Converging and Sustaining Fiscal Policy in a Monetary Union—I

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Topics to be covered:

1. Why is fiscal convergence needed for monetary union?
2. How can fiscal frameworks use targets and rules to help achieve convergence?
Two fiscal convergence challenges

• **A**: Fiscal policies should support “locking in” of exchange rates at start of currency union;

• **B**: Fiscal policy should also be consistent with success of single currency after its adoption.

• Fiscal policies should aim to meet both goals (A+B) in advance of currency union.
“Locking-in” the exchange rate

• Question of what exchange rate to choose;
• Generally, opt for demonstrated stable/sustainable rate;
• This difficult to determine if:
  – Significant inflation differentials; or
  – Balance of payments distorted by large macroeconomic imbalances (unusual import-related currency demands, for example).
“Locking-in” the exchange rate

• Thus, three fiscal policy guidelines ahead of monetary union:
  – Fiscal policies consistent with low inflation (restrained demand; modest domestic financing needs)
  – Also consistent with balance of payments stability (restrained demand, modest foreign financing needs)
  – Also consistent with future single currency success.
The bottom-line:

<table>
<thead>
<tr>
<th>A</th>
<th>Sustainable revenue and grant base.</th>
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<tbody>
<tr>
<td>B</td>
<td>Spending plans consistent with <strong>low inflation</strong> and balance of payments stability.</td>
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<tr>
<td>A-B</td>
<td>Prudent fiscal deficit</td>
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</tbody>
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Seek overall consistency

<table>
<thead>
<tr>
<th>X+Y</th>
<th>Prudent financing potential.</th>
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<tbody>
<tr>
<td>X</td>
<td>Domestic financing consistent with <strong>restrained liquidity growth</strong> and long term debt sustainability.</td>
</tr>
<tr>
<td>Y</td>
<td>Foreign financing consistent with <strong>market access prospects</strong> and long term debt sustainability.</td>
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</tbody>
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Fiscal convergence

Current fiscal deficit

Before monetary union

Convergence process

Prudent fiscal deficit

After monetary union
Risks of fiscal slippage

Before monetary union—straightforward

• High or volatile inflation;
• Uncertainty about “equilibrium” exchange rate;
• Thus, delay the currency union.
• If proceed with currency union anyway, risks are more complicated. Worth studying in detail.
Features of a currency union—I

• Single currency—loss of independent monetary policy;
• Shared exchange rate—loss of devaluation options to restore competitiveness;
• Shared regional savings pool to meet public or private borrowing needs;
• Increased cross-country ownership of assets (bank in country A lends to debtor in country B);
Features of currency union—II

• More closely linked growth and trade patterns;
• No scope for inflationary debt reduction by governments (less creditor risk);
• Possibility of fiscal bail-out at regional level (less creditor risk);
• Increased regional contagion risks (due to closer economic/financial ties)
Loose fiscal policy before MU

• Small pool of savings;
• Debt stability concerns → Risk premium;
• Higher domestic demand → Higher inflation → Loss of competitiveness;
• Also, domestic demand → external current account pressures → pressure on exchange rate;
• Incentives for corrective fiscal policy;
Loose fiscal policy before MU

Policy measures:
• Cut fiscal deficits to slow and reverse debt build-up;
• Tighter fiscal policies + slower growth = lower inflation;
• Exchange rate depreciation → Improved competitiveness;
• Domestic financial strains from slower growth;
• Adverse devaluation impact on foreign holders of domestic currency debt.
Loose monetary policy after MU

• Large pool of savings;
• Risk premiums slower to respond to borrowing levels (implicit bail-out guarantees);
• Public debt levels rise more easily;
• Large current account deficits easily financed (no exchange rate pressures);
• Fewer incentives for fiscal correction;
Loose monetary policy after MU

Policy measures:
• Cut fiscal deficits to slow and reverse debt build-up;
• No scope for depreciation to improve competitiveness;
• Instead, reduce wages/prices through public sector wage cuts or tight economic policies;
• Need to explore non-price options to boost competitiveness (e.g., structural reform);
• Risks of adverse debt dynamics if economy shrinks faster than debt levels;
• Debt default may be needed when debt unsustainable. Implications for regional creditors (banks, etc).
Key fiscal problems of MU

• Reduced ex ante market discipline on public sector and current account imbalances;
• Thus, increased risk of over-borrowing;
• More limited policy tool kit for managing excessive debt burdens;
• Potentially dangerous domestic and regional consequences of over-borrowing.
Sustainable fiscal policy in MU

- Standard approach is to adopt fiscal rules and enforcement mechanisms to replace market discipline;
- Efforts to strengthen market discipline with “no bail out” message not typically effective;

Three pillars for sustainable fiscal policies:
- Convergence criteria (fiscal rules);
- Stepped up macroeconomic surveillance;
- Rules for enforcing policy adjustment.
Fiscal rules

• Ceiling on fiscal deficit for MU countries;
• How define (before/after grants)?
• Debt considerations (stronger fiscal position required when debt levels higher)?
• How to accommodate some countercyclical fiscal policies (CFP—see next presentation)?
• Scope for additional borrowing to finance investments?
• Trade-off between flexibility to meet national economic priorities and effectiveness as regional discipline.
• May need to sacrifice some flexibility to ensure effectiveness.
Macroeconomic surveillance

• Goal is to identify macroeconomic imbalances under MU at an early stage;
• Focus on fiscal sustainability, private sector imbalances, competitiveness;
• Independent regional institution to conduct surveillance. (Scope for external surveillance, at outset?)
• Surveillance to inform decisions on application of fiscal rules (whether or not to grant exemptions).
Enforcement of policy adjustment

- Who takes decision, when national policy adjustment needed?
- How to balance national and regional policy authority?
- Design of penalty/incentive regime? (withholding regional transfers; application of substantial fines; other.)