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Frameworks and stabilisation policy in a monetary union

Let me begin by thanking you for the invitation to come here and speak today on the occasion of Bank of Uganda's 40th anniversary. On several occasions the members of the Executive Board of the Swedish central bank, including myself, have had reason to address the interesting topic of monetary unions. Besides being a stimulating theoretical exercise, it has been of great practical importance with the creation of the euro. Also, from a Swedish point of view, because of the national referendum in 2003 when a majority of Swedish voters said no to adopting the euro. Another reason, from an international point of view, is the trend in exchange rate policies towards corner solutions, of which membership in a monetary union is one.

Although the East African Community (EAC) – with member states Uganda, Kenya and Tanzania – aims at eventually forming a political federation, and not only a monetary union, I am convinced that the experiences from other monetary unions, for instance the CFA Zone, will prove valuable to you in your efforts. However, since my comparative advantage concerns the Swedish and European experience I will discuss monetary unions from that perspective and I hope that this might be of some value. Hopefully, it can also shed some light on how the Bank of Uganda's role will transform over the coming decades.

Optimum currency areas – an illusive concept

When discussing whether or not to join or form a monetary union, concerns are usually expressed that the countries in the union at some point will have different needs in terms of stabilisation policy. Consequently, this then casts doubts on the appropriateness of a common, supranational monetary policy. If one country experiences rapid growth while the neighbouring country is in a pronounced downturn, how should monetary policy respond? On the other hand, this type of problem does exist within countries as well, as different regions' business cycles usually are not perfectly synchronised. Given these two observations, should we strive to create larger or smaller economic entities?

In his famous article published almost half a century ago, Nobel laureate Robert Mundell concludes that "[t]he optimum currency area is not the world" (Mun-

dell, 1961). Trying to establish what area would be optimal, it is from a practical perspective more fruitful to translate it into a question of whether or not a country should join a monetary union with other countries.[1] In order to do this, advantages need to be weighed against disadvantages.

When forming a monetary union, the member countries in effect lose some of their economic policy flexibility as they no longer have the possibility to individually adjust either their exchange rate, or their short-term interest rate. In turn, this means that a country-specific shock will be harder to handle for stabilisation policy. However, large asymmetric shocks occur fairly seldom, no more than a handful of times in the course of a century and as long as the shock – be it of internal or external origin – affects all countries within the monetary union, this poses less of a problem since the common monetary policy can respond to such a shock. If the monetary union also has a floating exchange rate, it will act as an automatic stabiliser.

The principal gains to be anticipated from joining a monetary union come from an improved functioning of the economy and an increase in foreign trade. A common currency means greater price transparency and therefore stiffer competition in, primarily, markets for tradables. In a country with a floating exchange rate, small- and medium-sized companies often find it too costly to hedge against currency risk when exporting or importing. When joining a monetary union, the absence of currency risk provides a greater incentive to trade, an incentive that will grow with the size of the union. Also, a common currency means that transaction costs for currency trading disappear.

However, when a country is weighing loss against gain, both are difficult to quantify. As for the gains, most estimates point to rather modest gains in transaction costs. Nevertheless, recent research points to an increase in trade. The estimated effect ranges from "modest" to "very sizeable", with the respective best estimates at 9 per cent and 40 per cent (Baldwin, 2006 and Persson, 2001, respectively).[2] It is my belief that as the current customs union in EAC evolves into a common market and later a monetary union, intra-trade flows will continue to grow at a rapid pace. Expressed as a percentage of their total exports, between 1991 and 2004, Kenya and Tanzania tripled their exports to EAC, while Uganda's has gone from 1.3 to 14 per cent of GDP. Hopefully, the continued expansion of trade also will entail a diversification and therefore a more broad based expansion. Assuming that the above-mentioned gains increase the growth rate by a moderate two tenths of a percentage point per year, this would nonetheless over the course of just one decade translate into an approximate increase in disposable income of 2 per cent. For the average household, this would amount to almost thirty thousand shillings in Uganda.

It should be noted that gains from increased competition could be accrued also by those countries which are from the outset relatively more efficient than the other countries in the monetary union. However, further complicating the analysis is the fact that the above-mentioned gains and losses vary with the country and area at hand. When trying to assess the risk of an asymmetric shock, the risk is obviously smaller the more similar the countries within the area. Similarity in this context concerns the business structure and the co-variation of business cy-

[1] Already Mundell (1961) noted that "[e]xcept in areas where national sovereignty is being given up it is not feasible to suggest that currencies should be reorganized…" (p.664).
[2] For a recent overview and summary of the field, see Rose and Stanley (2005). For another recent EMU application, see Baldwin, Skudelny and Taglioni (2005).

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cles. If, for example, all regions within the area are dependent on poultry farming, the bird-flu is a shock, but it is not asymmetric. The difficulty in responding with a common monetary policy increases the smaller the share of regions that are dependent on poultry farming. In practice however, it is difficult to identify a pure asymmetric shock. A recurring common feature, admittedly in varying degrees, is some form of policy mistake that has amplified the asymmetric shock. Interestingly, the same can be said about the co-variation of business cycles. An example of the latter is the behaviour of the Swedish and euro area business cycles that differed in the decades preceding 1992. In my opinion, a non-negligible part of this difference was due to national policy mistakes and not necessarily different economic structures. It is worth noting that the above-mentioned discussion on costs implicitly assumes that no such mistakes are made. Put differently, a possible further gain coming from a common monetary policy is that it will lower the risk of such policy mistakes.

As for the impact of an asymmetric shock, it varies with the possibility to absorb it; the more flexible the economy the smaller the impact. The prices of factors of production should preferably be flexible and the factors themselves should be mobile. Were, for instance, an asymmetric shock to create unemployment in one region, adjustment could take place through labour moving to another region and/or a change in wages. Furthermore, cooperation over time increases integration between countries. Although the business cycles in countries contemplating forming a union are perhaps not perfectly correlated at the outset, they will likely become more so over time as a result of increased economic integration; the so-called endogeneity hypothesis of the optimum currency area criteria.[3] In turn, this will mean increased efficiency of the common monetary policy. In general, better functioning markets imply greater economic efficiency. In this specific case, the better the markets for capital and labour function, the greater the scope for handling asymmetric shocks. However, simply waiting for optimality might be likened to waiting for Godot; i.e. in vain. Thus, a possible aspect of the issue of optimality is that focusing solely on the illusive goal will obscure the rewards coming from trying to get there. Or as the Swedish poet Karin Boye has put it, “Yes, there is goal and meaning in our path - but it's the way that is the labour's worth.”[4]

So, from an economic point of view it boils down to two important questions. First, is the country willing to pay an insurance premium consisting of a slightly less efficient economy, to retain the possibility of pursuing an autonomous stabilisation policy if an asymmetric shock were to hit the country? Second, does the monetary union have to constitute an optimal currency area at the outset of the project?

As hinted at earlier, the description so far leaves out the political dimension which in the European case has been very important. The EEC, predecessor of the European Union, was established after World War II primarily as a project for peace. Political integration was the objective, to be achieved in large measure with economic means. Against this backdrop, besides wanting to avoid war, one pragmatic political aspect of the decision on whether or not to join a monetary union is the possible gain of security and influence that comes with being a member.

But if a number of countries choose to form a monetary union, how – from an economist’s point of view – should they prepare themselves?

[3] For the case of EMU, see for instance Böwer and Guillemineau (2006).
[4] Excerpt from the poem "On the Move" from the collection "The Hearths".

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Before implementation of a monetary union

A number of questions arise when having decided to form a monetary union. The basic trade-off, as noted earlier, could be described as a choice between improved efficiency of the economy and hence higher living standards, as well as the possibility for each sovereign country to pursue an autonomous stabilisation policy in the case of asymmetric shocks. The questions just referred to could very well be addressed using this dichotomy.

Irrespective of whether the currency area is optimal, there is most likely room for improvement concerning both factor and product markets. The ability to absorb macroeconomic shocks increases with the flexibility of the labour market, meaning that improved efficiency also has a positive effect in terms of less need for stabilization policy. In the case of the EMU, ambitious welfare systems have been perceived as causing labour markets to become too rigid. Job safety for employees has in some cases resulted in pronounced insider-outsider problems, a reluctance to undertake structural reforms and a general difficulty to come to terms with increased competition on the back of globalisation. However, change is definitely possible. Using my own country as an example, one main question in the discussions before the referendum was the functioning of the wage formation process and the flexibility of the labour market. Today, not least due to reforms, these types of concerns have abided, at least in part.

As for the product and service markets, the new currency area offers distinct and tangible advantages. Primarily, since the new market is larger, there will be increased competition which benefits consumers through lower prices. Initially however, these effects may be hampered by practical issues such as different product standards. Laws and regulations that enforce common standards can thus be used to lay the ground for a further increase in competition. The possibility to create supervisory bodies means, for instance, that unwanted practices such as price dumping in certain markets now become more difficult. As for preparations in the above-mentioned aspects, the ambitious program outlined in the EAC Development Strategy bodes well.

Another type of institution building concerns the common monetary policy and how it is to be handled. As is well described by for instance Alexandre Lamfalussy, the task of institution building in the European monetary unification process was formidable (Lamfalussy, 2006). A number of vested interests meant that a lot of things could have gone wrong. That the project was successful after all is attributed to "the exceptional convergence of several facts and influences" (p.2). Naming but a few, importantly, the initiators of the project were heads of state. Also, the central bankers were entrusted by the politicians, in issues concerning central banking, to play a major role in the forming of the Maastricht Treaty. Although this important document left open a number of issues, it was clear on the independence, institutionally as well as financially, of the European Central Bank and the national central banks within the European System of Central Banks. Furthermore, it made clear what the convergence criteria were for accession to the Euro area. Importantly, there was also for EU members an explicit prohibition concerning fiscal dominance, i.e. a prohibition against fiscal policy being financed by monetary expansion. Of course, the amount of work depends crucially on what type of institution is to be built. Will monetary policy be a joint decision between the participating countries' central banks, institutionalised through the creation of a common central bank, or some alternative in between? Although centralisation is a natural part of a common monetary policy, decentralisation is

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pivotal through its role in accountability and acceptance. The national central banks will in this respect continue to play an important role.

The convergence criteria for the euro area concern price stability, government finances, exchange rates and long-term interest rates. Each member state must satisfy all four criteria in order to be able to participate. More generally, the criteria could be described as an absolute as well as a relative measure of macroeconomic health. Absolute, since no economy benefits from, for instance, an excessive fiscal deficit or a high rate of inflation. Relative, since differences between member countries should not be too large. Of course, a common monetary policy would be made much more difficult, if inflation rates were to diverge substantially already at the outset. In this respect, the development among the EAC countries is very promising, as is the harmonization of statistical practices. The size of the fiscal deficits in Uganda and Tanzania, on the other hand, is less promising. However, given a significantly higher potential growth rate compared to the euro area, fiscal deficits can be correspondingly larger without the debt to GDP ratio increasing.

Finally, there are several practical issues. The whole financial infrastructure must have time to prepare for the new legal tender and unit of account. In the case of Sweden, the plans prepared by banks and other financial institutions indicated that at least a couple of years would be needed to ensure a smooth transition to introducing the euro in Sweden. One factor contributing to the relatively long time lag was the complexity and old age of some of the IT-systems involved. In this respect I believe Uganda has a twofold advantage. First, the economy is relatively less dependent on electronic money and, second, the technological infrastructure is of a much younger date. The other side of the coin, if you will pardon the pun, is tangibles such as notes and coins. Here, authorities must ensure that enough time is given for production as well as distribution of the new currency. In a cash-based economy this will of course take relatively longer to prepare. Overall, the change-over preparations are less of a concern for the general public. What the average citizen usually finds most difficult is to get accustomed to the new unit of account. On the other hand, all companies, private and public owned alike, as well as government bodies, must prepare thoroughly for the transition.

After implementation of a monetary union

The main challenges after forming a monetary union are how to preserve stability and promote efficiency. With regard to efficiency, the message under this heading is very much in line with the previous one; since presumably no market functions perfectly there will always be room for improvement concerning flexibility and integration. However, given that certain markets can be more politically sensitive than others, we must recognize that such changes can take considerable time to implement.

The view on stabilisation policy as such does not change because of the creation of a monetary union. In general, normal swings in the business cycle are counteracted by automatic stabilisers in the public budgets that dampen oscillations. As the experiences from active fine-tuning are discouraging, the primary aim of active stabilisation policy should be to counter the occurrence of unduly large asymmetric cyclical fluctuations. Overall, the trend in monetary policy towards price stability targeting has brought down inflation virtually around the globe and thus one necessary condition for macroeconomic stability has been fulfilled.

When discussing the role of fiscal policy, the analysis is facilitated through addressing the roles of the monetary union and the individual country separately.

Stabilisation policy from a union point of view

Viewing the monetary union as a whole, the euro area can serve as an illustrative example on a couple of aspects. Firstly, the common fiscal budget is very small in comparison with national fiscal budgets. On political grounds, member countries are unlikely to give up significant parts of national economic policy. In turn, this implies that the relatively small common budget most likely is a persistent feature of monetary unions consisting of different countries. This would seemingly indicate that monetary policy as well as fiscal policy at union level, although for different reasons, would be of little use in the event of asymmetric shocks hitting one or more countries. However, despite the absence of formal rules or laws, the euro area appears to be able to handle similar incidents using ad hoc measures. One example is the direct fiscal support to the Netherlands in 2002 when they were troubled by foot-and-mouth disease. Thus, at least in this respect, political determination seems to have replaced a more formal structure. However, the determination has yet to be tested by a large asymmetric shock. Secondly – and still using the euro area as an example – after becoming a member of the monetary union, the fiscal convergence criteria are automatically replaced by the stability and growth pact (SGP). The pact has the same set of rules as the criteria, which is to ensure macroeconomic health among member countries. The difference between the two is that the union has the possibility to penalise members that do not meet the demands of the pact. However, striking the right balance is far from trivial. For fences such as limits for budget deficits to work they have to be rigid, but in practice flexibility is often needed. Obviously, the optimal features of such a system are difficult to pin down but the practice of name-and-shame has in itself raised the underlying issue and thus increased awareness of the importance of fiscal discipline. After decades of more or less lax fiscal policies in several countries, this basic achievement should not be forgotten.

Contributing to the problems of ensuring fiscal austerity is that the bigger the union, the smaller the relative size of individual countries. This means that free-riding very well might become a problem as it is rational to run deficits, even if your instinct is not to free-ride. Why? Because even though you belong to the small minority that does not worsen the fiscal position, all countries still have a tighter monetary policy that has come about as a result of the majority running lax fiscal policies. The result could be a bad macroeconomic policy mix: larger deficits and a higher interest rate than would otherwise be the case. In my view, this is a greater problem than the often discussed worst-case scenario of one or more countries experiencing a full-blown debt crisis as a result of a sustained lax fiscal policy. Acknowledging these practical difficulties, the recent re-haul of the SGP can serve as a starting point when deciding upon an appropriate framework that can hopefully minimise the problems touched upon here.

Developing a fiscal framework

The SGP could be characterized as consisting of three parts: governance, a preventive arm and a corrective arm.[5] The recent changes to the SGP, made in 2005,

[5] For a recent study of the SGP's effects on fiscal policy, see, for instance, Annett (2006).

aim at strengthening all three aspects. Better governance is to be achieved through stronger national fiscal incentives, more prudent forecasting and more reliable statistics. The fiscal incentives can take the form of budgetary rules, or as in the Swedish case a budget law. Surveillance is a measure that would bring increased attention to the development of public finances. Such monitoring on behalf of a national institution would mean that transparency increased significantly, an important prerequisite for accountability. At least in the EU, there has been a need for more prudent forecasting. Serving as merely one example of possible problems, a study by the ECB shows that the closer a country comes to an excessive deficit, the more likely it is that the forecast the government presents officially will later turn out to be wrong. As for more reliable statistics, common methodological standards and independency of statistical compilers are two ways of addressing such problems.

An integral part of the preventive arm is the yearly national stabilisation program. A product of the ministry of finance, it includes a thorough description of the economy, and the measures to be undertaken by policy makers in order to comply with the rules of the SGP.

The corrective arm consists of the excessive deficit procedure (EDP). If a country runs a fiscal deficit deemed to be too large, the limit being at 3 per cent of GDP, corrective action has to be taken. The recent change in the SGP concerns a relaxation of the rules. The definition of a severe recession, being a valid reason for exemption from the EDP, has now been relaxed. Also, a longer time frame for taking effective action is allowed, now three years instead of the earlier two, from when the deficit occurred.

The SGP has received its fair share of criticism, both before and after the changes made in 2005. Although it undoubtedly has it shortcomings, it is important to view it both in a longer perspective and from a more theoretical point of view. Too many euro area members have had lax fiscal policies in the past, resulting in deficits around 3 per cent of GDP or more. Combined with current low fiscal ambitions, this clearly constitutes a problem. However, with several EU countries in recent history having experienced deficits several times the size of that stipulated by the SGP, the main goal of a framework does not necessarily have to be to strive for a perfect world, but rather to avoid very large deficits. Somewhat unfairly, the SGP is sometimes evaluated as if it was the framework of an optimal policy. Trying to optimise everyone's well-being, one would have to take everything into account. However, in my view, the SGP has more in common with a simple instrument rule. Although not optimal, simple rules have the advantage that they increase the chance of avoiding large policy mistakes –a measure by which the SGP so far has succeeded. At the very least, the SGP has served well in bringing the political attention to the need for sustainable public finances.

A final observation concerns the dichotomy of before and after entry into the union. The general view among euro area accession countries seems to be that a lot would be gained from membership of the monetary union and the convergence criteria are viewed as a goal, while a widespread view among the old member countries seems to be that once a member, the SGP is a cumbersome constraint. Characterising the two cases – wanting to join and being a member – I believe it is clear that the carrot outperforms the stick. Contrasting the willingness to undertake reforms in the new accession countries with the state of affairs among the old members, the difference is rather striking. It is equally evident when comparing today's situation among the old members, with that before membership.

Given the importance of equal treatment of countries, it is far from certain that it is possible, or perhaps even desirable, to align the economic and legalistic view, but I believe that it is worth trying when establishing such a framework. With Rwanda and Burundi having applied to join, these types of considerations are currently a matter for the EAC as well.

Ending on a positive note, I would like to point out that one should dare to be optimistic. If economic and political developments turn out better than anticipated, a regulatory framework such as the SGP should be flexible enough to accommodate such events. The Swedish financial crisis of the 1990s brought a five-fold increase in the unemployment rate and three years of negative growth, the worst performance in a century. In the midst of the crisis, anyone painting the picture of the situation we have today would most certainly have been laughed at. Although such profound institutional and macroeconomic changes that later came about seemed implausible at the time, one should not rule them out in advance.

Stabilisation policy from a country's point of view

If we instead turn to viewing each country individually, the tendency is still less towards interventionism and that policy-makers should only respond in the event of large economic shocks. After joining a monetary union, fiscal policy is the only remaining tool for national stabilisation policy. Here, it should be remembered that the smaller the member country is, the less important it is for the overall economic developments of the monetary union. Thus there is a greater risk of the common monetary policy not suiting the smaller member country. Whether using the example of Sweden relative to the euro area or Uganda to the EAC, the general conclusion is that the role of fiscal policy is even more important in such a case. However, not least because of experiences in recent history, it is widely acknowledged that the stabilisation of aggregate demand through changes in public spending is not an easy task. Preferably, policy makers should refrain from fine-tuning, not least against the backdrop of inside and outside lags that distort the timing of such policies. It is far more important to ensure that the government budget is balanced over the course of a business cycle.

Over the last couple of decades, monetary policy has been geared towards price stability, thereby also indirectly contributing to stabilising demand. Given the success in regaining price stability, Uganda being one of many examples, it seems sensible to take a closer look at the guiding principles that have been important factors in making this possible.

Using inflation targeting regimes by independent central banks as a special case, four advantages of this strategy can be singled out as illustrated in a recent study (Schmidt-Hebbel and Mishkin, 2006). First, the nominal anchor should be based on the institutional set-up and not on individual policy makers, this to ensure consistency. Second, a credible commitment as just described produces stable expectations of a continued focus on the long-run. Third, transparency reduces uncertainty about the tools and goals of monetary policy. Finally, without a target, a lack of accountability might undermine the central bank's independence. When thinking about the set-up of national fiscal stabilisation policy in a monetary union intended to create credibility, these five guiding principles – consistency, commitment, transparency and accountability, coupled with independence of policy makers – are a good starting point.

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Fiscal stabilisation policy set-up

Turning to its design, three relevant questions provide a framework for discussing the set-up of a fiscal stabilisation policy regime for a country in a monetary union: *what* is to be stabilised, *how* should it be stabilized and *who* should do the stabilising?[6]

Addressing what is to be stabilised, two alternatives that were discussed in Sweden were the output gap and the inflation rate. Irrespective of what target is chosen, it should apply in the medium term, thereby allowing temporary deviations in the event of shocks hitting the economy. In the case of an inflation target, it should be designed in such a way as to take account of necessary changes in relative prices; i.e. allowing for adjustments in the real exchange rate. Different targets have different advantages and drawbacks. For our purposes, when discussing the framework, it is more important to stress that the motives and forecasts behind the stabilisation policy decisions should be presented in a clear and open fashion. In turn, this helps build credibility through accountability.

How is the policy objective to be stabilised? When compared to monetary policy, fiscal policy has a wide array of possible instruments on both the expenditure and revenue side of the government budget. A possible approach is to consider what characteristics the instrument should have. Preferably, the effect should be general and the measure should be used symmetrically and temporarily. Furthermore, stabilisation policy should, as far as possible, be distinguished from distribution and allocation policy. Proposals of such instrument could include personal income taxes, value-added tax and payroll taxes.

This observation leads me to who should do the stabilising. Although the arguments behind the delegation of monetary policy to independent central banks should presumably also apply to stabilisation policy in a fiscal policy regime, such an idea is currently quite far from being conventional wisdom. However, I argue that many of the decision-making problems that have been the basis for much of the academic criticism of fiscal policy stabilisation could be minimised if an independent authority using an appropriate instrument were to make the stabilisation policy decisions. In the short-term, a politically more plausible alternative is to establish an independent body with the responsibility of enhancing transparency by conducting independent forecasts of the country's deficits and providing recommendations on a regular basis. This is a part of improved governance, as discussed earlier. An institution building its authority on impartiality and expertise might well contribute to putting some much needed pressure on governments with lax fiscal policies. Here, transparency is a vehicle for accountability and political pressure. Public and political acceptance will be more likely if voters are not only given the possibility, but being helped, to form an opinion and to express it in general elections.

Summing up

Perhaps somewhat counterintuitive but in line with today's seminar topic, I would like to end this speech by questioning its underlying assumption. Is it necessarily a problem having to give up national monetary policy when joining a monetary union? The assumption presupposes that what is to be stabilised is mainly driven by factors that can be affected by national policy instruments. Is this really the

[6] This discussion is based on Boije, Borg and Eklund (2002) and Boije and Shahnazarian (2003).

case? A recent cross-country study suggests that determinants of inflation have become less "country-centric" and increasingly "globe-centric" (Borio and Filardo, 2006). Of course, national stabilization policy still plays an important role, but global factors are becoming increasingly important. At the same time, business cycles in the G7 countries seem to have become increasingly synchronised, thereby narrowing the difference between domestic and global determinants of inflation.[7]

As integration increases and differences diminish, monetary unions will have a greater chance of success. This chance will increase further if countries prepare their economies from a stabilizing as well as a structural perspective. Institutionally, frameworks for monetary and fiscal policy, at country and union level alike, should strive for consistency, commitment, transparency and accountability, coupled with independence of policy makers. Most importantly, the aim should be long-term stabilization rather than short-term fine-tuning. Against this back-drop, it is my belief that the advantages of a monetary union outweigh the disadvantages.

Obviously, a non-negligible part of the future environment for central banks hinges upon these developments. As time goes by, they will provide us with guidance as to which of the two corner solutions for exchange rate policy will prove the most popular – a freely floating currency or membership of a monetary union. However, although important, these developments are admittedly slow and differences in the end-result should not be exaggerated. I merely intend to suggest that the transition in stabilisation policy that comes with joining a monetary union perhaps is not as large as it first seems. Central banking has a long history and although it has been confronted with many changes in the past, it has far from lost its importance, if anything rather the contrary. Basic functions, such as aiding financial intermediation through large value payment systems and acting as a lender of last resort, will remain important in the future as well. Needless to say, it will be very interesting to follow the transformation of EAC in general and the role of the Bank of Uganda in particular.

[7] For a recent study of business cycle synchronisation, see Kose, Otrok and Whiteman (2005).

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