

The relationship between monetary policy and fiscal policies in the euro area

This article addresses the interactions between the single monetary policy and fiscal policies in the euro area. These interactions relate to the fact that both types of policy have an impact on key macroeconomic variables, and this in turn creates interdependencies in the pursuit of policy objectives. On the one hand, fiscal policy influences price developments, real interest rates and risk premia, as well as aggregate demand and potential output, all variables which need to be systematically taken into account by a monetary policy that focuses on price stability. On the other hand, monetary policy has an impact on, inter alia, short-term interest rates, inflation expectations and the risk premia incorporated in long-term yields which in turn affect the economic environment in which fiscal policy operates.

Given these interdependencies, there is a need for an institutional framework to govern the interactions between monetary policy and fiscal policy. In this respect, monetary policy has the mandate to maintain price stability, given that this is the only objective monetary policy can be expected to deliver in the long run. At the same time, it is important that monetary policy be granted full independence in the pursuit of this objective, so that it can be shielded from possible short-term political interests of governments. On the other hand, fiscal policies must provide a stable and predictable environment in which markets can operate efficiently and, as part of overall governance, foster public confidence and political consensus. In this respect, frameworks based on clear mandates and rules reflect a macroeconomic policy design that is generally preferable to the ad hoc discretionary co-ordination of day-to-day policy action in the face of shocks. Indeed, the discretionary or ad hoc co-ordination of policy actions has proved to be largely inefficient, if not actually counterproductive. This is because the discretionary co-ordination of policies always gives rise to implementation problems and incentive distortions for the actors involved.

The institutional framework of the euro area, founded on the Treaty and complemented by the Stability and Growth Pact, is designed to take the above considerations into due account. It assigns clear objectives and priorities to individual policy-makers and, together with its provisions for monitoring, sets proper incentives for them all to pursue and meet these objectives. (For a comprehensive discussion of the institutional macroeconomic framework in EMU see the article entitled “The economic policy framework in EMU” in the November 2001 issue of the ECB’s Monthly Bulletin).

I Introduction

Monetary and fiscal policies influence key macroeconomic variables, and this in turn creates interdependencies in the pursuit of policy objectives. On the one hand, fiscal policy affects the allocation of resources between the public and private sectors, as well as within the private sector itself, and has an impact on the incentives to consume, save and invest and thus on potential output and the business cycle. Fiscal policy can thereby influence price developments, real interest rates and risk premia. All these variables need to be systematically taken into account by a monetary policy that focuses on price stability. On the other hand, the monetary policy regime in place is a fundamental determinant of short-term

interest rates, inflation expectations and the premium that is incorporated in long-term yields to compensate for the risk of inflation variability. In addition, monetary policy can have a temporary impact on real economic activity and thereby, indirectly, on short-term developments in public revenue and expenditure. In all these ways, monetary policy exerts an influence on the macroeconomic environment in which other policy-makers operate.

Against this background, it is natural that the relationship between monetary policy and fiscal policy – the so-called “policy mix” – has always attracted attention in academic circles as well as in the policy debate. However, the

way economic thinking has analysed these interactions has evolved significantly over the last few decades. Until the early 1970s it was maintained that the impact that one policy could have on the other policy's sphere called for a joint, co-ordinated approach to business-cycle stabilisation. Both policies were regarded as powerful instruments to be implemented for the appropriate management of aggregate demand and the systematic promotion of economic growth. Fiscal policy was viewed as the dominant force in the determination of aggregate demand. At the same time, for many years mainstream monetary theory was based on the notion that it was possible for monetary policy to permanently raise output and employment at the cost of a limited sacrifice in terms of inflation. In this way, the view was often held that monetary policy could systematically assist the stabilising efforts of fiscal policy and, if needed, accommodate its financing necessities with only limited consequences for monetary stability. The interactions between the two policies were at that time primarily studied within a static model in which the level of output in the face of economic shocks was determined by the fiscal response, while monetary policy had responsibility for the composition of demand. Little or no attention was paid to the incentives driving policy-makers and to the role played by private sector expectations in determining the ultimate macroeconomic outcomes.

This paradigm was strongly challenged in the face of the macroeconomic policy failures of the 1970s. It became increasingly manifest that the systematic efforts to sustain demand by means of repeated fiscal impulses and to exploit the assumed trade-off between output and inflation were responsible for the persistently high inflation, rising unemployment and economic distress of the decade. Consequently, a new paradigm has since gradually established itself in line with the re-affirmation of the classical tenets of economic theory. This theory places the formation of private expectations at the

centre of economic analysis. It stresses that agents optimise their behaviour over time in anticipation of future economic developments, including the expectation of future policy actions. In the field of monetary-fiscal policy co-ordination, the emphasis has shifted away from the joint design of short-term policy responses to shocks towards the establishment of a non-discretionary, rule-based regime capable of providing monetary and fiscal policy-makers with a time-consistent guide for action and thus a reliable anchor for private expectations.

This article discusses the interactions between monetary policy and fiscal policy from the point of view of the new paradigm. It argues that the most effective solution to the problem of optimal macroeconomic policy design is the establishment of a regime which gives a clear and consistent allocation of mandates and objectives to the various policy-makers, includes rule-based and transparent frameworks and procedures, and in which monetary policy and fiscal policy are offered steady guidance for action, while short-sighted behaviour is discouraged. Within such a regime, provided it is appropriately designed and applied, the response of monetary policy and fiscal policy to changes in the economic environment will – almost by design – be mutually consistent and conducive to achieving the best macroeconomic outcome. Therefore there will generally be no need for further co-ordination of day-to-day policy moves. Under these conditions any further benefits to be had from the joint design of policy responses to shocks can only arise if the objectives assigned to the various policy-makers are misaligned and incoherent. However, if this is the case, the solution lies in an explicit realignment of objectives rather than in a common and co-ordinated response to shocks. The latter option would lead to confusion over policy spheres and hinder the accountability of the responsible policy-makers thus aggravating incentive distortions.

2 Economic considerations on the design of the monetary and fiscal policy regime

It is a fundamental principle that individual policies should be assigned only to those macroeconomic objectives that they can attain. In this context, it is now generally recognised that, given the neutrality of monetary impulses in the longer term, monetary policy cannot increase real output beyond the level that is determined by technological progress and the fundamental factors underlying economic decisions. These factors are rooted in individual preferences and incentives to work, to save, to invest and consume, and to assume risk, all of which are independent of the price level. Monetary activism aimed at modifying the long-term growth path of the economy would then be a counterproductive exercise. In fact, any systematic attempt by the monetary authority to fine-tune economic activity could easily destabilise inflation expectations and heighten uncertainty, thereby increasing the perceived risks associated with economic undertakings. Instability of the general level of prices would call for costly precautionary measures on the part of savers and lenders, which would reduce the amount of funds available for allocation to productive uses. It would also introduce inefficient variations in aggregate employment and output and a number of distortions in the composition of demand. Thus, viewed from a longer-term perspective, monetary fine-tuning is detrimental to the economic prospects of society. By contrast, an environment of price stability fosters the workings of the mechanism determining relative prices, favours allocation efficiency and, by anchoring inflation expectations, reduces market uncertainty and the risk premia included in long-term nominal contracts. As such, price stability is regarded as the foundation of a well-functioning market economy, and the best contribution that monetary policy can make to economic welfare.

On the fiscal side, it has been acknowledged that the scope for systematic, discretionary demand management aimed at steering short-

term economic activity is very limited. First, the intrinsic lags and uncertainties of the political process together with the lags with which, for example, a discretionary increase in government spending or a cut in taxes impacts on aggregate demand, and the substantial uncertainty about the magnitude of the economic response to the fiscal stimulus, make counter-cyclical fiscal policy a difficult and risky practice. Second, while fiscal instruments can be important tools in smoothing incomes across macroeconomic fluctuations, there is a risk that public debt burdens could grow from one business cycle to the next. Such a “deficit bias” typically originates from the fact that the political process is at times dominated by short-term considerations and goals associated with electoral cycles and pressures to further the interests of specific and well-organised groups. A relatively easy way for fiscal authorities to accommodate possibly conflicting demands on limited available resources is to finance expenditure by debt, thereby shifting the financing burden to future generations of taxpayers. In ageing societies, this may additionally lead to a build-up in the implicit liabilities of public pension systems. Such growing fiscal imbalances are indeed associated with large welfare costs. Unsustainable public finances limit the scope and effectiveness of fiscal policies to stabilise the economy, and increasing expenditure and debt ratios lead to rising tax burdens – current or future – that generate mounting efficiency losses due to distortionary taxation. In addition, drifting debt burdens can gradually crowd out the private accumulation of productive capital and depress economic growth in the medium term.

Growing awareness of the limitations associated with macroeconomic fine-tuning has led to a worldwide trend towards the adoption of more rule-based institutional frameworks. The purpose of such an approach to economic policy is twofold: first, to provide authorities with specific

mandates, i.e. clearly identified policy objectives, in order to set proper incentives at the decision-making level and ensure predictability of policy; second, to provide responsible authorities with guidance on the appropriate setting of their instruments in the face of constantly changing economic developments, in such a way as to keep the path of their action through time as consistent as possible with the long-term attainment of their policy objective. While these frameworks include certain “rules”, these need not normally be fully specified reaction functions, i.e. contingency plans prescribing the setting of policy instruments as a function of an exhaustive list of possible events. Instead, they ought to impose a rule-governed behaviour which disciplines policy-makers’ decisions to make them consistent through time. Such behaviour fosters trust in the economic institutions and promotes productive investment (see also the article entitled “Issues related to monetary policy rules” in the October 2001 issue of the ECB’s Monthly Bulletin).

In this environment, it becomes easy for the general public to assess policy moves and keep authorities under continuous scrutiny. To the extent that authorities’ actions can be seen to match systematically their professed commitments, private agents can continue to trust in a stable economic climate and can confidently factor it into their economic plans. By contrast, signs of systematic and unmotivated deviations will be sanctioned by a change in expectations and a loss of confidence. Such monitoring by the public requires a transparent setting in which policy moves and economic outcomes can be attributed to single policy-makers; thus public accountability is fully operative.

All this offers a strong argument for a clear delimitation of policy domains and spheres of responsibility across the various authorities, and it suggests that proper incentives should be set and the scope for conflicts and the confusion of responsibilities minimised. Obviously, objectives and instruments must be assigned to the various policy-makers in a

consistent manner, so as to ensure that the ultimate macroeconomic outcome is the best possible.

These general principles of macroeconomic governance have far-reaching implications for the relations between monetary policy and fiscal policy. First, maintaining price stability or keeping inflation low and stable has become the primary objective of monetary policy. To this end, central bank independence has been recognised as an indispensable instrument for the maintenance of a central bank’s control over the price level in the medium term. Second, it has become evident that sustainable public finances make an important contribution to an efficient inter-temporal allocation of resources. Given the influence that the level and structure of taxes and government expenditure exert on economic activity, a medium-term orientation of fiscal policies should guarantee the sustainability of public finances and allow the operation of automatic stabilisers. This implies that, in discharging its task of smoothing the profile of incomes over the business cycle, fiscal policy has to ensure that its response to shocks is symmetric. Rule-based fiscal policies can contribute to achieving these objectives and, thereby, also contribute to long-term income growth, employment and welfare more generally (see the articles entitled “Fiscal policies and economic growth” and “The operation of automatic fiscal stabilisers in the euro area” in the August 2001 and April 2002 issues respectively of the ECB’s Monthly Bulletin).

Central bank independence and fiscal rules

Price stability is regarded as a common good and an indispensable precondition for long-term prosperity. It is therefore in the interest of society to delegate the pursuit of price stability to an independent central bank that stands above the fray of day-to-day politics. Indeed, the move towards central bank independence in recent years has mainly taken place in response to concerns that monetary

policy may become subject to pressures originating from the fiscal side. One important reason for these concerns is the presence of the deficit bias in the political process discussed above.

Given that this bias exists, fiscal authorities may at times be tempted to influence monetary policy to reduce the cost of borrowing and thereby alleviate the burden of accumulated debt. In fact, retaining some form of control over the setting of the interest rate used by the central bank for its monetary operations may become the key to a policy of systematic debt financing. A central bank that is not equipped with institutional safeguards is likely to succumb to these attempts, and an inflation bias will result. Economic history supports this view. Many episodes of runaway inflation which were experienced in continental Europe in the early 1920s had their ultimate origin in a “contamination” of budgetary and monetary policies. Moreover, the fact that the monetary authorities were not sufficiently protected from the financing needs of the public sector was at the root of the prolonged era of high and unstable inflation which ensued in a number of European countries after the first oil price shock of the early 1970s.

The appropriate design of frameworks for monetary and fiscal policy is one way in which society has insured itself against persistent inflation and the macroeconomic disruptions inflicted by discretionary monetary policy and disorderly public finances. On the monetary side, one provision that can constitute a standing guarantee that the central bank retains effective control over its policy instruments is the full independence of its decision-making process, and thereby a clear and definitive prohibition of the monetary financing of budget deficits. Only an independent central bank that can, at any time, reject requests for the direct monetary funding of budget deficits is capable of retaining lasting control over the money supply and, thereby, the price level in the medium term.

On the fiscal side, procedures and objectives limiting, in one way or another, the pace at which government liabilities can grow in proportion to the size of the economy are extremely important and have therefore also gained increasing prominence over time. While these rules normally preserve a degree of flexibility for governments to cope with unexpected and extraordinary events, the general principle on which they are founded is to make the link between the expansion of spending programmes and the need to raise taxes to fund them evident to both policy-makers and the public. In this context, a constitutional limit on the government’s power to run a deficit gives policy-makers a stronger incentive to evaluate alternative spending plans more carefully in order to maximise the expected social benefit, taking into account the need to finance expenditure through revenues. By contrast, in the absence of any binding constraint on the amount of resources that the government can borrow, the need to finance disbursements entirely through taxes would be deferred to some point in the future. In these conditions, the incentives for governments to follow a policy that seeks to improve society’s welfare in the future may be rather less compelling.

Principles for fiscal policy in a monetary union

Distortions in fiscal incentives can be exacerbated in the context of a monetary union among sovereign states. Greater recourse to capital markets by national governments to finance an increasing debt level will ultimately affect financial market conditions in the area as a whole. Such spill-over effects are generally transmitted via higher long-term interest rates through the whole currency area, as expansionary fiscal policy in one country and the drain that this exerts on union-wide private savings put pressure on the cost of long-term finance in all constituent countries. Since the size of the overall financial market is large, the impact of an increase in the debt level of any individual member on its own refinancing conditions is

normally much smaller than it would be in the absence of a monetary union. Indeed, while such spillover effects are also possible across independent currency areas, they are more direct and immediate in a monetary union, given the single currency (and the irrevocably fixed exchange rates) and the higher degree of integration between national financial markets. Therefore, in monetary unions sovereign issuers receive stronger incentives to engage in debt financing because the impact of higher liabilities in the form of higher real rates is not entirely borne by those authorities which embark on fiscal expansion, but more widely shared by all their fellow participants in monetary union.

These incentive problems cannot be countered fully through market mechanisms. Financial operators have improved their ability to assess the country-specific credit risk of major borrowers, which normally results in higher national risk premia for those authorities that depart from a sound policy course. This type of market discipline is welcome, as it tends to discourage deviation from fiscal discipline by individual governments and provides the latter with further incentives to conduct sustainable policies. This notwithstanding, market mechanisms alone can only to a limited extent prevent national issuers from running up excessive deficits.

The arguments expounded above explain why a monetary union needs commonly shared rules of fiscal restraint and the appropriate enforcement and monitoring mechanisms. One such important safeguard is represented by rules which ensure that fiscal policies remain sound over the business cycle. Indeed, the experience of federal states has shown that balanced budget provisions or restrictions to the maximum size of the fiscal deficit that local authorities can run have proved instrumental in keeping the public finances of the general government under control. Also important is the obligation on the national fiscal authorities not to bail each other out in the event of national financial distress. Under this provision none of the

participating countries can be held responsible for the debt of any other government should funding difficulties manifest themselves. Such supranational rules facilitate the conduct of policy by individual governments, avoid moral hazard problems, and thus inspire mutual trust among members.

The rationale for mutually consistent objectives

Monetary and fiscal rules of the sort described above ensure that the long-term policy objectives assigned to individual policy-makers are duly internalised in their decision-making process, and systematic divergences from the intended policy course are avoided. They provide a clear demarcation of the domains in which individual policies can operate freely in the pursuit of their goals and can be easily assessed by the public. However, while necessary, these elements may not be sufficient for an efficient macroeconomic outcome, as the assigned objectives also need to be consistent.

Past experience shows that when monetary and fiscal authorities have conflicting objectives and preferences, the interaction of their responses to economic shocks may result in undesirable macroeconomic outcomes. This situation could materialise, for example, in cases where the monetary and fiscal authorities have differing views about the level of output that is sustainable in the medium term and that is thus consistent with lasting conditions of price stability. Using simple stylised models of the monetary-fiscal policy interactions, it can be shown that if the level considered desirable in the short term by the fiscal authority were to be in excess of true potential growth, a lack of co-ordinated action may translate into deteriorating public finance conditions and higher inflationary pressures; these pressures in turn lead monetary authorities to engineer a rise in real interest rates. In these conditions, co-ordinated policy action would appear in some models to be an

attractive solution. A joint setting of policy instruments would seem capable of overcoming the individual policy-makers' failure to factor into their respective moves the likely reaction of the other policy-makers in a way that could exploit the close interdependencies of the two distinct policy spheres. However, this conclusion would be flawed. It is apparent that, as the possible source of disruption lies in a misalignment of policy objectives, the remedy should be sought in an appropriate correction of this misalignment. In a situation of conflict between objectives or between views about the fundamental workings of the economy, recourse to active co-ordination would simply entrench and prolong an institutional problem that should instead be tackled at root.

The problems of ad hoc co-ordination

However, even if policy objectives are fully aligned, there are compelling arguments for avoiding recourse to the active co-ordination of monetary policy and fiscal policy in demand management. These arguments are related to the existence of significant implementation problems. In practice, the enhanced co-ordination of policy moves would be fraught with information, incentive and enforcement problems. In general, the existence of pervasive uncertainty and imperfect information about the state of the economy and future developments makes it difficult for policy-makers to agree upon and implement on a case-by-case basis co-ordinated policy plans in an effective and timely manner. The effective pursuit of such policies would require the nature of the shocks affecting the economy to be identified and, even more importantly, an agreement on a proper macro model in order to trace exactly their propagation pattern and quantify the

magnitude of the most appropriate policy response. Since it is difficult to identify correctly the nature of shocks and agree on their propagation over time and possible spillovers of joint policy actions, as well as to reach a common understanding of the "true" model of the economy, the pursuit of active policy co-ordination can often be counterproductive. This problem is exacerbated by the inherent difficulties for both monetary and fiscal policy to fine-tune economic developments.

However, more importantly, incentive and enforcement problems undermine the viability of active ad hoc co-ordination. First, there is a strong risk that, by blurring their respective responsibilities, policy-makers' incentives and/or ability to deliver on their specific objectives are weakened and the possibility for the public to hold them accountable is diminished. Second, the lack of appropriate instruments to monitor and implement co-ordinated actions in a way that would keep the policy-makers involved faithful to the agreed sequence of moves would make those incentive problems all the more severe. In the absence of enforcement mechanisms, such a policy framework would not be credible and would likely remain largely ineffective.

In conclusion, there are significant risks implicit in the design of concerted ad hoc policy interventions. Notably, the severe information, incentive and enforcement problems which undermine the viability of policy co-ordination strongly argue in favour of establishing *from the outset* mutually consistent frameworks and principles constraining the behaviour of single authorities. Under these conditions, individual authorities are provided with a stable environment in which there is no need for ad hoc agreements on specific courses of action.

3 The institutional setting for Economic and Monetary Union – Treaty foundations and practical conduct of policy

The Treaty establishing the European Community builds on the principles of sound macroeconomic governance described in the preceding section. It lays down a solid institutional foundation for economic policy-making in Europe. The specific design of Economic and Monetary Union, established by the Treaty, transfers the competence for monetary policy to the Community level while leaving the responsibilities for fiscal as well as other economic policies in most respects in the hands of the national authorities. In all fields, the Treaty sets up a clear allocation of policy responsibilities based on a set of shared objectives and guiding principles for the conduct of policies in Europe, notably stable prices, sound public finances and sustainable non-inflationary growth (Articles 2 and 4 of the Treaty).

For monetary policy, an independent central bank has been established to serve the primary objective of price stability. This aims, *ceteris paribus*, to ensure that economic shocks with an inflationary or deflationary potential receive a timely and appropriate monetary policy response. Such a stability-oriented framework removes one primary cause of economic instability. On the fiscal side, where the Treaty is complemented by the Stability and Growth Pact, disciplined fiscal policies anchored to the principles of medium-term close-to-balance or in-surplus budgetary positions and the avoidance of excessive deficits minimise the risk of macroeconomic instability stemming from the disturbances that are generated by unsustainable fiscal policies. Central bank independence and budgetary rules are therefore mutually reinforcing elements in this framework with a view to ensuring macroeconomic stability.

The Treaty foundations

The importance of price stability for the efficient functioning of the market mechanism implies that, within the single market, a stability-oriented monetary policy is a

common public good to be provided in a uniform manner by an independent central bank. The Treaty unambiguously assigns the Eurosystem (the ECB and the National Central Banks which have adopted the euro) and the single monetary policy the primary objective of maintaining price stability in the euro area (Article 105).

To ensure that this mandate can be fulfilled effectively, the Treaty assigns considerable independence to the Eurosystem and the members of its decision-making bodies. Article 101 stipulates that the monetary financing of public deficits is forbidden, and Article 108 safeguards independence in every respect, i.e. from an institutional, personal, functional and financial point of view (see also the article entitled “The institutional framework of the European System of Central Banks” in the July 1999 issue of the ECB’s *Monthly Bulletin*). The Treaty not only specifies that the Eurosystem and the members of its decision-making bodies shall not seek to take instructions from Community institutions or bodies, from any government of a Member State or from any other body, it also symmetrically states that “Community institutions” and “any government” undertake “not to seek to influence the members of the decision-making bodies of the ECB”.

The Treaty does not refer to any type of active policy co-ordination between monetary policy and fiscal policy. On the contrary, it clearly separates a Chapter on “monetary policy” from a Chapter on “economic policies”. At the same time, the Treaty takes into account interdependencies between policies. Article 105 states that the Eurosystem shall “implement the monetary policy of the Community” and “support the general economic policies in the Community”. This formulation suggests that the Eurosystem shares the objectives of the Community. The latter include “a harmonious, balanced and sustainable development of economic

activities, a high level of employment [...], sustainable and non-inflationary growth [and] a high degree of competitiveness and convergence of economic performance” (Article 2). However, the general mandate to support “general economic policies” contained in the second sentence of Article 105.1 is qualitatively different from the Eurosystem’s primary and direct obligation to maintain price stability. For practical and political economy reasons, which have been discussed in the previous section, the Treaty does not give the ECB direct responsibility for any additional objectives other than price stability. In particular, the Treaty does not refer to “secondary objectives” of the ECB or the Eurosystem. Rather, the Treaty requires that the Eurosystem take into account other Community objectives in the pursuit of its primary objective.

The Treaty also reflects the experience that budgetary rules may be needed as an additional safeguard for protecting the economy against the risks resulting from unsound fiscal policies. Notably, excessive budget deficits are to be avoided (Article 104). In addition, the “no bail-out” clause, which stipulates that neither the Community nor any Member State is liable for or can assume the debts incurred by any other Member State (Article 103), imposes further incentives on the part of national fiscal authorities to preserve budgetary discipline. In this respect, high government debt cannot be inflated away, nor can a government that does not stick to the rules rely on being eventually bailed out by other governments. Thus, in the current institutional framework, individual governments cannot shift part of the burden of high government debt to other parts of the euro area. In this way, it also ensures that unsound fiscal policies in one country will tend to lead to higher risk premia for the debt of that country and not for the debt of other countries. This in turn increases the incentives for fiscal discipline at the national level. The box entitled “The European framework for fiscal policies” reviews the main features of the institutional framework regulating fiscal policy in the EU.

The current fiscal regime focuses fiscal policies firmly on long-term objectives and should therefore make the path of fiscal policy through the business cycle more predictable. This regime, which is conducive to a sound fiscal policy, at the same time contributes to making the task of the central bank easier. The institutional provisions on public finances aim to free the conduct of fiscal policy at the national level from the impediments that have often tied governments’ hands in the past. Within the current institutions, governments are in a position to regain control over instruments of income smoothing and automatic stabilisation that they had largely lost in the face of spiralling debt burdens, rising costs of debt funding and increasing rigidities in the management of their budgets. Provided budgets are balanced on average over the cycle, built-in stabilising mechanisms can be left to work and act as efficient forces to counter economic hardships.

Within this overall institutional framework, conflicts and overlaps of competencies in the conduct of the single monetary policy and in the design of fiscal policies are avoided and responsibilities are clearly assigned to the ECB on the one hand and to fiscal policy-makers on the other. Thus, incentives for all policy-makers are properly established and genuine accountability is ensured.

Exchange of information between the ECB and other policy-makers

The ECB communicates through the public appearances of its representatives and through its publications which systematically provide an assessment of the economic situation together with explanations for monetary policy decisions. Thereby all policy-makers, including fiscal authorities, are given all the information they need to understand and thus anticipate monetary developments, including the responses of monetary policy to developments in fiscal and structural policies (see the Article entitled “Transparency in the monetary policy of the

ECB” in the November 2002 issue of the ECB’s Monthly Bulletin).

Moreover, since the ECB is part of the overall economic policy framework, additional channels of communication in the form of constructive and open exchanges of information and views with other policy-makers have been established. Owing to the fact that structural and fiscal policy measures may influence, *inter alia*, short-term price developments, supply conditions and the transmission mechanism of monetary policy, there can be economic advantages to be had from the ECB participating in exchanges of information and views about the current economic situation and fiscal and structural policies between the policy-making bodies of the European Union.

Conversely, the President of ECOFIN and a representative of the Commission can regularly participate in meetings of the Governing Council of the ECB (Article 113.1). In this way, ministers and the Commission are systematically kept aware of the broad orientation of monetary policy. Furthermore, a number of arrangements have been made for informal exchanges of information between the ECB and the Commission and ministers in meetings of the Eurogroup and in the context of the Macroeconomic Dialogue.

For its part, the ECB is well informed of current and planned fiscal policy measures through the fiscal programmes discussed in the context of the euro area surveillance exercises. The credible implementation of the Stability and Growth Pact and fully functioning surveillance and co-ordination procedures contribute to making budgetary behaviour both more reliable and more predictable.

This institutional framework thus provides for a fruitful exchange of information while ensuring the mutual respect of the independence of all parties, without any commitment or mandate to take and implement joint decisions in an active and pre-agreed manner. At the same time, it helps

to enhance mutual understanding of the policy objectives, responsibilities and behaviour in the respective policy areas and thus assists in achieving Community objectives in an efficient way, while not blurring policy responsibilities or weakening democratic accountability (see also the Article entitled “The accountability of the ECB” in the November 2002 issue of the ECB’s Monthly Bulletin).

The ECB has further specified the terms of the monetary policy framework by announcing a quantitative definition of price stability. With this announcement the ECB has defined a yardstick against which others can expect it to act and against which its performance can be assessed. Furthermore, the ECB has announced how it intends to assess risks to price stability within the framework of its monetary policy strategy. This helps other policy-makers to form expectations about its policy moves in the face of new economic developments. The ECB has illustrated its monetary policy strategy in detail and systematically provides explanations of monetary policy decisions. In this context, it has been made clear how monetary policy will respond to economic developments, including fiscal and structural policies. Obviously, monetary policy actions are always conditional on the prevailing economic climate and on the nature and magnitudes of economic shocks that are expected to affect price stability. Thus, any statement about the monetary policy response in this respect must always be subject to an “all other things being equal” qualification, and there can never be a one-to-one response pattern of monetary policy to fiscal (or structural) policy. However, the ECB’s mandate and its strategy provide a binding framework within which policy responses have to be framed and pursued. Monetary policy can react to fiscal policies (and structural economic reform). However, the extent of such reaction is determined by the effects of these measures on risks to price stability, and occurs within the limits that are dictated by the need to preserve price stability over the medium term.

It is also important for all policy-makers to be aware that the ECB has made it clear that it reacts differently to different shocks. In this respect, there is typically no conflict between pursuing its objective and avoiding unnecessary volatility in economic activity. This is most evident in the case of demand shocks. As these shocks tend to move inflation and output in the same direction, a stabilising reaction on the part of the ECB will normally also have the positive side effect of counteracting the movements in output. A more complex task is for monetary policy to determine the appropriate response to forces which move inflation and output in different

directions, such as cost-push shocks. In these circumstances, the ECB will need to focus on its primary objective as there is always a risk of propagation of these price disturbances through the economy to the point where they may become entrenched in wage and price-setting behaviour. However, the ECB has made it clear that it will pursue its objective with the appropriate medium-term orientation. This normally implies that the ECB will have scope for a more measured response to such shocks, which, in turn, will avoid introducing unnecessary volatility in real activity.

4 Conclusions

It is now widely acknowledged that institutional regimes in which monetary policy and fiscal policy are disciplined by clear mandates and transparent medium-term oriented frameworks generally represent a policy approach to the optimal design of macroeconomic policy that is preferable to the ad hoc discretionary co-ordination of day-to-day policy action in the face of shocks. Within such a regime the behaviour of monetary policy should be determined by a transparent monetary policy strategy which allows other policy-makers to foresee and take into account in their actions the likely way in which the central bank will respond to new developments – including monetary policy reactions to structural and fiscal policies. Such a framework provides a stable and reliable environment in which the single monetary policy and the national fiscal policies in the euro area can interact harmoniously, markets can operate efficiently and, as part of overall governance, these policies can foster public confidence and political consensus. By contrast, an active co-ordination of discretionary policy actions in the face of shocks does not seem warranted. Co-ordination of policy actions

is likely to result in reduced welfare due to implementation problems, incentive distortions and lack of transparency.

All the institutional preconditions for a stable currency and for steadily improving the prospects for long-term economic growth are in place in Europe today. The Treaty establishing the European Community provides an efficient assignment of objectives with a clear, sound allocation of responsibilities to individual policy-makers. This assignment makes active policy co-ordination of monetary and fiscal policy redundant. An independent central bank like the ECB, which is prohibited from monetary financing of government deficits, can thus consistently reassure private agents and markets that governments will not eventually resort to inflation as a way of solving fiscal imbalances. The Treaty's fiscal provisions, including the "no bail-out" clause, limit the risk of unsustainable fiscal positions building up. Through all these provisions, the Treaty sets the right incentives for policy-makers to design and implement the policies for which they are responsible.

Box

The European framework for fiscal policies

The European framework for fiscal policies preserves national responsibility for fiscal policy-making but makes this subject to clearly defined rules and procedures. This framework guarantees the sustainability of public finances and allows fiscal policies to play a stabilising role. It is based on the Treaty establishing the European Community and on the Stability and Growth Pact.

The Treaty establishing the European Community

Article 104 of the Treaty states that “*Member States shall avoid excessive government deficits*”. Compliance with this requirement is assessed on the basis of two criteria:

- the general government deficit ratio should remain below the 3% of GDP reference value or should have declined substantially and continuously and reached a level that comes close to the reference value;
- the government debt ratio should remain below the 60% of GDP reference value or should be sufficiently diminishing and approaching the reference value at a satisfactory pace.

If a country does not fulfil the requirements under one or both of these criteria, the Council may decide that an excessive deficit exists, on the basis of a procedure involving the European Commission and the Economic and Financial Committee. At the same time, the Council makes a recommendation to the Member State concerned with a view to bringing that situation to an end. Sanctions may be applied should the excessive deficit persist. The Treaty allows the reference value for the deficit ratio to be exceeded only when the excess over the reference value is “exceptional” and temporary, and the ratio remains close to the reference value.

The Stability and Growth Pact

The Stability and Growth Pact¹ requires that countries attain the “medium-term objective for the budgetary position of close to balance or in surplus”. As stated by the European Council, “adherence to the objective of sound budgetary positions close to balance or in surplus will allow all Member States to deal with normal cyclical fluctuations” without breaching the 3% of GDP reference value. The Stability and Growth Pact specifies that an excess over the 3% of GDP deficit limit is considered “exceptional” when resulting from an unusual event outside the control of the Member State concerned and which has a major impact on the financial position of the general government, or when resulting from a severe economic slowdown. The Stability and Growth Pact sets out the steps of the excessive deficit procedure and specifies when an early warning should be given. It also reinforces multilateral surveillance by requiring that the euro area countries submit stability programmes, and the other EU countries convergence programmes, on a yearly basis.

Fiscal sustainability and flexibility

Compliance with the Treaty guarantees budgetary discipline, thereby securing the sustainability of public finances. Compliance with the Stability and Growth Pact ensures that the necessary room is created for fiscal policies to let the automatic stabilisers operate throughout the business cycle without breaching the 3% of GDP reference value, thereby contributing to the stabilisation of the economy. In this way, by adhering to the Pact, fiscal policies can make a positive contribution to macroeconomic stability.

The Treaty refers to the government deficit ratio in nominal terms for detecting excessive deficits, and the Stability and Growth Pact also requires the annual budget targets in the stability and convergence programmes

¹ The Stability and Growth Pact consists of Council Regulation (EC) no. 1466/97 and Council Regulation (EC) no. 1467/97, complemented by a European Council Resolution adopted on 17 June 1997.

to be formulated in nominal terms. However, in its monitoring and surveillance of budgetary developments, the Commission and the Council need to assess the targets and outcomes in the light of cyclical conditions.

Recent discussions

The European framework for fiscal policies is currently being put to the test. Several euro area countries have been unwilling to honour their commitments to respect the rules, with the result that these countries have recorded or will record budgetary deficits above or close to the 3% of GDP reference value. Accompanying the fiscal deterioration, weaknesses in the existing surveillance mechanism have also become apparent. These developments have threatened to undermine confidence in the existing fiscal framework. Some initiatives have therefore been taken to renew commitment to consolidation and improve the implementation of the Stability and Growth Pact.

Eurogroup renews commitment to consolidation

In October 2002, following disappointing news on budgetary developments, the Eurogroup renewed its commitment to the Stability and Growth Pact and expressed its hope that progress could be made towards fiscal consolidation in those countries with remaining imbalances. For these countries, the Eurogroup agreed on the need for a clear consolidation strategy requiring the continuous adjustment of the underlying (i.e. cyclically adjusted) balance by at least 0.5% of GDP per year. Ministers committed themselves to proposing realistic adjustment paths in the next updates of their stability programmes, based on realistic assumptions on the economic outlook and the measures specified. Furthermore, the finance ministers underlined that the procedures for preventing and correcting excessive deficits must be implemented in a strict and timely manner.

Commission Communication emphasises implementation

In November 2002 the Commission released a communication in which it re-affirmed that the Stability and Growth Pact remains the appropriate framework for the conduct of budgetary policies. The Communication also advanced a number of proposals to improve the implementation of the Stability and Growth Pact, which could mostly be realised within the existing institutional provisions. These proposals emphasise re-prioritising consolidation (assessed in cyclically adjustment terms), preventing pro-cyclical policies in upturns, and putting more emphasis on the sustainability and quality of public finances. To attain these objectives, political commitment is essential, but the analysis of budgetary developments also needs to be based on improved budgetary statistics and strengthened surveillance mechanisms.