

Budgetary Balances and Restrictions in the European Monetary Union

Thesis Abstract:

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By most accounts the European Monetary Union (EMU) has been a successful experiment in monetary integration, but one area of continued disagreement is the management of fiscal positions. Deficits across member states dramatically decreased in the decade preceding the formation of the EMU, but have subsequently worsened. In my first essay I empirically test whether this reversal is the result of increased fiscal intervention or fiscal fatigue. Joining a monetary union could lead to increased reliance on fiscal policy if shocks across the union are asymmetric or if the conduct of policy by the new central monetary authority is significantly different than that of the previous authority. Using long run restrictions on structural VARs (SVAR) to identify supply and demand shocks of EMU members, I find that structural shocks are sufficiently similar across the union. Fiscal and monetary reaction functions are estimated and impulse response functions are derived using timing restrictions on a panel SVAR. Using this estimation, I find that the conduct of stabilization policy has changed little since the formation of the EMU, and the change in the response of the monetary authority to fiscal shocks lessens the need for fiscal intervention. Fiscal movements on the other hand, have become more deficit biased since the advent of the EMU, indicating the existence of fiscal fatigue.

In my second essay I analyze how successful deficit restrictions have been in overcoming deficit biases and inducing changes to the structure of budgets across the EMU. I document legislated fiscal actions for three groups of EMU members with different budgetary performances in the run up to the EMU and beyond. Each country's budgetary actions are classified as structural, temporary, or mixed and the justification for such moves are recorded. I look at the timing and nature of budgetary actions used by the members of the EMU through the steps of monetary integration. The actual policies undertaken by the EMU members indicates that the existence of deficit rules has played an important role in inducing structural changes to budgets across the EMU. On the other hand, the numerical nature of the restrictions has been at best a blunt instrument in ensuring these structural changes and has often led to unsustainable temporary adjustments that detract from the structural changes that need to be made.

In my third essay I construct a two country DSGE model designed to capture the unique situation of the transition countries that were recently admitted into the EU and will eventually become members of the EMU. These countries are still in the process of catching up to their Western European counterparts. The catching up process, as well as the falling international risk premium once becoming a member of the EMU, often leads to productivity differences across sectors. The new member state is modeled with two sectors, tradable and non-tradable, where productivity differences across sectors lead to inflation through the Balassa-Samuelson effect, strong growth, and budget surpluses. Sustained budget surpluses are politically difficult to maintain, as constituents call for tax cuts or greater spending on social or investment programs. The EMU, on the other hand, has a commitment to keep inflation low and may ask new members to control inflation through counter-cyclical fiscal policy which would further increase surpluses. I use my model to analyze the effect of three different policy reactions to a productivity shock in the tradable sector and its resultant inflation and surplus: (1) no fiscal reaction to the productivity shock, (2) the EMU forces fiscal authority to restrict inflation with counter-cyclical policy, and (3) Fiscal authorities respond by reducing the surplus, leading to greater inflation. The utility levels of the EMU and the individual member are then compared in analyzing the outcomes of each policy reaction.