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The Fiscal Policy Implications of European Economic and Monetary Union and its implications for Great Britain

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With only two more years to run on the European Community's (EC) 1992 single market program, European leaders have been seeking for the last several years to develop and specify a range of extensive proposals to enhance the benefits of an integrated market. One principal direction in which the Community has embarked has been to set the course for economic, monetary and political union.

While political union probably will have the most visible impact on the face of Europe as we know it, any real progress seems light years away. No one in Europe is prepared to make the hard decisions required until some concrete evidence of the success of the single market is apparent.

For the moment the most visible movement toward any substantial kind of union is in the realm of economic and monetary affairs (EMU). Originally intended for furthering the benefits already obvious from a decade's experience with closer currency cooperation by locking in the cross rates between member countries, EMU, even in the draft stage, is taking on a much larger significance for the economies of each member state.

Thus far it has been the apparent inevitability of the establishment of a single, continent-wide currency and the attendant impact on the latitude of member states to formulate their own monetary policy that has garnered the most attention in Europe and abroad. Indeed, recent political turmoil in Great Britain as well as the pace and direction of German reunification

have both, in part, occurred with an eye toward an eventual single currency.

However, another factor of EMU is slowly evolving and beginning to take its place on the European stage. The E of EMU implies a convergence of economic policymaking by the member states over time with Brussels playing a more central and independent role. The practical result of this drive for economic convergence will be a harnessing of the fiscal independence of the national governments under some somewhat continental regime, setting limits on spending, revenue and most importantly, budget deficits.

Although final decisions have yet to be made, it has become apparent over the last two years since the EC began seriously to consider the form and outline of EMU what the implications might be for fiscal policy. The original plan for EMU envisioned a very tight lid on the size and scope of member states' budget deficits. The most likely plan to be approved in the Intergovernmental Conference slated for next month in Rome is a much looser agreement on how to formulate fiscal policy.

Background

Recognition of the need for a link between the currencies of the members of the EC extends back to the signing of the Treaties of Rome. Signatories acknowledged that if the Common Market they envisaged for Europe was to become truly common it would have to eliminate the uncertainties involved in exchanging the currency of one country for another in order to accomplish a market transaction.

However, for the first fifteen years the Community focussed merely on the melding of six very diverse and distinct trade policies. Many layers of governmental trade distorting practices had to be removed before the different European currencies became a factor. In any event, the generally fixed currency rates, anchored by a gold-backed dollar, prevailing in the 1950s and 60s under the Bretton Woods Agreements meant that European currencies varied only slightly against each other.

The 1971 collapse of the Bretton Woods pacts and the deterioration of the follow-up arrangements combined with the EC's search for new frontiers in economic integration led to renewed interest in monetary and currency union. The Smithsonian agreement signed in December, 1971 laid down a plan whereby currencies could fluctuate by a specified margin against the dollar. Dissatisfied with the implications of this arrangement for the wider fluctuation of European currencies against each other, the European countries hammered out the Basel agreement in April 1972, which was intended to improve upon the Smithsonian arrangement. In Basel the Europeans committed themselves to a narrower intra-European currency fluctuation margin known subsequently as the "[European currency] snake in the [Smithsonian] tunnel." This informal understanding in Basel was to serve as the basis for the more formal, legally binding European Monetary System of the 1980s.[1]

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[1] Toward a European Central Bank by Hugo Kaufman BUSINESS FORUM, Fall 1989 p.52-53

The economic turbulence of the 1970s coupled with the growing awareness of the risks posed to capital movements and trade flows by fluctuating exchange rates led to a renewed emphasis on a resumption of pegged exchange rates in Europe.

In March, 1979 the EC launched the European Monetary System (EMS). It consisted of two main features: a pegged exchange rate mechanism (ERM), which laid out the trigger for government intervention; and the creation of the European Currency Unit (ECU) -- a composite currency made up of a "basket" of all the currencies of the member states -- to serve as a further constraint on currency divisions by alerting policymakers to the early need for corrective action.

While some thought had been given to the need for further monetary integration, such as the creation of a European Central Bank, at the launch of the European Monetary System, nine years passed before further concrete steps were subsequently taken. At the Hannover summit in June 1988, Community Heads of State agreed to a proposal for a report within a year outlining steps to be taken to full economic and monetary union.

Named after the Commission President, Jacques Delors, the report spelled out a suggested path the EC member states could take to build up from the EMS to full EMU. The report did not lay out a specific timetable, although it suggested the three stages leading to EMU could be accomplished over a period of several years following the completion of the Single Market in 1992. Recent statements by the German government, which stands

as the de facto monetary leader by virtue of the size and strength of their economy, indicate that stage II could begin in January, 1994 the final stage and the creation of the European Central Bank to come in 1997 or 1998. A more comprehensive and final decision is expected to be reached next month at the Inter-Governmental Conference on EMU to be held in Rome.

Fiscal Policy implications

While the fiscal policy implications of EMU have played a major role in the moves toward greater currency and monetary union, there has been universal recognition that any closer monetary cooperation will necessarily have to involve greater fiscal coordination and cooperation among the member states. In obtaining that closer fiscal policy coordination, however, it will be necessary to strike the optimum balance between a rigid system that does not consider unique or unusual characteristics of a national or regional economy and too loose a system that provides an adverse incentive for national governments to run excessive budget deficits with little or no financial market penalization.

To set binding, universal and inflexible limits on the size of Member State's fiscal deficits would not only ignore the current state of the EC-12 economies but in the event of, say, an external economic shock, accentuate rather than cushion regional imbalances and do little to recognize the fundamental differences between the national economies. To begin with, the national economies would be entering a budgetary straightjacket from very different

macroeconomic and budgetary starting points. While the United Kingdom's fiscal deficit is just now slipping into the red, at the other end Greece and Italy are running deficits approximating 19% and 10% of their Gross Domestic Products respectively.[2] These differences would be further highlighted in times of economic crisis. For example, there has recently been a rapid rise in the price of oil which has had very different fiscal implications for the United Kingdom, a net oil producer, than for Germany, a net oil consumer.

On the other hand, ignoring the effects of national budget deficits on economic and monetary union would not only require the central monetary authority to take all the responsibility for macroeconomic policy adjustment, but could, in fact, counteract desired monetary policy goals. Without the buffer of fluctuating currencies, the unrestrained excessive fiscal actions of one member state might have a negative effect on the economies of many, if not all, of the others. An example of this effect came in the early days of the European Monetary System. Following the May 1981 election of socialist Francois Mitterand to the French Presidency, the French government embarked on an expansionary fiscal program. This run-up in the French budget deficit and subsequent inflation rate caused a concomitant increase in the value of the french franc against the other members of the EMS. The result was a series of EMS realignments to take into account the more aggressive French

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[2] The EMU and the European Commission: View from a Room THE ECONOMIST, March 24, 1990 p. 86

fiscal stance. Under the envisaged plan for EMU such realignments would no longer be possible, meaning that such a fiscal policy would have an immediate, mostly contrary, impact on other EMU members.

In addition, any expansive fiscal policy financed by higher deficits would have a direct and specific impact on the monetary authority -- in the case of EMU, the European Central Bank. The Bank would be faced with the dilemma of not only whether to finance the increased budget deficit of one country but what effect that higher deficit might have on European-wide interest rates. It might be faced with the unpleasant choice of having to raise interest rates for all of Europe because of the free-spending activities of just one member. This would, in effect, mean that other member states would have little or no choice in financing the extravagant spending style of an individual country. This could almost result in an incentive to run high national deficits if the pain would be spread out among the entire 12 members.

The Delors Report

The 1989 Delors report commissioned the year before by the Community leaders at the Hannover summit highlighted three necessary complements to the single market that would need to be accomplished to create economic and monetary union: stronger competition policy, reinforced regional policies, and better macro-economic coordination. While much of the report focussed

on the mechanics and possible configuration of monetary union, it began to lay the groundwork for future fiscal coordination.

Pointing out that the most powerful fiscal tool in the hands of the member state governments under EMU will be in national budget formulation, the report called for a system of binding rules "governing the size and the financing of national budget deficits." It outlined two major reasons that size of Member national budget deficits will be of concern under EMU: one, that the formulation of a diversified fiscal policy in the twelve capitals work in tandem with the centralized monetary policymaking by the ESCB; and, two, that Member States be under no illusions about their ability to monetize their deficits.

Zeroing in on the need for budget coordination by Member States under EMU, the report says:

> In particular, uncoordinated and divergent national budgetary policies would undermine monetary stability and generate imbalances in the real and financial sectors of the Community. Without such coordination [of national budgetary policies] it would be impossible for the Community as a whole to establish a fiscal/monetary policy mix appropriate for the preservation of internal balance, or for the Community to play its part in the international adjustment process. Monetary policy alone cannot be expected to perform these functions.[3]

Worrying aloud about the adverse financial incentives that EMU might provide Member governments, the report goes

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[3]REPORT ON THE ECONOMIC AND MONETARY UNION IN THE EUROPEAN COMMUNITY ("The Delors Report") p. 16, By the Committee for the Study of Economic and Monetary Union, April 12, 1989 Delegation of The European Communities, Washington, DC

on to mention the need for tight limits on member government borrowing:

> In the budgetary field, binding rules are required that would: firstly impose effective upper limits on budget deficits of individual member countries of the Community, although in setting these limits the situation of each member country might have to be taken into consideration; secondly, exclude access to direct central bank credit and other forms of monetary financing while, however, permitting open market operations in government securities; thirdly, limit recourse to external borrowing in non-Community currencies. Moreover, the arrangements in the budgetary field should enable the Community to conduct a coherent mix of fiscal and monetary policies.[4]

Thus the overall objective in achieving the appropriate fiscal/monetary policy mix and limiting the borrowing capabilities of member states would be not only a review of current budget plans and arrangements of the Twelve, but a commonly agreed upon and binding medium-term goal for national budgetary convergence.

While the Delors Report achieved a measure of success in setting out a timetable for monetary union and the creation of a single currency, its proposal for binding limits on budget deficits fell on politically deaf ears. In view of the ceding of monetary policy to Brussels, which was out of the reach of politicians in many countries in the first place, member governments were not ready to accede to a recommendation to surrender their fiscal tools and levers.

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[4]Ibid. p. 17

Commission Input

To keep progress toward EMU on track, the Commission set to work on revising some of the more controversial features of the Delors report, including the proposals for binding fiscal deficit limits.[5] Rather than echoing the Delors Report call for "binding limits" on national deficits, the Commission document outlined a series of "binding procedures" to ensure that fiscal deficits were kept within a more reasonable range. This transformation from limits to procedures was more than a semantic change, it was an effort to focus the need for fiscal convergence more on those countries running excessively high budget deficits rather than affecting all twelve.

The Commission's paper urged that the provisions on fiscal deficit be carved in stone. It suggested the inclusion of two specific rules in the treaty on economic and monetary union that would force a member state to feel the arctic blast of the market reaction to excessive deficit financing. First, that monetary financing of public debt through the expansion of the money supply would be prohibited and that there could be no special access to international capital for the financing of national deficits. Second, that there be no implicit promise or understanding that either the Community as a whole or individual states acting on their own could bail out or otherwise assist another member state in financial difficulty. A member state was

[5] Economic and Monetary Union: the Economic Rationale and Design of the System THE EUROPEAN COMMISSION March 20, 1990

supposed to be under no illusion as to the costs to its own economy should it choose to run a high deficit.

The report then went on to spell out the binding procedures that would exist to keep member states fiscal deficits in line. During the transition to complete economic union under stages I and II of the Delors plan, member states would have to submit and implement medium-term strategies designed to reign in any excessive public finance. These guidelines on the future size and direction of the deficit would with some input from Brussels have to be enacted into national law. Then the Commission would monitor individual compliance, adjustment and enforcement of these guidelines. In the event that a budget deficit stays stubbornly high a possible stick is brandished in Brussels withholding the disbursement of Community regional funds to intransigent member states.

Five months later the Commission produced a further note[6] to elaborate several points left unspecified in March and underline that the implications for "monetary stability and the sustainability of the union [posed by high deficits] . . . is of special concern."[7] It described the steps to be taken if multilateral surveillance of a member's budget deficit finds it exceeds the recommended limits. First a member government is subjected to a variety of peer pressure starting in private but

[6] Economic and Monetary Union COMMISSION OF THE EUROPEAN COMMUNITIES, August 21, 1990 [Sec(90)1659 final]

[7] Ibid, Section 3.3

spilling out publicly if need be. Then if the country is still unable to reduce its fiscal deficit the stick of withheld regional funds is replaced with the carrot of the promise of a new special financial support scheme in the form of grants or loans to help members in economic difficulty who reduce their deficits.

The note also represents the first official attempt of the Commission to tackle the question of just what constitutes an "acceptable" level of national deficit. While it points out that each country has a unique set of economic and political factors that indicate to what extent it can maintain a fiscal deficit, it does offer several guideposts:

> .. the golden rule of public finance, i.e., that public borrowing shall not exceed investment expenditure, appears the most satisfactory from an analytical point of view and is the only one widely applied in existing federations. Complementary to this rule, other objective criteria, such as the deficit and debt to GDP ratios might prove helpful in this context.[8]

The likely outcome on this question will most likely be more towards the particular circumstances and situation of each country rather than any universal yardstick. Such an outcome would allow both the Commission and the member governments more needed flexibility.

The Heads of State meeting in Rome in late October essentially ratified the positions taken in these two papers. In a document outlining the conditions for the commencement of the second phase of EMU on January 1, 1994, included the two

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[8] Ibid, Section 3.3

amendments to the treaty limiting the monetary financing of budget deficits and prohibiting the bailing out of a member state. "The European Council recalls that, in order to move on to the second phase, further satisfactory and lasting progress towards real and monetary convergence will have to be achieved, especially as regards price stability and the restoration of sound public finance." [9]

Ironically, all this preparation for the Rome Intergovernmental Conference on EMU in December, 1990 became rather unnecessary in the area of fiscal policy convergence. The member states, with the notable exception of the United Kingdom (which may change its position in the next several weeks under Prime Minister John Major), have, in general, agreed to the restrictions on their ability to raise further excessive public debt. While they obviously won't, and have not in the past, consented to a rigid formula for limiting deficit financing, they are apparently content to allow the proposals drafted by the Delors group and the Commission go forward and serve as a blueprint for fiscal policy in the next stage of economic and monetary union.

Central Budget

In view of the continual flow of governmental responsibilities (and to some extent, resources) from the member state capitals to Brussels an additional factor in this debate

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[9] Conclusions of the Presidency, EUROPEAN COUNCIL Rome 27 and 28 October 1990 SN 304/90 REV 2, p. 7

should be raised. The eventual aim of the most federalist of Europeans is not only to consolidate all monetary policymaking in Brussels but also to move the locus of fiscal policymaking there as well. European Commission President Jacques Delors has made no secret of his interest in seeing all economic policymaking originate from a central authority.

Thus the need to restrain and otherwise limit the ability of the member states to finance their budget deficits could be viewed as a prelude to further overall restrictions on their ability independently to raise revenues and make autonomous spending decisions.

Experience of the United Kingdom

For most of the nations of the EC, the moves in the direction of EMU have had little if any domestic political impact. Since any actual union has so far progressed little beyond the talking and planning stage, member state politicians have opted to keep it out of the general political debate. It has not changed the life of the ordinary voter, and will, most likely, be noticed in the political arena in the near future for its adverse effects on countries rather than any immediate positive benefits.

The notable exception has been the United Kingdom (UK) where the Conservative-led government of Margaret Thatcher has continually dragged back into the national political debate the question of EMU membership for the UK and the evolution of an eventual single currency. It is no understatement that this

issue more than any other has resulted in the Prime Minister's recent resignation.

The United Kingdom has always been a reluctant participant in the European Community. During the formation of the early institutions of the EC in the 1950s, Britain preferred to go it alone and play the swing country of the Atlantic alliance. In the 1960s after realizing that membership inside the EC was better for its sickening economy than remaining on the periphery, Britain found its half-hearted application to join vetoed by the French. Finally after joining (at admittedly less than favorable terms) in 1972, the government of the day had to put the question of continued membership to the voters in a referendum. More recently, Mrs. Thatcher's early European policy was marked by several years of wrangling to put right some of the inequities of Britain's terms of membership. Britain's activities and participation in Europe have always remained one or two steps behind the rest of the EC member states.

Nowhere is this as true as in monetary cooperation. Although they permitted sterling to be counted as part of the European Currency Unit (ECU) Britain opted not to join in the 1979 creation of the Exchange Rate Mechanism (ERM) of the EMS. The UK felt, justifiably in an economic sense at the time, that to put their oil-influenced currency in such a straitjacket would not be helpful to either the EC or Britain's economy.

Only in the last several years with the way forward from EMS coming into focus has Britain's lack of participation in the ERM

begun to take its toll. Since the Delors Report for Stage I of EMU called for all member states to be full participants in the ERM by the end of 1990, Britain either had to stay in albeit as a reluctant participant or make a conscious decision not to be a part of any new process. The British Prime Minister's unwillingness to budge in any direction since the 1988 Hannover Summit has resulted in a series of cabinet resignations over the past year and a half.

Finally, with little warning to her continental partners and on her terms, Mrs. Thatcher decided to allow the inclusion of sterling in the ERM in late October. However, by that point the political weaknesses displayed in staying out of the ERM and remaining an active opponent to the Delors vision for EMU took their toll on her Premiership.

In late 1989 after the Delors plan had been on the table for more than a year Mrs. Thatcher proposed, with the half-hearted support of her Chancellors of the Exchequer, an alternate plan to the Delors report. Known as the "hard ecu", the British plan would have created a 13th currency backed by the independent monetary authorities of the member states and managed by a new multilateral European Monetary Fund (EMF). While this plan seems to have received some serious scrutiny in several quarters in Brussels, it has generally been dismissed as inadequate to the objectives set for full economic and monetary union.

The focus of the UK's resistance to EMU has been because of its implications for monetary policy. Among the members of the

European Community, Britain has one of the more politically subservient monetary authorities. In contrast to say, Germany where the Bundesbank is very independent and autonomous, the Bank of England takes its marching orders on monetary policy direct from the elected Government. So where other politicians see a transfer from an autonomous national entity to a Community one, Britain's politicians see a net loss of power and influence to Brussels.

In fiscal policy Britain has also been particularly loathe to submit to any binding EC regime on deficits. And, in their view, the majority of the other member states support them in this position. The British proposal on the hard ecu does not contain any mention of fiscal policy coordination; although Ministers' statements around the time of its introduction suggest a very limited, if not non-existent role for multilateral supervision of national fiscal policies. Further, Britain has made an active effort to ensure the replacement of Delors' binding rules on deficits, which the British view as an infringement of their sovereignty, with the fiscal guidelines discussed above. The British government has indicated its support for the concept of multilateral surveillance of member states fiscal conditions as well as accepting the need for specific provisions to disallow monetary financing of budget deficits and prohibit the bailing out of member governments.[10]

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[10] Conversation with Mary Brown, Economic Counsellor at the British Embassy, Washington DC November 26, 1990