Fiscal Policy in Commodity Republics
Comments

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Cespedes-Velasco

- Commodity price data for the period 1900-2010.
- Identifies two price boom periods: 1970 to early 1980 and the years prior to 2008.
- Presents some evidence showing that the recent episode shows a less pro-cyclical bias than the earlier episode.
- And concludes that “this time is different.”

Quick Comment

- The 1970-1980s episode involved some structural shocks (at least with respect to oil), which may have created the expectation that it was likely to be a highly persistent boom,
- especially when compared to the recent episode in which the boom cannot easily be attributed to *fundamentals*, and proved to be very short-lived.

- On that account, even pro-cyclical policymakers are likely to show less pro-cyclicality in the recent episode,
- especially, taking into account that the recent episode took place in the midst of the largest global recession since the 1930s.
- Therefore, maybe “this time is not different,” after all.

Extensions

- Fiscal policy during commodity busts.
- Are there glaring asymmetries between booms and busts?
- Current Account (of the Balance of Payments) during these episodes.
- Are there glaring differences between fiscal deficits and private-sector current account?

STABILIZATION FUNDS:
A Non-Keynesian Perspective

The Relevant Question

- The main question regards "the best policy rule for determining how the fund will grow or decline over time, before the shocks take place."
- Not after the shocks take place.
- After the shocks, it is always good to have a large stabilization fund.
- Before the shocks, the issue is much more debatable.

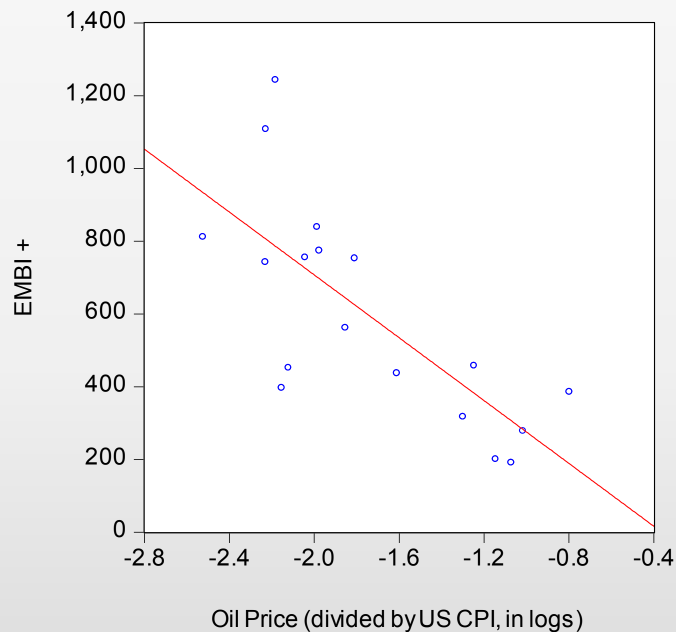
Conventional Approach
Commodity Shocks

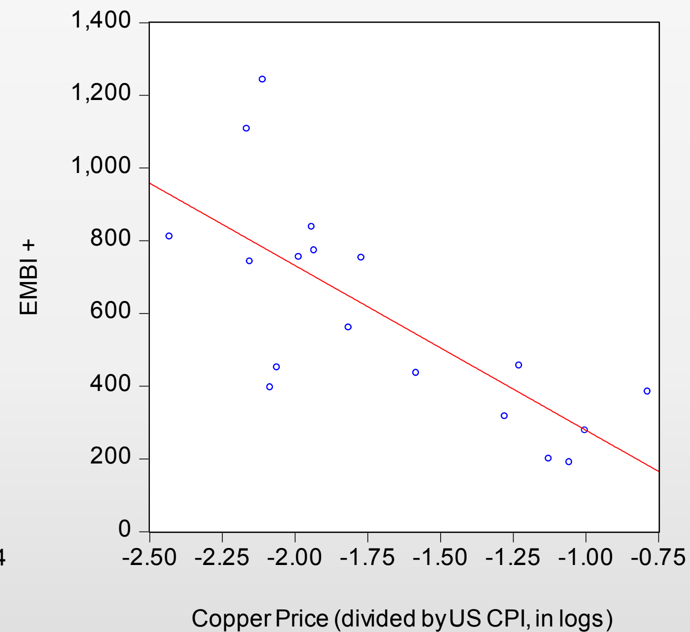
- Commodity prices are highly persistent over time. “Fat years” last long!
- Thus, in absence of financial shocks, a boom (decrease) in commodity prices should be accompanied by an equivalent boom (decrease) in spending (public + private).
- This runs counter to the principle “save during fat years.”

Conventional Approach
Financial Shocks

- The EMBI is also highly persistent,
- and commodity booms go hand in hand with low spreads.
- Low spreads call for higher spending.
- Thus, according to standard economic theory, financial shocks <u>should</u> contribute to exacerbate spending boom during fat years!
- (This will be qualified later on)

EMBI and Commodity Prices





Qualifications and Policy Challenges

Risk Aversion and Big Shocks

- The conventional results could be overturned if the government is very risk averse.
- For example, if it cares for "worst-case scenarios," like in a *Value at Risk* strategy followed by some banks.
- Alternatively, conventional results could be overturned if negative shocks are large (e.g., Sudden Stop), even under modest risk aversion.

Risk Aversion and Policy

- Risk aversion is a very subtle concept, which is hard to articulate in policy debates.
- There is plenty of room for disagreement.
- For example, the incumbent is likely to be more risk averse than the opposition, because nobody wants deep crisis to occur under one's watch – and the crisis will likely win votes for the opposition.

Sudden Stop and Policy

- The string of financial crises since mid 1990s provides some information about the size of big shocks and the factors that enhance their probability and output or employment incidence.
- The stock of international reserves is a factor that lowers both the probability of Sudden Stop and its impact on the real sector.

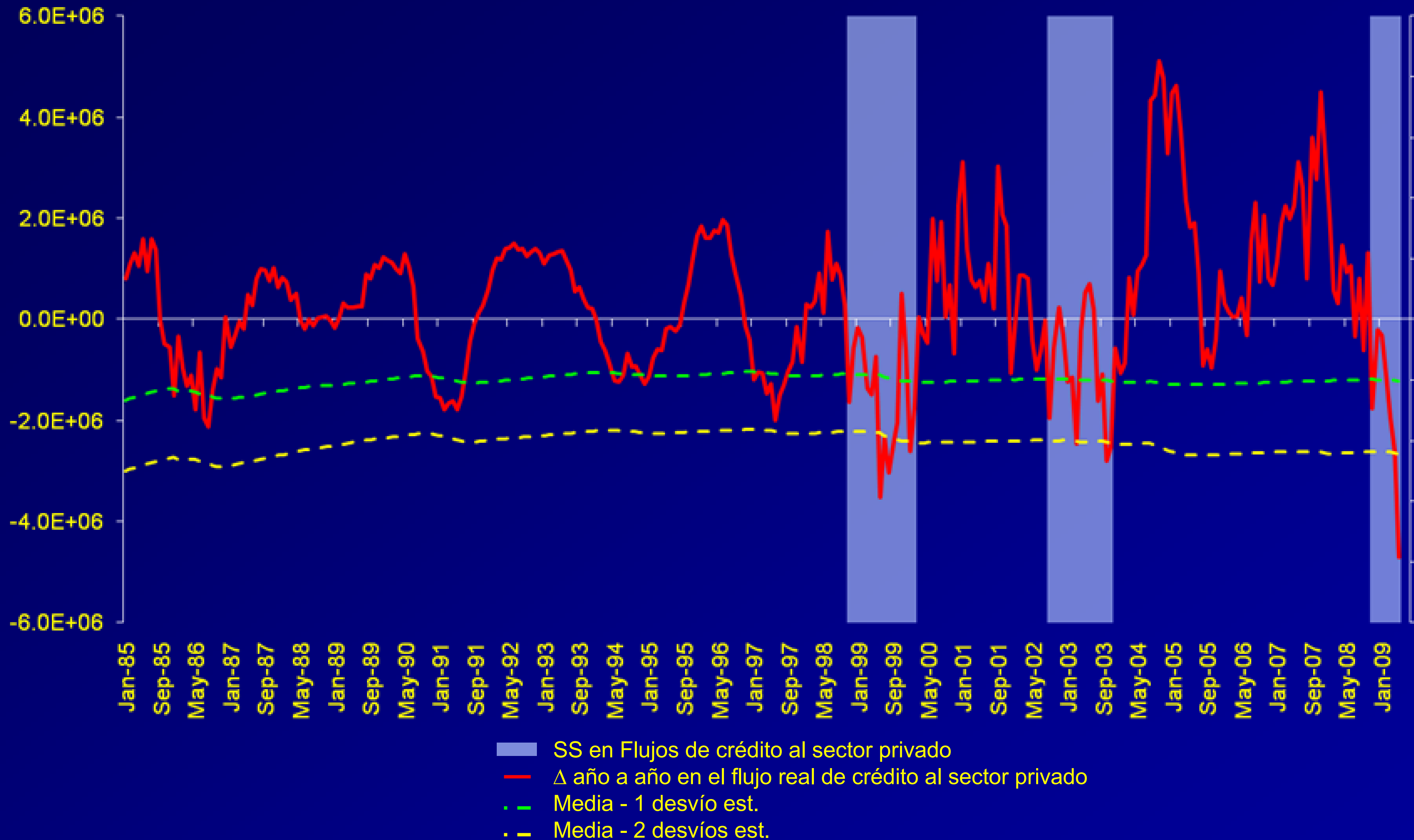
- However, the estimates about optimal stock of international reserves seem to be highly unstable: they are highly dependent on the model specification.
- Therefore, acknowledging the presence of big shocks still leaves the issue of optimal stabilization funds in a state of flux.

STABILIZATION FUNDS:
How Effective?

CHILE: A Case Study

- Chile has followed an exemplary macroeconomic policy for many years.
- Fiscal surplus and a large stabilization fund stand out.
- However, the Chilean economy suffered one of the largest credit crunches, and peak-to-trough output contraction in Latin America during the Lehman episode,
- despite a major increase in government expenditure.

Chile: Credit Crunch, private sector.



Source: Own calculations based on IFS data.

Some Open Questions

- Moral hazard. Could a rich fund induce excessive risk-taking by the private sector?
- Who should be in charge of allocating the funds in case of shocks, and how?
- Should the central bank temporarily abandon inflation targeting and buy "toxic assets?"

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