Fiscal Aspects of Recent Capital Account Crises

Lessons for Latin America

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Types of Financial Crises

- Currency crises, debt crises, and banking crises.
- Many emerging market crises combine elements of all three.
- Fiscal policy can contribute to each type of crisis.
- It can also provide a bridge between them.

Role of Fiscal Policy

- Large fiscal imbalances have frequently been a direct source of excess demand pressures, leading to traditional (current account) currency crises.

- The contribution of fiscal policy to modern (capital account) currency crises is more complex.

- Unsustainable public debt dynamics can give rise to concerns about government solvency. The maturity and currency structure of government debt can lead to concerns about government liquidity.

Role of Fiscal Policy

- Concerns about liquidity and/or solvency are linked directly to debt crises, and the possibility of default.
- They can also be a source of pressure on the exchange rate, and can prompt concerns about the health of commercial banks, thus leading and/or contributing to currency and banking crises.
- Conversely, large depreciations of the exchange rate and bank bailouts can lead to sharp increases in the public debt stock, fueling concerns about solvency and liquidity.

Empirical Evidence

- Fiscal balances were large and/or worsened in the run-up to most crises.

Overall Balance (in Percent of GDP)

Country (Crisis Year = T)	T-2	T-1	T	T+1	T+2
Argentina (2001)	-4.1	-3.7	-6.8	-10.4	-7.4
Brazil (1998)	-5.9	-6.1	-8.0	-10.0	-4.6
Indonesia (1998)	1.0	-1.2	-2.3	-1.4	-1.1
Mexico (1995)	-2.5	-3.9	-3.9	-5.3	-5.9
Russia (1998)	-8.9	-7.9	-8.0	-3.1	3.6
Turkey (2001)	-22.9	-19.1	-21.2	-11.4	-9.8
Ukraine (1999)	-5.4	-2.8	-2.4	-1.3	-1.6
Average overall balance	**-7.0**	**-6.4**	**-7.5**	**-6.1**	**-3.8**

Source: IMF staff estimates and projections.

Numbers in blue show a worsening with respect to the preceeding year.

Empirical Evidence

- Similarly, public debt ratios also tended to be relatively high, and/or rising, in the run up to debt crises. Short-term debt was consistently above normal in the run up to debt, currency, and banking crises.

Public Debt (in Percent of GDP)

Country (Crisis Year = T)	T-2	T-1	T	T+1	T+2
Argentina (2001)	47.6	51.1	64.4	129.0	131.0
Brazil (1998)	34.4	35.2	43.4	49.4	49.3
Indonesia (1998)	23.9	32.5	66.4	87.4	99.1
Mexico (1995)	27.6	32.7	48.9	49.8	46.6
Russia (1998)	52.5	51.2	68.7	92.7	62.0
Turkey (2001)	61.0	57.7	92.8	82.1	75.2
Ukraine (1999)	29.9	38.5	50.9	45.3	37.3
Average public debt	**39.6**	**42.7**	**61.9**	**76.5**	**71.5**

Source: IMF staff estimates and projections.

Numbers in blue indicate an increase relative to the previous year.

Empirical Evidence

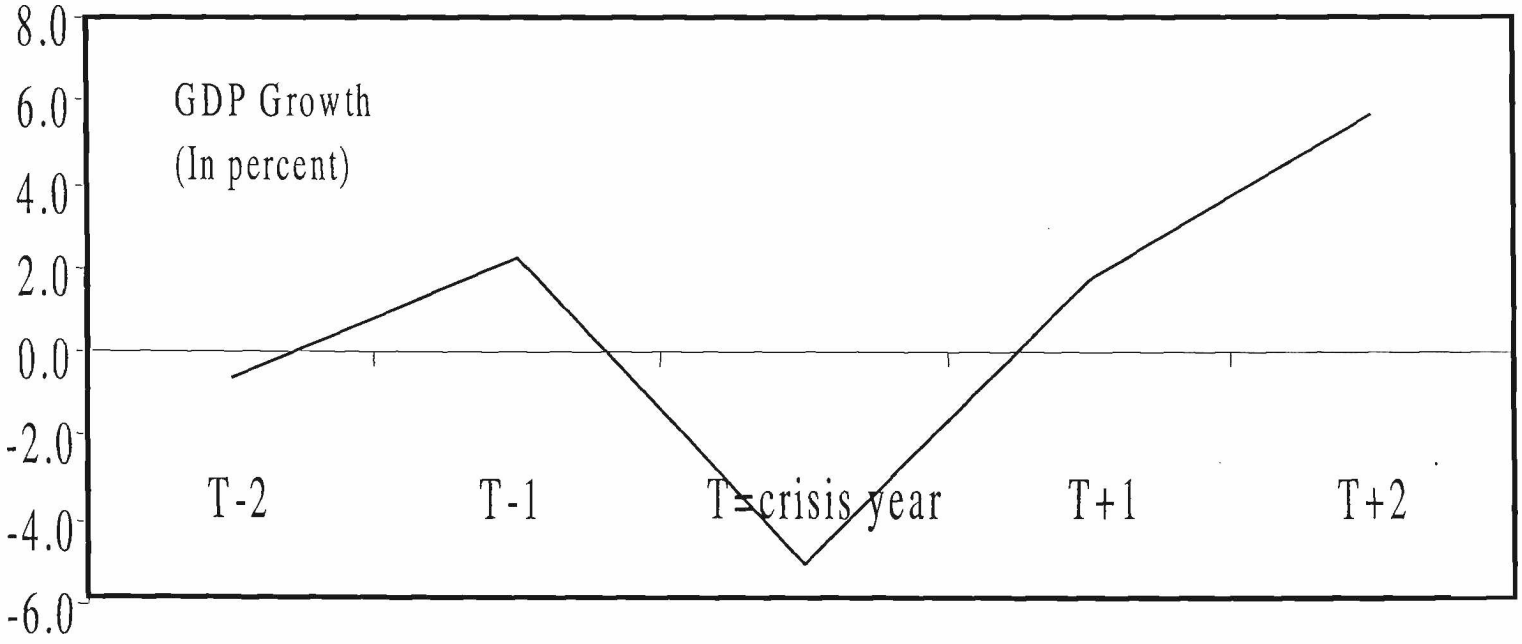
- Fiscal deficits and public debt have been key contributors to crises in several countries--Brazil, Bulgaria, Ecuador, Pakistan, Russia, and Ukraine, among others. Debt restructuring was needed in Ecuador, Pakistan, and Ukraine.
- In other countries--Argentina (1995), Czech Republic, and Mexico-- fiscal deficits and public debt contributed to, but were not the main cause of, crises.
- In the Asian crisis countries, fiscal positions were initially sound --especially in Korea and Thailand-- and the crises mainly reflected balance of payments weaknesses.

Empirical Evidence

- If fiscal policy contributes to crises, can fiscal indicators be used to help predict crises?
- In the IMF's currency crisis models ("EWS models"), they make only a marginal contribution to predicting crises.
- They also do not add significantly to models explaining the severity of crises.
- Fiscal indicators may be better predictors of debt crises, and work is proceeding in the IMF on EWS models of debt crises. However, this work will not yield a "magic number" for a threshold level above which the public debt becomes a problem.

Fiscal Policy Responses

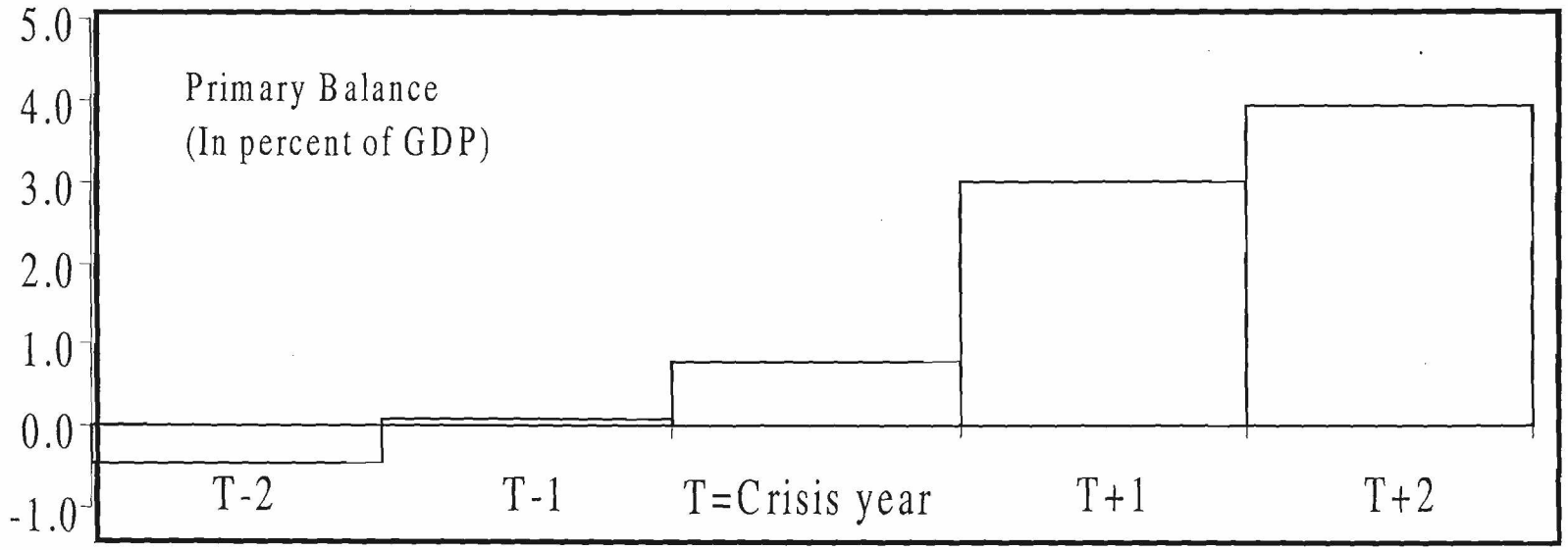
- What have been common policy responses in crisis countries?
- To start with, financial crises usually lead to sharp recessions.



Source: IMF staff calculations, based on evidence from several crisis countries, incl. Argentina (2001), Brazil (1998), Indonesia (1998), Mexico (1995), Turkey (2001), and Ukraine (1999).

Fiscal Policy Responses

- In a Keynesian framework, fiscal and monetary easing are considered an appropriate response to an economic downturn.
- In contrast, procyclical fiscal (and monetary) tightening has been a common response to crises in emerging market economies.



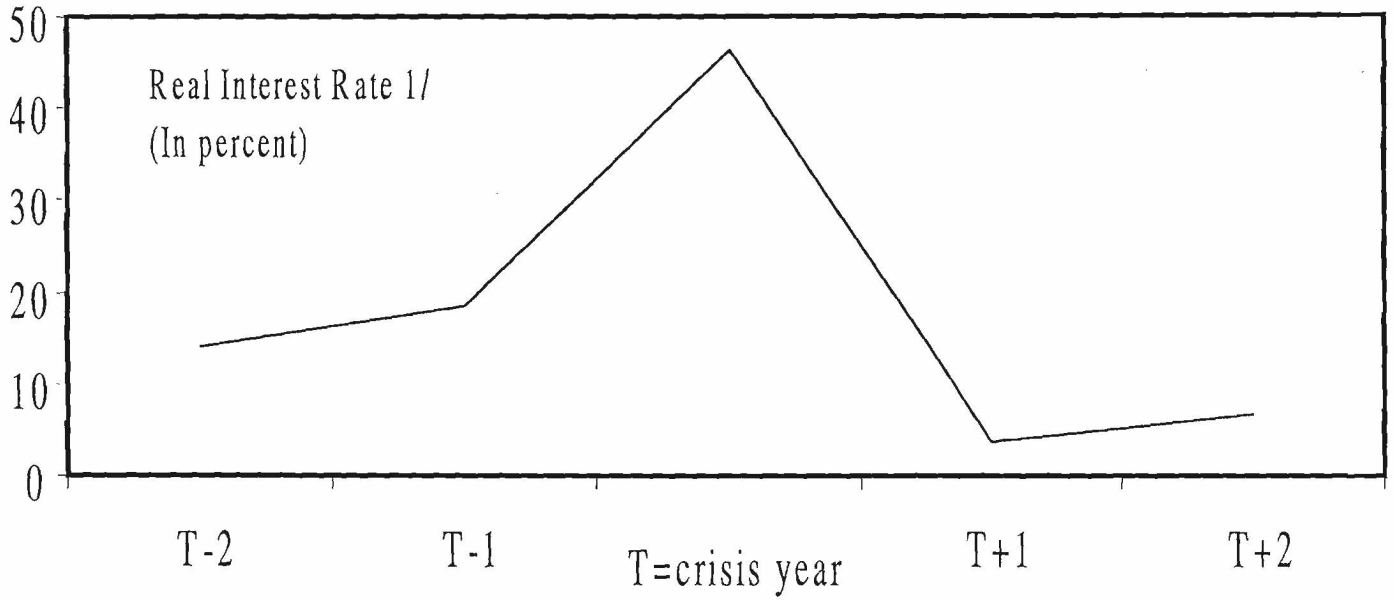
Source: IMF staff calculations, based on evidence from several crisis countries, incl. Argentina (2001), Brazil (1998), Indonesia (1998), Mexico (1995), Turkey (2001), and Ukraine (1999).

Fiscal Policy Responses

- Procyclical fiscal tightening is usually dictated by the need to:
  - Maintain/achieve debt sustainability.
  - Address loss of market access that constrains financing; and, in some cases,
  - Relieve excess demand pressures, to ensure macroeconomic stability.

Fiscal Policy Responses

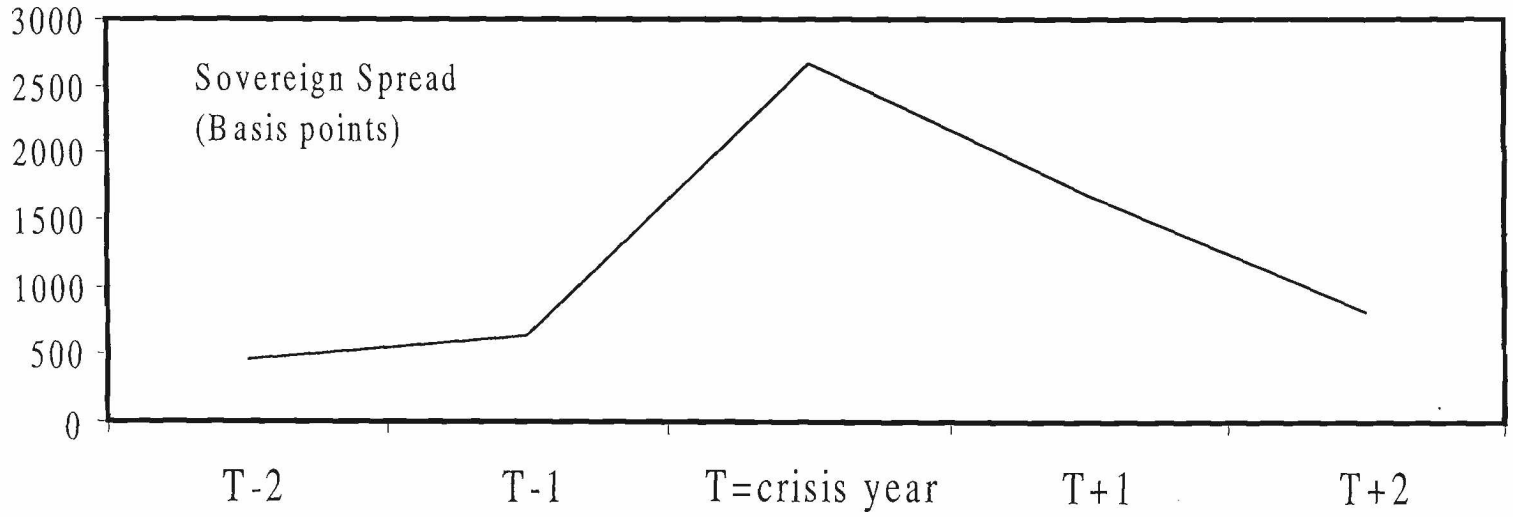
- The fiscal stance during crises is largely constrained by the availability of financing. In the runup to a crisis, domestic interest rates and sovereign bond spreads increase, while market access dwindles.



Source: IMF staff calculations, based on evidence from several crisis countries, incl. Argentina (2001), Brazil (1998), Indonesia (1998), Mexico (1995), Turkey (2001), and Ukraine (1999).

Fiscal Policy Responses

- There are limits to the extent to which official financing (e.g., from the IFIs) can replace market financing and be used to ease financing constraints. Usually, the scope for more active fiscal policy increases only when market access is restored.



Source: IMF staff calculations, based on evidence from several crisis countries, incl. Argentina (2001), Brazil (1998), Indonesia (1998), Mexico (1995), Russia (198) ,Turkey (2001), and Ukraine (1999).

Fiscal Policy Responses

- When a crisis hits and output falls, automatic stabilizers tend to widen the fiscal deficit. However, financing constraints frequently require offsetting contractionary fiscal measures. Thus, a seemingly only modest decline of the fiscal deficit in the immediate aftermath of a crisis may disguise a more significant discretionary fiscal adjustment.

- Moreover, the impact on the public debt of events like a large depreciation and/or a bank bailout can require additional fiscal adjustment, beyond what is called for by short-term financing constraints.

Demand Impact of Fiscal Tightening

- According to the standard Keynesian model, fiscal tightening during crises will deepen the recession.
- However, fiscal multipliers are generally small, and countries cannot use countercyclical fiscal expansions to grow out of a debt problem. Hence, procyclical fiscal policies alone may not cause much damage.
- Output growth is more likely to be adversely affected by high interest rates and a drying up of financing, especially to the private sector. Fiscal tightening may, on balance, have a positive net effect on output, particularly if it improves market confidence, reduces interest rates, and helps restore market access.

Demand Impact of Fiscal Tightening

- Still, fiscal tightening is not always warranted during crises, especially when underlying fiscal conditions are relatively sound (as was the case in most of the Asian crisis countries). In such cases it may be appropriate to let automatic stabilizers work in full, or even introduce a discretionary fiscal stimulus.

- Empirical evidence suggests that the bulk of fiscal tightening occurs after a crisis has bottomed out.

Demand Impact of Fiscal Tightening

Change in Primary Balances (in percent of GDP)

Country (Crisis Year = T)	T	T+1	T+2	Cumulative
Argentina (2001)	-1.8	1.4	2.6	2.2
Brazil (1998)	1.0	3.2	0.3	4.5
Indonesia (1998)	0.4	1.6	1.6	3.6
Mexico (1995)	2.0	0.3	-1.2	1.1
Russia (1998)	-0.3	6.4	4.9	11.0
Turkey (2001)	3.1	0.6	0.0	3.7
Ukraine (1999)	0.4	1.8	-1.4	0.8
Average change in primary balance	**0.7**	**2.2**	**1.0**	**3.8**

Source: IMF Staff estimates and projections.

Quality of Fiscal Adjustment

- Political and institutional constraints frequently entail a trade-off between the speed and quality of fiscal adjustment.
- The need to act quickly at the peak of a crisis frequently makes it inevitable to resort to low quality fiscal adjustment measures.
- But protracted reliance on distortionary tax and expenditure measures, or ad-hoc measures that are not likely to be durable, makes it difficult to restore credibility.
- This underscores the importance of implementing high-quality structural fiscal reforms in crisis countries.

Quality of Fiscal Adjustment

- An important aspect of the quality of fiscal adjustment are the social costs involved. Even high quality adjustment measures can impose significant social costs, at least in the short run.
- These social costs could undermine the socio-political sustainability of the adjustment effort, and market credibility may not be restored as a result.
- This, in addition to humanitarian and moral concerns, underscores the importance of adequately strengthening social safety nets during crises.
- Fully protecting efficient social spending and key infrastructure investments also improves the prospects for sustainable growth over the medium to long-term.

Quality of Fiscal Adjustment: Brazil

- The example of Brazil can by used to illustrate some of these various points on the quality of fiscal adjustment.
- The quality of fiscal adjustment in Brazil in recent years has been mixed. Main positive features have been:
  - A much strengthened tax administration;
  - Significant reforms of income taxes;
  - Substantial improvements in budgeting & planning, and transparency of the public finances;
  - Important initial reform of the social security system for private employees;
  - Reforms in social spending, leading to improvements in social indicators, especially in education;
  - Substantial improvement in the finances of state and local governments.

Quality of Fiscal Adjustment: Brazil

- However, there were also some features that adversely affected the quality of fiscal adjustment:
  - Protracted reliance on distortive revenue measures (turnover taxes, CPMF);
  - Increased erosion of the base of the state-level VAT (ICMS);
  - Increased degree of earmarking of revenues;
  - Increasing rigidities in public expenditures.

Institutional Reform: Overview

- Both short-term adjustment and longer-term sustainability are easier to achieve with effective fiscal institutions.
- Priorities for institutional reform:
  - Improving the capacity to design & implement fiscal policy, including through the adoption of appropriate fiscal rules, supported by increased fiscal transparency.
  - Upgrading revenue administration & budget management;
  - Strengthening intergovernmental fiscal relations;
  - Improving public debt management, by lengthening debt maturities and reducing the share of foreign currency-denominated or –indexed debt.

Successful Institutional Reforms

- Brazil: Introduction of a Fiscal Responsibility Law, applicable to all levels of government, and supported by strong sanctions for non-compliance.
- Mexico: Substantial improvements in public debt management, in particular, elimination of foreign currency-denominated domestic debt, deepening of domestic debt markets, and significant lengthening of average maturity.
- Russia: Enactment of modern tax code; significant strengthening of tax administration; progressive implementation of modern treasury.

Unsuccessful Institutional Reforms

- Still, in some crisis countries there has been significant retrocess in the institutional framework.
- An unfortunate example is Argentina in recent years:
  - Substantial deterioration in the tax administration
  - Proliferation of special treatments and privileges in the tax system
  - Emergence of substantial budgetary arrears, especially at the provincial level; and
  - Weakening of long-term health of private pension funds.

Fiscal Policy & Crisis Prevention

- Key role of fiscal policy in crisis prevention: to establish sound fiscal positions. Main indicators of macro-fiscal soundness are a low, or consistently declining, public debt to GDP ratio, and a structure of the public debt that limits vulnerability to exogenous shocks.
- Sound fiscal management includes building up surpluses during booms, to facilitate a countercyclical fiscal policy during recessions, and to speed up debt reduction.
- However, the political economy of running surpluses during booms is not easy. A transparent budget rule that calls for balance or modest surpluses over the cycle (similar to Chile) can help in this respect. But the practical difficulties of designing, implementing, and monitoring such a rule should not be understimated.

Fiscal Policy & Crisis Prevention

- Sound fiscal management also includes due attention to the quality of revenue and expenditure policies and of fiscal institutions.
- Although, sometimes, crises provide an opportunity to build a hitherto elusive social & political consensus for needed institutional reforms, they also make the implementation of these reforms more costly, especially in social terms.
- These considerations underscore the importance of implementing structural reforms as an instrument of crisis prevention, rather than crisis management.