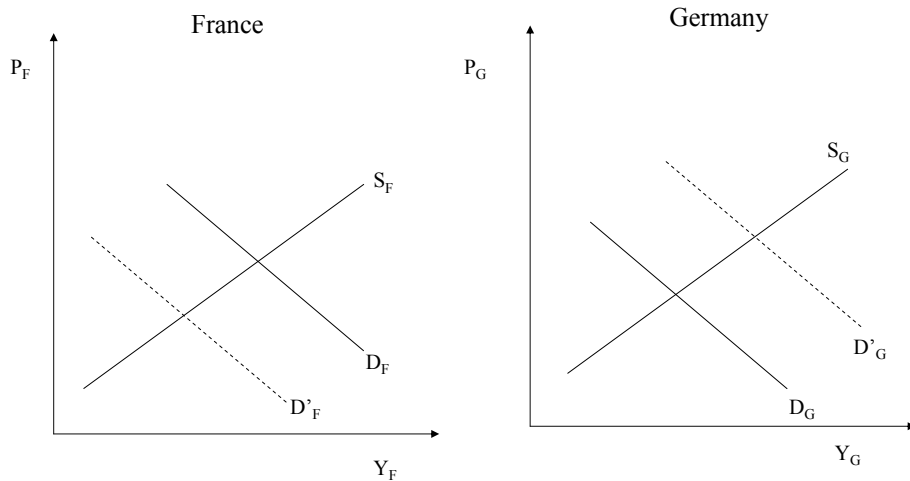


Fiscal Policies in Monetary Unions

Introduction

- What is the role of fiscal policy in a monetary union?
- How independent can national fiscal policies be?
- Does a monetary union increase or reduce fiscal discipline?
- What rules, if any, should be used to restrict national fiscal policies?
- Stability and growth pact

Fiscal policies and the theory of optimum currency areas



- Two cases:
- France and Germany form a monetary and budgetary union
 - The centralized European budget automatically redistributes income from Germany to France
 - There is international (inter-regional) risk sharing
- France and Germany form a monetary union without budgetary union
 - If asymmetric shock occurs:
 - France runs a budget deficit and accumulates debt;
 - Germany reduces deficits and debt;
 - If capital markets are integrated, French borrowing is eased by increased German supply of savings
 - Inter-generational (inter-temporal) risk sharing.

- Note that insurance systems (inter-regional or inter-generational) should only be used to address temporary shocks
- Permanent shocks should be absorbed through wage flexibility or factor mobility
- Transfers discourage workers from moving in search of jobs or from accepting low wages.
- They may also lead to political conflicts and even disintegration (e.g. Belgium, Italy, Germany, former Czechoslovakia and Yugoslavia).

- Theory of optimum currency areas:
 - It is desirable to centralize a significant part of the national budgets to the European level.
 - Risk sharing reduces the costs of participating in a monetary union.
 - If such a centralization of the national government budgets in a monetary union is not possible, national fiscal policies should be used in a flexible way and national budgetary authorities should enjoy autonomy to facilitate inter-temporal risk sharing.

- The OCA argument has not prevailed
- Instead rigid rules have been imposed
- These find origin in the view that the systematic use of fiscal policies can lead to unsustainable debts and deficits

‘Stability and Growth Pact’

- Countries must balance their budgets over the business cycle
- Countries with a budget deficit $> 3\%$ of GDP will be subject to fines (up to 0.5% of GDP)
- Fines will not be applied if countries experience exceptional circumstances, e.g. a natural disaster or a GDP decline $> 2\%$ during one year

Rationale for SGP

- A country with unsustainable government debt creates negative spillover effects for the rest of the monetary union.
- Such country will increasingly borrow on the capital markets of the union
 - The union interest rate increases.
 - This higher union interest rate increases the debt burden of the other countries.
 - These will be forced to follow more restrictive fiscal policies.
- A second spillover :

Criticism based on efficient markets

- If the capital markets work efficiently, there will be no spillovers:
 - There will be different interest rates in the union, reflecting different risk premia on the government debt of the union members.
 - It does not make sense to talk about union interest rate.
- However, there is interdependence in the risk of bonds issued by different governments because within EMU: governments may bail out a defaulting member state
- Thus, financial markets may find it difficult to price these risks correctly.
- The ‘no-bailout’ clause introduced in the Maastricht Treaty may not be credible.

Fiscal discipline in monetary unions

- Membership in a monetary union may change the incentives of fiscal policy-makers, and, in so doing, may affect budgetary discipline.
- There are two opposing effects
 - Once in monetary union, individual governments face a larger ‘domestic’ capital market and lower interest rates (no risk of devaluation); their capacity to borrow increases; this will lead them to borrow more and to have larger deficits (moral hazard).
 - Countries which join the union reduce their ability to finance budget deficits by money creation. As a result, the governments of member states of a monetary union face a ‘harder’ budget constraint than sovereign nations. This will reduce budget deficits.

Table 9.1 Budget balances of member states of unions and of EC member countries (as % of revenues)

	Weighted mean	Unweighted mean
USA (1985)	10.9	4.6
Australia (1986-7)	-10.1	-9.1
West Germany (1987)	-6.4	-8.2
Canada (1982)	-0.4	-1.4
Switzerland (1986)	-1.3	-0.7
European Community (1988)	-10.1	-11.4

Note: a positive sign is a surplus, a negative sign a deficit.

The weighted mean is obtained by weighting the deficits with the share of the member state in the union’s GDP.

Source: Lamfalussy (1989: 109-24)

- The *average* budgetary deficit of the member states in monetary unions tends to be lower than the average deficit of independent countries in the EC.
- On average, the membership in a union constrains the ability of the member states to accumulate budget deficits.
- Thus, it appears that the no-monetization constraint is a powerful disincentive to running large budget deficits.

Historical origins of the Pact

- Main proponent was Germany
- SGP intended to placate German public opinion by announcing tough rules
- and to create an additional obstacle for the Club Med countries

The Pact is politically unintelligent

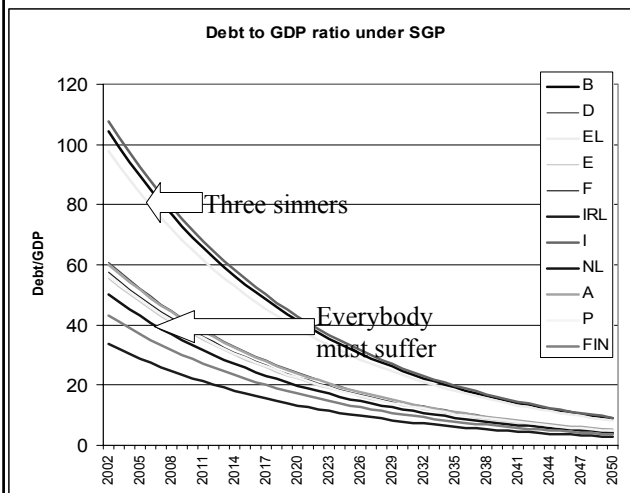
- Spending and taxation are the responsibility of national governments and parliaments
- That is also the level at which democratic legitimacy is vested
- The Pact now imposes an elaborate control and sanctioning system top-down
 - on the net effect (budget deficit) of this democratic decision making process
 - by institutions that lack the same democratic legitimacy

- Such a system is bound to lead to conflicts
- It has in the past
- It will continue to do so in the future
- And, in the past, the imposition of fines envisaged by the Pact was blocked

The Pact is unintelligent from an economic point of view

- 3% deficit rule is not based on rational economic analysis. It is arbitrary
- This makes it less likely for the rule to be ignored by policy makers
- Balanced-budget rule is equivalent to imposing debt ratio to be zero

Stability Pact makes sense for the three sinners



SGP makes sense for Belgium, Italy and Greece which have excessive debt levels,

It will force them to reduce debt/GDP ratio

The problem is that it was forced on everybody as a permanent strategy

This makes as much sense as forbidding all firms to issue debt because some have issued too much debt.

- Requirement to bring the debt ratio to zero creates incentives to reduce government investment:
 - governments are required to finance all new investments by current taxation.
 - a large part of benefits of these investments will be reaped by future governments.
 - this gives incentive to governments today to reduce these investments and only spend on items that benefit the present voters.
 - GSP is likely to lead to lower government investments and thus lower growth.

How should an intelligent Pact look like?

- The objective should be to avoid that countries get into a debt crisis.
- Such a debt crisis would harm everybody.
- This calls for targeting **debt levels**.
- The 3% deficit ceiling should be dropped.
- Debt targeting and 3% deficit ceiling are incompatible

	Required deficits (% GDP) to reach different target debt ratios (nominal growth of GDP = 5%)					
target debt ratio	10%	20%	30%	40%	50%	60%
required deficit	0.5%	1.0%	1.5%	2.0%	2.5%	3.0%

Example:

- Suppose, that the right debt ratio for Germany is 50%
- This implies that the steady state deficit that Germany should aim at over the cycle is 2.5%
- But this implies that with every recession, because of automatic stabilizers, the deficit will exceed 3%, and should exceed 3%

	Required deficits (% GDP) to reach different target debt ratios (nominal growth of GDP = 4%)					
target debt ratio	10%	20%	30%	40%	50%	60%
required deficit	0.4%	0.8%	1.2%	1.6%	2.0%	2.4%

- If the long term nominal growth rate is only 4%, the steady state deficit to aim at is 2%.
- But the basic problem remains the same.

Stability pact and the pension problem

- Because of greying population, future pension liabilities will be high
- SGP forces countries to reduce their debt ratios in anticipation of future increases in cost of old age
- But it lowers incentives to introduce structural reforms in pension systems
- Introducing fully-funded pensions would be a better strategy

Who should be responsible for implementing debt-targeting?

- National authorities.
- This is where the democratic legitimacy about taxation and spending is vested.
- Monitoring and control process should be organized at the national level.
- A new Pact should then devise stronger **national** control systems.
 - e.g. independent national agency

Is there no role for European institutions?

- Yes, but only in monitoring the extreme outliers in terms of debt ratios.
- Today, three countries come close to being outliers, Belgium, Italy and Greece with debt levels that are close to or exceed 100%
- Other countries are in no risk in debt default
- Therefore, there is little point setting up an elaborate monitoring and control mechanism for them

Conclusion

From Top-Down to Bottom-Up

- Mature democratic countries have shown to be able to avoid debt crises in the last 50 years when stability pact did not exist.
- There is no reason to believe that they cannot do so in the future.

The Reform Proposals:

- On March 22-23, 2005, the European Council agreed to a reform of the Stability Pact
 1. Countries with a low debt ratio (and a high growth potential) are allowed to maintain a deficit of 1% over the business cycle. The other countries have to maintain a balanced budget over the business cycle. The 3% budget deficit ceiling, however, is maintained for all countries.
 2. Under the new Stability Pact, it will be enough to have a negative growth rate or a “protracted period of very low growth relative to potential growth” to be allowed to (temporarily) exceed the 3% limit.

3. Countries will be able to invoke more special circumstances for exceeding the 3% ceiling. For example, investment programs, pension reforms that increase the debt today while improving the future sustainability of government finances will be accepted as special circumstances allowing for a temporary breach of the 3% rule.
4. Countries which exceed the 3% ceiling but have low debt levels will be allowed to stretch the adjustment over a longer period than countries with a high debt level.

Evaluation

- The proposals go in the right direction of targeting the debt levels and allowing more flexibility
- However, by keeping the 3% rule but allowing for many exceptions, the proposals have laid a minefield for future discussions and conflicts