

# Government deficits, wealth effects and the price level in an optimizing euro-model<sup>☆</sup>

Barbara Annicchiarico<sup>\*</sup>

*Department of Economics, University of Rome "Tor Vergata", Via Columbia 2, 00133 Roma, Italy*

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## Abstract

In the context of the current policy debate on the reform of European fiscal rules, there is wide consensus on the need to place more attention on debt–GDP ratios. Proposals have been made to alleviate fiscal pressure on Member States with relatively low public debts. The present paper gives support to this view. Economies with high public debt–GDP ratios are shown to experience larger price deviations after a fiscal expansion. These results are derived in a model, calibrated to euro area quarterly data, with capital accumulation, flexible prices and wealth effects in the presence of an independent monetary authority.

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## 1. Introduction

The negative consequences of large government debt and deficits on inflation and the interrelations between fiscal and monetary policy are central issues in the macroeconomic policy debate. From the present debate, it emerges that the independence of the central bank is a necessary but not sufficient condition to ensure price stability. Unsustainable public finances may exert pressure on the monetary authorities to alleviate the burden of accumulated government

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<sup>\*</sup> Tel.: +39 0672595731; fax: +39 062020500.

E-mail address: [barbara.annicchiarico@uniroma2.it](mailto:barbara.annicchiarico@uniroma2.it).

debt. Given these interdependencies, there is a need for strong and enforceable fiscal rules to limit national budget deficits in order to guarantee an autonomous conduct of monetary policy. In a monetary union, these risks are exacerbated because of the problems of moral hazard that may arise. The negative consequences of individual members' unsound fiscal policies will affect all member states of the monetary union in terms of higher interest rates or a weaker currency.

The Maastricht Treaty and the Stability and Growth Pact (SGP) contain provisions for budgetary surveillance and coordination of EU Member States' fiscal policies. In particular, they provide an institutional framework to govern the interactions between monetary and fiscal policy in the euro area and impose explicit limitations on the size of public debt and deficits for each country.<sup>1</sup> However, the institutional framework has not succeed in enforcing a significant reduction of the debt level in most of the Member countries and has not prevented euro area countries to breach the 3% deficit ceiling.<sup>2</sup> The SGP has been reformed in early 2005, after long negotiations, in an attempt to deal more effectively with unsound fiscal scenarios.<sup>3</sup> The original framework has been changed, increasing flexibility of the provisions but still lacking an effective enforcement device.<sup>4</sup> The new fiscal guidelines place more attention on public debt sustainability, requiring that government debt ratios should diminish and approach the 60% reference value at a satisfactory pace and, at the same time, prescribing more favourable treatments for virtuous countries with debt ratios below the limit.

In the economic literature, it is well known that the conduct of a stability-oriented monetary policy is very much facilitated by sound fiscal policies. An established result, since the seminal contribution by [Sargent and Wallace \(1981\)](#), is that fiscal policy matters for price stability, since large deficits and increasing government debt may eventually force the central bank to issue money to ensure solvency. In an optimizing general equilibrium model, [Aiyagari and Gertler \(1985\)](#) study the inflationary effects of high current public deficits expected to be financed by future money creation. In a stochastic monetary model, [Leeper \(1991\)](#) shows that the effects of monetary policy on prices depend on the fiscal rule adopted by the government. More recently, following the contributions by [Woodford \(1994, 1995\)](#) and [Sims \(1994\)](#), the 'fiscal theory of the price level' (FTPL) has become increasingly popular in providing a theoretical framework able to identify the conditions under which fiscal policy alone determines inflation dynamics. The FTPL distinguishes between 'Ricardian' and 'non-Ricardian' fiscal regimes, in the terminology of [Woodford \(1995\)](#): in the first case, the nominal anchor is provided by monetary policy and the price level is determined in the money market, while in the second case fiscal policy serves as the nominal anchor and determines the price level. From this point of view, the FTPL shows how the time path of the price level is determined by the needs of fiscal solvency and provides a theoretical rationale supporting the idea that the respect

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<sup>1</sup> The Maastricht Treaty and the SGP state that the general government deficit should not exceed the 3% to GDP reference value and the debt to GDP ratio should be below 60%, or, if above, approach to that reference value at a satisfactory pace. In addition, EMU Member States are required to have medium-term objectives, which range from 1% deficit to close to balance or in surplus budgetary positions, depending on the country specific public debt ratio and potential growth.

<sup>2</sup> France and Germany have breached the 3% deficit limit for 3 years in a row. In 2005, Italy and Portugal reported deficit ratios well above the limit and their balance positions are expected to deteriorate in the future. Greece's recent fiscal developments do not adhere to its stability programme. See [European Commission \(2005a, 2005b\)](#).

<sup>3</sup> See [ECB \(2005\)](#) and [European Commission \(2005b\)](#) for details. For an insightful critical discussion on this issue, see [Eichengreen \(2005\)](#).

<sup>4</sup> The Governing Council of the ECB in an official statement declares itself "seriously concerned about the proposed changes" to the SGP ([ECB, 2005](#)).

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