Abstract

This 2003 Institute for Fiscal Studies Lecture addresses two sets of issues relevant to current and prospective future EU members: the consequences of the Stability and Growth Pact for fiscal-financial sustainability and macroeconomic stability, and some risks associated with operational independence of the central bank. The relevance of the second issue is not restricted to EU members.

Poor communication, co-operation and co-ordination between the fiscal and monetary authorities can be costly in two contingencies. The first of these occurs when the central bank’s role as the lender of last resort needs to be backed up by the willingness of the Treasury to recapitalise the central bank, should the need arise. The second contingency occurs when unwanted deflation needs to be prevented or combated, but the central bank’s conventional monetary arsenal is exhausted. Friedman’s helicopter drop of money, a temporary tax cut or transfer payment increase financed through the issuance of base money will always stimulate demand provided it is not expected to be reversed, in present value terms, in the future. In most real-world institutional/legal settings, – the implementation of a helicopter drop of base money requires co-ordinated actions by the central bank and Treasury. Central bank independence is unlikely to survive if either or both of these contingencies occur, if there is an ineffective response by the fiscal and monetary authorities and if this is blamed on lack of communication, co-operation or co-ordination.