Chapter 2

Perspectives for fiscal adjustment in Latin America

Lisa M. Schineller,

Standard & Poor's

This chapter discusses the market's perception of fiscal adjustment in Latin America. It reviews the key methodological features used to determine a sovereign credit rating and assesses the fiscal performance of a number of Latin American credits. Several fiscal indicators are reported. A sovereign rating focuses only on a government's ability and willingness to repay debt on time and in full. Sovereign rating methodology is argued to be both quantitative and qualitative, incorporating an assessment of policy credibility, transparency and predictability. Fiscal policy plays a crucial role in credit rating analysis, including the fiscal authorities' ability and willingness to adjust policy to shocks or changing economic conditions.

Introduction

Standard & Poor's rates 16 sovereigns in Latin America, but only two countries, Chile and Mexico, have investment-grade ratings. Their stronger creditworthiness reflects their comparatively stronger fiscal positions in relation to the other Latin American countries, as well as other factors. The level of government debt does not *determine* a rating by itself. For example, Belgium has net general government debt of almost 90% of GDP and a "AA+" rating, while Ecuador's net debt of almost 40% of GDP is much lower, but so is its "CCC+" rating. These very different ratings reflect different political and institutional strengths, these countries' ability and willingness to adjust policy to shocks or changing economic conditions, and different policy track records, as well as fiscal flexibility, the structure of debt (the relative weight of domestic- as opposed to foreign currency-denominated securities, maturity structure, etc.), the depth of local capital markets, external vulnerabilities and the strength of the economy, among other determinants.

While sovereign analysis incorporates a variety of factors, a key focus is, obviously, on fiscal policy. Within the framework of Standard & Poor's sovereign fiscal criteria, this chapter will consider the various successes and challenges that remain in the fiscal area across Latin America. The chapter outlines aspects of Standard & Poor's methodology, compares various fiscal indicators and discusses strengths and weaknesses in fiscal institutions across the region. In comparing fiscal indicators, the chapter generally first considers Chile, Mexico, Brazil and Argentina (in order of descending rating level), and then other selected Latin American countries by rating category (Colombia, Costa Rica, Panama, Peru, Uruguay, Venezuela and Ecuador). The analysis spans the periods 1997-2000, 2001-04 and 2004 to compare recent and past trends.

Sovereign ratings and methodology

A sovereign rating is an opinion on a government's creditworthiness, not a recommendation to buy or sell a security or a prediction of the stability/volatility of a security price. As such, a sovereign rating reflects the ability and willingness of a government to repay debt on time and in full. It incorporates medium-term repayment prospects and aims to be robust through business, interest-rate, political and commodity-price cycles, as well as near-term market developments.

Standard & Poor's sovereign rating methodology is both quantitative and qualitative in nature. In addition to focusing on various data, it incorporates an assessment of political/institutional credibility, as well as the transparency and

predictability of policy by current and future administrations. Vulnerability to internal/external shocks is affected by the country's economic structure, the consistency of the government's macroeconomic policy mix, the public/private sector external debt burdens and recent debt-servicing track records (Table 2.1).

Countries with investment-grade ratings have more resilient, predictable institutions, as well as stronger economic, fiscal and external positions. By definition, a speculative-grade credit is more vulnerable to internal and external shocks given a combination of its political and economic structures and institutions, as well as its fiscal, monetary and/or external vulnerabilities. By definition, Standard & Poor's is less confident about the ability and willingness of policymakers in a speculative-grade credit to effectively respond to shocks and to adjust policy in accordance with evolving economic conditions.

A sovereign rating reflects a confluence of factors with fiscal policy being a key component of credit quality. Standard & Poor's takes six main criteria into account when considering a sovereign rating: political risk, economic structure and growth prospects, fiscal policy/stability, monetary stability, external liquidity, and external public and private sector debt burdens. While a rating is forward-looking, the legacy of past policies does play a role, a key example being the nation's public debt burden.

Table 2.1. **Latin America: Foreign currency sovereign ratings**
As of November 2004

	S&P credit rating
Chile	A
Mexico	BBB-
El Salvador	BB+
Colombia	BB
Costa Rica	BB
Panama	BB
Peru	BB
Brazil	BB-
Guatemala	BB-
Uruguay	B
Venezuela	B
Bolivia	B-
Paraguay	B-
Ecuador	CCC+
Dominican Rep.	CC
Argentina	SD (Selected Default)

Source: Standard and Poor's.

The fiscal policy criteria

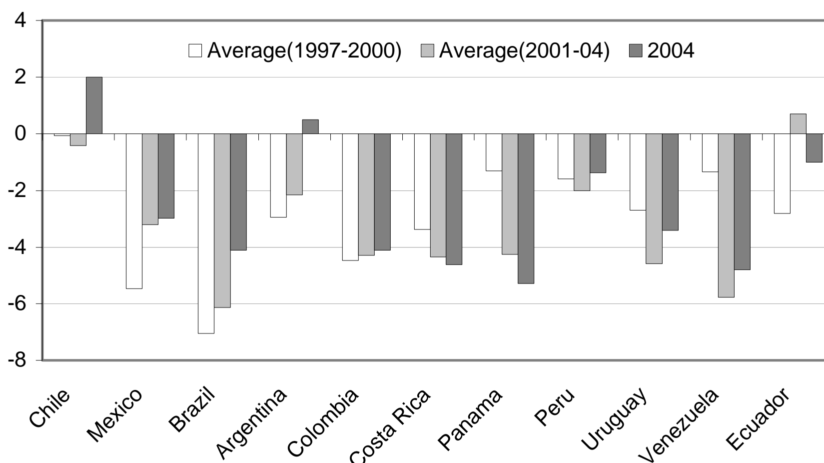
Standard & Poor's looks at the following fiscal indicators when analysing prospective fiscal policy: the current and projected path of budget balances (including expenditure and revenue flexibility), the current and projected level of government debt and interest burden, and off-budget and contingent liabilities. The analysis is based on fiscal indicators for the general government; namely, the central government (including the central bank), the middle-tier and local governments, the social security system and other government agencies. When such data are not readily available from official sources, estimates are compiled for comparative purposes. Non-financial and financial public enterprises are considered for potential contingent liabilities.

In assessing fiscal balances, Standard & Poor's employs stricter standards or benchmarks for countries that are officially dollarised or that have very limited monetary or exchange rate flexibility. In the region, this includes not only Panama, El Salvador and Ecuador, which are dollarised, but also Costa Rica and Uruguay. While implicit in the Standard & Poor's methodology before the Argentine default in 2001, the current criteria incorporate a more specific assessment of fiscal balances, should monetary/exchange rate policy autonomy be constrained. It is important to note that Standard & Poor's does not judge the merits of a fixed *versus* floating exchange-rate regime *per se*, but the rating aims to reflect the consistency, or lack thereof, of the country's macroeconomic policy mix. The combination of various moves towards floating exchange-rate regimes and the stabilisation of the real/nominal exchange rate, coupled with some improved fiscal effort in a number of Latin American countries, reflects a healthier, more consistent policy mix. For example, since the late 1990s, there have been moves towards more sustainable policy frameworks in Brazil, Colombia, Uruguay and post-crisis Argentina, with debt restructuring in the latter two countries.

Fiscal balances: Mixed record reflects rating divergences

In terms of fiscal balances, Chile clearly stands out demonstrating the strongest fiscal performance in the region (Figure 2.1), in line with its "A" rating. In Chile, the general government posted balanced budgets on average during 1997-2003, including a surplus of 2.2% of GDP in 2004. In Mexico, Brazil and Argentina, fiscal imbalances improved over the period 2001-04 compared to 1997-2000. However, fiscal positions in other "BB" and "B" Latin American credits remain fragile with some deterioration over the period 2001-04.

Figure 2.1. **General government budget outcomes**
Headline budget balance in per cent of GDP



Source: Standard and Poor's.

Mexico had a legacy of relatively high deficits in the 1990s, averaging 5.5% of GDP during 1997-2000. Mexico's average deficit, however, declined to the neighbourhood of 3% of GDP during 2001-04, which contributed in part to its upgrade to "BBB-" in early 2002. For Mexico, Standard & Poor's uses the public sector balance as an approximation for the general government balance. Fiscal consolidation at the central government level has been important in bringing down the headline deficit, given the existence of off-budget expenditure commitments. Except for 2002, when the central government deficit reached 1.7% of GDP, the deficit averaged below 1% of GDP during the Fox administration. A progressive reduction in the costs associated with bank restructuring (from the 1994-95 Tequila crisis) has been offset by increases in off-budget infrastructure spending.

Until recently, Brazil's general government deficits have been high and volatile. Amid crises in 1999 and 2002, the headline budget deficit reached some 10% of GDP, given the depreciation of the *real*, the hike in interest rates needed to restore monetary and exchange rate stability, and the problematic structure of domestic debt. However, an improvement in public finances is expected in the near term owing to continued consolidation of the government's primary fiscal effort, coupled with a more stable exchange rate and the reduction in the share of US dollar-linked debt. This fiscal improvement was one of the factors that contributed to the upgrade of Brazil's ratings to "BB-" in late 2004.

In Argentina, fiscal performance worsened through 2001 when the headline budget deficit peaked at 6% of GDP in the midst of a severe economic crisis. The subsequent strengthening of public finances reflects an effort to control spending and the limited financing options available after the debt default. For 2004, the projected general government deficit of 0.7% of GDP incorporates some spending restraint and better-than-anticipated revenue performance, given the economic rebound, with windfall revenue being largely saved.

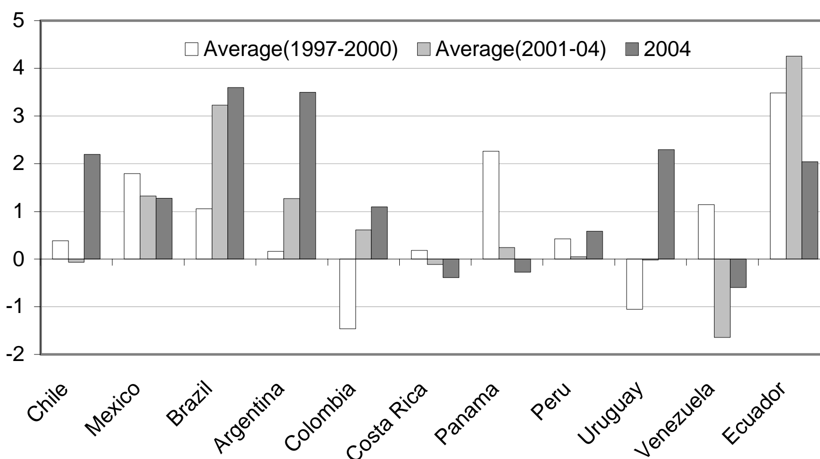
Other Latin American countries have a mixed fiscal track record, as reflected in their rating levels and outlooks. The fiscal positions of Colombia ("BB") and Peru ("BB") are improving. However, Panama's ("BB") and Costa Rica's ("BB") budget balances have deteriorated in recent years. Limited or no monetary flexibility has underpinned negative outlooks on these ratings, with policy effort to redress the fiscal imbalances being key to removing the negative outlooks. "B"-rated Uruguay had experienced significant fiscal deterioration until 2003-04 when the government accelerated fiscal adjustment amid crisis. The debt restructuring of 2003 altered expectations and permitted an economic recovery that strengthened fiscal performance in 2004, supported by some spending restraint. In Ecuador, the 1999 crisis, the debt restructuring of 2000 and dollarisation have been conducive to fiscal improvement. Nevertheless, the government has not used its oil revenue as effectively as it could. Similarly, Venezuela has not taken advantage of a favourable oil-price environment to reduce its fiscal imbalances.

Primary fiscal balances: Also a mixed performance

As part of its analysis of fiscal sustainability, Standard & Poor's assesses the primary fiscal effort undertaken by the government against that needed on the basis of the magnitude of the government's debt burden and prospects for economic growth and the level of real interest rates. In general, this is more important for lower-rated sovereigns, reflecting greater uncertainty about fiscal sustainability and their comparatively weak creditworthiness. In addition to having a bearing on the assessment of the prospective public debt trajectory, the primary surplus effort is an important determinant of access to capital market financing, which is another variable to monitor at the more precarious rating levels (and taken for granted for higher-rating credits). Likewise, the availability of financing from multilateral agencies often depends on compliance with primary and/or headline budget balance targets.

Given their investment-grade ratings, the discussion of a "minimum" or "needed" primary effort should not come into play when analysing Mexico or

Figure 2.2. **General government primary budget balances**
In per cent of GDP



Source: Standard and Poor's.

Chile (Figure 2.2). However, the strengthening of Brazil's primary surplus effort has been a crucial component of the improved credibility of its fiscal policy. Brazil's general government primary surplus more than doubled from an average of 1.1% of GDP during 1997-2000 (beginning from a 1.1% of GDP deficit in 1997) to an average surplus of 3.2% of GDP during 2001-04, and 3.6% of GDP in 2004. Under considerable debate in the markets is the magnitude of the feasible and acceptable primary effort by the Argentine government to reduce its debt burden. Argentina's recent performance has been much stronger than initially expected: the general government budget surplus could be around 6% of GDP in 2004, higher than the government's stated commitment over the medium term. When debt restructuring is completed, and the magnitude of the debt burden is determined, the post-default rating Standard & Poor's assigns to Argentina will incorporate the actual expected primary fiscal effort in relation to what is "needed" given economic growth and real interest rate trends, among other parameters.

Just as the headline budget balances, primary efforts also vary across countries. Deteriorating primary budget balances against the magnitude of their debt burdens imply the need for the primary surplus effort to rise in Panama and Costa Rica. The primary budget balance has slowly risen in Colombia since the late 1990s, but additional effort is needed in response to rising spending on pensions. In Uruguay, the primary effort turnaround has been impressive over the past two years, but must rise even further. Given the country's high debt burden and limited growth prospects, favourable primary (and overall fiscal)

performance, with some additional tightening of policy, is needed to ensure access to capital market and multilateral funding. Ecuador has run a primary effort higher than most other countries in the region in recent years, and its debt is also low compared with its peers. However, cash flow constraints and the policy of official dollarisation and limited access to capital markets and multilateral financing leave the government with no alternative policy option. Even with high oil prices, institutional weaknesses and a poor policy track record constrain the rating at a very low level.

Fiscal institutions and policy track record

Fiscal institutions and practices play an important role in analysing prospective fiscal performances, as does the government's policy track record. In general, investment-grade ratings reflect comparatively strong(er) institutions and greater predictability of policy, especially in the fiscal area. The recent trend in Latin America to legislate "fiscal responsibility" is laudable and a step towards fostering policy predictability. However, Standard & Poor's analyses potential improvements in fiscal policy and fiscal institutions not just by mere passage of a law, but also in terms of implementation and the establishment of a credible policy track record. Both Chile's and Mexico's investment-grade ratings reflect the comparatively strong predictability of fiscal policy and fiscal institutions, although neither country has a formal fiscal responsibility law. Brazil passed a fiscal responsibility law in 2000 that has contributed markedly to the development of a spirit, culture and general awareness of fiscal prudence across political parties and levels of government. While there remain some violations of the letter of the law, it has successfully contributed to improving fiscal performance at all levels of government, backed by market pressures as well.

Panama passed a fiscal responsibility law in 2002, which has not been respected in spirit or letter. The government that took office in September 2004 legislated a temporary suspension of the law, while aiming to bring balances back in line with the fiscal rule. Peru passed a fiscal responsibility law at the end of 1999, but one that has not been systematically complied with, leading to its revision. The government also missed the fiscal targets established with the International Monetary Fund (IMF) during a number of years. However, Peru's fiscal track record has strengthened and its goal of attaining a deficit of 1% of GDP for the non-financial public sector in 2005 is within reach. Colombia's track record of revising its fiscal targets with the IMF weakens credibility in its budgetary planning process. However, the government passed a fiscal responsibility law in 2003 and is moving towards strengthening the budget planning process.

Chile stands out in the region as having a prudent fiscal policy framework and established a strong track record, as evidenced by its highest rating in Latin America. Chile is the only Latin American country with a low enough debt burden to effectively pursue counter-cyclical fiscal policy, as discussed by Luiz de Mello and Nanno Mulder in Chapter 1. In 1987, Chile created a copper stabilisation fund to save copper revenue windfalls and moderate fiscal contractions during economic slowdowns. Such funds are an appropriate policy buffer in nations dependent on commodity revenue. Chile's policy track record strengthened further with the adoption of a fiscal rule, beginning in 2001, with the aim of achieving a structural budget surplus of 1% of GDP. This degree of fiscal policy maturity is not found elsewhere in Latin America. The separation of political interests from the budget process includes an independent commission to estimate potential GDP growth and medium-term copper prices that are used to calibrate revenue projections. Last year provided a good test as to how the policy performs under higher-than-expected growth and copper prices, which led to increased fiscal savings. The government posted a budget surplus of over 2% of GDP in 2004 consistent with abidance by the structural surplus rule.

Mexico's fiscal track record and policy framework suggest that commitment to prudent policy has become mainstream, as in Chile, and across political party lines. This enhanced policy credibility was a key component of the upgrade to "BBB-", or investment grade, by Standard & Poor's in February 2002. While not having a formal fiscal responsibility law, Mexico's track record of prudent policy adjustment has been tested under political transition. Successive governments have followed a policy of reducing central government spending in line with revenue shortfalls; the budget incorporates automatic spending cuts in line with fluctuations in revenue.

In general, a comparatively centralised fiscal framework has been more closely associated with fiscal prudence, at least in Latin America. Unlike other countries in the region, Mexico's intergovernmental fiscal relations have not compromised fiscal prudence. Fiscal adjustment has been shared across the different levels of government, because local governments raise little of their own revenue and rely on transfers from the central government. These transfers are rules-based and depend on revenue performance at the central government level. As Mexican local governments have become more interested in policy autonomy and in raising their own budget financing, the government established credit controls for bank lending to local governments (loans now require ratings by two independent agencies), although implementation is yet to be fully tested.

Despite its investment-grade rating, Mexico does not yet have a sufficient degree of flexibility to pursue counter-cyclical fiscal policy. Off-budget

spending, most notably for failed banks and infrastructure projects (PIDIREGAS), and reliance on revenue from the state-owned oil company (PEMEX), which could be compromised by the need to increase investment, imply that additional fiscal improvement is required at the general government level over the medium-term before counter-cyclical fiscal policy can be considered an effective policy option. In addition, the practice of effectively saving higher-than-expected revenue, specifically oil receipts, has yet to be secured.

Brazil's fiscal institutions are at least as strong as those of its peer credits, having strengthened significantly since the late 1990s, culminating with the passage of a fiscal responsibility law in 2000. Fiscal performance has also been bolstered by Brazil's consistent meeting, or surpassing, the primary budget targets established with the IMF since 1998. Note that Brazil does not have headline budget balance targets, which it would likely not have met in crisis years. In addition, Brazil's three-year budget guidelines law indicates the likely fiscal stance over a three-year time horizon. Owing to growing awareness of the need for fiscal responsibility, it includes an analysis of essentially downside risks to the macroeconomic and budgetary projections. Each level of government also presents a four-year public spending/investment plan. In combination, these policies have led to a perception of more credible and responsible fiscal policymaking.

Not unlike other countries in Latin America, many provisions in Brazil's 1988 Constitution had significant negative fiscal implications, including the mandated transfer of revenue to the states and municipalities without commensurate expenditure responsibilities. However, Brazil's fiscal federalism arrangements have become sound(er) since the late 1990s. A significant deterioration of state finances prompted various bailouts by the federal government in the early 1990s. The federal rescheduling of sub-national government debts during 1997-2000, the passage of the fiscal responsibility law and the closure of the states' financial institutions have been effective to date in generating an important contribution by the sub-national governments to fiscal adjustment. These agreements allow for only limited borrowing and, on balance, have been respected, despite intermittent pressure by the states to loosen some of the constraints.

Argentina's fiscal institutions are weak in relation to most rated sovereigns. The protracted nature of Argentina's debt rescheduling with private-sector creditors and tensions with the IMF over policy commitments have eroded the institutional improvement that occurred during the early 1990s. A much stronger-than-anticipated fiscal performance in 2003-04 reflects the economic rebound that has buoyed tax revenue, as well as expenditure restraint.

However, the increase in the revenue-to-GDP ratio is unlikely to be permanent, hence the need for reform to bolster medium-term fiscal performance. Progress on longer-term fiscal reform has been limited, with no real advance on pursuing a solid fiscal responsibility law, putting in place budgetary mechanisms to ensure fiscal discipline at the provincial level, or reforming the tax-sharing agreements (*coparticipaciones*) between the central and provincial governments, as discussed by Oscar Centrangolo in his comments on Pablo Guidotti's chapter. In addition, uncertainty remains about effective policy implementation. Establishing a track record will be the key to restoring credibility.

Revenue flexibility

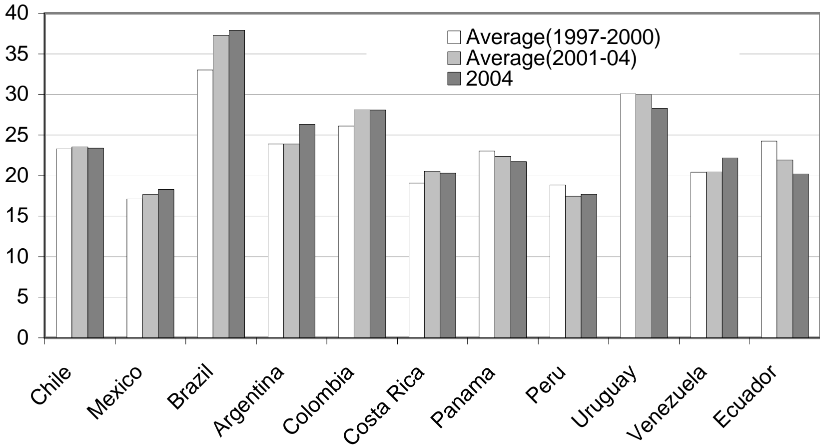
In assessing prospective fiscal performance, Standard & Poor's considers revenue flexibility and the ability to adjust (namely, increase) collections to changing economic conditions and fiscal needs, as well as the adequacy and efficiency of the tax system. Latin America suffers from comparatively narrower revenue bases in relation to higher-rated and/or industrialised countries (Figure 2.3).

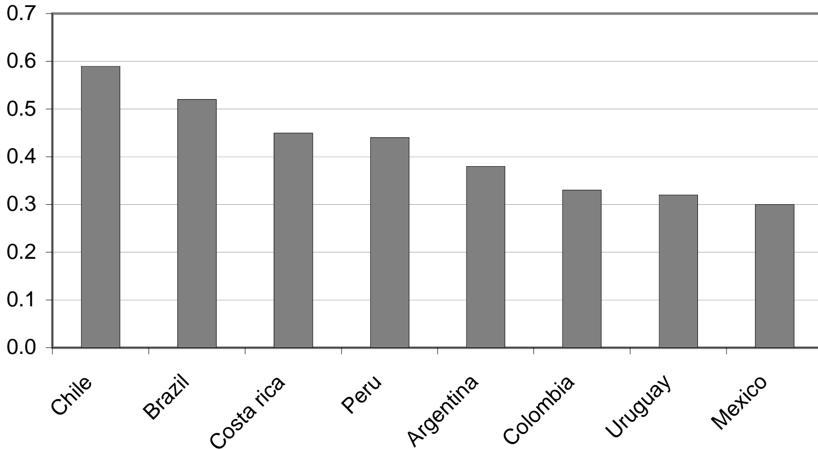
The exception, however, is Brazil, with a general government revenue base of 38% of GDP, and tax revenue accounting for about 35% of GDP in 2004. Brazil's tax burden rose from 29% of GDP in the mid-1990s, as the government increased taxes to support the generation of primary budget surpluses. Brazil's tax regime, while comparatively effective in collecting taxes, is very complicated and poses a large burden on the formal economy. In the near term, it would be important to reform the tax system so as to reduce distortions. Once the debt-to-GDP ratio has declined, lowering the tax burden in line with a reduction in expenditure commitments would prove more supportive of investment and conducive to sustainable, long-term growth.

Chile's general government revenue has remained relatively stable at about 23% of GDP, with taxes accounting for around 18% of GDP. While these revenue bases are lower than similarly-rated credits, whose revenue accounts for an average 42% of GDP, they are adequate for Chile's fiscal burden. In addition, Chile's tax collection is the most effective among Latin American credits. By contrast, Mexico's revenue base is very small and narrow, and tax administration is comparatively inefficient. Central government revenue is around 18% of GDP, much lower than peer credits whose revenue averages 32% of GDP. Mexico's tax take is close to 10% of GDP, excluding oil-related revenue. Mexico has struggled to increase and broaden its tax base, facing strong political resistance. An important policy goal would be to broaden the value-added tax base since one-half of the potential tax base is zero-rated or

exempt, as discussed by Rogelio Arellano and Fausto Hernández in Chapter 6. Other things equal, improved creditworthiness and a stronger fiscal framework could depend on the ability to increase/broaden the tax base to satisfy pressing social and infrastructure needs over the medium term.

Figure 2.3. **General government revenue and tax productivity**





1. VAT revenue in per cent of consumption divided by the standard VAT rate, 2001.

Source: Standard and Poor's.and IMF.

Problems of weak tax administration and enforcement have constrained Argentina's fiscal performance since the 1990s, when the government granted tax amnesties periodically. Argentina's general government revenue base averaged 24% of GDP during the late 1990s. Tax revenue, however, averaged a much lower 15-17% of GDP, suggesting that there is room for improvement in collection, although not as much as in Mexico. In 2004, tax revenue was buoyant, reflecting some improvement in tax administration and collection effort, and mainly strong economic recovery and the introduction of distortionary taxes on exports (including oil) and financial transactions. Dependency on an increasingly narrow tax base and on inefficient instruments, along with increased informal economic activity since the crisis, tends to undermine the sustainability of Argentina's tax base over the medium term.

Elsewhere in the region, the governments of Costa Rica and Panama are pursuing tax reform to broaden the tax base against a background of numerous loopholes and/or the absence of taxation in many sectors of the economy. While overall general government revenue in these countries is between 20-22% of GDP, the ratio of tax revenue to GDP is much lower, around 12% in Costa Rica and a mere 9% for the central government in Panama. Reform to increase the tax base by 2.5% of GDP has proven politically difficult in Costa Rica, being under discussion in Congress for several years. In Panama, the new government aims to bring some of the more buoyant sectors of the economy, currently exempt from taxation, into the tax base. In both countries, prospects for reform are likely to have credit implications. Passage and effective implementation of solid reform is important given a recent deterioration in public finances and limited monetary flexibility.

Peru's revenue and tax bases of almost 18% of GDP and 13% of GDP, respectively, are also very low in view of its social spending needs and compared with peer credits. Future reform includes reducing the tax incentives granted by the regional governments. However, Peru's tax regime is comparatively more efficient than those of other countries in the region. In Uruguay, efforts to improve tax administration advanced in late 2003; central government tax revenue is about 15% of GDP, against central government revenue of 28% of GDP. Colombia's revenue base of 28% of GDP is comparatively high vis-à-vis its peers. Its tax base is about 20% of GDP, although efficiency is quite low.

Financial transactions taxes

A recent trend in the region has been to use distortionary financial transactions taxes (Argentina, Brazil, Colombia, Peru and Venezuela) since they are easy to collect and capture activity in the informal economy. The benefit of

these taxes is that they can – and are being used by the authorities – to combat tax evasion through the cross-checking of tax declarations. In fact, some nations, such as Peru, plan to reduce the rate over time or permit payments to be deducted against other tax liabilities. All things equal, the use of less distortionary taxes would be preferable, given their detrimental impact on economic competitiveness and growth prospects. However, at lower rates, where revenue generation is often crucial to underpin stronger fiscal performance, the quality of taxation becomes of second-order importance.

Dependency on volatile commodity revenues

For countries that are dependent on commodity-related revenue, the creation of stabilisation funds enhances revenue flexibility over the business cycle, in addition to generating savings for future generations, as in many countries in the Middle East. In Latin America, only Chile has a stabilisation fund that operates effectively and smoothes copper revenue over business/commodity cycles. While Mexico has a fund that contains monies from oil revenue that exceeds the budget's reference price, most of these funds are actually spent each year according to a formula, thus rendering fiscal policy pro-cyclical, as discussed by Rogelio Arellano and Fausto Hernández in Chapter 6, as well as Bénédicte Larre in her comments. While the fiscal responsibility law of 2002 created an oil fund in Ecuador, such that 70% of the monies be used for debt buybacks/reduction, the funds have been used to date essentially to finance the deficit. In Venezuela, where 50% of government revenue stems from oil, there is no effective oil stabilisation fund.

Expenditure flexibility

Expenditure flexibility is particularly crucial when assessing a government's ability to adjust its finances in the face of challenging economic conditions. Countries at lower rating levels, which includes most Latin American credits, have limited expenditure flexibility, with payroll, pensions, interest payments and other "earmarked" items accounting for a large share of spending. Unfortunately, in combination with tight fiscal positions at the lower-rating level, this implies limited opportunity for increasing economically important social, human capital and physical capital expenditures that would tend to raise productivity and enhance growth prospects over the longer term.

Chile and Mexico have comparatively more expenditure flexibility than other Latin American credits, which is not surprising given their stronger creditworthiness. Non-discretionary spending accounts for 50-55% and 60% of central government revenue in Chile and Mexico, respectively. On the other hand, around 80% of Brazil's central government revenue goes towards payroll,

pensions, interest payments and other mandated spending. Before its default and the cessation of interest payments, 60-65% of Argentine central government revenue went to cover payroll, pensions and interest payments. Inflexibility was even higher, at around 95% of revenue, if transfers to the provinces were included. In Colombia, around two-thirds of central government revenue goes towards wages, pensions and interest payments, but non-discretionary spending also includes mandated transfers to local governments. In Costa Rica and Ecuador, non-discretionary spending captures 75% of central government revenue, while in Panama and Uruguay the figure is close to 90%.

For most of Latin America, improving expenditure flexibility requires a concerted political effort. It entails overcoming cumbersome constitutions that legislate aspects of fiscal policy, implementing administrative reform that includes payroll restraint, working towards a sustainable reduction in indebtedness, and, in many instances, implementing pension reform.

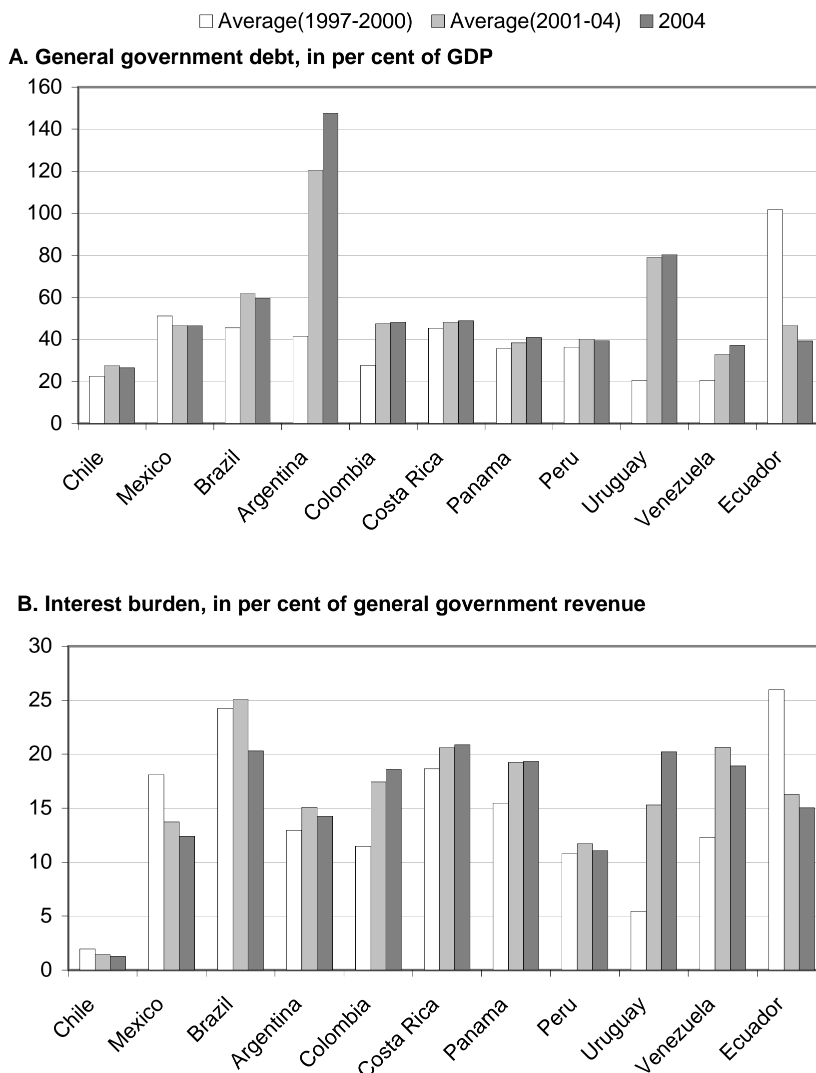
Pension reform

Pension reform has yielded mixed results across Latin America. While the privatisation of pension regimes and a shift away from pay-as-you-go, government-sponsored systems has been successful to date in Chile and Mexico, it failed to stem fiscal imbalances elsewhere in the region. Many governments underestimated the transition costs involved in reform, as discussed by Pablo Guidotti in Chapter 3, and/or have inadequately adjusted spending to accommodate these transition costs, which proved to be a destabilising fiscal burden in Argentina, Uruguay and Bolivia. Large pay-as-you-go fiscal imbalances still weigh on expenditure flexibility in Brazil, Panama and Colombia, where further pension reform could improve creditworthiness. Pension reform is clearly needed in these systems to better align entitlements with contributions, but whether a complete shift to a privatised individual account scheme is appropriate is unclear.

Debt burden

Although not the sole determinant of a sovereign rating, as noted previously, the size of government debt (net of liquid assets available for debt repayment) as a share of GDP does play an important role in assessing fiscal sustainability and creditworthiness. Investment-grade Chile and Mexico have among the lowest debt ratios in Latin America, at around 20 and 40% of GDP, respectively (Figure 2.4) Brazil's net general government debt-to-GDP ratio is higher at almost 52% of GDP in 2004, and Argentina's pre-debt restructuring was around 140% of GDP.

Figure 2.4. **General government debt and interest burden**



Source: Standard and Poor's.

For "BB"-rated Colombia, Costa Rica, Panama and Peru, net debt stands at between 40-50% of GDP. Much lower-rated Ecuador and Venezuela also have net debt ratios at around 40% of GDP, with their ratings reflecting other weaknesses, particularly political and institutional, as well as the questionable sustainability of their macroeconomic policy mixes. Ecuador restructured its debt in 2000 with a 40% reduction in face value. In contrast, Uruguay has a

significant debt ratio, at around 80% of GDP, and the 2003 debt restructuring did not include a reduction in principal. Expectations of Uruguay's commitment to keeping fiscal policy on a prudent track would permit a gradual reduction in debt over time; comparatively stronger institutions and policy predictability support its debt at the "B" rating level.

With regard to the magnitude of a government's debt burden, credit rating analysis considers not only the debt-to-GDP ratio, but also the general government interest burden and the composition of public debt. In general, Latin American sovereigns have high interest burdens compared with other similarly-rated credits, the marked exception being Chile, whose general government interest burden is lower than that of its peer credits. Even Mexico's 12% interest-revenue ratio is almost double that of other credits in the "BBB" category. Brazil's interest burden has settled at around 20% of revenue, but has spiked much higher during periods of financial stress. Argentina's interest burden reached 15% of revenue in 2004, although it was not servicing 60% of its debt. In recent years, the interest burden in Colombia, Costa Rica, Panama, Uruguay and Venezuela rose to around 20% of revenue, a comparatively high ratio. Ecuador's interest-revenue ratio declined toward 15%, a drop that in part reflects debt relief.

The composition and maturity structure of government debt also contributes to Standard & Poor's fiscal analysis. The composition of debt itself can have important effects on the level of indebtedness relative to GDP and on the volatility of interest payments relative to revenue, and hence on fiscal balances. A prime example is how the problematic composition of Brazil's domestic debt exacerbated the debt dynamics during the 2002 crisis, ahead of the nation's presidential election. Given the then high share of debt indexed to the US dollar and also to local overnight interest rates, the significant depreciation of the *real* and the subsequent monetary policy response to hike overnight rates resulted in an increase in Brazil's debt-to-GDP ratio of about 13 percentage points during that year. The very short tenor of Brazil's domestic debt also heightened concern about rollover risk in 2002. The recent debt crises in Argentina and Uruguay further highlight the vulnerabilities created by issuing debt in foreign currency in countries with semi or fixed exchange-rate regimes undermined by an inconsistent policy mix. Debt-to-GDP ratios more than doubled in these crisis situations as a result of currency depreciation.

A sovereign should ideally issue debt at long tenors, at fixed interest rates and in its own currency. Latin American nations do not enjoy this luxury. Even "A"-rated Chile has 85% of its debt denominated in US dollars, as noted by Luiz de Mello and Nanno Mulder in Chapter 1. In recent years, Mexico's prudent liability management, aided by pension reform that supports demand

for long-term debt placements in local currency, has served to reduce fiscal vulnerability. The government has lengthened the domestic yield curve with placements of 20 years' maturity. While still comparatively short, the average domestic tenor of 2½ years has doubled since 2001, and 40% of domestically issued/locally held central government debt is at fixed rates.

Brazil has made significant progress in reducing the share of US dollar-indexed debt from a peak of just over 40% of domestic debt in 2002 to under 10% at the end of 2004. However, with about 40% of domestic debt maturing within a 12-month period and over 50% of securities indexed to the overnight interest rate, much room remains for improvement in Brazil's debt structure. Such weaknesses in debt composition span the region.

Contingent and other potential liabilities

In addition to assessing fiscal balances, fiscal flexibility and a sovereign's debt burden, the analysis of the fiscal underpinnings of credit rating incorporates estimates of potential contingent liabilities to the government. In Latin America, debt burdens have systematically been compromised by off-budget, debt-creating operations. Chile is estimated to have lower contingent liabilities than the rest of sovereigns rated in Latin America.

In general, off-budget quasi-fiscal activities, as well as explicit or implicit guarantees by the government, are considered when estimating contingent liabilities. Recognition of debt arising from judicial rulings and other off-budget spending in various countries, such as Brazil and Argentina, contributed to important increases in their respective debt burdens. Recognition of debt in Argentina during 1993-2001 amounted to some 13% of GDP. In Brazil, the recognition of fiscal "skeletons" added about 10% of GDP to the debt burden during 1996-2003.

Standard & Poor's takes a cautious view of excluding public-sector investment from the fiscal targets. Such behaviour presents the risk that off-budget and/or unsupervised spending of a potentially more questionable nature may not be unaccounted for. The same reasoning could hold for guarantees and spending commitments associated with public-private partnerships (PPPs), should they be established without sufficient fiscal safeguards. Since the budget balance and the debt data are for the general government, an assessment of the potential drain on public finances posed by poorly-managed state-owned enterprises is also considered in credit-rating analysis. Pension liabilities are included in the assessment of fiscal balances. The financial sector may present another important contingent liability

Table 2.2. **Potential contingent liabilities**

	Estimated NPL peaks (in %)	Credit to the private sector and non-financial public enterprises (in % of GDP, 2004)	Cost (in % of GDP)
Chile	10-20	64	7-14
Colombia	15-30	25	4-8
Panama	15-30	86	13-26
Brazil	25-40	33	8-13
Costa Rica	25-40	32	8-13
Mexico	25-40	16	4-6
Peru	25-40	21	5-8
Uruguay	25-40	42	10-17
Venezuela	35-50	9	3-5
Argentina	50-75	26	13-20
Ecuador	50-75	22	11-17

Source: Standard & Poor's and IMF.

for the government. As seen in numerous countries within and beyond Latin America, governments have been called upon to bail out large banks and/or the banking system as a whole. To estimate this risk, Standard & Poor's projects a scenario of peak non-performing loans (NPL) that could result from a "deep-recession" environment, given its assessment of the strengths and weaknesses of the nation's financial system (Table 2.2). Coupled with the extent of financial intermediation, the potential cost to the sovereign is calculated.

Future challenges and policies to improve creditworthiness

With the vast majority of Latin American sovereigns rated by Standard & Poor's in the speculative-grade category, there is ample opportunity for significant improvement in fiscal policy and fiscal institutions in the region. In addition to running tighter budget balances and reducing debt levels, improved fiscal flexibility is important. Most nations could benefit from broader revenue bases to support widespread pressure for increasing efficient, well-targeted and productive government spending, such as on physical, social and human capital accumulation. In addition, less distorting tax regimes would contribute to making these economies more efficient. Reduced expenditure rigidities via politically difficult pension reform, payroll restraint and the elimination of widespread earmarking in many countries could support increased ability to adjust spending as needed under unforeseen stress scenarios.

The establishment of prudent fiscal rules and norms, as well as transparent decision-making processes through the enactment of well-designed fiscal responsibility legislation, should increase policy predictability, as could the creation of stabilisation funds for commodity-dependent sovereigns. However, the development of a strong policy track record is crucial to gaining confidence. Entrenching prudent fiscal behaviour and norms is key not only at the central government level, but also throughout the public sector, given current patterns of devolution of fiscal responsibilities to local governments. Finally, debt management practices aimed at lengthening tenor, issuing securities denominated in local currency and at fixed interest rates, while taking time and part of overall capital market deepening, are important to reduce the vulnerability of debt stocks and interest burdens.

Comments

Patrick Lenain,

OECD Economics Department

Credit rating agencies and information asymmetry

The fact that emerging markets are subject to information asymmetry is well established in the empirical literature. Issuers of emerging market debt are not required by market overseers to provide detailed economic and financial reports. Faced with high costs for acquiring information, most market participants prefer to follow supposedly better-informed investors, such as large institutional investors. This has been associated with the occurrence of "herd behaviour", contagion across countries and sudden capital flow reversals (Kräussl, 2003).

Thus, improving the transparency and quality of information is an important step towards strengthening international finance. Together with data dissemination standards, credit rating agencies can play a critical role in this respect. By assessing the creditworthiness of sovereign borrowers, rating agencies provide investors with the tools needed to make well-informed decisions. Thus, in principle, they can help to reduce adverse selection, steering investors towards creditworthy governments and away from fragile borrowers. Ratings can also lead market participants in the right direction, helping to cool off euphoria during periods of boom and to attenuate pessimism during periods of bust – if so warranted.

Several authors, however, doubt that rating agencies play this role effectively. They argue that these agencies tend to follow, rather than lead, market trends. Reisen (2003), for instance, finds that ratings fail to predict currency crisis and criticise rating agencies for having downgraded sovereign borrowers after the occurrence of crises, rather than before. This claim is based on a wide definition of the rating agencies' mandate, which typically includes the prediction of currency crises. If a narrower (and more accurate) definition of

sovereign ratings is used – the probability of sovereign bond defaults – rating agencies appear apt to perform their task. Reinhart (2002) correctly tests whether credit ratings are good predictors of debt defaults, but she uses a data sample that includes defaults on the reimbursement of commercial bank credits, rather than defaults on sovereign bonds.

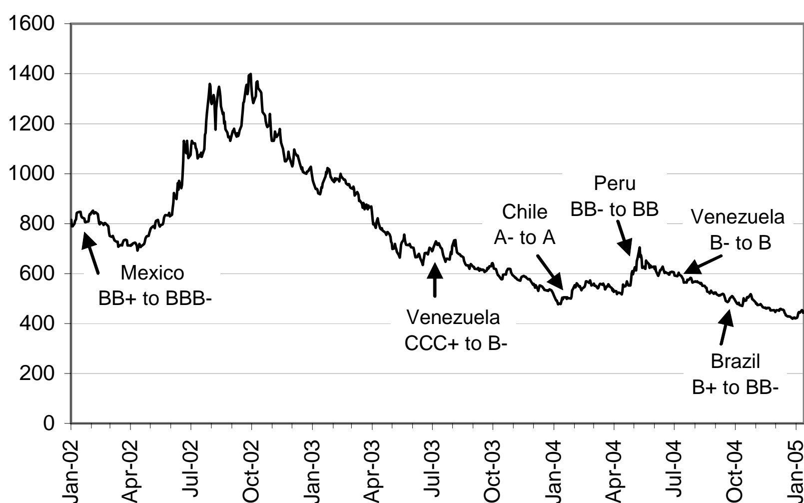
My comments adopt a different angle. Rather than discussing the predictive value of credit ratings, they examine qualitatively whether ratings contribute to reducing information asymmetry in the case of the Latin American borrowers examined by Lisa Schineller. For this purpose, two questions are asked: do rating agencies lead or follow market trends? And do ratings bring valuable information to the market?

Do credit ratings lead or follow market trends?

The intuition that rating agencies follow market trends is not implausible. Rating agencies could decide to upgrade borrowers when they benefit from large capital inflows and downgrade those suffering from large capital outflows. In this regard, it is worrying that rating agencies made a record number of upgrades shortly after a wave of optimism regarding emerging market prospects. Standard & Poor's raised 27% of its ratings in 2004, an unprecedented amount since it resumed assigning sovereign ratings in 1975 (Standard & Poor, 2005). In Latin America, the agency upgraded the sovereign debts of Brazil, Chile, Paraguay, Peru, Uruguay and Venezuela by one notch. It did not downgrade any major sovereign borrower in the region. The troubling fact is that this series of upgrades followed a period of market optimism, as illustrated by the fall of interest rate spreads on Latin American sovereign debt (Figure 2.5).[1] The sequencing of these two movements is worrying: at first glance, it could suggest that rating agencies just followed the optimism of market participants.

Rating agencies, however, remain cautious about the quality of Latin American sovereign debts. As Lisa Schineller's chapter reminds us, Latin American sovereign borrowers have a "mixed track record". The region includes a wide variety of credit ratings, ranging from the strong performance of Chile (rated "A") to the selective default of Argentina on certain classes of its obligations (rated "SD"). Despite recent upgrades, many countries in the region continue to have fragile debt servicing capacity: only two sovereign borrowers are regarded as "investment grade" (Chile and Mexico), while all the other rated sovereign borrowers are seen as having "significant speculative characteristics" due to inherent uncertainties (including Brazil and Peru).

Figure 2.5. **Interest spreads on Latin American sovereign debt, 2002-05**



Source: JP Morgan EMBI+ for Latin America, and Standard and Poor's.

Lisa Schineller rightly stresses that several countries are still suffering from weak fiscal and debt management frameworks. Despite recent improvements, many of the countries have large and volatile budget deficits. They have narrow tax bases, which tend to fluctuate following commodity price cycles, and face large demands for public expenditure. Outstanding government debt stocks vary across countries, but are substantial and perhaps above prudent levels in some cases. This cautious assessment seems to have been overlooked by market participants in their search for yields in an environment of ample global liquidity. Thus, vigilance is called for.

Do credit ratings bring new information to the market?

In order to reduce information asymmetry, credit ratings need to provide new valuable information. If they merely reflect publicly-available information already incorporated in current market conditions, ratings will be ignored by investors or worse, they will exacerbate market trends. To be valuable, credit ratings need to reflect information unavailable to market participants and react rapidly to new developments. In this regard, the importance of providing an overall assessment of fiscal trends, rather than a narrow evaluation of the central government budget, cannot be stressed enough. Indeed, past emerging market crisis occurred unexpectedly in part because critical information on underlying fiscal developments was overlooked.

A typical example in this respect is the large exchange-rate exposure builtup by the Thai banking sector before the Asian crisis. Banks were borrowing in foreign currency and lending in domestic currency in large magnitudes, leading to a potentially damaging currency mismatch (Williamson, 2004). Although the banking sector is not part of the general government, most countries come to the rescue of banks that are too-large-to-fail and such financial risks should therefore be considered as a potential contingent government liability. This has prompted the IMF to integrate a Financial Sector Assessment Programme in its surveillance activity.

A second example is the accumulation of payment arrears by governments in transition economies, particularly Russia and Ukraine, as a way to ease budget deficits on a cash basis. In 1996-97, governments allowed wage and pension arrears to build up so as to avoid higher borrowing, which would have signalled a deterioration in the public finances. Although the accumulation of payment arrears was unsustainable, it masked the deterioration of the fiscal situation. A third example relates to the operation of fiscal federalism frameworks, with public expenditure obligations being transferred to lower levels of governments without the resources required, as occurred in Argentina before the 2001 financial crisis.

Getting the full picture in an environment of asymmetric information can be difficult and costly. In a comparative study of the resources spent by rating agencies in developed and developing countries, Ferri (2004) concludes that they allocate fewer resources to emerging market issuers than to OECD issuers. Lisa Schineller, by contrast, appears to go after the full picture, taking off-budget liabilities seriously, including explicit and implicit government guarantees, liabilities of state-owned companies, future pension burdens and potential non-performing loans accumulated by the financial sector. Let us hope that this effort indeed succeeds in providing a broad assessment of possible sources of fiscal stress.

Note

1. According to the EMBI+ spread index for Latin America.

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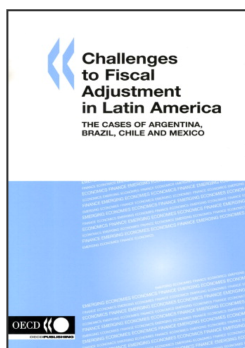

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