

Commentary: Should the European Central Bank and the Federal Reserve Be Concerned about Fiscal Policy?

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Canzoneri, Cumby, and Diba have written a very good paper on the relationship between fiscal and monetary policy. It is informative, clear, and persuasive. As the title indicates, the analysis deals exclusively with the cases of the United States and the European Union (EU). In a way, however, these are the countries where the discussion on the connection between fiscal and monetary policy is least interesting. This is because, as the authors themselves persuasively point out, it is very difficult to argue seriously—either theoretically, empirically, or historically—that the United States or the EU have lacked Ricardian fiscal discipline. Clearly, these are not cases of fiscal dominance.

There are, however, a number of other countries where the issue of fiscal constraints on monetary policy actions is very important. Many of these countries are in Latin America, and a premier example is Argentina, where the dominance of fiscal policy—and, in particular, of rampant fiscal imbalance in the provinces—ended up triggering a massive crisis at the end of 2001. A second case, although not nearly as serious as Argentina, is that of Brazil, where recent—that is, during July and August of this year—concerns about the sustainability of fiscal policy have generated very serious financial upheaval and have resulted in a rapid weakening of the currency and a significant jump in the country risk premium.

In these comments, I expand the analysis presented by Canzoneri, Cumby, and Diba to the case of the emerging markets, with especial emphasis on Latin America. I will address three issues. First, I will discuss how the existence of indexed debt changes the channels through which macroeconomic shocks are validated. Second, I will discuss two specific cases: Chile and Brazil. And third, I will deal with a brief discussion on monetary policy and financial sector regulation in the emerging markets.

As is explained in great detail in their paper, in standard *fiscal theory of the price level* stories, jumps in the price level play an important role in making sure that the intertemporal budget constraint holds. This comes out very clearly in the paper's equation 4. A higher price level reduces the real value of outstanding public-sector debt and restores the intertemporal equilibrium condition when the deficit is too high as to assure sustainability. This, of course, is a very plausible story when the public debt is denominated in the local currency. Things, however, change if the debt is indexed. Consider the extreme case when all of the public-sector debt is fully indexed to the domestic price level. Under these circumstances, jumps in the domestic price level do nothing to restore equilibrium: A jump in the price level results, through the indexation mechanism, in an immediate equiproportional jump in the nominal value of outstanding debt, and the debt-to-GDP ratio is restored to its pre-price level jump level. A similar situation, although not as drastic, will take place when a proportion of the debt is indexed to the price level, or when the debt is indexed to the nominal exchange rate. This was, indeed, the case of Argentina during the 2001 to 2002 crisis.

In the presence of massive indexation, there are two ways out of the problem. One alternative is that the authorities understand that with indexed debt, price level jumps do not help to restore equilibrium; all they do is unleash a public debt-driven hyperinflation process. As a result of this understanding, the government authorities change their behavior and conduct fiscal policy in a super careful, conservative, and austere way. That is, the sheer existence of indexation provides an incentive for the government to fiscally be disciplined, in a Ricardian sense. Some authors have argued that this would, indeed, be the case

and have suggested that emerging markets should deliberately index their debt to the nominal exchange rate as a way of generating a conservative fiscal behavior. History, including the recent Argentine debacle, has shown, however, that this is not a likely outcome of indexing the public-sector debt. Instead, the presence of indexed debt—and, in particular, debt indexed to the exchange rate—will usually result in perverse incentives, where the monetary authorities intervene in the foreign-exchange market in an effort to avoid the weakening of the currency. A second way out of the inconsistencies generated by indexed debt is that instead of the intertemporal constraint being re-established by a jump in the price level (an upward jump in the denominator in equation 4), it gets re-established by a write-off of all or part of the debt itself (this is a downward jump in the numerator in equation 4).¹ This is, indeed, the way in which the situation was resolved in Argentina at the end of 2001, when the government defaulted on \$140 billion (U.S. dollars) of debt. As the developments of the last eight months in Argentina have shown, the costs associated with this option—in terms of loss of access to the international capital market, collapse in output, and climb in the rate of unemployment—can be very high, indeed. In fact, I believe that it is fair to say that one of the most important lessons of the Argentina debacle is that, contrary to what a number of observers claimed in the period leading to the crisis, there isn't such a thing as a costless—or even low cost—debt default.

The second part of my comments refers to two country experiences—those of Chile and Brazil—that are particularly relevant for the discussion at hand. Chile provides a particularly interesting case because it has not only been the most successful country in Latin America in the last decade and a half, but since the year 2000 it has operated with two rules: a monetary rule based on an inflation-targeting framework and an explicit, publicly known fiscal rule. As background, Chile has posted an average rate of growth of 5.8 percent during the last fifteen years; it has an extremely open economy—average import tariffs are approximately 4.8 percent; inflation has been stable at around 4 percent; and it has had an independent central bank since the return of democracy in 1990. Chile has been a pioneering inflation-targeting country and has a very low public-sector debt-to-GDP ratio, in the order of 12 percent. In early 2000, the incoming

administration of President Ricardo Lagos adopted a very strict fiscal rule that calls for a yearly *structural surplus of 1 percent of GDP*. This rule has three interesting characteristics: First, it is a deficit-based, as opposed to debt-based, rule of the type that Canzoneri, Cumby, and Diba criticize in their paper. Second, the Chilean rule is significantly stricter than the *Stability and Growth Pact* rule in effect in the EU. And third, by defining the rule in terms of the structural fiscal balance, it has allowed the government to run a counter-cyclical fiscal policy, something that almost no Latin American country has been able to in the last thirty years or so. In fact, it is expected that during 2002—a year of recession and depressed terms of trade—the consolidated nominal public-sector deficit in Chile will be 3.2 percent of GDP.

What is particularly interesting about Chile's rule is that it was not enacted—as some uninformed observer could conclude—as a way of protecting the independent central bank from a non-Ricardian public sector. The main reason why the Lagos Administration implemented this rule is to protect the Treasury from the government's own political supporters, both in Congress and outside of it. This strict rule has, indeed, helped keep the left-of-center coalition member parties at bay in their requests for increasing expenditure in pet projects. Although the fiscal rule main objective was not to isolate the central bank from “fiscal theory of the price level” type of pressures, it has allowed the bank to use greater degrees of freedom. In particular, it has allowed the central bank to pursue a more aggressive low-interest-rates policy during the last few months. In addition, with fiscal policy governed by the above-mentioned rule, the central bank has felt comfortable with a weaker currency and has avoided intervening (very) actively in the foreign-exchange market.

From a political economy point of view, the different political forces have broadly accepted the overall notion of a fiscal rule. Some of the details—including the calculation of potential GDP growth and of the “normal” price of copper—have been challenged, but the principle has been accepted. This is, on itself, important and may very well start a trend among Latin American countries.

I now turn to Brazil, a country that has been profusely in the news

lately—in particular as a result of deteriorating financial conditions and the large IMF package announced a few weeks ago. Although it is clear that in Brazil there is no “fiscal dominance,” the fiscal side does introduce some important constraints to the conduct of monetary policy. This is for two basic reasons: First, Brazil’s public-sector debt is at its limit, having reached its “ceiling” some time during the first few months of this year. In terms of GDP, the consolidated public-sector debt was 30 percent by the end of 1994—the first year of the *real* plan. It was 50 percent by mid-2001, and it had climbed to 62 percent by the end of July of this year.² Second, most of this public-sector debt is indexed, either to the foreign exchange or to short-term interest rates. Recent calculations indicate that, all in all, more than 70 percent of total public-sector debt is indexed, with 40 percent tied to the real/U.S. dollar exchange rate and another 30 percent tied to interest rates. This has left the central bank between a rock and a hard place. In particular, under conditions of instability and uncertainty, the central bank is greatly constrained on its ability to use the interest rate as a policy tool. If it raises interest rates, that part of the debt tied to it will increase, raising the debt-to-GDP ratio generating through this channel, greater instability. If, however, interest rates are not raised, the currency will tend to depreciate—as it has during much of this year—also generating a higher debt ratio, which feeds into greater instability.

Earlier this year, things took a turn for the worse in Brazil. This was the result of two shocks: First, the collapse of the Argentine economy introduced great uncertainty with respect to the future of the regional trading bloc MERCOSUR, generating a drastic decline in FDI in Brazil. And second, there has been a great deal of uncertainty surrounding the October 6 presidential election. In particular, private-sector analysts have been concerned with the very strong showing in the polls of the left-wing candidate Luiz Inacio da Silva, “Lula.” The combination of these two shocks and the very high debt-to-GDP ratio, discussed above, have shown to be a fatal combination. Investors have dumped Brazilian bonds, local firms have tried to cover their foreign-exchange exposure, and international banks have been calling in their credit lines. As a result, the risk premium on Brazilian international bonds has climbed past the 2,000 basis points mark, and the exchange rate, which in January stood at 2.3 reals per dollar, has migrated to the

3.2 to 3.4 range. The country has rapidly moved into a “bad equilibrium,” where the beliefs that a crisis may occur have generated a series of reactions that have resulted in an increase in the probability that the crisis may indeed occur. Brazil has been trapped in a vicious circle.

The IMF program announced a few weeks ago has been a serious attempt to move Brazil out of this bad equilibrium. It is a solid and largely well-designed program. At \$30 billion (U.S. dollars), it is larger than what most people expected; it is back-loaded and provides the right incentives; it includes \$6 billion (U.S. dollars) of fresh resources to be disbursed this year; it lowers the international reserves floor to \$5 billion (U.S. dollars), increasing the amount of usable reserves significantly; it introduces flexibility into the inflation-targeting rule; it maintains a primary surplus target of 3.75 percent of GDP; and it is lean in terms of ancillary conditions. I believe that this program has a fighting chance of succeeding. All political candidates have broadly supported it, the trade surplus is increasing, and for a few days the market seemed to have reacted positively to the news of renewed multilateral support. Having said this, it is important to emphasize that for the public debt situation to really stabilize, a constellation of factors has to come into line. First, during 2003 to 2004, average rate of growth should move back to the 4 to 4.5 percent mark. Second, the cost of borrowing for Brazil should go down from its current level of approximately 1,900 basis points above Treasuries, to the vicinity of the 700 basis points. Third, maturing bonds, loans, and credit lines have to be rolled over massively. Fourth, the primary surplus should go up to approximately 3.9 percent of GDP and maintained at that level for the foreseeable future. And finally, the currency has to strengthen drastically, moving from the current 3.3 reals per U.S. dollar rate, to around 2.3 to 2.4 reals per dollar. While it is not impossible to fulfill this rather formidable list of requirements, it will not be easy to do it.

The final part of my remarks refers to two issues regarding monetary and financial policy in the emerging countries. Here, I am on more tentative terrain, and instead of making a statement I want to raise some questions that I believe will have important consequences for the future stability of the emerging nations and of the world financial system. The first question is whether the exchange rate should

enter into the monetary policy rule in an inflation-targeting framework. From a technical point of view, this discussion may be framed in terms of the form of the Taylor rule in a small open economy. Taylor himself has posed the problem as follows (2001, p. 263.): “How should the instruments of monetary policy (the interest rate or a monetary aggregate) react to the exchange rate?” In order to address this question more formally, consider the following equation (see Taylor, 2001.):

$$r_t = f\pi_t + gy_t + h_0e_t + h_1e_{t-1}. \quad (1)$$

Where r_t is the short-term interest rate used by the central bank as a policy tool, π_t is the deviation of the rate of inflation from its target level—possibly zero— y_t is the deviation of real GDP from potential real GDP, and e_t is the log of the real exchange rate in year t .³ f and g are the traditional Taylor rule coefficients; h_0 and h_1 are the coefficients of the current and lagged log of the real exchange rates in the expanded Taylor rule and are the main interest of this discussion. Traditional analyses have assumed that the central bank should ignore open economy considerations when undertaking monetary policy—in terms of equation 1, this means that $h_0 = h_1 = 0$. It is conceivable, however, that in a small open economy the optimal monetary policy rule—that is the policy that maximizes the authorities’ objective function—is one where both h_0 and h_1 are different from zero. Interestingly, if $h_0 < 0$ and $h_1 = -h_0$, then the rule implies that monetary policy should react to changes in the (real) exchange rate. Notice that the formulation in equation 1 does not imply, even when h_0 and h_1 are different from zero, that the monetary authorities should defend a certain *level* of the exchange rate.

The second question is whether foreign-currency indebtedness should be regulated in emerging countries with a floating exchange rate and inflation targeting. The importance of this question is based on the fact that when there is massive foreign-currency-denominated debt—either public or private—changes in the nominal exchange rate will tend to be translated into large balance-sheet effects. This, in turn, is likely to affect the authorities’ willingness to let the exchange rate to truly float. There is some evidence suggesting that price-based and transparent mechanisms that regulate capital *inflows*, such as the flex-

ible tax on short-term capital used by Chile during much of the 1990s, work relatively well as a transitional device. It allows for some capital mobility and discourages short-term speculative monies; at the same time, it avoids arbitrary decisions by bureaucrats. But, as I have argued elsewhere, even Chile-style capital controls have costs, and they did not spare Chile from contagion or macroeconomic instability during the second half of the 1990s. This is a question that, as the previous one, will require additional research.

Endnotes

¹ From a purely algebraic point of view, a third option is that *real GDP*, the second variable in the denominator in equation 4 experiences a jump. From a practical point of view, however, this is not a relevant alternative, as it is extremely unlikely that in a country with doubtful solvency real GDP growth will increase at the rates required to solve the intertemporal imbalance.

² Only 20 percent of this debt corresponds to foreign debt.

³ In this formulation, an increase in e denotes a real exchange rate appreciation.

References

Taylor, J. "The Rules of Exchange Rates in Monetary Policy Rules," *American Economic Review*, May 2001.