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volatility, social cohesion and the political economics of the reforms

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**CRISIS, VOLATILITY, ECONOMIC CYCLES AND FISCAL POLICY
IN LATIN AMERICA**

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Crisis, volatility, economic cycles and fiscal policy in Latin America

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I. Introduction¹

This paper analyses the relation between macroeconomic fluctuations and fiscal policy in Latin America, in order to identify structural and behavioural factors relevant to formulating fiscal stabilization policies (countercyclical and macroeconomic adjustment policies). Empirically, the study draws on experience in the region during the second period of globalization, which began in the late 1970s. Analytically, the main point of reference is the literature on countercyclical fiscal policy and macroeconomic volatility in Latin America.² Although the present focus goes beyond specific situations and circumstances, it is important, in the context of the current international crisis, to devote particular attention to evaluating the new demands and constraints that are likely to affect fiscal policy as a consequence of the macroeconomic imbalances associated with the crisis.

The negative forces associated with the financial crisis that originated in the developed world are being transmitted through all of the channels that connect Latin America with the global economy: capital flows, foreign direct investment (FDI) and remittances. At the same time, the price and volume of exports are declining, risk premiums are rising, access to capital markets is either nonexistent or limited, and flows of FDI and remittances are decreasing. As is inevitable in such circumstances, the simultaneous effect of these factors, as they move through the various channels, creates substantial macroeconomic imbalances. Recessive forces are aggravated, since the decline in exports directly depresses aggregate demand, while financial constraints and the decline in FDI have indirect effects, inasmuch as they affect investment demand and the demand for durable consumer goods, while limiting government's capacity to adopt countercyclical measures. Although remittances vary in importance from one country to another, they represent, for some countries, a substantial portion of disposable income, and thus a reduction in their flow can cause a drop in domestic demand and weakness in the current account balance.

Initially there was speculation that the region might be able to remain detached from the turbulent events affecting the United States and Europe. Today, however, no one doubts that the governments of the region will face serious macroeconomic challenges. This applies to both overall fiscal policy and stabilization policy. Although, at the start, the central banks made strenuous efforts to inject liquidity into the financial systems to try to ensure the normal functioning of local credit markets, the nature of the crisis, the sharp drop in confidence, as well as significant differences in the degree of monetization and in the depth of individual financial markets, have made it necessary to adopt other types of measures. While liquidity must be ensured and interest rates kept as low as possible, liquidity itself does not necessarily guarantee greater access to credit, nor does a greater

¹ The authors are grateful to Ramiro Albrieu for his assistance and to Rafael López Monti and Leandro Cabello for their comments.

² On volatility in the region, see *Economic Survey of Latin America and the Caribbean, 2007-2008* and the accompanying annotated bibliography. On countercyclical fiscal policy, see Bello and Jiménez (2008) and Perry and others (2008).

supply of credit guarantee increased demand for goods. Although monetary, and even exchange rate, policy must be part of an orderly and coherent set of measures, fiscal policy is the strongest tool in cases such as the present one. In crafting solutions, authorities will likely confront additional pressures due to tensions between the different policy-making segments of government, as well as between government and specific social and productive sectors—all of which will impede efforts to stabilize the economy through the implementation of coordinated and efficient countercyclical fiscal policies and budget adjustments. In the fiscal realm, the most critical tensions are likely to involve (i) ensuring the sustainability of public debt vs. mitigating the social and financial effects of the global crisis; (ii) protecting the liquidity of the settlements system through monetary or fiscal supports vs. maintaining international reserves and controlling inflation; (iii) fostering macroeconomic stability vs. providing subsidies to specific sectors in order to prevent sectoral and social conflicts with major political consequences; and (iv) subsidising sectors with high exposure to the international crisis vs. resorting to protectionism.

Not surprisingly, intense efforts are underway throughout Latin America to identify effective measures to buffer the region's economies from the macroeconomic effects of the crisis. If these are successful, imbalances will be minimized and potential conflicts will be averted. Given these concerns, it seems useful to consider past experiences in the region with regard to countercyclical fiscal policy and crisis management. A deeper understanding of the relation between volatility and fiscal policy may provide useful guidance in designing policies that take optimal advantage of what, at least for some time, may be a rather limited policy space.

The remainder of the opening section of this paper will briefly examine the available evidence regarding the effects of the crisis, so as to assess the present turbulence and determine the types of demands and challenges that may be expected to arise in the wake of countercyclical fiscal and macroeconomic adjustment policy. The operative notion, here, is that the perturbations created by the international crisis are primarily taking the form of exogenous trade shocks and sudden stops in capital flows.³ In addition, it is argued here, the form and intensity of the perturbations in each of the region's economies depend on structural factors such as the size of the economy, the volume of the flows, and the particular areas of trade specific to the country. Section II adopts a more analytical approach, presenting a number of stylized facts regarding volatility in Latin America, in an attempt to understand their substantive implications for fiscal stabilization policy in Latin America. A central argument proposed here is that the usual assertion—that one function of fiscal policy, in addition to its role in allocation and distribution, is to stabilize the economic cycle—obscures the ambiguities in how one interprets “stabilize”, a word whose meaning can vary greatly depending on whether the situation being described is normal or exceptional. In the former case, as we shall see, “stabilization” involves implementing countercyclical policy, while in the latter case it refers to adjustment. Here, it is argued, this ambiguity has led to failures in both designing and coordinating policy. We therefore propose the notion of “policy space” as a means of avoiding these traps, and opt for a more precise definition of the stabilising function of fiscal policy (section III). Section IV examines the anatomy of two different types of exogenous international shocks: trade shocks, and sudden stops of capital inflows, in an attempt to analyze how these two types of shocks interact with the

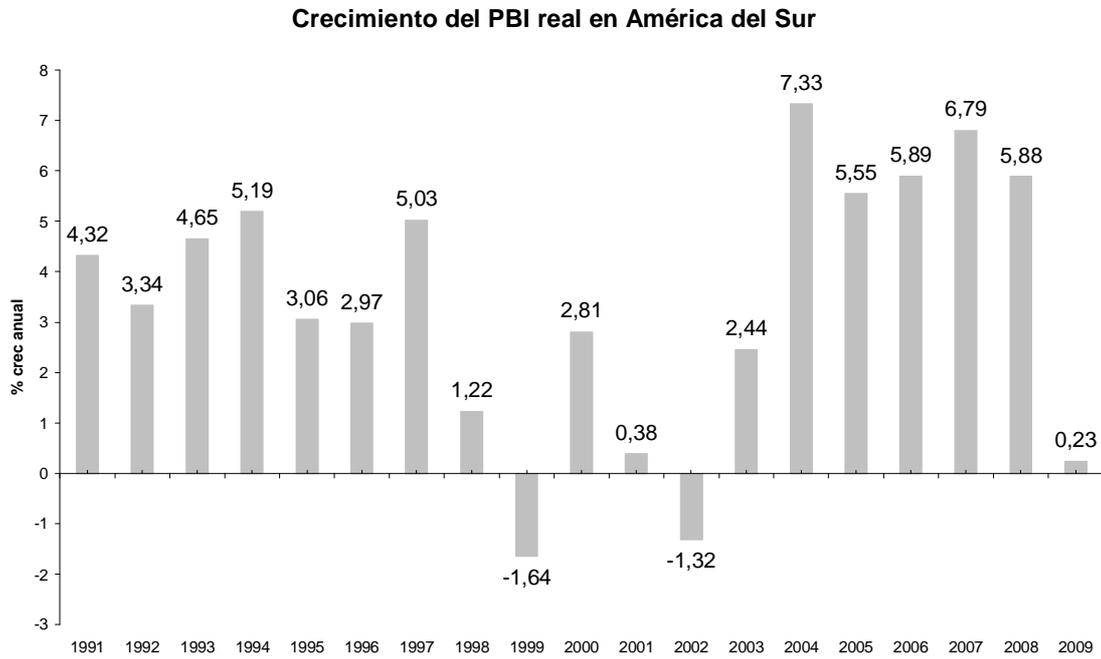
³ On sudden stops and their effects on macroeconomic dynamics, see Calvo and others (2006).

countercyclical fiscal policy space. The two types of shocks were selected because of their importance during the second globalization period, and because the available evidence indicates, as has been mentioned, that the effects of the current crisis are similar in nature to those that accompany such shocks. This paper, in line with its overall objective, focuses on the challenges confronting countercyclical fiscal policy, as well as on the problems of coordinating the types of policy typically employed in Latin America to deal with the macroeconomic consequences of shocks. The final section of the paper discusses the specific elements of fiscal stabilization policy that should be included in attempting to curb volatility in the region and, in the context of the current crisis, delineates the factors that constrain, and place demands upon, fiscal policy with regard to its stabilization function.

A. Transmission of the crisis to Latin America, and the associated fiscal policy challenges

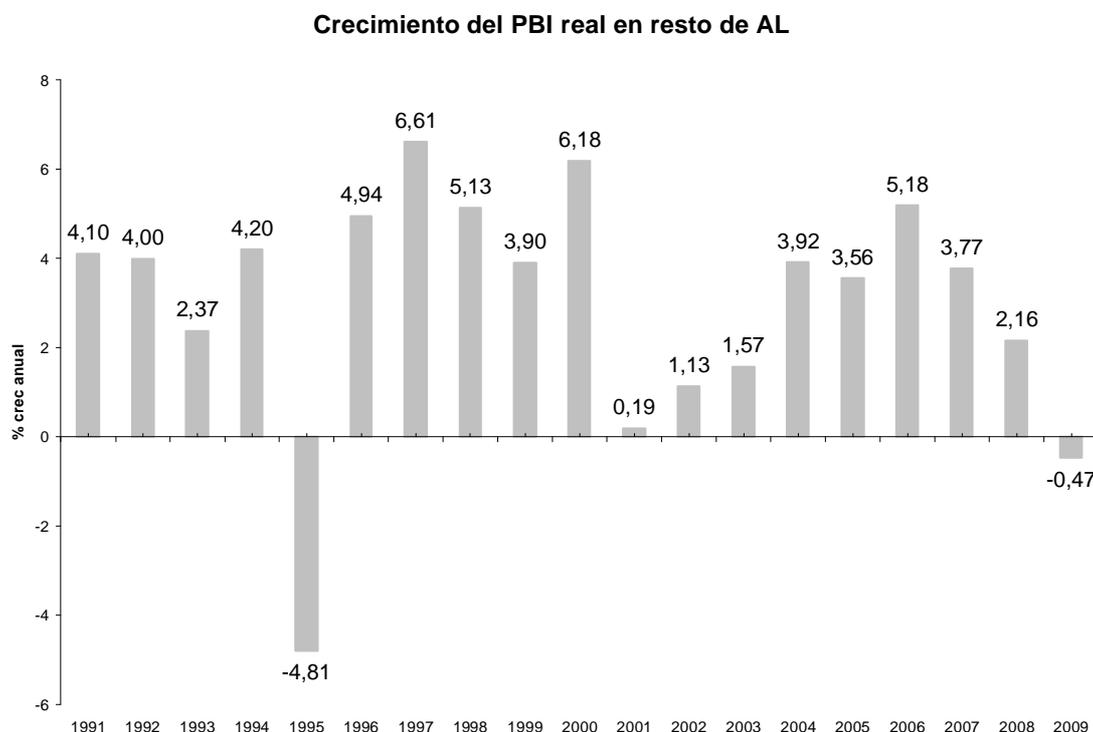
In the five years preceding the current crisis, growth rates in Latin America—as well as in the global economy—were good. Increased growth was particularly strong in countries that export natural resources, as their positions were enhanced by major improvements in the terms of trade. Economies that depended on energy imports, on the other hand, felt the effects of rising oil prices, although for many countries the problem was balanced by increased remittances resulting from the high level of economic activity in the United States. As figures 1.a and 1.b show, the growth rate in South America (which is a major exporter of natural resources) was greater than in other countries of the region. In the five-year period from 2004 to 2008, the region's median annual growth rate was 5.7%. This contrasts significantly with the preceding five years (1999-2003), when there were episodes of financial crisis in emerging countries and the median rate barely exceeded 1%. The current crisis put an end to this positive scenario, and projections for this year are for negative growth.

Figure 1 a
SOUTH AMERICA: REAL GDP GROWTH
(In percentages)



Source: Prepared by the authors, on the basis of figures provided by the Economic Commission for Latin America and the Caribbean (ECLAC).

Figure 1 b
REST OF LATIN AMERICA: REAL GDP GROWTH
(In percentages)

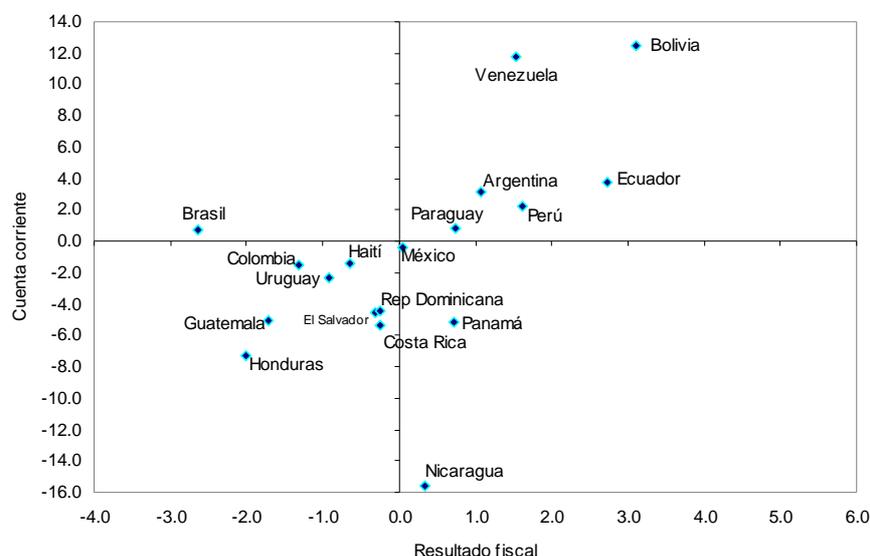


Source: Prepared by the authors, on the basis of figures provided by the Economic Commission for Latin America and the Caribbean (ECLAC).

The financial channel has clearly played a central role in transmitting the crisis to the region, as reflected in the quantity of capital inflows, as well as in risk premiums. The margin between the risk-free rate and the average rates for the region has increased noticeably (approximately 500 basis points, as measured by the EMBI) between the trough of early 2007 and the first quarter of 2009. Nevertheless, the current level remains far below the peaks reached during the Russian and Argentine crises (1,100 basis points and 1,400 basis points, respectively).

This more moderate risk-premium response is consistent with the fact that Latin America's macroeconomic fundamentals are solidier than they have been at other times of international turbulence. In early 2008, a number of the region's largest countries—Argentina, Chile, Ecuador, the Plurinational State of Bolivia, Paraguay, Peru and the Bolivarian Republic of Venezuela, among others—had twin central-government and current-account fiscal surpluses (see figure 2).

Figure 2
LATIN AMERICA (19 COUNTRIES): CURRENT ACCOUNT BALANCE AND FISCAL BALANCE, 2006-2007
(In percentages of GDP)



Source: Prepared by the authors, on the basis of figures provided by the Economic Commission for Latin America and the Caribbean (ECLAC).

Note: The data refer to the central government except in the cases of Argentina, Brazil, Colombia, Ecuador, the Plurinational State of Bolivia and Mexico, where they refer to the non-financial public sector.

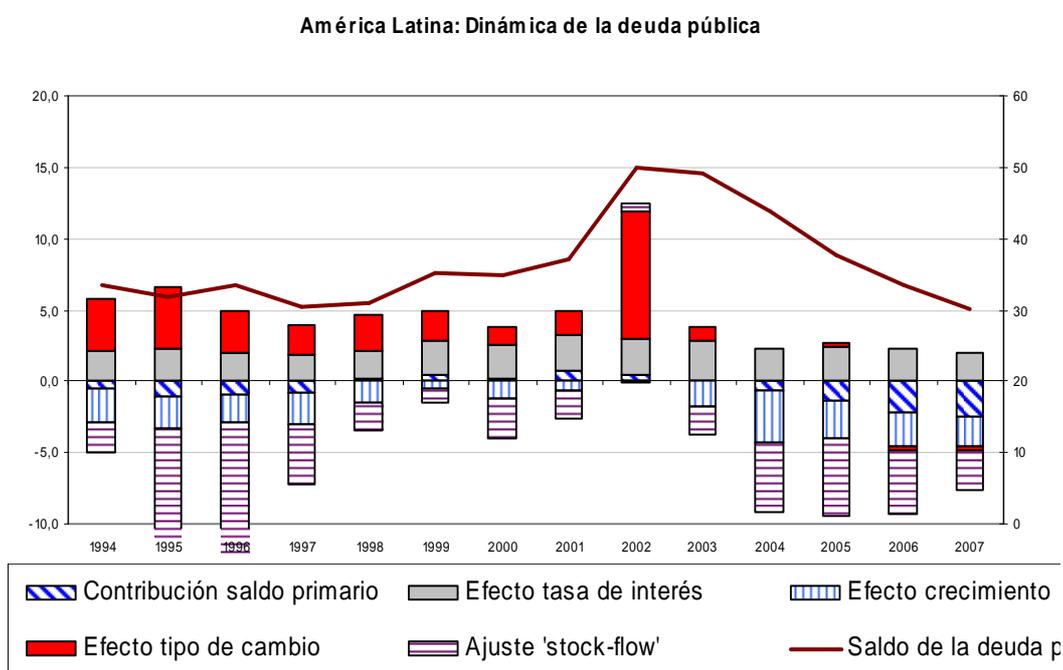
In this context, it is not surprising that the importance of the public debt as a risk factor also declined. The factors that most convincingly account for these variations are the sharp fluctuations in the macro variables (changes in the exchange rate and high volatility in the level of economic activity), the presence of debt restructuring initiatives, and the recognition of contingent liabilities (see figure 3).⁴

⁴ Figure 3 shows a debt-financing exercise. In this case, the variation in public indebtedness has five components. The first term on the right side of the equation represents the contribution of the primary fiscal balance; the second represents the effect of the interest rate; the third represents the contribution of economic growth; the fourth represents the effect of the exchange rate on that portion of the debt denominated in foreign currency; and the final term is a residual amount (stock flow).

$$d_t - d_{t-1} = -rp_t + d_{t-1} \cdot \frac{i_t}{1+n_t} - d_{t-1} \cdot \frac{n_t}{1+n_t} + d_{t-1}^{\$} \cdot (s_t - s_{t-1}) + sf_t$$

For further details on the variation of the debt, and the calculation method used, see Aliaga, Jiménez and Tromben (2009).

Figure 3
LATIN AMERICA AND THE CARIBBEAN: VARIATION IN NON-FINANCIAL PUBLIC SECTOR DEBT
(In percentages of GDP)



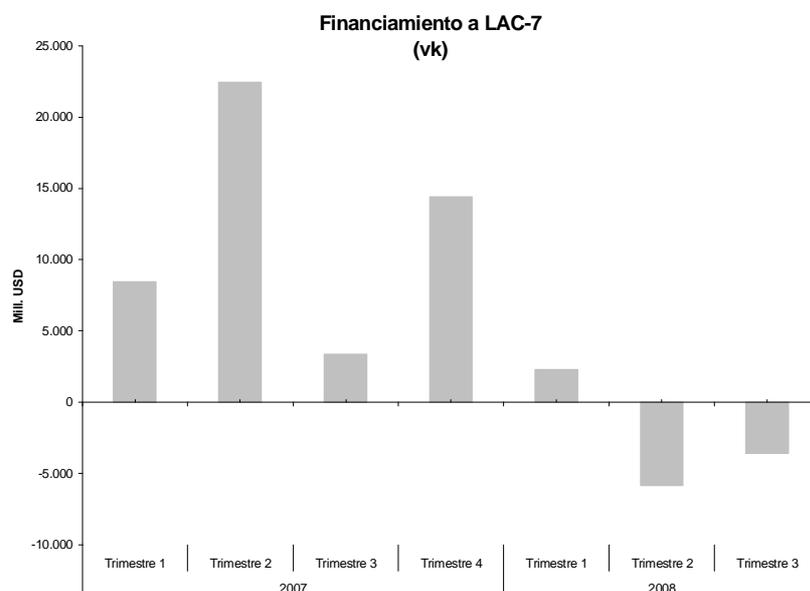
Source: Prepared by the authors, on the basis of figures provided by the Economic Commission for Latin America and the Caribbean (ECLAC).

Although the generation of fiscal and current account surpluses was not always the result of fiscal and monetary policy decisions, there is no doubt that sudden stop episodes between 1998 and 2002 were followed by a tendency to accumulate international reserves as insurance against these types of shocks.

Figure 4, showing net capital flows for Latin America's seven largest economies, indicates that the change in net flows occurred before the growth rate dropped.⁵ This suggests that financial constraints have played a leading role in the economic slowdown. With the increased uncertainty created by the crisis, investors' emphasis shifted toward high-quality assets, to the detriment of riskier ones, including real estate. Thus, the fact that the change in flows coincides with key events in the banking crisis in the United States and Europe, and that the change occurred in a context not only of high growth but also of greater macroeconomic stability in the region, suggests that the event is exogenous to Latin America and has the characteristics typical of a contagion-induced sudden stop. The major way in which the contagion was transmitted was through a flight to quality, and through a very sudden increase in illiquidity in developed markets, which led investors to liquidate positions in emerging countries.

⁵ Net capital income is defined as gross capital income minus interest payments.

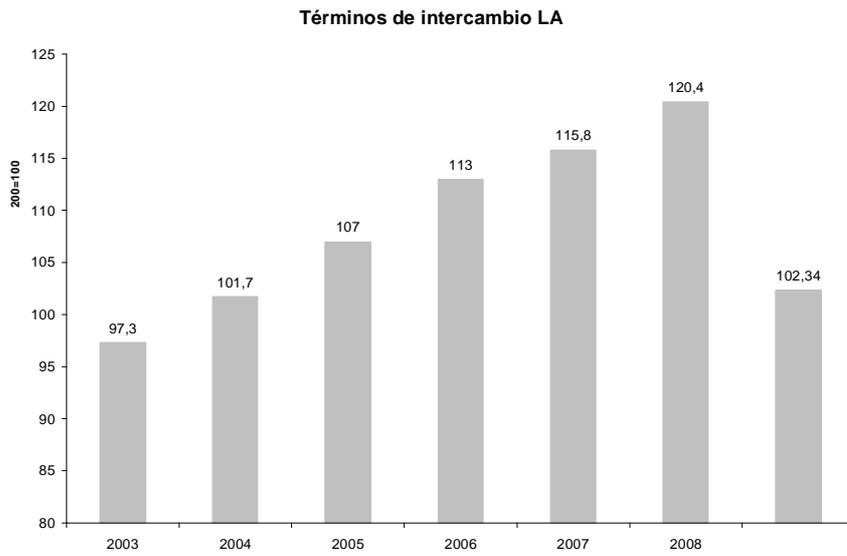
Figure 4
LATIN AMERICA (7 COUNTRIES): NET CAPITAL FLOWS
(In millions of dollars)



Source: Prepared by the authors, on the basis of figures provided by the Economic Commission for Latin America and the Caribbean (ECLAC).

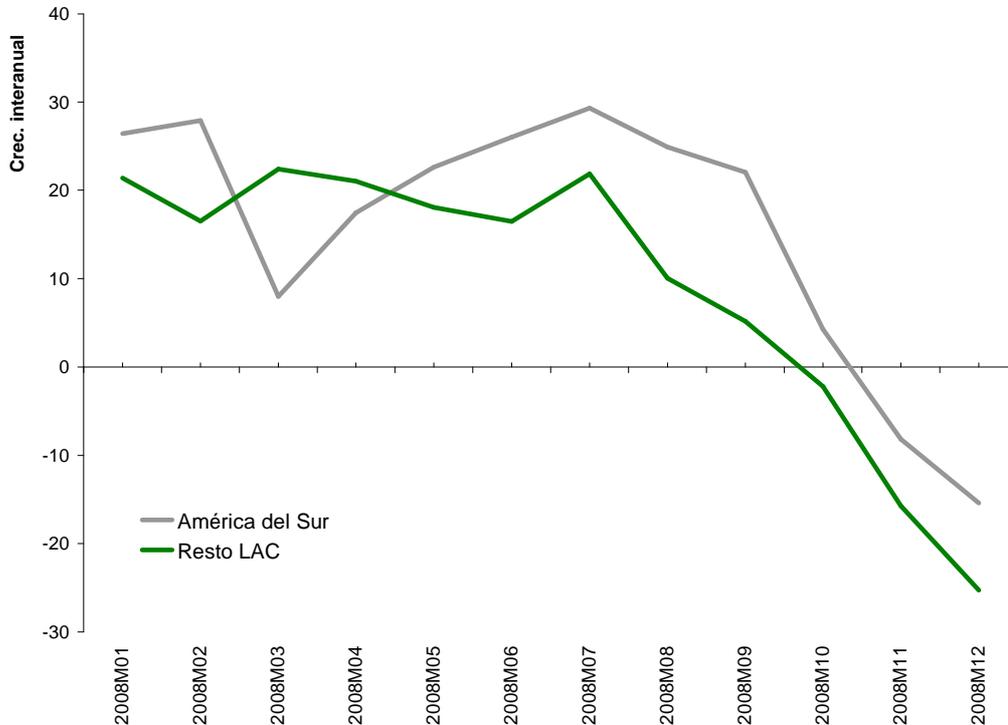
Trade has also been a very active channel, with the negative trade shock being reflected in both price and volume. figures 5.a and 5.b show the recent changes in export volumes and terms of trade. The shock seems to have been somewhat stronger for the region's small countries than for the large ones, and the exports of the seven largest countries declined less than those of the other countries. The terms of trade plummeted from their peaks of 2007 and 2008, and are now at the same level as at the beginning of the above-referenced five-year period—a level that, in any case, could be considered relatively satisfactory. Indeed, some products seem to have found a floor, possibly due to the increased structural presence of China and India in the international market (cf. Lederman and others, 2006).

Figure 5.a
LATIN AMERICA (7 COUNTRIES): TERMS OF TRADE



Source: Prepared by the authors, on the basis of figures provided by the Economic Commission for Latin America and the Caribbean (ECLAC).

Figure 5.b
RECENT CHANGES IN EXPORTS



Source: Prepared by the authors, on the basis of figures provided by the International Monetary Fund (IMF).

Despite the importance of the trade shock, the financial parameter is probably the major factor in the sudden economic slowdown. There is little doubt that recessive pressures created by the slowdown in trade will intensify. As figure 5.b shows, we are seeing a rapid decline in the rate at which export volumes are increasing, in tandem with the sharp downturn in world trade. At the same time, there is a danger that protectionism will increase, and that the countries most affected by the sudden stop will implement aggressive real depreciations of their currencies in order to shore up their foreign trade positions. In fact, as a result of increased uncertainty, a number of the region's large countries have implemented significant nominal depreciations in response to the financial crisis (see table 1).

Table 1
LATIN AMERICA (7 COUNTRIES): RECENT CHANGES IN NOMINAL EXCHANGE RATES

| | enero de 2008 | marzo de 2009 | Devaluación (%) |
|-----------|---------------|------------------|-----------------|
| Argentina | 3,16 | 3,66 | 15,81 |
| Brasil | 1,78 | 2,33 | 30,69 |
| Chile | 481,56 | 603,28 | 25,28 |
| Colombia | 2.012,42 | 2.498,02 | 24,13 |
| México | 10,93 | 14,71 | 34,67 |
| Perú | 3,00 | 3,22 | 7,43 |
| Venezuela | 2.148,80 | 2.152,03 | 0,15 |

Source: Prepared by the authors, on the basis of information provided by the Centre of International Studies at Argentina's Ministry of Foreign Affairs, International Trade and Worship.

An intensification of the trade shock would have major fiscal consequences, on top of those already present, for countries in which government revenues are tied to natural resources. The *Preliminary Overview of the Economies of Latin America and the Caribbean, 2008 (ECLAC, 2008b)* and the subsequent updating by Gómez Sabaini and Jiménez (2009) project a decline of fiscal resources on the order of 3.4% of GDP, and a drop of approximately 0.5% of GDP for other revenues, with figures expected to vary widely from country to country and according to what assumptions are made regarding growth rates, prices and the elasticity of tax revenues. Thus, the overall impact on public revenues caused by shrinking demand and falling prices is projected to be on the order of 3.8% of GDP for the group of countries strongly dependent on natural resources.

Remittances, tourism and FDI have also been affected by the crisis, but the importance of these factors varies significantly from one country to another, with the effect of the crisis (as a proportion of GDP) being inversely related to the size of a country's economy. For example, while FDI in 2008 moved within a band of 1% to 3% in the largest countries, it reached 6% in Costa Rica, and twice that figure in the Dominican Republic. In the case of tourism, the situation is similar, though the differences are less pronounced. In terms of remittances, Mexico is the largest recipient in absolute terms, but even as a proportion of income, remittance income in the seven largest economies does not, in any instance, come close to what is typical for the Central American and

Caribbean economies. Therefore, the impact of reduced remittances, in terms of foreign trade balance and level of economic activity, will be much more severe in these latter economies, and will have the strongest effect on the purchasing power of low and middle economic strata. In cases where governments depreciate their currencies, this effect will be mitigated, but a similar effect will not be possible in dollarized economies. Moreover, the impact on the external sectors of small energy-importing countries has been partially buffered by the reduction in oil prices.

In short, although the perturbations act through different channels, the effects of the international crisis on national economies are likely to take forms similar to those seen in the case of sudden stops and negative shocks affecting international trade. Thus, although the effects of the crisis differ from what has been seen in past exogenous trade and financial shocks, the resulting imbalances that will need to be addressed, through countercyclical fiscal and adjustment policies, may share a number of features typical of such shocks. Thus, distributive tensions, as well as tensions in the area of political economy, may also be expected to show similarities, and this will most likely affect the space available for fiscal policy.

These facts suggest that constraints on fiscal policy will be aggravated for two reasons. The first of these is the drop in fiscal revenues, whether due to a decline in export-related economic activity or to falling international prices for natural resources. The second factor is the increased difficulty in accessing voluntary financing in the market—financing that could dry up entirely. The effect of the international crisis on tax revenues in the region will vary from country to country, with the scope of the fiscal impact depending on the nature of a country's economy and tax system—more specifically, its structure, the revenue levels, and the sources of the revenue (Gómez Sabaini and Jiménez, 2009).

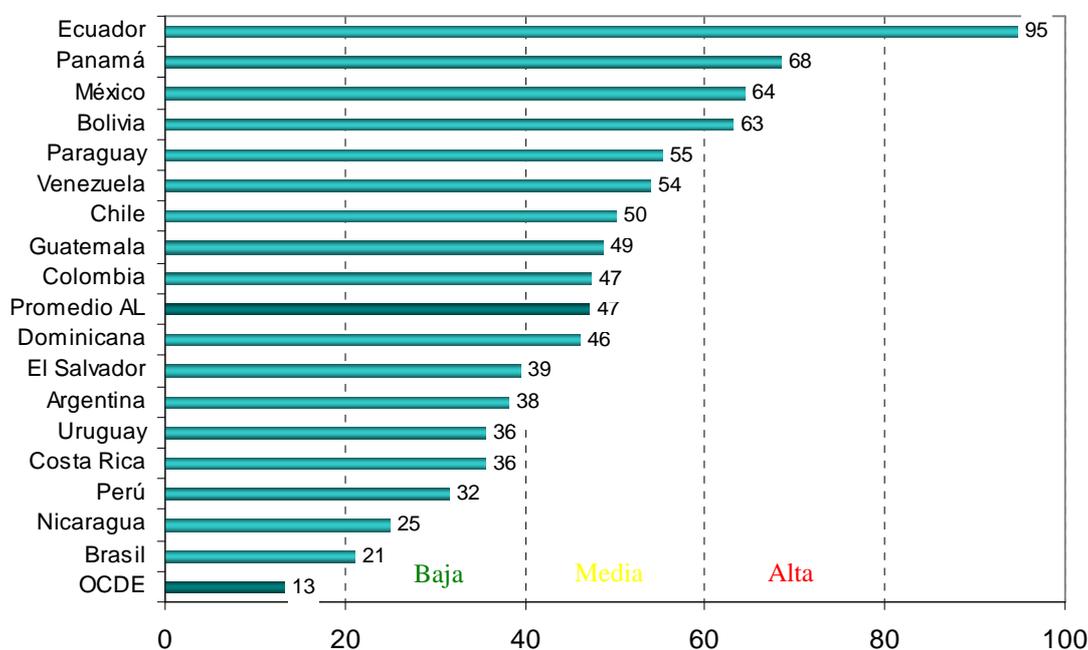
Gómez Sabaini and Jiménez (2009) review the relevant characteristics—e.g., whether a significant portion of a country's resources is linked to exploitation of natural resources—and examine how they vary from one country to another. The authors develop an index of the degree of each country's exposure to the present crisis based on its revenue-raising capacity, analysing the impact of various macroeconomic factors on fiscal revenue to make this determination. In order of importance, the variables they examine are:

1. Role of natural resources as a proportion of overall financing.
2. Degree of institutional rigidity.
3. Taxes as a percentage of imports.
 - a. Proportion of exports destined for the United States.
4. VAT as a proportion of all revenues.
 - a. Productivity of the VAT.
 - b. Revenue from remittances.
5. Social security contributions as a percentage of total tax revenue.
6. Income tax as a percentage of total tax revenue.
 - a. Distribution of income tax (firms vs. individuals).

According to this index developed by Gómez Sabaini and Jiménez, the countries most exposed to the crisis are Ecuador, the Plurinational State of Bolivia, Mexico and Panama. Based on their analysis, these countries have the most important of the above

attributes: revenue highly dependent on natural resources exploitation; low tax burden; and imports that represent a significant proportion of tax revenues (Mexico excepted). For Ecuador, 38% of tax revenues are derived from the VAT and 28% from social security, categories previously identified as being highly sensitive to economic slowdowns. Accordingly, Ecuador is the region's most exposed country, with an index of 95/100. The countries that may be considered as having moderate exposure, with indices between 40/100 and 60/100, include Paraguay (55), the Bolivarian Republic of Venezuela (54), Chile (50), Guatemala (49), Colombia (47) and the Dominican Republic (46). The region's least exposed countries include El Salvador (39), Argentina (38), Uruguay (36), Costa Rica (36), Peru (32), Nicaragua (25) and Brazil (21). The average for the region is 47/100 (see figure 6).

Figure 6
LATIN AMERICA (17 COUNTRIES): EXPOSURE RATIO OF LATIN AMERICAN TAX COLLECTIONS TO THE INTERNATIONAL CRISIS



Source: Juan Carlos Gómez Sabaini and Juan Pablo Jiménez, “El papel de la política tributaria frente a la crisis global: consecuencias y perspectivas, 2009”, Santiago, Chile, Economic Commission for Latin America and the Caribbean (ECLAC), 2009, unpublished.

By way of reference, or as a framework for comparison with the developed countries, the same exercise was performed including the average of the Economic Cooperation and Development (OECD) countries, resulting in a ratio of 13/100, the lowest in the sample. This result is justified, since, compared with the Latin American countries, the OECD countries are not dependent on the exploitation of natural resources or on import taxes for their revenue, and have much lower levels of consumption taxes.

There is increased demand for fiscal policies to stimulate economic activity, with government expected to buffer recessive forces by increasing spending or reducing taxes. The fact that a country may have access to compensatory financing from

multilateral and regional institutions can help make the reduction of funds less abrupt. Nevertheless, consideration of the present case must also take account of the fact that, as the trade consequences of the crisis are increasingly felt in the region, there will be an increase in recessive forces, unemployment, poverty, distributive conflicts and financial constraints. The projected sudden downturn in regional growth will have a negative impact on income distribution. ECLAC projects an increase in unemployment from 7.5% in 2008 to around 8% in 2009, as well as increased informality. The increase in unemployment will have a greater impact on lower income households, while the increase in informal employment will reduce the median incomes of informal workers. At the same time, the reduction in remittances will affect low- and medium-low income households—this in an environment in which poor households have been most severely affected by increased inflation (food prices) during 2008. Moreover, the pressures associated with these factors are not yet being fully felt, given the fact that the region has been in a period of growth that featured increased employment, declining unemployment, and somewhat improved income distribution.

The authorities' initial reaction to the crisis has been to institute countercyclical programmes to mitigate the effects of the recession. As ECLAC (2009) shows, the dominant initiatives selected have been ones that favour spending over tax cuts, and social spending over jobs programmes. In the fiscal realm, governments have increased spending (investment projects) while lowering taxes or increasing subsidies. Only certain countries have imposed restrictions or have increased tariffs on imports. An analysis of discretionary measures directly related to fiscal policy indicates, on the spending side, that most of the countries have announced packages of measures that include plans to support small and medium-sized enterprises (SMEs) and agricultural sectors, in addition to increasing spending on infrastructure and housing. On the tax side, less than half of the region's countries announced reductions in the income tax, while several others announced reductions in business income taxes. Thus, governments have attempted to use the space gained previously in order to adopt a fiscal policy based on a more orderly macroeconomy.

Nevertheless, the space for fiscal policy may shrink rapidly if the international situation does not improve. This pressure arises not only from the decline in resources, but also as a result of the fact that in crisis situations, where new priorities emerge, previously available policy instruments tend to disappear. During difficult financial periods, ensuring the sustainability of the public debt generally takes on special importance, thus competing with the goal of stabilising the economic cycle. This competition between stabilising the debt and stabilising the economic cycle was very apparent during the most recent period of sudden stops in the region. As may be seen in table 2, the link between public debt and average GDP in the region increased significantly between 1998 and 2002; thus, it is not surprising that the most highly indebted countries have opted to first generate general and current account surpluses—a strategy that proved effective in achieving stabilization—and only afterward work to reduce debt levels. It is clear that having a lower debt-output ratio helps create manoeuvring room for countercyclical policy.

Table 2
LATIN AMERICA AND THE CARIBBEAN: GROSS PUBLIC DEBT BALANCE
OF THE NON-FINANCIAL PUBLIC SECTOR

(As percentage of GDP)

América Latina y el Caribe: Saldo de la deuda pública bruta del Sector público no financiero
(En % de PIB)

| | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
|-----------------------------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Argentina | 41.5 | 39.4 | 42.6 | 49.3 | 53.1 | 64.8 | 184.4 | 156.9 | 143.3 | 87.6 | 76.3 | 66.7 | 64.3 |
| Bolivia | 65.8 | 61.0 | 60.4 | 64.3 | 65.8 | 76.7 | 80.2 | 89.5 | 83.9 | 78.3 | 52.6 | 40.0 | 35.9 |
| Brasil | 31.9 | 32.9 | 39.4 | 48.5 | 47.7 | 50.8 | 59.6 | 53.7 | 49.3 | 46.7 | 46.0 | 46.1 | 38.7 |
| Chile | 18.3 | 16.8 | 17.4 | 19.0 | 18.6 | 20.2 | 22.1 | 19.5 | 16.8 | 13.0 | 10.6 | 9.1 | 12.1 |
| Colombia | 20.4 | 23.9 | 26.1 | 34.5 | 39.5 | 42.9 | 49.5 | 46.7 | 42.4 | 38.9 | 36.5 | 32.6 | 31.5 |
| Costa Rica | ... | ... | ... | ... | 41.8 | 43.2 | 45.1 | 45.6 | 46.9 | 43.0 | 38.4 | 31.9 | 29.8 |
| Ecuador | 64.4 | 56.6 | 62.5 | 94.0 | 81.7 | 62.7 | 54.3 | 49.2 | 43.7 | 38.6 | 32.3 | 30.0 | 26.1 |
| El Salvador | ... | ... | ... | 28.3 | 30.0 | 33.6 | 38.6 | 40.3 | 40.5 | 39.7 | 39.7 | 36.6 | 35.2 |
| Guatemala | 18.3 | 18.5 | 19.4 | 22.7 | 21.2 | 21.7 | 19.6 | 22.0 | 22.4 | 21.5 | 21.9 | 21.9 | 20.3 |
| Haití | 43.3 | 45.3 | 41.1 | 42.7 | 49.1 | 50.7 | 66.5 | 63.5 | 51.1 | 47.5 | 38.1 | 34.4 | 35.2 |
| Honduras | 75.7 | 67.8 | 62.8 | 66.0 | 55.4 | 53.5 | 55.1 | 59.9 | 59.4 | 44.8 | 30.2 | 18.3 | 18.8 |
| México | 35.6 | 29.3 | 31.2 | 28.3 | 25.3 | 24.1 | 25.7 | 26.1 | 24.2 | 23.0 | 22.7 | 23.0 | 27.6 |
| Nicaragua | 129.4 | 122.4 | 125.4 | 120.2 | 114.7 | 111.3 | 134.1 | 138.0 | 100.7 | 92.8 | 69.1 | 43.0 | 37.4 |
| Panamá | 73.5 | 67.1 | 64.8 | 67.2 | 66.5 | 71.1 | 69.4 | 67.0 | 70.4 | 66.2 | 61.0 | 53.7 | 45.4 |
| Paraguay | 16.5 | 23.2 | 23.5 | 33.5 | 35.3 | 44.0 | 63.0 | 46.9 | 41.7 | 32.8 | 24.8 | 20.3 | 18.2 |
| Perú | 47.8 | 32.6 | 43.0 | 48.1 | 45.2 | 44.2 | 45.7 | 47.4 | 41.7 | 38.2 | 31.2 | 27.2 | 23.8 |
| R. Dominicana | ... | ... | ... | ... | ... | ... | ... | ... | ... | ... | ... | 19.0 | 20.7 |
| Uruguay | 27.9 | 27.8 | 28.6 | 30.9 | 35.9 | 46.7 | 106.0 | 100.4 | 78.9 | 70.4 | 62.7 | 54.0 | 52.7 |
| Venezuela | 47.4 | 30.8 | 29.4 | 29.3 | 26.8 | 30.4 | 42.4 | 46.3 | 38.1 | 32.8 | 23.9 | 19.3 | 14.2 |
| América Latina y el Caribe | 47.3 | 43.5 | 44.8 | 48.6 | 47.4 | 49.6 | 64.5 | 62.2 | 55.3 | 47.5 | 39.9 | 33.0 | 30.9 |

Fuente: CEPAL sobre la base de información oficial.

Source: Economic Commission for Latin America and the Caribbean (ECLAC), based on official information.

While it is certainly true that countries that took advantage of good times to lower their debt and strengthen their fiscal sectors will have greater room for policy measures, the reality is that the current crisis is deep and global in scope, which, other things being equal, increases the size of the fiscal stimulus needed to stabilize the cycle. This is due to the fact that the current trade shock depresses aggregate demand by reducing exports. In today's circumstances, the region's countries cannot rely on the expansive effect of increased export volumes or on an improvement in the terms of trade, which aided greatly in overcoming the consequences of the period of sudden stops between 1998 and 2002.

These circumstances highlight the importance of redesigning the international financial architecture to improve access to financing, thus providing increased room for fiscal policy to operate without jeopardising debt sustainability. The recent agreements among the Group of 20 (G-20), in London, to increase availability of funds for the International Monetary Fund (IMF) are a positive sign. To be effective, however, this must be accompanied by a fiscal policy approach that emphasizes using funds to increase the space for countercyclical fiscal measures. Otherwise, there is a risk that compensatory credits will be used to finance capital flight during periods of financial instability, rather than to stabilize economic activity. Viewing the problem from this perspective, it

becomes clear that it is essential to coordinate the use of fiscal instruments with monetary, exchange rate and financial policy.

In short, experience with trade shocks and sudden stops suggests that the authorities may be compelled to:

- Make adjustments in the policy targets, in order to deal with the fact that funds that were previously available have evaporated. The need to lower targets because of reductions in tax and financial revenues will produce conflicts. For example, if less money is available, the following questions arise: To what extent should subsidies to productive sectors be adjusted during a recessive period? What poverty reduction goals are realistic? In attempts to promote growth, at what pace should infrastructure projects be pursued? One key challenge will be finding ways to make these adjustments so that the conflicts they engender will have a minimal impact on macroeconomic balance, business climate and juridical security.
- Make difficult choices among alternative fiscal objectives, reallocating available resources towards macroeconomic objectives. Countercyclical policy and anti-crisis adjustments require money, thus creating dilemmas such as the following: Should adjustments be made in public investment, in social spending, or in both areas in order to preserve a balanced budget and protect debt sustainability, even at the cost of a decline in economic activity and jobs? How can transfers to subnational governments be adjusted to maintain the solvency of the federal government and ensure financial stability, even if the social policies implemented at the subnational level provoke resentment?
- Compete for the use of scarce instruments, and intensify demands for coordination between fiscal, monetary, financial and public debt management policy. For example: Should the emphasis be on inflation objectives or on achieving exchange rate stability through intervention in the exchange market? Should short-term fiscal financing be emphasized in order to minimize the cost of the debt, or should longer-term and more expensive financing to be favoured? Should greater priority be placed on price stability or on currency depreciation aimed at compensating for depreciations in neighbouring countries and for protectionism on the part of client countries?

Depending on the particular country, the relevance and importance of these imperatives will vary. There will also be country to country differences based on the previous behaviour of the respective governments during expansionary and recessive phases of the economic cycle, since this will determine the extent to which saving has occurred in good times. The availability of financing and the actions of international lending institutions will also be important factors. Below, we analyse the relation between macroeconomic volatility and the stabilization function of fiscal policy in Latin America. If the looming policy challenges are to be successfully met, there must be an understanding of how these two elements interact in the context of the region.

II. Volatility and fiscal stabilization policy

The amount of policy space that government has to carry out its stabilising function is determined by three key variables: the amount of resources available to finance countercyclical and adjustment initiatives; the number of independent instruments available to meet the proposed objectives; and the degree of competition between countercyclical fiscal policy and other policies placing claims on the use of funds and instruments. One distinctive characteristic of the region's policy space is that it can shrink or expand rapidly when perturbations occur. Shocks alter the policy space not only because they affect funds, but also because they determine the intensity with which other policies compete with stabilization policy. For example, in cases of negative shocks such as the present one, sectoral demands increase, intensifying competition for the use of both funds and policy instruments, which are structurally scarce in the region.

These facts create a two-way relationship between the fiscal stabilization function and macroeconomic shocks and imbalances. While fiscal policy seeks to remedy the imbalances created by the shocks, the very same shocks and imbalances, by changing the amount of manoeuvring room available, restrict the policy-making ability of authorities. This is evident in the case of fiscal policy, where decreased output is accompanied by decreased tax collections. At the same time, the procyclical nature of access to capital markets affects the public sector's ability to borrow.⁶

Below, we attempt to deploy the concept of fiscal space to clarify this issue. By way of preface, however, it may be helpful to mention two central points of the argument being presented here. First, the way in which the two-way relationship between shocks and policy space operates depends on the particular characteristics of the shock. Exceptional shocks, whether trade-related or due to sudden stops of financial activity, can have effects on the policy space that are qualitatively different from those associated with a normal shock. Second, very similar shocks can give rise to different interactions between policy and macroeconomic spaces when the economies in question differ in their degree of vulnerability. Many case studies provide evidence that both the degree and form of the imbalances caused by perturbations, and the ability to implement policy responses, depend essentially on the degree of vulnerability to the specific shock occurring. The fact that vulnerability depends on a number of risk factors that may or may not be present, and that combine in different ways, introduces an idiosyncratic element that must be taken into account in the analysis.

It follows from this that the degree of freedom available for decisions on fiscal policies varies according to the specific shocks and imbalances involved. From this perspective, it may be a mistake, in certain situations, to assume that the number of policy instruments and their degree of independence are invariant throughout the economic cycle. Case studies indicate that authorities usually have less space to manoeuvre in the trough of the cycle, and that the space can be minimal when production slumps in the wake of a sudden stop. Indeed, it is precisely the lack of instruments and funds to deal

⁶ Some econometric work on countercyclical fiscal policy, given the reciprocal causality between the variables, places special emphasis on controlling countercyclical initiatives (spending or primary surplus) and aggregate income. The treatment of failures of the financial market, on the other hand, has received less attention. See, for example, Jaimovich and Panizza (2007), Fatás and Mihov (2007) and Kaminsky and others (2004).

with a slump in output that tends to lead to a crisis which, in turn, has more than transitory effects on the economy (ECLAC, 2008a).

Given the econometric limitations posed by problems of identification and reduced capacity to share experiences (see Durlauf and others, 2006), many analysts choose to analyse episodes in a manner akin to case study methodology (see ECLAC, 2008a; Spilimbergo and others, 2008). The idea behind this approach is to identify stylized facts that complement econometric studies, making it possible to develop richer guidelines for policy design and implementation. While not neglecting econometric findings, this method more closely resembles an episodic approach. It uses stylized facts to analyse the interaction of shocks, macroeconomic imbalances and changes in the fiscal policy space, in an attempt to understand the meaning of the stabilising function of fiscal policy in a volatile context such as that of Latin America. As will be seen, confusion arises from the fact that the term “stabilization” is used in more than one sense. Here, it is proposed that the approach to countercyclical fiscal policy must be reformulated to account for all of the dimensions in which the fiscal stabilising function manifests itself in the region. In order to detail these ideas more fully, the remainder of this section will present a set of stylized facts relating to volatility, showing their connection with the stabilising function of fiscal policy.

A. Volatility in Latin America

In recent years, knowledge of the region’s aggregate fluctuations has improved. Among the most important findings regarding the relation between fiscal policy and volatility are the following:

- Perturbations with more than temporary effects on the economy are frequent in Latin America. Those that lead to lasting changes are associated with crisis episodes, changes in the economic structure (external and institutional shocks), and random perturbations that influence long-term trends (ECLAC, 2008a; Aguiar and Gopinath, 2004).
- Macroeconomic volatility in the region is high, and far greater than is usual in the developed countries. Measured as a function of variance in growth between 1951 and 2008, volatility in Latin America is 50% greater than in Europe and the United States. In addition, there is evidence that the greater volatility itself has an effect on the performance of the economy in terms of growth, consistency in consumption patterns, and the vulnerability of specific groups. Thus, researchers have emphasized that reducing excessive volatility should be an integral objective of growth policy (ECLAC, 2008a; Catão, 2007; Loayza and Hnatkovska, 2005).
- Crisis episodes are very frequent, and are usually accompanied by a slump in production or, at least, by an interruption in the processes that foster growth (ECLAC, 2008a; Goyal and Sahay, 2006).
- External shocks—changes in access to external funding, and changes in the terms of trade—are closely related to national macroeconomic fluctuations, both normal ones and those associated with exceptional or crisis episodes (ECLAC, 2008a, Edwards, 2007; Catão, 2007).

- The sudden reversals of capital flows associated with contagion phenomena tend to create periods of turbulence that affect many of the region's countries simultaneously (a phenomenon seen a number of times during the second globalization period, which began in the late 1970s). This suggests that the current global crisis will be one of the decisive factors in determining the macroeconomic dynamic of the region overall—though it should be borne in mind that certain consequences may prove to be irreversible (Calvo and others, 2006; Catão, 2007; Fanelli, 2008).
- Aggregate fluctuations are often accompanied by pronounced changes in the sustainability of public and foreign debt, and by changes in the fragility of the financial system. Evidence indicates that the relationships between balances and flows, the interrelationships among the balance sheets of key aggregate agents, and capital losses and gains, are central determinants of sustainability and financial fragility, and hence of macroeconomic fluctuations (Fanelli, 2008; Easterly, 2000; Heymann, 2007).
- The reformulation of governance structures (contracts, property rights and regulations) habitually plays an important role in the adjustment process that follows a perturbation, especially if the shock has caused a crisis or slump in production. Modifications in governance range from changes in the composition of public spending and redesign of labour contracts and rules governing distributions among central and subnational governments, to refinancing, and reform of banking regulations, capital movements, the pension system and tariff structures (ECLAC, 2008a; Fanelli, 2007).

This list of stylized facts shows that macroeconomic volatility involves a variety of stochastic processes that can affect the economy in both the short and long term. Therefore, the authors believe that “fiscal mechanisms for filtering macroeconomic perturbations” is a more apt description than “countercyclical fiscal mechanisms”. This phrasing highlights the fact that the perturbations that require policy responses are not necessarily stationary or cyclical, and do not necessarily represent deviations within a corridor of stability around a trend. The treatment of phenomena such as perturbations that affect the trend, structural changes, and non-convergent trajectories requires a more complex battery of fiscal responses. Notably, macroeconomic imbalances may be associated with trend shocks and structural changes that serve to accelerate growth. If the nature of the perturbation causing the fluctuation is not precisely identified, it is difficult to judge whether the increased volatility is good or bad. Attempting to artificially reduce volatility may have undesired consequences, reducing growth by eroding incentives to take risks, or aborting a process of structural change. In speaking of filtering mechanisms, it should be emphasized that the objective of fiscal policy is to filter out the negative effects of the perturbations, without affecting the positive ones associated with structural changes that result from the disappearance of obsolete sectors, increasing sectoral differences in productivity, or the reform of inefficient governance structures. One consequence of this analytical approach is that it promotes stronger efforts to identify the characteristics of shocks and the responses that follow, in varying contexts—a largely unexplored field of analysis.

There is another major difference between the approach that emerging economies take to the fiscal stabilization function and the narrower, more short-term approach taken by developed countries. In emerging economies, reducing excessive volatility (both cyclical and trend volatility) is regarded as an independent objective that is valuable, in itself, for two reasons, both of which concern long-term goals.⁷ First, this type of volatility is detrimental to growth (Easterly and others, 2000; Ramey and Ramey, 1995). Second, the risk associated with excessive income volatility disproportionately affects the vulnerable segments of the population that lack the means to protect themselves from such risks; thus, repeated recessions ultimately generate social exclusion, low accumulation of human capital, structural duality and poverty traps (cf. Fatás, 2002; Barlevy, 2004).

Based on these facts, it is understandable that the intention of fiscal stabilization policy is rarely limited to smoothing out temporary fluctuations from the trend. In supporting policy, arguments are frequently put forth invoking the need to ensure the solvency of the public sector, stabilize the economy in order to promote growth, achieve investment levels that ensure access to foreign credit, or eliminate regressive inflationary taxes that stand in the way of financial deepening. These fiscal policy objectives seem directed more at the factors affecting the economic trend, or at correcting a dangerous course, than at correcting temporary deviations with regard to potential output. It would therefore seem wrong to group, under the countercyclical rubric, policies that have quite different contents and objectives, and that thus demand different instruments and types of coordination.

Much can be learned in Latin America about the diversity of tasks involved in the stabilising function of fiscal policy, precisely because, unlike the developed world, where excessive volatility and macroeconomic crises are probabilistically rare, such events, although exceptional, have been more frequent in Latin America. This is reflected, for example, in the far more complex form in which fiscal stabilization policy is conceived and practiced. Except in special cases, stabilization in the industrialized countries involves adopting countercyclical policies, with the objective of smoothing out fluctuations around a trend (see, for example, Auerbach, 2002). In addition, it is implicitly assumed that, with or without stabilization policy, the economy will always move within a narrow corridor around potential output (which is always difficult to define) and will by itself tend to return to the trend.⁸ Not surprisingly, given this view, automatic stabilizers are relied upon as the predominant tool for making countercyclical policy.⁹ In Latin America, automatic mechanisms are much less relevant, and discretionary initiatives are therefore more common. The components normally defined as automatic stabilizers are income tax (on the revenue side) and unemployment insurance (on the spending side). Both, however, play a very minor role in Latin American budgets.

⁷ For a definition of excessive volatility, see Fanelli (2008) and ECLAC (2008a).

⁸ Here, the notion of “corridor” is used in Leijonhufvud’s sense (1981). According to that author, when the economy is outside the corridor that is present in an environment of full employment, economic agents have difficulty coordinating their plans, because of failures of effective demand. This is due to the fact that when the economy is far short of full employment, there are no mutually consistent rules or expectations to bring the economy quickly back to full employment.

⁹ In the literature, automatic stabilizers are defined as those mechanisms in public accounts that act countercyclically, independent of any government intervention, reducing variations in output (Suescún, 2007; Auerbach and Feedberg, 2000).

In Latin America, stabilization—in the sense of smoothing out the cycle—is only applied in normal times, when the economy is moving within the corridor. When a sufficiently large perturbation occurs, or when the mechanisms that propagate the shock automatically destabilize the economy, threatening to put it on a dangerous course, the “stabilization” that typifies normal periods is, not surprisingly, replaced by the alternative meaning of the term. This usually occurs when the public debt becomes unpayable, or when the financial system’s net worth becomes negative. If the economy violates the condition of transversality and, without prior indication, adopts a dangerous course, “stabilization policy” comes to mean macroeconomic adjustment policy, making it necessary to reform some economic parameter (tax burden, elimination of public spending programmes, or financial or other property rights) in order to deactivate the mechanisms that are causing the danger. Because the current situation in the developed world is exceptional, there is greater interest in understanding the policy challenges associated with “stabilization” in this second sense of the term (see, for example, Spilimbergo and others, 2008). Thus, a mandatory first step should be to more precisely define the use of the word “stabilization” in the context of countercyclical policy, since the interpretation of the term changes policy content in an essential way.

III. Countercyclical fiscal policy

The stylized facts regarding volatility indicate that crises and shocks with lasting effects are very frequent in the region, and the notion of a filtering mechanism underlines the need to distinguish between two distinct types of shocks. Thus, in designing fiscal stabilization policies in Latin America, one must differentiate normal shocks, which induce stationary fluctuations around a trend, from exceptional shocks, which may have irreversible effects.

One well-known obstacle to designing fiscal measures for exceptional events is that measures for dealing with non-stationary shocks must have a significant degree of discretionality. In the case of a non-stationary event, it is impossible to know precisely, beforehand, how the trend will evolve—much less how the structure of the economy and its forms of governance may change as a result of the shock. Thus, it is impossible, beforehand, to answer with any precision questions fundamental to the success of fiscal policy in its stabilising function. These include questions such as: How will the size and distribution of fiscal revenues and the tax base change? What sectors will merit assistance once the consequences of the shock are known, in terms of relative effects on sectoral productivity, international competitiveness and income distribution? What type of spending, and what sectoral distribution of spending, will most effectively address the shock? Which agents will be impacted most in terms of liquidity and solvency? How should regulations be changed to reflect the new situation? What new forms of private sector contractual arrangements will emerge, with the potential to expand or shrink the policy space—e.g., when term reductions for contracts deprive the public sector of long-term financing instruments?

Since the region has greater exposure to exceptional and non-stationary shocks, discretionary fiscal responses are frequent. Moreover, given the weakness of institutions and the major constraints in terms of political economy, it should be no surprise that these discretionary responses have not been of high calibre, and that, therefore, the question of discretionality has remained at the centre of the debate on fiscal stabilization policy.

One proposal put forth repeatedly in recent years to address this issue has been to limit discretionality, to the extent possible, in making decisions on policy responses. The proposed method for accomplishing this was to impose predetermined rules on fiscal policy (cf. Perry, 2003). In practice, this means renouncing the use of special measures to manage the consequences of exceptional events, unless one simply assumes that such events will not occur in the future—an assumption not justified by available evidence concerning volatility. The empirical evidence on fiscal policy in the case of both Latin America and the European Union, suggests that authorities find the cost of inaction in the face of exceptional events to be greater than the benefit of avoiding discretionary responses. When macro circumstances are deemed exceptional, the rules are modified.¹⁰ Indeed, this has been explicitly recognized by including escape clauses in fiscal regulations. Beyond a recognition of these facts, there must be a better understanding of the relation between normal and exceptional conditions. Specifically, there needs to be greater clarity on how this relationship operates in different stochastic and institutional

¹⁰ On the question of fiscal rules and discretionality, see, for example, Dos Reis and others (2007), Perry (2003) and Perotti (2007).

contexts, along with a determination of what the proper fiscal responses would be to the occurrence of different types of stationary or non-stationary shocks.

Governments, as well as the overwhelming majority of analysts, agree that the current crisis in the United States and Europe is an exceptional event. Thus, analysis of the fiscal stimulus policies being implemented to prevent a depression will produce valuable lessons on the relationship between rules, automatic stabilizers and discretionary fiscal responses. From an analytical perspective, one advantage is that this exceptional event has occurred in a context in which moderation of the cycle and the operation of automatic stabilizers were the norm rather than the exception. In this sense, the crisis resembles a natural experiment. Taking these factors into account, we shall use some of the events that are presently occurring to identify five points considered central to understanding the macroeconomic challenges facing fiscal policy in Latin America.

First, when perturbations of exceptional size and nature occur, uncertainty about the effects of fiscal stabilization policies increases. As is clear from Spilimbergo and others (2008), policy makers today face serious difficulties in assessing one element that is essential in calculating the necessary fiscal stimulus, namely, the value of the associated multiplier. Existing estimates of the value of the multiplier under normal conditions differ significantly. Moreover, it remains unclear whether the value of the multiplier calculated under normal conditions applies to shocks and fiscal responses of the magnitude of the present circumstances (cf. Spilimbergo and others, 2008).

Second, during a crisis situation, the demand for coordinated policy increases exponentially, due largely to increased policy competition for the use of funds and instruments. This applies particularly to the coordination of countercyclical fiscal policy vs. monetary, public debt and financial crisis management policy (Togo, 2007). Government is allocating enormous fiscal resources to stabilize the banking system and stimulate the economy, and as a consequence, the fiscal deficit and the debt-GDP ratio will rise above the goals established prior to the shock. Thus, anti-crisis policy may supersede the objective of maintaining debt sustainability, thereby placing rigid limitations on the fiscal policy space available to future governments. These countercyclical fiscal actions may also dominate monetary policy objectives. Many analysts suggest that the significant increase in the money supply and in public spending will lead to a sharp upturn in inflation further downstream. The shift from inflation objectives to quantitative easing merely describes the dominance of countercyclical policy over inflation objectives. Obviously, short-term measures to prevent the economy from falling prey to high unemployment seems well-advised, but it will undeniably make it more difficult in the future to coordinate fiscal policy with monetary and public debt policy.

Third, debt sustainability takes on a major role when there is a shock of unusual magnitude. The quantitative effects of the fiscal stimuli being implemented are highly dependent on the course of the financial markets and on the uncertainty factor. This is reflected, above all, in the discussion concerning sustainable levels of public debt. Many analysts believe that a large fiscal stimulus, added to the enormous resources being required to stabilize the banking system, could move the public debt-to-GDP ratio toward unsustainability.¹¹ This produces a rather paradoxical situation that, in itself,

¹¹ For a view that emphasizes the question of the debt, and coordinating it with other policies or regimes, see, for example Cochrane (2003), who has persistently focused on the issue of whether fiscal policies are

constitutes a source of uncertainty. Given a particular fiscal policy, the task of calculating the sustainable debt level requires knowing what long-term interest rates and growth rates will be, yet these variables will only be known once the economy stabilizes around a new equilibrium, following the shock.¹² Thus, short-term attempts to stabilize the economy and revitalize private spending require that economic agents assume that the increase in the public debt is sustainable. For agents to invest and commit themselves for the long term, it must be clear that the economy will converge toward a new stable equilibrium. However, it is precisely the difficulty that economic agents confront in ascertaining which way the economy is heading that provokes uncertainty, puts a brake on spending, and threatens to coalesce expectations of a negative equilibrium, similar to the liquidity trap. Evidence from the developed world indicates that the difficulty in using fiscal stimuli is a function of the indebtedness of the public sector, and an inverse function of the degree of monetary autonomy to resist a massive outflow of capital.

Fourth, fiscal stabilization measures are being accompanied by initiatives that, in addition to being countercyclical, encompass major reforms of governance structures (contracts, regulations). A prerequisite to coordinating expectations on an equilibrium outside the trap of high unemployment is ensuring that there is not a collapse in the financial system or in production. To achieve this, governments have committed themselves rather explicitly to a policy of rescuing entities that are too large to fail, an approach that entails the ex post reformulation of regulations and contracts. A side effect of such reformulation of governance mechanisms is that it increases moral hazard and the perception that the rules of the game are unstable. In these situations, the need to stabilize the economy takes precedence over the need to have stable economic institutions—a situation that affects incentives to invest. It is not clear that fiscal and other stimuli will have the same effects on private spending in such an environment as would be true under normal circumstances. This is particularly the case in smaller countries that are more deeply affected by the crisis.

The fifth and final point relates to how the political economy dynamic of the crisis can affect fiscal stabilization policy. As has been noted, gearing expectations toward equilibrium—achieving full employment and avoiding the trap of high unemployment—requires that the government give clear signals that the public debt is sustainable, particularly in the case of small countries. The strongest way of signalling this is to make it clear that future taxes will be raised to service the debt. This creates a problem of political economy: if a private investor today has a sound project and the liquidity to carry it out, why should he invest and demonstrate to the government his ability to generate profits, when he knows that political economy constraints will very likely cause the government to ultimately increase taxes on those who have profited, rather than lost, in the crisis? This expectation of future appropriation of private gains depresses investment and makes it difficult to coordinate expectations of a positive equilibrium. A problem similar to that of potential appropriation applies to the uncertainty regarding the rules of the game and the moral hazard associated with financial rescue operations. This does not mean that the economy will be unable to coordinate on an equilibrium outside the trap; it does, however, assume that businesspeople will demand a higher profit

effective in the current situation. The alternative view is represented by the International Monetary Fund. See, for example, IMF Fiscal Affairs Department (2009) and Freedman and others (2009). Also relevant is the discussion of debt sustainability in Buitert (2009).

¹² This is especially the case if one considers that some consequences of the crisis will be irreversible and will therefore affect growth and yields in the long term.

margin for investing (given the greater risk in a tense institutional environment)—a situation that will delay the revitalization process.

The purpose of this brief discussion of the problems of countercyclical policy in the industrialized countries is to illustrate how crises and major shocks transform and increase the problems that countercyclical policy inevitably faces. This transformation is no surprise, of course, to those familiar with fiscal problems in Latin America, where, because of the frequency of crises, problems of public debt sustainability are common, as is uncertainty about the effects of fiscal stimuli, lack of coordination among different policies, changes in the rules of the game, as well as changes in allocating the tax burden as a result of macroeconomic adjustment and pressure from distributive conflicts.

Whether in relation to Latin America or to the crisis in the developed world, these five points highlight the need for a comprehensive and consistent view of the set of fiscal tools for dealing with the fluctuations, in order to use them in a coordinated fashion and be able to assess the constraints that limit the space for policy making. The fact that policies with very different objectives are often termed countercyclical creates confusion. It seems reasonable, at a minimum, to distinguish between fiscal policies for normal situations and fiscal policies for exceptional circumstances—e.g., between policies that seek to coordinate expectations in situations where there are two equilibria, and policies that seek to smooth out fluctuations around an equilibrium; or between discretionary adjustment policies designed to redirect the economy from a dangerous course, and marginal discretionary policies that seek only to complement the normal function of automatic countercyclical stabilizers. The evolution of fiscal policy regulations in the European Union suggests that introducing the distinction between normal and extraordinary situations and studying the effects of discretionary responses to unusual shocks can be highly useful (cf. Fatás and Mihov, 2009).

Notably, general interest in countercyclical fiscal policy was driven in the 1930s by the search for discretionary fiscal tools to bring the economy out of the high unemployment trap created by exceptionally intense shocks. Equally notable is the fact that, after relying on discretionary fiscal policies, stabilization was diluted in tandem with changes in the economic structure of the developed world. For as the public sector grew in size (while income taxes and unemployment programmes also grew), automatic stabilizers became more important; as financial markets deepened, greater space for monetary policy developed; and, finally, the absence of a slump in production led to a period of very moderate cycles in which fiscal activism seemed an anachronism. The corollary of this evolution was the formation of a new consensus: the notion that discretionary fiscal policy should not be used for countercyclical purposes, since this function was covered by the automatic stabilizers (cf. Auerbach, 2002), and that monetary policy should focus on ensuring that any temporary perturbations not jeopardize price stability. Indeed, many writers attributed the apparent stability of the economy to the quality of monetary policy, dismissing the argument that it could be simply the result of good luck, i.e., a long period of time without extraordinary perturbations (cf. Stock and Watson, 2003; Blanchard and Simon, 2001). A paradoxical side of this evolution in fiscal thinking is that the consensus reached its peak just at the moment when authorities were forced to act with great discretionary force to address an exceptional shock, in a context of relatively ineffective monetary policy in the industrialized countries.

Although this reference to the industrialized countries is intended to highlight the need for an approach to countercyclical fiscal policy that emphasizes both the specific characteristics of particular perturbations and the automatic-discretionary relationship, any analogy between the emerging world and the developed world has limited applicability, due to the inherent structural differences.

A number of differences are particularly noteworthy. First, as will be seen below, there was no significant moderation of the cycle in Latin America. Second, access to capital markets is distinctly procyclical and, at least until the current crisis, sudden stops of capital flows did not occur in the wealthy countries. The fact that capital markets remain open even in recessionary times is clearly beneficial to the developed countries, since it prevents a shrinking of the space available for countercyclical fiscal policy precisely when it is most needed. It should be borne in mind that fiscal deficits must be financed regardless of whether they are generated by automatic or discretionary mechanisms. Third, automatic fiscal mechanisms to stabilize the economic cycle play a much larger role in economies with a large public sector. Fourth, problems regarding the sustainability of the public debt are not comparable, although debt-to-GDP ratios are not necessarily higher. In particular, changes in risk tolerance on the part of investors in Latin America, and variations in the real exchange rate, have very pronounced effects (Blanchard, 2004). Finally, as is well known, the problem of unstable governance structures and potential appropriation of investments places much tighter constraints on the effectiveness of fiscal stimulus policy in Latin America. This means that the expected increase in the profit margin required to bring the economy out of a low growth trap is much greater, because the risk discount created by the business climate will be greater.

In light of these differences, it is not surprising that the “Great Moderation” consensus that originated in the developed countries has always proven somewhat abstract for Latin American policy makers. Regional authorities operate in an environment in which a slump in production is an ever-present threat, monetary policy freedom is limited or nonexistent, and automatic fiscal stabilization mechanisms are weak. Thus, it is hardly surprising that, for Latin American authorities, discretionary fiscal measures have always occupied centre stage. This means that there are probably important lessons to learn from Latin America’s experience, in terms of the relation between discretionary policies and cyclical fluctuations.

In summary, from the perspective of the present analysis, the more traditional conception of countercyclical fiscal policy has two pronounced weaknesses. The first is that, while countercyclical policy essentially involves initiatives designed to smooth out temporary deviations from long-term trends, much of the volatility in Latin America, as noted here, derives from perturbations that change economic trends, not from cyclical deviations around a trend. Thus, structural changes are often associated with reforms and with international or political events that put the economy on a dangerous course, outside the corridor of normalcy. It therefore seems inappropriate to focus solely on stationary phenomena. Indeed, such a focus would be inappropriate today, even for the developed countries, given that the crisis may have irreversible effects (for example, on the banking system and the level and distribution of wealth among families) and that it threatens to ultimately put public indebtedness on a dangerous course that will require a profound adjustment of governance structures. Thus, it would seem more appropriate to include, under the rubric of fiscal stabilization policy, the entire set of initiatives

designed to address the aggregate fluctuations, and reserve the concept of countercyclical fiscal policy to situations in which only stationary phenomena are involved. Under this scenario, the stabilization function of fiscal policy would involve the following elements:

Countercyclical policies, in the strict sense, that are designed to deal with the economic cycle, i.e., temporary deviations from an existing trend.

- Macroeconomic adjustment policies to manage the consequences of lasting shocks by changing the rules. Here, the objective may be to structurally reduce excessive volatility, or (in the case of multiple equilibria) to coordinate decisions in order to put the economy in a particular equilibrium deemed to be superior to another.
- Anti-crisis policies, whose objective may be to correct the direction of an economy that is on—or is in danger of embarking on—an unstable course, or to correct situations in which no equilibrium exists.

Strictly speaking, anti-crisis policy is a type of adjustment policy, but because of its importance it has been classified as its own type of policy. This distinction is apt, inasmuch as it shows how policies with differing content and objectives, and requiring different instruments, appear together under the umbrella of stabilization policy.

If anti-volatility policy is conceived as risk management policy, with the policy designer playing the role of risk manager, the three types of policy can imply action in three different dimensions: risk prevention and mitigation; measures to moderate the consequences of shocks by taking precautions before they occur; and rescue or assistance measures implemented once the perturbation takes place.

Finally, three further points: First, each of these types of policy, because of the very nature of the problems it must address, requires not only a different magnitude of space, but a consideration of the specific context, which will affect the size of the space, since structural and political constraints vary according to the characteristics of the situations involved. Second, in addition to the three types of policy already cited, there are other anti-volatility structural reform policies that are much longer-term in scope, and that may be designed to alter the structure of the economy in order to reduce volatility directly or increase policy space. Examples of such reforms are: adopting measures to increase the diversification of trade so as to reduce exposure to terms of trade shocks; increasing trade openness as a means of aligning the economy with international inflation; promoting financial development to create greater independence between fiscal and monetary policy; and reforming economic institutions to reduce macroeconomic volatility by extending the duration of contracts. Lastly, like any classification that attempts to identify the elements of a complex phenomenon such as anti-volatility policy, this classification merely attempts to impose a degree of analytical order, not to draw arbitrarily strict lines between different types of policy. For example, it is difficult to separate adjustment policies from structural reform or anti-crisis policies. This is especially true in view of the fact that governments often take advantage of the room that a crisis provides for autonomy, in terms of political economy, making it possible at times to temper the demands of special interest groups and successfully launch reforms that would meet resistance in more normal periods.

The following section shows how fiscal authorities in the region, in attempting to bring about stabilization, use the three policies: anti-cyclical policy, adjustment policy and anti-crisis policy. Given the hypotheses that trade shocks and sudden stops of capital flows have accounted for the most important exogenous perturbations and play a central role in crisis situations, the following section is devoted to these shocks.

IV. External disruptions and fiscal policy: the anatomy of two shocks

Next is an examination of how sudden stops of capital flows and exogenous trade shocks relate to the amount of space available for fiscal stabilization policy. The analysis follows three lines. First is a discussion of an argument outlined in the foregoing section: that the fiscal policy space must not be conceived statically, since shocks affect its central components, i.e., the resources and instruments available to authorities, as well as pressure from competing policies. Second, the analysis focuses on vulnerability to trade shocks and sudden stops, underlining the fact that an economy's starting point at the time a shock occurs affects its subsequent course, and thereby affects the components of the policy space. It will be seen that lack of space for fiscal stabilization policy when a shock occurs is, in itself, an element of vulnerability.¹³ Third, it will be shown how difficult it can be to solve the problems of policy coordination that arise from exceptional trade or financial shocks—problems that can lead to situations in which one policy predominates over another, or directly dominates the response to crisis situations.

To illustrate the importance in Latin America of the types of shocks being analyzed here, table 3 shows past periods of trade shocks and sudden stops in the largest countries.¹⁴ This draws on information from Calvo and others (2006) for these countries. A similar methodology was used to identify trade shocks.

¹³ On the fiscal situation in the context of the present crisis in Latin America, and the policy space, see Bárcena and others (2009).

¹⁴ For a recent discussion of the observed effects of the trade and financial shocks in the region, as compared with previous shocks, see Pineda and others (2009).

Table 3
LATIN AMERICA (7 COUNTRIES): TRADE SHOCKS AND SUDDEN STOPS

| | Crunches de Comercio | Sudden stops |
|-----------|-----------------------------|-------------------------------|
| Argentina | 1986-87; 1993; 2002-03 | 1980-84;1994-96; 1998-2004 |
| Brasil | 1986;1999-2003 | 1981-85 |
| Chile | 1985-86; 2002-03 | 1981-86; 1998- 2000 |
| México | 1986;1992-94; 2003 | 1982-85; 1994- 97 |
| Colombia | 1983;1985; 2002-04 | 1998-2002 |
| Perú | 2001-04 | 1981-86; 1997- 99 |
| Venezuela | 1986-88;1998; 2002-03 | 1980-86 |

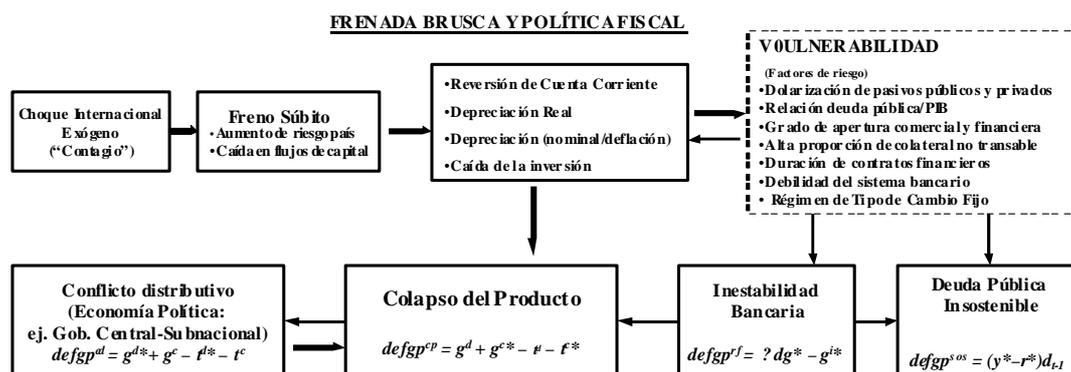
Source: Prepared by the authors, on the basis of figures provided by the Economic Commission for Latin America and the Caribbean (ECLAC).

A. Sudden stops, trade shocks and their effects on the primary deficit

First, as a general indicator of the changing fiscal space, an overview of the features of sudden stops and trade shocks is presented, in order to show how they relate to vulnerability and provide a description of the channels through which they affect the public deficit. The main objective here is to illustrate the way in which these factors create conflicts between different fiscal policy objectives. The following section draws on these conclusions to discuss the problems of policy coordination and predominance that arise in the case of exceptional shocks, as well as the dilemmas they create for the fiscal stabilization function, particularly as regards countercyclical policy vs. adjustment policy.

Sudden stops or reversals of capital flows will be discussed first. To stylize these perturbations, we shall draw on facts that appear repeatedly in the literature (e.g., in Calvo and others, 2006; Kaminsky and others, 2004; Ortiz and others, 2007; and Bordo, 2006). Diagram 1 provides an overview of this type of shock, the imbalances provoked by it, the risk factors that determine vulnerability, and the channels through which the shock affects the fiscal position, as represented by the primary fiscal deficit (*defgp*).

Diagram 1 SUDDEN STOPS AND FISCAL POLICY



Source: The authors.

UPT: please see other file with translation of diagram and typeover Spanish diagram

The first box on the left shows an important feature of this type of shock: its exogenous nature, associated with contagion or portfolio decisions that are correlated because of the illiquidity of international investors. This type of shock is systemic, inasmuch as it affects all components of the banking system and of the capital markets. According to Calvo and others (2006), two of its distinctive features are the increased risk premium that must be paid by the country affected, and a decline in capital flows. As was seen in section I, both of these phenomena were present in the periods following crises in a number of the region's countries, although the rise in the risk premium was less intense than the decline in capital flows. The effect on capital flows was greater in the larger countries, which have more access to capital markets. In the smaller countries, the reduced supply of foreign funds took the form primarily of a drop in FDI, which was closely linked to increased financial uncertainty, as well as being a reaction to the trade shock.

The box in the upper centre of the diagram lists the principal effects that the literature associates with sudden stops: a reversal in the current account, declining investment and real depreciation. Nominal depreciation is an important instrument for achieving real depreciation in countries that have a degree of monetary autonomy. In dollarized countries such as Ecuador and El Salvador, on the other hand, the change in relative prices can only take the form of price deflation, which itself can provoke new macroeconomic imbalances, as (evidence suggests) occurred in Argentina during the convertibility period (Fanelli, 2008). Beyond this, sudden stops regularly lead to marked declines in the demand for domestic financial assets. To soften these pressures, authorities are generally forced to intervene in currency markets, though this usually entails conflicts with established monetary rules. Such is the case currently in countries like Chile and Mexico that were following an inflation target regime and found themselves compelled to alter their currency market interventions in order to alleviate some of the pressure and prevent excessive depreciation.

As the dotted box on the right shows, the severity of the imbalances depends largely on how vulnerable an economy is, which in turn depends on the status of the risk factors

generally cited in the literature, and listed in the box. Their importance varies, of course, according to the structural features of both the economy and the particular situation.

The first of these factors is the degree of both public and private debt dollarization. This has played an important role in Latin America since the debt crisis of 1982. The most recent traumatic episodes occurred between the Russian crisis of 1998 and the Argentine crisis of 2002. Since sudden stop episodes provoke major changes in the real exchange rate, debtors with dollar-denominated liabilities usually experience a sharp rise in their real debt as a percentage of assets. As this produces a general increase in financial leverage (i.e., in the debt-asset ratio), systemic financial fragility rises as well. Thus, the greater the depreciation-induced upward correction in the value of the debt, as a percentage of assets, the steeper is the rise in leverage and fragility. It also follows that firms operating in the tradables sector will be least affected, since, in that case, the value of assets will tend to rise with the depreciation.

The second factor in the list is the ratio of public debt to output. This is important because the greater this ratio is, the more pronounced the effects under examination here will be. Note that even if the public debt is not dollarized, a reversal of capital flows will increase interest rates, and correspondingly intensify the demand for money to service the debt. This effect was very pronounced in Brazil in the first half of the 2000 decade, as Blanchard (2004) demonstrates.

A third risk factor is associated with the level of economic openness. The more open the economy, the greater the size of its tradables sector, and hence the smaller the effect of the increased leverage produced by the real depreciation. This is true for both the public and private sectors. If a major portion of public sector revenue derives from the tradables sector—either because this is the tax base or because the revenue includes dividends from public enterprises that export—there will be less vulnerability associated with the dollar-denominated public debt. Thus, in assessing the fiscal effects of a sudden stop, one must consider the characteristics of the assets that serve as collateral for dollar debts (Caballero, 2000). Evidence on the decline of fiscal resources, estimated by ECLAC (2008b) to be on the order of three percentage points of GDP in 2009, suggests that the financial position of a number of the region's governments will be impacted. In this connection, note that the conjunction of a trade shock with a financial shock imparts greater force to both. In the context of a sudden stop alone, the tradables sector (which may include the State) remains capable of leading a recovery, since it is less affected financially. This is not the case, however, when a trade shock accompanies the sudden stop.

An additional reason for the relation between the openness of an economy and its vulnerability is that, other things being equal, the smaller the tradables sector is as a percentage of the economy, the greater is the proportion of domestic absorption that must be sacrificed to gain an extra dollar through reduced imports—this being the typical form of short-term external adjustment (Fanelli, 2008). Thus, a lack of openness may ultimately exacerbate the economic slowdown if authorities compensate for the sudden stop of financial flows by reducing imports. Case studies suggest that, to achieve a slowdown of imports, authorities must implement a greater real exchange rate correction (cf. Fanelli, 2008). A major correction of relative prices and level of economic activity aggravates the problem—for both government and business—of excessive financial leverage. However, the greater the amount of dollarized revenue that

the State has, due to either imports or natural resources, the smaller this effect will be (Jiménez and Tromben, 2006; Sabaini and Jiménez, 2009).

An economy's financial openness also has an effect on vulnerability: the greater the vulnerability, the greater the capital flows, and hence the more risks the economy faces if flows are reversed (Ocampo and Griffith-Jones, 2008). Note that this argument assumes that capital flows are procyclical—as is normally the case in the region, especially in the impermanent environment of sudden stops (Fanelli, 2008). If there were fewer failures of capital markets, access to foreign capital markets could be used to smooth out the cycle, since domestic agents (both public and private) could borrow at the trough of the cycle, and generate surpluses to repay the loans at the peak. The procyclical behaviour of flows is facilitated when financial contracts are short-term. When bad times loom, it is easy to jettison instruments with domestic risk and flee to higher-quality assets. It is a stylized fact that contracts tend to become shorter in direct relation to inflation and volatility of quantities, from which it follows that this risk factor is particularly important in the most unstable countries (Fanelli, 2008). This factor tends to influence fiscal authorities to the extent that, as liquidity is abruptly reduced, the private sector postpones meeting its tax obligations, or resorts to evasion, to finance short-term working capital. This effect can be significant, and in fact acts as quite a powerful automatic stabilizer, since, when rising interest rates affect working capital in emerging countries with short contracts (Cavallo, 1977), the normal effect that increased interest rates have on aggregate demand is aggravated by the negative effect on the supply of goods, due to the greater difficulty of financing working capital. Delayed payments to government soften this effect – at the expense, of course, of aggravating the public sector's problems in obtaining credit in the context of a sudden stop.

Other vulnerability factors that were identified in the analysis of sudden stop events are: a poorly regulated and supervised banking system, excessive short-term bank deposits and loans, and fixed exchange rate regimes. Moreover, these factors may interact perversely, since, if financial assets are short-term, it is easier for investors to flee to higher quality at signs of weakness in the banking system. This generates a process of deleveraging that makes banks illiquid and leaves businesses without credit for investment or working capital. This latter factor tends to add supply problems to aggregate demand problems. Also, capital flight increases the likelihood that authorities will be forced to devalue the currency to protect constantly falling reserves. In a number of countries, this pattern of vulnerability factors ultimately provoked twin crises: exchange-rate and financial (Kaminsky and Reinhart, 1999). This type of crisis usually threatens the sustainability of public debt, since along with any effects that the real depreciation has on the real weight of the public debt—and in addition to the slump in economic activity, which reduces the denominator of the debt-GDP ratio—the public sector faces the problem of finding funds to shore up the financial system, at the same time as its revenue is reduced by the working capital effect mentioned above.

Since, in general, the public sector acts not only as a lender, but also as an insurer of last resort (see Fanelli, 2008), it follows that the combination of factors most threatening to the sustainability of the public debt is a highly dollar-indebted tradables sector combined with a closed economy, a weak banking system, short contracts, a fixed exchange rate and a public sector whose revenue is highly dependent on the non-tradables sector—precisely the factors that were so notably present when Argentina experienced the sudden stop of its recent crisis, and found itself in default. To a greater or lesser extent,

these factors were also present in other recent crises: in the Dominican Republic, where financial crisis led to a sharp increase in public debt (Fanelli and Guzmán, 2008); in Brazil, where increased interest rates, in an environment of political uncertainty as Lula Da Silva took office, led to a very significant increase in the public debt (cf. Blanchard, 2004); and in Chile in the 1980s, where it took several years to escape from a course of low debt sustainability, although this was eventually achieved with great success (Magendzo and Titelman, 2008).

The four lower boxes of diagram 1 show the imbalances induced by sudden stops. The slump in output, the lack of sustainability of the public debt, and financial crisis are the three most visible and important imbalances, but the distributive conflicts that inevitably accompany these phenomena and express themselves in the area of political economy must also be taken into account.

The sudden stop is an exceptional situation, and hence a good way of illustrating how imbalances create demands and constraints that change the fiscal space, and how their nature makes it essential to distinguish between countercyclical policies and adjustment policies associated with the two meanings of “stabilization” discussed above. To underline this fact, each of the four boxes representing the imbalances includes the primary fiscal deficit equation ($defgp^i$) with the superscript i added ($i = cd; cp; rf; sus$) to indicate that this is the deficit associated with the imbalance represented in the box. Asterisks have been added to some of the variables in the $defgp^i$ equation to indicate that the imbalance represented in the box affects this variable directly, apart from any controls and measures by fiscal authorities. This may reflect new demands (pressures for subsidies in the context of the imbalance), automatic responses (e.g., VAT, or postponed payment of taxes to finance working capital) or loss of an instrument because of the exceptional situation (rationing of credit).

The collapse of output box has an asterisk for the cyclical component of spending (g^c) and the collections component (t^c), which are affected by the terms of trade (ToT) and change in the gap between actual and potential output (gap). On the other hand, the discretionary components of spending (g^d) and taxation (t^d) are not necessarily affected by the shock. These effects determine the size of the slump in production deficit ($defgp^{cp}$). If public debt is available as an instrument, the placement of new debt will provide sufficient fiscal space to finance this deficit. If government has been following a constant structural deficit rule ($t^d - g^d = \text{constant}$) because it considered such a level of discretionality optimal, it presumably was not experiencing problems in obtaining financing to cover occasional increases in the cyclical deficit. This additional cyclical deficit is equal to ($g^c - t^c$). A sudden stop is not a stationary cyclical movement, but an exceptional event that produces a collapse. It is not a normal recession, and the size of the cyclical deficit to be financed will be very great.

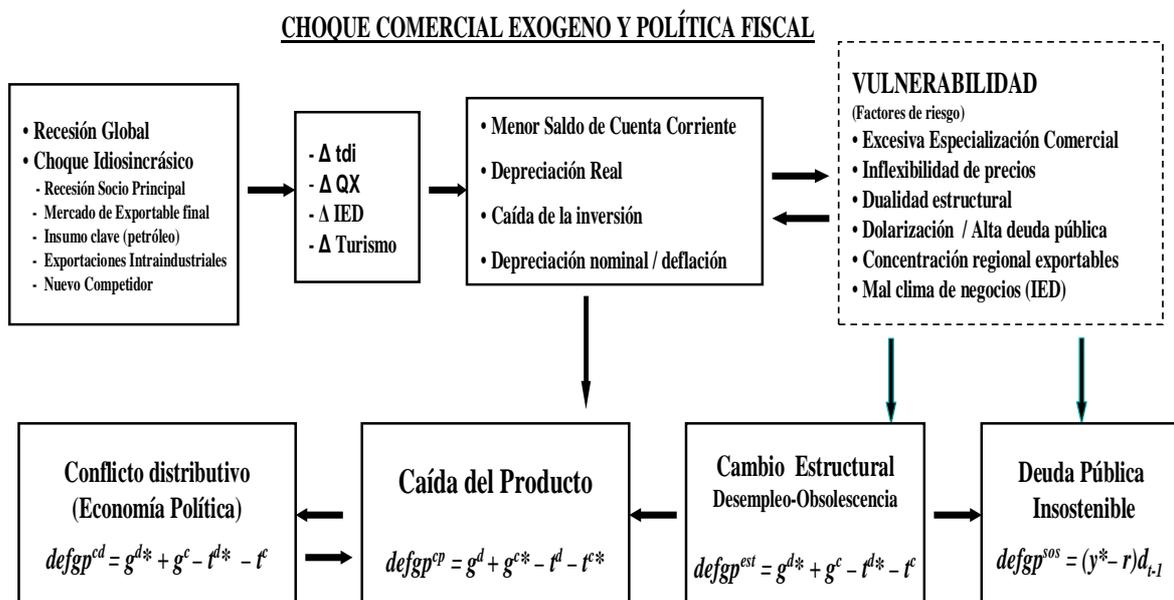
To this high cyclical deficit are added the political economy pressures associated with the collapse (as the box at the left indicates). Many pressures might be cited, but that will not be done here, since they depend in great measure on the political environment. Nevertheless, there is one that is highly relevant for the present purpose, concerning the relation between central and subnational governments. When the economy is subjected to a financial shock, subnational governments have more difficulty obtaining credit (if they are permitted to borrow) in a context of declining collections. Thus, they lobby for more transfers, and this affects the discretionary component of central government

spending (g^d), or the tax component (t^d) if there are demands to increase taxes in order to finance the transfers. Accordingly, asterisks have been placed on those variables. The political economy pressures lead to a deficit determined by the distributive conflict ($defgp^{cd}$) that such pressures create.

We now turn to imbalances of a financial nature. The two boxes at the lower right indicate that sudden stops produce instability in the banking system and can jeopardize the sustainability of the public debt. As a result, two objectives of stabilization policy will compete with countercyclical objectives: maintaining financial stability and ensuring the sustainability of the public debt. If financial imbalances destabilize the banks, a probable market reaction will be to ration credit for the public and private sectors. Thus, when there is instability in the banking system, government can, at most, generate a deficit of $defgp^{rf}$. This means that the maximum financing government can obtain will be determined by the amount of rationing imposed by the market. This amount will be equal to the difference between the net placements of public debt (Δdg) and interest payments on that debt (g^i), an amount that may even be negative. Since the loss of public debt placement as an instrument is a direct result of financial instability, these two latter variables appear with an asterisk in the banking instability box. Experience in the region indicates that the level of deficit $defgp^{rf}$ allowed by the financial restriction tends to be negative. In this way, an exceptional shock can endogenously and markedly reduce policy space.

In situations of financial instability, the public sector in general is forced to provide subsidies that are not necessarily budgeted, such as central bank rescue operations that will appear on the central bank's balance sheet, not on the government's. However, since investors assess the government's ability to pay as a whole, risk premiums may rise even if government adjusts the deficit to the availability of funds, and the cost of servicing the debt (r) will simultaneously rise, because of doubts regarding the sustainability of the debt once the central bank cost of the rescue is taken into account. Similarly, a collapse of output may lead to a reassessment of the capacity for long-term growth (y), which also affects sustainability. To reflect this fact, the last box at the right presents $defgp^{sos}$ as the maximum primary deficit permitted by the fact that the public debt-GDP ratio may not be greater than it was in the previous period (d_{t-1}). Since the sudden stop affects growth and interest rates independently, asterisks have been placed on the variables r and g . Revised market expectations regarding long-term growth and interest rates may ultimately put the debt in an unsustainable position regardless of governmental decisions. If the debt becomes unsustainable for these reasons, the objective of reversing the situation by increasing the primary surplus to the level required by $defgp^{sos}$ will compete strongly with the countercyclical objective. Fiscal adjustment policy to stabilize the debt will compete with countercyclical fiscal policy designed to stabilize the level of economic activity.

Diagram 2
EXOGENOUS TRADE SHOCKS AND FISCAL POLICY



Source: The authors.

Diagram 2 provides an overview of the imbalances and vulnerability factors associated with a trade shock.¹⁵ As may be seen in the upper right box, a variety of events can trigger a trade shock, and all have occurred in Latin America. In the current situation, however, global recession is clearly the cause. According to a recent IMF study (Terrones and others, 2009) on the developed countries, it is the consequences of this type of shock that tend to be most lasting and hardest to reverse. Diagram 2 also shows that the global recession can be felt in different ways: worsening terms of trade, declining export volumes, decreased remittances, a drop in tourism and declining foreign investment, especially in countries where free zone exports play an important role. All of these effects are present today. The terms of trade effect is particularly important in South America. In other subregions, such as Central America and the Caribbean, the falling price of oil is having a positive effect on the smallest countries, which are net importers.

In terms of macroeconomic imbalances, the effects are similar to those of a sudden stop. However, this observational equivalence hides differences that are significant for our present purpose, principally because the relevant vulnerability factors are not necessarily the same, and because the effects on the fiscal variables, and hence on the policy space, are different.

The upper right box in diagram 2 shows the risk factors that determine vulnerability. Although some of the macroeconomic vulnerability factors are shared by the two types of shock—e.g., dollarization and high public debt—the real factors are more important in the case of a trade shock. Economies that specialize excessively in a few products, as

¹⁵ On trade shocks, see Terrones and others (2009), Funke and others (2008), ECLAC (2008a) and Pineda and others (2009).

is the case of most of Latin America's economies, are particularly vulnerable macroeconomically, both to terms of trade shocks and to external demand in general. In a shock of this type, macroeconomic adjustment tends to require very significant changes in relative prices. Thus, price inflexibility is a second risk factor, particularly important in economies with fixed or dollarized exchange rates. Structural duality is also a vulnerability factor that impedes rapid adjustment in response to a shock. For example, if there is a very large difference in productivity between export sectors and traditional sectors, it will be difficult for an exchange rate correction alone to increase the production of tradable goods. Adjustment is also difficult when the production of exportable goods is regionally very concentrated, and when there are strong political economy pressures to avoid the adjustment.

As for the case of sudden stop, the four lower boxes of diagram 2 show the most important macroeconomic imbalances associated with trade shock, and each box shows the $defgp^i$ corresponding to the particular imbalance involved. Variables that tend to move independently are marked with asterisks. Note, however, that although the effects on the primary surplus may operate through the same variables as they do in sudden stops (the asterisk appears on the same variable), the form in which this occurs may be very different, and thus the stabilization policies required may differ. As diagram 2 shows, three imbalances of major importance that are also present in the sudden stop scenario are declining output, debt sustainability problems and the imbalances associated with distributive conflict. A fourth important source of imbalances, characteristic of high-intensity trade shocks, is the structural change normally provoked by shocks with these features.

The structural change box has asterisks for spending and discretionary taxes, since such change tends to create specific demands for subsidies and tax exemptions on the part of the sectors affected by the trade shock. From a more positive perspective, public investment in infrastructure and human capital also tends to be necessary as part of the effort to adapt the country's trade specialization profile to the new circumstances. This is most applicable if the effects are highly concentrated regionally or sectorally. These pressures determine a level of deficit $defgp^{est}$. In their effects relating to pressure for discretionary policies, structural changes are similar to the demands that arise in distributive conflicts in general. However, the latter are broad, and are mutually reinforcing because of changes in relative prices, which usually aggravate the problem of poverty and income distribution that is structural in the region. Thus, after a severe trade shock, there will be a deficit associated with the distributive conflict ($defg^{cd}$), and it may be very sizable. The features of the current crisis suggest that the demand for policies to mitigate its social effects will be in the spotlight in the near future.

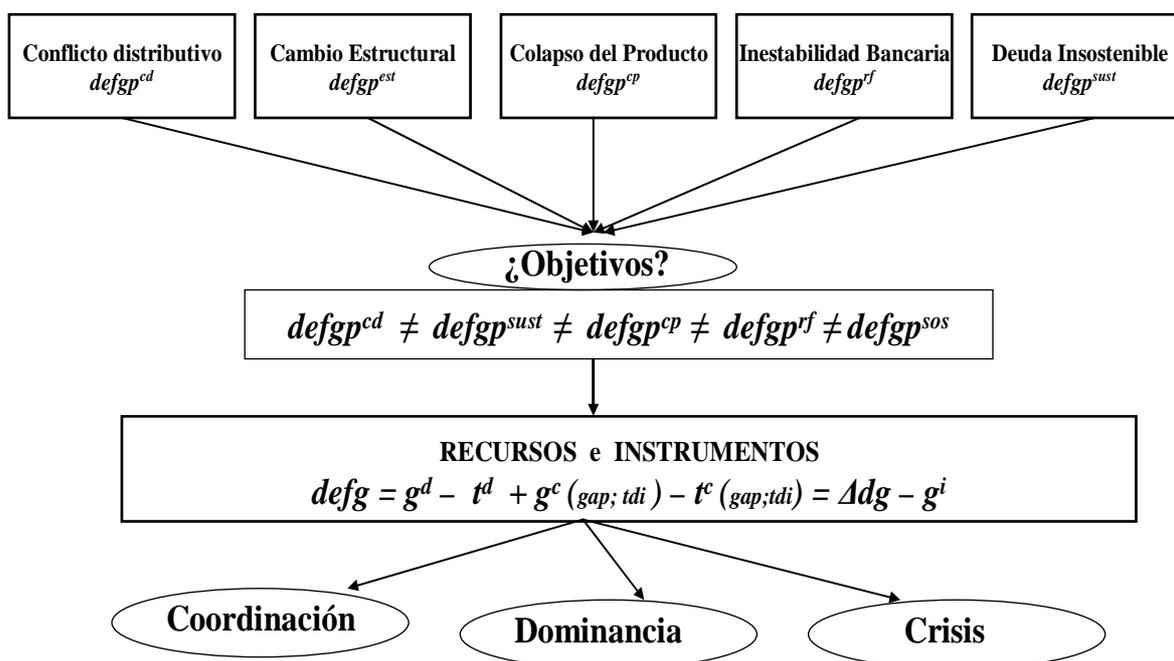
In the financial area, two realities that differ from those of the sudden stop scenario have important consequences for the fiscal policy space. The first is that a trade shock does not destabilize the banking system, for this occurs only in cases where the banking system is in a vulnerable situation that is further aggravated by the illiquidity created by the shock. Therefore, the box for banking instability does not appear in this diagram. A benign financial scenario can be a very positive factor in increasing policy space to stabilize the economy after a trade shock. In principle, a country with a good credit history can obtain financing to maintain its level of economic activity and thus prevent a collapse in the growth rate. This means that, depending on the circumstances, the net financing variable ($\Delta dg - g^i$) may or may not have an asterisk. In any case, access to

credit today is very limited due to the sudden stop, and credit can only be relied upon from the multilateral institutions. Even in a less adverse financial situation, a large trade shock may affect the sustainability of the public debt. In particular, if the shock is very strong and judged to be of lasting effect, sustainability will be affected by the expected decline in the economy's growth rate. As a result, the y variable in the equation for the maximum primary deficit compatible with a constant debt appears with an asterisk here. Whether the r variable will have an asterisk or not depends on the course of the financial factors already cited.

B. Exogenous shocks, policy space and coordination

The stylized facts analysed here show that a great diversity of elements independently affect government's primary deficit in situations of trade shocks and sudden stops. The facts also indicate that only by chance will the primary deficit levels compatible with the state of the cycle ($defg^{cp}$), the distributive conflicts ($defg^{cd}$), the sustainability of the public debt ($defg^{sos}$), the structural change ($defg^{est}$) and financial stability ($defg^{rf}$) be equal. If this occurs, the scarcity of funds and instruments would force a choice of priorities regarding objectives (and, accordingly, as to the amount of the primary deficit). The process of establishing priorities among objectives and allocating the use of scarce instruments among different policies requires a significant degree of coordination. Moreover, to be successful, policy coordination requires that incentives for the agents that will be responsible for implementing the policies in a decentralized fashion be in line with the objectives. This is difficult to achieve when decentralized agents have very different amounts of political power, and are able to act for their own interests and objectives, or can make use of instruments that were reserved for other policies. When this occurs, some policies prevail over others, leading to failures in the coordination sought by the central government. Worse yet, when power is highly dispersed, lack of coordination can lead to a fiscal crisis that prevents the government from taking initiatives to stabilize the economy, thus aggravating the effects of the shock. Diagram 3 presents a stylized view of the relation among shocks, imbalances and coordination.

Diagram 3
IMBALANCES AND POLICY COORDINATION



Source: The authors.

Diagram 3 underlines three points. The first is the fact, already cited, that each type of imbalance affects the government budget differently, and creates a need to define objectives and assign instruments so as to define a unique value for the primary fiscal surplus, which appears in the central box. The second point is that rules established beforehand for the use of funds and instruments will not necessarily be practiced during the actual event. This will depend on government's capacity to coordinate policy. The lower part of the diagram shows that, based on that capacity, the three possible results are coordination, policy predominance and crisis. In principle, the coordinated result should be the best, although it is not difficult to conceive of situations in which policy predominance could work effectively. The problem with the predominance scenario is that it is never clear whether it is, in fact, the objectives of the executive branch that ultimately prevail, rather than those of society at large. The crisis case is worse yet, because in such cases the situation is over-determined, and the final result of inconsistently applied measures will be indeterminate.

Naturally, the greater the existing policy space, the greater will be the ability to coordinate policy. As has been pointed out, however, the policy space is not invariable with respect to the type and size of shock and the economy's vulnerability to it. It is to be expected, therefore, that the greater the perturbation, the more competition there will be among policies, both in terms of appropriation of available resources and in terms of the use of scarce instruments. Below, it will be seen how the fiscal space is changed, and the types of coordination problems that appear in the context of the two types of shocks being examined.

As noted, during a sudden stop episode, the authorities have less resources they can allocate to stabilize the economy. In particular, the combination of a slump in output

with a reversal of capital flows is extremely difficult to manage. In these cases, external financing disappears precisely when tax revenues are diminishing. Resources must be allocated to sustain the banking system, and the amount of interest that must be paid on the public debt tends to increase. The latter is particularly true when short-term debt constitutes a high proportion of total public debt, making it necessary to refinance major maturities in a context of increasing risk premiums, as occurred in Brazil at the beginning of the 2000 decade (Blanchard, 2004) and in Argentina in the period that began in 1999 (Fanelli, 2008).

As to the amount of competition between different objectives, sudden stops tend to create significant dilemmas: the goal of softening the collapse of output is pitted against other objectives, such as stabilising the banking system to revitalize credit, ensuring a minimum of liquidity to protect the settlements system, ensuring the sustainability of the public debt, providing incentives for the competitiveness of the tradables sector, and cushioning the effects of the crisis on the poorest segments of the population. Case studies and episode studies provide evidence of how, in practice, the authorities resolve these conflicts between countercyclical policy and adjustment policy, designed to prevent the economy from embarking on a dangerous course. Specifically, given the need to increase the deficit in order to stabilize aggregate demand and bring it to the $defgp^{cp}$ level, while at the same time ensuring the sustainability of the debt by generating a deficit equal to $defgp^{sos}$, the second objective tends to prevail. When funds are needed to sustain the banking system, resources to stimulate the economy are pulled back. Thus, financial stabilization and public debt policy tend to prevail over the stabilization of aggregate demand. This predominance is not necessarily present in cases where the intensification of the financial constraints does not reach the level of a sudden stop, when neither financial stability nor debt sustainability is jeopardized, and when government can therefore finance a countercyclical deficit. If the shock does not eliminate financing as an instrument, government can implement a level of deficit equal to $defgp^{cp}$, thus regaining its ability to adopt countercyclical policy. This level of deficit does not necessarily entail discretionary measures. The current deficit may be compatible with a constant structural surplus rule.

In the case of financial shocks, the ambiguity of the term *stabilization* tends to become evident. If the financial shock takes the form of a sudden stop, debt markets close down, production collapses and interest rates increase significantly. If, as a consequence, the public debt becomes unsustainable, stabilization will mean implementing anti-crisis policies to keep the public debt, and hence the economy, from taking a dangerous course, even at the expense of deepening the collapse in production. If, on the other hand, the financial shock does not become a sudden stop, and only takes the form of increased cost for short-term financing in public debt markets, then to “stabilize” will involve acting countercyclically to soften the decline in production, even at the cost of increasing the deficit and the public debt. This distinction between adjustment policy and countercyclical policy is useful as an illustration of the fact that the size of the available fiscal space is not independent of the type of shock occurring. In the case of fiscal measures to stabilize the economy after a sudden stop, it is by no means correct to state that the discretionary decisions of the authorities were procyclical. Rather, one must recognize that the policy of shoring up the banks or the public debt, or both, takes precedence over the objective of stabilising production, notwithstanding pressure from other parts of the public sector for coordinated action to mitigate the effects of the shock on the productive structure and on vulnerable sectors of the society.

This only reconfirms the point made by Tobin (1999) and Togo (2007), namely, that failures of the market intensify a lack of policy instruments. Here, we put forward a corollary to that argument: if the sudden stop aggravates the failures of the market, eliminating the public debt market through rationing, it is logical that this should intensify the scarcity of instruments. And if this is the case, it is also logical to suppose that the size of the policy space is not invariable with respect to the shocks. From this perspective, it is not appropriate to measure the procyclicality of fiscal policy econometrically, assuming that the space, and hence the degree of freedom to make discretionary decisions, remains constant over time and is independent of the type of shock affecting the economy.

In reality, a sudden stop can significantly change the size of the fiscal space by reducing the number of policy instruments. Due to market failures, different policies tend to compete to use the same channels to influence objectives. This effect, which Tobin (1999) has dubbed the “common funnel”, produces correlations among the instruments, and this reduces the possibility of having a sufficient number of instruments to meet the policy objectives. For example, central banks are generally expected to use the domestic short-term bond market to carry out monetary policy, and in the absence of a domestic long-term bond market treasuries are expected to finance the fiscal deficit in external foreign markets, so as to prevent fiscal policy from interacting with monetary policy. When a sudden stop closes the markets, however, the treasury is forced to resort to domestic short-term markets. This leads to the common funnel effect: while the central bank intervenes in the market to meet inflation objectives, the treasury seeks to finance the deficit that arises from the countercyclical or adjustment objectives. Another common case of competition for use of instruments occurs when balancing the budget requires a marked nominal depreciation, but the central bank is fearful of floating the exchange rate because of the need to maintain banking stability, and postpones the depreciation by sterilization operations. (On this type of problem, see Kaminsky and others, 2004). In this case, the exchange-rate instrument cannot meet two objectives simultaneously, and the result tends to be procyclical reductions in spending to prevent greater depreciation. If the central bank is hesitant to float the exchange rate and the treasury hesitates to implement adjustments, the result will be a failure of coordination that will lead, first, to a rapid loss of reserves, and then to a disorderly depreciation and problems of public debt sustainability. This is aggravated when the exchange rate is unavailable as an instrument, as is the case with fixed exchange-rate regimes.

The stylized facts relating to exogenous trade shocks suggest that the effect of these shocks on the size of the fiscal space can be as great as that of sudden stops. However, because of the differences in the macroeconomic adjustment dynamics and the vulnerability factors mentioned above, the problems of stabilization and competition between policies for use of the fiscal space also differ. One important point is that the effect of sudden stops on the fiscal space takes the form, above all, of financial constraints, while trade shocks primarily affect resources for formulating fiscal stabilization policy. In addition, the specific form in which this occurs is highly dependent on the structure of the economy.

One paradigmatic case is variations in resources induced by terms of trade shocks. There are three possible scenarios: (a) countries where the public sector owns a significant proportion of the natural resources (e.g., copper in Chile, or oil in Mexico and in the

Bolivarian Republic of Venezuela); (b) countries that tax exports, such as Argentina; and (c) economies that subsidize energy consumption, such as the Dominican Republic. While negative shocks from natural resources prices reduce resources in the former two cases, they increase them in the third. This differential effect is important for the countercyclical policy space. In the case of governments whose revenues are positively correlated with natural resources prices, the policy space moves procyclically in relation to the global cycle. When the global economy slows down, the funds available for countercyclical policy also diminish, and it becomes more difficult to obtain external credit since, as Caballero (2000) points out, when international prices fall, the value of debt collateral follows suit. These facts have two implications. First, in defining the relationship between the cyclical and structural deficits it is essential to take into account not only the gap in output but the terms of trade. Second, even when a government is sufficiently solvent to make debt payments, a trade shock can create serious short-term liquidity problems as the value of collateral drops.

When there is a trade shock without a sudden stop, the government's resources diminish, but the option of borrowing does not. If the trade shock is transitory, the government has more possibility of implementing countercyclical policy and financing a larger fiscal deficit. It is also probable that the increased demands for assistance by sectors suffering from the shock will be addressed to a greater degree, and that pressure from distributive conflicts will be correspondingly reduced. This possibility shrinks considerably when the sustainability of the debt is in doubt. In fact, if sustainability is not a problem, the groups affected by a shock may exert very strong pressure—not only because they enjoy political representation, but because if they perceive that the government has some room for countercyclical policy they will exert pressure for discretionary initiatives to soften the external shock.. In reality, when there is room for countercyclical policy and sectoral pressures are strong, such that the deficit required to satisfy these demands ($defg^{cd}$) is high, the central issue is preventing the realization of such a deficit from ultimately jeopardising the sustainability of the debt. In such situations, a structural deficit rule can be a great help, because it is a functional instrument for rationalising discretionary spending. The government may argue that although it is capable of making and funding countercyclical policy, the primary deficit should not be far from the amount of the cyclical deficit ($defgp^{cp}$). Obviously, it can also invoke the argument that an excessive increase of the deficit in a context where the value of collateral has fallen as a consequence of the shock could put the government in a position of illiquidity. This second argument, however, will probably carry less weight in the political arena. Since structural deficit and liquidity management policy is invoked to ensure the sustainability of the debt and satisfy the demands for discretionary spending coming from the most vulnerable sectors and from domestic producers, it is not surprising that the technical need to better coordinate adjustment and countercyclical policy becomes, in the political arena, a struggle between national interests and producers on one hand, and domestic rent-seekers and global financial capitalism on the other. Nevertheless, political economy issues prevail over the objective of this task. The point being put forth here is that distributive conflicts have a role in determining how problems of policy dominance are resolved, and also, therefore, in determining the size of the policy space.

Trade shocks are not always negative, and thus in good times, government resources increase significantly, especially in countries where the State receives some of the profit from natural resources. Jiménez and Tromben (2006) analyse this issue in Latin America and show that the magnitude of the increase can be very significant. In these cases, the

best option seems to be to accumulate a sovereign fund in good times, which can be used to finance initiatives that soften the effects of adverse situations. Accordingly, thinking regarding the fiscal space should have a significant intertemporal dimension. The example of Chile, which is the country in the region that has advanced furthest on this path, suggests that better intertemporal distribution of resources could contribute to structurally increasing the fiscal stabilization space. One particularly important effect would be a contribution to mitigating the impact of financial constraints in bad times, and thus preventing adjustment policies from prevailing over countercyclical ones. At the same time, we have seen that one stylized fact of Latin American macroeconomics is that consumption is highly volatile, and this is particularly detrimental to the most vulnerable sectors. It follows that more stable consumption levels could significantly improve wellbeing (ECLAC, 2008a).

However, it should be emphasized that creating a fund of this sort does not obviate the need for policy coordination, since such funds could have negative side effects in countries exposed to sudden stops and procyclical capital flows. The existence of such a fund could ultimately create incentives to take financial risks in good times, if it is clear that it will always be possible to flee to quality in bad times. Thus, the creation of a stabilization fund must be accompanied by appropriate financial regulations to prevent this. Appropriate economic policy must also complement the existence of the fund. New governments will always be tempted to draw on accumulated resources to increase discretionary spending. However, Latin America has progressed in its macroeconomic management during the goods times that ended with the high-risk mortgage crisis, which suggests that it may in the future be in a position to address the complex tasks involved in structural enlargement of the fiscal space.

V. Final remarks

Viewing the region's situation from the perspective of the analysis set forth here, an abnormally sharp recession induced by trade shocks or sudden stops, or both, is a very concrete threat. As regards financial imbalances and public debt sustainability, the situation for the time being appears better than it was during other episodes of contagion, such as those of 1998-2002 (cf. Bárcena and others, 2009). There is little room for optimism, however, since the constraints already operating have been sufficient to create major recessive forces, and financial balances seem to be occurring in a razor's-edge context. In reality, the fact that the financial toll has been less severe in the current crisis than in the last episode of contagion could have to do with the hypothesis put forward at the beginning of the crisis regarding Latin America's decoupling. The hope at that time was that progress in controlling the risk factors that determine vulnerability—accumulation of international reserves, reduction of public debt levels and de-dollarization of liabilities—had driven an effective decoupling process. Some progress had also been made in controlling the weaknesses of the financial system—though to certain countries these were not a problem, simply because their lack of financial development prevented over-leveraging. Despite these advances, however, the decoupling did not materialize. As we have seen, capital flows flagged, a number of countries were obliged to use their reserves, and the level of economic activity has been falling. A view of this situation appears in table 4, which shows the distance that separates the region's largest economies from an exceptional trade shock or sudden stop, or a simultaneous occurrence of both.

Table 4
LATIN AMERICA (7 COUNTRIES): DISTANCE FROM A TRADE SHOCK OR
SUDDEN STOP
(Percentages)

| | Distancia al crash de comercio ⁽¹⁾ | Distancia al sudden stop ⁽²⁾ |
|-----------|--|--|
| Argentina | 6,90 | 39,11 |
| Brasil | 55,21 | -159,21 |
| Chile | -11,83 | 97,05 |
| México | -127,54 | n.a. ⁽⁴⁾ |
| Perú | -85,60 | -5,43 |
| Venezuela | -293,96 | 39,1 ⁽³⁾ |
| Colombia | -25,78 | n.a. ⁽⁴⁾ |

Notas: (1) Toma como referencia el trimestre 11-08/01-09;

(2) toma como referencia el 4T de 2008;

(3) corresponde al 3T de 2008; (4) no registra salida de capitales

Source: Prepared by the authors, on the basis of figures provided by the Economic Commission for Latin America and the Caribbean (ECLAC).

These figures represent percentages of the deviation required before the shock would be considered exceptional. A positive number represents the percentage of the deviation that remains before that point. For example, Argentina is closer to a trade slump than is Brazil. Negative numbers mean that the economy has already travelled further than the threshold level, and is in fact suffering from the shock. As may be seen, this yardstick shows Chile, Colombia, Mexico, Peru and the Bolivarian Republic of Venezuela to be suffering from a trade shock, and Argentina very close. Although Brazil seems better protected, it is experiencing the effects of a sudden stop, as is Peru. Naturally, this evidence should be considered cautiously, since the figures are subject to change.

It emerges from this analysis that fiscal policy spaces are not invariant, and, more important, that they are sensitive to pre-shock behaviour and tend to undergo significant changes with large shocks. There is no doubt that the current shocks have reduced fiscal policy space and will create challenging dilemmas by increasing competition between policies for existing resources and instruments. Thus, the ability of the States to coordinate policy will depend critically on factors such as the organization of the public sector and the effectiveness of the bureaucracy and institutions in managing conflicts in reduced spaces. For example, it will be more difficult to coordinate policy in decentralized countries where subnational governments have a great deal of political weight, or where there is more demand for job or social assistance policies. Moreover, as

is well-known, the proper use of resources and policy instruments depends on the quality of the bureaucracy and the credibility of institutions.

One point to underline is that, above all, the sudden stop puts forces in motion that tend to restrict the fiscal space precisely when the authorities most need it. In this sense, the fiscal space behaves procyclically: it shrinks with negative shocks, and increases once capital movements recover and the sudden stop episode is past. Therefore, it is crucial to create incentives to increase the fiscal space in boom times. One question confronting fiscal stabilization policy is: what factor can reverse the conditions that come together to create a sudden stop? This is a key element in deciding where to focus fiscal efforts in a situation of very limited policy spaces and exceptional shocks. Although it is beyond the scope of the present paper to explore this question, the authors believe that the distinction made here between the different meanings of “stabilization” in relation to fiscal policy is central, as are the distinctions between adjustment policy, countercyclical policy and anti-crisis policy. One example will suffice to illustrate the complexity of the dilemmas involved.

The stylized facts discussed here underline the importance of changes in governance (regulations, ownership, contracts) that lead to a crisis, and the way in which this creates a need for higher private-sector profitability to compensate for institutional risk (i.e., a poor business climate). Escaping the exceptional recession trap requires exceptional increases in profitability. In Latin America, such windfall profits generally appear after sharp currency depreciations in the wake of shocks. Depreciation works to reduce real wages and the cost of non-tradable inputs for the tradables sector. Although the decline in non-tradable sector wages and income can intensify recession in the short term, the recovery of profits in the tradable sector is crucial for reversing the negative expectations of some key investors in the case of a slump in production. Thus, the reversal of profit expectations in the short term tends to be more important in the export sector than in the import substitution sector, due to the presence of low domestic demand. In Latin America, the traps are most often escaped in this way, when the tradables sector succeeds in regaining its profitability. When this recovery is insufficient, as it was in the lost decade of the 1980s, where the international situation provided no help, recessions are prolonged and economies remain caught in the trap.

Since many governments in Latin America represent a good portion of the tradables sector, and tradables are a key factor in the recession/expansion dynamic, it is surprising that the literature on fiscal affairs, which attempts to assess the cyclical behaviour of the public sector, devotes so little attention to this point. For example, States whose revenues are linked to natural resources typically confront the dilemma of whether to depreciate the currency to re-establish debt sustainability and obtain resources in a situation of rationed credit, or avoid depreciation in order to protect wages and the level of economic activity in the short term. Thus, for example, a sudden stop poses the dilemma of whether to re-route what is probably a dangerous course, in terms of debt, by generating a primary surplus, or to implement countercyclical policy in the traditional sense. In light of these facts, it is hardly surprising that one should often see recovery of the fiscal surplus precede an economy's escape from productive collapse in Latin America. By ensuring the sustainability of the debt through depreciation, the public sector simultaneously restores the profitability of the tradables sector, and reduces the likelihood that property rights will be violated as a result of the public sector finding itself without funds. Thus, acting countercyclically in the short term succeeds in

stabilising the economy. It is clear that, as a recession deepens, the economy becomes unstable, then stabilizes either by avoiding a depression trap or by ensuring that the public debt does not embark on a dangerous course—or both simultaneously. Once the private sector's perception that the State is likely to appropriate profits subsidies, investment increases sharply and begins, along with exports, to help pull the economy out of the trap. In the new environment, fiscal policy space expands, and government is likely to be pressured into compensating those who were losers in the crisis. One must, of course, take account of the fact that the perceptions of private interest groups, as to the latitude that the public sector has available to meet their demands, also changes with the cycle, and may vary procyclically.

If the current situation is viewed from this perspective, the most serious problem is the fact that a sudden stop is coinciding with a trade shock generated by global recession. Under these conditions, it appears unlikely that exports will provide the traction that the economy needs. Thus, although the tradables sector must not be neglected, all available credit margin must be used to prevent a deepening of the cycle. If the recession worsens, international trade cannot be relied upon to avert the recession trap. In such situations, countercyclical financing from international institutions is essential.

The analysis here shows that the diagnosis and cure in situations where procyclical fiscal decisions are discretionary and politically autonomous must differ from what is called for in situations where procyclical discretionary initiatives are designed to adjust the needs to the funds available, or to serve the imperative of protecting the sustainability of the public debt. When the decisions are autonomous, the problem is one of political economy, but when financial constraints compel decisions, the problem becomes the lack of instruments, in conditions that intensify failures of the financial markets. It is in the latter case that the assistance of international institutions is most important. Greater access to credit, with funds and instruments being provided at a critical moment, can temper the financial constraints and expand the countercyclical fiscal policy space, reducing the need for excessively severe adjustment policies. If the problem is one of political economy, and the need for adjustment derives from excessive spending, it becomes more likely that the new resources will be used ineffectively. Since it is clear that the sudden stop we are seeing today is exogenous, and originated in the developed world, the increased availability of multilateral funding will be of great assistance. External support makes even more sense considering that the combination of sudden stop and trade shock aggravates failures of the market, generating an endogenous and procyclical contraction of the policy space.

Currently, major efforts are being made to adapt the international financial architecture to the needs of the moment. In this context, the recapitalization of the IMF, the greater role of the emerging countries via the G-20, and the reformed Financial Stability Forum are auspicious signs. Nevertheless, a long road remains to be travelled. For example, little progress has been made in articulating multilateral initiatives with regional ones along the lines suggested by Ocampo (2008) and Park (2008). From a Latin American perspective, it seems obvious that the region should make use of institutional structures and draw on successful experiences of collaboration (e.g., the Latin American Reserve Fund) to test regional responses to global problems.

From the perspective of the analysis presented here, it is clear that one of the central issues requiring further thought is the relationship between international efforts and the

national policies that accompany them. What should the content of these policies be, and how can they best be coordinated with international efforts? It is in the interest of the global economy to prevent the recession in Latin America from deepening to a point that the decline in the region's exports aggravates a similar decline in the rest of the world. One key challenge for fiscal policy in Latin America is to update the content of policies to take account of findings on volatility and on the current exceptional trade and international finance situation. However, examining the content of anti-volatility policies only makes sense if government has sufficient space (funds and instruments) to formulate macroeconomic policy and coordinate it with other policy areas.