Committee of Governors of the
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MONETARY FINANCING OF BUDGET DEFICITS IN STAGE THREE

In order to contribute to the independence of the System, Article 21.1 of the draft Statute of the European System of Central Banks and of the European Central Bank rules out the possibility of any direct financing of public entities by the ECB and the national central banks.

Section I of this note presents alternative financial arrangements between the monetary authorities and public entities and assesses their effectiveness in preventing monetary financing of budget deficits. Section II discusses the potential merits and drawbacks of Article 21.1, and Section III summarises the conclusions. The attached Annex examines the monetary effects of budget deficits in Stage Three.

I FINANCIAL ARRANGEMENTS TO PREVENT MONETARY FINANCING OF BUDGET DEFICITS AND THEIR LIMITS

I.1. Alternative arrangements

In practice, various alternative financial arrangements between the monetary authorities and public entities could be considered with a view to preventing monetary financing of budget deficits. In what follows, three of them are described in decreasing order of restrictiveness:

(a) The ECB and national central banks are prohibited from granting any credit facilities to public entities and purchasing public debt in the primary and secondary markets. In this case, the balance sheet of the ECB and national central banks would not contain claims on public entities.

(b) The ECB and national central banks are prohibited from extending credit facilities to public entities and purchasing public debt in the primary market. This corresponds to Article 21.1 of the draft Statute, which states that: "The ECB and national central banks shall not grant overdrafts or any other type of credit facility to the Community, Member States and other public entities in the Member States or purchase debt

instruments directly from them." In this case, the monetary authorities will not be prevented from purchasing government securities in the secondary market.

(c) The ECB and national central banks are allowed to extend credit facilities to public entities and to undertake purchases of public debt on the primary and secondary markets, but only on a voluntary basis. Credit extension by the monetary authorities to public entities may or may not be subject to limits.

All these financial arrangements exclude automatic access of public entities to central bank financing. This serves two purposes. On the one hand, it prevents that the monetary authorities are impeded in their ability to influence money market conditions in accordance with the objective of price stability, i.e. to freely set short-term interest rates and to attain the targeted money supply growth. On the other hand, excluding automatic access contributes towards placing the public sector on the same footing as the private sector, thus increasing the scope for market discipline to be exerted on government budget financing.

On the contrary, automatic access of public entities to central bank financing would diminish the ability of monetary authorities to freely set money market interest rates. Market determined interest rates could be distorted when the public sector obtains financing directly from the central bank rather than from the market. In particular, the total demand for funds in the market and interest rates will be higher when the public sector obtains financing in the market rather than directly from the central bank. In this respect, there is the question whether automatic access to central bank financing (either at market or pre-set interest rates) would be fully in accordance with the rule that "The System shall act consistently with the principles of free and competitive markets" (Article 2.3 of the draft Statute).

I.2. Limits

None of the above three options, not even the most stringent, would suffice to insulate monetary policy from pressures exerted by budget deficits. On the assumption that flexible exchange rates vis-à-vis third currencies allows the ECB to pursue an autonomous monetary policy, the emergence of large budget deficits in one or several Member States will

tend to raise the Community interest rate and to appreciate Community currencies relatively to third currencies. As a result, the international competitiveness of the Community will deteriorate and net exports will be crowded out. Under these circumstances, none of the above options would preclude that pressures are exerted on the ECB to limit the rise in the Community interest rate through its open market operations, thereby jeopardising price stability.

If the Community were to pursue exchange rate objectives vis-à-vis third currencies, the resulting loss of monetary autonomy would imply that the ECB would not be able to avoid that the increase in the Community nominal income and money demand arising from budget deficits would lead to faster than desired monetary growth. In practice, this would occur either through open market and credit operations of the ECB and national central banks with the financial sector or through official intervention in the foreign exchange market. The attached Annex describes in more detail the monetary effects of budget deficits in Stage Three under flexible and fixed exchange rates.

II RELATIVE MERITS AND DRAWBACKS OF ARTICLE 21.1

Bearing the above considerations in mind, the question arises whether Article 21.1 provides the most appropriate financial arrangement regarding central bank financing of budget deficits, or whether preference should not be given to either more or less stringent arrangements, such as those described in options (a) and (c), respectively, of Section I.

II.1. Relative merits

The main merit of excluding any direct financing of public entities by the monetary authorities in option (a) and in Article 21.1 would be to strengthen the credibility of the System as an independent authority, which at the beginning of Stage Three will still need to be built up. In contrast, financial arrangements making room for voluntary credit extension and/or voluntary purchases of public debt in the primary market by the ECB and national central banks, as in option (c), might leave some doubts regarding the functional independence of the System in spite of the general principle of independence stated in Article 7 of the draft Statute. In particular, markets may suspect that central bank financing

designed to meet only temporary fluctuations in the financial position of the public sector will be used on a more permanent basis.

In addition, the exclusion of any direct financing of public entities by the monetary authorities may contribute to exerting discipline on national governments by making them aware that present budget deficits will have to be financed by future surpluses (by means of lower public expenditure and/or of higher taxes), which may involve important economic and political costs. It may further promote fiscal discipline by exposing governments to higher borrowing costs. In particular, by ensuring that under no circumstance will governments have access to central bank financing to service their debts, markets may realise that public debt is not free of credit risk and therefore incorporate higher credit risk premia into market interest rates. Under these circumstances, higher budget deficits would entail higher borrowing costs which may further tighten government budget constraints.

Finally, excluding direct financing by national central banks to the public sector would facilitate the conduct of a centralised monetary policy.

For the above reasons, the exclusion of direct financing of budget deficits by the ECB and national central banks appears to be warranted. Accordingly, option (a) and Article 21.1 would be preferable to option (c).

As regards <u>option (a)</u> and <u>Article 21.1</u>, the second should be preferred. The prohibition of central bank operations in the secondary market of government securities does not seem to be well founded on economic grounds. Provided that the terms and conditions are the same, open market transactions would have the same monetary effects whether they are conducted through public or private financial market instruments. Moreover, excluding the former would confer a liquidity premium to the latter which does not appear to be economically warranted.

It is clear, however, that Article 21.1 will <u>not suffice</u> to exert as much discipline as is needed to avoid excessive budget deficits, or to induce markets to correctly set interest rates on public debt. On the one hand, public entities may still enjoy a privileged access to financial markets as a result of national fiscal, banking and prudential legislation. On the other hand, markets may expect that governments will ultimately be bailed out when encountering difficulties in refinancing their debt, and

governments may expect the same. Finally, as indicated in Section I, Article 21.1 would not prevent that budget deficits lead to pressure being exerted on the ECB to pursue a more accommodating monetary policy.

II.2 Relative drawbacks

One potential drawback of Article 21.1 is that by excluding voluntary credit facilities by the ECB and national central banks to public entities and voluntary purchases of government securities on the primary market, it would suppress a useful monetary policy tool. Voluntary central credit extension may allow to meet short-term fluctuations in the financial position of the public sector. In addition, it would avoid the problems resulting from the inability of the public sector to obtain financing at times of severe market disruptions.

However, it could be argued that with competitive and efficient financial markets there is no reason why short-term fluctuations in the financial position of public entities could not be dealt with through financial arrangements with banks. Moreover, in a financially integrated market disruptions arising in one particular financial centre would not prevent governments from having access to other centres.

Another potential drawback of Article 21.1 is that it is not unlikely that, by forcing public entities to meet their liquidity shortages in the market, it will also turn these entities to the market for the management of their liquidity surpluses and for the placing of their debt. As a result, services traditionally provided by central banks to governments would be taken over by private market participants.

III CONCLUSIONS

The main purpose of this note has been to examine whether Article 21.1 provides the most appropriate financial arrangement regarding central bank financing of public entities or whether more or less stringent arrangements should not be preferred.

A more stringent arrangement than Article 21.1, which would bar the monetary authorities from purchasing public debt in the secondary market, is not economically justified since open market operations have the same monetary effects whether they are conducted through public or private debt instruments.

A <u>less</u> stringent arrangement than Article 21.1, which would allow for voluntary central bank financing of public entities, would have the advantage of preserving one flexible monetary policy tool. Voluntary credit extension by the ECB and national central banks to public entities may help smooth short-term fluctuations in the latter's financial position. Moreover, it would allow national central banks to continue their current activities in the management of liquidity surpluses of public entities and in the placement of their debt. However, a less stringent arrangement than Article 21.1 would have two main drawbacks. Firstly, it may leave some doubts regarding the functional independence of the System. In particular, markets may suspect that central bank financing designed to meet only temporary fluctuations in the financial position of the public sector will be used on a more permanent basis. Secondly, the possibility of voluntary credit extension by the ECB and national central banks to public entities would not help as effectively as its exclusion to exert market discipline on national fiscal policies.

It is nonetheless evident that prohibiting monetary financing of budget deficits directly by the ECB and national central banks will not suffice to exert as much discipline as is needed on government finances or to guarantee that monetary policy will remain autonomous in the presence of excessive deficits. For excessive deficits to be avoided, other measures would be needed such as a credible no "bail-out" clause and explicit constraints on budget deficits. Finally, the choice of the exchange rate policy of the Community vis-à-vis third currencies will critically affect the degree of monetary autonomy of the ECB and thus the overall monetary effects of budget deficits.

ANNEX

MONETARY EFFECTS OF BUDGET DEFICITS

This Annex attempts to describe the monetary effects of budget deficits in Stage Three. Section 1 presents the accounting identity which links the money supply to its counterparts. Sections 2 and 3 examine the effects of budget deficits on the money supply and its counterparts under fixed and flexible exchange rates, respectively. The conclusions are summarised in Section 4.

1. THE MONEY SUPPLY AND ITS COUNTERPARTS

In an open economy, the basic identity relating the assets and liabilities of the balance sheet of the consolidated banking system (central bank plus banks) is:

ASSETS					LIABILITIES	
Net Foreign Assets of the Central Bank	+ Net Foreign Assets of Banks	+ Domestic Credit to Public Sector	+ Domestic Credit to Private Sector	=	Money Supply	+ Net non-monetary liabilities

Assuming that net non-monetary liabilities are constant, a change in the money supply will be reflected in the net foreign asset position of the central bank, the net foreign asset position of banks and/or domestic credit. Domestic credit may be granted to the public and the private sector.

2. MONETARY EFFECTS OF BUDGET DEFICITS UNDER FIXED EXCHANGE RATES

For reasons of expositional convenience, it will be assumed that in an environment of world-wide financial market integration the ECB would have no monetary autonomy in Stage Three if a policy of fixed exchange rates vis-à-vis third currencies were to be followed. In practice, however, the loss of monetary autonomy would not be complete insofar as the Community plays a role in determining world interest rates.

Under the above assumption, a higher nominal income and money demand in the Community arising from larger budget deficits in one or several Member States would result in a higher money supply. Specifically, the initial excess demand for money would lead to upward pressure on the Community interest rate and attract capital inflows. As the ECB intervenes to maintain exchange rate stability this would result in an increase in official reserves and the money supply in the Community. Attempts by the ECB to prevent an overshooting of the money supply would lead to renewed upward pressures on the Community interest rate which would stimulate further capital inflows.

Accordingly, under fixed exchange rates, higher budget deficits in the Community will result in a higher money supply no matter how they are financed: through borrowing from Community banks, from Community non-bank residents or from outside the Community.[1] Only the impact on the counterparts of the money supply will depend on how the deficit is financed, as shown below.

2.1. <u>Public sector borrowing from Community banks</u>

Public entities may finance larger deficits through borrowing from banks in the Community. In this case, to the extent that the larger deficits increase nominal income and money demand in the Community, the higher money supply will be reflected in domestic credit to the public sector.

The higher money supply will enlarge the need for base money insofar as it leads to a higher demand for bank reserves and for currency. The ECB will have to decide whether or not to accommodate the need for base money through its open market operations. If it <u>accommodates</u>, the higher base money will be reflected in the ECB or national central banks' domestic assets and the increase in the money supply will be fully mirrored in domestic credit creation. If, on the contrary, the ECB <u>refuses to accommodate</u> the need for base money through its open market operations, there will be upward pressure on the Community interest rate level. This

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1 It is assumed that Article 21.1 of the draft Statute will exclude access of public entities to direct financing by the ECB and the national central banks.

would attract private capital inflows forcing the ECB to intervene to maintain exchange rate stability. The increase in base money will then be reflected in the net foreign asset position of the ECB. The higher money supply, on the other hand, will be fully reflected in domestic credit if the capital inflows are channelled through banks, with the result that the net foreign asset position of the consolidated banking system (central bank plus banks) will be unchanged. If part of the capital inflows takes place through transactions outside banks, the increase in the money supply will be reflected both in domestic credit and in the net foreign asset position of the ECB.

2.2. Public sector borrowing outside the Community

Consider the situation where the public sector has part of its larger deficit financed outside the Community. A first possibility would be for the public sector to borrow foreign currency directly abroad and to sell the proceeds to the ECB. In this instance, only part of the increase in the money supply will be reflected in domestic credit to the public sector; the rest will be reflected in the net foreign asset position of the ECB. A second possibility would be for the public sector to borrow the foreign currency abroad indirectly through Community banks. In this instance, the increase in the net foreign asset position of the ECB will be offset by a decline in the net foreign asset position of banks (which fund their credit to the public sector by borrowing abroad), and the higher money supply will be fully mirrored in a higher domestic credit. A third possibility would be that the upward pressure on the Community interest rate induces non-residents of the Community to purchase public debt issued in Community currencies. In this instance, the higher money supply will be reflected only partly in domestic credit. Part of it will be mirrored in the net foreign asset position either of the ECB or of banks, depending on whether the foreign investors finance their purchases by selling assets denominated in third currencies or in Community currencies, respectively.

2.3. Public sector borrowing from Community non-bank residents

Consider the case where the public sector decides to finance its larger deficit through sales of long-term securities to Community non-bank

residents.[2] As a result, upward pressure will be exerted on the Community interest rate. This will also encourage investors outside the Community to purchase public securities. Moreover, the above pressure could induce private sector borrowers on the Community bond market to switch to borrowing abroad. In both cases, capital inflows (public in the first case and private in the second) will provide the increase in base money needed to support the higher money demand arising from the larger budget deficit.

Under these circumstances, the increase in the money supply would be reflected partly in the net foreign asset position of the banking system and partly in domestic credit to the private sector. This illustrates that when domestic credit increases following larger budget deficits this is not necessarily reflected in domestic credit to public entities.

3. MONETARY EFFECTS OF BUDGET DEFICITS UNDER FLEXIBLE EXCHANGE RATES

Flexible exchange rates would in principle allow the ECB to pursue an autonomous monetary policy. The ECB would indeed have control over the base money and thus over the money supply. Under the assumption that it does not provide additional liquidity in the presence of larger budget deficits, the resulting upward pressure on the Community interest rate would lead to an appreciation of the Community currencies which will depress net exports. In the extreme case, there would be full crowding-out of net exports by the larger budget deficits and income and money demand will remain unchanged. In practice, however, pressures could be exerted on the ECB to limit the rise in the Community interest rate through its open market operations.

4. CONCLUSIONS

When the pursuit of exchange rate <u>objectives</u> vis-à-vis third currencies entails a loss of monetary autonomy by the ECB, pressures on nominal income and money demand originating from larger budget deficits in

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2 If budget deficits were financed by means of short-term monetary assets issued by the public sector and sold directly to the public, the money supply will directly be affected.

one or several Member States would result in a higher money supply in the Community. In this case, capital inflows would defeat any attempt by the ECB to maintain monetary growth on track. Consequently, the money supply will grow faster irrespective of whether the larger budget deficits are financed through borrowing from Community banks, Community non-bank residents or non-EC residents.

The method of deficit financing will only determine how the increase in the money supply will be reflected in its counterparts. Changes in the counterparts, however, will also depend on whether the ECB accommodates the need for base money resulting from the higher money supply directly through its open market operations or indirectly through intervention in the foreign exchange market. In this respect, the analysis of Section 2 has shown that larger budget deficits need not necessarily result in domestic credit creation to public entities or public capital inflows from third countries. They could also ultimately be reflected in higher domestic credit to the private sector or in private capital inflows.

In contrast, if the Community pursues a policy of flexible exchange rates vis-à-vis third currencies, the ECB would in principle have control over the base money and, therefore, over the money supply. If the ECB keeps base money growth on track, larger budget deficits would cause an appreciation of Community currencies which, through lower net exports, will offset the impact on nominal income and money demand of the larger deficits. Accordingly, money supply would not be affected.