


5th September 1991

TO THE MEMBERS OF THE COMMITTEE OF GOVERNORS

Please find attached a brief note for discussion in which the Economic Unit has analysed the implications for Community countries of an unbalanced mix of fiscal and monetary policy. It is intended to serve as a background note for the Committee's discussion under Item II of the agenda.

With kind regards,


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THE IMPLICATIONS OF AN UNBALANCED POLICY MIX

- Note for discussion -

INTRODUCTION

The stance of both monetary and fiscal policy jointly contribute to the price and output performance of the economy. Although a broad consensus has emerged that monetary policy should be assigned to the objective of price stability, its effectiveness in achieving this objective, and the economic costs that may be involved, depend significantly on the prevailing fiscal conditions. For this reason, the reversal of the general trend towards a gradual decline of budget deficits in the Community in 1990 - and the further deterioration indicated by the prospects for 1991 (see Table 1) - raise serious concerns about the repercussions on the conduct of monetary policy.

When analysing fiscal developments, it is worth recalling that the usual indicators of the fiscal stance (public debt and deficit as a ratio of GDP) should be interpreted with care.¹ The effects of a budget deficit, in fact, vary according to the size of the primary deficit, the ratio of transfers to purchases and the composition of the latter between current consumption and investment. Furthermore, the implications of a given budgetary position depend on whether it is transitory or structural and whether it is perceived by markets to be temporary or permanent.

1 Following a suggestion made at the July 1991 meeting of the Committee of Governors, the Economic Unit plans to undertake an analysis of the measurement of budgetary positions in EC countries, with particular regard to the possible importance of off budget items.

Notwithstanding the differences among EC countries in the nature of budget deficits, as well as in public debt stocks (see Chart 1) and in cyclical phases, the recent slippage in fiscal positions is not only likely to constrain further the scope for monetary policy but may have severe adverse consequences for the economic performance of the Community.

In order to sketch out the main implications of an unbalanced policy mix, this note examines the implications from three different angles. The first section focuses on the short-run effects of a widespread fiscal expansion in the Community as a whole. The second section looks at the short-run implications of a shift to a looser fiscal policy in only some ERM countries. The third section briefly outlines the medium-term effects of persistent fiscal imbalances. Some issues for discussion conclude the note.

I. THE SHORT-RUN EFFECTS OF A GENERALISED FISCAL EXPANSION IN THE COMMUNITY

A general increase in net government spending in all Community countries will boost nominal demand throughout the Community, while inducing similar upward pressure on EC interest rates following the increased recourse to capital markets. Higher interest rates will tend to crowd out private investment and will lead to an appreciation of the Community currencies vis-à-vis third currencies. The aggregate trade balance of the Community with the rest of the world will deteriorate as a result of both the income effect following the rise in nominal demand and the price effect associated with the appreciation of Community currencies.

Unless cyclical conditions are weak, the budgetary shock will result in inflationary tendencies in the Community. If monetary policy is tightened in all Community countries in order to counter these pressures - i.e. the overall policy mix of the Community is characterised by a combination of a relatively loose fiscal policy and a relatively tight monetary policy - it will reinforce the (fiscal-policy induced) upward movement in interest rates. Private investment will be cut back further and Community exchange rates will continue to appreciate, leading to a further deterioration in the Community's trade position with third countries. Although lags can be relatively long and of uncertain duration, the action of the monetary authorities will eventually succeed in easing

price pressures. However, while price developments can be brought under control by a generalised tightening of national monetary policies, the unbalanced policy mix will entail considerable costs in terms of crowded-out private investment and net exports vis-à-vis non-Community countries, affecting growth potential. In addition to these implications for the Community, an EC-wide unbalanced policy mix will affect economic conditions in the rest of the world, as both interest rate and trade impulses are transmitted abroad.

The experience of the United States in the early 1980s illustrates clearly the consequences of a radical shift towards an unbalanced policy mix. The fiscal expansion drove up US interest rates (see Chart 2) and prompted a sharp appreciation of the US dollar, which in turn gave rise to a reduction in private investment (Chart 3a) and a marked deterioration of the trade balance (Chart 3b).

However, the analogy between a fiscal expansion in the United States and a widespread rise in net government spending in the Community should not be stretched too far. The Community will operate like a single economy only in Stage Three of Economic and Monetary Union, i.e. when exchange rates have been irrevocably locked and monetary policy has been centralised. Even then fiscal policy will be largely decentralised: an important difference from the U.S. While the effects described above will become more prevalent as economic conditions converge and national central banks succeed in co-ordinating their monetary policies in a framework of credibly stable intra-EMS exchange rates, at the present time economic divergences, the existence of separate national currencies and the possibility of an exchange rate realignment imply that an unbalanced policy mix - especially if it originates from a fiscal expansion in one or a few Community countries - will be felt predominantly in intra-Community tensions. These repercussions are examined in the following section.

II. THE SHORT-RUN EFFECTS OF A FISCAL EXPANSION IN AN ERM COUNTRY

The shift to a more expansionary fiscal policy in an individual Community country will - at least in the first instance - have the same effects as those described in the previous section. In particular, the country concerned will witness an expansion of domestic demand which, depending on the state of employment and capacity utilisation, will be

reflected in upward pressure on the price level. At the same time, owing to increased bond financing, interest rates will rise, adversely affecting private investment and inducing an appreciation of the exchange rate towards the upper end of the ERM fluctuation band.

However, the effect within the Community and the policy implications will differ considerably according to whether or not the developments in the country in question exert a significant influence on overall monetary conditions. This will depend not only on the size of the country in terms of output but also on the extent to which markets assign to it a leading role in the determination of the monetary conditions in the ERM area. An important feature of the ERM is that countries benefited from the anti-inflationary credibility of German monetary policy by attributing to it the role of nominal anchor and market participants still place different weights on changes in individual ERM countries' monetary developments. Accordingly, not all ERM countries influence the overall monetary stance of the Community to the same degree. In order to facilitate the analysis, it is therefore useful to distinguish between "large" Community countries (which do affect significantly the overall monetary conditions) and "small" ones (which do not), although their distinction may prove less relevant as the convergence process towards Economic and Monetary Union progresses.

If the fiscal expansion occurs in a "small" Community country, i.e. the rise in the domestic interest rate will have little or no effect on the overall monetary conditions in the Community, the economic consequences will be largely felt by the country in question. Given the constraints posed by ERM obligations on the movements of a "small" country's interest rates, the fiscal expansion is likely to result mainly in domestic inflationary pressures, since monetary policy is overburdened (see below). However, in view of the close trade interlinkages within the Community, an unbalanced policy mix in a "small" country (in particular if the latter is "small" in terms of its limited impact on the ERM-wide monetary conditions rather than for the size of its output), it is likely to transmit demand impulses to ERM partners. Other countries' nominal demand will receive an expansionary stimulus, while their interest rates will rise only to a relatively limited extent, unless the expansionary impact on their nominal demand is so strong as to give rise to inflationary pressures which are then counteracted by an overall monetary tightening.

By contrast, if the increase in net government spending occurs in a "large" Community country, the fiscal-policy induced rise in its domestic interest rate would tend to exert upward pressure on the overall interest rate level in the Community. As a result, while the stimulatory demand effect generated in the country with a fiscal slippage would boost net exports in the rest of the Community, there would also be a contractionary effect from higher interest rates, and the overall impact on economic activity would be uncertain.

In addition to the implications described above, the unbalanced policy mix in a "small" or a "large" Community country normally has different policy implications. With the effects of a fiscal slippage in a "small" country manifesting themselves primarily in "its" domestic interest rate and "its" exchange rate vis-à-vis other Community currencies, the authorities concerned would have little or no scope to tighten monetary policy in order to counter the inflationary pressures arising from the fiscal impulse. Any attempt to adopt a more restrictive monetary stance would be frustrated by increased capital inflows. In such circumstances monetary policy will become overburdened, as it is not possible to raise interest rates sufficiently to pursue price stability effectively while maintaining exchange rate stability. The overburdening of monetary policy could thus easily lead to a paradoxical situation where exchange rates deviate increasingly from "fundamentals", at least in terms of price performance. If, however, the deteriorating budgetary position generated expectations of a future depreciation of the exchange rate, there would be some room for a rise in domestic interest rates. Yet, this would not necessarily enhance the effectiveness of the monetary policy of the country concerned, as any greater risk of depreciation may also adversely influence the behaviour of price and wage setters.

The situation will be different if the fiscal expansion takes place in a "large" Community country. The increase in interest rates associated with the fiscal expansion and with the anti-inflationary stance of the monetary authorities will tend to be transmitted to the Community as a whole. The overall level of interest rates will consequently rise and the upward pressure on the exchange rate in the country concerned will be mitigated. In other words, the more restrictive monetary policy will pull up the entire ERM band vis-à-vis third currencies. As a result - not dissimilar to the situation described in Section I - monetary policy will

succeed in fighting inflation, although at the cost of crowded-out private investment and reduced net exports to third countries. Moreover, this policy response of a "large" country may well give rise to a policy dilemma and to tensions within the EMS, as some other countries in a weak cyclical position and with low rates of inflation may wish to maintain relatively low interest rates. On the other hand, the rise in interest rates might help the fight against inflation in countries where monetary policy is constrained by their currency being at the top of the band.

In practice, the effects of a country's, whether "small" or "large", fiscal imbalance on other countries' monetary policy will depend not only on the influence it exerts on the monetary stance of the ERM area but also on the initial position of the currencies within the band. At times, the spillover of an unbalanced policy mix may take the extreme form of a binding constraint, pushing one currency to the bottom of the band and thereby depriving that particular country's monetary policy of any leeway for reducing interest rates in the light of domestic conditions. The opposition of the French franc to the Italian Lira, and then to the Spanish peseta, in the fluctuation band (Graph 4, grey areas) can be regarded as an illustration of such a situation, although other factors (e.g. the different cyclical phases) were also significant.

III. THE MEDIUM-TERM EFFECTS OF AN UNBALANCED POLICY MIX

If a loose fiscal stance were to persist in one or several Community countries, it would make it increasingly difficult for monetary policy to preserve price stability and would exacerbate the costs associated with an unbalanced policy-mix. Debt servicing would mount through time, adding further to the budgetary deficit and risking an explosive spiral of public debt accumulation. This effect would be intensified by the pressure on interest rates stemming from the high and rising public sector borrowing and from the tight monetary policy necessary to counteract the continuing inflationary impulses. The decline in private investment and exports would become more acute, affecting growth potential further.

In the limit, the persistence of an unbalanced policy mix becomes incompatible with the requirement of fiscal solvency and the maintenance of nominal stability in any Community country, given that, sooner or later,

governments must make ends meet either through fiscal consolidation or through resorting to inflation and debt monetisation. If that latter option is to be ruled out, i.e. if nominal stability is not to be forsaken, there is no escape from correcting an unbalanced policy mix through fiscal consolidation. While the long-term effects of excessive net government spending may not always be fully apparent in the short-run, the inevitable need to reverse an unsustainable fiscal position calls for a correction at an early stage. In fact, if expectations of a debt monetisation (which will build up if the fiscal imbalance is perceived to persist indefinitely) were to spread among market participants, they could unfavourably affect price and wage setting and thus give rise to an inflationary spiral, which would be very difficult, if not impossible, to contain through monetary measures.

ISSUES FOR DISCUSSION

The above analysis has shown that fiscal imbalances entail significant economic costs and, when combined with ERM obligations, result in constraints on the conduct of monetary policy both in the country experiencing budgetary laxity and in the other ERM countries.

- Section III has argued that fiscal consolidation is the only option available to redress an unbalanced policy mix if nominal stability is to be durably preserved. Do Governors agree that some steps towards fiscal consolidation, signalling a resolve to reverse the recent slippage, should be undertaken notwithstanding the weak cyclical phase of some EC countries?

- If no signal in the direction of fiscal consolidation is given, some tightening of EC monetary conditions might be necessary in the pursuit of price stability. Would such a tightening be compatible with a certain differentiation of national monetary policies? Or, is there a danger that fiscal imbalances in the context of ERM obligations will become so strong that they will result (through the mechanisms outlined in Section II) in constraints which offer very little leeway for differentiated monetary policies?

Table 1

GENERAL GOVERNMENT DEFICITS AND BORROWING REQUIREMENTS (1)
(in percentages of GDP at current prices)

	Total revenue	Expenditure (excluding interest payments)	Surplus (+) Deficit (-) excluding interest payments	Interest payments (-)	Surplus (+) Deficit (-)	Other items (2)	Borrowing requirements (-) (2)		
							Net	Gross	
	(a)	(b)	(c)=(a)-(b)	(d)	(e)=(c)-(d)	(f)	(g)=(e)+(f)	(h)	
National sources (on an accruals basis unless otherwise stated)									
BE	1987	47.7	44.3	3.4	10.5	-7.2	-0.4	-7.6	-12.3
	1988	46.3	42.9	3.4	10.1	-6.6	-0.7	-7.3	-11.4
	1989	44.6	40.8	3.8	10.3	-6.5	-0.5	-7.0	-13.1
	1990	44.6	39.6	5.0	10.5	-5.5	-0.5	-6.0	-8.9
	1991 f)	44.3	40.0	4.3	10.4	-6.0			
DK	1987	59.8	49.2	10.6	8.4	2.2	-0.8	1.4	-13.4
	1988	61.0	51.6	9.4	7.9	1.5	-2.8	-1.3	-18.3
	1989	58.6	51.7	6.9	7.4	-0.5	-2.0	-2.5	-16.8
	1990	56.4	50.7	5.7	7.2	-1.5	-1.4	-2.9	-14.8
	1991 f)	56.6	50.7	5.9	7.5	-1.5	-1.9	-3.4	-15.4
DE (8)	1987	46.9	46.4	0.5	2.9	-2.4	0.0	-2.4	..
	1988	46.2	45.9	0.3	2.9	-2.6	0.0	-2.6	..
	1989	47.0	44.5	2.5	2.8	-0.4	-0.8	-1.2	..
	1990	45.4	44.0	1.4	2.7	-1.3	-3.4	-4.6	..
	1991 f)	46.6	49.0	-2.4	3.1	-5.4	0.0	-5.4	..
GR (3)	1987	28.3	32.3	-4.0	6.5	-10.5	-1.3	-11.8	..
	1988	26.4	33.0	-6.6	7.3	-13.9	-0.8	-14.7	..
	1989	24.8	35.3	-10.5	7.2	-17.7	0.4	-17.3	..
	1990	27.9	34.5	-6.6	10.9	-17.6	-0.6	-18.2	..
	1991 f)	34.7	35.3	-0.6	11.0	-11.6	-0.2	-11.8	..
ES	1987	37.8	37.5	0.3	3.5	-3.2	-1.1	-4.3	-5.4
	1988	38.0	37.9	0.1	3.4	-3.3	0.1	-3.2	-4.3
	1989	39.7	39.0	0.7	3.4	-2.7	-0.1	-2.8	-4.0
	1990	39.3	39.8	-0.5	3.5	-4.0	-0.1	-4.0	-4.5
	1991 f)	40.8	40.7	0.1	3.7	-3.6	-	-3.6	-3.7
FR (2)	1987	50.7	49.0	1.7	2.8	-1.1	-	-1.1	..
	1988	49.9	48.9	1.0	2.8	-1.8	-	-1.8	..
	1989	50.9	49.3	1.6	2.8	-1.2	-	-1.2	..
	1990	51.1	49.7	1.4	3.1	-1.7	-	-1.7	..
	1991 f)	51.4	49.7	1.7	3.1	-1.4	-	-1.4	..
IE (2)	1987	41.9	42.0	-0.1	9.7	-9.8	-	-9.8	..
	1988	42.9	39.4	3.5	9.4	-5.9	-	-5.9	..
	1989	39.0	33.6	5.4	8.5	-3.1	-	-3.1	..
	1990	39.0	34.0	5.0	8.5	-3.5	-	-3.5	..
	1991 f)	42.1	36.0	6.1	8.8	-2.6	-	-2.6	..
IT (2)	1987	39.7	42.8	-3.1	7.9	-11.0	-0.6	-11.6	..
	1988	40.1	42.8	-2.7	8.1	-10.8	-0.7	-11.5	..
	1989	42.0	43.0	-1.0	9.0	-10.0	-1.2	-11.2	..
	1990	42.8	43.7	-0.9	9.7	-10.6	-0.3	-10.9	..
	1991 f)							-9.6	..
LU	1987	56.0	49.5	6.5	1.2	5.3	..	..	..
	1988	55.8	49.2	6.6	1.2	5.4	..	..	..
	1989	53.5	50.1	3.4	1.0	2.4	..	..	..
	1990	54.8	50.7	4.1	0.7	3.4	..	..	..
	1991 f)	52.4	50.7	1.7	0.6	1.1	..	..	..
NL	1987	54.4	54.6	-0.2	6.1	-6.4	-1.6	-8.0	-13.7
	1988	53.6	53.2	0.4	6.0	-5.6	-0.6	-6.2	-12.7
	1989	51.6	49.5	2.1	5.9	-3.8	-1.1	-4.9	-10.6
	1990	51.3	50.0	1.3	5.9	-4.6	0.2	-4.4	-10.0
	1991 f)	52.0	50.1	2.0	6.0	-4.0	0.6	-3.6	..
PT (2)	1987	37.1	36.8	0.3	7.8	-7.5	-4.2	-11.7	..
	1988	37.6	37.1	0.5	7.7	-7.2	-3.1	-10.3	..
	1989	40.7	37.9	2.8	7.1	-4.3	-1.8 (6)	-6.1	..
	1990	39.6	38.1	1.5	8.2	-6.7	0.1 (6)	-6.6	..
	1991 f)	42.0	39.8	2.2	8.7	-6.5	1.1	-5.4	..
GB (2)	1987	40.3	37.4	2.9	4.4	-1.5	0.2	-1.3	-1.9
	1988	40.1	35.2	4.9	3.9	1.1	2.2	3.3	0.6
	1989	39.8	35.0	4.8	3.6	1.2	1.1	2.3	-0.4
	1990	40.0	37.3	2.7	3.4	-0.7	1.8	1.1	-1.0
	1991(7)	39.4	38.5	0.9	3.0	-2.1	-0.2	-2.3	..
EEC(5)	Community sources (on a national accounts basis) (4)								
	1987	43.6	43.0	0.6	4.8	-4.2	..	..	..
	1988	43.3	42.3	1.0	4.7	-3.7	..	..	..
	1989	43.6	41.7	1.9	4.8	-2.9	..	..	..
	1990	43.3	42.3	1.0	5.0	-4.0	..	..	..
1991 f)	44.0	43.4	0.6	5.3	-4.7	..	..	..

(1) For details, see explanatory notes. Discrepancies in totals are due to rounding.

(2) On a cash basis.

(3) Only central Government.

(4) 1972, 1980-1987: EUROSTAT figures; 1988-1990: Commission's Economic Budget of January 1989.

(5) 1972: excluding Greece and Portugal.

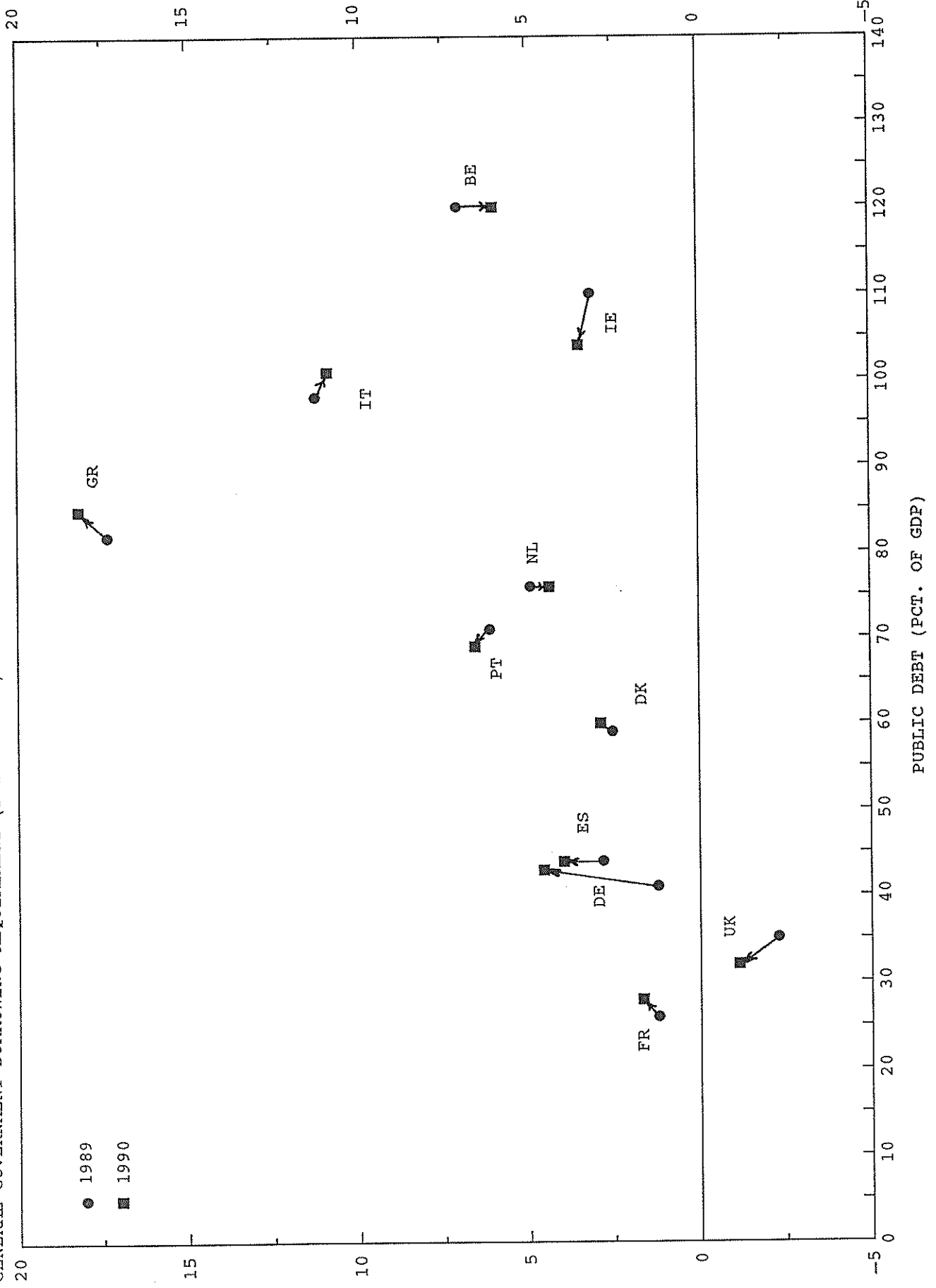
(6) In 1989 and 1990 Treasury lending operations are already considered in the deficit. For these years "Other items" include the assumption by the Treasury of public enterprises debt and revenues from privatisations.

(7) Forecast for financial year 1991/92.

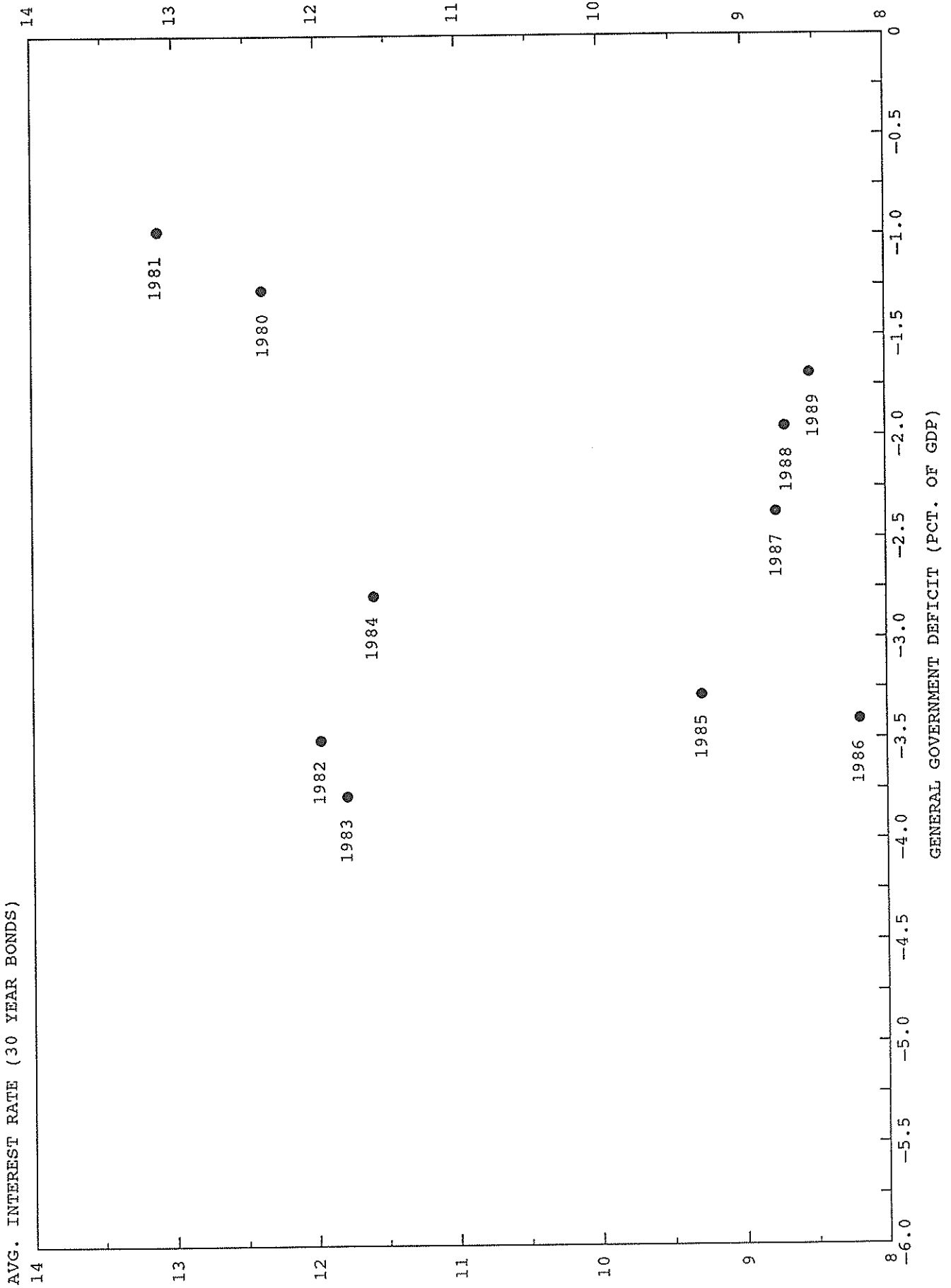
(8) 1990 data for western Germany; 1991 data for eastern and western Germany.

INDICATORS OF FISCAL STANCE IN THE EEC 1989-90

GENERAL GOVERNMENT BORROWING REQUIREMENT (PCT. OF GDP)



US INTEREST RATE - GVT. DEFICIT



AVG. INTEREST RATE (30 YEAR BONDS)

GENERAL GOVERNMENT DEFICIT (PCT. OF GDP)

US PRIVATE INVESTMENT

PER CENT OF GDP

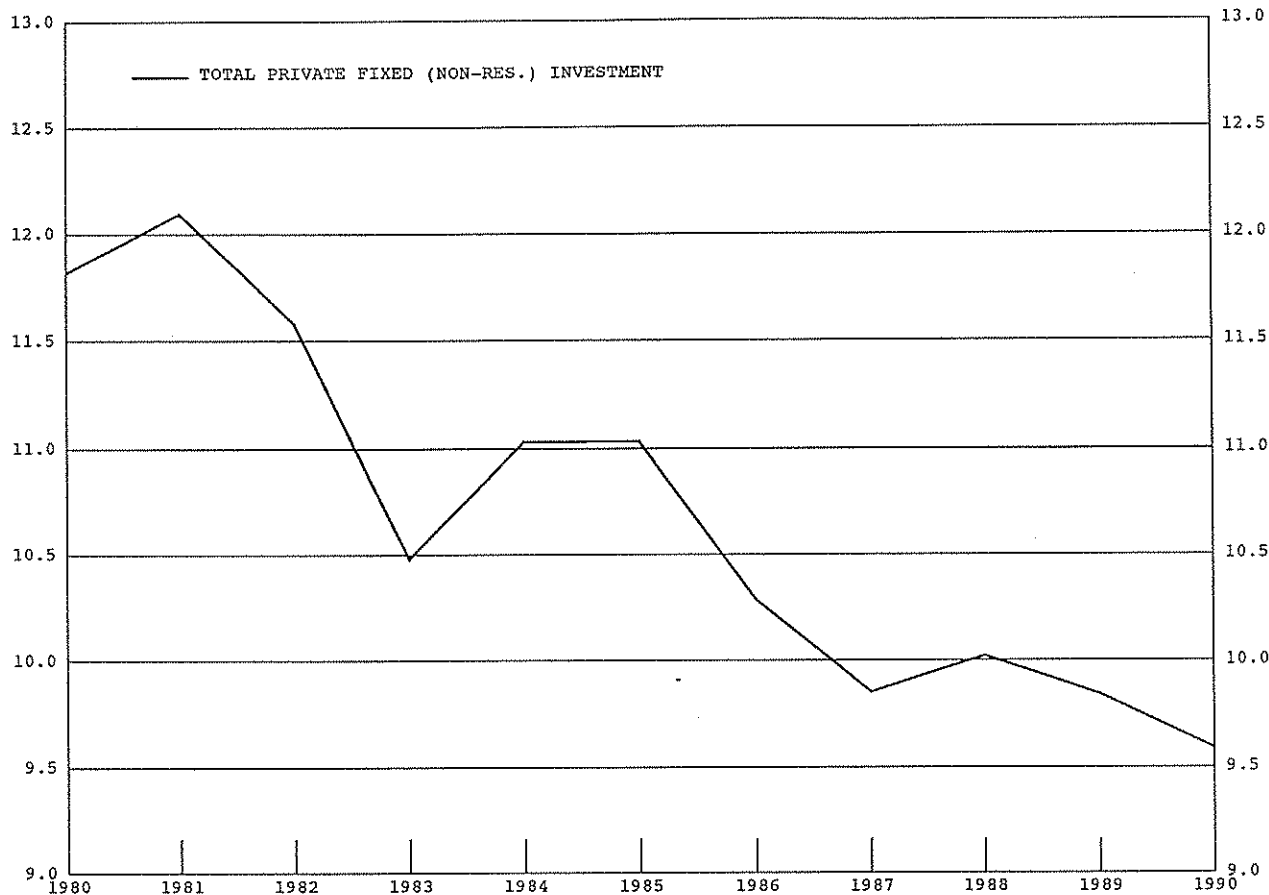
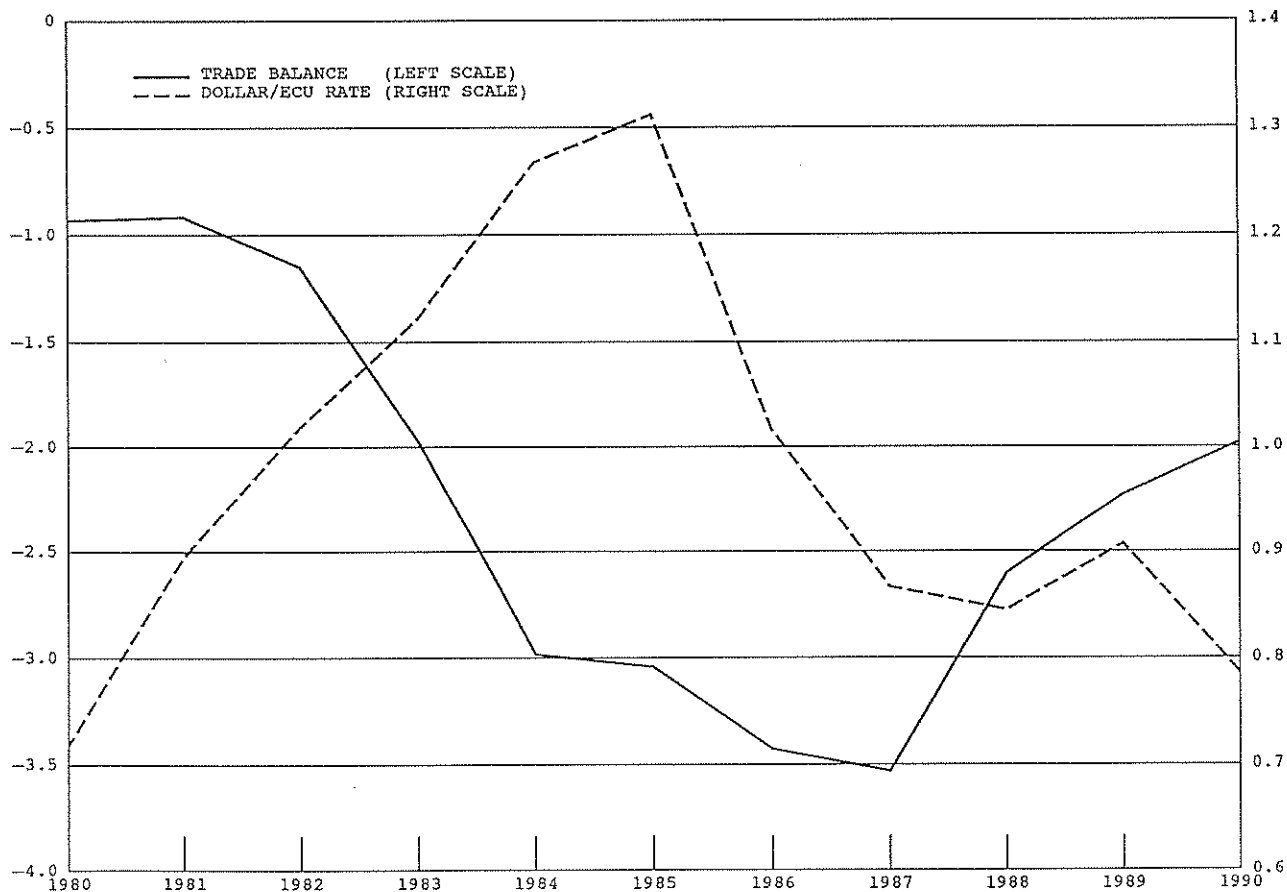


Chart 3b

US TRADE BALANCE

PER CENT OF GDP

USD/XEU



ITL, ESP AND FRF IN THE ERM

