PhD THESIS ABSTRACT

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Fiscal Policy Coordination and Government Debt Deleveraging in the EMU

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Abstract

In Chapter 1 I explain my motivation for the topic and review some literature on Fiscal Policy Coordination in Currency Unions, in particular in the European Economic and Monetary Union (EMU). The EMU is a perfect case study for this key issue, which has been covered more and more by the recent literature. Fiscal Policy Coordination was initially discussed by the seminal article of ?, where one of the successful criteria of an Optimum Currency Area (OCA) was shown to be a risk-sharing system like fiscal transfers that redistribute money to areas adversely affected by shocks. This motivates the creation of a Fiscal Union inside a Currency Union like the EMU, and can be seen as an extreme case of Fiscal Policy Coordination. I also suggest some questions and avenues of research, which guide my work.

In Chapter 2 we build a Two-Country Open-Economy New-Keynesian DSGE model of a Currency Union to study the effects of fiscal policy coordination, by evaluating the stabilization properties of different degrees of fiscal policy coordination, in a setting where the union-wide monetary policy affects fiscal policies and viceversa, because of price rigidities and distortionary taxation. We calibrate the model to represent two groups of countries in the European Economic and Monetary Union and run numerical simulations of the model under a range of alternative shocks and under alternative scenarios for fiscal policy. We also compare welfare under the different scenarios, bringing to policy conclusions for the proper macroeconomic management of a Currency Union. We find that: a) coordinating fiscal policy, by targeting net exports rather than output, produces more stable dynamics, b) consolidating government budget constraints across countries and moving tax rates jointly provides greater stabilization, c) taxes on labour income are exponentially more distortionary than taxes on firm sales. Our policy prescriptions for the Eurozone are then to use fiscal policy to reduce international demand imbalances, either by stabilizing trade flows across countries or by creating some form of fiscal union or both, while avoiding the excessive use of labour taxes, in favour of sales taxes.

In Chapter 3 we build a Two-Country Open-Economy New-Keynesian DSGE model of a Currency Union with a debt-elastic government bond spread in an incomplete market setting, to study the effects of government debt deleveraging, by evaluating the stabilization properties of different deleveraging rules, in a setting where the union-wide monetary policy affects fiscal policies and viceversa, because of price rigidities and distortionary taxation. We calibrate the model to represent two groups of countries in the European Monetary Union and run numerical simulations under a range of alternative shocks and under alternative scenarios for government debt deleveraging. We also compare welfare under the different scenarios, bringing to policy conclusions for the proper government debt management in a Currency Union. We find that: a) backloading deleveraging or reducing its speed provides more stabilization to the economy, b) taxes are the instrument for deleveraging which stabilizes the economy the most, c) coordinating fiscal policy by targeting the net exports gap, instead of the output gap, increases volatility with incomplete markets, d) the joint movements of the fiscal instruments increases volatility with incomplete markets, although consolidating budget constraints might otherwise smooth distortions. Our policy prescriptions for the Eurozone are then to reduce the speed of deleveraging and to use taxes to achieve it, while reducing domestic demand imbalances and avoiding to form a fiscal union like the one we describe. Once financial markets are completely integrated though, these results are overturned.