FISCAL AND MONETARY POLICY IN THE EUROZONE

Praise for *Fiscal and Monetary Policy in the Eurozone*

"Canale and Mirdala guide us through the world of policy and modeling explanations concerning developments in the Eurozone…. This well-written book provides coverage of a number of important issues and techniques treated in a refined didactic manner."

– Julius Horvath, Central European University, Hungary

"This book is useful both for readers interested in the euro area and those interested in the theoretical foundations of economic policies. This double perspective is rarely present in a single book."

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"(This book) addresses the needs of the Eurozone for alternative and pragmatic approaches to theoretical inquiry and policy making in a manner not typically found in other publications."

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"This book is an important contribution to the discussion of the most advances regional integration project on the planet."

– Martina Metzger, Berlin School of Economics and Law, Germany

"This book will be of much interest to students, scholars, and policy makers interested in understanding the fundamental origins of the euro-area crisis."

– Sergio Rossi, University of Fribourg, Switzerland

"*Fiscal and Monetary Policy in the Eurozone* by Rorita Canale and Rajmund Mirdala is an in-depth and useful text…. The book represents a valuable contribution to the analysis and the economic policy debate regarding the Eurozone."

– Daniele Schiliro, University of Messina, Italy

"*Fiscal and Monetary Policy in the Eurozone: Theoretical Concepts and Empirical Evidence* provides a complete and lucid narrative of the fiscal and monetary policy in the Eurozone."

– Yaya Sissoko, Indiana University of Pennsylvania, USA

FISCAL AND MONETARY POLICY IN THE EUROZONE: THEORETICAL CONCEPTS AND EMPIRICAL EVIDENCE

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Preface

This book was born from the intention to present in a different light and in a systematic way the institutional structure that regulates economic policy in the European Monetary Union.

The view is shared by both authors, which, despite belonging to different countries and with different personal experiences in respect to the Eurozone institutional consolidation process, found themselves convinced that it was necessary to make explicit the connection between the evolution of the economic theory and the path of construction of the European Monetary Union. The underlying idea is that the rules that determine its functioning are the result of the evolution of economic theory in light of historical facts and that it is essential to understand their meaning in terms of policy proposals. As the Keynesian approach revealed to be inadequate to interpret the facts after the 1970s, now the consolidated new neoclassical synthesis approach appears to be unable to solve the asymmetries inside the Eurozone without questioning the existence of the whole currency area. This approach provides a new perspective from which to examine the current Eurozone policy equilibria and, in the light of current crisis, calls for new answers in terms of policy prescriptions.

The authors would like to thank their families: someone would think that without their presence the book would have been written more quickly. However, they know that in the absence of those affections, they would not have had the necessary strength to carry out the project.

This book is dedicated to Rorita's family – Francesco, Anna, and Benedetta and Rajmund's family – Paulina and Ivana.

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Introduction

Subject and Approach

This book provides a theoretical and empirical reconstruction of economic paradigms that led to the present institutional framework of the Eurozone. Its attempts to merge the evolution of the theory with the changes in facts and presents the competing economic paradigms in the awareness that economic policy theory cannot be evaluated separately from the historical context. Special attention is devoted to the policy framework of the so-called "macroeconomic consensus," which in the light of the events occurred after the crisis, appear to be unable to incorporate in their analysis the real and financial fragility of modern economies.

The 2007–2008 economic and financial crisis highlighted the flaws in both operational and institutional design of economic policy in the Eurozone. Severe recession and reduced macroeconomic performance followed by increasing deflationary pressures represented a reasonable challenge for both monetary authority (ECB) and fiscal authorities (national governments). However, reduced maneuverability of fiscal authorities (in some cases consequences of fiscal irresponsibility during "good times," unstable size of fiscal multipliers during the crisis period), as well as monetary authority (liquidity trap, ineffective transmission mechanism of monetary policy) together with reduced predictability of macroeconomic development (another wave of recession during 2012–2013) clearly raised doubts and uncertainty about suitability of ad hoc discretionary policies based on traditional theoretical or even empirically verified concepts or models heavily used in good times. Moreover, still persistent heterogeneity across Eurozone member countries recalled emphasis on policy coordination. Finally, considering that the single monetary policy cannot cater for heterogeneity across member countries of the monetary union, even more, in the low interest rate environment, increased role of fiscal policies in reducing negative effects of external and internal shocks on macroeconomic performance of the Eurozone was just generally expected. However, many empirical studies emphasize the existence of asynchronous features strongly embedded in the mix represented by uncoordinated national fiscal policies combined with single monetary policy that even increases heterogeneity among the Eurozone member countries and thus reduces the overall benefits of deeper economic integration. The book *Fiscal and Monetary Policy in the Eurozone* provides rigorous insights into the theoretical and empirical dimensions of

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fiscal and monetary policy in the Eurozone that contributed to the rise and deepening of the external and internal imbalances within the monetary union.

The Policy Framework in the Eurozone

In this chapter, the historical and theoretical evolution of the policy framework in Europe and Eurozone is presented chronologically starting from the abandonment of the Bretton Woods, via reviewing the crucial milestones of economic and monetary integration in Europe, and until the creation of the common currency area with its key institutional and policy framework. It starts from the early steps guided by the general principles of the Keynesian theory in open economies, goes through its revision that occurred after the 1970s and the fall of the Bretton Woods agreements, the creation of the European monetary system, and ends with a presentation of the theoretical underpinning that brought to the model on which the European monetary union was built on. The evolution of the economic theory is pieced together (from Keynesian economics through neoclassical synthesis until New Keynesian economics), in the light of the main historical and political facts occurred. A first insight about the flaws of the Eurozone policy framework is provided.

Fiscal Policy in the Eurozone

The second chapter presents the fiscal policy content and associated theoretical background considering its evolution that influenced the policy principles implemented from the end of World War II to the present. It shows how the theoretical foundations evolved, from the Keynesian theory according to which public expenditure was conceived as an instrument to sustain aggregate demand and achieve full employment, to the present theoretical framework in which, following the intertemporal approach, it has been downgraded to an external shock. The public debt issue is examined with the aim of explaining why sound public finance represents in the Eurozone a primary policy challenge.

The objective of the chapter is to delineate the policy framework as a result of the evolution of the economic theory in which the economic policy experienced a progressive reduction in its role in defining macroeconomic equilibrium. Fiscal policy goes from the Keynesian paradigm, whose core is the consumption theory of current income, until the New Neoclassical synthesis in which the intertemporal optimization strategy and rational expectations allow underling the distortive contribution of government intervention to macroeconomic equilibrium.

Monetary Policy in the Eurozone

Monetary policy goes from the complete accommodative conditions of the 1950s to the interest rate setting rule defined by the Taylor rule. The inflation targeting became the main central bank's strategy with the aim of stabilizing prices, and assure the convergence toward the rate of full employment. The events following the crisis caused a revision of these conclusions and brought back in the theoretical and empirical debate the role of economic policy, both in the short and in the long run. It will be shown that despite this changing path and the process of conclusion revisions, the institutional framework has not yet acquired these changes.

The role of money and monetary policy of the central bank in pursuing macroeconomic stability has significantly changed over the period since the end of World War II. Globalization, liberalization, integration, and transition processes generally shaped the crucial milestones of the macroeconomic development and substantial features of economic policy and its framework in Europe. Policy-driven changes together with a variety of exogenous shocks significantly affected the key features of macroeconomic environment on the European continent that fashioned the framework and design of monetary policies.

This chapter examines the key basis of the central bank's monetary policy on its way to pursue and preserve the internal and external stability of the purchasing power of money. Substantial elements of the monetary policy like objectives and strategies are not only generally introduced, but also critically discussed according to their accuracy, suitability, and reliability in the changing macroeconomic conditions. Brief overview of the Eurozone common monetary policy milestones and the past Eastern bloc countries experience with a variety of exchange rate regimes provides interesting empirical evidence on origins and implications of vital changes in the monetary policy conduction in Europe and the Eurozone.

Policy Coordination in the Eurozone

Chapter 4 is devoted to the issue of policy coordination inside the Eurozone: the fixed rules find their underpinning in the spillover effects associated with different debt and deficit levels inside a currency area. After having briefly recalled the meaning of fiscal and monetary policy coordination in the Keynesian and present paradigm, it describes the meaning of coordination inside the Eurozone: it emerges as a marked subordination of national fiscal policies to the objective of the common monetary policy that in terms of the common currency represents a stability of price level and interest rates in the Eurozone. This feature generates two main fragilities to which the entire Eurozone is exposed: the first deriving from the role assigned to financial markets and the second one linked to the presence of external imbalances. Some reflections about the need to build up common policy institutions as a mean to grant stability and growth in the Eurozone are provided. After the crisis, the compliance to rules translated into external and internal imbalances and the issue of coordination translated into a balance-of-payment crises issue. The chapter will present alternative theories behind these imbalances and the possible solutions to ever-increasing processes of divergence among countries belonging to the Eurozone. Finally, some reflections about possible future scenarios will be discussed.