Department of Economics

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The Policy Mix in a Monetary Union: Who Bears the Burden of Asymmetric Shocks' Stabilisation?

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Discussion Paper No. 2022-12

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Non-Technical Summary

- This paper explores the policy mix in a multi-country monetary union where the authorities involved (the common monetary authority and the national fiscal authorities) act strategically when facing various shocks (demand/supply; common/asymmetric).
- The paper tries to answer the question of who bears the burden of asymmetric shocks' stabilisation.
- Empirical evidence highlights the importance of asymmetric shocks as a form of heterogeneity in the Economic and Monetary Union (EMU) in Europe.
- However, the European Central Bank (ECB) does not react to shock asymmetries, but only to union-wide shocks; so, the stabilisation burden is shared by the national fiscal authorities in the Union.
- The paper utilises a mathematical model in reduced-from of an aggregate demand (AD) equation and a Philips curve (PC) relation, which shares some neo-Keynesian features, and assumes: (i) interconnections among countries in the union; (ii) a core/periphery set-up, in that a leader (core) country has an informational advantage over the peripheral countries; (iii) policy instruments (namely, the common nominal interest rate, set by the ECB, and government budgets, set by the national fiscal authorities) that are not perfect substitutes in the stabilisation process, in that they can have short-run supply-side effects, too; and (iv) a richer palette of shocks that can also capture the covid-19 pandemic.
- The main finding is that under the before-mentioned assumptions, asymmetric shocks between the core and the periphery in the union pass through at the union-wide macroeconomic variables, namely to the inflation rate and to the output gap; so, shock asymmetries matter, independent on union-wide effects.
- The logic is simple: The core/periphery set-up induces asymmetries in the fiscal reactions to country-specific shocks, which makes the union-wide fiscal stance non-neutral. Since the latter affects union-wide output gap and inflation, it induces a monetary reaction. If the policy instruments are not perfect substitutes in the stabilisation process, then the ECB cannot fully offset those asymmetries, hence asymmetric shocks pass through at the union level.
- The model simply shows that monetary policy reacts to shock asymmetries in the core/periphery set-up, but it does not succeed in matching the corresponding fiscal reactions, since the two policy instruments are not perfect substitutes.
- A first best would be some form of cooperation among the fiscal authorities, which is de facto excluded in a core/periphery set-up.
- A second best might be to establish a strategic regime of fiscal leadership, in which the national fiscal authorities lead the game against the monetary authority, especially under strong interconnections, since this is a form of implicit coordination; or inducing the national fiscal authorities to use policy instruments that directly affect inflation negatively, like taxes, production subsidies, or public investment, especially when there is a cost channel of monetary policy, since this works in favour of substitutability.

You can read the full paper here.