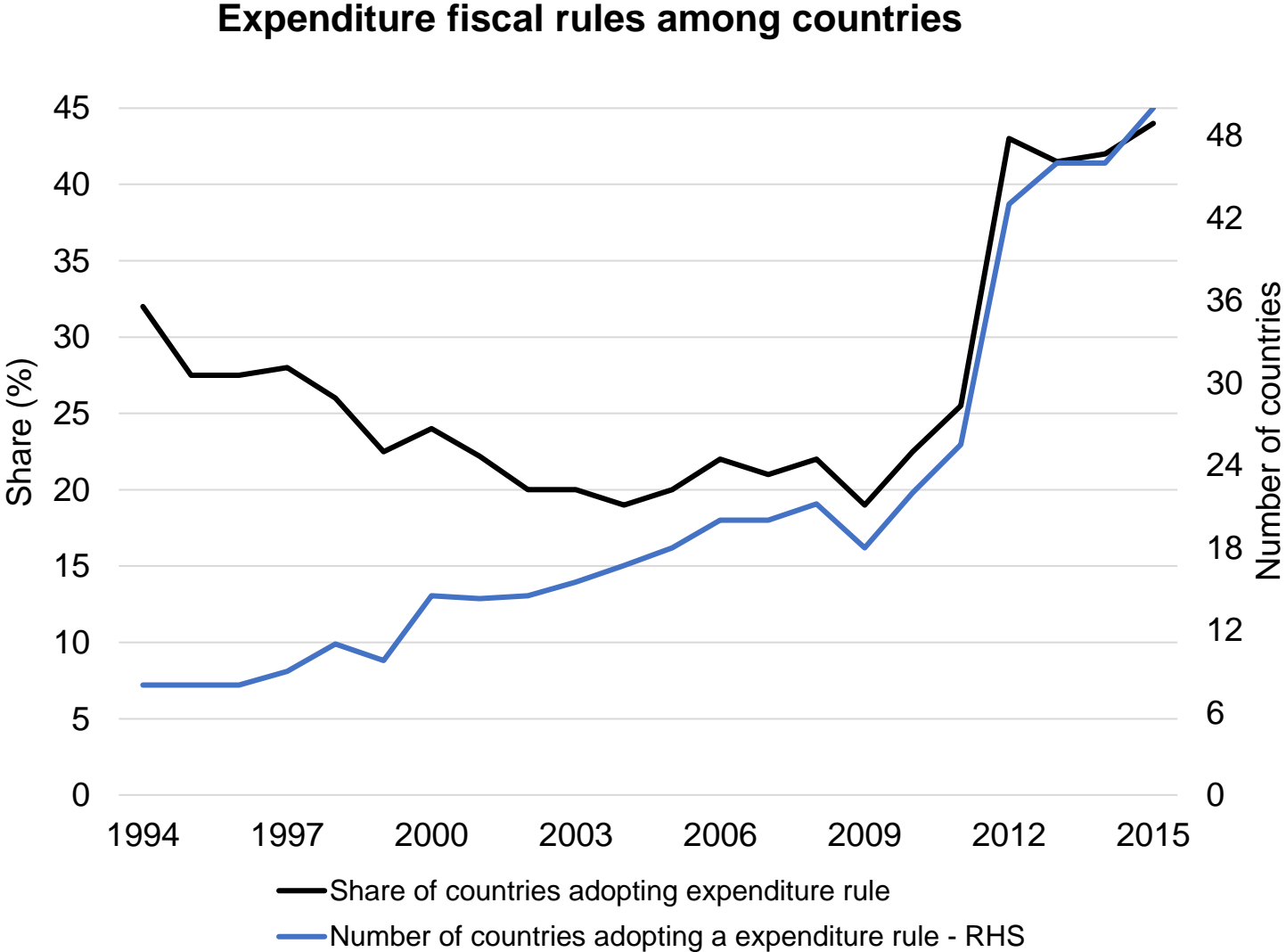
The impact of the pandemic has caused a substantial deterioration in fiscal accounts. Stabilization during the pandemic implied larger deficits and growing public debt.

## Average fiscal balance and public debt
(Percent of GDP)

Legend: ▬ Average fiscal balance ▬ Average public debt - RHS

Year	Average fiscal balance
2018	-3,4
2019	-3,5
2020e	-7,7
2021f	-5,7
2022f	-3,9
2023f	-2,8

Average public debt reaches 71,8

LAC countries: 2020 Fiscal deficit
(Percent of GDP)

Country	Value
SUR	16,7
BRA	14,2
BOL	12,0
LCA	11,5
BLZ	10,9
DMA	10,2
PAN	10,0
GUY	9,4
ARG	9,2
SLV	9,1
PER	8,9
CRI	8,6
DOM	7,7
CHL	7,5
VCT	7,2
COL	7,0
BHS	6,6
ECU	6,5
PRY	6,2
HND	5,6
URY	5,5
GTM	4,9
BRB	4,7
HTI	4,1
JAM	4,0
MEX	3,9
NIC	3,7
GRD	-0,3

Source: World Bank's Macro Poverty Outlook. Spring Meeting 2021.

The pandemic has caused a substantial fiscal deterioration

LAC countries: 2020 public debt
(Percent of GDP)

■ 2019 ■ 2020
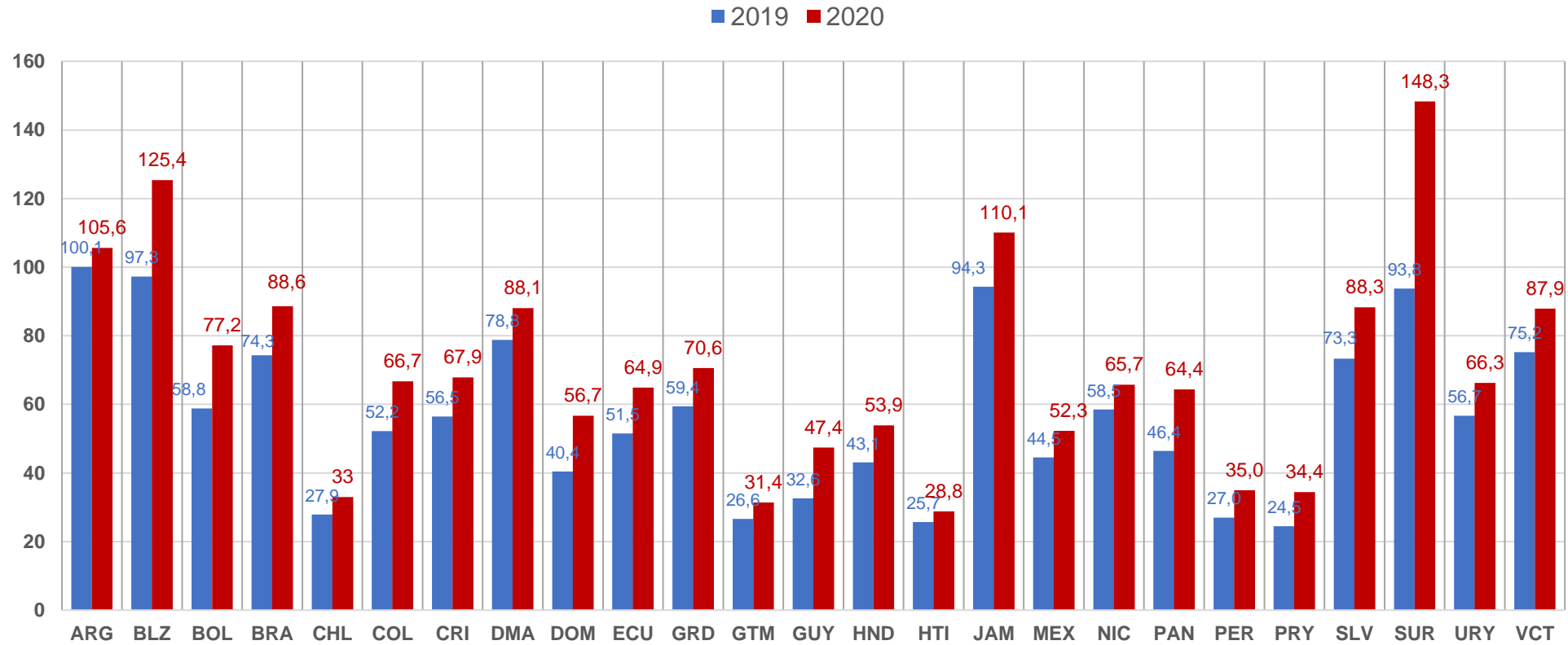
Now, stabilization requires thinking about fiscal consolidation. Primary balances required to stabilize debt-to-GDP ratios, even at the 2020 level, will be a major challenge in LAC

Projected Primary Balances and Debt-Stabilizing Primary Balances at the 2020 level
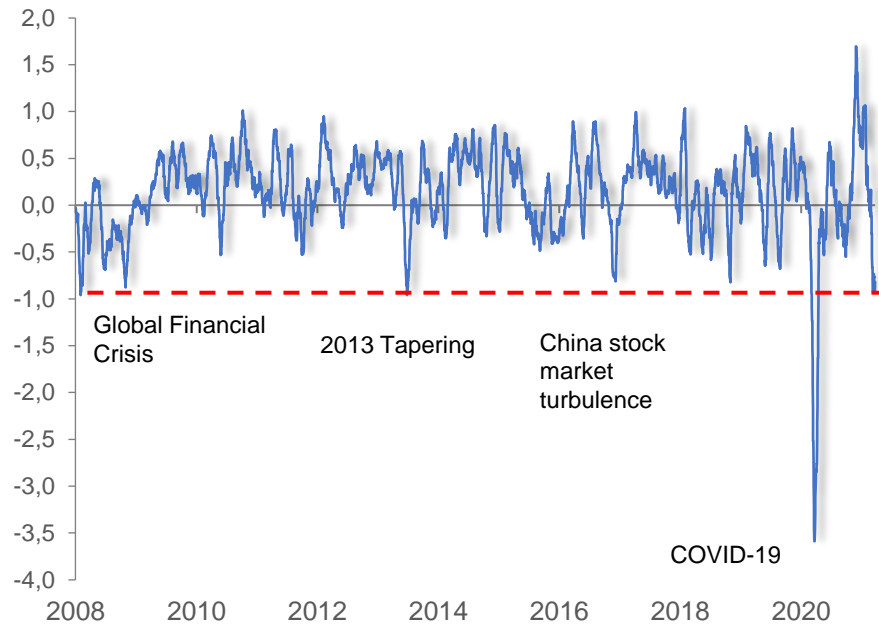
Consolidation period: 5 years

		Interest rate growth differential		MPO: Average primary balance 2020-23	Baseline scenario: DSPB*	DSPB considering a 100bps increase in r
		MPO	IMF			
JAM	Jamaica	1.2	-.-	5.5	5.5	6.6
SUR	Suriname	-6.1	-.-	-2.0	5.4	6.9
BRA	Brazil	0.9	1.3	-1.1	5.1	6.0
ARG	Argentina	-.-	-.-	-.-	2.9	4.0
CRI	Costa Rica	5.5	-.-	0.3	2.5	3.2
ECU	Ecuador	2.9	2.8	2.9	2.1	2.8
SLV	El Salvador	3.4	-.-	-2.0	1.9	2.8
MEX	Mexico	5.4	2.8	-0.3	1.8	2.3
URY	Uruguay	-4.9	-3.7	-0.1	1.6	2.2
COL	Colombia	0.9	1.2	-0.9	1.4	2.0
DOM	Dominican Rep.	0.3	-1.3	0.9	1.0	1.5
GTM	Guatemala	0.3	-.-	0.1	0.7	1.0
BLZ	Belize	-0.5	-.-	-2.0	0.4	1.7
PRY	Paraguay	1.8	-.-	-1.0	0.3	0.6
PER	Peru	0.1	1.4	-1.6	0.1	0.4
DMA	Dominica	3.7	-.-	-1.1	-0.1	0.7
HTI	Haiti	-6.5	-.-	-2.3	-0.2	0.1
CHL	Chile	-1.8	-2.3	-1.4	-0.2	0.1
PAN	Panama	3.3	-.-	-3.6	-0.5	0.1
GRD	Grenada	0.0	-.-	4.5	-0.7	-0.1
HND	Honduras	-3.1	-.-	0.4	-1.1	-0.6
GUY	Guyana	-22.6	-.-	-2.4	-1.3	-0.8
BOL	Bolivia	-0.3	-.-	-3.5	-1.3	-0.6
NIC	Nicaragua	2.4	-.-	0.0	-1.5	-0.8

Capital outflows and increased capital flow volatility in Emerging Markets are a major source of risk and instability in the region.

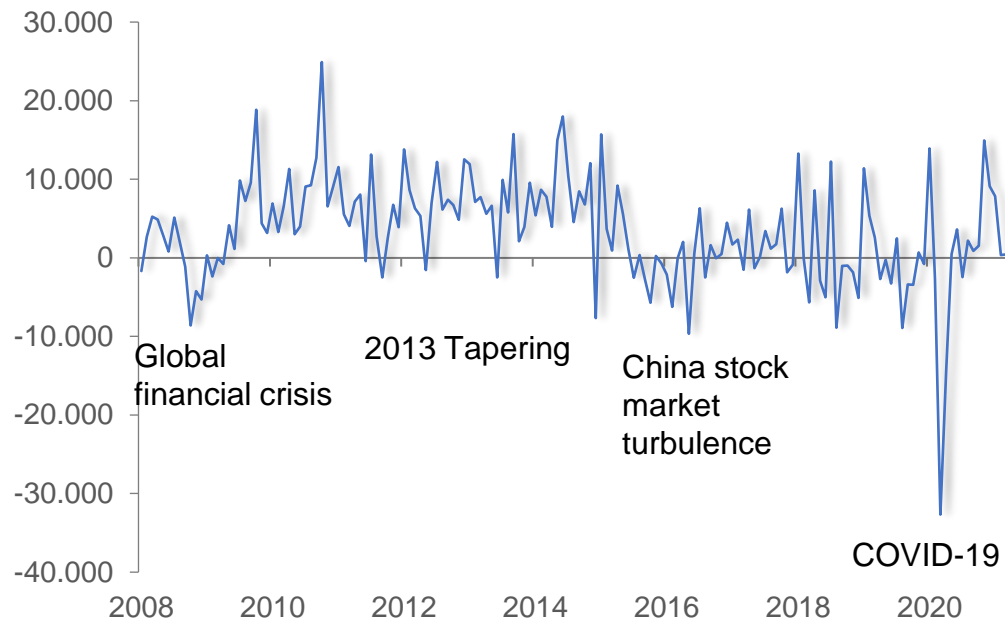**Daily non-resident portfolio flows to Emerging Markets, 28-day moving average**
(US$ Billion)

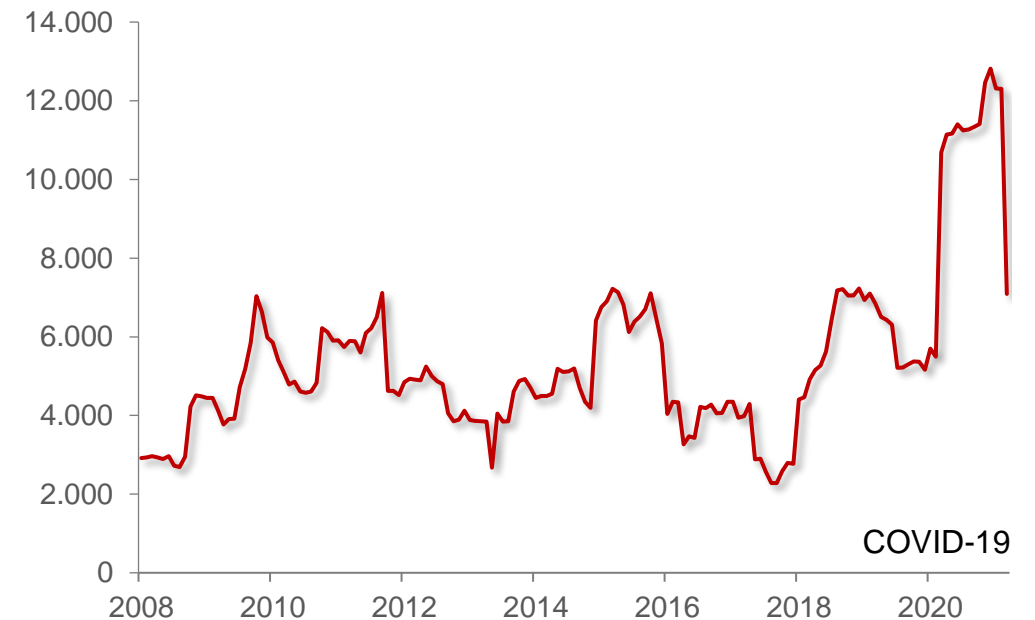**Daily non-resident portfolio flows to Emerging Markets,** 28-day rolling
standard deviation

Global Financial Crisis

2013 Tapering

China stock market turbulence

COVID-19

COVID-19

Source: The Institute of International Finance.
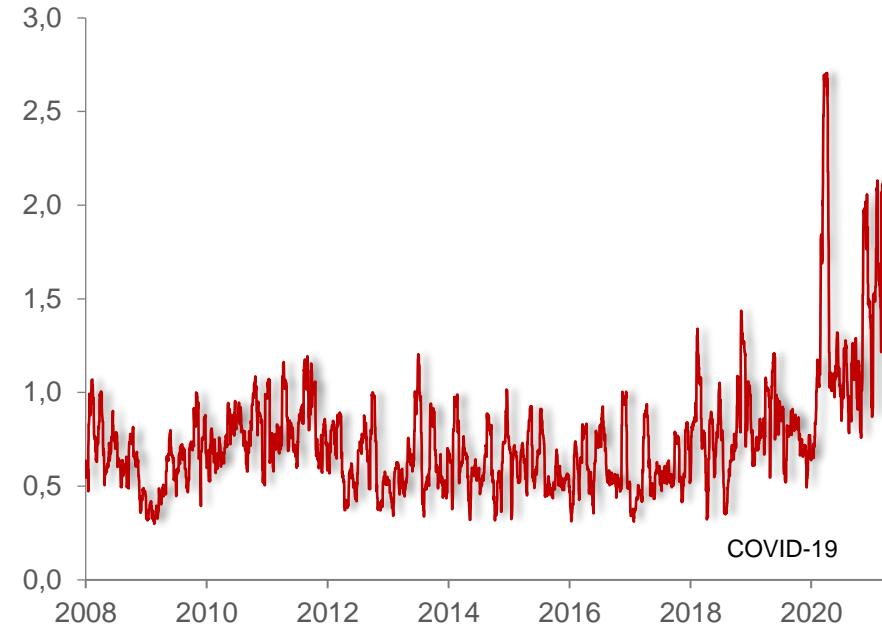
Capital outflows and increased capital flow volatility in LAC are a major source of risk and instability in the region.

Monthly non-resident portfolio flows to Latin America
(US$ Million)

Global financial crisis

2013 Tapering

China stock market turbulence

COVID-19

Monthly non-resident portfolio flows to Latin America
12-month rolling standard deviation

COVID-19

But LAC continues to suffer from the outbreak and currently represents 19% and 41% of new cases and deaths worldwide, respectively. Consolidation cannot be premature.

New cases per million (South America and Mexico)
(7-day moving average)
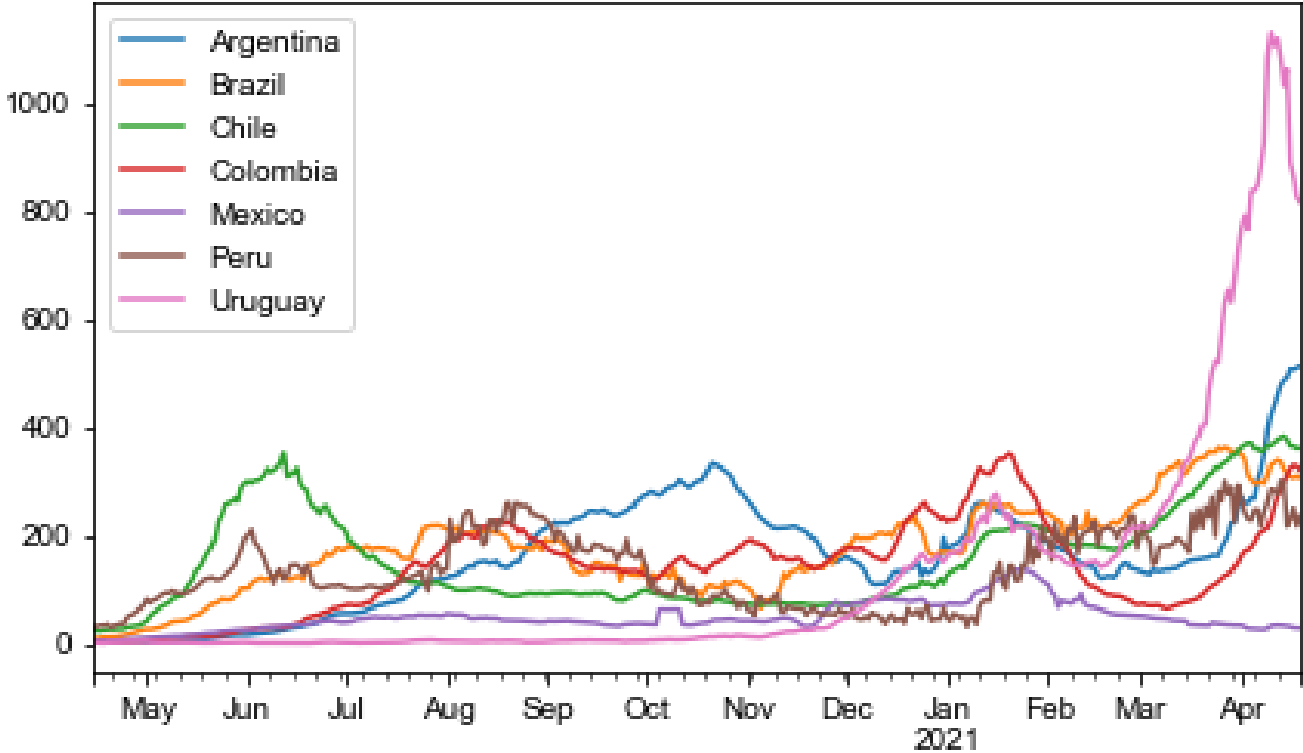
Stabilization must be contingent on controlling the pandemics: Strengthening fiscal policy and long-term credible fiscal frameworks will be key

- Fiscal policy, where possible, should continue to support households and businesses, focusing on the most vulnerable sectors of the economy

- Institutions matter: Long-term credible fiscal frameworks are needed to anchor expectations and communicate policy actions

- Fiscal councils could enhance the credibility of consolidation plans

However, social unrest will make fiscal policymaking more challenging. Social was increasing until the pandemic struck the region.

Google Trends Index (GTI) of Social Unrest
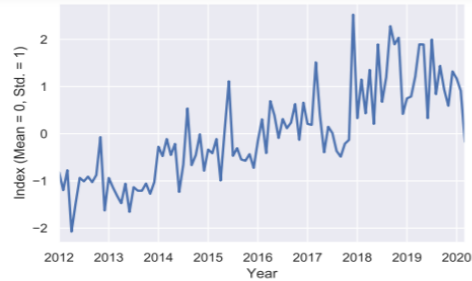
(a) Argentina
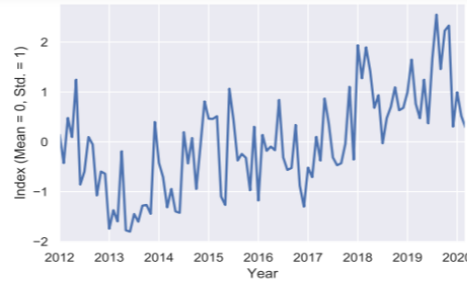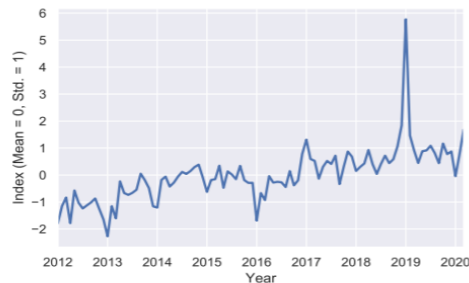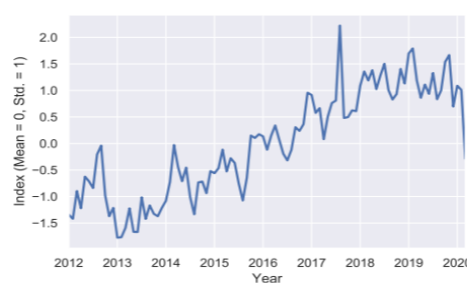
(b) Bolivia
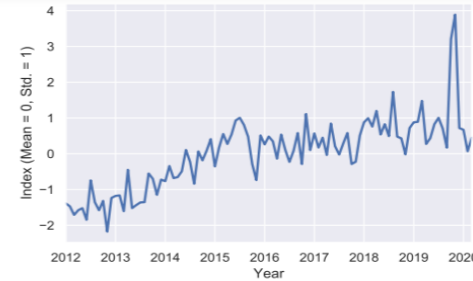
(c) Chile
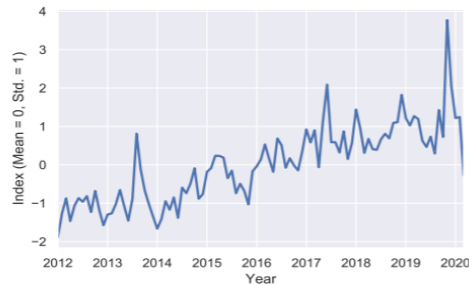
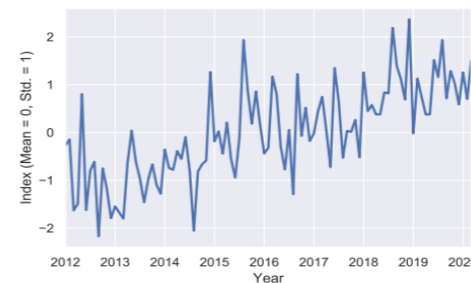(d) Colombia
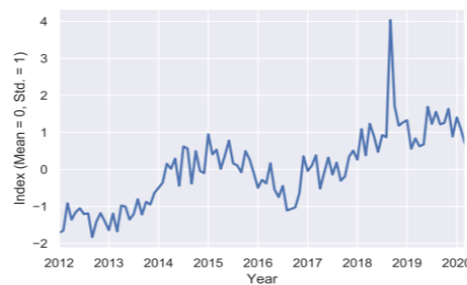
(e) Costa Rica

(f) Ecuador

(g) Mexico

(h) Peru

(i) Uruguay

The construction of the index of social unrest, based on Google searches (TECHNICAL SUPPLEMENTARY MATERIAL)

- An index of social unrest can be constructed based on direct searches of individuals in Google.

$$GTI_{T,c} = \sum_{i=1}^{N_z} S_i^*$$

- With S_i^* being the proportion of searches conducted with between two and five keywords in each group, among a certain length of keywords in time range.

- We used the following set of terms to construct the index for several countries of the LAC region

Terms and sub-categories used in the Construction of the Social Unrest Indexes

The Economy	Social Cohesion	Corruption	Quality of Services	Instability
trabajo	pobreza	corrupción	servicios públicos	protesta
sueldo	desigualdad	transparencia	inseguridad	manifestación
empleo	igualdad	mordida	educación pública	paro
salario	injusticia	soborno	salud pública	huelga
tarifa	seguro social	abuso de poder		marcha
inflación	pensión			cacerolazo
gasolina / gas				

# Fiscal policy is not contributing much to reduce inequality, especially when compared with the OECD

Differences in Income Inequality Pre- and Post-Taxes and Government Cash Transfers in Latin America, Compared with OECD and European Union

Source: 2021 Semiannual report of the Latin America and the Caribbean region. Spring Meetings 2021.
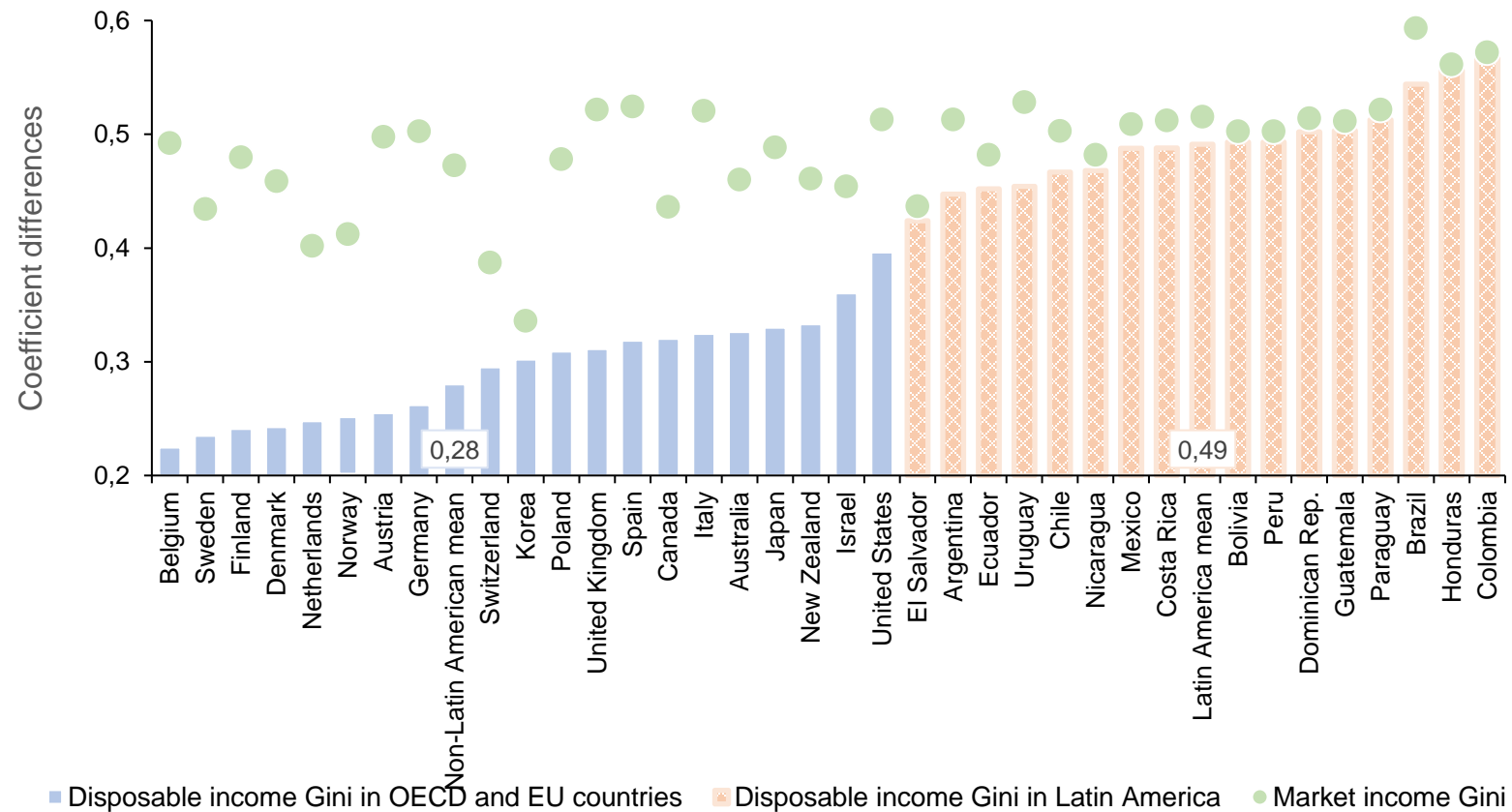
Subjective well-being (SWB) or happiness index calculated by the UN, decreased rapidly in LAC since 2014

Change in the subjective well-being (SWB) or the Life Ladder 2013-2018
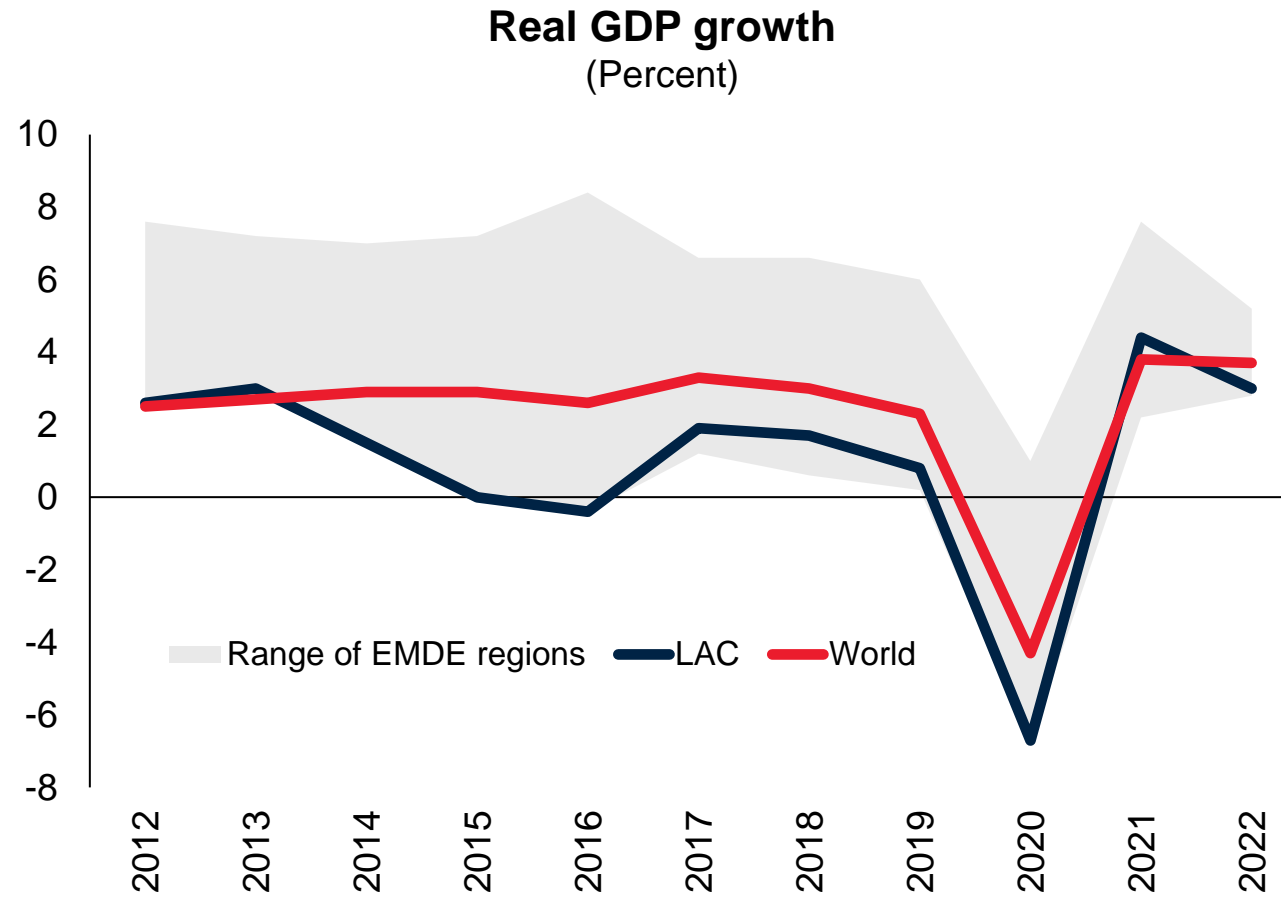(Index 2006=100)
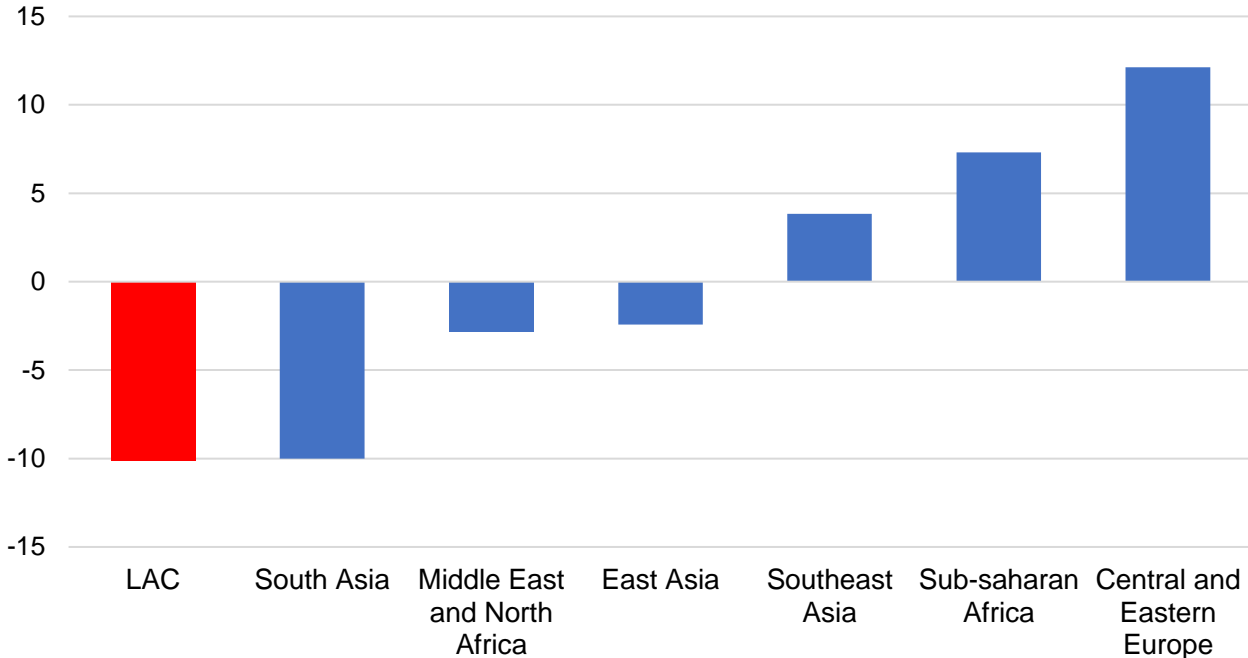
In LAC countries, SWB index changes are more strongly correlated with freedom of choice, quality of service delivery, GDP, and perception of corruption.
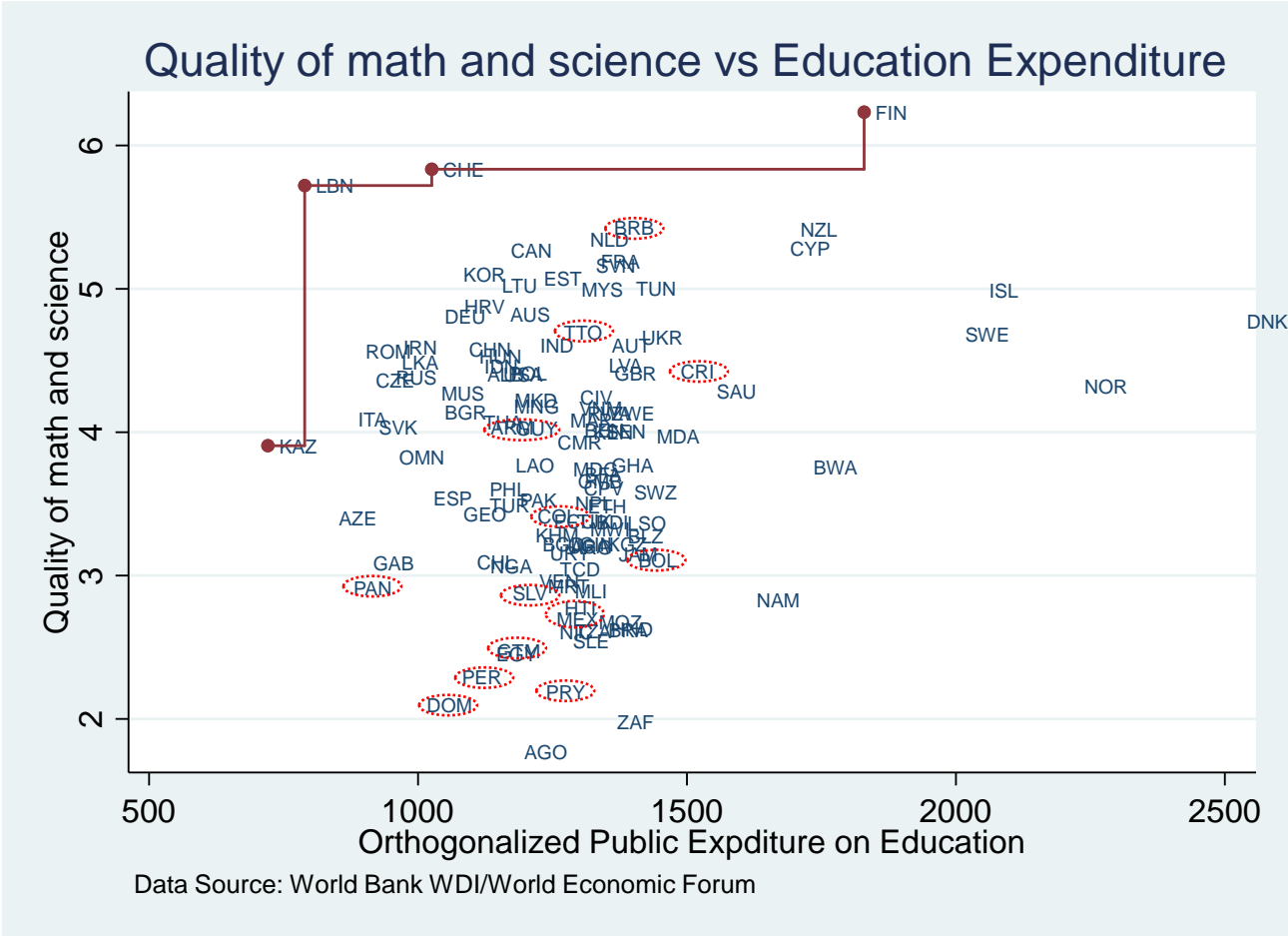
Covariates of changes in life ladder from 2005-2008 to 2016-2018

Latin America and Caribbean
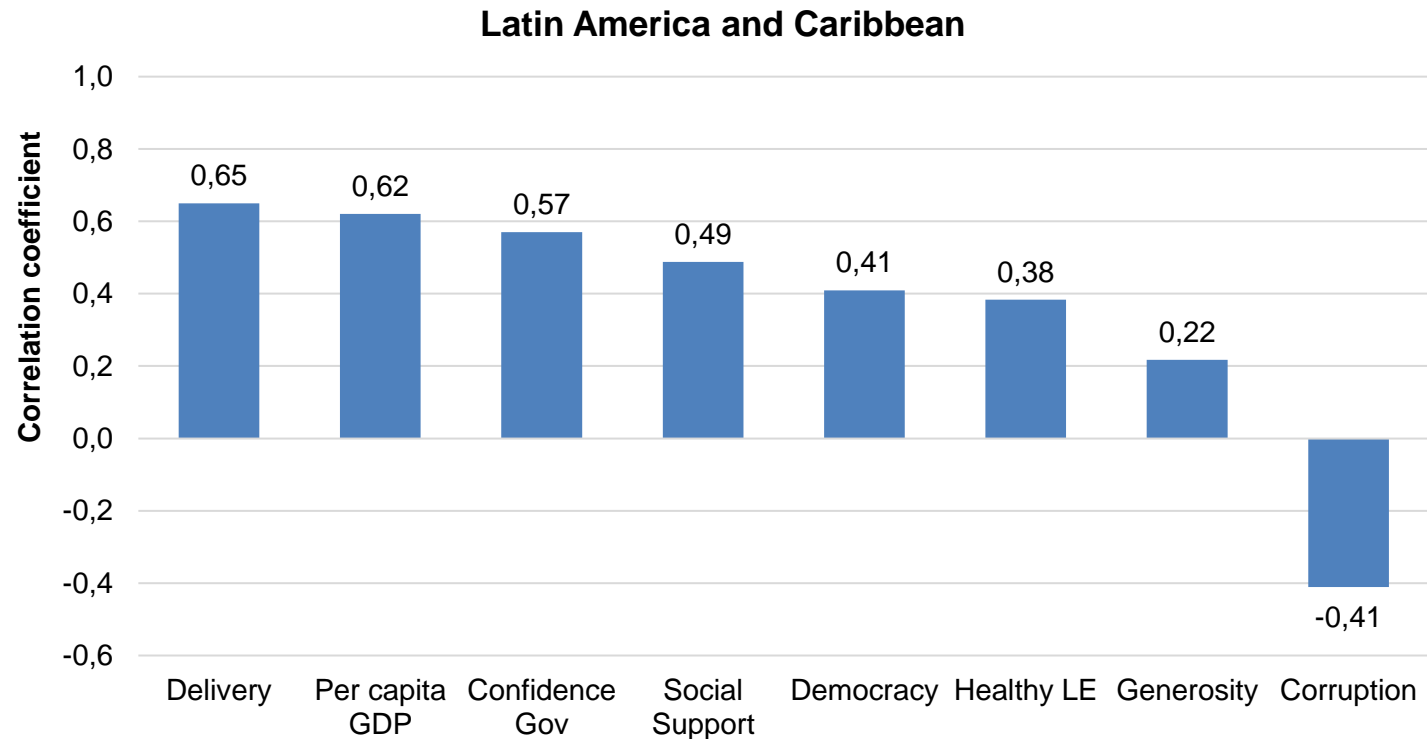
LAC had already been growing below other emerging and developing regions
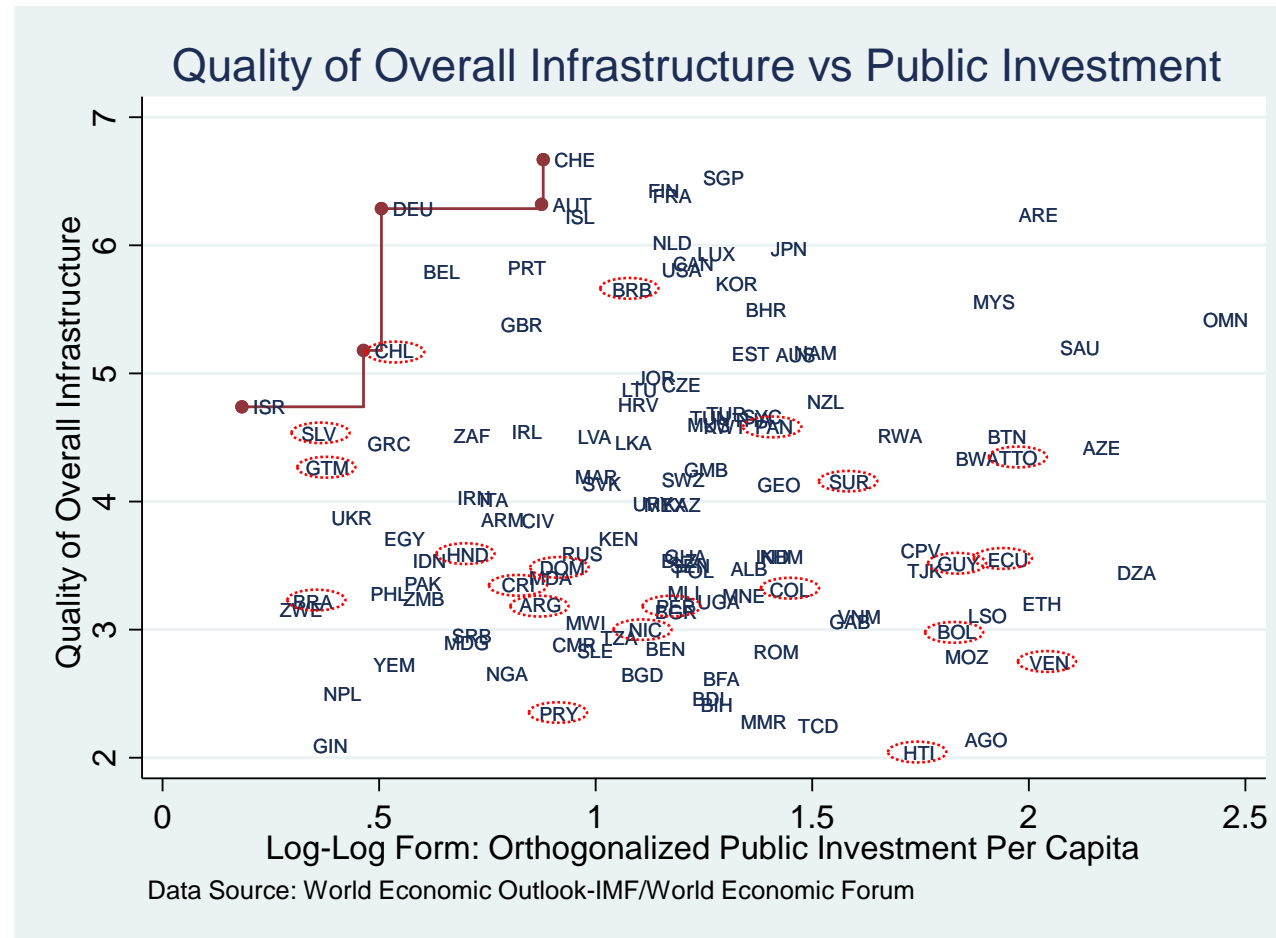
Real GDP growth
(Percent)

To support higher growth, public spending efficiency must be substantially improved in LAC. With the same input, countries could achieve 20% more education outcomes


Quality of math and science vs Education Expenditure

Orthogonalized Public Expditure on Education

Quality of math and science

Data Source: World Bank WDI/World Economic Forum

Capital spending is even less efficient, as output efficiency is about 60-70%.

Quality of Overall Infrastructure vs Public Investment

Data Source: World Economic Outlook-IMF/World Economic Forum
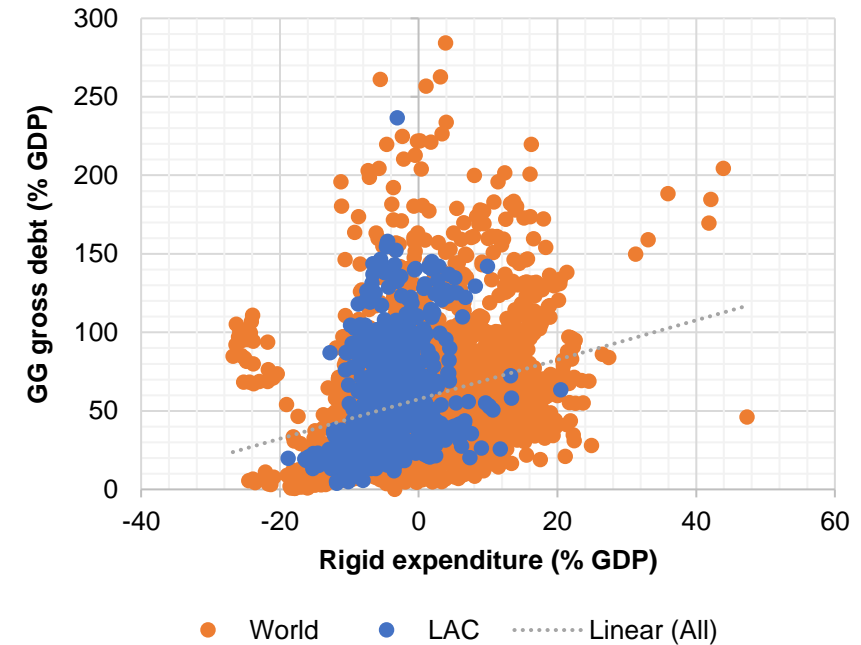
Composition of spending is relevant. Budget rigidity (spending on wages, pensions, interest payments) reduces fiscal maneuver to achieve policy objective.

**Value Added Tax Rates and Rigid Expenditure**
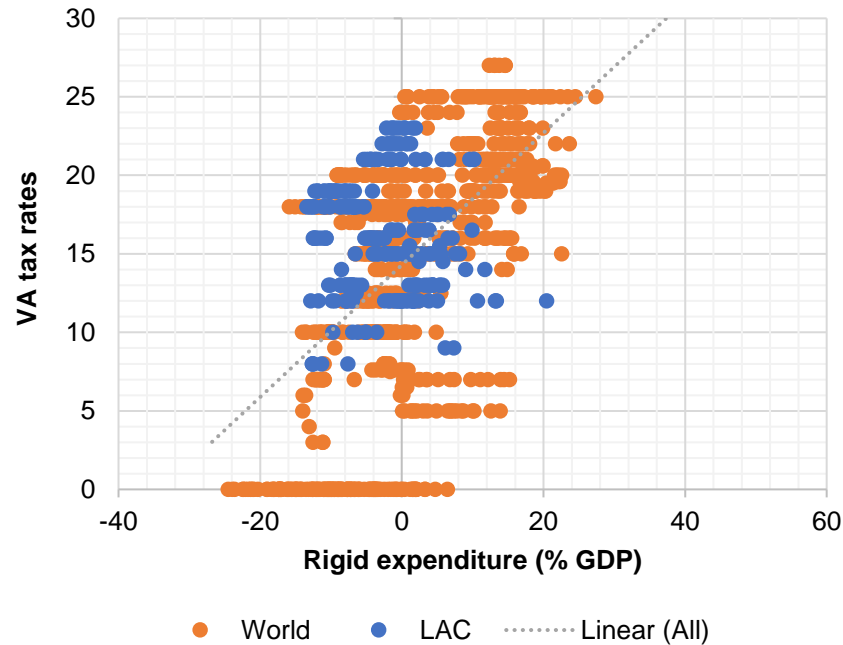
General Government Gross Debt and Rigid Expenditure

Structural policies will be difficult to implement this year, given the electoral cycle. Social and political fragmentation has increased over time in most countries.

Percent of votes of first two candidates in first round elections

■ Previous to Last Election ■ Last Election
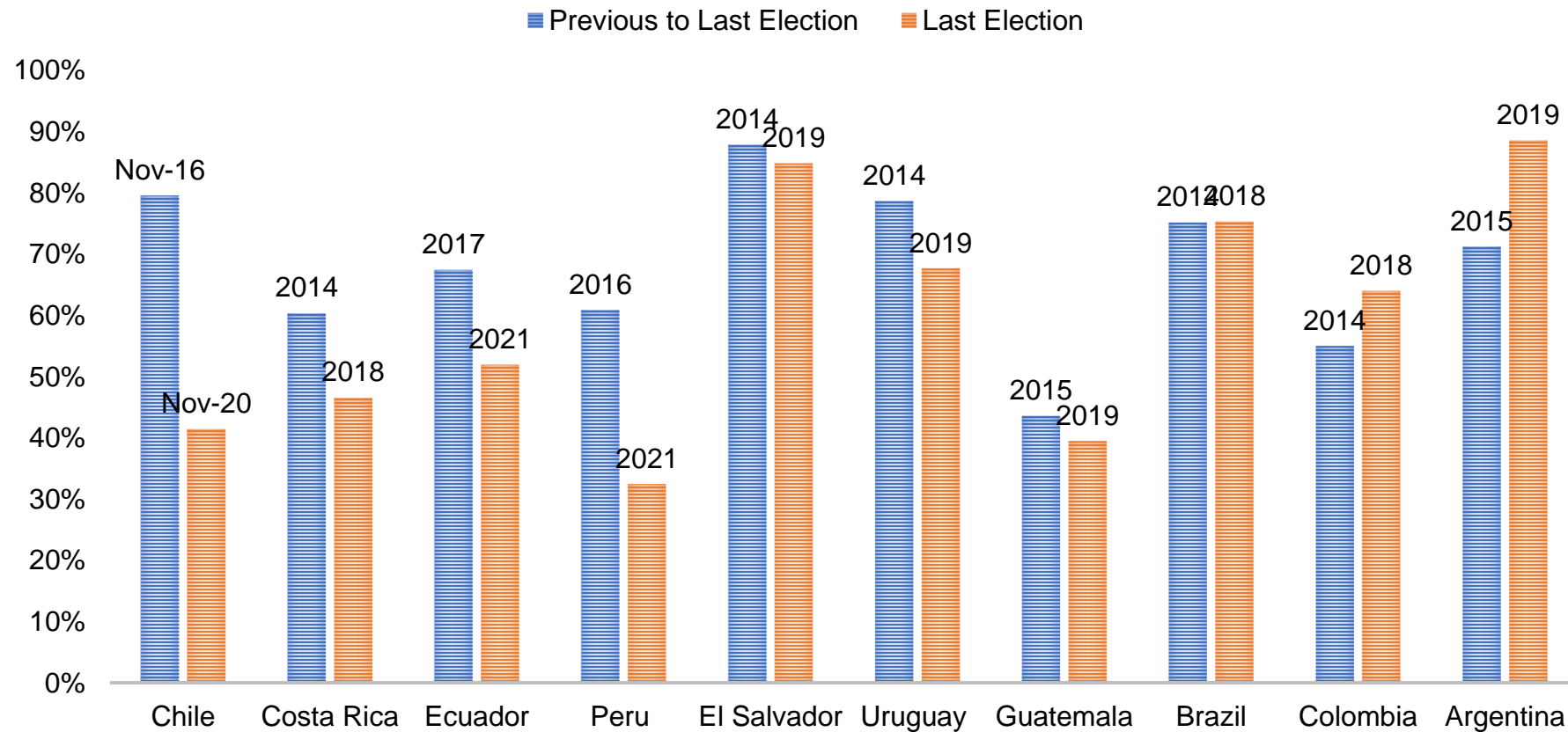
Policy implications

- Stabilization is essential in a volatile environment, but the pandemics will make it costlier and will delay implementation.

- Institutions for credible long-term consolidation plans (e.g. fiscal councils) are important to signal to markets the commitment to fiscal prudence. Flexibilization of spending will allow more discretion in resource allocation. This requires reducing revenue earmarking.

- Redistribution role of fiscal policy needs to be strengthened to mitigate social unrest and bolster legitimacy of decision makers. That would reduce the likelihood of populist politicians and economists.

- Composition of spending and efficiency need to be brough to the center of medium-term fiscal planning.