PRESERVING MONETARY STABILITY IN THE FACE OF BUDGET DEFICITS[1]

This article examines the relationship between the fiscal position and exchange rate stability both in Hong Kong and in other economies. It suggests that there is no simple, pre-ordained relationship between the two and concludes that, although Hong Kong's fiscal position is a matter for concern, monetary stability should not necessarily be the paramount element in that concern.

Introduction

There has been much talk recently in Hong Kong about the possible threat to exchange rate stability from the burgeoning budget deficit, which is predicted by many to reach about 6% of GDP for the current financial year as a whole. Evidence of this concern is apparent when any media report suggesting a deterioration in the fiscal position is invariably accompanied by a weakening, even if shortlived, in the forward exchange rate of the Hong Kong dollar.

This phenomenon is not confined to Hong Kong. In Europe, news of widening budget deficits, threatening to breach the terms of the stability and growth pact, and allegations of lack of commitment among officials to the degree of fiscal discipline necessary to conform to that pact, have tended to weaken the euro's exchange rate, at least temporarily.

But there is another story which can be told. This is of an economy where the budget deficit rose from about $1^1/_2$% of GDP to $4^1/_2$% in the space of 4-5 years. What happened to its exchange rate? It *strengthened* over the same period by some 70% in trade-weighted terms. The authorities reined in the deficit somewhat over the next couple of years, but then it began to expand again. On this occasion, the deficit doubled within three years, while the exchange rate appreciated once again.

That country was the United States and the references are to episodes when the deficit grew rapidly in the early 1980s and again at the turn of the 1990s. And some observers detect signs today of a similar replay beginning. To be fair, however, it should be noted that the dollar tended to remain as firm during the years of deficit reduction in the late 1990s as it had when the deficit was rising in the early 1980s, and that, on balance, there may not be a very clear long-term relationship in either direction between the US deficit and the dollar exchange rate. But at least the US experience warns us against presuming there to be an automatic negative causation flowing from the one to the other.

The Relationship Between Fiscal and Monetary Policies

It may be worthwhile examining more generally certain aspects of the relationship between fiscal policy and monetary policy.

The economy can be characterised as comprising any number of different sectors. At the highest level of aggregation the classification is usually the public sector, the corporate sector, the household sector and the overseas sector (the counterpart to the external balance of payments). Each sector may be in financial surplus or deficit, but the surpluses and deficits must, in accounting terms, sum to zero (although in terms of available statistics they may not, because of errors and omissions); every piece of deficit is necessarily matched by a piece of surplus.

Typically, one might envisage the savings surplus of the household sector being channelled

1 This is the text of an address given by Tony Latter, Deputy Chief Executive of the Hong Kong Monetary Authority to the Insight Investment Conference in Hong Kong on 20 November 2002.

through the banks and financial markets to fund a deficit in the corporate sector, arising from its capital investment and working capital needs. In this context the deficit in the corporate sector seems perfectly acceptable. Why, then, should a deficit in the public sector raise particular anxiety? Isn't the situation where the public sector has a funding need analogous to that where private sector corporate entities have such needs?

Not necessarily so. A number of factors may differentiate the two situations. What are these factors and what are the special considerations which may apply in the case of the public sector deficit?

First, when assessing the impact of different deficits one may need to look behind them, to associated developments in the real economy. For example, a financial deficit may reflect, at one extreme, spending on current consumption, and particularly on imports with no resulting benefit to domestic employment; or it may reflect, at the other extreme, investment which generates jobs and greater efficiency within the domestic economy. If there is a suspicion – whether or not well founded – that a public sector deficit is inclined to the former category, it will be judged less helpful to the long-term health of the economy and thus tend to weaken financial confidence. A sizeable underlying public sector deficit may anyway be regarded as a sign of fundamental weakness in an economy, if it signifies too heavy an involvement of government in the running of the economy.

It is these types of consideration which have led to the emergence of various recommendations and rules about fiscal deficits. There is, for example, the "golden rule" of the UK finance minister, Gordon Brown, which he first espoused in 1997, stating that, over the cycle, spending of a current (as opposed to capital) nature should be balanced by revenues, and borrowing should only be countenanced to cover capital expenditure. In Europe there is the supposedly sacrosanct cap on the fiscal deficit of each of the member countries of the euro-zone, at 3% of GDP. And in Hong Kong there is the Basic Law (Article 107), stating that Hong Kong should strive to achieve a fiscal balance and avoid deficits.

Secondly, the financing of private sector deficits is subject to market discipline, in that those who provide finance do so on the calculated expectation that the investment will generate sufficient internal returns to repay them in due course. By contrast, in the case of a public sector deficit, the investor's confidence is based not so much on any knowledge about the rate of return, if any, from the expenditure to which the funds are destined, as on faith in the government's ultimate ability to raise money through taxation, if necessary, at some future date in order to service its borrowings. Such a prospect of higher taxation might, among other things, serve as a dampener on financial confidence.

Thirdly, there may be a fear that public sector borrowing will crowd out worthy corporate sector borrowing from the financial markets, to the detriment of the economy as a whole, although to the extent that a public sector deficit has its counterpart in a corporate sector surplus (or reduced deficit), the corporate sector's borrowing requirement will anyway have been reduced.

Fourthly, in some cases a public sector deficit may be financed by a reduction in net foreign currency assets. For instance, the government may resort to foreign borrowing because the local financial market is not mature enough to supply the funding. Or, exceptionally, as in the case of Hong Kong, the Government may raise the funds by running down accumulated foreign currency investments. The respective build-up of foreign currency liabilities or reduction in foreign reserves may raise concerns in the context of net national wealth, national economic security, credit ratings, and so on. Moreover, foreign currency borrowing exposes the government to financial loss in local currency terms should the currency depreciate.

Fifthly, there may be a lurking fear that the government will be tempted to acquiesce to inflation and currency depreciation as the means both to repair its current finances (if it believes that revenue may be affected more quickly and positively than expenditure) and to reduce the real value of its outstanding indebtedness.

Sixthly, there may be a consequential fear that, as a means to that end, the government will seek to monetise its debt – "printing money" to fund the deficit. This would, however, require the cooperation of the central bank, and in most jurisdictions nowadays there is some form of prohibition on the central bank abetting such a strategy. More specifically, governments tend to be prevented – by force of law or moral pressure – from obtaining finance direct from the central bank (e.g. as might occur if the bank was forced to take up issues of government securities in the primary market), although the central bank is invariably permitted to buy (or sell) government paper in the secondary market as part of its discretionary monetary policy operations.

Practical Experience

What of experience in the real world?

Reference has already been made to the case of the United States. The US Government is regarded as just about the best credit risk in the world and there is a huge global appetite for US treasury securities. The Federal Reserve has an equally strong track record in avoiding inflation. For these reasons, markets have seldom, during living memory, considered a large fiscal deficit in the US as presaging monetary laxity or signalling a weaker dollar. Indeed, the contrary often seems to have been the case: with the fiscal deficit providing some circumstantial evidence of a deficiency of domestic savings, the prospect that interest rates might need to rise to bring savings and investment into equilibrium – or the reality of such a rise – may actually have contributed to the strength of the dollar on occasions, as noted already.

A similar trait was apparent with the deutschemark in the early 1990s in the wake of German reunification: the prospect – and subsequent emergence – of a substantial budget deficit, and hence higher interest rates than otherwise, was accompanied by a strengthening of the exchange rate. By contrast, however, and as discussed below, the more recent deterioration in the fiscal outlook in Germany has not been a positive factor for the euro.

At the other extreme lie examples of countries where budgetary indiscipline has plainly been a factor behind the collapse of the currency. It would be invidious to mention names, but the story can be caricatured as follows. The government is running a deficit which it is unable or unwilling to correct. Domestic savings are in short supply and savers do not have abundant faith in the government from the credit-risk perspective. The government finds itself having to pay ever higher interest rates, so that the interest burden itself becomes a significant component of the continuing deficit. Meanwhile the government may have been meeting some of its funding needs through foreign currency borrowing – initiated at a time when international sentiment was favourable and the interest rate seemed attractive, at least on an uncovered basis.

The situation then begins to unravel acutely. Foreigners take fright and don't wish to roll forward their lending, or will only do so at a much higher margin. The country can't afford higher foreign currency interest payments, still less to make net repayments of principal on foreign borrowing. Domestically the only means left by which to cover the deficit is for the central bank to fund it. This means that the central bank lends to the government virtually on demand by, effectively, crediting the government's bank account – resort to the printing press in all but name. Whether this lending carries an interest rate or not is largely immaterial, since the central bank can continue at the stroke of a pen to create the money to pay the interest. This procedure will inevitably be inflationary, but a wayward government may welcome this as a means of reducing the real value of its outstanding domestic debt. It may even feel that inflation will aid its current financial position, if its revenues inflate faster than its outgoings.

All of this is a clear recipe for disaster, including, probably, an exchange rate crisis.

Between these two extremes – the US and the no-hoper – there are of course many cases where the situation is less clear-cut or less predictable. Euroland provides an interesting example. Given the careful steps which were taken

before the advent of the euro to ensure the insulation of monetary from fiscal policy and to outlaw monetary financing of budget deficits, we might wonder why the news of impending budget overruns should cause the euro to weaken. It seems that not only do credit spreads faced by individual deficit countries widen (presumably for fear, however slim, of sovereign default), but also the currency weakens for fear of governments conspiring with the central bank to abandon its mandate against inflation or to break the rules against monetary financing. A rather different interpretation could be that foreign exchange markets are merely exhibiting a pavlovian reaction: having been brainwashed to the effect that a deficit is inherently bad if it surpasses certain pre-announced limits, the reaction when such a breach does occur is bound to be negative, even if analysis of the substance underlying the breach provides little or no justification for such a reaction.

In the context of trying to identify a relationship between the fiscal position and the exchange rate, these examples demonstrate that there is no simple, pre-ordained relationship. The outcome depends on a wealth of factors, including the nature of the disturbances affecting public finances, the policy regime and policy responses, and the state of sentiment in financial markets.

Hong Kong

How does the present situation in Hong Kong match up against these various considerations?

Hong Kong is in several respects exceptional, if not unique. It has no specific central bank law of the type common in other jurisdictions (although a number of laws, such as the Exchange Fund Ordinance and the Banking Ordinance, govern particular aspects of the Monetary Authority's functions). It has no mainstream government debt. It operates a currency board rather than a discretionary monetary policy. And it has only quite recently become familiar with the idea of a budget deficit persisting for longer than an isolated year or two.

Although the absence of a law to explicitly prohibit monetary financing of the budget deficit – of the sort which has been adopted in many economies, both new and old, in the course of the past couple of decades – may be thought a weakness, it need not be so in reality. Whether or not it has a formal legal basis, the proscription of monetary financing has nowadays become so firmly established as part of the policy landscape in the developed financial economies, that any of them which dared breach it would be immediately crucified by the markets, the world media, the IMF and so on. One could class this as a sort of *de facto* law of nature, which is likely to be at least as effective and durable as any law passed by a legislature, if not more so. Hong Kong can be regarded as being subject to this law of nature.

In any event, Hong Kong's Currency Board system rules out the creation of money except in exchange for foreign currency, and therefore serves as an operational safeguard against monetary financing of the budget.

In order to fund its deficit, the Government has a choice between running down its assets (the fiscal reserve) and borrowing, from banks or the markets. It has chosen for the time being the former route. The monetary impact would in either case be neutral. It may be worth explaining the process. If the fiscal reserve is drawn from the Exchange Fund and the Fund consequently needs to realise foreign currency assets, the foreign exchange is sold in the market. The counterparty surrenders Hong Kong dollars. These accrue temporarily to the Exchange Fund and are then transferred to the Government, which will in turn pass them to some other party, as the counterpart of the budget deficit. The net result is a change in the ownership of Hong Kong dollar money but not in the quantity outstanding. Similarly, borrowing Hong Kong dollars to fund the deficit would involve a shift in ownership of those dollars around the economy, but no net increase in quantity.

The mechanics of financing the deficit ought not therefore raise any concerns in Hong Kong in the context of monetary stability.

Nevertheless, in practice the markets do appear to exhibit a degree of negative reaction to the deficit. Why? A number of possible explanations come to mind.

First, and rather obviously, there is Hong Kong's Basic Law, which indicates that deficits should be avoided. It's understandable for markets to become nervous if they suspect that the law might be infringed.

Secondly, many people, whether in Hong Kong or elsewhere, anyway have a gut feeling that getting into debt is imprudent. This does not stop them individually from borrowing money, or from being tolerant of their Government being in debt, but they may nevertheless be uncomfortable about it. The underlying rationale for holding this view may not be well articulated, but it does not need to be – if the view exists, that is enough for it to have an impact. And the impact may be reinforced if the Government's record appears to run counter to what it has itself been preaching.

This leads to the third point, which is that Hong Kong has boasted since long ago about its budget surpluses and the absence of government debt. This makes it intellectually difficult to deny the significance of the deficit. Not that anyone is trying to downplay it – the expressions of concern from Government officials have been numerous, sincere and unambiguous. But in some ways this serves to highlight the difference. The present position is seen to represent a sea-change in the financial circumstances of Hong Kong, whereas other economies more familiar with deficits might be able to take a deterioration in public finances more easily into their stride.

Fourthly, there is the more specific concern, that either of the two available means for financing the deficit – by, as now, realising foreign currency investments or by government borrowing – would impact adversely on Hong Kong's financial standing in the eyes of rating agencies and others. Of course, it is by no means obvious that these financing activities would necessarily endanger monetary stability or weaken the exchange rate. Indeed, there are plenty of examples of economies with low foreign reserves or high government borrowing having enjoyed firm currencies and strong credit standings, and it is hard to see why, for example, the act of the Hong Kong Government borrowing modest amounts on the capital markets in its own currency should have any substantive adverse impact on sentiment. But perceptions are typically coloured as much by unusual or sudden changes in circumstances as by continuity of particular circumstances, and analysts and markets tend to respond accordingly.

Fifthly, observers may – not unreasonably – regard the deficit not so much as a problem in its own right as a symptom of other things, such as sharp cyclical recession or perhaps more serious underlying problems in the economy which affect future prospects. It would be natural for these considerations to unsettle general confidence, independently of the budgetary arithmetic.

Sixthly is fear of the unknown. The current run of fiscal deficits is taking Hong Kong into uncharted waters. It has been acknowledged that at least part of the deficit may be structural rather than cyclical in nature. Although official projections suggest that the combination of cyclical recovery and disciplined containment of Government spending should restore fiscal balance in due course, scepticism is understandable; this is an extraordinarily difficult field for forecasters, since the balance is the difference between two very large numbers, each comprised of many varied components. The air of uncertainty gives rise to rumours – of sweeping expenditure cuts, of asset sales, of new taxes, of higher tax rates or whatever – and to fears that Hong Kong may not be able to preserve its distinctive edge as a place with an uncomplicated tax system and low rates of tax.

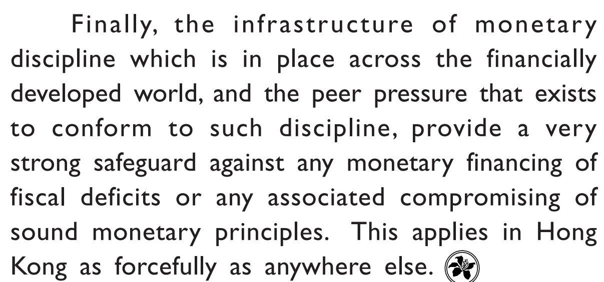
Concerns which arise under any of the above headings may find expression through the financial markets.

Conclusions

What can one conclude from all of this?

First, a number of reasons have been enumerated as to why fiscal deficits may be a worry, both for economies generally and for Hong Kong in particular. There can be no doubt that Hong Kong's fiscal position is a matter for concern, but monetary factors should not necessarily be paramount to that concern.

Secondly, and in the same broad context, one should beware of simplistic assertions or hypotheses about the monetary implications or, more specifically, the exchange rate implications of fiscal deficits.



Finally, the infrastructure of monetary discipline which is in place across the financially developed world, and the peer pressure that exists to conform to such discipline, provide a very strong safeguard against any monetary financing of fiscal deficits or any associated compromising of sound monetary principles. This applies in Hong Kong as forcefully as anywhere else.