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Fiscal stimulus for debt intolerant countries?

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What began as the subprime crisis in the United States during the summer of 2007 and morphed into a global financial crisis in the other advanced economies of the “North” has led to unprecedented fiscal stimulus efforts worldwide. The “North,” including the United States, Ireland, the United Kingdom, Spain, Switzerland, and Japan, needed stimulus because banking crises are usually accompanied by severe and protracted recessions and rising unemployment. The “South” sought to stimulate domestic demand by fiscal means in the face of collapsing exports, as available financing from global capital markets dried up in a “sudden stop” as predicted by Guillermo Calvo.

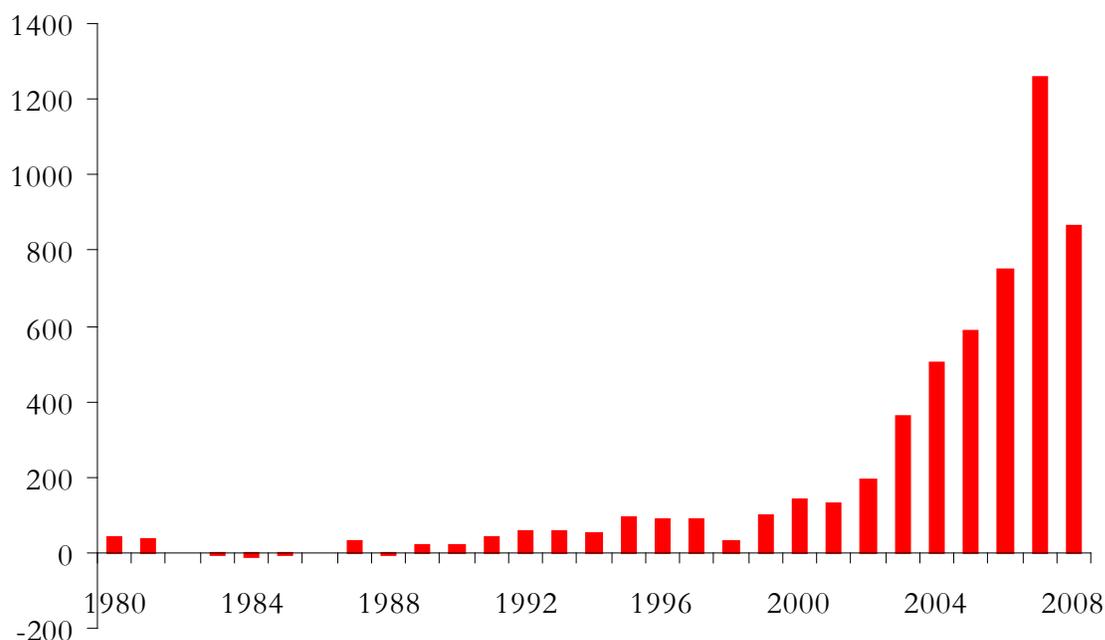
Emerging markets on the eve of the sub-prime shock

Fortunately for many emerging markets, this synchronous export and financing shock from the North came at a time where vast war chests of international reserves had been built over the “bonanza” years (Figure 1). Reserve managers learned the lesson of the Asian Crisis that when times get tough, the advanced economies look inward and the first line of defense in their own resources. In the fat years, commodity prices were booming, growth in the North was buoyant, international interest rates were low and stable, and international capital was plentiful. In such an environment, fiscal positions in many emerging markets improved markedly. Public debt levels had been stabilized, or even reduced, and many countries had substituted public external debt with domestic debt and lengthened the maturities of their outstanding debt.

If the adverse shock to the North had been a short-lived reduction in financing, as many observers believed at the time, emerging markets would have been well-placed to cope with the shock. A combination of currency depreciation (now possible owing to more flexible exchange rate arrangements) and some international reserve losses would seem to fit the bill. In addition, a short-lived fiscal response that entailed increasing government expenditures for a limited period of time did not seem to carry substantive risks to debt sustainability.

Figure 1. Accumulation of International Reserves by Emerging Market and Developing Economies, 1980-2008

Billions of U.S. dollars



Source: Reinhart and Reinhart (2008).

Such optimism proved to be misplaced in three important dimensions. *Firstly*, as the Inter-American Bank Development Bank (2008) report entitled *All That Glitters May Not Be Gold: Assessing Latin America's Recent Macroeconomic Performance* aptly emphasized, fiscal finances and external accounts were not as healthy as these appeared to be on the surface, once

accounting for the commodity price boom. *Secondly*, Reinhart and Rogoff (2008) argued that relying on public domestic debt was no panacea. Such domestic debts (often ignored in the literature and economic policy discussions) had historically often been defaulted on either outright or through unexpectedly high inflation. Furthermore, during the bonanza phase that ended in 2007, private debts (both domestic and external) had also been rising markedly in emerging markets. As crisis episode after crisis episode has consistently shown, private debts turn out to be contingent government liabilities. *Thirdly*, at the time of this writing, we are now two years after the onset of the crisis, with effects continuing to linger (even if recovery is at hand), which implies that this episode hardly classifies as fleeting shock as far as market participants, households, or policymakers are concerned.

Response to the crisis: Fiscal stimulus, North and South

Led by the United States, fiscal stimulus packages in various guises and magnitudes found favor in both advanced and emerging economies. By January 2009, the *Global Economic Monitor*, published by Institute for International Finance, detailed the packages either adopted or planned in about 20 advanced and emerging market economies, including China, Korea, Mexico, and Saudi Arabia. Less than two months later, the list of countries had expanded to include Russia and Turkey, among others.¹ The International Monetary Fund, both famous and infamous for advocating fiscal austerity packages in response to financial crises around the globe since its inception in 1945, began to advocate a “possible strategy whereby fiscal policy can foster the resumption of normal economic growth while maintaining public sector solvency.”²

To be sure, avoiding the acute fiscal policy procyclicality that has plagued most emerging markets for decades is, indeed, progress. As Kaminsky Reinhart and Vegh (2003) document,

¹ See Prasad and Sorkin (2009).

² See Cotarelli in the IMF’s March 2009 *Finance and Development* issue.

during 1965-2003 the most prevalent pattern in emerging markets during recessions (in contrast to their OECD counterparts) was sharp reductions in real discretionary fiscal spending. It is difficult to imagine that this would not help account for the greater volatility evident in emerging market output.

Fashions and fundamentals

Fashions are hard to resist, and it is now fashionable in much of the North to rely on a fiscal engine of growth. As for emerging markets, however, boosting spending at a time in which revenues are contracting or, in many cases, collapsing for an uncertain period of time is an more complicated matter.³ Policymakers would do well to keep four risks in mind.

1. Fiscal multipliers: North and South

Although there is little consensus in academic and policy circles as to point estimates, the discussion of fiscal multipliers in most OECD countries is at least informed by existing analytical and empirical studies. For emerging markets as a whole, however, it is fair to state that a comparable literature does not exist. Obviously, one can anticipate from the few reliable case studies that are available that the cross-country variation is bound to be substantial. Thus, any statement about fiscal multipliers for emerging markets (and developing countries) as a class has to be interpreted with care.

In the regard, there has been especially timely recent work by Ilzetki, Mendoza, and Vegh (2009), who calculate such multipliers for advanced high-income economies, emerging markets (middle income) and developing countries (low income) using quarterly data. Their analysis suggests that: (i) the fiscal multiplier on impact is larger for developing and emerging market countries than for the advanced high-income countries; (ii) the opposite is true for the peak

³ This is not intended to underestimate the difficulty and (usually) controversy of undertaking any kind of change in fiscal policy in the advanced economies.

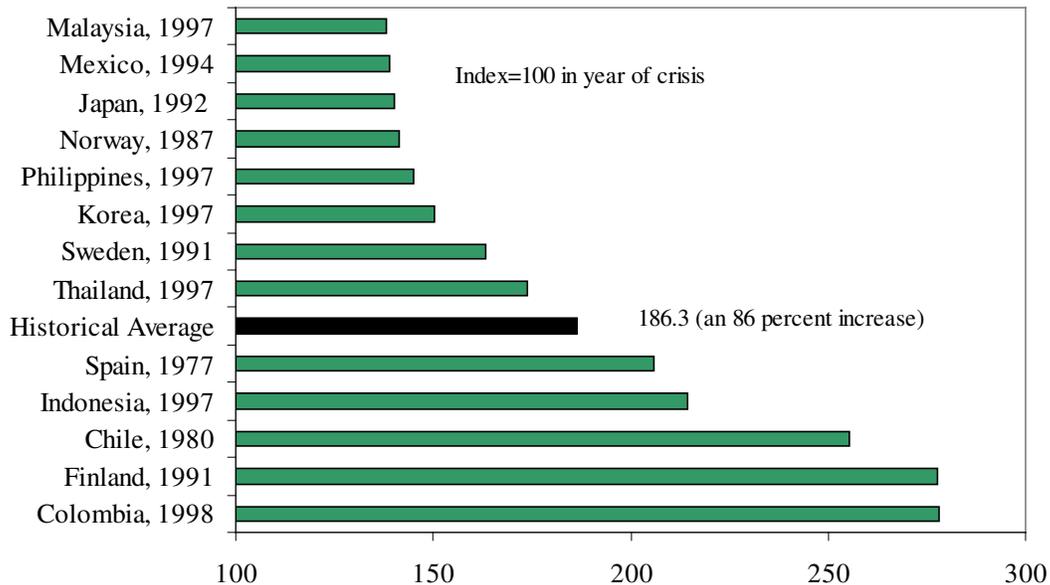
multiplier; (iii) and the cumulative multipliers are far smaller for emerging markets than for advanced economies, as the positive impact of fiscal spending on GDP dies out fairly quickly.

2. Emerging markets and global crowding out

Figure 2 highlights that public debt typically explodes in the years following a systemic financial crisis; on average, it nearly doubles three years after the crisis. Recessions lead to major revenue losses and fiscal spending expands, as the bailout of the banking sector proves costly and stimulus packages find favor. With severe banking crises, deep recessions, or a combination of the two in the world's largest economies simultaneously, international financing for emerging markets is likely to be far scarcer than during the bonanza years before 2007. Financing budget deficits will not be easy or cheap.

It is noteworthy that the last time the world experienced a crisis of the proportions of the present one (that is, the Great Depression), governments in the advanced economies were able to continue borrowing (Figure 3) as recovery remained elusive for nearly a decade. Debt rises by 44 percent in the first three years and by another 40 percent during years four through six. By contrast, the public debt of emerging markets remained frozen after the third year. This was not the result of rebounding revenues balancing the budget--in a number of cases it was the result of sovereign defaults.

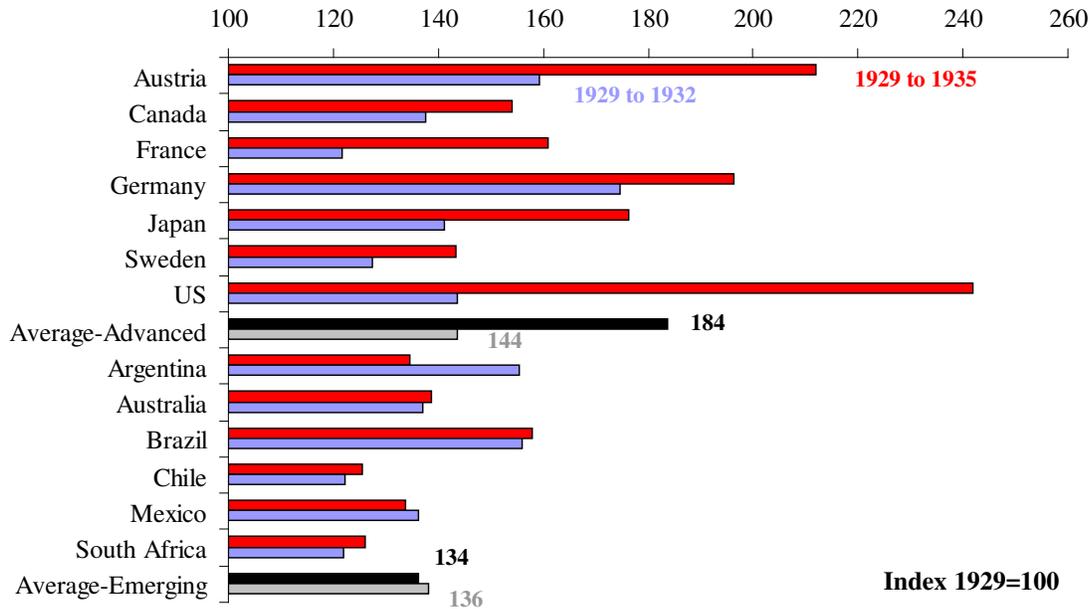
Figure 2. Cumulative increase in real public debt in the three years following the banking crisis



Source: Reinhart and Rogoff (2009).

Notes: Each banking crisis episode is identified by country and the beginning year of the crisis. Only major (systemic) banking crisis episodes are included, subject to data limitations. The historical average reported does not include ongoing crisis episodes, which are omitted altogether, as these crises begin in 2007 or later, and debt stock comparison here is with three years after the beginning of the banking crisis.

Figure 3. Cumulative increase in real public debt three and six years following the onset of the Great Depression in 1929: Selected countries



Source: Reinhart and Rogoff (2009).

Notes: The beginning year of the banking crises range from 1929 to 1931. Australia and Canada did not have a systemic banking crisis but are included for comparison purposes, as both also suffered severe and protracted economic contractions. The year 1929 marks the peak in world output and, hence, is used as the marker for the beginning of the depression episode.

3. Domestic debt is no panacea

The tilt in favor of domestic debt financing in recent years is by and large a welcome development as it may help foster a domestic capital market. However, as Reinhart and Rogoff (2008) argue, domestic debt is not new. Though less well documented than comparable external defaults, domestic defaults have been numerous through history. Including domestic debt in the calculus helps explain why governments default on foreign debts at seemingly low levels of debt

(see debt intolerance below) and why they resort to inflation as a means of reducing their debt burdens.

4. Above all--remember debt intolerance!

Historically, emerging market defaults have taken place at levels of debt that would appear to be safe and even conservative by advanced economy standards. The defaults of Mexico in 1982 and Argentina in 2001 were not exceptions. Table 1, shows that external debt exceeded 100 percent of GNP in only 16 percent of the default or restructuring episodes, *that more than one-half of all defaults occurred at levels below 60 percent—which would have satisfied the Maastricht criteria*—and that defaults took place against debt levels that were below 40 percent of GNP in nearly 20 percent of the cases. In effect, the external debt-to-GNP thresholds reported in Table 1 are biased *upwards* because the debt-to-GNP ratios corresponding to the year of the credit event are driven up by the real exchange rate depreciation that typically accompanies the event. Real exchange rate depreciation typically accompanies a default of course, as locals and foreign investors flee the currency. The fiscal “space” to implement ambitious stimulus plans in emerging markets is far more limited than that of advanced economies—not that policymakers in the latter may underestimate these constraints as well.

TABLE 1. External debt at the time of default: Frequency distribution, 1970-2008

<i>External debt-to-GNP range at the first year of default or restructuring</i>	<i>Percent of total defaults or restructurings in middle income countries</i>
Below 40 percent	19.4
41 to 60 percent	32.3
61 to 80 percent	16.1
81 to 100 percent	16.1
Above 100 percent	16.1

Source: Reinhart and Rogoff (2009) update of Reinhart, Rogoff, and Savastano(2003).

Final reflections

Taken together, these four risks have broader implications than for fiscal policy alone-- these are risks to macroeconomic policy at large, especially in emerging market countries where central bank independence is of recent vintage. Historically, fiscal dominance has played a major role in shaping the path of monetary policy, the exchange rate and inflation in many emerging markets. Gaining credibility is a long and difficult process, losing it to a fashion for fiscal stimulus can happen fairly quickly.

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