# Wanted: Discussion on the fiscal-monetary policy mix



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There is recurrent discussion in the press about the benchmark interest rate fixed by the Central Bank Monetary Policy Committee (COPOM) at its regular meetings. Less common, but economically much more relevant, is debate about how the inflation target for each year is set. A truly independent central bank should be publicly questioning whether fiscal policy as conducted by the Treasury is consistent with the annual target. Otherwise, a target that might be desirable for inflation may be bad for the country.

A more efficient institutional design, one that is also common in international practice, is for the Ministry of Finance to set the inflation target for the central bank, taking into account political considerations about, for instance, the optimal trade-off between short-term inflation and employment. The central bank would then make public its estimate of the maximum nominal public deficit that would be consistent with that target over the next few years.

In a flexible exchange rate system where capital is mobile, the central bank could use a very simple argument to argue for fiscal consistency: "If fiscal policy is not consistent with the inflation target, the only interest rates the central bank can set to meet the inflation target will be too high. That will deter private investment and growth of the economy. Such rates would also attract short-term international capital that would cause our currency

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to appreciate too much, which would carry the danger of adding imports and reducing exports. The consequences would be lower employment and the closing of some [or many] factories. It is not clear that with such a fiscal policy, setting interest rates to meet previously defined inflation targets would be effective for the country as a whole."

Making such an argument and promoting public discussion on the matter at the time the inflation target is being established should be an obligation of every governor of an effectively independent central bank. First, such a debate would protect the monetary authority from political pressures when setting interest rates to meet its statutory obligations of carrying out monetary policy. Second, it would also make clear the source of the problems for those who complain of excessive exchange rate appreciation.

In short, at the time the annual inflation target is set generating public discussion on the most appropriate fiscal and monetary policy mix is important to change the focus of discussion from the interest rate set by the COPOM to the amount and quality of public expenditure. If the central bank could encourage such a public debate, it would be a better measure of its independence from the government.

Today, incisive and public questioning of fiscal policy by the central bank is still very far from our reality. There is, moreover, an institutional obstacle that makes such questioning difficult, though not impossible. In Brazil inflation targets are determined by the National Monetary Council, whose members are the President of the Central Bank, the Minister of Planning and the Minister of Finance (chairman of the Council). Ideally, the Treasury alone would set the inflation target, as is done in other countries.

In this new context, discussion about the budget and macroeconomic policy would take precedence, at the expense of repeated discussions about how high central bank benchmark interest rates are, or are not. The change would also add value to the legislature: transparent and honest discussion of excessive earmarking and obligatory expenditures could revitalize the prestige of the current legislature.

The monetary authority engaging more actively in public discussions on the appropriate fiscal and monetary mix could create a virtuous circle: Subsequent discussions about earmarking and other budgetary practices that are not compatible with a presidential democracy could lead to a better balance between powers and generate a more constructive type of argument between the legislative and the executive. This conflict, as we know, can be very constructive when well designed.