Interaction between fiscal policy and monetary policy in MERCOSUR and associated countries

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Abstract

At time of formulating monetary policy, central banks take into account the main aspects that influence the achievement of their targets, among them the route of fiscal policy. Evidence in the last decades in emerging economies, shows that public sector had a predominant role in the course of monetary and exchange rate policies.

The objective of this document is to analyze the interaction between fiscal policy and monetary policy in the context of MERCOSUR (Argentina, Brazil, Paraguay, and Uruguay) and associated countries (Chile, Peru and Bolivia), using the results of a questionnaire sent to the central banks of these countries.[1]

At the institutional level, the main target of central banks of the region is the inflation control, in line with the legal reforms, that granted more independence to the issuing entities, at the beginning of the decade of the nineties. It is also important the effective independence in the control of monetary and exchange rate instruments, aspect that would be inversely related with the inflation level in the region. Likewise, the choice of the monetary policy regime is primordial for an adequate and sustained control of inflation, at the time it is observed a gradual transition to a regime of inflation targeting in these countries.

Meanwhile, the development of institutionalism of public sector in the region aims the objective of reestablish fiscal equilibria, looking for generating adequate conditions in the middle and long term to execute countercyclical policies when conditions require. To reach these objectives it is important to use fiscal rules, especially those with major legal hierarchy, as suggests empirical evidence in the region. Similarly, an increasing degree of fiscal transparency is important to build trust in public finances state in every country of the region.

The process of coordination of fiscal and monetary policies is crucial for the economic performance of the countries. For this, in the region it has formal and informal mechanisms of coordination, including those within the framework of negotiations with supranational organizations. In case of an eventual conflict, actual legislation in the region grants faculties to monetary authorities to respond according the circumstances.

On that line, a central bank is concerned in the continuous monitoring of fiscal position, both due to the effects that could have in inflation, as by eventual needs of financing. Most of central banks of the region use different criteria for the evaluation of public finances state, although are generally preferred global balances without adjustments by activities or relative prices changes. It is also frequent, to do forecasts of the main categories of public finances to evaluate temporary trajectories of fiscal situation and its possible effects on monetary variables.

To avoid the emergence of a “fiscal dominance” situation, central banks frequently evaluate the evolution of indicators of fiscal accounts sustainability, verifying that certain coefficients (as debt/PBI ratio or debt/exports ratio) be in a reasonable range, and with a decreasing trajectory in time. The regional outlook shows perspectives of a gradual improvement in the sustainability criteria, although at different paces. Besides, there are factors which modify sustainability criteria in time; especially exchange rate movements, implicit collaterals to public and private operations, and restructuring programs of debt.

Other fundamental channel refers to the reaction of certain economic variables to changes in fiscal policy. The main affected variables would be, aggregated demand and the exchange rates (nominal and real), thus

[1] Answers to survey do not compromise the opinion of respondent central banks. The Bank of International Settlements (BIS) contributed with comments as well as with bibliographic references on the topic, in particular BIS (2003) and Zoli (2005).

influencing to inflation, this last, the ultimate and main objective of monetary policy. In face of an important change of fiscal policy, generally, monetary policy would respond according to possible effects of inflation, especially through open market operations which limit monetary credit to central government.

Experience in countercyclical fiscal policy is limited, although there advances in recent years. Evidence points out that, with exceptions, the ability to use fiscal policies to mitigate the business cycle has been limited by the public indebtedness level. In most of cases the fiscal policy character has been procyclical, contributing to accentuate, instead of mitigate, the business cycle.

JEL Classification: *E52, E61, E63, H60, H70*
Keywords: *Fiscal policy; monetary policy; policy coordination*