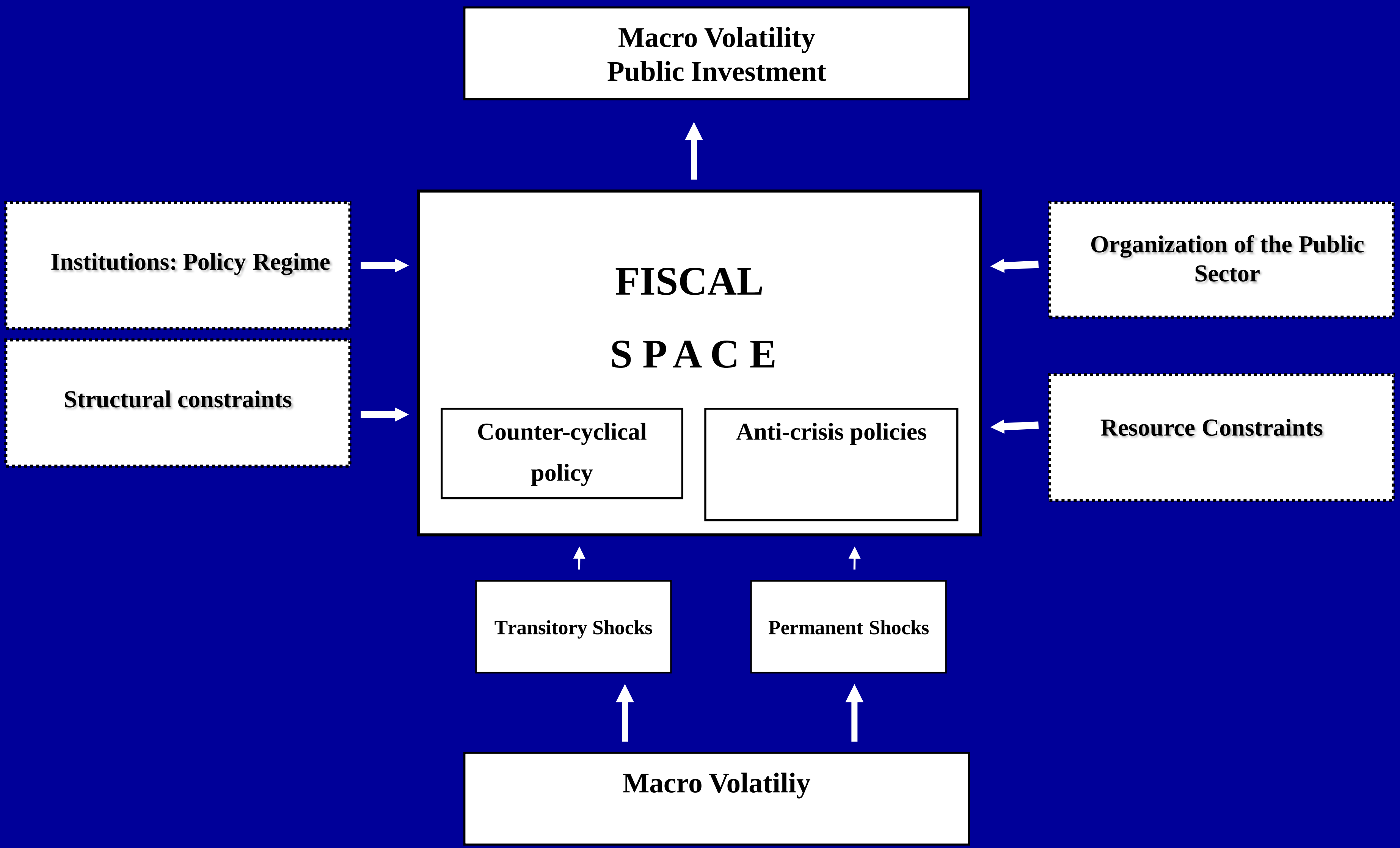
# *Fiscal Space and Policy Response*


***José María Fanelli***
***CEDES & MERCOSUR Research Network***


OECD - DeFiNe
October 11-12, 2010

# *The Project*

- ***Goal: to evaluate the interactions between macro volatility and fiscal space in the new LA scenario of the 2000s***
- ***Four case studies: Brazil, Argentina, Chile and El Salvador***
- ***There are two-way interactions between macro volatility and fiscal variables***
- ***We are interested in the effects of volatility on the size of the Fiscal Space***
- ***The Volatility → Fiscal Space link operates via direct and indirect channels***
- ***We use the notion of Fiscal Space developed in a previous ECLAC-CEDES project***


Macro Volatility
Public Investment
Institutions: Policy Regime
Structural constraints
FISCAL
S P A C E
Counter-cyclical policy
Anti-crisis policies
Organization of the Public Sector
Resource Constraints
Transitory Shocks
Permanent Shocks
Macro Volatiliy

# ***Results (I)***

- ***Volatility matters to Fiscal Space, in particular:***

- ***<u>1980s and 1990s</u>: The government acted as insurer of last resort and the fiscal imbalances provoked by the bailout of the banking system eroded public debt sustainability, reducing the fiscal space***

- ***<u>2000s</u>: LA countries adopted self-insurance strategies + Δ in fiscal space =***
  **- reserve accumulation**
  **- primary fiscal surplus**
  **- reduction in the Public-Debt GDP ratio + sovereign funds**

- ***Self-insurance and more fiscal space have been instrumental at reducing volatility: Argentina, Brazil and Chile implemented <u>counter-cyclical policies</u>***

- ***But self-insurance was associated with current account surpluses: valuable savings are diverted from productive and infrastructure investment*** ➔

- ***Preserving fiscal space to smooth the cycle may be instrumental at reducing the importance of self-insurance based on reserve accumulation and current account surplus***

# ***Results (II)***

- ***The stability of the policy regime and the ability to improve the rules of the game are not independent of the macroeconomic environment***

- ***Negative example: the fall of the convertibility regime in Argentina***
- ***Positive examples: fiscal responsibility laws and rules; in the 2000s Chile achieved the most successful and efficient enlargement of the fiscal space: institutional quality matters***

- ***The structural features of the economy determine the type of macro-shock and this hinges on the ability to generate fiscal space***

- ***Argentina and Chile: Revenues heavily depend on terms of trade (natural resources)***
- ***Brazil and Argentina: Fiscal federalism matters***
- ***El Salvador: The reduced size of the public sector heavily constrains the ability to increase the fiscal space***

***Thank you!***

***José María Fanelli***