

FISCAL POLICY AND ECONOMIC CYCLES: THE CHILEAN FISCAL RULE

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The content does not represent the views of the Central Bank of Chile.

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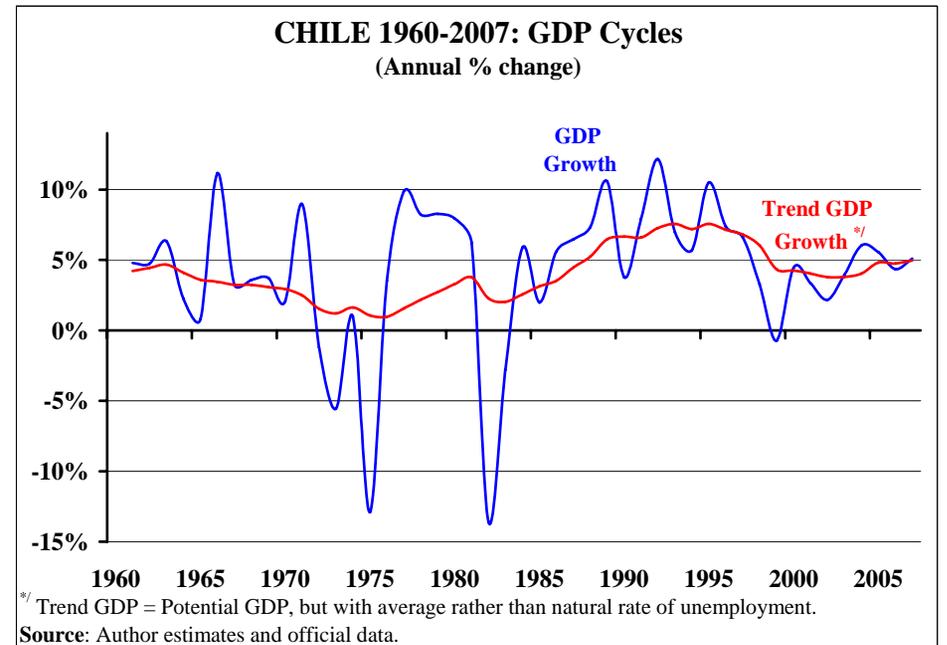
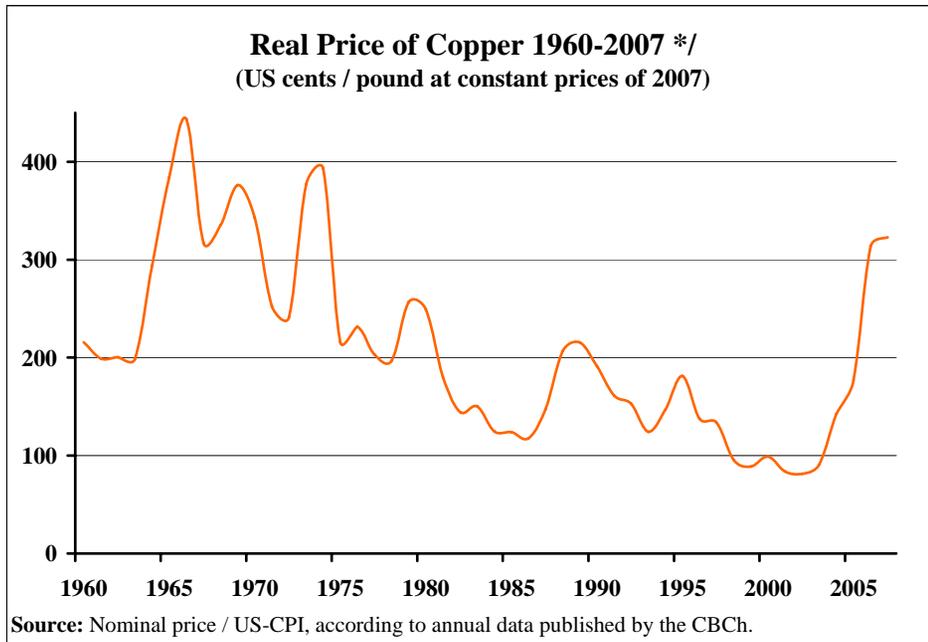
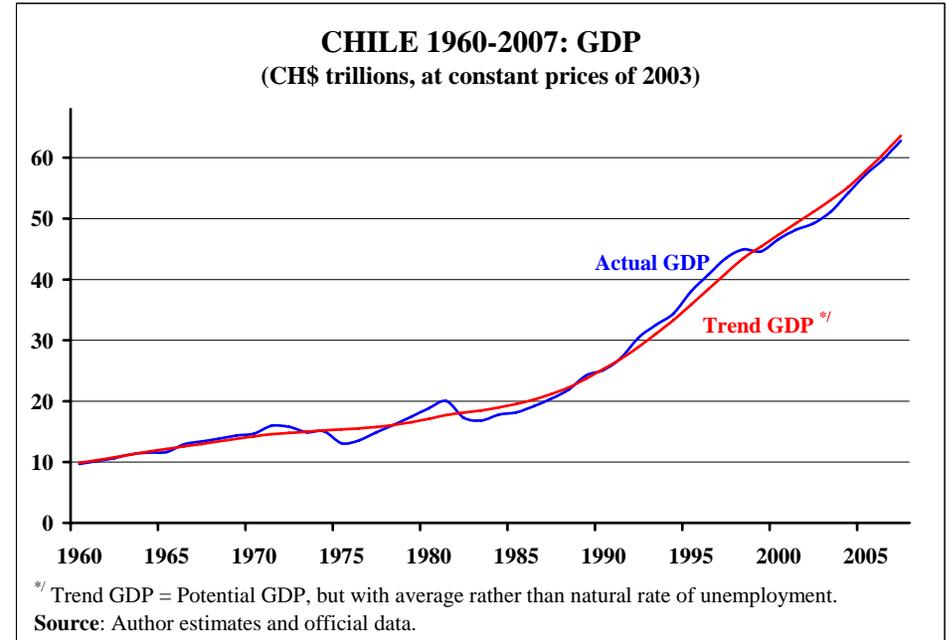
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BACKGROUND

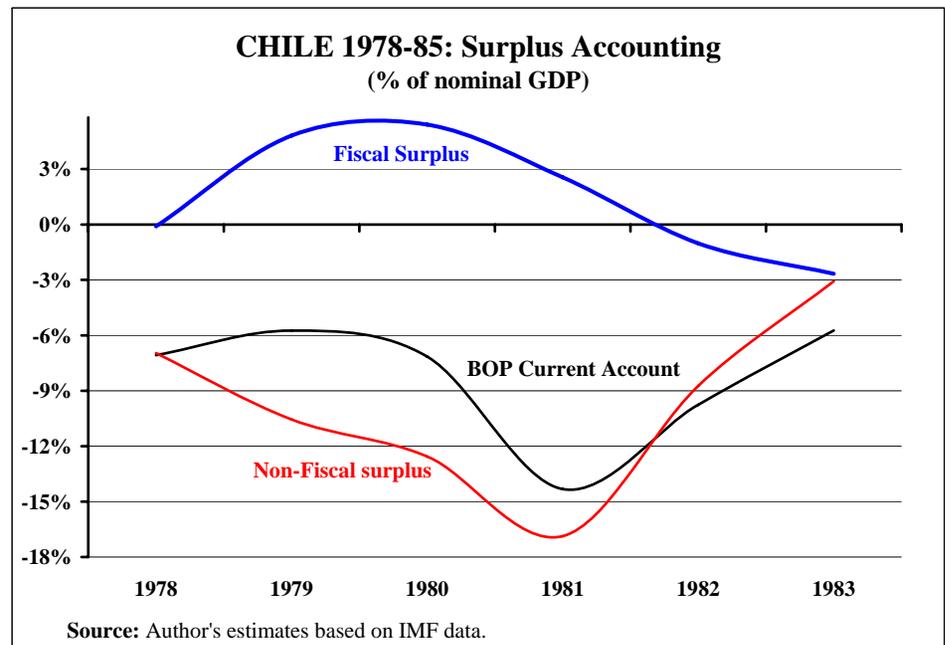
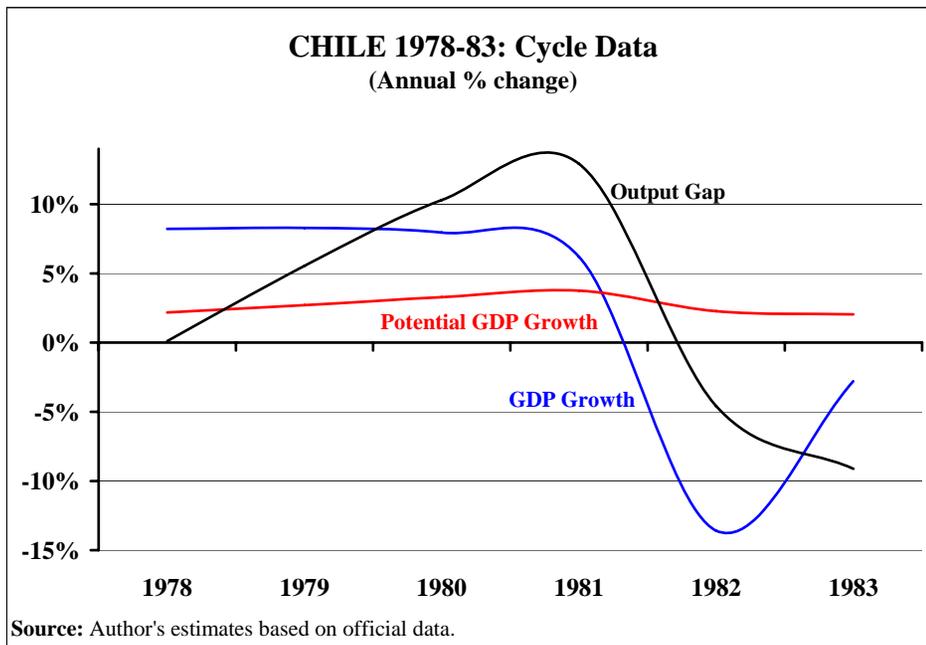
Two main sources of fiscal revenue:

- Tax collection ($\approx 70\%$ of total revenue), sensitive to GDP cycles.
- Copper-related revenue ($\approx 10\%$ of total revenue), sensitive to price swings.



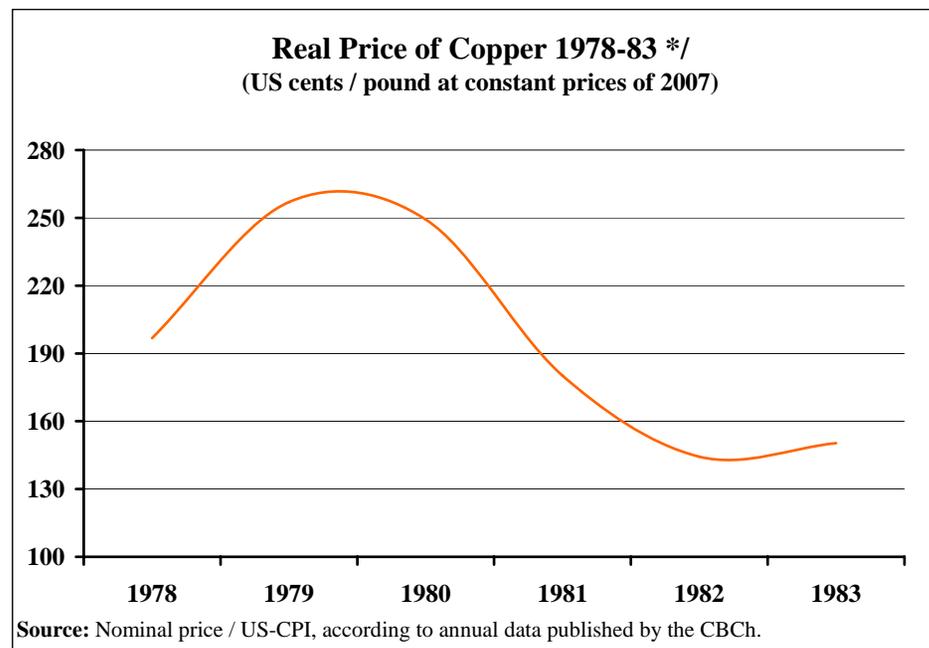
BACKGROUND

1. Historically, fiscal revenue volatility came along with a concomitant pro-cyclical fiscal expenditure (as in 1880-1929 with nitrate exports):
 - Rising copper prices generated both fiscal and balance of payments slacks, inducing new permanent government programs and/or tax cuts.
 - Falling copper prices were associated with fiscal and balance of payments shocks, inducing fiscal “over-killing”, with the 1975 crisis being the emblematic case.
2. As of 1975, fiscal authorities have tried to prevent pro-cyclicality in fiscal policy.



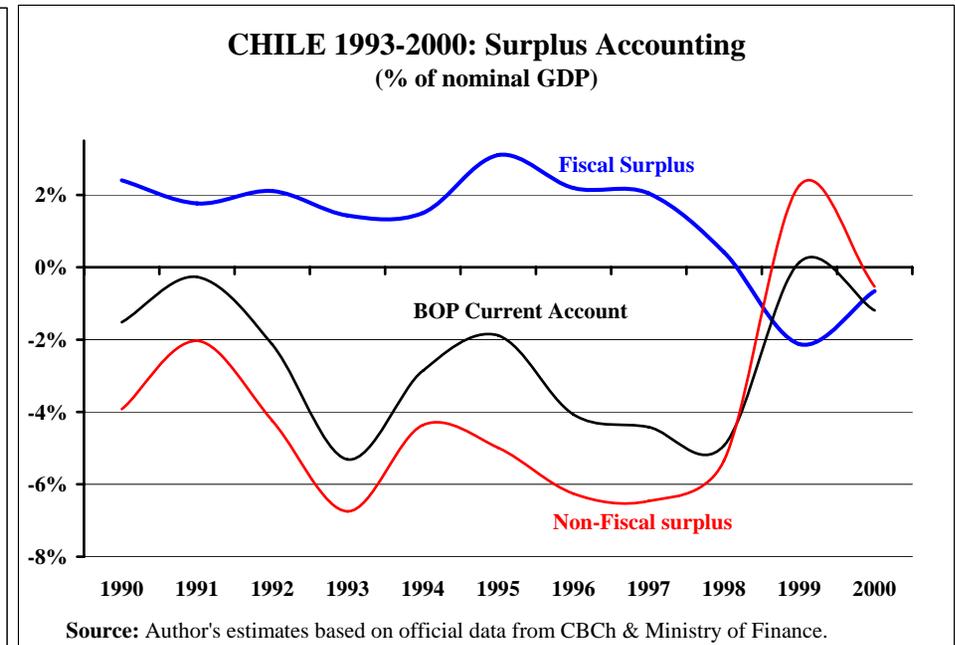
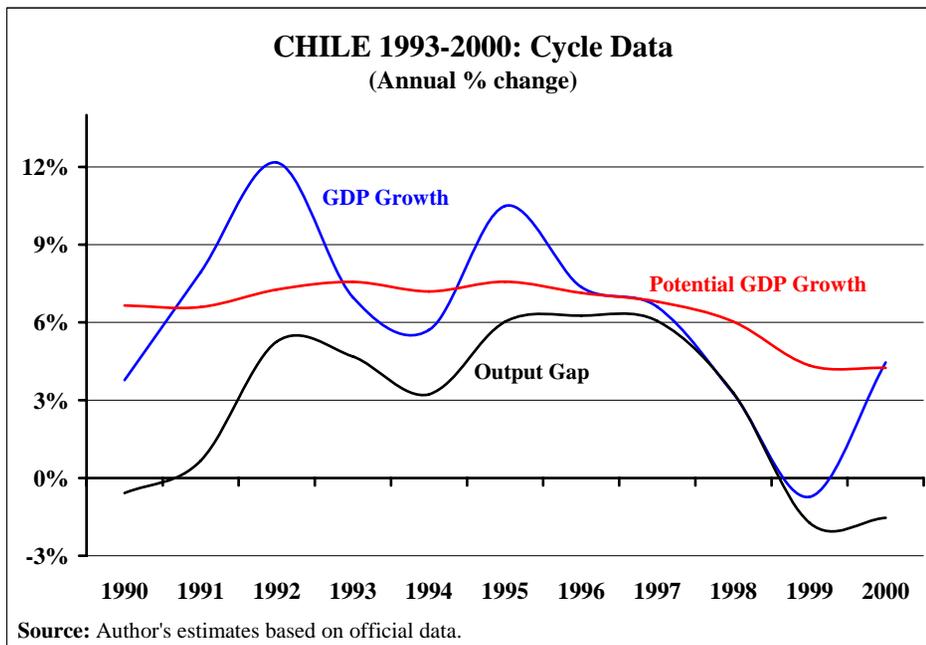
BACKGROUND

3. A “Copper Stabilization Fund” (CSF) started operating in 1986, as part of the conditionality of debt restructuring. In the 1990s, the CSF continued operating on a voluntary basis, and was the embryo of the present fiscal rule.
4. The CSF operated within bands centered in an historical moving average of copper prices. The inner band was associated with free disposable copper income. A second band forced partial savings on (or allowed partial withdrawals from) the CSF associated to the price difference. A third band forced (allowed) a 100% savings (withdrawal) of the price difference. The CSF allows no other use, except for voluntary public debt pre-payments



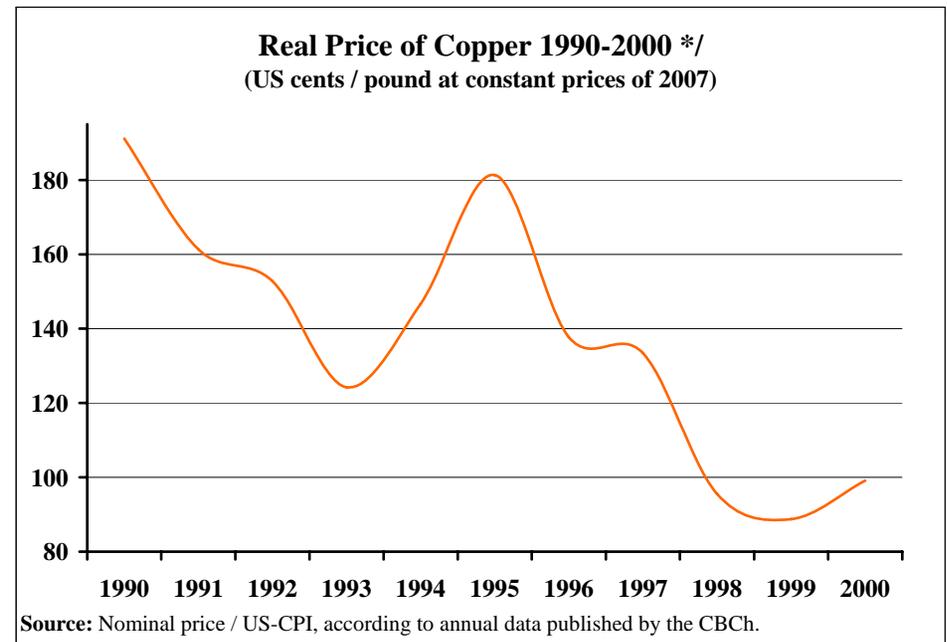
The 1990s

1. The decade coincides with the resumption of democracy. The main strategic economic task was to reconcile economic growth and increasing social equity. For that end, macroeconomic stability was considered a necessity by the political class. Stability was highly valued by society as well.
2. Short-run macroeconomic policy was organized around inflation targeting while monitoring a sustainable current account deficit and a stable real exchange rate. Policy coordination was a novelty. These efforts paid-off while they lasted.



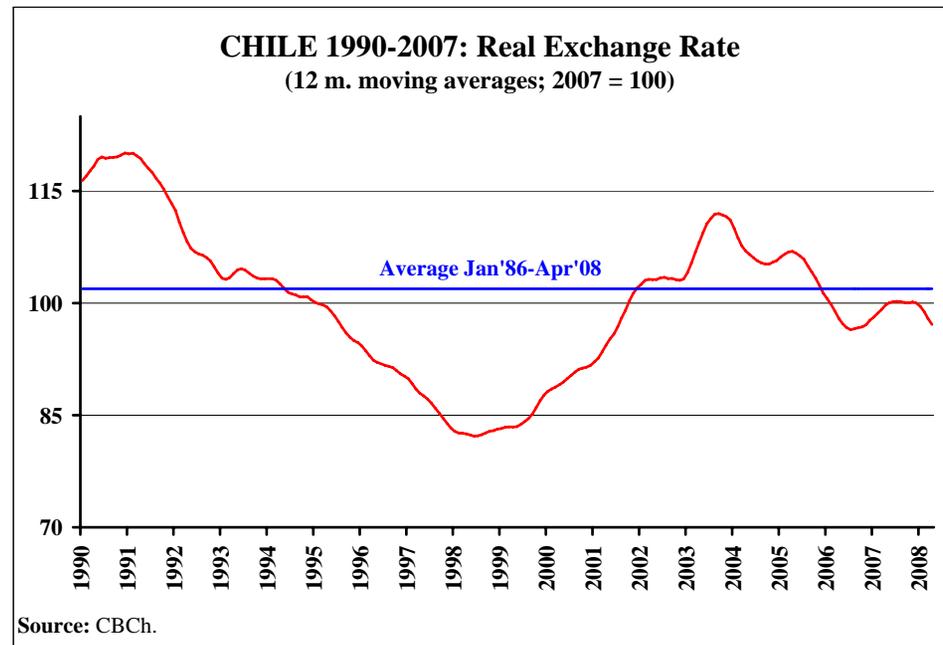
The 1990s

- 3. Policy efforts were not enough to prevent (once again) private sector exuberance, exchange rate misalignment and external vulnerability. While resilient to the “Tequila crisis”, the Chilean economy was stroked in 1998 by a terms of trade loss (once again) associated to the Asian crisis.**
- 4. The public sector had accumulated enough slack to allow a textbook counter-cyclical policy. Monetary policy, on the other hand, shifted to an exchange rate targeting for a while to avoid inflationary pressures. Each one of these moves are still debated.**



The 1990s

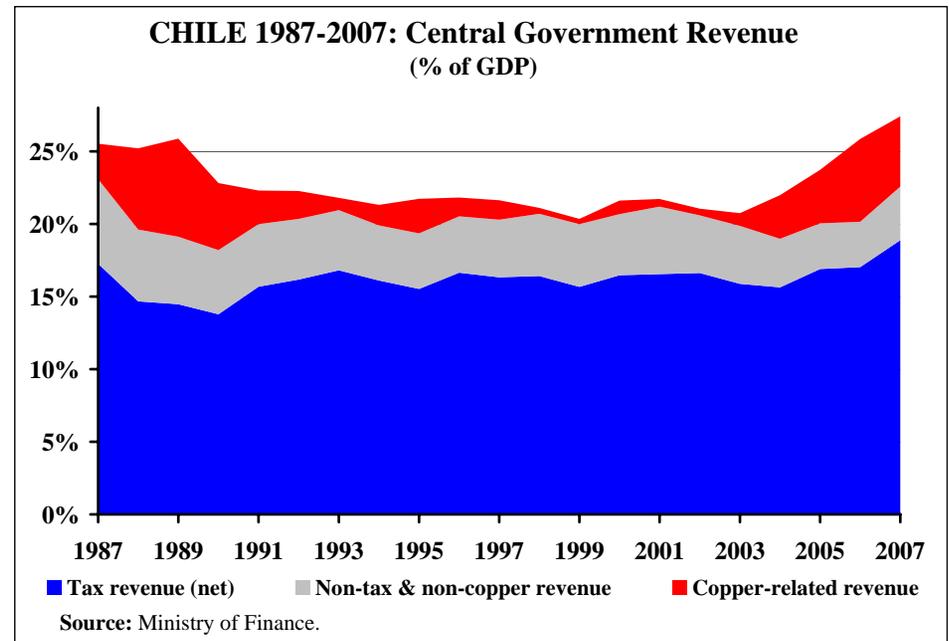
5. In 1999, a floating exchange rate regime was introduced, paving the way to a full-fledged inflation targeting monetary regime, inaugurated in 2000.
6. The 1990s ended with a mild – although too prolonged- recession. A similar terms of trade shock would have provoked a severe crisis in the past.



The 1990s

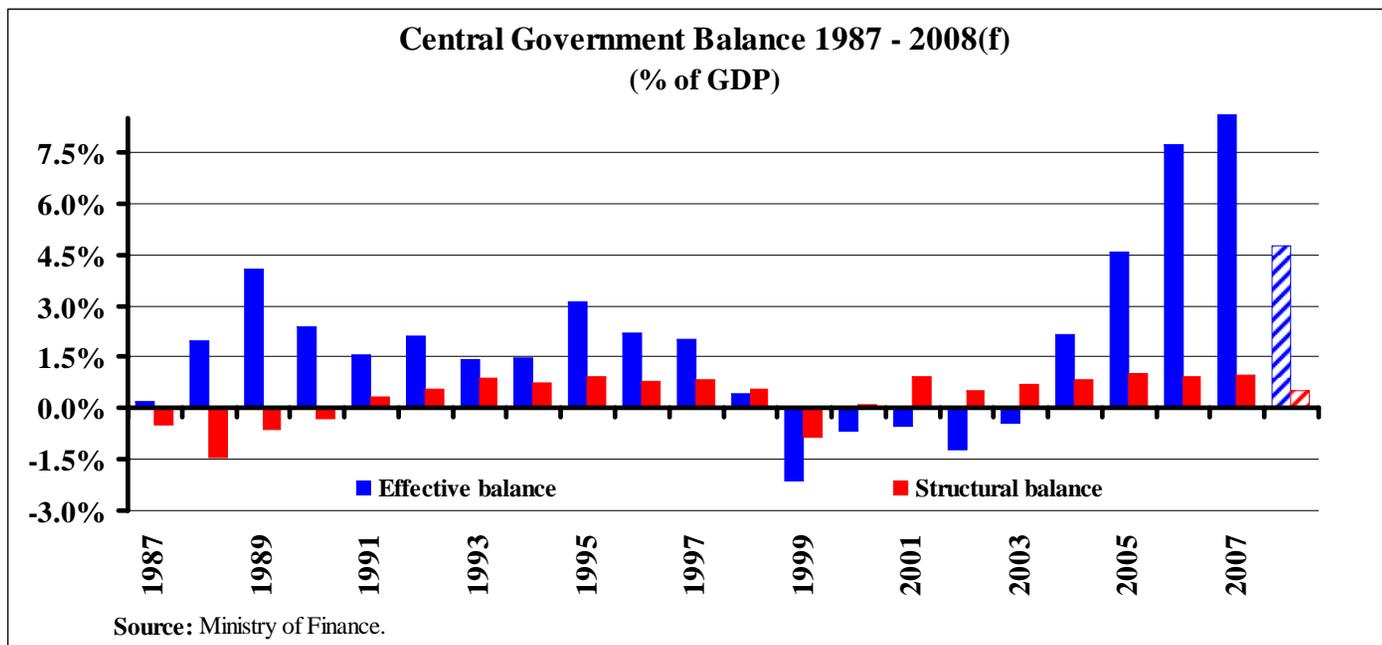
7. Fiscal policy of the 1990s will be well evaluated by economic historians. However, there are important lessons for posterity:

- Fiscal discipline always pays off.
- The political economy of fiscal surpluses is increasingly difficult to tackle, as has been the case in other experiences.
- Discretionary counter-cyclical fiscal policy must make constant and tiring efforts to generate a political backing
- Accumulated fiscal slack must be hidden, as was the case of the CSF, in order to prevent time inconsistency.
- Legislated government income based on wide political consensus also pays off.



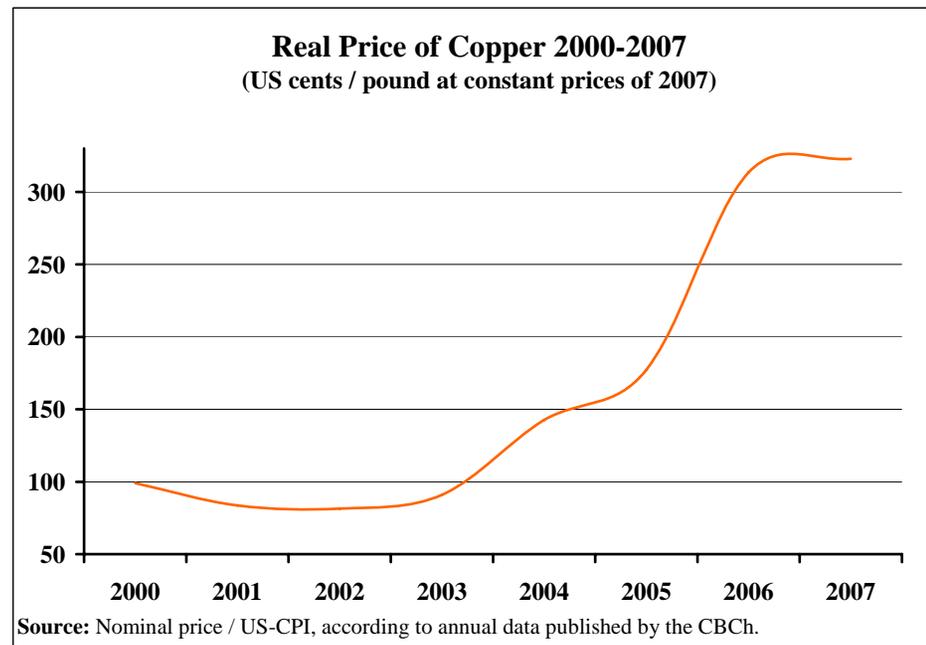
2000-2008: The era of the fiscal rule

1. President Lagos' administration (2000-2006) organized its fiscal policy around a rule targeting a "structural" fiscal surplus (SFSR) of 1% of Trend GDP (© Eyzaguirre & Marcel). As of 2008, the target is 0.5% of Trend GDP (© Velasco).
2. The structural fiscal balance corrects the effective revenue by the effect of:
 - a) The output gap.
 - b) The gap between the effective international price of copper and a "long-run" price of copper.



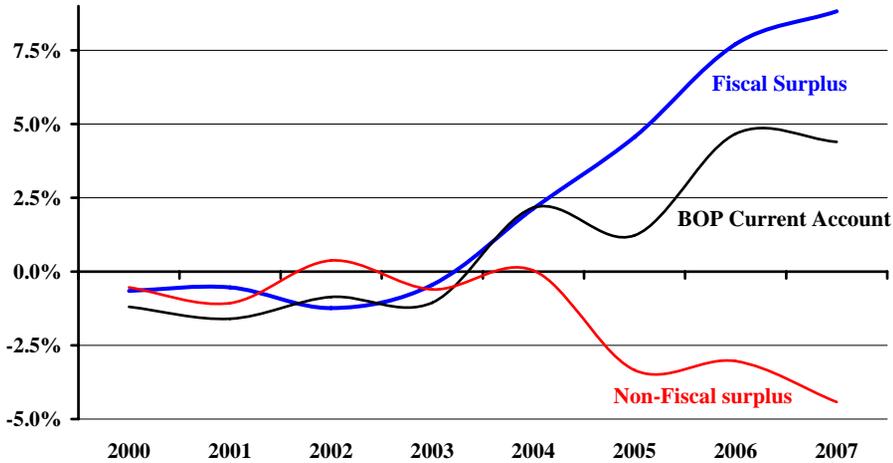
2000-2008: The era of the fiscal rule

3. Trend GDP and the long-run price of copper are determined as a trimmed average of a transparent poll among independent experts.
4. The historical record (1987-2000) shows that the magnitude of the difference between effective vs. structural fiscal balances was significant.
5. The initial years (2001-03) exhibited effective fiscal deficits along with structural surpluses. The true strength of the commitment was proved as of 2004, when a record windfall gain from copper prices started to be fully saved.
6. The impact on macroeconomic aggregates has been surprising, to say the least.



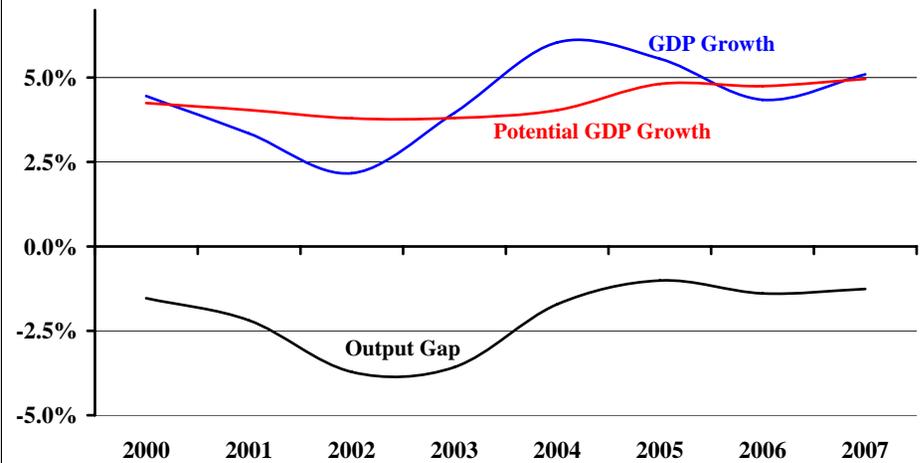
2000-2008: The era of the fiscal rule

CHILE 2000-2007: Surplus Accounting
(% of nominal GDP)



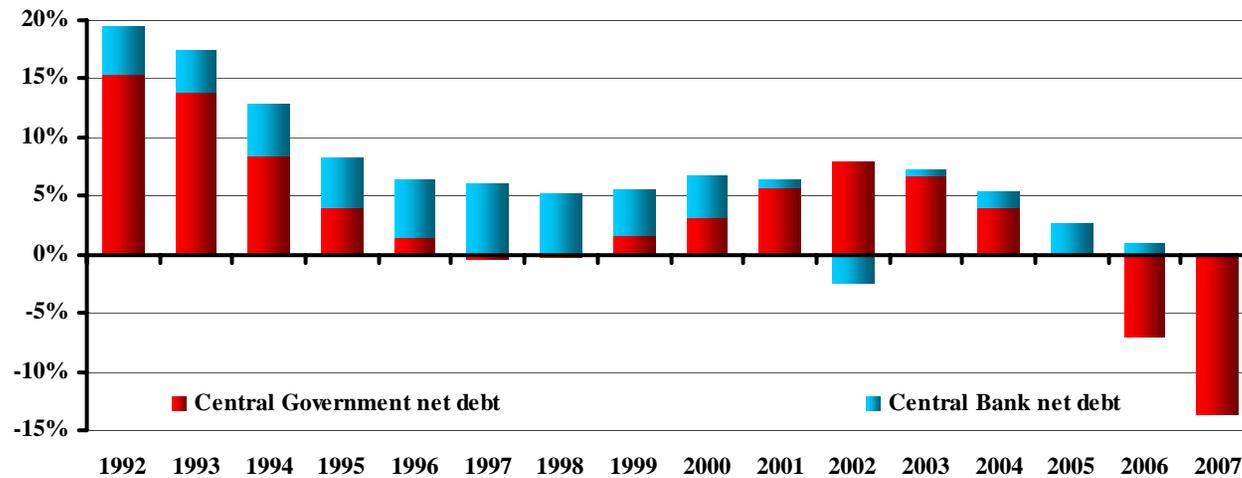
Source: Author's estimates based on official data from CBCh & Ministry of Finance.

CHILE 2000-2007: Cycle Data
(Annual % change)



Source: Author's estimates based on official data.

Central Government & Central Bank Net Debt
(% of GDP)



Source: Ministry of Finance and CBCh.

The mechanics and politics of the fiscal rule

- 1. The SFSR is most important when designing the fiscal budget.**
- 2. Every August, the Ministry of Finance asks each member of the group of “experts” on Trend GDP which is his (her) forecast for capital growth (investment), labor force growth and TFP growth for the next 7 years. The idea is to avoid the typical biases of the “last observation” in HPF. All experts share the same historical information and the same parameters.**
- 3. Simultaneously, the Ministry of Finance asks each member of the group of “experts” on the price of copper the average real price forecasted for the next 10 years.**
- 4. After all experts have answered the questionnaire, a trimmed average is computed and all the information and methodology is made public.**
- 5. The fiscal savings accumulated since 2004 are used in 3 ways:**
 - a) Capitalization of the Central Bank.**
 - b) Accumulation in the Economic and Social Stabilization Fund, managed by the Central Bank in oversea operations (to avoid exchange rate effects).**
 - c) Accumulation in the Pension Reserve Fund.**

The mechanics and politics of the fiscal rule

- 6. The two last (sovereign) funds added US\$ 16.5 billions in last May.**
- 7. The SFSR is a voluntary commitment. The next Government (and presidential candidates) will be asked to be explicit about their respective rule.**
- 8. The “rule format” eased the political discussions at the Parliament as compared to the late 1990s. The ingenuity on alternative uses of the fiscal slack has not calmed, however.**

Final remarks

- 1. The SFSR has had a significant impact to prevent fiscal pro-cyclicality.**
- 2. Reliability of fiscal institutions and policy instruments have been facilitators for the application of the rule. Wide tax bases with few exceptions, well-focused fiscal programs, low corruption as compared to most of the world, and fiscal transparency are a few of these facilitators.**
- 3. Good fiscal governance, where the macroeconomic role of fiscal policy is concentrated exclusively on the central government, allows credible commitments from the authority.**
- 4. The SFSR has an automatic counter-cyclical effect in the most traditional Keynesian way (automatic stabilizer). Little space for additional counter-cyclical efforts from the government, with the concomitant pressure on the Central Bank.**
- 5. Public discussion on medium-run Trend GDP growth has prevented private sector exuberance (so far).**
- 6. The coming agenda is to improve the polls to the “experts”. With regard to Trend GDP, the Central Bank has estimated that energy prices explain most of the changes in trend TFP in recent history. With regard to the long-run price of copper, the experts’ forecasts have proved to be too dependent on the pivoting price.**

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