STUDY

INSTITUTIONS, CREDIBILITY AND MACRO-ECONOMIC MANAGEMENT IN CHILE

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This article evaluates the institutions and rules of macro-economic policy in Chile in the light of recent experience. It comes to the conclusion that the independence of the Central Bank is the key to macro-economic stability and it should be maintained and perfected. At the same time the adoption of a system of goals for inflation and the flotation of the exchange rate are measures which cold improve Chile's macro-economic performance. But the transparency and the amount of public information with which such policies can be applied must also get better. Finally, the article points out that there is room for improvement in the procedures that generate fiscal policy, leading towards multi-annual budgetary goals.

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1. Introduction

The macro-economic performance of countries depends not only on the responsible decisions that the authorities take. It also depends (and in some cases to a greater extent) on the institutional atmosphere in which those decisions are taken and in the policy rules which are used to guide them. Independent Central banks, exchange systems with clear and predictable rules, fiscal regimes which provide the correct incentives to different agencies, procedures which make co-ordination between the monetary and fiscal authorities that much easier: these institutional schemes and others related to them are indispensable to safeguard the effectiveness and credibility of policies. In its turn, such institutions require an important degree of social consensus which legitimises their objectives, especially when reaching such goals (i.e. lower inflation) which are costly in the short term (i.e. economy in recession).

In Chile we have had a decade of successful experience in this matter. The sustained low rate of inflation is reflected in the solidity and credibility which has inspired an autonomous Central bank. Many consecutive years of fiscal surpluses is due in a good measure to a collection of fiscal institutions[1] which are according to various studies- in particular one produced by the office of the Head Economist of BID- among the best in Latin America and the Caribbean.

The effectiveness of such institutions has been called into question by the painful consequences of the Asiatic crisis. It is natural, in the light of recent experience, to re-evaluate the policies and institutions which generated them. But it does not do to be overcritical. In my opinion the size of the recession in 1999 was due to the magnitude of the external shock. It is a fact that Chile is the country in Latin America which has been most affected by deterioration in its terms of exchange and the decrease in demand in its export markets. It also suffered an important shock in the availability of international financing. Nevertheless the size of contraction in activity is much less than several of our neighbours (Argentina, Ecuador, Columbia, Venezuela and others) and it is probable that in the 3 year period from 1998 to 2000 the average growth rate in Chile will continue to be the highest in the region.

* Among others, the process of producing budgets within the Executive, the rules which govern the process of discussion and approval of the budget within Congress, the relationship between the Executive and the Legislative in this matter and the clarity and precision of the budget document itself. See Hausmann et al. (1999)

At the same time it is useful to recognise that the Asiatic crisis and its repercussions in the region have shown evidence of certain imperfections in our micro-economic institutions. It is plausible to conjecture that several of the costs of this external shock have been cushioned by a combination of institutional mechanisms which allowed us, among other things:

- a larger depreciation of the peso without fear that the credibility of anti-inflationary policies were being undermined
- to enjoy a greater flexibility in inflation goals, specifying them within a range and for a period longer than a year
- to assign the weight of adjustment more efficiently between monetary and fiscal policy
- to increase the co-ordination between authorities
- to increase the openness and public information available as to how fiscal and monetary policies are designed and applied

As Y shall argue in more detail later on in this article, Central Banks can only manage to make their anti-cyclical policies be effective if the credibility of their position against inflation is not in doubt. And such credibility is only possible if there is an institutional mechanism that guarantees (and not just people, however willing they may be. The cautious reply of the monetary authorities to the external shock of 1988 reveals that they themselves feared that their credibility was at risk, in the sense that it could be seen to be irreparably affected if the peso depreciated too brusquely or if the target for inflation was slightly exceeded. Similar considerations had weighed in the conduct of fiscal policy during 1999. All this suggests that anticyclical policy could have been more daring and effective if the framework for formulating policies and the institutional environment had been stronger. (It is also true to say that a more anticyclical policy that did not count on a distinctive framework would have been counter-productive and also dangerous. In this sense one can understand the relative caution of the Central Bank).

International crises have had another harmful consequence: a drastic deterioration in the quality of public debate in macro-economic matters. It is natural that in a recession and high unemployment you are going to hear unjustified or so called populist demands: it is also inevitable that a certain amount of frustration spreads among businessmen and workers groups. But what has happened recently in Chile goes further than cyclical disenchantment. We have seen pronouncements on the supposed irrelevancy of fiscal deficits, or on the excessive anti-inflationary zeal of the authorities, both of

which have been absent from Chile for some time. When an analyst from the street (whose opinions I am not used to sharing) comments on the fact that we have gone back 30 years in this discussion, I am afraid that he maybe right.

There is a great risk, at this juncture, that we are coming to the conclusion that all this means mistaken policies. To conclude that the Central Bank has enjoyed excessive autonomy would be ominous for the macro-economic future of the country. It would be equally dangerous to erode the anti-inflationary consensus and the pro-fiscal balance ideas that have been responsible for a good part of the success in Chile over the last decade in micro-economic matters. The prestige of institutions, whatever their conduct might be, is always fragile. The criticisms (much if them unjustified) which the institutions which manage fiscal and monetary policy have received have definitely eroded their political capital and credibility. The challenge for the future is to reverse this tendency.

The present recession, added to a change of government, offers a great opportunity to strengthen the mechanisms which govern macro-economic policy in Chile. Given the growing globalisation of financial markets, Chile will go on being exposed to fluctuations in the global economy, as well as to the instability which affects our Latin American neighbours. In the last two decades, financial crises and changes in the so-called "emergent" economies have multiplied. Such experience suggests that we will have to confront more crises of this type in the not too distant future and that it is sensible to revise our rules on monetary and fiscal policy bearing this possibility in mind. The Central Bank has recently made progress in perfecting the rules which apply to monetary and exchange policy. Especially, and as I shall discuss below, the adoption of a more flexible exchange system and the formulation of targets for inflation are two crucial steps in the right direction. There are other tasks pending in various areas. The rest of this article will suggest several ideas which could be of help.

2. The myths and realities of the functioning of Central Banks

Public debate in Chile today is being distorted by a number of myths about monetary policies and the institutions which manage them. Fortunately the last two decades have been very rich both in academic research and international experiences in this field. The performance of independent Central banks and of the system of targets for meeting inflation in countries like Canada, Australia, New Zealand, Spain, Britain and Israel is revealing.

A rapid revision of what we have learned will help to clarify some of the erroneous conceptions which are being bandied about in Chile today.

2.1 *Central banks and democracy*

The existence of an autonomous Central bank, whose directors are not chosen via a system of popular vote and who cannot be removed by the Executive, in no way infers a reduction of democratic control over monetary policy. The director of the Central Bank is chosen (indirectly) by the democratic institutions of the State and is ultimately responsible to them and the voters. It is not for nothing that the autonomy of Central Banks is becoming more common in the countries of Europe, North America and Oceania, countries which can count on successful and mature democratic institutions.

The difference between an autonomous Central Bank and the other powers of the State is the length of the cycle in which their authorities are renewed and therefore the time horizon in which they can take decisions. It is advisable that monetary policy is managed with long term criteria in mind, since in the short term even the most well meaning government could yield to the temptation of using interest rates to stimulate the economy further than its productive capacity. But what could be effective once, becomes counterproductive in the long term, since those who participate in the labour and financial markets will end up anticipating such expansionary policies and this will result in more inflation and not more growth.[2]

[2] In academic literature, this is the problem known as the "dynamic inconsistency" of monetary policy. Let us suppose that salaries are prefixed in nominal terms via contracts that have already been signed. Let us also suppose that the government or the Central Bank is willing to tolerate a little inflation in return for greater economic activity. So, a lowering of interest rates which causes some inflation and/or devaluation will reduce real salaries, pushing managers to contract and expand employment and production. But this will work only if the monetary stimulus is not anticipated. On the other hand (for example if the same policy is used again and again) people will demand better nominal salaries in their contracts, and so the inflation necessary to achieve an increase in employment will go on increasing. In other words the Phillips curve will go on moving, which makes the trade off between inflation and growth less attractive to the authorities. One could imagine that a rational government, understanding the problem, would abstain from using such expansionary policies, thus reducing the prospects of inflation. But if we return to a situation where the markets can anticipate low inflation, the authorities could once again get greater economic activity in exchange for a pinch of additional inflation. If they yield to this temptation (something they would do if their planning horizon is short term) the harmful cycle would begin again. A formal treatment of this theme can be found in the classic articles of Kydland and Prescott (1977) and Calvo (1979).

2.2 *Autonomy and Transparency*

But autonomy is not the same as secrecy. In order that the Central Bank can be effectively responsible before the Executive, the Legislative and the voters, these must be able to count on the information necessary to follow, understand and analyse the conduct of the monetary authority. Two requirements are indispensable for achieving that. The first is that the conduct of the autonomous Central Bank has to be very open, which is the case in most of the industrialised world, and is happening more and more in emergent countries like Argentina and Mexico (and to a lesser extent, in Chile). To achieve this those countries try and do the following:

- Publish, as rapidly as possible, statistics which measure not only the behaviour of the economy but also statistics on the Central bank itself (levels of reserves and debt, size of the exchange operations etc.). New technology makes this possible to do at weekly or even daily intervals.
- Explain in detail and in writing the logic of the policies which have been adopted, figures on which such policies have been based and the objective circumstances in which such policies could be altered. An excellent example of this is the “Inflation Report” of the Bank of England.
- Publish, no later than a term behind, the complete minutes of the deliberations of the board. Only by doing this will the government and parliament be able to evaluate the performance of the various members and decide whether or not to renew their mandate.

The second is that there are formal and periodic instances when the Central Bank informs and justifies its work before the other powers of the State. In some countries this does not happen just once a year, as in Chile, but three termly. It is advisable, for reasons of clarity and openness, that these sessions are made public.

2.3 *The Costs and Benefits of Autonomy*

There is no doubt that a greater autonomy of the Central Bank leads to less average inflation. It is enough to point out that the Central Banks with the greatest autonomous powers historically have been those of Germany and Switzerland, both countries with the lowest inflation in the post-

war period. In Latin America the greater autonomy of the 90’s has been reflected in a very significant fall in inflation in countries like Argentina, Mexico, Peru and Chile. Informal observations have been endorsed in a multitude of studies to this effect.[3]

Contrary to what is often supposed, there is no systematic evidence which allows one to conclude that the autonomy of the Central Bank has costs in terms of employment and growth. In an often quoted work, Lawrence Summers (who is the Treasury Secretary of the U.S.A. today) and his Harvard colleague, Alberto Alesina, demonstrated this point by looking at the experience of the OECD countries since 1973.[4] Their conclusions have been endorsed by numerous studies, not only on the rich countries but also on those developing ones which have granted an important degree of autonomy to their Central Banks. Even more, there are examples, such as those of New Zealand and Chile, where this autonomy coincides with a significant and sustained increase in the growth rate.

The reason why autonomy does not have long term costs as far as employment is concerned is simple. Once the authorities develop an anti-inflationary reputation, in such a way that their announcements on monetary policy enjoy credibility, so the nominal interest rates and salaries reflect these expectations and real salaries and interest rates come to be, on average, in line with the high levels of manpower usage.

2.4 *Central Bank objectives: one or various?*

The statutes of all Central Banks give absolute priority to the fight against inflation as being the prime objective. Some, like Germany’s Central Bank, transform it into the only objective, making it explicit that it is not up to the monetary authority to guarantee high levels of employment or economic activity. This is sometimes interpreted (incorrectly, in my opinion) as an excess of anti-inflationary zeal on the part of autonomous Central Banks which could have real costs.

There is a consensus among economists that in the medium and long term it is not possible to get greater growth at the cost of greater inflation. In fact the trade off could well be the opposite: greater than average inflation slows down growth.[5]

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[3] See, for example, Cukierman’s book (1992) and the work of Alesina and Summers (1993).

[4] Alesina and Summers (1993)

[5] For this, see the empirical evidence for Latin America in De Gregorio (1992)

Nevertheless there are no reasons to fear that making the fight against inflation the primary objective would lead to a lower average growth rate. This is the main justification for the type of statutes that all the independent Central Banks have.

More understandable is the fear that focusing as a priority on inflation will lead to more variable growth rate, because the monetary authority would not be able to implement an anti-cyclical policy. But this fear is based on two confusions, one factual and the other theoretical. In practice, there is no Central Bank in the world, whatever its statutes might say, that does not respond to the level of economic activity (or to be more precise, to the gap between observed and potential production), among other factors, by fixing the course of monetary policy. It is what even the Bundesbank does, according to what it has demonstrated recently[6], and it is what every country does that has adopted official goals for inflation[7]. One reason for this is that inflation depends primarily on the level of economic activity and therefore to control it necessarily implies a reaction to the other. Another reason is that there are not many countries where an anti-inflationary consensus protected by the work of the Central Bank, can be sustained if the policy leads towards ignoring growth and employment.

The theoretical point is that the statutes allow the Central Bank to ignore the level of economic activity and employment, they do not oblige it to do so. The distinction appears to be trivial, but it is fundamental. In fact, it is precisely the possibility of being able to ignore what happens in the actual economy that allows the Central Bank to implement an anti-cyclical policy, thereby establishing that very same economy. Paradoxical but true.

Let us take the case of adverse external "shock". A lowering of internal interest rates and the monetary expansion that results from it, will only help to cushion the shock if it is perceived that the expansion is a temporary one. A monetary expansion that is perceived to be permanent, in the sense that it will not be reversed in the future (or, even worse, that will be followed by other expansions) will go almost completely into prices and will not affect quantities. The exchange market will be exposed by a flight of capital and a sharp depreciation in the currency. But the devaluation will

[6] Clarida, Gali and Gertler (1998). This article demonstrates, by estimating empirically the function of the reaction of the Bundesbank, that for decades it has been governed by a "Taylor rule", where the nominal interest rate was fixed as a feature of the gap between the expected and hoped for inflation rate and the gap between the observed and potential product. The same can be said about almost all the Central Banks in the industrialised world.

[7] Leiderman and Svensson (1995), Bernanke and Mishkin (1997) and Mishkin (1999)

not improve the competitiveness of exports as internal prices will have increased to a similar extent. Another damaging alternative is that the Central Bank itself, conscious that its anti-inflationary policies are not original, will abstain from implementing a monetary expansion in response to the "shock", fearing that such an expansion will be "badly interpreted" by the markets. According to Hausmann et al. (1999), similar fear have inhibited the anti-cyclical response of various Central Banks- including the Chilean one- after the Asian crisis. The lesson is the same as the other one: without full anti-inflationary credibility, which a Central Bank, that has the freedom not to respond to each fluctuation in production, possesses, no policy of stabilisation is possible.

3. Goals for inflation and monetary policy

A Central bank has to take two key decisions when designing the framework to apply monetary policy: what will be the nominal anchor of the economy and the exchange system. The Central Bank of Chile has recently taken key decisions in both those areas, moving towards a kind of floating exchange rate and formalising the system of goals for inflation which have been operating de facto for a long time.[8] By doing this they have started a new chapter in the monetary history of the country. In this section I am going to look at the logic behind a system of goals for inflation and also some of the problems and opportunities that can come up. In the following one I am going to concentrate on how the system of a floating exchange rate functions.

The alternatives for the nominal anchor of low flotation can be reduced to two: monetary aggregates or goals for inflation. A group of developed countries, including Canada, Finland, New Zealand, Spain, Sweden and the U.K. have tried out goals for inflation policies. In accordance with the majority of published academic evaluations, their performance has been reasonably good.[9] Goals for inflation are less common among the emerging economies. According to Masson, Savastano and Sharma (1997) "Chile is the country which seems to be the nearest to conducting its monetary policy in a way that is consistent with inflationary objectives". Colombia, Indonesia (before its economic collapse) and the Philippines have or have had

[8] In fact it could be argued that up to a couple of years ago the de facto inflation goal in Chile was the rate of the previous year less something, given the commitment of the Central Bank to a gradual reduction in inflation. This was notwithstanding the existence of an estimate of inflation for the following year which the Central Bank had to deliver to the Senate every September and which gradually turned itself into the implicit goal for inflation.

[9] Leiderman and Svensson (1995), Bernanke and Mishkin (1997), Mishkin (1999).

regimes which, in one way or the other, have assimilated the idea of inflationary objectives. On the other hand, in Latin America, only Mexico is following a similar policy of quantifying objectives.[10]

3.1 *The logic behind a system of goals for inflation*

The popularity of a system of goals for inflation should not be surprising. Given the instability of the demand for money in the majority of economies, focusing on the aggregates is neither theoretically the best nor easy to bring about in practice.

The primary objective of this system is to guide the expectations of those who fix prices, salaries and nominal interest rates. By defining a goal, the monetary authority commits itself to utilising the instruments at its disposal to attain it. If the goals enjoy credibility, the behaviour of the different nominal variables will stick to the guidelines that are demanded and attaining the goal becomes possible without incurring greater costs in production. A goal for monetary policy defined in terms of inflation has the advantage of transparency and observability. The inflation rate can be published retrospectively but it is as accessible and understandable to a taxi driver as the type of nominal exchange rate. However trying to fix the type of exchange rate leaves the country exposed to attacks from speculators, something that does not happen if the variable which is intended to control it is tied to the rate of inflation. To predetermine a goal for inflation also helps to introduce a growing dose of discipline in the general micro-economic behaviour. In professional jargon, it can prevent the problem of dynamic inconsistency and the resultant bias towards inflation.[11] A monetary authority which systematically distances itself from its previously announced objectives endangers its reputation and the credibility of future announcements, which makes the conduct of monetary policy much more complicated and the costs of an anti-inflationary position even greater. There can also be personal costs for the governors of a Central Bank which fails, time and again, to meet its objectives: the Executive and Legislative powers would find it difficult to renew their tenure when the time came. In this sense, the existence of an explicit goal for inflation makes it easier to evaluate those who run the Central Bank and increases the accountability of the system.

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[10] Mexico mainly quantifies objectives, but also makes forecasts about inflation, which serve as a guide to expectations. See Aguilar and Juan-Ramon (1997) and Edwards and Savastano (1998).

[11] Ver la discusión al respecto en la sección anterior.

Finally goals for inflation allow the horizon of macro-economic planning to be enlarged and also the horizon for public debate.[12] This is especially true if the goal is multi-annual, which happens in the majority of countries and which happened in Chile from September 1999. Mishkin (1999) offers examples taken from the British and Canadian experiences which illustrate this point very well. In the 90's both countries found themselves in situations of monetary restriction and a turndown of economic activity. As was foreseen, there were voices raised in favour of a lowering in interest rates. But the public debate was especially fruitful, since instead of concentrating on the convenience of better short term growth (a fairly obvious point) it moved towards a quantification of the relevance of trade off. In flexibilising monetary policy like this, how much contraction should there be to attain future inflationary goals?. What would be the cost of greater immediate growth in terms of possibly less future growth?.

In order for such a public discussion to happen, it is nevertheless vital that the suppositions upon which monetary policy are based (in terms of figures as well as models and behavioural relationships) be made public and explicit. Only then can those students of the market, academics and businessman, compare their own projections and estimates with those of the monetary authority and decide for themselves if the appropriate policy is being followed at the time and what would be the costs and benefits (both in the present and the future) in altering it. In the cases of Great Britain and Canada this happens with the publication of very detailed Inflation Reports and with the periodic appearance of the Central Bank authorities before Parliament. In Chile the ordaining role of an inflationary goal has been perfected by transforming it into a multi-yearly one. It is now time to move on to another aspect- improving the information which the Central Bank gives out to the public.

3.2 *The flexibility of the system and anti-inflationary policy*

Contrary to what people believe, the goals for inflation that are used as a nominal anchor are not, in fact, a rigid system which prevents stabilisation policies from being carried out or anti-cyclical interest rates from being managed. As Bernanke and Mishkin said in 1997 goals for inflation are a guideline for monetary policy and not a rigid policy rule. In fact countries with a sophisticated system of goals use a series of mechanisms

[12] Bernanke y Mishkin (1997) hacen hinapié en este punto.

that deliberately allow an anti-cyclical role for monetary policy[13]. Among others are the following:

- One goal which specifies a range of one or two percent, but not as a given or inflexible figure. Chile adopted this system sometime after September 1999 by announcing that as from 2001 inflation would fluctuate around two to four percent[14].
- Escape clauses that allow the Central Bank an "out" for not meeting goals if certain pre-specified events happen (a sharp rise in the price of petrol, a natural disaster, or a war for example, among others).
- A definition of the goal in terms of a price index which excludes some volatile components such as energy, perishable goods and rents, for example. This frees the Central Bank from having to respond to changes in the IPC which are in no way related to the "fundamentals" of the economy.

This scheme allows a Central Bank to lower interest rates, for example, and to facilitate the depreciation of the currency as a response to a slump in external demand for exports, even if this results in a greater inflation in the short term. This does not contradict the predicted goal since it is still possible that the annual inflation level will be within that predetermined range. And in even marginally overtaking that ceiling, there are plenty of reasons for thinking that, once the external shock has finished, the type of nominal and real exchange rate will appreciate, which will rebound into lower inflation in the future.

The absence of a regime of this type in Chile between 1997 and 1998 forced the Central Bank to fight with all its might against the depreciation of the peso, fearing that, if not, inflation would increase sharply. The estimates of the transmission of exchange rates to prices and the subsequent overheating of the economy during this period justified this fear. The gamble was that the cost of such an inflationary shock, in terms of credibility and future stability was too high. So they preferred to use the interest rate even though it could result in higher unemployment.

Although the idea of appreciation does not appear to be so correct from today's perspective, there were reasons why the Central Bank pre-

[13] Véanse Leiderman y Svensson (1995), Bernanke y Mishkin (1997), Mishkin (1999) para mayores detalles.

[14] El Banco Central también se dio a sí mismo mayor flexibilidad al anunciar para el año 2000 una inflación de +/-3.5%, dclaramente mayor que la de 1999. Con ello se deshizo del compromiso implícito de bajar la inflación cada año.

ferred to stick to a more rigid system of inflationary goals in 1997 and 1998:

- From the beginning of the decade, inflation in Chile was following a descending trajectory, but it still had not reached international levels. It was becoming difficult to specify goals in terms of range or multi-yearly averages. Let us suppose that a range of 4% to 5% had been announced for 1998 and another one of 3% to 4% for 1999. To devalue the peso a lot in 1998, for example, with the result that inflation would have soared to the top of the permitted range for that year, or to lower the inflation to almost 3% in 1999 would have required an even greater contraction of the economy than the one adhered to.
- In Chile the experience of an autonomous Central Bank and a system of goals to combat inflation is a very limited one. The credibility of the Central Bank, given this lack of experience, is inevitably imperfect. Because of this, it was thought, quite plausibly, that it was advisable to make the system as simple and transparent as possible at the beginning.

And so in the year 2000, with a decade of experience on its shoulders, and with the anti-inflationary credibility of the Central Bank strengthened by its willingness to increase the interest rates strongly in recent years, there is space enough to be flexible. Therefore the determination to adopt a range of objectives for inflation was both opportune and adequate. Chile should benefit from this new dose of flexibility in the coming years.

3.3 *Other requirements for making a system of inflation goals work*

Apart from the technical aspects of this type of system, goals for controlling inflation only serve as an ordered framework of macro-economic policy if they enjoy three favourable factors of a more general character: co-operation between the other authorities who decide macro-economic policy (especially the Treasury officials), political legitimacy and social acceptance.

The last one is probably the key point, and because of that the most vulnerable. Anti-inflationary policy fundamentally defends itself in the rejection that inflation provokes in the public. It is a well-known fact that those countries that have suffered hyper-inflation - such as Germany and Argentina - are especially disposed to pay high costs to avoid having the

same experience again. In the rest of the countries the balance is more tenuous. People on the street do not want inflation, but they also do not want unemployment, high interest rates etc. The valuation relative to these costs, particularly in the short term, might be very unstable and seen to be influenced by the political climate of the country, the tone of public debate and so on. The temptation of short-termism, where the immediate benefits of inflation (however meagre they may be) exceed the their eventual costs, are always present. The responsibility of political leaders and public opinion is, in this area, keynote and undeniable.

The political legitimacy of inflation goals and of the costs which might be necessary to achieve them, depends a lot on public feeling but also on other factors. It depends, in particular, on how consensual the fixing of goals is between the elites and the institutions which represent them (powers of the State, political parties, unions etc.) and on how legitimate the mechanism is through which goals are fixed from time to time. In several of the more advanced countries the goals are fixed by the government (sometimes after ratification by Parliament) and the Central Bank's job is only to implement them. In this way any fears that the monetary authority can fix goals which do not represent the preferences of the people are avoided. The government, which unlike the Central Bank is elected by popular vote, can plausibly be said to represent such preferences and therefore enjoys a measure of political legitimacy for the goals which it chooses.Chile is the only one of those countries which have goals for inflation where this power is given to the Central Bank (although, de facto, the goals have to be agreed with the Treasury). To transfer the authority for fixing the inflation goal to the Treasury could have contributed to the legitimacy (and therefore the stability) of the anti-inflationary regime. Even now that they have announced a range which should be more or less permanent, the point might seem less relevant. Finally there is no possible system for inflation goals if the fiscal authority does not collaborate. As this is both a crucial and complex theme, I am going to dedicate my next section exclusively to discussing it.

4. Towards a type of floating exchange rate.

Chile is not alone in its transition towards a more flexible exchange rate. Almost all the countries of Latin America, with the well known exceptions of Argentina and Panama, have been moving in the same direction. The same thing is happening in post-crisis Asia and in some of the ex-Socialist nations of Central Europe.

4.1 *The simple argument in favour of flexibility*

The classic arguments of John Maynard Keynes (1936) and Milton Friedman (1953) in favour of flexibility still apply: if the prices of goods are moving too slowly, it is quicker and less costly to adjust the nominal exchange rate as a response to a shock which requires an adjustment to the real exchange rate. The alternative is to wait until an excess in the market of goods and work produces a fall in prices to their real value. You do not have to be an uncompromising Keynesian to suspect that this process is probably a slow and costly one. The analogy which Milton Friedman uses is a revealing one: each summer it is easier to put the clocks forward an hour than to co-ordinate a great amount of people and put their activities forward by an hour., with all the costs that this would involve.

The argument in favour of flexibility in the exchange rate is particularly convincing if the country in question is hit often enough by real shocks from the outside. If the shocks to the market of goods prevail over the shocks to the money market, then it is preferable to have a flexible rather than a fixed exchange rate. And, obviously, real external variations are particularly high for the export of raw materials and for countries with a very high external debt - in all a description which fits the economies of many emergent nations.

In fact the 90's have produced important fluctuations in the terms of the exchange rate and international interest rates which are relevant to those countries up to today. Moreover you can see a clear preference for flexible exchange rates in those developed countries with a strong base in natural resources: Australia, Canada, New Zealand and some of the Scandinavian countries are good examples. This classic assembly of arguments in favour of flexibility in the type of exchange rate has recently been attacked from different angles. One argument is that depreciations, the same as increases in the money supply, are effective only if they surprise the public. And, of course, no government can surprise the public all the time.: repeated depreciations only cause inflation, without generating any real effect. This argument is correct but, at the same time, completely irrelevant. The Keynes-Friedman argument in favour of flexibility certainly does not defend the use of a type of nominal exchange rate as a means of maintaining real activity far from its natural level of balance. On the contrary, it argues in favour of letting the nominal exchange rate move itself so as to adjust relative prices to the new level of balance, after the shock has left the old packet of relative prices obsolete.

A more relevant objection has been recently expressed by Hausmann and others (1990). They sustain that the argument put forward above could be correct in theory, but not in practice for developing countries. In their opinion, one problem lies in the common practice of indexing salaries. Given that, with indexing, it is improbable that a nominal depreciation would generate a real depreciation, Central Banks are reluctant to use depreciation with anti-cyclical objectives. Another difficulty stems from the problem of credibility, already discussed in full above: in countries with a sceptical public due to decades of profligacy in exchange rates, movements in nominal exchange rates tend to be anticipated by changes in nominal interest rates, in such a way that interest rates do not fall (and in fact can increase) as a response to adverse shocks. Hausmann et al (1990) put these two arguments to the proof by citing data from Latin America and they find a certain amount of backing for their position. Their influential conclusion is: flexibility in the nominal exchange rate does not generate much autonomy for monetary policy while it lacks the credibility associated with an exchange rate that is irrevocably fixed (such as the Argentinian one, for example).

This revisionist perspective does contain a grain of truth but in general does not invalidate the argument that flexibility in the exchange rate, managed properly, would be a stabilising factor. The key, as in fixed exchange rates, lies in maintaining credibility. Continued depreciations generated via imprudent or opportunist monetary management, would certainly be anticipated by market forces and would therefore have no real effect: occasional depreciations which respond exclusively to unforeseen shocks would have, almost by definition, real effects[15]. The difficult part is to guarantee that the second case will prevail over the first.

Another way of looking at the same theme is to concentrate on the level of pass-through effect in the change in prices. If every movement in nominal exchange rates is followed immediately by a price hike in domestic prices, then the insulation predicted by using a flexible exchange rate is non existent or nearly so. Theory as well as empirical evidence suggests that the structure of the market and level of competition in the market for goods are crucially relevant in determining the pass-through effect. But a point just as important as the previous one is if variations in the exchange rate are seen as permanent or transitory, and this depends, at the same time, on the average performance of inflation and monetary policy. Leiderman and Buf-

[15] Para un reciente estudio formal que genera este resultado, véanse Obsfeld y Rogoff (1995a).

man (1996) investigated this theme empirically by looking at various developed countries and their methods of development, concluding that the level of pass-through is stronger in an environment of higher inflation.

4.2 *How to confront short term fluctuations in the exchange rate*

The conclusion that a clean flotation is appropriate is of mainly academic interest. In the real world a clean flotation does not exist. The larger industrialised countries like Canada and the United Kingdom, the smaller ones like Australia and New Zealand and the countries with a medium size income like Peru and Mexico, carry out flotations with different degrees of “dirtiness”. Even the United States which is usually touted as the cleanest of the “floaters”, occasionally interferes in the exchange markets. The reason for this is clear enough. A clean flotation implies a high degree of volatility in the nominal exchange rate - much greater than its initial supporters, like Friedman (1953) and Johnson (1`969) anticipated[16]. And, as Mussa (1986) was the first to indicate and others since then have pointed out, given that prices move slowly nominal volatility almost always means a greater volatility in real exchange rate. It is the way in which this volatility in relative prices could be costly, be it directly or owing to what causes volatility in the product or in the health of the financial system itself, that the Central Banks want to mitigate.

Under an administration that believes in goals for inflation there are additional reasons that exist for managing the exchange rate in a certain way. In a small and open economy the exchange rate affects inflation in two ways, as Svensson (1998) has pointed out.

- The real exchange rate affects the relative price between domestic and foreign goods, which affects domestic demand as well as foreign demand for goods produced domestically and therefore the aggregate demand and inflation
- There is also a direct way where the exchange rate affects domestic prices of imported goods that are included in the price index to the consumer

However, whatever plan there is to control the inflation rate in the short term it must also control, to a certain extent, the behaviour of the

[16] Véase la perspicaz discusión histórica en Obstfeld (1995.

nominal exchange rate. This helps to explain the prevalence of a “dirty” or managed flotation in the real world[17].

4.3 *How to confront the cycles in the exchange rate*

A more difficult question is whether the authorities should seek to mitigate not only short term volatility but also movements of a longer duration in the nominal and real exchange rates. The question has sufficient empirical and practical justification. The majority of observers concur that in a system of flotation the exchange rate could be subject to persistent movements that are only vaguely related to the fundamentals of the economy. One instance that has been mentioned often enough is the behaviour of the dollar during the Reagan administration. Obstfeld (1995) pointed out: ¨The best example of irrational misalignment in the exchange rate has been for a long time the massive appreciation in the dollar between 1980 and 1985, where it reached between 40% and 60%, depending on the method utilised”.

Something similar could be said about the real sustained appreciation suffered by most of the Latin American currencies during the first half of the 1990´s. Part of this could have been justified by the gains in productivity which supposedly originated from market reforms: nevertheless a considerable part of the appreciation had its origin in a large inflowing of capital, which continued arriving owing to expectations that the currencies would appreciate even more. When these expectations died down, the currencies succumbed: as in Mexico 1994 and Brazil 1999 among others.

Williamson (1998) has recently proposed ¨monitoring bands¨as a possible solution. This is a band which is intended to moderate the fluctuations in the real exchange rate, but without having the obligation to defend the borders of the band (as in the case of conventional bands). There is a presumption that the authorities would normally interfere to discourage the exchange rate from moving away from the centre of the band, but Central Banks have an extra degree of flexibility to decide on the tactics they would use to achieve this. The problem with this proposal is that an implicit band could easily transform itself into an explicit one, giving place to a level of exchange that the Central Bank would feel obliged to defend. At the same

[17] Aunque ello no se refleja necesariamente en la compra y venta de reservas para influenciar el precio de la moneda. Como discuto más abajo, suele reflejarse en una función de reacción en que la tasa de interés reacciona en alguna medida frente a fluctuaciones en el tipo de cambio nominal.

time, this could give rise to credibility problems and the potential speculative attacks which we have already seen.

4.4 *The present Chilean system*

As from August 1999, Chile has an exchange system with 3 central characteristics

- the nominal exchange rate floats and in ordinary circumstances the Central Bank abstains from intervention in the foreign exchange market
- in exceptional circumstances - like an abrupt and “unjustified” fluctuation in the exchange rate - the Bank does allow itself to intervene, publicly detailing the reasons for its intervention
- the amount of intervention and the results of such intervention on the international reserves of the Central Bank are made public at short intervals

These are the three pillars of a new policy which were announced publicly. There is also a fourth element, which is neither public nor official, but which can be deduced from the Bank´s behaviour in recent years:

- the interest rate, the instrument of the Bank´s monetary policy, moves in accordance to implicit and flexible factors, which include the level of activity as well as the nominal exchange rate.

All this signifies a system of flotation which is more or less “dirty”. Beyond the practical criteria of implementation (How does one define an abrupt or “unjustified”fluctuation in the exchange rate?. How soon should there be intervention in the exchange market?), the central lines of this policy are, without a doubt, the appropriate ones, according to the theoretical criteria and experiences discussed previously. In my opinion the system is appropriate from three points of view. From the perspective of vulnerability, the actual system avoids commitments of the “fire and sword” variety with a given exchange rate, be it with or without a band. Such commitments only invite speculation. And as the experience of innumerable countries shows, speculators are wont to be the winners, eventually forcing an abandonment of parity, with a subsequent loss of credibility in the authorities.

From the point of view of flexibility, the actual system permits the execution of a contra-cyclical monetary policy, following the arguments of both Keynes and Friedman. There are obvious limits to such a policy, since with a flexible exchange rate domestic interest rates cannot move out of line too much with respect to international ones.

Bur greater flexibility, without a doubt, delivers levels of liberty that were absent before.

From the point of view of stability the fact that the flotation is "dirty" and that the interest rate responds to the fluctuations in the nominal value of the dollar allows the impact of the movements of the exchange rate over prices to be moderated. As we have seen above, this is best in a small and open economy and is a natural part of the application of inflation goals by an administration[18].

The present exchange policy, therefore, is heading in the right direction. It only needs to emphasise an element of caution: the new system will lead inevitably to the nominal and real exchange rates being more volatile. This could be problematical if agencies - especially the local financial institutions - do not adjust their behaviour accordingly. The natural thing would be to hope that these would diminish the proportion of debt which they have contracted in dollars, and moreover look for cover via futures, forwards etc. This suggests that there is important work to be done in promoting these markets, so that they can comply with the greatest liquidity possible. Strict banking supervision is also more important than ever, because abrupt changes in relative prices could cause a lot of damage in the balances of the banks.

5. Fiscal Policy and Co-ordination

With respect to fiscal policy there are three relevant points: the relationship between fiscal solvency and the credibility of monetary policy: the capability of fiscal policy to act in an anti-cyclical manner: and the co-ordination between the monetary and fiscal authorities. The following section will deal with these points in that order.

5.1 *Fiscal solvency and macro-economic credibility*

Today there is nobody who doubts that a balanced fiscal policy is fundamental to a healthy macro-economy. At least this is ritually repeated

[18] Véase Svensson (1998).

in public in Chile. Another thing, of course, is to act according to reality. Chile has a good record, in this respect, with eleven consecutive years of surpluses. The panorama has changed with deficits in this year and the next. Such deficits are definitely caused by cyclical elements and should therefore be transitory. But history is full of cyclical deficits that become permanent and structural due to the complicated economy policy of public finances. In Chile one can already observe a growing tendency in certain areas of expenditure - especially several areas of current expenditure - which could be difficult to reverse. What will happen in this respect still is not clear. The key responsibility will fall on the government which takes power in March 2000, that much is clear.

To face up to taking such decisions correctly it is important to understand the level to which the health of public finances determines the trajectory of the rest of the macro variables. Let us take the case of the exchange rate. In an administration that believes in flotation such as we have in Chile today, the price of the dollar will respond instantly and with great sensitivity to the changes of expectations with regard to a series of fundamental variables in the economy. And maybe there is no variable more fundamental in this sense than the fiscal one. The recent experience of Brazil, for example, suggests that if investors perceive that the fiscal house is not completely in order, then the exchange rate can become extremely volatile and respond abruptly to rumours which could affect the budgetary balance.

In this respect it also key to appreciate that several of the links between fiscal policy and other variables are not necessarily those which conventional theory prescribes to. In the Mundell-Fleming model, for example, a fiscal expansion results in demand increasing, interest rates rising, capital entering the country and an appreciation of the exchange rate. This might be correct as far as rich countries are concerned, where there are no fears about fiscal solvency or the possibility that deficits could end up financing themselves through issues. But in the typical developing country an excessive fiscal expansion (like the one we see in Brazil today) can lead to a depreciation in the exchange rate. Why the difference ?. Without a doubt, because of fears that fiscal expansion would bring a permanent deterioration in the monetary/fiscal accounts - because the deficit would become permanent or because it would bring an abrupt increase in debt which would eventually have to be monetarised.

This example also reveals that the effects of fiscal policy on other variables depend not only on actual deficits or surpluses but on the inferences that investors make in respect to what fiscal policy today is suggesting

about fiscal policy tomorrow. Clearly this depends crucially on the strength of the fiscal institutions and policies of the country in question. Y shall refer to this point in more detail in the next section. Such inferences also depend on the patrimonial aspects (estate debt, its cost, present and future privatisations etc.), demographic ones (the effects of an increase in old age pensioners on the social security situation, and the costs of a transition to a private system), institutional (fiscal responsibility for debt quotas) and others. In this respect there are factors in which Chile continues being a source of fiscal uncertainty in the medium term. Two of them spring to mind. The first is the patrimonial situation of the Central Bank, which earlier than later needs a considerable transference of power from the Treasury. The other is the situation in the State copper industry, whose contribution to public finances has been declining. To insure the credibility of fiscal policy, it would be appropriate to clarify the scenario in both.

5.2 *The benefits and difficulties of a contra-cyclical fiscal policy.*

The traditional Keynesian argument in favour of a counter-cyclical fiscal policy is very well known: the fiscal surpluses in times of expansion and the deficits during the reverse serve as automatic stabilisers to aggregate demand and therefore income. The neo-classical argument, constructed on the basis of Barro´s seminal work in 1979 requires a softening, over time, of the distortions created by high tax rates: i.e. governments should, optimally, generate a deficit and get into debt when the product and therefore revenues are excessively low and generate a surplus and repay the debts that they have contracted when the good times return. Thus both theories - the Keynesian and the neo-classical - require a pattern of deficits and fiscal surpluses to move against the economic cycle.[19]

[19] Nevertheless, there is an important qualification to make with respect to these conclusions: the neo-classical theory does not require a complete softening of taxes or expenditure in answer to shocks, even if it is known that the shocks are transitory and of short duration. Let us consider the extreme case of an oil producing nation which knows with complete security that the price of its oil (which belongs to the government and is its only source of income) alternates every period between high and low levels. Therefore if the price is low today, it is sure to be high tomorrow. Let us also suppose that the country in question only eats fruit, the price of which remains constant in nominal terms. And finally let us imagine that the relevant real interest rate also stays constant. Is it best for the country to maintain its expenditure constant each time a negative shock hits the economy ?. No. The actual value of government income is lower in times of low prices than in times of high ones. Because of this, expenditure must be lower. In practice, therefore, even transitory shocks require a tax increase and/or cuts in government expenditure.

For a lot of developing countries, however, these prescriptions are very far from reality. As has been demonstrated in a series of studies produced by the Office of the Chief Economist of BID, fiscal policy in Latin America has been clearly pro-cycle, in contrast to the theory and the behaviour of those countries in the OECD.[20] In the words of Gavin and Perotti:

> Fiscal results have been far more volatile in Latin America than in the industrialised economies. And, in stark contrast to those economies, the fiscal policy has been pro-cycle., particularly during recessions, putting in doubt the appropriateness of Barro´s hypothesis of a softening of taxation for Latin America.

How can we explain this divergence between theory and practice ?. There are two complementary explanations. The first is that governments would like to spend more and get into more debt during recessions but do not do it because the markets do not lend the money. This is what is called the theory of precarious creditworthiness: given the fiscal institutions, the volatility of the terms of the exchange rate and the subsequent volatility in fiscal revenue, the prior redemption of repayments, etc. the lenders simply do not make credit available when money is more necessary.[21]

Gavin and others (1996) offer a useful illustration of this based on the "post-tequila" effect experienced by Argentina and Mexico:

> In 1995 both countries found themselves in the middle of severe recessions. In spite of this, both of them applied strong policies of fiscal contraction, contributing to the deepening of the recession and a delay in recovery. This was not because of the authorities of both countries not wanting to implement more counter-cyclical policies but because the funds for financing the deficits, which would have generated a counter-cyclical policy, were not available, as investors had lost confidence in the short term perspectives.

The other explanation which is maybe more relevant is the case of Chile: in bad moments the capital markets are certainly willing to lend (albeit at a higher interest rate) but governments prefer not to get into debt because it might send a "negative signal" to the markets. Once again, everything depends on imperfect information that the investors count on about future fiscal policy, and on the inevitable inferences that they must

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[20] See Gavin and others (1996) and the references therein

[21] The formalisations of this hypothesis are based on models of sovereign debt which have been widely studied in the 80´s. For a recent and interesting example see Aizenmann, Gavin and Hausmann (1996)

make, based on recently observed behaviour. Thus, a country with great political stability, low debt, and a splendid track record in debt repayment can get itself into excessive debt whenever it needs to: a country with much weaker credentials, on the other hand, must behave itself “extra well” and get into less debt than it would have preferred, so as to send a positive signal of its seriousness and credibility[22].

What can one do in this respect ?. It seems clear that in emerging markets that are hit by exogenous shocks and crises of confidence some level of reduction in expenditure is inevitable as well as desirable. Inevitable because a total softening in taxes and expenditure is rarely the best thing, and because even if there were a private market for capital, it is hardly likely that it would give the finance required. Desirable, because some adjustment today is probably necessary to indicate the political willingness to make greater adjustments in the future.

But, without doubt, there are plans which could provide greater credibility to fiscal conduct and therefore open up better opportunities for stabilising the economic cycle through fiscal policy. In the two examples we saw previously, credibility was the key point: governments cannot get into debt today because markets do not believe it possible that a deficit and subsequent indebtedness today can be counterbalanced by a surplus tomorrow. It is obvious that the underlying problem is institutional: the political and fiscal mechanisms of the country in question does not inspire the necessary confidence in the markets.

A first step which is relatively easy to adopt is to increase the quality and availability of fiscal statistics, so that investors can take decisions with greater and better information. In Chile, although this has advanced a lot in recent years, the fiscal data which the public counts on is incomplete and is drawn up in accordance to a methodology that is not recognised internationally. It would be good if the fiscal data were to stick to the methodology of the IMF, so as to make it more transparent and comparable to other countries.

A more fundamental alternative is to go from an yearly horizon to a multi-yearly one in making up the fiscal budget. The first step would be to

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[22] This is a problem of especially complicated signs, since the information being transmitted does not only depend on the government but also on results in a complicated legislative process which the government does not fully control. In general, the severity of the problem will depend on the size of the fiscal adjustment necessary and on a previous history of prudence or imprudence for the country in question. During the recent crisis the Asian countries were more successful than the Latin American ones on both fronts. This allowed them to tolerate fiscal deficits which in several Latin American countries would have been highly destabilising.

construct scenarios over several years, where the trajectory of the relevant variables would project itself in line with certain supposed exogenous factors. Such a projection is absent today in almost all Latin American countries, including Chile. The second step would be to design legal mechanisms whereby the Executive and Legislative powers could fix at least a part of the budget with various years (say 3 to 5) of anticipation. Such mechanisms should contemplate the obligation to stick to what has been programmed in ordinary circumstances, as well as also specifying the extraordinary circumstances in which the budget of one year could differ from what the programme had previously agreed.

Once again the greatest benefit would be to furnish fiscal policy with the credibility and foresight that it lacks today. At the same time, and as in the case of monetary policy, greater institutional credibility would make it possible for fiscal variables to move in a markedly anti-cyclical fashion when circumstances required it.

A more drastic possibility is the one adopted by the National Fiscal Council suggested by Eichengreen and others (1996). The idea is to create an autonomous institution, whose input would be similar to an autonomous Central Bank with the responsibility to control the heavier tendencies of expenditure and debt. Such a Council will not decide the composition of expenditure or taxes, which are under the control of the Executive and Legal powers. The Council should limit itself, for example, to fixing the size of the deficit or surplus given the macro-economic circumstances. The benefit, as in the case of an autonomous monetary policy, would be to make sure that the tendencies in fiscal policy conduct themselves with long term criteria. Such ideas seem difficult to apply, but that is not necessarily so. There are a lot of countries in the OECD that have such mechanisms for fiscal stabilisation.. Nearer home Argentina approved a plan for Fiscal Convertibility not so long ago which contains a lot of similar elements to those mentioned above.

5.3 *Co-ordination between fiscal and monetary authorities*

There is a lot of talk about the need for co-ordination between fiscal and monetary authorities, but what people have in mind by this is rarely specified. Such co-ordination is important but it does not need to be converted into a fetish. It is natural and healthy that those who control fiscal and monetary policy are occasionally in disagreement , or that one institution uses different strategies against the other, trying to alter its behaviour. After

all, such authorities have different objectives and institutional mandates, and operate (deliberately, given the constitutional design of many countries) with very different planning horizons.

Given this natural tension, to achieve an adequate relationship depends, in my opinion, on satisfying two requirements:

- that there are formal and regular instances of collaboration and consultation, in such a way as to make co-operation easier instead of having competition or confrontation. In the jargon of strategic theory, there is an inevitable game between the fiscal and monetary authorities but if the rules of the game are well designed it will allow the equilibrium to be a co-operative one and not an uncooperative one.
- that the interaction between both sets of authorities is based on an atmosphere of complete information, in such a way that data and suppositions about the economy can be shared, and that decisions can be taken on the basis of this.

If the problem is looked at like that, it is fairly obvious that there are various gaps in the present Chilean system. We can start with the instances of formal co-ordination which today are non-existent. The Council of the Central Bank has no instances like that. It meets to take decisions, not to compare notes, homogenise budgets or elaborate scenarios. The weekly lunches, a tradition which has ruled since the beginnings of the 90´s, also do not serve this end in any respect at all: the meetings have no predetermined agenda nor a staff which worries itself primarily about furnishing those present with shared information. Moreover, the actual structure depends exclusively on the good will of all parties. If the monetary and fiscal authorities were to have opposing policies, it is not at all clear that the system would function so well, or even if it would function at all.

The information that is available is equally imperfect. Part of the problem is the Treasury's: the technical personnel there are very few and its capacity for analysing data (aside from the purely fiscal) is limited. Part of the problem is also the Central Bank's: as a source of almost all the macro information available in the country, the temptation to control its flow and use it monopolistically is very great. The Treasury could in theory come up with its own information using public sources (like the Central Bank does), but in practice it does not have the resources to do so and it would also probably create a duplication of unnecessary functions within the public sector. The result: the Treasury does not always have at its disposal the necessary data in advance or the background to it.

6. Summary and policy conclusions

To avoid excessive repetitions, I shall only mention here some of the conclusions and central recommendations that have arisen from this analysis:

1. Chile has good macro-economic institutions, but the Asian crisis and its sequel has brought to light some imperfections. In view of this now is a good moment to reform our rules regarding macro-policy.
2. There are also a number of criticisms and questions that have arisen about the independence of the Central Bank which point to the fact that it does not have sufficient experience internationally or in the relevant theories.
3. It is correct and advantageous that the Bank should act with the central goal of controlling inflation as a priority. To force it to be explicitly responsible for the level of economic activity and employment is not only costly in terms of an inflationary objective, it is also counter-productive, since it reduces the capacity of the Bank to act in a counter-cyclical way when circumstances demand it.
4. This does not mean that the actual operative mechanisms of the Central Bank cannot be bettered. In particular, a greater transparency in data, assumptions, models and deliberations used by the Bank to design its policies could better the understanding and reaction of the economic agencies towards its policies.
5. During the last few months the Central Bank has adopted a monetary/exchange framework which is adequate for a country like ours. The pillars of this new system are a floating exchange rate and a goal for inflation which serves as a nominal anchor.
6. Recent economic theory and the experience of other open economies like Australia, New Zealand, Mexico, Canada (and now Brazil) suggest that this monetary/exchange framework makes it possible for nominal stability to be compatible with a very necessary flexibility which allows monetary policy to play a counter-cyclical role.
7. As far as the policy of inflation goals is concerned, two points remain which need to be perfected. The first is that goals should be fixed in the future with the explicit agreement of the government, which should amplify their political legitimacy. The second is to study the possibility of using as a goal a rate of inflation defined not necessarily in terms of the IPC but perhaps in terms of a list of tendencies which may be less sensitive to unpredictable movements in certain prices.

8. As regards exchange policy, the main work that is pending is to go on developing an implicit rule which will indicate when to intervene and in what manner. This will also depend on the rule for monetary policy which the Council is going to adopt - especially as the rate at the moment of fluctuations in the nominal exchange rate will be so sensitive.
9. Fiscal policy has been and should go on being the corner stone of macro-economic policy of the country. In spite of a good performance historically, today the challenge is to reverse the tendency to deficits which public accounts have recently shown. Cyclical factors are mainly to blame for the actual deficit, but there are also long term tendencies in current expenditure which it would be advisable to weigh up and if necessary modify.
10. The rules with which fiscal policy is made could also be improved. In particular the advance towards a multi-yearly horizon for the elaboration and approval of the budget would give fiscal policy the foresight that it lacks at present.
11. The fiscal information available, even though much better than several years ago, is still incomplete. It is also difficult to compare it internationally as it does not use the standards set down by the IMF in this respect.
12. Formal instances of co-ordination between the monetary and fiscal authorities are practically non-existent. So are the instances of exchange of information and the joint elaboration of alternative scenarios. Without these, there can be no successful long term co-ordination.

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