

Fiscal Policy Coordination in a Monetary Union?

A project proposal

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Description of project

With the formation of the EMU, several EU countries have effectively closed a channel for potential stabilization of cyclical fluctuations, namely that of independent monetary policies. Taking the benefits of monetary unification as granted, this nevertheless raises the question of whether other policy measures can replace the flexibility lost?

A natural candidate is cyclical fiscal policies, which is (still) under the auspices of the national governments in the EMU area.¹ In the advent of an asymmetric shock hitting a member country, a common monetary policy response is clearly not suitable. Instead, some national discretionary fiscal policy action could be warranted. However, in a highly integrated economic environment, national fiscal policies are likely to have spill-overs on other countries. This begs the question whether some form of fiscal coordination is useful in order to internalize the externalities associated with unilateral policy measures? It is the main objective of this project to shed light on this question.

An extensive amount of work has now been done on optimal monetary policy in micro-founded models with sticky prices, see, e.g., Woodford (2003) for the canonical closed-economy model and Benigno (2004) for a two-country monetary union version. The literature, however, has so far paid little attention to the role of cyclical fiscal policy in multi-country models and on how monetary and fiscal policy interact in the stabilization of shocks. Recent work by Beetsma and Jensen (2004a,b) has tried to fill this gap by extending the model of Benigno (2004) to include discretionary public spending. The overall findings are that the optimal policy mix is one where monetary policy deals with symmetric shocks, and fiscal policies are confined to addressing asymmetric shocks. Moreover, it is found that the gains from active fiscal policy are quantitatively non-negligible.

A drawback of the analyses in Beetsma and Jensen is that the issue of fiscal policy coordination is not considered. Instead, the analyses contain a characterization of the optimal policy mix, in the sense that monetary and fiscal policies are conducted at a supranational level (and, thus, by definition are conducted cooperatively). While a useful benchmark, this does not constitute an adequate picture of current conditions in Europe.

It is therefore the aim of the project to extend the analyses of Beetsma and Jensen, so as to compare the optimal policies under a situation of non-coordinated fiscal policies with that of the case of coordinated policies. This should subsequently facilitate an evaluation of the (potential) gains from a more coordinated cyclical policy stance within the EMU.

¹ Assuming that there will be no conflict with the structural rules laid out in the Stability and Growth Pact, to the extent that these are still relevant constraints on policymaking.

I plan to carry out the project in collaboration with Roel M.W.J. Beetsma (University of Amsterdam) and Morten Spange (Bank of England).

Method

To provide meaningful estimates of the welfare consequences of various fiscal policy regimes, it is the intention of applying micro-founded dynamic general equilibrium models of a monetary union, which, as indicated above, are much in the spirit of Beetsma and Jensen (2004a,b). In such models, the general description of economic behavior as well as welfare measures are approximated appropriately by Taylor expansions (facilitating solutions with available numerical methods), and the structural parameters (i.e., the policy regime invariant parameters) are calibrated based on available empirical studies, e.g., on consumption and pricing decisions in the Euro area.² Robustness checks are of essence, so a host of sensitivity analysis will be an integral part of the analysis.

Policy relevance

Recent research (including that of my own with Beetsma) does not provide firmly founded estimates of the potential gains of increased fiscal policy coordination within the Euro area. That research “only” seeks to quantify some gains of active fiscal policy, but leaves moot the issue of whether the gains are accruing due to coordinated policy action. This issue can, of course, only be settled if one examines gains from fiscal policy coordination *per se*. From a policy perspective, the results from such an analysis would be most welcome input into the current policy debates on how to conduct fiscal policy in a monetary union. A debate covering opinions all over the spectrum. E.g., in the presidency conclusions of the Barcelona 2002 European Council meetings, it was stated that “There is a need, therefore, to make further progress to . . . reinforce existing economic, in particular fiscal, policy co-ordination mechanisms within the Eurogroup”³ On the other hand, in a statement by the Advisory Board to the Federal Ministry of Finance in Germany (August 2002), a more pessimistic view towards coordination is put forward, and one conclusion reads: “Anyone who makes proposals supporting increased coordination of anti-cyclical fiscal policy in Europe . . . must be able to prove . . . that the benefits of these measures outweigh the associated costs.”⁴

If results turn out to show little gains of fiscal policy coordination, this will be supportive of the current policy mode of mostly uncoordinated policies, whereas the opposite could provoke a rethinking of how cyclical fiscal policies should be designed among EMU member states (and potential future newcomers).

² As an aside, it should be mentioned that the approximation approach is non-trivial in the case of coordination versus non-coordination. Hence, some pure methodological progress could also result from the project. On this issue, in models featuring monetary policy coordination, see, e.g., Benigno and Benigno (2004) and Sutherland (2004). See Benigno and Woodford (2004) on approximation methods and optimal monetary policy generally in micro-founded models.

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<http://europa.eu.int/rapid/pressReleasesAction.do?reference=PRES/02/930&format=HTML&aged=0&language=EN&guiLanguage=en>

⁴ <http://eng.bundesfinanzministerium.de/Anlage19627/Increased-coordination-of-anti-cyclical-fiscal-policy-in-Europe.pdf>

Expected duration of project and publication plans

It is estimated that the project will last around four months, and the aim is that it will result in a research article suitable for publication in an international refereed journal (such as, e.g., *Journal of International Economics*)

References

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