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:

A	Sustainable revenue and grant base.
B	Spending plans consistent with <u>low inflation</u> and <u>balance of payments stability</u>.
A-B	Prudent fiscal deficit

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Seek overall consistency

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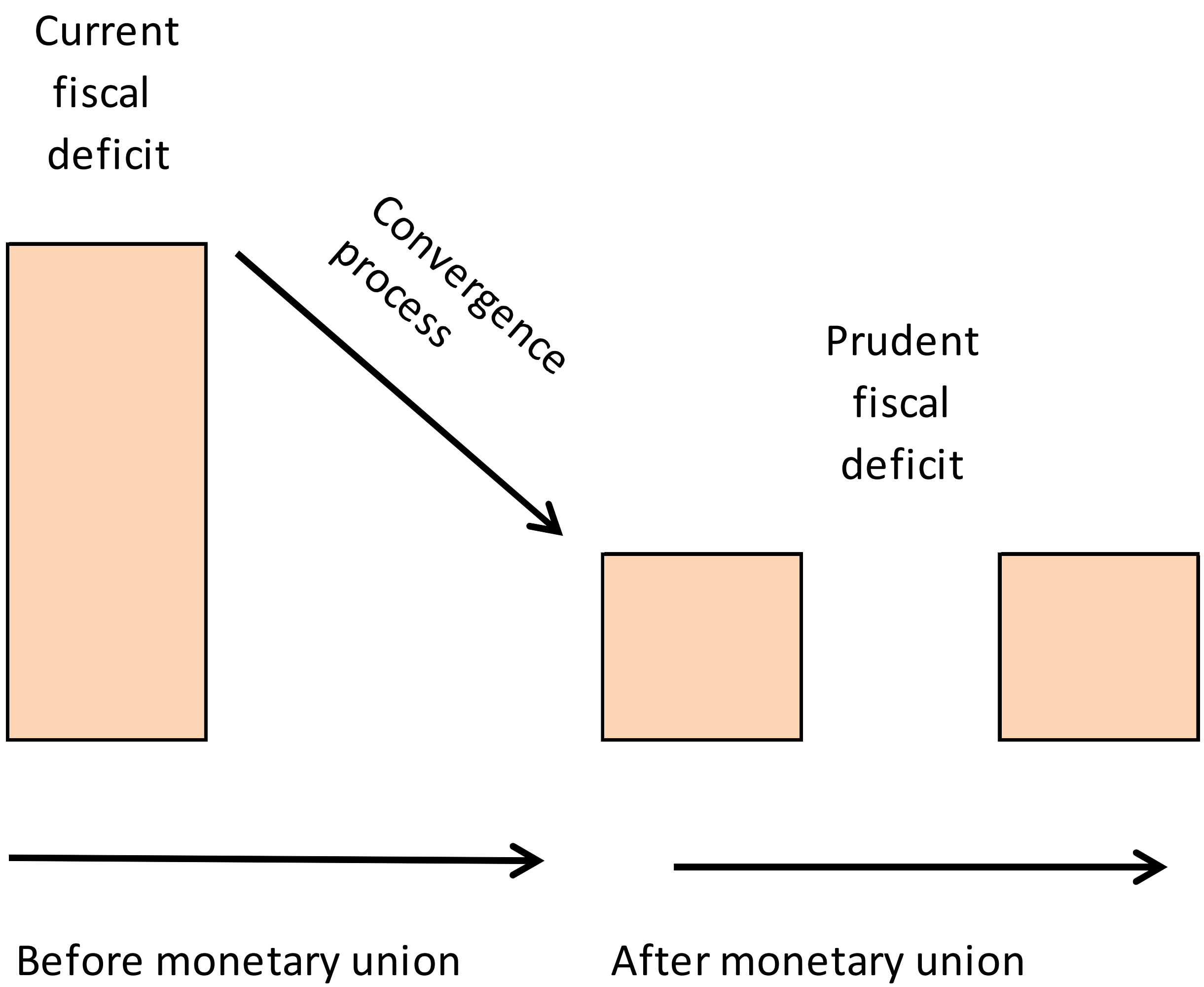
X+Y	Prudent financing potential.
X	Domestic financing consistent with <u>restrained liquidity growth</u> and <u>long term debt sustainability</u>.
Y	Foreign financing consistent with <u>market access prospects</u> and <u>long term debt sustainability</u>.

Fiscal convergence



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 $\rightarrow$ Risk premium;
- Higher domestic demand $\rightarrow$ Higher inflation $\rightarrow$ Loss of competitiveness;
- Also, domestic demand $\rightarrow$ external current account pressures $\rightarrow$ 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 $\rightarrow$ 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;

<u>Three pillars for sustainable fiscal policies</u>:

- 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 <u>flexibility</u> to meet national economic priorities and <u>effectiveness</u> 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.)