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The macroeconomic policy mix in a monetary union with flexible inflation targeting

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Abstract

Policy mix problems may arise in a monetary union with centralized monetary policy and decentralized fiscal policy. A consequence of this may be an inappropriate stabilization of shocks. This paper addresses how policy coordination problems between fiscal authorities depend on the type of shocks and the objectives of the monetary authority. It is shown that non-coordinated fiscal policies tend to be too counter-cyclical in the case of aggregate shocks, and that this bias can be reduced by lowering the weight to output stability in monetary policy. Oppositely, for country-specific shocks non-coordinated fiscal policies tend to be too pro-cyclical, and this bias can be reduced by increasing the weight to output stability in monetary policy. Considering the assignment of policy tasks – within the set of binding policy rules for fiscal and monetary policies – it is found that flexible inflation targeting dominates strict inflation targeting.

JEL classification: E52; E58; E61; E62; E63

Keywords: EMU; Policy mix; Shocks and policy cooperation

1. Introduction

The European Monetary Union has a centralized monetary policy and a decentralized fiscal policy. A recurrent issue is whether this decision structure leads to systematic problems with the macroeconomic policy mix, that is, would there be a tendency that monetary and fiscal policies are in conflict seen relative to the business cycle situation?

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Although the sample period is short, the available evidence for the EMU seems to indicate a tendency towards policy mix problems in the sense that the macroeconomic policy stance is characterized by an expansionary fiscal policy and a contractionary monetary policy (1998, 2000) or the reverse (1999, 2003), see e.g., European Commission (2004).[1] Interestingly, similar problems have not arisen for the US. It is an open question whether this difference is robust and whether the difference between the EMU and the US can be attributed to a difference between decentralized and centralized fiscal policy or different monetary policy objectives.

A growing literature has analyzed possible policy mix problems in the EMU (see e.g., Beetsma and Bovenberg, 1998, 1999; Beetsma et al., 2001; Dixit, 2001; Dixit and Lambertini, 2000, 2001; Uhlig, 2003). The primary focus has been on the role of sequencing between monetary and fiscal policies' decisions, i.e. the importance of whether fiscal policy decisions are made before or after monetary policy decisions. However, the current situation in the EMU can be interpreted as one where the monetary strategy is made clear (The Maastricht assignment, cf. e.g., Buti and van den Noord, 2004) and where fiscal decisions precede monetary policy decisions. The open question is which problems this structure leaves with respect to stabilization of various types of shocks.

A first step[2] in addressing this question is taken by Leitemo (2004), who considers how inflation targeting affects fiscal policy making in an open economy model with a trade-off between activity and inflation, a flexible exchange rate and fiscal policy affecting aggregate demand. If the fiscal authority perceives the monetary policy rule (the Stackelberg case),[3] no policy mix problem arises, since the fiscal authorities realize that monetary policy pins down the output level.[4] Note that it is a model property that the inflation targeted depends only on output. The intuition for the above-mentioned result is thus that inflation targeting works as a constraint on fiscal policy, making it more difficult for the fiscal authority to pursue an employment target in excess of the equilibrium level.

Decentralized fiscal policy is introduced in a similar framework by Sveen (2001),[5] by "splitting" the domestic economy in two fiscal jurisdictions, and allowing for idiosyncratic shocks to output in these areas. When fiscal authorities are in a leader role vis-à-vis the monetary authority (i.e. monetary rule known = inflation targeting), the non-cooperative case tends to produce a stabilization bias.[6] The bias arises since the fiscal policy response to idiosyncratic shocks is too weak compared to the cooperative case because the single fiscal authority does not take into account that the shock via traditional international interdependencies affects other countries.

[1] In 2001 and 2004, fiscal and monetary policies were loosened.

[2] Dixit (2001) and Dixit and Lambertini (2000) also discuss the implications of decentralized fiscal policy in a monetary union, but focus on situations where fiscal authorities do not take the monetary policy reaction into account, that is, monetary policy retains its discretionary power.

[3] If the fiscal authority does not perceive the monetary rule, but takes monetary policy as given, a policy mix problem arises in the presence of a conflict over output goals – monetary policy tends to be too contractionary, and fiscal policy too expansionary – in this case, an argument can be made for restricting flexibility in fiscal policy. This result is related to the findings in Dixit (2001) and Dixit and Lambertini (2000, 2001).

[4] There is a so-called state contingency in fiscal policy (see Svensson (1997)) since the fiscal stance depends on the realization of the inflation measure targeted, provided the fiscal authorities are concerned about not only stabilization of output, but also exchange rates and interest rates.

[5] There is still a passive "outside"country.

[6] There is a state-contingent bias in the aggregate fiscal stance, which is positively increasing in the inflation measure targeted. However, since expected inflation is zero, there is no systematic bias in the aggregate fiscal stance.