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Alternative monetary policies and fiscal regime in new EU members

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ABSTRACT

I investigate the relevance of a fiscal regime for disinflation in new EU member states (NMS). I generalize the framework of [Obstfeld, M., Rogoff, K., 1995. Exchange rate dynamics redux. *Journal of Political Economy* 103, 624–660] to incorporate the non-Ricardian fiscal regime and two monetary feedback rules: inflation targeting and depreciation targeting. Euro accession requires disinflation and stabilization of the exchange rate and thus restrictive monetary policy. The model illustrates that a sustainable and prudent fiscal policy is a necessary condition for successful stabilization of inflation. Thus, the lack of prudent fiscal policy, through its effects on inflation, may undermine the EMU accession of large NMS even when their fiscal outcomes fall within the Maastricht range.

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1. Introduction

Contrasting two alternative specifications of monetary policy feedback, I investigate the consequences of a fiscal regime for disinflation in the open economies of new member states (NMS) in the European Union (EU). In particular, I examine whether a temporary monetary contraction can cause higher inflation rates for a given fiscal regime and what constraints this imposes on the choice of fiscal regime during the process of euro adoption. Furthermore, I investigate whether a fiscal policy that

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delivers outcomes currently satisfying the Maastricht criteria can still be incompatible with the adoption of the euro. Unlike Woodford (1996) or Leeper (1991), who focus on closed economies, I use an open economy model to investigate policy interactions in very open NMS economies. In contrast to Daniel (2001), I include explicit fiscal and two alternative monetary feedback rules and simulate the model to study the dynamics. Finally, different from Devereux (2003), who also studies NMS, I consider a non-Ricardian fiscal arrangement.

When the fiscal authority is not credibly committed to paying outstanding debt in the future (a non-Ricardian fiscal regime), the monetary authority has to satisfy the government solvency constraint. In this environment, even monetary contraction leads to an increase in inflation due to wealth effects caused by changing debt. Based on the simulation results, I interpret the macroeconomic stabilization of the NMS that want to join the European Economic and Monetary Union (EMU). I specifically tailor the model to incorporate two possible monetary feedback mechanisms used in NMS: inflation targeting and depreciation targeting.

By joining the EU, the new Eastern European members agreed to adopt the common currency, the euro. Prior to the final fixing of exchange rates, they will have to participate in the Exchange Rate Mechanism (ERM II). This will seriously limit their ability to use monetary instruments and thus strengthen the temptation to rely on fiscal tools for responding to idiosyncratic shocks. However, fiscal expansion undermines the attempts of the central bank to stabilize inflation and thus the exchange rate. The frequently cited theoretical rationale for this conclusion is embedded in the Stackelberg leader interpretation of Sargent and Wallace (1981). They characterize the increase of government debt as a signal of future seigniorage/inflation tax collection which, due to the reaction of rational agents, accelerates current inflation. However, this interpretation cannot apply to countries that have explicitly declared an imminent transfer of monetary policy to the supra-national level.

Therefore, an alternative theoretical framework is employed: the fiscal theory of the price level.¹ The price level depends on aggregate government liabilities, thus the changes in public debt may determine the price level through their effects on wealth. As a result of increasing government debt, inflation may occur very quickly even if the central bank never changes seigniorage. In this case, the intertemporal government budget constraint is fulfilled by inflation-induced changes in the real value of assets. It is thus possible that monetary contraction, by raising the interest rate and consequently escalating accumulation of public debt, causes higher inflation.

I compare the results of monetary tightening under two alternative specifications of monetary policy found in NMS: inflation targeting (large NMS) and depreciation targeting (small NMS participating in the ERM II). Simulations show that a compatible and sustainable fiscal policy is a necessary condition for successful stabilization of both inflation and exchange rates regardless of the specification of monetary feedback. Such a fiscal policy is therefore a necessary condition for successful accession to the EMU. This remains valid even for countries with fiscal outcomes currently in line with the Maastricht limits. Unless their fiscal stance is prudent and sustainable, they will not be able to reduce and stabilize inflation. Indeed, as shown below, even a monetary contraction may be associated with an increase in inflation for economies without a prudent fiscal policy.

The structure of the paper is as follows: After providing some stylized facts on inflation and fiscal outcomes in Section 2, I discuss the model and the intertemporal budget constraint. The policy feedback for both monetary and fiscal policy is given in Section 4. In Section 5, I present and discuss the simulation results.

2. Fiscal outcomes and inflation in NMS: selected stylized facts

Full membership in the EMU requires NMS to meet the Maastricht criteria.² In pursuit of this goal, the central banks of the large NMS (Czech Republic, Hungary, and Poland) adopted explicit inflation

¹ The literature on the fiscal theory includes Bergin (2000), Daniel (2001), Leeper (1991, 1993), Sims (1994, 1999), Woodford (1994, 1996, 2003), and many others. Buiter (2002), Kocherlakota and Phelan (1999) and McCallum (2001) express skepticism about the implications of the theory for the equilibrium selection.

² The limit for the budget deficit is set at 3% of GDP, and for the public debt at 60% of GDP. Additionally, the inflation rate has to be within a 1.5% band of the three lowest countries, and the long-term interest rate within a 1% band of the lowest three countries. The new EMU candidates need to participate in ERM II for at least 2 years.

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