

José De Gregorio: Fiscal policy and macroeconomic performance

Opening remarks by Mr José De Gregorio, Governor of the Central Bank of Chile, to the 14th Annual Conference of the Central Bank of Chile “Fiscal policy and macroeconomic performance”, Santiago de Chile, 21 October 2010.

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Good morning. Welcome to the fourteenth installment of our annual conference, entitled *Fiscal Policy and Macroeconomic Performance*.

Year after year, this event gathers an outstanding group of economists from academic and policy circles to discuss a topic at the forefront of the global discussion, and a glance at our program makes clear that this year is no exception. This venue serves to reinforce the strong links that our Bank has cultivated with top research institutions around the world.

We at the Bank believe that rigorous research represents a fundamental pillar in the analysis of the causes and effects of economic developments, and we thus consider it an essential input to our policy decision-making process. Interaction between academics and policy makers is crucial, because it provides each with distinct feedback, permitting advances to occur at the frontier of knowledge – where they are most needed – while providing solid grounds for policy decisions.

As I have mentioned, the topic of discussion during this conference will be *Fiscal Policy and Macroeconomic Performance*. Understanding the way in which fiscal policy transmits into the economy in normal and abnormal times is key to enhance the effectiveness of monetary policy. As the world economy began feeling the brunt of the global financial crisis with the fall of Lehman Brothers in September 2008, public discourse in most countries called for a rapid and decisive policy response. In an unprecedented move, finance ministers from many OECD and emerging countries announced important fiscal packages in an attempt to revive the world economy. Chile was no exception, where the government implemented a fiscal expansion over 2% of GDP – in relative terms, among the largest in the world.

Central banks, for their part, also implemented large monetary expansion measures to stimulate the struggling economy, first by lowering interest rates to their effective lower bound, and then, in many cases, by taking additional steps aimed at providing liquidity to seized financial markets. This was also the case of Chile, where we reduced interest rates to its lowest historical level, and then increase its expansionary stance by implementing non-conventional measures. This is a fundamental factor in Chile's current strong recovery. The present challenge is the withdrawal of the monetary stimulus at an appropriate pace, which insures that inflation forecast is consistent with our target of three percent in a two year horizon. We are taking into account the different factors affecting the outlook, such as the behavior of the exchange rate, the strength of the expansion of demand and activity, and the perspectives of lower interest rates in the world, among others.

Two years into the crisis, the world economy has entered a new stage, in which fiscal policy is increasingly being discussed. The joint effects of monetary and fiscal policy have been central in averting a much deeper crisis. However, disentangling the effects of each one on the economy's performance and determining the best course of action remains the topic of heated debate within academia and in policy circles, in particular, on the speed and timing of the fiscal retrenchment. This is largely dependent on the strength of each country's fiscal accounts.

The ten papers to be presented during the Conference will be organized into three sections. The first will assess the effects of fiscal policy on macroeconomic outcomes. The first contribution to this section, by Tommaso Monacelli, Roberto Perotti and Antonella Trigari, will focus on the effects of tax cuts on the labor market. Joachim Voth will present work that

analyzes the extent to which fiscal retrenchment can take place before civil unrest is provoked. Rodrigo Caputo and Miguel Fuentes will examine the long-run effects of fiscal transfers and investment on the real exchange rate in a broad panel of countries. Mauricio Villafuerte, Pablo López-Murphy, and Rolando Ossowski will close with an examination of fiscal policies among resource-exporters in Latin America and the Caribbean.

The second section will investigate the interactions of fiscal and monetary policy. In the first presentation, Gauti Eggertsson will analyze how the fiscal multiplier is affected by the degree of coordination between the fiscal and monetary authorities. Then, Giancarlo Corsetti will question the conventional wisdom that fiscal policy is more expansionary under a fixed exchange rate than under a floating regime. Finally, Luis Felipe Céspedes, Jorge Fornero, and Jordi Galí will present a paper that estimates the effects of Chilean fiscal policy on consumption and income using a framework that relaxes the assumption of Ricardian equivalence.

The final section will focus on fiscal policy in emerging market economies. Jeffrey Frankel will discuss the structural fiscal spending rule implemented in Chile in 2001. Eduardo Engel, Christopher Neilson, and Rodrigo Valdés will conduct a welfare analysis of the effects of Chile's fiscal rule. Michel Strawczynski and Joseph Zeira will examine the cyclicity of fiscal policy in a broad set of emerging market economies, and will analyze whether the dynamics they observe can be characterized using Aguiar and Gopinath's distinction of permanent and temporary shocks. I would like to thank the organizers, Jordi Galí and Luis Felipe Céspedes, for putting together this first-rate programme, and Yan Carrière-Swallow and the Department of Institutional Affairs for coordinating the logistics that have made this event possible. I look forward to two days of engaging presentations and fruitful discussions. Thank you.