How Agile is Latin America in the Face of Further Shocks?

By Joana Pereira

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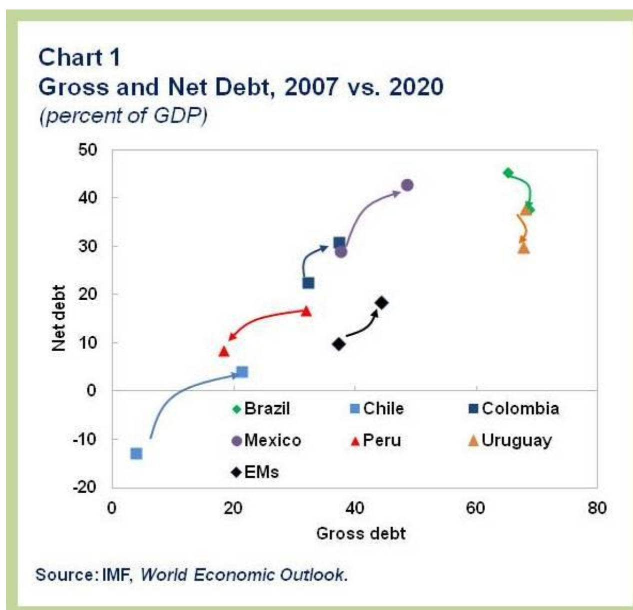
The global financial crisis marked the first major external shock that countries in Latin America were able to counter with a strong fiscal policy response, by using the financial cushions that they have built up over the previous decade. Today, more than six years later, most countries in the region have not fully rebuilt those buffers despite a period of sizeable commodity revenues and relatively strong growth. So, if another crises were to strike, how prepared is Latin America?

A recent study sheds some light on this question by looking at the fiscal space and vulnerabilities in the six largest Latin American countries—Brazil, Chile, Colombia, Mexico, Peru, and Uruguay. While we show that, overall the current debt outlook is generally manageable (Chart 1), the incomplete reversal of the fiscal stimulus implemented during the crisis has reduced their fiscal space (room in the government's budget to provide resources for a desired purpose without jeopardizing the sustainability of its financial position or the stability of the economy) to confront possible future downturns.



Source: IMF, *World Economic Outlook*.

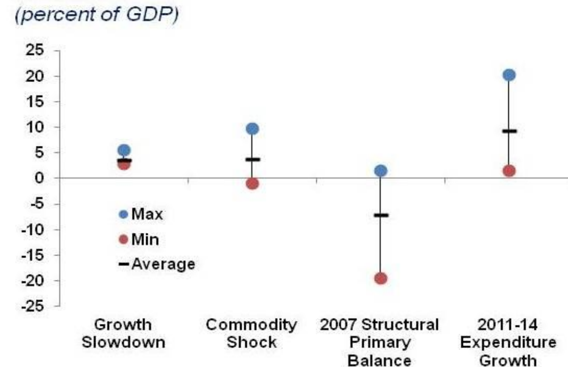
Erosion of fiscal space

Public debt in most countries remains above pre-crisis levels, primary balances (excluding interest payments and revenue) have deteriorated, and, despite the still favorable global financial conditions, the difference between interest rates and GDP growth is larger than before. Thus, while in 2008 all of these countries were generating debt-reducing fiscal balances, the opposite is true for 2015. This heightens vulnerabilities to potential shocks and spending pressures.

For example, should real GDP growth fall short of the current outlook by ½ percent or commodity prices fall to the 2004–05 levels, public debt ratios would climb on average by 4 percent of GDP in 2020, relative to current prospects. The impact would vary substantially across countries, however; with those already bearing a larger public debt (Brazil, Uruguay) and/or more susceptible to commodity shocks (Peru, Colombia) most affected (Chart 2).

But future policy choices can be even more important than economic shocks. We could see public debt rise by 9 percent of GDP on average by 2020 if the current pace of expenditure growth is maintained. However public debt could be lowered to 7 percent of GDP instead if, for instance, the structural primary balances revert to levels observed in 2007 (Chart 2).

Chart 2
LA6: Variation in 2020 Debt under Alternative Scenarios
(percent of GDP)



Sources: IMF, *World Economic Outlook*; and IMF staff calculations.
Note: The figure shows the maximum, minimum, and average change in 2020 debt-to-GDP ratios for each scenario relative to the WEO baseline. For details on the scenarios' calibration, see Figure 17 of the above mentioned study.

Fiscal risks

But macroeconomic headwinds and policy decisions are not the only relevant risk factors. The materialization of fiscal risks stemming, for instance, from natural disasters or from guarantees to public enterprises and the financial sector holds the potential of severely eroding already thin fiscal buffers. Improving the measurement and disclosure of such contingencies is therefore crucial to assess the vulnerability of current fiscal positions in these six countries. Looking ahead, spending pressures are also likely to go up as income levels rise, increasing the demand for public services. Demographic trends are also expected to put pressure on age-related spending, particularly on health care (Table).

Table. Age Related Spending Increase, 2014-30
(percent of GDP)

	Pension	Health	Total
Brazil	1.3	1.8	3.1
Chile	-1.5	1.5	-0.1
Colombia	-0.7	2.1	1.4
Mexico	1.1	1.1	2.2
Peru	0.8 *	0.9	1.7
Uruguay	0.0 **	0.7 *	0.7

Soures: *Fiscal Monitor*; and IMF staff estimates.
*estimates are based on Cotlear (2010);
**estimates are based on World Bank (2013).

How much room to adjust?

In view of these risks, there is a clear case to rebuild fiscal buffers across these six Latin American countries. However, the flexibility to adjust fiscal policy quickly varies across countries. Brazil and Uruguay have particularly high revenue ratios, and therefore the least headroom to raise taxes. "Rigid" spending (public wages, pensions, and social benefits) is also high in these countries, while extensive revenue earmarking adds to the adjustment challenge in Brazil. Colombia is also burdened by high rigid spending, but benefits from a lower tax burden and lower public debt. Adjustment is most flexible in Mexico, Chile, and Peru given their relatively low tax ratios and lower earmarking and spending rigidities, but these countries are also exposed to higher volatility from commodity prices.

Although it is difficult to assess the appropriate level of fiscal buffers going forward, the experience during the global financial crisis highlights the value of building ample margins. Some adjustment is already underway. Securing long-lasting resilience requires both an improvement of fiscal positions in the near term as well the strengthening of fiscal frameworks, including more thorough risk assessments and removing structural impediments to adjustment.

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