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DR. G. BAER

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Some current issues in fiscal policy, and their implications for the conduct of monetary policy

It is some fifteen years since the BIS autumn meeting of central bank economists last discussed the general topic of fiscal policy. The concern at that time was the precipitate move into large-scale budgetary deficit in the industrial world following the first oil shock, and fears that budgetary imbalance might be prolonged. In the latter respect at least the concern proved to be especially prescient. Although the average general government deficit in the industrial countries did quickly decline from the exceptionally high figure of 4% of GNP registered in 1975, it remained well above earlier customary levels. And, following the second oil shock, the average deficit exceeded 4% of GNP in both 1982 and 1983. The result was that, whereas the seven largest industrial countries had on average recorded deficits of 1/2-3/4% of GNP between 1960 and 1973, the corresponding figure for the period 1974 to 1986 was 3 1/4%. Amongst the smaller industrial countries developments were on average broadly similar.

At the same time, concern was growing over secular changes in certain structural features of the fiscal system, and, in particular, over their implications for incentives, or for the "supply side" of the economy in general. For example, the ratio of general government expenditure to GNP continued to rise sharply until the mid-1980s. In addition, the increase in public sector borrowing financed only a relatively small proportion of this rise, and the average tax burden therefore also went up steeply. There was also concern over the structure of the tax systems which delivered this revenue, and in particular over high marginal rates of taxation.

Another secular change which came to loom large in policy-makers' minds was the sharp and persistent rise in the outstanding stock of public sector debt. Hardly any industrial country was immune from this phenomenon in some degree. In certain cases the problem became acute as the ratio of government indebtedness to GNP approached, or even exceeded, 100%. Such countries began to feel increasingly threatened by the so-called "boule de neige" effect as interest outlays formed a greater and greater proportion of public expenditure. Interest rates, which were already high, threatened to rise still higher, with the increasing risk that yet more borrowing would be required just to pay the interest bill, and with the whole situation eventually becoming unstable. Indeed, in certain cases, where the maturity of the public debt was fairly short, the budgetary consequences of an appropriately anti-inflationary monetary policy were becoming a serious problem for the implementation of such a policy.

The proximate cause of the rise in public debt/GNP ratios was of course the large size of the budget deficits being incurred year after year. Debt ratios were also affected - arithmetically - by relatively low growth of GNP in real terms, as well as by the slowdown in price inflation after 1982. In addition, slow real growth was tending to exacerbate deficits themselves via automatic stabiliser effects. One bold response to this - which was also consistent with wider supply-side concerns - was the Reagan administration's programme of tax cuts, beginning in 1981. In the United States, as virtually everywhere else, the counter-cyclical manipulation of fiscal policy for demand management purposes was at this time viewed as having serious drawbacks, or even as being counter-productive, and the greatly increased size of the public debt was in many countries anyway providing a very powerful inhibition.

The attempt, instead, to stimulate the economy from the supply side - if successful - was also intended to bring the automatic stabilisers into play in a favourable way. Economic recovery could then have been combined with a falling budget deficit, precisely the reverse of the usual demand management combination. The lead of the United States in this matter was not however taken up by the rest of the world, which instead began to follow more orthodox routes to fiscal consolidation.

Two features of the outcome were especially worthy of note. Firstly, demand in the United States began to recover very rapidly, but the budget remained in large deficit. Secondly, the expansionary effects also spread to the rest of the world via foreign trade where they were powerfully supplemented by the exchange rate consequences of sharply differentiated fiscal/monetary policy mixes between the United States on the one hand and the rest of the world on the other. In the United States a tight-money/loose-fiscal policy combination prevailed, while the opposite one tended to be pervasive elsewhere. Apparently in part as a result of this, the dollar soared, thus raising new questions about exchange rate determination and, more generally, about the need for international co-ordination of macro-economic policies even under a floating exchange rate regime.

From roughly about the middle of the last decade the efforts of the great majority of countries which had opted for fiscal consolidation began to bear fruit. For example, the average deficit/GNP ratio of the six largest countries, excluding the United States, had by 1985 fallen by 1 percentage point from its peak of 4 1/4%. By 1989 it had declined to only 1/2%, with Japan and the United Kingdom in particular even registering moderate surpluses. In the United States, too, the ratio had come down sharply, to around 1 3/4%.

In 1990, however, fears began to arise that this process might be starting to go into reverse. In several countries cyclical influences contributed to some deterioration in budget balances, raising again the question of how appropriate it is to permit the full operation of automatic stabiliser mechanisms. One country in which these mechanisms have recently been working in the opposite direction is of course Germany, where boom conditions persist, at least in the west. At the same time, the unique circumstances of re-unification are overwhelming these effects and the budget is moving into very large deficit. This development raises new issues which are largely peculiar to Germany itself and to its current circumstances. It does, however, also raise again the issue of the international repercussions of sharply divergent policy mixes in different countries. In addition, and for the time being at least, it is being accompanied by precisely the opposite exchange rate reaction from that seen in the case of the dollar during the first half of the 1980s.

The current fiscal situation in the United States is also being affected by unusual circumstances, namely the operations of the Resolution Trust Corporation in connection with the bankruptcy problems in the Savings and Loans industry. The significance of such expenditures is difficult to gauge, especially as at least some of them are likely to be reversed as some of the assets acquired are sold off. More generally, there are several issues relevant to the analysis of credit and other off-budget items, such as the influence of such items in the measurement of fiscal stance, and the whole difficult issue of assessing the significance of contingent claims.

The recent renewed increase in budget deficits, the special fiscal situations of certain large countries, and the perspective which is now possible on the long period of growing public sector indebtedness, all combine to suggest that this might be an appropriate time to take a look at fiscal policy again and at its implications for monetary policy. And, given the deregulation and globalisation of financial markets, it seems especially appropriate to do so in an international forum. In inviting written contributions on this subject for the 1991 autumn economists' meeting, the BIS suggests that, as usual, the subject be viewed from a central bank perspective. For example, what are the key features of the present fiscal situation which are affecting, or complicating, the operation of monetary policy? These features are likely to differ from country to country, so that, in setting out a broad range of subjects and issues below, it is not intended to imply that each central bank will want to address all of them. Indeed for some, it may be that the domestic fiscal situation is such that it is mainly the international implications of policies elsewhere which are of greatest interest or concern. There may also be certain issues which central banks may wish to raise outside the following list. It is suggested that papers be sent to the BIS three weeks in advance of the meeting for circulation to all participants.

I. Recent budgetary developments and short-term issues

- To what extent, if any, is fiscal consolidation being reversed? What progress is being made in implementing last year's budget agreement in the United States?
- Are there any circumstances under which a more active - i.e. discretionary - counter-cyclical role could be envisaged for fiscal policy? What would be the appropriate monetary policy counterpart to any such shift?
- To what extent have recent increases in budget deficits been due to the working of automatic stabilisers? Is it appropriate to permit such effects to operate, especially at a time when monetary policy in many countries still needs to be actively addressed to the problem of containing or reducing inflation?
- The special fiscal situations of the United States and Germany. Is the latter country providing a demonstration of the fact that an appropriate monetary policy stance can actually lower somewhat the costs of a fiscal stance chosen partly for "non-economic" reasons?
- How can the stance of fiscal policy be measured now, especially where the situation is complicated by large changes in credit budgets, in privatisation receipts and in other off-budget items?
- In what ways, if any, are present fiscal settings complicating the assessment of an appropriate monetary policy stance and/or the implementation of such a stance? Or, have institutional changes increased the potential for central banks to set the stance of monetary policy independently of fiscal policy? If so, does the issue of "crowding out" in general become more acute?

II. Public debt and the issue of sustainability

- To what extent has the sustainability issue - the "boule de neige" effect - been solved? How can one define and measure sustainability?
- Does the debt legacy of past budget deficits pose a constraint on current monetary policy? For example, are interest-outlay effects

of higher short-term interest rates an inhibition on the appropriate setting of monetary policy?

- Or, on the contrary, have higher levels of outstanding public debt facilitated the use of open market operations, and/or the use of debt management techniques to influence long-term interest rates?
- Do present levels of long-term interest rates suggest that public debt-to-GNP ratios actually need to be reduced?
- In the attempts to restore sustainability, to what extent has public investment expenditure been "crowded out" within public expenditure as a whole? If so, does this constitute a further argument for not being content merely with the stabilisation of present debt/GNP ratios?
- To what extent do investors take into account the extent to which public sector borrowing finances current outlays rather than capital expenditure on the infrastructure, etc? Do the present levels of debt ratios inhibit or assist the development of "virtuous circles" in which initial cuts in primary deficits provide scope, via lower interest rates, for larger cuts in overall deficits?

III. Supply-side aspects of fiscal policy

- How much progress has been made in medium-term efforts to remove impediments to, or even bolster, the potential and flexibility of the supply-side of the economy? To what extent has any such progress been perceived - as was hoped - in reductions in the transitional side-effects and costs of counter-inflationary monetary policies? In other words, have transmission mechanisms of monetary policy been improved?
- One area in which relatively large and visible changes have been made in several countries is in the reduction of high marginal rates of taxation. What effects have been discerned?
- Is the still high share of public sector spending in total demand seen as implying any significant reduction in the proportion of

expenditure which is sensitive to interest rates, and therefore to monetary policy?

- Is there any scope for the use of income tax reductions to reduce the rate of wage inflation? If such reductions have to be financed by higher indirect taxes, and therefore lead to higher consumer prices, what are the net effects on wage formation?
- How are the progress with, and overall results of, privatisation programmes to be assessed?
- Have deregulation and globalisation in financial markets reduced the ability of monetary policy to offset changes in the stance of fiscal policy?

IV. International aspects: policy-mix differences, exchange rates and international policy co-ordination

- Under floating exchange rate conditions are sharp international differences in fiscal/monetary policy mixes ultimately unsustainable, given that monetary policy cannot under such circumstances be geared to maintaining an "appropriate" level of the exchange rate? This seemed to be the lesson of the early 1980s with respect particularly to the dollar. Does the recent behaviour of the Deutsche Mark vis-à-vis the dollar overturn such a judgement?
- Under fixed exchange rates, or a fortiori in a monetary union, how desirable, or even necessary, is it to maintain constraints on individual countries'/states' fiscal policies?
- To what extent does an inadequate level of public sector savings contribute to an unsatisfactory balance of overall saving and investment?