

THE PRIVILEGE OF NORMALITY: LATIN AMERICAN FISCAL SPACE, COUNTERCYCLICAL POLICY, AND THE 2008 FINANCIAL CRISIS

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Latin America has long been cursed with sudden economic downturns, credit crises, and sociopolitical instability.¹ Most recently, the 1997 Asian financial crisis and the 1998 Russian Ruble crisis triggered a drought of capital inflows to the region from 1998 to 2002, leading to debt crises, inflation, and slow or negative economic growth.² These years of crisis were in line with much of Latin America's economic history: overdependence on foreign financing and low levels of savings during economic upturns continually led to harsh credit crunches and contractions during downturns.³

Beginning in the fourth quarter of 2002, however, an exceptional combination of abundant financing, soaring commodity prices across the agricultural, mineral, and hydrocarbon sectors, and significant remittance flows produced an exuberant economic boom.⁴ Many nations also moved toward greater exchange rate flexibility, inflation-targeting policies, stronger central banks, moderate debt-to-GDP ratios, and credible monetary regimes.⁵ Taken together, these macroeconomic reforms and positive economic conditions led observers to a common conclusion: should a crisis arise, Latin America would enjoy newfound fiscal and monetary "space" in which to enact activist countercyclical policies.⁶

Such a crisis was not far off. With the 2008 collapse of the global financial system, Latin America saw a dramatic reversal in every driver of the boom. Remittance flows stagnated, international trade contracted drastically, commodity prices plummeted, and capital inflows to the region ground to a halt.⁷ Time was up. The boom had ended.

This paper focuses on a key question: has Latin America

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earned, in the words of José Juan Ruiz, “the privilege of normality?”⁸ Did Latin American countries develop the macroeconomic capacity necessary to escape the large-scale currency depreciations, major financial disruptions, and pro-cyclical “sudden stops” in financing during downturns that mar the region’s history? And if so, what circumstances contribute to or detract from states’ abilities to implement these countercyclical programs in the face of a crisis?

Through a controlled comparison of several Latin American countries, I demonstrate the pathway Latin American countries have taken to accumulate or deplete the fiscal space needed for countercyclical policy. By examining the macroeconomic behavior of these countries prior to and following the 2008 financial crisis, I determine that effective management of international reserves and fiscal sustainability are crucial conditions for any country looking to mediate the severity of an economic downturn. Some, but not all, Latin American countries developed these crucial macroeconomic capacities. Many enacted these policies on tenuous political grounds. Perhaps the most important question is whether those who *have* earned normality will continue the policies they need to keep it.

THE POLITICS OF RAINY DAY FUNDS

By September 2009, the economic crisis had turned global. Both academic and international financial communities had largely embraced the Keynesian theory that fiscal and monetary policy can play an important stabilization role in an economy by stimulating aggregate demand. By engaging in fiscal and monetary activism, governments can mitigate the impact of a global crisis, sustain the purchasing power of the middle class, avert social backlash and prevent further economic loss.⁹ Y.V. Reddy, for instance, writes that countercyclical policy can be crucial for developing countries, insofar as unchecked crises in emerging markets can lead to dramatic sociopolitical instability.¹⁰

In Latin America, the combination of democratization and frequent economic crises has led to governing coalitions that are mindful of economic performance. If a governing party fails to deliver on economic promises—or if the leader presides over a sharp economic downturn—this leader and party can expect to be voted out of office in the next national election.¹¹ At the onset of the crisis in 2008, political leaders in Latin America shared the general incentive, on both symbolic and material grounds, to implement countercyclical fiscal policies. On one hand, politicians would want to demonstrate to voters that they took decisive and immediate action in response to the crisis. On the other hand, by attempting to stimulate aggregate demand, they would ideally prevent a large-scale downturn that would harm their future political prospects.

While all governments in Latin America shared incentives to implement countercyclical policy, each government differed greatly in its capacity to do so. During the run-up to the crisis, each government made choices that contributed to or restricted its ability to respond with stimulus programs. This paper focuses on these variations in the ability to implement countercyclical fiscal policy, contending that the size and extent of fiscal stimulus programs in response to the 2008 crisis will be modulated by each government's actions during the 2003–2007 boom period.

Governments can finance countercyclical stimulus packages if they have savings or through loans. But as the region learned in the late 1990s, foreign capital flows are highly unreliable during economic downturns. The conditional loaning practiced by the International Monetary Fund (IMF) in the 1990s led to suspicion and general hesitation toward accepting financial support from that body. The challenge in the region therefore became, as Cardim de Carvalho (2010) writes, “To find ways to deal with the possibility of capital flows reversals other than appealing to the IMF for support.”¹²

What options did countries have? Latin American governments between 2003 and 2007 had an opportunity to take advantage of the export boom, either by increasing fiscal revenue streams through taxation or by profiting directly from state-owned com-

panies.¹³ If governments could also reduce discretionary expenditures—saving for a rainy day—then they could lower sovereign debt and run healthy fiscal balances that could fund stimulus programs or attract lower-interest loans in a crisis.

Governments could also prepare for capital reversals by accumulating international reserves.¹⁴ Through foreign liquidity inflows generated by commodity exports, countries in the region could have accumulated foreign exchange reserves throughout the boom. These reserves could then be used as an “alternate financing modality” to run temporary fiscal deficits.¹⁵ This latter use is of particular relevance to Latin America, a region that witnessed extensive accumulation of international reserves into rainy day funds or sovereign stabilization funds designed to account for fluctuations in capital inflows or commodity prices.¹⁶ During crises, international reserves’ opportunity costs rise at the same time that their returns fall, which incentivizes an appropriately countercyclical use of the funds.¹⁷

Two critical distinctions must be made regarding the accumulation of reserves. First, Cardim de Carvalho and Griffith-Jones and Ocampo (2008) argue that the current account balance should play a central role in considering the use value of international reserves.¹⁸ When reserve accumulation is driven by a current account surplus, these reserves represent a net accumulation of wealth in foreign exchange assets; these reserves are “owned” and ready to be put into immediate use. During a current account deficit, on the other hand, the reserves merely reflect an increase in foreign loans, and as such these reserves are merely “borrowed” liabilities.¹⁹ In order for reserves to be used as stabilization funds, they must be accumulated with a current account surplus.

Second, the use value of international reserves is further conditioned by fiscal sustainability. Although these rainy day funds can be measured objectively, to the governments that control them they have a relative value, one that can only be understood with respect to the perceived risks and benefits derived from their use. At the onset of a crisis, countries have an incentive to tap into these funds to stimulate aggregate demand and fight for electoral favor.

These outcomes represent a potential benefit for using the reserves at the moment of the crisis. But governments are also constrained by concerns with debt sustainability. If a government runs a fiscal deficit with high sovereign debt, its leaders risk depleting reserves today and leaving themselves highly vulnerable to worse crises in the future. But while holding onto the reserves may come with risk, these reserve pools would remain available for future dramatic sudden stops. In layman's terms, countries might not spend their rainy day funds today if they fear a torrential downpour tomorrow. As Alberola and Montero argue, past experiences with financial meltdowns and capital flight have made many Latin American countries particularly "debt intolerant"; governments concerned with their creditworthiness will have much greater incentives to hold on to their reserves as a last resort.²⁰ I therefore expect that these owned international reserves will be used to finance fiscal deficits only insofar as the risk of using them is perceived to be lower than the risk of holding them.

Of course, governments in the region may not have saved during the boom period. It is well known that sociopolitical pressures during times of plenty can create political economy distortions that prompt pro-cyclical spending.²¹ Griffith-Jones and Ocampo (2008) note that countries often neglect the ephemeral nature of commodity price booms and spend beyond their means. To varying extents and for multiple reasons, every country in the region engaged in at least some level of pro-cyclical public spending during the boom period.²²

Of the many explanations of fiscal pro-cyclicality, the most relevant for this time period is the "voracity" effect, wherein a temporary increase in fiscal revenues leads to disproportionately higher amounts of government spending, tax cuts, and subsidies.²³ The ability of a government to resist these political economy pressures during upturns depends on a wide variety of variables, including the composition of coalitions and political competition. A government that assents to expansionary political distortions during a boom may find that it has emptied the fiscal coffers when a crisis hits, rendering it largely incapable of responding with countercyclical

policy, however much it wants to protect its vulnerable citizens.²⁴ Taken together, these coalitional effects and political pressures alter each government's incentive to either spend or save during upturns, which in turn affects their capacities at the onset of the crisis.

I predict that the size and extent of fiscal stimulus policies will be determined by the combination of two variables: owned international reserves and fiscal sustainability.²⁵ Larger stockpiles of international reserves and favorable fiscal sustainability will result in larger stimulus programs, as governments tap into their reserve funds with confidence. A country with reserves but with doubts about sustainability may produce some stimulus programs, but these are likely to be limited in size by concerns of creditworthiness. Finally, countries with smaller pools of international reserves and greater concerns with debt sustainability are expected to enact little to no fiscal stimulus programs, despite the broad political incentives to do so. These two variables, of course, are two sides of the same coin: improvements in the fiscal balance and the accumulation of rainy day funds both speak broadly to solid macroeconomic management and to the fact that countries have saved prudently during the boom.

In selecting countries for this study, I have chosen the seven largest Latin American economies, or the LAC-7: Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela. Together, these countries account for over 90 percent of Latin America's total GDP.²⁶ In selecting the LAC-7, I establish a relatively controlled group of cases from which reasonable conclusions may be drawn. By focusing on Latin America, I hope to concentrate on a region with similar historical experiences and comparable political-economic institutions. Nevertheless, it should be said that further research in other emerging market regions—many of which experienced similar macroeconomic and sociopolitical phenomena over the same time period—could contribute to a greater understanding of fiscal space and policy.

ESTIMATING FISCAL SUSTAINABILITY

Fiscal sustainability is not a straightforward concept, but rather a multidimensional consideration of a country's budget conditions, its future prospects, and the international market for that country's debt.²⁷ Rather than rely on one measure alone, I have collected a series of data that capture various components of a country's prospects for sustainability and creditworthiness.

First, the measure most commonly used to account for international capital markets' view of emerging market sustainability is J.P. Morgan's Emerging Markets Bond Index (EMBI). These EMBI spreads serve as a "market-based indicator of available fiscal space" as defined by the "perceived default risk on external debt."²⁸ Second, I have included public debt as a percentage of GDP. Developing countries with unsustainably large debt burdens may find it particularly difficult to obtain renewed external financing, at least at manageably low interest rates.²⁹ Third, a government's fiscal balance provides another look at sustainability, given that high fiscal deficits are considered unsustainable while improvements in the fiscal balance are considered indicative of strong macroeconomic management. Fourth, Fernández-Arias and Montiel (2009) contribute another helpful measure of fiscal sustainability in the LAC-7 as of 2007. They calculate a "required structural adjustment" given as the percentage of GDP that would be necessary for each country to maintain its debt-to-GDP ratio at that time.³⁰ By adjusting for terms of trade, it makes a projection about what countries can expect when these factors worsen in a crisis. The higher the estimated required structural adjustment, the more likely it is that the country will face concerns about skepticism from foreign credit markets. Finally, I perform a calculation of total public expenditures over public revenues in each country. This is a rough measurement of how much each government has saved or spent during the boom years; values over one hundred show greater expenditure than revenues, whereas values below one hundred show more saving.³¹

The 2007 measures are displayed in Table 1 (online), which gives a broad overview of each country's long-term fiscal sustain-

ability immediately prior to the crisis.³²

Unsurprisingly, Chile stands out for its high degree of fiscal sustainability in every measure. Many close observers of fiscal policy in the region during the boom years noted that Chile demonstrated the most countercyclical fiscal restraint of any country.³³ Thanks to Chile's good reputation in international financial markets, it likely had few concerns about creditworthiness when the crisis struck. Peru's adoption of a Fiscal Responsibility and Transparency Law at the turn of the century earns it a close second place.³⁴ The clear advantage of Peru and Chile in all measures supports Ocampo's assessment in late 2007 that only Peru and Chile had sustained countercyclical restraint during the boom.³⁵

Conversely, there is the Bolivarian Republic of Venezuela, which has been legendary for its pro-cyclical spending.³⁶ This notoriety is well reflected in its high EMBI spreads. Interestingly enough, Venezuela's gross public debt and overall balance might suggest a somewhat secure fiscal position. But in this case these figures are misleading: over 80 percent of Venezuela's total exports are crude oil and other oil products, and while exports led to an average GDP growth rate of over 11 percent between 2004 and 2007, there was no accompanying improvement in fiscal management during that time.³⁷ As Venezuela's pro-cyclical rate of government expenditure and enormous required structural adjustment indicate, President Chávez's government greatly spent beyond its means, particularly in 2006–2007.³⁸ Venezuela will likely have the greatest concerns with debt sustainability.

Argentina is another country with serious doubts about creditworthiness and access to foreign financing. Like Venezuela, Argentina since its 2001 default has been regarded with suspicion in EMBI risk spreads. Most troubling, it has the highest debt-to-GDP ratio of the LAC-7. And while Argentina's overall balance and expenditure over revenue figures are a bit less worrisome, both of these measures went in a troubling direction between 2006 and 2007, reflecting what Ocampo warned was a "recent upward trend in public spending" in Argentina.³⁹ As Bill Faries noted in late 2007, much of the increased public spending was financed by the

commodity price boom and was driven in anticipation of the 2007 elections. This trend calls the country's fiscal sustainability further into doubt.⁴⁰

Mexico is a complex case. Its 2007 EMBI spreads and debt-to-GDP ratios would suggest that its leaders could have afforded to be optimistic. Its modest overall balance and government expenditures indicate that while the government has not made great strides, neither has it incapacitated itself with spending. Yet its required structural adjustment is the second most severe. Why would this be the case? This is attributable to Mexico's economic integration with the United States, and its resulting greatest single market overdependence among the LAC-7; it sent 82 percent of its total exports to the US in 2007.⁴¹ At the onset of the crisis, the Mexican economy could likely expect a much more severe contraction (and subsequently a drop in government revenues and an increase in sovereign debt) than the more diversified countries of South America. Therefore, while some of the 2007 figures indicate room for optimism, in practice, the Mexican government may have had more reason to worry that low-risk foreign financing would be available as the downturn continued.

This leaves Colombia and Brazil remarkably close in each measurement. Colombia enjoys some negligible advantages in several categories, but Brazil's strength as an emerging power could make up for these small differences in securing external financing. Moreover, both countries had enacted fiscal responsibility laws meant to increase investor confidence.⁴² In short, to Brazil and Colombia fiscal sustainability may not be of immediate concern, but policymakers in both countries should be mindful of these constraints as they enact fiscal policy.

It is now possible to group the LAC-7 into three categories of sustainability. Peru and Chile should have been unconcerned with their creditworthiness at the onset of the crisis. Mexico, Brazil and Colombia all enjoy a mix of encouraging and limiting factors, and therefore their governments should have displayed some reasonable concerns with sustainability. Lastly, the Chávez and Kirchner governments of Venezuela and Argentina, respectively, likely felt

highly constrained by creditworthiness at the onset of the crisis. By giving in to pro-cyclical spending toward the end of the economic boom, both governments handicapped themselves when it comes to enacting policy at the onset of a crisis.

The next section will evaluate the other component of my hypothesis: each country's holdings of international reserves.

INTERNATIONAL RESERVES AND THE CURRENT ACCOUNT

International reserves increased in every LAC-7 country between 2003 and 2007.⁴³ These across-the-board increases, with Brazil showing particularly spectacular leaps after 2005, were heralded as positive steps for the countries in the region. But for the purposes of this paper, it is crucial to distinguish between international reserve accumulations under current account surpluses or deficits.⁴⁴

Estimating the effect of the current account on international reserve accumulation to differentiate between owned and borrowed reserves presents methodological challenges. This paper proposes a simple, if crude, estimation by using the strength of the current account surplus as a multiplier effect on reserves. For each country and year, I have multiplied the international reserves in dollars by the size of the current account balance as a percentage of GDP. This index attempts to estimate an adjusted size of international reserve holdings as moderated by the current account balance; the higher the current account surplus, the more likely that these reserve accumulations will reflect owned reserves rather than just increased foreign liabilities. Conversely, low current account surpluses or current account deficits would imply that international reserves merely reflect increased foreign liabilities that would exacerbate, rather than help, a developing country's financing situation during a sudden stop.⁴⁵ I have included this index in Table 2 (online). Larger values imply a combination of significant reserve pools and a strong current account surplus.

A closer examination of the numbers for each country may reveal the utility of the index. I will start with the countries with the two highest indices: Argentina and Venezuela. These countries enjoyed only the third- and fourth-largest pools of international reserves in 2007. Between 2003 and 2007, Argentina's international reserves increased by a factor of 3.4, and Argentina ran a steady current account surplus over that period. Venezuela's international reserves pool increased by a factor of 1.7, but its current account surplus averaged 13.6 percent of GDP. Of course, it must be noted that Venezuela's 8.8 percent drop in international reserves between 2006 and 2007 is indicative of a pro-cyclical utilization of these funds. This depletion in the reserves pool is the only factor calling the Venezuelan government's access to reserves into question. Yet Argentina and Venezuela had both unquestionably accumulated a substantial amount of these owned international reserves.

Conversely, while Brazil had by far the largest pool of international reserves in the region, this figure is much less impressive when adjusted for the size of Brazil's economy and considering Brazil's explosive capital account surplus toward the latter half of the boom years.⁴⁷ These flows of borrowed assets into Brazil explain the country's leap in international reserves between 2006 and 2007. So while Brazil's international reserve statistics appear impressive, there is great reason to believe that these funds would not have been readily available to finance countercyclical stimulus programs, and this lower availability is reflected in Brazil's lower index score for 2007.

Chile's accumulation of international reserves, on the other hand, looks moderate at best in dollar amounts; reserves only increased by a factor of 1.06 over the boom. Does this mean that Chile did not accumulate enough reserves to finance countercyclical policy? Two factors suggest otherwise. First, much like Argentina, Chile ran a steady current account surplus after 2003, suggesting that its international reserves holdings reflect owned, rather than borrowed assets. More importantly, the Chilean government had created two sovereign stabilization funds, together worth about \$21.9 billion (over 15 percent of GDP), designed to protect against

currency shocks and to fund fiscal deficits during crises.⁴⁸ All factors considered, Chile's access to reserves to fund countercyclical policy is second to Argentina.

Peru is another country for which international reserve levels are more promising considering the current account and government prudence. Peru's current account surpluses after 2003 suggest that reserves accumulation was set in motion by increases in commodity exports. And, like Chile, the Peruvian government in 2003 created a Fiscal Stabilization Fund comprising international reserves from capital inflows on exports.⁴⁹ This fund provided for steady reserve accumulation in Peru even in 2007, when its current account surplus decreased slightly. Peru therefore falls behind Argentina and Chile with respect to available international reserves.

Last, Colombia and Mexico are remarkably similar in terms of international reserves. Throughout the boom, both accumulated international reserves under a steady current account deficit (capital account surplus).⁵⁰ But both countries had also established sovereign stabilization funds to accumulate reserves from their oil exports. And while these sovereign funds were less substantial than those of Chile and Peru, they could nevertheless account for some fiscal flexibility at the onset of the crisis.⁵¹ In general, both Colombia and Mexico accumulated a fair amount of international reserves in sovereign funds, but under conditions that call into question their abilities to fund fiscal deficits during a sudden stop.⁵²

I group the countries into four categories based on the size and owned nature of their international reserves. Argentina, by virtue of its large-scale accumulations and the surplus in its current account, and Chile, from its comparable gains and sovereign stabilization funds, lead the pack. Peru saw less reserve accumulations and a relatively smaller current account surplus, but its sovereign stabilization fund contributes to its capacity to use international reserves for fiscal stimulus. I place it in the second-highest category. Venezuela joins Peru in this second category; its reserve accumulations under a large current account surplus are slightly counterbalanced by considerable depletion of the stockpile during 2006 and 2007. Next, in the third category, are Colombia and Mexico. While

their reserve accumulation was modest and took place during capital account surpluses, the fact that both countries have sovereign stabilization funds with predetermined criteria for use during economic downturns indicates that the governments have at least some immediately deployable reserves.

I place Brazil alone in the last category for two reasons. First, while Brazil's reserves pool is the largest in the LAC-7, this increase came only during an intense period of foreign capital loans at the end of 2006; these numbers are inflated by the sheer size of Brazil's economy and do not reflect truly owned reserves. Second, unlike Colombia and Mexico, the Brazilian government at the time of the crisis had not established sovereign stabilization funds in preparation for an economic downturn. I therefore judge Brazil to have the least immediate access to international reserves for deficit financing.

TWO-DIMENSIONAL EXPRESSION OF FISCAL SPACE

Large levels of international reserves will result in large fiscal stimulus programs, but only insofar as concerns with long-term fiscal sustainability do not limit governments' willingness to tap into these rainy day funds.⁵³ My hypothesis predicts that, as a country accumulates more owned foreign reserves and improves its fiscal sustainability, the size and extent of its countercyclical fiscal stimulus programs enacted in reaction to the 2008 crisis will increase. Based on the information I have gathered, then, I therefore predict that Chile will enact the largest fiscal stimulus program in the area, with Peru enacting the second largest.

Drawing out predictions for the remaining five countries is a bit more complex, insofar as doing so requires making assumptions about which requires making more restrictive assumption: a lower availability of international reserves or concerns about debt sustainability. As previously mentioned, I conceive international reserves according to their relative value. Concerns with debt sustainability will condition a given government's evaluation of the costs

and risks of using the rainy day funds in response to a crisis. While international reserves may be the financing source for countercyclical spending programs, debt sustainability is the condition that allows or restrains the use of those funds.

Consider Argentina, whose pool of international reserves is quite large. It is crucial to remember Argentina's traumatic experience with financial crises, its aversion to the IMF, and the multiple reasons to question its creditworthiness with respect to the future. This aversion to debt fundamentally alters the use value of these reserve pools by increasing the perceived risk in using these funds today rather than saving them for the future. The same holds true for Venezuela. Despite high levels of international reserves, I expect debt sustainability concerns to incentivize saving the funds rather than using them. Argentina and Venezuela, therefore, are expected to have the smallest degrees of countercyclical fiscal responses to the crisis.

While Brazil, Colombia, and Mexico each should have roughly similar expectations of debt sustainability, the latter two countries had established sovereign stabilization funds by the time of the crisis, whereas Brazil had not. These stabilization funds offer pre-established procedures for implementing countercyclical spending and could be expected to have a significant effect. I therefore expect Colombia and Mexico to have larger levels of fiscal stimulus than Brazil.

To review, my hypothesis predicts that the LAC-7 fiscal stimulus programs in response to the 2008 crisis should fall, from largest to smallest, as follows: Chile, Peru, Colombia and Mexico, Brazil, Argentina, and Venezuela.

RAINY DAYS AT HAND: FISCAL STIMULUS PROGRAMS IN THE REGION

Estimations of the size of stimulus packages throughout Latin America tend to vary widely.⁵⁴ For each country, I have used the most commonly accepted figures. Moreover, I attempt to measure

only programs enacted through 2009, thereby isolating the initial fiscal responses to the crisis without having the results altered by changing economic performance or a return of financing to the area.

In Figure 2, below, I present an overview of both the size and composition of countercyclical fiscal policies enacted through 2009 in the LAC-7. For the most part, these programs combined government spending or investment programs with tax cuts. Figure 2 shows that the order of the LAC-7's countercyclical fiscal programs from largest to smallest would be: Chile, Peru, Colombia, Argentina, Mexico, Brazil, and Venezuela.

Figure 2

Country	% GDP	Details of fiscal policies
Chile ⁵⁷	2.3%	Features income tax cuts; subsidy increases for low-income families; large-scale public investment in public works, infrastructure, and housing
Peru ⁵⁸	2.0%	Infrastructure investment projects and broad increases in public spending; stimulus support to workers and SMEs; social infrastructure spending
Colombia ⁵⁹	1.4%	Tax cuts on income tax, wealth tax, and stamp duty; infrastructure spending in public works (roads, housing and irrigation projects)
Argentina ⁶⁰	1.3%	Large-scale public works investment plan focusing on roads, hospitals, and housing projects; tax and pension fund moratorium on certain liabilities; tax reductions for the middle class

Mexico ⁶¹	1.2%	Modest tax cuts and increases in public spending allocations; public infrastructure investment; government support programs for SMEs; other public spending cuts made elsewhere; targeted tax increases
Brazil ⁶²	0.55%	Focus on tax cuts (for financial operations, processed products, for the middle class, etc.); investment projects that will rely on private sector have been delayed; public spending cuts in later 2009
Venezuela	– –	Generally no countercyclical stimulus of which to speak. Instead, tax increases (especially to VAT); broad public spending cuts in the government budget; wage ceilings for senior civil servants

In Venezuela, Chávez's government, notwithstanding the steady populist rhetoric, was compelled to resort to blatantly procyclical policies in response to the crisis. This did not surprise many observers, who for years had called attention to the fundamental macroeconomic issues of Chávez's regime.⁶¹ The severity of the concerns with long-term debt sustainability in light of Venezuela's poor creditworthiness, together with these macroeconomic problems, made countercyclical policy untenable. Venezuela anecdotally demonstrates that spending during upturns, even in the case of current account surpluses, will limit a government's ability to enact countercyclical fiscal policy during downturns.

At first glance, the fact that Argentina's stimulus programs amounted to 1.3 percent of GDP—the fourth largest in the LAC-7—seems to refute my hypothesis. But there is a missing piece of crucial information here: Argentina was indeed hesitant to tap into its “rainy day” funds. Its international reserve holdings actually slightly *increased* from 2007 to the end of 2009. Instead, to finance its stimulus programs, the Argentine government instituted a mas-

sive forced nationalization of private pension savings, the flow of which accounted for up to 1.5% of GDP.⁶² The implications of this policy move are twofold. First, the example of Argentina lends credence to the logic of my thesis insofar as creditworthiness concerns limited the government's willingness to tap freely into rainy day funds, deemed a risky solution. Second, and perhaps more importantly, the example of Argentina calls to the forefront an important point about political economy and causality. This paper attempts to relate macroeconomic characteristics with an ideal policy choice. Nevertheless, sovereign governments acting under constraint may choose from an infinitely larger set of heterodox policy options. This is a healthy limitation on assumptions of causality: international reserves may provide a vehicle for countercyclical policy, and fiscal sustainability may be an enabling condition, but the ultimate policy will depend on a complex decision-making process with a broader variety of possible outcomes than simple models suggest.

The small size of Brazil's fiscal stimulus packages may have stumped those who argued that international reserves were the determining factor of Latin America's macroeconomic progress. However, both the type of reserves and a country's concerns with sustainability can greatly alter the utility of reserves with regard to countercyclical policy. Moreover, a close comparison with Colombia and Mexico—which were similarly positioned to Brazil with respect to sustainability—can elucidate some interesting conclusions about reserve accumulation. Colombia, Mexico, and Brazil all accumulated their reserves under low-to-negative current account balances, but while Colombia and Mexico saved in established sovereign stabilization funds, Brazil lacked a similar program. This suggests that, all else being equal, sovereign wealth funds with stabilization as an institutionalized motivation, with automatic procedures resistant to political pressures, may enable policy action where the mere accumulation of general reserves does not. Beginning in 2009, the Brazilian government began accumulating surplus government revenue in the Sovereign Fund of Brazil (FSB), a multi-billion dollar fund designed explicitly for stabilization during future financial crises, implying that Brazil may have learned a

lesson from its energy-exporting neighbors.⁶³

Colombia and Mexico, as predicted by my hypothesis, both enacted countercyclical fiscal programs that were moderate in size. Likewise, in Chile and Peru, sovereign stabilization funds of international reserves were utilized to finance broad spending increases and tax cuts,⁶⁴ and as predicted, Chile's programs were slightly larger than those of Peru.⁶⁵ Thanks to both countries' fiscal surpluses and manageable debt-to-GDP ratios, policymakers were able to tap into these rainy day funds without fearing disproportionately worse credit crunches in the future.

Considered altogether, the region's fiscal policy responses to the crisis offer some preliminary support to my hypothesis that while the accumulation of international reserves is an important element of preparing for economic shocks, the utility of these reserves is conditioned by their composition and by the country's fiscal sustainability. Furthermore, sovereign wealth funds specifically designed for stabilization purposes during sudden stops and commodity price drops played a crucial role in the largest stimulus policies in the region. Of course, in several cases, the two variables go hand in hand; Peru and Chile created stabilization funds at the same time that they improved fiscal balances and lowered sovereign debt. The examples of Mexico and Colombia relative to Brazil, though, suggest that these funds may be related to the size of stimulus programs when fiscal sustainability is held more or less constant. Finally, as previously mentioned, macroeconomic variables may act as constraints on government policy, even if these constraints may be loose. Argentina's substantial fiscal stimulus program would not have been possible under the model described by my thesis, but the government's nationalization of pension funds provided increased revenue with which to finance further deficits.

From a general standpoint, while enthusiasm for Latin America's improved macroeconomics was not entirely unfounded, it often neglected critical differences within the region. Contrary to the common assertion, a nation's current account balance improvements may or may not have been significant, depending on a given government's ability to increase trade-related revenues and

control its expenditures. International reserves accumulation was an important step, but how these reserves were accumulated seems more salient. Despite the region's strides toward autonomy, certain countries remained highly constrained by poor creditworthiness and limited access to financing. Finally, while it is important not to confuse favorable external factors for improvements in fiscal management, it does appear to be the case that the steady accumulation of reserves and modest fiscal balance improvements can allow developing nations to better weather downturns.⁶⁶

CONCLUSIONS

In striving for descriptive richness, this paper has limited itself to the largest countries in a particular region. But the 2008 global financial crisis struck the developing world all at once, implying that there is a great opportunity for studies with broader sample sizes, more complex datasets, and multivariate analysis. While I am confident in the instrumental value of my measures, there is certainly room for improvement. In particular, future studies could arrive at more detailed analysis of owned compared to borrowed reserves. Nevertheless, as studies become broader, they should be accompanied by the type of close examination performed here to account for institutional or political phenomena outside the parameters of the model.

My findings suggest that some Latin American countries may have indeed earned the privilege of normality, in that they found themselves better positioned to handle the 2008 financial crisis. By limiting the procyclical political impulse to spend during booms and by saving for rainy days, Latin America has thus far generally avoided the type of large-scale economic collapse that tarnishes its history.⁶⁷ Indeed, after a precipitous drop in 2009, growth rates for the LAC-7 countries (excluding Venezuela) rose to an average of 6.7 percent for 2010.⁶⁸ Nevertheless, this macroeconomic improvement must be understood as both limited and contingent. As this paper has shown, only the combination of international reserves accumulation and improved sustainability will lead to

broadened fiscal space, barring one-time heterodox policies as seen in Argentina.

Above all other considerations, countries must be careful to learn the correct lesson from the 2008 crisis. It was not public spending in general, but rather countercyclical public spending—and, indeed, the improvement of external conditions—that enabled growth rates to revive across the region. As Cárdenas and Levy-Yeyati (2011) discuss, it takes far less political maneuvering to tap into rainy day funds than it does to later renew countercyclical saving as conditions improve. Everyone wants to use rainy day funds, but in good times these funds can be difficult to store away. As much as the 2003–2007 boom was an important test of macroeconomic restraint in the region, the upcoming years post-crisis will likely be even more important, as countries must look for ways to cool off spending programs and begin to replenish, or at least maintain, their stocks of reserves. Countries may have earned the privilege of normality with respect to 2008; but will they fight to maintain it?

Latin America has the potential to provide for stability in the face of the ups and downs of the business and commodity cycles, but only if its countries can consolidate the fiscal restraint displayed in spurts between 2003 and 2007. As Rojas-Suarez (2010) argues, public savings rates in Latin America are still much too low, and governments in the region must find a way to sell renewed countercyclical restraint to their populations in anticipation of the next global downturn. Doing so will be difficult. Programs implemented in the wake of crises are often broadly popular, and rolling these back is a tricky task for any politician seeking reelection, or indeed any party seeking public support.⁶⁹ But even given this healthy dose of skepticism, it is difficult to deny that Latin America has significant prospects for growth and stability in the foreseeable future. The 2008 crisis, for Latin America, was a far cry from the utter economic meltdowns witnessed at the turn of the century. It is clear that the region has progressed quite far in a relatively short period of time. As fiscal space, trade diversification, and targeted sovereign stabilization funds grow throughout the region, Latin

America may be on the path toward normality.

To view all charts and tables, visit:
<http://www.helvidius.org/2012/getz>

Endnotes

1 As Guillermo A. Calvo and Ernesto Talvi once wrote, “Latin America does not grow. It occasionally hits an ice patch where output speeds up, only to fall on its face when the ice patch ends.” Calvo and Talvi, “Sudden Stop, Financial Factors and Economic Collapse in Latin America: Learning from Argentina and Chile,” Working Paper No. 11153 (Cambridge, MA: National Bureau of Economic Research, February 2005): 2 See also, e.g., Inter-American Development Bank (IDB), *All That Glitters May Not Be Gold: Assessing Latin America’s Recent Macroeconomic Performance* (Research Department of the IDB, April 2008; Idem., *Social and Labor Market Policies for Tumultuous Times: Confronting the Global Crisis in Latin America and the Caribbean* (IDB, March 2009).

2 Between 1998 and 2002, Latin America averaged annual growth rates of just 0.7%, compared to 4.3% between 1990 and 1990. Alejandro Izquierdo, Romero Randall, and Ernesto Talvi, *Booms and Busts in Latin America: The Role of External Factors* (Washington, D.C.: Inter-American Development Bank, February 2008): 5–6.

3 See, e.g., Enrique Alberola and Manuel Montero, “Debt Sustainability and Procyclical Fiscal Policies in Latin America,” Documentos de Trabajo No. 0611 (Madrid, Spain: Banco de España, 2006); Michael Gavin and Roberto Perotti, “Fiscal Policy in Latin America,” in *NBER Macroeconomics Annual 1997*, Vol. 12, edited by Ben S. Bernanke and Julio Rotemberg, 11–72 (MIT Press, January 1997).

4 Across the region, annual growth rates jumped to 6% between 2003 and 2007. IDB, *All That Glitters May Not Be Gold*, 3. See also Stephany Griffith-Jones and José Antonio Ocampo, “The Financial Crisis and its Impact on Developing Countries,” Working Paper No. 53 (Brasilia, Brazil: International Policy Centre for Inclusive Growth, April 2009); José Antonio Ocampo, “Latin America and the Global Financial Crisis,” *Cambridge Journal of Economics* Vol. 33 (2009): 707.

5 See, e.g., Mauricio Cárdenas and Eduardo Levy-Yeyati, “Latin America Economic Perspectives: Shifting Gears in an Age of Heightened Expectations,” Latin America Initiative, The Brookings Institution, April 2011; IDB, *All That Glitters May Not Be Gold*; Eduardo Fernández-Arias and Peter Montiel, *Crisis Response in Latin America: Is the Rainy Day at Hand?* (Washington, D.C.: Inter-American Development Bank, June 2009).

6 The widespread nature of this conclusion was matched only by the general confusion as to what exactly constituted this supposed increased fiscal and monetary capacity. Among the various explanatory factors considered were the current and capital accounts, international reserves, primary balances, tax structures, stabilization funds, financing constraints, and commodity dependence. Furthermore, this issue of generality was exacerbated by a too-frequent tendency to treat the region as a whole, thereby foregoing valuable country-level comparisons. See, e.g., Yilmaz Akyüz, “The Management of Capital Flows and Financial Vulnerability in Asia,” in *Time for a Visible Hand: Lessons from the 2008 World Financial Crisis*, edited by Stephany Griffith-Jones, José Antonio Ocampo, and Joseph E. Stiglitz (New York: Oxford University Press, 2010): 219–241; Ivanna Vladkova-Hollar and Jeromin Zettelmeyer, “Fiscal Positions in Latin America: Have They Really Improved?” Working Paper No. WP/08/137 (International Monetary Fund, May 2008); Cárdenas and Levy-Yeyati, “Latin America Economic Perspectives”; Juan Pablo Jiménez and Varinia Tromben, “Fiscal Policy and

the Commodities Boom: The Impact of Higher Prices for Non-Renewables in Latin America and the Caribbean,” *CEPAL Review* 90 (December 2006): 59–84; Ocampo, “Latin America and the Global Financial Crisis”; Christian Daude, Ángel Melguizo, and Alejandro Neut, “Fiscal Policy in Latin America: Countercyclical and Sustainable?” *Economics: The Open-Access, Open-Assessment E-Journal* vol. 5, no. 2011-14 (September 28, 2011); Cesar Calderón and Pablo Fajnzylber, “How Much Room Does Latin America and the Caribbean Have for Implementing Counter-Cyclical Fiscal Policies?” Latin America & Caribbean Regional Crisis Brief, World Bank, April 29, 2009.

7 Ocampo, “Latin America and the Global Financial Crisis,” 706–7; Economic Commission for Latin America and the Caribbean (ECLAC), *Economic Survey of Latin America and the Caribbean, 2009-2010* (Chile: United Nations, 2010): 21.

8 José Juan Ruiz, “Latinoamérica 2009: el privilegio de ser como todos,” *Política Exterior* 128 (March/April 2009): 55–74.

9 While the largest fiscal stimulus programs would be seen in developed countries, these policies were thought to be equally useful for developing nations. See Alberola and Montero, “Debt Sustainability”; Charles Freedman, Michael Kumhof, Douglas Laxton, and Jaewoo Lee, “The Case for Global Fiscal Stimulus,” Staff Position Note No. SPN/09/03 (International Monetary Fund, March 6, 2009): 9; International Monetary Fund (IMF), “Update on Fiscal Stimulus and Financial Sector Measures,” (IMF, April 26, 2009); “The Limits to Fiscal Stimulus in Latin America and the Caribbean,” (The Brookings Institution, March 20, 2009).

10 Y.V. Reddy, “Regulation of the Financial Sector in Developing Countries: Lessons from the 2008 Financial Crisis,” in *Time for a Visible Hand: Lessons from the 2008 World Financial Crisis*, edited by Stephany Griffith-Jones, José Antonio Ocampo, and Joseph E. Stiglitz (New York: Oxford University Press, 2010): 242–252.

11 For an empirical analysis of the dynamics of retrospective voting based on economic performance, see Victoria M. Murillo, Virginia Oliveros, and Milan Viashnav, “Electoral Revolution or Democratic Alternation?” *Latin American Research Review* vol. 45, no. 3 (2010): 87–114.

12 Cardim de Carvalho, “The Accumulation of International Reserves as a Defense Strategy,” in *Time for a Visible Hand: Lessons from the 2008 World Financial Crisis*, edited by Stephany Griffith-Jones, José Antonio Ocampo, and Joseph E. Stiglitz (New York: Oxford University Press, 2010): 275.

13 José Antonio Ocampo, “The End of the Latin American Boom,” paper presented to the James A. Baker III Institute from Public Policy, November 18, 2008; Stephany Griffith-Jones and José Antonio Ocampo, “Sovereign Wealth Funds: A Developing Country Perspective” (Initiative for Policy Dialogue, Columbia University, February 18, 2008).

14 Cardim de Carvalho, “Accumulation of International Reserves.”

15 These reserves could also be used in activist monetary policy to intervene in currency markets. See Eduardo Fernández-Arias and Peter Montiel, “The Great Recession, ‘Rainy Day’ Funds, and Countercyclical Fiscal Policy in Latin America,” *Contemporary Economic Policy* vol. 29, no. 3 (July 2011): 306–8.

16 See, e.g. Cardim de Carvalho, “Accumulation of International Reserves”; Jiménez and Tromben, “Fiscal Policy”; Griffith-Jones and Ocampo, “Sovereign Wealth Funds.”

17 Fernández-Arias and Montiel, *Crisis Response*, 30.

18 The current account balance is the net trade balance, plus net earnings from rents, profits and dividends, excluding long-term borrowing or investment.

19 Griffith-Jones and Ocampo, *Sovereign Wealth Funds*, 16.

20 Alberola and Montero, “Debt Sustainability.”

21 See, e.g., Alberola and Montero, “Debt Sustainability”; Calvo and Talvi, “Sudden Stop.”

- 22 See, e.g., Izquierdo et al., *Booms and Busts*; Jiménez and Tromben, "Fiscal Policy."
- 23 Bernadin Akitoby, Benedict J. Clements, Sanjeev Guptan, and Gabriela Inchauste, "The Cyclical and Long-Term Behavior of Government Expenditures in Developing Countries," Working paper, International Monetary Fund, October 2004.
- 24 Ernesto Talvi and Carlos A. Végh, "Tax Base Variability and Procyclical Fiscal Policy in Developing Countries," *Journal of Development Economics* 78, no. 1 (October 2005): 156–190.
- 25 For clarity, I will use the term "owned" reserves to refer only to those reserves representing foreign exchange assets immediately available for use to finance stimulus programs, rather than long-term liabilities in the form of foreign loans ("borrowed" reserves). As mentioned, a country with a surplus in the capital account (producing a good amount of borrowed reserves) may face *additional* credit constraints at the time of a sudden stop.
- 26 IDB, *All That Glitters May Not Be Gold*, 2.
- 27 Vito Polito and Mike Wickens, "Measuring Fiscal Sustainability." Discussion Paper No. 5312 (London: Centre for Economic Policy Research, October 2005).
- 28 The higher the EMBI spreads, the higher that given country's default risk is judged to be. See Fernández-Arias and Montiel, *Crisis Response*, 28. See also Roberto Frenkel and Martin Rapetti, "Economic Development and the International Financial System," in *Time for a Visible Hand: Lessons from the 2008 World Financial Crisis*, edited by Stephany Griffith-Jones, José Antonio Ocampo, and Joseph E. Stiglitz (New York: Oxford University Press, 2010): 253–268.
- 29 See, e.g., Cárdenas and Guerreiro, "The Limits to Fiscal Stimulus"; Veena Jha, "The Effects of Fiscal Stimulus Packages on Employment," Working Paper No. 34 (International Labour Organization, 2009); Fernández-Arias and Montiel, *Crisis Response*.
- 30 Fernández-Arias and Montiel, *Crisis Response*, 27. Essentially, this measure attempts to quantify the following: If terms of trade drop off, how drastically would countries have to cut back just to maintain the same level of sovereign debt? To calculate this required adjustment, the authors use the standard HP Filter and another which mimics the Chilean fiscal rule, the latter of which is more suitable for countries "with sizable commodity-linked revenues." *Ibid.*, 26.
- 31 For a similar utilization of expenditures as compared to revenues to measure the pro- or counter-cyclicality of fiscal policy, see Graciela L. Kaminsky, Carmen M. Reinhart, and Carlos A. Végh, "When It Rains, It Pours: Procyclical Capital Flows and Macroeconomic Policies," in *NBER Macroeconomics Annual 2004*, Vol. 19, edited by Mark Gertler and Kenneth Rogoff (MIT Press, April 2005): <http://www.nber.org/chapters/c6668.pdf>, 11–82.
- 32 Note that while I have provided merely the data for 2007—recognizing that the majority of year-end 2008 data is at least partially affected by the downturn and subsequent policy reactions.
- 33 See, e.g., Cárdenas and Levy-Yeyati, "Latin America Economic Perspectives."
- 34 Ian Lienert, "Should Advanced Countries Adopt a Fiscal Responsibility Law?" Working Paper No. WP/10/254 (Fiscal Affairs Department, IMF, November 2010): 14.
- 35 José Antonio Ocampo, "The Macroeconomics of the Latin American Economic Boom," *CEPAL Review* 93 (December 2007): 23–4.
- 36 See Cárdenas and Levy-Yeyati, "Latin America Economic Perspectives."
- 37 Jiménez and Tromben, "Fiscal Policy," 62; World Bank, World Development Indicators Data Tool: <http://data.worldbank.org/data-catalog/world-development-indicators>.
- 38 The classic example of this spending frenzy during that period was the gasoline subsidy, which cost the nation an estimated \$9 billion per year. See Simon Romero, "Venezuela's Gas Prices Remain Low, but the Political Costs May Be Rising" *The New York Times*, October 30, 2007.
- 39 Ocampo, "Macroeconomics," 26.

40 Bill Faries, “Argentina’s Fernández Set for Election Win, Inflation,” *Bloomberg*, October 25, 2007.

41 Liliana Rojas-Suarez, “The International Financial Crisis: Eight Lessons for and from Latin America,” Working Paper No. 202 (Washington, D.C.: Center for Global Development, January 2010): 6.

42 Singh, Anoop, “Macroeconomic Volatility: The Policy Lessons from Latin America,” Working Paper No. WP/06/166 (International Monetary Fund, July 2006).

43 See Tables 5 and 6 online at Helvidius.org/2012/getz.

44 See Table 7 online at Helvidius.org/2012/getz.

45 See Cardim de Carvalho, “Accumulation of International Reserves”; Griffith-Jones and Ocampo, “Sovereign Wealth Funds.”

47 *Ibid.* Brazil’s capital account surpluses of \$16 billion in 2006 and \$89 billion in 2007 were the most drastic in the region and reflected a rapid inflow of external loans.

48 Ocampo, “The End of the Latin American Boom,” 9. The Economic and Social Stabilization Fund in particular was designed to be financed by the temporary copper price boom. See Jiménez and Tromben, “Fiscal Policy,” 78.

49 *Ibid.*, 77.

50 It must be added, though, that their scores on my adjusted reserve index are somewhat exceedingly negative due to the manner in which it is calculated.

51 It must be added, though, that their scores on my adjusted reserve index are somewhat exceedingly negative due to the manner in which it is calculated.

52 One must also remember that, in addition to financing fiscal stimulus packages, international reserves are also important to countries looking to engage in currency interventions to adjust the rate of inflation.

53 One way to express this hypothesis visually would be to arrange both variables along separate axes and to populate the field with countries based on my previous analysis. See Figure 1 online at helvidius.org/2012/getz.

54 Particularly with relation to tax cuts—which are often counterbalanced by cuts in spending or tax increases elsewhere—it can be difficult to estimate the size of the programs.

61 Cárdenas and Levy-Yeyati, “Latin America Economic Perspectives.”

62 See ECLAC, *Reactions of the Governments*; Cárdenas and Guerreiro, “The Limits to Fiscal Stimulus.”

63 “Sovereign Fund of Brazil,” *Sovereign Wealth Fund Institute*, <http://www.swfinstitute.org/fund/brazil.php>. The creation of this fund coincided with the discovery of significant deep-water crude oil reserves off the coast of Rio de Janeiro. See Adriana Arai, “Brazil Will Use Pre-Salt Oil to Eradicate Poverty, Lula Says,” *Bloomberg*, September 7, 2008.

64 ECLAC, *Reactions of the Governments*.

65 This initial disparity may have disappeared over time. Through early 2011, Chile and Peru had instituted a roughly comparable level of fiscal stimulus of about 3% of GDP. Luis Carranza, Christian Daude and Ángel Melguizo, “Public Infrastructure Investment and Fiscal Sustainability in Latin America: Incompatible Goals?” Working Paper No. 301 (Development Centre, Organisation for Economic Co-operation and Development, June 2011).

66 See, e.g. Izquierdo et al., *Booms and Busts*.

67 Furthermore, unlike in past crises, Latin America largely avoided the initial source of economic contagion: financial channels. The reduction in trade volumes and commodity prices was severe, but it would have been far worse to see Latin American banks holding securitized sub-prime mortgages at the start of 2008.

68 World Bank, World Development Indicators Data Tool. With Venezuela’s economic decline of 1.91% included, the LAC-7 average is 5.5%.

69 Throughout Latin America, there have been an increasingly broad array of demonstrations and public mobilizations aimed at increasing or at least maintaining the levels

of social spending and government investment. This is both a positive sign and a challenge for the region. Again, it is worth noting that sovereign stabilization funds with an automatic component may provide governments with a valuable “out”: they can justify their countercyclical restraint as something out of their control and use their remaining revenues as they see fit.