Center for Global Development

CGD Note
JUNE 2021

Fiscal Policy at a Time of Polarization: Addressing Latin America's Tough Dilemmas

Latin American Committee on Macroeconomic and Financial Issues Statement N. 44

EXECUTIVE SUMMARY

- While social and political resistance to reforms (particularly on the fiscal side) has intensified, the region must rise to the challenge and convert the expected cyclical (post-COVID) rebound into a more promising scenario for job creation.
- Government resources to respond to the pandemic should not be spared, but while the policy response can be large, it must also be transitory.
- Combining fiscal expansion in the short term with a strong commitment to fiscal responsibility in the medium term is key. The short-term fiscal response to the pandemic should come hand in hand with active measures to strengthen structural fiscal positions.
- This is the time to raise awareness and avoid mistakes that may prove costly over the long run: the scope for short-sighted, populistic responses and policy errors has widened.
- Public policy should be increasingly directed at reducing insecurity and risk, while maintaining and improving transfers targeted to low-income citizens.
- Multilaterals should make available required resources for countries with more limited access to external financing, with conditionality ensuring that foreign assistance goes to targeted sectors, and that it does not feed capital flight.
- The IMF should continue to raise its voice in favor of fiscal responsibility and efficient utilization of scarce resources, in particular given the current context of political challenges of the region. By pushing across the board for fiscal expansions that go beyond the indispensable and temporary response to the pandemic, and which are not matched by an increase in tax income, the IMF could promote undesired time-inconsistent policies.
- Policymakers in Latin America need to remain vigilant of potential future sudden stops of capital inflows and strive to build buffers to navigate such events.

I. INTRODUCTION

In the last two decades, Latin America's economic performance has been disappointing in comparison to that of other emerging market regions, such as Asia. In part, such performance reflects a combination of macro instability, imperfect international trade and financial integration, institutional weaknesses, and varying degrees of adherence to the rule of law that are not conducive to investment and growth. The COVID-19 pandemic hit the already underperforming region particularly hard and its effects are likely to be persistent. Hence, another "lost decade" cannot be discounted. Moreover, because of significant vaccination delays and the use of vaccines with low efficacy rates, several countries in the region are currently experiencing the effects of a "second wave" of infections that is significantly more rapid and powerful than the initial wave of the pandemic.

Despite this new and unusually difficult situation, most of Latin America expects a rebound in economic activity this year. As vaccines spread globally and severe lockdowns end, an opportunity emerges to transform a mechanical rebound into a sustained economic recovery. However, most countries in the region are struggling to obtain enough good-quality vaccines in order to achieve herd immunity and to administer their limited available stocks efficiently and transparently.

These challenges notwithstanding, Latin America is beginning to benefit from a more benign global economic outlook that is anchored, among other factors, in an expansion in global demand, a resumption of capital flows to emerging markets, and a boom in commodity prices. In this context, **the Committee believes that, while the social and political resistance to reforms (particularly on the fiscal side) has understandably intensified, the region must rise to the challenge and convert the expected cyclical (post-COVID) rebound into a more promising scenario for job creation.**

The current juncture poses significant risks. On the one hand, given the tremendous threat to both lives and livelihoods, governments have no choice but to respond forcefully to the new waves of the pandemic with expenditures and relief measures targeted to the more vulnerable population. On the other hand, the more favorable external conditions may induce policymakers to underestimate the long-term risks of high budget deficits and public debts. **The Committee believes that, given the widespread suffering and setbacks in social welfare produced by the pandemic, the pressures on public spending are substantial and the scope for short-sighted, populistic responses and policy errors has widened. This is the time to raise awareness and avoid mistakes that may prove costly in the long run.**

II. A CRITICAL DILEMMA: HOW MUCH FISCAL RESPONSE TO THE PANDEMIC AND HOW MUCH FISCAL CONSOLIDATION?

On the one hand, the health (testing & vaccination) response to the pandemic, with few exceptions such as Chile and Uruguay, has been poor compared to other regions. In some cases, such as Argentina and Brazil, the health response has been slow and inefficient. Limited access to vaccines and inefficiency in health policies in a number of countries (Argentina, Brazil, Mexico, and Peru, for instance) will call for stronger government responses and, possibly, additional spending. To be sure, a necessary condition to resume growth in Latin America is to significantly improve its public health response and, in this way, allow for a safe, rapid, and sustainable reopening of economic activities.

On the other hand, despite implementing fiscal stimuli—estimated at around 4% of GDP on average—that are significantly smaller relative to those adopted in advanced economies, Latin America displays significant risks in its fiscal outlook. In a context of sustained growth underperformance, fiscal weakness translates in higher uncertainty regarding debt sustainability. As the pandemic drags on, high public debts in some countries loom as a Damocles' sword, especially where it is mainly denominated in dollars and/or overly sensitive to interest rates variations.

The combination of low growth and fiscal weakness poses a significant challenge: how to respond to the pandemic while maintaining fiscal sustainability and, hence, continued access to the international capital markets at low interest rates. Some countries in the region, such as Chile and Peru, which started the pandemic with a relatively robust fiscal stance, are in the position of issuing debt in the international market at interest rates which do not pose significant strain on fiscal sustainability. However, there are countries in the region where the pandemic raised already very high debt levels —for instance, Brazil and Uruguay— and also countries that have virtually lost all market access —such as, Argentina, Ecuador, and Venezuela.

The Committee recognizes upfront that responding to the pandemic is necessary and government resources —if well used in this task— cannot and should not be spared. The fiscal response to the pandemic can be large but it must also be transitory; so, in principle, debt financing is appropriate. For countries with weaker fiscal positions and more limited access to external financing, multilaterals should make available the required resources that cannot be obtained through the international capital market.

However, **the Committee also recognizes that the needed fiscal response to the pandemic will likely worsen the medium and long-term fiscal and debt sustainability outlook. The Committee believes that the short-term fiscal response to the pandemic should come hand in hand with active measures to strengthen structural fiscal positions.** Endangering medium-term fiscal and debt sustainability because of the necessary response to the pandemic may be politically attractive today but socially costly tomorrow. **The Committee believes that combining fiscal expansion in the short term with a strong commitment to fiscal responsibility over the medium term is key in order to maintain credibility and access to external financing at favorable terms, as well as to lay the grounds for healthy growth with social equity.** As we discuss below, this is even more important as new risks may emanate from the global outlook.

The effects of COVID-19 have been highly uneven across sectors and population segments. As a result, the pandemic has increased income inequality everywhere in the world. **In the view of the Committee, it is paramount to avoid a recovery that exacerbates inequality and poverty. Should taxation be used as an instrument to contain inequality and prevent further fiscal deterioration? The Committee believes that, while there is space for increasing taxes in some countries, tax pressure is already high in others—notably Argentina and Brazil—and in these countries a further increase could be detrimental to much-needed private investment.** On the one hand, while there is certainly space for increasing the tax base and reducing tax evasion, achieving this goal is a medium-to-long term-endeavor and may face significant political opposition in the midst of the pandemic, as the Colombian case illustrates. On the other hand, politically palatable measures directed at "taxing the rich" may end-up yielding only small revenue gains and raising investors' uncertainty. **In this vein, the Committee believes it is time to design new ways for the State to address major anxieties faced by society while ensuring fiscal and debt sustainability.**

How could this be achieved? One of the main concerns in the wake of the pandemic has been the increase in volatility and insecurity —in access to jobs, ability to sustain income levels, and access to public services. Moreover, in some countries, COVID-19 has also made it evident the poor conditions of health systems, with few and low-paid doctors, and insufficient hospital infrastructure and medical equipment. **The Committee believes that public policy should be increasingly directed at reducing insecurity and risk, while maintaining and improving transfers targeted to low-income citizens. In the view of the Committee, Uruguay provides a good example in the region of how a reasonably well developed and comprehensive social insurance system allowed for an efficient response to the pandemic while keeping in check the demand for populist responses.** To be sure, social assistance schemes have improved substantially (in terms of their targeting and overall poverty-reducing effectiveness) in much of the region and were actively used to channel around 70% of the Covid-related relief measures. However, major reforms and considerable fiscal muscle will be needed in most Latin American countries to achieve Uruguay-like standards in social insurance. Unlike social assistance, which provides poverty relief ex-post, social insurance systems are particularly relevant to citizens that live above the poverty line yet need adequate protection ex-ante against downside risks associated with employment, ageing, and health shocks. Social insurance systems will be, therefore, an increasingly important part of the social pact and, hence, of the legitimacy and functionality of representative democracies in the region.

The discussion dwells on whether an excessive concern with fiscal sustainability by governments may facilitate the rise of populism in the region. **While the Committee recognizes the importance of ensuring that the response to the pandemic remains consistent with fiscal sustainability, it could be counterproductive to ignore the new political trends in the region that result both from weakened political institutions and polarization, and from the economic challenges faced especially by the lower and middle-income sectors of society. Times of structural break offer opportunities for change in society,** which can lead to structural reforms and renewed growth, or can well derail into economically unsustainable populism and even into institutional breakdowns—for instance, Venezuela. The region's experiences of the 1970s stand as painful testimonies of such derailments.

In this context, is there a role for the IMF in facilitating the resolution of the above challenges? Is the IMF playing such role effectively? In Statement No. 43, the Committee called for the IMF to make available increased support to the region, estimated in the range of USD200/300 billion. Moreover, Statement No. 43 noted: *"alongside the issue of size,* **the Committee believes that it is necessary to revise the criteria under which liquidity assistance is provided to member countries.** *In particular, given that the Covid-19 crisis is a large and exogenous shock affecting all countries, access criteria should be uniform across recipient countries.* **The Committee believes that conditionality should focus on ensuring that foreign assistance goes to targeted sectors, and that it does not feed capital flight."**

In the current context of political changes and challenges, **the Committee believes that the IMF should continue to raise its voice in favor of fiscal responsibility and efficient utilization of scarce resources, rather than mechanically applying to emerging markets conclusions that hold for advanced economies.** Fiscal space is more limited and uncertain in emerging markets, which have lower tax-revenue-to-GDP ratios than advanced economies, more volatile commodity-linked fiscal revenues, face higher interest rates and steeper yield curves, and have to live with highly volatile capital flows, which depend not only on investors' assessment of debt sustainability, but also on shocks to global monetary policy and risk appetite over which emerging market authorities have no control.

The Committee believes that, by pushing across the board for fiscal expansions that go beyond the indispensable and temporary response to the pandemic, and which are not matched by an increase in tax income, the IMF could facilitate time-inconsistent policies. While in the short run even the capital market—out of self-interest— might support such a stance, badly designed fiscal policies may lead to a wave of debt restructurings in the future. For Latin America, such a scenario would have highly negative economic and political consequences that might reverse the decades-long investment many countries in the region have made in building stronger fiscal and financial institutions.

As the pandemic eventually recedes thanks to the effects of vaccination, and aggregate demand expands, current account deficits are likely to grow. History shows that large and persistent current account deficits are essential ingredients of sudden stop episodes. After many years of unusually low interest rates and ample liquidity, the global economy may experience some normalization in interest rates in the future as advanced economies also grapple with the historically high public debt levels reached during the pandemic. US Federal Reserve policies have been extraordinarily expansionary during the pandemic, as monetary aggregates have increased to record levels, far surpassing those observed during the Global Financial Crisis.

Since last year, the US has also embarked on a highly expansionary fiscal policy. This is worrisome because, as the output gap is expected to close before year end, the increase in government expenditure may lead to an overheating of the US economy. Moreover, a unique characteristic brought about by the pandemic the surge in precautionary private-sector savings and an unprecedented increase in the demand for money. As the US economy reopens, private consumption and investment may increase significantly and may collide with the massive fiscal stimulus under way. **The Committee believes that, in the absence of fiscal restraint and a pre-emptive monetary response by the Fed, US-inflation expectations may increase and lead the Fed to adopt an overly tight policy stance in the future.**

The Fed's expansionary policy may be behind a "new" inflation: that of asset prices. In this respect, the strong performance of the stock market may be underpinned in part by the significant expansion of liquidity and by record earnings that justify higher valuations. But if asset prices are sustained at current elevated levels mostly by monetary policy, those asset prices will become highly sensitive to (actual or potential) required normalization of monetary policy. In addition, zero or negative real interest rates and the search for yield have fueled the expansion of margin borrowing and, more recently, the increased participation of small retail investors in the stock market as they saved and invested a large share of the assistance transfers received from the government. All of this suggests that financial fragility might have increased significantly. In this context, **the Committee believes that policymakers in Latin America need to remain vigilant as regards the future evolution of current account deficits and strive to build buffers to navigate potential events of sudden stops with minimal effects on country-risk premia,** while emphasizing policies that attract stable and long-term foreign direct investment rather than just portfolio debt flows.

The Latin American Committee on Macroeconomic and Financial Issues (CLAAF) gratefully acknowledges financial support by the Center for Global Development, the Central Bank of Chile, and FLAR for funding its activities during 2021. The Committee is fully independent and autonomous in drafting its statements.

This statement was jointly produced by:

Laura Alfaro, Warren Albert Professor, Harvard Business School, Former Minister of National Planning and Economic Policy, Costa Rica.

Guillermo Calvo, Professor, Columbia University; former Chief Economist, Inter-American Development Bank.

Augusto De La Torre, Former Chief Economist for Latin America and the Caribbean, The World Bank. Former Governor, Central Bank of Ecuador.

José De Gregorio, Professor of Economics, University of Chile. Former Governor of the Central Bank and former Minister of Economy, Mining and Energy, Chile.

Roque Fernandez, Economics Professor, UCEMA University; former Minister of Finance, Argentina.

Pablo Guidotti, Professor of the Government School, University of Torcuato di Tella; former Vice minister of Economy, Argentina.

Paulo Leme, Executive in Residence Professor of Finance, Miami Business School, University of Miami.

Enrique Mendoza, Presidential Professor of Economics, University of Pennsylvania.

Ernesto Talvi, Former Director of the Latin America Initiative, Brookings Institution, DC; Former Academic Director of CERES; Former Minister of Foreign Affairs, Uruguay.

Liliana Rojas-Suarez, President, CLAAF; Senior Fellow and Director of the Latin American Initiative, Center for Global Development; Former Chief Economist for Latin America, Deutsche Bank.

Andrés Velasco, Dean of the School of Public Policy, London School of Economics, UK. Former Finance Minister of Chile.

Center for Global Development

Ideas to Action: Independent research for global prosperity

WWW.CGDEV.ORG

LILIANA ROJAS-SUAREZ is director of the Latin American Initiative and senior fellow at the Center for Global Development.

Contact:
Alejandro Fiorito, research assistant,
afioritobaratas@cgdev.org