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2020 Joint Research Program, [Digital] Intermediate Meeting "The Interdependence of Fiscal and Monetary Policies"

Opening Remarks

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Good morning. **I would like to welcome everyone to the (Digital) Intermediate Meeting of the Joint Research Program**. I hope you and your family are doing well. I truly wish for celebrating next year's meeting here in Mexico City, as has been a tradition for some years now.

This Program is on 'The Interdependence between Fiscal and Monetary Policies.' This is a natural step to take after last year's topic on 'Fiscal Sustainability and Institutional Change.' There are, of course, several ways to approach their interdependence. Allow me to point out some of the points around this topic, which perhaps can motivate different ways to analyze it, underscoring the main features in each case. **Needless to say, due to the time constraint, I will cover a small part of what is certainly a very broad topic.**

Even under favorable economic conditions in which fiscal and monetary policies have little impact on each other, policy makers should have a keen interest on their interdependence. One ought to understand the implications of macro shocks very well and how they might affect such policies. This can be motivated purely from a positive perspective. What is more, **there is much scope for policy coordination and the possibility of responding to such shocks**, evidently, a normative concern.

Under a situation in which there are some fiscal difficulties, fiscal policy might affect the strength of the transmission of monetary policy. In the same way, in a general equilibrium setup, inflation expectations are a function of the prevalent economic conditions and information available to agents, including the assessment of fiscal states with a low probability of occurring, regardless whether these states materialize. **Thus, minor variation in key fiscal variables and small probabilities of critical fiscal states can have a bearing on the conduction of monetary policy.**

Under substantial fiscal difficulties, in particular, doubts on the sustainability of government debt, fiscal authorities might see themselves forced to increase seigniorage, a situation known as *fiscal dominance* (Sargent and Wallace, 1981).

This would probably escalate any pressure on the price level, leading to a disarray in the implementation of monetary policy. This is relevant for the Latin American and Caribbean region considering its fiscal and monetary history (e.g., see Esquivel et al. 2019). **Even today, one cannot discard the possibility of having some of our economies transiting from a balanced relationship between such policies to one of fiscal dominance.**

The institutional arrangement for the coordination of fiscal and monetary policies plays a role in their interdependence as well. Commonly, there is communication between authorities and coordination. For instance, there are committees that formulate policy recommendations, and in some cases have shared responsibilities, like financial stability.

With the Covid-19 Crisis, it became a given that monetary policy, while having a role, has stopped being "the only game in town." It is interesting to note that the macroeconomic policy responses have been in general different from those in the Global Financial Crisis (GFC). In effect, this time around fiscal policy has taken a front seat. Several governments have responded implementing substantial changes in their fiscal policies, many of which have had as their main objective enabling the health policies necessary to face the pandemic. Moreover, as governments take on more responsibility for income re-distribution and risk-sharing, an increase in government debt is unavoidable (Catao and Obstfeld, 2019).

Going forward, changes in fiscal policy will probably lead to a rise in government debt levels in several economies. In effect, eventually, additional economic policies will need to be put in place. They will likely involve challenging decisions on the extent to which firms will be aided and, more importantly, which ones will be aided. This will also involve the process of orderly liquidations for some. The implementation of such policies could have significant fiscal implications, in economies that already had weak fiscal positions prior to the Coronavirus crisis.

The long run fiscal consequences will depend on several factors, prominently, on the pace at which the health contingency is resolved. Of course, in its origin, this is a public health crisis. In turn, it will be contingent on the speed of the economic recovery, and the pace with which interest rates level rise. While low interest rates have allowed government to issue debt at lower costs, there might be challenges once interest rate rise and to the extent debt accumulates without little or no economic growth.

These conditions pose new challenges in terms of research, analysis and policy, as the "new normal" eventually sets in place. There is, of course, much uncertainty about when and how an economic recovery will materialize. What is certain is the enormous need to have a better understanding of how the pandemic will affect and reshape our economies; particularly so, in terms of monetary and fiscal policies. It is worth underscoring that having balanced monetary and fiscal policies is paramount for being ready to respond to further shocks.

A related matter is the fact that, in most economies in our region, the informal sector plays a significant role in both policies. In effect, it is not unusual to see that a significant portion of the labor force working in the informal sector. A major difference between the formal and informal sectors is their productivity, with the former having a higher one. The presence of the informal sector can be interpreted in some sense as a buffer mechanism to macro shocks, crucially, reallocating labor between these sectors. Having said that, such reallocations can be costly in terms of productivity, which can adversely affect economic growth.

The presence of a large informal sector can affect the way monetary and fiscal policy interact. On the one hand, workers in the informal sector have little financial access, which could affect the transmission of monetary policy. **On the other hand**, as workers transit from the formal to the informal sector, the level of tax collection might decrease. Professor Carlos Urrutia will present some of these issues in more depth.

To sum up, the Joint Research Program is one of the most emblematic activities in CEMLA. Thus, we will do our best efforts to improve the quality and scope of the research done in this program. I hope you embrace the opportunity of interacting with your colleagues from other central banks, as well as with Professor Carlos Urrutia.

I wish you a very productive meeting. Thank you very much.

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