Session 22
Time to bury Keynes?

A View from the Tropics
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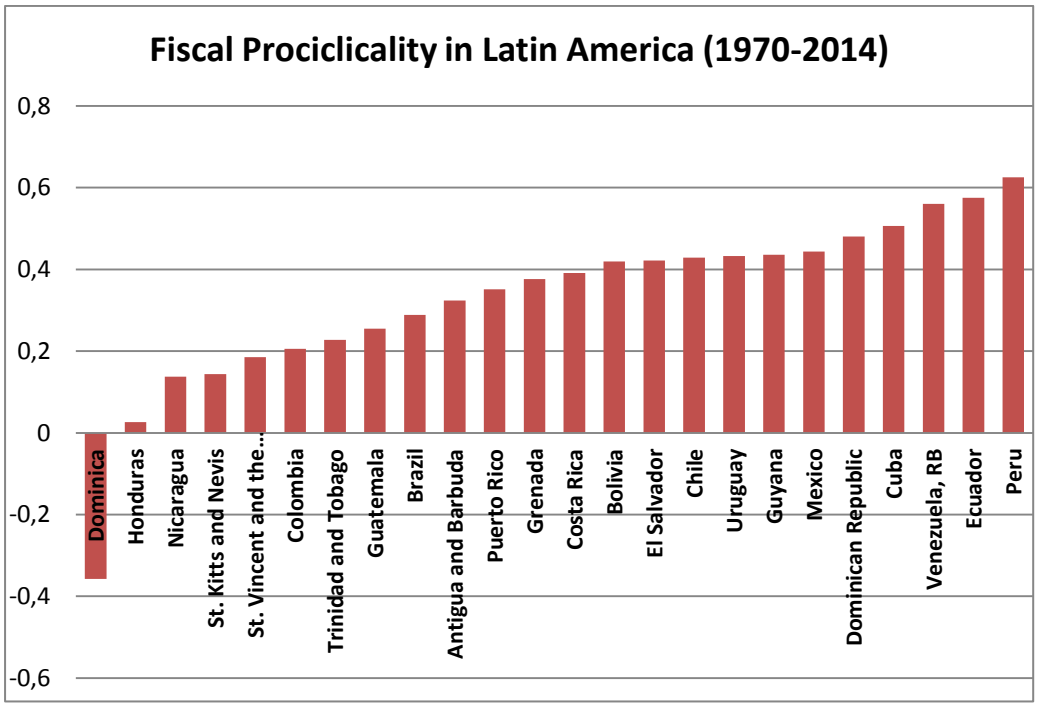
There seems to be a disconnect between the lack of academic consensus about the efficacy of Keynesian macroeconomic policies in todays´ world of more open and more flexible economies (exchange rate flexibility and less labor market rigidities), and the enthusiasm with which developed and developing countries alike, supported by the IMF, attempt to apply countercyclical fiscal and monetary policies, especially in downturns and recessions.

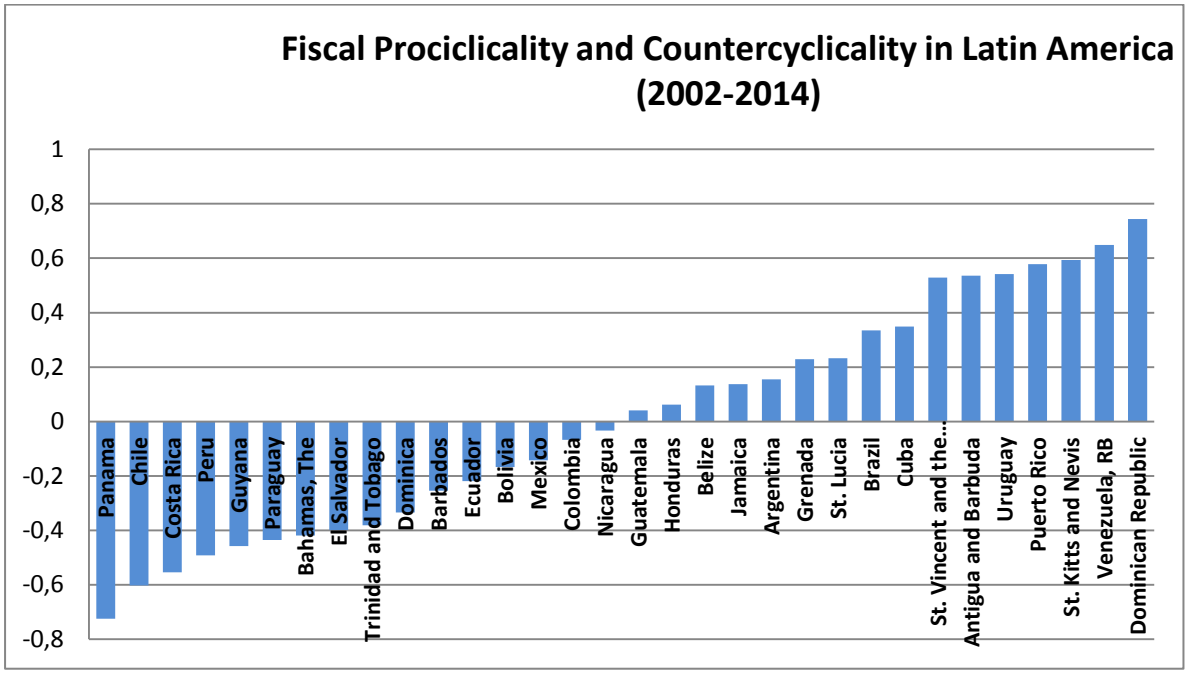
It is easy to construct theoretical models in which exogenous fiscal and monetary shocks have high positive, zero or even negative output effects, depending on a host of differential assumptions about the structure of the economy and the reaction of economic agents.

Empirical work (see the IMF 2014 survey) tend to find positive effects of (presumably exogenous) fiscal shocks. However, the estimated size and persistence of multipliers depend critically on:
– the composition of fiscal shocks: larger and more persistent for public investment than for current expenditures or tax shocks –and, within the latter, larger for corporate tax shocks than others;
– cyclical factors: larger and more persistent in downturns and, especially in recessions;
– structural aspects of the economy: lower in more open and flexible economies, especially on those with floating exchange rates;
– level of public debt: negative when debt levels are over a threshold;
– monetary policy: larger when monetary policy validates the fiscal shock.

Izletsky and others find similar results for developing countries.
However, all empirical results are always presented full of *caveats* and are highly contested because of the presence of reverse causality and endogeneity problems and econometric difficulties in detecting purely exogenous shocks.

Empirical work on the extent of use of counter- and pro-cyclical fiscal and monetary policies is more conclusive. Most studies used to find a significant difference between developed countries (where a large fraction of countries –and especially most of the best managed– show adherence to strong counter cyclical fiscal and monetary policies) and developing countries (especially in Latin America and Africa), where the large majority of countries used to suffer from pro-cyclical fiscal and monetary policies and these have allegedly contributed to their higher output volatility and proneness to macro-financial crises. However, some recent studies show a major recent change among developing countries. Thus, while more than 90% of Latin American countries appear to have pro cyclical fiscal policies, defined as a significant positive association between cyclical components of public expenditures and GDP for the 1970-2000 or the 1970-2014 period, about half had counter cyclical fiscal policies when the estimation is done only for the 2002-2014 period (see below authors' calculations).





A similar result is obtained in Sub-Saharan Africa. This is a major change!
Frankel and Vegh (2014) obtained similar results for fiscal policies and Vegh and Vulletin (2014) also for monetary Policies.

An examination of fiscal and monetary policies in South America during the recent boom and bust of commodity prices, show interesting insights.

Those countries that applied highly expansionary fiscal and monetary policies during the boom (Venezuela and Argentina), in addition to anti-private sector micro policies, ended up in crisis even before the commodity boom was over. Indeed, Venezuela and Argentina got into currency crisis (accelerated lost reserves –Figures 1 and 2-), lost access to international credit markets since 2007, when the global financial crisis was beginning, and fell into recession.

More generally, all countries that applied pro-cyclical fiscal policies during the boom –and kept continuous deficits– face now the need to apply pro-cyclical fiscal policies during their slowdown. This is also the case of Colombia, Mexico and Ecuador. (Figure 1)

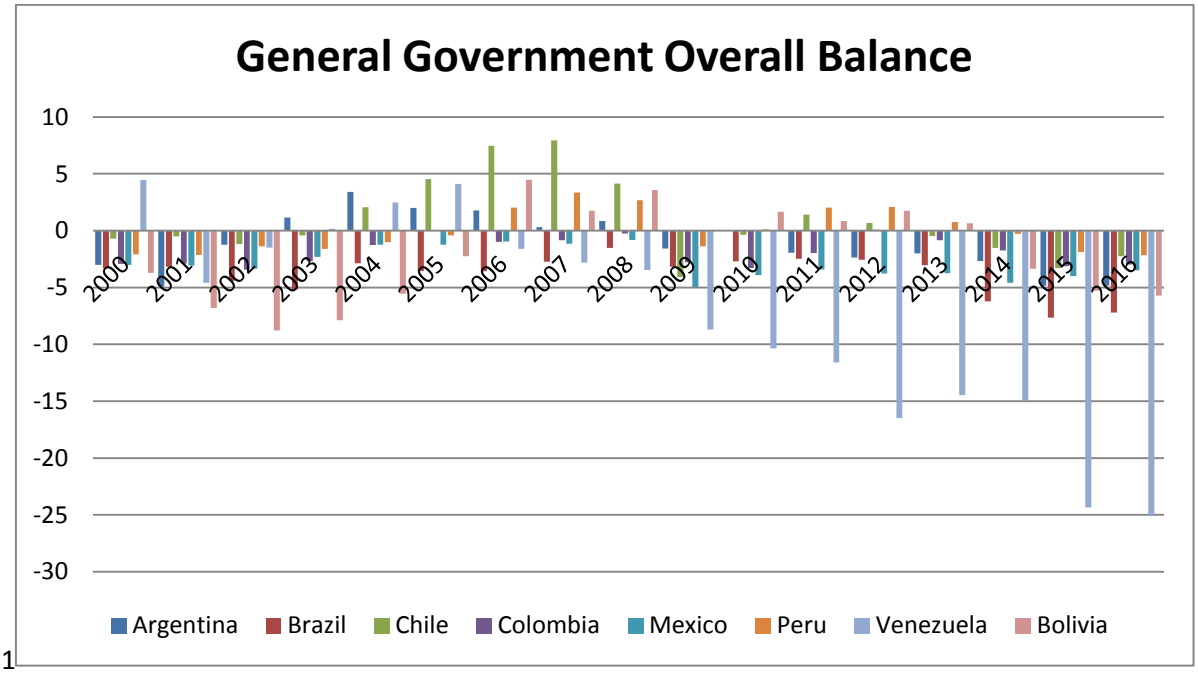


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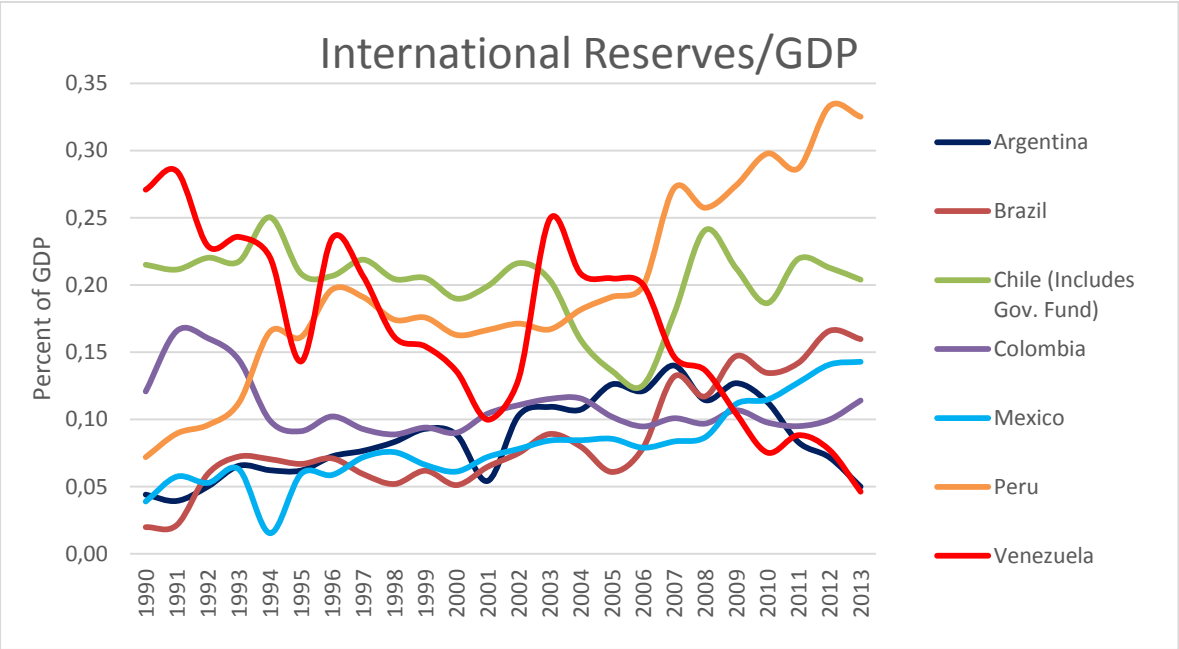
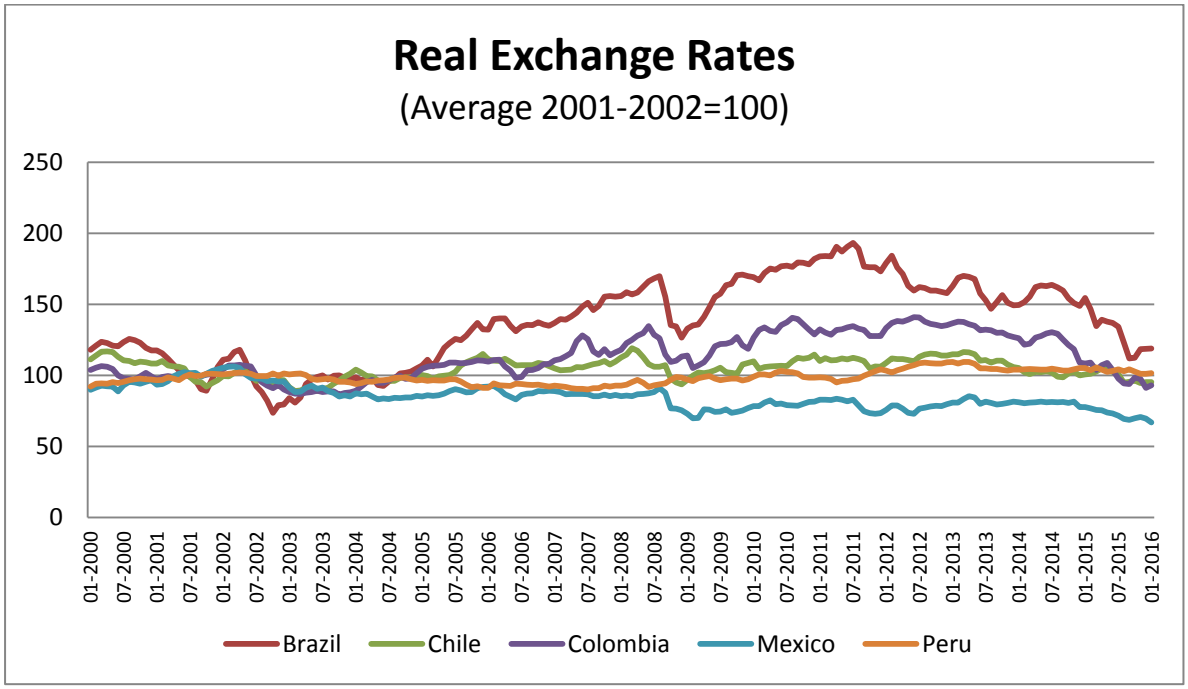
Figure 2



On the contrary, those that applied countercyclical or a-cyclical fiscal policies, generating surpluses during the boom, such as Bolivia, Peru and Chile, do not face such a need. Further, these latter countries (which were also those that accumulated more reserves/GDP) were able to moderate the appreciation of their currencies and did not showed Dutch Disease effects (stagnant industrial production and exports) during the boom. (Figure 3 and Perry and Echeverry, CGD, 2013)

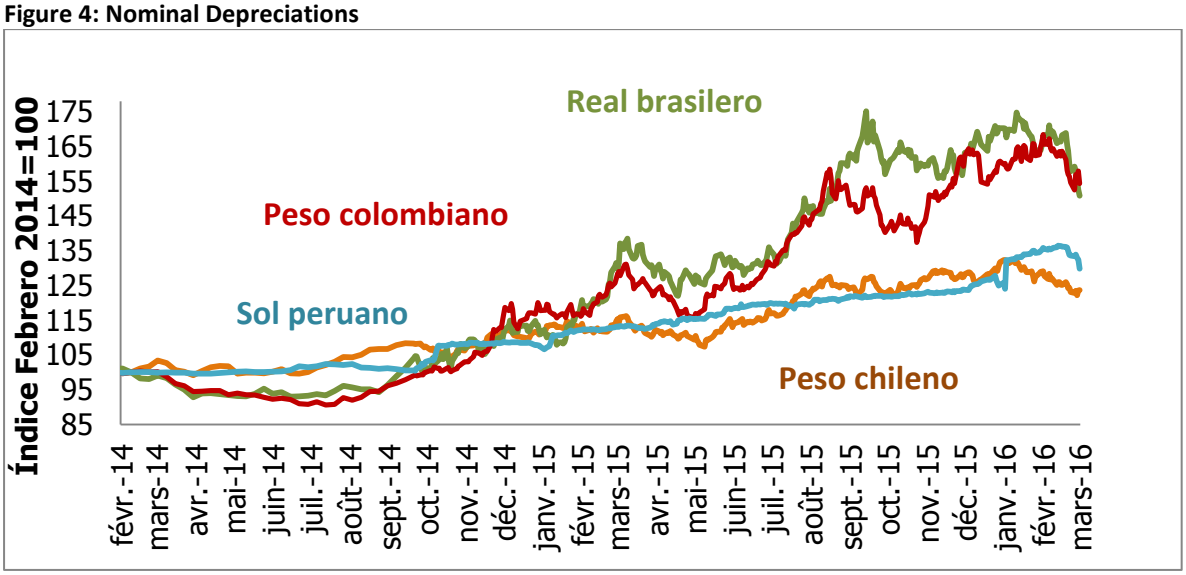


In contrast, countries like Brazil and Colombia showed significant appreciations and Dutch Disease effects during the booms, and when these were over have faced fast currency depreciations, which led

to inflationary pressures and required applying pro-cyclical Monetary policies on top of pro cyclical fiscal policies (´back to school´on both fronts). Figures 4 to 6

These differences illustrate clearly why an increasing share of policy makers in Latin America and Africa are shifting towards orthodox fiscal and monetary counter cyclical policies to manage the volatility of commodity prices, even if the academic community has not arrived to a broad consensus about the efficacy of fiscal multipliers

Figure 4: Nominal Depreciations



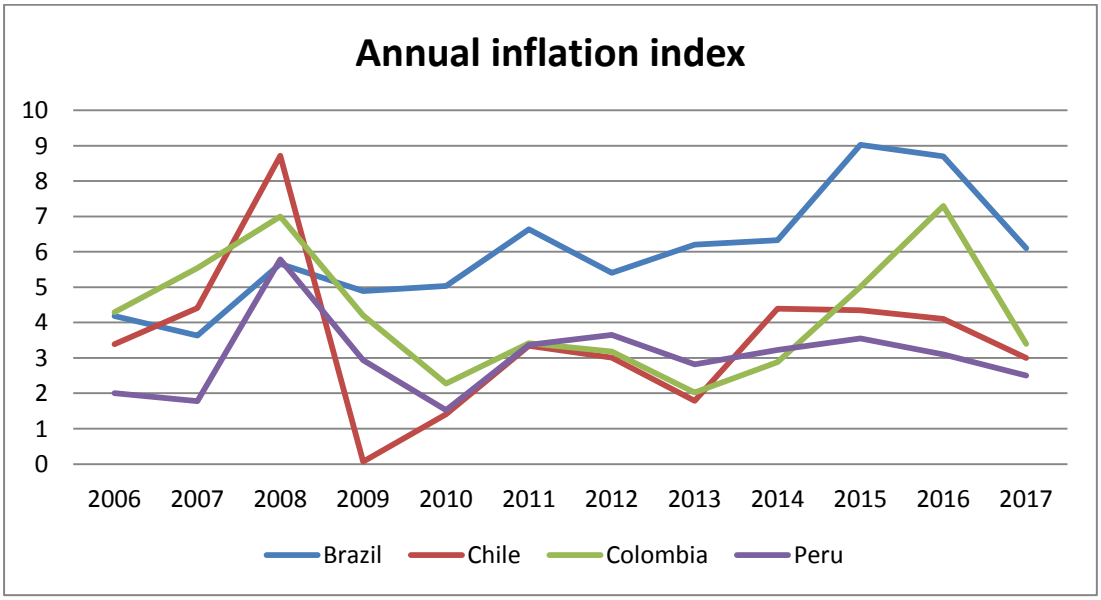
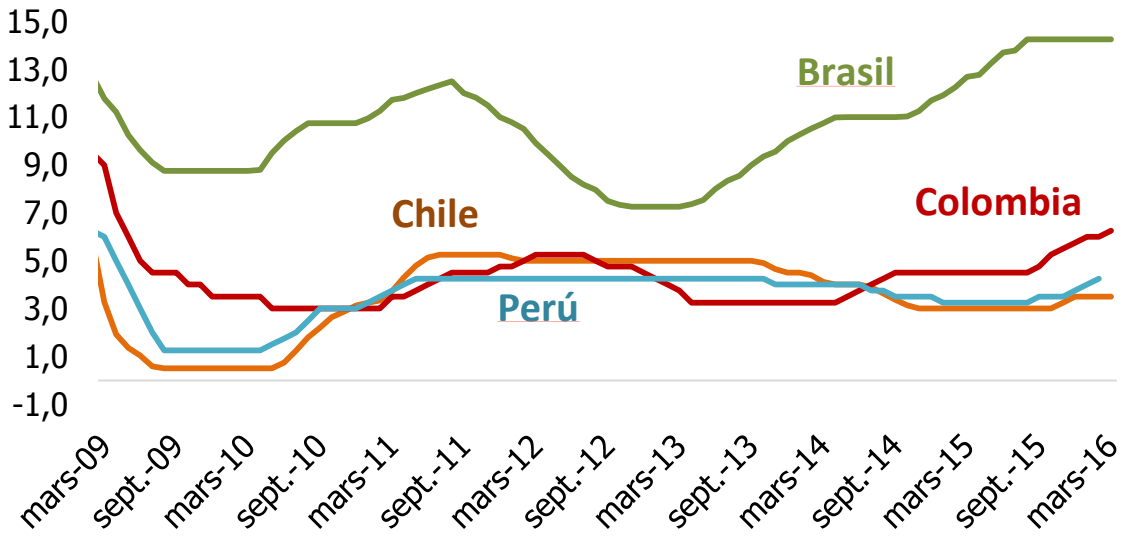


Figure 6. Central Bank Intervention Rates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