Fiscal Policy Coordination in a Monetary Union at the Zero Lower Bound

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Key question

In the aftermath of the 2008 financial crisis, facing high ratios of public debt to GDP and depressed outputs, Euro Area governments were led to a trade-off between debt-reducing and growth-supporting fiscal policies and had opted for fiscal consolidation. Fiscal policy in one country of the Euro Area may affect the other countries, according to the monetary policy reaction. The article analyzes, in a monetary union, the influence of a Zero Lower Bound (ZLB) on nominal interest on the impact of fiscal policies. It also explores under which conditions fiscal coordination is desirable and sustainable in a monetary union.

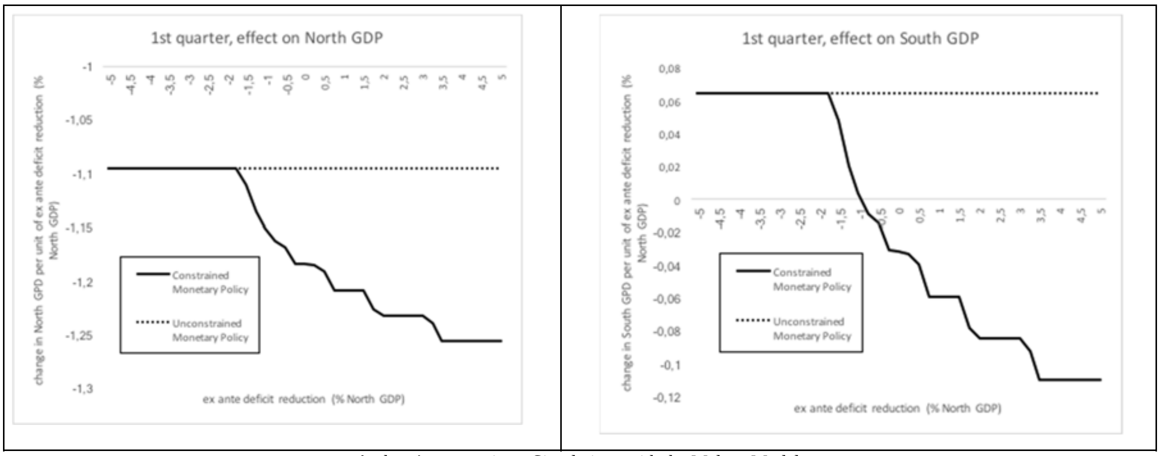
Methodology

A two-region (‘North’ and ‘South’) Dynamic Stochastic General Equilibrium (DSGE) model of the Euro monetary union is calibrated to replicate the economic conditions prevailing at the end of 2012. Based on this model, fiscal multipliers of spending-based and VAT-based consolidations are calculated. Once a policy objective function is set for each national Government, weighting between the gains from increased output and those from reduced deficit, the optimal coordinated union-wide spending policy in the monetary union is compared with the Nash non-cooperative equilibrium.

Main results

- At the ZLB (when the monetary policy is constrained), a fiscal consolidation has larger multiplier than out of the ZLB (when the monetary policy is unconstrained): for instance, at the ZLB, a 1% of GDP spending-based consolidation induces a 1.2% decrease in activity during the first quarter, compared with a 1.1% decrease in activity outside the ZLB. The larger the consolidation, the larger the multiplier effect will be at the ZLB. Spillover effects on the other region are larger at the ZLB than outside. Besides, they vary from 5 to 10% of the initial shock size and can reach up to 40% for VAT-based consolidations.
- National and union-wide objectives are more closely related at the ZLB. When the monetary policy hit the ZLB in 2012 in the Euro Area, the optimal coordinated spending policy would have required a fiscal stimulus in the North – an increase in the *ex ante* deficit by 0.3% of GDP – and a consolidation in the South – a cut of public spending by 0.3% of GDP.
- If the monetary policy had not been constrained, the optimal coordinated spending policy would have led to stronger consolidations (a decrease in spending of 2% of GDP in both regions).

Impact of a spending-based consolidation in the North on North and South GDP



Authors’computations. Simulations with the Meleze Model.

Main message

These results suggest that, in a constrained monetary environment (as experienced until recently), gains from cooperation are low, thus weakening the rationale behind external fiscal rules such as the Stability and Growth Pact. However, the results also imply that as monetary policy normalizes, gains from cooperation will jump. This article therefore calls for additional investigations on the conduct of fiscal policy and on the design of fiscal rules in a monetary union.

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