Fiscal Stimulus, Fiscal Policies and Financial Instability[1]

Alicia Girón and Eugenia Correa[2]

> "Apart from the necessity of winning the war, facing society today so important as the elimination of economic insecurity" (Lerner, 1943:38).

In the short term, the economic and social perspectives of capitalism changed on a global scale. However, these were not far from the forecasts made by the criticism of the persistence of neoliberal policies and austerity as a way out of the issues after the Great International Crisis (GIC). The deterioration of institutions and the persistent concentration of wealth slows down the capacity of countercyclical policies and fiscal stimuli, especially in countries like those of Latin America who neither have a solid social spending policy structure nor the necessary experience of supporting institutions to hold up the generalization of full unemployment.

This document intends to analyze the fiscal stimulus programs and their limitations in Latin American context where debt's burden in public spending hinders and stable economic development. COVID-19 sanitary emergency makes evident a limited public health system's capacity, specially the imposed limitations by the debt and the lack of capital control. The so-called budgetary limits, the conditions for expanding spending in some of the economies, and the social and institutional advantages if carrying out a fiscal policy without restrictions, are exposed.

Keywords: Fiscal policy, Financial Instability, Latin America, Great International Financial Crisis

JEL: E62, O23, H50, H12, O54

The dilemma between monetary and fiscal policies

The prevalence of economic, financial, and political crises, as well as the crisis of democracies during the last fifty years, shook the economic policies exercised in the postwar period when the creation of employment and social welfare had their best years in developed countries under Keynesian thought, and in Latin America under the thought of the Prebisch of the Economic Commission for Latin America (CEPAL). The Brazilian and the Mexican miracles are two

---

[1] This paper is the result of the PAPIIT IN301918 Project "Financial Geography and Institutions in the World's Economy" of the General Directorate of Academic Personnel Affairs (DGAPA-UNAM). The author is thankful with the National Council of Science and Technology (CONACyT) scholarship holders Adheli Galindo, Jairo Cisneros and Daniel Mirón. Social service Leslie Badillo and Paola Díaz for compiling the material.

[2] Alicia Girón, Coordinator of the University Program for Asian and African Studies (PUEAA) and Researcher at the Economic Research Institute UNAM. Email: (alicia@unam.mx). Eugenia Correa, member of the Posgraduate Economics Program and professor of the School of Economics UNAM. Email: (correa@unam.mx).

significant examples, they achieved 8% growth rates under an “import's substitution industrialization” process despite its subsequent undermining by the monetarist counter-revolution. The influence and the imposition of orthodox policies by the International Monetary Fund (IMF), from the seventies, turned towards stabilization plans, contractionary monetary policies, and austerity, supported by coups in South America and, even after the establishment of democracy, the hegemonic thought, which has lasted over fifty years.

There has been a process of economic and financial deregulation and liberalization accompanied by the privatization of the public sector. Its basis locates with Thatcher and Reagan, whose ideas articulate through the Washington Consensus, the Maastricht Treaty, the creation of the European Central Bank in Europe, and in underdeveloped, emerging countries such as Argentina, Brazil, and Mexico, with the Fiscal Reform. The first of the ten commandments, contemplated by said consensus, was regarding fiscal discipline: a lock on governments to avoid spending more than what was received from tax purposes. (Arestis, 2004) In addition to a reordering of spending priorities, where compliance with the external debt service is a priority. Financial deregulation obtained the central banks' autonomy, whose main objective was to set inflationary goals, leaving aside the economic development. The integration of financial circuits at an international level and an invisible, progressive financial deregulation and liberalization allowed to obtain speculative profits and strengthen institutional investors, the non-financial corporate sector, parallel banking, and large commercial banks. An “irrational financial exuberance” of great profit to which the president of the Federal Reserve of the United States alluded (Greenspan, 1996) evident ten years later. In the “subprime crisis” and its development.

The GIC of 2008-2009, described as the expression of the third crisis of economic thought in “The Third Crisis in Economics” by Galbraith[3] (2013), referring to the conference by Joan Robinson (1972) entitled “The Second Crisis in Economics”, was characterized as the crisis of financialization, globalization, and neoliberalism by some authors (Duménil and Levy, 2013), which led to the entry of the “lender of last resort” and, as Skidelsky stated, “Keynes. The Return of the Master[4]” (Skidelsky, 2010). On the contrary, procyclical support from central banks to face recession and asset depression took a 180-degree turn by deepening the austerity policies and indebtedness development of both the countries and the non-financial corporate sector. A clearly opposing idea to the Keynesian proposal which is based on the need for public deficit spending and the complementarity between monetary and fiscal policies. Where, despite the support provided by central banks and a zero interest rate, when profit expectations are not favorable and the interest rate cannot fall any further, it is only from the impulse of public investment that marginal capital efficiency will improve private agents' profit expectations. The confusion regarding the monetary policy implemented "...got that many economists from the mainstream thought as well as from different heterodox perspectives pronounced the dreaded words 'SS', Secular Stagnation" according to (Seccareccia, 2020).

Fiscal Policy and Financial Instability

[3] James Galbraith “The Third Crisis in Economics” presidential address at AFEE, ASSA (2013).

[4] Robert Skidelsky, “Keynes. The Return of the Master” (2010).

Just as Lerner (1943) mentioned: to win the war, one of the most important measures is the elimination of economic insecurity, "…the central idea is that government fiscal policy, its spending and taxing, its borrowing and repayment of loans, its issue of new money and it withdrawal of money, shall all be undertaken with an eye only to the *results* of these actions on the economy and not to any established traditional doctrine about what is sound or unsound" (Lerner, 1943: 39). For Minsky, a Big Government "…to stabilize output, employment, and profits by its deficits, the lender of last resort stabilized asset values and financial markets" (Minsky, 2006: 43). If Lerner and Minsky had known the macroeconomic indicators at the end of 2019 as well as the forecasts of the International Monetary Fund (IMF) at a global level, including the Latin American region, they would have been anxious to know the causes of the lack of complementarity between fiscal and monetary policies, they would also be surprised by the development of the fall of the world's economy from 9.5% at the end of 2020, except for China which showed a 2.3% GDP recovery (IMF, 2020).

In a capitalist economy, the productive dynamics work through an overdraft, and the maintenance of zero deficit balance sheets implies limiting the credit lines of banks, companies, and households. Contrary to orthodox economic theory, it is the anticipated spending and loans that generate deposits. If the government decides to increase its expenses, companies and households will see their monetary balances increased through the sale of merchandise with which they will be able to reduce their debts through deposits. (Lavoie, 2014:196.197, 205-207) In such a way that if spending is constrained, the virtuous circle allows the management of liabilities and economic activity, leading to stagnation, a dynamic that Latin America has been experiencing for half a century through different stabilization and austerity plans under the thought of the IMF's Washington Consensus.

Over half a century, Latin America has been experimenting with different stabilization and austerity plans under the Washington Consensus and the IMF. Latin America's development from 2008-2009, and after governments whose achievements in social matters improved the population conditions by reducing the poverty indicators, reversed the decrease in poverty during the second decade of this century. There is no doubt that the pursuit of orthodox policies trying to reduce fiscal deficit laid the foundations of economic and financial fragility and instability. Therefore, the Latin American region did not achieve sustained economic growth due to a lack of fiscal policy looking to reorient public spending and achieve full employment policies. The monetarist counterrevolution focused on paying the growing external debt and on the deepening of integration into international financial markets.

The second decade of this century is a lost decade for Latin America[5], although it is unparalleled with the eighties. A decade when a Big Government was lacking and the Washington Consensus guidelines emerged along with inequalities, which resulted from income concentration in the absence of an efficient fiscal policy. To this day, Latin America faces an unprecedented historical

[5] The pandemic has resulted in a 91% GDP drop of the growth rate, which means a poverty rate of up to 37.3% and an unemployment rate increase of 13.5%, evidencing a deplorable state of the systems of health and an informal economy of 158 million workers, that is, 54% of the economically active population is in informality (ECLAC, 2020: 77). A higher decrease between 45% and 55% in the inflow of these capital flows due to foreign direct investment coupled with the declining trend worldwide, a drop in tourism and financial volatility which only leads to infer economic instability and financial (ECLAC, 2020).

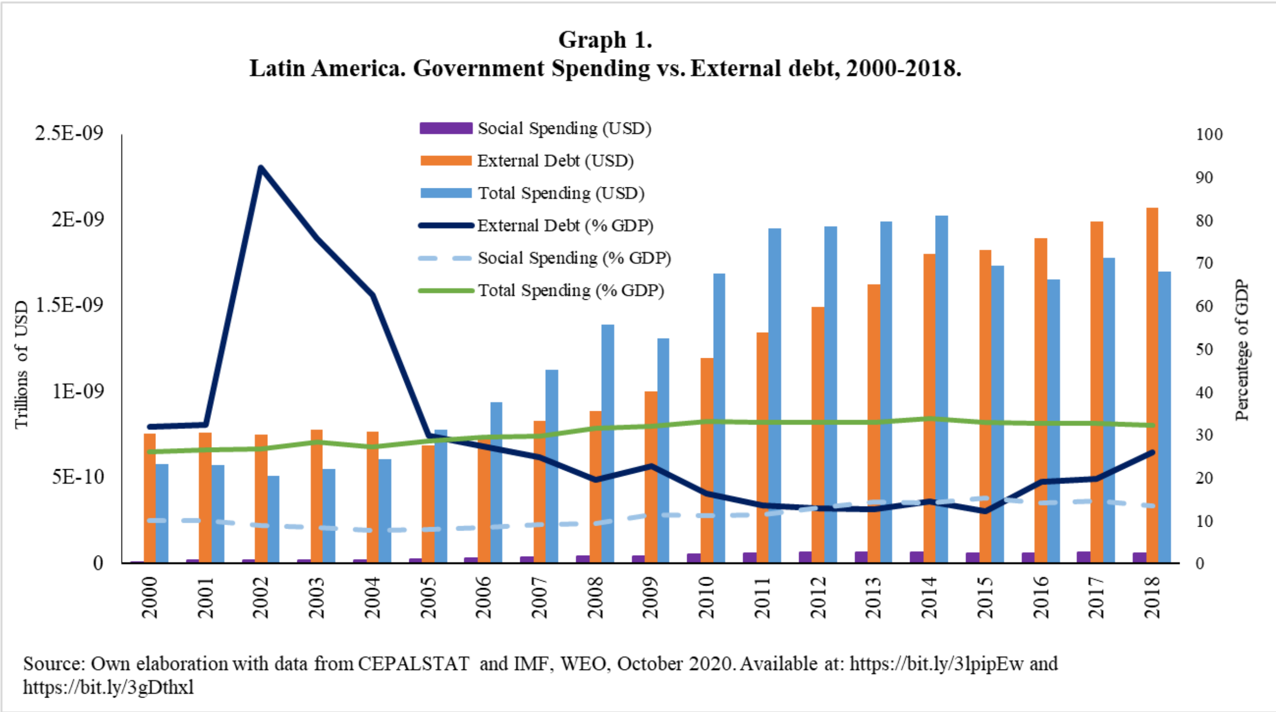
crisis due to the impact of COVID-19 and an uncertain, unstable, and indefinite post-pandemic process in the short, medium, and long terms.

It is relevant to mention the antecedents indicated by ECLAC before the pandemic: a 0.4% economic growth performance of the GDP on average between 2014 - 2019. During 2019, growth came along with a reduction in foreign direct investment of 7.8%, commodities prices on average 5% below the levels of 2018. The blurring of public and private investment, coupled with a fall in exports, aggravated the growing external indebtedness. The gross public debt of the non-financial public sector represented 60.3%, and the gross public debt went from 29.8% in 2011 to 46.0% of GDP in 2019; added to this is a total gross external debt/exports of goods and services of 160.9%, which means fiscal fragility of the public finances of Latin American countries.

The priority of the region has been "to safeguard the sustainability of the public debt…a reduction of the primary deficit in Latin America, which stood at 0.6% of GDP in 2019, compared to 1.1% of the recorded GDP in 2016" (ECLAC, 2020: 79). Therefore "...the spending policy has focused on containing its growth, which has led to a reduction in primary spending to adjust the increasing weight of interest payments" (ECLAC, 2020: 79).

For the case of Latin America, observing the development of Public Expenditure during the last decade will be enough, especially in Argentina, Brazil, and Mexico. As shown in Graph 1, the austerity policy has been imposed as one of the major burdens for Latin America so far in the twentieth century. The so-called "healthy" public finances that support the zero deficit have deteriorated the capacity of production and the well-being of the societies of the region. As Graph 1 shows, the government spending to cover Latin America's external debt as a proportion of the GDP has exceeded the total spending for much of this century, except for the 2011 to 2014 period. However, the trend reverses during 2015, when the government's total expense fell to $ 1.7 trillion, 32.9% of the GDP, and debt remained at $1.8 trillion or 36.3% of GDP.

In absolute terms, the fiscal burden of total government spending was exceeded by the amount of regional external debt as of 2015 until 2018, a time when the external debt was equivalent to 2.1 trillion dollars, total public spending decreased to 1.6 trillion dollars, and only 60.5 trillion allocated to social spending, that is to say, only 0.35% of the total amount. Although government investment in social spending has developed positively in recent years, considering the 19 billion dollars they presented in 2001, they are still very small amounts compared to the size of the external debt.



Graph 1.
Latin America. Government Spending vs. External debt, 2000-2018.

Source: Own elaboration with data from CEPALSTAT and IMF, WEO, October 2020. Available at: https://bit.ly/3lpipEw and https://bit.ly/3gDthxl

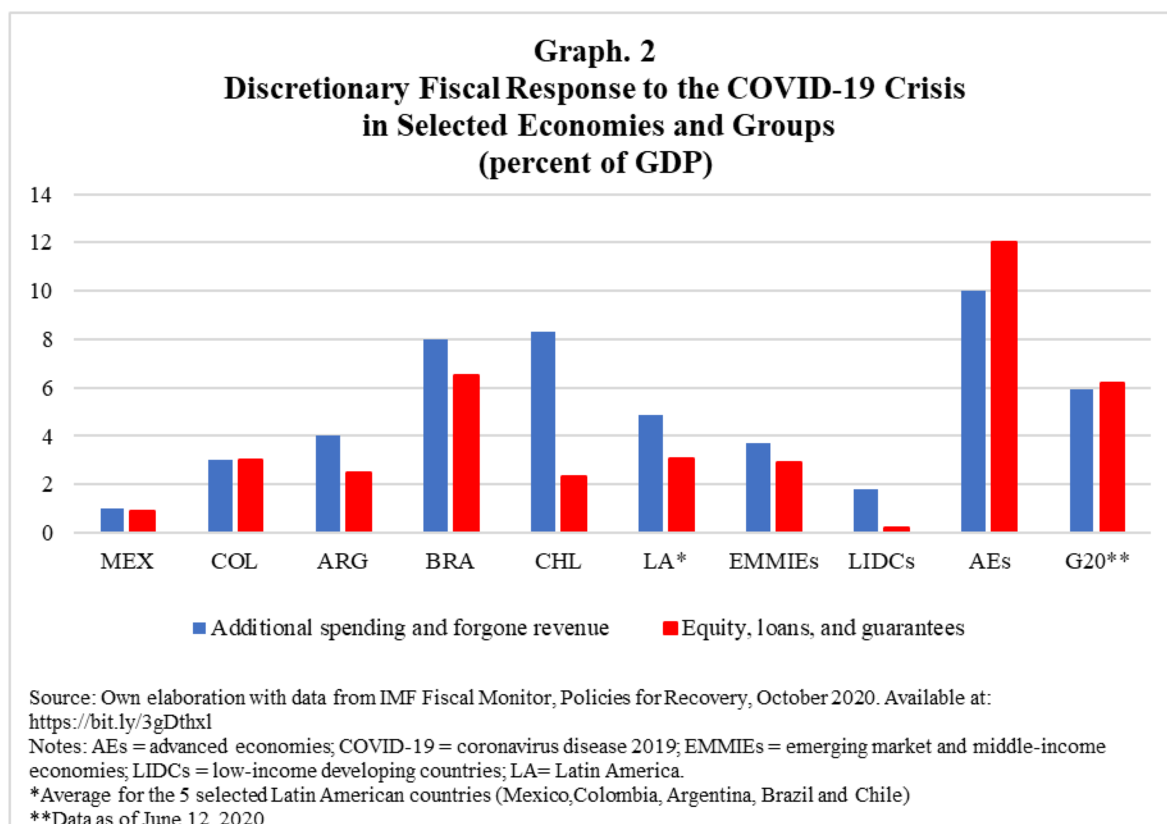
Fiscal Policy and Emergent Measures

The pandemic, unleashed by the COVID-19 virus, brought an unprecedented fiscal response throughout the world to provide extraordinary resources to public health systems, companies, and households in vulnerable situations. Fiscal measures reached 11.7 trillion dollars; that is, around 12% of global GDP, according to information from the International Monetary Fund (IMF, 2020). Half of this figure corresponded to additional expenses or unreceived income from the waiver of tax income, while the other half came from loans and guarantees besides a liquidity injection by the public sector.

The extraordinary fiscal measures (Graph 2) have not been homogeneous since they have varied according to the country and the fiscal space available for each of them. While advanced economies (AEs) have allocated resources equivalent to a range between 10% and 12% of the GDP in additional spending and loss of income, capital, loans, and guarantees, respectively, the sums in low-income developing countries (LIDCs) equals 1.8% and 0.2% of GDP. The latter means that the discretionary response capacity in fiscal terms has been proportional to the economies' size. The higher the income, the greater the number of resources destined to alleviate the pandemic. A situation which is also evident in emerging middle-income market economies (EMMIEs), whose fiscal response in terms of GDP has oscillated between 3.7% and 2.9%.

Latin America (as an average of the five major economies of the region) as part of the EMMIE countries responded with discretionary fiscal measures allocating 4.86% of GDP for additional expenses and foregone tax revenues. For capital, loans, and guarantees, the sum is equivalent to 3.04% of GDP. It is relevant to highlight the heterogeneity of the figures for the five major Latin

American economies. While countries like Chile and Brazil have presented fiscal responses that range between 6.5% and 8.3% of GDP, countries like Mexico have not exceeded one percentage point of their GDP in either of the two estimated items. The case of Argentina and Colombia would be in an average situation, having allocated between 2.5% and 4% of GDP as a response in fiscal terms to alleviate the COVID-19 pandemic[6].



Graph. 2
Discretionary Fiscal Response to the COVID-19 Crisis in Selected Economies and Groups (percent of GDP)

Source: Own elaboration with data from IMF Fiscal Monitor, Policies for Recovery, October 2020. Available at: https://bit.ly/3gDthxl
Notes: AEs = advanced economies; COVID-19 = coronavirus disease 2019; EMMIEs = emerging market and middle-income economies; LIDCs = low-income developing countries; LA= Latin America.
*Average for the 5 selected Latin American countries (Mexico,Colombia, Argentina, Brazil and Chile)
**Data as of June 12, 2020

Reflection

When reflecting upon Post-COVID-19 times, Latin American countries will face a long period of negative growth rates; massive unemployment; a digital divide that has split society; the lack of skilled workforce; an incapable system for meeting the needs of its population, and a very unequal population pyramid. In short, the future is uncertain and, for future generations, it will be a long period where the social fabric will have to be reborn as it was after the Second World War.

The proposed monetary policies to overcome the great depression in which all the economies (except for China) have been enveloped show 50 years of mismanagement, after decades of stabilization and adjustment programs, economic and financial reforms, and several processes of

[6] September 2020 data.

financial deregulation and liberalization impacting economic and financial fragility and instability. To this is added that even the policies carried out by central banks, after the Great International Financial Crisis (GCFI) of 2007-2008, did not consider the functional policies exposed by Lerner in 1943, instead, there was an insistence on austerity policies and low-interest rates, which promoted indebtedness for non-financial corporations and an increase on sovereign debts.

References

Arestis, Philip. 2004. "Washington Consensus and Financial Liberalization" Journal of Post Keynesian Economics / Winter 2004–5, Vol. 27, No. 2 251.

CEPAL, 2019. Estudio Económico de América Latina y el Caribe "El nuevo contexto financiero mundial: efectos y mecanismos de transmisión en la región." Naciones Unidas.

CEPAL, 2020. Estudio Económico de América Latina y el Caribe "Principales condicionantes de las políticas fiscal y monetaria en la era pospandemia de COVID-19." Naciones Unidas.

Duménil, Gerard y Dominique Levy 2011. The Crisis of Neoliberalism. Harvard University Press.

Galbraith, James 2013. "The Third Crisis in Economics." Journal of Economic Issues. Vol. XLVII No. 2 June. DOI 10.2753/JEI0021-3624470203

Greenspan, Alan. 1996. "The Challenge of Central Banking in a Democratic Society", Annual Dinner and Francis Boyer Lecture of The American Enterprise Institute for Public Policy Research, Washington, D.C. December 5th.

Fiscal Monitor. 2020. International Monetary Fund, October.

https://www.imf.org/en/Publications/FM/Issues/2020, /09/30/october-2020-fiscal-monitor

Lavoie, Marc (2014) "Post-Keynesian Economics: New Foundations." Cheltenham, UK. / Massachusetts, USA: Edward Elgar Publishing Limited.

Lerner, A. P. 1943. "Functional Finance and the Federal Debt." Social Research, 10(1/4), February: 38-51.

Lerner, Abba P. 1947. "Money as a Creature of the State." The American Economic Review, Vol. 37, No. 2, pp. 312-317. https://www.jstor.org/stable/1821139

Minsky, H. P. 2008. Stabilizing an Unstable Economy. McGraw Hill: New York, first published in 1986.

Robinson, Joan. 1972. "The Second Crisis of Economic Theory." American Economic Association, The American Economic Review, Vol, 62 N° 1/2 pp. 1-10

Seccareccia, Mario. 2020. "¿A donde va la política monetaria desde la crisis financiera global y qué debe hacerse?" Revista Ola Financiera. http://www.olafinanciera.unam.mx/new_web/35/index.html

Skidelsky, Robert. 2010. Keynes: The Return of the Master. Public Affairs, New York, USA.

Ülgen, Faruk. 2012. "Financial Instability and Functional Finance: a Lerner-Minsky perspective" paper presented in the 24th Annual Conference of the European Association for Evolutionary Political Economy (EAEPE) Cracow University of Economics, Krakow October.