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Regional Heterogeneity in the Relationship between Fiscal Imbalances and Foreign Exchange Market Pressure

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Summary. — The relationship between fiscal imbalances and other macroeconomic variables is complex and multifaceted. However, it remains important to understand it, not least in order to facilitate the design of appropriate policy. One central issue is whether the relationship varies across countries or groups of countries. If it does, an implication is that policy will also have to be differentiated. This paper empirically explores the relationship between fiscal imbalances and pressures in the foreign exchange (FX) market in Latin America & Caribbean (LAC) and East Asia & the Pacific (EAP) regions. Using panel data over 1970–2000, it finds that fiscal imbalances have a significant effect on FX pressures in LAC but not in EAP.

Key words — foreign exchange pressure, fiscal imbalances

1. INTRODUCTION

Two issues of central importance to developing and emerging economies relate to the macroeconomic effects of fiscal deficits and the choice of exchange rate regime. A key element in the Washington Consensus was that large fiscal deficits have severe deleterious effects and need to be reduced or eliminated, while another element of it focused on the need to avoid currency misalignment. [1] In principle, these issues may be connected in as much as the monetary implications of fiscal deficits are inflationary and, in the context of pegged exchange rates, lead to a loss of competitiveness. Indeed the first generation currency crisis model built on this connection to show how fiscal deficits could cause current account balance of payments deficits, a loss of international reserves and financial crisis. [2] At the same time, currency misalignment may have implications for the fiscal balance as, for example, the revenues from trade taxes are affected.

Theoretical analysis suggests that the impact of fiscal deficits will vary according to a range of factors that are likely to differ across countries. It is therefore unsafe to assume that they will have any one particular set of effects. Empirical studies have tended to confirm this supposition (see, e.g., Easterly & Schmidt-Hebbel, 1994).

Part of the difficulty in assessing the effects of fiscal deficits is that they can materialize in various ways; some direct and some indirect. Moreover, the diverse effects may be offsetting. This creates a daunting challenge for any study that seeks to estimate their detailed macroeconomic consequences. This paper has a much more modest objective. It concentrates on the relationship between fiscal deficits and pressures in the foreign exchange market. Do countries with larger fiscal deficits experience more foreign exchange market pressures? Furthermore, does the nature of the relationship differ across groups of countries? To test this, we commence with what has almost become a stylized fact; namely that fiscal deficits have constituted a more significant problem for Latin American than for Asian economies. This idea found succinct summary among those who criticized the IMF's initial response to the economic crisis in East Asia in 1997–98. Here, critics claimed that the Fund adopted a

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conventional and fiscally contractionary approach to deal with foreign exchange crises that had little to do with fiscal excesses. Is the evidence consistent with the suggestion that Latin America and Asia differ when it comes to the association between fiscal deficits and foreign exchange markets? [3]

The paper is organized in the following way. Section 2 reviews descriptive statistics relating to fiscal imbalances in Latin America and Asia. These imply that the effects of fiscal deficits may indeed be expected to be different across the two regions. Section 3 explains the methodology used to estimate more formally the relationship between fiscal deficits and foreign exchange market pressures as well as to explore the relevance of the exchange rate regime as classified by Reinhart and Rogoff (2004). Our methodology has a number of advantages over that adopted in much of the existing literature on currency crises, since it allows us to map pressures in the foreign exchange market as a continuous variable. The least squares dummy variables method is used to estimate the panel. The section then goes on to present and interpret our findings. Section 4 briefly examines some of the broader policy implications of our results for the design of fiscal policy in the two regions. Section 5 offers a few concluding remarks and points to some of the limitations of the research reported in the paper.

2. DESCRIPTIVE STATISTICS

Both theory and empirical evidence suggest that the macroeconomic consequences of fiscal deficits may vary across countries. If there are differences in private sector saving-investment imbalances, in the structure of domestic financial markets, in the degree of capital mobility and confidence among capital markets and in the nature of exchange rate regimes, there are also likely to be differences in the effects of fiscal deficits. Focusing on foreign exchange market pressures, it may be assumed that these will be more strongly related to fiscal deficits where private sector saving is low, where current account deficits are high, where external debt is large and where, perhaps as a consequence, the confidence of capital markets is low. Confidence may also be affected by the perceived strength of any commitment to defend the exchange rate and by the general reputation of policy makers for sound economic management. Those countries that have a history of failed attempts to stabilize exchange rates and a track record of weak economic management may find it more difficult to sustain fiscal deficits by means of capital inflows with the result that such imbalances lead to greater foreign exchange market pressure.

Table 1 presents comparative data relating to the factors that theory and empiricism suggest may have a bearing on the relationship between fiscal deficits and foreign exchange market pressures. We present this at a high level of aggregation. While recognizing that cross-country variations within regions may be important and interesting and that these differences will be concealed by looking at regional averages, our objective in this paper is to explore whether there is evidence of regional variation between Latin America and Asia.

The table shows that over the period 1970–2000 fiscal deficits, as measured by their mean value, have been of similar magnitude in the two regions (they averaged 2.64% of GDP in Latin America and 2.60% in Asia). However, when we consider the median, which is not affected by extreme values, the overall budget balance is in fact lower for Latin America. The good news for LAC though stops here, as it is apparent from the data that the budget balance has been substantially less volatile in the EAP region. Furthermore, it needs to be noted that private savings are generally higher in Asia than in Latin America and this will tend to offset the macroeconomic effects of fiscal deficits. [4]

External indebtedness appears to be greater in Latin America (average 68.8%) than in Asia (50.5%). A given budget deficit implies a lower rate of debt build-up in Asia because growth rates are generally much higher than in Latin America in our sample period. But again, the median for Latin America is substantially lower than the mean—and of similar magnitude to the Asian median value—indicating that not all countries in the geographical area have maintained high debt-to-GDP ratios. The mean is affected by a few high-debt countries such as Nicaragua, Bolivia and Panama. The year-on-year increases in external debt as a fraction of GDP over the sample period averaged about 1% in EAP and 1.5% in LAC. However, if we consider the median instead of the mean, the average increases were actually higher in Asia.

Despite this fact, capital markets have in general charged Latin American countries a 50% higher interest rate for lending to them. Both