Fiscal Policy in Emerging Market Economies

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Road Map

1. Fiscal policy in emerging market economies: the issues
   1. Deficit bias and procyclicality
   2. Political economy
2. Chile´s fiscal rule
   1. Initial conditions
   2. The rule at work
   3. Some results
3. Thinking about fiscal rules

1. Fiscal policy in commodity-rich emerging markets: the problems
   - Deficit bias
   - Procyclicality

Deficit Bias

- Drop in of government net assets on average: over the cycle
- Drop government net assets even when standard smoothing considerations suggest the opposite
- See Alesina and Perotti (1995)

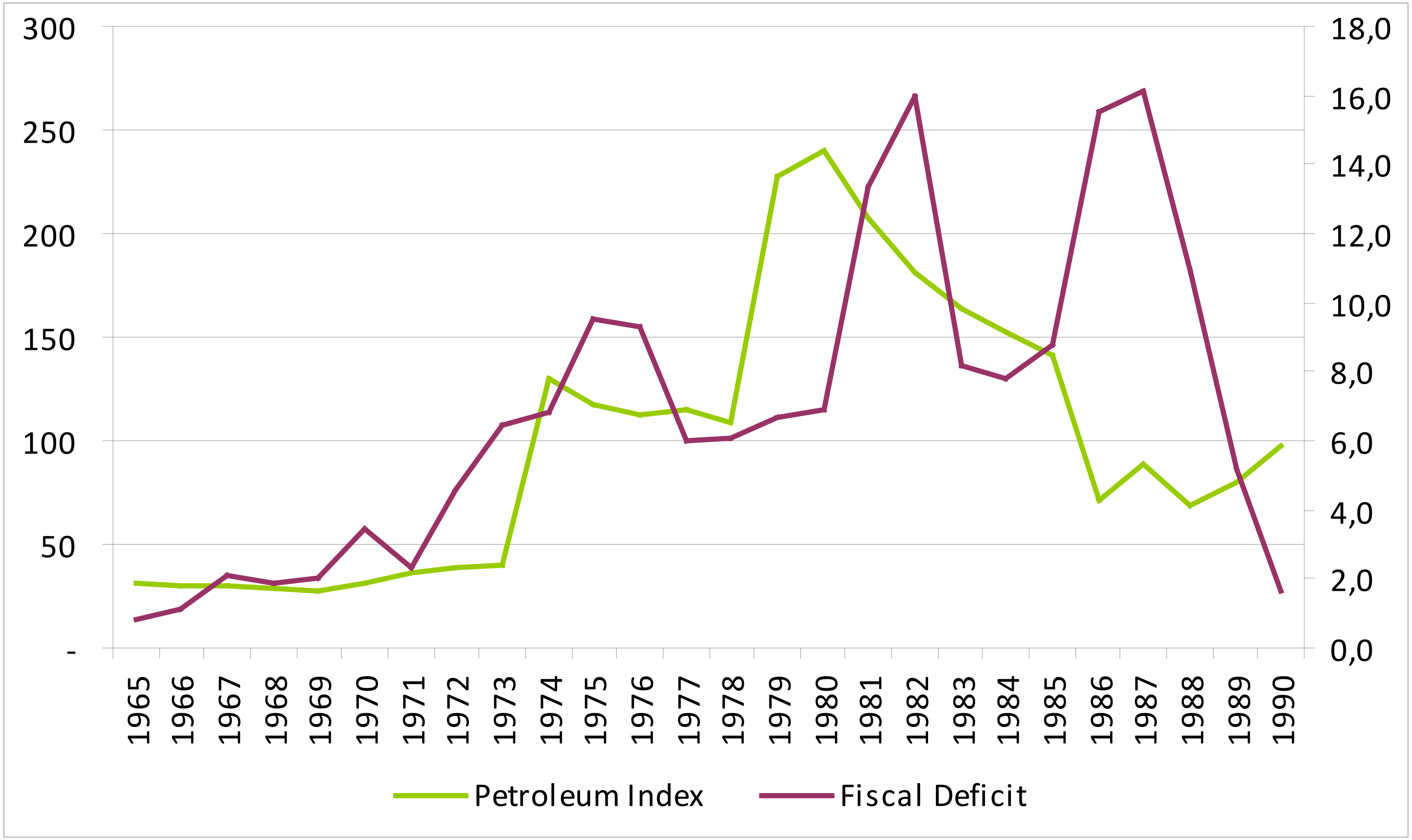
Procyclicality

- Conventional wisdom: save in booms and disave in recessions
- Reality: save too little in booms or even disave
- See Cuddington (1989), Sinnott (2009), Talvi and Vegh (1995)
- Arezki and Brückner (2010a): commodity price booms lead to increased government spending, external debt and default risk in autocracies, and have smaller such effects in democracies

Procyclicality is especially an issue for commodity exporters

- Commodity-linked revenues (taxes, royalties, profits) can be a large portion of government revenue. See Sinnott (2009)
- Commodity price volatility is large (see next slide)
- International capital flows are also procyclical: borrowing constraints are relaxed during booms. See Kaminsky, Reinhart, and Vegh (2005), Reinhart and Reinhart (2009), Gavin, Hausmann, Perotti and Talvi (1996), and Mendoza and Terrones (2008).

Mexico: an extreme example of procyclicality



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
- In practice, both probably interact

Deficit bias and procyclicality: what can you do?

- Why has fiscal performance improved in commodity republics?
- One possibility: adopt fiscal rule that guides expenditure over long horizons, and constraints its over the cycle
- Chile did that in 2001, and took further steps in 2006

Fiscal rules: new fashion

- According to the IMF (200), by 2009 exactly 80 countries had some kind of fiscal rule in place
- However… only 8 of those rules involved "cyclical" or "structural" adjustments
- Prominent example in Europe: Sweden
- Ireland is now supposed to get one

2. Chile´s fiscal rule
   - Initial conditions
   - The rule in operation
   - Some consequences
     - Fiscal
     - Otherwise

Chile: initial conditions

- Strong budget institutions
- Good fiscal performance since 1990
  - More surpluses than deficits in 1990-2000
  - By 2000, gross public debt only 35% of GDP
- So why did Chile need rule?
  - Economic concerns
    - No longer-term framework for fiscal policy
    - Contingent liabilities: pensions, infrastructure
  - Political concerns
    - Inefficient negotiation inside Executive and in Congress
    - Subnational governments

Chile: the rule in operation

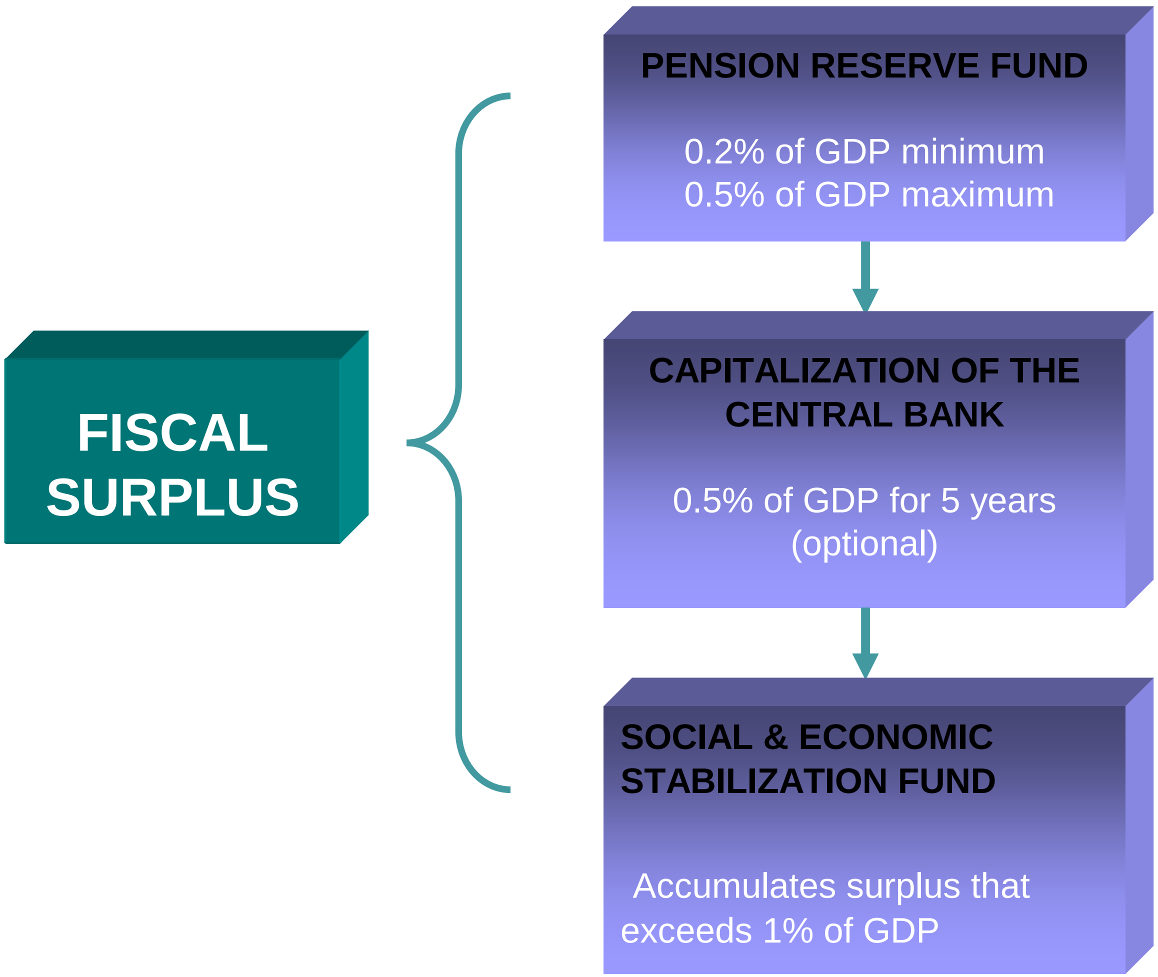
- Dealing with flows: the structural balance approach
- Dealing with stocks: creation of SWFs

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

Chile: institutional issues

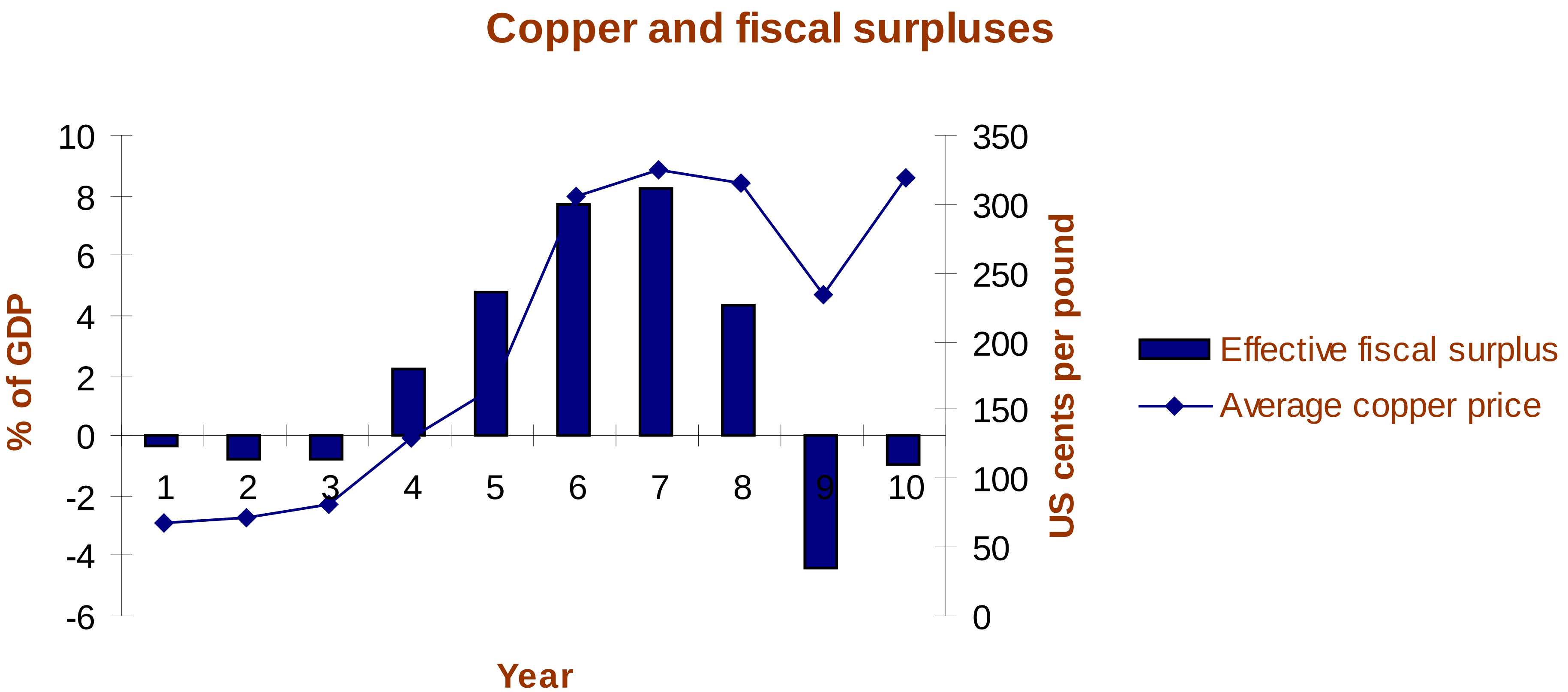
- The rule was self-imposed (no legal constraint) in 2001-2006
- Fiscal Responsibility Law (2006) made it legal
- However, law did not specify
  - Details of cyclical adjustment methodology
  - Target for structural surplus or deficit
- Over time, government updated to methodology: eg, correcting for moly prices
- Over time, government changed surplus target: from 1% of GDP to 0.5% to 0 when crisis hit


FISCAL SURPLUS
PENSION RESERVE FUND
0.2% of GDP minimum
0.5% of GDP maximum
CAPITALIZATION OF THE CENTRAL BANK
0.5% of GDP for 5 years (optional)
SOCIAL & ECONOMIC STABILIZATION FUND
Accumulates surplus that exceeds 1% of GDP

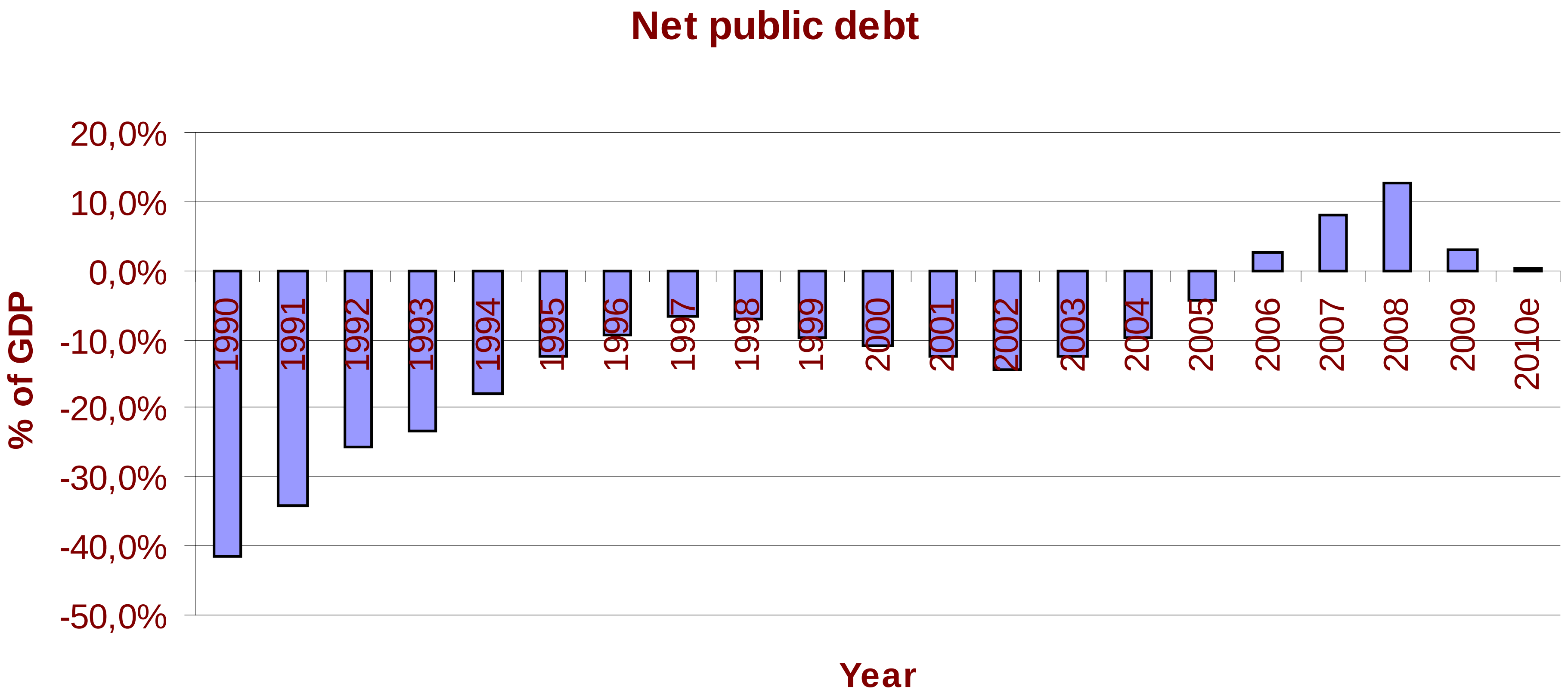
Chile: fiscal results

- Fiscal surpluses and the price of copper
- Falling public debt
- Rising financial savings

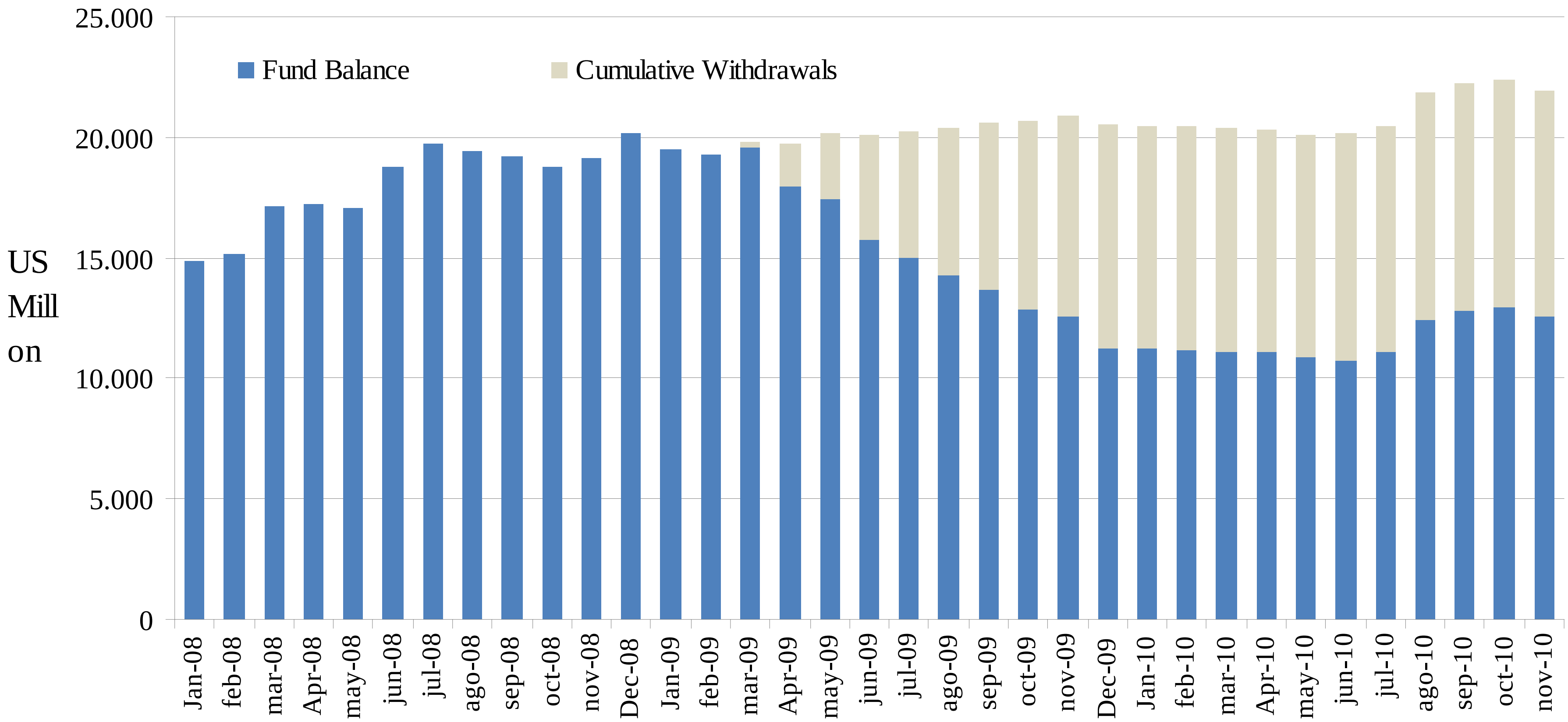
The end of procyclicality?



Public debt: far away from Europe



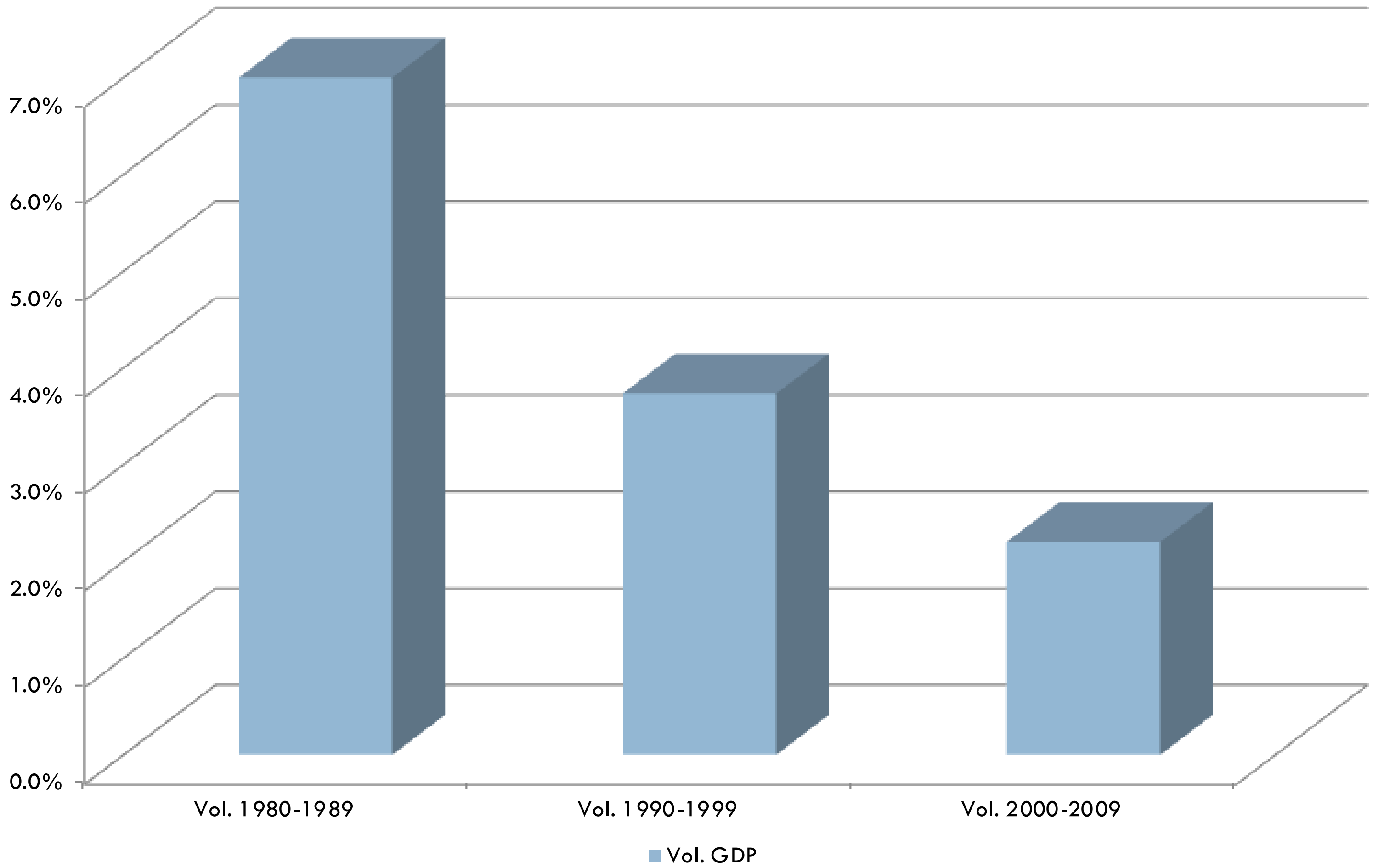
A stabilization fund that stabilizes



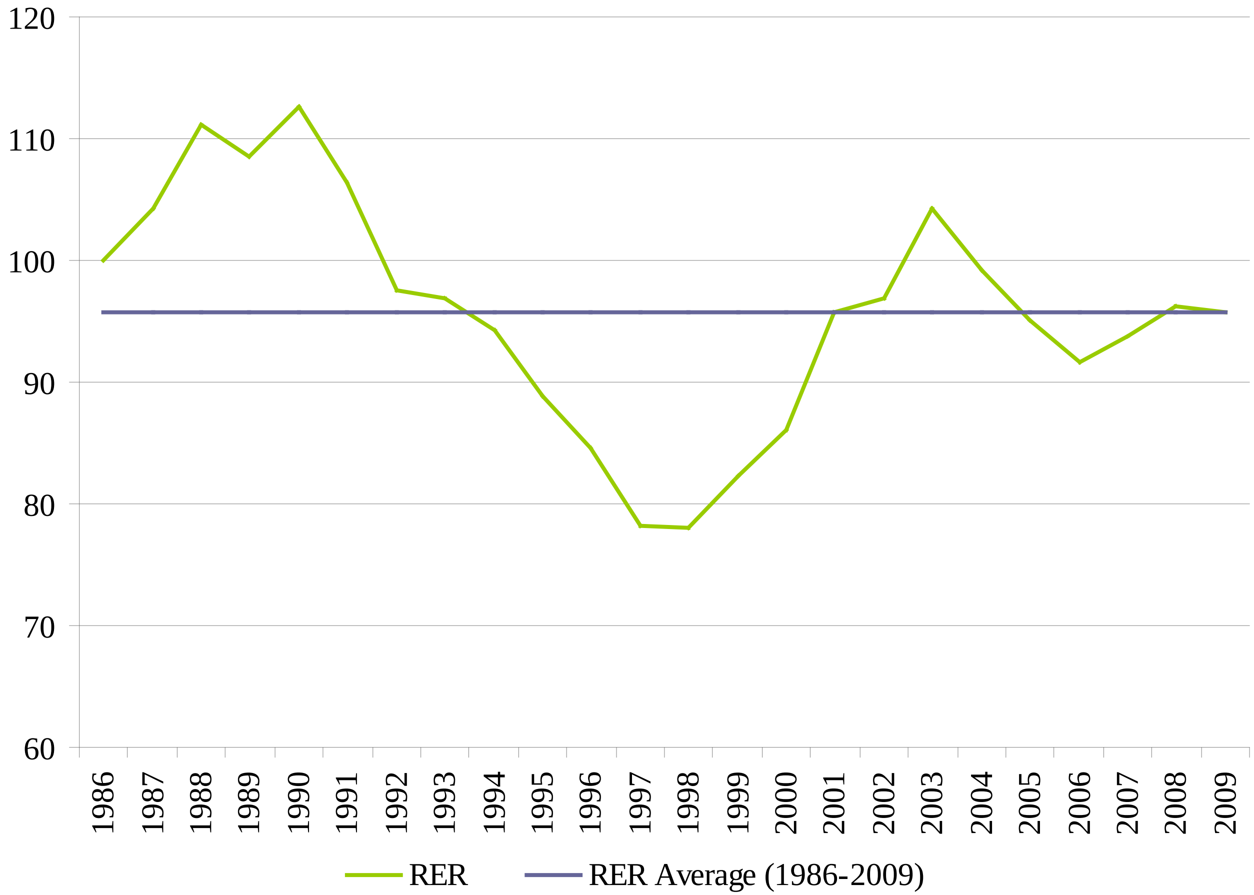
Chile: macro results

- Output volatility
- The real exchange rate
- Room for countercyclical policy during the crisis

Falling output volatility: a consequence?



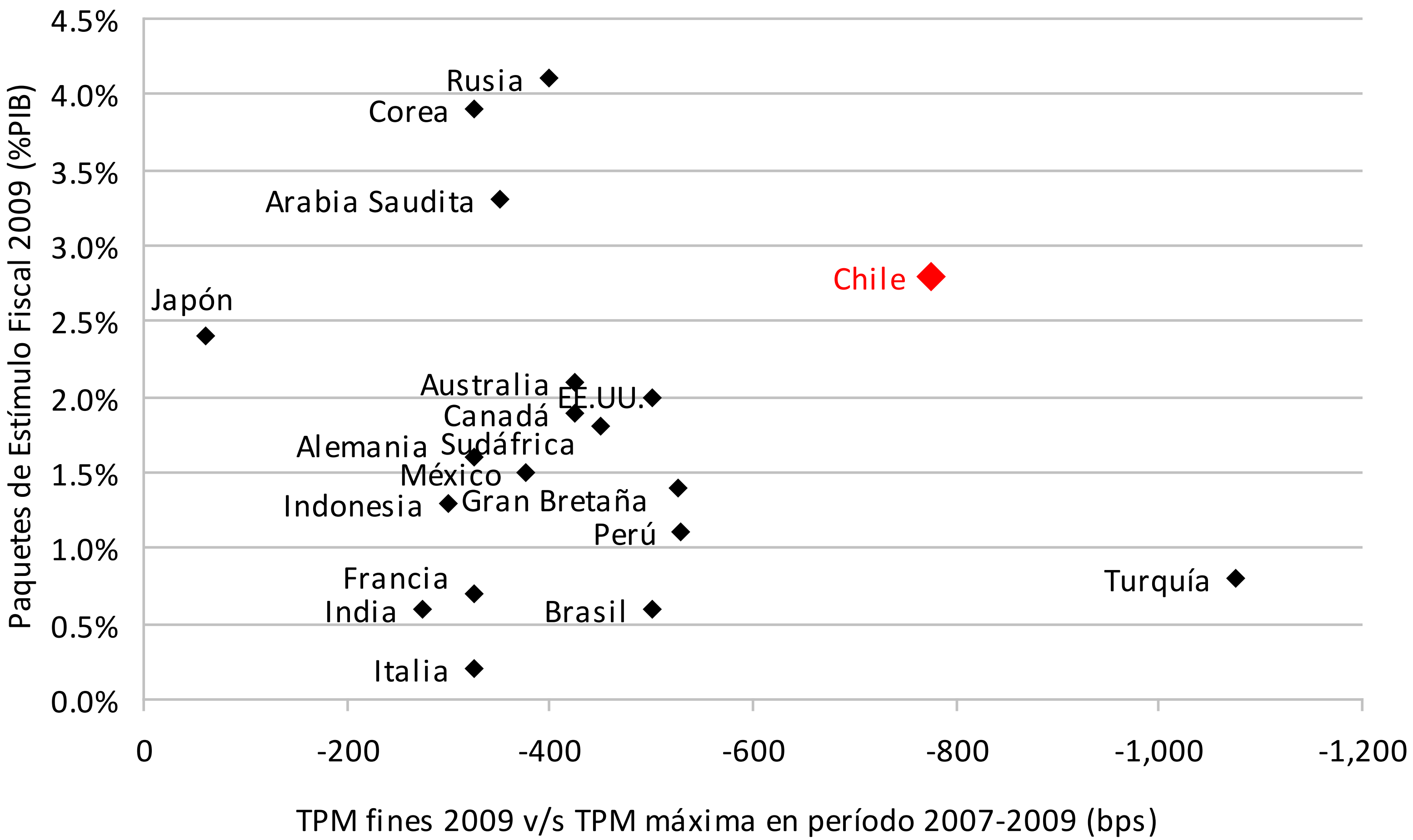
Avoiding Dutch disease? The real exchange rate



The January 2009 fiscal stimulus

- Overall: 2.8% of GDP
- Additional spending
  - Infrastructure
  - Transfers to poor households
- Temporary tax cuts
  - Stamp taxes
  - PPMs for SMEs
  - Individual tax rebates
- Capitalization of Codelco: state-owned copper producer

Fiscal and monetary stimulus



3. Thinking of optimal rules
   - What to correct for?
   - Cyclical adjustment versus PIH
   - Degree of countercyclicality
   - Ex post v. ex ante rules

What to correct for?

- OECD and other standard adjustments only correct for GDP cycle
- Chile procedure includes copper prices and other metals prices
- Is this enough? Probably not (Lane, 2010)
- What are we leaving out?
  - Activity cycles that are linked to expenditure, not output: what do do with consumption booms and large current account deficits?
  - Sectoral booms (real estate in Spain and Ireland)
  - Effects of movements in asset prices (again, land)
  - Effects of movements in the real exchange rate
  - Changes in the stock of government-held assets
- As usual…tradeoff between accuracy and simplicity

Cyclical adjustment v. PIH

- Cyclical adjustment corrects for deviations of GDP, copper prices and other variables from their long term levels
- To this rule one must add PIH criteria
  - How much to spend of accumulated assets? The interest rate? Which interest rate?
  - Need to take a stance on temporary policy fluctuations
    - Temporary tax cuts (or increases)
    - Temporary spending (natural disasters)
- Current debate in Chile
  - With no stance on temporary policy, all temporary shocks are treated as permanent
  - With no stance on interest rate, one can consume too much (or too little) of accumulated assets

Degree of countercyclicality

- Rule based on cyclical adjustment + PIH is largely acyclical
- Optimal to have decidedly countercyclical rules
- Engel, Neilson and Valdés (2010): need to have switching regime –different spending coefficients in different states (normal, good, bad)
- Challenges
  - Simplicity: the taxi driver test
  - Legitimacy: use of independent fiscal board?

Ex ante versus ex post rules

- Whatever the rule –acyclical, countercyclical— it typically involves an ex ante committment
  - Spend according to criteria X and Y and get projected outcome Z
- Results ex post (outcomes) depend on a host of factors other than actions and committments
  - Actual economic prices and quantities
  - Varying elasticities of revenue to those Qs and Ps
  - Behavior of endogenous components of expenditure
- Conclusion: the probability that the ex-post result will be exactly equal to the ex-ante target is close to zero.

Ex ante versus ex post rules (cont)

- Central banks recognized this problem long ago. Therefore..
  - They set ranges, not points, as targets
  - They set variable time spans for achieving targets: from 18 to 24 months….
- Fiscal authorities have to move in the same direction
- Alternatives:
  - The CB route: set target with band, longish time horizon
  - The Fiscal Board route: set tight target with escape clause, triggered by decision of independent board

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