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FISCAL IMBALANCES, MONETARY POLICY AND ERM TENSIONS

INTRODUCTION

The general trend towards a gradual decline of budget deficits in the Community has been reversed during 1990, as shown by Table 1. Prospects for 1991 indicate a further deterioration in the fiscal position of the Community, although less marked than in 1990. These developments have brought to the fore the constraints posed by a loose fiscal stance on the management of monetary policy.

Before discussing the channels through which monetary and fiscal policy interact, affecting the functioning of the ERM, it is worth recalling that the usual indicators of the fiscal stance (public debt and deficit as a ratio of GDP) have to be interpreted with care.[1] The implications of a given 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 impact of the budgetary position depends on whether it is transitory or structural and on whether it is perceived by the markets to be temporary or permanent. Such differences across countries in the nature of budget deficits, as well as in public debt stocks (see Chart 1) and in cyclical phases, should be taken into account when assessing the effects of the current fiscal slippage in the Community.

The note is organised in three sections, adopting, for the sake of clarity, a step by step approach to the analysis of the interaction between fiscal and monetary policy. The first section focuses on the short-run consequences of an unbalanced policy mix under a flexible exchange rate regime. The implications of ERM constraints are brought into the picture in the second section, while the medium-run effects of

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1 Following a suggestion made at the July meeting of the Committee of Governors, the Economic Unit plans to undertake an analysis on the possible importance of off-budget items in EC countries.

persistent fiscal imbalances are outlined in the third section. Some issues for discussion conclude the note.

1. IMPLICATIONS OF AN UNBALANCED POLICY MIX UNDER FLEXIBLE EXCHANGE RATES

The stance of both monetary and fiscal policy jointly contribute to the price and output performance of the economy and thus in principle the two policies could be simultaneously set to determine the optimal mix with respect to the final objectives. However, in practice a broad consensus has emerged on the assignment of monetary policy to the objective of price stability. The reasons underlying this assignment are numerous, ranging from the relative effectiveness of the two policies to its implications on the expectations of wage and price setters. Nevertheless, the ability of monetary policy to achieve price stability will be conditional on the prevailing fiscal conditions.

To analyse more clearly the interaction between the two policies, let us consider at first a fiscal deterioration (perturbing a situation characterised by an adequate policy mix) in an economy with a flexible exchange rate regime. The higher budget deficit stimulates nominal demand, while putting pressure on interest rates through the associated increase in bond financing. If the cyclical phase is not weak, the fiscal impulse will lead the economy to hit capacity constraints, resulting in inflationary pressures. Higher interest rates crowd out private investment and conduce to the appreciation of the domestic currency. The trade balance deteriorates because of both quantity effects following the rise in nominal demand and of price effects associated with the appreciation of the exchange rate.

Can monetary policy attain price stability in the presence of a fiscal shock? Although relatively long (and uncertain) lags may be needed for a monetary tightening to curb inflationary pressures effectively, monetary policy maintains, in a regime of flexible exchange rates, its ability to pursue price stability successfully, even in cases of fiscal laxity. Yet the resulting policy mix (a loose fiscal stance combined with a tight monetary policy) will not be appropriate, as it implies a high level of interest rates and a strong currency which in turn entail significant

economic costs in terms of the crowding-out of private investment and net exports.

The economic developments in the U.S. in the early 80's supply a vivid illustration of the functioning of these mechanisms. The fiscal expansion was in fact associated with high interest rates (Chart 2) and with a sharp appreciation of the dollar, which in turn were accompanied by a reduction in private investment and a marked deterioration of the trade balance (Chart 3).

In addition to the implications at the national level, the combination of fiscal laxity and monetary tightness in a sufficiently large country will affect the economic conditions of foreign countries. The fiscal imbalance results in the transmission of both interest rate and trade effects to other countries. The latter's exports rise as a result of both the higher income and/or the appreciation of the currency of the country experiencing the fiscal slippage. Interest rates rise also in the exporting countries. Moreover, if these are already operating at full capacity, the stimulus to exports leads to inflationary pressures which call for an offsetting action by monetary authorities, in turn implying a further increase in interest rates. In sum, if no exporting country operates below full capacity, private investment will be crowded out both in the country with a lax fiscal stance and in those which experience an increase in their exports.

Besides establishing a benchmark useful in the analysis of the implications of ERM constraints, the above discussion can be helpful in tracing the consequences, for the Community as a whole, of a generalised fiscal slippage. The EC area can in fact be considered as a large economy with flexible exchange rates against the rest of the world. Hence, fiscal imbalances will tend to put pressure on EC interest rates and currencies, resulting in the crowding-out of investment and exports vis-à-vis third countries.

2. ERM CONSTRAINTS AND AN UNBALANCED POLICY-MIX

ERM commitments exert a pervasive influence on the functioning of the mechanisms described above under a flexible exchange rate regime. This applies to both the domestic implications and to the international spillovers of an unbalanced policy mix.

At the national level, as the exchange rate has to be maintained within the band, monetary policy becomes overburdened in the presence of an inappropriate fiscal policy because it has to aim at both price and exchange rate stability. Consequently, in the case of a fiscal slippage which puts upward pressure on interest rates and prices, an attempt to tighten monetary policy would be frustrated by the obligation to maintain the exchange rate within the fluctuation margins. Monetary policy may be thus deprived of the possibility of being sufficiently tight to curb inflation effectively, as the exchange rate appreciation following the interest rate increase associated with the budgetary expansion may take virtually all the room for manoeuvre within the band. This situation makes it impossible for monetary policy to fight inflationary pressures adequately, if a realignment is to be avoided.

The exchange rate "paradoxes" of the Italian lira and the Spanish peseta - strong currencies (Chart 4) in spite of the high rate of inflation prevailing in the two countries - are cases in point. In both countries, fiscal imbalances led to the overburdening of monetary policy, which was constrained in its fight against inflation by ERM obligations.

Furthermore, if fiscal developments are interpreted by market participants as signalling a permanent change in policy, the "risk-premium effect" associated with budgetary laxity may be expected to be more forceful than under flexible exchange rates, since the implications of fiscal slippages for the sustainability of current parities are more likely to be taken into account by markets. However, this would not necessarily result in more room to differentiate policies as any intensified risk of depreciation may also influence the behaviour of price and wage setters.

The transmission of the spillover effects arising from an unbalanced policy mix is altered by the presence of ERM constraints, as the upward pressure on the exchange rate associated with a fiscal slippage can be accommodated only within the available margin. As a result, the contractionary interest rate effect resulting from a fiscal imbalance can be expected to be stronger, relatively to the induced increase in exports,

than under a regime of flexible rates, implying a smaller overall impact on other countries' nominal income.[2]

On the other hand, ERM commitments increase the degree of interdependence between monetary policies, thereby amplifying the impact of an unbalanced policy mix on other countries' monetary policy, since the upward pressure on interest rates following the fiscal slippage has immediate consequences on ERM currencies' relative positions.

The actual effects of the fiscal imbalance on other countries' monetary policy will depend on the initial position of the currencies within the band. At times, they may take the extreme form of a binding constraint, pushing one currency at 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 (Chart 5) can be interpreted as an illustration of such an extreme spillover effect, even though other factors (e.g. the different cyclical phases) concurred to determine that situation.

More generally, the upward pressure on interest rates stemming from a country's unbalanced policy mix will be transmitted to other countries more quickly and intensely than it would have been under flexible exchange rates. Although the interest rate effect may help the fight against inflation in countries whose monetary policy is constrained by their currency being at the top of the band, an unbalanced policy mix can be expected to lead to the crowding-out of private investment and of exports vis-à-vis non-ERM countries in the whole Community.

3. THE MEDIUM TERM EFFECTS OF AN UNBALANCED POLICY MIX

If a loose fiscal stance were to persist, 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

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2 This conclusion is also confirmed by the results of the simulations for the Community obtained from the Multimod macroeconomic model, which are reported in Emerson et. al (1991), One market, one money, Oxford University Press, Oxford.

and leading to a perverse "snowball effect" in the accumulation of public debt. This effect would be intensified by the pressure on interest rates stemming from high and rising public 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. Prolonged fiscal imbalances may lead to (higher) risk premia on government paper, as market participants may have doubts about the sustainability of the fiscal position. Also, if expectations of a debt monetisation (inevitable in the limit if the fiscal imbalance persists) were to increase, they could affect price and wage setting, giving rise to an inflationary spiral difficult, if not impossible, to contain through monetary means.

Under ERM constraints, the persistence of an unbalanced policy mix has even stronger effects as the requirement of fiscal solvency combines with the maintenance of price and exchange rate stability. Therefore, if nominal stability is not to be forsaken, fiscal policy becomes "endogenous", in the sense that it has to be set so as to ensure the fulfilment of the government intertemporal budget constraint in a non-inflationary manner.

ISSUES FOR DISCUSSION

The above analysis has shown that fiscal imbalances, together with ERM commitments, result in constraints on the conduct of monetary policy both in the country experiencing budgetary laxity and in the other ERM countries. Another important conclusion is that, if price stability is to be maintained, an unbalanced policy mix entails significant economic costs even under flexible exchange rates, thus implying that a change in ERM parities, besides its other costs, would not alleviate the detrimental effects of fiscal profligacy.

- While there is fiscal slippage in a number of Community countries, are fiscal stances considered to be too loose in all EC countries? Are there cases where the weak cyclical position could justify, if not a fiscal relaxation, the postponement of fiscal consolidation? Are there other measures (such as income and supply-side policies) which should accompany (or substitute for) fiscal tightening? Are there any desirable changes in the relative stance of national fiscal positions which would

improve the leeway for monetary policy to help overcome differences in economic growth while bringing down inflation?

- If the first-best solution of fiscal consolidation in countries where it is appropriate were not to be adopted, what are the possibilities open to policy co-ordination? How should monetary policy respond to the persistence of fiscal imbalances? Is there any scope for changes in the relative stance of national monetary policies?