



Effects of the Global Financial Crisis on LAC's Public Finances

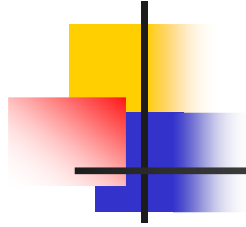
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Overview of presentation

- Background: the unfolding global crisis
- How did the LAC region look at the outset of the crisis?
- Impact of the crisis on the region's economies and public finances
- Fiscal policy response



The unfolding global crisis



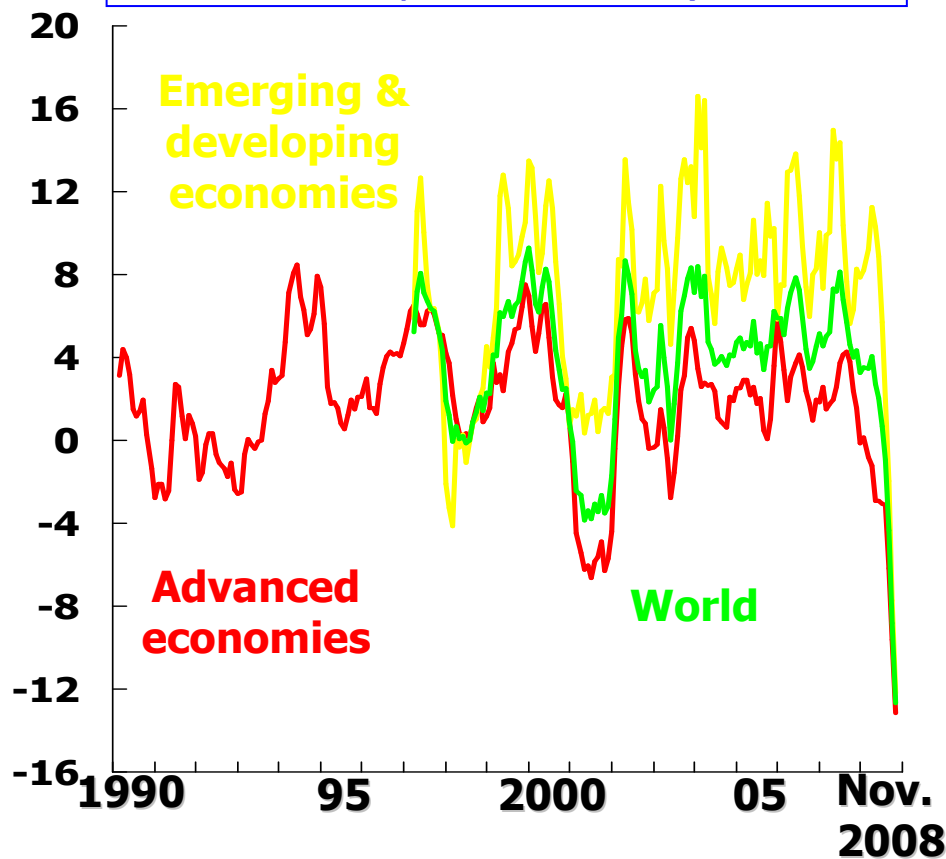
The adverse financial-macro feedback loop

- Sharp declines in real and financial wealth, as well as reduced credit availability, affecting negatively private consumption in advanced countries
- Tightening credit constraints and negative demand outlook impacting private investment
- Downturn originating in advanced countries increasingly spreading to EMs and LICs, through contraction in trade flows, decline in commodity prices, tightening of external financing, and deteriorating consumer and business sentiment
- Global economic downturn feeding back adversely onto the financial sector through increased losses and counterparty risk

Downturns in output and trade

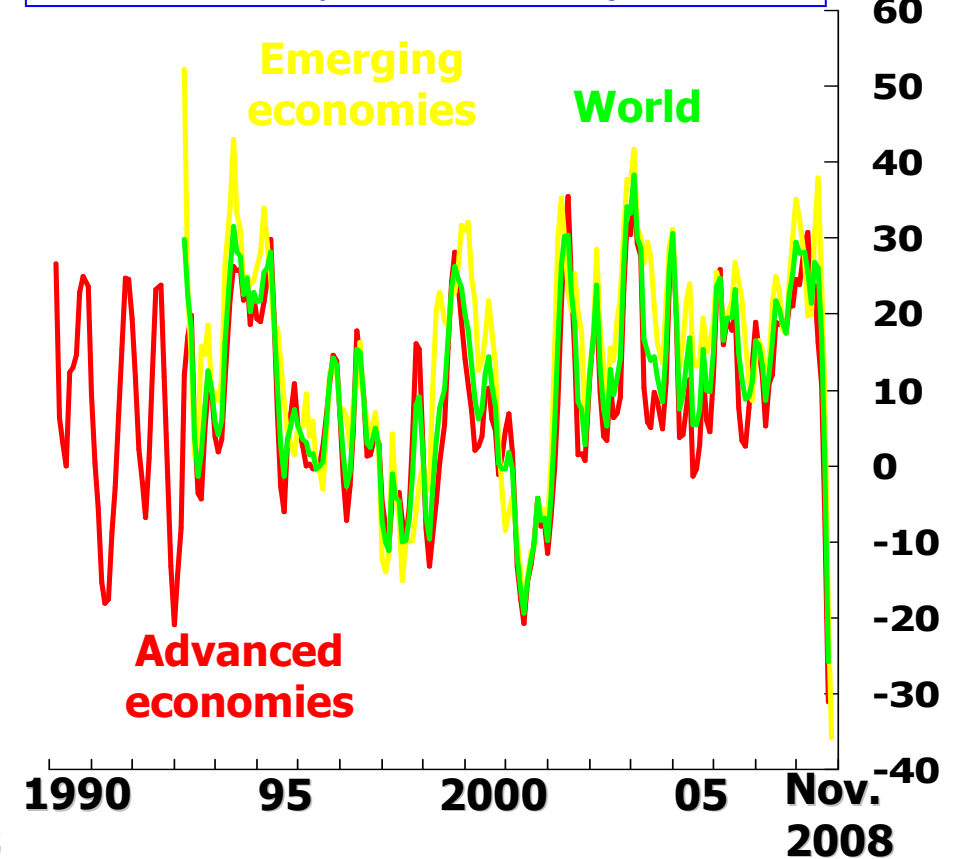
Industrial Production

(Annualized percent change of 3mma over previous 3mma)



Merchandise Exports

(Annualized percent change of 3mma over previous 3mma)





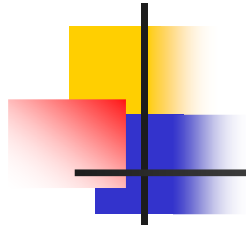
The policy response to date

- **Support to the financial sector**
 - Massive short-term liquidity provision by Central Banks
 - Recapitalization of selected financial institutions “too big to fail”
 - Limited purchases of toxic assets
 - Stepped-up provision of guarantees
 - But, likely still short of need, and too piecemeal
- **Assorted fiscal stimulus packages** of varying intensity, timeliness and likely effectiveness



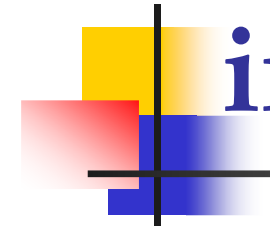
A gloomy outlook for the world economy

- **World output** likely to stagnate on average in 2009, and to recover only slowly in 2010; but further downside risks cannot be ruled out, especially if policy response “too little, too late”
- **Risks of deflation** in some industrial countries; inflation pressures sharply diminishing in most EMs and LICs
- Outlook for reduction of **global imbalances** unclear. Risks of protectionism and exchange rate manipulation

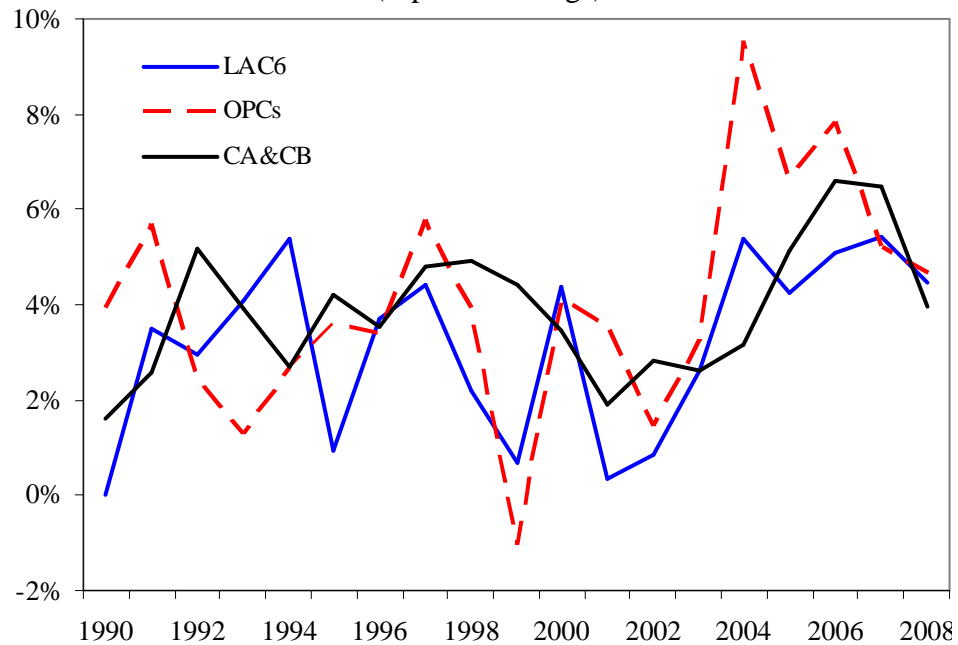


How did the LAC region look at the outset of the global crisis?

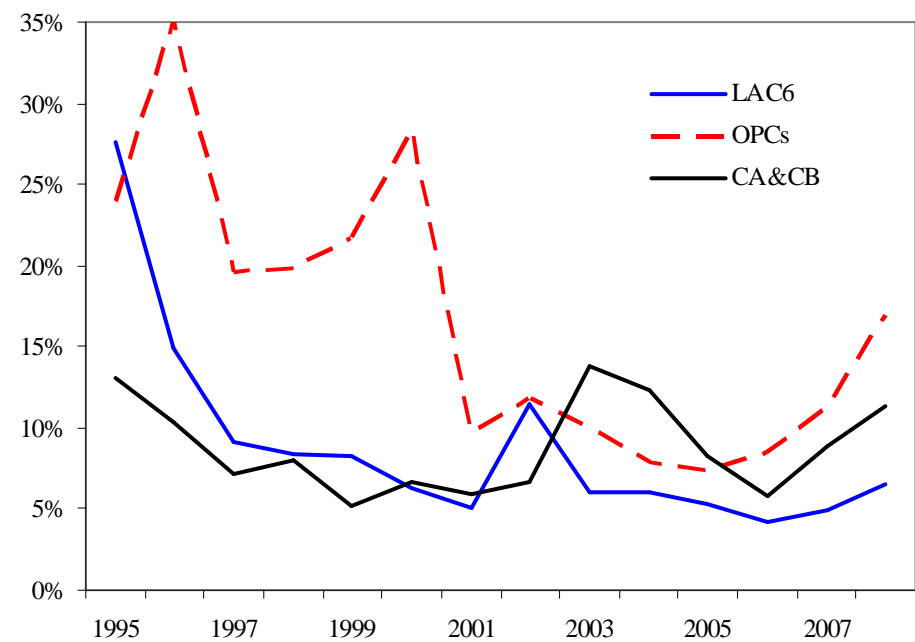
Favorable growth and inflation performances



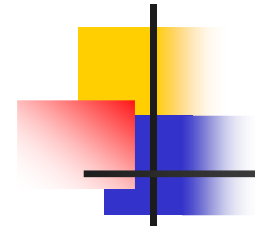
Real GDP Growth Rates
(in percent change)



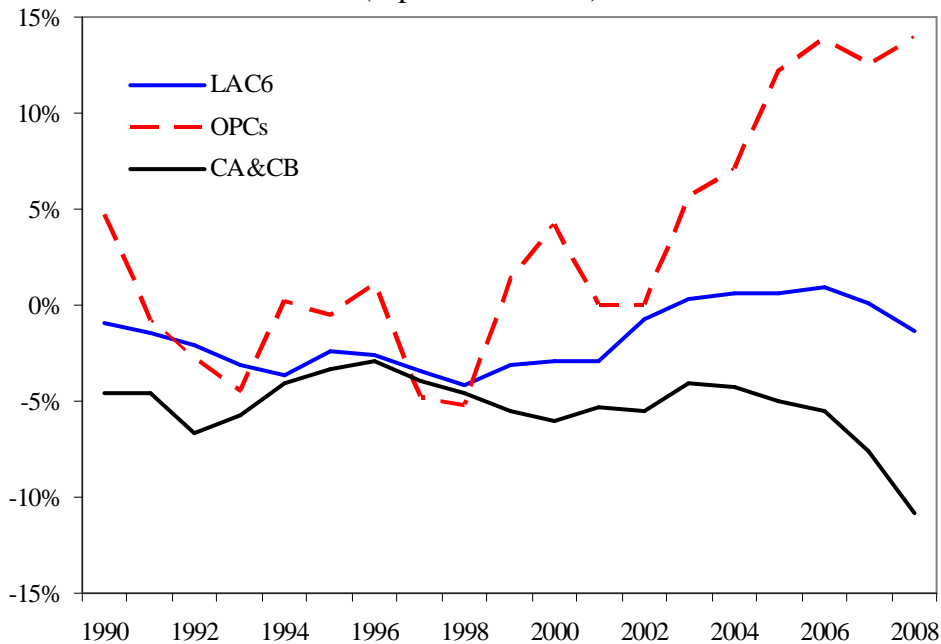
12-month Inflation
(end-of-period, in percentage points)



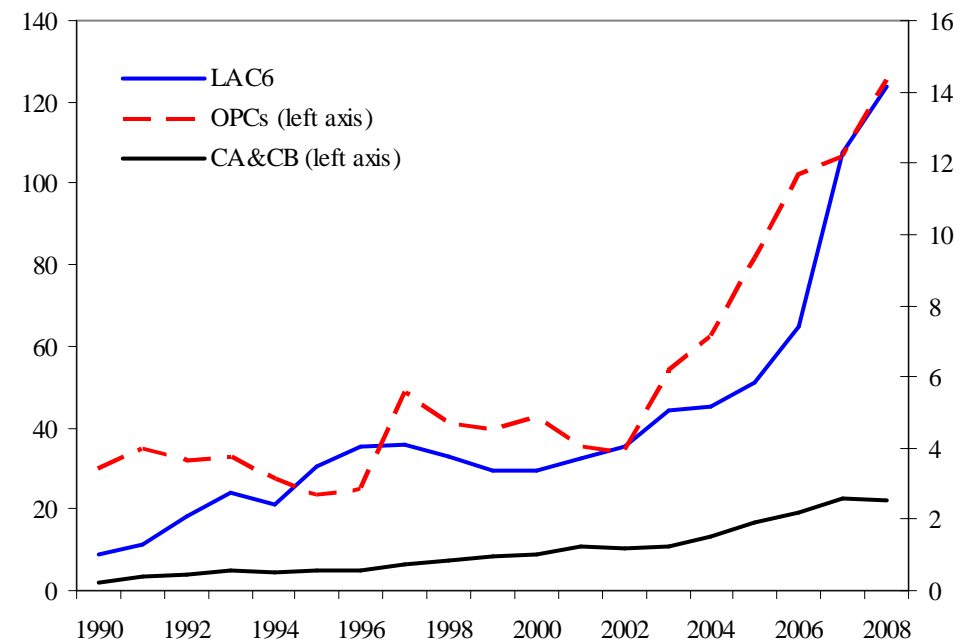
Reduced external vulnerabilities



External Current Account Balance
(in percent of GDP)

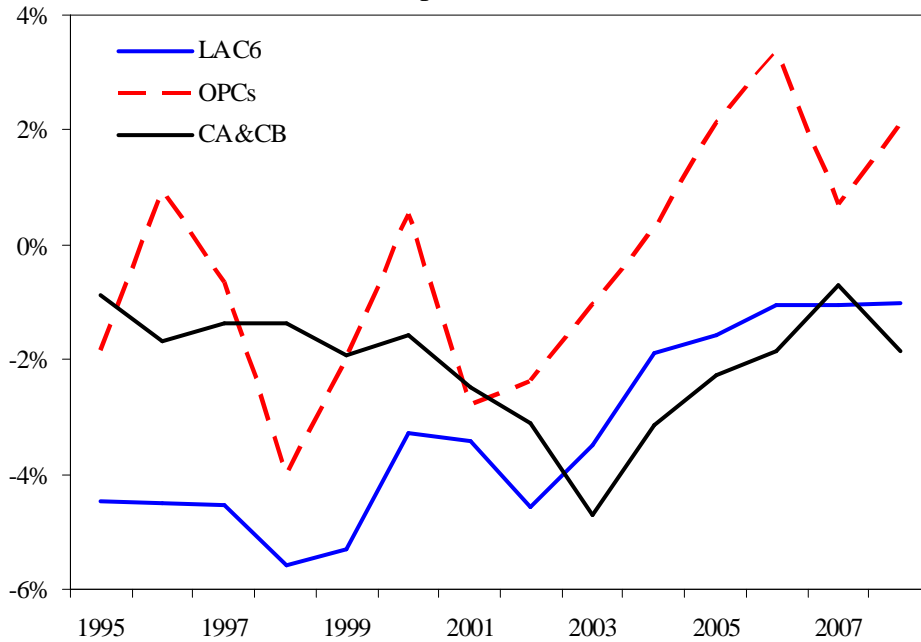


Stock of International Reserves
(in Billions of US\$)

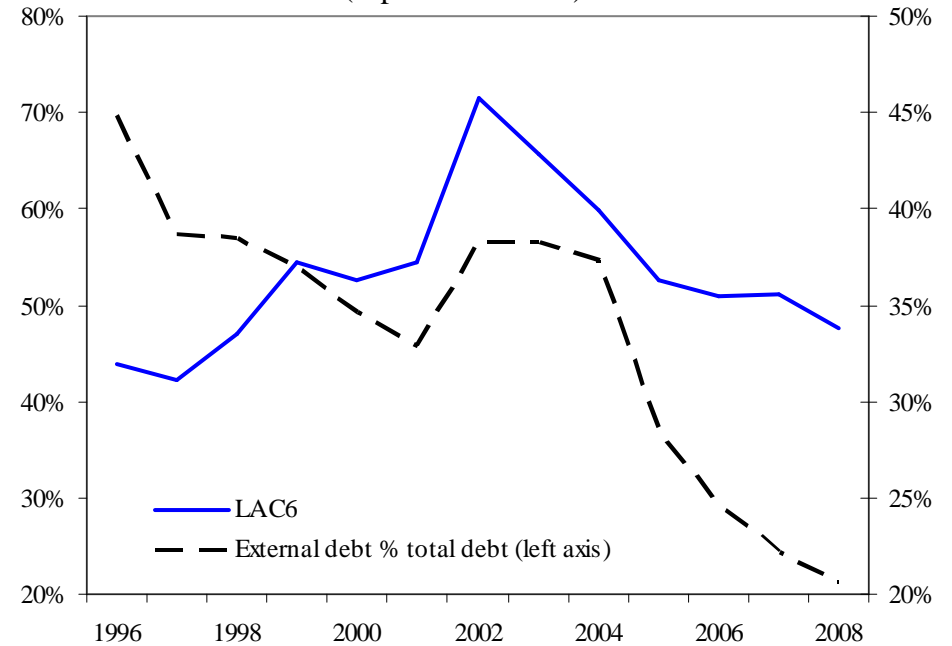


Improved fiscal positions

Overall Fiscal Balance
(in percent of GDP)



Public Debt
(in percent of GDP)





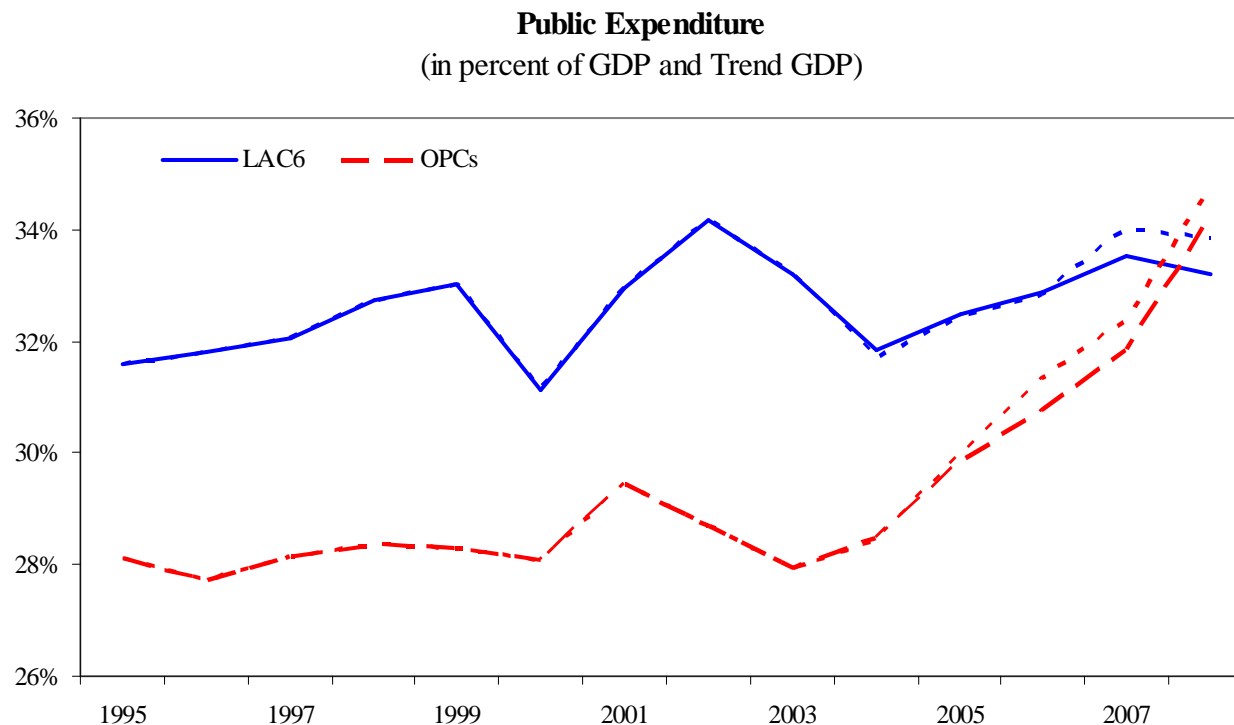
Determinants of fiscal improvement

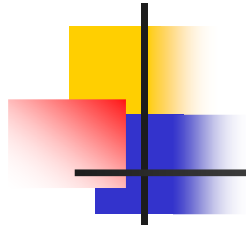
- **Improved fiscal frameworks and structural fiscal reforms contributed to the region's recent fiscal performance.**
 - Fiscal rules/Fiscal responsibility legislation
 - Debt management reforms
 - Improvements in tax administration
 - Selected tax reforms

- **However, highly favorable external and cyclical factors played a crucial role,** masking the continuation of significant vulnerabilities, which the current crisis is beginning to expose

Rapid growth in public expenditure

- An element of fiscal vulnerability is the continuing rapid growth of public spending, relative to actual and, even more, to potential GDP





Impact of the crisis on LAC's economies and public finances



Economic prospects for the region

- Recent forecasts all point to a **sharp deceleration in growth in 2009**, with a modest recovery in 2010
- **Inflation is also expected to slow significantly** from the commodity-induced spike in 2008
- **Current account positions likely to weaken** in South America, and (less so) in the Caribbean, but to improve in Central America, reflecting favorable TOT effects for the latter
- **Substantial declines also likely in FDI and other capital inflows**, with attendant tighter financing constraints for sovereigns and corporates



Main transmission channels of the crisis onto LAC's public finances

- Operation of the automatic stabilizers
- Other non-discretionary fiscal impacts
- Discretionary fiscal measures, including support to the financial system



Automatic stabilizers

- Endogenous response of government revenue and expenditure to cyclical output changes
- Factors pointing to relatively small size of automatic stabilizers in the LAC region
 - Relatively small government size
 - Limited spending programs tied to economic cycle (e.g., unemployment benefits)
 - Historical income elasticities of non-commodity revenues close to 1
- But, impact may be magnified in current circumstances by increased tax non-compliance, and by changes in the composition of the bases of some taxes (e.g. a disproportionate decline in imports)



Automatic stabilizers

- A preliminary (and probably optimistic) calculation of the impact on fiscal accounts through automatic stabilizers in 2009

Impact through Automatic Stabilizers
(In percent of GDP, relative to previous year)

| | |
|-----------------|-------------|
| Major LAC 1/ | -0.6 / -1.1 |
| OPCs 2/ | -0.5 / -1.5 |
| Central America | -0.1 / -0.4 |

1/ Arg, Brz, Chl, Col, Mex, Per

2/ Bol, Ecu, T&T, Ven

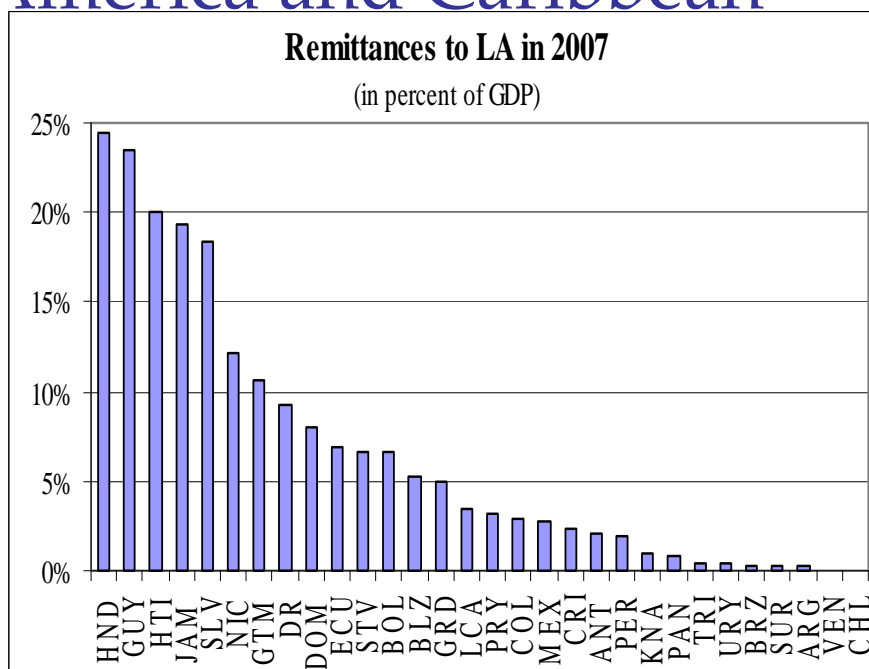


Fiscal impact of decline in commodity prices

- The recent sharp decline in commodity prices will have an asymmetric impact in the region
 - Central America and Caribbean will benefit
 - OPCs will be the most negatively affected (with Mexico partly protected by its hedging operation)
 - Mineral producers (e.g. Chile) are also expected to suffer substantial losses in revenues
- Recent exchange rate changes will partly offset the fiscal impact of the decline in commodity prices for a number of countries in the region

Fiscal impact of declines in remittances and tourism

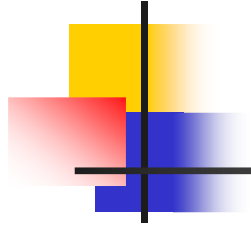
- Remittances and tourism particularly important for Central America and Caribbean countries
 - Inflows are linked to private consumption and imports, with resulting impact on VAT and custom duties





Other non-discretionary fiscal impacts

- **Equity and housing prices**
 - Wealth effects
 - Capital gains taxation
- **Financial sector activities**
 - Reduced profits and CIT receipts
 - FTT and other taxes on financial sector
- **Impact likely to be less significant for LAC than for advanced countries**, given less developed state of financial markets, and relatively low share of revenues from property and capital gains



Fiscal policy response



Discretionary fiscal measures to date

- LAC governments have been so far relatively cautious in adopting **fiscal stimulus measures**
- Measures announced typically involve:
 - Increase or acceleration of public investment spending (e.g. Argentina; Mexico; Peru)
 - Support to credit to private sector (housing, exports, small firms) (e.g. Brazil; Chile)
 - Targeted transfers (e.g. Chile; Mexico; Argentina)
 - Selective tax reductions(e.g. Brazil; Chile)
- Some countries have also provided guarantees to the financial system



Scope for countercyclical fiscal policy

- **Room for countercyclical fiscal policy is likely to vary significantly across LAC region, reflecting:**
 - **Macroeconomic space**
 - In current circumstances (falling output; declining inflation) mainly relevant for countries with weak external positions and inflexible exchange rate policies
 - **Financing constraints**
 - Reflect gross, not just net, financing needs
 - Exacerbated by ongoing global de-leveraging
 - **Solvency considerations**
 - Starting debt levels and composition
 - Vulnerability to exchange rate changes
 - Interest rate-growth rate differentials
 - Existence of a credible medium-term budget framework
 - **Extent of fiscal rigidities**
 - Entitlement programs
 - Earmarking



What should a fiscal stimulus package look like?

- **Optimal design of a fiscal stimulus package depends on country-specific circumstances, but in general desirable features include:**
 - Non permanent character
 - Timeliness of implementation
 - Short-term effectiveness in stimulating domestic demand
 - Broad consistency with longer-term structural reform objectives

- **In light of above, preferable stimulus measures include:**
 - Increased spending on sound infrastructure projects (including at sub-national level) that address key supply bottlenecks
 - Strengthened social safety nets
 - Cuts in distortionary taxes (turnover, payroll, and financial transaction taxes)
 - Income tax reductions for lower brackets



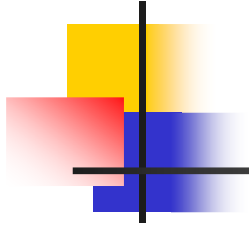
Main conclusions

- The impact of the global financial crisis on LAC economies is becoming more acute and evident
- Sound macro-economic and fiscal policies in recent years have created fiscal space in several countries of the region to absorb the endogenous impact of the crisis on the public finances, thus avoiding the pro-cyclicality experienced in previous crisis
- Some countries also appear to have room for a moderate discretionary fiscal stimulus



Main conclusions

- The design (as well as the size) of such a stimulus should reflect country-specific economic and institutional factors. There is no “one size fits all” model
- In all cases, however, the stimulus should be reversible or at least temporary, and accompanied by a strengthened, credible commitment to longer term fiscal sustainability



THANK YOU!