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Budget Rules and Monetary Union in Europe

Among the most controversial issues in the continuing debate over the path to an economic and monetary union (EMU) in Europe is the extent to which fiscal policies must converge among member countries to ensure its success. One view holds that, with a unified central bank, rules to ensure fiscal convergence are necessary to limit the potential disruptiveness of divergent government financing needs on the operation of a monetary union. Most policymakers seem to share this opinion, and stringent measures on fiscal discipline were incorporated into the agreement on monetary union reached at Maastricht, Netherlands in December 1991. In particular, the treaty includes an "excessive deficits procedure" that would limit budget deficits to less than 3 percent of GDP and total government debt levels to less than 60 percent of GDP.

Another view, however, holds that,so long as the central bank is prohibited from financing individual government budget deficits, rules to ensure fiscal convergence are not strictly necessary and may even be undesirable. Binding public finance rules are *unnecessary*, it is argued, because private markets will impose sufficient discipline on excessive government borrowing by charging higher interest rates and compelling governments to balance their budgets over time. Rules also may be *undesirable* if they limit individual members' ability to use budget policy as a stabilization tool, especially since both monetary and exchange rate instruments are not available for this purpose within a monetary union.

This *Weekly Letter* considers international evidence which sheds light on this debate by looking at the degree of budget "discipline" and convergence in member states of various monetary arrangements: the European Monetary System (EMS), quasi-monetary unions, and full-fledged monetary unions.

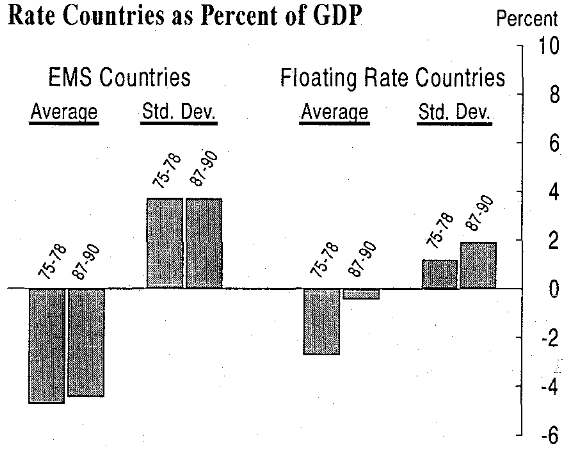
Monetary and fiscal convergence in the EMS

The EMS began operation in 1979 when its seven initial members—Germany, France, Italy, Netherlands, Belgium, Denmark, and Luxembourg—agreed to limit exchange rate fluctuations among themselves. Since then, convergence among EMS members towards lower levels of average monetary growth and inflation is clearly evident. Between 1975–1978 and 1987–1990, the cross-country variability of broad money growth (measured by the standard deviation) fell by almost half; the variability of the inflation rate fell by two-thirds. Over the same period, average annual broad monetary growth declined by about 7 percentage points to 7.4 percent, and the average inflation rate declined about 5 percentage points to 4.2 percent, reflecting the weight of conservative German monetary policies within the EMS. This is consistent with the view that maintaining fixed exchange rates has constrained EMS member countries in conducting divergent monetary policies.

In terms of fiscal policy, however, there is little evidence of any convergence associated with EMS participation. The standard deviation of general government budget deficits as a percent of GDP in member countries remained unchanged between 1975–1978 and 1987–1990 (see Chart 1). Moreover, average general government budget deficits as a percent of GDP

Chart 1

Fiscal Surpluses in EMS and Floating Rate Countries as Percent of GDP



decreased less than ½ percent between these two periods to 4.4 percent. (See Chart 1.) Thus the move to greater exchange rate stability within the EMS, as well as the convergence to greater price stability and lower money growth, does not seem to have provided effective constraints or incentives to lower fiscal deficit variability.

Further light on the relationship between monetary and exchange rate regimes and convergence is shed by comparing the experience of the initial EMS members with a representative group of other industrial countries that followed flexible exchange rates for most of the 1980s, including the U.S., Japan, U.K., Canada, Australia, and Switzerland. For flexible rate countries there is little evidence of monetary convergence during the past decade; broad monetary growth rates actually diverged further (although convergence toward a lower common inflation rate occurred). Also in contrast with the EMS, these countries experienced a greater degree of fiscal convergence. Average general government deficit positions in the flexible rate countries declined by more than 2 percentage points between 1975–1978 and 1987–1990, improving to a small surplus of 0.4 percent of GDP. Moreover, the standard deviation of the budget surplus measure of the flexible rate group was only half of that of the EMS group during the 1987–1990 period. Thus, compared to floating rate countries, the members of the EMS appear to have experienced less movement towards fiscal convergence.

Fiscal convergence in quasi-monetary unions

The exchange rate–monetary relationship of Germany, the Netherlands, and Austria can be characterized as a quasi-monetary union. The exchange rate between the DM and the Dutch Guilder has been the most stable within the EMS: Between 1979 and 1984 the bilateral nominal exchange rate was realigned by more than 2 percentage points only twice, and the exchange rate has been virtually unchanged since 1984. Outside the EMS, even greater stability has been evident in the exchange rate relationship of Germany and Austria. Since 1980 the Austrian National Bank has followed a pure peg against the DM, successfully keeping the schilling within a very narrow band around the DM. These relatively stable exchange rate relationships have been maintained by closely aligned monetary policies. Dutch and Austrian short-term interest rates have typically moved in step with Germany's.

In 1978 all three countries had roughly similar general government budget deficits of around 2½ percent of GDP. Despite participation in a quasi-monetary union, however, the budgetary positions in Germany, the Netherlands, and Austria, in fact, have widened in the past decade. Germany's deficit peaked at 3.7 percent in 1982, and then gradually fell through the end of the decade until a small surplus of 0.2 of GDP was recorded in 1989. (The costs of reunification with East Germany in 1990 resulted in a reversion to large deficits.) Like Germany, the Dutch government's financial borrowing as a percentage of GDP peaked in the early 1980s. However, the Dutch government had much less success in reducing its fiscal spending (in part due to the loss of natural gas revenues in the mid 1980s); only once since 1981 have Dutch deficits fallen below 5 percent of GDP. Government deficits in Austria also have followed a different pattern from those in Germany. They declined somewhat in 1978–1981, rose intermittently in 1982–1987 to a peak of 4.3 percent of GDP, and again declined in 1988–1990.

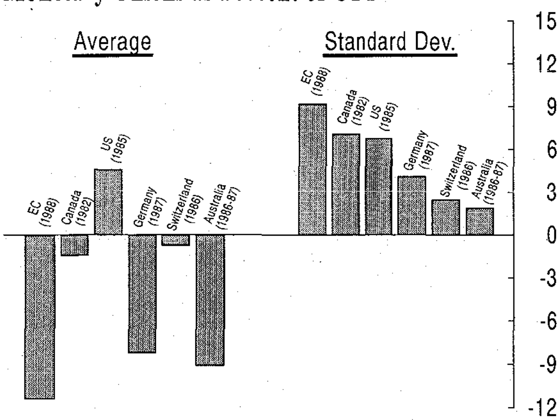
The wide differences in the current fiscal positions of these three countries indicate that their quasi-monetary union relationship has resulted in little if any fiscal convergence.

Fiscal convergence in full-fledged monetary unions

What has been the degree of fiscal convergence within full-fledged monetary unions? Studies by De Grauwe (1990) and Lamfalussy (1989) show that the average budget deficits of the member states or provinces in monetary unions with a single independent central bank, such as the United States, Germany, Canada, Australia, and Switzerland, have tended to be lower than the average deficit among countries in the European Community (EC). The comparison also indicates that the standard deviation of budget deficits of states or provinces within monetary unions tended to be somewhat smaller than that of countries in the EC. (See Chart 2.) This suggests prohibiting the central bank of a monetary union from financing member government deficits contributes to lower average deficit levels and deficit variability. Nevertheless, the result that the standard deviation of deficits within full-fledged monetary unions is nonzero suggests that member states still retain some autonomy over setting budget deficits over the short and medium term.

What is the evidence on the need for additional fiscal policy rules within full-fledged monetary unions? Among the countries shown in Chart 2, only Australia and Germany have centrally imposed fiscal rules. In Australia permanent federal

Chart 2
Fiscal Surpluses Across Member States in Monetary Unions as Percent of GDP



controls limit state borrowing. In Germany, the Länder are constitutionally bound (except under special circumstances) to limit their borrowing to the financing of investment. In contrast, deficit spending by Canadian provinces and Swiss cantons is not subject to legal constraints. Similarly, there are no centrally imposed constraints on state borrowing in the U.S., although restraints are usually self-imposed via state constitutions or statute. There is no evidence that Canada, Switzerland, and the U.S. have had higher average budget deficit levels among their states than states in Australia and Germany have had. This suggests that prohibiting the central bank of a monetary union from financing member state fiscal deficits suffices to ensure budget discipline—that is, additional centrally imposed binding fiscal rules are not essential.

Implications

The empirical evidence suggests that fixed rate regimes and quasi-monetary unions do not provide strong pressure toward fiscal convergence in the short to medium term. Although some budget consolidation occurred in the original EMS members since the late 1970s, even greater reductions in budget deficits were generally observed in countries with flexible rate regimes. Moreover, the divergence in fiscal positions among EMS countries did not narrow despite more than a decade of commitment to a fixed exchange rate regime. Evidence on countries in quasi-monetary unions (Germany, the Netherlands and Austria) also points to wide divergences in budgetary positions.

However, the experience of member states in full-fledged monetary unions, such as the United States, Germany, Canada, Australia, and Switzerland, suggests that centrally imposed fiscal rules are not necessary for the success of monetary unions. In particular, member states in monetary unions generally experience relatively low budgetary deficits even without federal constraints on spending and borrowing. Significant divergence in the budgetary positions of member states was also observed, consistent with the view that discretion in the conduct of short-term fiscal policy need not be disruptive in monetary unions.

Interpreted most broadly, this evidence suggests that the "excessive deficits procedure" adopted in Maastricht may be unnecessary to ensure the success of a European monetary union. Interpreted more narrowly, it suggests that the criteria of the "excessive deficits procedure" are overly rigid in setting specific constraints on the levels of debt and deficits of member governments. Requiring governments to balance budgets over longer periods may provide a better criterion that would permit greater short-term flexibility in exercising fiscal policy. This is particularly desirable in view of the fact that monetary union membership limits the independent exercise of other policy instruments, such as monetary or exchange rate policy.

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