

Debt Sustainability and Procyclical Fiscal Policies in Latin America

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Abstract: The computation of structural primary balances for the nine main Latin American countries and the comparison of their changes with their cyclical position during the period 1981–2004 confirm that fiscal policy is procyclical in the region. From this evidence, the paper shows strong evidence that the fiscal behavior is closely linked to the financial vulnerability position of the economies and, in particular, to the perception on the sustainability of public debt. The current threshold balance, defined as the primary balance that would render the debt stable under the existing economic and financial conditions, is used as our gauge for measuring debt sustainability concerns at each point in time. The empirical analysis reveals that fiscal stance tightens when the perceptions of debt sustainability worsen, that the impact is stronger the less sustainable debt is perceived, and that when controlling for these effects fiscal policy loses its procyclical stance. The results are robust to different specifications and estimation methods.

Keywords: procyclical fiscal policy, debt sustainability

JEL Classification: H6, E6, F3