8 Reflections on the fiscal implications of a common currency

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1 Introduction: sense and nonsense in the Delors Report

The much increased likelihood of significant advances in European monetary integrations – and even of European monetary union in the medium-term future – has not surprisingly shifted the spotlight onto the need for coordination of fiscal policies as a complement to monetary unification. The Delors Report (1989) made much of the fiscal implications of the movement towards a greater degree of rigidity of nominal exchange rates among participants in the exchange rate arrangements of the European Monetary System (EMS).

> A monetary union would require a single monetary policy and responsibility for the formulation of this policy would consequently have to be vested in one decision-making body. In the economic field a wide range of decisions would remain the preserve of national and regional authorities. However, given their potential impact on the overall domestic and external economic situation of the Community and their implications for the conduct of a common monetary policy, such decisions would have to be placed within an agreed macro-economic framework and be subject to binding procedures and rules. This would permit the determination of an overall policy stance for the Community as a whole, avoid unsustainable differences between individual member countries in public sector borrowing requirements and place binding constraints on the size and the financing of budget deficits. (Delors Report, 1989, p. 18)

1.1 No deficits, please

There are frequent further references in the Delors Report to the need to control national public sector deficits and in a number of places the Report becomes rather specific about the constraints to be imposed on national budgetary policy. The passage quoted below (and similar ones scattered through the Report) make this clear:

> In the budgetary field, binding rules are required that would: firstly, impose effective upper limits on budget deficits of individual member countries of the Community, although in setting these limits the situation of each member country might have to be taken into consideration; secondly, exclude access to direct central bank credit and other forms of monetary financing while, however, permitting open market operations in government securities; thirdly, limit recourse to external borrowing in non-Community currencies. (Delors Report, 1989, p. 24)

Space constraints do not permit an exhaustive analysis of this rather unusual statement. Note however, in the first proposed binding rule, the startling asymmetry of the constraints on the public sector deficit: upper limits but no lower limits. Such an asymmetry can only be rationalized through a belief that absent these constraints there would be a bias towards government deficits that are too large rather than too small. The reader of the Report is provided neither with a criterion for measuring excess or deficiency in public sector deficits nor with a hint of the evidence on which the empirical judgement is based. The statement appears to represent the typical Pavlovian conditioned reflex of fiscally conservative central bankers when faced with any and all government deficits.

1.2 An independent European Central Bank: form and substance

The second proposed binding rule only makes sense if one believes that it is possible that the new 'independent' European System of Central Banks (ESCB) could still be forced (at any rate under extreme circumstances such as those represented by a very high public debt overhang) into inflationary monetization. Such a situation could come about either because the ESCB would lack formal independence or because, despite formal independence, the ESCB would choose to lose a game of chicken with the budgetary authorities rather than cause a monetary and financial crisis by not giving in. In what follows the wisdom (or lack of it) of having an independent Central Bank will not be considered. There are good arguments both for and against it. The discussion is limited to the meaning of 'independence' and the means of achieving it.

An effectively independent ESCB is one which cannot be forced, either by law or by circumstances under the control of the budgetary authorities (be they member state governments or an emerging central fiscal authority) to monetize deficits, to engage in open market operations or to engage in foreign exchange market interventions (especially non-sterilized interventions).

Even if it were possible to identify any given change in the stock of base money either as additional money issued 'to finance the government deficit', or as money issued as the counterpart of an open market purchase

or as money issued as the counterpart of a non-sterilized purchase of official foreign exchange reserves, the distinction would be behaviourally meaningless unless the different ways in which an additional ECU gets into the system somehow convey different signals about the future actions of the monetary authority. In any case, monetary deficit financing, money injected through open market purchases and money injected through non-sterilized purchases of foreign exchange cannot be separately identified from the data. The three sources of base money growth are also operationally equivalent.

Consider for example the case of an accounting period during which the government deficit excluding borrowing from the Central Bank is, say, ECU 100, the monetary base and the Central Bank's holdings of public debt each increase by ECU 100 and the stock of foreign reserves remains unchanged. This could be interpreted as representing ECU 100 of monetary financing of the government deficit with no net open market purchase of government debt by the Central Bank and no unsterilized or sterilized foreign exchange market intervention. Alternatively it could be interpreted as the outcome of zero monetary financing of the deficit, ECU 100 of open market purchases of government debt by the Central Bank and zero unsterilized and sterilized foreign exchange market intervention. A third possible interpretation is to view it as the outcome of the following set of financial operations. First, ECU − 100 of monetary financing of the deficit. The Treasury is 'overfunding' the deficit by borrowing ECU 200 from the non-Central Bank public (ECU 100 more than the government deficit) and thus increase its balance with the Central Bank by ECU 100. This corresponds to an ECU 100 reduction both in the monetary base and in Central Bank holdings of government debt. Second, ECU 300 of open market purchases of public debt by the Central Bank (that is an ECU 300 increase in the monetary base and an equal increase in Central Bank holdings of public debt). Third, ECU 100 of sterilized purchases of foreign exchange (that is an ECU 100 increase in foreign exchange reserves and an equal reduction in Central Bank holdings of public debt) and fourth, ECU 100 of non-sterilized sales of foreign exchange reserves (that is an ECU 100 reduction in reserves matched by an equal reduction in the monetary base). There is no natural benchmark or counterfactual. There are too many degrees of freedom.

If a Central Bank is formally independent but can easily be manoeuvred by the fiscal authorities into a position where, given the Central Bank's own objectives, the optimal thing to do is to create money to a much greater extent than it would have chosen to do if the fiscal authorities could have been induced to act differently, then Central Bank independence is an empty shell. Substantive independence presupposes a

non-trivial domain over which choice can be exerted. Even if every inhabitant of Bangladesh were formally free to buy a Rolls Royce (which owing to import restrictions in that country is actually unlikely to be the case) the budget constraints of most Bangladeshis make this formal freedom an empty one.

One can easily imagine a formally independent Central Bank with a strong (but not an absolute) aversion to inflation, confronting a fiscal authority that is persistently unwilling (even though technically able) to cover current outlays with current revenues. Assume that, if the Bank does not provide accommodating monetary growth and the Treasury does not reduce the deficit, the public debt-GDP ratio will increase steadily. If the debt were to grow persistently faster than the rate of interest, eventual insolvency of the Exchequer would result. Even if there is no threat of insolvency, the increasing debt burden will, if there is no 'first-order' debt neutrality, put upward pressure on real interest rates and crowd out interest-sensitive categories of private spending or increase the external current account deficit.

Sargent (1986, pp. 19–39) contains an interesting description (attributed by Sargent to Neil Wallace) of this game of 'chicken' between a Central Bank and a Treasury. 'Chicken' is a non-cooperative game in which both players promise that they will adopt the strategy of Stackelberg leaders. For each of the players, of course, the announced strategy is feasible only if the other player acts as a follower. This struggle for dominance between the monetary and fiscal authorities represents a situation of Stackelberg warfare (Sargent, 1986, p. 37). To complicate matters, in the USA the game is between the Central Bank and a rather more Balkanized set of fiscal authorities, i.e. it is a three- or more-sided game of chicken.

The Central Bank asserts that, come hell or high water, it will not engage in inflationary monetization, in the hope of forcing the fiscal authorities to take steps to reduce the deficit. A unified fiscal authority counters by asserting that it will under no circumstances reduce its deficit, hoping to convince the Central Bank to monetize the deficit in order to prevent a steep rise in real interest rates, financial distress etc. Alternatively, with a Balkanized fiscal authority, the Central Bank may (mixing metaphors) suffer the fall-out from an unresolved game of chicken between two or more fiscal warlords. The White House fiscal warlord may threaten to veto any tax increase ('read my lips') in the hope of forcing one or more of the Capitol Hill fiscal warlords to accept spending cuts. Blocking coalitions of Capitol Hill warlords may veto cuts in certain spending categories ('not in my constituency') in the hope either of directing the spending axe elsewhere or of securing a tax increase.

Unpleasant things tend to happen when an irresistible force meets an

immovable object. While no one likes to be caught bluffing, the resolve of the Central Bank may well weaken as it sees the debt burden rising. If it believes the fiscal authority is unlikely to mend its ways, it may rationally opt to be chicken rather than risking a head-on collision. The dilemma is resolved through monetization and inflation.

In a recent paper Ben Friedman (1990) has argued that in the years to come the rising corporate debt burden in the USA may play the role attributed to public debt in the Sargent-Wallace scenario: tough anti-inflationary monetary policy is not credible given the financial exposure and fragility of the US corporate sector. In the British context Buiter and Miller (1983) have identified a similar game of chicken during the 1970s between the trade unions on the one hand and the monetary and fiscal authorities on the other hand (in Britain the Central Bank is formally and effectively subordinate to the Treasury). Unions submitted inflationary wage demands (and often succeeded in imposing inflationary wage settlements) in the expectation that demand management would be accommodating. No government would be willing to live with the unemployment consequences of non-accommodating monetary and fiscal policy. Governments talked tough about not validating inflationary wage and price developments. During most of the 1970s it was the governments that blinked and lost the game. The new Conservative administration that came to power in 1979 changed the rules of the game (at any rate during its early years) and broke the inflationary momentum with the deepest recession since the 1930s.

One way to increase the likelihood that the Central Bank will win the game of chicken with the fiscal authorities is by convincing the latter that the Central Bank is implacably, irrevocably and unalterably opposed to any and all inflation. This could be achieved by the founding fathers and mothers of the Central Bank appointing someone (or a group of people) to head the Central Bank who is known to possess extreme, perhaps even irrational or pathological, inflation-aversion. (The appointment procedure for the first and subsequent heads of the Central Bank will of course be crucial for this to work.) It is not wise for anyone to play a game of chicken with an adversary who may be slightly insane. Believing it is dealing with an anti-inflationary fanatic of doubtful rationality, the Treasury may prefer to give in rather than to test the resolve of the Central Bank. The possible rationality of choosing an agent who does not exactly share one's objectives (or who may even be irrational) is explained very clearly in Schelling (1960)

> The use of thugs and sadists for the collection of extortion or the guarding of prisoners, or the conspicuous delegation of authority to a military commander of known motivation, exemplifies a common means

> of making credible a response pattern that the original source of decision might have been thought to shrink from or to find profitless, once the threat had failed. (Just as it would be rational for a rational player to destroy his own rationality in certain game situations, either to deter a threat that might be made against him and that would be premised on his rationality or to make credible a threat that he could not otherwise commit himself to, it may also be rational for a player to select irrational partners or agents.) (Schelling, 1960, pp. 142–3)

This idea has recently been taken up again, amongst others by Rogoff (1985b).

While formal independence is not sufficient to rule out the possibility of the ESCB being forced into accommodating inflationary monetization, it is a necessary condition. It is important to stress that formal independence requires that the ESCB have control over all sources of money creation: monetization of public sector deficits, monetization through open market purchases and monetization though (non-sterilized) purchases of foreign exchange. If, say, foreign exchange market intervention were to continue to occur at the initiative of the national Treasuries (or the central European Community (EC) fiscal authority) and if the ESCB were not to be free to engage in sterilizing sales or purchases of public debt, there would not even be a formally independent monetary authority. What this means in practice is that for the Central Bank to be independent, the exchange rate of the ECU with non-EC currencies must be under the control of the Central Bank, and not of the national or supranational fiscal authorities.

In principle it is of course possible for the Central Bank to have control over all sources of money creation and yet for the Treasury to have control over the exchange rate. This would be the case if fiscal instruments could be used to influence the various arguments in the money demand function. Even with perfect capital mobility between the EC and the rest of the world, international interest taxes or subsidies could enforce departures from uncovered interest parity. Since the EC is large in the world economy, fiscal policy could be used to influence the world level of real interest rates and (given the stance of monetary policy) also the level of nominal interest rates, which is one of the arguments in the money demand function. If nominal interest rates affect EC money demand differently than money demand in the rest of the world, this would be a further channel through which the exchange rate could be influenced through fiscal policy. In addition, various spending and tax instruments could be used to influence the 'scale variables' in the money demand function such as income or (financial) wealth. Given the rather severe limitations in practice on the flexible use of fiscal instruments and their uncertain effects on money demand and on the exchange rate, at least the

day-to-day management of the exchange rate would have to be the province of monetary policy.

The post-Delors Report consensus that is emerging in and around Brussels appears, fortunately, to have been purged of the Report's rather obsessive concern with upper limits on national public sector budget deficits. However, there also appears to be agreement that the determination of the common EC external exchange rate should not be the exclusive province of the 'Eurofed', but should be determined by the appropriate political budgetary authority (or authorities) in the new Community. We sympathize with the view that the exchange rate is too serious a matter to be left to the Central Bank. The unavoidable implication of that view is, however, that the Central Bank cannot be independent.

The authors of the Report may well be right in their lack of confidence (implicit in the – now apparently discarded – budgetary recommendations of the Report) in the independence of the proposed ESCB. The recent embarrassing (to Central Bank pride) subjugation of the Bundesbank by Chancellor Kohl in connection with the latter's 'out of the blue' proposal for instant monetary union between the FRG and the GDR makes it clear that in the last resort even the most independent Central Bank will give in to the political authorities. It is however, somewhat ironic to find side by side in the Delors Report a statement about the need to create an independent ESCB and an implicit admission that there are identifiable contingencies when independence is bound to be an empty phrase.

As regards the last of the triad of proposed binding rules, it is very hard to make sense of the curious concern with the currency composition of external borrowing. If a European national fiscal authority or an emerging Federal European fiscal authority can borrow externally in US Dollars, Japanese Yen or inconvertible Rubles, why shouldn't it? Where is the externality?

2 Exchange rate unification, monetary unification and fiscal coordination

If phases 2 and 3 of the Delors Report's scheme for exchange rate unification and monetary union are eventually implemented, a single European Central Bank and a single European currency will emerge. The long-standing opposition to this scheme by British Prime Minister Thatcher (and the less vocal but probably no less determined opposition of the Bundesbank and part of the current West German political leadership) make it unlikely, however, that full exchange rate and monetary union for the European Community are imminent. The recent