FISCAL AFFAIRS

ECLAC XXXV Regional Seminar on Fiscal Policy

MAY 16, 2023

SANTIAGO, CHILE

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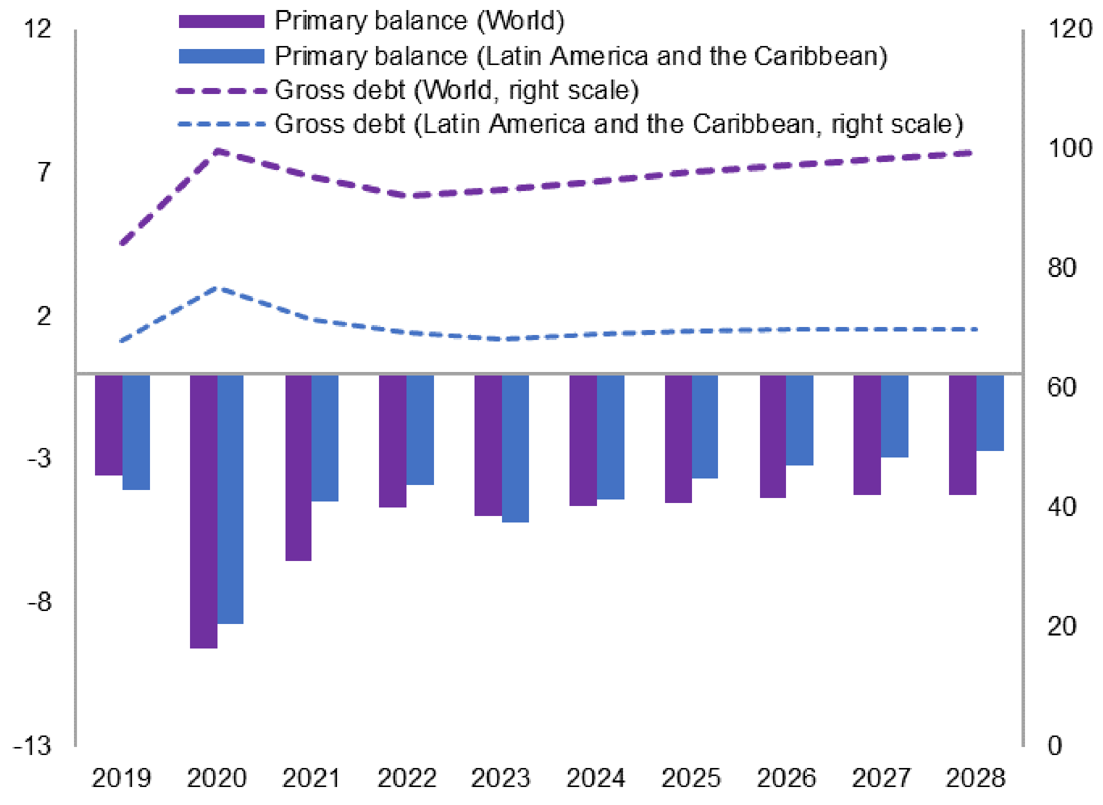
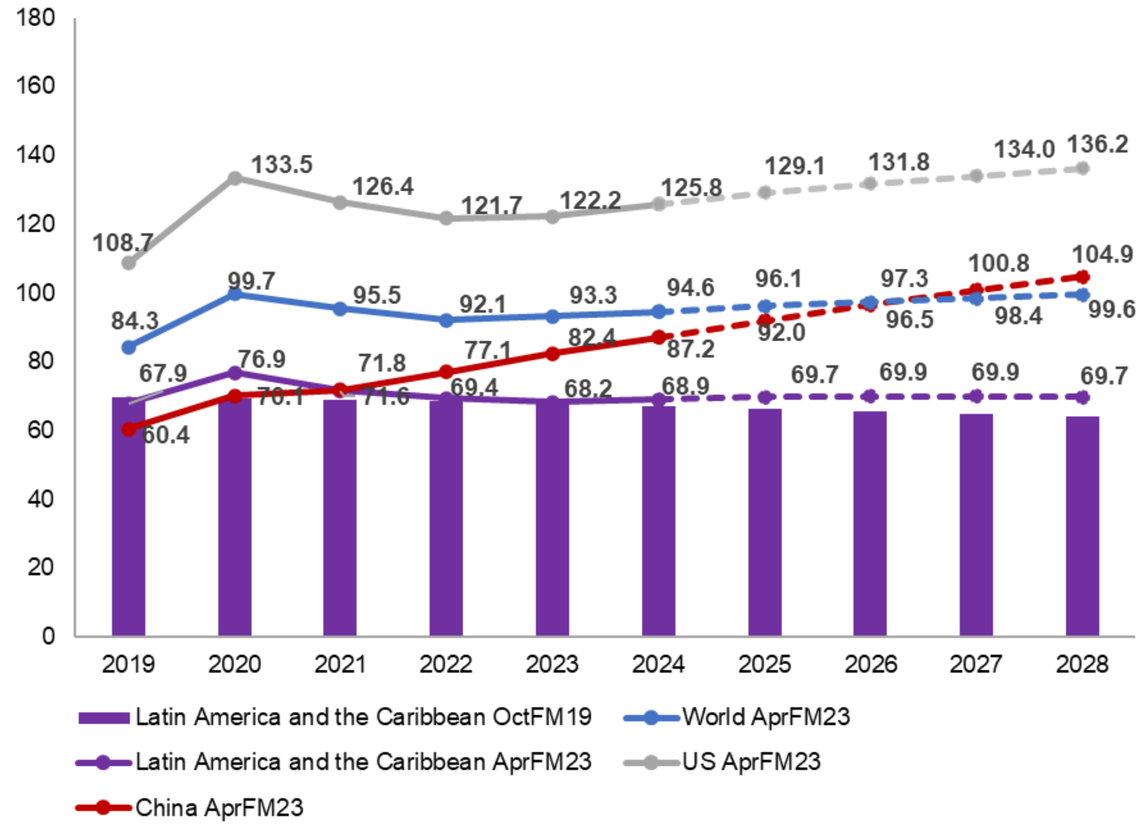
Fiscal Affairs Department

Public Finances in the World and Latin America: Back to Normal

Public Debt and Primary Balance: 2019-28



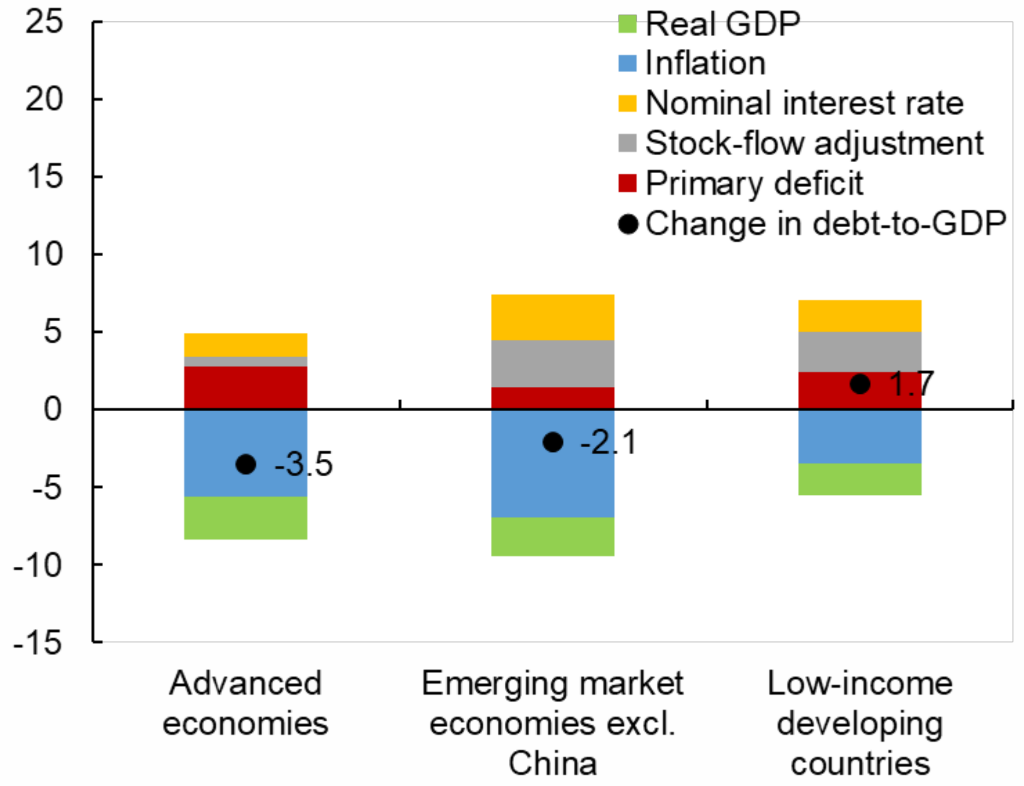
Public Debt-to-GDP: 2019-28



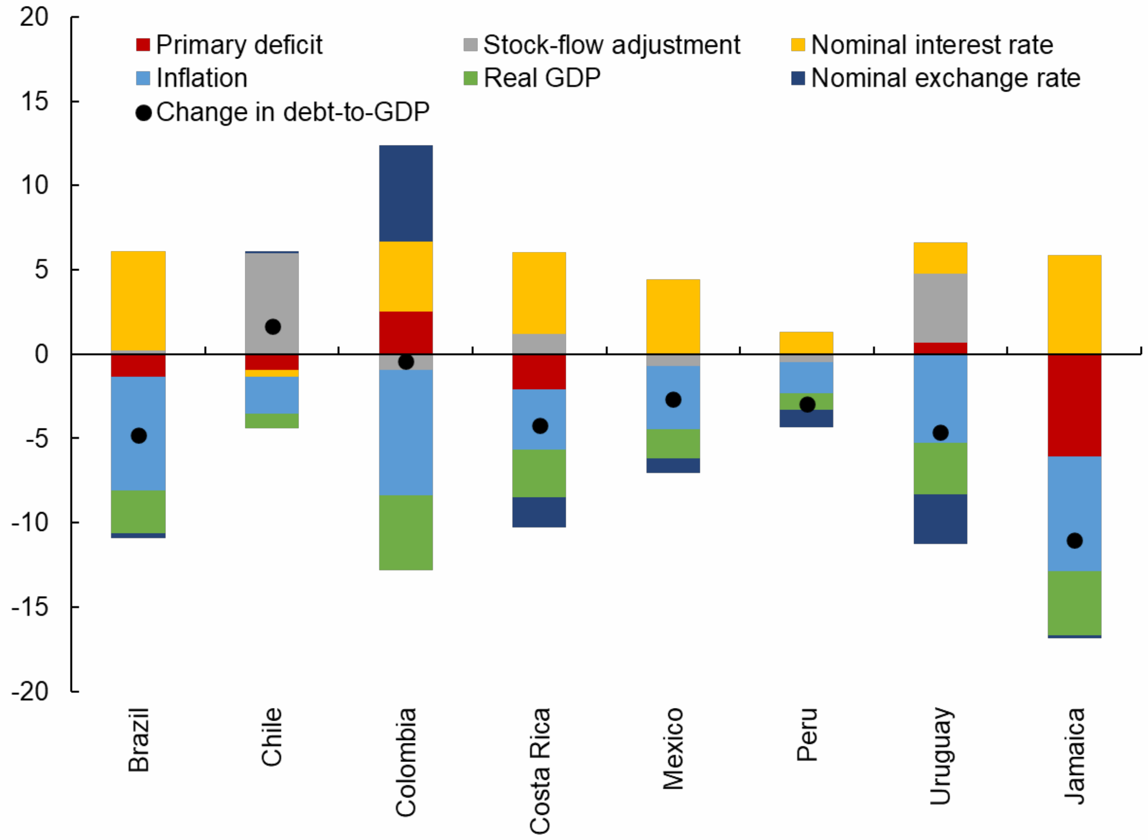
Source: April 2023 IMF World Economic Outlook (WEO) & IMF Staff Calculations.

What Explains Changes in Public Debt in 2022?

Drivers of Change in General Government Debt, 2021-22
(Percent of GDP)

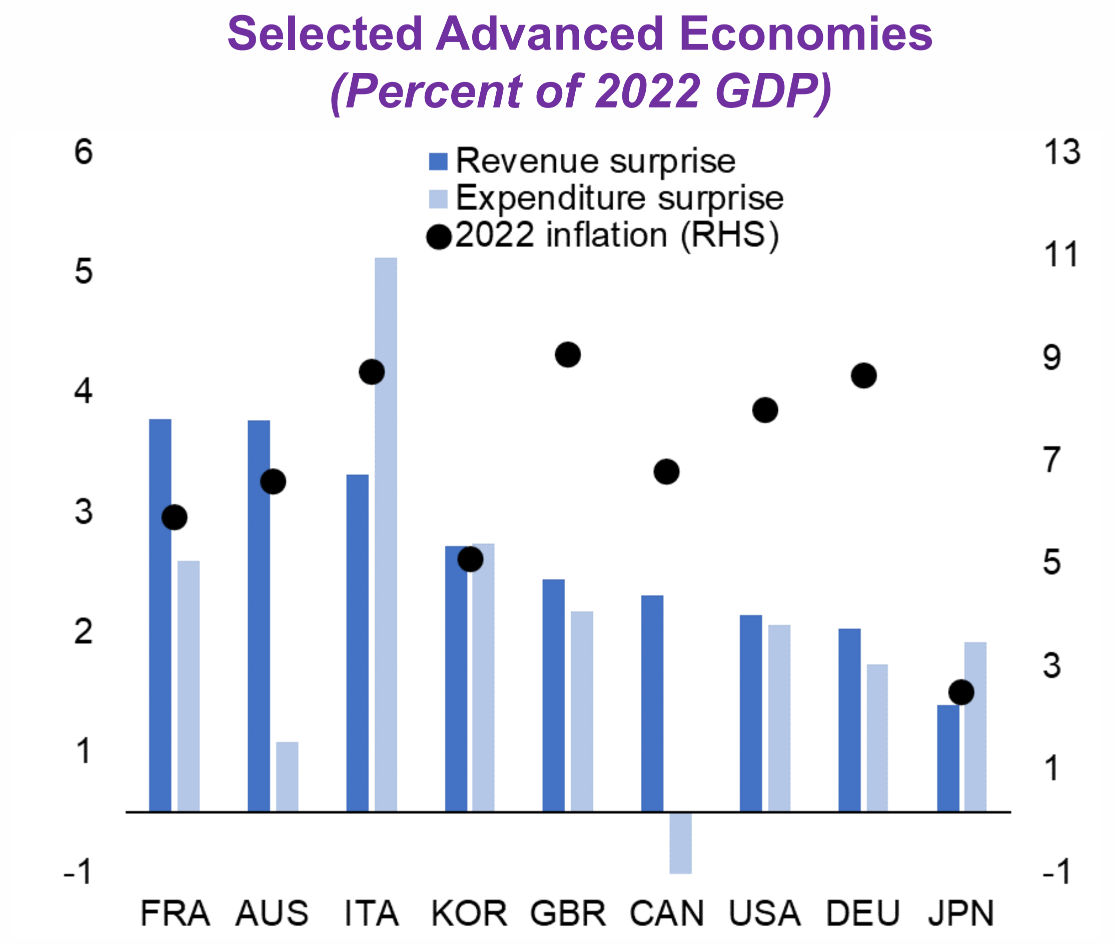


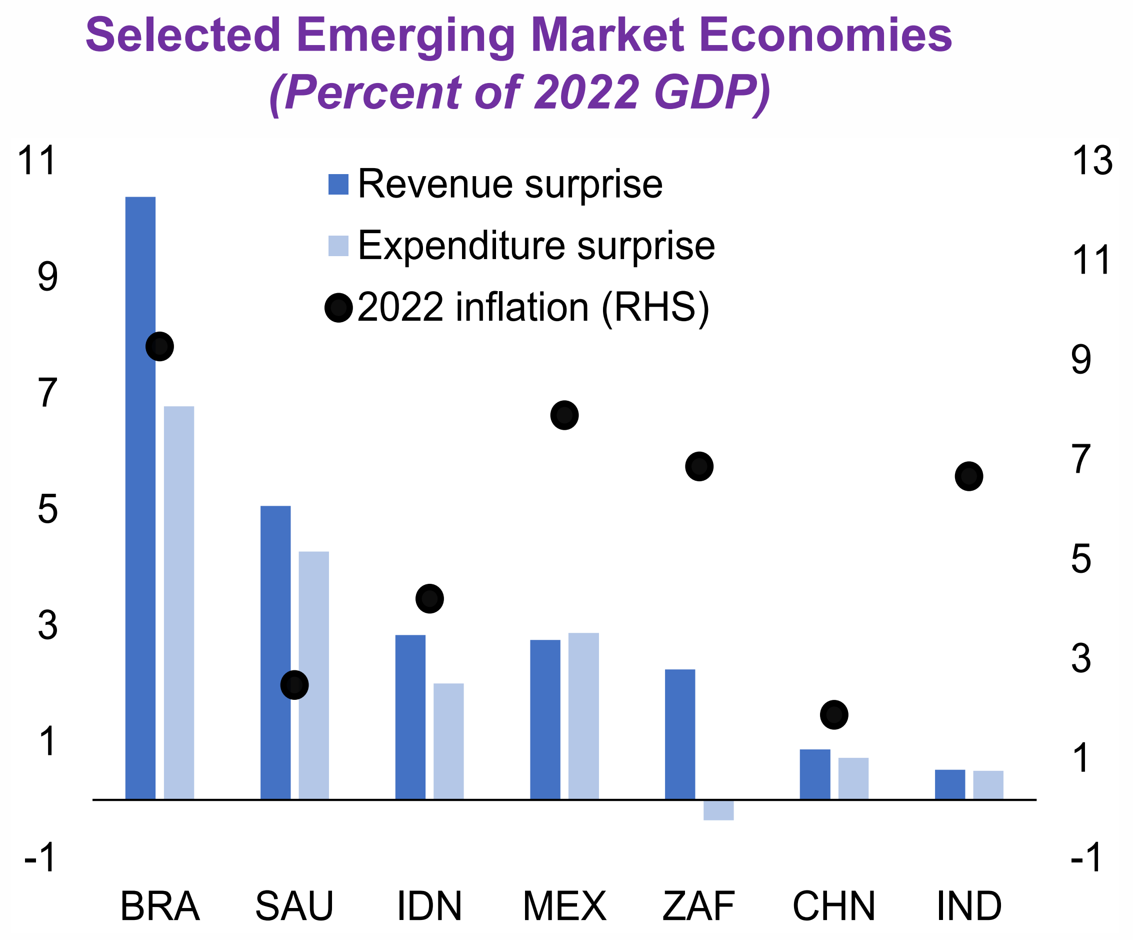
Selected Latin American Countries, 2021-22
(Percent of GDP)



Source: April 2023 IMF World Economic Outlook (WEO) & IMF Staff Calculations.

What Share of Revenue Surprises was Saved?



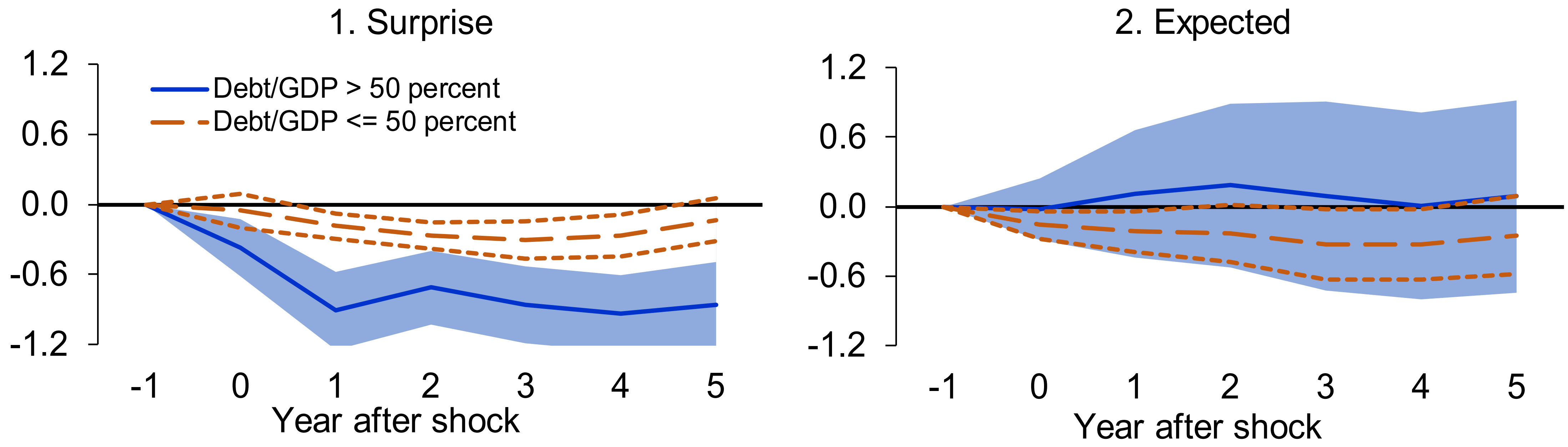


Source: April 2023 IMF World Economic Outlook (WEO) & IMF Staff Calculations.

Inflation (Surprises) Tends to Lower the Debt Persistently

Debt Reaction to Surprise versus Expected Growth Spikes in the GDP Deflator

(Percent of GDP)

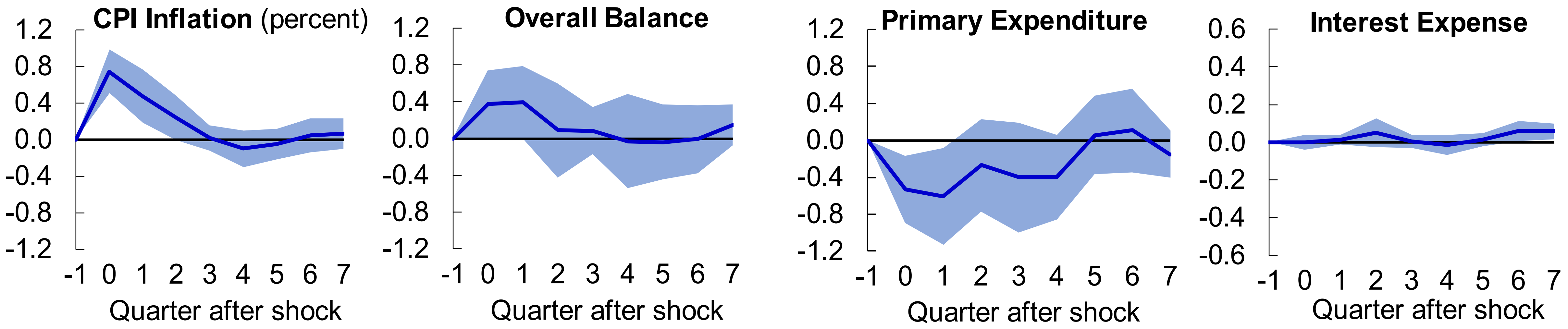


Source: IMF staff estimates using data from the IMF Public Finances in Modern History and World Economic Outlook databases.
Note: Fixed effects ordinary least squares regressions include 85 countries during the period with available data 1992–2019. Countries with population of less than 1 million in 2019 are excluded, as well as observations with annual surprise or expected inflation higher than 30 percent in absolute terms or for which the original data source changes. Expected inflation is defined as the one-year-ahead forecast; surprise inflation is realized minus expected inflation. The panels plot the average impulse response and the 90 percent confidence bands (blue shaded areas and red short-dashed lines), with standard errors clustered at the country level. See Online Annex 2.2 for details.

CPI Inflation Shocks Improve Fiscal Balances in Short-term

Estimated Initial Gains to Fiscal Balances from CPI Inflation Spikes

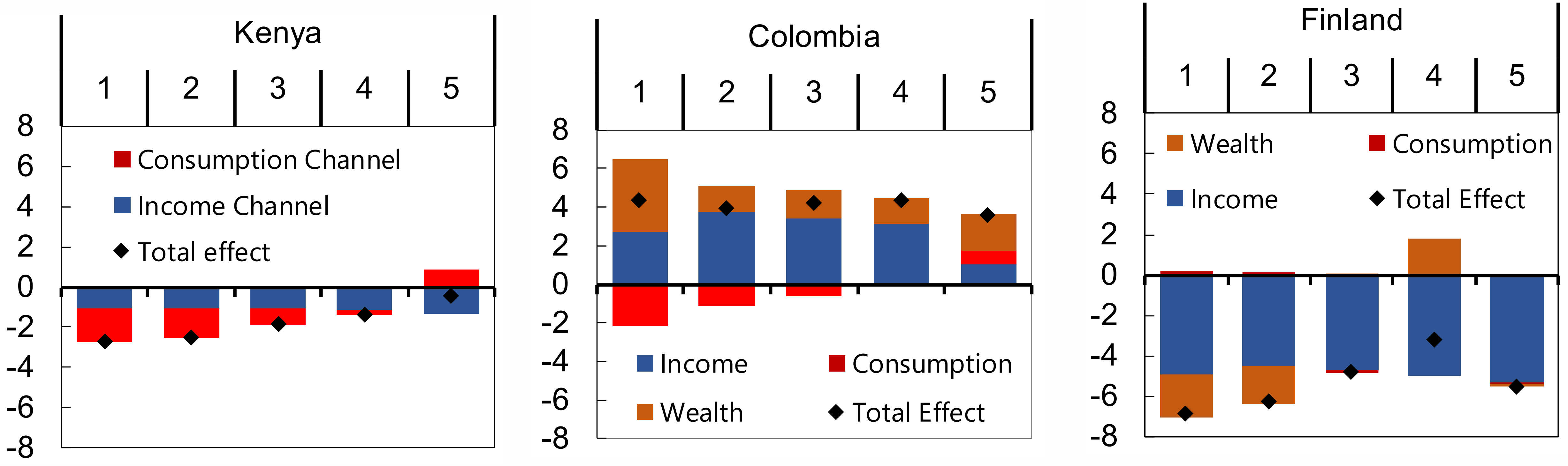
(Percent of GDP; unless stated otherwise)



Sources: IMF staff estimates using data from Gruss and Kebhaj (2019); Ilzetzki, Reinhart, and Rogoff (2019); and IMF International Financial Statistics and World Economic Outlook databases.
Note: Regressions are estimated between the first quarter of 1999 and the fourth quarter of 2019 using instrumental variables and control for quarter indicator variables and country and year fixed effects (fixed effects two stage least squares). The panels plot the average impulse response and the 90 percent confidence bands (blue shaded area) with standard errors clustered at the country level. See Online Annex 2.2 for details. CPI = Consumer Price Index.

Distributive Effects of Inflation can be Significant

Income, Consumption, and Wealth Channels, 2021–22
(Percent of household income)



Sources: IMF staff calculations, as described in Online Annex 2.3.
Notes: The figure covers the period from the second quarter of 2021 to the second quarter of 2022. For *Colombia*, results are based on the financial inclusion module of the Great Integrated Household Survey (GEIH) to include the wealth effect. Results for income and consumption basket channels using a representative survey are similar.

Fiscal Policy and Inflation

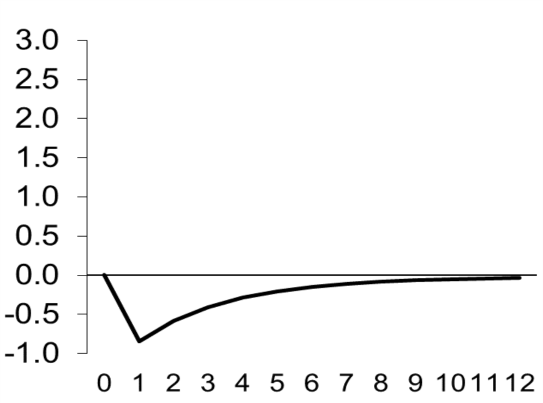
Disinflating via Different Policy Tightening Options in the HANK Model
(Deviation from long-term value, unless stated otherwise)

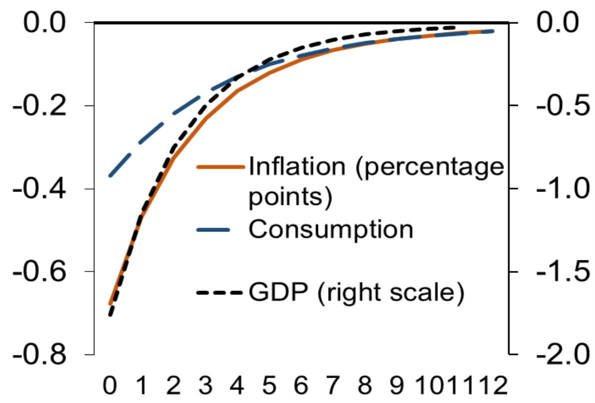
Variation in Interest Rates
(Percentage points)

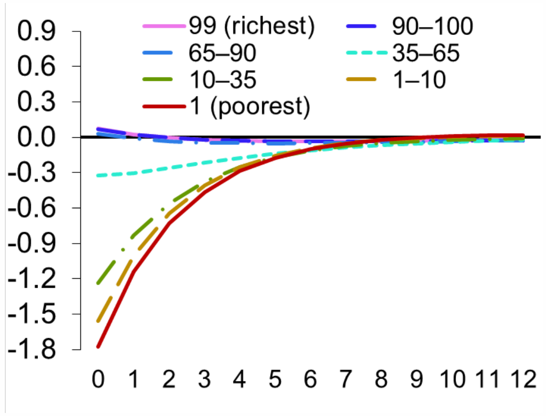
Impact on Inflation, Consumption, and Output
(Percent, unless stated otherwise)

Consumption by Income Bracket Percentile
(Percent)

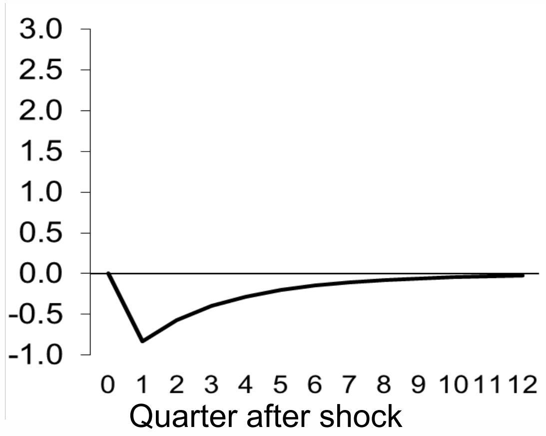
1. Fiscal restraint only

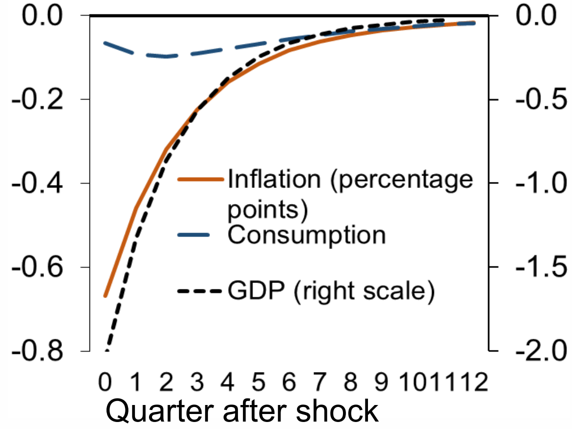


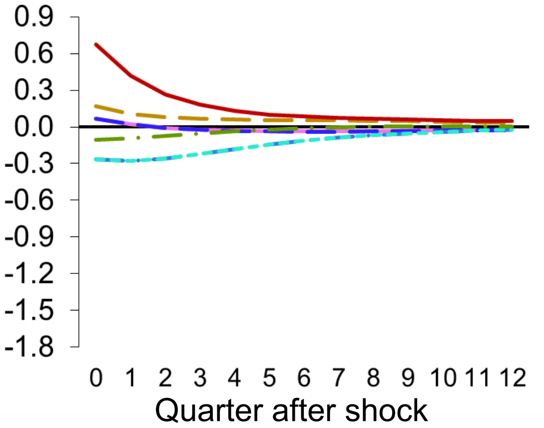




2. Fiscal restraint with targeted transfers



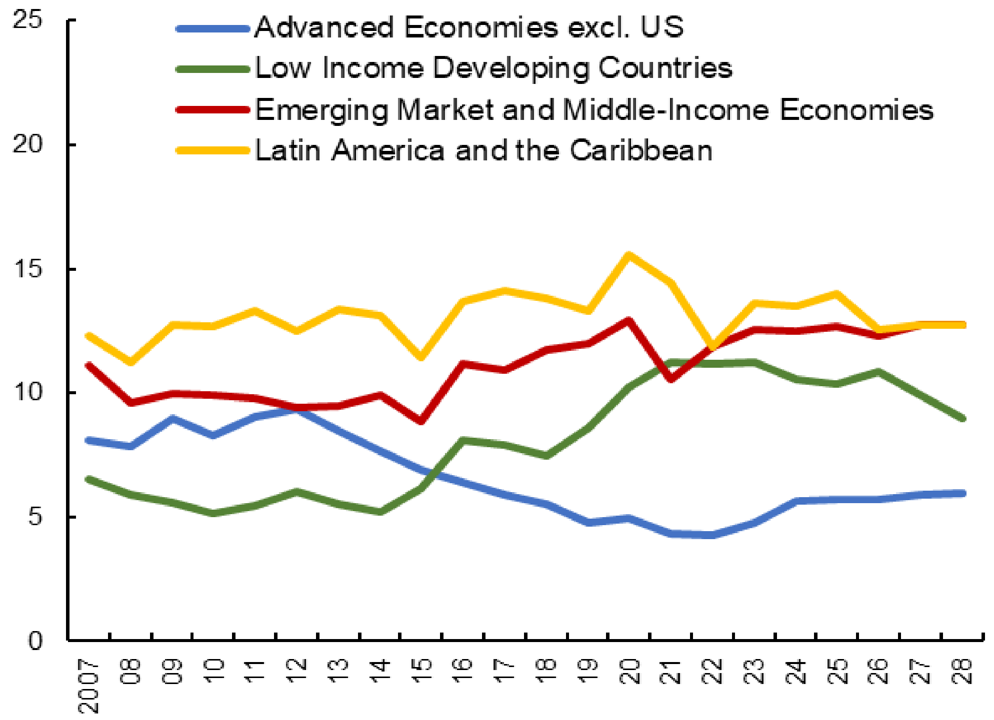




Source: IMF staff calculations based on the model calibration in Auclert and others (2021).
Note: HANK = Heterogeneous-Agent New Keynesian.

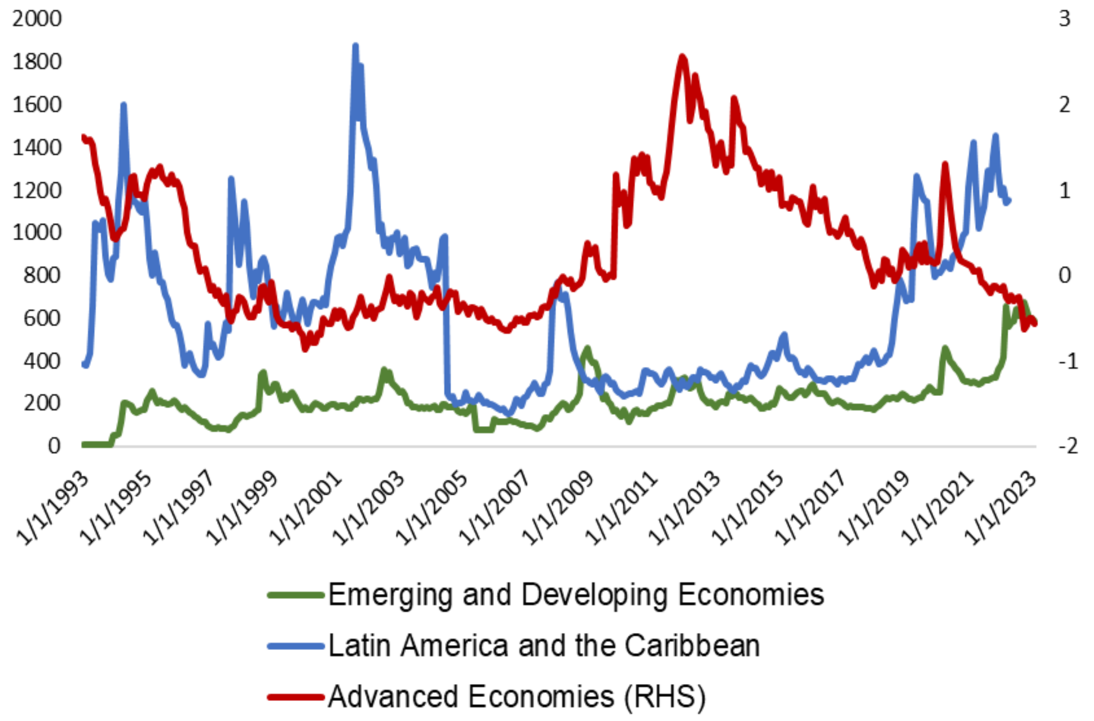
Debt Burdens Elevated Amid Tightening Financing Conditions

Median Interest Payments as a Percentage of Tax



Source: April 2023 IMF World Economic Outlook (WEO) & IMF Staff Calculations.

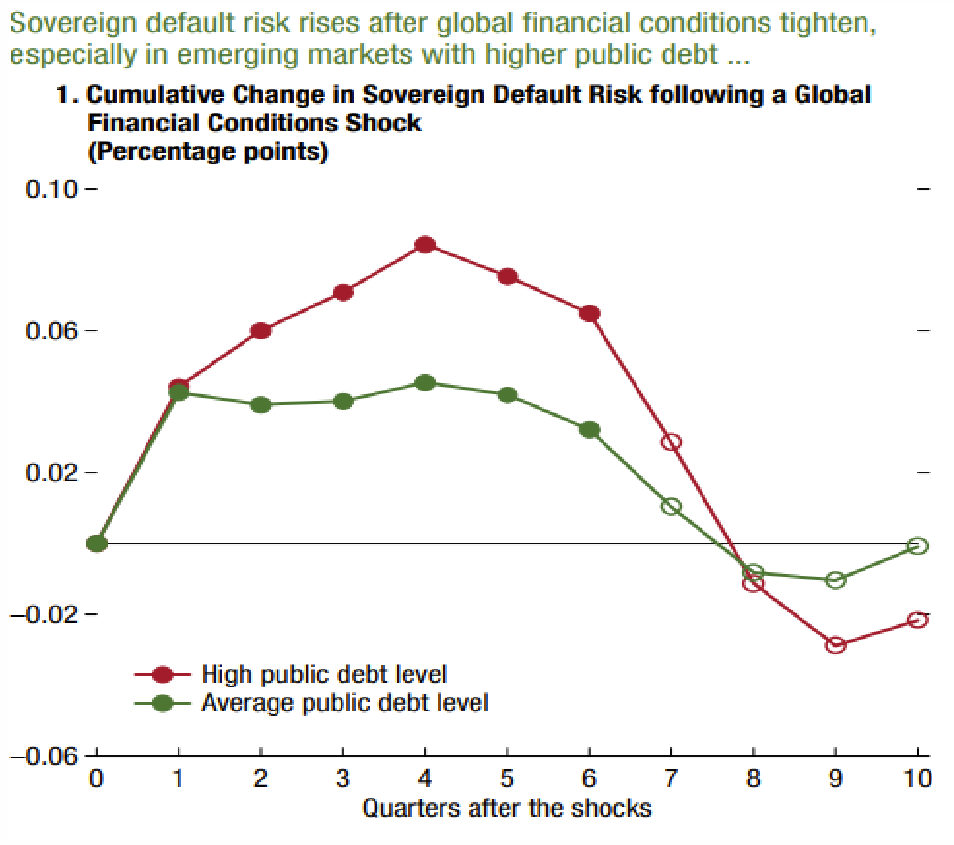
Sovereign Spreads *(Basis Points)*



Source: DataStream, Global Financial Data. Latest observation is March 1, 2023. LAC5 includes Brazil, Chile, Colombia, Mexico, Peru.

Public Debt Heightens Key EME Vulnerabilities

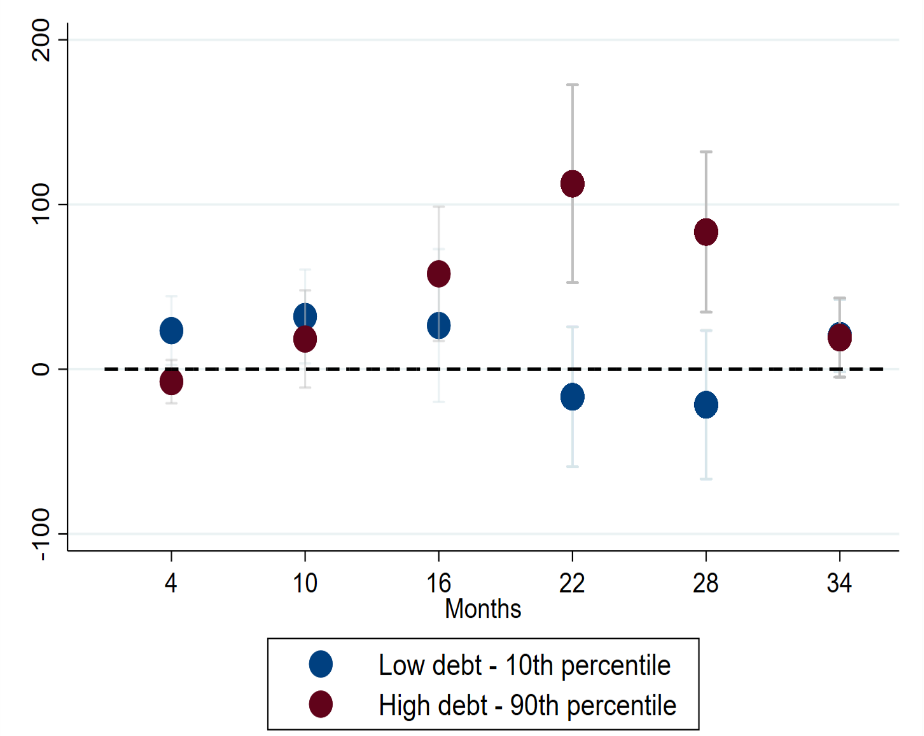
More public debt raises default risk and borrowing costs…



Source: GFSR (April 2022)

…and increases risk that inflation expectations de-anchor

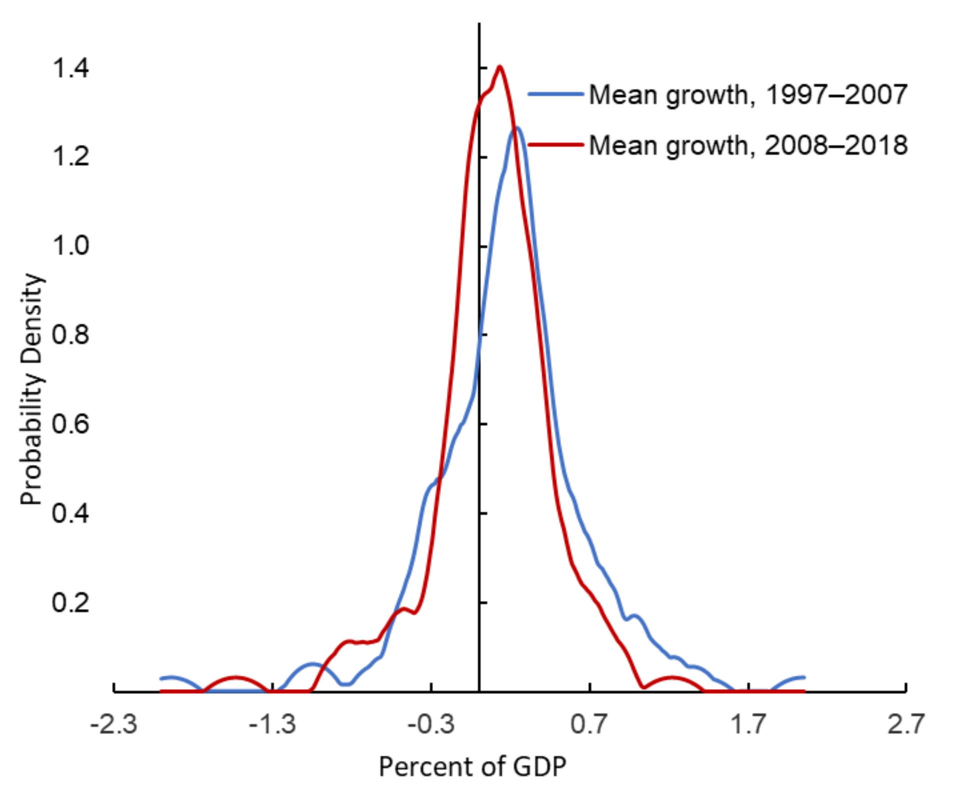
5-yr Inflation Expectations response to a debt surprise
(Basis points)



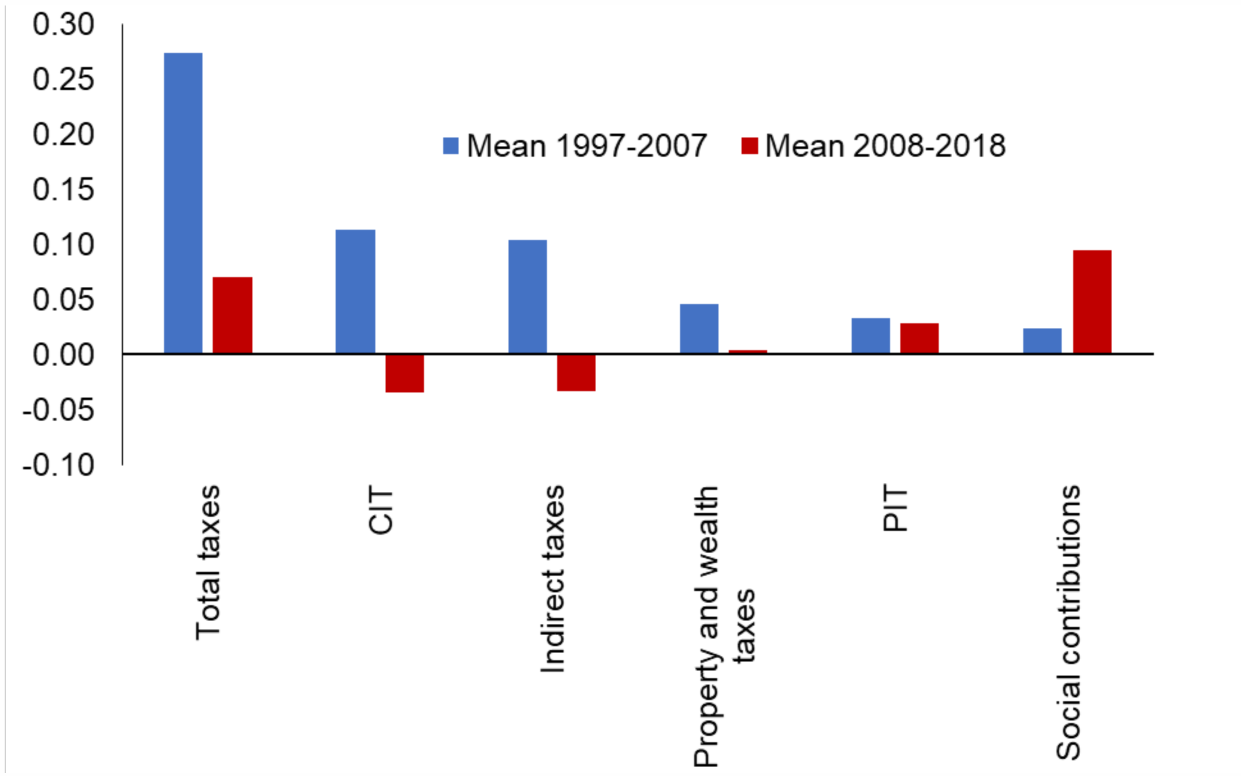
Source: Brandao-Marques, Casiraghi, Gelos, Harrison, Kamber (2023).
Note: Sample covers EMs. The figure plots the responses to a 10 percent debt surprise

Tax collections in Emerging Market Economies have Stagnated

Slowdown in Mean Tax-to-GDP Growth



Tax Base Components of Slowdown



Source: Bachas and others 2022; and IMF staff calculations.

Note: In LHS chart, x-axis is percent of GDP, y-axis is the density. In RHS chart, bars reflect decade average of year fixed effects in a panel regression of the yearly change in the tax-to-GDP ratio on year and country fixed effects, with each country weighted by its share of GDP in the same year. CIT: corporate income tax; PIT=personal income tax.

Conclusion

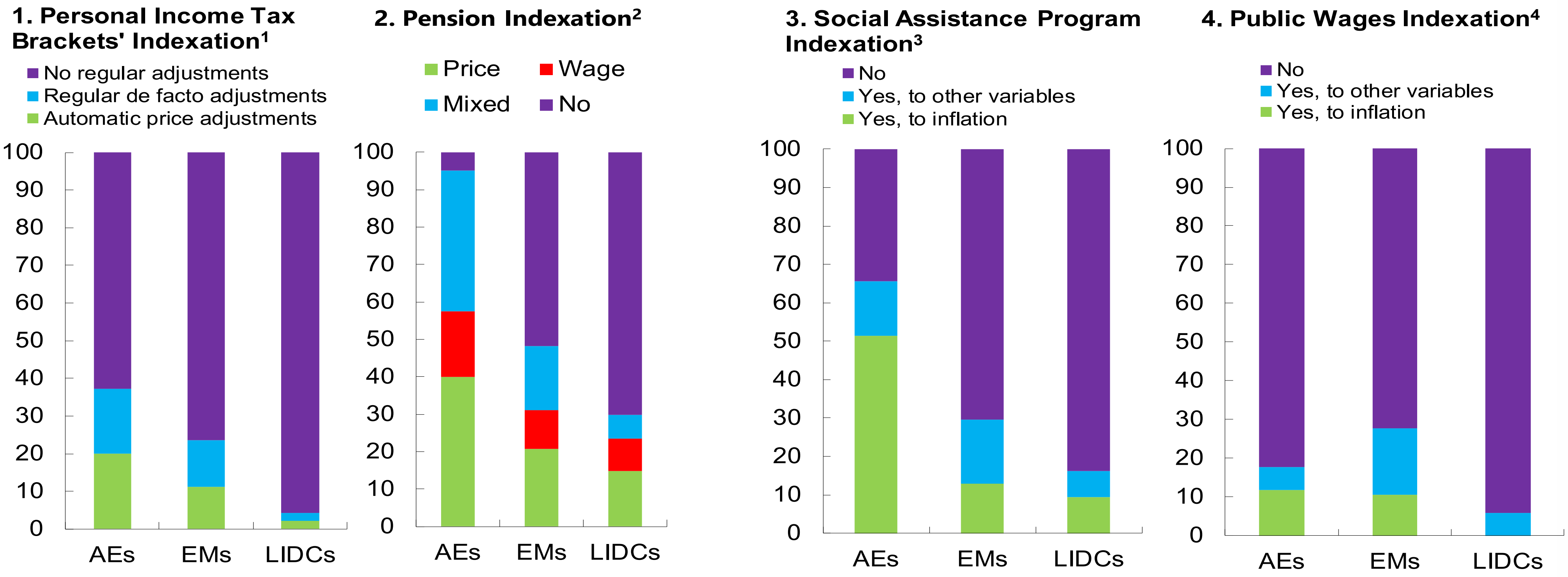
- **Inflation shocks are associated with a fall in public debt over the medium-term and with an initial improvement in fiscal balances.**
  - ➢ But as inflation becomes persistent and expected, further debt reduction cannot be achieved. *Inflating debt away is neither a desirable nor a sustainable strategy.*
- **The redistributive effects of inflation on households are more complex than usually thought.**
  - ➢ Impact of inflation on families depends on their consumption, income, and wealth.
- **In many countries, fiscal policy should tighten to ease inflation pressures, in line with monetary policy tightening.**
  - ➢ Well-targeted fiscal restraint can be designed to support monetary policy in attaining price stability while protecting the most affected by the cost-of-living crisis.
- **Countries need to adopt more ambitious fiscal strategies to bring down debt risks and rebuild fiscal buffers.**
  - ➢ This includes renewed efforts to raise tax capacity as revenues remain stubbornly low and social spending needs are pressing (also addressing climate change)
  - ➢ Restoring pre-pandemic position should be done in a way that is progressive (on both tax and spending)
  - ➢ Over the medium-term, need to address long-standing supply constraints to boost growth prospects.
- **Countries should enhance efforts to contain debt vulnerabilities**, including through fiscal reforms, and coordinate with creditors on preemptive and orderly restructurings when in debt distress, using the G-20 Common Framework when applicable.

THANK YOU!

Indexation Varies, but Higher in Advanced Economies

Indexation Practices Vary Across the World and Across Budget Items

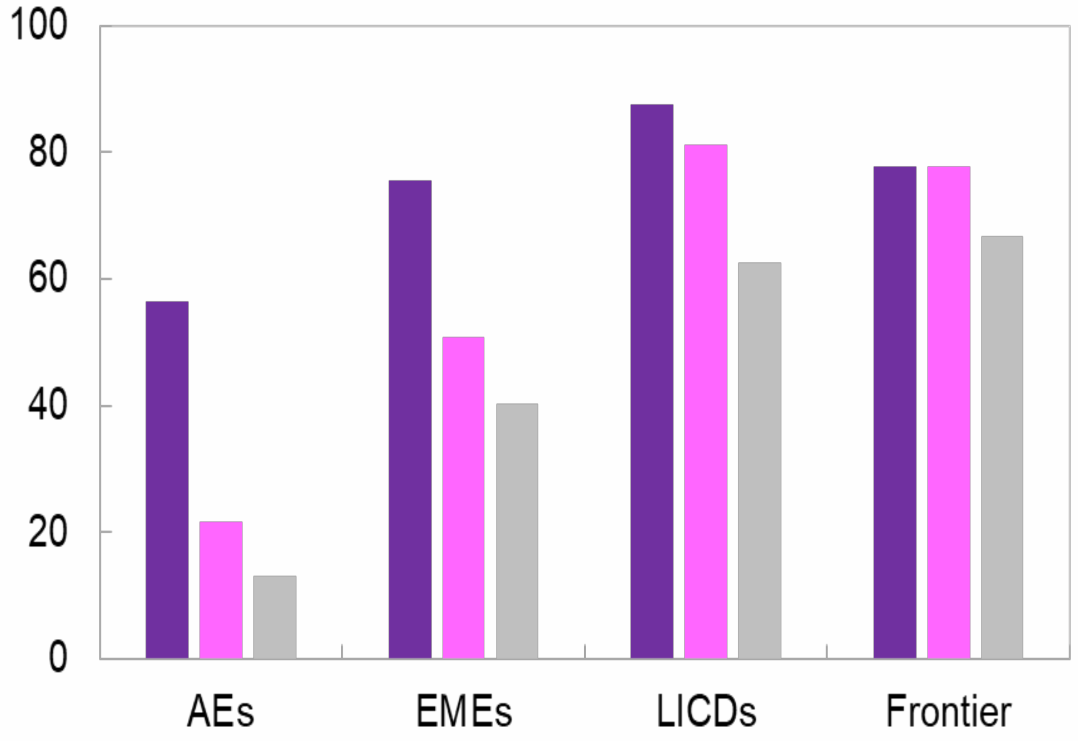
(Percentage of countries in each income group)



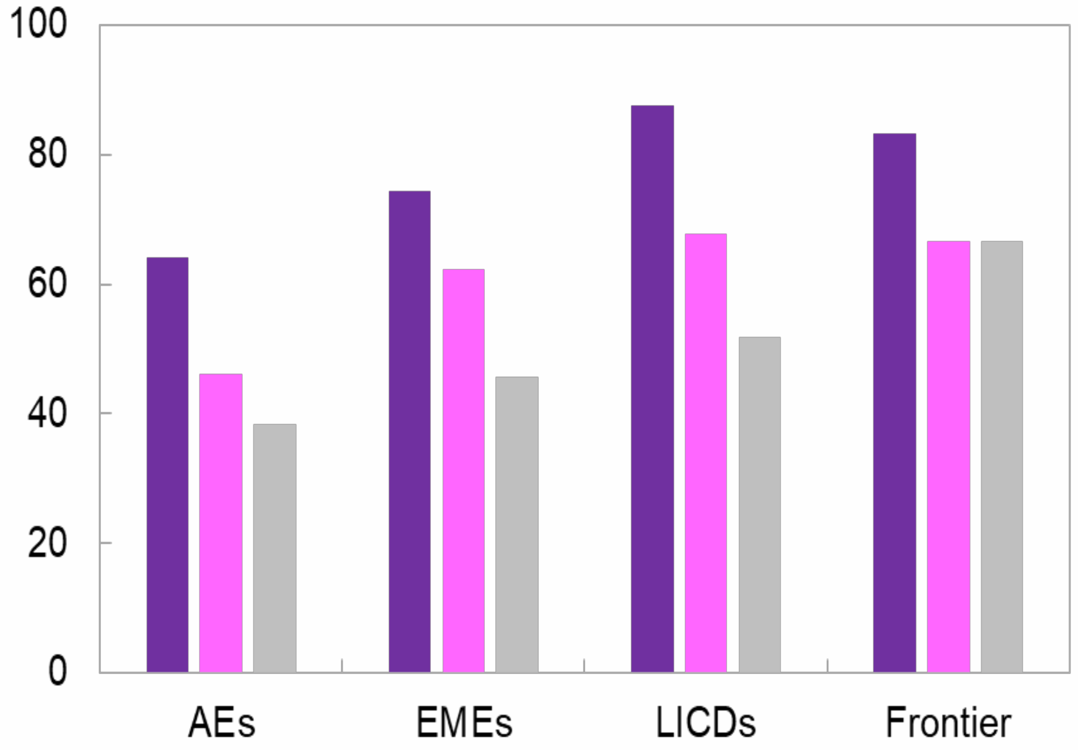
Sources: IMF staff analysis based on an IMF survey and using additional data from Beer, Griffiths, and Klemm (2023); IMF Pay Systems database (2016); International Social Security Association database; OECD (2022c), and US Social Security Administration databases.
Note: Panels include data for 2016–23. Observations vary from 116 to 176 countries in each panel (see Online Annex 2.1 for details). Price indexation includes different measures of inflation, for example, "core," or measures that include only urban workers or exclude fuel, tobacco, alcohol, and others. Even with automatic indexation, discretionary approval stages may be part of the framework that result in ad hoc adjustments. AEs = advanced economies; EMs = emerging market economies; LIDCs = low-income developing countries.
[1] "Regular de facto adjustments" means that personal income tax thresholds are regularly revised but not automatically.
[2] "Mixed" indexation refers to an adjustment that includes a mix of price, wages, and other variables.
[3] Social assistance programs include major fixed cash transfer programs. "Yes" means that majority of benefits are indexed in the country.
[4] "No" means that inflation does not play an automatic or mandatory role in the setting of public wages. Indexation includes both partial and full indexation.

Debt Vulnerabilities Have Risen

Countries with Increasing Average Sovereign Bond Spreads, 2022-23 versus pre-2019
(Percent of group)



Countries with Increasing Public Debt Ratio, 2022 versus pre-2019
(Percent of group)



Above Average ■ Above Average + 1 st.dev. ■ Above Average + 2 st.dev.