

Comments on International Capital Flows and Destabilizing
Fiscal and Monetary Policy

Franz Hamann

Banco de la República, Colombia

The paper addresses two questions:

1. Are monetary and fiscal policies procyclical in LatAm?
2. What is the impact of capital flows on monetary and fiscal policies?

- The technique: VAR-GMM allowing for simultaneity between policy variables and GDP growth.

- Policy variables:
 1. For fiscal policy: primary surplus
 2. For monetary policy: real interest rate
 3. For capital inflows: net capital inflows to exports

Main results:

1. Monetary and fiscal policies are destabilizing.
2. Capital inflows affect policies in procyclical direction.
3. Chile is the exception: policies are countercyclical.

First things first:

- The paper addresses two of the most important questions for conducting macro policy EM's
- Improves the quality of the evidence through rigorous econometrics
- The paper adds to a recent list of works initiated by Gavin and Peroti (1997) and continued by Talvi and Végh (2000) and Calderon and Schmidt-Hebbel (2003).

Main concerns with this family of papers:

1. Conceptual

2. Statistical

I will focus on the conceptual issues, but I think that the second are important too.

1. Conceptual issues:

- To determine the cyclical properties of a policy it needs to be defined in terms of policy *instruments*
- Is running deficits in recessions and surpluses in expansions a countercyclical policy?
- Is a low real interest rates in recessions and a high real interest rates in expansions a countercyclical monetary policy?

(a) Fiscal Policy

Consider the primary surplus:

$$s_t = \tau_t y_t - g_t \quad (1)$$

where τ is the tax *rate*, y is real gdp and g is real expenditures (excluding interest payments)

- It is reasonable to think as $\{\tau, g\}$ as the policy instruments
- Notice that the tax revenue, τy , is not an instrument and therefore the primary surplus, s , is not an informative policy indicator

Expected Correlations of FP indicators with the Business Cycle

	τ	g	s
countercyclical	+	-	+/-
procyclical	-	+	+/-

Definition: Fiscal policy is destabilizing when two things happen:

- the correlation between the tax rate and output is positive
- the correlation between expenditures and output is negative

Correlations of FP Indicators with the Colombian BC
1970-1999*

	σ_x	$\rho(x, y)$	result
Consumption Tax Rate	0.5%	0.39	C
Capital Tax Rate	1.1%	-0.36	P
Labor Tax Rate	0.9%	-0.06	A
Inflation Tax	2.0%	0.23	A
Government Expenditures	3.9%	0.26	A

*The business cycle is defined as the cyclical component of output using BP-filter at upper frequency of 0.5 and low of 0.125. The tax rates are effective, computed by Fergusson (2003) following Mendoza et. al. (1994). Government expenditure is primary central national government expenditure. Similar results are obtained by using HP filter.

(b) Monetary Policy

- The *real* interest rate may not be the best indicator of the cyclical behavior of MP
- The correlation between the cyclical movements of the *nominal* interest rate and output may also be misleading
- Why not estimate a simple MP rule in the context of a small structural model for each country?

Consider a simple monetary policy rule (recently) used by many Central Banks:

$$i_t = r + \bar{\pi} + \alpha_{\pi}(\pi_t - \bar{\pi}) + \alpha_y(y_t - \bar{y}) + \epsilon_t$$

Definition: A policy is counter-cyclical if $\alpha_y > 0$.

For Colombia: Bernal (2000) finds $\hat{\alpha}_{\pi} = 1.34$ and $\hat{\alpha}_y = 0.19$ from 1991-99. So, monetary policy has been counter-cyclical in Colombia.

Now, consider these two conditions:

- Absence of an active monetary policy: $\epsilon_t = 0$ for all t
- Acyclical monetary policy: $\alpha_y = 0$

The cyclical correlation between i_t and y_t depends on the source of the shocks:

- A productivity-driven business cycle may exhibit a positive correlation between interest rate and output
- A “demand-driven” business cycle may exhibit a negative correlation between interest rate and output

2. Statistical issues (assuming identification)

- Structural change may be important
- Three possible sources for which policy is not time invariant:
 1. Exchange rate regime
 2. Capital market integration
 3. Sudden Stops and EM's Crises (addressed in paper)
- Structural change, if not treated correctly makes the GMM estimator inconsistent and renders all subsequent inferences misleading

- GMM is based on the population moment $E[f(v_t, \theta_0)] = 0$, where $v_t = (x'_t, z'_t, u_t)'$ and it is assumed that this holds for all the sample.
- Need to test for structural stability distinguishing between instability in identifying and overidentifying restrictions
- This may help to determine whether instability lies in the parameters or in a more general form

Final Remarks:

- Understanding the conduct of economic policy in EM's is a key issue
- The challenge in this literature is to determine the “stylized facts” in EM's of policy conduct defining policy in terms of instruments
- Having a structural model may help to achieve this goal
- This paper is a step forward in that direction