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**Article**

## Fiscal and Monetary Policy

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## FISCAL AND MONETARY POLICY

In this chapter we discuss the relative role of fiscal and monetary policy both from a long-run perspective and in view of the severe slowdown predicted by our forecasts.

Because monetary policy is the same for all EU members, country-specific shocks can only be fought using fiscal policy. The next section analyses the size and consequences of country-specific divergences in business cycle conditions.

### 1. The Importance of Cross-country Imbalances

Prior to EMU a lot of studies concluded that because of the low rate of labour mobility within the Euro area, monetary union could be quite costly if individual countries faced large asymmetric shocks. These same studies, however, also found that the variance of asymmetric shocks had not been very large and that EMU was unlikely to impose large costs on its members because of this channel.<sup>1</sup>

In recent years this assessment has not been invalidated as far as the larger countries are concerned, but some countries at the periphery have diverged. These imbalances are due to different business conditions. Table 3.1 reports growth rates for the Euro area during 1998–2000. Not only Ireland is a substantial outlier, Spain, Greece and Portugal have also grown faster than the North.

What are the consequences of such imbalances for the ECB's monetary policy? In principle, it should not pay attention to them and only look at union-wide aggregates. In particular, higher growth in poorer countries is the normal thing to be expected since it means they are converging to the GDP levels of the richer countries. However, it is reasonable to believe that at least in the Irish case,

<sup>1</sup> For an updated discussion see C. Wyplosz (2001).

**Table 3.1**

#### Growth rates

| Country        | 1998 | 1999 | 2000 |
|----------------|------|------|------|
| Austria        | 3.3  | 2.8  | 3.2  |
| Belgium        | 2.4  | 2.7  | 4.0  |
| Denmark        | 2.8  | 2.1  | 2.9  |
| Finland        | 5.3  | 4.2  | 5.7  |
| France         | 3.3  | 3.2  | 3.2  |
| Germany        | 2.1  | 1.6  | 3.0  |
| Greece         | 3.1  | 3.4  | 4.1  |
| Ireland        | 8.6  | 9.8  | 11.0 |
| Italy          | 1.8  | 1.6  | 2.9  |
| Luxembourg     | 5.0  | 7.5  | 8.5  |
| Netherlands    | 4.1  | 3.9  | 3.9  |
| Portugal       | 3.6  | 3.0  | 3.2  |
| Sweden         | 3.6  | 4.1  | 3.6  |
| Spain          | 4.3  | 4.0  | 4.1  |
| United Kingdom | 2.6  | 2.3  | 3.0  |
| Euro area      | 2.8  | 2.6  | 3.4  |
| European Union | 2.8  | 2.6  | 3.3  |

Source: OECD.

part of the excess growth is not due to convergence but to a strong, temporary expansion.

Differences in GDP growth are mirrored in differences in inflation, as shown in Table 3.2. Countries with stronger growth also have higher inflation. The explanations for differences in inflation mirror those for growth. Inflation differentials are dis-

**Table 3.2**

#### Inflation rate (consumer price index)

| Country        | 1998 | 1999 | 2000 |
|----------------|------|------|------|
| Austria        | 0.9  | 0.6  | 2.4  |
| Belgium        | 1.0  | 1.1  | 2.5  |
| Denmark        | 1.8  | 2.5  | 2.9  |
| Finland        | 1.4  | 1.2  | 3.4  |
| France         | 0.8  | 0.5  | 1.7  |
| Germany        | 0.9  | 0.6  | 1.9  |
| Greece         | 4.8  | 2.6  | 3.2  |
| Ireland        | 2.4  | 1.6  | 5.6  |
| Italy          | 2.0  | 1.6  | 2.6  |
| Luxembourg     | 1.0  | 1.0  | 3.2  |
| Netherlands    | 2.0  | 2.2  | 2.5  |
| Portugal       | 1.8  | 2.3  | 2.9  |
| Sweden         | 0.4  | 0.3  | 1.3  |
| Spain          | 4.3  | 4.0  | 4.1  |
| United Kingdom | 3.4  | 1.6  | 2.9  |
| Euro area      | 1.1  | 1.1  | 2.3  |
| European Union | 1.8  | 1.3  | 2.5  |

Source: OECD.

cussed at length in the next chapter on relative prices. Here, it is nonetheless useful to summarise a few policy conclusions. First, countries that are converging must have a real exchange rate appreciation because of what is called the Balassa-Samuelson effect. Differences in business cycles in turn imply differences in inflation by virtue of the Phillips curve, a short-run relationship between the output gap and inflation, which tells us that in expansions greater tensions in factor and product markets are reflected in stronger inflationary pressures.

While there is not much that the ECB can do about differences in inflation with its single monetary policy, we argue that they are worrying for at least two reasons.

First, meeting the target of a 2 per cent maximum inflation rate with a fairly large inflation differential across countries means that in the low inflation countries – i.e., according to the above arguments, those that are richer and/or in low phases of their business cycles – one must actually have deflation. Deflation can be severely contractionary if nominal wages are downward rigid, i.e. if people resist nominal wage cuts. The maximum rate of deflation that can then be achieved is the rate of growth of labour productivity, which may be quite low at low phases of the business cycle. This effect is compounded by the fact that, given a common nominal interest rate imposed by the ECB, deflationary countries will face a higher real interest rate in the short run than inflationary countries.

Second, to the extent that the ECB's policy is tailored to a median, or mean European country, the wider the differences across countries, the greater the difference between the ECB's policy and the one most preferred by a given country, and the greater the proportion of countries which are not satisfied with the ECB's policy. Therefore, it is important that asymmetries across countries be limited if one wants to preserve the political stability of the system.

A natural answer to these worries is that fiscal policy should be used to alleviate cross-country asymmetries in business conditions. In particular, countries that have a strong expansion should engineer a fiscal contraction.

Table 3.3 looks at government financial balances. Three conclusions emerge. First, while booming

**Table 3.3**  
**General government financial balances**  
**(as a percentage of nominal GDP)**

| Country                       | 1998  | 1999  | 2000 <sup>a)</sup> |
|-------------------------------|-------|-------|--------------------|
| Austria                       | - 2.2 | - 2.1 | - 1.5              |
| Belgium                       | - 0.9 | - 0.7 | 0.0                |
| Denmark                       | 1.1   | 3.1   | 2.4                |
| Finland                       | 1.3   | 1.8   | 6.7                |
| France                        | - 2.7 | - 1.6 | - 1.4              |
| Germany                       | - 2.1 | - 1.4 | - 1.0              |
| Greece                        | - 2.5 | - 1.8 | - 0.9              |
| Ireland                       | 2.2   | 2.1   | 4.5                |
| Italy                         | - 2.8 | - 1.8 | - 1.5              |
| Netherlands                   | - 0.7 | 1.0   | 1.3                |
| Portugal                      | - 2.3 | - 2.0 | - 1.7              |
| Sweden                        | 1.7   | 1.8   | 4.0                |
| Spain                         | - 2.6 | - 1.2 | - 0.4              |
| United Kingdom                | 0.4   | 1.3   | 1.9                |
| Euro area                     | - 2.2 | - 1.3 | - 0.7              |
| European Union                | - 1.6 | - 0.7 | 0.0                |
| <sup>a)</sup> Excluding UMTS. |       |       |                    |

Source: OECD, EU Commission.

countries tend to run less of a fiscal deficit, this is largely due to automatic stabilisers and there does not seem to be much of an effort, except in the case of some smaller countries which are running fairly high surpluses (Finland, Ireland, Sweden). Second, there remain large imbalances. For example, the deficit is higher in high-growth Spain than in the Benelux. Third, despite the strong expansion that has prevailed between 1998 and 2000, in many major countries there is still a deficit, suggesting an expansionary fiscal policy.

This suggests that national authorities have few incentives to design fiscal policies to stabilise their economic fluctuations. In particular, this means that in an expansion they are not running enough of a surplus and consequently imbalances across countries are too large. In the next section we discuss why this may be the case.

## 2. The Risk of Easy Fiscal Policy During Expansions

According to many analysts, for many European countries one of the most salient benefits of belonging to European Monetary Union is the elimination of inflationary biases in the use of monetary policy. A benevolent government will be subject to such a bias to the extent that it tries to increase the employment level beyond its natural rate by exploiting a short-run trade-off between inflation and unemployment. However, such a

trade-off exists only if inflation is unanticipated. In the long run, the government's incentive to inflate is reflected in people's inflationary expectations, and the economy ends up at a higher rate of inflation without having achieved the attempted increase in employment.

The inflationary bias is the higher, the greater the desired employment level relative to its equilibrium level, the more the government cares about employment relative to inflation, i.e. the lower the welfare cost of inflation, and the higher the inflation increment needed to achieve a given increase in output.

If the government cannot commit itself in advance to the future stance of monetary policy, it will set it on a discretionary basis so as to exploit the short-run trade-off between employment and inflation. On the other hand, commitment devices such as constitutional rules or central bank independence permit getting around this trade-off, because they allow policy to take a longer view and to embody the fact that actual behaviour must be reflected in people's expectations.

It is now widely believed that these incentives no longer exist because monetary policy is in the hands of the European Central Bank which has an explicit mandate of price stability. National governments no longer control, directly or indirectly, the money stock. In effect, European Monetary Union is one of the commitment devices allowing to get rid of the inflation bias.

Contrary to much popular belief, however, this does not mean that the ECB alone controls the inflation rate and that national government's decisions are irrelevant. In fact, this is only true in the long run in the sense that the rate of increase of the price level cannot differ from the growth rate of the money stock, otherwise real money balances would either explode or shrink without limit.

In the short run, a national government can inflate the economy even though it no longer controls monetary policy. It just has to stimulate aggregate demand, for example by running a larger fiscal deficit. Indeed, any instrument which boosts aggregate demand will be enough to move the economy along its short-run inflation/output trade-off.

Despite the loss of control of money, a government disappointed with its average employment perfor-

mance has the same incentive to boost aggregate demand by injecting fiscal stimulus into the economy. This means too high a deficit in recessions and not enough fiscal consolidation in expansions.

These incentives may be compounded by the public's psychological perception that national governments are no longer in charge of fighting inflation, so that they will not be held accountable for inflationary tensions.

How do national governments' incentives for providing fiscal stimulus interact with the central bank's reaction to inflationary pressures?

In a world without frictions, the central bank could impose a huge penalty for any deviation of inflation from its official target. That is, if inflation exceeded such a target even by a tiny amount, it would impose a huge increase in interest rates in order to cool the economy down enough to bring inflation back within the desired range. Recognising that, governments would refrain from fiscal stimulation, as they would expect that any increase in aggregate demand associated with their actions would be offset by an equivalent reduction in aggregate demand due to the response of the monetary authorities.

In practice, however, such razor-edge rules are impossible to implement, if anything because inflation is measured with a lag and because the components of aggregate demand such as investment and consumption also respond with delays to changes in nominal interest rates. So a better representation of a central bank's policy is that its policy instrument (typically, the nominal interest rate) reacts to the inflation rate and perhaps the output gap. (See the box on Taylor rules).

A national government's incentive to inflate by using fiscal policy will nonetheless depend on monetary policy: the greater the central bank's reaction to inflation and to the output gap, the lower the government's incentive to inflate. If the central bank's policy is such that inflation will eventually be brought back to its long-run target, then the government's lack of credibility does not generate inflation in the long run. However, depending on the welfare costs of running budget deficits, the economy ends up with an inadequate policy mix of too easy a fiscal policy and too tight a monetary policy. This results in excessively high real interest rates and excessively high government debt.

What happens if such an economy joins a monetary union? Monetary policy will now only react to union-wide aggregates. In particular, it will react much less to specific developments in a given country. As a result, a country tempted to run a deficit will take into consideration that the monetary backlash against its fiscal stimulus will be much weaker. In other words, the short-run output-enhancing effect of such fiscal stimulus is stronger in the monetary union than if the country had an independent central bank of its own. As a result, the temptation to inflate is higher, which implies higher deficits and greater inflationary pressures.

If all national fiscal authorities independently give in to the incentive to run a much too easy fiscal policy, then the ECB ends up facing a tougher challenge than any independent national central bank in that it will have to combat an even more expansionary fiscal policy, which – in the long run – will lead to bigger imbalances between fiscal and monetary policy.

But this is not the end of the story. For there are strategic complementarities between fiscal expansion at home and fiscal expansion abroad. Despite some direct cross-country spillovers on aggregate demand, an easier fiscal stance abroad tends to increase the aggregate price level and Euro-area interest rates, thus making it more desirable to expand at home. And this is reinforced by the Euro-area monetary contraction associated with fiscal expansion abroad.

Note that smaller countries have a greater incentive to pursue fiscal stimulus than larger ones because their policies have a lower impact on Euro-area wide aggregates and therefore trigger a lower counter-inflationary reaction by the ECB. As a result, one may observe long-lived imbalances between small and large countries.

While we have mostly focused on output and employment stabilisation, similar incentives to run high budget deficits are induced by non-anticipated changes in the price level of the Euro area as a whole due to fiscal imbalances in some countries. These changes in the price

level reduce the real value of public liabilities, therefore causing a wealth transfer from bond holders to governments.

### 3. The Risk of Overly Restrictive Fiscal Policies in the Current Downturn

EMU is not without instruments to prevent excessive fiscal stimulus. The ‘stability pact’ is the main one, but many individual countries have also committed themselves to reach balanced budgets over time in the framework of the ‘stability programme’. These instruments are, however, far from perfect. Among their many deficiencies one seems to be particularly damaging in the present circumstances, i.e. that specific fiscal targets are not explicitly made contingent on the business cycle.

The three per cent upper boundary on the deficit/GDP ratio established by the stability pact is unlikely to bind in expansions. This strongly reduces the scope for fiscal consolidation in good times. With a cyclically corrected target, the effort by individual governments to reach fiscal discipline would be much more transparent.

By the same token, within the stability programme, individual countries commit themselves to fixed fiscal targets over time; i.e. these targets are not defined contingent on the business cycle and underlying assumptions about the effect of specific fiscal measures. Thus, any unanticipated economic event (a world recession, a stricter US monetary policy and the like) automatically offers an excuse to re-contract and modify targets, with little or no relation to the original commitment.

Consider Table 3.4, based on data of the European Commission, reporting both the actual and the

**Table 3.4**  
**Budgetary outlook for the Euro area (% of GDP)**

|   | 1998  | 1999  | 2000  | 2001  | 2002  | 2003  |
|---|-------|-------|-------|-------|-------|-------|
| Actual budget balance (without UMTS proceeds) | - 2.2 | - 1.3 | - 0.8 | - 1.1 | - 1.4 | - 1.0 |
| Cyclically adjusted balance                   | - 2.0 | - 1.3 | - 1.3 | - 1.3 | - 1.4 | - 1.0 |
| Cyclically-adjusted primary balance           | 2.7   | 3.0   | 2.8   | 2.6   | 2.6   | 2.7   |
| Growth rate                                   | 2.9   | 2.7   | 3.4   | 1.6   | 1.3   | 2.9   |

Source: Based on the figures of the Commission services.

cyclically-adjusted budget deficits. According to these figures, despite the good growth record in the years between 1998 and 2000, on average the structural progress on the road to fiscal consolidation was extremely slow. The cyclically-adjusted deficit remained as high as 1.3 per cent of GDP. Cyclically adjusted primary surpluses, excluding interest payments, actually fell in 2000 relative to 1999, despite the higher growth rate. While cyclically adjusted figures are to some extent arbitrary, and therefore potentially subject to cosmetic manipulation, the message from Table 3.4 is quite clear: the decline in the actual deficit in those years is not to be confused with structural improvement. But this makes future fiscal targets extremely difficult to meet in practice, although, in light of our considerations, attempts to stick to balanced-budget targets in the next few years should be welcome.

However, our forecasts – as well as the forecasts by virtually all international institutions – predict a severe slowdown in 2002, and the objective of fighting this slowdown should also be given proper weight. Given the world-wide nature of the slowdown that will also affect all EMU countries, it is feasible, and indeed desirable, to counteract it mainly with monetary policy. European policy-makers should cut interest rates, rather than relying on fiscal policies, for which the room for manoeuvre is much more limited, and because fiscal stimulus would run counter to the long-run consolidation objectives.

But at some point monetary policy may prove ineffective, particularly if very low nominal interest rates are matched by low inflation. To avoid the risk of pushing fiscal policies into dangerous corners, it may be counterproductive to pursue fiscal consolidation at all cost, in the midst of a slowdown, even if such consolidation may be regarded as a high-priority long-term goal.

For the next two years, on average, national governments should simply let automatic stabilisers work, that is, they should not counteract the loss of fiscal revenue and the increase in welfare spending caused by the macroeconomic contraction. They should not, however, provide further stimulus. Discretionary fiscal policy measures, while effective, have two major drawbacks. First, once government spending is increased and/or taxes are cut, these measures are usually very difficult to reverse.

The progress of the last few years in fiscal consolidation may be put at stake. Second, the adoption and implementation of such measures is usually subject to lags, and their timing may end up being wrong.

We therefore advocate a ‘neutral’ policy stance in light of the short-run need for fiscal stimulus, without compromising the long-run need for consolidation. The balance between these two needs may be different from country to country. In some cases, the long-run consolidation should be given higher priority over short-run stabilisation. Yet, it is quite clear that stabilisation and consolidation require much more than looking at quantitative targets in terms of debt and deficits. They are likely to require reforms of tax codes and spending structure, efficiency standards in the provision of public goods, and a rethinking of the scope and scale of government intervention. While reforms are hard to implement at times of slow economic growth, it is not obvious that their further delay will help in any way the countries that mostly need them – not surprisingly, the countries in which growth rates have been consistently the lowest during the past few years.

#### 4. A Proposed Framework for Fiscal Policy

As argued above, fiscal policy targets should be defined in a framework explicitly designed to separate structural from cyclical deficits. As objectionable and rough the measurement of these two deficits may be, a cyclically-corrected deficit provides better guidance on the formulation of targets and the assessment of fiscal performance than the ratio of the general government deficit to GDP.

For each year, countries should decompose the overall deficit into these two components:

$$d = s + c,$$

where  $d$  is the total deficit,  $s$  is the structural deficit and  $c$  the cyclical one. The structural deficit would then follow a pre-determined time pattern independent of the business cycle. For example a highly indebted country might want to reduce it by, say, one percentage point a year on average. The other component of the deficit,  $c$ , should be allowed to vary with the business cycle.

## 5. Summary

The following points summarise the main findings and recommendations of this chapter.

- Because business cycle fluctuations are not identical across countries, fiscal policy will retain an important stabilisation role. In particular, this implies fighting inflation in booms. It is incorrect to think of inflation as the sole business of the ECB.
- Inflationary bias may arise in the setting of fiscal policy; it is likely to be stronger in a monetary union with nationally set fiscal policies than in a closed economy. Within the union, it is more likely to happen in smaller economies.
- It is important, therefore, to design institutions for the commitment and coordination of fiscal policies in order to mitigate such biases.
- These considerations are in line with the observation that little fiscal effort has been made in the last expansion, following large deficits in the mid-nineties. To enhance the transparency of commitments by national authorities, fiscal targets should be made explicitly contingent on the business cycle.
- In order to reconcile the need for fiscal stabilisation with that of avoiding a severe recession, we advocate a 'neutral' stance in the next two years, i.e. letting automatic stabilisers work without engineering further fiscal stimulus.

## References

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