COMMITTEE FOR THE STUDY OF ECONOMIC AND MONETARY UNION

1st February 1989

Please find attached two notes by M. Lamfalussy, which are submitted for consideration by the Committee in its forthcoming discussions. The first note contains a proposal for organising monetary policy co-operation in Stage II of the process towards economic and monetary union. The second note deals with issues relating to fiscal policy co-ordination in an economic and monetary union.

Confidential

31st January 1989

The need for co-ordination of fiscal policies in a European Economic and Monetary Union

At our February meeting we shall be discussing the need for co-ordination of fiscal policies in a European EMU - a topic, obviously, of major political importance. To help us in our discussions, I have asked a member of the Monetary and Economic Department of the BIS (Dott. C.E.V. Borio) to prepare a note containing both a review of fiscal policy arrangements in a number of federal states and an analytical assessment of the pros and cons of fiscal policy co-ordination within a European EMU as seen by a professional economist - a standpoint which is not necessarily that of our Committee, but which we should nevertheless bear in mind. Dott. Borio's paper is attached.

To contribute to our discussion, here are my own reflections, prompted by reading Dott. Borio's paper.

1. The experience of federal states in the field of fiscal policy co-ordination is of relevance for our discussion, but this relevance is limited by significant differences between a potential European EMU and the cases examined in the note.

There have been no large and persistent differences in the fiscal behaviour of member states in the various federations (though Canada may be regarded as a possible exception), despite the absence of any strictly imposed rules of conduct. I suspect that much of this practical convergence has to do with tradition and history.

This is in contrast with European tradition and history. With widely divergent "propensities to run deficits" prevailing in the various European countries, I doubt whether we could count in the foreseeable future on a convergence within a European EMU similar to that observed in most contemporary federal systems. Nor do I believe that it would be wise to rely principally on the free functioning of financial markets to iron out the differences in fiscal behaviour between member countries: (a) the interest premium to be paid by a high-deficit member country would be unlikely to be very large, since market participants would tend to act on the assumption that the EMU solidarity would prevent the "bankruptcy" of the deficit country; and (b) to the extent that there was a premium, I doubt whether it would be large enough to reduce significantly the deficit country's propensity to borrow. There is, therefore, a serious risk that, in the absence of constraining policy co-ordination, major differences in fiscal behaviour would persist within a European EMU. This would be one contrast between most contemporary federal systems and a European EMU.

The other is equally striking and even less conjectural. This is the fact that the Community budget will, in the foreseeable future, remain a much smaller proportion of total public spending in Europe than the federal budget as a percentage of total public expenditure in other contemporary federal systems.

2. The combination of a small Community budget with large, independently determined national budgets leads to the conclusion that, in the absence of fiscal co-ordination, the global fiscal stance prevailing within the EMU would be the accidental outcome of decisions taken by member states. This boils down to saying that there would simply be no Community-wide macro-economic fiscal policy.

Two concerns emerge from this conclusion.

Firstly, the only global macro-economic tool available for the regulation of domestic demand within the EMU would be the common monetary policy implemented by the European central banking system. Even within a closed economy, this would be an unappealing prospect both in conditions of overheating and, equally, when the economy was in recession. In the first case, interest rates might have to be pushed to a level that would put far too much of the burden of adjustment on investment, rather than on consumption, and could at the same time be detrimental to financial stability. In the second case, the stimulation of domestic demand might require money creation at a rate that would be incompatible with the longer-run objective of preserving price stability.

Secondly, such a situation would appear even less tolerable once the EMU was regarded as part and parcel of the world economy, with a clear obligation to co-operate with the United States and Japan in an attempt to preserve (or restore) an acceptable pattern of external balances and to achieve exchange rate stabilisation. To have the smallest chance of reaching these objectives, all co-operating partners need flexibility in the fiscal/monetary policy mix - as we have so often told the United States.

In short, it would seem to me very strange if we did not insist on the need to make appropriate arrangements that would allow the gradual emergence, and the full operation once the EMU is completed, of a Community-wide macro-economic fiscal policy which would be the natural complement to the common monetary policy of the Community.

3. The likelihood that, in the absence of fiscal policy co-ordination, large and sticky differences in national fiscal policies would persist raises two additional concerns, which would differ according to the stage reached in our progress towards a fully-fledged EMU.

If we were still at stage 2, the greater part of the burden of trying to respect the stricter intra-Community exchange rate commitments would have to be borne by the monetary policies of individual member countries. We are quite familiar with this problem today within the ERM, but the task in stage 2 would be even harder to fulfil and failure to succeed would have much more devastating consequences for the whole integration exercise than it would today.

If we had reached the stage of irrevocably locked exchange rates, the emergence, or the persistence, of a significant public sector borrowing requirement in one or more of the member countries would mean that real interest rates would be higher in the other member countries than they would otherwise have been. Private investment in these countries would thus be "crowded out" by the fiscal policies of the deficit countries. This could lead not only to the emergence of intra-EMU political tension, but also to pressure on the federal monetary authority to relax monetary policy.

4. Fiscal policy co-ordination would therefore seem to be an indispensable component of a European EMU. Such co-ordination would have to be conceived and implemented with two objectives in mind:

- to allow the determination of a global fiscal policy stance in a way that is sufficiently adjustable to changing domestic and international requirements; and

- to avoid excessively large differences between the public sector borrowing requirements of individual member countries.

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Confidential

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Monetary policy co-operation in Stage Two

We have so far had little discussion - except in our tour de table on Governor Ciampi's note - on Stage Two, in general, and on its monetary policy component, in particular. The attached paper contains a proposal submitted to the Committee for organising monetary policy co-operation in a way which, in my view, could make a useful contribution to progress in such co-operation during that Stage.

This proposal is based on certain assumptions and premises concerning Stage Two:

- it is assumed that the Treaty is ratified and that the policy concertation carried out by the Committee of EEC Governors during Stage One has yielded results;

- in the monetary field, Stage Two is supposed to go beyond Stage One in three important respects: (a) at least the embryo of a federal central banking structure should be put in place; (b) while the final word on the conduct of monetary policy would remain with the monetary authorities of the member states, there should be a visible further strengthening in the co-ordination of national monetary policies; and, similarly, (c) while it would still be possible to alter intra-Community exchange rates, there should also be visible progress in co-ordinating intervention policy in the exchange markets;

- progress in these three areas should be such that it prepares the ground for stepping into Stage Three - i.e. the irrevocable locking of exchange rates and the full operation of a federal central banking system.

I can think a priori of three routes that could be followed, with these premises in mind, to enhance monetary policy co-operation during Stage Two. These three routes may be regarded as separate alternatives but could also be combined.

The first is the gradual but formal transfer of decision-making power from the monetary authorities of the member countries to the federal central banking system. This would seem to be the most logical procedure, but probably also the most difficult one to realise in practice: the "indivisibility" argument demonstrates the difficulties inherent in the gradual transfer of decision-making power; at the same time, there are wide differences among member countries as to who is responsible for monetary policy decisions.

The second alternative - exemplified by Governor Ciampi's proposal - would set up a formal system of federal monetary control. I see two advantages in this approach: firstly, it creates a framework which gives a measure of flexibility for handling the problem of power transfer (member countries would retain the freedom to choose their own monetary policy stance by changing their exchange rate vis-à-vis the ECU); secondly, the system could be operated in a way that gave it a conservative, anti-inflationary bias. The main problem is that the proposal provides for a monetary-base control technique which, if it is to be operated without too many problems in terms of collective decision-making, lacks the flexibility that, in my view, is much needed in today's innovative, highly mobile financial markets (for example, to respond speedily and effectively to exchange rate tensions both within the Community and vis-à-vis third currencies).

The attached note, drafted at my request and under my guidance by [redacted], of the Monetary and Economic Department of the BIS, presents a third type of proposal, the essence of which is the centralisation of money and exchange market operations in a new, jointly owned institution without any transfer of authority to a collective body. The problem of the explicit transfer of authority is thus bypassed and no formalised system of federal monetary control is proposed. The centralisation of operations, however, (a) could have a powerful demonstration effect, (b) would provide a highly efficient training ground for, and a strong practical stimulus to, the implementation of joint monetary policy and exchange market intervention, and (c) would imply the setting up of an institutional framework that could evolve gradually towards a fully-fledged federal central banking system, as envisaged in Stage Three.

Whichever route, or whichever combination of routes, the Committee may want to favour, I believe that a distinct Stage Two is necessary if we want to fulfil our mandate (which talks specifically about practical steps - in the plural - towards an EMU) and that a report by a Committee in which central bank Governors form a majority cannot be credible unless it puts forward fairly specific technical proposals (even if only in a summary form) for monetary policy co-ordination at that Stage.

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