## Martín Redrado: Fiscal space for stability, growth and social inclusion

Remarks by Mr Martín Redrado, Governor of the Central Bank of Argentina, at the G-20 workshop, Buenos Aires, 19-20 June 2008.

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As many have mentioned, it could be a rarity to find a central banker addressing on fiscal policy. But, as we have been discussing over the two days of this workshop, the growing complexity of the world economy poses major challenges to policy makers. And, definitely, the ability and flexibility to coordinate the different branches of economic policy lay as one of the most significant.

It seems long ago when Keynes realized that there was more room for fiscal policy than just being a public good provider. I believe it wasn't just a coincidence that it was him, being a specialist in monetary issues, who came out with an answer to, probably, the most intriguing problem of his time. His extraordinary comprehension about how the economy works planted the seeds for the emergence of a macroeconomic theory, which we are still working out and improving on a daily basis. In my opinion, we have a debt of honor to his legacy given the long misinterpretation and wrong pursuing in economic policy on his word.

The analysis of public finance has many sides, some of which were addressed along this workshop. From a theoretical standpoint, we can not state that a clear cut effect from fiscal policy on growth. For instance, neoclassical growth models in the Solow's spirit account for the government basically as a tax collector, showing that the impact on consumers' behavior depends on savings pattern derived from the usual consumption optimization process. This ultimately implies that fiscal policy can only determine the level of income, but can hardly affect the pace of economic growth. These models have become an engine for the analysis of fiscal policy and taxation.

In my view, these kinds of frameworks are robust in terms of describing some stylized facts for free-market environments with very simplified hypothesis. However, they are not able to address some empirical regularities, which are more usual in emerging countries. The vast amount of unemployed resources, including the capacity of the public sector to take the first step in solving this inefficiency is just one example.

On the other hand, endogenous growth models acknowledge that fiscal policy is one of the key factors in explaining the different growth rates among countries. But according to this line of thinking, as well as the classical models, a rise in public expenditure has no long-run effect on the growth rate. The exception is the fact that they may increase private sector's yields and, in that case, public investment could have positive effects on growth. This ultimately can be seen as an improvement in productivity, and might help to understand why the fiscal policy effect on growth seems to be underestimated, as Daniel Cohen pointed out on his exposition.

But, as we are aware, models are set for very limited environments and the real world is extremely complicated. Santiso made this point clearly.

I am not saying that we must forget about theory. Instead, i am suggesting that, in very dynamic economies, we, policy makers, should relay as much on models as we do on good judgment. The world is not linear, we have many discontinuities in the form of shocks from many different sources. It would be too much to ask a model to be able to account for these regular irregularities and, further, to be able to extract sound policy advice from it.

Another relevant issue on fiscal policy relates to the appropriate moment for implementation, especially with regard to its implications for stability. In this respect, we need to identify better ways to put together long-run objectives with short-run ones.

In the later case, we are more prone to recognize its role as a stabilizing force. However, the ability of fiscal policy on reducing the volatility of the economic cycle is under deep scrutiny, especially in the developed world. Probably this has to do with the usual handing over of the stabilizing role to monetary policy. Also, the budgetary process seems to be too rigid to be able to respond in a timely way.

In developing economies, usually more exposed to external shocks that hinder long-run fiscal sustainability, the implementation of countercyclical policies seems to be more difficult. Notwithstanding, there is mounting evidence on the relevance of fiscal policy as a stabilizing economic force.

As we are witnessing today, when there are dual mandates and divergent paths, we, central bankers, are confronted with an extremely challenging task that calls for coordination with other economic policy instruments, that gives more room for fiscal action.

As an answer to the budgetary rigidities, there is a growing case for fiscal rules. Many countries are putting in place this kind of framework as an institutional device to preserve the countercyclical role of fiscal policy. We heard relevant experiences such the UK and Chile, showing the applicability to both, industrial and emerging economies. But, we can not forget the intervention from our colleges from Japan. They reminded us how disappointing this could be and that there is no single recipe for every country.

Another striking issue for policy makers is the scope of public expenditure as a mean to improve social inclusion and economic growth. We have seen the debate within the G-20, evolving to these policy aspects. This morning the clear distinction between monetary and fiscal policy was made, with the later, definitely, better suited to tackle micro problems.

In my opinion, this issue must be included on top of every single country agenda given that income distribution is becoming not only a typical problem for developing countries but also, more recently, for developed ones too.

As a central banker, the issue of policy interaction – largely debated on the economic literature – is of great importance. One usual approach relates to the intertemporal debt sustainability that calls for an aggregate budget constraint between fiscal surplus and seigniorage revenue. This is a clear implication that macroeconomic management involves both the treasury and the central bank. As a matter of fact, as Sargent and Wallace pointed out back in 1981, the fiscal surplus must be large enough to pay out public debt services. They framed it as a necessary condition for a consistent reduction in the rate of inflation over time.

And this calls for another relevant relationship between fiscal and monetary policy, named fiscal dominance. Fiscal dominance can arise in situations were public deficits and a perception on government debt unsustainability hinders monetary policy credibility, even when central banks have legal and *de facto* independence. In this regard we have the theoretical framework first devised by Woodford that shows that is not enough to have a monetary commitment to price stability to achieve it. Fiscal behavior must be clear in order to evaluate the ability of the central bank to put in place its policy.

Pierpaolo Benigno also stressed the point when he was asked about the interaction of fiscal and monetary policy over the business cycle. Speaking about inflation targeting, he stated that a specific target on inflation might not be the best framework for countries with high fiscal dominance or high nominal output volatility.

For instance, the eighties for Latin-American countries are acknowledged as a period of deep fiscal dominance, which ended up in a collapse of many economies derived from overspending and over-indebtness processes that in some cases led to hyper inflation episodes.

Today the picture looks very different. Policy makers seem to be very aware of the costs of overtaking money supply to fund public expenses. Recently, many emerging markets

reduced the fiscal stimulus as economic growth became more stable and resilient. Definitely, what i call a “crowding-in” process. Several countries in Latin-America evolved towards the recreation of budgetary institutions to encourage inter-temporal fiscal responsibility. Latin-American governments have made notable efforts in the fiscal area to improve debt levels and management as a mean to reduce vulnerability, with significant progress in recent years. Pablo Guidotti also showed this yesterday.

As a result, financing needs are not an issue as it was in the past, even though shallow capital markets all over the region act as a constraint for sustainable growth over the long term. In fact, financial development is key – and will be even more so in our agenda.

The depth of the financial system and its integration with international capital markets has a powerful disciplinary effect as it reduces incentives to follow expansionary policies as foreign capital flow out to other markets with more predictable returns.

On the liability side, important progress has also been made in the region. The public debt to GDP ratio decreased almost 30 percentage points over the last five years. This reflects, in part, better liability management, which also shows up in the enormous reduction in the exposure to foreign currency debt. The region is finally leaving behind the well-known original sin that features last decades (currency mismatches), providing solid grounds for developing domestic yield curve in local currency.

All over Latin America, financial systems are better-matched, well capitalized and less exposed to public sector debt, another sin from the past. Not long ago, we used to have not only central banks but also the financial system financing the treasury with no limits whatsoever. In the case of Argentina, for instance, the policy designed by the central bank aimed to this purpose led banks to reduce their government debt holdings that recently stands at 14.6% of net assets, the lowest level in many years.

In my view, good economic analysis also imply not to bundle Latin American countries as they follow very different patterns and are at different stages in their paths towards long-term sustainability. Hasty diagnosis and simplistic comparisons among the various countries’ situations may lead to inappropriate policy recommendations.

To sum up, we have been through a period of better macroeconomic management all across the world. We are witnessing the most turbulent times for the world economy in decades.

As I referred to early last year, when were heading towards a more volatile environment, the resurgence of volatility is about to remain with us for a while. In such a context, emerging economies are more resilient than in the past to confront external shocks.

And, while unusual conditions such as commodities price increases have played an important role (as it was discussed this morning), more robust monetary policy and fiscal strength are a key development behind this performance. On a longer-run, we must keep working on rising human capital productivity by improving public education, investing on social infrastructure all across the cycle, and adopting countercyclical measures to prevent distributional effects in the downswings. Ultimately, this is the most important contribution that we can deliver to our constituents.

As policy makers, we have to be careful about our assessment of current economic environment. We must avoid a usual mistake which is to take that exceptionally good times are about to remain forever, leading to policy relaxation. Here we are confronted with two types of error: the first one is to take the good times as permanent ones, when it is really only a temporary situation. The other possibility is to work as it is only a transitory good time but the real underlying developments are about to be in place on a more permanent basis. As policy makers we can not afford to fall in the first one. Thank you.