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Monetary and fiscal interactions in open economies ☆

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Abstract

A two-country sticky-price model is used to analyse the interactions between fiscal and monetary policy. The role of an 'activist' fiscal policy as a stabilisation tool is considered and a measure of the welfare gains from international fiscal policy cooperation is derived. It is found that welfare gains from fiscal cooperation do exist provided monetary policy is set cooperatively. There are also welfare gains from fiscal policy cooperation in a monetary union. However, it is found that a 'non-activist' fiscal policy can be better than non-cooperative fiscal policy when the international correlation of shocks is strongly negative. And non-cooperative fiscal policy can be better than cooperative fiscal policy if monetary policy is not set cooperatively.

JEL classification: E52; E58; F42
Keywords: Fiscal and monetary policy; Policy coordination

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1. Introduction

This paper uses a two-country model to analyse the interactions between fiscal and monetary policy when these policies are used as tools of macroeconomic stabilisation. There are two main questions of interest. First is the extent to which there is a role for fiscal policy as a stabilisation tool and the extent to which this interacts with monetary policy. Second is the scope for welfare gains from international fiscal policy cooperation and the interaction between these gains and the monetary policy regime. The formation of a monetary union in Europe and the debate about the 'Stability and Growth Pact' make the analysis of fiscal and monetary interactions an especially interesting topic. It is often argued that the loss of monetary policy flexibility due to the merger of currencies increases the potential role of fiscal policy as a stabilisation tool and increases the need for fiscal policy cooperation within Europe. The issue of fiscal and monetary interaction also arises at the global level where concern about large fiscal and current account imbalances has added to the debate about policy coordination between the major world economies.

The appropriate role for monetary policy in a stochastic world has been a major topic of research in the last few years. Much attention has been focused on the welfare implications of monetary policy regimes, especially in cases where there is some degree of nominal rigidity. These welfare effects of monetary policy have also been an important topic in open economy research. In this context there has been extensive analysis of the role and scope for international monetary cooperation. The present paper is an attempt to build on this literature by incorporating a role for fiscal policy. [1]

There is obviously also an extensive existing literature which seeks to analyse the interaction between fiscal and monetary policy (see Chari and Kehoe, 1999). One issue which has received considerable attention is the way in which the government's budget constraint creates links between fiscal and monetary policy. [2] This issue is not addressed in this paper. Another focus of the existing literature is the methodological parallels between the analysis of optimal monetary policy and optimal taxation. The question addressed in this literature is the extent to which monetary policy can be viewed as a distortionary policy instrument which can be used to offset other structural or stochastic distortions. Viewed in another way this 'public finance' approach is beginning to tackle the interaction between monetary and fiscal policy as instruments of macroeconomic stabilisation (e.g. Correia et al., 2001).

[1] For closed economy models see Woodford (2003) and the references cited therein. In the context of stochastic open economy models, contributions to the modern theory of optimal monetary policy can be found in Obstfeld and Rogoff (1995, 1998, 2000, 2002), Corsetti and Pesenti (2001a,b), Devereux and Engel (2000), Benigno and Benigno (2001), Clarida et al. (2001) and Sutherland (2003). Canzoneri et al. (2002) highlight the contribution of the modern approach to international policy cooperation relative to the 'first generation' models. The latter are described in Canzoneri and Henderson (1991).

[2] This issue dates back at least to the 'Monetarist Arithmetic' of Sargent and Wallace (1981). Interest in this issues has re-emerged more recently thanks to contributions by Sims (1994), Woodford (2003, Chapter 5) and Buiter (2002) on the fiscal theory of the price level.