Commentary: Monetary Policy Implications of Greater Fiscal Discipline

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The risks generally associated with public indebtedness were already clearly identified by Adam Smith. In his principal work, *The Wealth of Nations*, he wrote: "The practice of funding has gradually enfeebled every state which has adopted it." To me this does not mean that all public debt has to be called into question, even if influential politicians here in the United States are once again demanding a constitutional requirement of a balanced budget. On the other hand, it is true that a government which incurs an increasing level of debt finds itself on a path between Scylla and Charybdis.

The risk of inflation is one of the problems encountered along this path. Time and again, governments have solved their budgetary problems by simply printing more and more money. Fortunately, there is now a worldwide tendency to block the access of governments to central bank credit. But even then, the inflationary risk associated with an expansionary budget policy is by no means fended off. In countries where the central bank is not independent, the government can, in principle, alleviate its financing problems by inducing monetary policymakers to adopt an accommodating policy stance. But even independent central banks can be put under considerable political and social pressure to tailor their monetary policy course to the government's borrowing requirements. Anyway, every central bank always takes the economic costs of its stabilization policy into account when determining its policy stance. Last but not

least, an interest rate policy which is regarded as restrictive often meets with objections abroad, mostly couched in terms of a demand for a better international coordination of monetary policy.

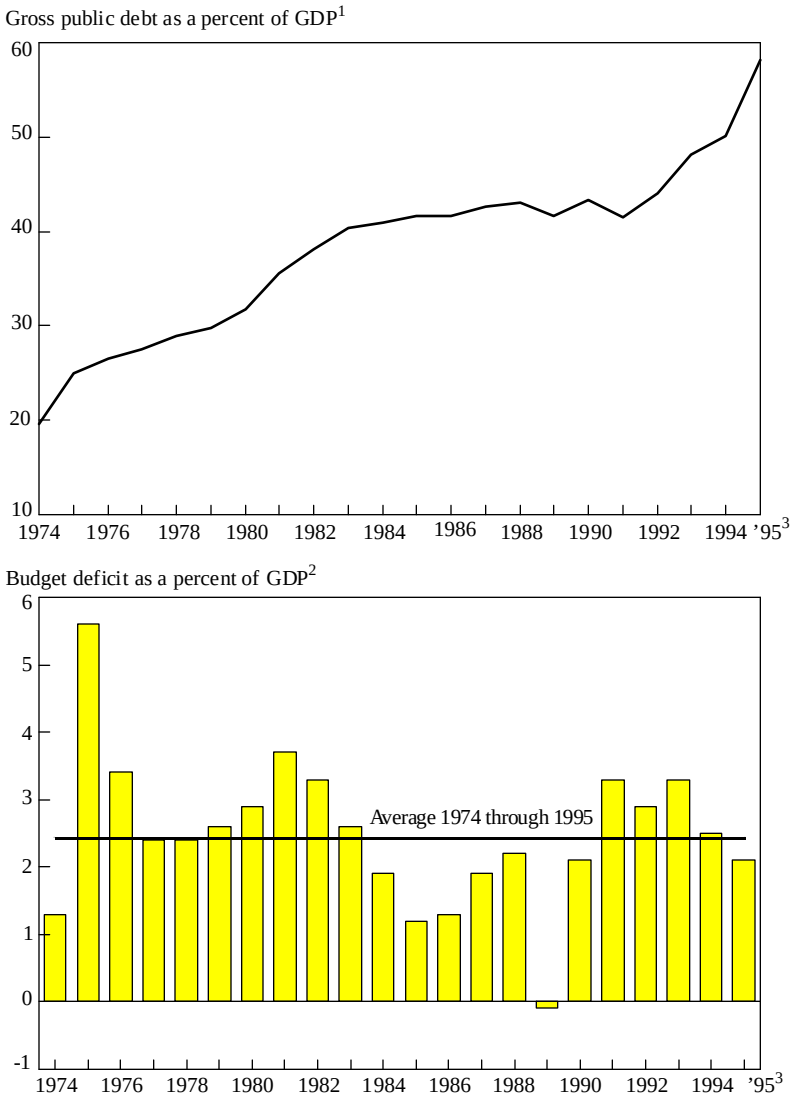
I do not think I need to dwell any further in general terms on the monetary policy implications of budget deficits and debt. John Taylor has explained all of this comprehensively and most expertly. Instead, I would like to describe the experience which we have had in Germany since the 1970s with periods of high budget deficits. In this respect, there are two questions: how has the Bundesbank responded to such developments? And what was the ultimate outcome of its policies? In addition, I would like to make some comments on the fiscal policy preconditions which will have to be met in Europe if the planned Economic and Monetary Union is to be implemented as envisaged.

Western Germany experienced a first dramatic increase in public indebtedness as a result of the recession of the mid-1970s. The general government budget deficit rocketed to 5.5 percent of GDP in 1975, after a surplus had been recorded in 1973 (national accounts definition). This vigorous expansionary swing was primarily a result of the "built-in stabilizers," but it also owed much to tax cuts and discretionary increases in expenditure. Overall, the Bundesbank approved this anticyclical policy.

The subsequent adjustment process, however, was less vigorous than had been hoped. Given a weakening economic trend, fiscal policymakers once again reverted to demand management in 1977-78 (with the G-7 summit held in Bonn in 1978 providing an additional impetus). As a consequence, the budget deficits remained substantial, and the ratio of public debt to GDP climbed continuously. (See Chart 1.)

The expansionary fiscal policy of that time contributed to a further worsening of the then oil-price-related deterioration in the German current account. In the end, the German current account balance recorded a huge deficit in 1980, after a large surplus had been registered in 1978. At that time, the Bundesbank had to be concerned

Chart 1
Budget Deficits and Public Debt in Germany



[1]The increase in 1994 and 1995 mainly reflects the assumption of debt from ex-public corporations which were privatized or dissolved (the Federal Railways, the housing administration agency in eastern Germany, the Treuhand agency).
[2]System of National Accounts (SNA) basis
[3]Partly estimated.

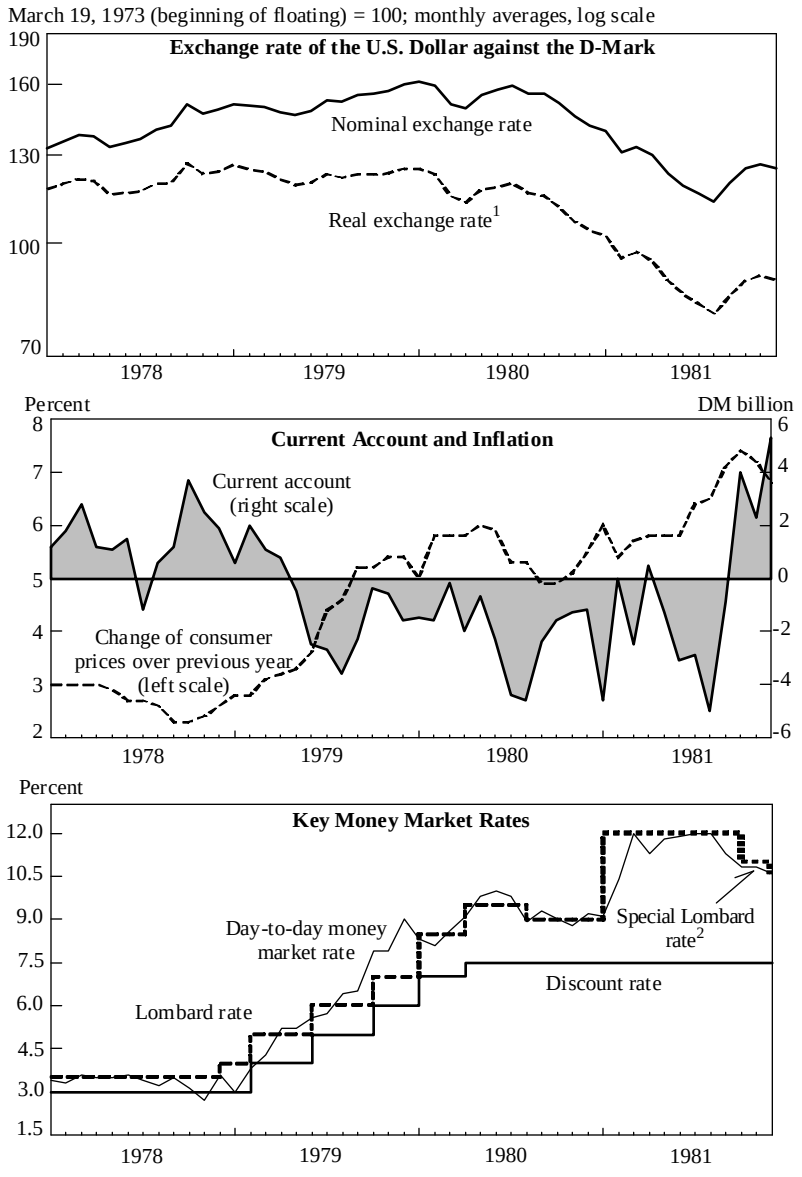
about the reversal in the current account, as it was accompanied by substantial downward pressure on the deutsche mark. The depreciation of the deutsche mark threatened seriously to increase the pressure on prices in Germany, after rising oil prices, high inflation rates abroad, and sharply rising domestic demand had already worked through to the inflation rate (which amounted to an annual average of 5.5 percent in 1980).

In this difficult situation, the expansionary trend in German financial policy, over and above its negative effects on the current account, also proved to be a factor of uncertainty which additionally undermined confidence in the internal and external stability of the deutsche mark. In fact, the situation in the foreign exchange markets deteriorated so acutely in February 1981 that there was public talk of a crisis of confidence with regard to the deutsche mark. In view of the deutsche mark's significance as an international investment currency, this could quickly have led to an avalanche of capital outflows and to even heavier pressure on the exchange rate. Ultimately, there was the potential danger of a vicious circle of depreciation and inflation.

In responding, in February 1981, the Bundesbank took resolute action. By squeezing liquidity and strongly raising the cost of lombard borrowing, it increased the day-to-day money market rate by 300 basis points to 12 percent. (See Chart 2.) As a result, the external adjustment process was quickly promoted through a slowdown in domestic demand, and—in line with the improving current account—confidence in the deutsche mark was regained in the foreign exchange markets. Furthermore, through this "monetary warning shot across its bows," the government was made fully aware of the unsustainability of its deficit policy. From then on, budget consolidation was increasingly recognized as being an urgent task and was steadfastly pursued.

German fiscal policy posed new challenges to monetary policymakers in the wake of reunification. After equilibrium had been achieved in the general government budget of 1989, financial support for eastern Germany once again led to massive budget deficits.

Chart 2
DM Weakness of 1981 and Monetary Policy Reactions



[1]On the basis of consumer price movements.
[2]The rate of the special Lombard (which temporarily replaced the normal Lombard) could be changed daily, and the facility could be discontinued any time.

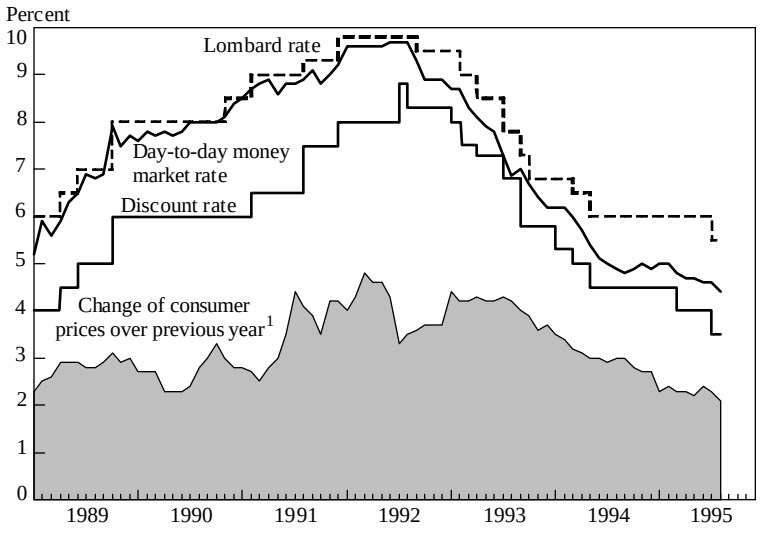
Incidentally, the official data do not show the full scale of this development. According to the budget definition of the national accounts (that is, mainly after adjustment of new debt for loans granted), the German deficit reached its highest level in the years 1991 to 1993, at a range of between 3 percent and 3.5 percent of GDP. This did not include the funds borrowed by the Federal Railways and the Treuhand privatization agency.

Meanwhile, the Federal Railways and the Treuhand agency have been privatized and dissolved, respectively, with their debt being completely assumed by the government (and further debt of the housing agencies in eastern Germany was partly also assumed). Given the heavy debt service on these obligations, which is now included in the budget, and given the earlier under-recording of the relevant budget deficits, the progress in consolidation that has been achieved since 1994 has been quite substantial. According to estimates by the Organization for Economic Cooperation and Development (OECD), the German general government budget deficit is likely to fall to 2.3 percent in the current year. It would then be significantly below the deficits of most other G-7 nations.

At the beginning of 1990, when the monetary union with the former GDR was announced, the market had already anticipated the problems and risks associated with reunification by a surge in German bond yields. Indeed, owing to a "catch-up" boom in eastern Germany, financed mainly by a generous conversion rate, and owing to the expansionary budget policy, but also on account of a sharp increase in wages, the west German economy experienced a true Keynesian boom. Because of this, Germany temporarily decoupled itself from the cyclical downward trend prevailing among its major trading partners. As a result, the current account position changed from large surpluses to a deficit. Moreover, in spite of the corresponding import of foreign resources, the pressure on prices increased sharply. In March 1992, the inflation rate reached a peak of 4.8 percent.

In order to counteract the alarming price movements, the Bundesbank further tightened its monetary policy stance until mid-1992. (See Chart 3.) While the German government was very early convinced

Chart 3
Price Pressures and Monetary Policy Since 1989



[1]Western Germany

that the heavy public recourse to the credit markets had to be corrected as soon as possible, the uncompromising stabilization measures adopted by the Bundesbank no doubt reinforced the fiscal policymakers' consolidation efforts. In turn, the emerging prospect of a credible consolidation strategy, and—even more so—the visible progress made, increasingly helped the Bundesbank to lower its interest rates from their peak level. This also applies to the Bundesbank's most recent interest rate reductions of March and August 1995. Thus, German fiscal and monetary policymakers are acting in concert now, after a clear case of a wrong policy mix in the first few years after reunification.

The temporary policy mix of an expansionary fiscal policy and a restrictive monetary policy also created problems in the European Monetary System (EMS), where the deutsche mark plays the role of

an anchor currency. It was understandably difficult for some of our partner countries to orient their monetary policy, in the interest of exchange rate stability, to the relatively high level of German interest rates at a time when their own cyclical conditions already appeared to be quite apt for lowering interest rates. However, in our partner countries' own interest, too, it would not have been appropriate to solve these difficulties by adopting a less ambitious interest rate policy in Germany. Any domestically premature relaxation of the German monetary policy stance would have weakened the internal stability of the anchor currency, and would thus have run counter to the declared aim of creating a zone of monetary stability in Europe. Incidentally, previous criticism of German monetary policy all too easily overlooked the fact that, prior to the turmoil in the EMS, German money and capital market rates were, as always, not the highest, but rather, together with the Dutch and Belgian rates, the lowest in the EMS area. Our partner countries could therefore certainly have achieved some lowering of their interest rates autonomously by solving their own problems. Apart from adjusting overvalued exchange rates, this would primarily have necessitated tackling the widespread shortcomings in budget policy.

The Economic and Monetary Union (EMU) criteria laid down in the Maastricht Treaty impose an additional need for budgetary consolidation on the member states of the European Union. According to the treaty, countries may join the planned EMU only if their general government budget deficit, as defined in the national accounts, amounts to no more than 3 percent of GDP, and if their gross public debt does not exceed 60 percent of GDP. Apart from Luxembourg and Germany, no other country presently meets these fiscal policy preconditions for the start of EMU. Nevertheless, these requirements must on no account be watered down, as EMU might otherwise easily become an inflation community.

Furthermore, once EMU has been established, the problem will arise of how a high degree of budgetary discipline among the participants can be ensured in the long run. It is true that the existing budget surveillance procedure of the EMU already envisages that the budget and debt ceilings of 3 percent and 60 percent of GDP

must continue to be observed in the monetary union. However, the existing regulations do not seem to have sufficient clout to prevent a member country from adopting an excessively expansionary budget policy. Thus, both the federal government and the Bundesbank believe it is necessary to envisage additional routes to strengthen budgetary discipline. One option would be that only those countries which participate in EMU sign a separate treaty in order lastingly to avert excessive budget deficits.

If this were to prove possible, a major cornerstone would be laid in Europe for stability-oriented cooperation between monetary and fiscal policy. However, it is at present highly uncertain whether such a treaty can be agreed. At all events, it will be crucial for achieving price stability in EMU to make it clear from the outset that the European Central Bank—as was the case with the Bundesbank in Germany—will not be prepared to accommodate a fiscal policy stance that endangers monetary stability. According to the long-standing experience of the Bundesbank, the monetary policy emergency brakes will have to be applied resolutely, if necessary, to counteract an overly expansionary fiscal policy, even if thereby adversely affecting short-run economic activity. Such a "custodian" function of an independent central bank, in particular vis-à-vis fiscal policymakers, is based on the conviction that, in the medium and longer term, monetary stability constitutes an essential precondition for economic prosperity and social progress. Of course, stability-oriented cooperation between monetary and fiscal policy is preferable to confrontation, thus explaining our efforts to bring about a treaty of this type in Europe. Moreover, it is obvious that a central bank should exhaust all its options of consultation, persuasion, exhortation, and warning before it takes any painful action. However, especially in the case of a new, untried, and untested central bank such as the future European Central Bank will be, it is also true that no doubts must be allowed to arise as to its determination not to shrink from tough measures in the event of a conflict.