

ARTICLES

FISCAL POLICY INFLUENCES ON MACROECONOMIC STABILITY AND PRICES

This article explores the main influences of fiscal policies on macroeconomic stability and price developments. It discusses a number of reasons why a fiscal policy orientation towards preserving stable economic conditions, both in the short and long term, is the most suitable one. The European fiscal framework provides an appropriate institutional setting for achieving these conditions.

As to the short term, fiscal policies that allow the operation of automatic stabilisers normally contribute to smoothing economic fluctuations. Macroeconomic stability can also be promoted by tax and benefit systems which provide the right incentives for agents to adapt flexibly to changing economic circumstances, and by expenditure policies that facilitate an efficient economic structure. In contrast, discretionary fiscal fine-tuning has often proven to have pro-cyclical effects and led to higher fiscal deficits over time. As to the longer term, sound fiscal policies guarantee the sustainability of public finances and thus enhance a macroeconomic environment that promotes higher economic growth and price stability. In this respect, a rules-based framework is conducive to maintaining fiscal discipline while also supporting economic stabilisation. Such a framework also makes fiscal policy predictable for economic actors.

The ECB's monetary policy takes the influences of fiscal policies into account, primarily in its economic analysis but also in its monetary analysis. Ultimately, the conduct of a stability-oriented monetary policy is very much facilitated by sound fiscal policies.

I INTRODUCTION

It is a fundamental economic principle that macroeconomic policies should be assigned those objectives that they can attain best. Monetary policy and fiscal policy both have an impact on key macroeconomic variables. It is now widely recognised that, given the neutrality of monetary impulses for economic growth 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. At the same time, an environment of price stability fosters the workings of the mechanism determining relative prices, which favours allocation efficiency. By anchoring inflation expectations, such an environment also reduces market uncertainty and the risk premium included in long-term nominal contracts. Price stability is regarded as the foundation of a well-functioning market economy, and the best contribution that monetary policy can make to economic prosperity.

From the perspective of a central bank whose primary objective is to maintain price stability,

the focus of the analysis of fiscal policies is naturally on their influence on macroeconomic stability, because this defines the environment in which monetary policy has to operate. In the short term, fiscal policies can contribute to macroeconomic and price stability, particularly through their stabilising impact on the disposable income of households via taxes and unemployment benefits, and through their effect on the price level and price formation. In the longer term, fiscal policies that guarantee the sustainability of public finances, and thus enhance macroeconomic stability, also contribute to an economic policy environment that is conducive to price stability.

In the course of the last few decades, there has been a shift in the prevailing views in Europe about how fiscal policy should contribute to macroeconomic and price stability. Thirty years ago the prevailing opinion was that fiscal policy could be fine-tuned to steer the course of the economy in the short term and, consequently, maintain macroeconomic stability in the long term. At present, the consensus is that such fiscal policies can fail on both accounts. They can destabilise the economy in

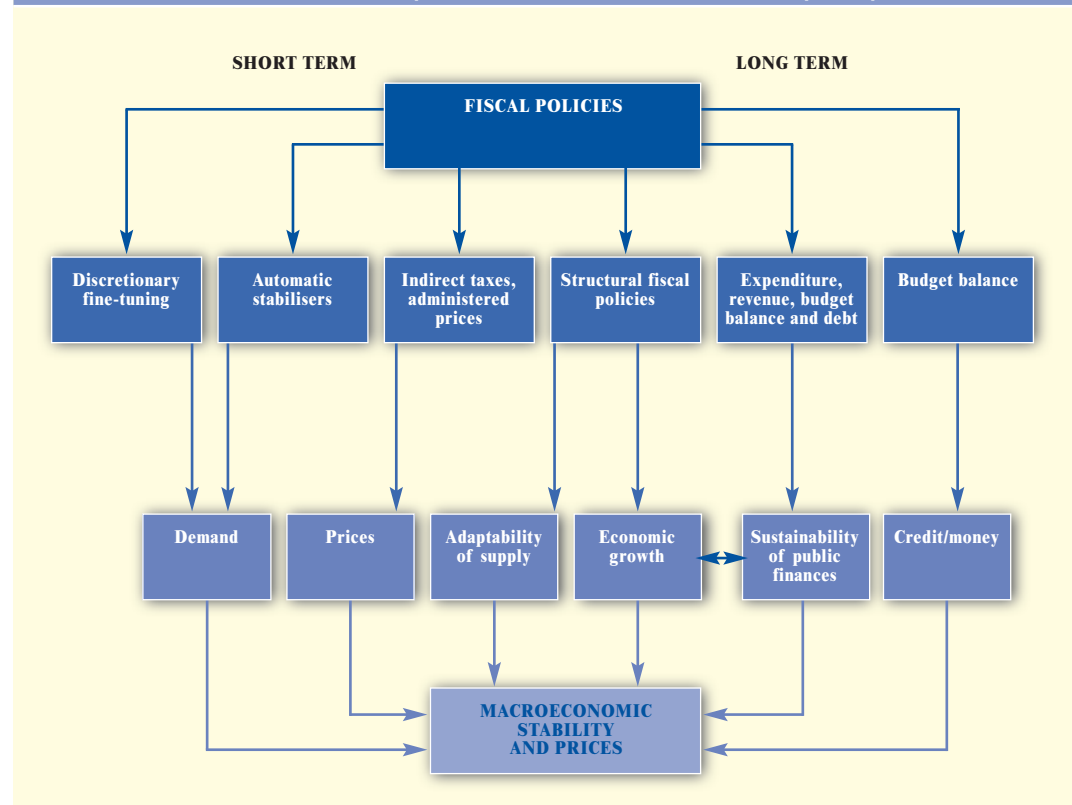


the short term and erode the sustainability of public finances and undermine macroeconomic stability in the long term. In contrast, the prevailing view now leaves the smoothing of income fluctuations in the short term to the operation of the automatic stabilisers. Automatic stabilisers are changes in government revenue and expenditure that arise automatically, without discretionary policy intervention, from the impact of cyclical fluctuations. Discretionary measures, on the other hand, are active changes to government revenue or expenditure. Such measures nowadays are not considered useful for the purpose of managing aggregate demand but rather are justified by the need to preserve the sustainability of public finances in the long term and by the necessity of raising potential economic growth. Both automatic stabilisation and sustainability-oriented discretionary fiscal policies provide a predictable and stable

environment for economic agents to implement welfare-improving actions. Moreover, an appropriate set of fiscal policy rules and institutions is seen as essential to generate a favourable fiscal policy environment, notably in a monetary union with decentralised fiscal policy-making. The chart below contains a simplified presentation of the main channels from fiscal policies to macroeconomic stability and prices that will be explored further in the text.

In the next two sections of this article, the influences of fiscal policies on macroeconomic stability and prices in the short and long term are examined. The role of fiscal rules and a discussion of the main features of the EU fiscal framework are presented in Section 4. The conduct of monetary policy in this framework is explained in Section 5, while the last section summarises the main conclusions.

Chart 1 Main channels from fiscal policies to macroeconomic stability and prices



2 SHORT-TERM FISCAL INFLUENCES

Macroeconomic stability improves social and economic welfare by reducing fluctuations in income and consumption. There are three main channels through which fiscal policies can affect the short-term environment for monetary policy. First, fiscal policies may affect economic growth and prices via discretionary fine-tuning measures, i.e. active changes to government revenue or expenditure aimed at stabilising the economy. Second, the free operation of automatic stabilisers can contribute to reducing short-term volatility. Third, governments have some instruments at their disposal that have a quick or even immediate effect on price developments, such as rates of value added tax.

Turning first to discretionary fine-tuning measures, standard theory suggests that deficit-increasing measures will have a positive effect on macroeconomic growth and price developments in the short term. A loosening budget stance due to stimulating measures may, under certain assumptions, increase aggregate demand and result in upward pressure on prices. The effects on activity and prices depend on various factors, including the precise measures taken, the degree of capacity utilisation, the level of competition, and expectations about fiscal sustainability.

Attempts by governments to use the demand effects of fiscal measures to reduce output volatility have, however, had disappointing results. Lags between identifying the need for measures and their effective operation are long, causing measures aimed at boosting economic activity to be effective often in economic upturns, and vice versa. Thus, discretionary demand management may be a source of destabilisation rather than moderating economic fluctuations. More pronounced business cycles due to pro-cyclical fiscal policies may, in turn, be reflected in larger price fluctuations. Moreover, the conduct of fiscal policy over the cycle often turns out to be asymmetrical. A policy of increasing deficits in a recession by introducing stimulative measures is usually easily adopted, but policy reversals in

periods of above-average economic growth are more difficult to implement. As a result, government deficit and debt ratios are generally at a higher level after a full business cycle, reducing the sustainability of public finances. Thus, while benefits to short-term macroeconomic stabilisation may be limited, fine-tuning may turn out to have adverse longer-term consequences.

The usefulness of anti-cyclical demand management is further put in doubt by the recognition of the non-Keynesian expansionary impact of consolidation efforts (see Box 1). It has long been known that fiscal multipliers – measuring real GDP effects of a one percentage point change in a government budget item – vary depending on circumstances. The literature on non-Keynesian effects highlights even more the difficulty of predicting demand effects of fiscal policies.

The free operation of automatic stabilisers is the second channel through which fiscal policies can contribute to short-term macroeconomic stability. In a recession, deficits increase automatically on account of lower tax revenues and higher unemployment benefit expenditure. Automatic stabilisers help to dampen cyclical demand fluctuations, and thus contribute to reducing price volatility.

Compared with a discretionary policy aimed at economic stabilisation, a major advantage of relying on automatic stabilisers is that flexibility of government revenues and expenditures is built into the fiscal structure. Automatic stabilisers are thus timely as no active decisions have to be taken that could delay the implementation of measures and their stabilising effects. For the same reason, they are also more predictable than discretionary fine-tuning, allowing agents to better form expectations. Furthermore, the stabilisation properties of the budget operate symmetrically over the cycle. Also, the changes in the automatic stabilisers are proportionate; the larger the economic fluctuations, the larger the induced changes in the budget. Finally, relying on automatic stabilisers reduces the need for

NON-KEYNESIAN EFFECTS OF STRONG FISCAL CONSOLIDATIONS

The prescriptions of the traditional Keynesian model are sometimes at odds with historical experiences. The debate on non-Keynesian effects started when fiscal consolidation processes, such as in Denmark (1983-1986) and Ireland (1987-1989), suggested that contractionary policies might prompt expansionary effects on economic activity which outweigh the potential recessive effects triggered by a reduction in public spending or an increase in taxes.¹

Expansionary effects of fiscal consolidation

Academic literature has highlighted a number of channels through which fiscal consolidation might lead to less detrimental or even favourable effects of budget retrenchment on economic activity.

On the demand side, contractionary fiscal policies might reduce the risk premia paid on interest rates by increasing confidence in government solvency, particularly in countries with high debt ratios. A decline in interest rates would directly stimulate aggregate demand via investment. Expansionary effects on private consumption via so-called Ricardian effects are also possible. Large fiscal consolidations could signal future lower tax burdens, which would lead to an increase in the expected lifetime income of economic agents. Therefore, when governments are committed to fiscal discipline in a credible way, economic agents may expect higher wealth over their life cycle, which may also spur demand in the short term.

On the supply side, expansionary effects are also possible when fiscal contractions contribute to improving the economy's competitiveness. In particular, if fiscal consolidation can induce moderating effects on wage demands, relative unit labour costs might fall, with positive medium-term effects on GDP growth via higher profits and exports. A reduction in social benefits may also have expansionary supply-side effects via enhanced incentives to work.

Main empirical results

A large body of literature has examined the experiences of fiscal consolidation that have taken place in OECD countries over the past three decades in order to determine the size and sign of fiscal multipliers. The approach adopted usually focuses on specific episodes of fiscal consolidation in various countries, so as to identify the transmission channels of potentially expansionary fiscal retrenchment. This approach has a number of limitations, such as some arbitrariness in defining a "fiscal episode" and not taking into account the effects of non-fiscal factors, like devaluations and accommodating monetary policies.

Several studies provide evidence suggesting that fiscal consolidation may have non-Keynesian effects.² Crucial aspects of budgetary adjustments for determining possible expansionary effects on economic activity are their size, persistence, composition, the speed of

1 See F. Giavazzi and M. Pagano (1990), "Can Severe Contractions be Expansionary? Tales of Two Small European Countries", NBER Macroeconomic Annual, 5, pp. 75-111.
2 An overview of this literature is given in European Commission (2003), "Can Fiscal Consolidation in EMU be Expansionary?", Report on Public Finances in EMU, Brussels.

implementation, and the initial state of public finances. However, conclusions differ as to the relative importance of the various aspects of a budgetary adjustment. There is broad agreement that an expenditure-based adjustment tends to be more growth-friendly and lasting than a tax-based adjustment without expenditure retrenchment. Large initial fiscal imbalances and sizeable adjustments may contribute to the expansionary effects of a fiscal tightening.

frequent changes to tax rates, and thus may foster the predictability of the tax system and, thereby, also long-term growth.¹ Studies covering European countries indicate that, on average, automatic stabilisers reduce output fluctuations in the euro area by around 25% to 35%.² Therefore, automatic stabilisation has many advantages over discretionary fine-tuning.

Finally, some government measures have a direct impact on price developments in the short term. They do not primarily operate via changes in aggregate demand, although they may affect real macroeconomic developments via second-round effects. Changes in indirect tax rates, such as value-added, tobacco or energy taxes, feed quickly into prices. The size and timing of the effect on prices depends on a possible shifting of the burden and on second-round effects. For example, an increase in rates of value-added tax may not affect the price level by the full magnitude in a weak economic environment, where it may not be fully passed on to consumers. Adverse second-round effects on inflation could arise if price changes are not perceived as having a one-off effect on the price level but raise inflationary expectations and create upward pressure on wages and on prices. Governments also set administered prices, especially in areas with a public service character.³

While changes in indirect taxes and administered prices represent important channels running from fiscal policies directly to prices, other fiscal measures can also have an impact on prices and price formation. For instance, price liberalisation in previously government-controlled sectors, such as energy, water and telecommunications, have often

caused downward changes in prices, reflecting the introduction of competition. Other examples include wage increases in the government sector that may indirectly affect prices because of their impact on private wage negotiations, and changes in direct tax rates or social security contributions that feed into unit labour costs and prices.

3 LONG-TERM FISCAL INFLUENCES

The main longer-term effects of fiscal policies on macroeconomic stability occur via their impact on the sustainability of public finances and on potential economic growth.

Fiscal sustainability denotes a government's ability to pay for its outstanding obligations. A measure which is commonly applied to gauge sustainability is the ratio of public debt (possibly including contingent liabilities) to GDP. An alternative measure that is sometimes applied is the ratio of debt service costs to total revenue. The higher these ratios and the less favourable the expected future dynamics are, the more significant the concerns about fiscal sustainability are.

Fiscal sustainability impacts favourably on expected macroeconomic stability, as economic

1 More information on automatic stabilisers can be found in the article entitled "The operation of automatic fiscal stabilisers in the euro area" in the April 2002 issue of the ECB's Monthly Bulletin.

2 See, for instance, P. van den Noord (2000), "The Size and Role of Automatic Stabilisers in the 1990s and Beyond", OECD Economics Department Working Paper, No. 230.

3 The box entitled "The impact of developments in indirect taxes and administered prices on inflation" in the January 2004 issue of the ECB's Monthly Bulletin provides some quantitative information on the importance of these factors for euro area inflation in recent years.

agents will not expect the government to raise taxes or default on its obligations. A stable macroeconomic environment provides a proper framework to enhance confidence and facilitate long-term decision-making among economic agents in the private sector. This applies in particular to private investment decisions.

Concerns about the sustainability of current fiscal policies may be reflected in the general level of interest rates in the economy. While current fiscal policies may affect interest rates through increased demand for funds, an additional effect may arise from anticipated deficits and debts. These can give rise to increases in credit, inflation and exchange rate risk premia which will, in turn, worsen the financing conditions for government debt, and thus the deficit and debt dynamics. In an extreme case, financial instability could arise from a lack of fiscal discipline and lead to concerns about government solvency, with potentially more devastating effects on macroeconomic stability.

Unsustainable public finances may also reduce the scope and strength of the short-term stabilising effects of fiscal policy. High government deficits and debts reduce the fiscal room for manoeuvre of governments to take action when needed, such as in a severe economic recession. Furthermore, private agents take into account longer-term developments in current decisions. Concerns about unsustainable public finances may lead consumers to offset anticipated tax increases through their saving behaviour. As a result, a fiscal stimulus may lead to a lower than expected rise in aggregate demand and could even be fully offset by additional private savings. By contrast, increased trust in the sustainability of public finances may be reflected in greater economic confidence, boosting the economy via higher private consumption and investment.

Turning to the second channel through which fiscal policies may affect the longer-term macroeconomic environment, fiscal measures

have the potential to increase the trend economic growth rate compatible with price stability. Higher economic growth can be promoted by improving the quality of public finances. Tax rates and the tax structure have an impact on incentives to work, save, invest and innovate. Lower tax rates may increase after-tax returns on these economic activities, thus providing incentives to economic agents to increase the supply of such activities. Government expenditure on physical and human capital can improve the quality of production factors.⁴

Structural reforms of government finances can not only raise the potential growth rate of the economy, but can also contribute to reducing short-term fluctuations. This is particularly the case for reforms that intensify competition in product and labour markets, and reduce potentially harmful distortions caused by various forms of government intervention (taxes, subsidies, capital transfers, loans, guarantees, public procurement, etc.). Such reforms therefore reduce nominal and real rigidities, which facilitate the absorption of economic shocks. As a result, the amplitude and persistence of economic fluctuations may decrease. Quicker and stronger adjustment in product and labour markets can also contribute to lower inflation volatility and lower inflation persistence.

Long-term growth and fiscal sustainability are closely intertwined and can reinforce each other. Sustainable public finances create a macroeconomic environment in which uncertainty about long-term macroeconomic developments is reduced and confidence increases. This can have favourable effects on interest rates and financing conditions which, in turn, contribute to longer-term decision-making and lift the growth potential of the economy. At the same time, a higher economic growth

⁴ For a comprehensive discussion of the role of fiscal policies in promoting growth, see the article entitled "Fiscal policies and economic growth" in the August 2001 issue of the ECB's Monthly Bulletin.

rate raises the financing basis of government activities, thus reducing sustainability concerns about public finances.

Short-term stabilisation and sustainability considerations are also closely interlinked and provide some guidance for the design of fiscal reform. Discretionary measures aimed at improving fiscal sustainability and macroeconomic stability in the longer term, be they via budgetary consolidation measures or reforms to improve economic efficiency, need proper financing to maximise their effect. Expenditure restraint is more likely to be growth-friendly and to produce lasting budgetary improvements than tax increases, as mentioned in Box 1. Expenditure-based measures boost confidence in sound public finances and favourable economic and financing conditions in the future which, in turn, also positively affect demand in the short term. The packaging of fiscal measures aimed at enhancing growth is also important. Financing tax-reducing measures through lower non-productive expenditure is the consolidation strategy most likely to produce favourable medium-term macroeconomic effects. It may improve the quality of public finances while avoiding increases in distortive taxes. Attempts to boost fiscal sustainability through tax increases are likely to be detrimental to potential growth, given the distortive nature of taxes and the already high level of taxes in the euro area. As a result, the financing base for government operations may increase less in the case of tax-based consolidation, thus not contributing as much to restoring fiscal sustainability as would be possible via expenditure restraint.

4 THE ROLE OF FISCAL RULES

While achieving long-term sustainability of public finances and allowing for a free play of automatic stabilisers is key to macroeconomic and price stability, the approach used to attain these objectives also matters. After presenting the main benefits of a rules-based strategy in fiscal policies, this section discusses the strategy adopted for the EU fiscal framework.

From the government's intertemporal budget constraint, it follows that sustainability requires all debt to be covered by future primary (i.e. excluding interest expenditure) surpluses. However, this condition is not sufficiently specific to anchor expectations about the future course of fiscal policies, as governments can promise to cover current high debts with large primary surpluses in an ever more distant future. This leaves agents with much uncertainty as to whether, by the time required, action will be taken as promised.

Setting fiscal policy according to a rule (or set of rules) gives agents more certainty that fiscal policy will remain on the "right" course, and thus facilitates longer-term planning in the private sector. Fiscal policy that is set according to a pre-determined rule gives the fiscal authorities a clear mandate, discouraging short-sighted behaviour that could lead to short-term gains but longer-term costs. It gives guidance to governments on how to act in the face of inevitable changes in the economic environment, and on how to keep current policies in line with the longer-term policy objective. As a consequence, the rules also give the public a basis on which to set expectations about government behaviour. If this behaviour is in line with the rule, it will foster trust in sound policies in the future and promote an economic climate of stability and confidence. Fiscal institutions can thus play a major role in supporting the medium-term orientation of budgetary policies. Via the design of rules, the focus on fiscal sustainability issues can be institutionalised.

The benefit of fiscal policies along such lines is even greater in a monetary union such as EMU, with a single centralised monetary policy and decentralised fiscal policies, than in a single country case. In the context of a monetary union among sovereign states, distortions in fiscal incentives can be exacerbated. The impact of an increase in the debt level of any individual member on its own refinancing conditions is much smaller than it would be in the absence of a monetary union. Indeed, while such spillover

effects from high debt levels to interest rates in other countries are also possible between independent currency areas, they are more direct within a monetary union, given the single currency and the higher degree of integration between national financial markets. This raises incentive problems for fiscal authorities which cannot be countered fully through market mechanisms.

While potentially constraining fiscal activism, a rules-based fiscal policy does not imply that discretionary fiscal policy measures are no longer necessary. Such measures may still be needed in order to achieve fiscal sustainability. Pursuing a rules-based fiscal policy provides a predictable and stable environment for economic agents to take their preferred course of action, leaving intact the principle of smoothing of income fluctuations in the short term by the operation of automatic stabilisers. Thus, instead of fiscal activism focusing on current developments, discretionary measures should aim primarily to improve the long-term soundness of public finances. As mentioned before, in order to achieve strong and lasting effects, measures should be expenditure-based.

Market forces by themselves are not sufficiently strong to ensure fiscal sustainability. A country with a non-sustainable fiscal policy will be faced with higher interest rates, which encourage it to restore sound public finances. However, uncertainty about the size and timing of interest rate increases raises serious doubts about the strength of this mechanism (see Box 2). Thus, market forces cannot be seen as a substitute for a rules-based fiscal framework, but they could complement and reinforce its working.

The need for an appropriate fiscal framework in Economic and Monetary Union is reflected in many provisions in the Maastricht Treaty. These rules are aimed at ensuring that fiscal policies remain sound, both over the business cycle and in the long term.

The fundamental fiscal rule of the Treaty is that Member States shall avoid excessive deficits.

Compliance with this rule for budgetary discipline is examined on the basis of government deficit-to-GDP and debt-to-GDP ratios. The deficit ratio should not exceed the reference value of 3% of GDP, unless it is expected to be temporary and has occurred under exceptional circumstances. In any case, the deficit has to remain close to the reference value. The government debt-to-GDP ratio should not exceed the reference value of 60% of GDP, unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace. While sustainability is related ultimately to developments in the debt ratio, close monitoring of, and setting limits on, the deficit-to-GDP ratio provides an additional safeguard against unsustainable policies. Examining both budgetary variables provides a useful cross-check of budgetary trends, as they are closely related but do not always provide the same information. Privatisations, for example, are not reflected in the officially recorded deficit according to European System of Accounts (ESA 95) standards, but do affect officially recorded debt.

In the Stability and Growth Pact, Member States have committed themselves to achieving a medium-term budgetary position of close to balance or in surplus.⁵ The medium-term nature of this goal allows for short-term fluctuations around that level (reflecting automatic fiscal stabilisers) without substantial risks of breaching the 3% of GDP reference value. It also leaves room for unforeseen adverse developments that are a source of variability and uncertainty in budgets. If a country has not yet reached a medium-term budgetary position of close to balance, automatic stabilisers can still be allowed to operate, provided that the medium-term consolidation path is appropriate and the free operation does not result in deficits above 3% of GDP.

⁵ The Stability and Growth Pact is described in more detail in the article entitled "The implementation of the Stability and Growth Pact" in the May 1999 issue of the ECB's Monthly Bulletin.

Box 2

FISCAL POLICIES AND MARKET DISCIPLINE

A basic issue in the policy debate on EMU has been whether monetary union requires a fiscal framework or whether capital markets exert sufficient disciplinary power on governments to allow for the proper functioning of a single monetary policy. It is generally assumed that capital markets put a default premium on government bond yields which rises in parallel with government debt, all else being equal. This premium is the price investors demand for possible losses from partial or total default, both on interest payments and principal repayment. Eventually, markets could even deny access to issuers for whom the credit risk becomes too high. Rising borrowing costs and the threat of losing market access should provide incentives for governments to exercise fiscal prudence.

The Maastricht Treaty contains various articles that are conducive to the operation of market discipline. These articles subject governments to clear restrictions limiting any preferred access to financing on capital markets. In particular, the Treaty precludes any direct financing of public entities by the ESCB (Art. 101), excludes any privileged access to financial institutions (Art. 102), and establishes a no-bail-out clause (Art. 103). The latter provision stipulates that neither the Community as a whole nor governments in Member States are liable for the commitments of other Member States, nor should they assume such liabilities. As a consequence, government financing in capital markets is in many respects subject to the same limitations and scrutiny as private borrowing.

Given these provisions, it has been questioned whether an EU fiscal framework based on fiscal rules is necessary to preclude excessive borrowing and possibly sovereign default. Although there is empirical evidence suggesting that government bond yields indeed tend to react to changes in expected future deficits and indebtedness, this reaction is not necessarily smooth and predictable. Risk premia may remain small as long as credit risk remains within a certain range, and then be abruptly readjusted when new information is forthcoming or the market view on the sustainability of a country's public finances changes. Under these circumstances, the sudden increase in borrowing costs can even contribute to the unfolding of a crisis and create a self-fulfilling prophecy. The occurrence of actual sovereign defaults indicates that markets have not always been able to operate as a pre-emptive force.

Policy-makers may have more immediate domestic concerns which distort their view of borrowing costs or default risk. They may also operate in an environment that creates stalemates and inertia which complicate a timely adjustment to a looming default crisis. Pre-empting such a situation may therefore be necessary. The EU fiscal framework includes such a pre-emptive device. Compliance with the commitments under the Stability and Growth Pact would foreclose any deficit bias in budgetary decision-making and would reassure markets that the long-term sustainability of public finances is safeguarded.

The medium-term orientation of the EU fiscal framework is also clearly present in the stability programmes that euro area countries have to prepare annually. Budgetary plans in these programmes should be specified with a horizon of at least three years. Furthermore, Member States need to provide summary information on the impact of demographic developments on public finances over a longer period in the annual updates of the programmes, whereas more detailed information should be included at least every three years. Although inevitably subject to considerable uncertainty, the exercise helps to focus on the need to preserve fiscal sustainability in the longer term.

5 MONETARY POLICY AND FISCAL POLICIES

All channels through which fiscal policies may affect inflation and economic growth need to be systematically taken into account by a monetary policy that focuses on price stability. In the framework of its monetary policy strategy, the ECB bases its policy decisions on a comprehensive analysis of risks to price stability, comprising an economic analysis and a monetary analysis.⁶

Obviously, monetary policy actions are always conditional on the overall prevailing economic environment and on the nature and magnitude of economic shocks that are expected to affect price stability. Thus, any statement about the monetary policy response to any such shock 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 any new development in isolation. However, the ECB’s mandate and strategy provide a clear framework within which policy responses have to be framed and pursued.

In the context of its monetary policy strategy, the ECB assesses the impact of fiscal policies on real interest rates, risk premia, aggregate demand conditions, long-term growth, monetary developments and, ultimately, risks to price stability. The fiscal stance is also taken

into account in the ECB’s assessment and the Eurosystem staff macroeconomic projections. The ECB also assesses direct pressure on price developments exerted by fiscal policy, for example, via indirect taxes and administered prices. Monetary policy cannot control such short-term price developments, but it has to closely monitor the risk that they may lead to second-round effects on wages and inflation expectations, making the impact on inflation more intrinsic. All other things being equal, expected pressures on inflation coming from these sources may imply temporarily higher short-term policy rates to maintain price stability over the medium term.

Longer-term fundamental trends in budgetary positions are crucial for the environment in which a central bank operates. Unsustainable public finances can create pressure on the central bank to ease the public debt burden. As this would create uncertainties among the public, it may complicate the conduct of monetary policy. One specific channel through which fiscal deficits may impact on monetary growth is illustrated in Box 3.

Monetary policy has to take into account the possible effects of fiscal policies. For example, non-disciplined fiscal policies can undermine confidence and thus reduce potential output and longer-term growth. Such an adverse effect on potential output can also be brought about by the distortionary effects which taxes may have on decisions concerning investment in physical and human capital, on saving and consumption, on labour supply and demand, and on the process of technological innovation.

The same applies in the opposite case, i.e. fiscal reforms that lead to lower current and future taxes in the euro area help to increase aggregate supply and thus potential output. With a higher level of sustainable long-term economic growth and lower public debt, the task of monetary

⁶ See the article entitled “The outcome of the ECB’s evaluation of its monetary policy strategy” in the June 2003 issue of the ECB’s Monthly Bulletin.

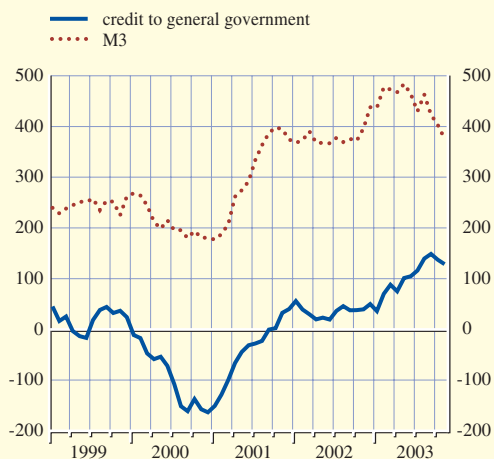
Box 3

THE RELATIONSHIP BETWEEN MFI CREDIT TO GENERAL GOVERNMENT AND BROAD MONEY

In its monetary policy strategy the ECB assigns a prominent role to money. Consequently, the ECB closely analyses developments in monetary and credit aggregates with a view to extracting information relevant for the conduct of a monetary policy that serves the objective of price stability. Particular emphasis is placed on developments in the broad monetary aggregate M3. Over the medium term, M3 growth has demonstrated a stable relationship with price inflation, subject to developments in other macroeconomic variables such as output and interest rates.

Chart Credit to general government

(annual flows in EUR billions)



Since the second half of 2001, M3 has expanded at a strong pace in the euro area. This was largely due to portfolio shifts from longer-term riskier assets into monetary assets in an environment of heightened economic and financial market uncertainties. In recent months, M3 growth declined, reflecting a gradual reversal of the portfolio shifts.

As regards credit to general government, a strong *prima facie* correlation appears to exist between credit extended by monetary financial institutions (MFIs) to general government and developments in M3. On the basis that monetary dynamics are associated with inflationary pressures over the medium term, this relationship suggests that larger fiscal deficits, and thus increased government borrowing from MFIs, might imply risks to

price stability through their impact on monetary developments and liquidity conditions.

The relationship between MFI credit to general government and M3 can be illustrated in the context of the consolidated MFI balance sheet. An increase in the credit extended to general government by MFIs (either in the form of loans or as purchases of government debt securities) will expand the asset side of the MFI balance sheet. All other things being equal, the accounting identity underlying the balance sheet implies that either another item on the asset side must shrink or the liabilities side of the MFI balance sheet must also expand, for instance, through an increase in M3 (which represents the largest component of MFI liabilities). In practice, most but not all increases in MFI credit to general government are – directly or indirectly – associated with a corresponding rise in M3. If MFIs buy government securities from resident households or firms, both credit to general government and M3 would rise by the same amount. In cases where MFIs grant loans to the central government, the link is more indirect. First, central government deposits which are not included in M3 would increase. However, as soon as these funds are used to pay the private sector (e.g. via wages or transfers), M3 will be affected. By contrast, if MFIs buy government securities from non-residents, M3 will not be affected at all. Instead, the increase in credit to general government will be associated with a decline in net external assets.

Of course, other counterparts of M3 on the MFI balance sheet will also change, so that the link between credit to government and M3 can be masked by other factors. For example, an increase in MFI credit to general government may be accompanied by a corresponding decline in credit to the private sector, leaving M3 unchanged. Alternatively, MFIs might fund their purchase of government securities by issuing long-term bank bonds, with the overall result being a rise in longer-term financial liabilities rather than an increase in M3.

The consequent absence of a mechanical link between credit to general government and M3 is also illustrated in the chart above. In the second half of 2000, the government sector repaid credit obtained from MFIs while M3 remained relatively stable. In recent months, the growth of M3 has moderated despite increased government borrowing from MFIs. Thus, over the short term, the correlation between MFI credit to general government and M3 is not always strong.

Looking beyond accounting identities, it is important to evaluate the behavioural relationships underlying the correlation between MFI credit to general government and M3. In some circumstances, MFI credit to general government and M3 may exhibit co-movement, as they both respond to a common stimulus. One example is the response to the slowdown in economic activity and the rise in economic and financial uncertainty in the second half of 2001. Government borrowing from MFIs increased as fiscal deficits rose, but the sharp increase in M3 growth was also due to portfolio shifts into safer and more liquid monetary assets. In other circumstances, MFI credit to general government may be the main driver of M3 growth. For example, a persistent and rising fiscal deficit financed by a trend increase in government borrowing from MFIs is likely to have an impact on M3 dynamics over the medium term.

As this box illustrates, the accounting and behavioural relationships between monetary dynamics and government borrowing from MFIs are complex. Overcoming these complexities to pick up the signals offered by monetary developments about the outlook for price developments over the medium term is central to the regular monetary analysis undertaken at the ECB. While shorter-term relationships may be hard to interpret, persistent large government borrowing from MFIs is likely to increase M3 growth and create excess liquidity which, on the basis of past experience, may pose risks to price stability over the medium term.

policy – to maintain price stability – would be easier and the economy as a whole would be able to enjoy prolonged periods of non-inflationary high growth.

aggregate level of activity and on prices. In the longer term, both fiscal sustainability and supply-side oriented reform measures have the potential to lift the non-inflationary growth rate of the economy and improve the macroeconomic environment for monetary policy.

6 CONCLUSION

The most important way in which fiscal policies can improve the environment in which the ECB operates is by supporting macroeconomic stability. In the short term, automatic stabilisers rather than discretionary fiscal measures are likely to have a stabilising effect on the

Views on how to achieve macroeconomic stability in the short and long term, and on the actual fiscal policies needed for this, have changed markedly over time. The emphasis in discretionary fiscal policy-making until some 20 years ago was on fine-tuning, with a view to stabilising short-term economic fluctuations. However, this produced

unsatisfactory results, both from a macroeconomic and from a budgetary point of view. Therefore, the current consensus is that discretionary measures need to be focused more on longer-term considerations. Preserving the sustainability of public finances plays a key role, while short-term stabilisation is left to the operation of automatic stabilisers.

A medium-term oriented framework is appropriate to take both stabilisation and sustainability considerations into account. The EU fiscal institutions have rightly incorporated these considerations into a rules-based framework. The reference values for the government deficit and government debt are ways to enhance responsible fiscal behaviour. The medium-term budgetary position of close to balance or in surplus, as required under the Stability and Growth Pact, contributes to short-term economic stabilisation via the free operation of automatic stabilisers without breaching the 3% of GDP reference value under normal circumstances. At the same time, it ensures improvements in the sustainability of public finances by inducing lower debt ratios.

The emphasis on short-term stabilisation and longer-term sustainability in the EU fiscal framework is also appropriate from a monetary policy perspective. The ECB assesses the shorter-term impact of fiscal policies, as well as the impact that longer-term fiscal trends may have on the euro area economy and prices, mainly on the basis of its economic analysis but also on the basis of its monetary analysis. Increasing macroeconomic stability and sound fiscal policies facilitate the maintenance of price stability.