

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

